FOR AGENDA

EBS/83/26

CONFIDENTIAL

February 2, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Yemen Arab Republic - Use of Fund Resources

Attached for consideration by the Executive Directors is a paper on a request from the Yemen Arab Republic for a purchase equivalent to SDR 4.875 million. A draft decision appears on page 5.

This subject will be brought to the agenda for discussion on a date to be announced.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

YEMEN ARAB REPUBLIC

Use of Fund Resources

Prepared by the Middle Eastern Department

(In consultation with the Exchange and Trade Relations Department, the Legal Department, the Research Department, and the Treasurer's Department)

Approved by A. K. El Selehdar and Subimal Mookerjee

February 2, 1983

I. Introduction

At the request of the authorities of the Yemen Arab Republic (Y.A.R.), a staff mission 1/ visited Sana'a during the period January 10-14, 1983 to assess the economic and financial impact of the earthquake which hit the Y.A.R. on December 13, 1982 and to discuss with the authorities possible use of Fund resources under the Fund's emergency assistance related to natural disasters. The mission met with the Prime Minister, Deputy Prime Minister, the Governor of the Central Bank, the Deputy Chairman of the Central Planning Organization, the Director General of the Local Development Associations, the Under Secretaries of Public Works and Telecommunications, and the UNDP representative. In a letter to the Managing Director (Attachment I) the authorities requested a purchase of 25 per cent of quota, amounting to SDR 4.875 million, under the Fund's policy on emergency assistance related to natural disasters, for the purpose of financing urgent import needs. The letter and attachment also stated the intention of the authorities to collaborate with the Fund in formulating an appropriate adjustment program as soon as circumstances permit.

II. The Economic Problem

On December 13, 1982 a severe earthquake occurred in the Dhamar Governorate, causing considerable loss of life and extensive damage to rural infrastructure (Attachment I). No precise account of the total cost of the damage is yet available; preliminary official estimates place it at about US$1.8 billion, the vast bulk of it representing lost or damaged private property, especially dwellings. The affected areas continue to be active seismically, delaying the return of the homeless to their villages and necessitating the maintenance of temporary shelter and other relief facilities and services.

1/ The mission was composed of Mr. G.T. Abed (Head) and Mr. S. Geadah (both of MED).

Bilateral donors and international organizations assisted the authorities in ensuring the safety of the surviving population and in providing relief supplies of water, food, shelter, and medical care. More than 200 planeloads of tents, blankets, clothes, medicine, water tanks, electricity generators, and other items were received, and several medical teams arrived in the days following the earthquake. External grants amounting to about US$32 million in cash, mostly from Saudi Arabia, and about US$15 million in kind have been received. The UNDP office in Sana'a is coordinating international assistance efforts and the World Bank has dispatched a mission, in coordination with Arab development aid institutions, to assist the Y.A.R. authorities in the tasks of assessment of damage and post-emergency reconstruction planning.

The need for relief supplies remains acute, especially tents and building equipment and materials. Because of continued seismic activity in and around the affected areas, official relief activities are likely to continue for at least several months. The budget and balance of payments costs of the relief efforts are difficult to estimate because of lack of centralization of relief activities, the involvement of the armed forces and foreign relief teams, as well as the extensive area over which relief services are being administered. The additional budgetary expenditures are provisionally estimated at US$5-7 million per month, the bulk of which would be reflected in higher imports. The earthquake has also disrupted, at least temporarily, the agricultural production system in the area and caused the loss of household stocks of grains and livestock. As a result, a further increase in imports may be required to offset these losses.

Over the medium term, the tasks of reconstruction and rehabilitation are expected to take several years; a portion of the cost will be borne by the government budget, primarily for the reconstruction and rehabilitation of community facilities, rural infrastructure, and for possible assistance to home owners. Furthermore, new structures are likely to require more earthquake-resistant design and construction, leading to an increase in imports of steel and cement, as well as machinery and equipment.

III. Recent Developments

After several years of buoyant economic activity in the mid- and late-1970s, economic growth in the Y.A.R. has subsided in recent years. The rate of growth of GDP declined steadily from a peak of 8.3 per cent in 1977/78 to 3.3 per cent in 1981. This was in large part due to a general slowdown in economic activity in the region, especially in the neighboring oil countries, the main source of private remittances and official transfers. Increased tension in the area may have also dampened private sector investment.

