Macroeconomic outlook

Kuwait: Growth improving on projects and receding fiscal adjustment

> Nemr Kanafani
Head of Research
+965 2259 5365, nemrkanafani@nbk.com

Overview and outlook

- **Non-oil GDP is expected to see further recovery to 3.5-4% in 2018 and 2019 as capital spending ramps up and the consumer sector stabilizes.**
- **Fiscal deficit is seen largely steady in FY18/19 and FY19/20 with most of the fiscal adjustment behind us and oil prices stable.**
- **Inflation is expected to accelerate slightly on hikes in utility prices and dollar weakness, after easing in 2017 on cooler housing inflation.**
- **Credit growth remains robust, reflecting healthy project execution and comfortable liquidity.**
- **Stocks gained on the robust outlook and market's upgrade by FTSE.**

The economy continues to bounce back from a 2015 slowdown, which was induced by a fiscal adjustment in the wake of the decline in oil prices. Growth in non-oil activity is expected to have improved to 3.0% in 2017, with growth seen accelerating further to 3.5-4% in 2018 and 2019. The key driver has been capital spending, bolstered by the improving implementation of the government's National Development Plan. A shift toward a more gradual fiscal adjustment should also reduce the drag on growth while ensuring continued progress on reducing the fiscal shortfall.

Substantial fiscal buffers, including large foreign reserves and a relatively low fiscal breakeven oil price, provide Kuwait with significantly more space to move gradually on fiscal adjustment than some of its GCC neighbors. As a result, authorities are keen to maintain their commitment to their capital spending plans and to continue absorbing the bulk of Kuwaiti entrants into the labor market. At the same time, the government is pushing forward with needed structural reform in an effort to encourage the private sector to play a larger role in generating new jobs in the medium-to-long-term.

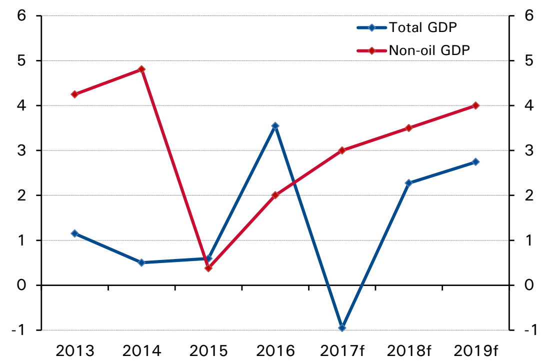
The outlook is not without its risks. Indeed, the robust growth outlook depends on a continued commitment to the projects pipeline and the ability by the various authorities to push that ahead despite bureaucratic and sometimes political resistance. Though we think this risk is low in the medium-term, it could certainly materialize. Meanwhile, though the probability of oil prices moving much lower from current levels has receded for now, it remains a distinct risk. While Kuwait would be able to sustain $20 oil for some time, such a scenario is certain to alter the

Table 1: Key economic indicators

		2016	2017f	2018f	2019f
Nominal GDP	KD bn	33.5	37.6	39.3	41.1
Nominal GDP	USD bn	111	124	130	136
Real GDP growth	% y/y	3.5	-1.0	2.3	2.7
Oil	% y/y	2.3	-4.5	1.1	1.5
Non-oil	% y/y	2.0	3.0	3.5	4.0
Inflation (average)	% y/y	3.5	1.6	2.2	2.8
Budget balance*	% of GDP	-17.7	-12.3	-12.7	-12.3

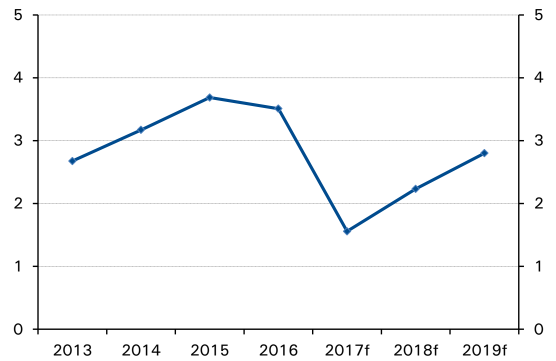
Source: CBK, MOF, CSB, NBK estimates; *after FGF

