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0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/41

3:00 p.m., March 18, 1988

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Abdallah	E. T. El Kogali
	C. Enoch
	Jiang H.
C. H. Dallara	
	J. Prader
A. Donoso	E. V. Feldman
M. Finaish	
	B. Goos
J. E. Ismael	
A. Kafka	
M. Massé	D. McCormack
	C. V. Santos
	I. A. Al-Assaf
G. Ortiz	
J. Ovi	M. Fogelholm
H. Ploix	
G. A. Posthumus	
C. R. Rye	
G. Salehkhou	S. Rouai, Temporary
A. K. Sengupta	
K. Yamazaki	
S. Zecchini	

L. Van Houtven, Secretary and Counsellor
L. Collier, Assistant
K. S. Friedman, Assistant

Also Present

IBRD: P. Bottelier, Latin America and the Caribbean Regional Office. African Department: A. T. B. Taylor. European Department: M. Guitián, Deputy Director. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; J. T. Boorman, Deputy Director; E. Brau, S. Kanesa-Thasan, B. C. Stuart. External Relations Department: H. O. Hartmann. Fiscal Affairs Department: T. M. Ter-Minassian, Deputy Director; E. S. Kreis. Legal Department: F. P. Gianviti, General Counsel; H. Elizalde, A. O. Liuksila. Middle Eastern Department: H. P. G. Handy, M. D. Knight, E. B. Maciejewski, S. Thayanithy, M. Yaqub. Research Department: N. M. Kaibni. Secretary's Department: C. Brachet, Deputy Secretary, M. J. Miller. Treasurer's Department: A. J. Mathuran. Western Hemisphere Department: S. T. Beza, Director; M. Caiola, Deputy Director; J. Ferrán, Deputy Director; C. V. A. Collyns, D. N. Lachman, P. Neuhaus, F. van Beek. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: M. B. Chatah, W. N. Engert, A. G. A. Faria, K.-H. Kleine, P. D. Péroz, G. Pineau, D. C. Templeman, A. Vasudevan, J. E. Zeas. Assistants to Executive Directors: F. E. R. Alfiler, J. R. N. Almeida, A. A. Badi, H. S. Binay, E. C. Demaestri, F. Di Mauro, M. Hepp, G. K. Hodges, A. Iljas, K. Kpetigo, M. A. Kyhlberg, V. K. Malhotra, W. K. Parmena, A. Rieffel, G. Schurr, C. C. A. van den Berg, D. A. Woodward.

1. ARGENTINA - REVIEW UNDER STAND-BY ARRANGEMENT; EXCHANGE SYSTEM; AND PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors continued from the previous meeting (EBM/88/40, 3/18/88) their consideration of a letter on economic policy from the Argentine authorities (EBS/88/41, 2/24/88; and Cor. 1, 3/15/88) and a restricted staff report for the review under the stand-by arrangement for Argentina (EBS/88/41, Sup. 1, 2/26/88; and Sup. 1, Cor. 1, 3/15/88), together with a request for a purchase under the compensatory financing facility (EBS/88/42, 2/26/88; Cor. 1, 3/4/88; and Sup. 1, 3/17/88).

The Executive Board then took the following decisions:

Review Under Stand-By Arrangement

1. Argentina has consulted with the Fund in accordance with paragraph 4 of the stand-by arrangement for Argentina (EBS/87/5, Sup. 3, as approved at EBM/87/107 (7/23/87) and as amended by Executive Board Decision No. 8739, adopted December 2, 1987) and as contemplated in paragraph 26 of the Memorandum of Understanding on Economic Policy, annexed to the letter dated January 12, 1987, and in the letter dated November 12, 1987, from both the Minister of Economy and the President of the Central Bank of the Republic of Argentina, in order to review the progress made in the implementation of the program, and to reach understandings regarding the circumstances in which purchases under the stand-by arrangement can be resumed, including understandings on performance criteria relating to the implementation of policies during the remaining period of the stand-by arrangement.

2. Paragraphs 1 and 2(a) of the stand-by arrangement shall be amended to read as follows:

> 1. For the period from July 23, 1987 to September 30, 1988, Argentina will have the right to make purchases from the Fund in an amount equivalent to SDR 947.5 million subject to paragraphs 2, 3, 4, 5, and 6 below, without further review by the Fund.
>
> 2(a). Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 285.5 million until October 20, 1987; the equivalent of SDR 451.0 million until December 20, 1987; the equivalent of SDR 616.5 million until May 20, 1988; and the equivalent of SDR 782.0 million until August 20, 1988.

