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July 15, 1983

To: *Members of the Executive Board*

From: The Secretary

Subject: Yemen Arab Republic - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with the Yemen Arab Republic. A draft decision appears on page 12.

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

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Floyd (ext. 57119) until July 27, 1983 or Mr. Noursi (ext. 57117) thereafter.

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INTERNATIONAL MONETARY FUND

YEMEN ARAB REPUBLIC

Staff Report for the 1983 Article IV Consultation

Prepared by the Staff Representatives for the
1983 Consultation with the Yemen Arab Republic

Approved by A. K. El Selehdar and Subimal Mookerjee

July 14, 1983

I. Introduction

The 1983 Article IV consultation discussions with the Yemen Arab Republic (Y.A.R.) were held in Sana'a during the period May 17-24, 1983. The Y.A.R. representatives included the Deputy Prime Minister for Economic Affairs, the Ministers of Finance, Development, Economy and Industry, and Agriculture, and the Governor of the Central Bank, as well as other senior officials. The staff mission comprised Messrs. G. T. Abed (Head), R. H. Floyd, S. Thayanithy (all of MED), G. Hacche (CBD), and Ms. A. R. Cheriyan (Secretary - ADM). The discussions were also attended by the five experts assigned to the Y.A.R. under the technical assistance programs of the Fiscal Affairs and Central Banking Departments. The Y.A.R. continues to avail itself of the transitional arrangements of Article XIV of the Articles of Agreement.

II. Background

In 1981 the Y.A.R. completed the First Five-Year Development Plan (FFYP), 1/ which had aimed at establishing basic services and infrastructure, setting up social and economic institutions, and diversifying the economy from a narrow agricultural base. These efforts at structural change were carried out within the framework of a free and open economy. Throughout the period, the Y.A.R.'s domestic resources were augmented by substantial inflows of workers' remittances and official external assistance which permitted consumption and investment to grow rapidly and, in the first half of the period, allowed official reserves to increase.

During the FFYP period, real economic growth averaged almost 6 per cent per annum. The growth of the dominant agricultural sector was much lower, averaging only 1 per cent per annum, mainly because of the emigration of farm labor to urban centers and neighboring countries, unfavorable weather conditions, and the expansion of the area planted to

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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 calendar year 1981.

qat. 1/ On the other hand, the manufacturing, electricity and water, construction, financial, and government services sectors all achieved growth rates in excess of 10 per cent per annum. Over the period, real gross fixed investment in relation to GDP rose slightly and averaged about 42 per cent, but real consumption expenditure increased as a proportion of GDP from 107 per cent to 117 per cent.

Government expenditures have risen continuously since the mid-1970s as institutional and supply bottlenecks which had constrained spending in the early 1970s were substantially overcome. Relative to GDP, current and extrabudgetary outlays rose by about two thirds, and capital budgetary outlays doubled between 1977/78 and 1981. Overall expenditures reached 59 per cent of GDP in 1981. During the same period, government revenues remained relatively stable at about 24 per cent of GDP but foreign grants doubled. The overall deficit rose steadily from about 4 per cent of GDP in 1977/78 to 22 per cent by 1981. Increased reliance on external financing was not sufficient to prevent the bank-financed deficit from rising sharply to 15 per cent of GDP in 1981.

The Y.A.R.'s balance of payments showed considerable strength in the mid-1970s, largely reflecting the rapid growth in official assistance and inward remittances and low absorptive capacity. Annual current account surpluses were realized until 1978/79, and overall surpluses until 1979/80. However, remittance inflows ebbed and subsequently declined, mainly as a result of a reduction in Y.A.R. emigration caused by narrowing wage differentials and by increased competition for jobs in the oil exporting countries. 2/ Imports, on the other hand, rose sharply and steadily through 1980 when the current account deficit peaked at US$691 million (24 per cent of GDP). With a fall in imports in 1981 and an increase in official grants more than offsetting the decline in remittances, the current account deficit narrowed to US$664 million (23 per cent of GDP). However, partly because of deterioration in the capital account, the overall deficit increased to US$262 million (9 per cent of GDP). Reserves, which had reached a peak of US$1,613 million in March 1979, declined to about US$967 million by the end of 1981 (equivalent to about seven months' imports). The external debt servicing burden rose over the period but remained small and required only about 5 per cent of current account receipts by 1981.

