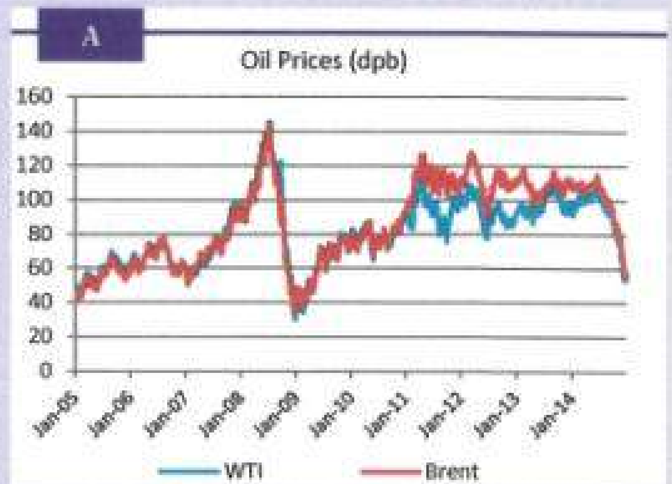
Box: 4.1

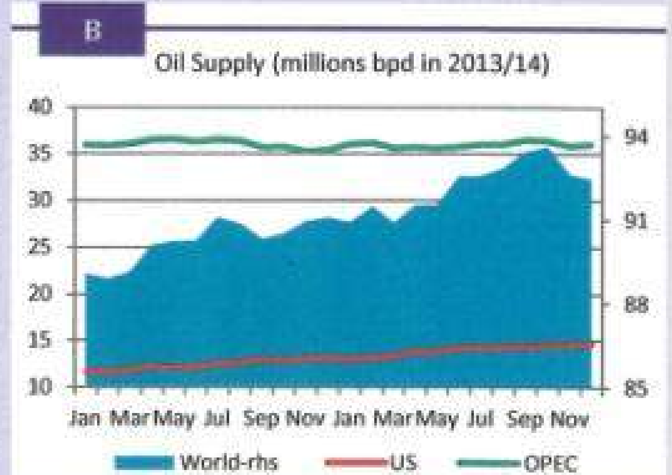
Falling oil prices and Kuwait's Banking System

Oil prices have been on a swift descent since July 2014. After hovering above $100 per barrel (dpb) for a few years, price of Brent has plummeted by more than 50% during the second half of 2014, hitting a five-year low of $55 dollars by the year-end (*Figure A*). In this box, we first examine the reasons behind this persistent decline in oil prices and then explore its potential implications for Kuwait, in particular with reference to the domestic banking system.

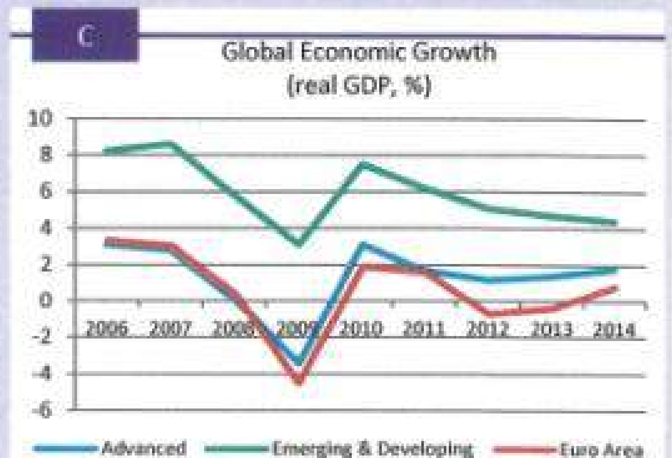


Why oil prices have nosedived?

The falling oil prices are the result of a confluence of factors, both on the demand as well as the supply side. The primary reason appears to be a glut in the market; oil supply has been increasing steadily over the last few years, with the growing contribution of U.S. shale (*Figure B*). Moreover, contrary to the market expectations, conflicts in Libya and Iraq has left the oil supply from these countries almost unaffected. To top it all, OPEC has done little to stem the slide in prices; rather their decision in late November 2014 to maintain the current production level despite the increasingly excess supply and falling prices has only reinforced the downward spiral. Seemingly, some of the OPEC countries, particularly with lower breakeven prices and/or substantial financial assets, have opted to sustain the current production levels with an aim to maintain (and possibly gain) market share. Arguably, this strategy has an additional benefit of rendering the otherwise expensive investments in alternative energy sources almost unfeasible, thus reducing the threat of competition from non-conventional producers.



