

**FOR
AGENDA**

SM/09/18

January 22, 2009

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Republic of Yemen—Staff Report for the 2008 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 2008 Article IV consultation with the Republic of Yemen, which is tentatively scheduled for discussion on **Monday, February 23, 2009**. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of the Republic of Yemen indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Mr. Schneider (ext. 35662), Mr. Pani (ext. 38536), and Ms. Ongley (ext. 38414) in MCD.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the Arab Monetary Fund and the Islamic Development Bank, following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF YEMEN

Staff Report for the 2008 Article IV Consultation

Prepared by the Staff Representatives for the 2008 Consultation with the Republic of Yemen

Approved by Adam Bennett and David Marston

January 21, 2009

- Discussions took place from October 21 to November 3, 2008 in Sana'a. The mission comprised Mr. Schneider (head), Mr. Almounsor, Ms. Ongley, Mr. Pani (all MCD), and Ms. Rahman-Garrett (SECOP).
- The mission met with the prime minister, the deputy prime minister, and the ministers of finance, oil and minerals, industry and trade, civil service, and social affairs and labor; the governor of the central bank; and other government officials. The mission also met with various private sector representatives and donors.
- Yemen has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions.
- Yemen's de facto exchange rate regime is currently classified as a conventional peg, reflecting stability vis-à-vis the U.S. dollar since mid-2007, although the de jure classification remains free floating.
- The Executive Board concluded the 2007 Article IV consultation on September 17, 2007. The staff report and PIN were made available at: <http://www.imf.org/external/country/YEM/index.htm>.
- The quality and timeliness of data are weak but still adequate for surveillance purposes. Yemen participates in the General Data Dissemination Standard.
- A donor roundtable was conducted at the end of the mission.

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EXECUTIVE SUMMARY

The 2008 Article IV consultation discussions with Yemen focused on the appropriate policy response to high inflation and mounting fiscal and external vulnerabilities.

Background

Recent economic performance has been mixed. Oil production continues to decline, and oil reserves are expected to be depleted in 10–12 years. Non-oil sector growth is estimated at about 5.3 percent in 2007 and 4.8 percent in 2008. Inflation has been volatile, reflecting the surge in international commodity prices and local drought. High oil prices buffered government revenue and exports in 2007 and the first half of 2008, but pressures are quickly mounting on public finances and the balance of payments as oil prices decline.

Authorities' views

- Efforts are being made to compress expenditures in 2008 so as to avoid upward pressure on inflation and reduce the deficit. The authorities remain committed to fiscal consolidation, including elimination of fuel subsidies, a smaller wage bill, and boosting non-oil revenues. Social stability concerns are key to the pace of reform.
- Monetary policy has sought to mitigate inflation through exchange rate stability and controlling domestic liquidity. A stable rial has brought benefits, but there are limits given balance of payments pressures and the need to minimize reserve losses.
- Financial intermediation is deepening. Banks' balance sheets continue to improve, but some weaknesses remain. Further strengthening the banking sector is a priority.

Staff recommendations

- The fuel subsidy system should be phased out in combination with an increase in, and better targeting of, social welfare transfers. The civil service wage bill should be reduced. Action is needed on overdue non-oil revenue reforms.
- Exchange rate stability should be maintained for the short term to dampen inflation, but monetary policy must focus more on price stability going forward. There is no clear evidence of significant exchange rate misalignment, but flexibility will be needed in coming years, given falling oil prices and dwindling oil reserves.
- Financial sector reform and modernization are essential to deepening financial intermediation and growth prospects. Further reform of the investment environment is key to fostering alternative sources of growth as oil output declines.

I. INTRODUCTION

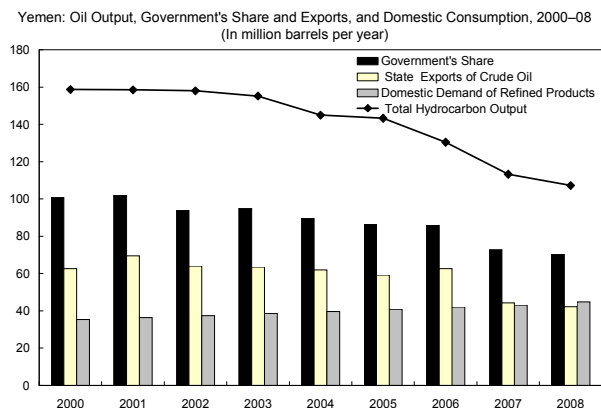
1. **Yemen is one of the poorest countries in the Middle East.**¹ An estimated 35 percent of the population lives below the poverty line. Oil reserves are expected to be depleted in about 10–12 years. Yemen has few other natural resources and is also facing depletion of its groundwater. These challenges are compounded by an expanding population, poor infrastructure, weak institutional capacity, a fragile security situation, and the widespread use of qat—a mild narcotic accounting for over one-third of agricultural production and about a quarter of total water resource use.

