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December 11, 1984

To: Members of the Executive Board

From: The Secretary

Subject: Kuwait - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with Kuwait.

This subject will be brought to the agenda for discussion on a date to be announced.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Tomasson, ext. 73379.

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INTERNATIONAL MONETARY FUND

KUWAIT

Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives for the 1984 Consultation with Kuwait

Approved by P. Chabrier and Subimal Mookerjee

December 10, 1984

I. Introduction

The 1984 Article IV consultation discussions with Kuwait were held in Kuwait City during the period October 24-November 1, 1984. The Kuwaiti representatives included the Governor and other senior officials of the Central Bank, and senior officials of the Ministries of Finance, Oil, Commerce and Industry, and Planning, as well as of the Kuwait Petroleum Corporation and the Kuwait Investment Authority. The staff mission was composed of Messrs. P. Chabrier (Head), A. Ouanes, G. Tomasson, and L. Wolfe, and Miss H. Sudo (secretary), all of the Middle Eastern Department.

Kuwait accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund Articles of Agreement on April 6, 1963.

II. Background to the Discussions

1. Overview of the decade to 1981

In recent decades, economic developments in Kuwait have been dominated by substantial increases in oil revenue. These, in turn, reflected the steady growth of oil production in the 1950s and 1960s--to 3.0 million barrels per day (mbd) in 1970--and the dramatic increases in world oil prices during the ten years to 1981 which more than offset a reduction in the volume of oil production by almost two-thirds to 1.13 mbd in 1981.

The associated increase in government revenue during this period allowed Kuwait to proceed with a large-scale development of basic infrastructure, residential housing, and social services. In turn, government demand for goods and services was the main impetus to activities in the non-oil sector. The real growth of that sector averaged about 11 percent a year over the ten years to 1981, although it was on a generally declining trend after 1975. Manufacturing activities contributed only a small part of total value added in the non-oil sector during the period but construction activities, transportation, trade, and financial services, expanded rapidly. In the oil sector, an integrated industry was developed, comprising activities ranging from oil production and refining at home, to oil exploration and retail marketing abroad. The high rate of economic growth achieved during the 1970s was facilitated by a doubling in the number of expatriate workers to about 400,000, representing about 80 percent of the total labor force in 1980. By 1980, per capita income in Kuwait had reached the equivalent of US$20,000, and the provision of social services was among the most extensive in the world.

The rate of inflation was contained at less than 10 percent a year in the 1970s, reflecting the pursuit of prudent financial policies, and the maintenance of an open trade system and an exchange rate policy, the principal objective of which was reasonable stability in the purchasing power of the Kuwaiti dinar. The surge in oil exports and in investment income in the ten years to 1981 resulted in a steady increase in the current account surplus of the balance of payments. The disposition of these surpluses took largely the form of acquisition of a diversified range of assets abroad by the Government, and, to a smaller extent, by the private sector, given the limited investment opportunities at home and the freedom of foreign transactions. By end-1981, the combined foreign assets of the Government and the Central Bank were valued at about US$47 billion.

2. Recent economic developments

Economic developments in the 1982-84 period have been less satisfactory than in the preceding ten years, particularly as regards growth performance. The main contributing factor has been a further decrease in oil output to 0.82 mbd in 1982, which resulted in a reduction in budget revenue by one-third in 1981/82 and by a further 3 percent in 1982/83 (fiscal year ending June 30). Oil production recovered to about 1.05 mbd after mid-1983, but the softness of world oil prices and reduced revenue from investment income limited the increase in government revenue to only 4 percent in 1983/84. Given these developments, budget expenditure in 1982/83 and 1983/84 was contained at the level achieved in 1981/82, thereby limiting the reduction in the overall budget surplus (Table 1 and Chart 1). The level of non-oil sector activity was also adversely affected by the collapse of the unofficial stock market (the Souk Al-Manakh) in August 1982 1/ which, together with the armed conflict between two neighboring countries, adversely

1/ For the most part the strength of speculative activity in that market reflected the extensive use of postdated checks in private share transactions, whereby company shares were traded at very high premiums over spot prices subject to final settlement at some future time. At the time of the market collapse in August 1982, there was a gross total of some US$90 billion in postdated checks outstanding; after netting out offsetting claims and counterclaims, some US$27 billion of postdated checks reportedly remained to be settled.

CHART 1

KUWAIT

FISCAL INDICATORS

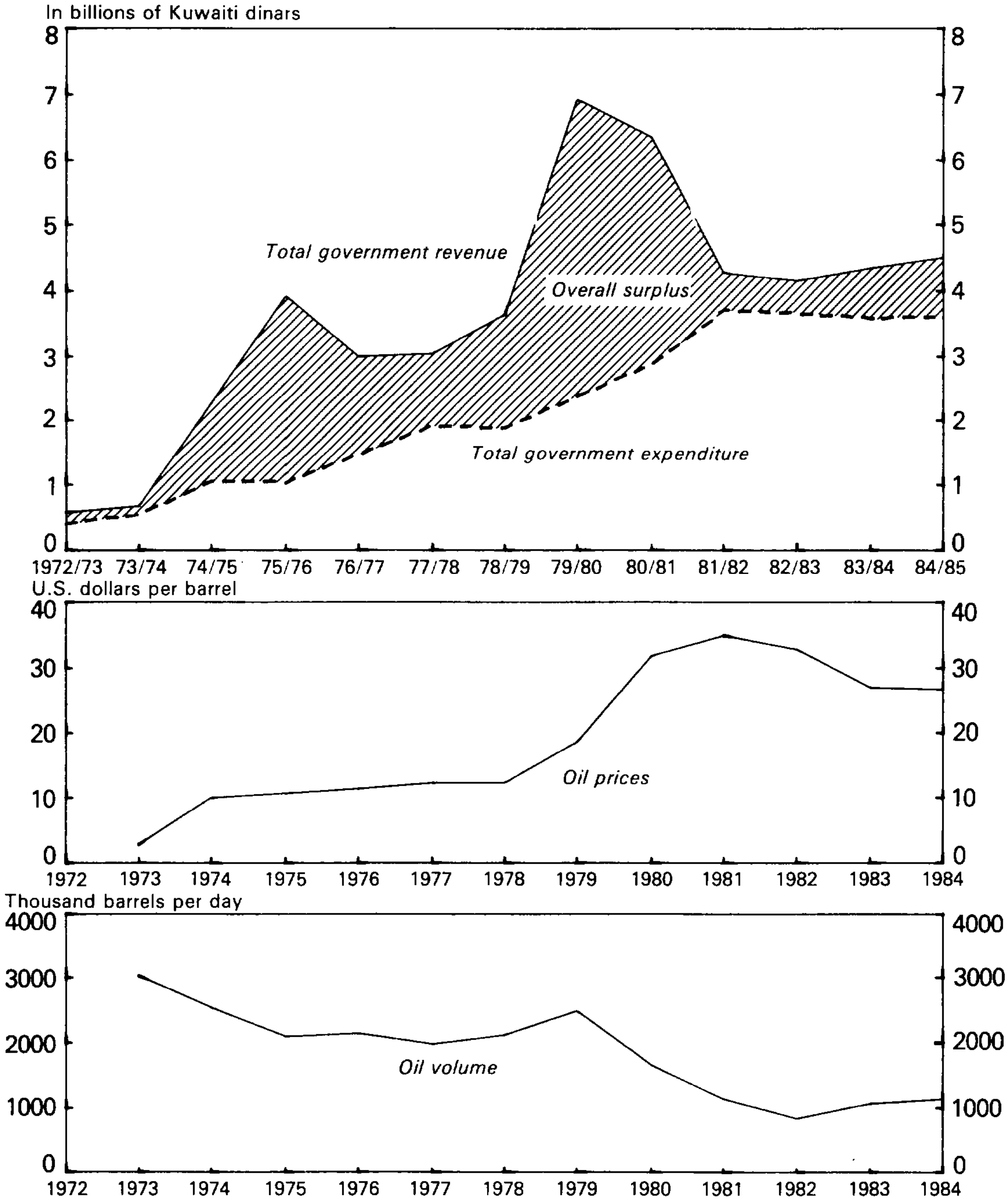

Table 1. Kuwait: Summary of Government Financial Operations, 1979/80-1984/85

(In millions of Kuwaiti dinars)

	Actuals				Prov. Actual	Budget	Budget
	1979/80	1980/81	1981/82	1982/83	1983/84	1983/84	1984/85
Revenue	6,923	6,351	4,280	4,155	4,362	4,323	4,512
Oil and gas	5,942	4,435	2,765	2,338	2,923	2,788	2,912
Investment income	880	1,744	1,364	1,657	1,286	1,286 1/	1,286 1/
Other	101	172	151	160	153	249	314
Expenditure	2,378	2,877	3,714	3,663	3,584	3,406	3,609
Current	1,247	1,434	1,670	1,930	1,858	2,280	2,457
Wages & salaries	(478)	(484)	(564)	(662)	(689)	(720)	(724)
Goods & services	(486)	(493)	(562)	(594)	(577)	(555)	(533)
Subsidies & other domestic transfers	(283)	(457)	(544)	(674)	(592)	(1,005)	(1,200)
Development	423	489	663	708	766	662	813
of which:							
Electricity & water	(134)	(108)	(126)	(157)	(...)	(...)	(...)
Housing facilities	(141)	(197)	(319)	(343)	(...)	(...)	(...)
Transfers abroad	213	262	245	231	193	314	189
Land purchase	264	392	450	220	227	150	150
Loans and equity	231	300	686	574	540	...	...
Surplus	4,545	3,474	566	492	778	...	...
Memorandum items:							
As a percent of GDP							
Revenue	98	90	69	70	70	...	...
Expenditure	34	41	60	61	58	...	...

