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February 4, 1987

To: Members of the Executive Board

From: The Secretary

Subject: Yemen Arab Republic - Staff Report for the 1986 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1986 Article IV consultation with the Yemen Arab Republic, which is proposed to be brought to the agenda for discussion on Monday, March 2, 1987. A draft decision appears on page 22.

Mr. Sassanpour (ext. 6763) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

YEMEN ARAB REPUBLIC

Staff Report for the 1986 Article IV Consultation

Prepared by the Staff Representatives for the
1986 Consultation with the Yemen Arab Republic

Approved by P. Chabrier and S. Kanesa-Thasan

February 3, 1987

I. Introduction

The 1986 Article IV consultation discussions with the Yemen Arab Republic (Y.A.R.) were held in Sana'a during November 16-24, 1986. The Y.A.R. delegation was led by the Deputy Prime Minister (who is also the Minister of Planning) and included the Minister of Finance, the Minister of Agriculture, and the Governor of the Central Bank, as well as senior officials from the Ministry of Economy, Commerce, and Supply and from a number of public enterprises. At the end of its stay, the mission briefed the Prime Minister on the outcome of the discussions. The staff mission was composed of Messrs. K. Nashashibi (Head), S. Geadah, B. Rajcoomar, and C. Sassanpour (all of MED), and Ms. N. Merchant (Secretary--FAD).

The Y.A.R. continues to avail itself of the transitional arrangements of Article XIV of the Fund's Articles of Agreement. Summary statements on relations with the Fund and the World Bank are presented in Appendices I and II, respectively. The Y.A.R. authorities have requested the use of Fund resources under the Structural Adjustment Facility and accordingly a staff mission is expected to visit Sana'a in February 1987.

II. Economic Background

The Y.A.R. is a small open economy with a limited resource base. Nevertheless, the country has achieved considerable economic and social progress in the past two decades. The pace of economic development gained substantial momentum during the period of expanding oil wealth in the region in the mid-1970s. At the same time, the structure of the economy was rapidly transformed from traditional activities based on subsistence agriculture and limited infrastructure to a more modern and diversified system of production and exchange. Guided by the authorities' forward-looking policies and encouraged by a liberal economic system, the country's impressive economic gains in the latter part of the 1970s were spearheaded by an ambitious public investment program and by a considerable increase in private sector investment. These achievements were made possible largely by a sizable inflow of external financial resources through foreign assistance and private remittances. As a result, this period was characterized by rapid economic growth and a rise in the standard of living, relatively small budgetary deficits, surpluses in the balance of payments, a strong foreign reserve position, and exchange rate stability.

Since the early 1980s, however, the external economic environment has been less favorable. The economic slowdown in the region resulted initially in a decline in official foreign assistance and subsequently in a drop in private remittances which constrained development financing and exerted increasing pressure on the balance of payments (Table 1 and Chart 1). The impact of the decline in external financial resources on the economy was particularly pronounced, since efforts to mobilize domestic savings did not keep pace with the rising level of expenditure. Tax administration was still in its formative years and only limited resources could be mobilized through the developing financial sector. Consequently, the fiscal deficit rose steadily, reaching a peak equivalent to 32 percent of GDP in 1982. Moreover, in view of the decline in external support, the financing of the budget deficit was increasingly borne by borrowing from the Central Bank, which led to an expansion of liquidity in excess of increases in domestic output. Initially, the impact of the rapid expansion of liquidity on prices was moderated by a sharp increase in imports which was financed through a drawdown of external reserves. Reflecting this increase in imports as well as the decline in foreign exchange receipts, the balance of payments deteriorated rapidly, reaching a record deficit of over US$300 million in 1982, and the underlying pressures on the exchange rate intensified. Concerned with the sharp decline in reserves by the end of 1983, the authorities re-evaluated their economic strategy in light of the evolving external situation.

III. Policy Response and Economic Developments in 1983-85

1. External sector

As a first step, the authorities abandoned their efforts to maintain a fixed exchange rate by suspending sales of foreign exchange by the Central Bank and allowing the secondary market exchange rate to seek its own level. Subsequently, the official rate of exchange was periodically adjusted to reflect movements in market rates. In 1984, four successive depreciations of the rial, with a cumulative total of 25 percent, kept the official exchange rate in line with the market rate. However, as the depreciation of the rial subsequently accelerated in the secondary market, the official exchange rate was adjusted with growing lags and the gap between the two widened significantly.

Table 1. Yemen Arab Republic: Selected Economic Indicators, 1981-86 1/

Area and population						
Area	195,000 square kilometers					
Population (1986)	9.3 million					
Per capita GNP (1986)	US$430					

	1981	1982	1983	1984	1985	Est. 1986
	(In percent per annum)					
Rate of growth of real GDP at market prices	7.1 2/	8.3	1.7	2.3	4.2	4.5
Rate of growth of real GNP at market prices	2.7 2/	7.7	-5.7	0.7	--	0.2
Rate of change in Sana'a retail price index	7.4 2/	2.7	5.3	12.6	27.4	37.0
	(In billions of Yemen rials)					
Government finances						
Revenues and grants	4.9	5.7	5.3	5.4	6.0	8.7
Domestic revenues	(3.3)	(3.7)	(4.4)	(4.7)	(5.4)	(7.1)
Grants	(1.5)	(2.0)	(0.9)	(0.8)	(0.7)	(1.6)
Expenditures	7.8	11.0	10.1	10.0	11.1	12.4
Current (including extrabudgetary)	(4.1)	(6.9)	(7.1)	(6.8)	(7.9)	(8.9)
Capital (including externally financed)	(3.7)	(4.0)	(2.9)	(3.2)	(3.1)	(3.4)
Overall deficit	2.9	5.3	4.8	4.6	5.0	3.7
Financing						
External	(0.9)	(0.8)	(0.9)	(0.8)	(0.8)	(0.5)
Domestic	(2.0)	(4.4)	(3.9)	(3.8)	(4.3)	(3.3)
	(In percent of GDP at current market prices)					
Revenues and grants	37	35	30	28	26	28
Domestic revenues	(25)	(23)	(25)	(24)	(23)	(23)
Grants	(12)	(12)	(5)	(4)	(3)	(5)
Expenditures	60	67	57	52	47	40
Current (including extrabudgetary)	(31)	(42)	(40)	(35)	(33)	(29)
Capital (including externally financing)	(28)	(25)	(17)	(17)	(13)	(11)
Overall deficit	23	32	27	24	21	12
	Changes during period (In billions of Yemen rials)					
Domestic liquidity	0.7	2.6	3.4	4.4	4.1	4.9
Claims on Government (net)	(2.0)	(4.4)	(3.9)	(3.8)	(4.3)	(3.3)
Claims on nongovernment	(0.3)	(0.1)	(0.2)	(1.1)	(0.8)	(0.8)
External transactions (net)	(-1.2)	(-1.4)	(-1.0)	(-0.6)	(-1.2)	(0.4)
Other items (net)	(-0.4)	(-0.5)	(0.3)	(0.1)	(0.2)	(0.4)
	Changes during period (In percent of domestic liquidity at beginning of period)					
Domestic liquidity	8	26	28	28	20	20
Claims on Government (net)	(22)	(45)	(31)	(24)	(21)	(13)
Claims on nongovernment	(3)	(2)	(2)	(7)	(4)	(3)
External transactions (net)	(-13)	(-14)	(-8)	(-4)	(-6)	(2)
Other items (net)	(-4)	(-6)	(2)	(1)	(1)	(2)

Table 1 (concluded). Yemen Arab Republic: Selected Economic Indicators, 1981-86 1/

	1981	1982	1983	1984	1985	Est. 1986
	(In millions of U.S. dollars)					
Balance of payments						
Exports	10.5	4.9	9.8	9.0	8.2	14.0
Imports	-1,748.4	-1,952.4	-1,796.0	-1,413.7	-1,106.1	-732.0
Services (net)	-51.5	-37.3	-51.5	-40.0	-56.0	-73.0
Unrequited transfers	1,125.1	1,392.7	1,293.1	1,137.3	850.2	740.0
Of which:						
Government receipts	(336.8)	(468.7)	(189.4)	(143.4)	(102.8)	(215.0)
Private receipts	(987.6)	(1,191.4)	(1,244.4)	(1,067.0)	(809.2)	(600.0)
Current account	-644.3	-592.1	-544.6	-307.4	-303.7	-51.0
(In percent of GDP)	(-23)	(-16)	(-14)	(-8)	(-9)	(-2)
Nonmonetary capital 3/	383.7	281.6	328.2	186.1	142.6	102.0
Of which:						
Drawings on loans	(262.1)	(231.8)	(223.8)	(214.5)	(167.4)	(130.0)
Repayment of loans	(-57.5)	(-43.8)	(-23.6)	(-63.7)	(-48.0)	(-67.0)
Overall balance	-260.6	-310.5	-216.4	-121.3	-161.1	51.0
(In percent of GDP)	(-9)	(-9)	(-6)	(-3)	(-5)	(2)
Central Bank's gross foreign assets	966.8	557.7	361.4	304.2	317.6	409.8 4/
(In months of imports, c.i.f.)	(6)	(3)	(2)	(3)	(3)	(7)
Stock of debt (medium- and long-term)	1,085.8	1,401.5	1,573.7	1,657.4	1,962.7	2,026.0
Debt service	68.1	54.4	36.0	79.3	66.8	113.6
(In percent of current receipts)	(4)	(3)	(2)	(5)	(6)	(12)

