

Non-oil growth seen at 3% in 2019, and fiscal position remains manageable

Highlights

- GDP growth will moderate to 2.2% next year from 2.9% in 2018 due to oil output cuts linked to OPEC policy.
- Non-oil growth is seen improving slightly to 3.0%, but longer-term growth potential would be improved by reforms.
- Project awards could pick up after a subdued 2018, while decent employment growth will support consumer spending.
- Having hit a 15-year low in November, inflation will see a mild pick-up to average 2.0% in 2019.
- The fiscal position will end up close to balance in FY2018/19 but deteriorate slightly next year on lower oil prices.
- Credit growth has picked up from its lows partly on account of solid growth in consumer lending.
- Relatively low interest rates should also benefit growth next year.

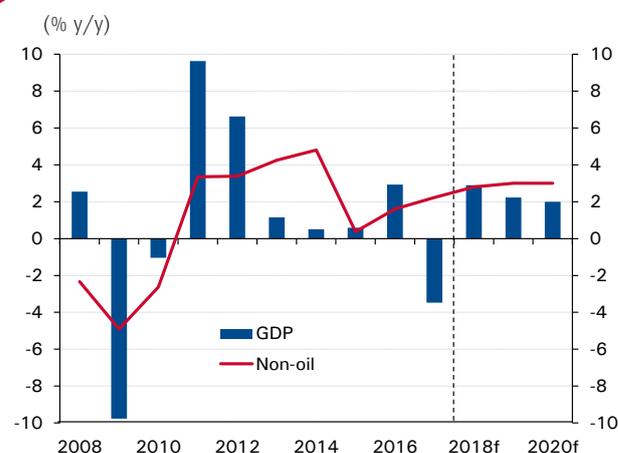
Economic performance has steadily improved over the past two years, and the outlook for growth remains broadly encouraging. The downgrade to our oil price forecast implies a weakening fiscal outlook, but with the budget now close to balance following a period of successful consolidation and government reserves still very large, we do not expect a major change in fiscal policy that would negatively affect growth. We also look for some pick-up in project activity in 2019, delays in which weighed on growth last year – as did slow credit growth and property market weakness, both of which may now be fading. This should help offset the impact of a weaker external environment and possible rises in interest rates over the next couple of years.

Growth to remain above 2% despite crude output cuts

After rebounding to an estimated 2.9% in 2018 due in particular to recovering oil output, GDP growth is set to ease to 2.2% in 2019. (Chart 1.) The moderation is entirely due to slower growth in oil GDP reflecting changes in OPEC+ strategy. Although country-level quotas have not been announced, we

assume that Kuwait's crude production falls by around 2% in 2019 from its October reference level of 2.76 mb/d, broadly in line with the proposed aggregate cut for the group overall. However the impact on oil GDP is more than offset by the continued rise in condensate output – not part of the OPEC agreement – which is projected to reach 0.18 mb/d in 2019 from 0.1 mb/d in 2018 (a further smaller rise is projected for 2020). Overall oil GDP therefore rises 1.5% in 2019 from 3.0% in 2018. Recent news suggests that an agreement may soon be struck with Saudi Arabia to restart production in the Neutral Zone. But any rise would likely be offset by a lowering of output from other mature fields such as Burgan.

▶ Chart 1: Real GDP



Source: Thomson Reuters Datastream / NBK estimates

▶ Table 1: Key economic indicators

		2017	2018f	2019f	2020f
Nominal GDP	USD bn	120	138	138	143
Real GDP	% y/y	-3.5	2.9	2.2	2.0
- Oil	% y/y	-7.2	3.0	1.5	1.0
- Non-oil	% y/y	2.2	2.8	3.0	3.0
Inflation	% y/y	1.5	0.6	2.0	2.5
Budget balance*	% of GDP	-9.0	-0.5	-1.0	-2.0

Source: Official sources, NBK estimates * Before RFFG transfers, financial year

Over the past two years the non-oil economy has experienced a mild cyclical upswing, but upward pressures are still not very strong. Non-oil growth is estimated to have risen to 2.8% in 2018 from 2.2% in 2017, and is forecast at 3.0% in 2019. The recovery in consumer spending that helped growth through 2017 may have peaked, though with inflation still low and employment growth steady, prospects remain reasonable. Meanwhile, despite lower oil prices, fiscal policy should remain broadly supportive, with capital spending forecast to continue to rise. The pick-up in business credit growth recently also suggests that private investment may be recovering, potentially helped by the central bank's decision to hike interest rates more slowly than the US Fed.

