



KUWAIT

SELECTED ISSUES

September 2023

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July 20, 2023

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Approved By
**Middle East and
Central Asia
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SPILOVERS FROM U.S. MONETARY POLICY TIGHTENING TO KUWAIT¹

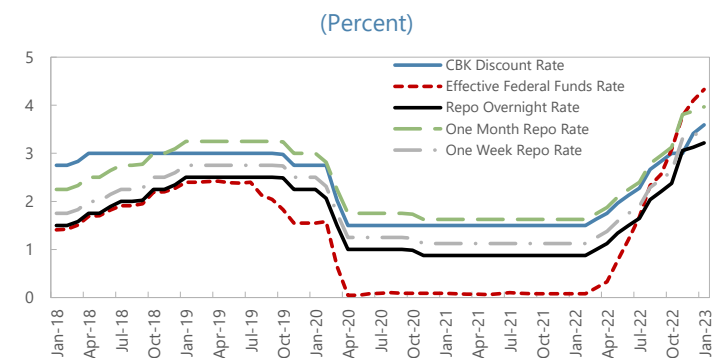
The Central Bank of Kuwait's (CBK) policy rates closely track the U.S. policy rate given the exchange rate peg. As a result, ongoing U.S. monetary policy tightening could have significant implications for Kuwait's banking sector and economic growth. This paper empirically investigates the banking sector and macroeconomic spillovers to Kuwait from U.S. monetary policy tightening. It finds that pass-through from the U.S. policy rate to lending and deposit rates in Kuwait is high in the short run, and complete in the long run. It also finds that the impact of U.S. monetary policy tightening on the Kuwaiti economy depends on the level of oil prices relative to their fiscal breakeven.

A. Introduction

1. The U.S. Federal Reserve (Fed) has unwound its accommodative monetary policy stance to contain rising inflation. Over most of the past decade global interest rates remained unprecedentedly low, reflecting the accommodative monetary policy stance in the U.S. and other advanced economies. This monetary accommodation was extended to mitigate the negative impact of the COVID-19 pandemic and support economic recovery from the resultant global recession. Inflation rates have recently soared in the U.S. and across the world on the back of pent-up post-pandemic demand, supply chain disruptions and external factors, including higher international food and oil prices due to Russia's war in Ukraine. To control inflation, the Fed has tightened monetary policy, hiking its policy rate by about 450 basis points between March 2022 and February 2023.

2. Monetary policy in Kuwait is largely imported from the U.S., reflecting the fixed exchange rate regime. The peg of the Kuwaiti Dinar to an undisclosed basket of currencies has provided a clear and credible monetary policy anchor, which has helped contain inflation. However, the exchange rate peg

Figure 1. Policy and Interbank Interest Rates in Kuwait



Sources: Haver and IMF staff calculations.

¹ Prepared by Muayad Ismail. The author would like to thank Jasem Mohammed Almsaileem and his team, and participants from the Central Bank of Kuwait and Ministry of Finance at the 2023 Article IV analytical seminar, for their very helpful suggestions and comments. The author also thanks Francis Vitek for insightful guidance, and Dalia Aita for excellent research assistance.

constrains the scope for Kuwait to conduct an autonomous monetary policy.² In this context, the Central Bank of Kuwait (CBK) hiked its policy rate by 250 basis points since the beginning of 2022 through February 2023, less than the 450 basis points increase in the U.S. federal funds rate, reflecting the discretionary room provided by the exchange rate basket. In addition to adjusting its discount rate, the CBK uses open market operations (OMOs), reserve requirements, and short and long-term lending facilities to achieve its monetary policy objectives.

3. Spillovers to Kuwait from U.S. monetary policy tightening could be significant, especially for countries with U.S. dollar pegs. This is particularly pertinent for Kuwait, where market interest rates closely track the U.S. policy rate. As such, U.S. monetary policy tightening is likely to be strongly transmitted to the Kuwaiti economy through the interest rate channel, whereas the exchange rate channel is muted by the currency peg. In particular, higher bank lending rates in Kuwait may be expected to reduce private consumption and investment demand, lowering aggregate output.

4. Oil price developments could play an important role in mitigating or amplifying the impact of U.S. monetary policy tightening on the Kuwaiti economy. Higher oil prices are likely to increase oil revenues for the government and oil sector state-owned enterprises (SOEs), which could lead to higher domestic liquidity through increased government and SOE deposits in the banking system. In this context, monetary policy tightening may be expected to have a smaller impact on economic growth when oil prices are high and liquidity is abundant than at other times (Adedeji, et al., 2019).

5. Against this background, this paper empirically analyzes the potential effects of the ongoing U.S. monetary policy tightening on the Kuwaiti banking sector and economy. It also investigates the possible role of oil prices in affecting this international monetary policy transmission and mitigating spillovers to the Kuwaiti economy. Towards these ends, this paper estimates an autoregressive distributed lag model (ARDL) model to assess the short and long-run pass-through from the U.S. policy rate to bank lending and deposit rates in Kuwait. It also estimates impulse response functions using local projections to measure the impact of monetary policy tightening on Kuwait's non-oil GDP growth.

6. The rest of this paper is organized as follows. Section II discusses stylized facts about U.S. monetary policy spillovers to the Kuwaiti banking sector and economy. Section III discusses the empirical approaches adopted in this paper and presents its key findings. Section IV concludes.

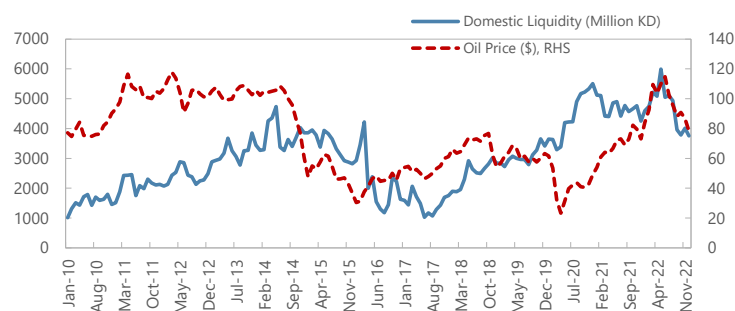
² Policy makers in countries with fixed exchange rate regimes and open capital accounts are faced with a Mundellian Trilemma, where they need to give up monetary autonomy to sustain a fixed exchange rate and open capital account.

B. Stylized Fact on U.S. Monetary Policy Spillovers to Kuwait

7. Large fiscal surpluses during periods of high oil prices appear to be associated with increases in domestic liquidity.

Specifically, liquidity in the banking system, as proxied by commercial banks deposits with the CBK, remained high from 2010 to mid-2014 when oil prices were elevated³. This liquidity receded following the collapse of oil prices in late 2014 to mid-2016, then picked up in late 2017 and continued to increase thereafter until 2021. The oil price peaked in mid-2022, which coincided with the highest level of bank liquidity.

Figure 2. Bank Liquidity and Oil Prices in Kuwait



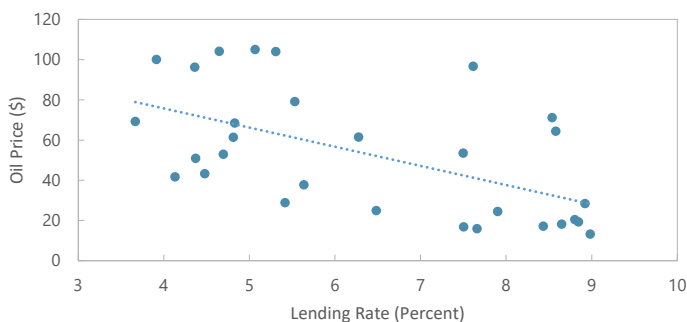
Sources: Haver and IMF Staff Calculations.

Note: (i) Domestic liquidity consists of commercial banks' time deposits, Tawarruq, and sight deposits with the Central Bank of Kuwait. (ii) Correlation between domestic liquidity and international oil price is 0.6.

8. Excess bank liquidity driven by high oil prices puts downward pressure on market interest rates.

Banks with excess liquidity tend to supply more loans to other banks through the interbank market at lower interbank rates. This in turn reduces the overall cost of funding, prompting banks to pass it on to borrowers through lower lending rates, stimulating private domestic demand. Indeed, lending rates are negatively correlated with oil prices in Kuwait. Likewise, tight liquidity conditions driven by low oil prices tend to be associated with high interbank rates, putting upward pressure on lending rates and curtailing private domestic demand.

Figure 3. Relationship Between Oil Price and Lending Rate



Sources: Haver and IMF staff calculations.

Note: Correlation between the lending rate and oil price is -0.6.

