FOR AGENDA

SM/82/14

CONTAINS CONFIDENTIAL
INFORMATION

January 19, 1982

To: Members of the Executive Board

From: The Secretary

Subject: Kuwait - Staff Report for the 1981 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1981 Article IV consultation with Kuwait.

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

Att: (1)

Other Distribution:
Department Heads

CONTAINS CONFIDENTIAL INFORMATION

INTERNATIONAL MONETARY FUND

KUWAIT

Staff Report for the 1981 Article IV Consultation

Prepared by the Staff Representatives for the 1981 Consultation with Kuwait

Approved by A.K. El Selehdar and W.A. Beveridge

January 18, 1982

I. Introduction

The 1981 Article IV consultation discussions with Kuwait were held in Kuwait City during the period November 18-22, 1981. The Kuwaiti representatives included the Governor of the Central Bank of Kuwait and senior officials of the Central Bank and of government ministries and agencies. The mission was composed of Messrs. A.K. El Selehdar (Head - MED), A.H. Kayoumy (MED), D.R. Khatkhate (CBD), M.C. Niebling (MED), and E.M. Taha (MED), and Miss L. Allardice (Secretary - MED).

Kuwait accepted the obligations of the Article VIII, Sections 2, 3, and 4 of the Fund Articles of Agreement on April 5, 1963.

II. Background

Kuwait's economy continues to be dominated by the oil sector which on average accounts for over two thirds of total GDP, 80 per cent of total budget revenues, and for more than 90 per cent of the country's foreign exchange receipts.

The main thrust of Kuwait's economic policies in recent years has been to utilize the enlarged financial resources derived from oil exports to broaden the productive base of the economy, encourage the growth of financial institutions, and strengthen the development of a welfare state. The implementation of these policies entailed substantial increases in government net domestic expenditures (domestic outlays less domestic non-oil revenues), particularly during the period 1974-78, which resulted in high rates of growth in the non-oil sectors. In addition to improving social services, the Government sought to distribute oil income to the private sector through sharp increases in expenditure under its land purchase program. 1/ The ensuing high rate of liquidity injection into

1/ Under this program the Government purchases land from Kuwaiti citizens for construction of infrastructural facilities and housing. The program also involves reselling land to individuals and corporations to build houses or set up factories, at prices substantially lower than acquisition prices.

the economy, which was reinforced by a sharp expansion of bank credit to the private sector, led to overheating of the economy. The fiscal and monetary stimuli exceeded the economy's absorptive capacity, and the resultant domestic inflationary pressures threatened to undermine the Government's economic policy objectives. Furthermore, in view of the small size of the Kuwaiti labor force, the accelerated development effort necessitated a large-scale inflow of immigrant workers, who by the late 1970s accounted for three fourths of the total labor force. Such a liberal immigration policy raised political and social concerns for the authorities.

In response to these developments, the Kuwaiti authorities initiated a reorientation of their economic policies with the objective of achieving rates of growth in the non-oil sectors consistent with maintenance of domestic financial stability and an acceptable level of foreign labor inflow. Fiscal and monetary policies turned restrictive during 1977 and the rate of increase in net domestic expenditures was sharply reduced from an annual average of about 40 per cent during 1974/75-1977/78 to almost nil in 1978/79. 1/ This restrictive fiscal stance, coupled with stringent liquidity requirements imposed by the Central Bank on commercial banks in April 1978, resulted in a considerable slowdown in the rate of domestic liquidity expansion (from 24 per cent in 1977/78 to 16 per cent in 1978/79). Reflecting the success of the authorities' restrained demand management policy, the real growth of non-oil GDP decelerated to an average of less than 4 per cent in 1978-79, significantly lower than in the preceding two years. The easing of demand pressures, together with the successful implementation of programs to expand infrastructural facilities and to encourage private construction, resulted in a considerable moderation of inflationary pressures, with the increase in domestic prices slowing to about 5 per cent in 1979.

