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April 30, 1984

To: Members of the Executive Board

From: The Secretary

Subject: People's Democratic Republic of Yemen - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with the People's Democratic Republic of Yemen. A draft decision appears on page 16.

It is proposed to bring this subject to the agenda for discussion on Monday, May 21, 1984.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Nashashibi (ext. 73197).

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INTERNATIONAL MONETARY FUND

PEOPLE'S DEMOCRATIC REPUBLIC OF YEMEN

Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives for the 1984 Article IV Consultation with the P.D.R. of Yemen

Approved by S. H. Hitti and Subimal Mookerjee

April 27, 1984

I. Introduction

The 1984 Article IV consultation discussions with the P.D.R. of Yemen were held in Aden during the period February 13-21, 1984. The Yemeni representatives were led by the Governor of the Central Bank and the Deputy Minister of Finance and included senior officials from various ministries and public sector institutions. The mission also met with the Minister of Finance. The staff team consisted of Messrs. K. Nashashibi (Head), M. Arif, R. H. Floyd, and S. Geadah (all of MED) and Miss D. C. Tenorio (Secretary - TRE). The Executive Board considered the Staff Report on the 1982 consultation discussions (SM/82/243) on February 16, 1983. The P.D.R. of Yemen continues to avail itself of the transitional arrangements of Article XIV.

II. Background

The P.D.R. of Yemen is a relatively poor country with a per capita income of about US$500. Under British jurisdiction, the focus of most economic activity was on the Port of Aden and its servicing of ships transiting the Suez Canal. After independence in 1967 the country had to adjust to the closure of the Suez Canal and a transformation of the economy along socialist lines. The development policies were therefore geared toward the structural transformation of the pre-independence service-based economy into a production-oriented one, while at the same time providing for the population's basic needs for food, shelter, and social services. Development strategy has been adjusted in response to the changing circumstances. For instance, in the early 1970s, there was some emphasis on relatively labor-intensive production techniques and the buildup of socioeconomic infrastructure to reduce widespread unemployment. Subsequently, under the First Five-Year Development Plan (1974-80) the policy was to encourage manufacturing activities while gradually shifting toward capital-intensive technology in the wake of the availability of large external assistance and the emerging labor shortage, given the increasing opportunities for Yemenis to work abroad. A Second Five-Year Plan (1981-85) was designed with a view to consolidate and expand the newly established production base in agriculture, fisheries, and manufacturing while providing for greater expansion of areas such as housing which had been relatively neglected in the 1970s. Although these development plans gave priority to the expansion of the public sectors (state farms and cooperatives), the private sector still accounts for one half of all activity in agriculture, construction, trade, and transport. Its high levels of productivity and supply response to production incentives has prompted the authorities to encourage its expansion.

Growth performance was vigorous during the five years ended in 1981 (an annual average of about 5 percent growth in real terms) as it was sustained by rapid increases in external assistance and in remittances from Yemenis employed in neighboring countries as well as by a strong domestic resource mobilization effort. However, economic performance in 1982 was dealt a serious setback by the severe floods of the spring season. Damage to agricultural infrastructure, such as diversion weirs and dikes, irrigation canals and wells, and highways, was extensive, and a substantial portion of the cotton, cereals, and vegetable crops and large numbers of livestock were lost. The balance of payments was adversely affected partly by reducing export proceeds, but mainly by the need for emergency imports. In order to assist the P.D.R. of Yemen in meeting its urgent import needs, the Fund approved a purchase, in June 1982, of SDR 15.375 million, equivalent to 25 percent of the previous quota. Emergency assistance was also provided by UN agencies, certain Arab and European countries, and the World Bank.

During the three years ended in 1980, the Government made substantial progress in strengthening budgetary operations. Domestic revenues were increased sharply, growing at an average of 37 percent per annum, thus contributing to a reduction of the budgetary deficit from 21 percent of GNP in 1977 to 17 percent in 1980. The increase in domestic revenues reflected the buoyancy of the tax system as well as improvements in tax administration, especially the recovery of tax arrears. In 1981, budgetary trends were reversed. While there was a deceleration in domestic revenues, expenditures increased sharply (48 percent), reflecting much higher outlays on both current expenditures and capital investment associated with the initiation of the Second Five-Year Plan. Since this rise in expenditures was not offset by a larger inflow of foreign budgetary support, there was a rise in the overall deficit as a proportion of GNP to 24 percent.

The growing budget deficit was financed through increased reliance on foreign borrowing (mostly project loans) while maintaining domestic borrowing from the banking system relatively stable at about 8 percent of GNP. However, with the additional liquidity injection stemming from consecutive balance of payments surpluses and some expansion in credit to nongovernment sectors, the overall expansion in money supply averaged 23 percent a year over the 1977-81 period. The growth in liquidity, however, is not well reflected by movements in the price indices, since most commodity prices are subject to strict controls. The consumer price index rose by 7.6 percent annually over the period 1977-81 mainly reflecting changes in administered prices.

Remittances from workers abroad (US$410 million in 1981) amount to about two thirds of current account foreign exchange receipts and are equivalent to about 45 percent of GNP. Domestic exports, roughly equally divided between goods and services, only account for 4 percent of current account receipts, but foreign aid has been substantial (about US$300 million in 1981) with a large grant component (40 percent). During the 1977-81 period, imports, remittances, and foreign grants more than doubled, with the result that the current account deficit of US$68 million in 1977 also more than doubled to US$153 million in 1981. Consequently, since capital inflows did not keep pace with the rise in the current account deficit, the balance of payments surplus which emerged in 1977 declined steadily, to US$41 million in 1981.

