

Prominent Landmarks in the Operation of the Central Bank of Kuwait

It is proper, when we discuss the operation of the Central Bank of Kuwait (CBK), to refer first to the beginning of central banking, which came with the establishment of the Bank of England in 1694. The Bank of Sweden, established in 1656 was the first bank in the world to be empowered by the State to issue currency. During the 300 years since the establishment of the Bank of England, which recently observed its tercentenary, the goals and operations of central banks have developed beyond solely issuing currency; they have been expanded to functions such as the acting as the banks' bank and the government's bank, supervising national banks and drawing up and implementing monetary policy.

The number of central banks has increased dramatically, especially since World War II, a period which also saw the establishment of the International Monetary Fund in 1945. The reasons for which many countries established central banks included: the need to protect monetary interest and banking systems in these countries, and a desire for international cooperation through these banks in financial and monetary areas. This review of the beginning of central banking, the increased number of central banks and the developments in their goals and functions, has been offered for the purpose of establishing a context for the inception and functions of the Central Bank of Kuwait. This Bank belongs to what can be called the latest generation of central banks, in comparison with other central banks established before World War II, such as the Bank of England (1694), the Bank De France (1800), the Federal Reserve System (1914), the Bank of Canada (1934) and the Reserve Bank of India (1935).

Following the independence of the State of Kuwait and the establishment of the Kuwaiti Currency Board in 1960, and circulation of the Kuwaiti dinar on April 1, 1961, CBK was established on June 30, 1968, in accordance with Law No. (32) of 1968 concerning currency, the Central Bank of Kuwait and the organization of banking business. CBK started operations effective April 1, 1969.

The Central Bank of Kuwait differs from older central banks in that it has been able from the beginning to take full advantage of developments in central banking functions. CBK, for example, has used quite a number of monetary policy instruments, stated in the Bank's law, as needed. Lessons derived from the operation of central banks are based on how these banks respond to the practical challenges and events they face, achieving monetary policy objectives with timely efficiency, consistent with the directions of the general economic policy of the country.

Just as the Bank of England has on the occasion of its tercentenary celebration prepared two studies: The Development of Central Banking, and Modern Central Banking, the Silver Jubilee Anniversary of the Central Bank of Kuwait is being highlighted by an article entitled "Prominent Landmarks in the Operation of the Central Bank of Kuwait". This article opens this third book, which includes, as in the previous two books entitled "Recent Issues of Central Bank Policy in Kuwait", speeches I have delivered locally and abroad about the Bank's views on numerous economic issues, and on the directions and performance of monetary policy in Kuwait.

This title was chosen not only to celebrate the Silver Jubilee Anniversary, but also to choose those of the Bank's operations

and concerns, which represent prominent landmarks in its course, examples of the kinds of challenges it faced and evidence of its aspirations. I would like to emphasize that these landmarks were chosen from the perspective of their importance, their indication for the achievements in serving the objectives of our national economy and their participation in facing the economy's challenges and difficulties.

These are the Bank's prominent landmarks:

First: The KD Exchange Rate System

The basic role for any central bank is to draw up and implement monetary policy within the framework of the general economic policy of the country. This role is not easy, since drawing up monetary policy necessitates full knowledge of the general economic policy of the country, developments and recent economic, financial and monetary events in the country, and developments and events abroad that reflect on the current financial and monetary conditions in the country.

Having this knowledge, the central bank should then be able to apply it so as to enable the monetary policy to achieve its objectives. At this point, views, concerns and priorities differ from one central bank to another and from one period to another for the same bank. Also, methods of work, their kind and effectiveness differ, because of the different stage of economic growth in each country, the volume and diversity of its economic and financial resources, the status of its banking system and the extent of its efficiency. Other variables include the growth level of the capital market, its volume of activity and the extent of its organization, the money market and the volume of its activity, and the financial and commercial relations with the outside world. Therefore, one can say that monetary policy instruments differ in their effects and

effectiveness with the different economic and monetary circumstances and positions within which they work.

