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KUWAIT

SELECTED ISSUES

November 6, 2013

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OPTIMAL FISCAL POLICY FOR KUWAIT: HOW MUCH TO SAVE AND HOW MUCH TO INVEST[1]

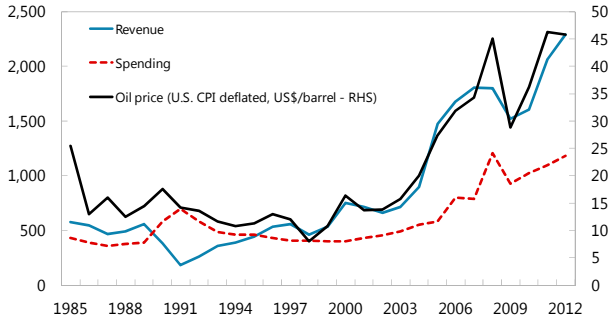
This study estimates the optimal allocation of government current spending, precautionary saving, and investment for Kuwait under uncertainty. The results show that in the face of high oil income volatility and the expected decline in oil prices, projected current spending exceeds the optimal amount over the medium term (2013–18). However, there is room to increase investment spending, which should contribute to growth of the tradable sector, as the projected investment rate is lower than the optimal investment rate of 20 percent of government income.

A. Introduction

1. Kuwait's government income is mostly determined by oil revenues and is highly susceptible to oil price volatility. Oil revenues accounted for 85 percent of total government revenues in 2011. Although total spending was less volatile than total revenues between 1985 and 2012, it nonetheless has exhibited considerable volatility during this period (Figure 1). The riskiness of relying on one source of volatile income is apparent in the fall in real spending in the mid-1980s and 1990s when real oil prices declined substantially from their peak in the late 1970s. Spending recovered since oil prices started rising in the 2000s. In terms of welfare, real consumption per capita (in PPP terms) was relatively flat during 1990–2000 and started slowly rising thereafter (Figure 2).[2]

Figure 1. Real Revenue and Spending and Oil Price, 1985–2012

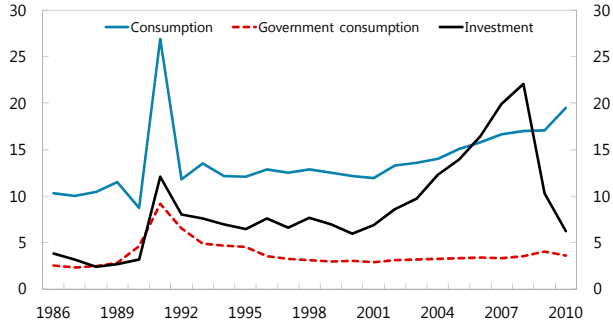
(KD billions; unless otherwise specified)



Source: IMF, World Economic Outlook.

Figure 2. Real Consumption, Government Consumption, and Investment per Capita, 1986–2010

(PPP-based, US$ 000s)



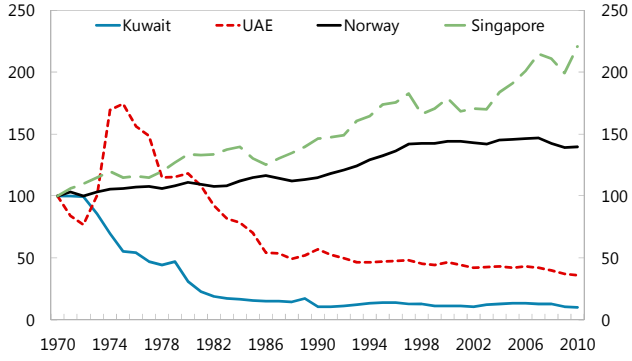
Source: Penn World Table v7.1.

[1] Prepared by Fuad Hasanov.

[2] Figure 1.2 actually underestimates the resulting welfare gap because many countries have been growing during the same time period; in cross-country rankings, Kuwait has fallen behind.

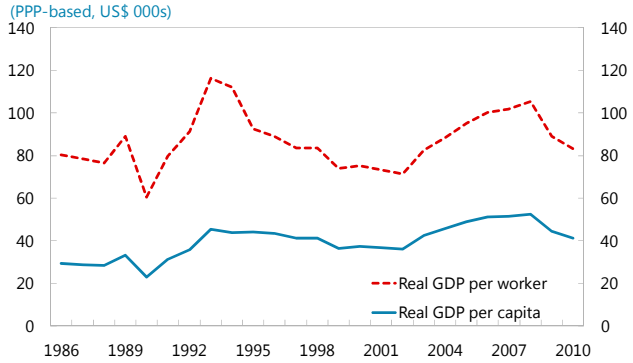
2. Fiscal policy should address smoothing spending and investing in tradable sectors, and building precautionary savings. High volatility of government income calls for smoothing spending; however, reliance on oil as a predominant source of income also suggests that the accumulation of liquid and safe assets in case of large and prolonged negative income shocks is a key ingredient of effective stabilization. The government also needs to determine the amount of public investment needed to facilitate growth of the tradable sector and improve productivity (Figures 3-4).

Figure 3. Total Factor Productivity, 1970–2010
(Index, 1970=100)



Source: Calculations based on Arezki and Cherif (2010).

Figure 4. Real GDP per Worker and Real GDP per Capita, 1986–2010
(PPP-based, US$ 000s)



Source: Penn World Table v7.1.

3. Most currently used methods of assessing fiscal policy are inadequate at addressing multiple goals of fiscal policy in a parsimonious framework. The structural revenue rule (as used in Chile, for example) is designed to smooth spending, and provides a way to save part of the windfall income or spend part of accumulated savings during temporary drops in income. While useful in restricting the government from overspending in case of higher-than-expected prices, this rule does not clearly indicate whether the amount saved or spent is optimal, given the oil production profile, high volatility, and persistence of oil income, and various smoothing methods. Another commonly used method, the perfect-foresight, infinite-horizon, permanent-income hypothesis (PIH) model, provides a way to smooth spending and computes an annuity value that can be consumed forever based on a net present value of oil wealth. It addresses the intergenerational equity concerns, though it does not deal with income volatility and is sensitive to parameter specifications such as the real interest rate, growth, and oil prices and production that go far into the future. The computed benchmark could be quite sensitive to the assumptions chosen.

4. This paper proposes a finite-horizon precautionary saving model with investment that incorporates income volatility to derive optimal fiscal policy for Kuwait. It estimates how Kuwait should allocate its volatile hydrocarbon revenues among domestic investment, consumption and safe savings. The model is based on the "silo" model of Cherif and Hasanov (2012) and features two assets, a safe and liquid bond (e.g., in a sovereign wealth fund) and risky and illiquid investment. Both permanent and temporary income shocks drive the income process. The model produces optimal shares of consumption, investment, and saving in a safe asset (precautionary saving) for each period in contrast to the standard PIH model in which the computation of optimal investment that affects the growth path is absent. The shares are based on permanent income. The finite horizon of the model can bypass the

making of stringent assumptions into the infinite future, and incorporates the oil depletion profile while focusing on the relevant short-and medium-term decision horizon. Applying the parameters to Kuwait's economy, we find that current spending is expected to exceed the optimal path while the actual investment rate is below the optimal investment rate of 20 percent of permanent income. These projections are based on a projected decline in oil prices in the medium term (baseline scenario), but they raise important questions as to whether current spending should continue on its projected path. The measure of success of the investment is how the tradable sector develops and how productivity evolves, because investment, in the model, directly contributes to the growth of tradable income.

B. A Silo Model of Precautionary Saving and Investment

5. Fiscal policy is modeled as a social planner's life-cycle optimal consumption and investment program under income uncertainty. This section closely follows Cherif and Hasanov (2012) in describing the model used.

Preferences

In period 0, a representative agent has the following utility over a tradable consumption good X for T periods:

$$\mathrm{E}_0\left[\sum_{t=0}^{T}\beta^{t}\frac{X_t^{1-\rho}}{1-\rho}\right] \tag{1}$$

where β is a discount factor and the utility function is of the constant relative risk aversion (CRRA) form with the relative risk aversion coefficient, ρ.[1]

Production

The tradable good output process $\{Y_t\}$ is specified as follows:

$$Y_t = P_t\epsilon_t \tag{2}$$

where P_t is the permanent income component and ϵ_t is the temporary shock to output and evolves according to a log-normal i.i.d. process. The permanent income is evolved according to the following equation:

$$P_{t+1} = (1+\tau\xi)P_t\vartheta_{t+1} \tag{3}$$

where τ is the constant investment rate as a share of permanent tradable output and ξ is a parameter interpreted as a measure of productivity. ϑ_t is the permanent shock to output and follows a log-normal i.i.d. process.[2] Investment is irreversible and risky. This specification implies that average income growth is a linear function of the investment rate and productivity. There is no differentiation between oil and

[1] Please see Cherif and Hasanov (2012) for a simple treatment with a nontradable good. Because nontradable good production is fully consumed every period, for saving dynamics, it is the tradable income that matters.

[2] Income volatility can stem from both fluctuations in price and tradable output volume.

non-oil tradables, but the composition is captured by calibrating tradable income volatility using total exports.

Budget constraint

Given the wealth accumulated at the end of period *t*, W_t, a 100 percent depreciation rate, and a constant interest rate *r*, the budget constraint at any period *t* is:

$$W_{t+1} = (1 + r)W_t + Y_t - \tau P_t - X_t \quad (4)$$

The next period's wealth is total current resources, or "cash on hand," less consumption X.

Equilibrium

Given initial wealth W_0 and the investment rate τ, an equilibrium allocation specifies a consumption path such that the representative agent maximizes its utility subject to the budget constraint and such that markets clear.

Solution

The solution to the maximization problem is given by the following Bellman equation (variables in small letters are normalized by permanent output) and solved as in Carroll (1997, 2001):[3]

$$v_t(w_t) = \max_{x_t} \left\{ \frac{{x_t}^{1-\rho}}{1-\rho} + \beta \mathrm{E}_t[(1 + \tau\xi)^{1-\rho} v_{t+1}(w_{t+1})] \right\} \quad (5)$$

Calibration

The coefficient of relative risk aversion ρ is set to 2, the lower end of the range generally used in the literature. The discount rate is set to the standard value of 4 percent. The productivity parameter, ξ, is set to 0.08, implying that with the investment rate of 20 percent, the trend tradable income growth is 1.6 percent per year on average. The low productivity observed suggests that even this number may be high. Permanent and temporary income shocks are assumed to be unit-mean log-normal.[4] Standard deviations of permanent and temporary shocks of exports (in constant U.S. dollars), σ_ϑ and σ_ϵ, proxied for tradable output, are estimated using the Kalman filter over the period 1975–2010 and the World Bank's World Development Indicators database. The estimated parameters, 0.25 and 0.07 for permanent and temporary shocks, respectively, are based on an average of the available data from the Gulf Cooperation Council (GCC). As a reference, the standard deviation of real oil price is about 0.3. A time horizon is 65 years, at the end of which all accumulated wealth is depleted and the diversified non-oil economy is left for future generations. The initial wealth-to-income ratio is calculated based on the ratio of Kuwait's assumed liquid portion of the sovereign wealth fund to government revenue and equals 1.3 in 2012. The initial output is normalized to 1. Results should be interpreted in percentage of initial income.

[3] The return on wealth, r, is assumed to be zero without a loss of generality, which is conservative and broadly consistent with average after-tax real return on Treasury bills in the second half of the 20th century (Dacy and Hasanov, 2011).

[4] We also assume a probability of 1.7 percent of a temporary production drop of 30 percent, following Barro's (2009) rare disaster analysis.