2. **Economic reforms slowed after the 1990s, and urgently need to be reinvigorated.** Although a number of reform initiatives emerged in recent years—including civil service and public financial management (PFM) reforms, a major adjustment to fuel subsidies in 2005, a new general sales tax (GST), an anticorruption drive, and improvements to the social safety net—most have been only partially implemented and with significant delays. Fund advice on preparing for the transition to a non-oil economy has had limited traction, particularly in the context of record world oil prices and increasing political and security constraints. However, recent developments—the sharp decline in oil output in 2007 and the even sharper decline in oil prices in late 2008—are bringing a new sense of urgency to the debate on economic reform.

II. RECENT ECONOMIC DEVELOPMENTS

3. **Recent economic performance in Yemen has been mixed.** Oil production continues to decline. Non-oil economic activity has grown at a reasonable rate but is likely to have slowed moderately in 2008. Inflation has been a key concern. Pressures related to the global slowdown and the falling price of oil began to materialize in late 2008.

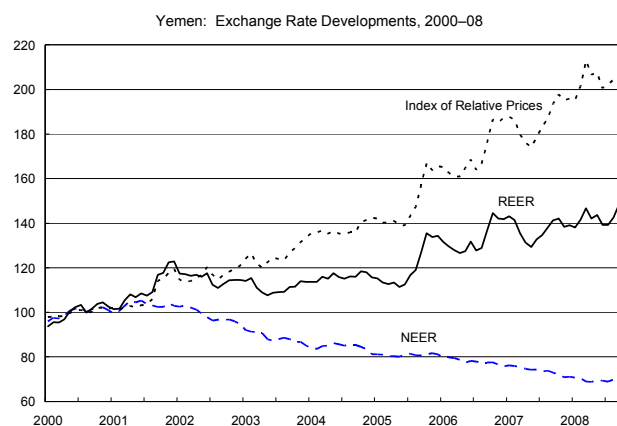
- **Overall real GDP grew by about 3.3 percent in 2007**, reflecting real non-oil growth of 5.3 percent and a



¹ Yemen ranks last among 13 Middle East and North Africa countries surveyed in the World Bank's *World Development Indicators* in terms of per capita income, life expectancy, completion of primary education, and access to improved water.

13.1 percent decline in oil output.² Overall growth should pick up in 2008, with somewhat lower non-oil growth of 4.8 percent compensated for by a smaller decline in oil output.

- **Core inflation (excluding qat) rose to 27 percent by May 2008**—reflecting the surge in global commodity prices. Inflation has since declined to about 18 percent in October. Some spillover to nonfood items may have emerged. Inflation excluding qat and food reached a record 18 percent by June—mainly due to the cost of services, clothing, housing, and fuels (Box 1).
- **A sizeable fiscal deficit emerged in 2007, and another is likely for 2008.** A sharp decline in oil production, coupled with inflexible government expenditure, led to an overall fiscal deficit of 5.8 percent in 2007. For 2008, a deficit of around 5–6 percent of GDP is possible in the wake of the recent drop in international oil prices, continued rigid expenditures, and limited non-oil revenue improvements.
- **Monetary policy in 2008 focused on exchange rate stability and controlling excess liquidity in the domestic banking system.** The rial has remained steady against the U.S. dollar since mid-2007, helping to mitigate imported inflation. In real effective terms, the rial appreciated by 9.5 percent in the 12 months to October. The Central Bank of Yemen (CBY) used its full allowance of Treasury bills to absorb domestic liquidity in the first nine months of the year, and has since relied on central bank certificates of deposit (CDs) and additional foreign exchange auctions. Broad money and reserve money growth through October were 15.5 percent and 10.9 percent, respectively. The benchmark deposit rate remains fixed at 13 percent.



