FOR AGENDA

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August 29, 1986

To: Members of the Executive Board

From: The Acting Secretary

Subject: People's Democratic Republic of Yemen - 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 People's Democratic Republic of Yemen, which will be brought to the agenda for discussion on a date to be announced. A draft decision appears on page 18.

Mr. Zavadjil (ext. 7115) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

PEOPLE'S DEMOCRATIC REPUBLIC OF YEMEN

Staff Report for the 1986 Article IV Consultation

Prepared by the Staff Representatives for the 1986 Consultation with the P.D.R. of Yemen

Approved by S.H. Hitti and J.T. Boorman

August 28, 1986

I. Introduction

The 1986 Article IV consultation discussions with the P.D.R. of Yemen were held during the period July 5-13, 1986 in Aden. 1/ The mission also held preliminary discussions on the Structural Adjustment Facility (SAF) in which two staff members of the World Bank also participated. The Yemeni representatives were led by the Governor of the Bank of Yemen and included senior officials from various ministries and other public sector institutions. The mission also met with the Prime Minister and the Minister of Finance. The Executive Board considered the Staff Report on the 1985 consultation discussions (SM/85/133) on June 10, 1985. The P.D.R. of Yemen continues to avail itself of the transitional arrangements of Article XIV. Relations with the Fund and the World Bank Group are outlined in Appendices I and II, respectively.

II. Background

Since independence in 1967, the P.D.R. of Yemen has pursued a development strategy, formulated within a socialist framework, aimed at developing infrastructure, diversifying production, and meeting the basic needs of the population. The task of development is a formidable one as the country lacks natural resources, has a widely dispersed population, and the harsh arid climate renders over 95 percent of the land unsuitable for agriculture. The main generator of economic growth has been the ambitious public investment program, which has absorbed over 40 percent of GNP in most years. While notable strides have been made in achieving some of the goals outlined above, growth has averaged only 2-3 percent per annum since 1967. Although this was partly due to

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1/ The staff team consisted of Messrs. K. Nashashibi (Head, MED), G. Begashaw (ETR), S. Geadah, P. Stella, and M. Zavadjil (all of MED), and Mrs. Pauline Dhillon (Secretary, INST).

the large portion of investment directed toward social services, it also reflected some rigidities in the allocation of resources and the lack of sufficient production incentives. In particular, extensive controls have been maintained over the activities of both private and public sector enterprises. Inflexible official pricing policies have tended to constrain production, especially in the agricultural sector, while exchange rate policy has distorted cost-price relationships, limiting the expansion of the traded goods sector. However, it should be noted that detailed plans are not made for enterprise inputs and outputs, leaving them some room to maximize profits despite the maintenance of extensive price controls.

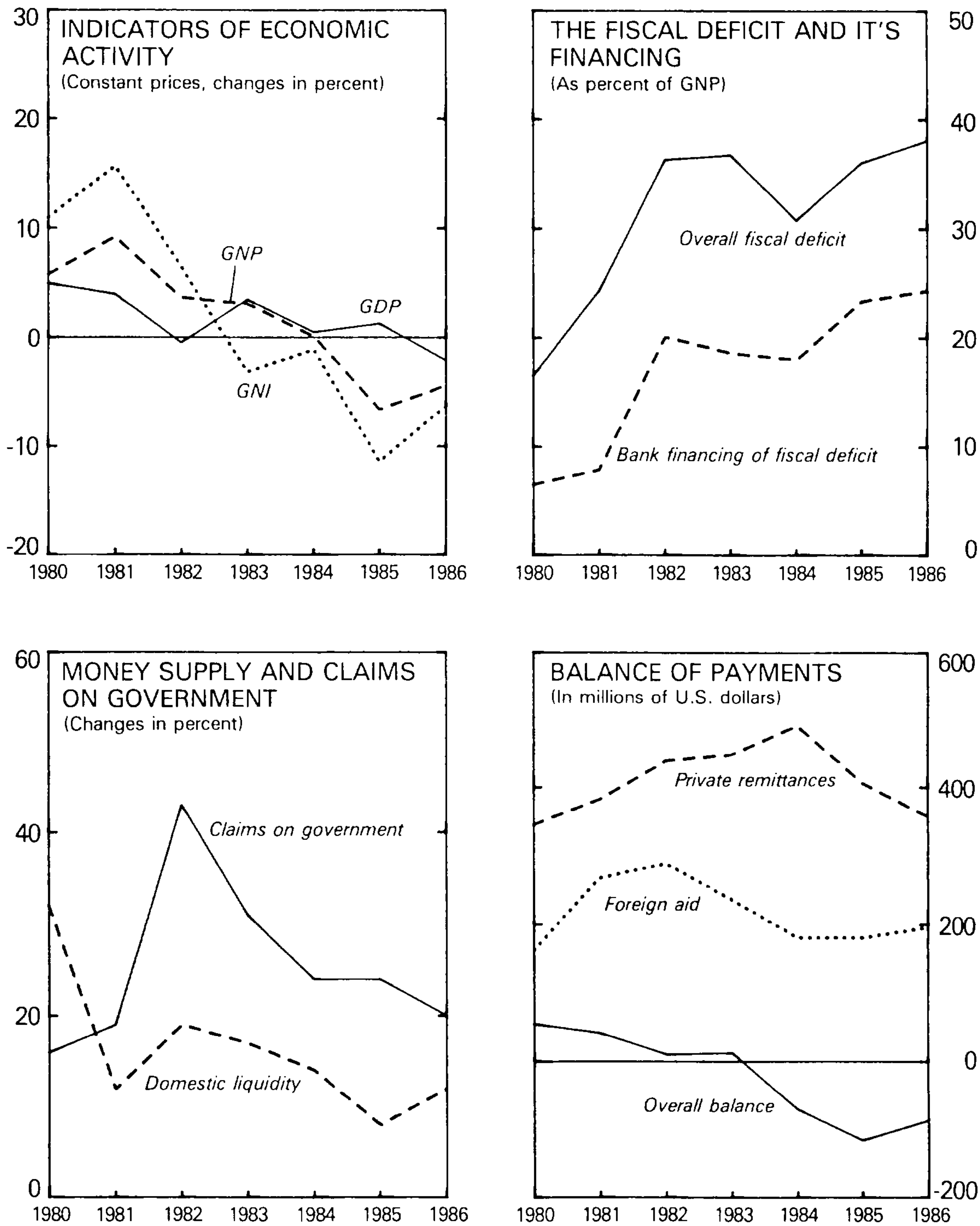
In the mid-1980s, the country's development effort began to face considerable financing constraints, partly as a result of a deterioration in the external economic environment, particularly the economic slowdown in the oil producing countries of the region. Foreign aid was reduced by 37 percent in 1983-84, while the growth of inward remittances slowed in 1983-84, and a decline of 17 percent was recorded in 1985 (Appendix III, Table 1, and Chart). Furthermore, the country's traditional source of foreign exchange, the refinery, lost its competitiveness in relation to the technologically more advanced refineries in neighboring countries, and demand for the bunkering services of the Port of Aden declined sharply. In addition to these external factors, floods in 1982 caused considerable damage, while the drought (1983-86) has hampered agricultural production. Economic growth was sluggish in 1982-85, averaging an estimated 1 percent against 5 percent in the preceding five years.

