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INFORMATION

April 18, 1989

To: Members of the Executive Board

From: The Secretary

Subject: Kuwait - 1989 Staff Report on the Interim Article IV Consultation Discussions

There is attached for the information of the Executive Directors the 1989 staff report on the interim Article IV consultation discussions with Kuwait. As Kuwait is on a bicyclic consultation procedure, the 1990 Article IV consultation will be completed not later than March 18, 1990.

Mr. Handy (ext. 7073) or Mr. M. Z. Khan (ext. 4528) is available to answer technical or factual questions relating to this paper.

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INTERNATIONAL MONETARY FUND

KUWAIT

1989 Staff Report on the Interim Article IV Consultation Discussions

Prepared by the Staff Representatives for the 1989 Consultation with Kuwait

Approved by P. Chabrier and J. T. Boorman

April 14, 1989

I. Introduction

The 1989 interim Article IV consultation discussions with Kuwait were held in Kuwait City during the period March 3-10, 1989. The Kuwaiti representatives included the Governor of the Central Bank of Kuwait, and senior officials of the central bank and government departments and offices responsible for economic and financial policy. The staff representatives were Messrs. H. P. Handy (Head), J. G. Borpujari, M. Z. Khan (all MED), N. U. Haque (RES), and Mrs. W. Buenaobra (Secretary, MED).

Kuwait accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement on April 6, 1963. The last Article IV consultation was completed by the Executive Board on March 28, 1988. Further information on relations with the Fund is given in Appendix I. World Bank involvement in Kuwait in recent years has been in the area of technical cooperation (see Appendix II). Statistical issues are discussed in Appendix III.

II. Background

Through the exploitation of its enormous hydrocarbon resources and judicious economic management over a long period, Kuwait has achieved considerable economic and social progress. Per capita GNP in Kuwait stood at $14,870 in 1987. A comprehensive range of social services is provided to all residents of the country. Also, Kuwait provides employment for more than half a million expatriate workers who constitute almost 80 percent of total employment.

Second only to Saudi Arabia and Iraq in proven oil reserves, Kuwait's reserves at current production levels of 1.04 million barrels per day (its present OPEC quota) are for practical purposes inexhaustible. Over a period of many years, the oil sector has been extensively diversified into exploration, refining, petrochemicals, and marketing, both at home and internationally. A modern infrastructure has been

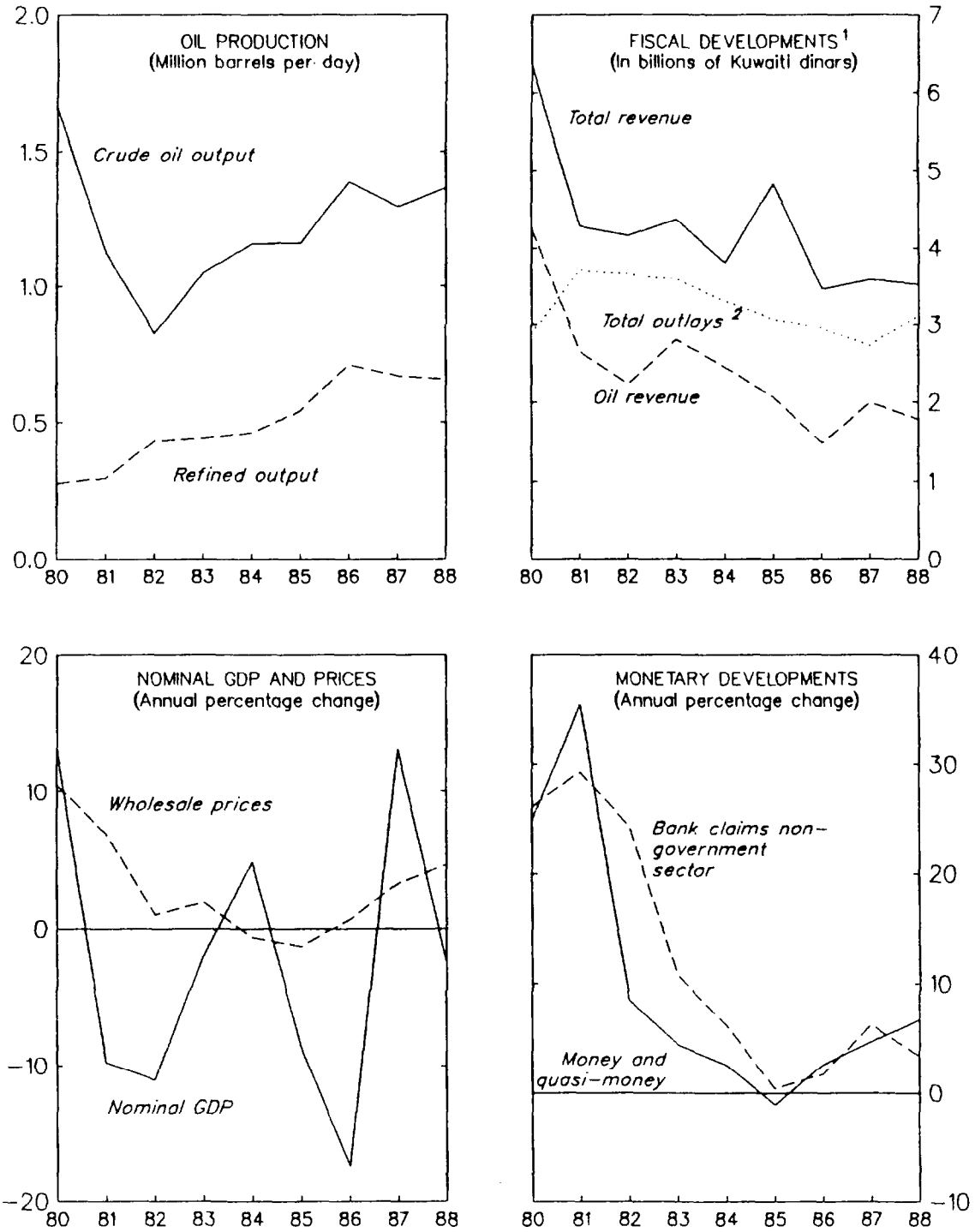
developed and the non-oil sector has accounted for close to 40 percent of GDP in recent years. Domestic demand management has been cautious and large external current account surpluses have financed the acquisition of a substantial and diversified portfolio of real and financial foreign assets which has been prudently managed. Investment income has grown considerably, and over the past three years, has been roughly equivalent to oil income.

