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May 16, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Kuwait - Staff Report for the 1986 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1986 Article IV consultation with Kuwait, which will be brought to the agenda for discussion on a date to be announced.

Mr. Handy (ext. 7073) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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KUWAIT

Staff Report for the 1986 Article IV Consultation

Prepared by the Staff Representatives for the
1986 Consultation with Kuwait

Approved by A. S. Shaalan and J. T. Boorman

May 15, 1986

I. Introduction

The 1986 Article IV consultation discussions with Kuwait were held in Kuwait City during the period March 21-27, 1986. The Kuwaiti representatives included the Governor and other senior officials of the Central Bank, and senior officials of the Ministries of Finance and Economy, Oil, and Planning, as well as of the Kuwait Petroleum Corporation and the Kuwait Investment Authority. The staff mission comprised Messrs. P. Chabrier (Head), P. Griffith, H. Handy, D. Noursi, and Mrs. R. Pahigiannis (secretary), all of the Middle Eastern Department.

Kuwait accepted the obligations of Article VIII, Sections 2, 3, and 4, of the Articles of Agreement on April 6, 1963.

II. Background and Recent Developments

Based on its oil wealth, Kuwait has made considerable economic progress in the 25 years since its independence. The oil sector itself has been extensively developed and diversified. Over 50 percent of oil output is now refined at home and the domestic oil sector encompasses gas liquefaction, petrochemicals, and fertilizers. Internationally, the Kuwait Petroleum Corporation is engaged in oil exploration worldwide, shipping, and retail marketing, particularly in Europe. At the same time, the non-oil sector, benefiting from the oil boom, generous incentives and subsidies, and improvements in infrastructure, has also expanded, particularly in the areas of construction, finance, and other services, and has accounted for about 50 percent of GDP in recent years. Over the years, large external current account surpluses have been utilized in part to build up foreign assets, the income from which amounted to more than half of export earnings from oil and about 30 percent of budgetary revenues in 1985. Demand management on the whole has been prudent, price performance favorable, and a high, if uneven, long-term rate of growth has been achieved. Today, Kuwait maintains a

comprehensive system of social services, and per capita income, in spite of having fallen sharply over the past few years, is still among the highest in the world. 1/

The overriding influence on economic developments and policies over the past few years has been the gradual weakening of the world oil market which culminated in the precipitous drop in oil prices in the opening months of 1986. During the period 1982-85, declining world oil prices and restraint in domestic output and exports combined to keep oil revenues at an average of about US$10 billion a year, little more than half their level at the turn of the decade (Chart 1). In addition, investment income, the only other major source of foreign exchange and budgetary revenues, declined over the same period, reflecting a change in the composition of the foreign asset portfolio toward less liquid claims with a lower current yield, as well as the fall in world market interest rates. In light of these developments, and prompted by a desire to continue to accumulate foreign assets, the Government took steps on a number of occasions to arrest the very high rate of growth of budgetary expenditure which had been a feature of the years up to 1982.- Budget outlays, which are the primary impulse to demand in the economy, have since been on the decline, and the overall budget surplus was, until last year, kept in the range of 8-14 percent of GDP (Chart 2).

Monetary policy, by contrast, has played a modest role in demand management. The minimum reserve requirement is low (3 percent of deposits) and has not been changed since 1980. The scope for open market operations is limited by the lack of debt instruments and interest rate rigidity; the rediscount rate, for example, has been unchanged for seven years. Over the past two years, however, with the decline in domestic inflation to 1-1.5 percent a year and falling world market interest rates, real domestic interest rates have risen appreciably both in absolute and relative terms (Chart 3). As a result, there has been a shift out of currency and demand deposits in favor of quasi-money instruments as well as from foreign currency denominated deposits into dinar deposits. Meanwhile, the demand for credit by the private sector has been weak not only because of high real interest rates but also because of sluggish domestic activity and the fall in local real estate and stock prices; in fact, the growth in credit to the private sector over the past two years is even less than the monetary data would suggest (i.e., about 3 percent annually) because they incorporate capitalization of interest on some nonperforming loans. Given the banks' excess liquidity position, the squeeze on their profits, and a desire to keep capital outflow within bounds, the Central Bank began, in late 1984, offering special deposit facilities to commercial banks at market-related interest rates; as of end-1985, these deposits were the equivalent of about 19 percent of narrow money.

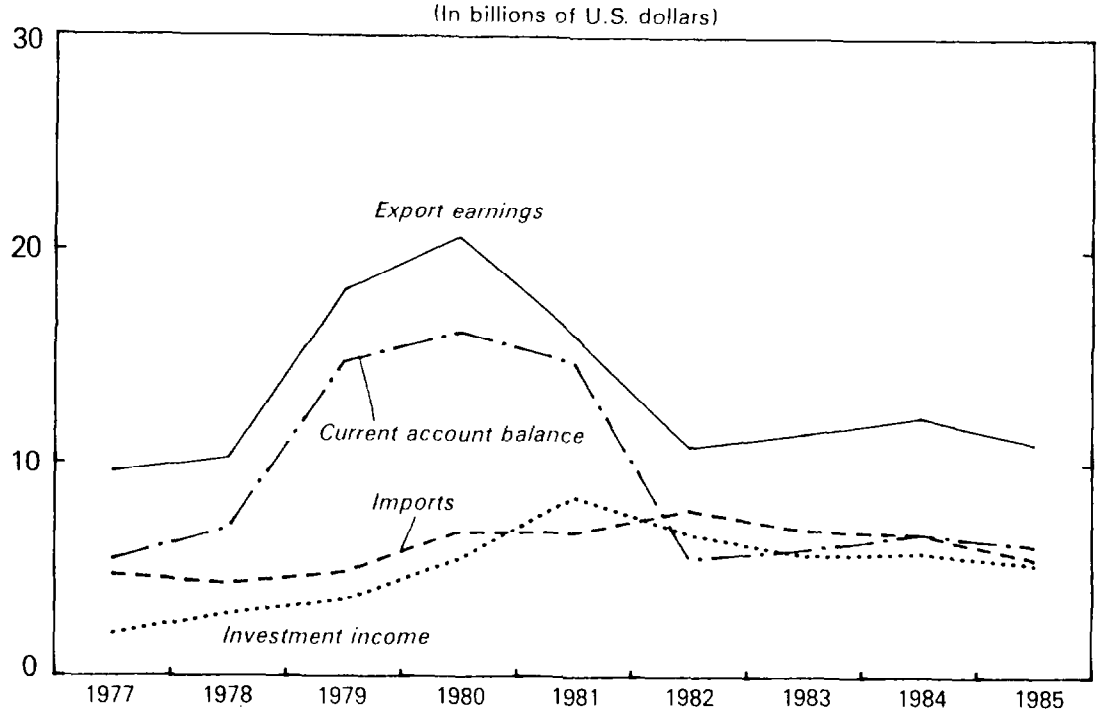
1/ See basic Data, Appendix V.

CHART 1

KUWAIT

SELECTED EXTERNAL ECONOMIC INDICATORS

(In billions of U.S. dollars)



