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SM/09/81

March 26, 2009

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Kuwait—Staff Report for the 2009 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 2009 Article IV consultation with Kuwait, which is tentatively scheduled for discussion on **Friday, April 10, 2009**. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of Kuwait indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Mr. Senhadji (ext. 38380) and Mr. Hasan (ext. 37325) in MCD.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Friday, April 3, 2009.

This document, together with a supplement providing an informational annex, will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities. The supplement, which is not being distributed in hard copy, will also be available in the Institutional Repository; a link can be found in the daily list (http://www-int.imf.org/depts/sec/services/eb/dailydocumentsfull.htm) for the issuance date shown above.

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INTERNATIONAL MONETARY FUND

KUWAIT

Staff Report for the 2009 Article IV Consultation

Prepared by Staff Representatives for the 2009 Consultation with Kuwait

Approved by Juan Carlos Di Tata and David Marston

March 25, 2009

- **Discussions:** Held in Kuwait during January 25–February 9, 2009 with Mr. Al-Shamali, Minister of Finance; Sheikh Salem Al-Sabah, Governor of Central Bank of Kuwait; other senior government officials; the Financial Committee of Parliament; and private sector representatives.

- **Team:** Messrs. Senhadji (Head), Hasan, Charap, Prasad, and Williams (all MCD).

- **Mission Focus:** Impact of the global crisis on the Kuwaiti economy and the appropriate policy response to preserve financial stability and support economic growth.

- **Previous Consultation:** was concluded on April 18, 2008. The PIN of the Executive Board's discussion is available at http://www.imf.org/external/np/sec/pn/2008/pn0867.htm

- **Exchange Arrangement:** The exchange regime has been reclassified as conventional peg to a basket. Kuwait has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions on payments and transfers for current international transactions, other than certain security-related restrictions notified to the Fund pursuant to Decision 144-(52/51).

- **Data:** Data are adequate for surveillance but further progress regarding timeliness is needed.

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EXECUTIVE SUMMARY

The 2009 Article IV consultation discussions with Kuwait focused on policies to contain the impact of the global financial crisis on the domestic economy.

Economic developments and outlook

Kuwait's macroeconomic performance in 2008 was strong but the outlook has been adversely affected by the global crisis and the sharp fall in oil prices. Real GDP is projected to contract by about 1 percent and inflation is expected to return to single digits. The sharp drop in oil prices will reduce substantially the fiscal and external current account surpluses. The outlook is projected to improve gradually over the medium term with the global recovery, but risks are tilted to the downside. The contentious relationship with parliament has resulted in the resignation of the cabinet—the fourth in two years—in mid-March 2009 and may delay key legislations, including a financial stability plan.

The authorities' views

- The authorities are working on a comprehensive plan to preserve financial stability and support economic activity. While the related legislation is still being debated in parliament, the objective is to restructure systemically important financial institutions that are under stress but solvent, facilitate the exit of insolvent ones, and encourage lending to productive economic activities.
- Fiscal prudence through lower transfers and current expenditure while maintaining capital spending is necessary in light of the sharp decline in revenues and the uncertainty surrounding future oil prices.
- The return to a basket peg has enhanced the flexibility of monetary policy and has kept the Kuwaiti dinar (KD) broadly in line with fundamentals.
- The authorities will continue their ambitious investment plan in the oil sector despite the sharp decline in oil prices.

Staff recommendations

- The authorities' financial stability plan should not prevent the necessary consolidation and restructuring of the financial sector, favor upfront recognition of losses, avoid rewarding excessive risk taking, and minimize fiscal cost. The central bank should strengthen oversight of risk management practices and conduct comprehensive stress tests to assess the impact of a further decline in asset prices and a prolonged period of low growth. These tests would help determine how and whether the authorities should intervene.
- The authorities' financial plan should be complemented by a fiscal stimulus package focused on key infrastructure projects. Fiscal reform is key to reducing the dependence on oil revenue and preserving long-term sustainability.
- The KD is broadly aligned with fundamentals and the basket peg remains appropriate in the run up to the GCC monetary union.
- Implementation of structural reforms that are critical to private-sector led growth should be expedited.

I. Introduction

1. **The 2009 consultation discussions were held against the backdrop of the global economic slowdown and continued political stalemate.**

- While Kuwait continues to enjoy a relatively strong economic and financial position, the sharp decline in oil prices and possibly large losses to the assets managed by the Kuwait Investment Authority (KIA) have weakened this position.

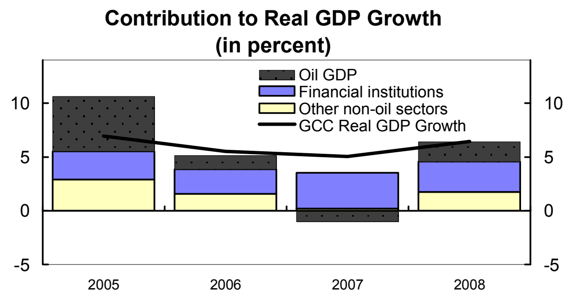
- The cabinet resigned on March 16, 2009—the fourth time in two years—after parliamentarians filed a motion against the prime minister. The Emir dissolved parliament and elections will be held in two months. This contentious relationship with parliament has significantly hampered the pace of economic reforms.

2. **The main elements of the authorities' economic strategy** is to use oil wealth to boost non-oil GDP growth in order to generate private sector employment for Kuwaitis while accumulating public financial assets for future generations. Policy discussions focused on preserving financial stability and cushioning the impact of the global slowdown.

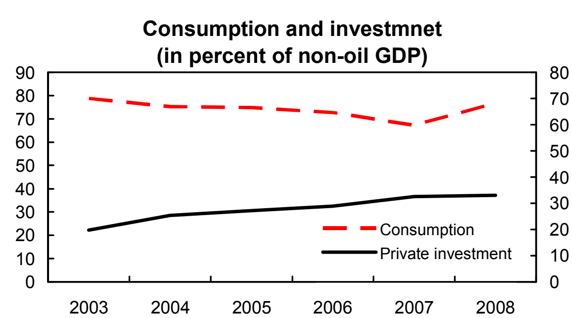
II. Recent Developments

3. **The global crisis has started to weaken economic activity and affected adversely the financial system and the fiscal position.**

- **Growth:** Reflecting higher oil production, real GDP growth is estimated at 6.4 percent in 2008, up from 2.5 percent in 2007 (Table 1). Non-oil GDP growth remained robust at about 7.3 percent, supported by strong domestic investment and consumption.



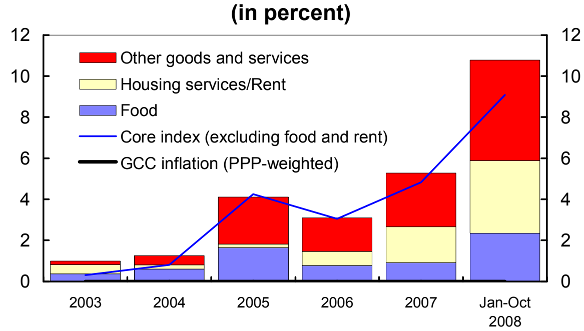
Sources: Authorities; and IMF staff estimates.



Sources: Authorities; and IMF staff estimates.

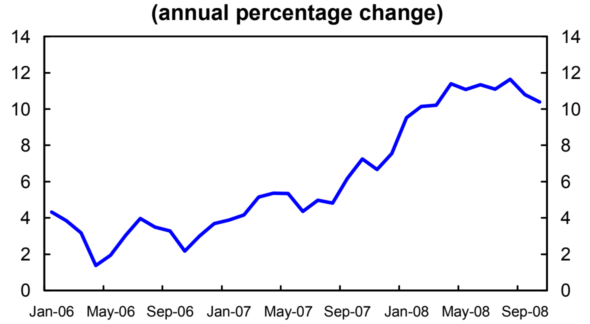
- **Inflation:** Inflation increased during the first eight months of 2008, peaking at 11.6 percent in August 2008 (year-on-year), driven by higher rent and food prices. It moderated somewhat toward the end of the year, reaching 10.4 percent in November, owing to weaker domestic demand and lower import prices.

Contribution to Inflation (in percent)

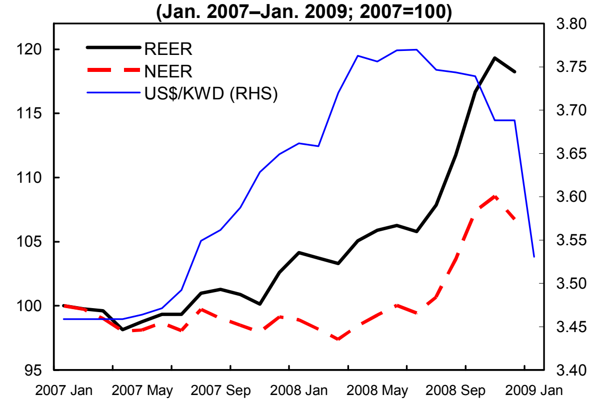


Sources: Central Bank of Kuwait; and IMF staff estimates.

Monthly Inflation, Jan. 2006–Oct. 2008 (annual percentage change)



Kuwait: Exchange Rate Developments (Jan. 2007–Jan. 2009; 2007=100)



Sources: Central Bank of Kuwait; DataStream; and INS.

- **Exchange rate:** After switching back from a dollar to a basket peg in May 2007, the authorities let the KD appreciate against the U.S. dollar in order to slow inflation. This, along with high inflation, led to a 7 percent appreciation in the real effective exchange rate (REER) in 2008.

- **Fiscal and external balances:** High oil prices in the first half of 2008 led to substantial fiscal and current account surpluses. The overall budget surplus reached 40 percent of GDP in 2007/08 and is estimated at 26 percent in 2008/09, despite a large increase in spending due mainly to the recapitalization of the pension fund (10.5 percent of GDP).[1] The non-oil deficit (excluding oil revenue, income from investments, and recapitalization transfers to the pension fund) as a ratio to non-oil GDP—a measure of the budget's contribution to aggregate demand—rose by 2 percentage points to 61 percent of non-oil GDP in 2008/09 (Table 2). Despite rising imports, the current account is estimated to have recorded a surplus of $70 billion (45 percent of GDP) (Table 3). Kuwait continues to enjoy a strong economic and financial position (Table 7), but this position is expected to weaken owing to the sharp decline in oil prices and potentially large losses in the value of assets managed by the KIA.