Source: Ministry of Finance.

Note: A strict comparison between actual outlays and proposed budget expenditures is not possible. Budget estimates exclude any expenditures on net domestic lending (which is financed directly from reserves) and the expenditure of attached budgets are not itemized into wages and salaries, goods and services, etc., but are shown in total as part of subsidies and other domestic transfers. Investment income is excluded from the Kuwaiti budget statements, but is included in actual figures.

1/ Staff estimate.

affected confidence and economic activity in the private sector. As a result, the rate of real output growth in the non-oil sector, which averaged about 6 percent per annum during the five-year period through 1981, decelerated to 4.7 percent in 1982 and to an insignificant amount in 1983.

In order to revive non-oil sector activity, the authorities took a series of measures from mid-1983 onward: steps were taken to encourage housing construction; import tariffs on some import competing products were raised; regulations were introduced assigning certain percentages of public project execution to local contractors and suppliers; 1/ and obstacles to the re-export of most commodities were eliminated. Most important, however, was the considerable financial assistance extended by the Government to the private sector in the form of purchases of equity interest in local companies and banks, supplemented by grants to private creditors affected by the stock market collapse. Allowing for government outlays for the above purposes, as well as under the budget, domestic government spending is estimated by the Central Bank of Kuwait to have been about 39 percent higher during the second half of 1983 than in the corresponding period of 1982. Finally, total expenditure in the 1984/85 budget was projected to increase by 6 percent relative to the original budget estimates for 1983/84. Notwithstanding these supportive actions, preliminary indications suggest a negative growth rate in non-oil activity for 1984 as a whole, with output in trade, real estate, construction and in some manufacturing units being particularly affected. In contrast, sizable increases have been recorded in electricity and water output.

Low activity levels after 1982 were reflected in a slowdown in credit expansion to the private sector from 29.3 percent in 1981 to 9.7 percent in the 12 months to September 1984. Also, the slack in economic activity and private sector capital outflows led to a considerable slowing down in the growth of liquidity of the private sector from an annual average of 30 percent in 1980 and 1981, to only 8 percent and 4 percent in 1982 and 1983, respectively. Liquid assets fell marginally in the 12 months to June 1984; whereas liquidity denominated in domestic currency fell by 11 percent in that period, foreign currency denominated deposits more than doubled. As an interim response to these developments, the Central Bank of Kuwait introduced a separate, more depreciated dinar exchange rate for financial transactions in April 1984. In June, however, commercial banks started to pay interest rates at, or close to, those on international markets, thereby effectively ending an informal agreement to limit interest paid on deposits to 7.5 percent. As a result, there was a slowdown in the outflow of

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1/ The 1984/85 budget proposed that domestic producers be accorded preference in government procurement of goods and services provided these were of comparable quality with foreign goods and services, and that supply prices did not exceed the prices of imports by more than 10 percent.

private funds after June, while liquidity held in Kuwaiti dinars increased concurrently with a decline in liquidity denominated in foreign currency, and the exchange rate differential was eliminated by August 1984.

The reduced rate of monetary expansion in 1983 and 1984, together with the nominal effective appreciation of the Kuwait dinar, low world inflation, and stagnant conditions in the domestic economy, have combined to further reduce the rate of price increases from 4.8 percent in 1983 to less than 1 percent in the 12 months to August 1984.

As regards the balance of payments, the main development has been a reduction in the current account surplus from an average of US$15.2 billion a year in 1979-81 to about US$5.2 billion in each of the three following years (Table 2). This reduction has taken place even though oil production recovered to 1.05 mbd after mid-1983, a level broadly maintained through October 1984; subsequently, Kuwait's production has been temporarily reduced to 0.9 mbd, as part of the Geneva OPEC agreement at the end of October. Nevertheless, oil export earnings are estimated to increase by 6 percent to US$10.2 billion in 1984, a level still 47 percent below that reached in 1980. Meanwhile, other exports have been on a declining trend since 1981, due partly to the impact of the neighboring conflict. Import payments have remained within a narrow range around US$7.3 billion per annum since 1982, reflecting the stagnant level of domestic activity and low world inflation. In the services accounts, investment income has declined from a high of US$8.4 billion in 1981 to an estimated US$5.3 billion in 1984 due in part to the progressive decline in world interest rates over the period; also, private transfers abroad (mainly foreign workers' remittances), which are sensitive to the level of non-oil sector activity, have stagnated at about US$0.9 billion after 1981.

As a result of the reduced current account surpluses and the financial support of the local economy by the Government after 1982, there has been a sharp turnaround in the flow of government foreign investments in the capital account of the balance of payments (Chart 2). After increasing by an average of US$9.2 billion per annum during 1979-81, such investments declined marginally in 1982 and have been drawn down by an estimated US$1.5-2.0 billion in both 1983 and 1984. Despite these developments, the large overall surpluses in the balance of payments gave way to a deficit of the order of US$1 billion in 1983, but a surplus ($0.2 billion) is estimated for 1984 as a whole. At the end of September 1984, the gross foreign exchange reserves of the Central Bank of Kuwait were US$5.1 billion, the equivalent of about nine months of imports at the 1983 level. 1/ Kuwait does not maintain restrictions on payments or transfers for international transactions, and its trade system is virtually free of restrictions.

1/ At end-1983, the last date for which published data are available, foreign asset holdings of the Government in the State General Reserve and in the Fund for Future Generations were of the order of US$45 billion.

Table 2. Kuwait: Balance of Payments Summary, 1979-84

(In millions of U.S. dollars)

	1979	1980	1981	1982	Prov. 1983	Est. 1984
Trade balance (f.o.b.)	13,246	13,849	9,216	2,918	4,294	4,488
Exports	18,118	20,605	15,961	10,722	11,274	11,628
Petroleum	(17,025)	(19,066)	(13,958)	(8,803)	(9,621)	(10,200)
Other	(1,093)	(1,539)	(2,003)	(1,919)	(1,653)	(1,428)
Imports	-4,872	-6,756	-6,745	-7,804	-6,980	-7,140
Services account 1/	1,549	2,313	5,468	2,183	895	680
Receipts	4,760	6,712	9,804	7,294	6,133	6,035
Investment income	(3,577)	(5,487)	(8,411)	(6,354)	(5,306)	(5,270)
Other	(1,183)	(1,225)	(1,393)	(940)	(827)	(765)
Payments	-3,211	-4,399	-4,336	-5,111	-5,238	-5,355
Private transfers	(-532)	(-692)	(-689)	(-874)	(-906)	(-901)
Other	(-2,679)	(-3,707)	(-3,647)	(-4,237)	(-4,332)	(-4,454)
Current account	14,795	16,162	14,684	5,101	5,189	5,168
Capital account	-14,393	-15,118	-14,407	-3,140	-6,160	-4,964
Official assistance	-959	-1,354	-1,203	-1,232	-1,369	-935
Government investment	-9,358	-10,379	-7,948	21	1,458	1,870
Other 2/	-4,076	-3,385	-5,256	-1,929	-6,249	-5,899
Overall balance	402	1,044	277	1,961	-971	204
Memorandum items:						
Central Bank gross reserves (months of imports)	7	7	8	9	8	9
Foreign assistance as a percent of						
Current revenues	4.2	5.0	4.7	6.8	7.9	5.3
GDP	3.9	4.9	5.0	6.2	6.4	4.4
Current account/GDP ratio	60.8	58.7	60.7	25.7	24.3	24.5

Source: Data provided by the Kuwaiti authorities.

