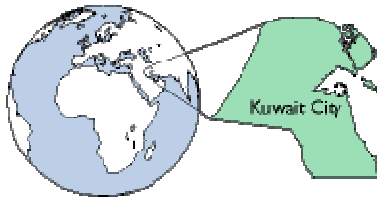


COUNTRY REVIEW

Kuwait



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ANALYST: Andrew Atkinson

EULER HERMES COUNTRY RISK GRADE: BB

**Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.**

Strengths

- World's fourth largest proven oil reserves (8.2% of global resources)
- Strategic importance in troubled region and "major non-Nato ally" of the US
- Despite continuing problems in Iraq, removal of Saddam Hussein improved long-term security
- High incomes
- Strong oil revenues in times of high oil prices generate large fiscal and current account surpluses and "excess" earnings are invested in foreign assets and used to supplement an oil account that is for the use of future generations
- Position as net external creditor largely mitigates transfer risk
- Favourable external debt ratios
- Generally supportive structural business environment

Weaknesses

- Combative political system has resulted in inertia in the reform programme
- Industry is capital intensive and job creation is inadequate for a growing population. This has social repercussions as the unemployed seek alternative voices to vent their frustrations, including association with militant Islamic groups
- High degree of public ownership and control of oil and gas sectors results in a weak private sector, thereby limiting job prospects
- Vulnerability of oil installations and foreign personnel to attacks by Islamic extremists or other terrorist groups or vested interests
- Regional volatility and uncertainty, including Iraq and Iran
- Exposure to oil price and output cycles has contributed to growth volatility and stagnation of real incomes over the long term

Country Risk Assessment

Ratings	Kuwait		Median Grade BB	Oman	Peers	
	Latest	Previous			Bahrain	UAE
Systemic Political Risk:	P2-	P2-	P2-	P2-	P2-	P2+
Systemic Economic Risk:	E3	E3	E3	E3	E3	E2
ME rating:	ME3	ME3	ME3	ME3	ME3	ME2
<i>Structure</i>	5.0	4.5	3.8	5.0	5.7	5.0
<i>Policy</i>	5.6	4.2	3.8	3.8	3.8	3.8
<i>Solvency</i>	1.0	1.0	1.3	1.0	1.3	1.0
<i>External Liquidity</i>	1.7	1.0	2.3	1.3	2.3	1.3
SBE rating:	SBE2	SBE2	SBE2	SBE2	SBE2	SBE2
COUNTRY GRADE:	BB	BB	BB	BB	BB	A

Nomenclature:
 Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).
 Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).
 ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).
 The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).
 SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).
 Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile

Capital city:	Kuwait City
Population:	2.85 mn (2007)
GDP:	USD 112073 mn (2007)
Currency:	Dinar (KWD)
Form of state:	Emirate
Head of government:	Sheikh Sabah al-Ahmad al-Jaber al-Sabah
Next elections:	National Assembly; scheduled May 2012

Major Industries (% of GDP at market prices, 2007e)		Global Assumptions	2008	2009f
Agriculture	0.5%	Real GDP grth (% yr/yr) *	1.0	-0.6
Industry	57.0%	Inflation (% , av) *	3.4	1.5
Services	42.5%	Dated Brent (USD/b)	98.0	50.0
		* Major economies		

Main Exports (% of total, 2007e)		Main Imports (% of total, 2007e)	
Crude oil	95.0%	Consumer goods	41.0%
		Capital goods	23.0%
Lead Export Markets (% of total exports, 2007e)		Lead Import Markets (% of total imports, 2007e)	
Japan	14.0%	US	14.0%
South Korea	12.0%	Japan	9.0%
Singapore	7.0%	Germany	8.0%
US	6.0%	China	8.0%

Basic indicators

Selected economic indicators	2005	2006	2007	2008e	2009f
Nominal GDP (USD mn)	80,799	101,645	112,074	148,816	119,040
Population (mn)	2.70	2.78	2.85	2.92	2.99
GDP per capita (USD)	29,926	36,563	39,324	50,964	39,813
Real GDP growth (% yr/yr)	11.3	6.3	5.0	8.0	2.5
Inflation (% , average)	4.1	3.0	5.5	11.5	6.5
Fiscal balance (% of GDP)	39.4	29.1	42.4	35.0	4.7
Current account balance (% of GDP)	42.5	50.7	42.4	39.6	10.5
External debt/GDP (%)	20.4	24.6	29.9	25.5	31.5
External debt/Exports of goods & services (%)	27.0	30.8	37.6	34.5	75.0
Debt-service ratio (%)	1.5	1.8	3.4	2.7	6.6
Foreign exchange reserves (USD mn)	8,380	12,178	16,286	16,544	15,000
Import cover (months)	4.3	5.6	5.4	4.4	4.0
Exchange rate assumption, KWD:USD (av)	0.29	0.29	0.28	0.27	0.27
f: CRU central forecast					

