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Minutes of Executive Board Meeting 76/73

FILES

10:00 a.m., May 10, 1976

H. J. Witteveen, Chairman

Executive Directors	Alternate Executive Directors
	C. P. Caranicas
P. Åsbrink	
S. Y. Cross	
	H. G. Schneider
	F. K. Hussein, Temporary
	D. Lynch
	A. G. Zoccali, Temporary
S. Jagannathan	W. M. Tilakaratna
	E. Avillez, Temporary
	M. Wakatsuki
	Sein Maung
	T. de Vries
	J. B. Zulu
	E. O. de Toledo
	B. Goos, Temporary
	P. Kent
	G. Heyden Q., Temporary
	J. Foglizzo
R. J. Whitelaw	R. S. Deane
	S. Nana-Sinkam

W. L. Hebbard, Secretary
B. J. Owen, Assistant

Also Present

European Department: R. Evensen. Exchange and Trade Relations Department: S. Mookerjee. Legal Department: R. C. Effros. Middle Eastern Department: A. K. El Selehdar, Deputy Director; G. T. Abed, S. Al-Khury, M. T. Dajani, A. S. Gerakis, S. M. Nsouli. Research Department: C. F. Schwartz, Deputy Director; G. I. Brown, L. U. Ecevit, L. M. Goreux, Z. Hodjera, N. Kaibni, G. M. Khatchadourian. Treasurer's Department: D. Gupta. Advisors to Executive Directors: C. Bouchard, A. Malek. Technical Assistants to Executive Directors: V. Amiel, S. Arancibia, D. Berthet, J.-M. Bisson, I. M. Cobbold, A. Doizé, R. Khonsary, H. Kuroda, C. J. Lohmann, A. K. Mullei, K. Nakayama, C. C. Ozumba, S. K. Panya, M. Pietinen, E. Sacerdoti, S. P. Upasani, A. van Dorssen, L. F. Vílches, M. A. Wasfy.

1. PEOPLE'S DEMOCRATIC REPUBLIC OF YEMEN - 1976 ARTICLE XIV CONSULTATION AND PURCHASE TRANSACTIONS - COMPENSATORY FINANCING AND FIRST CREDIT TRANCHE

The Executive Directors considered the staff report and proposed decision for the 1976 Article XIV consultation with the People's Democratic Republic of Yemen (SM/76/75, 4/20/76), together with a request that SDR 2.5 million of an earlier purchase in the first credit tranche be reclassified as compensatory under Paragraph 10 of the Decision on Compensatory Financing of Export Fluctuations (EBS/76/178, 4/20/76), and a request for a purchase in the first credit tranche (EBS/76/179, 4/20/76; and Sup. 1, 5/5/76). They also had before them a report on recent economic developments in the People's Democratic Republic of Yemen (SM/76/76, 4/23/76).

The staff representative from the Middle Eastern Department noted that the reference on page 3 of the staff report to the heavy losses inflicted on agricultural production by floods in 1975 should be corrected to indicate that the losses were mainly in equipment, livestock and dwellings, rather than directly in current crops. The cotton crop in particular had not been affected because there had been no flooding in the Abyan delta and the Lahej area where cotton was grown, a relevant point in the export projections made in connection with the requested reclassification under the compensatory financing decision of the first credit tranche drawing in May 1975.

In the report on recent economic developments (SM/76/76), the staff representative added, there was a statement on page 23 to the effect that most of the financing of the Second Plan during its first two years had come, contrary to expectations, from domestic sources rather than from foreign assistance. As indicated in footnote 1, the staff had felt that some foreign aid had been classified as domestic finance under the Development Fund. More recent information confirmed that view and indicated that in the two-year period 1974-75 at least 60 per cent of development expenditures had been financed from abroad on concessionary terms. That conclusion was consistent with the actual experience under the First Plan, with the objectives of the Second Plan itself, and also with the balance of payments statistics, which showed a sizable inflow of foreign capital in 1974 and 1975.

Mr. Caranicas made the following statement:

> On behalf of my Yemeni authorities and myself I wish to thank the staff for its excellent reports, the clear analysis of the economy of the People's Democratic Republic of Yemen and the sound appraisal of its present day needs and problems. Having participated in the last part of the mission's consultations in Aden, I may add that the discussions proceeded smoothly and in a very cooperative spirit and friendly atmosphere.

When the Executive Directors considered a year ago almost to the day the serious economic problems of the People's Democratic Republic of Yemen and approved a purchase in the first credit tranche, they did not fail to recognize the valiant efforts of the authorities to implement a reasonable program and their sensible approach to development.

It will be useful, I believe, in order to better grasp the Yemeni problems to have a look back to 1967 when the People's Democratic Republic of Yemen, one of the "least developed" and "most seriously affected" countries, acquired its independence. The cessation of British budgetary grants along with the withdrawal of British forces and the closure of the Suez Canal in the same year contributed to the loss of a considerable part of its revenue and foreign exchange earnings. To achieve viability, the country immediately resorted to stringent budget and other measures involving a severe reduction in living standards. Consequently, the Yemeni authorities have had to contend with the twin problems of a low rate of growth and a weak balance of payments position, as political and social change coincided with an economic recession.

