MOODY'S
INVESTORS SERVICE

Rating Action: Moody's affirms Kuwait's A1 rating; maintains stable outlook

26 May 2022

New York, May 26, 2022 -- Moody's Investors Service ("Moody's") has today affirmed the Government of Kuwait's long-term local and foreign currency issuer ratings at A1. The outlook remains stable.

The decision to affirm the ratings is underpinned by Moody's assessment that Kuwait's balance sheet and fiscal buffers will remain strong for the foreseeable future, which preserve macroeconomic and external stability and anchor the credit profile. Balanced against this key credit strength is the persistently challenging political environment that limits the prospects for reforms that would reduce the vulnerability of the economy and government finances to long-term carbon transition risks.

The stable outlook reflects balanced risks to the ratings. Effective implementation of measures to reduce the government's exposure to oil revenue and diversify the economy, which Moody's does not currently factor into its baseline assumptions for at least the next two years, may raise the resilience of Kuwait's credit profile to oil price fluctuations. By contrast, accelerating global momentum towards carbon transition that lowers the demand for and price of oil, in the absence of reforms including the passage of legislation to expand the government's financing options, may reintroduce liquidity risks and weigh on the credit profile longer term.

Kuwait's local and foreign currency country ceilings remain unchanged at Aa2. The narrower-than-average two-notch gap between the local currency ceiling and the sovereign rating reflects the country's stable balance of payments through episodes of oil price volatility, against the economy's exposure to a key revenue source and a challenging domestic political environment that constrains reform and diversification prospects. The zero-notch gap between the foreign currency ceiling and local currency ceiling reflects very low transfer and convertibility risks, given the country's very large net external creditor position that includes ample foreign exchange reserves held by the central bank.

RATINGS RATIONALE

RATIONALE FOR THE RATING AFFIRMATION

KUWAIT'S BALANCE SHEET AND FISCAL BUFFERS WILL REMAIN STRONG FOR THE FORESEEABLE FUTURE

Kuwait's credit profile is supported by its large sovereign wealth buffers and very low debt level, and Moody's expects the government's balance sheet to remain extraordinarily strong for the foreseeable future. Furthermore, in the current environment of high oil prices and rising production agreed by the Organisation of the Petroleum Exporting Countries (OPEC) with some other major oil exporting countries, Moody's expects the government to reaccumulate liquid assets in its General Reserve Fund (GRF), which will eliminate liquidity risk – even if self-imposed – for at least the next two to three years.

Moody's estimates that liquid sovereign wealth fund (SWF) assets managed by Kuwait Investment Authority (KIA) far exceeded the size of its GDP at the end of 2021 and dwarfs the government's debt of just below 6% of GDP at the end of fiscal 2021 (year ending March 2022). The size of Kuwait's SWF assets as a share of GDP is one of the three largest globally, together with Norway and Abu Dhabi.

With the sharp increase in oil prices this year driven by the Russia-Ukraine military conflict, coupled with higher oil production under the OPEC+ agreement, Moody's expects Kuwait's stock of SWF assets to grow over the next two years. This is driven by Moody's forecast that Kuwait will run a fiscal surplus of 7-8% of GDP in fiscal 2022 and around 2-3% of GDP in fiscal 2023, based on the rating agency's oil price assumptions of $105 and $95 per barrel on average in 2022 and 2023, respectively. Moreover, with very limited amounts of debt to repay and no requirement to transfer surpluses to the Future Generations Fund (FGF, which is at the discretion of the finance minister after the change in law in September 2020), Moody's expects the surpluses to be accumulated in GRF as liquid buffers.

The reaccumulation of assets after seven consecutive years of drawdown because of fiscal deficits will bolster Kuwait's credit profile and eliminate the need for government financing and any associated liquidity risk while the fiscal balance is in surplus. While these needs will return from fiscal 2024 onwards, when, based on Moody's oil price assumptions, Kuwait will again run fiscal deficits, the near-term period of high oil prices provides time to the government to take some measures that would allow it to finance its deficits.

