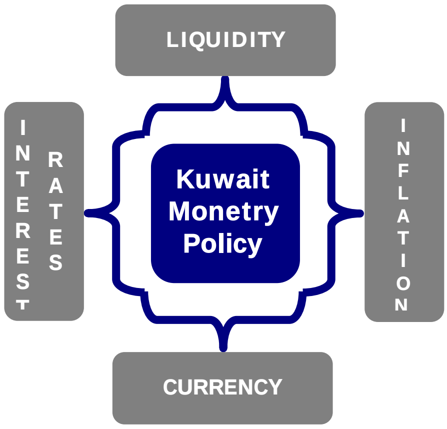
March 2008

The Vicious "Square"

Monetary Policy Options for Kuwait

Monetary authorities in Kuwait (or for that matter in the Gulf) have never been challenged as much as they are now. The monetary policy is surrounded by various factors, what we call as the vicious square, all exerting diverse influence. (**Appendix: 1**).

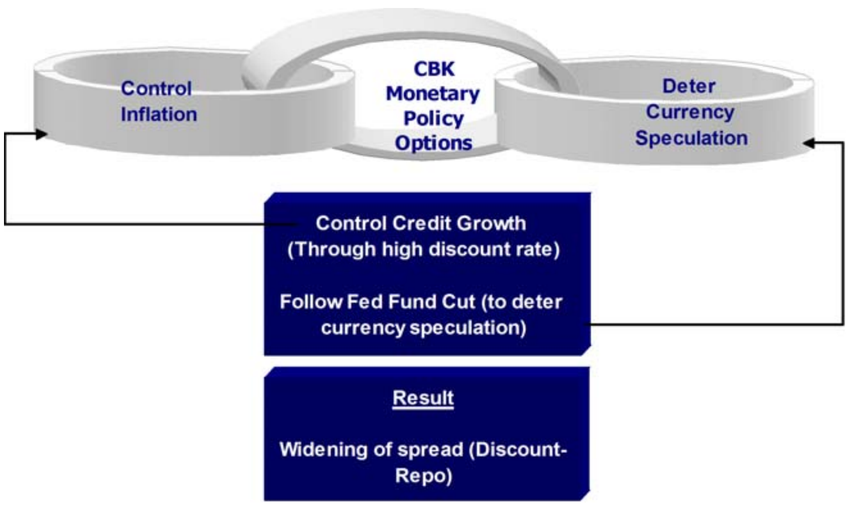


Liquidity: Liquidity has experienced very sharp growth during the last few years, thanks to high oil prices. The challenge is to control its impact on inflation.

Inflation: Recent data on inflation points to a surge caused by both domestic (rent, etc) and imported (food, etc). The challenge is to control the inflation through direct and indirect method. Traditional tools like interest rate is providing counter-productive due to currency peg. It is interesting to note that Saudi Arabia has implemented a number of measures recently to combat inflation. (**Appendix: 2**)

Currency: The currency peg has led to imported inflation. This is also forcing the authorities to follow monetary policy actions of US, which is completely divorced from that of local economy. While US is on an easing mode in order to ward off recession, GCC economies are experiencing high growth and inflation which necessitates tight monetary policy. The challenge is to allow for a gradual appreciation of the currency without giving in to speculators.

Interest Rates: US monetary policy action is causing the repo rate to drift lower. However, the discount rate (benchmark for lending rate) continues to be high leading to higher spread. The challenge is to contain this spread without stoking inflation. The current spread is at 2.25% and is the historic high. We expect this spread to widen further to 2.5% by end-2008. This is based on the expected evolution of Fed Fund rate for the year end 2008. We expect the discount rate to contract by 75 bps to 5% from the present 5.75%. We expect the repo rate to contract 100 bps from 3.5% to 2.5%.



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1. LIQUIDITY

Deposits grew at a CAGR of 17%, and credit at a CAGR of 21% during the last six years.

