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October 22, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Yemen Arab Republic - Staff Report for the 1985 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1985 Article IV consultation with the Yemen Arab Republic, which is proposed to be brought to the agenda for discussion on Friday, November 15, 1985. A draft decision appears on page 19.

Mr. Kawar (ext. 7138) or Mr. Noursi (ext. 7117) 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 1985 Article IV Consultation

Prepared by the Staff Representatives for the
1985 Consultation with the Yemen Arab Republic

Approved by A. S. Shaalan and J. T. Boorman

October 21, 1985

I. Introduction

The 1985 Article IV consultation discussions with the Yemen Arab Republic (Y.A.R.) were held in Sana'a during August 14-20, 1985. Meetings were held with the Prime Minister, the Deputy Prime Minister (who is also Minister of Planning), the Minister of Finance (who is also Acting Minister of Petroleum), the Minister of Supply and Commerce, the Minister of Agriculture, the Governor of the Central Bank, and senior officials. The staff mission was composed of Messrs. A. S. Shaalan (Head), S. Kawar, D. B. Noursi, B. K. Short (all MED), and Mrs. R. Khoonei (Secretary-TRE).

The Y.A.R. continues to avail itself of the transitional arrangements of Article XIV of the Fund's Articles of Agreement. Relations with the Fund and the IBRD are outlined in Appendices I and IV, respectively.

II. Economic Background

The Y.A.R. has a relatively narrow resource base, negligible merchandise exports, and a population widely dispersed over rugged and semi-arid terrain. Nevertheless, the country has experienced considerable economic and social progress since it was opened to the outside world less than two decades ago under the combined influence of policies that contributed to a liberal trade and payments system, judicious investment in infrastructure, large and growing remittances from Yemenis working abroad in the last half of the 1970s and, to a lesser extent, foreign aid. As a result, rapid economic growth was achieved (about 7 percent per annum in real terms in 1975-81), and foreign exchange reserves rose to a peak of US$1.7 billion--equivalent to 15 months' imports--in March 1979.

Since 1979 the external economic environment has been less favorable and serious financial imbalances have emerged (Table 1). The receipts of workers' remittances declined after 1980 and official aid after 1982, due mainly to the slowdown of economic activity in neighboring countries.

Moreover, a steady increase in government expenditures was not matched by a corresponding mobilization of domestic resources. A spurt in government spending at the outset of the Second Five-Year Plan (SFYP) in 1982 raised the fiscal deficit to 33 percent of GDP. The large fiscal deficit contributed to an acceleration of monetary growth from 8 percent in 1981 to 26 percent and to a widening of the overall balance of payments deficit to US$310 million (16 percent of current receipts). The Central Bank's net foreign assets declined by about US$880 million over 1980-82. During that period, the rate of inflation (measured by the consumer price index) declined to 3 percent in 1982 as the pressures of aggregate demand were largely accommodated through a high level of imports as improved port facilities removed transportation bottlenecks.

III. Developments in 1983-84

1. Fiscal adjustments

Aware that the SFYP could not be fully implemented without exacerbating the domestic and external imbalances, the authorities undertook action in 1983 which led to significant progress in fiscal adjustment. Increases in several taxes and duties and improved tax collection led to a 19 percent increase in revenues (excluding foreign grants), a rate of growth twice as high as that in 1981-82. Expenditures were reduced by 9 percent mainly on account of wage and salary restraint and a 27 percent reduction in development expenditures. The improvement in the fiscal deficit was limited by a 60 percent drop in foreign grants, but nevertheless decreased by 5 percentage points relative to GDP to 28 percent. Domestic bank financing, which is almost entirely from the Central Bank, shrank from 45 percent of the beginning period money stock in 1982 to 31 percent.

Efforts to reduce the fiscal deficit were continued in 1984. The exchange rate used for customs valuation was depreciated and greater effort was directed to combating contraband trade and at more fully assessing duties on overland imports. Despite these steps, domestic revenue increased by only 6 percent; the main factors were a lower volume of imports and a shift away from higher to lower taxed imported commodities. Current spending was reduced by 4 percent mainly through a large decrease in defense spending and continued restraint on increases in wages and salaries. Although the level of development spending increased by 5 percent (mainly the part financed by foreign loans), total government spending was unchanged from its 1983 level. Despite the unsatisfactory revenue performance and a further reduction in foreign grants, the fiscal deficit declined further to 26 percent of GDP and domestic bank financing to 24 percent of the beginning period stock of money.

Table 1. Yemen Arab Republic: Selected Economic Indicators, 1980-85

	1980	1981	1982	1983	1984	Proj. 1985
			(In percent of per annum)			
Rate of growth of real GDP at factor cost	...	4.6	9.7	2.3	2.7	1.0
Rate of change in CPI	9.8 1/	5.0	2.7	5.3	12.8	...
			(In billions of Yemen rials)			
Government finances						
Revenues and grants,	3.7	4.9	5.8	5.3	5.4	6.0
Of which:						
Revenues	(3.0)	(3.3)	(3.7)	(4.4)	(4.7)	(5.2)
Expenditures	7.0	7.8	11.1	10.1	10.0	10.7
Current (including extrabudgetary)	(3.1)	(4.1)	(7.0)	(7.1)	(6.9)	(7.0)
Capital (including externally financed)	(3.9)	(3.7)	(4.0)	(2.9)	(3.1)	(3.7)
Overall deficit	3.3	2.9	5.3	4.8	4.6	4.7
			(In percent of GDP at current market prices)			
Revenues and grants	...	36	37	31	30	...
Of which: Revenues	(...)	(25)	(23)	(26)	(26)	(...)
Expenditures	...	58	70	59	56	...
Overall deficit	...	22	33	28	26	...
			(In billions of Yemen rials)			
Changes in money and credit						
Net credit to Government	1.3	2.0	4.4	3.9	3.8	4.3 2/
Credit to nongovernment	0.6	0.3	0.2	0.2	1.1	1.4 2/
Net external transactions	-0.2	-1.2	-1.4	-1.0	-0.5	-1.1 2/
Other items net	-0.9	-0.4	-0.6	0.3	--	-0.8 2/
Domestic liquidity	0.9	0.7	2.6	3.4	4.4	3.7 2/
Reserve money	0.5	0.8	2.2	3.4	4.0	3.9 2/
			(In percent per annum)			
Rate of growth of money and credit						
Net credit to Government	...	100	109	46	31	30 2/
Credit to nongovernment	...	10	5	7	32	33 2/
Domestic liquidity	...	8	26	28	28	19 2/
Reserve money	...	10	27	33	29	25 2/
			(In millions of U.S. dollars)			
Balance of payments						
Exports	13	11	5	10	9	10
Imports	-1,915	-1,748	-1,952	-1,796	-1,414	-1,170
Services (net)	-21	-52	-37	-52	-46	-70
Unrequited transfers (net)	1,232	1,125	1,393	1,293	1,137	990
Of which:						
Government receipts	(148)	(337)	(469)	(189)	(143)	(120)
Private receipts	(1,341)	(988)	(1,191)	(1,244)	(1,067)	(960)
Current account	-691	-664	-592	-545	-313	-240
Nonmonetary capital (net) 3/	652	404	282	328	169	80
Of which:						
Drawings on official loans	467	262	232	224	215	148
Private short-term loans (net)	101	101	3	66	-53	-19
Overall balance	-39	-260	-311	-216	-144	-160
Central Bank's gross foreign assets (end of year)	1,284	967	558	361	304	284 2/
In months of imports	(8.0)	(6.6)	(3.4)	(2.4)	(2.6)	(2.9)
Stock of debt (medium- and long-term--end of year)	679	1,101	1,301	1,509	1,507	1,608 2/
Debt service	...	68	54	36	79	77
In percent of current account receipts	(...)	(4.0)	(2.7)	(2.1)	(5.4)	(5.9)