The P.D.R. of Yemen maintains a number of restrictions on payments and transfers on current international transactions (as detailed in the Recent Economic Developments report to be issued shortly) under the transitional provision of Article XIV. It also continues to maintain comprehensive controls on imports and invisible payments. Exchange allocations for imports are made according to an annual program prepared at the beginning of the year on the basis of estimated foreign exchange requirements and availabilities; the program may be adjusted in the course of the year in light of changing circumstances. The P.D.R. of Yemen has had a long-standing policy of restricting labor emigration and of encouraging Yemenis residing abroad to return home in order to limit manpower shortages. Labor shortages had resulted in the importation of foreign workers. The Yemeni authorities reported that migration of the labor force within the country and abroad had stabilized because of increased employment opportunities in rural areas, decreased opportunities in oil producing neighboring states, and the near equivalence of domestic and foreign wages after adjusting for differences in living expenses. Since 1978, to encourage the inflow of remittances from Yemenis residing abroad, the authorities have permitted the maintenance of convertible foreign exchange accounts in local banks at preferential interest rates and allowed duty-free imports, within specified limits, for returning workers. The Yemeni dinar has been pegged to the U.S. dollar at the rate of US$2.89524 = YD 1 since February 1973.

Wage levels were not increased in 1982 or 1983, and no increase was planned for 1984. However, wage costs have increased in many sectors reporting productivity gains following the introduction of output-based wage incentive schemes.

III. Report on Discussions

1. Economic activity and planning

The floods which occurred in March 1982 reduced the output of field crops by 28 percent and also reduced the output of related activities, such as transportation and trade. Therefore, the authorities expected a small decline in GDP for that year. While there was some rebound in economic activity in 1983, as indicated by preliminary data showing increases in agricultural and industrial output, the authorities believed that real GDP would be the same or higher than the GDP level of 1981. However, preliminary data on output in various sectors indicate that this expectation may not have been realized. Prospects for 1984 are uncertain, as drought conditions appeared in the last quarter of 1983 and continued through the first quarter of 1984.

Policies in the agricultural sector have been directed toward the achievement of self-sufficiency in vegetables, fruits, and cereals, and increasing the output of new as well as traditional exports. However, between 1975 and 1983 agricultural output stagnated. The output and exports of cotton declined sharply, while cereals production has been stable. The only crops which have shown steady increases are fodder and vegetables which benefit from free market prices and protection from imports, if only on account of the high inland transportation costs for imported substitutes, particularly livestock. While the P.D.R. of Yemen has become more dependent on imports of cereals, this may have benefited the economy to the extent that relatively more efficient crops (fodder and vegetables) have been cultivated instead. With the decline of cotton exports, consideration was being given to discontinuing the cultivation of long-staple varieties, particularly since their costs of production exceeded their export prices. Cultivation costs of short-staple cotton also exceed international prices but production will be retained to provide cotton lint for the domestic textile mill. Greater attention has been devoted to nontraditional exports, such as tobacco and coffee, which offer good prospects for expansion.

The authorities were attempting to raise managerial efficiency in state farms (which account for 20 percent of value added in agriculture) by introducing performance-related incentives. However, as most state farms were being run at a loss, greater emphasis is being put on cooperatives (accounting for 60 percent of value added) which have been more responsive to price changes as they provide better incentives to their members by allowing them to retain all income earned except for taxes and cooperative fees. This prompted the authorities to eliminate seven inefficient state farms and merge two others into a cooperative farm.

Encouraged by the supply response of cooperatives, the authorities have been pursuing greater price flexibility. Producer prices are determined on the basis of production costs plus a profit margin to maintain the profitability of the agricultural sector. In addition, as of January 1984, the Ministry of Agriculture and Agrarian Reform has been given authority to adjust producer prices of certain perishable products; previously, approval of the Council of Ministers was required. Alternatives to the present production tax were under consideration with the aim of reducing production disincentives.

There was a recovery in the fisheries catch in 1983 from the cyclically depressed levels of 1981-82, and further recovery is anticipated in 1984. This was also due to the continuing conservation measures which limited foreign fishing. Several measures were adopted to increase domestic fishing activity. In the cooperative sector, which is mostly oriented toward local consumption, various projects are being implemented to improve fishing techniques and gear, transportation facilities, and cold storage facilities. For the public sector, a wage incentive scheme based on output was introduced.

Industrial policy focused on rehabilitation of existing facilities with the aim of improving technological and managerial efficiency. These measures aimed at improving production and investment incentives, while lessening the constraints which faced industrial output. Electricity generation increased by 23 percent in 1982, thus overcoming previous shortages. To increase productivity, labor-incentive schemes have been introduced and marketing activities are now handled directly by some factories, thus enhancing their familiarity with consumer preferences. Preliminary data for manufacturing output in the first half of 1983 indicate some response to these measures, and an increase of 10 percent was estimated for the year in the output of the manufacturing units under the supervision of the Ministry of Industry. Prices were set to reflect production costs plus a profit margin of 5-20 percent, depending on the importance of the good in local markets and the degree of protection afforded the industry. The Yemeni authorities have sought to encourage private sector participation in the manufacturing sector, especially from Yemenis working abroad, through the Investment Promotion Law of 1981. However, the law elicited a modest response and only a few enterprises were initiated. In addition to the continuing rehabilitation of manufacturing units, efforts in 1984 were expected to focus on modernization and expansion of the Aden Refinery, to reduce its persistent operational deficits, and on the installation of grain silos at the Aden Port, which will save some import costs. The authorities also planned to seek foreign investment for exploitation of the substantial deposits of minerals, such as lime, gypsum, clay, marble, and granite.

