# The GATS Agreement And Liberalizing The Kuwaiti Banking Sector

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## Abstract

The GATS will affect the performance of the Kuwaiti banking sector, if it is realized by the year 2003. The Kuwaiti banking sector was selected for this study because it is inefficient and because it exists in a capital-abundant economy, where the number of institutions are small and have traditionally been over-protected by the government. Kuwait must prepare its financial sector to face international competitiveness, by reducing costs and increasing efficiency and quality, as foreign banks are allowed to enter the financial market and operate. Though this move may hold positive prospects for banks to expand their market share, it also poses a challenge to Kuwaiti banks to operate at global, international standards.

**Keywords**

GATS, General Agreements on Trade In Services, liberalization, competitiveness, efficiency and quality.

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## I. Introduction

The progressive liberalization of trade has become a motive not only for developed economies but for 'developing' economies alike. Institutionalizing this movement in the form of The World Trade Organization in 1995, following the eight year Uruguay Round negotiations, systematized the ensuing trade liberalization process and established a forum for dialogue between and amongst the various signatory nations. The WTO became the breeding ground for more agreements that would aim to liberalize additional sectors of the respective signatory economies.

One such agreement is the GATS, the General Agreement on Trade in Services.[1] Services may be characterized with a number of salient characteristics which make this sector more pliable and responsive to liberalization. [2] Inherently, liberalization invites competition and FDI, foreign direct investment, which will subsequently modernize the entire business infrastructure and upgrade the quality of the indigenous service providers. Developing countries cannot afford to maintain inefficient sectors. [3] In order for LDCs to participate and integrate competitively in the world community, their objectives should focus on external liberalization combined with an active strategic plan to deregulate and privatize core infrastructural sectors.

Trade liberalization has become an inevitable, unavoidable process for developing countries, the way it was for their 'developed' counterparts decades ago. Trade liberalization is always controversial, however, its long-term benefits to most parties involved are always rewarding. In a nutshell, trade stimulates economic growth, raises incomes and leads to a more efficient allocation and utilization of scarce resources. [4] The basic argument of comparative advantage, competitive advantage and international division of labor is still the thrust behind trade liberalization at a very basic level. Empirical estimates of the impact of liberalization on growth, welfare and development have shown that open economies have grown on average approximately 2.5% faster than closed economies. [5] For 'developing' countries the figures are even more promising. [6]

The objective of this paper is to investigate the impact of liberalization on a service sector, namely the banking sector in Kuwait, and consequently the extent of its

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[1] It is often implied that trade liberalization is a luxury, affordable only by rich countries, however, the truth of the matter is that 'developing' countries that are relatively resource-poor cannot afford to waste this scarcity on inefficient, costly operations. Liberalization may be initially painful but it provides solutions.

[2] The case for liberalization is readily made in addition to the fact that protectionism is not deeply institutionalized in many services.

[3] Liberalization is one of the quickest ways to develop a sector without public expenditure. Introducing a dose of foreign competition, frees government and tax payers from that burden.

[4] Benefits of trade are extensive they range from economies of scale, technology transfer, economies developing a comparative or relative advantage to all-around efficiency. The competition involved in trade promotes the "survival of the fittest" theory.

[5] Sacks, J.D and A.Warner. *Economic Reform and Process Of Global Integration.* Brookings Papers on Economic Activity, 1995.

[6] Ibid.

strategic and tactical preparedness in face of the liberalization of services which is scheduled to occur in 2003, since Kuwait is a member of the WTO and a signatory to the GATS, the General Agreement to Trade in Services.

The more focused objective of this paper is to introduce the GATS, the General Agreement on Trade in services, as a product of the WTO and how that agreement will impact, benefit and/disadvantage the banking sector, in this small, capital-abundant developing country. Being a member of a regional economic block, the G.C.C, whose members share many economic and social commonalities, many results and recommendations may be globalized to the region.

The financial sector is an important field of study because it is one of the fastest growing sectors in Kuwait's economy, which supports the claim that, "trade and investment have become major engines of growth in developed and developing countries alike, including the Arab region". [7] The way this sector will be affected by liberalization, whether positive or negative or both, is an interesting phenomena to study whether it is from an absolute perspective or placed in the context of the region. The service industry in general, has its own peculiarities that will characterize its response to liberalization, in ways that differ than that of the industrial sector.

The organization of this paper will be as follows: an introduction to the WTO and the GATS, followed by an introduction to the financial sector in Kuwait, the competitiveness of the G.C.C banking sector at large, since Kuwait is part of this regional trade agreement (RTA), followed by the current performance and structure of the Kuwaiti banking sector prior to liberalization, to be concluded with an assessment of the competitiveness of the Kuwaiti banking sector after the imposition of liberalization. In conclusion, options will be recommended to the Kuwaiti banking sector in an effort to increase its competitiveness in the event of liberalization. It is important to be aware of the fact that there are data-related constraints involved when studying a sensitive sector such as this. Kuwaiti banks are very conservative with information about their functions and especially their plans, fearing that disclosure will only give their competitors a head-start to formulate pre-emptive and retaliatory measures. Therefore, much of the research in this field will provide expectations and forecasts based on the Kuwaiti banks' various publications.

## II. Background

The origins of the WTO goes back to a group of formalized, uninstitutionalized agreements, namely GATT or the General Agreement on Tariffs and Trade which was signed in Bretton Woods, New Hampshire, in 1947. This initiative was mainly on the part of the United States and became referred to as the 'trade agreements program'. In the face of outrageous tariff rates, as a result of the Smoot-Hawley Act of 1930, the United State's share of world trade dropped significantly, from 16% to 11% over the next five years [8]. The Great Depression of the 1930s worsened matters further, causing total international trade to decrease, which brought about retaliatory protective measures. In an effort to break this vicious cycle, the United States proposed the initiation of a set of bilateral agreements. This

[7] Safadi, Raed. "The Arab World and the New Multilateral Trade Agenda: Trade in Services and Investment Provisions in the WTO". *Journal of the Arab Planning Institute*: December, 1998.

