Monetary Policy and the Structure of Interest Rates in the Kuwaiti Market [1]

I would like to express my thanks to the Kuwaiti Economists' Association for inviting me to lecture on "Monetary Policy and the Structure of Interest Rates in the Kuwaiti Market." Dealing with this subject requires first defining the scope and objectives of monetary policy in Kuwait and outlining its instruments used by the Central Bank, demonstrating the existing structure of domestic interest rates and finally examining the future role of the Central Bank in light of the objectives of the general economic policy of the country.

We are all conscious of the great efforts to be exerted if the monetary policy in Kuwait is to play its expected role in achieving the objectives of the State's economic policy, in view of local and foreign developments which affect certain aspects of the Kuwaiti economy.

The major role of a Central Bank is to formulate and implement monetary policy in line with the objectives of the State general economic policy of the country. Thus, the Central Bank must assimilate these objectives and keep pace with local and foreign monetary and economic developments.

The techniques used in pursuing these objectives are different in degree, scope, type and effectiveness, from one central bank to another. They depend upon many factors, mainly the degree of economic growth in the country, the volume and diversification of its financial resources, the

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structure of its banking system, its international financial relationships in terms of being debtor or creditor, the maturity of its capital market, and finally the degree of organization and activity of its money market. Knowledge of these factors will help determine the limits of possible effectiveness for this policy so as not to be overloaded with issues beyond its scope.

Moreover, realizing the objectives of the country's general economic policy requires that a certain role must be played by each of the authorities concerned with the implementation of these objectives. It also requires harmonic co-ordination among their activities; otherwise, the decisions relating to the implementation of monetary policy will be ineffective and sometimes contradictory.

Certain issues resulting from the structural and institutional framework of the Kuwaiti economy have consistently restricted the effectiveness of monetary policy within the overall economic activity in Kuwait. These include the dominance of the oil sector over the gross domestic product, the narrowness of the productive base, the control of government expenditure over the general economic activity, the absence of an advanced local financial market, and consequently the non-availability of sufficient domestic outlets for productive investment.

Here an important question arises: what have been the results of Kuwait's experience with monetary policy during previous years, so as to envisage the meaning and the expected role of that policy in the future? These results can be summarized from the experience of the Central Bank in managing the monetary policy, with special reference to the structure of interest rates in the Kuwaiti market.

First: Objectives of Monetary Policy in Kuwait :

It is possible to refer to the following monetary policy objectives:

1- Maintenance of relative stability in the purchasing power of the Kuwaiti currency.
2- Availability of adequate levels of bank liquidity.
3- Supervision over the volume and trends of bank credit.
4- Development of both the money and capital markets in Kuwait.
5- Reinforcement of the role of the banking system through supervision over it.

1- Maintenance of relative stability in the KD exchange rate and its purchasing power:

Boosting the purchasing power of the KD and protecting the domestic economy against the adverse effects of imported inflation are goals of the monetary policy in Kuwait, particularly as the Kuwaiti economy is open to the outside world in the fields of trade and foreign investment.

The KD exchange rate has witnessed many developments since April 1961 when the KD was first issued for circulation as a national currency. The most important development is that the KD exchange rate has been tied since March 1975 to a basket of currencies which reflect Kuwait's most important commercial and financial relationships with other countries, and is in line with the CBK policy of ensuring the highest degree of stability in the KD against other major currencies and utmost security for local capital that flow abroad seeking better investment outlets, together with maintaining the stability of domestic price levels.

From the effective performance of the KD basket, we can realize the stability that the KD exchange rate has achieved against major currencies, and the protection of the KD purchasing power, as follows:

a) Relative stability of the KD exchange rate:

The rates of monthly change in the average KD exchange rate against the dollar show relative stability as compared with the dollar's volatility against each of the major currencies. The rates of change in the exchange rates of major currencies against the dollar, during 1986 for example, ranged between -6.8% and 4.7% for the Japanese yen, between -4.7% and 1.7% for the deutsche mark and between -3.8% and 3.8% for the pound sterling, whereas the change in the KD exchange rate against the dollar, up and down, has not exceeded 1.6%.

b) Protection of the KD purchasing power:

Tying the KD to a basket of currencies has led to protection of its purchasing power and moderate volatility. The effective KD exchange rate index (18 March 1975 = 100) against twenty currencies, represented in 88% of Kuwait's imports, indicate that the KD purchasing power during the period 1980-85, for example, rose by 4.6% per annum. Thus, a rise in the purchasing power of the KD undoubtedly plays a positive role in reducing the rate of imported inflation.