Monetary developments in recent years have mirrored the evolving fiscal and balance of payments positions. Before 1978/79 sharp increases in net foreign assets were the primary impetus to domestic liquidity expansion. Beginning in 1978/79, however, the impact of external transactions became less expansionary, and in 1979/80 it became contractionary.

1/ Qat is a plant widely consumed in the Y.A.R. whose leaves act as a mild stimulant when chewed; its cultivation is not adequately accounted for in the agricultural production statistics.

2/ Recorded remittances have also been affected by the increasing tendency for workers to remit their earnings through money changers or in the form of imports brought overland (in both cases the inflows may not be caught in the balance of payments tabulations).

At the same time, the Government shifted from being a net depositor to being a substantial net borrower from the banking system. Mainly because of the compensating effects of the external and government sectors, there was a steady decline in the growth rate of domestic liquidity (money and quasi-money) from 74 per cent in 1976/77 to 8 per cent in 1981. The rate of inflation, as measured by the retail price index, decreased steadily from 17 per cent in 1977/78 to about 5 per cent in 1981, reflecting the slower growth of domestic liquidity, improvements in the balance between supply and demand for labor, and more recently the impact of the appreciation of the Yemen rial.

The Y.A.R. continues to pursue liberal trade and exchange policies and does not maintain any restrictions on the making of payments or transfers for current or capital international transactions. There has recently been some informal tightening in the review process for import license applications aimed at safeguarding public health and safety and at providing some protection for domestic production. Since February 1973 the Yemen rial has been pegged to the U.S. dollar at the rate of US$1 = YRls 4.50. As a result of this peg arrangement, the Yemen rial has appreciated along with the U.S. dollar against most other currencies including those of the major suppliers of the Y.A.R.'s imports. Against the SDR the Yemen rial appreciated by 9.6 per cent in 1981, and the nominal import-weighted exchange rate of the rial appreciated by 13.4 per cent.

III. Report on the Discussions

The discussions focused on economic developments in 1982 and the prospects for 1983 and on policy adjustments needed to correct internal and external financial imbalances. In addition, they included an assessment of the economic impact of the December 1982 earthquake and the plans that the authorities have formulated to deal with the financial consequences of the disaster.

1. Production and investment policies

Overall developments in 1982 pointed out the ambitious nature of the Second Five-Year Plan (SFYP). 1/ While the 5 per cent real growth rate of GDP was satisfactory, it fell short of the Plan target of 7 per cent, mainly due to low growth (1 per cent) in the agriculture sector, but also due to slow growth in the construction, financial, and other services sectors. Preliminary data indicated that public investment reached only YRls 2.1 billion (73 per cent of the annual average in the Plan), in part

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1/ Although the SFYP covered the period 1982-86, it was not finalized until May 1982 in order to incorporate the views of the participants in the Yemen Second International Development Conference held in April 1982. The conference was attended by representatives of all major potential aid donors. 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.

due to lags in the introduction of the Plan but also due to increasingly limited foreign aid and other financial resources. Although the SFYP called for reductions in the ratios of consumption and net imports of goods and services to GDP and for increases in government and private sector savings, these variables remained little changed in 1982.

The mission expressed concern at the continued high level of consumption and slow increase in capital formation. The Y.A.R. representatives recognized the need to limit the growth of consumption expenditures, especially those of the Government, and to increase the accumulation of domestic savings. They stated that the data somewhat exaggerated government consumption outlays in the context of the Y.A.R. because certain current expenditures on education, health, and security should be considered as essential investments without which stability and growth would be difficult to achieve. With regard to prospects for the whole of 1983, the authorities expected an overall growth rate of 5 per cent in real terms.

In terms of sectoral developments, the slow growth in the agricultural sector in 1982 was principally due to inadequate rainfall, continued shortages of rural labor, and the traditional problems of poor cultivation methods, inferior inputs, and pest infestation. To redress these problems a High Ministerial Council for Agricultural and Rural Development had recently been established to promote improved agricultural production through higher investment outlays and the initiation of measures to bring under cultivation some land left fallow and to improve the irrigation system. The Y.A.R. representatives added that there was no price fixing for agricultural products. Other than free extension services and low-cost credit provided to farmers, there were no subsidies on farm inputs or outputs.

