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April 20, 1976

To: Members of the Executive Board

From: The Secretary

Subject: People's Democratic Republic of Yemen - Staff Report and Proposed Decision for the 1976 Article XIV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1976 Article XIV consultation with the People's Democratic Republic of Yemen. The decision proposed by the staff appears on page 8.

This subject, a request for reclassification under paragraph 10 of the Decision on Compensatory Financing of Export Fluctuations (EBS/76/178), and a request for a purchase in the first credit tranche (EBS/76/179), will be brought to the agenda for discussion on a date to be announced.

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INTERNATIONAL MONETARY FUND

PEOPLE'S DEMOCRATIC REPUBLIC OF YEMEN

Staff Report for the 1976 Article XIV Consultation

Prepared by Staff Representatives for the 1976 Consultation
with the People's Democratic Republic of Yemen

(Reviewed by the Committee on Article XIV Consultations)

Approved by John W. Gunter and Subimal Mookerjee

April 19, 1976

I. Introduction

The 1976 Article XIV consultation with the P.D.R. of Yemen took place in Aden during the period from February 7 to February 12, 1976. The P.D.R. of Yemen's team was chaired by the Governor of the Bank of Yemen (the central bank) and included several representatives of the banking system and various government departments. Some members of the mission benefited from discussions with the Prime Minister and the Ministers of Finance, Industry and Planning and Trade and Supply. Negotiations were also held on the possible use of Fund resources by the P.D.R. of Yemen. The staff representatives were Messrs. A. S. Gerakis, S. Thayanithy, S. M. Nsouli and Mrs. M. M. Redman (all of MED), Mr. Z. Iqbal (ETR) and Mr. S. Al-Khuri (YPP). The Alternate Executive Director for the P.D.R. of Yemen attended some of the mission's meetings.

II. The P.D.R. of Yemen's Economic Policies

The P.D.R. of Yemen, one of the "least developed" and "most seriously affected" countries, has experienced severe difficulties since its independence in 1967. With the departure of the British and the closure of the Suez Canal, it lost a sizable fraction of its budgetary and foreign exchange receipts. Nationalization policies initiated in 1969 led to an almost complete disappearance of private investment activity, while strained relations with neighboring states reduced the availability of much needed external assistance. Moreover, the recent sharp increases in import prices have intensified pressures on the domestic price level as well as on the balance of payments.

Faced with the problem of a persistently low rate of growth, the Government has pursued expansionary fiscal policies accelerating both development and ordinary expenditures. Simultaneously, however, it has sought to contain private consumption by severely compressing personal incomes. These policies as well as their long-term effects on economic growth, monetary equilibrium and the balance of payments are described in the following paragraphs; the mission's evaluation is set forth in section III. In support of purchases in the first credit tranche, the P.D.R. of Yemen agreed to implement financial programs during the year ended in March 1976 and in the ensuing 12-month period. Both programs incorporate the basic policies just mentioned and they are discussed in detail in EBS/76/179.

Development policy: The Yemeni authorities attach considerable importance to their development effort which is supervised directly by the Prime Minister and absorbs a good deal of attention at Cabinet meetings. Investment expenditures have been increased from about YD 4 million in 1971/72, the initial year of the First Three-Year Plan, to about YD 20 million in 1974/75, the first year of the current Five-Year Plan, the target for 1976 is almost YD 46 million, but based on past experience implementation may not exceed two thirds of this amount.1/

The main emphasis of the development effort is on much needed infrastructure, including education and health, and, at the same time, on small quick-yielding projects designed to alleviate the balance of payments problem. Agriculture and fisheries are receiving a substantial share of total expenditure. Recently, the authorities have initiated important projects to rehabilitate the Port of Aden in view of the increase in traffic expected to result from the reopening of the Suez Canal. They have also stepped up exploration for petroleum and other minerals and have employed foreign, including some western, companies to help them in this endeavor. The development programs have been financed mainly by foreign economic assistance and to a lesser extent by domestic nonbank resources, such as the after-tax profits of public sector enterprises reliance on the banking system is small. Another notable feature of the plans is that they are revised annually in light of changing circumstances and the availability of funds.