3. The letter of February 24, 1988 from the Minister of Economy and the President of the Central Bank of the Republic of Argentina and the Memorandum on Economic Policy annexed thereto shall be attached to the stand-by arrangement, and the letter of January 12, 1987 from the Minister of Economy and the President

of the Central Bank and the Memorandum of Understanding on Economic Policy annexed thereto, as supplemented and modified by the letter of July 8, 1987 and the letter of November 12, 1987 with attached Memorandum of Economic Policy shall be read as supplemented and modified by the letter of February 24, 1988 and the Memorandum on Economic Policy annexed thereto.

4. Accordingly, Argentina will not make purchases under the stand-by arrangement that would increase the Fund's holdings of Argentina's currency in the credit tranches beyond 25 percent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 percent of quota:

(a) during any period in which the data at the end of the preceding three-month period indicate that:

(i) the limit on the combined operational deficit of the nonfinancial public sector and the Central Bank described in paragraph 16 and Table 2 of the attached memorandum of February 24, 1988; or

(ii) the limit on the overall deficit of the nonfinancial public sector described in paragraph 16 and Table 2 of the attached memorandum of February 24, 1988; or

(iii) the limit on treasury outlays described in paragraph 16 and Table 2 of the attached memorandum of February 24, 1988; or

(iv) the limit on the change since December 1987 in net domestic assets of the Central Bank, described in paragraph 17 and Table 3 of the attached memorandum of February 24, 1988; or

(v) the targets for the change in the net international reserves of the monetary authorities, described in paragraph 23 and Table 4 of the attached memorandum of February 24, 1988, have not been met; or

(b) during any period after March 31, 1988 in which the transfer abroad of profits and dividends through the free exchange market has not been permitted or during any period in which the intentions regarding external payments arrears have not been observed, as specified in paragraph 28 of the attached letter of February 24, 1988; or

(c) if Argentina fails to observe the limits to the total outstanding disbursed external debt of the public sector and the cumulative net disbursements of short-term external debt of the public sector, as described in paragraph 29 and Table 5 of the attached letter of February 24, 1988; or

(d) during any period after March 31, 1988, unless the Fund finds that satisfactory progress toward arrangements for the financing of the estimated balance of payments deficit for 1988 has been made and that satisfactory progress on a program for the elimination of payments arrears has been made.

5. The Fund decides that the review contemplated in the letter dated November 12, 1987, is completed and that, notwithstanding the nonobservance of performance criteria referred to in paragraphs 4(a)(i) and (ii), (c), and f(ii) of the stand-by arrangement, Argentina can resume purchases under the stand-by arrangement.

Decision No. 8819-(88/41), adopted
March 18, 1988

Exchange System

Argentina maintains exchange restrictions and multiple currency practices as described in Appendix III to EBS/88/41, Supplement 1. The Fund welcomes the intention of Argentina to eliminate the restrictions evidenced by external payments arrears and the treatment of remittances of profits and dividends, and encourages Argentina to further simplify its exchange system and to eliminate the remaining exchange restrictions and multiple currency practices as soon as possible. In the meantime, the Fund grants approval of exchange restrictions and multiple currency practices of Argentina as described in Part 1 and Parts 2(b), (c), and (f), until September 30, 1988. The Fund urges Argentina to eliminate the restrictive features of the bilateral payments arrangements relating to imports of natural gas from Bolivia.

Decision No. 8820-(88/41), adopted
March 18, 1988

Purchase Transaction - Compensatory Financing Facility

1. The Fund has received a request from the Government of Argentina for a purchase equivalent to SDR 233.15 million under the decision on compensatory financing of export fluctuations (Decision No. 6224-(79/135) adopted August 2, 1979, as amended).

2. The Fund notes the representations of Argentina and approves the purchase in accordance with the request.

3. The Fund waives the limitations in Article V, Sections 3(b)(iii).

Decision No. 8821-(88/41), adopted
March 18, 1988

2. KUWAIT - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with Kuwait (SM/88/17, 1/14/88). They also had before them a background paper on recent economic developments in Kuwait (SM/88/40, 2/18/88).