Chart 1: Real GDP growth
(%)



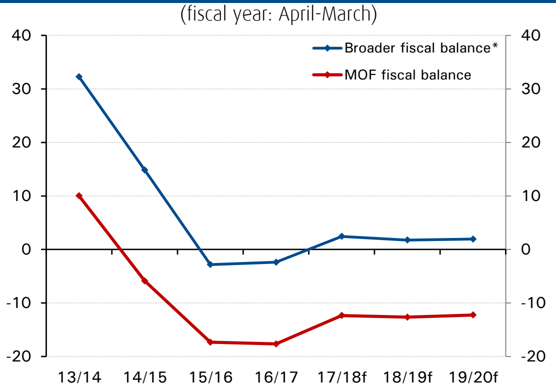
Source: Central Statistical Bureau, NBK estimates

Chart 2: Consumer price inflation
(%, annual average)



Source: Central Statistical Bureau, NBK estimates

Chart 3: Budget balance
(fiscal year: April-March)



Source: MOF, CSB, NBK estimates; *Before FGF transfer & incl. invest. inc.

government's fiscal policy and hurt sentiment, with the consequent impact on non-oil activity.

Non-oil growth to improve further in 2018 and 2019

After slowing in 2015, the pace of non-oil GDP growth improved to 2.0% in 2016. Non-oil growth had dropped to 0.4% in 2015, a figure which caught most analysts by surprise, including the IMF. The slowdown was largely a result of government spending cuts implemented in the wake of the mid-2014 decline in oil prices. Those cuts, which largely spared capital spending and the government wage bill, reduced spending excluding energy subsidies by 10% in FY15/16.

The fiscal adjustment has since been far smaller. There was still a decline in spending by around 2.9% in FY16/17, but outlays are expected to return to positive growth in FY17/18 and beyond. This shift to a more supportive fiscal stance should increasingly support non-oil growth in 2018 and 2019. That, combined with continued strength in project implementation and a recovering consumer sector, should help sustain non-oil growth at 3.5-4% in 2018 and in 2019.

Government project activity remains healthy

Over the last few years, an improved pace of capital spending has been a key driver of the non-oil economy. We feel that that momentum has been sustained and should continue to provide solid impetus to the economy through 2019 and possibly beyond. We estimate that over KD 28 billion worth of projects are likely to have been awarded during the last five years through the end of 2017. While the pace of project awards has slowed, the impact on growth is likely to be sustained in the medium term.

The projects pipeline remains solid, with the government still strongly committed to the ambitious capital spending program in the National Development Plan. The plan, as part of Kuwait Vision 2035, seeks to transform the country into a financial, cultural and trade leader and includes capital spending on infrastructure, housing, power and water, and the oil sector. Around a third of the spending is slated to come from public-private partnership (PPP) projects. Though progress on the PPP projects has been slow, it is expected to pick up.

Consumer sector bouncing back after slowdown

The consumer sector, long a robust and reliable source of growth, appears to be bouncing back after a period of slowdown. The sector was hit in 2015 and 2016 as a consequence of the decline in oil prices. This happened as households took a more cautious view, with the Ara consumer sentiment index falling to a low of 83 in September 2016. A year on and the index has improved significantly; the index hit 110 in September 2017 (Chart 5).