The weakness of world oil markets in the 1980s has been the overriding influence on recent economic developments and policies. Lower oil prices combined with output restraint led to a decline in export receipts from a peak of about $20 billion in 1980 to a range of $10-12 billion annually during 1982-85 and to $7-8 billion in 1986-88. In an effort to moderate potential foreign reserve losses, the Government acted decisively to arrest the very high rate of growth of budgetary expenditure that had been a feature of the years up to 1982 (Chart 1). This task was facilitated by the completion of a number of major infrastructure projects. Budget outlays, which are the primary impulse to demand in the economy, have since been reduced in nominal terms by about 3 percent annually, and the overall budget surplus, though variable, has remained large (mostly in the range of 12-16 percent of GDP).

The reduced fiscal stimulus, combined with uncertainty arising from insecurity and conflict in the region and the repercussions on business confidence from the 1982 crash of the unofficial stock market, led to recession in the private sector. Despite continued support to the private sector in the form of subsidies and procurement preferences, non-oil GDP contracted sharply after 1982, declining on average about 4 percent annually between 1983 and 1985. Indications are, however, that the recession in the non-oil sector bottomed out in 1986 and that marginal real growth (about 1 percent annually) has been achieved over the past two years.

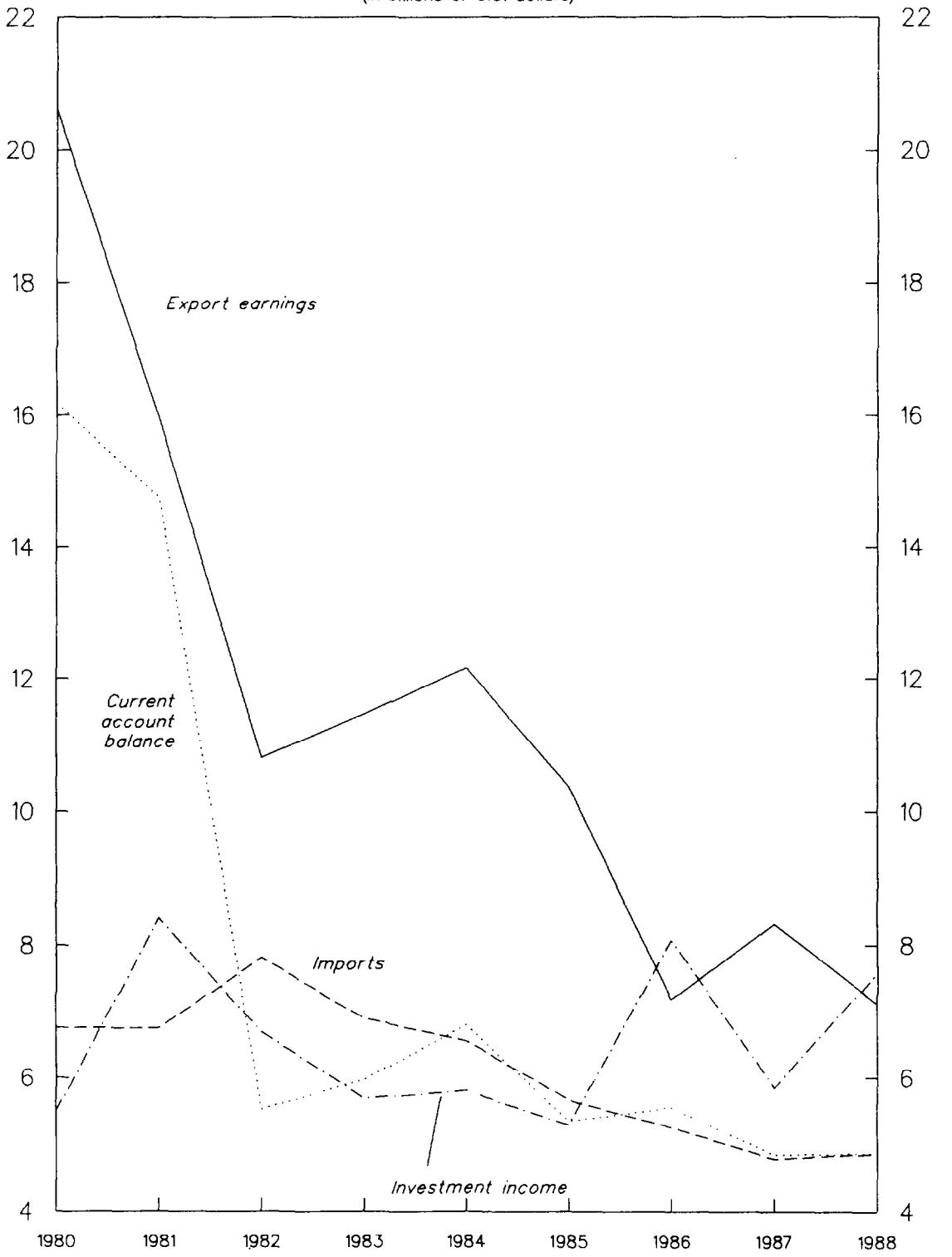
In the realm of monetary policy, priority has been accorded to rebuilding confidence in the financial system in the wake of the stock market crash and the recession. The position of domestic financial institutions--which had a number of nonperforming loans on their books--appears to have strengthened in response to regulatory reforms and official financial support. Demand for bank credit has, on the whole, remained weak and banks continue to be highly liquid. The introduction of government securities in late 1987, despite its modest scale, offers a new mechanism for influencing bank liquidity as well as providing the authorities with greater flexibility in implementing fiscal policy in the future. The introduction of the new instruments, which carry market-related interest rates, has been accompanied by certain changes in domestic interest rate policy, which are discussed below. In December 1988 interest ceilings, which are maintained on dinar-denominated loans, were raised in the face of a widening differential between domestic and international rates. Monetary developments are sensitive to movements in relative interest rates, and during 1988 the

CHART 1
KUWAIT
SELECTED DOMESTIC ECONOMIC INDICATORS



Sources: Kuwaiti authorities and staff estimates.
[1]Data in this panel are on a fiscal year basis (July 1–June 30).
[2]Expenditure plus net lending.

