Institute of Banking Studies Research >>

Money Market Operations in Kuwaiti Banks
(Conventional vs. Islamic Banks)

Consultancy and Research Department

By

Mr. Mysara Abdelwahab M Bioumy

External Consultant

September 2024

Please note that the findings and recommendations presented in this report are the sole responsibility of the author and do not reflect the views of the Central Bank of Kuwait or any other government body.

Table of Contents

Exclusive summary

Liquid and efficient money markets have long been recognized for being critical to financial stability. Many market participants secure a material portion of their funding from within the money market. This paper aims at exploring the money market in the State of Kuwait. It starts with addressing the status quo of the Kuwaiti money markets, then it explores the money market in the Kuwaiti landscape along with suggesting the introduction of some additional Islamic inter-bank money market instruments based on some *Shariah* principles. It presents developments in the money supply and factors influencing it. It also covers money market and money market funds along with associated risks, risk management and risk exposures in the money market funds. It further explores the interconnection between exchange rate regime, interest rate and the money market. Moreover, it looks into the link between monetary policy and economic growth. The study wraps up with conclusions and recommendations. The findings of the study are summarized in the following points:

- The Kuwaiti money market landscape has considerable potential for expansion to be a leading backbone of development.
- Financial institutions can further deepen their money market by introducing more instruments based on other *Shariah* principles, in inter-bank money market or money market funds, that have not been brought into practice yet.
- The Islamic money market, like the conventional money market, faces a number of risks that need to have strategies to deal with, especially *Shariah* compliance.
- Money market funds are among the most effective tools to manage risks and contain risk exposures.

- Economic growth has been stimulated via monetary policy.

1. Background

The economy's growth, society welfare and performance of financial players across countries are mainly stimulated and affected by the health and soundness of their own financial systems. For the latter to perform its role efficiently, financial infrastructure should be in place; this is to allow and provide those with funds with channels to transfer/allocate their funds to those who are competent to invest them in the most appropriate and productive ways. Regardless of being an appealing avenue for funds allocation, financial systems can encounter some serious setbacks such as asymmetry of information, where one party can be in an advantageous situation due to possession of superior information relative to other parties, leading to inefficient allocation of financial resources. Generally, a financial system consists of three key pillars, namely financial markets, financial intermediaries (institutions), and financial regulations. Each pillar has a specific role to play within the system. Functionally speaking, a financial market is a channel that allows the flow of funds for the sake of financing projects and investments by corporates, governments, and individuals. In the financial market, financial institutions are regarded as the key players given the significant role they perform, intermediation. For these institutions (participants) to function in a healthy and sound way, financial regulators are charged with monitoring and regulating their activities.

A financial market is an avenue where financial assets/instruments are exchanged and traded. It provides three main functions, namely price discovery, liquidity, and reduced cost of transaction. Similar to the long-term critical functions performed by capital markets, money markets are of paramount importance in the short-term owing to the central role they play in influencing monetary policy. In addition to the traditional role, performing monetary policy, they also perform other vital functions such as fund raising, cash management, risk management, speculation or position financing, signaling, providing access to information on prices. A money market consists of various segments: an interbank market where banks deal with the central banks as well as with each other; a primary market for new issues to take place, allowing borrowers to raise funds; a secondary market where different short-term securities are traded to ensure liquidity, increasing lending supply and reducing prices. As for the derivatives market, it is regarded as an avenue for financial contracts that derive their value from underlying instruments that are traded. A variety of instruments are traded in the money market, including treasury bills, certificates of deposit, interbank loans and deposits, repurchase agreements, commercial papers, interest rates and currency derivative instruments. All these instruments share common features in terms of duration (short-term nature), their low risk level, their high-liquid nature, and being close to money. However, these features are, to some extent, different in degree across these instruments, especially when secured and unsecured nature is involved. In terms of structure of the money market, it differs across countries. The structure basically depends on regulatory and legislative frameworks in place, factors that support or limit the development of this type of market, the impact of business culture and traditions, as well as industrial structures. The contribution of money markets to the economy at large is driven by several factors, including the market size, infrastructure development, efficiency, growth of government securities issues and their costs considerations, and taxation policies. Key participants in this market are credit institutions and other financial intermediaries, governments, and individuals (households) with a limited role. In addition to the aforementioned key participants, money market funds, investment funds other than money-market funds, insurance companies and pension funds find money markets an appealing resort to maintain ongoing activities, expand business activities and promote economic growth via investments.

Unlike the developed money markets the developed countries enjoy, emerging and developing countries, especially Muslim countries, still struggle to have deep money markets that cater for the needs of participants. This can be attributed to the lack of developed infrastructure, the shortage of available instruments due to absence of robust regulatory/legislative frameworks or certain types of laws that govern activities (religious ones in case of Muslim countries), as well as other barriers, e.g., technology. In the Middle East, the money market is striving for depth, robust regulatory framework, developed infrastructure, more instruments, transparency and confidence. In the light of Islamic banking and finance penetration of the Kuwaiti financial landscape, it became imperative for the government and relevant authorities to provide an inducive legal and governance environment as well as a developed infrastructure, especially the Islamic version given its distinguished nature compared to the conventional one. Islamic banks, having secured a material share of the market following the successful penetration of the Kuwaiti banking landscape, have become as significant and active as their conventional counterparts, and have their own say in the current and future developments of the financial system in Kuwait. Given this gained significance, under the supervisory requirements of the CBK, each Islamic bank established a Shariah Board that ensures that its activities and products are Shariah compliant. In addition, there is the Higher Committee of Shari’ah Supervision that reports directly to the Central Bank of Kuwait’s Board of Directors. It undertakes several responsibilities, the most important of which is monitoring of Shari’ah conformity of the

Central Bank’s financial transactions with Islamic banks and making decisions in cases of disagreement among members of the Shari’ah Boards at Islamic banks and finance institutions.

It is evident that the Kuwaiti money market has appealing prospects in view of the financial resources the state enjoys, especially oil-based ones. In view of the above discussion and the significant roles the money market plays in the financial system, this study is organized as follows:

1. Background
2. Introduction to money market
3. Money market instruments & functions (Islamic & Conventional)
4. Money market participants and developments in money supply and influencing factors.
   - 4.1 Money supply components
   - 4.2 Quasi-Money components
   - 4.3 Decomposition of foreign assets in local banks
5. Money market and risk
   - 5.1 An explanation of the suggested inter-bank Islamic money market instruments
6. Banks and Money market funds & risk management & risk exposures
7. Money market, exchange rate, and interest rates in Kuwait
8. Monetary policy and economic growth
9. Central bank’s monetary policy implementation and money market
10. Conclusion and recommendations

2. Introduction to Money Market

Basically, the money market consists of intermediaries and instruments for short term funds. It is considered as an integral part of the Kuwaiti financial system. It mainly provides ready sources of funds for market participants, where those with temporary surpluses (lenders) seek short-term investment opportunities and those with temporary deficits (borrowers) require funding. In the money market, operations fall under two key categories: fixed deposits and borrowing against time and buying and selling money market instruments.

The fiscal year, 2022/2023, has witnessed a set of economic developments at the international, regional and local levels, the most notable of which was the rise in price of basic commodities in the global markets as a result of geopolitical developments related to the Russian-Ukrainian conflict, the faltering supply chains that had not fully bounced back following the Covid-19 pandemic, as well as high uncertainty. These developments have forced central banks in major economies to respond quickly by tightening their monetary policies and raising interest rates at rapid rates, including the US Federal Reserve, the European Central Bank, the Bank of England and other central banks around the world. In view of these developments, and by virtue of its monitoring responsibility, the Central Bank of Kuwait, in response to global and local economic conditions and monetary policy trends in major economies, raised its discount rate gradually, during the fiscal year 2022/2023, by 225 basis points, reaching 4.25% from about 1.75% at the end of the previous fiscal year. It was also decided to amend, in varying proportions, the intervention rates in the money market applied to all durations of the interest rate structure, including repurchase operations (repo), Central Bank of Kuwait bonds and securitization, the system for accepting term deposits, and direct intervention tools, in addition to public debt instruments. This came within the framework of the balanced approach adopted by the Central Bank in raising interest rates, in order to enhance the prudent management of its monetary policy, aimed at establishing the foundations of monetary stability and financial stability for the banking and financial sector units, and to maintain the attractiveness of the national currency as a reliable receptacle for local savings on the one hand, and with the aim of enhancing the supportive environment for sustainable economic growth, especially non-oil activities, on the other hand, taking into account the nature of the Kuwaiti economy that is open to the external world.

