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SM/84/95
Correction 1

CONTAINS CONFIDENTIAL INFORMATION

May 17, 1984

To: Members of the Executive Board

From: The Secretary

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

The following correction has been made in SM/84/95 (4/30/84):

Page 13, line 10: for "US$30 million" read "US$10 million"

A corrected page is attached.

Att: (1)

Other Distribution:
Department Heads

by the national airline were to be improved, especially for migrant workers. Studies that aimed at increasing the production of exports were already under way. Coffee and tobacco were encouraging prospects, and oil exploration held some promise. A number of measures were adopted to reduce imports. The import of nonessential goods was constrained, especially car imports, which were banned in 1984. Development imports could also be reduced, as no new projects were to be initiated except those with guaranteed foreign financing of at least 75 percent of the cost. This would also help in reducing outgoing remittances. Furthermore, the construction of wheat silos was expected to save US$10 million per year in bagging and handling costs; efforts to exercise greater control of government current expenditures would also assist in limiting the growth of imports. The Yemeni representatives stated that they do not intend to introduce new restrictions on current payments and transfers, nor to intensify existing restrictions for balance of payments purposes, nor to introduce any multiple currency practices.

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

IV. Staff Appraisal

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

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

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

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