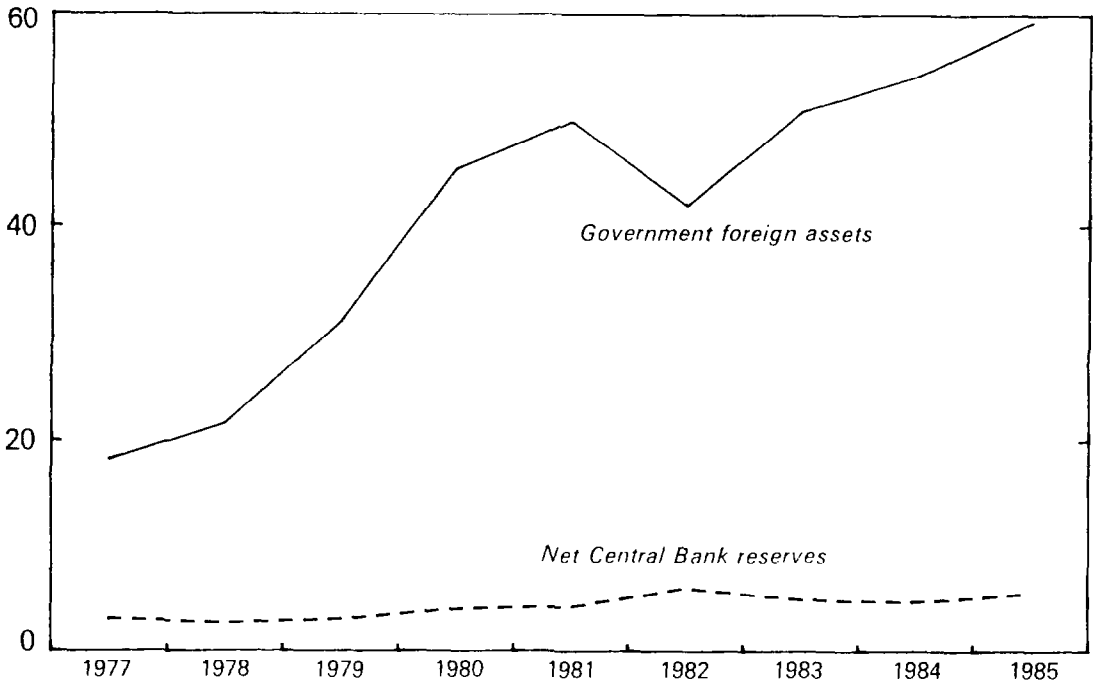
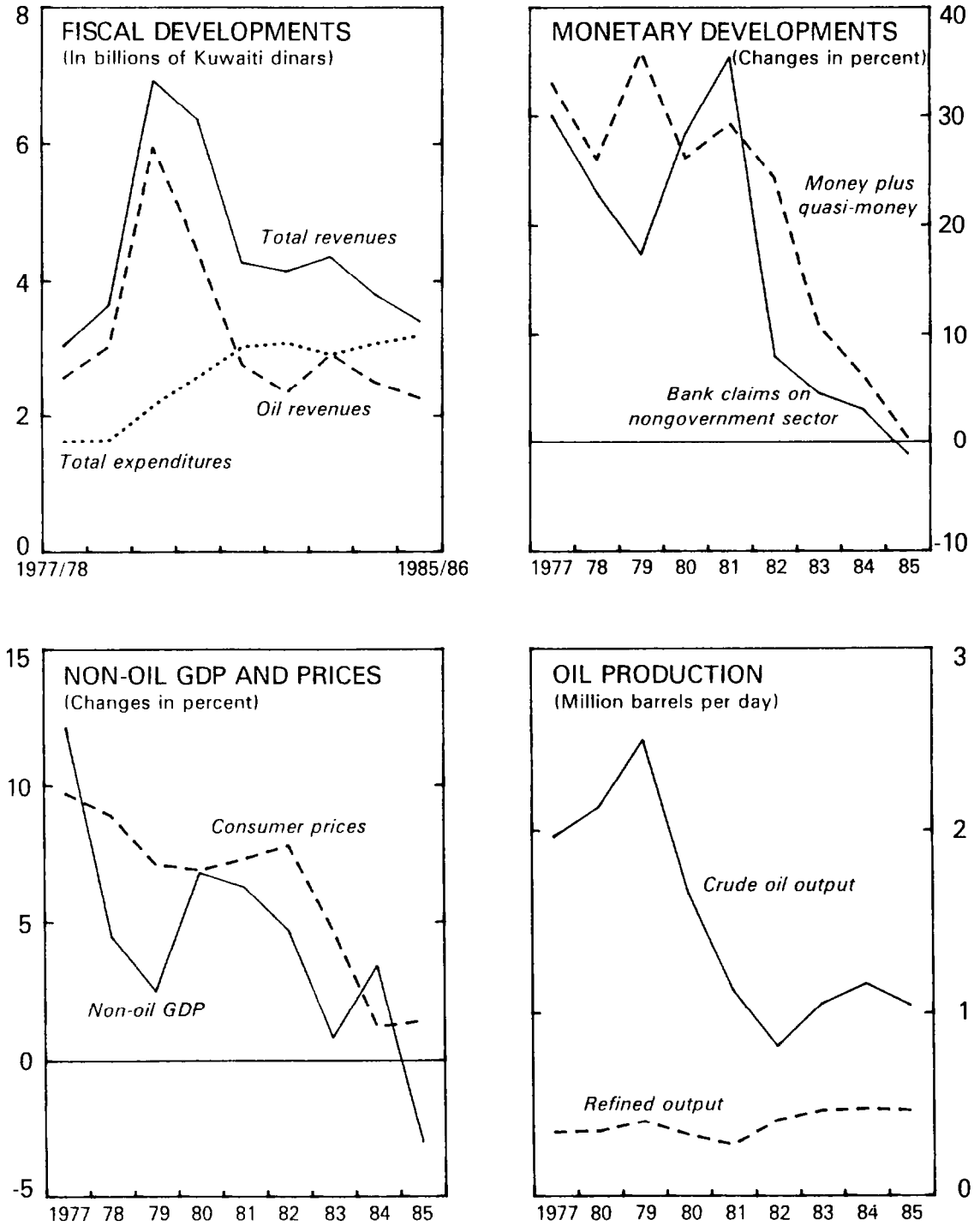


CHART 2

KUWAIT

SELECTED DOMESTIC ECONOMIC INDICATORS



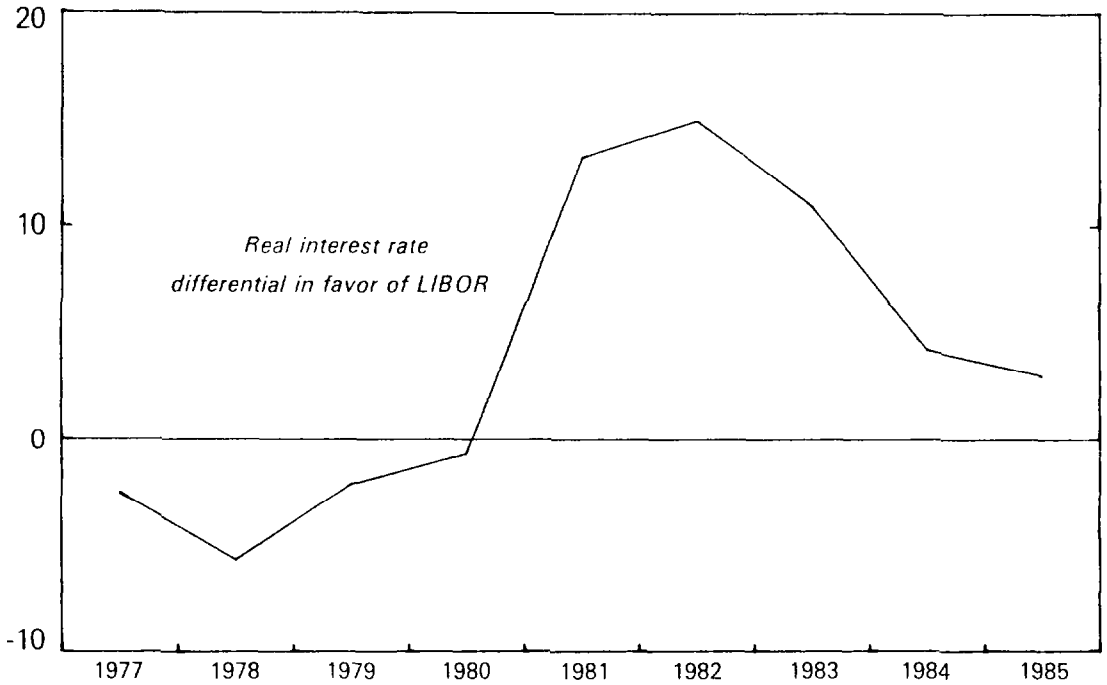
Sources: Data supplied by the Kuwaiti authorities, and Fund staff estimates and projections.

