FITCH AFFIRMS KUWAIT AT 'AA'; OUTLOOK STABLE

Fitch Ratings-Hong Kong-02 May 2018: Fitch Ratings has affirmed Kuwait's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'AA' with a Stable Outlook.

A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS
Kuwait's key credit strengths are its exceptionally strong fiscal and external metrics and, at a forecast USD56/bbl, one of the lowest fiscal breakeven Brent oil prices among Fitch-rated oil exporters. These strengths are tempered by Kuwait's heavily oil- dependent economy, geopolitical risk, and weak governance and business environment. A generous welfare state and the large economic role of the public sector present increasing challenges to public finances, given robust growth of the Kuwaiti population.

Assets and performance of the Kuwait Investment Authority (KIA) are not disclosed. We estimate that KIA assets reached USD580 billion or 460% of GDP in 2017. Of this amount, the Reserve Fund for Future Generations (RFFG) accounted for almost USD490 billion and has continued to increase, due to favourable asset market returns and the statutory annual transfer of 10% of government revenue. Meanwhile, the value of the General Reserve Fund (GRF), which holds the accumulated government surpluses after transfers to RFFG, is estimated to have fallen for the fourth year in a row as the government tapped the GRF for financing.

Although tapping the RFFG would allow Kuwait to sustain current deficit levels for decades, we estimate that the GRF could be depleted within around five years in a hypothetical scenario where fiscal deficits remain at the level expected for the fiscal year ended March 2019 (FY18/19), the transfer to the RFFG continues, there are no valuation gains or losses and the GRF is the sole source of financing. We estimate that Brent oil prices of over USD80/bbl would have to be sustained to eliminate the central government's drawdown of the GRF. We believe that if the GRF were to approach depletion, the government could tap the RFFG for debt repayments and other budgetary needs.

We expect the government to post a surplus of around KWD900 million (2.4% of GDP) for FY17/18, including estimated investment income of around KWD4.6 billion and excluding the statutory annual transfer of revenue to the RFFG, worth around KWD1.6 billion. The government does not count investment income and treats the RFFG transfer as expenditure in its own presentation, resulting in a deficit figure of nearly KWD5.3 billion. The improvement relative to FY16/17 is driven by a rise in oil revenue. We expect spending in FY17/18 to increase primarily due to rising costs of oil-related subsidies and electricity generation, as well as continued growth in the wage bill.

We expect modest surpluses of around KWD300 million (around 0.7% of GDP) in FY18/19 and FY19/20, under our baseline Brent oil price assumption of USD57.5/bbl. According to the government's reporting convention, the forecast deficit would be nearly KWD5.9 billion, which roughly corresponds to the financing need, as the government does not intend to touch the RFFG. The government's draft budget proposal plans for an even higher deficit, but this is based on a more conservative oil price assumption of USD50/bbl and the government usually spends less than it budgets.

In FY17/18, the government issued domestic debt of more than KWD700 million, meeting the rest of its KWD5.3 billion financing need by drawing down on the GRF. The absence of foreign

borrowing in the last fiscal year reflects the government's struggle to win parliamentary approval for a new public debt law, which would increase the cap on public borrowing to KWD25 billion (from KWD10 billion currently) and allow maturities of up to 30 years (from 10 years currently).

We assume that the debt law will eventually get passed, paving the way to more debt issuance in FY18/19 and FY19/20. Under our forecasts, the government issues just under USD16 billion in foreign debt in the coming two years, and the debt/GDP ratio rises to around 38% by 2019.

The government is making slow progress on its reform programme aimed at balancing public finances, improving the business environment and boosting the role of the private sector as a provider of economic growth and jobs for Kuwaiti nationals. It is focusing its efforts on regulatory and administrative measures that do not require approval from parliament, which in turn is trying to minimise the immediate costs to its constituents of any reform.

We expect broad policy continuity after the government reshuffle of late 2017. The most significant appointment seems to be that of the Amir's eldest son, 69-year old Sheikh Nasser Sabah Al-Sabah, as First Deputy Prime Minister and Minister of Defence. Sheikh Nasser appears to be seen as strongly reform-minded. However, there is uncertainty around the viability of his headline proposal to spearhead reform and development with the construction of a new USD200 billion city and free trade zone (mostly FDI-financed).

Real GDP fell by 2.9% in 2017 as Kuwait's oil output cut in line with the OPEC agreement outweighed a recovery in non-oil growth. Kuwait's oil production has been at the reference level of 2.7 million barrels per day since the start of 2017. We do not factor in any recovery in production volumes in 2018, although there are plans to boost production capacity to 4 million barrels per day by 2020. The completion of the 615,000-barrel-per-day Al-Zour refinery in 2019 should provide a boost to oil GDP in 2019, on the back of expected completion in 2018 of upgrades to two existing refineries as part of the Clean Fuel Project.

We expect non-oil growth of around 3.5% in 2018-2019 amid continued growth of government spending on wages and investment. Higher oil prices and the end of austerity should be supportive of retail trade and confidence indicators. The record number of land grants under the government's housing programme in 2016 will support residential construction activity for some years to come. Infrastructure spending will continue at a steady pace, supporting the broader private sector. We pencil in 4% private credit growth in 2018-2019, and the banking sector would be well placed to extend more credit, being adequately capitalised, liquid and profitable.

SOVEREIGN RATING MODEL (SRM) and QUALITATIVE OVERLAY (QO)
Fitch's proprietary SRM assigns Kuwait a score equivalent to a rating of 'AA' on the Long-Term Foreign-Currency (LT FC) IDR scale.
Fitch's sovereign rating committee did not adjust the output from the SRM to arrive at the final LT FC IDR.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

RATING SENSITIVITIES
The main factors that could individually or collectively lead to negative rating action are:
- Erosion of fiscal and external positions, for example due to a sustained period of low oil prices or an inability to address structural drains on public finances.

The main factors that could individually or collectively lead to positive rating action are:
- Improvement in structural factors such as reduction in oil dependence, and a strengthening in governance, the business environment and the economic policy framework.

KEY ASSUMPTIONS
We forecast that Brent crude will average USD57.5/bbl in 2018-2019.

We assume broad policy continuity and a smooth eventual transition of power from Kuwait's current Amir.

Fitch assumes that regional conflicts will not directly impact Kuwait or its ability to trade.

The full list of rating actions is as follows:

Long-Term Foreign-Currency IDR affirmed at 'AA'; Outlook Stable
Long-Term Local-Currency IDR affirmed at 'AA'; Outlook Stable
Short-Term Foreign-Currency IDR affirmed at 'F1+'
Short-Term Local-Currency IDR affirmed at 'F1+'
Country Ceiling affirmed at 'AA+'
Issue ratings on long-term senior-unsecured foreign-currency bonds affirmed at 'AA'

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Additional information is available on www.fitchratings.com

Applicable Criteria
Country Ceilings Criteria (pub. 21 Jul 2017)
https://www.fitchratings.com/site/re/901393
Sovereign Rating Criteria (pub. 23 Mar 2018)
https://www.fitchratings.com/site/re/10024428

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