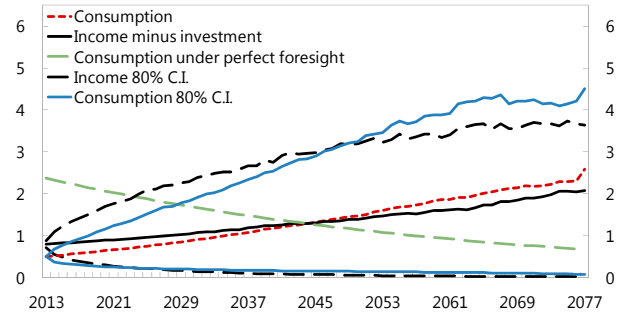
C. A Need to Accumulate Precautionary Savings While Investing Moderately

6. Using current parameters, in the initial period, the model produces an optimal investment rate of 20 percent of permanent income, initial consumption rate of 50 percent, and precautionary saving rate of 30 percent. This is in contrast to the prediction of the perfect foresight consumption and saving paths, in which initially, there is large borrowing (Figure 5). In addition, confidence bands of income and consumption show that the actual paths, depending on the realization of actual income, could differ drastically from the average path. Figure 6 shows the average path of the SWF. It rises to about 6.5 times the initial income until it is run down by the end of the horizon. If there is a preference for keeping some assets in the SWF by the end of the horizon, the initial precautionary saving rate would be higher.

7. The optimal marginal propensity to consume (MPC) out of permanent income shocks is about 0.45 and that of temporary income shocks or windfalls is about 0.04. Produced by the model, MPCs are useful when gauging how optimal consumption should respond to a change in permanent income or windfall revenue. A one-dollar decline in permanent income should reduce consumption by about 45 cents, investment by 20 cents, and the precautionary saving by the remaining 35 cents. A temporary drop in income indicates that consumption should drop by only 4 cents while saving drops by 96 cents, but does not envisage a change in investment because permanent income has not changed. As expected, there is more smoothing of spending in the case of a temporary drop in income.

Figure 5. Simulated Time Paths of Average Consumption and Income, 2013–77

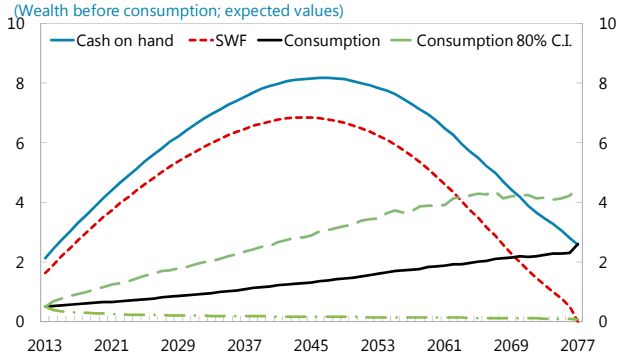
(80 percent confidence intervals and perfect foresight consumption at average income; expected values)



Source: IMF staff calculations.

Figure 6. Average Consumption, SWF, and "Cash on Hand," 2013–77

(Wealth before consumption; expected values)

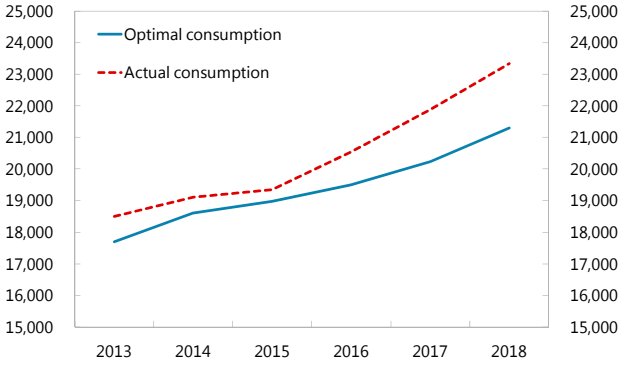


Source: IMF staff calculations.

8. The model suggests that the projected current spending exceeds the optimal path while investment spending is below its optimal in the medium term. Using the current initial wealth ratio, we obtain optimal consumption, investment, and precautionary saving rates going forward. Multiplying the ratios by projected government income of the moving average of order 3 to approximate permanent income, the actual levels of the variables are computed. The gap between projected and optimal current spending starts widening from 2015 and reaches 3.6 percent of GDP by 2018 (Figure 7). The projected investment spending reduces the gap with the optimal path in the medium term but is still 3 percent of GDP below the optimal level of investment as suggested by the model (Figure 8).

Figure 7. Optimal vs. Projected Current Spending, 2013–18

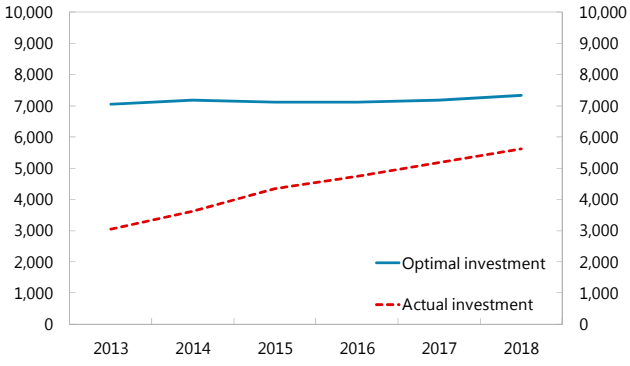
(KD millions)



Source: IMF staff calculations.

Figure 8. Optimal vs. Projected Investment Spending, 2013–18

(KD millions)



Source: IMF staff calculations.

D. Concluding Remarks

9. Fiscal policy in Kuwait has to pursue several objectives. Volatility of oil prices calls for smoothing of spending as well as accumulating safe and liquid assets. Diversification away from one source of income argues for investments in the tradable sector. How much should be saved, invested, and consumed? This paper addresses these concerns in a parsimonious framework. A model with precautionary saving and investment under income uncertainty is used to derive the government's optimal fiscal policy.

10. In the face of high income volatility and the expected decline in oil prices, there is a need to accumulate a large amount of safe and liquid assets. The model shows that the Kuwaiti government is spending more on current expenditures than warranted, and the shortfall is projected to widen over the next five years as spending continues to grow with declining oil prices. It may be that oil prices will not decline in the medium term, in which case the gap would automatically shrink. Although this is a possibility, a prudent policy would take into account a projected decline in oil prices and restrict spending policy until more information becomes available.[5]

11. The optimal investment rate of 20 percent suggests that the government needs to revamp its investment spending, but more importantly, investment should contribute to growth of the tradable sector. The model assumes that investment adds to the tradable sector; but in reality a lot of investment can go to waste or support nontradable consumption. Indirectly, low labor productivity and TFP attest to a low return on public investment. More diligence is needed in this area and improving productivity should take a priority. The model does predict that as productivity improves, the optimal investment rate should increase. In addition, as the economy diversifies and volatility falls, large precautionary savings are no longer required and more resources could be consumed and invested, thus increasing growth while keeping volatility low.

[5] The model can be re-run every period to obtain optimal shares, which could be assessed using updated projections of oil prices and income.

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IN PURSUIT OF DIVERSIFICATION, PRIVATE SECTOR DEVELOPMENT, AND JOB CREATION[1]

Economic diversification into areas with greater national employment potential and creating incentives for employment of nationals in the private non-oil sector should be a key priority to reduce Kuwait's dependence on oil in the future. Promotion of export-oriented industries offers an opportunity to diversify the Kuwaiti economy away from oil and generate jobs for nationals. The state needs to lead this effort by providing an enabling environment for private sector development: creating special economic zones, supporting export industries, investing in the relevant skills, and removing impediments in physical, legal, and business infrastructure. Improving the effectiveness of public administration and containing the government's role as "the employer of first resort" are integral parts of the reform. To bring on board all the parties, such as government agencies, the private sector, and the people, incentives need to be realigned to spur a major shift in the social and economic landscape of the country to achieve sustainable long-run growth.

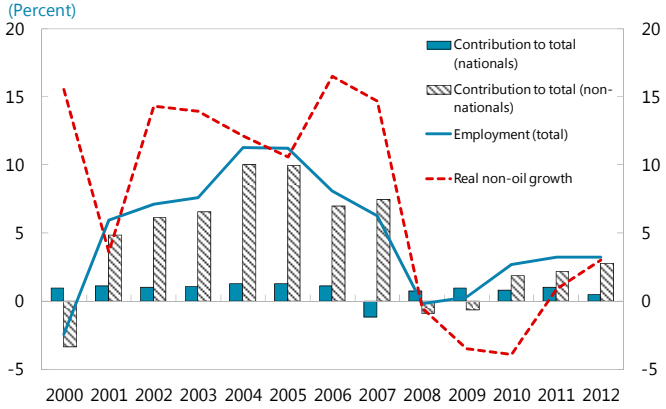
A. Output and Employment Trends during the Past Decade

1. Kuwait's output and export structures are heavily based on hydrocarbons. Hydrocarbons account for about 63 percent of output. Kuwait's economy is much more concentrated in mining and much less in trade, manufacturing, and even services compared to Singapore—a comparator country with similar size and large non-national population—and other GCC countries (Figure 2). More than 95 percent of goods exports is in one commodity—oil. This structure contrasts sharply with Singapore's highly diversified export base that has been shown to have positive impact on long-run growth (Hausmann, Hwang, and Rodrik, 2007).

2. Kuwait witnessed high growth throughout the past decade until the global financial crisis of 2008. Non-oil economic activity grew at a fast pace during the 2000s; it turned negative in 2008 and only moved slightly to a positive territory in 2011. Unemployment remained low, at 3 percent for Kuwaitis. Real non-oil growth averaged 7.8 percent during 2000–11 and was accompanied by employment growth for both nationals and non-nationals (4.6 percent and 5.9 percent per year, respectively) with non-nationals contributing most of total employment growth (Figure 1). External and domestic

Figure 1. Employment and Non-oil Growth, 2000–12

(Percent)

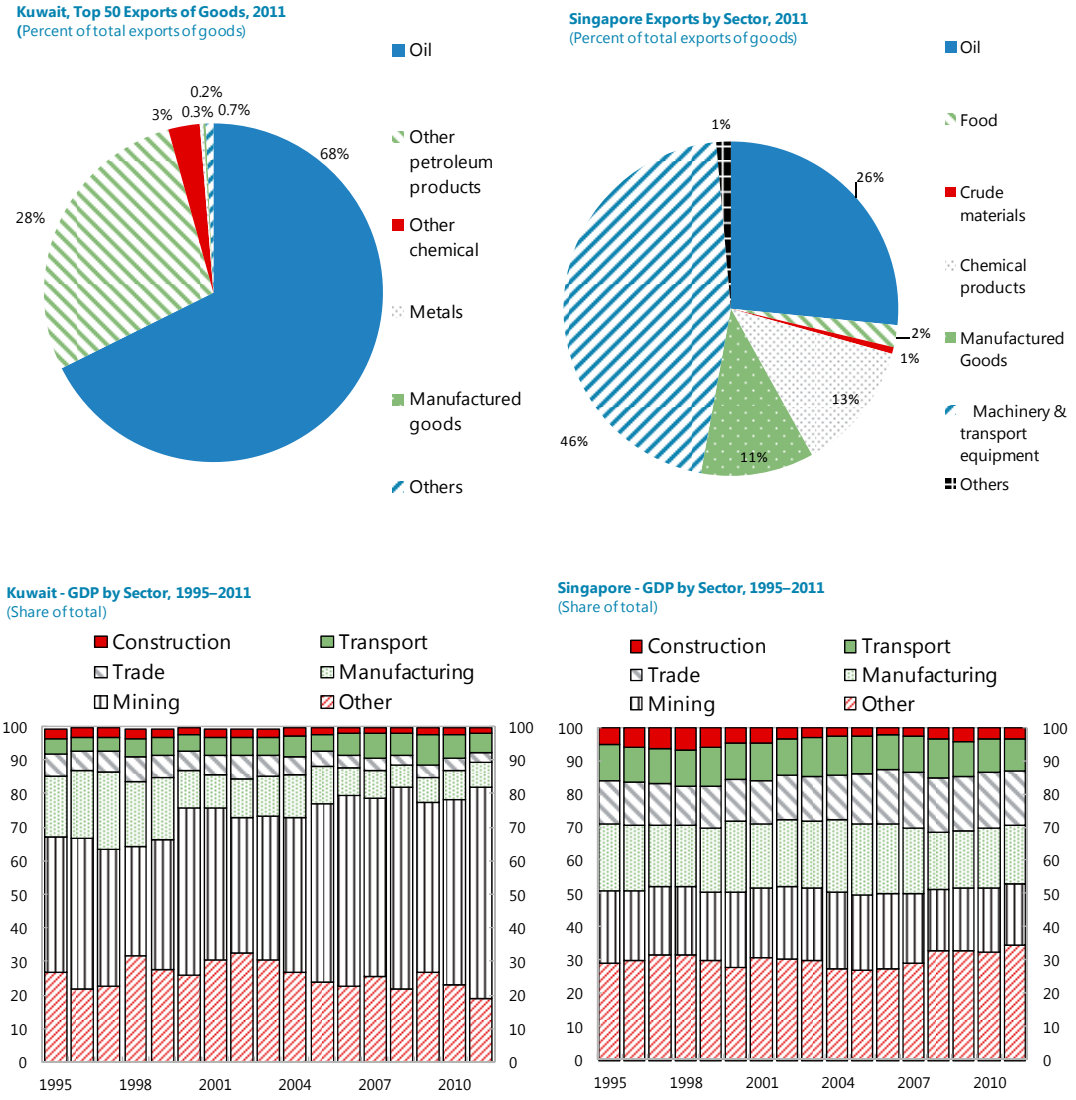


Sources: Country authorities; and IMF staff calculations.