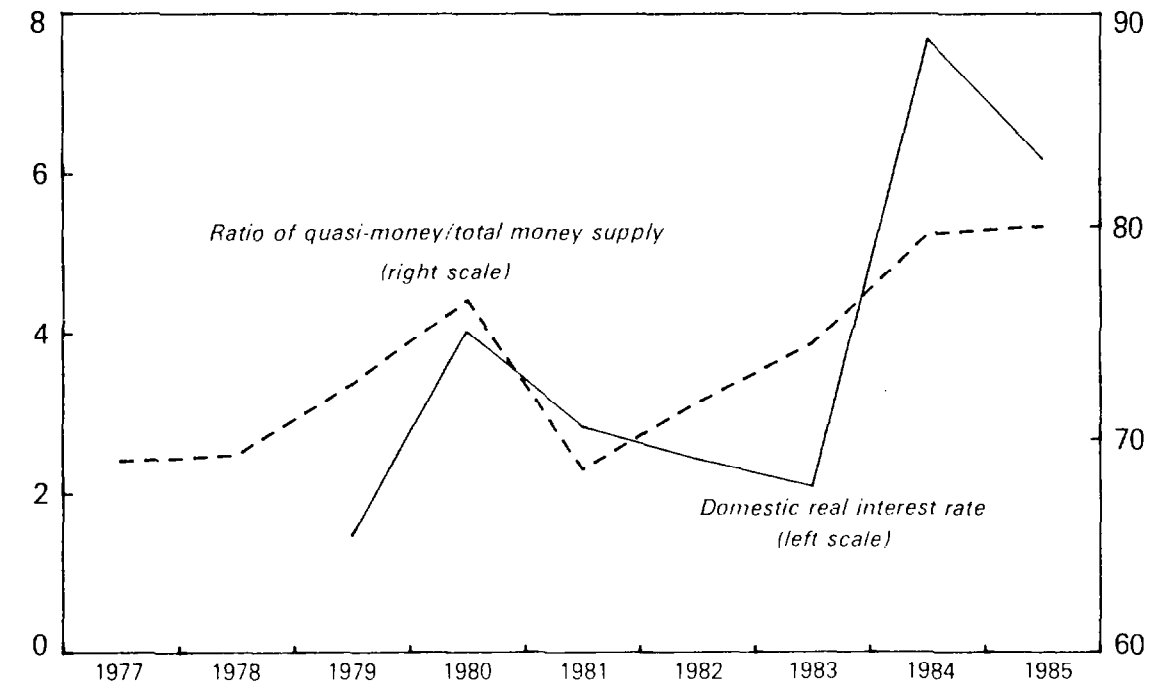
CHART 3

KUWAIT

DEVELOPMENTS IN DOMESTIC REAL INTEREST RATE AND DOMESTIC LIQUIDITY

(In percent)





With stagnating oil revenues through 1985 and the associated policies of financial restraint, activity in the rest of the economy has been subdued. Real non-oil GDP fell by about 3 percent last year. In addition, private sector confidence has suffered from insecurity in the region as well as from the lingering consequences of the collapse of the unofficial stock market (Souk al Manakh) in October 1982 following a period of frenzied speculation. The Government has since paid out the equivalent of US$7 billion in compensation to investors and in acquiring shares in domestic corporations in order to support their prices. Despite the scale of government intervention, stock prices have fallen by at least 60 percent since the closure of the unofficial market. Falling prices of stocks and real estate have, in turn, strained domestic banks holding such assets as collateral, and a high proportion of bank loans have been nonperforming. As a result, the authorities have stepped up considerably their monitoring and supervision of banks, and the Government has been called upon to support some banks financially.

The Government has also been under pressure from the business community for some time to reflate demand in order to revive private sector activity. This has been resisted, but a number of steps have been taken to assist the private sector. Drawing on recommendations of a high-level committee that reported in February 1985, the Government has embarked on an expenditure rationalization program aimed at giving priority to spending on productive projects and at a progressive reduction in transfers and subsidies. This policy is to be carried forward in the new five-year development plan which covers the period through the end of the decade. In addition, the Government recently announced increases in import tariffs for certain items to protect local producers and is taking steps to acquire equity in certain local companies in financial difficulties with a view to reorganizing them. Finally, the policy of according preferences to local contractors in bids for public sector projects and to domestic producers in official procurement is being continued.

Balance of payments developments over the past few years have been marked by continued large current account surpluses--in the region of 30 percent of GDP--which have served to finance substantial deficits on capital account, comprising government investment abroad, private capital outflow, and foreign assistance. In addition to its aid program, which has averaged about 5 percent of GDP, Kuwait has also made an important contribution to the developing world as a large employer of migrant workers, whose remittances have grown rapidly and now exceed US$1 billion annually. On the whole, the external position has been strong and official foreign assets have increased. Net foreign reserves of the Central Bank at end-1985 (US$5.5 billion) were equivalent to the estimated value of merchandise imports in that year. In addition, close to US$60 billion of foreign assets are held in the name of the Ministry of Finance; though conservatively valued at acquisition cost, a portion of these assets is not liquid.

The exchange system remains free of restrictions on current and capital transactions and Kuwait's trade system is virtually free of restrictions. The dinar is pegged to an undisclosed basket of currencies, but the exchange rate has moved fairly narrowly vis-à-vis the U.S. dollar over the past few years (Chart 4). During 1985, the index of the real effective exchange rate of the dinar was falling, thus unwinding some of the appreciation that had occurred over the previous few years. By the end of 1985, the dinar was less than 10 percent appreciated in real effective terms over its level in 1980. 1/

III. Policy Issues and Discussions

On the occasion of the last consultation with Kuwait in January 1985, Executive Directors noted that weakness of the world oil market together with the completion of many major infrastructure projects and structural problems of the non-oil sector had resulted in sluggish domestic economic activity. While endorsing the stance of fiscal and monetary policies, Directors stressed the importance of promoting efficient domestic resource allocation over the medium term through reductions in subsidies, avoidance of protectionism, and by keeping the appropriateness of the exchange rate under review. They also emphasized the importance of maintaining the soundness of the financial system.

Keeping the tenor of the last Board discussion in mind as well as the fact that the recent deterioration in the world oil market made the earlier policy recommendations even more compelling, the policy discussions focused on three broad areas: the responses needed to cope with the recent precipitous fall in oil prices and the uncertainty surrounding future developments; measures to reinforce the financial institutions and the securities market; and medium-term priorities and policies.

1. Oil market developments and their policy implications

a. Impact of recent oil price developments

The considerable uncertainties pervading the world oil market together with the fact that the current round of negotiations within OPEC are still in progress preclude, in the view of the Kuwaiti authorities, any firm projections of oil output and prices, even for the near term. The staff team, in consultation with the authorities,

