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Habib A. Al-Naqi

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ABSTRACT

Kuwait has a small open economy, depends totally on exporting one primary single commodity (oil) to earn its income and is dependent on the rest of the world to import its needs of consumer and capital goods. Thus, the vulnerability of the Kuwaiti economy to exogenous pressures is reflected in the local monetary sector, as well as in the other sectors. However, this external pressure on the monetary sector is isolated from the condition of the balance of payments - especially in the short-term - because the persistent surplus of the balance of payments reflects the oil revenue which is kept outside the country in the foreign reserve of the government. On the other hand, the government expenditure in the local economy is determined by some socio-economic and other political tendencies rather than the level of the oil revenue. Hence, the persistent deficit of the private non-oil balance of payments against the outside world is offset by the government monetary injection in the local economy through its annual budgetary spending to cover the cost of its development plans. Nevertheless, the external influence on the local monetary condition is due to structural and institutional constraints in the financial market and the economy on one hand, and to the policies of the monetary authorities on the other.

The purpose of this study is to investigate the application of the monetary policy instruments by the Central Bank of Kuwait during the period 1970-1988 to achieve its economic and monetary objectives postulated in its Charter. Moreover, in addition to this originality, this study has also updated previous empirical works concerning the behaviour of the money stock, since the latest academic research in this field ended in 1982.

The behaviour of the monetary sector is studied through the balance sheet of the Central Bank, the consolidated balance sheet of the commercial banks, specialized banks, investment companies, and other participants in the financial market. This study shows that the banking system has experienced a considerable growth in its activities inside and outside the country. But in spite of the structural shift in the investment portfolio of the commercial banks in favour of the local opportunities against foreign investment, the distribution of bank credit among the various productive sectors shows unfair trends against some sectors such as industry and agriculture, and in favour of speculative activities in the stock market and real-estate, which highlights some doubts on the credit rationing policy of the Central Bank.

The econometric model of the demand for-and-supply-of money function shows that the equilibrium level of the money stock is determined by external and internal factors, with the Central Bank playing the role to accommodate the external pressures on local liquidity, rather than controlling the quantity of money.

The low interest rate policy adopted by the Central Bank shows that it has failed to secure a fair distribution of bank credit among the productive sectors in the local economy. On the other hand, it encouraged the speculative trends in the stock market and brought about inflationary impacts. Moreover, this policy along with the exchange rate policy has provided the right environment for capital outflow, and exposing the local liquidity to external influences. Nevertheless, the exchange rate regime (the basket peg) has succeeded in maintaining the stability of the Kuwaiti Dinar against the major foreign currencies, and avoiding some undesirable impacts on the Kuwaiti economy resulting from the appreciation or depreciation of the Kuwaiti dinar.

The implementation by the Central Bank of monetary policy instruments shows that these instruments were introduced either to help the commercial banks to overcome their liquidity problems in local currency, or to regulate this liquidity among them: therefore, no attention whatsoever was paid to controlling the credit policies of the commercial banks. Such conclusion is evidenced throughout this study either by the exposition of the tendencies behind the introduction by the Central Bank of its instruments of control, or by its neglecting to make effective use of these instruments in accordance with their orthodox concepts. The main findings are discussed and a series of recommendations to enhance the use of the monetary policy instruments are suggested.

HABIB A. AL-NAQI.

MONETARY POLICY APPLICATION  
IN THE OIL-EXPORTING COUNTRIES.

THE CASE OF KUWAIT.

HABIB A. AL-NAQI.

Submitted for the degree of Master of Philosophy  
at the University of Durham.

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DECLARATION.

The work described in this thesis was carried out in the Department of Economics at the University of Durham between January 1989 and December 1990. All the work is my own unless stated to the contrary and it has not been submitted previously for a degree at this or any other University.

Habib A. Al-Naqi.

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Habib A. Al-Naqi.

C H A P T E R     O N E

INTRODUCTION

During the period following the Second World War, more attention was focussed on the economic development of the developing countries. During this period, the Keynesian framework of the role of money and monetary policy was considered the appropriate method to stimulate economic growth under price stabilization. It was thought that a monetary policy of expansion with low interest rates, together with the increasing trend towards government expenditure, would stimulate economic growth, especially with regard to the idle resources in these countries. Owing to inflationary pressures, partly the result of severe bottlenecks on the supply side, the Keynesian approach has failed to cure the problems of economic growth in the developing countries; attention has shifted to the other extreme of the quantity theory framework, which had also failed to represent the appropriate approach to economic growth in these economies. As a result, many economists have argued that the economic concepts appropriate to developed countries are inappropriate for the developing economies, and that new economic concepts should be considered, and the actual role of money in these countries reappraised. It is believed that the role of money as a medium of exchange and store of value is still vital, but the function of money as a channel through which resources can be passed from surplus units to investors as an integral part of a



comprehensive development plan is still underestimated. For a more comprehensive survey, see Coats and Khatkhate (1983).

Indeed, there is a big difference in terms of both economic structure and institutional framework between the developed industrialized countries and the developing countries. The undeveloped financial markets and a shortage of financial instruments are major obstacles for any effective monetary policy through which the monetary authorities seek to execute their policies and achieve their objectives, either within the monetary sector or the real sector. Moreover, since most of the developing countries gained autonomy after the Second World War, the establishment of Central Banks in these countries was more a show of prestige than a decision to implement a monetary policy backed by economic concepts.

In general, the role of money and monetary policy in the economic growth of the developing countries is handicapped by age-old habits such as commodity hoarding and the existence of unorganised markets. Furthermore, the power given to monetary authorities to pursue their monetary policy is still influenced by the central government or finance ministry.

### The Conditions in The Oil-exporting Countries of the Gulf

The oil-exporting countries in the Gulf region have their own economic peculiarities, thanks to their dependence on

oil revenues on the one hand, and their dependence on the rest of the world for imports on the other. In these economies, monetary policy has been either neglected or influenced by the reliance of the authorities on public expenditure being at the forefront of the economic development plans. After the discovery of oil in these countries, the governments found themselves faced with a long list of priorities in terms of economic development and modernization. It was the public sector that had to take the lead in diversifying the economy into its new phase. Hence, it is believed that the predominant role of the public sector during the period of economic growth has led to the neglect of the role of the monetary policy, despite the existence of monetary authorities in these countries. The role of the monetary authorities has been that of government banker and issuer of local currency.

Although the role of the public sector in the economies of the oil-exporting countries appears to overshadow the role of monetary policy, there has been a growing trend towards the strengthening of the role of the monetary authorities. This trend has taken either the form of giving more power to the Central Banks, as was the case in Kuwait in 1977, or the form of converting their currency boards or monetary authorities to fully fledged Central Banks. The role of monetary policy has been encouraged by the inflationary trends occurring during the late Seventies as a result of rising public expenditure and the inability of fiscal policy alone to achieve the objectives of economic

development in these countries. Thus fiscal policies have been totally dependent on public expenditure programmes, which rely on oil revenues with no taxation schemes or public debt instruments to back expenditure.

Furthermore, the smallness of the economies of the oil-exporting countries, together with their openness to the rest of the world, has led external pressures to exert great influence on their local liquidity, which in turn prevents the monetary policy from effectively controlling the money supply. The expanding patterns of banking credit in these countries, especially after the oil price rises of October 1973, presented a further challenge to the expected role of the monetary policies. Therefore, external pressures generated by the movement of foreign interest rates, and internal pressures caused by the expanding credit policies implemented by the banking systems in these economies, represent the actual dilemma faced by the monetary authorities.

However, the undeveloped financial markets in these countries represent another challenge to the monetary authorities, since these markets are considered major vehicles for the monetary authorities to use in order to bring their policies to bear on the whole economy.

#### Monetary conditions in Kuwait

Like most oil-exporting countries, Kuwait's dependence on the rest of the world for its imports is absolute.

Furthermore, the country is dependent on its oil revenues to fund its development programs. During the 1970s, as a result of the rise in oil prices in October 1973, the government expenditure expanded considerably to meet development requirements such as infrastructure and public services. Moreover, the commercial banks also expanded their credit to the local economic sectors in response to the expansionary tendencies of the economy. These conditions caused the money supply to expand and exert inflationary pressures on the economy. Thus it is believed that there are two main sources of price increase in Kuwait: the external source, generated by the rest of the world, especially the exporting countries; and the internal source, generated by the expansionary trends of government expenditure and banking credit. Thus, given these conditions, it is very difficult for the monetary policy in Kuwait to control the money supply in an environment of stable prices. Instead, maintaining the purchasing power of the Kuwaiti dinar against the major foreign currencies by choosing the appropriate foreign exchange regime is seen as a better strategy for the monetary policy to adopt.

Furthermore, the smallness of the Kuwaiti economy and the fact that it is open to the rest of the world, with no restrictions on capital movement and the available information about the international foreign markets, have allowed exogenous factors to exert their influences on local economic conditions and thus lessen the

effectiveness of the monetary policy. For instance, when foreign interest rates increase to levels above the local interest, local investors and depositors convert their KD funds into foreign currencies so as to maximize their returns, which is tempting when exchange risks are minimal. This capital outflow exerts great pressure on local liquidity, especially within the banking sector, and pushes the Central Bank to react by injecting more liquidity into the banking system through instruments such as the discount window and swap operations in order to allow the commercial banks to meet the local demand for bank credit.

However, external pressures on local monetary conditions are encouraged to a large extent by both the interest rate and the exchange rate policies adopted by the Central Bank. When the monetary authorities attempt to stimulate the real investment inside the economy by imposing a ceiling on lending rates, the local interest rates structure becomes uncompetitive compared with those on the foreign markets. On the other hand, the exchange rate policy adopted by the Central Bank, which ensures the stability of the exchange rate between the Kuwaiti dinar and U.S. dollar in particular, and other major foreign currencies in general, encourages the outflow of funds outside the local economy, since this policy can eliminate or reduce the risks of exchange.

Since its inception in 1968, the Central Bank of Kuwait has promoted its monetary policy instruments in order to

meet the objectives postulated in its Charter. The Charter was amended in 1977, and more power was given to the Bank in terms of exerting control on the banking system. The objective of the present study is to investigate the implementation by the Central Bank of its instruments of control in order to achieve its monetary and economic objectives. The researcher hopes to be able to recommend appropriate measures that have to be taken by the Central Bank in order to enhance the application of the monetary policy instruments and thus realize its objectives. The methods used in the study are theoretical, descriptive, and empirical.

This study will cover the applications of the monetary policy instruments in Kuwait for the period 1970 to 1988. This period is significant in that it covers the whole experience of the Central Bank of Kuwait in its monetary applications. This period also saw a dramatic rise in oil prices in October 1973, with far-reaching consequences for the local economy. Moreover, it was during this period that the impact of the Gulf War made itself felt, especially on the re-export activity in Kuwait. Two crises in the stock market also occurred during this period, the first in 1977 and the second in 1982; the latter in particular had a wide impact on the Kuwaiti economy. Furthermore, the Central Bank developed most of its monetary policy instruments during this period, and so one may build up from this a fairly complete picture of

the monetary policy applications and their effects on the Kuwaiti economy.

### Outlines of the study

Apart from the introductory chapter, there are eight other chapters and a Statistical Appendix.

Chapter Two illustrates the structure and characteristics of the Kuwaiti economy, with special emphasis on the role of the government in economic growth, given that the government owns the country's entire oil industry. The participation of the private non-oil sectors in the Gross Domestic Product is also discussed in this chapter. Foreign trade is also reviewed in order to highlight the over-dependence of the Kuwaiti economy on the rest of the world for its capital and consumer goods. All these topics are relevant to this study because of the strong interrelation between the monetary and real sectors.

Another aim in this chapter is to understand the economic conditions that influence the behaviour of the Central Bank of Kuwait, and hence affect its monetary applications.

Chapter Three deals with the development of the financial market in Kuwait. It is believed that through this market the monetary authorities can execute their monetary policies and exert their influence on the real sector. The behaviour of the various components of the financial market are discussed, and the balance sheet of the Central

Bank of Kuwait and the consolidated balance sheet of the commercial banks, specialized banks, and investment companies are studied. Moreover, the behaviour of other participants in the financial market, e.g. money-changing companies and the Stock Market, is also investigated. Special emphasis is placed on the distribution of banking credit among the various productive economic sectors, and the shares of these sectors in Gross Domestic Product are compared.

Chapter Four is devoted entirely to an econometric model which aims to determine the monetary and economic variables that influence the behaviour of the money stock in Kuwait. Topics such as the appropriate definition of money, the monetary base, and the role of the multiplier are discussed in the theoretical section of this Chapter. In the model specifications, all the monetary and economic variables that are believed to influence the demand for, and the supply of, money are discussed in detail, as are their effects and interrelation in the local economy. For the empirical work of the model, the demand for money function is disaggregated into three equations for a specific realization of the factors that determine the demand for each component of the monetary stock (currency in circulation + sight deposits + time deposits). This disaggregation is based on the assumption that different motives lie behind the demand for each of those components, while the supply of money function is represented in one equation. The Ordinary Least Squares

method (OLS) is used to estimate the four equations by using quarterly statistical data for the period 1970-1988. Some of the quarterly data were difficult to obtain, especially for the early 1970s. A discussion of the results of the empirical work is found at the end of the chapter. The importance of this chapter to the study as a whole lies in the simple fact that, in order for an effective monetary policy to be pursued, the behaviour of the monetary stock, and those factors which influence it, must be perfectly understood.

Chapter Five concerns the objectives of the monetary policy in Kuwait. Since the use of the monetary control instruments should be guided and then judged in accordance with certain objectives, an attempt is made in this chapter to delineate the objectives of the monetary policy. In this context two sets of objectives are postulated. The first set is derived from the Charter of the Central Bank of Kuwait and from other sources such as the governors of the Bank and its published reports. The second set is derived from the literature concerning the application of the monetary policy in developing countries. This chapter also addresses the issue of the independence of the Central Bank of Kuwait and its relationship with the government in general and the Ministry of Finance in particular. In this discussion, the elements of conflict between the Ministry of Finance, which is responsible for the fiscal policy, and the

Central Bank, which conducts the monetary policy in the country, are reviewed.

Chapter Six deals with the interest rate policy of the Central Bank. This policy is seen as an important weapon that the monetary authorities can employ to control banking credit and influence other market conditions. The chapter begins with a theoretical discussion about the prominent role of the interest rate in developing countries. The various applications of the interest rate policy in Kuwait during the period of study are discussed in detail in connection with their impact on local economic conditions. Given that the Central Bank of Kuwait has imposed ceilings on lending rates for most of the period of this study, the researcher has focussed on the results of this imposition on the distribution of bank credit among the productive sectors in the local economy. The connection between the tendency of the monetary authorities to impose the ceiling in favour of the borrowers, and the nature of the saving-investment mechanism in Kuwait, is investigated in order to provide an evaluation of the validity of this policy. Other topics investigated include the interrelation between local and foreign interest rates, the reaction of individual depositors and the commercial banks to changes in the local interest rates structure, and the relationship between the interest rate policy and the exchange rate policy. Finally, since the Central Bank of Kuwait introduced a new interest rate structure in

December 1988, in which the discount rate was used for the first time as the key rate to control all interest rates included in the new structure, and ceilings were imposed on interest rates paid on bank deposits, the motives behind the introduction of this structure as revealed by the Central Bank of Kuwait are discussed, together with other possible motives suggested by the researcher.

Chapter Seven concerns the exchange rate policy and its monetary application in the Kuwaiti economy. The chapter begins with a theoretical discussion about the optimal choice of the exchange rate regime in developing countries. The Kuwaiti experience of its choice of peg (basket peg) is reviewed in the context of the effort of the monetary authorities to pursue the stability of the exchange rate of the Kuwaiti dinar against the major foreign currencies. However, since the Kuwaiti economy is import-oriented, it is considered very difficult for the monetary authorities to achieve stability of prices via control of the monetary stock; instead, maintaining the purchasing power of the local currency by adopting the appropriate exchange rate regime becomes the major objective of the exchange rate policy of the Central Bank of Kuwait. This issue, along with the impact of the appreciation and depreciation of the Kuwaiti dinar on the local economy, is addressed.

Since the component and the weights of the foreign currencies included in the basket regime that determines the exchange rate of the Kuwaiti dinar are unknown, a

hypothetical example of the mechanism of the basket peg is presented, with special consideration given to the role of the U.S. dollar in the basket. Finally, the choice of the basket peg is submitted to three tests, the aim being to evaluate the ability of the basket peg to maintain the stability of the exchange rate of the Kuwaiti dinar against the major foreign currencies, and to determine the impact of this choice of peg on the cost of imports and the depletion of the main source of income in the local economy (oil revenues). These tests are based on a comparison between the choice of a basket peg and the alternative choice of the peg to a single foreign currency (U.S. dollar).

In Chapter Eight we discuss two issues: the lending policy of the Central Bank and its efforts to regulate the liquidity positions of the commercial banks. In the discussion on the lending policy of the Central Bank, two instruments of control are used: the discount window and direct lending. The implementation of these two instruments is investigated in connection with the traditional role of the Central Bank as "the lender of last resort". The extent to which the Central Bank is using these instruments to influence bank credit in favour of the productive sectors in the economy is also explored. The use of the discount rate and the direct lending rate as a bank rate or penalty rate to influence the market rates are also tackled in the context of local conditions. Moreover, the external influences on the domestic banking

system are pointed out through the interrelation between the discount operations and the movements of foreign interest rates.

In the discussion on the regulation of the liquidity of the commercial banks, five instruments of monetary policy are presented. These instruments are discussed and evaluated in the light of their influence on the reserve positions of the commercial bank, and hence on the monetary stock, with special emphasis given to the role of the reserve-requirements ratio. In addition to the presentation provided in Chapter Three regarding the development of the financial market, two measures are used in this chapter to evaluate the evolution of the financial market in general, and the banking services in particular.

Finally, Chapter Nine presents a summary of the findings of the study, along with the relevant recommendations. Suggestions for further research are also made in this chapter. The Statistical Appendix contains all the basic data used in the econometric model in Chapter Four.

## C H A P T E R     T W O

### STRUCTURE AND CHARACTERISTICS OF THE KUWAITI ECONOMY

The objective of this chapter is to present an overview of the structure of the Kuwaiti economy. Although this study is concerned mainly with the monetary sector, the interrelation between the latter and other sectors in the economy is so obvious that it can not be ignored. One example is the impact of credit control policy on the evolution of the various economic sectors, and the effect of the expansion of the money supply on prices.

This chapter will contribute to an understanding of the following points:

- 1) The historical background and the current situation of the Kuwaiti economy.
- 2) The interaction and the behaviours of the different sectors of the economy.
- 3) The peculiarities of the Kuwaiti economy.

#### Historical Background

Kuwait has been classified as a developing country in most of the literature that has been concerned with the Kuwaiti economy but in reality the Kuwaiti economy through its rapid change has defied the traditional classification of either a developed or a less developed economy. A shortage of capital is the main difficulty that most developing countries are facing, but Kuwait has not

experienced this problem for many decades since the emergence of its modern economy in the 1950s. Moreover, it experienced a high per capita income, a good annual growth rate and a balance of payments surplus, which are all indicators of a developed economy. But on the other hand, it shares with developing countries some of their characteristics, such as, the total dependence on the export of a single primary commodity (oil), the lack of a domestic supply of skilled labour, the need to import almost all capital and consumer products, and the influence of external conditions over domestic economic variables. Thus the main source of income from oil exports is vulnerable to international market conditions, and price stability is influenced by exogenous factors. The question for Kuwait in terms of economic development is how to employ the surplus funds resulting from oil extracting to meet development priorities. Despite the fact that Kuwait has succeeded in developing its oil industry by establishing refining and petrochemical activities, through diversification efforts in the domestic economy, the country remains dependent on basic primary production. It of course, maintains various investment portfolios in different parts of the world, especially in the United States of America and western Europe, as a potential substitute for the reliance on one source of income. Nevertheless, it can be argued that domestic oil industry still depends on a depletable commodity (oil), while foreign investment is subject to

some extent to external constitutional and political factors.

Since 1946, when the first oil shipment was exported, Kuwait started enjoying a high standard of living, compatible with a modern industrialized country.

"The country's growth since then (1946) has largely mirrored the smooth and swift exploitation of its vast oil reserves. Within a span of no more than fifteen years, its population came to enjoy living standards normally considered the prerogative of the most developed among the industrialized countries. The pattern of growth that Kuwait has experienced since 1946, the development of its infrastructure, institutions and welfare systems that has evolved are unparalleled in modern history."

(Khouja and Sadler, 1979, p.25).

Moreover, oil has not only become the predominant sector in the economy, but has also substituted for some existing sectors such as seafaring and fishing. As a result of oil exploration, and the small Kuwaiti population, which was estimated in 1946 at Ninety thousand (90,000) people and only half a million in the late 1960s, modernization touched all aspects of life in the country.

A persistent capital surplus was demonstrated in the gap between government revenues and expenditures, a comparison between the total savings and the amount invested locally, and in the balance of payments (see El-Mallakh, 1968). This was due to the increasing levels of oil production and the increase in oil prices, specially after the dramatic rises of 1973. In the beginning of the 1980s, Kuwait applied a rational scheme to oil production in

order to reserve its vital source of income, which was encouraged by the unfavourable market conditions.

Nevertheless, the question of why Kuwait has been and is still extracting oil in quantities exceeding its requirements for development will be answered in this chapter.

As mentioned earlier, the Kuwaiti economy became overdependent on the rest of the world for imports of capital and consumer goods and even for the labour force it needed. In the government budget of 1985/86 the revenues from abroad represented 94.8 percent of the total revenues, and the expatriate labour force represented 71.6 percent of the total labour force according to the 1985 census. The latter indicator constitutes a major issue facing the policy makers in the country. This phenomenon has increased over time because of the small population of the Kuwaitis coupled with the rapid growth of the economy during the last three decades. As a result, the Kuwaitis became a minority in their own country. In 1989, officials announced that the Kuwaitis represent only 27 percent of the total population of over 1.8 million. In the five-year plan for 1985/86-1989/90, the adjustment of the population structure is clearly stated as the first objective to be achieved during the plan period. Nevertheless, it can be argued that ongoing development projects will without doubt not succeed in the absence of an expatriate labour force. Yet, there are many political

issues underlying the existence of half a million Palestinians living in Kuwait.

Another peculiarity of the Kuwaiti economy is the dominant role played by the government. This is due to the fact that the government controls the oil industry exclusively, and is committed to provide free health and education services, subsidized electricity, water and food. It participated with the private sector to set up various economic activities such as banks, insurance companies, investment companies, and manufacturing; even now it gives donations to run sport clubs and social societies. Moreover, jobs and houses are available for all Kuwaitis. This behaviour, combined with the absence of income tax, has created a nation totally dependent on its government. When the unofficial stock market (Soukh Al-Manakh) collapsed in 1982, it was popularly expected that the government would interfere to solve the problems and rescue the losers. Through a series of special measures, the government tried to terminate the consequences of the crisis. The main danger was the threat to public confidence in the banking system, due to the fallen values of the collateral held by banks, and the inability to repay or to service most of the due credit facilities by the borrowers, which again induced the government through the Central Bank to present, "The Difficult Credit Facilities Settlement Program", in August 1986. Through the implementation of this program the government will sacrifice a certain amount of funds by placing deposits

with the affected banks for low or zero interest rates in order to allow them compensation for their bad debts.

However, this outstanding role of the Kuwaiti government was criticised on the grounds of its typical deficiency in administering the development plans in the developing countries. Khouja and Sadler (1979) argued that in view of the relatively low degree of efficiency of government agencies and enterprises, a continuation of the dependence on the government's role in the economy might impede development efforts. This argument was supported by the World Bank mission on the "Promotion of Manufacturing in Kuwait" (1977). It drew attention to the apparent lack of coordination among various government agencies, and the lack of an explicit, coherent policy on development and diversification within which such agencies can work.

### The Oil Sector

It was mentioned that the emergence of the modern economy of Kuwait in 1946 was started by the first shipment of oil. But the history of oil began in December 1934 with the establishment of the Kuwait Oil Company (KOC) by the Gulf Oil Corporation and the Anglo-Persian Oil Company (which later became British Petroleum). A concession was awarded to KOC to develop and market oil found within 6000 square miles of land and territorial water until December 2000. Accordingly, the Kuwaiti government was to be paid U.S. \$ 0.13 per barrel royalty, compared with U.S. \$ 0.22 per barrel which was being paid to the governments of

Iran, Iraq and Saudi Arabia. In 1962, over half of the original concession area came under the control of a company established in 1960, the Kuwait National Petroleum Company (KNPC).

Other concessions were granted to other companies after the Second World War. In 1948 Aminoil (American Amalgamated Oil Company) was given the right to explore and develop Kuwait's 50 percent interest of the Neutral Zone for sixty years. The same company was granted another sixty-year concession in 1955 to explore and extract oil in Kuwait's territorial water and from some of its islands. The Arabian Oil Company Ltd. (AOC), a subsidiary of the Japanese Trading Company, was granted a concession in 1958 for forty and a half years with oil exports to Japan beginning in 1961. In the latter case, the concession included a provision which gives the government of Kuwait the option to buy 10 percent of AOC's shares at the issue price upon the discovery of oil. A concession of forty five years was given to the Kuwait Shell Petroleum Development Company, Ltd. (KSPDC) in 1951, with reserved rights to acquire 20 percent interest upon the discovery of oil in commercial quantities.

All terms of the foregoing concessions were subject to various amendments over time to give the country more control over its major source of income. In 1972, when the oil-producing countries of the Gulf states gained 25 percent participation in oil production from major oil companies, Kuwait was already entitled to 25 percent of

oil production by KOC. In January, 1974, its share was extended to 60 percent, and full participation was completed by December 1975. In 1977, Aminoil's concession was terminated; this left the Japanese with a 40 percent share.

### The dependence of the Kuwaiti economy on oil

The dependence of the Kuwaiti economy on the oil sector can be examined through the following ratios:

- 1) Oil GDP to total GDP.
- 2) Oil revenue to total government revenues.
- 3) Oil exports to total exports.

Oil GDP registered an average of 58.2 percent of the total GDP for the period between 1970 and 1987. The highest ratio was recorded in 1974 at 79.3 percent, which reflected the striking increase in oil prices in October 1973, while the lowest ratio was registered in 1986 at 36.8 due to the unfavourable market conditions. Thus, the price of one barrel of Kuwaiti crude oil has declined from \$ 25.75 in January 1986 to \$ 7.40 in July of the same year. Non-oil GDP has shown more smooth and reasonable trends through the period, which registered 39.7 percent of total GDP in 1970, and 61.9 percent in 1987, averaging 41.7 percent and moving in the opposite direction to the trend of oil GDP. This is mainly caused by the influence

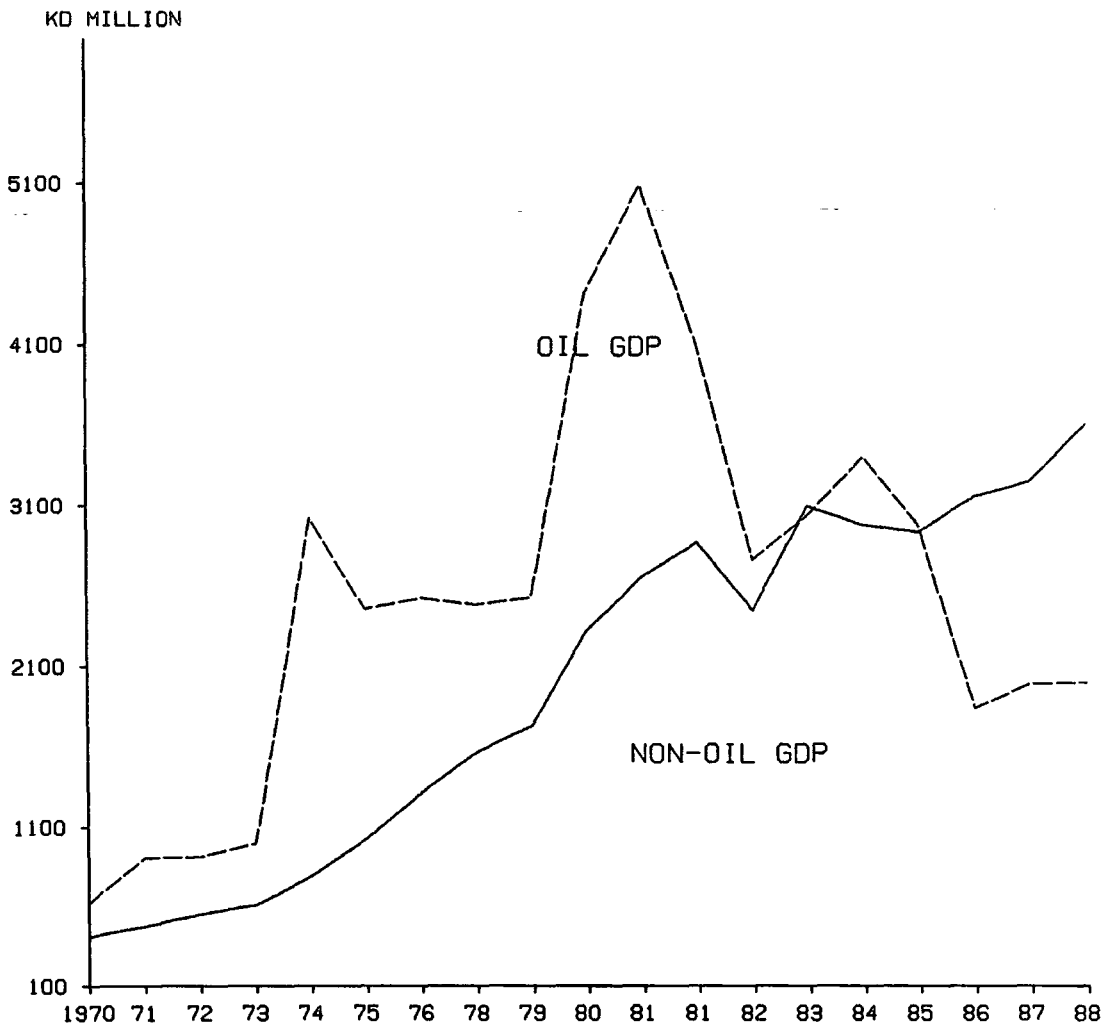
of exogenous factors over the oil sector. These factors are mainly the demand and supply forces in the oil markets, the degree of convergence which prevails among oil-producing countries, and the energy saving efforts of oil consumers.

Figure 2.1 illustrates the ratio of oil and non-oil GDP in total GDP, and shows to what extent the total GDP has been influenced by the oil sector. It also indicates that there was no direct relationship between the two sectors in the short term. When the oil GDP reached its highest level in 1974, the non-oil GDP registered its lowest, while the opposite occurred in 1986.

Oil revenue within government total revenues (total government revenues include income from investments abroad), registered an average at 75.7 percent through the period between the 1970/71 to 1985/86 (fiscal years). The highest ratio of the oil revenue was observed at 92.2 percent in 1974/75, while the lowest was at 43.3 in 1985/86. This volatility of oil revenue was attributed to the oil market conditions. Figure 2.2 shows the relationship between the oil revenue and the total revenues that the government relies on to run the economy. Hence oil revenue has become the main source of foreign exchange earnings.

The third ratio through which to examine the dependence of the Kuwaiti economy on its oil sector is the ratio of oil exports to total exports (Figure 2.3), which averaged at

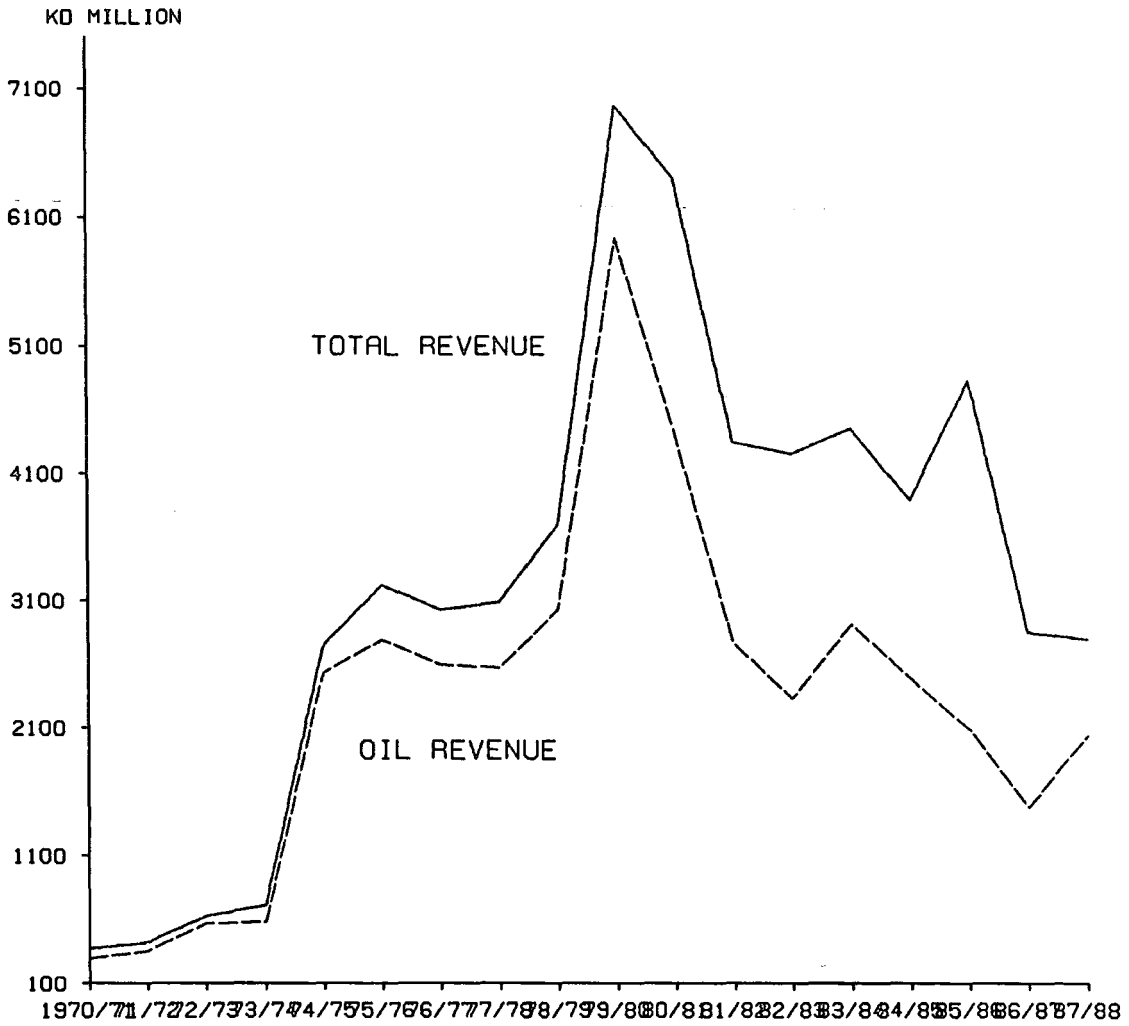
FIG:2.1 OIL AND NON-OIL GDP



SOURCE: CENTRAL BANK OF KUWAIT



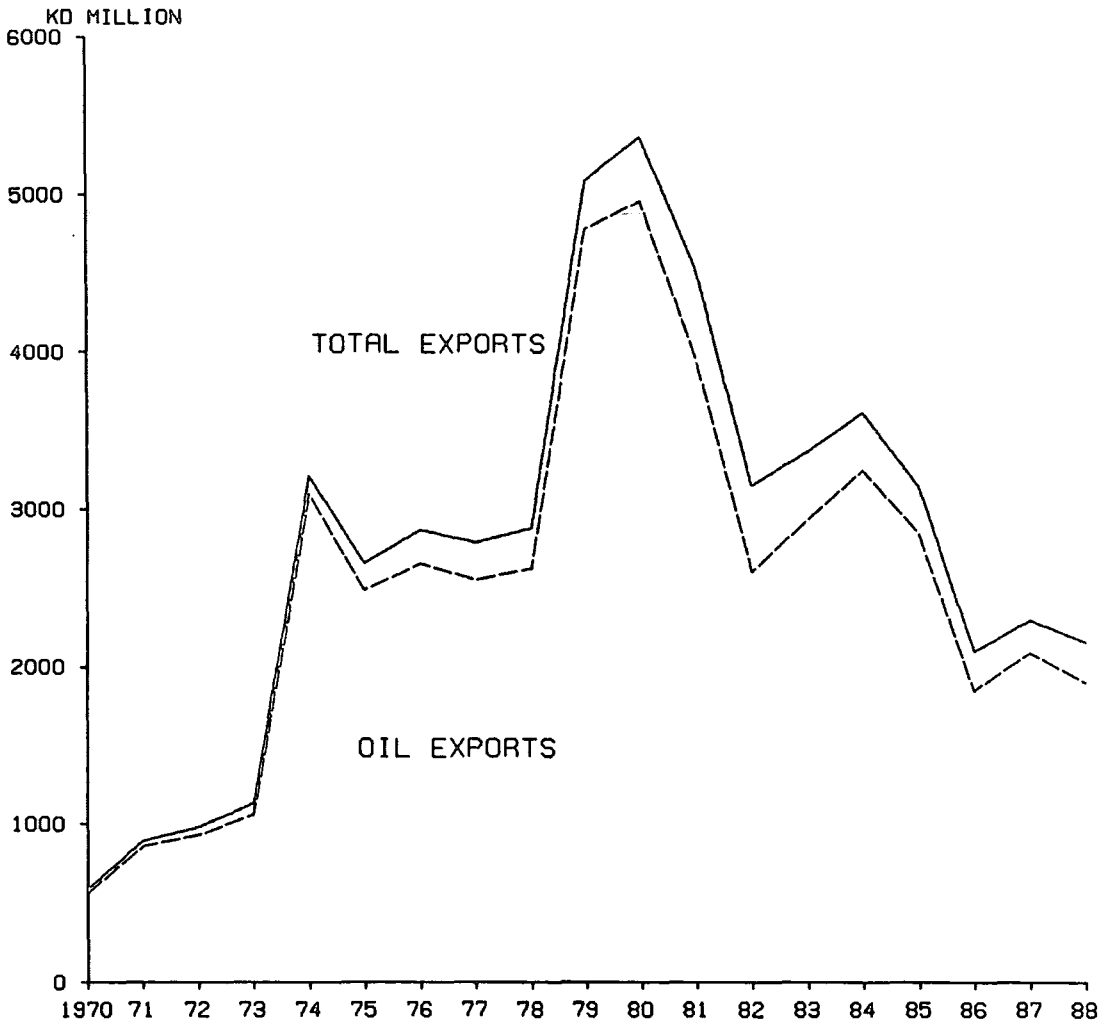
FIG:2.2 OIL REVENUE AND TOTAL REVENUE



SOURCE: CENTRAL BANK OF KUWAIT



FIG:2.3 OIL EXPORTS AND TOTAL EXPORTS



SOURCE: CENTRAL BANK OF KUWAIT



91.6 percent throughout the period 1970 to 1987. The highest ratio registered was 96.1 percent in 1971 and the lowest was 82.7 in 1982. Conversely to the fluctuation pertaining between the first two ratios, the production of crude oil has exercised a rapid increase from 5.9 million U.S. barrels in 1946 to 1102.5 million U.S. barrels in 1973. From 1984 to 1987, oil production was subject to noticeable fluctuation to maintain the balance between oil market conditions and the persistent need of the government for a constant level of revenue to fulfil its commitments to the maintenance of an advanced welfare state.

Non-oil exports have shown a consistent growth for the period between 1970 to 1980, with re-exports accounting for a considerable portion. After the outbreak of the war between Iraq and Iran, re-export activities declined continuously, and the total of non-oil exports was affected negatively.

Moosa (1986) found out from a simple regression that the growth of oil GDP is the main determinant of overall economic growth for the period 1970-1982, where

$$R^2 = 0.996.$$

Kuwait enjoys remarkable oil reserves, which are estimated at 71.2 billion barrels, and represent 11 percent of the world's total known reserves. According to information about total crude oil production in 1985, at 387.4 million

U.S. barrels, these reserves could last for 153.8 years; even if they were exploited at the peak level registered in 1972, at 1201.6 U.S. barrels, they would last for 59 years. This favourable condition, can be considered a great advantage to the country in implementing its development plans. But despite this fact, it can be argued that oil production has exceeded the development requirements of the economy and government domestic consumption, especially as oil production involves an extracting of the depletable national wealth, and transforming it into national income. El-Mallakh and Atta, (1981, p.20) stated that Kuwait did not need to produce more than 22 percent of what it produced in order to cover its development expenditures and domestic consumption for the period between 1970 to 1977. This argument seemed to be evidenced by the accumulated balances of foreign exchange invested abroad that yielded 2.5 billion Kuwait dinars in 1985/86, when oil revenue was 2.34 KD billion. That past trend of oil production was also criticised and related to some extent to the political relations influenced by the developed industrialized countries over the Gulf countries (see Al-Tammar, 1985).

There were a number of issues which determined the level of oil production, which were perhaps the basis of such an argument. First was the need to compensate for the poverty that the Kuwaitis had suffered for a long time before the discovery of oil. Second was the distribution

of the national wealth among the population. Third, there was a need to create an alternative source of income (see Al-Khalifa, 1979). Fourth, Kuwait had committed itself to help the Arab and third world countries.

The need for diversification in the local economy seemed to be quite obvious in the case of Kuwait. Thus, Kuwait started its first effort to diversify the source of income in the 1950s, with the setting up of the water desalination plants. But the major efforts started in 1961, with the establishment of the Shuaiba Industrial Zone and the related supporting services. Diversification in Kuwait towards industrialization could be summarized into three areas: oil refining, the petrochemical industry, and relevant services.

Table 2.1 shows the rapid growth of the export of refined oil to the total exports of the petroleum products. It increased from 14.1 percent in 1970 to 49.5 percent in 1985. Despite a portion of this increment necessitated by the depressed demand for crude oil, the export of refined oil has registered an annual growth rate of 8.9 percent between 1980 and 1985. The petrochemical industry is based on the production of fertilizer, which comprises urea, ammonium sulphate, ammonia and sulphuric acid. This industry has experienced a noticeable fluctuation due to the uncertainty and the competition in international markets. The related supporting services are mainly represented by the sea transportation of crude oil and gas.

Table 2.1: Refined-Oil Exports 1970-1985  
(Million barrels)

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	1970	1975	1980	1985
Crude Oil Exports	941.7	652.7	477.0	173.7
Refined-oil Exports	154.6	107.6	111.3	170.6
Total Petroleum Exports	1096.3	760.3	588.3	344.3
Refined-oil Exports to Total Petroleum Exports (%)	14.1	14.2	18.9	49.5

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Source: Central Bank of Kuwait, Quarterly  
Statistical Bulletin (Oct-Dec, 1974-1988).

### Non-Oil Sector

It was mentioned earlier that non-oil GDP has shown a continuous growth from KD 407.51 million in 1970 to KD 3250.0 million in 1987. Despite the fact that the non-oil sector consists of various economic activities, its average participation in total GDP has been less than the participation of the oil sector, which for the former averaged 41.7 percent for the period from 1970 to 1987. This illustrates the difficulties encountered in the efforts to develop and enlarge the base of the economy. These difficulties can be attributed to various reasons, as the following survey will disclose.

### Agriculture and Fisheries

Agricultural production plays a very marginal role in total GDP. Its share was 1.1 percent in 1986, increasing from 0.3 percent in 1970, as illustrated in Table 2.2. The labour force involved in this activity numbered 12,632 (including fisheries), according to the 1985 census, and represented only 1.8 percent of the total labour force. The low output of agriculture could be attributed to many reasons, including the severe climatic conditions, poor soil, scarcity of irrigation water and a limited supply of trained manpower. Out of the area of Kuwait of 17,818 kilometres, only 9.0 percent is cultivatable, as estimated by the Central Statistical Office in 1985, which is almost the same estimation as it was in 1970. In order to overcome the irrigation problem, the government reached an

agreement with the government of Iraq in 1989, by which Shat Al-Arab water will be supplied to Kuwaiti cultivated land, and in return, the Kuwaiti government will supply the south part of Iraq with electricity. Nevertheless, it is doubtful that such an agreement can be relied on, due to the unstable political relations between the two countries, in spite of the positive stand of the Kuwaiti government with Iraq during the Gulf war.

However, the fishing industry could have better prospects than agriculture, as the output of the former already satisfies more than 90 percent of total domestic consumption. In recent years, the government has encouraged the development of the fishing industry, and intensified research work through the Kuwait Institute for Scientific Research (KISR) to secure and increase fish production.

### Manufacturing

Table 2.2 shows an increasing share of manufacturing output in total GDP, averaging 4.4 percent in 1970 and 11.3 percent in 1980. In the non-oil GDP, the percentage of manufacturing was found to be 18.0 percent in 1986.

Incentives were offered by the government to encourage the private sector to participate in the industrial-development programme, such as:

1. Ten years tax exemption for legally registered industrial firms.

Table 2.2: Economic Sectorial Participation in GDP (%)  
(Current Prices)

Sector	1970 %	1975 %	1980 %	1985 %	1986 %
1. OIL	57.2	70.5	66.2	50.9	37.3
2. NON-OIL	42.8	29.5	33.8	49.1	62.7
- Agriculture & Fisheries	0.3	0.2	0.2	0.7	1.1
- Manufacturing	4.4	5.7	5.6	6.5	11.3
- Electricity, Gas & Water	0.7	0.4	(1.0)	(2.6)	1.9
- Construction	2.8	2.1	3.6	3.4	3.2
- Wholesale & Retail Trade	8.0	6.1	7.2	8.5	9.5
- Transport, Storage & Communications	2.6	1.7	2.4	4.1	5.1
- Financial Institutions	3.2	1.1	2.2	3.8	4.4
- Insurance	0.1	0.2	0.2	0.3	0.3
- Others	20.6	12.1	12.4	21.8	25.9
1 + 2	100	100	100	100	100

Source: Central Bank of Kuwait, Quarterly  
Statistical Bulletin (Oct-Dec, 1974-1988)

2. Tariff protection against similar imported goods for ten years.
3. No import duties on industrial goods.
4. Preference given to domestic products in government purchases.

In addition, the Industrial Bank of Kuwait (IBK) was established in 1974 as a joint private/government venture to finance manufacturing activities. Nevertheless, and apart from the petroleum industry, private sector industry has been exposed to serious constraints, such as the lack of raw materials, obsolete know-how, dependence on an expatriate labour force and rigorous competition from imported products. One noticeable feature of domestic industrial firms is the high proportion of production intended to cover the regional markets of the Gulf countries, as Kuwait had exceeded its neighbours in this field. This pattern generated high direct costs after the Gulf countries copied almost every form of industrial activity of Kuwait; consequently, a tremendous drop in sales occurred, especially to Saudi Arabia, the largest market for Kuwaiti products. Poor administration has been another factor inhibiting industry for a long time, either because of the lack of trained staff, or the disengagement of the people involved in the business (see, Report on Activating the Economic Movement in Kuwait, 1985).

### Construction

Large scale construction work began in the late 1940s, following the exports of oil and the resultant revenues. There was a natural stimulus to the building industry. The government of Kuwait has succeeded in building up the infrastructure of the country and providing all the services needed by the public, including education, health, communication, housing, electricity and water. The participation of construction output in total GDP has shown a consistent percentage through the period from 1970 to 1986, as it registered 2.8 percent in 1970 and 3.2 in 1986, while it averaged 8.3 percent of non-oil GDP for the same period. Investment by the private construction sector depends totally on government expenditure, as the latter plays the main role in the Kuwaiti economy. For the period between the 1970/71 and 1986/87 fiscal years, government expenditure on construction represented 19.0 percent and 17.5 percent of total expenditure respectively.

### Foreign Trade

The Kuwaiti economy is an open economy. Since the creation of the country three hundred years ago, trade has been encouraged by the difficult natural conditions and the geographical location of the country. Between 1970 to 1986, Kuwait has depended heavily on oil exports to meet its necessity for imports. Non-oil exports have represented a humble share in this sense and are regarded

as unreliable for import finance. None the less, non-oil exports have shown a growing portion in total exports, rising from 4.5 percent in 1970 to 11.9 percent in 1986, as illustrated in Table 2.3. The peak of non-oil exports occurred at 17.3 percent in 1982. Since then, it has declined because of the unfavourable effects of the Iraq-Iran war and the establishment of new ports in neighbouring countries. The collapse of the unofficial stock market also adversely affected trading activities, as demonstrated by the observation of letter of credit movement in the banking sector between 1983 to 1986 (Al-Sabah, 1987). Non-oil exports have been influenced by re-export activity, which were 75 percent in 1971 and 64.0 percent in 1986. The remaining part of non-oil exports are products of Kuwaiti origin and consist mainly of steel structures, prefabricated buildings, steel pipes and chemicals.

Imports comprise almost everything to cover requirements for development and consumption. Since oil revenues are the main available source of income, the value of imports is strongly related to oil exports. It is through revenue from the latter that the government finances its annual budgets and the people satisfy their increasing consumption, encouraged by the distribution of national income policies applied by the government. Table 2.3 shows the increasing trend of imports for the period 1970 to 1986. During the 1970s, imports increased almost eight times. The peak year for imports was in 1982 when the

Table 2.3: Summary of Foreign Trade  
(Million Dinars)

Year	Oil Exports	Non-oil Exports Other Exports	Exports Re-exports	Non-oil Exports to Total Exports (%)	Total Exports	Imports	Trade Balance
1970	564.5		26.4	4.5	590.9	223.3	367.6
1971	859.4	8.6	25.8	3.8	893.8	232.3	661.5
1972	931.7	16.4	33.2	5.1	981.3	262.2	719.1
1973	1059.9	27.3	42.5	6.2	1129.7	310.6	819.1
1974	3097.5	59.1	58.1	3.6	3214.7	455.1	2759.6
1975	2492.7	81.5	88.7	6.4	2663.0	693.2	1969.8
1976	2658.7	57.0	158.7	7.5	2874.4	972.0	1902.4
1977	2557.1	58.1	177.4	8.4	2792.6	1387.0	1405.6
1978	2628.7	68.5	166.9	8.2	2884.1	1263.9	1600.1
1979	4781.0	86.6	220.9	6.0	5088.5	1437.0	3651.5
1980	4960.8	113.1	302.6	7.6	5368.9	1764.9	3604.0
1981	3969.2	164.5	419.8	12.8	4530.8	1945.4	2608.1
1982	2611.5	147.1	397.9	17.3	3156.4	2384.6	771.8
1983	2938.2	121.0	314.3	12.9	3373.6	2149.1	1224.5
1984	3256.9	124.5	251.0	10.3	3622.4	2041.7	1590.7
1985*	2847.7		304.2	9.7	3151.9	1784.7	1367.2
1986	1853.4*	90.3	160.6	11.9	2102.3	1673.5	430.8
1987*	2096.7	-	-	-	-	1476.0	854.0

\* Provisional or estimated figures

Source: Central Bank of Kuwait, Quarterly Statistical Bulletin, (Oct-Dec, 1974-1988).

value reached KD 2384.6 million, a lag of two years after oil exports peaked in 1980. Since 1983, imports have declined, following the declining trend of re-exports and oil exports.

### Public Sector

The public sector is the dominant sector in the Kuwaiti economy, as the government owns the entire petroleum industry that produces over 60 percent of the GDP. In addition, its participation in most private sector activities was estimated at 43 percent in 1985.

Government revenues are earned from three main sources:

1. oil and gas sales,
2. foreign investments, and
3. other minor sources, namely, taxes on net income and profits of oil and non-oil companies, customs duties and charges for public services, which together represented 4.6 percent of total revenues in the 1985/86 fiscal year.

Oil income has been the pillar of government revenues for the period 1970/71 to 1985/86 (fiscal year) and for the period as a whole oil revenue averaged 73 percent of government revenues, while investment income averaged 19.5 percent for the same period. In 1985 and 1986 investment income exceeded oil revenue by 51.5 percent and 43.3 percent respectively. As the government's policy aims to

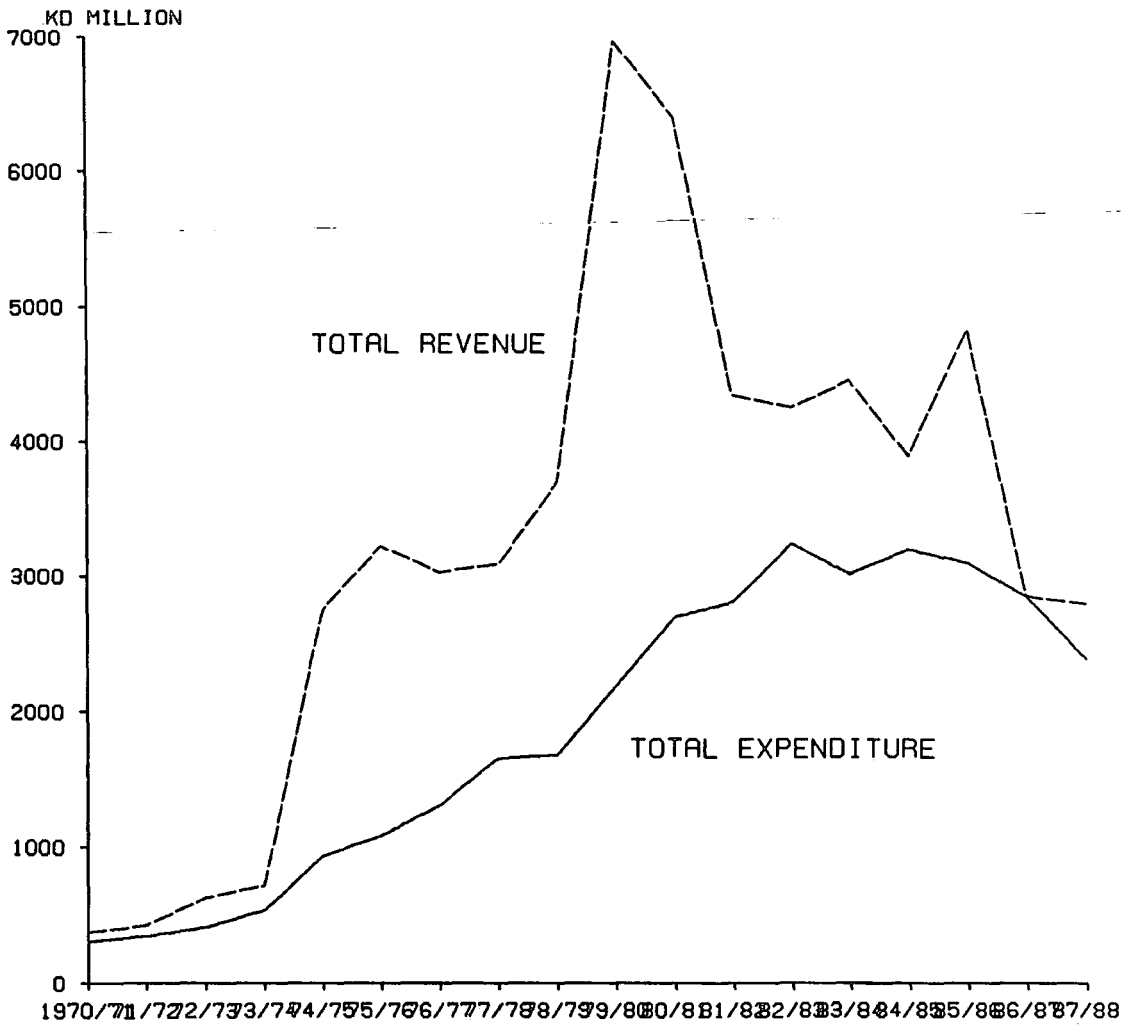
develop a substitute source of income for oil revenue, it can be argued that despite uncertainty concerning the condition of the foreign market, and other constraints, investments are a useful source of income. Problems can arise, however. One example is the dispute which occurred in 1989 between the Kuwaiti and British governments because of the Kuwaiti investments in the British Petroleum Company (BP). As a consequence, Kuwait had to dispose of its shares, which could have caused a great loss to Kuwait. Another example of constraints are the measures issued by the American government regarding foreign direct investment (see Al-Tammar, 1985).

