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**Directorate-General External Policies**

**Policy Department**

**NOTE**

**ON THE POLITICAL AND ECONOMIC SITUATION**

**IN KUWAIT AND RELATIONS**

**WITH THE EUROPEAN UNION**

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## EXECUTIVE SUMMARY

Kuwait is a country dominated by oil. Output peaked at 3.3m barrels/day in 1972 but was then reduced substantially to conserve oil reserves. It has some of the largest oilfields in the world and 90/95% of exports are petroleum. At current rates of production, Kuwait has sufficient reserves for more than 100 years of oil output.

There are no significant threats to stability and for the near future political changes are likely to be minor; some economic reform measures may soon be introduced but the National Assembly remains resistant to any changes that might affect the salaries of public employees. High oil prices sustain high public spending. The prime minister, and effective head of state, Sheikh Sabah al-Ahmed al-Sabah, supports reform but is not likely to seek to build support for more significant economic and political changes within the ruling family or the National Assembly (parliament). Important electoral reform was finally introduced in 2005 to enable women to both vote and stand in elections to the National Assembly. However a majority of the population of naturalised Kuwaitis and foreign workers are still unable to participate in elections. The next elections are scheduled for 2007.

Few members of the ruling family wish to alter the predominant role of the state in the economy and in welfare provision. There is little pressure to introduce structural reforms, given the state's ongoing ability to provide generous welfare payments to a small national population and the fact that the country's high levels of non-oil income provide a cushion against the volatile nature of the oil market.

The proposed US\$7bn foreign investment in the northern oilfields (Project Kuwait) is likely to be approved by parliament during 2005 (*unresolved at the time of writing*). This and other infrastructure projects will help to lift foreign investment inflows next year. Rising non-oil trade and the beginning of new capital projects, along with a modest expansion of oil output, should see firm real growth in 2005, with further foreign investment and a more modest increase in oil output spurring real GDP growth in 2006.

## **I. POLITICAL SITUATION**

### ***1. Introduction***

#### *1.1. Geographical data*

The Emirate of Kuwait lies at the north-west end of the Persian Gulf, surrounded by Iraq to the north-west and by Saudi Arabia to the south. Its territory consists of a mainland and small islands (about 18000 sq.km total area). A neutral (partitioned) Zone of 2,600 sq.km, shared with Saudi Arabia, lies right in the south of Kuwait, along the Gulf. Much of Kuwait is an arid desert, and the climate is usually hot and humid. The official language is Arabic. English is also used in commercial circles. Kuwait City is the capital.

The non-Kuwaitis are mainly Iranians, Indians and Pakistanis, as well as other Arabs. Of a total population of approximately 2.5 million inhabitants, citizens are estimated to be less than 1 million, of whom about two thirds are Sunni and one third Shiite Muslims. The departure of the British following independence in 1962, the oil boom in 1973 and then the enforced departure of Palestinians following the Gulf War in 1991 have encouraged large waves of immigration from Asia. As in other Gulf States there is massive employment of immigrant labour working for indigenous families. Insofar as Kuwaitis work it is in higher-level occupations. The foreigners are not allowed to participate in local political life.

#### *1.2. History*

Kuwait became a part of the Turkish Ottoman Empire in the 16<sup>th</sup> century. During the later years of Ottoman rule Kuwait became a semi-autonomous Arab monarchy, with a local administration controlled by a Sheikh of the Sabah family, which has been the ruling dynasty since 1756. In 1899, fearing an extension of Turkish control, the ruler of Kuwait signed a treaty with the United Kingdom, accepting British protection while surrendering control over external relations. Turkish sovereignty over Kuwait formally ended in 1918, with the dissolution of the Ottoman Empire.

Kuwait became fully independent in 1961, when the United Kingdom and Kuwait agreed to terminate the 1899 Treaty. Kuwait was accepted in the League of Arab States despite opposition from Iraq, which claimed that Kuwait was historically part of Iraqi territory. The first elections in Kuwait took place in 1961. A new Constitution was adopted the following year. In 1977, Sheikh Jaber Al-Ahmad Al-Sabah became the ruler or 'Emir' of Kuwait.