The CBK has continued its efforts and endeavors for the fiscal year 2022/2023, intended to achieve relative exchange rate stability for the Kuwaiti dinar versus foreign currencies. This is in a way that contributes to reducing inflationary pressures in the prices of imported goods by implementing an exchange rate system based on pegging the Kuwaiti dinar to an undisclosed weighted basket of currencies of the most important commercial and financial partners of the State of Kuwait, since May 20, 2007, under Decree Law No. (147) of the year 2007 (CBK, 2023). As any other country's money market, it has initiated actions to ameliorate monetary policy and its tool, maintaining the exchange rate stability and purchase power of the Kuwaiti Dinar, supporting SMEs and banks, in addition to considering other activities that will efficiently assist in diversifying from oil activities. Having a developed and deep money market will be one the strategies Kuwaiti authorities need to pursue to achieve their development objectives.

3. Money Market Instruments & Functions (Islamic & Conventional)

Money market is an integral pillar of the financial system, enabling transactions of financial assets between lenders and borrowers, where transactions take place over the counter (OTC) via electronic telecommunication. Traditional money market instruments are usually traded for a period of three (3) months or less. However, the maturity of money market instruments can generally range from overnight to twelve (12) months. Being close to money, these short maturity financial instruments/securities are characterized by high liquidity, low risk, easiness of tradability, easiness of convertibility to cash. Table 1 outlines commonly traded instruments in both conventional and Islamic money markets.

Table 1: Selected common money market instruments.

Malaysia[1]		Saudi Arabia[2]-[3]	UAE[4]-[5]
Conventional	Islamic (Malaysia as an example)	Bonds (short- to medium-term)	Treasury bills and bonds
Treasury bills[6]	*Mudarabah* Interbank Investment (MII)	Floating-rate notes	Time deposit

[1] Retrieved from https://ubsmebooks.com/book/info/182852/2nd-Edition-Islamic-Financial-System-Principles-and-Operation
[2] Retrieved from https://www.sabinvest.com/content/12022017_saudiriyalmoneymarketfund-30jun16.pdf
[3] Retrieved from https://www.sama.gov.sa/ar-sa/MonetaryOperations/Pages/default.aspx
[4] Retrieved from https://mof.gov.ae/federal-debt-management-office-ar/
[5] Retrieved from http://dspace.univ-chlef.dz/handle/123456789/1831
[6] Treasury bills are issued by the government. Certificates of deposit are negotiable financial papers issued by banks.

Certificate of Deposit (CD's) is a negotiable term deposit accepted by commercial banks, they are usually issued through promissory notes. The inter-bank market is a segment of the market where scheduled commercial banks lend or borrow on short notice (say a period of 14 days) in order to manage day-to-day cash flows. Commercial papers are issued by corporates issue to meet their short-term working capital

Certificate of deposits (CDs)	*Wadiah* Interbank Investment	Time deposits	Repurchase agreements.
Call money (inter-bank) market	Islamic Accepted Bills (IAB)	Certificate of deposit	Treasury and corporate bonds
Commercial papers	Islamic Negotiable Instruments	Repurchase agreements.	Certificates of deposits
Banker's acceptances	Islamic Debt Securities	Forward-rate agreements	Short-term corporate paper
Money market funds	Malaysia Islamic Treasury Bills (MITB)	Interest-rate swaps	Other discounted instruments of a tenure not exceeding 1 year.
Repurchase agreements (repos)	Bank Negara Negotiable Notes	Currency swaps	Instruments based on *Shariah* principles such as *Wakala* and *Murabaha*, Islamic deposits, and sukuk instruments with a duration less than a year
Municipal and government loans	Government Investment Issue (GII)	Money market funds that invest in short-term debt	

requirements; therefore, it serves as an alternative to borrowing from a bank. A banker's acceptance is a short-term issuance by a bank that guarantees payment at a later time, and it is often used in importing and exporting, with the importer's bank guaranteeing payment to the exporter. A money market fund is a type of mutual fund that invests in high-quality, short-term debt instruments, cash, and cash equivalents. A repurchase agreement (repo) is a form of short-term borrowing for dealers in government securities, most repos are overnight, though they can be longer.

		securities and Shariah-compliant instruments such as *Murabaha*	

Source: prepared by author.

As for Islamic money market instruments, *Mudarabah* Interbank Investment (MII) enables a deficit Islamic Financial Institution (IFI) (*mudarib*) to obtain investment from a surplus IFI (investor bank) based on Mudarabah (profit sharing is negotiable). The investor bank serves as the *rab al maal* while the deficit bank is the *mudarib*. Under the MII the investor bank will provide funding to the deficit bank for a definite period of time. In accordance with the *Mudarabah* principle, the two parties will agree on the profit-sharing formulae in advance, while losses, if any, are borne by the investor bank (*rab al maal*). Both the principal and profit are repaid by the deficit bank at maturity - usually overnight to twelve (12) months. In the interbank market, money is lent overnight or at weekends for three days. However, banks usually borrow for longer periods of up to twelve months.

Based on the concept of *Wadiah ad-dhamana*, *Wadiah* Interbank Investment enables IFIs to place their surplus funds with Bank Negara Malaysia (BNM, the Central Bank). BNM, as custodian of the funds, is under no obligation to pay any specific return on the depositor's account. However, the custodian, at their own volition, may declare and pay the depositor dividends in which case the dividend is treated as *hibah* (gift). *Wadiah* Interbank Investment is flexible with the Central Bank. It does not compel the Central Bank to invest the funds in their custody. Hence, an efficient tool in facilitating liquidity management for the Central Bank.

Similar to Bankers Acceptances, Islamic Accepted Bills (IAB) were first issued in 1991 under the *Murabaha* concept and traded on *bai' ad-dayn*. The main aim was to encourage and promote both domestic and foreign trade by providing a competitive Islamic financial product to traders. Islamic Financial Institutions (IFIs) mainly use IAB in two types of financing – import or purchase and export or sales of commodities.

Approved and endorsed by the National Shari'ah Advisory Council of Bank Negara Malaysia, Islamic Negotiable Instruments (INI) are modeled on conventional Certificate of Deposits (CDs). INIs are of two types:

1- Islamic Negotiable Instruments of Deposit (INID)

Structured under the concept of Mudarabah, INID represents a sum of money deposited with an IFI (the issuing bank) to be repaid to the bearer, on a specified future date, at the nominal value of INID plus declared dividends/profit. Under the concept of *Mudarabah*, the issuing bank is *mudarib* while the investor is the *rab al maal*.

2- Negotiable Islamic Debt Certificate (NIDC)

Structured under the concept of *Bai' Bithaman Ajil* (BBA), NIDC represents a sum of money deposited with IFIs to be repaid to the bearer on a specified future date at the nominal value of NIDC. NIDC enables IFIs to sell their assets to customers on cash basis and later buy it back from the customer at principal value plus profit (to be settled at an agreed future date). They represent Certificates of Deposits that enable mobilizing medium and long-term deposits.

Islamic Negotiable Instruments can be traded in the secondary market in either of the following ways:

1- Outright sale and purchase – the holder of the INI sells to a third party without recourse.

2- Purchase and redemption – the Issuer redeems its own INI before maturity.

3- Sell and buy back – the holder sells the INI to an investor and promises to buy it back in the future.

As for Islamic debt securities, these instruments were introduced in 1990 under three concepts – *Bai' Bithaman Ajil (BBA), Murabaha* and *Mudarabah.* Their maturity ranges from three (3) to fifteen (15) years. Under the BBA concept, IFIs purchase assets from the customer and later resells the asset at a profit. The loan arising from the instrument is securitized by the issuance of two notes – the primary and secondary notes. The primary note is equivalent to the purchase price of the asset from the borrower while the secondary note is equivalent to the profit realized from the resold asset. These notes are traded in the secondary market under the *bai' ad-dayn* concept.

An alternative to the conventional Treasury Bills, Malaysia Islamic Treasury Bills (MITB) are issued by BNM on behalf of the Malaysian government to raise short-term funding of government spending. Whereas MITB finance government operating expenses Government Investment Issue (GII) funds development expenditure of the Malaysian government. MITB are issued weekly under the concept of *bai' al inah* with original maturity of three (3), six (6) and twelve (12) months. Both Islamic and conventional institutions can purchase and trade on MITB.

<u>*Illustration:*</u>

Bank Negara Malaysia (BNM), acting on behalf of the Malaysian government, identifies a government asset and sells it through a tender to an IFI that offers the most competitive price. The IFIs will buy the asset at a discounted nominal value and sell the asset back to BNM at par value based on the credit terms. The government will then issue MITB to the successful IFIs to represent the debt created.