CHART 2
KUWAIT
SELECTED EXTERNAL INDICATORS
(In billions of U.S. dollars)



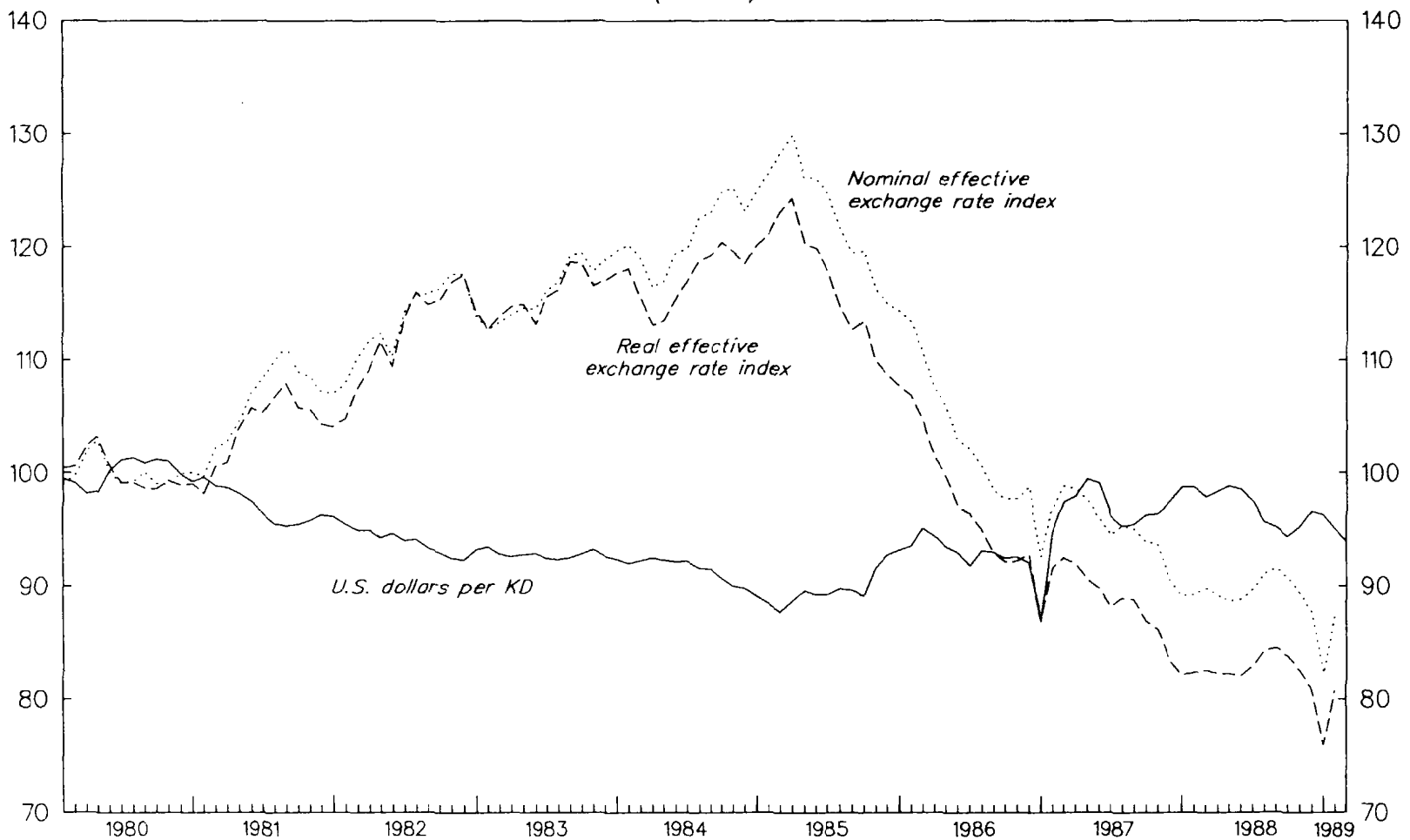
Sources: International Monetary Fund, *International Financial Statistics* and staff estimates.

CHART 3

KUWAIT

EXCHANGE RATE INDICES

(1980=100)



Sources: International Monetary Fund, Information Notice System, and *International Financial Statistics*.

composition of money supply had changed significantly with narrow money declining by 8 percent and quasi-money (reflecting rapid growth in foreign currency deposits) rising by 11 percent.

Developments in the balance of payments in recent years, in addition to the drop in oil export earnings, have been marked by a steady decline in imports, substantial receipts from investment income, and large but variable capital outflows on private and official account (Chart 2). The external current account surplus has narrowed (though it represented as much as 18 percent of GNP in 1988) and the overall balance of payments has recorded deficits of about $2 billion in each of the past two years. As a result, gross official foreign exchange reserves held by the central bank had fallen to about $2 billion (or the equivalent of five months of merchandise imports) at end-1988. These overall deficits have to be viewed in the context of continued foreign investment by the Government, averaging about $3 billion annually during the same period. Details of the amounts and composition of official foreign asset holdings, which are maintained in two extrabudgetary reserve funds, are not available. 1/

The dinar, which is pegged to an undisclosed basket of currencies reflecting Kuwait's trade and financial relations with other countries, has moved narrowly vis-a-vis the U.S. dollar for the past several years (Chart 3). The dinar depreciated in real effective terms by 40 percent between March 1985 and December 1988, more than offsetting the appreciation of 23 percent that had taken place in the preceding four-year period.

III. Policy Issues and Discussions

In concluding the 1987 Article IV consultation with Kuwait Directors commended the authorities for their effective response to lower oil revenues and for the progress made in restoring stability and confidence in the financial sector in the years following the collapse of the unofficial stock market in 1982. The combination of fiscal retrenchment, public expenditure rationalization, and prudent monetary and exchange rate policies, was seen as having been effective in adjusting to a sustainable level of economic activity while conserving official foreign assets. Having regard to the uncertainties in the oil market, Directors recommended that fiscal policies should aim at improving the structure of the budget including actions to increase non-oil revenues and to reduce implicit subsidies. They also saw closer

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1/ The nature and policies governing the operations and activities of the General Reserve Fund and the Reserve Fund for Future Generations are described in the accompanying report on Recent Economic Developments.

collaboration within the Cooperation Council for the Arab States of the Gulf (GCC) as an important factor in promoting balanced economic growth, both in Kuwait and in the region as a whole.

Against the background of these broad policy conclusions and recommendations as well as subsequent developments, the policy discussions focused on prospects for the oil sector, the economic objectives and priorities of the authorities, and their implications for economic and financial policies both for the immediate future and over the medium term.

1. The real economy

a. Oil sector developments and policies

The Kuwaiti authorities expressed their firm support for the OPEC agreement of November 1988 to restore output restraint and official pricing and affirmed their determination to adhere to this accord. Under the agreement, Kuwait's quota has been set at 1.037 million b/d for the first half of 1989. The staff assumes some scope for upward adjustments of OPEC quotas in the second half of 1989 and subsequently, based on the widely envisaged recovery of world oil consumption and little or no growth in non-OPEC production. Accordingly, Kuwait's oil production is projected by the staff to average 1.15 million b/d in 1989. This would represent a decline of about 16 percent in volume compared with estimated production in 1988. In spite of continued higher prices (as envisaged in the current WEO), Kuwait's dollar earnings from oil exports would slip to about $5.8 billion this year from about $6.2 billion in 1988.