Under the Second Five-Year Plan (1981-85) total investment was projected at YD 508 million at 1980 prices or almost twice as much as has been actually spent during the preceding seven-year period. It sets an ambitious growth target of 10 percent per annum and concentrates on infrastructure and social sectors. The share of agriculture and fisheries is reduced by one half (from 34 percent during the First Five-Year Plan to 17 percent) while manufacturing is reduced from 7.6 percent to 6.0 percent. On the other hand, allocations for electricity, water supply, sewage, and housing were increased from 10 percent of total investment in 1974-80 to 37.7 percent, as these sectors were neglected in the past. However, following the recent flood damage, agricultural investment is likely to obtain a significantly larger share of development funds than originally planned. Moreover, it appears that the actual growth rate for GNP over the Plan period will be considerably lower than the targeted growth, given the likelihood of some decline in output over the 1981-83 period and the existing constraints in the construction sector, which will be aggravated by the work necessary to repair the flood damage. Hence, the period ahead appears to be one of consolidation in agriculture and manufacturing (no new projects are scheduled) with attempts at raising efficiency and capacity utilization. As foreign financing of the Plan has fallen well short of expectation, greater resort to domestic resources, especially bank financing, is being envisaged.

2. Public finance

The rapid growth of domestic revenues attained in the 1977-81 period slowed down sharply in 1982, in part because of unusually high tax collections in 1981, especially of arrears, but also possibly because of reduced collections following the flood losses. Thus, the increase in foreign grants from YD 11 million to YD 19 million, mainly as a result of flood relief, accounted for about two thirds of the increase in total revenue receipts. Total expenditures rose by 12 percent, entirely because of increased capital outlays, while current expenditures declined marginally. The overall deficit rose by 62 percent to YD 118 million; expressed as a proportion of GNP it rose from 24 percent in 1981 to about 37 percent in 1982. As net foreign borrowing only increased by 7 percent, the expansion in the overall deficit was accommodated almost entirely by increased domestic bank borrowing from YD 24 million in 1981 to YD 65 million in 1982, or the equivalent of 20 percent of GNP.

In connection with the emergency purchase from the Fund in June 1982, the authorities developed during the 1982 consultation discussions an indicative financial program for 1983. The objectives of the program were to maintain a satisfactory growth rate for the economy with relative price stability while containing the balance of payments deficit to a manageable level (Table 1). Preliminary data for 1983 indicate that most financial targets of the program were met.

The program aimed at an overall budget deficit to GNP ratio in 1983 that would be no higher than in 1982, projected at the time to be about 30 percent but subsequently rising to 34 percent with the decline in GNP. This target was met as the actual outturn for 1983 was 34 percent which was also lower than the ratio of 37 percent recorded for 1982. Revenues and grants totaling YD 180 million were targeted, of which YD 141 million was projected from domestic sources and YD 39 million from foreign grants. Actual domestic revenues of YD 145 million rose by 12 percent over 1982 and exceeded the target, but grants totaled only YD 10 million which the Yemeni authorities attributed to restrictive financial policies in donor countries. Due to the exercise of some fiscal restraint, the rise in total expenditures did not exceed 13 percent and both current and capital expenditures were held below the targeted levels of YD 160 million and YD 140 million, respectively. Most of the shortfall in current outlays represented savings on budgeted subsidies to the Price Stabilization Fund, which had benefited from domestic price increases of tea and sugar in 1982 and decreases in international commodity prices in 1983. This maintained the overall deficit of YD 118 million within the program target of YD 120 million. Because of the shortfall in foreign financing, the bank-financed deficit of YD 66 million (equivalent to 19 percent of GNP) exceeded the program target by 12 percent.

Table 1. P.D.R. of Yemen: The Financial Program, 1983

	1982	1983	
	Actual	Target	Actual
Output and prices			
Growth rate of GDP (in percent) 1/	-4	5-6	3
Change in consumer price index (in percent)	... 2/	10	...
Government finance			
Revenues and grants (in millions of Yemeni dinars), of which:	148	180	155
Domestic revenues	129	141	145
Total expenditures (in millions of Yemeni dinars)	259	300	294
Overall deficit/GNP (in percent)	37	34 3/	34
Bank-financed deficit/GNP (in percent)	20	17 3/	19
	(In millions of U.S. dollars)		
Balance of payments			
Goods, services, and private transfers (deficit-)	-199	-327	-239
Overall balance (deficit-)	10	-43	12
	(In percent)		
Money and credit			
Growth rates			
Domestic liquidity	19	16	17
Domestic credit	24	24	21
Claims on Government	43	29	31

Sources: Bank of Yemen, Ministry of Finance, and staff estimates.

1/ Staff estimates.

2/ Data made available to the 1982 consultation mission, but not provided to the 1984 mission because of revisions, indicated that the consumer price index increased by 16 percent during the first five months of 1982.

3/ Expressed in terms of the revised GNP estimates. The percentages originally stated were 30 percent of GNP for the overall deficit and 15 percent for bank financing.