9. The transmission of U.S. monetary policy to the Kuwaiti economy and banking sector is likely to depend on the level of oil prices. Excess liquidity driven by high oil prices could limit the pass-through of hikes in the CBK's policy rates to market interest rates, weakening the monetary

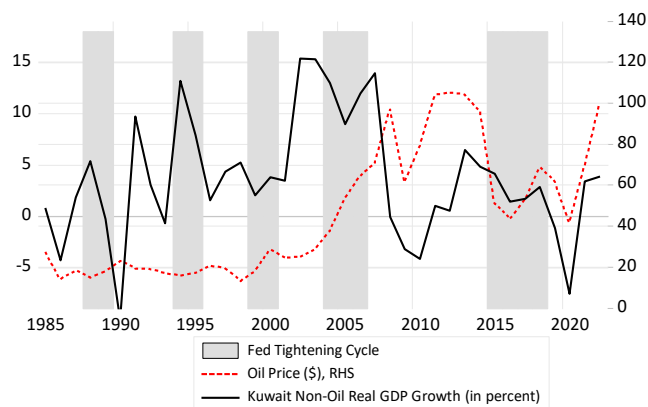
³ Commercial bank time and sight deposits with the CBK are used as a proxy for bank liquidity due to the unavailability of data on bank excess reserves.

policy transmission mechanism. Conversely, monetary policy tightening could be amplified by low oil prices and liquidity, increasing market interest rates by more than normal, and curtailing private domestic demand.

10. Non-oil GDP growth in Kuwait appears to be less sensitive to U.S. monetary policy tightening during periods of high oil prices.

Contractions in non-oil GDP growth in Kuwait were milder during U.S. monetary policy tightening cycles that coincided with relatively high oil prices in the late 1990s, mid 2000s, and late 2010s. Specifically, higher oil prices could support higher government spending in Kuwait, mitigating the impact of monetary policy tightening on private domestic demand. In addition, lower lending rates induced by abundant liquidity from high oil prices could spur credit expansion and further mitigate the impact of monetary policy tightening. The role of oil prices in mitigating U.S. monetary policy spillovers is empirically examined in the next section.

Figure 4. U.S. Monetary Policy Tightening Cycles, Oil Price, and Non-Oil GDP Growth



Sources: Haver and IMF staff calculations.

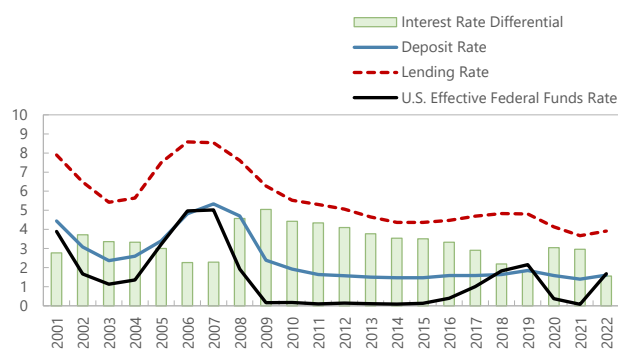
C. Empirical Analysis of U.S. Monetary Policy Spillovers

Pass-Through of U.S. Monetary Policy Tightening to the Banking Sector

11. Bank lending and deposit rates in Kuwait have closely tracked the U.S. policy rate. This indicates relatively high pass-through from U.S. monetary policy to market interest rates in Kuwait. These rates have been converging towards the U.S. effective federal funds rate, with the interest rate differentials narrowing over the past decade. This convergence was, however, interrupted by the pandemic.

12. To assess short and long run pass-through from the U.S. effective federal funds rate to domestic lending and deposit rates, autoregressive distributed lag (ARDL) models are estimated using annual data from 1994–

Figure 5. Bank Interest Rates (Percent)



Sources: Haver and IMF staff calculations.

Note: Interest rate differential is calculated as the difference between the weighted average deposit and lending rate and U.S. Effective Federal Funds Rate.

2022. The ARDL Model takes form where r_t denotes the domestic lending or deposit rate, while e_t denotes the U.S. effective federal funds rate. The lag orders in the ARDL model are restricted to one, given the relatively short sample size.

$$r_t = \gamma + \sum_{i=1}^{P_1} \theta_i r_{t-i} + \sum_{i=0}^{P_2} \delta_i e_{t-i} + \varepsilon_t \quad (1)$$

Table 1. Kuwait: Estimated Pass-Through from U.S. Interest Rates to Kuwaiti Lending and Deposit Rates

Dependent Variable	Lending Rate		Deposit Rate	
	Short-Run	Long-Run	Short-Run	Long-Run
Lending Rate (Lag 1)	0.811*** (0.096)			
Deposit Rate (Lag 1)			0.520*** (0.102)	
U.S. Effective Federal Funds Rate (Current)	0.499*** (0.056)	1.126*** (0.250)	0.475*** (0.055)	0.878*** (0.065)
U.S. Effective Federal Funds Rate (Lag 1)	-0.286*** (0.094)		-0.053 (0.096)	
Constant	0.608 (0.454)		0.487** (0.174)	
R-squared	0.97		0.97	
Breusch-Godfrey Serial Correlation LM Test (P-Value)	0.13		0.46	
Breusch-Pagan-Godfrey Heteroskedasticity Test (P-Value)	0.62		0.051	

Note: *, **, *** correspond to 10%, 5% and 1% significance, respectively, based on robust standard errors. Numbers between parentheses denote standard errors. Long-run coefficients and significance levels of the effective federal funds rate are obtained based on the Long Run solution of the ARDL and Bound Test. That is, with one lag in the ARDL model and using the notation of equation 1, the long run coefficients are estimated as $\frac{\delta_0 + \delta_1}{1 - \theta_1}$.

13. We estimate economically and statistically significant short run spillovers from the U.S. policy rate to market interest rates in Kuwait. These market interest rates do not fully track the U.S. policy rate in the short run. We estimate that a 100 basis points increase in the U.S. effective federal funds rate is associated with increases of 50 basis points and 48 basis points in the lending

rate and deposit rate in the short run, respectively. Deviations from full pass-through in the short run could be influenced by several factors, including interest rate controls, and the limited use of variable interest rate products. They could also reflect the CBK's use of other policy instruments, such as reserve requirements and macroprudential policy tools, to affect liquidity and credit conditions.

14. Lending and deposit rates in Kuwait are estimated to closely track the U.S. effective federal funds rate in the long run. Indeed, the estimated long run pass-through coefficients are close to one, indicating that long run uncovered interest parity holds between Kuwaiti and U.S. interest rates.

Effects of U.S. Monetary Policy Tightening on Growth

15. To assess the impact of U.S. monetary policy tightening on the Kuwaiti economy, we estimate impulse response functions using the local projections (LP) method developed by Jordà (2005). We focus on real non-oil GDP growth rather than overall GDP growth to more accurately measure the macroeconomic effects of U.S. monetary policy tightening, because the oil component of GDP growth is very sensitive to international oil market and price developments.⁴

16. The local projections model is specified as:

$$\Delta Y_{t+i} = \alpha + \beta_1 M_t + \beta_2 \Delta Y_t + \beta_3 M_t * BO_t + \delta_k x_{i,t} + \varepsilon_t$$

where ΔY_{t+i} are leads of non-oil GDP growth, M_t is an estimated U.S. monetary policy shock (see paragraph 17), and $M_t * BO_t$ is an interaction term between the U.S. monetary policy shock and the percentage deviation of the oil price from its fiscal breakeven level⁵. This oil price variable has advantages over other variables, such as an oil price dummy based on the average oil price, as it allows for greater flexibility in capturing the impact of oil prices. $x_{i,t}$ is a vector of control variables that includes the percentage change in government spending and inflation (y-o-y). This local projections model is estimated using annual data from 2003 to 2022.

17. To examine spillovers from U.S. monetary policy tightening, we use a measure of U.S. monetary policy tightening constructed by Ugazio and Xin (2023), which decomposes changes in U.S. benchmark interest rates into a monetary policy shock and an information news shock. They use a heteroskedasticity-based partial least squares approach to estimate monetary policy shocks, based on the sensitivity of U.S. zero coupon yields at different maturities to Federal Open Market Committee (FOMC) announcements. Such a decomposition is important to

⁴ The high sensitivity of oil GDP growth in Kuwait to international market developments stems from oil production and prices, which are determined by the Organization of the Petroleum Exporting Countries (OPEC) and the international oil market, respectively.