While recognizing the uncertainty in the outlook for the world oil market over the medium term, the staff team in collaboration with the authorities made some tentative projections of Kuwait's prospective oil income. Based on the working assumptions (in line with the WEO) that world oil prices remain at current real levels and that demand for OPEC oil rises by about 4 percent per year during 1990-92, Kuwait's export earnings from oil would rise gradually to about $7.2 billion in 1992--about 16 percent above their dollar value in 1988, but still some 18 percent below the average dollar level during the preceding five years.

b. The non-oil sector

Though quantification of developments in the real sector is hindered by the absence of a suitable GDP deflator, staff estimates based on indices of import prices and the wholesale price index, point to a rather modest recovery in real terms. Non-oil GDP is estimated to have increased by about 1 percent in each of the past two years, with activity in most sectors other than oil refining remaining subdued. Real output is expected to expand in the range of 1-2 percent in 1989. These estimates are broadly consistent with the contemporaneous

evolution of related key variables such as government spending, credit to the nongovernment sector, and imports. Employment has shown little growth in recent years and a margin of unutilized capacity exists in most productive sectors.

The authorities broadly concur with this assessment. They point out that economic activity in the private sector has benefited from the resolution of the problems associated with the 1982 crash of the unofficial stock market. Also, they believe that the recently improved climate of security in the region and the potential for a revival of entrepot trade augur well for the immediate future.

c. The development strategy

The authorities are currently in the process of finalizing a development strategy which will form the underpinnings of the next development plan (scheduled to commence in 1990). The strategy will encompass three broad elements, namely: diversification in those areas in which Kuwait can be competitive domestically and abroad; continued coordination and rationalization of investment within the framework of the GCC; and the pursuit of greater efficiency in public utilities and social goods through appropriate pricing and user charges.

The authorities stress that the focus and priorities of the development strategy transcend economic growth, for which prospects are limited in view of Kuwait's narrow resource base and insufficient indigenous managerial expertise and technology. In this regard the authorities reaffirmed their intention to avoid the creation of private activities dependent upon subsidies and protection, in favor of the longstanding policy of investing abroad, the benefits from which are now accruing to the economy in the form of substantial external investment income. Domestically, the new plan is to aim at consolidating the progress made so far toward improvements in investment efficiency and labor productivity, and social progress. High priority will continue to be attached to the policy of promoting the participation of Kuwaiti nationals in the labor force, and to reducing the demographic imbalance whereby Kuwaitis constitute a minority of the total population. Thus far, the emphasis has been placed on the public sector, in which the share of local manpower is estimated to have risen to 42 percent in 1988. In the new plan, the emphasis is to be shifted to the private sector, where the participation of nationals remains extremely low.

Largely for social and security reasons, increased emphasis is to be placed in the coming years on agricultural development and diversification. While the potential is recognized to be limited, the intention is to aim at a measure of local self-sufficiency in farm products, particularly vegetables and dairy produce. The staff representatives agreed that the scope for efficient agricultural production was decidedly limited and urged the authorities to proceed cautiously as the expansion of agriculture could only be possible at the cost of heavy government subsidies and support.

2. Financial policies

a. Fiscal policy

During the 1980s the thrust of the adjustment to lower oil export earnings has come from a sustained policy of budgetary expenditure retrenchment. The bulk of the budgetary savings has been found in the development budget, following the completion of much of the country's infrastructure. Current expenditures have remained broadly unchanged in nominal terms, though their composition has shifted in favor of wages and salaries, with declines in all other major components (Table 1).

In addition to restraint, expenditure policy in recent years has focused on rationalization and the achievement of improvements in efficiency. One aspect of this has taken the form of elimination of surplus or unproductive jobs in the civil service. However, efforts at containing government employment have had to be reconciled with the practice of guaranteeing employment in the public sector for all Kuwaitis, a policy that is seen as being justified by the nature of the Kuwaiti economy, the limited employment opportunities in the private sector, and the objective of "Kuwaitization". Although growth in public sector employment is believed to have come virtually to a standstill, the government wage bill, the largest single item in the budget, now accounts for about a third of budgetary expenditures compared with about a quarter five years ago.

Expenditure rationalization has also involved emphasis on reductions in budgetary subsidies which have declined to about 17 percent of total spending in 1987/88 from over 20 percent in the early 1980s. Taking advantage of weaker prices in 1986-87, the authorities reduced food subsidies; the subsidy on electricity is expected to decline this year due to improved efficiency in power generation.

Further savings are to be attained through planned increases in fees and user charges for subsidized government services and utilities. The authorities see the application of adequate fees and user charges as serving the dual purpose of eliminating wasteful consumption as well as generating revenues. It is through this approach, rather than through the introduction of taxes, that they intend to pursue their aim of enhancing non-oil revenues over the medium term. A number of steps have already been taken in this direction (including the introduction of a residence fee for non-Kuwaitis and an airport fee) which are expected to increase non-oil revenues by 7 percent in 1989/90 and further measures including a health insurance system and increases in charges for electricity and water are under consideration.

Table 1. Kuwait: Summary of Government Fiscal Operations, 1983/84-1988/89

(In billions of Kuwait dinars) 1/

	1983/84	1984/85	1985/86	1986/87	Budget 1987/88	Prov. Actuals 1987/88	Budget 1988/89
Revenue	4.4	3.8	4.8	3.5	3.6	3.6	3.5
Of which:							
Oil and gas income	(2.8)	(2.5)	(2.1)	(1.5)	(1.7)	(2.0)	(1.8)
Investment income	(1.3)	(1.2)	(2.5)	(1.8) 2/	(1.7) 2/	(1.4) 2/	(1.6) 2/
Expenditure	3.0	3.1	3.0	2.6	3.1	2.7	3.1
Current	(2.0)	(2.2)	(2.0)	(1.9)	(2.1)	(2.0)	(2.1)
Of which:							
wages and salaries	[0.7]	[0.7]	[0.8]	[0.8]	[0.9]	[0.9]	[1.0]
Development	(1.0)	(0.9)	(1.0)	(0.7)	(1.0)	(0.7)	(1.0)
Net domestic lending	0.5	0.2	0.1	0.1	—	—	—
Overall surplus	0.8	0.5	1.7	0.7	0.5	0.9	0.4
Memorandum item:							
Net domestic expenditure 3/	2.7	2.5	2.3	2.1	...	2.2	...

Sources: Ministry of Finance and Economy; and staff estimates.

1/ Rounded to the first place of decimal.
2/ Staff estimates.
3/ Defined as government domestic expenditures minus revenue of domestic origin.