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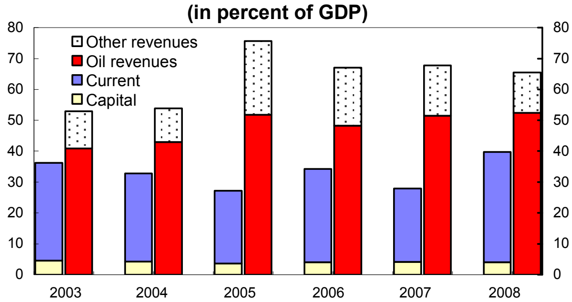
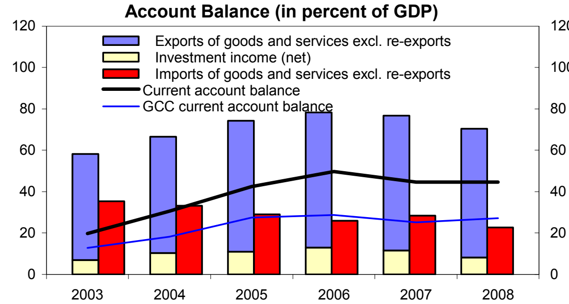
[1] The fiscal year starts April 1.

Government Revenues and Expenditures, 2003–08
(in percent of GDP)



Sources: Ministry of Finance; and IMF staff estimates.

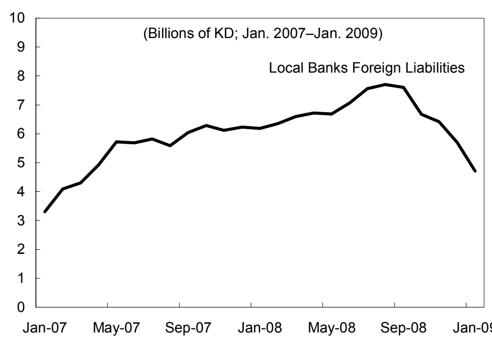
Imports, Exports, Investment Income and Current Account Balance (in percent of GDP)



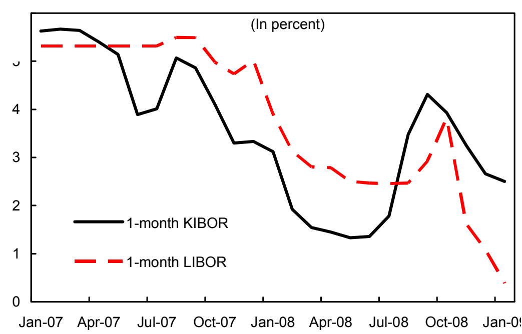
Source: IMF staff estimates.

- **Money and credit:** Broad money and credit growth declined from 19 percent and 36 percent (y-o-y), respectively, in 2007 to 16 percent and 19 percent in 2008, owing to measures introduced by the Central Bank of Kuwait's (CBK) to contain credit growth in the first half of 2008 and tight liquidity conditions in the second half of the year (Table 4).

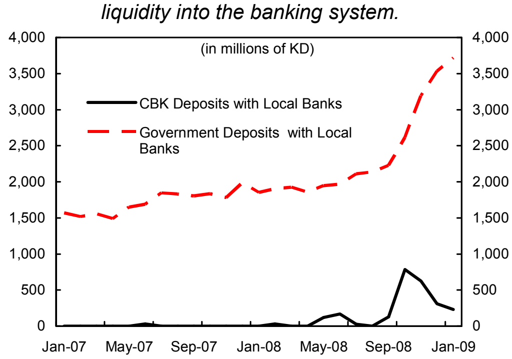
Reversal of revaluation speculation along with heightened risk aversion led to capital outflows...



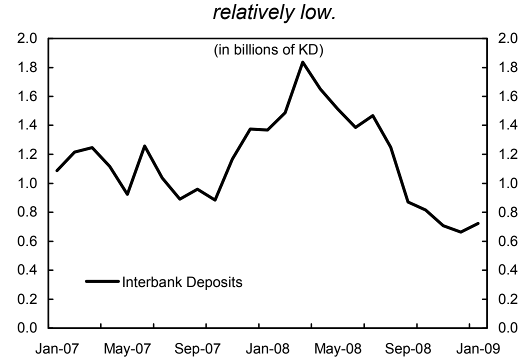
… and a temporary sharp increase in KD interbank rate (KIBOR)...



… which prompted the authorities to inject liquidity into the banking system.



However, activity in the interbank market remains relatively low.

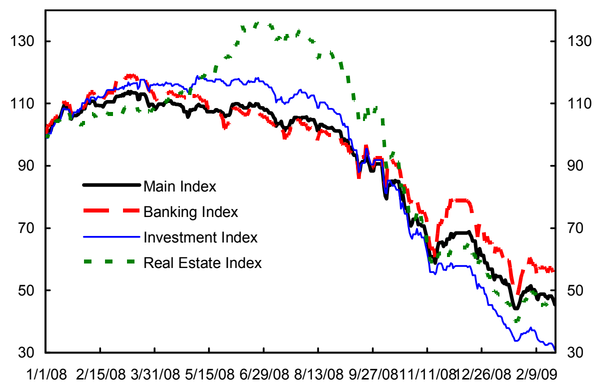


Source: Central Bank of Kuwait.

- **Financial system**: The global financial crisis has affected adversely Kuwait's financial system. Liquidity conditions tightened in the second half of 2008, reflecting capital outflows and rising concerns about counterparty risk. Since the deepening of the global crisis after the fall of Lehman Brothers, the Kuwait Stock Exchange (KSE) index fell by 50 percent, with larger declines in indices for investment and real estate companies. In

October 2008, the third largest bank lost \$1.4 billion, mostly on derivative transactions; in December 2008, the largest investment company in Kuwait defaulted on most of its \$3 billion debt obligations (and is currently negotiating a debt restructuring); and a large Islamic investment company was reported to be seeking to refinance up to \$1 billion in debt.

Kuwait Stock Exchange Indices
(index January 1, 2008=100)



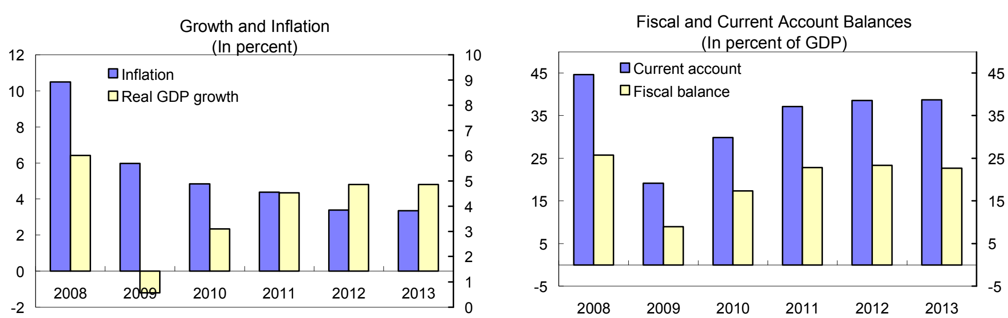
Sources: Kuwait Stock Exchange; and IMF staff estimates.

III. Economic Outlook

4. **The economic outturn in 2009 will be driven largely by the fallout from the global slowdown.** Real GDP is projected to contract by 1.2 percent in light of lower oil production (-5 percent)[2] and a decline in non-oil growth to 1 percent owing to weaker activity, particularly in the financial and construction sectors. Lower import prices, weaker domestic demand, and a moderation in rents should bring inflation down from an estimated 10 percent in 2008 to 6 percent in 2009. The fiscal and current accounts surpluses are projected to decline significantly in 2009, owing to lower oil revenue (Table 5).

5. **The medium-term outlook will depend largely on developments in the global oil market.** Implementation of government investment plans and progress with structural reforms to promote private investment are also critical to increase annual growth to the 4–5 percent range. The fiscal and current account positions should improve gradually over the medium-term in line with the projected increase in oil prices.

Kuwait: Medium-Term Outlook Projections



Sources: Kuwait authorities; and IMF staff estimates and projections.

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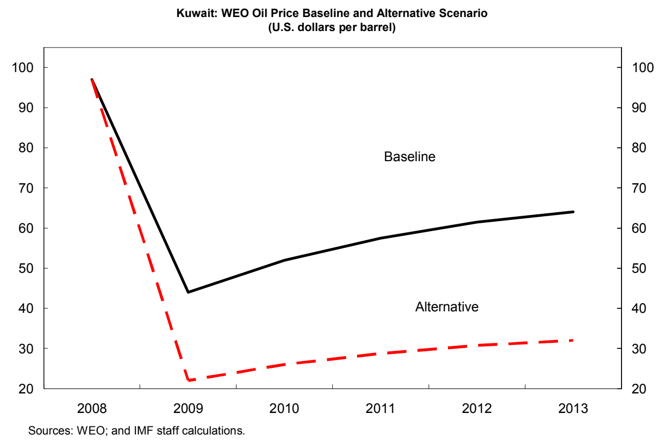
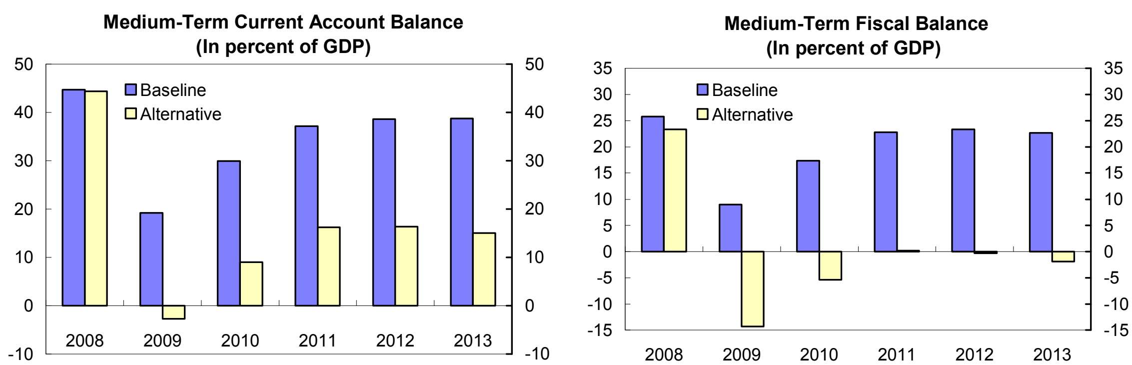
[2] While Kuwait's production of crude oil averaged 2.68 million barrels per day (mbpd) in 2008, output was reduced to about 2.5 mbpd in February 2009, in line with OPEC's decisions.