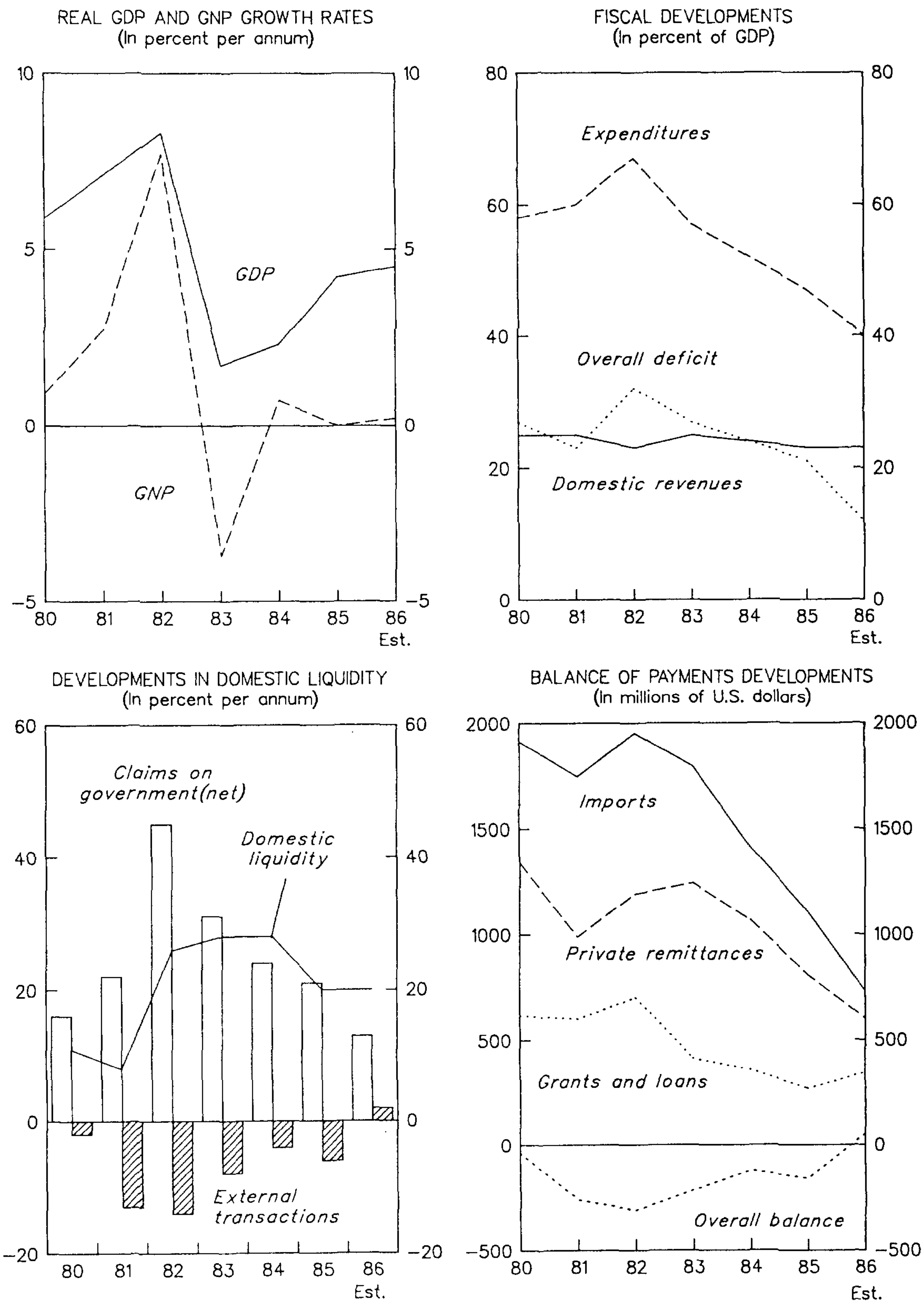
Sources: Central Planning Organization; Ministry of Finance; Central Bank of Yemen; and IMF staff estimates.

1/ Figures may not add up to total due to rounding.
2/ Until 1981, national accounts and price data were reported on a June-to-June basis. Accordingly, these growth rates correspond to estimates for the calendar year.
3/ Includes errors and omissions.
4/ As of end-November 1986.

CHART 1

YEMEN ARAB REPUBLIC

MACROECONOMIC INDICATORS, 1980–86



Sources: Data provided by the Yemen Arab Republic authorities; and staff estimates.

Concurrently, and with the aim of reducing pressures on the balance of payments and the exchange rate, the Central Bank issued regulations limiting the foreign exchange transactions of commercial banks. 1/ In particular, these regulations obliged banks to finance imports from foreign exchange resources made available through a "purchasing committee" formed to make collective purchases from the money changers on behalf of all the banks. 2/ Banks were also discouraged from allowing their customers to use their foreign currency deposits to finance imports. In addition, in early 1984, priorities for foreign exchange allocation were defined and an import licensing procedure was initiated. While the Central Bank was able to arrest the drain on its reserves, some of the burden of financing government imports was shifted to the largest commercial bank, which increased its foreign exchange exposure considerably.

Between 1982 and 1984, imports declined by 28 percent in U.S. dollar terms, partly due to the decline in remittances and foreign assistance, but also in response to the price and income effects of currency depreciation which became a powerful instrument in curtailing aggregate demand. Import licensing and the foreign exchange allocation mechanism also contributed to this decline. Consequently, the current account deficit narrowed markedly from the equivalent of 16 percent of GDP to 8 percent. The progress achieved in 1983-84 in the external accounts was not extended into 1985. While imports were compressed further, private remittances and foreign grants also declined and the current account deficit remained largely unchanged; however, the overall balance of payments deteriorated significantly as foreign loan disbursements continued their decline. While the commercial bank exchange rate depreciated by about 29 percent against the U.S. dollar in 1985, the official rate was only adjusted by 11 percent and the gap between the two rates widened. However, the distorting impact of this development was limited as additional external transactions were moved to the more depreciated commercial bank rate.

In response to development financing needs, official external debt increased from US$1.4 billion (39 percent of GDP) at end-1982 to nearly US$2 billion (54 percent of GDP) at end-1985. However, since almost all official external debt has been contracted on concessional terms to finance long-term investment, external debt service obligations claimed only 6 percent of current foreign exchange receipts in 1985.

1/ For details of the exchange and trade system, see the forthcoming report on Recent Economic Developments.

2/ The rate negotiated between the committee and the money changers on the basis of market rates constitutes the commercial bank exchange rate. Money changers are licensed foreign exchange dealers whose primary function is to facilitate the repatriation of earnings of the Yemenis working abroad. As one money changer appears to account for 70 percent of remittance transfers, the establishment of this committee was meant to exercise some countervailing power.

A rescheduling with the country's main external creditor, which involved consolidation of US$60 million in principal and interest falling due in 1984-85, also helped to reduce the debt service burden.

2. Fiscal adjustment

In light of the sharp reduction in external budgetary support and the limited possibilities of significantly expanding domestic revenue in the short term, the brunt of the fiscal adjustment was borne by reductions in expenditures. Between 1982 and 1985, expenditures declined by about one third in real terms, due largely to a sharp drop in capital spending, and to a lesser extent on account of wage and salary restraints. Compared with 1982, capital spending declined by half in real terms and was reduced from the equivalent of 25 percent of GDP to 13 percent in 1985. Extrabudgetary expenditures (which are believed to be largely transfers related to security as well as interest payments to the Central Bank) also declined noticeably to 7 percent of GDP in 1985. At the same time, efforts were made to mobilize domestic resources, primarily by increasing taxes on international trade, which represent the largest component of domestic revenue. These measures involved increases in import duty rates, the use of a more depreciated exchange rate for customs valuation, and a better collection effort, particularly on unlicensed imports. However, these steps were partly offset by the decline in the volume of imports as well as a shift in their composition away from high duty commodities. Efforts were also made to increase tax revenues through the collection of arrears and widening the tax coverage; nontax revenues benefited from the increase in the Government's share of central bank profits. Nevertheless, while domestic revenue remained largely unchanged in real terms, foreign grants declined considerably, lowering total revenues by 30 percent between 1982 and 1985. However, the effort on the expenditure side permitted the overall budget deficit to be reduced from 32 percent of GDP in 1982 to 21 percent in 1985.

3. Monetary and price developments

Reflecting the improvement on the fiscal front, the borrowing requirement to finance the budget deficit declined noticeably; net claims on the Government by the banking system decreased from 45 percent of the initial level of domestic liquidity (money plus quasi-money) in 1982 to 21 percent in 1985, but still remained the major source of liquidity expansion. At the same time, in view of improvements in the balance of payments position during this period, the contractionary impact of the external sector on liquidity growth was reduced substantially. Claims on the nongovernment sector also increased during this period, reflecting the higher financing needs of public corporations as well as increased borrowing by the private sector, encouraged by lending rates which were declining in real terms. As a result, the rate of growth of domestic liquidity edged up from 26 percent in 1982 to 28 percent in 1983-84, before declining to 20 percent in 1985.

The high rate of liquidity expansion at a time of declining economic growth resulted in an increase in the liquid holdings of banks and the public. To reduce the liquidity of the banking system, the authorities doubled the statutory reserve requirement to 20 percent in 1984 and required the commercial banks to maintain the margins paid by importers upon the opening of letters of credit in interest-free earmarked accounts. In early 1985 the interest rates offered to banks on their excess deposits with the Central Bank were increased, which in turn encouraged the banks to accept more time deposits from the public. At the same time, regulations were issued requiring public enterprises to move their deposits from the commercial banks to the Central Bank. These measures helped to neutralize partially the impact of reserve money growth on domestic liquidity expansion. Despite these efforts, domestic liquidity expansion was not reduced significantly, and in view of the compression of imports, exerted increasing pressure on prices. More importantly, since much of the country's consumption basket is imported, the increasing depreciation of the rial became a major factor in raising the rate of inflation sharply from less than 3 percent in 1982 to 27 percent in 1985. Moreover, since yields on domestic financial assets were becoming increasingly negative in real terms, while foreign assets were benefiting from the public's expectations for further rial depreciation, there was a marked shift in portfolio composition in favor of real assets and foreign currencies, thus exacerbating further the pressure on the exchange rate and prices.

