Kuwait at a glance: 2006-07

OVERVIEW
The succession issue seems to have been resolved with Sheikh Sabah al-Ahmed al-Jabr al-Sabah replacing the ailing Sheikh Saad Abdullah al-Salem al-Sabah as emir. However, despite tensions over the prospect of the less powerful Al Salem line of the ruling family also being sidelined in favour of the Al Jabr branch when it comes to appointing a new heir apparent, the Economist Intelligence Unit does not expect disagreements to be expressed in the public domain. Failure to resolve the issue of who is to fill the positions of crown prince and prime minister will not handicap governance, but it would further constrain traditionally cautious Al Sabah decision-making. Either way, we expect the government to make progress with long-standing plans to draw foreign capital and expertise into the upstream oil sector (Project Kuwait), provided elections are not brought forward from their scheduled mid-2007 date and succession questions do not escalate. Economic growth will slow as net exports ease in real terms, but domestic demand will continue to expand at a robust pace. High oil prices will ensure that the trade and current accounts, as well as the fiscal account, continue to generate very large surpluses in 2006-07.

Key changes from last month
Political outlook
• The ailing Sheikh Saad, who became emir following the death of, Sheikh Jabr al-Ahmed al-Jabr, has been replaced by Sheikh Sabah. The office of crown prince and prime minister are expected to be split once again in a move that would resolve the fairly long-standing succession dispute should a younger Al Sabah take up one of these positions.

Economic policy outlook
• Our economic policy outlook is unchanged. The government will continue to pursue gradual economic change, with Project Kuwait expected to gain parliamentary approval over the next 12 months.

Economic forecast
• We have changed our forecast for real GDP growth in 2006-07 to reflect the fact that we now expect oil output to rise more modestly in 2006, but to increase more firmly in 2007, than previously projected.
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Outlook for 2006-07

Political outlook

Domestic politics

The ailing Sheikh Saad Abdullah al-Salem al-Sabah, who became emir following the death of Sheikh Jabr al-Ahmed al-Jabr al-Sabah in mid-January, has been forced to stand down. Senior members of the ruling Al Sabah family have reached agreement on the accession, in the expectation that this will satisfy both domestic elite and international opinion. The National Assembly (parliament) then approved Sheikh Saad's removal from office on health grounds, in a constitutional procedure that the senior leadership had hoped would be unnecessary but that proved to be a formality.

Sheikh Sabah al-Ahmed al-Jabr al-Sabah, a senior member of the Al Jabr line of the Al Sabah, is the new emir. However, his appointment by the family council will require a debate in parliament and approval by a majority vote. The accession of Sheikh Sabah still leaves open the question of who will then become crown prince and prime minister, a question that, under the constitution, must be resolved within 12 months. The Economist Intelligence Unit expects the two posts, which were split for the first time in 2003, to remain separate so that the other, less powerful line of the ruling family, the Al Salem, can be more easily accommodated and a future succession crisis avoided.

We do not, however, envisage a political crisis, much less instability, if the issue of who becomes crown prince and prime minister is not resolved quickly. That said, the issue of how to accommodate the demands of the Al Salem (that a member of their line should become emir after Sheikh Sabah) will continue to generate public discussion and possible dispute until it is settled. Solving this should deal with wider parliamentary and elite frustration over the future transition to the next generation of leaders. To some MPs, the forthcoming parliamentary debate on Sheikh Sabah’s accession will relate to the future succession question. However, given that parliament has historically been reluctant to interfere in succession questions, and has an inbuilt government majority, the Assembly is highly unlikely to refuse to approve the appointment of Sheikh Sabah, who has the support of most of the senior Al Salem (as well as the Al Jabr). As emir, Sheikh Sabah is unlikely to move far from the ruling family’s cautious approach to governance, which characterised his de facto rule over the past three years. However, by dint of personal inclination and energy, he will take full advantage of the executive powers invested in the office of emir, and is likely to push a little more firmly within family circles on issues to which he is strongly committed.

