Crucial Tasks of the Central Bank of Kuwait During the Iraqi Occupation and After the Liberation of Kuwait [(1)]

May I thank the Interarab Cambist Association for its kind invitation, as it gives me great pleasure to be given this opportunity to shed light on the crucial role played by the Central Bank of Kuwait in managing Kuwait's banking system from abroad during the Iraqi invasion and occupation of Kuwait, which started on the second of August, 1990, and how the Bank was able to prepare and plan in advance for the difficult post-invasion period.

My address on this occasion will concentrate on the following three dimensions:

The first is to briefly clarify the main course of the Kuwaiti economy before the Iraqi invasion, with an emphasis on the main characteristics of the economy, the types of problems faced by local economic sectors, including the banking and financial sector, and the achievements of different economic policies and regulations. This background information is needed to visualize the kinds and magnitude of the problems and challenges we faced during and after the invasion.

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(1) Delivered on November 30, 1991 in Manama, Bahrain, on the occasion of the 17th Inter-Arab Cambist Association.

The second objective is to demonstrate the crucial tasks taken up by the Central Bank of Kuwait abroad, focusing its attention on preparing the groundwork for Kuwait's banking system to meet the needs and challenges imposed on it as a result of the Iraqi invasion of Kuwait, and to discuss the efforts exerted by the Bank to prepare the system to take immediate steps to assume its normal role in the post-invasion period.

The third objective is to present a more critical group of tasks faced by the Bank, as part of national efforts aimed at economic reformation and development after the liberation of Kuwait. These tasks include correcting the massive destruction inflicted upon the Kuwait economy by the Iraqi invasion and the resulting economic disequilibrium, as well as organizing and reshaping Kuwait's banking and financial system.

Thus, my remarks will not be simply a historical overview, but will seek to delineate the economic conditions under which Kuwait can move toward stability, prosperity and continued development.

First: The Kuwaiti Economy before the Invasion

To elaborate on the performance of the Kuwaiti economy in view of its features, available statistics indicate that the following conditions prevailed before the invasion:

1- During the five years ending in 1989, the oil sector accounted for an average of 45% of overall GDP, 90% of export proceeds, and 88% of total government revenues. The concern about this distinct dominance of the oil sector over the economy accounts for the attention given to supporting and enhancing the non-oil sectors of the economy in Kuwait's economic plans, with special reference given to the banking and financial sector.

2- The imbalance in both population and manpower structures stems from the fact that Kuwait's total population, according to a 1989 survey, had reached some 1.93 million, of which only about 40% were Kuwaiti national. The total labour force in 1989 numbered 863 thousand, of which 86% were non-Kuwaitis, against 81% in 1985. These figures have given rise to government concern over population and labour force imbalances, and led to the introduction of policies that attempt to correct these imbalances.

3- Although oil revenues were falling steeply during the last decade by comparison with their peak level in 1980, public expenditure remained moderate in order to serve the development efforts of Kuwait and strengthen the activities of its main economic sectors. As a matter of fact, the downward trend of public expenditure was reversed in fiscal 1988/89 as total government expenditure rose from KD2806 million in the previous fiscal year to about KD3000 million.

4- The Central Bank of Kuwait introduced, managed and administered the Difficult Credit Facilities settlement Program which was announced on August 10, 1986, to help the financial institutions to cope with the after-effects of the 1982 Al-Manakh crisis, and thus was able to help restore confidence in the financial system and solve the problem of non - performing credits.

The authorities announced a further initiative in December 1989 based on the Economic Report of the Joint Committee to Reactivate the Economic Momentum, for the purpose of promoting the effectiveness of the debt settlement program and reactivating economic momentum in the non–oil sectors. A committee was appointed by His Highness the Crown Prince and Prime Minister, headed by myself, to follow up on these measures and ensure their implementation during the designated period.

5- Kuwait’s domestic economy has always depended heavily upon imports. As a result, domestic inflation has always been subject to international price and exchange rate fluctuations. The consumer price index, which includes several commodities subject to subsidies, increased by only 3.3% in 1989, following increases of 0.6% and 1.5% and in 1987 and 1988 respectively.

The Kuwaiti Dinar had enjoyed relative stability in its exchange rates against major currencies. On the day before the invasion, for example, the US dollar exchange rate decreased against the KD by a mere 1.7% compared to its level at the end of 1989,while its decline against other major currencies raged between 6% (against the Deutsche mark) and 13% (against the pound sterling) during the same period. This achievement was the result of Kuwait’s policy of basing the KD exchange rate on a basket of currencies representing Kuwait’s principal trading and financial partners. This policy had proved to be a bulwark against imported inflation.