6. **The major risks to the economic outlook are a rapid deterioration in the balance sheet of financial institutions and a prolonged global recession that could maintain oil prices significantly below the fiscal and current account breakeven points**.[3] These risks would affect adversely investor and consumer confidence, limit fiscal space, and worsen the growth prospects. An illustrative alternative medium-term scenario assuming a 50 percent reduction in oil prices relative to the baseline suggests that the fiscal and current account balances would plunge initially into deficit and recover only gradually thereafter. While a deterioration in the geopolitical environment remains an important risk, an improvement in security conditions in Iraq could help the construction and the services sectors since Kuwait has the potential to function as a gateway to Iraq.



Kuwait: Medium-Term Baseline and Alternative Scenario



Sources: Kuwaiti authorities; and IMF staff estimates and projections.

IV. Policy Discussions

The key challenge for economic policies in the near term is to contain the fallout from the global crisis on the domestic economy. Therefore, discussions focused on the policy response to restore liquidity in the interbank market, clear the credit channel to the private sector, preserve the soundness of the financial system, and support growth.

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[3] The fiscal/current account breakeven point is the oil price at which the fiscal/current account position is balanced. The fiscal and current account breakeven points for 2009 are estimated at $33 and $30 per barrel, respectively.

A. Preserving Financial Stability

7. **The authorities have responded forcefully to stabilize the interbank market and restore liquidity.** Following the tightening of liquidity conditions in October 2008, the CBK resorted to direct injection of liquidity in the banking system, supplemented by deposits from government institutions. The CBK expanded its monetary policy tool kit by introducing KD-dollar swaps and repos of varying maturities to facilitate liquidity provision to the financial system. Consequently, interbank rates have come down significantly but activity in the interbank market remains subdued. The authorities attributed the low volumes to heightened uncertainty in global financial markets.

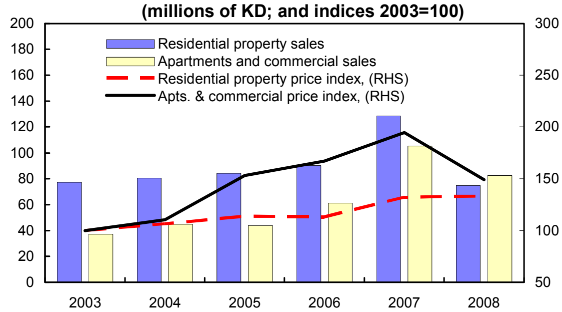
8. **The authorities indicated that the banking sector has shown strong resilience and remains generally sound, but agreed that risks associated with banks' exposure to asset markets and distressed investment companies have emerged**. Despite the difficult conditions, banks maintained a relatively good profitability in 2008.[4] The authorities reaffirmed that the banking sector have capital adequacy ratios well above the required regulatory norm, low NPLs, and relatively low liquidity risk,[5] owing in part to the CBK's loan-to-deposit prudential ratio that encouraged banks to seek stable domestic sources of funds (Table 6 (FSI)). Staff argued that banks' capital and reserve buffers could deteriorate significantly over the near term as a result of their large exposure to weakening real estate and equity markets and distressed investment companies (ICs).

Banking Sector Performance and Soundness (2004–08)
(in percent)

	2004	2005	2006	2007	2008 Sept 1/
Capital Adequacy Ratio	17.3	21.1	21.8	18.5	16
NPLs to total loans	5.3	5.0	3.9	3.2	3.1
Before invasion2/	2.9	2.2	1.8	1.4	1
Since liberation	2.4	2.8	2.1	1.8	2.1
Provisions for NPLs	82.5	107.2	95.8	92.0	85
Net Interest Margins	2.8	3.1	3.2	2.5	-
Return on Assets	2.5	3.0	3.2	3.4	3.2
Return on Equity	20.9	22.9	27.1	28.1	27.8
Cost-Income Ratio	25.9	27.3	28.6	28.5	-

Sources: Kuwaiti authorities; and IMF staff estimates.
1/ Based on 8 major banks.
2/ Fully provisioned.

Real Estate Sector Activities and Prices
(millions of KD; and indices 2003=100)



Sources: National Bank of Kuwait; and IMF staff estimates.

9. **Investment companies, which invest heavily in stock markets and depend largely on leverage, could be the main source of vulnerability in the financial system.** ICs have grown rapidly, their number almost doubling to 99 since 2005, with on-and off-balance sheet

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[4] Preliminary results for 2008 (covering only 5 out of 9 local banks) report profits, albeit 20 percent lower than in 2007, reflecting in part large provisions.

[5] Private deposits accounted for about 54 percent, while foreign liabilities accounted for only 15 percent of total bank liabilities at end-2008.

assets representing more than 100 percent of the banking system assets, making them systemically important. Refinancing difficulties and the deterioration of the solvency of some ICs could affect adversely banks' profitability and asset quality directly through lending, and indirectly by exacerbating the negative impact on asset prices, investors' confidence, and corporate sector balance sheet (Box 1). If prolonged and in the absence of an appropriate policy response, these conditions could pose a systemic risk to the financial system and eventually increase the cost of preserving its soundness (Box 2).

10. **The authorities have taken several measures to preserve financial stability.** In addition to restoring liquidity and stabilizing the interbank market, the CBK eased credit conditions—especially for ICs (see below). Following losses recorded by the third largest bank, the CBK successfully facilitated its recapitalization—with shareholders providing 68 percent of the new capital and KIA the rest—and a law guaranteeing customer deposits at local banks was passed. To support the equity market, the government established a long-term fund to invest in the KSE with an initial capital of about $5.5 billion funded by the KIA and other public entities.

11. **The authorities have also been working on a comprehensive strategy to maintain financial stability.** A draft Financial Stability Law (FSL) was recently adopted by the cabinet and submitted to parliament. The authorities view the law as a precautionary step and while the law covers both banks and ICs, its focus is on preserving the stability of the banking system. While details are still unavailable (the draft law is still being debated in parliament), the objective of the FSL is to restructure systemically important financial institutions that are under stress but solvent, facilitate the exit of insolvent ones, and encourage lending to productive economic activities. The authorities estimated the upfront fiscal cost for the initial FSL draft at about $5 billion but the cost is likely to be higher for the final draft. Potential help to distressed institutions will carry conditionality, including the right to merge institutions. The draft also provides a resolution framework for insolvent financial institutions. Some parliamentarians have advocated major changes to the FSL and have sought to tie its approval to providing public assistance for household debt, a request that was rejected by the government in the past.

12. **A key element in the overall strategy for financial stability is to restore normal credit access to the private sector.** To facilitate credit growth, the CBK raised the loan-to-deposit ratio from 80 percent to 85 percent, increased bank-specific caps on credit growth by 5 percentage points, and encouraged banks to maintain and renew credit lines to deserving ICs and avoid selling collateral shares in their possession. The FSL envisages providing partial loan guarantees to encourage lending to productive domestic economic activities. Nevertheless, the authorities are aware of the need to strike an appropriate balance between encouraging credit growth and preserving the quality of banks' assets.

Box 1. Investment Companies and Financial Sector Vulnerabilities

Activities and structure: ICs' activities include both proprietary and fiduciary investments. ICs provide *asset management services* such as brokerage, portfolio management, forward trading, IPOs, local and international fund management and *financial services* such as corporate finance advisory services (mergers, acquisitions, underwriting, and private placements) and private equity. ICs have grown rapidly, their number almost doubling to 99 since 2005, with $65 billion and $95 billion of on- and off-balance sheet assets, respectively, higher than the banking system's assets.

Sources of vulnerability: Several structural characteristics created vulnerabilities in the sector. These include (i) highly leveraged positions, (ii) significant dependence on external financing, (iii) maturity mismatch between assets and liabilities (long term assets such as private equities are financed by short term liabilities), (iv) large exposure to asset markets (equity and real estate), (v) weak disclosure, and (vi) fragmentation of the industry (an average of KD 0.40 billion of assets per investment company).

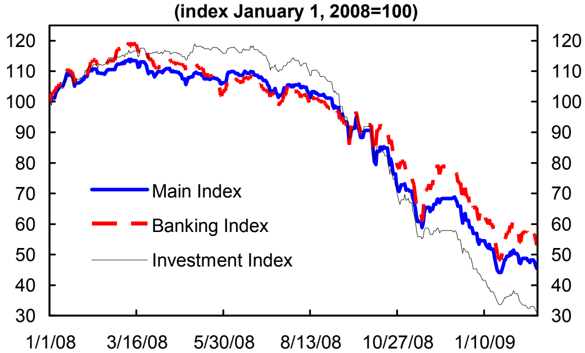
Investment Companies: Assets and Liabilities
(in billion U.S. dollars)

	2006	2007	2008
Total Assets	45.0	58.8	64.9
Investments in equities and real estate	28.8	41.2	42.9
of which: foreign assets	16.0	21.5	25.2
Equity	15.8	19.8	22.2
Borrowings from local banks	5.3	9.6	10.6
Other debt	16.3	20.2	22.0
of which: foreign liabilities	8.2	11.5	15.6

Source: The Central Bank of Kuwait.

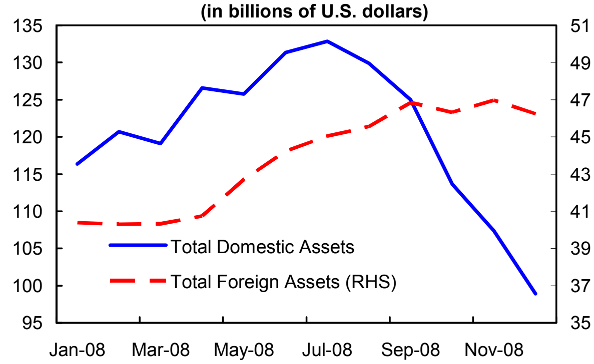
Global crisis impact: Tight global liquidity conditions exposed vulnerabilities i, ii and iii. Many ICs are facing difficulties maintaining and renewing existing lines of credit, especially foreign lines ($16 billion), and some have defaulted or are on the brink of default. The fall in assets prices has exposed vulnerability iv. IC assets contracted by $30 billion to $148 billion between August and December 2008, reflecting both losses and redemptions by investors. Preliminary nine-month results for 46 listed ICs show a 27 percent decline ($1 billion) in investment income and $0.3 billion of unrealized losses. The deepening of the global crisis is likely to have induced further losses and redemptions.

Kuwait Stock Exchange Indices
(index January 1, 2008=100)



Sources: Kuwait Stock Exchange, CBK; and IMF staff estimates.