Sources: Central Planning Organization, Ministry of Finance, Central Bank of Yemen, and Fund staff.

1/ Rate of change between 1979/80 and 1980/81.
2/ Twelve months ended June 1985.
3/ Including errors and omissions.

2. Monetary developments

Despite lower levels of bank financing of the fiscal deficit and the less contractionary effect from external transactions, the rate of monetary expansion crept up from 26 percent in 1982 to 28 percent in both 1983 and 1984. The main factor underlying the continued rapid rate of monetary growth in this period was a 32 percent surge in credit to the nongovernment sector during 1984 which largely reflected increased borrowing for real estate transactions and speculative activities, as well as the capitalization of interest on nonperforming loans. This expansion of nongovernment credit could be accommodated because of the practice of financing the fiscal deficit by borrowing from the Central Bank, which kept commercial banks liquid. The high rate of monetary growth in the face of declining rates of real economic growth (see below) clearly indicates rising levels of liquidity in the hands of the public.

3. External sector

Reduced imports and slightly higher receipts of workers' remittances led to a reduction in the overall balance of payments deficit to US$215 million in 1983 despite a drop in official foreign grants inflows. During 1983 the Central Bank's gross foreign assets dropped by US$200 million to the equivalent of US$361 million (2.4 months of imports), with net foreign assets of US$318 million.

Through 1983 the Y.A.R. pursued liberal exchange and trade policies, with no restrictions for current or capital international transactions. In view of the persistent deficit in the overall balance of payments, the authorities made a number of changes in the exchange and trade system in 1984 which introduced restrictions. 1/ First, a comprehensive foreign exchange budget was drawn up for 1984. To assure adherence of imports to that budget, an import licensing system was initiated at the beginning of 1984, with priority to foodstuffs, petroleum products, medicines, and inputs for agriculture and industry. Second, in February 1984, a committee (with representation from the commercial banks and the Central Bank) was established to make all purchases of foreign exchange on behalf of the commercial banks. Of the committee's purchases, 10 percent (raised to 15 percent in 1985) was to be used in a manner designated by the Central Bank with the balance allocated among banks according to predetermined shares. Simultaneously, importers were required to finance their imports with foreign exchange purchased from

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1/ Until late 1983, market exchange rates were generally very close to the Central Bank's rates. During the late 1970s the Central Bank frequently sold rials to commercial banks (accumulating foreign exchange reserves in the process) but this policy changed during 1980-83 with the Central Bank selling foreign exchange to the market. In November 1983, banks were allowed to work with an increased spread of 2.4 percent (rather than 1 percent as previously) from the Central Bank's buying and selling rates (YRls 4.55 = US$1 and YRls 4.575 = US$1, respectively). See part B of Appendix I for further details on the exchange system.

banks rather than the market as well as to have an import and exchange license. Importers were also obliged to meet margin requirements by lodging import deposits in local currency with commercial banks when arranging import financing. 1/ Finally, in February, May, August, and November 1984 the official exchange rate was adjusted toward the more depreciated market exchange rate. The cumulative depreciation of 22 percent vis-a-vis the U.S. dollar brought the midpoint of the Central Bank's buying and selling rates from YRls 4.5625 = US$1 at end-1983 to YRls 5.86 = US$1 at end-1984.

The measures taken in 1984, as well as a drop in unrequited transfers, were responsible for a significant fall in import payments in 1984. Nevertheless, the overall balance of payments deficit, at US$145 million, was only moderately lower because of larger loan repayments by both the Government and the private sector. The shift in the private sector's position, from net short-term borrowing in 1983 to net repayments in 1984, was mainly due to the requirement that importers arrange financing for their imports through banks in the Y.A.R. At the end of 1984 the Central Bank's gross foreign assets had fallen further to the equivalent of US$304 million (2.6 months of imports) while its net foreign assets position had been reduced to US$268 million. The continued pressure on the external payments position was also manifested in the differential between the official exchange rate and the market rate widening to about 20 percent at the end of 1984.

Almost all official external debt has been contracted on concessional terms and used for development purposes. At June 30, 1985 the medium- and long-term civilian external debt outstanding was the equivalent of US$1.6 billion (equivalent to about one half of GDP). Despite the concessional nature of the Y.A.R.'s external debt, servicing rose from US$36 million in 1983 to a scheduled US$108 million in 1984. However, because some payments due in 1984-85 were rescheduled, the actual debt service in 1984 was US$79 million, equivalent to 5.4 percent of current account receipts.

4. Growth and price performance

The rate of real economic growth fell during 1983 and 1984 due to the earthquake at the end of 1982, which destroyed productive capacity, and droughts during both 1983 and 1984. In addition to the adverse impact of these misfortunes, the decrease in foreign exchange receipts also reduced real growth both by lowering personal income and by decreasing the supply of foreign exchange from which to finance imported inputs.

A major development in 1984 was the discovery of oil in commercially exploitable quantities. A refinery with a capacity of 10,000 barrels per day (b/d) is now under construction and is expected to begin producing

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1/ For details, see the accompanying Recent Economic Developments report (SM/85/...).

for one third of the domestic market from March 1986. Following major investments by the foreign partner companies, exports are expected to commence in 1988 at a minimum level of 100,000 b/d perhaps rising to 400,000 b/d (see below).

The high rate of monetary expansion in 1982-84, coinciding with the slower growth of domestic production and reduced availability of imports due to licensing, intensified demand pressures within the economy. Moreover, the depreciation of the rial in 1984 added a cost-push element to domestic inflation. The rate of inflation (which had fallen in 1980-82 partly due to improvements in transportation) accelerated to 13 percent in 1984.

