FOR AGENDA

EBS/76/179

CONFIDENTIAL

April 20, 1976

To: Members of the Executive Board

From: The Secretary

Subject: People's Democratic Republic of Yemen - Use of Fund Resources - First Credit Tranche

Attached is the staff's analysis and recommendation with respect to a request received from the People's Democratic Republic of Yemen for a purchase in the first credit tranche. 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 the staff report for the 1976 Article XIV consultation with the People's Democratic Republic of Yemen (SM/76/75), will be brought to the agenda for discussion on a date to be announced.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

People's Democratic Republic of Yemen - Use of Fund Resources

Prepared by the Middle Eastern Department and the Exchange and Trade Relations Department[1]

(In consultation with Legal and Treasurer's Departments)

Approved by John W. Gunter and Subimal Mookerjee

April 19, 1976

I. Introduction

In the attached letter dated March 8, 1976, the Government of the P.D.R. of Yemen has requested a purchase from the Fund equal to the balance in its enlarged first credit tranche. This would amount to SDR 5.7625 million, should the Executive Board approve the P.D.R. of Yemen's request that SDR 2.5 million of its May 1975 purchase be reclassified as compensatory (see EBS/76/178). A waiver of the conditions of Article V, Section 3 (a)(iii) will be required. Prior to making this purchase the P.D.R. of Yemen will consult with the Managing Director regarding the currencies to be purchased.

The P.D.R. of Yemen purchased in August 1974 the balance in its gold tranche equivalent to SDR 3.75 million and in May 1975 it made a first credit tranche purchase equal to SDR 7.25 million. Under the 1974 and 1975 Oil Facilities it purchased SDR 11.8 million and SDR 12.02 million, respectively. Following the proposed purchase, the Fund's holdings of Yemeni dinars would rise to 227.0 per cent of quota of which 82.1 per cent will correspond to the Oil Facilities and 8.6 per cent to the Compensatory Financing Facility. As a participant in the Special Drawing Account, the P.D.R. of Yemen has received allocations totaling SDR 9.9 million; currently, its holdings amount to SDR 3.3 million, or 32.9 per cent of net cumulative allocations. No par value has yet been established for the Yemeni dinar; the dinar is pegged to the U.S. dollar at the central rate of YD 1 = US$2.89524.[2]

II. Recent Economic Developments

Recent economic developments have been described in detail in the staff report on the 1976 Article XIV consultation (SM/76/75) and the accompanying background paper (SM/76/76). As indicated in these reports, one of the basic economic problems confronting the authorities has been that of a low rate of growth. In order to revive and develop the economy, the Government

1/ A staff mission consisting of Messrs. A. S. Gerakis, S. Thayanithy and S. M. Nsouli and Mrs. M. M. Redman (all of MED), Mr. Z. Iqbal (ETR) and Mr. S. Al-Khuri (YPP) conducted from February 13 to February 18, 1976 the negotiations for the use of Fund resources which provided the basis for this paper.

2/ The representative rate now in force is YD 1 = US$2.886.

has stepped up both investment and ordinary budgetary expenditures. At the same time, it has applied a stringent incomes policy and comprehensive controls. A measure of success in very difficult circumstances has thus been achieved in reducing the level of unemployment and laying the foundation for sustained economic growth in the near future, while monetary expansion has been generally held within acceptable limits. However, the balance of payments position has been weak ever since the country's independence in 1967 and has deteriorated in 1974-75 owing to sharp increases in import prices; the external sector has thus increasingly become a constraint on economic growth and the development effort.

III. The Financial Program for 1975/76

In support of its May 1975 drawing in the first credit tranche, the P.D.R. of Yemen drafted a financial program for 1975/76. Although complete data are not yet available, the performance under the program can be appraised on the basis of the monetary statistics for the first half of the program year and the most recent projections of the authorities for the full 12 months. In order to avoid confusion, it should be noted here that this program and the following one in 1976/77 do not coincide with Yemeni fiscal years. The financial programs cover 12-month periods ending in March 1976 and 1977, respectively. Through 1974/75 the fiscal year ended in March also, but beginning in 1976 it will be the same as the calendar year. Interim (investment and current) budgets were implemented in the last three quarters of 1975.