Assets Under Management of Investment Companies, January–December, 2008
(in billions of U.S. dollars)



Transmission channels: Bank loans to ICs (12 percent of banks' total loans) have deteriorated in quality. With ICs and banks accounting respectively for 13 percent and 34 percent of KSE market capitalization, deterioration in the solvency of ICs would affect directly the asset quality of banks and indirectly by putting further downward pressure on equity prices; weakening household and non-financial corporate balance sheets.[1] As banks' asset quality deteriorates, so will access to credit, setting in motion a vicious circle.

[1] For example, at end-September 2008, 35 real estate companies with total assets of $20 billion had invested up to $4 billion in the KSE. Bank loans to individuals for investing in stocks represent 12 percent of banks' total loans.

Box 2. Banking Sector Stress Test

Scenarios: The stress tests cover various macroeconomic scenarios that differ in their severity. A further slowdown in the global economy would lower oil revenues, reduce investor and consumer confidence, constrain access to credit, especially for ICs, and depress asset prices. Consequently, loan defaults and losses would increase, especially from risky sectors (construction, real estate, individuals who borrowed to invest in securities, and ICs). This would erode banks' capital due to losses arising from impairment charges (both for lending and investments) and negative mark-to-market valuations. The degree of severity of the scenarios is reflected in the percent of default in loans and the percent of losses in investments.

Banks' Relatively High Risky Assets, 2008

	Share of total assets (percent)	Share of capital (percent)	Share of total loans (percent)
Lending to construction	4.3	38.4	7.2
Lending to real estate	14.5	130.2	24.4
Lending for purchase of securities	6.8	63.1	11.8
Lending to investment companies	7.0	64.7	12.1
Other local investments 1/	4.5	40.9	…
Foreign investments 1/	5.0	45.5	…
Total exposure	42.0	382.8	141.8

Sources: CBK data and IMF staff calculations.
1/ upper bound

Assumptions: For simplicity and in the absence of detailed information, the analysis assumes that the capital adequacy ratio (CAR) for the banking sector is 16 percent (September 2008 level), no growth in the credit portfolio in 2009, a decline in risk weighted assets equivalent to the increase in NPLs, a 75 percent loss-given-default ratio, a default rate in loans to other sectors equal to ¼ of the default rate of loans to risky sectors, loss in investment equal to the default rate of loans to risky sectors, and regulatory capital equal to owners' equity in December 2008.

Results: The first two scenarios, which assume 5 to 10 percent default/loss rates, indicate that the banking system would remain adequately capitalized although some banks would become undercapitalized. The third and fourth scenarios (15–20 default/loss rates) would make the system undercapitalized. Recapitalizing the banking system to a 12 percent CAR under the fourth scenario would require the injection of at least $5 billion, equivalent to 5 percent of GDP.

Kuwait: Results of Stress Test for Credit and Market Risk

	Baseline	Scenarios: Default rate in loans to risky sectors and investment loss rate (in percent)			
	2008	**5%**	**10%**	**15%**	**20%**
Banks regulatory capital (in million KD)	4,425	3,643	2,861	2,080	1,298
Banks risk weighted assets (in million KD)	27,658	26,275	24,892	23,509	22,126
Capital adequacy ratio (CAR) (in percent)	16.0	13.9	11.5	8.8	5.9
NPLs to total loans (in percent)	3.1	5.9	8.6	11.4	14.2
Recapitalization needs (in million U.S. dollars) 1/	0.0	0.0	443.2	2,617.8	4,792.5
Recapitalization needs (in percent of 2009 GDP)	0.0	0.0	0.4	2.6	4.8

Sources: CBK data and IMF staff analysis
1/ This number is a lower bound given that banks differ in CAR.

13. **The authorities agreed that the following principles should guide the financial stability strategy:**

- The strategy should not delay or prevent necessary consolidation and restructuring of the financial sector.

- The strategy should favor upfront recognition of losses, as in the case of the recent bank recapitalization.

- Recapitalization of banks should, to the extent possible, rely on the participation of existing shareholders or new private investors.

- To reduce monitoring costs, enhance transparency, and speed up implementation, measures to address stress in financial institutions should be relatively simple.

- An effective communication and coordination plan that details actions and communication at each stage by all necessary parties is key to the success of the strategy.

14. **The authorities plan to tighten regulatory oversight, especially of ICs.** The global financial turmoil has focused attention on the need for stricter regulation and closer supervision of non-bank financial institutions. The authorities are cognizant of the importance of conducting comprehensive stress tests for the financial system, including ICs, particularly to assess the impact of a pronounced decline in real estate prices and further losses in the stock market. To address difficulties in assessing the value of some ICs' foreign assets, the CBK has appointed international experts. The authorities requested an FSAP update in late 2009.

B. Macroeconomic Policy Mix

15. **While the 2009/10 budget has not been finalized, the authorities announced that capital expenditures will be maintained but current expenditures could be cut.** Furthermore, the previously-planned transfer of KD 5.5 billion to the pension fund will be postponed. While some withdrawal of fiscal stimulus is expected, the 2009/10 budget will not imply a significant change in the fiscal stance, given the limited scope for reducing current spending. The non-oil deficit as a share of non-oil GDP is estimated to fall by 3 percentage points to 58 percent in 2009/10.

16. **In light of the expected economic slowdown, the mission urged the authorities to complement the financial stability package with a fiscal stimulus package.** The authorities noted that fiscal prudence was warranted in light of the sharp decline in revenues and the uncertainty surrounding oil price developments. While they agreed with staff that a fiscal stimulus would increase demand, shore up investor confidence, and help stabilize asset markets, they argued that it would have a limited impact on the Kuwaiti economy given the significant leakages through remittances and imports. They also noted that capacity constraints limit their ability to expand capital spending significantly, as evidenced by relatively low implementation rates in recent years.

17. **If oil prices were to remain low for a prolonged period, the fiscal stance would have to be adjusted to preserve long-term fiscal sustainability and intergenerational equity.** This adjustment could be supported by:

- Reducing subsidies for fuel, electricity, and water which, in addition to their substantial fiscal cost (9.5 percent of GDP and 25 percent of total government expenditures), distort prices, misallocate resources, and damage the environmental.

- Reforming the pension system through a restructuring of the contribution and benefit rules so as to ensure its long-term viability.

- Linking salaries and benefits in the public sector to performance in order to limit fiscal costs and increase the incentives to acquire marketable skills.

- Stepping up efforts to introduce the VAT in coordination with other GCC countries.

To assess the medium-term impact of short-term policy measures and anchor yearly budgets by medium-term goals, it would be useful to formulate fiscal policy within a medium-term framework. A recent IMF technical assistance mission has made detailed recommendations in this regard.

18. **The authorities' monetary policy stance remains appropriate in light of the projected weakening of economic activity.** The recent easing of the monetary stance and supportive measures—such as the injection of liquidity and the relaxation of the loan-to-deposit ratio—will support macroeconomic and financial stability. Nevertheless, as in many countries, the interest and credit channels of monetary transmission are likely to remain impaired until global market confidence returns. Real interest rates should return to positive territory given the expected decline in inflation.

19. **The CBK noted that the move to the basket peg has enhanced its flexibility in fine tuning interest rates and managing inflation.** The authorities abandoned the peg to the U.S. dollar in May 2007 and reverted to pegging the KD to a basket of currencies with undisclosed weights. This move was motivated partly by rising inflation over the past few years.

20. **The authorities consider that the current level of the KD is consistent with domestic and external stability.** A CGER-type analysis finds the KD to be broadly aligned with its fundamentals (Box 3). The *Equilibrium Real Exchange Rate* (ERER) method finds that the appreciation of the REER in 2008, along with the reversal of terms-of-trade gains toward the end of the year, have brought the REER broadly in line with its equilibrium level by end-2008. Both the Macro Balance (MB) and External Sustainability approaches find the KD to be somewhat overvalued in 2008 but the MB expects the overvaluation to turn to a small undervaluation by 2013.

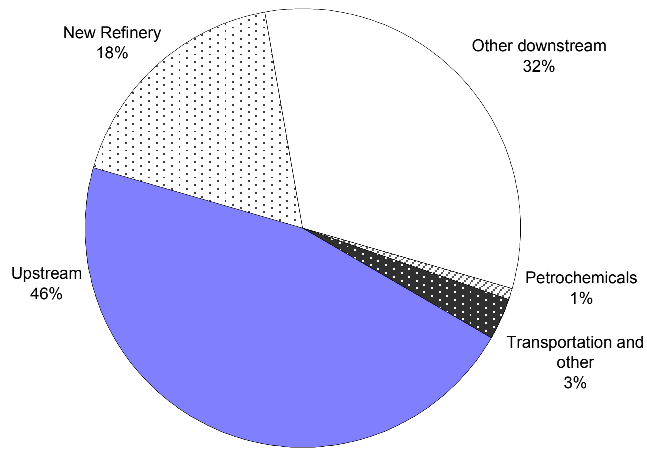
21. **The authorities believe that the global crisis provides additional impetus to expedite preparation for the GCC monetary union.** At their last meeting in late 2008, the GCC Heads of States reaffirmed their commitment to achieving monetary union by 2010 and agreed to establish a monetary council—a precursor to a GCC central bank— by end-2009.

Regarding the exchange rate regime for the monetary union, the authorities said that all options will be considered.

C. Oil Sector Prospects

22. **The authorities reaffirmed that the recent decline in oil prices would not affect Kuwait's upstream and downstream investment plans, as the medium- and long-term outlook for global oil demand remains strong.** They plan to increase oil production capacity from the current level of 2.7 mbpd to 3.0 mbpd in 2010 and to 3.2 mbpd in 2013–14. Kuwait finished the first stage of its gas project and is currently producing 150 million cubic feet (mcf). The second stage (2011–12) would boost production to 400 mcf, while the third stage (2015–16) would increase production to 1.0 billion cubic feet. These expansions will not involve international oil companies (IOCs). The authorities highlighted that these projects would be self-financed, although a need for borrowing might arise if oil prices declined or remained low for a prolonged period. They expected the cost ($84 billion) to decline, given market developments. Expanding production capacity would not only improve Kuwait's long-term outlook but would also ensure proper utilization/recovery of current fields. While IOCs would bring advanced technology that could lower costs and enhance recovery, lack of political consensus has hindered their involvement.

Kuwait: Distribution of the $84 Billion Investment Plan in the Oil and Gas Sector



Source: Ministry of Oil.