Sources: Central bank, IMF, World Bank, Euler Hermes Country Risk Unit

Political Stability

After a lengthy illness, Sheikh Jaber al-Ahmed al-Jaber al-Sabah died in January 2006. However, his replacement, Sheikh Saad al-Abdullah al-Sabah, also had a medical history and the PM, Sheikh Sabah al-Ahmad al-Sabah, effectively remained as manager of daily governance—he had been the de facto ruler for several years. After less than two weeks in office and following cabinet and parliamentary pressure, Sheikh Saad had to step down and Sheikh Sabah officially took over as head of state. By tradition, the role of head of state rotates between two branches of the al-Sabah family (al-Salem and al-Jaber) but these recent manoeuvres now call that succession policy into question. Nevertheless, the al-Sabah ruling family remains in control of all the key levers of power and is likely to do so for several years to come.

The ascent of Sheikh Saba ensured that there would not be a significant change in policy direction and, specifically, that Kuwait would retain its pro-West stance. Policy continuity has been seen in pledges to continue with Project Kuwait—the development of northern oilfields with international involvement—and parliamentary reforms—women were enfranchised in 2005. However, opposition from the National Assembly (parliament) has created a deep division between the legislative and executive branches of government and delayed progress in these key areas.

The ineffectiveness of parliamentary procedures results in periodic government resignations to avoid votes of no confidence in ministers, suspension of the National Assembly and rule by emiri decree. The parliamentary system (and associated impotency of governments):

- provides undue influence to sectarian and tribal groups who, allied with Islamists, liberals and independents, block government initiatives;
- prevents effective reform initiatives; and
- the Kuwaiti partial-democracy model is seen by other regional states, particularly elsewhere within the GCC grouping, as a failure and therefore provides further reasons for those countries not to advocate widespread political reforms.

Without fundamental changes it is difficult to envisage a more effective political environment. However, the al-Sababs are unlikely to countenance deep reforms as these could erode their power base. As a result, frequent changes in government can be expected and policy implementation is likely to remain largely stultified. Parliamentary effectiveness will therefore remain elusive.

In general, Kuwaitis are supportive of strategic ties with the US—which remains guarantor of external security—because many have memories of the Iraqi invasion and occupation. Accordingly, the emirate was able to provide the land base from which the US launched the Iraq War, without a significant backlash from public opinion, as occurred in Saudi Arabia. Indeed, the collapse of the Saddam Hussein regime lifted a long standing security threat and improved long-term trade and investment prospects, despite current uncertainties in relation to Iraq's future. The issue of debt and reparations owed by Iraq has yet to be resolved. Other regional relations tend to be good. In particular, ties with Saudi Arabia remain strong and both countries are members of the Gulf Co-operation Council, which formed a customs union in 2003 and seeks to forge a full monetary union by 2010, although this timetable appears overly optimistic.

Economic Stability

Kuwait possesses the world's 4th largest proven oil reserves (8.2% of global resources) and, at current rates of extraction, its oil will last for another 100 years. Similarly, gas reserves have a life time of over 100 years. Accordingly, oil and gas production dominate the economy. Hydrocarbons account for over 40% of GDP, 85% of government revenues and around 95% of export receipts. Such a narrow output base leaves the economy highly vulnerable to world oil price cycles and to the output quotas agreed by the member countries of OPEC. As a result, real per capita income growth remains limited. Nevertheless, nominal GDP per capita of USD40,000-50,000 classifies the country within the World Bank's high-income range.

The volatility in the international oil market translates directly into economic growth. Annual real GDP expanded by only 0.3% in 1990-2002 (although this period covered the Iraqi invasion) but over 10% in 2003-07, over which period oil prices more than doubled. Oil prices peaked in early July 2008 (Benchmark Brent at over USD145/barrel) and we estimate real GDP will have grown by around 8% last year. To date in 2009, with a severe global slowdown as background, oil prices average only USD45/b and, consequently, we forecast real growth of only 2.5% this year.