The budgetary, credit and monetary provisions of the program (see Tables 1 and 2) were implemented reasonably well even though some of the underlying assumptions were not realized.1/ The authorities intended to hold current budget expenditures to the level of the previous year, which at the time the program was negotiated (January 1975), was forecast at YD 26 million but, according to provisional data which have become available recently, turned out to be YD 27.45 million. It is now estimated that current expenditures were YD 29 million in 1975/76, the main reason why they exceeded their target being that it became necessary to grant a 5 per cent increase in the take-home pay of government employees. As a result, the current budget deficit and total Treasury recourse to the banking system (including financing of the investment budget) also proved higher than their respective ceilings. In contrast, domestic credit expansion was considerably less than projected. However, since the balance of payments deficit was much smaller than forecast, the actual increase in domestic liquidity (money and quasi-money) amounted to 13 per cent, rather than the expected 8 per cent.

1/ For example, it had been assumed that import prices would rise in 1975/76, but they in fact declined (see p. 5).

Table 1. Budgetary Provisions of Financial Programs and 1976 Budget

(In millions of Yemeni dinars)

	1975/76 Program	1975/76 Latest Projections	1976 Budget Estimates	1976/77 Program
Current budget deficit	10.0	12.0	18	14.0
Expenditures	(26.0)	(29.0)	(36)	(32.0)
Revenues	(16.0)	(17.0)	(18)	(18.0)
Bank financing of investment budget	2.0	1.0	2	2.0
Total bank-financed deficit	12.0	13.0	20	16.0

Sources: Bank of Yemen and Ministry of Finance.

The financial program included a number of other provisions which were also carried out. In particular, the P.D.R. of Yemen reduced subsidies on essential items. There was no borrowing abroad on commercial terms and the country limited itself to utilizing concessionary assistance. Energy saving measures adopted earlier were maintained. Furthermore, no multiple currency practices were introduced, nor were restrictions on trade and payments introduced or intensified.

Table 2. Factors Affecting Domestic Liquidity

(In millions of Yemeni dinars)

Changes in	1975/76 Program Targets	1975 Actual Mar.-Sept.	1975/76 Provisional Estimates	1976/77 Program Targets
Foreign assets (net)	-15.0	-1.6	-10.0	-13.0
Domestic credit (net)	19.6	6.8	17.3	21.0
Claims on Government (net)	12.0	7.6	13.0	16.0
Claims on nongovernment sector	8.0	-1.9	3.0	5.0
Other items (net)	-0.4	1.1	1.3	--
Domestic liquidity	4.6	5.2	7.3	8.0
Money	(...)	(3.7)	(...)	(...)
Quasi-money	(...)	(1.5)	(...)	(...)
Growth rate of domestic liquidity (in per cent)	8.0	9.0	12.6	12.0

Sources: Bank of Yemen and Ministry of Finance.

IV. The Program for 1976/77

1. Main objectives

Following the expiration of the program described above, the Government intends to implement a new program over the ensuing 12-month period in 1976/77 ending on March 31, 1977 in support of a purchase of the balance in its first credit tranche. Consistently with the overall objectives of the P.D.R. of Yemen's economic policy, this new program will seek to further accelerate budgetary expenditure in order to achieve a growth rate of 5-7 per cent. The balance of payments deficit is to be limited to YD 13 million (SDR 31 million). Ceilings will be observed with respect to the budget deficit and domestic credit to ensure that monetary expansion will not exceed 12 per cent.

2. Fiscal policy

Although the investment budget for 1976 provides for development expenditures of YD 45.5 million, the authorities believe that actual outlays in 1976/77 will be of the order of YD 35 million, which would still represent a substantial rise over the annual rate of about YD 24 million probably implemented during 1975/76. This high level of expenditure will be made possible by the expected increase in foreign aid and, to a lesser extent, a larger volume of nonbank domestic resources; bank financing of the investment budget will not be more than YD 2 million. If foreign assistance proves less than projected, the authorities intend to scale down development expenditure accordingly.