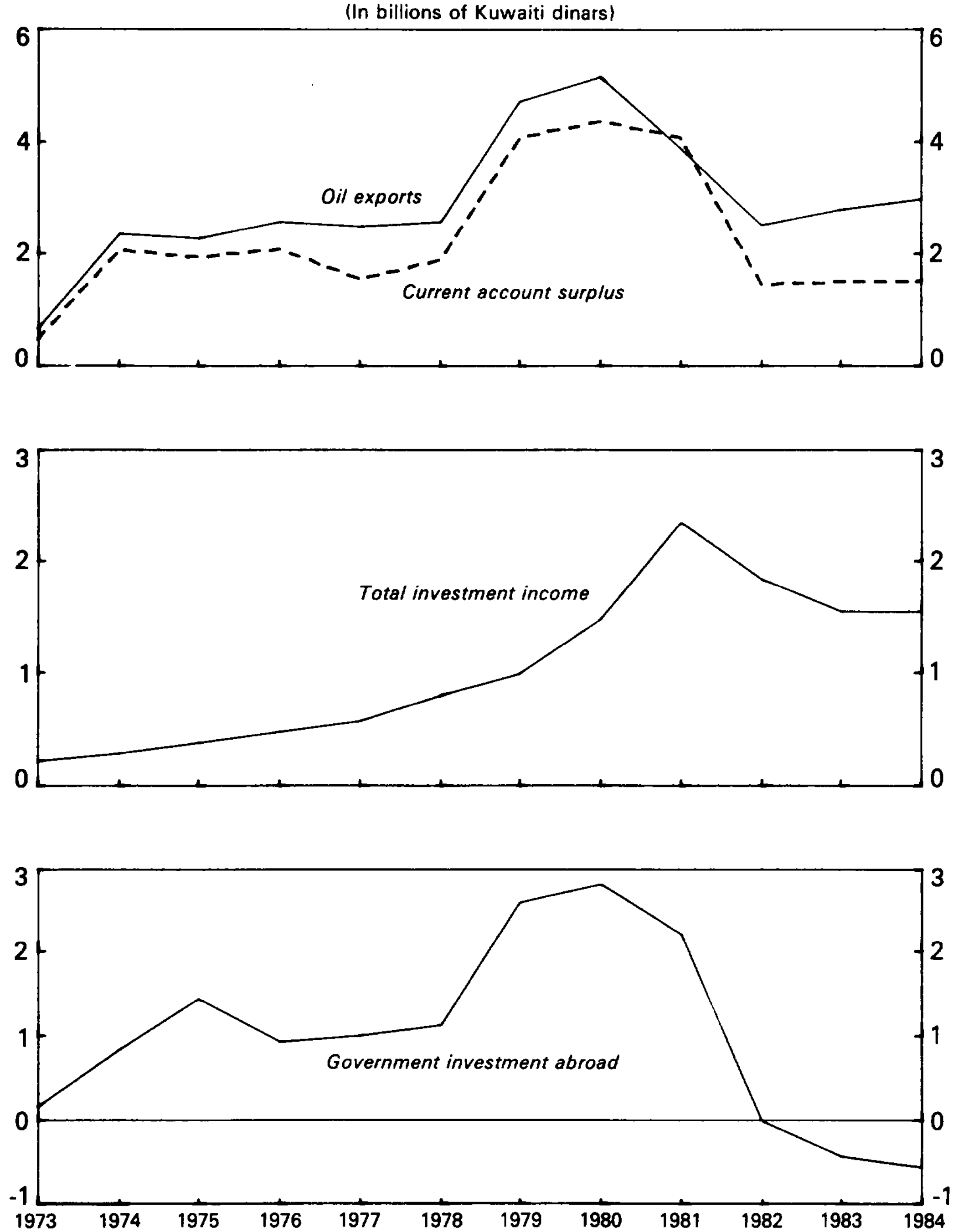
1/ Including private transfers.
2/ Including private sector capital transactions, and errors and omissions.

CHART 2

KUWAIT

SELECTED BALANCE OF PAYMENTS INDICATORS

(In billions of Kuwaiti dinars)



III. Policy Issues and Discussions

The developments of the past several years have highlighted the sensitivity of Kuwait's non-oil sector to changing levels of oil revenues and government spending, as well as the limited effectiveness of steps taken by the Government to reactivate the private economy through financial support. The Kuwaiti authorities have been concerned with the recent poor performance of the non-oil sector despite the presence of very considerable investment and production incentives. 1/ While the more expansionary stance of the 1984/85 budget and the substantial progress made toward the resolution of issues relating to the Souk Al-Manakh affair will no doubt help in improving private sector confidence, the authorities have been considering various further means of strengthening non-oil sector activity, both in the short run as well as in the context of promoting a more sustainable medium-term pattern of growth. In this connection, the mission was invited to present its views on issues and policies relating to the strengthening of non-oil sector activity. Against this background, policy discussions were centered on the short- and medium-term prospects for sustained growth of such activity.

Projections prepared by the staff team on the basis of a macroeconomic model of the Kuwaiti economy, and incorporating various plausible assumptions with respect to oil export earnings and government budget expenditures in the period through 1987, suggested that, in the absence of fiscal and other financial policy adjustments, the external current account and overall budget surpluses would decline relative to their projected 1984 levels under both a high and a low government expenditure assumption (Charts 3a and 3b). In addition, either limited growth would be achieved in the non-oil sectors or, under the scenario of high government expenditure in infrastructure and housing activity, the high growth rate achieved would not derive from the creation of internationally competitive productive units in manufacturing and related services which would durably improve the structure of the economy. Consequently, the staff concluded that changed circumstances, in particular the completion of the major infrastructure projects and the uncertain outlook for oil, now made it essential that new policy issues be addressed and a course charted for the economy over the medium term. The staff has discussed this conclusion with the IBRD staff, who expressed general agreement therewith. 2/

1/ Investment incentives provided by the authorities include long-term investment loans at concessional rates of interest, subsidized land leases, equity participation by the Government, adequate infrastructure facilities, low-cost utilities, import protection, tax exemptions, and preferential treatment in the awarding of government construction and supply contracts.

2/ A report on recent economic trends and policies is being prepared by the IBRD staff, who visited Kuwait in February 1984.

1. Production and growth strategy

In the view of the staff, the basic issue facing the Kuwaiti authorities was how to develop investment opportunities at home for the private sector as an alternative to foreign investments. Past infrastructure development had created a solid foundation on which to base the next phase of economic development; the country also possessed abundant energy resources, large financial holdings, and the services of a well-established financial system. Now that the impetus for growth generated by government expenditure on basic infrastructure was diminishing, domestic policy adjustments were needed in order to diversify the sources of future economic growth. There is some room for developing agriculture and fisheries. However, given the limited size of the domestic market and present labor constraints, particularly in terms of availability of skills and the desire of the authorities to limit the size of the expatriate labor force, priority should be given to the development of capital-intensive non-oil export industries as well as of related service enterprises. This strategy would need to be supported by adequate incentives to producers and facilitated by the streamlining of existing administrative procedures, in particular cumbersome licensing practices.