In 1979/80 the overall emphasis of economic policy continued to be on maintenance of domestic financial balance and price stability. With the economy more or less free from supply constraints and inflationary expectations, the Kuwaiti authorities felt able to resume an expansionary fiscal policy allowing net domestic expenditures to rise by about 26 per cent in 1979/80. The upsurge in expenditures was due mainly to an upward adjustment in public sector wages and sharply higher expenditures under the land purchase program. Reflecting partly the exansionary fiscal policy, private liquidity expanded by over 29 per cent. Nevertheless, the real growth of non-oil GDP in 1980 remained moderate at slightly over 6 per cent, and the rate of domestic inflation rose to only about 8 per cent.

While overall labor policy has remained fairly liberal in recent years, the Kuwaiti authorities have tightened administrative procedures governing the issuance of work permits and the admission of foreign labor. This effort to slow the growth of the expatriate work force is matched by a willingness to permit slower economic growth rates.

1/ Fiscal years ended March 31 for 1974/75 and June 30 subsequently.

Kuwait has long enjoyed a strong balance of payments position, reflecting the fact that import payments have remained well below oil export receipts. An important new feature of Kuwait's external accounts is a sharp rise in investment income, reflecting large additions to public and private foreign assets as well as high international interest rates. These earnings on foreign assets rose by about 60 per cent to US$6.0 billion in 1980. The current account surplus averaged US$6.5 billion during 1976-78 and with the sharp upward adjustment in oil prices more than doubled to US$15.0 billion in 1979 and reached a record level of US$17.3 billion in 1980. Between 1976 and 1980, official grants and other assistance to developing countries rose by over 50 per cent to US$1.4 billion, equivalent to 5 per cent of GDP.

Kuwait maintains an exchange and trade system which is virtually free from restrictions. Effective March 18, 1975, the Kuwaiti dinar has been linked to a weighted basket of currencies of the country's major trading partners. The Central Bank's buying and selling rates for the U.S. dollar, the intervention currency, have generally been set at one sixteenth of 1 per cent from the midpoint, which at end of December 1981 was KD 1 = US$3.55.

There has been a noticeable improvement in Kuwait's economic and financial data base, due in large part to the efforts of the Central Bank and the Ministries of Finance and Planning. However, the availability of timely statistics still remains a problem, particularly in the areas of petroleum and the government foreign investment.

III. Report on the Discussions

1. Petroleum policy

Kuwait's petroleum policy has four main goals. conserving the country's oil and gas reserves; maximizing long-term sales revenues through flexible marketing; increasing domestic value added in exports; and making complementary investments in the industry abroad. Since early 1980 the vehicle for pursuing these goals has been the Kuwait Petroleum Corporation (KPC), which was established in January of that year, to hold, direct, and streamline the state's investments in the sector. KPC also assumed responsibility for marketing both crude oil and refined products, deriving its income from the excess of its sales prices over crude oil purchased from the state at an official price which is determined within the context of OPEC decisions.

Both the conservation objective and a flexible marketing strategy were evident in decisions on production levels in recent years. Having reduced crude oil production during the mid-1970s, the authorities permitted it to rise during late 1978 and in 1979 to about 2.5 million barrels per day (mbd) as market conditions became tight and prices rose. With budgetary revenues more than ample thereafter due to upward price adjustments and with the market eventually softening, the Kuwaiti authorities reduced oil output and exports. Successive cuts in the production ceiling in April 1980 and April 1981 reduced output by 1.0 mbd, and further declines, in response largely to a continued softening of the market, brought the 1981 average level to about 1.1 mbd. The estimated average price of over US$35.50 per barrel realized by Kuwait for its petroleum exports in 1981 was nearly three times that of 1978, although during the last two months of the year crude oil prices declined to US$33.00 per barrel and those for 1982 were set at US$32.30 per barrel.