⁵ The fiscal breakeven oil price is the minimum price per barrel that an oil exporting country needs to meet its expected fiscal spending needs while balancing its budget. Using the deviation of oil price from fiscal breakeven in the local projections model provides an indication of fiscal space to stimulate the economy through higher spending which also injects liquidity to domestic economy.

appropriately assess U.S. monetary policy spillovers, as it separates monetary policy shocks from monetary policy responses to information news shocks concerning the U.S. economic outlook. Accordingly, we focus on exogenous U.S. monetary policy tightening measures that are likely to have adverse growth spillovers⁶. The monetary policy shock variable is constructed such that contractionary monetary policy shocks are indicated by positive values, and vice versa. Accordingly, the coefficient on the U.S. monetary policy shock in the LP regression is expected to have a negative sign reflecting the adverse growth spillovers from monetary tightening.

18. U.S. monetary policy tightening is estimated to have a significant negative impact on non-oil GDP growth over the short run. The adverse spillovers from monetary tightening to the Kuwaiti economy are found to be short-lived, with the growth impact turning insignificant beyond one year after the shock. Government spending is estimated to have a positive and statistically significant effect on non-oil GDP growth, while inflation is estimated to have a statistically significant negative effect.

Table 2. Kuwait: Local Projection Regressions—Impact of U.S. Monetary Policy Tightening on Non-Oil GDP Growth

Dependent Variable: Lead Non-Oil GDP Growth Grow	T+1	T+2	T+3
Constant	3.230 (2.301)	3.434 (2.444)	4.586* (2.283)
Pure Monetary Policy Shock	-1.941* (1.016)	-1.108 (0.812)	-1.909 (1.331)
Current Non-Oil GDP Growth (T)	0.635*** (0.120)	0.314* (0.160)	0.141 (0.299)
Government Spending (Percent Change)	0.123*** (0.020)	0.011 (0.034)	0.093 (0.061)
Interaction Term (Monetary Shock * Deviation of Oil Price from Breakeven)	0.117** (0.049)	0.158*** (0.051)	0.102* (0.051)
Inflation (y-o-y)	-1.482*** (0.478)	-0.925 (0.537)	-1.401*** (0.572)
R-Squared	0.69	0.53	0.30

Note: *, **, *** correspond to 10%, 5% and 1% significance, respectively, based on HAC robust standard errors. Numbers between parentheses denote standard errors.

⁶ Using a measure of the U.S. monetary policy shock in the local projections model supports identification of spillovers to Kuwaiti non-oil GDP growth from U.S. monetary policy, by isolating its unsystematic component. Instead, using the effective federal funds rate (EFFR) in this model would confound the identification of these spillovers, as the systematic component of U.S. monetary policy responds contemporaneously to the oil price. In the interest rate pass-through analysis in Section III.A, using the EFFR in the ARDL model is more appropriate, as the objective is to estimate conditional correlations of lending and deposit rates in Kuwait with respect to it.

19. The estimation results suggest that the negative impact of U.S. monetary policy tightening on non-oil GDP growth depends on the level of oil prices. Specifically, the overall growth impact of monetary tightening declines as the percentage deviation of the oil price from its fiscal breakeven level increases. Consequently, oil prices above breakeven help mitigate the contractionary impact of U.S. monetary policy tightening. On the other hand, oil prices below breakeven amplify the adverse impact of monetary tightening. Table 3 shows the overall impact of U.S. monetary policy tightening after factoring in hypothetical oil price breakeven deviations.

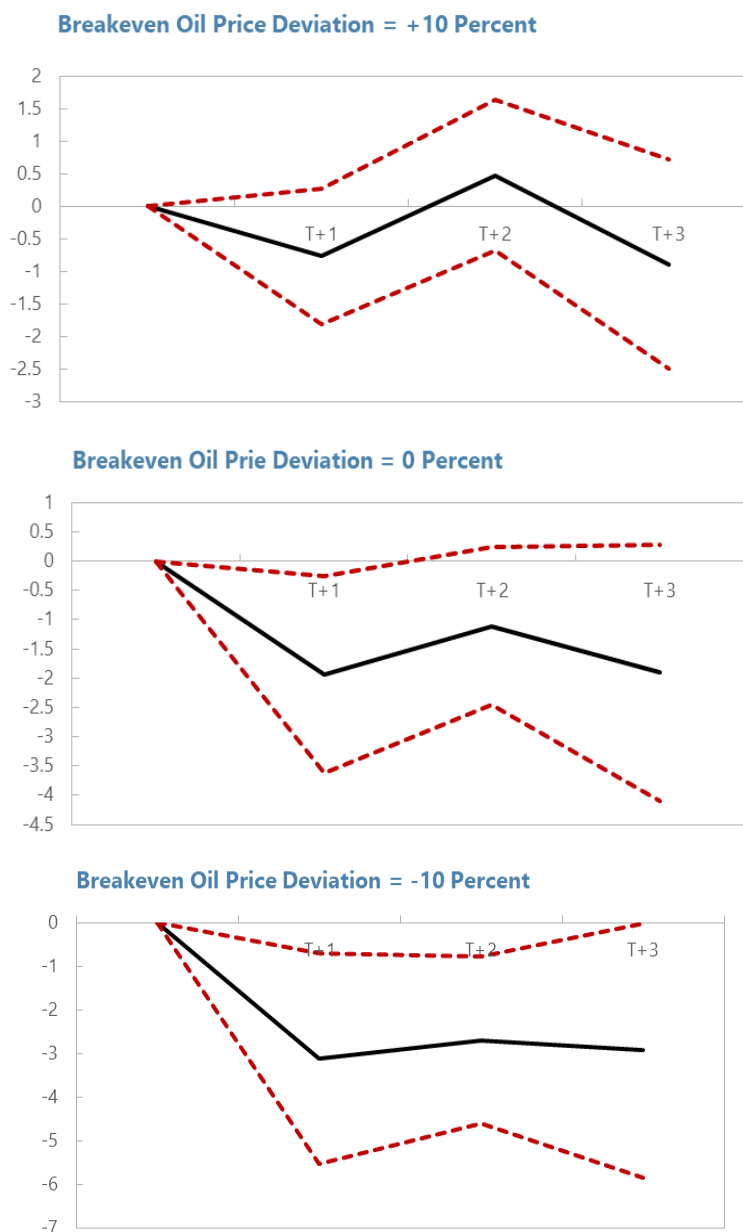
Table 3. Kuwait: Overall Impact of U.S. Monetary Policy Tightening on Non-Oil GDP Growth

Time Horizon	T+1	T+2	T+3
Monetary Policy Shock	-1.94*	-1.11	-1.91
Interaction Term (Monetary Shock * Deviation of Oil Price from Breakeven)	0.12**	0.16***	0.10*
Overall Growth Impact			
At +10 percent Oil Price Breakeven Deviation	-0.77	0.48	-0.89
At 0 percent Oil Price Breakeven Deviation	-1.94*	-1.11	-1.91
At -10 percent Oil Price Breakeven Deviation	-3.11*	-2.69**	-2.93*

Note: The overall impact of U.S. monetary policy tightening on non-oil GDP growth in Kuwait is calculated as the sum of the coefficients on the monetary policy shock (β_1) and interaction term between the monetary policy shock and breakeven oil price deviation (β_3) at 3 different hypothetical percentage deviations of the oil price from its fiscal breakeven. The significance level of the overall growth impact coefficients is based on the joint confidence intervals of the coefficients associated with the monetary policy shock (β_1) and interaction term (β_3) at 3 different oil price breakeven deviations. *, **, *** correspond to 10%, 5% and 1% significance, respectively, based on HAC robust standard errors. Numbers between parentheses denote standard errors.

20. The overall growth impact of U.S. monetary policy tightening is found to be larger and more persistent when oil prices are below their fiscal breakeven level. The estimated impulse responses of non-oil GDP growth to a U.S. monetary policy shock are negative and statistically significant when the oil price is 10 percent below its fiscal breakeven level, with the pass-through effects lingering three years after the shock. In contrast, the estimated impulse responses of non-oil GDP growth to a U.S. monetary policy shock are smaller and statistically insignificant over the three-year horizon when the oil price is 10 percent above its fiscal breakeven level.

Figure 6. Overall Response of Non-Oil GDP Growth to One Standard Deviation Monetary Policy Shock



Note: Solid lines report point estimates and dotted lines represent 90 percent confidence bands. X-axes represent the response time horizon in years with T being the year of the monetary policy shock. Y-axes represent the magnitude of the non-oil GDP growth responses in percentage points to the monetary policy shock at different breakeven oil price deviations. These response are obtained by estimating β_1 and β_3 in equation (2).

21. These empirical results are robust to alternative oil price thresholds and U.S. monetary policy shock measures. Replacing the percentage deviation of the oil price from its fiscal breakeven

with an oil price dummy based on a real oil price threshold of \$43, as used in the existing literature on GCC countries, does not substantively change our empirical results. They are also robust to using an alternative oil price threshold of \$51, based on the average oil price over the sample period. Finally, our empirical results still hold when we replace the monetary policy shock variable used with the one estimated by Jarociński and Karadi (2020).

