

February 16, 1982 - 82/13

Statement by Mr. Finaish on
1981 Article IV Consultation with Kuwait
Executive Board Meeting 82/17 - February 17, 1982

I wish to thank the staff for two well-prepared documents on the Kuwaiti economy (SM/82/14 and SM/82/25).

The main focus of domestic economic policies in Kuwait in recent years has been the utilization of its enlarged financial resources derived from oil exports for strengthening and broadening the economy's productive base as well as raising the level of economic welfare of its people. The pursuit of these objectives entailed a substantial increase in public expenditures during the mid-1970s, resulting in high rates of growth in the non-oil sectors. However, the accompanying high rates of liquidity expansion contributed to a substantial intensification of inflationary pressures. This led to a reorientation of financial policies toward greater restraint, beginning in 1978/79, with a view to bringing economic expansion more in line with growth in absorptive capacity. Policies in subsequent years have continued to emphasize the need for maintaining a reasonable level of financial stability in pursuit of the country's growth and welfare objectives.

In the oil sector, the country's financial requirements and the conservation objective have come to exercise an increasing influence on production policies, though market conditions and the needs of the international community remain important considerations. Since early 1980 the responsibility for the implementation of the country's petroleum policy has rested with the Kuwait Petroleum Corporation (KPC), which was established in January of that year, absorbing the various national companies handling the different segments of the petroleum industry. The functions of KPC include the marketing of both crude oil and refined products as well as the direction of state investments in the petroleum industry. An important objective of Kuwait's investment strategy is to increase the domestic value added of its petroleum exports. To this end, substantial investments have been made in oil refining and production of petrochemicals. Based on the country's chief natural resource and generally requiring highly capital-intensive techniques of production, these industries are obvious choices for leading the process of industrial development in the country. The petrochemical industry has now started to move from fertilizers into more sophisticated products. Opportunities for investment in petroleum industry abroad are also being pursued. These include joint ventures in refining and petrochemicals, and investment in oil exploration--particularly in other developing countries.

In addition to the petroleum-based industries, some other types of manufacturing industries have also grown in varying degrees. Growth in services, a traditionally important area of the economy, and in sectors such as construction and transportation has further

contributed to the diversification of the productive base. Recently, Kuwait's industrial development policy has undergone a shift of emphasis from rapid growth to improvements in productivity and capacity utilization. More selective criteria are currently being applied to proposals for the establishment of new industries.

The emphasis placed by the authorities on minimizing inflationary pressures and achieving a sustainable growth rate is reflected in the continuation of a relatively cautious fiscal policy. Net domestic expenditure of the Government increased by 14 per cent during 1980/81, which was about one third of the average rate of increase during 1974-1977 and a little over one half of the increase during 1979/80. Reflecting the restrained fiscal stance, the real growth rate of non-oil GDP has been of the order of 5-6 per cent during 1979-81, as compared with the average rate of 13 per cent during 1974-77. The increase in government expenditure is expected to decelerate further during 1981/82, reflecting in part the authorities' intention to cut down waste and to give priority to the completion of ongoing projects while subjecting new ones to closer scrutiny.

Government development expenditure continued to be lower than budgeted during 1980/81. Part of this shortfall is attributed by the authorities to certain unavoidable delays in the allotment of land for projects and in the procurement of needed equipment. Part of the shortfall, however, was only apparent as it reflected the transfer of oil-related development expenditures to KPC (whose accounts are kept separate from the general budget). At the same time, the authorities have been taking measures to encourage greater private sector participation in the development process. These have included, among other things, the establishment of necessary socio-economic infrastructure, facilitating an adequate flow of credit for productive investments and, in many cases, direct government participation in joint ventures with private concerns.

