FOR AGENDA

SM/84/228

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INFORMATION

October 18, 1984

To: Members of the Executive Board

From: The Secretary

Subject: Yemen Arab Republic - 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 Yemen Arab Republic. A draft decision appears on page 14.

It is proposed to bring this subject to the agneda for discussion on Monday, November 26, 1984.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Floyd (ext. (5)7119) through October 26 or Mr. Kayoumy (ext. 72950) from November 13 or Mr. Floyd (ext. (5)7119) from November 19, 1984.

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INTERNATIONAL MONETARY FUND

YEMEN ARAB REPUBLIC

Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives for the
1984 Consultation with the Yemen Arab Republic

Approved by Paul Chabrier and Subimal Mookerjee

October 17, 1984

I. Introduction

The 1984 Article IV consultation discussions with the Yemen Arab Republic (Y.A.R.) were held in Sana'a during the period August 16-23, 1984. The Y.A.R. representatives included the Ministers of Development, Finance, Supply and Trade, and Agriculture, the Governor of the Central Bank, and other senior officials. The mission also met with the Prime Minister after the conclusion of the discussions. The staff mission comprised Messrs. S. Mookerjee (Head - ETR), R.H. Floyd, M. Hosny, and A. Kayoumy (all of MED), and Ms. E. Sheridan (Secretary - ETR). The discussions were also attended by technical assistance experts assigned to the Y.A.R. by the Fiscal Affairs and Central Banking Departments. The Y.A.R. continues to avail itself of the transitional arrangements of Article XIV.

Relations with the Fund and the IBRD are found in Appendices I and V, respectively.

II. Background

In 1981 the Y.A.R. completed its First Five-Year Plan (FFYP), 1/ which had given priority to the establishment of basic services and infrastructure and social and economic institutions. Throughout the FFYP period, substantial inflows of workers' remittances and official external assistance permitted consumption and investment to grow rapidly and, until 1979, official reserves to increase within the context of a free and open economy. Real economic growth averaged almost 6 percent per annum over the period.

1/ The Plan was originally intended to cover the period 1976/77-1980/81 (fiscal year ended June 30); it was later extended to the end of the calendar year 1981.

The Second Five-Year Development Plan (SFYP) assigned relatively greater priority to the commodity-producing sectors, heavier industry, private services, and electricity and water. 1/ It also aimed at reducing the shares of real consumption expenditure and net exports in GDP, while increasing those of domestic savings and investment. Real GDP was targeted to grow by 7 percent per annum; in 1982 real GDP (at factor cost) rose by 8.7 percent. 2/ However, the ratio of consumption to GDP was well above the Plan target, with government consumption accounting for the entire excess, and the ratios of private consumption, gross fixed capital formation, and domestic savings to GDP fell well below the Plan targets.

Government expenditures have risen sharply since the late 1970s as institutional and supply constraints were overcome. As a ratio to GDP, current and extrabudgetary outlays more than doubled between 1978/79 and 1982. Although they rose in 1980, capital expenditures fell by 1982 to about the same ratio to GDP as in 1978/79. During the same period, government domestic revenues remained a relatively stable portion of GDP, but foreign grants fluctuated considerably. The overall deficit rose from about 8 percent of GDP in 1978/79 to 33 percent by 1982 (Table 1). Despite sharply higher foreign grants in 1981 and 1982, the bank-financed deficit rose from 4 percent of GDP in 1978/79 to 28 percent in 1982.

The rapid growth in official assistance and inward remittances and the low absorptive capacity of the economy resulted in surpluses on both the current account and the overall balance of payments throughout most of the 1970s. However, over the 1980-82 period the current account and the overall balance of payments recorded average annual deficits of US$657 million and US$203 million, respectively; as imports rose, the rise in external grants decelerated and inward remittances declined with the slowdown in economic activity in the neighboring oil producing countries. 3/ Moreover, net receipts on the capital account fell by two thirds between 1980 and 1982. The Y.A.R.'s reserves, which peaked at US$1,551 million in 1979 (equivalent to about 15 months of imports in that year), declined in the subsequent years to about US$558 million by the end of 1982 (equivalent to about 3 months of imports in 1982).

1/ Although the SFYP covers the period 1982-86, it was not finalized until May 1982 in order to incorporate the views of the participants (including potential aid donors) in the Yemen Second International Development Conference held in April 1982. The revisions to the SFYP were relatively minor, and they would not result in any significant change to the description presented in SM/82/118.

2/ Official statistics for GDP are believed to understate the level and growth of GDP as they do not adequately account for the cultivation of qat. The consumption of qat leaves, which act as a mild stimulant when chewed, is widespread and believed to be expanding in recent years.

3/ Recorded remittances also declined because of the increasing tendency for Yemeni workers to remit their earnings through money changers or in the form of imports brought overland, which are not recorded in the balance of payments tabulations.