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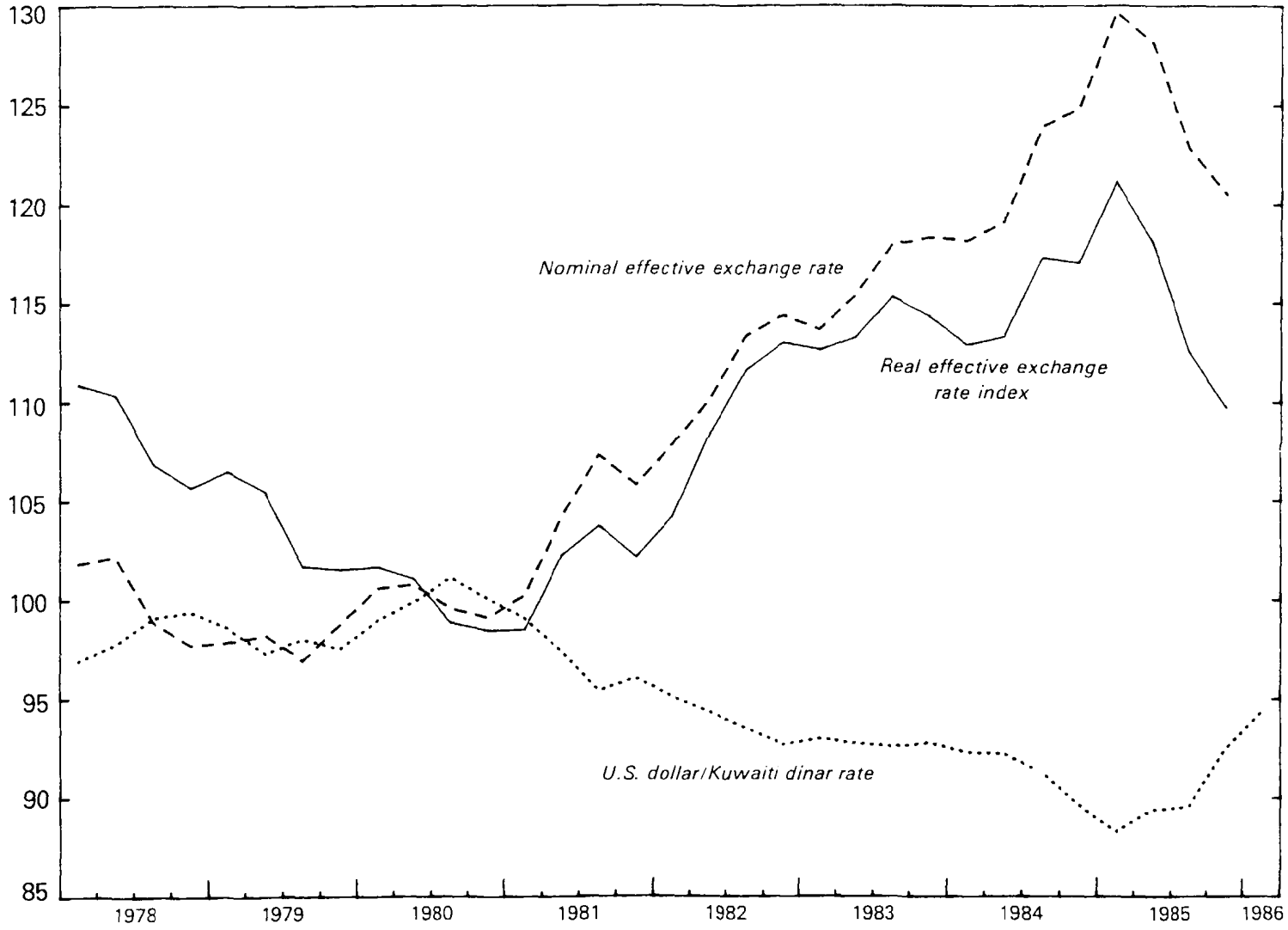
1/ The standard index developed in connection with the information notice system indicates that from the time of the last Executive Board discussion of Kuwait's exchange rate policy--the 1985 Article IV consultation in January 1985--through March 1986, the Kuwaiti dinar depreciated in real effective terms by 12.1 percent. Since recent developments in the exchange rate of the dinar are discussed in the present paper, no separate information notice will be issued.

CHART 4

KUWAIT

EXCHANGE RATE INDICES

(1980 = 100)



Sources: IMF, Information Notice Sysytem and IFS.

adopted the working assumption that domestic production in 1986 would average 1.2 million barrels a day (mbd). This level of production would represent about 60 percent of Kuwait's capacity and would imply exports of about 1.1 mbd (compared with 0.98 mbd in 1985). It was also assumed that Kuwait's petroleum exports will fetch an average price of US$15 per barrel in 1986, compared with an estimated average export price of US$27.35 in 1985.

Kuwait is better placed to withstand the current adverse trends than most other oil exporters. As far as the oil sector is concerned, the country has considerable flexibility to expand output and exports, if conditions deemed such action appropriate, given its enormous reserves, extremely low marginal cost of production, and the current high margin of unused capacity. In addition, aside from the country's very substantial earnings from official foreign investments (exceeding US$5 billion last year and representing about a quarter of GDP), private citizens have also accumulated large holdings of capital assets both domestically and abroad. Finally, the large expatriate labor force (accounting for nearly 80 percent of total employment) will probably bear the brunt of the economic slowdown.

In spite of these mitigating factors, the economy is still highly vulnerable to movements in world oil prices. At current levels of production, every dollar off the world market price of oil has meant a drop of US$400 million in annual export earnings and a loss of 3 percent in budget revenues. Based on the above assumptions, total export earnings in 1986 could be 35 percent lower than last year, sharply reducing the external current account surplus. At the same time, total budget revenues could drop by about 20 percent. Thus, the authorities are confronted with an adjustment challenge which, especially in the present climate of uncertainty, involves important policy choices and a coordinated strategy.

b. Balance of payments and external policies

In the present circumstances, a primary goal of the Government is to continue to accumulate foreign assets, albeit on a much reduced scale compared with the recent past. Recognizing that official foreign asset holdings are already very high, the Kuwaiti authorities appear to conceive of foreign investment as having been, in a broad sense, an important element of the country's diversification. In addition, the Kuwaiti representatives pointed out that about half of the official holdings of foreign assets were tied up in the Reserve Fund for Future Generations, income from which cannot be utilized for budgetary support. 1/ A portion of the remaining assets were not liquid. The staff commented

1/ The Reserve Fund for Future Generations was established in 1976. Its assets, 76 percent of which are held abroad, amounted to KD 11.8 billion (US$38.9 billion) at end-June 1985: they cannot be used before 2001.

that, in light of expected developments in the oil market, achievement of the external objectives described above would not be feasible in the absence of a tightening of the current financial stance.

Asked to describe the policy strategy through which they would aim to continue to build up foreign assets, the Kuwaiti representatives stressed that a tightening of the budgetary stance was of paramount importance since net domestic expenditures of the Government were the primary source of liquidity creation and, hence, the crucial determinant of the private sector's demand for foreign exchange. While concurring with this view, the staff team asked if the authorities envisaged a role for exchange rate policy as well. Noting that the close de facto link of the dinar to the U.S. dollar had in recent months resulted in a sharp depreciation of the dinar in real effective terms, they inquired if this foreshadowed a more active exchange rate policy in the period ahead aimed at curbing private sector demand for imports and limiting private capital outflow. Moreover, the staff team wondered if a more flexible exchange rate policy would not better serve the goals of the authorities than the recent steps to increase protection for certain local industries both through higher tariffs and preferences in official procurement.

The Kuwaiti representatives saw limited scope for exercising a more active exchange rate policy as a means of strengthening the balance of payments. In part, this stemmed from a view that the primary constraints on the expansion of non-oil manufacturing and exports lay in deep-rooted structural weaknesses and in the limited size of the economy rather than in inadequate price incentives. It also reflected some concern that any departure from the established pegging policy, especially in the current climate of uncertainty, could have the perverse effect of undermining confidence and, thereby, prompting large-scale capital flight--a scenario that the authorities wanted to avoid. If the needed fiscal adjustment were to be unduly delayed, the authorities would propose to respond to an increase in private capital outflow by means of credit and interest rate policy rather than through action on the exchange rate. For those reasons, no consideration was being given to changing the existing exchange arrangements. On a related issue, the Kuwaiti representatives noted that a study of the scope for coordinating exchange rate policy among the Gulf Cooperation Council (GCC) countries was currently under way.

As regards trade policy, the Kuwaiti representatives stressed that the recent protectionist actions were intended to be limited both in scope and duration. They recognized that protection was costly not only in terms of higher procurement costs but also in the longer term through its tendency to breed inefficiency. Some of these measures had been prompted to deal with unhealthy competition, including dumping. The authorities were, indeed, firm in their resolve to maintain liberal and open trading policies. In this connection, the Kuwaiti representatives mentioned that exports of petrochemicals from Kuwait and other GCC

countries had faced higher tariff barriers in the European Community, a matter that was currently under negotiation between the two trading entities.

c. Fiscal policies

Total revenues for the fiscal year ending in June 1986 are estimated to fall short of the original budget by 15 percent. In light of this prospect, the Council of Ministers in early 1986, instructed government departments to cut spending for the remainder of the year by a like amount--apart from wages and salaries which have, in principle, been frozen for nearly two years. The indications are that ongoing commitments have made it difficult for these cuts to be implemented immediately. However, with some savings on goods and services as well as on subsidies, and a shortfall in aid disbursements, current expenditures are likely to be 5 or 6 percent below the original budget estimates. In addition, savings are expected to be found in the development budget, as well as from cuts in official land purchases for development projects and housing, and reduced capital transfers to public enterprises. Overall, the 1985/86 budget is expected to be broadly in balance, in sharp contrast with the large surpluses of previous years.

