July 17, 2009
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 09/35-1

2:30 p.m., April 10, 2009

1. Kuwait—2009 Article IV Consultation

Documents: BUFF/09/57; SM/09/81 and Supplement 1

Staff: Senhadji, MCD; Marston, SPR

Length: 46 minutes

Executive Board Attendance

T. Kato, Acting Chair

Executive Directors	Alternate Executive Directors
	G. Tesfamichael (AE), Temporary
	S. Bah (AF), Temporary
	V. De la Barra (AG), Temporary
	J. Moon (AU), Temporary
	J. Prader (BE)
	R. Perez (BR), Temporary
	H. Yung (CC), Temporary
	J. Cova (CE), Temporary
	S. O'Sullivan (CO)
A. Fayolle (FF)	B. Claveranne (FF)
	C. Denk (GR), Temporary
	N. Choudhary (IN), Temporary
	M. Xafa (IT)
	H. Yamaoka (JA)
	M. Daïri (MD)
A. S. Shaalan (MI)	S. El-Khouri (MI)
	M. Tanasescu (NE), Temporary
	K. Mogensen (NO), Temporary
	A. Tolstikov (RU), Temporary
A. Alazzaz (SA)	A. Al Nassar (SA)
	D. Kartikoyono (ST), Temporary
	S. Sagdullayev (SZ), Temporary
	S. Lin (UA), Temporary
	G. Drummond (UK), Temporary

B. Esdar, Acting Secretary
I. Teodoru, Assistant

Also Present

IBRD: K. Carey. Middle East and Central Asian Department: P. Ananthakrishnan, J. Charap, M. Hasan, M. Khamis, F. Kumah, G. Leon, A. Ribeiro da Silva, A. Senhadji, O. Williams. Secretary’s Department: P. Martin, P. Ramlogan. Strategy, Policy, and Review Department: D. Marston. Senior Advisors to Executive Directors: W. Abdelati (MI), M. Choueiri (MI), N. Riad (MI). Advisors to Executive Directors: A. Ducrocq (FF), M. Jakoby (BE), S. Maherzi (MD), Y. Shinagawa (JA), N. Thapa (ST).

1. KUWAIT—2009 ARTICLE IV CONSULTATION

The staff representative from the Middle East and Central Asia Department (Mr. Senhadji) submitted the following statement:

> This statement provides information on recent developments in Kuwait that has become available since the staff report was circulated to the Executive Board on March 26, 2009. This information does not change the thrust of the staff appraisal.
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> An Amiri decree was issued on March 26, 2009 approving the Financial Stability Law. The law seeks to preserve financial stability by:
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> - Addressing possible bank undercapitalization through a combination of capital injections and government guarantees.
> - Providing support to liquidity-constrained investment companies that are financially solvent and with a viable business model through several measures, including guaranteeing 50 percent of new loans to these companies. The support to both banks and investment companies would be subject to some conditionality, including the authorities' right to merge institutions.
> - Encouraging lending through government guarantees for 50 percent of new loans from local banks to economic productive sectors (maximum KD 4 billions in two years). The new guaranteed loans cannot be used for speculative investments in equity and real estate markets or for repayment of existing loans.
> - Providing a legal framework for resolution of insolvent financial institutions.
>
> Another Amiri decree was issued on March 29, 2009 approving the 2009/10 budget. Available information indicates that the budget is broadly in line with the information provided to the mission by the authorities. Current expenditures allocations would remain broadly unchanged relative to the staff report projections, with the increase in salaries, transport and equipment being offset by lower allocations for goods and services. Allocation for construction and maintenance (capital budget) would decline by 24 percent, owing in part to a reduction in purchases of land. With an under-execution of the capital budget of at least 25 percent in recent years, the reduction in the

budgetary allocation is unlikely to lead to a significant decline in actual capital spending. The main spending cutback is the cancellation of a one-off payment of KD 5.5 billion (about 13 percent of 2008 GDP) to the pension fund.

Mr. Shaalan submitted the following statement:

On behalf of the Kuwaiti authorities, I would like to express my appreciation to staff for their continued constructive engagement with Kuwait. The authorities appreciate the helpful discussions and Article IV consultation report, which appropriately focused on preserving financial stability and limiting the impact of the global slowdown on the domestic economy.

Recent Developments

Kuwait's economic performance continued to be strong in 2008. GDP growth picked up sharply to 6.4 percent, from 2.5 percent in 2007, reflecting higher oil production and buoyant growth in the non-oil economy. The fiscal and external accounts continued to post large surpluses, reflecting high international oil prices. Notwithstanding increased imports stemming from buoyant demand, the current account is projected to show a surplus of 45 percent of GDP and the budget surplus for 2008 is estimated at 26 percent of GDP, despite a large transfer to recapitalize the pension fund. Price pressures moderated toward the end of the year after having peaked at 11.6 percent, on account of domestic demand pressures and higher import prices.

Notwithstanding this performance, which represents a continuation of Kuwait's prudent macroeconomic management, intensifying global financial strains and the rapidly deteriorating global outlook have adversely affected Kuwait's financial system by mid-2008, and will weigh on Kuwait's economic outlook for 2009. Against this background, the authorities have taken a number of measures aimed at safeguarding financial stability and limiting the spillovers from the global turbulence on the domestic economy. These efforts, alongside the adoption of a prudent fiscal stance and plans to expand oil and gas production, bode well for sustainable high growth over the medium term.

Financial Sector Issues and Policy Responses

The authorities have responded forcefully to the strains affecting the financial sector. Their strategy aims at restoring liquidity in the interbank market, restoring normal credit access to the private sector, and preserving the soundness of the financial system, while supporting growth. The authorities helped stabilize the market through ample liquidity injections as liquidity conditions tightened in the second half of 2008, reflecting capital outflows and rising concerns about counterparty risks.

At the same time, efforts aimed at preserving financial stability were stepped-up. These included the promulgation of a law guaranteeing customer deposits at local banks and support in recapitalizing the third largest bank, which had recorded losses associated with derivative transactions. In order to support the equity market, the government established a long-term fund to invest in the Kuwait Stock Exchange. Going forward, the authorities are developing a comprehensive financial stability framework. A decree law aimed at strengthening the financial stability of the state was issued on March 26, 2009. Its specific objectives are to restructure systemically important financial institutions that are under stress but solvent, facilitate the exit of insolvent ones, and encourage lending to productive economic activities. The decree law also provides a resolution framework for insolvent financial institutions. In order to enhance their financial stability strategy, the authorities intend to reinforce the regulatory oversight of non-bank financial institutions, including Investment Companies.

In an effort to restore normal credit access to the private sector, the decree law on financial stability considers providing partial loan guarantees to encourage lending to productive domestic economic activities. At the same time, the Central Bank of Kuwait (CBK) raised the loan-to-deposit ratio from 80 percent to 85 percent, increased bank-specific caps on credit growth by 5 percentage points, and encouraged banks to maintain and renew credit lines to deserving Investment Companies. They have requested an FSAP update in late 2009.

Macroeconomic Policy Mix

The fiscal surplus is expected to decline significantly in FY2009/10 on account of lower oil revenue. Accordingly, and given the uncertainty surrounding oil price developments, the authorities remain committed to fiscal prudence. Consequently, transfers and current expenditures will be contained in real terms in the 2009/10 budget. In addition, the authorities will postpone a previously-planned transfer of KD 5.5 billion to the pension fund. Nonetheless, capital expenditures, commensurate with the economy's absorptive capacity, will be maintained in order to prevent an abrupt deceleration in economic activity. The authorities take note of staff's advice to embrace further fiscal reforms aimed at reducing dependence on oil revenue and rationalizing fiscal spending.

In the context of the pegged exchange regime, and against the background of moderating demand and declining inflationary pressures, the CBK eased the monetary stance in the second half of 2008. Further to the actions undertaken, notably to enhance market liquidity and boost private credit, monetary policy will remain geared toward supporting the authorities' macroeconomic and financial stabilization efforts.

The authorities consider that the recent move to a basket peg has created some room for maneuver in relation to US monetary policy, in view of the differences in the two countries' cyclical positions, while better aligning the peg with Kuwait's trading and investment patterns. They share staff's assessment that the KD is broadly aligned with its fundamentals.

Oil Sector Developments

Kuwait remains committed to supporting global oil market stability while improving the domestic economy's long-term growth potential. To this end, it has launched an $84 billion investment plan in the oil and gas sector. The plan aims at expanding oil production capacity while optimizing the utilization/recovery of current fields. It would increase oil production capacity from the current level of 2.7 mbpd to 3.0 mbpd in 2010 and to 3.2 mbpd in 2013–14. It would also increase gas production from the current level of 150 million cubic feet (mcf) to 400 mcf in 2011–12 and 1,000 mcf in 2015–16. The plan would be essentially financed by Kuwait's own resources.

Statistical and Other Issues

Notwithstanding progress achieved in improving the quality and dissemination of economic data, the Kuwaiti authorities remain strongly committed to further improvements. They fully recognize the need to improve the production of the CPI, national accounts and trade data.

The global crisis calls, in the authorities' view, for steadfast preparation for the GCC monetary union. At their last meeting in December 2008, the GCC Heads of States approved the statute for a Monetary Council, a precursor to a regional central bank, and reiterated their commitment to achieving monetary union by 2010.