Government Investment Issue instruments were first introduced in July 1983, initially under the concept of *Qard al Hasan*, but later, in 2001, changed to *bai' al inah* (sale and buy back) to enable trading in the secondary market. They are issued to fund the development agenda of the Malaysian government.

Illustration:

Bank Negara Malaysia (BNM) identifies a *Shariah*-compliant asset and sells it through a tender to an IFI that offers the most competitive price. The IFI will buy the asset at a discounted nominal value and sell the asset back to BNM at par value upon maturity. The difference between the purchasing price and the selling price will be the profit from the investment. Effective from 22 July 2013, GII is issued based on *Murabahah* concept.[7]

In Addition, Bank Negara Negotiable Notes (BNNN) instruments were introduced in November 2000 under the concept of *Al-Ijara*. They are used for liquidity operations in the Islamic money market. BNNN were later replaced by Bank Negara Monetary Notes (BNMN) which are based on *Tawarruq* (commodity *Murabaha*) with a maximum tenor of three (3) years. Cagamas Mudarabah Bond instruments were introduced in March 1994 by Cagamas Berhad - the national mortgage corporation of Malaysia. Initially, they used Mudarabah concept, but BBA was subsequently applied. The aim was to finance the purchase of Islamic mortgages and Islamic hire-purchase debts. The instruments are

---

[7] https://financialmarkets.bnm.gov.my/islamic-instruments. Since 2013, all GIIs are issued using the commodity *murabahah-tawarruq* arrangements.

redeemable at par and profits are shared at maturity between the bondholder and the issuer (Cagamas) according to the agreed profit-sharing ratio. Finally, as for Sukuk Bank Negara Malaysia Ijarah (SBNMI), BNM Sukuk Berhad[8] buys assets from BNM. Thereafter, the assets will be leased to BNM for consideration of lease payments which are distributed to investors as returns semi-annually. Upon maturity, BNM Sukuk Berhad will sell the asset to BNM at a predetermined price.

It can be noted that most of the Malaysia Islamic money market instruments are based on contracts that are generally non-compliant with *Shariah* such as *bai' al inah* and *bai' ad-dayn*.

The Kuwaiti money market is an essential source of working capital for businesses such as Kuwaiti banks and other financial institutions. The duration of the operations that take place on the Kuwaiti money market can range from one day up to an entire year. Kuwaiti commercial bills, Kuwaiti certificates of deposit, Kuwaiti treasury bills, and other financial instruments in Kuwait are the types of instruments that are used.

In Kuwait, the number of available money market instruments is limited. Table 2 highlights short-term financial instruments in Kuwait. Prior to 2022, there were no 12-month CBK bonds and related Tawarruq; however, in 2022 and 2023 there were balances of 100 and 130 million dinars of this type with interest rate of 4% and 4.625% respectively.

[8] A special purpose vehicle (SPV) that was specifically established for the purpose of issuance of SBNMI

Table 2: money market debt instruments in Kuwait

End of Oct	Instrument							
	3-Month CBK bonds and related Tawarruq				6-Month CBK bonds and related Tawarruq			
	matured	New issue	Balance	Interest rate (%)	matured	New issue	Balance	Interest rate (%)
2016	365	400	1355	1.000	240	235	1315	1.125
2017	440	480	930	1.750	240	240	1570	1.875
2018	680	680	1440	2.750	240	240	1490	2.875
2019	680	680	1410	2.750	240	240	1520	2.875
2020	680	680	1410	1.125	-	-	1520	1.250
2021	440	440	1170	1.125	240	240	1760	1.250
2022	200	200	1290	3.375	480	480	2300	3.750
2023	440	440	1320	4.375	480	480	1830	4.50

* Currency: Million KD
Source: statistics and publications by the Central Bank of Kuwait, available at: https://www.cbk.gov.kw/en/statistics-and-publication/dynamic-statistical-releases/monthly
Prepared by author.

Table 3 shows the volume of Treasury bills & bonds and related Tawarruq in Kuwait with their corresponding yearly interest rate over the period 2016-2023. All these instruments are held by local banks. There was a new issue in 2016 with 200 million Dinars. As for maturity, there was a maturity of 200, 22.3, 150, 520, and 70 million Dinars of these instruments in 2017, 2020, 2021, 2022, and 2023 respectively[9].

[9] https://www.cbk.gov.kw/en/statistics-and-publication/dynamic-statistical-releases/monthly

Table 3: Treasury bills & bonds and related Tawarruq

Oct	2016	2017	2018	2019	2020	2021	2022	2023
Treasury bills & bonds and related Tawarruq (balance)	2967.3	4767.3	3542.3	2372.3	1050	950	280	210
One-year interest rate (%)	1.25	2	3	3	1.375	1.375	4	4.625

* Currency: Million KD
Source: statistics and publications by the Central Bank of Kuwait, available at: https://www.cbk.gov.kw/en/statistics-and-publication/dynamic-statistical-releases/monthly
Prepared by author.

The money market in Kuwait lacks depth due to the limited number of tradable instruments. In addition, all treasury bills, bonds, and *tawarruq* instruments are held by local banks.

4. Money Market Participants and Developments in Money Supply and Influencing Factors.

Table 4 illustrates the developments in M1, M2, M3[10], as well as factors affecting M2, namely local assets (claims on CBK, claims on government, claims on public institutions, claims on private sector (mainly credit facilities to residents), local interbank deposits, loans to banks) and foreign assets with local banks (foreign investments, deposits with foreign banks, credit facilities to non-residents, loans to foreign banks, and other assets), for the end of October over the period from 2016 to 2023. At the end of October 2023 compared to the corresponding month in 2022, money supply in its narrow sense, "Narrow Money" (M1), continued to slow down (on an annual basis since August 2022) by KWD

[10] M3 comprises M2 plus deposits with other financial institutions, specifically private sector deposits with deposit-taking investment companies.

0.71 billion (6.1%) to KWD 10.99 billion at the end of October 2023, against KWD 11.70 billion at the end of the corresponding month in 2022. On the other hand, money supply in its broad sense (M2) increased by 4.1% to KWD 39.34 billion. The total local banks' assets grew by KWD 3.06 billion (3.7%), while net foreign assets with local banks increased by KWD 1.85 billion (19.0%) to KWD 11.58 billion at the end of October 2023 against KWD 9.74 billion at the end of the comparative month. This rise was mainly due to the increase in foreign assets by KWD 2.37 billion (10.9%).

Table 4: Money supply and relevant factors[11]

End of Oct	Money supply		Factors affecting M2			
	M1[12]	M2[13]	local assets	Net local assets[14]	foreign assets	Net foreign assets
2016	9,440.2	35,633.0	60,049.1	18,376	12,410.8	8,136.1
2017	9,626.1	35,980.6	62,663.3	20,233.5	12,527.2	7,183.0
2018	9,973.1	38,037	65,270.4	20,450.5	13,269.4	7,249.0
2019	10,067.9	38,057.7	69,817.4	19,345.9	15,697.9	7,743.2
2020	12,270.8	40,048.8	72,602.2	18,357	16,195.1	7,784.9
2021	12,292.7	36,434.1	75,763.1	17,403.3	17,476.6	6,572.3
2022	11,699.6	37,789.8	83,354.8	15,807.1	21,878.1	9,737.2

[11] Currency: million dinars.

[12] **M1** represents narrow money, namely money in circulation outside the local banks plus KWD sight deposits.

[13] **M2** represents money supply in its broad sense, it includes M1 and Quasi-Money (KWD saving deposits, KWD time deposits, and deposits in foreign currency).

[14] Net Local Assets includes net claims of CBK and local banks on government, public institutions and private sector less government's deposits and accounts, and other "net").

2023	10,989.7	39,339.1	86,414.2	15,395.1	24,251.9	11,582.8

Source: statistics and publications by the Central Bank of Kuwait, available at: https://www.cbk.gov.kw/en/statistics-and-publication/dynamic-statistical-releases/monthly
Prepared by author.

4.1 Money supply components

Table 5 illustrates the developments in the components of M1 and M2. The decline in M1 mainly resulted from the decrease in KWD sight deposits by KWD 0.69 billion (6.8%) to KWD 9.38 billion, and the drop in currency in circulation outside the local banks by KWD 0.02 billion (1.3%) to KWD 1.61 billion. As for M2, money supply in its broad sense, it increased by KWD 1.55 billion (4.1%) to KWD 39.34 billion at the end of October 2023 against KWD 37.79 billion at the end of the comparative month in 2022. This gain resulted from the rise in quasi-money (KWD saving deposits, KWD time deposits and deposits in foreign currency) by KWD 2.26 billion (8.7%), and the decline in narrow money (M1) by KWD 0.71 billion (6.1%). The data indicates that the rise in M2 was driven by the increase in net foreign assets by KWD 1.96 billion (Table 1), i.e. 8.9% (as a result of the increase in net foreign assets with local banks by KWD 1.85 billion, i.e. 19.0% and net foreign assets with CBK by KWD 0.12 billion, i.e. 0.9%), and the decrease in net local assets by KWD 0.41 billion (Table 4), i.e. 2.6% (resulted from the rise in claims on private sector and other “net”, in addition to the decline in claims on government, public institutions and government’s deposits and accounts) (CBK, 203).

