State of Kuwait

Capital Standards Rating (CSR) assigns sovereign rating of AA $_{(pi)}$ to Kuwait

Capital Standards Rating Co. (CSR) has assigned a long-term local and foreign currency sovereign rating of AA$_{(pi)}$ to the State of Kuwait. The national rating of Kuwait is AAA$_{kw}$, indicating the highest rating that can be achieved by any issue/issuer in Kuwait on the country's national rating scale by CSR. The outlook for the rating is stable. This is an unsolicited, first time rating assigned to the State of Kuwait by CSR.

Kuwait's sovereign rating reflects the country's large oil reserves, strong financial position and a robust balance sheet owing to the budget surpluses accumulated over the past 13 consecutive years. The huge current account surplus also safeguards against global economic slowdown. However, the rating is mainly constrained to some extent by the slow execution of the development plan, instability during the formation of the new parliament and slow growth in the non-oil sector. The economy's heavy reliance on oil and gas reserves exposes Kuwait to the volatility of the global oil market.

Kuwait's economic growth is underpinned by its extensive oil reserves, which accounts for 6% of the world's proven oil reserves. It is one of the top ten exporters of oil in the world and was the second largest economy in 2011 among the Gulf Cooperation Council (GCC) countries, as per the IMF. Kuwait is also a significant member of the OPEC (Organization of Petroleum Exporting Countries). The increase in oil prices since 2003 has resulted in a significant improvement in Kuwait's economy. According to the IMF, Kuwait's GDP grew by 8.16% in 2011.

The country's economy is highly dependent on the oil sector, which contributed 49.23% to the GDP as of 2010. The oil sector also contributed 93.74% to the total revenues of Kuwait as of 2011. This leaves the country's main revenue source exposed to oil price volatility risk. However, CSR assesses that the country's substantial financial flexibility and the robustness of the budget surpluses provide a protective cushion against oil price volatility.

Table 1: Kuwait Economic Indicators

(Figures in KWD bns)	2007	2008	2009	2010	2011	2012e
Real GDP*	19.66	20.49	18.88	19.36	20.94	22.27
Real GDP growth (%)	6.45%	4.19%	(7.82)%	2.52%	8.16%	6.35%
Nominal GDP*	32.58	39.62	30.49	34.37	44.41	48.54
Real GDP per capita*	5783.24	5951.79	5418.32	5404.05	5686.35	5883.27
Gross Investment/GDP (%)	20.46%	17.63%	17.97%	20.26%	15.59%	17.29%
Unemployment Rate (%)	1.70%	1.67%	1.64%	2.07%	2.07%	2.07%

Source: IMF & CSR research
National Currency (Kuwaiti Dinar)

The increase in oil prices over the past several years is one of the most important factors that contributed to the country's budget surpluses. The government estimates its oil revenues at USD 65 per barrel, which is significantly lower than the global oil prices recorded over the last couple of years. This resulted in record budget surpluses over the past 13 consecutive years. The accumulation of surpluses strengthened the country's balance sheet and supported the government in controlling its debt. Kuwait's economy is highly influenced by the volatile global oil market and the production levels imposed by OPEC. CSR believes that the current high dependence on oil income necessitates the non-oil sector to grow at a faster pace in order to contribute to the economic growth in the long run.

As of 2011, Kuwait's oil exports averaged at 92.78% of the total exports for the past five years. The government revenues from the oil sector are channeled through its investment arm Kuwait Investment Authority (KIA). Nearly 48.00% of Kuwait's invested portfolio is in the GCC states, as per the IMF. However, the gross investment to GDP percentage has a declining trend since 2007 primarily due to higher growth in GDP as compared to investments. Additionally, a major portion of the government's investments are in markets that are interconnected. CSR expects Kuwait to remain a net creditor in the long-run.

According to the IMF, Kuwait's GDP is expected to grow by 6.35% in 2012, primarily driven by the increased demand and expected increase in oil production. The slight slowdown in the GDP growth in 2012 as compared to 2011 is mainly attributed to the minor political tensions in the country along with the delays in the implementation of the four-year development plan. CSR expects Kuwait's economy to continue its dependence on oil revenues in the upcoming years.

Kuwait's general gross debt remained low as compared to its GCC peers at 8.06% of GDP in 2011. Given the strong liquid position of the country, Kuwait's net debt is not expected to increase in the near to medium term. The banking sector of Kuwait is well capitalized (Market Capitalization- USD 38.08 bn as of 2012). CSR considers Kuwait's banking sector to be stable, supported by regulations and oversight of the Central Bank of Kuwait (CBK). However, Kuwait has a loose monetary policy, due to which the discount rate has been declining since the past 5 years. The discount rate was further lowered to 2.00% in 2012, in order to promote low cost credit in the market and improve business environment. This led to a 5.00% increase in the total loan portfolio of Kuwait's banking sector in 2012.