Beginning in the early 1970s, the Government initiated an expansionary expenditure policy. Within the framework of the Three-Year Plan and the current Five-Year Plan, investment outlays were stepped up substantially. Particular attention has been given to infrastructure--roads, schools and hospitals--but quick-yielding projects in agriculture and fisheries have received an equally high priority in an attempt to alleviate the balance of payments problem. Expenditures were also increased for organizing a governmental structure, building up the public sector administration, and staffing development projects as they were being completed.

In order to offset the effect of increased government expenditure on aggregate demand, the Yemeni authorities sought to restrain private consumption with a very harsh incomes policy. Owing to these policies, the People's Democratic Republic of Yemen has been able to reduce unemployment considerably and lay the foundations for a resumption of reasonable economic growth, while improving at the same time its social services.

However, the world inflation of the last two years and serious floods in 1975 dealt the People's Democratic Republic of Yemen severe setbacks. Thanks to the help of drawings under the 1974 and 1975 oil facilities and a purchase in the first credit tranche, the country was able to overcome its difficulties. In support of these drawings the Yemeni authorities adopted a financial program covering the 12 months ended in March 1976, which incorporated the policies just outlined. The program contained also provisions aimed, inter alia, at restricting credit expansion under an appropriate ceiling and avoiding external debt on hard terms. Despite many uncertainties the program has been implemented reasonably well and so the momentum of recovery was not slowed down.

For the current year 1976-77, a new financial program, designed to achieve a rate of growth of between 5 per cent and 7 per cent, will be implemented. For this purpose, a substantial acceleration of investment expenditures is envisaged, a higher level of foreign assistance having been made possible by the continuing improvement in relations with neighboring countries.

In contrast, budget expenditures will be about the same in real terms as in the previous year. Thus the overall budget deficit will be held within appropriate limits, and monetary expansion will not exceed 12 per cent, a rate which appears quite reasonable in the circumstances.

As regards the balance of payments deficit, it is expected to be somewhat larger than in the previous year; it will be necessary to rebuild depleted stocks of consumer goods and to increase imports of equipment in order to achieve the Government's development objectives.

Two other commendable features of the program are the continuing policy to avoid foreign borrowing on hard terms, and the liberalization of the exchange system aimed at stimulating the re-export trade.

To ensure the success of this program, the Yemeni authorities are asking for Fund assistance. In particular they are requesting that SDR 2.5 million of their drawing in May 1975 be reclassified as compensatory on the basis of an export shortfall in calendar year 1974. Should the Executive Board approve this reclassification, the balance in the People's Democratic Republic of Yemen's enlarged first credit tranche would be SDR 5.7625 million, and the Yemeni authorities have requested a purchase equal to that amount.

In line with the wishes of this Board, the staff's reports on the Article XIV consultation and the Yemeni request for the use of the Fund's resources are being presented simultaneously for the critical evaluation of the Executive Directors. My authorities in Aden are in general agreement with the staff's appraisal and proposed decision for the 1976 Article XIV consultation. They also believe that their policies as set forth in their letter of intent of March 8, 1976 amply justify the approval of their request, which I warmly support.

Mr. Hussein wondered whether there was any explanation for the slower than expected recovery of activity in the port of Aden. As for Yemen's request for the reclassification of SDR 2.5 million of a previous purchase in the first credit tranche as a compensatory drawing, a new feature had been introduced in the estimation of the shortfall, which had been neither discussed nor approved by the Executive Board, although its introduction abrogated the definition and procedure for reclassification provided in the Decision on Compensatory Financing of Export Fluctuations. It appeared that the staff had taken the accumulation of stocks in the shortfall year and carried them over into the postshortfall period to deflate the estimated judgmental forecast of the shortfall on the grounds of double compensation. The result had been a reduction of SDR 1.5 million from the judgmental forecast of a shortfall equivalent to SDR 4.0 million.

The approach followed raised a number of procedural and economic issues, Mr. Hussein continued. Paragraph 10 of Executive Board Decision No. 4912-(75/207), adopted December 24, 1975, stated that member countries could request the reclassification of all or part of outstanding drawings as compensatory drawings. It was also stated that the Fund would agree to such requests "if at the time of the drawing under the tranche policies or the extended Fund facility the member could have met the requirements for a drawing of an equal amount under the decision." There was no reference to the method of calculation adopted by the staff with respect to the reclassification of the Yemeni drawing. Moreover, to the best of his knowledge, there had been no mention of stock adjustments at the meeting when the Decision on the Compensatory Financing of Export Fluctuations had been adopted. Also, neither of the explanatory papers issued by the staff on double compensation and on the application of the 1975 decision (SM/76/59, 4/1/76 and SM/76/60, 4/1/76) made any reference to stock adjustments. He failed to understand why the procedure for reclassifying ordinary drawings, as set out in SM/76/76, should have been reversed, especially since reclassification of the full amount of the estimated shortfall of SDR 4 million would not have increased the entitlement of Yemen to draw.

The new approach implicitly meant that commodity stocks were equated with cash on hand, Mr. Hussein observed. The assumption seemed incorrect, for three reasons. First, stock levels and production should be correlated. Second, commodity stocks involved a high degree of uncertainty with respect to their marketability, prices, and quality. Third, it was hard to define what was an adequate level of stocks. In conclusion, he considered that stock adjustments were a departure from both the wording and the spirit of the Executive Board's decision on compensatory financing. It had even been specifically stated in a staff paper on the Sudan's request for a drawing under the decision that "to deduct the value of all the stocks accumulated in 1975 from the judgmental shortfall would not seem appropriate" (EBS/76/211, 5/6/76).