The original budget estimates for 1984 projected a decline in domestic revenues and capital expenditures, increases in foreign grants and current expenditures, and a sharp increase in the overall deficit to YD 171 million (43 percent of GNP). However, as these estimates had been prepared before the 1983 outturn was clear and prior to the decision to implement certain measures to correct the continuing budgetary difficulties, revisions in the budgetary accounts were made. Forecasts of domestic tax and nontax receipts were increased by 5 percent to YD 133 million, while forecasts of current outlays were decreased by YD 25 million to YD 167 million. The expected increase in foreign grants to YD 26 million partly reflected an attempt to account for all grants in the budget for the first time. On the expenditures side, all ministries had been directed to reduce current outlays by 10 percent from the original budget estimate. An additional saving of YD 5-10 million was expected in the budget allocation for subsidies. Capital expenditures were already budgeted to fall 4 percent to YD 132 million in 1984, mainly in response to a ban on the initiation of any new project for which guaranteed concessional foreign financing of at least 75 percent of total cost was not available. The recommendations of a Fiscal Commission on ways to mobilize additional domestic resources were expected in March 1984, and other studies were already under way on other means to reduce the deficit further. Notwithstanding such reductions, a budget deficit of YD 140 million and projections of net foreign financing of YD 55 million would result in domestic bank financing of YD 85 million, a 28 percent increase over 1983.

The mission commended the authorities' efforts to scale down the deficit originally forecast in the budget. However, it noted that even with the envisaged measures the overall deficit would rise from the equivalent of 34 percent of projected GNP in 1983 to over 35 percent in 1984 while the central bank financing would rise from 19 percent of GNP in 1983 to 21 percent in 1984. No price data are available for 1982 and 1983, as the authorities are revising the price indices, but the monetary expansion resulting from this deficit financing in the wake of the budgetary results of 1982 and 1983 will generate inflationary pressures in the economy. On the whole, the mission expressed concern that the recent and projected fiscal developments reflected an emerging structural imbalance and that additional resource mobilization measures, such as increased public enterprise prices, were needed immediately.

3. Monetary policies

In 1982 the rate of monetary expansion had increased to 19 percent, owing mainly to an increase of 24 percent in domestic credit over the year. Net borrowings of the Government accounted for the entire increase in domestic credit, as lending to the nongovernment sector declined marginally during the year. Government borrowing to finance the budgetary deficit in 1982 accounted for 25 percent of the money stock at the end of 1981 compared with 10 percent in the previous year. Net foreign assets declined by YD 8 million during the year, primarily reflecting valuation changes.

In 1983 monetary growth slowed to 17 percent as the growth rate of credit to the Government was reduced, credit to the nongovernment sector stabilized, and net foreign assets again declined slightly, due to valuation changes. Most of the increase in liquidity had taken the form of sharply higher deposits of the National Bank of Yemen, the P.D.R. of Yemen's only commercial bank, with the central bank. In 1983 loans to public entities were stable, but there was some increase in loans for private entities. While the increase in net claims on Government of 31 percent exceeded the program target (29 percent), overall credit expansion of 21 percent remained below the program target (24 percent) as credit to the nongovernment sector did not increase. As in the previous year, quasi-money rose more rapidly, increasing by 35 percent, or almost triple the rate of increase in money which was another manifestation of excess liquidity. The mission observed that, while there had been some improvement in 1983, liquidity creation was still too large and should be decelerated by reducing the budget deficit and increasing the profitability of public enterprises. The mission also commented that the structure of interest rates ranging from 4.5 percent to 6 percent on deposits and 3 percent to 8 percent on loans was too low. Even under conditions of excess liquidity, the underpricing of capital would result in a misallocation of resources.

The Yemeni representatives explained that the increase in lending to the private sector in 1983 had been mainly for housing loans. Loans to the public entities and cooperatives had declined as improved management had reduced their credit needs and enabled some entities to accumulate cash balances which would eventually be transferred to the Government or used for development projects. The Government was attempting to raise the profitability of public enterprises mostly through enhanced productivity and was hoping for a 5 percent increase in profitability in 1984. As regards means to mobilize savings, the Yemeni representatives believed that the first priority was to improve the quality of banking services and to increase the number of branches of the National Bank of Yemen in order to enhance the banking habit of Yemenis. A rise in interest rates would only increase costs of production without affecting the level of investment which is determined by the Plan.

For 1984 the Yemeni representatives expected net claims on Government to increase by YD 85 million and claims on the nongovernment sector to increase by YD 20 million, mainly because bank credit would be provided for the expansion needs of the Aden Refinery and the national airline company. Increases of 27 percent in domestic credit and 30 percent in net claims on Government were projected and, in view of the balance of payments forecast, a 20 percent increase in domestic liquidity is projected. The mission noted that such an increase in domestic liquidity would inject substantial purchasing power into the economy, in addition to the large excess liquidity already accumulated in 1982 and in 1983. Therefore, further effective efforts were needed to mobilize domestic revenues and to reduce government current expenditures in order to avoid accentuating pressures on domestic prices and the balance of payments.

4. Balance of payments policies

The overall surplus in the balance of payments had declined steadily since 1978 from US$91 million to US$10 million in 1982 mostly as a result of a faster growth in imports than the growth in foreign exchange receipts. Exports and re-exports in 1982 fell by 22 percent to US$38 million, because of lower exports of fish and cotton. However, as imports also fell 4 percent to US$747 million, the trade deficit declined from US$733 million in 1981 to US$709 million in 1982. The mission noted that, in view of the emergency imports for flood relief during 1982, the decline in imports was surprising. The relatively large negative entry of US$88 million for net errors and omissions, coupled with a substantial increase in tonnage handled through the Port of Aden over 1981, might be indicative of an underrecording of imports. The Yemeni representatives explained that imports for flood relief were included in the data for 1982, which were still preliminary. They agreed that the decline in imports was surprising and stated that, because the level of recorded imports in 1981 had seemed low, upward adjustments to the 1981 data had been made perhaps excessively. They were also concerned about the large entry for errors and omissions and had sought to review the data in the hope of finding an explanation. Remittances, which are determined on the basis of exchange receipt records, increased by 14 percent to US$467 million in 1982. This increase, coupled with the decline in the trade deficit, reduced the current account deficit of the previous year by half to US$73 million. Both official grants and loans had risen marginally to US$303 million during the year.