On the expenditure side, five sections are classified:

1. current expenditure, which includes consumption of goods and services, salaries and wages;
2. capital expenditure;
3. development expenditure,  
(both 2 and 3 are concerned with domestic investments);
4. land purchase,  
which represents payments from the government to the public in return for their properties purchased by the state at higher prices than the market in order to allow them to enhance their living standards, or to build suburban public services; and
5. other expenditures.

Figure 2.4 shows that there is no direct one-to-one relationship between total expenditures and total revenues, because the government invests its foreign earnings from oil sales abroad and supplies its budgetary expenses by transferring available foreign currencies to the Central Bank against the purchase of Kuwaiti Dinars, which were distributed on a monthly basis by the Central Bank among the ministries and government agencies. Figure 2.5 demonstrates the increasing trend of total expenditures in spite of the downward trend of oil revenues, thus the government's annual budgets are influenced by domestic requirements and some political factors pertinent to foreign financial aid to other countries. Since the 1981/82 fiscal year, oil revenues have been unable to cover government expenditure, which has forced the government to call on a part of its general reserve to finance the deficit. The budget deficit has continued and become a prevailing feature of every annual budget. This raises critical issues, as the government has to liquidate its foreign investments to meet its budgetary obligations. Therefore a programme was applied to bring down the expenditure, which resulted in a 5.6 percent reduction for the period between the 1983/84 and 1986/87 fiscal years, and from KD 3248.2 million to KD 2400.6 million respectively. But, despite that, the government still needs more than the oil revenues, and the general reserve has to be called on. What made it worse was the declining exchange rate of the U.S. dollar

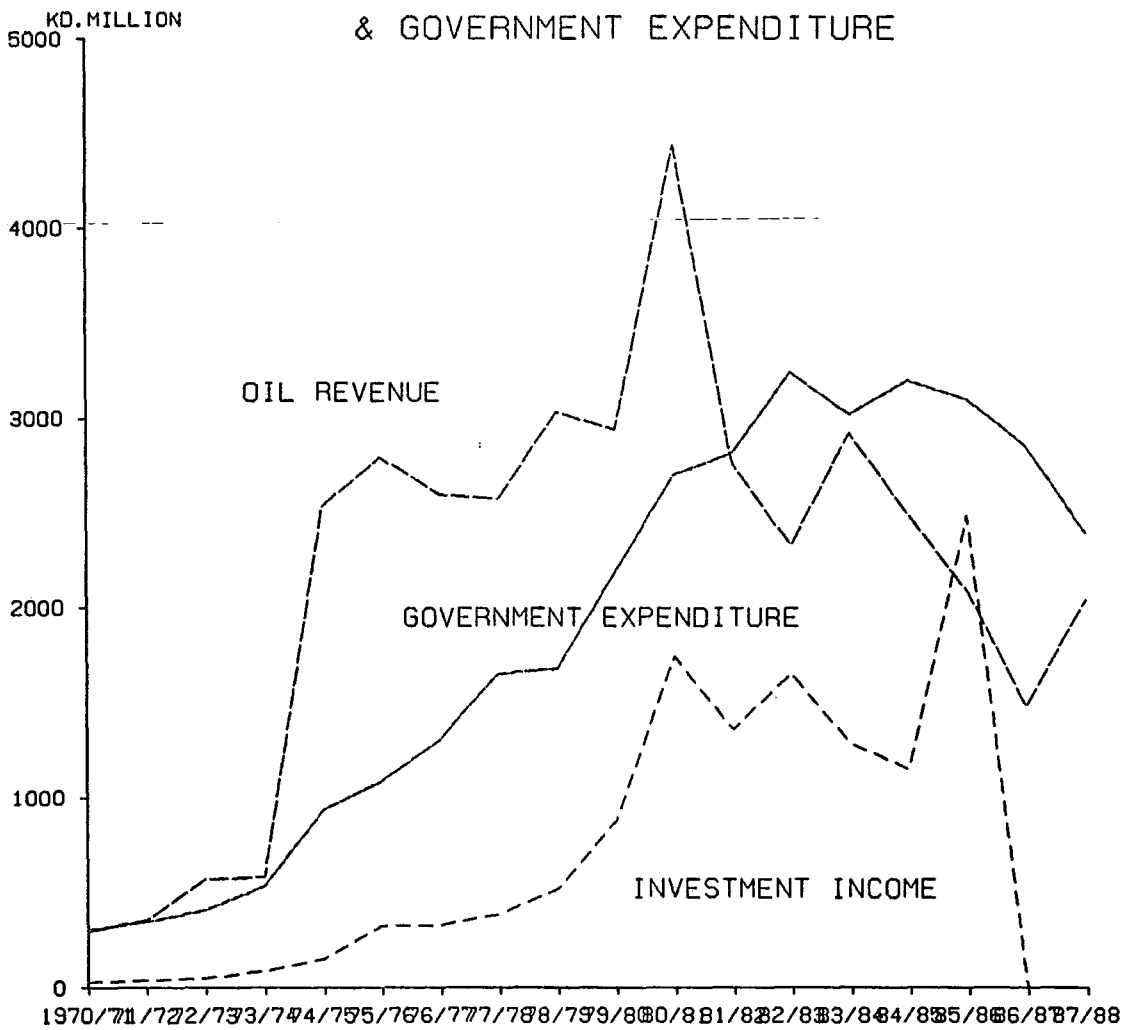
FIG:2.4 TOTAL REVENUE & TOTAL EXPENDITURE



SOURCE: CENTRAL BANK OF KUWAIT



FIG:2.5 OIL REVENUE, INVESTMENT INCOME & GOVERNMENT EXPENDITURE



SOURCE: CENTRAL BANK OF KUWAIT



in 1986-87, so more dollars have to be converted into KD to cover the budget deficit.

### Public Debt

For the first time in Kuwait, the government introduced its public debt instruments in November 1987 to finance the budget deficit. Two instruments were introduced, interest-bearing bonds of one to seven years' maturity, and notes of 90 days on an auctional discount base. The allocation of both was only to financial institutions in the primary market. Hence, individuals can buy them only through financial institutions or in the secondary market as they are issued for the bearer. Al-Sabah (1987) the Governor of the Central Bank, aimed to achieve two objectives by the creation of these instruments: first, to develop the financial market, and second, to strengthen the fledgling monetary policy by conducting open market operations, which means more control over the money supply.

### Labour Force

Labour force questions are another area of disagreement in the Kuwaiti economy. A shortage of labour is a common problem experienced by most of the Gulf countries in the face of the abundance of capital. Short and long-term development programs can only be conducted with reasonable control over the relevant elements to improve the economy gradually. The sudden flow of wealth which emerged in

Kuwait caused the Kuwaitis to become a minority in their own country, and over-dependent on expatriate workers. Many local citizens opted for an easy way of life, while others joined the public sector as permanent employees.

The size of the population has increased rapidly since the emergence of oil in 1946, almost eight-fold from 1946 to 1970, from 90,000 people to 740,000 people. In the 1985 census, the size of the population was approximately 1.7 million, of which less than fifty percent were Kuwaitis. Indeed, the labour force is positively related to the size of the population. Hence, the increasing growth of the population was reflected in the influx of expatriates to fill work opportunities generated by the development plans.

Table 2.4 demonstrates the distribution of the total labour force among the economic sectors, along with relevant output. The surprising phenomenon is the small percentage of employment in the oil sector, averaging between 1.0 percent and 2.0 percent, while this sector produces more than fifty percent of total GDP. The reasons behind this can be attributed to the high dependence on capital and advanced technological employment in this industry, as well as the highly skilled labour and disciplined measures. On the other hand, social services, which are all within the public sector, have the largest share of employment, averaging 50.0 percent for the period 1970 to 1985, while its

Table 2.4: GDP, and Manpower By Sector.

S e c t o r	1975 %		1980 %		1985%	
	GDP	Manpower	GDP	Manpower	GDP	Manpower
Oil	70.5	1.6	65.7	1.3	50.4	1.0
Agriculture & Fisheries	0.3	2.5	0.2	1.8	0.7	1.9
Manufacturing	5.6	8.2	5.5	8.4	6.4	7.6
Construction	2.1	10.8	3.6	19.7	3.3	18.5
Electricity, Gas & Water	0.4	2.4	-4.6	1.6	-2.5	1.1
Wholesale, Retail trade, Restaurants & Hotels	6.0	13.3	7.7	11.9	9.3	11.3
Transport, Storage & Communications	1.7	5.3	2.3	6.1	4.0	5.5
Finance, Insurance, Real Estate & Business services	1.3	2.2	6.6	2.6	8.3	3.0
Social Services	12.0	53.7	8.5	44.8	19.0	48.7
	100	100	100	100	100	100

Source: Central Bank of Kuwait, Quarterly Statistical Bulletin (Oct-Dec, 1975-1988). Ministry of Planning, Statistical Office, Annual Statistical Abstract, Kuwait, 1988.

contribution to total GDP averaged at 13.1 percent for the same period. Indeed, although the Kuwaiti government provides jobs for all the Kuwaitis who are capable of work, it can be argued that this trend has deprived other economic sectors of a domestic supply of workers and forced them to seek expatriates. Furthermore, the imported labour force is presumed to be needed for more coming development plans, though this merits serious investigation in order to adjust and balance both the population and the labour force structures.

## C H A P T E R     T H R E E

### THE FINANCIAL MARKET

This chapter aims to examine the financial market in Kuwait, through which savings of surplus units can be channelled into the productive economic sectors to enable the development process to be realised. The Central Bank of Kuwait is at the head of the financial pyramid, with broad economic and developmental objectives postulated by its organic law.

The balance sheet of the Central Bank will be reviewed to interpret its behaviour and interrelation with both the government and the banking system.

The consolidated balance sheet of the commercial and the specialised banks will be subjected to an elaborate review by tracing their components' behaviour with an emphasis on the trends of the credit policy of the banking system in general, and towards the productive economic sectors in particular.

The role of other participants in the financial market shall also be examined; thus, a comprehensive understanding of this market will, hopefully, be presented. These participants include investment and money-changing companies.

### Historical Background

The Central Bank of Kuwait was established on the 30th of June 1968 by organic law number 32. It succeeded the Kuwaiti Currency Board, which was established in 1961 when the national currency - the Kuwaiti Dinar - came into circulation for the first time. Prior to 1961, the Indian Rupee had been legal tender on the basis of an agreement between the Kuwaiti government and the Reserve Bank of India. Kuwaiti banks had the right to change their holding of excess Rupees into Sterling. The sole function of the Currency Board was to issue the national currency, 50 percent of which was covered by gold and 50 percent by foreign reserves; the law provided that the foreign reserves could be converted into gold.

When the Central Bank of Kuwait was founded its objectives were as follows:

1. To exercise the privilege of issuing currency on behalf of the State;
2. To endeavour to secure the stability of the Kuwaiti currency and its free convertibility into foreign currencies;
3. To direct credit policy in such a manner as to assist social and economic progress and the growth of national income;
4. To control the Kuwaiti banking system;
5. To serve as Banker to the Government;
6. To render financial advice to the Government.

The capital of the Bank was two million Dinars which was paid by the government, since the Bank was owned entirely by the State.

Article (18) stipulates that the management of the Bank shall be carried out by a Board of Directors composed of:

- a) the Governor, who shall be the Chairman of the Board;
- b) the Deputy Governor;
- c) a representative of the Ministry of Finance;
- d) a representative of the Ministry of Commerce and Industry;
- e) four other members, provided that all members of the Board shall be Kuwaitis.

Provisions were made to organize the banking business and clarify the relationship between the commercial banks and the Central Bank. The required cover of the currency issue remained unchanged. In October 1977 some articles of the law were amended as a result of changes in the economy; developments in the financial sector in particular made it necessary for more powers to be given to the Central Bank. New provisions were added, especially those concerning the inspection of banks and institutions subject to supervision by the Central Bank. The required cover for the national currency issue was amended by terminating the 50 percent of gold reserve

backing. The objectives of the Central Bank, as well as the management's provisions, remained unchanged.

### The Financial Market

The financial market in Kuwait consists of the Central Bank of Kuwait, seven commercial banks, one of which works according to the Islamic banking concept, three specialized banks, twenty two investment companies, some insurance companies, and thirty nine money-changing companies. Since the first national bank was established in 1952 by private initiative, there has been only one commercial bank operating the banking business in the country. This was the British Bank of the Middle East, which had been given a concession for thirty years in 1941. In 1971, upon the end of the concession, the Bank of Kuwait and Middle East superseded the former as a private-Government venture. Two private commercial banks were founded in 1960, The Commercial Bank of Kuwait and The Gulf Bank. Two more banks were established: Alahli Bank, as a private shareholding company, and The Burgon Bank as a private-government shareholding company, in 1967 and 1976 respectively. In the second half of 1977, the first and only Islamic bank was established (The Kuwait Finance House) as a private-government venture, which conducts, in addition to the same banking activities based on Islamic rules, a wide range of functions as a merchandise trader, thus, competing with other trading corporations in various activities. The total number of

branches of these banks reached 179 at the end of 1986. Indeed, the pattern of government participation combined with private initiatives has been a conspicuous phenomenon that developed the banking system in Kuwait and has spread out over the whole financial sector. It is worth mentioning that no foreign banks or branches are permitted to work in the country. The only exception is the branch of the Bahrain and Kuwait Bank, which was admitted in 1978 to operate in Kuwait. This bank is owned by Kuwaiti and Bahraini interests and based in Bahrain.

#### The Balance Sheet of the Central Bank of Kuwait

The balance sheet of the Central Bank for the period between 1970-1988 will be reviewed in order to outline the importance of this institution's role in the financial market. Table 3.1 shows the increasing growth of the total assets of the Central Bank for the above mentioned period, starting from 72.5 million Kuwaiti dinars to 1443.4 million K.D, recording a growth rate of 18.0 percent. It is noteworthy that the growth rate was affected adversely by the sharp drop down of the total assets in 1987 and 1988, which was over 23.0 percent for the period between 1970 to 1986. The reasons behind this will be disclosed during the following review of the assets components as they mainly consist of three items:

Table 3.1: Assets and Liabilities of  
The Central Bank of Kuwait.

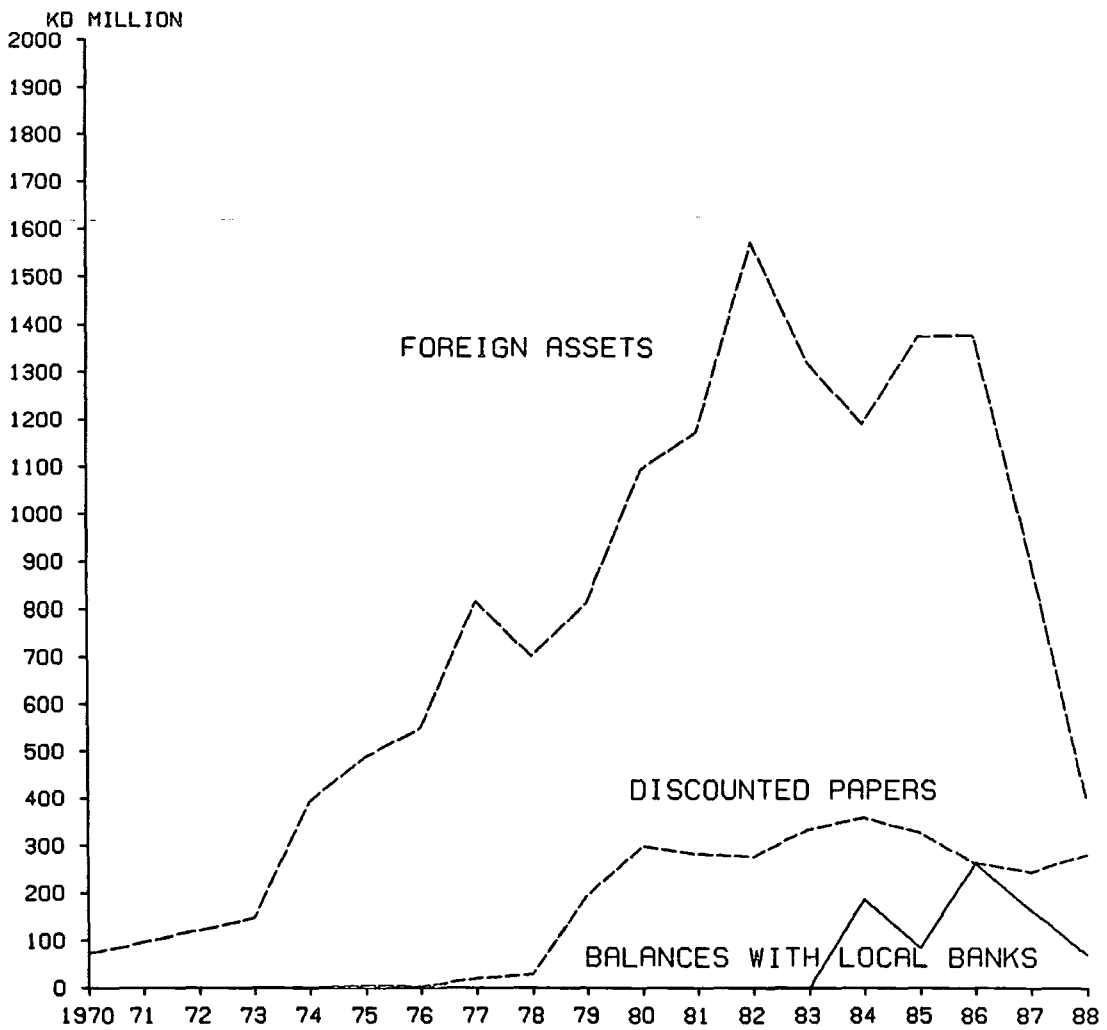
	1970	1988	% Composition	Growth Rate per annum
<u>ASSETS:</u>				
Foreign Assets	72.5	399.4	82.8	9.9
Rediscounted papers	4.5*	282.0	13.6	37.4
Loans & Deposits with Local Banks	188.0**	71.8	8.8	-21.3
Other Assets	0.4	690.2	4.8	51.2
Total Assets	72.9	1443.4	100.0	18.0
<u>LIABILITIES:</u>				
Reserve Money	51.1	394.3	45.3	12.0
Government Accounts	14.7	720.9	38.1	24.1
Capital and Reserves	5.0	184.0	4.8	22.1
Local Banks Deposits	68.8**	50.0	11.8	-7.7
Other Liabilities	2.1	84.2	8.4	22.8

\* From 1975.

\*\* From 1984.

Source: Central Bank of Kuwait, Quarterly  
Statistical Bulletins From 1974 to 1988.

FIG:3.1 MAIN ASSETS OF THE CENTRAL BANK



SOURCE: CENTRAL BANK OF KUWAIT



1. Foreign assets, which represent 82.8 percent of total assets on average.
2. Rediscounted commercial papers which represent an average of 13.6 percent of total assets.
3. Other assets, which include public debt instruments starting from the year 1987.

### Foreign Assets

The components of the foreign assets are divided into three main categories:

(i) the gold held by the International Monetary Fund, which is evaluated at a fixed rate in compliance with the relevant decree that postulated the value of one fine gold ounce at 12.5 K.. In 1988 this item represented only 7.9 percent of total foreign assets.

(ii) treasury bills, bonds, and other financial papers in foreign currency, which recorded 4.6 percent of foreign assets in 1988.

(iii) deposits in foreign currencies, mainly in U.S. dollars.

Out of the former two items, the Central Bank earns its profits and preserves cover of the currency issue. The foreign deposits amounted to 87.4 percent of total foreign assets in 1988. In absolute value this item dropped strikingly in 1987 by 44.0 percent compared with the previous year, from 1222.3 million K.D to 681.8 million K.D, and by 48.7 percent, to 349.3 million K.D in 1988, which in turn reduced the total assets of the Central Bank

as mentioned earlier. However, this pattern of behaviour can be explained by the outflow of funds, wherever depositors of commercial banks transfer their Kuwaiti dinars into foreign currencies, seeking more profitable or secure investments, when the international market offers higher interest rates or the foreign exchange rates encourage such transfer. Accordingly, the commercial bank put pressure on the Central Bank to buy more foreign currencies, as the latter depends solely on the government's supply of such currencies earned from oil revenues. Thus, the mobilization of these funds are considered vital to the Central Bank's foreign holding. After the government became a borrower of the Central Bank and the public, due to the budget deficit, a result of the unlikely willingness to liquidate its foreign investments, the transfer of foreign currencies to the Central Bank has become more limited, which exposed the latter to the pressure of the open economy's behaviour. Indeed, for a free economy such as Kuwait's, where the movements of funds are unrestricted, due to public pressures for openness, the Central Bank has to respond positively to the commercial banks' requirements for foreign currencies. On the other hand, the Central Bank is obliged to settle the government's purchase orders from abroad. Needless to say, minimum balances of foreign holdings ought to be maintained to comply with international monetary arrangements and to cover the issuing of local currency. To show how this issue is crucial, in 1984, when the

Central Bank faced a similar problem (capital out flow), the former Governor, in order to curb the outflow of funds, introduced what was called a "Two Tier System" of exchange rates, where two different exchange rates were to be declared for each foreign currency, one for import and export purposes and the other for non-commercial transfer of funds, so that investors had to pay a sort of penalty or a tax on their outside investments. Since the interest rate ceiling was not more than 10.0 percent according to the law, the introduction of the system was aimed at equalling the local and foreign interest rates paid on banking deposits. But, that was not the end of the story. The majority of the interests in the country felt that a threat to their own rights had grown up, whereupon they poured their anger out on the Central Bank, which led, along with other reasons, to the resignation of its Governor. Of course, this sort of crisis would raise the argument regarding institutions other than the Central Bank managing the foreign reserves of the government. Hence, such problems would not have appeared if the Central Bank had been entitled to control these reserves.

### Rediscounted Bills

The rediscounted bills are the second major item in the Central Bank's assets, which were introduced for the first time as a "discount window" in February 1975, applicable on commercial papers discounted by the commercial banks of not more than three months maturity. The commercial banks

had mixed views about the "discount window". A great proportion of their loans are in the form of credit facilities which are renewed on an annual basis, thus they felt that they would not procure much benefit from the discount window, unless they face liquidity problems. So, in 1975, the balance of this item reached 4.5 million K.D and declined to 2.1 million K.D in 1976, which represented only 0.9 percent and 0.4 percent of the total assets. In October 1977, the rediscount system was amended to include the discounted papers of twelve months maturity. Hence, this item has shown a rapid growth from 20.7 million K.D in 1977 to 282.0 million K.D in 1988, recording 2.4 percent and 19.5 percent of total assets in the respective years. The growth rate of this category registered at 13.6 percent for the period between 1970-1988. At the time, the objectives of the Central Bank in introducing the discount window were as follows:

1. To increase the lending ability of the commercial banks.
2. To counter liquidity problems that may face the commercial banks.
3. To encourage the commercial banks to diversify their lending portfolios that were geared to credit facilities rather than to definite loans on regular instalments.

### Other Assets

This category represented 47.8 percent of total assets in 1988, a major part of which were public debt instruments purchased by the Central Bank.

On the liabilities side of the balance sheet, the reserve money almost averaged half of the total liabilities for the period 1970-1988, starting from 70.0 percent to 27.3 percent respectively, recording an average of 45.3 percent and a growth rate of 12.0 percent for the same period.

The reserve money consists of three items:

- (i) currency issued,
- (ii) local banks' balances with the Central Bank, and
- (iii) Central Bank's bills.

The issued currency has been the major part of the reserve money, thus, it represented 93.3 percent in 1988, while the local banks' deposits formed 6.7 percent and the Central Bank's bills at zero percent in the same year. For the latter, it is worth mentioning that these Bills used to have a larger portion of the reserve money, but it dropped sharply from 233.0 million K.D in 1986 to 10.0 million K.D in 1987 and to zero balance in 1988, due to the introduction of public debt instruments in November 1987. Thus, the commercial banks shifted to the Treasury note of ninety days maturity instead of the CBK Bills. As far as the liquidity requirements are concerned, the Central Bank has offered the same privileges for them as the CBK Bills.

### Government Deposits

The government Accounts mainly reflect the foreign assets of the Central Bank. Table 3.1 shows an increasing growth of this item from 14.7 million K.D in 1970 to 720.9 million K.D in 1988, achieving a growth rate of 24.1 percent and averaging 38.1 percent of total liabilities. Nevertheless, and in spite of the remarkable growth, the government deposits with the Central Bank have decreased remarkably since 1985 from 655.1 million K.D to 380.3 million K.D in 1987, including 200.0 million K.D granted as a loan by the Central Bank to help the government to cover its expenditure programmes. In 1988, this item jumped to 720.9 million K.D due to the sale of public debt instruments to the financial institutions and the public.

### Capital and Reserves

Although capital and reserves achieved a high growth rate of 22.1 percent during the period between 1970-1988, it remained a minor percentage of total liabilities at an average of 4.8 percent. In 1984, the former Governor of the Bank, with the help of the organs, tried to follow a build-up scheme of the Bank's reserves by adding the net profits of the Bank to the reserves in order to enhance its self-resources, whereby, the Central Bank would not have to approach the Finance Minister for funds to implement its monetary policy. That attempt has succeeded and the reserves have been raised from 25.0

million K.D to 179.0 million K.D. Another attempt was made in the following year, but it failed because of the government's budget deficit.

Consolidated Balance Sheet of the Commercial Banks,  
1970 - 1988

During the last three decades, the banking sector has evolved noticeably. This evolution has been driven by private initiatives in response to the expanding trend of the economy, which took the form of increasing the number of banks, branches, and diversifying their services. Nowadays, the commercial banks provide all kinds of services that exist within a modern banking system, including cash points and credit card facilities.

Table 3.2 shows the growth of total assets and liabilities of the commercial banks during the period 1970 to 1988, which have grown remarkably from 610.0 million K.D to 10402.1 million K.D respectively, achieving a growth rate of 17.0 percent. Nevertheless, the interrelations between the banking sector and other economic sectors in the country will be examined in the following review of the main components of the commercial banks' consolidated balance sheet.

Table 3.2: Consolidated Balance Sheet of The Commercial Banks  
(million K.D)

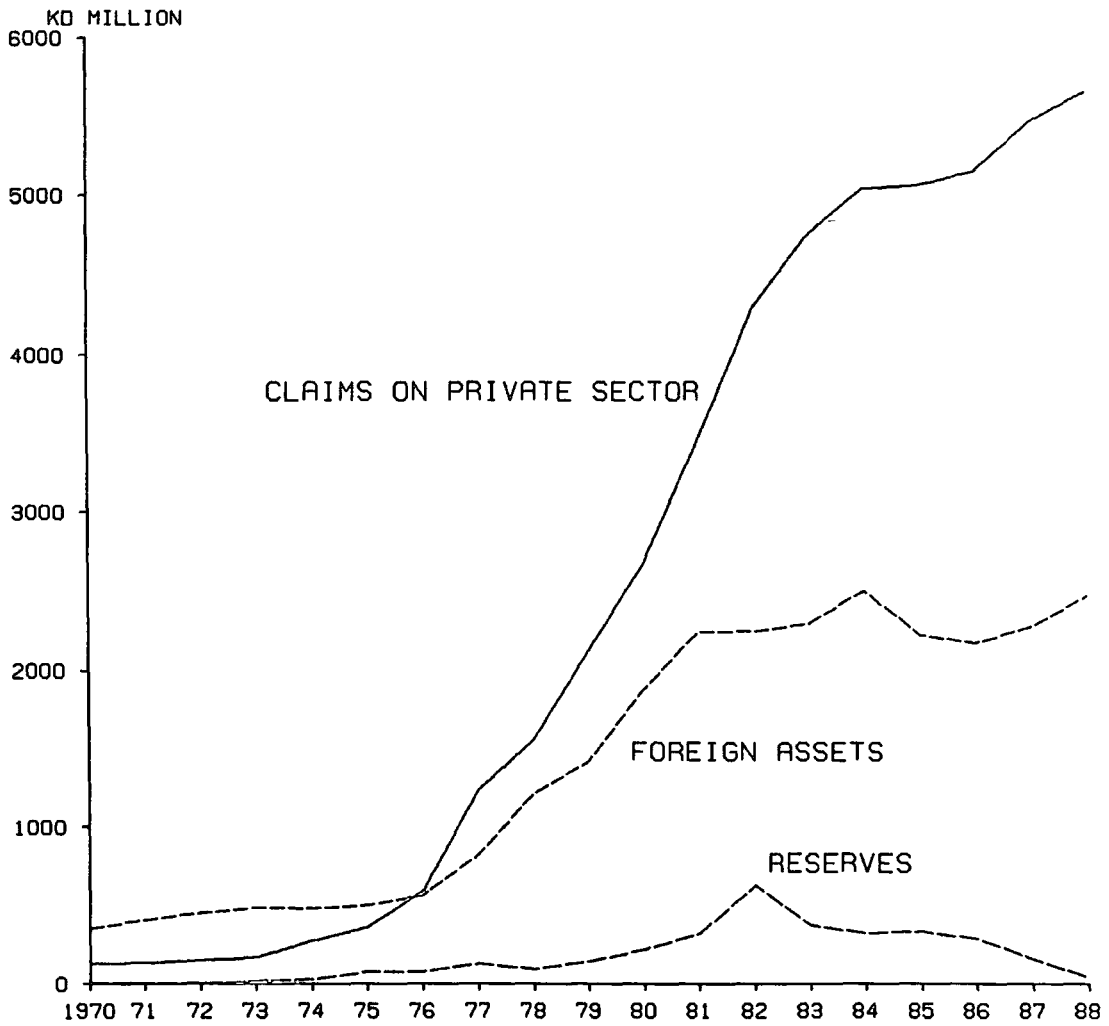
	1970	1975	1980	1985	1988	Per- cent- age to total Assets	Growth Rate %
<u>Assets</u>							
Reserves	6.2	67.2	221.7	335.3	42.0	3.4	11.2
Foreign Assets	439.5	616.1	1880.0	2229.6	2476.1	39.0	10.0
Claims on the private sector	141.2	506.7	2671.4	5067.8	5658.0	44.2	22.7
Other Assets	23.7	110.7	876.0	1420.6	2225.9	13.4	28.7
<b>Total Assets</b>	<b>610.6</b>	<b>1300.7</b>	<b>5649.1</b>	<b>9053.3</b>	<b>10402.1</b>	<b>100.0</b>	<b>17.0</b>
<u>Liabilities</u>							
Sight Deposits	50.4	188.6	418.4	565.8	549.7	9.7	14.2
Quasi-Money Government Deposits	266.9	600.9	2187.8	3554.6	4199.6	41.6	16.5
Foreign Liabilities	80.9	87.3	171.3	385.5	93.6	4.9	0.8
Capital and Reserves	115.6	169.0	1134.3	1360.3	1261.9	15.8	14.2
Other Liabilities	31.6	63.8	336.9	839.9	1031.6	6.8	21.3
	65.2	191.1	1400.4	2347.3	3262.7	21.0	24.3
<u>Claims on the Private Sector Credit</u>							
Facilities	137.1	462.5	2418.5	4198.5	4696.9	89.0	21.7
Other*	4.1	44.2	252.7	869.3	961.1	11.0	35.4
<u>Quasi-Money</u>							
	**					Per- cent- age to total Quasi- Money	
Saving Deposits	101.6	175.8	272.5	473.4	596.1	21.0	10.9
Time Deposits and CDs	145.2	303.5	1327.4	2524.0	2299.3	53.0	16.6
Foreign Currency Deposits	96.9	121.6	587.9	557.2	1304.2	26.0	15.5

\*The major part consists of local investments in bonds and shares, and the remaining part of claims on specialized banks.

\*\*Figures of 1971

Source: Central Bank of Kuwait, Quarterly Statistical Bulletins from 1974 to 1988.

FIG: 3.2 MAIN ASSETS OF THE COMMERCIAL BANKS.



SOURCE: CENTRAL BANK OF KUWAIT



### Reserves

The reserves of the commercial banks consist of cash, balances with the Central Bank, and bills issued by the Central Bank. This item has shown a growth rate of 11.2 percent for the period between 1970 and 1988, and averaged at 3.4 percent of the total assets.

The liquidity position of the commercial banks can be examined by two ratios: first, reserves to private deposits and second, reserves to total K.D deposits (private deposits plus government deposits, minus foreign currency deposits), which amounted to 3.6 percent and 4.4 percent respectively. The lower pattern of these ratios is due to the fact that no required reserve ratio has been applied by the Central Bank until June 1980 when it was set at 3.0 percent of total deposits, which remains below the actual reserves of the banks. Instead, the Central Bank introduced in 1974 what was called the Liquidity system; whereby, the commercial banks were obliged to maintain 25.0 percent of total deposits and claims for the Central Bank in liquid assets, with at least 7.5 percent of these in Kuwaiti dinars. Accordingly, the ratio of reserves to total deposits, jumped from 4.8 percent in 1973 to 8.1 percent in 1974. It is noteworthy here that what was meant in this system by liquid assets was the cash held by the commercial banks, balances with the Central Bank, and the net result of the inter-bank balances. In 1978, the liquidity system was substituted by a different one based on the structure of deposits held

by the commercial banks and their maturity dates. Thereby, each individual bank had to have its own liquidity ratio. In 1979, upon the introduction of the Central Bank's Bills, the Central Bank imposed a requirement upon the commercial banks that they should hold not more than 10.0 percent of their liquid assets in these bills. The cash balances of the commercial banks with the Central Bank or in their tills would be deducted from the defined percentage. As the CBK Bills bear interest, the commercial banks were willing to employ more of their reserves in these bills which recorded a growth rate of 48.3 percent between 1979 to 1987, and represented 74.0 percent of total reserves in 1986. In 1987, this item declined sharply because of the introduction of the public debt instruments.

### Foreign Assets

The foreign assets of the commercial banks consist of three items:

1. Balances with foreign banks which represent the major portion of the foreign assets.
2. Discounts and advances to non-residents.
3. Foreign investments.

Table 3.2 shows an increasing growth of the foreign assets in absolute value, but a declining trend percentage-wise. The total foreign assets have increased in magnitude from 439.5 million K.D equivalent in 1970 to 2476.1 million K.D

equivalent in 1988, while the percentage of foreign assets to total assets has declined from 72.0 percent to 23.8 percent, which can be attributed to the expansion of absorptive capacity of local demand for bank credit, in addition to the risks and uncertainty surrounding international markets. Therefore, the local banks are inclined to prefer secured employments, even with less profitable opportunities, rather than potentially profitable investments but with higher risks implied due to exchange rate fluctuations.

It is noteworthy that the components of foreign assets have exercised a structural change during the period between 1970 to 1988 in favour of credit facilities to non-resident and foreign investment on account of the balances with foreign banks. Thus, the three components have registered growth rates of 7.9 percent, 15.6 percent and 15.2 percent respectively.

The increasing preference, or response of the commercial banks to the local demand for credit can be figured out from the ratio of the foreign assets to the claims on the private sectors, which has dropped strikingly in favour of local credit, from 113.3 percent in 1970 to 43.7 percent in 1988. But, this does not mean that the commercial banks have turned down their foreign investment policies. The declining pattern of foreign investment can be attributed to two main reasons: first, the nature of the credit mechanism in Kuwait which took the form of 'demand leads' - 'supply follows'; second, the commercial banks'

sensitivity to profitability - since they are profit making companies they have to account for their performance before the shareholders. An insight into the annual growth rate can explain the behaviours of the foreign investment policies against the local economic changes. In 1974, when the government increased its expenditures, benefiting from the rise of oil prices in October 1973, the foreign investments growth rate rose by 17.2 percent, while it recorded a 6.7 percent decrease in 1973. It also registered a high growth rate in 1980 at 32.5 percent due to the increasing interest rates on the international markets, which induced them to invest more of their resources in foreign currencies. Conversely, in 1982, the growth rate of foreign assets hardly achieved 0.2 percent, which can be attributed to flourishing speculations in the unofficial stock market that pushed up the local demand for bank credit.

#### Claims on the Private Sector

Claims on the private sector have increased in importance, thus they constituted more than half of the total assets of the commercial banks from the year 1984 onwards. This item has achieved a growth rate of 22.7 percent for the period between 1970 to 1988, a jump in percentage from 23.1 to 54.3 of total assets, which changed the structure of the assets side of the consolidated balance sheet against the foreign employments. During that period, the

increasing demand of the private sector for bank credit can be interpreted by the following factors:

1. The expanding economic plans adopted by the government, triggered by the increasing oil revenues, followed by the increasing trend of public expenditures.

2. The private initiatives of the Kuwaitis as a trade-orientated nation.

3. The predominant trend of establishing share holding companies.

4. The increase of goods' prices, as Kuwaiti is totally dependent on the rest of the world for most of its consumption and investment requirements.

5. Prevailing speculations in the stock markets.

The ratio of claims on the private sector to total deposits in K.D over time has shown an increasing trend that proved the growing demand for bank credit. This ratio has increased from 46.8 percent in 1970 to 92.2 in 1979. From 1979 to 1988, deposits in K.D have failed to cover the demand for credit, thus, it registered 113.4 percent to 164.2 percent respectively. Therefore, the commercial banks had to approach other items of their liabilities to meet the demand of the private sector for credit. As a matter of fact, the growth of the claims on the private sector during the period 1979 to 1988 can be attributed to two relevant factors: first, the large scale speculation in shares and real estate, till the

collapse of the unofficial stock market in the second half of 1982; and, second, to the accumulated unpaid interests on the disordered overdrafts which have been granted by the banks on a personal basis.

The major component of the claims on the private sectors is the credit facilities granted by the various economic sectors in the country, which constituted 89.0 percent on average. The remaining parts of these claims consist of local investment in bonds, shares and claims on specialized banks that achieved a growth rate of 35.4 percent, while the former reached 21.7 percent. Table 3.3 illustrates the distribution of the credit facilities among the economic sectors. The table reflects the economic sectors' behaviour as discussed in the previous chapter in terms of the importance that each sector has represented in the Kuwaiti economy. Apart from the personal credit facilities, the trading sector absorbed a bigger stake than the other sectors, achieving a growth rate of 18.6 percent between 1972 and 1988, which might be expected in the case of Kuwait, as import and export activities have always been the core of the economy.

Industry, and agriculture and fisheries had the lowest percentages of the credit facilities respectively; in spite of the former experiencing a considerable growth rate of 18.7 percent, it shared only 4.3 percent of total credit facilities during the period 1972-1988. The latter has recorded a lower level of both: a growth rate

Table 3.3: Commercial Banks.  
Credit Facilities (CF) By Sectors  
(million K.D), 1972-1987.

Sector	1972	1975	1980	1985	1988	Per- cent- age to Total CF	Growth Rate %
Trade	63.0	164.3	671.8	932.8	967.2	28.0	18.6
Industry	8.7	24.8	159.2	122.2	136.1	4.3	18.7
Construction	40.6	97.0	408.0	680.0	813.7	18.5	20.6
Agriculture & Fisheries	12.8	9.9	39.9	21.8	12.3	1.8	0.2
Financial Services	21.5*	93.8*	142.8	360.9	362.0	10.1	19.3
Personal	29.1	72.7	620.7	1188.3	1346.7	24.0	27.0
Real- estate	-	-	306.6	768.6	912.4	16.3	14.6
Other	-	-	69.6	123.9	146.5	2.9	9.7
Total Credit Facilities	175.7	462.5	2418.6	4198.5	4696.9	-	22.8

\* Including Real-estate and others.

Source: Central Bank of Kuwait, Quarterly  
Statistical Bulletins from 1974-1988.

at 0.2 percent and a percentage averaged at 1.8 percent of total credit facilities. It can be argued that this is because of the market forces of the oil economies' role in economic development. Indeed, part of the impediment is related to the natural conditions of the country, but also, the inclination of the commercial banks to maximise their profitability overwhelmed their reasonable role in economic development. Furthermore, the irrational behaviour of the commercial banks in terms of economic development has been proved by the magnitude of credit facilities granted on a personal basis to finance speculators on shares and real-estate activities, both of which contributed to hectic speculation in the market, thus resulting in a national crisis in 1982 after the collapse of the stock market. The consequences of this were that the borrowers were unable to settle their loans, followed by the sluggishness of collateral values, which exposed the banking system to a solvency problem.

Personal credit represented 24.0 percent of total credit on average for the period 1972-1988, the highest after the trade sector, and recorded the highest growth rate at 27.0 percent. In absolute value it increased from 29.1 million K.D in 1972 to 1346.7 million K.D in 1988, which equalled nine times the credit facilities granted to industry and agriculture and fisheries. Personal credit is granted by the banks for customers to finance different types of activities such as consumption, land purchase, and speculation on shares and real-estate; against

collaterals such as salaries, shares and real-estate, and sometimes without any collateral. Of course, speculation in shares and real-estate will increase their values which entitled the borrowers to more credit facilities.

The construction sector has gained a fair portion of total credit, averaging at 18.5 percent and it recorded a growth rate of 20.6 percent, which reflected the modernisation of the country's infrastructure, carried out by both the government and private sector.

By and large, the main features of the commercial banks' credit policies can be summarized as follows:

1. The predominance of profitability preference at the expense of sectoral economic development.

2. Structural diversification on employment of their resources between foreign and local investment in favour of the latter.

3. Poor management of their domestic credit activities. Most long-term loans were unplanned, representing over-draft facilities that were renewed automatically on an annual basis, which resulted in liquidity problems from time to time.

4. The absence of any explicit credit control policy by the Central Bank.

In contrast, in order to regulate the credit policies of the commercial banks, the Central Bank has introduced

several measures that, for the purpose of this discussion, can be summarized as follows:

1. Moral suasion, especially for the few years after its inception in 1968, during regular meetings between the Governor and the heads of the commercial banks.

2. In September 1973, the Central Bank issued a directive concerning a ceiling for provided credit facilities to the Banks' customers for subscription in public shareholding companies.

3. The liquidity system in 1974.

4. The central risks system in 1974, whereby, the commercial banks were obliged to provide the Central Bank with all the information about their credit facilities. The banks could use this system to obtain any information concerning borrowers.

5. In 1976, the Central Bank fixed the ceiling of uncollateralised credit facilities so that no one customer would be granted more than 10.0 percent of the total owned funds of each bank (capital and declared reserves).

6. In 1980, the Central Bank issued various directives aiming at diversifying the structure of the credit facilities' components, by which the commercial banks were required to concentrate on loans with definite terms and purposes instead of overdraft facilities that characterized their credit pattern over the foregone time.

The Central Bank has been pursuing its directives through the inspection function to secure the compliance of the commercial banks. However, and in spite of all efforts that were exercised by the Central Bank in order to rationalise the credit policies of the commercial banks, it is quite clear that there has been no attempt by the Central Bank to induce the commercial banks to direct their credit facilities towards the productive economic sectors. In real terms, neither has the Government adopted a comprehensive plan in this respect.

#### Consolidated Balance Sheet of the Specialized Banks

The establishment of specialized banks in Kuwait was to finance specific economic sectors and to deal with medium-term and long-term loans. Accordingly, they have been deprived of the acceptance of demand deposits. Under Law Number 32 of the year 1968, concerning currency, the Central Bank of Kuwait and the organization of banking business postulated, in Article 76, examples of three sectors to be served by specialized banks: industry, agriculture and real-estate.

Three banks have been working in these areas - The Credit and Saving Bank, The Kuwait Real-Estate Bank, and The Industrial Bank of Kuwait.

The Credit and Saving Bank was established as a government shareholding in 1965 with paid capital of 80.0 million K.D as a successor to the Credit Bank which was

established by the government in 1960. This Bank deals mainly with housing and real-estate activities.

The Real-Estate Bank was established in 1974 as a public shareholding company, which operates on a commercial basis.

The Industrial Bank of Kuwait was established in 1974 by the government and the banking sector as a joint venture and deals mainly with the existing industrial sector and promoting new industrial projects. The latter and The Credit and Saving Banks are providing loans to their customers under favourable conditions, such as low interest rates, and long maturity periods. Table 3.4 shows the main items of the specialised banks' consolidated balance sheet for the period between 1976 and 1988. During that time, the total balance sheet has been increased four-fold, achieving a growth rate of 13.0 percent. This increment can be ascribed to the growth of the specialized banks' own funds that averaged at 40.3 percent of the total balance sheet.

It can be argued that the specialized banks could not rely on local deposits to finance their long-term loans or participate in founding new projects; whereas the private depositors were inclined to prefer the form of short investment with the commercial banks, seeking better opportunities either inside or outside the country. This phenomenon can be seen from the very limited success of the CDs and bonds issued by The Real-Estate Bank and

Table 3.4: Specialized Banks -  
Main Items of Consolidated Balance Sheet  
(percentage)

Year	Assets %			Liabilities %				Total Assets = Total Liabilities (K.D. million)
	CFR	LI	FA	LD	GD	CDs & Bonds	C & R	
1976	37.6	2.3	30.0	32.4	10.0	1.7	28.2	473.2
1977	42.8	2.0	28.0	33.7	10.5	4.0	29.2	705.2
1978	47.3	3.6	24.9	27.3	10.9	7.8	32.5	868.5
1979	49.2	3.0	23.3	26.7	12.0	6.7	36.6	962.4
1980	49.4	2.5	21.8	24.6	13.4	5.9	35.4	1166.8
1981	49.1	2.2	18.7	25.6	16.3	4.9	35.8	1433.8
1982	56.0	2.3	15.0	26.2	14.7	4.1	40.1	1776.2
1983	56.0	3.3	15.5	27.0	13.0	2.2	42.3	1939.1
1984	58.5	3.9	16.2	21.7	12.4	2.4	45.3	2020.5
1985	59.3	3.7	15.6	19.5	13.2	2.6	47.4	2091.1
1986	62.8	2.6	15.4	18.6	11.1	2.2	48.6	2057.1
1987	65.7	4.3	11.8	18.5	11.7	1.7	50.8	2051.8
1988	68.8	4.6	12.4	17.6	10.8	1.1	51.8	2061.1
Average	54.0	3.1	19.1	24.5	12.3	3.6	40.3	Growth Rate 13.0

List of Abbreviations:

CFR = Credit Facilities to Residents.

LI = Local Investment.

FA = Foreign Assets.

LD = Local Deposits (including private and local Banks' deposits).

GD = Government Deposits.

C & R = Capital and Reserves.

Industrial Bank which averaged only 3.6 percent of total liabilities. The government deposits with these banks represented an average of 12.3 percent of total liabilities, which reflected the interest of the government in supporting the specialized banks' activities.

On the assets side of the balance sheet, the credit facilities for residents has doubled over the time and averaged at 54.0 percent of total assets. It is worth mentioning here that the credit facilities could have been financed totally by the own funds of the specialized banks and the government deposits on the liability side of the balance sheet; while the foreign investments could have been financed by the local deposits, so the banks can profit from the differential between the rate of interest paid in Kuwait and those gained from international markets.

#### Investment Companies

One of the features of the expansion of Kuwait's overseas financial involvement is the upward trend in the number of investment companies. At the inception of the Central Bank there were only two companies. At the end of 1987, according to the Central Bank's economic report, the officially registered companies reached twenty two, in addition to those still waiting to be registered in compliance with the Central Bank's regulations. However, three major companies have been dominating this area,

these being known as, 'the three Ks'. These include the Kuwait Investment Company (KIC) which was established in 1961, half owned by the government; the Kuwait Foreign Trading, Contracting and Investment Company (KFTCIC) which was established in 1965 and in which the government had an 80 percent shareholding; and the Kuwait International Investment Company (KIIC) which was privately founded in 1974. The government involvement in this field at the initial stage was influenced by two explanatory factors:

(i) the desire to induce the private sector to explore the forms of long-term investment, and,

(ii) the need to investigate the outside opportunities for foreign investment, so that the surplus of domestic savings could be channelled into the international investment.

Some investment companies succeeded in managing various bond issued mainly for non-resident interests. However, it is worth mentioning that these companies are subject to certain articles of the law of the Central Bank. By the initiative of the latter, some of them agreed to comply with the control decisions issued by the Finance Minister for each individual company. In January 1987, in response to the request of the Central Bank, the Minister of Finance issued the decision concerning the regulating supervision of the Central Bank over these companies. Indeed, such a decision has become a necessity after the difficulties that these companies have encountered as a

result of their involvements in the collapse of the stock market in 1982. The decision of the Finance Minister meant the Central Bank has a wide range of responsibility in this respect which can be summarised as follows:

1. A special register for those companies is to be kept at the Central Bank.

2. CBK Board should set the rules to be observed by these companies to secure their credit worthiness, particularly maintenance of ratio of own funds (Capital and reserve) to the companies' financial obligations toward a third party.

3. CBK supervision of the companies' ability - their provisions for facing the risks of their extended loans and the decline in the values of their investment portfolios.

4. To set rules for the bonds to be issued in favour of the investment companies, and participation in the issuance of bonds in favour of others in the local market.

5. To determine the maximum limit of lending that may be extended to one person, and to regulate loans extended to their customers.

6. To develop criteria for risk appraisal regarding loans granted by these companies.

7. To issue to those companies instructions it is deemed necessary to regulate their business and to realize the aims of credit or monetary policies adopted by the Central Bank.

Indeed, it can be argued that such a role should have been played as an integrated part of the existence of the Central Bank since its inception and should not have been left to the trial and error method of learning. Nevertheless, part of the blame can be laid on the Central Bank for not using its constitutional right in this regard, while the major part of the malfunction can be attributed to long procedures that required the Central Bank to seek the approval of the Finance Minister whenever it was realised that such an investment company would be subject to its control, where no primary data was held or supplied by these companies to the Central Bank.

Table 3.5 shows the available data of the consolidated balance sheet of the registered investment companies for the period between 1976 to 1988, the total balance sheet of which has grown considerably over the time at a growth rate of 17.1 percent and from 319.3 million K.D to 2132.9 million K.D respectively; almost seven-fold. As the major role of these companies has been to channel the local surplus into the international markets, the foreign assets have constituted the main portion of total assets, forming more than half and averaging at 54.6 percent between 1976-1988. Of course, the experience of these companies in foreign markets has reflected its privileges on the liabilities side of the balance sheet. Thus, the foreign liabilities, which are mainly comprised of foreign currencies, have registered the highest average for the time at 34.2 percent, the peak of which was reached at

Table 3.5: Investment Companies -  
Main Items of Consolidated Balance Sheet  
(percentage)

Year	LDR	Assets %				Liabilities %			TA = TL (K.D Million)
		LI	FA	OA	C & R	RFR	FL	OL	
1976	6.9	12.8	62.5	7.6	24.1	34.8	20.0	21.1	319.3
1977	7.3	12.0	58.3	8.9	18.7	34.9	27.8	18.7	470.5
1978	8.5	12.8	58.8	7.6	16.9	35.6	35.6	11.9	611.0
1979	11.2	16.2	60.0	9.5	21.7	33.2	35.6	9.4	715.4
1980	13.0	17.3	57.3	8.6	17.0	33.4	42.4	7.2	952.2
1981	18.2	13.6	52.7	13.1	15.7	30.0	42.7	11.6	1431.1
1982	23.8	18.0	43.3	12.7	23.4	27.5	39.4	9.7	1937.9
1983	17.2	19.9	53.1	7.2	21.8	27.7	45.0	5.5	1936.2
1984	12.1	20.6	55.0	9.2	17.6	37.2	36.8	8.3	1824.5
1985	10.4	19.5	51.0	14.6	16.0	32.5	36.9	14.5	1731.0
1986	16.8	20.0	50.3	9.6	16.1	37.0	31.7	14.9	1519.9
1987	15.3	20.1	53.4	7.0	18.3	38.5	26.4	16.7	1559.1
1988	13.1	16.7	54.7	7.6	23.8	37.4	24.8	14.0	2132.9
Aver- -age Growth Rate:	13.4	16.9	54.6	9.5	19.3	33.8	34.2	12.6	17.1

List of Abbreviations:

LDR = Loans and Discount to Residents.

LI = Local Investment.

FA = Foreign Assets.

OA = Other Assets.

C & R = Capital and Reserves.

RFR = Resources From Residents.

FL = Foreign Liabilities.

OL = Other Liabilities.

TA = TL : Total Assets = Total Liabilities.

45.0 percent in 1983. There was, however, a subsequent decline to the 24.8 percent level in 1988 as the involvement of these companies in the stock speculations has raised questions over their solvency. The item of loans and discount to residents also showed a peak in 1982 at 23.8 percent of total assets, reflecting the flourishing activity in stock speculations, then fell to 13.1 percent in 1988. Hence, it can be said that the balance sheet of the investment companies has clearly reflected their involvement in stock market speculation, either directly or indirectly by financing the speculators; where almost all the items of their consolidated balance sheet have responded in line to that activity, and therefore, upon the crises of the stock market. In order to enhance their positions, new bonds were issued and sold to the government and local banks that increased the portion of their resources from residents from 27.5 percent in 1982 to 38.5 percent in 1987. Moreover, their capitals and reserves have been increased in 1987 for the same reason.

Money-changing Companies:

The number of money-changing companies registered with the Central Bank reached thirty nine at the end of 1987, but the licensed companies were known to be more than seventy. In March 1984, those companies were subjected to the supervision of the Central Bank. Since then, the Central Bank has conducted its responsibility by collecting all

necessary data in order to assess their financial positions, as per its postulated measures. Consequently, many of those companies were registered, while the rest of them were instructed to rearrange their positions as a precondition for registration at the Central Bank. Failure to take such action could result in their licences to operate being terminated - as has happened to some of them.