[8] Edward, John. "The Determinants of Tariffs and Non-Tariff Trade Restrictions In the United States". *Journal of Political Economy.* February, 1981.

program evolved into a multilateral tariff reduction process, so that trade never becomes devastatingly encumbered again.

The GATT was integral to a mechanism devised in the post-war era to restore the international system back to health. Kuwait became a member to the GATT in 1963, three years after its independence from British colonization.[9] One of the GATT's main functions was to provide a framework for multilateral tariff bargaining sessions. While the GATT sought to install a stable trade policy regime, governments circumvented these efforts by non-tariff controls and tariffs tailor-made to the perceived needs of protected domestic industries.

It was not until 1995 that this movement for liberal international trade was institutionalized and transformed into an official international organization, the WTO.

### A. The World Trade Organization (WTO)

The World Trade Organization was established in January, 1995, in Geneva. It's creation was a result of a long stream of cumbersome efforts; the Uruguay Round negotiations (1986-94), or the (URAs) Uruguay Round Agreements, to which Kuwait is a signatory. Among other things, member countries' service industries were not protected under the URAs nor was their production, trade and usage of intellectual property. [10]

Over 140 countries are signatories to the WTO. The WTO was developed to organize, systematize and develop greater liberal and secure trade between nations, with the understanding that trade liberalization is a continuous, gradual and progressive process.[11]

Over three-quarters of the WTO's members are classified as "developing countries". They have special provisions, especially with respect to the time granted to implement agreements and commitments. This should indicate two things to developing economies; firstly, that they should be especially proficient with WTO rules and regulations so that maximum benefits may be achieved during negotiations and secondly, that the "developed" countries of the world need LDC markets, whether in the form of supply or demand. A case in point is that of South East Asia. During the latter part of the 1980s when the Japanese economy was booming and saturated, it found that it had to develop its regional neighbors economically, in order to sustain its own economic performance. By 'teaching' its neighbors how to develop and produce an internationally competitive and "tradeable" range of products, the Japanese were in essence creating a market for their own exports and simultaneously moving out their

[9] Kuwait's financial sector holds a shred of 'colonial liberalization' manifested in the banking sector. One of Kuwait's eight commercial banks is a remnant of British colonization. The British Bank/Iranian Imperial Bank monopolized the financial sector in Kuwait, in the 1940s and 1950s, after competing with the Arab Bank, the Ottoman Bank and the Eastern Bank. This foreign commercial bank operated between 1941 and 1971, after that it was transformed in to a Kuwaiti bank, well-known today as BKME Bank of Kuwait and the Middle East.

[10] TRIPS (the Agreement to Related Aspects of Intellectual Property) under the WTO is responsible for intellectual property rights. Its main features are the creation of standards, their enforcement and dispute settlement.

[11] OECD. "*Open Market Matters: The Benefit of Trade and Investment Liberalization".* Paris, 1998.

labor-intensive industries to these 'developing S.E. Asian economies to make room for a new generation of technology intensive industries to be produced in Japan.[12]

The main functions of the WTO are categorically presented in article III of the agreement: to administer trade agreements, to provide a forum for trade negotiations, to handle trade disputes, to monitor national trade policies, provide technical assistance and training for developing countries and to cooperate with other international organizations. There are varied opinions on both ends of the spectrum as far as WTO's ability to contribute to the welfare of developing countries. Many will argue that the WTO is a dictatorial body that exists to benefit countries that are already capital-abundant, others believe that this is an objective organization whose purpose is to spread the knowledge and know-how of free trade. In practice, the WTO's core mission is to "teach" developing countries, that are inherently not traditional free-traders how to liberalize,[13] and gradually develop open markets. The WTO is especially committed to countries undergoing this transition during this critical transitory phase. The WTO is closely associated with the World Bank and the IMF, International Monetary Fund, in order to develop concerted, orchestrated strategies and plans. [14]

The WTO's fundamental trade framework is based on two principles: MFN, most favored nation clause and the non-discrimination clause. These principles were already established under the GATT agreement and they are inter-related in their practice. The principle of non-discrimination which is incorporated in the MFN rule which is also complemented by the national treatment rule requires a member country to extend any advantage, favor, privilege or immunity that it shares with its trading partners, to all other WTO signatories. This also applies to trade in services.

## A. The General Agreement on Trade in Services (GATS)

The GATS was one of the major outcomes of the Uruguay Round Agreements (URAs), based on the same principles as the previous GATT. The General Agreement on the Liberalization of Financial Services is part of the General Agreement for the Liberalization of Trade in Services, (GATS). The former has identified "financial services" carefully. The services agreement under the WTO, signed in 1995, did not effectively deal with this sector, therefore, a new set of rules were set forth in December, 1997 and implemented in March, 1999. Three sectors within "financial services" were greatly improved the stock market, insurance and banking. Based on these agreements Kuwait has accepted up to 40% foreign ownership in its local banks.

All WTO signatories are also GATS members, however, they may differ in the levels of quantitative commitments within each service sector covered under the GATS. The GATS covers 160 sectors. There are 11 aggregate sectors identified in the 'classification' list. Tourism, for example, has drawn the highest number of 'bindings' by member, followed by business and financial services. Financial services includes two broad categories of services: insurance and insurance related services, banking and other financial services. "Banking" includes all the traditional

[12] Jabsheh, Faten. "*Industrial Policy as a Strategy for Economic Development: The Cases of Japan and Egypt".* Michigan: U.M.I, 1994.
[13] The WTO organizes 3 trade policy courses and over 100 technical cooperation missions to LDCs annually.
[14] In fact, the Trade and Development Center is run jointly by the World Bank and the WTO.

services provided by banks such as acceptance of deposits, lending of all types, payment and money transmission services, as well as services related to trading in foreign exchange and securities, money broking, asset management, settlement and clearing services.