In the industrial sector, manufacturing output rose by 13 per cent in 1982, or somewhat slower than in earlier years. The general policy was to promote import-substituting industries utilizing domestic raw materials and private sector involvement, but no direct industrial subsidies were granted. However, domestic and foreign investment in private sector industry had been encouraged by, inter alia, Public Investment Law No. 18 of 1975 which provides for exemptions from import duties on capital goods and some raw materials, income tax holidays, and complete freedom of profit repatriation. Despite the progress that has been made, the Y.A.R.'s industrial development continued to be hampered by high labor costs, appreciation of the rial, extensive smuggling which denies many domestic industries the benefit of tariff protection, the relatively small size of the local market, and the shortage of entrepreneurial and professional skills.

Concerning energy pricing, the policy has been that while energy prices were rising, the added costs were passed through to users; however, in an environment of falling energy prices the emphasis of policy was to use the pricing of petroleum products as a source of government revenue. Consequently, although the domestic sale prices of fuel oil and aviation fuel had been reduced, the latter to meet competition from neighboring airports, those of other products were being kept unchanged. Except for a small operating deficit in the case of diesel oil, which is widely used in rural areas to generate electricity, profits were generated by the Petroleum Corporation on the sales of all petroleum products.

With the continued slowdown in economic activity in the Y.A.R., domestic inflationary pressures have eased considerably. In 1982 the rate of inflation as measured by the consumer price index declined to 2.8 per cent. This decline was also attributed to the continued peg of the Yemen rial to the U.S. dollar, to declines in several international commodity prices, and to the free trade and exchange system which ensured the adequacy of supplies of imported goods. The authorities expected the overall inflation rate in 1983 to rise somewhat to about 6 per cent.

2. Fiscal policies

The sharp deterioration in the Government's fiscal position quickened in 1982 as the overall deficit rose to YRls 5.9 billion, or about 36 per cent of GDP. Domestic bank financing doubled relative to GDP to 30 per cent and was equivalent to 45 per cent of the beginning period money stock. The mission observed that these ratios were disturbingly high and that the deficit had been the primary factor contributing to the growth of domestic liquidity and excess demand pressures which, in an open economy with an exchange rate pegged to the U.S. dollar and a small production base, tended to be vented through a drawdown of official reserves. The Y.A.R. authorities concurred with the mission's assessment, but they added that the deficit in part reflected the pressing needs for government spending to finance institution building, basic infrastructure, security, and other social and economic purposes.

The principal cause of the deterioration was the increase in government (especially current and extrabudgetary) expenditures which rose by 41 per cent in 1982 to the equivalent of 75 per cent of GDP. Although precise data were not available the extrabudgetary expenditures appear to comprise liquidation of public sector companies' debt by the Treasury and various outlays for security and emergency purposes. More than half of the increase in current expenditures represented increased wage and salary outlays resulting from an upward adjustment in the salary scale, reclassifications of civil servants within the scale, and increased employment. The mission expressed concern about the rapid rise in current expenditures, and it urged that greater control be exercised in 1983. The Y.A.R. representatives explained that the wage increases in 1982 had been necessary to discourage departures of qualified personnel from the civil service and to attract additional personnel. The authorities did not expect extrabudgetary outlays to be as high in the future as they had been in 1982.

Current revenues rose by 12 per cent in 1982 but fell by 27 per cent below the original budget estimate. Tax revenues also fell below the budget estimate, but increased by more than the rate of increase in GDP so that the tax ratio rose to 21 per cent during the year. Taxes on international trade accounted for more than half of the shortfall. Nontax revenues declined slightly from 1981 and fell about 42 per cent short of the budget estimate, primarily because of a large shortfall in revenues from earnings of public sector institutions, in particular the Central Bank. Grants in 1982 rose by one third. The Y.A.R. representatives explained that tax collections, particularly from direct taxes which rose by 44 per cent in 1982, had improved despite the recent economic slowdown, because of better tax administration and some expansion in the tax bases such as extension of the income tax to salaries of members of the armed forces.

Tentative projections of the likely fiscal outturn for 1983 indicated that the overall deficit would fall to YRls 3.9 billion (24 per cent of estimated GDP) mainly as a result of a sharp drop in extrabudgetary outlays and a shortfall in Plan implementations; domestic bank financing would also decline to about 18 per cent of estimated GDP and 24 per cent of the beginning period money stock. The mission welcomed the projected decline in the overall deficit and in its bank financing, but observed that both remained too large in absolute and in relative terms to be consistent with domestic and external financial stability.