D. Structural reforms and statistical issues

23. **Progress with structural reforms is slow.** With the exception of the capital market law, little progress has been achieved in enacting companies, competition, public-private partnership, and privatization laws. While Kuwait has reduced the marginal corporate tax rate on foreign companies from 55 percent to 15 percent in 2008, some companies underscored the absence of information about the necessary implementing regulations. Slow pace of structural reforms, limited access to land, and heavy bureaucracy have discouraged FDI inflows to Kuwait.

24. **The authorities are revising the Anti Money Laundering and Combating Financing of Terrorism (AML/CFT) law** to make it compatible with international standards. The revised draft law is currently with the Ministry of Finance.

Box 3. Exchange Rate Assessment

A CGER–type analysis indicates that the KD is broadly in line with fundamentals. The results are subject to the well-known estimation difficulties, especially for oil exporting countries.

The equilibrium real exchange rate (ERER) approach[1] suggests that the strengthening of the KD in 2008 and the sharp deterioration in the terms of trade in the second half of 2008 reversed the undervaluation of the KD in 2007 to a small overvaluation (6 percent) by end-2008. The depreciation of the KD in early 2009 should help close this small gap.

An assessment based on the macroeconomic balance (MB) approach using panel estimates for the GCC countries indicates that the current account surplus is slightly below its "norm", but the gap is expected to close over the medium term and by 2013 the KD will slightly be undervalued.[2]

Under the external sustainability (ES) approach, the projected current account surplus is too low relative to the norm derived from the annuity that would finance a constant per capita non-oil CA deficit, suggesting larger surpluses might be needed to maintain intergenerational equity.[3]

Projected Current Account and Norms Based on MB and ES Approaches (in percent of GDP)

	Estimated/ Projected CA	MB norm	ES norm
2008	44.7	45.4	51.1
2013	38.8	34.6	53.0

Source: IMF staff projections and calculations.

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[1] Staff found evidence of a long-run cointegration relationship between the ERER and key fundamentals (notably terms of trade, government expenditure, and investment income).

[2] Explanatory variables for the current account norm include the fiscal balance, net foreign assets, oil balance, population, and output growth.

[3] The calculations assume: (i) reserves of 102 billion barrels; (ii) a 64 percent recovery rate; (iii) production peaking at 2.9 mbd in 2030 and then declining by 2 percent per annum; (iv) beyond 2013 oil prices and the GDP deflator increasing by 3.5 percent a year , real GDP by 2.8 percent, and population by 2 percent; (v) a nominal discount rate and rate of return on assets of 6.5 percent; and (vi) an initial financial wealth of $0.3 trillion.

25. **More progress is needed to address data weaknesses.** The CPI, national accounts, and especially trade data are made available with a considerable lag.

V. Staff Appraisal

26. **Kuwait's economy performed strongly in 2008 but important challenges lie ahead.** The key short-term challenge is preserving financial stability and cushioning the impact of the global slowdown. Maintaining strong non-oil growth over the medium term will require public spending focused primarily on expanding the economy's productive capacity, as well as implementation of structural reforms that promote private investment.

27. **Policies to safeguard the soundness of the financial sector should not prevent the necessary consolidation and restructuring of the sector.** The government's financial stability package should favor upfront recognition of losses, avoid rewarding excessive risk taking, and minimizes fiscal cost. Staff encourages the authorities to conduct comprehensive stress tests for the overall financial system to assess the impact of a further decline in asset prices and a prolonged period of low growth. This would help determine how and whether the government should intervene. Given the lack of political consensus and low investor confidence, an effective communication strategy would be key to success.

28. **The central bank should strengthen oversight of risk management practices and encourage restructuring of the IC sector.** This would require ensuring the existence of adequate policies and procedures for identifying, monitoring and controlling risks, adopting tighter conditions for granting IC licenses, introducing a minimum set of *fit and proper* criteria for the appointment of IC managers and board members, and enhancing disclosure. These measures, if enforced strictly, would encourage consolidation in the sector, lead to fewer and well-managed institutions, and provide a quality hurdle to entry. Staff welcomes the authorities' interest in undertaking an FSAP update.

29. **In light of the expected economic slowdown, staff urges the authorities to complement the financial stability package with a well-designed fiscal stimulus package.** These packages along with strengthening capital spending capacity would be key to mitigate the negative feedback loop between weakening balance sheets of financial institutions and lower economic activity. A fiscal stimulus would support economic activity not only through the standard multiplier channel but also by shoring up investor confidence. Kuwait's fiscal cushion should allow it to maintain a healthy level of quality capital spending over the next few years without jeopardizing medium-term fiscal sustainability.

30. **The recent decline in oil prices highlights the importance of fiscal reforms aimed at reducing dependence on oil revenue and rationalizing fiscal spending.** These include reducing large subsidies and transfers, reforming the pension system to ensure its long-term viability, linking public sector salaries and benefits to merit, and introducing the VAT in coordination with other GCC countries.

31. **Staff encourages the authorities to continue implementing their investment program in the hydrocarbon sector to enhance economic prospects and support oil market stability.** Participation of IOCs would bring the necessary know-how for the efficient development of the sector.

32. **The KD is broadly aligned with its fundamentals.** The current exchange rate regime remains appropriate in the run up to the GCC monetary union.

33. **The authorities should expedite the structural reforms that are vital to private-sector investment,** including key laws regulating private sector activity. Other important measures include streamlining business registration and other administrative barriers to investment, and enhancing access to land for private businesses and individuals.

34. **Staff welcomes the signing of the treaty to establish the GCC Monetary Union as well as the adoption of the charter for the Monetary Council.** Meeting the remaining key prerequisites by the stated deadline of 2010—including developing a monetary and exchange rate policy framework and building the GCC-wide data requirements—remains a challenge.

35. **A sustained effort to address weaknesses in macroeconomic statistics is needed.** In this connection, staff encourages the authorities to conduct a comprehensive review of the role and resources of the General Statistical Office.

36. **Kuwait's generous external assistance program is commendable.** The size of Kuwait's foreign aid program is estimated to have averaged about 2 percent of GDP over the past 20 years. Staff encourages Kuwait to continue providing debt relief to all eligible-HIPC countries.

37. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.

Table 1. Kuwait: Selected Economic Indicators, 2004–09

				Est.	Proj.	
	2004	2005	2006	2007	2008	2009
Oil and gas sector						
Total oil and gas exports (in billions of U.S. dollars)	27.8	44.1	55.7	60.1	84.1	35.2
Average oil export price (in U.S. dollars/barrel)	34.1	49.1	60.2	67.8	92.4	40.0
Crude oil production (in millions of barrels/day)	2.29	2.57	2.64	2.58	2.68	2.56
	(Annual percentage change, unless otherwise indicated)					
National accounts and prices						
Nominal GDP (market prices, in billions of Kuwaiti dinar)	17.5	23.6	29.5	31.8	42.5	28.1
Nominal GDP (market prices, in billions of U.S. dollars)	59.4	80.8	101.6	111.8	158.1	99.2
Real GDP (at factor cost)	10.2	10.7	5.2	2.5	6.4	-1.2
Real oil GDP	8.1	11.4	2.9	-2.3	4.2	-4.5
Real non-oil GDP	12.1	10.6	8.3	7.8	7.3	1.0
CPI inflation (average)	1.3	4.1	3.1	5.5	10.5	6.0
Unemployment rate (Kuwaiti nationals)	3.9	3.8	4.0	...	...	...
	(In percent of GDP at market prices)					
Investment and savings						
Investment	18.2	16.4	16.2	19.4	17.6	14.7
Public	3.7	3.0	2.8	3.4	3.1	5.2
Private 1/	14.5	13.5	13.4	15.8	14.5	9.5
Gross national savings	48.7	58.9	66.1	64.2	62.2	33.9
Public	36.2	56.2	60.8	57.0	46.3	39.6
Private 1/	12.5	2.7	5.3	7.1	15.9	-5.7
Savings/investment balance	30.6	42.5	49.8	44.7	44.7	19.2
	(In percent of GDP at market prices)					
Budgetary operations 2/						
Revenue	53.8	75.6	67.0	67.8	65.5	48.1
Oil	42.9	51.7	48.3	51.5	52.4	36.8
Non-oil, *of which:*	10.9	23.9	18.7	16.3	13.1	11.4
Investment income	7.5	21.4	15.8	13.0	10.0	7.1
Expenditures and net lending	32.8	27.2	34.2	27.9	39.7	39.2
Current 3/	28.6	23.6	30.1	23.8	35.7	33.3
Capital	4.2	3.6	4.1	4.1	4.0	5.8
Balance	21.0	48.5	32.8	39.9	25.8	9.0
Domestic financing	-5.7	-1.2	-2.8	-3.1	-4.4	-0.8
External financing	-15.4	-47.3	-30.1	-36.8	-21.4	-8.2
Non-oil balance (in percent of non-oil GDP) 4/	-60.3	-57.0	-58.9	-58.9	-61.0	-58.1
Total gross debt (calendar year-end)	17.3	11.8	8.3	6.9	5.3	8.0
	(Changes in percent of beginning broad money stock)					
Money and credit						
Net foreign assets 5/	10.3	3.2	12.5	1.1	10.0	1.2
Net domestic assets	1.8	9.1	9.1	18.2	5.6	7.2
Claims on government (net)	-10.4	-2.6	-6.4	-6.8	-9.0	-1.1
Claims on nongovernment sector	14.5	17.6	24.5	35.6	19.2	6.4
Broad money	12.1	12.3	21.7	19.3	15.6	8.4
Kuwaiti dinar 3-month deposit rate (year average; in percent)	1.6	2.9	5.0	5.2	3.3	1.6
Stock market unweighted index (annual percent change) 6/	33.8	78.6	-12.0	23.6	-37.5	-11
	(In billions of U.S. dollars, unless otherwise indicated)					
External sector						
Exports of goods	30.1	47.0	58.9	63.7	88.2	40.0
Of which: non-oil exports	2.3	2.9	3.3	3.6	4.1	4.7
Annual percentage change	4.6	23.0	14.5	10.3	13.0	16.0
Imports of goods	-11.7	-14.2	-15.4	-18.5	-21.2	-19.7
Annual percentage change	18.1	22.1	8.3	20.0	14.4	-7.1
Current account	18.2	34.3	50.6	50.0	70.6	19.0
In percent of GDP	30.6	42.5	49.8	44.7	44.7	19.2
External debt including private sector	12.1	16.5	26.4	26.3	26.7	...
of which External public and publicly guaranteed debt	0.7	1.8	...	...	...	...
International reserve assets	7.3	8.1	11.8	15.9	17.8	16.9
In months of imports of goods and services	4.6	4.3	5.5	5.7	6.0	6.0
	(Percentage change; unless otherwise noted)					
Memorandum items:						
Exchange rate (U.S. dollar per KD, period average)	3.39	3.42	3.45	3.52	3.72	...
Nominal effective exchange rate (NEER)	-3.9	0.4	0.5	-2.2	0.3	...
Real effective exchange rate (REER)	-5.1	2.0	0.9	0.4	7.2	...
Sovereign rating (S&P)	A+	A+	A+	AA-	AA-	...