[1] Prepared by Fuad Hasanov.

shocks in the late 2000s affected Kuwait's economic activity, and the average annual growth rate during 2008–11 was negative, about 15 percentage points lower than that during 2000–07 (12.7 percent).[2]

Figure 2. Output, Trade, and Exports



Sources: World Economic Forum; Haver Analytics; United Nations Statistics Division; country authorities; and IMF staff calculations.

3. Real growth in the non-hydrocarbon sector during the past decade was broad-based, with transportation growing at the highest rate (Figure 8). Transportation grew the fastest

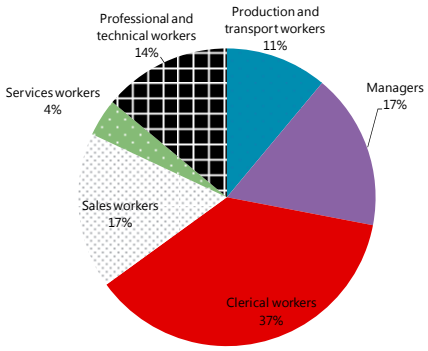
[2] The external shock refers to the global financial crisis, which started in 2008, and the domestic shock refers to the political turmoil and tensions that started in 2011.

compared to other GCC countries and other comparators, except for Qatar. The rate of growth of Kuwait's construction sector was higher than in Singapore, Chile, and Indonesia, similar to that in Bahrain, but not as high as in Qatar and Oman. Mining and other services grew at a higher rate than in most GCC countries; however, manufacturing and trade grew much more slowly than in the comparator countries.

4. Kuwait's growth is largely driven by government spending, such as the public wage bill and investment, generated from oil income. Oil accounts for a large part of exports and fiscal revenues. The oil and gas sector contributed 86 percent of total exports and 85 percent of government revenues in 2011. Spending by households and public capital projects drive the non-oil sector, in which most activities are concentrated in services (19 percent of total GDP) and transport (6 percent of total GDP). Construction comprises a small part of the output compared to other GCC countries, though it grew substantially in the early 2000s, resulting in oversupply of commercial office space.

5. Kuwaiti nationals are employed mostly by the public sector. Public sector employment for nationals increased on average by about 7 percent between 2005 and 2011, at about double the rate of the decade before. Although private sector jobs for nationals increased substantially, at about 15 percent in late 2000s, the share of nationals in the private sector is less than 5 percent of the employed. Most nationals in the private sector are in clerical positions, followed by sales personnel and managers, and professional workers (Figure 3). Nevertheless, rapid national population growth (averaging 3.1 percent per year during 2000–12) combined with a relative shortage in nationals' marketable skills and higher reservation wages compared to expatriates, could result in future pressures to absorb nationals into the public sector.

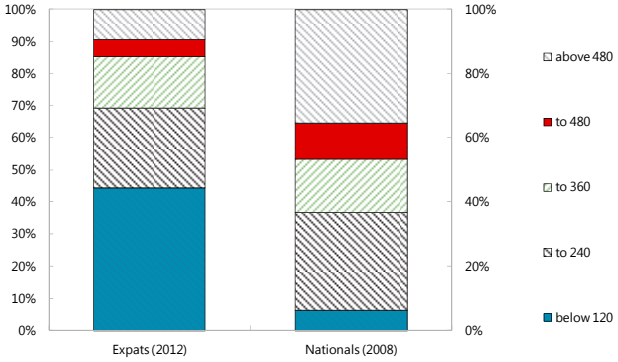
Figure 3. National Workers in the Private Sector by Occupation, 2008



Sources: Country authorities, and IMF staff calculations.

6. Non-national workers represent a significant share of the labor market. Non-nationals are mostly employed by the private sector, and most are in low-wage professions (Figure 4). Only 10 percent of non-national workers earn above KD480/month ($1700). The non-national work force in the private sector also grew substantially in the 2000s. They are mostly employed in trade and hospitality, social services, construction, and industry sectors.

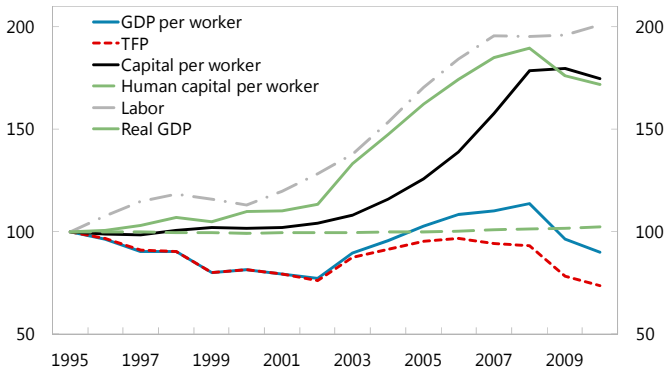
Figure 4. Private Sector Employment, by Nationality and Wage, 2008 and 2012



Sources: Country authorities, and IMF staff calculations.

7. With the majority of the labor force in government and low-skilled private sector jobs, productivity growth has been disappointing over the past couple of decades. Output per worker and total factor productivity (TFP) declined compared to 1995. In contrast, they grew substantially in many Asian countries. The recent growth was mostly due to labor accumulation and capital as TFP and human capital per worker did not rise in the past couple of decades (Figure 5).[3] Despite improvements in some social indicators, Kuwait is largely lagging behind in education and health quality, infrastructure development, and business climate and regulations (see Kuwait: 2013 Article IV Consultation Report). Low-productivity activities in construction, government, and services do not pave way for high and sustainable long-run growth.

Figure 5. Kuwait: Growth Decomposition, 1995–2010
(Index, 1995=100)



Sources: Country authorities; and IMF staff calculations.

B. A Need for Diversification

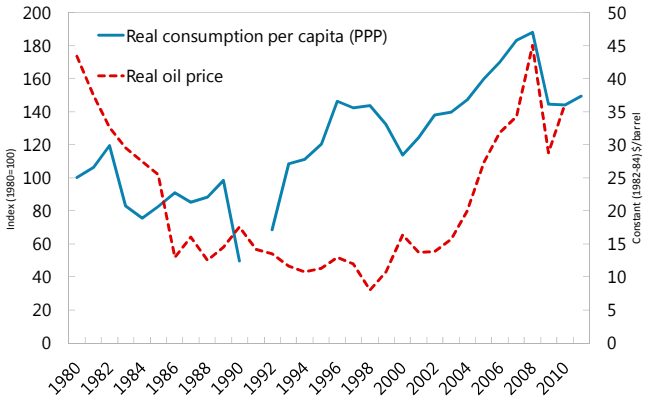
8. Despite high levels of GDP per capita, the current growth model and labor market structure pose challenges. The current unemployment rate for nationals is low, at 3 percent, but projected non-oil growth levels might not provide enough future employment opportunities. Increasing public sector employment to absorb new labor force entrants is not a sustainable strategy.[4] With the 25 percent public wage hike in 2012, public sector employment—with high salaries, generous benefits, and shorter working hours—has become a preferred choice for most nationals again. The private sector employs nationals in professional, sales, and managerial positions, which have potential to be competitive with public sector jobs. As the working-age population in Kuwait continues to grow, there is increasing recognition that nationals need high-productivity and high-paying jobs in the private sector.

[3] For computational details, see "Development Accounting and the Rise of TFP" by R. Arezki and R. Cherif, IMF working paper 10/101, 2010.

[4] The government has absorbed about 13,000 national workers per year in 2011–12. The 2012 Kuwait Article IV Consultation report estimates that 74,000–112,000 Kuwaitis would enter the job market over 2012–16 with only 17,000 jobs created by the private sector. The rest would have to be absorbed by the public sector, increasing the public sector's size by 13–22 percent from the current level. Although this would translate into a fiscal cost of less than one percent of GDP per year, it would become problematic if oil prices were to fall. In addition, public sector efficiency would suffer substantially.

9. Strong reliance on oil income increases income volatility and risks to long-run growth. Given its large accumulated external wealth, Kuwait can ride out temporary drops in oil prices, but a sustained decline in oil prices would create a large negative shock to the economy. A permanent drop in oil prices would be detrimental to investment and government spending and reduce savings for intergenerational equity. Real consumption per capita could substantially fall, as witnessed in the 1980s (Figure 6).

Figure 6. Consumption vs. Oil Price, 1980–2010



Sources: Country authorities; and IMF staff calculations.

10. A sustainable and diversified economy is key to improving welfare and labor market conditions in the long run. To create this economy, diversification needs to be focused on export-oriented industries, which would reduce the reliance on oil, improve productivity, have spillovers to the rest of the economy, and create attractive job opportunities. The experience of Asia suggests that export-orientation provides a powerful incentive to improve production and business methods to compete in international markets but requires a different approach to development (Chang 2009).

11. The Kuwaiti government recognizes these challenges, and attempts to diversify the economy have met little success so far. The state is investing in physical and human capital, improving the business environment, and implementing projects through public-private partnerships (PPPs). Currently, the authorities are in different stages of tendering and implementing several infrastructure projects such as power stations, roads, the port, and the airport, and investing in education and health to create a skilled national labor force and encourage private sector development. The government's agenda also includes the easing of procedures for conducting business, strengthening legal and regulatory environment (e.g., company law and direct investment law), and labor market reforms (e.g., training nationals and improving visa procedures for non-nationals). These reforms may of themselves still not be adequate to diversify away from oil and spearhead the creation of various industries. The state may have to take a more active role in creating opportunities, taking risk, and paving the way for private sector development.

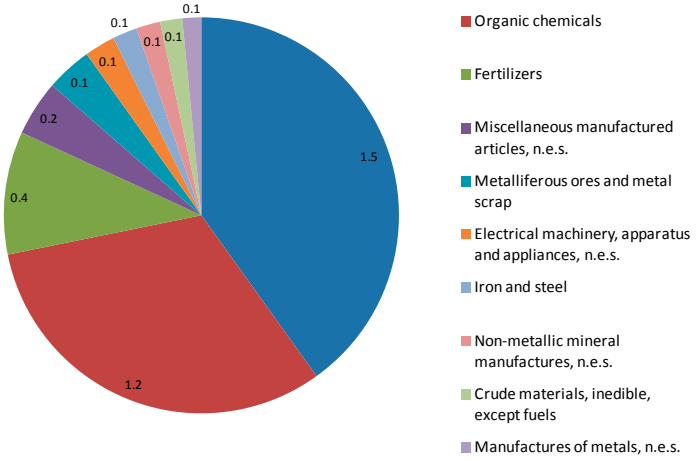
C. A Sustainable and Diversified Economy: Main Elements

12. The promotion of export-oriented industries would pave the way for a sustainable and diversified economy. The development of the tradable sector would diversify exports, create a less concentrated economic structure, have positive spillovers to the rest of the economy, and generate gains to national employment. Asian countries such as Korea, Singapore, and Malaysia have used export-oriented industrial policies to create and develop various industries that spurred growth for decades (Chang 2009). Korea, one of the poorest countries in the world in the 1950s, has recently joined the ranks of advanced economies, a remarkable transformation achieved only within a couple of generations.