Table 5: M1 and M2 components

End of Oct	Currency outside banks	Sight deposits	**M1**	Quasi-money	**M2**
	(1)	(2)	(3) = (1) + (2)	(4)	(5) = (3) + (4)
2016	1,338.2	7,839.4	9,177.6	26,192.7	35,370.3
2017	1,316.7	8,309.4	9,626.1	26,354.5	35,980.6
2018	1,354.0	8,619.1	9,973.1	28,063.9	38,037.0
2019	1,475.1	8,592.8	10,067.9	27,989.8	38,057.7
2020	1,884.0	10,386.8	12,270.8	27,778.0	40,048.8
2021	1,756.7	10,937.3	12,694.0	26,195.9	38,889.9
2022	1,633.1	10,066.5	11,699.6	26,090.2	37,789.8
2023	1,611.9	9,377.8	10,989.7	28,349.4	39,339.1

* Currency: Million KD
Source: statistics and publications by the Central Bank of Kuwait, available at: https://www.cbk.gov.kw/en/statistics-and-publication/dynamic-statistical-releases/monthly
Prepared by author.

4.2 Quasi-Money components

Table 6 illustrates private sector quasi money developments at the end of October over the period 2016-2023. According to a report published by CBK (2023) on key local monetary and banking indicators for the period 2022-2023, the utilized cash portion of credit facilities to residents increased by KWD 1.17 billion (2.5%), and the total residents' deposits with local banks went up by KWD 1.26 billion (2.7%). Likewise, the resident private sector's deposits increased by KWD 1.57 billion (4.3%).

Table 6: components of Quasi money[15]

End of Oct	Quasi Money			
	Saving deposits	Time deposits	Deposits in foreign currency	Total
2016	4,649.7	18,686.3	2,856.7	26,192.7
2017	4,828.6	19,153.0	2,372.9	26,354.5
2018	4,959.2	20,490.9	2,613.9	28,063.9
2019	5,097.8	20,087.6	2,804.5	27,989.8
2020	6,339.9	19,184.9	2,253.2	27,778.0
2021	6,934.2	15,461.5	1,745.7	24,141.4
2022	6,914.5	17,463.5	1,712.2	26,090.2
2023	5,849.8	20,664.8	1,834.9	28,349.4

* Currency: million KD
Source: statistics and publications by the Central Bank of Kuwait, available at: https://www.cbk.gov.kw/en/statistics-and-publication/dynamic-statistical-releases/monthly
Prepared by author.

4.3 Decomposition of foreign assets in local banks

Table 7 breaks down foreign assets in local banks into their key components. Foreign assets accounted for 28.1% of the local banks' total assets at the end of October 2023 (higher than the average percentage (26.8%) for the period from the end of October 2022 to the end of October 2023). This came from the rise in the balances of foreign investments, deposits

[15] Quasi-money: Balances of Savings deposits (in KD) + time deposits (in KD) + foreign currency deposits + CDs (in KD). The private sector maintains quasi-money components with local banks.

with foreign banks, credit facilities to nonresidents and other assets by 15.5%, 16.8%, 3.0% and 13.4%, respectively.

Table 7: foreign assets in local banks

End of Oct	Foreign investment	Deposits with foreign banks	Credit facilities to non-residents	Loans to foreign banks	Other assets
2016	3,770.1	6,229.8	1,731.3	-	679.6
2017	3,932.1	5,902.3	1,943.3	-	749.5
2018	4,252.7	5,900.8	2,226.2	-	889.7
2019	4,824.7	7,246.6	2,508.8	-	1,117.8
2020	5,035.1	7,202.0	2,886.9	-	1,071.0
2021	5,328.5	7,985.0	3,041.1	1,470.6	1,127.4
2022	8,784.1	5,881.7	3,474.7	2,270.7	1,467.1
2023	1,0147.3	6,867.0	3,579.7	1,995.1	1,662.9

* Currency: million KD
Source: statistics and publications by the Central Bank of Kuwait, available at: https://www.cbk.gov.kw/en/statistics-and-publication/dynamic-statistical-releases/monthly
Prepared by author.

Table 8 shows the total assets of local banks by main components. The balances of claims on CBK, claims on government, claims on public institutions, loans to banks and other assets fell by 7.7%, 17.6%, 0.2%, 2.2% and 5.7%, respectively, at the end of October 2023 compared to the corresponding month in 2022. Claims on the private sector represents the main source of local banks' assets. These claims accounted for 52.3% of the local banks' total assets in October 2023. The claims on the private sector are mainly credit facilities to residents (accounted for 95.0% of the claims on the private sector, and 49.7%

of the local banks' total assets) as well as other local investments as at the end of October 2023.

Table 8: Local Banks' Total Assets by Main Components (KWD Million)

Statement	Oct 2022	Oct 2023	Change		To total (%)
			Value	%	
Claims on CBK	7,872.3	7,265.7	-606.7	-7.7	8.4
Claims on Government	519.6	428.3	-91.2	-17.6	0.5
Claims on Public Institutions[16]	3,630.5	3,623.2	-7.3	-0.2	4.2
Claims on Private Sector, of which:	43,758.1	45,225.1	1,467.0	3.4	52.3
Credit Facilities to Residents	41,751.3	42,950.1	1,198.8	2.9	49.7
Foreign Assets	21,878.1	24,251.9	2,373.8	10.9	28.1
Loans to Banks	999.4	977.0	-22.4	-2.2	1.1
Local Interbank Deposits	1,761.7	1,874.3	112.6	6.4	2.2
Other Assets	2,935.1	2,768.6	-166.5	-5.7	3.2
Total Assets	83,354.8	86,414.2	3,059.4	3.7	100

Currency: million KD
Source: statistics and publications by the Central Bank of Kuwait, available at: https://www.cbk.gov.kw/en/statistics-and-publication/dynamic-statistical-releases/monthly
Prepared by author.

[16] These are financial/non-financial institutions wholly or partially (50% and above) owned by the government.

5. Money Market and Risk

Varieties of risk faced by conventional and Islamic money markets include counterparty risk, liquidity risk, interest rate risk, regulatory risk, accounting risk, as well as risks specific to Islamic banking, including *Shari'ah* compliance risk, fiduciary risks in respect of profit-sharing investment accounts, rate-of-return risk, and lack of *Shari'ah*-compliant lender of last resort facility. As for conventional money market instruments, the Kuwaiti money market instruments are few and may not suffice in dealing with the many exposures and needs in the market. In addition, according to Table 3, all treasury bills, bonds, and Tawarruq instruments are held by local banks. In doing so, the Kuwaiti money market will provide alternatives to conventional instruments, enrich the market with *Shariah*-compliant instruments, supply more tools to counteract the many risk exposures, especially liquidity risk, and enhance the risk management process, provide investors with various options to invest their liquid funds on an Islamic basis, and deepen the financial system at large. However, this means that many essential pillars have to be in place, including a legal framework, *Shariah* governance framework, and a robust risk management process to ensure stability, transparency, rights protection, and accountability.

The idea of establishing an Islamic money market, inter-bank Islamic money market, or a secondary money market where instruments can be traded in Kuwait has not crystalized yet and requires serious initiatives by relevant authorities to make it real and viable. Table 9 suggests some Islamic Inter-bank money market instruments Kuwaiti authorities can consider introducing.

Table 9: Suggested inter-bank Islamic money market instruments.