On the demand side, slower growth in the world economy has kept the demand for energy products low. Most of the advanced economies have experienced weaker-than-expected growth; the only bright spot has been the visible recovery in the U.S. economy. In the euro area, lingering legacies of the financial crisis continue to weigh on the recovery (*Figure C*). Looming concerns about deflation has prompted the ECB to launch its €60 billion a month bond-purchase stimulus.



Japanese economy slipped into technical recession during the third quarter of 2014 though weakening yen and lower oil prices are likely to help. Emerging markets have also been down to a slower growth trajectory; China's double-digit growth of the past decade is no longer possible as the economy matures and potential for investment growth declines. Russia is facing a bleak outlook amid falling oil and biting sanctions. Collectively, weaker-than-projected growth in many countries has dampened the demand for oil.

Some developments in the financial markets have also played their part, albeit in a much more limited way. The dollar has continued to climb, amid a solid recovery in the U.S. economy and increasing likelihood of an interest rate hike by the Fed later in 2015. Appreciation of the dollar along with falling energy prices have doused investor's appetite to invest in oil futures as traditionally investors have expected oil prices to go down when dollar gains. Furthermore, strong dollar also makes oil imports expensive. Accordingly, markets have witnessed massive liquidation of long positions in the oil market, from July to October 2014 in particular.

To conclude, while a variety of factors have precipitated the fall in oil prices, excess supply is the primary trigger, both on account of increasing share of U.S. shale and uninterrupted production from the OPEC nations. While the net impact of lower oil prices on the global economy would be positive, oil-exporting countries are bracing for diminished revenues.

Oil shock and the banking sector in Kuwait

The oil sector plays a dominant role in Kuwait's economy as it contributes around 63% to Kuwait's GDP, 86% to country's total exports of goods and services and above 80% to government revenues. While these numbers undoubtedly indicate Kuwait's high dependency on oil, they don't necessarily imply a commensurate level of vulnerability. In fact, given Kuwait's lowest break-even oil price and ample financial assets, the country is far less vulnerable to falling oil revenues than almost any other oil exporting nation.

To understand how the drop in oil prices and the attendant reduction in government revenues can possibly affect the banking sector, we postulate two broad channels of transmission (*Figure D* on next page). Starting with the hypothetical path-1 in the diagram, lower government revenues can potentially affect the pace of mega development projects, reducing the demand for bank credit from various private contractors. However, government has expressed its commitment to continue with its ambitious development plan for 2015-2019 notwithstanding of the steep fall in oil prices.

Regarding our hypothetical case of path-2, though the pace of growth in salaries and wages would surely taper off, we do not see a reversal either. Again, the government has emphasized that it would not cut wages. While some fuel related subsidies have been withdrawn, the measure has a limited affect in general. It rather reflects the efforts of the government to capitalize on the current period of lower oil prices as an opportunity to introduce much-needed reforms. Moreover, individuals are unlikely to face any debt servicing issues as CBK has already put in place stringent measures to protect both the consumers as well as the lending banks. For instance, CBK regulations require that individuals' debt servicing must not exceed 40% of their

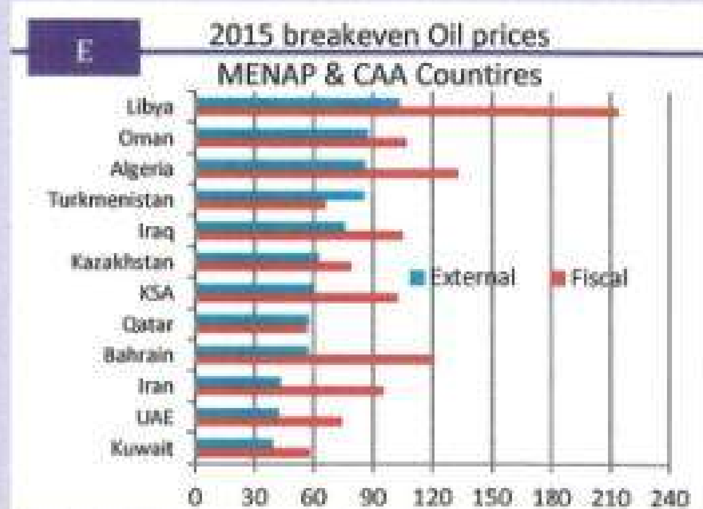
monthly incomes, providing sufficient cushion even under a scenario of stalling wage-growth. The NPLR (non-performing loan ratio) for the consumer loan segment is among the lowest of any major sector, reflecting healthy consumer credit portfolios of Kuwaiti banks.