Kuwait continues to provide substantial assistance to developing countries. Its development assistance, estimated at about 2 percent of GDP on average over the past 20 years, significantly exceeds the U.N. target.

Ms. Xafa and Mr. Crispolti submitted the following statement:

The global financial crisis and the collapse of oil prices are taking a significant toll on Kuwait's economy. After years of robust economic expansion, growth is expected to enter in negative territory in 2009, while the external and fiscal surpluses are projected to fall markedly. The economic outlook is subject to significant downside risks stemming from a further decline of oil prices and a continued deterioration of the balance sheets of financial institutions. Against this background, the authorities will need to combine the steadfast implementation of their financial stability strategy with prudent fiscal policies and market-oriented reforms in order to safeguard macro stability and support growth.

While we share the thrust of staff's appraisal, we would appreciate hearing more from staff on the following areas:

Financial Stability

The authorities have adopted important measures to preserve financial stability in the face of the global credit crunch and severe recession. As discussed in Mr. Shaalan's informative buff statement, the recent decree law on financial stability aims to restructure systemically important financial institutions that are under stress but solvent, facilitate the exit of insolvent ones, and encourage lending to productive economic activities. However, we are concerned that other initiatives, such as instructing banks to avoid selling collateral shares posted by investment companies and setting up a state fund to invest in the Kuwait Stock Exchange, will simply transfer the losses incurred to the balance sheets of the banks and the government. We also wonder whether banks would be willing to extend new credit in view of the risk of being undercapitalized under adverse scenarios (Box 2). We welcome the authorities' intention to request an FSAP later this year.

Exchange Rate

As reported in previous research, fiscal policy is the main determinant of the current account balance in GCC countries (Box 5, SM/08/284). Moreover, these countries need to run large current account surpluses in order to transform oil wealth into financial wealth, so as to ensure intergenerational equity. We thus remain unconvinced that the REER plays a significant role in ensuring external stability in Kuwait, or that standard CGER estimates are relevant for countries producing exhaustible resources.

Fiscal Policy

We take note of staff's recommendation to complement the ongoing efforts to preserve financial stability with a well-designed fiscal stimulus package aimed at supporting demand and boosting investor confidence. We would appreciate it if staff could be more specific about the size and composition of the recommended stimulus. Given the sharp drop in revenues and the existing capacity constraints on capital spending, it seems that effective fiscal stimulus can only be provided through higher current spending, which would eventually undermine confidence in long-term sustainability, particularly if oil prices remain low.

KIA

In the latest WEO, staff suggests that risks of financial stress in the Middle East may be magnified by the potentially large losses incurred on assets invested in advanced economies experiencing a crisis.[1] We wonder whether staff can elaborate on the relevance of this transmission channel in Kuwait with a focus on the role of KIA.

Mr. Kishore and Mr. Krishnan submitted the following statement:

We thank staff for a focused paper and Mr. Shalaan for his lucid buff statement on Kuwait. The Kuwaiti economy is caught up in the storm of the global crisis and impacted by the drop in oil prices. Despite current political differences, the authorities have a strong record of economic management and can be expected to respond appropriately to the situation. We note that there is a broad convergence of views on many key issues between staff and the authorities and we confine our comments to a few specific aspects.

On the financial stability plan and the measures to restructure systemically important financial institutions, we agree with staff that the plan should allow for necessary consolidation and restructuring of the financial sector. We note that the authorities have been quite proactive in this regard. We also note from Mr. Shalaan's buff statement that a decree law on financial stability has been issued on March 26, 2009. Staff may like to share some further details on the law and also indicate to what extent it incorporates the elements suggested by staff.

On the fiscal front, the perceptions of the authorities and staff appear to differ regarding the desirability of a fiscal stimulus in the current situation. The authorities are stressing the importance of fiscal prudence given the cyclical pattern Kuwaiti economy, while staff consider that there is room for fiscal stimulus and urge necessary measures to support demand. Clearly these are extraordinary circumstances and the desirability of stimulus measures being undertaken in the countries with the room for such measures cannot be overstated. There appears to be some room for appropriate capital expenditure and structural measures which would ensure long term growth prospects. We note that the authorities appear to be willing to consider such an approach and we encourage them to do so.

Kuwait has followed an exchange rate policy since May 2007 which has deviated from other GCC members. We note that staff and

[1] Forthcoming WEO, chapter 4, "How Linkages Fuel the Fire: The Transmission of Stress from Advanced to Emerging Economies".

authorities concur on the appropriateness of this policy in the Kuwaiti context. We also note that in the context of the eventual GCC monetary union, all options are open, which presumably include the Kuwaiti model.

We wish the authorities well in their endeavours.

Mr. Legg and Mr. Moon submitted the following statement:

We are grateful to staff for a well-focused and concise report and to Mr. Shaalan for his helpful buff statement. As is clear from the report, the deteriorating global environment has started to weaken Kuwait's economic activity and affect the financial system. The sharp fall in oil prices has produced a significant contraction in GDP, and the fiscal and current accounts surplus. Inflation has declined. Also, the balance sheets of financial institutions have deteriorated sufficiently to require close monitoring. Thus, we welcome staff's approach to focus on the impact of the global financial crisis on Kuwait's economy.

Overall Strategy

We agree with the authorities that Kuwait's key strategic challenge is how to use its oil wealth to boost non-oil GDP growth in order to generate private sector development. Diversification of Kuwait's economy to reduce its vulnerability to oil markets would require casting structural reforms in the context of a comprehensive strategy. Implementation of government investment plans and progress with structural reforms to promote private investment are critical. In this connection, we welcome the staff's recommendation to expedite the structural reforms that are vital to private sector investment. However, we note that little progress has been achieved in the last year regarding the enhancement of competition, the development of public-private partnerships, FDI inflows to Kuwait, etc. We would welcome further details from staff or the authorities on the reasons behind this.

Financial Stability

We agree with staff that the central bank should strengthen oversight of risk management practices, with comprehensive stress tests, and should encourage restructuring of the Investment Companies (ICs).

We are concerned that ICs which invest heavily in stock markets on the basis of a highly leveraged position, mismatched maturities, and limited transparency could be the main source of vulnerability. ICs could pose a systemic risk to the financial system through the operation of a vicious circle connecting the banking sector and real economy. We join the staff, therefore, in emphasising the importance of stricter regulation and closer supervision of non-bank financial institutions. The banking sector stress tests summarised in Box 2 highlight that banks remain vulnerable to a further global slowdown. In this context, we stress the importance of the upcoming, and very timely, FSAP update which the authorities have requested.

We welcome the authorities' comprehensive response, including the Financial Stability Law (FSL) to stabilise financial markets, and encourage the authorities to persevere in negotiations with parliament to ensure its impact is not undermined. We agree with staff that the financial stability strategy should encourage consolidation and restructuring of the financial sector with enhanced transparency in order to boost both domestic and external investor confidence.

Foreign Exchange Rate Regime

At the Board meeting for Kuwait's Article IV last year, we were reminded of the methodological difficulties surrounding the assessment of exchange rate equilibrium for oil exporting countries. At that time, we asked staff for further work on these issues and also encouraged a review of the experience with fixed exchange rates to determine whether alternative arrangements might be more suited to Kuwait. The aim was to address a persistent lack of analysis on the costs and benefits of alternative exchange rate policies for Kuwait and other Middle East countries. While these issues are not addressed explicitly in the staff report, we note staff's conclusion that the return to a basket peg has kept the Kuwaiti dinar broadly in line with fundamentals. This strikes us as an important observation, given the need to improve the macropolicy framework, and the region's contribution to global imbalances.

Fiscal Stimulus Package

We agree with staff that a fiscal stimulus package will complement the financial stability package, not only through the multiplier channel, but also by strengthening investor confidence, especially given investor concerns regarding the potential for broader contagion from the difficulties confronting Investment Companies. In this context, we would invite staff's comment on the authorities' concerns that leakages through remittances and imports would dampen any package's expected impact on the Kuwait economy.

We wish the authorities every success.

Mr. Warjiyo and Mr. Thapa submitted the following statement:

We thank staff for the well-written and informative report and Mr. Shaalan for his helpful buff statement. We broadly agree with the overall thrust of the staff appraisal. Despite the adverse effects of the global financial crisis, the Kuwaiti economy continues to perform well, with strong fiscal and current account surpluses. However, the global recession and fall in oil prices would weigh on Kuwait's growth prospects and financial sector risks remain elevated. Going forward, the authorities need to continue their efforts to preserve financial sector stability and support the economy. In this regard, the Kuwaiti authorities are to be commended for handling the initial liquidity crisis well and for successfully recapitalizing the third largest bank.

Despite progress towards stabilization, we share the view that the Kuwaiti financial sector remains vulnerable owing to its exposure to the global troubled financial institutions and consequent emerging distress in many of its investment companies. We note that the latter has grown too fast in the last few years with significant amount invested in the moribund equity and real estate market. Kuwaiti banks have considerable exposure to investment companies lending activities reaching 12 percent of banks total loan. We support staff's view that the risks of the financial system is expected to increase and the authorities' main focus in the years ahead would be on investment companies as business prospect of which has been continuously receding in line with the deepening of the global financial crisis. Over the near term, safeguarding the financial stability by recapitalizing problem banks would not necessarily be effective, if this measure were not followed by the steps of consolidation and restructuring of investment companies.