The implementation of the budget for the current fiscal year appears to be following a course which broadly mirrors that of recent past years. In particular, expenditures are again likely to fall substantially short of budgeted amounts, primarily due to a significant shortfall in development spending; the latter is attributed, in turn, to technical delays in project implementation. At the same time current expenditures also seem likely to be below budget again, reflecting shortfalls in all major categories of expenditure. These developments are likely to be broadly offset by a shortfall on the revenue side; oil receipts are now expected to be lower than budgeted. The net effect would be to leave the thrust of fiscal policy broadly unchanged from last year, while the original budget proposals envisaged a modest shift toward expansion, relative to the restraint of recent years. 1/ The budget for the new fiscal year beginning on July 1, is currently under preparation. The staff understands that no major fiscal adjustments are being proposed, and that the structure of the budget and the fiscal stance can be expected to remain broadly unchanged.

The introduction (in late 1987) of a range of government debt instruments (extending from 91-day treasury bills to 10-year bonds) was aimed primarily at providing the authorities with greater flexibility in implementing fiscal policy, by lessening the extent to which government spending needs to respond to year-to-year fluctuations in oil receipts. The new instruments bear market-related interest rates with yields on treasury bills being determined by competitive bidding and bonds with fixed coupons. They have provided a much needed vehicle for investment and the original ceiling on issues (KD 1.4 billion) has already been reached. An increase in the ceiling is expected to be announced shortly.

b. Monetary policy

For the central bank, the new debt instruments have provided an additional important tool for managing domestic liquidity. The bank supervises debt issuance and auctions and has the right to buy and sell government instruments for its own account. As of end-December 1988, the central bank held about 30 percent of the outstanding debt, and the bank has been encouraging the development of a secondary market with a view to engaging in open market operations. The staff representatives observed that the substantial purchases of new issues of debt by the central bank, aimed at influencing interest rates, might undermine the liquidity control objective of the exercise. However, the Kuwaiti representatives pointed out that in managing treasury issues, the central bank sought to keep both liquidity and interest rates in view.

1/ Net government domestic expenditures (defined as government domestic expenditures minus revenue of domestic origin), a key indicator of the impact of the budget on aggregate demand, are estimated to be at roughly the same level as last year.

The significant increase in international interest rates during 1988 caused a substantial shift into foreign currency denominated deposits and a surge in private capital outflow in the course of the year. This prompted, in December 1988, adjustments in the structure of domestic interest rates and an increase in their levels. Effective from December 11, 1988, the central bank discount rate was raised from 5 percent to 7.5 percent, and it was announced that the legally mandated interest rate ceilings on loans would thereafter be established on the basis of maximum markups over the discount rate. Those markups were set at 2 percentage points for loans of less than one year maturity and at 2.5 percentage points for loans exceeding one year. Under the new policy, the separate subceilings on productive and nonproductive loans were eliminated. Finally, minimum markups over the discount rate were specified for deposits of various maturities. The interest rate adjustments had an immediate impact on the composition of quasi-money, spurring a resurgence of growth of Kuwaiti dinar deposits and a sharp fall in the growth of foreign currency deposits with the domestic banking system; however, the effect has been muted by the continued upward drift of international interest rates.

Commenting on the new interest rate policies, the staff representatives underlined the desirability of allowing domestic interest rates to reflect market forces, particularly in an open economy like Kuwait which had no restrictions on capital movements. Moreover, the specification of both a ceiling on loan rates and a floor for deposit rates had the effect of restricting the spread to a maximum of 2 percentage points which limited the scope for the emergence of a market-related term structure of interest rates as well as crimping banks' income earning capacity. Given that the legal requirement of ceilings on lending rates could be expected to be maintained, the mission suggested that substantially higher ceilings (preferably a unified ceiling) be set so as to give the financial institutions greater freedom in setting both lending and deposit rates; this approach could foster competition among the banks and promote a market-related interest rate structure. The Kuwaiti representatives stated that a variety of factors influenced the setting of domestic interest rates including the local interbank rates, the treasury bill rate, foreign interest rates, and domestic monetary developments and capital movements. The level of interest rates, as well as interest rate policy, were kept under active review.

3. External policies and prospects

a. Policies

The Kuwaiti representatives expressed their satisfaction with the operation of the current exchange rate arrangement. The major objective of exchange rate policy continues to be that of maintaining stability in the exchange rate of the dinar relative to the (undisclosed) basket of currencies and of insulating the domestic economy from external shocks. It is also recognized that exchange rate policy has a role to play in fostering the efficient development and diversification of the non-oil

sector, and the depreciation of the dinar in real effective terms over the past four years is regarded as having been beneficial in this respect.

Kuwait continues to work closely with other member countries of the GCC toward regional cooperation and economic integration. Efforts are being pursued by members in a number of directions. These include harmonization of external tariffs and the proposed introduction of a common exchange rate arrangement. However, policy action in these areas is not expected in the near future.

In the area of trade policy, domestic industries have received protection and support in a variety of ways. In addition to subsidized inputs (particularly power and water) and capital, domestic industries are entitled to a margin of preference in competitive bidding for government contracts. External tariffs are generally low, although protective tariffs have been applied to a range of construction materials since 1985-86. The authorities did not report any difficulties regarding access for Kuwait's exports of petrochemicals or other goods to markets overseas.

Kuwait's official foreign assistance has been scaled back significantly in recent years as foreign exchange earnings have declined. Nevertheless, total foreign assistance, the bulk of which is on highly concessional terms and is provided on a broad geographic basis, amounted to roughly 2 percent of GNP in 1988. The authorities are committed to maintaining their aid effort.

b. Medium-term balance of payments outlook

The mission, in consultation with the Kuwaiti authorities, prepared balance of payments projections for the period 1989-92. As in the past, balance of payments prospects hinge above all else on oil earnings, the outlook for which has been discussed in Section 1 (a) above. Other assumptions underlying the medium-term projections are detailed in the footnotes to Table 2. Broadly, the current account is expected to remain in substantial surplus through 1992, though its size relative to GNP would slip from about 18 percent last year to around 14 percent on average during 1990-92. Underlying these projections is the assumption that imports, reflecting continued cautious fiscal policy, will rise in step with oil revenues. The other major component of the current account is investment income, receipts from which are projected on the basis of staff estimates of the stock of official foreign assets and assumptions regarding international interest rates consistent with WEO projections.