D. Conclusion and Policy Implications

22. This paper finds that spillovers from U.S. monetary policy tightening to the Kuwaiti economy depend on oil prices. It shows that market interest rates in Kuwait comove strongly with the U.S. policy rate. While lending and deposit rates do not fully track U.S. interest rates in the short run, they roughly do so in the long run. Moreover, the overall growth impact of U.S. monetary policy tightening depends importantly on the deviation of the oil price from its fiscal breakeven level. Specifically, oil prices above breakeven help mitigate the negative impact of U.S. monetary policy tightening, whereas oil prices below breakeven tend to amplify its contractionary impact.

23. Greater economic diversification in Kuwait would help reduce vulnerability to oil market developments, thereby mitigating the amplifying effects of low oil prices on U.S. monetary policy spillovers. At the same time, interest rate pass-through and monetary policy transmission could be strengthened by removing ceilings on market interest rates and further developing the Kuwaiti financial markets. A more diversified financial system in terms of institutions and instruments would also help accelerate the transmission of monetary policy measures.

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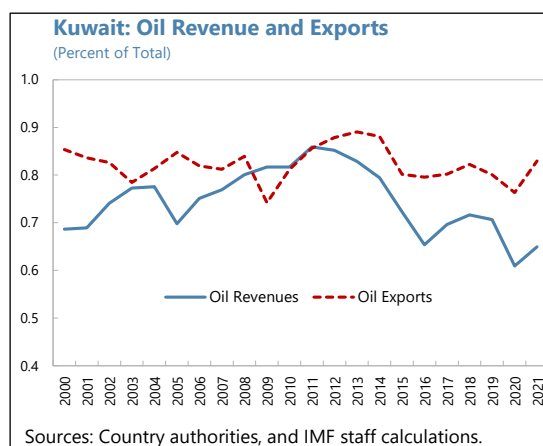
Ugazio, G. and Xin, W., 2023. "U.S. Monetary Policy Spillovers to Middle East and Central Asia: Both Shocks and Fundamentals Matter." Forthcoming. International Monetary Fund.

BUILDING A MEDIUM-TERM FISCAL FRAMEWORK IN KUWAIT¹

Strong medium-term fiscal consolidation is needed to reinforce fiscal sustainability and rebuild buffers. While the Kuwaiti authorities are making efforts to strengthen the fiscal accounts, establishing a solid medium-term fiscal framework would support sound policymaking and rigorous evaluation of reform options. This paper discusses conceptual aspects of, and the rationale for, a medium-term fiscal framework in Kuwait—with a rule based on non-oil structural primary balance—and provides simulations for potential fiscal paths under alternative scenarios, which would help inform policy choices.

A. Context

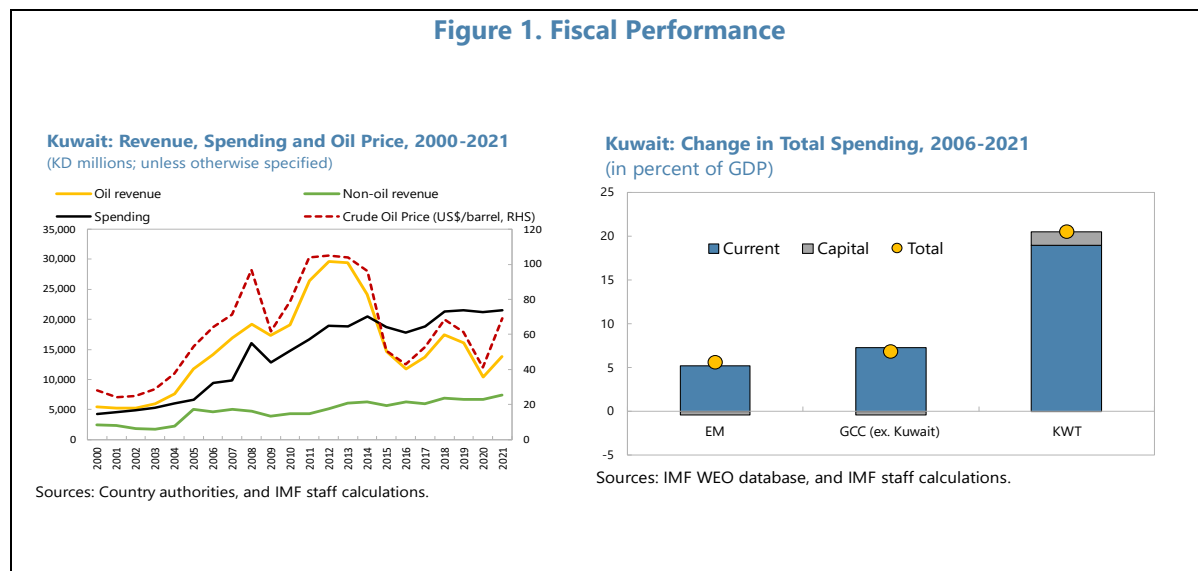
1. Fiscal policy plays a key role in oil wealth management and redistribution. Oil receipts are the major sources of fiscal revenues and export income in Kuwait, accounting for about 70 percent of government revenues and some 80 percent of exports, on average, over 2017-21. The oil sector, including oil extraction, production, and refining, creates jobs and provides energy for domestic consumption. The nation's oil income also affects the rest of the economy, mainly through government spending. Over the past several decades, government spending on infrastructure, education, health, and social programs has transformed the Kuwaiti economy and supported some of the highest living standards in the world.



2. The volatile nature of oil revenues poses a challenge to fiscal policy in Kuwait. Fiscal accounts are highly sensitive to oil price fluctuations. Government spending tends to be procyclical with respect to oil prices, thus propagating the impact of oil price volatility through the **domestic** economy. And such spending in Kuwait has increased more than the Gulf Cooperation Council (GCC) average over the past two decades. Nonetheless, spending is less elastic than revenue—following the decline of oil prices in 2009 and 2015, government spending declined only slightly despite the large drop of oil revenues (Figure 1).

¹ Prepared by Fei Liu. The author would like to thank Dr. Abdulaziz Alosaimi and his team, and participants from the Central Bank of Kuwait and Ministry of Finance at the 2023 Article IV analytical seminar, for their very helpful suggestions and comments. The author also thanks Dalia Aita for excellent research assistance.

Figure 1. Fiscal Performance



3. The fiscal position deteriorated sharply since the 2014-15 oil-price shock and more recently with the COVID-19 pandemic. Oil revenue in 2015 plummeted to 35.4 percent of GDP from 51.9 percent a year earlier, while expenditure increased from 48.8 percent of GDP to 52.7 percent. As a result, the overall fiscal balance worsened from a surplus of 17.6 percent in 2014 to a deficit of 1.4 percent in 2015. Since then, the government launched structural reforms, took steps to rationalize employment benefits and reduce energy and water subsidies. However, the fiscal reform momentum faltered as oil prices recovered in 2017–18. Government spending rose significantly again, and approval of the long-awaited GCC-wide value-added tax (VAT) and excises was put on hold. In 2020, the twin COVID-19 and oil price shocks have again brought the fiscal balance from a surplus of 0.8 percent of GDP in 2019 to a deficit of 16.6 percent.

4. Financing risks have intensified despite the large Future Generations Fund (FGF).

Drawdown from the General Reserve Fund (GRF) in the past years has provided needed fiscal financing and is consistent with the GRF's role as a treasury account and stabilization fund. However, in 2020, financing needs rose to 31.1 percent of GDP despite the suspension of the compulsory 10 percent of revenue transfer to the Future Generations Fund (FGF).² In the absence of a public debt law to permit borrowing, or legal authority to draw from the large FGF, financing has relied on drawdown of the liquid assets of the much smaller General Reserve Fund (GRF), which neared depletion, pushing the authorities to swap illiquid GRF assets for liquid assets from the FGF.

5. The volatile and exhaustible nature of natural resources and/or global energy transition also require saving adequately for the future, necessitating careful calibration of fiscal policy to balance between the twin goals of economic stabilization and

² In August 2020, parliament passed legislation to mandate the transfer of 10 percent of revenues (net of investment income) to the FGF only in the case of a budget surplus during the same fiscal year. Prior to that, the transfer was required irrespective of whether the budget was in surplus or deficit.

intergenerational equity. Further pressures on future oil revenues and on the viability of hydrocarbon extraction will emerge as the global economy mitigates climate challenges and reduces reliance on fossil fuels. The global transition to low carbon economies calls for strengthening the fiscal framework in Kuwait to ensure sustainability and intergenerational equity (See Box 1 for fiscal reforms in other GCC countries).