Table 1. Yemen Arab Republic: Summary of Recent Financial Developments, 1980-84

	1980	1981	1982	1983	Staff Estimate 1984
			(In percent of GDP)		
Public finances					
Total revenues and grants	30.3	36.0	35.9	30.6	30.5
Domestic revenues	(24.9)	(24.7)	(23.3)	(26.2)	(26.8)
Grants	(5.4)	(11.3)	(12.6)	(4.4)	(3.7)
Total expenditures	57.1	58.0	69.1	59.3	54.5
Current and extrabudgetary	(25.2)	(30.6)	(43.8)	(41.8)	(37.4)
Overall deficit	-26.8	-21.9	-33.2	-28.6	-23.9
Bank financing	(10.3)	(15.1)	(27.8)	(23.3)	(20.7)
			(In percent per annum)		
Money and credit					
Domestic liquidity	11	8	26	28	27
			(In billions of U.S. dollars)		
Balance of payments					
Current account	-0.7	-0.7	-0.6	-0.6	-0.1
Imports	(-1.9)	(-1.7)	(-2.0)	(-1.8)	(-1.3)
Remittances 1/	(1.3)	(1.0)	(1.2)	(1.2)	(1.2)
Overall balance	-0.04	-0.3	-0.3	-0.2	--

Sources: Recent Economic Developments report, to be issued shortly, and staff estimates.

1/ Private unrequited transfer receipts.

Over the 1980-82 period the external debt servicing burden rose from about US$15 million to US$54 million, but in relation to current account receipts it remained small, equivalent to about 2.7 percent of current receipts in 1982.

Through 1978/79, increases in net foreign assets were the primary impetus to the expansion of domestic liquidity (money and quasi-money). However, beginning in 1979/80, external transactions became contractionary, and at about the same time the Government shifted from being a net depositor to a substantial net borrower from the banking system. Mainly because of the contractionary effects of the external sector, there was a steady decline in the growth rate of domestic liquidity to 8 percent in 1981. This pattern was reversed in 1982, when the decline in net foreign assets only partly offset the sharply increased bank borrowing by the Government, and the growth of domestic liquidity jumped to 26 percent. The rate of inflation, as measured by the retail price index, decreased steadily to about 5 percent in 1982, reflecting the slower growth of domestic liquidity up to 1982, an increased supply of labor and, more recently, low world inflation and since 1980 the appreciation of the Yemen rial along with the U.S. dollar. 1/

Through 1982 the Y.A.R. pursued liberal exchange and trade policies, with no restrictions on payments or transfers for current or capital international transactions. The Yemen rial had been pegged to the U.S. dollar at a rate of US$1 = YRls 4.50 since February 1973. After 1980, as a result of the peg arrangement, the Yemen rial had appreciated along with the U.S. dollar against most other currencies, including those of the major suppliers of the Y.A.R.'s imports.

III. Developments in 1983 and 1984

Overall developments in 1983 were not favorable with the real growth rate falling to 1 percent. This reflected the combined effects of a substantial drop in value added in the dominant agricultural sector, smaller declines in related trade and transportation activities, a decline in construction activity, and increases in most other sectors, especially mining and quarrying. Preliminary data indicate that gross fixed investment fell by 4 percent in constant 1975/76 prices, and real consumption expenditure declined by about 2 percent. A fall in real imports of goods and services was in part associated with a drawdown of inventories.

The fiscal position improved modestly in 1983 as the overall deficit fell by 9 percent to YRls 4.8 billion, equivalent to about 29 percent of GDP. Domestic bank financing declined to the equivalent of 23 percent of GDP and 38 percent of the beginning period money supply. Current revenues rose by 19 percent, but due to a large reduction in foreign grants, total revenues and grants fell by 10 percent to YRls 5.2

1/ The retail price index is believed to understate the actual rate of price increase.

billion. Total expenditures dropped by 9 percent to YRls 10.0 billion. However, all of the decline had occurred in capital outlays, which fell by 27 percent to YRls 2.9 billion. Combined current and extrabudgetary expenditures remained essentially unchanged. 1/

The balance of payments current account and overall deficits fell in 1983 to US$568 million and US$216 million, respectively, and there was an increase in the capital account's surplus. A decline in imports reflected the slowdown in economic activity, the tightening of the import licensing system, and the depreciation of the Yemen rial in the free market since early 1983. The fall in imports more than offset a decline in government transfer receipts that resulted from the cessation of certain exceptional assistance payments. The improved capital account resulted from both a drop in loan repayments following a rescheduling of payments to certain countries, and a rapid increase in private capital inflows as the business community borrowed abroad to finance imports. By the end of 1983 reserves had fallen to US$361 million (2.4 months of imports). Furthermore, the spread between the official and open market rates widened in the last half of 1983, and on November 10, 1983 the rial was officially devalued by 2.4 percent vis-a-vis the U.S. dollar.

In the first half of 1984, the overall balance of payments position showed a surplus of US$67 million, compared with a deficit of US$172 million in the similar period of 1983. The current account deficit fell sharply to about US$43 million in the first half of 1984 compared with the same period of 1983, as imports continued to decline and transfer receipts remained steady. The current account deficit was more than offset by a surplus on capital account and a favorable move in the balancing item. At the end of June 1984, official reserves were US$348 million, or equivalent to about three months' imports at the projected 1984 level. However, spreads continued to develop between the official and open market rates, leading to a reluctance by banks to open letters of credit as shortages of foreign exchange developed in the banking system and as further rate changes appeared inevitable. To alleviate this situation and to avoid further loss of foreign reserves, the Yemen rial was further devalued on February 15, May 20, and August 14, 1984, leading to a cumulative devaluation of about 21.6 percent.

