The Experience of Monetary Policy in Kuwait and its Directions During the Nineties in Light of the Main Recommendations of the Joint Economic Report [(1)]

I am very pleased to meet with you today to highlight monetary policy directions in light of both the main recommendations contained in the Joint Economic Report and the basic principles of long-term development strategy. As these recommendations and ends represent the State's general policy, particularly its economic aspect, my address to you today on the future outlook of monetary policy directions in Kuwait is but a mere framework of that policy during the new stages of the Kuwaiti economy, in light of economic policy directions and the objectives and ends that the State is seeking to achieve through interim targets and long-term goals.

As an introduction to this subject, I will outline briefly the general framework of the monetary policy and the limits of its action, followed by a demonstration of the main features of the experience of monetary policy in Kuwait from the mid-eighties until the present time, and finally a brief discussion of the directions of monetary policy in Kuwait during the nineties.

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First: Introduction

1- Those concerned with monetary policy issues realize that there are limits to the performance of this policy. Though these limits cannot be overlooked even by the economies of developed countries that have diverse economic structures and long experience in the field of monetary policy, the features of these limits remain more evident in the Kuwaiti economy, not only as a developing economy but also as an economy with specific features and characteristics. Therefore, as much as monetary policy affects local economic conditions, these local economic conditions have their counter effects on the framework of monetary policy, which cannot be overlooked or underestimated. This fact underlines the importance of introducing changes in the structural characteristics of the Kuwaiti economy; this is a course that currently exists and is reflected in both the long-term development strategy and the recommendations of the Joint Economic Report. It also confirms the importance of coordination between monetary policy and other economic policies, issues that should be taken into account by the directions of monetary policy in Kuwait and its framework during the nineties.

2- Our meeting today is not intended to discuss the theoretical aspects of monetary policy. However, it may be appropriate to indicate briefly that monetary policy, as a part of a comprehensive planning process, needs to identify the complementary aspects of the framework of this policy, which consists of a number of ends, instruments, intermediary targets and indicators.

The ends include the well-known ultimate aims of economic policy, represented in realizing stability in price levels, high rates of employment, higher rates of economic growth and the elimination of imbalances in the balance of payments, including the protection of currency values abroad through maintaining stable levels of exchange rates. There are other aims not often included among the traditional aims, the most important of which is maintaining the soundness of the banking system.

The instruments include means that are available to monetary authorities and that are used to achieve the ultimate aims. Central banks generally use a number of key instruments such as changes in the ratio of legal reserves, the discount rate or the central bank rate, and open market operations. Very often, these instruments are enhanced by using other supplementary instruments, known as direct instruments, generally in the form of instructions issued by the central bank. Direct instruments are much used by developing countries because the nature of the economic problems of these countries and their economic conditions do not allow their monetary authorities to be quite free in applying traditional instruments of monetary policy.

The <u>intermediate targets</u> of monetary policy represent a number of variables constituting a connecting link between the instruments of monetary policy and the ultimate aims. These variables include money supply, the monetary base, interest rates, available credit and any other variable the monetary authority deems fit as an intermediate target for its monetary policy. This point, though important for the work of monetary policy, is still a controversial issue among economists.

However, the determination of intermediate targets of monetary policy should be made in light of the structural and behavioral characteristics of the concerned economies and any changes in them, taking into account the nature and the reality of aims to be achieved by monetary authorities and the priorities of these aims. There are strong reasons to believe that the effects of monetary procedures can be transferred through several channels and therefore the estimation based on all relevant data and factors still remains the best model for formulating monetary policy.

Monetary policy <u>indicators</u> are a number of variables representing a supervision system used by monetary authorities to ensure that their procedures are on the right track. Therefore, it is important to choose indicators the changes in which reflect a high degree of true response to the applied monetary measures. In Kuwait there is a wide range of indicators like changes in private sector deposits, volume of demand for bank credit, changes in interest rates by which banks apply for subscription to treasury bills and any other banking and financial data considered valid as indicators to validate monetary procedures.

3- We, as a monetary authority, know well that while we are discussing the framework of monetary policy in the manner shown above, we have a special situation in Kuwait. We realize the nature of the difference among our economic problems, and that our monetary policy has its own features that should cope with the nature of these problems and help fulfill the desired aims.