Since the Government's net domestic expenditure constitutes the main component of the growth of domestic liquidity, the lower rate of expansion of the former since 1978/79 is reflected in a lower average rate of growth of the latter over this period than in the preceding few years. Together with an easing of supply constraints, this was instrumental in keeping the rate of inflation during the period since 1978/79 within the range of 5-8 per cent, representing a considerable moderation of the inflationary pressures built up over the mid-1970s. Bank credit to the private sector has, however, assumed a greater role in domestic liquidity expansion over the last two years. Thus, while the increase in net domestic government expenditure slowed down further during 1980/81, domestic liquidity grew at about the same rate as during the previous year. A sizable proportion of bank credit to the private sector is believed to have gone into financing speculative activities, particularly in the domestic stock market. In order to restrict this, banks have been directed by the Central Bank to reduce

the ratio of overdrafts to their total credit to 45 per cent by end-1981 (down from a high level of about 80 per cent during 1979) with a corresponding increase in their term loans. Furthermore, a minimum cash reserve ratio of 3 per cent was introduced in mid-1980, thereby adding to the instruments of monetary control at the disposal of the Central Bank. On the other hand, the Bank has continued its policy of providing adequate liquidity to commercial banks through swaps and rediscount facilities in order to enable them to meet the credit requirements of productive activities. There are indications that these measures, supplemented by moral suasion and close supervision of commercial bank operations by the Central Bank, are beginning to achieve the desired results: private sector credit expansion slowed down in the third quarter of 1981 and there has been a substantial reduction in overdrafts as a proportion of total bank credit in favor of term loans; term loans increased from 29 per cent of total bank credit in 1979 to 45 per cent in September 1981. Another development that has helped to channelize a greater proportion of financial resources to productive activities has been the increasing role that specialized financial institutions and investment companies have come to play in Kuwait's financial system. The overall financial system in the country itself has grown considerably since the mid-1970s.

With respect to interest rate policy, the authorities are of the view that the containment of inflation in recent years at relatively low levels, the stability in the value of the Kuwaiti dinar, and the desirability of ensuring an adequate supply of funds for private investment at a reasonable cost are important considerations to be taken into account when assessing the appropriateness of the level of interest rates in the country. They believe that, in view of these considerations, the present level of interest rates on domestic bank credit remains broadly appropriate. While the authorities recognize the significance of interest rate differentials as an influence on capital outflow, they feel that, given the large and volatile fluctuations that have taken place in major international financial markets over the last two years, rates in these markets may not necessarily serve as a correct guide for setting the level of interest rates in Kuwait. In such circumstances, in their view, it may be necessary to shield the domestic economy from the destabilizing effects of such fluctuations. Besides, as indicated above, some other measures have been taken to tighten credit extension for speculative purposes. But all this does not mean that the authorities have a rigid policy with respect to the level of interest rates. As mentioned in the staff report, the Central Bank is empowered to vary interest rate ceilings when it thinks such a move is called for. As a matter of fact, consideration is already being given to introducing two types of interest rate ceilings on domestic bank credit (in place of the present single one) as a step toward a more flexible interest rate policy. This change will involve placing a higher ceiling on medium- to long-term loans-- in order to encourage the banks to increase investment credits to the private sector--and a lower one on short-term loans.

As a surplus country, Kuwait continues to pursue responsible external financial policies, helpful to the functioning of the international monetary system and the adjustment process. It has maintained a liberal trade and exchange system and has provided substantial financial assistance to other developing countries, with a wide geographic distribution. Aid flows to developing countries have averaged about 7-8 per cent of GNP in recent years. Moreover, the large number of expatriate workers in the country--about three fourths of the total labor force--has helped to strengthen the services account of the balance of payments of several developing countries. In addition, the authorities have followed a prudent policy with respect to management of the country's foreign assets, avoiding large and abrupt movements of funds in response to short-term changes in interest or exchange rates.

Finally, I wish to point out that the Kuwaiti authorities feel that the preliminary figure for 1981 current account surplus given in the staff report may be significantly overestimated because the assumed price premia on total crude oil exports may be higher than actual, given the downward pressure on oil prices during the year. They also consider that the rate of recovery in oil production assumed for 1982 balance of payments projections could be too high.