Domestic liquidity and money both expanded by 28 percent in 1983. Government borrowing from the banking system remained the primary contributing factor, although its contribution was somewhat less than in 1982. This improvement was more than offset, however, by a reduction in the drawdown of net foreign assets, increased lending to public and mixed enterprises, and a turnabout in the other items (net). This trend accelerated in the first half of 1984 with domestic liquidity increasing at an annual rate of 41 percent. The contribution of government borrowing was again reduced, but it remained the largest factor.

1/ Extrabudgetary expenditures are comprised primarily of various outlays of a current nature, such as expenditures for defense, security, and emergency purposes, and for the liquidation of public sector companies' debts.

Domestic inflationary pressures intensified in 1983; the rate of inflation as measured by the consumer price index rose to 7.8 percent. However, the increase was dampened by the unchanged peg of the Yemen rial to the U.S. dollar throughout most of the year, the drawdown of inventories, and the relatively open trading system which ensured adequate supplies of imports.

IV. Report on Policy Discussions

1. Production and investment policies

Contrary to the aims of the SFYP, the recent trends indicated an increase in the role of the government sector relative to the private sector and of consumption relative to investment. In particular, the ratio of government consumption to GDP (in current prices) rose from 29 percent in 1981 to 38 percent in 1983, an increase that occurred at the expense of private consumption, fixed investment, and exports, all of which had fallen well below the Plan's targets. The Y.A.R. representatives explained that the deviations from the targets in the first two years of the Plan had resulted mainly from government extrabudgetary expenditures for defense and security. They added that the Plan targets for 1986 remained as their goals and that beginning in 1985 the authorities would implement annual plans, whose aim would be to redress the current imbalance.

The decline in agricultural value added in 1983, especially for cereals and legumes, had been primarily due to insufficient rainfall and also to the displacement of some farmers in areas affected by the earthquake of December 1982. Other than the heavy reliance on rainfall, the main problems in agriculture continued to be marketing, distribution, reduced yields, and low profitability. The Y.A.R. representatives explained that investment in agriculture in the last two years had not increased as planned, and that the targets for government agricultural investment were not likely to be met as it was now the policy to induce the private sector to increase its agricultural investment. They added that, except for the provision of free extension services and low-cost credit to farmers, there were no subsidies on farm inputs or outputs and no price fixing for agricultural products.

The general industrial policy was to promote private and mixed investment in import-substituting and export-oriented industries, and extractive industries had been given high priority. Consequently, value added in the manufacturing and mining and quarrying sectors rose by almost 22 percent in 1983, but that of the construction sector stagnated due to the completion of housing projects in 1982. The Y.A.R. representatives explained that direct involvement of the Government in industrial activity was limited to areas where the private sector was unable or unwilling to participate. No direct industrial subsidies were granted, but normal investment incentives were provided. Recently, the electricity tariff for industrial users had been lowered by one third, and a number of new incentives such as the provision of technical assistance, the assignment of high priority to imports of needed spare parts, and the preparation of feasibility studies to identify new investment projects, had been approved. In addition, investment guarantee agreements with other countries were being expanded, and the joint stock company law was being revised.

An especially encouraging development was the recent discovery of oil in the Marib region. Although it had not yet been determined if the find would be commercial, all available indications were encouraging, and additional exploration was already underway. However, no significant production was expected before 1987.

Turning to energy pricing policy, the mission asked if cost increases resulting from the recent devaluations of the Yemen rial would be passed on to consumers. The Y.A.R. representatives explained that the general policy was for public enterprises to pass on increases in costs so that no subsidies would emerge, but that careful study would be required in the case of domestic energy prices due to their ramifications for production costs throughout the economy. However, with the exception of diesel fuel, prices would be raised as necessary to cover costs.

Concerning recent wage and price movements, the Y.A.R. representatives explained that since 1982 there had been no change in government wages and an annual ceiling of 5 percent had applied to wage increases in public enterprises. Wages in the private sector, which were determined by market forces, had risen more rapidly, and they were now up to double those in the public sector. However, the public sector still provided greater job security and better pension benefits.

2. Fiscal policies

The mission expressed concern about the continuing sizable fiscal deficit which had been reduced slightly in 1983 primarily at the expense of capital outlays. The Y.A.R. representatives explained that, after the 1983 budget had been prepared, quarterly reviews of revenues and expenditures had indicated that expenditure cuts were needed in order to contain the overall and bank-financed deficits. It had been difficult to contain current expenditures, especially since additional outlays had been needed for defense and current transfers. However, the wage and salary bill had risen by only 2.6 percent despite the need to provide staff for newly completed projects. The implementation of new investment projects to be financed from domestic sources, mainly projects in the defense, educational, agricultural, and construction areas, had therefore been stopped. Foreign financed projects were still being undertaken along with any associated local costs. Resource mobilization efforts had concentrated on improving tax collection procedures, but tax rates on motor vehicles and tariff rates on some luxury goods had been increased; consequently, tax revenues had risen by almost one fourth and the ratio of taxes to GDP had risen by 3 percentage points to 22 percent. In addition, nine revenue measures had been introduced in June 1983 to mobilize domestic resources for the earthquake reconstruction program. 1/ However, these proceeds were earmarked to accrue to the Supreme Council for Reconstruction and Rehabilitation, which had been placed in charge of the reconstruction program and whose operations were independent of the budget. 2/

Turning to 1984, the mission inquired about the overall policy objectives and whether discretionary measures had been introduced to mobilize domestic resources or to curtail the growth of expenditures. The Y.A.R. representatives stated that the primary objective was to achieve a balance on the current account with the proceeds of foreign grants and loans reserved for development purposes, but they also aimed to contain bank borrowing within a reasonable level.