2- **Availability of adequate levels of bank liquidity :**

To ensure the availability of bank credit sufficient to finance productive economic activities in the non-oil sectors and to keep the cost of such finance as low as possible, the Central Bank helps banks to meet the shortage in bank KD liquidity by means of discounts, swaps, loans and Central Bank deposits with commercial banks.

The Central Bank's policy in supplying banks with KD liquidity involves two main factors affecting the volume and trends of bank credit:

- The interest rate which is charged by the Central Bank. This rate affects the cost of funds obtained by banks from the Central Bank. It also affects the level of interest rates charged on loans granted by banks to their customers.

- The volume of funds the Central Bank agrees to provide to banks, and the relevant conditions set by the Central Bank in this respect. Some of these conditions relate to the economic activity that should receive the funds.

By means of the two factors above, the Central Bank also helps to overcome the problem of incidental shortage of liquidity, so as to keep banks always capable of meeting the real needs of economic activities.

So far, the Central Bank has used a number of monetary policy instruments, as need arose, stipulated in Law No. 32 of 1968 (concerning currency, the Central Bank and the organisation of banking business), to secure appropriate levels of liquidity with banks, particularly CBK loans and deposits with banks, discounts and swaps.

In this regard, Articles 40, 41 and 42 of Law No. 32 of 1968 concerning currency, the Central Bank of Kuwait and the organisation of banking business stipulate that the Central Bank may open deposit accounts with banks and extend loans to these banks under certain conditions with the aim of providing banks with liquidity, whenever necessary.

Further, the discount and rediscount system applied by the Central Bank aims at providing banks with liquidity in conformity with certain rules and conditions that help to use discounts as one of the monetary policy instruments. The application of the discount system goes back to February 1, 1975, in response to the CBK desire to give banks an opportunity to obtain facilities from it when these banks became, then, short of KD funds.

Discount operations were relatively limited in the beginning and conducted at prolonged intervals due to a shortage in commercial papers in local bank portfolios, and because the concerned law, before being amended, provided that the paper maturity should not exceed three months following the date of its discount at the Central Bank. An amendment to Law No. 32 of 1968 at the end of 1977 permitted discounting of papers with maturities of up to one year from the date of their discount.

For example, discounts and rediscounts of commercial papers at the Central Bank had totalled KD 455.1 million at the end of July 1984 against KD 264.3 million in December 1986.

On May 30, 1978, the Central Bank introduced swap operations with local banks, for periods ranging between one week and three months, as a means of withdrawing a part of the KD liquidity surplus that was available then at banks. However, these operations have been used the other way round since February 1979, as a means to help any bank increase its KD funds when it faces a shortage. These procedures can also be used as a means to withdraw some of the liquidity surplus of the banking system. The outstanding value of swap operations peaked at the end of June 1984, totalling KD 515.2 million.

The current liquidity system applied by the CBK to banks provides that KD liquid assets shall not be less than one third of the total liquid assets to be held against different types of deposits. The banks also undertake to keep a part of these liquid assets in the form of bonds issued by the CBK, sight deposits with the CBK or cash assets in their own vaults.

Furthermore, the liquidity system takes into account bank profitability, as banks maintain relatively lower liquidity ratios on longer term deposits, which are more expensive resources.

Central banks, however, are now using the liquidity system as a monetary policy instrument to affect the volume of bank credit, along with the main objective of the liquidity system represented in the banks' capability to satisfy their obligations toward depositors.

3- Supervision over the volume and trends of bank credit:

Aiming to direct bank credit in favour of economic growth, promote productive economic sectors and curb the expansion in unproductive economic activities, the Central Bank issues directives to banks as it deems necessary. Further, the Central Bank applies certain rules and conditions regarding the provision of liquidity to banks, which affect the volume and trends of bank credit.

As an example of the Central Bank's instructions in this connection, we cite those which regulate and rationalize the banks' credit policy, and which emphasise time-fixed loans and the reduction of overdraft credit facilities. Moreover, the Central Bank requires the lending bank to evaluate the client’s financial position, and follow up the use of the loan for the purpose specified in the loan contract without exceeding the determined limits of overdraft facilities.