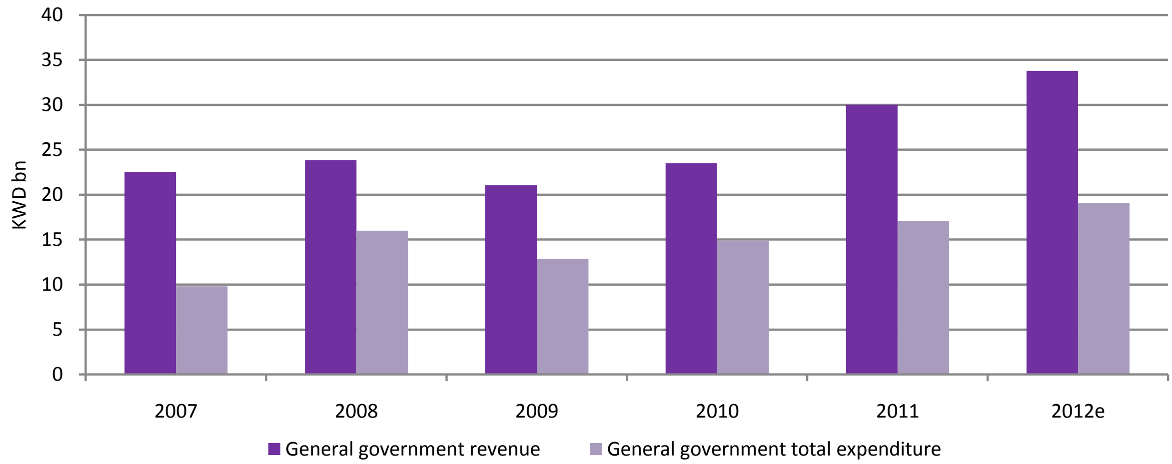
Another positive aspect of the country's economy is related to its Sovereign Wealth fund, which is considered as one of the 10 largest funds in the world. The total value of the fund is estimated to be USD 261.47 bn as of March 2012 and it ranked 7th in the world.

Kuwait's ongoing efforts to diversify the economy have resulted in the creation of the Kuwait Development Plan (KDP). The plan includes several major projects like Silk City, a major container harbor, railways and a metro system along with additional spending on infrastructure and services; particularly health and education. The KDP has been developed and approved to diversify Kuwait's economy by transforming the country into a regional financial and trade hub. However, the implementation of the KDP is currently constrained by the red-tape in Kuwait. Furthermore, the high geopolitical risks in the Arab region are mitigated by the strategic relations of Kuwait with the United States of America (USA) and the European Union (EU). Kuwait's institutional framework is also in a developing stage and is expected to improve with development and further improvement in the business environment of the country. Should the current elected government show stability, the KDP implementation may become active, which in turn may aid the economy to diversify.

The non-oil sector can only gain momentum if there is an increase in the government spending on infrastructure and on the transformation of Kuwait into a financial center with efficient trade facilities. However, growth in the non-oil sector may not materialize if the focus of the government spending is on consumption and public sector wages. The manufacturing sector plays a vital role in developing the economy and providing a boost to the private sector. Kuwait's industrial manufacturing sector is considered to be under-developed compared to other GCC countries. CSR assesses that further delays in the implementation of the KDP may impose a threat to the non-oil sector's future economic growth.

Kuwait's total expenditure is distributed among capital and current expenditures, which accounted for 12.79% and 87.20%, respectively. Compensation to employees[1] has been on an increasing trend since 2007, reflecting the high wages of the public sector. Wages and salaries account for 26.68% of the current expenditure of Kuwait, which has more than doubled in the last 6 years. CSR observes that the rising trend of wages and salaries, if continued, may exert pressure on government spending in other areas of importance such as the KDP. In addition, 55.75% of the current expenditure is accounted for government subsidies and transfers as of 2011. Should the government be able to create a balance between current and capital expenditures in the future, the non-oil economic development of the country could boost.

Figure 2: Revenue and Expenditure Analysis



Source: IMF & CSR Research

Furthermore, the unemployment rate in Kuwait has been low at 2.07% in 2011 and is expected to remain low in the near term. The government is also making efforts to encourage the private sector to employ more local workforce. Currently most of the local workforce is employed in the public sector. CSR believes that this may not continue in the long run due to the privatization of the public sector.

The outlook for Kuwait's sovereign rating is stable. CSR believes that the country's robust financial strength and huge oil resources far outpace the weaknesses it faces from political instability. According to the IMF, Kuwait's GDP is expected to grow by 6.35% in 2012. The implementation of KDP, which is expected to diversify the economy and a drive of improvement in the country's institutional reforms, may positively impact the rating in the future. However, increasing political tensions and further delays in the implementation of KDP could create a potential for a rating downgrade.

Kuwait has a strong financial position primarily driven by its substantial oil income; perhaps this has resulted in slow growth in the non-oil sector. Nevertheless, Kuwait has scope for economic progress with improvement in the institutional reforms, which may create a healthy investment climate and enhance business competitiveness. The

[1] Kuwait has been ranked 3rd with respect to Per Capita Income as per World Bank, as of 2011.

Financial Stability Law and the development of Capital Market Authority Law are expected to further enhance the growth prospects in the country.

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The principal methodology used in rating the State of Kuwait is "CSR's Sovereign Methodology", and it can be found at www.capstandards.com in the 'methodologies brief' sub-directory under the Rating tab.

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