The KD exchange rate system emerges as a prominent landmark in the operation of the Central Bank of Kuwait, because this system is the instrument through which the Kuwaiti economy maintains the relative stability of the KD exchange rate against major currencies. Its effectiveness is apparent in light of the substantial fluctuations in the exchange rates of major currencies against each other. This system links the KD exchange rate with an undeclared basket of major currencies, which are weighted according to their countries' relative importance in trade and financial relations with the State of Kuwait. The relative stability achieved limits the level of imported inflation in the domestic economy, the result of fluctuations in import prices, which are themselves subject to international inflation.

The present KD exchange rate system has been in force since March 18, 1975; its signal characteristic is its being linked with a special basket of currencies, rather than with an individual currency, regardless of the margin. The principal feature of the Kuwaiti economy is the dependence on the production and export of oil, which is priced and paid for in dollars in the international oil markets. Imports play a crucial role in satisfying total domestic demand by the public and private sectors for goods and services. Kuwaiti legislations emphasize free trade and payments, and freedom from constraints on currency transfers; therefore, it has been vital for the following objectives to be considered in drawing up and implementing monetary policy:

1. Achieving, as much as possible, stability in the KD exchange rate against the basic intervention currency (the

dollar) and other currencies of importance in Kuwait's trade and financial relations with the outside world. This relative stability prevents instability in the activities of local economic sectors with the outside world, as well as indicators of importance to the Kuwaiti economy, such as domestic prices and the balance of payments.

2. Maintaining, as far as possible, the purchasing power of the KD against major currencies, by means of protecting the national economy from the negative effects of inflation.
3. Regulating the flow of capital to and from the domestic economy, as well as limiting speculation on the Kuwaiti dinar.
4. Maintaining the free trade and payments system.

The KD exchange rate adopted by the Central Bank of Kuwait has effectively maintained relative stability for the KD against major currencies, as is shown by available quarterly statistics extending from the first quarter of 1988 to the second quarter of 1995 (a period covering the years immediately before the brutal Iraqi invasion of the State of Kuwait, and from the liberation to the present). These statistics show that fluctuations in the U.S. dollar exchange rate against the Kuwaiti dinar were at a very small rate if compared with its fluctuations against other major currencies, as the highest rise and lowest decline of the dollar against the dinar were 3.67% and 2.22% respectively. But fluctuations of the dollar against other major currencies were at much higher rates, as follows:

	<u>Highest Increase</u>	<u>Lowest Decline</u>
	(%)	(%)
French franc	10.75	10.16
Japanese yen	11.71	11.12
Italian lira	17.63	9.18
Swiss franc	13.68	14.03
Deutsche mark	9.36	12.11
<u>Sterling pound</u>	<u>14.17</u>	<u>6.59</u>
<u>Kuwaiti dinar</u>	<u>3.67</u>	<u>2.22</u>

The effectiveness of the KD exchange rate system drew the attention of the IMF, which indicated in its reports on Recent Economic Developments in Kuwait that maintaining the current KD exchange rate arrangements (being tied to a special basket of currencies) is an effective way of reducing fluctuations in the nominal value of actual oil revenues and in the levels of domestic prices.

Second: Multiple and Developed Monetary Policy Instruments

In recent years, the CBK has used a number of monetary policy instruments provided for in the Bank's Law when the local monetary circumstances made it necessary. Without going into unnecessary detail, the "landmark" in the exercise of the instruments lies in the fact that the Bank did not automatically apply the traditional instruments used in other central banks; the Bank acted in response to local needs, taking care that the chosen instruments work in harmony with the conditions of the Kuwaiti economy.