Mr. Zulu said that he shared the concerns expressed by Mr. Hussein and that he would be interested in the answers to the questions raised. The Yemeni economy was clearly fragile at its present stage of development. At the same time, the economy was being restructured and it would be some time before socialized institutions began to yield dividends, although the authorities were determined to make them succeed.

The rate of increase in the capital budget had been greater than that in the recurrent budget in the recent past, Mr. Zulu observed. Infrastructure projects, while they might not yield goods for immediate consumption, nevertheless raised the absorptive capacity of the economy. He hoped that the performance of the refinery and of the fisheries would improve in the better world economic climate, which would also increase demand for Yemen's exports. Greater efforts should be made to rehabilitate agriculture, particularly after the recent flood damage. It might have been more sensible for the authorities to have introduced another three-year development plan, especially as resources were scarce and uncertain in nature. Also, both local and external financing were likely to become greater constraints, the longer the period of the development plan. Recent rates of world inflation, which were not likely to abate, would tend to raise the cost of machinery, materials, and services. The resulting cost overruns on projects might force a scaling down of planned targets.

The authorities of the People's Democratic Republic of Yemen seemed to feel that political pressures ruled out the control of recurrent expenditures, Mr. Zulu commented. Yet, in his view, a moderation in the rate of increase of recurrent expenditures seemed unavoidable. The authorities themselves had stated that there was little room for incresing revenue through taxation. Thus, the control of expenditure remained the only practical tool for the proper management of the economy. The line taken recently on wages and salaries showed that the political risks were probably being exaggerated. He agreed with the authorities that the best way to mobilize savings at the present stage of development was an expansion in the number of commercial bank branches rather than an increase in the rate of interest. Also, there were many forced saving schemes that the authorities could introduce, adapting them to their special circumstances.

Mr. Sein Maung said that his chair was willing to go along with the proposed decisions on the 1976 Article XIV consultation and with the requests for use of the Fund's resources. However, like Mr. Hussein, he wished to draw attention to the new procedure used by the staff in arriving at the compensable shortfall of SDR 2.5 million and to express his reservations on that score.

Mr. Lynch remarked that he agreed with Mr. Zulu on the necessity for dealing with the high level of public expenditure. There had been a large increase in the budgetary deficit between 1970/71 and 1974/75 and 1976, from YD 4.3 million to YD 15.5 million, with the estimate for 1976 being YD 13-14 million. A commendable effort was being made to reduce the deficit, but it was still a high proportion of revenue. The authorities would need to overcome their reluctance to increases in taxation, for which there seemed to be some scope. The economy seemed to suffer from a structural problem of overemployment and low wages, together with a lack of incentive to production, that worked against an increase in savings and revenues. Again, the tendency to overrecruit for the public service was hard to understand since there was virtually no unemployment. Also, too much emphasis was perhaps being placed on infrastructural rather than on productive development.

A more realistic interest rate structure seemed necessary, Mr. Lynch considered. He wondered whether there was an explanation for the apparent inconsistency between SM/76/75--which put the increase in domestic liquidity at 18 per cent, and noted that it was unduly high--and EBS/76/179, in which it was estimated that the increase in domestic liquidity would be 12 per cent, with the comment that the figure was appropriate under present circumstances.

Exchange rate policy was also an area calling for more attention, Mr. Lynch said. Nevertheless, the Yemeni authorities were making commendable attempts to cope with their various problems, and he could go along with the proposed decisions.

Mr. de Vries recalled that the Yemeni economy had suffered from the closing of the Suez Canal and from a loss of receipts when foreign bases on its soil had been closed. The authorities had applied themselves with vigor to the task of adapting to such a fundamental change in the economy and they were to be commended for their achievements within the limits imposed on them. It was therefore a matter of some concern to him to learn from the staff reports that a danger point was being reached in the field of budgetary planning. During the coming year, only half of budgetary expenditure would be covered by receipts, a low percentage. Even the ordinary budget was not covered, yet in the longer term it should be able to provide savings for financing the development effort. The apparent decision to stress the development effort might pose a real danger and lead to the need to reverse expenditure policy. A steady development policy would be far more efficient.

As for the exchange rate policies of the Government, Mr. de Vries recognized that the considerable extent of regulation of the economy meant that the exchange rate might have less influence than it would otherwise have. Nevertheless, the fact that receipts by the Port of Aden had not picked up as quickly as those of other ports since traffic had again begun to flow through the Suez Canal might be related to the exchange rate. Again, the authorities believed that exports were largely determined by the economic decisions of the Government. Yet, as the basic data in Appendix II of SM/76/75 showed, exports had declined steadily since 1971. From 1973 onward, exports had been from one fifth to one quarter below the level of earlier years. The exchange rate might be a greater force than the authorities believed.