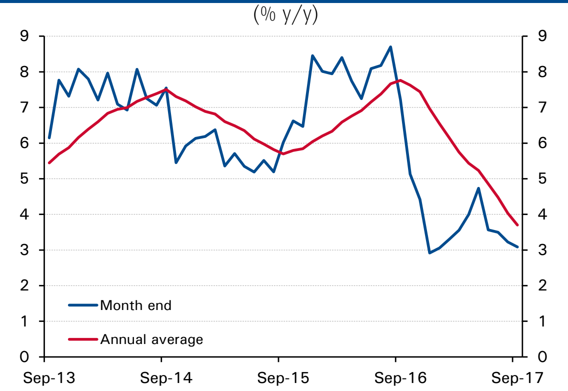
The consumer sector continues to be well supported by steady growth in employment and salaries, particularly in the government sector and among Kuwaiti households. Employment growth among Kuwaiti nationals remains relatively solid, with public sector employment growing by around 2% y/y through June 2017. Expatriate employment has slowed but remains healthy at 3.6% y/y.

Real estate market appears to be turning a corner

The real estate market has been showing evidence of improvement following more than two years of weakness. Sales for all sectors during the three months through October 2017 were up 33% y/y (Chart 6). Real estate prices also appear to have stabilized, after undergoing an orderly

Chart 4: Private credit growth

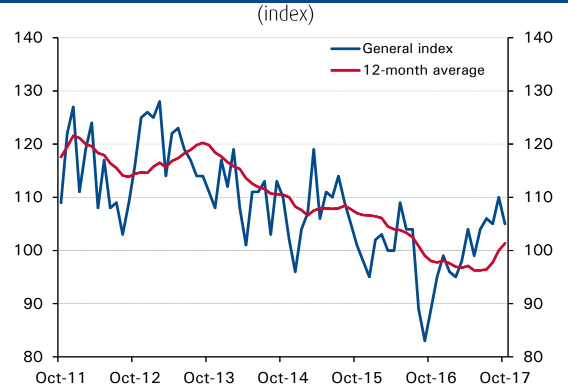
(% y/y)



Source: Central Bank of Kuwait

Chart 5: Consumer confidence index

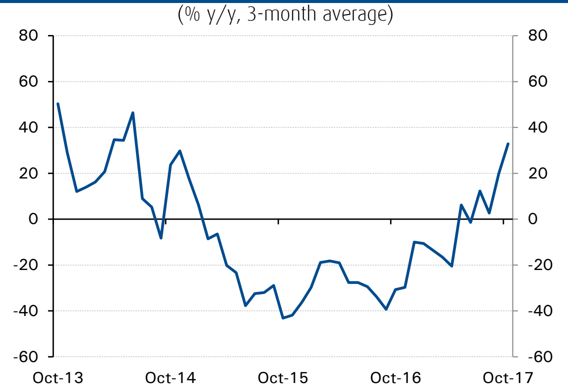
(index)



Source: Ara Research & Consultancy

Chart 6: Real estate sales

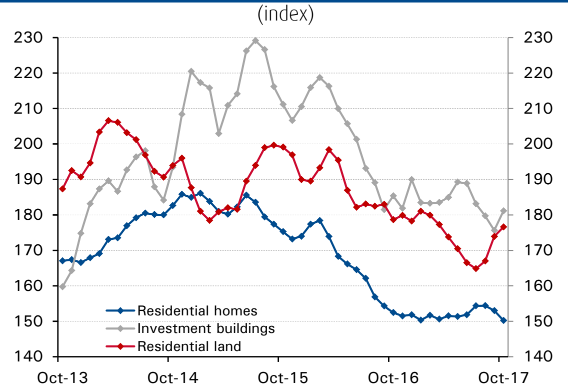
(% y/y, 3-month average)



Source: Ministry of Justice

Chart 7: Real estate prices

(index)



Source: Ministry of Justice, NBK estimates

15-20% correction since 2014 (Chart 7). NBK's real estate price indices now show prices down 1-6% from a year ago, compared to declines of 6-13% y/y at the end of 2016.

Inflation eased significantly in 2017 on weak housing rent

New revised statistics revealed significantly lower inflation in 2017. Inflation in October eased to 1.4% y/y, down from 2.6% y/y at the end of 2016 (Chart 4). The main source of softer price growth has been housing rent, which is now in deflationary territory with prices down 0.3% y/y. Base effects also explain the decline in inflation, especially as the fuel price hikes of September 2016 faded.

