MOODY'S
INVESTORS SERVICE

Rating Action: Moody's changes outlook on Government of Kuwait's Aa2 rating to stable from negative; affirms rating

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Frankfurt am Main, May 26, 2017 -- Moody's Investors Service has today changed the rating outlook on the Government of Kuwait to stable from negative. Concurrently, the long-term issuer rating has been affirmed at Aa2.

The decision to change the outlook to stable from negative reflects Moody's view that there are sufficient signs of the government's institutional capacity to effectively implement its fiscal and economic reform program to preserve creditworthiness in the medium-term, which has the stated objective of diversifying and enhancing the economic base and its budgetary revenues.

The affirmation reflects Moody's view that, despite Kuwait's slower fiscal and economic reform progress relative to other highly-rated peers in the Gulf in response to lower oil prices, the sovereign's extraordinarily strong balance sheet, very high wealth levels and vast hydrocarbon reserves continue to support a credit profile that remains consistent with an Aa2 rating.

Kuwait's long-term and short-term foreign-currency bond and deposit ceilings remain unchanged at Aa2 and Prime-1, respectively. Kuwait's long-term local-currency country risk ceiling also remains unchanged at Aa2.

RATINGS RATIONALE

RATIONALE FOR CHANGING THE OUTLOOK TO STABLE

The decision to change the outlook for Kuwait's rating to stable from negative reflects Moody's view that institutional strength has improved to a degree that will help limit downside risks to the rating. In addition, fiscal performance in the past fiscal year proved slightly stronger than expected at the time of the last rating action.

Positive fiscal reform steps undertaken by the Kuwaiti government so far include the establishment of a debt management unit at the Ministry of Finance (MoF) and improved coordination between key institutions such as Kuwait Investment Authority (KIA), MoF and Central Bank of Kuwait (CBK). Some fuel subsidy rationalization was implemented in 2016, and implementation of additional excise taxes on harmful items, as well as further utility tariff reforms are likely to happen in the second half of 2017.

Preparation to implement a medium-term budget framework supports this view. The proposed framework will cover a three-year rolling period and involves different entities in the budgeting process, such as Kuwait Petroleum Corporation, the Civil Service Commission, the Secretary General of the Supreme Council for Planning and Development, CBK, and the MoF.

While the goal is to cap overall spending at 2017-18 levels at around KWD19 billion annually, Kuwait's particular political set-up means there is a higher likelihood than in other Gulf Cooperation Council (GCC) countries that due to opposition from parliament the government will not be able to implement this planned cap. However, in Moody's view the planned move to multi-year budgeting alone marks a significant institutional improvement.

In addition, the public sector compensation law is currently under discussion in parliament. If approved, this would standardize allowances and set rules for salary increases based on general cost of living increases and performance, and help the goal of capping government expenditures.

Furthermore, the Kuwaiti authorities have signaled a renewed willingness to increase transparency with regard to government financial assets. The successful Eurobond issuance earlier in the year supports improved transparency and institutional development. Finally, implementation of projects under the current five-year National Development Plan is progressing better than under previous plans, which supports the economic growth outlook.

Moody's acknowledges that the timeline for implementing value-added tax has slipped. Original plans to introduce GCC-wide VAT from January 2018 have moved back, and Moody's expects implementation of the 5% VAT to happen sometime in the first half of next year.

RATIONALE FOR AFFIRMING THE Aa2 RATING

The decision to affirm the Government of Kuwait's Aa2 rating is driven by the government's very strong net asset position, which will persist despite ongoing debt issuance expected over the coming years. Given Kuwait's extraordinarily large hydrocarbon reserves, low oil production costs, its low fiscal and external breakeven oil prices, and Moody's expectation of oil prices remaining between $40-$60 per barrel over the coming 2-3 years, the rating agency thinks that Kuwait's credit profile will retain its key strengths, despite a more gradual reform pace than some of its peers in the region.