Looking ahead to FY 1986/87, the staff team inquired as to objectives and priorities of fiscal policy in light of the overall budget deficit that now appears in prospect. The Kuwaiti representatives said that the new budget was under preparation and due to be submitted to the National Assembly shortly. As in the past, the budget would be framed with a view to safeguarding the external payments position and permitting some further reserve accumulation. Total expenditures, excluding wages and salaries, would be cut by 15 percent compared with the original 1985/86 budget, as called for by the Council of Ministers. However, the authorities would seek to effect these savings without aggravating the current economic slowdown. Primary emphasis would, therefore, be placed on expenditure rationalization, particularly through reductions in nonproductive subsidies and transfers, aimed at increasing efficiency and productivity throughout the economy. To this end, some food subsidies had already been eliminated, and the policy now was to withdraw all subsidies from foodstuffs other than six essential items covered by the rationing system. While such action would save the equivalent of 1 percent of government expenditures, increases in rates for water and electricity--which are heavily subsidized--were also planned to take effect during FY 1986/87. Another focus of expenditure restraint would be the development budget. Development projects and expenditures were being reviewed and new criteria would be established. Nonessential projects, not yet initiated, were expected to be first in line for cuts. Other likely targets for budget savings included the land purchase program and lending to public enterprises.

Underscoring the uncertainty surrounding current developments and prospects, the staff representatives noted that fiscal policy would in the future, as in the past, have to be implemented in a flexible and pragmatic way. While the authorities were clearly right in placing the primary emphasis of budgetary restraint on the expenditure side, the staff team suggested that the currently proposed cuts might not prove adequate to achieve the external objective. In this event, they wondered if the authorities envisaged a need for revenue initiatives and, if so, as to how and where additional budgetary resources would be mobilized. The Kuwaiti representatives said that on the revenue side priority would be placed on introducing or increasing fees and charges for government services--an area with considerable potential for raising revenue. In this regard, certain adjustments were already under study. Beyond that, revenue mobilization was subject to many constraints. Though some additional increases in certain customs duties had been proposed by the Council of Ministers, further such increases were limited by Kuwait's obligations as a member of the GCC as well as concerns of encouraging smuggling. At this stage, the authorities were not thinking of introducing new taxes, either direct or indirect. Apart from the initial costs of setting up an administrative apparatus to collect taxes, it was felt that income or other direct taxes would simply follow the oil revenue cycle--given the close linkage of the entire economy to oil--and that sales or excise taxes would, in addition, tend to encourage smuggling.

Keeping in mind the special circumstances of Kuwait, the staff representatives opined that the authorities appeared to be taking a somewhat too pessimistic view of revenue potential, and suggested that they might wish to have some contingency plan in the field of taxation in case developments over the medium term warranted the introduction of revenue measures. For the time being, however, the staff concurred with the authorities that budgetary savings should first be sought by means of expenditure rationalization and restraint as well as by the introduction of charges for public services.

Finally, the staff team asked how the authorities planned to meet the legal requirement of transferring 10 percent of budgetary revenues to the Reserve Fund for Future Generations, given the prospect of approximate overall balance in the current fiscal year, and how they would plan to finance a deficit in the budget if one should subsequently emerge. The Kuwaiti representatives said that if present trends continued, the required transfers could only be met by drawing down assets of the General Reserve or through borrowing. 1/ The authorities would respond to the emergence of a temporary deficit in the budget through the introduction of public debt instruments, a matter that is

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1/ The General Reserve, amounting to KD 11.4 billion (US$37.6 billion at end-June 1985), comprises the accumulated surpluses of past budgets. Its assets can be drawn upon, as required, for purposes of economic, social, and political policy.

under active consideration. The aim would be to make such securities attractive to the nonbank private sector so as to dampen the effect of a deficit on liquidity creation: it was clear that the introduction of such instruments would have wider implications for interest rate policy.

d. Monetary policy

While interest rates, like the other instruments of monetary policy, had been little used in the past, the Kuwaiti representatives said that the authorities had an open mind on the matter and that greater flexibility of interest rates was regarded as a feasible policy option in current circumstances. Though interest rates on commercial bank lending in dinars were currently subject to an upper ceiling of 10 percent, thereby leading to de facto limits on deposit rates, they noted that borrowing and lending transactions in foreign currencies were not subject to interest rate ceilings. In addition, the special deposit facilities offered by the Central Bank to commercial banks with a view to regulating their liquidity and containing capital outflow, carried interest rates that were set with reference to rates on the unregulated interbank market. Thus, certain areas of the financial system were not influenced by regulated interest rates, and it was clear that the possible introduction of treasury bills or government bonds as a means of budget financing or liquidity regulation would inevitably enlarge the share of transactions outside the scope of interest rate controls. 1/

The staff representatives suggested that as a first step the authorities might consider the abolition of the ceilings on domestic lending rates. Since the present upper ceiling was above prevailing world market rates, such a move could now be made with little if any impact on the level of domestic interest rates. Moreover, the retention of interest rate ceilings could lead to difficulties later on, both as regards budgetary financing as well as the goal of containing capital outflow, if confidence weakened or world market interest rates started rising again. The Kuwaiti representatives agreed that recent trends in the composition of liquid assets revealed the responsiveness of local savers to movements in real interest rates as well as to shifts in domestic and international interest differentials. The authorities had embarked on a thorough review of all aspects of monetary policy and of the interrelations between monetary policy and exchange rate policy. The staff representatives expressed the view that this re-examination was timely and important; given the less favorable budget prospects and the objective of safeguarding the balance of payments, monetary policy would have an essential role to play in the period ahead.

1/ Kuwait has one Islamic banking institution, the Kuwait Finance House, the role and operations of which are described in SM/85/2 (1/2/85), pp. 48-49.

2. Strengthening the financial sector

The authorities continue to be preoccupied with the consequences of the Souk al Manakh collapse. While the program to assist individual investors has been completed, attention has now shifted to restoring the soundness of the financial institutions--particularly the commercial banks--as well as to reorganizing local shareholding companies and strengthening the stock market. These operations, particularly the steps to strengthen the commercial banks, are seen as a top priority of policy not only for domestic reasons but for reasons of external stability as well.

Action has already been taken to enhance procedures for monitoring and supervising the financial institutions. Both banks and nonbank financial institutions have been required since mid-1985 to report on their financial position--particularly their loan portfolios--on a quarterly basis. In addition, from the end of last year, all commercial banks have been required to make provision for doubtful or nonperforming loans in accordance with a prescribed schedule. The authorities have also brought the foreign exchange houses under the purview of the Central Bank and limited the scope of their operations. This followed the failure of one such house in the course of last year, which necessitated government intervention to discharge its outstanding foreign exchange obligations.

Asked how the banking system had adapted to the new regulations, the Kuwaiti representatives said that certain banks with a large proportion of nonperforming loans were in need of financial support. A proposal by the Minister of Finance to make available up to KD 500 million in official deposits with such banks had been held up by the National Assembly. However, it was expected that the scheme could go into effect very shortly. The authorities were determined to ensure that any such deposits carried strict conditions: in particular, the management and operation of the banks concerned would be subject to close and rigorous supervision by the Central Bank.

Turning to the securities market, the Kuwaiti representatives said that the Government was engaged in supporting the share value of local closed companies by acquiring such shares at a total cost projected to be of the order of KD 200 million. These purchases were being financed through the General Reserve. At the same time, the Government was taking the opportunity of reorganizing such companies through mergers and consolidations and, in some cases, liquidation. Also, longer-term solutions to the problems of these companies were being proposed by the Government, including strengthening their management, rationalizing their salary structures and, most importantly, setting up a system for supervising their operations so as to safeguard the Government's investments. The Kuwaiti representatives stressed that this support was necessary to protect individual investors, to support those financial institutions holding such stock as collateral, and to normalize stock market trading in local shares.