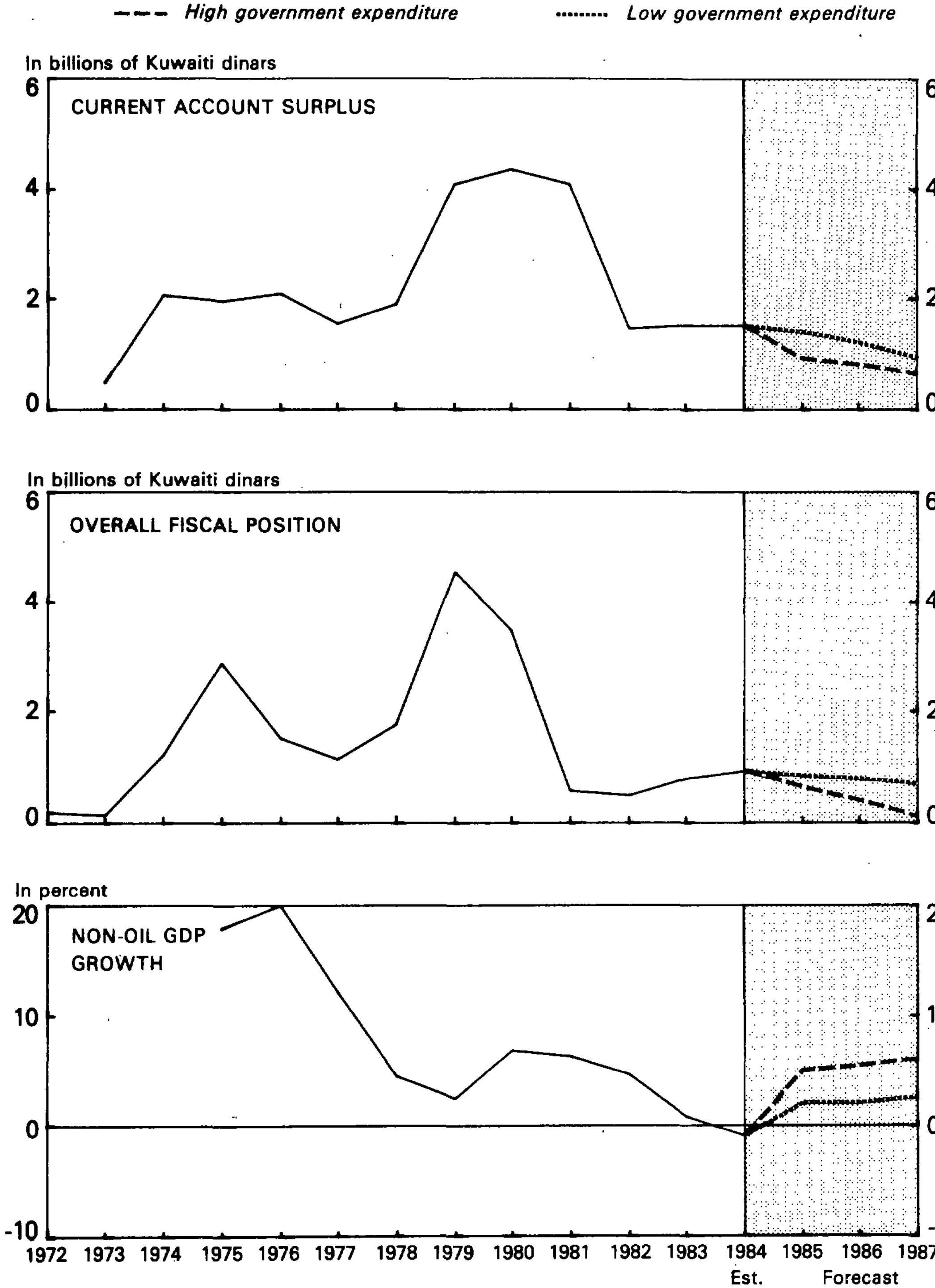
The Kuwaiti representatives, responding to the staff team's views, noted that a high-level committee, chaired by the Minister of Oil and Finance, had been formed in October 1984 to "review the various aspects of economic and financial activities, especially banking activity, securities market activities, the real estate and the contracting sector; to consider the means for stimulating these activities and eliminating the difficulties they encounter and to submit the solutions necessary." The committee was to report back to the Government by February 1985. With respect to the medium term, the authorities favored coordinated planning for economic development, whereby a comprehensive evaluation would be made of the economic assets possessed by Kuwait--both their strengths and weaknesses--so that the formulation of a medium-term economic strategy can proceed in full awareness of the present situation and future possibilities. Within the Kuwait Government, the present challenge was viewed as one of moving away from excessive dependence on government budget expenditures toward an environment conducive to private sector initiative and participation in sound economic activities.

The staff representatives expressed the hope that the high-level committee would give special consideration to various medium-term aspects of official policies relating to non-oil sector activities. In the view of the staff, a satisfactory medium-term strategy could not be based on the provision of excessive protection and subsidization of industries and activities which otherwise would not be viable. The staff representatives, noting that regulations had been introduced recently giving preferential treatment to local enterprises in the awarding of government construction contracts, cautioned that such measures could result in higher costs in the short run and in the

CHART 3a

KUWAIT

MEDIUM-TERM FORECAST: HIGH OIL SCENARIOS

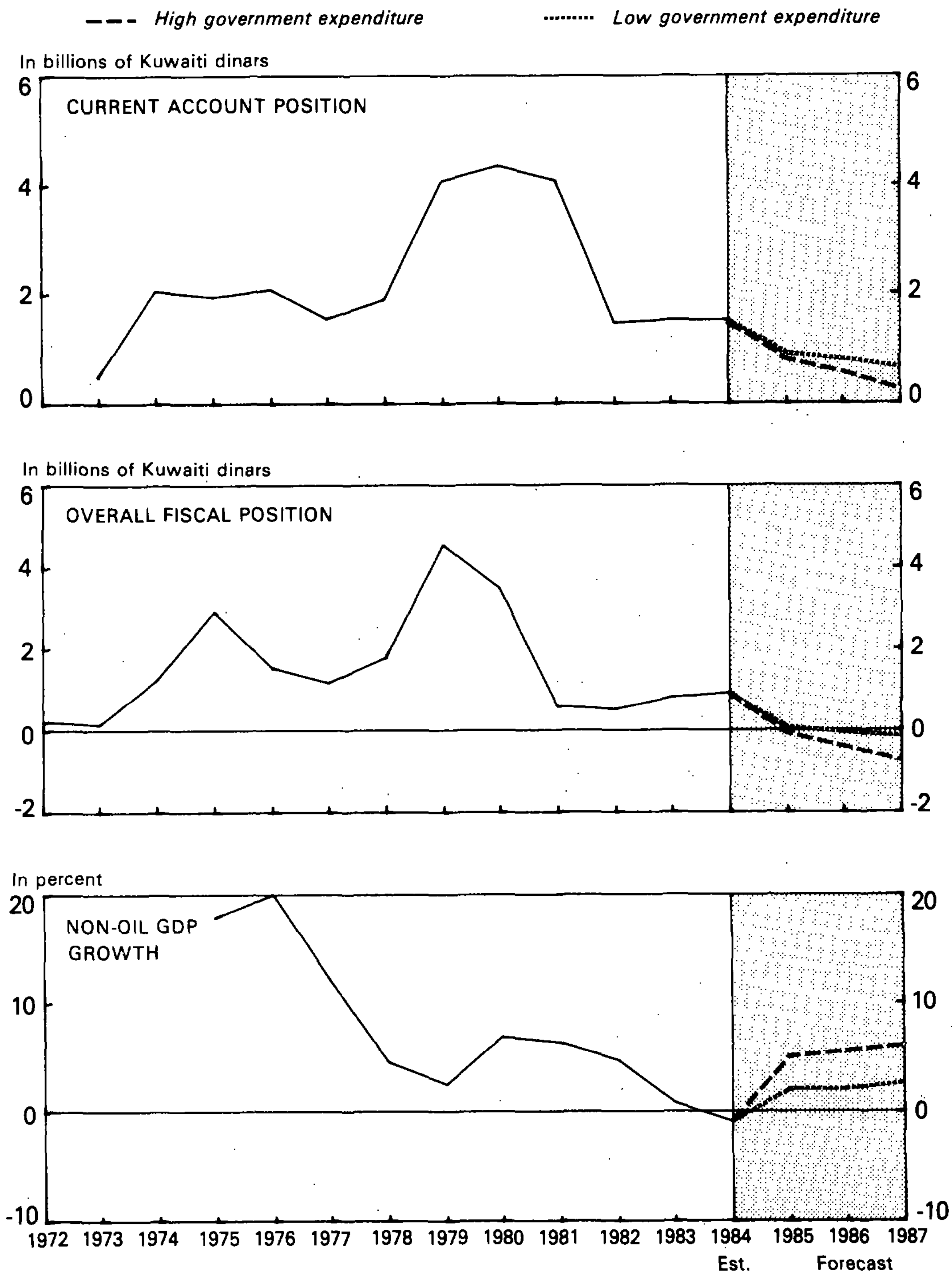


Note: The high oil scenarios assume oil prices to remain unchanged at their 1984 level while oil output increases by 2 percent per annum from the OPEC ceiling of 1.05 mbd. The high and low government expenditure represent assumed rates of growth in total government outlays of 10 and 5 percent respectively.

CHART 3b

KUWAIT

MEDIUM-TERM FORECAST: LOW-OIL SCENARIOS



The low oil scenarios assume oil prices unchanged at their 1984 level while oil output declines to .9 mbd through 1987.
The high and low government expenditure represent assumed rates of growth in total government outlays of 10 and 5 percent respectively.

development of a noncompetitive construction industry in the medium term. The Kuwaiti representatives observed that the local construction industry was suffering from low rates of capacity utilization, and that the requirement that 40-100 percent of construction work under government contracts be performed by Kuwaiti contractors was likely to lead to the utilization of capacity which otherwise would remain idle, rather than increase costs. Moreover, local contractors often subcontracted some project work to foreign firms, especially in the case of high technology projects.