IV. Medium-Term Prospects

During their discussion of the 1984 Article IV consultation with the Yemen Arab Republic (EBM/84/168, November 21, 1984), Executive Directors noted that the high rate of growth experienced in the past had slowed while the rate of inflation was rising. Expressing concern at the continued high level of consumption, especially by the Government, and the related fiscal imbalance, Directors called for measures to reduce government spending, to mobilize domestic resources, and to restrain aggregate demand. They encouraged the authorities to continue to pursue a flexible exchange rate policy and to take steps to liberalize imports as well as to return to an exchange system free of restrictions.

In a review of the SFYP, 1/ the World Bank staff also expressed concern over the magnitude of the fiscal deficit, the rapid monetary growth, the decline in foreign exchange reserves resulting from expansionary macroeconomic policies, and the prospect of higher rates of inflation. Consequently, the report proposed that greater effort be made to improve fiscal revenue collections, to reduce current public spending, and to undertake government borrowing from domestic sources other than the Central Bank. With regard to public investment, the World Bank recommended that the SFYP's investment target be cut by 20 percent by concentrating on ongoing projects, while postponing and phasing down some investments in transportation, electricity generation, higher education, mining, and administrative buildings. In agriculture, manufacturing, and urban development, the Bank report advised the Government to avoid investing in production units and interfering with the pricing process, reserving for itself the role of catalyst.

To focus discussions on policies for the medium term, the mission, in cooperation with Yemeni officials, prepared illustrative scenarios for 1985-87, based on the current policy stance (Table 2). Alternative balance of payments scenarios were drawn up for different levels of oil exports during 1988-90 (Table 3). The underlying assumptions are outlined

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1/ IBRD, Yemen Arab Republic: Second Five-Year Plan Public Investment Program Review, (January 1985) Report No. 4821-YAR.

in Appendix V. The scenario indicates that serious financial imbalances will persist, at least through 1987. Despite restraint on public capital expenditures and continuation of present efforts to raise revenues, the growth of current budget expenditures is projected to result in rising fiscal deficits. Central bank financing of these deficits is anticipated to keep commercial banks highly liquid. Strong increases in domestic credit are projected to lead to monetary expansion of 25 percent per annum, exceeding the expansion of domestically available goods. Thus, the scenario indicates that strong pressure on prices and the balance of payments will continue. Despite limited growth of imports due to maintenance of tight licensing policies and some import substitution, notably after the opening of the oil refinery in 1986, it is anticipated that the sustained decline in the inflows of workers' remittances will lead to widening deficits in the overall balance of payments during 1985-87. Beyond 1987 the outcome depends crucially on the volume of oil exports. The overall balance shifts into a surplus for 1988-90 provided that oil exports reach about 200,000 b/d.

Similar results have been arrived at by the World Bank staff in their latest report. 1/ With oil production of only 100,000 b/d, the report concluded that a 5 percent per annum real growth rate in 1985-95 appeared unattainable without an excessive external debt service burden by the mid-1990s. Although oil production of 200,000 b/d would make a 5 percent per annum real growth rate attainable, uncertainties about non-oil foreign exchange earnings indicated the need for caution in external borrowing and in setting growth targets. Both scenarios made clear the need for increased effort at domestic resource mobilization. Only with oil production of 400,000 b/d would a growth rate of 8 percent per annum appear attainable.

V. Developments in 1985 and Policy Discussions

With the illustrative scenario as background, discussions were focused on the need and prospects for additional adjustment measures to reduce the financial imbalances in the economy.

1. Growth prospects and investment policies

The authorities explained that the late rains in 1985 had adversely affected agricultural production. Furthermore, the drop in inflows of workers' remittances, coinciding with a decrease in foreign aid, had reduced the availability of foreign exchange and thus hampered private sector activity. For these reasons, as well as due to restraint on public sector investment, little growth in economic activity was expected for 1985. However, the authorities believed that growth might well increase in 1986 due to the multiplier effect of investment in petroleum development.

1/ IBRD, Yemen Arab Republic: Country Economic Memorandum, Current Position and Prospects, (June 1985) Report No. 5621-YAR. This report is still under discussion with the authorities.

Table 2. Yemen Arab Republic: Ilustrative Scenario of Macroeconomic Developments, 1984-87

	Prov. Actual 1984	Proj. 1985	Scenario 1986	Scenario 1987
	(In percent per annum)			
Rate of growth of real GDP	2.7	1.0	2.0	2.0
Government finances				
Revenues and grants	2.9	11.4	6.4	12.2
Current expenditures 1/	-2.8	1.4	18.1	16.4
Capital expenditures 2/	5.3	19.7	6.4	5.5
Overall deficit	-4.1	2.0	23.9	13.7
Changes in monetary aggregates				
Net credit to Government	30.7	25.4	25.7	25.5
Credit to nongovernment	31.5	34.3	33.2	32.4
Domestic liquidity	27.5	24.3	24.9	25.2
	(In millions of U.S. dollars)			
Balance of payments				
Exports	9	10	10	10
Imports	-1,414	-1,190	-1,150	-1,200
Services (net)	-46	-70	-50	-45
Unrequited transfers (net), of which:	1,137	990	920	870
Government receipts	(143)	(120)	(120)	(120)
Private receipts	(1,067)	(960)	(900)	(850)
Current account	-313	-260	-270	-365
Nonmonetary capital (net) 3/	169	100	70	45
Overall balance	-144	-160	-200	-320
Debt service to current account receipts (percent)	(5.4)	(5.9)	(13.3)	(15.4)

Sources: Central Bank of Yemen, Ministry of Finance (both for 1984), and Fund staff estimates (1985-87).

1/ Includes extrabudgetary expenditures.
2/ Includes foreign financed expenditures.
3/ Includes errors and omissions.

Table 3. Yemen Arab Republic: Illustrative Balance of Payments Scenarios, 1988-90

(In millions of U.S. dollars)

	Outcome with Oil Exports of								
	100,000 b/d			200,000 b/d			300,000 b/d		
	1988	1989	1990	1988	1989	1990	1988	1989	1990
Exports	215	420	420	445	885	885	695	1,370	1,370
Imports	-1,300	-1,600	-1,650	-1,300	-1,600	-1,650	-1,300	-1,600	-1,650
Services (net)	-105	-140	-175	-105	-140	-175	-105	-140	-175
Unrequited transfers (net)	810	775	775	810	775	775	810	775	775
Of which:									
Government receipts	(50)	(--)	(--)	(50)	(--)	(--)	(50)	(--)	(--)
Private receipts	(850)	(850)	(850)	(850)	(850)	(850)	(850)	(850)	(850)
Current account	-380	-545	-630	-150	-80	-165	100	405	320
Nonmonetary capital (net)	95	200	200	95	200	200	95	200	200
Overall balance	-285	-345	-430	-55	120	35	195	605	520
Debt service to current account receipts (In percent)	(14.3)	(12.6)	(13.0)	(12.3)	(9.6)	(10.0)	(10.6)	(7.7)	(8.0)

Source: Fund staff estimates.