Table 2. Kuwait: Balance of Payments Summary, 1985-92

(In millions of U.S. dollars)

	1985	1986	Prov. Actual 1987	Prel. Est. 1988	Projections 1/ 1989	1990	1991	1992
Current balance	5,345	5,543	4,835	4,854	4,121	4,263	4,399	4,552
(in percent of GNP)	(22.0)	(23.1)	(19.4)	(18.5)	(15.8)	(15.1)	(14.4)	(13.7)
Trade balance, f.o.b	4,713	1,943	3,547	2,258	1,645	1,779	1,914	2,067
Exports and re-exports	(10,377)	(7,184)	(8,317)	(7,112)	(6,591)	(7,053)	(7,560)	(8,186)
Petroleum 1/	[9,350]	[6,269]	[7,441]	[6,209]	[5,627]	[6,004]	[6,424]	[6,963]
Other	[1,028]	[915]	[876]	[903]	[963]	[1,049]	[1,136]	[1,223]
Imports, f.o.b.	(-5,664)	(-5,242)	(-4,771)	(-4,854)	(-4,946)	(-5,274)	(-5,646)	(-6,119)
Services and private transfers	632	3,601	1,289	2,595	2,476	2,484	2,484	2,484
Receipts	(6,419)	(9,123)	(6,906)	(8,690)	(8,573)	(8,756)	(8,947)	(9,138)
Investment income	[5,282]	[8,075]	[5,851]	[7,578]	[7,477]	[7,644]	[7,818]	[7,991]
Other	[1,138]	[1,048]	[1,055]	[1,111]	[1,096]	[1,112]	[1,129]	[1,147]
Payments	(-5,787)	(-5,523)	(-5,618)	(-6,094)	(-6,097)	(-6,271)	(-6,463)	(-6,654)
Freight and insurance	[-838]	[-802]	[-747]	[-1,083]	[-1,141]	[-1,216]	[-1,286]	[-1,355]
Other services	[-3,905]	[-3,642]	[-3,769]	[-3,832]	[-3,826]	[-3,909]	[-3,996]	[-4,083]
Private transfers	[-1,044]	[-1,079]	[-1,102]	[-1,179]	[-1,130]	[-1,147]	[-1,181]	[-1,216]
Capital (net) and grants	-2,864	-7,654	-4,968	-5,352	-2,711	-2,873	-3,008	-3,167
Official foreign assistance	-868	-983	-337	-534	-417	-490	-560	-695
Government investment	-1,903	-6,078	-3,866	-3,316	-904	-983	-1,038	-1,077
Other equity and portfolio investment	-416	-730	104	-835)				
Commercial banks	259	-322	-398	-477)				
Oil export credit	3	308	-7	129)	-1,390	-1,400	-1,410	-1,395
Identified short-term capital	60	151	-463	-319)				
Other short-term capital and errors and omissions 2/	-1,919	2,151	-1,709	-1,484	-1,400	-1,385	-1,380	-1,375
Overall balance	562	41	-1,841	-1,982	10	5	11	10
Memorandum items:								
Gross official reserves 3/	5,566	5,609	4,267	2,043	2,053	2,058	2,069	2,079
(in months of imports)	(12.0)	(12.9)	(11.7)	(5.7)	(4.9)	(4.6)	(4.3)	(4.0)

Sources: Central Bank of Kuwait; and staff projections.

1/ Based on the following major assumptions: (i) average price of oil exports to rise 12 percent in 1989 and 4 percent p.a. subsequently; (ii) crude oil output to average 1.15 mb/d in 1989, rising 4 percent p.a. thereafter; (iii) imports grow at same rate as oil export earnings; (iv) investment income rises in step with interest rate developments as projected in WEO.

2/ Includes unrecorded short-term capital flows.

3/ In addition to official reserves, substantial holdings of official foreign assets are maintained in two extrabudgetary reserve funds, details of which are not available.

Turning to the capital account, it is assumed that central bank reserves will be maintained at approximately their existing levels, and that the current differential in favor of world market interest rates is allowed to persist. In these circumstances, private capital outflows might be expected to continue at recent levels with the result that the overall surplus remaining for new government investment abroad would be of the order of US$1 billion per year. Thus, aside from the existing stock of foreign assets, the outlook is such as to give the authorities considerable room for policy choices.

The prospective scale of government foreign investment would, nevertheless, represent a significant reduction compared with that of recent years, and would be substantially lower than the repatriation of earnings from foreign investment included in the current account projections for the balance of payments. Although the authorities do not set strict quantified targets for official foreign investment, the policy of building up overseas assets is seen as an important dimension of diversification, a valuable insulator for the economy against oil price shocks, and a store of wealth for the benefit of future generations.

The mission explored some of the policy options available to the authorities through which they could achieve a higher level of official foreign investment, if desired. In this regard, it was noted that a more active monetary policy (including new issues of government securities and a more flexible interest rate policy aimed at reducing or closing the differential in favor of foreign currencies) could help curtail private outflow at little or no cost to the domestic economy. On the other hand, if the higher level of government investment were sought through a more restrictive fiscal policy, the reduced demand stimulus and cuts in imports that would be implied, would impart a deflationary bias to the domestic economy.

IV. Staff Appraisal

During the 1980s, Kuwait has adjusted to the fall in world oil prices through a sustained program of fiscal retrenchment. This approach has enabled the authorities to add further to the large stock of official foreign assets which is seen as both an insulator for the domestic economy against the vagaries of the world oil market and a store of wealth for the benefit of future generations. The emphasis on foreign investment also reflects the limited scope for the efficient use of capital domestically, given the country's narrow resource base and other impediments.

Despite continued government support in various forms, private sector non-oil activity has been influenced by the prolonged fiscal restraint and other exogenous developments, and experienced several successive years of recession before staging a modest revival recently. The staff is of the view that the evolution of the non-oil sector in

recent years has also reflected an inevitable adjustment to more normal conditions, following a decade of rapid diversification and development from a very low starting point.

Based on current assessments of the outlook for the world oil market over the medium term and the improved security climate in the region, the Kuwaiti economy now appears poised for a period of consolidation and modest growth. The proposed economic strategy for the next development plan is well conceived, notably in its emphasis on limiting diversification to areas where Kuwait can be competitive; on continued rationalization of investment within the framework of the GCC; and on the pursuit of greater efficiency in the public sector. As regards the proposed increased emphasis on agriculture, the staff urge the authorities to proceed cautiously in this direction keeping in mind the evident limits to efficient agricultural production in Kuwait.

In the area of financial management, the very large official holdings of foreign assets and the favorable balance of payments outlook provide considerable latitude for policy choices. As in the past, the budget will remain the crucial policy instrument. Indications are that the policy of fiscal cautiousness will be maintained in the foreseeable future. Notwithstanding the unchanged overall stance of fiscal policy, the authorities rightly perceive that added scope exists for further expenditure rationalization and improved efficiency in the public sector. To this end, they intend to pursue a manpower policy for government that is both consistent with expanded employment for nationals and higher productivity. At the same time further reductions in subsidies are planned. On the revenue side, some user charges and fees for government services have been increased or introduced and further such steps are contemplated as a basis for broadening the revenue base.