4. Economic growth and structure

In response to demand management measures and the decline in private remittances, but also reflecting the adverse impact of natural calamities, the rate of economic growth declined from 7 percent per annum in the five-year period before 1983 to 3 percent during 1983-85. The earthquake of late 1982 damaged severely the economy's production base and led to a rechanneling of resources from development to reconstruction. The drought conditions of 1983-84 seriously hampered the performance of the agricultural sector. As a result of these difficulties and fiscal retrenchment, public sector investment and economic growth fell short of the targets established by the Second Five-Year Plan (SFYP), which were designed to guide economic development during the period 1982-86. The SFYP, formulated at a time of seemingly ample foreign exchange resources, had projected an investment target of YRls 18.9 billion and an annual growth rate of output of 7 percent, with substantial increases planned for private sector services, public utilities, small-scale manufacturing, and mining and quarrying. However, only 70 percent of the Plan's investment target was realized and economic growth was less than half of the target rate, with the shortfall attributed largely to the decline in agricultural output during the drought years and the slowdown in construction, wholesale and retail trade, and private and government services.

The structure of economic activity also shifted gradually. During the period of oil boom in the region, the rapid rise in wages and the maintenance of a fixed exchange rate had discouraged the expansion of the traded goods sector and shifted resources toward construction and services. However, helped by the substantial depreciation of the rial, the economic structure gradually reverted to the more traditional activities, mainly agriculture and, more recently, import-substituting industries. As a result, the country has become self-sufficient in many agricultural products and basic household goods, and in the process has been able to divert scarce foreign exchange resources to imports of other essentials and capital goods. The prospects for sustained economic growth were bolstered by the discovery of oil in commercial quantities in 1984.

IV. Developments in 1986 and Report on Policy Discussions

The stabilization policies undertaken by the authorities since 1983 have to a considerable extent eased the financial imbalances facing the economy. However, in concluding the 1985 Article IV consultation with the Y.A.R., Executive Directors noted that the continued financial imbalances called for further corrective actions, including measures to mobilize domestic resources, to reduce government spending, and realign investment priorities along the lines suggested by the World Bank. They also noted that pressures on the external payments position should be addressed immediately through stronger demand management and exchange rate flexibility. Indeed, despite certain improvements in 1986 and prospects of oil exports in the near future, the rapid decline in remittances and foreign assistance and rising pressures on prices and the exchange rate have introduced a sense of urgency to implementing these measures. Accordingly, discussions focused on the scope and prospects for additional adjustment measures to ease pressures on the exchange rate and prices, and thus provide a more stable financial environment for economic growth.

1. Fiscal policy

The Y.A.R. representatives noted that on the basis of provisional estimates, the budget deficit would decline from YRls 5 billion in 1985 to YRls 3.7 billion in 1986, corresponding to a decline from 21 percent of GDP to 12 percent. This improvement largely reflected the delayed disbursements of foreign grants from 1985 and the slow growth of expenditure. Despite the sharp decrease in imports, domestic revenue remained virtually unchanged in terms of GDP due to the adjustment in the exchange rate used for customs valuation as well as increases in some tariffs, removal of exemptions, and increases in fines on unlicensed imports. Government revenues benefited further by an increase in Zakat collections (an Islamic wealth tax), proceeds from the Government's share of the newly constructed oil refinery, and collection of tax arrears. With a view to improving domestic revenue performance, several directives were issued by the Council of Ministers in July 1986. These measures included an increase in customs tariffs and the cancellation of tax exemptions on imports of raw materials; the revision of stamp duties; and higher municipal, medical, and educational user charges. Directives were issued to increase collections of qat taxes, 1/ and efforts were initiated to improve the monitoring of imports and reduce smuggling.

A significant further decrease in government outlays in real terms was expected in 1986, with overall expenditure declining to the equivalent of 40 percent of GDP in 1986 from 47 percent in 1985. The directives issued in July 1986 also included the imposition of a freeze on government employment, except on the hiring of some university and technical school graduates, a slowdown in the recruitment of expatriate workers, and the continuation of the policy of wage restraint adopted in 1982. 2/ The increase in current expenditures projected for the whole year was partly attributed to the impact of the exchange rate depreciation on expatriates' salaries. 3/ As regards capital spending, the Government decided to postpone projects which had not started in the first half of 1986, except those financed through external loans. The estimated 11 percent increase in capital spending would therefore entail a further significant decline in real terms. Extrabudgetary expenditures were expected to be contained mainly due to a decision to have public sector enterprises service their own loans instead of burdening the budget.

The authorities informed the mission about the broad outlines of the 1987 budget. Compared with the provisional outcome for 1986, domestic revenues were budgeted to increase by 15 percent, partly due to higher nontax revenue as a result of earnings from oil. Grants, which were not included in the budget, were projected at about YRls 1 billion (equivalent to 2 percent of estimated GDP). Current expenditures were budgeted to increase by 11 percent; however, to a large extent, this increase reflected the reclassification of about 30 percent of extrabudgetary expenditures within the budget. Starting with the 1987 budget, a decision was taken to absorb all extrabudgetary expenditures within the budgeted categories by 1991. Excluding this adjustment, current expenditures were budgeted to increase by only 4 percent.

1/ Qat is a plant whose leaves are chewed as a stimulant for an effect similar to that from consuming caffeine. Qat is widely grown and consumed in the Y.A.R. The consumption of qat represents a major element of household expenditure, but taxes collected constitute only a negligible portion of total taxes.

2/ Public sector wages have not been adjusted since 1982 and no merit increases have been granted since 1983. Consequently, the civil servants' real wages have declined considerably in recent years.

3/ The salaries of about 16,000 expatriate teachers employed in the Y.A.R. were set in terms of U.S. dollars, half of which was paid in Yemen rials at the commercial bank rate.

The mission estimated that capital expenditures would rise by 17 percent--implying a further substantial decline in real terms--primarily reflecting the anticipated increase in project loans from external sources. On that basis, the mission estimated that implementation of the 1987 budget would result in a fiscal deficit of about YRls 5 billion, equivalent to 12 percent of estimated GDP, the same ratio as in 1986. However, the authorities were confident that, since additional measures were contemplated, the outcome would be substantially better than that indicated by the 1987 budget.

The mission commended the authorities for the measures undertaken, but expressed the view that in the absence of further corrective steps, the fiscal deficit would remain high, the exchange rate would continue to bear most of the burden of adjustment, and the pressure on prices would be maintained. Because it would be difficult to make further substantial reductions in expenditures without adversely affecting the development effort or the quality of government services, the mission recommended that the authorities concentrate on revenue enhancing measures. In this respect, the mission proposed that revenues be increased through the following measures: (i) increasing the customs valuation rate from YRls 9.0 = US$1 to the commercial bank exchange rate (most recently YRls 12.25 = US$1 in November 1986) and establishing a mechanism for adjusting the rate on a monthly basis; (ii) eliminating customs exemptions and imposing minimum tariffs on imports of capital equipment and raw materials; (iii) raising user charges; (iv) raising the excise tax on cigarettes; and (v) improving collection efforts, particularly on overdue taxes and on qat taxes, with the latter having a substantial potential for increase. The authorities concurred with the mission that implementation of these measures would reduce the deficit from the estimated level to about YRls 3 billion. It was stated that an adjustment in the exchange rate for customs valuation would be expected soon, and other suggestions made by the mission would be taken under active consideration in light of the recommendations of a recent FAD technical assistance mission that visited Sana'a in November 1986 to suggest areas for increasing revenues.

As regards expenditures, the mission agreed with the authorities that a prolonged freeze in government wages and salaries, and the ensuing difficulties in retaining a well-qualified cadre, may have detrimental effects on the development effort in the long run. However, the mission suggested that the authorities may wish to consider selective wage adjustments linked to performance, instead of a general salary increase. Because of the magnitude of extrabudgetary expenditures, the mission supported the authorities' efforts at reclassifying these expenditures and believed that such action would also enhance budgetary discipline and accountability. As regards capital spending, the mission endorsed the position taken by the authorities, and supported by the World Bank, to proceed only with completion of ongoing projects, while reviewing others in the context of the Third Five-Year Plan (TFYP) currently under preparation.

2. Monetary policy and inflation

Domestic liquidity expanded by 20 percent in the 12 months ended September 1986. The major factor contributing to this growth continued to be the financing of the budget deficit, although its expansionary impact had moderated further. In contrast, given the improvement in the balance of payments, the external sector ceased to exert a contractionary influence on domestic liquidity expansion. Since the growth of reserve money decelerated noticeably in 1986 in response to lower government borrowing, the rate of domestic liquidity expansion would also have been lower had it not been for the increase in the money multiplier. Prior to 1986, the authorities had been successful in insulating partially the impact of reserve money expansion on domestic liquidity growth by adopting measures which acted to absorb banks' liquidity and reduce the money multiplier. In 1986, however, the money multiplier increased as a result of the slower growth of commercial banks' deposits with the Central Bank and the shift from domestic currency to foreign currency bank deposits. Since foreign currency deposits are exempted from the reserve requirements, this development has created the potential for further increases in the multiplier.