Under the current format of the GATS, few obligations apply to signatories unless a sector and the associated modes of delivery are subject to 'specific commitments' in the schedule of the signatory or the member. The main general obligations of the agreement are the MFN or the Most Favored Nation principle (II) and the transparency principle (article III). The GATS' main provisions are the recognition of qualifications (article VII), monopolies and exclusive suppliers (article VIII) and business practices (article IX). The central 'Specific Commitments' are with respect to market access and national treatment. Market access (article XVI) provides a negative list of obstacles and barriers to trade that signatories should refrain from engaging in. Examples include imposing limitations on the number of suppliers, limitations on the participation of foreign capital, limitations on the total number of service operations or on the total quantity of service output, limitations on the total number of natural persons that may be employed, limitations on the total value of service transactions or assets and measures which restrict or require specific types of legal entity or joint ventures. The national treatment provision in the GATS (specified in article XVII) specifies that members should treat foreign countries' products and services as they would treat their own, without imposing tariff and non-tariff barriers, unless there are special exceptions and arrangements made to suggest the contrary.[15]

Kuwait is one of the moderate members in the GATS, along with Brazil, Colombia, Israel, Morocco, Nicaragua, Philippines and Romania, it is committed to 41-15 commitments. Trade in services is mandated under article XIX (19) of the GATS. The GATS is considered a landmark agreement. It applies to all services except those that are non-commercial and government-related; for example, activities of central banks, social security authorities and monetary authorities.

The GATS 'Annex on Financial Services' provides specific provisions with respect to domestic regulation and recognition arrangements. The Understanding on Commitments in Financial Services states that, "members shall endeavor to remove or limit any significant adverse effects of non-discriminatory measures on the financial service suppliers of any other member". [16]

Associated with the GATS are protocols,[17] two of which pertain to the liberalization of financial services. The second protocol "financial services" was adopted in July, 21, 1995, entered in to force in September 1996[18] and the fifth protocol, adopted in November 1997 and enforced in March,1999.

The GATS was developed to improve trade and investment conditions, "through continuous multilateral negotiations amongst members".[19] It categorizes the supply of services into four main groups: cross-border supply, consumption abroad, commercial presence and presence of natural persons. "GATS is a powerful integrating mechanism. No government is obliged to liberalize, or make commitments on infrastructural services like finance and telecommunications. But

[15] WTO official reports.
[16] Ibid.
[17] "Protocols" deal with results of subsequent negotiations.
[18] The structure and administrative organization of the GATS will not be discussed because it is outside the scope of this paper and its insights are irrelevant.
[19] WTO official reports.

the efficiency gains for these countries which do so make the cost of protecting inefficient services very high because GATS is about investment and technology transfer, among other things, and market access commitments are a powerful attraction for foreign direct investment (FDI)". [20] The whole concept behind developing countries' participation in a multilateral trading system is to encourage capacity building. Liberalization had to be closely tied to foreign investment because LDCs have shown a particular interest in investment-induced policies and in incentive mechanisms that attract them. Making the GATS investment-friendly served to enhance LDCs ' trade in services.

One of GATS central principles is the concept of "progressive liberalization", knowing very well that liberalization is a continuous, gradual process where countries are at different stages of, in addition to the fact that it is a process foreign to many LDCs that are historically trained to upkeep large public sectors. Liberalization in the service sector is particularly important for developing countries considering the fact that trade in services has grown faster than trade in goods over the past decade.

Services may be characterized with a number of salient characteristics. Services are: intangible, invisible, difficult to measure, constraints related to data exist particularly in the services sectors, simultaneously produced and consumed and not easily identifiable. The mere question of what represents a unit of production may spur a debate.

Numerous market access obstacles on trade in financial services have been relaxed or removed during GATS continuous unilateral and multilateral negotiations. Though trade restrictions in financial services have been reduced, greater strides in this field will be achieved only if domestic regulations in the various member countries are improved.

## III. The Financial Sector In Kuwait

Financial services compose a significant portion of Kuwait's GDP. There are 11 banking institutions in Kuwait, 7 of which are commercial banks, 3 specialized banks and 1 Muslim bank.

The following are the banks that will be most affected by liberalization, the commercial banks in Kuwait: Ahli Bank of Kuwait, Burgan Bank, Bank of Kuwait and the Middle East, Commercial Bank of Kuwait, The Gulf Bank and The National Bank of Kuwait. NBK was the first bank to be established in Kuwait in 1952, followed by most of the others during the following decade. These are the banks that will be pressured to liberalize their services and open their doors. There are 3 specialized banks: the Savings and Loans bank, the Industrial Bank and the Real Estate Bank. The Savings and Loans Bank was established in 1960 by the government to extend long-term loans (up to 45 years) with interest not exceeding 2%. The Industrial Bank, established in 1974 extends medium term loans (3-9 years) for industrial projects with sub-market interest. The Real Estate Bank, although also specialized in the development of construction activity, is more commercial than the Savings and Loans Bank, which is completely government run and owned, and will probably not be included under the GATS since it is government owned and operated. The only Muslim bank in Kuwait is the Kuwait Finance House. It conducts all banking functions with the provision that their execution, inputs and outputs abide by

[20] WTO official reports.

the Islamic Shariah. In 1968 the Central Bank was established in Kuwait to monitor and oversee the financial sector of the economy.

One cannot meaningfully consider financial activity in isolation of other economic indicators (reference to Table 1). The Kuwaiti market shows high values for the share of its national banks as a percentage of GNP (also refer to tables 2-8), inspite of the fact that the local market is not saturated , with only 11 units in operation, compared to Bahrain, where 70 banking institutions are in operation.[21] Other indices used to evaluate and measure market concentration[22] and the presence of competition and the extent of it, such as the Linda Index, the Hart Index, the Rosenblath Index and the Hershman-Hervendal Index,[23] in addition to the entropy index have shown that the financial sector in Kuwait is moderately concentrated[24], meaning that it is moderately competitive, (moderately controlled and monopolized) compared to its G.C.C counterparts, where Saudi Arabia and the U.A.E were most competitive (least monopolized market) and Qatar and Oman being the most monopolized or least competitive. [25] This was based on a measure of loans, deposits, reserves and retained earnings and assets.

