DOCUMENT OF INTERNATIONAL MONETARY FUND AND FOR OFFICIAL USE ONLY

BUFF/ED/11/113

July 12, 2011

Statement by Mr. Shaalan on Kuwait
Executive Board Meeting
July 15, 2011

1. On behalf of the Kuwaiti authorities, I would like to thank staff for the constructive dialogue and candid advice during the article IV discussions. The authorities broadly concur with staff's analysis and recommendations. The discussions rightly focused on the planned fiscal and financial reforms, as well as on the agenda to achieve sustainable growth and economic diversification.

Recent developments

2. After contracting by 5 percent in 2009, economic activity recovered to about 3 percent in 2010, underpinned by a supportive fiscal stance and reflecting a rebound in both the oil and non-oil sectors. Headline inflation increased on account of higher international food prices. Non-food prices, however, remained subdued.

3. The fiscal and external accounts continued to post large surpluses, reflecting high international oil prices. The fiscal surplus is estimated at 21 percent of GDP in 2010, notwithstanding an increase in government expenditure by 21 ½ percent of GDP.

4. Financial soundness indicators point to a considerable improvement in banking system strength and resilience. Capital adequacy ratio remained significantly above the minimum required by the Central Bank of Kuwait (CBK). Bank profitability increased and non-performing loans dropped due to write-offs of fully provisioned loans. Credit to residents, however, recorded modest growth in 2010, as a result of stricter regulations following the financial crisis and the cautious lending policies adopted since last year.

An ambitious development plan

5. In February 2010, Kuwait's parliament approved a US$ 108 billion development plan extending over 4 years. This plan is the first of six successive plans that are aimed at rendering Kuwait a regional financial and trade hub by 2035. The plan will help restructure the economy by promoting diversification away from the oil sector and paving the way for greater private sector participation in economic activity. Half of the investments envisaged in the plan will come from the private sector and three quarters of investments will benefit the

non-oil sector. The plan also envisages the enactment or revision of laws that are intended to enhance the role of the private sector.

Economic outlook and risks

6. Growth momentum is likely to be sustained in 2011 and beyond, on the account of the newly approved development plan. While there may be concerns regarding the government's capacity to execute the development plan in a timely manner, the restoration of confidence in the prospects of the economy is likely to have a positive impact on the non-oil sector. The increase in oil prices in 2011 will provide an added incentive for the government to move ahead with the large projects and more generally, expedite the pace of project execution. However, price pressures are expected to pick up in 2011, although this mainly reflects an increase in international food prices.

Towards sustainable economic growth

7. Kuwait's economy and public finances remain very reliant on the oil sector, which accounts for more than 90 percent of budget revenues and exports. The new development plan aims at building a more diverse and dynamic economy, by providing incentives for the private sector to assume a leading role in the economy. This will also reduce pressures on the government to continue providing job opportunities for Kuwaiti nationals.

8. The business environment in Kuwait will largely benefit from the investments identified in the development plan. The plan incorporates an upgrade of the country's infrastructure, including roads, airports, and hospitals. It also calls for sizable investments in education in order to prepare Kuwaiti nationals for employment in the private sector.

9. The development plan took off slowly in its first year due to delays in introducing the needed legislative base. This new legislation aims at improving efficiency, governance, and competitiveness.

Fiscal policy reforms

10. The strong recovery in oil prices will enable Kuwait to sustain continued spending over the medium term while still achieving a significant surplus. Staff's analysis points to a high government expenditure multiplier. The authorities are in agreement with this finding. They concur with staff on the importance of better targeting spending, and particularly subsidies. Currently, work is ongoing to improve collection and proposing a new pricing mechanism for public utilities. A significant portion of government spending is also directed towards the recapitalization of the social security fund.

11. On the revenue side, and in order to enhance non-oil revenue, the authorities will introduce tax reforms in the medium term. They intend to introduce a VAT as well as an income tax. Progress has also been achieved in establishing a macro-fiscal unit at the Ministry of Finance.

Monetary policy and financial sector issues

12. Monetary policy has been accommodative since the onset of the global financial crisis. Below potential growth in the non-oil GDP, import-driven inflationary pressures, and low global interest rates; all justify an accommodative stance. Nonetheless, the CBK remains vigilant to the developments of liquidity in the banking system, and stands ready to tighten its monetary stance when market conditions signal overheating.

13. The pegged exchange rate regime continues to serve the Kuwaiti economy well. Although the US dollar plays a dominant role in the basket, the exchange rate regime gives the CBK a degree of flexibility in relation to the US economy, in view of the differences in the business cycles of the two countries. The CBK has a set of policy instruments, such as loan-to-deposit ratio and credit growth limits, to resort to if needed.

14. The banking system remains well supervised and highly capitalized. Banks' profitability is expected to rise with the healthy growth in the economy and the financing opportunities that will be created by the development plan. Stress tests carried out by CBK and by staff indicate a strong resiliency of banks to severe shocks. The adequate provisioning against loans to investment companies (IC) will mitigate the impact of IC risks on banks profitability. The CBK has issued new regulations in June 2010 imposing a number of prudential limits on IC liquidity, leverage, and foreign exposure. In addition, IC must meet the quantitative regulations of the CBK by 2012 to ensure that IC are undertaking a proper restructuring. The CBK continues to monitor progress in this area.

Other issues

15. Kuwait is committed to continue its support to developing countries, especially through the HIPC Initiative. More recently, Kuwait pledged to support the Managing Natural Resources Wealth topical fund and the Tax Policy and Administration topical fund.