6- Since 1985, when the Five-Year Plan for the period 1985/86-1989/90 was launched, the authorities have given priority to confronting a number of Kuwait's structural problems. This plan adopted policies which were to correct Kuwait's demographic imbalance, in addition to promoting investment, in social development improving public administration and involving the private sector more actively in the development effort.

   The following Five-Year Plan (1990/91-1994/95) was expected to have two broad principal areas of concentration. The first was continued efforts to correct the population and labour force imbalance. The second was to use the oil wealth more efficiently to develop human resources. Kuwait's long-term development strategy, according to a study by CMT International, was stated in terms of diversifying production through encouraging industries with high value added, and through greater interaction between the public and private sectors.

It can be concluded from what I have said about the performance of the Kuwaiti economy before the Iraqi invasion, that Kuwait's effective economic management had fared better than that of most oil-dependent economies in acclimatizing itself to the developments and difficulties of the late 1980's. The strengthening and diversification of the non-oil sectors, careful attention to investments and development of financial and securities markets, as well as efforts to bring manpower and population into balance, have been the focal points of Kuwait's development strategies in recent years.

According to Central Bank estimates, the non-oil GDP for the first quarter of 1990 indicate that the December 1989 reactivation program was clearly bearing fruit, as the annual non-oil GDP growth rate in that quarter reached 4.3% compared with 3.6% for 1989.

As monetary policy has been pursued more vigorously in recent years, the role of the Central Bank has become increasingly prominent. It has been involved in forming policies to reactivate the economy. Its role as a stabilizer of the economy through its management of domestic liquidity and the KD exchange rate has remained unchanged.

The Central Bank of Kuwait, in order to make the interest rate policy more effective to influence bank credit and money supply, changed the structure of interest rates effective from December 1988 by means of setting maximum limits on lending in KD and a minimum limit for KD deposits. These rates were linked to a single discount rate. This new structure, besides allowing KD interest rates to be in line with international trends, proved to be more flexible and realistic.

Second: The Central Bank's Critical Efforts during the Difficult Period of the Iraqi Occupation

Great damage was inflicted on the Kuwaiti economy by the Iraqi occupation, which lasted about seven months. With the destruction and theft of economic resources, productive units and infrastructure, the invasion reflected negatively on all aspects of the Kuwaiti economy, especially its performance and productive capacity and development capabilities.

This negative impact of the invasion was comprehensive, as clearly demonstrated in the cessation of the production process in all domestic economic sectors, not to mention the hundreds of oil wells set ablaze or damaged and the oil industries and refineries that were dismantled. Even the banking sector resources and productive facilities were either removed or destroyed.

It is beyond the scope of my address to itemize or quantify the magnitude of these losses. It is enough to say with assurance that without the will of Kuwait aided by the assistance of its friends and the international community, aiming at alleviating these massive losses, the course and development of the Kuwaiti economy would have suffered a long-term setback.

However, coming closer to the immediate consequences of the Iraqi invasion and occupation on Kuwait's banking system in particular, we faced the following problems:

- Loss of bank records

- Cancellation of most of the credit lines extended by international banks to Kuwaiti banks

- Freezing of Kuwaiti balances and assets in major countries

- Loss of legal capacity, which made the presence of Kuwaiti banks abroad very difficult

- Loss and dispersal of human resources in Kuwaiti banks

- Inability to settle outstanding transactions in the inter-bank or foreign exchange markets

With the aforementioned prospects and banking developments in mind, the Central Bank of Kuwait found that there was a need for multi-stage plan for managing Kuwait's banking system during the invasion, then planning for reviving and restructuring the financial services sector of Kuwait.

This plan consisted of short-term efforts for handling bank problems and preparing these banks for re-opening after the invasion, a review later of the various tools of monetary policy and implementing policies that would add to market stability and encourage capital to settle at home, and finally longer-term efforts that involved assessing Kuwait's banking and financial system, and developing or establishing strong institutions capable of competition.

The measures taken by the Central Bank of Kuwait during the crisis had obvious effects on maintaining confidence to a large extent in Kuwaiti banks. These measures are summarized as follows:

1. The Reorganization of Kuwaiti Banks Abroad:

These reorganization efforts were implemented through the cancellation of all authorized signatures and limiting them to the signatures of chairmen and their deputies. In addition, reorganization and re-grouping of top executives abroad were achieved. Correspondence with the banks which used to deal with Kuwaiti banks took place in order to reconstruct our bank records.