The decline in foreign resources, coupled with the acceleration of development spending during the Second Five-Year Plan (1981-85) and the slowdown in economic growth, led to considerable pressures on the fiscal position. The overall deficit reached 37 percent of GNP in 1983, and in consequence the Government embarked on an adjustment program whose results were felt largely in 1984. In that year domestic revenues increased by 11 percent--reflecting increases in some sales tax rates, better collection procedures, and a rise in the contribution of public enterprises--while growth of expenditures was contained to 5 percent, mainly on account of the stagnation of capital expenditures. The overall deficit was reduced by YD 15 million to YD 116 million, or 31 percent of GNP. In 1985, however, the fiscal situation deteriorated once more with the overall deficit rising to 36 percent of estimated GNP and bank financing to 23 percent of GNP. Revenues declined substantially due principally to a one-third decrease in taxes on international trade reflecting lower imports, as well as a shift in their composition away from consumer items that bear high duty rates. Another factor was the slowdown in growth of GNP to about 1 percent per annum in nominal terms, which reduced revenues from public corporations. Because of the expanding infrastructure and social services, current expenditures continued to grow in 1985, but development expenditures were reduced to YD 112 million from YD 131 million.

CHART 1

P.D.R. OF YEMEN

SELECTED ECONOMIC INDICATORS, 1980-86



Sources: Data provided by the PDR of Yemen authorities, and staff estimates.

Table 1. P.D.R. of Yemen: Selected Economic Indicators, 1980-86

	1980	1981	1982	1983	1984	Est. 1985	Proj. 1986
			(Annual change, in percent)				
National income and prices							
GDP (at constant factor cost)	5.0	4.0	-0.5	3.5	0.5	1.3	-2.1
GNP (at constant prices)	5.8	9.2	3.7	3.1	0.1	-6.6	-4.4
GNI (at constant prices)	10.9	15.6	6.5	-3.2	-1.1	-11.4	-6.3
Consumer prices	10	4	10	11	1	...	...
Wholesale prices	8	4	5	1	--	...	...
Government finances							
Grants and revenues	65.6	12.1	10.1	2.4	14.9	-10.0	6.7
Revenues	70.8	20.1	-2.5	12.9	10.6	-9.6	11.0
Expenditures	29.5	48.4	12.1	8.7	5.2	-4.8	3.0
Money and credit							
Domestic liquidity	32	12	19	17	14	8	12
Claims on government	16	19	43	31	24	24	20
External sector							
Exports	53.6	-18.5	-22.0	6.1	-23.6	17.9	27.8
Imports	55.6	7.5	7.8	-1.0	7.4	-15.0	-15.7
Private transfers	11.2	17.9	15.0	1.9	9.7	-17.3	-12.3
Foreign aid	87.8	63.8	7.9	-18.1	-23.3	--	8.3
Nominal effective exchange rate (appreciation +)	...	17.1	13.4	10.1	11.4	-10.4	-8.4 1/
			(In percent of GNP) 2/				
Government finances							
Revenues	39.2	41.2	37.2	38.2	40.1	37.3	43.2
Expenditures	59.1	76.8	79.8	78.9	78.7	77.1	83.3
Overall fiscal deficit	16.5	24.4	36.3	36.7	30.7	36.0	38.1
Bank financing of fiscal deficit	6.5	7.9	20.1	18.6	18.0	23.4	24.4
External sector							
Current account deficit	21.0	13.1	15.1	22.6	24.9	22.3	18.7
External debt	82.7	85.1	100.9	108.6	116.6	132.8	147.9
			(In millions of U.S. dollars, unless otherwise stated)				
External sector							
Current account	-157	-114	-141	-234	-270	-236	-190
Overall balance	54	41	10	12	-71	-116	-87
Gross international reserves 3/	363	367	393	367	280	221	136
External debt 3/ 4/	620	739	952	1,123	1,269	1,403	1,499
Debt service 4/	11	6	8	8	10	19	31
Debt service ratio (in percent of exports of goods and services and private remittances) 4/	6.9	3.5	4.0	4.0	5.1	11.6	20.7

Sources: Data provided by the P.D.R. of Yemen authorities; and staff estimates.

1/ To end May 1986.
2/ At factor cost.
3/ End of period.
2/ Including obligations to the Arab Monetary Fund, the IMF, and short-term foreign liabilities.

Despite the rapid growth of net claims on Government, growth of domestic liquidity slowed to 14 percent in 1984 and 8 percent in 1985, as much of the expansionary effect of government borrowing was offset by the drawdown in net foreign assets. Credit to the nongovernment sector grew only marginally in 1984-85, 1/ reflecting the authorities' efforts to restrain the growth of domestic liquidity. During 1984-85 growth of domestic liquidity greatly exceeded the increase in real GNP, but the resulting inflationary pressures were to a large extent suppressed through strict price controls. The consumer price index increased by only 1 percent in 1984 and a similar outcome is estimated for 1985.

The balance of payments of the P.D.R. of Yemen is characterized by a large trade deficit which is financed mainly by private transfers and foreign aid. After recording overall surpluses in the 1980-83 period, serious balance of payments difficulties emerged in 1984-85. During the latter period exports averaged only US$33 million a year, somewhat lower than in previous years, while the services account turned negative for the first time in 1985, as lower foreign exchange reserves and international interest rates reduced interest earnings. As already noted, inward remittances recorded a substantial decline in 1985 while foreign aid receipts averaged US$181 million in 1984-85, compared with US$262 million in the preceding two years. As a result, large overall deficits, averaging US$94 million, were recorded in 1984-85. In response to declining reserves, the Government tightened controls in 1985 so that imports fell by 16 percent, although this decline partly reflected the purchase of two aircraft in 1984.

