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INFORMATION

April 26, 1988

To: Members of the Executive Board

From: The Secretary

Subject: Yemen Arab Republic - Staff Report for the 1988 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1988 Article IV consultation with the Yemen Arab Republic, which will be brought to the agenda for discussion on a date to be announced. A draft decision appears on page 17.

Mr. Yandle (ext. 8769) or Mr. Geadah (ext. 7121) 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 1988 Article IV Consultation

Prepared by the Staff Representatives for the 1988 Consultation with the Yemen Arab Republic

Approved by A.S. Shaalan and S. Kanesa-Thasan

April 25, 1988

I. Introduction

The 1988 Article IV consultation discussions with the Yemen Arab Republic (Y.A.R.) were held in Sana'a during the period February 18-25, 1988. The Y.A.R. delegation was led by the Deputy Prime Minister for Economic Development and included the Ministers of Finance and Agriculture, the Governor of the Central Bank, and other senior officials. The staff team comprised Messrs. Yandle (Head), Geadah, Kawar, and Zavadjil, and Mrs. Buenaobra (Secretary)--all of MED.

The Y.A.R. avails itself of the transitional arrangements of Article XIV. Relations with the Fund and the IBRD are summarized in Appendices II and III, respectively.

II. Economic Background

Although petroleum in commercial quantities was discovered in 1984, the Y.A.R.'s resource base remains limited. Structurally, domestic economic activity has centered on the agricultural and trade sectors, while prior to 1988 exports were negligible. Despite these limitations the country achieved substantial economic progress during the 1970s based upon large and rising inflows of private remittances from Yemenis abroad and official assistance, along with liberal economic policies including the maintenance of an open trade and payments system. Real output and incomes rose rapidly, fiscal deficits were for the most part moderate, while the balance of payments position remained strong. From the early 1980s, however, private transfer and foreign assistance flows began a downtrend, reflecting slackening activity in neighboring countries. With continued growth in government expenditure, the fiscal deficit (including grants) rose to a peak of 26 percent of GDP in 1982, 1/ financed largely by borrowing from the Central Bank. The

1/ Based on recently revised national accounts data. These data are seriously understated, however, by the exclusion of *qat* growing and marketing, resulting in GDP ratios being overstated. *Qat* is an indigenous plant which provides a mildly stimulating effect when chewed.

resulting sizable expansion of liquidity together with the fixed exchange rate led to continued import growth and a substantial worsening in the balance of payments, including a rapid drawdown in external reserves.

The authorities began to adjust from 1983 to the substantially lower level of external resource availability. The fiscal deficit was reduced to 10 percent of GDP by 1986, despite a decline in grants (Table 1 and Chart 1). Over the same period, domestic bank financing was reduced from 45 percent of beginning money stock to 13 percent, notwithstanding a decline in net foreign borrowing. The brunt of this adjustment was borne by expenditure which declined from 55 percent of GDP in 1982 to 33 percent in 1986. Expenditure measures included restraints on employment, a freeze on merit increases and allowances, limits on defense outlays, and sizable reductions in capital expenditures. A number of revenue generating measures (focused on import taxes) were implemented and the tax administration strengthened. However, with the dependence of revenue on customs duties, the yield of which was affected by the fall in imports and shift in their composition to lower duty items, revenue growth was limited and the discretionary measures only enabled the revenue ratio to be maintained.

Although substantially lowered, bank financing of the fiscal deficit remained the principal element in domestic liquidity expansion. To reduce its impact on liquidity, however, commercial banks' total reserve requirements were increased from 20 percent to 30 percent in 1984 and the banks were required to maintain in interest-free accounts one half of the margins paid by importers on letters of credit. In early 1985 interest rates offered to banks on their excess deposits with the Central Bank were increased and public enterprises were required to move their deposits to the Central Bank. Nevertheless, with increasing credit to other sectors and an improving external position (see further below), the expansion of liquidity remained in the range of 20-28 percent annually between 1982 and 1986. Moreover, as yields on domestic financial assets became increasingly negative in real terms, there was a shift to other assets, exacerbating demand pressures. This liquidity expansion and portfolio shift increased pressure on prices, which accelerated strongly, with the rate of increase reaching 29 percent in 1986.

In the external sector, by 1983 the Central Bank had curtailed its sale of foreign exchange, allowing the commercial market exchange rate to depreciate. Subsequently, the rate in the official market (which applied to a limited range of transactions) was also depreciated. Between end-1982 and end-1986 the exchange rate was depreciated from YRls 4.50 to YRls 8.99 per U.S. dollar in the official market and to YRls 11.86 per U.S. dollar in the commercial market; a real effective depreciation in the latter market of 31 percent (Chart 2). To further restrain demand for foreign exchange, limitations were imposed on commercial banks' foreign exchange operations.

Table 1. Yemen Arab Republic: Selected Economic and Financial Indicators, 1982-88

	1982	1983	1984	1985	1986	Prel. 1987	Proj. 1988
			(Annual percentage changes, unless otherwise specified)				
National income and prices							
Real GDP (at market prices)	...	2.4	3.4	4.5	9.4	4.8	25.0
Nonpetroleum GDP (at market prices)	...	2.4	3.4	4.5	8.1	4.2	4.2
Oil production ('000 b/d)	--	--	--	--	7.5	17.9	173.0
Consumer prices	2.7	5.3	15.1	24.6	29.4	21.7	...
External sector							
Exports, official grants, and private transfers	24.7	-13.3	-15.6	-24.5	0.6	7.1	68.9
Imports	11.7	-8.0	-21.3	-21.8	-21.6	58.0	8.8
Import volume	16.9	-3.5	-19.0	-20.6	-29.0	41.3	-0.4
Nominal effective exchange rate 1/ (end of period: depreciation -)	9.1	7.4	-9.3	-33.6	-39.1	8.2	...
Real effective exchange rate 1/ (end of period: depreciation -)	8.1	10.9	-2.6	-19.0	-25.1	25.0	...
Central government budget							
Revenue	10.8	19.3	6.1	14.2	34.6	4.8	69.1
Expenditure	40.5	-8.2	-0.2	9.8	16.3	44.1	5.4
Money and credit							
Domestic credit 2/	46.1	33.1	30.9	24.8	15.5	16.5	16.1
Government (net) 2/	(44.6)	(31.2)	(23.8)	(20.9)	(13.1)	(20.4)	(12.6)
Private and NPE sectors 2/	(1.5)	(1.9)	(7.1)	(3.9)	(2.4)	(-3.9)	(3.5)
Money and quasi-money	26.4	27.5	27.5	20.0	25.5	10.1	12.7
Velocity (nonpetroleum GDP relative to M2)	1.8	1.5	1.4	1.4	1.4	1.3	1.4
Interest rate (6-month deposits)	10.0	10.0	10.0	10.0	10.0	11.0	11.0
			(In percent of GDP, unless otherwise specified)				
Overall fiscal deficit							
Excluding official grants	-36.4	-25.9	-21.2	-18.4	-14.7	-25.2	-11.0
Including official grants	-26.4	-22.0	-18.6	-16.2	-9.9	-21.8	-9.0
Exports	0.1	0.2	0.2	0.2	0.4	1.1	16.2
Imports	44.1	37.0	30.3	25.7	19.9	30.6	23.8
External current account deficit							
Excluding official grants	-23.9	-15.1	-9.8	-10.1	-8.4	-18.1	-7.5
Including official grants	-13.4	-11.2	-6.7	-7.6	-2.3	-14.2	-5.4
External debt (excluding suppliers' credits)	31.6	32.4	35.5	46.9	58.6	72.0	59.8
Debt service ratio (in percent of external receipts from goods, services, and private transfers)	2.7	2.1	5.4	6.0	9.4	23.9 3/	17.2
			(In millions of U.S. dollars, unless otherwise specified)				
GDP at current market prices (in billion Yemen rials)	19.9	21.9	24.8	31.0	38.4	43.5	61.0
Exports	4.9	9.8	9.0	8.2	16.4	69.0	1,012.3
Imports (-)	-1,952.4	-1,796.0	-1,413.7	-1,106.1	-867.7	-1,370.7	-1,492.0
Private transfers	1,191.4	1,244.4	1,067.0	809.2	669.0	761.7	550.0
Foreign grants and loans	700.5	413.2	357.9	270.2	382.5	634.3	365.0
Balance of payments							
Current account deficit (including grants)	-592.1	-544.6	-313.2	-319.3	-92.4	-606.9	-286.5
Overall deficit (-)	-310.5	-216.4	-121.3	-161.1	194.2	-52.8	-119.6
Gross official foreign reserves (in months of imports)	5	4	4	6	10	6	5

Sources: Data provided by the Y.A.R. authorities and staff estimates.
1/ Commercial bank exchange rate.
2/ Change as a percent of beginning money stock.
3/ Includes for the first time debt service on suppliers' credits.

