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Research Update:

Kuwait Ratings Affirmed At 'AA/A-1+'; Outlook Stable

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Overview

- The low oil price environment continues to affect Kuwait's fiscal and external balances, given the country's high dependence on oil. However, Kuwait has built up very large fiscal and external net asset positions over many years, via a longstanding sovereign wealth fund, and these assets will continue to help it weather the current low oil price environment.
- We are therefore affirming our 'AA/A-1+' long- and short-term foreign and local currency sovereign credit ratings on Kuwait.
- The stable outlook reflects our expectation that Kuwait's overall fiscal and external positions will remain strong, backed by the significant stock of financial assets.

Rating Action

On Aug. 12, 2016, S&P Global Ratings affirmed its 'AA/A-1+' long- and short-term foreign and local currency sovereign credit ratings on Kuwait. The outlook is stable.

Rationale

The affirmation indicates that our ratings on Kuwait continue to be supported by the sovereign's high levels of accumulated fiscal, external, and household wealth, despite the low oil price environment. The ratings are constrained by the concentrated nature of the economy and persistently low economic growth on a per capita basis, as well as by regional geopolitical tensions. Kuwait derives about 60% of GDP, more than 90% of exports, and over 80% of fiscal receipts from hydrocarbon products. Given this high reliance on the oil sector, we view Kuwait’s economy as undiversified, and the sharp fall in oil prices over the past two years has significantly affected Kuwait’s fiscal and current account (flow) balances, as well as its wealth levels as measured by GDP per capita.

The Kuwaiti government, via the Kuwait Investment Authority (KIA), has accumulated substantial assets through savings from oil and gas production over the years, amassing an estimated more than $500 billion. By law, the Kuwaiti government has to allocate at least 10% of its annual revenues to its Reserve Fund for Future Generations (RFFG), managed by the KIA. Kuwait has therefore saved its oil wealth in what we consider to be a prudent manner and the government's large net asset position, which we estimate at over 3.5x GDP at the end of 2016, is a significant ratings strength that provides a substantial buffer to lower oil prices.

We forecast oil prices (Brent) to average US$40 per barrel (/bl) in 2016, $45/bl in 2017, and $50/bl in 2018-2019. Kuwaiti crude (KEC) trades at about a US$5 discount to Brent. The country’s crude oil production in 2016 is estimated at about 2.8

million barrels per day (bpd), and is expected to grow by at least 2% year-on-year in 2016 and 2017, following two years of contraction, primarily due to outages in the shared neutral zone with Saudi Arabia.

The government does not publicly disclose the size and structure of the reserve fund and information on KIA's assets is limited, but we estimate that KIA manages more than US$500 billion, of which about $380 billion is in the RFFG and $120 billion in the General Reserve Fund (GRF). While the RFFG is designed to assist future generations, ostensibly after oil supplies have run out, the GRF can, and has, been used to meet present-day fiscal needs. We include both the RFFG and GRF in our estimate of government reserve assets because, if needed, we believe the government may consider authorizing drawdowns from the RFFG. RFFG funds will continue to grow on reinvested earnings, and further, albiet lower, contributions from fiscal transfers. On the flip side, however, the government will partially finance fiscal deficits by drawing down from the GRF. On a net bottom-line basis, we still expect Kuwait’s net fiscal asset positions to remain above 3x GDP up to 2019.

Kuwait increased its annual contributions to the RFFG to 25% of total revenues from 10% in the three fiscal years (ending March 31) up to and including fiscal 2014/15, because high oil prices produced very strong revenues, and the government chose to save more. With oil prices sharply lower since late 2014, transfers to the fund from 2015/16 onward have reverted to 10%, which is the long-term saving rate and the minimum that can be transferred into the RFFG by law.

Our base-case scenario assumes that Kuwaiti oil output will remain at a minimum of 2.8 million bpd until 2019. Production is likely to increase if an ongoing dispute in the shared Neutral Zone with Saudi Arabia is resolved, and if Kuwait's planned investment in the oil sector, especially the new northern fields, comes to fruition. We estimate real GDP growth to average about 2.2% in 2016-2019 tied to an increase in oil production, the development of non-crude and non-oil projects, and relatively steady domestic consumption.