Sources: Data provided by the authorities; and Fund staff estimates and projections.

1/ Also includes government entities.
2/ Kuwaiti fiscal year ending March 31, e.g. 2007 refers to fiscal year 2007/2008.
3/ In 2006/07 KD 2 billion was transferred to partly cover the actuarial deficit of the Public Pension Fund.
In 2008/09 , KD 5.5 billions are budgeted.
4/ Excluding investment income and pension recapitalization.
5/ Excludes SDRs and IMF reserve position.
6/ Change in the KSE as of February 5, 2009 for 2009.

Table 2. Kuwait: Summary of Government Finance, 2004/05–2009/10 1/

	2004/05	2005/06	2006/07	Budget 2007/08	Prel. 2007/08	Budget 2008/09	Proj. 2008/09	Proj. 2009/10
				(In billions of KD)				
Total revenue	**10.2**	**19.0**	**20.1**	**8.3**	**23.3**	**12.5**	**25.5**	**14.0**
Oil and gas	8.2	13.0	14.5	7.5	17.7	11.7	20.4	10.7
Investment income and transfer of profits of public entities 2/	1.4	5.4	4.7	0.0	4.5	0.0	3.9	2.1
Other current revenue 3/	0.6	0.6	0.9	0.9	1.1	0.8	1.2	1.2
Capital revenue	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditure	**6.2**	**6.8**	**10.3**	**11.1**	**9.6**	**18.7**	**15.4**	**11.4**
Current	5.4	5.9	9.0	8.5	8.2	16.7	13.9	9.7
Current excluding recapitalization of social security	5.4	5.9	7.0	8.5	8.2	11.2	9.8	9.7
Wages and salaries	1.9	2.1	2.5	3.0	2.8	3.6	3.5	3.7
Goods and services 4/	1.4	1.4	1.6	1.9	1.8	2.0	2.0	2.1
Interest on domestic debt 5/	0.1	0.1	0.1	0.0	0.1	0.0	0.1	0.1
Transfers abroad	0.1	0.2	0.2	0.4	0.4	0.6	0.5	0.5
Subsidies and transfers 6/ 7/	1.9	2.1	4.7	3.2	3.2	10.5	7.9	3.3
Of which:								
Recapitalization of social security	0.0	0.0	2.0	0.0	0.0	5.5	4.1	0.0
Capital	0.8	0.9	1.2	2.6	1.4	2.1	1.5	1.7
Overall balance (excluding KIA income)	**3.0**	**9.5**	**4.9**		**11.3**		**7.9**	**1.5**
Overall balance	**4.0**	**12.1**	**9.9**	**-2.8**	**13.7**	**-6.3**	**10.0**	**2.6**
Overall balance exc. oil rev.	**-4.2**	**-0.8**	**-4.6**	**-10.2**	**-4.0**	**-17.9**	**-10.4**	**-8.1**
Overall balance exc. oil rev. and inv. income	**-5.6**	**-6.2**	**-9.4**	**-10.2**	**-8.5**	**-17.9**	**-14.2**	**-10.1**
Financing	**-4.0**	**-12.1**	**-9.9**	**2.8**	**-13.7**	**6.3**	**-10.0**	**-2.6**
Domestic (net)	-1.1	-0.3	-0.8	...	-1.1	...	-1.7	-0.2
Banks	-1.1	-0.3	-0.8	...	-1.1	...	-1.7	-0.2
Nonbanks	0.0	0.0	0.0	...	0.0	...	0.0	0.0
External	0.0	0.0	0.0	...	0.0	...	0.0	0.0
Reserve funds 8/	-2.9	-11.8	-9.0	...	-12.7	...	-8.3	-2.4
				(In percent of GDP)				
Revenue	**53.8**	**75.6**	**67.0**	**24.2**	**67.8**	**32.0**	**65.5**	**48.1**
Oil and gas	42.9	51.7	48.3	21.6	51.5	30.0	52.4	36.8
Investment income	7.5	21.4	15.8	0.0	13.0	0.0	10.0	7.1
Other current revenue 3/	3.1	2.4	2.8	2.5	3.3	2.0	3.0	4.2
Expenditure	**32.8**	**27.2**	**34.2**	**32.2**	**27.9**	**48.2**	**39.7**	**39.2**
Current	28.6	23.6	30.1	24.6	23.8	42.9	35.7	33.3
Current excluding recapitalization of social security	28.6	23.6	23.4	24.6	23.8	28.8	25.3	33.3
Wages and salaries	10.2	8.5	8.2	8.7	8.1	9.3	9.0	12.8
Goods and noninterest services 4/	7.5	5.8	5.2	5.5	5.2	5.2	5.1	7.2
Subsidies and transfers	9.8	8.3	15.7	9.2	9.2	26.9	20.2	11.3
Of which: recapitalization of social security	0.0	0.0	6.7	0.0	0.0	14.1	10.5	0.0
Capital	4.2	3.6	4.1	7.6	4.1	5.3	4.0	5.8
				(In percent of non-oil GDP)				
Revenue	110.5	175.0	160.6	57.9	162.5	74.7	152.8	80.1
Expenditure	67.3	62.8	81.9	77.1	66.8	112.4	92.7	65.2
Current excluding recapitalization of social security	58.7	54.6	56.2	58.9	56.9	67.2	59.0	55.5
Wages and salaries	20.9	19.6	19.7	20.7	19.3	21.6	21.0	21.3
Goods and noninterest services 4/	15.3	13.3	12.6	13.2	12.4	12.2	11.8	11.9
Capital	8.6	8.3	9.8	18.2	9.9	12.4	9.3	9.7
Overall balance/GDP	**21.0**	**48.5**	**32.8**	**-8.0**	**39.9**	**-16.1**	**25.8**	**9.0**
Non-oil deficit/Non-oil GDP	**-44.9**	**-7.5**	**-37.1**	**-71.1**	**-27.7**	**-107.6**	**-62.1**	**-46.3**
Non-oil primary deficit/Non-oil GDP (excluding recapitalization of social security and investment income)	**-44.9**	**-57.0**	**-58.9**	**...**	**-58.9**	**...**	**-61.0**	**-58.1**
Memorandum items:								
Average oil export price (in U.S. dollar/barrel)	37.8	51.8	62.1	36.0	73.9	50.0	79.3	41.9

Sources: Ministry of Finance; Central Bank of Kuwait; and Fund staff estimates and projections.

1/ Coverage of budgetary operations includes the operation of the KIA. Data are on an accrual basis.
2/ Excluded from the national budget presentation. Estimated by Fund staff.
3/ Excludes revenues from utility tariffs (which are included in the national budget presentation), but includes UN (Iraq) compensations.
4/ Includes other miscellaneous expenditures in FY 07/08 and 08/09.
5/ Covers interest payments on the treasury bills and bonds, and on the DCP bonds. Only the latter is included in the national budget presentation.
6/ In 2006/07 KD 2 billion was transferred to partly cover the actuarial deficit of the social security fund. In 2008/09 KD 5.5 billion is budgeted.
7/ The 2006/07 budget reflects KD195 million on account of a KD 200 one off grant transfer to each Kuwaiti citizen.

Table 3. Kuwait: Summary Balance of Payments, 2004–13

	2004	2005	Prel. 2006	Prel. 2007	Est. 2008	Proj. 2009	2010	2011	2012	2013
	(In billions of U.S. dollars)									
Current account	**18.2**	**34.3**	**50.6**	**50.0**	**70.6**	**19.0**	**33.4**	**46.2**	**52.1**	**56.6**
Goods (trade balance)	18.4	32.7	43.5	45.2	67.1	20.3	26.0	30.2	32.2	33.4
Exports	30.1	47.0	58.9	63.7	88.2	40.0	47.7	54.2	58.6	62.6
Oil exports	27.8	44.1	55.7	60.1	84.1	35.2	42.6	48.6	52.6	56.1
Non-oil exports including re-exports 1/	2.3	2.9	3.3	3.6	4.1	4.7	5.2	5.6	6.0	6.5
Of which: re-exports	0.5	0.6	0.5	0.5	0.6	0.7	0.8	0.8	0.9	1.0
Imports	-11.7	-14.2	-15.4	-18.5	-21.2	-19.7	-21.7	-24.0	-26.4	-29.2
Services	-3.8	-3.9	-2.5	-3.1	-3.4	-2.0	-2.1	-2.2	-2.3	-2.5
Transportation	-0.6	-0.6	-0.4	-0.7	-0.7	-0.3	-0.4	-0.5	-0.7	-0.9
Insurance	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2	-0.2	-0.2
Travel	-3.5	-4.1	-5.0	-5.9	-6.7	-6.4	-6.8	-7.2	-7.6	-8.0
Other services	0.3	0.9	3.0	3.6	4.1	4.8	5.2	5.7	6.1	6.6
Investment income	6.1	8.9	13.2	12.9	12.9	6.3	15.5	24.8	29.4	33.4
Receipts	6.6	9.4	14.7	15.7	14.2	6.9	16.7	27.0	31.7	35.6
General government 2/	5.2	6.5	9.4	8.5	7.9	3.9	9.3	15.0	17.6	19.9
Other sectors 3/	1.4	2.9	5.3	7.1	6.3	3.1	7.4	12.0	14.0	15.8
Payments	-0.5	-0.6	-1.5	-2.8	-1.3	-0.6	-1.3	-2.2	-2.3	-2.3
General government	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	-0.4	-0.5	-1.5	-2.7	-1.3	-0.6	-1.2	-2.2	-2.2	-2.2
Current transfers	-2.6	-3.4	-3.6	-5.1	-6.0	-5.6	-6.0	-6.5	-7.1	-7.7
Capital and financial account	**-16.4**	**-30.1**	**-50.4**	**-42.8**	**-68.6**	**-19.9**	**-31.9**	**-44.6**	**-50.3**	**-54.6**
Capital account 4/	0.4	0.8	0.9	1.6	1.7	1.7	1.7	1.8	1.8	1.9
Financial account	-16.8	-30.9	-51.3	-44.4	-70.3	-21.6	-33.6	-46.3	-52.1	-56.5
Direct investment	-2.5	-4.9	-8.1	-13.6	-8.6	-2.2	-3.9	-5.3	-6.0	-6.5
Abroad	-2.5	-5.1	-8.2	-13.7	-8.7	-2.3	-4.0	-5.5	-6.2	-6.7
In Kuwait	0.0	0.3	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Portfolio investment	-13.9	-10.5	-29.1	-40.0	-55.8	-12.5	-21.8	-31.9	-35.6	-37.9
Other investment (net)	-0.4	-15.4	-14.1	9.2	-6.0	-6.9	-7.9	-9.1	-10.5	-12.1
Net errors and omissions 5/	-1.1	-3.4	3.5	-3.1	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	**0.7**	**0.8**	**3.7**	**4.0**	**2.0**	**-0.9**	**1.5**	**1.7**	**1.8**	**2.0**
	(In percent of GDP)									
Memorandum items										
Current account/GDP (in percent)	30.6	42.5	49.8	44.7	44.7	19.2	29.9	37.1	38.6	38.8
Current account (excl. oil)/GDP (in percent)	-16.1	-12.1	-5.0	-9.1	-8.6	-16.3	-8.2	-1.9	-0.3	0.3
Investment income/GDP (in percent)	10.3	11.0	13.0	11.6	8.2	6.4	13.9	19.9	21.8	22.9
WEO oil price (dollars per barrel)	37.8	53.4	64.3	71.0	97.0	44.0	52.0	57.5	61.5	64.0
Import growth (in percent)	18.1	22.1	8.3	20.0	14.4	-7.1	10.4	10.4	10.3	10.3
International reserve assets (in millions of U.S. dollars) 6/	7.3	8.1	11.8	15.9	17.8	16.9	18.5	20.2	22.0	23.9
In months of imports of goods and services	4.6	4.3	5.5	5.7	6.0	6.0	6.0	6.0	6.0	6.0