Kuwait's investment strategy in petroleum concentrates on refining and production of petrochemicals, both domestically and abroad, but opportunities in other parts of the sector are also being pursued. The authorities plan to expand and upgrade the local refineries substantially by 1985 so as to process about one half of the country's crude oil output and produce a lighter, more valuable mix of products. Expansion of the national tanker fleet thus emphasizes product carriers rather than crude oil tankers. Meanwhile, petrochemical projects are moving from fertilizer into more sophisticated products. Several opportunities for joint ventures in refining and petrochemicals abroad are also being pursued. In addition, KPC has begun to invest in oil exploration abroad, notably in other developing countries, and has also recently concluded the acquisition of an oil drilling and service company. These investments appear to be gradually developing KPC into an integrated international oil company.

2. Fiscal policy

In 1980/81 the Kuwaiti authorities pursued a somewhat less expansionary fiscal policy than the year before, with the rate of growth in government net domestic expenditures slowing from 26 per cent to 14 per cent. Real non-oil GDP is estimated to have slowed down slightly to about 5 per cent in 1981, while the rate of domestic inflation remained unchanged at about 8 per cent with rising direct and individual government subsidies.

Despite the near doubling of government investment income in 1980/81 to KD 1.7 billion (equivalent to US$6.4 billion) 1/ total revenue fell for the first time since 1976/77 because of lower crude oil production, smaller increases in oil prices, and the transfer of revenues from the sale of refined products to KPC, whose accounts are not incorporated in the general budget. On the other hand, total outlays rose by 14 per cent to KD 2.7 billion. Two expenditure items exceeded their budget allocations--transfers to other developing countries (by KD 10 million) and expenditures under the land purchase program (by about KD 200 million), but expenditure on development projects continued to be substantially lower than budgeted. The authorities attributed the shortfall partly to delays in allotment of land for projects, inadequate infrastructural facilities such as electricity and water, and administrative delays in procurement of machinery and equipment from abroad. Part of the apparent shortfall in 1980/81 was due to the transfer of oil-related development expenditures to KPC.

1/ KD 1 = US$3.68.

In the 1981/82 budget total expenditures show only a modest increase of 2 per cent over the previous year's budget. The slowdown reflects the authorities' intention to reduce waste and to emphasize completion of ongoing development projects while subjecting new ones to closer scrutiny in terms of both cost and priority. The mission inquired as to the impact on the 1981/82 budget of recent reductions in oil output and prices. The Kuwaiti representatives explained that oil revenues had been estimated on the basis of an annual average oil output of 1.5 mbd and a per barrel oil price of US$35.50. Developments during late 1981 indicated, however, that both the output and price figures would probably turn out to be lower than had been assumed for the budget and that a substantial shortfall in revenues was likely. Nevertheless, the authorities still expected to realize a sizable budget surplus. They informed the mission that they intended to pursue an expenditure policy that would be consistent with the objectives of maintaining price stability in 1982 (a rate of domestic inflation of well below 10 per cent) while achieving a reasonable real growth (5-6 per cent) in non-oil GDP.

3. Monetary policy

In Kuwait the growth of the Government's net domestic expenditure has been the main determinant of the growth of domestic liquidity, although in more recent years the growth in bank credit to the private sector has assumed increased importance in liquidity expansion. While there was a deceleration in the rate of growth of government net domestic expenditure in 1980/81, the growth of domestic liquidity remained at about 29 per cent. An important factor in this growth was the acceleration in the rate of increase of commercial banks' credit to the private sector. In contrast to the previous two years, such credit tended to finance domestic speculative activities, particularly in the stock market, more than capital outflows. The Central Bank took measures to restrain credit expansion in support of speculative activities. Banks were asked to scale down, in steps, the ratio of overdrafts utilized (which were believed to have been used mainly for financing speculative activities) to their total credit from the high level of 80 per cent experienced in 1979, to 55 per cent by end-1980, and further to 45 per cent by end-1981. Furthermore, starting in mid-1980, a minimum cash reserve ratio of 3 per cent was introduced; the variation of this ratio could potentially become an effective monetary policy instrument. On the other hand, the Central Bank has continued its policy of providing liquidity to banks when needed through swaps and rediscount facilities at low interest rates in order to enable them to meet the credit requirements of productive activities in the domestic economy. A slowdown in the rate of private credit expansion by the third quarter of 1981 and a substantial reduction in overdraft facilities as a proportion of total commercial bank lending in favor of term loans indicated that the Central Bank measures were proving successful.