Money-changing companies deal mainly with cash outflows, at the request of expatriates working in Kuwait, by selling Kuwaiti dinars to the commercial banks against foreign currencies. They also trade for themselves and their customers in foreign currencies, gold, silver, and other commodities. The decision that stipulated the Central Bank should supervise these companies was partly motivated by the desire to obtain data relating to the volume of foreign transfers by these companies, and the effect of this on domestic liquidity. It was thought to be desirable to ensure that they operated within the limit of their constitutional purposes and are not practising banking businesses. Furthermore, it has been of great importance to keep a close eye on these companies to prevent them representing foreign banks in Kuwait. The soundness of their financial positions are also monitored by the Central Bank.

According to the Annual Economic Report of the Central Bank for 1987, the aggregate balance sheet of thirty three companies totalled 78.0 million K.D on the liabilities

side, local funds represented 51.7 percent, of which 58.5 percent were constituted by the net equity of partners. The other portion of liabilities was obtained from foreign sources, which represented 48.3 percent. On the assets side, local assets accounted for 66.9 percent (K.D 52 million) of total assets, most of which were concentrated in claims on banks and other financial institutions, while the foreign assets represented 33.1 percent (K.D 26 million) of total assets. It is noteworthy that in addition to money-changing companies, there are a large number of individual money-changing institutions that deal only with cash money changing and have a different legal entity than the money-changing companies. Those institutions are controlled by the Commerce Ministry.

#### Inter-bank Market

Several incentives induced the banks to commence inter-bank operations in 1974:

- (i) the increasing demand for bank credit,
  - (ii) the liquidity system which was imposed by the Central Bank,
  - (iii) the inception of two specialized banks and some financial and investment companies,
- all of which have placed pressures on the liquidity of the commercial banks; therefore, they felt the necessity to help each other with surplus funds. The Central Bank has encouraged this trend by two measures. First, by considering the inter-bank deposits as a part of their

liquidity requirements; second, by exempting the inter-bank operations from the interest rate ceiling. Consequently, these operations increased very rapidly from less than 10 million K.D in August 1974 to 500 million K.D in 1979, peaking at 2455.0 million K.D in 1983.

Some institutions are working as intermediaries in the inter-bank market, thus, they supply the concerned parties with daily interest rates on the bid and offer sides on deposits of various maturities. In the 1980s, new instruments have been developed in the inter-bank operations, taking the form of CDs and deposits in foreign currencies, but still representing a marginal portion of the total inter-bank operations.

### The Money Market

Until the beginning of 1980, two instruments were used in the money market: the Central Bank's bills, which can only be obtained by financial institutions, and negotiable Certificates of Deposits. Later on, the Central Bank entered the money market as a lender and borrower in order to maintain the structure of the interest rate and the exchange rate of the local currency against foreign currency. In November 1987, a public debt instrument, of treasury notes of ninety days maturity, was introduced into the market - that was expected to activate the day-to-day operations and enhance the role of the Central Bank in open market operations.

### The Stock Market

Though the first shareholding company was established in 1952 (the National Bank of Kuwait), the inception of the stock market was not realised until 1970 by law number 32 concerning the regulation of trading in financial paper of shareholding companies. In August 1971, the Minister of Commerce issued a decision which entrusted the concerned Department in the Ministry with circulating a daily report of stocks prices and proper statistical analysis about the registered shareholding companies, movement of their stocks, and profits. This decision has also obliged all dealers to be officially registered at the Ministry of Commerce, and to inform the Ministry, on a daily basis, of all transactions of individual shares. Although trading in the stock market is concentrated in shares of national and some Gulf companies which officially were registered in the market in 1984, the stock market has been involved with other instruments such as bonds issued in Kuwaiti dinars in favour of non-residents, and Negotiable Certificates of Deposits with floating interest rates - as were introduced to the market in 1977 for the first time by the Industrial Bank of Kuwait.

The development of the stock market can be recognised by some elements of its evolving. At the end of 1973 the total number of registered public shareholding companies was 31, which increased to 52 by the end of 1987. The traded quantity of shares in 1973 registered at 9,956 million shares (equalling 344.230 million K.D), while it

reached 3286.2 million shares (equalling 828.8 million K.D) in 1987. The big difference in traded shares' numbers between the year 1973 and 1987 is due to the shares split that took place in April 1987 when the minimum limit of share nominal value was reduced to 100 fils instead of one Kuwaiti dinar (1000 fils). This procedure was intended to enlarge the market base - by encouraging small investors to bring their savings into the market - and to increase the competitiveness of the Kuwaitis against the non-Kuwaiti companies' shares of low nominal values. Nevertheless, and in spite of the effect of the foregoing procedure, the increasing value of the traded shares for the period between 1973-1987 which increased 2.5 times can be considered a fair indicator to the funds employed in the market, in spite of the exposure of the market to the shock which occurred in 1982 and its effect on shares prices. The stock market had followed several frenzied and sluggish courses during its lifetime. The periods of frenzied activity occurred during 1971-73, 1975-76 and 1980-82; followed by sluggish activity in the market expressed by a decrease in shares' prices and traded quantity. Two serious crises followed the brisk trading of the periods 1975-76 and 1980-82. The former was overcome by government intervention. While the latter started initially in the non-official market, it spread not only to the official stock market, but also affected a wide portion of the economy, in spite of all measures adopted by the government and the Central Bank to regulate and control the stock market activities.

Trading in bonds has constituted a marginal role in the stock market; although the first issue of these was launched in 1968 in favour of the International Bank of Reconstruction and Development (IBRD), thus, traded bonds did not exceed 5.0 percent of total issued bonds. In 1978, following the inception of the Arab Company for Trading Securities, bond trading reached a peak at 31.0 percent of total issued bonds. In 1979, due to the increasing level of interest rates, both the primary and secondary bonds' markets were sluggish. However, activity increased by 1983, as the revealed data by the Central Bank showed that 20.0 percent of total issued bonds had been traded. In 1984, due to the collapse of the stock market in the second half of 1982, the Central Bank decided to suspend bond issues in Kuwaiti dinars in favour of non-residents, in order to review and regulate the activity of bonds trading. Three issues of bearer Treasury bonds, which totalled 205.0 million K.D, were introduced in the primary market by the Central Bank and were fully subscribed. The maturity of these bonds ranged between one and seven years; whereas their denominations varied between one thousand, and five hundred thousand, Kuwaiti dinars - the interest rates of these bonds being payable in K.D every six months. In order to restore the activity of the primary market of non-resident K.D bonds, the Central Bank permitted the issuance of such bonds after three years of suspended trading. Consequently, the market witnessed two issues; one in favour of the world Bank and the other for the

Republic of Finland, both totalling 50 million K.D. Four K.D issues for local borrowers, totalling K.D 63 million, were authorised in the same year. By and large, the total value of K.D bonds traded in the securities market - for both residents and non-residents - reached 188 million K.D at the end of 1987. The secondary market showed some improvement against the previous year of 1986, resulting from the reduction of local interest rates. This improvement was reflected in an increase in both the value of tradable bonds and the number of transactions, by 1632. percent and 169. percent respectively. In the light of the foregoing presentation of the stock market activities, and in order to produce an overall evaluation of the reasons that induced its volatile activities, it is of great importance to consider the peculiarity of the stocks as an infant of the surplus economy.

In real terms, savings result from the relationship between income and consumption, or actual production and consumption. Thus, savings can be transferred from the surplus units to the deficit units through channels of financial assets - of which shares are considered to be one form. Thus, the evolving of this form of financial assets is closely related to the developments of the real production. Therefore, the power of real production, or absorptive capacity, has its influence over the demand and supply of such financial assets. However, the situation in Kuwait has quite different and separate factors affecting the demand and supply of shares, which cause a

disequilibrium and a weak relationship between the production needs for finance and the ability to finance. The production needs for finance are influenced by indigenous factors that control the development and enlargement of real production base in the economy, which can be evolved gradually and over quite a long period of time through the diversification efforts of a developing economy. In contrast, the accumulated savings in Kuwait resulted from, and were influenced by, exogenous factors (oil prices and production) which have no connection with the base of real production in the local economy, but reflect the balance of power between the oil-consuming and oil-producing countries. For example, in 1973, the increase of oil prices followed by tremendous earnings of oil producers, induced propensity for saving to rise through the increase of public expenditure, while the real production of the non-oil sector remained unchanged, or even declined within the oil industry. Of course, it can be argued that savings can be channelled into productive activities through comprehensive economic development plans. But, nevertheless, given that some inflationary or speculation patterns are inevitable when the absorptive capacity of the economy is responding positively to development plans, it follows that, with a limited absorptive capacity such as exists in the Kuwaiti case, such undesirable patterns implied the underlying existence of unusual or unsatisfactory conditions which prompted their appearance. Therefore, the unexpected brisk increase in trading in the Kuwaiti stock market can be



explained mainly by the private financing ability that exceeded the investment capacity in real production: whereby, the demand for shares has been always tracing a small quantity of shares and pushing the prices upward. This trend has been encouraged on some occasions by exogenous factors such as the inflationary patterns in the international markets in the 1970s, which induced the demand for non-cash assets to increase, and the bank credit facilities which were given to the speculators on a personal basis.

On the debit side of the stock market's activities, two serious crises occurred; one in the last quarter of 1976 and the other in the second half of 1982. The effects of the first crisis started to be registered in 1977; thus, in spite of the enlargement of the issuance base, the quantity of traded shares decreased by 31.0 percent, while the number of transactions declined from 19.8 million shares in 1976 to 13.8 million shares in 1977, the market value of traded shares also declined by 64.0 percent in the same year. The effects of the second crisis were more dramatic in both markets - the stock market, and what was called the parallel unofficial market (Souk Al-Manakh). The traded shares in the stock market declined very sharply in 1983, totalling 74 million shares valued at 512.0 million K.D, against 255 million shares valued at 1938.0 million K.D. In the parallel market, which reached a peak during the period June-August 1982, with traded shares of 2 billion, in September of the same year

the traded shares declined to 72 million shares. In 1983 the traded shares recorded 1620 million shares, but the decline in prices ranged from 6.0 to 93.0 percent compared to 1982 prices.

The last collapse of the market can be attributed mainly to the forward purchase mechanism that widely prevailed in the market, by which speculators succeeded in creating their own credit market to finance themselves for more trading. This mechanism of forward purchase is expressed by a pre-arranged deal between the buyer and the seller, where the future price of the deal depends on the date that the seller will cash his post-dated cheque, while the buyer can have his shares on the spot. Thus, it remains up to him whether he likes to sell these shares for cash or to get a post-dated cheque; whereby, two prices were constituted for shares - one was the on-the-spot price, and the other was the forward price which varied according to the periods of post-dated cheques and to the prices agreed between traders. It follows that, as the on-the-spot prices had not increased to catch up with the forward ones, the market came to the point that the debtors failed to settle their liabilities to the creditors. Hence, it was the collapse of the first link in the chain.

Nevertheless, some other factors also contributed to the last collapse of the stock market. Such factors can be attributed to:

1. the speculative mood of the traders seeking quick gains;
2. the personal Bank credit which increased remarkably in the early 1980s and enlarged the ability of the speculators to pour more money into the stock market;
3. the persistent surplus of the Kuwaiti economy that encouraged the increasing trend of the government expenditures;
4. the fragmentation of the market, where the price of each individual share was determined separately between the buyer and the seller, coupled with the lack of information about the concerned companies and proper regulations to control the market's activities.

C H A P T E R     F O U R

THE DEMAND FOR - AND SUPPLY OF - MONEY IN KUWAIT

This chapter deals with the factors that determine the demand for - and supply of - money function. Having discussed the financial market aspects in general and the role of the Central Bank of Kuwait in particular in the previous chapter, it is of great importance to study the factors that influence the behaviour of the monetary stock at its given definition in Kuwait. Having studied that, one could evaluate the monetary policy instruments that are used by the Central Bank of Kuwait to achieve its objectives for the benefit of the growing economy of Kuwait. The issue of the monetary policy instruments is the concern of the following chapters.

This present chapter is divided into two main sections - theoretical and empirical. The theoretical part concentrates on the monetary and real issues that have played the main role in formulating the behaviour of the demand for, and supply of, money.

The argument of definition of money is discussed on the basis of the controversies over the role of money, by reviewing some of the relevant literature, and pointing to some difficulties that relate to the definition of money in Kuwait. In addition, this chapter clarifies the transmission mechanism of the balance of payment influence on the monetary sector, via the government expenditure.

The scale of variables that are assumed to influence the behaviour of the demand for, and supply of, money in Kuwait - such as: income, local and foreign interest rates, credit facilities of the commercial banks to economic sectors, import activity, trading in stock market, and prices - are discussed in detail, in order to build up the theoretical model against which the empirical work of the second section of this chapter can be seen in perspective.

As the Kuwaiti economy in general, and the monetary sector in particular, have been subjected to various theoretical and empirical studies undertaken by individual researchers and international bodies, a review of some selected studies is incorporated in this section. The selection of these studies is based on the degree of their closeness to the concern of this research. Finally, this section concludes with some hypotheses which are examined in the second section of this chapter.

The second section deals with the econometric model that verifies the demand for, and supply of, money. Having defined the components of the money supply in Kuwait in the first section (currency in circulation, sight deposits, and quasi-money), three equations are introduced to estimate the demand function of each component, while one equation is introduced to estimate the supply of money function. The reason for this disaggregation of the demand function is based on the assumption that the motives (explanatory variables) behind the demand for each

component of the money stock are varied and could postulate contradictory effects on the other components. Therefore, the estimation of the demand for money in aggregate terms would give an insignificant result. Thus, four equations are introduced for estimating the full model by using quarterly observations for the period between 1970-1988 in nominal terms. As some of the data is not available, especially for the first years of the above-mentioned period, the number of observations for each equation varies according to the number of missing data. In some cases, when it is found appropriate, the missing data is substituted by the mean of existing data.

Ordinary least squares method (OLS) is applied for the multiple regression analysis of the equations of the model, as it is found the most appropriate method for this purpose. Moreover, the "Identification problem" as a coherent issue to the estimation of the demand-for-money function is also addressed.

As the discussion of the monetary issues in the first section of this chapter represents the theoretical background of the model, the second section contains the following parts:

1. Model specification.
2. Model estimation.
3. Discussion of estimation results.

THEORETICAL FOUNDATION OF THE MODEL

Definition of Money

The controversy over the definition of money has its roots in the argument over the function of money and the needs which its existence is designed to fulfil, or precisely, what money is demanded for. It has been argued that the demand for money stems from three basic needs; transaction, precaution, and speculation. It is around these needs that the argument over the definition of money revolves, an argument that is still not finalised, and is likely to continue, especially with the creation of more financial assets, and as more financial institutions enter the market.

While it is easy in theory to define money as a means of payment, in practice difficulties arise when one considers the variety of assets, apart from money, that can be used as a means of payment, or a medium of exchange. Bank sight deposits or current accounts are widely used as a means of payment, to settle debts through the transferral of cheques, and are considered an excellent or perfect substitute for money. Other types of assets can be converted into sight deposits or currency in very little time, or even instantly. For example, a client may arrange with his or her bank to cover an overdrawn balance on a current account with funds from a time deposit account. Such practices mean that the term, 'means of payment', could include concepts such as substitutability

and liquidity among assets other than currency, and can not be limited to currency alone.

In his discussion of the definition of money, Gowland (1984, p.5) brings another dimension to the argument when he says that:

"In practice, money is normally defined as privately held currency plus bank deposits. In a textbook this seems precise enough. In practice, there are a number of problems. First, it is not clear what a bank is. Second, in textbooks, all bank deposits are demand or sight deposits and are usually assumed not to pay interest. If some bank deposits are interest-bearing or time deposits are they money? Thirdly, should foreign held or public sector deposits be included? Finally, what about deposits in foreign currencies held by residents?"

He also asserts that it is impossible to draw the line between a bank and a non-bank since some financial institutions take deposits and give loans, and are able to affect the controllability of the money supply if left unchecked by the authorities.

Sayers (1982, p.69) in his discussion of the means of payment concept as the most generally accepted common factor in terms of defining money, raises three problems that pertain to this approach. First, the widespread use of credit cards, and whether these cards are considered as a means of payment or not. Second, the convertibility or liquidity of some assets that can be converted into the means of payment. Third, the acceptability, that is determined by conventions which change over time and from place to place. In his conclusion, he pointed out the

relationship between any given definition of money and the control of money that the authorities aim at is the crucial element in this context.

According to Gowland, one may thus conclude that the existence of non-banks, i.e. institutions such as building societies in England, or insurance companies in Kuwait, which grant long-term loans to their customers against their insurance policies, make the definition of money - tied closely to the concept of controllability - problematic, to say the least. According to Friedman and Schwartz (1970, p.137):

"Money is that to which we choose to assign a number by specified operation, it is not something in existence to be discovered, like the American Continent."

The authors go on to say that the criterion according to which assets are classed as a means of exchange, or rejected as such, is an unsatisfactory one. Two examples from the situation in Kuwait may serve here to highlight the difficulties inherent in the "means-of-payment" approach to the definition of money. First, demand deposits, for example, appear at first glance to be the closest substitute for money, since they can be used to settle debts by drawing cheques. Many people use demand deposits solely as a store of value because they do not enter into transactions which would involve the payment of interest, which, in Islamic law, is classed as usury and is therefore proscribed; hence such people do not employ their money in interest-bearing deposits.

However, the volume of this type of demand deposits is unknown to the authorities and can thus, to a certain extent, distort the studies and statistics of money supply behaviour. The second example concerns the acceptability of demand deposits as a means of payment. After the collapse of the unofficial stock market (Souk Al-Manakh) in 1982, many retailers lost confidence in cheques and refused to accept them from customers, preferring cash or credit cards instead. The crisis was short-lived but nevertheless serves to show the instability of any given component of the 'means of payment' approach to the definition of money.

Since the 'means of payment' approach holds that money should include currency and current account, liquidity or substitutability present a problem. Various types of time deposits in local and foreign currency or government treasury notes can be changed into means of payment instantly or after a short period of time, with most banks issuing cheque books against interest-bearing accounts so that holders can use these accounts as a means of payment. Foreign currency deposits can also be converted in no time at all to local currency and used to settle debts. The same applies to government treasury notes. Indeed, the authorities should consider the question of liquidity if they are to adopt the 'means of payment' approach.

Moreover, from the point of view of controllability, the existence of new financial institutions, such as building societies in England and the Islamic finance houses and

insurance companies in Kuwait, have added a new dimension to the issue. In situations in which commercial banks are the only controlled institutions, liquid assets can be transferred from the controlled sector to the uncontrolled sector. In some other developing countries the problem of transferring funds in this way is problematic since the phenomenon of disintermediation prevails whereby direct lending takes place between lenders and borrowers. For instance, the Kuwait Finance House (an Islamic bank) remains outside the control of the Central Bank of Kuwait, since according to its legal statutes it is not considered to be a bank; yet it opens current accounts, issues cheque books and accepts interest-bearing deposits according to Islamic law.

Nevertheless, the concept of liquidity or substitutability remains an ambiguous issue. For example, which time deposits are to be considered a good substitute for currency or current accounts in terms of liquidity? What period of maturity should be taken to distinguish between types of time deposits: weeks, months, or years? The same questions apply to near-liquid assets such as bonds and treasury bills. Ghatak (1981, p.4) agrees that government securities and bonds as financial assets are a close substitute for money, but says that, "the essential property of money as a means of exchange should not be neglected." Friedman and Schwartz (1970, p.129) say that the criterion of "liquidity" is more problematic than the criterion of "medium of exchange". In their

discussion of the definition of liquidity they say that, "attempts to define 'liquidity' precisely have failed to produce anything like a consensus." Friedman and Schwartz add two new dimensions to the argument over the 'liquidity approach' to the definition of money, the ability to sell any proposed asset as a close substitute for money within a specified time limit for a nominal sum fixed in advance; and the degree of perfection of the market in which the asset is offered for sale at a well-defined market price. Moreover, Goodhart (1989, p.24), in his exhaustive discussion of the influence of uncertainty and information on the whole monetary concepts, argues that the need for money as a means of payment is caused by the existence of uncertainty. Thus money - in his view - is a specialized means of payment. He based his view on the grounds that there is a distinction between the means of payment and a medium of exchange, as the latter is a broader concept than the former. Therefore, for an object of a medium of exchange to be used as a means of payment, it needs sufficient information to make it generally acceptable without detailed and costly investigation. However, Goodhart concluded his argument by pointing out that with a wider range of financial institutions able to provide payment's services on deposits, and with a further range of institutions, "then the whole question of the definition, quantification and interpretation of monetary quantities

would become much more problematical and uncertain." (Goodhart, 1989, p.103).

To conclude, one may say that money can be defined as a tool, or number, which serves a specific purpose, and not something which has a definite, concrete existence. Consider, for example, two defined monetary aggregates: M1, which includes currency and demand deposits; and M2, which includes all bank interest-bearing deposits in addition to M1. When the two aggregates grow or decline over time at the same rate, the authorities face no problem in targeting the growth rate of the money supply. However, when the two aggregates show different rates of growth or decrease, the authorities face a real dilemma, since they have to choose one of them to control. Hence, there is no harm in adopting more than one definition of money as long as the goal of controlling one particular aggregate is quite clear. Furthermore, any given definition of money can be changed after a time, especially when the financial market has been developed and new instruments, such as government securities, introduced. Thus, for the sake of controllability, the definition of money needs to be expanded to include more financial assets or institutions. Obviously the variations inherent in different economies and the difference in degree of sophistication between financial markets mean that the definition adopted by one country may not suit another country.

Definition of the Money Supply in Kuwait

According to the publications of the Central Bank of Kuwait, two monetary aggregates are used to express the term 'money'.

$$1) \quad M1 = C + SD$$

where:

M1 = narrow definition of money

C = currency in circulation held by the public  
= currency issued by the Central Bank of Kuwait  
= currency held by the commercial banks

SD = private sight deposits at the commercial bank  
in Kuwaiti dinars.

$$2) \quad M2 = M1 + QM$$

where:

M2 = broad definition of money (money supply)

QM = Quasi-money  
= savings deposits in (K.D)  
+ time deposits in (K.D)  
+ certificate of deposits in (K.D)  
+ deposits in foreign currencies  
owned by residents.

The size of the money supply either in its narrow (M1) or broad (M2) definition depends mainly on the base money through the multiplier. It is useful to explain the definitional equation of the base money in Kuwait and its main determinant factors.

Base or high power money goes under the term (reserve money) in the Central Bank Budget as:

$$B = R + C$$

where:

B = The base money:

R = local banks' reserves:

= cash held by commercial banks

+ deposits of the commercial banks  
at the Central Bank of Kuwait

+ Central Bank Bills owned by  
the commercial banks.

C = currency in circulation held by the public.

Let us assume that m = monetary multiplier,

M = money supply, and

B = monetary base.

Then  $m = \frac{M}{B}$ .

The size of the multiplier would vary according to whether M signifies the narrow or the broad definition of the money supply. By adopting the narrow definition (M1) of money, the size of the multiplier (m) is smaller than when the broad definition of money (M2) is used.

Using this equation, one can conclude that, when the narrow definition of money is used (M1):

$$m = \frac{C + SD}{R + C}$$

or when the broad definition of money is used:

$$m = \frac{C + SD + QM}{R + C}$$

QM indicates the interest bearing deposits at the commercial banks.

$$\therefore \frac{M}{B} = \frac{C + SD + QM}{R + C}$$

The multiplier equation can be rewritten in terms of ratio as follows, by dividing the right hand side by total deposits (TD).

Where:

$$TD = SD + QM$$

$$\frac{M}{B} = \frac{C/TD + SD/TD + QM/TD}{C/TD + R/TD}$$

$$\text{As } M = mB$$

$$\therefore M = \left( \frac{C/TD + SD/TD + QM/TD}{C/TD + R/TD} \right) B$$

Thus, the multiplier is given by

$$m = \frac{C/TD + SD/TD + QM/TD}{C/TD + R/TD}$$

Sources of the monetary base

By referring to the balance sheet of the Central Bank of Kuwait, one can disclose the sources that influence the monetary base, as -

Total Assets = Total Liabilities.

Thus:

Foreign Assets  
+ Commercial paper Rediscounted  
+ Other Assets

= Currency Issued  
+ Local Banks' Balances  
+ Central Bank Bills  
+ Government Accounts  
+ Capital and Reserves  
+ Other Liabilities.

°.° B = Foreign Assets  
+ Commercial Paper Rediscounted  
+ Other Assets  
- Government Accounts  
- Capital and Reserves  
- Other Liabilities.

△ B = △ Foreign Assets  
+ △ Commercial Paper Rediscounted  
+ △ Other Assets.

As B = C + R

°.° B = Currency in Circulation  
+ Cash held by the commercial banks  
+ Deposits of commercial banks at the Central Bank  
+ Central Bank Bills owned by the commercial bank.

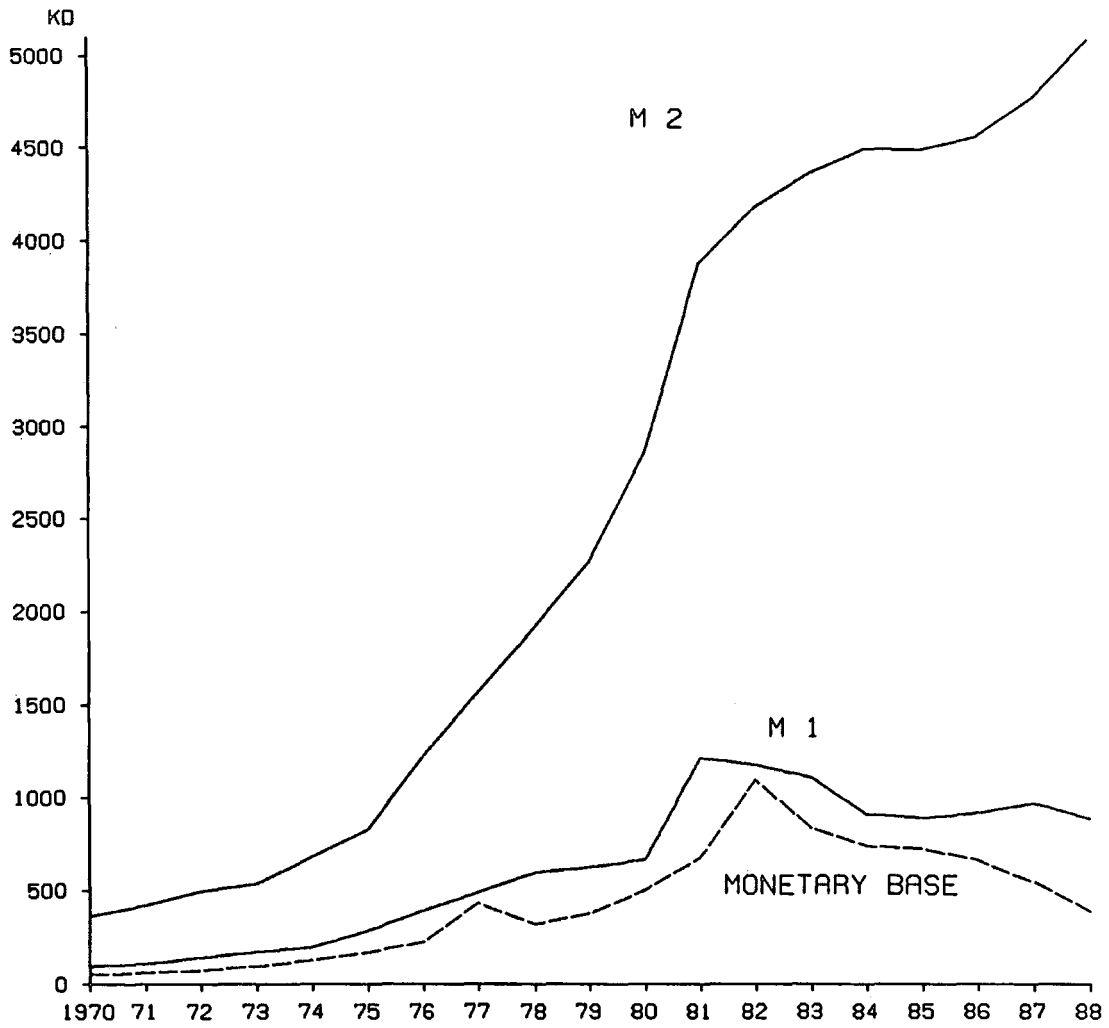
Thus the following aspects of the interrelationship between the components of the multiplier equation can be derived:

1. The money supply is determined by the multiplier and the monetary base.
2. An increase in the base resulting from an increase of the currency held by the public - which is related to the balance of payment position of foreign currency -, or an increase in commercial banks' reserves, will reduce the multiplier at a given level of money supply, and vice versa.
3. Given that the monetary base contains two elements (R+C), if the currency in circulation (C) declines in favour of the commercial banks' reserves, the ability of the commercial banks to create money will increase. This would occur over time as the banking habit grows.
4. If the demand for bank deposits increases against a decline of the demand for currency as the banking and investment habits grow over time, especially in the growing economy of Kuwait, that will raise both the demand and quasi-money ratios in the multiplier equation, which in turn increase the money supply as more reserves will be available for banks.
5. Lower reserve ratio will increase the excess reserves of the commercial banks and enhance their lending ability,

which will lead to a higher money stock as more currency is held outside the banking system.

Figures 4.1 and 4.2 illustrate the growth trend of the components of the multiplier equations for the period between 1970 and 1988. In Figure 4.1 the monetary base growth seems to correspond more to the M1 line than to the M2 line, this is because currency in circulation represents an important portion of the narrow definition of money (M1), while in the broad definition of money (M2), the quasi-money represents the major portion. However, Figure 4.2 shows the trend of the two multipliers, which indicates that both multiplier move together for the whole period from 1970 to 1988 in spite of the fact that the value of the multiplier of the broad money (M2) is greater than the other multiplier of the narrow money, and shows a larger fluctuation. Thus the difference between the multipliers of the two aggregates is due to the fact that in the broad definition of money - as the quasi-money is included - we give more room to the behaviour of the commercial banks to be reflected in the size of the multiplier, since these banks have the ability to create more money in the economy. Therefore, this ability of commercial banks to influence money creation is of great importance, This underlies the need for the monetary authorities to control the money supply through controlling the reserves of these banks. On the other hand, the fluctuation of the multiplier within the same aggregate can be attributed to the behaviour of the

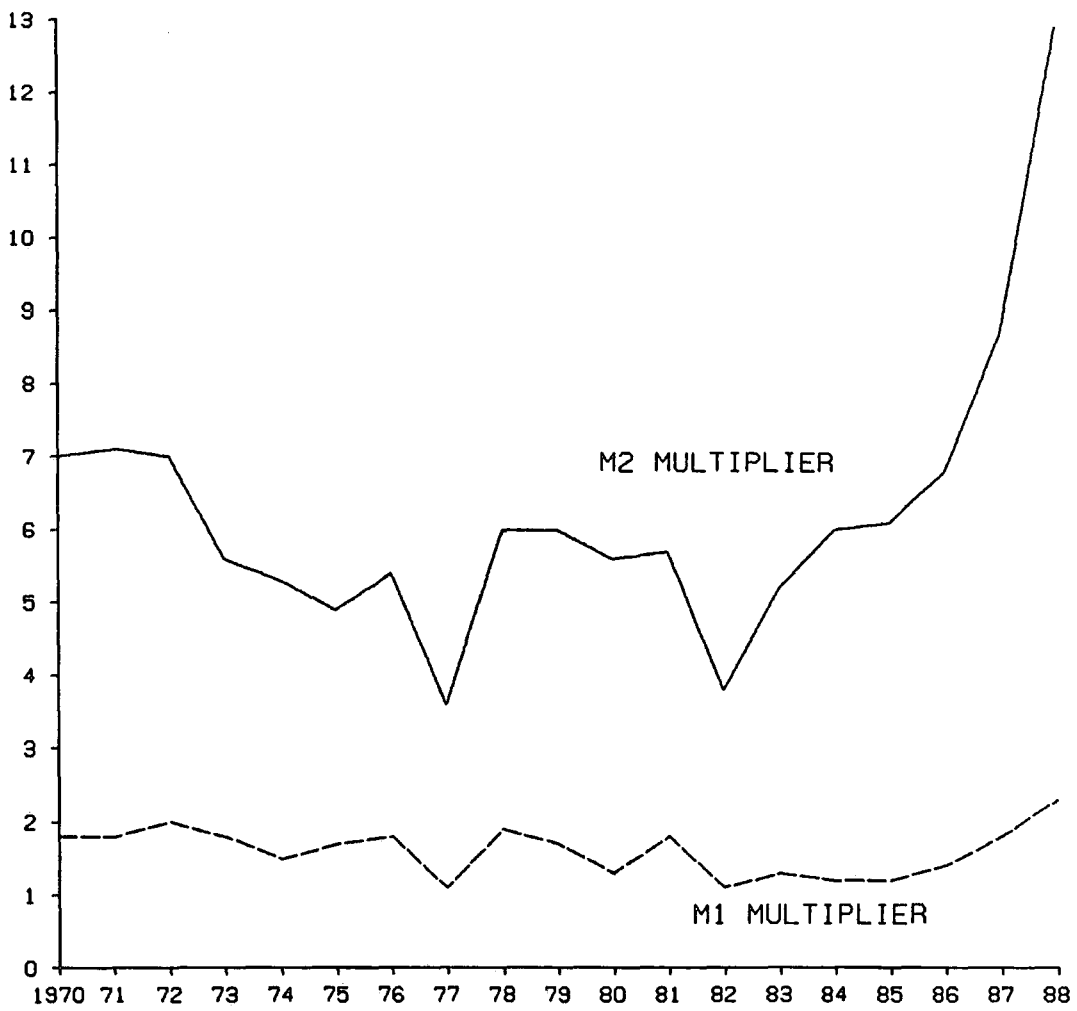
FIG: 4.1 GROWTH OF MB, M 1 & M 2



SOURCE: CENTRAL BANK OF KUWAIT



FIG:4.2 M1 & M2 MULTIPLIERS



SOURCE: CENTRAL BANK OF KUWAIT



sources that influence the component of the multiplier equation. For example, if the currency to total deposits ratio increases because the public decide to hold more cash, the value of the multiplier will decline. The same result will occur when the reserve to total deposits ratio rises as a result of the desire of the banking system to keep higher reserves. Moreover, in the fractional reserve system as a policy instrument, the Central Bank can change its monetary liabilities which result in proportional changes in bank reserves, and hence affect the size of the multiplier. However, the stability of the multiplier is of great importance to the monetary authorities with regard to their ability to control the money supply. Therefore, if the multiplier is stable and predictable, they can influence the money stock by influencing the monetary base, since the latter is the liability of the Central Bank which is assumed to be able to control it. In Kuwait, the fluctuation of the multiplier can be attributed to various economic agents that have influence over its component. For example, one reason for the fluctuation of the two multipliers in Figure 4.2, especially their upward rise during periods before 1977 and 1982, and their sluggishness following those two years, can be attributed to the behaviour of the commercial banks in response to the flourishing activity in the stock market and its subsequent collapse. Thus, the commercial banks, by expanding their credit, have caused the value of the two multipliers to rise, and to decline when they ceased their loans after the collapse of

the stock market. This condition is encouraged by the marginal reserve ratio imposed by the Central Bank, which allow the commercial banks to hold sizable excess reserves.

Another reason for the fluctuation of the multiplier within the same aggregate is the growing expenditure trend of the Kuwaiti government, as this trend will induce changes between the various component of the multiplier, and hence affect the size of the multiplier. Moreover, one can also envisage the effect of the influx of huge numbers of expatriate labourers with high demand for currency holding on the composition of the public portfolio, and hence on the component of the multiplier equation which result in changing the value of the multiplier.

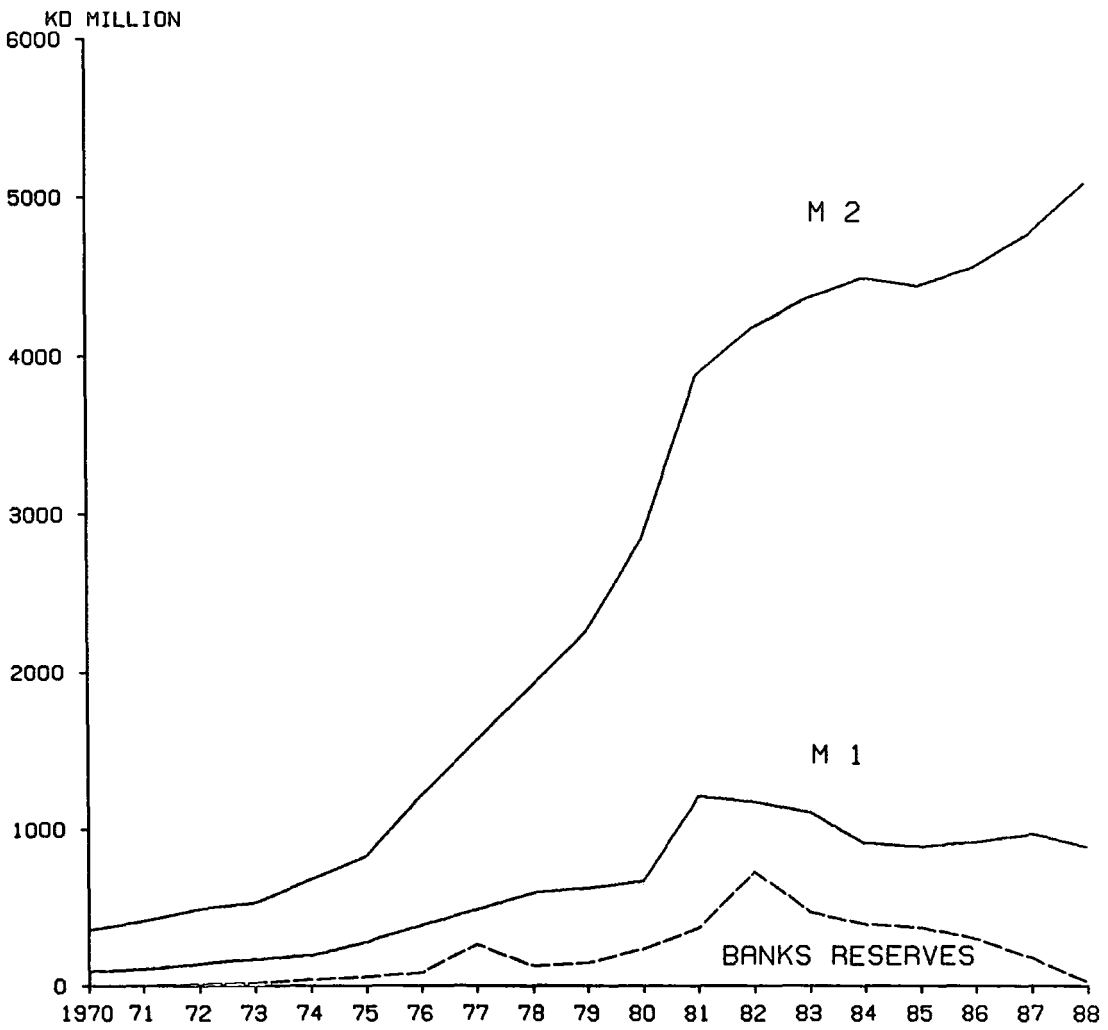
The fluctuation of the multiplier in Kuwait can also be attributed to some exogenous influence via the effect of foreign interest rates on the quasi-money to total deposits ratio. Thus, when foreign interest rates increase, especially on the U.S. dollar deposits, more KD deposits are converted into foreign deposits outside the local economy, and reduce the quasi-money to total deposits ratio which in turn reduce the bank reserves and the size of the multiplier. However, this external influence on the multiplier is encouraged by the interest rates and exchange rate policies adopted by the Central Bank of Kuwait, the former imposed a ceiling on local interests rates that weakens their competitiveness to

those prevalent in foreign markets, while the latter secures a stability of the exchange rate of the Kuwaiti dinar against major foreign currencies, hence encouraging capital outflow.

When the growth rates of the components of the multiplier equation were calculated over the period between 1970 and 1988, it was found that the monetary base registered an annual increase of 12.0 percent, which is very close to the growth rate of the M1 at 13.0 percent, while the growth rate of the M2 recorded 16.0 percent average annual increase. The growth rates of both narrow and broad multipliers were found to be 14.0 percent and 35.0 percent respectively. The means were recorded at 1.6 and 6.2 for both multiplier respectively, and the narrow multiplier fluctuated from 1.1 to 2.3, giving a range of 1.2, while the broad multiplier fluctuated from 3.8 to 12.9, recording a range of 9.2.

As the commercial banks' reserves (required reserves + excess reserve) represent an important part of the monetary base, Figure 4.3 illustrates the relationship between the banks' reserves and M1 and M2. The banks' reserves consist of cash held by the commercial banks, deposits with the Central Bank, and Central Bank bills owned by the commercial banks. It is worth noting that the required reserve ratio applied by the Central Bank in the second quarter of 1980 is 3.0 percent of the total deposits; thus, the total reserves of the commercial

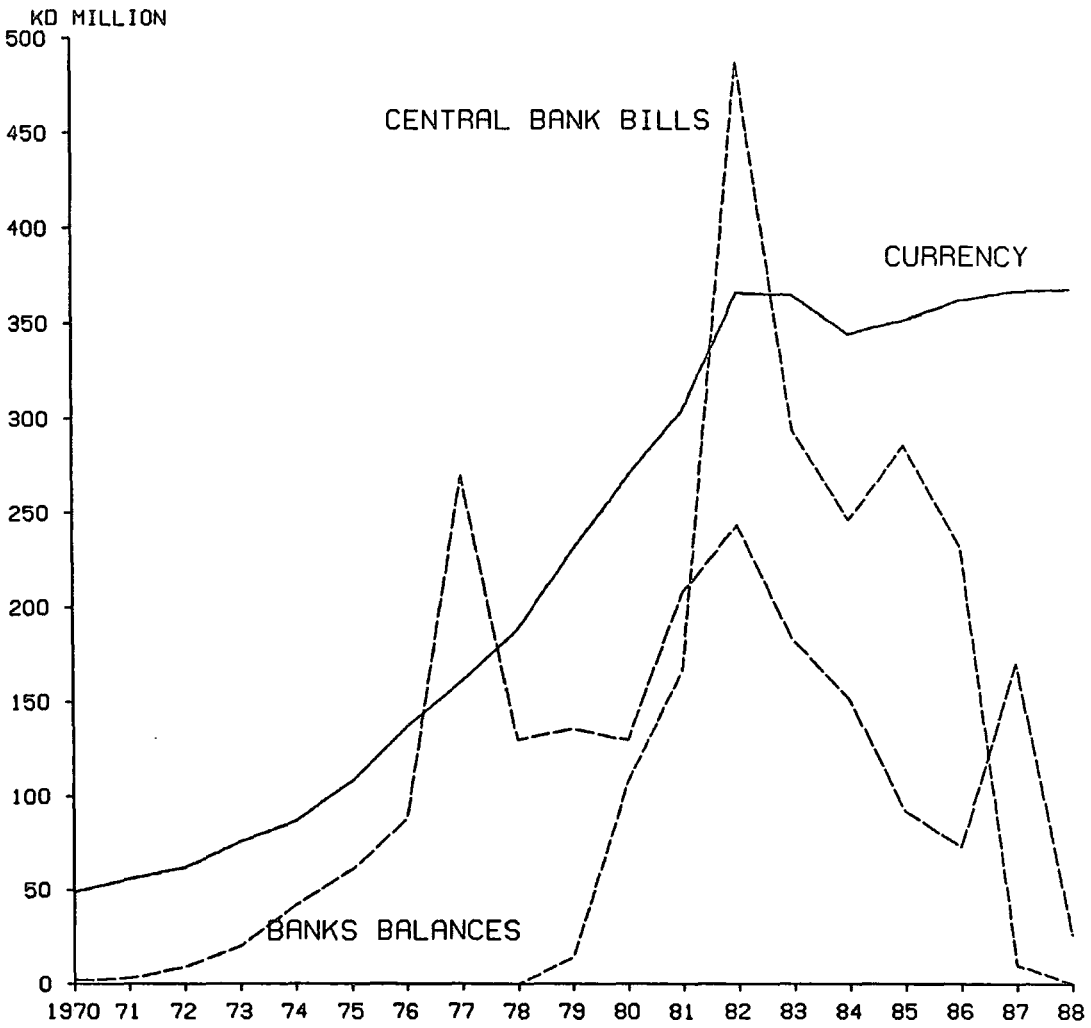
FIG: 4.3 GROWTH OF BANKS RESERVES ,M1 & M2



SOURCE: CENTRAL BANK OF KUWAIT



FIG: 4.4 COMPONENTS OF THE MONETARY BASE



SOURCE: CENTRAL BANK OF KUWAIT



banks have always exceeded the required reserve. The reason for this is quite simple: the Central Bank bills are interest-bearing reserves. It is believed that since banks are profit makers, the behaviour of their reserves is influenced by the profitable opportunities available in the market. Thus the downward trend of the reserve line in Figure 4.3 corresponds to the upward trend of both M1 and M2, while the sharp drop of the Central Bank bills holding, as shown in Figure 4.4, can be attributed to the move to acquire public debt instruments introduced to the market in November 1987.

#### Behaviour of The Money Stock

It is conventionally assumed that the behaviour of the quantity of money in the economy should have its equilibrium state where the demand should equal the supply of it. And by assuming that the money supply is under the control of the authorities either directly or indirectly, the authorities should exert their influence to bring about the level of the supplied quantity of money to its demanded level. On the other hand, intensive studies at the macroeconomic level have been carried out on the demand for money and these studies have been concentrating on analysing the motives behind the demand for money, or to answer the question why money is demanded, and to determine the variables that influence this function. Hence, the relationship between the demand for - and supply of - money, is of a great

importance to the policy maker. An important objective is to bring about stabilisation in the economy, in order to avoid the undesirable effects that occur from the disequilibrium in the relationship of the demand for - and supply of - money. Such effects should leave their impact on prices and output. For a comprehensive review of the theories on the demand for money, see Laidler (1985).

The stability of the demand for money has been an important issue that economists elaborately addressed in their studies. The importance of this issue is based on the assumption that if there is a stable and predictable relationship between the behaviour of the demanded money stock and those factors play the key role in determining its demand, it becomes easier for changes of policies to induce the required effects in the economic conditions. In this respect, Laidler (1970) has argued for a great deal of conventional evidence in favour of a stable function of the demand for money. On the other hand, Goodhart (1989, p.95) has questioned the stability of the demand for money function especially during the last two decades. His question is based on the exhaustive review of studies provided by Judd and Scadding (1982), as he concluded that the most common explanation about the instability of the demand for money function in general, and in particular during the inflationary periods - such as following the first oil shock in 1973 -

is attributed to financial innovation. Such innovation, once it occurs, is irreversible.

Another area of argument over the demand for money is the scale of variables used in estimating this function, and whether these are well represented or not. Such arguments are well focussed in the controversies over the use of income or wealth as an independent variable.

Laidler (1985) suggests that wealth variable has gained a wide consensus to be used, while Goodhart (1989, p.82) argues that "wealth is the capitalization of present and future incomes, so the above explanatory variables are not fully independent, the normal procedure is to omit either wealth or income from the estimating equation".

Moreover, there is also a disagreement over the representative interest rate that should be included in the demand for money function, and whether this interest rate should represent the yield on the financial assets or yields on other assets, including real assets. This argument is based on the contention over the range of substitutability of money balances for other assets in the economy, or in other words, whether money balances are close substitutes to alternative financial assets, or whether money is a substitute for all other assets, including real assets. Therefore, the representative interest rate included in the demand for money function should reflect yields on a wide range of assets in the latter assumption, while in the former case, a

representative interest rate for a sub-set of liquid financial assets is to be included. However, and apart from the theoretical argument, in practice, the availability of the data, especially in the developing countries, stands as a real obstacle to the empirical works to comply with theoretical concepts, which would affect the results of such empirical works. For instance, one can not include wealth as an explanatory variable in estimating the demand for money function in Kuwait since there is no published data concerning this variable. Moreover, the available data of the income variable is only on an annual basis. This represents a problem if the desire is to build a model using quarterly data, and hence one would have no choice but to extrapolate quarterly data from the available annual data. On the other hand, the data for interest rates on bank deposits is also not available in Kuwait which exhibits another obstacle for estimating the demand for money function, especially if the demand for interest-bearing deposits is in question. Therefore, one should find a close alternative variable to be included in the equation. However, these obstacles could affect the significance of the results of such empirical work.

Having defined the components of the money supply and the sources of the monetary base at the beginning of this chapter, one may conclude that the behaviour, or process of the money supply is a combined effect of the behaviour of different sectors of the economy; namely, the

government, the public, the banking system and the Central Bank, plus the rest of the world. It follows that the ability of the monetary authorities to pursue a successful monetary policy depends on their understanding of the parties that influence the money supply, the instruments that are available to them, and the political and social environment in which the monetary authorities are working.

In many countries the government can affect the money supply by monetizing its deficit through the borrowing from the Central Bank and expanding the money supply by spending the borrowed funds. It can also affect the money supply by direct borrowing from the public and then by exercising the open market operations. The Central Bank can influence the money supply by holding net foreign reserves which reflect the position of the country vis-a-vis the rest of the world, but this depends on whether the country follows a fixed or floating exchange rate policy. The Central Bank can also influence the money supply indirectly by controlling the required reserve ratio of the commercial banks. In contrast, the commercial banks can influence the money supply by using their unique ability to create money, this being dependent on their excess reserves and the required reserve ratio imposed by the Central Bank. However, in an open economy, where local currency can easily be converted into foreign currency, and capital movement is unrestricted, one can imagine the influence exerted by the two-way flow of funds on the money supply. Funds can move in and out,

seeking more profitable opportunities, and advanced communications technology can play a great role in transferring information among financial markets, thus encouraging the movement of funds from one country to another. Competition can also play a great role in the import and export activity among countries, and so the money supply can be influenced by the net position of the trade balance.

Estimation of the money supply function is a sophisticated task. To estimate successfully, one must consider all the above mentioned factors plus the particular conditions prevailing in the country concerned.

According to Gowland (1984, p.43), the overseas flow is a major determinant of the money supply in an open economy, where the balance of payment deficit can reduce the money supply and lead to a lower monetary target. Llewellyn (1982, p.66) argues that the determination of the money supply,

"... is part of a more general process of how the real and financial sectors of the economy move towards general equilibrium and how interdependent adjustments are made."

He admits, however, that a wide model capable of specifying all the behavioural relationship of all agents for all assets and liabilities would be unwieldy.

Nevertheless, the demand for, and supply of, money functions, in developed and developing countries are different. Even in the developing countries themselves

there are variations. For example, the banking habit can play a great role in reducing the currency hold of the public and increasing bank reserves, thus affecting the supply side of the monetary equation. In contrast, an understanding of the concept of the purchasing power of money, together with the level of the investment habit of the society, can increase the demand for interest-bearing bank deposits. In some developing countries, the so-called unorganised sector is an arena for direct lending between lenders and borrowers without any financial intermediaries, preventing the banking system from playing its expected role, which is to meet the demand for money from the productive sectors (see Ghatak 1981).

### The Balance of Payments and The Money Supply

It is of great importance to explore the unique pattern of the position of the balance of payments of Kuwait, before estimating the function of the money supply.

Unlike most developing countries, Kuwait has experienced a persistent large surplus in its balance of payments as a result of its exports of oil, though the surplus fell with the oil price reductions of the 1980s. However, the lack of most basic products in Kuwait has led the country to depend on the rest of the world for consumer and capital goods (see Chapter 2). It follows that the balance of payments of the private sector with the rest of the world has suffered a continuous deficit. This deficit is covered indirectly by the oil revenue through government

budget expenditure. The mechanism of transferring the oil revenue into the local economy can be described as follows:

1. Oil revenues are paid in dollars, which are placed outside the country in the form of various types of investment assets as part of the country's foreign reserves.

2. The government budget is prepared annually and is influenced by economic, political, and social factors.

3. To finance its expenditures, the government calls on the appropriate amount from the foreign reserves by the Ministry of Finance and sells dollars to the Central Bank against Kuwaiti dinars. Accordingly the foreign assets of the Central Bank increase, as do the K.Ds deposited by the government with the Central Bank.

4. Once the government starts to use its K.D deposits for its expenditures through the Ministries and other channels, the monetary injections of the balance of payments position find their way into the local economy. In other words, the effects of the balance of payments surplus in the economy does not follow a direct pattern; it rather occurs only when the government decides to use its foreign reserves to finance its spending. It follows that the expansionary effect on the money supply is exerted by government spending and not by the oil revenues or the balance of payments surplus. The correlation coefficient between the oil revenue and the government

expenditure was calculated for the period from 1973 to 1988, and was found at  $R = 0.219$ , which means a weak relationship between the two variables. Hence, one can assume that the pattern of the realized oil revenue does not influence the injection of money into the economy because of spending occasioned by the government budget. However, it is believed that government spending influences the money supply. For the period from 1974 to 1988, government spending averaged 41.6 percent of the total GDP of the country. The correlation coefficients between the government expenditure and the money supply for the period 1970 to 1988 were  $R = 0.87$  for narrow money, and  $R = 0.88$  for broad money.

#### Government Domestic Expenditure

For a better understanding of the widespread effect of government expenditure across the various economic sectors of the Kuwaiti economy, it might be useful to disaggregate its components as follows:

#### Total Government Expenditure

= wages and salaries.

+ Requirements of goods and services.

+ Means of transport and equipment.

+ Development projects and land purchase

+ Miscellaneous expenditure and transfer payments.

Thus, the government domestic expenditure equals:

Government Domestic Expenditure

⇒ Total Government Expenditure

-Transfers Abroad (which represents a proportion  
of the transfer payments).