The key challenge for the authorities in preserving financial sector stability, therefore, lies in tactful handling of systemically important banks and investment companies. As the stress test results showed, the banking system may need a recapitalization of 5 percent of GDP if the worst case scenario materialized, this is not impossible especially if the global financial crisis is prolonged. We feel that the authorities' proposed financial stability plan is timely and appropriate. The authorities' plan to restructure those, which are under stress but viable and facilitate the exit of those which are not viable will help make the Kuwaiti financial sector stronger and robust. Although adopted by the Cabinet, the financial stability plan encapsulated into a draft Financial Stability Law (FSL) is yet to be passed by the parliament. As some have tied its passage with the need for public assistance for households, and the elections for the dissolved parliament are slated to be held in two-month time, what are the political risks associated with this plan, especially if more money may be needed for the financial sector?

In addition, we urge the authorities to enhance the central bank's regulatory capacity as well as develop regulatory oversight in non-bank financial institutions especially investment companies. We welcome the authorities' request for an FSAP in late 2009, which would be helpful to examine these issues. However, we wonder if the authorities' request can be met given staff constraints in the Fund. Staff comments are welcome.

On the fiscal policy front, we support staff's recommendation that a fiscal stimulus package carefully designed should complement the financial stability plan to spur economic growth. The Kuwaiti authorities should used the fiscal cushion they have for developing the non-oil sector and thereby help reduce their dependence on oil for economic growth and revenue generation. While focusing on quality capital spending, the authorities need to streamline their regular spending for ensuring medium-term fiscal sustainability. The introduction of targeted subsidies for fuel, electricity and water as well as the initiation of pension reforms will certainly help bring down the level of regular expenditure. Moreover, to facilitate credit growth in viable oil and gas projects along with its policy to preserve fiscal sustainability, the authorities can consider introducing a joint financing scheme between government budget spending and commercial banks' loan. On the revenue front, we encourage the introduction of VAT system in coordination with other GCC countries that would be able to make up a loss in oil revenues on account of the fall in oil prices.

On monetary policy, the peg to a basket of currencies has continued to serve them well. The current arrangement provides flexibility to the authorities in their pursuit of promoting growth and managing inflation. The recent monetary easing in support of the financial sector was an appropriate move, and it also plays a useful role in stimulating the economy. However, like Ms Xafa, we wonder how relevant is the role of the REER for external stability in Kuwait, given the unique features of oil-producing countries and that current account surplus are largely driven by fiscal dynamics?

On structural reforms, we urge the authorities to focus on developing legal infrastructure, which is a key for the private sector development. In this regard, we also feel that enacting laws relating to companies, competition, public-private partnership and privatization will help accelerate the private sector growth.

With these comments, we wish the authorities success in their endeavors.

Mr. He and Mr. Yung submitted the following statement:

We thank staff for a well-presented report. Staff has appropriately identified the key risk areas, which were the focus of the discussions in the consultation exercise. We share staff's views that the major risks to Kuwait's economic outlook are a rapid deterioration in the balance sheet of financial institutions and a prolonged weakness in global activities that could keep oil prices under persistent pressure. So in the short run, it is important for the authorities to safeguard the soundness of the financial institutions and cushion the possible impact of the global slowdown on Kuwait.

We agree with the thrust of staff's assessment in the report. Our comments are briefly set out in the following:

Financial Sector

While Kuwait's banking sector has shown respectable resilience to the global crisis, we share staff's view that there are increasing risks emerging from their large exposures to two sectors: investment companies and real estate.

We strongly support the authorities' plan to tighten regulatory oversight of investment companies, which are systemically important to Kuwait's financial stability. Staff's efforts in analyzing the vulnerability of the sector and outlining the possible risk transmission channels are highly appreciated. We are convinced that investment companies, which are highly leveraged, could be the main source of vulnerability in the financial system. Given this, we see merits in incorporating investment companies in the authorities' stress tests to help substantiate the understanding of the contagion of risks among key financial sector participants and enhance the overall preparedness of public sector intervention. Meanwhile, we note that the central bank has appointed international experts to help address difficulties in assessing the value of some investment companies' foreign assets. Could staff elaborate further as to the risks of such exposures incurred by investment companies?

We note that exposure to the real estate sector (nearly 25 percent of banks' total loans) is a major source of vulnerability to banks as well as investment companies. Perhaps staff could provide a brief update in the board meeting as to the latest developments in Kuwait's real estate markets and the outlook

Fiscal Stimulus

We note the divergence in views between the authorities and staff on fiscal stimulus package. On the one hand, staff's call for such a stimulus package to increase demand, shore up investor confidence, and help stabilize asset markets is logical and in line with the Fund's usual stance. On the other hand, we share the authorities' concern on fiscal prudence and the effectiveness of stimulus in practice given the leakages (through remittances and imports) and the limitation in significantly expanding capital spending as pointed out in the staff report. Overall, we can understand the difficulties in striking a good balance between different choices of policy responses. But ultimately, whether to implement the fiscal stimulus package seems to be a judgment call. In our view, it is key for the authorities to maintain flexibility in their fiscal stance and stand ready to take actions if necessary.

In the longer run, we note that there is a clear case for the authorities to advance the efforts in fiscal reforms targeting at reducing the dependence on oil revenue and rationalizing fiscal spending, including cutting large untargeted subsidies and transfer which could distort prices and reforming the pension system.

Mr. Alazzaz submitted the following statement:

I thank the staff for an excellent report and Mr. Shaalan for his informative buff statement. The Kuwaiti authorities are to be congratulated for another year of impressive economic performance. Last year, GDP growth was robust and both the fiscal and external current accounts registered large surpluses. The authorities also deserve to be commended for taking strong measures in the face of turmoil in the global financial markets to preserve the soundness of the financial system. While these measures along with easing inflationary pressures should facilitate a return to robust growth as projected in the staff's medium-term baseline scenario, further efforts are needed to address the risks arising from the difficult global environment.

On the fiscal front, the substantial surpluses that have been generated over the past years have enhanced the economy's resilience by providing a financial cushion. Going forward, it is encouraging that although Kuwait's fiscal and external positions are projected to remain in surplus, the authorities are cognizant of the need to continue improving the structure of the budget and enhance efficiency. In this connection, the authorities are rightly focused on increasing capital spending while containing current expenditures. However, if the economic situation weakens further, the authorities may wish to consider additional spending.

On monetary policy, the Central Bank of Kuwait has rightly eased the monetary stance in the second half of 2008 in light of receding inflationary pressures and moderating demand. Turning to financial sector issues, the authorities' comprehensive and timely measures, including liquidity support, capital injections, and deposit guarantees, have helped safeguard financial stability during the current global financial turmoil. I am also encouraged by the issuance of a decree law with the objectives of restructuring systemically important financial institutions that are under stress but solvent, facilitating the exit of insolvent ones, and encouraging lending to productive economic activities.

Turning to the external sector, the continued strong current account position is reassuring. Increased cooperation and harmonization in the context of the GCC also bode well for the future. Turning to the exchange rate, the current policy continues to serve the economy well. While noting the staff's assessment that the exchange rate is in line with fundamentals, I remain skeptical regarding assessments of the equilibrium real effective exchange rate, especially in oil-producing countries.

On the oil sector, I commend the authorities for their constructive efforts to help stabilize global oil prices. As noted in Mr. Shaalan's buff statement, the authorities have launched an $84 billion investment plan in the oil and gas sector with the aim of increasing oil production capacity to 3.2 million barrels per day by 2013-14 and gas production capacity from the current level of 150 million cubit feet (mcf) to 400 mcf by 2011-12.

Finally, I commend the authorities for their continued generous external assistance and wish them further success.

Mr. Rutayisire submitted the following statement:

We thank Staff for their comprehensive report and Mr. Shaalan for his informative buff statement.

The Kuwaiti economy recorded strong economic performance in 2008. Reflecting higher oil production, strong domestic investment and consumption, real GDP growth is estimated to have reached 6.4 percent, up from 2.5 percent in 2007. Fiscal and external current accounts have recorded substantial surpluses and inflation decreased. However, noting that since the beginning of 2009 the global crisis has adversely affected economic activity and the financial system, we commend the authorities for their bold responses to limit the effects of the crisis on the economy and preserve financial stability. In this context, we welcome the authorities' commitment to use oil wealth in order to boost non-oil GDP growth, generate private sector employment and accumulate further financial assets for future generations. As the medium-term outlook will hinge largely on the global oil market developments, we encourage the authorities in their efforts to implement government investment plans and pursue structural reforms in order to stimulate economic growth and promote private investment.

In the fiscal sector, the overall budget surplus in 2008/09 has declined to 26 percent of GDP from 40 percent of GDP in 2007/08 owing to the large increase in spending notably the recapitalization of the pension fund. Could the Staff provide more elaboration on what is happening in the pension system. Is the problem reflecting the nature of the pension system itself or the way the pension assets are managed. Is the capital injection going to solve the problems? We are encouraged to note that in a context of decline in oil prices the authorities are determined to preserve the country's long-term fiscal sustainability. In this regard, implementing fiscal reforms to reduce dependence on oil revenue and rationalize fiscal spending is a key to further fiscal sustainability. We also see merit in reforming the pension system to ensure its long-term viability as well as the introduction of the VAT in coordination with other GCC member countries. To further enhance economic prospects and support oil market stability, we encourage the authorities to pursue the implementation of their investment program in the hydrocarbon and infrastructure sectors based on domestic resources. We also encourage the implementation of the recommendations made by the recent IMF technical assistance in the area of fiscal policy formulation within a medium-term framework.