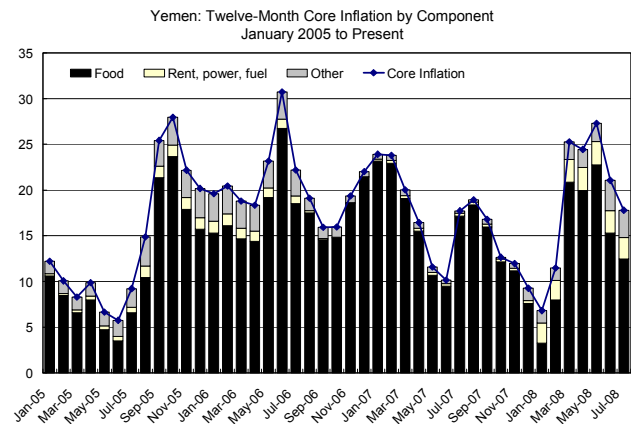
² The Central Statistics Office (CSO) recently revised and rebased national accounts series with the help of a technical expert from the United Nations Economic and Social Commission for Western Asia (ESCWA). The exercise is an important step forward in establishing a more timely and credible set of data on GDP. However, technical problems remain and work will continue with the objective of producing a revised and consistent data set by the end of 2008. The staff and authorities agreed to use the established national accounts series for the purpose of this report.

Box 1. Inflation Developments in Yemen and the Policy Response

Inflation developments: Inflation in Yemen has been extremely volatile in the past year. During January–July 2008, 12-month core inflation (i.e., excluding qat) averaged 19 percent. Food prices have been the main impetus, with food inflation averaging 22 percent during the first two quarters of 2008—in line with the most vulnerable net food importing countries in the region. While non-tradables have not generally been a major source of inflation—due at least in part to administered domestic fuel prices—some of the recent push from commodity prices seems to be feeding into other components of the CPI (such as housing and related items). Though the worst of the food crisis appears to be over, recent developments underscored Yemen's vulnerability to commodity shocks.

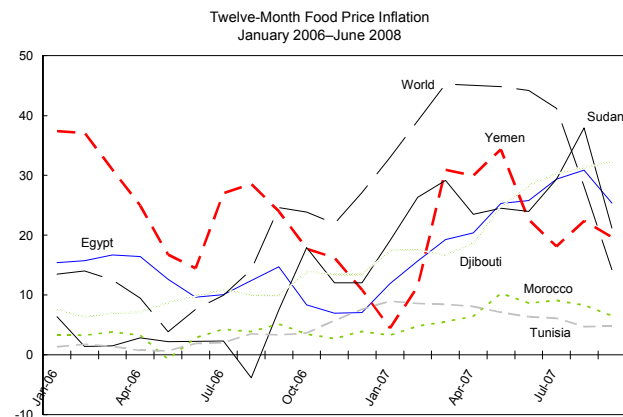
Social and macroeconomic impact: The surge in commodity prices is likely to have aggravated poverty, particularly for small farmers and the landless. Increasing poverty and food prices also appear to have contributed to growing social tensions. Record international fuel prices for the first half of 2008 also raised the fuel subsidy bill and added to the 2008 government fiscal deficit.

Policy response and external assistance: The government has sought to mitigate the impact of surging prices through direct support to consumers and increasing the supply of commodities. In March 2008, the government increased wages, pensions, and social welfare benefits—at an estimated cost of YRL 60 billion in 2008. The government also intervened in the wheat market through direct sales to the public. International donors have increased their support to Yemen through a mix of loans, grants, and direct food aid. The central bank has meanwhile maintained a prudent monetary policy and suspended the practice of steadily depreciating the rial in favor of exchange rate stability in order to mitigate the extent of imported inflation.