Mr. Finaish made the following statement:

Since the early 1980s, there has been a marked shift in the focus and objectives of economic policy in Kuwait. In the preceding decade, the emphasis had been on rapid development of infrastructure and institutions and laying the foundations for a modern and more diversified economy. With these objectives essentially achieved and in light of the decline in oil revenue, the emphasis shifted toward consolidation and adjustment to a lower, but more sustainable, rate of growth. In addition, economic policy had to cope with the effects of the regional security situation and the collapse of the unofficial stock market (Souk Al-Manakh) in 1982.

Thus, the challenge which faced the authorities in the last few years was to formulate policies that strike a balance among divergent objectives, including (a) the need for fiscal restraint, (b) restoring confidence in the financial sector, (c) containing the slowdown in the non-oil sectors, and (d) maintaining a strong external position.

The outcome since 1983 indicates that, by and large, the authorities have succeeded in meeting these objectives. During the period 1983/84-1986/87 government expenditures declined by about 4 percent annually, and government operations were rationalized and made more efficient. The administration and safeguards of the financial sector were also strengthened, and confidence in the banking system was largely restored through the debt settlement program. The external position remained strong, and inflation was kept at a very low level. The effort to expand downstream activities in the petroleum sector also continued. Although non-oil economic activity slowed down during the period, there are indications that the downward trend has probably reached an end and may have been reversed in the last few months.

A reversal of the downward trend in non-oil GDP would be consistent with the recent moderate shift in financial policies. With the generally improved confidence in the economy, the authorities moved in 1987 to support a modest growth in non-oil activity. In the FY 1987/88 budget, net domestic spending was increased above the actual level of the preceding year, although budgeted spending was about the same in the two years. It should be mentioned in this connection that the expenditure shortfall in 1986/87 was due largely to lower subsidies and other domestic transfers, as well as slower than expected project implementation. While non-oil revenue remains relatively small, improved collection and administration in the last few years has resulted in a large increase in nontax revenue in 1985/86 and in the receipts from taxes on non-oil businesses in 1986/87. In light of the authorities' effort to support a modest growth in economic activity, no new taxes were included in the 1987/88 budget. The authorities do expect, however, that non-oil revenue will play a larger role over the medium term.

Excluding investment income, the 1987/88 budget envisages a deficit of about KD 1.4 billion. In late 1987 a modest amount of government securities was offered for the first time. While the immediate purpose of the introduction of these securities was to help finance the fiscal deficit, the broader objective was to reduce the link between fiscal spending and oil revenue, as well as to broaden the domestic financial market and improve the conduct of monetary policy. Recent reports indicate that the first four issues of government securities were heavily oversubscribed and that by early February about 70 percent of the projected budget deficit in the current fiscal year had been covered by the sale of these securities. The authorities hope that these new public debt instruments will form the nucleus of a secondary market in which the Central Bank intends to be active.

The focus of monetary policy in the last few years has been on restoring confidence in the banking system. A major problem was the large volume of nonperforming bank loans precipitated by the collapse of Souk Al-Manakh in late 1982. With the help of the authorities, a comprehensive debt settlement program was recently implemented. This program, which was well received by banks, as well as by bank debtors, was a major cornerstone in regaining confidence in the banking system. In 1987, monetary policy also aimed at complementing the moderately stimulative fiscal stance. In order to support modest growth in non-oil economic activity, short-term interest rates were reduced to 7.5 percent in March of last year. This was also facilitated by the downward trend in international interest rates and the low level of domestic inflation. At the same time, the interest rate structure was made more flexible by setting the ceiling on longer-term lending and bond rates at a margin over the Kuwait Interbank Offered Rate (KIBOR), which is responsive to market conditions.

Despite the decline in export revenue in recent years, the current account of the balance of payments continued to register a substantial surplus, reflecting the decline in imports associated with fiscal restraint and the general economic slowdown. In 1986, the overall external payments position was in approximate balance, with the current account surplus being offset by official and private sector investment abroad. The authorities expect the 1987 outcome to be comparable to that of 1986. Even if the overall balance were to register a deficit, it is their expectation that it would be smaller than the one envisaged by the staff.

Looking into the medium term, the authorities agree broadly with the staff's analysis and conclusions. It is their intention to allow only a moderate increase in government expenditures so that some growth in non-oil GDP could be achieved without compromising the balance of payments objectives.