Additional budget revenues were expected from several new measures. The exchange rate at which imports were valued for customs purposes was being adjusted along with the central bank rate. Tariffs on luxury goods had been increased and new tariffs introduced on wheat, cereals, and other foodstuffs in January and March 1984. User charges for health and educational services and drivers' license fees had also been raised. The expected revenue yield of these measures was YRls 260 million in 1984. Efforts to improve the tax administration and to collect tax arrears were being pressed. Higher property income receipts were expected from the Central Bank and other public enterprises as a result of efforts to reduce costs and to limit wage increases.

With regard to expenditures, the measures implemented in 1983 had been continued into 1984. In addition, capital transfers were expected to fall below the budget estimate as such transfers were no longer being made to public enterprises, with the exception of those required under IBRD loan agreements. Instead, the requirements of these enterprises were to be met through loans on commercial terms from the Central Bank guaranteed by the Government. Current transfers to public enterprises were also expected to fall as operating subsidies for all but three public authorities were being eliminated. The Y.A.R. representatives explained that public enterprises can request and receive permission to raise prices of commodities from their parent ministry, but cabinet approval is required to increase prices of public services. They noted, however, that only one request for a price increase had been approved in the latest 12 months as emphasis was being placed on reducing costs.

Revised 1984 budget estimates prepared by the mission on the basis of part-year data and discussions with the authorities indicated an overall deficit of YRls 4.4 billion, with domestic bank borrowing of YRls 3.8 billion. A 10 percent increase in total revenues and grants to YRls 5.6 billion was estimated, roughly equally divided between tax and nontax revenues. Grants totaling YRls 0.7 billion were projected. Total expenditures were projected to increase by 1 percent to YRls 10.1 billion,

1/ For details of these measures, see SM/83/163, p. 23.
2/ Data on the financial operations of the Supreme Council are not available and are not included in the fiscal data in this report.

with combined current and extrabudgetary outlays falling to YRls 6.9 billion and capital expenditures rising by 7 percent to YRls 3.2 billion. The Y.A.R. representatives stated that the staff estimates were in general realistic, but they believed that total expenditure would be only about YRls 9.8 billion, of which YRls 850 million would be extrabudgetary outlays. They added that they still hoped to attain the budget estimates of revenue and expenditures.

The mission noted that with two thirds of the fiscal year completed, additional discretionary measures would be needed to attain the budget estimate. The Y.A.R. representatives indicated that some measures could be implemented relatively quickly, including further increases in user charges, an increase in the price on which petroleum products are valued for tax purposes (currently the 1973 prices are used), intensification of efforts to increase public enterprise profitability, and increased inducements for importers to use air and sea routes rather than overland routes that often escape customs taxation.

3. Monetary policies

The mission observed that, as real GDP had risen by only about 1 percent in 1983, the disparity that had emerged in 1982 between economic growth and monetary growth had continued. The adverse consequences of the liquidity generated in the previous year had been mitigated by many factors, including the openness and continuing monetization of the economy, the ready availability of smuggled goods, and the drawdown of inventories. More recently, pressures had been exerted on the exchange rate, and the Government's borrowing, much of which had financed government consumption, continued to add to liquidity in the economy. The Y.A.R. representatives agreed that the fundamental problem could only be corrected through reduced fiscal deficits, but added that the borrowing had been a calculated risk undertaken to sustain the development effort until expected new revenue sources became available. The introduction of a proposed bond scheme, aimed at absorbing existing excess liquidity, had been delayed by religious objections to certain features of the scheme, but modifications had been made to mollify these, and approval of the revised scheme by the People's Assembly was expected in the near future. Also, a number of new mixed enterprises were expected to provide new investment opportunities, and the establishment of an Islamic bank was being contemplated in order to provide religious persons with an opportunity to make time deposits under conditions consistent with their beliefs. In addition, the statutory reserve requirement had been raised from 10 percent to 15 percent and then 20 percent to absorb some excess liquidity, which had been reflected in the sharp increase since September 1982 in special interest-bearing deposits of commercial banks with the Central Bank.

The Y.A.R. representatives explained that the increased borrowing by the private sector had been sparked by the discovery of oil which had led to speculative land purchases. Also, some borrowing had been undertaken to finance speculation against further depreciation of the rial and the increased costs of imports. Interest rates had remained unchanged with a maximum lending rate of 15 percent and a minimum rate on time deposits (3 months) of 9.5 percent. Although banks had been reluctant to accept time deposits, they cited the recent increase in bank lending as an indication that the interest rate spread remained adequate for bank profitability despite the recent increase in the reserve requirement. They also noted that many deposits are kept in noninterest-bearing accounts and that the noninterest-bearing margin requirements for opening letters of credit had been raised along with the reserve requirement.

4. External sector policies

The balance of payments projections for 1984 prepared by the Central Bank of Yemen indicated a sharp reduction in the current account deficit to US$98 million, as an estimated 29 percent decline in imports more than offset small reductions in net receipts from official and private transfers. The overall balance of payments position was projected to show a small surplus. The mission noted that the projected level of imports as a percentage of estimated GDP would fall to about 31 percent, compared with an annual average of about 58 percent from 1980 to 1983, and inquired whether this level of imports could be consistent with the expected rise in the level of GDP in 1984. The Y.A.R. representatives stated that a foreign exchange budget had been implemented in 1984 allowing for the projected level of imports and that in the first half of the year the targets were almost met. Although efforts would be made to remain within the exchange budget's annual ceiling, they agreed that the actual level of imports was likely to be higher than that projected and that the overall balance of payments surplus was likely to be quite small.