13. Reforms need to be geared toward supporting an overarching goal of economic diversification. Reforms should focus not only on facilitating an enabling business environment but also on integrating the state-owned enterprises (SOEs) into this process. Spearheading industrial projects, for instance, by forging links between SOEs and private firms and promoting small and medium-sized enterprises (SMEs) and startups, would be an important element in this diversification strategy. Special economic zones that provide the entire infrastructure, especially land (which is controlled by the State in Kuwait), roads, energy, legal/business environment, etc., would provide an attractive place to conduct business. Incubator and professional support services would create synergies across firms. Government agencies need to establish support services to help firms comply with government regulations and requirements. Lastly, the macroeconomic environment needs to provide stability, and the real exchange rate dynamics have to be conducive to export promotion and economic diversification.[5]

14. Promoting exports of certain existing industries, developing oil downstream operations, and creating new export-oriented industries would be one way to approach this goal. With more than 95 percent of goods exports in oil and refined oil products, the rest are in other items such as chemicals, metals, and manufactures (Figure 7). Promoting certain existing industries, for instance in chemicals and manufactures, and developing oil downstream industries as the state is currently pursuing, would be a first step. The strategy should capitalize on the importance of technology in the oil industry such as in seismic, drilling, and extraction operations, with the support of joint ventures and eventually local firms providing oil services. Promoting local content in the oil industry requires relevant human capital, technology, and know-how. The state should actively pursue developing these skills and knowledge by investing in research and development, partnering with foreign and local universities, encouraging students to pursue science and engineering majors, and attracting scientists and engineers from other countries to lead this process forward. The Kuwait Institute for Scientific Research (KISR) seems to be ideally placed to coordinate and engage with the concerned agencies. In addition, because oil is used substantially in power generation, there is room for increasing the efficiency of domestic household power consumption (e.g. by reducing across-the-board electricity subsidies) and release oil for other uses. Modernizing refineries, as Kuwait Petroleum Corporation

Figure 7. Non-oil Exports, 2012



[5] Currently, the real exchange rate is estimated to be broadly aligned with economic fundamentals (see Kuwait: 2013 Article IV Consultation Report).

(KPC) is currently pursuing, would also support developing local talent, technology, and know-how. Finding a niche in downstream operations, for instance, in petrochemicals, is another avenue to pursue. An active program to support local firms and create support functions would be helpful, especially for SMEs and startups. The newly established Kuwait National Fund for SME Development, with $7 billion in equity, has been given this mandate. The government can also provide incentives for large companies and SOEs to reorient their goals toward export creation. Lastly, creating new industries and venturing into high value–added exports (e.g., manufactured and intermediate products) and services should also contribute to the development of the tradable sector. Manufacturing acts as a strong catalyst for growth convergence and creates spillovers in the economy (Rodrik 2012). In addition, firms engaged in exportable services are more innovative than firms in non-exportable services (Iacovone et. al. 2013), supporting growth and improving productivity.

15. Although Kuwait has relatively good infrastructure, streamlined regulations and processes would further support private sector development. Improvements in business and labor regulations, control of corruption (especially in the contract tendering process), and legal and property rights will improve the business climate. Although Kuwait is doing well in some indicators of governance (e.g. rule of law), doing business (e.g. getting electricity), and competitiveness (e.g macroeconomic environment), much more needs to be done (particularly in government effectiveness, starting business, and labor market efficiency indices) to improve the investment climate by cutting red tape, streamlining bureaucratic processes and regulations, and reducing delays. The recently introduced licensing law, which has enabled the issuance of temporary licenses to set up businesses with zero time lag, is a step in the right direction. Bankruptcy law is being developed, which has the potential to boost private sector investment. The foreign labor regulations, including visas, and oversight are being brought under the Public Authority for Manpower to better regulate the inflow of labor. Further prioritization of spending is needed; Kuwait spends about 4 percent of GDP on education (a bit less than the OECD average of 5 percent of GDP) but its educational quality, as measured by test scores, has been largely lagging behind other GCC countries and emerging markets. Developing a reliable medium-term budget framework to help anchor fiscal policy and provide predictability, especially for multi-year investment projects will enable prioritization of spending.

16. An active labor market policy is required to develop the relevant skills and encourage nationals to seek jobs in the private sector. First, sustainable non-oil growth is needed to provide opportunities for labor market entrants. Second, improving the quality of the labor force is crucial. Third, providing incentives for the nationals to enter or move to the private sector should complement other initiatives. These incentives could include provision of targeted wage subsidies, skill training, and apprenticeship programs. Large hikes in public wages that increase the gap between public and private wages should be curtailed, and hiring in the public sector should only be need-based and matched with skills. In the future, rationalization of public agencies, functions, and employment is called for.

17. Kuwait has higher female labor market participation than other GCC countries; further improvements in labor force participation can support future growth prospects. Kuwait's labor force participation rate for Kuwaiti women (53 percent) is slightly above the world average (51 percent) and much higher than the MENA average (21 percent). The implementation of policies to further

improve women's participation in the labor force—including providing job training and job search support services, improving educational quality, and promoting diversity at the workplace—would lay the groundwork for utilizing the potential of a large fraction of the national population, and should stimulate growth if these workers are absorbed by the private sector.

18. Regional and global integration would expand Kuwait's growth potential. Focusing on the regional market is natural. Given low barriers to trade and capital flows in the GCC, the harmonization of enterprise legislation and tax regimes would be beneficial. In addition, the coordination of ongoing projects in finance, manufacturing, culture, tourism, and real estate is important for the creation of a GCC market that would be more attractive for outside investors, provided there is no replication of large projects across countries. As exports get diversified across countries, the common GCC market would also promote trade in the region. Currently, however, the GCC countries, which share with Kuwait significant dependence on oil, might not be able to provide a diversified source of income in case of a sustained drop in oil prices. This potential vulnerability also calls for diversification across countries; for example, Kuwait is a natural gateway to Iraq and Iran. Regional integration should be pursued in parallel with expansion to other markets, especially to emerging markets that could provide additional opportunities for non-oil export growth.

D. Concluding Remarks

19. High growth in the past decade, driven mostly by labor and capital accumulation, has resulted in large increases in non-national employment. Nationals continued to be absorbed in the public sector for jobs. Declining productivity has been a drag on growth. Both output and exports are still substantially concentrated in oil and oil products, and thus largely depend on oil price dynamics.

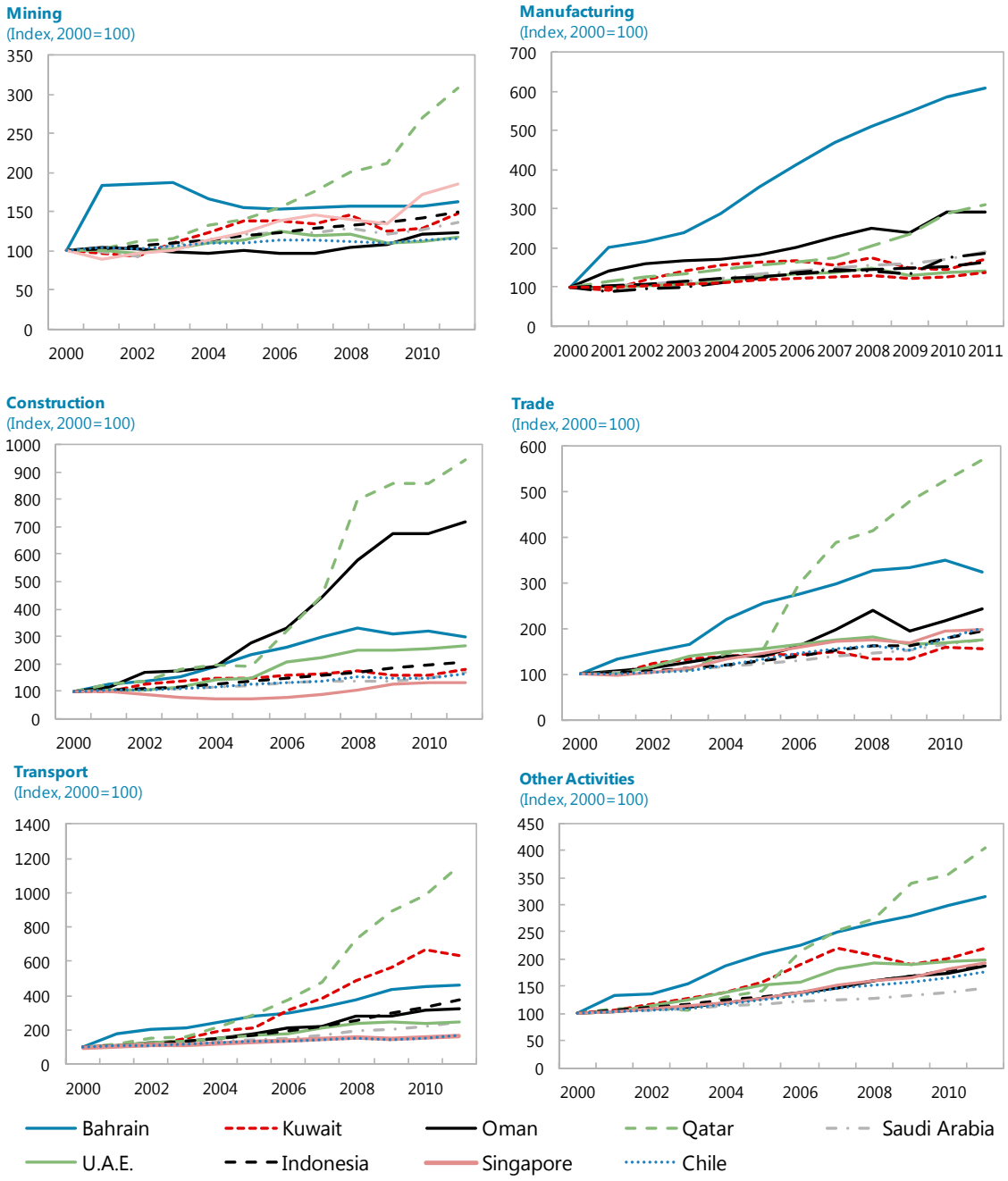
20. The absorption of new labor market entrants and the need to protect against sustained oil price drops call for reforms that support the tradable sector to help build a diversified export base and promote national employment. The expansion into manufacturing (oil downstream and other industries) has the potential to create large spillovers to the rest of the economy. Developing current non-oil exports and providing oil field services to the oil industry would further enhance skills and encourage the development of technology. Special emphasis could also be given to investments that enlarge exportable services. Small and medium-sized export-oriented firms can also act as a catalyst to generate growth and move the economy towards higher value-added sectors and better job opportunities. SOEs could be a driving force to absorb technologies, create industries, and generate jobs, if they are managed and operated as autonomous bodies. Product diversification should be promoted to supply regional and global markets.

21. The productive transformation of the oil wealth is key to sustaining development. Diversifying the Kuwaiti economy would require a strategy to disband various barriers to growth with the state coordinating across various agents. These, at minimum, could include:

- Developing special economic zones, especially to grant access to land, with a predominantly export mandate.

- Improving the legal infrastructure, reducing barriers to entry for business, and promoting joint ventures, foreign direct investment, and local firm content to support technology diffusion and innovation.
- Providing support services and training to firms on government regulations and doing business, to promote effective operations.
- Investing in research and development and enhancing educational quality, vocational training, apprenticeship programs, and education in hard sciences and engineering.
- Restructuring public administration and containing public wages and employment.
- Promoting female labor force training and participation and other labor market reforms to encourage entry into the private sector.
- Further harmonizing business and tax regimes within the GCC countries, and coordinating on large-scale infrastructure projects that are being pursued.

Figure 8. Kuwait and Selected Comparators: GDP by Sector, 2000–11



Sources: United Nations Statistics Division; and country authorities.

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STRENGTHENING RESILIENCE IN THE FINANCIAL SYSTEM[1]

A. Introduction

1. The Kuwaiti financial system is characterized by a high degree of interconnectedness. Ownership linkages in the financial system are complex, with close connections among industrial and commercial groups, banks, sovereign, and investment companies (ICs). Some large industrial and commercial groups have ownership stakes in Kuwaiti banks. The Kuwaiti government—through different government agencies—has stakes in several banks (Annex IV). Banks in turn own investment companies, and also provide industrial and commercial groups and ICs with credit as part of their banking business (Annex IV).[2] ICs also have ownership stakes in banks and industrial and commercial groups. Nevertheless, the risk arising from the direct linkages between local banks and ICs appears limited since banks have been reducing their direct exposures and building up precautionary provisions against weak ICs.