Before the death of Sheikh Jabr there had been genuine concerns within the ruling family and parliament over Sheikh Sabah’s existing authority. The eldest member of the Al Sabah and head of the National Guard, Sheikh Salem Ali al-Salem al-Sabah, the most senior figure (after Sheikh Saad) from the Al Salem branch of the ruling family, which has lost authority in recent years, sought to exploit the frustrations of politicians and the wider public over the political vacuum. Sheikh Salem Ali and some other family members had wanted to
prevent Sheikh Saad from allowing the prime minister to realise his ambition without a clear route for someone from the Al Salem line to become emir after Sheikh Sabah. (If an Al Salem were to become emir after Sheikh Sabah, this would resume the traditional (but not obligatory) pattern of leadership alternation between the two branches, after what would have been two emirs from the Al Jabr line in succession.) However, despite the constellation of interests that have backed a prompt resolution of the leadership issue, it is not clear whether there will be a quick move to determine who will now become crown prince and prime minister.

It is possible that the relatively young (mid-50s) foreign minister, Sheikh Mohammed Sabah al-Salem al-Sabah, who is the only Al Salem in the cabinet and is close to the prime minister, could be chosen as crown prince. Sheikh Mohammed has the advantage in the eyes of senior members of the ruling family of being, despite his age, from the current generation of Al Sabah leaders. The popular, and younger, energy minister, Sheikh Ahmed al-Fahd al-Ahmed al-Sabah, has influence with his uncle, Sheikh Sabah, and with the wider family. That said, his comparative youth, he is in his mid to late 40s, could count against him at this stage, as senior Al Sabah leaders continue to be wary of transferring power to the next generation. We do not expect Sheikh Ahmed to use either his influence with MPs or the pivotal energy portfolio to further his leadership ambitions, which, after all, are subject to the blessing of the senior Al Sabah, including his uncle, the new emir. Given sensitivities over age, and inbuilt Al Jabr dominance, the first deputy prime minister and interior minister, and (slightly) younger brother of Sheikh Sabah, Sheikh Nawaf al-Ahmed al-Jabr al-Sabah, could be a contender for the position of crown prince. In such a scenario the post of prime minister would probably go to Sheikh Mohammed. However, if Sheikh Nawaf takes both posts, then the future succession issue will continue to rumble on, not least since the Al Salem, or at least Sheikh Salem Ali and his allies, could push the issue with more intensity. In both family and policy terms, the rise of these candidates for the second and third positions in the government hierarchy is unlikely to produce a significant change in the direction of domestic, much less foreign, policy.

Project Kuwait (a long-standing economic reform proposal to introduce foreign investment into four northern oilfields) continues to attract vehement opposition from relatively nationalist, centrist MPs, as well as Islamist MPs, emphasising that, as emir, Sheikh Sabah will have to be mindful of parliamentary opinion, even in the current, malleable National Assembly. Furthermore, parliament has concerns over the terms of the project, which are likely to lead to further debate, especially as the government appears to be prepared to allow additional time for parliamentary discussion. However, Sheikh Sabah could push legislation approving the deal through the Assembly in the next 12 months, if he so wishes. We expect him to do so, assuming that there is not an intensification of the succession dispute, nor early parliamentary elections.

The debate in the Assembly over further reform of parliamentary politics is likely to continue despite a reining in of expectations by Sheikh Sabah late last year over the legalisation of political parties. Outstanding proposals, officially supported by the government, would, though, reduce the number of electoral
constituencies from 25 to ten. However, with the electorate set to double, following the granting of women's suffrage last summer, the government is likely to stall on additional political reforms, despite support for such measures from Islamist and, increasingly, centrist politicians who are often the most critical of the government's Project Kuwait proposals. The next election will include female voters for the first time (on the assumption that it does not take place much before its scheduled date of mid-2007, when the bureaucratic procedures for their participation would be complete). However, with MPs highly likely to initiate further questioning of senior (non-Al Sabah) ministers, the government could decide to dissolve parliament before 2007, citing an inability to carry out government business (the basis on which it was constitutionally dissolved in 1999).