At the end of 1985, gross official foreign exchange reserves amounted to US$221 million, equivalent to about four months of imports, compared to a peak of US$393 million in 1982. Almost all external debt has been contracted on highly concessional terms--with an average interest rate of around 2 percent--from the CMEA member states, as well as from the World Bank and regional development institutions, and has been used almost entirely for development purposes. At the end of 1985, the external debt, including obligations to the IMF and the Arab Monetary Fund, amounted to about US$1.4 billion, equivalent to about 130 percent of GNP.

In January 1986, a conflict broke out in the P.D.R. of Yemen which resulted in substantial destruction. This has necessitated a major reconstruction effort as damage to buildings and infrastructure is roughly estimated at US$120 million. In addition, there was considerable disruption of economic activity, particularly in the industrial, trade, and services sectors. On the positive side, the decline in international oil prices in 1986 is expected to save the country about US$90 million (about 9 percent of GNP).

1/ Excluding a loan to the national airline for the purchase of two aircraft.

The Yemeni dinar has been pegged to the U.S. dollar at the rate of US$2.89524 = YD 1 since February 1973. By May 1986 the dinar had appreciated by 34 percent in nominal effective terms over its average level in 1980. As prices are largely controlled and the basket of traded goods produced in the P.D.R. of Yemen differs markedly from the composition of its imports, real effective exchange rate movements do not accurately reflect changes in the competitiveness of the traded goods sector. Therefore, competitiveness in the P.D.R. of Yemen can best be gauged by evaluating costs of production in major traded activities in relation to the prices of their alternative imports. A study undertaken two years ago revealed that costs of production of a number of agricultural products--including traditional export crops such as cotton--exceeded the international prices of their equivalents; indications are that these divergencies have widened since then.

The P.D.R. of Yemen maintains extensive controls over payments for imports of goods and services under the transitional provisions of Article XIV. Exchange allocations for imports are made according to the annual program prepared at the beginning of the year; the program may be adjusted during the year in the light of changing circumstances. To encourage remittances from Yemenis abroad, the maintenance of foreign exchange accounts by nonresidents has been permitted since 1978.

III. Medium-Term Outlook

To focus the discussions on structural policies, the mission, in cooperation with the Yemeni officials, prepared illustrative balance of payments and fiscal projections for 1986-89, assuming no major change in policies (Tables 2 and 3). These projections indicate that, in the absence of a sustained adjustment effort the downward trend in remittances would necessitate a reduction in imports thereby causing a steady decline in GNP, as well as a rise in the fiscal deficit.

Exports are anticipated to rise somewhat because of the start of production of asphalt and LPG at the refinery with a large part of the output expected to be sold to neighboring countries. With some decline in receipts from bunkering services likely, a rising deficit is projected on the services account as a result of declining interest earnings on foreign exchange reserves and rising interest payments on the external debt. Remittances are also expected to continue decreasing in 1987-89, although at a more moderate pace than in 1985-86. After an increase in 1986, partly reflecting the disbursement of a loan to finance a power station, foreign aid is also projected to decline as a result of financial retrenchment in some oil exporting donor countries. Assuming, as a policy objective, that foreign exchange reserves are maintained at about two months' imports, and no commercial borrowing, imports would have to be reduced from US$701 million in 1985 to US$475 million in 1989. The need to allow a modest growth in food imports would put the burden of adjustment on capital and intermediate goods which in turn would cause a decline in GDP and the standard of living.

Table 2. P.D.R. of Yemen: Balance of Payments, 1983-89

(In millions of U.S. dollars)

	Actuals			Projections			
	1983	1984	1985	1986	1987	1988	1989
Exports, f.o.b.	40	31	36	46	58	63	67
Domestic exports	25	24	30	40	52	57	61
Re-exports	15	7	6	6	6	6	6
Imports, c.i.f.	-768	-825	-701	-591	-542 1/	-499 1/	-475 1/
Petroleum	-165	-83	-106	-82	-77 2/	-74 2/	-71 2/
Food	-183	-251	-232	-232	-237	-243	-246
Intermediate goods	-167	-190	-163	-130	-110	-86	-77
Capital goods	-198	-200	-153	-116	-101	-87	-72
Other	-55	-101	-47	-31	-17	-8	-9
Trade balance	-728	-794	-665	-545	-484	-436	-408
Services, net	4	3	-7	-27	-34	-36	-37
Unrequited transfers, net	490	521	436	382	376	371	362
Private	448	491	406	356	347	342	333
Official grants	42	30	30	26	29	29	29
Current account	-234	-270	-236	-190	-142	-101	-83
Loans, net	194	139	109	104	96	101	83
Drawings	194	151	151	170	159	153	145
Repayments	-7	-12	-18	-32	-38	-46	-58
Trust Fund loans	-1	-3	-5	-6	-6	-6	-4
Arab Monetary Fund loans	8	3	-19	-27	-19	--	--
Other capital	58	6	-35	-1	--	--	--
Net errors and omissions	-7	54	45	--	--	--	--
Overall balance	12	-71	-117	-87	-46	--	--
Counterpart to valuation changes	-17	-24	33	10	--	--	--
Monetary movements (increase in assets -)	6	95	84	77	46	--	--
Memorandum items:							
Gross reserves (end of period)	367	280	221	136	83	83	83
Net reserves (end of period)	279	184	100	23	-23	-23	-23
Debt service ratio	4	5	12	21	20	15	18
External debt/GNP	109	117	133	148	159	174	184

Sources: Data provided by the P.D.R. of Yemen authorities; and staff projections.

1/ In these projections imports are projected as residuals given projected drawings on loans, remittances from abroad, debt service payments, and other net foreign exchange receipts. Moreover, gross foreign exchange reserves are to be maintained at a level close to the equivalent of two months of imports. It is also assumed that the reduced availability of external resources would not affect food imports, and thus, the burden of adjustment would fall on imports of capital, intermediate and other consumer goods, and to some extent on oil imports.

2/ In 1986, the oil price is assumed to average about US$12.5 per barrel. During 1987-89, the oil price is assumed to increase at 4.5 percent per year.