Box 1. Fiscal Reforms in Other GCC Countries

Bahrain: The Fiscal Balance Program (FBP) was launched in 2018 with the overall objective to achieve a balanced fiscal budget by 2022. Considering the impacts of the Covid-19 pandemic and the lower oil and gas prices in 2020, the government approved a 2-year extension of the original Fiscal Balance target, aiming for achieving overall fiscal balance by 2024. The revised plan includes both expenditure rationalization and revenue mobilization measures, such as streamlining cash subsidies to citizens and increasing VAT to 10 percent.

Oman: The authorities launched a Medium-Term Fiscal Plan (MTFP) in 2020, aiming to alleviate fiscal pressures, address fiscal vulnerabilities, and achieve fiscal balance in the medium term (2020-2025). The plan intends to diversify revenues by boosting the non-hydrocarbon revenue stream and restrain fiscal expenditure. Guided by the MTFP, a 5 percent VAT was introduced in April 2021. Staff proposed a fiscal rule based on the non-hydrocarbon structural primary balance to disconnect spending from the volatility of oil and gas prices and economic fluctuations. (IMF, Oman 2022 Article IV consultation).

Saudi Arabia: The authorities' Fiscal Sustainability Program (originally the Fiscal Balance Program launched at the end of 2016) is a medium-term program which aims to achieve a balanced fiscal budget and sustained public finances. To support an appropriate path over the medium and long term, staff proposed an expenditure rule setting 1 ½-2 percent real growth in spending, based on a fiscal anchor derived from the Permanent Income Hypothesis (PIH) to delink spending from oil price fluctuations. (IMF, Saudi Arabia 2022 Article IV consultation).

Qatar: The authorities' 2022-24 budget framework aims for an expenditure-based fiscal consolidation, with a flat public wage bill in real terms and a sizeable reduction in public investment envisaged. Staff recommended a more balanced and growth-friendly consolidation strategy which could help achieve the dual objectives of intergenerational equity and diversification. The strategy consists of three pillars: diversifying revenues, in particular, accelerating the implementation of the VAT; enhancing current spending efficiency through subsidy reforms and public wage bill rationalization; and reorienting spending to boost productivity, economic diversification, and green investment. (IMF, Qatar 2022 Article IV Consultation Staff Report).

United Arab Emirates: Staff recommended a combination of fiscal restraint and reforms to enhance fiscal buffers, reduce public debt burdens, and avoid procyclicality, and urged the authorities to adopt a transparent, rules-based UAE-wide fiscal framework, including by enhancing and coordinating emirate-specific frameworks and anchors while enforcing fiscal rules. (IMF, United Arab Emirates 2022 Article IV Consultation Staff Report).

6. This paper proposes a fiscal framework for Kuwait. The framework will help guide a fiscal path that supports consolidation and avoids pro-cyclicality but will also support sound policymaking and rigorous evaluation of reform options. The paper clarifies the conceptual aspects and the rationale of the framework, discusses policy considerations, and provides simulations to illustrate potential fiscal paths under different scenarios. The proposed framework mainly builds on staff

analysis and policy recommendations made in the 2021 Article IV Consultation (SM/22/89) and the IMF's framework for Resource Rich Countries (see IMF 2012) to propose alternative long-term paths to fiscal sustainability. Section II proposes the fiscal framework and fiscal anchor. Section III concludes.

B. Fiscal Framework and Fiscal Rule

Fiscal Framework

7. **The current fiscal arrangement has supported the buildup of substantial national wealth.**

The arrangement, transferring to the FGF 10 percent of government revenues excluding investment income, has allowed Kuwait to accumulate financial buffers (544 percent of GDP at end 2021) during periods of high oil prices and diversify oil proceeds into a wide range of financial investments. The large national wealth has provided financial buffers to Kuwait during difficult times and helped bring down borrowing costs for the sovereign.

8. **However, the arrangement does not insulate the economy from oil price fluctuations or ensure sufficient savings for future generations.**

It imposes no constraint on fiscal policy in good times, allowing the government to spend the windfall from high oil prices. Spending (in dinar terms) rose by nearly 25 percent in the two years starting FY2017/18 as oil prices recovered. In bad times, the government can run large deficits while still making mandatory transfers to FGF (until August 2020) by drawing on the GRF and/or accumulating debt (up through 2017), as it did in the aftermath of the 2014-2015 oil price shock that opened up large financing needs.³

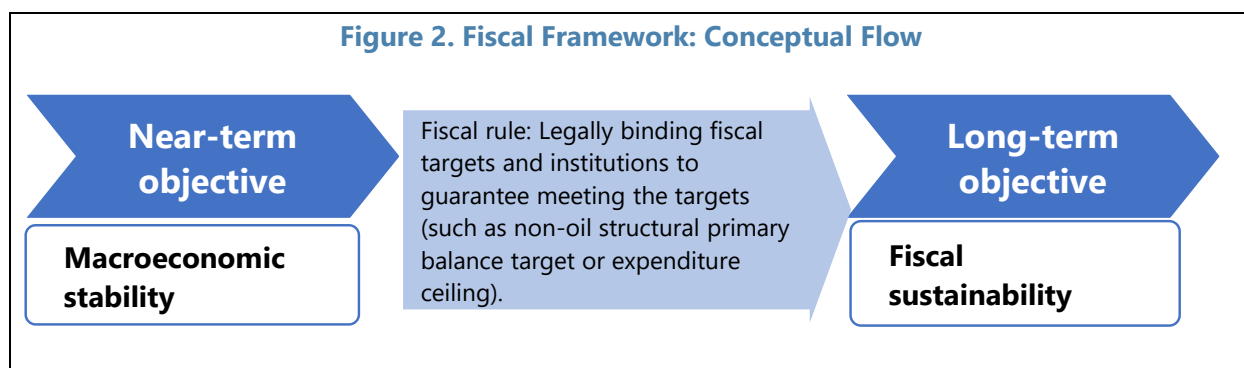
9. **A robust medium-term fiscal framework, with a clear fiscal anchor, is needed to support fiscal policy making.**

The objectives of fiscal policy differ according to the time horizon, ranging from long run fiscal sustainability to short-medium term macroeconomic stabilization. Fiscal frameworks enable the authorities to establish mechanisms to pursue both short and long run objectives in a coherent and consistent manner (see Figure 2 for a conceptual flow of a fiscal framework).

- **Long-term objective: fiscal sustainability.** A fiscal position is sustainable if a government can credibly service its public finances over the long term. For natural resource rich countries, large financial assets and unexploited resource revenues should be taken into account when assessing fiscal sustainability. The unexploited natural resources generate future revenues that can finance future spending, but the pace of such spending would need to be calibrated to avoid an unsustainable situation where financial assets are depleted eventually, and/or the debt-GDP ratio rises without bound with interest payments taking an ever-increasing share of government expenditure (Kanda, 2011). A well-designed medium-term fiscal framework can be used to calibrate fiscal policies to be consistent with the objective of fiscal sustainability.

³ With the expiration of the existing debt law in 2017, the government does not have the legal authority to issue debt beyond then.

- **Near-term objective: macroeconomic stabilization.** Fiscal policy can be used to contain aggregate demand pressures when there are economic booms, which in turn helps contain external imbalances and inflation, and to support aggregate demand, jobs, and economic growth when economic slack is present. The scale of tightening or loosening envisaged should reflect the size of the output gap as well as the need to pursue a medium-term fiscal path that, on average, does not deviate substantially from the long-run fiscal anchor. Country authorities could also have parallel objectives, such as supporting growth and strengthening social protection systems, which can be set up under the fiscal framework while being mindful that these objectives should not result in a fiscal path that deviates substantially from long-run fiscal sustainability.
- **Fiscal anchor.** The anchor is a specific fiscal variable that directly relates to achieving the long-term fiscal objective. In Kuwait, it can take the form of a target level of net financial assets that ensures intergenerational equity.
- **Fiscal rule.** Fiscal frameworks typically ensure consistency of short-term objectives with long-term fiscal sustainability by adopting a fiscal rule. The rule typically refers to legally binding fiscal targets or fiscal aggregates, such as an expenditure ceiling, revenue targets, fiscal balance, or a cyclically adjusted non-oil primary balance.



10. As fiscal reforms will likely take several years to implement, a medium-term fiscal framework (MTFF) is needed to support sound policymaking and rigorous evaluation of reform options. The medium-term fiscal framework encompasses multiple pillars (Figure 3).