Turning to 1983, preliminary estimates based on the nine-month data indicated an overall surplus of US$12 million. The trade deficit rose slightly to US$729 million as imports increased by 3 percent to US$769 million and domestic exports by 10 percent to US$23 million. The mission observed that after adjustment for increases in world prices, it appeared that there had been a noticeable decline in the volume of imports since 1980. As development and essential consumer imports had increased in real terms, shortages of other consumer and intermediate imports might have emerged. Cotton exports increased despite the floods and the ensuing drought, because of the sale of stocks from the 1981/82 season, which had been withheld from the market because of low prices in 1982. In the services account, investment income fell by 47 percent to US$26 million in 1983 due to lower interest rates and to some decline in foreign assets while interest payments on foreign debt increased. Remittances were virtually unchanged at US$469 million. The authorities agreed with the mission that remittances were likely to follow a downward trend as a result of reduced earning opportunities in the neighboring oil producing countries. Such trends were already apparent in other neighboring countries with labor employed abroad. In addition, outward remittances from foreign labor employed in the P.D.R. of Yemen were rising, which would reduce net remittances even further. The mission noted that, while employment opportunities abroad may have become more difficult, the Yemeni authorities could still encourage its expatriate workers to remit a larger share of their earnings. The mission suggested that interest rates on nonresident accounts, denominated in foreign exchange, ranging from 5 percent to 9 percent, were low in comparison with rates commonly available in neighboring countries and should be increased. This would also raise the foreign exchange deposit balances of nonresidents with the National Bank of Yemen which had declined since 1980. The Yemeni representatives did not believe that increased interest rates on foreign currency deposits would result in higher remittances, but rather only in higher foreign exchange costs. Free land for home construction and the provision of building material were considered to be adequate pecuniary incentives.

Foreign grants fell from US$125 million in 1982 to US$53 million in 1983. This, coupled with the stabilization of remittances and the higher trade deficit, increased the current account deficit sharply, bringing it in line with its rising trend since 1976. In the capital account, an inflow of US$70 million reflected a two-year credit to the Aden Refinery from a foreign national oil company to finance crude imports for domestic consumption. The mission observed that the financing program for 1983 had targeted an overall deficit of US$43 million while a surplus of US$12 million was actually achieved. However, to the extent that this surplus was the result of the US$70 million supplier credit, there was in fact an underlying balance of payments deficit of US$57 million which exceeded the target. This was due to a US$63 million shortfall in official grants and loans from the envisaged level of US$116 million.

For 1984 the Yemeni representatives projected a deteriorating balance of payments despite efforts to restrain the growth in imports. With a stable level of remittances, a decline in capital inflows, and an increase in loan repayments, an overall deficit of US$46 million was projected. Little increase in exports was projected as expectations for higher fish and coffee shipments were partly offset by a decline of cotton exports as a result of the drought and the depletion of stocks. Imports were projected to grow by about 5 percent to US$810 million, a modest increase, given the stagnation in imports since 1981. This included US$240 million for the development program as contrasted with US$255 million in 1983. Remittances were projected to remain unchanged at US$469 million, but some improvement was expected in receipts from other services. External assistance was projected to rise by 15 percent to US$250 million, primarily because of higher grants, but loan repayments were expected to double to US$28 million because of net repayments to the Arab Monetary Fund after three consecutive years of drawings. Debt servicing is not expected to exceed 4.5 percent of current account receipts.

The mission noted that the emerging overall deficit reflected dwindling foreign exchange earnings from traditional sources. In particular, remittances from Yemenis working abroad have decelerated to a point where no increase was projected for 1983 and 1984, and there has been a decline in the volume of domestic exports between 1976 and 1983. Moreover, receipts from external assistance, after having peaked in 1981 and 1982 at about US$300 million, declined in 1983 to US$226 million and little increase over this level was expected in 1984. On the payments side, the demand for imports was increasing, simultaneously fueled by returning migrant workers with heightened expectations for consumer imports, by the continuing development effort, and by the expanding manufacturing base.

Over the medium term these demands were likely to increase despite the strict controls on imports, especially in view of the excess liquidity in the economy. The authorities have not provided the mission with debt servicing data for the medium term as these have been under preparation. But, information compiled by the World Bank suggest that the debt profile of the P.D.R. of Yemen, which benefited from a high proportion of concessional loans, will begin to reflect a rising debt service burden. This is due to a lower level of concessionality, higher interest rates, and some resort to commercial borrowing. The mission suggested that sustained efforts should be deployed to increase foreign exchange earnings, particularly from remittances, and to pursue stricter demand management policies to reduce excess demand for imports. In this respect, both the interest rate structure for domestic and foreign currency deposits and the exchange rate were available policy instruments that should be reviewed for possible use.