As regards the oil sector, the Kuwaiti representatives noted that, while temporary output reductions were in effect because of weak demand in the world oil market, it was likely that Kuwait's output in 1985 could again be raised to the original OPEC ceiling of 1.05 mbd set in March 1983 as they expected world demand for oil to be about the same as in 1984. With respect to the Kuwait Petroleum Corporation (KPC), its strategy continued to be to diversify both marketing outlets and products so as to stabilize oil production levels. While the Far East had long been a principal outlet for Kuwaiti oil, the KPC had worked systematically in recent years to expand sales in Europe through the acquisition of refineries and retail outlets. Another facet of that strategy was to increase the share of refined products in total oil exports from about 50 percent at present to 65 percent by the end of 1986, with the completion of ongoing expansion of domestic refining capacity. Also, by the end of 1988, development of recently discovered fields containing high quality crude would further enhance the flexibility of KPC in meeting changing conditions in the world oil market.

The staff representatives, recalling that KPC had abandoned plans for a major petrochemical project in Kuwait, asked about the conditions under which such plans might be reconsidered. The Kuwaiti representatives replied that KPC would proceed with expansion plans only when that promised to be profitable. In this connection, the Kuwaiti representatives observed that while the opportunity cost of flared natural gas--the major input for petrochemicals--was effectively zero, labor and investment costs were generally higher in the petrochemical industry in Kuwait than in industrialized countries. The question of fair market access was a very important one for petrochemical producers of the region. They noted also that negotiations on various trade issues relating to exports of petrochemicals from Gulf Cooperation Council (GCC) members to the European Economic Community (EEC) were currently in progress.

Concerning labor market policies, the Kuwaiti representatives stated that these remained under continuous review, especially with respect to expatriate workers. Although expatriate unskilled labor was relatively cheap in terms of direct costs, such was not the case when allowance was made for the various social costs involved. Accordingly, it was the firm policy of the Kuwaiti authorities to maintain strict control over the size of the unskilled expatriate labor force.

2. Government finance

The Kuwaiti representatives stated that the budget for 1983/84 reflected a continuation of the policy of restraint on current expenditure introduced in 1982/83. Thus, wage and salary levels had remained unchanged between the two years (apart from normal merit increases), concurrently with a ban on the filling of most vacancies in the government sector, and current expenditures on goods and services had been stabilized. Subsidies and other domestic transfers had declined by 12 percent in 1983/84, reflecting the effects of lower oil prices on the cost of electricity generation and on losses incurred by KPC on domestic oil product sales, but the cost of subsidization of other goods and services had increased, including the cost of food subsidies. Development expenditures had increased by 8 percent due largely to increased housing construction; indeed, an additional appropriation of KD 25 million had been provided to the National Housing Authority during the year.

The main objectives of the 1984/85 budget were to encourage economic growth, to ensure appropriate income distribution, and to further rationalize government expenditures. Total expenditure was set at KD 3.6 billion compared with the 1983/84 budget estimate of KD 3.4 billion. The Kuwaiti representatives stated that the policy of current expenditure restraint would be continued. Wage and salary levels were expected to remain unchanged, and the ban on most government hirings would be continued. However, mainly in view of expanded activities of certain public sector agencies, domestic transfer payments were expected to increase substantially. In the development budget, outlays were to increase by 6 percent above 1983/84 actuals, with emphasis increasingly being placed on the completion of ongoing projects and the maintenance of existing capital assets. On the revenue side, total receipts were projected to be marginally above the 1983/84 level, with revenue from both oil sector sales and investment income estimated to show little change from their 1983/84 levels. The oil revenue estimate was based on total production at the OPEC quota level of 1.05 mbd and unchanged oil export prices; in view of the temporary reduction in Kuwait's production under the recent OPEC agreement, however, actual oil revenue in 1984/85 might fall short of the budget estimate, so that the overall surplus was likely to be close to that achieved in 1983/84.

The staff representatives indicated that a successful medium-term development strategy would benefit from a diversification of the sources of budget revenue. This was so because the dependence on oil as the main source of government revenues leads to fluctuations in the growth rate of government outlays, adversely affecting medium-term planning and investment by the private sector. A broadening of the revenue base could be achieved, inter alia, through the introduction of personal income and sales taxes at moderate rates. Also, increases in users' charges for public services would help reduce waste and improve the budget structure by reducing the high cost of consumer subsidies. Indeed, subsidies and other domestic transfers paid through the budget had risen from 23 percent to 32 percent of current outlays between 1979/80 and 1983/84, with the major subsidies covering electricity (the price of which had not been raised since the late 1960s) water, housing, and food items. 1/ More generally, the share of total budget expenditures allocated to subsidies and domestic transfers--including also loans and equity participation and land purchases--had increased from an annual average of 34 percent during the three years through 1979/80 to an average of 42 percent in the three following years. Noting also that extrabudgetary transfer payments had increased substantially in recent years, the staff representatives suggested that emphasis should be placed on limiting the share of such outlays in the period ahead.

The Kuwaiti representatives said that steps had already been taken during the past two years to rationalize budget expenditures by directing available resources increasingly toward economically useful projects and away from nonessential consumption. Specifically, a start had already been made in reducing government subsidies through a substantial increase in the prices of petroleum products in 1982. 2/ However, practical considerations and prudent management required that major steps in the area of consumer subsidies, which were a form of oil income redistribution, be realized over some period of time. The Kuwaiti representatives emphasized that decisions on electricity rates and water prices in Kuwait had to be taken within the context of the GCC, where the objective was the unification of such rates and prices among the member countries. Recently, GCC Ministers had recommended minimum and maximum rates for domestic and commercial users of electricity, and had decided to make the adequate insulation of all new buildings compulsory in the interest of energy conservation.

3. Money and credit policies

Concerning recent trends in credit to the private sector, the Kuwaiti representatives stated that much of the 24 percent increase in credit in 1982 reflected capitalization of interest due on loans extended to borrowers involved in the Souk Al-Manakh affair. In 1983, on the other hand, many overdue loans had been repaid out of funds received from the Government in the course of its rescue operation. The slower growth of credit in 1984 was largely a reflection of the slow pace of activity and the prudence exerted by banks in extending credit in the light of the weak financial situation of some borrowers. In the face of the strained domestic currency liquidity position of commercial banks, the Central Bank increased substantially its net provision of funds to the banks after July 1983 through its swap and rediscount operations.

1/ A discussion of subsidies is included in the report on Recent Economic Developments to be published soon.

2/ The increases ranged from 25 percent to 660 percent according to products, with prices averaging about two thirds of international c.i.f. prices after the changes.

The Kuwaiti representatives noted the continued redirection of commercial bank credit to the private sector from overdraft facilities to term loans during 1983; a regulation originally introduced in 1980 had placed a ceiling of 60 percent on the share of total bank credit which could be extended in the form of overdrafts--which were unsecured and usually based upon the personal reputation of the borrower--but the ceiling had subsequently been lowered in steps to 40 percent at present. In connection with this change, the Kuwaiti representatives stated, the commercial banks had strengthened their capacity to assess the creditworthiness of individual borrowers and the viability of projects to be financed with term loans. It was the intention of the authorities to maintain prudent credit and monetary policies in the period ahead, making sure that priority be given to credit for productive purposes.

Concerning interest rate policy, the Kuwaiti representatives noted that interest rates on dinar deposits had been increased by as much as 4 percentage points in June 1984 in order to stem the flow of funds for deposit abroad or into foreign currency deposits with domestic banks. Together with uncertainty with respect to the future exchange rate of the dinar against the U.S. dollar, following the introduction of a separate exchange rate for financial transactions in April 1984, the increase in interest rates had proved effective in reversing the trend toward foreign currency deposits. The staff representatives suggested that these recent exchange and interest rate developments highlighted the importance of continued coordination of policies relating to the domestic financial market.