Going forward, inflation is expected to pick up pace. A moderately weaker US dollar, which implies a weaker dinar, is expected to put some upward pressure on prices in 2018. Also, the hike in utility prices taking place in stages in 2017 and early 2018 are expected to filter into the rest of consumer prices gradually in the coming year. Finally, we expect the value-added tax (VAT) to be introduced in 2019, impacting prices moderately then. As a result, average annual inflation is seen picking up from 1.6% in 2017 to 2.2% in 2018 and 2.8% in 2019.

Fiscal deficits will persist, but to remain manageable

The Ministry of Finance is expected to continue to register a deficit in the medium-term, even though oil prices have improved and despite some fiscal consolidation. We expect the price of Brent crude to average around $55 per barrel in 2018 and 2019, little changed from 2017. As a result, the fiscal balance is expected to register a deficit of 12-13% of GDP in FY18/19 and FY19/20 (Chart 3), after the mandatory allocation to the Future Generations Fund (FGF), a level that is largely in line with what we expect for FY17/18.

There was some good progress on fiscal consolidation during the first two years after the decline in oil prices, though we expect the pace will slow in the coming two years. The bulk of the progress came in the form of spending cuts. Expenditures were reduced by 15% and 3% in FY15/16 and FY16/17. Cuts in spending came from general belt-tightening in areas outside the wage bill and capital spending. They have also included cuts in subsidies, with fuel prices and utility rates seeing hikes.

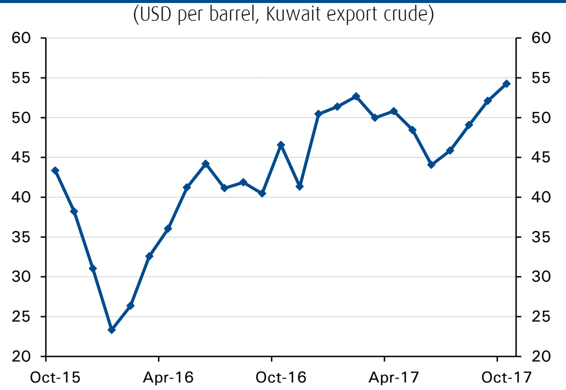
Spending is expected to return to positive growth in FY17/18 and beyond, with the government's focus shifting to the revenue side. Fiscal reforms include the introduction of a corporate income tax and a value added tax (VAT), though both are in early stages and have yet to receive legislative approval by the National Assembly (NA). There is a good chance that the VAT will be introduced in 2019, with the corporate earnings tax not likely before 2020. We estimate that these reforms together will boost non-oil revenues by around 2-3% of GDP by 2020.

Sovereign wealth fund remains substantial

A relatively prudent fiscal policy over the years has allowed Kuwait to amass one of the largest sovereign wealth funds (SWF) in the region. Kuwait's SWF is estimated to be worth around $560 billion or 450% of GDP as at the end of 2017, with the bulk of the assets held overseas. The assets are split between the Future Generations Fund (FGF) and the General Reserve Fund (GRF). The latter, whose holdings are mostly in liquid assets, is generally available to finance the deficit. Kuwait has continued to add to the FGF even as oil prices declined, at the expense of the GRF or increasing public debt.