Instrument	Description
Islamic Negotiable Instruments of Deposit (INID)	Certificates issued in accordance based on *Mudarabah* principle, they represent sums of money deposited with an IFI (the issuing bank) to be repaid to the bearer, on a specified future date, at the nominal value of INID plus declared dividends/profit. Under the concept of *Mudarabah*, the issuing bank is *Mudarib* while the investor is the *Rab al Maal.*
Sell and Buy Back Agreement (SBBA)	An Islamic money market transaction two parties in which the first party in the agreement, the seller, sells assets to the second party in the agreement, the buyer, at an agreed price, and subsequently, both parties enter into a bilateral promise (*Muwa'adah*) in which the buyer promises to sell back the specific asset to the seller at an agreed price. For a detailed description of this agreement, refer to Alam and Rizvi (2016).
Islamic Accepted Bills (IAB)	Also known as Interest-Free Accepted Bill (IAB), it is a bill of exchange. The aim of introducing IABs is to encourage and promote both domestic and

	foreign trade, by providing Kuwait traders with an attractive Islamic financing product. The IAB is formulated on the Islamic principles of *Murabahah* (deferred lump-sum sale or cost-plus). This instrument is suitable for imports and local purchases, where the financing happens based on a *Murabahah* working capital financing mechanism. Based on this concept, the commercial bank appoints the customer as the purchasing agent for the bank. The customer then purchases the required goods from the seller on behalf of the bank, which then pays the seller and resells the goods to the customer at a price, inclusive of a profit margin. The customer is allowed to pay on a deferred basis with a period up to 200 days. Upon maturity of *Murabahah* financing, the customer pays the bank the cost of goods plus a profit margin. This instrument can be applied based on *bay al-dayn*; however, the latter is not permissible in *Shariah.*
Ijarah-based Sukuk	An instrument based on the *al-ijarah* or ‘sale and lease back’ concept. A special purpose vehicle (SPV) issues the *sukuk ijarah*. The proceeds

	from the issuance (cash flow from the investors) will be used to buy the assets of the central bank. Subsequently, the assets will be leased to the central bank for rental payment, which is distributed to investors as a return (coupon) over a given period, let's say semi-annually. Upon the maturity of the *sukuk*, at the end of the rental tenure, SPV will sell the assets back to the central bank at a predetermined price (principal). The *Shariah* principle applied in this instrument is *Ijarah muntahiyah bi al-tamlik*.
Ar Rahnu Agreement	An agreement where the financing provider will provide finance to another party which needs financing, based on the concept of *Qard hasan*. The recipient of the finance will pledge its securities as collateral for the financing granted. However, in the event that the recipient fails to repay the loan on the maturity date, the financier has the right to sell the collateral and use the proceeds from the sale of the collateral to settle the financing. If there is any surplus money, the financier will return the balance to the recipient of the finance.

Source: Prepared by author

A couple of issues and challenges may be associated with the suggested instruments in Table 9, which entails due diligence and assessment to ensure the viability of the instruments under different circumstances and scenarios. These issues include pricing of the instruments, benchmarking, the profit sharing ratio where agency problems may arise, a return in *Ar Rahnu* agreement should not be promised upfront and should be discretionary in the form of *Hibah* and should not be based on any interbank money market rate, the prohibition of *bay al-inah* in the sell and buy back instrument as well as the promise which takes place at the time of the first contract. As for Ijarah-based Sukuk, its viability as a money market instrument is questionable because its issuance requires the availability of assets to back the issuance; a scenario may not be possible all the time.

Introducing some of the above suggested inter-bank money market instruments will pave the way towards establishing a deep and liquid Islamic money market as well as highly diversified money market funds, which in turn will assist Islamic banks to tackle many challenges and issues such as liquidity, risk management, risk exposures, etc.

5.1 An explanation of the suggested inter-bank Islamic money market instruments

1- Islamic MM instrument of Islamic Negotiable Instruments of Deposit (INID).

INID includes several processes as following:

- The customer deposit money into a bank.
- The bank accepts the customer's deposit and issues an INID to the customer as evidence of receiving the deposit.
- The INID is tradable in the secondary market.
- on maturity, the customer or holder of INID returns it to the bank and receives the principal value of the INID and the declared dividend; and

- The declared dividend is from the profit derived from the investment of the deposit.

Under INID, the term floating is used, it refers to the characteristic of the product that it changes in value based on the dividend declared by the bank from time to time. The concern in the case of INID is to ensure that the investment process mentioned above is in line with *Mudharabah* principle.

INID computation process under assumptions such as trading on price basis, principal value quoted in terms of price per KD100 nominal value specified to four decimals, can be simplified as follows:

	Formula	Example
Profit sharing ratio in favour of customer	PSR (k)	70:30
Deposit placement	D	1,000,000
Declared dividends rate	R	10%
Tenor (months)	T	6
Or, day to maturity		182.5
Proceeds	$D * (1 + \frac{r*t*k}{365})$	1,035,000
Customer's profit	Profit	35,000

2- Islamic MM instrument of sale and buy back agreement (SBBA).

The transacting parties enter into two separate agreements, where in the first agreement the seller, owner of Islamic negotiable instrument, sells and the buyer (investor) purchases the instruments at an agreed upon price by both parties. Subsequently, a second separate agreement takes place where the buyer (investor) promises to sell back the instrument to the original seller, and the seller promises to buy it back at a specified price on a specified future date. This can be referred to as bilateral promise (*muwa'adah*)[17]. Under SBBA, Ownership of the INI shall be transferred to the buyer (investor) upon conclusion of the first agreement of the SBBA. Nonetheless, some conditions should be adhered to under SBBA, including the fact that the issuer cannot buy its own negotiable instrument, and the tenor of SBBA must be within the tenor of the negotiable instrument used for the transaction. In addition, the SBBA should not use an instrument that pays periodic dividends or coupon as profit as in the case of negotiable Islamic debt certificate (NIDC). Under SBBA, there should be another institution willing to enter into the agreement on a regular basis using a two-way quotation either by quoting rates or profit-sharing ratio. Furthermore, upon its release, the SBBA which uses an Islamic negotiable instrument shall be governed by the guidelines of the Sell and Buy Back agreement guidelines.

Some argue that SBBA is not but a *bay al-inah* contract; however, this claim can be refuted given that under *bay al-inah* the second agreement in the transaction shall take place promptly after the conclusion of the first agreement, while under SBBA, the second agreement shall be performed at a later time. It is only the bilateral promise that takes place immediately after the conclusion of the first agreement of the transaction. Other may also argue that a bilateral promise is not allowed in *Shariah*. This claim, as the first one, can be refuted given that a bilateral promise is not equivalent to a contract.

3- Islamic MM instrument of Islamic Accepted Bills (IAB)

[17] *Muwa`adah* is a bilateral binding promise between two parties to enter into a contract in the future. It is ruled by some parties that that *muwa`adah* is permissible as it is not equivalent to a contract. Since the contract is yet to be entered into during the *muwa'adah* period, it does not have the effect of a contract. the promisor who breaches his promise is liable to pay compensation based on the actual loss suffered by the aggrieved promisee due to the breach.

Its main goal is the promotion of both local and foreign trade by providing Kuwaiti traders with an appealing Islamic financing product. Refer to table 9 above for more details.

4- Islamic MM instrument of Islamic *Ijarah*-based Sukuk

This instrument uses the most recognized *Shariah* principle, that is *ijarah muntahiyah bi al-tamlik*, a principle broadly recognized by *Shariah* scholars. However, its attractiveness as a money market instrument is controversial for its issuance demands the availability of assets to back the issuance; a scenario may not be possible all the time. Figure 1 is a representation of the explanation provided in Table 9 about this instrument.