Regarding interest rate policy, the Kuwaiti authorities continue to maintain a legal interest ceiling of 10 per cent on domestic credit extended in Kuwaiti dinars. The mission was told that the Government's policy in this respect was not rigid and that the Central Bank was empowered to vary the ceiling if it thought such a move was appropriate. Consideration was being given to proposals to introduce two types of ceilings--a lower one on medium-term and long-term loans offered by nonbank financial institutions and a higher ceiling on short-term loans offered by commercial banks. So far, the maintenance of the existing 10 per cent ceiling was thought to ensure credit to productive sectors at a reasonable cost, currently estimated at 7-8 per cent, without seriously limiting the amount available. As interest rates on deposits (in Kuwaiti dinars or in foreign currencies) are not subject to a ceiling, the Central Bank lends to commercial banks at rates considerably lower than the market-determined rates they pay on deposits, thereby preventing erosion of their margins. Moreover, it is generally believed that commercial banks have been able, through various devices, to raise the effective cost of domestic credit beyond the ceiling. 1/ The mission felt that the proposed differentiated interest rate ceilings would be a step in the direction of a more flexible interest rate policy.

4. External sector policies

Tentative balance of payments estimates for 1981, prepared in cooperation with the Central Bank, indicate that there was only a small decline in the current account surplus, with the drop in petroleum export receipts being in large part offset by the sharp further rise in investment income. Petroleum exports are estimated to have fallen by about US$5 billion in 1981, to less than US$15 billion, as shipments fell by one third and initial price increases were later eroded. Meanwhile, investment income receipts rose by US$3.5 billion to US$9.5 billion, a level significantly higher than imports. With increases in other receipts and payments roughly equal, the current account surplus declined by about US$1.5 billion to US$15.8 billion. The major share of this surplus augmented government foreign assets held and managed by the Ministry of Finance, which are estimated at about US$55 billion at the end of 1981.

The 1982 balance of payments projections assume a modest (14 per cent) recovery in oil production to 1.3 mbd, a lower average oil price than in 1981, continued moderate (15 per cent) growth in imports, and a much slower rise in investment income due to a lower average yield. Based on these assumptions, the 1982 current account surplus would be just over US$15 billion, not much less than in 1981.

There has been no change in Kuwait's policy with respect to the management of the foreign assets held by the Ministry of Finance or of the reserves held by the Central Bank. As in the past, the policy with respect to management of the Government's foreign assets is guided by considerations of a stable real rate of return and the avoidance of disruptive movements in response to short-term changes in interest or exchange rates. The reserve management policy of the Central Bank continues to be guided by liquidity considerations and the gradual diversification of reserves among currencies in order to minimize the risk of losses from exchange rate fluctuations.

1/ For details, see Recent Economic Developments, to be issued shortly.

Regarding exchange rate policy, the main objectives of the authorities have been to maintain a stable relationship between the Kuwaiti dinar and a weighted average exchange rate derived from a basket of currencies representing the country's major trading partners. This policy seems to have served Kuwait well and is expected to remain unchanged in 1982.

IV. Staff Appraisal

The main objectives of domestic economic policy in Kuwait continue to be to achieve a sustainable rate of real economic growth, to minimize inflationary pressures, and to spread the benefits from oil income to the population. Both the pace of economic activity in the non-oil sectors and the rate of inflation have been reduced from the unsustainable levels of the mid-1970s through the application of an appropriate mix of fiscal and monetary policies. The influx of expatriate workers has also been slowed somewhat by administrative measures. The average growth rate in the non-oil GDP was reduced from over 13 per cent in 1974-77 to about 6 per cent in 1979-81, and the rate of increase in domestic prices was brought down to the range of 6-8 per cent. For 1982 the authorities do not intend to depart from the policies they have pursued in recent years. As the fiscal stance for 1981/82 is only moderately expansionary and the economy is largely free of supply constraints, domestic price increases are likely to remain small.