2. The Payment of Due Interest and Preparation for Settlements of Outstanding Transactions of Kuwaiti Banks:

These operations were carried out by means of:

- the preparation and execution of a plan for the payment of interest on Kuwaiti bank liabilities, so that foreign banks could avoid making provisions against their holdings of Kuwaiti banks assets, since the end of the year was approaching at that time.

- the enumeration of Kuwaiti bank transactions in the foreign exchange market and starting their settlements, either by settling due transactions or by bringing future maturity dates of transactions to the present and then settling them.

- the settlement of transactions in the inter-bank market by offering foreign banks the option of renewal of their deposits with Kuwaiti banks or their complete settlement. An agreement was reached by the governors of central banks and monetary agencies in the Gulf Cooperation Council (GCC) to renew and roll over current deposits among Kuwaiti banks and banks in the other GCC countries.

3- The Treatment of Conditions Arising from Freezing Kuwaiti Balances Abroad:

This freeze was implemented at the request of Kuwaiti authorities to protect these assets from falling into the hands of the Iraqi aggressors. Therefore, freezing was a necessary evil. In spite of protecting Kuwait's right and its investments, it was an obstacle that prevented Kuwaiti institutions from managing their assets easily.

The Central Bank of Kuwait asked foreign authorities to lift the freeze in stages from the assets of Kuwaiti banks, after ensuring that these banks had the ability to manage these assets.

The cooperation of most foreign monetary authorities had a positive effect on facilitating various settlement transactions. These authorities issued necessary licenses after collecting documents and details regarding Kuwaiti banks' plans to settle outstanding transactions.

4- Other Crucial Tasks:

- The Central Bank of Kuwait held regular meetings in London with chairmen of Kuwaiti banks to discuss different issues and coordinate their efforts.

- There was continuous and close contact among the Central of Kuwait, the Ministry of Finance, the Kuwait Investment Authority and the Kuwait Investment Office in London. These contacts aimed at discussing current issues and problems and coordinating what needed to be done.

- To illustrate the kind of support we received from the governors of central banks and monetary agencies in the GCC, without which it would not have been easy for us to defeat the odds, these GCC institutions continued exchanging the Kuwaiti dinar during the crisis in coordination with the Central Bank of Kuwait to facilitate transactions of Kuwaitis who emigrated from the brutality of the Iraqi occupation. In a meeting held in London on August 17, 1990, the governors of the central banks and monetary agencies in the GCC countries agreed on specific exchange rates for the Kuwaiti dinar against each GCC currency. A maximum limit of KD 500 per Kuwaiti was also set. The total value of purchased KD's was about KD 92 million.

- The Iraqi occupation forces looted the vaults of the Central Bank of Kuwait and stole the cash currency notes which had not been issued, and large quantities of gold. An Amiri decree was issued abrogating the stolen cash currency notes and declaring them void as legal tender. The Central Bank of Kuwait immediately took measures to print new currency notes (the fourth issue), which were ready in the beginning of December 1990.

- The Bank coordinated with central banks in other countries to inform their banks and financial institutions to cease accepting the abrogated Kuwaiti currency notes, which were no longer legal tender.

- The Central Bank of Kuwait prepared instructions in advance, to be implemented by the banking system and exchange companies on their return to Kuwait after the liberation.

- Also, the Bank kept track of its principal officials, in order to take them to Kuwait immediately after the liberation. In addition, the Bank was throughout the occupation period in close touch with Kuwait, to learn about whatever related to the Central Bank and to arrange to infiltrate funds to Kuwaitis to support their resistance.

Third: The Central Bank's Role after the Liberation of Kuwait

After the liberation of Kuwait, there was on our hands the immense task of rebuilding our war-shattered economy. Kuwait confronted a serious economic problem as a result of the damage to its infrastructure and the destruction inflicted upon its production and development capacity. The extent of this problem is not only limited to the imbalance between the financial burdens of reconstruction and development and public revenues, but is also aggravated by the intensity of efforts required to move along a carefully drawn course for the economy, in order to achieve our longer-term objectives without sacrificing in that process our immediate or shorter-term requirements.

In this context, the Central Bank of Kuwait was responsible on its part for reviving the activities and the role of the banking and financial sector in Kuwait. The Bank introduced the new currency notes on March 24, 1991, together with certain controls on withdrawals and transfers. It is worth mentioning here that we instructed our local banks to reset the balances of all customer accounts with them to what they were before the invasion on August 1st 1990, and to pay interest on savings and fixed deposit accounts for the whole period of the invasion and occupation of Kuwait.