A commercial bank committee was formed to acquire foreign exchange from licensed money changers and banks were discouraged from allowing customers to use their foreign currency deposits to finance imports. From 1984, foreign exchange allocation priorities were set, an import licensing procedure was initiated and progressively tightened, and increasingly severe import deposit requirements were instituted. Overall, the authorities' policies reduced imports from nearly US$2 billion in 1982 to less than US$0.9 billion in 1986, a greater fall than the decline in transfers and assistance. The external current account deficit declined from 13 percent of GDP in 1982 to 2 percent in 1986 and the overall balance swung from deficit to a small surplus.

While significant reduction in the external imbalance was achieved, output growth slowed between 1982 and 1985 before recovering in 1986, affected in part by the severe earthquake in 1982 and the impact of drought on agriculture in the 1983-85 period. However, manufacturing grew strongly, principally because of the high protection afforded by import restraints and depreciation, but also because petroleum refining started in April 1986. Altogether, while the authorities' actions succeeded in arresting and even reversing the loss of reserves, by the close of 1986 the balance of payments outturn had become dependent on administrative controls while mounting inflationary pressures remained to be addressed.

III. Developments in 1987 and Report on the Discussions

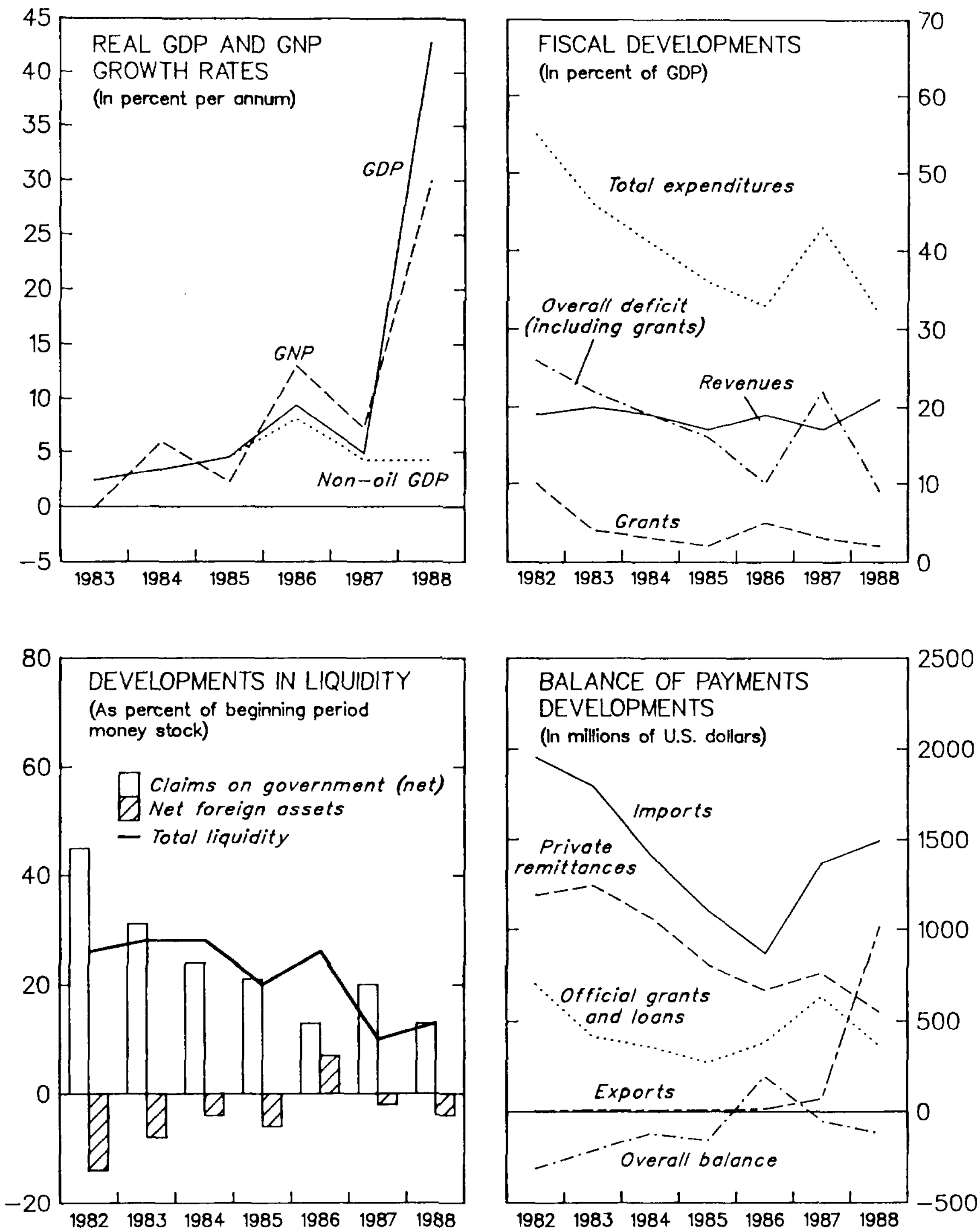
The need for continued adjustment efforts, even with the prospects for petroleum exports, was noted by Executive Directors in concluding the 1986 Article IV consultation. In particular, Executive Directors indicated the need for fiscal deficit reduction, tighter credit and monetary policies, and greater exchange rate flexibility, along with liberalized import and payments procedures. Such efforts were needed both to alleviate demand and balance of payments pressures, and to improve the competitiveness of the nonpetroleum sector.

With the imminence of petroleum exports and a related increase in external financing availabilities there was a noticeable shift in policy in 1987. Fiscal operations became much more expansionary with sharply higher expenditure. Reflecting this change and to address existing demand pressures as well as low capacity utilization, a large increase in licensed imports was allowed, financed by sharply higher long-term concessional loans, suppliers' credits, and a reserve rundown. Additionally, tighter controls on goods and currency movements enabled the exchange rate to be appreciated. With these developments and the authorities' wish to quicken the pace of output growth, the discussions focused on the factors leading to the changed policy stance, the production strategy, and the need for adjustment policies in 1988 and the medium term.