The transfer abroad of funds consists of financial aid to friendly countries plus direct government purchases from abroad. The influence of government expenditure on the expansion of the money supply in the Kuwaiti economy can be imagined in a broad sense if one can understand the nature of the fiscal policy in Kuwait. Normally, three main tools are used to exercise fiscal policy and achieve objectives: government expenditure, taxation, and management of public debt. The authorities can use any or all of these tools to adjust the conditions of the economy either in real terms or between the real and monetary sector. For example, income tax policy can be used to influence the impact of income or public spending on prices, while the public debt instruments can be used by the authorities, through open market operations, to influence the quantity of money and avoid any undesirable impact of its expansion. In Kuwait, government spending is the only weapon that the authorities can use to execute fiscal policy, with expansion being the result, unless the government tries to use this weapon in comprehensive terms, which seems impractical and lacks empirical evidence as to its efficacy. Hence, the disturbing trend

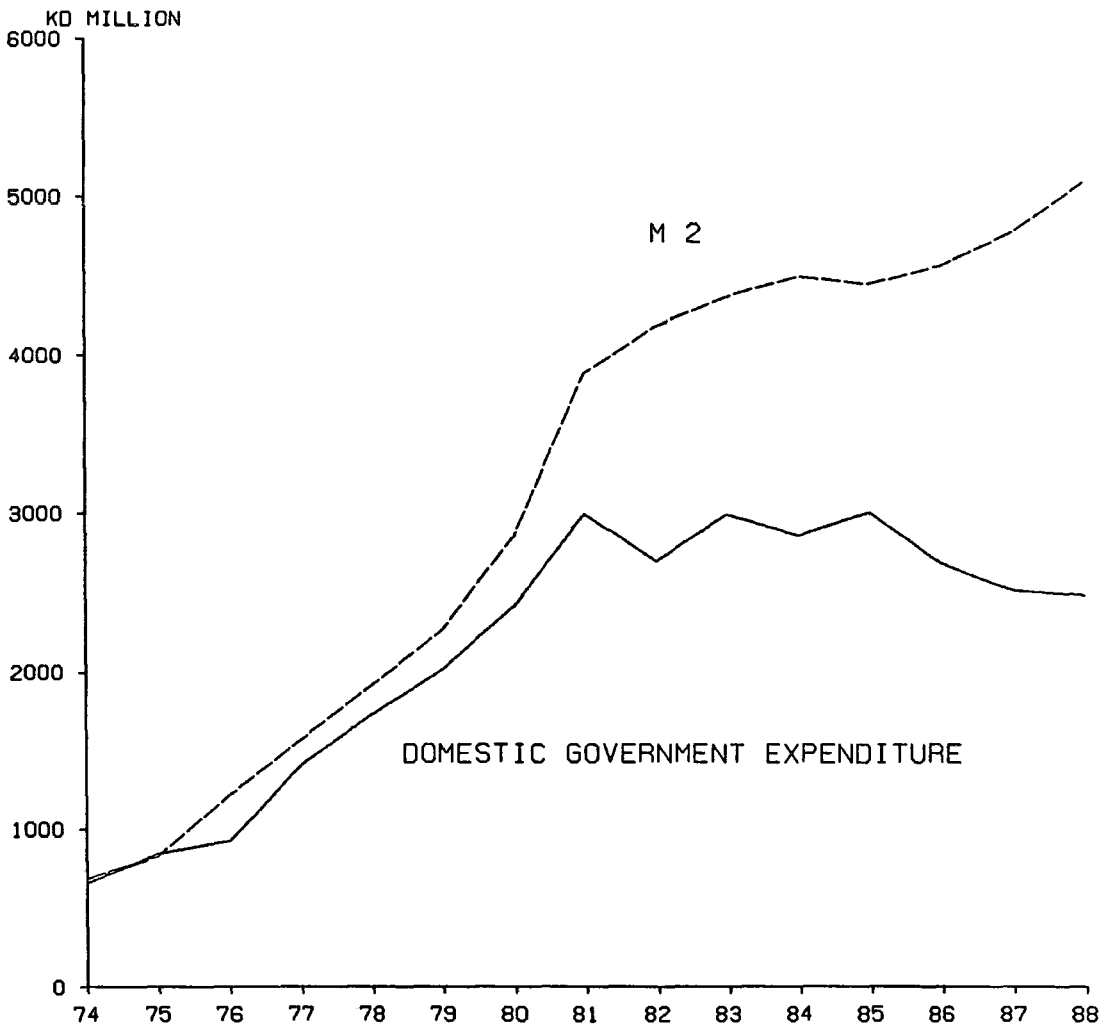
of public expenditure during the 1980s can be attributed to the policy of rationalization of expenditure due to the decrease in oil prices and demand, rather than to an economically orientated policy. Therefore, one may conclude that in the absence of any application of income tax and public debt instruments, the money supply is expected to expand as a result of government spending. As a matter of fact, the public debt instruments were introduced in November 1987. There is a need for more evidence to examine the effects of this tool on the money supply behaviour. Hence, as this study covers the period between 1970 to 1988, this factor is disregarded. Figure 4.5 shows the relationship between the government's domestic expenditure and the money supply for the period 1974 to 1988, based on annual data from the Central Bank.

Some theoretical and empirical works were carried out on the economy of Kuwait covering different periods of time, and it is our concern here to argue for the importance of the impact of government spending on the money supply by reviewing such researches. El-Mallakh and Atta (1981, p.73) in their work on monetary analysis in Kuwait for the period between 1973-1978, say that,

"The level of liquidity in Kuwait depends on two factors: the government's net injection from oil revenues and net flow of capital out of Kuwait."

Khouja and Sadler (1979, Chapter 7) in their macroeconomic model of Kuwait, in which they rely on annual data for the

FIG: 4.5 GROWTH OF M 2 & D.G. EXPENDITURE



SOURCE: CENTRAL BANK OF KUWAIT



period from 1961-62 to 1975-76, use two explanatory variables to estimate the money supply function, the net government outlay, and the short-term Euro-dollar interest rate - this under the assumption that the monetary authority has had little influence on changes in the money supply, and that effective monetary instruments have been absent. The authors believe that the money supply was influenced to a large extent by factors outside the monetary sector.

However, this impression can be attributed to the fact that prior to 1968, when the Central Bank was inaugurated, the Kuwaiti Monetary Board was only responsible for issuing the local currency (see Chapter 3). From 1969 to 1975 it may be argued that the Central Bank was involved more in developing the financial market in general, and the banking system in particular, rather than in regulating the money supply. Another empirical work on the monetary sector by Ghuloum (1984) implies that for the period between 1974 to 1982, government expenditure was used to explain the money supply behaviour in its narrow and broad definitions.

For the purpose of this study the government's domestic expenditure will be used as an exogenous variable to estimate the supply function of money according to the following definition:

$$GDE = TGE - TA$$

where:

GDE = Government domestic expenditure

TGE = Total government expenditure

TA = Transfers abroad.

### Bank Credit

In general, bank credit can play an important role in influencing the money supply through the unique ability of the commercial banks to create money. The ability of the banking system to expand the money supply depends on various factors reflecting the demand-supply function of bank credit, and these are rather complex. For example, private demand for bank deposits is a major determinant for increasing banks' reserves and enhancing their ability to supply more money. Hence this factor cannot be isolated from the whole portfolio adjustment system of the private sector, which includes the substitutability of other financial and real assets in the economy. The local interest rate is also incorporated in the function for it affects both the demand for banking deposits by the private sector, and the supply side by the banking system as they adjust their investment portfolio. The required reserve ratio applied by the Central Bank, along with qualitative credit measures, can affect the ability of the commercial banks to create more money.

It has been noted that some studies have underestimated the role of bank credit in their estimations of the money supply function. Khouja and Sadler (1979, pp.86-107), for example, consider that the money supply function is explained completely by government expenditure and foreign interest rates. The whole monetary sector had even been ignored by the World Bank macroeconomic study on Kuwait's long-term development strategy (1980), as it was taken for granted that government expenditure is the sole determinant of the local liquidity level. To some extent, one can understand the doubt expressed in such studies about the development of the financial market in Kuwait, especially those studies concerned mainly with the pre-1970s period, such as that of Khouja and Sadler. The reason that the World Bank study excluded the monetary sector in its macroeconomic model is that the model is general purpose orientated, together with the preconceived assumption about the obstacles prevailing in developing economies such as disintermediation. Ghuloum (1984) and Moosa (1986), however, highlight the inflationary impact of bank credit in Kuwait (see Chapter 3 for the development of the credit facilities of the commercial banks).

In Kuwait the factors that influence banking credit are as follows:

1. The development of the banking system, which includes the number of commercial banks, their branches, and services.

2. The role of the Central Bank in controlling bank credit.
3. The evolution of the banking habit among the public, which includes the growth of the investment habit. The realisation of the difference between real and nominal economic terms such as, income, interest rates, and the purchasing power of money.
4. Pressure of the trading sector on commercial banks.
5. Religious factors.
6. Social pressures on commercial banks.
7. The relationship between foreign and local interest rates.
8. Speculative trends in stocks.
9. Economic conditions of the country.

The growth of the Kuwaiti economy during the last three decades, especially during the 1970s after the sharp increase in oil prices, has caused great changes in all aspects of the country's life. The banking system is assumed to have expanded during the 1970s, with nine banks and more than one hundred branches scattered throughout the country. In other countries this number might be considered modest, but for a small country like Kuwait,

with a population of less than two million, the number of bank branches allows everyone in the country to reach any bank in less than twenty minutes. For example, more than 90.0 percent of government employees cash their salaries through their bank accounts. Moreover, in each suburb there is a complex of different services, including at least one or two bank branches. It is assumed that the spread of banking services has served to encourage demand for these services, including bank credit and particularly consumer loans.

As the country develops, the banking habit is expected to grow accordingly, as the public becomes accustomed to using cheques more in settling their transactions and reducing their cash holding. It is believed that the credit policy of a particular bank can play a substantial role in encouraging the banking habit among the public. For example, if a bank is particularly sympathetic to the idea of consumer loans, this will induce everyone who applies for a consumer loan to open an account with that bank.

The investment habit plays a great role in increasing the demand for bank deposit, as does the supply of credit by the commercial banks as a result of increasing their reserves. One may assume that the investment habit could be induced by incentives offered by the commercial banks such as deposit cheque accounts, where the depositor is given a cheque book for his interest-bearing deposit.

The realization of the purchasing power of money can encourage the investment habit, with an increase in the public demand for bank interest-bearing deposits, in order to compensate for the decline in the purchasing power of money. Moreover, the awareness of the society of real versus nominal economic terms can affect both the demand and supply side of bank credit through what is termed the "general portfolio adjustment process" in the private sector.

Social pressures can also influence the credit policy of the banking system. For a small country such as Kuwait, where the ownership of the banks is confined mainly to family groupings, it is expected that friends and relatives will find an easy way to bank credit (see Personal Credit in Chapter 3).

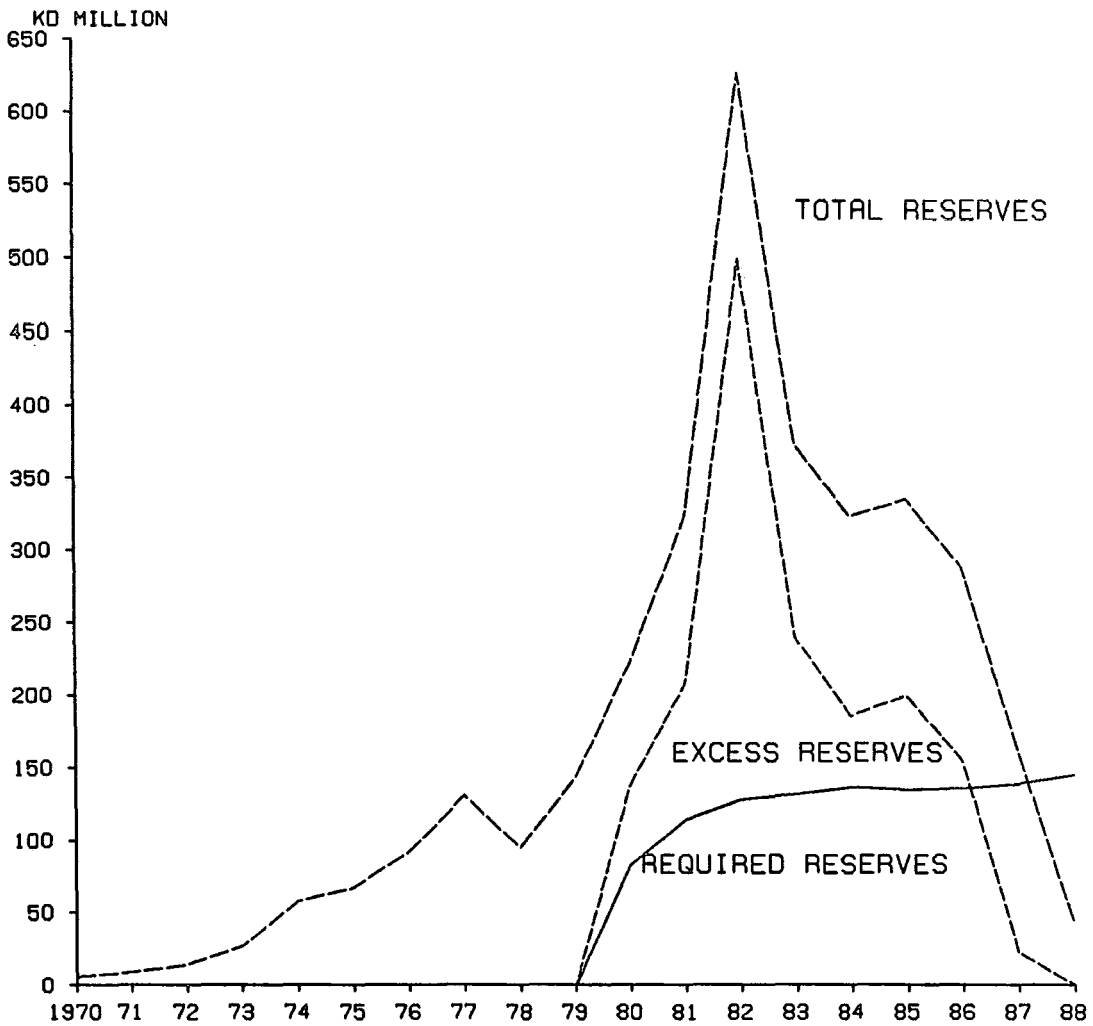
The trading sector exercises tremendous pressure on banks to obtain credit to finance imports. The over-dependence of the country on the rest of the world's imports generates increasing demand for goods and services. It is a fact that in some periods, demand for bank credit exceeded private sector liabilities at the banks, and thus the commercial banks faced a liquidity problem which was accommodated by the government and the Central Bank. The latter had suggested to the commercial banks various measures to solve their liquidity problem and enhance their K.D position through swap operations, rediscounted bills, and an exchange deposits system.

Religion also tends to influence the supply and demand function of bank credit. For example, it is assumed that the demand for sight deposits derives from the traditional concept of the demand for money as a means of payment, while the demand for bank interest-bearing deposits is a demand for money as a store of value. The religious factor can distort or blur the clear line between these two motives for demand. Some people place their money in sight deposits, not because they intend to use them as means of payment, but because they believe that having any interest on their balances is a form of usury, proscribed by Islamic law. Yet since the motive behind using any kind of bank deposit cannot be discerned when someone opens a bank account, the scale of this sort of demand deposit is impossible to classify. Therefore, from the banks' position, and so far as the liquidity ratio is concerned, all demand deposits are dealt with as one aggregate, which tends to leave the bank with idle liquidity. However, this phenomenon is believed to have died out since the inauguration of the Islamic Bank in Kuwait (the Kuwait Finance House).

By contrast with the importance of the required reserve ratio in developed countries, or whenever the required reserve ratio is an active weapon in the hand of the monetary authorities, it influences the supply function of bank credit. Usually, banks are supposed to keep as excess reserves as small as they can, and so the Central Bank can influence the banks' total reserves by changing

the required reserve ratio, in order to control the banks' ability to grant credit to their customers. Of course, this depends on the size of the required reserve ratio and the excess reserve. Since the required reserve ratio was introduced in Kuwait by the Central Bank in 1980 at 3.0 percent of the total deposits of the commercial banks, it has not affected the lending ability of the commercial banks. This is because the marginal size of the ratio contrasts with the large size of the total reserves of the commercial banks. Another reason for the inefficiency of the ratio is the fact that it has been stable at 3.0 percent since it was introduced; a fact which reflects a lack of seriousness on the part of the Central Bank to use the ratio as a policy measure. The relationship between the required reserve and the total reserves of the commercial banks is shown in Figure 4.6. Assuming that the excess reserves of the commercial banks is equal to their total reserve before the introduction of the ratio in 1980, the imposition of the ratio has not affected the growing trend towards excess reserves; a result of which is that the decision to determine the excess reserve is in the hands of the commercial banks. In actual fact, the size of the excess reserve is influenced by indigenous and exogenous factors. Since the commercial banks are profit maximizers, the utility of their excess reserve is determined by three factors: the Central Banks Bills as an interest-bearing reserve; local demand for bank credit; and the foreign interest rates trend. The sharp

FIG: 4.6 COMMERCIAL BANKS RESERVES



SOURCE: CENTRAL BANK OF KUWAIT



increase in banks' excess reserves in 1982 reflects the recession of the local economy after the collapse of the unofficial stock market in the second half of 1982, while the decrease in excess reserves in 1984 corresponds in part to the local increase of demand for bank credit and the increase of foreign interest rates. The 3-month Euro-dollar interest rate is considered for this analysis.

Because of the absorptive capacity of the Kuwaiti economy (Chapter 2), the increasing national wealth is unable to find enough outlets inside the local economy; as a result, capital outflow is a common feature of the portfolio adjustment process of the economic sectors. Indeed, this phenomenon can be seen clearly in the Central Bank budget for the years 1986-88, when its foreign assets holding declined noticeably. But the issue is not as simple as it appears. Decisions concerning foreign investments as a response to the increase in foreign interest rates are very sensitive because of the simple fact of the exchange rate risk. Therefore, the investors, including the banking sector, prefer to invest their money inside the country, so as to avoid foreign exchange loss. The trend has its undesirable results, such as the inflationary trends reflected in price increases, and hectic speculation, over financial and real assets. This in turn increases the demand for currency and bank credit. However, speculative trends can be considered as an explanatory variable of the demand function of money, but the direction of the effect will

depend on the size of the different components of the money supply. For example, when sight deposits represent the major part of money supply, the effect of speculative activity is expected to be positive as people will move from interest-bearing deposits to sight deposits and increase their demand for more sight deposits (bank credit). But when quasi-money is the major part of money, the effect is expected to be negative. The speculation in shares that prevailed in Kuwait from 1980 through to the second half of 1982 increased the demand for bank credit, which in turn increased the size of demand deposits and lessened the demand for time deposits, since the depositors believed that trading in the stock market was an alternative to bank interest-bearing deposits.

Table 4.1 below shows the movements of both the interest-bearing deposits and demand deposits during the period between 1980 to 1984, during which the hectic phase of speculation in the stock market reached its peak. As the data illustrates, the ratio of the demand deposits to interest-bearing deposits increased dramatically from 19.1 percent in 1980 to 35.1 percent and 28.6 percent in 1981 and 1982 respectively; it then decreased to 24.2 percent and 16.4 percent in 1983 and 1984 respectively, following the collapse of the stock market.

Therefore, it is believed that the banks' credit facilities to the private sector are an important

Table 4.1: Relationship Between  
Interest-bearing Deposits  
and Demand Deposits (1980 - 1984).

List of Abbreviations

I B D = Interest-bearing Deposits.  
 D D = Demand Deposits.  
 T D = Total Deposits.  
 DD/TD = Demand Deposits to Total Deposits.  
 DD/IBD = Demand Deposits to Interest-bearing Deposits.

Year	I B D K.D million	D D K.D million	T D K.D million	DD/TD %	DD/IBD %
1980	2187.8	418.4	2606.2	16.0	19.1
1981	2652.9	930.1	3583.0	26.0	35.1
1982	2998.3	857.0	3855.3	22.2	28.6
1983	3254.2	787.6	4041.8	19.5	24.2
1984	3583.0	588.8	4171.8	14.1	16.4

Source: Central Bank of Kuwait; Quarterly Statistical  
 Bulletin: (July - September 1981),  
 (January - March 1987), (October - December 1988).

explanatory variable of the money supply function, to which it is expected to be positively related. Figure 4.7 shows the growth trend between the money supply and credit facilities from 1970 to 1980.

### Interest rate

Interest rates can play a dual role in both the demand for, and supply of, money. As far as money at its aggregation level is concerned, a low interest rate is expected to increase the money supply, since this will reduce the cost of borrowing reserves from the Central Bank, and vice versa, provided there is a highly sensitive response by the financial market in general, and by the banking system in particular, to any changes in the Central Bank's rate. Thus the net effect of changes in interest rate represents the accumulative influences on the components of the money supply. The picture will be clearer if we disaggregate the money supply into its basic components. The broad definition of money supply in Kuwait is used for this purpose.

$$M2 = C + SD + QM$$

where:

M2 = Money supply

C = Currency in circulation

SD = Sight deposits

QM = Quasi-money (interest-bearing deposits).

FIG: 4.7 M 2 AND BANK CREDIT FACILITIES



SOURCE: CENTRAL BANK OF KUWAIT



When the interest rate increases, it is assumed that the public will reduce their cash holdings on the grounds that the cost of holding high levels of liquid assets has increased. It follows that the demand for cash money will decline. One can argue that the elasticity of demand for cash to interest rate's fluctuation varies among the different sectors of the economy. Thus one may assume that enterprises would be more responsive than the public to changes in the interest rates as the former are more organised than the latter in their cash management systems. On the other hand, the public hold cash mainly for transactions purposes, thus their response is expected to be smaller. In general, one can assume that at a given level of income, the decrease in demand for cash money will change the structure of the monetary base in favour of the banks' reserve, which in turn serves to strengthen the lending ability of the commercial banks. But this is not always the case in developing countries where the rural economy is predominant. In such economies, when the nominal bank interest rate increases, prices begin to rise, inducing a large proportion of the public to convert their cash into real commodities rather than financial assets, in an attempt to avoid the risk of holding cash. Thus, although the currency is negatively related to interest rates, it depends on the level of response of the public to changes in interest rates. Since sight deposits are seen as the first and closest substitute for currency in terms of liquidity, it is

expected that as the banking habit grows, the use of cheque accounts rather than cash for the purpose of settling transactions will increase.

In the developed countries, it is not unusual to see people paying small amounts of money to a cooperative or small shop by cheque, while in the developing countries only large amounts are paid by cheque. Indeed, the more the people use sight deposits, the greater the increase in the lending ability of banks as the proportional relation of the monetary base is changed. It is believed that this is the case in Kuwait, as the growth of banking services has almost covered the whole country. Government and enterprises have also played a major role in encouraging the banking habit by transferring the salaries of their employees to the commercial banks, which promotes direct contact between the employees and the banks. Moreover, the increase of the labour influx into the country over the last three decades has increased the demand for banking services, including the use of sight deposits.

The effect of changes in interest rate on the demand for sight deposits is expected to be similar to its effect on currency. However, foreign interest rates are able to influence the demand for sight deposits. First, we will deal with the effect of local interest rates. It may be assumed that the increase of local interest rates would reduce the demand for sight deposits and increase the demand for interest-bearing deposits as the economic

sectors, including the public, will become more careful in adjusting their assets holding. On the other hand, as local interest rates decline, the demand for sight deposits will increase, since holding money in such accounts will become less costly, especially when the holders are waiting for speculative opportunities. Moreover, the decline of the interest rates will induce the demand for bank credit, since, when the banks grant loans to their customers they make the funds available to them in sight deposit accounts.

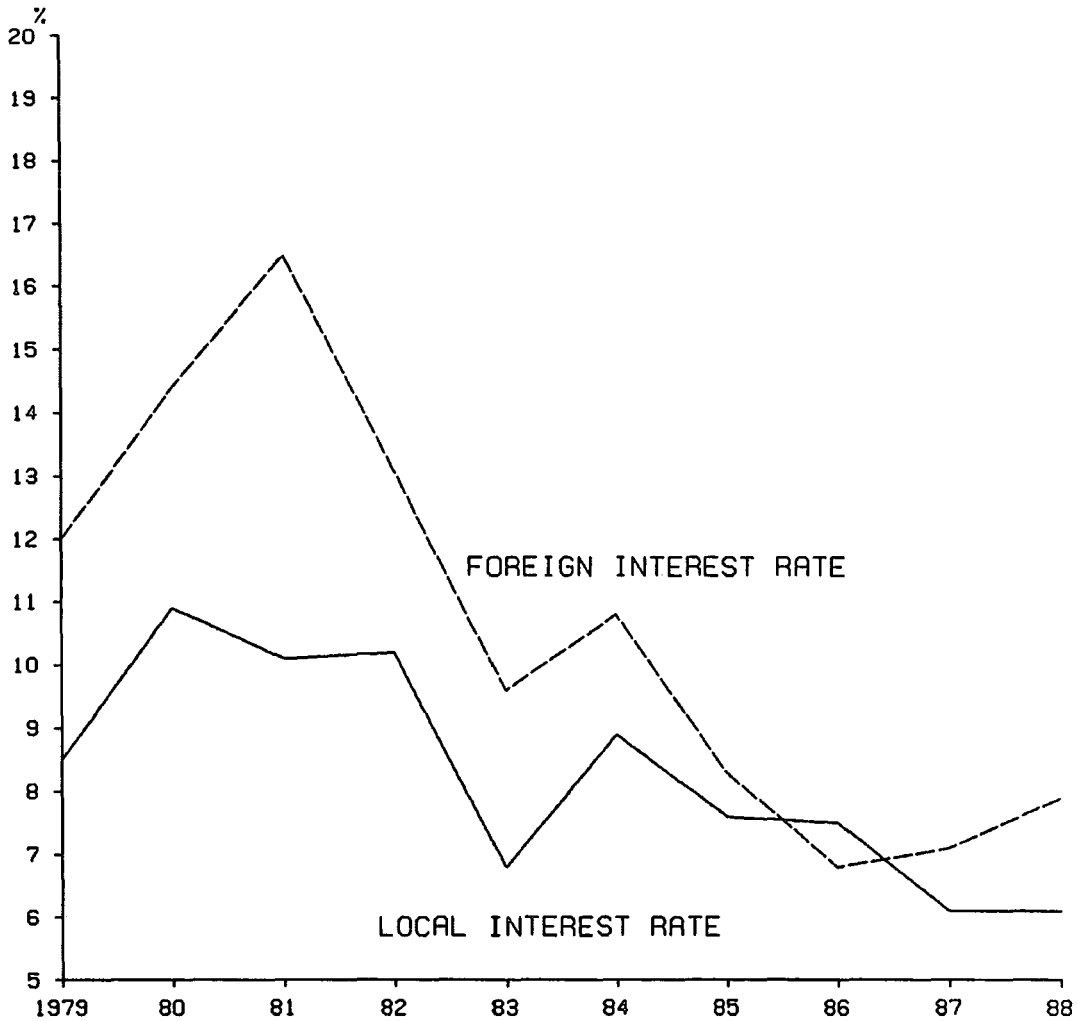
In an open economy, such as that of Kuwait, where the movement of funds is unrestricted and exchange controls are non-existent, foreign interest rates have an effect on the monetary aggregates. To examine the assumption that foreign interest rates influence sight deposits, let us imagine the following scenario. The structure of local interest rates is determined administratively with a ceiling of 10.0 percent. During the period that a holder of a sum as a sight deposit is adjusting his financial assets portfolio, the local interest rate on K.D deposits is raised to compete with the increase in the foreign interest rate on U.S. Dollar deposits. If the increase in foreign interest rates is beyond the ability of the local banks to respond, and large enough to cover any expectations of exchange risk, the holder can easily convert his K.D into U.S. Dollars deposits. This kind of transaction tends to lessen the demand for sight deposits and reduce the money supply as well. Moreover,

speculators can borrow from local banks and place the funds abroad in foreign currencies. Figure 4.8 illustrates the relationship between three month local interest rate (inter-bank rate) and foreign interest rate (Euro-dollar). It is clear that both rates are highly correlated - in spite of the difference between them - in favour of the foreign interest rate.

Changes in local or foreign interest rates can have a more direct influence on quasi-money, the third and largest portion of the money supply. Therefore it is expected that an increase in the local interest rate would encourage more people to place their money in interest-bearing deposits. However, an increase in foreign interest rates tends to reduce the demand for local time deposits and increase the demand for foreign currencies. Figure 4.9 shows the growth trends of the three components of money supply. The increasing trend of quasi-money is believed to be attributable to the evolution of the investment habit of the society, which is illustrated by the time trend, as well as to the growth of the private income (non-oil GDP).

Saving deposits represent an important part of the quasi-money, thus it is believed that the increase in government expenditure, especially in salaries, has contributed to a large extent to an increase in the demand for saving deposits.

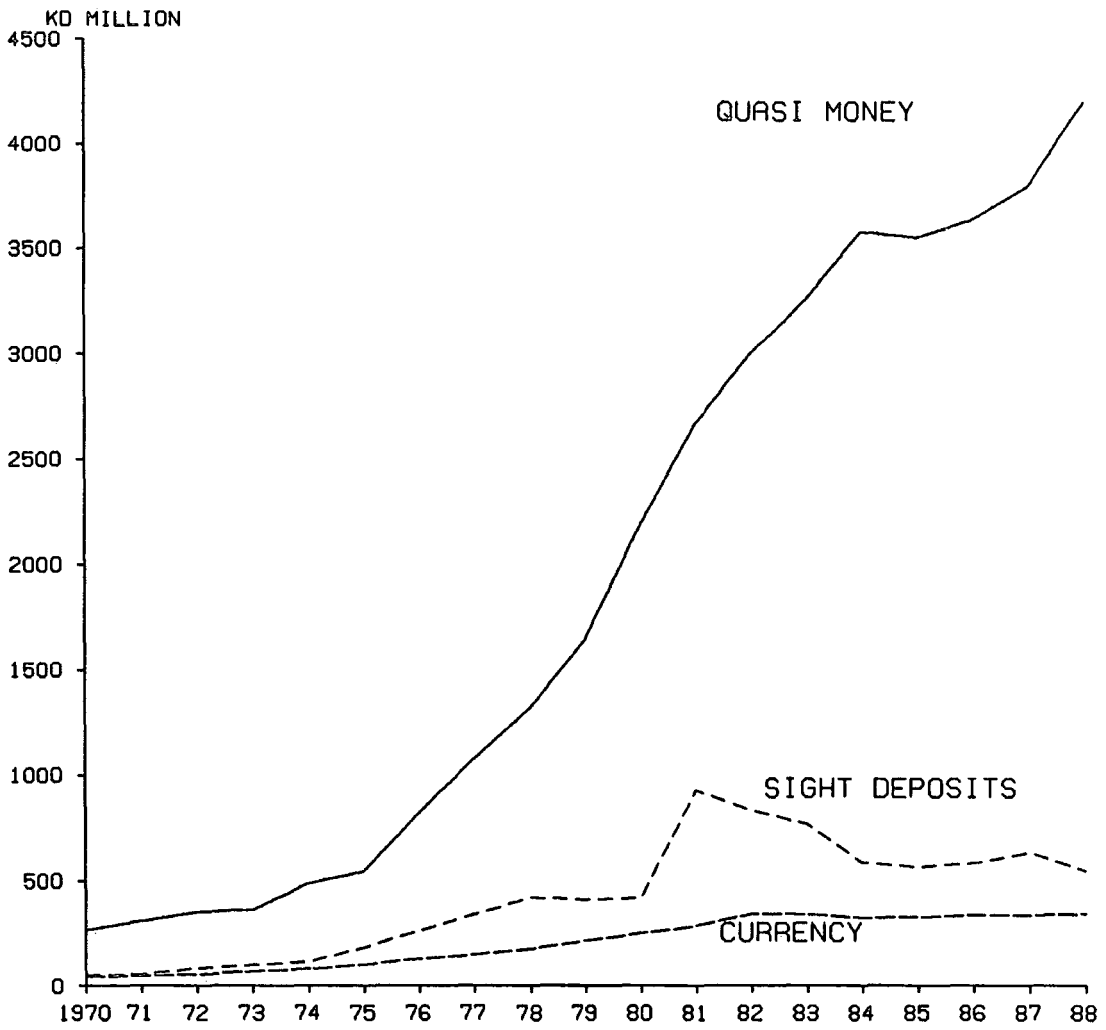
FIG: 4.8 FOREIGN & LOCAL INTEREST RATES



SOURCE: CENTRAL BANK OF KUWAIT &  
INTERNATIONAL FINANCIAL STATISTICS (I.M.F)



FIG: 4.9 COMPONENTS OF THE MONEY SUPPLY



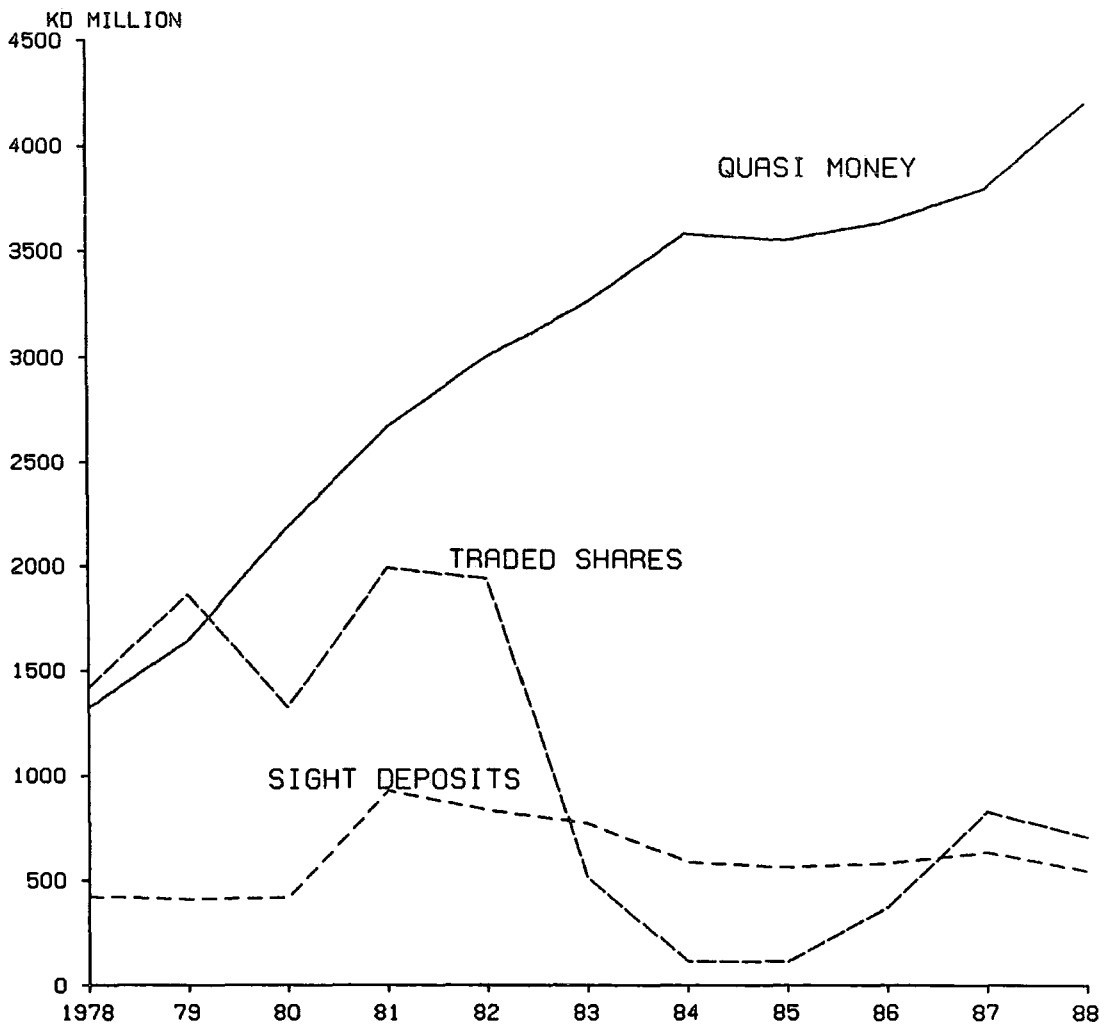
SOURCE: CENTRAL BANK OF KUWAIT



Before introducing the model, it is worth remembering that the purpose of this thesis is to study the development of the monetary policy instruments that have been applied by the Central Bank of Kuwait in order to pursue its monetary policy in Kuwait. It is not the researcher's aim in this chapter to introduce a comprehensive model for the whole economy of Kuwait; rather, it is to explore the variables that influence the behaviour of the quantity of money in its broad definition, on the grounds that the conduct of a successful monetary policy depends on a good understanding of the behaviour of the monetary aggregates. From the above discussion it is possible to arrive at certain hypotheses:

1. Both the government expenditure and credit policy (facilities) of the commercial banks have played an important role in expanding the size of the money supply: the former through its annual budget expenditure which in general has played a consistently noticeable role in the Kuwaiti economy; and the latter through the provision of credit facilities to the economic sectors. It is assumed that during the past three decades, especially after the oil price increase in October 1973, the country's economy has flourished. As a result of the increasing national income of the country, both the increase in the ability of the commercial banks to supply credit and the rise in private sector demand

FIG: 4.10 SD, QM & TRADED SHARES



SOURCE: CENTRAL BANK OF KUWAIT



FIG: 4.11 IMPORTS & SIGHT DEPOSITS



SOURCE: CENTRAL BANK OF KUWAIT



FIG: 4.12 IMPORTS & DISCOUNT FACILITY



SOURCE: CENTRAL BANK OF KUWAIT



for credit, have grown. This has caused the money supply to expand.

2. The high dependence of Kuwait on the rest of the world for goods and services, in addition to the speculative activities in stocks, has increased the demand for banks' credit.
3. The unrestricted movement and convertibility of local currency to foreign exchange, together with local interest rates incompatible with those on the international market, have rendered the money supply vulnerable to the effects of the outside world.
4. Under the interest rate ceiling system, the Central Bank of Kuwait plays the role of accommodator to the contractionary effects of the outside world on the money supply. It does this through various operations, such as a rediscount facility, and swap operations with the commercial banks. The aim of these operations is to provide more liquidity to the commercial banks whenever the latter face liquidity crises as a result of moving funds outside the local economy in the search for more profitable opportunities.

### Model Specification

This section is concerned with the estimation of the demand for - and supply of - money in Kuwait, for the period 1970 to 1988, by introducing an econometric model

of four equations. Three equations are devoted to estimating the demand for money function in a disaggregated manner, and the fourth equation is introduced to estimate the supply of money function in its aggregated components. The quantity of money of three different components ( $C+SD+QM$ ) can be estimated by employing the appropriate econometric techniques to determine the coefficients of explanatory variables' influence on the quantity of money from either its demand or its supply side. It is believed that the three components of the definition of money have their own properties with each component open to influence by certain economic variables which do not necessarily affect the other components. For example, it is assumed for the purpose of this empirical analysis that sight deposits are positively related to the value of imports. This does not apply to quasi-money, in which case it is determined mainly by the national income and interest rate fluctuation. Hence, it is the proportional importance of each component that influences the determination of the explanatory variables that fit in the equation, otherwise it leads to a conflict between the statistical significance and the theoretical background of the model. This trend of disaggregation was advocated by Tobin (1982) on the grounds that it is essential for analysing monetary policy. Therefore, the disaggregation is needed to get a fair estimate of the demand function, and to obtain a good statistical result. Hence, three equations are

introduced to estimate the demand for money function in its given components:

currency in circulation (C),  
sight deposits (SD), and,  
quasi-money (QM).

One area of argument related to the estimation of the demand for money function is that called "identification problem". According to this concept, to obtain a good estimate of the behavioural equation, the demand function should be well identified. This is because the quantity of money demanded is usually not an observable variable. What can be measured is the quantity of the money supply, and by assuming the equilibrium state in the money market, then the money supply can be used to measure the demand function. Thus, by relating the money stock to some explanatory variables, one can not be sure that the money supply function, or the combined effects of both the demand and supply function, are measured, rather than the demand function. However, in order to overcome this problem, economists have used techniques by which both the supply and demand functions are estimated simultaneously. In this context, Laidler (1970, p.86) asserts that to be sure that the supply function of money shifts independently of the demand-for-money function, ensure that the supply-of-money function contains at least one variable that does not appear in the demand function; although he treated as reliable, evidence generated by

tests that ignore this problem. Moreover, Laidler (1985, p.101) asserts that,

"The fact that parameter estimates obtained for the demand function when the problem has been ignored tend to be very much like those generated in studies where it has been explicitly addressed certainly suggest that this issue may not be a critical one."

Thus, following Laidler, our model for the estimation of the demand for-and-supply of money function is assumed not to embody this problem since all the explanatory variables which appear in the supply function are not included in the demand for money function.

#### Demand for currency

Currency in circulation consists of bank notes and coins held by the public for transaction purposes. The definitional equation of the currency in circulation in Kuwait is as follows:

$$C = CI - CB$$

where:

C = currency in circulation

CI = currency issued by the Central Bank

CB = currency held by commercial Banks.

In a growing economy like that of Kuwait, increasing demand for currency is expected to be a function of increasing income. Thus one may assume that when income increases over time, the cash holding would also increase to satisfy the need for more transactions. Hence, the Private Gross Domestic Product (non-oil GDP) is introduced as an explanatory variable in the demand for currency equation. The relationship between the currency and the income variable is expected to be positively related. Since the public uses currency mainly for transaction purposes, one would naturally expect price rises to engender an increase in currency holding. The consumer price index is introduced in the equation - as an explanatory variable - to express the influence of prices on the demand for currency where the effect of the latter is positively expected on the dependent variable (demand for currency). It is believed that the increase in local prices is generated by two sources: first, imported inflation since the local economy is import-oriented, where the local market forces have no influence on the prices of imported products; secondly, local source of inflation as a product of the expansionary economic cycle, especially during the time when speculative trends prevail.

The quasi-money variable (interest-bearing deposits) is introduced in the equation as it is expected to exert negative effects on the demand for currency, on the grounds that the quasi-money growth reflects the

increasing cost of cash holding. The using of the quasi-money variable in the function instead of local interest rate on bank deposits is due to the unavailability of the latter. It could also be assumed that the quasi-money variable can be considered a suitable proxy to express the growth of the investment habit in the growing economy of Kuwait, as the public reduce their cash holding over time, at its minimum required level, and tend to place their cash in interest-bearing deposits. Obviously, the growing investment habit exerts a contractionary effect on the demand for currency holding.

Demand for Sight Deposits (Current Accounts)

Sight deposits can be divided into two main components: first, deposits which are placed by the public in order to be used for transaction purposes; and second, funds deposited by various economic sectors to finance their import requirements, plus deposits belonging to speculators for use in speculative activities. Thus, the definitional equation of sight deposits can be written as:

$$SD = C_p + D_E + D_S$$

where:

SD = sight deposits at commercial banks.

C<sub>p</sub> = Current accounts belonging to the public.

D<sub>E</sub> = Deposits belonging to economic sectors.

D<sub>S</sub> = Deposits belonging to speculators.

Therefore, one may assume that the demand for sight deposits is overwhelmed by two main factors: import and speculative activities. It was mentioned in Chapter II that the Kuwaiti economy is so overdependent on the rest of the world for consumer and capital goods that the balance of payments of the private sector has been in a continuous deficit. The dependence of the country on imports is due to the natural conditions of the country - deprived as it is of the basic elements of production - and also due to the fact that the people want to use their newly-found oil wealth to change their lifestyle and move from poverty to modernization.

One result of the narrow absorptive capacity of the economy, which cannot assimilate the accumulated wealth inside the economy, is that speculation in stocks and other real assets can be expected to be a major trend in the Kuwaiti economy. Hence, import and value of traded shares variables are introduced into the equation of the demand for sight deposits function, as explanatory variables (independent) where both variables are expected to have a positive effect on the function. The import variable represents the value of imported goods for local use, hence:  $\text{Import} = \text{Total imports} - \text{re-exports}$ ; since the import for re-exporting purposes is influenced by factors determined in other countries.

A dummy variable is introduced in the equation to represent the hectic activities which prevailed in the

stock market during the period between 1980(Q1) to 1982(Q2).

Under the assumption that a big stake of the sight deposits belongs to speculators, foreign interest rates are believed to exert an influence on sight deposits. Thus, an increase in foreign interest rates will decrease the size of the sight deposits, since traders can convert their funds into foreign currencies - searching for more profitable opportunities; hence, a negative relationship is expected between the two variables. The three months Euro dollar interest rate is used in the function to express the effect of foreign interest rates on the demand for sight deposits.

The dependent variable (sight deposits), lagged one period (quarter), is used in the equation as an independent variable on the grounds of the adaptive expectation theory, which implies that the dependent variable is determined by the expected value of the independent variable (Kennedy, 1986, p.117). For the demand for sight deposits, there is a strong belief that, due to the speculative nature of the stock market, the demand for bank sight deposits is influenced by the future expectations of the share traders. Hence, when the speculators expect an increase in share prices in the foreseeable future, they tend to adjust their portfolio in such a way as to make more of their money available in the form of sight deposits, to use them in stock trading.

Demand for Quasi-Money

Quasi-money (or interest-bearing deposits) represents the major portion of the money supply in its broad definition. Thus, the definitional equation of the quasi-money is:

$$QM = SD + TD + CDs + TF.$$

where:

QM = Quasi-money.

SD = Savings deposits in Kuwaiti dinars.

TD = Time deposits in Kuwaiti dinars.

CDs = Certificates of deposits in Kuwaiti dinars.

TF = Time deposits in foreign currency  
for residents.

These deposits are assumed to reflect the surplus of various economic units that are supposed to be channelled through the commercial banks to the productive units in the economy. Interest rates exert a sensitive role in attracting demand for such deposits. It was mentioned earlier in the theoretical discussion of this chapter that the structure of local interest rates is administratively determined by the law to exceed not more than 10.0 percent as a ceiling. Demand for quasi-money is affected by changes in foreign interest rates on the international market. This is especially so in Kuwait, given the openness of its economy to the rest of the world and the

free convertibility of local currency to foreign currencies. Moreover, although one cannot ignore the exchange rate risk involved in movements of local funds outside the country, which can affect the net profit that local investors are able to gain from foreign investments, experience has shown that when the foreign interest rates were compared with the local interest rate trends (Figure 4.8), the gap between the two rates was large enough to cover or reduce any potential loss that might have occurred as a result of exchange rate fluctuations. In spite of that, the inter-bank rate is used in the above-mentioned figure, which is assumed to be higher than the interest rates that are paid by the commercial banks on local deposits. Thus, one can conclude that local interest rates cannot compete with foreign interest rates and hence curb or reduce the outflow of funds towards foreign currencies. There are two reasons for this: firstly, the ceiling that prevents local interest rate from exceeding 10.0 percent; and secondly, high interest rates would raise the cost of borrowing money, which means price increases if the demand for bank credit persists, or low demand for bank credit.

Another factor that lends importance to the relationship between local and foreign interest rates - and hence the influence of the latter on the demand for quasi-money function, or even on the control of the money supply - is the proportion of the quasi-money in the magnitude of the money supply. On average, quasi-money represented

76.0 percent of the money supply in its broad definition (C + SD + QM) for the period 1970 to 1988. Thus, in order to estimate the demand for quasi-money function, the foreign interest rate variable is introduced in the equation which is expected to be negatively related to the former. The three months Euro-dollar interest rate has been adopted for this purpose.

Another factor with contractionary effects on the demand for quasi-money is the trading activity in the stock market. This is because interest-bearing deposits are considered potentially profitable financial assets among others available in the market; therefore, shares can compete with them, especially during periods of hectic speculative activity. When the value of traded shares increases, more money is employed in stock speculations motivated by the rising trend of shares prices. Consequently, depositors tend to remove their funds from interest-bearing deposits to buy stocks in order to gain more profits in a short period of time. Hence, the value of traded shares variable is introduced in the equation and is expected to have a negative relationship with the quasi-money.

Demand for quasi-money (interest-bearing deposits) is expected to increase as the income of the private sector increases. This can be supported for more than one reason. For example, the demand for quasi-money can be considered as a saving activity, since saving depends on the income situation, which is in turn rooted to the

traditional macroeconomic Model which holds that saving is a function of income [saving = f(income)]. It can also be attributed to the eagerness of the various economic sectors to reduce the cost of holding money as their income increases. The non-oil GDP variable is introduced in the demand for quasi-money function as an explanatory variable whose influence is expected to be positive.

As the composition of the quasi-money includes saving deposits, which represent 21.2 percent of the total quasi-money, and on the ground that most owners of saving deposits are public employees, the government wages and salaries variable is introduced to the equation. Its relationship with the behaviour of the quasi-money is expected to be positive. This variable is lagged four quarters as it was found appropriate to fit the equation, which means that government employees will need an average one year to adjust the relation between their consumption and saving after they receive the first increase in their income.

It is worth mentioning here that lagged variables are very often used in econometric models on the grounds that the dependent variable (Y) responds to independent variable (X) with a lapse of time (Gujarati, 1988, p.510). In his discussion of the reasons for 'lags', Gujarati asserts that, "due to the force of habit (inertia), people do not change their consumption habits immediately following a price decrease or an income increase". He also concludes

that there is not a prior assumption as to which is the maximum length of the lag.

Koutsoyiannis (1977, p.290) says that,

"Economic theory, even where it recognises the importance of time lags, never suggests the precise number of lags that should be included in the function."

Therefore it would appear that the experimental approach is the appropriate method of determining the extent of the lags that statistically fit the function.

#### The Money Supply Function

Based on the same theoretical discussion which appeared in the first section of this chapter, the quantity of the money supply is assumed to be determined to a great extent by the government domestic spending in the economy and the banking credit facilities to the economic sectors. Therefore, both variables are introduced in the estimation of the money supply function, and the government domestic expenditure variable is lagged one quarter. The effects of both variables on the money supply are expected to be positive.

The definitional equation of the government expenditure is:

$$\text{GDE} = \text{TGE} - \text{TA}$$

where:

GDE = Government Domestic Expenditure.

TGE = Total Government Expenditure.

TA = Transfers Abroad.

Local interest rates are also presumed to play a distinct role in influencing the quantity of the money supply in Kuwait. The three months inter-bank interest rate is used in the function as a proxy to the local interest rates on bank deposits since the latter are not published. The relationship between the inter-bank interest rate and the money supply is expected to be negative due to the fact that this variable is reflecting the liquidity position of the commercial banks. Thus, when funds in local currency are converted into foreign currencies due to the availability of profitable opportunities, the commercial banks face liquidity shortage and hence, increase their inter-bank interest rates to attract loanable funds from each other to meet the local demand for bank credit and other obligations.

According to the above-mentioned argument, the Central Bank of Kuwait exerts accommodation measures to modulate the effect of the outflow of funds towards foreign

currencies. Such accommodation actions take the form of different operations between the Central Bank and commercial banks, such as: rediscount of commercial papers, swap operations, and placing deposits in local currency at the commercial banks. Hence, a discount variable is introduced in the equation to signify the role of the Central Bank in providing funds to the commercial banks to solve their liquidity problem, and to explore the effect of such operations on the money supply. It is expected that the discount variable is positively related to the money supply.

A dummy variable is also introduced to the equation to represent the upward trend which prevailed in the stock market during the period between 1980(Q1) to 1982(Q2).

Having addressed the identification problem in the earlier stage of this chapter, and its relevance to the model presented for the empirical work; among various methods of estimation, the Ordinary Least Squares method is adopted for its simplicity and popularity since the model contains four single equations

For the preference of the Ordinary Least Squares (OLS), we refer to the Conference on Large-scale macroeconomic models (Michigan, October 16-27, 1978), as one of the conclusions of the Conference was that despite econometric and computing advances, OLS is still the most preferable estimating technique. Howery (University of Michigan), asserts that, "Ordinary Least Squares (OLS) is still a

very popular estimator." He postulates some reasons for this popularity of using the OLS estimator. First, OLS is inexpensive and an easy computation to explain; second, as many structural models are so large that none of the consistent estimators can be used without modification, it follows that the number of behavioural equations could exceed the number of observations. Maddala (University of Florida), although he was in favour of the Two stage-Least Squares (2 SLS) and Limited-information maximum-likelihood (LIML) methods of estimation, he prefers the OLS method in large models where almost all the explanatory variables that should belong in an equation are taken into consideration. Maddala, in this respect, asserts that some guidance to the acceptance of the OLS estimators can be provided by the magnitude of  $R^2$ 's from the estimated OLS equations. Maddala bases his defence of OLS on the grounds that, when almost all the explanatory variables are included in the equation, error variances are likely to be very small. Modigliani (Massachusetts Institute of Technology), declared his preference for OLS with autoregressive transformation on the grounds that OLS are "objective"; since they do not call for a choice of exogenous variables, as is the case in Two- or Three-Stage Least Squares estimation. Durby (University of California), pointed out that in a number of existing models there are so many predetermined variables relative to the number of available observations that 2 SLS are identical to OLS.

The empirical work is executed by the Computer Statistical Package for Social Sciences (SPSSX).

The Model

$$C_d = a_0 + a_1CpI + a_2QM + a_3GDP + u_1$$

$$SD_d = b_0 + b_1IM + b_2DD + b_3FIR + b_4VTS + b_5SD(t-1) + U_2$$

$$QM_d = C_0 + C_1GDP + C_2FIR + C_3VTS + C_4WS(t-4) + U_3$$

$$M_s = d_0 + d_1DISC + d_2GDE(t-1) + d_3LIR + d_4CR + U_4$$

The following responses are expected:

$$a_1 > 0, \quad a_2 < 0, \quad a_3 > 0$$

$$b_1 > 0, \quad b_2 > 0, \quad b_3 < 0, \quad b_4 > 0, \quad b_5 > 0$$

$$c_1 > 0, \quad c_2 < 0, \quad c_3 < 0, \quad c_4 > 0$$

$$d_1 > 0, \quad d_2 > 0, \quad d_3 < 0, \quad d_4 > 0$$

where:

a's, b's, c's and d's = parameters to be estimated,

u<sub>1</sub>, u<sub>2</sub>, u<sub>3</sub>, u<sub>4</sub> = error terms.

All variables are measured in K.D million, unless otherwise stated.

List of variables:

- C = currency in circulation
- CPI = consumer price index (base year 1978).
- QM = Quasi-money.
- GDP = Non-oil Gross Domestic Product
- SD = Sight deposits.
- IM = Imports.
- DD = Dummy variable for stock market boom  
= 1 for 1980(Q1) to 1982(Q2), 0 otherwise.
- FIR = Euro-dollar 3 months interest rate (percentage).
- VTS = Value of traded shares.
- WS = Wages and salaries of government employees.
- M<sub>3</sub> = Money supply in broad definition.
- DISC = Discount of commercial papers at the Central Bank.
- GDE = Government domestic expenditure.
- LIR = 3 months inter-bank interest rate.
- CR = Credit facilities of commercial banks.