Table 1: Liquidity

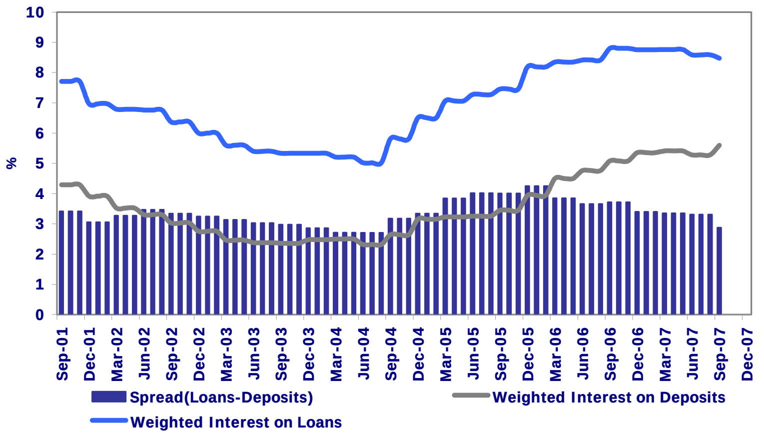
	Total Deposits KD Million	Change	Total Loans KD Million	Change	Loan/Deposit Ratio
2001	10,608		6,851		65%
2002	11,534	9%	7,808	14%	68%
2003	12,150	5%	9,481	21%	78%
2004	13,587	12%	10,814	14%	80%
2005	16,243	20%	12,936	20%	80%
2006	20,174	24%	16,148	25%	80%
2007	26,544	32%	21,821	35%	82%
CAGR*	17%		21%		

Source: Central Bank of Kuwait & Markaz Research
* Refers to compounded annual growth rate

At the heart of the monetary policy is the issue of liquidity. Liquidity in Kuwait is primarily driven by oil price. While broad money would be a good benchmark to measure liquidity, bulk of the money supply comes from deposit growth. Banks that take these deposits lend it in the form of credit, which then forms the other side of the coin. Monetary policy makers are confronted with a heated up economy (thanks to oil price) that is driving the credit growth. While deposits grew at a compounded growth rate of 17% during the last six years, credit grew at 21%. **(Table 1)**. It must be noted that there has been a significant pick up in the credit growth during the last three years relative to the earlier period. Credit growth would have been even higher but for the monetary tool in the form of Loan to deposit ratio that is currently pegged at 80%. Commercial banks are the direct beneficiary of this stupendous credit growth given the high margin (spread) between lending and deposit rates **(Figure 1).** Average spreads since 2001 is 337 basis points. For a long time (May 02-Jan 06), these spreads used to be more than the deposit rates!

Spread between lending and deposit rate continues to be high

Figure 1: Banking Spreads

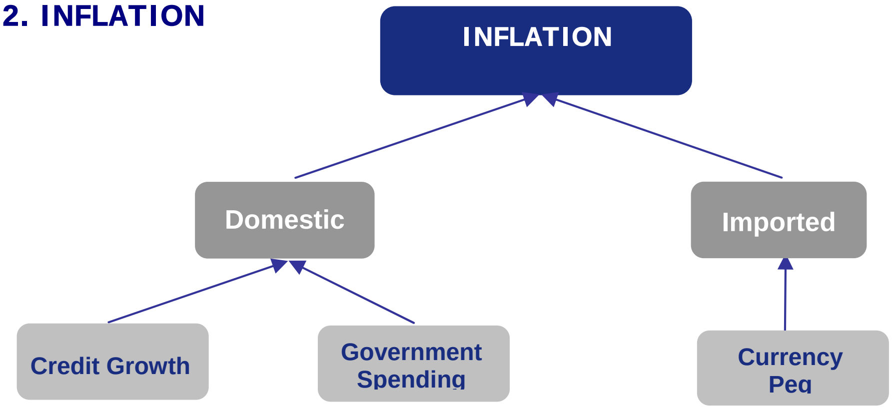


Source: CBK & Markaz Research

Monetary Policy Options: Either the loan to deposit ratio of 80% should be increased or the discount rate should be increased or try other sterilization measures.