Table 3. P.D.R. of Yemen: Fiscal Accounts, 1983-89

(In millions of Yemeni dinars)

	Actuals			Projections			
	1983	1984	1985	1986	1987	1988	1989
Revenues and grants	143	165	148	158	157	149	145
Revenues	136	151	136	151	147	139	135
Taxes on international trade	(38)	(39)	(25)	(26)	(26)	(24)	(23)
Contribution of public sector enterprises	(55)	(59)	(61)	(80)	(77)	(72)	(69)
Other revenues	(43)	(52)	(50)	(45)	(44)	(43)	(43)
Grants	7	14	12	7	10	10	10
Total expenditures	281	296	282	292	283	284	286
Current	151	165	170	172	178	184	191
Capital	130	131	112	120	105	100	95
Statistical discrepancy	7	15	2	--	--	--	--
Overall deficit	131	116	133	133	126	136	141
(As a percent of GNP)	(37)	(31)	(36)	(38)	(36)	(40)	(42)
Net foreign financing	65	48	46	48	42	37	30
Drawings	67	52	52	59	55	53	50
Repayments	-3	-4	-6	-11	-13	-16	-20
Domestic bank financing	66	68	86	85	84	99	111
(As percent of GNP)	(19)	(18)	(23)	(24)	(24)	(29)	(33)

Sources: Data provided by the P.D.R. of Yemen authorities; and staff estimates.

The fiscal deficit is projected to rise to over 40 percent of GDP in 1989; as the demand generated by its bank financing could not be absorbed through an increase in imports, inflationary pressures and distortions in the allocation of resources would be aggravated. Domestic revenues are projected to decline in 1987-89 reflecting their high elasticity with respect to GDP with both taxes on international trade and the contributions of public enterprises to the budget showing decreases. Reflecting the decline in foreign aid and the foreign exchange shortage, government development expenditures are expected to decrease 7 percent per annum over this period. Total government development expenditures under this scenario probably could not exceed an average of YD 105 million per year.

The mission also developed an alternative scenario for the period 1987-89 based on strengthened policies. These policies included: (i) increasing incentives to both workers and managers in public enterprises; (ii) providing a more favorable environment for private sector activity; (iii) improving the allocation of resources through more flexible price and exchange rate policies; and (iv) strengthening the public finances through restrictive expenditure policies and some measures to enhance revenues. Such policies could result in a modest resumption of growth and improved fiscal and balance of payments performance. With the shift of resources into the traded goods sector, and some increase in foreign financing reflecting the adoption of a strong adjustment effort, external constraints to growth could recede permitting the country to finance a considerably higher level of imports which would facilitate economic growth. A considerable improvement in the fiscal position could also be expected as a result of more rapid rise in revenues on account of faster GDP growth, the better financial performance of public enterprises, and the effect of higher imports on customs duties. On the expenditure side, a somewhat higher level of capital expenditures in relation to the baseline scenario could be sustained because of the country's increased ability to finance capital imports.

The P.D.R. of Yemen representatives expressed interest in the mission's projections and recommendations, as well as in exploring the possibility of utilizing SAF resources. They were in general agreement with the analysis of the current economic difficulties and with the objectives of adjustment policies. They were not in a position to comment on the specific policy proposals of the mission but undertook to study these carefully. A World Bank mission is scheduled to review the public investment program in November/December 1986.

IV. The Policy Discussions

During the last Board meeting Directors encouraged the authorities to take steps to promote economic efficiency and competitiveness and to provide the necessary incentives for productive private sector activity in order to expand the production of exportables and import substitutes while selecting profitable development-oriented projects. A flexible interest rate policy and an early reversal of the substantial appreciation of the dinar were also recommended as desirable steps for strengthening the external payments position and restoring financial stability.

Against this background the consultation review concentrated on prospects for 1986 and the medium-term adjustment strategy for the economy. The Yemeni authorities stated their intention to act firmly to correct the macroeconomic imbalances. They have already taken a number of measures to reduce domestic excess demand, mainly through reducing government expenditures. The mission explained that, while these measures were necessary to contain the financial deterioration, far-reaching structural reforms were needed to lessen the dependence on remittances and foreign aid and to generate growth impulses within the country. The World Bank staff were in general agreement with the thrust of the recommendations.

1. Development planning and structural issues

In view of the prospective external resource constraints, the authorities were reviewing the Third Five-Year Plan (1986-90). Only the first year of this Plan had been approved in January 1986, while the draft Plan for 1987-90 had been returned to the individual ministries for revision. Development expenditures of YD 149 million were approved for 1986, compared to the YD 176 million originally proposed, and the YD 197 million approved for 1985. It is anticipated that development spending in 1987-90 would be reduced gradually, so that it would show little increase in nominal terms in relation to the preceding Five-Year Plan. All projects are currently being reviewed, including on-going ones. The structure of investment during the current plan period would reflect the shift in emphasis from infrastructure and social services toward productive activities, especially the consolidation and improvement of existing facilities and maximum utilization of capacity already installed. In agriculture, for example, investment would be directed at raising yields, rather than expanding irrigated areas.

The mission agreed that a reduction in development expenditures was unavoidable, but stressed that this need not necessarily lead to a reduction in growth since there was considerable scope for more efficient use of the country's human resources and its capital stock. In particular, incentives for both the private and public sectors could be improved by strengthening links between incomes and economic performance through granting enterprises more responsibility for their business decisions, thus stimulating them to cut costs and making them more responsive to market signals. Steps have already been taken to increase incentives in public enterprises. An incentive scheme linking wage payments to productivity has been introduced and is being extended to all sectors of the economy. Furthermore, the Government continues to refrain from financing enterprise losses. The mission urged that consideration should be given to allowing enterprises to retain a part of their profits in order to finance bonus payments or other benefits, as well as giving enterprises more autonomy in setting wages. 1/ The portion of profits available for self-financing of investments and the purchase of spare parts could also be raised; the lack of spare parts is one of the principal reasons for the present low rate of capacity utilization. If accompanied by more appropriate pricing policies these measures could improve enterprise efficiency and the allocation of resources.

With the increase in remittances in the early 1980s, the private sector in the P.D.R. of Yemen has gained in strength, particularly in the retail trade, construction contracting, transportation, and other services. In addition, the Investment Promotion Law of 1981 provides significant incentives for investment by Yemenis working abroad. Although the Government is generally satisfied with the level of private sector activity, it appears that there is considerable scope for expanding private investment and thus creating employment opportunities for workers returning from the oil producing countries. With this in mind, the mission welcomed the present review of the incentive structure provided under the Investment Promotion Law, and suggested that new areas could be opened to the private sector, thus expanding the range of services offered to consumers. In agricultural marketing, for example, competition between the Agricultural Marketing Corporation and the private sector could improve supply considerably.