Noting the Souk Al-Manakh collapse, the slack in domestic economic activity, and the narrowing between deposit and lending rates, 1/ the staff representatives asked whether the profitability of Kuwaiti banks had been impaired in the recent past and inquired about measures taken by the Central Bank to ensure their financial soundness. The Kuwaiti representatives stated that some banks had nonperforming loans on their books. In June 1984, the banks had been instructed to begin regular reporting to the Central Bank on the quality of their asset portfolios, but it was too early to draw any firm conclusions relating thereto on the basis of reports received so far. The Kuwaiti representatives noted, however, that the commercial banks were highly capitalized, (capital and reserves in September 1984 amounted to 15 percent of total assets) and that no bank could extend loans to any single borrower in amounts exceeding 10 percent of its own capital and reserves. Also, as a step to ensure the soundness of the financial system, in March 1984, a ministerial decree placed exchange dealers' operations under the supervision of the Central Bank and restricted the activities of such dealers to trading in foreign exchange and precious metals.

As regards the organization of the banking sector, the Kuwaiti representatives said that current policy was to limit the banking industry to a few (seven at present), highly capitalized banks (but

1/ There is a legal ceiling of 10 percent on lending rates.

with a large number of branches). Competition among them would continue to maintain both operational efficiency and a desirable pace of technological innovation. Moreover, the freedom of external current and capital account transactions required that domestic banks remain competitive with banks operating in the international financial market. In the medium term, the need for increased modernization of both bank management and operational procedures was recognized, and the Central Bank was encouraging the further development of training programs for bank personnel at the Kuwait Banking Institute. Also, the rapid increase in overseas branches of commercial banks was providing valuable training to their staff. As for the recent increase in government holdings of equity in the commercial banking system (from 13 percent of paid-up equity of six banks at the end of 1982 to 21 percent at the end of 1983), the Kuwaiti representatives explained that this was the result of government purchases of bank shares under the share-price support scheme instituted after August 1982.

Following the collapse of the Souk Al-Manakh market, a principal concern of the Government has been to protect the domestic financial system from the potentially disruptive effects of illiquid loan collateral and investments held by individual institutions. An early step by the Government was to redeem, in the form of cash and bonds, claims on other investors by creditors holding no more than US$7 million equivalent of postdated checks. Another step was the support of share prices on the official market at an estimated cost on the order of US$3 billion; by the time of its discontinuation in mid-1984, this scheme is reported to have raised government holdings to about one half of all outstanding shares of the enterprises concerned. 1/ The Government has also taken the lead in working out and imposing the terms on which multilateral clearings of outstanding claims have been effected among all but a handful of the largest net holders/issuers of postdated checks. The final financial settlements are to be made soon. Recently, the Government has also issued new regulations governing stock market operations aimed basically at preventing excessive speculation. For instance, all companies listed on the stock market have been ordered to issue half-yearly, as well as annual, reports.

Concerning the recent operations of the Kuwait Finance House (KFH), the only Islamic banking institution in Kuwait, the Kuwaiti representatives noted that total funds deposited had increased by 47 percent in 1983 to KD 700 million at the end of the year, representing the equivalent of 17 percent of private sector deposits with the commercial banking system. Profits paid on deposits by the KFH had averaged 7.5 percent in 1983 compared with 12 percent for 1982. In the wake of the uncertainty created by the Souk Al-Manakh affair, the inflow of deposits into the KFH had been maintained at a high rate while

1/ In the months after June 1984, some of the shares involved have been traded or quoted on the newly reorganized official stock exchange at prices up to 50 percent below the government support level.

available outlets for investment funds in the domestic economy had been curtailed. Accordingly, the KFH had limited its acceptance of deposits since the second half of 1983.

4. External sector

With respect to the possible future diversification of export production, the staff representatives suggested that the creation of efficient and competitive production units, particularly in capital-intensive export industries, would be facilitated through the establishment of joint ventures with foreign investors, who command both technical knowhow and market access. However, such an approach would require that existing foreign investment regulations be reviewed. The Kuwaiti representatives said that in the case of GCC nationals the 49 percent maximum foreign ownership share had recently been raised to 75 percent and would eventually be allowed to reach 100 percent.

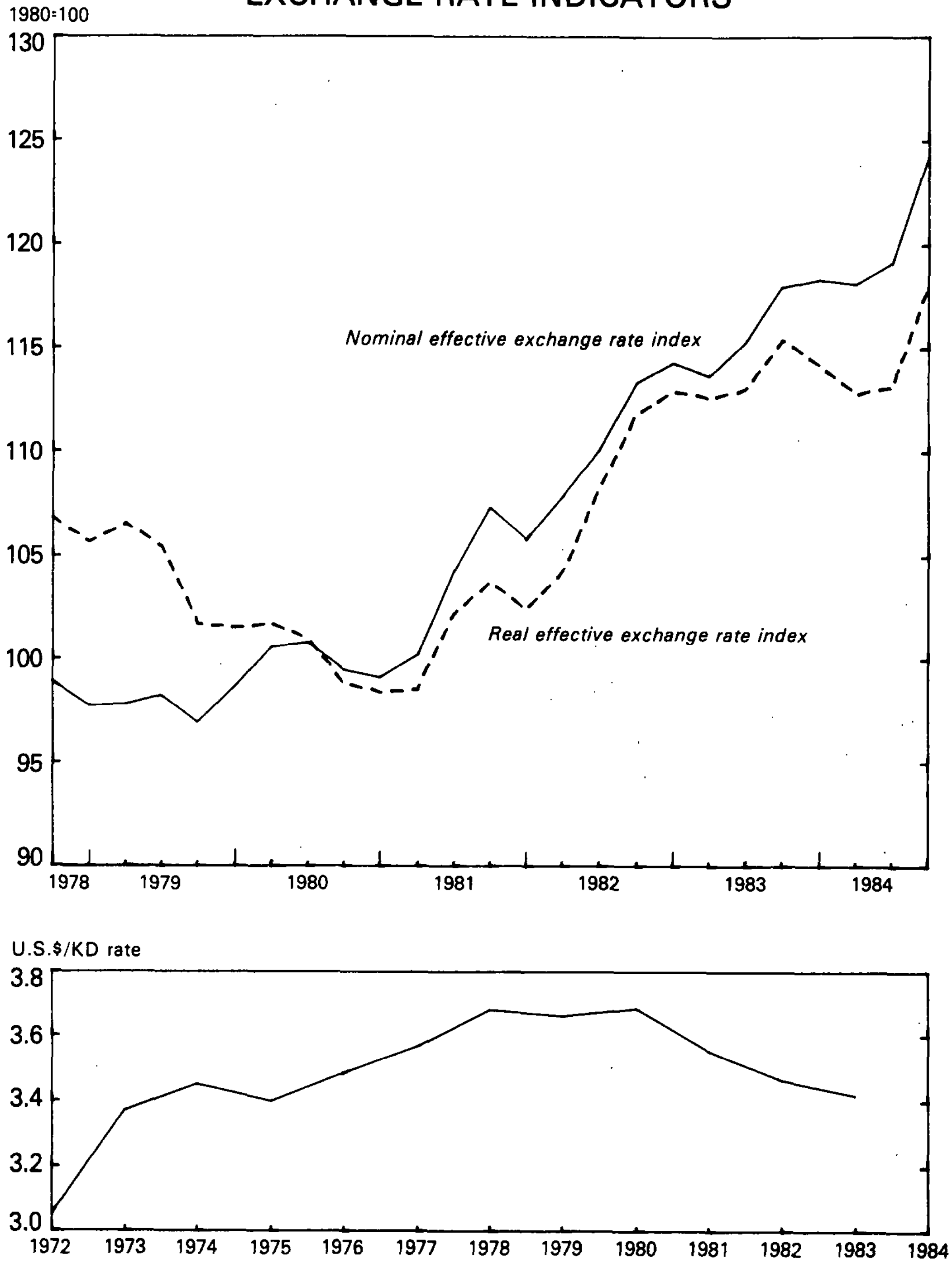
The Kuwaiti representatives said that the declared rate for the dinar continued to be set on the basis of an undisclosed basket of currencies, the composition of which was subject to periodic review. The main objective was to limit the dinar's fluctuations against major world currencies, in particular the U.S. dollar (Chart 4). Based upon import weighted calculations, the real effective exchange rate of the dinar, which had weakened between 1977 and 1980, appreciated by about 20 percent between the last quarter of 1980 and the third quarter of 1984. In response to a staff suggestion that the recent increase of several tariff rates to protect local industries and the low level of non-oil exports (excluding re-exports) seemed to indicate that profitability of some producing units was under pressure as a result of the dinar's appreciation, the Kuwaiti representatives explained that the profitability of non-oil exports was less a function of the effective exchange rate than of other factors, such as input subsidies, tax provisions, and the availability of financial resources. The staff representatives suggested that future exchange rate policy should take into account factors such as the budgetary cost of subsidized inputs received by Kuwait's private sector, the level of tariff protection, the trend in the cost of labor in Kuwait, and the desired rate of growth and diversification of export and import substituting activity. In the view of the staff, and as experience in many countries had shown, the maintenance of a realistic exchange rate was an important instrument for economic development.

