Monetary and Financial Aspects of Issuing Public Debt Instruments in Kuwait [1]

I would like to thank the Faculty of Commerce for arranging this meeting, which I hope will lead to the clarification of certain monetary and financial aspects related to the issue of public debt in Kuwait. Among these aspects is the use of deficit-financing by public borrowing as an instrument of an expansionary fiscal policy affecting economic activity, and consequently affecting some of the variables related to the financial market. We will especially try to become acquainted with certain monetary aspects such as the relationship between public borrowing and the liquidity position in the economy, and the link between public debt management and the regulation of liquidity levels.

To begin with, I would like to review in brief some factors and developments which led to the passage of Decree Law No. 50 of 1987, which permits the Government to resort to public borrowing.

The last few years have witnessed a decline in oil prices, which, combined with a marked drop in the U.S. dollar exchange rate during 1986 - 1987, have led to a shift in terms of trade against oil exporting countries, including Kuwait. This shift has been associated with pressure on Kuwait's State

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budget, particularly in light of the Government's commitment to complete its development programs and the infrastructure, in addition to a desire to maintain the standard of living achieved over the past years.

According to the method applied in Kuwait to estimate public revenues, the first deficit in the State budget in recent years was recorded in the fiscal year 1981/82. The estimates of the current year 1987/88 show a deficit of KD 1376 million, the largest estimated deficit ever witnessed by the State budget in Kuwait. It should be noted that the expected deficit depends on estimated revenues, based on expected oil revenues at the time of budget preparation, which means that the actual deficit may be different from that estimated. The recent marked increase in the budget deficit, coupled with other factors, made the State choose public borrowing as a means to finance the deficit. Several factors were crucial in reaching this decision:

First : Recognizing the importance of completing the economy's infrastructure, especially as some major projects were already under way, and considering current economic circumstances, it was deemed inappropriate to resort to balancing the budget, which would necessarily entail a reduction in public expenditure. In view of the expected adverse effects of such a course on the domestic economy, the Government chose to resort to deficit financing, along with a tightening of expenditure in certain budget items.

Second: During the past few years, the authorities in Kuwait have paid special attention to Kuwait's financial market and have closed regulatory gaps that affected its stability and growth. Recently, the Central Bank of Kuwait has concentrated on the role of the financial market in the economy and investigated what can be done on the part of the Bank to help develop this market and diversify its available investment instruments, leading to the development of the financial market as an important sector in the Kuwaiti economy. Public debt was seen as a helpful step in this direction.

Third: In the mean time, the Central Bank of Kuwait has studied its available monetary policy instruments and found it necessary to augment these instruments by introducing new channels for regulating liquidity levels in the Kuwaiti economy and thereby increasing the efficiency of monetary policy in the coming period.

Governments in general play a vital role in developing their economies, and public expenditure is one important instrument used in performing this role. Should the public revenues be insufficient to cover the required expenditures, Governments usually resort to external or internal borrowing to meet the deficit. The authorities in Kuwait found themselves with two alternatives: either to follow the traditional method, which most oil countries have used to finance the budget deficit, i.e. drawing from the reserves; or resort to a new method, which at the same time might serve other objectives of economic policy, i.e. offering public debt instruments. The major factor behind this choice was an analysis of the economic and financial costs and benefits, particularly in the medium and long terms. Weighing the cost and benefits, it was found that borrowing from the local market would be the best method. However, when the decision was made to resort to public debt, the following factors were taken into account:

1- It was deemed inappropriate to obtain the required financing by liquidating certain domestic assets, to avoid adverse effects on asset values in the domestic economy, particularly that a major portion of these assets has good rates of financial returns. Meanwhile, the capital values of these assets are expected to grow in the future.

   Further, it was deemed inappropriate to liquidate foreign assets already built up during recent years, as selling part of these assets would result in the loss of good rates of financial returns, plus the loss of good quality investments.

2- The Kuwaiti financial market still suffers from limited investment instruments. The instruments need to be diversified to include new instruments reflecting financial transactions with different maturities. Such a diversification is required for market development. Further, offering public debt instruments with maturities ranging from three months to several years will lead to the development of the term structure of interest rates, and will consequently increase the efficiency of the market, which now concentrates on short-term dealings.

3- Monetary policy in Kuwait has recently focused on money market operations to regulate liquidity. It was seen that issuing public debt instruments will enable the Central Bank of Kuwait to build up from these instruments a portfolio of local assets through which the bank can engage in open market operations. This will allow the monetary authorities, for the first time, to use a key monetary policy instrument, one that is highly flexible, thereby influencing the monetary base which consists of currency in circulation and bank reserves, consequently influencing money supply.

4- Resorting to public borrowing will diversify the sources of budget finance and will consequently reduce direct dependence on oil income. Further, the settlements of public borrowing over the coming years will distribute the burden of deficit finance over longer periods, in addition to providing stability to the resources side of the budget.

5- Resorting to borrowing utilizes part of the private sector's financial surplus in financing public expenditure and consequently allows this sector to participate in financing a part of the budget. Moreover, the treasury bills and bonds are guaranteed investment instruments and provide a good return for their holders.