Revenues and grants were estimated to increase by 7 per cent despite a projected fall in grants. Current revenues were projected to rise by 16 per cent mainly due to the implementation of several discretionary revenue measures. Effective March 24, 1983 there were upward revisions in a number of tariff rates especially on luxury and high-profit imports. Registration fees on motor vehicles were also raised, although this would not result in increased collections until 1984. Other measures were also under consideration, including effective increases in cigarette and petroleum taxes resulting from changes from specific to ad valorem rates and increases in various fees and charges. Closer supervision of public authorities and companies was expected to result in improved profitability and higher nontax revenues. Additional taxes were to be introduced with proceeds to be used to finance an extrabudgetary, earthquake rehabilitation and reconstruction program that was expected to be completed over a 3-3 year period. These measures, which had been approved by the People's Assembly and were only awaiting presidential authorization, include one and two percentage point increases in the rates of income taxes, qat tax, and customs duties and new fees on the issuance of passports, family ID cards, drivers' licenses, work permits, and construction permits.

Total expenditures were forecast to decrease by 8 per cent to about 62 per cent of estimated GDP. Investment spending would fall, both because of lower budget authorizations and reductions in capital expenditures financed by foreign borrowing. Current outlays were expected to rise by only 10 per cent, reflecting enhanced control procedures and the absence of a major wage and salary adjustment. Extrabudgetary outlays for earthquake relief were expected to exceed available resources only slightly. With regard to other extrabudgetary outlays, the Y.A.R. representatives expected that these disbursements would not exceed about one half of their corresponding level in 1982.

3. Monetary policies

The pattern of earlier years was reversed in 1982 when the decline in net foreign assets only partly offset the sharply increased bank borrowing by the Government, and as a result the rate of growth of domestic liquidity accelerated sharply to 26 per cent. Bank lending to the private sector also had an expansionary impact on the money supply in 1982, rising by 22 per cent after 18 months of stagnation. This development reflected a lowering of interest rates in December 1981, business optimism engendered by the initiation of the SFYP, and the increased level of private sector imports in 1982. At the end of March 1983 liquidity was still 26 per cent higher than a year earlier, but its annual growth rate in the first quarter had moderated to 19 per cent.

Interest rates in the Y.A.R. have been broadly unchanged since December 1981, although rates abroad have declined by five percentage points or more. The current maximum lending rate for commercial banks is 15 per cent and the minimum deposit rates range from 9.5 per cent to 12 per cent. The Y.A.R. representatives intend to maintain the relative advantage of domestic interest rates in view of the country's external financial position and because of the need to develop financial intermediation and improve the mobilization of the country's financial resources.

The buildup of high liquidity in the commercial banking system continued in 1982. At the end of March 1983, the reserve ratio of the commercial banks stood above 40 per cent, compared with the statutory minimum of 20 per cent. This buildup reflected delays in the response of bank lending to the recent rapid rate of money creation and the lack of profitable lending opportunities. Commercial banks had also been discouraged by the Central Bank from acquiring assets abroad. To reduce the adverse impact of excess liquidity on banks' profitability, the Central Bank had since September 1982 paid 5 per cent per annum interest on the excess reserves of the Yemen Bank for Reconstruction and Development (51 per cent government owned and accounting for more than two thirds of total commercial banks' deposits), and other banks were expected to take advantage of this arrangement. The Y.A.R. authorities are also considering measures to improve the effectiveness of monetary policies through a broadening of financial markets to help absorb excess liquidity in the system. A proposed scheme for selling government bonds to the commercial banks had been approved by the People's Assembly and was likely to be introduced before September 1983.

4. External sector policies

The overall deficit in the balance of payments widened to US$364 million in 1982 in spite of a modest narrowing of the current account deficit which had resulted from largely offsetting movements in imports and transfers. Imports increased by 12 per cent, mainly on account of government purchases, but this was outweighed by an improved surplus on transfers, stemming from a recovery in workers' remittances and an increase in government grants. The current account improvement was, however, more than offset by a decline in the capital account surplus and an adverse movement in the balancing item. In the first quarter of 1983 the overall deficit was US$105 million, and by the end of March 1983 reserves had fallen to US$497 million (equivalent to about three months' imports). The mission observed that, while the utilization of external reserves in the past to build up real productive capacity and to improve the consumption levels of the population in the Y.A.R. was understandable, it was also clear that deficits of such magnitude could not be continued.