The exchange and trade system, which was free of restrictions and prescribed only an import license requirement that was granted freely until the end of 1982, underwent a number of changes in 1983 and 1984. 1/ The more significant changes included the following. As reserves dwindled, the Central Bank ceased selling foreign exchange to commercial banks toward the end of 1982. With the squeeze on reserves continuing, the granting of import licenses was tightened in mid-1983, and the foreign exchange budget was introduced in January 1984. In an effort to counterbalance the near monopoly position of private exchange dealers, commercial banks were required to obtain foreign exchange through a joint purchasing committee of the Banking Association rather than individually. Commercial banks were subsequently prohibited from stamping or negotiating letters of credit until they had transferred the required foreign currency abroad. The Ministry of Supply and Trade would only approve requests for import licenses that had been stamped by a commercial bank. Furthermore, the

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1/ For details and exact dates of the changes introduced in 1983 and 1984, see Recent Economic Developments report, to be issued shortly.

transfer abroad by banks of foreign currency deposits made after August 9, 1984, to finance imports or any other foreign transaction was prohibited, and individuals were prohibited from depositing foreign currency with banks to open letters of credit or to settle collections. Deposits after August 9 could only be sold to commercial banks at official rates or retained as a foreign currency deposit. They could be transferred abroad only with the permission of the Central Bank.

The mission noted that the manner in which the exchange budget was operated and the restrictions on the use of residents' foreign exchange deposits, appeared to constitute exchange restrictions that were in contrast to the long tradition of a free and open exchange and trade system in the Y.A.R. as well as the Fund's Articles of Agreement, and it suggested alterations that would remove the restrictive elements. The Y.A.R. representatives said that their goal had not been to impose exchange restrictions but rather to limit and improve the composition of imports in view of the continuing pressures on the balance of payments. They added that they would change the existing procedures to remove any exchange restrictions as soon as possible.

With regard to the official exchange rate, they explained that it was now the policy to follow the free market rate closely. The mission welcomed the change in the exchange rate policy but questioned whether the existing interest rate structure would prevent capital flight. The Y.A.R. representatives stated that the interest rate structure maintained a slight premium over the rates abroad as evidenced by the increase in foreign currency deposits of the residents in commercial banks.

On external debt, the Y.A.R. representatives noted that debt service payments during the current year were about 4 percent of current receipts. These were expected to remain at about the same level in 1985 and to rise marginally in 1986. The level of external borrowing in 1985 was expected to be about US$190-200 million, but it might increase slightly if pressures on the external sector could not be avoided. Since 1981, tight controls had been imposed on foreign borrowing, with all government and public sector loans requiring approval of the Cabinet, the Parliament, and the President. The mission commended the prudent external debt policy of the Y.A.R.

5. Medium-term outlook

On the assumption of unchanged policies, projections of the fiscal, monetary, and balance of payments outlooks were prepared for 1985 and 1986. As the recent discovery of oil may result in significant structural changes beginning in 1987, reliable projections beyond 1986 did not seem possible. However, should substantial oil revenues be forthcoming, the balance of payments problem may be resolved, but other problems as were experienced in other oil producing countries, such as inflation and shortages of some goods and services, could be expected. If substantial oil revenues are not forthcoming, the projections for 1985 and 1986 indicate that under current policies the financial situation may not be sustainable.

The projections assumed that imports continued to be constrained to levels consistent with an overall balance in external transactions and that there is some increase in remittances through official channels as a result of the more flexible exchange rate policy (Appendix III, Table 2). Thus, on the basis of a neutral balance of payments outcome and existing trends in revenues and expenditures, the overall fiscal deficits were projected at YRls 5.9 billion and YRls 7.0 billion in 1985 and 1986, respectively, and the associated levels of domestic bank financing at YRls 5.1 billion and YRls 6.1 billion. The implied rates of increase in domestic liquidity were 28 percent in 1985 and 26 percent in 1986.

The mission noted that these projections illustrated an urgent need for discretionary actions of substantial magnitude to reduce the fiscal deficit and the growth of liquidity if financial stability and the development effort were to be sustained. It also noted that if increased economic growth were to be achieved, considerably higher levels of imports than envisaged in the projections would be required, which underscored the need to pursue policies aimed at encouraging remittances. The Y.A.R. representatives agreed with the need for significant adjustments but explained that the measures to be taken and the period of adjustment would have to be tailored to the circumstances of the Y.A.R.

IV. Staff Appraisal

During the 1970s the Y.A.R. recorded impressive economic achievements. Substantial inflows of workers' remittances and bilateral and multilateral aid helped to finance rapid growth of both consumption and investment, to develop basic infrastructure and social and economic institutions, and to diversify the economy from its agricultural base. However, since 1978/79 financial developments have deteriorated. The growth of government expenditures, especially for consumption, accelerated, leading to substantial dissaving and rising overall fiscal deficits. The balance of payments also moved from a position of surplus to deficit, and the large reserves that had been built up in earlier years began to be depleted. In 1982 the fiscal and balance of payments deficits rose to record levels, and reserves fell to their lowest level in years.