The staff representatives concurred with the Government's policy of acting decisively to clear up the remaining problems of the financial sector but expressed a number of reservations. In particular, support on the scale envisaged could frustrate the goal of achieving fiscal restraint. At the same time, the Government's apparent willingness to provide repeated official support to the private sector could undermine financial discipline: in present circumstances, given the need for fiscal consolidation, it seemed timely to send a clear signal to private sector entities that they would, henceforth, have to bear the financial consequences of their own investment decisions. The Kuwaiti representatives replied that the ongoing official intervention to support the financial sector and the securities market had been necessary to resolve the remaining consequences of the Souk Al Manakh crisis and to revitalize the financial system. The present actions were aimed at fostering a healthier financial climate and, together with the measures taken to strengthen official supervision of the financial institutions, would, in their view, lay the basis for more rational decisions by the private sector in the future.

The staff team observed that in recent years the Government, through its support activities, had substantially increased its ownership of the economy and inquired if divestiture of private sector securities was being considered as a means of budgetary support in the foreseeable future. The Kuwaiti representatives said that while it was the intention of the authorities to dispose of government holdings of private stock when the economy and stock market recover, circumstances were not currently propitious for such action and those assets were, thus, regarded as a medium- to long-term investment.

3. Medium-term issues

An assessment of the medium-term outlook and prospects for Kuwait is unusually difficult in the current climate of uncertainty surrounding the world oil market. For that reason, the authorities were not prepared to discuss quantified balance of payments projections beyond 1986. Projections for 1986 prepared in collaboration with the authorities and tentative projections made by the staff for 1987 on the basis of known policy intentions at the time of the mission, are given in Appendix I. Discussions of medium-term issues and prospects focused on the thrust of policy responses that seemed to be called for rather than on a quantified forecast.

a. Nature of the current slowdown

The authorities regard the current economic slowdown as being largely structural in nature reflecting, as it does, not only a long-term contraction of government spending associated with declining oil revenues but also the completion of much of the country's infrastructure. Thus, the slowdown is seen as involving an inevitable shrinkage of most, if not all, sectors as the economy moves to a new

and more sustainable plateau. For these reasons, the Kuwaiti representatives explained that the authorities were resisting pressure from some quarters to reactivate the economy by boosting demand, a process that could only impede the structural adjustment now under way and lead to a drain on foreign reserves. Moreover, the ongoing adjustment was not without its salutary effects: producers were being forced to restructure production and contain costs, especially labor costs, in an effort to protect their market shares. New investments had to be based on more rigorous feasibility studies and profitability criteria than in the past, and would aim at quick-yielding projects. These pressures would help to increase efficiency and thus foster sounder growth in the medium term.

The staff representatives supported the authorities in their intention to refrain from demand reflation in current circumstances. The pace of growth attained during the past decade was clearly not sustainable. The staff team also agreed that the present economic climate would serve to foster greater efficiency as would the decision by the Government to reform its spending policies, particularly as regards the intended reduction in subsidies and transfers to the private sector. The latter would help to restrain consumption and assure a more efficient allocation of resources. In this context, too, the staff team welcomed the earlier affirmation of the Kuwaiti representatives that the recent protectionist measures, which could run counter to these goals if they were allowed to become entrenched, were limited to dealing with unfair trade practices or to providing temporary relief to local industry facing external competition.

b. Development planning

The new five-year plan, covering the remaining years of the present decade, was approved by the Council of Ministers in mid-1985 and is now being reviewed by the National Assembly. Recalling that the plan had been drafted prior to the recent decline in oil prices, the staff asked if subsequent developments had brought about any corresponding adjustments in its targets or priorities. The Kuwaiti representatives stated that adjustments would in due course be made in the quantitative targets of the plan to take account of changed conditions in the oil market and their impact on export earnings and the budget. However, the priorities under the original plan were unlikely to be significantly altered.

The highest priority of the plan is to achieve a better balance in the population and labor market between Kuwaitis and non-Kuwaitis. The plan envisages the share of Kuwaiti citizens rising from 40 percent of the total in 1985 to 45 percent in 1990, with a view to reaching 50 percent by the turn of the century. The share of Kuwaitis in the total labor force would rise from 19 percent at present to 24 percent by 1990. Improving labor productivity is seen as a necessary complement to achieving the plan target. Consequently, investment in human resources through training and education programs involving greater emphasis on

technical skills is receiving high priority. Other objectives of the plan include improvements in public administration, more efficient use of the country's financial resources, and a consolidation of public sector investment through adequate maintenance and the completion of the infrastructure program, especially in the areas of electric power generation and water. As drafted, the plan envisages about 85 percent of the financing for programmed investments coming from the public sector and the remainder from the private sector: the authorities are now exploring ways of increasing private sector participation in the financing of certain projects in order to help offset the emerging constraints.

The Kuwaiti representatives noted that further diversification of the economy was not emphasized in the present plan. This reflected the official view that there were many obstacles and constraints on the creation and expansion of new industry in Kuwait. On the supply side, Kuwait was a labor-short, high-cost economy; it was for that reason that the Government provided a variety of incentives to industry, including low interest financing and subsidized energy and water; the cost of labor was also subsidized indirectly through the provision of social services. Constraints on the demand side were more difficult to offset. The domestic market was narrow--even though per capita incomes were very high--and neighboring markets had been saturated with competing products. The constraints on efficient diversification of the economy were also brought out in a report on the Kuwaiti economy by the staff of the World Bank. 1/

Efforts are being made to coordinate industrial development with neighboring countries within the framework of the GCC. While agreement on a formula for coordinating production of existing plants has so far proved elusive, new projects are being tackled jointly and a long-term industrial strategy for GCC countries is under consideration. The legally permitted limit to participation of GCC nationals in Kuwaiti enterprises, other than oil or banking, has been increased to 75 percent of total equity: the limit remains at 49 percent for non-GCC nationals. As for the direction of private investment, the Kuwaiti representatives expected that in the near term the private sector would be more cautious in its investment decisions and aim at quick-yielding and highly profitable projects.

IV. Staff Appraisal

The Kuwaiti economy is currently going through a necessary period of contraction. Primarily this reflects the beginnings of a process of structural adjustment following a dozen years of an oil-led boom and the virtual completion of a comprehensive base of infrastructure. For that

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1/ Further information on this report together with a summary of Kuwait's relations with the World Bank is given in Appendix III.

reason, the staff feels that the authorities are right to demur at proposals for reactivating the economy by boosting demand, and to concentrate instead on constraining government spending with a view to increasing efficiency and maintaining a strong external position. Also, the emphasis in the new development plan on improving labor efficiency and productivity, primarily with a view to achieving a better population balance, is well placed as it will assist in achieving these goals.

Growth and efficient diversification of the economy over the medium term will depend, above all, on a sound macroeconomic policy framework geared toward stable financial conditions and a price structure that reflects the true economic cost of inputs. It will also depend upon maintaining a competitive environment and instilling a new spirit of self-reliance throughout the private sector. Only by these means can the authorities foster a rational and efficient allocation of resources and thereby encourage the growth of viable economic activities. Such a strategy carries many implications for the orientation of policies over the medium term, particularly as regards support for ailing industries and firms, pricing of services and utilities provided by the Government, and financial policies.

For the immediate future, in light of the weakness and uncertainty regarding world oil prices, the intention of the authorities is to seek to continue to build up external reserves and official foreign assets, albeit on a reduced scale compared with the past. Even though foreign asset holdings are very large, this policy can be justified on the ground that overseas investment constitutes a sound form of diversification in an economy highly exposed to the vagaries of the world oil market and with limited scope for efficient investment domestically. The narrowness of the country's resource base, the limited size of the market--even when extended to encompass the GCC--and the shortage of manpower, constitute formidable impediments to diversification and growth--a reality that is justifiably recognized in the new development plan. Income from foreign investments offers a practical alternative source of foreign earnings for the future. In this regard, the Reserve Fund for Future Generations will continue to have a key role, and the authorities should maintain their vigilance over the quality, yield, and stability of its assets.

Sound balance of payments and reserve management will depend crucially upon the implementation of judicious fiscal and monetary policies. In particular, the staff supports the efforts of the authorities in seeking budget cuts, and welcomes the emphasis being placed on reductions in subsidies and transfers so as to foster greater efficiency. Over the medium term, thought may have to be given to domestic revenue initiatives. In any event, budgetary policy will have to be adapted flexibly as developments in the world oil market unfold. Monetary policy, too, will have an important role, and in this regard the application of stricter discipline over the financial sector as well as the prospect of greater flexibility in interest rates are to be welcomed. A more active monetary policy, involving use of the various

instruments at the disposal of the authorities, especially interest rates, has a vital bearing on the official goal of keeping private capital outflow within acceptable bounds, especially at a time when the demand for domestic liquidity is weak.