2. INFLATION

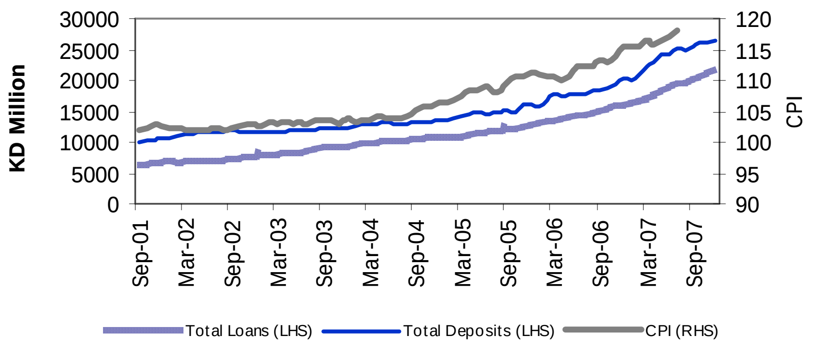
Inflation is a product of both domestic and imported inflation.



A direct fall out of following the US monetary policy is the spiraling inflation, the effect of which is quite well discussed and debated in public and professional forums. It is very clear that inflation is now a product of both domestic and foreign factors. Abundant liquidity leads to high credit growth (as exhibited in the earlier section) as well as increase in government spending which induces inflation**.** The imported inflation problem arises basically out of currency peg due to which non-USD imports are becoming expensive as the US dollar depreciates. This is particularly true for food items whose prices have been sharply escalating. A scenario where interest rates are decreasing (due to US monetary policy) while inflation is accelerating leads to negative real rate of interest. Monetary authorities view inflation as a temporary problem and hope that it will subside as soon as global food prices moderate and US dollar starts strengthening. However, this may not necessarily be the case. It is interesting to note the measures Saudi Arabia has recently undertaken to tackle the inflation problem **(Appendix 2).** Measures include increase in government salaries (though inflationary in nature, is aimed to empower people to tackle inflation) and decrease in costs of certain services. Kuwait has also recently announced increments in government salaries to the extent of KD 120 for nationals and KD 30 for expatriates.

Inflation may not be a temporary problem

Figure 2: Inflation & Liquidity



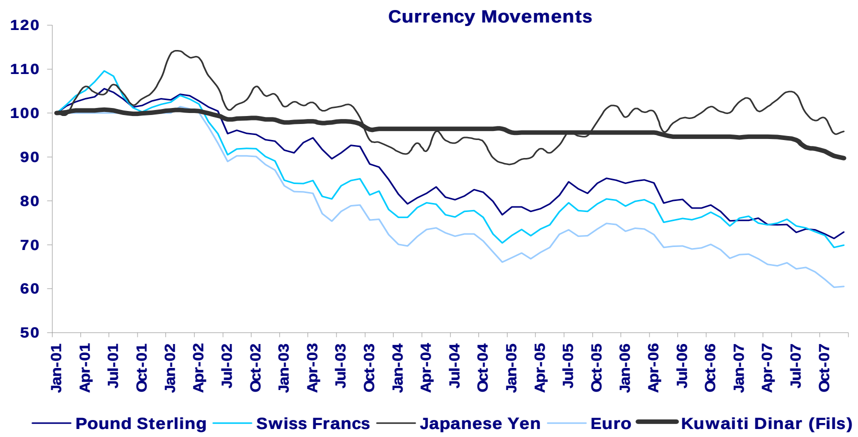
Source: CBK & Markaz Research

Monetary Policy Options: In order to reign in inflation, the following options are available:

1. **Control credit growth** on the lines suggested in the earlier section through increase in interest rate
2. **Reduce government spending:** Reducing government spending will mean actions like reducing work force or reducing salary, which may not be a move well received by the general public.
3. Allow currency to appreciate which is already happening

3. CURRENCY

Figure-3



Source: CBK & Markaz Research

Dollar slide is imposing high cost to Kuwait economy

Currency has been at the heart of the debate. GCC countries provided exchange rate stability by pegging its currency to the US dollar. This served well when US dollar used to be a strong, stable and preferred currency all over the world. However, things have changed dramatically during the last few years when US dollar turned to be a weak, unstable and not-so-preferred currency on the back of high US deficits**.** However, GCC countries continued with their peg more for political reason than economic reason. US Dollar has depreciated nearly 40% against Euro and 30% against British Pound. Compared to this, the US dollar has depreciated only 11% against Kuwaiti dinar leaving a significant gap **(Figure-3 Table-2)**.

