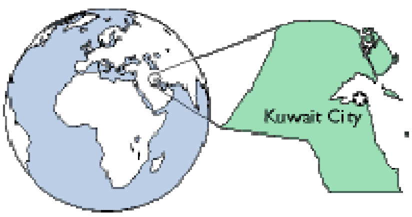
COUNTRY REVIEW

Kuwait



27 August 2010

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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 fifth largest proven oil reserves (7.6% 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 over the long term

Key Risks

- Collapse of global demand for energy and associated large fall in oil prices

Country Risk Assessment

Ratings	**Kuwait**		**Median**		**Peers**	
	Latest	**Previous**	**Grade BB**	**Qatar**	**Bahrain**	**UAE**
Systemic Political Risk:	**P2-**	**P2-**	**P2+**	**P2-**	**P2-**	**P2+**
Systemic Economic Risk:	**E3**	**E3**	**E3**	**E3**	**E3**	**E3**
ME rating:	ME3	ME3	ME3	ME3	ME3	ME3
Structure	*5.0*	*5.0*	*4.0*	*5.0*	*5.0*	*5.7*
Policy	*4.8*	*5.6*	*4.3*	*2.8*	*5.2*	*3.9*
Solvency	*1.0*	*1.0*	*1.3*	*2.8*	*1.9*	*1.9*
External Liquidity	*1.9*	*1.7*	*3.3*	*3.2*	*2.8*	*3.3*
SBE rating:	SBE2	SBE2	SBE2	SBE2	SBE2	SBE3
COUNTRY GRADE:	**BB**	**BB**	**BB**	**BB**	**BB**	**BB**

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:	2.99 mn (2009)
GDP:	USD 116412 mn (2009)
Currency:	Dinar (KWD)
Form of state:	Emirate
Head of government:	Sheikh Sabah al-Ahmad al-Jaber al-Sabah
Next elections:	National Assembly; scheduled May 2013

Major Industries (% of GDP at market prices, 2009e)	
Agriculture	0.5%
Industry	48.5%
Services	51.0%

Global Assumptions	2010f	2011f
World GDP growth (% yr/yr)	3.3	2.9
Inflation (%, average)	1.2	1.4
Dated Brent (USD/b)	75.0	70.0

Main Exports (% of total, 2009e)	
Crude oil	95.0%

Main Imports (% of total, 2009e)	
Consumer goods	40.0%
Capital goods	20.0%

Lead Export Markets (% of total exports, 2009e)	
Japan	16.0%
South Korea	15.0%
India	11.0%
US	7.0%

Lead Import Markets (% of total imports, 2009e)	
US	12.0%
China	10.0%
Germany	8.0%
Japan	8.0%

Basic indicators

Selected economic indicators	2007	2008	2009	2010f	2011f
Nominal GDP (USD mn)	114,696	148,024	116,413	134,940	148,750
Population (mn)	2.85	2.92	2.99	3.04	3.09
GDP per capita (USD)	40,244	50,693	38,934	44,420	48,195
Real GDP growth (% yr/yr)	4.4	6.4	-2.0	3.5	5.0
Inflation (%, average)	5.4	10.6	4.0	3.5	3.0
Fiscal balance (% of GDP)	41.4	12.6	23.9	17.9	11.8
Current account balance (% of GDP)	36.8	40.7	24.6	29.6	30.3
External debt/GDP (%)	29.2	25.0	27.5	23.0	21.5
External debt/Exports of goods & services (%)	37.6	32.9	44.5	34.0	33.8
Debt-service ratio (%)	3.4	2.7	4.4	3.3	3.0
Foreign exchange reserves (USD mn)	16,286	16,611	17,608	18,000	18,500
Import cover (months)	5.4	4.8	6.4	5.4	5.2
Exchange rate assumption, KWD:USD (av)	0.28	0.27	0.29	0.29	0.29
f: CRU central forecast					

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

Political Stability

By tradition, the role of **head of state rotates between two branches of the al-Sabah family (al-Salem and al-Jaber)** but that succession policy appears to be diluting in favour of a more-pragmatic stance whereby ability rather than strict family connections dictate the channel for a hand over. Who ever comes to the fore, **the al-Sabah ruling family will remain in control of all the key levers of power** and is likely to do so for several years to come.