- A medium-term macroeconomic framework (MTMF) serves as the basis for the forecasts and estimates in the MTFF, and should reflect a genuine forecast for the economy, not an aspirational target. Operationalizing such a framework would require rejuvenating the staffing, resources, and technical capacity of the Macro-Fiscal Unit in the Ministry of Finance.⁴ The MTFF

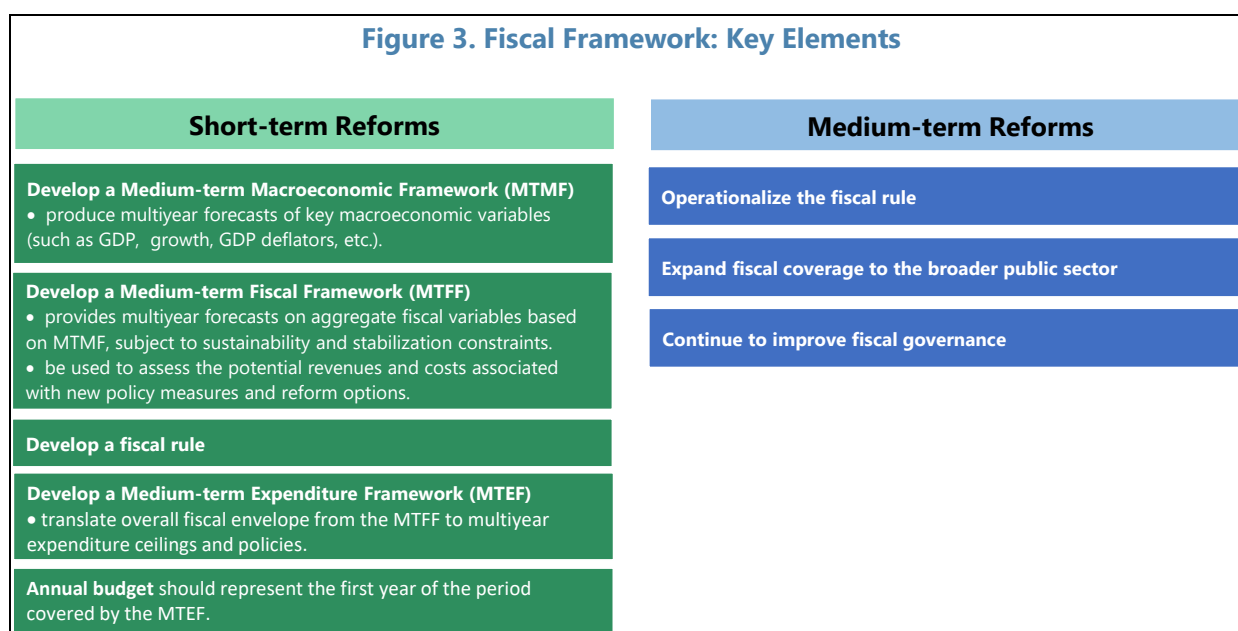
⁴ Other GCC countries including Oman, Saudi Arabia, and Qatar also established such type of macro fiscal units. While the specific mandates vary, these units are generally tasked with developing and performing macro-fiscal policy analysis through a Medium-Term Fiscal Framework to improve policy advice. The fiscal coordination council in UAE provides fiscal stance assessment and fiscal policy recommendations.

can be used to assess potential fiscal costs and benefits associated with structural reform measures, new fiscal measures, and expansion or reduction of existing policies.

- The medium-term expenditure framework (MTEF) translates the overall fiscal envelope from the MTFF to multiyear expenditure ceilings and policies. Main elements of the MTEF would best be done ahead of decision making on the annual budget to form a coherent budget process. Changes in fiscal policy measures would need to be reconciled with the MTEF based on the costing of new policy measures or of the expansion or reduction of existing policies to achieve fiscal targets. A fiscal strategy is usually a part of the MTEF process, and it clarifies the fiscal objectives and how these objectives are to be achieved.

11. The strength and credibility of the fiscal framework and fiscal reforms are underpinned by fiscal transparency and sound institutional arrangement. For the fiscal rule to be effective, it would be best to be legally binding, and enshrined in a sound institutional framework that includes political commitment, sound public financial management, comprehensive budget reporting, and transparent accounting practices. Reporting of fiscal developments and outlook, as well as the underlying assumptions and deviations from the fiscal rule, should be made in line with international standards such as the IMF Fiscal Transparency Code (IMF 2019). A monthly fiscal report could provide more details on macroeconomic and fiscal performance and narrative. An annual fiscal report could analyze compliance with fiscal targets. In case of non-compliance with the MTFF, the document should explain the causes and the short-term policy options to correct the fiscal path. Analysis of fiscal risks, including the factors that may cause fiscal outcomes to deviate from expectations or forecasts, should be conducted under the MTFF and updated regularly to help identify mitigating measures.

Figure 3. Fiscal Framework: Key Elements



Fiscal Rule

12. The past two decades have seen an expansion in the number of countries that adopted rules-based fiscal frameworks. As of end-2021, about 105 economies have adopted at least one fiscal rule, up from 94 countries in 2015 and 9 countries in 1985. Also, the number of emerging market and developing economies (EMDEs) with fiscal rules has risen rapidly since the late 2000s. As of end-2021, there are more than twice EMDEs with fiscal rules than advanced economies (Davoodi and others 2022).

13. There are different types of fiscal rules, which are widely used to constrain fiscal policy discretion and promote fiscal discipline. Research has found that well-designed rules are indeed effective in constraining excessive deficits, and to be effective, fiscal rules should have three main properties—simplicity, flexibility, and enforceability (IMF, 2018). Rules that allow automatic stabilizers to operate freely—through constraints applied to the cyclically adjusted deficit or through expenditure ceilings—are becoming more widespread.⁵ The debt rule, balanced budget rule, revenue or expenditure rules are still widely used, and many countries use a combination of rules, such as debt and balanced budget rules, which could mitigate some of the shortcomings of each rule used separately.

14. The choice of the fiscal rule should reflect Kuwait's circumstances. Tradeoffs are inevitable when choosing the most suitable fiscal rule (Annex I). Generally, more flexible rules can better adapt to macroeconomic shocks and thus serve the economic stabilization objective.

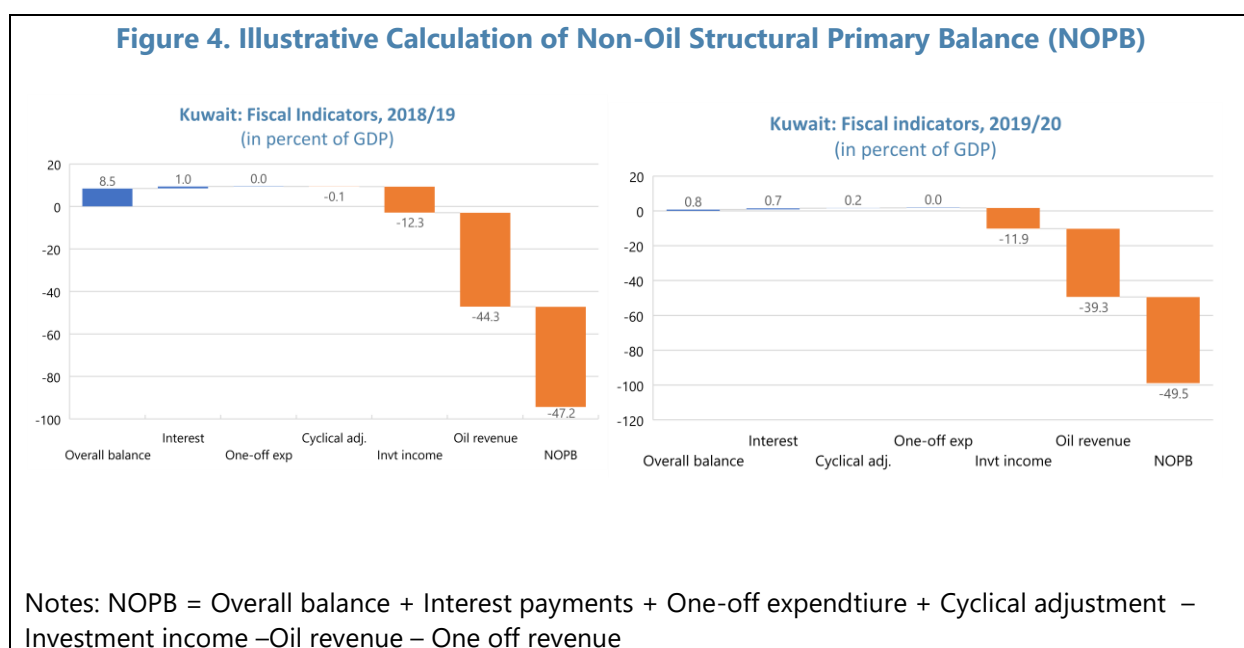
15. A rule based on the non-oil structural primary balance (NOPB) could be appropriate for Kuwait, balancing the long-term fiscal sustainability objective with the short-term stabilization objective. The non-oil structural primary balance, by definition, excludes interest payments, one-off expenditures, investment income and oil revenue, and removes the impact of economic cycles (Figure 4). The potential pros and cons associated with non-oil structural primary balance rule include:

- Excluding oil revenues from the fiscal target can disconnect spending from the impact of volatile oil price, thus delink fiscal decisions from commodity price volatility and reduce the sensitivity of fiscal position to external shocks (commodity fluctuation). It requires saving oil revenues when prices are high and drawing on these savings to finance expenditures when needed.
- The rule adjusts for economic cycles and allows greater flexibility for automatic stabilizers to work, thus helping to achieve the short-term macroeconomic stabilization objective. It requires timely and reliable estimates of the output gap. Nonetheless, real-time assessment of the

⁵ To ensure a sound implementation of more flexible rules, enforcement procedures have been enhanced. For instance, many independent fiscal councils were tasked with monitoring compliance with rules and with ensuring that rules were not circumvented by being based on overoptimistic macroeconomic and fiscal forecasts or manipulation of cyclically adjusted indicators (IMF, 2018).

cyclical position of the economy can be challenging and requires developing institutional and technical capacity and enhancing data availability and quality.

- However, a structural balance target can be more challenging to communicate to the general public, as it involves explaining output gaps and cyclical adjustments. The government could choose to communicate the overall balance that is derived from the structural balance (Figure 3), while leaving technical details available for those who are interested.



16. The Permanent Income Hypothesis (PIH) approach is used to measure long-run fiscal sustainability. The PIH is a commonly used approach in countries with substantial exhaustible natural resources to derive long-term fiscal sustainability benchmarks. Under the PIH rule, the flows available for consumption should broadly match the returns to the discounted value of future resource revenue inflows, so that the financial asset will not trend down and be depleted eventually. PIH also allows alternative scenarios that aim at reducing spending gradually over a period of time that is long enough to permit a gradual transition to the time at which natural resources will be depleted.⁶ PIH-based fiscal balance benchmarks are derived under two scenarios (Figure 5):

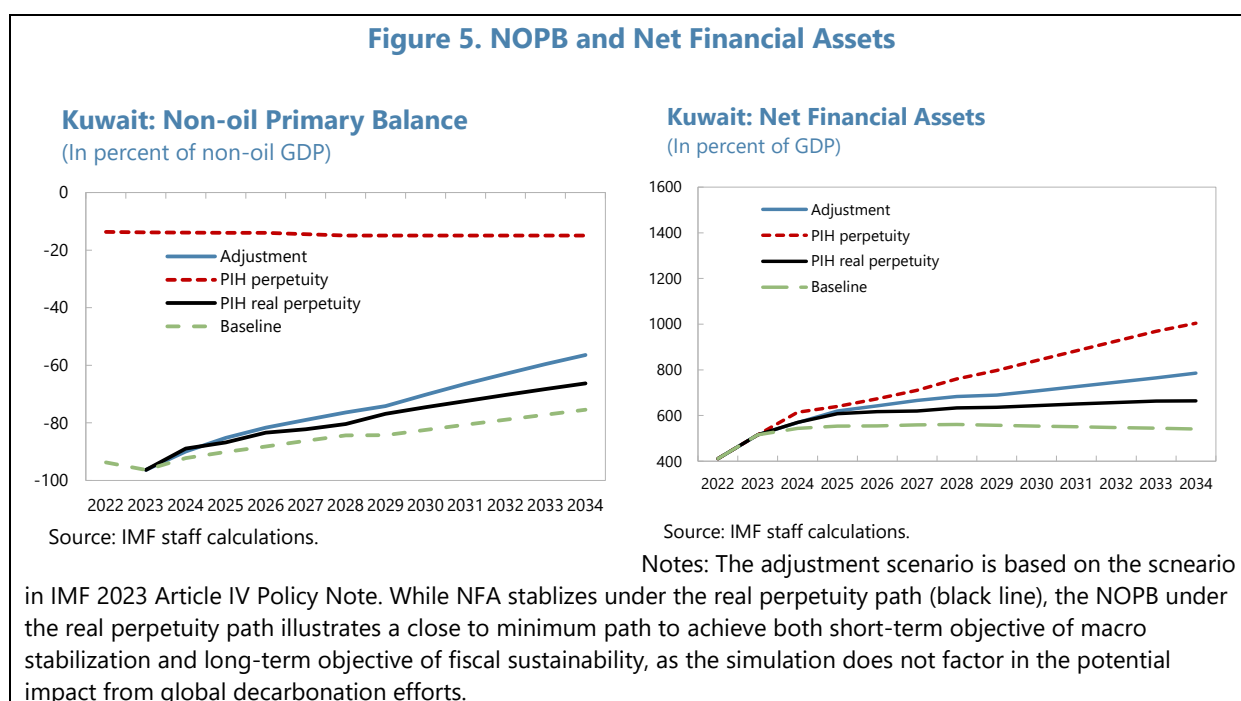
- **PIH perpetuity:** This scenario estimates that a constant non-oil structural primary balance (NOPB) of -15 percent of non-oil GDP would maximize Kuwait's net assets in the long-term while being sustainable indefinitely throughout the projection horizon.⁷ This scenario envisages

⁶ PIH starts with estimating a country's net wealth – the sum of the initial stock of the net financial assets (KIA assets net of public debt) and the present value of future oil revenues. The latter depends on assumptions regarding available oil reserves, their rate of extraction, future oil prices, the exchange rate, and the government's share of oil revenue. The pace of wealth accumulation depends on assumptions regarding long-term growth, real interest rate, and inflation.

⁷ In the long run, non-oil primary balance equals non-oil structural primary balance since economy is assumed to converge to equilibrium over the long term and thus output gap is closed. NOPB is calculated as a share of non-oil GDP to remove the impact of the volatile oil GDP.

large and upfront theoretical adjustment, which would not be feasible nor desirable. Nonetheless, this scenario represents an indicative upper bound of NOPB.

- **PIH real perpetuity:** This scenario derives an initial NOPB that improves over time at the rate of inflation and that stabilizes net assets in the long run. This approach assumes a gradual adjustment at the beginning and, as the non-oil sector grows, would smooth the consolidation path.



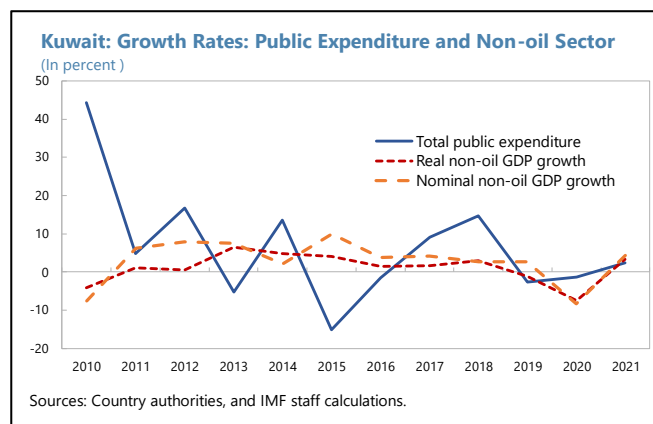
17. Kuwait is not saving sufficiently for future generations under both PIH scenarios. Absent additional consolidation efforts, the structural non-oil primary balance (NOPB) under the baseline is projected to worsen as a share of GDP over the medium term but improve as a share of non-oil GDP as the latter is projected to grow faster than overall GDP. However, it is well below the levels estimated under various PIH scenarios, showing that Kuwait is not saving sufficiently for future generations. Under the PIH perpetuity approach, a NOPB share of non-oil GDP of -15 percent would maximize Kuwait's net wealth at the end of our forecasting period. However, this approach implies a large upfront adjustment and may not be feasible for an economy with sizeable infrastructure and human capital development needs such as Kuwait. As non-oil GDP grows, future generations are expected to be better off.

18. Following a NOPB path that allows earlier generations to consume a larger share of oil resources (PIH real perpetuity approach) may work for Kuwait. Under this approach, the NOPB would start from a level much closer to the actual NOPB, but gradually improve, averaging -78 percent of non-oil GDP over the first decade of the projection.