The current budget: Expenditures in the ordinary (current) budget have risen appreciably over the years from YD 21 million in 1971/72 to YD 27 million in 1974/75. According to the available functional classification, the major component of expenditure, wages and salaries, accounted for a sizable fraction of this increase. The Government has built up the civil service, expanded the armed forces and staffed projects completed under the development programs. However, its hiring policies may also have been influenced by the desire to provide work for the unemployed. Over the same period the second largest category of expenditure, "materials, supplies and miscellaneous" increased at an even higher rate then the wage and salary bill, partly due to the inflationary trend in import prices. The authorities are somewhat reluctant to limit current expenditure: they contend that the distinction between development and some types of ordinary outlays is arbitrary and that both are equally important.

1/ The central rate for the Yemeni dinar is YD 1 = US$2.89524. Through 1974/75 the fiscal year ended in March, but beginning in 1976 it will coincide with the calendar year. An interim budget was implemented over the last three quarters of 1975.

Ordinary revenues rose by a smaller amount than expenditures and, as a result, the deficit in the current budget almost doubled to YD 9.3 million from 1971/72 to 1974/75. Although they recognize the need for an improvement in the financial position of the Government, the Yemeni representatives do not feel that they can impose new revenue measures; they are convinced that the burden of taxation is already too high in relation to incomes.

Reflecting the strong political and social pressures to which the policy-makers are subject in the P.D.R. of Yemen, the 1976 budget provides for a very large increase in expenditure to YD 36 million; the breakdown of these outlays indicates that the Government plans to expand the armed forces, as well as the civil service, particularly in the ministries of education and health. Ordinary revenues are placed at YD 18 million. Hence, the current deficit would also be YD 18 million and, allowing for the above-mentioned financing of the investment budget, total Treasury reliance on the banking system would amount to no less than YD 20 million.

<u>Incomes policy</u>: While increasing employment in the civil service, the Government has followed an extremely tough line on wage rates. Cuts in wages and salaries were effected on a progressive scale in 1972; since then, an across-the-board raise of only 5 per cent was granted in 1975, but professionals have also received sizable allowances in an attempt to stem the emigration of skilled personnel to neighboring countries. Meanwhil , prices which are extensively controlled by the Ministry of Trade, were allowed to rise substantially to reflect the higher cost of imports. In order to moderate the impact of the inflationary trend, a few essential commodities have been subsidized to some extent; however, even the prices of these items were raised significantly. Overall, the wage earner in the P.D.R. of Yemen has suffered a considerable loss in his real income and, despite the lack of national account statistics, it is reasonable to assume that the volume of private consumption has declined.

<u>Effects on national income</u>: The policies described above have been instrumental in achieving progress in several fields, most notably in education and health care. The Yemeni authorities believe, furthermore, that unemployment has been virtually eliminated. If their assessment is correct, this would represent a remarkable accomplishment, all the more so as in recent years large numbers of women have been absorbed into the labor force. Nevertheless, the growth rate has not picked up appreciably as yet. In part this may be explained by the long gestation period of some infrastructural projects. An additional reason may be found in the disappointing performance of the large B.P. Refinery in Aden, which accounts for about two thirds of value added in industrial production. Output of the refinery declined in both 1974 and 1975 to a level about one fifth of its capacity; apparently, bunker fuel, one of the refinery's main lines, is facing stiff competition in neighboring ports. Furthermore, the increase in traffic at the Port of Aden following the opening of the Suez Canal proved below expectations, while serious floods in 1975 inflicted heavy losses on agricultural production.

According to the Yemeni representatives, the prospects for a recovery from the current recession are encouraging. The development effort has now laid the foundations for an upswing in coming years. Relations with neighboring Arab states are improving and, as a result, the P.D.R. of Yemen may be receiving more external assistance in the future. A stimulus to the economy may also come if the Government is successful in its efforts to mobilize the private sector within the framework of the country's socialist economic system.