Mr. Whitelaw remarked that while the transaction with the People's Democratic Republic of Yemen was a small one, it raised interesting principles. It seemed from the staff report that the Yemeni authorities and the staff thought along the same lines in very few areas. The first point of difference was over the major policy recommendation by the staff that Yemen should make appropriate changes in its foreign exchange policy, one suggestion being that the authorities should consider the need to devalue. The Yemeni authorities rejected an exchange rate adjustment on the grounds that a devaluation would simply result in a substantial increase in the cost of living, that export receipts would not rise, owing to the small export base, and that the demand for most of Yemen's exports was not highly price elastic. There was another difference in relation to raising interest rates. The staff argued that savings would be increased and resources mobilized by an increase in interest rates; it emphasized the beneficial effects of a better allocation of credit under such a market system than could be obtained under the committee structure used in Yemen. But the Yemeni authorities rjected that argument also, primarily because they felt that the interest rate policy could not have a significant impact on savings, owing to the low level of incomes in the country. It would be interesting, he felt, to learn whether the staff had evidence for its recommendations in terms of experience with other developing countries.

A third area where the staff and the Yemeni authorities appeared to differ, Mr. Whitelaw continued, was in that of fiscal policy. The staff felt that ordinary government expenditure should be restrained and taxation increased. On the other hand, the Yemeni authorities were convinced that the burden of taxation was already too high relative to incomes, and that the distinction between public development and ordinary outlays was arbitrary, both being equally important. On the more general issue of direct controls, the staff clearly would favor less reliance on them and emphasized the beneficial results to be achieved in a market system. The Yemeni authorities held the opposite point of view.

He understood the purpose of the Fund to be to provide temporary balance of payments financing, Mr. Whitelaw said. Yemen's balance of payments had been in deficit by almost SDR 25 million in 1974, and by SDR 20 million in 1975. The projection for 1976 was a further deficit of SDR 31 million, as imports were expected to rise by 19 per cent in the current year. The temporary nature of the balance of payments difficulties did not, therefore, seem obvious. If, in the exchange of views between the staff and the Yemeni authorities, the staff view was the right one, he wondered whether the Fund was indeed financing a member's temporary balance of payments deficit or whether it might not be extending development finance. Of course, the primary objective of the Fund's financing was not always easy to state precisely, and some of the Fund's facilities were designed to offer more than temporary financing. Basically, however, the central objective of the Fund should be to finance temporary balance of payments difficulties.

In conclusion, Mr. Whitelaw said that like others he would be interested in the staff's explanation of the method of calculating the shortfall.

Mr. Jagannathan commented that temporary balance of payments assistance to Fund members should not be ruled out, simply because the country also needed development assistance. It should be borne in mind that it took time to mobilize development aid. Also, a country might be short of foreign exchange over a period of years but not at exactly the same level at all times so that there was a case for temporary balance of payments assistance supplementing, during the most difficult years only, a steady stream of development assistance lasting a number of years. For other reasons, such as the reopening of the Port of Aden and an improvement in cotton exports, the shortfall in Yemen's foreign exchange receipts might diminish. Therefore, he supported the proposal for temporary balance of payments assistance by the Fund, although development assistance appeared to be needed as well.

As for the staff estimate of the compensable shortfall, Mr. Jagannathan said that he agreed with Mr. Hussein that it seemed strange to use, as an offset against the judgmental forecast, stocks carried over from the shortfall year. He accepted the point that the stocks had been sold in a subsequent period. However, he saw no justification for taking the receipts of a subsequent period, or the carryover of stocks, as an element which ought to reduce the results of the judgmental forecast. For instance, there might well be two shortfall years in a row in some countries, because of a prolonged recession in demand for its principal export; the stocks carried over from the first shortfall year might, instead of helping the country in the following year, tend only to depress both the export price and the country's earnings in that year as well.

Mr. Zoccali said that, while in general his chair supported the staff appraisal and the proposed drawings, he wished to express the strong reservation of his authorities regarding the methodology used by the staff for calculating the shortfall for the purpose of reclassification.

Mr. Cross said that Mr. Whitelaw had made some pertinent comments in the sense that there did appear to be a marked difference of approach between the Yemeni authorities and the Fund staff as to the appropriate direction of policy in many areas. Of course, the People's Democratic Republic of Yemen was a country with a limited resource base and persistently low rate of growth. The serious problems facing it were spelled out in the staff reports. Nationalization policies had apparently almost eliminated private investment, and there were possibly contraints on the availability of external financing from some neighboring states. He shared the staff's view that impressive progress had been made under difficult circumstances. But he noted that the staff had also expressed dissatisfaction with the reliance on controls and the tendency to push expansionary policies too far. He shared the concern about the low priority accorded to monetary policy, and especially about the reluctance of the authorities to reform the exchange system, the dinar having appreciated for several years past despite the difficulties encountered by the economy. It was not so much a question of whether or not the Fund should provide balance of payments financing--because that was probably appropriate--as of the need for more agreement between the Yemeni authorities and the staff on the best way to extricate the economy from its serious difficulties.

The reclassification of a drawing as compensatory, Mr. Cross continued, seemed to him not only appropriate but necessary. It was hard to see why, in 1976, the Fund should be financing a shortfall for 1974 that had resulted from the accumulation of stocks that had been sold in the intervening period. Perhaps it was the interpretation by the staff of the subsequent sale of stocks as a matter of double compensation that had raised issues which were complicated ones.