During this period, the fiscal and balance of payments positions came under increasing pressure. The overall budget position showed a small deficit in 1977/78 for the first time in many years. Subsequently the deficit widened rapidly, amounting to nearly 26 per cent of GDP in 1980. It declined to 18 per cent in 1981, largely as a result of higher inflows of cash grants. The 1982 deficit is likely to have exceeded 30 per cent of GDP. 1/ Central Bank lending to the Government increased from YRls 2.0 billion in 1981, equivalent to about 16 per cent of GDP and about 22 per cent of the beginning period money stock, to an estimated YRls 4.2 billion in 1982. At this level, it would have been equivalent to just under 30 per cent of GDP and 40 per cent of the beginning period money stock. The expansionary effect of government borrowing on domestic liquidity, however, was offset by the deteriorating balance of payments position. An overall balance of payments deficit emerged in 1979 and, since then, the deficit has increased sharply; it rose from US$147 million in 1980 to US$331 million in 1981 and to an estimated US$475 million in 1982. Projections for 1983 indicate a further deterioration in the balance of payments position, with an overall deficit of at least the same magnitude as in 1982. Gross foreign exchange reserves have declined steadily in the past three years; they fell from US$920 million at the end of 1981 to about US$520 million at the end of 1982, at which level they were equivalent to about three months of imports.

Pending the formulation of structural reforms in the fiscal and balance of payments areas, the Y.A.R. authorities have taken some measures to raise budgetary revenues, control expenditures, and otherwise restrain the growth of domestic demand. The 1983 budget virtually freezes expenditures at the 1982 budgeted level (in nominal terms) and seeks to increase revenues over the 1982 actuals, mainly through changes in fees and charges and through improved administration. Import taxes on commodities whose international prices have declined in terms of Yemeni rials, particularly petroleum products but also foods and intermediate goods, are to be increased in a manner so as to maintain their domestic prices, thus raising budgetary revenues and contributing to a rationalization of imports. In addition, the authorities expect to reduce, if temporarily, pressures on the external reserves through arrangements involving improved credit terms from suppliers on imports of certain basic food commodities and petroleum products. 2/

The Yemen rial has been pegged to the U.S. dollar at the rate of US$1 = YRls 4.50 since February 1973. The Y.A.R. continues to maintain a free trade and exchange system. In light of the rising pressures on the country's foreign exchange reserves, the authorities have asked for staff advice on the exchange rate and the staff has been in discussion with the authorities on matters related to exchange rate policy, including existing pegging arrangements. The country's external debt, all of which has been contracted at highly concessionary terms, stood at US$1.7 billion at the end of 1981; debt service ratio in 1982 was about 5 per cent of external current receipts.

1/ Assuming a growth rate in nominal GDP of 10 per cent in 1982.

2/ These arrangements include three-year credit facilities, at concessionary interest rates, on food commodities already concluded, and one-year credit facilities on petroleum products expected to have been concluded early in 1983.

IV. Staff Appraisal and Proposed Decision

The earthquake has had a serious and adverse impact on the Y.A.R.'s balance of payments. Available information indicates that the need for food, medicine, basic social services, temporary housing facilities, and various other relief supplies is urgent. Furthermore, the need is likely to continue for several months in view of the unsettled seismic conditions in the affected areas. The cost of the associated imports, for which the Government has already incurred extrabudgetary expenditures, is expected to exceed the external financial assistance received and anticipated by a wide margin and will exceed, by far, the amount of the requested drawing from the Fund. In the absence of immediate external financial flows, including Fund assistance, the underlying pressures on the Y.A.R.'s foreign exchange reserves will intensify, and reserves could drop below what is prudently advisable. The country has negligible exports and other sources of foreign exchange receipts (aid and remittances) are highly vulnerable.

Over the medium term the Government will focus its primary efforts on the rehabilitation of the basic infrastructural facilities including water systems, communication networks, schools and health facilities, as well as the restoration of social services. Concerning the rehabilitation and reconstruction of dwellings and other private property, the Government intends to limit its role to that of providing partial financing (perhaps through specialized low-cost loans) and supportive technical services. Priorities within the framework of the Second Five-Year Development Plan are to be shifted toward projects in the areas affected by the earthquake, and the Government is considering measures to mobilize domestic as well as external resources for the rehabilitation and reconstruction effort. The staff considers the approach taken by the authorities in dealing with the economic and financial consequences of the earthquake to be appropriate in the circumstances.