It can be said that there have been two main features characterizing the use of monetary policy instruments in the State of Kuwait:

1. The introduction of each instrument was necessitated by local or foreign financial and monetary developments, which affected local monetary positions and the safe performance of the banking and financial system.
2. There have been continuous amendments to the use of monetary policy instruments by the Bank, for the purpose of increasing their effectiveness in light of economic and financial circumstances, and developments in the banking system. Examples are numerous of monetary policy instruments introduced by the Bank because of need. Among them are the following:
 - The liquidity system: it was initiated by the Central Bank in September 1974, with the aim of unifying the liquidity ratio and rules that were applied then by the Kuwaiti commercial banks, and guaranteeing that banks continue to meet their obligations towards depositors. This system adopted the lowest limit of liquidity requirements when compared with liquidity systems applied by other central banks, and was the monetary policy instrument used to affect the ability of local banks to lend.
 - In April 1978, the Bank enforced a new liquidity system, which was characterized by greater comprehensiveness and flexibility in responding to financial and monetary developments in local and foreign markets, and to structural and qualitative developments in the local banking system. The specialized banks were also subject to the new liquidity system, under which local banks were required to maintain a liquidity ratio ranging from complete exemption for deposits of more than a year, to 35% for demand deposits. According to the new liquidity system, the liquid assets in Kuwaiti dinar should not be less than one third of

total liquid assets to be held against various types of deposits.

- Lending to banks when necessary: according to Article (41) of Law No. (32) of 1968, as amended under Decree Law No. (130) of 1977, the Central Bank of Kuwait was authorized to give loans or advances, in emergency cases, through the current account, for a period not exceeding six months, against such collateral as the Bank may consider adequate. Article (42) of this Law authorized the Bank to extend the term of loans for not more than six months.
- Opening deposit accounts with banks: this was initiated in 1974 when local banks were facing shortages in their KD balances. The Bank does not recommend the use of this instrument except when other instruments fail to supply local banks with the appropriate liquidity, because opening deposits with banks is inflexible and does not allow the CBK to supervise the use of funds obtained by banks in this way.
- Discount and rediscount of commercial papers: this system was put into effect on February 1, 1975, with the intention of providing local banks with credit facilities from the CBK, after late 1974, when these banks first encountered shortages in their KD balances.
- Opening interest-bearing deposit accounts for banks: this was initiated on April 15, 1973, with the aim of utilizing part of the banks' excess KD balances, which were subject to risks caused by the severe fluctuations in the exchange rates of major currencies. This system cannot actually be considered flexible in regulating liquidity levels in the banking and financial system, since the Central Bank is

able to only a limited extent to absorb part of the excess liquidity. Also, this system cannot be used in the other direction of providing banks with liquidity when necessary. Accordingly, the CBK discontinued this system on April 4, 1979, when it introduced its own negotiable bills to replace the system of interest-bearing deposit accounts for banks.

- Swap operations: beginning May 30, 1978, the CBK started swap operations with local banks. These operations enable banks to increase their KD balances when they face a shortage in their KD liquidity, and can be used to absorb part of the excess KD liquidity in the banking system.
- Issue of negotiable bills (CBK Bills): this became effective the first week of April 1979, according to regulations, which included the willingness of the CBK to repurchase these bills before maturity from the holders who wish to sell them. The acquisition of bills was, in the first stage, limited to local banks and the bills were negotiated among banks only. At a later stage, local investment companies were permitted to purchase and trade the bills with local banks. In an attempt to support the bills scheme and widen their acquisition, it was decided in 1980 to include these bills in the liquidity ratio whereby banks were required to hold a minimum of 3% of the total deposits subject to the liquidity system in the form of CBK bills, or current accounts with the Central Bank, or cash with banks.
- Public debt instruments: the CBK started to issue these instruments (treasury bills and bonds) on behalf of the Ministry of Finance in November 1987. These instruments have provided financial resources that could be used to cover the deficit in the State general budget, and presented good investment outlets for the surpluses of local banks, investment companies and individuals, in a way that would

help in KD repatriation. Also, these instruments have been used, through open market operations, to enhance monetary policy effectiveness for regulating levels of domestic liquidity and achieving stability in the local money market.