These controls were necessitated by the exceptional working conditions in the banking system, which were mainly due to a lack of technical professional manpower and a lack of basic services, such as electricity, the breakdown of computer equipment, the unavailability of accounting records and systems and the deficiency of a communications network. However, as these technical and logistical shortages started to show signs of improvement, on July 1, 1991, the controls were eased by increasing the maximum limit on withdrawals and transfers allowed for each customer from his accounts in local banks from four thousand dinars to six thousand. Later, on August 3, 1991, these controls were lifted completely and necessary precautions were taken to meet the possibility of large capital outflows taking place.

It was taken into consideration by the Central Bank that the maximum amount of currency withdrawals be consistent with a volume of domestic aggregate demand that would conform with the supply of goods and services available in the local markets, thus avoiding a sharp increase in levels of domestic prices. These prices rose in April 1991 by 85% of their level before the invasion, according to the domestic price indicator prepared by the Bank.

We are pleased to see that the rate of increase in domestic prices has fallen substantially during the last few months, reaching 9%

only at the beginning of November 1991. The economic history of Kuwait will not forget this outstanding achievement in a relatively short period of time, thank to the massive efforts of the concerned authorities who succeeded in providing the local market with needed supplies of goods at reasonable prices.

The Central Bank policies, especially the KD exchange rate policy, have been among these efforts that aimed to control domestic inflation.

Lifting the aforementioned controls resulted in deposit withdrawals from banks and transfers to foreign currencies much less than was anticipated. This reflected the Central Bank's success in maintaining depositor confidence in the banking system and the new Kuwaiti dinar.

Among the factors contributing to that confidence is the KD exchange rate policy, which is the same as the one successfully followed for more than a decade before the invasion. It is based on pegging the KD to a basket of currencies of our major financial and trade partners. This policy preserved the strength of the KD against foreign currencies.

The interest rate structure is another element supporting the KD, because the interest rate on KD deposits enjoys favorable margins over corresponding US dollar deposit rates. In addition, we might add the recovery of all stolen gold, commemorative coins and currency notes from the Iraqi regime.

Regarding the change of Kuwaiti currency notes, the board of directors of the Central Bank of Kuwait issued a resolution during its regular meeting in March 1991 concerning the withdrawals of the third issue of Kuwaiti currency notes and replacing them with a new issue according to rules and regulations set by the Bank in this connection. Now the new fourth issue of Kuwaiti currency notes is firmly established.

The Central Bank of Kuwait extended its financial support to local banks to facilitate first the settlement of their domestic inter-bank transactions, and next the settlement of inter-bank transactions to GCC banks. This financial support reflects the Central Bank's deeply rooted belief in the importance of stressing the principle of credibility and of honoring such commitments.

Overseeing the resumption of banking operations and the restoration of full financial services in the banking and financial sector, the Central Bank engaged in the process of assisting the banks and other financial institutions in adjusting their financial positions. It has proposed to the government a plan to resolve the difficult debts problem; according to this plan, the government would buy the difficult debts from the local banks and financial institutions, thus relieving them of this problem, improving their balance sheets, revitalizing their loan portfolios and, in consequence, allowing them to concentrate on their main role in the reformation and development of the Kuwaiti economy. On the other hand, the government would no longer guarantee the bank shareholders' equities, so that banks become more responsible for their actions and bear the consequences of their own decisions.

The Central Bank is also endeavoring to chart out the future course of action for its role in managing the banking and financial system in Kuwait. These endeavors focus on a number of issues, which include:

- consolidation of the local banking and financial system to create stronger, more efficient and competitive institutions through mergers.

- recruitment, training and encouragement of national manpower in the banking and financial sector.

- deeper integration of the Kuwaiti banking and financial sector into the world economy, and additionally, forging stronger relations between our banks and international banks.

However, a challenge is foreseen to re-establish and strengthen our financial institutions and reinforce the international outlook. Such a goal would require a review of the overall structure of the banking and financial system. It could perhaps include serious consideration of amending existing law and regulations wherever needed, and examining the institutional framework of that system with a view to implementing any needed modifications and adaptations.

It must be clear that the main responsibility to adapt to the new situation, and to take advantage of its opportunities and reduce its risks, lies with the private sector itself. Banks and financial institutions must prepare their own individual plans for the future, which will be a period of self-reliance, competition, and integration with international markets. The Central Bank of Kuwait will provide the monetary and supervisory framework for stability and competition, but the banks and financial institutions will have to prove their ability to adjust and compete.

May I conclude by saying that as a central bank, God willing, we shall prove to all in Kuwait, as well as in the region and the world, that we are capable of overcoming all challenges put to us, and time shall testify to this.