Table 2: Currency Movement

$1 fetched	Pound Sterling	Swiss Francs	Japanese Yen	Euro	Kuwaiti Dinars
2001	0.696	1.668	132.690	1.131	307.483
2007	0.493	1.137	112.020	0.685	274.215
Change	-29%	-32%	-16%	-39%	-11%

Source: Central Bank of Kuwait and Markaz Analysis

Currency peg is more for political reason than economic reason

Kuwaiti dinar was pegged to a basket of currencies for a period of 25 years till 2002, when it was directly pegged to US dollar like other GCC countries. However, in 2007 Kuwait broke ranks with other GCC countries and again shifted the peg back to a basket of currencies primarily to contain inflation. The basket is estimated to be about 80% dollars, 15% euros and the remaining shared by British Pound and Japanese Yen though no official announcement to this effect has been done.

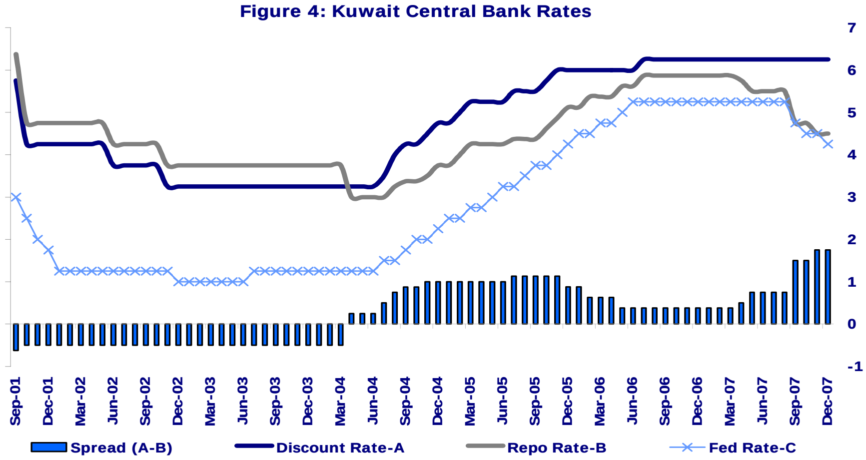
Monetary Policy Options: In the currency context, having already de-pegged from the dollar, the option would now be to narrow the gap by a one-off revaluation followed by allowing Kuwaiti dinar to gradually appreciate albeit in a measured manner in order to deter currency speculators. Gradual Kuwaiti dinar appreciation will ease the pressure on monetary policy.

4. INTEREST RATES

Given the diversity of terminologies used in this space, **Annexure-3** provides an explanation of what these terms mean.

