Remarks on the Foreign Trade Sector in Kuwait and Trade Relations with the United States [(1)]

It is a sobering circumstance for me to be invited by the American Arab Association for Commerce and Industry to give my thoughts on the foreign trade sector in Kuwait and trade relations with the United States. This title is indeed very broad and sounds as if I were going to give some rocking-chair stories of immediate possible ways to enhance Kuwait's trade relations with the United States, but that is not my intention. What I would like to do is to sketch the main characteristics and importance of these relations and their future prospects in the Kuwaiti economy, which at the present time is passing through a decisive stage requiring practical acclimatization with several domestic and foreign developments. This would entail a fundamental review of the existing commitments and policies such as the commercial policy. This approach I hope might enhance our understanding of the fundamental aspects of American Arab trade relations, as well as merit a larger measure of interest and attention from you.

Kuwait's commercial sector was one of the main sources of livelihood for Kuwaitis in the pre-oil era. Dhows used to sail from Basra to Bombay and Africa to bring back to Kuwait such necessary commodities as dates, teak and mangrove woods, textiles, spices and rice. The geographical location of Kuwait on the Arabian Gulf helped it to develop into a prominent port, through which

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caravans linked trade from the East with ports on the Mediterranean . It was also a favourite oasis for the caravans of the north-south trade. The discovery of oil in the 1930's and the onset of large-scale production after World War II brought the commercial sector into even greater prominence. During the past decade, 1975-1984, exports and imports have contributed an annual average of about 71% and 41% of Kuwait's GDP at current prices respectively.

A free-market philosophy has been adopted as a result of Kuwait's unique demographic, geographic, and historical characteristics. Kuwait's climate and geographical location limit the variety of natural resources available for development. Certain socio-political factors which shape the country's political and cultural stance have their roots in the distant past. At the same time, however, the state is heavily involved in directing the course of the economy. The State administers and owns the oil industry, from which emanates a large proportion of the GNP at current prices (79% in 1973, 38% in 1982). However, adherence to the principles of free trade, unrestricted private investment and private enterprise is quite strong.

Foreign trade is one area in which the free market philosophy is clearly in evidence.

Foreign Trade Policy:

The overall status of the Kuwaiti economy is determined basically by the State's commercial policy (price of oil and its output level).

Since crude oil extraction is wholly owned by the government and because very limited amounts of domestically produced materials and labor are used in the extraction process, nearly all the domestic income generated by the oil sector accrues to the government which is therefore in a position to insulate the domestic economy from fluctuations in the price and quantity of crude oil exports.

The non-oil component of the Kuwaiti GDP is also predominantly influenced by direct State action. Public expenditure in Kuwait is high in relation to the size of the domestic non-oil economy. The ratio of public expenditure to non-oil GDP was around 60 percent in the early seventies and increased to 78 percent at the close of the decade. The financing of such a large expenditure, not by taxes but mainly by external sources of revenue, renders a change in the level of public expenditure, the most powerful policy instrument in the country. Since domestic expenditures are financed by sales of foreign exchange against KD, fiscal action has immediate monetary consequences and is reflected in money supply and domestic liquidity.

Finally, Kuwait enjoys a status of complete capital mobility. There are no direct or indirect controls on capital flows.

In the light of the above characteristics of the Kuwaiti economy, the objectives of Kuwait's foreign trade policy can be seen in line with the general goals of the broader economic policy, and can be summarized as follows:

1- To secure construction of the basic infrastructure which is needed to increase the economic growth rate.

2- To help in the achievement of structural changes in the economy.

3- To increase the productivity and competitiveness of locally produced goods.

4- To expand and improve the productive base.

5- To satisfy the consumption needs of residents.

The first and final objectives have been to a large extent realized, although a discussion of the extent to which these objectives have been fulfilled is beyond the scope of my talk.

Customs tariffs imposed on imports may reach 30% for commodities competing with locally manufactured goods. Exceptionally, a 100% duty is applied on imports of LPG. All others are subject to a modest 4% duty, except for imported foodstuffs, which are exempted altogether. Although import licenses are required for all commercial imports other than fresh fruits and vegetables, they are freely issued to registered Kuwaiti merchants and companies.

Kuwait has a liberal import policy. The few prohibitions which are in force are intended to protect domestic manufactures (oxygen, certain steel and asbestos pipes) and maintain certain social and religious values (pork or foodstuff containing pork, and alcoholic beverages). Moreover, all types of transactions with Israel and South Africa are subject to the Arab boycott as well. It may be noted here that quantitative restrictions and quotas are not used to control the inflow of imports or to protect domestic production.

On the export side, licenses are required for the export of arms and ammunition, live sheep and poultry, and certain other items which may be prohibited for export in times of emergency or shortage. Apart from these, no licenses are required for other exports or re-exports.

The customs duty was a source of state revenue before the growth of the oil industry, and has been maintained since as an alternative revenue source. Tariffs were introduced on certain goods in order to protect infant industries, but the limited range of application of these tariffs reflects the limited extent of Kuwait's manufacturing base. Diversification of income sources is one of the major objectives of economic development in Kuwait, and involves expansion of the productive base by means of encouragement and protection of import-substitution industries (the current trend is to emphasize export-oriented industries) as a means to reduce the degree of economic exposure.