2. The interconnectedness among banks, industrial and commercial groups, sovereign and ICs can pose a risk to the financial system and the economy during periods of stress. The 2009 crisis, which resulted in the insolvency of some ICs and in a subsequent stress on the banking system, is a reminder that the current interconnectedness in the financial system can propagate and exacerbate financial and real shocks. The bankruptcy of an industrial or commercial group could lead to a stress in the banking system. This underscores the need for higher capital cushions in the banking system.

3. The rest of the paper is organized in the following manner: Section II deals with the assessment of risks in the banking system. Section III discusses the financial situation of the ICs. The final section, IV, makes recommendations for strengthening the resilience of the financial system.

B. Assessment of Risks in the Banking System[3]

Interconnectedness

4. Kuwaiti banks have diverse business models. Some banking groups are focused predominantly on commercial banking (corporate and retail) while other groups also have

[1] Prepared by André Oliveira Santos and Ananthakrishnan Prasad.

[2] The total assets of the ICs in which banks own equity comprise 10 percent of the total assets of the IC sector.

[3] The analysis in this section is based on eight listed banks as of end-December 2012.

treasury and investment management activities and international operations (Table 1).[4] Treasury and investment management services, including collateral management, are provided to corporates and investors by investment company subsidiaries that are also owned by banks. Banks have also expanded their international operations by acquiring foreign bank subsidiaries, including in Turkey and other Middle East and North African (MENA) countries.

Table 1. Bank Segment Results, 2012
(In KD millions)

A. Commercial Banking

	ABK	AUB	BOUB	BUR	COBK	GULF	KFH	NBK
Operating income	102	70	46	73	106	137	664	385
Segment result	39	29	12	55	30	72	281	211
Segment assets	2,092	2,010	918	2,091	2,184	3,461	6,396	9,081
Segment liabilities	1,740	1,697	157	1,692	1,457	2,891	9,278	6,445

B. Treasury and Investment Management

	ABK	AUB	BOUB	BUR	COBK	GULF	KFH	NBK
Operating income	14	16	(6)	26	18	17	165	26
Segment result	11	9	9	8	(29)	11	32	14
Segment assets	818	570	402	1,275	1,484	1,307	6,777	61
Segment liabilities	657	600	911	1,679	2,211	1,370	2,486	6

C. International Operations

	BUR	NBK
Operating income	92	126
Segment result	32	64
Segment assets	2,610	5,093
Segment liabilities	1,986	4,713

Sources: Bank annual reports; and IMF staff calculations.

Note: The banks are Al Ahli Bank of Kuwait (ABK), Ahli United Bank (AUB), Boubyan Bank (BOUB), Burgan Bank (BUR), Commercial Bank of Kuwait (COBK), Gulf Bank (GULF), Kuwait Finance House (KFH), and National Bank of Kuwait (NBK).

5. The expansion of Kuwaiti banks abroad is an opportunity to diversify their portfolios and earnings but also poses risks. Burgan Bank (BUR) and National Bank of Kuwait (NBK) have been more aggressive in expanding abroad and have recently acquired important foreign subsidiaries. In total, foreign subsidiaries represented more than 31 percent of NBK group's total assets and about 44 percent of BUR group's total assets at end-2012. Given BUR

[4] A majority of the treasury operations include holdings in money market instruments and Treasury Bills.

and NBK's reliance on foreign operations, collaboration and engagement of the Central Bank of Kuwait (CBK) with other host supervisors is important from a financial stability perspective.

Assessment of risks

6. Kuwaiti banks' gross exposure is concentrated in corporates in the real estate sector.[5] Geographically, on a consolidated basis,[6] Kuwaiti banks' on- and off-balance sheet gross exposures are mostly arising from operations in the Middle East and North Africa (MENA). Most of the exposures are funded (on-balance sheet), but off-balance sheet exposures represented one-fourth of gross exposures at end-2012 (Table 2). The largest portfolio is represented by corporates (except in Kuwait Finance House) with exposures to construction and real estate representing more than 12 percent of total gross exposures (Table 3). The large share of corporates in gross exposures reflects not only the limited opportunities for consumer lending in Kuwait but also the interconnectedness, through lending, between banks and industrial and commercial groups. Although most gross exposures are located in the Middle East and North Africa, some banks have exposures to Europe, the United States, and Asia.

Table 2. Bank Gross Exposures by Geographic Region, 2012
(KD millions)

	Funded	Unfunded	MENA	Europe	US	Others
Cash	590	188	329	412	1	36
Claims on sovereigns	7,548	720	6,931	562	531	244
Claims on public sector	676	180	855	0	-	-
Claims banks	5,043	2,803	4,179	1,611	188	1,908
Claims on corporates	14,751	6,742	18,157	3,010	321	1,191
Regulatory retail exposure	7,049	1,546	7,290	1,283	12	183
Past exposures	1,166	207	1,283	47	-	45
Other	8,937	2,494	9,766	756	255	662
Total	45,760	14,880	48,791	7,681	1,308	4,270

Sources: Bank annual reports; and IMF staff calculations.

Table 3. Bank Gross Exposures by Sector, 2012
(KD millions)

Sector	Gross Exposure
Personal	5,408
Banks	7,837
Other financial institutions	6,109
Trading and manufacturing (including oil)	8,746
Construction and real estate	12,913
Other Services	21,037
Total	62,050

Sources: Bank annual reports; and IMF staff calculations.

7. To reduce adverse selection in lending operations, banks require borrowers to post collateral or provide guarantees. Most credit risk mitigation (CRM) consists of financial collateral (mainly domestic equity shares), cash, and real estate in Kuwait, with a coverage of almost 200 percent of the loan amount. Aligned with Basel II, the use of credit risk mitigation

[5] Kuwaiti banks' loan portfolios are concentrated in consumer (about 20 percent of total lending at end-June 2013) and real estate (about 18.5 percent) lending.

[6] The Kuwaiti banks' consolidated annual reports include not only the operations of the parent bank but also of other domestic and foreign subsidiaries (e.g., ICs, foreign banks fully owned by Kuwaiti banks).

(CRM) allows Kuwaiti banks to reduce their gross exposures (Table 4).[7] As a result of CRM techniques, net exposures after CRM represented about 75 percent of gross exposures at end-2012, underscoring the importance of transparent and independent collateral appraisal in credit risk management.

Table 4. Bank Net Exposures and Capital Requirements, 2012
(KD millions)

	Gross Exposure	Credit Conversion Factor (CCF)	Gross Exposure after CCF	Credit Risk Mitigation	Net Exposure	Risk Weighted Assets	Average Risk Weights	Capital Requirement
Cash	778	-	778	-	778	-		-
Claims on sovereigns	8,268	23	8,245	4	8,242	283	3.4	34
Claims on public sector	855	24	831	27	804	207	25.8	25
Claims banks	7,887	1,400	6,487	139	6,348	2,028	31.9	243
Claims on corporates	22,678	2,460	20,218	6,016	14,202	13,251	93.3	1,590
Regulatory retail exposure	8,769	122	8,647	672	7,975	6,978	87.5	837
Past exposures	1,375	7	1,368	656	712	552	77.5	66
Other	11,439	(19)	11,458	3,537	7,921	8,585	108.4	1,030
Total	62,050	4,017	58,033	11,052	46,982	31,884	68	3,826

Sources: Bank annual reports; and IMF staff calculations.

8. Bank capital ratios are dependent on credit risk mitigation given the nature of collateral in Kuwait. To assess the sensitivity of banks' capital ratios to CRM, a 15 percent and 50 percent reduction in the value of collateral is assumed in Table 5.[8] Even though banks had high capital ratios at end-2012, the results of the stress tests show that under the scenario of a 50 percent haircut in collateral, while the combined Tier 1 capital ratio for banks would still remain above the regulatory minimum of 8 percent, the ratio would fall below the minimum 8 percent for two banks (Table 5).

Table 5. Bank Capital Requirements
(KD millions)

	100% CRM	80% CRM	50% CRM
Tier 1 capital	5,472.5	5,472.5	5,472.5
Tier 2	596.9	596.9	596.9
Investment in associate	-4.6	-4.6	-4.6
Total capital	6,064.7	6,064.7	6,064.7
Risk Weighted Assets	35,201.9	37,398.7	40,693.8
Capital required	4,224.2	4,487.8	4,883.3
Tier 1 capital adequacy ratio (in percent)	15.5	14.6	13.4
Number of banks below 12% CAR	1	1	2
Total capital adequacy ratio (in percent)	17.2	16.2	14.9
Number of banks below 12% CAR	0	0	0

Sources: Bank annual reports; and IMF staff calculations.

[7] Unfunded (off-balance sheet) exposures are converted into credit equivalents by a credit conversion factor (CCF), which reduces gross exposures.

[8] As seizing and liquidating financial collateral and real estate property in Kuwait is difficult, collateral might be held on banks' books at low haircut or at high prices.

9. The asset quality of most Kuwaiti banks is high. Most loans were rated as high or standard grades at end-2012 (Table 6). In addition, overall, most nonperforming loans were fully covered by provisions, except corporate loans in some banks.[9] Stress tests with Loss-Given Default (LGD) at about 50–60 percent and Probabilities of Default (PDs) in the range of 0.1-10 percent under a central scenario indicate that asset quality shocks to different portfolios would not lead the Tier 1 capital ratio in any of the Kuwaiti banks to decline below 8 percent (Table 7). Even under a severe shock scenario, with LGD at about 50–60 percent and PDs in the range of 0.15-15 percent (1.5 times under the central scenario), the combined Tier 1 capital ratio of banks would remain above 8 percent on average, but would fall below the minimum for two banks. Banks whose Tier 1 capital ratios fall below 8 percent under this scenario are those affected by the initial low nonperforming loan coverage.

Table 6. Bank Loan Ratings and Provisions, 2012
(KD millions)

Panel A. Bank Loan Ratings, 2012

	High Grade	Standard Grade	Acceptable Grade	Past Due Not Impaired	Past Due Impaired
Loans and advances	13,452	9,870	4,270	1,474	1,671
Corporates	9,735	7,078	3,460	950	1,426
Retail	3,717	2,792	810	414	245

Panel B. Non-Performing Loans and Provisions, 2012

	Non-Performing Loans	Specific Provisions	General Provisions	Coverage (Percent)
Total	1,839	508	1,188	92
Corporates	1,426	338	1,003	94
Retail	245	165	109	112
Other	168	5	76	48

Sources: Bank annual reports; and IMF staff calculations.

Table 7. Stress Testing, 2012
(Percent)

Scenario	Tier 1 Ratio
2012 Tier 1 capital ratio	15.5
Tier 1 capital ratio under central scenario	15.4
Number of banks below 8%	0
Tier 1 capital ratio under adverse scenario	12.0
Number of banks below 8%	2

Sources: Bank annual reports; and IMF staff calculations.

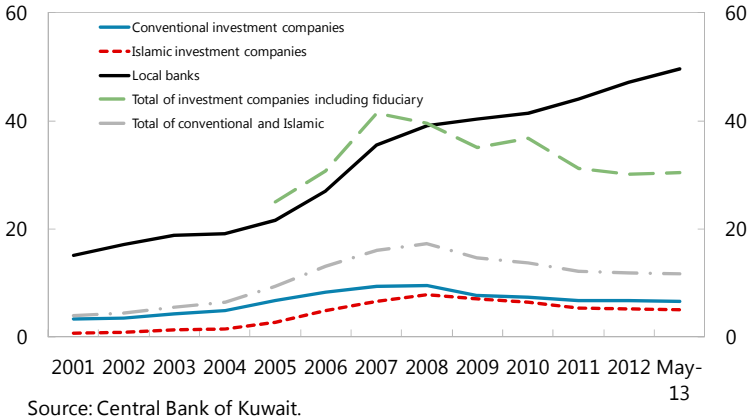
[9] Under Basel II, provisions in Kuwaiti banks should cover expected losses while capital is a buffer against unexpected losses.