International relations

Kuwait's primary strategic relationship will continue to be with the US. Differences over whether the government should move beyond "counter-terror" measures to restrict or monitor legal Islamist activity will fail to weaken ties. Despite periodic tensions with Iraq over border issues, relations should benefit from the prospect of generous Kuwaiti economic aid and debt write-offs when circumstances allow. Any easing of the Iraqi reparations burden arising from the 1990 invasion, however, may be difficult for Kuwait to agree to, given the ambiguous position of some leading Iraqi politicians over the two countries' shared border.

Economic policy outlook

Policy trends

The nexus between state control of much of the economy, including oil revenue, and the political legitimacy of the ruling family places limits on the structural reforms that will be sought by the government. Few members of the ruling Al Sabah family wish to fundamentally alter the predominant role of the state in the economy and in welfare provision, given the small national population and the massive revenue generated in recent years by exceptionally high oil prices. Even during less bullish periods, the high levels of non-oil income generated by the state's vast stock of foreign assets have eased the pressure for far-reaching—and politically unpopular—changes to the structure of the economy or cuts to the generous, all-embracing welfare system open to Kuwaiti nationals.

Although there is some official recognition that the state cannot continue to absorb new entrants to the labour market indefinitely, shorter-term exigencies will ensure that this policy continues for the foreseeable future. Nevertheless, some measures to encourage the development of the private sector are expected, and private infrastructure investment is being actively promoted on a build-operate-transfer basis. The government's commitment to attracting foreign direct investment could see a reduction in corporate tax rates for foreign business in the non-oil sector. More significantly, we expect legislation to be passed by end-2006, enabling Project Kuwait to start conceivably by mid-2007.

Fiscal policy

In fiscal 2006 (April 1st 2006-March 31st 2007) a relatively modest rise in oil output will push up revenue to KD14bn (US$48bn), or 63% of GDP, up by 2.7%
on the fiscal 2005 outturn, then a record high. Although non-oil earnings will rise as investment income strengthens (as global interest rates continue to increase), non-oil income will decline as Iraqi compensation payments (administered by the UN) ease, a trend that began in fiscal 2005. Both recurrent and capital expenditure will continue to rise firmly, with the latter continuing to grow particularly markedly as infrastructure projects attract additional government resources. This is forecast to result in a still very strong government surplus of KD6.4bn (28.7% of GDP). In fiscal 2007 revenue is projected to decline marginally, to KD13.9bn, as oil output levels remain constrained by production capacity and as international oil prices, though still strong, fall by 15%. At the same time, continued firm increases in government expenditure, with recurrent and capital expenditure rising strongly, are expected to produce a 11% contraction in the fiscal surplus, which will end the forecast period at a still very strong KD5.7bn (26.8% of GDP).

**Monetary policy**

The Kuwaiti dinar has been pegged exclusively to the US dollar since January 2003 and interest rates will continue to track closely those set by the US Federal Reserve (the central bank). This has already prompted the authorities to raise rates several times during the past year and should lead to further increases over the remainder of the forecast period as US rates return towards their historical norms. We do not expect a widening in the interest rate differential over the forecast period, as Kuwait is unlikely to face currency pressures.

**Economic forecast**

**International assumptions**

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**Note. Regional GDP growth rates weighted using purchasing power parity exchange rates.**

Global growth (measured using purchasing power parity exchange rates) averaged an estimated 4.4% in 2005—slightly above the long-term average, but a deceleration compared with the 5% growth recorded in 2004. We expect global expansion to ease further but to remain relatively strong in 2006-07, at an
annual average of around 4%. US interest rates will continue to rise—an important consideration for Kuwait, which is all but certain to retain the dinar's peg to the dollar.

With most oil producing countries operating at close to their maximum, the market does not have significant spare capacity, putting oil prices under sustained upward pressure, especially at a time when ongoing instability in the Gulf raises uncertainty over the security of supply. In 2006 we forecast that rising international demand will lead to a slight increase in oil prices compared with 2005, as any spare capacity will remain largely confined to OPEC producers. In 2007, however, a combination of additional supply, including of the more in demand sweeter crudes, and a fall in international demand is expected to push average oil prices down to a still-high US$46.8/b.