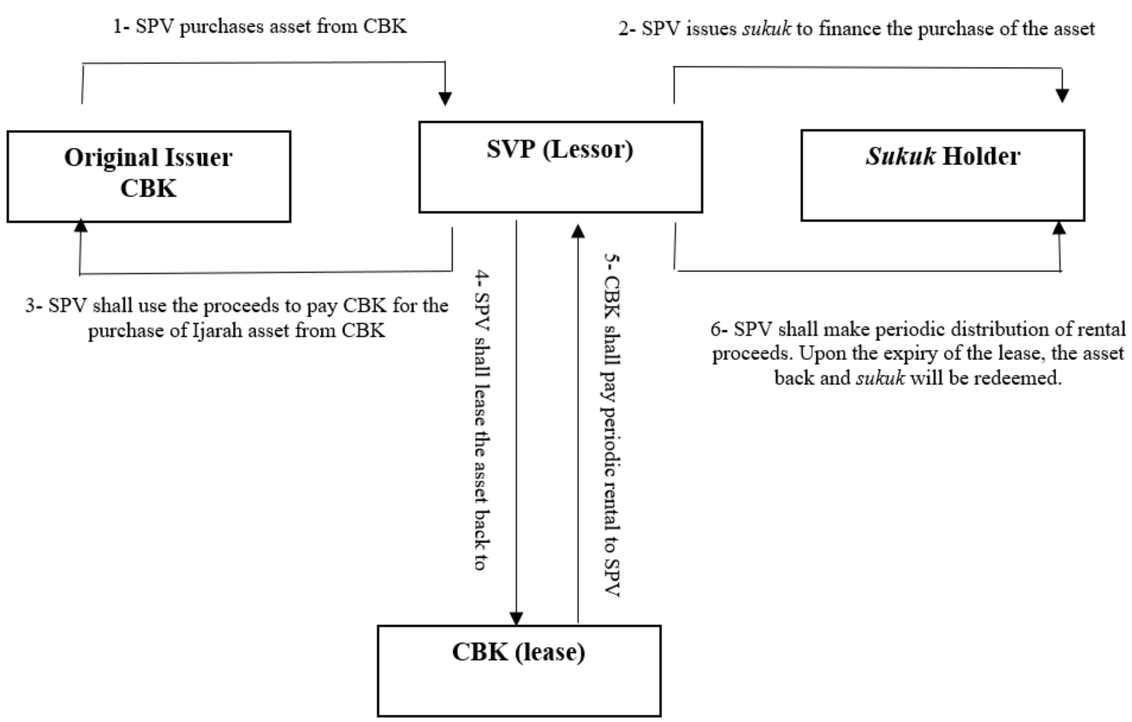


Fig. 1 structure of the proposed instrument *Ijarah*-based Sukuk

5- Islamic MM instrument of *Ar Rahnu* Agreement

In addition to the explanation in Table 9, this instrument can be used as a liquidity management tool for its money market operations. return from the Ar Rahnu agreement will be in the form of a gift (*hibah*) and determined based on the average interbank money market rates. The giving of *hibah* is completely discretionary and must not be promised in the original *rahn* or *qard* contracts.

6 Banks and Money Market Funds & Risk Management & Risk Exposures

Conventional money market funds (MMFs) are open-ended fixed income mutual funds that invest in short-term debt securities, such as treasury bills, municipal bills, and short-term corporate and bank debt instruments that come with low credit risk and emphasize liquidity. Likewise, Islamic money market funds resemble conventional ones, however, the instruments invested in should be *Shariah*-compliant. MMFs are considered as one the most effective tools to manage risk in the money market as they provide investors with a safe medium through which they can invest in easily accessible, secure, and highly liquid cash-equivalent debt-based assets with a short-term maturity. In Kuwait, there are a couple of money market funds such as Boubyan KD Money Market Fund II, which is a *shariah*-compliant fund that invests in instruments based on *Wakalah* and *Murabaha* deposits with banks, and high-quality government and/or corporate Sukuk. It also considers investing in other investment funds that have a similar investment objective. Watani KD/USD Money Market Fund According to Islamic *Shariah* Principles II, the fund seeks to achieve returns higher than the rate of return on fixed deposits in Kuwaiti Dinars. The fund seeks to increase its net asset value while maintaining a high level of liquidity by investing in diversified and high-quality money market instruments. Warba Islamic KD/USD Money Market Fund is a high quality, *Shariah* compliant, open-ended money market fund that avails investors' liquidity through weekly subscriptions and redemption windows. It seeks to maximize current income within the constraint of capital preservation, and the maintenance of liquidity, by investing strictly in *Wakala* placements with banks and high-quality money market instruments. KFH capital Money Market Fund aims to realize returns on the invested amounts (in a *Shariah*-compliant way) through investing in short and medium-term cash instruments, deposits with banks, Islamic *Sukuk* offered by governmental authorities or high-quality companies to ensure high liquidity and low risk. The Fund may also invest in other money market funds with similar investment objectives. In addition to traditional risks, Islamic money market funds also face a variety of risks, which has been pointed out earlier, of which risks *Shariah* compliance is the most prominent. The latter has been regarded as a serious impediment for achieving a deep Islamic money market either due to the *Shariah*-compliant instrument being unattractive/unprofitable for banks or to the inability of structuring as many as possible instruments that are compliant with *Shariah* based on different Islamic principles. For example, in the case of Kuwait, money market funds are only introduced based on *Wakalah*, *Murabaha*, and *Sukuk* to some extent. Several other Islamic principles such as *Mudarabah*, *Musharakah*, *Salam*, *Istisna'a*, *Ar Rahnu Wadi'ah,* etc., based on which instruments can be introduced have not been considered. On the other hand, even though MMFs are regarded as a safe resort to invest in over the short term, they can still encounter some risks, such as liquidity risk resulting from market volatility or from a lack of liquidity in underlying securities held by a fund. It also can face credit risk which measures the likelihood that issuers or counterparties will default or be downgraded. As for conventional MMFs, the interest rate of the held securities is one of the leading risks to be contained. By the virtue of its low returns which are compensated by low risk, MMFs returns may fall below inflation rate, providing negative real returns to investors (inflation risk). MMFs that invest in instruments across borders that are denominated in other currencies other than the home currency may be exposed to foreign exchange risk. Environmental change in terms of regulations and policies such as money supply and interest rate also can pose threats to the price of money market securities and their issuers' financial standing. Table 10 provides information on four Islamic MMFs in Kuwait which was published by the funds in February 2024.

Table 10: Islamic MMFs in Kuwait

Fund	KFH Capital Money Market Fund KWD	Boubyan KD Money Market Fund II	Warba Islamic Money Market Fund		Watani Money Market Fund According to Islamic Shariah Principles II	
Currency	KD	KD	KD	USD	KD	USD
Incorporation	08/18/2019	08/02/2016	10/11/2023	12/03/2023	06/25/2014	07/13/2015
Fund ID	98	66	115	116	36	37
Monthly return	0.35%	0.361%	NA	0.45%	0.35%	0.44%
Return of the previous year last quarter	1.02%	1.072%	NA	0.17%	0.96%	1.32%

Return since the start of the year	0.35%	0.361%	NA	0.45%	0.35%	0.44%
Previous year return	4.09%	4.096%	NA	0.17%	3.87%	4.97
Return since incorporation	10.52%	17.170%	NA	0.63%	16.86	12.90

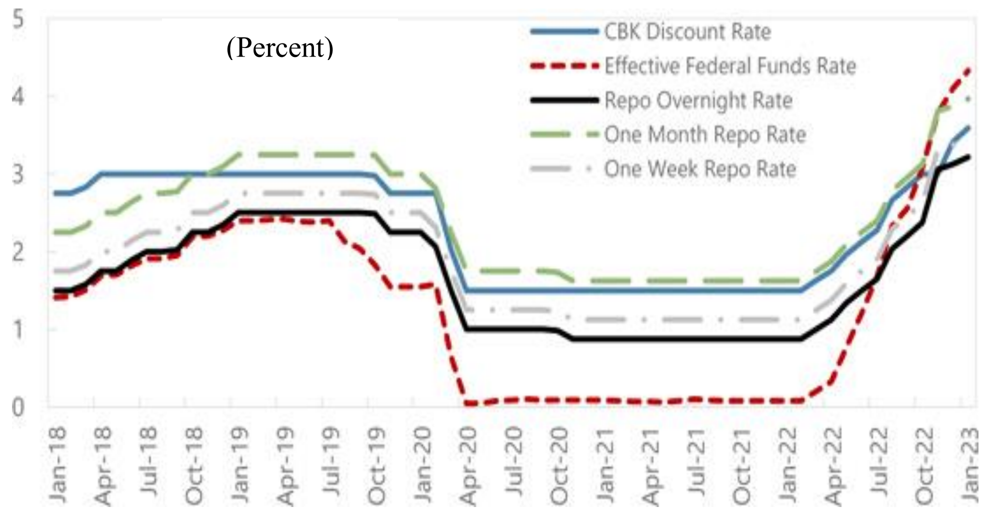
Source: Boursa Kuwait. Available at : https://www.boursakuwait.com.kw/en/participants/participants/mutual-funds

7. Money Market, Exchange Rate, and Interest Rates in Kuwait

Monetary policy in the State of Kuwait is set and implemented by CBK in accordance with the Law No. 32 of the year 1968 concerning Currency, the Central Bank of Kuwait and the Organization of Banking Business. Monetary Policy's prime goal is to maintain monetary stability with the objective to mitigate the impacts of inflation. One of the tools used by monetary policy is the money market, whereby open market operations affect short-term interest rates, which in turn affect long-term rates and economic activity. In addition to managing economic activity, monetary policy is widely used to affect the target inflation.

The CBK increased its policy rate by 250 basis points since the beginning of 2022 through February 2023, less than the 450 basis points increase in the U.S. federal funds rate, reflecting the discretionary space provided by the exchange rate basket. In addition to adjusting its discount rate, CBK uses open market operations (OMOs), reserve requirements, and short and long-term lending facilities to achieve its monetary policy objectives.