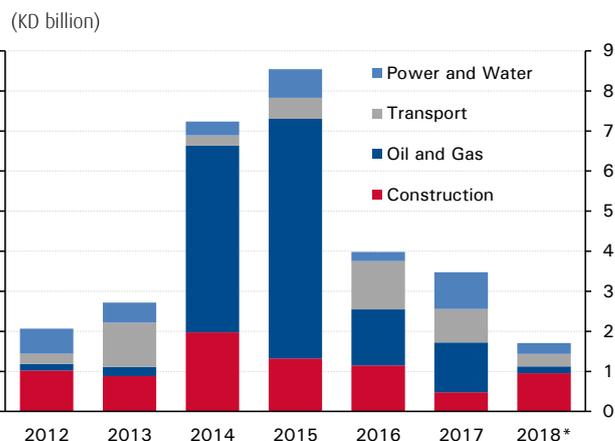
In the medium term, however, growth will remain constrained by the slow pace of reforms, a lack of economic diversification and a potential slowdown in global growth. The most serious challenge facing the government is arguably the employment situation, with the private sector recently accounting for only 15% of job growth for Kuwaiti nationals which is, in turn, pressuring the public sector wage bill. In addressing this, the government should focus on the skills mismatch and on measures to improve growth and the business climate, where the latest World Bank report shows that Kuwait continues to lag behind its Gulf peers. Political opposition to the government's agenda, which includes plans for the introduction of the VAT and excise tax as well as further fuel subsidy cuts and a new debt law, are slowing reforms.

Project awards to rise after disappointing 2018

A further reason for modest growth in 2018 was a reduced pace of project activity. This has been important in supporting growth in earlier years. Project awards had reached a disappointing KD 1.6 billion by early December 2018, less than half of the KD 4 billion expected at the beginning of the year, and significantly below the average of the last five years. (Chart 2.) The low level of awards was due to delays in the implementation of megaprojects such as the KAPP Al-Zour North IWPP and the KIPIC petrochemical complex. Further setbacks came from cancelled roadworks that were scheduled to take place in the 1st half of 2018. Restructuring of relevant government agencies (PART, KAPP) may have been at the root of the delays, among other factors.

With pressure increasing from parliament and the State Audit Bureau arising from the setbacks, and given the critical role key projects play in Kuwait's five-year (FY2015/16-2019/20) development plan and Vision 2035, awards are expected to pick up in 2019. The bulk of awards is expected to come from the power and water, oil and gas, and construction sectors, and will include rescheduled projects from 2018.

▶ **Chart 2: Awarded projects**



Source: MEED Projects * Reported up to early December

Consumer spending growth strong but easing

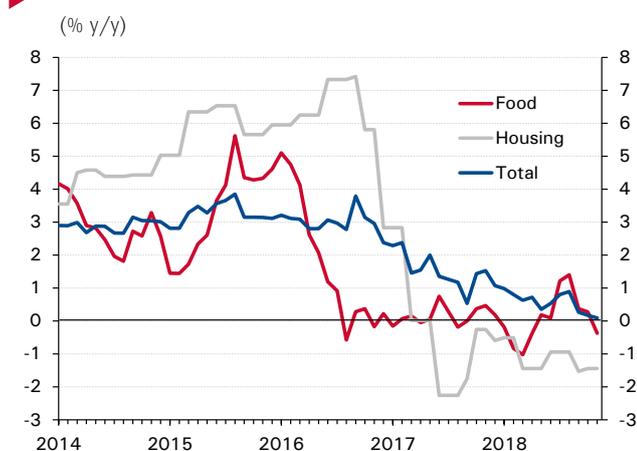
Accelerating consumer spending growth has played an important role in the recovery in the broader economy over the past two years, but there are signs that the improvement may be tapering off. Growth in ATM and POS transactions eased to 8.6% y/y in 3Q18, while growth in the NBK consumer spending index slowed to a one-year low of 4.1% y/y. However, inflation is low, and other fundamentals, such as employment and credit growth, remain reasonably strong, so any slowdown in spending seems unlikely to be sharp.