The maintenance of a legal interest rate ceiling of 10 per cent on domestic credit extended in Kuwaiti dinars has tended to complicate monetary management in Kuwait's open economy, as was the case in 1979-80 when the attraction of high interest rates abroad led to shortages of dinar liquidity to finance domestic activities. The various measures taken by the Central Bank to reduce credit extension for financing speculative foreign investment and the banks' ability to raise the effective cost of credit appear to have been successful in easing the problem. The authorities are also considering more flexible options with respect to the interest rate structure. A flexible interest rate policy should enhance the supportive role of monetary policy in the management of the economy.

In the conduct of their external financial policies, the Kuwaiti authorities have been mindful of their responsibility as a surplus country. In addition to utilizing the enlarged financial resources to expand the economy's capacity to absorb imports, the authorities have maintained a liberal exchange system and have provided sizable financial assistance to other developing countries. As in the past, the policy with respect to management of the Government's foreign assets is guided by considerations of long-term yield and security rather than short-term gains. The country's foreign reserves, which are held by the Central Bank, are also managed with emphasis on liquidity considerations and the gradual spreading of exchange risks.

Kuwait: Fund Relations 1/

Date of membership:	September 13, 1962.
Status.	Article VIII.
Quota:	SDR 393.3 million.
Fund holdings of Kuwaiti dinars:	SDR 271.0 million or 68.9 per cent of quota.
SDR Department:	Kuwait became a participant on April 30, 1980. Holdings were SDR 35.4 million or 132.4 per cent of allocation.
Lending to the Fund.	Kuwait lent the Fund the equivalent of SDR 685 million for the oil facilities, of this amount SDR 95.6 million is outstanding. Kuwait has also agreed to lend the Fund up to SDR 400 million for the supplementary financing facility, of which SDR 191.8 million has been drawn.
Direct distribution of profits from gold sales:	Kuwait has ceded to the Trust Fund its share of profits from gold sales. Total contribution amounted to US$10.3 million.
Gold distribution:	Kuwait acquired 55,628.986 fine ounces (four distributions).
Exchange rate system:	Effective March 18, 1975 Kuwait ceased pegging the dinar to the U.S. dollar and linked its currency 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 per cent either side of the currency basket derived exchange rate which was KD 1 = US$3.5535, or 2.9 per cent above the rate prevailing on March 17, 1975.
Technical assistance:	Two experts are currently on assignment to the Central Bank of Kuwait under the Central Banking Department Program.
Last Article IV consultation:	April 1980; the Staff Report (SM/80/126) was discussed by the Executive Board on June 30, 1980.

1/ As of December 31, 1981.

Kuwait - Basic Data

Area	17,900 square kilometers
Population	1.36 million (1980 census)

(In per cent)

Year ended December 31	1972	1975	1977	1979	Est. 1980
Origin of GDP at current prices					
Oil sector	62.4	70.5	61.1	68.8	67.5
Non-oil GDP	37.6	29.5	38.9	31.2	32.5

Year ended December 31	1977	1978	1979	Est. 1980	Est. 1981
Annual changes in output and prices					
Non-oil GDP at constant (1972) prices	12.1	1.3	6.1	6.4	5.0
Implicit non-oil GDP deflator	6.5	5.2	12.9	7.9	...
Cost of living index	9.7	6.2	5.2	7.7	8.0
	(In millions of barrels per day)				
Crude oil production	1.97	2.13	2.50	1.66 1/	1.14 2/

(In millions of Kuwaiti dinars)

Year ended June 30	Actuals 1977/78	1978/79	1979/80	Prov. Actual 1980/81	Budget 1981/82
Government finance					
Revenue	3,049	3,649	6,923	6,303	7,202
Oil revenue	(2,575)	(3,036)	(5,940)	(4,435)	(5,097)
Other revenue	(474)	(613)	(983)	(1,868)	(2,105) 3/
Expenditure	1,612	1,633	2,147	2,570	2,930
Current expenditure	(716)	(832)	(1,207)	(1,420)	(1,654)
Transfers abroad	(214)	(194)	(213)	(261)	(264)
Development expenditure	(494)	(499)	(463)	(497)	(712)
Land purchases	(188)	(108)	(264)	(392)	(300)
Net domestic lending	304	262	231	148	...
Overall surplus	1,133	1,754	4,545	3,585	4,272
Memorandum item:					
Net domestic expenditure (change in per cent)	(40.0) 4/	(0.05)	(26.4)	(13.8)	(...)