Tentative projections of the balance of payments for 1983 indicated that overall imports would drop slightly to US$1.9 billion, reflecting a large fall in government imports (supported by the first quarter figures) and a relatively small rise in private imports. External grants, based on commitments which were expected to materialize later in the year, were expected to fall only slightly to US$400 million. Inward remittances were projected to increase by 3 per cent from 1982. The current account deficit would fall to US$557 million while the overall deficit was projected at about US$358 million, little changed from 1982. On the assumption that the Central Bank's foreign liabilities remain unchanged from end-March 1983, this overall deficit would leave the Central Bank with less than US$210 million of usable reserves at the end of the year, equivalent to about six weeks of imports at the projected 1983 level. The Y.A.R. representatives considered that such an outcome would represent an inadequate level of import cover, as they preferred to maintain a minimum of reserves of about three months of imports, and they indicated that the reserve position would be kept under active review. The mission suggested that measures needed to be taken quickly in view of the rapidly deteriorating external position. In particular, demand management measures, especially aimed at reducing the fiscal deficit, were urgently required.

The mission asked the Y.A.R. representatives for clarification of changes which were reported to have occurred recently in the import licensing system. The Y.A.R. representatives explained that the Ministries of Supply and Economy had been reviewing requests for import licenses more carefully, primarily for public health and safety reasons and to some extent for the protection of local products such as fruits and cement. While expressing its understanding for these actions by the authorities, the mission voiced its concern that measures to restrict imports, no matter how limited initially, carry the danger of widening in scope with potentially adverse consequences. The Y.A.R. representatives agreed and reiterated that it was not their intention to introduce restrictions in the trade system.

Against the SDR, the Yemen rial appreciated by a further 5.5 per cent in 1982, and the nominal import-weighted exchange rate appreciated by 13.4 per cent. The Y.A.R. representatives felt that the present peg to the U.S. dollar at the rate of US$1 = YRls 4.5 continued to serve their needs adequately, although, in light of the recent appreciation of the rial, exchange rate policy would remain under active review. The mission emphasized that this appreciation was likely to have contributed to the weakening of the Y.A.R.'s balance of payments position during the past two years. The mission, therefore, expressed the view that, in addition to measures to restrain overall demand, direct action in the exchange rate area appeared to be called for in order to strengthen the balance of payments.

In December 1982 the Central Bank discontinued sales of foreign exchange to commercial banks. The Y.A.R. representatives explained that this measure had been taken in response to the decline in official reserves and the buildup of the commercial banks' foreign assets in 1982. Until the time of the discussions, the rate used by nonbank money changers in the informal market had remained within the limits prescribed for commercial banks' foreign currency transactions, although some signs of pressure on this rate had already become evident.

On the external debt, the mission noted that in 1982 the debt service ratio had fallen to 3.5 per cent of current account receipts and that it remained low compared with other developing countries, as the Y.A.R. had been fortunate in obtaining relatively large amounts of concessional aid. Nevertheless, the Y.A.R. representatives reported that arrangements for debt rescheduling were under discussion with a number of creditor countries.

5. The Earthquake Relief and Rehabilitation Program

The discussions also focused on the implications of the earthquake of December 1982 for the Y.A.R.'s financial position and the policies the authorities have formulated to ensure that the strains on domestic and external resources are contained to manageable levels. The broad strategy had been to divide the response to the earthquake into two phases--the immediate relief phase and the reconstruction phase. The authorities had responded with notable speed and efficiency to the immediate needs for food, shelter, and other emergency services, and with the assistance of regional and international organizations have essentially completed the relief phase.

The Y.A.R. representatives explained that, in the reconstruction phase just beginning, a systematic approach would be applied to the task of rebuilding in the earthquake stricken areas and that use of the experience of local, regional, and international specialized organizations would be maximized. In view of the enormous destruction to the housing stock in the area, the authorities had given this matter particular attention and were planning to assist the local population in housing reconstruction.

