FitchRatings

FITCH AFFIRMS KUWAIT AT 'AA'; OUTLOOK STABLE

Fitch Ratings-Hong Kong-23 October 2017: Fitch Ratings has affirmed Kuwait's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'AA' with a Stable Outlook.

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

KEY RATING DRIVERS

Kuwait's key credit strengths are the sovereign's exceptionally strong fiscal and external metrics and, at a forecast USD50/bbl, one of the lowest fiscal breakeven Brent oil prices among Fitch-rated oil exporters. These strengths are tempered by Kuwait's heavily oil- dependent economy, geopolitical risk, weak governance and a poor business environment. A generous welfare state and the large economic role of the public sector present increasing challenges to public finances, given robust growth of the Kuwaiti population.

Assets and performance of the Kuwait Investment Authority (KIA) are not disclosed. We estimate that KIA's assets exceeded USD514 billion or 453% of GDP at end-2016. Of this amount, the Reserve Fund for Future Generations (RFFG) accounted for almost USD400 billion and continues to increase, due to investment income and the statutory transfer of 10% of government revenue. Meanwhile, the value of the General Reserve Fund (GRF), which holds the accumulated government surpluses of previous years, is estimated to have fallen for a third year in a row, to USD116 billion, as the government tapped the GRF for financing.

In a hypothetical scenario where fiscal deficits remain at the level expected for the fiscal year ending March 2018 (FY17/18), the transfer to the RFFG continues and the GRF remains the sole source of financing, the GRF would be exhausted within about 10 years, while tapping the RFFG would allow Kuwait to sustain its current deficits for decades.

The government met its FY16/17 financing need by issuing around KWD2.2 billion (USD 7.3 billion) of net new local debt, USD8 billion of eurobonds and taking around USD4 billion from the GRF. We expect the financing mix in FY17/18 to have a similar debt component, although this is conditional on the passage of the new debt law in the National Assembly, doubling the government's borrowing cap to KWD20 billion. Assuming that the law will be passed, we see debt approaching the new cap in FY19/20, when it would be equivalent to 48% of GDP.

We estimate the general government balance at KWD74 million (0.2% of GDP) in FY16/17, including estimated investment income worth around KWD4.7 billion and excluding the statutory transfer of 10% of revenue to the RFFG, worth around KWD1.3 billion. The government does not count investment income and treats the RFFG transfer as an expenditure in its own presentation, resulting in a deficit of more than KWD5.9 billion. The balance in FY16/17 was almost unchanged from FY15/16, as a further 3% drop in oil revenue was offset by a similar decline in current spending. A mild decline in current spending masked significant under-spending relative to the budget (nearly KWD1.2 billion, or 6.3%).

Under our baseline Brent oil price assumption of USD52.5/bbl in 2017-2018, we expect the fiscal balance to be broadly unchanged at KWD57 million (0.2% of GDP) in FY17/18. According to the government's reporting convention, our forecast deficit would be KWD6.4 billion, which roughly corresponds to the government's financing need, as the government does not intend to touch the RFFG. The government's own headline budget deficit is KWD7.8 billion for FY17/18, mainly due to a lower oil price assumption of USD45/bbl.

Progress on the government's "Programme for Economic and Fiscal Sustainability" has been slow, partly due to a strengthening of parliamentary opposition after elections in November 2016. The September 2016 fuel price hike has remained in place and has been upheld by courts. Utility price hikes came into effect gradually between May and September 2017 but are far lower than initially approved by parliament, remain below production costs and international rates and, as expected, did not directly apply to Kuwaiti citizens, the biggest consumers. The government has been working on non-legislative measures to limit spending, including by cracking down on employee absenteeism in the public sector, tightening bonus rules, stopping the creation of new allowances and limiting budgetary entities' fiscal discretion.

We expect that the government will continue to enjoy some success on measures that do not require major new legislation, such as multi-year budgeting, expenditure ceilings and further tightening of rules for hiring and compensation in the civil service. Progress will be slower on more comprehensive measures such as a new public sector wage law, privatisation and VAT and excise tax laws. This is due to strong political opposition in a fractious parliament and due to capacity constraints in the parliament and in the public sector. In particular, we do not factor in VAT or excise tax revenue into our forecasts.

The government commands an effective majority in parliament as its unelected ministers also have voting rights and because the authority of Kuwait's Amir, who appoints the government, is respected. However, members of parliament can and have obstructed the government's agenda by resorting to hearings of ministers and votes of no confidence. Despite a degree of consensus in many parts of society on the structural challenges that Kuwait is facing, the government's proposed answers to these challenges remain deeply controversial.

We expect Kuwait's real GDP to fall 3.5% in 2017 (after 3.5% growth in 2016) as oil production cuts in line with the OPEC agreement will imply an 8.3% drop in production from 2016 average levels. We expect non-oil growth to pick up to 3% in 2017-2019 from 2% in 2016 amid higher government spending, particularly on investment. Despite increases to fuel prices, inflation has been muted, which along with higher oil prices and continuation of government spending should help retail trade and confidence indicators recover from their dip in mid-2016. A record number of land grants under the government's housing programme in 2016 will support residential construction activity in the coming years. Banks remain adequately capitalised, liquid, and profitable.

Kuwait has remained neutral in the dispute between Qatar, and Saudi Arabia and the UAE, instead stepping into the role of mediator. Kuwait's traditionally low-key, non-interventionist foreign policy is respected within the Gulf Cooperation Council, and we see little risk of sanctions being imposed on it for its continued ties with Qatar or Iran.

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 rated peers, as follows:
- Public Finances: +1 notch, to reflect an exceptionally strong fiscal position, which is reflected in Kuwait's sovereign net foreign assets but is not sufficiently covered by fiscal indicators included in the SRM.

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.

RATING SENSITIVITIES
The main factors that could individually or collectively lead to negative rating action are:
-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.

The main factors that could individually or collectively lead to positive rating action are:
-Improvement in structural factors such as reduction in oil dependence, and a strengthening in governance, the business environment and the economic policy framework.

KEY ASSUMPTIONS
We forecast that Brent crude will average USD52.5/bbl in 2017-2018 and USD55/bbl in 2019.

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.

The full list of rating actions is as follows:

Long-Term Foreign- and Local-Currency IDRs affirmed at 'AA'; Outlook Stable
Short-Term Foreign- and Local-Currency IDRs affirmed at 'F1+'
Country Ceiling affirmed at 'AA+'
Issue ratings on long-term senior-unsecured foreign-currency bonds affirmed at 'AA'

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Additional information is available on www.fitchratings.com

Applicable Criteria

Country Ceilings Criteria (pub. 21 Jul 2017)
https://www.fitchratings.com/site/re/901393
Sovereign Rating Criteria (pub. 21 Jul 2017)
https://www.fitchratings.com/site/re/901261