

## RATING ACTION COMMENTARY

# Fitch Downgrades Kuwait to 'AA-'; Outlook Stable

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Fitch Ratings - Hong Kong - 27 Jan 2022: Fitch Ratings has downgraded Kuwait's Long-Term Foreign-Currency Issuer Default Rating (IDR) to 'AA-', from 'AA'. The Outlook is Stable.

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

## KEY RATING DRIVERS

The downgrade reflects ongoing political constraints on decision-making that hinder addressing structural challenges related to heavy oil dependence, a generous welfare state and a large public sector. There has been a lack of meaningful underlying fiscal adjustment to recent oil-price shocks and the outlook for reforms remains weak, despite some positive political developments as part of a national dialogue. While we assume a debt law will be agreed in 2022, this has been under discussion since 2017, reflecting slow processes for decision-making in Kuwait.

A new cabinet was formed in December 2021, three months after the Amir convened a national dialogue to resolve the impasse between the government and National Assembly, Kuwait's parliament, which has prevented agreement on a new law to allow the government to issue debt. The national dialogue addressed some points of contention with the opposition, notably an amnesty agreement that saw the return from abroad of a number of opposition figures. The cabinet also includes three opposition MPs, whereas it did not before.

We assume that a debt law will be agreed in 2022, although some uncertainty remains. Even without a debt law, the government would still be able to meet its financing obligations. However, the difficulties in passing the law and institutional gridlock have forced the government to rely on stop-gap measures, which is unusual for Kuwait's rating level. The debt law needs to be presented to the parliamentary finance and economic committee, before going to parliament for further discussion and voting. Higher oil prices have relieved some immediate pressure, which could slow decision-making.

Political divisions remain, despite the national dialogue, and are likely to prevent broader reform of Kuwait's fiscal rigidities. More than 70% of government spending consists of sticky current spending, including salaries and subsidies, and about 80% of Kuwaiti nationals are employed in the public sector. We forecast a sharp rise in debt to around 50% of GDP over the medium term after the debt law is approved, from the current low level of 10% of GDP. Further periods of political paralysis also remain a risk. In November, the Amir, who took over the leadership in 2020, handed over some powers to his half-brother, the Crown Prince. While succession processes in Kuwait have generally been smooth, they can present a further headwind to decision-making.

Kuwait's IDRs also reflect the following key rating drivers:

Kuwait remains committed to meeting its obligations, even in the absence of a debt law. The government will rely on the assets of the General Reserve Fund (GRF) - the government's treasury account - to meet gross financing needs until new financing arrangements are secured. The bulk of the GRF's liquid assets were drawn down during 2020-2021, necessitating the sale of illiquid assets to the Future Generation Fund (FGF), which contains the bulk of Kuwait's foreign assets. The GRF's current level of liquid assets is not disclosed, although the government has indicated that it more than covers the sovereign's USD3.5 billion eurobond maturity in March and that the GRF still owns extensive illiquid assets that could be sold quickly to the FGF if necessary. This occurred in 2020-2021, when the FGF purchased close to USD16 billion of GRF assets and a previous transfer of around USD7 billion from the GRF to the FGF was reversed.

The government is also proposing an FGF contribution law to allow for dividend payments from the FGF to help finance budget deficits subject to an annual cap. The current law prevents the government from direct access to FGF assets. The contribution law would represent an important financing tool and would allow for a slower rise in government debt. Discussions on the contribution law are more fledgling than discussions over the debt law.

Kuwait's fiscal and external balance sheets remain among the strongest of Fitch-rated sovereigns, despite severe oil-prices swings since 2014 and intermittent political gridlock. We estimate Kuwait's sovereign net foreign asset position at more than 500% of GDP, the highest among all Fitch-rated sovereigns and 10x the 'AA' median. The bulk of the foreign assets are held in the FGF. Gross government debt/GDP is low and we expect it to fall to 10% of GDP in the fiscal year ending March 2022 (FY21), against a 'AA' median of 47%, although government debt is likely to rise to 50% of GDP over the medium term.

We forecast the general government budget deficit to narrow to 1.6% of GDP in FY21 from 20.6% of GDP in FY20, largely due to higher oil prices. Attempts to control budget spending have also helped and we expect total spending to be less than budgeted. We forecast the budget deficit to widen to 2.4% of GDP in FY22 and 5.7% in FY23 as oil prices fall back, spending pressure continues and progress on fiscal reforms remains limited. We do not assume the implementation of a value added tax in the next few years.

Fitch's budget calculations include estimated investment interest income of the Kuwait Investment Authority, which is not officially disclosed. Our forecast budget deficit would be 10% of GDP (KWD4.3 billion) in FY21 under the government's reporting convention, which excludes the investment income from revenue, followed by deficits averaging 12% of GDP in FY22-FY23. This corresponds to the government's budget financing needs, as investment income relates to the FGF and is retained by the Kuwait Investment Authority.