The Y.A.R. representatives explained that in order to expedite relief and reconstruction the financial aspects of both phases would be kept outside the usual budgetary process. The Government's total outlays expected over both phases had been estimated at YRls 1.8 billion. More importantly, the authorities intend insofar as possible to fund reconstruction expenditures through new domestic and foreign resource mobilization. The relief phase had been financed mainly through assistance in kind and cash from foreign governments, international organizations, and Y.A.R. citizens living abroad. These receipts had been sufficient to cover relief expenditures and provide substantial funds for reconstruction. To finance the reconstruction phase, the new measures to be introduced were expected to yield about YRls 183 million on an annual basis. It was hoped that they would be implemented beginning in September 1983. In view of the available resources, the Supreme Council for Earthquake Reconstruction and Rehabilitation had been authorized to disburse up to YRls 500 million in 1983 for reconstruction. Although this was YRls 179 million more than currently available or projected, the Y.A.R. representatives stated that additional foreign resources would be forthcoming and, in any event, only a portion of the allocated amounts was likely to be spent in 1983 and early in 1984.

IV. Staff Appraisal

During the decade of the seventies, the economy of the Y.A.R. recorded impressive achievements. Supported by substantial inflows of workers' remittances and bilateral and multilateral aid, both consumption and investment expanded rapidly. Efforts to develop basic services and infrastructure, to establish social and economic institutions, and to diversify the economy from its traditional agricultural base were generally successful.

However, since 1978/79 financial developments in the Y.A.R. have become increasingly worrisome. As institutional and supply bottlenecks eased, the growth rate of government expenditures accelerated and the fiscal position shifted from one of surplus to one of rising deficits. The balance of payments also moved from a position of surplus to deficit, and the substantial 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. Although the use of accumulated reserves to finance the Y.A.R.'s development requirements is reasonable, the decline in reserves and the rate at which it has occurred render the Y.A.R.'s financial position clearly unsustainable.

The large fiscal deficit is surely at the root of the deterioration in financial conditions in the Y.A.R. If this deficit is not reduced substantially and at an early date, the financial stability that has marked the past decade of economic development in the country is likely to be undermined. By the end of March 1983 the level of external reserves had fallen to just over the equivalent of three months' imports and the decline was continuing. In view of the vulnerability of the Y.A.R.'s sources of external receipts, failure to arrest this decline could have serious consequences for the immediate prospects of the economy.

The authorities have taken some action to control the growth of government spending and raise domestic budget revenues. They have already effected substantial increases in certain tariff rates and have under study various additional revenue measures. Capital expenditures under the Plan have been held down and greater flexibility in project financing has been exercised. In the area of monetary policy, interest rate differentials have been maintained in favor of rial deposit rates and measures have been taken to absorb excess liquidity in the economy. Nevertheless, the staff believes that greater fiscal restraint is called for and, in the circumstances of the Y.A.R., this must necessarily take the form of significant reductions in the planned level of government expenditures and more effective constraints on extrabudgetary expenditures, which in 1982 were considerable.

Moreover, and in light of the sharp deterioration in the Y.A.R.'s balance of payments, the staff believes that, in addition to effective demand management policies, the authorities should review the appropriateness in current circumstances of their exchange rate policy under which the rate has remained pegged at an unchanged level to the U.S. dollar for a number of years.

The staff notes that the Y.A.R. authorities have continued to adhere to a free exchange and trade system and have consistently rejected the introduction of restrictions on external payments and transfers.

As envisaged in their letter of January 18, 1983 to the Fund requesting emergency assistance, the authorities have formulated and discussed with the staff an adjustment program for 1983 designed to deal with the balance of payments problem, which has been aggravated by the impact of the earthquake. The staff notes that the authorities intend to finance reconstruction through noninflationary earmarked resources and to limit the element of subsidy provided to housing. While the program provides a reasonable basis for containing the balance of payments impact of the earthquake, the staff believes that additional policy measures of the type described above are required in order to minimize the inflationary impact of earthquake-related reconstruction and to achieve a stable financial environment for the continued growth and development of the Y.A.R. economy.

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 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. In view of the recent sharp deterioration in the external payments position and the difficult outlook, the Fund notes with satisfaction that 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.

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 June 30, 1983, Fund holdings of Yemen rials amounted to SDR 29.25 million (150 per cent of quota). The proposed quota under the Eighth Review is SDR 43.3 million.
SDR position:	As of June 30, 1983, the Y.A.R.'s holdings were SDR 14.79 million, equivalent to 239.18 per cent of its 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 for Trust Fund assistance.
Direct distribution of profits from gold sales:	SDR 1.6 million.
Gold distribution:	8,557.999 fine ounces (four sales).
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 considerable technical assistance through central banking and fiscal experts stationed in the Y.A.R. At present, the Central Bank of Yemen has three experts assigned by the Fund while the Ministry of Finance has two. In addition, the Fund staff prepared technical assistance reports on domestic resource mobilization (with the IBRD), the assessment of the macroeconomic impact of alternative fiscal policies for 1982, the macroeconomic effects of exchange rate policies since 1973, and a preliminary report on the operations of the informal money market.
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.