Spread between discount rate and repo rate at its historic high

Figure 4: Kuwait Central Bank Rates

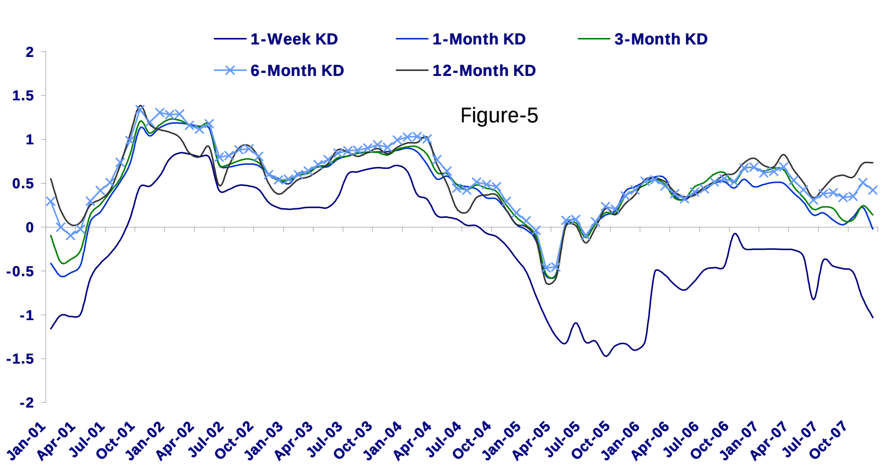


Source: CBK & Markaz Research

The discount rate can be used as a benchmark rate for lending while the repo rate closely aligns with the Fed rate. Till Dec-04, the spread between discount rate and repo rate used to be – 50 basis points (negative) **(Figure 4)**. However, this turned into positive since then and the spread has been climbing higher and hovered around 75 basis points (positive). Since recessionary fears gripped US and the Federal Reserve started cutting rates aggressively, the spread has been widening and has reached a historic high of 225 basis points. This can be attributed to CBK's need to follow the Fed rate. However, the central bank is reluctant to reduce the discount rate in tandem with a reduction in repo rate, for the fear of stoking inflation as reduction in discount rate would increase the credit growth. If the CBK breaks away from Fed and increases the repo rate (thereby bringing back the spread to its long-term average) then it will risk "carry trade" (borrow in US dollars and invest in KD) and bring un wanted pressure on currency. Hence, on the one hand the CBK wants to control speculators through lower deposit rates (thus making KD unattractive for carry trade options). On the other hand, CBK does not want to reduce the discount rate for the fear of stoking inflation through higher credit growth. A true dilemma indeed!

Reduction in discount rate will stoke inflation

Deposit Rate Spreads (KD-US)



Source: CBK & Markaz Research

The spread between KD deposit rate and US deposit rate has been narrowing, especially on the shorter maturities (3-months and lower) **(Figure-5).** For e.g., the current spread for a 3-month deposit is 14 basis points as against the historical average spread of 486 bps. However, for longer maturities (6-months and 1-year), the current spread is in alignment with historical average. We expect the spread to continue to be narrow at the short end of the maturity spectrum.

Table 3: Kuwait Interest Rates: Monetary Policy Options

	Kuwait Discount Rate-A	Kuwait Repo Rate-B	Spread (Discount-Repo)(A-B)	Fed Rate-C	Fed Change	Repo Change
Dec-04	4.75	3.75	1	2.25	1	0
Dec-05	6	5.12	0.88	4.25	2	1.37
Dec-06	6.25	5.87	0.38	5.25	1	0.75
Dec-07	6.25	4.5	1.75	4.25	-1	-1.37
Jan-08	5.75	4	1.75	3.50	-0.75	-0.5
Feb-08	5.75	3.5	2.25	3.00	-0.5	-0.5
18–March-2008	5.75	3.5	2.25	3.00	0	0
29/30-April - 2008	5.75	3.25	2.5	2.75	-0.25	-0.25
24/25–June-2008	5.5	3	2.5	2.50	-0.25	-0.25
5–August-2008	5.5	2.75	2.75	2.25	-0.25	-0.25
16–September-2008	5.5	2.75	2.75	2.25	0	0
28/29–October-2008	5	2.5	2.5	2.00	-0.25	-0.25
16-December-2008	5	2.5	2.5	**2.00**	0	0

Source: Markaz Research. The shaded portion refers to FOMC dates .The boxed number refers to average forecast of Fed Fund rate by Goldman Sachs, Citibank, Economist, CLSA & Merrill Lynch

We expect discount rate to narrow to 5% by the end of 2008

We expect the discount rate to narrow by 75 bps to 5% by the year end. We also expect the repo rate to contract by 100 bps **(Table 3).** This is based on the expected evolution of Fed Fund rate and the likely response of CBK to the same. The consequence of these actions will be a likely expansion of spread (Discount-Repo) to 250 basis points from the current 225 bps.

Monetary Policy Options: In the interest rate context, the following policy options are available:

1. **Reduce the discount rate:** A moderate reduction in the discount rate will enable to contain the growing spread. It will definitely spur credit growth (and therefore inflation), which can be contained through reserve requirement and moral suasion.
2. **Increase the Repo rate:** This will mean moving against the Fed. It will be deflationary but will encourage currency speculation.

5. SUMMARY

CHALLENGE	MONETARY POLICY OPTIONS	RATIONALE
LIQUIDITY	**1. Increase deposit to loan ratio from 120% to a higher level** 2. Increase discount rate 3. Sterilize excess liquidity	Increasing the discount rate will further increase the spread between the discount rate and repo rate. Sterilizing measures have been less successful in the past.
INFLATION	1. Increase interest rate 2. Reduce government spending **3. Continue to allow currency to appreciate**	Reducing government spending may be anti-populist measure. Increasing interest rate may be counter to Fed move.
CURRENCY	1. Revalue the dinar **2 Continue to allow Kuwaiti dinar to gradually appreciate.**	Revaluing on a one-off basis may be seen as giving in to speculators.
INTEREST RATES	**1. Reduce the discount rate** **2.** Increase the Repo rate	Increasing repo rate will be counter to Fed move and may encourage speculators.