The mission observed that real public sector investment had only amounted to YRls 7.2 billion during the first three years of the SFYP and was expected to fall significantly short of the total plan target of about YRls 19 billion. In this connection the authorities noted that they had felt obliged to scale down public sector investment as part of their efforts to relieve pressures on domestic and external resources. While no formal revision of the SFYP was being considered, the authorities had sought the views of the World Bank on rearranging priorities. Pending the completion of the review by the authorities of the recommendations of the World Bank on the investment program, the strategy in the annual programs was to freeze the implementation of new projects except when the financing was available from external sources or when the projects were complementary to existing ones. Priority was now being given to projects that would establish activities based on available domestic materials and that would produce import substitutes.

The authorities informed the mission that they were looking ahead to formulating the Third Five-Year Plan to start in 1987. At this time, it was felt that the next plan would concentrate on expanding the area under cultivation by building small dams and related irrigation facilities, exploiting the new oil and gas discoveries as well as other mineral resources, promoting manufacturing based on domestic raw materials, and developing human resources.

The authorities reported that 12 exploratory wells had been drilled in the Marib/Jawf area (125 miles east of Sana'a) of which 8 had yielded oil and 3 gas. Tests were continuing to delineate the field but it was already known that reserves would support a level of production that would allow 100,000 b/d to be exported. Production might reach 400,000 b/d. Studies were under way of a 225-mile pipeline from the oil fields to the Red Sea and related port facilities. It was expected that tenders would soon be called for, so that exports could begin in 1988. The present estimate of the cost of the pipeline, storage, and port facilities as well as the refinery currently under construction was US$1 billion which would be financed by the foreign partner companies, although the Government was ready to help arrange financing, if necessary.

The mission observed that the rate of inflation had increased sharply in 1984 which it attributed to the high rate of monetary growth and reduced availability of imported goods due to licensing. The authorities agreed with this assessment noting that inflation had been more pronounced toward the end of 1984 and that this pace had carried over into the first quarter of 1985.

2. Fiscal policy

The 1985 budget projected a deficit of YRls 2.7 billion, excluding (as in budgets for earlier years) full receipts of foreign grants (which averaged YRls 800 million in the previous two years), capital spending financed by foreign loans (averaging YRls 970 million), and extrabudgetary spending (averaging YRls 950 million), the same level as budgeted in 1984.

Tax revenues were to increase by 28 percent over the provisional estimate for 1984 from increases in fees, charges, and stamp duties; improved collections from the excise tax on qat 1/ and motor vehicle registration; and the elimination of arrears in the payment of the petroleum excise tax. Nontax revenues were projected to increase by 41 percent, mainly reflecting higher profit transfers from the Central Bank. On the expenditure side, current spending was estimated to remain constant while budgeted capital spending (excluding investment financed from abroad) was to increase by 45 percent over the provisional actual level in 1984 (but only 5 percent over the budgeted amount for 1984).

The revenue prospects for 1985 have been adversely affected by the continued decline in import volume, persistent difficulties in collecting excises on qat, 2/ and delays in implementing proposed increases in various fees and charges. Nevertheless, the authorities expected that overall collections would increase by about 15 percent over provisional estimates for 1984. This was primarily due to (i) improved receipts from customs duties reflecting, in turn, continued efforts to combat smuggling and to direct overland imports through official channels, as well as a further depreciation of the exchange rate used to value imports for customs purposes (to YRls 6.5 = US$1), and (ii) the recent approval by the National Assembly of educational fees (annual charges for books and registration) for the 1985/86 school year.

With regard to the outlook for expenditures, the authorities believed that the growth of current expenditures could be limited to 4 percent. The depreciation of the rial was not expected to result in higher than budgeted current spending. Although one half of the salaries of the 25,000 expatriate teachers 3/ was paid in foreign exchange, a reserve had been set aside for this contingency. Nor would higher rial costs for imported goods lead to budgetary overruns because all ministries had firm instructions not to exceed appropriations. However, capital spending was expected to rise from the low levels of 1983-84 to about the level of 1981. Unlike 1984, it was expected that there would be no shortfall in defense capital spending from the budgeted level. Accordingly, the fiscal deficit would be about 2 percent higher than in 1984 (equivalent to slightly less than 25 percent of GDP). The corresponding level of bank financing would be about 20 percent of the beginning of the year money stock.

1/ Qat is a plant whose leaves are chewed as a stimulant for an effect similar to that from consuming a large amount of caffeine. Qat is widely grown and consumed in the Y.A.R.

2/ The authorities were concerned by the difficulties being experienced in collecting the qat tax and requested technical assistance from the Fund to improve the administration of that tax.

3/ These outlays will amount to more than YRls 1 billion in 1985, about one sixth of current expenditures.

The mission welcomed the authorities' continuing efforts to restore fiscal balance but stressed that these had not been sufficient in view of the magnitude of the existing and projected imbalances in the economy. It therefore urged that a combination of revenue and expenditure measures be given consideration. Revenues could be increased by (i) raising user charges toward the levels that would recover full cost of public services, (ii) converting excise taxes from specific to an ad valorem basis, (iii) extending the application of the planned consumption tax to a larger number of products, and (iv) adjusting prices charged by the public sector in order to raise transfers of taxes and profits to the Treasury. In this regard, retail prices for petroleum products should be increased to eliminate the losses of YRls 18 million per month currently being incurred by the government-owned company responsible for import and distribution of petroleum products. These losses had eroded the company's finances rendering it unable to pay accrued petroleum excise taxes.

The mission observed that, in recent years, government expenditures had amounted to 60-70 percent of GDP, a level which was too high for a market-oriented economy such as that of the Y.A.R. Although much of the growth of expenditures during the 1970s reflected the accelerated development effort, government consumption was now well in excess of revenues. A lower real growth rate of government consumption could not be avoided in view of the lower foreign exchange receipts. Although reducing current spending would regrettably decrease living standards at first, not doing so would exacerbate domestic and balance of payments pressures with severely adverse effects on future economic growth and living standards. In containing current outlays, the mission cautioned against a prolonged freeze of wages and salaries since this would encourage civil servants to leave government employment and would prove detrimental to the development effort in the long run in view of the shortages of qualified personnel. Instead, the mission encouraged the authorities to continue to restrict the number of public sector employees to a small, well-trained cadre. The mission added that it was important that extrabudgetary spending (largely transfers related to internal security and interest payments to the Central Bank) be brought within the budget. Leaving any spending outside the budgetary framework could easily lead to a proliferation of such outlays and a concurrent weakening of fiscal responsibility. As regards capital spending, the mission fully supported the position of the World Bank to scale down the public investment program and focus it on ongoing or supporting projects while postponing others.