Meanwhile, the large proportion of SWF assets invested in liquid, foreign currency assets help preserve macroeconomic and external stability. Moody's estimates that Kuwait runs a very large net international investment position because of FGF and foreign exchange reserves are ample. Kuwait's very sizeable stock of foreign assets significantly lower external vulnerability risk by supporting the credibility of the currency peg and deterring speculation against the Kuwaiti dinar, even during periods of low oil prices. In turn, the monetary policy regime – which relies on the central bank's exchange rate peg against a basket of currencies including the US dollar as the main policy tool – has been effective in maintaining price stability and limiting inflation volatility.

In terms of fiscal policy, the buffers – to the extent that they can be used – also help limit procyclical fiscal policies especially when oil prices are low, allowing the government to continue supporting the economy. For example, over 2020-21, despite the prospect of low prices, Kuwait kept government expenditure relatively unchanged in nominal terms, which supported the economy. Nonperforming loan levels in the banking system have remained low even after the expiry of the loan deferral programme launched by the central bank during the coronavirus pandemic.

PERSISTENT CHALLENGES IN THE POLITICAL ENVIRONMENT LIMITS PROSPECTS FOR REFORMS TO REDUCE RELIANCE ON HYDROCARBON REVENUE AND VULNERABILITY TO CARBON TRANSITION

At the same time, Kuwait's very high exposure to developments in the oil sector weighs on the resilience of its credit profile because of the long-term transition away from hydrocarbons. Moreover, compared to many hydrocarbon producing peers that are making progress in fiscal and economic diversification away from reliance on hydrocarbons, prospects for reforms and diversification will remain weak in Kuwait, hampered by the country's political climate.

In Kuwait, oil revenue accounts for around 90% of government revenue while hydrocarbon exports make up around 80% of total exports; the contribution of the hydrocarbon sector is among the largest across sovereigns that Moody's rates. Although the government has sought to introduce fiscal reforms, it has yet to implement any nonoil revenue measure since the oil price shock in 2015, unlike other countries in the Gulf Cooperation Council (GCC). The country's focus on welfare for citizens through wages and subsidies also implies limited scope for deep expenditure cuts as wages and subsidies account for around three-quarters of spending. As a result, Kuwait's fiscal balance is significantly more volatile compared to GCC peers.

As for economic diversification, the government has made some initial progress, but prospects remain limited. The completion of the Clean Fuels Project in 2021 and the likely completion of the Al Zour refinery this year will provide some downstream diversification within the hydrocarbon sector. However, other projects aimed at spurring nonhydrocarbon sectors such as transport and logistics – including the Silk City and the Mubarak Al-Kabeer port – have faced delays, with the economic returns still uncertain. Economic diversification prospects are in part limited by Kuwait's still weaker economic competitiveness compared to GCC peers.

In Moody's view, the inability to implement fiscal and economic reforms and lack of progress in diversification stem from the fractious relationship between the government and parliament. While the political structure provides ample room for policy debate, checks and balances, and voice and accountability – features that are unique in the GCC – the fragmentation of views across members of parliament and absence of stable coalitions has instead led to regular gridlocks on policy initiatives and changes in government or the cabinet. Until the relationship between the government and members of parliament becomes constructive, Moody's does not assume that any major reform measures can be implemented. That said, the presence of KIA, particularly GRF, to meet the government's spending requirements and debt service in the absence of other financing options when lower oil prices lead to fiscal deficits points to some institutional credibility in preserving Kuwait's creditworthiness.

Longer term, the inability of political institutions to agree on and implement reforms leaves Kuwait highly vulnerable to long-term carbon transition. In particular, the possibility of Kuwait's balance sheet strength significantly eroding over time will increase with the acceleration in carbon transition trends if institutions are unable to adjust to an environment of lower oil prices and demand.

RATIONALE FOR THE STABLE OUTLOOK

The stable outlook reflects balanced risks to the ratings.

On the upside, the implementation of reforms to reduce the government's reliance on oil revenue may raise the resilience of the credit profile to oil price fluctuations and longer-term carbon transition risks. The government has been considering various types of nonoil revenue but has yet to push any new tax through parliament. Moody's does not currently factor any such measures into its baseline assumptions for at least the next two years. A more productive relationship between the executive and legislative branches of government that raises prospects for long-term, structural reforms may also strengthen the credit profile beyond Moody's current expectations.