On the other hand, the CBK has given considerable attention to developing monetary policy instruments and increasing their effectiveness to be consistent with local situations, and international events that affect the local market. Examples of this attention can be given from the developments witnessed by the KD interest rate structure, as follows:

1. The CBK recognized from the start of its operation that the maximum contractual interest rate on KD transactions of 7% per annum, according to Article 166 of the Kuwaiti Commercial Law, represents an obstacle in using interest rates as a monetary policy instrument. Therefore, the Bank was aware of the need in Kuwait for an interest rate structure in harmony with monetary and economic conditions prevailing locally and abroad. For this reason, the Bank submitted a request to the government asking for a change of Article 166 of the Commercial Law authorizing the Board of Directors of the Bank, upon approval of the Minister of Finance, to fix the maximum contractual interest rate on KD transactions. Accordingly, a decree law was issued changing that article; this allowed the Bank, in February 1977, to increase the maximum limit for the contractual interest rate on KD transactions to 10% fix the minimum limit for interest rates on KD-denominated deposits, and leave the interest rate on transactions in foreign currencies to supply and demand forces in the international financial markets.

Therefore, the Bank was able to assist in providing productive economic activities with credit facilities at

reasonable rates, using the interest rate as a tool to supervise credit and its direction.

2. Starting in December 1988, the CBK applied a new KD interest rate structure to cope with local developments and international events, represented in domestic interest rate pressures due to significant rises then in international interest rates. Accordingly, interest rates on the KD were raised, after linking them to the discount rate (as a pivotal rate) of the CBK, the change of which can be used by the Bank to adjust both the maximum interest rate on KD lending and the minimum interest rate on KD deposits. This new structure, which has been adjusted recently to free that minimum, provided the Bank with flexibility to adjust local interest rates when needed, and in harmony with local and international developments.

The Central Bank of Kuwait started its supervision over investment companies according to the ministerial resolution issued on January 8, 1987, and over exchange companies according to the ministerial resolution of March 19, 1984. The objectives of CBK supervision over these companies include: providing coordination and integration among the activities of both banks and financial companies, applying effective monetary and credit policy, which is not affected by institutions not subject to CBK supervision through their attempts to weaken this policy, and ensuring the safety of the financial positions of these companies and the continuation of their activities.

Third: Challenges of the Occupation Period

During the period of the brutal Iraqi occupation, the Central Bank performed its duties from exile, and concentrated its efforts on several important matters that can be divided into

two areas complementing each other. The first area represented the obligations that required immediate implementation and follow up in order to mitigate the consequences of the illegitimate actions of the authority of the brutal Iraqi occupation. The second area was represented in the arrangements and procedures which required future perspective, such as the careful preparation of a post-liberation strategy that was concentrated on restoring monetary stability, strengthening confidence in the Kuwaiti dinar and rearranging the positions of the banking and financial system, including the problems and challenges it might face, in order to be able to play its role in serving the national economy immediately after the liberation.

One might say that both these work areas of the Bank during the occupation period represent a unique experience and a prominent landmark in the operation of the Central Bank due to the Bank's achievements necessitated by the exceptional circumstances of that difficult period. Also, if we want to be fair in judging these achievements and their importance and the difficulties in implementing them at that time, we should look at these achievements not only from the perspectives of the performance density, quality, exception, and speed. We ought also to consider in judging those achievements the strong feeling we had, as one of the Kuwaiti working teams, to defend Kuwait's interests, wherever we were, with everything we owned and across all frontiers.

1. Rapid procedures: these covered many areas whose implementation required proper attention and intensive efforts. Among these procedures were the following:
 - Securing the financial resources to meet the obligations of the legitimate Kuwaiti government, by means of asking the financial and monetary authorities in the major industrial countries to unfreeze Kuwaiti assets in these countries. The

freeze had been enacted upon the request of the State of Kuwait to protect its assets abroad during the occupation period.

- Canceling all authorized signatures of local banks and limiting them to specific signatures of chairman and their deputies. Also, efforts to reorganize and regroup the top executives abroad were fulfilled. These procedures, along with the procedure to reconstruct local bank records, helped maintain the rights of both depositors and shareholders, in addition to maintaining each bank's rights and properties.
- Assisting the Kuwaiti banks to pay their dues and obligations to foreign banks and international organizations. This required the preparation of a program for the payment of interest on Kuwaiti bank liabilities, and the enumeration of these banks' transactions in the foreign exchange and inter-bank markets.
- Depriving the enemy of benefit from Kuwaiti currency notes, which were looted by forces of the Iraqi regime before having been issued, by means of abolishing their legal tender according to Decree Law No. (2a/90) issued on October 7, 1990 relieving the Central Bank of the obligation to pay the value of the currency notes stolen from its vaults. On the same date, Ministerial Resolution No. (1a/90) specified the denominations and numbers of the stolen currency notes. Therefore, the Central Bank of Kuwait contacted central banks in other countries to inform their banking and financial units to cease accepting the abrogated Kuwaiti currency notes.