The authorities have reconsidered the current budget estimates for 1976 and they intend to reduce expenditures below the original level of YD 36 million. Their financial program envisages that current outlays will amount to YD 32 million in 1976/77, i.e., to 10 per cent more than the figure of YD 29 million estimated to have been spent in 1975/76. However, taking into account the inflationary trend,[1/] there will be little or no increase in real terms during the program year. Although the civil service will be expanded, inter alia to staff completed development projects, the intention is to continue the extremely austere wage policy followed since 1972 (see SM/76/75, p. 3 and SM/76/76, pp. 16-17) and not to grant any general wage raise to employees in the public sector. An effort will also be made to further reduce (extrabudgetary) subsidies. If the international prices of essential foodstuffs decline during the program year, controlled consumer prices will not be reduced pari passu.

In the belief that the burden of taxation is already too high, no new taxes are to be imposed in 1976/77. Current revenues are nevertheless projected to rise by YD 1 million over the level of YD 17 million in 1975/76 reflecting a pickup in economic activity and the continuing improvement in collection procedures. It should be noted that the total of YD 18 million

---

1/ Wholesale prices increased by 40.7 per cent in 1974 and 14.3 per cent in 1975; the cost of living rose by 24.3 per cent and 6.6 per cent in 1974 and 1975, respectively.

forecast for 1976/77 is the same as the (record) amount realized in 1974/75. The absence of any discernible upward trend in revenues is partly due to statistical reasons: receipts normally shown in the budget seem to have been increasingly channeled into extrabudgetary accounts, such as the account for consumer subsidies.1/ In a more real sense, revenue growth has been stymied by the fact that the volume of imports has not increased in recent years and that the consumer or development goods actually imported are either exempt from tariffs or subject to very low rates; in addition, exemptions from excise and customs duties have been granted to newly established industries participated in by the private sector.

Given the above limitation on expenditures as well as the forecast for revenues, the financial program envisages a current budget deficit of YD 14 million and total Treasury reliance on the banking system (including financing of the investment budget) equal to YD 16 million. The comparable deficits in 1975/76 are estimated at YD 12 million and YD 13 million. Those implied by the 1976 budget, which were a source of concern to the mission in the course of the Article XIV consultation, were YD 18 million and YD 20 million, respectively.

3. Credit and monetary provisions

In light of their plans for exports, imports and other activities, the Yemeni authorities estimate that the credit requirements of the nongovernment sector in 1976/77 will amount to YD 5 million. Domestic credit expansion will therefore amount to YD 21 million, as compared with YD 17.3 million in 1975/76.2/ Assuming a balance of payments deficit of YD 13 million, domestic liquidity will register an increase of YD 8 million or 12 per cent. Such a rate of monetary expansion seems appropriate considering the growth objective of 5-7 per cent,3/ the expected rise in import prices and continued monetization of the economy.

4. The external sector

It was mentioned above that the balance of payments deficit in 1975/76 (SDR 24.7 million) was smaller than forecast at the beginning of the year (SDR 36 million). This was made possible by cutting back allocations for imports through the state trading companies; in addition the average import unit value declined by 3 per cent instead of rising by 7 per cent as had been assumed by the authorities. Stocks of imported commodities have now been drawn down to levels regarded as inadequate and the Government plans to

1/ Almost no information on these accounts was made available to the Fund mission.

2/ It is assumed, also, that there will be no change in "other items."