Results of the estimation

Demand for currency (1977(Q1) to 1988(Q4), 48 cases):

$$C_d = -522.836 + 7.557CPI - 0.071QM + 0.049GDP$$

$$(8.79) \quad (-4.96) \quad (1.56)$$

$$R^2 = 0.938 \quad SE = 13.735 \quad DW = 1.75$$

Demand for sight deposits

(1977(Q1) to 1988(Q4), 48 cases):

$$SD_d = 47.927 + 0.574IM + 202.912DD - 11.544FIR$$

$$(2.74) \quad (5.30) \quad (-3.15)$$

$$+ 0.147VTS + 0.669SD_{(t-1)}$$

$$(2.57) \quad (9.22)$$

$$R^2 = 0.916 \quad SE = 63.991 \quad DW = 1.83$$

Demand for quasi-money (1970(Q1) to 1988(Q4), 76 cases):

$$QM_d = -503.475 + 4.263GDP - 33.967FIR - 0.968VTS$$

$$(27.87) \quad (-2.84) \quad (-4.52)$$

$$+ 4.727WS_{(t-4)}$$

$$(5.27)$$

$$R^2 = 0.957 \quad SE = 291.679 \quad DW = 1.79.$$

Money supply (1973(Q3) to 1988(Q4), 62 cases):

$$M_s = 726.933 + 0.789DISC + 0.404GDE_{(t-1)} - 27.271LIR$$

(2.05)                      (2.21)                      (-2.43)

$$+ 0.823CR + 195.631DD$$

(26.02)                      (3.73)

$$R^2 = 0.993 \qquad SE = 104.527 \qquad DW = 1.50$$

where:

(T) = t, statistic

R<sup>2</sup> = Coefficient of determination

SE = Standard error

DW = Durbin Watson test.

The empirical results show that all the equation are well determined as having high explanatory power. All variables' coefficient are significant at 95.0 percent level, the only exception is the coefficient of the GDP variable in the first equation of the demand for currency. The reason for that could be attributed to the interpolation of the quarterly data of this variable as it is derived from the available annual data, the coefficient of GDP variable is significant at 80.0 percent level. The Durbin Watson statistic of the last equation (Money Supply) shows that it falls in the indecisive area. Two

reasons are believed to cause this result: first, the inclusion of the inter-bank rate (LIR) as a proxy to interest rates paid on bank deposits since they are not available; second, the absence of some policy variables used by the Central Bank and believed to influence the behaviour of the money supply, such variables are represented in this equation by the discount variable (DISC).

### Discussion of The Results

In general, the results of the estimation confirm the theoretical discussion of the model, and clearly illustrate the internal and external influences on the behaviour of the money stock.

The large negative intercept term in the demand for cash money equation, along with the positive effect of the price level, implies that the demand for cash holding is mainly influenced by transaction purposes, and increases with prices. Nevertheless, there is evidence of the growing investment habit in the economy, reflected by the negative coefficient of the quasi-money variable in the equation. The encouragement of this trend is of great importance to the monetary policy, especially in the growing economy of Kuwait, since it will reduce the cash holding with the public and increase the reserves of the commercial banks. Hence, the ability of the commercial banks to extend more credit to the productive sectors will accelerate. However, it is believed that the imposition

of the ceiling on lending rates has been reflected by the commercial banks imposing low interest rates on bank deposits, which in turn hinders the encouragement of the investment habit. On the other hand, the large number of the expatriate labour force in Kuwait, from undeveloped countries, along with the caution exercised by the commercial banks in granting them banking services, represent further obstacles to reducing the cash holding, and prevent the growth of the banking habit in the economy.

The result has also revealed the effects of the speculations in the stock market on the behaviour of the money stock. On the one hand, it shows that the activity in the stock market increases the demand for sight deposits, which, to a large extent, reflect the demand for bank credit, since the commercial banks make the money demanded for speculative purposes available to the traders in sight deposits. On the other hand, it shows that the flourishing activity in the stock market negatively affects the demand for interest-bearing bank deposits. Hence, the negative coefficient of value traded shares variable (VTS) in the demand for quasi-money equation implies that local depositors see in domestic shares a good alternative to bank deposits, especially during the period when the stock market witnesses brisk activity. However, the result of such a shift from bank deposits to the stock market would deprive the banking system of a large amount of savings, and hence reduces their reserves,

which in turn affects their lending ability. Therefore, one may criticize the interest rate policy of the Central Bank which aims at keeping the local interest rates at levels lower than the yields on other financial assets in the market. This criticism is based on the grounds that the low interest rates policy would produce a reverse result to the original intention of such policy, that is - to meet the productive sectors' need for bank credit.

The external pressures on the behaviour of the monetary stock are clearly demonstrated by the negative coefficient of the foreign interest rate variable in the equations for both the demand for sight deposits and the demand for quasi-money. Thus, the negative correlation between foreign interest rates and the demand for sight deposits implies that the demand for this kind of money is induced by speculative motives, since the local speculators prefer to keep their money temporarily in sight deposits until they decide to employ them in the most profitable assets outside the country. On the other hand, the negative correlation between foreign interest rates and the demand for quasi-money (interest-bearing deposits), indicates the inability of the local interest rates to match those prevalent in foreign markets, due to the imposition of the ceiling by the Central Bank. Therefore, the consequences of such a shift from local deposits to deposits in foreign currencies has exposed the commercial banks to liquidity problems and affected their ability to meet the local demand for bank credit, which induced the Central Bank to

react by injecting more funds into the banking system through its monetary instruments such as the discount and swap operations. Hence, one may argue that the Central Bank has used its monetary policy instruments to moderate the external pressure on local liquidity, or more precisely to defend its interest-rate structure, rather than to control the monetary stock by the use of these instruments. This conclusion is evidenced by the positive effect of the discount variable as it appears in the money supply equation, since it implies that the Central Bank has participated in expanding the money stock by injecting more money into the banking system.

The money supply equation shows that in addition to the role of the Central Bank in expanding the monetary stock, both the commercial banks and the government are the other two participants in this role. However, since we assume that the role of the government in expanding the money supply is beyond the control of the Central Bank, the latter can regulate the money stock by controlling the lending ability of the commercial banks, since they play the major part in expanding the money supply in the economy. It follows that the Central Bank should adopt monetary targets and then manipulate its instruments of control in order to achieve either the required quantity of money, or the required growth in this quantity. Nevertheless, it seems from the behaviour of the monetary stock that the Central Bank has preferred to defend its interest-rate structure and to secure the liquidity

position of the commercial banks, and has left the quantity of money to be determined by the interrelation between the local and foreign influences, since the latter can exert a contractionary effect on the money supply and bring it to its equilibrium level.

The external influence on the money supply is represented by the inter-bank interest rate variable - as highly correlated with foreign interest rates<sup>(1)</sup>- which exerts a considerable negative influence on the behaviour of the money supply. Again, this condition can be attributed to the insistence of the Central Bank to keep the local interest rates at low levels, and is encouraged by the exchange rate regime which maintains the stability of the Kuwaiti dinar against major foreign currencies.

However, the Central Bank did not use any of its lending rates (direct lending and discount rate) actively as a bank rate to control the lending ability of the commercial banks, which in turn would have controlled the behaviour of the money stock. The negative relationship between the inter-bank rate and the money supply suggests that when the Central Bank decides to abolish the ceiling and leave local interest rates to market forces, it can actively use its bank rate to influence the growth of the money stock.

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(1) The inter-bank rate is exempted from the ceiling, so it can move freely, and is determined by local and foreign market forces.

Moreover, it is shown in the equation of the money supply that the inflationary trends which prevailed in the economy during the boom in the stock market<sup>(1)</sup> have caused the monetary stock to expand considerably. This is because in the small economy of Kuwait, with few financial assets and investment opportunities to absorb the surplus of funds, the rise of share prices would push up all other prices in other sectors of the economy, even the prices of goods and services, which in turn increase the money supply. Therefore, one may argue that the speculative activity in the stock market is attributable, on the one hand, to the absence of the government regulations that should govern the behaviour of this market, and on the other hand, to the lack of control by the monetary authorities over the credit policy of the commercial banks.

At the end of this discussion, one final remark is to be mentioned, that is that the discussion of the result of the model is manipulated to disclose issues which are relevant to the monetary policy instruments of the Central Bank, as they will be the concern of the rest of this study.

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(1) represented by a dummy variable during the period between 1980 Q1 to 1982 Q2.

C H A P T E R     F I V E

MONETARY POLICY OBJECTIVES

In its early years, the Central Bank could not be expected to act in controlling the monetary sector and play its expected role in the economy like any other experienced Central bank, despite the wide range of authorities granted to it by its Charter. Thus, the Central Bank of Kuwait has introduced its instruments of control gradually, hand in hand with the development of the financial sector in general, and the banking sector in particular. When the Central Bank was inaugurated in 1968, the financial market was composed mainly of four national commercial banks, one foreign bank, and two investment companies. It might, therefore, be expected that the Central Bank would concentrate its efforts on evolving the financial sector and promoting the banking system. The existence of such a financial market is necessary if the Central Bank is to pursue its monetary control.

However, since the monetary policy instruments were gradually introduced into the monetary system, the successful implementation of these instruments is dependent on the power that is given to the Central Bank in order to pursue its monetary policy on the one hand, and the variation of these instruments on the other. Therefore, this chapter begins with a discussion on the

independence of the Central Bank of Kuwait and its relationship with the Government (Ministry of Finance).

The degree of freedom, or, more precisely, the independence of the Central Bank will be considered from various perspectives, in order to understand the environment that shapes its activities and the scope to implement monetary policy in the Kuwaiti economy. This discussion will be based on theoretical grounds, supported by the opinions of some researchers and writers in this arena. Empirical data from past experience in this respect will be drawn upon to illustrate crucial arguments.

The rest of this chapter is devoted to a discussion on the monetary policy objectives of the Central Bank of Kuwait. In this context, two sets of objectives are adopted, the first being the objectives postulated in the Central Bank's Charter, and the second being the objectives derived from the literature dealing with the applications of monetary control in developing countries.

Discussion of monetary control in Kuwait is based on both theoretical and empirical considerations, the aim being to discover, by reviewing each tool of control, whether the implementation of monetary control has succeeded in fulfilling its stated objectives. Moreover, since the pursual of monetary policy depends on various socio-economic and political factors, it would be useful here to

recapitulate the main conclusions presented in previous chapters.

1. The predominant role of the government in the Kuwaiti economy is a result of its ownership of the main source of income in the country, i.e. oil (Chapter 2).

2. The role of the commercial banks in creating and distributing credit among the various economic sectors and its shortcomings (Chapter 3).

3. The influence of both government expenditure and bank credit facilities on the expansion of the money supply (Chapter 4, the Model).

4. The great effect of foreign interest rates on capital flow movements as an inherent phenomenon of the openness of the Kuwaiti economy on the one hand, and of its limited absorptive capacity on the other (Chapters 2 and 4).

The relationship between the Central Bank and the government, and the issue of independence

As we have seen in Chapter Three, the Central Bank of Kuwait was given two main roles to play in the Kuwaiti economy. Firstly, it was to control the monetary sector and the financial market. Secondly, it was to regulate the banking system in terms of the development process of the economy. Some economists see central banks as promoters of growth in developing countries (Bhatt, 1977,

and Ghatak, 1981). This is because their concerns are directed to rural economies where the agricultural sectors are predominant and where saving/investment mechanisms have been hampered by age-old habits and customs. For an economy like that of Kuwait, which has shown increasing growth over the past three decades, a fully-fledged central bank is highly recommended in order to ensure stable conditions for orderly economic development. Moreover, while Kuwait, by dint of its dependence on a single primary commodity, may be classed as a developing country, this is true only in a broad sense; in actual fact, Kuwait's dependence on oil yields results which are of quite a different order to those seen in other single-commodity economies. This is why the Kuwaiti economy has, in some of its indicators, been on a par with the industrialized developed countries. It was astonishing when Hopkins (1965, p.10) stated that:

"Kuwait does not seem to require many of the usual services of a central bank. From the stand-point of credit controls, the liquidity of the commercial banks is now extremely high, but their lending policies are quite conservative."

This invitation for completely free banks to operate in the economy, carrying the nation's savings without control of productive allocation, is quite strange, especially since in 1965 there was no central bank in the country. El-Mallakh and Atta (1981, p.55) came to a different conclusion about the role of the Central Bank of Kuwait:

"The role which the Central Bank of Kuwait has played since its establishment is reflected in the rapid financial developments that have taken place in the 1970s, the opening of more bank branches, the growth of specialized banks and investment institutions, and the general increase in banking activities and in the level of sophistication of the financial system."

These observations surely reflect the expected responding role of the Central Bank to the economic development which occurred during this particular period.

As the government entrusted its Central Bank to carry out many important functions in the economy, a close relationship was to be maintained which was explicitly expressed in the provisions of the statute law of the Central Bank. But to what extent is such closeness desirable? This argument will be discussed with reference to two main issues: firstly, the role of the Central Bank as banker and financial advisor to the government; and, secondly, the independence of the Central Bank from the Finance Minister.

The statute defines the relationship between the government and the Central Bank in eight elaborate articles as follows:

Article 31:

The Central Bank shall act as banker and fiscal agent for the Government. On this basis:

a) Government funds in Kuwaiti Dinars on current accounts shall be held solely with the Bank. No interest shall be paid by the Bank on such deposits.

b) The Bank shall in general carry out, free of charge, banking transactions and services relating to the Government inside and outside the country.

c) The Government may place funds in Kuwaiti dinars with local banks, after seeking the opinion of the Central Bank and in a manner not conflicting with the monetary policy in force.

d) The Minister of Finance may entrust the Central Bank with the administration of any other Government funds in accordance with the conditions agreed upon at the time.

e) The Minister of Finance shall transfer to the Central Bank such amounts as may be necessary for the implementation of any particular monetary policy, after the Minister of Finance has approved such policy.

Article 33:

The Central Bank shall enforce the law and regulations pertaining to exchange control.

Article 34:

The Central Bank shall, either directly or through banks and other financial institutions, undertake operations relating to the sale and management of securities issued or guaranteed by the Government. The Bank may also undertake operations relating to the sale and management of securities issued in Kuwaiti dinars by any public institutions in Kuwait.

Article 35:

In accordance with the provisions of Article 26(H) of this law, the Central Bank may:

a) purchase, sell, discount or rediscount Government treasury bills;

b) purchase and sell public debt securities issued and offered for sale by the Government.

(This provision entrusted the Board of Directors to fix the amounts allocated for the purchase and discount of public securities or Government treasury bills.)

Article 36:

The Central Bank may not give any loans to the Government, municipalities, public establishments or bodies except in the following case:

The Bank may give temporary advances to the Government to cover deficits in budget revenues. Such interest as may be determined by the Board of Directors of the Bank in agreement with the Minister of Finance shall be paid by the Government on these advances.

The total of such advances may not, at any time exceed 10 per cent of the public revenues of the state Budget for the preceding fiscal year.

Such advances shall be repaid as quickly as possible. If they are not paid by the end of the following fiscal

year, the Bank shall not grant any new advances until those outstanding have been paid.

Article 37:

For the purpose of financial development projects or strengthening the financial market, the Central Bank may upon approval of the Ministry of Finance:

a) Own or sell shares or stocks of any Kuwaiti joint-stock company or concessionary company or public establishment in Kuwait;

b) Give loans to banks, public financial or credit establishments, against of their holdings of such shares or stock; provided that the total amount allocated for the acquisition of aforementioned shares or stocks, or for loans against their mortgage, shall not exceed the value of the reserves of the banks;

c) Issue negotiable bills.

Article 38:

The Governor shall keep the Minister of Finance continuously informed of the monetary and credit policy pursued or intended to be pursued by the Bank. If the Minister of Finance has a different view he may issue general directives to be followed by the Bank, and such directives shall become binding.

If the Board of Directors has any objections to these directives, it may submit such objections, together with

the reasons for them, in writing to the Minister. The Minister shall then submit the directives, together with the objections, to the Council of Ministers to decide on the matter. The decision of the Council of Ministers shall be final.

Article 39:

Government departments, public institutions and organizations, and companies operating in the State of Kuwait shall submit to the Governor of the Central Bank all information and statistics which the Bank may require for its studies.

It had been customary for central banks to preserve a close relationship and an active coordination with the government, or, more precisely, with the Ministry of Finance or Treasury. This was mostly because, with a few exceptions, central banks were founded by governments and acted as their agents. In the case of Kuwait, the government earns most of the national income and implements fiscal policy through the Ministry of Finance. Moreover, the government has become the biggest spender in the economy, a fact which affects the credit ability of the banking system, and expands the money supply, which it is the responsibility of the Central bank to control. On the other hand, the government has become a borrower from the Central Bank as well as from the commercial banks and the public, which has resulted in the Central bank being involved in the management of the public debt. For these

reasons, the Governor of the Bank and the Finance Minister should keep a close relationship and coordinate together to avoid any undesirable effects in the economy such as, for example, the inflationary trends caused by an expanded public expenditure policy or a loose credit policy.

In accordance with the statute, the capital of the Central Bank was set at 5 million K.D, paid totally by the government, and the general reserve is 25 million K.D to be built up by the net profit, which after that should be paid to the government. The general reserve should be used to meet the losses incurred by the Central Bank; otherwise the government shall cover the deficit. The Central Bank is the sole holder of the government's accounts in Kuwaiti dinars; the government is committed not to place any amount with local banks without the approval of the Central Bank.

Unlike most central banks in the world, the Central Bank of Kuwait is not entrusted with the administration of foreign reserves: these are managed by an independent authority headed by the Finance Minister. The Central Bank of Kuwait obtains foreign currency - mainly dollars - from the Ministry of Finance against selling the Kuwaiti dinars. In recent years, as a result of the declining oil revenue, transfers of U.S. Dollars to the Central Bank have dropped sharply, affecting the foreign currency holding in the Central Bank. This trend has been illustrated clearly in the financial statement of the Central Bank for the period between 1984/85 to 1987/88

(financial year), when the foreign currency holding fell from 1.4 billion (K.D equivalent value) to 633.4 million K.D, a decrease of 54.3 per cent. On the other hand, the demand for foreign currencies by the commercial banks has increased over the same period, mainly because of the economic recession and the high interest rates on the international market compared with the local interest rates paid to the depositors. This situation induced the Central Bank to alter the structure of the interest rates in order to temper the out-flow of Kuwaiti dinars and reduce the pressure on the Central Bank.

The question of the independence of central banks is related to the controversies over the actual necessity for their existence, the Ricardian view being that,

"the nation had decided, and decided rightly, that the value of the monetary unit should be made to depend upon the world value of gold, and that the supply of money should be so closely tied to conditions in the market of gold that there should be no room for human manipulations however well intentioned. Any discretionary action would be 'tinkering with the currency'."  
(Sayers. 1957, p.1).

Conversely, Sayers asserted that the essence of central banking is discretionary control of the monetary system. He states that, "the central banker is the man who exercises his discretion, not the machine that works according to rule" (Sayers, 1957, p.1). Nowadays, while the need for the central banks has been taken for granted in both developed and underdeveloped countries, the question is one of the independence of central banks, or

the degree of independence given to those entities within the general frame of the economy, and whether they should institute their own monetary objectives or be tied to the objectives postulated by the government and left to implement and choose the appropriate instruments. This argument is based on some important views. Firstly, the stability of the money values can be achieved best by lifting control of the money supply as far as possible out of the avenue of politics. Secondly, to procure the advantage of the participation of a neutral party (central bank) in the formation of the economic policy; and thirdly, the quality of knowledge possessed by such institutions.

Fair (1979), in his survey of sixteen central banks in developed industrial countries considers Germany, Switzerland and the United States as having the best-known independent central banks. He states that, "Today, there is no real case for central bank independence from government, but the degree of independence within government varies greatly." (Fair, 1979, p.31). If this is the case for developed countries, the situation in the developing world is more or less similar. Basu (1957), in his survey of eight developing African central banks, found that the degree of their independence from the government varies according to factors such as - economic objectives, conditions at the time of their establishment, and the political and social environments. Surprisingly, the colonial effect has its role as well. For instance,

the Central Banks of Morocco and Tunisia enjoy a reasonable independence following the practice of the French Central Bank, that,

"there is no legislation providing for government intervention in any form whatsoever in the conduct of their business. Nor is there any provision empowering the government to issue general-policy directives to be complied with by the banks."  
(Basu, 1967, p.72).

However, the situation of the Sudanese Central Bank, with its English colonial legacy is different. Aufrecht (1965, p.90), in his comparative survey of the laws of twenty one central banks in developed and underdeveloped countries showed a wide range of differences in the degree of independence from the government. He attributes this to two phases of central banking in recent history: a first phase covering the period between 1920-1936 where new or reformed central banks obtained a maximum degree of independence as a result of the Brussels Conference, 1920; and a second phase, starting in the late 1930s, when the trend towards nationalization of central banks began. By and large, for new emerging countries, governments are influenced by two considerations: firstly, to have a central bank as a prestige symbol of the autonomy of the country; secondly, the centralization tendency which directs new governments to control the economy.

The independence of the Central Bank of Kuwait has been argued over by many researchers and writers (see Moosa,

1986; Ghuloum, 1984; and El-Mallakh, 1981), either explicitly or implicitly. Moosa has stressed the strong presence of the Minister of Finance in the statute of the Central Bank of Kuwait, while Ghuloum found as a result of his empirical work that increasing government expenditure is the main determinant of the money supply that confused the monetary control system implemented by the Central Bank.

In this part of the study, some crucial issues in this connection will be discussed for two reasons: first, to assess the degree of freedom that is conferred on the Central Bank to conduct its monetary policy and exercise its instruments; and second, to build up a sound base for any recommendations derived as an outcome of this study. Although the statute of the Central Bank of Kuwait has defined the Bank as "a public institution, having an independent juristic personality" (Article 13), and, "the Bank shall be considered as a merchant in its relations with other parties, and its operations and accounts shall be conducted and organised in accordance with commercial banking rules" (Article 14), it was postulated in the latter that, "the Board of Directors shall, with the approval of the Minister of Finance, lay down all rules and regulations concerning the administration and financial affairs of the Bank, including staff and accounting matters, without being limited in all this by the provisions of the public Tenders and Civil Service Laws". It is noteworthy that

the term 'independent' was meant to explain that the Central Bank has a separate budget that is not to be combined with the government budget for disclosure and parliamentary purposes. Indeed, experience has proved that the Finance Minister used his right of approval over the regulations concerning staff affairs of the Central Bank, to send them to the Civil Service Council to be moderated in accordance with the Civil Service law. For example, the salary scale and the staff training regulation of the Bank was imposed by the Civil Service Council regardless of the peculiarity of such an institution and the competition for highly skilled staff within the banking sector.

As per Article 19, the appointment of the Governor of the Bank and his deputy, as well as their salaries and allowances, depends on the recommendation of the Finance Minister. This is not an encouraging sign in the transcript establishing the independence of the Central Bank. In addition to this, the statute requires two members of the Board to represent the concerned Ministries, one for the Ministry of Finance and the other for the Ministry of Commerce and Industry. The other four members are appointed by decree on the recommendation of the Finance Minister for a renewable period of three years (Article 20). Moreover, in spite of the fact that most of the organs are recommended by the Minister of Finance, the representative of the Finance Ministry has been given more power on the Board. Article 24 states

that, "At meetings of the Board the quorum shall consist of five members at least, including the Governor or his Deputy and the representative of the Ministry of Finance"; who is awarded the right to request the suspension of any resolution issued by the Board relating to monetary and credit policy for referral to the Minister of Finance (Article 27). Fair (1979, p.35) asserted that having a representative of the Minister of Finance on the board can diminish, and may tend to forestall or stultify, fruitful discussion of issues between Bank and Treasury. In this connection, Aufricht (1965, p.13) said that,

"the board's independence of the government is likely to be ensured most effectively if the members are titular members and if none is subject to instructions by any authority outside the Central Bank."

As the Central Bank is entrusted to direct credit policy in such a manner as to assist social and economic progress and the growth of national income (Article 15), its hands are tied by various provisions in the statute. The Bank has to refer to the Finance Minister whenever a particular policy is to be adopted. Article 31(E) states that,

"the Ministry of Finance shall transfer to the Central Bank such amounts as may be necessary for the implementation of any particular monetary policy, after the Minister of Finance has approved such a policy."

The Central Bank is also required to obtain his approval, if, for the purpose of financing development projects or strengthening the financial market, it may own or sell shares or stocks of any Kuwaiti joint-stock or

concessionary companies or public establishments in Kuwait and gives loans to banks, public financial or credit establishments in Kuwait (Article 37). Furthermore, in accordance with Article 38 the Governor is obliged to keep the Minister of Finance continuously informed of the monetary and credit policy pursued or intended to be pursued by the Bank, and, if the Minister has a different view, he may issue general directives to be followed by the Bank, and such directives shall become binding on the Bank. But, if the Board of Directors has any objection to these directives, it may submit those objections in writing to the Minister, who shall submit them with his directives to the Council of Ministers to issue the final decision. Therefore, it is left to the organs to transfer the case to the Council of Ministers.

The power conferred upon the Central Bank to control the banking system (Article 15) has been violated by another Ministry as well - this being the Ministry of Commerce and Industry, which is entrusted among other responsibilities to apply the Law of commercial companies. The commercial banks in Kuwait, as private or private and government ventures, are subject to this law in some aspects of their activities. In their relations with the Central Bank, the opinion of the Central Bank shall be sought with respect to the articles of association and memorandums of agreement, or amendments thereto, in order to ascertain the economic viability of such companies (Article 55). But the opinion of the Central Bank on such amendments is

considered in Article 61 as an 'in principle approval', so that the particular bank should carry out the process with the Ministry of Commerce to accomplish the formalities in accordance with the provisions of the law of commercial companies. Although, such amendments shall not be effective until they are entered in the Register of Banks at the Central Bank. The Commercial Banks have been given the chance to manoeuvre with a third party, thus, the responsibility of such matters is distributed between the Central Bank and the Commerce Ministry, where it should be placed solely with the former.

The role of the Central Bank as financial advisor to the government does not contain enough power to stand against, or resist decisions taken by the Government that might cause undesirable effects on the economy as seen from the Central Bank's point of view. This role has been tested in the late 1970s, when a committee of three Ministers, contrary to the advice of the Central Bank, recommended the Government to open the door for more companies in various activities to be established to absorb increasing private savings and the excess liquidity within the banking sector. Therefore, and because of the narrow absorptive capacity of the stock market, such decisions led to a frenzy of speculative activities which was counted, a few years later, as being among the reasons provoking the collapse of the stock market (Souk Al-Manakh) in mid 1982.

Nevertheless, the amended law of 1977 conferred on the Central Bank more power in the arena of banking supervision, which designated in detail for the first time the inspection process to be carried out by authorized staff of the Bank. Such a process is applicable only to the commercial and specialized banks, in spite of the fact that the Article concerned, Article 78, included the financial companies and institutions as subject to supervision by the Central Bank under the provisions of the law. This is obvious because Article 55 had already excluded public credit institutions, financial and investment institutions and companies, even if they were permitted by their articles of association to receive deposits and execute investment operations and some banking operations, from being subject to the whole chapter concerning the organisation of banking business unless the Central Bank obtained the approval of the Finance Minister.

In conclusion, it is apparent from the foregoing discussions that the argument about the relationship between the Central Bank and the Government, as well as the issue of the independence of the former, revolves around three topics: first - the influence of the Finance Minister over the Central Bank; second - the management of the foreign reserves of the government; third - the own resources of the Central Bank in Kuwait dinars.

Monetary policy objectives

Although the Charter of the Central Bank had entrusted the Bank with the formulation of its monetary and credit policy in Article (26,a), with the board of directors instructed to carry out the task, no set of objectives was postulated. Nevertheless, the Charter outlined certain details of the procedures involved in the implementation of conventional monetary policy instruments such as discount, open market operations, and affecting the liquidity position of the commercial banks by granting loans to, or exchanging deposits with them.

Apart from the argument about the precise definition of, and the differences between, terms such as objectives, purposes, and responsibilities, one can discern certain major objectives of the monetary policy in Kuwait from various chapters of the Central Bank's Charter. It is also possible to learn whether those objectives are included in the chapter which defines the purposes of the Central Bank, or in the chapter that determines the responsibilities of the Board of Directors of the Bank.

The Charter of the Central Bank states in Article (15.2) that one of the objectives of the Bank is "to endeavour to secure the stability of the Kuwaiti currency and its free convertibility into foreign currencies." This is considered to be an objective that is crucial to monetary policy since the Central Bank is the sole monetary authority in the country, and the formulation of monetary

policy is left entirely to its discretion. The inclusion of this objective in the Charter reflects two main functions that the Central Bank should undertake if it is to play its expected role in the economy: firstly, to protect the economy during its development process against external shocks by choosing an appropriate exchange rate regime, bearing in mind the dependence of the economy on oil revenue as the main source of income, and the import-oriented nature of the economy; and, secondly, by referring to the free convertibility of local currency into foreign currencies, to reflect the adopted concept of capitalism in running the economy and hence to obviate the use of any sort of exchange control to curb capital movement towards the international markets. Furthermore, one may thus assume that the nature of this objective implies that the Central Bank should resort to monetary measures, rather than to direct control, in order to influence capital outflows. Such measures could include an interest rate policy; the building up of the financial market; and accommodation measures.

The second explicitly postulated objective of the Central Bank under the same Article is "to endeavour to direct credit policy in such a manner as to assist the social and economic progress and the growth of national income". This objective clearly points to measures and efforts that the Central Bank should exert to control the commercial banks' money creation and their granting of credit to the economic sectors in order to evolve the productive units

in the economy which leads ultimately to the growth of national income. However, the empirical work of the previous chapter has highlighted the prominent role of bank credit facilities in expanding the money supply; now it is important to examine the role of the Central Bank in controlling bank credit.

Under the same Article (15.4) the Charter of the Central Bank presented a third objective to the monetary policy, which deals with the development of the banking system. Since the Central Bank is entitled "to control the banking system in the State of Kuwait" (15.4), the form of control is covered in great detail in Chapter Three of the Charter of the Central Bank, and ranges from the establishment of a new bank to its deletion and liquidation. It may be argued that this Chapter is concerned with the administrative aspects of the Central Bank's role rather than with the actual implementation of monetary policy.

In this respect, it is believed that the degree of maturity of the banking system - among other factors - is essential to the success of the monetary policy. For Kuwait as a developing country, the development of the banking sector comes at the forefront of the objectives of its monetary policy. Therefore, by this measure the monetary policy will be judged in the light of its effectiveness in developing the banking sector in the country.

However, in the search for objectives of the monetary policy, in my view no more than the above mentioned three objectives could be derived from the Central Bank's Charter. Another way of discovering the objectives of the monetary policy is by trying to discern how the Governors of the Central Bank see the issue. This is because these Governors have been in charge of drawing up and executing the monetary policy and guiding it to its short and long-term objectives. Thus, we refer here to the speech of the first Governor of the Central Bank, made at the opening of a new bank building in 1976;

1. "The Bank has always strived to maintain the power of the Dinar, and has adopted several measures for this purpose, which culminated in the decision taken in March 1975 to unpeg the exchange rate of the Kuwaiti Dinar. Thus, the exchange rate of the Dinar is currently fixed in the light of the exchange rates of the currencies of those countries with which Kuwait maintains financial and trade relations."
2. "The Bank has always endeavoured to place banking credit within reach of productive economic productive activities that serve the national economy."
3. "We feel that among the priorities of ensuring the sound process of the Kuwaiti economy is to strengthen and foster economic institutions within the State, particularly the banking and financial institutions."

(Abbas, 1976.)

The above quotations, extracted from the speech of the first Governor of the Central Bank, confirmed the foregoing objectives of the monetary policy which we derived from the law of the Central Bank.

Furthermore, the present Governor has assented that the essence of the monetary policy is to achieve monetary stability in its broadest sense through maintaining local price stability and a stable exchange rate of local currency within reasonable boundaries. He admits that the monetary policy alone can not realize monetary stability, and that cooperation with other active sectors in the economy, namely the public and private sectors, is crucial. The method employed by Central banking to achieve this objective is, in his view, mainly confined in controlling the degree of variability of local liquidity by influencing bank credit (Al-Sabah, 1986). Although the Governor postulated price stability as an objective of the monetary policy, it is obvious that his main concern is to influence bank credit in order to control local liquidity. On a different occasion, Al-Sabah had explicitly stated five objectives for the monetary policy of the Central Bank of Kuwait (Al-Sabah, 1987, p.73);

1. To maintain the relative stability of the exchange rate of the Kuwaiti Dinar and its purchasing power;
2. To secure the availability of an appropriate level of liquidity with the banks;
3. To control the size and trends of bank credit;
4. To develop the money and capital market in Kuwait;

5. To enhance the role of the banking system through the supervision function of the Central Bank.

To conclude, three main measurable objectives have been adopted for the monetary policy in Kuwait. These objectives will be submitted to various tests throughout the review of the monetary policy instruments applied by the Central Bank of Kuwait during the period of this study. These objectives are:

1. To regulate bank credit in terms of channelling savings into the productive units of the economy.
2. To maintain the stability of the exchange rate of the Kuwaiti Dinar.
3. To develop the financial market in general and the banking sector in particular.

These objectives are long-term ones, and apparently more appropriate for a study covering almost two decades of practicing monetary policy. Nevertheless, one may derive some short-term objectives that influence the day-to-day operations of the Central Bank of Kuwait. Thus, these short-term objectives are considered as follows:

1. Maintaining the foreign reserve of the Central Bank at a reasonable level, to meet the local demand for foreign currencies, and its international commitments. Needless to say, this foreign reserve is the sole source upon which the Central Bank can issue the local currency.

2. Defending the interest-rate structure by monitoring the margin between KD and U.S. dollar interest rate, and the inter-bank rates, the tendency has been to temper the effect of the capital outflow on local liquidity.
3. Controlling the cost of public borrowing in order to keep it at an acceptable level.
4. Maintaining the stability of the exchange rate of the Kuwaiti dinar by manipulating the components and weights of the basket.
5. To control the commercial banks' activities through its supervisory power given by the Central Bank's Charter.

As mentioned at the beginning of this Chapter, these objectives represent the view of the Kuwaiti monetary authorities on the matter. A further search for monetary policy objectives will be conducted through the literature on monetary policy in the developing countries.

"If the development of the economy is to be accelerated, it is essential that the resources saved by surplus sectors be put to the most productive uses and that the amount of such surpluses be increased, Since both of these require providing more saving, policies should be such as to supply the financial assets that are demanded by the surplus sectors."

(Coats and Khatkhate, 1983, p.6.)

Coats and Khatkhate assigned the major objectives to the monetary policy in the developing countries: growth and stabilization. Under the growth objective they call for the establishment of more new financial institutions to create an organised market for mobilizing savings into productive investments. They emphasise the importance of the interest rate policies to encourage savings in the form of financial assets with the financial

intermediaries. This emphasis on the interest rate policies should be seen in the light of certain characteristics prevalent in some developing economies. One such characteristic is what is known as disintermediation, the process by which borrowers can meet lenders directly and deal with them without recourse to any intermediary. This practice is usually adopted when interest rates on bank deposits are too low to encourage savers to place their money with the commercial banks, or when interest rates on other financial assets (if there are any) such as government bonds, are below those in the unorganised market.

Another characteristic of such economies is the willingness of the surplus units either to keep their savings in the form of cash money or to transform them into real assets, especially when there is inflation or fear of inflation. This transformation of savings into real assets takes the form of commodities and gold holding which do not represent a productive form of saving. Hence, it is for these reasons that interest rate policies can play a prominent role in attracting savings into bank deposits by keeping their rates of interest at a competitive level to those prevailing in the unorganised market. However, as inflation, or the fear of inflation, is the main incentive for the surplus units to keep their savings in the form of real assets, Coats and Khatkhate argue that the rate of inflation must be reduced in order to prevent such transformations. Therefore, one can

understand that the postulate of the growth objective by the authors was not intended as a call for more financial institutions to be established regardless of other efforts made by the monetary authorities. Such efforts are concerned with interest rate policies and combat inflation in order to increase available savings in hand at financial intermediaries.

With regard to stabilization as the second main objective of the monetary policy in the developing countries, Coats and Khatkhate asserted that it is the mandate of the monetary policy to maintain the international balance of payments. In this respect, the monetary authorities are faced with two mutually exclusive alternatives: to keep the local prices in harmony with the rest of the world, either by controlling the money stock under any exchange rate; or to make the appropriate adjustment to the exchange rate regime at any price level. Of course the former policy is assumed under the fixed exchange rate regime.

Bhatt (1983), in his paper, discusses the role of Central banking in evolving the financial system as an achievement conducive to any economic development in the developing countries. He asserts that,

"... economic development is not only facilitated but its pace is quickened by the appropriate development of the financial system structure of financial institutions, instruments and interest rates."

(Bhatt, V., 1983, p.115.)

In this regard, he postulated two major roles of Central banking in the developing countries; firstly as promoters and secondly, as regulators. His thesis is based on the assumption that there is a significant difference between the role of Central Banks in developed countries and that of those in developing countries, since the stage of development of these two groups of countries are different. He argues that the monetary and financial system was already well established when the Central Banks were set up in the developed countries, and thus as a corollary, the regulatory role of these banks is emphasised. Bhatt (1983) has argued that in a large number of developing countries, commercial banks grant credit mainly in order to finance foreign trade and industrial activities, the latter being considered ancillary to foreign trade activities; the credit needs of agriculture, small business, industry, and a large number of traditional enterprises are still financed by traditional non-banking lenders. Hence, under such conditions the promotional role of Central banking should emerge to secure the equality of bank credit among various productive sectors in the economy.

The author also calls for a wider geographical and functional penetration of the banking systems under the direct supervision of Central Banks. To guarantee fair cooperation between the Central Bank and the banking system, Bhatt suggests that the former be a lender first and foremost, rather than at the last resort.

Since the regulatory role is considered by Bhatt to be the second of the two roles of Central banking in the developing countries (or the second objective of the monetary policy), the author believes that credit regulation depends to a large extent on achievement in the first domain (i.e. as a promoter). He argues that the regulatory function depends on:

- 1) the geographical scope;
- 2) the functional scope of the banking system;
- 3) the extent of the banking system's reliance on the assistance of the Central Bank.

When the activities of the banking system are confined in big cities and do not meet the credit needs of agricultural borrowers, the credit regulation measures applied by the Central Bank prove inefficient since they do not reach a wide sector of the borrowing market. On the other hand, the ability of the Central Bank to regulate bank credit is dependent on the reliance of the commercial banks on the former to obtain funds whenever they need them so as to meet the demand for borrowing. In some developing countries where the commercial banks can find an alternative source of funds, or where branches of foreign banks (uncontrolled by the local Central Bank) are dominant, the reliance of the commercial banks on the Central Bank would diminish, hence the power of the latter to control bank credit would be affected.

Collyns argues that,

"... in small open developing economies that have opted for export-oriented growth based on free trade and the judicious encouragement of private enterprise, it is desired to achieve a stable exchange rate regime with a commitment to maintain currency convertibility and relatively unrestricted capital flows."

(Collyns, 1982, p.7.)

He bases his argument on the assumption that monetary policy in such economies must be related to the long-term development strategy of the economy. Thus it is the responsibility of the monetary policy to promote confidence in the economy by maintaining the domestic inflation rate close to the world inflation rate. An inflation rate higher than that in the competing countries would cause a drop in competitiveness and the possible devaluation of local currency.

In developing countries where the domestic rate of inflation is above world level, and where there is an unsustainable balance of payments deficit, Collyns says that these are symptomatic of high levels of expenditure relative to income, or to expansion of domestic credit greater than the growth in demand for monetary assets. Furthermore, he calls for the monetary policy in the developing economies to ensure that the overall magnitude of domestic saving be compatible with the national development program and that the necessary funds be channelled towards investment priorities. Thus, according to Collyns, the former objective can be achieved

by setting minima to the deposits rates paid by the commercial banks, and revising them in line with trends of inflation and external opportunities. However, although the suggestion presented by Collyns has its merits, it is thought that setting minima to the bank deposit would conflict with other measures that are of a great importance either to the authorities or to the banking sector in the developing countries. For example, to set minima in order to attract savings would mean raising the borrowing cost on productive units, especially for those of small size as they might not be able to bear the high cost of borrowing money, particularly when their firms need to build up their fixed capital at the first stage of their establishment. As a corollary small businesses would be deprived of the opportunity of obtaining bank credit, which contradicts any development plan concerned with encouraging such businesses to grow. By contrast, some developing countries follow radically different interest rate policies by fixing a ceiling on bank credit so as to encourage productive sectors to obtain relatively cheap credit from the commercial banks. Moreover, by setting minima to bank deposits, bank profits are negatively affected, especially when the demand for bank credit declines; this in turn induces the commercial banks (in an open economy) to invest their money outside the country in the search for profitable opportunities with which to cover their expenses and maximize their profits. It is clear, then, that the minima policy would not achieve its original objective, which is to make

domestic saving available for use by the productive units in the economy.

By and large, and in spite of the fact that some of Collyns' prescriptions are not applicable to the Kuwaiti conditions, the thrust of our argument is that the main role of interest rate policies is to achieve the monetary policy objectives in the development plan, and to make bank credit control conducive to the development of productive sectors in the country.

Sen (1967, p.230) claims that it is the role of the Central Banks to bring about the rapid development of the resources of the country by achieving low interest rates. He says that in Latin American countries some economists have suggested direct financing of industrial development by the Central Banks.

Ghatak (1981, p.101) suggests three major objectives of the monetary policy in the developing countries: money and credit control; price stabilization; and economic growth. He emphasises that price stabilization is the most important objective in the developing countries on the grounds that these countries are suffering more from inflation than are the developed countries; and the monetary policy is more efficient than the fiscal policies in dealing with inflation. He argues that a modest rise in prices (between 5.0 to 10.0 percent) is not regarded as harmful to the economy and could boost the level of profit, investment and rate of economic growth, and in

turn enable the authorities to achieve full employment. In addition, he states that monetary policy is a useful tool with which to achieve equilibrium in the balance of payments and stabilize the exchange rate.

Basu (1967) concentrates on the two traditional roles of Central banking in the developing country, i.e. its regulatory role and its promotory role. With regard to the regulatory role, the monetary policy, in order to regulate bank credit, should use a wide range of traditional instruments such as interest rate, discount, open market operations, and variable reserve ratio. With regard to the promotory role, the monetary policy should aim at the development of the money and capital market, and the formation of an institutional framework conducive to rapid economic growth.

From the above review one can see that the objectives of the monetary policy in developing countries have been expressed in different ways and contexts. At times they are postulated explicitly, while at other times they are mentioned implicitly under the role of Central banking or the monetary authorities. What is worth mentioning here is that most of the writings on the developing countries deal with the monetary policy from a general perspective, and therefore one should be careful when adopting a measure and applying it to any particular developing economy with its own peculiarities. Moreover, one may assume that those studies which deal with the developing countries have been coloured deeply by certain

characteristics prevalent in most of the developing economies such as: the existence of rural sectors; the disintermediation phenomenon; the lack of saving, or saving in unproductive assets; the shortage of bank services. Hence, the suggested objectives of monetary policies are geared to cure such problems.

However, in some other developing economies, such as those of the oil exporting countries (e.g. Kuwait) one comes across different problems that call for quite different objectives and solutions. For example, in most of the poor developing countries with low incomes, savings promotion receives much attention from the monetary authorities. Furthermore, since savings in other developing countries take the form of real assets such as land or commodities, which are classed as unproductive assets, this form of savings deprives the productive units in the economy of funds. The monetary authorities should bear in mind that their main objective is to encourage the surplus sectors to place their savings in the form of financial assets with the financial intermediaries. Hence, interest rates policy would be suggested as an important tool to be implemented. By contrast, in the developing oil-exporting countries, which enjoy high national incomes, savings have reached such high levels that the available investment opportunities have become the main concern of the monetary authorities. Thus one may adopt those objectives in a general form and consider

them as long-term objectives of the monetary policy in a developing economy.

To conclude, the proposed objectives of the monetary policy in the above review of literature dealing with the developing economies may be summarized into four main groups. This enables us to apply these general objectives to the Kuwaiti situation:

1. To develop the financial market:

This objective has been conceived as part of the comprehensive national plan of economic growth in the country. It includes the enlargement of the financial institutions, as well as the expansion of their activities and the creation of the appropriate institutional framework for their activities. These sub-objectives are necessary if the saving-investment mechanism is to be placed in its proper domain. In some cases, although probably not in Kuwait, this setting could combat the existence of the unorganised market and the disintermediation phenomenon.

2. To maintain the equilibrium of the balance of payments:

As some developing countries suffer from a sustained deficit in their balance of payments, it is of great importance to the monetary

authorities to reach a level of equilibrium between the balance of trade deficit and the capital inflow by using the appropriate tools. In Kuwait, whose balance of trade has shown a persistent surplus thanks to the oil revenues, this objective will be tested in a different manner under the discussion of the exchange rate policy.

3. To control bank credit in a manner conducive to the development of the productive sectors in the economy.

4. To stabilize prices:

Since most of the developing countries depend on exporting a single primary commodity and importing most of their capital and consumer goods, they have been susceptible to two sources of inflation: imported and local; thus this objective can be met through the regulation of the money supply via the control of bank credit and the adopted exchange rate regime. In the case of Kuwait, as the economy is import oriented, this objective can be conceived under the second objective of the monetary policy, which implies the stability of the purchasing power of the Kuwaiti dinar.

However, in the face of the two sets of objectives, one may argue that the Central Bank of Kuwait is obliged to be judged only against those objectives being postulated by its Charter, regardless of those assigned to the developing countries in general terms. This argument has its merits on the grounds that each economy has its own characteristics that impel the monetary authorities to constitute the objectives which suit the peculiarities of the economy in question. Therefore, the implementation of the monetary policy instruments used by the Central Bank of Kuwait, will be evaluated against the first set of objectives, while the second set of objectives will be considered as guidelines to evaluate the performance of the Central Bank of Kuwait in conditions of developing economy.

## CHAPTER SIX

### INTEREST RATE POLICY

This chapter is concerned with the implementation and evaluation of the interest rate policy, since it represents the main instrument that the Central Bank can use to participate in the process of the country's economic development through manipulating the saving-investment mechanism.

Thus, a theoretical framework of the interest rates policy in the developing countries is presented at the beginning of this chapter, with a special emphasis on the use of interest-rate ceilings. This emphasis is deliberately embodied as the Kuwaiti authorities have decided to impose a ceiling on interest rates since the latter was legalized in the country, and up to the recent introduction of the interest rates structure in December 1988.

However, the implementations of the interest rates policy in Kuwait will be discussed from different angles, but within a framework that helps to judge the use of this instrument in the face of the monetary policy objectives.

#### Interest Rates Policy

The importance of the interest rate in the modern economy can be traced to the Neo-classical-Keynesian argument over the issue. For the neo-classicists, the interest rate was determined by the real sector via the balanced state

of the saving-investment schedules at the level of full employment. The followers of Keynes, however, saw the interest rate within the monetary sector as being conducive to the required level of investment, with savings seen as an increasing function of income. Today, with monetarist economies predominant in the modern industrialized world, interest rates - as an effective instrument of monetary policy - are used to influence major issues such as inflation, defence of the exchange rate of local currency, short-term capital flows, and the regulation of bank credit.

Sayers (1957, pp.123-124) asserts that,

"Bank Rate and open-market operations are at the heart of central banking; they are the means whereby the price of credit and the ease of obtaining it are governed."

He also says that this weapon has been seen to serve five purposes:

- (1) as a penalty rate;
- (2) as a governor of the international capital movement;
- (3) as a check upon the accumulation of stocks of commodities;
- (4) as a regulator of the demand for real resources to be embodied in fixed capital, through its influence upon the whole structure of interest rates; and
- (5) as an 'Index'.

The use of the interest rate in the developed countries to serve the purposes outlined by Sayers does not mean that it can be used in the developing countries in the same way. The substantial differences in the economic structures and institutions between these two groups of countries clearly obviates this. For example, when the bank rate is used as a penalty rate by the Central Bank of a developed country to control bank credit and make the supply of funds more expensive to them, one must bear in mind the long history of the Central Bank, and the legal and institutional framework in which it operates, which enable it to do so. In a developing country with a nascent central banking system, the bank rate as a penalty rate must be used with great caution, since the Central Bank needs first to strengthen its position within the existing banking system and build up its relationships. In this stage, the Central Bank needs to prove that commercial banks can resort to it whenever they face shortages in their liquidity. Furthermore, when a Central Bank in an industrialised developed country uses the interest rate as a weapon with which to influence the flow of capital, it does so on the proviso that the local financial market is able to absorb the repatriated funds. However, if in a developing open economy, with its infant financial market and its simple financial assets, a Central Bank tries to use this weapon in the same context, it can only harm the economy by bringing undesirable inflationary effects. Therefore, the interest rate as a weapon of monetary policy in the developing countries must

be viewed in a manner consistent with the particular conditions of the country in question.

Broadly speaking, the interest rates in the developing economies should serve the process of mobilizing national resources to encourage productivity. This attracts savings into the coffers of the financial intermediaries and makes funds available to the productive units of the economy. Nevertheless, the mobilization process of national savings in a developing economy is a critical task, beset with difficulties arising from the special conditions of that economy and the degree of its liberalisation. For example, in a developing country with an unorganised market where disintermediation is prevalent, the authorities might need to raise the bank deposit interest rates in order to draw the surplus from the unorganised sectors; however, this rise in deposit rates would increase lending rate on productive sectors and hinder the real investment trend. Moreover, as some developing countries have liberalised their economies, and freed capital movements towards foreign markets, it has become crucial that the required level of interest rates appropriate to the mobilization process be carefully determined.

If the local financial market is linked with international markets, local interest rates will be exposed to external pressures which will affect the investment activities in the local economy. Therefore, the authorities of the developing countries hesitate to consider whether the

interest rates should be geared as a deposit-or-lend rate. Nevertheless, the existence of financial markets in the developing countries will help the effectiveness of the interest rate as an instrument in the development plan, since it is through these markets that the intended changes in interest rate will pass to affect the economic sectors. Edwards and Khan (1985) assert that there is a positive association between the degree of development of the financial sector and the economic performance in developing countries. Sayers (1957, p.130) writes,

"I would claim this weapon as one of the most important for the central banking in a country lacking an active security market."

However, structural deficiencies in most developing countries have been reflected in an absence of developed financial markets, and so, in order to implement their plans for economic development, the authorities have brought the interest rate under administrative legislation. Such control on interest rates is called "Interest rate ceiling", with the monetary authorities fixing a maximum or minimum ceiling on various deposit or lending rates. The chief aim of the authorities is to maximize the impact of the interest rate policies on the saving-investment mechanism. Other reasons could also lead the monetary authorities in developing economies to approach the ceiling. In some developing countries, for instance national savings are much lower than the amount required for development needs, and thus creditors have good reason to impose high rates of return on borrowers.

This situation raises the cost of investment and hinders economies' development. High interest rates could also bring inflationary effects if the economy is import-oriented as in the case of Kuwait. High interest rates imposed by the creditors could impede growing or recently established small businesses, and so the monetary authorities exert a low maximum ceiling on the lending rates.

In some developing countries the monetary authorities are left with a small scope of discretion in terms of controlling the money supply by implementing various instruments to regulate bank credit. These impediments arise from legal constraints or from the inefficiency of the financial sector. Furthermore, to encourage saving, some central banks postulate a minimum ceiling to be paid by the commercial banks on private deposits. And finally, in other developing countries, social and political pressures make inevitable the imposition of a ceiling on either deposit or lending rates.

From 1973 to 1980, the Greek authorities imposed an interest-rate ceiling on deposits and loans, and a ceiling on the supplies of certain types of credit. This was in order to encourage what were perceived to be desirable economic activities (e.g. agriculture, small-scale manufacturing, industrial investment, exports and tobacco trade) at the expense of less desirable areas (e.g. speculative investment in real estate), (Molho, 1986, p.485). The interest-rate ceiling was also used by the

Federal Reserve in America in 1966 and 1969 to prevent banks from paying high rates on saving and time deposits. The reasons given by the Fed. for this course of action was that for the banks to pay such high rates would lead them to make unsafe loans (Chandler, 1973, p.267). Although the interest-rate ceiling might be used in some developed countries as in the case mentioned above, it is usually for temporary purposes and under abnormal conditions, while the use of the ceiling in developing countries often lasts so long that it becomes a structural feature of the economy. Chandler points out that the imposition of the ceiling in the United States in 1966 and 1969 occurred only because of unusual financial pressures; he criticized the ceiling on the grounds that it tends to inhibit the growth of the most efficient financial institutions and practices.

Interest rate control in the developing countries is used to achieve objectives related to economic growth. Nevertheless, one may argue that the imposition of the ceiling could have the following advantages:

1. It could encourage real investment when imposed on lending rates (cheap-money policy).
2. It could combat the undesirable effects of the unorganised sector; in this respect a minimum ceiling could be imposed on rates paid by banks to depositors, with a maximum ceiling on lending rates.

3. It could combat undesirable inflationary effects resulting from high interest rates imposed by creditors.
4. Selective interest-rate ceilings may be applied to secure the availability of funds to some productive sectors.

On the other hand, an interest-rate ceiling could have some negative consequences for the economy in general and for the financial market in particular:

1. During the inflation cycles, the ceiling on bank deposit rates could give negative yields since nominal interest rates become low in real terms.
2. Imposing the ceiling in the banking sector could put other financial institutions in a better position to attract deposits.
3. A low interest-rate ceiling could encourage speculation in real estate and the stock market.
4. In an open economy, an interest-rate ceiling could lead savers and investors to resort to foreign markets.
5. A low interest-rate ceiling would cause disequilibrium between saving and investment, since it would reduce the demand for bank deposits and increase the demand for bank credit.

To conclude, the case for or against the ceiling can only be viewed in general terms, and therefore, the evaluation of any application of interest-rate ceiling should be assessed in the light of the peculiarities of the economy concerned.