- Receiving information throughout the occupation period for the purpose of learning about matters related to the Central Bank and the Kuwaiti banking system, and arranging to extend funds to Kuwaitis in Kuwait to support their resistance.
2. Longer-term procedures: these were represented in the preparation in advance of a plan containing the arrangements and instructions which ought to be implemented by all units of the banking and financial sector for the purpose of rearranging their positions and starting their normal activities immediately after the liberation. Also, the plan included methods to face the effects of the invasion on the performance and efficiency of that sector. A list of the Bank's principal officers was prepared to keep in touch with them, for them to be ready to return to Kuwait immediately after the liberation. In addition, the Central Bank exchanged views about several issues and their possible solutions with Kuwaiti authorities (as the Ministry of Finance, and the Kuwait Investment Authority represented by the Kuwait Investment Office in London), and with international organizations (such as the International Monetary Fund (IMF), and the World Bank).

Fourth: The Efforts and Concerns of the Central Bank After the Liberation

Undoubtedly, the achievements of the Central Bank, at record speed, during the period after the liberation is a prominent landmark in its operation, because this period witnessed the tasks of reconstruction, building confidence in the Kuwaiti economy, the banking and financial system and the national currency. This was in addition to the substantial and exceptional difficulties of the near complete cessation of activities in the local banking and financial system, and the

stoppage of oil-production and export, the main source of the country's income. These developments caused fundamental changes in the structure of the national economy regarding its size, its population structure, the financial position, and the performance rates of different economic sectors.

During this period, also, several hazards were to have been expected if we had not finished quickly the tasks of rebuilding, rehabilitating the oil sector after extinguishing the well fires, and preparing the banking and financial system to resume their normal activities. These hazards would have appeared in monetary instability, lost confidence in the national currency, a rise in the increasing rate of domestic inflation, and additional decreases in both domestic income and foreign reserves.

The following tasks coincided with efforts to resume fast basic services, and to provide an adequate supply of essential commodities:

- The complete exchange of the Third Issue currency notes for those of the new Fourth Issue as of March 24, 1991.
- Smooth and effective resumption of withdrawals from customer accounts and of money transfers from the Kuwaiti dinar to the foreign currency.
- The adoption of the KD exchange rate policy that was followed before the brutal Iraqi invasion.
- The continuation of careful monetary policy, strengthening the banking and financial sector, which had an effective role in stimulating economic activities

in the country. All these matters have led to the following two important achievements, according to the International Monetary Fund (IMF):

1. Restoring confidence in the Kuwaiti dinar as witnessed by the slight decrease in deposits at local banks. The stable KD exchange rate, along with the policy of interest rates on the dinar, which allowed higher rates than those on major foreign currencies and promoted preference for KD assets over foreign assets, were able to reduce the pressures on the demand for foreign currencies, and on the outflow of funds. Available statistics showed that the volume of deposit withdrawals from local banks and financial transfers to foreign currencies were much less than what was feared during these exceptional circumstances.
2. The substantial decreases in the levels of domestic prices, although these levels were high at the beginning of the post-liberation period, recording an 85% increase over pre-invasion levels (May 1990=100), due to shortages in the supplied commodities in the local market resulting from the great damage inflicted by the brutal Iraqi invasion on local production capabilities, and its looting of the commodity stocks of different economic sectors, in addition of its robbery of individuals' homes and their belongings. To explain this sharp decline in the levels of domestic prices, the price indicator, which was prepared by the Central Bank, recorded an increase in the general level of domestic prices to only 9% by the end of December 1991 compared with the pre-invasion level.