The ascent of **Sheikh Sabah al-Ahmad al-Jaber al-Sabah** in 2006 ensured that there would not be a significant change in policy direction as he had been premier and **de facto ruler for several years**. Specifically, Kuwait retained its **pro-West stance** but policy continuity was also evident 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 some 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-Sabahs are unlikely to countenance deep reforms as these could erode their power base. As a result, frequent changes in government can be expected and formal 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 fully. 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 (GCC)**, which formed a customs union in 2003. The GCC seeks to forge a full monetary union with a common currency, although Kuwait has indicated that it is unwilling to follow this path in the short term.

Economic Stability

Kuwait possesses the **world's fifth largest proven oil reserves (7.6% 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 in excess of USD40,000 classifies the country within the World Bank's high-income range**.

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 real GDP expanded by 6.4% in that year. **In 2009, with a severe slowdown in key export markets as background** and oil prices averaging USD63/b after USD98.5/b in 2008—and averaging only USD45/b in Q1 2009—**real GDP growth recorded a contraction of around 2%** that year. Only a moderate recovery is now forecast for the world economy in 2010-11 but we **forecast that Kuwaiti GDP will expand by 3.5% this year and then 5% in 2011, fuelled by government spending.**

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. The fiscal account remained in surplus (1.7% of GDP) even in 1998 when oil prices fell below USD10/b and, accordingly, **large budget surpluses equivalent to 20-40% of GDP were regularly recorded from 2000 to 2007 and even in 2009 we estimate that a surplus of around 24% of GDP was registered.** We forecast that annual fiscal surpluses will be equivalent to **18% and 12% of GDP in 2010 and 2011, respectively, reflecting tight energy markets and high government expenditure**. As a result of 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 USD350bn**. 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. Continuing fiscal and current account surpluses and large foreign assets suggest that strong downward pressure on the currency is unlikely and we **forecast relative stability in the exchange rate** and annual average inflation will fall from a high average of 10.6% in 2008 to around 3% in 2011.

As with the fiscal accounts, **surpluses in the current account** are magnified in times of high oil prices. Accordingly, surpluses **equivalent to 10-40% of GDP** are recorded, even in years of relatively low oil prices. Official FX reserves are currently USD17.6bn (Q1 2010), providing **import cover in excess of five 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 highly comfortable.

Structural Business Environment

The structural **business environment is sound and generally above average** of the countries we assess. The Heritage Foundation’s 2010 Index of Economic Freedom (IEF) ranks Kuwait 42 out of 179 countries, below Qatar, Barbados and Mexico but above Oman, Israel and Peru. The IEF indicates good scores for fiscal, labour and monetary freedoms but suggests 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 61 out of 183 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 than elsewhere in the area. Transparency International’s Corruption Perceptions Index for 2009 ranks Kuwait 66 out of 180 countries, above Ghana, Bulgaria and Greece but below Saudi Arabia, Tunisia and Croatia.

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. Although there have been improvements in the regulatory and supervisory roles of the central bank, the **financial system was adversely affected by the recent global financial crisis**, with the third largest bank receiving state funds and the government providing deposit guarantees. In addition, the largest investment company went into default and underwent a debt restructuring.

