Some Thoughts about Recent Challenges of Monetary Policy in Kuwait [1]

I am delighted to have this opportunity to share with you our recent experience in the Central Bank of Kuwait after the liberation of Kuwait from the Iraqi occupation, which started on August 2, 1990 and lasted about seven months. The consequences of this unexpected occupation have put before us several drastic problems and challenges which caused great concern and required concerted efforts. Now that more than a year has elapsed since the liberation of Kuwait, I avail myself of this opportunity to elaborate on the main outcome of our monetary policy experience in Kuwait

During the occupation, damage inflicted on the Kuwaiti economy and its infrastructure was massive and caused our productive capacity and development capabilities to be severely handicapped. This negative impact of occupation has been comprehensive as manifested in arrested production in all domestic economic sectors, not to mention the hundreds of oil wells set ablaze or damaged and the oil industry plants and refineries that were dismantled.

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(1) Delivered on June 11, 1992, in London, UK, on the occasion of the annual meeting of central bank governors, organized by the Bank of England.

The Central Bank of Kuwait played its role in exile during the invasion, with its attention given to reorganizing Kuwaiti banks abroad and to extending its full support to these banks in order to assist them in meeting their obligations to foreign banks, whether with regard to settlement of outstanding transactions or the payment of interest due on Kuwaiti bank liabilities. Also the bank had prepared a contingency plan for reviving the activities of the banking and financial system immediately after the liberation of Kuwait.

Meeting the economic challenge of reviving the domestic economy, and then putting it back on the development horizon, required massive efforts in more than one direction. We have seen commendable achievements in this respect in both the resumption of vital services in record time and in the controlling and extinguishing of hundreds of oil well fires in a mere seven months, a year and a half less than the most optimistic predictions of time needed for accomplishing this task. Actual oil production started in May 1991, while the capping of burning oil wells was in progress. Oil production gradually increased, reaching more than half a million barrels a day by the end of that year and about one million barrels per day in May 1992.

As regards monetary developments following the liberation of Kuwait, the banking system resumed its operations in less than a month, and the full range of banking services was restored a few months later as soon as electricity, communications, and other relevant services became available.

The Central Bank of Kuwait has engaged tirelessly in solving problems of the banking system arising from the Iraqi occupation of Kuwait and has managed to restore public confidence in the local currency and Kuwaiti banks. Turning to specific efforts exerted by the Bank after the liberation in order to maintain monetary stability, let me share with you the following thoughts:

First: With respect to policies, the Bank announced on March 24, 1991, the day when the Kuwaiti banking system resumed its operations after the liberation of Kuwait, the KD exchange rate according to the same previous policy of pegging the dinar to a basket of currencies of Kuwait's major trade and financial partners. The KD exchange rate announced on that day was very close to its last pre-invasion level. We have found this policy quite effective in maintaining a distinct relative stability in the dinar exchange rate against currencies of Kuwait's trade partners. This policy has proved to be a bulwark against imported inflation, and together with the adoption of the domestic interest rates structure, in effect since December 1988, they restrained the outflow of funds.

Second: The Bank resumed its issuing of public debt instruments, which include treasury bills and bonds, on behalf of the Ministry of Finance; the outstanding balance of these instruments was KD 1.4 billion by the end of 1991, compared to KD 2.3 billion immediately before the Iraqi invasion.

Third: Several important measures were adopted by the Central Bank of Kuwait during 1991 that had significant bearing on monetary developments in the country. One of these measures was to replace the third issue of Kuwaiti currency notes with a new issue as legal tender. Arrangements were made to withdraw the cancelled currency notes by the end of last September. Changing currency notes was a measure taken to counter the pillage and plunder carried out by the Iraqi forces and their looting of currency notes and large quantities of gold bullion from the Central Bank of Kuwait vaults.

With the new currency notes, the Bank imposed a maximum limit of KD 4000 a month on cash withdrawals and fund transfers abroad by each client, to check inflationary pressures on domestic prices and to allow local banks to cope with the exceptional working conditions following the liberation of Kuwait. These conditions resulted from a shortage of technical professional manpower and a lack of basic services. This limit was raised to six thousand dinars in July 1991 before being abolished completely a month later. The capital outflow that followed lifting the controls was less than feared earlier, which indicated an increased confidence in local banks and Kuwaiti currency.

On the other hand, the Iraqi aggression has aggravated the difficult debts problems by the destruction and pillage that took place during that aggression and the resultant additional decline in the value of assets.

Many businesses suffered huge property and income losses and incurred the cost of renovation and repair of their properties and of restocking their inventories.

In accordance with the Difficult Credit Facilities Settlement Program, which was approved by the Cabinet of Ministers in August 1986, the State of Kuwait is obliged to protect depositors' rights in Kuwaiti banks. Taking this into consideration, then leaving the banking and financial sector to face the aftermath of the Iraqi aggression without government's intervention, would mean the collapse of many of this sector's units, and consequently the government would have to incur a large and immediate cash burden to meet its obligations towards this sector. This is over and above the adverse effects of the loss of confidence in Kuwait's banking and financial sector, which would require manifold burden and efforts, as well as a long period of time to restore.

The Bank took the initiative of proposing its views on solving the difficult debts problem, upon which a decree law was recently issued regarding the treatment of banking and financial system conditions and providing a solution to the difficult debts problem. According to this law, the Central Bank of Kuwait is permitted to purchase up to KD 5.6 billion of difficult debts, as defined in the decree law, from banks, investment companies and the Kuwait Finance House, in addition to the real estate portfolio of the Kuwait Finance House.

These debts shall be transferred to the Central Bank of Kuwait alongside their existing personal and physical collateral. Also to be transferred to the Central Bank, are the mortgages and guarantees to third party of the real estate portfolio. The date of purchase is specified as December 31, 1991. Against the purchased debts, the government shall issue bonds with a maximum maturity of twenty years; bonds with a maximum maturity of ten years shall be issued against the real estate portfolio.

This solution of buying out the difficult debts of the banking and financial sector will improve the solvency and liquidity of its units, as cleaning the balance sheets of this sector’s units will allow them to operate normally and independently without government subsidies. In addition, solving the debts problem will allow debtors and their guarantors to resume their activities, which are inter-linked with those of other sectors.

In the light of changes in the population structure of Kuwait, the Central Bank of Kuwait believes that the time has now come to restructure the banking and financial system in Kuwait by means of mergers, which will help the banking and financial units to maintain their solvency, liquidity and reasonable profitability, as well as to improve their competitiveness, domestically and internationally.

In addition, the Central Bank of Kuwait is now in the process of developing its supervision mechanisms, and implementing the Basel Committee standards with the Difficult Debt solution. Also, the Bank is closely monitoring the developments in central banks of the industrial countries regarding off-balance sheet items, and the instruments derived from them, which are worryingly growing.

In conclusion, I might add that we are passing through a critical point in our efforts to reshape our monetary policy and to increase the effectiveness of our banking and financial system. The road ahead will not be easy, but with our will and realism, together with a dedicated and objective approach to needed monetary policy, we remain confident that we are up to these challenges.