The statistical data supporting the request for a compensatory financing drawing covered a considerable time period, Mr. Cross noted. Provision had been made in the Decision on the Compensatory Financing of Export Fluctuations for such a time lag, but he wondered whether there were likely to be other requests where the time lag was so great. Also, the price and volume assumptions underlying the judgmental forecast must have been made in the expectation of a sharp recovery in exports during the second half of 1975, since exports in the first half of the year had been less than in the same period of 1974. Although the world price for cotton had declined, the cotton acreage in Yemen had also declined as a result of the disincentives to cotton production created by internal price policies. The acreage would be further reduced as a result of a conservation program. Reform of the exchange system was also necessary to strengthen the balance of payments position, as suggested in the staff reports.

As other speakers had already pointed out, Mr. Cross said, it was not immediately clear whether such elements had been fully considered in the three staff analyses before the Executive Board. Of course, progress was relative and had to be assessed in the light of the circumstances in which an individual country found itself. Yemen was faced with grave problems that must be taken into account. He shared the concern of the staff about what appeared to an outsider to be an excessive use of controls as a substitute for monetary and exchange policies, together with an inclination to increase fiscal expenditures without accompanying increases in taxes or other revenues. He hoped that the authorities' stringent incomes policy, a modest scaling down of projected current account expenditures, the elimination of broken cross rates and the attention being given to increasing exports were evidence of both an inclination and an ability to pursue even more stringent measures to achieve meaningful economic development, within the obvious domestic and external constraints that existed.

In conclusion, Mr. Cross said that he fully supported the requests for a reclassification of part of an earlier drawing as compensatory and for a first credit tranche drawing. His observations with respect to the compensatory financing drawing had been made simply because of the need to benefit from experience with the operation of the modified decision on compensatory financing.

Mr. Nana-Sinkam commented that it was not clear to him from the staff reports whether the subsequent sale of the cotton stocks had taken place in 1975 or in 1976. There might have been a considerable difference in the calculation of the shortfall, depending on whether the sale had been deducted from the 1975 or from the 1976 cotton exports. Of course, if the subsequent sale of cotton stocks to the value of SDR 1.5 million had taken place in 1974, it was understandable that the deduction should be made from the figures for the shortfall year. The problem of stocks should be considered on a case-by-case basis with all necessary flexibility, and any use of a mathematical model as a framework should be avoided.

Mr. Avillez said that in general his chair agreed with the staff on the need for a reformulation of the Yemeni exchange system as well as of fiscal and monetary policies. On the other hand, he shared the concerns expressed by Mr. Hussein and Mr. Jagannathan about the new approach used by the staff in calculating the export shortfall, based on the judgmental forecast. The Executive Board should be careful in taking it as a precedent because it was a deviation from the spirit of the recently amended decision on compensatory financing. Therefore, he reserved the position of his chair on the matter.

Mr. Kent remarked that the main cause of the export shortfall was of course the failure to sell the cotton crop during a world recession. Yet Yemen was regarded as only a marginal supplier of cotton, and it would be interesting to know whether another factor might not be the exchange system and particularly the way in which the Yemeni dinar had appreciated effectively by rather a large amount. The country was competing with some of its neighbors to provide similar commodities and similar services, such as the facilities of the Port of Aden, and he wondered whether the exchange rate might not be a handicap. The reduction in cotton acreage suggested that there would be little upturn in export earnings from cotton. The future prospects of the economy would thus be largely dependent upon the fish exporting industry, where the Yemeni authorities had been peculiarly successful. Yet other exports and invisible earnings might be encouraged if the exchange rate system were to be liberalized. As usual, it was difficult to compare a managed economy with one where market forces were at work.

In conclusion, Mr. Kent said that it seemed to him that there was a qualitative difference between the calculation of a shortfall when stocks remained unsold and might or might not deteriorate, and one when the stock had actually been sold. He agreed with Mr. Cross that it was right to take such sales into account in making the final calculation, however it was presented. He supported the proposed decisions.

The staff representative from the Middle Eastern Department, in response to Mr. Whitelaw's observations, said that it was true that the staff differed with the Yemeni authorities on certain aspects of Yemen's economic policy. However, the staff admired what the authorities had tried to do in their own way and what they had accomplished in very difficult circumstances. The differences Mr. Whitelaw had referred to had been substantially narrowed in the financial program that was to be implemented in 1976/77. The program aimed at achieving an increase in the growth rate, but at the same time it included measures of restraint designed to check inflationary pressures. In particular, the country's stringent incomes policy was to be continued. Ordinary expenditures were not to rise in real terms above the level of the previous year. Ceilings on the budget deficit and domestic credit expansion were to be observed and the increase in money and quasi-money envisaged in the program was quite reasonable. The authorities would continue their policy of avoiding foreign borrowing on hard terms and they would introduce various other measures to improve the balance of payments position in the medium term. Moreover, they had liberalized the foreign exchange system to some extent with a view to stimulating the re-export trade. All things considered, the staff felt that the program constituted a commendable effort fully deserving Fund support in the first credit tranche.

In response to specific questions, the staff representative said that a three-year rather than a five-year development plan might have been preferable in difficult and changing circumstances, as Mr. Zulu had suggested. However, it was reassuring that the authorities were implementing their development plan flexibly, with annual reviews that took into account all relevant factors, and in particular external assistance.