Kuwait's pegging policy has resulted in a relatively stable exchange rate for the dinar vis-à-vis the U.S. dollar in recent years. The external position has been strong, the exchange system remains free of restrictions for current and capital transactions, and restrictions on trade are minimal. The staff can understand the reluctance of the authorities to depart from the established pegging policy in current circumstances. However, the staff feels that the fall in foreign exchange earnings coupled with the official goals of safeguarding the balance of payments and maintaining competitiveness of the country's fledgling non-oil tradables sector, would point to the need for keeping the exchange rate under close scrutiny in the period ahead. In this regard, the recent depreciation of the dinar in real effective terms has been timely.

With the concurrence of the authorities, it is recommended that Kuwait remain on an 18-month consultation cycle and, accordingly, that the next consultation discussions be held in the fall of 1987.

Table 1. Kuwait: Balance of Payments Summary, 1980-85 and Projections for 1986 and 1987

(In millions of U.S. dollars)

	1980	1981	1982	1983	Estimates 1984	Estimates 1985	Projections 1986	Projections 1987
Trade balance, f.o.b.	13,876	9,289	3,008	4,577	5,534	5,475	2,339	2,400
Exports	20,631	16,027	10,821	11,469	12,240	10,996	7,234	7,050
Petroleum	(19,063)	(13,949)	(8,900)	(9,943)	(10,889)	(9,729)	(5,963)	(5,820)
Other	(1,569)	(2,077)	(1,921)	(1,527)	(1,351)	(1,267)	(1,271)	(1,230)
Imports	-6,755	-6,738	-7,812	-6,893	-6,706	-5,521	-4,895	-4,650
Services account 1/	2,312	5,464	2,515	1,396	1,172	669	978	1,460
Receipts	6,711	9,798	7,632	6,556	6,693	6,379	6,068	6,300
Investment income	(5,486)	(8,406)	(6,690)	(5,688)	(5,804)	(5,262)	(4,982)	(5,200)
Other	(1,224)	(1,392)	(941)	(868)	(889)	(1,118)	(1,086)	(1,100)
Payments	-4,398	-4,334	-5,117	-5,160	-5,521	-5,711	-5,090	-4,840
Private transfers	(-692)	(-689)	(-875)	(-865)	(-963)	(-1,044)	(-1,096)	(-1,040)
Other	(-3,707)	(-3,645)	(-4,241)	(-4,295)	(-4,558)	(-4,667)	(-3,994)	(-3,800)
Current account balance	16,188	14,753	5,523	5,973	6,706	6,143	3,317	3,860
Capital account	-15,145	-14,473	-3,561	-6,972	-6,764	-5,581	-3,701	-3,900
Official assistance	-1,354	-1,202	-1,233	-1,376	-862	-865	-859	-850
Government investment	-10,377	-7,943	-4,436	1,431	-5,446	-2,262	-1,540	-1,450
Other items 2/	-3,414	-5,328	2,109	-7,026	-456	-2,455	-1,302	-1,600
Overall balance	1,043	280	1,963	-998	-57	562	-384	-40
Memorandum items:								
Central Bank net reserves (months of merchandise imports equivalent)	7	7	9	9	8	12	...	...
Foreign assistance as a percent of GDP	5	5	6	6	4	4	...	...
Current account/GDP ratio	59	61	27	27	31	30	...	...

Source: Data provided by the Kuwaiti authorities. Projections for 1986 were prepared in cooperation with Kuwaiti authorities. Projections for 1987 were prepared by the staff.

1/ Including private transfers.

2/ Including private sector capital transactions, and errors and omissions.

Assumptions Underlying Balance of Payments Projections for 1986 and 1987

1. Projections for 1986 were prepared in cooperation with the Kuwaiti authorities. They are based on the following principal assumptions:

a. Petroleum exports of 1.1 mbd at an average price of US$15 per barrel. Other exports estimated to remain at about the same rate as in 1985.

b. Imports are projected to decline by about 11 percent reflecting lower economic activity and trends in government spending.

c. Investment income is expected to drop by about 5 percent due to lower yields.

d. Official assistance is estimated to remain at about the same level as last year in line with present government policies.

e. Lower projected government investment is associated with the decline in oil receipts.

f. Other capital outflow (other items) is expected to diminish reflecting planned cuts in government expenditure and a narrowing of the interest differential vis-à-vis world capital markets.

2. Projections made by the staff for 1987 are based on the following assumptions:

a. Petroleum exports of 1.1 mbd at US$14.5 per barrel are based on the assumption in the World Economic Outlook adjusted for the composition of Kuwaiti oil exports.

b. Other exports are projected to fall by 3 percent from 1986 in line with lower regional demand.

c. Imports are projected to decline by 5 percent reflecting an estimated decline of 9 percent in government spending in 1987 based on current policies and programmed cuts in the 1986/87 budget (described in the text), and some stock-building.

d. The projected increase in investment income in 1987 reflects the increase in investment and slightly higher yields.

e. Official assistance is projected to remain at US$850 million, while government investment abroad is expected to fall further in line with lower export receipts.

f. Other capital flows, with unchanged domestic policies, are projected to increase over their level in 1986.

Kuwait: Fund Relations

(As of April 30, 1986, in millions of SDRs)

(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	318.77 (50.17 percent of quota)
Fund credit	None
Reserve tranche position	316.55
Current Operational Budget (maximum use of currency)	36.4

	Limit	Outstanding
Lending to the Fund SFF	400.0	309.2

III. Kuwait Has Not Used Fund Resources to Date.

IV. SDR Department

Net cumulative allocation	26.74
Holdings	111.43 (416.67 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, either side of the currency basket derived exchange rate. On December 31, 1985, the exchange rate of the dinar was US$1 = KD 0.28919.

VII. Last Article IV Consulation

Discussions were held in October/November 1984; the Staff Report (SM/84/268) was discussed by the Executive Board on January 16, 1985. The summing up indicated that the next Article IV consultation would be on an 18-month cycle.

VIII. Technical Assistance

In November/December 1983, a STAT mission visited Kuwait to review balance of payments methodology.

Kuwait: Relations with the World Bank

A technical cooperation agreement covering the period March 1986-June 1987 has been concluded between the IBRD and the Ministry of Planning covering monitoring and evaluation of the development plan, and specific sector reviews in the following areas: education and training, public expenditure, and the labor market.

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. Though that report predated the recent decline in oil prices, its principal conclusions remain valid. Among those conclusions, the Bank staff emphasized the following:

"... what is required is vigorous action by the Government in increasing the participation of Kuwaitis in the higher skill labor force and in labor productivity in general. These two measures have to be taken, regardless of the government policy with respect to the level of population which is deemed appropriate for the country. Any decision by the Government to deliberately reduce the population level of the country will make those measures only more imperative. In their absence, the growth prospects of the economy, or the potential for increasing the Kuwaiti participation in the labor force, will be substantially reduced.

"Increased efficiency must be the Government's primary goal not only with respect to labor, but to all other production factors as well. For it is in greater efficiency of the various production processes, whether of private or public goods and services, that lies Kuwait's best bet against the future. For this purpose, pricing of basic inputs, i.e., oil, power, water, and capital, must reflect their economic value for the country. This will not only prevent their wasteful use but will also test the economic profitability of those economic activities which utilize them. Appropriate pricing of basic inputs is not, however, sufficient to increase the efficiency of the economy. Increased computerization in the delivery of private and public services, more capital-intensive techniques in the construction sector and, finally, a gradual reduction of the highly labor intensive and atomized private trade sector are critical changes toward attaining such greater efficiency."