C. Financial Situation of Investment Companies

Current Situation

10. Kuwait's ICs continued to deleverage in 2012 and 2013 but at a lower pace.[10] Total assets in ICs (including assets under management) amounted to 63 percent of GDP and 61 percent of banking system assets (Table 8) at end-May 2013. Overall, since end-2008, ICs' own assets shrank by 36 percent, and assets under management shrank by 15 percent (Figure 1). Deleveraging took place both among conventional and Islamic companies. Even though the pace of deleveraging slowed down in 2012, ICs' own assets shrank by KD 200 million (2.0 percent) during January-May 2013 to KD 11.7 billion at end-May 2013 while assets under management increased by KD500 million—for the first time since 2008—reflecting new investment flows. The share of own funds has increased since their peak in 2008, and the share of foreign financing in total financing has decreased while bank lending to ICs has shrunk. ICs have also relied on equity-debt swaps and asset sales to reduce their leverage, with impairments taking a toll on their financial conditions.

Figure 1. Assets of Investment Companies and Banks
(KD billions)



Source: Central Bank of Kuwait.

[10] There are 92 investment companies—43 conventional and 49 operating in accordance with the provisions of Islamic law. Of these, 44 are listed in the Kuwait Stock Exchange (the analysis excludes several companies from the Kuwait Stock Exchange financial services index, with 56 companies at end-2012, that were previously classified as real estate, industrial, services, or non-Kuwaiti companies). The analysis in this note combines aggregate data published by the Central Bank of Kuwait for the 92 ICs and the balance sheet data available in public domain for the listed ICs.

Table 8: Investment Companies Operations

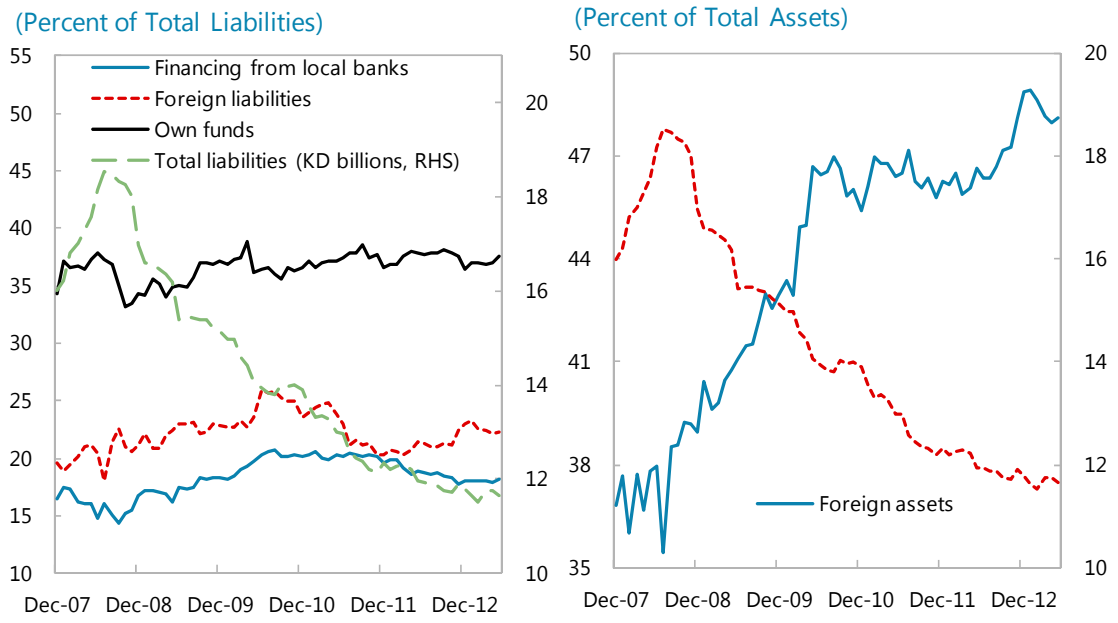
(KD billions)

	2002	2005	2007	2008	2009	2010	2011	2012	May 2013
Investment companies									
Conventional									
Number	27	33	40	46	46	46	44	43	43
Assets	3.5	6.7	9.2	10.3	7.6	7.3	6.9	6.6	6.6
Islamic									
Number	11	23	38	53	54	54	51	50	49
Assets	4.3	9.4	6.6	7.8	7.0	6.5	5.4	5.2	5.0
Total	7.8	16.1	15.8	18.1	14.6	13.7	12.3	11.9	11.7
Off-balance sheet									
Assets		15.5	24.6	22.2	20.4	23.1	19.0	18.2	18.7
Total									
Number	38	56	78	99	100	100	95	93	92
Assets	7.8	31.7	40.4	40.3	35.0	36.8	31.3	30.1	30.4
Percent of GDP		105.9	132.4	99.8	114.9	103.4	70.3	62.5	63.0
Percent of banking assets		115.6	116.5	100.9	86.9	88.9	70.8	63.8	61.1

Source: Central Bank of Kuwait.

11. ICs continue to be vulnerable to swings in financial and real estate markets. ICs continue to have large exposures to domestic, regional, and international equity and real estate markets. In particular, asset price volatility and correlation in domestic markets have magnified ICs' losses. ICs are also exposed to regional and global asset markets, with foreign assets constituting 48 percent of total assets. Despite considerable deleveraging, foreign liabilities of ICs account for 22 percent of total liabilities (Figure 2) as of end-May 2013. Overall, conventional ICs depend on foreign operations more than their Islamic counterparts, with their foreign assets and liabilities constituting 57 percent and 26 percent of their balance sheet size, respectively, while those of Islamic ICs amount to 36 percent and 17 percent as of end-May 2013. The total foreign assets of ICs stood at KD5.6 billion (US$20 billion) at end-May 2103, representing a net foreign asset position of KD2 billion.

Figure 2: Financial Sector Conditions



Source: Central Bank of Kuwait.

12. Some ICs have made progress on debt restructuring, but the pace has been slow. While there was some initial progress in ICs restructuring during 2009–10 (e.g., Kuwait Finance and Investment Company (KFIC); and Global Investment House (GIH)), the sector experienced renewed setbacks resulting from continued weakness in asset markets and the reemergence of global liquidity strains during 2011–12. The debt restructuring of GIH, which was concluded on December 4, 2012, included the setting up of two special-purpose entities. These off-balance sheet structures will hold non-core principal investments, debt, and paid-in shares, leaving GIH debt-free. Investment Dar (ID) also reached an agreement in July 2013 to reduce 30 percent of its debt. It will set up a special-purpose vehicle that will hold assets as collateral and 15 percent of its debt (a new Islamic loan), implying a 50 percent discount.

13. Local banks' funding to investment companies has remained stable since the onset of the global financial crisis. Bank funding to these companies represented about 4.3 percent of total bank lending at end-2012 and banks are fully provisioned against the troubled ICs.[1] Funding from banks is an important source of financing; it represented 17 percent of total liabilities of ICs at end-2012. While the 2009 Financial Stability Law (FSL) allowed government guarantees of up to 50 percent of bank funding to investment companies for the period 2009–10

[1] The CBK has required banks since 2009 to provision against nonperforming ICs' loans and to take additional precautionary provisions against weak ICs.

under certain conditions, none of the ICs applied for such guarantee, possibly because they were not able to meet the conditions set in the law.[1]

14. The financial situation of many ICs remains precarious. In aggregate, both conventional and Islamic ICs are well capitalized at about 37 percent of total assets. Nevertheless, several ICs continued to post losses during 2012. In the absence of data on the net income position of all ICs, staff depended on the published balance sheets and income statements of ICs listed in the Kuwait Stock Exchange to assess their performance. The aggregate results of 44 listed companies indicate that while they have reduced the size of their operations, they continued to record losses in 2012 (Table 9 and Figure 3), though lower than in previous years. Out of the 44 companies, 23 (of which seven were Islamic ones) posted cumulative losses in 2012, with one company having cumulative losses that exceeded half of the paid-up capital. Overall, based on most recent published data, nine out of the 44 listed companies (of which four were Islamic ones) have already depleted more than half of their paid-up capital through accumulated losses.

Table 9. Kuwait Investment Sector,[1] 2007–12
(US$ billions)

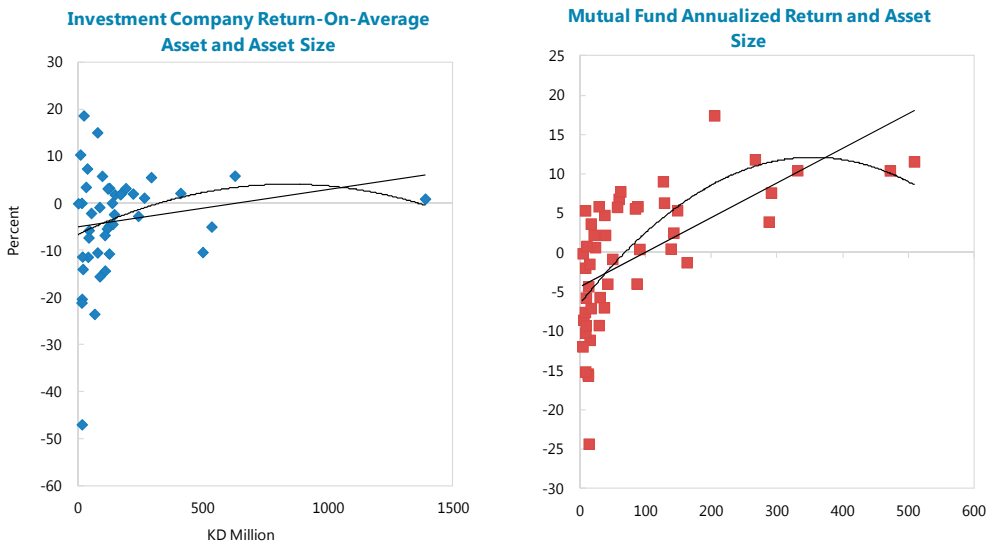
	2007	2008	2009	2010	2011	2012
Total assets	38.05	38.84	31.76	29.81	25.86	27.39
Cash	0.93	0.97	1.03	1.08	1.17	1.37
Equity (paid up +reserves)	10.34	13.73	12.30	11.72	10.29	10.31
Total liabilities	18.20	23.44	18.55	16.65	14.69	15.04
Net profit before tax	3.75	-3.74	-1.83	-0.82	-0.87	-0.21

Source: IMF staff calculations based on Zawya balance sheets.

[1]Based on 40 out of 55 listed investment companies. Excludes nine Holding companies and six companies that have not published their 2012:Q4 financials as of July 2013.

[1] The FSL allows the government to support viable ICs that face liquidity pressures by guaranteeing 50 percent of their new borrowing, under certain conditions.

Figure 3: Investment Company and Mutual Fund Performance

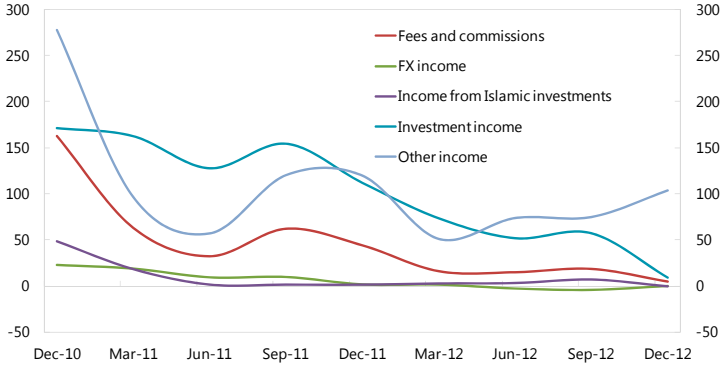


Sources: Zawya; and IMF staff estimates.

15. The losses in ICs reflect major weaknesses in corporate governance and risk management practices, including investment guidelines in their assets under management (AUM). Out of the 44 listed ICs, most have focused on proprietary trading and Islamic investment activities. Both of these represented more than 30 percent of total operating income in 2012, while fees and commissions stood only at 10 percent (Figure 4). In addition, volatility in investment income has been higher than in other income sources. Low fees and commissions are also the result of the low performance in mutual funds under ICs' management. Previous studies have indicated that the capacity of ICs to generate Alpha is limited, even compared to other GCC countries.[1] Most conventional and Islamic mutual funds have underperformed benchmark indices.