The challenge now facing Kuwait's trade policy is how to harmonize encouragement and support of domestic industry with a policy of protection, and at the same time integrate these policies into the regional framework of the GCC.

Meanwhile there remains a direct link between levels of oil revenue and the overall level of national economic activities. Reduced oil income restrains government expenditure, the main impetus for economic development. Moreover, the private sector is heavily dependent on these government outlays, meaning that its rate of expansion will also slow if oil revenues are decreased.

Thus fiscal and monetary policies have a very important role in securing the objectives of Kuwait's foreign trade policy. Fiscal policy provides for the necessary financing of imports, public expenditure being the main source of domestic liquidity, while at the same time restraining domestic inflation and encouraging local industry through its subsidies of necessary goods and services. Monetary and credit policies serve to regulate domestic liquidity and to provide adequate credit facilities at reasonable cost for the productive sectors of the economy such as the trade sector. In addition, monetary policy aims to provide stability for the purchasing power of the local currency against other currencies in order, among other things, to protect the trade sector from imported inflation.

Foreign Trade Structure:

Kuwait's balance of trade has always been in surplus because total exports have generated income in excess of the absorptive capacity of the developing domestic economy with its limited investment opportunities.

The increase in Kuwait's imports during the seventies and early eighties was caused by a number of factors, including the accumulation of oil-generated revenues which resulted from opportune conditions in world oil markets. This motivated the drive towards modernization which in turn stimulated different economic activities. These flourishing economic activities boosted population growth from 0.7 million in 1970 to 1.7 million in 1985 as the required labor force grew (from 242,196 in 1970 to 491,509 in 1980). The population growth was naturally accompanied by a growth in demand for goods and services and in the standard of living, as shown by an increase in per capita income from KD 1413 in 1973 to KD 4642 in 1984.

Limited natural resources and a narrow productive base have in creased Kuwait's propensity to import. Available data on imports show that the increase in capital goods, imported to satisfy the needs of development projects and domestic industry, was accompanied by a similar increase in consumer goods, reflecting consumption patterns which have resulted from the growth in income, limited investment opportunities, and the demonstration effect. However, recent developments have tended to adjust the growth rates of capital versus consumer goods; capital goods grew at an annual rate of 119% during the 1980-1983 period, compared with 102% for consumer goods.

Unlike imports, the variety of exported commodities is limited, with petroleum exports constituting 90% of total exports on the average. Exports of non-oil commodities have grown in both variety and volume during the past decade, assuming a greater relative importance, from 3.8% in 1971 to 12.6% in 1983. Petroleum exports have begun to include more refined products at the expense of crude oil exports. The production of refined products, by way of illustration, rose from 11% of total crude in 1972 to 45% in 1983.

In spite of the marginal improvement in the composition of exports, however, the commodity concentration ratio (exports of crude oil and refined products over total exports) fell from 94% in 1973 to 87% in 1983, showing the degree of imbalance in the foreign trade structure. Analysis of the seven-point positive decline in the commodity concentration ratio reveals the trend towards adjustment of the foreign trade structure.

Bank Financing of Kuwaiti Imports:

The banking system in Kuwait has played an important role in financing and thus developing foreign trade activities. The private sector receives 25% on the average of total credit facilities extended to it by the commercial banks for trade activities. In 1980, the credit facilities granted to the trade sector amounted to KD 672 million out of total facilities of KD 2419 million (28%). By the end of December 1985, these facilities had increased to KD 933 million representing 22% of total credit facilities of KD 4199 million. On the other hand, the discount window as one of the monetary policy instruments of the Central Bank allows the local banks to get the necessary funds to meet the local demand for bank credit; the outstanding balance of the discount facilities was KD 328.5 million at the end of December 1985. In addition, the banking system facilitates settlement of trade payments using a variety of trade financing techniques, such as documentary letters of credit, documentary bills for collection, open accounts, clean drafts…etc.; the U.S. dollar is the major currency used for these settlements. In 1985, 50% of total settlements made for documentary L/Cs, B/Cs and other payment orders were in U.S. dollars against 56% in the preceding year. Trade financing through these conventional methods reached KD 1166.1 million in 1985, against KD 1418.9 million in the previous year.

Trade Relations with the United States:

Kuwait’s trade with the United States of America has been characterized by constant growth in the value of imports, which have increased from only KD

44 million in 1973 to KD 239 million in 1983, an annual growth of 117%. The value and volume of Kuwaiti exports to the United States are negligible.

The bulk of Kuwait’s imports from the American market include machinery and transport equipment, such as passenger cars, heavy vehicles, spare parts and various machines and instruments. The value of these imports grew from KD 42 million in 1974 to KD 154 million in 1983. Next in importance are manufactures, classified according to materials. These include textiles, rubber, wood and cork manufactures, and iron and steel, as well as metallic and non-metallic manufactures. Imports of these commodities increased from KD 4 million in 1974 to KD 24 million in 1983. The value of imports of manufactures such as furniture, clothing, medical instruments, photographic and cinematographic instruments and miscellaneous articles reached KD 23 million in 1983, as against KD 4 million in 1973. Food and live animals, together with chemical products, claimed most of the rest of imports, KD 7 million in 1974 as against KD 21 million in 1983.