Monetary policy, in the light of projected weakening of economic activity, remains appropriate as it will help support their efforts in macroeconomic and financial stabilization. We encourage them to create conducive conditions of a rapid return of real interest rates to positive territory given the expected decline in inflation. We are heartened to note that the exchange rate of the Kuwait Dinar is broadly in line with fundamentals and the basket peg remains appropriate and supportive of the country's participation in the projected GCC monetary union.

With regard to financial issues, we commend the authorities for their responses to the tightening of liquidity conditions in October 2008. Restoring direct injection of liquidity in the banking system, introducing KD-USD swaps and repo of varying maturities have been helpful in the authorities efforts to preserve financial stability. We welcome the draft financial stability law submitted to parliament which aims at restructuring important financial institutions, facilitating the exit of insolvent institutions and encouraging lending to productive activities. The measures put in place by the central bank, in particular, raising the loan-to deposit ratio, encouraging banks to maintain and renew credit lines to deserving investment companies and avoiding sales of collateral shares in their possession will help to restore normal credit access to the private sector. However, we agree that there is a need to preserve the quality of banks' assets in order to strengthen financial stability, in light of these new measures which are supportive of credit growth. We support the authorities' interest in undertaking an FSAP update which will be helpful in their endeavors to further strengthen the resilience of the financial sector and the central bank's capacities in monitoring risk management practices as well as the supervision of non-bank financial institutions.

We commend the authorities for the progress made towards the creation of GCC monetary union notably the decision to establish a monetary council by end-2009 and achieve the monetary union by-2010. The efforts to make the draft law of AML/CFT compatible with international standards are steps are also commendable.

On structural reforms, we share the view on the need to speed up efforts in implementing required reforms to private investment promotion and annual economic growth increase to the range of 4-5 percent. The capital market law will be helpful in deepening the financial intermediation. We encourage the authorities to finalize the laws on competition, public-private partnership and privatization to further attract FDI inflows to Kuwait. The regulations on the newly reduced marginal corporate tax rate on foreign companies also need to be implemented.

We are grateful to the Kuwaiti authorities for their generous assistance to low income countries through a substantial financing of public investment programs and debt relief under HIPC Initiative. It is important to underscore that over the past two decades, the Kuwait's external assistance have averaged about 2 percent of GDP. We encourage them to continue their support to the fight against world poverty and the attainment of the MDGs.

With these remarks, we wish the Kuwaiti authorities every success in their future endeavors.

Mr. Daïri and Mr. Maherzi submitted the following statement:

We thank the staff for a well-focused report and Mr. Shaalan for his informative statement. Strong track record of sound policy implementation has placed the Kuwaiti economy in a relatively comfortable position as it faces the impact of global crisis and the sharp decline in oil prices. As indicated by Mr. Shaalan, the authorities' forceful actions to address emerging risks and vulnerabilities, particularly in the financial sector, while preserving macroeconomic stability and pursuing their important investment program, including in the oil sector, are noteworthy and bode well for improved medium-term prospects as global economy recovers.

While a fiscal stimulus package would support economic activity without undermining medium-term fiscal sustainability, as staff note, the authorities understandably underscore the need for fiscal prudence in light of the sharp decline in revenues and heightened uncertainties. Their intention to contain transfers and current spending while preserving capital expenditure, in line with absorptive capacity, is well placed. Over the medium term, reforming the subsidies and pension systems and expanding the tax base, as staff recommend, should help reduce budget dependence on oil revenue.

Monetary policy remains well geared toward supporting activity, particularly in view of the expected further decline in inflation. The authorities are to be commended for the measures taken to preserve financial stability. Looking ahead, implementation of the recent law on financial stability and stepping up reinforcement of the regulatory oversight of nonbank financial institutions, as intended, should help address potential vulnerabilities and restore normal credit access. We welcome the convergence of views between the authorities and staff on the guiding principles for their financial stability strategy, including timely action and recognition of losses, relying to the extent possible on the participation of existing shareholders or new private investors for bank recapitalization, enhancing transparency, and ensuring effective communication and coordination. An FSAP update, as requested by the authorities, should contribute to identifying useful directions to future reform.

The authorities' long-standing track record of generous ODA is praiseworthy. We wish them further success in their endeavors.

Mr. Prader and Mr. Jakoby submitted the following statement:

We thank the staff for an interesting report and Mr. Shaalan for his informative buff statement. We broadly share the staff appraisal. The following comments are for emphasis.

Kuwait's economy has continued to perform well and showed solid resilience to the global crisis. The country has also benefited from increased exchange rate flexibility thanks to the shift from the peg to the US dollar to the peg to a basket of currencies, particularly with respect to inflation. However, risks are building up in the financial sector and the prospects of a protracted global recession will adversely affect the fiscal accounts through lower oil-price related revenue.

We welcome the consensus between the authorities and staff on the key components of the financial stability strategy. At this juncture, protecting the soundness of the banking sector is a crucial goal. In this view, the planned stress testing for different scenarios of real estate and stock market developments are of particular importance. The large losses of investment companies fuelled by excess leverage and maturity mismatches indicate the need to improve their regulation and oversight. The current capital adequacy ratios provide some buffer for Kuwait's banks, as shown in the two out of four illustrative scenarios in the Staff Report. However, the remaining two, more severe, scenarios, result in recapitalization needs of 2.6 and 4.8 percent of GDP, respectively. We would welcome staff comments on the probability of the latter scenarios, particularly in the context of the recent downward revision in the global economic outlook. We also note in today's staff statement that the authorities appear cognizant of the need for deeper government involvement in a potential financial sector rescue. Staff comments on this issue are also welcome.

We have some doubt about the staff's recommendation to complement the financial stabilization strategy with a fiscal stimulus package. In this regard, the authorities have provided quite persuasive arguments about the probably very limited effect of such stimulus. However, we see some merit in accelerating priority public investment, in line with the existing implementation capacities.

While oil prices are expected to gradually rise as the global economy recovers, the Kuwaiti authorities are well advised to promote the growth of the non-oil economy through continued structural reforms. We encourage the authorities to step up their efforts to improve the business environment, particularly with respect to its transparency and predictability, the regrettably slow progress in enacting the key corporate legislation and the reduction of red tape. Such improvement should have a larger impact on the investors' confidence than a short-term fiscal stimulus.

The high current dependency on hydrocarbon fiscal revenue also calls for efforts to enhance non-energy revenue base. In this view, we support staff recommendation to accelerate efforts to introduce the VAT.

We welcome the authorities' request for an FSAP update and encourage them to address the current weaknesses in the timeliness of data provision. The Kuwaiti authorities deserve credit for their continued commitment to development assistance to low-income countries.

Mr. Vogel and Mr. De la Barra submitted the following statement:

The global turmoil has created an unfavorable external environment for Kuwait, particularly due to lower oil prices, which could lead to a contraction in real GDP growth, after having had a robust macroeconomic performance in the past years. Precisely, after exhibiting large fiscal and current account surpluses, this seems to be the time to use part of the accumulated reserves in order to mitigate some of the negative effects stemming from the global crisis.

On the fiscal side, we find merit in both the authorities' and the staff's position. Given the uncertainty related to the future revenues and, especially, to the financial system, the authorities' view of remaining committed to fiscal prudence, as noted in Mr. Shaalan's helpful buff statement, is understandable. On the other hand, considering this exceptional global crisis, we agree with Mr. Kishore and Mr. Krishnan on the desirability of the fiscal stimulus undertaken by countries with room for such measures. The positions of both the staff and the authorities may be conciliated in the staff's suggestion that fiscal stance would have to be adjusted should oil prices remain low in the coming years.

The state of the financial system is a reason for concern and a comprehensive strategy is appropriate. Clearly, the design of such strategy is not an easy task given the complex nature of the problems and the links between banks and investment companies identified in Boxes 1 and 2 of the staff report. The recent decree approving the Financial Stability Law seems to be headed in the right direction; nevertheless, we would appreciate the staff's assessment of it, particularly its achievements and shortcomings.

The authorities have signed the treaty to establish the GCC monetary union. It would be useful to know the staff's opinion on the likelihood of meeting the remaining prerequisites next year.

With these comments, we wish the authorities every success in their future endeavors.

Mr. Lushin and Mr. Tolstikov submitted the following statement:

We thank staff for a well-written report and Mr. Shaalan for his helpful buff statement.

Kuwait's economic situation has changed significantly in 2008. In the first half of the year growth remained strong and inflationary pressures were the main concern. After the collapse of oil prices in mid-2008 and the unfolding of the global financial crisis, the stability of the financial sector became the most pressing issue. However, Kuwait's substantial financial cushions, a strong fiscal position as well as the authorities' financial stability strategy instill confidence that the immediate problems of Kuwait's financial sector are manageable. Over the medium term, the main risk is a prolonged period of low oil prices, which may limit fiscal space and impair investors' confidence. This may give an additional impetus to the implementation of the necessary reforms aimed at strengthening the fiscal system and improving business climate.