### Interest Rates Structure in Kuwait

From 1961 to 1988, Kuwait has experienced an interest-rate ceiling determined by different official measures with various levels of ceilings. From 1961 to November 1976, the maximum ceiling on lending rates was set by the Commercial Law at 7.0 percent. During that period, interest rates on deposits and loans were determined by gentlemen's agreements between the commercial banks. In November 1976, the Commercial Law was amended and the setting of the interest rates came under the jurisdiction of the Central Bank. The new amendment required the approval of the Finance Minister prior to the Central Bank's announcement of the interest rate. After this amendment, the latter raised the interest-rate ceiling to 10.0 percent. Interest rates on foreign currency deposits were left to be determined by market forces and according to interest rates prevalent in the international markets. Within the 10.0 percent ceiling, two ceilings were set: 7.0 percent on secured loans (for the productive sectors) with a maturity of less than one year; and 8.5 percent ceiling on unsecured loans with a maturity of less than one year. A minimum ceiling of 4.5 percent

was set to be paid on saving deposits. This structure of interest rates remained in operation until March 1987 when a new structure was introduced by the Central Bank; now the maximum ceiling of interest rate on loans transactions with a maturity of less than one year was fixed at 7.5 percent. For loans with a maturity of more than one year, the ceiling was not to exceed 1.0 percent more than the rate of interest on inter-bank market, which is determined by market forces. Loans to non-residents and in foreign currencies were left to be determined by market forces. Moreover, a 6.0 percent ceiling was set for loans with maturities of less than one year granted to productive sectors, while the interest on saving deposits remained unchanged at a minimum of 4.5 percent. However, according to the three previous interest rate structures, lenders are requested not to exceed the ceiling unless they provide borrowers with additional services ("real services" as it is termed by the law), and thus it is presumed that when local interest rates come under pressure due to the increase of foreign interest rates, commercial banks will exceed the ceiling by offering administrative services to their customers, or claiming to do so.

The fourth interest-rate structure was introduced in December 1988. Major changes were made, with the ceiling of interest rates on loans and deposits being connected directly to the discount rate announced by the Central Bank. Consequently, the interest rates become more

flexible in terms of changes as they can be increased or decreased automatically by changing the discount rate of the Central Bank. According to the new structure, the ceiling rate on loans with a maturity of less than one year were not to exceed 2.0 percent of the discount rate, while the rate on loans with a maturity of more than one year were not to exceed 2.5 percent; in both cases the new structure paid no attention to whether loans were productive or not.

The new structure allows banks to charge their customers 0.5 percent in advance as a "rate of intent" on the full amount of credit facilities. Interest rate on consumer loans was fixed at a maximum of 6.0 percent, while interest paid on saving deposits was to remain at 4.5 percent minimum. Inter-bank operations and loans in favour of non-residents are exempted from the ceiling. In addition, a new feature of the structure is that a minima of interest rates is to be paid on time deposits. Time deposits with a maturity of one to three months are to be paid not less than 0.5 percent above the discount rate, while those with a maturity of three to six months should be paid an interest rate of not less than 1.0 percent above the discount rate. Interest rates on deposits with a maturity of less than one and over six months are left to be competed for by the commercial banks, but not less than 1.0 percent above the discount rate.

However, the new structure postulates minimum interest-rate ceilings in favour of time deposits, a move that will serve two purposes. Firstly, it will encourage deposits to be placed locally at the banking system in an environment of high foreign interest rates; and secondly, it will take away from the commercial banks their power to determine the level of interest rates on private deposits. Table 6.1 illustrates the new interest-rates structure.

From the above exposition of the development of interest-rate structures, with the exception of the last change, it can be argued that the use of the ceiling in Kuwait could be considered as loans rate-oriented, and thus a regulator of the cost and availability of credit rather than a regulator of the savings-investment mechanism. The condition that conflicts with the fact that in the developing economies, both savings of surplus units and investments by productive units are of great importance for the process of economic development.

### Islamic Views on Interest and the Policy of Ceilings

In the following discussion, we will try to answer two questions: Why does the interest rates structure favour those seeking loans rather than depositors?, and: Why have the authorities changed their policies in the last amendment by including minima on deposit interest rates? First of all I would like to refer to some writers and

Table 6.1

Interest Rates Structure Introduced In December 1988.

TYPE OF TRANSACTION	INTEREST RATES AND MATURITIES			
Interest-rate ceiling on loans	less than one year		more than one year	
	2% above the discount rate		2.5% above the discount rate	
Interest-rate ceiling on consumer loans	6% can be discounted in advance provided that maturity of loans do not exceed four years.			
Minimum interest rate to be paid on time deposits	less than one month	1-3 months	3-6 months	more than 6 months
	free	0.5% above the discount rate	1% above the discount rate	free, but not less than 1% above the discount rate
Minimum interest rate on saving deposits	4.5% annually			
Money market operations	free			
Loans to non-residents	free			

researchers (e.g. Fadil (1985, p.393) and Khaleel (1982, p.787)) who have attributed the (hypothetically) low interest rates ceiling to religious considerations, interest rate being considered as a kind of usury in Islam.

Indeed, Islam does prohibit interest rates on loans and, by definition, on bank deposits, which are regarded as loans given by depositors to banks. However, there is no point at all in applying this concept to certain levels of interest rates since interest as a whole is rejected by Islamic doctrine. Therefore, it would have been better for such writers to have avoided the issue of religious considerations as the sole reason, or even as one among other reasons, for the low interest-rate ceiling in Kuwait; instead they should look for other factors relevant to the special conditions of the Kuwaiti economy. In this context we refer to the Second Conference at the Islamic Research Academy of al Azhar (Majma al Buhuth al Islamiyyh) held in 1965 in Cairo, where all participants from the different Islamic Countries issued two religious edicts (fatwa) concerning banking interest rates. According to the first ruling, all interest is prohibited regardless of the rate or the amount; according to the second, all bank operations which involve interest (e.g. deposit accounts, saving accounts) are prohibited. As a corollary, one may argue that the Kuwaiti authorities would not have raised the interest-rate ceiling from 7.0

to 10.0 percent in 1976 if religion had had any influence on the matter.

Moreover, when the interest rate ceiling is termed low, it is compared with foreign interest rates during the time in which the latter have exceeded the local interest-rate ceiling and not at the time when the ceiling was constituted. Experience has shown that in 1986, the local inter-bank rate exceeded foreign interest rates (3 months Euro dollar market)(Chapter 4), upon which the authorities reduced the ceiling in March 1987 from 10.0 to 7.5 percent since foreign interest rates, especially those on the dollar declined, and thus the level of the ceiling became low or high compared with other interest rates on the international market. Thus it is believed that the shortcomings of the ceiling lie in its rigidity rather than its level.

However, the imposition of the ceiling can be viewed against two major measures: the role of interest in regulating the saving-investment mechanism in the local economy; and the transmission of external pressures onto local interest-rates structure thanks to the close relationship between local and international financial markets.

In most of the developing countries where age-old habits such as disintermediation, commodity saving, and gold hoarding are still in existence, not to mention the predominant agriculture sector where banking services can

not reach all potential surplus units, savings crowding sits at the top of the local authorities' list of priorities in their endeavour to implement plans for economic development. In those economies (non-oil exporting) national income is seen as being relatively low, with exports depending mainly on a single primary commodity. Revenues can not thus be compared with those of the developing oil-exporting countries, and so the governments are not in a good financial position to participate on a large scale in the economic development plans. Furthermore, a large number of developing countries are so deep in debt that the matured interests of their loans have become a great burden. In these circumstances, when the interest rates are set by the authorities, be it under the ceiling system or not, encouraging saving must be taken into consideration.

Because of Kuwait's high oil revenues and methods of wealth distribution followed by its government (land purchase, government subsidies and services), private saving has never become an obstacle to economic development. By contrast, investment outlets are an integral part of the economic development plan because of shortcomings related to the absorptive capacity of the Kuwaiti economy (Chapter 2).

Table 6.2 shows the ratios of private savings (bank interest-bearing deposits) to both non-oil GDP and total GDP for the period 1970-1988. As the table illustrates,

the average of private savings stood at almost 40.0 percent of total GDP, and at 87.0 percent of non-oil GDP. Private savings have also exceeded the non-oil GDP in absolute values over the period 1983 to 1988. This trend of accumulative saving balances is virtually non-existent in non-oil exporting countries; thus it indicates that the balance of saving-investment mechanism is on the side of saving. Moreover, the growth rate of private savings is greater than the growth rate of total GDP and non-oil GDP for the same period. Hence this trend of private savings to increase and accumulate persistently over time, together with the narrow capacity of the local economy, has encouraged the Kuwaiti authorities to concentrate on securing the kind of environment that is conducive to the development of investment activities through the interest rate structure. Nevertheless, this kind of cheap-money policy, though intended to stimulate productive units for real investment, has had undesirable effects on the economy. Since the interest-rate structure ceiling is geared towards securing bank credit availability for all economic sectors without any preconceived measures to distinguish between favourable and unfavourable sectors, and in the absence of any selective credit control, the commercial banks as profit maximizers have, in order to discharge their duties to depositors, extended credit on a large scale and urged speculative trends in stock market and real estate.

Table 6.2  
Ratios of Savings (1970-1988)

Year	(1) Savings KD million	Total GDP KD million	Ratio of Saving to total GDP %	Non-oil GDP	Ratio of saving to Non-oil GDP %
1970	328.8	1026.31	32.0	407.51	80.7
1971	375.1	1381.79	27.1	473.96	79.1
1972	378.0	1463.97	25.8	549.52	68.8
1973	397.2	1604.14	23.6	607.58	65.4
1974	521.0	3812.95	13.7	790.34	65.9
1975	600.9	3484.98	17.2	1025.98	58.6
1976	826.5	3839.64	21.5	1315.56	62.8
1977	1092.7	4003.72	27.3	1526.41	71.6
1978	1351.4	4221.79	32.0	1701.24	79.4
1979	1663.2	6790.60	24.5	2378.06	69.9
1980	2187.8	7679.79	28.5	2593.49	84.4
1981	2668.4	6908.05	38.6	2793.09	95.5
1982	2998.3	6128.91	48.9	3365.44	89.1
1983	3254.2	6060.55	53.7	3022.62	107.6
1984	3583.0	6316.40	56.7	2916.31	122.9
1985	3554.5	5898.73	60.3	2915.57	121.9
1986	3639.9	5059.34	71.9	3380.24	107.7
1987	3798.8	5897.68	64.4	3665.50	103.6
1988	4199.6	5608.71	74.9	3607.13	116.4
Average			39.1		86.9
Growth Rate	15.2	9.9		12.9	

(1) Savings = Interest-bearing deposits at the commercial banks.

Source: Central Bank of Kuwait; Quarterly Statistical Bulletin (1974-1989)

Table 6.3

Effect of Foreign Interest Rates on  
Private Deposits with The Commercial Banks

Year	Percentage change		Euro dollar Interest Rate %	Interest Rate Ceiling %
	KD.D %	FC.D %		
1972	-	-	9.0	7.0
1973	4.7	20.7	10.1	7.0
1974	14.3	85.3	10.5	7.0
1975	43.4	-29.8	6.8	7.0
1976	38.6	36.3	5.3	10.0(November)
1977	45.4	-47.4	7.1	10.0
1978	18.3	107.4	11.1	10.0
1979	7.2	96.1	14.7	10.0
1980	17.5	65.3	17.1	10.0
1981	48.8	1.2	13.8	10.0
1982	17.3	-44.1	15.5	10.0
1983	-2.2	79.4	9.9	10.0
1984	0.3	20.2	9.8	10.0
1985	3.2	-22.4	8.1	10.0
1986	0.4	16.5	6.1	10.0
1987	-3.4	51.5	8.0	7.5(March)
1988	-0.2	32.6	9.0	7.5

where:

KD.D = KD private deposits with the commercial banks.

FC.D = private deposits in foreign currencies with  
the commercial banks.

Source: Central Bank of Kuwait; Quarterly  
Statistical Bulletin (1974-1988),  
International Financial Statistics (I.M.F.).

Foreign Influences on Domestic Interest Rates

On the other hand, as a result of the Kuwaiti economy being open to the rest of the world, the local interest rates structure has come under great pressure whenever foreign interest rates have reached or exceeded the ceiling; capital outflows towards foreign currencies accelerate the fall in banks' liquidity and force the Central Bank to react by injecting more funds into the banking system through its various channels such as the discount window, swap operations, and direct loans. Thus when the authorities set the interest-rate ceiling for the first time, and when they introduced the amendment on the ceiling during the latter stages, they must have considered the levels of foreign interest rates on the international market in order to mitigate the external pressures on local liquidity, and hence to curb capital outflows to foreign currencies.

Table 6.3 shows the response of private deposits in KD and foreign currencies at the commercial banks to changes in foreign interest rates and to changes of the local interest-rate ceiling. The following readings can be abstracted from the table:

1. When foreign interest rates decline, deposits in foreign currencies decline in favour of KD deposits, and vice-versa, with some exceptions during the period between 1981-1982 when private deposits in foreign currencies had decreased in spite of the increase of foreign interest

rates to high levels at 13.8 percent and 15.5 percent respectively. This occurrence can be attributed to the stock market boom during that period when local investors preferred to invest their money in the stock market regardless of high foreign interest rates.

2. When the interest-rate ceiling was raised from 7.0 percent to 10.0 percent in March 1976, private KD deposits increased by 45.4 percent against a decrease in foreign currency deposits of 47.4 percent in 1977. This shows that the commercial banks raised their deposit rates following the increase of the lending rates. However, when the ceiling was reduced from 10.0 percent to 7.5 percent in March 1987, private KD deposits declined by 3.4 percent, while private deposits in foreign currencies rose by 51.5 percent.

3. The rise of the interest-rate ceiling in 1976 followed an increase in foreign interest rates, while the reduction of the ceiling in 1987 followed a drop in foreign interest rates.

4. Although the first interest-rate ceiling (7%) lasted from 1961 to 1976, and the second ceiling (10%) from 1976 to 1987, the third ceiling (7.5%) had been in force for less than two years when the new interest-rate ceiling was introduced in December 1988. It is believed that the reason for such a short life span of the third ceiling was related to the introduction of the public debt instruments

in November 1987; this will be verified during the discussion of the new structure.

5. Over the period 1986-1988, and especially after the amendment of the interest-rate ceiling in 1987, foreign deposits were preferred over KD deposits as a result of the decline of the ceiling and the increase of foreign interest rates on currencies such as the dollar and sterling. The pressure felt by KD deposits as a result is possibly one of the reasons that prompted the authorities to formulate the new structure.

Having viewed the behaviour of private bank deposits in the face of changes in foreign interest rates and changes of the local interest-rate ceiling, we turn now to discuss the reaction of the commercial banks to the same variables. The net position of the commercial banks with the Central Bank of Kuwait is taken as an indicator of such behaviour. The net position of the commercial banks represents their claims on the Central Bank minus the claims of the latter on them. The claims of the commercial banks consist of current balances for their daily use, interest-bearing deposits, and the CBK bills; the claims of the Central Bank consist of interest-bearing deposits, discounts, and direct loans to the commercial banks. Hence the net claims of the commercial banks represent their excess reserves that would be employed to meet the increasing demand for bank credit, or be

converted into foreign currencies when foreign interest rates are encouraging.

However, the relationship between the net position of the commercial banks and changes in the interest-rate ceiling is assumed to be positive. This is because, when the monetary authorities raise the ceiling, the commercial banks increase their KD reserves, imposing higher rates on lending and expanding their supply of credit. Conversely, when the ceiling is cut down, they decrease their KD reserves and shrink their supply of credit to local economic sectors, provided that foreign interest rates are relatively high; otherwise, the banks' reserves will be employed with the Central Bank. Table 6.4 shows that when foreign interest rates increase, the net position of the commercial banks decline. When foreign interest rates soared in 1979 and 1980, the net position became negative. At the same time, the claims of the Central Bank on the commercial banks increased, which indicates that the latter had converted more KD into foreign currencies and had satisfied the local demand for bank credit by borrowing from the Central Bank, either directly or through discounted bills.

In contrast, during periods where foreign interest rates are low, the commercial banks place more of their reserves in interest-bearing deposits or bills at the Central Bank, since they prefer to avoid the exchange rate risks, when foreign interest rates are not high enough to cover such

Table 6.4

Relationship Between The Net Position of The Commercial Banks, Changes of Local Interest Rate Ceiling, and Foreign Interest Rates.

YEAR	(1) CMCL	(2) CBCL	(1-2) NB	Foreign Interest		Changes of Interest-rate Ceiling %
				Rate *	% Changes	
				\$	%	
1970	1.7	-	1.7	7.5	-	7
1971	3.0	-	3.0	6.3	-16.0	7
1972	9.4	-	9.4	9.0	42.9	7
1973	20.0	-	20.0	10.1	12.2	7
1974	42.2	-	42.2	10.5	4.0	7
1975	61.4	4.5	56.9	6.8	-35.2	7
1976	87.8	2.1	85.7	5.3	-22.1	10(November)
1977	270.2	20.7	249.5	7.1	34.0	10
1978	130.4	30.6	99.8	11.1	56.3	10
1979	149.7	195.3	-45.6	14.7	32.4	10
1980	237.5	293.6	-56.1	17.1	16.3	10
1981	375.8	282.4	93.4	13.8	-19.3	10
1982	732.2	276.7	455.5	15.5	12.3	10
1983	476.2	334.6	141.6	9.9	-36.1	10
1984	468.0	547.0	-79.0	9.8	- 1.0	10
1985	542.7	414.8	127.9	8.1	-17.3	10
1986	875.8	527.8	348.0	6.1	-24.7	10
1987	417.6	411.7	5.9	8.0	31.1	7.5(March)
1988	76.4	353.8	-277.4	9.0	12.5	7.5

where:

CMCL = Commercial banks claims on the Central Bank (balances, deposits, C.B.K Bills).

CBKCL = Central Bank claims on the commercial banks (discount, deposits, loans).

NB = Net balance of the commercial banks.

Source: Central Bank of Kuwait; Quarterly Statistical Bulletin (1974-1988).  
International Financial Statistics (I.M.F.).

\* 3 months Eurodollar market in London.

risks. The table also shows that when the interest-rate ceiling was raised from 7.0 percent to 10.0 percent in November 1976, in the following year the commercial banks increased their reserves at the Central Bank, and hence improved their net position to be ready to expand their lending under the new high ceiling.

However, when the monetary authorities brought the interest-rate ceiling down to 7.5 percent in March 1987, the commercial banks reduced their claims on the Central Bank. This is because they were able to gain more profit by employing their excess money in foreign deposits than from local lending or the Central Bank. The exception to the above analysis is what happened in 1982. The table reveals that the net position of the commercial banks has shown a high level as a result of an increase in their claims on the Central Bank at a time when foreign interest rates were high at 15.5 percent. This can be attributed to the flourishing activity of the stock market during the first half of 1982 and its collapse in the second half of that year. In both cases, the result would be more excess reserves for the commercial banks.

To conclude, we may say that the raised interest-rate ceiling for lending rates is encouraged by an overabundance of private savings in the surplus economy of Kuwait; hence the authorities have chosen to follow a cheap-money policy in order to develop the economy. Moreover, as the interest-rate ceiling comes under external pressures when foreign interest rates rise, the

monetary authorities prefer to defend, rather than change the ceiling, by injecting more funds into the banking system to enhance the liquidity positions of the commercial banks. When external pressures on the interest-rate ceiling persist for long periods, and local reactions to these pressures take the form of structural rather than cyclical patterns, the authorities tend to amend the ceiling to the right level. We may therefore add that the exchange rate policy, which aims at maintaining a stable relationship between the dinar and the dollar, has helped to encourage capital outflows towards foreign markets and has exposed the commercial banks to liquidity crises.

Table 6.5 reveals how the exchange rate policy has facilitated capital movements in response to fluctuations in foreign interest rates - or, in other words, how the exchange rate policy has protected the value of expatriated capital in local currency. Generally speaking, during the time when foreign interest rates trends experienced increases, the exchange rates between the dollar and the dinar have shown a more stable relationship, or have been in favour of the dinar, which implies more encouragement for outside investments.

#### The Effects of the New Interest-Rate Structure

We now turn to the most recent change in the interest-rate structure (December 1988). Although the new structure

Table 6.5

Relationship Between the Exchange Rate of  
U.S. Dollar/KD and Some Monetary Variables.  
(percentage changes)

Year	NB %	KD Deposits %	FC Deposits %	Exchange Rate dollar/KD %	Interest Rate \$ (1) %
1975	34.8	43.4	-29.8	-	-35.2
1976	50.6	38.6	36.3	1.0	-22.1
1977	191.1	45.4	-47.4	-1.6	34.0
1978	- 60.0	18.3	107.4	-9.6	56.3
1979	-145.7	7.2	96.1	0.4	32.4
1980	-123.0	17.5	65.3	-2.1	16.3
1981	-193.4	48.8	1.2	3.1	-19.3
1982	387.7	17.3	-44.1	3.3	12.3
1983	- 69.0	-2.2	79.4	1.22	-36.1
1984	-124.7	0.3	20.2	1.52	- 1.0
1985	227.9	3.2	-22.4	1.62	-17.3
1986	172.1	0.4	16.5	-3.55	-24.7
1987	- 99.2	-3.4	51.5	-4.18	31.1
1988	-377.4	-0.2	32.6	0.03	12.5

where:

NB = Net position of the commercial banks with  
the Central Bank.

KD Deposits = private KD deposits with  
the commercial banks.

FC Deposits = private deposits with the commercial banks  
in foreign currencies.

(1) = Eurodollar market in London.

Source: Central Bank of Kuwait; Quarterly  
Statistical Bulletin (1975-1988),  
International Financial Statistics (I.M.F.)

has provided more room for the Central Bank to manoeuvre, the ceiling concept has been maintained. While the previous three structures emphasised the lending rates ceiling, the new structure contains both a ceiling on lending and on deposits rates. Moreover, these ceilings are to be determined by the discount rate, which is to be fixed by the Central Bank. The latter is thus able to change all ceilings together by amending the discount rate. Given that the Central Bank announced its discount rate at 7.5 percent after the introduction of the new structure, one can know immediately the different ceilings on lending and deposit rates by looking at the interest-rate structure in Table 6.1. One may assume that the maximum ceiling on the lending rate had moved up to its previous level of 10.0 percent before the third amendment of the structure in March 1987 when it was reduced to 7.5 percent, but this time with more power in the hands of the Central Bank, and new ceilings on bank deposits to be paid by the commercial banks.

The Central Bank's main justification for the introduction of the new structure is the eradication of the negative effects of foreign interest rates on local liquidity (Al-Sabah, 1988, p.9). Indeed, this justification has its merits, especially when one considers that the capital outflow to the international markets would exert a lot of pressure on the foreign assets of the Central Bank since it is the sole source of foreign currencies in the country. Thus the published data indicate that the

foreign assets of the Central Bank have declined from 1.4(KD bn)(4.75 dollar bn) in 1986 to 0.4(KD bn)(1.4 dollar bn) in 1988. The justification of the Central Bank can also be supported by viewing the relationship between private deposits in KD and foreign currencies during the period prior to the introduction of the new structure.

Table 6.6 shows that there has been a considerable transfer of KD deposits to deposits in foreign currencies as a result of escalating foreign interest rates. By charting the effect of the new structure, the table tells us that an inverse effect has been achieved in favour of KD deposits against deposits in foreign currencies during the year 1989. Similar conditions can be seen in the same table with regard to the second interest-rate structure, introduced in November 1976; this strengthens the argument that external pressures arising from increasing foreign interest rates have been a strong inducement to change the interest-rate ceiling from time to time in Kuwait. It is therefore believed that the flexibility embodied in the new structure will allow the Central Bank to counter the movements of foreign interest rates by changing only the discount rate, without any need to alter the whole structure. The new structure could also help the monetary authorities to defend the KD exchange rate and reduce the burden on the exchange rate policy, reflecting the relationship between the Kuwaiti

Table 6.6

Changes In KD And Foreign Currency Deposits  
During Periods of Amendment of Interest-Rates Structure.

Period	KD Deposits		Foreign Currency Deposits		Foreign interest rate	
	Amount (million)	Change %	Amount (KDmillion)	Change %	(1) \$	(2) £
1988						
Q1	3592.0	-	974.1	-	7.0	8.49
Q2	3448.7	-4.0	1022.3	5.0	7.4	7.92
Q3	3350.5	-3.0	1113.1	8.9	8.3	10.75
Q4	3445.1	3.0	1309.8	17.7	9.0	11.96
1989						
Q1	3703.4	7.5	1245.7	-5.0	9.2	12.42
Q2	3649.8	-1.4	1394.6	12.0	9.7	12.87
Q3	3672.4	0.6	1358.2	-2.6	8.9	12.45
Q4	3662.0	-0.3	1296.8	-4.5	8.6	14.47
1976						
Q1	760.2	-	98.0	-	5.5	9.04
Q2	862.9	13.5	124.2	26.7	5.9	10.19
Q3	889.2	3.0	139.5	12.3	5.7	11.26
Q4	925.5	4.1	165.7	18.8	5.3	13.99
1977						
Q1	1044.8	12.9	130.8	-21.1	5.1	11.20
Q2	1163.8	11.4	102.5	-21.6	5.6	7.72
Q3	1189.3	2.2	110.4	7.7	6.2	6.55
Q4	1330.3	11.9	87.5	-20.7	7.1	5.26

(1) 3 months Eurodollar market in London.

(2) Treasury Bills Rate in London.

Source: Central Bank of Kuwait; Quarterly Statistical Bulletin (Oct-Dec. 1976, 1977, 1988, 1989), International Financial Statistics (I.M.F.).

dinar and other major currencies in a more realistic manner.

On the other hand, the introduction of the new interest-rates structure has come under much criticism from market interests on several grounds. Since the Kuwaiti economy suffered a succession of internal and external shocks during the '80s, the introduction of a new structure in the form of high interest rates on lending and deposits was not welcomed by most sectors of the economy. Internal shocks caused by the collapse of the stock market in the second half of 1982, external shocks arising from the fall in the price of oil, and the effect of the Gulf War on re-export activity, induced the authorities to decrease the interest-rate ceiling from 10.0 percent to 7.5 percent in November 1987, thus obviating the need to raise such a ceiling again.

Al-Neabari (1988) criticizes the new structure on the grounds that the rise of lending rates will raise the cost of investment - hence causing the investors to pass the cost on to the final consumer - while the rise of deposit rates will restrain activity on the stock market.

Generally speaking, the rise of lending rates would increase the cost of investment and could raise consumer prices; it could also restrain the demand for bank credit, especially for purposes of speculation in stocks and real estate. By way of contrast, the rise of interest rates on bank deposits would affect stock market

activity, as traders would clear their positions and place their money in bank deposits. It would also force some small businesses which are facing financial difficulties, to move out of the market as the lending rates became higher. However, raising the rates on lending would decrease the demand for bank credit; consequently the commercial banks will encounter difficulties in finding outlets for such accumulative balances. One may argue, therefore, that if the intention of the monetary authorities was to encourage expatriate funds to flow into the local economy to enhance local liquidity, as was alleged by the Central Bank, why is it that the latter has not only imposed ceilings on bank deposits at appropriate levels but has raised the ceiling of lending rates as well?

To answer this question, the author believes that two main incentives have induced the authorities to raise both lending and deposits interest rates. The first is related to the elasticity of the demand function for bank credit in Kuwait, while the second reason is related to the introduction of the public debt instrument issued in November 1987.

In some developing countries where the demand for bank credit for real investment is considered interest-elastic, the rise of interest rates on lending in this case would cause problems for the productive units as it will increase the cost of output. If these units succeed in passing this extra cost to the consumers, it will cause a

price increase and bring about inflationary trends. But when the demand for credit is interest-inelastic, with interest on borrowing money representing only a minor portion of the production cost, the rise of the lending rates would encourage the productive units to use the borrowing money in a more efficient manner, particularly in the area of inventory-investment.

In Kuwait, it is believed that the demand for bank credit in general and for investment purposes in particular is highly inelastic with respect to interest rates for various reasons. Firstly, the existence of some specialized financial institutions in financing agriculture and industrial projects such as the Industrial Bank of Kuwait and the Bank for Credit and Saving, which means that the agriculture and industrial sectors do not deal with the commercial banks, preferring instead to obtain credit from those specialized institutions at low rates subsidised by the government. Secondly, there is a self-financing policy. A large number of private enterprises resort to their retained profits and owners to finance new projects; this trend is encouraged by the government policies of income distribution through land purchase and property acquisition.

However, the published data at the end of 1988<sup>(1)</sup> reveals that 86.0 percent of bank credit is distributed among four

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(1) Central Bank of Kuwait; Quarterly Statistical Bulletin (Oct-Dec, 1988, p.12)

sectors in the economy, namely; trade at 20.6 percent; constructions at 17.3 percent; personal facilities at 28.6 percent; and real estate at 19.4 percent. Thus, if the rise in lending rates affects the demand for bank credit for speculative purposes, the result will be seen as positive. Construction activity, with its large scale projects and infra structure maintenance are financed mainly by the government, and so these activities are inelastic to interest rate. Credit facilities are open to the trade sector to finance import activities; consequently, import prices increase in local currency as a result of the increase in lending rates. In this context, two events may occur when the extra cost of borrowing money is passed on to consumers; firstly, the consumer will accept the increase of prices on imported goods; and secondly, the demand for consumer goods will decline thanks to the increase in prices, forcing importers to adjust their prices. For Kuwait, since the economy is import-oriented, with a high per capita income along with basic food and services being subsidized by the government, there is more chance to consider the demand for consumer and capital goods is inelastic to price increase. Therefore, the rise of lending rates in the trade sector is not expected to affect either the demand for bank credit for import, nor the demand for consumer and capital goods.

Table 6.7 illustrates the distribution of bank credit among various sectors of the economy for the period

Table 6.7

Distribution of Bank Credit  
Among Economic Sectors (1987 Q3 - 1989 Q4).

Year	Trade K.D m. (%age change)	Industry K.D m. (%age change)	Const. K.D m. (%age change)	Agric. & Fish. K.D m. (%age change)	Financl. Insts. K.D m. (%age change)	Pers- -onal K.D m. (%age change)
1987						
Q3	974.1 (0.5)	118.7 (2.3)	774.1 (1.2)	12.7 -(23.0)	418.7 (10.1)	1275.5 (1.8)
Q4	962.1 -(1.2)	140.3 (18.3)	784.7 (1.4)	11.8 -(7.1)	465.5 (11.1)	1295.8 (1.6)
1988						
Q1	1001.1 (4.0)	131.3 -(6.4)	786.6 (0.2)	12.0 (1.7)	417.2 -(10.4)	1299.2 (0.3)
Q2	948.4 -(5.2)	142.3 (8.4)	755.8 -(3.9)	13.7 (14.2)	409.1 -(1.9)	1360.0 (4.7)
Q3	971.2 (2.4)	160.1 (12.5)	803.9 (6.4)	11.6 -(15.3)	381.0 -(6.9)	1333.1 -(2.1)
Q4	967.2 -(0.4)	136.1 -(15.0)	813.7 (1.2)	12.3 (6.0)	366.2 -(3.9)	1346.7 (1.0)
1989						
Q1	1004.7 (3.9)	141.6 (4.0)	804.7 -(1.0)	14.8 (20.3)	351.7 -(4.0)	1362.0 (1.1)
Q2	1005.7 (0.1)	151.9 (7.3)	807.5 (0.2)	17.4 (17.6)	364.1 (3.5)	1367.7 (0.4)
Q3	987.7 -(1.8)	150.6 -(0.9)	807.7 (0.1)	20.7 (19.0)	331.7 -(8.9)	1401.9 (2.5)
Q4	975.4 -(1.2)	135.2 -(10.2)	743.8 -(7.9)	20.0 -(3.4)	347.4 (4.7)	1457.3 (4.0)
Annual Average						
1988	972.0 (-)	142.5 (-)	790.0 (-)	12.4 (-)	393.4 (-)	1334.8 (-)
1989	993.4 (2.2)	144.8 (1.6)	790.0 (0.1)	18.2 (46.8)	348.7 -(11.4)	1397.2 (4.8)

Source: Central Bank of Kuwait; Quarterly Statistical Bulletin (Oct-Dec, 1989).

K.D m. = K.D million.

Const. = Construction.

Agric. & Fish. = Agriculture and Fisheries.

Financl. Insts. = Financial Institutions.

April 1987 to December 1989. The aim of this table is to reveal the reaction of the economic sectors and the commercial banks to the last two interest-rate structures introduced by the Central Bank. As was mentioned earlier, the third structure was put into effect in March 1987 when the maximum lending rate was reduced from 10.0 percent to 7.5 percent. The fourth structure was introduced in December 1988 when the maximum lending rate was raised to 10.0 percent, with the discount rate fixed at 7.5 percent. At first glance, one may notice that bank credit to all sectors has increased as a result of the lowering of the lending rate ceiling from 10.0 to 7.5 percent; the only exception is the sector of agriculture and fisheries. But from 1987 Q3 to 1988 Q4, the bank credit given to the economic sectors has shown different trends; there is no general trend which characterises the effect of the decline in lending rate ceiling on the behaviour of bank credit. Nevertheless, in general the table shows that personal facilities have scored most positively during this period. Bank credit to the industrial sector has increased considerably during the period, rising from 118.7 to 136.1 KD million, while credit to the trade sector declined from 974.1 to 967.2 KD million.

However, during 1989, when the ceiling was raised to 10.0 percent, the data show a more general trend; one may say that in spite of the high lending rates, credit facilities for almost all economic sectors have increased. This

trend can be attributed to the fact that as the new structure of interest rates fixes minimum rates on bank deposits, depositors are encouraged to convert from foreign currency deposits to KD deposits, which enhances the KD reserves of the commercial banks and puts them in a better condition to expand their supply of credit. Meanwhile, the increase in lending rates has not reduced the demand for bank credit by various sectors in the economy. This fact is evident if we compare the distribution of bank credit among the economic sectors at the end of the period in which the ceiling was fixed at 7.5 percent (April 1987 - December 1988) with the period in which the ceiling was fixed at 10.0 percent (January to December 1989). As is shown in Table 6.7, the shares of all sectors have increased during the second half of that period with one exception, namely, the financial institutions, which can be attributed to the high sensitivity of this sector to interest rate movements. Therefore, the increasing demand for bank credit during the period of higher interest rates proves the former assumption of the low elasticity of the demand for credit to interest rates increase. One may also conclude that the low shares of some productive sectors such as industry exist because of the attitude of the commercial banks towards such sectors, rather than being the result of the low demand of these sectors for bank credit, especially in the absence of any credit control measures by the monetary authorities (the Central Bank). Moreover, the increasing trend of credit given to the sector of agriculture and

fisheries is related to a rise in government facilities provided to this sector through the commercial banks.

It is worth noting here that the new interest-rate structure explicitly permits the commercial banks to deduct the amount of interest rate from consumer loans in advance, a situation which inflates the actual rate of interest on such loans. Prior to the new structure, the commercial banks, as a matter of course, used to deduct the amount of interest rate from different kinds of loans. The application of this deduction means that the actual interest rates paid by the clients were higher than the nominal rates. To illustrate this concept, let us assume that a bank's client has been granted a loan of 1000.0 KD for one year at 6.0 percent rate of interest, and that the bank has deducted the amount of the interest rate in advance. The client will receive the following amount:

The amount of interest =

$$1000.0 \times \frac{6}{100} \times \frac{12}{12} = 60.0 \text{ KD}$$

The amount of loan given to the client =

$$1000.0 - 60.0 = 940.0 \text{ KD}$$

The actual interest rate paid by the client =

$$\frac{60}{940} \times \frac{12}{12} \times 100 = 6.4 \text{ percent}$$

Therefore, in such cases the client will actually pay 6.4 percent on his loan and not 6.0 percent.

Let us now see how much the bank will gain from this loan by assuming that the borrower is required to settle the loan in twelve even instalments, with the bank investing these monthly payments paid by its client in other lending at the same rate (6.0 percent):

The amount of loan paid to the client =

$$1000.0 - 60.0 = 940.0 \text{ KD}$$

The monthly instalment paid by the client =

$$1000.0 \div 12 = 83.3 \text{ KD}$$

Profits that the bank receives when investing the instalment at 6.0 percent =

$$83.3 \times \frac{6}{100} \times \frac{11}{12} \times 12 = 56.0 \text{ KD}$$

Total amount of interest received by the bank =

$$(1000.0 + 56.0) - 940.0 = 116.0 \text{ KD}$$

The actual interest rate of the loan =

$$116.0 = 940.0 \times R \times \frac{12}{12}$$

$$\therefore R = \frac{116.0}{940.0} \times \frac{12}{12} \times 100 = 12.3 \text{ percent}$$

Thus the actual interest rate achieved by the bank is 12.3 percent. Furthermore, when foreign interest rates exceed the local ceiling of lending rate, the commercial banks, in order to exceed the ceiling, impose extra charges for what are called "administrative services".

In conclusion, the first incentive that induced the Central Bank to raise the ceiling of lending rates is its conviction that the raising of the ceiling would not affect the demand for bank credit by the economic sectors. Moreover, the rise in the lending rates will enable the commercial banks to maximize their profits, and hence improve their financial positions, which were damaged by the collapse of the stock market in 1982.

#### The Creation of a Market in Government Securities

The second reason that is believed to be behind the introduction of the new interest-rates structure (and even the structure that preceded the new one) is that when the Central Bank reduced the ceiling from 10.0 to 7.5 percent in March 1987, the object was to secure funds for the purchase of the public debt instruments at the lowest possible cost. The following scenario unfolds:

The Central Bank intended to issue the instruments of public debt on behalf of the government in November 1987, covering the budget deficit which had persisted since 1982, and thus avoiding liquidation of its foreign investment. In order to persuade the government to fall into debt to the public for the first time in its modern history, it was argued that borrowing from the public would cost the government less than would the liquidation of its foreign investments. Two considerations encouraged the Central Bank to persist in

the debate and win the argument. The first was the fall in foreign interest rates, which enabled local interest to be reduced without causing any harmful consequences to the economy. The second was that the "Difficult credit Facilities Settlement programme" had reached its final stages, and thus a decline in local interest rates was required to increase the value of the assets (collaterals) held by the commercial banks against loans granted to their debtors; which in turn would enhance the positions of the commercial banks and reduce the amount of financial help that the government intended to provide in order for them to recover their losses.

Thus, the Central Bank proceeded to reduce the interest-rate ceiling from 10.0 to 7.5 percent in March 1987 and issued the public debt instruments in November 1987. At that time, the government was allowed to borrow up to 1.4 KD bn from the private sector, with the intention of raising the ceiling of the borrowed amount in the future.

The published data show that during the fourth quarter of 1987 (Table 6.8), the Central Bank succeeded in selling the amount of 628.0 KD mn to the financial institutions (including the Central Bank). The sale of these instruments (bills and bonds) increased during the first and second quarters of the year 1988. But the data imply that the demand for these instruments declined during the second half of 1988, since the outstanding balances of both instruments remained unchanged from the end of the

Table 6.8

Outstanding Balances of The  
Public Debt Instruments (KD million).

Period	Bills	Bonds	Total	Central * Bank's share
1987				
Q4	423.0	205.0	628.0	81.0
1988				
Q1	510.0	574.5	1084.5	283.9
Q2	770.0	624.5	1084.5	360.3
Q3	770.0	624.5	1084.5	315.2
Q4	770.0	624.5	1084.5	460.3
1989				
Q1	1000.0	465.0	1465.0	99.9
Q2	1538.1	445.0	1983.1	321.4
Q3	1565.0	445.0	2010.0	158.2
Q4	1816.25	370.0	2186.25	335.4

\*: As the Central Bank does not reveal its purchase of the public debt instruments, this column contains, in addition to the former, the purchase of other local KD bonds (which represent a marginal portion only); hence the figures of this column are to be taken as an indicator only.

Source: Central Bank of Kuwait; Quarterly Statistical Bulletin (Oct.-Dec, 1989).

second quarter through the rest of the year. The fall in the demand for these instruments is clear from the Central Bank's increased share of these instruments. This trend of public demand can be attributed to the increase in foreign interest rates which began just after the reduction in the ceiling of local interest rates. Hence, in order not to frustrate the continuity of government borrowing, the Central Bank found itself bound to cover the shortage in private sector demand for the government securities and to supply the government with the KD necessary to meet its expenditure.

Moreover, when foreign interest rates (especially on the dollar and sterling) continued to increase and no control could be applied on capital outflows, the Central Bank realized that there was no choice but to raise the interest-rates ceiling. This time, however, the spotlight was on deposit rates and greater flexibility to secure adequate control on the management of the public debt. Given that the imposition of minima on bank deposit rates would induce the Kuwaiti dinar to inflow in the economy, there were no worries about how such funds could be absorbed when the government increased the level of its borrowing from 1.4 KD bn to 3.0 KD bn in March 1989. The data in Table 6.8 show that by raising the interest-rate ceiling and imposing minima on deposit rates, the Central Bank has succeeded in crowding out the funds for public borrowing, but this time by paying higher costs than under

the previous ceiling, although the cost of borrowing will remain lower than it would be if the government were to resort to its foreign investment in order to finance the deficit, as foreign interest rates remain high.

Meanwhile, the active role of the discount rate under the new structure is expected to secure a persistent stream of KD funds with which to purchase the public debt instruments. Despite this, the discount rate has been fixed at 7.5 percent, and the new policy has not been in force long enough for one to judge the new role of the discount rate as a "bank rate" and its influence over the financial market and the local economy as a whole in view of the development of investment of the productive sectors.

Nevertheless, if the discount rate is devoted to curbing the outflow of funds in order to help the government to market its securities, the rate may be influenced by external forces only. Therefore, there are certain fears that the foreign pressures would influence local conditions under the new framework of the discount rate. Such fears materialise when the government becomes a competitor for bank credit, and uses savings to finance the budget deficit instead of mobilizing them to the productive sectors. This assumption depends on whether the government will increase its borrowing in the future or not, assuming that the government will depend totally on local borrowing to finance its deficit, while its

expenditure continues to inflate without generating new local resources to supply its revenues. These conditions would lessen the availability of local bank credit to meet the local demand, and so generate external pressures on the interest rates to rise because of the struggle between the private and public sectors over available savings.

However, the existence of government securities in the market will give the Central Bank an opportunity to influence the reserves of the commercial banks by performing open market operations, and thus affecting the credit ability of the banking system.

#### Conclusions on Interest-Rate Policy

To conclude, one may say that the applications of the interest-rate ceiling prior to the latest amendment have been in favour of borrowers rather than savers. Although the authorities are able to justify this policy by stating their desire to encourage local investments, the experience has had adverse results, as both the industrial and agriculture and fisheries sectors have been granted the lowest share of bank credit, while personal loans attained the second highest share for the period between 1972 to 1988 (Chapter 3).

There is no evidence that the monetary authorities have resorted to any credit control to encourage bank credit to any favourable sectors, or vice-versa; credit conferment has been left totally to the discretion of the commercial

banks. Moreover, the imposition of the ceiling on lending rates has not succeeded in preventing the commercial banks from violating this ceiling and charging their customers extra percentages in the form of administrative charges, or by deducting the amount of interest rates from the loan in advance.

Since the Kuwaiti economy is considered to be an open one, with no restrictions on the movement of capital, the interest rate policy has, by emphasising lending rates, ignored the external pressures on the local interest-rates structure. The results of this policy have rendered foreign interest rates attractive to the depositors, who invest their money in foreign currencies and expose the commercial banks to several liquidity crises. This policy has also encouraged the demand for bank credit for speculative purposes and led the economy into a depression after the collapse of the stock market in the second half of 1982. Moreover, the ignorance of the external pressures on the interest-rates structure, has cost the monetary authorities dear, since the latter had to inject more liquidity into the banking system in order to offset these pressures.

However, the introduction of the new interest-rates structure can be considered a further step towards the liberalisation of the interest rate, despite the predominance of the ceiling concept in the structure. Although the official announcement of the Central Bank

states that the main purpose of the new interest-rates structure is to curb capital outflow in favour of local conditions, it is believed that the main beneficiary of this event is the government, which can sell more of its securities.

C H A P T E R        S E V E N

EXCHANGE RATE POLICY

This chapter is concerned with the exchange rate policy implemented by the Central Bank of Kuwait in order to fulfil the second objective of its monetary policy, that is - "to maintain the stability of the exchange rate of the Kuwaiti dinar and its convertibility into other foreign currencies".

In March 1975, the Kuwaiti monetary authorities chose to peg local currency to a basket of foreign currencies of countries that have trading and financial transactions with Kuwait (a basket peg). A theoretical discussion is carried out at the beginning of this chapter concerning the optimal choice of currency peg to the developing countries. Some highlights on the advantages and disadvantages of the choice of peg are also disclosed.

Moreover, a historical background, pertaining to the experience of the Kuwaiti authorities in the field of currency peg, is explored in the second part of this chapter; especially when the Kuwaiti dinar was pegged to Sterling and the U.S. dollar (a single peg) prior to 1975.

However, when the Central Bank of Kuwait has adopted the basket peg to determine the exchange rate of the Kuwaiti dinar, both the number and weights of the foreign currencies included in the basket have been kept secret. Therefore, a hypothetical example of the performance of

the basket is given in order to understand its mechanism on the one hand, and to emphasize the association between the Kuwaiti dinar and U.S. dollar on the other. This relationship between the two currencies is believed to have a great influence on maintaining the stability of the exchange rate of the Kuwaiti dinar, and it is influenced by the special conditions of the Kuwaiti economy.

In the last section of this chapter, the performance of the exchange rate regime (the basket peg) is evaluated in the face of some important features of the Kuwaiti economy. This evaluation is based on a comparison between the choice of the basket peg and the peg to a single foreign currency.

### Theoretical Discussion

Since the departure from the Bretton Woods system and the last attempt to save the fixed exchange rate systems of the Smithsonian Institute in Washington in December 1971 and mid-1972, most currencies have fluctuated against each other beyond their parity rates and assigned margins. Thus, almost all countries have followed one of two exchange rate regimes: the floating exchange rate, or the peg exchange rate. Under the latter, a country pegs its currency either to a single currency or to a basket of currencies. The choice of a floating exchange rate regime is based on the assumption that the exchange rate of any currency will float until it reaches the level at which the imports and exports of the country in question

balance. Hence, this assumption of choice concentrates only on the traded transactions between countries to influence the exchange rates of currencies. Thus, it neglects other factors that play a prominent role in determining exchange rate variations, such as capital movements between countries, speculations transactions over currencies, and arbitrage transactions. These activities could influence the exchange rate of any currency - especially when they occur in a large amount - and thus affect the level at which imports and exports balance. Therefore, governments of floating exchange rate regimes intervene in the exchange market in order not to allow the exchange rate of their currencies to float freely (see Einzig, 1972).

Pegging to a single currency simply means that the exchange rate of the local currency is fixed at a certain level to a single foreign currency. It follows that the exchange rate of the local currency will change against other currencies, following the same patterns of the currency to which it is pegged. Pegging to a basket of currencies means that the exchange rate of the local currency is determined according to the currencies of a number of trading partners. Hence, it is a weighted basket that takes into consideration the trading relationship between the country of the local currency and the countries of the currencies included in the basket.

Developing countries apply different weighted baskets: import-weighted, export-weighted, and bilateral trade-weighted which is the average of the two former methods.

In the case of a single currency peg, any depreciation of the peg currency will have far-reaching effects on the economy of the pegged currency. If the latter has an import-oriented economy, the direct effect will be a price increase in imports from the countries of currencies which have appreciated against the peg currency, thus raising inflation. At the same time, a depreciation of the local currency would increase the competitiveness of domestic products if the economy of this country is export-oriented. However, when the peg currency appreciates against other currencies, the local currency will appreciate accordingly; import prices will then decrease and domestic products will become less competitive. The final result of a depreciation or appreciation of the peg currency depends on the pattern of the local economy of the pegged currency, and the distribution of trading shares among the country of the peg currency and the rest of the world.

Wickham (1985, p.277) argues that if most of the developing country's contracts are dominated by one major currency, then a peg to this currency will be the most suitable option. His argument is based on the promise that such a peg will eliminate short-term exchange risks for most transactions and transactors, although he admits that other contracts in other currencies will be exposed

to exchange risks. Thus when there is a strong trading relationship between the developing country and a country of major currency, a single peg regime is favourable; otherwise a basket peg would be the optimal choice, this is in order to protect the economy of the developing country from the risks of exchange rate variability. Such risks could be generated from the uncertainty of exchange rates expectations which affect the behaviour of individuals and institutions who are worried about their future commitments in foreign currencies. Some of the short-term risks can be avoided by forward transactions, but long-term risks are unavoidable.

On the other hand, uncertainty about exchange rate variabilities could affect the productivity of the economic sectors, with uncertainty about profit streams, biasing decisions concerning the level of output and investment.

Crockett and Nsouli (1977, pp.125-143) list a number of advantages and disadvantages for a peg regime, either to a single currency or a basket of currencies. Firstly, they argue that a peg to a major currency would increase capital inflow for investment purposes from the developed country to the developing country. Secondly, under the assumption that the exchange rate of the developed country is more stable vis-a-vis the rest of the world than that of the developing country, trade with, and investment from, the rest of the world might be stimulated. Thirdly, pegging to a major currency could increase

confidence in the currency of the developing country, since the policies of the partner country are regarded as adequate for promotion of relatively stable prices. As for the disadvantages, Crockett and Nsouli argue that under a single currency peg system, movements in the exchange rate of the pegged currency do not reflect the actual developments in the balance of payments in the developing country; rather they reflect the developments in the balance of payments of the developed country to which the developing country is pegged. Thus, the need for reserves by the developing country, which depends on the nature of the equilibrium conditions of the exchange rates of the two countries. If the factors that affect the equilibrium exchange rates of the two countries are closely related, there could be less need for reserves by the developing country than would be the case under adjustable par values and vice versa.

Furthermore, since not all the developing countries peg their currencies to the same major currency, under a single currency peg the exchange rates between these developing countries will be subject to variation. As a result, an increase in product prices may be needed among the developing countries to compensate for the uncertainty of exchange rates. To avoid the disadvantages of pegging to a single currency, some developing countries have pegged to a basket of currencies. Among the various methods of the basket peg, Crockett and Nsouli favour the import-weighted basket, which has the advantage of

reducing the price instability engendered by foreign exchange rate fluctuations. Nevertheless, when the composition and weights included in the basket are not known, the value of the currency becomes subject to fluctuation because of the possible change in the composition of the basket, capital inflow for investment purposes would reduce.

Once the authorities decide to peg to a basket of currencies, other problems occur such as the number of currencies that should be included in the basket, and the appropriate weight to be assigned for each currency. Wickham (1985, p.248) suggests that, "care must be taken with the currencies that have multiple exchange rates, and not to include in the basket currencies that are rapidly depreciating". To avoid problems associated with the choice of a basket peg, some developing countries have decided to peg to the SDR (Special Drawing Rights), the prices of which are given on a daily basis by the International Monetary Fund (I.M.F.).

#### The Exchange Rate of The Kuwaiti Dinar

The exchange rate of the Kuwaiti dinar has passed three main stages.

First stage (April 1961 - June 1972):

The Ameri decree number 41 of 1961 fixed the value of the dinar at (2.48828) grams of fine gold, equivalent to one pound sterling, and so the dinar was pegged to sterling at

a fixed parity rate. In 1967, when sterling was devalued for reasons related to the performance of the British economy, the Ameri decree was amended to fix the parity rate of the Kuwaiti dinar at the same equivalent value of gold but without mentioning the sterling link explicitly. In practice, the dinar had continued to be pegged to sterling at its new parity rate after the latter's devaluation. The exchange rate of the dinar against other currencies was determined in accordance with the new exchange rate between the dinar and sterling. However, the dinar peg to sterling was a result of the historical relationship between Kuwait and Britain. During this period the exchange rate of the dinar enjoyed relative stability against sterling, the dollar and gold.

**Second stage (June 1972 - March 1975):**

After the floating of sterling in June 1972, the Dinar abandoned sterling and pegged to the Dollar at a fixed exchange rate within a movement margin of  $\pm(2.25)$  according to the Smithsonian Agreement of 1971. During this period the Dinar appreciated against the Dollar, the latter devalued by 10.0 percent in February 1973. Later on, the Dollar was exposed to pressures that culminated in further depreciation against other major currencies. In March 1975, the Kuwaiti dinar had appreciated against the Dollar by 14.5 percent because of its persistent value against Gold. The Dinar had also fluctuated against other major currencies as a result of the fluctuation of the exchange rate of the devalued Dollar.

The fluctuation of the Dinar against other major currencies was not interpreted as having any connection with changes in the local economy of Kuwait; nor did it reflect any increasing or decreasing demand for the Dinar by foreign sectors. Accordingly, the local authority tried to find a new formula to determine the exchange rate of the Kuwaiti dinar.

Third stage (From March 1975):

At this stage the peg to a single currency regime was abandoned and a new regime of a peg to a basket of currencies adopted. The new Decree stipulated that the Central Bank of Kuwait should fix the rate of exchange of the Kuwaiti dinar on the basis of the exchange rates of a group of currencies, in a manner that would reflect, in general, the trade and financial relations between Kuwait and other countries. It was not clear whether the new basket is weighted by imports, exports, or by bilateral trade. The composition of the basket and the weights of the currencies included are kept unknown. The high level of secrecy surrounding the basket is believed to prevent speculation on the exchange rate of the Dinar.

As was mentioned under the objectives of the monetary policy, the optimal exchange rate regime is sought so as to maintain the stability of the local currency against other currencies. By pegging to a basket, the monetary authorities aim to achieve multiple sub-objectives that are of great importance to the Kuwaiti economy.

These sub-objectives can be summarized as follows:

1. To sustain the purchasing power of the local currency;
2. To safeguard the movements of the national capital of an economy which is characterised by a surplus in excess of its absorptive capacity;
3. To combat imported inflation.

Since the oil revenue is paid in dollars, the stability of the exchange rate between the Dinar and the Dollar is considered to play a crucial role in determining the composition of the basket. Moosa (1986, p.200) concludes that the Dollar accounts for over three quarters of the basket to which the KD is pegged. He bases his argument on data, the result of which implied that when the dollar appreciates (or depreciates) against other currencies, it does appreciate (or depreciate) against the KD, though less than proportionately.

However, as the composition of the basket is unknown, and is subject to amendment at any time at the discretion of the Central Bank, it is difficult to determine with any accuracy the weight of the dollar or any other currency included in the basket. Nevertheless, one may assume that under any formula of a basket peg for Kuwait, the authorities must pay great attention to the relationship

between the exchange rate of KD/dollar. The importance given to the dollar can be justified by the following reasons; firstly, almost the entire revenues of the government are paid in dollars; secondly, as most of the government's foreign investments are in dollars, it represents the reserve currency; thirdly, all imports from countries of minor currencies are priced in dollars; fourthly, the bulk of Kuwait's trading activities are with the United States.

Table 7.1 shows financing imports by the commercial bank during the period 1984 to 1988 in different major currencies. As the Table illustrates, more than half of the imports value was paid in U.S. dollars. The second currency is the Japanese yen, which represents a mere 8.9 percent of the total value of imports during that period.

To verify Moosa's (1986) conclusion concerning the relationship between changes in the dollar, Kuwaiti dinar, and other currencies, Table 7.2 shows the percentage changes of annual averages in exchange rates of the dollar, Kuwaiti dinar and major currencies over a period different from that taken by Moosa.