3/ As defined in the Letter of Intent, the growth rate relates to GNP excluding output of the B.P. Refinery. In present circumstances the P.D.R. of Yemen receives more or less constant amounts in taxes, salaries and fees, regardless of fluctuations in the refinery's production of petroleum products. Therefore, in determining the safe limits of monetary expansion, it seems appropriate to focus on a concept of GNP which disregards the refinery.

allow an increased inflow of consumer goods in 1976/77 to avoid the emergence of shortages and an increase in the cost of living. Higher imports of raw materials and equipment will be also needed if the targeted growth rate is to be attained. Furthermore, prices are projected to rise by about 3 per cent over the program period. Therefore, total imports are likely to increase by 19 per cent in 1976/77. While domestic exports will probably register significant gains, receipts from services, transfers and capital are not expected to be much larger than in the previous year. These factors explain why the Letter of Intent assumes a widening of the balance of payments deficit (to SDR 31 million) in the program year.1/

The P.D.R. of Yemen is pursuing various policies aimed at strengthening the external sector in the medium term. It is hoped that in part this can be achieved through adaptations in the development program. Although the export base is still small, an effort is underway to enlarge it through sizable investments in the dynamic sector of fisheries; the fishing fleet is being increased, additional refrigeration and other facilities are being built and new fishmeal and fish oil plants are being constructed or expanded. In the agricultural sector, a major conservation and irrigation project is being carried out in order to eventually increase cotton acreage and exports, while every effort is being made to step up production and reduce imports of cereals and other foodstuffs. In industry, the Government is establishing small factories of the import-substituting variety, such as food processing and textiles. Moreover, the facilities of the Port of Aden are being improved and exploration for minerals has been speeded up. Several steps have been taken to encourage the entrepot trade. For example, foreign firms have been allowed to establish tax exempt branches both for sales and for manufacturing in the free zone area; the authorities have also started to grant local traders credit facilities in foreign exchange for a period of up to six months in order to finance imports for re-export. It should also be noted in this connection that there are prospects of increased external assistance as a result of improving relations with neighboring countries.

With respect to foreign debt management, the financial program continues the previous policy of relying primarily on grants and loans on concessionary, rather than hard, terms. Such assistance will be available in 1976/77 from multilateral agencies, in particular the Arab Fund, the Abu Dhabi Fund and IDA, as well as from certain friendly countries. Short- or medium-term loans on commercial terms will be contracted only if total concessionary inflows fall short of requirements for the development plan. However, the Government will do so only for projects expected to generate a flow of foreign exchange earnings more than sufficient to cover service payments.

1/ The deficit of SDR 31 million mentioned above for 1976/77 is the same as the deficit for calendar year 1976 given in SM/76/76. The authorities believe that there will not be any significant difference in the balance of payments outcome as between these two periods.

The authorities have taken steps to improve their exchange and trade system, for instance by increasing interest rates on nonresident accounts in order to attract remittances from abroad and by eliminating broken cross rates for most quoted currencies; broken rates remain for only a few currencies which cover a very small part of total foreign exchange transactions. In the attached letter, the P.D.R. of Yemen undertakes not to introduce multiple currency practices or restrictions on trade and payments for current international transactions, nor will it intensify existing restrictions.

V. Staff Appraisal

Over the 12 months ended in March 1976, the P.D.R. of Yemen implemented its financial program reasonably well. While the budgetary provisions of the program were exceeded to some extent, net domestic credit of the banking system increased significantly less than had been envisaged. The balance of payments deficit was considerably smaller than projected and a steep decline in reserves was thus avoided. As a result, however, monetary expansion was larger than its target.

A new financial program has been drafted for the following 12 months. Like its predecessor, this program accommodates the Government's desire to revive and develop the economy, but it also seeks to keep aggregate demand within the limits of available resources. With the latter objective in mind the authorities will continue their extremely stringent incomes policies aimed at containing private consumption. Insofar as government consumption is concerned, the 1976 budget estimates have been reconsidered and current expenditures scaled down so that in real terms they will not exceed by much the level of the previous year; thus the current budget deficit and total Treasury reliance on the banking system, including financing for the investment budget, will be held to an appropriate level. As a result, and taking into account expected balance of payments developments, monetary expansion is to be limited to 12 per cent, a figure which the staff believes is reasonable in the circumstances of the case.