As in other GCC states, official budget statements are not to be taken at face value. They are typically based on highly conservative oil price estimates and historically overstate expenditure while excluding returns on foreign assets. We estimate that annual fiscal surpluses were equivalent to over 36% of GDP in 2005-08 but, with significantly weaker oil prices, the surplus will be reduced this year. The fiscal account remained in surplus (1.7% of GDP) even in 1998 when oil prices fell below USD10/b and, accordingly, we forecast that there will be a budget surplus this year, although “only” around 5% of GDP. As a result of previous oil-related “windfall” earnings, a substantial foreign asset base has been created and Kuwait is a net creditor nation. Estimates of the true value of the emirate’s undisclosed investments vary, but we consider it likely that the Reserve Fund for Future Generations (RFFG)—to which 10% of oil income is allocated annually—the General Reserve Fund and foreign assets of parastatals are in excess of USD300bn. Despite this strong position, the authorities have attempted to introduce liberalisation of the economy in an attempt to boost private sector growth and reduce the burden on the state as the primary employer of nationals. There are increasingly tight regulations/quotas in relation to employment of nationals, rather than expatriate workers. Extensive foreign participation in the upstream oil and gas sectors remains unlikely in the short term, although the petrochemicals and financial sectors should be areas of increased foreign investment and activity. Overall, however, economic reforms will remain slow, partly reflecting the conservative nature of the ruling family and also because of the relative wealth of the country and its ability to generate large foreign exchange receipts through exports of oil and gas.

Unlike the other GCC currencies, the Kuwaiti dinar is pegged against a trade-weighted basket. In practice, with oil representing the bulk of export earnings and traded internationally in USD, monetary policy is similarly aligned to actions of the Fed. In 2008, the dinar appreciated on average against the USD to around USD1:KWD0.27 but, with projected USD strengthening, dinar depreciation is likely in 2009, although continuing fiscal and current account surpluses and large foreign assets suggest that strong downward pressure on the currency is unlikely. Monetary policy will continue to focus on maintaining a positive interest rate differential with US Fed rates. Annual average inflation will fall this year after recording an estimated 11.5% in 2008. Nevertheless, average consumer price inflation is forecast at 6.5% this year.

As with the fiscal accounts, surpluses in the current account are magnified in times of high oil prices. Accordingly, in 2005-08 we estimate average surpluses were equivalent to over 42% of GDP and, even with significantly lower oil prices, the surplus is forecast at 10% of GDP in 2009. Official FX reserves are currently approximately USD16.5bn, providing import cover of over four months. Given that a considerable proportion of FX earnings is invested in foreign assets or transferred to the RFFG and other long-term accounts, the external position will remain comfortable.

Structural Business Environment

The structural business environment is sound and generally above average of the countries we assess. The Heritage Foundation’s 2009 Index of Economic Freedom (IEF) ranks Kuwait as the 50th ‘freest’ economy (out of 183), with good scores for fiscal, labour and monetary freedoms. However, the IEF notes that, while barriers to trade are low, government involvement in the economy is high and foreign investment remains heavily regulated and subject to sector restrictions. Moreover, property rights are difficult to guarantee, given the government’s authority over the courts and tendency to favour nationals over foreigners. The latest World Bank’s Doing Business survey ranks Kuwait 52nd out of 181 economies in terms of overall ease of doing business. Enforcing contracts in Kuwait is quicker (significantly) and less expensive than the regional average but involves more procedures. Similarly, the cost of closing a business is less onerous than the regional average and the rate of recovery is higher but it takes longer to resolve bankruptcies in Kuwait than elsewhere in the area. Transparency International’s Corruption Perceptions Index for 2008 ranks Kuwait as 65th with Cuba out of 180 countries, above Georgia, Ghana and Colombia but below Namibia, Croatia and Tunisia.

The banking system is relatively well developed and provides a full range of financial services. The state continues to play a central role in the banking industry, despite pledges to privatise the sector. There have been improvements in the regulatory and supervisory roles of the central bank, although this did not prevent large losses at the second-largest commercial bank at the end of 2008, partly as a result of the global financial crisis. Nevertheless, the central bank has large financial assets at its disposal and overall liquidity is unlikely to be put in question.

Andrew Atkinson

London: +44 (0)20 7860 2577

Charts