In reviewing monetary developments, the mission stressed that the current rate of liquidity expansion was not consistent with the slow pace of economic activity and the sharp reduction in imports. In this connection, the mission observed that inflationary pressures had intensified considerably, with the index of retail prices for Sana'a rising at an annual rate of 37 percent during the first half of 1986. The authorities concurred with the mission that the only viable solution to curb liquidity expansion and moderate price increases was to reduce the budget deficit and limit its financing through the Central Bank. Notwithstanding efforts to limit the rate of liquidity expansion, the authorities believed the inflation rate may be even higher in 1987, considering the recent sizable exchange rate depreciation. The authorities explained that a series of measures were adopted in 1986 to reduce the commercial banks' liquidity and increase monetary control. These measures included: (i) raising interest rates offered on banks' deposits with the Central Bank; (ii) increasing the margin on letters of credit from a range of 15-40 percent to 40-100 percent, thus obliging banks to maintain higher deposits in earmarked accounts; and (iii) significantly restricting the extension of central bank credit to the public enterprises while enforcing more strictly a decision taken in 1985 requiring these enterprises to shift their deposits from the commercial banks to the Central Bank.

The mission welcomed the recent measures taken by the authorities, and observed that in response to the incentives provided by higher interest rates, commercial banks' deposits with the Central Bank had increased sharply through July 1986; however, the decline in the level of these deposits from YRls 5.5 billion to YRls 4.9 billion between July and October 1986 may have been a reflection of banks' increased short-term lending activity in response to substantially negative real lending rates. At the same time, the mission noted that this increased lending had not been supplemented by attracting domestic currency deposits. Since the rise in commercial banks' deposits in 1986 was largely attributed to expanding foreign currency deposits, which as mentioned earlier were exempted from reserve requirements, a growing component of domestic liquidity was in essence outside the control of the monetary authorities. While most commercial banks have avoided incurring foreign exchange exposure by placing their foreign currency deposits abroad, the mission expressed concern about the short-term foreign indebtedness of the largest commercial bank and the magnitude of potential losses due to the recent sharp depreciation of the rial. The authorities shared the mission's concern, but stated that the net foreign exchange exposure of this bank had declined considerably to about US$200 million by October 1986.

The mission emphasized that, together with measures to reduce the financing requirements of the budget, more substantive actions were needed to facilitate the mobilization of domestic resources and improve liquidity control. 1/ Measures to achieve these objectives should include: (i) a substantial increase in interest rates, with the aim of achieving positive real rates over the medium term; (ii) reducing bank financing of the budget deficit by issuing government debt instruments; these instruments should be attractive enough to raise private savings and shift resources from real assets and foreign currencies to domestic financial assets; (iii) monitoring commercial banks' short-term lending activities, while promoting long-term lending by strengthening the judicial system in the area of loan recovery; (iv) imposing a statutory reserve requirement of 20 percent on foreign currency deposits; 2/ and (v) encouraging the specialized development banks to play an active role in the process of domestic resource mobilization.

The authorities were broadly receptive to these suggestions. As regards interest rates, they agreed that current levels were low considering the rapid pace of price increases and the expectations of further exchange rate depreciation. However, while agreeing that there may be some scope for raising the interest rate structure, the authorities expressed concern about the impact of a substantial rate increase on prices. Instead of using the interest rate as a mechanism for credit allocation, the authorities indicated that quantitative measures would be taken to arrest the increase in banks' short-term lending to the private sector. Among the measures under consideration were the lowering of the loan ceiling from YRls 5 million to YRls 0.5 million for

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1/ A CBD mission visited Sana'a in July 1986 to study the financial sector. In its report, which was presented to the authorities in November 1986, a number of measures aimed at improving domestic resource mobilization were suggested.

2/ While the imposition of this requirement may result in a small reduction in interest paid by banks on foreign currency deposits, it should not induce depositors to shift their deposits abroad.

individuals and to YRls 2.5 million for corporate borrowers. In addition, the authorities were considering the imposition of an indicative ceiling on credit extended by commercial banks to the private sector. As regards direct government borrowing from the public, the authorities indicated that they were actively pursuing the idea of issuing "investment bonds"; it was felt that in order to avoid religious objections and receive wide acceptance, such instruments should comply with Islamic principles. In this connection, the authorities requested a Fund technical assistance mission familiar with Islamic laws to suggest concrete proposals on the modalities and implementation of such instruments.

3. External sector

Developments in 1986 were dominated by expectations of a substantial reduction in the current account deficit to the equivalent of 2 percent of GDP (from 9 percent in 1985) and the emergence of a surplus in the overall balance for the first time since the late 1970s. However, this improvement was largely due to certain exceptional factors, such as the sharp decline in international oil prices and the carryover of grants from 1985, and hence did not represent a fundamental reversal of the underlying weaknesses in the balance of payments. Notwithstanding the contribution of these factors, much of the external adjustment was borne by a further reduction in imports (to about 37 percent of their 1982 levels) which more than offset the decline in private remittances. With rising balance of payments pressures, the commercial bank rate, which applies to all but a few government transactions, depreciated sharply from YRls 8.10 = US$1 at end-1985 to YRls 12.25 = US$1 by November 1986. However, the official exchange rate was adjusted in January 1986 to YRls 7.24 = US$1 and further to YRls 9.0 = US$1 in December 1986, subsequent to the departure of the mission. 1/

The mission noted that there were two issues regarding the exchange system, namely the divergence between the official rate and the commercial bank rate, and the existence of restrictions on the trade and payments system. As regards the exchange rates, it was pointed out that the maintenance of two exchange rates constituted a multiple currency practice. Moreover, while the substantial depreciation of the commercial bank rate was a welcome recognition of the economy's financial imbalances and had contributed significantly to curtailment of aggregate demand, the adjustment of the official rate has lagged behind. The existence of a substantial differential between the two exchange rates

1/ The official exchange rate only applies to the following official receipts: (i) central bank interest earnings from abroad, and (ii) foreign grants and loans (excluding commodity aid) accruing to the Government; and to the following payments: (i) debt service payments, (ii) imports financed by foreign loans and grants, and (iii) services related to the Y.A.R. embassies. In 1985, a deficit of US$90 million was recorded on the account of these transactions.

could lead to pressure in the future to finance certain imports from oil export receipts at an overvalued official exchange rate. As regards the administrative controls on trade and payments, the mission stressed that, as evidenced by the experience of other countries, such restrictive practices not only lead to a misallocation of resources and create administrative burdens, but also hinder production and divert imports to unofficial channels leading to a reduction in customs receipts. The latter could be particularly relevant in the case of the Y.A.R., as the large overland trade is difficult to monitor. The mission urged the authorities to use the opportunity offered by the start of oil exports to take the necessary steps toward an early unifi-cation of the exchange rates and the removal of restrictions. It was stressed that the unification of the exchange rates would have no significant budgetary or price implications, since the official exchange rate had a very limited coverage. Moreover, the authorities were urged to maintain their flexible exchange rate policy to diversify the economy's production base and lessen its future dependence on oil receipts. In recommending to the authorities to dismantle the licensing system and eliminate the restrictions on payments procedures, the mission stressed that the underlying pressures on the exchange rate could not be removed by artificial controls. However, the mission was encouraged by a certain degree of flexibility shown by the Central Bank in occasionally allowing importers to use up to 50 percent of their foreign currency deposits with domestic banks to finance certain priority imports.

The authorities expressed their strong commitment to the principle of unification of the exchange rates, but were concerned about the psychological impact on the foreign exchange market of an immediate and substantive adjustment in the official rate. Instead, the authorities favored a gradual process phased out over the next three years with the aim of full unification by end-1989. Concurrent with this effort, the coverage of transactions effected at the official rate would be gradually narrowed and limited to the servicing of soft loans, the financing of military imports, and cash grants. As regards restrictions on the trade and payments system, the authorities stressed that these arrangements, which were necessitated by the external difficulties faced by the country since 1982, were temporary in nature. It was intended to liberalize the system of import financing in 1987 by allowing importers to increase further the use of their own foreign exchange deposits with the commercial banks for the purpose of financing imports. The import licensing system and related payments procedures would be gradually dismantled over the next three years.