Indeed, the achievement of specific growth targets is not given priority in the current development plan. Unlike most other countries where the main objective of development planning is to increase per capita income and employment, in the case of Kuwait a major objective is to increase the proportion of Kuwaiti nationals in the labor force and in the total population. Thus, aiming at high rates of growth would not be consistent with that objective. This is also an important factor behind the authorities' emphasis in their diversification effort on downstream petroleum activities which are capital intensive and in which Kuwait has a comparative advantage. Increasing private sector participation in the development plan continues to be an important objective, although the unfavorable regional situation has not been conducive to that in recent years.

As far as exchange rate policy is concerned, the aim has been to maintain relative stability of the dinar exchange rate and to insulate the domestic economy from large fluctuations in the external environment. Within these broad objectives, the authorities have kept the components and weights in the currency basket, to which the Kuwaiti dinar is linked, under constant review. The authorities consider the effective depreciation of the dinar in the last two years to be appropriate.

Finally, the Kuwaiti authorities continue to attach importance to regional and international cooperation. Within the Cooperation Council for the Arab States of the Gulf (GCC), efforts have increased in recent years to foster closer economic cooperation, including in the area of development planning and in harmonizing monetary, trade, and exchange rate policies. Kuwait continues to maintain a free exchange system, and the authorities intend to gradually reduce the import tariffs which had been imposed to assist certain non-oil industries. Despite the decline in oil income in recent years, Kuwait has continued to provide external development assistance on a generous scale.

Mr. Al-Assaf made the following statement:

Over the past few years, Kuwait has faced significant economic challenges that the authorities have readily addressed. In response to the drop in oil revenues, the authorities undertook a commendable rationalization of public expenditure. Although this restrained fiscal stance led to an unavoidable slowing of economic activity, it facilitated the return to a more sustainable level of domestic demand, an increase in economic efficiency, and an improvement in the quality of growth. Furthermore, the authorities' prudent management of their foreign reserve assets led to the emergence of a new source of income that has overtaken oil as the main source of foreign exchange receipts and government revenues. This achievement is commendable, as it has reduced the country's vulnerability to fluctuations in world oil markets.

Looking ahead, the main issue facing the authorities is how to consolidate the gains achieved through the recent adjustment effort while restoring growth on a more solid foundation. Given the authorities' well-placed emphasis on the private sector, the role of the authorities should simply be to set the stage for the private sector to become the main locomotive of the next development phase.

The cautious fiscal expansion that the authorities are planning to undertake in coming years will provide the needed impetus for growth and private sector investment. As the first scenario presented in the staff paper indicates, this moderate fiscal expansion will have minimal and adverse effects on inflation and the balance of payments. In addition, the recent issuance of public debt instruments will facilitate this expansion and make government expenditure even less vulnerable to short-term fluctuations in oil revenue. In this context, the authorities are certainly aware of the possible adverse implications of the increased linkages between monetary and fiscal policies resulting from commercial bank use of treasury bills to meet a part of their reserve requirement. The active involvement of the central bank in managing and monitoring securities, as noted in Mr. Finaish's opening statement, confirms the existence of this awareness.

Even with an accommodating fiscal policy, the private sector cannot be expected to significantly increase its economic role overnight or to do so without a favorable internal and external economic environment. On the domestic front, the authorities are to be commended for their bold and effective tackling of the 1982 crisis in the financial system. The debt settlement program initiated in 1986 has significantly reduced commercial bank difficulties and has revived and indeed strengthened the financial system and restored confidence in the economy. Externally, adequate world economic growth would naturally reinforce the revitalization of Kuwait's economy, which depends heavily on oil exports and investment receipts. The establishment of the Gulf Cooperation Council, and the growing cooperation among its members, also provide the Kuwaiti private sector with further avenues to increase its economic participation via wider markets and greater investment opportunities. The recent effort by the Gulf Cooperation Council to coordinate monetary, fiscal, and exchange rate policies will further promote an environment that is conducive to private sector growth.

Despite the prevailing uncertainties in the international oil market and the security problems in the region, the medium-term prospects for Kuwait seem promising. As the staff report indicates, the Kuwaiti economy will be in a position to resume growth, albeit at a low rate, without adversely affecting the external position.