Meanwhile, although higher oil prices coupled with increasing production are currently providing a significant boost to Kuwait's credit metrics, the improvement will invariably reverse in the absence of reforms, once oil prices begin falling towards Moody's medium-term price range of $50-70 per barrel. Higher oil prices may also reduce the incentive for reforms. Moody's expects Kuwait's oil production to increase over 2022-23 and underpin real GDP growth of 8% this year and 5.5% next year. Kuwait has the ability to increase oil production further if allowed by OPEC+, as its expected capacity for fiscal 2022 is 3.1 million barrels per day (mbpd), compared to an average production of around 2.7mbpd that is likely this year.

On the downside, Kuwait is highly vulnerable to accelerating momentum towards carbon transition that may reduce the demand for and price of oil. While currently elevated oil prices imply a window of opportunity for progress, without fiscal and economic reforms to strengthen the country's resilience to lower oil prices and exports Kuwait's credit profile will inevitably weaken over time despite the very strong starting point. Carbon transition is the key factor underpinning Moody's assessment of Kuwait's highly negative exposure to environmental risks. Meanwhile, the return of wide fiscal deficits as oil prices moderate, if persistent, may also reintroduce liquidity risks in the absence of new legislation to expand the government's financing options, since GRF's resources are ultimately finite.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Kuwait's ESG Credit Impact Score is moderately negative (CIS-3), reflecting its high exposure to environmental risks, moderate social risks and institutional challenges, which constrain the government's capacity to respond to shocks.

Kuwait's exposure to environmental risks is highly negative (E-4 issuer profile score), as the economy and government finances are highly susceptible to a global transition away from hydrocarbon fuels over the longer term, although low oil production costs provide a degree of insulation to carbon transition. While less pertinent to the credit profile than carbon transition, Kuwait is also one of the world's top 10 most arid countries, and rapid growth in recent decades has further increased the challenges surrounding water sustainability. Most of Kuwait's water is produced by desalination plants, which are highly energy intensive and vulnerable to oil spills in the Gulf.

The exposure to social risks is moderately negative (S-3 issuer profile score), driven mainly by the young demographics, which will drive rapid growth in the labour force over the coming decades. The challenge in keeping unemployment low among citizens is more relevant in Kuwait than some of its regional peers because its private sector is relatively underdeveloped. Education outcomes are also not commensurate with the level of government spending. However, the country's financial wealth places it in a position of comparative strength to manage these challenges.

The influence of governance is moderately negative (G-3 issuer profile score) in Kuwait. This largely reflects the fractious relationship between the executive and legislative branches of government that impedes effective policy formation and constrains the sovereign's ability to implement longer-term reforms and respond to shocks.

GDP per capita (PPP basis, US$): 43,252 (2020 Actual) (also known as Per Capita Income)

Real GDP growth (% change): -8.9% (2020 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 3% (2020 Actual)

Gen. Gov. Financial Balance/GDP: -29.9% (2020 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: 3.2% (2020 Actual) (also known as External Balance)

External debt/GDP: [not available]

Economic resiliency: baa1

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

On 24 May 2022, a rating committee was called to discuss the rating of the Kuwait, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's institutions and governance strength, have materially increased. The issuer's fiscal or financial strength, including its debt profile, has not materially changed. The issuer's susceptibility to event risks has not materially changed.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

The ratings may be upgraded if prospects for fiscal and economic diversification away from oil were to significantly improve, in turn raising Moody's assessment of the sovereign's resilience to longer-term carbon transition risks. A more productive relationship between the executive and legislative branches of parliament that would foster greater policy effectiveness and increase the government's ability to respond to shocks would also exert upward pressure on the ratings.

Conversely, the ratings may be downgraded if the government's fiscal strength were likely to substantially weaken over the medium term, potentially in a scenario where the inability to implement reforms led to wide fiscal deficits as oil prices decline, and accompanied by markedly higher debt (should a new debt law be passed) and/or lower sovereign wealth buffers. While unlikely in the near term, renewed government liquidity risk, particularly if GRF assets were to be significantly drawn down because of persistently wide fiscal deficits, would also put downward pressure on the ratings.

The principal methodology used in these ratings was Sovereign Ratings Methodology published in November 2019 and available at https://ratings.moodys.com/api/rmc-documents/63168 . Alternatively, please see the Rating Methodologies page on https://ratings.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.

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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 on https://ratings.moodys.com/rating-definitions.

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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://ratings.moodys.com/documents/PBC_1288235.

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