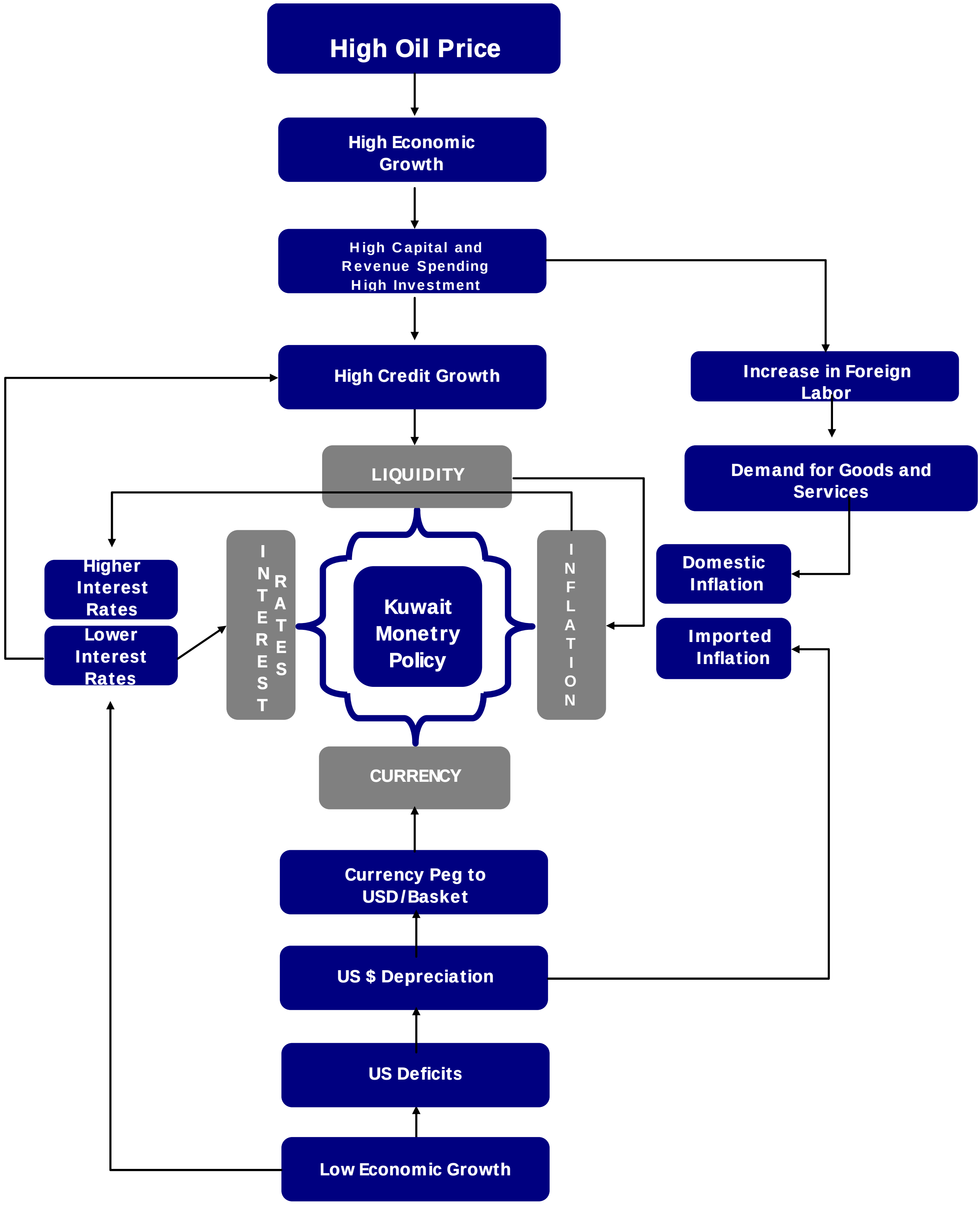
In our assessment, the following could be the likely outcome of Kuwait monetary policy:

1. Banks may face pressure to contain credit growth through an increase in reserve requirement and reduction in discount rate. This will impact their profitability though they will be helped by a reduction in deposit rates.
2. Kuwait dinar will certainly appreciate in order to contain inflation, though the jury is still not out on the impact of appreciation achieved so far on inflation. Revaluation may not happen.