Encouragingly, employment growth appears to be gradually picking up, reaching 3.3% y/y in 2Q18 from 2.4% y/y in 4Q17. The shedding of expatriate jobs in the public sector, down 14% y/y in 2Q18 mainly due to Kuwaitization initiatives, has been more than offset by stronger growth in the private sector. But for Kuwaiti nationals, much of the rise in employment (around 85%) continues to come in the public sector, which will be difficult to sustain longer term. Another softer spot for the spending outlook is wage growth, which for Kuwaiti nationals (for whom data is available) has been anemic in recent quarters. This could in part reflect the low inflation environment, but also potentially poor productivity growth.

Inflation to pick up in 2019, but remain low

Inflation has come in even softer than expected in 2H18, and reached a 15-year low of just 0.1% y/y in November. (Chart 3.) Weakness continues to be driven by deflation in housing services (mostly rents), where price falls have intensified this year due to ongoing softness in the real estate market. Low rates of food price inflation – reflecting international food price trends – have also been a factor. But one measure of 'core' inflation, which excludes both of these items, also decelerated to 1.3% in November, half its rate of the end of last year.

► **Chart 3: CPI inflation**



Source: Thomson Reuters Datastream

We expect inflation to pick up next year to an average of 2.0% from a downwardly-revised 0.6% in 2018. But much of this rise reflects a rise in food and housing inflation after pronounced weakness in 2018. By contrast, core inflation will accelerate more modestly, to 2.2% from 1.9% in 2018, with most of the factors containing price pressures recently remaining in place. These include only moderate economic growth, the strong Kuwaiti dinar (reflecting the partial tie to the strong US dollar) bearing down on import prices, and the absence of planned subsidy cuts that pushed inflation higher in 2016 and 2017. We also do not expect the VAT to be introduced until 2021 at the earliest, while the impact of a proposed excise duty on tobacco and selected drinks would be modest.

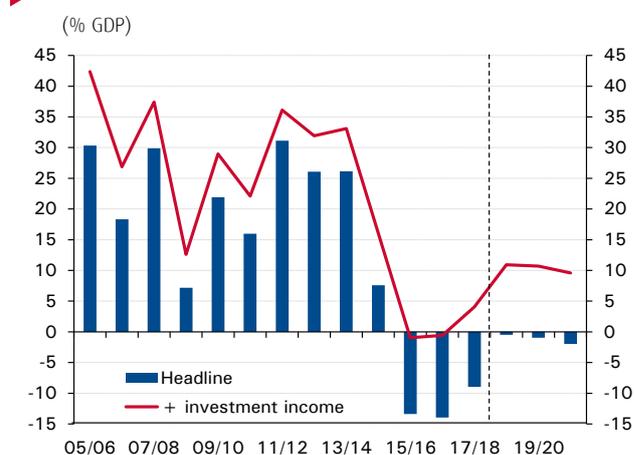
Fiscal position to finish close to balance in FY18/19

The past two years have seen a major improvement in the fiscal position, thanks to a combination of higher oil prices and spending restraint. The deficit narrowed to 9% of GDP in FY17/18 from nearly 14% of GDP a year earlier; this year a further narrowing to just 0.5% of GDP is forecast and a balanced budget, which would be the first in four years, cannot be ruled out. (Chart 4.) Despite a recent fall, oil revenues – worth 90% of the total – are projected to rise 27% in FY18/19 based upon an average price of Kuwait Export Crude of \$68/bbl, before slipping next year as oil prices fall back. Non-oil revenues are projected to see notable rises due to the resumption in 2018 of UNCC compensation payments.

