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December 18, 1975

To: Members of the Executive Board

From: The Secretary

Subject: Yemen Arab Republic - Staff Report and Proposed Decision for
the 1975 Article XIV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1975 Article XIV consultation with the Yemen Arab Republic. The decision proposed by the staff appears on page 9.

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

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INTERNATIONAL MONETARY FUND

YEMEN ARAB REPUBLIC

Staff Report for the 1975 Article XIV Consultation

Prepared by Staff Representatives for the 1975 Consultation
with the Yemen Arab Republic

(Reviewed by the Committee on Article XIV Consultations)

Approved by A. K. El Salehdar and Subimal Mookerjee

December 17, 1975

I. Introduction

The 1975 Article XIV consultation with the Yemen Arab Republic (Y.A.R.) took place in Sanaa during the period November 4-9, 1975. The Y.A.R. representatives were headed by the Minister of Finance and included the Minister of State for Development, the Deputy Governor of the Central Bank of Yemen, and senior officials of these and other ministries and government departments. The discussions were attended by the experts assigned to the Y.A.R. by the Fiscal Affairs Department and the Central Banking Service. Some members of the mission also had discussions with the Prime Minister and the Deputy Prime Minister for External and Economic Affairs. The staff representatives were Messrs. F. A. Abdullah, G. Arnaoot, G. Abed and Miss M. Yse (all of MED), Mr. C. Wong (INST) and Mr. S. Al-Khuri (YPP).

II. Summary of Recent Developments

The economy of the Y.A.R. experienced impressive growth in 1974/75 (fiscal year ended June 30) following some decline in real output in each of the preceding two years caused by severe droughts which adversely affected agricultural production in both years. The growth, estimated at 25-30 per cent in real terms, reflected record agricultural crops and continued rapid expansion in construction activity, trade, industry and services financed by substantial remittances from Yemenis working abroad. The prospects for 1975/76 are for a growth rate of 6-8 per cent in real terms based on an expected small increase in agricultural production and continued rapid growth of the other sectors.

The decline in economic activity in 1972/73 and 1973/74 was accompanied by a high rate of monetary expansion leading to increased inflationary pressures. These pressures were intensified by shortages induced by the drought conditions and by the higher prices of imports, particularly of foodstuffs. The expansion in domestic liquidity stemmed largely from the use of external official aid to finance domestic expenditures as well as from a high rate of increase in credit to the private

sector induced by the financing needs of the expanding nonagricultural sectors. Monetary expansion accelerated sharply in 1974/75 resulting in a further buildup of demand pressures and a continued rapid increase in domestic prices. The cost of living index for Sanaa, the only available indicator of the rise in the general price level in the country, rose by 32 per cent compared to a slightly higher rate in the preceding year, despite the record crops which helped to moderate the inflationary pressures.

Government finances have been under pressure in recent years, resulting in increasing reliance on external official grants to finance domestic expenditures. The persistence of budgetary imbalance has its roots in the limited revenue base while the demand for increased expenditures on government services and institutions have continued to rise. The budget deficit on current operations declined somewhat in 1973/74, but rose substantially in 1974/75 due to an acceleration in the rate of increase in current expenditures, despite a favorable revenue performance. Development expenditures, which had stagnated during the period 1971-73, increased sharply in 1973/74 and 1974/75, but fell substantially short of the investment targets in the Three-Year Development Program (1973/74-1975/76). Since 1973/74 the inflow of external official aid has been large enough not only to finance the budget deficits, but also to enable the Government to improve significantly its cash position with the banking system.

The Y.A.R.'s balance of payments is characterized by a large and widening deficit on merchandise account (exports cover only about 5 per cent of imports), which is sustained by inflows of remittances from Yemenis working abroad and receipts of substantial external official assistance. The balance of payments has been in surplus since 1970 due to substantial and rising receipts from these sources, particularly remittances from expatriate Yemenis. As employment opportunities and wages in neighboring oil producing countries increased substantially in the last two years, the number of Yemenis working in these countries rose sharply and their remittances have become the major source of foreign exchange earnings, financing most of private imports in 1974.