Effects on monetary sector: In 1973/74 and 1974/75, monetary expansion, though large in absolute terms, was appreciably less than the rise in the price level resulting chiefly from the inflation in import prices. It seems likely, therefore that by the end of the latter year, any liquidity overhang from the period of overexpansion in the early 1970s had been eliminated, or much reduced. According to the latest official projections, the increase in domestic liquidity (money plus quasi-money) was expected to be about 13 per cent in 1975/76 this rate would be higher than envisaged in the financial program of the Yemeni authorities, but not unreasonable in the circumstances (see EBS/76/179). As regards the outlook for the near future, the budgetary plans of the Government, taken in conjunction with plausible forecasts for the other principal headings of the monetary accounts, imply an unduly high increase in domestic liquidity of the order of 18 per cent.

In their discussions with the mission on monetary policy, some of the Yemeni officials tended to discount the injurious effects of such an excessive expansion in the supply of money and quasi-money on the grounds that with their comprehensive controls they are able to neutralize pressures on prices and the external sector. To suggestions that interest rates should be raised, these officials responded that interest rate policy cannot have a significant impact on savings, given the low level of incomes in the P.D.R. of Yemen. In their view more can be accomplished by establishing commercial bank branches in the rural areas. Insofar as the allocative function is concerned, they felt that the existing system of controls assures a reasonable distribution of financing to the high priority areas.

Effects on the external sector: For several years the P.D.R. of Yemen's balance of payments position has been weak. However, until the end of 1973 the authorities were able to prevent a large decline in their gross reserves. Initially, this was accomplished by imposing restrictions on private transactions. With the passage of time, foreign trade was gradually nationalized so that the bulk of imports and all exports are currently carried out by the public sector; imports are now being held within the limits of foreign exchange availability by adjusting allocations for state import agencies in the foreign exchange budget and the import program. Mainly due to the sharp increase of more than 40 per cent in the P.D.R. of Yemen's average import prices, the balance of payments deteriorated substantially in 1974 and 1975. Despite purchases under the oil facility and in the first credit tranche, gross reserves were drawn down appreciably in both years, but they are still fairly ample by conventional standards, i.e., equal to somewhat more than three months' imports; net foreign assets are slightly under five weeks' imports.

The P.D.R. of Yemen's balance of payments problem reflects, in addition to the recent international inflation, a disappointing performance in the country's foreign exchange receipts. Total exports have not grown much in absolute terms over the years, as the increase in fish exports has been offset to some extent by a declining trend in agricultural and other domestic exports and in re-exports. There is some reason to believe that the export potential created by the development effort is being partially neutralized by the effects of inadequate incentives to producers. Transfers, which consist mainly of emigrant remittances, are now considerably lower than they were in 1970 and 1971, despite some increase in the last two years. The steep upward trend of such receipts in the Arab Republic of Yemen implies that Yemenis working abroad prefer to send their funds to the North, partly because remunerative investment opportunities are available there. Unlike other receipts, the capital inflow has shown an upward movement (notwithstanding a decline in 1975), but its increase has been relatively modest, clearly insufficient to prop up the external sector by itself. As a consequence of the sluggish behavior in receipts it has become necessary to hold down imports, which in the period 1972-75 have not risen in real terms above their 1971 level. This has led to shortages in consumer goods and has acted as a constraint on the development effort.

The Yemeni authorities do not consider an exchange adjustment as an acceptable means of strengthening the balance of payments. They note that in an economy like theirs, in which a large proportion of consumption is import-intensive, a devaluation would result in a substantial increase in the cost of living. Export receipts would probably not rise significantly as the export base is small and most of the items involved are not subject to a high price elasticity of demand abroad. Similarly, invisibles might not respond positively. Furthermore, in a socialist economic system the allocation of resources reflects centralized decisions rather than the price mechanism.