The reduction in the deficit over the past two years has seen the government switch tack and boost spending to support the economy. After rising 9% last year, spending is projected to see another solid rise of 5% in FY18/19, boosted by some one-off factors but also higher transfer payments due to rising oil prices. This still leaves spending 6% below its FY14/15 peak due to large cuts in the intervening years. Expenditures are projected to fall back slightly in FY19/20 as the drop in oil

prices reduces transfer payments and as some of the one-off spending items drop out. This limits the impact of lower oil revenues on the deficit, which climbs to 1% of GDP.

► **Chart 4: Fiscal balance***



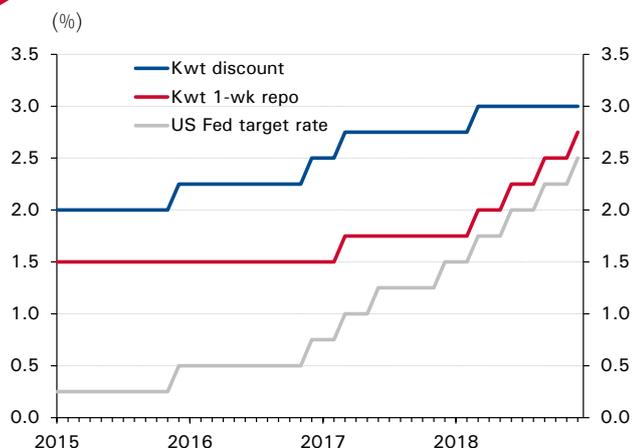
Source: Ministry of Finance / NBK * Before transfers to RFFG

Thanks to surpluses accumulated in previous years, the government's broader financial position remains very strong, with sovereign wealth fund assets estimated at nearly \$600 billion. Moreover, annual returns on these assets are worth up to 12% of GDP and not included in the headline fiscal accounts. These assets also underpin the government's very strong AA credit rating, which has been maintained in recent years. Nevertheless, the government's room for maneuver on fiscal policy in the near term is slightly more limited than these figures imply. General Reserve Fund assets, which are used to finance deficit shortfalls, had declined to \$88 billion at end-FY17/18, and could be depleted in a few years if the oil price weakens and if non-oil revenue-generating reforms are absent. Also, the government is unable to issue any further debt until the new debt law has been passed by parliament.

CBK maintains low interest rates to support growth

Monetary policy remains geared towards maintaining the dinar's peg to a basket of currencies dominated by the US dollar. Unlike some other GCC countries whose currencies are fixed to the dollar, the Central Bank of Kuwait (CBK) left its lending rate on hold at 3.0% in December following the 25 bps hike by the US Fed. (Chart 5.) The bank has now followed four out of the Fed's nine rate hikes during the current tightening cycle which began in 2015, though the repo rate, a benchmark for deposits, has risen more frequently. In keeping rates low, the bank is taking advantage of the flexibility provided by the peg to an exchange rate basket to support economic growth while using other monetary policy instruments to ensure the stability of the dinar. The CBK implied that banks can raise their deposit rates without changing lending rates, which are benchmarked to the discount rate.