The authorities have successfully stabilized the financial sector after the escalation of the global financial crisis in October 2008. Banks have shown resilience and remain generally sound. However, risks for banks and investment companies substantially increased, requiring further systemic measures to maintain financial stability. We note the adoption of the Financial Stability Law, which facilitates recapitalization of banks, provides support to viable investment companies, encourages lending and provides a legal framework for resolution of insolvent financial institutions. We would welcome staff comments on the potential fiscal implications of this law.

To complement the financial stability package, staff also recommend additional fiscal stimulus in 2009/10, arguing that a well-designed stimulus package, mostly through capital spending, would stimulate economic activity, shoring up investors' confidence and reducing risks for financial institutions. We note that views of staff and the authorities diverge on this matter. The authorities fear that additional stimulus would have a limited impact on the domestic economic activity, as its substantial part would finance imports and remittances. Furthermore, the authorities have already committed to maintaining the level of capital spending, including plans to invest in the expansion of oil and gas production capacity. What kind of projects do staff have in mind when advising to increase fiscal spending?

Staff emphasize the need for fiscal reforms aimed at improving efficiency of public expenditures and broadening the revenue base, associating it, however, with the prospects of a prolonged period of low oil prices. It would be more prudent to emphasize that Kuwait would benefit from such reforms in any case, even if oil prices recover in the medium term. At the same time, from Mr. Shaalan's buff statement we learn that "the authorities take note of staff's advice to embrace further fiscal reforms", which leaves an impression that they have some reservations. Staff comments are welcome.

Deadlines for the creation of the GCC Monetary Union, including development of a common monetary and exchange rate framework, are rapidly approaching. Some countries in the region peg their currencies to US dollar, while Kuwait moved to a peg based on a basket of currencies. In this regard, we are interested in staff views on Kuwait's experience with the basket peg and its potential benefits for the GCC Monetary Union.

Mr. Guzmán and Ms. Cuenca submitted the following statement:

We thank the staff for the comprehensive set of documents as well as Mr. Shaalan for his helpful buff statement. Kuwait's macroeconomic performance has been strong in the last few years, reflecting higher oil production and high oil prices. Vulnerabilities may arrive caused by the crisis in the global financial system. The sharp drop in oil prices will reduce the fiscal and external current account surpluses, but this still at reasonable levels.

To prevent the consequences of the global crisis from weakening economic activity, we broadly agree with the staff to urge the Kuwaiti authorities to complement the financial stability package with a fiscal stimulus package to mitigate the negative feedback between weakening balance sheets of financial institutions and lower economic activity.

Beyond this, it is advisable to undertake investment plans and to promote structural reforms and encourage private investment. The key challenge will be to propel the infrastructure projects. At the same time, it is necessary to start a strategy to restore normal credit access to the private sector.

We share the staff's view that there are particular risks arising in the real estate sector and investment companies, so it is important for the banking sector to safeguard transparency, soundness and good management in order to cushion any possible impact.

We would like to applaud Kuwait's substantial assistance to developing countries and we encourage the authorities to continue providing debt relief to all eligible HIPC countries.

Finally, we advise Kuwaiti authorities to implement their investment program in the hydrocarbon sector, which could sustain fiscal expansion and consolidation. And to continue developing the monetary integration among GCC countries.

We wish the authorities success in their endeavors.

Ms. Agudelo and Mr. Perez submitted the following statement:

We thank the staff for a concise report and Mr. Shaalan for his informative buff statement.

As Kuwait is now experiencing the adverse impact of the global financial and economic crisis and the sharp fall in oil prices, the short-term challenge of the authorities is to preserve financial stability and to support economic activity. However, Kuwait's political fragmentation has created some delays in the approval of legislation that is critical for the financial stability plan. At the same time, short-term urgencies cannot hide the need to address long-term challenges. As discussed during the last article IV consultation, to sustain growth over the medium term, efforts are needed to enhance non-oil sector growth, promote private investment, and focus public investment in infrastructure and education.

The banking sector has shown resilience with a sound position at the outset of the crisis and enough capital to buffer some losses. However, given the complexity of its relationship with the ICs, its vulnerability has increased substantially with the ongoing crisis. The authorities' efforts could break the vicious circle between banks, ICs and the KSE. We agree that the difficulty is to balance the need to keep banking credit flowing while minimizing risks. We welcome the authorities' effort to pursue stress tests to the banking sector and to the ICs. However, without the main results of the stress tests, we fail to understand how banks can follow the advice to "maintain and renew credit lines to deserving ICs and avoid selling collateral shares."

The authorities' plan to tighten the regulatory oversight of the financial sector, with a special emphasis on ICs, goes in the right direction. We commend the authorities for their commitment to recapitalize the country's third largest bank, as its systemic nature could deepen the crisis. We welcome the authorities' request for the FSAP update in late 2009.

On the fiscal side, the implementation of a fiscal stimulus package in the case of Kuwait has its limitations. While Kuwait has a fundamentally strong fiscal position that allows room for anti-cyclical actions to support economic activity, the adsorptive capacity of the country and leakages through imports limit its effectiveness, as explained by Mr. Shaalan in his buff statement. In this sense, and given that staff recommends a fiscal stimulus to support the economic activity, we would like to know if staff has calculations on the fiscal multiplier for the Kuwaiti economy.

For the long-term sustainability, we agree that structural reforms are critical to sustain economic growth and to maintain intergenerational equity. These reforms are even more urgent if oil prices remain low for a long period of time.

We commend the authorities for their substantial assistance to countries inside and outside the region, their active support to the HIPC initiative, and for considering ways to extend the HIPC debt relief.

With these remarks, we wish the authorities success in dealing with the challenges that lie ahead.

Mr. Bergo and Ms. Mogensen submitted the following statement:

The Kuwaiti economy overall performed strongly in 2008 but is now confronted with important headwinds. On the basis of the very well-written and concise staff report, we only have a few comments and questions:

We underscore the importance of devising appropriate strategies for withdrawing public support to the financial sector in a timely manner.

The vulnerabilities exposed in the financial system supports that one of the lessons of the current crisis is to ensure appropriate regulation of all systemically important financial institutions. We welcome the authorities' intension to reinforce regulatory oversight of non-bank financial institutions, including investment companies, as testified by Mr. Shaalan, as well as the interest in an FSAP update.

We see the case for well-designed fiscal stimulus focused on key infrastructure projects, but at the same time recognize the limitations noted by the authorities. As other Directors, we would welcome staff's comments on this divergence in view.

A large part of non-oil sector GDP growth in recent years has emanated from the financial institutions. How do the now exposed vulnerabilities in the financial system, including high leverage of the investment companies, affect staff's view on non-oil related growth prospects going forward? On the same issue, we would note that while the plans to increase oil production capacity are understandable, this might risk reducing incentives to engage in other, over time more sustainable economic activities. We strongly encourage the authorities to advance key fiscal and structural reforms aimed towards reducing the reliance on depletable resources.

We welcome the authorities' efforts to make their AML/CFT laws in compliance with international standards.

Mr. O'Sullivan submitted the following statement:

We wish to thank the staff for the excellent report and Mr. Shaalan for his informative buff statement. We agree with the broad thrust of the staff's appraisal. We offer brief comments below on the soundness of the financial sector and on fiscal policy.

The Financial Sector

The authorities are to be commended for their longer-term strategic approach which is centered on strengthening the prospects for sustainable growth of the non-oil sector and ensuring intergenerational equity, and for their agile response to the immediate challenges posed by the deteriorating external economic environment. The need to press ahead with measures to restructure the financial sector is central to achieving both the short term and the longer-term goals. We welcome the recent issue of the decree law which aims at preserving financial stability, in particular its provision of a legal framework for the resolution of insolvent institutions and we note the prompt action which was taken to facilitate the recapitalisation of the third largest bank which reportedly lost $1.4 billion, mostly in derivative transactions in October 2008.

Although capital adequacy ratios currently exceed the regulatory norms and other indicators of financial soundness appear favourable, banks may have significant exposures to potentially troubled investment companies. The stress test results contained Box 2 report that the banking system would remain adequately capitalized in the event of a 5 to 10 percent default rate. However, no indication is given as to whether the potential losses of the investment companies might impose a strain on the banking sector in excess of 5 to 10 percent. The staff's comments would be welcomed on that point and on whether the position of investment companies will be fully dealt with in the intended FSAP. We agree strongly with the staff recommendations regarding the extension of oversight to the IC sector.

Fiscal Policy

Fiscal policy rightly concentrates mainly on establishing the basis for longer-term sustained growth in the non-oil sector and on intergenerational equity. The recent transfer of 10.5 percent of GDP to the pension fund will have served both goals. This will clearly help to fund future liabilities but we would welcome clarification as to whether this transfer was made principally to address portfolio losses which the pension fund may have sustained recently or whether it reflected a policy of building-up the pension fund progressively. Can the staff indicate the extent to which the pension fund will need further injections over time? While understanding the authorities' wish to exercise fiscal prudence at present, intergenerational equity considerations would point to the need to use part of the current fiscal surplus to ensure the long-term health of the fund.

We note that the estimated fiscal breakeven oil price for 2009 is $33 per barrel. For oil prices to reach that level and to remain at that level for some time, the world economy would likely be in a profoundly depressed state for quite an extended period, a circumstance which would of course affect other drivers of the fiscal balance in Kuwait, as elsewhere. Is it possible, therefore, that a protracted period of lower oil prices would imply a somewhat higher fiscal breakeven oil price for Kuwait?

With these remarks, we wish the authorities well in their endeavours.