Two noteworthy aspects of the P.D.R. of Yemen's balance of payments management are the measures with respect to foreign debt and the free zone. As regards the former, the authorities have avoided borrowing on commercial terms, with only minor exceptions, so that the burden of debt service will continue to be minimal in the near future. Regarding the latter, a number of steps have been taken recently liberalizing the restrictive system in an effort to revitalize the entrepot trade and facilitate the establishment of industries in Aden's free zone. These measures are all the more significant as the free zone is for the time being reserved for the private sector. In addition, several duty free shops have been opened to cater to the tourist trade which is expected to pick up pari passu with the increase in traffic at the Port of Aden. It should be noted also that progress has been made in eliminating broken cross rates.

III. Staff Appraisal

Over the period covered in this report the principal objective of the Yemeni Government has understandably been to revitalize and develop the economy. The authorities have mainly relied on a combination of fiscal and incomes policies, coupled with comprehensive controls. They have thus been able to lay the foundations for a resumption of economic growth at satisfactory rates, while keeping monetary expansion within reasonable limits. Furthermore, unemployment is said to have been reduced and considerable progress has been made in the social field. The staff is favorably impressed with what has been accomplished in very difficult circumstances. It felt, however, in the course of the consultation discussions that a danger has now emerged. In their eagerness to achieve their goals, the authorities are displaying a tendency to push expansionary policies too far at the expense of monetary stability. Another weakness in their present thinking is that they are neglecting policies to strengthen the balance of payments, which has become a potent constraint on economic growth and the development effort.

The staff believes that continued monetary restraint is essential. Price controls do not provide an acceptable alternative. Should they be tightened, it would be difficult to prevent a lengthening of buyer queues and a step-up in black market activity which would oblige the Government to expand substantially the rationing system. Moreover, capital flight might be intensified. Such developments would constitute a misallocation of the country's scarce resources. If it is true that the P.D.R. of Yemen has reached, or is approaching, a phase of full employment, an unrestrained increase in effective demand might also exercise strong upward pressures on wages jeopardizing the Government's so far successful incomes policies.

The most important option available in order to increase savings would be to reduce the current budget deficit, indeed the long-term objective should be to eventually achieve a surplus in the ordinary budget. During the consultations the staff suggested that total ordinary expenditures should be reduced and that the selection of particular items to be curtailed necessarily depended on the scale of priorities established by the authorities. As indicated in EBS/76/179, a decision was subsequently made to revise expenditure downward. This decision is to be welcomed. There also appear to be some areas where taxation can be increased. For example, as a revenue measure the Government should consider an increase in tariffs which appear low on the average.

Secondly, resources might be mobilized by adequately raising interest rates. In this connection it would seem that the authorities underestimate the disincentive effect of existing, negative interest rates on deposits; at the same time they overestimate the ability of appointed committees to allocate credit resources rationally, without the guidance which would be available to them if the price of capital adequately reflected its scarcity value. It is probably true, however, that a small increase in interest rates would prove ineffective and that a large one might be politically difficult.

With regard to the external sector, the staff welcomes the policies aimed at stimulating the entrepot trade and avoiding borrowing on hard terms. However, a more far-reaching approach may be necessary, if the existing basic difficulties are to be overcome. A reform of the exchange system may indeed be overdue. No action was taken immediately after independence to adjust for the substantial losses in foreign exchange earnings which the P.D.R. of Yemen experienced at the time. On the contrary, in the period of international currency realignments since 1970, the dinar was maintained in terms of gold with the result that it has appreciated in effective terms in relation to the currencies of the P.D.R. of Yemen's main trading partners. It could perhaps be argued that the stringent incomes policy applied by the Government has obviated the need for a reform. However, there is no evidence that this policy is in fact leading to an improvement in the external sector. Furthermore, on a priori grounds, it cannot be assumed that the two policies are satisfactory substitutes for each other holding down incomes across-the-board does not bring about the redistribution necessary to stimulate export production. The staff does not believe that the demand or the supply of the P.D.R. of Yemen's exports are price inelastic.