On interest rate policy, the staff representative noted that over the past three years deposit rates had remained unchanged in the range of

3.5 per cent to 6 per cent, while prices had increased substantially, the cost of living having risen by about two thirds. That situation had discouraged depositors and, as a result, time and savings deposits had declined appreciably as a fraction of domestic liquidity. Inflation had been reduced to about 7 per cent and it might well continue at about the same level in the foreseeable future. The staff felt, therefore, that a significant increase in the interest rate structure at the present juncture would yield depositors a positive return in real terms, and that might possibly revive interest in time and savings deposits if sustained over a sufficiently long period of time. However, the Yemeni authorities were of the view that the impact of changes in interest rates could only be marginal in an economy where the level of income was so low that there was no scope for savings.

On the question of exchange rate policy, the staff representative agreed with Mr. de Vries' observation that a reform of the foreign exchange system might have a beneficial impact on foreign exchange receipts. One of the principal objections raised by the Yemeni authorities was that the method would not work in a socialist economy. However, in the view of the staff, the private sector and the profit motive were still very much in evidence in Yemen. Recently, there had been a strike by fishermen protesting low pay for the catch they surrendered to the state. According to an IBRD agricultural expert, owing to the inadequate return paid to cotton farmers, cotton was not always fully picked. Emigrant remittances--Yemen's largest source of foreign exchange receipts--were presently lower than they had been a few years ago; it appeared that Southern Yemenis working abroad were sending a considerable fraction of their funds to Northern Yemen. The staff therefore felt that a reform was a necessary though perhaps not a sufficient condition for increasing foreign exchange earnings. However, the suggestion of a devaluation had been based on observations the mission had been able to make in Aden in February. The authorities were now hopeful that they would discover petroleum in large quantities; furthermore, Yemen might receive substantial financial assistance following the recent rapprochement with Saudi Arabia. Thus, the suggestion might need to be reconsidered.

In reply to the question by Mr. Hussein about the Port of Aden, the staff representative said that in 1966, before the closure of the Suez Canal, 6,000 ships, with a total tonnage of 31.5 million, had called at the port. Traffic had declined continually thereafter; by 1974, the number of ships had fallen to 1,250 and their total tonnage to 5 million. The Suez Canal had been reopened in June 1975 and in that year 1,450 ships totaling 6 million tons had called at Aden. The reasons for the small recovery were not entirely clear. The prevailing view appeared to be that technological advances since 1966 had been unfavorable to the Port of Aden. For instance, ships now bunkered at the ports where they loaded and discharged cargos and did not need to shop at intermediate points. Furthermore, Aden could not handle large ships. IDA and the

Arab Fund were jointly financing a US$17 million rehabilitation project, which included the replacement of equipment as well as dredging to enable the Port of Aden to service ships of up to 54,000 tons. According to projections made by the World Bank staff, Aden's traffic would regain the 1966 level by 1980.

In response to Mr. Cross, the staff representative said that exports had indeed been low in the first half of 1975, but in all likelihood they had increased substantially in the second half. It was known that in the latter period the Yemenis had started exporting both cotton stocks accumulated in 1974 and the 1975 cotton harvest; moreover, production of the new fishmeal and fish oil plant was believed to have picked up considerably.

The staff representative from the Exchange and Trade Relations Department, responding to the general question raised by Mr. Whitelaw about whether granting the first credit tranche drawing requested by Yemen was consistent with the Fund's general policies, stated that the improvement in policies reflected in the letter of intent constituted a reasonable effort, in the view of the staff. True, the staff had differed from the Yemeni authorities in a number of areas. In particular, the staff believed that greater attention to exchange rate policy would serve to strengthen the balance of payments. The Yemeni authorities, on the other hand, had argued that their difficulties were largely due to special circumstances and that their present policies would help them to overcome their difficulties in the medium term. As noted on page 4 of the staff report (SM/76/75) the authorities believed that the prospects for recovery were encouraging and that the development effort had laid the foundation for an upswing. Relations with neighboring countries were improving. Also, there would be a further stimulus to the economy if the Government was successful in its efforts to mobilize the private sector. It was the Fund's policy for drawings in the first credit tranche to give the benefit of the doubt to the member in certain areas, if the Fund was satisfied that the country was on the whole making a reasonable effort. It was on that basis that the request by Yemen had been presented to the Executive Board.

The staff representative from the Research Department, in reply to a question by Mr. Cross regarding the lengthy interval between the end of the shortfall year and the request for reclassification, explained that Yemen had access to the compensatory financing facility with export data 16 months in arrears because the time limit for reclassification had been extended in Executive Board Decision No. 4912-(75/207) from 6 to 18 months. The existence of that time limit meant that no future requests would be based on data that was more than two months further in arrears than the data submitted by Yemen.

As Mr. Hussein had stated, the staff representative continued, neither the 1975 decision nor the staff paper on its application (SM/76/70) contained any provision regarding adjustments for variations in the level of inventories. The problem of stocks had, however, been discussed in the Executive Board as recently as April 1, 1976 (EBM/76/56), when the Philippines had requested a compensatory drawing. At that time, the staff had explained that even if an adjustment had been made for the increase in sugar inventories during the shortfall year, the adjusted shortfall would still have been greater than the requested drawing, which was equivalent to 50 per cent of quota. The case of Yemen was different because the adjustment for stocks did affect the member's entitlement.