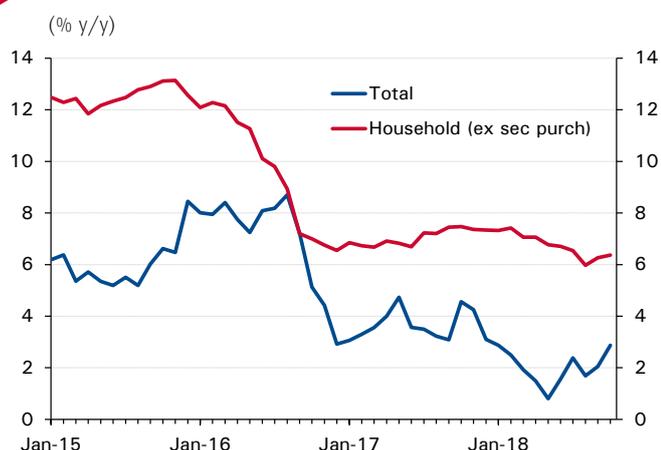
Chart 5: Policy interest rates



Source: Thomson Reuters Datastream / CBK

Following a rough start to 2018, credit growth is gradually recovering and reached 2.9% y/y in October from a low of 0.8% y/y in May. (Chart 6.) The improvement has been driven by a pick-up in business lending, helped by the unwinding of base effects (due to repayments in 2017) that have weighed on loan growth in that sector. Household lending has also picked up, and remains comparatively strong at 6.4% y/y. We expect credit growth to end 2018 at 4-5% y/y and to maintain that pace in 2019, supported by a pick-up in project awards. The CBK's relaxation of lending restrictions late in 2018 should boost household borrowing in 2019.

Chart 6: Bank credit



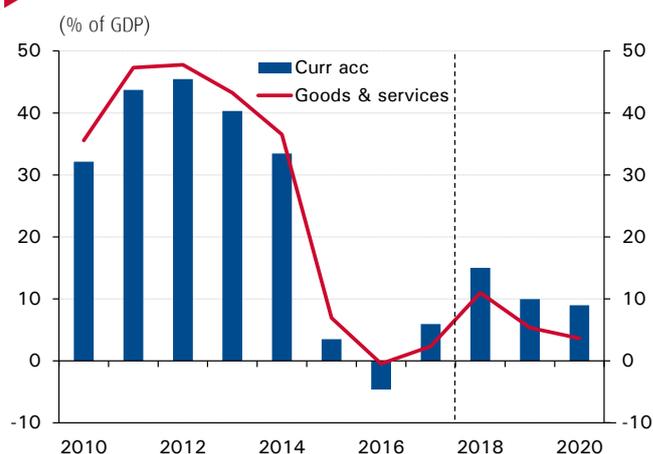
Source: Thomson Reuters Datastream / NBK

External position improving on higher oil prices

The current account has recovered after falling into deficit for the first time in modern history in 2016, and is forecast to record a surplus of 15% of GDP in 2018. (Chart 7.) The improvement was due to a 32% rise in oil exports driven by higher oil prices (oil receipts account for around 90% of all merchandise exports). Data for 1Q-3Q18 show goods imports up 10% y/y, boosted by imports of intermediate goods, but

imports of capital goods were weak at 2%. In 2019, the surplus is forecast to dip to 10% of GDP as the fall in oil prices lowers export revenues, but import growth is expected to remain reasonably solid. We note also that income from investment (mostly government) was worth a huge 16% of GDP in 2017, more than double the level of five years earlier.

Chart 7: Current account balance



Source: Thomson Reuters Datastream / NBK

The dinar had, by mid-December, edged lower year-to-date against the US dollar (USD), but risen 5% versus the euro and 6% against the British pound. These changes reflect movements in the USD, which has appreciated by more than 5% on a trade-weighted basis due to a combination of strong US economic growth and rising US interest rates. It also reflects some reversal of USD weakness from 2017, when it had fallen by 8%. On a five-year basis, the dinar is still up more than 10% against the euro due to the longer-term rise in the dollar.

Stock market sees heightened foreign interest in 2018

Boursa Kuwait performed relatively well in 2018 to end-November, supported by improved sentiment linked to continued market development efforts and inclusion in the FTSE Emerging Market index. Despite a drop in monthly trading volumes relative to previous years, 2018 has seen a record KD177 million of net capital inflows, helping the All Share price index gain 5.8% year-to-date – the GCC region's third best performer. Market capitalization stands at KD 29 billion. While volatile global markets, rising interest rates and the drop in oil prices in 4Q18 may weigh on market sentiment going forward, foreign interest will be helped by the second phase of inclusion in the FTSE EM index, scheduled for late December and also by a possible upgrade by MSCI in 2020 to be announced in June 2019. Moreover, the Ministry of Commerce in December proposed to remove the current 49% limit on foreign ownership of banks.

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 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