The authorities should be commended for their efforts to compile and improve economic statistics. The staff hopes that this work, which is supported by assistance from the Fund, will be continued. The most urgent need for improvement is in the areas of the national accounts and the presentation of budgetary data. These and other statistical improvements will facilitate the appraisal of current conditions and the formulation of economic policy.

IV. 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 1976 consultation with the People's Democratic Republic of Yemen pursuant to Article XIV, Section 4, of the Articles of Agreement.

2. In recent years, the P.D.R. of Yemen has been accelerating development and ordinary budget expenditures and, at the same time, pursuing a policy of restraint on incomes in order to contain private consumption. As a result, unemployment has been reduced and the outlook is for an increase in the rate of growth in the near future. The budgetary deficit has been held within reasonable limits so far, and monetary expansion has been in line with the availability of goods and services. The Fund welcomes the new financial program of the Yemeni authorities which provides for a continuation of these policies.

3. In 1975 the balance of payments deficit was sizable, though somewhat smaller than had been expected. The Fund believes that appropriate changes should be made in the P.D.R. of Yemen's foreign exchange policies in order to strengthen the external sector, thus making possible a vigorous recovery in the economy and further acceleration of the development effort. The Fund notes the liberalization of the restrictive system in regard to the free zone in Aden and progress made in eliminating a number of broken cross rates for foreign currencies.

Fund Relations with the People's Democratic Republic of Yemen

The P.D.R. of Yemen became a member of the Fund on September 29, 1969 with a quota equivalent to SDR 22 million, of which the equivalent of SDR 2 million was paid in gold. The quota was increased to the equivalent of SDR 29 million under the Fifth General Review; 25 per cent of this was paid in gold.

No par value for the Yemeni dinar (YD) has yet been established. In January 1972 the P.D.R. of Yemen communicated a central rate of YD 1 = US$2.60571, equal to 2.13281 grams of fine gold, and availed itself of wider margins under paragraph 3 of Executive Board Decision No. 3463-(71/126), adopted December 18, 1971. The dinar was thus at parity with the pound sterling until June 1972. Following the sterling float in that month, the Yemeni authorities informed the Fund that they would maintain unchanged the gold content of the dinar and would discontinue pegging it to sterling. The gold value of the dinar was again maintained in February 1973 and the central rate is now YD 1 = US$2.89524. A representative rate for the Yemeni dinar has been established under Rule O-3, paragraph (c)(i) against the U.S. dollar it is YD 1 = US$2.886, the midpoint between the buying and selling rates of the National Bank of Yemen (the commercial bank). In August 1974, the P.D.R. of Yemen made a gold tranche purchase of SDR 3.75 million, and in May 1975 it purchased SDR 7.25 million in the first credit tranche. Under the 1974 Oil Facility, the P.D.R. of Yemen made two purchases, one of SDR 9.306 million in November 1974 and a second of SDR 2.494 million in March 1975; under the 1975 Oil Facility, it purchased SDR 4.6 million in July 1975 and SDR 7.42 million recently. At present the Fund's holdings of Yemeni dinars are equal to 207.1 per cent or, excluding purchases under the Oil Facilities, 125 per cent of quota. As a participant in the Special Drawing Account, the P.D.R. of Yemen has received allocations of SDR 9.9 million; currently, its holdings of SDRs amount to 32.9 per cent of the cumulative allocation. The P.D.R. of Yemen has received technical assistance from the Fund in the field of central banking. A general adviso- has been assigned to the Bank of Yemen since April 1973, and a research advisor from January 1975.

The last Article XIV consultation discussions were held in Aden during the period January 24 to February 1, 1975. The Executive Board Decision No. 4665-(75/82), adopted May 16, 1975, was as follows:

1. This decision is taken by the Executive Directors in concluding the 1975 consultation with the P.D.R. of Yemen, pursuant to Article XIV, Section 4, of the Articles of Agreement.