The general government budget (not counting investment income) averaged a surplus of around 25% of GDP between 2001 and 2013/14, but the surplus began to fall sharply in 2014/15. Excluding KIA’s investment income, Kuwait’s government ran a deficit of about Kuwaiti dinar (KWD) 6 billion (or 17% of GDP) in 2015/16, financed by a combination of drawdowns from the GRF and some domestic debt issuance. In fiscal 2016/17, the government has set a deficit target of KWD8.6 billion (25% of GDP) assuming an oil price of US$35/bl and 2.8 million bpd of production, before accounting for transfers to the RFFG, and KWD9.6 billion (28%) after accounting for the transfer. When we include income from its vast KIA investments, we forecast the Kuwaiti government will continue to run surpluses of around 6.5% of GDP for the budget years 2016/17-2019/20, despite low oil prices.

The Kuwaiti government is managing the lower oil price environment in several ways. First, it plans to increase oil production by restarting production in the shared Neutral Zone with Saudi Arabia. This will likely increase production by about 150,000 bpd. The government is also planning to step-up production at other wells and in new areas.

In the medium term, on the revenue side, the government is considering a corporate tax at a flat rate of 10% as well as introducing a value-added tax. However, neither is likely to be implemented before 2018. On the expenditure side, spending on goods and services was down in 2015/16, but the wage bill has remained broadly constant. The biggest savings have been on fuel subsidies, which automatically fell after the fall in the oil purchase price. Significant electricity tariff increases have been planned for September 2016. Wage freezes and the repricing of public services are being considered, but face significant opposition from some Kuwaiti MPs and Kuwaiti nationals. A strike at the state-owned Kuwait Oil Company in response to planned benefits cuts led to those cuts being scrapped. Despite the fiscal pressures, the government has increased capital spending to give the economy a fiscal boost. The government plans to finance fiscal deficits via drawdowns from the GRF as well as domestic and international bond issuance, and has already increased issuance on the domestic market.

Strong oil exports led to current account surpluses averaging more than 33% of GDP in 2009-2015. We forecast these surpluses will fall to an average of 4.3% in 2016-2019. Given the government's policy of investing a large portion of its surplus abroad, we estimate Kuwait had a net external asset position of more than 6x current account receipts (CARs) in 2015. At the same time, we project that gross external financing needs will remain relatively low, averaging around 99% of CARs plus usable reserves in the next four years. Externally, Kuwait's metrics are very strong, and stronger than those of almost all peers, including in the Gulf Cooperation Council (GCC).

Kuwait's exchange rate is pegged to an undisclosed basket of currencies. We view Kuwait's regime as slightly more flexible than the foreign exchange regimes in most other GCC countries, which maintain a peg to the dollar alone. That said, we acknowledge that the exchange rate regimes for all GCC countries are consistent with a reliance on U.S. dollar-based oil export revenues and that Kuwait has sufficient resources to defend the peg. We view Kuwait's financial system as stable; its banks are well capitalized, with ample liquidity as per Basel III standards, and operate in a reasonably strong regulatory environment. Domestic credit growth is expected to remain broadly flat. Our Bank Industry Country Risk Assessment (BICRA) for Kuwait is '4', on a scale of '1' (strongest) to '10' (weakest).

Geopolitical tensions remain, with the IS militant group in Iraq and Syria, as well as the ongoing war in Yemen, posing a potential threat to the wider region and Kuwait. In June 2015, an IS militant detonated a bomb that killed 27 people at a Shia mosque in Kuwait City; the first terrorist attack on Kuwaiti soil since the First Gulf War. Nevertheless, so far it has not had major repercussions and relations between the Sunni majority and Shia minority in Kuwait remain reasonably good. Kuwait's foreign policy is aligned to that of the GCC countries and is based around its strategic alliance with the U.S. and Saudi Arabia. Given the U.S.'s extensive engagement to liberate Kuwait in the first Gulf War and the fact that it has over 20,000 troops still stationed in Kuwait, we believe the U.S. would come to the aid of Kuwait in the event of a tangible geopolitical threat.

