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Statement by Shakour Shaalan, Executive Director for Kuwait
March 10, 2006

1. On behalf of the Kuwaiti authorities, we thank staff for a well-balanced set of reports, which evaluate Kuwait's policy options for consolidating macroeconomic stability, while providing a comprehensive review of strategies aimed at fostering medium- and long-term growth.

Recent Developments

2. Buoyant oil and non-oil activity over the past twelve months undeniably strengthened Kuwait's already solid macroeconomic performance further. This performance was coupled with subdued inflation, and exceptionally high fiscal and external surpluses. As a result, per capita GDP increased to more than US$26,000, assets for future generations continued to buildup, and Kuwait consolidated its remarkably strong net external creditor position. At the same time, domestic private investment as a share of GDP increased markedly, equities continued to increase strongly, and unemployment remained low despite the growing labor force. Alongside favorable oil market developments, which have helped in entrenching Kuwait's strong performance, sound economic policies, as well as prudent management of hydrocarbon revenues over time have been major contributors.

3. Looking forward, the medium-term outlook for the Kuwait economy remains strong. This is due to the determination to maintain sound macroeconomic policies and a prudent investment policy of oil proceeds in external assets. These policies contributed largely to reducing Kuwait's vulnerability to international oil price volatility. The Kuwaiti authorities are determined to take advantage of the remarkable oil revenues induced windfall opportunity to launch reforms aimed at achieving sustainable high rates of GDP growth in the medium- and long-term. These include efforts aimed at productively diversifying the economy, reforming the labor market to encourage private sector employment and reduce the role of the public sector, achieving long-term fiscal consolidation, and providing an enabling environment for private sector-led growth.

Supporting Oil Price Stability

4. Kuwait is well aware of its responsibilities as a major global oil producer, with about 8 percent of the world's proven crude oil reserves. It continued to play a constructive role in ensuring an additional supply of oil over the past years, thus supporting international oil price stability. The authorities have raised their production of crude oil by 47.5 percent since 2002 in response to the increasing global demand and are currently running almost at full capacity.

5. The authorities' readiness to support global oil market stability is reflected by launching a mega investment program of US$22 billion for expanding crude oil capacity, increasing refining capacity, almost doubling the production of petrochemical products, and boosting gas production for domestic uses. The project would be essentially financed by the Kuwait Petroleum Corporation's own resources and its joint venture foreign partners.

Fiscal Developments and Policies

6. Higher oil revenues have led to a significant strengthening of the fiscal position over the past two years, with the overall fiscal surplus estimated at 24 percent of GDP in 2004/05. In spite of increasing demands on the budget engendered by the favorable fiscal position—already manifested in higher subsidies and transfers—the authorities remain committed to fiscal prudence. This is evidenced in the steady decline, expected to continue into the future, in both current and total expenditures in relation to GDP, from 39.3 percent and 43.9 percent in 2001/2002 to 30.7 percent and 35.2 percent, respectively, in 2004/05. The composition of spending has also improved with the share of wages and salaries as well as subsidies and transfers in total expenditures declining over the same period. The prudent fiscal stance has allowed the government to accumulate substantial foreign assets, with two-thirds of the increase in hydrocarbon revenues estimated to have been saved in 2004/05.

7. The fiscal position is expected to remain exceptionally strong in the medium term. Nonetheless, the authorities remain committed on using the surplus in a manner consistent with ensuring fiscal sustainability in the medium term and intergenerational equity. To improve intergenerational equity, the Reserve Fund for Future Generations will likely continue to receive an additional contribution amounting to 5 percent of government revenues—in addition to the statutory annual transfer of 10 percent of all government revenues—provided the budget outcome remains favorable. A portion of the remaining surplus will be also utilized to increase investments in health and education and to improve physical infrastructure, within the medium-term fiscal framework expenditure program. It is worth noting that the sizable planned budget outlays are in line with Kuwait's increasing absorption and implementation capacity. On the other hand, the authorities would like to reiterate their commitment to moderate increases in the general level of wages in the economy and to stricter rules for additional recruitment in the public sector.

8. Going forward, the focus on improving the structure of the budget and expenditure management will be maintained. The authorities recognize that there is scope for rationalizing transfers and subsidies, recapitalizing the social security system, and achieving a better balance between productive expenditure and fiscal savings. They are considering the staff recommendations in this regard. The authorities are also intent on implementing planned budgetary reforms, which are now included in the five-year plan. These reforms include the introduction of a three-year rolling budget, the consolidation of the budgetary process, and the adoption of budget classifications in line with international accounting standards. Efforts are also continuing to coordinate with other GCC members the introduction of a Value Added Tax.

Monetary and Financial Sector

9. The Central Bank of Kuwait (CBK) was successful in maintaining price and exchange rate stability through continued monetary restraint. In order to ensure that money and credit growth remains commensurate with the expansion of non-oil activity, the CBK increased the benchmark interest rate in line with global interest rate developments, introduced a ceiling on the credit to deposit ratio, and recently relied upon market-based

monetary control mechanisms. These policies have resulted in a substantial increase in domestic currency deposit rates, which have risen above U.S. dollar deposit rates. Moreover, the rate of credit growth was restrained in 2004-05, which in turn contributed to moderating equity price increase, while restoring the balance between the rate of growth of credit and deposits. The authorities consider the loan-to-deposit ratio ceiling as a temporary prudential measure aimed at avoiding any emergence of credit risk that could undermine the soundness of the banking sector. Although they do not believe that the measure has interfered with the efficient allocation of bank resources, the authorities will continue to closely monitor the situation, as all local banks have met the loan-to-deposit ratio requirement and are now, with their increasing deposit base, in a position to meet the private sector financing needs.

10. The financial sector strengthened further in 2005 and played an important role in supporting non-oil private sector activity. The Kuwaiti banking system realized strong profits and considerably increased provisions coverage for non-performing loans. Banking supervision has strengthened further over the past year, foreign competition was allowed in the banking sector, in line with the recent amendment of the banking law, and the CBK applied the Basel II capital adequacy requirements for conventional banks effective December 31, 2005. The CBK is confident that these developments will further strengthen the soundness and stability of the banking system by motivating banks to apply best practices in managing and monitoring various aspects of risk. While there are clear indications that the banking system is increasingly resilient to any reasonable stock market correction, the authorities are monitoring the upward trend in the stock market index closely. In this context, accelerating the approval of the stock market and insurance sector laws, as recommended by staff, in addition to improving the banking sector transparency, remain a priority.

External Sector

11. The external current account surplus rose substantially in 2004-05 mainly due to higher oil export receipts, as non-oil exports which increased strongly in 2003, were slower on account of a decline in re-exports to Iraq. Imports remained high, on account of the strong domestic economic activity. Staff's projections indicate that a substantial external current account surpluses will continue over the medium term. Although they take comfort from these projections, the Kuwaiti authorities will maintain their efforts to diversify the production and export base in an effort to reduce the economy's vulnerability to developments in international oil markets. Several measures, aimed at allowing market access and competition in industries previously dominated by the public sector, including the telecommunications, airlines, and infrastructure sectors, were implemented. These measures included granting licenses for three airlines and four additional private universities, allowing private companies to operate gas stations, building two new power plants, completing the joint venture Boubiyan Island port project by 2008, in addition to the proposed North-South GCC train line.

12. Significant progress has been made in trade liberalization and regional integration. The GCC common external tariff at 5 percent has been in effect since early 2003, and import duties are no longer levied on products from Arab countries under the Greater Arab Free Trade Area since January 2005. Moreover, the GCC common market is projected to come