The authorities have clearly perceived the difficulties facing the economy and have not shied away from effectively addressing them. The authorities are setting the stage for an economic recovery that entails a major role for the private sector, and I endorse the policies that have been adopted in this connection.

I commend the authorities for Kuwait's impressive record of development assistance despite the substantial financial challenges the country has faced.

Mr. Enoch made the following statement:

The staff paper shows that Kuwait is continuing to adjust to the difficult circumstances of the late 1980s following the unsustainable growth of the 1970s. The present rate of economic growth is much lower than the rate of previous years, and domestic economic indicators have displayed considerable volatility from year to year. In 1985, for the first time, government revenues from past investments exceeded revenues from energy production.

The authorities are to be commended for their generally creditable approach to adjustment. In particular, demand-management policies have been prudent. I agree with the staff that, at this stage, some moderate growth in spending is justified, but it is important to channel the growth to productive sectors of the economy to ensure that the needed impetus to non-oil growth will be provided. The authorities' intention to rationalize further existing expenditure is welcome, and further information on the focus of the effort would be helpful.

The authorities are clearly trying to reduce the dependence on oil revenues. However, the staff report contains only a vague discussion of the possible sources of non-oil revenue, and the 1987/88 budget appears not to include the options that the World Bank suggested during the previous Article IV consultation. Given the uncertainties in the oil market, I hope that the authorities are at least preparing contingency revenue measures, such as a sales tax.

The introduction of treasury bills and bonds is welcome, and the first such issues have been heavily oversubscribed by the banks. The new bills and bonds could become a useful revenue source and a tool for more effective liquidity management, but much depends on the establishment on a secondary market, which will undoubtedly take time.

The central bank's first steps to underpin the financial system after the collapse of the unofficial stock market in 1982 are welcome. Although costly, the difficult credit settlement facilities program introduced in August 1986 has been efficiently implemented and has done much to restore domestic confidence. I wonder whether any additional details on how this program is progressing are available. In this connection, it is important to maintain firm bank supervision, as a lengthy period of consolidation is necessary, particularly as domestic lending opportunities are likely to remain limited.

The alternative medium-term scenarios presented in the staff paper are helpful. However, it is not clear to me whether, under the second scenario, based on an increase in government expenditure, there would not also be a rapid increase in capital outflows, which would further strengthen the case for pursuing the first alternative scenario.

The scenarios suggest that the prospects for non-oil growth are merely modest. The staff should comment on the scope for diversification. Greater involvement by the Gulf Cooperation Council in drawing up the next five-year plan for Kuwait would be welcome. Closer cooperation with the Gulf Cooperation Council could help to avoid the duplication of excess capacity that seems to have occurred in the past--for example, in the cement industry.

On the external side, the assumptions behind the medium-term projections seem to be plausible. Given the uncertainties in the oil market, the staff has correctly encouraged the authorities to increase non-oil exports. In this connection, I support the authorities' intention to phase out tariff restrictions, which seem to be coming entrenched, as a way of promoting efficiency in the non-oil sector. Similarly, the recent exchange rate depreciation and continued exchange rate flexibility are appropriate.

I support the proposal to bring Kuwait under the bicyclic procedure on the basis of the timetable suggested in the staff report.

Mr. Abdallah made the following statement:

The authorities are to be commended for their traditional prudent economic management, which has made the present situation relatively comfortable despite the collapse of oil prices and of the unofficial stock market several years ago. The various indicators confirm the authorities' achievements in economic and social fields. For example, despite the high level of per capita income--in excess of $14,300--and the impressive accomplishments indicated in Mr. Finaish's opening statement in the economic and social infrastructure, the authorities aim at moderately increasing per capita income and further improving the quality of life of the Kuwaiti people through a more extensive distribution of social amenities, such as electricity, water, health, education, and housing.

However, in 1987, the Kuwaiti economy faced recessionary conditions following a sustained period in which the authorities implemented their self-designed adjustment policies. Particularly notable are the sharp cuts in government expenditure in 1986/87. Some of these cuts were intended, but as the staff explains, a large part was due to slower than expected project implementation. On the whole, however, the austerity was a prudent policy in response to the steep deterioration in oil export earnings and to the need to proceed with caution owing to the prevailing insecurity in the region. The staff report vividly illustrates the gravity of the collapse in oil prices. For example, oil export receipts fell from $19 billion in the late 1970s to $6 billion in 1986. The unfortunate security situation that continues to adversely affect the service sector of the economy has contributed to the slowing of economic activity. These factors led to a substantial declining trend in non-oil GDP over the last two years. However, as the authorities have continued to maintain sound monetary and exchange rate policies, inflation has been virtually nonexistent in Kuwait; the consumer price index has risen on average by just 1 or 2 percent.