Figure 2: Policy and Interbank Interest Rates in Kuwait

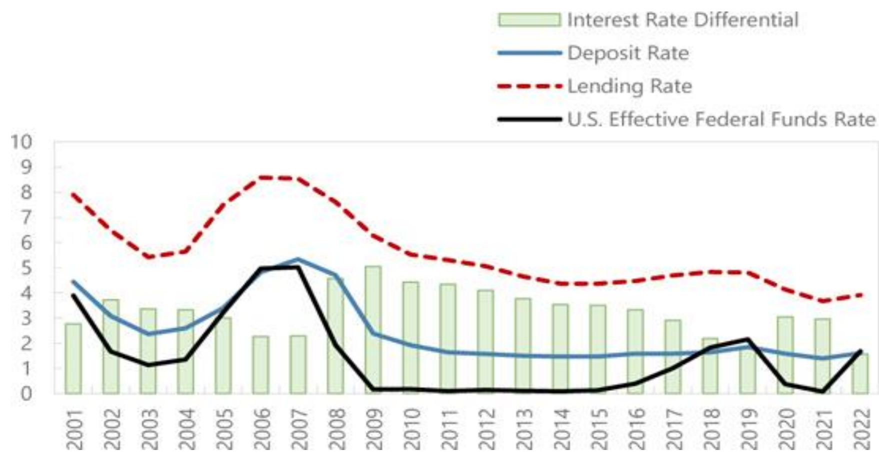


Sources: Haver and IMF staff calculations.

Given that the Kuwaiti market interest rates closely track the U.S. policy rate, the impact on its monetary policy could be material. Hence, the interest rate will serve as a channel through which U.S. monetary policy tightening spillovers will be transmitted to the Kuwaiti economy, whereas the exchange rate channel is muted by virtue of the currency peg to a basket of currencies. Specifically, higher bank lending rates in Kuwait may be anticipated to reduce private consumption and investment demand, lowering aggregate output (IMF, 2023).

As for bank lending and deposit rates in Kuwait, Figure 3 shows the high pass-through from U.S. monetary policy to market interest rates in Kuwait as the rates have been converging towards the U.S. effective federal funds rate, with the interest rate differentials narrowing over the past decade. This convergence was, however, interrupted by the pandemic.

Figure 3: Bank interest rates (percent)



Sources: Haver and IMF staff calculations.

Note: Note: Interest rate differential is calculated as the difference between the weighted average deposit and lending rate and U.S. Effective Federal Funds Rate.

8. Monetary Policy and Economic Growth

It is expected that higher oil prices are likely to boost oil revenues for the government and oil sector state-owned enterprises (SOEs), which in turn could enhance domestic liquidity through increased government and SOE deposits in the banking system. In this regard, it is expected that the monetary policy tightening may have more of an impact on economic growth when oil prices are high and liquidity is abundant than at other times (Adedeji, et al., 2019). Figure 4 shows the movements in bank liquidity and oil prices in Kuwait over the period 2010-2022.

Figure 4: Bank liquidity and oil prices in Kuwait

Sources: Haver and IMF staff calculations.

Note: Note: (i) Domestic liquidity consists of commercial banks' time deposits, Tawarruq, and sight deposits with the Central Bank of Kuwait. (ii) Correlation between domestic liquidity and international oil price is 0.6.

As shown in figure 4, liquidity in the banking system remained high from 2010 to mid-2014 when oil prices were experiencing an increasing trend. This liquidity retracted in the aftermath of the collapse of oil prices in late 2014 until mid-2016, after that it increased in late 2017 and continued to increase up until 2021. As the oil price peaked in mid-2022, bank liquidity witnessed the highest level. Banks that enjoyed high/excess liquidity are expected to give out more loans to other banks via the inter-bank market at affordable rates. As a result, the overall funding cost will be reduced and private domestic demand will be stimulated. It is worth mentioning that lending interest rate and oil prices are negatively correlated. Correspondingly, tight liquidity conditions driven by low oil prices will tend to be associated with high interbank rates, putting upward pressure on lending rates and curtailing private domestic demand (IMF, 2023).

As the monetary policy is one of the effective tools through which the government can steer the growth of its economy, it was documented by the report of the IMF (2023) on Kuwait that the U.S. monetary policy tightening has a negative impact on non-oil GDP growth over the short run. However, this adverse impact is not of a persistent nature, it is only evident in the short run. On the other hand, it was found that Government spending is documented to have a positive and statistically significant effect on non-oil GDP growth. They concluded that the overall impact of the U.S. monetary policy tightening is strongly linked to oil prices. They stated that oil prices above the fiscal breakeven level help mitigate the contractionary impact of U.S. monetary policy tightening, and oil prices below breakeven amplify the adverse impact of monetary tightening.

9 Central bank's monetary policy implementation and money market

Central banks have two methods[18] to implement monetary policy[19], namely the direct method embodied in the use of liquid asset requirements, interest rate controls, and directed credit, and the indirect method which is basically conducted via open market operations. The former, particularly credit ceilings, is mainly used to target the balance sheet of commercial banks, and it may not always be of an effective impact as it may lead to hindering the development of a money market due to lack of banks incentives to actively respond to change in their liquidity risk management, whereas the latter, if supported with deregulation and a liquid money market, will bring about opportunities for innovation in

---

[18] The first method uses direct instruments to influence prices (interest rates) or quantities (credit) through regulations, whereas the second one uses indirect instruments, market-oriented instruments, where the target is influencing underlying demand and supply conditions.

[19] The process through which the monetary authorities (government or central bank) of a country monitor the supply and availability of money, and cost of money or rate of interest, so as to achieve a number of goals meant for the stability and growth of the economy. It can be either expansionary or contractionary, as appropriate.

the way central banks manage their balance sheet. Hence, central banks that are more into using indirect methods to implement monetary policy, especially open market operations, need an effective interest rate transmission mechanism, which also calls for a liquid money market. On the other hand, the presence of a deep and liquid Islamic money market (IMM) will further enable the central banks to achieve stability and carry out its monetary policy effectively. The indirect method of money market implementation will be quite effective when associated with enhanced liquidity management and improved government debt and cash management as it will allow enough room for the central bank in setting its operating procedures. A central bank's procedures have a vital impact on banks' motives to actively manage the risk of running short of reserve money, in other words, the greater the motives, the more banks will transact among themselves, and therefore the more liquid the market will be (IMF, 2001)[20]. Accordingly, two significant components can determine the effectiveness of conducting the monetary policy, namely the central bank open market operation and the extent the central bank is kept in the loop about the government cash flows. Hence, coordination between monetary policy and government debt and cash management can moderate the influence of government expenditures and receipts on the banks' cash balances. However, in the presence of direct constrains imposed by government controls over deposits, interest rates, and lending, neither money markets nor central banks will function effectively; central banks will not be enabled to effectually carry out their monetary objectives and money market transactions will be discouraged. As for

[20] International Monetary Fund. Developing Government Bond Markets: A Handbook (2001). International Monetary Fund. Retrieved from https://www.elibrary.imf.org/display/book/9780821349557/ch02.xml?tabs=fulltext (Accessed: 28 March 2024). https://doi.org/10.5089/9780821349557.069

the role played by the Islamic Interbank money market, having a developed and deep one will not only facilitate funding and adjusting Islamic financial institutions' portfolios in the short run, but also serve as a channel through which monetary policy is transmitted using indirect instruments. According to Khatat (2016) [21], in a dual banking system, designing a monetary policy regime is complex. The complexity entails the observation of the heterogeneity between the conventional and the Islamic systems and the monetary policy, *Shariah* compliance, and the relationship between financial development and financial stability policies for Islamic banks.

Monetary policy implementation in the Gulf Cooperation Council countries (GCC), where a dual banking system dominates the banking landscape, does not differ much as the many embrace a fixed exchange rate regime. Table 11 presents methods adopted by the Gulf countries in carrying out their monetary policy. As evident from the table, regardless of the considerable share of the banking industry enjoyed by Islamic banks, GCC countries still, to a great extent, operate under a fixed exchange rate regime in carrying out their monetary policy, which could undermine the central bank autonomy, in other words, monetary authorities are not quite free. This can be attributed to the fact that markets still need further robustness and stability to be a vital driver of monetary policy. However, many market-based (indirect) instruments are in play in conducting monetary policy.

[21] Khatat, M. E. (2016). *Monetary policy in the presence of Islamic banking* (IMF Working Paper #WP/16/72). Retrieved from the IMF website (https://www.imf.org/external/pubs/ft/wp/2016/wp1672.pdf).