Domestically, the political system is dominated by a powerful government and vocal parliament (albeit with limited authority over ministerial decisions), which have often clashed and continue to disagree on many issues. Kuwait held its third parliamentary election in 18 months in July 2013 and, owing to the boycott of the election by several opposition groups, a more government-friendly parliament was elected, which in turn has led to more progress on long-planned projects. However, the main extra-parliamentary opposition groups have recently stated their intention to end the boycott and participate in the next elections, which are due in July 2017. Concerns over royal succession also contribute to ongoing political uncertainty. We have factored Kuwait's political and geopolitical framework into the current rating.

Outlook

The stable outlook reflects our expectation that Kuwait's fiscal and external positions will remain strong, backed by a significant stock of financial assets. We expect these strengths to offset risks related to the current low oil price, Kuwait's undiversified oil economy, and what we assess as its relatively nascent parliamentary system, in addition to geopolitical tensions in the region.

We could lower the ratings if low oil prices or slow growth were to significantly weaken Kuwait’s fiscal and external positions or undermine Kuwait's wealth levels (measured by GDP per capita), if Kuwait's domestic political stability were to deteriorate, or if geopolitical risks were to significantly escalate.

We could raise the ratings if political reforms were to enhance institutional effectiveness and improve long-term economic diversification, if geopolitical risks fade significantly, and if prospects for the oil sector improve significantly.

Key Statistics

Table 1

State of Kuwait Selected Indicators

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. LC)	33	43	49	49	46	34	34	37	40	43
Nominal GDP (bil. $)	115	154	174	174	163	114	115	128	137	148
GDP per capita (000s $)	37.7	47.6	50.9	48.5	43.3	29.3	28.9	31.2	32.7	34.5
Real GDP growth	(2.4)	9.6	6.6	1.1	0.5	1.8	1.9	2.0	2.3	2.6
Real GDP per capita growth	(8.1)	3.5	1.0	(3.8)	(3.8)	(1.8)	(0.8)	(0.5)	0.0	0.3
Real investment growth	19.8	(2.3)	5.1	8.9	4.5	13.0	2.0	2.0	2.0	1.2
Investment/GDP	17.7	13.5	12.8	14.4	16.3	25.0	26.1	26.3	26.7	27.1
Savings/GDP	49.7	56.5	58.3	54.3	49.5	32.5	29.8	30.8	31.3	31.4
Exports/GDP	66.7	73.2	74.7	70.9	68.5	54.4	53.3	54.9	55.8	56.6
Real exports growth	(0.5)	14.3	7.7	(4.0)	1.4	1.0	1.0	4.0	5.0	5.0