3. Monetary policy

The mission observed that the lower monetary growth for the 12 months ended June 1985 (19 percent) was not the outcome of a significant deceleration in net domestic credit but mainly the result of a decrease in the net foreign assets of the commercial banks and an as yet unexplained large fall in the banks' residual net assets. The growth of liquidity in excess of the growth of nominal GDP indicated the liquid position of the private sector, which was predominantly in the form of currency holdings (two thirds of broadly defined money). In view of the slower growth of production and the restraints on imports, this accumulation of liquidity by the private sector and the projected high growth of liquidity in 1985-87 portended continued pressure on prices, the exchange rate, and official reserves.

The authorities responded that the ···re concerned about the liquidity of the commercial banks and ;eneral public and had already taken initiatives to deal with this ˙.ne Central Bank was now offering higher interest rates to banks on excess reserve deposits; the proceeds of these deposits were notionally being allocated to funding government borrowing from the Central Bank. This p· ss was tantamount to the Government borrowing from the banks. To sorb bank liquidity, regulations had recently been issued moving all ublic sector entities' deposits to the Central Bank and all join ventures' deposits to the government-owned commercial bank. This had reduced the banks' deposit base by about 10 percent, reducing their excess liquidity and prompting them to increase interest rates offered on time deposits from 3-4 percent to as high as 11 percent.

The mission welcomed these steps but noted that in view of the excess liquidity still in the system, further action should be taken to absorb liquidity in commercial banks and in the hands of the public possibly through (i) shifting the financing of the fiscal deficit from the Central Bank to the commercial banks, (ii) increasing commercial banks' reserve requirements, (iii) issuing government bonds with suitable returns and other features to the nonbank public, and (iv) adjusting the structure as well as raising the level of interest rates to encourage the holding of deposits denominated in rials and term lending by commercial banks. The negative real interest rates on deposits and loans in rials encouraged borrowing to finance speculation in land, commodities, and foreign exchange. As regards the level of interest rates, the authorities noted that financial instruments should be created that would appeal to religious persons who were not attracted by interest rates. They also requested technical assistance from the Fund on means of absorbing commercial bank and private sector liquidity.

There had been an increase in the amount of doubtful or bad debts which had led to a capitalization of the interest due on these loans. This weakness in the quality of the banks' loan portfolio and the increase in their unclassified assets and liabilities pointed to the need for increased supervision and vigilance over the commercial banks. The authorities indicated that they were aware of the erosion in the quality of the banks' loan portfolios and poor lending practices. They were expanding supervision by the Central Bank and increasing contacts with the banks to make them more responsive to the situation.

4. External sector

The authorities reported that the official exchange rate had been depreciated by 10 percent against the U.S. dollar in February 1985, bringing the midpoint of the Central Bank's buying and selling rates to YRls 6.485 = US$1. In view of the persistence of a differential between the official and market rates, all but a few government transactions had subsequently been transferred to the market rate. In addition, importers had been allowed to use--subject to central bank approval--half of their own foreign currency deposits to finance certain categories of imports. 1/

Midyear projections by the Central Bank indicated that imports would decline by 17 percent in 1985 due to lower receipts of foreign exchange by the public and private sectors, higher rial prices for imports, and tighter import licensing. Nevertheless, little change was expected in the overall deficit of the balance of payments because of the continued decline in workers' remittances and foreign grants as well as lower official loan drawings. The overall deficit would be financed mainly by further reducing the foreign assets of the Central Bank, which could reach US$225 million (about two months of imports) by the end of 1985.

The mission noted that there were two issues regarding the exchange system, namely the restrictiveness of the system and the adequacy of the official exchange rate level. As regards the former, exchange restriction took the form of import licensing in accordance with the foreign exchange budget. 2/ In addition, the mission observed that official acceptance of two divergent exchange rates--the official exchange rate (YRls 6.485 = US$1) and the market rate (about YRls 7.8 = US$1)--constituted a multiple currency practice. The mission noted that experience in other countries had shown that restrictive import licensing not only misallocated resources and hampered real growth but also created administrative burdens and difficulties and undermined customs revenues by maintaining a too appreciated exchange rate. Indeed, the introduction of a restrictive import licensing system in the Y.A.R. had not only kept the level of the exchange rate artificially appreciated, which initially reduced pressure on rial prices of imports, but had also discouraged import substitution and reduced customs receipts. The more appreciated exchange rate used for capital imports financed from foreign aid also encouraged adoption of capital-intensive techniques. Moreover, the existence of a differential between the official and market exchange rates could lead to pressure in the future to finance certain imports from oil export receipts at an artificially appreciated exchange rate. Therefore, the mission urged that the licensing system and supporting exchange restrictions be removed--accompanied by greater efforts at demand management to reduce excess aggregate demand and to alleviate pressure on the exchange rate--and that the market and official rates be unified at a level that would be set flexibly afterward.

1/ These categories include foodstuffs, petroleum products, medicines, industrial inputs, and spare parts.

2/ In support of this restriction, importers are required, with certain exceptions, to obtain foreign exchange from commercial banks (rather than the secondary market or their own deposits) and commercial bank purchases of foreign exchange take place through a committee that allocates its purchases according to predetermined shares.

The exchange rate had remained stable vis-a-vis the U.S. dollar up to 1983 without any interference in the market or any imposition of restrictions. However, between the end of 1983 and February 1985, the rial in the official exchange market underwent a cumulative depreciation of 30 percent against the U.S. dollar while the consumer price index (CPI) in the Y.A.R. rose by 9 percent relative to the U.S. CPI. 1/ This depreciation suggested a welcome improvement in the competitive position of tradable goods; but it was accompanied by the imposition of restrictions and therefore could not be considered an adequate rate. The mission pointed out that in view of the possibility of substantial oil exports at the end of the 1980s, it was important that the exchange rate be adjusted flexibly to take account of the international competitiveness of non-oil production in the Y.A.R.

The authorities stressed that they were committed to a market-oriented economy, that they had transferred all but a few government transactions from the official exchange market to the secondary market during 1985, and that the exchange and trade restrictions were temporary departures which would gradually be eliminated as order was restored to the exchange market. Depreciation of the official exchange rate to the market rate without first implementing supportive measures to absorb excess liquidity would result in further depreciation of the market rate. Thus the authorities were looking forward to the requested technical assistance study by the Fund on measures to absorb excess liquidity. Thereafter, they would formulate a package of demand management measures that would lay the groundwork for unifying the exchange rates and removing the exchange and trade restrictions. The mission welcomed the authorities' commitment to the market mechanism and their intention to unify the exchange rates and to eliminate restrictions within a brief period. In this regard, the scenario for 1986-87 illustrated the need for further strengthening of demand management. Even though the present debt servicing burden was relatively low, the mission urged the authorities to pursue a prudent approach to external borrowing, keeping borrowing to finance the payments deficit well within the level that could be readily serviced from confirmed levels of oil production and a conservative projection of oil export prices.

