Financial Liberalization in the State of Kuwait: Objectives and Challenges

I wish first to express my sincere pleasure at the holding of this economic forum with the participation of a select group of distinguished leading personalities, businessmen and experts, to address some of the most significant challenges and issues confronting the design and execution of a strategy for transforming the State of Kuwait into a leading regional financial and trade center. I also wish to thank Al-Bayan Investment Company and other corporate sponsors which organized this forum and provided me with the opportunity to meet you and exchange views with you. I hope that this forum will achieve its expected success, that our efforts will contribute to a deeper and more comprehensive understanding of the issues at hand, and that positive results and constructive recommendations will be reached in this regard.

When we address the issue of transforming Kuwait into a leading regional financial center, we actually mean that international banking and financial institutions will be physically present in the domestic market, side by side with the local banking and financial system units, and extend all financial intermediation services linking savers to investors both inside and outside the country. Accordingly, establishing a leading regional financial center is in essence a project that has political, legislative, economic and social dimensions, whether in terms of the benefits derived from it, or the requirements for such a transformation. For more specificity in my discussion, I shall focus - in light of my specialization - on one of the many aspects of the project concerning the transformation into a leading regional financial center. This aspect concerns "The Objectives and Challenges of Financial Liberalization in the State of Kuwait", considering that the liberalization of the banking and financial sector, though insufficient by itself for advancing the strategy of transformation into a regional financial center, is nonetheless a necessary condition to achieve that end.

Therefore, financial liberalization is the main starting point for the efforts aimed at becoming a leading financial center. It is perhaps appropriate in this regard to start with a concise clarification of the meaning of financial liberalization. The term 'financial liberalization' (i.e. deregulation) is known to describe a system of legislative and regulatory procedures aimed at curbing the administrative constraints on the activities of the banking and financial system units. From that perspective, financial liberalization increases the scope of the banking and financial units' activity, their quest to develop their operations and products so as to serve the wishes and needs of savers and investors. Within this context, financial liberalization can be viewed as describing the measures connected to the openness of the domestic banking and financial system to the outside world, with regard to the possibility for the domestic banking and financial institutions to operate in foreign markets and their fields of activity there, or the entry of foreign banking and financial institutions into the domestic market.

We have to emphasize at the outset that financial liberalization does not at all signify revoking rules and regulations, or relaxing supervision and oversight over the banking and financial market; on the contrary, financial liberalization adds to the significance of regulatory controls and regulations, therefore increasing the burden on the concerned supervisory authority. Specifically, supervisory authorities are requested to provide a climate that supports competition and market freedom, through the enhancement of their supervisory roles. In this regard, Philip Hildebrand, member of the Governing Board of the Swiss National Bank, says, " A commitment to competition includes a firm commitment to an effective regulatory system based on transparency, proportionality, predictability and an uncompromising fight against abuse. Such a regulatory framework does not stand in opposition to a commitment to free markets. To the contrary, it strengthens free markets by upholding the integrity of markets".

In fact, financial liberalization means making a qualitative change in the legal and legislative framework, as well as in the supervisory and regulatory framework, within both of which the banking and financial sector units operate. This will lead to the attainment of these units' objectives regarding the development of their operations, services, products and instruments on the one hand, and the maintenance of the domestic banking and financial systems' stability and its protection from risks on the other. It is to be noted that should these risks increase in one of the system's units, they may not remain confined to it; rather, their negative effects may spread to other sectors of the domestic economy as well as to the other economies connected to it.

Countries differ in the order of priority they assign to the purposes sought from financial liberalization, depending on the phase they are going through. One country may essentially seek to attract foreign capital through financial liberalization, while another may seek to achieve the transfer of technology and expertise; a third would endeavor to enter new markets, while a fourth would seek to develop and deepen its domestic market, etc. Nonetheless, the common denominator among all these priorities is that financial liberalization encourages competition in the banking and financial sector, leading consequently to higher efficiency of that sector's units in the proper allocation of resources and, consequently, to the development and growth of the economy and the enhancement of citizens' welfare.

In this regard, it is worth noting that the stability of the banking and financial system does not signify providing blanket protection to that system against all the shocks and risks it may be exposed to, as this is understandably not possible. But, what the supervisory authorities aim to achieve is to immunize the banking and financial sector by means of a system of supervisory policies and programs that ensures the effective management of risks. This will help curb the effects of internal and external shocks, and reduce their negative repercussions decisively and efficiently in the early stages of their occurrence. Perhaps one of the most important lessons learned from the financial crises which numerous countries have experienced is that the availability of advanced and efficient supervisory policies and programs plays a decisive role in absorbing the shocks to which the banking and financial sectors are exposed, and in overcoming their negative effects.

Furthermore, hasty and insufficiently studied financial liberalization may lead to objectives divergent from expectations and have negative effects on the banking and financial sector which may extend to the rest of the domestic economic sectors as a whole, as well as to other economies. It is therefore necessary to follow a graded approach in the application of financial liberalization policies to ensure maximum possible benefits and to limit the possible downsides associated with inadequate preparation for full financial liberalization.

It is known that, since the early 1980's, Kuwait's banking and financial system confronted serious events which tangibly affected its role and development in the State of Kuwait. Particularly notable among these events were the long-drawn-out Iraq-Iran war, the crash of the parallel stock market 'Souk Al-Manakh', the catastrophe of Kuwait's occupation, and finally, after liberation, the difficult debt crisis. As we all know, these events and crises were accompanied by substantial fluctuations in world oil prices, which reflected negatively on the general economic performance, and consequently on the performance of the banking and financial sector.