Table11: Monetary policy implementation in the Gulf Cooperation Council countries

Country	Exchange rate regime	Monetary policy instruments	
		Direct	Indirect
Kuwait	Pegged to an undisclosed weighted basket of major currencies.		Open market operations. . Regulatory liquidity ratio Discount rate/central bank rate. Short and long-term lending facilities.[22]
Saudi Arabia	Pegged to U.S. Dollar	Direct deposits	Policy rates. Foreign exchange swaps. Reserve requirements. Open market operations.[23]
United Arab Emirates	Pegged to U.S. Dollar		Standing facilities and base rate. Statutory reserve requirements Liquidity insurance. Open market operations.[24]

[22] International Monetary Fund. Middle East and Central Asia Dept. (2023). Kuwait: Selected Issues (No. 332). International Monetary Fund. Retrieved from https://doi.org/10.5089/9798400255434.002 (Accessed: 08 April 2024).

[23] IMF. (2022). Impact of U.S. *Monetary Policy on The Saudi Economy and Banking Sector*. International Monetary Fund. available at: https://www.elibrary.imf.org/downloadpdf/journals/002/2022/275/article-A002-en.xml

[24] https://www.centralbank.ae/en/our-operations/monetary-policy-and-domestic-markets/dirham-monetary-framework/

Qatar	Fixed parity between the Qatari riyal (QR) and the United States dollar (USD)		Qatar Central Bank deposit, lending, and repo rates. Required Reserve Ratio.[25]
Oman	Pegged to U.S. Dollar[26]		Open market operations (buying and selling of securities, issuance of Central Bank's own securities, swaps etc.). Reserve requirements and lending ratios.
Bahrain	Pegged to U.S. dollar		Reserve requirements. Deposit and lending standing facilities. Foreign exchange swaps.[27]

Source: prepared by author

[25] https://www.qcb.gov.qa/en/Pages/MonetaryPolicyTools.aspx
[26] https://cbo.gov.om/Pages/MonetaryPolicy.aspx
[27] https://www.cbb.gov.bh/monetary-policy/#:~:text=Reserve%20Requirements-,Monetary%20Policy%20Framework,an%20anchor%20for%20monetary%20policy.

Monetary policy in Kuwait, like other GCC countries, is conducted in the light of an exchange rate peg regime by virtue of the Decree No. 147/2007. The Kuwaiti Dinar is pegged to an undisclosed weighted basket of major currencies, especially those of countries that have material trade and financial ties with the State of Kuwait. According to the central bank of Kuwait, the peg system is meant to maintain and boost the stability of the KD against other currencies, protect purchasing power of the KD, in addition to shielding the domestic economy against the adverse impact of inflationary pressures [28].

10 Conclusion and Recommendations

A country's financial system is regarded as the backbone of its economy, given the many functions it fulfills and the channels it provides for governments, central banks, financial institutions, businesses, and individuals. One of the vital components of the financial system is the money market; it is sought by many players in the economy and is regarded as a safe avenue to either satisfy their funding needs (borrow) or invest their surplus (lend). The attraction of the money market stems from its unique features, including short-run horizon for lending or borrowing funds, low risk, high creditworthiness of short-term financial assets issuing parties, ease of trading short-term financial assets, high liquidity. In Kuwait, the money market is not enjoying its full potential and depth given the limited number of instruments tradable in it, especially the Islamic ones. In addition, the exchange rate in Kuwait is pegged to a weighted basket of currencies, the market interest rates closely track the U.S. policy rate which implies spillovers. This study sought to explore the Kuwaiti money market from the lenses of its present status, tradable instruments, interest rate,

[28] https://www.cbk.gov.kw/en/monetary-policy/exchange-rate-policy

exchange rate, monetary policy, and prospects from an Islamic perspective. The study relied on secondary data, namely quality papers, reports and statistics published by the CBK and reports by the IMF. The study contends that the money markets in Kuwait lack depth, and banks need to introduce more financial instruments, especially those with an Islamic nature given the expansion of Islamic finance in the banking landscape of the country. The paper proposed some Islamic inter-bank money market instruments the government of Kuwait could consider introducing, Table 9. The study contends that money market funds can be extended to include more *Shariah* compliant instruments based on other Islamic contracts that have not been considered yet in the Kuwait money market. To contain risks in the money market, MMFs can be developed further by introducing and incorporating more *Shariah*-compliant instruments in the funds. This will make the fund more diverse and risk absorbing.

The peg of the exchange rate to a basket of currencies and the close tracking of market interest rate to the U.S. policy rate entails giving up monetary autonomy to sustain a fixed exchange rate and open capital account – however the CBK's peg to a basket of currencies provides flexibly to countries with a direct peg. Non-oil GDP and oil prices are highly interconnected affects the money market; this is because in times of high oil prices government spending increases, fostering non-oil GDP growth, banks receive more deposits and tend to lend to banks at a lower rate, private local demand gets stimulated. In contract, low oil prices and liquidity can amplify monetary policy tightening, increasing market interest rates by more than normal, causing lending to shrink, and consequently reducing private local demand. The IMF 2023 country report documented that lending and deposit rates do not fully track U.S. interest rates in the short run, they roughly do so in the long run. Hence, money market rates are not affected given their short-term nature; however, the government is expected to capitalize on high oil prices in the long run, especially if they deviate from the fiscal breakeven in a favorable manner, namely when above fiscal breakeven level. This study recommends that the banks:

- Deepen the money market by introducing more instruments based on some other *Shariah* principles, in inter-bank money market or money market funds, that have not been brought into practice yet.
- Capitalize on money market funds given that it is one of the most effective tools for managing risks and containing risk exposure.

References

ISRA (2021). *Islamic Financial System: Principles and Operation*, 2nd Edition, Kuala Lumpur: International Shariah Research Academy for Islamic Finance (ISRA).

Ismath Bacha, O. (2008). The Islamic interbank money market and a dual banking system: the Malaysian experience. *International Journal of Islamic and Middle Eastern Finance and Management*, *1*(3), 210-226. https://doi.org/10.1108/17538390810901140

Muttalib, S. A. (2014). Islamic Money Market: An Instrument for Managing Liquidity Risk in Islamic Banks. *Islam and Civilisational Renewal*, *274*(1711), 1-21. https://doi.org/10.52282/icr.v5i2.403

Ahmed, U. (2023). An Assessment of The Effectiveness of Islamic Inter-Bank Money Market Instruments in Oman. *AZKA International Journal of Zakat & Social Finance*, 1-12. DOI: 10.51377/azjaf.vol4no1.110

Alam, N., & Rizvi, S. A. R. (Eds.). (2016). *Islamic capital markets: Volatility, performance and stability*. Springer. https://doi.org/10.1007/978-3-319-33991-7

Alhammadi, S., Archer, S., & Asutay, M. (2020). Risk management and corporate governance failures in Islamic banks: a case study. *Journal of Islamic Accounting and Business Research*, *11*(9), 1921-1939.

Central Bank of Kuwait. (2023). Annual report on the 2022/2023 fiscal year. Available at: https://www.cbk.gov.kw/en/statistics-and-publication/annual-publications/annual-reports

Central Bank of Kuwait. (2023). Summary of the key local Monetary and Banking Indicators. Available at: https://www.cbk.gov.kw/en/statistics-and-publication/bulletins-and-periodicals/summary-of-the-key-local-monetary-and-banking-indicators

International Monetary Fund. Middle East and Central Asia Dept. (2023). Kuwait: Selected Issues (No. 332). International Monetary Fund. Retrieved from https://doi.org/10.5089/9798400255434.002 (Accessed: 11 February 2024).

Adedeji, M. O. S., Roos, M. E., Shahid, M. S., & Zhu, L. (2019). *US monetary policy spillovers to GCC countries: do oil prices matter?* IMF Working Paper WP/19/304, International Monetary Fund, Washington, DC. https://ssrn.com/abstract=3524323

International Monetary Fund. Developing Government Bond Markets: A Handbook (2001). International Monetary Fund. Retrieved from https://www.elibrary.imf.org/display/book/9780821349557/ch02.xml?tabs=fulltext (Accessed: 28 March 2024). https://doi.org/10.5089/9780821349557.069

Khatat, M. E. (2016). Monetary policy in the presence of Islamic banking (IMF Working Paper#WP/16/72). Retrieved from the IMF website (https://www.imf.org/external/pubs/ft/wp/2016/wp1672.pdf).

International Monetary Fund. Middle East and Central Asia Dept. (2023). Kuwait: Selected Issues (No. 332). International Monetary Fund. Retrieved from https://doi.org/10.5089/9798400255434.002 (Accessed: 08 April 2024).

IMF. (2022). Impact of U.S. Monetary Policy on The Saudi Economy and Banking Sector. International Monetary Fund. available at: https://www.elibrary.imf.org/downloadpdf/journals/002/2022/275/article-A002-en.xml