The recent introduction of government debt instruments not only provides the authorities with greater flexibility in implementing fiscal policy, but equips the central bank with a new mechanism for influencing bank liquidity--a feature it has been quick to avail of. The new government securities carry market-related interest rates, and a revised system for determining the structure of interest rates, based on the central bank's discount rate, is now in place. The stage is thus set for the introduction of a more flexible and market-related interest rate policy. This course, which the staff would strongly endorse, would promote a more efficient and integrated domestic money and capital market and, in coordination with exchange rate policy, could give the authorities greater influence over capital flows in Kuwait's unfettered capital market.

Kuwait's exchange system remains free of restrictions on payments and transfers for international transactions on both current and capital account, and its trade system is virtually free of restrictions. Exchange rate policy, through which the dinar is pegged to a basket of currencies reflecting Kuwait's trade and financial relations with the rest of the world, has been sound. Over the past few years, Kuwait's

competitiveness has improved markedly (as the dinar has depreciated in real effective terms) thus supporting the process of diversification of the economy and balance of payments adjustment. The staff believe that recent developments in the real effective exchange rate provide an opportunity to the authorities for relaxing the existing arrangements for tariff and nontariff protection for certain domestic producers--a step that would be consistent with the government's goal of fostering improved efficiency and productivity in the non-oil sector. The staff encourages Kuwait to maintain its commendable foreign assistance effort.

Kuwait has been placed on a bicyclic procedure by the Executive Board. Accordingly it is expected that the next Article IV consultation will be completed within 24 months of the 1987 consultation, that is by March 18, 1990.

Kuwait: Fund Relations

(As at February 28, 1989)

(Amounts in millions of SDRs, unless otherwise indicated)

I. Membership Status

Date of membership	September 13, 1962
Status	Article VIII

A. Financial Relations

II. General Department (General Resources Account)

Quota	635.3
Total Fund holdings of Kuwaiti dinars	458.9 (72.2 percent of quota)
Fund credit	None
Reserve tranche position	176.4
Current Operational Budget (maximum use of currency)	(December 1988-February 1989)
Transfers	2.2
Receipts	17.3

	Limit	Outstanding
Lending to the Fund		
SFF	400.0	58.4

III. Kuwait Has Not Used Fund Resources To Date

IV. SDR Department

Net cumulative allocation	26.7
Holdings	86.2 (322.4 percent of net cumulative allocation)
Current Designation Plan	No amount of designation was assigned to Kuwait because holdings were above acceptance limits.

V. Administered Accounts None

B. Nonfinancial Relations

VI. Exchange Rate Arrangement

Effective March 18, 1975, Kuwait ceased pegging the dinar to the U.S. dollar and linked it to a weighted basket of currencies of its major trading partners. The Central Bank's buying and selling rates for the U.S. dollar have normally been maintained at one sixteenth of 1 percent on either side of the currency-basket-derived exchange rate. On February 28, 1987 the exchange rate of the dinar was US$1 = KD 0.28725.

VII. Last Article IV Consultation

Discussions were held in November 1987; the Staff Report (SM/88/17) was discussed by the Executive Board on March 28, 1988. The summing up indicated that Kuwait will be on the bicyclic consultation procedure, and that the first simplified consultation will take place in April 1989, with the next Article IV consultation to be held 12 months later.

VIII. Technical Assistance

In October/November 1986, a Bureau mission visited Kuwait to review balance of payments methodology, as a follow-up to an earlier visit in November/December 1983. In April 1987, a mission visited Kuwait to assist the Central Bank of Kuwait in econometrics and computer applications. In December 1988 a mission visited Kuwait to follow up on a visit earlier in July 1985 to facilitate Kuwait's participation in the Bureau's International Banking Statistics (IBS) project.

Kuwait: Relations with the World Bank

Under the last technical cooperation agreement covering the period March 1986-June 1987, the IBRD assisted the Ministry of Planning with the planning and monitoring of human resources development.

The last World Bank mission to Kuwait took place in February 1984 and their report, Kuwait: Recent Economic Developments and Prospects, was published in November 1984.

Kuwait--Statistical Issues

Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published in the country page for Kuwait in the April 1989 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Central Bank of Kuwait, which during the past year have been provided on a timely basis, although the data for other financial institutions and on the Treasury Bill rate are not current.

Status of IFS Data

		Latest Data in April 1989 IFS
Real Sector	- National Accounts	1987
	- Prices: CPI	October 1988
	- WPI	September 1988
	- Production (crude petroleum)	September 1986
	- Employment	n.a.
	- Earnings	n.a.
Government Finance	- Deficit/Surplus	November 1988
	- Financing	November 1988
	- Debt	n.a.
Monetary Accounts	- Monetary Authorities	December 1988
	- Deposit Money Banks	December 1988
	- Other Financial Institutions	September 1988
Interest Rates	- Treasury Bill Rate	November 1987
	- Bank Lending/Deposit Rate	September 1988
	- Bond Yield	n.a.
External Sector	- Merchandise Trade	
	Values	Q4 1987
	Prices (export prices crude petroleum)	October 1988
	- Balance of Payments	1987
	- International Reserves	January 1989
	- Exchange Rates	January 1989

Kuwait: Basic Data

I. Economic Indicators, 1983-88 1/

	Actuals 1983	1984	1985	1986	Prel. Estimates 2/ 1987	1988
	(Annual percentage changes)					
Production and prices						
Nominal GDP	-1.3	4.0	-8.6	-17.4	13.0	-5.2
Nominal non-oil GDP	-10.2	-3.7	-4.5	4.5	8.0	7.0
Crude oil production 3/	27.9	10.3	-8.5	30.8	-6.8	5.6
Average petroleum export price 3/	-13.9	-4.0	-3.1	-50.6	26.9	-21.6
(U.S. dollars per barrel)	(28.4)	(27.3)	(26.4)	(13.0)	(16.5)	(13.0)
Import price index 4/	-3.5	-1.8	-1.9	13.4	10.4	8.0
Wholesale price index	1.9	-0.6	-1.3	0.7	3.3	4.6
Consumer price index	4.7	1.2	1.4	1.0	0.6	1.5