Undoubtedly, there are many questions about the kind of instruments to be offered for subscription, the method of subscribing, and the yields on these instruments. Allow me to explain that these public debt instruments will be of two kinds: treasury bills with three-month maturity, offered for subscription on a discount basis and according to an auction system; and treasury bonds, with fixed interest rates payable every six months, in accordance with their attached coupons. These bonds are issued for maturities not less than a year and not exceeding ten years. These instruments will be issued in five denominations: KD 1000, KD 10,000, KD 50,000, KD 250,000 and KD 500,000, thus meeting the requirements of all types of investors, whether corporate or individual.

Though the right of subscription to public debt instruments in the primary market shall be exclusive, in the first phase, to banks and investment companies that are under the supervision of the Central Bank, any individual or company may request any of these financial institutions to subscribe for him. The requests of these shall be included within the requests of those parties.

No limitations are imposed on trading in these instruments in the secondary market since they are bearer instruments: nationals, residents and others can buy these bills and bonds. Within the general framework of financial market development, the Central Bank shall activate a secondary market for these instruments, which will increase their liquidity.

Offering public debt instruments for subscription will surely give rise to further questions about certain monetary and financial effects, and I would like to explain these aspects of government borrowing from the local financial market.

It is known that investment outlets that are available for the private sector in the local market are limited to bank deposits, shares of companies and the real estate sector. Here a question may be raised about the monetary effect of public debt instruments on bank deposits and the cost of financing in the local economy, in the sense that the State may crowd out the private sector by competing with the banking sector to obtain available financial resources, which in competition may contract the deposit base of local banks on the one hand, and raise interest rates and consequently the cost of government financing on the other.

The effects of public debt issuance on private sector deposits should be considered in light of the successive monetary effects of the issue and the realistic potential for the disposal of these funds, whether by the Ministry of Finance in the area of public expenditure, or by the Central Bank in the area of using monetary policy instruments. We should not ignore the effects of these high quality debt instruments on bank assets, their role in fostering the growth of high-yield liquid assets, improving banks' investment portfolios, lessening pressure on lending portfolios, and consequently reducing bank risks and promoting bank performance in general.

Therefore, we cannot accept the common misconception that there is always a negative relationship between state borrowing and private sector deposits. There should be a distinction between the immediate effects and the more important effects on the medium term. This means that there are primary and secondary effects: in the first phase, offering public debt instruments for subscription may lead to partial contraction in the deposit base with banks, but this does not represent the ultimate effect of these instruments, as the private sector may finance its participation by means of a transfer of foreign assets, plus the fact that a great portion of demand for these instruments will come from banks themselves by means of substituting the public debt instruments for what they have of CBK bills. It can be noted in this respect that local bank holdings of CBK bills totalled around KD 700 million at the end of October 1987.

Therefore, about half the amount which was permitted to be borrowed as per the law will be covered by resources already available at local banks, i.e. the current bank deposit base will not be greatly affected. If we consider the later effects, we must take into consideration the role of public expenditure in the monetary cycle and its positive effects on the deposit base, particularly since the aim of public borrowing is to maintain the appropriate level of public expenditure which feeds these deposits through the different expenditure items of the budget, in addition to funds that might be injected by the Central Bank into the banking system through its operations within the context of monetary policy or in its capacity as the lender of last resort to banks.

Furthermore, it is useful to take into consideration the different channels available to the Central Bank to influence the banking sector and alleviate any transitional negative effects of public borrowing.

As for allegations that the issuance of public debt instruments will have negative effects on the stock market, the Central Bank's experience during the past few months when issuing its own bills shows that the financial market can absorb the expected volume of public debt without any negative effects on the local share market. Further, state borrowing will foster demand in the local market, which is usually characterized by an excess of actual and potential supply of funds over demand. This will enhance stability of the market for funds, especially since the government will then become a local source of stable demand for funds.

If we go back to the performance of international stock markets in recent years (before the shock of October 1987), we notice that stock prices in the United States, which annually finances not less than 20% of its budget by borrowing, had witnessed a continuous upward trend for some years, despite the rise in the ratio of public debt to the gross national product to about 43% in 1986.

In addition, it is clear that a number of factors are working out now in favour of stabilising local share prices, particularly since most national companies have recently realised the effect of low asset values on the outcome of their operations, which have consequently improved their financial positions. These factors will, however, give more stability to share prices. It should also not be forgotten that the private sector in Kuwait holds foreign assets as a result of the absence of local investment opportunities. It is not unlikely, in view of the unstable atmosphere in the international markets, that a part of these funds will come back to the local market if the profits are high and stable.

Regarding the remarks that may be raised about the effect of public debt on transferring the financial burden to future generations, I would like first to explain that the State concern with future generations should not mean sacrificing the welfare of the present generation. Further, giving public debt serious consideration by the Government emphasises its continuous concern with future generations. Resorting to public debt instruments to finance the budget deficit is supported by the availability of domestic surpluses at suitable interest rates, and the need for keeping the invested reserves intact, in order to benefit from their high yield. This will, sooner or later, reduce the final costs borne by the government, as the real burden is not merely reflected by the cost of interest on debt instruments, but also represented by the differential between the paid interest and the return on invested reserves.

Finally I would like to mention that the issuance of public debt instruments shall be managed by the Central Bank on behalf of the Ministry of Finance. The influence of these issues on the economy and the financial sector and consequently their success in realising the targeted objectives will depend on the details of these issues, particularly the yield and the possibility of developing an active secondary market. We must also not forget that public borrowing is one of several avenues for monetary and fiscal policy available to policy makers in Kuwait. It is the first such experience in Kuwait, which we hope will be successful.