CHART 1

YEMEN ARAB REPUBLIC

MACROECONOMIC INDICATORS, 1982–88



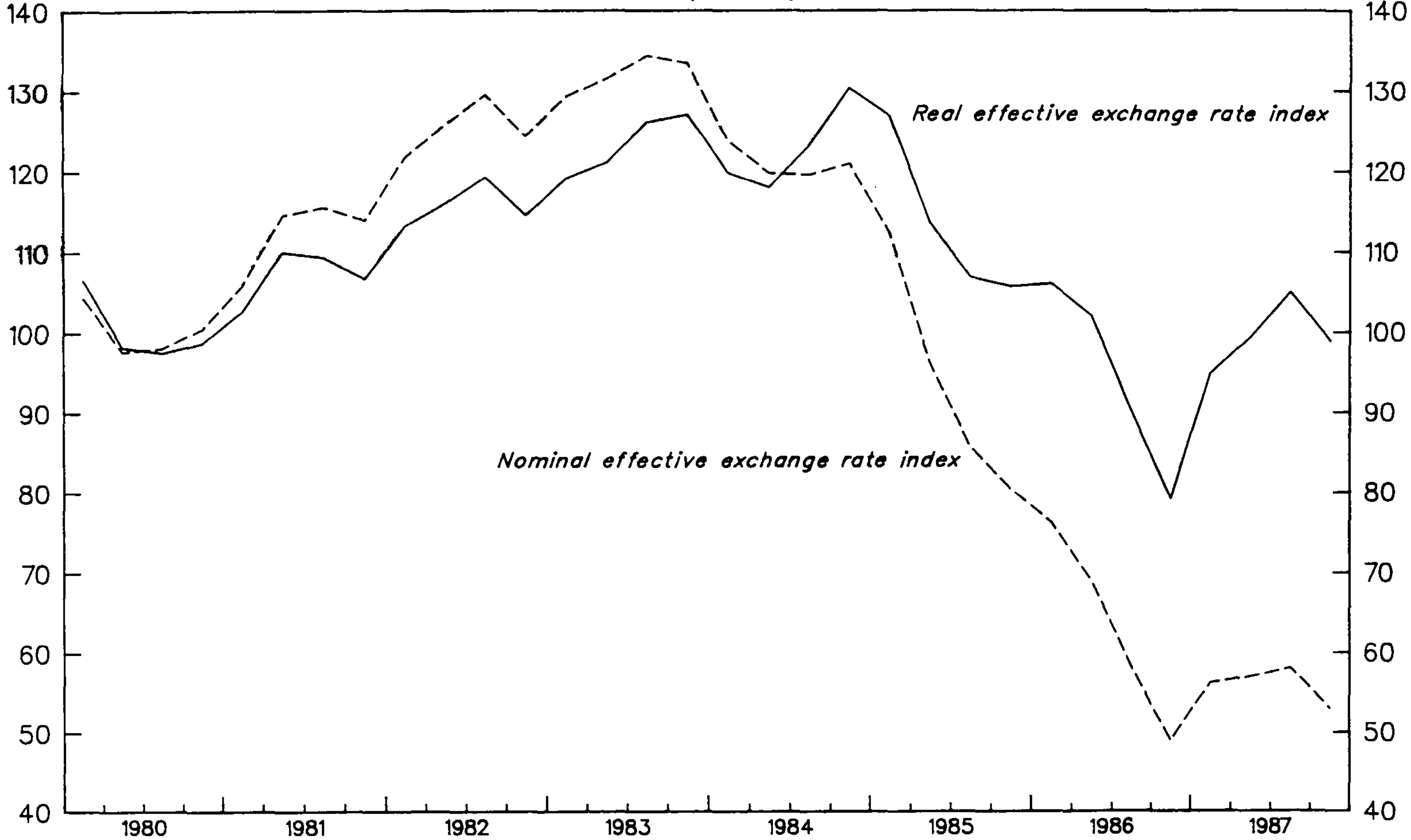
Sources: Data provided by the Yemen Arab Republic authorities; and staff estimates.

CHART 2

YEMEN ARAB REPUBLIC

NOMINAL AND REAL EFFECTIVE EXCHANGE RATES, 1980–87

(1980=100)



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

a. Production, growth, and development policies

Provisional data indicate that real GDP grew by 5 percent in 1987, buoyed by expanding petroleum sector activities along with gains in electricity generation, transport, and financial services. On the other hand, agricultural and construction output weakened. Price performance also improved, with the Sana'a consumer price index (CPI) increasing by 22 percent compared with 29 percent in 1986, reflecting the reduced growth in domestic credit in 1986 and 1987, the exchange rate appreciation and the increased availability of imports.

The start of petroleum exports is the most favorable recent development affecting the economy's growth prospects. Petroleum in commercial quantities was discovered in 1984. A refinery (10,000 barrels per day (b/d) capacity) began production in mid-1986, while completion of an export pipeline allowed production to rise to 95,000 b/d in December 1987. Output has since risen further and is expected to reach 175,000 b/d by mid-1988, the long-term production level for the existing fields. Pricing policy is to base export sales on an average of spot market prices at the time of shipment. Production at these levels and projected prices would add about 20 percent to GDP in 1988 while boosting exports by over US$900 million (US$450 million net of the foreign partners' cost recovery and profits). Recoverable reserves with present investment is estimated at a little over 500 million barrels, with additional probable reserves, extractable with further substantial investment, put at 350 million barrels. This indicates that output from the present fields will decline by about the mid-1990s. Two nearby fields have recently been discovered, but their potential is still under assessment.

Growth in output from agriculture, which continues to employ at least 60 percent of the labor force, leveled off to 2 percent in 1987 mostly due to less favorable weather. Agricultural policy, the Y.A.R. representatives indicated, is based on food security objectives along with domestic and international market conditions. Thus, wheat and cotton are currently not being encouraged, while import bans are in effect to protect domestic growers of fruits and vegetables. On the other hand, coffee has lost ground to the cultivation of qat. Support to the agricultural sector is provided through investment, import bans and restrictions, and fertilizer subsidies. The mission cautioned that protection provided by import bans and subsidies resulted in resource misallocation, and drew attention to the disparity between import costs and local selling prices, which showed that domestic prices for many commodities were 2-3 times the import cost. This indicated large and differential levels of protection and hence distorting production incentives. The mission's view was that it would be more efficient if competitiveness were established through exchange rate policy, supplemented by moderate tariffs. In response, the representatives stated that protection was designed to improve agricultural employment and output. They were aware that this resulted in higher agricultural prices, but felt that the use of exchange rate policy would lead to a general rise in prices.

Regarding manufacturing, the Y.A.R. representatives noted that trade restrictions in effect since 1983 had raised both profitability and output (up 8 percent in 1987), despite limits on raw material imports. Nonetheless, capacity utilization in 1987 was as low as 30 percent in some industries; to raise these rates, import allocations for raw materials are being increased. Industrial policy aimed at encouraging profitable industry and craft shops employing returning migrants. Encouragement is provided mainly through protection against imports (this has been eroded by smuggling, however) along with income tax holidays and exemptions from customs duties under the Investment Law.

For 1988, a sharp rise in production is anticipated. In addition to the boost from petroleum, agricultural output is expected to increase, assuming normal weather, while higher manufacturing production is expected reflecting the planned increase in imports. The authorities explained that the objectives of the Third Five-Year Plan launched in January 1987 included an annual growth of about 8 percent, with the focus on growth from the agricultural, petroleum and natural gas, and industrial sectors. Infrastructure and service sectors, in a shift of emphasis from the past, will have lower priority. Major petroleum sector development projects under the Plan include LPG plants and, possibly, a pipeline to allow the substitution of natural gas for oil in electricity and cement plants. Studies on a second refinery are also under way. In agriculture, a Plan focus is on completion of the Marib Dam and associated canals, along with progress in small dam construction. This is expected to lessen the impact on output of the variable rainfall. With the industrial sector, an important objective is greater use of local resources (e.g., extractive industries) with high value added. Private investment is being encouraged in these areas through licensing and tax incentives. In financing the Plan, a principal source anticipated is earnings from the petroleum sector, supplemented by other domestic resource mobilization and concessional external borrowing.

b. Fiscal policy

Fiscal policy turned sharply expansionary in 1987 with the overall deficit, which had been progressively reduced to YRls 3.8 billion (10 percent of GDP) by 1986, rising to nearly YRls 9.5 billion (about 22 percent of GDP), or almost double the level initially targeted (Appendix I). Despite a fivefold rise in net external financing of the deficit, central bank financing almost doubled, from about YRls 3.2 billion to YRls 6.2 billion, or to 20 percent of beginning money stock.