Given the prevailing conditions in 1987, the authorities had to take courageous decisions to stimulate the economy. The authorities' firm stand to reverse the declining trend in non-oil GDP through expansionary fiscal and monetary policies is welcome. As the fiscal stimulus in 1987/88 is to be generated by a substantial reduction in the budget surplus, from an estimated 17 percent of GDP in 1986/87 to about 10 percent in 1987/88 if the budget is fully implemented, I strongly urge the authorities to strengthen project implementation capacity. In the monetary policy area, the expansionary measures introduced in March 1987--namely, the 1 percentage point reduction in the ceiling on short-term interest rates, and the introduction of greater flexibility in the long-term interest rate structure--are leading to substantial growth in credit to the private sector. While real interest rates in Kuwait remain clearly positive, the staff should comment on how competitive they are in encouraging an inflow of investment income from abroad. This matter is very important, as investment income now exceeds the value of total exports and re-exports.

Under the innovative debt settlement program, private sector nonperforming loans resulting from the collapse of the unofficial stock market have been rescheduled on very concessional terms, which should save an important part of the private sector and provide further stimulus to the economy.

For 1988-90, I fully endorse the staff recommendation that the authorities should maintain policies that will restore growth without placing undue pressure on the balance of payments. However, I would support a non-oil GDP annual growth rate in the upper end of the range of 1-2 percent. This effort might imply some continued depletion of foreign assets if oil prices remained depressed. However, the present level of gross official reserves covers more than a year's import requirements and thus still provides a reasonable cushion.

A major aim of the ongoing Five-Year Development Plan, covering 1986/87--1989/90, is to raise the proportion of Kuwaiti nationals in the national population and in the labor force from about 40 percent to parity by the end of the century. Given Kuwait's traditional hospitality, this national objective is fully understandable. The Government is to be commended for providing housing, employment, and welfare to many noncitizens from neighboring countries, particularly Sudan, Jordan, the Yemen Arab Republic, and Oman. The remittances of these workers contribute importantly to the balance of payments of their home countries. In addition, Kuwait deserves commendation for maintaining one of the highest levels of official development assistance--4 percent of GNP. Other high-income countries should emulate Kuwait's example.

Mr. Rouai made the following statement:

Like other oil exporting countries, Kuwait continues to face challenges caused by the precipitous decline in oil prices. The authorities have been relatively successful in alleviating these difficulties through appropriate expenditure restraint and rationalization reinforced by judicious management of oil revenues through the net accumulation of foreign investment. In addition, the authorities have oriented their efforts at diversifying the economic base toward promoting a non-oil sector and adapt the economy to lower oil revenues. However, since economic activity remains heavily dependent on developments in the oil sector and on government domestic expenditure, the restrained demand-management policy stance has exerted a depressive effect on the non-oil sector, resulting in the reduction in its share of GDP from 57 percent in 1982 to 42 percent in 1986.

It is against this background that the Government adopted, beginning in early 1987, more expansionary fiscal and monetary policies in order to revitalize domestic non-oil activity. The 1987/88 budget includes a substantial increase in government expenditure, aimed partly at salaries and domestic subsidies for petroleum products and food. Given the country's high per capita income, I agree with the staff that there is scope for further rationalization of some subsidies to achieve greater economic efficiency, particularly at a time when no new taxes are contemplated by the authorities.

A main feature of the economy is the growing importance of foreign investment income, which has exceeded oil revenue since 1985. This trend may be consistent with the appropriate management of large current account surpluses; however, in view of the narrow domestic market, the authorities should keep in mind the high degree of volatility of investment income; it may be as volatile as oil revenues, a conclusion that should encourage the authorities to reinforce their efforts to diversify foreign investment and expand the domestic non-oil sector. These efforts are particularly important in light of the recent events in international security and in financial markets. Staff comment on possible links between the estimated decline of investment income in 1987/88 and the October 1987 stock market crash would be welcome.