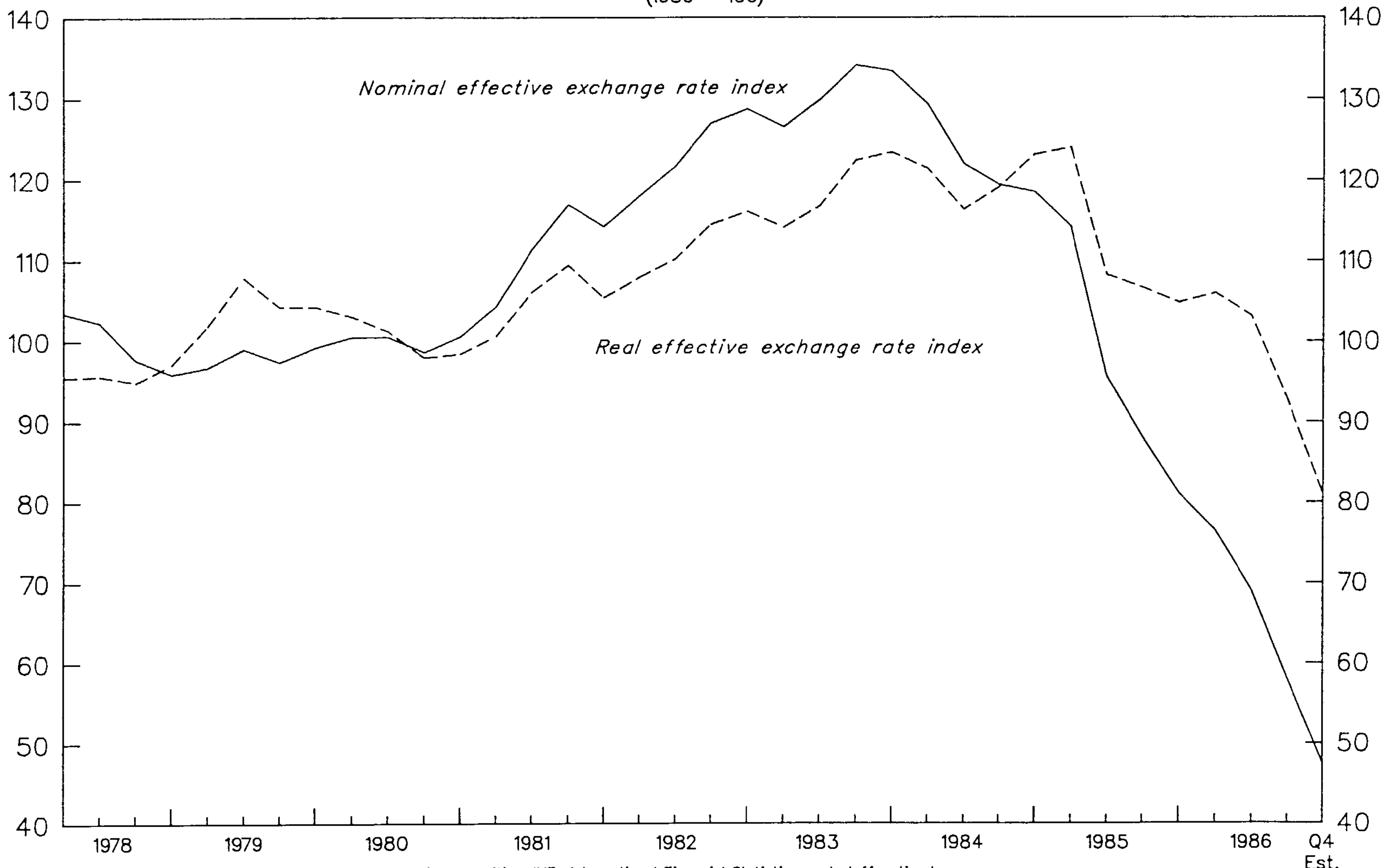
Regarding external debt, the mission commended the authorities for having pursued a prudent approach to foreign borrowing, despite the external difficulties. It was also noted that the debt servicing burden during 1986-88 would be alleviated partially by the recent rescheduling of principal payments amounting to US$260 million with the country's main bilateral creditor. Given the prospects of oil exports in the near future, the mission supported the authorities' recent efforts at

CHART 2

YEMEN ARAB REPUBLIC

NOMINAL AND REAL EFFECTIVE EXCHANGE RATES, 1978–86

(1980 = 100)



Sources: Data provided by the Yemen Arab Republic authorities; IMF, *International Financial Statistics;* and staff estimates.

obtaining credit facilities on concessional terms for some essential imports. This should ease the adjustment burden without adversely affecting the country's debt profile.

4. Economic growth and structure

The authorities indicated that economic growth in 1986 was in the range of 4-5 percent, similar to the performance in 1985. While reduced government capital outlays and the decline in the overall level of consumption were dampening economic activity, the agricultural sector and those import-substituting industries which rely mainly on domestic raw materials and which had been stimulated by their increased competitiveness were providing the major impetus to growth. While the real exchange rate has fallen by 33 percent since 1984 (Chart 2), it was most likely that the improvement in the competitiveness of agriculture and industry was even greater considering that their cost structure is more heavily weighted toward domestic inputs, particularly labor, the price of which had increased less than the CPI. Activities in the oil sector would also contribute to the overall economic performance in 1987, although oil exports were not expected to commence until early 1988. As a result, the mission estimated that the rate of real economic growth in 1987 would remain at about its 1986 level.

As regards activities in the oil sector, the authorities reported that the refinery at Marib had started operation in April 1986. Given its capacity of 10,000 barrels per day (b/d), about one third of domestic requirements were being met by the output of this refinery. The construction of the pipeline linking the oil fields to the Red Sea, and of the port and storage facilities, began in November 1986 and was expected to be completed within a year. These construction costs, which were estimated at US$500 million, would be financed by foreign partner companies and recovered from future oil proceeds. The initial pipeline capacity would be 200,000 b/d, but could be doubled by the addition of two pump stations. The authorities indicated that production would start at a rate of 135,000 b/d, and would be maintained at that level through the end of the decade. Encouraged by the recent discoveries, exploration activity both in the producing regions as well as in new areas has intensified and the preliminary results have been promising. Thus, the authorities were confident that the estimate of recoverable reserves would be double the current announced level of 500 million barrels.

V. Medium-Term Prospects and Policies

The mission noted that on the basis of current oil reserve estimates, receipts from oil exports are not expected to fully offset the decline in private remittances and foreign aid, which is expected to continue during the last third of the decade. Therefore, the external position will remain vulnerable over the medium term. While the onset of oil exports in 1988 would reduce external imbalances significantly in that year, these imbalances would re-emerge and widen in subsequent years in the absence of strong adjustment measures. Reflecting substantial capital outflows due to the repayment of oil investments and the need to increase imports from present levels to sustain a moderate growth rate, large financing gaps could arise by the end of the decade unless the measures suggested above were taken. Since foreign financing of these deficits through increased commercial loans would not be advisable, further depreciation of the Yemen rial and higher inflation could be expected.

The Y.A.R. representatives indicated that in order to avoid such a course of events and achieve a sustainable balance of payments position while stimulating the growth of non-oil output over the medium term, they have initiated a comprehensive set of policy measures, many of which were described in Section IV. These measures are aimed at reducing dependence on foreign aid and private remittances from abroad and avoiding excessive future reliance on oil revenues. This would be achieved largely through the rapid growth of the traded goods sector, improvement of the efficiency of the public sector, and the implementation of tight demand management policies. The other main objectives include: (i) exploiting new mineral discoveries, including domestic production of liquid petroleum gas; (ii) formulating and implementing a manpower strategy to develop the skills of the labor force; (iii) a rational utilization of the country's scarce water resources; (iv) the development of administrative capacity; and (v) expanding further health and education services. As some of these issues can only be addressed over the long term, the Third Five-Year Plan (TFYP), which incorporates these objectives, is being placed in the framework of a longer-term development program which will also include the following two five-year plans. Such a strategy has the support of the World Bank. The staff was not in a position to discuss fully some of the envisaged structural measures, as the draft plan had not been completed. However, a staff mission is scheduled to visit Sana'a in February 1987 to discuss the authorities' program, and the possibility of access to SAF resources in support of that program.

The authorities recognized that a stable financial environment was necessary to achieve the objectives outlined above since it would promote a more rational allocation of resources and greater resource mobilization. A crucial step toward achieving financial stability would be a substantial reduction of the fiscal deficit. The measures suggested in Section IV.1, if undertaken promptly, would reduce the overall deficit to about 9 percent of GDP in 1987, while a surplus could be generated in 1988 given the large increase in oil revenues. Over the medium term, fiscal prospects could be improved further by strengthening tax collection (especially on qat), and the pursuit of pricing policies that would permit public sector enterprises to increase their contribution to the budget. In conjunction with the fiscal effort, the monetary policy measures described in section IV.2 should encourage resource mobilization. Allocative efficiency would be enhanced through a liberalization of the exchange and trade system which will be carried out in parallel with the reduction in external imbalances in order to avoid increasing pressure on the exchange rate and prices.

In the traded goods sector, the authorities intend to reduce the various tax and customs duties exemptions granted to the private sector and discourage potentially inefficient industries which generate only a thin domestic value added and which have expanded rapidly in the past. Industrial policy will attempt to foster efficient industries that utilize local raw materials and intermediate goods or produce such goods for other domestic industries. In the agricultural sector, the authorities intend to channel resources to areas in which the country has a comparative advantage, particularly production of fruit and vegetables, and optimizing the use of scarce water resources. The mission welcomed these objectives but cautioned that the authorities should concentrate their limited financial resources on essential services such as research and extension, the maintenance of the irrigation system, control of excessive ground water extraction, and the improvement of irrigation efficiency.

The authorities informed the mission that the emphasis of the TFYP would be on projects which are unlikely to be implemented by the private sector, mainly physical and social infrastructure, but which would enhance capacity utilization in the productive sectors and conserve natural resources as recommended by the World Bank. For example, in the energy sector, emphasis would be on developing gas resources. In view of their sharp real decline in recent years, the authorities believed that there is room for a moderate growth of capital expenditure, as a number of projects hold promise for substantial savings of foreign exchange and/or natural resources. The Government aims to strengthen further the performance of the relatively small public sector by improving management and financial control and streamlining production and marketing strategies.

The full and timely implementation of the measures proposed by the authorities--and broadly agreed to with the staff during the consultation discussions--could result in a significant improvement in economic performance. On the basis of these policies, the tentative medium-term projections set out in Table 2 indicate that a sustainable balance of payments position could be achieved by the end of the decade, with the overall position being roughly in balance over the period 1988-90 (Chart 3). 1/ Foreign exchange resources should be sufficient to support real import growth of 4-5 percent per annum which should be consistent with growth of non-oil output of at least 4 percent, especially when the accelerating import-substitution process is taken into account. It is anticipated that the growth in output will be mostly concentrated in the agricultural and industrial sectors.