Based on a firm belief in the philosophy of financial liberalization, and the importance of free-market mechanisms for a better performance of the domestic banking and financial sector, the Central Bank of Kuwait (CBK) continually seeks greater openness and global integration of that sector, aiming thereby to, first, promote the spirit of competition, which will raise the efficiency of the banking and financial institutions operating in the domestic market in delivering their principal function, namely the extension of financial intermediation services to savers and investors, leading to better allocation of financial and economic resources to the society; and, second, make available an appropriate environment for the establishment of a regional financial center in the State of Kuwait, which would strengthen the elements of sustainable economic growth and further diversify the sources of national income.

Therefore, after Kuwait's liberation from the brutal Iraqi occupation, the CBK pursued its unrelenting efforts for the financial liberalization of the domestic banking and financial sector through organized and well-studied steps. The starting point was the reorganization of the financial positions of the banking and financial system units according to Law No. 41 of 1993 and its amendments, concerning the purchase by the State of some debts and the means for their collection. In parallel, the CBK keenly pursued the development of a legislative and regulatory framework for banking and financial work, and the upgrading of its supervisory policies and programs, in line with the Basel Committee Recommendations for effective banking supervision.

Worth noting, too, is the issuance of Law No. 30 of 2003, which introduced to the Law No. 32 of 1968 (concerning currency, the Central Bank of Kuwait and the organization of banking business), a special section on banks operating according to the provisions of Islamic Shari'a, thus allowing the CBK to supervise the activity of these banks. With the improvement in the position of the domestic banking and financial sector, and the relaxation of the regional conditions, the government guarantee on deposits at local banks was lifted on 26 April 2004, thus enhancing the atmosphere of competition in that sector. The efforts for financial liberalization culminated of late in allowing the entry of foreign banks into the domestic market. To date, three foreign banks have been licensed to open one branch each in the State of Kuwait.

After this review of the background on the efforts deployed for financial liberalization, it is a must to highlight the main challenges which confront financial liberalization as an instrument for driving competition and making available an appropriate environment for the establishment of a regional financial center in the State of Kuwait. Most notable among these challenges is the need for unrelenting efforts on two parallel levels to develop the regulatory and legislative environment, and the macroeconomic environment, since the banking and financial sector operates within both of them.

Regarding the legislative and regulatory environment for banking and financial activity, there is no doubt that the establishment of a leading regional financial center in the State of Kuwait would deepen the integration of our banking and financial sector into the world financial markets, resulting in a broader scope of regulatory oversight and increased supervisory burdens on regulatory authorities in general and the CBK in particular. It is therefore important that the enhancement of the CBK's regulatory and supervisory powers constitutes an element of the strategy for transforming Kuwait into a financial center. Additionally, consideration should be granted to making the necessary arrangements for ensuring the full independence of the CBK as the regulatory and supervisory authority of the domestic banking and financial system. This will strengthen the

CBK’s role in controlling and directing the banking and financial practices to match the currently accelerating pace of changes in the banking and financial market, along with achieving the expansion and growth of that market, the diversification of its components, and its increased integration into world markets. It is necessary here to emphasize that the banking and financial markets are of a dynamic nature which requires keeping abreast of the various changes and developments through the continual review of current banking and financial legislation, as well as other connected legislation, such as court litigation procedures and arbitration.

Paralleling the development of the regulatory and legislative environment, the establishment of a leading regional financial center in the State of Kuwait requires the availability of an appropriate macroeconomic environment, characterized by firmly established elements of financial and monetary stability, along with sound and sustainable macroeconomic policies. As is known, the insufficiency of public economic policies in a closed economy can be dissimulated for some time; however, failures of economic policies are fast uncovered, and their costs are exacerbated, with the economy’s increased openness to the outside world and higher integration into world markets.

In this regard, considering the latest developments in the growth of the banking and financial sector, the diversification of its units, and its increased integration into the world market, along with the associated acceleration and higher volume of capital inflow, there is an obvious need to enhance the CBK’s independence in drawing up and executing its monetary and supervisory policies and strengthening its financial capabilities, so that it many fulfil its role in firming the bases of monetary stability in the country.

Additionally, there is a need to intensify efforts for the execution of policies aimed at remedying certain structural imbalances in the national economy in order to strengthen the elements of sustainable economic growth and improve the efficiency of economic resource allocation. The main structural imbalances in the Kuwaiti economy have been diagnosed. These imbalances are exemplified into structural imbalances in the general budget, the limitations of the private sector's contribution to the domestic economic activity, and labor market imbalances. The consensus is that these imbalances are connected to the expanded role of the government in domestic economic activity. Therefore, sound remediation of these imbalances starts with redefining the role of the government in economic activity as being limited to that of regulating and directing, along with activating the private sector's role in the development of domestic productive capabilities and the creation of employment opportunities.

In closing, I believe that the valuable contribution of the honorable participants to this session will enrich the discussion on the proposed issues. I hope that I have been able to shed some light on certain aspects of this involved subject. I also wish all participants in this forum success in reaching a clearer perception of the main elements of a Kuwaiti strategy for becoming a leading regional financial center.