The mission stated that there were several indicators pointing to the need for a more flexible exchange rate policy. The exchange rate vis-a-vis the U.S. dollar has remained virtually unchanged (YD 1 = US$2.89) since World War II except for a brief period (1967-70) when the Yemeni dinar followed the depreciation of the pound sterling. Since 1978 there has been a turnaround in the balance of payments with declining surpluses and a projected deficit for 1984 and over the medium term. This, coupled with a rise in inflationary pressures and the recent appreciation of the U.S. dollar relative to the currencies of most of the P.D.R. of Yemen's trading partners, has resulted in an appreciation in the import-weighted nominal effective exchange rate by 26 percent over the 1979-83 period. There is also some tentative evidence that the domestic cost structure has gone out of line with international prices. In 1977 the costs of production of export crops (cotton, potatoes, and onions) and major import substitutes (sorghum, wheat, and maize) were below their international prices. By 1982 only the potatoes and onions had costs which remained below their export prices. This would imply that the real effective exchange rate has appreciated. Staff evaluation of the competitiveness of the major agricultural crops at international prices indicate that only these two crops would be competitive at the current exchange rate. A substantial loss was being incurred on the production of cereals, which are intended to substitute for imports and cotton, the traditional export crop, which partly explains the steady reductions in its cultivated area and an even sharper decline of its output to less than one third of the 1975 level. A provision of adequate incentives to farmers to reverse the decline in agricultural production would require a substantial increase in producer prices and a concomitant adjustment in the exchange rate. The supply response to enhanced incentives would stem from higher yields resulting from better crop husbandry and higher labor input and from some expansion in land cultivation, particularly in the Hadramawt Valley where a greater utilization of the underground water resources is feasible.

The Yemeni representatives explained that the Government was seeking a variety of means to increase foreign resources as well as to reduce payments. New emphasis was being given to tourism, and services provided by the national airline were to be improved, especially for migrant workers. Studies that aimed at increasing the production of exports were already under way. Coffee and tobacco were encouraging prospects, and oil exploration held some promise. A number of measures were adopted to reduce imports. The import of nonessential goods was constrained, especially car imports, which were banned in 1984. Development imports could also be reduced, as no new projects were to be initiated except those with guaranteed foreign financing of at least 75 percent of the cost. This would also help in reducing outgoing remittances. Furthermore, the construction of wheat silos was expected to save US$30 million per year in bagging and handling costs; efforts to exercise greater control of government current expenditures would also assist in limiting the growth of imports. The Yemeni representatives stated that they do not intend to introduce new restrictions on current payments and transfers, nor to intensify existing restrictions for balance of payments purposes, nor to introduce any multiple currency practices.

With regard to the exchange rate, the Yemeni representatives explained that the P.D.R. of Yemen had only a limited number of exportable commodities with modest potential for expansion. Moreover, they did not share the view of the staff with regard to the supply responsiveness of a number of crops to price incentives in view of the water constraint. And since the country was discouraging migration to neighboring countries for employment, an adjustment in the exchange rate would not have a significant effect on remittances. Nevertheless, they stated that interest and exchange rate policies would be kept under review, and changes would be introduced if it were felt that they would be effective in improving the external accounts. With regard to the debt profile, the Yemeni representatives explained that the P.D.R. of Yemen was fortunate that most of its loans were on concessional terms from such sources as the IDA, the Arab Fund for Economic and Social Development, and the Islamic Development Bank. In 1984 and 1985 debt service payments were not expected to exceed YD 9 million and there was a possibility of rescheduling repayments of some loans on a bilateral basis.

IV. Staff Appraisal

Economic policy in the P.D.R. of Yemen has been directed since the country's independence toward transforming the country from a service oriented economy to one geared to production. Despite its poor resource base, the country has been able to mobilize domestic and external resources for development, thereby achieving growth and expanding the country's infrastructure. At the same time the basic needs of the population have been provided for.

Between 1975 and 1981 economic performance was generally strong with consecutive surpluses in the balance of payments coupled with internal financial stability. Recently, setbacks resulted from severe floods in 1982 and a drought in 1983 which is still continuing into 1984. These developments were particularly harmful to agricultural output, reducing exports and necessitating additional imports particuarly of foodstuffs. As a result, development priorities had to be reoriented toward reconstruction of the damaged infrastructure which will reduce growth from the targets initially set out in the Second Development Plan. Despite these difficulties, there has been notable expansion in the production of meat and poultry products and of certain manufactures, and prospects for the country's fisheries have again improved. However, output declined in 1982 because of the floods and there was only modest growth in 1983, but prospects may improve in 1984 if there is some relief from the ongoing drought.

A strong domestic resource mobilization effort succeeded in trebling domestic revenues during the five-year period 1977-81, while expenditure growth was held to a lower rate. Coupled with sustained external assistance, this limited the domestic bank financing of the deficit to about 8 percent of GNP. However, since 1982, there has been a deterioration in the budgetary situation that was exacerbated by the effects of the 1982 floods. On the revenue side, the growth of both tax and nontax receipts from the existing revenue base has decelerated despite notable efforts at improving tax administration. On the expenditure side, the expanding development effort has been inevitably accompanied by an expansion in the associated current expenditures and by increased resort to bank financing. These trends have been compounded by a decline in external assistance. As a result, bank financing of the deficit rose from 8 percent of GNP in 1981 to 20 percent of GNP in 1982. In 1983 the authorities were able to contain the fiscal deterioration and observed by and large the fiscal and monetary targets set in a financial program in connection with an emergency purchase under the Fund's policies related to natural disasters. Bank financing of the deficit was reduced to 19 percent of GNP and the expansion of domestic liquidity was reduced from 19 percent in 1982 to 17 percent in 1983. However, as this liquidity creation was well in excess of any real growth in output during both years, it generated inflationary pressures and raised the demand for imports. Increased demand for bank financing was further expected in 1984 as 20 percent of the development budget for that year was expected to be financed from this source, compared with about 8 percent in 1982. Although the authorities maintain tight controls on prices and imports, the underlying rate of inflation had nevertheless risen, and the repressed demand for imports was either shifted to domestic substitutes or postponed to a future time.