Chart 8: Oil price

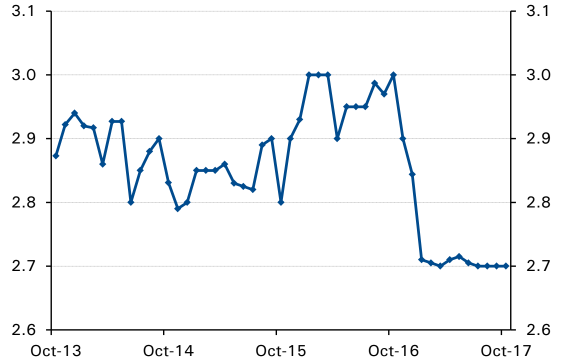
(USD per barrel, Kuwait export crude)



Source: Kuwait Petroleum Corporation

Chart 9: Crude oil production

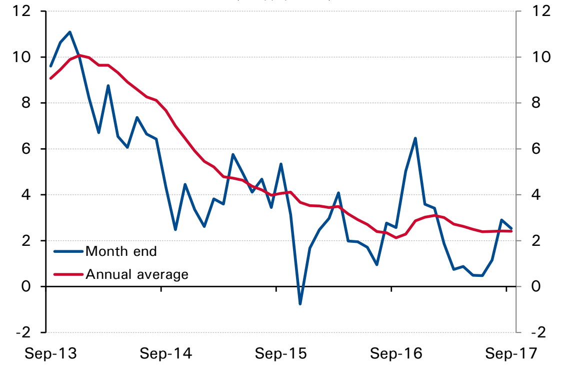
(million barrels per day)



Source: OPEC

Chart 10: Money supply growth

(% y/y, M2)



Source: Central Bank of Kuwait

Chart 11: Central bank foreign reserves

(months of imports)

Source: Central Bank of Kuwait, NBK estimates

Government tapped domestic and international bonds in FY16/17

Despite a large SWF, Kuwait has opted to also rely on debt to finance its deficit. Since April 2016, the government issued KD 3.6 billion in debt domestically and another KD 2.4 billion ($8 billion) internationally. This increased total debt to KD 7.1 billion or 20% of GDP as of the end of October 2017. Debt issuance has financed around two-thirds of the deficit since the April 2016.

Debt issuance has been on hold since September 2017 following the expiration of the law that allows the Ministry of Finance to issue debt. New legislation is being considered by the National Assembly which would renew the issuance mandate, double the sovereign borrowing ceiling to KD 20 billion and permit, for the first time, the issuance of 30 year debt. In the past, issuance was limited to tenors of up to 10 years.

Current account recorded its first deficit since liberation

After recording its first deficit in over two decades during 2016, the current account is expected to have swung back to surplus in 2017. A surplus of KD 0.6 billion was recorded in 2Q17, up from KD 0.4 billion in 1Q17. We expect a surplus in 2017 as a whole of around KD 1.9 billion or 5% of GDP after recording a deficit of 4.5% of GDP in 2016. The improvement has come largely on the back of a higher oil price, with the Kuwait crude oil price expected to have increased by more than 30% between 2016 and 2017.

However, after improving in 2017, the current account is expected to deteriorate slightly in 2018 and 2019. With oil prices expected to remain largely steady and continued growth in imports and worker remittances in tandem with growth in the non-oil economy, the current account surplus is seen shrinking to under 1% of GDP by 2019 (Chart 12).

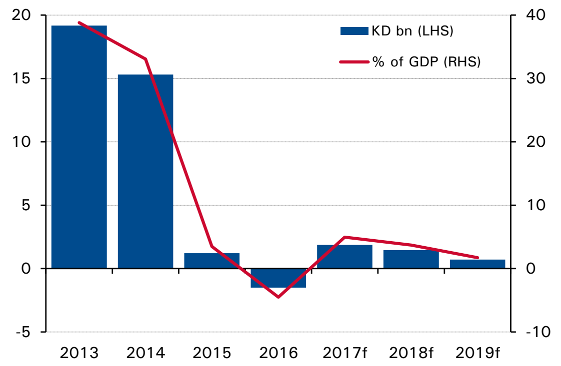
Dinar down in 2017 on dollar weakness

Following three years of gains, the Kuwaiti dinar (KWD) retreated during most of 2017. A weaker US dollar has seen the dinar decline by 3.7% in trade-weighted terms year-to-date (ytd) through October 2017. The Kuwaiti currency had gained around 3% a year in the three years between 2014 and 2016. The dinar, which is pegged to a basket dominated by the US dollar, has increased by 1.1% against the US currency since the start of this year (Chart 14).