VI. Staff Appraisal

The Y.A.R., with a relatively narrow resource base, has witnessed remarkable development over the last 15 years in human resources, the stock of infrastructure, the standard of living, and administrative institutions. With virtually no merchandise exports, the economy has remained highly dependent on workers' remittances and, to a lesser extent, foreign aid. In the last half of the 1970s, rapid growth in these receipts formed the basis for a surge in economic growth and accumulation

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1/ This improvement occurred after ten years during which the official exchange rate was unchanged vis-a-vis the U.S. dollar while the Y.A.R. CPI rose by 75 percent relative to the U.S. CPI.

of foreign exchange reserves. Credit for this economic performance must largely be given to the growth-oriented policies pursued by the authorities within the context of an exchange and trade system virtually free of restrictions.

During the early 1980s strains developed in the economy as government spending grew more rapidly than revenue and the external environment became less favorable. The decline in foreign exchange receipts reduced the availability of imported goods which together with natural calamities slowed the growth of production. In response to the worsening domestic and external imbalances, the authorities initiated in 1983 and sustained in 1984-85 efforts to strengthen government finances through revenue measures, improved tax collection procedures, and restraint on expenditures, including sharp cuts in public sector capital spending. As a result, the fiscal deficit decreased relative to GDP from 33 percent in 1982 to an estimate of less than 25 percent in 1985. Nevertheless, the Government has continued to rely heavily on financing from the Central Bank, a major factor in the continued high rates of monetary expansion that occurred despite the contractionary impact from external transactions and banks' residual net assets. The measures taken during 1985 to reduce bank liquidity by raising the interest rate paid on excess reserves and shifting public sector deposits from the commercial banks to the Central Bank are welcome. In addition, to relieve external payments pressures, the authorities supplemented the fiscal tightening by adopting temporary restrictions on imports and external payments in 1984, by depreciating the official exchange rate by 30 percent against the U.S. dollar in five steps since the beginning of 1984, and by moving all but a few transactions in 1985 to the secondary exchange market which has a more depreciated exchange rate.

Despite the above measures, excess aggregate demand has kept pressure on prices, the exchange rate, and the Central Bank's external reserves. Fiscal and monetary projections for 1986-87 as well as balance of payments projections for 1986-90 clearly indicate the need for a comprehensive and vigorous package of further corrective measures to be applied at least through 1987 so as to reduce the injection of liquidity into the economy and restrain the demand for foreign exchange. Such measures should cover the major policy areas in public finance, monetary and credit policies, public investment priorities, and the exchange and trade system.

The major effort of adjustment should come from steps aimed at reducing the expansionary thrust of government operations. Budget revenue should be enhanced through increases in user charges, conversion of excise taxes from a specific to an ad valorem basis, prompt implementation of the proposed consumption tax on domestically produced goods and its extension to a larger number of commodities, adjustment in the prices charged by public sector companies that are operating at a loss (especially the government-owned petroleum company), and improved receipts from the qat tax. On the expenditure side, the authorities should consider bringing extrabudgetary spending within the budget and further reducing these outlays, realigning investment priorities along the lines suggested by the World Bank, and containing current spending. Excessive reliance on further cuts of capital outlays would only depress future growth prospects and should be done only in a way that would guarantee the efficiency of the investment program.

In the monetary and credit area, the Government's financing needs could be met directly from commercial banks rather than the Central Bank (which would reduce the growth of reserve money) and, if possible, from the nonbank public. The level of interest rates should be positive in real terms and competitive relative to the expected yield on foreign currency assets in order to curb the demand for credit and to direct the flow of saving into productive uses; the interest rate structure should also encourage term lending; and a financial instrument should be designed to mobilize savings from religious persons who are not motivated by interest. Finally, the authorities could consider raising the reserve requirement on bank deposits to reduce bank liquidity. The transfer of all but a few government transactions from the official exchange market to the secondary exchange market during 1985 has reduced the scope of the official exchange rate. The major drawback from its continued use for certain operations is the distortion in public investment decisions as a result of understating the cost of capital. In addition, prolonged existence of an appreciated official exchange rate could lead to future pressure to finance certain imports from oil export receipts at an artificially appreciated exchange rate. The staff therefore encourages the authorities to unify the two exchange rates soon, to adopt full exchange rate flexibility afterwards, and to eliminate exchange and trade restrictions so as to improve the overall allocation of resources and to reduce the administrative costs of the present system. A more depreciated exchange rate would encourage import substitution and and some merchandise exports, as well as augment customs receipts.

The authorities have expressed their determination to remove the restriction on external payments and have emphasized their commitment to a free and liberal exchange system. In so doing, they have requested Fund technical asssistance to advise on policies to absorb commercial bank and private sector liquidity, while simultaneously reviewing the level and structure of interest rates. They have stated that they would take measures based on the technical assistance to lay the groundwork for elimination of the restriction and unification of the exchange rates promptly. The staff is satisfied that the restriction is necessary for balance of payments purposes and that its use will be temporary while the authorities are seeking to eliminate the need for it. The staff therefore recommends that the exchange restriction and multiple currency practice be again temporarily approved by the Executive Board.

The pressures on the external payments position should be addressed through stronger demand management and exchange rate flexibility. A cautious approach to incurring external debt should be pursued. The purpose of foreign borrowing should not be to sustain an inappropriate level of consumption. In view of the uncertainties prevailing in international oil markets, the servicing of such borrowing should be well within the projected debt servicing capacity from oil earnings.

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

VII. Proposed Decision

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

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

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

Yemen Arab Republic: Fund Relations
(As of September 30, 1985)

(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:	53.1 (122.5 percent of quota)
(c) Fund credit:	9.8 (22.5 percent of quota)
Of which:	
credit tranche	--
(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:

Special Facility	Date	Amount 1982	1983	1984
Emergency assistance	February 25, 1983	--	9.8	--

IV. SDR Department

(a) Net cumulative allocation:	6.2
(b) Holdings:	8.5 (138.1 percent of net cumulative allocations)
(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

VIII. 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 February 15, 1984 and four occasions thereafter (most recently February 1985) the Yemen rial was depreciated. Presently, the central bank rates for buying and selling U.S. dollar telegraphic transfers, checks, and bank notes are YRls 6.47 = US$1 and YRls 6.50 = US$1, respectively. The representative rate established under the Fund's Rule O-2 is YRls 6.485 = US$1 as of February 1985. A parallel informal market in foreign exchange also exists involving primarily transactions between money changers, remittance agents, and Yemeni expatriates.