Thus, identifying the theoretical problems relating to the aspects of monetary policy action, and following up the developed countries' experience in this respect, fall within a perspective for better understanding of the special reality of the Kuwaiti economy, including its main features, such as being a one-source economy, being a highly-exposed small economy depending on imports to meet the major part of investment and consumer demand, the high relative importance of public expenditure in economic activity, the imbalance in the sectoral structure of the domestic product, and the nature of its labour market. All these features have their effects on the behavior of monetary policy in Kuwait, regarding both the nature of its objectives and priorities and the type of instruments and goals that can be chosen in view of many of the existing legal and institutional systems.

4- Though future outlooks for monetary policy in Kuwait have to be based on existing economic grounds, these outlooks cannot be determined apart from past and present experience, a fact which necessitates, while talking about these outlooks, demonstrating briefly the most important features of the present CBK monetary policy, which has more clearly crystallized in the light of recent experience. Such a discussion is not intended to bring out certain events that were effective and important in the development of the mechanism of monetary policy performance, but to identify the challenges and obstacles that were and still are faced by monetary policy in Kuwait and their effects on the framework of monetary policy and its future outlooks. Perhaps the most important among these obstacles are those related to the characteristic of economic exposure and the influence of external changes on it, the necessity of having legal maximum limits for interest rates, and the financial problems the banking system has faced as a result of the difficult debt crisis.

In their discussion of economic development theory both Robert Bouldwin and Gerald Mayer have said: “The past is always with us and controls us. There is only one way to control it, even for a limited extent; that is to realize how things occurred in the past to help us understand their true nature and their relationship with the realities of the present life". Perhaps I can find this statement an appropriate beginning for a demonstration of the experience of monetary policy in Kuwait, taking into consideration factors that have influenced its course during past years.

Second: Main Features of Monetary Policy since the Mid-Eighties

1- Since the mid-eighties the Central Bank of Kuwait has been on a course dictated by the nature of new developments witnessed by the Kuwaiti economy as a result of a number of internal and external effects of the securities market crisis on the whole economic condition, including the emergence of the difficult debt problem as a key issue threatening the financial system in the country. The Central Bank of Kuwait had no alternative but to make the protection of the banking and financial system its top priority and to take necessary measures to identify repercussions of the securities market crisis and prevent the accumulation of its negative effects on both the Kuwait economy and community.

   Based on the priority of this commitment, the Central Bank adopted a number of measures, mainly the intensification of banking supervision, through inspection of banks and other financial institutions subject to its supervision, in order to fully understand the nature and size of the financial problems faced by these institutions.

In December 1985, the Central Bank of Kuwait provided banks with instructions regarding rules and principles for classifying credit facilities and calculating their provisions and profits. These instructions aimed at identifying the actual volume of the debt problem on technical and objective bases. The policy of debt classification was the basis for the "Difficult Credit Facilities Settlement Program" issued on August 10, 1986, including various regulations regarding the settlement of difficult credit facilities; the Government's obligation to safeguard banks' financial positions in order to protect shareholders' equity as of December 31,1985 and to maintain depositors' rights at these banks; and a number of rules related to providing deficit banks with financial support. The Central Bank's efforts in the application of the settlement program and the rules set for bank use of support funds have been highly effective in improving the performance levels of these banks.

Under the authority of the ministerial resolution issued on January 15, 1987, regulating the Central Bank's supervision of investment companies, the Central Bank was able to obligate many of these companies to consolidate their financial positions on the basis of criteria applied in light of conclusions and recommendations for taking necessary corrective measures following inspection and assessment of the financial positions of these companies.

2- As a result of the downward trend taken by interest rates on major foreign currencies starting from the second half of 1986, the Central Bank of Kuwait set a new structure for interest rates on KD in March 1987 that included a reduction in the maximum limits of interest rates, mainly reducing the interest ceiling on productive lending for up to one year to 6% per annum, and setting an interest ceiling on non-productive loans of up to one year at 7.5% per annum. Interest rates for more than one year were left to be determined on the basis of a margin not exceeding 1% above the prevailing interest rate on KD transactions in the local inter-bank market.

This new structure contained new directions for monetary policy on the level of interest rates, notably putting an end to the inactivity of the previous structure of interest rates which had been applied for more than 10 years, in addition to excluding the security element as an effective factor in rendering loans at special interest rates. This was a direction dictated by the lending experience of the credit system during recent years and a direction to urge banks not to concentrate on the security element as a major factor when taking their decisions on financing several economic activities.

3- The framework of monetary policy in Kuwait took a new trend in harmony with the behaviour of the macro-economy due to a major change witnessed by the economy after the severe decline in oil revenues, leading to deficits in the general budget, which obliged the State to choose the method of deficit financing by resorting to public borrowing as an experience witnessed by the Kuwaiti economy for the first time since November 1987 through the issuance of treasury bills and bonds.