Behind these two achievements, according to the IMF, stood the careful monetary policy and the increased supply of

commodities in the local market. Accordingly, the IMF commended the monetary authority for its efficient financial management, especially as monetary stability would provide suitable circumstances for the State of Kuwait to face difficult economic tasks, presently and in the future.

Furthermore, among the CBK's efforts during the post-liberation period, there were the following three matters, which received considerable attention from the Bank:

1. The instructions given by the Central Bank to local banks not to consider any changes in the balances of their customer accounts during the period extending from August 1, 1990 (the day before the invasion) to March 24, 1991 (the date when Kuwaiti banks resumed their normal activities); other instructions were for these banks to pay interest on savings and fixed deposits accounts for the whole period of the invasion.
2. The financial support given by the Bank to local banks in order to facilitate their transactions in the inter-bank market and the settlement of these transactions with the GCC banks. This financial support emphasized the Central Bank's belief in the importance of stressing the principle of credibility and of honoring commitments.
3. The CBK participation since the post-liberation period in efforts to solve the difficult debts problem; this participation, which required substantial time and effort, stemmed from the Bank's deeply-rooted conviction about the expected negative effects of this problem on the ability of the banking and financial sector to perform its role of strengthening the performance of domestic economic sectors, because this sector represents the main channel of economic movement to these sectors.

Fifth: The Future Outlooks

Explaining CBK performance ought not be limited to the past twenty five years, because the Bank's role is not only limited to the current treatment of monetary and economic issues, but also includes its views on the future outlook, which needs to be emphasized. This future outlook, represented in crucial concerns of the Central Bank, and in a prominent land-mark in its operation, can be explained as follows:

1. The economic outlook, through which the Central Bank expressed its views on major economic issues and challenges, hoping for the national economy to reach its desired goals in the coming phase. During the periods before and after the invasion, the Bank gave the future outlook special attention based on studied objectives.

Included in the economic outlook that occupied the Bank' attention recently has been the need to review the directions of public finance in the State of Kuwait, and deal with the deficit in the general budget, since the ratios of this deficit to the public revenues, the GDP and the value of Kuwait's imports have grown considerably when compared with the corresponding ratios in many other countries. Treatment would necessarily require reviewing both public spending (its components, yields and actual effects on the national economy), and the possibility of providing regular sources of non-oil revenues.

Other outlook emphasized the fact that the declined role of the public sector in domestic economic activities, as a result of treating the deficit in the general budget, ought to be compensated by an increase in the ability of the private

sector to enhance its role in domestic activities.

Here, we can see the importance of privatization programs for transferring public sector ownerships and activities to the private sector (local and foreign), and the use of the market mechanism, which requires maintaining economic freedom in the production and marketing operations of the local market, and provides foreign opportunities to increase the value of non-oil exports.

The Central Bank has often indicated in its reports and studies on domestic economic conditions that treating these conditions, through an economic reform program, which can be implemented at proper speed, should be based on a future economic plan. This plan ought to include specific objectives and clear directions that are based on a long-term development strategy which aims at expanding the local production base, diversifying sources of income, achieving stable growth rates in non-oil economic sectors, and increasing the role of the private sector in the Kuwaiti economy, including providing more opportunities for the national labor force.

2. The future outlook for the banking and financial system includes ways to improve its performance, to increase its effectiveness in serving the national economy, to deepen the role of monetary policy in achieving monetary stability and strengthening confidence in the national currency, and to improve the Bank's role in organizing the banking profession, supervising units of the banking system and maintaining its stability.

Here, it is obvious what the Central Bank is seeking to achieve in the coming phase, specifically to free monetary policy instruments and to provide, with the aid of merger

operations and foreign participation, banking and financial units that are capable of producing outstanding performance, of meeting international standards and of providing initiatives and free competition, locally and abroad.

I hope I have been successful in shedding light on certain prominent landmarks in the operation of the Central Bank of Kuwait which can be characterized, as we have explained, by their intensive efforts, renewed contributions and optimistic future perspectives.