Furthermore, the decision determining the maximum unsecured credit facilities that any bank may grant to one person - whether natural or notional- aims at expanding the base of beneficiaries of bank credit.

4- Development of efficient money and capital markets in Kuwait:

The development of efficient money and capital markets in Kuwait and providing these markets with instruments and means necessary for their effectiveness are among the Central Bank's major interests, as an adjunct to the growth of a sound and healthy banking system. For example, there is no doubt that the existence of a flexible and developed money market will offer options and opportunities suitable for short-term investments. This will secure a tangible portion of domestic investment at local banks; thus, the Central Bank's supervision over banks will expand and the objectives of its operations will be served.

Among the measures put forward by the Central Bank to develop both money and capital markets are the following:

a- Activating the inter-bank market:

The Central Bank of Kuwait encourages the operations of the inter-bank market. To avoid any negative effects on the operations of this market, the Bank has set a liquidity system which stipulates that inter-bank deposit operations shall be exempted from liquidity ratios if so requested by the concerned bank and the deposits re-employed at other banks are for the same maturities of these deposits.

b- Legislative flexibility in determining the structure of interest rates:

The maximum contractual interest rate was specified in the previous law of commerce, before being amended in November 1976 upon the Central Bank's request. Thus, the decision determining the maximum contractual interest rate shall be made by the Central Bank's board of directors, subject to the approval of the Minister of Finance. This flexible method of determining the maximum contractual interest rate has enabled the Central Bank to set a structure of interest rates that accommodates the conditions and requirements of the State's economic activity on the one hand, and eliminates the obstacles that would impede the development of the money market on the other. The current law of commerce stipulates - upon the Central Bank's request - that the Central Bank may determine more than one maximum contractual interest rate, meaning that a maximum interest rate could be set for each of the financial transactions according to its nature.

c- Encouraging banks to issue certificates of deposit and bonds:

Among the most outstanding developments witnessed by the money market in Kuwait during the last quarter of 1977 was the issue of certificates of deposit denominated in Kuwaiti dinars. In October of that year, the Central Bank authorized banks to issue certificates of deposit with maturities ranging between three months and three years at interest rates to be agreed upon. Some banks issued certificates of deposit at a floating interest rate so that the yie1d would reflect the prevailing trend of interest rates in the market. However, despite the flexibility of these interest rates, the absence of a secondary market for trading these certificates checked their effectiveness. Moreover, the Central Bank encouraged some banks to issue bonds put for public subscription.

d- Bills issued by the Central Bank of Kuwait :

In April 1979 the Central Bank commenced the issuance of bills expressed in Kuwaiti dinars to local banks desirous of purchasing them. Later, other financial institutions were allowed to purchase these bills, as well.

In view of the actual experience of the bills system, the Central Bank made several amendments to develop the role of these bills. Among these amendments the Bank considered its bills as an integral part of liquidity requirements and was ready to purchase them from their holders offering them for them for sale before their maturity. The Central Bank further allowed banks to use these bills as collateral for loans from the Central Bank. The Central Bank also approved of “re-purchase agreements” made by banks to cover the debit balance in their current accounts within certain limits, provided that these bills were not used as collateral and were in excess of the limit required for covering the ratio of liquid assets.

In addition, the Central Bank decided to diversify the bill maturities, with some having a one-week maturity, some a four-week maturity and others a 13-week maturity. This decision aims at providing various maturities for banks to attract them to invest their funds in these bills.

We must, however, wonder whether these bills have realized their targeted purposes. To answer this, we have to mention that the bills system was developed to replace the system of banks’ interest-bearing deposits with the Central Bank, which was applicable at that time. That system was deficient in having relatively stable interest rates on deposits which were not tradable. In this context it can be said that the bills system has realized its purpose of absorbing liquidity surpluses at banks. Furthermore, these bills received reasonable interest from banks to be used as collateral for Central Bank loans and as an important alternative for liquidity requirements.

However, the bills system was not broad enough to play an important and effective role as an instrument of both money and capital markets. The relatively low interest rates apparently account for the inactive trading in the CBK bills.

e- Regulating the issuance of bills in the local market for the benefit of foreign agencies:

These issues were prompted by relative stability in the KD exchange rate and by the expertise of certain Kuwaiti investment companies in issue management. This encouraged prime borrowers to enter the market for KD-denominated bills. For its part, the Central Bank sets the rules regulating the issuance of these bills and ensures, by means of sufficient information about the issues to be made, that timing of issues conforms with liquidity circumstances in the market. The Central Bank encourages these issues in principle, as they support the development of a capital market in Kuwait.