Mr. Heath and Mr. Lin submitted the following statement:

The Kuwaiti economy performed well in 2008, but now faces strong headwinds due to domestic financial vulnerabilities and much lower oil prices. We agree that the major risks to the outlook are instability of domestic financial institutions and a prolonged global recession, and we support the staff's key recommendations for managing these risks.

Financial Sector

The staff report makes a convincing case that risks to financial stability are significant. We note with concern the results of the staff's stress tests, and the declining indicators of capital adequacy and provision coverage. Together with the recent distress of several major financial institutions, these developments underscore the importance of policy action to stabilize the financial system.

We commend the authorities for their forceful response thus far. The stabilization of the interbank market is a positive development, as is the successful restructuring, including a major infusion of private capital, of the third largest bank.

Nevertheless, more must be done to restore the health of credit markets. We agree that forward-looking stress-testing, establishment of a resolution framework for insolvent institutions, restructuring of viable institutions, resolution of insolvent banks, and tighter regulation of investment companies should be priorities. We note the recent enactment of the Financial Stability Law by Amiri decree. How effectively will this measure address the key problems in the financial sector? We would appreciate further comment by the staff. We are also interested in the staff's views on how the economic stimulus package approved by the Cabinet in late March will affect credit market functioning. Finally, we welcome the authorities' intention, as noted in Mr. Shaalan's statement, to reinforce regulatory oversight of nonbank financial institutions.

Fiscal Policy

We support the staff's recommendation to implement a well-designed fiscal stimulus package that directly supports domestic demand. Kuwait's strong public balance sheet affords it ample capacity to undertake stimulus. We note the authorities' view that significant leakages of fiscal stimulus occurs through imports and remittances. However, we believe that the Kuwaiti economy would benefit from fiscal stimulus. And we recall from Wednesday's informal briefing by the Middle East and Central Asia Department that the jury is still out on the income elasticity of remittances.

We support the staff's recommendation to formulate fiscal policy within a medium-term framework.

Exchange Rate

We note the staff's exchange rate assessment. We would have appreciated further documentation that enables a fuller evaluation of this assessment. For example, how sensitive is the ES approach to different rules of thumb for equilibrium saving? To what extent is the GCC-based MB panel model attributing variation in equilibrium current account balances to economic fundamentals, rather than unknown country-specific factors?

AML/CFT

We welcome Kuwait's progress on systemic anti-money laundering issues, including its strong and consistent contributions in the Middle East and North Africa Financial Action Task Force. At the same time, Kuwait remains the only Gulf Cooperation Council country without a terrorist financing law. Despite repeated assurances since 2004 that a "draft law" is being considered, little meaningful progress has been made to bring Kuwait into compliance with international standards. We urge the authorities to redress the situation.

Mr. Yamaoka submitted the following statement:

We thank the staff for their informative report and Mr. Shaalan for his helpful statement.

Investment Companies

As the Staff Report illustrates in Page 11, investment companies (ICs) in Kuwait are funding through bank loans and investing in equities. Since the stock prices have fallen by over 50 percent from the peak, the market value of ICs' assets have substantially declined. Thus, if we imagine the "consolidated" balance sheet of banks and ICs, it is very likely that the actual risks in the banking sector are much larger than expressed in prudential indicators calculated solely on banks' own balance sheet.

For example, according to the basic consideration of the Basel II, since banks' loans to ICs are similar to the investment in "collective investment schemes", the risk weight of 400 percent (or 1,250 percent) might be appropriate as reflecting the actual risks involved in bank loans to ICs. (By making loans to ICs, banks owe risks stemming from the volatility of stock prices, which are usually much bigger than the credit risks in commercial loans. In addition, banks are currently not allowed to sell the collateral at their own will, and such situation is similar to the "automatic stay" of the Chapter 11-type procedures.) In this regard, we would like to know how much risk weight is imposed on bank loans to ICs, since it may substantially affect the capital adequacy ratio. In addition, although many countries have introduced blanket guarantee on banks' existing liabilities, the government's guaranteeing 50 percent of new loans to ICs may not be an orthodox policy, since it may increase the risks in the financial system over the long run. We would welcome the staff's comments on these issues.

Fiscal Policy

In viewing the double-digit inflation as well as the uncertainty in future oil prices, we welcome the authorities' fiscal prudence. (Generally speaking, the increase in fiscal spending under supply constraints may lead to a "crowding-out" of private demand and an increase in inflationary pressures, without effectively stimulating aggregate demand.) Since the authorities' argument that a fiscal stimulus package "would have a limited impact on the Kuwaiti economy given the significant leakages through remittances and imports" seems plausible, we would welcome the staff's elaboration on the rationale behind their recommendation on a fiscal stimulus packages, as well as their assessment on its marginal effectiveness on domestic economy.

With these remarks, we wish the authorities every success in their future endeavors.

Mr. Fayolle submitted the following statement:

We thank Staff for a concise report as well as Mr. Shaalan for his insightful buff statement. We also take note of the updated information provided by staff on the authorities' Financial Stability Plan.

Recent Developments

Kuwait's macroeconomic performance has been strong in 2008, reflecting higher oil production and robust activity in the non-oil sector. Fiscal and current accounts have also posted large surpluses which have strengthened the reserve position, in particular reserves held by the Kuwait Investment Authority (KIA) General Reserve.

Although real GDP's contraction seems unavoidable given lower oil production and weaker activity stemming from strains on the financial sector, Kuwait is in a strong initial position to face the crisis and mitigate its impact. Like staff, we believe that the key challenges are now to stabilize the financial sector and support activity through counter-cyclical fiscal policy.

Financial Sector Issues

Kuwait's financial sector has been severely impacted by the global financial crisis. Deleveraging has triggered significant capital outflows and the tightening of liquidity conditions has been heightened by the unwinding of speculative positions on the foreign exchange market. However, vulnerabilities in the financial sector are in our view mainly related to domestic issues, especially the lack of supervision of investment companies (ICs): as underscored in Box 1, ICs have grown rapidly in the recent period and represent a risk to monitor closely.

The authorities seem to be ready to tackle this issue and tighten regulatory oversight of ICs. The recent decree on financial stability should also help restore confidence since ICs will be able to access direct support from the authorities and will benefit from the government's partial guarantee on new loans. However, like Mrs. Xafa and Mr. Crispolti, we wonder if the 50 percent guarantee will be enough to convince banks to provide new loans to ICs and we would appreciate staff's comments. The negotiations undertaken by Global Investment House with its creditors to restructure its $ 3 billion debt could be a good test case : can staff provide updated information on these negotiations? Lastly, we encourage the authorities to rapidly provide details on the criteria for assessing the solvency and viability of ICs. In our view, the Fund's assistance could be useful in this matter.

Notwithstanding transmission channels between ICs and regular banks, the banking sector appears more solid. While we recognize that vulnerabilities arise from the exposure to real estate and stock market related loans, we also think that there are some mitigating factors, in particular a low loan-to-deposit ratio; in addition, the authorities have confirmed their readiness to support troubled banks and stress tests conducted by staff show that the maximum potential amount of capital needed, albeit significant, remains limited compared to the level of reserves. However, we agree with staff that careful monitoring is needed and we urge the authorities to conduct comprehensive stress tests and encourage more conservative risk management practices: in this respect, we are concerned by the decline in loan provisions to nonperforming loans (Table 6) and we would appreciate staff's comments on this trend. Given that Gulf Bank's past difficulties have been triggered by losses on derivative instruments, we would also appreciate more information on other banks' potential exposure to foreign toxic assets.

Lastly, we welcome the recent decree on financial stability and recognize that it provides a useful framework to address the above-mentioned issues and look forward to its ratification by the Parliament. We also welcome the authorities' request for a FSAP update.

Fiscal Policy

Like staff, we think that the authorities' financial stability plan should be complemented by a fiscal stimulus package to increase demand and support the economy. In this respect, we welcome the authorities' intention to maintain their investment plan in the oil sector. Staff's comments on this plan would be welcome in light of the relatively small increase of capital expenditures this year and the under-execution of the capital budget in the past.

We take note of the cancellation of the transfer to the pension fund. The very significant transfers that have already taken place in the recent years raise however the question of its financial sustainability. We would appreciate if staff could provide some details on the nature and magnitude of the adjustments that are required in their view.

Structural Reforms

Kuwait remains very dependant to the oil industry as illustrated by the non-oil fiscal deficit, which is very high even by regional standards. To achieve higher diversification of the economy, the business climate must be improved and become more conducive to investment, including foreign direct investment. This also implies that the generous welfare state arrangements in place be modernized, in order to progress towards a more private sector-led growth. We recognize that political challenges are associated with this agenda, but we hope that the crisis can be seen as an opportunity to find new compromises and accelerate the pace of structural reforms.

Like staff, we encourage Kuwait to continue providing debt relief to all eligible HIPC countries.

Extending his remarks, Mr. Shaalan made the following statement:

Let me first thank Directors for the interest they have shown in Kuwait's developments and prospects. I certainly will relay their thoughtful advice and views to the authorities. I also wish to thank the staff for its continued productive interaction with the Kuwaiti authorities, which they very much appreciate.

As is the case in many countries, Article IV reports that come before us at this time increasingly, and understandably, focus on the impact of the global recession on the domestic economy of the country. This is a very legitimate issue, and the staff rightly dealt with this aspect of the current economic developments in the case of Kuwait.