The authorities have tried to limit the repercussions of these fiscal and monetary developments and took a number of measures to reduce the anticipated deficit and the level of aggregate demand within the framework of their 1984 budget and after its enactment. Most significantly there has been a scaling-down of investment in implementation of the Development Plan and a ban on new projects which do not obtain a high level of concessional external financing. The staff nevertheless believes that even the revised level of bank financing projected for 1984 would further increase inflationary pressures and that larger reductions in the deficit are needed in order to alleviate pressures on domestic prices and the consequent unfavorable effects on the balance of payments.

With respect to the external sector, a growing structural imbalance may require sustained efforts over the medium term to increase foreign exchange earnings. Traditional sources of foreign exchange earnings have either declined or may offer only modest growth prospects. In particular, the growth in remittances, the country's major source of foreign exchange, has decelerated and their level may even decline. While this trend partly reflects a slackening demand for labor in the neighboring oil producing countries, it is also the manifestation of government policy intended to encourage Yemenis residing abroad to return to the P.D.R. of Yemen and to restrict Yemeni labor from working abroad. These policies stem from the growing manpower requirement of the development program and the emergence of labor shortages which had to be alleviated by the importation of foreign labor. But, more profoundly, they reflect the misgivings of the Yemeni authorities toward the pattern of consumption demonstrated by the returning laborers, its large import content, and the contrast it poses with the relatively austere domestic policies which are more oriented toward investment and production. However, given that domestic exports only amount to 4 percent of current account earnings and that foreign aid has had a tendency to decline, it is difficult to visualize, within the medium term, alternative sources of foreign exchange earnings to remittances. The authorities are hopeful for an expansion in service earnings such as tourism, but these are at best long-term prospects. In the meantime, a decline in remittances will lead to severe pressures on the balance of payments. Past balance of payments surpluses which built up reserves to about US$280 million (equivalent to about four months of imports) have already given way to an underlying deficit of US$57 million in 1983 (financed by a two-year loan) and the projection of a somewhat smaller deficit for 1984. The authorities have attempted to mitigate these imbalances by holding imports constant in nominal terms since 1981 and by increasing foreign borrowing.

As imports of consumer nonessentials have already been reduced to a minimum, the authorities realize that there is limited scope for constraining imports further and that fundamental adjustment needs to be pursued. In addition to restrained demand management, the mission suggested a review of the country's labor migration policies with the objective of fostering some growth in the flow of remittances until alternative sources of foreign exchange earnings are developed. A more flexible exchange rate policy also appears to be appropriate given the high levels of domestic costs of production, the decline in traditional exports, and the need to expand the traded goods sector.

The authorities' are aware of the adverse balance of payments trends and are making efforts to reduce the fiscal deficit. The country's present level of reserves and low debt service ratio gives the authorities the necessary time to strengthen the process of adjustment which they have already started.

It is recommended that the next Article IV consultation be held on the standard cycle.

V. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision relating to the exchange measures of the P.D.R. of Yemen subject to Article VIII, sections 2 and 3, and in concluding the 1984 Article XIV consultation with the P.D.R. of Yemen, in the light of the 1982 Article IV consultation with the P.D.R. of Yemen conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance Over Exchange Rate Policies).

2. The P.D.R. of Yemen continues to maintain a comprehensive system of controls on payments and transfers for current international transactions. The Fund hopes that the authorities will take appropriate measures which would enable them to simplify the system.

P.D.R. of Yemen - Fund Relations
(As of March 31, 1984)

I. Membership Status

(a)	Date of membership:	September 29, 1969.
(b)	Status:	Article XIV.

A. Financial Relations

II. General Department (General Resources Account)

(a)	Quota:	SDR 77.2 million.
(b)	Total Fund holdings of Yemeni dinars:	Fund holdings of Yemeni dinars amounted to SDR 92.6 million, or 119.9 percent of quota.
(c)	Fund credit:	SDR 15.4 million, or 19.9 percent of quota.
(d)	Reserve tranche position:	SDR 3.9 million.
(e)	Current operational budget:	none.
(f)	Lending to the Fund:	none.

III. Current Stand-by or Extended Arrangement and Special Facilities

(a) Current Stand-by or Extended Arrangement: none.

(b) Previous Stand-by and Extended Arrangements: none.

(c) Special facilities: the P.D.R. of Yemen made a purchase of SDR 15.4 million in June 1982 under the Fund's tranche policies related to natural disasters.

IV. SDR Department

(a)	Net cumulative allocation:	SDR 22.6 million.
(b)	Holdings:	SDR 20.5 million and 90.9 percent of net cumulative allocations.
(c)	Current Designation Plan:	none.

V. Administered Accounts

(a) Trust Fund loans
    (i) Disbursed: SDR 28.3 million.
    (ii) Outstanding: SDR 26.2 million.

(b) SFF Subsidy Account
    (i) Donations to Fund: none.
    (ii) Loans to Fund: none.
    (iii) Payments by Fund: none.

VI. Overdue Obligations to the Fund

(a) General Department: none.
(b) SDR Department: none.
(c) Trust Fund: none.

B. Nonfinancial Relations

VIII. Exchange Rate Arrangement:

The Yemeni dinar is pegged to the U.S. dollar at YD 1 = US$2.89524.