5- Reinforcement of the role of the banking system through supervision over it:

Because the implementation of the monetary policy adopted by the Central Bank is ultimately the responsibility of the banking and financial institutions, this policy will remain of limited benefit in the absence of a sound and regulated banking system that would enable the banking institutions to work on sound bases and in favour of the Kuwaiti economy and to find out the deficiencies of these institutions and remedy them. The Central Bank has used different instruments of monetary policy, and issued decisions and instructions that aim at ensuring the soundness of these institutions and the promotion of their performance.

Moral suasion has been successful in this respect, as the Central Bank usually resorts to this method to enhance its continuous dealing with local banks by means of mutual consultations leading to appropriate formulas of measures and decisions that cater to the protection and promotion of the banking system in Kuwait.

A review of the instruments of monetary policy, instructions and regulations used by the Central Bank in previous years emphasizes the Bank's concern in maintaining a stable banking system. For example, in June 1971, the Central Bank introduced the bank risk system which necessitates obtaining data and information regarding local bank customers, then classifying these data and information before making them available to banks upon request to assess the financial positions of customers applying for credit facilities. In January 1975, the Central Bank introduced some amendments to the bills system to be more comprehensive and thereby to provide sufficient information about various credit facilities.

Moreover, the liquidity system currently applied by the Central Bank was a result of the application of a previous liquidity system which was comprehensive in dealing with deposits regardless of their maturities and was not diversifying liquid assets according to deposit maturities. The present system takes into account the deposit structure at each bank. For this purpose, these deposits, including certificates of deposit issued by banks, are divided into five categories. Against each category, banks have to keep liquid assets determined by this system, provided that they should not be less than a certain ratio, varying according to deposit maturities.

In July 1976, the Central Bank determined the maximum limit that might be lent to one person, and obliged commercial banks not to grant unsecured credit facilities to one person exceeding 10% of the bank's own funds. This decision aimed at protecting local banks whose financial positions would be jeopardized if their debtors who obtained big unsecured credit facilities failed to pay. It also gives banks' credit granting policy objective bases leading to credit distribution, the curtailment of its concentration and an expanded base of beneficiaries of credit facilities.

The Central Bank also applied a number of systems to enhance banks' KD liquidity and alleviate the pressure on their liquidity so as to enable these banks to go on performing their functions of financing domestic economic activities. In previous years, the Central Bank provided local banks with funds at costs relatively low if compared with those of other bank resources by means of discounts, re-discounts, swaps and direct lending, as mentioned before.

The Central Bank procedures aiming at the maintenance of sound bank positions have included principles and rules set recently by the Central Bank for the classification of bank debts and the building up of provisions.

Thus, we can realize how far the Central Bank is concerned with supporting and enhancing the role of the banking system in the country so that this system can help in implementing the objectives of monetary policy besides the other privileges achieved by having a sound banking system in the country.

Second: The Structure of Interest Rates in the Kuwaiti Market:

In November 1976, upon the Central Bank's request, a legislative amendment to Article 166 of the previous law of commerce was issued empowering the Central Bank's board of directors, subject to the approval of the Minister of Finance, to determine the maximum contractual interest rate.

Pursuant to this amendment, the Central Bank issued a number of decisions at the beginning of 1977 which are still in force, determining maximum interest rates in Kuwait on transactions denominated in KD, leaving interest rates on foreign currencies to be determined by the two parties concerned, according to the prevailing interest rates on these currencies in the foreign financial markets.

The Central Bank issued a decision determining the general maximum limit of the contractual interest rate by 10% on transactions denominated in KD.

As for certain types of KD loans made by banks and financial and investment companies subject to the Central Bank's supervision, the Central Bank enacted a decision determining their maximum contractual interest rate at 7% per annum on guaranteed loans of up to one-year maturity extended to productive economic activities, and at 8.5% per annum on unguaranteed loans whose terms do not exceed one year. This decision has also determined a minimum interest rate on savings at 4.5% per annum.

The structure of interest rates is occasionally subject to certain pressures caused by the sharp upward trend of world interest rates and growing local demand for bank credit, combined with the rise in interest rates paid by Kuwaiti banks on deposits.