More flexible pricing policies could also contribute significantly to a better utilization of resources. Although the Government does adjust prices for most products to cover costs and generate some profits, these adjustments have often lagged behind changes in costs. The mission suggested that in areas where there is sufficient competition, such as the retail trade and transportation services, prices should be liberalized. However, in areas where public sector companies had virtual monopolies, it cautioned against raising prices automatically to cover costs, as this may perpetuate inefficiencies. In general, prices should be set within a margin of the border price of equivalent imported goods, assuming the implementation of an appropriate exchange rate policy. In cases where such prices result in losses, the Government should review the operation of these enterprises to ascertain their long-term viability.

The authorities said that they recognized the effectiveness of pricing policy in stimulating agricultural production. Prices of some vegetables which had disappeared from the market have recently been freed, and prices of onions, red peppers, and bananas have been increased, with a considerable supply response. There were plans to introduce greater differentiation between prices for products of different qualities, and for different seasons; the latter was expected to help spread production more evenly over the year and thus ease

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1/ At present enterprises can only retain 15 percent of their profits in a General Reserve Fund which can be used to finance small investments.

marketing problems. While welcoming these measures the mission called for further and more generalized liberalization of agricultural prices--beginning with fruit and vegetables--and marketing arrangements. This would help reduce losses evident in the marketing of agricultural products and make production of fruit and vegetables more competitive with qat 1/ and fodder, which are not subject to price control, and which expanded in production more than any other agricultural crop. Another major distortion of the cropping pattern has resulted from the authorities' objective of achieving self-sufficiency in grain production. Hence, producer prices are set at over twice the international price. The mission noted the high costs of producing cereals on irrigated land in terms of foregone production of alternative crops where the P.D.R. of Yemen may have a comparative advantage.

The long-term viability of the Aden refinery was also reviewed in the discussions. This establishment has been incurring losses for several years due to the low rate of capacity utilization and out-of-date technology. In view of the worldwide surplus of refining capacity and the existence of a number of very modern refineries in the region, it appears unlikely that the refinery can raise its throughput significantly over the medium term. The Yemeni representatives acknowledged the economic difficulties of the refinery but added that the refinery continued to be a net foreign exchange earner and that the addition of the asphalt and LPG units would strengthen it financially.

2. Financial policies

With the need for reconstruction of facilities damaged during the January conflict and a further decrease in economic activity likely, increased pressure on the fiscal position is expected in 1986. In the original budget estimates, the fiscal deficit was projected to rise by 35 percent to YD 178 million, greatly aggravating inflationary and balance of payments pressures. Revenues were projected to fall by 7 percent, largely reflecting the effect of the projected decrease in imports on customs receipts and public enterprise profits. Expenditures were budgeted to rise 11 percent, although this assumed the filling of all vacancies in the civil service. 2/

However, the authorities have taken important measures to contain the growth of the deficit in the first half of the year. Expenditures on general administration are to be reduced by 25 percent from the originally budgeted amount, while expenditures on materials and supplies have been substantially curtailed. Furthermore, the filling of

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1/ Qat is a plant whose leaves are chewed as a stimulant for an effect similar to that of coca leaves. Since it is to a large extent a nontraded good because of a premium for freshness, its consumption and cultivation are limited to the P.D.R. of Yemen, the Yemen Arab Republic, Somalia, Djibouti, and Ethiopia.

2/ Reflecting the authorities' caution, budget projections traditionally underestimate revenues and overstate expenditures.

vacancies in the civil service has been frozen and savings from underspending in certain categories would no longer be shifted to other categories. Moreover, there will be no general wage increase for the public sector (the last was in 1979). In addition, an increase in import duties on items such as liquor, cigarettes, tobacco, and petroleum, and in the sales tax on certain products, such as cigarettes, has been proposed; these measures would yield YD 15-20 million on an annual basis. Increases in water and electricity rates have also been proposed. Furthermore, considerable savings will result from the decline in international oil and other commodity prices which, in view of the difficult fiscal position, will not be passed to the consumer; as a result, the refinery and the Price Stabilization Fund (PSF) should generate substantial profits in 1986. Assuming the above measures were implemented promptly, the fiscal deficit would be only marginally above the level attained in 1985 with revenues rising 11 percent and expenditures 4 percent. Bank financing would remain unchanged at approximately YD 85 million.

The mission welcomed the authorities' efforts to contain the fiscal imbalance but stressed that even with the contemplated measures the fiscal deficit and domestic bank financing would rise in the coming years. In the medium term, the most promising area for reducing the fiscal deficit appeared to be in an improvement in the financial performance of public enterprises and the resumption of growth. Apart from enhancing their overall efficiency through increasing incentives, the financial position of public enterprises could be strengthened through greater price flexibility. Revenues could also be increased through improving tax collection procedures and ensuring that enterprises do not build up arrears to the Government. As noted above, the mission suggested that development expenditures could be scaled down considerably without weakening growth performance. The potential for savings on current expenditures was more limited in view of the need to staff and equip completed facilities. Nevertheless, growth of current expenditures could be restrained through making maximum use of existing facilities, streamlining recruitment, and reducing overstaffing in some ministries. Subsidies on seven staple products provided by the PSF amount to YD 18-19 million (5 percent of GNP) and are financed largely by trading profits on other products (particularly sugar) and a 10 percent surcharge on imports. Due to the decline in international commodity prices the PSF did not require budgetary financing in 1985 and as noted above, a surplus is expected in 1986. Nevertheless, the mission urged the authorities to reduce subsidies, possibly through targeting them to lower income groups, and thus prevent deficits from arising in the future.

The high level of bank borrowing required to finance the fiscal deficit is expected to accelerate domestic liquidity growth to 12 percent in 1986, despite a further drawdown of net foreign assets. As in preceding years, credit to the nongovernment sector is expected to show little growth. Although this was partly due to sluggish economic activity, and the consequent decline in demand for credit, it also reflected the Government's restrictive credit policy with respect to the public enterprises and the private sector. While fully recognizing the need to limit credit expansion, the mission emphasized that the crowding out of nongovernment borrowing was not conducive to growth and the restructuring of the economy. Therefore, efforts should be made to redistribute credit toward the productive sectors.