Already good year for equities boosted further by FTSE upgrade

After rallying in late 2016 and early 2017, equities were again boosted in 3Q17 after FTSE Russell upgraded Kuwait's market to emerging market status. Recent catalysts also included interest by Omantel to acquire a sizeable stake in Kuwait's largest telecom provider Zain. Boursa Kuwait's value-weighted index (IXW) soared by 9.1% in 3Q17 (Chart 15). The index was up 10.5% year-to-date through October. Activity is also up in 2017, though the daily average value of shares traded has eased from peaks in January 2017.

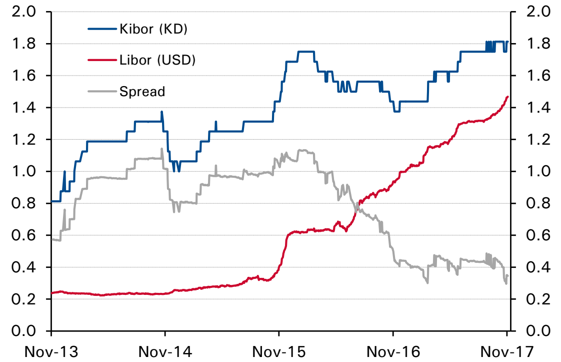
Chart 12: Current account balance



Source: Central Statistical Bureau, NBK estimates

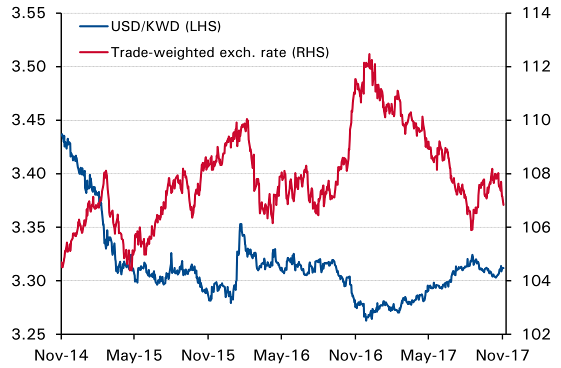
Chart 13: Interbank rates

(%, 3-month)



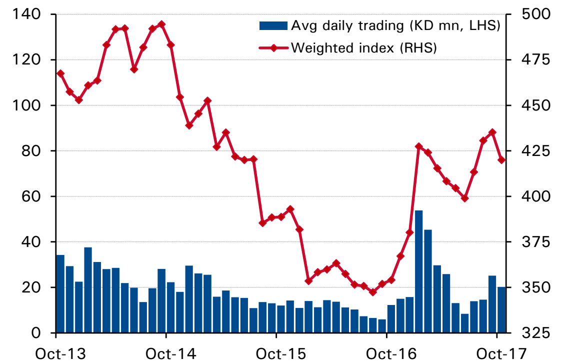
Source: Central Bank of Kuwait, Thomson Reuters Datastream

Chart 14: Exchange rate



Source: JP Morgan, Thomson Reuters Datastream

Chart 15: Stock market



Source: Boursa Kuwait, Thomson Reuters Datastream

Head Office

Kuwait
National Bank of Kuwait SAKP
Abdullah Al-Ahmed Street
P.O. Box 95, Safat 13001
Kuwait City, Kuwait
Tel: +965 2242 2011
Fax: +965 2259 5804
Telex: 22043-22451 NATBANK
www.nbk.com

International Network

Bahrain
National Bank of Kuwait SAKP
Zain Branch
Zain Tower, Building 401, Road 2806
Seef Area 428, P. O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

National Bank of Kuwait SAKP
Bahrain Head Office
GB Corp Tower
Block 346, Road 4626
Building 1411
P.O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