With respect to the external sector, the program assumes that the deficit in 1976/77 will be larger than in the previous year. This is necessary in view of the fact that over a protracted period the economy had been starved for imports; the authorities are prepared to allow some drawdown in their gross reserves which are presently equal to about three months' imports. Several steps are being taken to improve the balance of payments position in the medium term. They include well conceived adjustments in the development plan to achieve an increase in foreign exchange receipts. The energy saving measures adopted earlier are being continued. Furthermore, certain new policies have been initiated in an attempt to stimulate the re-export trade.

All things considered, the Yemeni program constitutes, in the view of the staff, a "reasonable effort." It is likely to contribute toward an improvement in the present difficult situation in the P.D.R. of Yemen, all the more so as the authorities intend to review it continually and make necessary adjustments in their policies to ensure its successful implementation. The program's principal weakness is that it does not contain a reform of the foreign exchange system. The staff believes that such a reform is necessary in order to strengthen the balance of payments so that it can provide a sound framework for growth and development.

VI. Recommendation

On the basis of the above assessment the following decision is submitted for consideration by the Executive Directors:

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, Sections 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 , 1976, reproduced in EBS/76/179, Sup. 1).

ATTACHMENT

LETTER OF INTENT

8th March, 1976

The Managing Director,
International Monetary Fund,
Washington, D.C. 20431
U.S.A.

Dear Mr. Witteveen,

1. For several years until the end of 1974, the P.D.R. of Yemen experienced a severe recession as well as balance of payments difficulties due to factors beyond its control such as the closure of the Suez Canal, unfavorable weather conditions for agriculture, a very small volume of external assistance and recent inflationary conditions in world commodity markets. In dealing with these problems we substantially increased investment expenditures within the framework of our development plans. These plans, particularly the Second Five-Year Plan, which is being implemented now, stress infrastructure together with small, quick-yielding projects in the sectors of agriculture and fisheries having a direct impact on the balance of payments. At the same time, we made a strong effort to increase savings in the economy. We have tried to reduce private consumption expenditure in real terms mainly through stringent incomes policies. Following the cuts in wages and salaries in 1972, the Government granted only minor increases, except for certain allowances to professionals designed to stem the tide of emigration of highly skilled personnel. These increases were substantially less than the rise in the cost of living. The Government provided subsidies for a few essential commodities, but even the prices of these items were adjusted upwards.

2. During 1974 and 1975, the P.D.R. of Yemen sought and obtained assistance from the Fund in the first credit tranche and under the Oil Facilities. In connection with these drawings we agreed on a financial program for the 12-month period ending March 31, 1976. The program, which was outlined in our letter dated February 27, 1975, is being implemented. Thus, in the six-month period ended September 30, 1975, the increase in domestic credit was about YD 5 million, i.e., half the annual rate which had been envisaged. However, monetary expansion was of the order of 9 per cent mainly because the balance of payments deficit proved much smaller than expected. Moreover, it became necessary to grant an increase in the take-home pay of wage and salary earners, which averaged only 5 per cent.

3. During the 12 months from April 1, 1976 through March 31, 1977 the Government will continue these policies. Two of our major objectives will be to achieve a growth rate of 5-7 per cent in GNP (excluding output of the refinery) and to accelerate development expenditures appreciably. While we intend to contain the balance of payments deficit as much as possible, we do not believe that it can be reduced below YD 13.0 million (SDR 31 million) in view of the expected further inflation of import prices.

Recognizing that the growth of domestic liquidity (money plus quasi-money) should be appropriately managed so as to avoid a buildup of excess demand pressures, we will hold the increase in domestic credit (the banking system's net claims on Government and its gross claims on the nongovernment sector) to YD 21 million. Thus, monetary expansion will not exceed YD 8.0 million or 12 per cent, a rate which appears reasonable given our growth projection, the expected rise in import prices and further monetization in the economy. The Government will review its financial policies continually and make necessary adjustments so as to ensure the achievement of the objectives of the program. In support of this program, the P.D.R. of Yemen is requesting a purchase from the Fund equivalent to the balance in the first credit tranche, due allowance being made for a possible reclassification of our drawing in May 1975. Before making the purchase under this request, the Government will consult with the Managing Director on the particular currencies to be purchased from the Fund. In addition, the P.D.R. of Yemen intends to approach the Fund for any other financial assistance it may be eligible to receive.