Persistently high oil prices would lower financing needs, as budget outcomes are sensitive to changes in oil prices and production. We assume annual Brent crude prices of USD70/barrel (bbl) in 2022 and USD60/bbl in 2023 and expect Kuwait's average oil production to increase to 2.7 million bbl a day in FY22, in line with the OPEC+ taper, and 2.8 million bbl a day in FY23, from the current level of 2.5 million bbl a day. A USD10/bbl change in the oil price impacts the budget by around 5.5% of GDP, all things being equal. A change of 100,000bbl a day of production affects the budget by about 1.7% of GDP.

ESG - Governance: Kuwait has an ESG Relevance Score of '5[+]' for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption. These 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 at the 52nd percentile, reflecting low scores for voice and accountability, weak government effectiveness and middling scores across other governance indicators.

## **RATING SENSITIVITIES**

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

-Structural Features: Depletion of the GRF in the absence of a new debt law, legislation permitting access to the FGF or other extraordinary measures to ensure that the government can continue to make good on its payment obligations, including but not limited to debt service.

-Public Finances: Significant deterioration in 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.

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

- Structural Features/Public Finances: Evidence that Kuwait's institutions and political system are able to tackle long-term fiscal challenges, for example, through actions to implement a clear deficit reduction plan that is resilient to lower oil prices, as well as adopting a transparent and sustainable government funding strategy.

## **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 IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final Long-Term Foreign-Currency IDR by applying its QO, relative to SRM data and output, as follows:

- Structural: -1 notch to reflect political constraints on enacting key economic and fiscal reforms, as illustrated by the difficulties in passing a debt law and the lack of progress on addressing structural public finance challenges stemming from heavy oil dependence, a generous welfare state and a large public sector.

- External Finances: -1 notch to offset the increase in the sovereign net foreign assets/GDP ratio feeding into the SRM, which has been driven in part by the sharp decline in nominal GDP in 2020 (as well as by buoyant global financial markets driving strong investment gains) and which should moderate as nominal GDP bounces back with higher oil prices.

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 Long-Term Foreign-Currency 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.

## **BEST/WORST CASE RATING SCENARIO**

International scale credit ratings of Sovereigns, Public Finance and Infrastructure 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, visit <https://www.fitchratings.com/site/re/10111579>.

## **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.

## **ESG CONSIDERATIONS**

Kuwait has an ESG Relevance Score of '5[+]' for Political Stability and Rights, as WBGs have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and a key rating driver with a high weight. As Kuwait has a percentile rank above 50 for the respective Governance Indicator, this has a positive impact on the credit profile.

Kuwait has an ESG Relevance Score of '5[+]' for Rule of Law, Institutional & Regulatory Quality and Control of Corruption, as WBGs have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and are a key rating driver with a high weight. As Kuwait has a percentile rank above 50 for the respective Governance Indicators, this has a positive impact on the credit profile.

Kuwait has an ESG Relevance Score of '4' for Human Rights and Political Freedoms, as the Voice and Accountability pillar of the WBGs is relevant to the rating and a rating driver. As Kuwait has a percentile rank below 50 for the respective Governance Indicator, this has a negative impact on the credit profile.

Kuwait has an ESG Relevance Score of '4[+]' for Creditor Rights, as willingness to service and repay debt is relevant to the rating and is a rating driver for Kuwait, as for all sovereigns. As Kuwait has track record of 20+ years without a restructuring of public debt and captured in our SRM variable, this has a positive impact on the credit profile.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit [www.fitchratings.com/esg](http://www.fitchratings.com/esg)

## RATING ACTIONS

ENTITY / DEBT ⚡	RATING ⚡			PRIOR ⚡
Kuwait	LT IDR	AA- Rating Outlook Stable		AA Rating Outlook Negative
	Downgrade			
	ST IDR	F1+	Affirmed	F1+
	LC LT IDR	AA- Rating Outlook Stable		AA Rating Outlook Negative
	Downgrade			
	LC ST IDR	F1+	Affirmed	F1+
	Country Ceiling	AA+	Affirmed	AA+
senior unsecured	LT	AA-	Downgrade	AA

[VIEW ADDITIONAL RATING DETAILS](#)

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**APPLICABLE CRITERIA**

[Country Ceilings Criteria \(pub. 01 Jul 2020\)](#)

[Sovereign Rating Criteria \(pub. 26 Apr 2021\) \(including rating assumption sensitivity\)](#)

**APPLICABLE MODELS**

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

Country Ceiling Model, v1.7.2 (1)

Debt Dynamics Model, v1.3.1 (1)

Macro-Prudential Indicator Model, v1.5.0 (1)

Sovereign Rating Model, v3.12.2 (1)

## **ADDITIONAL DISCLOSURES**

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Kuwait

EU Endorsed, UK Endorsed

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