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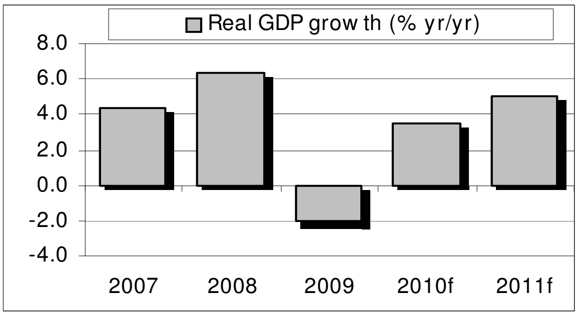
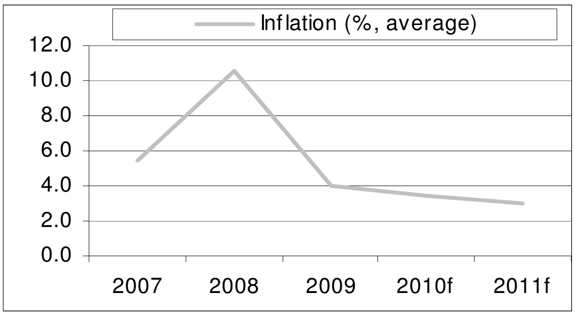
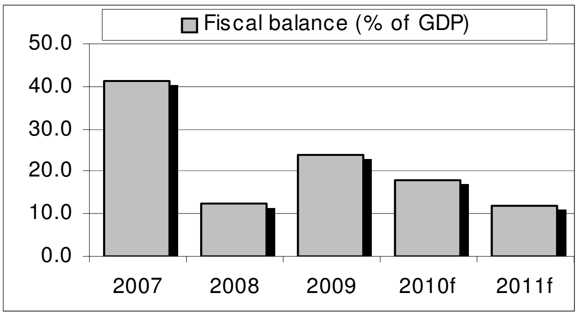
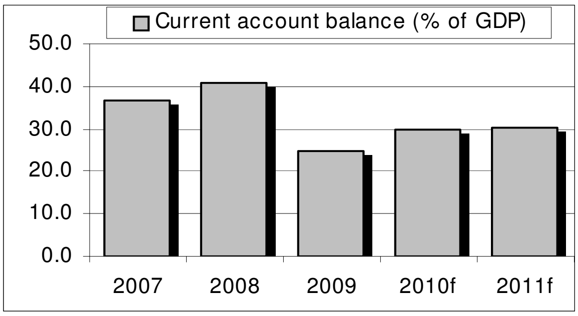
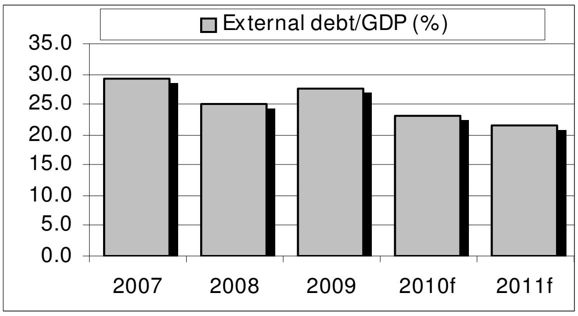
Charts


Real GDP growth (% yr/yr)
8.0
6.0
4.0
2.0
0.0
-2.0
-4.0
2007
2008
2009
2010f
2011f

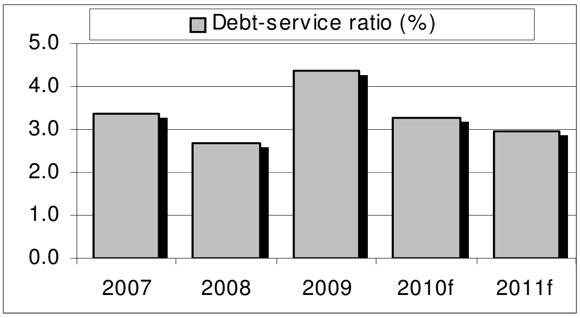

Inflation (%, average)
12.0
10.0
8.0
6.0
4.0
2.0
0.0
2007
2008
2009
2010f
2011f

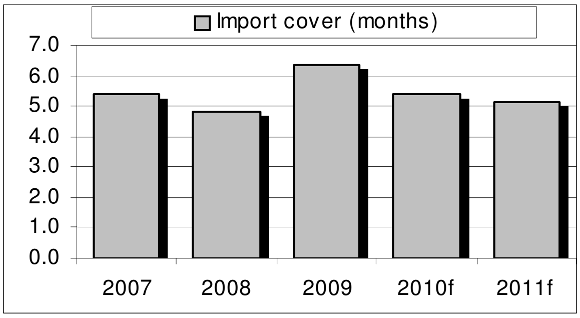

Fiscal balance (% of GDP)
50.0
40.0
30.0
20.0
10.0
0.0
2007
2008
2009
2010f
2011f


Current account balance (% of GDP)
50.0
40.0
30.0
20.0
10.0
0.0
2007
2008
2009
2010f
2011f


External debt/GDP (%)
35.0
30.0
25.0
20.0
15.0
10.0
5.0
0.0
2007
2008
2009
2010f
2011f


External debt/Exports of goods & services (%)
50.0
40.0
30.0
20.0
10.0
0.0
2007
2008
2009
2010f
2011f


Debt-service ratio (%)
5.0
4.0
3.0
2.0
1.0
0.0
2007
2008
2009
2010f
2011f


Import cover (months)
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
2007
2008
2009
2010f
2011f