The principal factor in the fiscal outturn was a 44 percent increase in expenditure, paced by a very large (7 percent of GDP) rise in externally financed spending on special equipment (provisionally treated as capital) and a 35 percent increase in wage outlays. Most other expenditure elements were also higher. Revenues increased by only 5 percent, even though the authorities took a number of revenue measures during the year and benefited from growth in petroleum receipts.

Revenue measures included the imposition of additional taxes on cigarettes, raising the customs valuation rate, extending Zakat to corporations and further improved tax administration. However, revenue from international trade taxes declined by 28 percent even though imports rose 58 percent in U.S. dollar terms. The representatives explained that this resulted from the structure of imports shifting further to lower taxed consumer and intermediate goods, and because much of the import growth had occurred in development and military imports which are exempt from duties.

The mission expressed concern over the adverse fiscal developments in 1987 which, with the enlarged deficit and bank financing, represented a reversal of the past more restrained policies, and noted that the large increase in recourse to external borrowing might have troublesome implications for future debt servicing. The Y.A.R. representatives, while recognizing the fiscal stance was expansionary in 1987, felt that comparing the outcome with that of 1986 was somewhat misleading because the strengthening in fiscal performance in that year could not be continued. Compared with 1985, the 1987 fiscal outturn showed a lesser deterioration.

As to the expansion in expenditure, the representatives explained that the increase in wage outlays resulted from concern over the erosion of real wages in the Government and the need to restore loss of competitiveness with the private sector. As a result, the freeze that had been in effect since 1982 on merit increases and allowances was ended, pay scales in the educational system were increased, and a one-month salary bonus was awarded in 1987. The large increase in special equipment outlays was for both civilian and military purposes and in part attributable to the launching of the Third Five-Year Plan and the availability of concessional financing. The Government had also been required to assist some public utility companies with debt servicing. On revenue, the Y.A.R. representatives pointed to the measures taken during the year, indicating that their yield was upward of YRls 1 billion on a full year basis (2 percent of GDP). With regard to foreign borrowing, the representatives said that the increase had been on concessional terms and that its servicing was manageable.

In 1988 the Government's finances are expected to strengthen due to a sharp (YRls 3.9 billion) increase in petroleum revenue, and the overall deficit is projected by the staff to decline to about YRls 5.5 billion (about 9 percent of projected GDP). The authorities consider, however, that through strengthened tax administration they can limit the deficit to YRls 5 billion. With reduced net foreign financing, domestic bank financing would still be about YRls 4 billion, or 13 percent of money stock. Only minor revenue measures were included in the budget (primarily fees and surcharges on imports). However, due largely to the full year effect of the 1987 measures and a recovery in trade taxes, it is expected that nonpetroleum revenue will increase by 20 percent. Including petroleum revenue, the staff estimates total revenue and grants will increase by 55 percent. With expenditure, a sharp reduction in special equipment outlays is expected to offset sizable increases in virtually all other categories, containing the overall growth to 5 percent. Major areas of increase include wages (14 percent), defense (20 percent), and goods and services expenditure (46 percent).

The mission welcomed the intended tightening in the fiscal stance but also pointed out that as budgeted there was still a very large bank financing requirement, which would exacerbate inflationary pressures. Moreover, should petroleum prices be less buoyant than envisaged, the deficit and bank financing would increase correspondingly. These considerations argued for efforts to contain the deficit, if possible to the YRls 3-3½ billion range, through both selected expenditure restraints and through additional revenue measures. With respect to the latter, the mission referred to the recent Fund technical assistance revenue recommendations, which included: (i) elimination of customs exemptions and the imposition of a minimum customs duty; (ii) raising user and service charges, including tariffs for electricity and water; (iii) converting domestic petroleum taxes from specific to ad valorem rates, with a rate of about 20 percent; (iv) raising the scale of government fees; and (v) intensifying efforts to collect qat tax.

In response, the Y.A.R. representatives said that with the beginning of petroleum exports, the expectations of growth and higher living standards by the population were high. Consequently, it would be difficult to take additional measures immediately although they would be continuing their efforts to improve the fiscal outturn through intensified revenue collection efforts. The representatives added, however, that they would be prepared to act more forcefully later in the year if the fiscal performance warranted it.

c. Monetary and credit policy

Growth in liquidity was reduced to 10 percent in 1987, from 26 percent the previous year. However, with the increase in credit to Government (20 percent of money stock), this was achieved by the imposition of credit ceilings and controls to reduce outstanding credit to the private sector (down 15 percent) and by using external reserves. Credit to public enterprises also fell. At the same time commercial bank domestic currency deposits were augmented by a shift from foreign currency deposits, which fell from 24 percent to 9 percent of total deposits, reflecting changed exchange rate expectations following the appreciation of the rial in early 1987. Thus, while lending was constrained, commercial bank deposits rose by 15 percent and reserves with the Central Bank rose from 46 percent of deposits at end-1986 to 74 percent by end-1987. The restraints on bank lending were accompanied by increased reserve requirements (from 30 percent to 40 percent) and an increase in minimum interest rates on deposits with commercial banks to 8.5-13 percent while maintaining lending rates at a maximum of 15 percent. Consequently, a negative marginal return for banks on most interest-bearing deposits developed, even though interest rates on excess reserves were increased to 5-8.5 percent.

The mission, while welcoming the reduction in monetary growth, expressed concern over the instruments used to achieve it. Crowding out other sectors to offset government requirements could not be sustained without an impact on growth and thus Plan objectives. Further, the use of controls had led to a sizable liquidity overhang within the banking system. The mission urged that commercial bank excess liquidity be addressed directly, i.e., primarily through fiscal adjustment and curtailment of credit to Government, including through the issuance of nonbank financing instruments by the Government.

The Y.A.R. representatives indicated that given the Government's financing needs, credit to other sectors had to be reduced to contain liquidity growth in 1987. The decline in private sector credit had been consistent with the anticipated import level, given that previous increases in private sector credit had in part been used for land speculation and foreign currency purchases. The effects of the large required reserves on bank earnings had been offset by raising the interest rates on excess reserves by up to 1 percentage point. The mission emphasized, however, that while high reserve requirements and controls may be effective over the short term, they posed serious problems for longer term objectives, including efforts to foster greater financial intermediation. Apart from the impact of interest rate policy on bank profitability, the role of interest rates in encouraging savings and efficient resource use is also important. An active interest rate policy with liberalized interest rates was therefore called for. In response, the representatives explained that delays in obtaining parliamentary approval for government nonbank financing instruments had limited the range of policy options. The investment certificate scheme (aimed at directly tapping private savings) might, however, be put into effect in mid-1988. However, the authorities expressed opposition to any increase in interest rates, noting particularly their concern over the possible price impact of higher lending rates.

Looking to 1988, the Y.A.R. representatives said credit to the private sector was targeted to rise by 25 percent, in line with increased import allocations. Interest rates on excess reserves had been reduced by 0.5-1 percentage point. They also indicated the authorities' intention to phase out credit and other administrative controls over the next three years, with a first step possibly in mid-1988. Although the present credit program indicates that an increase in liquidity of about 13 percent is likely, there were no plans to raise reserve requirements.

d. External sector developments and policies

The external position weakened considerably in 1987 (Appendix I). Despite higher transfers, the current account deficit expanded to 14 percent of GDP (2 percent in 1986) while the overall balance shifted to a deficit. The main factor in this deterioration was a 58 percent rise in imports, to about US$1.4 billion, due to a doubling of government imports and a 26 percent increase in private sector imports. To help finance this increase, borrowing from official sources tripled, sizable borrowing from suppliers was undertaken, and there was some rundown in reserves, which nonetheless remained comfortable at about six months' imports. In the process, medium- and long-term external debt rose to 72 percent of GDP, while the debt service ratio jumped from 9 percent to 24 percent; abstracting from the first time inclusion of suppliers' credits repayment, the increase was to 14 percent. In commenting on 1987 developments, the representatives emphasized that the higher imports were to raise capacity utilization and ease inflationary pressures. The suppliers' credits were on favorable terms and had only been drawn in the second half of the year when petroleum exports were imminent. The mission noted, though, that the economy had been moved to a significantly higher level of foreign resource absorption stimulated by the fiscal expansion, and financed by stepped-up borrowing.

