Comments of His Excellency the Governor, Basel A. Al-Haroon
in the session titled "Assessment of Global and Regional Vulnerabilities"
during the Financial Stability Board's (FSB) Regional Consultative Groups (RCGs) for the Middle East and North Africa Meeting*

Ladies and gentlemen, esteemed participants
Good morning

At the outset, I'd like to extend my thanks to Governor Ayman Al-Sayari for his hospitality in hosting us here today.

I would also like to extend my thanks to the FSB for their efforts in organising these meetings, and preparing the detailed papers that we find very helpful.

Introduction

As we start the chapter of 2024, to adequately assess the current financial system vulnerabilities that we face, it is worthwhile to reflect on the events that took place over the past few years and those that brought us here today.
Starting with the Covid-19 pandemic of course, which lead to the condensation of an entire business cycle into a couple of years, we were met with an ever-shifting landscape with unprecedented events taking place ranging from lockdowns to bank failures.

Against this backdrop, and despite central banks being mostly successful in dealing with the immediate risks, some vulnerabilities have already appeared while others are expected to emerge. These differ in urgency, with some being more material in the short-term, while others become more tangible looking further down the horizon.

Near-term vulnerabilities

Ability to generate capital organically

In the near-term, the complications arising from interest rates being held higher for longer may threaten bank's abilities to generate capital organically (i.e. through own profits versus raising from markets).

* Speech delivered by His Excellency the Governor of the Central Bank of Kuwait, Basel A. Al-Haroon, in the Financial Stability Board's (FSB) Regional Consultative Groups (RCGs) meeting, held in Riyadh, Kingdom of Saudi Arabia on February 6, 2024.

Monetary-policy setters have refrained from declaring victory in the fight against inflation, leading to a clouded interest-rate outlook as price levels have still not reached targets.

This uncertainty in interest rate trajectory was further exacerbated by the recent escalation in geopolitical tensions and trade route disruptions.

Initial estimates show that these may increase shipping times and freight insurance costs by up to 60% and 20% respectively[1], which may potentially lead to a rebound in inflation that was previously on a downwards trajectory.

Higher for longer interest rates have come at the cost of multiple growth indicators starting with loan growth which has experienced a material slowdown globally. In advanced economies, total loans have declined in 5 of the first 7 months of 2023.

Apart from slowing growth, credit quality is also expected to be impacted as the full effect of higher borrowing costs materializes.

For debt assets, this will appear in the form of higher defaults, which we are already seeing with global defaults on corporate debt jumping 80% in 2023.[2]

Together, we anticipate that these two factors (lower loan growth and deteriorating credit quality) may strain bank's ability to grow organically both globally and regionally, if we did not apply early interventions.

These effects will be most material to institutions suffering from structural vulnerabilities such as overreliance on interest rate-sensitive assets, and those with low buffers.

The urgency of the abovementioned vulnerabilities necessitates that policymakers be proactive and countercyclical in addressing these risks.

[1] Red Sea crisis may push shipping cost by up to 60 pc, insurance premiums by 20 pc: GTRI - The Economic Times (indiatimes.com)

[2] https://www.spglobal.com/ratings/en/research/articles/240116-default-transition-and-recovery-corporate-defaults-jumped-80-in-2023-to-153-12968832

Medium to long term vulnerabilities

Technology adoption vs adaptation: a mismatch

Looking further down the horizon, the rapid development and adoption of technology has given rise to novel risks, raising the question of whether stakeholders can keep up with these developments. On this topic, there exists multiple vulnerabilities especially for the MENA region, and they include: skills gaps & technology governance, digital inclusion, and security concerns.

Indicators show that emerging markets score below advanced economies in terms of technology governance. This is highlighted in the IMFs AI preparedness index which can be used as a proxy for technology governance. With that said, risks arising from skill gaps may be lower regionally, given a lower percentage of high-exposure employment relative to advanced economies.

When assessing the broad technological environment, we must not disregard the other side of the coin; inclusion and availability of digital services for all. History has shown that technological adoption can increase financial inclusion and be a key driver of economic prosperity. On that note, indicators show that the MENA region is on the right path, but has some catching up to do to be in line with the global average.

Finally, a vulnerability which I expect few would disagree on, is related to security concerns. Global cybercrime damage costs are predicted to amount to $9.5 trillion in 2024[3], equivalent to almost 9% of estimated global GDP.

Given the unique nature of these issues and shortage of talents in the field, inter-agency and cross-border cooperation is key for the exchange of experiences and skills, where one entity's experience can complement that of another to ultimately help achieve the most complete and effective framework.

[3] The 2023 Annual Cybercrime Report sponsored by eSentire.

Financial fragility in the face of climate challenges

Finally, the vulnerabilities with the farthest potential effects in terms of time horizon, but arguably the most important, are those prone to shocks from the global shift in weather patterns, or climate change.

According to NASA, the planet's average surface temperature has risen about 1 degree Celsius since the late 19th century, with the seven most recent years being the warmest.

This has led to a rise in global sea levels by about 8 inches, with extreme weather events increasing in frequency. As we all know, these shifts will create two types of risks: physical and transition risks.

On the former, emerging markets are expected to be impacted more severely, with S&P global estimating 8% of annual GDP to be at risk for the MENA region, versus around 4% for the world, mainly due to lower resources to cope.

On transition risks, estimates show that global stranded assets as present value of future lost profits in the upstream oil and gas sector exceed US$1 trillion.[4]

MENA countries are expected to shoulder a large portion of these losses given economic dependence on oil and fossil fuel industries.

With that said, given the long-term nature of the implications of climate change, proactive and steady initiatives are crucial to avoiding sudden adjustments that may shock markets and consumers. Additionally, alignment between governmental agencies is crucial to maximizing the effectiveness and prudency of these initiatives.

[4] https://www.nature.com/articles/s41558-022-01356-y

Conclusion

In conclusion, I would like to emphasize the importance of the unique experiences gained over the past years, which have enabled us to build solid frameworks that proved their effectiveness in the most challenging conditions. I am fully confident that additional coordination between stakeholders will increase this effectiveness, helping to maintain stability and overcome any future obstacles in our continuous pursuit of inclusive and sustainable prosperity.

To that end, CBK highly values the existing ties with your respective countries' central banks, and is appreciative of the continuous fruitful dialogues taking place.

Thank you for listening