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Rating Action: Moody's places Kuwait's Aa2 rating on review for downgrade

30 Mar 2020

New York, March 30, 2020 -- Moody's Investors Service has today placed Kuwait's Aa2 long-term issuer rating on review for downgrade.

The decision to place Kuwait's issuer rating on review for downgrade reflects the significant decline in government revenues resulting from the sharp decline in oil prices combined with weak governance leading to heightened uncertainty that the government will be able to access sufficient sources of financing at a time when its financing needs have increased significantly. Moody's judgment regarding effective governance was one of the drivers of this action.

The rapid and widening spread of the coronavirus outbreak, deteriorating global economic outlook, falling oil prices, and asset price declines are creating a severe and extensive credit shock across many sectors, regions and markets. The combined credit effects of these developments are unprecedented. With a government revenue base nearly entirely reliant on oil, Kuwait is highly exposed to the collapse in oil prices that has resulted from depressed global oil demand and a slow adjustment of supply following the collapse of the OPEC+ agreement.

During the review, Moody's will assess the government's capacity to adjust the sovereign's funding strategy in light of the ongoing parliamentary impasse regarding legal authorization to issue debt that is accelerating the depletion of the liquid assets within the General Reserve Fund (GRF, the smaller stabilization fund which holds part of the sovereign wealth fund assets managed by the Kuwait Investment Authority). Moody's will also assess the government's policy response to prevent the budget deficit from widening to close to 30% of GDP this year. Without new financing sources, Kuwait's creditworthiness would be significantly weaker than currently estimated. And even if financing is secured for the short term, the absence of a credible medium-term funding strategy may indicate markedly weaker institutions and governance strength, and creditworthiness, than Moody's has so far assumed.

At this juncture, Kuwait's creditworthiness continues to be supported by the vast Future Generation Fund assets which represent the majority of the sovereign wealth fund assets, based on the assumption that some of these assets can be deployed, if required, to meet government financing requirements.

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 bond and deposit ceilings also remains unchanged at Aa2.

RATINGS RATIONALE

RATIONALE FOR INITIATING A REVIEW FOR DOWNGRADE OF KUWAIT'S Aa2 RATING

The decision to place the rating on review for downgrade reflects the significant decline in government revenues resulting from the sharp decline in oil prices combined with weak governance that could have very significant implications for Kuwait's capacity to finance its borrowing needs in the next few years.

Due to depressed global oil demand arising from the coronavirus outbreak alongside a sharp increase in the supply of crude oil as the OPEC+ talks failed, Moody's has revised down its oil price assumptions for 2020 and 2021 to an average of $43/barrel and $53 respectively, about $20 and $10 below the previous assumptions.

Such lower oil prices will have a very large impact on Kuwait's fiscal position. Hydrocarbon revenues account for 90% of Kuwait's total government revenues and about a third of GDP. Moody's revised oil price assumption implies a 34% decline in total revenues in fiscal year 2020/21 (the year ending in March 2021) compared with its previous estimates.

While Moody's expects the government to enact some fiscal adjustment in response to lower oil prices this year, making significant expenditure reductions will prove challenging. Moody's expects a modest decline in energy subsidies as a result of lower crude oil prices, but measures to further reduce salaries and subsidies will in most cases require parliamentary approval, which has proven difficult to secure in recent years despite budgetary pressures.

In the absence of more significant fiscal consolidation measures, Moody's projects a budget deficit equivalent to 28% of GDP ($37.5 billion) for fiscal year 2020/21.

Without legal authorization to issue debt since the expiration of the public debt law in 2017, the government has relied on drawing down the assets of the General Reserve Fund (GRF) to fund expenditure and service debt obligations. As a result of large and persistent fiscal deficits since the oil price shock in 2015, the GRF has been shrinking rapidly. According to Moody's estimates, accelerated drawdowns to meet the much wider borrowing needs would deplete the liquid portion of the GRF before the end of the current fiscal year.