1/ The projections should be treated with caution as several vital elements of the program remain to be discussed.

Table 2. Yemen Arab Republic: Medium-Term Projections, 1986-90

	Est. 1986	Projections 1987	1988	1989	1990
	(In millions of Yemen rials)				
Government finances					
Revenues and grants	8,655	11,170	20,211	22,815	26,630
Domestic revenues	7,100	10,220	18,971	21,330	25,185
Of which: oil revenue	(177)	(376)	(7,108)	(7,745)	(10,213)
Grants	1,555	950	1,240	1,485	1,445
Expenditures	12,362	14,689	19,124	23,055	26,678
Current expenditures	7,406	8,206	10,241	11,814	12,142
Capital expenditures	3,446	4,280	6,134	8,038	9,939
Extrabudgetary expenditures	1,510	2,203	2,749	3,202	3,597
Overall budget deficit (-)/surplus (+)	-3,707	-3,519	1,087	-240	-48
	(In millions of U.S. dollars)				
Balance of payments					
Trade balance	-718	-754	14	-48	-103
Exports	14	17	857	880	908
Of which: oil	(--)	(--)	(838)	(857)	(882)
Imports	-732	-771	-843	-927	-1,011
Of which: oil	(-120)	(-114)	(-124)	(-133)	(-144)
Services (net) 1/	-73	-42	-219	-273	-320
Unrequited transfers (net)	740	515	485	480	485
Of which:					
Government receipts	215	100	100	100	85
Private receipts	600	500	475	475	500
Current account	-51	-282	280	159	61
Nonmonetary capital	102	190	-225	-212	-59
Of which: oil investment repayments	-11	-16	-270	-276	-119
Overall balance	51	-92	55	-53	3
Memorandum items:	(In percent of GDP)				
Domestic revenues	23	25	30	29	31
Capital expenditures	11	10	10	11	12
Overall budget balance	-12	-9	2	--	--
External current account	-2	-10	7	4	1
Overall balance of payments	2	-3	1	-1	--

Source: Staff projections based on information provided by the Yemen Arab Republic authorities.

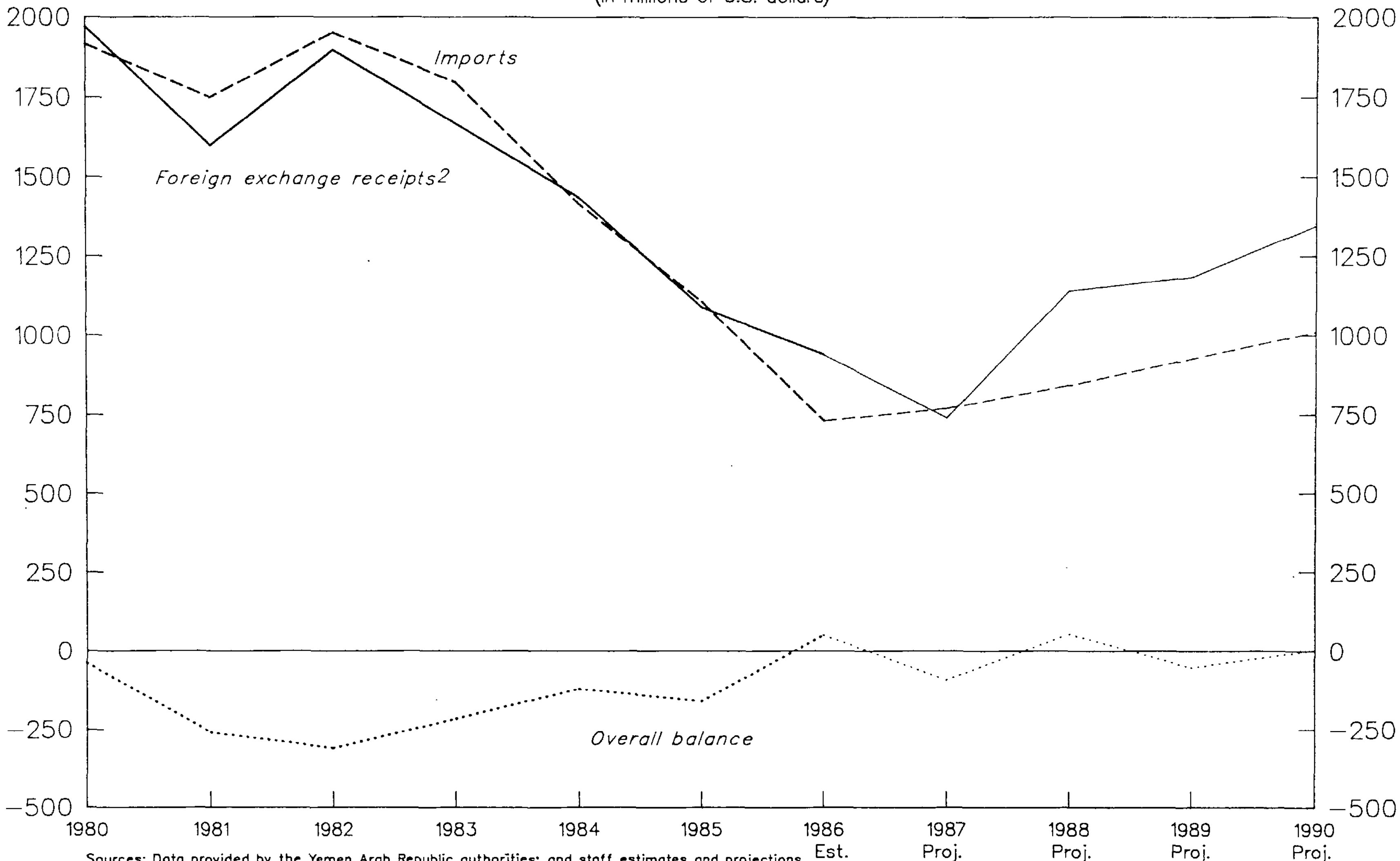
1/ Includes foreign oil company profits remitted.

CHART 3

YEMEN ARAB REPUBLIC

TRENDS IN EXTERNAL ACCOUNTS, 1980–90[1]

(In millions of U.S. dollars)



Sources: Data provided by the Yemen Arab Republic authorities; and staff estimates and projections.
1 Projections for 1987–90 are based on the adjustment scenario described in Section V and Table 2.
2 Private remittances, foreign grants and project loans, non–oil exports, and from 1988 onward oil receipts excluding cost recovery and remitted company profits.

A substantial reduction in the financial imbalances is also projected with the overall fiscal position broadly in equilibrium in 1988-90. This improvement in the fiscal accounts does not reflect a withdrawal of purchasing power from the private sector as it stems to a large extent from the contribution of oil revenues. Excluding oil revenues and foreign grants, the fiscal deficit would be reduced from 18 percent of GDP in 1986 to an average of 12 percent in 1988-90, mainly on account of continued restraint in current expenditures and some growth in domestic revenues. Such a fiscal outcome should be sufficient to stabilize the exchange rate and permit a sharp decrease in the rate of inflation from 1988.

VI. Staff Appraisal

During the last two decades, the Y.A.R. has achieved impressive economic growth accompanied by substantial improvements in the standards of living of the population. As a result of the authorities' forward-looking and growth-oriented policies, the structure of the economy has been rapidly transformed within the framework of a liberal and market-oriented economic system. Given the limited domestic resource base, and negligible merchandise exports, the development efforts have been largely financed by the substantial inflows of workers' remittances and foreign aid. The pace of economic development gained momentum in the 1970s during the period of expanding oil-financed activities in the region.

During the early 1980s, financial imbalances emerged in the economy. The growth of government expenditure accelerated, leading to rising fiscal deficits and increasing pressures on the balance of payments which compounded the effects of declining private remittances and foreign assistance, stemming from the slowdown of economic activity in the region. The demand for imports, encouraged by the fixed exchange rate regime, reached an unsustainable level, resulting in a sharp decline in external reserves in 1983.

Concerned with the deteriorating external situation, the authorities abandoned efforts at maintaining a fixed exchange rate by allowing the commercial bank rate (which applies to most transactions) to respond more flexibly to market forces, and by adjusting periodically the official exchange rate. However, this increased exchange rate flexibility was accompanied by the adoption of temporary restrictions on imports and external payments. The income and price effects of the rial depreciation reduced aggregate demand, and helped shift domestic resources toward the traded goods sector, generating substantial import substitution and encouraging an incipient export sector. However, since much of the country's consumption basket consists of imports, the rial depreciation contributed to a sharp acceleration in inflation. On the fiscal side, the authorities stabilized expenditures in nominal terms, while increasing revenues sharply. As a result, the budget deficit declined from the equivalent of 32 percent of GDP in 1982 to 12 percent in 1986. This fiscal retrenchment was supplemented by a number of measures to reduce domestic liquidity expansion. Among the most significant were increases in reserve requirements and in the remuneration offered to the commercial banks on their excess deposits with the Central Bank. Nevertheless, domestic liquidity expansion remained high, exerting further pressure on prices and the exchange rate.

The combined effect of the external and demand management measures, and the reduced availability of foreign resources, was a reduction in imports in 1986 to about one third of the 1982 level, resulting in a small balance of payments surplus, despite the continued decline in remittances and foreign assistance. However, the adjustment process was also accompanied by a slowdown in output growth, reflecting the fall in aggregate demand as well as natural calamities. On the positive side, a stronger economic structure emerged with a shift in resources away from construction and services, which thrived during the oil boom, and toward agriculture and industry which have a good potential for expansion.