There was a sharp increase in the overall payments surplus from about SDR 22 million in 1973/74 to SDR 93 million in 1974/75. Exports declined slightly, mainly because of the decline in international prices of cotton, but their impact on the balance of payments was negligible due to their limited contribution to the financing of imports. The latter increased by 30 per cent compared with 53 per cent in the previous year due largely to deceleration in imports of foodstuffs and some moderation in the rise of international prices. Reflecting mainly the sharp increase in private remittances and other invisible receipts and the near tripling of external grants, a substantial surplus on current account was recorded. Official reserves at the end of June 1975 were equivalent to about nine months' imports.

III. Report on Discussions

Discussions focused on the problem of the rising inflationary pressures emanating from the rapid increase in private liquidity, which has been fueled by the large external receipts of the private and government sectors. Pressures on domestic resources intensified in the past year due in part to physical constraints which limited the increase in imports.

1. Expansion of private liquidity and monetary policy

The factors underlying the expansion in liquidity in the last three fiscal years are delineated in Table 1. Although the Government experienced a cash surplus in 1973/74 and 1974/75, financial operations of the Government contributed significantly to the monetary expansion through the use of the local counterpart of official foreign aid to finance domestic expenditures. The contribution of government operations to the monetary expansion could be measured as the excess of external receipts, in the form of cash grants and loans, over government imports and other external payments net of any increase in government deposits with the domestic banking system. This represents the net injection of liquidity into the income stream, which, in 1974/75, amounted to about YRls 140 million or 34 per cent of total monetary expansion, compared to YRls 81 million (56 per cent of total monetary expansion) in the previous year. The expansionary impact of the private sector operations intensified in 1974/75 due in part to the acceleration in the growth of credit provided by the banking system (64 per cent in 1974/75 compared to 37 per cent in 1973/74). Moreover, the rise in private imports and other external payments was not large enough to offset the sharp increase in remittances from Yemenis abroad and in other receipts. The expansionary impact of private sector operations accounted therefore for about two thirds of the liquidity expansion in 1974/75.

The mission indicated that liquidity expansion in recent years had been excessive when related to the real rate of economic growth and the justifiable monetization needs of the economy. In the two years ended June 1974, GDP in real terms declined somewhat but liquidity rose by over two thirds. In 1974/75, while domestic liquidity rose by 56 per cent, real GDP was estimated to have risen by less than 30 per cent. This would suggest that, even after allowing for monetization of the subsistence sector, monetary expansion was well in excess of the requirements of the economy, resulting in pressures on domestic resources and a sharp increase in prices as evidenced by the rise in the cost of living index (over 80 per cent in the three-year period). Demand pressures had further intensified due in part to supply bottlenecks related to the capacity of Hodeida Port and other physical constraints which had limited the expansion of private imports. While it was essential to meet the genuine credit requirements of the dynamic and rapidly expanding private sector and the increasing monetization of the economy, there was ample justification for moderating the rate of credit expansion.

The Y.A.R. representatives stated that they were keenly aware of the dimensions of the problem of excess liquidity and receptive to suggestions of appropriate corrective policies, although they believed that the scope for restraining credit to the private sector was somewhat limited in view of the expanding needs of that sector, most of which were in relation to financing imports. At the request of the Yemeni representatives, several policy options were examined which included, inter alia, the use of credit control instruments at the disposal of the Central Bank to restrain credit

expansion and measures to siphon off part of the counterpart of incoming remittances to contribute to the capitalization of specialized credit institutions and other productive investments. In this connection, the mission stated that the recent increase in creditor interest rates (by 1-1½ percentage points for fixed deposits, and from a range of 4-6 per cent to a flat rate of 5 per cent for savings deposits) was a step in the right direction.