Although the sharp drop in oil prices from their mid-2014 peaks resulted in Kuwait's nominal GDP declining by over 30% in 2015 compared to 2013, with an estimated further 2% contraction in 2016, Moody's expects the country's nominal GDP to reach its pre-oil price shock level by 2021, in line with the rating agency's anticipation of a gradual recovery of oil prices and increase in productive capacity.

Moody's also notes that, despite the sharp economic contraction, Kuwait's GDP per capita -- estimated by the International Monetary Fund (IMF) at $71,887 in purchasing power parity terms in 2016 — remains extremely high by international standards, and that this level of wealth continues to provide a significant economic buffer in terms of social stability.

While government finances have deteriorated, with a surplus of just 1.2% of GDP in fiscal year 2015/16 (including investment income and excluding mandatory transfers to the Future Generations Fund, down sharply from a surplus of nearly 30% the year before) and a deficit of 0.9% of GDP estimated for fiscal year 2016/17 which ended on 31 March, Moody's believes that Kuwait's very low levels of government indebtedness at the onset of the oil price decline and its very large reserve buffers provide enough space to accommodate the deterioration in its fiscal balance within the Aa2 rating level.

General government debt was KWD8.2 billion or around 24% of estimated GDP in 2016, and Moody's estimates that total assets managed by the KIA reached about KWD187 billion ($612 billion) that year, of which Moody's estimates around one third to be in the General Reserve Fund (GRF) which is available for funding government spending. At this level, total assets in the GRF would cover almost three years of government spending.

Going forward, Moody's expects Kuwait's government debt to rise to about 34% of GDP by 2020, as the government will increasingly use debt issuance as a source of funding its expenditures. At these levels, Kuwait's government debt ratio would remain below the Aa-rated median, and Kuwait's government debt affordability indicators would remain significantly stronger than those of most Aa-rated peers. For instance, government debt as a share of revenues would be around half, and interest payments as a share of government revenues would be around a third of the Aa-rated median. Furthermore, Moody's expects that the total assets managed by KIA at the end of the forecast period will continue to dwarf accumulated debt.

Given the low external breakeven oil price, which the IMF projects at $43 per barrel in 2017 and $44 in 2018, Moody's forecasts a return of current account surpluses of around 7% of GDP on average in 2017-18, following a deficit of 4.8% in 2016. External debt levels will remain broadly stable at around 40% of GDP, and the projected recovery in foreign exchange reserves will support Kuwait's strong external liquidity position.

WHAT COULD MOVE THE RATING UP/DOWN

The stable rating outlook signals that upward and downward pressures for Kuwait's rating are balanced.

Steady diversification of government revenues and economic activity away from the oil sector could apply upwards pressure on the rating. Additionally, sustained improvements to the institutional framework, in particular in government transparency and reporting standards, would support Kuwait's sovereign credit profile.

Moody's would consider a negative rating action if Kuwait's reform momentum were to slow beyond the already anticipated comparatively slower-than-peers pace, for example, in the event that parliamentary resistance blocks or forces the reversal of planned reforms related to government finances and the management of government debt.

In addition, a further sustained fall in the price of oil, a further marked worsening in the fiscal balance for which there was no clear plan for reversal, or signs of falling government financial assets would also exert downward pressure on the rating. A deterioration in the domestic or regional political environment resulting in disruptions to oil production or a deterioration in the business climate would also be credit negative.

GDP per capita (PPP basis, US$): 71,182 (2015 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 3.1% (2016 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 3.5% (2016 Actual)

Gen. Gov. Financial Balance/GDP: -0.9% (2016 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: 0.8% (2016 Actual) (also known as External Balance)

External debt/GDP: 39.4% (2016 Estimate)

Level of economic development: High level of economic resilience

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 23 May 2017, a rating committee was called to discuss the rating of the Kuwait, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's institutional strength/framework, have somewhat improved. The issuer's governance and/or management, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, has not materially changed. The issuer's susceptibility to event risks has not materially changed.

The principal methodology used in these ratings was Sovereign Bond Ratings published in December 2016. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

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