The Kuwaiti representatives stated that speculative demand for foreign exchange had necessitated the introduction of a two-tier exchange rate system in April 1984, under which foreign exchange was provided for documented commercial transactions at the declared rate while a more depreciated exchange rate was applied to capital and certain transactions of a current nature. In establishing a supplementary exchange rate, the authorities had effectively decided to let market forces determine the exchange rate at which speculative transfers

CHART 4

KUWAIT

EXCHANGE RATE INDICATORS



would be effected. In July 1984, however, circumstances were deemed suitable for the initiation of Central Bank intervention in the market, and by August the financial rate had been brought to parity with the declared rate.

Since the last consultation discussions in April 1983, a new agency, the Kuwait Investment Authority, has been established to manage official reserve assets previously managed by the Ministry of Finance. The Kuwaiti representatives stated that this change had not affected official reserve management policies; as before, the realization of satisfactory rates of return and asset diversification, particularly among long-term investments, were principal objectives of management.

Kuwait has continued to provide substantial levels of official external assistance. In the past six years, such assistance has averaged close to US$1.2 billion a year. However, relative to current external receipts, the ratio of this assistance rose from 4.6 percent in 1979-81 to 6.7 percent in the period 1982-84. In response to a question by the staff representatives, the Kuwaiti representatives explained that the level of official transfers shown in each year's budget was determined by the Cabinet, independent of current budget revenue prospects. Also, a high level committee had recently been appointed to review Kuwait's foreign aid program and make recommendations on future aid policies.

5. Statistical issues

During the last decade, there has been a steady improvement in the range and quality of economic and financial statistics for Kuwait. However, the analysis of recent developments would be improved if the delays relating to several important macroeconomic statistics were reduced. The national accounts are fairly comprehensive, but the constant price series (1972 base) would benefit from an update to a recent period so as to include in the weighting pattern the marked changes that have occurred in the Kuwaiti economy since 1972. Balance of payments statistics are subject to substantial revisions, while data on the oil sector are available with varying time lags. The external trade data for Kuwait have been improved and the monetary data are available with a minimum time lag. The Kuwaiti authorities are aware of the areas in need of data improvement and have encouraged specialized training; in support of this effort, Fund technical assistance in balance of payments methodology was provided in late 1983.

IV. Staff Appraisal

Over the past three decades, rapidly rising oil revenues have permitted Kuwait to embark on an ambitious program of infrastructure development, together with greatly expanded provision of social services. A judicious investment strategy was implemented in the petroleum sector in both upstream and downstream markets. The strong growth in government outlays provided the main stimulus for the rapid increase in activity in the non-oil sector. Notwithstanding large increases in imports of goods and services, the external current account surplus continued to grow. The disposition of these surplus earnings took largely the form of investments abroad by the Government and, to a lesser extent, by the private sector. At the same time, Kuwait provided high levels of external assistance. Good price performance was achieved, as financial policies remained prudent, while the trade and exchange systems were kept free of restrictions. A high rate of economic growth was maintained, and both per capita income and the provision of social services reached levels that are among the highest in the world.

Since 1981, however, the reduced level of oil revenue and the adverse impact on private sector confidence of an armed conflict in the region and of the collapse of the unofficial stock exchange, have resulted in a sharp decline in the growth rate of economic activity in the non-oil sector. Concurrently, price inflation has been moderate and both the external current account and the overall budget have recorded large, although reduced, surpluses. Initially, the authorities adjusted to the reduction in budget revenue by constraining the growth of public expenditure, with most of the adjustment being borne by current outlays. Since mid-1983, however, various steps have been taken to encourage activity in the non-oil sector, including the mildly expansionary stance of the 1984/85 budget and large-scale financial support by the Government to the private sector. While this fiscal policy stance is appropriate from both a domestic and international perspective, in and by itself it has not yet been effective in reactivating the non-oil sector.

In the view of the staff, the low activity level in the non-oil sector in the past three years is partly structural in nature. In the past, the main impetus to growth stemmed from government outlays as Kuwait embarked on the implementation of essential infrastructural projects. Now that the bulk of these projects has been completed, and given the uncertainty with respect to future oil market developments, there is a need to find alternative sources of economic stimulus in the period ahead. For this purpose, the Government has appointed a high-level committee to review means of ensuring adequate rates of non-oil sector growth. In this connection, the staff believes that the most promising area for future growth lies in the field of capital-intensive and export-oriented manufacturing industries, for which Kuwait's large energy and financial resources would represent the principal inputs, together with technology and marketing services provided by possible foreign partners.

In order to encourage such a strategy, appropriate incentives need to be provided to potential investors. This would require, inter alia, that administrative procedures relating to private sector investment be simplified and that present regulations relating to domestic and foreign investment in the Kuwaiti economy be reviewed. Satisfactory development of the non-oil sector will also depend on the Government's policies concerning the size, composition, and skill profile of the expatriate labor force, and means of increasing participation of Kuwaitis in the labor market for higher skills; the latter would require greater emphasis on technical disciplines within Kuwait's education system.

A development strategy along the above lines would need to be supported by changes in the budget structure. The authorities have already taken certain steps to rationalize government budget expenditures, notably the containment of current expenditure growth and public employment as well as the substantial increase in domestic sale prices of petroleum products in 1982. As the authorities recognize, there remains substantial scope for further expenditure rationalization, especially with respect to direct and indirect subsidization of electricity and other public utilities and services. On the revenue side, a broadening of the revenue base would be helpful in reducing its present vulnerability to changing oil and investment income; by contributing to greater stability in the pattern of budget expenditure growth, this would provide a more stable environment for decision-making by local entrepreneurs. In this connection, the staff believes that consideration should be given to the introduction of broadly based income and sales taxes at moderate rates, perhaps in cooperation with other member states of the Gulf Cooperation Council.

Credit and monetary policies in the period ahead would need to ensure that proper incentives be offered to domestic savers and that adequate credit on appropriate terms be provided to the productive sectors. In this connection, the decision of the Central Bank of Kuwait to limit the proportion of credit on overdraft is highly appropriate. An active interest rate policy can also play an important role in ensuring satisfactory growth of the monetary base, as shown by the effects of the adjustment of deposit rates after June 1984. It is also essential that confidence be maintained in the soundness of the financial system. In this regard, the recent decision of the Central Bank of Kuwait to instruct banks to begin reporting on the quality of their asset portfolios on a regular basis, and the new regulations applying to the operations of the stock exchange, are highly appropriate.

In the interest of long-term growth of the non-oil sector and efficient use of resources, the staff is of the view that encouragement of productive activity in the Kuwaiti economy should not be based on excessive protection and subsidization of activities. Given the relatively small size of the domestic market, government policy should encourage the growth of productive activities that can remain competitive in international markets, as now is the case with Kuwait's oil sector. In this respect, exchange rate policy will have to play an important role.

The staff notes that Kuwait has continued to provide substantial amounts of foreign aid to developing countries, despite the decline in oil export earnings during the past two years from earlier levels. The staff commends the Government's past record on foreign aid as having made an important contribution toward world economic growth and development.

It is recommended that, as requested by the Kuwaiti authorities, the next Article IV consultation discussions be held in the early months of 1986.

Kuwait - Fund Relations

(As of November 30, 1984)

(Amounts in millions of SDRs, unless otherwise indicated)

I. Membership Status

Date of membership	September 13, 1962
Status	Article VIII

A. Financial Relations

II. General Department (General Resources Account)

Quota	635.3
Total Fund holdings of Kuwaiti dinars	281.0 (44.2 percent of quota)
Fund credit	None
Reserve tranche position	354.3
Current Operational Budget (maximum use of currency)	22.6 transfers 8.0 receipts 14.6 net use

	Limit	Outstanding	Uncalled
Lending to the Fund			
SFF	400.0	370.3	...

III. Kuwait has not used Fund resources to date.

IV. SDR Department

Net cumulative allocation	26.74
Holdings	76.05 (284.3 percent of net cumulative allocations)
Current Designation Plan 1/	1.4

1/ September-November 1984.

B. Nonfinancial Relations

V. Exchange Rate Arrangement

Effective March 18, 1975, Kuwait ceased pegging the dinar to the U.S. dollar and linked it to a weighted basket of currencies of its major trading partners. The Central Bank's buying and selling rates for the U.S. dollar have normally been maintained at one sixteenth of 1 percent, either side of the currency basket derived exchange rate. On November 22, the exchange rate for the dinar was US$1 = KD 0.30137.