Table 1. Factors Affecting Changes in Money Supply:
An Alternative Presentation

(In millions of Yemen rials)

Fiscal year ended June 30	1972/73	1973/74	1974/75
<u>Excess of government domestic expenditures over domestic revenue</u>	70.4 ^{1/}	81.4 ^{1/}	140.8 ^{1/}
Receipts from foreign cash grants and aid	126.5 ^{1/}	269.2 ^{1/}	577.8 ^{1/}
Aid-financed imports	-68.9	-155.8	-163.4
Other government foreign expenditures	n.a.	n.a.	-42.0
Change in government deposits with domestic banking system (increase -)	12.8	-32.0	-231.6
<u>External transactions of the private sector</u>	43.1	4.3	153.4
Net imports	-465.8	-655.8	-942.0
Net invisible receipts and remittances	469.0	588.4	993.2
Other (including errors and omissions)	39.9	71.7	102.2
<u>Claims on private sector (including changes in unclassified items)</u>	71.2	58.9	116.6
<u>Changes in money and quasi-money</u>	184.7	144.6	410.8
Increase in money	123.1	140.7	347.6
Increase in quasi-money	61.6	3.9	63.2
<u>Changes in per cent</u>			
Money	35.4	29.8	56.8
Quasi-money	216.3	3.4	53.8
Money and quasi-money	46.0	24.7	56.3
Claims on private sector	55.5	36.5	63.6

Sources: Based on data provided by the Central Bank of Yemen and staff estimates.

^{1/} These amounts include commodity grants and therefore exceed the foreign assistance figures which appear in the budgetary tables.

2. Budgetary developments and fiscal policy

The Y.A.R. representatives indicated that developments in 1974/75 had been characterized by increasing pressures on the expenditures side due to the impact of inflation as reflected in the requirement for a 25-30 per cent general salary increase decreed in July 1974 and in the maintenance of subsidies to limit the consumer price increases for petroleum and wheat. Additionally, there was the continued need to set up new institutions to establish government presence in the provinces as well as to expand basic public services. The shortfall in capital expenditures, particularly in the externally financed segment, was attributed in part to the emergence of structural supply bottlenecks related to the limited capacity of Hodeida Port and the transport system, as well as to shortages of technical and skilled manpower.

In 1975/76 revenues were budgeted to rise by 28 per cent while current expenditures were to rise by 21 per cent, which would slightly reduce the deficit on current operations compared with 1974/75. Capital expenditures were projected to double, compared to the level realized in the previous year, as spending on major projects was expected to accelerate in the third year of the development program. A considerable shortfall, however, is likely to materialize due to the persistence of institutional constraints experienced in the first two years of the program. As in 1974/75, foreign aid was projected at a level which would not only meet the overall budget deficit, but would also result in a substantial cash surplus for the Government.

Revenue estimates were characterized by stagnation in some major revenue items such as "taxes on income and profits" and "taxes on goods and services," and a substantially lower rate of growth in customs receipts than the projected increase in private imports. The Y.A.R. representatives stated that stagnation in receipts from taxes on income and profits was related to difficulties in assessing and collecting these taxes due to shortage of trained personnel and lack of proper accounting records. As to taxes on goods and services, the bulk of receipts in this category had usually accrued from excise taxes on consumption of petroleum products, which was not expected to increase significantly in 1975/76 following the sharp rise in the previous year. While the budgeted receipts from import duties represented an underestimate, actual receipts would not be increasing in line with the projected growth in imports due to exemption of certain basic commodities from duty, as well as the expected shift in the composition of imports to a higher proportion of capital goods which are subject to low tariff rates. Nevertheless, it appeared that the underestimation of revenues from these sources would probably be sufficient to offset the overestimates in certain other items and that, on the whole, the overall revenue estimate appeared realizable.

With respect to the planned sharp deceleration in the growth of current expenditures and methods to restrain the rise in such expenditures, the Y.A.R. representatives referred to the recent strengthening of the role of budget officers located in the spending agencies and other recent institutional reforms which had made possible the exercise of closer control over expenditures.

The mission stated that the availability of external aid for budget support should not lead to slackening of efforts to rectify the budgetary imbalance. Achievement of a balance on current budgetary operations should be an important objective of fiscal policy. This would require a substantial deceleration in the rate of growth in current expenditures and a significantly higher revenue performance both from existing sources and from new revenue producing areas.