Besides the role played by the program of public debt instruments in financing the budget deficit and providing new investment venues to the banking system, investment companies and other private sector companies and individuals, through which the KD surplus was absorbed, the public debt system has provided the Central Bank with a new instrument to regulate liquidity levels and realize stability in the money market both through the primary market for treasury bills and bonds and through Central Bank intervention in open market operations, buying and selling these bills and bonds. For example, from November 1987 through January 24, 1990, the Central Bank of Kuwait offered 90 issues of treasury bills and bonds totalling KD 10 billion. On January 20, 1990, the outstanding balance of these issues reached KD 2235 million, which is still less than the maximum limit of public borrowing, totalling KD 3 billion. The subscription ratio of these issues was very high, exceeding 400% for some issues. Since treasury bills are issued by auction, the Central Bank uses the rates quoted by parties authorized to subscribe as an important indicator of the prevailing monetary condition, and this has provided the Central Bank with more ability to act to regulate liquidity levels and take measures necessary to realize stability in the money market through open market operations by buying and selling treasury bills.

As further explanation, I point to the volume of Central Bank operations in the open market, which had reached KD 1839 million during the period from January to December 1989, i.e. a monthly average of KD 153 million. Through these operations, the Central Bank was able to realize marked stability in the money market. In addition, the Central Bank used a repurchase agreement system as a means to cover those daily liquidity requirements faced by banks as a result of unexpected exposure in their accounts with the Central Bank.

During the same period, the number of repurchase agreement transactions reached 225, the value of which exceeded KD 1.6 billion. The Central Bank's presence in the money market was maintained through other instruments of intervention, such as discount and swap operations, to regulate liquidity levels. But the Bank's intervention through these instruments took a trend based on qualitative development in using these instruments, not as channels to provide banks with permanent liquidity, as the case was during the past years when these instruments were mainly used to supply banks with liquidity, within an objective aiming at the protection of interest rate structure.

4- Monetary policy with regard to interest rates witnessed another change when the Central Bank implemented, in December 1988, a new KD interest rate structure which is highly flexible in responding to fiscal and monetary developments. According to this structure, the discount rate declared by the Central Bank became a pivotal rate around which the deposit and lending interest rates fluctuate within certain margins. The new interest rate structure, which raised interest rates, was a result of the upward trend in interest rates on major foreign currencies, which appeared more clearly in the beginning of the second half of 1988. This trend left the Central Bank with no alternative but to fix the discount rate at a level that resulted in higher interest rates, because the CBK did not have the necessary flexibility for fixing interest rates and in turn for raising these rates gradually.

Compared to the previous structure, the new structure has characteristics that reflect a new stage in the development of monetary policy regarding interest rates. The first characteristic is its flexibility, as the CBK can move as necessary to adjust interest rates through adjusting the discount rate. The second characteristic is that it involves an increase in KD interest rates, taking into consideration the changes in international interest rates. This characteristic is imposed by the nature of the Kuwaiti economy as a free economy with no restrictions whatsoever on foreign transfers, in addition to its strong relationship with and susceptibility to ongoing developments in the world economy.

However, this nature of the Kuwaiti economy does not mean to underestimate the domestic economy’s requirements whenever allowed by monetary and fiscal considerations. This new trend in regulating the interest rate structure makes it easier for the CBK to defend this structure and achieve monetary stability with a near market-based intervention method. The third characteristic of this new structure is its discarding of the productivity condition to differentiate among lending interest rates. This trend resulted from the experience of past interest rate structures, in which loopholes allowed large borrowers to channel the funds borrowed for productive purposes to other purposes not sanctioned by the banks, especially with the diversified business of clients.

The implementation of the new structure for KD interest rates has produced positive results as it reduced the shift to foreign currencies; moreover, there were some clear indicators of an inflow of funds. Comparing development in private sector deposits a year before the implementation of the structure and a year afterward, it has been noted that private sector KD deposits during the period from November 1987 to November 1988, i.e. a year before the implementation, registered a decline of KD 244 million, i.e. approximately a -8% change. Private sector foreign currency deposits during the same period increased by KD 294 million, i.e. a growth of 37%.