In 1983 there was a fall in real GDP (at factor cost), primarily due to a drought-related decline in agricultural value added. Gross fixed investment declined for the second year, but government consumption remained close to its record level of the previous year. Although some measures implemented in 1983 accelerated the growth of tax revenues, they were more than offset by a sharp fall in foreign grants, and the modest reduction in the overall fiscal deficit primarily resulted from a substantial decline in capital outlays. Furthermore, developments in the first half of 1984 suggest that the fundamental causes of the deterioration in the Government's finances persist. The balance of payments deficit was reduced in 1983, primarily as a result of stricter controls on imports. In recent months the authorities have introduced much-needed flexibility in their exchange rate policy, as evidenced by the frequent adjustments in the foreign value of the rial. Gross reserves at the end of July 1984 remained at a low level, equivalent to three months' imports at the revised projected 1984 rate. In the area of monetary policy, some measures have also been taken to absorb excess liquidity of commercial banks, but in all probability there exists an overhang of liquidity in the economy that poses a potential threat to financial stability.

The large fiscal deficit is the fundamental cause of the deterioration in financial conditions in the Y.A.R. This level of deficit is clearly unsustainable and if it is not reduced substantially and at an early date, the growth of liquidity in the economy will continue to be excessive. In the circumstances of the Y.A.R., fiscal restraint must primarily take the form of significant reductions in the level of government current expenditures and more effective constraints on extrabudgetary expenditures, which continue to be considerable. Without a determined effort to reduce the growth of such expenditures, it would not be possible to maintain the momentum of development. In addition, improved price flexibility could rapidly increase the profitability of public enterprises, reduce the need for budgetary outlays for current and capital transfers, and increase budgetary receipts. Also, the tax measures already under consideration should be implemented as quickly as possible to enhance the tax effort further. In addition, steps must also be taken to mop up existing liquidity, for example, by expediting the implementation of the proposed bond scheme.

On the external side, the recent flexible approach to exchange rate policy should be continued, and the aim should be to build up foreign reserves to a more adequate level. In the beginning of 1983 the authorities reacted to the developing foreign exchange stringency by tightening the import licensing system and later linking it closely to the exchange budget, and by restricting the use of residents' foreign exchange deposits. These measures involve exchange restrictions and are subject to Fund approval under Article VIII. More fundamentally, attempts to protect the balance of payments by means of trade and exchange restrictions are likely to foster vested interests and malpractices, absorb scarce administrative resources and, most importantly, they are not likely to be effective in the circumstances of the Y.A.R. The free exchange and trade system that the Y.A.R. had traditionally maintained had contributed greatly to the rapid development of the economy over the years. The staff believes that the best way to overcome current balance of payments strains is to pursue appropriate exchange rate, fiscal, and monetary policies in the context of an open trading system. These policies will strengthen confidence in the economy, encourage remittances, and thus provide resources for the continued development of the economy. The Y.A.R. representatives have agreed to review the recent trade and exchange regulations at an early date and to remove the restrictive elements, and the staff therefore recommends that they be temporarily approved.

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 Yemen Arab Republic's exchange measures subject to Article VIII, Section 2, and in concluding the 1984 Article XIV consultation with the Yemen Arab Republic, in the light of the 1984 Article IV consultation with the Yemen Arab Republic conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The licensing of imports in accordance with an exchange budget and the limitations on the use of residents' foreign exchange deposits, as described in SM/84/__, constitute exchange restrictions requiring approval under Article VIII. The Fund notes the intention of the Y.A.R. authorities to eliminate the restrictive elements of these regulations at an early date and grants approval for these restrictions until November 30, 1985 or the next Article IV consultation, whichever is earlier.

Yemen Arab Republic: Fund Relations
(As of September 30, 1984)

(Amounts in millions of SDRs, unless otherwise indicated)

I. Membership status

(a)	Date of membership:	May 22, 1970.
(b)	Status:	Article XIV.

A. Financial Relations

II. General Department (General Resources Account)

(a)	Quota:	43.3
(b)	Fund holdings of Yemen rials:	47.1 (108.8 percent of quota).
(c)	Fund credit:	9.8 (22.5 percent of quota).
	Of which: Emergency assistance:	9.8 (22.5 percent of quota).
(d)	Reserve tranche position:	6.0 (13.7 percent of quota).
(e)	Current operational budget:	--
(f)	Lending to the Fund	--

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

(a)	Current Stand-by or Extended Arrangement:	None.
(b)	Previous Stand-by or Extended Arrangement:	None.
(c)	Special facilities:	February 25, 1983; a drawing of 9.9 under the Fund's policy on emergency assistance.

IV. SDR Department

(a)	Net cumulative allocation:	6.2
(b)	Holdings:	8.8 (143.4 percent of net cumulative allocation)
(c)	Current Designation Plan:	--

V. Administered Accounts

(a) Trust Fund loans	
(i) Disbursed:	--
(ii) Outstanding:	--
(b) SFF Subsidy Account	
(i) Donations to Fund	--
(ii) Loans to Fund	--
(iii) Payments by Fund:	--

VI. Overdue Obligations to the Fund: --

B. Nonfinancial Relations

VIII. Exchange Rate Arrangement:

The Yemen rial is pegged to the U.S. dollar which is the intervention currency. In February 1973 the Central Bank rate was set at YRls 4.5 = US$1. The rate was first changed on November 10, 1983. This and three subsequent changes resulted in a 21.6 percent cumulative devaluation vis-a-vis the U.S. dollar. As of August 14, 1984, the representative rate established under the Fund's Rule O-2 is now YRls 5.74 = US$1, the average of the Central Bank's buying and selling rates.