In their communications with the Fund the authorities have stated their intention to collaborate with the Fund in finding a solution to the balance of payments problem and in formulating an adjustment program as soon as circumstances permit. The next Article IV consultation discussions are scheduled for early May, by which time the preliminary studies currently under way may be completed. This would provide an appropriate time for a more careful assessment of the economic impact of the earthquake and for a staff review of policies to deal with the attendant financial problems. In the meantime, the Y.A.R. authorities have requested an emergency purchase under the Fund's tranche policies. This request is consistent with earlier Fund practice regarding the provision of financial assistance in cases of natural disasters. The Y.A.R. authorities have stated their intention not to impose new restrictions on payments and transfers for current international transactions, nor introduce any multiple currency practices, nor impose any new or intensify existing import restrictions for balance of payments purposes.

Accordingly, the following draft decision is submitted for the consideration of the Executive Board:

1. The Government of the Yemen Arab Republic has requested a purchase equivalent to SDR 4.875 million.

2. The Fund notes the intentions of the Government of the Y.A.R. as stated under paragraphs 5 and 6 of Attachment I dated January 18, 1983, and approves the purchase in accordance with the request.

Ministry of Finance
Sana'a
Yemen Arab Republic

January 18, 1983

Mr. J. de Larosiere
Managing Director
International Monetary Fund
Washington, D.C. 20431

Sir,

On 13th December, 1982 a major earthquake occurred in the Yemen Arab Republic, resulting in the death of more than 1,500 people and the homelessness of about 300,000. Extensive physical destruction spread across a wide area of the country where a considerable portion of the private housing stock and public infrastructure facilities were seriously damaged or totally destroyed.

The Y.A.R. hereby submits a request for a drawing, equivalent to 25 per cent of quota, under the Fund's policy on emergency assistance related to natural disasters, to help finance needed emergency imports.

The attached statement describes the economic impact of the earthquake and outlines the approach the Government intends to take in dealing with the balance of payments problem that has arisen from this emergency. We would very much appreciate your early consideration of this matter.

Very truly yours,

/s/

Mohamed Yahya Al-Adhi
Governor for the Fund

Attachment

Statement on the Main Elements of the Yemen Arab Republic's Economic and Financial Policy to Deal with the Emergency Caused by the Earthquake

1. On 13th December, 1982 an earthquake measuring 5.9 on the Richter scale (U.S. Geological Survey estimate) occurred in the Dhamar Governorate of the Yemen Arab Republic. The first and major tremor lasted 42 seconds and caused the total or partial destruction of nearly 25,000 houses and some damage to about 15,000 more. More than 1,500 people died and about 300,000 were made homeless. In addition, more than 300 mosques, 46 schools and 13 electricity generating facilities, several clinics and health centres were destroyed or seriously damaged. More than 120 villages lost their source of water supply and many villages and localities became inaccessible because of serious damage to the transportation and communication facilities and networks. The affected areas continue to be active geologically and a large number of minor tremors, including a major tremor on 30th December, 1982, have been recorded.

2. In the immediate period following this natural disaster, the Government of the Y.A.R. focused its attention on the task of ensuring the safety of the surviving population, on providing basic relief supplies of water, food and medicine and on controlling environmental health conditions in the affected areas. This we were able to accomplish with the help of emergency supplies and technical assistance from a number of countries and from international organizations. We are currently in the process of completing the second stage, centered on providing the affected areas with temporary shelter and with a continuous flow of food, medicine and other supplies and services, also with assistance, in cash and in kind, from neighbouring Arab countries, from other bilateral sources and from international relief organizations. We have also just completed a comprehensive census of the damage and are in the process of developing the factual basis for the subsequent task of rehabilitation and reconstruction planning. In this connection, we are currently holding discussions with a technical team from the World Bank and with experts from regional and international organizations.

3. The immediate costs of dealing with the effects of the earthquake are reflected in the resources required for maintaining the affected population in temporary shelters and for providing them with the basic necessities of life. Because of the continued uncertainties regarding seismic conditions in the affected areas, this task is likely to extend for an unusually long, and so far indefinite, period. For the medium term the economic impact of the earthquake is expected to entail the allocation of considerable resources to the rehabilitation and reconstruction of substantial private housing stock and associated household property as well as the rehabilitation of a large number of infrastructural facilities. This task is expected to take several years, although we intend to begin the rehabilitation and reconstruction program as soon as the necessary studies are completed and as circumstances permit. The total cost over the medium term, private as well as

public, is provisionally estimated at US$1.8 billion, although a more accurate assessment will be available once the studies now under way have been completed.