While concurring with the mission as to the appropriate course of fiscal policy, the Y.A.R. representatives indicated that pressures on government finances were likely to abate in the coming years with the completion of the institutional setup of the Government and when facilities providing such basic services as health and education have caught up with the backlog of needs in these areas. Proposals were being formulated to widen the taxes on commercial and industrial profits and other areas of revenue were being examined. It was also the authorities' intention to review the entire revenue system with a view toward increasing receipts along the lines suggested in the Report on Tax Policy in the Yemen Arab Republic prepared in July 1974 by a Fund technical assistance mission.

3. Balance of payments and external sector policies

Balance of payments estimates for 1975/76 prepared by the Y.A.R. representatives indicate a small increase in the overall payments surplus to about SDR 100 million. While the trade deficit was projected to widen further due to a 25 per cent increase in imports, this would be more than offset by an increase in receipts from remittances, other invisibles and from grants. Nonmonetary capital inflow was projected at about the previous year's level. With regard to the medium-term balance of payments projections, the Yemeni representatives noted that the surpluses were likely to decline due to an expected increase in government imports to finance the step-up in development efforts. They further noted that a major factor in the recent sharp increase in the payments surplus was the increase in official grants which was not a dependable source of foreign exchange.

There has been no change in exchange rate policy since last year's consultation discussions. The Central Bank continues to peg the Yemen rial to the U.S. dollar at the rate of YR1 1 = US\$0.22, which has remained unchanged since February 1973. During the period February 1973-September 1975, the effective rate for the Yemen rial, based on import weights, appreciated by about 15 per cent against currencies of suppliers of Y.A.R. imports.

The Y.A.R. continues to follow liberal exchange and trade policies. Recent legislation eliminated restrictions on exchange transactions which had not been applied in practice for some time. The mission welcomed the step taken by the authorities to ensure the conformity of statutory provisions to practice.

The Y.A.R. representatives stated that the payments agreement with Egypt has remained inoperative and that its termination depended on the conclusion of negotiations of outstanding financial issues between the two countries.

IV. Staff Appraisal

Following setbacks in 1972/73 and 1973/74 related to drought conditions, economic activity rebounded sharply in 1974/75 due to record agricultural output and continuing growth in the other sectors. Remittances from Yemenis working outside the Y.A.R., which have assumed substantial proportions in recent years, have fueled economic growth and, together with external aid received by the Government, have contributed to rising balance of payments surpluses.

The favorable performance in 1974/75, however, was accompanied by an acceleration in the rate of monetary expansion which resulted in a further buildup of demand pressures leading to a substantial increase in domestic prices. The budgetary imbalance widened further due to an acceleration in the growth of current expenditures which the authorities attributed largely to the continuing need to expand the government machinery and build new institutions, particularly in the provinces, as establishing government presence in these areas was deemed vital for political as well as economic and social considerations. The rise in development expenditures was limited in part by the physical constraints which hampered the importation of capital goods despite the availability of ample domestic and external financial resources.

Prospects for continued economic growth in 1975/76 are favorable, albeit at a much lower rate than in the previous year. Although the non-agricultural sectors are expected to continue their recent rapid growth, virtually no improvement in agricultural performance is expected over the record crop of 1974/75. The 1975/76 budget provides for a reduction of the deficit on current operations to be achieved by a significant deceleration in the rate of increase in current expenditures, but the budget contained no important new revenue measures. Achievement of a balance on current budgetary operations is an important objective of fiscal policy which would require measures to effectively control current expenditures and significant action on the revenue side. The achievement of this goal would help reduce the pressure on domestic resources and prices and would divert larger proportions of domestic and external resources to the development effort.

The highest priority in economic policy for 1975/76 and 1976/77 should be placed on containing the inflationary pressures. While it is essential to meet the genuine credit needs of the private sector, a more active monetary policy is required to curb excessive liquidity creation. Such a policy, together with appropriate budgetary and fiscal measures, should contribute significantly to the achievement of this goal. The authorities have shown keen awareness of the dimensions of the problem and are considering appropriate corrective measures.

Another large payments surplus is projected for 1975/76 as both remittances from Yemenis working abroad and external official assistance are expected to register further gains. The favorable external reserves position and the balance of payments outlook should provide the basis for an acceleration of development expenditures. Efforts should be directed in particular to overcoming the physical constraints to pave the way for a sustained rise in the development effort.