IX. Last Article IV Consultation:

Discussions were held by the staff in Sana'a during the period May 1-24, 1983. The Staff Report (SM/83/160) was discussed by the Executive Board on August 24, 1983. It was agreed that the next consultation be on the standard 12-month cycle.

The Executive Board's decision (Decision No. 7502-83/122) adopted August 24, 1983, was as follows:

1. The Fund takes this decision in concluding the 1983 Article XIV consultation with the Yemen Arab Republic, in the light of the 1983 Article IV consultation with the Yemen Arab Republic conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that, despite external payments difficulties, the Yemen Arab Republic intends to continue to maintain an exchange system that is free of restrictions on payments and transfers for current international transactions.

X. Technical Assistance

(a) CBD: At present and for the past several years the Central Bank of Yemen has had three CBD experts assigned in the fields of foreign exchange, bank control, and research. In addition, CBD prepared a report on the operations of the informal money market (1982).

(b) FAD: At present one Fund expert is assigned to the Ministry of Finance in the budget area. For the two previous years there were two fiscal experts assigned in the areas of taxes and customs. In addition, in November 1983 a Fiscal Affairs Department technical mission visited Sana'a and subsequently prepared a report reviewing the financial performance of selected public enterprises.

(c) Other: In addition, in 1982 the Fund staff prepared technical assistance reports on domestic resource mobilization (with the IBRD) and the macroeconomic effects of exchange rate policies since 1973. In November 1983, a MED/ETR technical assistance mission visited Sana'a to assist in preparing projections of the balance of payments for 1984 and to review and advise on contemplated corrective measures.

XI. Resident Representative/Advisor: None

Yemen Arab Republic: Basic Data

Area and population	
Area	195,000 square kilometers
Resident population (1981)	7.3 million
Per capita GDP (1981)	YRls 2,300 (US$510)

	1981	1982	1983	Proj. 1984
	(In millions of Yemen rials)			
Production and prices				
GDP in current market prices	13,460	15,868	16,802	...
GDP in constant 1975/76 prices	7,002	7,640	7,751	...
Percentage growth of real GDP (at factor cost)	(8.7)	(8.7)	(-0.6)	(...)
Percentage change in Sana'a retail price index	(7.4)	(5.2)	(7.8)	(...)
Public finances				
Total revenues and grants	4,852	5,700	5,152	5,642
Revenues	(3,336)	(3,696)	(4,405)	(4,954)
Grants	(1,516)	(2,004)	(747)	(688)
Total expenditures	7,801	10,961	9,959	10,064
Current expenditures	(3,325)	(5,181)	(5,924)	(6,907) 1/
Capital expenditures	(3,683)	(4,017)	(2,937)	(3,157)
Extrabudgetary expenditures	(792)	(1,763)	(1,098)	(...)
Overall deficit (-)	-2,949	-5,261	-4,808	-4,423
External financing	920	846	900	607
Domestic bank financing	2,029	4,415	3,907	3,816
Deficit as a percentage of GDP (at market prices)	(21.9)	(33.2)	(28.6)	(...)
Overall deficit without grants	4,466	7,265	5,555	5,111
Overall deficit without grants as percentage of GDP	(33.2)	(45.8)	(33.0)	(...)
Money and credit (change during period):				
Money	303	2,396	2,871	...
Domestic liquidity (money and quasi-money)	726	2,614	3,448	4,277
Net foreign assets	-1,181	-1,399	-974	37
Net claims on Government	2,023	4,415	3,907	3,816
Claims on nongovernment sector	294	160	226	424
Public and mixed enterprises	(264)	(-301)	(132)	(...)
Private sector	(30)	(461)	(94)	(...)
Percentage change in domestic liquidity	(8)	(26)	(28)	(27)
Ratios of:				
GDP to money 2/	(1.74)	(1.75)	(1.44)	(...)
GDP to domestic liquidity 2/	(1.41)	(1.42)	(1.18)	(...)

Yemen Arab Republic: Basic Data (concluded)

	1981	1982	1983	Proj. 1984
	(In millions of U.S. dollars) 3/			
Balance of payments				
Exports, f.o.b.	10	5	10	7
Imports, f.o.b.	-1,748	-1,952	-1,796	-1,328
Trade balance	-1,738	-1,948	-1,786	-1,321
Services (net)	-51	-37	-52	-45
Private transfers (net)	788	924	1,104	1,100
Official transfers (net)	337	445	166	127
Current account	-664	-615	-568	-139
Nonmonetary capital	331	216	293	88
Errors and omissions (net)	72	89	58	58
Overall balance	-261	-311	-216	7
Current account deficit as percentage of nominal GDP (at market prices)	(22.2)	(17.4)	(15.2)	(...)
Total reserves (end of period)	967	558	361	315 4/
In months of imports	(7)	(3)	(2)	(3)
Disbursed external debt outstanding (end of period)	1,101	1,421	1,635	...
In percentage				
External debt to GDP	(37)	(40)	(44)	(...)
External debt service to GDP	(2.3)	(1.5)	(1.0)	(...)
External debt service to current account receipts	(4.0)	(2.7)	(2.1)	(4.0)

1/ Includes extrabudgetary expenditures.
2/ Denominators are beginning and end-of-period averages.
3/ Converted at US$1 = YRls 4.5 through 1983 and at US$1 = YRls 5.44 for 1984.
4/ August 31, 1984.