Some basic indicators about the Kuwaiti banking sector show that Kuwait has a medium competitive position within the most logical framework it may be placed in at this time; the G.C.C, since it is the RTA, regional trade arrangement that Kuwait is a member of, and also because G.C.C
members signed in December, 1997, at the 18th Summit, held in Kuwait, to allow all members to open branches of their national banks in each others countries. This is an effort to materialize the cooperative spirit of the G.C.C and an effort to ease the way to extra-regional openness. These indicators also show that Kuwait's banking sector is relatively competitive with respect to net profits and returns to assets. The financial sector in Kuwait is relatively protected, with firm barriers against new entrants, which makes the sector relatively low risk. Issues of adequate reserve and capital adequacy are regulated by the Central Bank of Kuwait that has made claims that it will not come to the aid of the Kuwaiti banks if the need arises in the case of a wide open door policy. It claims that it will have a 'laissez-faire' policy.[26] These issues will be discussed in greater detail in the next two sections in addition to the liberalization and how it will affect the banking sector and the competitiveness of the Kuwaiti banking sector vis-à-vis the G.C.C.

[21] Bahrain's figures are inflated relative to its size because of its active off-shore banking business, which was developed to circumvent financial restraint. However, with increased liberalization, off-shore activity should lose much of its impetus.

[22] Market Concentration produces a concentration ratio which measures the extent to which one or more firms control the levels of production in an industry.

[23] Hart, P. *"Entropy and Other Measures of Concentration."* Journal of The Royal Statistical Society, 1971.

[24] Indices have their shortcomings, each one of the indices mentioned above measured one dimension or more, but not one alone was sufficient. E.g. the concentration index excludes small units, the Linda Index differentiates between large and small units and the Hart Index assigns relational weight according to size.

[25] KFAS. Competitiveness of the G.C.C Banking Sector. Kuwait: Institute of Banking Studies, 2000.

[26] Ibid.

## A. Critical Issues In Financial Liberalization

Financial liberalization is most appreciated from the perspective of its absolute antagonist; financial repression. Financial repression is characterized mainly by regulated fixed rates of interest on loans and deposits, restraint of capital flows in and out of the country, deliberate disfavor toward foreign financial competitors, controlling the exit of financial mediators from the market and non-competitively soliciting work for the banking sector through insurance programs that are financed by the government sector.

The objectives of liberalization are to increase the levels of competitiveness in the financial sector by opening the door to entrants,[27] increasing and upgrading the available financial tools and options for investors and depositors by expanding the financial infrastructure of the sector, improving the process of determining and deriving interest rates so that these rates reflect actual costs of financial resources, Improving foreign exchange distribution so that real costs are reflected and improving the packaging and customization of financial resources.

Banks may be affected by liberalization in the following ways: profitability, development and market share, pricing policy, levels of risk and the quantity and quality of financial services. Other symptoms that may accompany liberalization include large increases in interest rates, under-capitalization, a noticeable increase in the level of risk and a rapid deterioration in the quality of loan packages. Inevitably, those banks that are unable to stay abreast, will have to declare bankruptcy.

History has shown that the road to liberalization is bumpy, it goes through phases, the first of which is a critical transient stage of transformation. This is the phase where most financial crises occur if they are going to happen. There are many examples around the world where this has occurred; Mexico, 1996, a crisis that cost over the long-run almost 15% of that country's GNP. Brazil and Venezuela underwent similar experiences also in 1996. In all three cases, financial crises occurred following intensive liberalization to the banking sector.[28] Some of the reasons for the onset of a financial crisis include: excessive lending activity before liberalization, lack of information available to investors about banking principles, legal and corporate restraints that weaken banks' positions and the occurence of financial turbulence outside the banking sector, which reduces investors' confidence in the local banks and results in capital flight which in turn reduces the banks' liquidity.

A number of tools and indicators are available to predict whether a specific banking institution can survive post-liberalization. Closely monitoring banks at the outset of liberalization alerts decision-makers to early warning signals, setting an administrative or a managerial mechanism to identify institutions that are most susceptible to troubleshoot.

These tools should be used effectively to aid in abating a crisis.

[27] Marcus, A. "*Deregulation and Bank Financial Policy*". Journal of Banking and Finance, volume 8.

[28] These crises are quantified by calculating their costing dimensions as a percentage of GNP, in order to standardize the phenomenon.

## IV. Competitiveness of the Kuwaiti Banking Sector In the G.C.C As A Regional Trade Arrangement (RTA)

The GCC is composed of six countries, The Kingdom of Saudi Arabia, Kuwait, Qatar, Bahrain, Oman and the UAE, United Arab Emirates. As mentioned earlier, the 18th GCC Summit, which met in Kuwait embarked on liberalizing the banking sector of the member countries; which is a step in the direction of the WTO's objectives.

The GCC has already set guidelines in an effort to set forth minimum requirements for the banks desiring to establish branches in other GCC countries. These requirements are placed to reduce incidences of crashes and sectoral failures. Guidelines and standards have been set with respect to licensing, capital and capital reserve, monitoring and inspection of licensed foreign banks, bank closures, minimum capital retention requirements and a minimum age for a bank (10 years old), among other requirements.

Each banking sector within the GCC is structured differently. Conducting comparative analysis, while useful, has its limitations. There is great difficulty in identifying the productive units in the services sector, especially in the financial sector, where units' ratio of domestic to foreign activity is often hazy. Kuwait is considered on average, less competitive than the U.A.E, Saudi Arabia and Bahrain and more competitive than Oman and Qatar, based on the following criteria: average assets, average return on assets, average net profit, average number of branches per bank, average number of ATMs per bank and average number of employees. Though it is difficult to homogenize even the services that are offered across the various banking institutions except in broad terms; techniques and measures such as market concentration[29] are able to reveal some of the required data. In terms of competitiveness, again relying on the market concentration ratio, the United Arab Emirates has the most competitive (least monopolized) banking sector, followed by Saudi Arabia, Bahrain, Kuwait, Oman and Qatar. Therefore, Kuwait's banking sector is moderately competitive when compared to their GCC counterparts with respect to average value of assets, average number of bank branches, average number of automated bank tellers, average number of employees and average number of subsidiary companies. Kuwait has a relative comparative advantage with respect to average net profits (#2 in GCC), however, there is no clear indicator with respect to average return to assets (Kuwait is ranked #4 amongst GCC members).[30] Kuwait also has a relative comparative advantage with respect to average expenditure (rent, salaries, and other expenditures); average expenditure on R&D [31] and expenditure to total assets are minimal when compared with other GCC banks. Kuwait, however, does not have a comparative advantage with respect to spending on information technology development. The Kuwaiti banks need to therefore develop a strategy to allocate or appropriate funds (as a percentage of profits or assets) to this vital area that is so crucial to competing in business and staying abreast today.