The Executive Board's decision (Decision No. 7178-(82/102)), adopted August 6, 1982 was as follows:

1. The Fund takes this decision in concluding the 1982 Article XIV consultation with the Yemen Arab Republic, in the light of the 1982 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 the Yemen Arab Republic continues to maintain an exchange system that is free of restrictions on payments and transfers for current international transactions.

Yemen Arab Republic: Basic Data

Area and population	
Area	195,000 square kilometers
Resident population	6.6 million
Per capita GDP (1981)	YRls 2,025 (US$450)

	1979/80 1/	1981	1982	Proj. 1983
	(In millions of Yemen rials)			
Production and prices				
GDP in current prices	11,919	13,120	14,637	...
GDP in constant 1975/76 prices	6,318	6,685	7,042	...
Percentage growth of real GDP	(5.5)	(5.8)	(5.3)	(...)
Percentage change in Sana'a retail price index	(10.6)	(4.9)	(2.8)	(...)
Public finances				
Total revenues and grants	3,214	4,854	5,742	6,135
Revenues	(2,763)	(3,335)	(3,724)	(4,335)
Grants	(451)	(1,519)	(2,018)	(1,800)
Total expenditures	5,547	7,797	11,004	10,072
Current expenditures	(2,531)	(3,325)	(4,584)	(5,068)
Capital expenditures	(2,492)	(3,683)	(4,321)	(3,725)
Extrabudgetary expenditures	(524)	(789)	(2,099)	(1,279)
Overall deficit (-)	-2,333	-2,943	-5,262	-3,937
External financing	525	921	847	943
Domestic bank financing	1,808	2,023	4,415	2,994
Deficit as a percentage of GDP	(19.6)	(22.4)	(35.9)	(...)
Overall deficit without grants	2,784	4,462	7,280	5,737
Overall deficit without grants as percentage of GDP	(23.4)	(34.0)	(49.7)	(...)
Money and credit (change during period)				
Money	1,077	303	2,405	...
Domestic liquidity (money and quasi-money)	1,240	726	2,614	...
Net foreign assets	-127	-1,181	-1,399	-1,611
Net claims on Government	1,808	2,023	4,415	2,994
Claims on nongovernment sector	630	294	160	...
Public and mixed enterprises	(316)	(264)	(-301)	(...)
Private sector	(315)	(30)	(461)	(...)
Percentage change in domestic liquidity	(16)	(8)	(26)	(...)
Ratios of				
GDP to money 2/	(1.75)	(1.70)	(1.62)	(...)
GDP to domestic liquidity 2/	(1.45)	(1.37)	(1.31)	(...)

1/ Year ended June 30.
2/ Denominators are beginning and end of period averages.

Yemen Arab Republic: Basic Data (concluded)

	1979/80 1/	1981	1982	Proj. 1983
	(In millions of U.S. dollars) 2/			
Balance of payments				
Exports, f.o.b.	7	10	5	9
Imports, f.o.b.	-1,546	-1,748	-1,967	-1,889
Trade balance	-1,539	-1,738	-1,962	-1,880
Services (net)	--	-51	-37	-33
Private transfers (net)	1,099	788	924	956
Official transfers (net)	112	337	445	400
Current account	-329	-664	-630	-557
Nonmonetary capital	158	230	192	209
Commercial banks (net)	-119	1	-54	-76
Errors and omissions (net)	143	172	128	67
Overall balance	-148	-262	-364	-358
Current account deficit as percentage of nominal GDP	(12.4)	(22.8)	(19.4)	(...)
Total reserves (end of period)	1,430	967	558	...
In months of imports	(11)	(7)	(3)	(...)
Disbursed external debt outstanding (end of period)	592	1,101	1,421	...
Percentages of				
External debt to GDP	(22)	(38)	(44)	(...)
External debt service to GDP	(0.4)	(2.3)	(1.7)	(...)
External debt service to current account receipts	(0.7)	(5.0)	(3.5)	(...)

1/ Year ended June 30.
2/ Converted at US$1 = YRls 4.5.