V. Proposed Decision

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

1. This decision is taken by the Executive Board in concluding the 1975 consultation with the Yemen Arab Republic pursuant to Article XIV, Section 4, of the Articles of Agreement.

2. There was rapid economic growth in 1974/75 and prospects for continued growth in 1975/76 are favorable. Following the large increase in liquidity in the preceding two years, monetary expansion accelerated in 1974/75, leading to a buildup of demand pressures and a sharp increase in domestic prices. The Fund believes that a fiscal policy, aiming at eliminating the deficit on current budgetary operations as well as an active monetary policy to restrain credit expansion in the private sector, are needed to control inflationary pressures and to promote sustained economic development.

3. Rising receipts from remittances and foreign aid contributed to the large external payments surplus realized in 1974/75 and are expected to be the main factors in a continued strong payments position in 1975/76. The exchange and trade systems continue to be liberal and the Fund welcomes the recent elimination of restrictions which had not been applied in practice for some time.

Fund Relations with the Yemen Arab Republic

The Yemen Arab Republic became a member of the Fund on May 22, 1970 with a quota of SDR 8 million. The quota was increased on December 24, 1970 to SDR 10 million under the Fifth General Review. The present Fund holdings of Yemen rials equal 75 per cent of the quota. The Y.A.R. became a participant in the Special Drawing Account on May 22, 1970 and was allocated SDR 2.1 million during the first basic period; present holdings are equal to 100 per cent of the net cumulative allocation.

No par value for the Yemen rial (YR1) has been declared to the Fund. The rial is issued by the Central Bank of Yemen and its gold value has not yet been defined. Practically all transactions in the Y.A.R. took place at the free market rate up to December 1971; by then the rate had stabilized at YR1 1 = US\$0.20. During December 1971-February 1973 the Central Bank maintained this as the central bank rate but after the U.S. dollar depreciation, the central bank rate was changed to YR1 1 = US\$0.22 with effect from February 25, 1973. This rate has been maintained since then. The Y.A.R. has established a representative exchange rate with the Fund under Rule 0-3, paragraph (c) (i). This is the midpoint of the Central Bank's buying and selling rates for the U.S. dollar.

The last Article XIV consultation discussions with the Y.A.R. took place in Sanaa during the period November 9-14, 1974. The Executive Board Decision on this consultation (No. 4612-75/29), adopted March 12, 1975, was as follows:

1. This decision is taken by the Executive Board in concluding the 1974 consultation with the Yemen Arab Republic pursuant to Article XIV, Section 4, of the Articles of Agreement.

2. Following two years of severe drought conditions which adversely affected the performance of the agricultural sector and resulted in a decline in gross domestic product, economic activity is expected to increase sharply in 1974/75. A sizable increase in agricultural output is expected because of timely and abundant rainfall.

3. The stagnation of economic activity in 1972/73 and 1973/74 was accompanied by substantial monetary expansion contributing to pressures on domestic resources and a sharp increase in prices, particularly in 1973/74. Budgetary operations have been the main factor in the monetary expansion. The budget for 1974/75 projects a sizable increase in the deficit on current operations. The Fund believes that the authorities should give priority to increasing domestic revenues and curbing the growth in current expenditures. The reform of fiscal procedures made effective in 1973/74 is a welcome development.

4. Mainly on account of increasing foreign aid, the balance of payments continued to be in surplus in 1973/74 and another but probably reduced surplus is likely in the current year. The exchange and trade systems continue to be largely free from controls and the Fund welcomes the intention of the authorities to maintain these policies.

Yemen Arab Republic: Basic Data

IMF data

Date of IMF membership	May 1970
Status	Article XIV
Quota	SDR 10 million
Currency	Yemen rial
Fund holdings of Yemen rials	75 per cent of quota
Par value	None. All exchange transactions are effected at the Central Bank rate (at present YR1 1 = US\$0.22)
Special Drawing Account	Participant. Allocated SDR 2.1 million during the first basic period; no use of SDRs has so far been made.

