FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Kuwait at 'AA'; Outlook Stable

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Fitch Ratings - Hong Kong - 07 Apr 2020: Fitch Ratings has affirmed Kuwait's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'AA' with a Stable Outlook.

KEY RATING DRIVERS

Kuwait's key credit strengths are its exceptionally strong fiscal and external balance sheets. These are increasingly offset by Kuwait's institutional paralysis and slow pace in addressing growing public finance challenges stemming from heavy oil dependence, a generous welfare state and its large public sector. Indicators on governance and the business environment are well below the 'AA' median.

We estimate the foreign assets of the Kuwait Investment Authority (KIA) at around USD529 billion at the end of the fiscal year ending March 2020 (FY19/20), accounting for the bulk of Kuwait's sovereign net foreign asset position of 472% of GDP (the highest of any Fitch-rated sovereign). Financial losses in 1Q20 largely erased double-digit gains in 2019. Of the KIA total, the Reserve Fund for Future Generations (RFFG) accounted for around USD489 billion and has grown over an extended period, due to investment 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 sixth year in a row as the government tapped the GRF for deficit financing and the repayment of domestic maturities.

We expect a general government deficit of 20% of GDP (KWD7.3 billion) for FY20/21, reflecting our baseline assumption that the Brent price will average USD35/bbl in 2020 and USD45/bbl in 2021. The government is unlikely to be able to mount a significant fiscal policy response to the oil shock given the ongoing pandemic and parliamentary elections in October 2020. On the government's reporting convention (not including KIA investment income in revenue and treating the RFFG transfer as expenditure), the deficit would be over 33% of GDP. We estimate the fiscal surplus in FY19/20 at around 1% of GDP for FY19/20.

The government's authorisation to issue debt has expired and it is unable to borrow, even to refinance existing maturities, which currently have to be met out of the GRF. As a result, general government debt fell to 14% of GDP at the end of FY19/20. Kuwait's outstanding eurobonds mature in 2022 and 2027.

Under our forecasts, the foreign assets of the GRF will be nearly depleted in FY20/21, and we assume that the government will resume borrowing and open up the RFFG for financing starting FY21/22. Accessing RFFG assets would allow the deficit to be financed at the FY20/21 level for over a decade, but will require parliamentary approval and will be politically contentious. The government is currently making a renewed push on the debt law and is not contemplating a change in the framework governing RFFG assets. Our understanding is that Kuwait's constitution would give the Amir the flexibility to issue an emergency decree permitting debt issuance or the use of the RFFG. In our view, other extraordinary measures might be possible in order to ensure timely debt service.

The government has made minimal progress on its reform programme aimed at boosting its underlying fiscal position, improving the business environment and boosting the role of the private sector as a provider of jobs for a young and growing population of Kuwaiti nationals (80% of Kuwaiti citizens were employed in the government sector in 2018). It has focused 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 reform.

Entrenched political divisions have stymied progress on reform. Conflicts between an appointed government and an elected parliament are a recurring feature of Kuwaiti politics, resulting in frequent resignations of ministers. In November 2019, disagreements between two senior royal family members resulted in the government's resignation. In our view, the latest public dispute involving senior royals reflects an underlying struggle for influence ahead of the upcoming election and an eventual leadership transition. Kuwait's Amir, 90-year-old Sheikh Sabah, appears to retain firm control of government affairs, but underwent month-long medical treatment in the US in late 2019. Crown Prince Nawaf is 82 years old and is a half-brother of the Amir.

We estimate that real GDP growth was around zero in 2019, weighed down by oil production cuts as per the OPEC agreement and delays to refinery upgrades as part of the Clean Fuels Project (CFP). In 2020, overall real GDP growth is likely to be positive amid an expansion of oil production and the commissioning of refinery upgrades, although disruptions related to the coronavirus will likely push the non-oil economy into recession for the year. The banking sector could absorb a rise in problem loans, being adequately capitalised, liquid and profitable.

We expect Kuwait's oil output to average to 2.8 million bbl/day in 2020 (from less than 2.7 million bbl/day in 2019). Kuwait has not yet announced an intention to raise oil output, unlike Saudi Arabia and Abu Dhabi, and our forecast increase reflects the restart of production at the Saudi-Kuwait Divided Zone.

We forecast Kuwait's current account deficit at 4% of GDP in 2020, the first current account deficit in two decades. Kuwait's bank and non-bank private sectors are net external creditors and major investors in the rest of the region, reflecting relatively muted domestic growth prospects. This supports the current account balance and Kuwait's net international investment position, which we estimate at 514% of GDP in 2018, exceeding the sovereign net foreign asset position by around 50% of GDP.

Kuwait's fiscal and external metrics are particularly sensitive to changes in oil prices and production. We estimate that a USD10/bbl change in the average oil price from our baseline assumption would shift Kuwait's fiscal balance by around 9% of GDP. An additional 100,000 bbl/day of oil production would impact the fiscal balance by around 1% of GDP.

ESG - Governance: Kuwait has an ESG Relevance Score (RS) of 5 for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption, as is the case for all sovereigns. Theses scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model. Kuwait has a medium WBGI ranking in the 49th percentile.

SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)

Fitch's sovereign rating committee did not adjust the output from the SRM to arrive at the final LT FC IDR

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- Improvement in structural factors such as substantial reduction in oil dependence, or a strengthening in governance or business environment indicators to levels approaching the 'AA' medians.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- 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.

- Continued depletion of the GRF in the absence of a new debt law, legislation permitting access to the RFFG or confidence in the ability of Kuwaiti authorities to take other extraordinary measures to ensure timely debt service.

BEST/WORST CASE RATING SCENARIO

Ratings of Public Finance issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings https://www.fitchratings.com/site/re/10111579.

KEY ASSUMPTIONS

We forecast that Brent crude will average USD35/bbl in 2020 and USD45/bbl in 2021.

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.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

The KIA's assets are not officially reported by the government. Fitch estimates these assets by compounding the government's transfers into the KIA, using assumptions about returns and asset allocations that are informed by discussions with the KIA. Fitch benchmarks government transfers into the KIA and KIA investment income against the balance of payments. Fitch has sufficient confidence in these estimates to maintain the rating.

RATING ACTIONS

ENTITY/DEBT	RATING		
Kuwait	LT IDR	AA	Affirmed
•	ST IDR	F1+	Affirmed
•	LC LT IDR	AA	Affirmed

ENTITY/DEBT	RATING		
•	LC ST IDR	F1+	Affirmed
•	Country Ceiling	AA+	Affirmed

VIEW ADDITIONAL RATING DETAILS

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 05 Jul 2019)

Sovereign Rating Criteria (pub. 28 Mar 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v1.7.1 (1)

Macro-Prudential Indicator Model, v1.4.0 (1)

Sovereign Rating Model, v3.11.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Kuwait	EU Endorsed

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Sovereigns Middle East Asia-Pacific Kuwait