The balance of payments outlook for 1988 does not indicate any easing in the overall balance, despite the first full year of petroleum exports. Import allocations were raised 9 percent to about US$1.5 billion even though special equipment imports (and their financing) are much lower, as a 43 percent increase in nongovernment import license allocations is planned. As net earnings from petroleum will not fully cover the potential drop in transfers and foreign assistance, a further sharp rise in suppliers' credits (to US$380 million) and a large reduction in reserves is anticipated. On this basis the current account deficit is expected to be sizably reduced while the overall deficit will more than double. Summarizing, the mission considered that the external outlook supported the argument for implementing a comprehensive program of adjustment. However, the Y.A.R. representatives felt that given the strong reserve position, the projected reserve loss could be met, as could the servicing of suppliers' credits, repayment of which continue to be over 1-3 years at favorable terms.

Early in 1987 the Central Bank took control of all organized foreign exchange activities, 1/ and subsequently restrictions on movements in goods and currencies were tightened to reduce the smuggling of goods into the Y.A.R. and the supply of Yemen rials to the Saudi market. Together with the increase in licensed imports this resulted in the commercial market exchange rate appreciating from YRls 11.86 at end-1986 to YRls 9.76 per U.S. dollar by end-1987, an appreciation of 25 percent in real effective terms. The initial phase of this appreciation apparently prompted anticipation of further appreciation, thereby increasing the conversion of foreign currency holdings into Yemen rials.

Exchange rate appreciation, the mission noted, had eroded the competitiveness of the traded goods sector, and was thus contrary to the expressed policy of broadening the economy's production base. It would in time also discourage private transfers. The fact that the appreciated rate cleared the market--in that there was little differential

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1/ Activities of foreign exchange dealers were banned in December 1986, and in January 1987 the Central Bank became the sole banking system domestic buyer and seller of foreign exchange with the commercial banks as agents.

between the exchange rate in the controlled domestic and free outside markets--did not imply that an equilibrium rate had been achieved given pervasive licensing, large foreign borrowing, and a rundown of reserves. Accordingly, the mission urged greater flexibility with, as a first step, erasure of the real effective appreciation which has taken place since the end of 1986. In response, the authorities indicated that depreciation was not being considered, rather it was likely that the rial would continue to appreciate. Further, they were skeptical over the potential impact of a devaluation on export growth in the nonpetroleum traded goods sector given the economy's resource base. On this latter point the mission commented that with the expected limited duration of petroleum production, it was important to prepare now for the post-petroleum era. The available options indicated that policy should aim at encouraging the traded goods (and services) sector, as well as more generally encouraging efficient resource allocation, including the possibility of a buildup in reserves. These objectives could best be achieved through a combination of the outlined exchange rate policy, and supporting fiscal, credit, and interest rate policies.

The mission welcomed the liberalization of the exchange and trade system that had taken place since the last Article IV consultation. This liberalization includes the unification of the official and commercial market exchange rates on February 1, 1988 (at YRls 9.76 per U.S. dollar). The unified rate is being determined periodically on the basis of central bank foreign exchange purchases in the Jeddah free market. Additionally, the import deposit requirements against the opening of import letters of credit were reduced on January 9, 1988 to between 25 percent and 50 percent of import value, depending on the class of goods to be imported. However, although reduced in scope, the scheme remains an exchange restriction subject to Fund approval. Lastly, the limits on sales of foreign exchange to travelers were increased on January 9, 1988, and amounts larger than the stated limits are now routinely granted. As regards import licensing, in addition to the total value of licenses being increased, any holder of a valid import license is now assured of receiving the equivalent foreign exchange, in contrast with earlier experience. In commenting on these developments the Y.A.R. representatives noted that their objective was to gradually remove all administrative restraints to trade and payments over a period of about three years, and recent changes should be seen as steps in this direction. Additionally, as of 1988 exporters were allowed to use their entire nonpetroleum export receipts (compared with 50 percent previously) to finance permitted imports. The mission noted, though, that although the covered exports were small, it had a distortionary impact and it would be much better to alleviate external imbalances through exchange rate policy.

e. The medium-term outlook

The mission and the authorities jointly prepared two sets of balance of payments projections for the period up to 1992 (Table 2 and Appendix IV for details), assuming a continuation of present policies but under different petroleum production assumptions. Essentially, for each petroleum production level foreign borrowing was held to a level which would maintain the debt service ratio at about 25 percent, with imports utilizing all available resources subject to attaining a gross reserves level of about 4 months' imports (scenario A) and 2½ months' imports (scenario B) in 1992. The two petroleum production levels were (i) 175,000 b/d (scenario A), based upon output plans for the existing fields, and (ii) 300,000 b/d from mid-1989 (scenario B), assuming that sizably more output is confirmed from the two newly discovered petroleum finds. The projections are based upon petroleum export prices for 1988 (US$16.90/barrel) at the time of the mission.

These projections, while cautious regarding private transfers, indicate that with the higher petroleum production level (scenario B) nominal import growth of only 4 percent annually in U.S. dollar terms can be sustained if debt service is to be stabilized and the cushion of reserves is to be held. Alternatively, if output remains at 175,000 b/d, imports need to be reduced by 15 percent annually in 1988 and 1989, before 5 percent annual growth can be resumed. Moreover, a fall in the average export price over the projection period of US$2 per barrel would reduce annual net earnings from petroleum on average by US$75 million in scenario A and US$125 million in scenario B, lowering the sustainable import level significantly in each case.

With this outlook, the mission urged greater caution through implementing a coordinated set of fiscal, monetary, and balance of payments measures to reduce absorption, increase financial savings, and curtail trade restrictions. Such a package should reduce imports from the planned 1988 levels while stimulating the tradable goods sector and encouraging private transfers. Should the higher petroleum production scenario subsequently prove achievable, the options of expanding imports or building reserves could be considered, keeping in mind the limited life of the existing fields. 1/

1/ Subsequent to the discussions, the staff explored the domestic adjustment implications of the two scenarios, assuming the existing exchange rate is maintained. In brief, this showed that if all the adjustment is in the fiscal sector, under scenario A large fiscal deficit reductions averaging 6½ percent of GDP to reach deficits of 5-6 percent of GDP would be needed. Under scenario B a policy of moderate fiscal restraint (provided by a limited decline in the expenditure ratio) would sufficiently limit aggregate demand expansion. However, the higher petroleum revenues would be fully absorbed. An active exchange rate policy would, of course, ease the scale of needed domestic adjustment.