Most GCC banks believe that they are adequately competitive for each other. It is important to note that some GCC members have already had years of

[29] With a noticeable rise in mergers and acquisitions, increased interest and focus has poured into the issues of 'economic concentration' in the financial sector.
[30] KFAS. Competitiveness of the G.C.C Banking Sector. Kuwait: Institute of Banking Studies, 2000.
[31] Although Kuwaiti banks' expenditure on R&D is the highest in the GCC, it is still extremely low.

experience conducting business with foreign banks. Oman, for example, already has 13 foreign banks Qatar has 10 foreign, Arab and Islamic banks and Bahrain has an extensive off-shore banking sector. This kind of exposure raises these countries' confidence levels because the experience is already underway.

The more cautious GCC banks have taken some steps to improve their posture, by securing an adequate capital base, adequate liquidity, diversification of assets and managerial talent and abilities, highly competitive services to customers and most importantly by investing in implementing the '*marketing approach*', by basically understanding the various segments' differentiated needs and being able to supply it readily.

The Kuwaiti banking sector is extremely protected and it is not saturated or over-banked. Economic indicators (refer to Tables 2-5) and outside statistics show that there is room for the Kuwaiti market to absorb more banks (so is the case for Saudi Arabia). The Kuwaiti banking sector should become more prepared to compete with foreign banks as they enter their markets. Director General Mike Moore, in a speech in Buenos Aires said that, "while regionalism can be a positive force and provide an important complement to the multilateral system, it cannot be a substitute this means above all that we need to push hard for a new round which is the surest way to ensure that regional and multilateral interests converge". [32] These indications should push Kuwait to think in more global terms; its plans should include preparedness not only for the entrance of regional banks but also for foreign extra-regional ones.

## V. The Current Competitiveness and Profitability of the Banking Sector in Kuwait

The SWOT analysis (strengths, weaknesses, opportunities and threats) may be used effectively to briefly evaluate the competitiveness of the Kuwaiti banking sector. The current strengths of the Kuwaiti banking sector are mainly; good average net profits compared to their regional counterparts,[33] their expenditures as a percentage of total assets are the least, they invest the most in R&D (although in an absolute sense it is still an inadequate level of expenditure), high average assets and average profits per employee, the percentage of experienced, college graduates of the total banking labor force is quite high, knows other G.C.C markets very well, views the GATS as a positive agreement, has placed preliminary plans to upgrade and improve productivity of bank employees and customer service, plan to directly reward performance to an objective reward system, plan to upgrade technology to improve competitive capability and the availability of long-term planning in some Kuwaiti banks.

Some of Kuwait's other strengths are the fact that its barriers to trade are minimal, its tariffs are low, restriction to the movement of capital are low, there are stable foreign investment laws and the fact that Kuwait is a net importer. This puts Kuwait at an advantage, since the basis for liberalization is already present.

The weaknesses of the Kuwaiti banking sector on the other hand, are as follows: decreasing average return to assets, decreased spending on R&D during the latter years, inadequate awareness of the GATS and its implications, reduced confidence in the Kuwaiti banks' ability to compete with other banks in the region,

[32] WTO press releases.
[33] Banks' annual reports.

employee related problems are numerous, especially with regard to absenteeism and the involuntary severance of contracts, and poor performance in spite of efforts to reform and retrain and lack of team work skills amongst bank employees.[34]

Kuwait has much to gain in terms of opportunities from the WTO agreement if it succeeds in planning carefully and undertaking the required changes. Opportunities exist in increasing market share since market concentration indices indicate that Kuwait's banking sector is not saturated, especially via merging, since new markets already exist in that case; upgrading human capital and information technology resources and in reducing costs in the long-run. The general protective economic environment will only put the country's economic sectors at a disadvantage in the long-run.[35]

Some of what is in stock for Kuwait when in it opens its doors include greater opportunities for foreign direct investment and finance, the ability to provide higher quality, lower cost services to consumers will be improved, and this will catalyze the development of financial services and the sector at large. In addition, the market will hold a larger pool of potential customers, which will make the banks more creative in their benefits and offers, and in turn, customers will have greater choices. Since banking decisions will be based absolutely on competitive economic factors, many of the banks in Kuwait will be encouraged to merge, whether with other Kuwaiti banks, other G.C.C banks or with a foreign, extra-regional bank, in order to diversify risk, increase assets and penetrate new markets where market share is already determined.

There are a number of things that the Central bank in Kuwait can do in order to facilitate the local banks for liberalization, without being considered 'meddlesome'. The Central Bank may help reduce the unnecessary capital and financial requirements on the local banks; relax capital market rules and regulations; standardize those rules and procedures that are not in accordance with international law; place clear, unambiguous rules so that new financial entrants may organize themselves in Kuwait, and specify the activities that foreign banks may engage in; remove pricing constraints and most importantly, internalize and operationalize the WTO agreement, by forming a consortium with the Kuwaiti banks and establishing an effective matrix communication network. This will improve the level of confidence of the sector, at large.

In terms of profitability, Kuwaiti banks saw notable improvement in their consolidated profits in year 2000. After two difficult years, all banks reported positive growth in profits varying between 0.5% and 500% over 1999. Consolidated profits of the 8 reporting banks rose to a record KD 263 million, an increase of 22%.[36] While growth in the profits of individual banks varied widely, only two banks saw their net interest income and income from fees and commissions rise. Even though funding cost rose for the sector as a whole, the net interest margin improved from 2.36% to 2.43%. [37] Profitability ratios also improved with return on average equity (ROAE) and return on average assets (ROAA) rising to 18.17% and 2.03% respectively. The level of competition among Kuwaiti banks is intense, evidenced by the varying levels of growth and profitability. However, in anticipation of the advent of their foreign counterparts and future competitors to Kuwait, this competition is expected to be further intensified.