In addition to the statement I circulated, in which I have elaborated on Kuwait's position, I would like to directly address two main issues that were highlighted in a number of grays. The first relates to the authorities' response to the strains affecting the financial sector. The second refers to the very important subject of the authorities' fiscal response to the projected economic slowdown, which was the central focus of the discussions.

To address possible strains in the financial sector, the authorities have responded very forcefully and quite swiftly. They have adopted a comprehensive three-pronged strategy aimed at restoring liquidity in the interbank market, which was one of the most important measures they took; restoring normal credit to the private sector, which did show some decline initially; and preserving the soundness of the relatively sizable financial system.

They have also requested an FSAP update from the Fund, which they hope will take place later this year. In the meantime, the central bank has taken a number of measures to encourage lending to the private sector. One measure, which was taken by the authorities very recently, launched a KD 5.5 billion rescue plan—KD 5.5 billion incidentally is about 14-15 percent of GDP—which will guarantee 50 percent of new loans provided by banks to local firms. So, a fund representing 15 percent of GDP was created to guarantee half of the loans extended to local banks.

The authorities' fiscal response to risks affecting Kuwait's economic prospects in the period ahead needs to be analyzed in the context of what happened in FY2008. As we know, FY2008 was a year when oil prices were relatively high. So, the surpluses were abnormally high. It is of no surprise that with the decline in oil prices in 2009, the surpluses declined quite sharply since 2008. Looking at it in this manner, one should not be surprised that during a period of slowdown in economic activity, Kuwait has cut the fiscal surplus. They have reduced expenditures, but expenditures in real terms are in fact no lower today than they were in the previous year. What has happened was that revenues have slipped quite sharply. I emphasize that because some Directors were surprised that Kuwait reduced the budget surplus in response to the crisis.

In addition, fiscal stimulus at this juncture would have a very limited impact on economic activity in Kuwait, because of leakages through remittances and imports. The Kuwaiti economy is diversified. A good part of the diversification outside the oil sector is in the services sector. An injection of liquidity tends to be absorbed through remittances and imports. So, it would not have much of an effect on the local domestic economy. That is at least what many in the Kuwait government believe.

The authorities are confident that the measures they have taken will safeguard financial stability, together with the prudent policy stance and the plans to expand oil and gas production. These two factors will hopefully reinforce confidence and pave the way for a sustainable high level of growth in the medium term. But, should their hopes or the projections not materialize, they are ready to take corrective measures to steer the economy to a path of higher growth.

The staff representative from the Middle East and Central Asia Department (Mr. Senhadji), in response to questions and comments from Executive Directors, made the following statement:

We had quite a few questions, and we tried to group them into four categories: financial stability, fiscal policy, exchange rate and monetary union issues, and structural reform issues. I will try to keep my responses relatively brief given the number of questions.

I will start addressing the financial stability issues, but before getting into this topic, I would like to put the vulnerability of the Kuwaiti economy into perspective, at least with regard to the financial system. While vulnerabilities have emerged, particularly in the investment companies (IC) segment of the system, the banking sector remains healthy, capital adequacy ratios are significantly higher than the regulatory minimum of 12 percent, which is much higher than the international standards. Banks recorded profits even in the last quarter of 2008. Deposits continue to grow, and credit, while it slowed, is still growing in the first two months of 2009.

It is worth mentioning that the government sovereign wealth fund, the KIA, has assets that were estimated at about US$260 billion at the end of March, 2008, which more than cover total liabilities of the whole financial system.

There were several questions or requests asking us to give more detail about the Financial Stability Law. I will quickly describe the salient features of this law, and also perhaps provide our views on its different components. First, the financial stability law is a preemptive set of measures to try to shore up investor confidence, and the stability of the financial system in general. There are essentially four groups of measures. The first one is addressing possible bank undercapitalization. The measure involves a combination of capital injections and government guarantees. More specifically, if a bank is undercapitalized, the law provides two choices for the government to intervene. One is to inject capital directly into the system, and the second is to provide enough breathing room for banks to essentially accumulate provisions. The way it does that is to guarantee the shortfall in provisions and any potential decline in assets. Our position is that we would favor upfront recognition of losses as we say in the staff report, rather than to delay recapitalization, and to do it in a gradual fashion over time, although there is a trade-off on the fiscal side. This way of intervening in the financial sector was very successful for the Gulf Bank, which was recapitalized relatively quickly, and with the bulk of the money coming from existing shareholders.

The second measure is to provide support to investment companies, which are solvent and have a viable business model, but which have some difficulties in finding financing. The supporting measures include guaranteeing 50 percent of new loans to these companies, and direct capital injection. Again, the authorities have kept essentially a choice between intervening directly and using guarantees, rather than injecting money directly. The new loans would be used to pay bank debt to domestic entities other than domestic banks. These include repaying up to 25 percent of IC's obligations to foreign banks, only in the context of a well-structured rescue plan. The support for both banks and investment companies will be subject to some conditionality, including the authorities' right to restructure institutions if they assess that it is needed. The staff supports these measures, but we have recommended keeping the plan relatively simple to reduce monitoring costs, enhance transparency, and speed up implementation. Given the political environment, and some confusion in the private sector, we also recommended that it would be helpful to put in place an effective communication strategy.

The third component of the law is to encourage lending through government guarantees for up to 50 percent of new loans from local banks to economic productive sectors. There was a sale of total government guarantees of KD 4 billion—approximately US$15 billion. The new guaranteed loans cannot be used for speculative purposes or payment of existing loans. The staff believes these incentives, with adequate oversight, could be useful for a short period of time, but they should be unwound gradually as soon as confidence returns.

Finally, the fourth component is to provide a legal framework for the resolution of insolvent financial institutions and this is described in chapter 11.

I will first address the specific question of whether banks would be willing to extend new credit to ICs in view of the risk of being undercapitalized. To encourage banks to lend to ICs, the law requires the borrowing IC to put all its assets as collateral against the lenders' old annual loans. In addition, the government will guarantee the new loan up to 50 percent. We think these incentives, when combined with a viable restructuring plan, could be enough to entice banks to lend to ICs. A gray noted that the government's guarantee of 50 percent of new loans to ICs may not be an orthodox policy, since it may increase the risk in the financial system over the long run. It is true, although the guarantee would be only for 50 percent, and therefore, the loss-sharing feature should limit moral hazard. In addition, this measure will remain in place for only two years, and the maximum maturity for the guaranteed loans would be five years.

There was a question on the political risks associated with the Financial Stability Law, given that the law still needs to be approved by the upcoming parliament. Indeed, the political risk exists, and this will depend to a large extent on the new parliament, its composition, and in particular the Prime Minister. Therefore, we hope that, with the new parliament, there will be no amendments that would significantly delay the law, especially an amendment reported in the news that aimed at guaranteeing household loans. That would substantially increase the cost of the law.

For the potential fiscal implication of the law, the only estimate that we have is the estimate provided by the authorities, which is KD 1.5 billion, or US$5.2 billion. This is a global estimate, which would cover contingent liabilities, or assuming the probability that those contingent liabilities will become real liabilities, and also, any upfront cost that could be disbursed.

Would an initiative such as encouraging banks to avoid selling collateral and setting up a state fund to invest in the Kuwait Stock Exchange simply transfer the losses incurred by ICs to banks and government balance sheets? It is true that restricting banks to save collateral to recover part of their losses is a bad policy in normal times. But this is a crisis situation and, therefore, the potential cost of fueling a downward spiral in assets, if all banks or a large number of banks or ICs were to sell their collateral, would hurt more the financial system than really help it.

With respect to using public funds to invest in the Kuwait Stock Exchange, it is worth highlighting that the fund's resources are invested in the stock market through private sector fund managers on a purely commercial basis. Other non-GCC countries have actually taken similar measures.

A couple of grays asked what is the probability of the worst-case scenario of the stress tests, which assumes actual rate of default and loss rate exceeding 10 percent. It is difficult to quantify precisely the likelihood that the scenario materializes, but we believe that it is a low probability event. A more precise assessment would require, among other things, an analysis of the individual bank's default and loss rates. We hope the FSAP Update will shed some light on this.

There was a question about the risk weight imposed on ICs. It is the standard 100 percent. A couple of grays wondered whether the risk of financial stress may be magnified by the potentially large losses of KIA. Indeed, KIA is likely to have incurred losses. We do not know exactly how much, but they are probably significant. Therefore, the strength of the government balance sheet may have been eroded, although it remains strong.

There was a question on whether Kuwaiti banks hold toxic assets. The Gulf Bank's losses did not result from exposure to toxic assets, but from weak risk management and internal controls related to foreign exchange derivatives. The central bank conducted a detailed assessment of the banking system and of off-balance sheet activities, and found no other bank with a similar situation, or with a large open position, or a similar position on derivatives. Subsequently, the Gulf Bank also significantly strengthened its regulation regarding derivatives.

We were asked to comment on the decline in loans provision for nonperforming loans. Indeed, provisions for NPLs declined somewhat in 2008, although they remain at 85 percent, which is comfortably high among emerging markets. This is particularly true given that these loans are mostly collateralized.

A gray requested a brief update on the latest development in Kuwait's real estate market. The high frequency data that we have show that real estate sales or volumes continued to fall by 29 percentage points in January this year to their lowest level since September 2005. The decline in January came largely from a decreased activity in the residential sector. However, on the positive side, there are signs of a pickup in loan approvals.