Table 2. Yemen Arab Republic: Medium-Term Balance of Payments, 1987-92

(In millions of U.S. dollars)

	Prel. 1987	Scenario A 1988	1989	1990	1991	1992	Scenario B 1988	1989	1990	1991	1992
Current account	-607	13	259	191	18	-59	-287	75	305	101	36
Exports	69	1,012	1,098	1,137	1,178	1,221	1,012	1,575	1,962	2,031	2,104
Imports	-1,371	-1,192	-1,013	-1,064	-1,117	-1,173	-1,492	-1,552	-1,614	-1,678	-1,745
Services (net)	-185	-422	-383	-371	-479	-491	-422	-506	-545	-702	-723
Of which: petroleum company profits	-8	-192	-206	-213	-321	-332	-192	-258	-297	-451	-467
Unrequited transfers	880	615	557	502	450	400	615	557	502	450	400
Official	162	115	100	85	70	55	115	100	85	70	55
Private (net)	718	500	457	417	380	345	500	457	417	380	345
Capital account (including errors and omissions)	554	-133	-341	-340	44	44	167	-348	-494	44	44
Loans	472	250	200	200	200	200	250	200	200	200	200
Suppliers' credits	265	150	150	150	150	150	380	380	380	380	380
Repayment of loans	-110	-120	-242	-243	-231	-231	-120	-242	-243	-231	-231
Repayment of suppliers' credits	-123	-115	-170	-170	-150	-150	-115	-263	-307	-380	-380
Petroleum investment repayments	-12	-328	-354	-352	--	--	-328	-498	-599	--	--
Other	62	30	75	75	75	75	100	75	75	75	75
Change in reserves	-53	-120	-82	-149	62	-15	-120	-273	-189	145	80
Memorandum items:											
Net petroleum exports 1/	18	450	493	525	808	836	450	775	1,018	1,531	1,584
Debt service ratio (in percent of current receipts)	23.9	16.7	26.0	26.0	24.3	24.3	17.2	25.4	23.9	25.9	25.6
Gross reserves of banking system (in months of imports)	6.0	5.9	6.0	4.1	4.5	4.2	4.8	2.5	1.0	2.0	2.4

Sources: Central Bank of Yemen; and staff projections.

1/ Oil exports minus oil company profits and repayments of investments.

In response, the authorities said that while aware of the risks, they were optimistic that the higher petroleum output level would be achieved and felt it was premature to undertake policies to reduce imports now. Should prospects prove less favorable than scenario B by mid-1988, demand management and import licensing could be tightened from the second half of the year. Given present expectations in the country, an earlier policy response was not feasible.

IV. Staff Appraisal

Up to the early 1980s, growing private transfers and official assistance supported rising levels of expenditure, rapid real growth, and a buildup in external reserves in the framework of an open trade and payments system. However, with a downturn in these inflows from the early 1980s financial imbalances arose, necessitating by end-1982 adjustment of the economy to a much lower level of foreign resource availablity.

The authorities' policy response to these changed circumstances over the period up to 1986 comprised a combination of demand and structural measures, together with administrative restraints. Central to this adjustment, was a decrease in the overall fiscal deficit from 26 percent of GDP in 1982 to 10 percent in 1986, largely through expenditure reductions. Even with this large reduction, bank financing of Government remained the major element in monetary expansion, which averaged 25 percent annually. Moreover, monetary expansion was only held to this level by increasing reserve requirements on banks, offering higher interest rates on excess deposits, and by use of official reserves. Another important measure was the substantial depreciation of the exchange rate by allowing a commercial market to be established. On the other hand, restraint of demand for imports was supplemented by import licensing and payments restrictions which were tightened progressively in an effort to contain the imbalances and limit the depreciation of the exchange rate.

As a result of these measures the external current account deficit declined from a peak of 13 percent of GDP in 1982 to 2 percent in 1986, despite private and official transfers being almost halved, while the overall balance was shifted to a sizable surplus. However, price increases accelerated sharply and real output growth became increasingly dependent on the protection afforded by import licensing and other external barriers. Thus, while a significant degree of adjustment was achieved, further efforts were needed to address the inflationary and balance of payments pressures that remained at the end of 1986, including through a reduction in import licensing and other restrictions, in order to achieve a more efficient economy.

By 1987 an important new factor in policy formulation was the imminence of petroleum exports. Against a background of accelerating inflation and shortages of imported inputs the authorities chose to anticipate the possible easing of the foreign exchange constraint by increasing sizably their foreign borrowing and imports, while shifting the stance of fiscal policy toward expansion. Overall, the fiscal deficit rebounded to over 20 percent of GDP in 1987 principally due to a jump in expenditure, while its bank financing doubled. In an effort to offset the expansionary effect on monetary aggregates the authorities reduced credit to the rest of the economy and drew down reserves. These actions, along with a shift from foreign to domestic currency deposits, resulted in commercial bank reserves with the Central Bank rising to three quarters of deposits, creating major excess liquidity in the banking system. Externally, with a tightening of controls and increased anti-smuggling efforts the commercial market exchange rate was appreciated. Due to a doubling of government imports and a sizable increase in private sector imports the external current account deficit thus returned to a much higher level and an overall deficit was incurred. While the staff recognizes that the authorities were faced with the pressures of rising expectations, the relaxation of fiscal and expenditure restraint in 1987 has moved the economy to a much higher level of expenditure and absorption, a development facilitated by borrowing against future petroleum receipts.

With the beginning of petroleum exports the authorities' policy is to achieve a large reduction in the 1988 fiscal deficit (equal to the gain in petroleum revenue) to 9 percent of GDP. The authorities are to be commended for this policy objective despite the continuing pressures of rising expectations. However, the staff estimates that even if this objective is achieved bank financing of the fiscal deficit will still be large and will add further to inflationary pressures. Moreover, petroleum export receipts are not expected to cover the anticipated drop in private transfers and foreign assistance and, consequently, a further rise in suppliers' credits and reduction in official reserves may be unavoidable. As shown in the analyses of the medium term, the size of petroleum-related resources is crucial in determining the scope of needed adjustment policies. The indications are that a continuation of the present policy stance is not sustainable at present oil production and price levels, and would be barely sustainable even if a sharp increase in exports is obtained from newly discovered fields. The staff is therefore of the view that there is a need to implement adjustment policies without delay. The authorities, on the other hand, have expressed their awareness and concern over the implications of present policies for the future, but indicated that they consider a reassessment of prospects and policies by mid-1988 will be quite soon enough to address any problems that might emerge.

In addition to the need for adjustment policies, a central issue is how to use most effectively petroleum receipts to further economic progress. Given the limited life of the present oil fields, policies which will encourage diversification and growth without the need for trade barriers are of great importance. To advance these objectives, a comprehensive package of measures is called for, embracing the major policy areas of public finance, credit and monetary policies, and the exchange and trade system. These policies should, of course, include a continuation of the present open domestic pricing policies and further progress in eliminating restrictions.

A cornerstone of any policy package needs to be a sustained reduction in the overall fiscal deficit and its bank financing. With the boost to revenue from petroleum, outstanding bank financing should perhaps even be reduced over the medium term. In addition to ongoing efforts to improve tax administration and expenditure control, the staff would urge early implementation of revenue measures recommended by the recent Fund technical assistance mission. This would improve the elasticity and structure of the tax system in addition to increasing its immediate yield. With expenditure, areas for adjustment include pruning low priority outlays and focusing investment priorities on high-return projects.

A reduction in the Government's credit needs would enable removal of credit restraints to be accelerated, increasing financing to other sectors while addressing the problem of very high commercial bank reserves with the Central Bank. The issuance this year of investment certificates to the nonbank private sector would be helpful in this process. A flexible, liberalized interest rate policy with positive real rates is of central importance, both to encourage savings and promote efficient resource use, and to ensure positive returns to banks on marginal deposits.

In a welcome move, the authorities have unified the exchange rates at the commercial market rate and simplified the trade and payments system. These actions have eliminated exchange restrictions subject to Fund approval under Article VIII, except for the restriction arising from the import deposit requirements. As the authorities have indicated their intention to phase out all administrative restraints over the next three years, the staff recommends approval of this remaining restriction. Adjustment of the now unified exchange rate to a level which does not require protective devices or unsustainable levels of foreign borrowing would be appropriate, perhaps initially by erasing the recent real effective appreciation. Indeed, setting the exchange rate at a level which ensures the competitive position of the non-oil traded goods sector is essential. The authorities have indicated their intention to remove the remaining exchange restriction and restraints on inputs over the next three years, as circumstances permit. It would be desirable for this to be done at an early date as part of the outlined comprehensive policy package.