## ***2. Domestic policy***

### **2.1. State organisation**

The political system is formally characterised by a division of power between the hereditary monarchy and a democratically-elected legislative Assembly. The relationship between the executive and the legislative power is set out in the 1962 constitution, which created the Unicameral National Assembly. Although Kuwait is nominally a constitutional monarchy, power is in fact still firmly held by the Emir, who has the power to appoint the Council of Ministers and push legislation through when he deems it necessary. However, the National Assembly has increasingly begun to assert itself in recent years, and has slowed down various legislative reforms and often voiced strong criticism of the government.

#### a) Executive branch

*Emir:* The Emir is the head of state, and is chosen from among two alternating branches of the al-Sabah family. His authority is exercised through his chosen prime minister, traditionally the crown prince.

*Council of Ministers:* The Council of Ministers (cabinet) is presided by the Prime Minister, usually the crown prince. The key ministerial positions in the cabinet are normally given to other important members of the royal family, with lower ranking ministers increasingly appearing from the ranks of the elected National Assembly.

#### b) Legislative branch

*National Assembly (Majlis al Umma):* The Assembly consists of 50 elected members, in addition to the ministers (ex officio members of the Parliament), who serve for a term of four years. Until recently voting rights were reserved exclusively for men (over the age of 21 and of Kuwaiti nationality by right), but on 16 May 2005 they were extended for the first time to women.

#### c) Judiciary

Civil law system with elements of Islamic law.

#### d) Regional Administration

Local administration is carried out in five municipalities – Kuwait City, Hawalli, Jahra, Farwaniya, and Ahmadi – each of which has its own governor.

## 2.2. Key political forces

Formal **political parties** are illegal, with deputies sitting as independents - although informal groupings do exist. These include the Islamic Constitutional Movement, the Islamic Popular Grouping, the Shi'a group, two Sunni Islamic and some traditionalist groups, a group of independents close to the al-Sabah, and a secular group known as the Kuwaiti Democratic Forum.

Sheikh Jaber al-Ahmed al-Jaber al-Sabah became **Emir** in 1977, after serving as the first Finance Minister of the state from 1949 and, later, as a Prime Minister. As such, he has been the centre of power in the rapid oil-led development of Kuwait. The Sheikh has been reluctant to share his power. In 1986, he dissolved the National Assembly, reinstating it in 1992 under pressure from Western powers after the Gulf War, only to dissolve it again in 1999 when relations between the government and parliament had become tense. Iraq's invasion of Kuwait severely damaged public respect for the Emir and the ruling family, who were accused of lacking foresight. He has now handed much of the day-to-day running of the state over to the Crown Prince, partly due to his ill health.

The Crown Prince: Sheikh Saad al-Abdullah al-Salem al-Sabah is five years younger than the Emir but also in poor health. He resigned his position as Prime Minister in 2003. There is speculation that he will shortly also give up the title of Crown Prince.

Sheikh Sabah al-Ahmed al-Jabir al-Sabah was appointed Prime Minister in 2003 having served previously as Foreign Minister. He is half-brother of the current Emir and is keen to pursue economic reforms. He is also in a strong position to become the next Emir.

A traditional merchant class continues to control private-sector activity and maintains strong ties with the royal family. Some MPs are tribal representatives and hold the balance of power in the assembly.

In July 2003 the Islamist-affiliated opposition in the 50-seat National Assembly was strengthened, even though those identified with Islamic parties fell from 15 to 12. Numbers of liberal supporters of reforms were also reduced. However, political parties are illegal and political affiliations loose.

Despite Sheikh al-Sabah's 1999 decree to allow women to both vote and stand as candidates in elections to the National Assembly, the strengthened position of the Islamist-affiliated groups has blocked the necessary parliamentary approval of the decree. This remained the case until Monday 16 May 2005 when approval was granted in the National Assembly.

This was too late to allow women to take part or stand in local elections on 2 June 2005. Nevertheless, the breakthrough is a historic step for Kuwait and an important regional development (only Iran, Bahrain, Oman and Qatar allow women to vote). It now opens

the way for women to stand as candidates as well as to vote in the 2007 National Assembly elections. In contrast to the gains by Islamist-affiliated opposition in 2003 the recent decision on the role of women in elections is a positive sign towards social reform.