	Actuals 1983/84	1984/85	1985/86	1986/87	Prov. Actuals 1987/88
	(Annual percentage changes)				
Government finances 5/					
Revenue	5.1	-12.8	24.8	-27.2	3.5
Of which: Oil and gas	(25.5)	(-12.5)	(-15.8)	(-28.0)	(34.2)
Investment income	(-22.2)	(-10.5)	(116.0)	(-27.5)	(22.1)
Expenditure	-1.4	1.0	-3.3	-11.1	2.7
Current	(-5.5)	(5.7)	(-7.0)	(-5.1)	(5.1)
Development	(8.3)	(-8.6)	(5.2)	(-23.5)	(-3.6)
	(In percent of GDP)				
Revenue	69.8	61.9	87.0	69.1	66.6
Of which: Oil and gas	(46.7)	(40.6)	(37.7)	(29.7)	(37.0)
Investment income	(20.6)	(18.8)	(45.7)	(36.1)	(26.2)
Expenditure	48.7	50.0	54.5	52.9	50.5
Current	(32.6)	(35.1)	(36.8)	(38.1)	(37.2)
Development	(16.1)	(14.9)	(17.7)	(14.8)	(13.2)
Net domestic lending	8.6	3.7	1.6	1.8	--
Overall balance (deficit -)	12.5	8.1	31.0	14.4	16.1
	(In millions of Kuwaiti dinars)				
Revenue	4,367	3,806	4,831	3,457	3,581
Of which: Oil and gas	(2,798)	(2,448)	(2,060)	(1,484)	(1,991)
Investment income	(1,289)	(1,154)	(2,493)	(1,808)	(1,408)
Expenditure	3,047	3,077	2,975	2,860	2,717
Current	(2,042)	(2,158)	(2.008)	(...)	(2,004)
Development	(1,005)	(919)	(967)	(...)	(713)
Net domestic lending	540	228	86	90	--
Overall balance (deficit -)	780	501	1,690	507	1,091

Kuwait: Basic Data (continued)

	Actuals 1983	1984	1985	1986	Prel. Estimates 2/ 1987	Prov. 1988
	(Annual percentage change)					
Money and credit						
Money and quasi money	4.4	2.6	-1.1	2.6	4.7	6.7
Money	(-6.0)	(-19.0)	(-2.2)	(3.2)	(5.8)	(-8.5)
Quasi-money	(8.5)	(10.1)	(-0.8)	(2.4)	(4.4)	(10.6)
Of which: Foreign currency deposits of residents	[79.4]	[20.2]	[-22.4]	[16.5]	[51.5]	[32.6]
Claims on nongovernment sector	10.7	6.2	0.4	1.7	6.2	3.4
Government deposits	-16.0	25.4	0.4	-43.2	-10.1	50.5
With Central Bank	(-21.9)	(40.9)	(1.1)	(-44.5)	(-5.1)	109.0
With commercial banks	(-7.9)	(7.0)	(-0.6)	(-41.2)	(-17.4)	-50.0
Net government expenditure 6/	0.1	-2.0	5.8	-9.8	-2.0	2.0
Net foreign assets	-14.1	8.5	4.8	4.7	-15.4	-19.0
	(In millions of U.S. dollars)					
Balance of payments 7/						
Exports, f.o.b.	11,473	12,159	10,377	7,184	8,317	7,122
Of which: Oil	(9,943)	(10,875)	(9,350)	(6,269)	(7,441)	(6,209)
Imports, f.o.b.	-6,891	-6,553	-5,663	-5,247	-4,771	-4,854
Net services and private transfers	1,390	1,186	632	3,601	1,289	2,595
Of which: Investment income (gross)	(5,688)	(5,804)	(5,282)	(8,075)	(5,851)	(7,578)
Private transfers	(-865)	(-963)	(-1,044)	(-1,079)	(-1,102)	(1,174)
Current balance	5,971	6,792	5,345	5,543	4,836	4,854
Nonmonetary capital flows (net)	-563	-7,869	-2,864	-7,654	-4,968	-5,352
Of which: Official foreign assistance extended	(-1,376)	(-862)	(-868)	(-983)	(-337)	(-532)
Government investment	(1,431)	(-5,642)	(-1,903)	(-6,078)	(-3,866)	(-3,316)
Identified short-term capital	(-7)	(-784)	(60)	(151)	(-463)	(-319)
Errors and omissions 8/	-6,407	1,019	-1,919	2,151	-1,709	-1,484
Overall balance (deficit -)	-998	-57	562	41	-1,841	-1,982
Gross official reserves (end-year)	5,285	4,677	5,566	5,604	4,267	2,043
External debt (end of year)						
Commercial banks' monetary liabilities	5,299	5,126	4,707	4,153	4,468	4,467
	(Annual percentage changes)					
Exports, f.o.b.	6.0	6.0	-14.7	-30.7	15.6	-14.8
Of which: Oil	(11.7)	(9.4)	(-14.0)	(-32.9)	(18.7)	(-16.9)
Imports, f.o.b.	-11.8	-4.9	-13.6	-7.3	-9.1	-1.3
Investment income (gross)	-15.0	2.0	-9.0	52.8	-27.3	28.6
Private transfers	-1.1	11.4	8.5	3.3	2.1	6.5
Official foreign assistance	11.6	-37.4	0.8	13.2	-65.7	57.9
Exchange rate (depreciation -)						
U.S. dollar/dinar (average rate)	-1.2	-1.5	-1.6	3.0	4.8	0.6
Real effective exchange rate	2.9	1.4	-1.1	-17.0	-8.4	-7.0

Kuwait: Basic Data (concluded)

	Actuals				Prel. estimates	
	1983	1984	1985	1986	1987	1988
	(As a percent of GNP)					
Current account	22.9	25.6	22.0	23.1	19.4	18.5
Petroleum exports	38.2	41.0	38.5	26.1	29.9	23.7
Investment income (gross)	21.8	21.9	21.7	33.7	23.6	29.3
Official foreign assistance extended (net)	5.3	3.2	3.6	4.1	1.4	2.0
Overall balance (deficit -)	-3.8	-0.2	2.3	0.2	-7.4	-7.5
	(In months of current year's imports (c.i.f.), net of re-exports)					
Gross official reserves	10.1	9.6	12.0	12.9	11.7	5.7

II. Social Indicators

Area	
Total land area (square kilometers)	17,800
Agricultural (share of total)	7.6 percent
GNP per capita (1987; current price)	US$14,870
Population characteristics	
Total (1987)	1,837,000
Urban (share of total)	94 percent
Population growth rate	5.3 percent
Life expectancy at birth	73 years
Population density per square kilometer of agricultural land	1,267
Health, education and energy use	
Population per physician	600
Population per nurse	200
Population per hospital bed	200
Access to safe water (share of population)	100 percent
Pupils reaching grade 6 (share of total)	93 percent
Labor force	
Total	709,000
Agriculture (share of total)	2 percent
Industry (share of total)	32 percent

Sources: Central Bank of Kuwait; Ministry of Finance and Economy; staff estimates; and WEO projections.

1/ Calendar years, unless otherwise indicated.
2/ Data other than the monetary and balance of payments statistics are staff estimates.
3/ Official sources for 1983-85; staff estimates since 1985.
4/ World Economic Outlook (WEO) estimates of export unit values of major trading partners for non-oil trade; IMF, Research Department, Kuwait--Selected Indicators of Foreign Demand and Prices.
5/ For fiscal years ended July 1.
6/ Excludes net domestic lending.
7/ Current account data for 1987-88 are preliminary estimates.
8/ Includes unrecorded short-term private capital.