Figure 4. Operating Income in Investment Companies, 2010–12

(Percent)

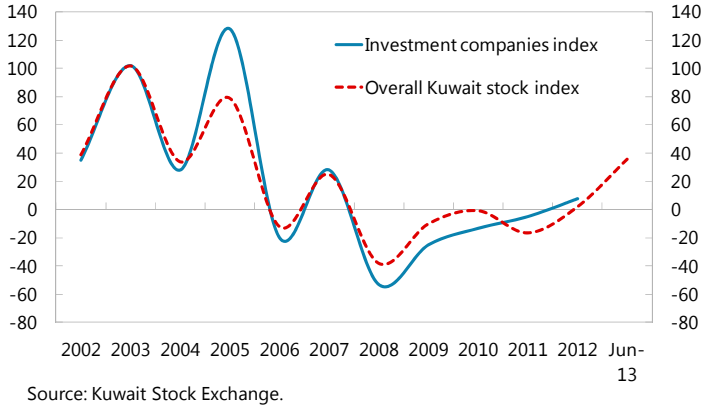


Sources: Zawya; and IMF staff estimates.
Note: Data is based on 44 of 56 listed financial services companies at end-2012.

[1] Alpha is a measure of the return generated by active portfolio managers in excess of the market returns.

16. In view of the above, ICs have still not recovered the stock market valuation losses that they suffered during the global crisis. The ICs' index, which was below the overall index during 2011–12, has recovered from its trough of 2011 but is still below its 2007 peak (Figure 5). The share of ICs in total market capitalization has plummeted by more than half to 7 percent at end-2012 and in the week ended July 18, 2013, compared to 16 percent at end-December 2007.

Figure 5. Stock Market Performance Trends, 2002–13
(Percent change in index)



Source: Kuwait Stock Exchange.

17. Ongoing improvements in financial sector regulation and supervision are welcome. The Capital Market Authority (CMA) commenced its supervisory role in September 2011. The ICs are under dual supervision with CBK supervision covering only lending activities. The CMA has issued new regulations on investment funds (including on asset managers, custodians, controllers, permissible funds and activities, investment guidelines, valuations, alternative managers), brokerage activity, information disclosure, and corporate governance.

D. Strengthening the Resilience of the Financial System

18. Macroprudential policy can play an important role in Kuwait to mitigate systemic risk in the financial sector. The interconnectedness among banks, industrial and commercial groups, ICs, and the sovereign can pose a risk to the financial system and the economy during periods of stress. To build on the current progress in improving regulation and supervision and identifying systemic risks, the development of a more formal and transparent macroprudential framework would be desirable. The operations of ICs continue to have financial stability implications, although these appear to be limited. ICs continue to be vulnerable in view of the sluggish improvement in global, regional, and domestic asset markets. Furthermore, the continued dependence on foreign lines of credit could pose potential risks to liquidity and profitability if foreign banks withdraw their lines of credit or conditions in the financial markets tighten. Nevertheless, risk arising from the direct financial linkages between local banks and ICs appears limited at present, since banks have been building up precautionary provisions against weak ICs.

19. While the CBK has many of the tools that can help address vulnerabilities at an early stage, as well as help build buffers to absorb shocks ex post, there is scope for refining the existing macroprudential toolkit. In the area of building and maintaining buffers, the CBK has been relying strongly on high capitalization of banks and on building provisions. This would be usefully complemented by an enhanced role for Pillar 2, and a further strengthening of risk-based supervision. While CBK already has time-varying loan-to-deposit

ratios to alleviate procyclicality, time-varying loan-to-value ratios could help contain excessive exposure to the real estate sector. CBK is appropriately focusing on the instruments for reducing liquidity risks, and is developing the regulation to comply with Basel III requirements. To help with liquidity management, the development of the domestic debt market is essential and requires continued efforts from the CBK.

20. It would also be desirable to underpin CBK's approach to financial stability by strengthening the institutional arrangement for macroprudential policies. A more formal macroprudential framework would help ensure that responsibilities and coordination among regulators and other relevant parties are well established.

21. The current restructuring of ICs needs to be expedited. In the absence of an adequate bankruptcy/restructuring framework, the timeframe and the legal process under which weak and unviable ICs have been restructuring have remained protracted. The liquidation/foreclosure proceedings have been lengthy and Kuwait's performance compares unfavorably with the experience of GCC countries and international experience (Table 10). The government is undertaking a review of its bankruptcy law with the assistance of the World Bank.

Table 10. Average Time Required For Resolving Insolvency, 2012

Country	Time (years)	Average Cost of Bankruptcy Proceedings (% of Total Value)	Recovery Rate (Cents on the U.S. Dollar)
Middle East & North Africa	3.4	13.0	33.7
OECD high income	1.7	9.0	70.6
Bahrain	2.5	10.0	66.2
Kuwait	4.2	10.0	31.7
Oman	4.0	4.0	36.6
Qatar	2.8	22.0	55.5
Saudi Arabia	2.8	22.0	28.0
United Arab Emirates	3.2	20.0	29.4

Source: The World Bank.

22. Some consolidation would be desirable for reducing ICs' operating and regulatory compliance costs and increasing efficiency. ICs' return on equity will fall if they do not revamp their business activities. Initial evidence suggests that larger ICs have been more profitable than smaller ones, on average, in the management of their own resources (Figure 3). In addition, the larger mutual funds have also had better performance than smaller ones. Risk management costs, cost of regulatory compliance**,** and other operating costs might encourage mergers of smaller ICs to obtain economies of scale and remain competitive in the AUM industry. The new Company Law should facilitate this process.[2] In addition, pooling expertise might also provide ICs with new ways to generate Alpha for their investors.

23. Well-functioning local debt markets can provide ICs with alternative sources of funding and facilitate risk management. A deep and liquid domestic debt market will provide longer-term or more competitive sources of funding for investment companies than may be

[2] However, greater clarification is required on issues, including accountability to creditors and appointment of independent liquidators.

available from the banking system. It will also allow investment companies to manage duration and interest rate risks. The authorities should lay out the foundation for the development of a corporate debt market by providing the appropriate building blocks for the government securities markets.

24. Greater information disclosure is needed to help assess and monitor risks. There are important gaps in information disclosure by the ICs regarding their performance, fund size, and top investment holdings. Although there are 92 ICs, only 44 are listed for which financial information is available in the public domain. Balance sheet data on all 92 ICs are published on a monthly basis by the central bank, but the income statement is not available in a systematic manner.

Annex I. Restructuring Update

Global Investment House

Global Investment House (GIH) has gone through three phases of restructuring since the global crisis. In September 2011, GIH requested the lending banks' support for the near-term deferral of principal repayments due in December 2011, deferral of any increase in rate of interest from December 2011 onwards, and waiver/deferral of certain covenants applicable to GIH under its debt arrangements. These modifications were designed to facilitate discussions between GIH and its lending banks about a more comprehensive restructuring of GIH's debt obligations. A formal request for these waivers was circulated to the lending banks on 3 November 2011. Also, in the case of KD45 million bonds due on 25 April 2012, a waiver was sought to defer the principal maturity to 10 June 2012.

During 9M 2011 GIH made $54.4 million principal repayments, bringing the total repayments since inception under the restructured bank debt to $232.8 million (13.2 percent of the original principal amount).

In December 2011, GIH obtained the requisite consent from its lending banks and bondholders, subject to certain terms and conditions, to defer certain mandatory minimum principal payments to June 10, 2012, defer any increase in margin to June 10, 2012 and defer/waive certain covenants applicable to GIH under its lending arrangements to June 10, 2012.

GIH concluded its debt restructuring in July 2013. The implementation of the restructuring agreement entered on December 4, 2012 included two Special-Purpose Entities (SPEs) that provided the legal framework underlying the debt-equity swap. The first SPE, NAC Ventures SPC, holds GIH's non-core principal investments and assumed US$1.28 billion of the company's debt. The second SPE, NCH Ventures SPC, holds US$428.8 million in paid shares and assumed US$428.8 million of the company's debt.

The Investment Dar

On 2 June 2011, The Investment Dar (TID) was admitted under the Financial Stability Law (FSL) following the approval of the restructuring plan, which the Company submitted to the Court on May 5, 2011.[1] According to the restructuring plan, whose implementation started on June 30, 2011, approximately KD 82 million in total will be paid out in the first year, which will go to individual investors and small nonfinancial institutions. In the second, third, fourth, and fifth years there will be fixed payments to the remaining banks and investors, followed by a final payment before

[1] The FSL provides the necessary legal framework under which TID can implement the court-approved restructuring plan ("the Plan)" in which full repayment of all of its banks and investors is incorporated.

June 30, 2017 which will make up the balance owed to this group plus an amount equating to an annual profit over the 8.5 year period.

For the duration of the plan, the company has undertaken to remain subject to a variety of commercial restrictions detailed in the Court judgment; these ensure that at all times TID's business activity is centered on maximizing the value of its assets, meeting the repayment schedule given in the Plan, and maintaining value for TID's shareholders in the longer term. The commercial restrictions include a freeze on dividends to shareholders, on new TID investments and on taking on any new indebtedness. The plan also undertakes to separate the roles of the Chairman and CEO within the company. Informal comments from market participants indicated that the process was very complicated and that implementation is not proceeding according to the original plan accepted by creditors.

Investment Dar also reached an agreement to swap 30 percent of its debt in July 2013. It will set up a special-purpose vehicle that will hold assets as collateral and 15 percent of its debt (a new Islamic loan), implying a 50 percent discount on the initial debt swapped.

Noor Financial Investment Company (Noor)

In August 2011, Noor, a subsidiary of National Industries Group (NIG), concluded a restructuring deal with Gulf Bank of Kuwait regarding KD62.5 million loan facilities (40 percent of its total debt). This deal converted the facilities to a six-year tenor, maturing in 2017.

In October 2012, Noor completed a restructuring agreement with Commercial Bank of Kuwait to reschedule its debt of KD11 million (10 percent of total debt) to a six-year tenor maturing in 2017. In November 2012, Noor signed an agreement with Al Ahli Bank of Kuwait to reschedule KD 34.515 million of its debt over six years at a low interest rate, and in April 2013, it paid back KD4.4 million debt to Kuwait Finance House, as part of its debt restructuring plan with local lenders.

Aayan Leasing & Investment Company

Ayan is another company being restructured under the FSL.

In May 2011, Aayan finalized a KD205million (USD743.6mn) five-year debt restructuring deal with nine creditors, restructuring 62 percent of its total debt. As part of the deal, the creditors agreed to write-off 10 percent of KD205million, while 15 percent was transferred to shares in the firm.

In 2013, the shareholders approved increasing capital by KD15 million through a rights issue. In July 2013, it announced that 80 percent of its creditors have joined the restructuring process.

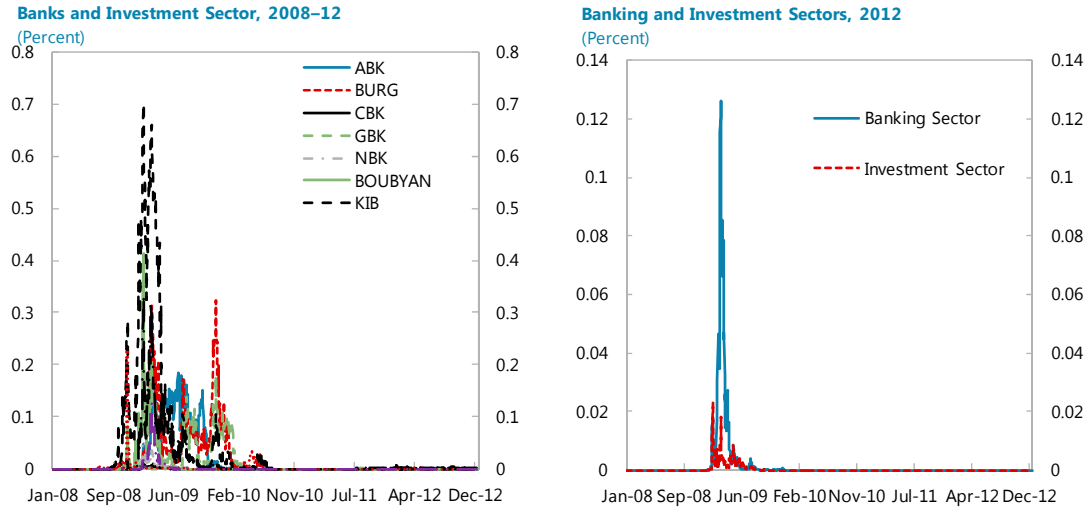
Annex II. Financial Interconnectedness and Global Spillovers to the Banking System[1]

Financial Interconnectedness

This annex assesses the interconnectedness among Kuwait banks and investment companies. Interconnectedness is proxied by an increase in vulnerability of eight Kuwaiti banks and 92 ICs altogether. Banks had a total of KD 47 billion in assets at end-2012 (92 percent of GDP) while in assets ICs amounted to KD 30 billion (60 percent of GDP).