Kuwait - Basic Data (continued)

(In millions of Kuwaiti dinars)

Year ended June 30	Actuals 1977/78	1978/79	1979/80	1980/81
Changes in money and credit				
A. Foreign assets (net)	382.7	-105.0	438.7	395.4
B. Domestic assets (net)	-42.9	382.6	155.2	357.7
Claims on nongovernment sector	(194.2)	(537.4)	(485.7)	(689.4)
Government deposits	(-68.0)	(-36.0)	(-190.5)	(-160.3)
Other items (net) (increase-)	(-169.1)	(-118.8)	(-140.0)	(-171.4)
C. Money and quasi-money (A+B=D+E+F)	339.8	277.6	593.9	753.1
D. Government net domestic expenditure	1,377.4	1,384.9	1,750.9	1,992.4
E. Monetary impact of non-government sector	-868.5	-988.5	-1,017.0	-1,067.9
F. Other items (net) (increase-)	-169.1	-118.8	-140.0	-171.4
Rate of change (in per cent)				
Money and quasi-money	23.9	15.8	29.1	28.6
Money	(30.7)	(6.2)	(14.5)	(30.6)
Claims on nongovernment sector	17.9	42.1	26.8	30.0

Year ended December 31	1977	1978	1979	1980	Prel. Est. 1981
Balance of payments					
Trade balance, f.o.b.	1,383	1,625	3,660	3,885	2,695
Exports and re-exports	2,740	2,815	5,006	5,720	4,695
Petroleum	(2,504)	(2,584)	(4,703)	(5,304)	(4,070)
Other 5/	(236)	(231)	(303)	(416)	(625)
Imports 5/	-1,357	-1,190	-1,346	-1,835	-2,000
Service and private transfers	187	298	475	801	1,715
Receipts	753	1,008	1,362	1,992	3,075
Investment income	(575)	(815)	(1,035)	(1,620)	(2,650)
Other	(178)	(193)	(327)	(372)	(425)
Payments	-566	-710	-887	-1,191	-1,360
Current account surplus	1,570	1,923	4,135	4,686	4,410
Capital (net) and grants	-1,544	-1,295	-3,311	-3,550	-3,220
Official assistance	-355	-274	-265	-366	-335
Government investment	-1,145	-790	-2,984	-3,048	-2,635
Other recorded capital	-44	-231	-62	-136	-250
Errors and omissions (net) 6/	243	-744	-712	-868	-1,000
Central Bank reserves (increase-)	-269	116	-112	-268	-190

Kuwait - Basic Data (concluded)

(In billions of U.S. dollars) 7/

	1977	1978	1979	1980	Prel. Est. 1981
Petroleum	8.7	9.4	17.0	19.6	14.6
Imports	-4.7	-4.3	-4.9	-6.8	-7.2
Investment income	2.0	3.0	3.7	6.0	9.5
Current account surplus	5.5	7.0	15.0	17.3	15.8
Official foreign assets 8/					
Central Bank reserves	3.0	2.6	3.0	4.0	4.7
Government investments	18.2	21.6	34.0	45.7	55.0

1/ Actual data.
2/ Staff estimate based on official data for the first three months of the year and press reports for the remainder of the year.
3/ Partly estimated.
4/ Annual average growth during 1974/75-1977/78.
5/ Includes nonmonetary gold.
6/ Includes most private capital movements, plus SDR allocations (KD 9 million) in 1981.
7/ The following annual average exchange rates (in U.S. dollars per Kuwaiti dinar) were used: 1977 - US$3.49; 1978 - US$3.64; 1979 - US$3.62; 1980 - US$3.69; and 1981 - US$3.58.
8/ At end of year.