In response to its desire to have stable interest rates on lending, particularly to productive economic activities, the Central Bank has attempted to maintain the structure of interest rates. This used to be done by means of supporting local bank liquidity with low-cost funds provided through available monetary policy instruments, mainly discount operations, swaps, loans and Central Bank deposits with local banks.

Available statistics indicate that the monthly averages of weighted interest rates on KD credit facilities granted by local commercial banks were relatively stable, ranging between 8% and 9% per annum during the last five years and surpassing by 3 percentage points the average of weighted interest rates on KD deposits with these banks. This gives concrete evidence of the Central Bank's efforts to maintain the cost of financing from local banks at stable and relatively low levels, to serve the purposes of productive activities.

For the sake of flexible interest rates, the Central Bank requested that the law of commerce should allow the Central Bank to determine more than one maximum contractual interest rate. Thus, the Bank may now determine more than one maximum interest rate, which is currently being considered and prepared by the Central Bank.

However, there are certain social and regulatory considerations that affect the Central Bank usage of the interest rate as an effective instrument of monetary policy. Therefore, the Central Bank must always act in view of these considerations to keep the structure of interest rates in Kuwait in line with the requirements of prevailing financial and economic circumstances, a matter which is not always easy to do.

Third: Prospective Outlook :

Upon outlining the prospective outlook of the Central Bank role, in light of the general objectives of the economic policy in the country and the availability of suitable circumstances for the Central Bank to perform this role, the features of the role can be envisaged through the following procedures to be carried out by the Central Bank:

1- Modifying and updating the currently applicable instruments of the existing monetary policy, coupled with the implementation of new systems and instruments leading to the required change in the nature of monetary policy from qualitative to quantitative. It is envisaged, for instance, that increased efficiency in the role of domestic interest rates would affect the volume and cost of the required lending and would rationalize bank credit as well. Further, there should be co-ordination between domestic interest rates and the KD exchange rate to maintain stability in the cost of imports to curb speculation on the KD and restrain unfavourable capital outflows.

2- Increasing the efficiency of the Central Bank’s supervisory role to re-inforce the banking and financial system and prepare it to meet the requirements of the economic activity in the country. This means that we are looking forward to a qualitative shift in the performance of the banking and financial system.

3- Co-ordination between both the fiscal and monetary policies pursuant to the current economic conditions and their prospective potentials so that monetary policy would not operate apart from other financial and economic policies. Further, co-ordination is expected through efforts that are currently being exerted, such as co-ordination aiming at the regulation of public expenditure which affects domestic liquidity, and other long-term efforts to achieve the goals of the five-year development plan 1985/86 - 1989/90 through the co-ordination of the country's economic, fiscal and monetary policies.

4- Kuwait as a financial market. Kuwait stands now at the threshold of a new economic stage which requires the combination of efforts exerted by all bodies involved in the country's economic management to lay down appropriate bases for adjusting the course of the Kuwaiti economy and fixing its direction in accordance with the requirements and aims of the country's economic and social plan. Thus, the development of the financial market in Kuwait, so as to become a financial centre in the area, is necessary for the forthcoming stage. Naturally, the Central Bank is taking part in the efforts exerted to expand the base of the capital market and furnish it with the prerequisites for growth and progress.

As examples of how the Central Bank may take part in the development and promotion of a capital market in Kuwait, we cite the following:

- Taking possession of shares of Kuwaiti companies which perform productive activities needed for economic development in Kuwait or purchasing debentures issued by Kuwaiti companies that the Central Bank deems it necessary to support, as their activities would be beneficial to the Kuwaiti economy. This can be done through both the primary and secondary markets for shares and bonds and in conformity with the provision of Article 37 of Law No. 32 of 1968 concerning currency, the Central Bank of Kuwait and the organisation of banking business.

- Trading in the secondary market of debentures issued by Kuwaiti companies to enhance the financial market in Kuwait, to promote bills as an instrument of trading in the market and to participate in providing the domestic economy with liquidity.

- Developing its bills system by, particularly, expanding the base of bills purchasers.

Discussing the present and future monetary policy in Kuwait manifests certain features of the Kuwaiti economy. The desired benefit, however, will not be perfectly achieved unless these features are drawn up by combined efforts of all bodies responsible for managing the Kuwaiti economy in accordance with plans drawn in response to the existing circumstances and future developments within the context of goals representing the welfare of the Kuwaiti people at present and in the future.