IX. Last Article IV Consultation:

Discussions were held in Sana'a during August 1984. The Staff Report (SM/84/228) was discussed by the Executive Board on November 21, 1984. Consultations with the Yemen Arab Republic are on a standard 12-month cycle.

The Executive Board's decision (Decision No. 7844-(84/168)) adopted November 21, 1984, was as follows:

1. The Fund takes this decision relating to the Yemen Arab Republic's exchange measures subject to Article VIII, Section 2, and in concluding the 1984 Article XIV consultation with the Yemen Arab Republic, in the light of the 1984 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 licensing of imports in accordance with an exchange budget and the limitations on the use of residents' foreign exchange deposits, as described in SM/84/248, constitute exchange restrictions requiring approval under Article VIII. The Fund notes the intention of the Y.A.R. authorities to eliminate the restrictive elements of these regulations at an early date and grants approval for these restrictions until November 30, 1985 or the next Article IV consultation, whichever is earlier.

X. Technical Assistance:

(a) CBD

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.

(b) FAD

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

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

(c) Other

In November/December 1983 an 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.

XI. Resident Representative/Advisor: None.

Yemen Arab Republic: Basic Data

Area and population	
Area	195,000 square kilometers
Resident population (1981)	7.15 million
Per capita GDP (1981)	YRls 1,872 (US$410)

	1981	1982	1983	1984	Proj. 1985
	(In millions of Yemen rials)				
Production and prices					
GDP in current market prices	13,382	15,868	17,170	17,950	...
GDP in constant 1981 prices	13,382	14,716	15,230	15,590	15,750
Percentage growth of real GDP (at factor cost)	(9.6)	(10.6)	(2.2)	(2.7)	(1.0)
Percentage change in Sana'a retail price index	(5.0)	(2.7)	(5.3)	(12.8)	(...)
Public finances					
Total revenues and grants	4,852	5,805	5,260	5,415	6,030
Revenues	(3,336)	(3,696)	(4,408)	(4,654)	(5,247)
Grants	(1,516)	(2,109)	(852)	(761)	(783)
Total expenditures	7,801	11,066	10,067	10,024	10,731
Current expenditures	(3,325)	(5,286)	(6,201)	(5,957)	(6,054)
Capital expenditures	(3,683)	(4,017)	(2,944)	(3,100)	(3,710)
Extrabudgetary expenditures	(792)	(1,763)	(922)	(967)	(967)
Overall deficit (-)	-2,949	-5,261	-4,807	-4,609	-4,701
External financing	920	846	900	802	592
Domestic bank financing	2,029	4,415	3,907	3,807	4,109
Deficit as a percentage of GDP (at market prices)	(22.0)	(33.2)	(28.0)	(25.7)	(...)
Money and credit (change during period):					
Domestic liquidity (money and quasi-money)	726	2,614	3,448	4,398	4,952
Net external transactions	-1,181	-1,399	-974	-511	-790
Net claims on Government	2,023	4,415	3,907	3,807	4,109
Claims on nongovernment sector	294	160	226	1,141	1,633
Percentage change in domestic liquidity	(8)	(26)	(28)	(28)	(24)
Ratio of:					
GDP (at market prices) to domestic liquidity 1/	(1.40)	(1.42)	(1.21)	(0.99)	(...)

Yemen Arab Republic: Basic Data (concluded)

	1981	1982	1983	1984	Proj. 1985
	(In millions of U.S. dollars) 2/				
Balance of payments					
Exports, f.o.b.	11	5	10	9	10
Imports, f.o.b.	-1,748	-1,952	-1,796	-1,414	-1,170
Trade balance	-1,737	-1,948	-1,786	-1,405	-1,160
Services (net)	-52	-37	-52	-46	-70
Private transfers (net)	788	924	1,104	994	870
Official transfers (net)	337	469	189	143	120
Current account	-664	-592	-545	-313	-240
Nonmonetary capital	331	193	272	103	80
Errors and omissions (net)	72	89	56	66	--
Overall balance	-260	-311	-216	-144	-160
Current account deficit as percentage of nominal GDP (at market prices)	(22.3)	(16.8)	(14.3)	(9.3)	(...)
Total reserves (end of period)	967	558	361	304	284 3/
In months of imports	(7)	(3)	(2)	(3)	(3)
Disbursed external debt outstanding (medium- and long-term, end of period)	1,101	1,301	1,509	1,507	1,608 3/
	(In percentage)				
Medium- and long-term external debt to GDP (at market prices)	37	37	40	49	...
External debt service to GDP (at market prices)	2.3	1.5	1.0	2.3	...
External debt service to current account receipts	4.0	2.7	2.1	5.4	5.9
	(Yemen rials per U.S. dollar)				
Official exchange rate (midpoint of buying and selling rates at end of period)	4.5625	4.5625	4.5625	5.86	6.485 3/

1/ Denominators are beginning and end-of-period averages.
2/ Converted at US$1 = YRls 4.5 through 1983, US$1 = YRls 5.31 in 1984, US$1 = YRls 6.33 in the first half of 1985, and US$1 = YRls 6.47 in the second half.
3/ June 30, 1985.

Yemen Arab Republic--Statistical Issues

1. Outstanding statistical issues

a. Government finance

The 1984 GFS Yearbook contains data on consolidated Central Government through 1983. The presentation, however, is incomplete since data on financing by type of debt holder does not contain the breakdown for foreign financing for the years 1980 through 1983, while data on financing by type of debt instrument does not contain the breakdown for domestic financing for the years 1981 through 1983.

b. Monetary accounts

The balance sheet data for the monetary authorities as reported to the Bureau show a large fluctuation in the below-the-line item "Memorandum accounts" (accounting for 42 percent of total assets/liabilities in March 1985). Further information has been requested on this item, to determine whether there are any serious classification errors, although so far no reply has been received.

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

The table below shows the currentness and coverage of data published in the country page for the Yemen Arab Republic in the October 1985 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Central Bank of Yemen, which during the past year have been provided on an irregular basis, and the currentness and coverage of data for external trade and the real sector is inadequate.