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

V. 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, Section 2, in the light of the 1988 Article IV consultation with the Yemen Arab Republic conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The payment procedure related to imports, as described in SM/88/__, constitutes an exchange restriction subject to approval by the Fund under Article VIII, Section 2(a). The Fund welcomes the elimination of the multiple currency practice which arose from the previous dual exchange rate system, the elimination of other exchange restrictions, and the Yemen Arab Republic's intention to eliminate the remaining restriction at an early date. The Fund grants approval for this practice until May 31, 1989, or the completion of the next Article IV consultation, whichever is earlier.

Yemen Arab Republic: Basic Data, 1982-88

I. Social and Demographic Indicators 1/

Area	Population	Density
195 thousand sq. km.	9.3 million	84 per sq. km. of agricultural land

Population characteristics

Life expectancy at birth (years)	45
Crude birth rate (per thousand)	48
Crude death rate (per thousand)	21
Infant mortality rate (per thousand)	154
Child death rate (per thousand)	34
Percentage age distribution: under 15	46
15-64	51
over 64	3
Urban population (in percent)	19
Per capita GNP (1987)	US$530

Food, Health and Nutrition

Index of food production per capita (1979-81 = 100)	95
Per capita daily supply of	
Calories	2,266
Proteins	65
Population per physician (thousand)	8.1
Population per hospital bed (thousand)	2.2
Access to safe water (percent)	31

Education

Primary enrollment rate	67
Male	112
Female	22
Primary pupil-teacher ratio	46

II. Economic and Financial Indicators 2/

	1982	1983	1984	1985	1986	Prel. 1987	Proj. 1988
				(In percent per annum)			
Rate of growth of real GDP at market prices	...	2.4	3.4	4.5	9.4	4.8	25.0
Rate of growth of real GNP at market prices	...	-0.1	5.9	2.2	13.0	7.2	20.0
Rate of change in Sana'a retail price index	2.7	5.3	15.1	24.6	29.4	21.7	...
				(In billions of Yemen rials)			
Government finances							
Revenue and grants	5.7	5.3	5.4	6.0	9.0	9.0	14.0
Revenue	(3.7)	(4.4)	(4.7)	(5.4)	(7.2)	(7.5)	(12.7)
Grants	(2.0)	(0.9)	(0.8)	(0.7)	(1.8)	(1.5)	(1.2)
Expenditure	11.0	10.1	10.0	11.1	12.8	18.5	19.5
Current (including extrabudgetary)	(6.9)	(7.1)	(6.8)	(7.9)	(9.9)	(11.9)	(14.2)
Capital (including all externally financed outlays)	(4.0)	(2.9)	(3.2)	(3.1)	(2.9)	(6.6) 3/	(5.3)
Overall deficit	5.3	4.8	4.6	5.0	3.8	9.5	5.5
Financing							
External	(0.8)	(0.9)	(0.8)	(0.8)	(0.6)	(3.3)	(1.3)
Domestic	(4.4)	(3.9)	(3.8)	(4.3)	(3.2)	(6.2)	(4.2)

Yemen Arab Republic: Basic Data, 1982-88 (continued)

	1982	1983	1984	1985	1986	Prel. 1987	Proj. 1988
			(In percent of GDP at current market prices)				
Revenues and grants	29	24	22	19	24	21	23
Revenues	(19)	(20)	(19)	(17)	(19)	(17)	(21)
Grants	(10)	(4)	(3)	(2)	(5)	(3)	(2)
Expenditures	55	46	41	36	33	43	32
Current (including extrabudgetary)	(35)	(32)	(28)	(26)	(25)	(28)	(23)
Capital (including all externally financed outlays)	(20)	(14)	(13)	(10)	(8)	(15) 3/	(9)
Overall deficit	26	22	19	16	10	22	9
Financing							
External	(4)	(4)	(3)	(3)	(2)	(8)	(2)
Domestic	(22)	(18)	(16)	(13)	(8)	(14)	(7)
			Changes during period (In billions of Yemen rials)				
Net foreign assets 4/	-1.6	-1.0	-0.1	-0.7	2.7	-0.3	-1.2
Net domestic assets	4.0	4.4	5.0	5.2	4.6	3.7	5.5
Claims on Government (net)	(4.4)	(3.9)	(3.8)	(4.3)	(3.2)	(6.2)	(4.3)
Claims on nongovernment	(0.1)	(0.2)	(1.1)	(0.8)	(0.6)	(-1.2)	(1.2)
Other items (net)	(-0.5)	(0.3)	(0.1)	(0.2)	(0.8)	(-1.3)	(--)
Total liquidity	2.6	3.4	4.4	4.1	6.2	3.1	4.3
			Changes during period (In percent of domestic liquidity at beginning of period)				
Net foreign assets 4/	-16	-8	-1	-3	11	-1	-4
Net domestic assets	41	35	32	26	19	12	17
Claims on Government (net)	(45)	(31)	(24)	(21)	(13)	(20)	(13)
Claims on nongovernment	(2)	(2)	(7)	(4)	(3)	(-4)	(4)
Other items (net)	(-6)	(2)	(1)	(1)	(3)	(-4)	(--)
Total liquidity	26	28	28	20	26	10	13
Memorandum items:							
Total liquidity (YRls billion)	12.5	16.0	20.4	24.4	30.7	33.7	38.0
Ratio of non-oil GDP to domestic liquidity 5/	1.8	1.5	1.4	1.4	1.4	1.3	1.4

Yemen Arab Republic: Basic Data, 1982-88 (concluded)

	1982	1983	1984	1985	1986	Prel. 1987	Proj. 1988
			(In millions of U.S. dollars)				
Balance of payments							
Exports	4.9	9.8	9.0	8.2	16.4	69.0	1,012.3
Imports	-1,952.4	-1,796.0	-1,413.7	-1,106.1	-867.7	-1,370.7	-1,492.0
Services (net)	-37.3	-51.5	-45.8	-71.6	-77.0	-184.9	-421.8
Unrequited transfers	1,392.7	1,293.1	1,137.3	850.2	835.9	879.8	615.0
Of which:							
Government receipts	(468.7)	(189.4)	(143.4)	(102.8)	(240.5)	(162.2)	(115.0)
Private receipts	(1,191.4)	(1,244.4)	(1,067.0)	(809.2)	(669.0)	(761.7)	(550.0)
Current account	-592.1	-544.6	-313.2	-319.3	-92.4	-606.9	-286.5
(In percent of GDP)	(-13.4)	(-11.2)	(-6.7)	(-7.6)	(-2.3)	(-14.2)	(-5.4)
Nonmonetary capital 6/	192.9	282.5	115.3	147.8	225.7	493.8	66.9
Of which:							
Drawings on loans	(231.8)	(234.3)	(226.6)	(167.4)	(142.0)	(472.1)	(250.0)
Repayment of loans	(-43.8)	(-23.6)	(-63.7)	(-48.0)	(-61.7)	(-110.2)	(-120.0)
Suppliers' credits	(...)	(...)	(...)	(10.7)	(130.0)	(264.7)	(380.0)
Overall balance	-310.5	-216.4	-121.3	-161.1	194.5	-52.8	-119.6
(In percent of GDP)	(-7.0)	(-4.5)	(-2.6)	(-3.8)	(4.9)	(-1.2)	(-2.2)
Banking system's gross foreign assets	795.9	598.7	523.2	537.6	688.9	686.1	591.0
(In months of imports, c.i.f.)	(4.9)	(4.0)	(4.4)	(5.8)	(9.5)	(6.0)	(4.8)
Stock of debt (medium- and long-term) (in percent of GDP)	31.6	32.4	35.5	46.9	58.6	72.0	59.8
Debt service							
(In percent of current receipts) 7/	(2.7)	(2.1)	(5.4)	(6.0)	(9.4)	(23.9)	(17.2)

1/ 1986 data, obtained from the World Bank and IFC, Social Indicators of Development, 1987.
2/ Data provided by the Central Planning Organization, Ministry of Finance and Central Bank of Yemen; and Fund staff estimates.
3/ Excludes approximately YRls 3.2 billion (7 percent of GDP) in special equipment purchases, provisionally classified as capital expenditure.
4/ Excludes Central Bank of Yemen valuation adjustment.
5/ Denominators are average of beginning and end-period data.
6/ Excludes errors and omissions.
7/ Includes suppliers' credits from 1987. Suppliers' credit repayments are not available for earlier years, although they are estimated to have been small. Data from 1987 thus not fully comparable to earlier years.