United Arab Emirates
National Bank of Kuwait SAKP
Dubai Branch
Latifa Tower, Sheikh Zayed Road
Next to Crown Plaza
P.O.Box 9293, Dubai, U.A.E
Tel: +971 4 3161600
Fax: +971 4 3888588

National Bank of Kuwait SAKP
Abu Dhabi Branch
Sheikh Rashed Bin Saeed
Al Maktoom, (Old Airport Road)
P.O.Box 113567,Abu Dhabi, U.A.E
Tel: +971 2 4199 555
Fax: +971 2 2222 477

Saudi Arabia
National Bank of Kuwait SAKP
Jeddah Branch
Al Khalidiah District,
Al Mukmal Tower, Jeddah
P.O Box: 15385 Jeddah 21444
Kingdom of Saudi Arabia
Tel: +966 2 603 6300
Fax: +966 2 603 6318

Jordan
National Bank of Kuwait SAKP
Amman Branch
Shareef Abdul Hamid Sharaf St
P.O. Box 941297, Shmeisani,
Amman 11194, Jordan
Tel: +962 6 580 0400
Fax: +962 6 580 0441

Lebanon
National Bank of Kuwait
(Lebanon) SAL
BAC Building, Justinien Street, Sanayeh
P.O. Box 11-5727, Riad El-Solh
Beirut 1107 2200, Lebanon
Tel: +961 1 759700
Fax: +961 1 747866

Iraq
Credit Bank of Iraq
Street 9, Building 187
Sadoon Street, District 102
P.O. Box 3420, Baghdad, Iraq
Tel: +964 1 7182198/7191944
+964 1 7188406/7171673
Fax: +964 1 7170156

Egypt
National Bank of Kuwait - Egypt
Plot 155, City Center, First Sector
5th Settlement, New Cairo
Egypt
Tel: +20 2 26149300
Fax: +20 2 26133978

United States of America
National Bank of Kuwait SAKP
New York Branch
299 Park Avenue
New York, NY 10171
USA
Tel: +1 212 303 9800
Fax: +1 212 319 8269

United Kingdom
National Bank of Kuwait
(International) Plc
Head Office
13 George Street
London W1U 3QJ
UK
Tel: +44 20 7224 2277
Fax: +44 20 7224 2101

National Bank of Kuwait
(International) Plc
Portman Square Branch
7 Portman Square
London W1H 6NA, UK
Tel: +44 20 7224 2277
Fax: +44 20 7486 3877

France
National Bank of Kuwait
(International) Plc
Paris Branch
90 Avenue des Champs-Elysees
75008 Paris
France
Tel: +33 1 5659 8600
Fax: +33 1 5659 8623

Singapore
National Bank of Kuwait SAKP
Singapore Branch
9 Raffles Place # 44-01
Republic Plaza
Singapore 048619
Tel: +65 6222 5348
Fax: +65 6224 5438

China
National Bank of Kuwait SAKP
Shanghai Representative Office
Suite 1003, 10th Floor, Azia Center
1233 Lujiazui Ring Road
Shanghai 200120, China
Tel: +86 21 6888 1092
Fax: +86 21 5047 1011

NBK Capital

Kuwait
NBK Capital
38th Floor, Arraya II Building, Block 6
Shuhada'a street, Sharq
PO Box 4950, Safat, 13050
Kuwait
Tel: +965 2224 6900
Fax: +965 2224 6904 / 5

United Arab Emirates
NBK Capital Limited - UAE
Precinct Building 3, Office 404
Dubai International Financial Center
Sheikh Zayed Road
P.O. Box 506506, Dubai
UAE
Tel: +971 4 365 2800
Fax: +971 4 365 2805

Associates

Turkey
Turkish Bank
Valikonagl CAD. 7
Nisantasi, P.O. Box. 34371
Istanbul, Turkey
Tel: +90 212 373 6373
Fax: +90 212 225 0353