As the above table shows, it is clear that when major currencies appreciate (or depreciate) against the dollar, the Kuwaiti dinar does appreciate (or depreciate) along with other currencies, but in a more stable manner. For example, during the first four years (1982-1985) when the four major currencies (pound sterling, Deutsche Mark,

Table 7.1

Local Banks Financing Kuwaiti Imports (paid up).

Period	U.S. dollar	Pound Sterling	*	**		French Franc	Others
			Deut. Mark	Italian Lira	Jap. Yen		
1984	59.24	4.36	7.65	2.05	10.09	1.72	14.89
1985	52.28	5.49	8.41	2.50	10.65	2.03	18.64
1986	51.63	5.18	8.30	3.28	9.66	2.20	19.75
1987	57.44	4.88	6.48	2.97	7.65	1.82	18.75
1988	59.65	3.88	6.66	3.02	6.69	1.57	18.53
Aver- -age	56.0	4.8	7.5	2.8	8.9	1.9	18.1

Source: Central Bank of Kuwait; Quarterly Statistical Bulletin (Oct-Dec, 1988).

\* Deut. Mark = Deutsche Mark.

\*\* Jap. = Japanese.

Table 7.2

Percentage Changes of Different Currencies  
Against The U.S. Dollar.

Period	Pound Sterling %	Deutsche Mark %	French Franc %	Swiss Franc %	Kuwaiti Dinar %
1982	-13.6	-7.6	-20.9	-3.4	-3.2
1983	-13.3	-5.0	-15.9	-3.6	-1.2
1984	-11.9	-11.4	-15.0	-11.6	-1.5
1985	-33.9	-3.2	-2.6	-4.2	-1.6
1986	13.4	26.0	22.5	26.5	3.4
1987	11.5	17.0	13.1	16.7	4.0
1988	8.8	2.6	1.2	2.3	0.02

French Franc, and Swiss Franc) depreciated against the dollar at a compound average of 11.1 percent, the Kuwaiti dinar depreciated a mere 1.9 percent. By contrast, during the period 1986-1988, when the four major currencies appreciated against the dollar at a compound average rate of 13.5 percent, the Kuwaiti dinar appreciated only 2.5 percent. These results supported the argument which postulates that the stability between the Kuwaiti dinar and the U.S. dollar dominates the formula of the basket and is a major factor considered by the monetary authorities when determining the composition and weight of currencies included in this basket. As further evidence we will present a hypothetical example of the basket to illustrate how it works, and to determine whether the relatively persistent stability of the KD/dollar value is related to the presumably large proportion of the dollar in the basket or not.

#### Hypothetical Example of the Kuwaiti Basket

Let us assume that the peg to the basket started on 31-12-1982 with four major currencies (U.S. dollar, pound sterling, Deutsche Mark, and French Franc). The exchange rates of the dollar against the other three currencies in the basket and the Kuwaiti dinar at that date are assumed as follows:

CURRENCY	(1) against the dollar.	(2) against the KD.	(3) weight %	(2x3) number of units in the basket.
U.S. dollar	1	3.4711	80	2.777
Pound Sterling	0.571	1.982	7	0.139
Deutsche Mark	2.425	8.417	10	0.842
French Franc	6.539	22.698	3	0.681
Kuwaiti dinar	0.28809	1		

Thus the Kuwaiti dinar exchange rate consists of: 2.777 of U.S. dollar + 0.139 of pound sterling + 0.842 Deutsche Mark + 0.681 French franc. Moreover, the dollar has been given the largest weight at 80 percent of the basket. On 31-12-1983 the major currencies of the basket were assumed to have depreciated against the dollar by 10.0 percent; the new exchange rates of these currencies against the dollar will thus be:

Pound sterling	0.628
Deutsche mark	2.668
French franc	7.193.

Hence the new exchange rate of the dinar against the dollar is calculated in the basket as follows:

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	(1) number of units in the basket	(2) against the dollar.	(1 - 2) component of the basket.
U.S. dollar	2.777	1	2.777
Pound sterling	0.139	0.628	0.221
Deutsche mark	0.842	2.668	0.316
French franc	0.681	7.193	<u>0.095</u>
Total units in U.S. dollars			3.409

°. The new exchange rate of the KD =

$$1 - 3.409 = 0.2993.$$

The depreciation of the KD against the dollar  
in percentage =

$$\frac{(0.28809 - 0.2993)}{0.28809} \times 100 = 3.9 \text{ percent.}$$

Let us now assume that the currencies in the basket have appreciated against the dollar by 10.0 percent, and by following the same calculation process, we find that the KD has also appreciated against the collar, but by 2.2 percent only.

Moreover, by reducing the weight of the dollar in the basket to 5.0 percent, and following the same calculation, the result implies that at the new weight of the dollar in the basket, when other currencies depreciate against the dollar by 10.0 percent, the dinar depreciates by 4.7 percent. When other currencies in the basket appreciate against the dollar by 10.0 percent the dinar appreciates

at 5.3 percent. Thus one may conclude that the more weight is given to the dollar in the basket, the more stable the exchange rate of the KD becomes against the dollar.

However, one can argue that the weight given to the dollar in the basket reflects the actual share of this particular currency in trading activities of the local economy, or it is used as a policy-oriented tool in order to maintain the stability of the dinar against the dollar. The clarification of this argument is dependent on the supply-demand function of the dinar on one hand, and the effects of its fluctuation against the dollar on the Kuwaiti economy.

As we have seen in Chapter Four, the supply of the KD is determined mainly by government injections into the local economy, and by the commercial banks through credit expansion. In their creation of the KD, both aim at meeting the local needs of various sectors for the dinar. If the government injection of KD into the local economy could induce its local exchange rate to depreciate, the capital outflow toward international markets would have a compensatory effect that would keep its value in balance.

Furthermore, the demand for the KD is also assumed to be influenced by local factors. Since oil revenues are paid in dollars and are placed abroad in different investment tools, no demand is expected from external sectors for the KD to settle the oil purchases that lead to the

appreciation of its value. Moreover, for reasons related to the narrowness of the investment opportunities of the local economy, and the shortage of its financial assets, foreign capital is not expected to inflow, thus creating a demand for the KD and the appreciation of its exchange rate. Another reason for the fall in foreign demand for the dinar is the sustainable deficit of the non-oil private sector, since there is neither surplus trade generated from the private sector over the domestic absorption, nor substitutability between local and foreign products.

Therefore, the relationship between the dinar and the dollar in the basket is to a large extent influenced by the willingness of the authority to protect the Kuwaiti interests. Hence, the variability of the KD/dollar exchange rate is seen as a crucial issue since it would affect certain major aspects of the Kuwaiti economy. In the following discussion, we shall shed some light on the effects of the appreciation (or depreciation) of the dinar against the dollar on four important domains of the Kuwaiti economy, namely oil revenues, foreign investments, public expenditures, and imported inflation.

If the Kuwaiti dinar appreciates against the dollar, the value of oil revenue (paid in U.S. dollar) decreases in local currency. The oil revenue for the Kuwaiti economy has its special conditions; on the one hand it represents the main source of income that the country counts on for its development programmes, while on the

other hand it constitutes the national wealth. Thus, any decline in the value of oil revenues is considered undesirable on economic and political grounds. The decline of the exchange rate of the dollar against the Kuwaiti dinar thus diminishes the amount of both oil revenues and foreign reserve of the government in local currency. This leads to an interruption in the budgetary process of the government, which depends totally on oil revenues to implement its plans to develop the local economy. Hence, under these conditions the exchange rate of KD/dollar should be maintained in a way that would remove the risk of uncertainty concerning the amount of oil revenue in local currency.

On the other hand, any appreciation of the dinar against the dollar will diminish the gains made from oil price increases, which would induce the government to increase the production of oil to compensate for the decline in oil revenues. Kuwait would thereby exceed its production share in the Organisation of Petroleum Exporting Countries (OPEC) and bring on itself an undesirable political dilemma.

Furthermore, an appreciation of the Kuwaiti dinar against the dollar would have unwelcome consequences for both public and private investments. Since the government's foreign investments are distributed among some major currencies but mainly in dollars, the decline of the value of these assets in local currency will expose the investment policy of the government to great criticism.

It will also induce the authorities to intervene in the exchange market, in line with other countries, to defend the exchange rate of the dollar. On the other hand, due to the openness of the Kuwaiti economy, the foreign investments of the private sector need to be protected against any fluctuation in the KD/dollar exchange rate. Thus the appreciation of the dinar against the dollar will decrease the yield of those investments, or even cause some losses when the dinar appreciates strongly against the dollar. Given this, the monetary authorities feel obliged to reduce the risk of uncertainty of the local currency exchange rate. This obligation is also applicable to the exchange of the dinar against other major currencies. Hence, the choice of the basket peg aims at achieving this.

To give one example of the size of the foreign investment of the private sector, the published data indicate that the foreign investments of the commercial banks and investment companies alone had reached 3643.9 KD million (\$13.06 billion) by the end of 1988, which represents more than twice the level of their own funds and more than 30.0 percent of their total assets, while the total overseas assets handled by the Kuwait Investment Office are estimated at \$100 billion. Indeed, although capital outflows can affect the monetary stock in negative terms, they are able to reduce some inflationary trends which occur as a result of the expansion of the money supply.

Hence, the stability of the Kuwaiti dinar exchange rate is seen as the major task of the exchange rate regime.

The appreciation of the dinar against the dollar also has an impact on public expenditure. This impact is perceived as undesirable, since the government finances its annual budget by selling part of its dollar reserves to the Central Bank against Kuwaiti dinars, thus the appreciation of the dinar means that more dollars have to be called from the reserves to obtain the same amount in local currency for the government to meet its expenditure. It also means that the reserves of the country are exposed to more depletion because of the exchange rate variability rather than any real increase in the public expenditure. The picture becomes clearer when one realises that over 90.0 percent of the public expenditure is financed from the foreign reserves, the rest being provided by domestic sources.

#### The Effects of Appreciation of the Kuwaiti Dinar

Appreciation of the Kuwaiti dinar against the dollar may have positive consequences since it would reduce the imported inflation on the one hand, and improve the competitiveness of local exports on the other. Indeed, when the value of the dollar depreciates against the dinar, the value of imports declines and thus moderates the rate of inflation; this is understandable when we consider that more than 50.0 percent of the imports is settled in U.S. dollars. However, the imported inflation

is not generated solely by the fluctuation in exchange rates; another source of inflation could be the price increase in the origin of imported goods or services which results from the increase of cost of production factors. This imported inflation can not be avoided by the appreciation of the local currency against the dollar or other major currencies without causing any harmful effects on other aspects of the economy.

Moreover, the appreciation of the dinar against the dollar means that other currencies have also appreciated against the dollar, and so the value of imports from those countries with appreciated currencies will increase and push up the rate of inflation. A good example of this is what happened during 1985-87 when the value of the dollar declined: the local prices of goods imported from West Germany and Japan increased sharply (E.I.U., 1988, p.11). In addition, it can be argued that the consuming nature and high mark-up policies of the Kuwaiti economy would hinder any potential decrease in import prices due to the appreciation of the Kuwaiti dinar, since the price elasticity of imports is considered to be very low because of the over-dependence of the economy on imports. Government subsidies to basic commodities provides further evidence of the marginal effect of the appreciation of the local currency on imported inflation.

To conclude, we may assume, according to the previous argument, that the appreciation of the Kuwaiti dinar

against the dollar would have undesirable consequences for the Kuwaiti economy.

### The Effects of Depreciation of the Kuwaiti Dinar

To contrast, we may say that the depreciation of the Kuwaiti dinar against the dollar would be of some benefit to the local economy, especially to the equivalent value of oil revenues and foreign reserves in local currency. When the dinar depreciates against the dollar, the value in local currency of both oil revenue and foreign reserves will inflate in the national accounts. This could have a positive impact since it offsets the decline in oil prices and the returns of the government foreign investments. The government also needs to transfer fewer dollars from its reserves to finance its expenditure. However, the depreciation of the dinar against the dollar could prove harmful to other sectors in the economy. As a result of the openness of the economy, and its close link with the dollar, the depreciation of the dinar will hit the capital outflow since the private investors will find themselves obliged to transfer more dinars into dollars in order to meet the value of their investment abroad, especially when they want to invest in real assets rather than in financial assets. Accordingly, the liquidity position in the market will be affected by the increasing outflow movements, especially if this coincides with high interest rates in the international market.

A depreciation of the Kuwaiti dinar against the dollar may also affect the import prices in local currency. Theoretically, when the value of local currency declines, local prices of imports will increase; the cost of production will also rise if the country depends on foreign resources to obtain raw materials or machinery. However, the competitiveness of local products will be enhanced as a result of the depreciation of local currency. Meanwhile, the market forces will bring about equilibrium in the market of goods and services. For example, when the value of imported goods in local prices increases as a result of the decline in the value of local currency, local products will be more able to compete with foreign goods in local and foreign markets, provided that they represent reasonable substitutes for imported foreign products. This example is not applicable to Kuwait, as it depends heavily on the rest of the world for imports, and the non-oil private sector almost has nothing to compete with foreign imported products. Hence, the decline of the value of the dinar would not help the competitiveness of national products either in local or foreign markets. Thus the decline of the dinar's value would only increase the value of imported goods and services in local prices and create more inflation in the economy. Moreover, the rigid wages policy in the country would also hinder any decrease in import volume needed to offset the increase in import prices brought about by depreciation of the dinar against the dollar. Non-oil production can not meet domestic needs; nor can it

replace the imported goods. Table 7.3 illustrates the marginal volume of non-oil exports to both total exports and imports. This has averaged at 2.8 and 6.5 percent respectively for the period 1970-1988, a statistic which reflects the shortcomings in the structure of the Kuwaiti economy and its inability to improve its production base to a level at which it would be possible to correct the disequilibrium of the private sector's balance of trade whenever the value of the dinar declines against the dollar or any other foreign currency.

One may conclude that the depreciation of the dinar will not improve the competitiveness of domestic exports because of its marginal importance and substitutability. The table proves that re-export activity is more important than export; hence, this sector will suffer from any depreciation in the value of the dinar since the contractors in question will pay more dinar to import the same quantity of goods required for re-exporting.

Another effect of the depreciation of the Kuwaiti dinar against the dollar or other major currencies occurs as a result of long-term contracts with foreign companies. As most foreign contractors involved in long-term projects price their contracts in their own currencies to avoid the risk of exchange rate fluctuations, the decline in the value of the dinar means that the cost of such projects will increase over time and could disrupt the development plans in the country.

Table 7.3

Percentage of Non-oil Exports and Re-Exports  
To Total Exports and Imports (1970 - 1988)

Year	Non-oil Exports To:		Re-Exports To:		Total Exports (million dinar)	Total Imports (million dinar)
	Total Exports %	Total Imports %	Total Exports %	Total Imports %		
1970	1.2	3.3	3.2	8.9	590.9	223.3
1971	1.0	3.7	2.9	11.1	898.8	232.3
1972	1.7	6.3	3.4	12.7	981.3	262.2
1973	2.4	8.8	3.8	13.7	1129.7	310.6
1974	1.9	13.1	1.8	12.7	3214.7	455.1
1975	3.1	11.8	3.3	12.8	2663.0	693.2
1976	2.0	5.8	5.5	16.4	2874.4	972.0
1977	2.1	4.2	6.4	12.8	2792.6	1387.1
1978	2.4	5.4	5.8	13.2	2864.1	1263.9
1979	1.7	6.0	4.9	17.3	5088.5	1437.0
1980	2.1	6.4	5.7	17.1	5347.9	1772.4
1981	3.6	8.5	9.2	21.6	4553.5	1945.4
1982	4.7	6.2	12.6	16.7	3156.4	2384.6
1983	3.6	5.6	9.3	14.6	3373.6	2149.1
1984	3.4	6.1	6.9	12.3	3632.4	2041.7
1985	3.5	6.1	7.3	12.8	3185.0	1806.0
1986	4.3	5.3	7.7	9.7	2105.0	1661.2
1987	3.8	5.7	5.3	7.9	2304.4	1530.7
1988	4.8	6.1	7.1	9.0	2166.2	1714.3
Ave- -rage	2.8	6.5	5.9	13.3		
Totals					52922.4	24242.1

Source: Central Bank of Kuwait; Quarterly  
Statistical Bulletin, (Oct-Dec, 1989),  
(July-Sept, 1981), (Jan-Mar, 1987).

The depreciation of the dinar could also affect the repayment of the loans granted by Kuwait to Third World countries. Kuwaiti aid to developing countries, in the form of loans, stood at KD 1305.4 million (\$4.4bn) in June 1985, which consists of 288 loans to some 64 countries. Since such loans are contracted in local currency, any decline in its value will reduce the equivalent amount of repayment in foreign currency. The same applies to the repayment of KD dominated bonds issued by some local financial institutions in favour of non-resident borrowers. Although the size of these issues is small in comparison with other international bonds, reaching 656.8 KD million (\$2.2 bn) at the end of 1984, the stability of the dinar's exchange rate is of great importance to both local lenders and foreign borrowers; therefore, the depreciation of the Kuwaiti dinar would render the local party reluctant to involve itself in such activity, thus hindering the development of the capital market.

To conclude, one may assume that neither the appreciation nor the depreciation of the Kuwaiti dinar against the dollar would be of benefit to the Kuwaiti economy. On the contrary, the structural nature of the local economy of Kuwait, along with its over-dependence on oil revenues and import-oriented nature, suggests a stable exchange rate of the dinar with special consideration for the dollar. Thus the choice of the basket peg was made in order to avoid the undesirable effects of the fluctuations of foreign exchange rates. Nevertheless, despite the

secrecy concerning the mechanism of the basket, one may argue that a periodical adjustment of the weights of the currencies included in the basket is necessary. This adjustment is needed to allow the dinar to appreciate against the dollar whenever a sudden rise of foreign prices occurs, or to allow it to depreciate against the dollar in order to moderate the outflow of funds outside the economy.

#### Evaluation of the Performance of the Kuwaiti Basket

The following evaluation of the performance of the exchange rate regime is based on a comparison between the choice of the basket peg and the choice of a peg to a single foreign currency. As for the alternative choice, the U.S. dollar is thought to have great merit because of its strong presence in all aspects of the Kuwaiti economy. Three different tests are presented to cover three different areas:

1. The stability of the KD exchange rate against some major foreign currencies according to the alternative pegs (Table 7.4).
2. The cost of imports according to the alternative pegs (Table 7.5).
3. The cost of public expenditure according to the alternative pegs (as an indicator of the depletion of foreign reserves), (Table 7.6).

As Table 7.4 shows, the choice of the basket peg has been more effective than the other choice of a peg to a single currency (U.S. dollar) in stabilising the exchange rate between the dinar and other major currencies. This conclusion can be verified by the lower coefficient and variation of the exchange rate of the five major currencies against the dinar than the coefficient of variation of the same currencies of the alternative choice of peg. The exchange rate of the dinar against the dollar has also shown more stability than the exchange rate of the dinar against the other major currencies; this shows the important weight of the dollar in the basket and thus supports the previous discussion which followed the presentation of the hypothetical example of the basket.

Moreover, Table 7.5 illustrates that the choice of the basket peg has cost the Kuwaiti economy less for its imports than the other alternative peg. In other words, Kuwait would have paid more for its imports over the period 1975 to 1988 than it would had the dinar been pegged to the dollar.

Table 7.6 shows that the cost of public expenditure has been less thanks to the basket peg. It has already been established that in order to undertake expenditure, the government sells some of its dollar foreign reserves to the Central Bank to acquire the dinar; consequently, the less the government transfers from its reserves, the more it will be able to maintain these reserves.

Table 7.4

Exchange Rates of KD Against Major Currencies  
According To The Alternative Pegs.  
(1975 Q1 - 1988 Q4).

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Average KD exchange rates according to alternative pegs.

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CURRENCY	BASKET PEG	U.S. DOLLAR PEG
<u>U.S. Dollar:</u>		
Average exchange rate	3.5086	3.5110
standard deviation	0.113	-
coefficient of variation (%) <sup>(1)</sup>	3.22	-
<u>Japanese Yen:</u>		
Average exchange rate	785.32	788.26
standard deviation	165.806	175.241
coefficient of variation (%)	21.11	22.23
<u>Pound Sterling:</u>		
Average exchange rate	2.027	2.037
standard deviation	0.332	0.384
coefficient of variation (%)	16.36	18.84
<u>French Franc:</u>		
Average exchange rate	20.727	20.866
standard deviation	5.125	5.693
coefficient of variation (%)	24.73	27.28
<u>Deutsche Mark:</u>		
Average exchange rate	7.910	7.955
standard deviation	1.147	1.381
coefficient of variation (%)	14.50	17.36
<u>Swiss Franc:</u>		
Average exchange rate	7.052	7.090
standard deviation	1.207	1.376
coefficient of variation (%)	17.12	19.41

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(1) Coefficient of variation (or relative dispersion) is a statistical measure used to compare the scatter in one distribution with the scatter in another by applying this formula:

Coefficient of variation =  $\frac{\text{standard deviation}}{\text{arithmetic mean}} \times 100$  (Clark and Schkade, 1969, p.66)

Table 7.5

Cost of Imports According To The Alternative Pegs  
During the Period 1975 - 1988.  
(Million Dollars)

Year	Basket peg 3.5086	U.S. Dollar peg 3.5110	Million Dinars
1975	2432.2	2433.8	693.2
1976	3410.4	3412.7	972.0
1977	4866.4	4869.8	1387.0
1978	4434.5	4437.6	1263.9
1979	5041.9	5045.3	1437.0
1980	6192.3	6196.6	1764.9
1981	6825.6	6830.3	1945.4
1982	8366.6	8372.3	2384.6
1983	7540.3	7545.5	2149.1
1984	7268.1	7273.0	2071.5
1985	6261.8	6266.1	1784.7
1986	5959.0	5963.1	1698.4
1987	5178.7	5182.2	1476.0
1988	5445.3	5449.1	1552.0
Totals	79223.1	79277.3	27676.0

Table 7.6

Cost of Public Expenditure According To The  
Alternative Pegs During the Period  
(1975/76 - 1978/99, Financial years).  
(Million Dinars).

Year	Basket peg 3.5086	U.S. Dollar peg 3.5110	Million Dinars
1975/76	3451.4	3453.8	983.7
1976/77	4222.6	4225.5	1203.5
1977/78	5338.7	5342.3	1521.6
1978/79	5408.9	5412.6	1541.6
1979/80	7174.7	7179.6	2044.9
1980/81	8436.4	8442.2	2404.5
1981/82	9015.0	9021.2	2569.4
1982/83	10458.8	10465.9	2980.9
1983/84	9725.8	9732.5	2772.0
1984/85	10364.8	10371.8	2954.1
1985/86	10018.8	10025.7	2855.5
1986/87	9168.3	9174.6	2613.1
1987/88	8932.9	8939.0	2546.0
Totals	111070.7	111146.7	31439.1

Public expenditure = Total public expenditure  
- non-oil revenue.

Al-Gharabali (1986) has tested the purchasing power of the Kuwaiti dinar during the period 1975-1985 by using the effective exchange rate of the dinar (weighted by twenty foreign currencies representing 85.0 percent of financing import). He charted the changes in purchasing power of the dinar according to three alternative pegs, namely the basket peg; peg to a single currency (U.S. dollar), and a peg to the S.D.R. He found that with the peg to the dollar, the purchasing power of the KD increased sharply whenever the value of the dollar increased, and vice-versa, but with a wide range of fluctuation. The annual percentage changes of the KD effective exchange rate as per this alternative ranged between 12.2 and -11.2 percent, and the purchasing power of the dinar was found to increase annually at an average of 9.1 percent, the coefficient of variation accounted for 11.6 percent. In the case of the peg to the S.D.R., Al-Gharabali found that the purchasing power of the KD would have a limited fluctuation registered at 3.1 percent (coefficient of variation), but with low annual increase averaging at 1.0 percent. He thus asserted that the actual peg to the basket represents a reasonable compromise since it allows for an annual average of 8.8 percent increase in the purchasing power of the KD with moderate coefficient of variation at 8.6 percent. He also tested the effect of pegging the KD to the same former alternative on the balance of trade over the same period. The result of this test indicates that the pegging of the dinar to the dollar as an alternative to the basket would cause a loss

of 526.7 million dollars in the balance of trade, and a loss of 4452.2 million dollars if the dinar was pegged to the S.D.R. as an alternative to the basket.

However, the secrecy surrounding the basket's structure hinders any thorough analysis and evaluation of the feasibility of Kuwait's decision to peg its currency to the basket. Nevertheless, one may conclude that the basket peg is more suited to the special conditions of the Kuwaiti economy than the choice of a peg to a single foreign currency, or to the S.D.R.

C H A P T E R     E I G H T

LENDING POLICY AND REGULATING BANK LIQUIDITY

This chapter is concerned with the monetary policy instruments implemented by the Central Bank of Kuwait to execute its lending policy and regulate the liquidity within the banking system. Under the lending policy of the Central Bank, two instruments are discussed. Firstly, the discount window, and secondly, direct loans to the commercial banks. The discount weapon is viewed in accordance with its orthodox role in influencing the reserves of the commercial banks, and hence controlling the lending ability of these banks via manipulating the discount rate. Moreover, the connection between the discount rate and interest-rates structure is emphasised in the discussion in order to highlight the special conditions of the local market that influence the use of the discount rate.

As one of the traditional roles of the Central Bank is to act as "the lender of last resort", where the monetary authorities can affect the cost of bank credit, and other rates of interest in the market, by changing the rate of direct lending to the commercial banks; this role is viewed under the peculiarity of the local economy to realise whether the Central Bank of Kuwait has employed this weapon in this context, or it was influenced by other tendencies.

Due to reasons related to the openness of the Kuwaiti economy, free capital movements, and those generated by local conditions, local liquidity has been subject to pressure from various sources. Therefore, in order to regulate local liquidity within the banking system, the Central Bank has employed several instruments as follows:

1. Swap operations.
2. Exchange deposits with the commercial banks.
3. Central Bank's bills.
4. The liquidity system and reserve ration.

However, all the above mentioned instruments will be discussed in this chapter in a manner that helps to evaluate the role of the monetary policy as a conducive to administer bank credit in favour of the productive sectors in the economy.

Since the Central Bank, on behalf of the government, has issued the public debt instruments in November 1987, which will enable the Central Bank to add a new instrument to its monetary policy by conducting open market operations. The advantage of this weapon is that by which the Central Bank can influence the reserve positions of the commercial banks, and hence their lending ability. The author believes that because of the short existence of this weapon, any useful evaluation concerning its effectiveness would be considered unmaturred. Nevertheless, the inter-relation effects between the open market operations and other monetary policy instruments are pointed out in this

chapter, with a special emphasis on the perspective of the use of this weapon.

Finally, in connection with the development of the financial market as one of the main objectives of the monetary policy, two measures are presented in this chapter: one concerns the evolution of banking services, and the other measures the growing activities of the main financial institutions in the country.

### The Discount Window

The conventional application of discount policy by the Central Bank is designed to influence the reserves of commercial banks. The availability of this tool to control bank credit is related to the status of Central Banks as "the lender of last resort". Under this principle, the Central Bank lends to the commercial banks whenever they want to increase their reserves in order to expand their lending ability, but at a cost which is fixed by the Central Bank. Thus the Central Bank is able to influence the lending ability of commercial banks by changing the discount rate. For example, raising the rate of discount would make commercial banks reluctant to borrow from the Central Bank through the discount window, or would induce them to settle their outstanding borrowed reserves with the Central Bank by calling in their current loans or liquidating some of their earning assets. Of course, in the latter case, commercial banks will liquidate some of their earning assets to pay for their

loans from the Central Bank whenever they find that the rate of discount is higher than the yield of those assets. The result of this response by the banking system to the increase in the discount rate is a decline in bank credit, and hence in monetary stock.

The use of the discount rate as a monetary instrument to control bank credit is considered vital. It was used before other instruments such as open market operations, or variation of cash-reserve requirements. Indeed, according to the Federal Reserve Act of 1913, discount rates were the principal instrument of monetary control (Aschheim, 1961, p.84).

In the developed financial markets, the rate of discount is used by the Central Bank for many purposes. For example, it can lead other market rates since it represents the cost at which the Central Bank is ready to lend to commercial banks, and so the rates of financial assets will adjust accordingly. The movement of the rate of discount also serves as an indication of the direction of monetary policy. Accordingly, a high discount rate suggests that the Central Bank is moving toward a tight policy, with higher interest rates, implying a fear of inflation. A low discount rate might indicate either an expansion policy which induces lenders to extend more loans or a cycle of recession.

The discount policy plays a prominent role in the economy, and its success depends to a large extent on the

development of financial markets and their diversifications in terms of financial instruments. In the developing countries, therefore, discounting is employed on a wider scale as an element of the development scheme. In this context, selective discount rates are imposed and a variety of eligible papers ranked in accordance with the list of priorities of the favourable productive activities. A low rate of discount could be fixed by the Central Bank to encourage bank lending to certain sectors in the economy, and vice-versa. The Central Bank can also exempt certain types of eligible papers from the discount ceiling in order to encourage commercial banks to extend more loans to the preferable productive sectors (see Basu, 1967).

The importance of the discount rate in the economy is connected with the traditional role of Central Banks as "lenders of last resort". Discounting may play a marginal role in influencing bank credit where a special provision is made for direct lending by the Central Bank to commercial banks; hence it is assumed that the lending rate is used as a penalty rate to influence bank credit. Moreover, the absence of a discount rate policy in some cases would lead the Central Bank to promote other instruments of monetary control such as variation of reserve-requirements or moral suasion.

The discount system was introduced by the Central Bank of Kuwait for the first time in February 1975 when the commercial banks faced liquidity problems. The chief

motive behind the introduction of the discount window was, therefore, to help the commercial banks to overcome their liquidity shortage by injecting more funds into the banking systems and thus satisfy the increasing local demand for bank credit. There were three main reasons for the shortage in bank liquidity at that time: firstly, the increasing demand for bank credit to meet the expansion of the local economy after the oil price rises in October 1973; secondly, the outflow of funds towards foreign markets as a result of the increase in foreign interest rates; and, thirdly, the inception of new (non-bank) financial institutions which affected the availability of funds within the banking system.

The rate of discount was fixed by the Central Bank at 5.5 percent and discounts were applicable on commercial papers of 3 months maturity only. Later on, the maturity of accepted papers was extended to one year, and different rates of discount were applied in accordance with the maturity of presented papers. Table 8.1 illustrates the various discount rates applied since the introduction of the discount system in 1975 to 1988.

According to the discount system, the Central Bank can assign a variety of discount rates to encourage the granting of bank credit to certain productive sectors. The Central Bank can also exempt from the discount ceiling, certain types of eligible papers that relate to certain activities. However, from the application of various levels of the discount rate, it is clear that the

Table 8.1

Structure of Discount Rates.

Period	Maturities			
	3 months	6 months	9 months	one year
February 1975	5.5	-	-	-
October 1977	5.5	6.0	6.25	6.5
April 1979	6.0	6.25	6.50	6.75
March 1987	5.5	5.5	5.5	5.5
November 1987	5.0	5.0	5.0	5.0
December 1988	7.5	7.5	7.5	7.5

Central Bank has not used this power to induce the commercial banks to extend credit to predetermined preferable economic activities. In fact, the only encouragement offered by the Central Bank with regard to discount operations was to exempt from the ceiling any bank which succeeded in adjusting the proportion of granted loans to overdrafts beyond the limits assigned by the Central Bank. Therefore, the apparent variations in the rates of discount are concerned only with the periods of maturity, regardless of the type of activities. Thus one may argue that the discount policy has helped the commercial banks to expand their lending, which in turn has brought about some inflationary effects in the economy and boosted the speculative trends in the stock market.

Prior to the most recent changes in discount rates in December 1988, the Central Bank had changed the rate of discount four times during the period 1975 to 1988. As the previous Table shows, the rate has remained static during most of the period of its implementation (April 1979 - March 1987). During this period the interest rate ceiling remained at one level (10.0 percent), which indicates that changes in the discount rate were connected to changes in the interest rate ceiling. Given that the rates of discount have been fixed at a lower level of the interest rate ceiling, and that the maximum amount of discounts was raised from 200.0 KD million in 1975 to 750.0 KD million in 1982, one may conclude that the discount policy has aimed at absorbing the negative

effects resulting from the outflow of funds toward foreign financial markets, thus defending the local interest rates structure. In this context, the discount policy may be seen as a measure designed to supplement the interest rate policy rather than as a principal instrument with which to control bank credit and direct it to serve the development of the productive sectors in the Kuwaiti economy.

The reliance of the commercial banks on discount facilities is illustrated in Table 8.2. The ratio of discounted papers to total bank credit reached its peak in 1980 at 12.3 percent during the stock market rush. The Table also shows that the use of discounts by the commercial banks has exceeded their total reserves on several occasions, a fact which shows that the commercial banks prefer to resort to the discount window rather than use their reserves with the Central Bank to expand their lending. This trend is encouraged by the Central Bank since part of their reserves is interest-bearing (C.B.K. Bills). Thus, the discount facilities can be seen as a kind of compensation for the commercial banks' obligation to keep some reserves with the Central Bank. The Table also shows that the commercial banks have insisted on maintaining most of their reserves with the Central Bank in the form of interest-bearing reserve to offset the price they have to pay for discounts.

However, the discount operations between the commercial banks and the Central Bank have been influenced by two main factors: the demand for bank credit by the local

Table 8.2

Ratios of Discount to Some Monetary Variables.

Year	Discount To Total Reserves %	Discount To Total Credit Facilities %	C.B.K. Bills To Total Reserves %	Total Reserves To Total Credit Facilities %
1975	6.7	1.0	-	14.5
1976	2.3	0.2	-	10.9
1977	15.8	1.9	-	12.2
1978	32.3	2.2	-	6.9
1979	136.2	10.2	9.4	7.4
1980	134.7	12.3	44.3	9.1
1981	87.8	8.9	48.3	10.1
1982	44.2	7.1	75.0	16.0
1983	89.8	8.7	74.1	9.7
1984	111.1	8.7	70.6	7.9
1985	98.0	7.8	78.5	8.0
1986	91.8	6.1	74.0	6.7
1987	152.6	5.3	4.3	3.5
1988	669.8	6.0	0.0	0.9
Ave- rages	119.5	6.2	53.2	8.8

economic sectors, and the movements of foreign interest rates which have induced the depositors to shift from KD deposits to those in foreign currencies. Table 8.3 shows that when foreign interest rates increase and the depositors convert their KD into foreign currencies, the commercial banks increase their demand for discount in order to satisfy the increasing demand for bank credit (1977, 1979, 1980). The increase in local demand for bank credit alone, regardless of the pattern of foreign interest rates, would also induce the commercial banks to resort to more discount (1983). Table 8.3 illustrates an adverse direction, especially in 1981 and 1982 as the demand for discounts by the commercial banks declined in spite of the increase in foreign interest rates. This situation can be attributed to the stock market boom which encouraged local investors to convert their foreign deposits into local currency and pour more funds into the banking system, hence inducing the commercial banks to reduce their discount balances.

The response of the Central Bank to the liquidity of the commercial banks when it reached a bottleneck was to raise the discount ceiling - after gaining the approval of the Finance Minister whose Ministry funds discount operations - and to enlarge the scope of acceptance for eligible papers.

It is worth mentioning in this context that the discount window has not been the only measure to which the commercial banks can resort in order to enhance their

Table 8.3

Relationship Between Discount Operations,  
Credit Facilities, And Foreign Interest Rates.

Percentage Change				
Year	Discount %	Private Deposits in Foreign Currencies %	Credit Facilities %	Foreign Interest Rates (\$ 3 months)
1974	-	-	-	11.0
1975	-	-29.8	31.5	7.0
1976	-53.3	36.3	83.6	5.6
1977	885.7	-47.4	26.3	6.0
1978	47.8	108.2	28.1	8.7
1979	538.2	96.1	39.5	11.9
1980	52.9	65.3	26.1	14.4
1981	-5.4	1.2	31.1	16.5
1982	-2.0	-44.0	22.8	14.4
1983	20.9	79.4	-1.3	9.6
1984	7.3	20.1	6.9	10.8
1985	-8.5	-22.3	2.2	8.4
1986	-19.5	16.4	3.1	6.8
1987	-7.1	51.5	6.8	7.2
1988	14.8	33.2	1.6	7.9

Source: Central Bank of Kuwait; Quarterly  
Statistical Bulletin (1974-1988).  
International Financial Statistics (I.M.F.).

liquidity positions. Other means used by the commercial banks include direct loans and swap operations. When their liquidity positions come under pressure as local depositors move to deposits in foreign currencies, or the demand for bank credit increases, the commercial banks can exchange foreign currencies against KD for a short period (swap operation), or they can have direct loans from the Central Bank.

In December 1988, when the new interest-rates structure was introduced, the discount rate was included in this structure for the first time as the key rate that other rates' ceilings on bank deposits and loans will automatically move to their appropriate levels following any change in the discount rate. Whether the new concept of discount rate will be employed correctly to serve the mobilization process of savings to real investment activities, and whether the Central Bank will use the discount rate policy to encourage the flow of bank credit to sectors in the economy that are in need of development such as Industry and Agriculture, depends among other things on how the Central Bank manipulates the discount rate in view of its strong connection with the interest-rates structure.

In December 1988 the Central Bank announced its new rate of discount at 7.5 percent, an increase of 2.5 percent on the previous discount rate. The direct effect of this was that the commercial banks reduced their borrowed reserves in the form of discounted papers by 45.5 percent

by the end of the first quarter of 1989, and by 43.5 percent at the end of the second quarter of the same year. But, for the second half of 1989, the commercial banks increased their discount balances to a lower level than at the end of 1988 when the discount rate stood at 5.0 percent. Thus, the net adjustment of their discount balances is a decline from 282.0 KD million in December 1988, to 188.7 KD million in December 1989. There are two main reasons for this reaction by the commercial banks to the increase in the rate of discount. Firstly, there is the cost-conscious reaction; as the cost of discount was raised to a higher level, the commercial banks reduced their borrowed reserves to the minimum required level. Secondly, there was the fear that the discount rate would be raised again by the Central Bank, making borrowing more costly, and the anxiety that the raising of the lending rate ceiling, coupled with minima on deposit rates, would reduce the demand for bank credit. Nevertheless, as the market adjusted to the new interest-rate structure, the commercial banks began once more to increase their demand for discount, but this time with greater caution. Thus, we may conclude that the discount rate can be manipulated to influence the reserves of the banking system if the intention of the Central Bank is directed to such an objective.

Furthermore, the recent interest-rates structure is dependent on one discount rate that is to be announced and changed at the discretion of the Central Bank, regardless

of the maturities of the discounted papers. This implies that changes in the discount rate will alter the ceilings on bank deposits and lending rates in a symmetrical pattern. Thus one may argue that when the discount rate is fixed at a high level, local depositors prefer to place their money in KD deposits rather than invest them in foreign currency; bank credit, however, will be more expensive and thus the demand for bank credit will decrease, or investors will pass the extra cost on to the consumers and generate some inflationary effects. Nevertheless, at a high discount rate, it is expected that the commercial banks will reduce their borrowing from the Central Bank; not because of the high cost of borrowing alone, but rather because of the high discount rate, as rates on bank deposits have become higher, which induces more KD to flow in the banking system.

In contrast, when the discount rate is fixed at a low level in order to stimulate investment, the demand for bank credit increases as it becomes cheaper; however, this implies that interest on bank deposits will also become lower, forcing KD deposits to shift to foreign currency deposits, especially when the foreign interest rates are higher than those prevailing in the local market. Such situations have been experienced in the past and have resulted in exposing the banking system to liquidity problems, which the Central Bank attempted to solve by injecting liquidity into the banking system. To avoid such conditions, the local discount rates should be

kept in line with movements in foreign interest rates in order to preclude the convertibility of local currency into foreign currencies. Although this is a plausible solution, it does imply that local economic conditions are influenced by external factors related to foreign economies.

One may argue that to maintain the discount rate at a competitive level relevant to those prevailing in foreign markets is preferable to the domestic conditions, than to maintaining it at a lower level. This argument rests on the solid fact that the influence of foreign interest rates on local conditions is inevitable (Chapter 4, The Model) because of the openness of the Kuwaiti economy. The only way left to curb the outflow of funds towards foreign markets is to encourage local investors to stick to KD deposits by giving them reasonable returns. On the other hand, the accumulative savings can find their outlets through the purchase of public debt instruments to cover the increasing government expenditures, and to supply bank credit to the productive sectors in the domestic economy. In this context, however, and for reasons discussed earlier, the elasticity of domestic investment to interest rate is believed to be low, and as a result some economic sectors have increased their demand for bank credit under a higher interest rate. It follows that granting loans to the economic sectors should not be left totally to the discretion of the commercial banks; a kind of selective credit control should be set up by the

monetary authorities in order to secure fair distribution of bank credit among the productive sectors.

To conclude, we may say that the discount window as an instrument of monetary policy was adopted by the Central Bank in 1975 to supply the banking system with more funds in order to solve their liquidity crises. There is no evidence to suggest that this instrument has been used to encourage some of the economic sector on a discriminatory basis, despite the fact that the discount agenda entitles the Central Bank to use it in this way. Thus, discount rates have been changed in accordance with changes in the interest-rates structure in order to make discount operations feasible for the commercial banks. Furthermore, since the discount rates were supplementary to interest rates, the discount policy can be perceived as a moderator which tempers external pressures on domestic interest rates. The discount operations have also been influenced by internal conditions resulting from the increasing local demand for bank credit. Thus the commercial banks have found in the discount facilities a cheap means of expanding their credit, thus accelerating hectic speculation on the stock market and in real estate.

A new role was assigned to the rate of discount in December 1988 as a prop to the interest-rates structure. It is believed that this role is to control the availability of KD funds and so secure the management of the public debt by the Central Bank.

Nevertheless, the author believes that maintaining the discount rate at competitive rather than lower levels is more suited to the nature of the domestic economy. Finally, a set of selective credit controls with respect to the discount rate is suggested as a means of securing a fair distribution of savings among the productive sectors.

### Direct Lending To The Commercial Banks

The traditional function of central banking implies that commercial banks can resort to their Central Bank to obtain funds as "the lender of last resort". Under this assumption, the Central Bank is able to influence the lending ability of commercial banks by affecting their reserves.

In developing countries where Central Banks have only recently been established, and where the financial market - especially the banking system - is in its infancy, these new Central Banks need to strengthen their relationship with the commercial banks in order to implement through them the kind of credit policies conducive to economic development. Thus the Central Bank as "the lender of last resort" becomes "the lender of primary resort"; and as a corollary the bank rate would not be expected to play the same role as it does in the developed world.

The Central Bank of Kuwait's direct loans to the commercial banks, along with its discount facilities, represents the "Lending policy" of the Central Bank in

response to the need of the commercial banks to expand credit facilities to their customers. According to Article (41,b) of its Charter, the Central Bank grants emergency loans or advances to the commercial banks, against adequate collateral, for a period not exceeding six months; the period of the loan can be extended a further six months. To comply with the law, the Central Bank usually requires the commercial banks to explain in detail their reasons for applying, the amount of collateral to be put forward, and the required period of repayment.

The interest rate on loans given by the Central Banks is usually used as a penalty rate to influence the lending ability of the commercial banks. The interest rate is fixed at a quarter of a point higher than the discount rate, making these loans more expensive. However, since the rate of interest on direct loans is dependent on the discount rate, which had, in spite of market conditions, remained static for a long period, the interest rate on direct loans can not be considered a penalty rate. Moreover, the Board of Directors of the Central Bank has decided that this rate should not exceed 8.5 percent, which means that the commercial banks can borrow from the Central Bank at 8.5 percent and lend at 10.0 percent or more whenever demand for bank credit increases. This implies that the lending policy of the Central Bank (discount + direct loans) is geared to helping the commercial banks to overcome the pressures on their

liquidity positions, rather than to regulating or controlling their lending ability.

Table 8.4 shows the amount of direct loans offered by the Central Banks to the commercial banks from 1977 to 1988. The table shows that the demand of the commercial banks for direct loans from the Central Bank increased in 1978 and 1979. This was in order to ease the pressure on their liquidity positions exerted by the rise in foreign interest rates, with more KD funds having been converted into foreign currencies, and the growing local demand for bank credit. The same trend occurred in 1982 when the debts of the commercial banks to the Central Bank almost doubled for the same reasons. Nevertheless, one may argue that when foreign interest rates are high, the commercial banks are able to borrow money from the Central Bank at the lower rate of 6.625 (one quarter of a point above the average discount rate in 1982) and convert it into foreign currency to get 14.0 percent. The Central Bank can not trace the use of money borrowed in this way by the commercial banks. However, from 1984 to 1988, as foreign interest rates declined, more KD were returned to the economy and the commercial banks reduced their borrowed reserves (discounts + direct loans).

This positive relationship between the external effect on the liquidity positions of the commercial banks and their borrowing from the Central Bank implies that this instrument of control (direct loans) can be judged in the same way as the discount policy, which means that the

Table 8.4

Amount of Direct Loans Granted By The  
Central Bank to The Commercial Banks  
(1977 - 1988).

Year	Direct loans to Commercial Banks KD million	percentage change %	Foreign Interest Rate (\$ 3 months)
1977	8.0	-	6.0
1978	58.0	625.0	8.7
1979	222.3	283.3	11.9
1980	222.5	0.1	14.4
1981	215.5	-3.1	16.5
1982	429.6	99.3	14.4
1983	225.5	-47.5	9.6
1984	135.0	-40.1	10.8
1985	20.1	-85.0	8.4
1986	-	-100.0	6.8
1987	-	-	7.2
1988	-	-	7.9

Source: Central Bank of Kuwait (unpublished information),  
International Financial Statistics (I.M.F.).

direct loan policy is employed to defend the interest-rates structure. It can, therefore, be regarded as supplementary to the interest rates policy. Therefore, the interest rate on direct loans can not be used as a penalty rate since it has been fixed below the lending rate of the commercial banks. Nevertheless, a penalty rate is applied by the Central Bank on the overdrawn balances of the commercial banks on a daily basis at 10.0 percent.

The validity of the interest rate on direct loans as a tool to be used by the Central Bank to influence the lending ability of the commercial banks is a crucial issue in the case of Kuwait. Theoretically, the commercial banks are supposed to maintain their reserves at a minimum in order to comply with the Central Bank's requirements. In this way, the Central Bank is able to impose a higher (lower) interest rate on the money that it is ready to lend to the commercial banks, and can thus influence their lending ability. However, the reserves of Kuwait's commercial banks have shown a persistent surplus (Chapter 4) because of the high rate of saving and the absorptive capacity of the economy. Indeed, this situation should hinder the use of the direct loan tool to control bank credit. The success of the direct loan instrument is dependent on the need of the commercial banks for such an outlet in order to enhance their liquidity position and to expand their lending. In fact, experience has shown the commercial banks have resorted far less to direct lending

than to other sources such as the discount window. Records show that the volume of funds granted to the commercial banks through the discount window were four times as much as those obtained through direct loans. It goes without saying that in order to adjust their liquidity positions, the commercial banks can use swap operations with the Central Bank or reduce their holding of the Central Bank's Bills through the re-purchase agreement. Hence, the effectiveness of the direct lending instrument is slight in terms of controlling bank credit since the general framework of the credit control applied by the Central Bank has been weakened.

To sum up, one may conclude that the implementation of direct lending by the Central Bank as an instrument of its monetary policy is devised to help the commercial banks to enhance their liquidity position during times of crisis resulting from the outflow of funds towards foreign currencies. Furthermore, no evidence has been found to support the assumption that this instrument has been employed to control the lending ability of the commercial banks, or to affect the market rates by considering the rate of interest of direct lending as a bank-rate.

#### Swap operations

Swap operations between the Central Bank and commercial banks began in June 1978. The aim behind the introduction of this instrument by the monetary authorities was to absorb the excess liquidity within the

banking system. The way in which this technique operates is as follows: the commercial banks can buy or sell KD against foreign currencies (mainly U.S. dollars) for an agreed period ranging from one week to three months, at the end of which the transaction is reversed. Two different exchange rates are involved in this operation: the spot exchange rate at the beginning of the deal, and a forward exchange rate for the reverse transaction, based on the difference between the KD interest rate in the local inter-bank market and the interest rate in the Eurodollar market.

At the beginning of the introduction of this technique and for a few months only, the commercial banks used to sell KD against U.S. dollars. Today, however, the commercial banks sell foreign currencies to the Central Bank in exchange for KD, thus enabling themselves to adjust their liquidity positions and expand their lending. Thus local liquidity is subject to two major sources of pressures; firstly, from the increasing local demand for bank credit, and secondly, from the movement of foreign interest rates, which induce capital outflow. In swap operations the commercial banks have found an effective means of adjusting their KD liquidity, since they can - during the periods of KD convertibility into foreign deposits - obtain local currency from the Central Bank by selling foreign currencies over short periods.

Table 8.5 shows the relationship between the swap operations and the movements of private deposits in

foreign currencies, which is used as a proxy to reflect the fluctuations in foreign interest rates on the international markets. The table shows that when the shift from KD to deposits in foreign currencies increases, the commercial banks resort more to swap operations in order to increase their KD liquidity and thus meet local demand for bank credit, and vice versa. This trend can be seen in the financial year (1983/84) when the amount of swap transactions reached its highest level in response to the high balance of private deposits in foreign currencies during the period of high foreign interest rates.

Although the swap operations technique has its merits, it also has its drawbacks - the main one being that its implementation is left to the discretion of the commercial banks. The Central Bank cannot force the commercial banks to resort to this method as a means of absorbing their excess KD liquidity. Furthermore, the commercial banks are allowed to buy or sell KD against foreign currencies without bearing any exchange risks, since both the spot and forward rates are determined at the outset of the deal regardless of the actual exchange rate between the KD and dollar when the transaction is reversed. Thus the Central Bank is supposed to bear the exchange risks. One may argue that the swap operations as an instrument of monetary policy were generated by the Central Bank to ease external pressures on bank liquidity and thus defend the interest-rates structure.

To conclude, we may say that although the original aim of

Table 8.5

Relationship Between Swap Operations,  
Private Deposits In Foreign Currencies,  
And Credit Facilities (percentage change).

Financial year	Swap operations %	PD FC %	Credit Facilities %	Volume of Swap operations (KD m.)	Balances of PD FC
1977/78	-	-	-	20.5	105.1
1978/79	516.1	114.1	48.6	126.3	225.0
1979/80	549.2	108.9	26.6	820.0	470.2
1980/81	N.A.	40.2	77.8	N.A.	659.5
1981/82	-	-27.8	5.0	2905.0	476.1
1982/83	-64.1	-15.0	-3.5	1042.2	404.9
1983/84	393.9	104.3	8.5	5148.0	827.4
1984/85	-56.5	-12.0	3.0	2238.0	727.8
1985/86	-89.8	-11.0	2.1	227.7	648.1
1986/87	-60.0	28.4	8.2	91.1	832.4
1987/88	N.A.	22.8	0.2	N.A.	1022.3

where:

PD FC = Private Deposits in Foreign currencies with the commercial Banks.

KD m. = KD million.

Source: Central Bank of Kuwait; Annual Report for Financial years from 1977/78 to 1987/88, Quarterly Statistical Bulletin (Oct-Dec 1979 to 1988).

the swap instrument was to absorb the excess liquidity within the banking system, it has failed to do so simply because there was no element of compulsion in this technique; the commercial banks could resort to the instrument or reject it at will. Furthermore, the Central Bank had to bear the exchange risks in order to temper the external pressures exerted on commercial banks' liquidity position by high foreign interest rates. Finally, the commercial banks have benefited from the swap operations: their KD balances have been enhanced and their lending has expanded.

#### Exchange Deposits with the Commercial Banks

In 1974, when the banking system faced its first ever liquidity crisis, the commercial banks approached the Central Bank for help. Besides introducing the discount window, the Central Bank deposited 12 million dinars within the banking system. The money came from the Ministry of Finance and was distributed equally among the banks. These deposits with the local banks have remained unchanged for a long time, which implies that this method of funding is a kind of subsidy rather than a dynamic instrument of monetary policy, since it is unidirectional and does not take into account changes in the liquidity positions of the banks. However, this policy was implemented once only and the Central Bank has not resorted to it again.

In April 1973, as a result of both the devaluation of the U.S. dollar two months earlier and the sharp fluctuation in the exchange market, the commercial banks experienced a surplus in their liquidity positions. Accordingly, the Central Bank allowed the banks to open interest-bearing accounts in order to absorb the excess funds within the banking system. The interest rate on these deposits was fixed at half a point above the rate paid by the commercial banks on saving deposits, and the periods were set at between one and three months. Moreover, the maximum volume of the deposits that the commercial banks were able to place with the Central Bank was set at 20.0 percent of the total deposits for residents, which almost equals the volume of saving deposits. Although this method is also considered a unidirectional means of controlling bank reserves, it has its shortcomings since it is dependent on the discretion of the commercial banks. Nevertheless, it appeared suitable at the time since the Central Bank had not imposed any reserve-requirements system to control the banks' reserves, and there were certain fears that the commercial banks would not accept any more deposits from the public since the banks were unable to find outlets for their investments either locally or on foreign markets. Thus, although the opening of interest-bearing deposits implies that the commercial banks will receive interest on their idle reserves, the Central Bank aimed to encourage at least the flow of savings from small depositors during the growth stage of the economy. However, this technique was

abolished in April 1979 when the Central Bank introduced its Bills as a substitute for the interest-bearing accounts.

In 1984, as a result of the increase in foreign interest rates (especially the dollar), the commercial banks faced further pressures on their liquidity positions. The Central Bank was induced once more to resort to the interest-bearing deposits scheme, but this time on a more improved and dynamic basis. The Central Bank offered to exchange deposits with the commercial banks on two different rates, so as to either absorb excess liquidity, or to inject liquidity into the banking system. By manipulating the interest rates on these deposits, the Central Bank aimed to control the interest rates prevailing on the inter-bank market which were freed from the imposed ceiling. The Central Bank also used the exchange rate policy to temper the convertibility of KD to foreign currencies in order to enhance local liquidity within the banking system. Table 8.6 shows the exchange deposits between the Central Bank and local banks for the period 1984-1988. As the Table indicates, when the liquidity positions of the commercial banks were under pressure from the increasing shift of KD to foreign currencies during 1983 and the first three quarters of 1984, the commercial banks had more deposits than they placed with the Central Bank. Similarly, when they adjusted their liquidity position in 1985, they placed more deposits than they had from the Central Bank. The

Table 8.6

Movements of Exchange Deposits Between  
The Central Bank and The Commercial Banks.