Interest rates in the P.D.R. of Yemen have not been changed since 1978. Maximum deposit rates are 6 percent, lending rates to mixed, private, and foreign sectors are 8 percent, while lending rates to the public sector range between 3 percent and 4 percent for productive sectors. The Yemeni representatives explained that with the decline in international interest rates and the rate of measured inflation in the P.D.R. of Yemen in 1984, interest rates no longer represented a disincentive for saving and workers' remittances. The mission noted the decrease in the measured rate of inflation and suggested that interest rates should be set taking into account the country's weak external position and the need to attract remittances, bearing in mind that inflation has been suppressed through controls and that strong underlying pressures were still evident. In order to eliminate the subsidy on borrowing by public enterprises, consideration should be given to raising interest rates on loans to public enterprises to the level paid by private, mixed, and foreign enterprises.

3. External sector policies

Balance of payments projections pointed to a further loss in reserves in 1986, despite some increase in exports and foreign borrowing, and another reduction in imports. Exports were projected to rise by about one quarter to US$46 million because of the diversification of production at the refinery. Imports were expected to decrease by 16 percent (7 percent in volume terms), partly because of a 23 percent decline in oil import costs due to falling international prices and fuel conservation measures, and partly because of further restrictions. 1/ The improvement in the trade balance would be partly offset by a further deterioration in the services account and by a projected 12 percent decline in private transfers; it was noted, however, that considerable uncertainty was attached to the projection of private remittances because it was difficult to gauge the effects of the January disturbances and the further decline in economic activity in the region on expatriate remittances. Even though gross foreign borrowing was expected to increase 13 percent, an overall deficit of US$87 million was projected in 1986 reflecting increased repayment of foreign debt. The Yemeni representatives noted that the increases in exports and foreign borrowing could be somewhat greater than projected by the mission, in which case the overall deficit could perhaps be limited to

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1/ The savings from the fall in international oil prices in 1986 may be greater as the value of oil imports in 1984-85 may have been understated because of misclassification, or a drawdown of stocks.

US$45 million. Nevertheless, they agreed that the projected further loss in reserves was a cause for concern in view of their already low level.

In light of the loss of foreign exchange reserves and the unfavorable medium-term outlook for the economy, the mission urged the authorities to adopt an adjustment program which would ensure a shift of resources into the traded goods sector over the medium term. Such a structural transformation of the economy would require a substantial depreciation of the Yemeni dinar for several reasons. First, a depreciation would improve the competitiveness of domestic producers by increasing the domestic prices of traded goods in relation to nontraded goods; a number of trading partners in the region, including some oil producers, have already depreciated their currencies. An exchange rate adjustment, together with supporting price and fiscal policies, should facilitate some expansion and diversification of exports and efficient import substitution by widening the range of profitable production opportunities available to the economy. Furthermore, a more depreciated exchange rate, coupled with an active promotion of investment opportunities for expatriate workers, could encourage a greater flow of remittances, particularly for the establishment of small businesses. Finally, with the reduction of the external imbalances, the import regime could be gradually liberalized, leading to a more efficient allocation of foreign exchange.

While agreeing that domestic costs had moved out of line with international prices for a number of products, the Yemeni representatives wondered whether an exchange rate adjustment would stimulate exports or import substitution in view of the economy's narrow resource base and the small domestic market. Furthermore, while a depreciation might encourage some investment by expatriates, remittances (measured in terms of foreign currencies) for family maintenance could decline. Nevertheless, in view of the difficult balance of payments situation and the need for adjustment over the medium term, the Yemeni representatives noted that exchange rate policy would be kept under constant review.

Although the debt service burden remained small in relation to exports of goods and services and private remittances, it rose sharply to 12 percent in 1985 and was projected to rise to 21 percent in 1986. This has prompted the authorities to approach their creditors bilaterally with a view to rescheduling their debts. However, the debt service ratio is forecast to decline to 15 percent in 1988, reflecting the repayment in 1987 of a loan to the Arab Monetary Fund.

There have been no changes in the trade and exchange system since the last consultation discussions. The Yemeni representatives explained that in light of the large external imbalances, there had been little room for liberalization. The mission noted that, even in the short run, the present system could be rationalized and simplified by decentralizing the granting of licenses, facilitating imports of raw materials and spare parts within the annual program, and liberalizing imports of capital goods by returning expatriates.

V. Staff Appraisal

Since independence in 1967, the P.D.R. of Yemen has made progress in developing infrastructure and in meeting the basic needs of the population. Sustained by a vigorous domestic resource mobilization and substantial inflows of foreign resources, the country has maintained a high rate of investment, but due to weaknesses stemming from rigidities in the price and incentive systems, growth has been modest. After 1982, the development effort began to face growing difficulties as a result of the less favorable external environment which exposed the economy's dependence on foreign resources. Foreign aid was reduced by over one third during 1983-84, the growth of inward private remittances decelerated in 1983-84, and a sharp decrease was recorded in 1985, while international demand for the services of the Port of Aden and the refinery declined. In addition, floods in 1982 and the long drought in subsequent years hampered agricultural production.

These factors contributed to a considerable deterioration of economic performance since 1981. Real growth of GDP is estimated to have averaged 1 percent per annum while financial imbalances have widened. Despite attempts at controlling current expenditures and a decline in capital expenditures in 1985, the fiscal deficit rose to about 36 percent of GNP in 1985 due to a decline in revenues. The monetization of the fiscal deficit intensified inflationary pressures, but these were suppressed through price controls, with the result that distortions in the economy have grown further. Mainly as a result of the decline in external resources, but also reflecting stagnant exports and rising debt service payments, large deficits in the balance of payments were registered in 1984-85, despite a tightening of import controls. By the end of 1985, external reserves had fallen to about four months of imports.

Prospects for 1986 point to continuing difficulties. Economic growth is expected to remain subdued, remittances are likely to decline further, and growing pressures on the fiscal position are anticipated. The authorities have taken strong measures to curtail the fiscal deficit, including cuts in administrative expenditures and restraint in capital spending. However, neither the projected fiscal deficit after these measures, nor the balance of payments deficit are sustainable over the medium term. In view of their already low level, and the anticipation of further external imbalances in the future, a substantial drawdown of reserves is not feasible, while borrowing on commercial terms should be avoided, given the recent rise in the debt service ratio. Therefore, further measures are needed to reduce the expansionary thrust of government operations in 1986 and beyond. In 1986, efforts should be made to contain capital expenditures to the level attained in 1985, to improve tax administration, implement the proposed increases in duty and sales tax rates as soon as possible, and improve the performance of public enterprises through a combination of greater incentives and price flexibility. If these measures are carried out promptly, bank financing of the fiscal deficit in 1986 could be contained to the 1985 level. Nevertheless, another substantial balance of payments deficit is expected in 1986 despite the fall in international oil prices and the further compression of non-oil imports.