Sources: Central Bank of Kuwait; and Fund staff estimates.

1/ Also includes unrecorded oil exports.
2/ Kuwait Investment Authority, Kuwait Petroleum Corporation, Kuwait Fund for Arab Economic Development, Public Institute for Social Security, Kuwait Airways Corporation, and Bank of Savings and Credit.
3/ CBK, local banks, investment companies, exchange companies, insurance companies, and the nonfinancial private sector.
4/ Includes UN war compensation.
5/ Includes other unclassified private sector flows.
6/ Includes SDRs and IMF reserve position.

Table 4. Kuwait: Monetary Survey, 2004–09

End of period	2004	2005	2006	2007	2008	Proj. 2009
			(In millions of KD)			
Foreign assets (net) 1/	3,535	3,904	5,545	5,718	7,610	7,876
Central bank	2,165	2,370	3,416	4,327	4,510	4,263
Local banks	1,370	1,534	2,129	1,392	3,100	3,613
Domestic assets (net)	8,120	9,182	10,375	13,269	14,341	15,927
Claims on government (net)	1,246	948	113	-968	-2,675	-2,910
Central bank (net)	-662	-520	-617	-920	-1,124	-1,006
Claims	0	15	0	0	0	0
Deposits	662	534	617	920	1,124	1,006
Local banks (net)	1,908	1,467	731	-47	-1,550	-1,904
Claims	2,750	2,463	2,165	1,912	1,985	1,985
Government debt bonds	604	378	176	0	0	0
Public debt instruments	2,146	2,085	1,989	1,912	1,985	1,985
Other claims	0	0	0	0	0	0
Deposits	842	996	1,434	1,959	3,535	3,889
Claims on nongovernment sector	10,886	12,937	16,148	21,822	25,460	26,875
Credit facilities	9,867	11,827	14,934	20,139	23,660	24,851
Local investments	1,019	1,109	1,215	1,683	1,800	2,024
Other items (net)	-4,011	-4,702	-5,886	-7,585	-8,444	-8,038
Broad money 2/	11,655	13,086	15,921	18,987	21,950	23,804
Money	3,174	3,727	3,550	4,147	4,370	4,739
Quasi money	8,481	9,359	12,370	14,841	17,580	19,064
Of which: Foreign currency deposits	1,169	1,548	2,245	1,710	1,899	2,060
			(Annual percentage change)			
Foreign assets (net)	43.5	10.4	42.0	3.1	33.1	3.5
Central Bank	10.1	9.5	44.1	26.6	4.2	-5.5
Local banks	175.4	12.0	38.8	-34.6	122.8	16.6
Domestic assets (net)	2.3	13.1	13.0	27.9	8.1	11.1
Claims on Government (net)	-46.4	-24.0	-88.0	-953.4	176.4	-8.8
Claims on nongovernment sector	16.1	18.8	24.8	35.1	16.7	5.6
Other items (net)	-6.6	-17.2	-25.2	-28.9	11.3	4.8
Broad money	12.1	12.3	21.7	19.3	15.6	8.4
Money	21.6	17.4	-4.8	16.8	5.4	8.4
Quasi money	8.9	10.4	32.2	20.0	18.5	8.4
Of which: Foreign currency deposits	18.0	32.4	45.0	-23.8	11.1	8.4
			(Change in percent of beginning of period broad money stock)			
Foreign assets (net)	10.3	3.2	12.5	1.1	10.0	1.2
Central bank	1.9	1.8	8.0	5.7	1.0	-1.1
Local banks	8.4	1.4	4.5	-4.6	9.0	2.3
Domestic assets (net)	1.8	9.1	9.1	18.2	5.6	7.2
Claims on government (net)	-10.4	-2.6	-6.4	-6.8	-9.0	-1.1
Claims on nongovernment sector	14.5	17.6	24.5	35.6	19.2	6.4
Other items (net)	-2.4	-5.9	-9.0	-10.7	-4.5	1.9
Broad money	12.1	12.3	21.7	19.3	15.6	8.4
Money	5.4	4.7	-1.4	3.7	1.2	1.7
Quasi money	6.6	7.5	23.0	15.5	14.4	6.8
Of which: Foreign currency deposits	1.7	3.3	5.3	-3.4	1.0	0.7
Memorandum items:			(In percent)			
Non-oil GDP/M2	76.4	79.4	76.4	71.9	75.3	71.9
Foreign currency deposits/M2	10.0	11.8	14.1	9.0	8.7	8.7
Private credit/non-oil GDP	115.0	114.8	121.3	144.7	140.7	142.4

Sources: Central Bank of Kuwait; and Fund staff estimates.

1/ Excludes SDRs and IMF reserve position.

2/ Excludes deposits with financial institutions which are marginal. For 2007, it was KD 26.1 million.

Table 5. Kuwait: Illustrative Macroeconomic Baseline Scenario, 2005–13

			Est.	Est.	Projections					
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
				(Percentage change, unless otherwise specified)						
Production and prices										
Nominal GDP (KD billions)	23.6	29.5	31.8	42.5	28.1	31.7	35.3	38.3	41.3	44.6
Nominal GDP	34.7	24.9	7.7	33.8	-33.9	12.7	11.3	8.6	7.9	7.8
Nominal non-oil GDP	16.8	17.1	12.2	21.0	3.6	7.4	9.1	8.8	8.8	8.8
Real GDP	10.7	5.2	2.5	6.4	-1.2	2.3	4.4	4.8	4.8	4.8
Real oil GDP	11.4	2.9	-2.3	4.2	-4.5	0.9	1.9	2.1	2.1	1.9
Real non-oil GDP	10.6	8.3	7.8	7.3	1.0	3.0	5.5	6.0	6.0	6.0
Kuwait crude export price (U.S. dollars per barrel)	49.1	60.2	67.8	92.4	40.0	47.9	53.7	56.9	57.5	60.0
Crude oil output (millions of barrels per day)	2.57	2.64	2.58	2.68	2.56	2.58	2.63	2.69	2.75	2.81
Consumer price index	4.1	3.1	5.5	10.5	6.0	4.8	4.4	3.4	3.4	3.4
				(Percent of GDP, unless otherwise specified)						
Public finance 1/										
Revenue, *of which* :	75.6	67.0	67.8	65.5	48.1	55.1	59.7	59.9	58.8	57.3
Oil and gas	51.7	48.3	51.5	52.4	36.8	39.3	40.1	39.6	38.3	38.2
Investment income 2/	21.4	15.8	13.0	10.0	7.1	11.9	15.9	16.7	17.0	15.7
Expenditure	27.2	34.2	27.9	39.7	39.2	37.8	36.9	36.5	36.2	32.5
Current 3/	23.6	30.1	23.8	35.7	33.3	31.9	30.8	30.0	29.3	25.1
Capital	3.6	4.1	4.1	4.0	5.8	5.9	6.1	6.5	6.9	7.4
Fiscal balance (deficit -)	48.5	32.8	39.9	25.8	9.0	17.3	22.8	23.4	22.6	24.8
Fiscal balance excl. inv. income (deficit -)	27.1	17.1	26.9	15.8	1.9	5.4	6.9	6.7	5.6	9.1
Non-oil primary deficit/Non-oil GDP (in percent) 4/	-57.0	-58.9	-58.9	-61.0	-58.1	-58.7	-58.4	-57.6	-56.8	-50.2
				(Change in percent of beginning of period broad money stock)						
Money and credit										
Foreign assets (net)	3.2	12.5	1.1	10.0	1.2	...	...	...	...	
Domestic assets (net)	9.1	9.1	18.2	5.6	7.2	...	...	...	...	
Claims on government (net)	-2.6	-6.4	-6.8	-9.0	-1.1	...	...	...	...	
Claims on nongovernment sector	17.6	24.5	35.6	19.2	6.4	...	...	...	...	
Broad money	12.3	21.7	19.3	15.6	8.4	...	...	...	...	
				(Percent change, unless otherwise specified)						
Exchange rates										
Exchange rates (U.S. dollar per KD, period average)	3.42	3.45	3.52	3.72	3.53	...	...	...	...	
Nominal effective exchange rate	0.4	0.5	-2.2	0.3	...	...	...	...	...	
Real effective exchange rate	2.0	0.9	0.4	7.2	...	...	...	...	...	
				(Percent of GDP, unless otherwise specified)						
Balance of payments 5/										
Exports of goods and services excl. re-exports	61.4	64.1	64.0	61.3	49.9	54.2	54.7	54.4	53.8	53.2
Of which : oil and refined products	54.6	54.8	53.8	53.2	35.5	38.1	39.0	38.9	38.4	37.9
Imports of goods and services excl. re-exports	-25.7	-23.7	-26.3	-21.0	-31.5	-32.8	-32.2	-32.3	-32.7	-33.1
Investment income (net)	11.0	13.0	11.6	8.2	6.4	13.9	19.9	21.8	22.9	25.8
Current account	42.5	49.8	44.7	44.7	19.2	29.9	37.1	38.6	38.8	40.6
Current account (excluding oil exports)	-12.1	-5.0	-9.1	-8.6	-16.3	-8.2	-1.9	-0.3	0.3	2.7
Public sector external assets, billions of U.S. dollars	200.1	245.5	307.4	349.7	388.9	427.5	477.8	535.0	596.5	596.5
Public sector external assets 5/	247.6	240.9	264.3	227.0	392.0	382.2	383.8	395.7	408.7	379.2
				(Percent of GDP, unless otherwise specified)						
Saving-investment balance										
Final consumption	47.9	43.3	42.9	42.2	66.9	58.7	55.2	55.6	56.0	57.1
Government	14.9	13.3	14.0	12.3	20.3	19.1	18.1	17.5	17.0	13.8
Private	33.0	30.0	28.9	29.8	46.6	39.6	37.2	38.1	39.0	43.4
Gross domestic investment	16.4	16.2	19.4	17.6	14.7	19.9	22.3	22.4	22.8	22.7
Government	3.0	2.8	3.7	3.1	5.2	5.2	5.4	5.7	6.2	6.6
Private	13.5	13.4	15.8	14.5	9.5	14.7	16.9	16.6	16.6	16.1
Savings	58.9	66.1	64.2	62.2	33.9	49.8	59.4	60.9	61.5	63.3
Government Saving	56.2	60.8	57.0	46.3	39.6	34.4	40.4	42.4	42.1	43.8
Private Savings	2.7	5.3	7.1	15.9	-5.7	15.4	19.0	18.6	19.4	19.5