Whilst a breakthrough, there still remain tight controls on the voting rights of naturalised Kuwaitis (requiring 30 years residency or ancestral residents since 1920) and the large foreign workforce (about 1.5 million).

### **2.3. Developments and policy prospects**

The issues of reform and succession to the current Emir dominate politics in Kuwait. Ministers' efforts to promote reform have for the most part been blocked in the assembly, often because such moves are seen as benefiting individuals but not the state as a whole. Reform is likely to mean a reduction in protection offered by the welfare state.

Sheikh Sabah is likely to become Emir fairly soon and to pursue cautious economic reforms but political changes will be limited. In particular, foreign investment in oilfields will be encouraged and the 'Project Kuwait' to develop new oilfields in the north of the country may go ahead if approved by the assembly during 2005. There will continue to be strict controls on the naturalisation of non-Kuwaiti Arabs and on citizenship for the large proportion of the population which consists of such naturalised Kuwaitis.

## **3. Foreign policy**

### **3.1. International organisations**

Kuwait is a member of the Gulf Cooperation Council, the Arab League, the Islamic Conference Organisation, the United Nations and the Organisation of Oil-Producing Countries (OPEC).

### **3.2. Neighbouring countries**

#### **a) Iraq**

The border with Iraq was demarcated for the first time by the UN following the Gulf War in 1991. March 2002 saw a somewhat unexpected thawing in relations at the Arab Summit in Beirut, Iraqi Vice-President Ezzat Ibrahim announced that Iraq recognised the sovereignty and independence of the country that it had occupied in 1990. A deal was struck at the summit, under which Iraq promised it would not repeat its invasion of the oil-rich emirate. But this was not accompanied by a formal recognition by Iraq of the border. Hostage-taking in Iraq also puts Kuwaiti companies operating there under pressure. Until the current border is accepted by Iraq there will be no debt written-off by Kuwait. However, expectations remain positive that progress can be made and Kuwait will write off a substantial part of the Iraqi debt.



## b) Iran

Relations with Iran have been improving steadily, particularly since the victory of the moderate Iranian President Khatemi in the 1997 elections. Military clashes between the two countries occurred during the Iran-Iraq war in the 1980s, when Kuwait was a major backer of the Iraqi military campaign. During the last few years, a series of high-level visits between the two countries has led to improved relations, inspired, in part, by a mutual mistrust of Iraq. Although in recent years Iranian elections have seen the sidelining of moderates, the more pragmatic conservatives seem willing to pursue a constructive Iranian image.

## c) Other Arab countries

Kuwait has been slower to normalise relations with the countries that did not clearly oppose the Iraqi invasion in 1990, such as Yemen, Jordan and the Palestinian National Authority.

## ***4. Security Policy***

### **4.1 The 2003 Iraq War and the post 9/11 'war on terrorism'**

Defence spending was substantially increased after the invasion by Iraq in 1990 but the USA and other Western powers remain the guarantors of Kuwait's security and independence. The USA maintains advisers and bases with large stocks of equipment on Kuwaiti territory.

Kuwait has supported the presence of US bases on its territory in particular since the US led the coalition forces against Iraq in 1991. When the US returned to invade Iraq in 2003 Kuwait supported the US military build up and subsequent transit route for US forces.

Recently suspected Islamist militants have been plotting and carrying out attacks in Kuwait, predominantly against western targets. On 31 January 2005 the National Assembly has responded by passing laws (renewable annually) that give the authorities wide-ranging powers to track and seize illegal firearms. Such developments are a reminder of broader regional tensions and potential instability.

## **II. ECONOMIC SITUATION**

### ***1. Overview***

The economy is supported by its substantial oil reserves (oil and associated products account for 95 % of the country's exports), together with investment income from foreign assets. These assets were secured by the past accumulation of sizeable current account surpluses, dating back to the oil price increases of the 1970s. Given the relatively low

"investment absorption" capacity of the country, the size of the financial assets are proportionately larger than those of other oil producers. The vast majority of citizens are dependent on public salaries paid for by government revenues from hydrocarbon exports, creating inflexible public expenditure commitments that are vulnerable to a decline in oil prices on the world markets. Attempts to reduce the budgetary burden have been limited, although a privatisation programme is now under way.