It was clear from Table 4 of EBS/76/178, the staff representative noted, that the sharp fall in cotton exports in 1974 was largely responsible for the shortfall on which the request was based. The cotton shortfall amounted to SDR 2.54 million, or almost two thirds of the overall shortfall of SDR 4 million. Export earnings from cotton had fallen so sharply, partly because of the size of the crop, but mainly because only a fraction of the available production had been sold in 1974. According to staff estimates, 700 tons had been exported in 1974, while inventories had increased by 1,800 tons. Allowance had been made for a 700 ton cotton reserve in anticipation of the needs of a textile plant that started production in 1976. The inventory of 1,800 tons was worth slightly less than SDR 1.5 million at 1974 prices and slightly more at 1976 prices. For the sake of simplicity, therefore, it could be assumed that earnings foregone in 1974 by the accumulation of stocks, and earnings from the sale of stocks in 1976, were both equal to SDR 1.5 million. On that assumption, the actual shortfall of SDR 4 million could be compared with the shortfall that would have been experienced by Yemen if no stocks had been accumulated in 1974. If an additional 1,800 tons had been sold in 1974, earnings would have increased from SDR 0.6 million to SDR 2.1 million. On the other hand, since 1,800 tons less would have been sold in 1975 and 1976, the sum of earnings realized during those two years would have been reduced from SDR 6.0 million to SDR 4.5 million. The shortfall would therefore have been reduced by exactly SDR 1.5 million. Yet the norm calculated as a five year average obviously would not have been affected by the sale of SDR 1.5 million less in one of the five years and of SDR 1.5 million more in another of those five years. Since the shortfall was defined as the excess of the norm over 1974 earnings, increasing the latter by SDR 1.5 million would have reduced the shortfall by the same amount. However the calculations were made, the results would be the same. Under the assumptions used, the effect of the stock adjustment was to reduce the aggregate shortfall from SDR 4 million to SDR 2.5 million.

Making the appropriate adjustment for changes in inventories might often raise difficult problems, the staff representative added, but in the particular case before the Executive Board those problems could be solved relatively easily. For instance, Mr. Hussein had said that stocks were not equivalent to ready cash. It was true that in general it was difficult to foresee when stocks accumulated during the shortfall year would be sold. The staff understood that Yemen's stocks had already been sold. By analogy with the buffer stock facility, the Fund could assist a member holding stocks; for Yemen, such assistance would have been represented by the SDR 1.5 million component of its May 1975 drawing in the first credit tranche. Once the stocks had been sold and the member had received foreign exchange, it would have been asked to repurchase promptly; the reduction of SDR 1.5 million in the amount reclassified as compensatory could be viewed in that light.

Another point made by Mr. Hussein, the staff representative recalled, was that the full amount of the stock increment should not have been deducted, since the staff had argued in the case of the Sudan that such a deduction would have unduly penalized the member. That argument had been made for the Sudan because the high level of carryover stocks had induced a reduction in the output of cotton during the postshortfall years. There was no evidence in Yemen that cotton production in 1975 and 1976 had been reduced on account of large carryover stocks.

As for the valuation of the stocks, the staff representative stated that it had been facilitated by two factors. First, Yemen was clearly a price taker. Selling 1,800 tons more in 1974 and 1,800 tons less in 1975 or 1976 would not have affected the level of world prices. Second, prices received by Yemen had not changed substantially over the period under consideration. They had increased from about SDR 800 per ton in 1974 to SDR 880 per ton in 1976. The choice of price was therefore of minor importance. Nevertheless, as a matter of principle, it would be appropriate to apply a weight of 0.8 to the price of the shortfall year and a weight of 0.2 to the price of the postshortfall years, since those weights had been applied in the calculation of the shortfall.

To conclude, the staff representative explained why the deduction had been made from the judgmental shortfall and not from the formula shortfall. As could be seen from the formula presented in footnote 1 of Table 3 of EBS/76/178, the 1974 earnings of SDR 7.9 million appeared in the numerator of the fraction. The accumulation of stocks in 1974 reduced the level of 1974 earnings, hence the extrapolated value of the 1975-76 earnings. In actual fact the opposite occurred because stocks accumulated in 1974 had been available for sale in 1975 and 1976. To avoid that perverse effect of the extrapolation formula, the deduction had been made from the judgmental shortfall, which took into account the increased export availability in 1975-76 resulting from the accumulation of stocks in 1974.

Mr. Caranicas thanked Executive Directors for their comments and good wishes. As for the remarks that had been made about the rather complex question of the method of calculating the shortfall, which had brought down the level of the shortfall from SDR 4 million to SDR 2.5 million, at the outset of the discussion he had reserved the position of his chair until the issue could be discussed more fully. After the exchange of views and the explanations of the staff on the problem of stocks, he had no difficulty in accepting the reduction of SDR 1.5 million in the amount being reclassified as compensatory.

The economic circumstances of the People's Democratic Republic of Yemen were almost unique, Mr. Caranicas considered. On acquiring independence in 1967 the country had suffered a great reduction in income as a result of the withdrawal of British forces and the closure of the Suez Canal in the same year. Moreover, the country was almost devoid of natural resources, although, as the staff representative had mentioned, the authorities hoped to find oil. Therefore, the Government had been making serious efforts to diversify the economy and to introduce a new social and economic framework emphasizing social equality and giving the state a dominant role in economic activities. An economy where economic activities were exclusively in the public sector had to be evaluated somewhat differently from a market economy.