Sources: Kuwait authorities; IMF World Economic Outlook; and Fund staff estimates and projections.

1/ Fiscal year ending March 31.
2/ Includes profits of public enterprises.
3/ In 2006/07 KD 2 billion was transferred to partly cover the actuarial deficit of the social security fund. In 2008/09 KD 5.4 billions are budgeted.
4/ Non-oil primary deficit is defined as total revenues excluding oil revenues and KIA investment income minus non-interest expenditures and recapitalization of pension.
5/ Staff estimates and projections, based mainly on balance of payment flow data and assuming return on foreign assets close to the LIBOR.

Table 6. Kuwait: Financial Soundness Indicators, 2004–08

	2004	2005	2006	2007	Sept. 2008
Core Set:			(In percent)		
Regulatory capital to risk-weighted assets	17.3	21.3	21.8	18.5	16.0
Nonperforming loans net of provisions to capital	5.9	...	15.2	12.6	15.2
Nonperforming loans to gross loans	5.3	5.0	3.9	3.2	3.1
Nonperforming loans from before invasion	2.9	2.2	1.8	1.4	1.0
Nonperforming loans since liberation	2.4	2.8	2.1	1.8	2.1
Return on assets	2.5	3.0	3.2	3.4	3.2
Return on equity	20.9	22.9	27.1	28.1	27.8
Liquid assets to total assets	13.2	11.1	8.1	7.0	7.7
Liquid assets to short-term liabilities	52.0	47.8	...	...	...
Net open position in foreign exchange to capital and reserves	8.7	7.4	1.4	1.1	0.4
Encouraged Set:			(In percent)		
Capital to assets	12.1	12.7	11.7	12.0	11.6
Average lending rate 1/	5.6	7.5	8.8	8.3	6.4
Average deposits rate 1/	2.7	3.5	5.5	5.3	4.2
Spread over 3-month deposit rate 1/	3.0	4.0	3.3	3.0	...
Foreign-currency-denominated assets to total assets	21.2	18.3	21.4	22.8	25.7
Foreign-currency-denominated liabilities to total assets	20.2	17.3	21.8	24.0	24.1
Loan provisions to nonperforming loans	82.5	107.2	95.8	92.0	84.7
Ratio of banks' lending to banks' capital					
Stock market related 2/	39.3	44.6	50.6	48.2	61.3
Real estate 3/	87.8	90.7	103.7	115.9	124.5
Total (stock market plus real estate)	127.1	135.3	154.3	164.1	185.8
Investment companies' capital and reserves to total assets 4/	30.3	36.2	35.4	34.8	36.0

Source: Central Bank of Kuwait.

1/ For local banks.
2/ Includes lending for stock purchases of listed and unlisted domestic and foreign companies.
3/ Includes only credit to developers (excludes credit to home buyers). Ratios may be overestimated due to problems with loan classification by the local banks.
4/ Excluding Islamic institutions.

Table 7. Kuwait: Vulnerability Indicators, 2004–08

	2004	2005	2006	Prel. 2007	Proj. 2008
	(In percent, unless otherwise indicated)				
External solvency indicators					
REER (CPI based, period average) 1/	-5.1	2.0	0.9	0.4	7.2
External debt including private sector (in billions of U.S. dollars)	12.1	16.5	26.4	26.3	26.7
Short-term debt (original maturity; in billions of U.S. dollars) 2	5.9	8.0	12.8	12.7	12.9
Medium- and long-term debt (in billions of U.S. dollars) 3/	6.3	8.5	13.6	13.6	13.8
External debt/GDP 4/	20.4	20.4	26.0	23.5	16.9
External debt/total exports of goods and services	35.8	31.9	39.5	35.9	26.9
Short-term debt/total exports of goods and services	17.4	15.5	19.1	17.4	13.0
External debt service/total exports of goods and services	3.7	1.7	2.3	...	...
Public sector solvency indicators					
General government domestic debt/GDP 5/	17.3	11.8	8.3	6.9	5.3
Interest payments/total revenue	0.8	0.5	0.5	0.4	0.3
Distribution of the public domestic debt by holders					
Local commercial banks	90.7	88.4	89.0	87.7	88.1
Other (including nongovernment public institutions)	9.3	11.1	11.0	12.3	11.9
Oil revenue/total revenue	79.2	70.1	71.2	75.1	79.0
External liquidity indicators					
CBK net foreign assets (in billions of U.S. dollars)	7.3	8.1	11.8	15.8	16.8
CBK gross foreign assets (in billions of U.S. dollars) 6/	7.5	8.5	12.3	16.4	16.7
In months of imports of goods and services	4.6	4.5	5.7	6.3	5.7
Relative to short-term external debt	126.9	106.2	96.0	128.6	129.4
Relative to M0	279.3	268.1	294.6	243.1	278.8
Relative to M1	69.2	66.5	100.0	107.9	102.6
Local banks' net foreign assets (in billions of U.S. dollars)	4.6	5.3	7.4	5.1	11.6
Foreign assets	10.8	13.0	18.1	28.0	32.8
Foreign liabilities	6.2	7.7	10.8	22.9	21.3
Oil exports/total exports	92.3	93.9	94.4	94.3	95.4

Sources: Central Bank of Kuwait; and Fund staff estimates.

1/ Percentage changes in period's average.
2/ Short-term data are obtained from the joint BIS-IMF-OECD-World Bank database.
3/ Medium- and long-term debt is estimated as a residual.
4/ Include private sector's debt.
5/ Treasury bills and bonds, and debt purchase bonds.
6/ Excludes SDRs and IMF reserve position.

INTERNATIONAL MONETARY FUND

Public Information Notice

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IMF Concludes 2009 Article IV Consultation with Kuwait

On April 10, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Kuwait.[1]

Background

The 2009 consultation discussions were held against the backdrop of the global financial crisis and the ensuing economic slowdown. Kuwait's economy continued to perform strongly in 2008, although signs of weakness emerged in the second half of the year. The authorities' key challenge in the near term is to preserve financial stability and cushion the impact of the global slowdown.

Real GDP is estimated to have picked up to 6.4 percent in 2008, up from 2.5 percent in 2007, reflecting both higher oil production and robust non-oil GDP growth. Inflation peaked at 11.6 percent (on a year-on-year basis) in August and started to moderate toward the end of 2008 on weaker domestic demand and lower import prices.

High average oil prices contributed to substantial current account and fiscal surpluses in 2008. Despite rising imports, the estimated current account recorded a surplus of 45 percent of GDP and the budget surplus for 2008/09 is estimated at 26 percent of GDP, notwithstanding a large transfer to recapitalize the pension fund (10.5 percent of GDP).

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the April 2008 Executive Board discussion based on the staff report.

Broad money and credit growth declined in 2008, owing to the Central Bank of Kuwait's (CBK) measures to contain credit growth in the first half of 2008 and tight liquidity conditions in the second half of the year. After switching back from a dollar to a basket peg in May 2007, the authorities let the Kuwaiti dinar (KD) appreciate against the US dollar in order to slow inflation. This, along with high inflation, led to a 7 percent appreciation in the real effective exchange rate (REER) in 2008.

The global financial crisis has affected adversely Kuwait's financial system. Liquidity conditions tightened in the second half of 2008, reflecting capital outflows and rising concerns about counterparty risk. Consequently, the KD interbank rate spiked in October 2008, prompting swift intervention by the authorities, through large liquidity injections, to stabilize the market. Since the deepening of the global crisis after the fall of Lehman Brothers, the Kuwait Stock Exchange (KSE) index fell by 50 percent. In October 2008, the third largest bank lost $1.4 billion, mostly on derivative transactions, leading the authorities to guarantee customer deposits at local banks and implement a successful recapitalization plan. In December 2008, the largest investment company in Kuwait defaulted on most of its $3 billion debt obligations and has been negotiating a debt restructuring.

The economic outlook for 2009 will be driven largely by the fallout from the global slowdown. Real GDP is projected to contract by 1.2 percent in light of lower oil production and a decline in non-oil growth, reflecting weak activity particularly in the financial and construction sectors. Lower import prices, weaker domestic demand, and a moderation in rents should bring inflation down to 6 percent. The fiscal and current accounts surpluses are projected to decline significantly owing to lower oil revenue.

The medium-term outlook will depend largely on developments in the global oil market and progress in the implementation of structural reforms to promote private investment. The fiscal and current account positions should improve gradually over the medium-term in line with the projected increase in oil prices.

The major risks to the economic outlook are a rapid deterioration in the balance sheet of financial institutions and a prolonged global recession that could maintain oil prices below $50. These risks would affect adversely investor and consumer confidence, limit fiscal space, and worsen the growth outlook.

Executive Board Assessment

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.