The commodity composition of US-Kuwait trade is still highly concentrated, even though it has improved somewhat since 1974. In 1983, 64% of total imports was concentrated in machinery and transport equipment, compared with 66% in 1974. Manufactures classified according to kind and miscellaneous articles each constituted 7% of total imports in 1974, and both improved to 10% each. Food, live animals and chemical products were 9% of total imports in 1974, rising to 10% in 1983. The terms of trade are in favor of the United States.

In recent years, the deterioration of the terms of trade against Kuwait has resulted from the decline in the price of oil. Should the terms of trade continue to be against Kuwait, which depends greatly on imports for consumption and development purposes, the adjustment process currently underway will impact the trade profile between Kuwait and the United States.

As might be expected with this background in mind, the bases on which the future outlook for the trade sector in Kuwait is to be founded can be summarized as follows:

1- The negative impact of the reduction in oil prices on Kuwait’s total exports, and on budget and current account surpluses. The deceleration in net government expenditure, in addition to the difficulties in the stock market and the instability in the region had contributed to the depressed value of Kuwait’s imports.

2- The need for greater effort toward the diversification of the Kuwaiti economy’s productive base, within the framework of a well-defined plan, in order to achieve a long-term and self-sustaining development strategy in the non-oil sector, which should expand the role of the private sector and concentrate on industries and modern services that are capital-intensive and export-oriented.

3- In the field of fiscal policy, attention is given to the importance of broadening the revenue base and gradually rationalizing public expenditures, especially on government subsidy programs. Although some cushion against fluctuations in all receipts is already provided by investment income, active consideration should be given to raising certain fees and charges such as customs duties, as well as certain direct and indirect taxes, including perhaps a personal income tax and general sales tax.

The Problem of Banks' Non-performing Loans:

Let me take this opportunity to shed some light on the current problem of the non-performing loans of Kuwaiti banks. This problem has resulted, as have other economic problems, from domestic, regional and international developments which have created a situation where the Kuwaiti economy faces unprecedented challenges that require a new growth strategy.

The government has undertaken to fully guarantee the safety of Kuwait's banking system in order that Kuwaiti banks remain solvent.

In addition, the Central Bank of Kuwait has taken the following measures to handle the problem of banks' non-performing loans:

1- The Central Bank has introduced a loan classification system in order to identify the magnitude of the non-performing loan portfolio carried by each bank. After using this system to distinguish performing from non-performing loans, the Central Bank has then classified the non-performing loans into three categories: substandard (non-performing for less than 180 days), doubtful (180-365 days) and bad (over 365 days). Several factors cause loans to be non-performing, such as the delay in paying the accrued interests or instalments exceeding the credit limit without previous bank acceptance or settlement program, non-renewal of an accrued loan, the cancellation of previously provided credit facilities, the debtor’s declaring bankruptcy, and a court case against the debtor.

2- Based on loan classifications, the Central Bank defined reasonable specific provisioning requirements to cover the risk of the unsecured (according to Central Bank’s required collateral ratios) part of each of the three non-performing loans. These specific provisioning requirements are 15%, 45% and 100% for substandard, doubtful and bad loans respectively. Accordingly, the Central Bank compares the amount of actual bank provisionings with that needed to meet the specific required provisionings; on that basis, the Central Bank has been able to identify those deficit banks which do not have adequate specific provisionings and therefore require government support.

3- Needless to say local banks are induced to reduce their specific required provisionings by means of debt settlements. In this regard, the Central Bank has proposed to local banks a debt settlement program to help them reach amicable settlement with their debtors. This program is based on well-defined principles and rests primarily on the debtors’ financial positions. Special attention has been given to the following matters:

   a) The loan settlement of any member of the bank boards of directors has to be approved by the Central Bank before the agreement is signed.

b) The establishment of a creditors’ committee to negotiate with the debtor in cases where the aggregate amount due to the banking system from a single debtor exceeds KD 500,000, with the largest creditor acting as leader. In the case of debtors whose total exposure to the banking system does not exceed that amount, the lead bank is empowered to negotiate unilaterally with the debtor and all other creditors must follow suit. Bank are requested to furnish the Central Bank with the settlement agreement for each debtor two weeks after singing.

4- Through the government support program, deposits are to be placed with banks via the Central Bank at concessional terms involving low rates. These deposits will be allocated amongst the deficit banks on a case to case basis, so as to enable each bank to generate sufficient earnings to be able to increase its provisioning level to that of the specific requirements.

Lastly, it is worth pointing out that all local banks have shown gross operating profits for 1985, and that most of them have adequate specific provisioning required by the Central Bank, due to the fact that they have been quite careful in recent years to accumulate hidden reserves and build up inner provisions in such a way so as to ensure the soundness of their financial positions.