On balance, lower oil prices are unlikely to have a perceptible impact on the banking sector NPLs, though credit off-take might somewhat slow down. An IMF paper published in 2009 has pointed out that the *direct* impact of oil prices on banks' profitability is insignificant[25]. Using data for 145 banks in 11 oil-exporting countries, the paper indicates that oil price shocks have *indirect* effect on banks' profitability (particularly in case of investment banks) channeled through country specific macroeconomic and institutional variables. So unless the oil prices seriously affect the macroeconomic activity in general, the effect on banking sector would be muted.

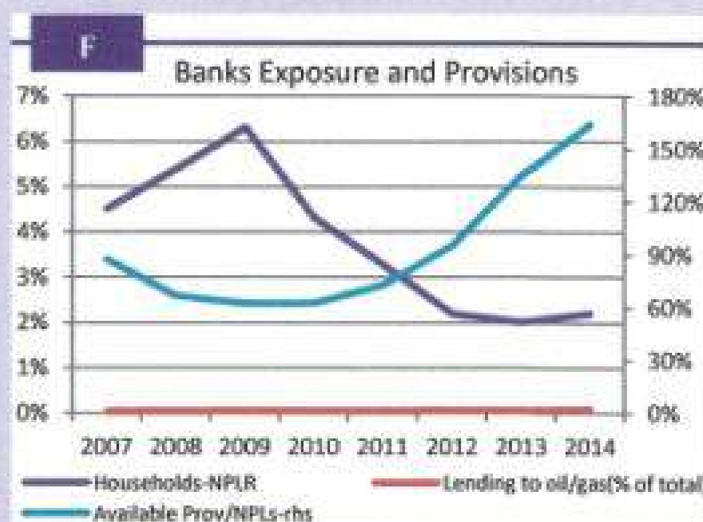
In the case of Kuwait, a number of mitigating factors, both at the level of macro economy and the banking sector, proffer another reason for optimism.

- On the macro front, government's commitment to continue with its development plan is backed by its ability to fund mega projects by using substantial savings the country has accumulated through its fiscal surpluses since 1995. Moreover, Kuwait's gross public debt is quite low (around 7% of its GDP) and banks are awash with liquidity; so the government can conveniently borrow in domestic currency if it chooses not to use its existing financial assets. Moreover, international borrowing would be equally easy to secure, given Kuwait's strong credit rating of Aa2 and its impeccable record of debt servicing even under very difficult circumstances. It is pertinent to mention that the scope of higher borrowing by the government is more of a theoretical proposition; in reality, government has ample financial resources at its disposal though it can opt for some mix of borrowing (e.g. issuing sukuk) and/or utilizing its financial assets.

- Second, Kuwait's breakeven oil price is among the lowest, compared to any other country in within the GCC or elsewhere. According to the IMF's recent estimates for 2015[26], Kuwait's external breakeven price is the lowest while the fiscal breakeven is very close to that of Qatar (*Figure E*). Admittedly, if fiscal expenditures continue at their current pace amid lower oil prices, the breakeven price for Kuwait would escalate in future.



- Third, Kuwaiti banks enjoy strong capital adequacy ratios, stable funding and ample liquidity. Nonperforming loans have been at the lowest in recent years and provisions at the highest level, thanks to CBK's proactive measure to countercyclically build an additional cushion for any potential losses (*Figure F*). Moreover, banks' exposure to the oil sector is almost negligible; so even a slowdown in the oil sector would not affect the banks' credit portfolios. Though household credit constitutes a significant part of banks' overall lending, the portfolio is least infected, with the lowest NPLR among major sectors (see Chapter 2 for details).



These factors collectively underscore the resilience of the banking sector in Kuwait to an oil price shock. In line with the IMF's findings mentioned above, we see limited direct impact of oil prices on banks' performance in the short run. However, if the oil prices remain at current level for an extended period, possibility of some second round effect on the banking sector cannot be overlooked.