In addition to demand management measures, the authorities need to confront the structural problems facing the economy, with a view to lessening its dependence on remittances and foreign aid. If stagnation over the medium term is to be avoided, a restructuring of the economy needs to be undertaken soon. With the decline in the availability of foreign resources, growth impulses will have to be generated within the country, entailing both more efficient use of available resources, and their shift into the traded goods sector. In this regard, introduction of the output based wage incentive scheme and the continued abstention from financing public enterprise losses are both welcome. However, the responsibility of enterprises for their business decisions should be strengthened further. This could be achieved by reducing price and profit controls--especially in sectors where there is sufficient competition--as well as by providing for greater retention of profits by enterprises. There is also considerable scope for expanding private sector activity and increasing competition with the public sector. With regard to private investment, the incentive structure provided under the Investment Promotion Law of 1981 should be improved.

The key to the structural adjustment effort is the introduction of greater flexibility in pricing policies in order to reduce the present cost and price distortions which are adversely affecting economic performance. Under the existing price system, prices often bear little relationship to the relative scarcity of goods, and are not adjusted frequently enough to cover costs. In the agricultural sector, a liberalization of prices would raise the production in areas where the P.D.R. of Yemen may have a comparative advantage, such as cotton, coffee, tobacco, fruits, and vegetables. In other sectors, prices should be adjusted frequently enough to avoid losses for public enterprises, although they should not be set above the border prices of equivalent imported commodities. In those sectors where there is sufficient competition, price liberalization should be considered.

The present level of real interest rates in the P.D.R. of Yemen does not appear to be a disincentive to domestic savings and remittances. However, since measured inflation considerably underestimates underlying trends, interest rate policy should be kept under constant review, taking into account the country's weak external position. Subsidization of borrowing by public enterprises should be eliminated by raising interest rates charged on their loans to the levels paid by mixed, private, and foreign enterprises.

A central element in the structural adjustment effort would be the adoption of a more flexible exchange rate policy. A depreciation of the Yemeni dinar would widen the production possibilities open to the economy by making potential export and import substitution activities profitable and thus facilitating the shift of resources to these areas. To be effective an exchange rate adjustment would have to be passed on to producer and consumer prices.

In view of the expected decrease in external resources, a decline in real income through an increase in traded goods prices is inevitable. It is preferable that this adjustment takes place in an orderly manner through the implementation of a comprehensive policy package rather than through shortages, repressed inflation, and a sharp reduction in imports which would severely reduce economic growth. As indicated above, this strategy should consist of effective demand management measures in order to restrain price pressures, and structural measures addressed at reducing the present distortions and rigidities. Given the present characteristics of the economy, a concerted strategy to resume growth and strengthen the balance of payments would produce results in terms of a more diversified economic structure only over time. It is essential, therefore, for the authorities to embark on a structural adjustment program as soon as possible. The decline in international oil prices provides the P.D.R. of Yemen with an opportunity to implement an adjustment program while minimizing the decline in consumption. Such a structural stabilization effort could also be expected to attract financial support from the international community which would alleviate balance of payments pressures until the reform policies begin to bear fruit over the medium term.

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

VI. Proposed Decision

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

1. The Fund takes this decision in concluding the 1986 Article XIV consultation with the P.D.R. of Yemen, in the light of the 1986 Article IV consultation with the P.D.R. of Yemen conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance Over Exchange Rate Policies).

2. The P.D.R. of Yemen continues to maintain a comprehensive system of restrictions on payments and transfers for current international transactions under the transitional arrangements of Article XIV as described in SM/86/227. The Fund encourages the authorities to take appropriate measures to simplify the exchange system.

P.D.R. of Yemen - Fund Relations

(As of end-July 1986)

I. Membership Status

(a) Date of membership:	September 29, 1969.
(b) Status:	Article XIV.

A. Financial Relations

II. General Department (General Resources Account)

(a) Quota:	SDR 77.2 million.
(b) Fund holdings of Yemeni dinars:	SDR 84.9 million (110.0 percent of quota).
(c) Credit tranche:	SDR 7.7 million (10.0 percent of quota).
(d) Reserve tranche position:	--

III. SDR Department

(a) Net cumulative allocations:	SDR 22.6 million
(b) Holdings:	SDR 1.2 million (5.3 percent of net cumulative allocations).

IV. Administered Accounts

Trust Fund loans:	
(i) Disbursed:	SDR 28.34 million.
(ii) Outstanding:	SDR 15.11 million.

B. Nonfinancial Relations

V. Exchange System:

The Yemeni dinar has been pegged to the U.S. dollar at YD 1 = US$2.89524 since February 1973.

VI. Technical Assistance:

(a) In 1984 a two-member mission from Fiscal Affairs Department visited the country to study various aspects of customs administration and submitted its report to the authorities.

P.D.R. Yemen - Fund Relations (concluded)

(b) A member of the fiscal panel has been assigned for six months beginning late May 1986 to provide technical assistance in customs administration.

VII. Last Article IV consultation

March 1985; the Staff Report (SM/85/133) was discussed by the Executive Board on June 10, 1985.

The Executive Board's decision concluding the Article IV consultation (Decision No. 8003-(85/93)) was as follows:

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with the People's Democratic Republic of Yemen, in the light of the 1985 Article IV consultation with the People's Democratic Republic of Yemen conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The People's Democratic Republic of Yemen continues to maintain a comprehensive system of controls, some of which constitute restrictions on payments and transfers for current international transactions under Article XIV, as described in SM/85/133. The Fund encourages the authorities to take appropriate measures to simplify the exchange system.

Consultations with the P.D.R. of Yemen are on the standard twelve-month cycle.

Financial Relations of the World Bank Group with the P.D.R. of Yemen 1/

	IDA	
	Total amount	Undisbursed
	(In millions of U.S. dollars)	
Agriculture and fisheries	55.3	21.6
Power and energy	21.5	7.3
Transport	54.1	14.8
Education and health	33.4	17.1
Water supply	23.7	5.2
Total	188.0	66.0
Repayments	0.64	

The International Development Association has so far extended 26 credits to the P.D.R. of Yemen, aggregating US$188.0 million, of which US$125.45 million has been disbursed. The assistance was mainly for agriculture and fisheries, power and energy, and transport. In 1984, two loans of US$17.4 million for water supply in the Seyiun area, and a fourth Education IV Project were approved. In 1985, two loans for US$19.4 million for agricultural research and extension, and a fourth highway project, were approved. The Second Greater Aden Water Supply Project is expected to be approved in October 1986. A mission will visit the P.D.R. of Yemen in November/December 1986 to review the investment program.