Leverage trading may not be profitable

Stock Market Implication: The implication of this for stock market may be muted, given the fact that lending rates do not move in tandem with discount rate. In other words, average lending rate will continue to be high or may moderate slightly. Hence, leverage trading (borrowing from banks and investing in stock market) may not be very profitable. Currency appreciation would certainly be a positive for foreign investors who have been immensely helped by the clarity on the taxation law, which now stipulates 0% tax on capital gains for trades done in Kuwait stock exchange.

Appendix 1: The Complex Web



Source: Markaz Analysis

Appendix 2: Tackling Inflation- Case Study of Saudi Arabia

Saudi Arabia experienced a sharp rise in its inflation. From a modest 0.2% in 2002, the current inflation stands at 4.1%. The Kingdom has implemented a number of measures to control inflation, some of which are re-produced below:

1. **Salary Increase:** The government will add an annual 5% cost of living allowance to the salaries of its employees and retirees for a period of three years. This salary hike comes on the back of a 15% rise that was given in October 2005 and came on the back of a twenty year pay-freeze. Public sector wages have been on the rise in other GCC countries as well. For e.g., Oman and Bahrain (+15%) and UAE (+70%).
2. **Reduction in Port Fees:** The government will bear for a period of three years, 50% of all port fees levied. This is aimed to reduce the import cost of goods.
3. **Increase in Social Insurance:** The government will increase social insurance benefits by 10% which will benefit more than 600,000 Saudis.
4. **Fees for passports, etc:** The government will bear, for a period of three years, 50% of the fees relating to passports, vehicle licenses and ownership transfers and renewal of residence permits for domestic workers. The current charges are:

Services	SR
Issuing Passport	300
Transferring Vehicle ownership	150
Renewing residence permit	600
Renewing car license	300
Rental car license	400
Pick-up van licenses	750
Truck license	1,100

Source: Saudi British Bank Research

Appendix 3: Interest Rate Terminologies

Terminology	What it means?	How is it used?
Repo Rate	It is the rate at which Central banks re purchase government securities from commercial banks. It is aligned with Fed rate due to currency peg.	A decrease in repo rate will increase money supply and vice-versa
Reverse Repo Rate	Same thing from a borrowers perspective	
Discount Rate	It is the interest rate charged to commercial banks for loans from the central bank.. Hence, discount rate is a benchmark for lending rate.	An increase in discount rate will reduce credit growth and vice-versa
Weighted average rate on deposits	This is the actual rates offered by banks to customers (weighted by maturity). This may or may not have relation with repo rate.	An increase in the rate will increase money supply and vice-versa
Weighted average rate of loans	This is the rate at which banks lend to its customers (weighted by maturity). Banks are allowed to charge from 250 bps to 400 bps over discount rate, depending on maturity.	An increase in the rate will reduce credit growth.
Fed Rate	The rate at which banks lend balances at the Federal Reserve to other institutions	It is used to regulate money supply in US
Libor	Is a daily reference rate based on interest rates at which banks offer to lend to other banks in London inter bank market	Libor is not fixed before hand like Fed rate. Hence, it has no macro economic ramifications

Source: Wikipedia and Markaz Analysis

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China and India: Too Much Too Fast GCC more than a global soother	Oct-07	Run up in China & India is too fast and is a cause of concern. The report suggests inclusion of GCC markets in the portfolio as a soother.
Kuwait: The New law to slash tax	Dec-07	A key obstacle to foreign investment has been removed on December 26th, 2007.
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Outlook 2008: Saudi Arabia	Jan-08	Expect Consolidation
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Lebanon Real Estate	Dec-07

Quantitative Research

Title	Release Date	Research Highlights
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