Despite the progress achieved during the 1983-86 period, the overall financial position remains weak and the pressures on prices and the exchange rate have intensified. Without further corrective measures, growing imbalances are expected to emerge over the medium term. While the recent oil discoveries are expected to generate sizable oil export revenues beginning in 1988, it is unlikely that, on the basis of current estimates of oil reserves and production, these revenues will offset fully the decline in remittances and foreign aid. Indeed, macroeconomic projections for the period 1987-90 without the measures suggested in Section IV point to an intensification of balance of payments pressures toward the end of the decade which would result in continued depreciation of the rial and an acceleration in inflation. These trends indicate the need for a comprehensive package of measures to be applied promptly, as the rising expectations associated with oil exports could undermine the political will to carry out the necessary economic reforms.

The principal objective of economic policy over the medium term should be to diversify the economy's sources of foreign exchange, which now consist almost exclusively of remittances and foreign assistance, while avoiding excessive dependence on future oil revenues. In the financial sphere, the thrust of the adjustment effort should be directed at limiting the expansionary impact of government budgetary operations through curbing further the fiscal deficit. Otherwise, the burden of adjustment would inevitably fall again on the exchange rate and prices. Since fiscal adjustment in recent years has been achieved largely by reductions in capital outlays and by a decline in the real wages and salaries of the civil service, the scope for further expenditure reducing measures appears to be limited. Therefore, the major impetus to fiscal adjustment should come from revenue enhancing measures. The report of the recent FAD mission should assist the authorities in identifying the major revenue areas which have a potential for increase. Over the medium term, the fiscal position should be strengthened further through the selection of investment projects that enhance capacity utilization in the economy as a whole and help conserve natural resources, as recommended by the World Bank. The staff welcomes the authorities' intention to pursue a restrictive monetary policy in 1987, as well as their plans to finance part of the fiscal deficit through the introduction of investment bonds. A sizable increase in interest rates would also encourage resource mobilization by diverting financial resources from speculative activities and foreign currency holdings to long-term financial commitments.

With regard to the external sector, the authorities should be commended for adjusting the official exchange rate shortly after the departure of the mission. However, considering that the official rate is applicable to very few transactions, a prompt unification would be desirable and would have only minor budgetary and price consequences. The pursuit of a flexible exchange rate policy should become more important as the country faces the challenge of expanding the non-oil traded goods sector to promote a diversified productive base. Moreover, continued resort to payments and import restrictions would only perpetuate the existing distortions. Advantage should be taken of the start of oil exports in 1988 to unify the exchange rate and remove these restrictions.

The authorities repeated their commitment to a free economy and stressed that the existing restrictions on trade and payments were only of a transitional nature. In this respect, they felt that the implementation of demand management measures was necessary to reduce the pressure on the exchange rate and lay the ground for import and payments liberalization. They were in the process of implementing some of the recommendations provided by the recent CBD technical assistance mission on the financial system and were awaiting the final report of the FAD technical assistance mission on resource mobilization. In the course of 1987 they intend to continue to adjust the official rate of exchange and liberalize import payments. In their commitment to adopt a package of adjustment measures which would address the economic imbalances over the medium term, the authorities have requested that a staff mission visit Sana'a in February 1987 to negotiate a program under the Structural Adjustment Facility. The staff is satisfied that the authorities are seeking ways to eliminate the need for exchange restrictions and unify the exchange rates and recommends that these practices be again temporarily approved by the Executive Board. The staff expects to reach agreement with the authorities on a timetable for the removal of the restrictions.

It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

VII. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision relating to the Yemen Arab Republic's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1986 Article XIV consultation with the Yemen Arab Republic, in the light of the 1986 Article IV consultation with the Yemen Arab Republic conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The payment procedures related to imports, as described in SM/87/ 28 , constitute an exchange restriction subject to approval by the Fund under Article VIII, Section 2(a). A differential in excess of 2 percent between the official exchange rate and the commercial bank rate evidences a multiple currency practice subject to approval by the Fund under Article VIII, Section 3. The Fund notes the intention of the authorities of the Yemen Arab Republic to eliminate this exchange restriction and unify the multiple exchange rates as soon as possible and grants approval for the retention of these practices until February 29, 1988 or the completion of the next Article IV consultation, whichever is earlier.

Yemen Arab Republic: Fund Relations
(As of December 31, 1986)

(Amounts in millions of SDRs, unless otherwise indicated)

I. Membership Status

(a)	Date of membership:	May 22, 1970
(b)	Status:	Article XIV

A. Financial Relations

II. General Department (General Resources Account)

(a)	Quota:	43.3
(b)	Total Fund holdings of Yemen rials:	49.4 (114.1 percent of quota)
(c)	Fund credit:	6.1 (14.1 percent of quota)
	Of which: extended Fund facility:	--
(d)	Reserve tranche position:	--
(e)	Current operational budget (maximum use of currency):	--
(f)	Lending to the Fund:	--

III. Current Stand-by or Extended Arrangement and Special Facilities

(a)	Current stand-by or extended arrangement:	None
(b)	Previous stand-by or extended arrangement:	None
(c)	Special facilities:	Emergency assistance, February 25, 1983, SDR 9.8 million

IV. SDR Department

(a)	Net cumulative allocation:	6.2
(b)	Holdings:	23.1 (374.3 percent of net cumulative allocation)
(c)	Current designation plan:	--

V. Administered Accounts

(a) Trust Fund loans
(i) Disbursed: --
(ii) Outstanding: --

(b) SFF Subsidy Account
(i) Donations to Fund: --
(ii) Loans to Fund: --
(iii) Payments by Fund: --

VI. Overdue Obligations to the Fund --

B. Nonfinancial Relations

VII. Exchange Rate Arrangement:

The Yemen rial is pegged to the U.S. dollar which is the intervention currency. In February 1973 the central bank rate was set at YRls 4.5 = US$1; on November 10, 1983 and several occasions thereafter (most recently December 1986) the Yemen rial was depreciated. Presently, the central bank rates for buying and selling the U.S. dollar are YRls 8.98 = US$1 and YRls 9.00 = US$1, respectively. The representative rate established under the Fund's Rule O-2 is now YRls 8.99 = US$1. However, the bulk of foreign exchange transactions is effected at the more depreciated commercial bank rate, which is negotiated between the commercial banks and the money changers.

VIII. Last Article IV Consultation:

Discussions were held in Sana'a during August 1985. The Staff Report (SM/85/271) was discussed by the Executive Board on November 20, 1985.

Consultations with the Yemen Arab Republic are on a standard 12-month cycle.

The Executive Board's decision (Decision No. 8133-(85/168)) adopted November 20, 1985, was as follows:

1. The Fund takes this decision relating to the Yemen Arab Republic's exchange measures subject to Article VIII, Sections 2 and 3, in concluding the 1985 Article XIV consultation with the Yemen Arab Republic and in the light of the 1985 Article IV consultation with the Yemen Arab Republic conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The joint licensing of imports and exchange under an exchange budget, as described in SM/85/271, constitutes an exchange restriction subject to approval under Article VIII, Section 2(a). A differential in excess of 2 percent between the official exchange rate and the market rate evidences a multiple currency practice subject to approval by the Fund under Article VIII, Section 3. The Fund notes the intention of the Y.A.R. authorities to eliminate this exchange restriction and multiple currency practice and to unify the multiple exchange rates as soon as possible and grants approval for these restrictions until November 30, 1986 or the completion of the next Article IV consultation, whichever is earlier.

IX Technical Assistance

(a) Bureau of Statistics

In May 1986 a staff technical assistance mission visited Sana'a to review the monetary data.

(b) CBD

1. For several years three experts have been assigned to the Central Bank of Yemen as advisors in the fields of foreign exchange, research, and banking supervision.

2. In July 1986 a staff technical assistance mission visited Sana'a to advise the monetary authorities on measures to absorb and manage liquidity and to improve the mobilization of domestic resources, and to review interest rate policies, reserve requirements, and the regulatory environment for financial operations. The mission report was submitted to the authorities in November 1986.

(c) FAD

1. In 1982 and 1983 experts were assigned to the Ministry of Finance as advisors in the internal tax and customs fields. These assignments have ended and in July 1984 an expert in the budget area was assigned to the Ministry of Finance until June 1985.

2. In November 1983 a staff technical assistance mission visited Sana'a and subsequently prepared a report reviewing the financial performance of selected public enterprises.

3. In November 1985 a staff mission visited Sana'a in response to the authorities' request for technical assistance to improve the administration of the excise duty levied on qat, and discussed a number of possible measures.

4. In November 1986 a staff technical assistance mission visited Sana'a to suggest areas for improving revenues. The mission report is due to be submitted to the authorities shortly.

(d) Other

In November/December 1983 a MED/ETR technical assistance mission visited Sana'a to assist in preparing projections of the balance of payments for 1984 and to review and advise on recent and contemplated corrective measures.

X. Resident Representative/Advisor: None.

Yemen Arab Republic: The Bank View of the Economy

1. The Yemen Arab Republic's position continues to be difficult due to a further decline in workers' remittances and disbursements on concessional loans. These are now down to less than 50 percent and 60 percent respectively, of their 1983 level in dollar terms. Nevertheless, the economy continues to adjust to this deterioration, as the budget deficit was lowered from its peak of 32 percent of GDP in 1982 to about 12 percent of GDP in 1986, and the balance of payments position improved from a US$310 million deficit in 1982 to a small surplus in 1986. The improvement in the budget resulted from a combination of a reduction of the public investment program to a core of priority projects identified with IDA assistance, a containment of recurrent expenditures particularly through freezing civil servant's wages, and improvements in tax collection. The improvement in the external accounts was a result of the flexible exchange policy, introduced in 1983 and of import restrictions introduced from 1984 which reduced imports to about 40 percent of their 1982 level in dollar terms. Despite these improvements, considerable inflationary pressures remain in the economy as the budget deficit is still too high and inflation is over 30 percent.