VI. Last Article IV Consultation

Discussions were held in April 1983; the Staff Report (SM/83/133) was discussed by the Executive Board on July 22, 1983. The summing up indicated that the next Article IV consultation would be completed by January 1985.

VII. Technical Assistance

In November/December 1983, a STAT mission visited Kuwait to review balance of payments methodology.

Kuwait - Basic Data

Area	17,900 square kilometers
Population (1980 census)	1.36 million
GDP per capita (1980)	US$20,302

Year ended December 31	1978	1979	1980	1981	1982	Prov. 1983	Est. 1984
				(In per cent)			
Origin of GDP at current prices							
Oil sector	62.1	71.7	71.1	63.1	51.1	52.5	...
Non-oil sector	37.9	28.3	28.9	36.9	48.9	47.5	...
Annual changes in output and prices							
Non-oil GDP at constant (1972) prices	4.5	2.5	6.8	6.3	4.7	0.8	-1.0 1/
Consumer price index	8.7	7.1	7.0	7.4	7.7	4.8	0.5 2/
Crude oil production (million barrels/day)	2.13	2.50	1.66	1.13	0.82	1.05	1.17 3/
Average oil export price (US$ per barrel)	11.97	18.54	31.74	34.82	32.92	27.51	...

Year ending June 30	Actuals 1979/80	1980/81	1981/82	1982/83	1983/84 4/	Budget 5/ 1983/84	Budget 5/ 1984/85
Government finance							
Revenue	6,923	6,351	4,280	4,155	4,362	4,323	4,512
Oil revenue	5,942	4,435	2,765	2,338	2,923	2,788	2,912
Investment revenue	880	1,744	1,364	1,657	1,286	1,286 1/	1,286 1/
Other revenue	101	172	151	160	153	249	314
Expenditure	2,378	2,877	3,714	3,663	3,584	3,406	3,609
Current expenditure	1,247	1,434	1,670	1,930	1,858	2,280	2,457
Wages and salaries	(478)	(484)	(564)	(662)	(689)	(720)	(724)
Goods and services	(486)	(493)	(562)	(594)	(577)	(555)	(533)
Subsidies and other transfers	(283)	(457)	(544)	(674)	(592)	(1,005)	(1,200)
Development expenditure	423	489	663	708	766	662	813
Of which:							
Electricity and water	(134)	(108)	(126)	(157)	(...)	(...)	(...)
Housing facilities	(141)	(197)	(319)	(343)	(...)	(...)	(...)
Transfers abroad	213	262	245	231	193	314	189
Land purchases	264	392	450	220	227	150	150
Net domestic lending	231	300	686	574	540	...	...
Overall surplus	4,545	3,474	566	492	778	...	...
Memorandum items:							
Government net domestic expenditure (change in per cent)	(29.7)	(13.8)	(43.4)	(-2.7)	(-2.1)	(...)	(...)
Budget surplus/GDP ratio	(64.1)	(49.0)	(9.1)	(8.2)	(12.5) 1/	(...)	(...)
Subsidies and domestic transfers including land purchase and net lending/total outlays	(32.7)	(40.0)	(45.3)	(40.1)	(37.9)	(...)	(...)

Kuwait - Basic Data (continued)

Year ended	December					Sept.
	1979	1980	1981	1982	1983	1984
	(In millions of Kuwaiti dinars)					
Changes in money and credit						
A. Foreign assets (net)	115.0	412.4	312.9	307.5	-265.1	-201.5
B. Domestic assets (net)	224.4	155.4	697.3	7.6	450.1	302.9
Claims on nongovernment sector	(558.9)	(553.1)	(782.2)	(838.9)	(460.1)	(439.8)
Government deposits	(-223.5)	(-284.2)	(57.1)	(-307.6)	(74.3)	(-94.2)
Other items (net) (increase-)	(-111.0)	(-113.5)	(-142.0)	(-523.7)	(-84.3)	(-42.7)
C. Money and quasi-money (A+B=D+E+F)	339.4	567.8	1,010.2	315.1	185.0	101.4
D. Government net domestic expenditure	1,579.8	1,877.4	2,255.8	2,385.9	3,064.8)	
E. Monetary impact of nongovernment sector	-1,129.4	-1,196.1	-1,103.6	-1,547.1	) -2,795.5)	144.1
F. Other items (net) (increase-)	-111.0	-113.5	-142.0	-523.7	-84.3	-42.7
Rate of change (in per cent)						
Money and quasi-money	(17.4)	(24.8)	(35.4)	(8.1)	(4.4)	(2.4)
Money	(4.6)	(6.9)	(81.4)	(-2.9)	(-5.6)	(-17.4)
Quasi-money, of which:	(23.1)	(31.5)	(21.3)	(13.2)	(8.4)	(9.9)
foreign currency	(96.1)	(65.3)	(1.2)	(-44.1)	(79.4)	(73.0)
Claims on nongovernment sector	(35.8)	(26.1)	(29.3)	(24.3)	(10.7)	(9.7)

	1979	1980	1981	1982	Prov. 1983	Est. 1984
Trade balance, f.o.b.	3,659	3,743	2,567	841	1,252	1,320
Exports and re-exports	5,005	5,569	4,446	3,090	3,287	3,420
Petroleum	(4,703)	(5,153)	(3,888)	(2,537)	(2,805)	(3,000)
Other 6/	(302)	(416)	(558)	(553)	(482)	(420)
Imports 6/	-1,346	-1,826	-1,879	-2,249	-2,035	-2,100
Service and private transfers	428	625	1,523	629	261	200
Receipts	1,315	1,814	2,731	2,102	1,788	1,775
Investment income	(988)	(1,483)	(2,343)	(1,831)	(1,547)	(1,550)
Other	(327)	(331)	(388)	(271)	(241)	(225)
Payments	-887	-1,189	-1,208	-1,473	-1,527	-1,575
Current account surplus	4,087	4,368	4,090	1,470	1,513	1,520
Capital (net) and grants	-3,975	-4,086	-4,012	905	-1,796	-1,460
Official assistance	-265	-366	-335	-355	-399	-275
Government investment	-2,585	-2,805	-2,214	6	425	550
Other recorded capital and errors and omissions 7/	-1,125	-915	-1,463	-556	-1,822	-1,735
Central Bank reserves (increase-)	-112	-282	-78	-565	283	-60

Kuwait - Basic Data (concluded)

	1979	1980	1981	1982	1983	1984
	(In billions of Kuwaiti dinars)					
Central Bank reserves and government foreign assets (end of period)						
Central Bank	0.8	1.1	1.2	1.7	1.4	1.5 8/
Government foreign assets	...	...	11.9	14.0	13.0	...
Reserve Account	(...)	(...)	(4.9)	(6.2)	(4.2)	(...)
Fund for Future Generations	(...)	(...)	(7.0)	(7.8)	(8.8)	(...)
	(In billions of U.S. dollars)					
					Prov.	Est.
Petroleum exports	17.0	19.1	14.0	8.8	9.6	10.2
Imports	-4.9	-6.8	-6.7	-7.8	-7.0	-7.1
Investment income	3.6	5.5	8.4	6.4	5.3	5.3
Current account surplus	14.8	16.2	14.7	5.1	5.2	5.2
Official assistance	-1.0	-1.4	-1.2	-1.2	-1.4	-0.9
Government investment	-9.4	-10.4	-7.9	—	1.5	1.9
Central Bank reserves (increase-)	-0.4	-1.0	-0.3	-2.0	1.0	-0.2
	(In U.S. dollars per Kuwaiti dinar)					
Exchange rate (period average)	3.620	3.699	3.588	3.474	3.431	3.400 3/
Real effective exchange rate (percentage change)	-4.3	-3.6	1.7	7.5	4.2	0.1 8/

1/ Staff estimate.
2/ Partly estimated.
3/ January-June 1984.
4/ Preliminary actual data.
5/ A strict comparison between actual outlays and proposed budget expenditures is not possible. Budget estimates exclude any expenditures on net domestic lending (which is financed directly from reserves) and the expenditures of attached budgets are not itemized into wages and salaries, goods and services, etc., but are shown in total as part of subsidies and other domestic transfers. Investment income is excluded from the Kuwaiti budget statements, but is included in actual figures.
6/ Includes nonmonetary gold.
7/ Includes institutional placements, private capital movements, and oil export credit.
8/ September 1984.