In response to Mr. Whitelaw's comments about the role of the Fund in assisting a member country whose needs might seem to call for longer-term aid rather than temporary balance of payments assistance, Mr. Caranicas stressed that all the Fund's consultations with its members were designed to permit the staff and national authorities to exchange views on appropriate policies in an effort to help countries overcome their difficulties. There were several points where the staff and his authorities did not think alike. The general philosophy of the Yemeni authorities made certain measures politically unacceptable to them. As the staff itself had noted in its appraisal (SM/76/75), a small increase in interest rates "would prove ineffective and a large one might be politically difficult." Certainly, as Mr. Zulu had observed, the Yemeni authorities had accepted a regime of great austerity with respect to wages and salaries. But in the final analysis, it must be left to the judgment of national authorities to decide what was politically feasible. Again, the Yemeni authorities were aware of the disadvantages of their exchange system but, in their judgment, the time had not yet come to proceed to its reform, and no doubt in a socialist economy the effects of any exchange rate action were blunted.

In conclusion, Mr. Caranicas drew attention to the letter of intent from the Minister of Finance, in which all the matters raised during the discussion had been touched upon and the lines of policies clearly delineated. Moreover, it had been promised that if those policies were not producing the desired results, the Yemeni authorities would consult with the Fund regarding appropriate additional measures so as to fulfill the program's objectives.

The Executive Directors then turned to the proposed decisions.

Mr. Jagannathan remarked that, although he had no difficulty in going along with the proposed decisions, he wished to reserve his opinion on the method of calculating the shortfall. The request from Yemen was not typical, because the compensable amount was being determined long after the shortfall year. He understood that the cotton stocks had not been sold until 1976. It was unclear to him what would have happened if the stocks had not been sold by the time the request came before the Executive Board and whether the determining element would then have been the net increase in stocks or the net increase in the normal carryover from year to year. His reservation was therefore being made in general terms and not specifically with respect to the Yemeni request, where those points did not arise.

Mr. Sein Maung asked for a short note on the treatment of stocks under the Decision on the Compensatory Financing of Export Fluctuations, to assist the Executive Board in its consideration of future requests.

The Executive Directors approved the proposed decisions.

The decisions were:

a. 1976 Article XIV Consultation

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.

Decision No. 5070-(76/73), adopted
May 10, 1976

b. Purchase Transaction - Compensatory Financing

1. The P.D.R. of Yemen has requested, under paragraph 10 of the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 4912-(75/207), adopted December 24, 1975), that the equivalent of SDR 2.5 million of the purchase equivalent to SDR 7.25 million to which the Fund agreed by Executive Board Decision No. 4666-(75/82), adopted May 16, 1975, be reclassified and treated for all purposes of the Decision on Compensatory Financing of Export Fluctuations as a purchase under paragraphs 2, 3, and 4 of that Decision.

2. The Fund agrees to the request.

Decision No. 5071-(76/73), adopted
May 10, 1976

c. Purchase Transaction - First Credit Tranche

The Fund has received a request by the Government of the P.D.R. of Yemen for a purchase of the equivalent of SDR 5.7625 million. The Fund grants the necessary waiver of the conditions of Article V, Section 3(a)(iii) of the Articles of Agreement and agrees to the requested purchase on the repurchase terms set forth in the communication of the Government of the People's Democratic Republic of Yemen dated May 2, 1976, reproduced in EBS/76/179, Supplement 1.

Decision No. 5072-(76/73), adopted
May 10, 1976

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executice Directors without meeting in the period between EBM/76/72 (5/5/76) and EBM/76/73 (5/10/76).

2. NEPAL - GOLD TRANCHE PURCHASE TRANSACTION

Nepal is making a gold tranche purchase in an amount equivalent to SDR 3,109,854 in Norwegian kroner pursuant to its request dated May 5, 1976. The Fund notes Nepal's request, including its representation in accordance with Article V, Section 3(a)(i), and its statement that it will comply with the principles set forth in Executive Board Decision No. 102-(52/11), adopted February 13, 1952 (EBS/76/210, 5/6/76).

Decision No. 5073-(76/73), adopted May 6, 1976

3. VALUE DATES FOR TRANSFERS OF CURRENCIES

In the last sentence of paragraph 2 of Executive Board Decision No. 3637-(72/41) G/S, adopted May 8, 1972, the words "two business days" shall be replaced by "three business days" (EBS/76/200, 4/29/76).

Decision No. 5074-(76/73) G/S, adopted May 5, 1976

4. JORDAN - DEVELOPMENT CONFERENCE - FUND REPRESENTATION

The Executive Board approves Fund representation at the Jordan Development Conference to be held in Amman, Jordan, as set forth in EBD/76/86 (4/30/76).

Adopted May 5, 1976

5. <u>EXECUTIVE BOARD TRAVEL</u>

Travel by Executive Directors and by an Advisor to an Executive Director as set forth in EBAP/76/106 (5/4/76), EBAP/76/108 (5/6/76), EBAP/76/109 (5/6/76), and EBAP/76/110 (5/6/76) is approved.

APPROVED BY THE EXECUTIVE BOARD:
Meeting 76/128, August 25, 1976

WILLIAM B. DALE
Acting Chairman

JOSEPH W. LANG, JR.
Acting Secretary