Area and population

Area	75,000 square miles
Population	6.47 million (Feb. 1975)

(Crop year ended June 30)

1971/72 1972/73 1973/74 1974/75

(In thousand metric tons)

Production

Cereals ^{1/}	1,332	1,195	1,105	1,975
Cotton	15	18	20	26

(Fiscal year ended June 30)	Actuals				Budget Est.
	1971/72	1972/73	1973/74	1974/75	1975/76

(In millions of Yemen rials)

Public finance

Current revenue	151.3	199.0	276.8	381.1	486.2
Tax revenue	(122.9)	(158.3)	(227.4)	(301.1)	(360.8)
Other revenue	(23.4)	(40.7)	(49.4)	(80.0)	(125.4)
Current expenditures	228.3	271.5	322.5	472.3	571.6
Deficit on current account (-)	-77.0	-72.5	-45.7	-91.2	-85.4
Capital expenditures ^{2/}	55.8	56.9	139.3	184.7	352.8
Overall deficit (-)	-132.8	-129.4	-185.0	-275.9	-438.2
External financing	170.6	116.5	249.9	548.6	587.0
Surplus (-) or deficit requiring domestic financing ^{3/}	-37.8	12.9	-32.0	-231.6	-148.8
Statistical discrepancy ^{3/}	--	--	-32.9	-41.1	--

^{1/} Sorghum and millet, wheat, barley and maize.

^{2/} Consists of the rial counterpart of the amounts utilized of project and commodity loans as well as budget development expenditures. Budget capital expenditures were YRls 13.6 million in 1973/74 and YRls 69.3 million in 1974/75.

^{3/} Represents unrecorded expenditures, exchange rate valuation adjustments associated with external financing, differences between beginning and end-of-year cash balances held outside the banking system, and errors and omissions.

Yemen Arab Republic: Basic Data (concluded)

	December				June	
	1971	1972	1973	1974	1974	1975
	(In millions of Yemen rials)					
<u>Money and credit</u>						
Money	276.8	402.3	531.8	707.9	612.0	959.5
Quasi-money	35.7	80.6	105.1	151.0	117.5	180.7
Credit to the private sector	70.0	119.8	169.5	260.5	230.1	376.5
Net claims on or deposits (-) of the Government	110.1	115.9	135.2	-17.6	84.2	-147.4
Net foreign assets	516.2	590.0	611.4	893.8	691.8	1,183.4
					July-June	
	1971	1972	1973	1974	1973/74	1974/75
	(In equivalents of millions of SDRs)					
<u>Balance of payments</u>						
Exports (adjusted)	6.4	6.3	7.4	9.3	11.4	10.4
Imports (adjusted)	-72.1	-94.3	-130.0	-185.1	-160.9	-209.2
Balance of trade (deficit -)	-65.7	-88.0	-122.6	-175.8	-149.5	-198.8
Services, remittances and transfers (net)	52.7	91.9	110.4	176.2	134.0	253.8
Nonmonetary capital ^{1/}	28.4	19.7	26.4	51.9	37.4	38.2
Overall balance excluding SDRs	15.4	23.6	14.2	52.3	21.9	93.2
SDR allocations	1.1	1.0	--	--	--	--
Overall balance including SDRs	16.5	24.6	14.2	52.3	21.9	93.2
<u>Monetary movements (increase in assets -)</u>						
Central Bank of Yemen ^{2/}	-16.5	-24.6	-14.2	-52.3	-21.9	-93.2
Commercial banks	-14.1	-18.5	-14.1	-56.7	-28.1	-80.0
	-2.4	-6.1	-0.1	4.4	6.2	-13.2
<u>Monetary reserves (end of period)</u>						
Central Bank of Yemen	21.6	46.2	60.3	112.5	74.6	167.9
Commercial banks	19.9	38.4	52.5	109.1	71.5	151.5
	1.7	7.8	7.8	3.4	3.1	16.4
<u>Memorandum item</u>						
Conversion rates: Yemen rials per SDR	5.43	5.43	5.43	5.51	5.43	5.56

1/ Including net errors and omissions.

2/ Prior to July 1971, Yemen Currency Board.