IX. Last Article IV Consultation:

November 1982; the Staff Report (SM/82/243) was discussed by the Executive Board on February 16, 1983. It was agreed that the next consultation be on the standard cycle.

The Executive Board's decision concluding the Article IV consultation (Decision No. 7324-(83/30)) was as follows:

1. The Fund takes this decision relating to the exchange measures of the People's Democratic Republic of Yemen subject to Article VIII, Sections 2 and 3, and in concluding the 1982 Article XIV consultation with the People's Democratic Republic of Yemen, in the light of the 1982 Article IV consultation with the People's Democratic Republic of Yemen conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The People's Democratic Republic of Yemen has continued to maintain comprehensive controls on payments and transfers for current international transactions in the context of a centrally planned economy. Some steps to liberalize the system were taken since the last consultation discussions. The Fund notes that the authorities intend to continue reviewing the exchange control system with the objective of simplifying it further.

X. Technical Assistance

A CBD expert has been working since August 1982 as Advisor for Currency and Operational Procedures to the Bank of Yemen to assist in organizing and improving the management of currency issue and the training of Bank staff.

XI. Resident Representative/Advisor: none.

P.D.R. of Yemen - Basic Data

Area	112,000 square miles
Population (end-1983)	2.1 million

	Actuals				Est.	Revised Est.
	1979	1980	1981	1982	1983	1984
	(In millions of Yemeni dinars)					
Public finance:						
Total receipts	68.5	113.9	135.3	148.2	155.0	159.6
Tax revenue	43.1	68.9	88.5	90.1	99.6	94.8
Nontax and other domestic receipts	17.2	34.4	36.0	38.8	45.4	38.7
Foreign grants	8.2	10.5	10.8	19.3	10.0	26.2
Total expenditures	120.0	155.4	230.6	259.2	294.0	299.2
Current expenditures	75.3	94.5	139.4	138.5	156.0	167.1
Capital expenditures	44.7	60.9	91.2	120.7	138.0	132.1
Other	9.9	-3.0	22.7	-6.7	21.1	--
Overall deficit (-)	-41.6	-44.5	-72.6	-117.7	-117.9	-139.6
Financing:						
Foreign borrowing (net)	18.5	27.3	49.0	52.6	51.5	54.6
Banking system	23.1	17.2	23.6	65.1	66.4	85.0
Changes in						
Domestic liquidity	49.5	68.7	35.2	61.3	64.5	89.0
Money	41.3	49.7	24.1	38.3	34.6	...
Quasi-money	8.2	19.0	11.1	23.0	29.9	...
Net foreign assets	20.9	12.8	-0.9	-7.6	-2.3	-16.0
Net domestic assets	28.6	55.9	36.1	68.9	66.8	105.0
Claims on Government (net)	23.1	17.2	23.6	65.2	66.2	85.0
Claims on nongoverment sector	2.7	36.7	8.5	-4.6	0.1	20.0
Other items (net)	2.8	2.0	4.0	8.3	0.5	--
	(In percent)					
Domestic liquidity	29	32	12	19	17	20

P.D.R. of Yemen - Basic Data (concluded)

	Actuals 1979	1980	1981	1982	Prov. Est. 1983	Proj. 1984
	(In millions of U.S. dollars)					
Balance of payments						
Current account	-24.8	-134.0	-153.4	-73.2	-185.9	-192.7
Exports	38.8	59.6	48.6	37.9	40.0	42.0
Imports	-430.5	-669.9	-781.7	-747.3	-769.0	-808.6
Services (net)	24.1	49.5	51.2	43.1	21.7	29.6
Private transfers	313.6	348.6	409.4	467.3	468.7	468.7
Grants	29.2	78.2	119.0	125.7	52.7	75.6
Official capital	63.4	85.7	175.7	177.1	159.5	146.5
Drawings on loans	57.6	85.4	148.5	164.4	165.0	174.3
Repayments of loans	-4.6	-9.3	-4.3	-10.4	-12.4	-16.5
Trust Fund loans	10.4	9.6	--	-0.3	-0.9	-2.6
AMF loans	--	--	31.6	23.5	7.8	-8.7
Private capital and errors and omissions (net)	29.8	110.0	18.5	-94.1	38.2	--
Overall balance (deficit-)	68.4	61.7	40.8	9.8	11.8	-46.2
International reserves (end-year)						
Gross reserves of Bank of Yemen	219.5	250.5	270.0	301.1	296.1	...
Net foreign assets of banking system	227.0	282.4	304.4	298.1	292.0	...
Disbursed external debt outstanding (end of period)	403.2	498.9	611.7	785.0	1,027.8	...

Financial Relations of the World Bank Group with the P.D.R. of Yemen 1/

	IDA Total amount	Undisbursed
	(In millions of U.S. dollars)	
Agriculture and fisheries	38.2	27.3
Power and utilities	36.2	23.7
Transport	19.5	12.4
Education and health	17.6	14.7
Petroleum development assistance	9.0	1.7
Other (fully disbursed credits)	37.6	--
Total	158.1	79.8
Repayments	0.1	

The International Development Association has so far extended 23 credits to the P.D.R. of Yemen, aggregating US$159.2 million of which US$78.4 million have been disbursed. The assistance was mainly for the sectors of agriculture and fisheries, power and utilities, and transport. In 1983, three loans of a total amount of US$23.6 million for post-flood reconstruction work, agricultural development in the Hadramawt area, and promotion of health facilities were approved. In 1984, a loan of US$7.0 million for water supply in the Seyiun area, was approved while another loan (Education IV) is under negotiation.

1/ The lending position as of April 1984.