4. Because of the uncertainties associated with the seismic conditions in the affected areas, it is exceedingly difficult at this time to assess the financial impact of private and public expenditures on the budget and balance of payments. The Government has already incurred extrabudgetary expenditures for relief, the provision of food, medicine, basic social services and for temporary housing facilities. Such expenditures are likely to continue for several months while plans for rehabilitation and reconstruction, and later the reconstruction itself, are under way. A considerable portion of the emergency supplies (tents, foods, medicines) is being imported and additional imports of such supplies as well as imports of machinery, equipment and construction materials are expected during the course of the year and beyond. The total cost of these imports is expected to exceed the external financial assistance, received and anticipated, by a wide margin.

5. Beyond providing for the immediate needs of the affected population, the Government's policy for dealing with the impact of this emergency is currently under discussion at the highest official levels. Concerning the task of rehabilitation and reconstruction, the Government will focus its primary efforts on the rehabilitation of the basic infrastructural facilities including water systems, communication networks, schools, health facilities and the restoration of social services. As regards the housing needs of the affected population, no final plans have been made. However, the Government's preliminary intention is to let the private sector shoulder the major share of the responsibility, limiting the role of the Government to that of providing partial financing (through specialized low cost loans) and supportive technical services. In order not to strain available resources during the reconstruction period, the Government will do its best to reallocate resources, within the framework of the Second Five-Year Development Plan, toward priority projects in the areas affected by the earthquake. The Government will also make use of all available external assistance and will seek to mobilize additional domestic resources for the rehabilitation and reconstruction effort. More specific policies and plans for dealing with the economic impact of this emergency will be formulated as soon as possible. In any event we intend to collaborate with the Fund in finding a solution to the balance of payments problem and in formulating an adjustment program as soon as circumstances permit. In the meantime, the Y.A.R. will not impose new or intensify existing restrictions on payments and transfers for current international transactions, nor introduce any multiple currency practice, nor impose or intensify existing import restrictions for balance of payments purposes.

6. The Government of the Y.A.R. believes that the general policies outlined in this statement, as well as the more detailed program to be formulated as soon as circumstances permit will be adequate to deal

with the balance of payments problems that have arisen from the emergency. In any event, the Government will take any further measures that may become appropriate for this purpose during 1983 and will remain in consultation with the Fund in accordance with its policies. Moreover, after a complete assessment of damages has been made, we will take this into account in reviewing our development plans and in formulating appropriate financial policies so as to maintain the momentum of our country's economic development within a framework of financial stability.

Yemen Arab Republic: Relations with the Fund

Date of membership:	May 22, 1970.
Status:	Article XIV.
Quota:	SDR 19.5 million.
Fund holdings of Yemen rials:	As of December 31, 1982, Fund holdings of Yemen rials were SDR 19.50 million (100 per cent of quota).
SDR position:	As of December 31, 1982, the Y.A.R.'s holdings were SDR 14.09 million (228.72 per cent of the net cumulative allocation of SDR 6.16 million).
Trust Fund:	The Y.A.R. was on the list of eligible countries, but did not satisfy the requirement of need.
Direct distribution of profits from gold sales:	SDR 1.58 million.
Gold distribution:	8,557.999 fine ounces.
Exchange system:	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, which has since been maintained. The representative rate established under the Fund's Rule O-2 is US$1 = YRls 4.5625, the average of the Central Bank's buying and selling rates.
Technical assistance:	Since 1970 the Fund has provided technical assistance through central banking and fiscal experts stationed in the Y.A.R. At present, the Central Bank of Yemen has three experts and the Ministry of Finance two experts assigned by the Fund. In addition, Fund staff participated in technical assistance missions on domestic resource mobilization (with the World Bank) in 1981, and have prepared studies on the macroeconomic impact of alternative fiscal policies (1981) and on exchange rate policy (1982).

Last Article IV consultation:	Discussions were held by the staff in Sana'a during May 2-6, 1982. The staff report (SM/82/118) was discussed by the Executive Board on August 6, 1982.