Financial markets have recovered strongly from the damage caused by the Iraqi occupation of 1990-1991, which saw short term debts rise quickly to help finance considerable reconstruction, including in the banking sector, but these have since abated. The state's capacity to continue generous welfare payments has been reinforced by recent increases in oil prices and this further reduces the incentives for privatisation and structural reform.

## ***2. Economic policy trends***

The rise in oil prices in 2004 which have continued into the first half of 2005 to over \$50 a barrel will again lead to large budget surpluses. Growth in 2004 is estimated at 5.5% of GDP. Next year foreign investment flows should further boost growth even though the value of oil exports is expected to stabilise if not decline.

Kuwait boasts the third largest bourse in the Middle East in terms of market capitalisation (after Egypt and Saudi Arabia) - the Kuwait Stock Exchange (KSE) - but it has performed poorly in recent years.

A number of significant reforms have been passed by parliament or are on the way. Restrictions on foreign investment and foreign ownership have been eased, the KSE will be opened to foreigners and legislation to open up the banking industry is planned. The free trade zone (FTZ) of Kuwait also continues to expand. However, plans to open the upstream oil sector to foreign companies have been slowed by a reluctant parliament.

The government approved the creation of a new authority to oversee the economic reform programme of the country in 2001. The programme calls for gradual measures that will meet short and long-term targets set by the programme. Privatisation of a number of state-run companies was expected, in combination with legal changes aimed at boosting private sector involvement but these are still not finalised.

Reliance on oil and oil product exports means that the ability of Kuwait to plan strategic investment in the economy is limited. Although the government always forecasts a prudent oil price for the year ahead, the volatility of the market can lead to a huge surplus or deficit. Inflexibility over fiscal policy is becoming an increasing problem as the costs of maintaining public services and providing employment for nationals spirals due to a growing population, threatening to reduce the huge "nest-egg" of overseas investment. The level of government-held foreign investments (some US\$100bn) does provide some levelling of revenue when oil prices are depressed, but ultimately a modern taxation system and a diversified economy must emerge to provide the government with secure

sources of revenue over the longer term and allow more strategic planning for investment in the domestic economy.

The country is perhaps the most oil-dependent economy in the region. High oil income provides a source of revenue that could help fund a more diverse economy, while the level of oil reserves mean that Kuwait will have high and secure export earnings for many years ahead. But the efforts of Kuwait to reform are dogged by conflicting influences. The government recognises the need to create a diverse economy and ease the financial burden on the state. However, the parliament is not keen to begin dismantling a generous state system that has taken decades to create, though the imperatives for doing so are seeping through gradually.

### ***3. External sector and attitudes towards foreign investment***

In the 1950s and 1960s, Kuwait began investing overseas in property and businesses in Britain. Because of the vastly expanded oil revenues of the 1970s, the overseas investment program of Kuwait grew tremendously. In 1976 the government established the Reserve Fund for Future Generations, into which it placed an initial US\$7 billion. It decided to invest 10 percent of its revenues annually in the reserve fund. Money from the fund, along with other government revenues, was invested in overseas property and industry. In the 1970s, most of these funds were invested in the United States and in Western Europe: in German firms (such as Hoechst and Daimler Benz, in each of which Kuwait owned 25 percent), in property, and in many United States Fortune Five Hundred firms. In the 1980s, Kuwait began diversifying its overseas investments, placing more of them in Japanese firms. By the late 1980s, Kuwait was earning more from these overseas investments than it was from the direct sale of oil.

The Iraqi invasion proved the importance of such revenues. With oil revenues suspended, the government and population in exile relied exclusively on investment revenues, including their sales for sustenance, as well as to pay for ongoing coalition expenses and post-war reconstruction and repair of the vital oil industry. Kuwait is receptive to foreign investment in those areas of the economy not dominated by the public sector. There are no foreign-exchange controls, and profits, capital gains and royalties are all freely transferable in and out of the country. Foreign firms may only tender for government contracts that are specified for international bidding.

The challenge for Kuwait is not simply one of changing the economic structure, foreign investment regulations and the legal and business environment, but also one of competing with the increasingly aggressive GCC neighbours. Dubai and Bahrain have been quick to open up their economies to tourism, finance and trade. They have geographic advantages (better for trading with Iran and international markets, for example) and more liberal religious regimes. Kuwait will not simply have to equal these competitors in economic liberalisation, but surpass them if the economy of the country is to become more diversified.