During the period from November 1988 to November 1989, i.e. a year after the implementation, an opposite movement was noticed, where private sector KD deposits increased by KD 382 million, i.e. a growth of 13%, and the growth rate of foreign currency private deposits fell from 37% to 9%. It is worth mentioning that public debt instruments bought by the private sector, excluding banks and investment companies, exceeded KD 220 million by the end of November 1989. This amount might totally or partially have gone abroad or been exchanged with foreign currencies had there not been the current interest rate structure. Such a positive development is reflected in another indicator, concerning the decrease of around 11% in net sales of dollars by the CBK to the banking system. The impact of this indicator was obvious in the foreign assets of the CBK, which had dropped to about KD 300 million before the implementation of the new interest rate structure, and now have exceeded KD 700 million, in spite of the increase of KD 150 million in Kuwaiti imports, which are financed through the banking system.

Further, the implementation of the new interest rate structure has resulted in the adjustment of the deposit maturities structure in favour of longer periods, which has positive aspects regarding the consistency between bank assets and liabilities. On the other hand, the CBK did not detect any negative effects on the demand for credit as a result of the implementation of the new interest rate structure.

The data received by the CBK from commercial banks regarding the credit given to new customers and the increase in limits of credit facilities provided to existing customers show that the amount of credit extended by banks during the period January-November of 1988, i.e. the eleven months before the implementation, had totalled KD 288.9 million, and it reached KD 318.5 million during the corresponding period in 1989, i.e. a growth of 10.25%. We have many other indicators that reassure us about the performance of the new interest rate structure, and about the ability of this structure to achieve the desired objectives without significant adverse effects on the performance of the macro-economy. Undoubtedly, the experience with this structure has given the CBK more ability to steer monetary policy in the field of interest rates in a way that will serve the national economy during the coming stages.

5- Concerning monetary policy in the area of exchange rates, the CBK has continued to determine the KD exchange rate depending on a weighted basket of currencies of countries having commercial and financial relations with Kuwait. This policy came into effect in March

1975 following the cabinet decision to disconnect the then existing linkage (peg) between the US dollar and the Kuwaiti dinar. This policy aims at achieving the highest possible degree of relative stability in the dinar exchange rate against foreign currencies.

To measure the strength of the dinar, it is necessary to monitor the changes in the dinar's effective exchange rate index. In this respect, it was observed that the dinar's effective exchange rate index, calculated according to index numbers at the end of the months from January to December, with the base year of 1979, and according to a basket of currencies of countries with financial and commercial relations with Kuwait, which is not the same as the one used for determining the daily exchange rate of the dinar, recorded an average of 100.9 points in 1986. This average declined in 1989 to 94.4 points, i.e. by 6.4% approximately. We believe that such a change during three years does not nullify the property of stable purchasing power enjoyed by the Kuwaiti dinar.

Third: Directions of Monetary Policy During the Nineties

The previous presentation of the main features of monetary policy in Kuwait indicates the directions of monetary policy in the nineties in light of the major directions of the Joint Economic Committee's report, and with reference to the main bases of the long–term development strategy. Apart from the detailed aspects of the recommendations incorporated in the Joint Economic Report, and also apart from the discussion of interim objective and long-term ends of the development strategy, it might be helpful to indicate briefly the directions of monetary policy in the nineties from the viewpoint of targeted economic changes, mainly the expansion of the private sector role in economic activity and existing developmental directions aiming at expanding the economic base and diversifying national income sources, in addition to the desire to activate and improve the performance of economic sectors as envisaged by the Joint Economic Report. Taking into account the main economic aspects, the prospective future directions of monetary policy can be summarized as follows:

1- The first direction represents the role which ought to be played by the CBK within certain measures that are considered essential requirements needed for enhancing the effectiveness of monetary policy to cope with macroeconomic developments in the nineties. These essential requirements are related to the speed in enacting measures necessary for improving efficiency and maintenance of the financial and banking system. The importance of these essential requirements arises from two standpoints. First, the banking system is the framework through which monetary policy measures affect the economy, and if this system is not flexible enough to respond to Central Bank measures, it will not be easy to implement an effective monetary policy.

Second, it is important to maintain the soundness of local bank financial positions, and to protect their solvency from risks that may impede their role as financial intermediaries, and leave negative effects on the credit flow in the economy.

Furthermore, any reduction in depositors' confidence in banks would result in breaking down the payments mechanism in the economy in a way that would adversely affect the monetary system. Therefore, some economists consider banking supervision one of the main functions entrusted to central banks on the basis that maintaining confidence in the banking system is on the priority list of goals of monetary policy. Since emphasizing the banking supervision role aims at safeguarding the banking systems and in turn the monetary and financial systems, we find this goal to be consistent with what others stress: that a central bank's role in achieving monetary stability internally and externally, and its role as lender of last resort, are the main functions of central banks.

