Foreign Exchange and Economic Policy in Kuwait [(1)]

The topic of my speech today concerns foreign exchange and economic policy in Kuwait. As you know, Kuwait was faced with a severe crisis during the past year as a result of the Iraqi invasion and occupation. Therefore, I feel it is important first to briefly explain the steps taken by the Central Bank of Kuwait after the liberation in order to restore the banking and financial system. These steps will define the environment that will influence the flow of funds within the Kuwaiti economy on the one hand, with the rest of the world on the other.

The Iraqi invasion and occupation on the second of August 1990 interrupted the normal flow of foreign currencies and KD funds into the Kuwaiti economy in several ways. The KD was taken from the flow equation, except for limited amounts exchanged for citizens and others in exile, to help them meet their living expenses. In addition, the flow of foreign exchange from the oil sector stopped, and our foreign assets became subject to freeze orders which imposed various degrees of limitation on access to them,

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depending on the particular jurisdictions, and the types of assets involved.

Perhaps you have noticed that income from our official foreign investments has grown close to the oil earnings of the state during recent years. The importance of our foreign investment was underlined during the past year, after the Iraqi invasion led to the cessation of oil exports, and Kuwait had to rely on investments to finance government functions and commitments overseas. This was made possible through the cooperation of various friendly authorities, in spite of the general freeze on our assets.

As most of you know, we worked immediately after the invasion to reconstruct the books of the Central Bank and other Kuwaiti banks. Then we developed arrangements to start meeting the Kuwaiti banks' obligations towards international banks and financial institutions. Meanwhile, we started planning for the post-liberation period, including the printing of new currency notes and means of meeting any liquidity pressures on the banks. We also prepared specific instructions regarding the resumption of bank operations after the liberation, with emphasis on efficiency of operations and preservation of depositors' rights.

Upon introduction of the new currency notes on March 24, 1991, the Central Bank also introduced certain restrictions on withdrawals and transfers. Due to technical and logistical considerations, a limit of four thousand Kuwaiti dinars per month for every individual was set for withdrawals from bank account and transfers into foreign currency. This limit did not cover transfers needed for legitimate economic activity, and exceptions were made for humanitarian purposes.

The limit on withdrawals and transfers was raised to six thousand KD last July, then it was removed completely on August 3rd. The removal was based on our firm belief in a free market economy, and on our conviction that lengthy and extensive controls are harmful and counterproductive. We also anticipated an upsurge of inflation, in view of the damage to the ports and transport system, and the supply network. Our data indicate that the consumer price index jumped to 85% in the early months after liberation, compared with less than two percent during 1989/90. Now we believe inflationary pressures have eased considerably, with the domestic price indicators during the two weeks ending on September 7,1991 registering an increase of only 12.8% over the base period of May 1990.

Before lifting restrictions, we had envisaged various scenarios for the possible size of demand for foreign currency. We were pleased that deposit withdrawals from banks and transfers to foreign currencies were much less than expected. For example, private deposits of residents were KD 4.57 billion at the end of last August, registering a very small decline from their level at the end April, when they were KD 4.64 billion.

The new KD that was issued in March 1991 is firmly established as the legal currency. The exchange rate of the KD is again based on the policy that has proved to be useful for our economy for seventeen years, which pegs the KD to a basket of the currencies of our major trade and financial partners. I believe our interest rate structure is now appropriate for our present policy goals, and the KD rates enjoy a considerable margin over corresponding dollar rates. Moreover, the Central Bank has regained all the gold and commemorative coins that were stolen from its vaults by the Iraqi occupation forces.

The banking system is functioning again, and the new measures proposed by the Central Bank to deal with the banks' loan portfolios will do much to clean up their books and retain depositor confidence. In addition, the Government of Kuwait will continue to guarantee deposits with the Kuwaiti banks. The measures are an important step toward putting our economy and our banking system back on track, especially in view of the devastation of various economic sectors caused by the Iraqi aggression.

In the meantime, we are still working to refine and adopt appropriate supervisory standards for our banks, with the goal of bringing them into line with international standards. We are also keeping in sight the goal of consolidation of the banking and financial system as an important requisite for the development of an efficient and competitive structure. In the longer term, we should look into ways to strengthen the ties between our banking system and the major international banks.

The measures I have just summarized provide the monetary environment within which the Kuwaiti economy will work. However, I believe our economy needs some fundamental redirection if we are to correct some of its basic structural imbalances. I will share my thoughts on this issue with you.

In our interdependent world, the flow of funds between countries and among currencies increasingly reflects the movement of capital seeking security and adequate returns.