The probabilities of default in the banking system were high during the 2009 financial crisis. Probabilities of default were proxied by expected default frequencies, which were derived from "inverting" the Black Scholes Merton (BSM) model.[2] Figure 1 indicates that default frequencies increased during the financial crisis but have lowered since early 2010.

Figure II.1. Expected Default Frequencies of Kuwait Banks, 2008–12



Sources: Country authorities; and IMF staff calculations.

Interconnectedness in the Kuwait banking system and the investment sector.

From the perspective of stock markets, the interconnecte0dness between banks and investment companies is low. The Co-VaR methodology was used to analyze levels of distress

[1] Prepared by Renas Sidahmed.

[2] To calculate probabilities of default, Merton (1974) assumed that a company's equity is a call option on its assets (the equity has value only if the value of assets exceeds that of debt) and provided the formula needed to back up the probability of default from the value of equity and the volatility of the equity price.

among banks. The predicted conditional default probabilities show the interlinkages between banks and ICs and the bilateral exposure of banks to each other; these interlinkages help identify systematically important banks and vulnerable banks. Tables 1 and 2 indicate that risks are concentrated among a few banks. On the other hand, there is a limited amount of contagion between investment companies and the banking sector.

Table II.1. Co-VaR Estimates for Kuwaiti Banks and Investment Companies, 2008–12

	Bank 1	Bank 2	Bank 3	Bank 4	Bank 5	Bank 6	Bank 7	Bank 8	Bank 9	Investment Co.	Vulnerability
Bank 1	.	0.13	0.10	0.07	0.08	0.07	0.11	0.09	0.10	0.08	0.09
Bank 2	0.15	.	0.09	0.05	0.06	0.06	0.08	0.09	0.07	0.04	0.08
Bank 3	0.00	0.00	.	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bank 4	0.07	0.08	0.03	.	0.01	0.02	0.02	0.01	0.01	0.01	0.03
Bank 5	0.01	0.01	0.01	0.00	.	0.00	0.01	0.01	0.00	0.00	0.01
Bank 6	0.09	0.05	0.06	0.01	0.01	.	0.03	0.04	0.01	0.01	0.03
Bank 7	0.40	0.24	0.23	0.09	0.06	0.06	.	0.18	0.09	0.09	0.16
Bank 8	0.12	0.11	0.09	0.03	0.02	0.02	0.05	.	0.06	0.04	0.06
Bank 9	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	.	0.00	0.00
Investment Co.	0.04	0.03	0.02	0.00	0.01	0.00	0.01	0.01	0.00	.	0.01
Importance	0.10	0.07	0.07	0.03	0.03	0.03	0.03	0.05	0.04	0.03	

Source: IMF staff calculations.

Note: Each cell in the table reports the predicted 90th percentile default probability of the bank listed in the rows conditional on the the bank listed in the columns being in distress (i.e. at its 90th percentile value). For instance, column 1 row 2 suggests that the predicted 90th default probability of Bank 2, conditional on Bank 1 being in distress, is 0.67.

For each column, the average represents the systemic importance of the bank in the column (the average of default probabilites of each other bank, conditional on column bank being in distress) . For each row, the average value represents the vulnerability of the bank in the row (the average of its conditional default probabilities, given that each of the other banks in the system is separately in distress).

Table II.2. Change in Co-VaR Estimates for Kuwaiti Banks and Investment Companies, 2008–12

	Bank 1	Bank 2	Bank 3	Bank 4	Bank 5	Bank 6	Bank 7	Bank 8	Bank 9	Investment Co.	Vulnerability
Bank 1	.	0.13	0.05	0.01	0.01	0.00	0.07	0.09	0.02	0.00	0.04
Bank 2	0.14	.	0.04	0.03	0.01	0.01	0.04	0.05	0.00	0.01	0.04
Bank 3	0.00	0.00	.	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bank 4	0.07	0.08	0.00	.	0.00	0.00	0.00	0.00	0.00	0.00	0.02
Bank 5	0.01	0.01	0.01	0.00	.	0.00	0.01	0.01	0.00	0.00	0.01
Bank 6	0.09	0.05	0.06	0.00	0.01	.	0.03	0.04	0.01	0.01	0.03
Bank 7	0.38	0.23	0.20	0.00	0.05	0.04	.	0.17	0.07	0.04	0.13
Bank 8	0.12	0.11	0.09	0.00	0.02	0.01	0.05	.	0.06	0.03	0.05
Bank 9	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	.	0.00	0.00
Investment Co.	0.04	0.03	0.02	0.00	0.01	0.00	0.01	0.01	0.00	.	0.01
Importance	0.09	0.07	0.05	0.00	0.01	0.01	0.02	0.04	0.02	0.01	

Source: IMF staff calculations.

Note: Each cell in the table reports the difference between: the predicted 90th percentile default probability of the bank listed in the rows conditional on the bank listed in the columns being in distress (i.e., at its 90th percentile value), and its predicted default probability conditional on the bank listed in the columns being at its median state (i.e., not in distress).

Annex III. Nonfinancial Corporate Sector and Banking Sector Profitability[1]

1. The nonfinancial corporate sector includes 121 listed companies with total assets of $67 billion at end-2012, down from $75 billion at end-2011. The total assets make up about 39 percent of GDP and 34 percent of bank assets. Net profits of $2.3 billion and an accumulation of $4.4 billion in cash balances at end-2012 provide some liquidity to the corporate sector (Table III.1).

Table III.1. Nonfinancial Corporate Profitability, 2008–12

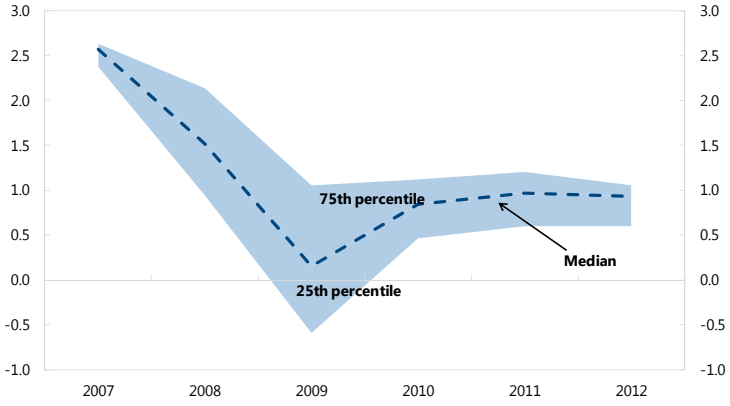
	2008	2009	2010	2011	2012
Net profits (US$ billions)	1.4	1.6	4.1	2.3	2.3
Return on assets (%)	1.8	2.2	6.1	3.1	3.5
Return on equity (%)	3.6	4.3	10.6	5.3	6.1

Sources: Zawya; and IMF staff calculations.

2. Profits remain unchanged from 2011 to 2012, mainly because of losses incurred by the second-largest telecommunications company. Except for a peak in 2010, ROA and ROE ratios are consistently low, indicating a challenging economic and operational environment. The companies in the real estate segment showed combined profits for the first time after 2008, although one-third of the companies are still making losses; however, the corporate sector's debt servicing ability is strong, as evidenced by the ratio of total liabilities (excluding shareholders' equity) to assets at 41 percent and an interest coverage ratio of 5.6. Since the financial crisis, banking sector profitability has improved (Figure III.1).

Figure III.1. Banking System: Range of ROAs, 2007–12

(Ratio)



Sources: Country authorities; and IMF staff calculations.
Note: Sample includes the nine publicly listed banks.

[1] Prepared by Renas Sidahmed.

Annex IV. Ownership and Subsidiaries of Kuwaiti Banks

Table IV.1. Ownership of Kuwaiti Banks

Bank	Shareholder	Ownership
Commercial Bank of Kuwait		
	East Holding	23%
Al Ahli Bank of Kuwait		
	Behbehani Investment Co	10%
	Behbehani Communication Co	9%
	Ali Murad Behbehani	6%
	Behbehani Financial Co	5%
	Kuwait Pension Fund	10%
	Office of Liquidation and Bad Debts (Kuwait Government-Kuwait Investment Authority)	10%
	Mohammed Behbehani	7%
Burgan Bank		
	KAMCO	41%
	Kuwait Pension Fund	8%
	United Gulf Bank	17%
Kuwait Finance House		
	Kuwait Investment Authority	24%
	Authority for Minor Affairs (Kuwait Government)	10%
	Awqaf (Kuwait Government)	8%
	Kuwait Pension Fund	6%
Boubyan Bank		
	National Bank of Kuwait	58%
	Commercial Bank of Kuwait	20%
National Bank of Kuwait		
	Kuwait Pension Fund	5%
Gulf Bank		
	Al Ghanim Industries	14%
	Al Ghanim Trading	13%
	Behbehani Investment Co and others	6%
	Kuwait Investment Authority	16%

Source: Kuwait Stock Exchange.

Table IV.2. Domestic Subsidiaries of Kuwaiti Banks

Bank	Subsidiary	Holding
Al Ahli Bank of Kuwait		
	Ahli Capital Investment Company	100%
Commercial Bank of Kuwait		
	Al Tijari Investment Company	100%
	Union Securities Brokerage Company	80%
National Bank of Kuwait		
	Watani Investment Company	100%
	Al Watani Financial Brokerage Company	87%
	Boubyan Bank	58%
Ahli United Bank		
	Kuwait & Middle East Financial Investment Company	50%
Boubyan Bank		
	Boubyan Capital Investment Company	100%
	Boubyan Takaful Insurance Company	68%
Kuwait Finance House		
	Development Enterprises Holding Company	100%
	Liquidity Management House for Investment Company	100%
	Muthanna Investment Company	100%
	Nakheel United Real Estate Company	100%
	International Turnkey Systems Company	97%
	Al-Enma'a Real Estate Company	50%
	ALAFCO Aviation Lease and Finance Company	53%
	AREF Investment Group	52%
	Sokouk Real Estate Development Company	51%
	Munshaat Real Estate Projects Company	53%
	Qitaf GCC Real Estate Fund	91%
	Aref Energy Holding Company	96%

Source: Bank annual reports.

Table IV.3. Foreign Subsidiaries of Kuwaiti Banks

Bank	Subsidiary	Country	Holding
Burgan Bank			
	Burgan Bank	Turkey	99%
	Tunis International Bank	Tunisia	87%
	Jordan Kuwait Bank	Jordan	51%
	Bank of Baghdad	Iraq	52%
	Gulf Bank Algeria	Algeria	91%
National Bank of Kuwait			
	NBK (International)	United Kingdom	100%
	NBK Banque Privée (Suisse)	Switzerland	100%
	National Bank of Kuwait (Lebanon)	Lebanon	86%
	Credit Bank of Iraq	Iraq	81%
	Al Watany Bank of Egypt	Egypt	99%
	National Investors Group Holdings	Cayman Islands	100%
Kuwait Finance House			
	Baitak Real Estate Investment Company	Saudi Arabia	100%
	Kuwait Turkish Participation Bank	Turkey	62%
	Saudi Kuwaiti Finance House	Saudi Arabia	100%
	Kuwait Finance House (Malaysia) Berhad [KFHMB]	Malaysia	100%
	KFH Financial Services	Cayman Islands	100%
	KFH Private Equity	Cayman Islands	100%
	Kuwait Finance House Bahrain	Bahrain	93%

Source: Bank annual reports.