1/ The lending position as of June 30, 1986.

P.D.R. of Yemen - Basic Data

Area	112,000 square miles
Population (mid-1984 estimate)	2.23 million
GNP at factor cost (1985 estimate)	YD 365 million

	Actuals					Est.	Proj.
	1980	1981	1982	1983	1984	1985	1986
	(In millions of Yemeni dinars)						
Public finance:							
Revenues and grants	113.5	127.2	140.0	143.3	164.7	148.3	158.2
Revenues	103.0	123.7	120.6	136.2	150.6	136.2	151.2
Foreign grants	10.5	3.5	19.3	7.1	14.1	12.1	7.0
Total expenditures	155.4	230.6	258.6	281.2	295.9	281.6	291.6
Current	94.5	139.4	137.9	150.8	164.8	169.6	171.6
Capital	60.9	91.2	120.7	130.4	131.1	112.0	120.0
Budget deficit	-41.9	-103.4	-118.7	-137.9	-131.2	-133.3	-133.4
Statistical discrepancy	-1.6	30.1	1.0	7.1	15.7	1.8	--
Overall deficit	-43.5	-73.4	-117.6	-130.8	-115.6	-131.5	-133.4
Financing							
Foreign borrowing (net)	26.3	49.8	52.5	64.6	47.9	46.0	48.0
Banking system	17.2	23.6	65.1	66.2	67.7	85.5	85.4
	(In millions of Yemeni dinars)						
Money and credit (change during period):							
Domestic liquidity	68.7	35.2	61.3	64.6	63.3	41.0	66.7
Net external transactions	13.5	-2.9	-9.0	-3.3	-33.3	-20.6	-15.2
Net domestic assets	55.2	38.1	70.3	67.9	96.5	61.6	81.9
Claims on Government (net)	17.2	23.6	65.2	66.4	67.6	85.5	85.4
Claims on nongovernment	36.7	8.5	-4.6	0.1	20.5	-6.2	--
Other items (net)	1.3	6.0	9.7	1.4	8.4	-17.7	-3.5

P.D.R. of Yemen - Basic Data (concluded)

	Actuals					Est.	Proj.
	1980	1981	1982	1983	1984	1985	1986
	(In millions of U.S. dollars)						
Balance of payments							
Exports, f.o.b.	60	49	38	40	31	36	46
Imports, c.i.f. 1/	-670	-720	-776	-768	-825	-701	-591
Trade balance	-610	-672	-738	-728	-794	-665	-545
Services, net	51	57	32	4	3	-7	-27
Unrequited transfers, net	402	501	565	490	521	436	382
Private	(324)	(382)	(439)	(448)	(491)	(406)	(356)
Official grants	(78)	(119)	(126)	(42)	(30)	(30)	(26)
Current Account	-157	-114	-141	-234	-270	-236	-190
Loans, net	86	176	175	194	139	109	104
Drawings	(85)	(148)	(162)	(194)	(151)	(151)	(170)
Repayments	(-9)	(-4)	(-10)	(-7)	(-12)	(-18)	(-32)
Trust Fund loans	(10)	(--)	(--)	(-1)	(-3)	(-5)	(-6)
Arab Monetary Fund loans	(--)	(32)	(24)	(8)	(3)	(-19)	(-27)
Other capital	33	--	-3	58	6	-35	-1
Net errors and omissions	92	-21	-21	-7	54	45	--
Overall balance	54	41	10	12	-71	-117	-87
Counterpart to valuation changes	-11	-20	-16	-17	-24	33	10
Allocation of SDRs	5	3	--	--	--	--	--
Monetary movements (increase in assets-)	-49	-24	6	6	95	84	77

Sources: Data provided by the P.D.R. of Yemen authorities and staff projections.

1/ Excluding imports of the Aden Refinery which are re-exported.

P.D.R. of Yemen--Statistical Issues

1. Outstanding statistical issues

The statistical data base on the P.D.R. of Yemen is generally weak.

a. National accounts

Official estimates of gross domestic product at current prices are available on the basis of domestic outpu data. A revision of the national accounts methodology is being undertaken with the assistance of a U.N. expert. This effort was set back, however, due to destruction of data during the January disturbances.

b. General economic data

Data on the consumer price index (CPI) are not current. The index itself is not representative (referring to government employees in Aden) and is outdated, as it is based on a 1969 survey. Consideration is being given to revising the index based on the results of an ongoing agricultural and household survey. Data on merchandise trade values are outdated and are reported only on an annual basis.

c. Government finance

The 1985 GFS Yearbook includes only institutional tables for this country. No data have ever been reported for publication in the Government Finance Statistics Yearbook.

d. Monetary accounts

No data have been reported since November 1985, resulting in a lag in currentness of eight months.

e. Interest rates

No interest rates are currently published in the IFS page for P.D.R. of Yemen but it is planned to publish at least the annual data obtained from Recent Economic Developments papers for the following rates:

(1) Savings deposits (three months) rate for the mixed sector, and

(2) Commercial lending rate.

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 P.D.R. of Yemen in the June 1986 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Bank of Yemen, which during the past year have been provided on a very irregular basis.

		Status of IFS Data	Latest Data in June 1986 IFS
Real Sector	-	National Accounts	n.a.
	-	Prices	AA 1983
	-	Production	n.a.
	-	Employment	n.a.
	-	Earnings	n.a.
Government Finance	-	Deficit/Surplus	1980
	-	Financing	1980
	-	Debt	1980
Monetary Accounts	-	Monetary Authorities	September 1985
	-	Deposit Money Banks	September 1985
	-	Other Financial Institutions	n.a.
Interest Rates	-	Discount Rate	n.a.
		Bank Lending/Deposit Rate	n.a.
		Bond Yields	n.a.
External Sector	-	Merchandise Trade: Values	AA 1984 1/
		Prices	n.a.
	-	Balance of Payments	1984
	-	International Reserves	November 1985
	-	Exchange Rates	April 1986

1/ Based on customs records reported for balance of payments statistics.