Kuwait--Statistical Issues

1. Outstanding Statistical Issues

a. National accounts

The national accounts are fairly comprehensive but the constant price series based on 1972 would benefit from an update so as to include in the weighting pattern the marked changes that have subsequently taken place in the economy.

b. Prices, production, and external trade

Data on prices and external trade are uncurrent; the recent data on export values are staff estimates based on production figures.

c. International banking statistics

In connection with the provision of data under the Fund's international banking statistics (IBS) project, the authorities have been reluctant to provide the country breakdown of foreign assets and liabilities of deposit-taking institutions resident in Kuwait for reasons of confidentiality. The staff have indicated to the authorities the importance placed by the Fund on the IBS project and assured them of the stringent procedures for protecting the confidentiality of disaggregated data. The staff will be keeping in touch with the authorities on this matter.

2. 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 May 1986 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, except for data on prices and external trade.

Status of IFS Data

			Latest Data in May 1986 IFS
Real Sector	- National Accounts		1984
	- Prices: CPI		Q1 1984
	WPI		Dec. 1985
	- Production: (crude petroleum)	Jan. 1986	
	- Employment		n.a.
	- Earnings	n.a.	
Government Finance	- Deficit/Surplus		Jan. 1986
	- Financing		Jan. 1986
	- Debt	n.a.	
Monetary Accounts	- Monetary Authorities		Jan. 1986
	- Deposit Money Banks	Jan. 1986	
	- Other Financial Institutions	Q4 1983	
External Sector	- Merchandise Trade:		
	Values: Exports		Q4 1984
	Imports		Q2 1984
	Prices	n.a. 1/	
	- Balance of Payments	1984	
	- International Reserves	Mar. 1986	
	- Exchange Rates		Mar. 1986

1/ Except for the export price of crude petroleum: December 1985.

Kuwait - Basic Data

Area	17,900 square kilometers
Population (1985 census)	1.69 million
GDP per capita (1984)	US$12,810

	1980	1981	1982	1983	1984	1985
			(In percent)			
Origin of GDP at current prices						
Oil sector	71.1	63.1	49.4	50.9	52.5 1/	...
Non-oil sector	28.9	36.9	50.6	49.1	47.5 1/	...
Annual changes in output and prices						
Non-oil GDP at constant (1972) prices	6.8	6.3	4.7	0.7	4.5 1/	-3.0 1/
Consumer price index	6.9	7.3	7.8	4.7	1.2	1.4
Crude oil production (million barrels/day)	1.66	1.13	0.82	1.05	1.16	1.04
Average oil export price (US$ per barrel)	31.70	34.81	32.95	28.39	27.28	27.35

	Actuals 2/					Budget 3/	Prel.3/
	1980/81	1981/82	1982/83	1983/84	1984/85	1985/86	1985/86
			(In millions of Kuwaiti dinars)				
Government finance							
Revenue	6,351	4,280	4,155	4,363	3,806	4,020	3,403
Oil revenue	4,435	2,765	2,338	2,924	2,494	2,802	2,250
Investment revenue	1,744	1,364	1,657	1,289	1,154	1,000	1,000
Other revenue	172	151	160	150	158	218	153
Expenditure	2,877	3,714	3,663	3,467	3,305	3,788	3,389
Current expenditure	1,696	1,915	2,161	2,042	2,158	2,432	2,264
Wages and salaries	(484)	(564)	(662)	(687)	(723)	(772)	(739)
Goods and services	(493)	(562)	(594)	(598)	(636)	(684)	(642)
Subsidies and transfers	(457)	(544)	(674)	(572)	(638)	(762)	(719)
Transfers abroad	(262)	(245)	(231)	(185)	(161)	(214)	(164)
Development expenditure	489	663	708	750	783	956	800
Land purchases	392	450	220	127	136	150	125
Net domestic lending	300	686	574	548	228	250	200
Overall surplus	3,474	566	492	896	501	232	14
Memorandum items:							
Government net domestic expenditure (change in percent)	(13.8)	(43.4)	(-2.7)	(-6.1)	(-6.2)	(...)	(...)
Budget surplus/GDP ratio	(49.0)	(8.9)	(7.9)	(13.4)	(7.5)	(...)	(...)
Subsidies and domestic transfers including land purchase and net lending/total outlays	(40.0)	(45.3)	(40.1)	(35.9)	(30.3)	(30.7)	(30.8)

Kuwait - Basic Data (continued)

	1980	1981	1982	1983	1984	1985 4/
	(In millions of Kuwaiti dinars)					
Changes in money and credit						
A. Foreign assets (net)	412.5	301.2	295.9	-253.0	166.9	87.0
B. Domestic assets (net)	155.3	709.1	14.4	442.6	-37.6	-139.7
Claims on nongovernment sector	(553.1)	(782.2)	(838.9)	(460.2)	(292.7)	(20.2)
Government deposits	(-284.2)	(57.1)	(-307.6)	(72.8)	(-171.5)	(44.0)
Other assets (net)	(-113.6)	(-130.2)	(-516.9)	(-90.4)	(-158.8)	(-203.9)
C. Money and quasi-money (A+B = D+E+F)	567.8	1,010.3	310.2	189.6	129.3	-52.7
D. Government net domestic expenditure	2,005.9	2,408.8	2,514.3	3,168.8	2,923.5	2,513.6
E. Monetary impact of nongovernment sector	-1,324.5	-1,268.3	-1,687.3	-2,888.8	-2,635.4	-2,257.0
F. Other items (net) (increase-)	-113.6	-130.2	-516.9	-90.4	-158.8	-203.9
Rate of change (in percent)						
Money and quasi-money	(24.8)	(35.4)	(8.0)	(4.5)	(3.0)	(-1.2)
Money	(6.9)	(81.4)	(-2.9)	(-5.6)	(-17.9)	(-2.8)
Quasi-money, of which:	(31.5)	(21.3)	(13.0)	(8.5)	(10.1)	(-0.8)
foreign currency	(65.3)	(1.2)	(-44.1)	(79.4)	(20.1)	(-22.0)
Claims on nongovernment sector	(26.1)	(29.3)	(24.3)	(10.7)	(6.2)	(0.4)
Trade balance, f.o.b.	3,751	2,589	866	1,334	1,638	1,646
Exports and re-exports	5,577	4,458	3,115	3,343	3,623	3,306
Petroleum	(5,153)	(3,888)	(2,562)	(2,898)	(3,223)	(2,925)
Other 5/	(424)	(570)	(553)	(445)	(400)	(381)
Imports 5/	-1,826	-1,818	-2,249	-2,009	-1,985	-1,660
Services and private transfers	625	1,523	724	407	347	201
Receipts	1,814	2,731	2,197	1,911	1,981	1,918
Investment income	(1,483)	(2,343)	(1,926)	(1,658)	(1,718)	(1,582)
Other	(331)	(388)	(271)	(253)	(263)	(336)
Payments	-1,189	-1,208	-1,473	-1,504	-1,634	1,717
Current account surplus	4,376	4,112	1,590	1,741	1,985	1,847
Capital (net) and grants	-4,094	-4,034	-1,025	-2,032	-2,002	-1,678
Official assistance	-366	-335	-355	-401	-255	-260
Government investment	-2,805	-2,214	-1,277	417	-1,612	-680
Other recorded capital and errors and *omissions 6/*	-923	-1,485	607	-2,048	-135	-738
Central Bank reserves (increase-)	-282	-78	-565	291	17	-169
	(In billions of U.S. dollars)					
Central Bank reserves and government foreign assets (end of period)						
Central Bank (net)	4.0	4.2	6.0	4.9	4.7	5.5
Government foreign assets	45.4	49.9	42.0	50.8	54.2	59.3
	(In U.S. dollars per Kuwaiti dinar)					
Exchange rate (period average)	3.699	3.588	3.474	3.431	3.378	3.3261
Real effective exchange rate (percentage change)	-3.1	3.7	10.5	1.2	2.3	-6.2

1/ Preliminary.
2/ Fiscal years ending June 30.
3/ A strict comparison between actual outlays and proposed budget expenditures is not possible. Budget estimates exclude any expenditures on net domestic lending (which is financed directly from reserves) and the expenditures of attached budgets are not itemized into wages and salaries, goods and services, etc., but are shown in total as part of *subsidies and other domestic transfers. Investment income is excluded from the Kuwaiti* budget statements, but is included in actual figures.
4/ Balance of payments figures for 1985 are preliminary estimates.
5/ Includes nonmonetary gold.
6/ Includes institutional placements, private capital movements, and oil export credit.