Although the measures taken by the Central Bank of Kuwait in this regard started early, especially with the Difficult Credit Facilities Settlement Program, which includes regulations to protect the financial positions of banks and provide financial support to them, these measures will assume a broader dimension with the implementation of recommendations of the Joint Economic Committee concerning enhancement of the effectiveness of the Settlement Program, especially with regard to providing one-time financial support to banks of amounts not less than the value of the Net Worth Certificates. Such support would place the banks on a normal performing track, and relieve the government of guaranteeing shareholders' rights as a first stage to discontinuing its guarantee of depositors' rights. Once a deposit insurance institution is established, banks would bear the results of their various decisions within a new stage where issues would be dealt with from a totally different perspective based upon the past experience, including their causes and consequences.

2- In line with the projected role of the private sector in economic activity, including the transfer of activities from the public to the private sector which would result in decreasing the growth rate of public expenditure due to reduced outlays in the State budget, monetary policy will play a vital role in boosting national savings and channeling them toward financing economic growth, which would attach a distinctive role in this regard to the interest rate policy.

Additionally, and in conformity with the previously mentioned direction, the CBK will set necessary regulations in view of past experience to develop bank lending policies. Notwithstanding the necessity of such regulations for implementing sound credit policies, these regulations will, however, be made within a special framework that necessitates developing them simultaneously and allowing qualitative changes in the bank's role in serving the domestic economy, especially by focusing on financing the goods and services in the production sectors within arrangements that assist the private sector to expand its role in economic activity, along with what this entails, such as extending necessary finance to facilitate and encourage the transfer of activities from the public to the private sector.

3- The CBK will continue to use different monetary policy tools integratively and with a high degree of coordination and flexibility to combat imbalances that might affect money market stability. The CBK will also continue the process which started with the implementation of the new interest rate structure because it is important to adjust the levels of these rates with flexibility and swiftness in order to keep abreast of changes in international interest rates, and with the aim of boosting national savings and thus alleviating the contractionary effects on domestic liquidity that might result from an outflow of funds, or due to a decline in public expenditure. The CBK will take into account the application of interest rates that suit the requirements of local economic conditions, so as to protect the existing interest rate structure and achieve a monetary stability compatible with the market mechanism and unlike, in substance, the traditional intervention operations which were formerly used to support local bank liquidity.

4- On the exchange rate level, the CBK will continue to carry out the existing directions that aim at achieving relative stability in the KD exchange rate through fixing the KD exchange rate according to a weighted basket of currencies of countries that have significant commercial and financial relations with Kuwait. We at the Central Bank know that achieving stability in the KD exchange rate not only aims at alleviating imported inflation, but also originates from the principle of supporting confidence in the local currency. The importance of this goal is underlined by what many economists indicate, that "it is imperative for monetary authorities in developing countries to accord primary consideration to insure their credibility and ability to implant internal and external confidence in both the national currency and the financial system". In addition, achieving stability in the KD exchange rate, together with an effective interest rate policy, will help discourage speculation on the national currency.

5- If current studies about establishing a financial center in Kuwait show the economic feasibility of such a project, monetary policy will have a major role to perform in developing both the institutions and the various instruments of the money and financial markets. The Central Bank's policy in the field of achieving stability in the KD exchange rate will assume a distinctive role, along with the Bank's role through interest rates, in achieving the monetary stability essential to the development of the proposed financial center.

6- Monetary policy directions during the nineties will take into consideration the importance of tending to the State's fiscal policy, and what public budget developments might necessitate in respect of parallel measures in the field of monetary policy, in light of domestic liquidity changes that might be affected by the developments in public expenditure.

7- Economic policy during the nineties will require a greater role for the banking and financial system in serving the national economy through promoting national savings and directing their use for economic growth, in order to meet the expansion in the demand for funds marked for investment. Monetary policy and the Central Bank's regulatory decisions will assume a wider dimension than at present, in line with changes in economic conditions.

Briefly, we could say that monetary policy directions during coming stages will be set in light of various new developments to be witnessed in macroeconomic behavior within the framework of the existing economic guidelines of public policies, and through the accomplishment of interim and long-term ends of the development strategy, as well as in light of carrying out the recommendations set forth by the Joint Economic Report.

I hope that I have been able today to shed some light on the main features of the monetary policy experience in Kuwait and its future directions, an experience which I believe is rich, in spite of what stands for or against it, and ambitious in its future outlook. I expect all concerned, while following up monetary and economic affairs in Kuwait, to evaluate this experience and assess it in view of the actual results that determine the framework of this policy and in light of the distinctive features of the Kuwaiti economy, in particular its being a free economy with high exposure to the international markets.