**Economic growth** We estimate that the economy expanded by 4.8% in 2005, and forecast that it will grow by a still comparatively strong 3.5% in 2006 and 3% in 2007. In 2006 high levels of government earnings will continue to provide a strong stimulus to growth in an economy reliant on public-sector contracts. Furthermore, investment spending is also expected to remain strong, a growing proportion of which is likely to be foreign-funded. However, oil output will increase less markedly than in 2005, which along with still-strong import levels will partly constrain the rate of expansion. In 2007 government spending will continue to boost real GDP growth, but with export volumes rising at a slightly slower pace than in 2006, as a result of oil production capacity constraints and possible OPEC quota restrictions, expansion will be more modest. However, government outlays will continue to provide an economic stimulus. Import volumes will continue to rise firmly in 2006-07, as demand for consumer, intermediate and capital goods remains high, and government expenditure increases. The latter will ensure that domestic demand, though weaker than in 2005, remains buoyant over the forecast period.

**Inflation** We estimate that inflation picked up markedly in 2005, although at an average of 3.7% it remained relatively benign. The higher than trend inflation rate was a reflection of the introduction of a new inflation index and some inflationary stimulus caused by strong domestic demand and the ongoing weakness of the US dollar against the currencies of Kuwait's other main trading partners. In 2006-07 we expect a much more modest rate of inflation, at an average of 2.7%, as import costs rise less firmly. The pace of inflation will also continue to be constrained by the maintenance of the government's extensive subsidies on core goods and services. The cost to the state of maintaining this system is rising (particularly for imported goods), but, given the strength of the government's finances and the political sensitivities that surround the subsidy regime, there is little prospect that price support will be reduced.

**Exchange rates** We expect the dinar's peg to the dollar to be maintained over the forecast period and beyond. Strong fiscal and current-account surpluses will ensure that the government will face no difficulty in maintaining the peg. In the highly unlikely event that pressure on the currency materialises, Kuwait has ample foreign-currency assets that could be called upon to support the dinar.
### External sector

In 2006 we forecast that total export earnings will reach a record US$44.2bn, as energy prices will be little changed on 2005 and oil production will rise, albeit modestly. In 2007 declining, but still high, oil prices and a comparable increase in oil output will see a contraction in export revenue to a still very healthy US$40bn. Although import spending will rise in line with domestic demand growth, the strength of export revenue will push the trade surplus up to US$31.5bn in 2006, the equivalent of 41.3% of GDP. Despite a fall in oil prices and rising import levels, the trade surplus in 2007 will be a still very strong US$26.6bn, equivalent to 36.5% of GDP.

Services debits will pick up over the forecast period, largely because of higher import spending and the non-merchandise needs of the industrialisation programme. In 2006 income debits will strengthen as robust domestic demand, still-high energy prices and increased oil output boost the repatriated profits of foreign firms in Kuwait. In 2007, however, as oil prices ease, the level of repatriated profits will fall, pushing down income debits. Current transfers outflows will increase as the country’s large population of expatriate workers continues to rise. However, Kuwait has significant sources of non-merchandise credits, notably earnings from its large stock of foreign assets. Services credits—largely related to overseas banking activities—are also strong, and are likely to grow over the forecast period. All told, we expect this to leave Kuwait with a current-account surplus of US$32.2bn (42.2% of GDP) in 2006—around three times the average surplus generated in the five years up to 2005. In 2007 the falling, but still very strong, trade surplus will ensure a current-account surplus of US$29bn, or 39.8% of GDP.

### Forecast summary

(% unless otherwise indicated)

<table>
<thead>
<tr>
<th></th>
<th>2004&lt;sup&gt;a&lt;/sup&gt;</th>
<th>2005&lt;sup&gt;b&lt;/sup&gt;</th>
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<sup>a</sup> Actual. <sup>b</sup> Economist Intelligence Unit estimates. <sup>c</sup> Economist Intelligence Unit forecasts.