Year	Deposits of Local Banks At The Central Banks (KD million)	Deposits of The Central Bank at The Local Banks (KD million)
1984	68.8	188.0
1985	165.0	86.3
1986	570.2	263.5
1987	236.0	166.1
1988	50.0	71.8

Period	Exchange Rate \$/KD	Inter-bank Interest Rate. (one month)	Private Deposits In Foreign Currencies
1983			
Q1	290.82	5.41	386.1
Q2	291.59	6.54	404.9
Q3	292.09	6.94	445.6
Q4	291.40	7.17	597.5
1984			
Q1	293.00	7.18	628.4
Q2	293.13	9.03	827.4
Q3	296.26	10.19	770.4
Q4	301.51	8.41	717.8
1985			
Q1	306.29	8.57	753.3
Q2	302.40	7.30	727.8
Q3	302.20	6.78	671.7
Q4	292.49	6.70	559.8

Source: Central Bank of Kuwait; Quarterly Statistical  
Bulletin (Oct-Dec. 1984, 1985, 1988).

Table also shows that in addition to exchanging deposits, the Central Bank used the exchange rate technique to render the dollar more expensive for those who wanted to abandon the Kuwaiti dinar.

Nevertheless, the policy of exchange deposits can be seen as a more advanced stage than the unidirectional policy of placing deposits with the commercial banks, who can choose whether or not to resort to the scheme. For example, during periods of increasing demand for bank credit, the commercial banks prefer to expand their lending rather than place reserves with the Central Bank in the form of interest-bearing deposits, unless the latter is ready to pay interest on these deposits above the lending rates of the commercial banks in order to control the expansion of the monetary stock. However, it is very doubtful that the Central Bank would follow this line since it is much less costly to impose a high reserve-requirement ratio to reach the same result.

### Central Bank Bills

The Central Bank bills system was introduced in April 1979 to replace the interest-bearing deposits scheme. The main aim of the new system was to regulate the liquidity position of the commercial banks. According to this system, the commercial banks can buy CBK bills to employ their excess liquidity; they can also negotiate these bills among themselves to adjust their liquidity positions. Moreover, whenever a bank faces pressures on

its liquidity, the bills can be re-purchased by the Central Bank. The bills are also accepted by the Central Bank as collateral against loans granted to the commercial banks.

Two types of CBK bills were introduced: bills of 28 days maturity, and bills of 91 days maturity. Interest on these bills was fixed at 5.25 and 5.50 percent respectively; in December 1979 the interest rates were raised to 5.75 and 6.0 percent respectively.

Since the reaction of the commercial banks towards the introduction of the CBK bills was not encouraging in the first year (1979), the Central Bank aimed to amend its liquidity system by making the bills part of the liquidity ratio required from the commercial banks. Moreover, to make the bills more attractive, the Central Bank pays interest on these reserves at 6.5 percent, which is more than the discount rate. The actual interest rate paid on the bills is more than the rate announced since it is calculated on the discount basis.

By introducing these bills, the Central Bank also aimed to help the commercial banks to adjust their liquidity positions and to prepare the ground for open-market operations.<sup>(1)</sup> Thus in 1980 the investment companies

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(1) The Kuwaiti Economy in Ten Years 1969-79;  
Central Bank of Kuwait.

were invited to join the commercial banks in dealing in CBK bills. This conclusion is supported by other features of the CBK bills system. Firstly, there is the re-purchase agreement between the Central banks and the commercial banks which makes the negotiation of these bills more dynamic. According to this agreement, the Central Bank may re-purchase the bills before maturity for a price 0.125% higher than the original price. Secondly, the Central Bank may also redeem the appropriate quantity of bills owned by any particular bank in order to cover its overdrawn balance on a daily basis at a price 0.25% higher than the original price. This transaction is practised temporarily until the bank in question adjusts its balance the following day.

However, by introducing its bills, the Central Bank has succeeded in offering the banking system a flexible tool with which to adjust their need for KD funds. The use of this instrument to conduct open market operations is considered unrealistic. This is because the bills are part of the liquidity ratio of the commercial banks, and thus this particular portion can not be traded on the market. Secondly, in open market operations, the Central Bank should buy or sell securities in large quantities and change the price in order to alter the holding of these securities by the commercial banks, thus influencing their reserves.

In the case of the CBK bills, however, the Central Bank can re-purchase bills only when the banks are willing to

sell them, or when their accounts become overdrawn, and at one direction of price change, which is more costly for the commercial banks. Thirdly, the prices of these bills, which are fixed at 5.75 and 6.0 percent and are below the ceiling of the lending rate, are considered relatively low compared to the rates of return on other financial assets in the market; therefore, the commercial banks are only expected to resort to these bills when they are unable to find other outlets for their investments. Fourthly, trading on these bills is confined to the commercial banks and investment companies, whereas the success of open market operations depends on the involvement of a wide range of participants, especially the public.

Therefore one might argue that the CBK bills instrument was implemented by the Central Bank with two main ends:

- (1) to help the banking system to regulate its liquidity position; and
- (2) to reduce the cost of idle balances held by the commercial banks.

Table 8.7 shows that the commercial banks have employed most of their reserves (Required + Excess) in the CBK bills over the period 1979 to 1987, which indicates that the banks have been able to use this facility to invest their idle balances. However, since the Central Bank imposed a very low reserve-requirements ratio at 3.0 percent in 1980 (which has remained unchanged), the

Table 8.7

The Use of CBK Bills By The Commercial Banks  
(1979 - 1987).

Year	CBK Bills		Private Deposits In Foreign Currencies		CBK Bills/ Bank Reserves
	KD million	changes %	KD million	changes %	
1979	13.5	-	355.6	-	9.4
1980	98.3	628.1	587.9	65.3	44.3
1981	155.3	58.0	595.2	1.2	48.2
1982	469.7	202.4	333.0	-44.0	75.0
1983	276.1	-41.2	597.4	79.4	74.1
1984	226.3	-18.0	717.4	79.4	70.0
1985	263.1	16.2	557.2	-22.3	78.4
1986	213.1	-19.0	649.0	16.4	74.0
1987	619.7*	190.8	983.3	51.5	86.0

\*: The balance in October 1987.

Source: Central Bank of Kuwait; Quarterly  
Statistical Bulletin (Oct-Dec. 1985, 1988).

commercial banks' reserves are assumed to be influenced by the local demand for credit on the one hand, and the convertibility of the KD to foreign currencies on the other. For example, during the period of hectic stock market speculation (1980 to mid 1982), the balances of the CBK bills were at relatively low levels when compared with those for the periods after the collapse of the stock market. Thus the high balance of the bills at 469.7 KD million at the end of 1982 reflects the fact that as local demand for bank credit declined following the sluggishness of the stock market, the commercial banks resorted to CBK bills in order to employ their excess balances; hence, in June 1982, this balance amounted to some 184.2 KD million with the stock market at full activity. However, when more KD funds were converted into foreign currencies (1983, 1984, 1986) in reaction to the attractive foreign interest rates, the balances of CBK bills demonstrated a negative trend. The reason for this was because the shift of the KD towards foreign currencies had exerted more pressure on the banks' reserves, thus reducing their need for CBK bills.

At the beginning of 1988 the Central Bank deserted the CBK bills system in favour of the public debt instruments; therefore the high balance of the CBK bills in October 1987, as shown in Table 8.7 can be considered as a sort of clustering of KD funds by the commercial banks to buy the public debt instruments.

In short, the implementation of the CBK bills instrument may be seen as a moderate attempt on the part of the Central Bank to control the excess reserves of the banking sector. Nevertheless, these reserves remained totally under the control of the commercial banks and are subject to external pressures, despite the fact that the introduction of the CBK bills has served to regulate liquidity within the banking system. Moreover, the failure of these indirect measures of control to influence the lending ability of the commercial banks is clear from the expansionary tendency of bank credit which has inflamed speculations in the stock market (Chapter 4).

#### Liquidity System and The Reserve Ratio

In April 1974, the liquidity system, which was only applicable to the commercial banks in the country, was introduced - for the first time - by the Central Bank. According to this system, the commercial banks are obliged to maintain not less than 25% of their total deposits and liabilities to the Central Bank in the form of liquid assets, of which not less than 7.5% should be in KD liquid assets. At the beginning of the implementation of this system, net of the inter-bank balances was accounted among the required liquid assets, but in August 1975 this term was amended to include among the required liquid assets the whole total of inter-bank balances. This step was made to encourage the inter-bank market. Nevertheless, and in spite of the simplicity of this liquidity system

which does not differentiate between various types of bank deposits, it can be considered a further step towards safeguarding the banking system against any sudden withdrawals by depositors, which might shake the solvency of the commercial bank; especially if we know that the commercial banks faced a liquidity crisis for the first time in this particular year (1974).

In March 1978, the previous liquidity system was abolished and a new more comprehensive one was introduced by the Central Bank. The new liquidity system is based on the structural setting of bank deposits that takes into consideration both different types of deposits and their maturities. Furthermore, the specialized banks were also brought under the new liquidity system.

According to the new system, banking deposits are divided into five different groups, and the liquidity ratios required against those groups are as follows:

<u>Type of Deposits</u>	<u>Liquidity Ratio</u>
1. Demand deposits and other deposit liabilities.	35%
2. Saving and time deposits payable within one month.	30%
3. Time deposits of more than one month and less than three months maturity.	20%
4. Time deposits of more than three months and less than six months maturity.	10%
5. Time deposits of more than six months and less than one year maturity.	5%

Against the first group of deposits (demand deposits and other deposit liabilities), the commercial banks are required to keep the following liquid assets:

1. Cash.
2. Current balances with the Central Bank.
3. Current and call accounts with other banks.
4. Time deposits with the Central Bank  
(Central Bank bills after 1979).
5. Other liquid assets to be defined by the  
Central Bank.

Against the other groups of deposits, the commercial banks are requested to maintain the following liquid assets:

1. Time deposits with other banks payable  
within one month.
2. Certificates of deposits issued by other banks  
payable within one month.
3. Treasury bills payable within three months.
4. Bank acceptances issued by other banks  
payable within one month.
5. Other liquid assets to be defined by the  
Central Bank.

Moreover, the liquidity system has postulated that at least one third of the required liquid assets be kept in KD. In 1979, after the introduction of the Central Bank bills and in order to encourage these bills, the Central Bank imposed a requirement on the local banks to maintain 10.0 percent of the required liquid assets in the form of

CBK bills, where they can obtain 6.5 percent interest rate on these bills, which is more than the discount rate; and upon the introduction of the public debt instruments in November 1987, the local banks were permitted to keep these instruments (bills and bonds) among the required liquid assets.

However, although the main purpose of the liquidity system has remained to secure the ability of the local banks to meet requests for withdrawal by various depositors, one can assert that the new system is more practical than the previous one because it implies the following features:

1. The new system has distinguished between various bank deposits in terms of type and maturity. Thus, the system required more percentage against demand deposits than against time deposits, since the withdrawal frequency of the former is more than the latter. And since the withdrawal of shorter period time deposits is more frequent than those of longer period time deposits, the banks have to maintain more liquid assets against the former.

2. The new liquidity system has considered the operations of the specialized banks as they deal with medium and long-term transactions. By imposing low liquidity ratio on medium-term deposits, and exempting those of more than one year maturity, the specialized banks are encouraged to develop their liabilities in a manner that would serve their investments.

3. The new system has also considered the profitability of the local banks by imposing lower liquidity ratio on deposits of longer maturity, since they cost the banks higher interest rates than those of shorter maturity.

Nevertheless, since the proportional distribution of the required liquid assets that the banks should maintain against the different groups of bank deposits has not been fixed by the liquidity system, instead it was left to the discretion of the banks, a state of fear was created that would diminish the optimal achievement of the system. For example, when the local demand for bank credit increases, or the commercial banks face liquidity shortages as a result of capital outflow, and the interest rate in the inter-bank market increases, the commercial banks can reduce their liabilities on the Central Bank in the form of current accounts, or even reduce their cash holding and increase their liabilities on each other, since the liquidity system permits every bank to keep all the required liquid assets against four groups of bank deposits in the form of time deposits with other banks.

On the other hand, this system could conflict with some monetary applications for the same reason: that is the undetermined proportional distribution of the required liquid assets that the commercial banks should maintain against their deposit liabilities; for example, when the monetary authorities intend to induce a monetary expansion in the economy, coupled with low interest rates to

encourage the local demand for bank credit. According to the liquidity system, the commercial banks can increase the proportion of their required liquid assets with the Central Bank in the form of time deposits (before 1979), or CBK bills (after 1979); especially when the interest rate on these bills is more attractive than the prevalent lending rates. The commercial banks may also resort to such behaviour in order to avoid risky loans. This condition would result in an increase of banks' claims on the Central Bank and reduces their claims on each other. As a corollary, the lending ability of the commercial banks is being diminished, and the tendency to monetary expansion is being hindered. Furthermore, the contrast may be conceived when the monetary authorities tend to induce a monetary depression.

In June 1980, a new amendment was made to the liquidity system, whereby the commercial banks should keep a minimum reserve ratio at 3% of their total deposits liability with the Central Bank in the form of cash, deposits, and CBK bills.

The reserve ratio is considered an important weapon in the hands of the monetary authorities to influence the reserve positions of the commercial banks, and hence their lending ability. When the monetary authorities raise the requirements reserve ratio, it tends to reduce the available excess reserves of the commercial banks and their ability to create money in order to curb or diminish the expansion in the money supply. In contrast, when the

Central Bank tends to encourage bank lending, it reduces the reserve ratio, which in turn increases the excess reserves of the commercial banks and leads them to increase their supply of credit. Moreover, the monetary authorities can also influence the local interest rates by changing the reserve ratio, since the commercial banks - in order to increase their lending and as a response to a decline in the reserve ratio - tend to decrease their lending rates to stimulate the demand for bank credit. Hence, local interest rates can be induced to decline when the monetary authorities increase the reserve ratio.

However, the importance of reserve ratio is emphasised when the financial market of the economy in question is undeveloped or in its infancy stage. Pendharkar and Narasimham (1983, p.200) assert that,

"A direct regulation of reserves through the instrument of variable reserves ratio or its variant of liquidity ratio would be a more potent weapon in a situation where the money and capital markets are not well developed."

Furthermore, Aschheim (1961, p.97) says that,

"Without open-market operations and without non penal rediscounting, conventional control banking is limited to variation of reserve requirements and moral suasion."

Johnson (1983, p.550) argues that among other instruments, reserve requirements is used in the developing countries to control bank credit. According to Johnson, the monetary authorities can resort to this weapon in order to influence the composition of the commercial banks'

portfolios. Thus, banks whose portfolios conform to the requirements of certain prescribed "high-priority" areas are allowed to maintain lower reserve ratios than the normal ratio, and vice-versa.

Therefore, the instrument of reserve ratio stands as an alternative to the open market operations when the latter are absent, or still not well developed, which are the conditions in most of the developing countries. This argument may be accepted with reservations because of the fact that open market operations is an instrument for day-to-day or week-to-week use, while the resort to the reserve ratio by the monetary authorities is assumed to occur on an infrequent basis in order to bring about large changes in the reserve positions of the commercial banks (see Chandler, 1973, p.241). Moreover, Dorrance (1965, p.275) calls that for the reserve ratio to be more effective, it must be kept at a level greater than the ratio which the commercial banks would maintain voluntarily for their working needs. This argument of Dorrance is applicable on the condition of the reserve ratio in Kuwait, as this ratio has not been changed since its imposition in June 1980 at a low level of 3%. Thus, due to the high level of the commercial banks' reserves, the reserve ratio has been absorbed by their excess reserves and had not influenced their total reserves. Moreover, since the Central Bank pays an interest on the banks' reserves in the form of CBK bills, which is more than the discount rate, the commercial banks have

considered this reserve as a sort of outlet for their investments rather than an abode for their idle money. Hence, it is not believed that the reserve ratio imposed by the Central Bank of Kuwait, would have any influence on the reserve positions of the commercial banks, for two reasons: firstly, the low level of this ratio at 3%, which is far below the normal excess reserves of the commercial banks; secondly, the stagnancy of this ratio at 3%, which negates the willingness of the Central Bank to resort to this weapon to control bank credit.

Table 8.8 illustrates the reserve positions of the commercial banks since the imposition of the reserve ratio in 1980 to 1988. The table shows that the excess reserves of the commercial banks have experienced a surplus state from 1980 to the end of 1987, which means that the required reserve ratio has been absorbed totally by the total reserves of the commercial banks that they usually maintain for their normal needs. The excess reserves show a negative sign in 1988 (-103.3) because of the low level of the total reserves of the commercial banks in this year. The reason for this condition can be attributed to the simple fact that the Central Bank ceased issuing its bills; instead, the commercial banks headed to invest their reserves in the public debt instruments. The table also shows that the commercial banks' balances of CBK bills have been in excess of their required reserves, which means that the required reserve ratio has been conformed with in the form of CBK bills since the

Table 8.8

Reserve Positions of The Commercial Banks.  
(KD million).

Year	Total Reserve 1	Required Reserve 2	Excess Reserve (1-2)	Borrowed Reserve 3	Free Reserve (1-2-3)	CBK Bills
1980	221.7	83.3	138.4	298.6	-160.2	98.3
1981	321.6	113.8	207.8	282.4	-74.6	155.3
1982	626.0	126.9	499.1	276.7	222.4	469.7
1983	372.5	131.7	240.8	334.6	-93.8	276.1
1984	323.0	136.8	186.2	359.0	-173.8	226.1
1985	329.9	135.0	194.9	328.5	-133.6	263.1
1986	288.0	133.5	154.5	264.3	-109.8	213.1
1987	160.9	138.7	22.2	245.6	-223.4	7.0
1988	42.1	145.4	-103.3	282.0	-385.3	-

Source: Central Bank of Kuwait; Quarterly Statistical Bulletin (Oct-Dec. 1985, 1988).

Central Bank pays interest on these bills. Moreover, the figures for borrowed reserve (discounted papers) reveal that the commercial banks borrow the money from the Central Bank at low discount rate and place them in the form of CBK bills since the interest rate of the latter is higher than the former. Therefore, one may argue that the required reserve is totally financed by the Central Bank, a condition which contradicts the basic objective of the reserve ratio, which is to influence the lending ability of the commercial banks and, hence, the money supply. This argument is supported by the negative positions of the free reserves of the commercial banks in Table 8.8. The free reserve stands for those reserves owned totally by the commercial banks, the equation of the free reserves is as follows:

$$\begin{aligned} \text{Free reserve} &= \text{Total reserve} - \text{Required reserve} \\ &\quad - \text{Borrowed reserve from the} \\ &\quad \text{Central Bank.} \end{aligned}$$

Therefore, the table shows that only in 1982 have the free reserves of the commercial banks marked a positive sign, which can be attributed to the shift of the local demand for bank interest-bearing deposits after the collapse of the stock market in the second half of 1982. A negative free reserve usually means that the commercial banks are fully loaned-up, but in our case, we may assume that the negative free reserves means that the Kuwaiti commercial banks are minimizing the cost of holding their excess reserve by borrowing funds from the Central Bank

(discounted papers), and keeping them as excess reserves (CBK bills) for almost the same rate of interest in order to resort to these reserves for their normal needs.

To summarise, we may conclude that the imposition of the liquidity system by the Central Bank was a necessary step in order to protect the banking system from the effect of any sudden withdrawals, since the major part of its operations consists of short-term liabilities. This system would have been more solid if the Central Bank had determined the proportional distribution of the required liquid assets that had to be maintained by the banks against their liability deposits; this condition would prevent any undesirable effects against any monetary applications.

On the other hand, the reserve ratio has been ineffective in controlling the reserves of the commercial banks since it has been maintained at a level much lower than the commercial banks would keep for their normal needs. Thus, the imposition of this ratio at 3% in 1980 can be imagined as a step taken by the Central Bank to encourage marketing of its bills. This condition negates any intention by the Central Bank to control bank credit through the use of this ratio.

However, if we conform to the argument of Dorrance (1965), that is that the reserve ratio should be fixed at a level higher than the commercial banks would usually maintain for their normal needs, the suggested ratio should not be

less than 8.5 percent, since this percentage stands for the average of the reserve that the commercial banks voluntarily maintain for their normal needs.

#### Open-Market Operations (the new instrument)

After the introduction of the public debt instruments in November 1987, the Central Bank of Kuwait has become in a better position to conduct the open market operations by selling/purchasing these instruments. Via open market operations, the Central Bank can pursue its monetary policy objective, especially that of controlling bank credit. The advantage of this weapon over other instruments is that it can be used for the day-to-day operations, thus it is considered the most effective tool in the hands of the monetary authorities in terms of controlling the lending ability of the banking system, and, hence, controlling the money supply. When the Central Bank intends to induce a monetary expansion, it can purchase the required quantity of these instruments to increase its monetary liabilities against the banking system, which would encourage them to expand their lending in the economy. On the other hand, when the Central Bank intends to curtail the lending ability of the banking system, it can sell the necessary quantity of these instruments, which in turn will diminish the available reserves of the commercial banks.

However, the effectiveness of open market operations is dependent, on the one hand, on the volume of the treasury

bills in the market; and on the other hand, on the frequency and the quantity that the Central Bank can buy or sell in order to induce the required influence. Moreover, these treasury bills are considered by local investors as alternative financial assets to local bank deposits, and to other financial assets inside and outside the local economy due to the openness of the Kuwaiti economy. Therefore, prices of these instruments are susceptible to pressure from two sources; firstly, locally, by the interest rate ceiling; and secondly, externally, by the movements of foreign interest rates. This study is nonetheless concerned with the implementation of the monetary policy for the period between 1970 to 1988, despite the fact that the one year of open market operations practice included in this period is believed to be too short a time on which to base an evaluation. In spite of that, one may notice that the direct effect of the existence of the open market operations is the considerable decline of the total reserves of the commercial banks (Table 8.8) in 1988. Furthermore, these low reserves were maintained at almost the same level until the end of 1989, which can be viewed as an encouraging sign of the Central Bank's ability to manipulate banks' reserves. The standing balance of the public debt instruments (bills and bonds) at the end of 1989 amounted to 2.2 KD billion (\$7.5 bn), which represents 46.8 percent of the total bank credit facilities granted to the economic sectors, and 20.2 percent of the total assets of the commercial banks.

Hence, one may assume that the volume of the treasury bills traded in the financial market is large enough to serve as a base for the open market operations. On the other hand, with regard to the yields and prices of the public debt instruments, it is assumed that they will be determined according to the market forces, with the necessary interventions by the Central Bank. Thus, and due to the recent amendment of the interest-rates structure (Chapter 6), the Central Bank can alter the discount rate in order to adjust the competitive conditions between these instruments and other financial assets inside and outside the economy.

To conclude, we stress again the point that more time is needed for useful evaluation on the use of the open market operations by the Central Bank in pursuing its objectives. Nevertheless, one may assume that the existence of the public debt instruments in the financial market would certainly exert some advantages in the financial market in particular, and in the economy in general. These advantages can be summarised in the following points:

1. Through the open market operations the Central Bank can exert more control on the monetary stock via influencing the reserve positions of the commercial banks.

2. The existence of the public debt instruments will develop the financial market and add more financial instruments in this market. This condition will absorb the excess liquidity in the economy, and hence reduce capital outflow towards foreign markets.

3. Through its management of the public debt instruments, the Central Bank can influence local interest rates, and hence reduce the pressures on both the interest-rates structure and the exchange rate policy.

4. The Central Bank, by using the open market operations - via manipulating the yields and prices of the public debt instruments - can combat any speculative trends in the stock market, and protect the local economy from crises similar to those which occurred after the collapse of the stock market in the second half of 1982.

#### Development of The Financial Market

The developing of the financial market in general and the banking sector in particular, has been assigned as an objective to the monetary policy in the developing countries. This task was postulated in both the Charter of the Central Bank of Kuwait and the literature concerning this issue in the developing countries (Chapter 5). The importance of a well-developed financial market to the monetary policy is based on the assumption that through this market the monetary authorities can pursue their monetary policy, and pass on the required effects to the real sector in the economy. In this context, we believe that Chapter Three has presented a fair view of the developing of the financial market in Kuwait, which will assist in evaluating the role of the Central Bank in this regard. Nevertheless, for further investigation, two measures are presented in this section to trace the

evolution of the banking system. The first is the growth of banking services, measured by the coverage of banks' branches to the growth of the population; and the second is the evolution of the activities of the main financial institutions operating in the economy, namely, the commercial banks, the specialized banks, and the investment companies.

Table 8.9 illustrates the coverage of the commercial banks' services in the country, measured by the share of population (per thousand) of one bank branch. At the first glance at the table, one may notice that the number of the commercial banks has only increased by one bank in 1977. This condition can be attributed to the conviction held by the monetary authorities that the Kuwaiti economy does not need large numbers of banks, since this would affect the profitability of the existing banks and would hinder their expansion. Instead, the monetary authorities prefer to encourage these banks to increase the number of their branches in order to provide the whole country with banking services. In this respect, one should admit that this policy of the monetary authorities has succeeded for the banking services reach almost every one in the country. This progress is encouraged by two factors: firstly, the small inhabited area of the country, and secondly, the small population of the country. However, the table shows that the spread of the bank branches has considerably evolved, from 72 branches in 1970 to 173 branches at the end of 1988, recording a

Table 8.9

Growth of Commercial Banks' Branches (1970-1988).

Year	Number of Banks	Number of Branches *	Labour force per one Branch	Population per one Bank Branch (Thousand)	Total Labour Force (Thousand)	Total population (Thousand)
1970	5 **	72	3364	10259	242196	738662
1971	5	75				
1972	5	78				
1973	5	81				
1974	5	85				
1975	5	91	3347	10932	304582	994837
1976	5	94				
1977	6	102				
1978	6	111				
1979	6	115				
1980	6	122	4029	11131	491509	1357952
1981	6	125				
1982	6	134				
1983	6	143				
1984	6	152				
1985	6	160	4189	10608	670385	1697301
1986	6	166				
1987	6	169				
1988	6	173				
Growth Rate %		5.0			5.8	4.7

\*: Including head offices.

\*\*: Including one foreign commercial bank.

Source: Central Bank of Kuwait,  
Annual Statistical Abstract;  
Ministry of Planning, 1970-1985.

growth rate at 5.0 percent, which almost conforms to the growth rate of both the total labour force and the total population. Moreover, before the inception of the Central Bank, and exactly in 1965, the total number of bank branches (including head offices) was 24. This number increased to 72 branches in 1970, just two years after the inception of the Central Bank. This rapid expansion of the commercial banks' branches in the early stage of the existence of the Central Bank proves its concern for the development of the banking system, which led to improvements in banking habits in the economy and a strengthening of the relationship between the various sectors in the country and the banking system. The wide spread of bank offices throughout the country has also encouraged the saving trend among the society and eased the gathering of these savings by the financial intermediaries in order to transfer them to the borrowers.

Table 8.10 contains combined items of the consolidated balance sheets of the main financial institutions in the country (commercial banks, specialized banks, and investment companies). This table is dedicated to reveal the progress of these financial institutions in the local economy, on one hand, and as evidence of the role of the monetary policy in developing the financial market, on the other. First of all, the table shows that the total assets and liabilities of the financial institutions have grown considerably from 1711.5 KD million in 1975 to 14596.1 KD million in 1988, almost sevenfold and at a

Table 8.10

Growth of The Financial Institutions.  
(KD million).

Description	Year				Growth Rates
	1975	1980	1985	1988	
Local Investments	806.6	3769.0	7176.5	8030.0	33.3
Foreign Investments	706.4	2680.4	3439.5	3899.9	23.8
Other Assets	114.8	1044.6	1801.9	2451.7	46.6
Capital & Reserves	198.0	912.1	2103.9	2613.8	38.1
Private Liabilities	1050.2	3391.5	4947.1	7222.2	27.1
Government Deposits	87.3	345.6	857.7	649.1	28.5
Foreign Liabilities	174.0	1653.5	2152.5	1956.3	35.3
Other Liabilities	202.0	1602.2	2811.4	3772.7	44.2
Total Assets And Liabilities	1711.5	7768.0	12872.6	14596.1	17.9

Source: Central Bank of Kuwait, Quarterly Statistical Bulletin (Oct.-Dec. 1988), Annual Economic Reports, 1976, 1985, 1988.

growth rate of 17.9 percent. The local investments of these institutions have accelerated ninefold, recording a growth rate at 33.3 percent, while their foreign investments have registered a growth rate of 23.8 percent. This condition reflects the growing of local profitable opportunities before these institutions. The percentage of local investments to total assets has increased from 47.0 percent in 1975 to 55.0 percent in 1988, while the percentage of the foreign investment has declined from 41.0 percent in 1975 to 26.7 percent in 1988. Moreover, the owned funds of these institutions, in the form of capital increase or retained reserves, have recorded a considerable growth rate at 38.1 percent, and the percentage of this item to total liabilities has increased from 11.6 percent in 1975 to 18.0 percent in 1988.

The foreign liabilities of the financial institutions has also increased during the same period, recording a growth rate of 35.3 percent. The proportion of these liabilities to the total liabilities of the financial institutions has increased from 10.0 percent in 1975 to 13.4 percent in 1988, which reflects the growing relations between the local financial institutions and those in foreign international markets, in spite of the crises faced by the local economy after the collapse of the stock market in 1982, and the effects of the Gulf War. On the other hand, the local liabilities have also increased from 1050.2 KD million in 1975 to 7222.2 KD million in 1988. Furthermore, the government deposits with these

institutions have increased from 87.3 KD million in 1975 to 649.1 KD million in 1988. The increasing trend of the government deposits can be attributed to two main reasons; firstly, to help the financial institutions to overcome their liquidity difficulties which occurred from time to time, and secondly, to encourage these institutions (especially the specialized banks) to supply their credit to some productive sectors such as Industry and Agriculture, since some of the financial institutions might consider loans to such sectors to be less profitable.

By and large, and according to the foregoing interpretation of Tables 8.9 and 8.10, one may conclude that the policy of the Central Bank has successfully achieved a good record in developing the financial sector.

C H A P T E R        N I N E

FINDINGS AND RECOMMENDATIONS

This chapter will be concerned with the recapitulation of the main findings of the study, and in the light of those findings, the necessary recommendations are presented. Such recommendations are assumed to enhance the role of monetary policy to achieve its objectives in the long run, and to improve the Central Bank manipulation of its instruments of control in the short run. Therefore, and before discussing the findings, we recall the main objectives of the monetary policy in Kuwait from Chapter Five. These objectives are the following:

1. To regulate bank credit in terms of channelling savings into the productive units of the economy.
2. To maintain the stability of the exchange rate of the Kuwaiti Dinar.
3. To develop the financial market in general and the banking sector in particular.

Although these objectives are long-term ones and their achievement will be judged on this assumption, the recommendations will also contain those of a short-term nature. Thus the interrelation between the short and the long-term objectives is assumed strong, since the outcome of any long-run operations is the outcome of a series of short-run operations. As the period of this study is

lengthy, running from 1970 to 1988, this has the advantage of enabling us to judge the objectives of the monetary policy in Kuwait on a long-term basis. This is especially appropriate given the developing nature of the Kuwaiti economy.

### Main Findings

Due to the nature of the Kuwaiti economy which depends totally on oil revenue on one hand, and on the outside world to import its needs of goods and services on the other, the government has played a prominent role in the local economy, because of its total ownership of the oil industry. By contrast, the overdependence of the Kuwaiti economy on the rest of the world for imports, produced a persistent deficit in the non-oil private sector balance of payments. This deficit is offset by the government through its public expenditure injection in the local economy. Therefore, the small open economy of Kuwait has been subject to external pressures and shocks from all directions. However, the responses and initiatives of the private sectors to the development plans of the government have shown different patterns. In some sectors such as construction, re-export, imports, and financial services, there has been a remarkable growth, while in other sectors such as industry and agriculture, the data show that their shares in the GDP are still marginal, in spite of the encouragement by the government. Furthermore, this marginal share of some economic sectors

is attributed to the absence of any control by the Central Bank over the credit policies of the commercial banks.

There has been no evidence of the Kuwaiti economy suffering from unemployment problems within the Kuwaiti population, since the major portion of the labour force consists of expatriates. On the other hand, the stability of prices to a large extent is beyond the influence of local authorities, since they are mainly determined in the economies of the exported goods. Nevertheless, the increase of the money stock resulting from expansionary bank credit, especially to finance the activities in the stock market and real-estate, could produce inflationary trends in the economy and push up the prices.

During several years immediately after its inception, the Central Bank concentrated its efforts to develop the banking system rather than to control the money supply, or ration bank credit. Therefore, more banking services were provided to the society by establishing more banks and increasing the branches of the existing banks. During this period, moral suasion was the only approach adopted by the Central Bank to pass its directives to the commercial banks. However, in 1977 the Central Bank was given more power in controlling the banking system, and its supervision over the commercial banks was enlarged. Moreover, the balance sheet of the Central Bank has shown a remarkable growth during the period from 1970 to 1988, especially in its holding of foreign assets, which

represent the main source of its monetary liabilities with two exceptions in 1987 and 1988. This is because the Central Bank depends totally on the government to obtain its foreign currencies against issuing the local currency. Therefore, when the government lessened its transfer of foreign currencies to the Central Bank during the above mentioned two years because of the decline of its oil revenue, and its unwillingness to liquidate some of the foreign investment, the Central Bank was placed in a difficult position as it has to meet the local demand for foreign currencies, and to maintain enough balances of foreign holding to meet its international obligations.

The consolidated balance sheet of the commercial banks has experienced a considerable growth during the period of this study, which reflects the enlargement of their activities. Nevertheless, in spite of the evidence that their foreign investment has declined in favour of investment in the local economy, there is strong evidence for unfair distribution of bank credit among the various sectors in the economy, especially to industry and agriculture, while personal credit occupied an outstanding portion of the total credit facilities. This discretion of the commercial banks, in addition to its implication for inflation, reflects the mismanagement of their credit policies on the grounds that extending loans on a personal basis as credit facilities, and renewing them annually, will delay their settlement and expose the commercial banks to liquidity problems. These liquidity problems

have induced the Central Bank to inject more funds into the banking system through its monetary instruments, and hence distort the effective use of these instruments of control.

On the other hand, and in spite of the fact that the specialized banks were established to serve some specific productive sectors, these banks have failed to raise funds from local private sources, in order to invest them in long-term projects in the local economy. Therefore, the specialized banks have resorted to their own funds and government deposits to finance the needs of those sectors such as industry and agriculture.

The money market in Kuwait is still simple with few instruments. The major activity in this market is dominated by the inter-bank operations.

The Stock Market has faced two severe shocks, in 1976 and 1982, and both of them followed hectic speculations. Although the consequences of the latter were considered more destructive to the economy, the Central Bank - for its failure to control bank credit, and the commercial banks - for their expansionary credit behaviour, are both held responsible for these crises.

The behaviour of the money stock in its broad definition is influenced by local and external factors, which make the task of the monetary authorities more problematic if they decide to control the quantity of money as a target. However, it has been evidenced in this study that this is

not the case; instead the Central Bank has been involved to pursue another target, which is to keep and to defend low lending interest rates. Nevertheless, the local influence on the money supply is generated mainly from the commercial banks through their credit, and from the government through its expenditure. The econometric model presented in Chapter Four has also significantly proved that the Central Bank, through its monetary policy instruments, has participated in expanding the money stock. On the other hand, the external influence on the money supply is mainly exerted by the outflow of funds, which is induced by the movement of foreign interest rates.

Furthermore, the model has also demonstrated that foreign interest rates have a negative effect on the demand for interest-bearing deposits, which affects the availability of funds within the banking system and exerts pressure on its liquidity position. The speculative activity in the stock market has proved to have a two-directional effect on the demand for money. In one phase, the Stock Market activity is positively related to the demand for sight deposits, since this demand reflects the demand for bank credit, and in the other phase, the Stock Market activity is negatively related to the demand for interest-bearing deposits, as the financial assets in the Stock Market represents an alternative opportunity to bank deposits. Moreover, the cash money is mainly held for transaction purposes and increases positively with prices, which

indicates that there is a reasonable portion of the public which prefer to hold cash to discharge their purchases. Nevertheless, there is evidence that the interest rate on bank deposits (represented by the movement of quasi-money) is negatively related to the demand for cash money, which indicates the existence of growing investment habits.

Since Kuwait has a small open economy, with no restrictions on capital movement, the conflict between the tendency of providing cheap money to the productive sectors by imposing a ceiling on the price of bank credit, and the influence of foreign interest rates on the local liquidity, had led the Central Bank into a dilemma. Therefore, in order to defend the ceiling, and to make bank credit available to meet local demand, the Central Bank devoted all its instruments of control to temper the negative effects resulting from the external pressures. Hence, the Central Bank diverted its attention from controlling the behaviour of the monetary stock to defending the interest-rate structures.

This study has shown that the applications of the interest rate policies have been in favour of the borrowers rather than the depositors until December 1988, when the Central Bank imposed the ceilings on bank deposits. These tendencies are triggered by the willingness of the local authorities to stimulate the real investment in the economy, and by the growing trend of private savings coming into the banking system. On the other hand, the imposition of the ceiling had led to contrary results due

to the capital outflows during the periods when foreign interest rates reach higher levels. Moreover, the imposition of the ceiling on lending rates has failed to provide bank credit to some important economic sectors such as industry and agriculture. It also failed to prevent the commercial banks from violating those ceilings, since they can do so by imposing extra rates against what is called "administrative services", or by deducting the amount of interest rate in advance.

An effort was made in December 1988 to curb the outflow of funds towards foreign markets, when the Central Bank introduced a new interest-rates structure, by which ceilings on both lending and deposit rates were imposed. All interest rates included in this structure are connected to one single discount rate, which can be altered by changing the discount rate by the Central Bank. This effort is believed to succeed in curbing the outflow of funds by changing the local discount rate according to variations in foreign interest rates. But, since curbing the capital outflow will be swallowed by the government through selling its public debt instruments, the availability of bank credit to meet the needs of some productive sectors will remain questionable. Furthermore, the increasing trend of government expenditure along with its increasing borrowing requirements, will initiate fears concerning the competition between the needs of the government and the private sector over the national savings.

By pegging the exchange rate of the Kuwaiti dinar to a basket of currencies, the Central Bank has succeeded in maintaining the stability of the exchange rate of the Kuwaiti dinar, and reduced the effect of the imported inflation on prices in local currency. The three tests carried out in Chapter Seven have suggested that by following the choice of the basket peg against the alternative peg of a single foreign currency (the United States dollar), the country has paid less for its imports, and depleted less from its foreign reserve during the period from 1975 to 1988. Moreover, maintaining the stability of the Kuwaiti dinar is of great importance due to the undesirable impacts of both appreciation and depreciation of the local currency on the economic conditions. On the other hand, the stability of the Kuwaiti dinar against other major currencies has encouraged the capital outflow towards the foreign market. The secrecy surrounding the components and weights of the foreign currencies included in the basket, produces doubts about whether the announced exchange rate of the Kuwaiti dinar is determined by the mechanism of the basket, or whether it is policy-oriented in favour of the Kuwaiti conditions; however, the latter is believed to be the case.

The discount operations were practised to help the commercial banks to overcome their liquidity shortage by injecting more money into the banking system along with the help of other instruments such as swap operations and

direct lending. Hence, there has been no evidence that the Central Bank has employed the discount rate, or its rate of direct lending, to control the reserve position of the commercial banks in order to influence their credit creation ability. Moreover, these rates were not used in such a way as to influence the monetary conditions as indicators to any future tendencies of the monetary authorities. The discount rate was not employed to encourage, or discourage, the commercial banks to grant their credit to some favourable productive sectors, in spite of the fact that this employment is included in the discount agenda. In general, the lending policy of the Central Bank is influenced by the tendency to temper the impact of the capital outflow on local liquidity, and to support the interest-rate structures. Furthermore, by introducing the swap operations, the Central Bank took the responsibility to bear the exchange rate risks in order to allow the commercial banks to adjust their liquidity positions.

The introduction of the Central Bank bills in 1979 has succeeded in attracting the commercial banks to keep their excess reserves with the Central Bank, since the latter pays interest on these reserves, which is more than the discount rate. This instrument has also succeeded in regulating the liquidity within the banking system, as the commercial banks can negotiate these bills among them, or return them to the Central Bank when they are in need of money. However, the Central Bank has failed to create

the open market operations by depending on its bills because part of these bills is compulsorily kept by the commercial banks as part of their liquidity ratio, and because the trading of these bills is only confined to the commercial banks and investment companies. Moreover, the low interest rates paid on these bills compared with yields on other assets in the market, and because the Central Bank cannot take the initiative to sell or buy these bills in the market, makes the reliance on these bills to conduct the open market operations impractical.

Since the main objective of the liquidity system imposed by the Central Bank is to protect the solvency of the commercial banks, the system does not include a cash ratio that the latter should keep against their more liquid liabilities such as demand deposits. Another shortcoming of the liquidity system is that it does not determine the ratios of different liquid assets that the commercial banks should maintain against their various deposit liabilities, whereby the commercial banks can offset any monetary application induced by the Central Bank as discussed in Chapter Eight.

The evidence shows that the Central Bank has neglected to manipulate the reserve-requirement ratio since its introduction in 1980. The inefficiency of the reserve ratio is due to its low level at 3.0 percent, which is far below the reserve that the commercial banks usually maintain for their normal needs, and to its being left unchanged, which suggests the unwillingness of the Central

Bank of Kuwait to resort to this weapon as a policy instrument.

Finally, we may say that the introduction of the public debt instruments in November 1987 is an encouraging sign in terms of developing the financial market in the country, and a good opportunity for the Central Bank to enter the open market operations.

### Recommendations

In the light of the above findings, the following recommendations are presented. The merit of these recommendations is to enhance the use of the monetary policy instruments available to the Central Bank to achieve its stated objectives, especially those concerned with controlling bank credit in a manner that leads to the development of the various productive sectors, and to avoid turbulent crises such as resulted from the collapse of the stock market in 1982.

1. Due to the prominent role of the government in the Kuwaiti economy, we call for closer coordination between the Central Bank and the Finance Ministry. Such coordination would strengthen the role of the Central Bank beyond its present advisory level. For example, the view of the Central Bank in matters like establishing new financial companies, and concerning monetary questions, should be totally left to the decision of the Central Bank.

2. More room should be given to the Central Bank to participate in the formation of the government development plans.
  
3. The Central Bank should be given more independence in its relations with the government, and the influence of the Finance Ministry should be reduced to the minimum level possible. Therefore, the entire authorities of the Finance Ministry stipulated in the Central Bank's Charter should be reviewed starting from its control over the Board of Directors and extending to its influence on the salary scales. However, two main urgent areas should be focussed on. Firstly, the Central Bank should be allowed to build up its own KD reserve to the level necessary to conduct an effective monetary policy. Secondly, it should manage at least part of the foreign reserve of the State. This management will enable the Central Bank to control the main source of its monetary liabilities, and isolate this resource from the influence of the oil revenue, which depends on external factors.
  
4. Special attention should be paid by the Central Bank to forming a credit policy scheme to control the credit behaviour of the commercial banks. Such policy would concentrate on the distribution

of bank credit among the economic sectors, and protect the Kuwaiti economy from internal shocks such as the one which resulted from the hectic speculation in the stock market in 1982.

5. The Central Bank should take the lead in encouraging the financial institutions to promote more financial instruments in the market. This will help to absorb the excess saving over the needs of the productive sectors, and will combat the capital outflow.
6. The local interest rates should be freed from the ceiling imposed, and left to be determined by market forces. This policy is seen as more appropriate to the open nature of the Kuwaiti economy.
7. The discount rate should be used actively to influence the ability of the commercial banks to extend credit and the distribution of their loans among the productive sectors in the local economy. Hence, the discount rate must be disconnected from the interest-rates structure.
8. The reserve ratio should be reactivated and used in its orthodox way to influence the total reserve of the commercial banks. The first step to pursuing this objective is to

raise the reserve ratio to the level that the commercial banks maintain for their usual needs. The suggested level is 8.5 percent of their total deposits.

9. The liquidity system should be amended to include a cash reserve ratio, and to support the active role of the reserve ratio. Thus the ratios of the liquid assets that the commercial banks should keep against their deposit liabilities must be clearly determined to prevent them from offsetting the effects of manipulating the reserve ratio by the Central Bank.

At the end of this study, and precisely when the first draft of this Chapter is written, in October 1990, nearly three months after the Iraqi invasion of Kuwait, along with my hope to see a quick end to this invasion, I expect that the role of the government expenditure will be even more vital for the Kuwaiti economy in the future - to rebuild what has been destroyed during the Iraqi occupation. However, one must hope that the monetary policy will not be left behind during the recovery period.

Finally, for further research, one may suggest that the role of public expenditure in economic development in Kuwait is a useful study to be carried out. Another

topic for research is the role of the banking system in the economic development of the country, and the extent to which it has facilitated or hindered domestic growth. This present study should hopefully be useful for those researching in these areas, as monetary policy has an important bearing on such issues.

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STATISTICAL APPENDIX.

Quarterly Data Used in  
The Econometric Model in Chapter Four (KD million).

List of abbreviations:

- C = Currency in circulation.  
SD = Sight deposits.  
QM = Quasi-money.  
Ms = Money supply (currency in circulation  
+ sight deposits + quasi-money).  
CR = Credit facilities of commercial banks.  
IM = Imports.  
DISC = Discounted papers at the Central Bank.  
LIR = 3 months inter-bank interest rate (percentage).  
FIR = Euro-dollar 3 months interest rate (percentage).  
VTS = Value of traded shares.  
GDP = Non-oil Gross Domestic product.  
CPI = Consumer price index (base year 1978).  
WS = Wages and salaries of government employees.  
GDE = Government domestic expenditure.  
DD = Dummy variable for stock market boom.

STATISTICAL APPENDIX.

Period	C	SD	QM	Ms	CR	IM	Disc	LIR %	FIR %
1970									
Q1	46	66	233	345	128	15	-	-	9.4
Q2	46	62	255	363	130	15	-	-	8.9
Q3	42	57	256	354	134	13	-	-	8.3
Q4	45	54	263	362	137	15	-	-	7.5
1971									
Q1	44	62	266	371	139	17	-	-	5.5
Q2	46	61	283	390	138	17	-	-	6.8
Q3	44	64	276	385	140	15	-	-	7.8
Q4	50	63	305	419	147	20	-	-	6.3
1972									
Q1	55	86	292	433	151	17	-	-	5.6
Q2	60	80	345	485	155	17	-	-	6.9
Q3	57	81	343	481	155	11	-	-	8.8
Q4	57	90	346	494	176	21	-	-	9.0
1973									
Q1	61	110	340	510	169	61	-	-	7.7
Q2	71	94	348	513	190	65	-	-	8.5
Q3	66	103	359	529	218	62	-	-	11.0
Q4	71	101	364	536	248	77	-	-	10.1
1974									
Q1	74	112	421	607	273	79	-	-	9.0
Q2	76	111	460	647	317	96	-	-	11.4
Q3	79	106	508	693	332	94	-	-	13.1
Q4	81	114	489	685	352	122	-	-	10.5
1975									
Q1	86	126	449	661	358	134	1	-	7.5
Q2	94	165	509	767	377	134	6	-	6.5
Q3	94	169	560	824	407	149	-	-	7.1
Q4	102	189	601	891	464	178	5	-	6.8
1976									
Q1	106	242	616	964	543	162	3	-	5.5
Q2	114	288	699	1101	634	210	-	-	5.9
Q3	117	271	758	1145	757	194	5	-	5.7
Q4	129	265	827	1220	849	247	2	-	5.3

STATISTICAL APPENDIX.

Period	C	SD	QM	Ms	CR	IM	Disc	LIR %	FIR %
1977									
Q1	137	287	888	1313	882	294	7	6.3	5.1
Q2	146	309	966	1421	966	291	6	5.9	5.6
Q3	143	304	995	1443	1039	278	27	5.8	6.2
Q4	151	340	1078	1569	1073	246	21	5.6	7.1
1978									
Q1	160	389	1062	1611	1010	233	6	5.0	7.3
Q2	167	428	1129	1722	1103	289	2	5.1	7.8
Q3	178	416	1196	1791	1196	358	10	5.2	8.7
Q4	177	422	1319	1918	1375	320	31	6.2	11.1
1979									
Q1	189	411	1388	1987	1511	272	65	7.2	10.9
Q2	190	442	1407	2039	1640	281	103	8.1	10.3
Q3	212	474	1561	2248	1833	280	124	8.2	11.7
Q4	216	411	1663	2290	1918	339	195	10.6	14.7
1980									
Q1	224	432	1828	2484	2028	291	186	10.9	17.1
Q2	224	500	1909	2632	2075	355	233	10.1	11.2
Q3	237	501	2021	2759	2258	360	222	9.3	12.1
Q4	251	418	2188	2858	2419	454	299	13.4	17.11
1981									
Q1	249	503	2224	2975	2541	288	281	11.4	16.3
Q2	262	683	2441	3386	2690	386	279	10.3	17.5
Q3	264	663	2598	3526	2887	374	266	9.2	18.4
Q4	285	930	2668	3883	3173	460	282	9.7	13.8
1982									
Q1	311	1216	2679	4205	3661	486	270	9.3	15.0
Q2	325	1282	2656	4263	3873	552	257	11.8	15.0
Q3	335	851	2927	4113	4029	469	263	12.2	12.0
Q4	343	837	3003	4183	3897	479	277	7.7	15.5
1983									
Q1	353	892	2973	4218	3824	461	239	5.9	9.2
Q2	368	914	2986	4268	3738	451	296	6.9	9.3
Q3	328	826	3066	4221	3753	427	295	7.9	10.1
Q4	341	773	3254	4368	3844	496	335	7.3	9.9

STATISTICAL APPENDIX.

Period	C	SD	QM	Ms	CR	IM	Disc	LIR %	FIR %
1984									
Q1	348	722	3274	4344	3889	484	310	7.2	10.1
Q2	383	645	3236	4264	4055	511	405	9.0	11.4
Q3	317	637	3368	4322	4111	386	384	10.5	11.9
Q4	325	589	3583	4497	4109	410	359	8.9	9.8
1985									
Q1	327	579	3616	4522	4141	447	421	8.8	9.0
Q2	345	597	3665	4607	4175	457	410	7.6	8.2
Q3	319	586	3684	4589	4198	426	383	7.0	8.1
Q4	328	560	3556	4444	4199	455	409	7.0	8.1
1986									
Q1	347	582	3503	4432	4239	428	387	7.2	7.9
Q2	352	580	3516	4448	4263	439	399	7.9	7.0
Q3	335	589	3667	4591	4303	395	359	7.6	6.2
Q4	337	585	3640	4562	4330	450	407	7.4	6.1
1987									
Q1	333	632	3520	4485	4360	387	333	6.6	6.3
Q2	354	603	3697	4654	4613	359	309	6.2	7.1
Q3	335	568	3801	4704	4640	343	295	5.8	7.2
Q4	338	637	3799	4774	4626	387	333	5.7	8.0
1988									
Q1	343	590	3977	4909	4585	393	338	4.8	7.0
Q2	349	621	3850	4820	4620	367	316	6.2	7.4
Q3	335	608	3855	4798	4675	325	280	6.2	8.3
Q4	342	550	4200	5092	4697	407	350	7.2	9.0

STATISTICAL APPENDIX

Period	VTS	GDP	CPI	WS	GDE	DD
1970						
Q1	-	100	-	-	-	0
Q2	-	104	-	-	-	0
Q3	-	95	-	-	-	0
Q4	-	109	-	-	-	0
1971						
Q1	-	117	-	-	-	0
Q2	-	121	-	-	-	0
Q3	-	111	-	-	-	0
Q4	-	126	-	-	-	0
1972						
Q1	-	135	-	-	-	0
Q2	12	140	-	-	-	0
Q3	22	128	-	-	-	0
Q4	55	146	-	-	-	0
1973						
Q1	25	150	-	-	-	0
Q2	83	155	-	-	-	0
Q3	162	142	-	40	71	0
Q4	74	162	-	50	103	0
1974						
Q1	45	195	-	52	126	0
Q2	40	202	-	54	106	0
Q3	13	184	-	55	142	0
Q4	10	211	-	76	170	0
1975						
Q1	15	253	-	78	165	0
Q2	87	262	-	72	158	0
Q3	62	239	-	63	132	0
Q4	248	274	-	70	162	0
1976						
Q1	169	324	-	73	197	0
Q2	306	336	-	81	240	0
Q3	331	307	-	80	195	0
Q4	146	351	-	86	233	0

STATISTICAL APPENDIX

Period	VTS	GDP	CPI	WS	GDE	DD
1977						
Q1	68	387	-	92	294	0
Q2	149	402	-	102	344	0
Q3	73	366	-	101	269	0
Q4	53	419	-	106	320	0
1978						
Q1	246	429	-	106	391	0
Q2	306	445	-	118	420	0
Q3	572	406	-	86	325	0
Q4	289	464	-	113	375	0
1979						
Q1	515	597	105.9	136	445	0
Q2	307	619	106.4	115	416	0
Q3	800	565	107.5	131	338	0
Q4	244	646	108.4	158	567	0
1980						
Q1	235	653	111.4	169	447	1
Q2	575	677	113.7	157	659	1
Q3	433	618	114.9	143	555	1
Q4	82	707	117.8	186	515	1
1981						
Q1	389	706	120.1	178	574	1
Q2	647	732	122.7	187	848	1
Q3	328	668	123.2	132	612	1
Q4	629	764	125.6	185	692	1
1982						
Q1	523	848	127.9	171	698	1
Q2	670	880	132.2	189	682	1
Q3	231	803	133.9	159	513	0
Q4	517	918	135.9	239	622	0
1983						
Q1	209	761	138.1	201	744	0
Q2	151	790	138.4	220	779	0
Q3	106	721	139.0	171	591	0
Q4	46	824	139.4	245	682	0

STATISTICAL APPENDIX

Period	VTS	GDP	CPI	WS	GDE	DD
1984						
Q1	12	733	139.7	216	743	0
Q2	56	760	140.4	244	728	0
Q3	7	694	140.6	147	574	0
Q4	42	794	140.8	164	700	0
1985						
Q1	16	700	142.3	172	686	0
Q2	15	726	142.4	147	822	0
Q3	52	663	142.2	159	652	0
Q4	34	758	142.8	180	696	0
1986						
Q1	61	823	143.8	179	664	0
Q2	18	854	143.7	185	763	0
Q3	127	779	144.0	171	518	0
Q4	169	891	143.6	189	696	0
1987						
Q1	334	891	144.6	188	600	0
Q2	178	925	145.0	179	643	0
Q3	160	844	145.3	131	522	0
Q4	158	965	144.1	246	716	0
1988						
Q1	83	878	145.5	197	586	0
Q2	198	911	147.3	199	665	0
Q3	288	830	147.0	190	607	0
Q4	158	950	147.2	203	602	0