For us in Kuwait, the importance of foreign exchange flows goes back to the pre-oil period, when it was even then tied to both trade and investments. The small Kuwaiti economy depends heavily on imports of goods and services, and although our trade balance in goods and services has traditionally registered surpluses, the private sector balance has consistently been in deficit, For example the surplus in our balance of trade in goods and services during 1988 was estimated at KD 2.45 billion. Yet our total imports of goods were estimated at about KD1.92 billion. Normally, the gap in private sector transactions with the rest of the world is more than offset by the surplus of the public sector, but the past year (1990) has been exceptional.

This example illustrates the fundamental problem of the Kuwaiti economy that needs to be resolved for the private sector to become an active partner in contributing to the well-being of the country. Traditionally, public spending is the vehicle through which oil revenues activate the domestic Kuwaiti economy. Oil sector foreign currency revenues are used to create dinar liquidity directly, through the impact of conversion into KD. Indirectly, public spending affects expectations and encourages bank lending to finance economic activity, and this in turn leads to the creation of demand for foreign currency in our open economy. Therefore, the mechanism described does not lead to continuous expansion of monetary aggregates, as demand for foreign currency to finance trade and other transactions acts to neutralize this expansion.

During the second half of the last decade, Kuwait experienced a sharp decline in the current account surplus. This was a result of declining oil market trends as oil supply increased, while demand growth was slow. This led to a decrease in the foreign currency revenues of the country. Meanwhile, the state budget was tightened, but the possibilities for reducing expenditures were limited. The government resorted, for the first time, to public borrowing through the issue of treasury bills and bonds in late 1987.

Toward the end of 1988, the Central Bank introduced a more flexible interest rate structure for the Kuwaiti dinar. The new structure tied maximum lending and minimum deposit rates to the CBK discount rate. The discount rate itself was raised so that the new structure would be in line with international interest rates. The Central Bank continued to monitor international interest rates and the flow of funds between the KD and the major currencies. The flow of funds into foreign currencies and the impact of monetary policy on domestic economic activity were the main considerations behind our interest rate policy.

The Central Bank net sales of foreign currencies to the local banks reached $ 12.4 billion during the fiscal year 1983/84, and the trend was downward until 1988/89, when total net sales were $ 8.2 billion. The average annual net sales of foreign exchange by the Central Bank for the period 1982-1989 was $ 9.3 billion.

As a matter of fact, the overall supply of foreign exchange in the Kuwaiti economy will depend largely on the speed of recovery of the oil sector, which is already increasing its exports. Another source of supply would be borrowing from international markets, whose main goal is to regulate the flow of foreign exchange in order to meet temporary financing gaps. The limited non-oil potential of the economy will mean that imports of goods and services will continue to meet most of our domestic needs. On the other hand, the population has been reduced, which would mean fewer imports and transfers, and therefore less demand for foreign currencies.

Perhaps the time has come for us to look into strategic changes in our domestic economic policy. Such a review should also include the role of the private sector in Kuwait. Our policies should be based on strategic objectives that reflect the basic concerns and aspirations of the country. Such aspirations are reflected in a high value-added strategy that seeks to reduce the pre-invasion population imbalance, reduce the built-in instability of the Kuwaiti economy, and utilize the potential strengths of economy. That strategy involves preparing the environment for an overhaul of the economic policies of the country, and then implementing it. The key element for the long-term success of the strategy would be investment in the development of human resources.

The outlook for the future, in terms of the flow of foreign currencies and its domestic impact, will depend to a large degree on the interactions among three elements: the fiscal authority, the monetary authority, and the role of the private sector. The fiscal mechanism, through the impact of expenditures on the supply of and demand for foreign exchange, will remain the major factor. The traditional supplemented temporarily with borrowing from international markets.

The scope of fiscal policy in Kuwait can and should be changed in the coming years. This can be done through privatization of certain institutions, shifting some activities to the private sector and changing some other aspects of our economic policy in order to rationalize subsidies and increase the link between public finance and domestic economic activities.

The role of monetary policy would be to ensure economic stability by following appropriate interest rates, exchange rates and credit. The target would be to regulate the growth of monetary aggregates, and to influence the flow of funds within the domestic economy and with the rest of the world, in order to encourage non-inflationary growth.

An unknown factor in the equation is the possible change in the relative roles of the public and private sectors. Steps toward privatization of some institutions and shifting activities to the private sector would reduce the role of the public sector in financing and supporting some sectors of the economy. I believe this is an important goal, but it is more a medium-term than a short-term solution, given the problems facing the private sector at this stage.

In the final analysis, public finance in Kuwait, on both the expenditure and revenue side, must take into account the heavy burden on public resources in the short term and the goals of economic strategy in the long term. Monetary policy must continue to provide the stable framework for growth, while being innovative in restructuring the banking system and working toward influencing the flow between the Kuwaiti dinar and foreign currencies.

We must provide the environment for a more active private sector, one that contributes more to the national income and takes responsibility for its economic decisions. This would mean not only expanding the scope of activity available to that sector, but also making it clear that economic decisions may entail some risks that should borne by the decision-makers.