#### ***4. Employment and wages***

The state currently employs the vast majority of the 212 000 working nationals, with citizens guaranteed a public sector job. Some observers maintain that many are effectively underemployed, being paid salaries for jobs that do not exist. With a youthful population adding 14 000 to the labour market every year, the government has increasingly struggled to cope with the demand for jobs - particularly as the level of education and career expectations has risen. The wage bill now accounts for more than half state revenues. In the private sector, some 5% of the work force are Kuwaitis - the rest are foreign workers. The government has begun to address this problem by imposing regulations to encourage the employment of nationals and penalise the employment of foreigners.

Kuwait still relies upon expatriate workers to fill a number of technical roles. Efforts to train Kuwaitis to assume management roles in the utilities and to train more technical staff receive a high priority. Unemployment is a growing problem and the government will need to reduce the employment and wage expectations of many Kuwaitis as higher unemployment looms. Public-sector workers use the threat of strikes to back up their wage and benefit demands.

Kuwait is a welfare state and heavily subsidises many social needs. The social sector of course was heavily damaged during the Iraqi occupation but strenuous efforts are underway to get it back to where it was on 1 August 1990.

The Prime Minister is under sustained pressure that is hindering prospects for economic reform. This is highlighted by three 'no-confidence motions' in the National Assembly since 2003. The most recent was on 6 April 2005 and led to the resignation of the Health Minister. Whilst the state's support to public and private employees can benefit from the high oil prices, it reflects a resistance to tackle economic reform. This was shown in the recent 16 May 2005 cabinet decision to approve \$445 million to raise salaries for public and private employees.

### **III. RELATIONS BETWEEN THE EU AND KUWAIT**

Relations are conducted exclusively in the context of EU links with the Cooperation Council for the Arab States of the Gulf (GCC). This is a regional organisation created in May 1981 by Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates (UAE). A GCC Customs Union entered into force in January 2003.

The European Community has no contractual relations with the individual countries, but in 1988 an EC-GCC Cooperation Agreement covering trade, investment and cooperation was signed. EU and GCC Foreign ministers meet once a year at the Joint Council/Ministerial Meeting (preceded by Senior Officials' Joint Cooperation Committee) as well as during the UNGA in September. The latest Joint Council/Ministerial Meeting took place in Manama on 5 April 2005 under the Luxembourg Presidency.

The meeting noted that cooperation activities needed to be reinforced along a small number of key lines reflecting the strategic nature of their relationship, including the view that trade, investment and cooperation were the foundations for developing relations. But the Joint Communiqué also covers discussions on political questions of common interest such as the fight against terrorism, respect for human rights, tackling non-proliferation as well as regional issues.

In recent years the opening of a Commission Delegation in Saudi Arabia to support the regional political dialogue and work towards a Free Trade Agreement had been held up but a breakthrough came in 2004. The Commission's External Relations DG is responsible for follow-up to the Cooperation Agreement and implements a number of economic and decentralised cooperation activities.

It is intended that the EU-Gulf FTA should cover not only trade in goods but also trade in services, government procurement and intellectual property rights. The Agreement was to be signed after the GCC internal Customs Union has been constituted, subject to successful conclusion of the negotiations. The Gulf Customs Union now exists but has not yet been implemented.

The Commission is also seeking to enhance cooperation activities with the GCC against the framework of the Strategic Partnership for the Mediterranean and the Middle East approved by the European Council in June 2004. This could encompass the political, economic and social fields including looking at possibilities for promoting domestic reforms, including on areas such as education and human rights.

#### **European Parliament**

Kuwait has figured prominently in EP resolutions concerning the situation in Iraq but the only resolution concerning Kuwait specifically is that of 16 December 1999 on voting rights for women. At the time the EP expressed deep disappointment at decisions taken by the national assembly of Kuwait which prevented women from exercising an elementary right. It is now important that Kuwait has recently sent a positive signal to the international community underlining the importance of the role of women in Kuwaiti society which is now reflected in

their right to stand as candidates and vote in future elections, in particular the next elections in 2007.

ANNEX

**MAP OF KUWAIT**