The implementation of an accommodative monetary policy combined with the introduction of the settlement program for nonperforming loans is consistent with the authorities' objective of encouraging private sector activity and of reinforcing confidence in the banking system.

I hope that Kuwait's record performance of official development assistance--averaging 4 percent of GDP in recent years--will be matched by the performance of the industrial countries, especially those with huge surpluses.

Given the favorable outlook for the balance of payments, the authorities' request to be placed on the bicyclic consultation procedure is appropriate.

The staff representative from the Middle Eastern Department said that the staff agreed that, as the authorities had now moved to a policy of expanding fiscal spending somewhat after a sustained period of expenditure restraint and rationalization, it would be important for growth to take place in the most efficient sectors of the economy. The authorities fully understood that requirement. They believed that the fiscal consolidation of recent years had encouraged private sector concerns to operate more efficiently than they had in the late 1970s, thereby enhancing their longer-term growth prospects. In addition, since 1982/83, some major subsidies on input costs, such as electricity and water, had been reduced not only as a proportion of total budgetary outlays, but also in absolute terms. There had also been some increases in user charges.

The budget for 1987/88 contained no new revenue measures, the staff representative noted; the authorities had not announced their intention to introduce a sales tax. Nevertheless, subsequent to the introduction of the budget there had been some increases in fees for various types of activities, residence permits, and other items.

It had been suggested by Mr. Enoch that, while the difficult credit settlement program was welcome, it had involved some costs for the authorities, the staff representative remarked. The staff had no additional information on the experience with the credit settlement program to date, but it was important to note that the program did not involve budgetary outlays. Rather, the authorities placed deposits with the banking system at below-market rates, thereby assisting the banks' cash flow position and permitting them to make provisions for doubtful loans.

There was a potential danger that the increased growth of fiscal spending might in itself result in larger capital outflows, the staff representative said. However, the authorities were fully conscious of that danger, and would be watching relevant developments closely. They had emphasized during the discussions with the staff that they were aware that there were narrow limits on the rate of increase in fiscal spending that was consistent with a stable evolution of the domestic economy and with the maintenance of balance of payments equilibrium.

The question had been raised whether interest rates in Kuwait were competitive with rates abroad following the reduction in Kuwait's short-term interest rate ceiling in March 1987, the staff representative recalled. While the authorities retained ceilings on interest rates for instruments of less than one year's maturity, the interest rates on assets with longer maturities were market related, based on the spread over the Kuwait interbank offer rate. Accordingly, longer-term interest rates in Kuwait would move in line with interest rates in financial markets abroad.

The question had been raised whether the stock market crash of October 1987 would result in a decline in Kuwait's investment income, the staff representative noted. The staff had no additional information on the types, geographic dispersion, or currency composition of the relevant official foreign assets and, therefore, could not answer that question.

It had been suggested by one Executive Director that, since the authorities had a reasonable cushion of foreign assets, it would be appropriate for them to increase fiscal spending at the higher end of the prudent range, the staff representative from the Middle Eastern Department remarked. The authorities had stressed that, given the uncertainties in world oil markets and the limited scope for expanding the domestic economy in ways that would ensure the continued efficiency and competitiveness of the non-oil sector, they wished to maintain a very prudent approach to the rate at which they would shift to a slightly more expansionary fiscal stance.

Mr. Finaish remarked that the main macroeconomic policy challenge facing the authorities was not to correct particular domestic or external imbalances; after all, the fiscal position was strong, the rate of inflation was low, and the balance of payments position was strong. The main issue was how to consolidate the gains of recent years and, in particular, the extent to which financial policies could be used cautiously to stimulate non-oil economic activity. There were, of course, limitations to such efforts, owing partly to the likely trend in oil prices and capital outflows. Achieving high rates of growth of non-oil GDP actually was not one of the authorities' major objectives; the authorities recognized that there were constraints on achieving that objective. The authorities also wished to increase the economy's absorptive capacity. Kuwait was a well-established exporter and had an impressive infrastructure and set of established institutions. The authorities attached importance to channeling investment to productive sectors. One of the constraints on achieving that and other objectives was the limited proportion of the indigenous population in the total population. Sixty percent of the population of the country was composed of non-Kuwaitis. The various developmental constraints helped to explain the authorities' particular diversification policy and investment strategy. Most investments were being channeled to downstream activities in the petroleum sector, where Kuwait clearly enjoyed a comparative advantage. In addition, the authorities stressed capital-intensive activities and financial investment abroad. Kuwait was probably the most successful oil country in those areas, as was reflected in the impressive foreign investment income and the downstream activities in the petroleum sector.