Status of IFS Data

		Latest Data in October 1985 IFS
Real Sector	- National Accounts	1982
	- Prices (consumer)	1983
	- Production	n.a.
	- Employment	n.a.
	- Earnings	n.a.
Government Finance	- Deficit/Surplus	1983
	- Financing	1983
	- Debt	n.a.
Monetary Accounts	- Monetary Authorities	May 1985
	- Deposit Money Banks	May 1985
	- Other Financial Institutions	n.a.
External Sector	- Merchandise Trade: Value	1985
	Prices	n.a.
	- Balance of Payments	Q3 1984
	- International Reserves	July 1985
	- Exchange Rates	July 1985

A Note on the World Bank Staff's View on the Yemen Arab Republic Economy

The Y.A.R.'s overall economic performance during the seventies was good. Gross domestic product grew by nearly 9 percent per annum and the increase in incomes benefited large segments of the population. The Government adopted a balanced policy that put priority for public investment on the development of the basic physical and social infrastructure, and relied for the rest on the private sector, minimizing interference with market forces. This policy proved beneficial for the country. Large inflows of workers' remittances, official grants, and concessional loans significantly contributed to this performance. However, recently, a noticeable deceleration in economic growth set in, mainly because of the leveling off in the inflow of workers' remittances, the reduction in official assistance, three years of drought, plus a major earthquake. This economic slowdown was also accompanied by a deterioration in the macrofinancial situation, as public investment and associated recurrent expenditures exceeded the Government's limited resources, and growing imports resulted in a widening balance of payments deficit. However, inflation continued to be low in 1982 and 1983, mainly because imports were cheapened by the appreciation of the Yemeni rial against most currencies (except the U.S. dollar to which it is pegged). But low inflation was obtained at the cost of a sharp reduction in foreign reserves.

In view of the shortage of investible resources, the Government started in 1983 to scale down its investment targets, by tightening investment priorities, with assistance from IDA. This effort was complemented by an endeavor to restrain recurrent expenditure growth and to increase tax revenue. These measures resulted in a sizable reduction in the budget deficit in 1983 and 1984. Yet inflation was significantly higher in 1984, rising to 13 percent mainly because of a series of adjustments to the value of the Yemeni rial which depreciated by about 30 percent. These adjustments, together with import restriction measures taken by the Government, resulted in a large decline in imports and a marked improvement in the balance of payments. However, considerable inflationary pressures remain in the economy, which points out the need for continuation of the stabilization program. In addition, to achieve a lasting improvement in its external position, the Y.A.R. should further reduce its budget deficit, pursue its flexible exchange rate policy and rely less on quantitative import restrictions.

Oil was discovered in 1984 in the eastern part of the country, and it seems that exploitable reserves are large enough to justify exports of crude oil, starting possibly in 1989. In the meanwhile, the Y.A.R. Government will face the challenge of continuing its stabilization program while preparing for the oil era. The oil discovery could improve the Y.A.R.'s development prospects significantly, but this would depend on the level of oil production, oil prices and the extent of the decline in other external resource flows (workers' remittances and official grants and loans).

Two issues, namely, population growth and the reduced availability of water, have emerged as serious long-term development issues. The rapid population growth (about 3 percent per annum) indicates that, despite cultural constraints, a more active policy is needed in view of the adverse consequences of rapid population increase. Water resources are being depleted rapidly, in particular around major cities. A number of initiatives are, therefore, called for to address these problems: (i) establishing a comprehensive water resources data base; (ii) improving coordination among the various agencies operating in the water sector; (iii) introducing legislation to manage water use; and (iv) strengthening cost recovery policies.

Medium-Te Scenario

The fiscal and monetary projections for 1986-87 are based on a continuation of current macroeconomic policies. Government revenues and expenditures are generally anticipated to grow in line with recent performance. In particular, taxes on income, profits, and property as well as stamp duties are expected to increase in pace with GDP. Excise taxes that are levied on a specific basis, other taxes, fees, charges, and fines are projected to grow at 5 percent per annum. The excise tax on qat, consular fees, Zakat, property income, capital revenue, and other nontax revenues are to grow by 10 percent per annum. Customs duties are estimated at 28 percent of the rial value of imports.

With regard to current spending, Chapter I outlays (wages, salaries, etc.--comprising 46 percent of current spending) are expected to grow by 20 percent per annum, Chapters II and III outlays (18 percent of current spending) by 20 percent per annum, and unclassified current spending (36 percent of total current spending, half of which is for military pay) by 15 percent per annum. Extrabudgetary spending (transfers related to internal security and domestic interest) are expected to remain constant while capital spending is to grow by 6.4 percent and 5.5. percent in 1986 and 1987, respectively.

The annual increase in net credit to the Government from the domestic banking system is derived from the fiscal deficit, less the rial value of foreign financing from the balance of payments projections. Net external transactions are also from the balance of payments. Credit to the non-government sector is anticipated to grow by 30 percent per annum, somewhat less than in 1984 (32 percent) and the 12 months ended June 1985 (33 percent) due to recent measures to absorb excess bank liquidity.

The balance of payments projections for 1986-90 also start from the assumption of no change in current monetary, fiscal, and external sector policies. For 1988-90 there are three variations to the scenario, each for a different level of oil exports (100,000 b/d, 200,000 b/d, and 300,000 b/d) which are assumed to begin in mid-1988. Oil export receipts are the Y.A.R.'s share (i.e., excluding exports by foreign partner companies) worked out according to information on sharing arrangements provided by the authorities. Official grants to the Government are projected to remain constant in 1986-87 at the level projected by the Central Bank of Yemen (CBY) for 1985, to fall by over 50 percent in 1988, and then to be zero. This elimination of grants reflects the expectation that, after oil exports begin, donors will withdraw their assistance. Workers' inward remittances are projected to continue to decline through 1987 due to the slower pace of economic activity in neighboring countries and the opening up of employment opportunities within the Y.A.R. in construction of oil export facilities. Remittances level off thereafter. Service receipts are anticipated to increase by modest amounts in 1986 and 1987 due to payments by foreign contractors to Yemenis working on construction of the oil facilities and then fall back to the 1986 level. Drawings on official loans by the Government in

1986-87 are projected to remain at the level projected for 1985 by the CBY due to a continued squeeze on the Government to provide local counterpart financing for foreign financed projects. With improvement in the Government's fiscal position from oil exports, drawings are projected to rise in 1988-90.

On the expenditures side, private sector imports are anticipated to continue to decrease in 1986 due to import substitution (notably the start-up of the oil refinery), import licensing, and the decline in private sector receipts of foreign exchange. After 1986, private sector imports grow at the modest rate of 5 percent. Private sector imports exclude imports of capital goods and other items by the foreign partner companies working in the oil sector (their remittances of earnings once they begin to export oil are also excluded from the balance of payments). Government imports in 1986-87 are projected to remain at the level projected for 1985 by the CBY and increase by a small amount in 1988 due to the tight foreign exchange position of the public sector. Government imports are projected to double in 1989 and to remain at that level in 1990 as oil export receipts increase the capacity to import. Total service payments are projected to increase moderately. Of these payments, a small proportion (13 percent in 1986) is for interest on official external debt. Interest payments are based on the schedule of interest due on currently outstanding debt provided by the CBY, adjusted upward for interest on debt incurred subsequently. Outward unrequited transfers by foreign workers in the Y.A.R. are projected to remain at the 1985 level in 1986-87 and then to decline moderately due to improvement in the domestic availability of skilled labor. Finally, loan repayments are according to the CBY's schedule.