Table 1

State of Kuwait Selected Indicators (cont.)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Unemployment rate	2.1	2.1	1.7	1.8	1.7	1.1	1.1	1.5	1.7	1.7
EXTERNAL INDICATORS (%)										
Current account balance/GDP	32.0	42.9	45.5	39.9	33.2	7.5	3.8	4.5	4.6	4.3
Current account balance/CARs	43.1	53.5	55.5	50.9	42.4	11.0	6.1	7.0	7.1	6.6
Trade balance/GDP	41.2	52.1	54.8	51.8	47.6	24.5	21.6	22.8	23.1	23.5
Net FDI/GDP	(4.0)	(4.9)	(2.2)	(8.7)	(7.8)	(4.5)	(3.0)	(3.0)	(2.0)	(1.0)
Net portfolio equity inflow/GDP	(13.8)	(5.8)	(4.2)	(11.1)	(17.6)	(22.6)	(3.0)	(3.0)	(3.0)	(3.0)
Gross external financing needs/CARs plus usable reserves	66.7	51.6	48.8	50.1	57.9	84.2	91.9	97.9	101.2	104.1
Narrow net external debt/CARs	(310.7)	(253.9)	(259.9)	(301.7)	(337.7)	(549.3)	(584.8)	(503.4)	(463.4)	(427.4)
Net external liabilities/CARs	(438.3)	(352.0)	(342.7)	(392.3)	(429.5)	(670.1)	(739.9)	(670.2)	(629.6)	(593.8)
Short-term external debt by remaining maturity/CARs	27.7	15.5	14.6	13.1	15.1	29.7	33.4	28.3	29.7	30.4
Reserves/CAPs (months)	5.7	5.2	5.6	5.9	5.3	5.5	4.9	3.1	2.7	2.4
FISCAL INDICATORS (%, General government)										
Balance/GDP	25.6	39.0	35.2	35.0	17.3	6.0*	2.0*	6.0*	9.0*	9.0*
Change in debt/GDP	1.4	(0.4)	(0.6)	(0.2)	0.5	0.9	2.6	1.5	1.5	1.5
Primary balance/GDP	25.8	39.1	35.3	35.1	17.4	6.1	2.1	6.1	9.1	9.1
Revenue/GDP	74.7	78.7	74.3	73.3	63.6	52.0	50.0	50.0	52.0	53.0
Expenditures/GDP	49.0	39.6	39.1	38.3	46.3	46.0	48.0	44.0	43.0	44.0
Interest /revenues	0.2	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2
Debt/GDP	11.5	8.5	6.8	6.5	7.4	10.9	13.5	14.0	14.5	15.0
Debt/Revenue	15.4	10.8	9.2	8.9	11.6	21.0	27.0	28.0	27.9	28.3
Net debt/GDP	(249.9)	(220.9)	(221.3)	(243.8)	(281.1)	(397.4)	(381.5)	(357.3)	(340.2)	(323.2)
Liquid assets/GDP	261.4	229.4	228.1	250.3	288.5	408.3	395.0	371.3	354.7	338.2
MONETARY INDICATORS (%)										
CPI growth	4.5	4.9	3.2	2.7	2.9	3.3	3.0	2.9	2.8	2.7
GDP deflator growth	15.4	17.2	7.5	0.2	(6.8)	(27.2)	(2.0)	6.0	5.0	5.0
Exchange rate, year-end (LC/$)	0.28	0.28	0.28	0.28	0.29	0.30	0.29	0.29	0.29	0.29
Banks' claims on resident non-gov't sector growth	1.9	2.6	2.8	7.3	5.1	7.6	6.0	6.0	6.0	0.0
Banks' claims on resident non-gov't sector/GDP	83.2	66.4	59.6	63.0	70.7	102.5	108.8	106.7	105.3	97.7
Foreign currency share of claims by banks on residents	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A

Table 1

State of Kuwait Selected Indicators (cont.)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Foreign currency share of residents' bank deposits	7.3	6.8	6.8	8.6	7.7	9.2	7.5	7.5	7.5	7.5
Real effective exchange rate growth	1.0	1.1	2.9	2.4	3.1	8.2	N/A	N/A	N/A	N/A

*Includes investment income from KIA funds. Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. LC--Local currency. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. The data and ratios above result from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

State of Kuwait Ratings Score Snapshot

Key rating factors	
Institutional assessment	Neutral
Economic assessment	Neutral
External assessment	Strength
Fiscal assessment: flexibility and performance	Strength
Fiscal assessment: debt burden	Strength
Monetary assessment	Neutral

S&P Global Ratings' analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of S&P Global Ratings' "Sovereign Rating Methodology," published on Dec. 23, 2014, summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral", or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

Related Criteria And Research

Related Criteria

- Criteria - Governments - Sovereigns: Sovereign Rating Methodology - December 23, 2014
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013

- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments - May 18, 2009

Related Research

- Sovereign Risk Indicators - July 6, 2016. An interactive version is also available at http://www.spratings.com/sri
- Default, Transition, and Recovery: 2015 Annual Sovereign Default Study And Rating Transitions - May 24, 2016

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that the economic assessment had deteriorated and that the monetary assessment had improved. All other key rating factors were unchanged.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria and Research').

Ashay Gokhale provided research assistance for this report.

Ratings List

	Rating	
	To	From
Kuwait (State of)		
Sovereign Credit Rating		
Foreign and Local Currency	AA/Stable/A-1+	AA/Stable/A-1+
Transfer & Convertibility Assessment	AA+	AA+

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.