2. Economic activity, which had been depressed for several years, picked up momentum in 1973/74 and 1974/75 and is expected to show a further improvement in 1975/76, responding to an acceleration in investment expenditure within the framework of the Five-Year Plan. Current expenditure has been slowed down and the budget deficit contained, notwithstanding the increase in the price level

due to the rising cost of imports. This policy and other measures to restrain consumption have served to moderate monetary expansion and inflationary pressures originating in the domestic sector. In the external sector a substantial deficit was registered in 1974/75 owing partly to a deterioration in the terms of trade; a further sizable loss in foreign exchange reserves is expected in 1975/76. To limit the extent of this loss, the authorities intend to continue measures of restraint in the areas of fiscal, monetary and incomes policy. The Fund agrees that such measures will prove helpful, but it feels that the P.D.R. of Yemen should also adopt in due course additional steps aimed at strengthening the balance of payments position.

3. In 1974 the P.D.R. of Yemen tightened the import regime somewhat, but at the same time took a number of steps to improve the foreign exchange and trade system. The Fund notes the progress made in reducing multiple currency practices arising from excessive spreads between buying and selling rates and from broken cross rates. It believes that the authorities should keep under review existing restrictions on trade and payments and take action toward their gradual elimination.

P.D.R. of Yemen - Basic Data

Area and population	
Area	112,000 square miles
Population	1.59 million
IMF data	
Date of IMF membership	September 1969
Status	Article XIV
Quota	SDR 29 million
Fund holdings of Yemeni dinars	207.1 per cent of quota
Currency	Yemeni dinar (YD)
Par value	No par value has yet been established. The Yemeni dinar is pegged to the U.S. dollar at a rate of YD 1 = US$2.89524. A representative rate of YD 1 = US$2.886 is now in force.
SDR account	Participant. Allocations received SDR 9.9 million. Current holdings amount to 32.9 per cent of net cumulative allocation

	Fiscal years ended March 31				April-Dec. 1/
	1971/72	1972/73	1973/74	1974/75	1975
	(In millions of Yemeni dinars)				
Public finance					
Domestic revenues	16.0	12.1	15.3	18.1	14.0
Current expenditures	20.7	21.7	22.7	27.5	n.a.
Deficit	-4.7	-9.6	-7.4	-9.4	n.a.
Development expenditures	4.1	9.0	12.1	20.0	18.7

	Calendar years				
	1971	1972	1973	1974	1975
	(In millions of Yemeni dinars)				
Money and credit (end of year) 2/					
Money supply	31.7	34.9	40.1	46.1	52.3
Quasi-money	8.2	8.9	8.9	9.0	10.8
Claims on the private sector	9.6	9.9	10.4	18.9	19.7
Claims on the public sector (net)	5.6	10.4	15.1	24.0	30.8
	(In millions of SDRs)				
Balance of payments 3/					
Exports	27.6	25.7	20.6	15.6 4/	20.5 5/
Imports	-104.2	-96.0	-108.3	-153.4	-154.0
Services and private transfers	70.6	44.2	45.1	56.5	57.5
Balance goods, services and private transfers	-6.0	-26.2	-42.6	-81.3	-76.0
Net capital and government transfers 6/	9.8	24.5	39.3	56.5	56.3
Monetary movements (decrease -)	3.6	-1.7	-3.3	-24.8	-19.7
Net official and banking foreign assets (end of year)	66.1	64.4	61.1	36.3	16.6
Bank of Yemen's gross reserves	59.2	61.7	63.0	55.2	46.7
Government (purchases from IMF)	-0.2	0.1	-- 7/	-9.3	-23.6
Commercial bank	7.1	2.5	-1.9	-9.7	-6.5 8/

1/ Provisional.
2/ End of September for 1975 money and credit data.
3/ Oil refinery treated as a nonresident.
4/ Preliminary.
5/ Estimates.
6/ Includes errors and omissions and SDR allocations.
7/ Less than SDR 100,000.
8/ End November for National Bank of Yemen.