[34] KFAS. Competitiveness of the G.C.C Banking Sector. Kuwait: Institute of Banking Studies, 2000.
[35] This also applies to water, electricity and many others economic sectors.
[36] NBK Quarterly.
[37] Ibid

## VI. Forecasting and Evaluating the Future Competitiveness of the Kuwaiti Banking Sector With Prospects of The Enforcement of The GATS in 2003

Based on the current state of the Kuwaiti banking sector we will try to speculate its future competitiveness. There is no doubt that liberalizing the banking sector will be accompanied by unsurpassed competition, which will raise the quality of services offered, reduce costs and diversify services; all of which are benefits to consumers and to producers in the long run. Technology development and transfer and the development of technical know how are also side-benefits that will be enjoyed specifically by the banks. Based on a grand survey[38] of top-level decision-makers in all of the banks in Kuwait, certain expectations were forecasted: the banks are expected to try to increase their sources of income through expansion in their provision of diversified, creative services in exchange for fees or commissions, add more smaller branches, reduce the manpower in their branches and intensify their use of internet banking, in an effort to increase their market share. In addition, it is expected that the number of banks will decrease due to the occurrence of mergers.

Kuwaiti banks are interested in pursuing their marketing efforts more aggressively, by diversifying their products, services and markets, in addition to improving customer service. Over half of Kuwait's banks want to aggressively seek the mutual funds market as a source of market diversification and expansion. However, international banking is of minimal interest to them. Kuwaiti banks are unlikely to operate through a consortium of regional or international banks.

Much of the sector's planning and activity will depend on the role that the Central Bank will assume. The Central Bank of Kuwait has made no intentions to revise monetary policy tools in order to improve the competitive position of the domestic banks, nor have the other GCC central banks. In fact, they see no justification for intervention. Though the Central Bank of Kuwait has claimed that it will facilitate the entrance of foreign banks to the country, the case for 'mergers' has been proposed.[39] Only 25% of Kuwaiti banks expressed their conviction that merging with another local bank was inevitable in order to survive. Each country within the G.C.C has different 'special agreement requirements'. Kuwait wants to have special agreements with other GCC members, for example, over the development of a monetary base, insurance, interest rates and other policies. Kuwait's Central Bank raised the capital-adequacy ratio in an effort to shoulder the risk. Decisions of this nature are more pervasive in the context of an RTA. In order to implement at least, the GCC's open door policy, there is a need to develop legislative and administrative homogeneity amongst the members.

Kuwaiti banks are more prepared to venture in to untraditional banking compared to their G.C.C counterparts. Although, they have an oblivious attitude toward the upcoming 2003 GATS event, they claim that they are willing to undergo changes in order to increase market share, because of their RTA, regional trade association.

Considering the above data, one of the conclusions that may be drawn is that in spite of the banks' public willingness to prepare for liberalization, it is only logical

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[38] Ibid.

[39] The case for merging Kuwaiti banks with each other or with other G.C.C banks has been proposed in order to improve the competitive advantage of the local banks, so that they are able to reposition themselves in the market, especially in light of liberalization. This is another valid subject in its entirety, outside the scope of this paper.

for Kuwaiti banks to resist the entrance of foreign banks to Kuwait because it will open up a wave of forced changes on all fronts. In spite of the fact that Kuwait's policies are already relatively liberal, for example, interest rates on savings accounts are already liberalized in Kuwait, and interest rates on real estate loans may also be liberalized; undergoing these changes is 'bitter medicine' for the banks. As mentioned in section V, resources, such as human capital, among others will have to be retrained in order to upgrade the quality of the banks' services so that it is able to compete effectively, greater investments will have to be dedicated to R&D and IT research and development and many other changes. In addition, there is a sense of over-confidence on the part of the Kuwaiti banks with regard to liberalization when they were surveyed.[40] Almost all of the banks believed that foreign competition was going to be challenging but that their current systems were adequately prepared. This over-confidence is comforting, it tends to postpone or even negate preparedness.

After analyzing the data presented from a regional and a sectoral perspective, it becomes obvious that Kuwaiti banks need to be made much more aware of liberalization and how they will be affected by the GATS. This will be an eye-opener to their serious need to restructure and plan strategically in order to develop world-class comparable global standards.

## VII. Strategic Planning

Strategic planning may be discussed at a general, comprehensive level and at a sector-specifc level. Generally, strategic, long-term planning that leads to operational and tactical plans that eventuates in their execution is not widespread in the Arab world. Planning in and of itself is meaningless without the determination of inputs, outputs, objectives and standards of achievement to be assessed and recycled repeatedly; all pouring into a greater, national, then regional, then global scheme. There is a need to improve planning competency and quality control. Part of the problem is the fact that upper management cadres are often interrupted and discontinued. The presence of a uniform standard of performance, procedure and documentation will help alleviate the problems that are associated with this break. General managerial talent and the local manpower need to be upgraded through career development and training programs, which arise from devising a comprehensive human resource investment program that will aim to achieve specified objectives within a time frame. These achievements may be later measured in order to devise more accurate policies and plans subsequently. Greater, well-designed investments in the fields of R&D in general and in IT and financial research, in specific, is warranted to make effective resources available to decision-makers and manpower, alike, in this field.

More specifically, with respect to the banking sector, there is a need to improve the systems of capital adequacy, financing and deposits, availability of liquidity and risk management with respect to investments, credit foreign exchange and international operations. Liberalization will push local banks to develop more creative products and services that are niched and customized for local markets rather than simply duplicating foreign efforts. What is worrisome is the fact that there is an unhealthy level of disbelief amongst the G.C.C countries, especially in Kuwait, with

[40] KFAS. Competitiveness of the G.C.C Banking Sector. Kuwait: Institute of Banking Studies, 2000.

respect to the materialization of the WTO agreement. The table below shows the GCC banks' own perspectives, by calculating a weighted average for all the banks in each country.