Even if ultimately a debt law is passed this year allowing issuance and a slower drawdown of GRF resources, Kuwait's financing needs will remain large during the next several years, potentially larger than the government can finance at affordable costs in domestic and international markets alone. In the absence of significant fiscal consolidation measures, and based on the rating agency's oil price assumptions, Moody's estimates that Kuwait's gross financing requirements will amount to KWD 31.6 billion ($100 billion, or 77% of GDP) over the next three years, which dwarfs GRF liquid assets and possibly market demand for Kuwaiti debt.

Kuwait's creditworthiness continues to be supported by the presumption that the vast Future Generation Fund assets can be deployed if required. Moody's estimates that FGF assets amount to more than three times GDP, although their value is not disclosed by the government. Moody's believes that the institutional arrangements in Kuwait do in principle allow access to the FGF, if and when they are required. However, this has only been done once in the past—almost three decades ago to fund reconstruction efforts after Iraqi occupation.

Accessing these assets would likely require amending existing legislation, which is politically contentious. The poor track record of cooperation between the government and parliament on financing issues in recent years raises the possibility that no legislative solution is found that would remove any uncertainty about Kuwait's financing sources in the medium term. In this scenario, Kuwait's institutions and governance strength may be markedly weaker than Moody's has assumed so far.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE CONSIDERATIONS

As a major oil exporter, Kuwait's environmental risks are predominantly derived from carbon transition. Under a scenario of rapid transition to low consumption of hydrocarbons globally, which is not Moody's current baseline assumption, Kuwait's credit profile would face downward pressure, although only over the longer-term and with sizeable buffers to provide support.

Social risks in Kuwait derive primarily from the rapid expansion of the labour force due to the young population. The current socioeconomic model in which the government acts as employer of first resort will continue to place rising pressure on government spending unless the private sector is able to attract and absorb a higher share of the growth in the Kuwaiti labour force, or the government reduces net public sector hiring. Lower public sector hiring not accompanied by the rising employment of nationals in the private sector could lead to higher unemployment and social discontent.

Governance risks drive today's action. They primarily relate to the factious relationship between the executive branch and the legislature, which has obstructed the passage of key legislation and reduced the government's ability to respond to shocks in a timely manner. The lack of transparency on the size and composition of sovereign wealth fund assets is also a constraint in our assessment of institutional strength.

WHAT COULD RESULT IN A DOWNGRADE

Increasing risks that the liquid GRF resources near depletion without access to new financing sources, in the absence of a debt law and/or legal authorization to access Future Generation Fund assets, could lead Moody's to downgrade the rating, potentially by more than one notch.

WHAT COULD RESULT IN CONFIRMATION OF THE RATING AT THE CURRENT LEVEL

Improved visibility over durable funding arrangements for the government's deficits, whether through an agreement between the government and parliament to allow for assured access to vast sovereign wealth fund assets, or over time, through fiscal adjustment that materially reduces financing requirements, could lead to a confirmation of the rating at the current level.

GDP per capita (PPP basis, US$): 66,652 (2018 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 1.3% (2018 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 0.4% (2018 Actual)

Gen. Gov. Financial Balance/GDP: -7.7% (2018 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: 14.5% (2018 Actual) (also known as External Balance)

External debt/GDP: 40.8% (2018 Actual)

Economic resiliency: baa1

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

On 25 March 2020, a rating committee was called to discuss the rating of the Government of Kuwait. The main points raised during the discussion were: The issuer's institutions and governance strength, have materially decreased. The issuer's governance and/or management, have materially decreased. Other views raised included: The issuer's fiscal or financial strength, including its debt profile, has materially decreased.

The principal methodology used in these ratings was Sovereign Ratings Methodology published in November 2019 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1158631 . Alternatively, 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.

The local market analyst for this rating is Thaddeus Best, +971 (423) 795-06 .

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1133569 .

At least one ESG consideration was material to the credit rating outcome announced and described above.

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