The authorities agreed that in the medium term, non-oil revenues should play a more active role, Mr. Finaish commented. In fact, there had been some increases in 1986/87 in nontax revenue and receipts from taxes on non-oil business, and some revenue measures had been introduced after the latest budget, as the staff representative had explained. On the whole, however, non-oil revenues had continued to account for a very small percentage of total revenue. The timing of the effort to increase the role of non-oil revenue in total revenue was important. At present, the authorities were trying to use financial policies to stimulate non-oil economic activities and were therefore hesitant to introduce new revenue measures at the present stage.

He agreed with speakers who had stressed that cooperation--including the coordination of development planning--with the Gulf Cooperation Council was important, Mr. Finaish said. There was room for useful coordination in several areas, including petrochemicals and cement. Most of the members of the Council faced marketing difficulties with respect to petrochemicals. The members of the Gulf Cooperation Council fully intended to increase their cooperation.

Though relatively a small country, Kuwait had played, and continued to play, an important and constructive role on the international level, Mr. Finaish commented. The authorities' commitment to that role was perhaps best evidenced in their foreign aid program, which in recent years had averaged about 4 percent of GDP. He did not believe there were many donor countries that could match Kuwait's record in that area.

The Acting Chairman made the following summing up:

Directors concurred with the thrust of the conclusions and policy recommendations in the staff report; they commended the Kuwaiti authorities for their effective response to lower oil revenues and for the progress made in restoring stability and confidence in the financial sector in the period following the 1982 crisis in the unofficial stock market.

The adjustment to these difficulties has been achieved through a combination of fiscal retrenchment, public expenditure rationalization, and prudent monetary and exchange rate policies. Directors said that these policies had been effective in achieving the two broad goals of adjusting to a sustainable level of economic activity and of conserving government foreign assets.

Directors noted that following several years of reduced levels of economic activity in the non-oil sector, the more accommodating fiscal and monetary policies since early 1987 were appropriate, and that the stance of these policies continued to be consistent with the authorities' external and inflation objectives.

They also added that, in view of the uncertainties in the oil market, fiscal policies should aim at improving the structure of the budget, and this would include actions to increase non-oil revenues and to reduce implicit subsidies.

It was noted with some interest that Kuwait's income from foreign investment now exceeded oil revenue. Closer collaboration within the Cooperation Council for the Arab States of the Gulf (GCC) was seen to be an important factor in promoting balanced growth of the non-oil sector, both in Kuwait and in the region as a whole.

Directors welcomed the resoluteness of the authorities in addressing the issue of nonperforming loans, as it would enhance the efficiency of the banking sector. The importance of continued firm banking supervision was emphasized.

Directors commended the authorities on their effective management of the issue of government securities in the domestic market. They added that this innovation would enhance the flexibility of monetary policy and promote development of domestic capital markets. The introduction of a more flexible market-oriented interest rate policy, combined with a flexible exchange rate policy, was welcomed with a view to improving efficiency and keeping private capital flows consistent with balance of payments objectives.

Directors commended the authorities on their impressive record of external assistance, despite the increasing budget constraints.

It was agreed that Kuwait will be on the bicyclic consultation procedure, and that the first simplified consultation will take place in April 1989, with the next Article IV consultation to be held 12 months later.

3. IBRD - RELEASE OF INFORMATION

The Acting Chairman noted that in the near future the World Bank's Executive Directors would carry out a first review of the experience with policy framework papers. In that connection, it would be helpful to make available to them as background documentation Fund staff papers prepared for the comprehensive review of experience with the structural adjustment facility that was held in June 1987.

The Executive Board approved the following decision:

The Executive Board approves the request from the World Bank to make available to the Executive Directors of the World Bank the Fund staff paper entitled "Structural Adjustment Facility

(SAF) - Review of Experience" (EBS/87/46, 2/27/87; and Sup. 1, 6/9/87), together with the text of the Chairman's summing up at the conclusion of the Executive Board discussion on the review of the structural adjustment facility at EBM/87/93 (6/19/87).

Adopted March 18, 1988

APPROVED: November 14, 1988

LEO VAN HOUTVEN
Secretary