**Perspectives of the GCC Members On The WTO Agreement**

| Country | Awareness of WTO Agreement | Competitive Preparedness | Indicate the Presence of Structural Constraints that Will Compromise Banks' Ability to Compete |
|---|---|---|---|
| **Kuwait** | 77.8% | 50% | 62.5% |
| **Saudi Arabia** | 100% | 80% | 20% |
| **Bahrain** | 85.7% | 83.3% | 0% |
| **U.A.E** | 100% | 80% | 0% |
| **Oman** | 100% | 100% | 66.7% |
| **Qatar** | 100% | 100% | 0% |

* Compiled from various Central Bank of Kuwait publications.

To maintain their market shares, local banks need to strengthen their administrative, organizational and infrastructural resources, in order to be able to compete more effectively. Insufficient economic development in the Arab world is primarily because strong socio-economic structures and institutions are absent, the private sector is under-represented and the public sector is excessively large, making dependence on a paternalistic government a tradition. "What is required is a long-term strategy in which the government plays a key role that is significantly different from its present one".[41]

## VIII. Recommendations and Conclusions

Many attempts were made to simulate the impact of the WTO agreement on selective sectors in a number of Arab economies. Using a multi-sector general equilibrium model[42] of world production and trade, Diwan[43] concluded that Arab economies will experience, an initial loss in welfare coupled with insignificant gains, a decline in the region's GDP, terms of trade and real wages. One of the fundamental reasons is the fact that the business and socioeconomic infrastructure in Arab countries is not currently built or set-up to function in a highly competitive global environment. Table 6, exemplifies that fact that Kuwaiti banks when compared to their OECD counterparts are not competitive. "The delicate balance between 'internal oriented sustainable reform' and 'outward oriented reform' is best illustrated by attempts to reform financial institutions. Lifting all curbs on capital flows without instituting a system to monitor private sector borrowing in the international money market and provide signals when the system overshoots or overheats, could lead to

[41] Sirageldin, Ismail. "Globalization, Regionalization and Recent Trade Agreements: Impact on Arab Economies". *Journal of Development and Economic Policies*. Vol. 1, 1998.
[42] Two separate reduced form equations were used to calculate trade diversion and trade creation for each market at the most intricate tariff levels. Other modeling attempts have indicated similar results. Refer to Harrison, et.al *"Quantifying the Uruguay Round".* World Bank, 1995, for greater detail.
[43] Diwan, I. and Wang, Z. *Prospects for Middle Eastern and North African Economies: From Boom to Bust and Back": New York: St. Martin's Press, Inc., 1998.*

crises and economic setbacks as the case of Southeast Asia illustrates. The pace of financial liberalization should be closely linked to development in 'internal oriented sustainable reform on the one hand, and to development in the international monetary regulatory institutions on the other hand".[44]

There are several recommendations that could be made to the Kuwaiti banking sector in an effort to improve its competitiveness: raise average returns to assets so that they are more comparable to regional and extra-regional standards; invest in human resource development, by emphasizing training and increasing job stability and security so that productivity is maximized and turnover is kept to a minimum; increase spending on R&D and formulate an effective R&D policy; raise interest and awareness in international issues and changes; consider the feasibility of merging with other banking institutions; adopt plans to diversify products and services in new markets; engrain a new mentality in the economy and its major participants; gradually remove protectionist measures; offer technical support and know-how to upgrade productive levels and finally stay updated and involved with the WTO and the GATS' proceedings.

In conclusion, more research needs to be done in this field to produce reliable accurate data that will facilitate reliable sensitivity analysis, among other forms, and the development of more operational plans of action, to be utilized by the banking sector in Kuwait. Above all, as Sirageldin succinctly expressed; "the resource-endowment of the G.C.C is not reflected nor is it utilized effectively because long-term sound strategies that are adhered to are absent. What is required is a long-term strategy in which the government plays a key role that is significantly different from its present one".[45] Effective economic planning rooted in collective, orchestrated, concerted efforts is in heavy demand at this poignant time of change.

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[44] Sirageldin, Ismail. "*Globalization, Regionalization and Recent Trade Agreements: Impact on Arab Economies".* Journal of Development and Economic Policies, December, 1998.
[45] Ibid.