2. Although most of Y.A.R.'s external debt has been contracted on concessional terms, debt service increased from about 6 percent of exports (including workers' remittances) in 1984 to more than 11 percent in 1986, after the rescheduling negotiated with the U.S.S.R. of repayments falling due in 1986-88. The debt service is projected to increase further in the coming years. The Government should pursue a cautious strategy in the future to avoid further endangering its external position and creditworthiness.

3. On the real side of the economy, GDP growth is estimated to have accelerated from less than 3 percent per annum over 1983-85, to about 5 percent in 1986, thanks mainly to the start in oil production and a better performance of agriculture, itself due to improved rainfall and the stimulus provided by the depreciation of the rial and the quantitative import restrictions. Import rationalization also resulted in some shortages of imported inputs and subsequent under utilization of capacity in industry. Although still low, unemployment is on the rise, and real wages are declining (particularly in the public sector) due to the return of migrants and the Government's stabilization program. While the social impact of the stabilization program will prove favorable in the medium-term, and strong family and tribal ties should reduce hardships from the program, it may be necessary to introduce measures during the adjustment period that ease the situation of the poorest segment of the population.

4. With assistance from the Kuwait Fund and IDA, the Government is completing the preparation of the Third Five-Year Plan (1987-91), which is a crucial one in many respects. First, the Government will have to continue its stabilization program, since considerable inflationary

pressures remain in the economy. Further adjustment would require a greater domestic resource mobilization effort (in both the fiscal and financial sectors), a more prudent management of the external debt, and a more flexible exchange rate policy to improve the external competitiveness of the traded goods sector.

5. Second, the Government will have to make the best use of oil which was discovered in 1984 and is expected to be exported starting in 1988. At present, proven reserves are estimated to be about 500 million barrels which should allow exports of about 135,000 barrels per day over 1988-92. However, unless reserves are larger than currently estimated, exports would decline rather quickly afterwards. In this respect, an optimum oil production profile is required to avoid a rapid depletion of reserves. Oil revenues are expected to improve the budget position substantially and are also expected to ease the foreign exchange shortage, although they will not fully offset the expected decline in workers' remittances and official aid. Since oil revenues are expected to decline after the Plan period, this temporary budget improvement might prove deceptive. Indeed long-term projections indicate that a serious deterioration is likely unless a comprehensive adjustment effort is undertaken.

6. Thus, during the Plan period the Y.A.R. will have to start preparing for the post-oil era. This would require: (i) an efficient public investment program particularly in the energy sector; (ii) stringent demand management measures to contain consumption and imports; (iii) a substantially greater revenue effort in the non-oil sector, and (iv) efforts to diversify the economy and reduce its excessive dependence on workers' remittances and oil. Clearly such a program would represent a great challenge for the country. The Bank intends to continue to assist the Y.A.R. in meeting this challenge.

7. The Y.A.R. faces a number of constraints for its long-term development: e.g., scarcity of arable land, limited resource base, and lack of skilled labor. Moreover, two important structural issues need to be addressed immediately given their overall long-term impact: water shortages and rapid population growth. Addressing the water shortage issue would require: (i) restricting drilling of wells and extraction of groundwater, particularly around Sana'a; (ii) improving cost recovery; (iii) establishing a water resource data base, and; (iv) improving coordination among the various agencies operating in the water sector. Reducing the rapid population growth (over 3 percent per annum) is also urgent and calls for a more vigorous effort in the area of family planning.

Yemen Arab Republic: Medium-Term Assumptions

I. Balance of Payments and Exchange System

1. Oil exports are assumed to start in 1988, with volume remaining unchanged at 135,000 barrels per day (b/d) during 1988-90. Oil export price forecasts are consistent with the latest WEO projections, adjusted for a mark-up of US$1.50 per barrel to reflect the higher quality of the crude. Non-oil exports are assumed to rise by an average of 16 percent per annum during 1987-90, due to the increased competitiveness of this sector resulting from the depreciation of the rial, and the incentives to be provided by the Government to stimulate output.

2. Oil imports are assumed to amount to 20,000 b/d in 1987, and to rise by an average of nearly 5 percent per annum during 1988-90. Non-oil imports are assumed to rise by about 9 percent per annum (in U.S. dollar terms) during 1987-90, reflecting an average annual rise in import volume of nearly 5 percent, which would be required to sustain the projected rise in non-oil GDP.

3. The main assumptions in the services account relate to the oil sector. Net service receipts from economic activity in the oil industry (construction of pipelines and related port and storage facilities) are assumed to equal 20 percent of total expenditure by the foreign oil companies. The projections of remittances of oil company profits are based on the production sharing agreement with the Government.

4. Official grants are projected to decline sharply in 1987, partly reflecting the high level reached in 1986 (due to delays in disbursements scheduled for 1985), but to remain constant in 1988-89, before declining in 1990. Private remittances are assumed to continue their decline until 1988-89, when they would stabilize.

5. Disbursements on loans are assumed to rise after 1988, reflecting improved lending opportunities after the onset of oil exports. Debt amortization is based on the schedule of payments due on debt contracted as of end-1986, as well as new borrowing both for projects and for balance of payments financing; the projections also take into account the 1986 bilateral rescheduling of principal payments falling due during 1986-88 to the principal creditor. Suppliers' credit projections are based on information regarding two netback arrangements in 1987 covering oil imports.

6. Oil investment repayments are derived from the production sharing agreement with the Government, which sets a 30 percent limit on the proportion of oil output that can be used for cost recovery purposes in any year.

7. After declining sharply in both nominal and real terms in 1987, the exchange rate is asumed to depreciate more slowly in 1988-90, reflecting the impact of the demand management measures to be introduced in 1987.

The differential between the official rate and the commercial bank rate is assumed to be narrowed gradually, with complete unification at end-1989.

II. Public Finance

1. Government revenue from oil exports is consistent with the balance of payments projections and the production-sharing agreement formula. Import duties are assumed to be equal to 45 percent of the value of imports during 1987-90, reflecting the already high tariff structure and the measures to be taken regarding the elimination of some exemptions, and the imposition of new duties. In addition, the customs valuation rate is assumed to be equal to the commercial bank rate with effect from 1987. Non-oil tax and nontax revenues are assumed to rise in line with the rate of domestic inflation during 1988-90, but to rise faster in 1987 due to a number of additional measures already announced.

2. Current expenditure in 1987 is consistent with the Government's budget, and is assumed to grow by 4 percent in real terms during 1988-90. The same assumptions apply to extrabudgetary expenditure, although the latter is scheduled to be fully incorporated into the budget by 1991. Capital expenditure in 1987 is also consistent with the budget, but is assumed to increase in real terms during 1988-90, to be consistent with the growth targets and reflecting the Third Five-Year Development Plan. It is also assumed that 10 percent of government oil revenue from crude exports in 1988 and 5 percent thereafter will be used for capital expenditures related to the oil sector.

III. Other Assumptions

1. Non-oil GDP is assumed to increase by about 5 percent per annum in real terms during 1987-90, while total real GDP is expected to rise by over 15 percent in 1988 with the start of oil production.

2. The domestic inflation rate is projected to rise to about 40 percent in 1987 given the sharp depreciation of the exchange rate, but to decline rapidly during 1988-90, reflecting both the deceleration in the rate of depreciation and the slower pace of liquidity expansion.

Yemen Arab Republic - Statistical Issues

1. Outstanding statistical issues

a. Government finance

The 1986 GFS Yearbook contains data on consolidated central government operations through 1984 and provisional data for 1985. The presentation, however, is incomplete since data on financing by type of debt holder does not contain the breakdown for foreign financing for the years 1980 through 1985, while data on financing by type of debt instrument does not contain the breakdown for domestic financing for the years 1981 through 1985 and the breakdown for foreign financing for 1984 and 1985.

b. Monetary accounts

The technical assistance mission which visited Sana'a in May 1986 found the data compilation procedures to be generally compatible with IFS standards and the recent computerization of the Central Bank accounting system to have been quite successful. Two main issues remain:

(1) A list of nonfinancial public enterprises (NFPEs) needs to be established. Commercial bank data for NFPEs need to be reported separately from those for specialized financial institutions; and

(2) The Central Bank needs to establish a regular reporting system for specialized financial institutions.

2. Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published in the country page for the Yemen Arab Republic in the January 1987 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Central Bank of Yemen, which during the past year have been provided on a timely basis. However, the currentness and coverage of data for external trade and foreign debt are inadequate, and those of national accounts and prices could be improved.

Status of IFS Data

		Latest Data in January 1987 IFS
Real Sector	- National Accounts	1984
	- Prices (CPI)	AA 1984
	- Production	n.a.
	- Employment	n.a.
	- Earnings	n.a.
Government Finance	- Deficit/Surplus	1985
	- Financing	1985
	- Debt	n.a.
Monetary Accounts	- Monetary Authorities	August 1986
	- Deposit Money Banks	August 1986
	- Other Financial Institutions	n.a.
Interest Rates	- Bank Lending/Deposit Rate	March 1986
External Sector	- Merchandise Trade: Value	AA 1983
	Prices	n.a.
	- Balance of Payments	Q1 1986
	- International Reserves	November 1986
	- Exchange Rates	November 1986