Table 2. Yemen Arab Republic: Medium-Term Outlook, 1984-86

	1984	1985	1986
	(In billions of Yemen rials)		
Public finances			
Total revenue and grants	5.6	6.8	8.0
Grants	(0.7)	(1.0)	(1.1)
Total expenditure	10.1	12.7	15.0
Current and extrabudgetary	(6.9)	(8.5)	(10.4)
Overall deficit	4.4	5.9	7.0
Bank financing	(3.8)	(5.1)	(6.1)
	(In percent per annum)		
Money and credit			
Domestic liquidity	27	28	26
	(In billions of U.S. dollars)		
Balance of payments 1/			
Current account	-0.1	-0.2	-0.2
Imports	(-1.3)	(-1.5)	(-1.7)
Remittances	(1.2)	(1.3)	(1.5)
Overall balance	--	--	--

Source: Staff estimates.

1/ Assuming unchanged current policies.

Yemen Arab Republic - Statistical Issues

1. Coverage, Currentness, and Reporting of Data in IFS

		Latest Data in October 1984 IFS
Real Sector	- National Accounts	1982
	- Prices	1982
	- Production	n.a.
	- Employment	n.a.
	- Earnings	n.a.
Government Finance	- Deficit/Surplus	1981
	- Financing	1981
	- Debt	n.a.
Monetary Accounts	- Central Bank	April 1984
	- Deposit Mone Banks	April 1984
	- Other Financial Institutions	n.a.
External Sector	- Merchandise Trade: Values	1982
	- Merchandise Trade: Prices	n.a.
	- Balance of Payments	Q4 1983
	- International Reserves	August 1984
	- Exchange Rates	August 1984

During the past year, the reporting of data for inclusion in IFS has been satisfactory for monetary and balance of payments data, but inadequate in other areas of statistics with regard to both currentness and coverage.

2. Outstanding Statistical Issues

National Accounts: Reported data prior to 1981 cover fiscal year ended June 30; year ends December 31 thereafter. No adjustment has been made to reconcile the two series.

Monetary Accounts: No details are reported to the Bureau of Statistics on the paired asset and liability memorandum accounts in the Central Bank's balance sheets. These accounts tripled in magnitude between Q3 and Q4 of 1981 and are now the largest items in the balance sheet.

Yemen Arab Republic: Summary of World Bank Staff Assessment of Supply Side Policies 1/

The Y.A.R.'s satisfactory economic performance is largely due to the adequacy of the Government's economic policy that succeeded to maximize the positive effects of favorable exogenous factors (chiefly the large inflow of workers' remittances and official aid). The Government concentrated its efforts on building the country's physical (roads, ports, power, and water) and social (education, health), infrastructure minimized its investment and more generally its intervention in the productive sector, and kept protection at a low level. As a result, distortions are minimal in the Y.A.R. Investment (public and private) and incomes grew rapidly, and strong family ties ensure that growth benefits are widely distributed.

The Second Five-Year Plan (1982-86) has a 7 percent GDP growth target calling for a total investment of around US$6.5 billion (1981 prices) over the Plan period. The sectoral distribution of investment underlies a continued broad-fronted strategy with an emphasis on physical infrastructure, agriculture, and manpower development. The Plan's financing envisaged heavy dependence on external sources with around 70 percent of investment expected to be covered by grants and loans from aid agencies and direct foreign private investment. However, since this expected level of foreign finance does not appear to be forthcoming and because of the extremely tight budgetary situation that has developed recently, the Government, with Bank assistance, has been revising downward its investment program.

Recently, large budget and balance of payments deficits (the latter being to a large extent the consequence of the former) have led the Government to depart somewhat from its previous free trade attitude by imposing some import restrictions, in particular to encourage import-substitution activities.

Two issues, namely population growth and the reduced availability of water have emerged as serious long-term development issues. The rapid population growth (about 3 percent per annum) suggests that, despite cultural constraints, the Government should start analyzing recent demographic trends to reach a better understanding of the consequence of this high growth rate and develop an appropriate policy. Water resources are being depleted rapidly, in particular around major cities. A number of initiatives are, therefore, called for to address these problems: (i) establishing a comprehensive water resources data base; (ii) improving coordination among the various agencies operating in the water sector; (iii) introducing legislation to manage water use; and, (iv) strengthening cost recovery policies.

1/ Source: IBRD.

Yemen Arab Republic: Statement of World Bank Group's
Credits and Investments, June 30, 1984

(In millions of U.S. dollars)

	IDA	IFC	Total
Agriculture	128.4	-	128.4
Transportation	54.2	-	54.2
Education	61.0	-	61.0
Industrial development	14.1	7.1	21.2
Water supply and sewerage	36.4	-	34.6
Power	41.0	-	41.0
Petroleum and geothermal	15.0	-	15.0
Urban	27.0	-	27.0
Health	10.5	-	10.5
Total	387.6	7.1	394.7
Repaid	0.5	1.6	2.1
Total committed	387.1	5.5	392.6
Undisbursed	193.7	4.0	197.7
Total outstanding	193.4	1.5	194.9

Source: IBRD.