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**Table 1**

| **Key Economic And Financial Indicators For Kuwait** | | | | | | | |
|---|---|---|---|---|---|---|---|
| | | | | | | | |
| **Indicator** | **1998** | **1999** | **2Q1999** | **3Q1999** | **4Q1999** | **1Q2000** | **2Q2000** |
| | | | | | | | |
| **Population (ooo's)** | **2,271** | **2,255** | **2,274** | **…..** | **2,255** | **…..** | **…..** |
| *year on year growth* | *2.80%* | *-0.70%* | *1.60%* | *…..* | *-0.70%* | *…..* | *…..* |
| Kuwaiti | 786 | 812 | 798 | ….. | 812 | ….. | ….. |
| Non-Kuwaiti | 1,485 | 1,443 | 1,476 | ….. | 1,443 | ….. | …… |
| **Oil Price (*$/barrel)*** | **10.85** | **16.73** | **14.57** | **19.17** | **22.95** | **24.54** | **25.11** |
| Crude Oil Production | 2 | 1.9 | 1.8 | 1.8 | 1.9 | 1.9 | |
| **GDP** | **7,718** | **9,033** | **…..** | **…..** | **…..** | **…..** | **…..** |
| *annual growth rate* | -15.20% | 17.00% | **…..** | **…..** | **…..** | **…..** | **…..** |
| Crude Oil Output | 2,371 | 3,354 | **…..** | **…..** | **…..** | **…..** | **…..** |
| Petroleum Refining Output | 595 | 766 | **…..** | **…..** | **…..** | **…..** | **…..** |
| **GNP** | **9,506** | **10,610** | **…..** | **…..** | **…..** | **…..** | **…..** |
| *annual growth rate* | -13.70% | 11.60% | **…..** | **…..** | **…..** | **…..** | **…..** |
| GNP/capita (KD) | 4,247 | 4,666 | **…..** | **…..** | **…..** | **…..** | **…..** |
| **CPI (*1978=100)*** | **202.9** | **210.5** | **202.6** | **207.8** | **210.5** | **…..** | **…..** |
| year on year inflation | 1.20% | 3.70% | 2.90% | 4.30% | 3.70% | ….. | ….. |
| **Exchange Rate (*KD/$)*** | **0.302** | **0.304** | **0.307** | **0.303** | **0.304** | **0.306** | **0.306** |
| **Money Supply (M2)** | **7,557** | **7,592** | **7,805** | **7,586** | **7,678** | **7,888** | **7,937** |
| Quasi-Money | 6,413 | 6,307 | 6,495 | 6,414 | 6,307 | 6,510 | 6,494 |
| Net Foreign Assets | 1,784 | 1,929 | 1,748 | 1,627 | 1,929 | 2,177 | 2,247 |
| CBK Foreign Assets | 1,083 | 1,322 | 1,135 | 1,116 | 1,322 | 1,498 | 1,599 |
| **Local Bank Assets** | **12,875** | **12967** | **13,047** | **13,236** | **12,961** | **13,145** | **13,620** |
| Claims on Private Sector | 5,303 | 5,620 | 5,440 | 5,634 | 5,616 | 5,739 | 5,857 |
| Private Deposits | 7,208 | 7,149 | 7,442 | 7,241 | 7,235 | 7,508 | 7,555 |
| **KSE stock market index** | **1583** | **1442** | **1570** | **1490** | **1442** | **1378** | **1417** |
| year on year growth | -40.30% | -8.90% | -26.10% | -31.00% | -8.90% | -9.40% | -9.70% |
| **Balance of Payments** | **61** | **282** | **…..** | **…..** | **…..** | **…..** | **…..** |
| current acount | 675 | 1,558 | **…..** | **…..** | **…..** | **…..** | **…..** |
| trade balance | 580 | 1,708 | **…..** | **…..** | **…..** | **…..** | **…..** |
| Exports | 2,931 | 3,726 | **…..** | **…..** | **…..** | **…..** | **…..** |
| Oil Exports | 2,582 | 3,357 | **…..** | **…..** | **…..** | **…..** | **…..** |
| Imports | 2,351 | 2,018 | **…..** | **…..** | **…..** | **…..** | **…..** |
| Capital and Financial Account | -866 | -1,688 | **…..** | **…..** | **…..** | **…..** | **…..** |
| General Govt. | -1,070 | -1,887 | **…..** | **…..** | **…..** | **…..** | **…..** |
| Other | 252 | 412 | **…..** | **…..** | **…..** | **…..** | **…..** |
| | | | | | | | |
| **Budget Revenues** | | | | | | | |
| Oil revenues | 2,798 | 2,224 | 2,307 | 1,005 | 1,289 | 1,468 | 1,463 |
| Expenditures | 2,254 | 1,761 | 1,927 | 907 | 1,184 | 1,382 | 1,321 |
| Surplus (Deficit) | 4,040 | 4,250 | 3,593 | 680 | 821 | 921 | 887 |
| | -1,243 | -2,026 | -1,287 | 325 | 468 | 547 | 576 |

Sources: Central bank of Kuwait and The Ministry of Planning Statistical Office.

**Table 2**
**Indicators Showing The Effective Performance of Kuwaiti Banks Compared To OECD Banks**

| | 1984-79 | 1985-89 | 1990-92 |
|---|---|---|---|
| Total return to capital in OECD | 0.76 | 0.73 | 0.65 |
| Net revenue of financial activities to capital (Kuwait | …. | ….. | 19.12 |
| Employee cost/capital (OECD) | 0.4 | 0.35 | 0.25 |
| Employee cost/capital (Kuwait) | …. | …. | 5.3 |

Source: Institute for Banking Studies: Financial Report For The Kuwaiti Banking Sector, 1980-95.

**Table 3**
**Monetary Survey**

| | 2Q1999 | 3Q1999 | 4Q1999 | 1Q2000 | 2Q2000 |
|---|---|---|---|---|---|
| **Total Liquidity (M2)** | **7,805** | **7,586** | **7,678** | **7,888** | **7,937** |
| Money (M1) | 1,311 | 1,173 | 1,371 | 1,378 | 1,440 |
| Demand Deposits | 947 | 828 | 929 | 997 | 1,059 |
| | | | | | |
| **Quasi-Money** | **6,495** | **6,414** | **6,307** | **6,510** | **6,496** |
| Savings Deposits | 1,275 | 1,166 | 1,084 | 1,186 | 1,203 |
| Time Deposits and CDs | 4,263 | 4,360 | 4,342 | 4,400 | 4,430 |
| Foreign Currency Deposits | 957 | 887 | 881 | 924 | 863 |
| | | | | | |
| **Foreign Assets (net)** | **1,748** | **1,627** | **1,929** | **2,177** | **2,247** |
| Central Bank (net) | 1,133 | 1,113 | 1,320 | 1,496 | 1,597 |
| Local Banks (net) | 616 | 514 | 609 | 682 | 650 |
| | | | | | |
| **Domestic Assets** | **6,057** | **5,959** | **5,749** | **5,711** | **5,690** |
| Claims on Govt. | 3,800 | 3,581 | 3,475 | 3,245 | 3,266 |
| Central Bank | -203 | -349 | -392 | -407 | -455 |
| Claims | 0 | 5 | 45 | 0 | 0 |
| Deposits | 203 | 354 | 437 | 407 | 455 |
| Local Banks (net) | 4,003 | 3,930 | 3,867 | 3,653 | 3,721 |
| Claims | 4,217 | 4,113 | 4,062 | 3,822 | 3,935 |
| Debt Purchase Bonds | 2,135 | 1,943 | 1,931 | 1,736 | 1,723 |
| Public Debt Instruments | 2,082 | 2,171 | 2,132 | 2,085 | 2,211 |
| Deposits | 214 | 184 | 195 | 169 | 213 |
| Claims on Private Sector | 5,438 | 5,634 | 5,616 | 5,739 | 5,857 |
| Credit Facilities | 4,925 | 5,040 | 5,015 | 5,155 | 5,242 |
| Other Local Investments | 513 | 594 | 601 | 584 | 615 |
| Other Items (net) | -3,181 | -3,256 | -3,342 | -3,273 | -3,434 |

Source: Central Bank of Kuwait