19. Careful calculations would be needed under the MTFF to set numerical fiscal targets under the structural fiscal rule. The NOPB under the PIH real perpetuity approach, where a smoother spending path is implied, could be more feasible to implement than the other path (PIH perpetuity) and can result in a stable net financial assets for Kuwait. In practice, the setting of numerical fiscal targets requires not just estimates of output gaps, but also depends on a solid budgeting process that sets a spending profile that balances the needs for consolidation and economic development.⁸

20. An expenditure rule can be used to complement the structural rule on NOPB. An expenditure rule imposes a ceiling on government spending, which can be specified in percent of non-hydrocarbon GDP or in terms of the nominal or real growth rate, and can be applied to current spending or total government spending. Expenditure rules (on total expenditure) do not necessarily imply limited room for investment. Instead, they are found to be associated with spending control, counter-cyclical fiscal policy, and improved fiscal discipline (Cordes et al. 2015). This reinforces the literature findings that by reducing incentives for spending overruns, expenditure rules can lead to stricter prioritization and greater efficiency in spending. However, using an expenditure rule alone would leave revenues outside of the coverage of the fiscal rule. Therefore, an expenditure rule can be nested within the non-oil structural primary balance rule to limit expenditure growth. While the structural rule provides a countercyclical anchor that is consistent with short- and long-term objectives, combining it with an expenditure rule would allow for a smoother path of fiscal consolidation over the medium term, and likely a more ambitious consolidation over the longer term. Also, it would help explicitly limit expenditure growth especially when oil prices are elevated.

21. Specific design of the expenditure rule would need to reflect Kuwait's circumstances and the authorities' preferences. One example can be linking expenditure growth to non-oil nominal GDP growth. Growth rates of public expenditure exceeded the growth rates of non-oil nominal GDP more than 50 percent of the time during 2010-2021. If history repeats itself going forward, setting an expenditure rule that limits total expenditure growth to be below non-oil nominal GDP growth implies that the rule would kick in and be binding about 50 percent of the time. Overall, the expenditure rule would need to reflect the pace of adjustment and the mixture of measures that the authorities envisage. It would also need to factor in the capacity of implementation and include escape clauses as needed.



22. Escape clauses can be used to provide flexibility under special circumstances. An escape clause broadly refers to a special circumstance where a government can deviate from its

⁸ Currently, the budget is prepared on a bottom-up basis. Total budgeted spending is a bottom-up summation of individual line ministries' proposals, after some negotiation with the Ministry of Finance. This approach could lead to budgets that arrive at large aggregate expenditures.

fiscal rule. The events triggering the activation of an escape clause could include severe economic downturns, large natural disasters, and sudden and large negative terms of trade shocks for commodity exporters. They should be outside government's control and preferably defined in quantitative terms if possible (IMF 2020). The global financial crisis catalyzed the use of escape clauses to allow deviations from numerical limits within the framework in exceptional times (IMF 2022). The use of escape clauses should be clearly specified and set in a transparent process to preserve the credibility of the fiscal framework (IMF 2020).

23. Independent fiscal institutions are important pillars of the rules-based fiscal framework. They are often used to assess fiscal plans and performance, evaluate macroeconomic and budgetary forecasts, and monitor the implementation of fiscal rules (IMF 2013). They help foster transparency and promote fiscal stability. Along with the growing adoption of fiscal rules, more countries have established independent fiscal institutions, such as fiscal councils, over the last decade. There were 51 fiscal councils in 49 countries as of 2021, about twice the number in 2010 (Davoodi 2022). Strong institutional capacity, proficiency, experience, operational independence, and access to timely information are crucial elements to fulfill the functions of an independent fiscal institution.

C. Conclusion

24. Kuwait would benefit from a transparent, rules-based fiscal framework to guide its fiscal policy. The increased volatility of oil prices amid uncertain global outlook underlines the need for strengthening fiscal discipline to support smooth fiscal operation, avoid liquidity pressures, and buttress economic stabilization. The eventual depletion of oil reserves and the possible lower global demand for crude oil due to the transition to low carbon economies require accumulating adequate savings for future generations. A well-designed and credible fiscal rule can help address these challenges. The design of the fiscal framework rests with the authorities and should reflect societal preferences. While designing a fiscal framework is an important first step, the effectiveness of fiscal framework and fiscal rules would hinge on several factors, including strong fiscal institutions, active and sound macroeconomic forecasting and analysis, and strong and sustained political commitment to a medium-term fiscal goal.

Annex I. Overview and Assessment of Selected Fiscal Rules¹

Rules on Fiscal Balance

1. **An overall balance rule** usually imposes a ceiling on the headline deficit in percent of GDP. The overall budget balance is closely linked to debt dynamics, making the rule effective in supporting debt sustainability. However, for resource-rich countries, the impact of the oil prices on the overall balance could give misleading signals about the underlying fiscal position and fiscal risks. The rule can also lead to a procyclical fiscal stance (e.g., consolidating to offset the cyclical decline in revenues in bad times and expanding spending in good times).
2. **A non-resource primary balance rule** excludes resource revenues and resource expenditures, which is more suitable for assessing long-term sustainability and fiscal risks in resource rich countries. The rule gives good signals about the underlying fiscal stance, with an increase in the non-resource primary deficit indicating a loosening of fiscal policy arising either from higher expenditure or a relaxation of non-resource revenue collection. A reduction in the non-resource primary deficit would signal fiscal consolidation. Non-resource primary balance is usually normalized by non-resource GDP to avoid the fluctuation caused by commodity prices and to better reflect the domestic economy.
3. **A golden rule** imposes a ceiling on the overall deficit net of capital expenditures, aiming to protect capital expenditures which are key to long-term economic growth. However, it may favor creative accounting through reclassification of unproductive expenditures as investment to circumvent the rule. The rule can also allow excessive borrowing and weaken the link between the targeted deficit and debt dynamics, creating possible risks to debt sustainability.

Structural Rules

4. **A cyclically adjusted rule** imposes limits on the overall balance, correcting for the effects of business cycle fluctuations on revenues and expenditures. By disconnecting spending from cyclical revenues and letting automatic stabilizers operate freely, such a rule can be used to stabilize the path of expenditures. However, monitoring and enforcing a cyclically adjusted balance rule is challenging, as it requires timely and reliable estimates of the output gap, which is often hard to estimate, particularly in countries that are undergoing structural changes and those with poor data quality. Cyclically adjusted balances are also prone to frequent ex-post revisions resulting from measurement errors of potential output.
5. **A structural rule** is an extension of cyclically adjusted rules (Bornhorst et al. 2011), as it adjusts the overall balance beyond the business cycle by correcting revenue and spending for one-off fiscal measures and other economic cycles, such as those related to asset or commodity prices. The structural budget balance allows for the smoothing of oil price volatility when setting spending

¹ This annex draws heavily on the Selected Issues Paper, IMF Country Report No. 22/344.

decisions. Specifically, expenditure is set based on an estimate of the long-term oil price—say, a 5 or 10-year average—and a target for the structural balance.

Expenditure or Revenue Rules

6. An expenditure rule sets a target on total, primary, or current spending. The rule is typically set in absolute terms (levels) or growth rates and occasionally in percent of GDP (and non-resource GDP for commodity exporting countries), with a time horizon that typically ranges from three to five years (Lledó et al. 2017). Expenditure rules in levels and growth rates allow automatic stabilizers to operate on the revenue side in times of adverse shocks, while expenditure rules set as a ratio of GDP tend to be procyclical.

7. A revenue rule sets floors or impose ceilings on government’s income proceeds. Neither revenues floors nor ceilings constrain spending, and therefore the rule does not ensure achieving fiscal sustainability. It can also complicate macroeconomic stabilization efforts by, for example, hiking taxes in bad times.

Assessment of Fiscal Rules	
<p>Overall Balance</p> <ul style="list-style-type: none"> + Easy to communicate and monitor + Closely linked to debt sustainability + Clear operational guidance - Could lead to procyclicality - Could adversely affect quality of adjustment <p>Expenditure</p> <ul style="list-style-type: none"> + Easy to communicate and monitor + Allow macroeconomic stabilization + Clear operational guidance + Could ensure debt sustainability if well-designed - Could adversely affect quality of adjustment - May reduce incentive to raise revenues <p>Cyclically Adjusted and Structural</p> <ul style="list-style-type: none"> + Foster economic stabilization + Good operational guidance - Difficult to compute and monitor 	<p>Golden (overall deficit net of capital expenditure)</p> <ul style="list-style-type: none"> + Protect public investment + Intergenerational equity - Weak link to debt sustainability - Creative accounting <p>Revenue</p> <ul style="list-style-type: none"> + Raise revenue or limit tax burden - Weak link to debt sustainability - Could lead to procyclicality <p>Non-Resource Primary Balance</p> <ul style="list-style-type: none"> + Easy to monitor + Could encourage non-resource revenue generation - Difficult to communicate - Narrow coverage and weaker link to financing needs/debt
Source: IMF 2018.	

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