There was a request for an update on the Global Investment House (GIH) case. As Directors may know, GIH defaulted late last year on most of its US$3 billion debt. GIH has been negotiating a debt restructuring with its creditors. It appointed HSBC as a financial advisor, and ongoing discussions culminated in a meeting with creditors in Dubai and London in late February. GIH, together with its advisors, presented a comprehensive restructuring plan backed up with a financial forecast, a detailed business model, and an independent evaluation. To further the restructuring process, GIH has continued to service its debt on a timely basis.

What is the impact of emerging vulnerabilities in the financial system on the oil sector growth prospects? In the short term, financial sector contribution to growth, which was about 50 percent during the past two years, would decline significantly and could even turn negative. This is expected to lower non-oil growth from about 7 percent in 2008 to around 1 percent this year. Over the medium term, growth in the financial sector is expected to recover, although it will not return to its pre-crisis level given the ongoing consolidation and deleveraging in the IC sector.

Regarding the authorities' request for an FSAP Update, we were asked whether staff constraints in the Fund could delay the update. This is a very real possibility. MCM indicated that it will consider the request, but certainly there is no definitive answer on when the FSAP Update will take place.

I will now address questions on the fiscal policy. A few Directors were asking for more details on the divergence of views between the authorities and the staff regarding the need for a stimulus package, as well as a request for some specific projects that the staff would recommend. While the staff agrees with the authorities about the fiscal leakages through imports and remittances, we think that the stimulus package would still be very beneficial at this point in time. In fact, the idea that fiscal policy may not be effective because of leakages does not square well with the boom in the GCC region during the past five years. That boom was driven mainly by fiscal policy. We find it difficult to argue that the fiscal withdrawal during one of the worst global recession, when the fiscal space exists, which is the case in Kuwait, can be defended on the ground of leakages of the fiscal policy.

A fiscal stimulus package would support economic activity not only through the standard multiplier channel but also by shoring up investor confidence, stabilizing asset markets, and strengthening the balance sheets of financial institutions. The fiscal stimulus package could include some key projects that are ready to be implemented and valued at about US$25 billion, over a five-year period or longer. These key projects have been vetted by several studies. A few of them are worth noting—a hospital, a university, and a town in an area where there is little employment or activity.

In addition, the staff encourages the authorities to facilitate the participation of foreign companies in the development of the oil sector to expedite the implementation and enhance the efficiency of investment plans, because one of the problems that we discussed with the authorities was the slow implementation in the oil sector, which could actually be resolved if foreign oil companies were allowed in the country.

A few Directors asked whether the recent transfers to the pension fund were principally made to address portfolio losses. The pension fund is profitable, with an average return on equity of about 9.5 percent. According to computations, 6.5 percent is needed to keep the Fund fully funded over its lifetime, once the gap is filled. The problem is that there is a big gap. The actual deficit has arisen in part because of the generous nature of benefits, including the ability to retire at a relatively young age after only 15 years of work for females, and 20 years for males. There were also ten rounds of pension increases implemented since 1979, and insufficient contributions. Regarding the nature and magnitude of adjustment that are required in the pension system, the actual deficit is estimate at about KD 7 billion, around US$25 billion. In addition to transfers to the pension fund, the authorities have also taken other measures to address the deficit, including an increase in the time and age by five years.

On exchange rate and monetary union issues, a few grays questioned the relevance of the CGER methodology in assessing the level of the exchange rate for oil-exporting countries. This is a very relevant question or issue we have to deal with every time we write a brief or staff report. We certainly agree that the CGER methodology is particularly flawed when it comes to assessing the exchange rate for oil-exporting countries. Current account fluctuations in oil-exporting countries are driven by the price of oil and fiscal policy, not really the real exchange rate. Furthermore, issues of intergenerational equity and decisions on how much to save for future generations complicate tremendously the modeling of the equilibrium exchange rate. Research in this area is ongoing, but unfortunately the CGER methodology is all we have at this point.

There was a question on Kuwait's experience with the basket peg and its potential benefits from the GCC monetary union. All GCC countries but Kuwait remain committed to the peg to the U.S. dollar, at least until the formation of the GCC monetary union. The Kuwait's decision to move away from the peg to the dollar to a basket peg in 2007 was essentially due to very high inflationary pressures, and the lack of enough flexibility on the monetary policy side to control it. According to the authorities, the move to a basket peg has given them some flexibility on the monetary policy side. Although, looking at inflation trends across the GCC, it is not clear to us that Kuwait was more successful in controlling inflation than the other GCCs.

There is actually a Board paper that looks at these issues of what is the appropriate exchange rate for the GCC countries. This paper was presented to the Board in September of last year. I will not go into details on the main conclusions, but the position of the staff has not been to recommend a change in the exchange rate policy framework in the run up to monetary union, given that it is planned for 2010. And then, once the monetary union is established, that will be the time, perhaps, to reconsider and see what is the appropriate exchange rate. The paper looks favorably at the basket peg, but, again, more research and more analysis is needed before arriving at a definitive answer or recommendation on this.

There was a question on the likelihood of meeting the remaining prerequisites for the monetary union by the 2010 deadline. Significant progress has been achieved, including the launch of the common market last year, and the agreement to set up a monetary council by the end of this year, but it will be very difficult to complete all key prerequisites by 2010. We are almost there.

Finally, on structural reforms, we were asked to comment on the reasons behind the slow progress with structural reforms, particularly the delay in the enactment of key laws that are essential for the promotion of private investment. The reason is simple. It is due mainly to the contentious relationship between the government and parliament.

Mr. Shaalan thanked Directors again for their interest in Kuwait and their continued support.

The Acting Chair (Mr. Kato) made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the Kuwaiti authorities' prudent macroeconomic policies, which have contributed to robust economic growth and strong fiscal and external positions. Directors considered the Kuwaiti economy to be in a favorable position to withstand the current global economic and financial crisis, noting, in particular, the resilience of the financial system.

Directors stressed, nevertheless, that downside risks to growth and financial stability have increased as a result of the global crisis. The sharp decline in oil prices will adversely affect the fiscal and external balances, large oil production cuts and weaker activity in the non-oil sector are expected to slow real GDP growth, and the credit squeeze and asset price deflation could pose significant risks to the financial system. The key near-term challenge faced by the authorities is to preserve financial stability and support economic activity. In the medium term, the main challenge is to use the oil wealth to diversify the economy and boost non-oil GDP growth through private investment.

Against this background, Directors commended the Kuwaiti authorities' proactive measures to safeguard financial stability and sustain economic growth, including through the injection of liquidity into the financial system and the adoption of a financial stability law. They stressed that financial sector policies should continue to encourage consolidation and restructuring of financial institutions, upfront recognition of losses, and participation of private investors in the recapitalization of financial institutions.

Directors also called for strengthening oversight of risk management practices by ensuring adequate policies and procedures for identifying, monitoring, and controlling systemic risk in the financial system. They emphasized the importance of restructuring the investment companies sector, and welcomed the authorities' interest in undertaking an FSAP update. Directors urged the authorities to speed up reform of money laundering and terrorism financing legislation to make it conform to international standards.

Directors commended the authorities' commitment to fiscal prudence and medium-term fiscal sustainability. A number of

Directors encouraged a fiscal stimulus to complement the financial stability package, given the expected slowdown in economic activity, Kuwait's strong fiscal position, and the positive effect of a stimulus on investor confidence and private investment. A number of Directors, however, saw merit in the authorities' concerns regarding a fiscal stimulus, including Kuwait's limited absorptive capacity, uncertainty regarding future oil prices, and the possible limited effectiveness of a stimulus due to significant leakages through remittances and imports.

Directors saw a continued need for medium-term fiscal reform aimed at reducing dependence on oil revenue and rationalizing fiscal spending. They encouraged accelerated introduction of a value added tax in coordination with other Gulf Cooperation Council (GCC) countries. They supported the staff's recommendation to maintain capital spending while containing current spending, including by curbing large subsidies and transfers, reforming the pension system, and moving to merit-based public sector salaries and benefits.

Directors stressed the importance of expediting the structural reforms that are vital to boosting private-sector investment and non-oil GDP growth. These include enactment of key legislation—the capital markets, companies, competition, public-private partnership, and privatization laws; streamlining of business registration and other administrative barriers to investment; and enhancement of access to land by private businesses and individuals. At the same time, Directors welcomed Kuwait's plans to increase oil production and refinery capacity, which would help support global oil market stability.

Directors concurred that the pegged exchange rate regime remains appropriate for Kuwait in the run up to the GCC monetary union, and that the recent move to a basket peg may have been helpful in containing inflation. They noted the staff's finding that the Kuwaiti dinar is broadly in line with economic fundamentals. In light of weakening inflationary pressures and the downside risks to economic growth, Directors supported the recent easing of monetary policy.

Directors welcomed the authorities' intention to improve economic statistics. To address some data weaknesses, Directors advised conducting a comprehensive review of the role and resources of the General Statistical Office.

Directors commended the authorities for their substantial development assistance to low-income countries in and outside the region, and for their active support of the HIPC initiative. They urged the authorities to continue providing HIPC debt relief to all eligible countries.

The next Article IV consultation with Kuwait is expected to be held on the standard 12-month cycle.

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G. RUSSELL KINCAID
Acting Secretary