4. In line with the objectives indicated in the preceding paragraph, actual development expenditures in 1976/77 are expected to be YD 35 million. These expenditures are to be mainly financed by foreign assistance and certain noninflationary domestic resources such as the after-tax profits of public sector enterprises and contributions of Yemenis; bank financing is estimated at YD 2 million. Should the volume of foreign assistance prove less than now projected, we will scale down the level of these expenditures. We have revised the Second Five-Year Plan adding a number of projects to improve the facilities of the Port of Aden in view of the expected increase in traffic following the opening of the Suez Canal. Furthermore, we are undertaking a major effort of exploration for petroleum and other mineral resources and have invited foreign companies to help in this endeavor.

5. Despite the ongoing inflation, we shall limit current budget expenditures in 1976/77 to YD 32 million, as compared with the estimated provisional figure of YD 29 million for 1975/76. This is to be achieved partly by continuing measures to economize on imports for the administrative departments. No increases in salaries are contemplated at the present time. Should there be any further decline in world prices of essential foodstuffs, the resulting savings will not be passed on to the consumer fully, and extrabudgetary subsidies will be reduced.

6. Since the tax burden on the economy is already high, we are not at the moment considering new taxes. However, we are improving collection procedures substantially and, as a result, it is expected that current revenues will rise to YD 18 million in 1976/77 from a level of YD 17 million in 1975/76. Hence, the deficit in the current budget requiring bank financing will be equal to YD 14 million. Total Treasury recourse to the banking system for both the investment and current budgets will not exceed YD 16 million, as compared with YD 13 million in 1975/76.

7. The credit requirements of the nongovernment sector including the nationalized enterprises, the cooperatives and the private sector for their productive activities in 1976/77 are estimated at YD 5 million. "Other items" in the banking statistics are likely to change but little. Therefore, given the projected budget deficit, domestic credit will rise by YD 21 million, as indicated above. Allowing for the estimated balance of payments deficit of YD 13 million, domestic liquidity will increased by YD 8 million or 12 per cent.

8. With regard to foreign capital inflow, we will continue to rely primarily on loans on concessionary terms. Some such loans will be available in 1976/77 from the Arab Fund, the Kuwait Fund, the Abu Dhabi Fund, IDA and certain friendly countries. However, the totals involved may be less than required to finance our development plans and, therefore, we may be obliged to borrow modest amounts on commercial terms: we will do so only for projects expected to generate a flow of foreign exchange earnings more than sufficient to cover service payments.

9. We have taken steps liberalizing our foreign exchange system, in order to revitalize the re-export trade in the free zone. We now grant credit facilities in foreign exchange to finance imports for a period of six months and have eliminated all restrictions relating to imports in the zone. Furthermore, the Government has decided to allow in the free zone the establishment of branches by foreign firms, both for sales and for manufacturing. Such investments will be exempt from local taxes. Over the period covered by this letter, the P.D.R. of Yemen will not introduce multiple currency practices. Moreover, it will not introduce or intensify restrictions on trade and payments and transfers for current international transactions or conclude bilateral payments agreements with Fund members.

10. The Yemeni authorities believe that the policies set forth in this letter are adequate to achieve the objectives of the program but will take any further measures that may become appropriate for this purpose. If, in the opinion of the Government of the P.D.R. of Yemen or the Managing Director of the Fund, these policies are not producing the desired results, the Yemeni authorities will consult with the Fund regarding appropriate additional measures to achieve the objectives of the program.

Sincerely yours,

/s/

FADHLE MOHSIN ABDULLA
MINISTER OF FINANCE