Yemen Arab Republic: Fund Relations
(As of March 31, 1988)

(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:	43.3 (99.97 percent of quota)
(c)	Fund credit:	--
	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:	8.7 (140.5 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 February 1, 1988) the Yemen rial was depreciated reaching YRls 9.76 per US$1, a rate which unified the official and commercial markets. Presently, the central bank rates for buying and selling the U.S. dollar are YRls 9.75 = US$1 and YRls 9.77 = US$1, respectively. The representative rate established under the Fund's Rule O-2 is now YRls 9.76 = US$1. Until the February 1, 1988 unification, the bulk of foreign exchange transactions was conducted at the commercial market rate. The commercial bank rate depreciated from YRls 4.5 to YRls 11.86 per U.S. dollar between 1984 and end-1986. It was subsequently appreciated and has been YRls 9.76 per U.S. dollar since September 1987.

VIII. Last Article IV Consultation:

Discussions were held in Sana'a during November 1986. The Staff Report (SM/87/28) was discussed by the Executive Board on March 2, 1987.

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

The Executive Board's decision (Decision No. 8539-(87/35) adopted March 2, 1987, 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 1986 Article XIV consultation with the

Yemen Arab Republic and 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.

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. The foreign exchange expert's position was discontinued in July 1986. The Central Bank has since requested a General Advisor; CBD is currently in the process of locating a suitable expert.

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.

3. In July 1987, a staff mission visited Sana'a to offer recommendations on the institutional set-up and characteristics of government securities which would comply with Islamic principles. The mission report was sent to the authorities in October 1987.

(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 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 reviewed the tax system. The mission report was submitted to the authorities in August 1987 and an Arabic translation was provided in February 1988. A follow-up visit took place in March/April 1988.

(d) Other

1. 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.

2. In December 1987, MED sent the Central Bank a note on alternative approaches to assess the value of the Yemen rial.

X. Resident Representative/Advisor: None.

Yemen Arab Republic: Relations with the World Bank

Statement of IDA Credits 1/

(As of October 31, 1987)

Purpose	Year	(Amount US$ millions) (Less cancellations) IDA Credit Amount	Undisbursed
Fully disbursed credits		156.8	
Tihama Agriculture III	1979	15.0	2.8
Education III	1979	10.0	0.9
Fisheries Development	1980	17.0	6.7
Southern Uplands Rural Development II	1980	17.0 2/	0.5 2/
Industrial Development I	1981	12.0	0.9
Sana'a Urban Development	1982	15.0	5.3
Education IV	1982	12.0	3.3
Petroleum and Geothermal Exploration	1982	2.0	0.8
Agricultural Research and Development	1982	6.0	1.6
Highways IV	1982	7.0	1.6
Health	1982	10.5	3.4
Agricultural Credit	1982	8.0	2.6
Education V	1983	10.0	5.7
Power III	1983	19.0	12.2
Highways V	1983	13.0	7.4
Urban II	1984	12.0	9.3
Central Highlands Agricultural Development	1984	8.0	5.7
Education VI	1984	10.0	8.0
Industrial Development II	1985	8.0	6.6
Technical Assistance to Central Planning Organization	1985	4.7	3.8
Wadi Al Jawf Agricultural Development	1985	10.0	9.7
Technical Training	1986	12.7	12.0
Tihama V Regional Agriculture	1986	10.0	9.0
Power IV 3/	1986	11.7	
Technical Assistance Petroleum Sector	1986	12.0	10.3
Marib-Safir Road	1986	10.0	4.5
Southern Regional Agricultural Development 4/	1987	12.3	
Teacher Training 3/	1987	10.4	
Totals		462.1	134.6
Of which has been repaid		3.4	
Total now held by IDA		458.7	

1/ Does not include IDA cofinancing.

2/ Beginning with the second credit in 1980, amounts have been denominated in SDRs. The dollar amounts in these columns represent the dollar equivalents at the time of credit negotiations for the IDA amounts and the dollar equivalents as of September 30, 1987, for the undisbursed amounts.

3/ Not yet signed.

4/ Not yet signed.

Medium-Term Scenario Assumptions

1. Assumptions common to both scenarios

The following common assumptions are made in both medium-term balance of payments scenarios.

a. Current account

Oil prices: US$16.9 per barrel in 1988, rising by 3.5 percent annually thereafter (in line with WEO).

Non-oil merchandise exports: 4 percent per annum volume increase, i.e., no substantial improvement in competitiveness.

Service receipts: growth of about 5 percent per annum in nominal terms.

Official transfers: a gradual decline to US$55 million in 1992.

Private transfers: 7.5 percent per annum decline in nominal terms, assuming some migrant workers return to the Y.A.R. This also implies that a substantial part of remittances remain outside the banking system.

Service payments: apart from interest payments, service payments are assumed to rise in line with merchandise imports (see below).

Private transfer payments: constant in real terms.

b. Capital account

Drawings on loans: stabilize at US$200 million per annum in 1989.

Other: private trade credit of US$75 million per annum.

Terms of suppliers' credits: US$100 million annually with one-year maturity, no interest; US$50 million annually at 5 percent interest, one-year maturity; remainder at 5 percent interest, three-year maturity (similar to 1987 loans).

Terms of project and commodity loans: 4 percent interest, five-year grace period, twenty-year maturity (average terms of past loans).

No debt rescheduling.

2. Different assumptions for each scenario

The two scenarios differ with regard to the level of oil production, imports, and foreign borrowing (suppliers' credits).

	Scenario A	Scenario B
Oil production	175,000 b/d from March 1987	With start-up of new fields production rises in 1990 to 300,000 b/d
Imports	15 percent per annum decreases in 1988-89, 5 percent per annum rise in subsequent three years	Increase to US$1,492 million in 1988; 4 percent per annum growth during 1989-92
Suppliers' credits	US$150 million per annum during 1988-92	US$380 million per annum during 1988-92

Yemen Arab Republic--Statistical Issues

1. Outstanding Statistical Issues

a. Government Finance

The 1987 GFS Yearbook and April 1988 IFS contain the same data on consolidated central government accounts through 1986. The presentation in the GFS Yearbook is complete except for tables on financing and outstanding debt by type of debt holder and debt instrument where the last year with full data presentation is 1980.

b. Monetary Accounts

Data for nonfinancial public enterprises need to be reported separately from 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 Yemen Arab Republic in the April 1988 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Central Bank of Yemen, which apart from monetary data have during the past year been provided on an infrequent basis.

Status of IFS Data

			Latest Data in April 1988 IFS
Real Sector	- National Accounts		1985
	- Prices: WPI		n.a.
	- Production		n.a.
	- Employment		n.a.
	- Earnings		n.a.
Government Finance	- Deficit/Surplus		1986
	- Financing		1986
	- Debt		1986
Monetary Accounts	- Monetary Authorities		November 1987
	- Deposit Money Banks		November 1987
	- Other Financial Institutions		n.a.
Interest Rates	- Discount Rate		n.a.
	- Deposit Rate		November 1987
	- Bond Yields		n.a.
External Sector	- Merchandise Trade:	Values	1986
		Prices	n.a.
	- Balance of Payments		Q4 1986
	- International Reserves		1987
	- Exchange Rates		February 1988