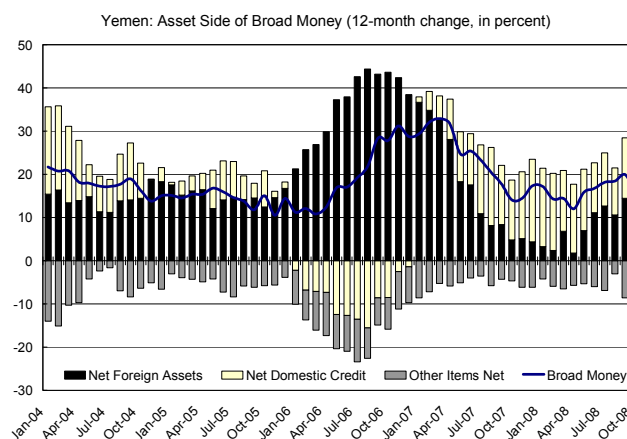


Standard Deviation of Monthly Food Inflation
January 2006–June 2008

Yemen	4.72
Sudan	3.76
World	2.54
Egypt	1.71
Djibouti	1.57
Morocco	1.48
Tunisia	0.63



- The external current account shifted to a deficit of 7 percent of GDP in 2007,** compared with an average surplus of about 2.4 percent during 2002–06. This shift reflected mainly FDI-financed imports for a liquefied natural gas (LNG) plant. The external accounts benefited from record oil prices during the first part of 2008, but pressures appear to be emerging in the wake of declining oil prices. The current account is projected to remain in deficit (about 2 percent of GDP) in 2008. CBY foreign exchange reserves look to remain roughly the same as at end-2007.



- Financial intermediation is deepening but remains shallow compared to the region.** Nonperforming loans

(NPLs) remain high but have fallen steadily as a share of total loans in recent years. Capital adequacy improved in mid-2008 compared to end-2007. Further improvements in capital adequacy are expected by end-2009, in line with revised minimum capital requirements for banks in Yemen. Dollarization has declined steadily in the past few years.

Cross-Country Comparison of Financial Intermediation

	Broad Money / GDP	Priv. Credit / Broad Money	Priv. Credit / GDP
Lebanon	282.5	25.5	72.0
Jordan	137.4	71.2	97.8
Morocco	105.0	67.1	70.4
Tunisia	66.6	92.0	61.3
Egypt	89.7	51.7	46.4
Oman	38.2	97.7	37.3
Sudan	21.0	60.1	12.6
Yemen	36.8	22.2	8.2

Source: IFS and WEO databases; all data end-2007.

Yemen: Indicators of Banking System Financial Soundness, 2004–08 1/ (In percent; unless otherwise indicated)

	2004	2005	2006	2007	2008 June
Capital adequacy					
Risk-weighted capital adequacy ratio	10.0	10.0	12.0	8.7	9.4
Capital (net worth) to assets	5.0	5.0	6.5	4.9	5.5
Portfolio quality					
Nonperforming loans to total assets	6.8	7.1	5.7	5.4	5.5
Nonperforming loans to gross loans	24.0	24.0	23.0	19.5	18.0
Portfolio performance					
Average return on assets	0.8	1.1	1.2	1.6	0.9
Average return on equity	15.1	17.8	17.3	19.7	12.2
Exposure to exchange rate risk					
Total foreign currency assets (billions of rials)	309.1	379.3	469.3	576.3	599.2
Total foreign currency liabilities (billions of rials)	288.9	354.8	458.1	520.1	523.2

Source: Central Bank of Yemen.

1/ Data refer to all banks, except for the Housing bank and CAC bank. 2006 data included CAC

- Yemen maintains close cooperation with the donor community,** but a substantial portion of the 2006 Consultative Group (CG) pledges have yet to be translated into actual disbursements or commitments.

III. POLICY DISCUSSIONS

4. Discussions focused on (i) risks to the outlook from the global slowdown and the dramatic drop in oil prices; (ii) appropriate fiscal and monetary policies to keep inflation on a downward path and address the recent and prospective deterioration in public finances; and (iii) macroeconomic and structural reforms to ensure fiscal and external sustainability.

A. Outlook and Risks

5. **Yemen remains relatively insulated from the financial side of the current world economic crisis** (Box 2). Yemeni banks have relatively low exposure to private foreign lending, which centers around trade flows. Portfolio investment is quite limited, given the absence of a domestic stock market or commercial credit market. Yemen's main foreign asset—the CBY's reserves—are highly liquid and kept predominantly in the form of deposits in international banks. While Yemen could suffer from a decline in external financing (either through lower remittances, FDI, or official financing flows), these risks have yet to materialize, and would move more slowly than financial contagion.

6. **Yemen remains vulnerable to commodity shocks and the effects of slower regional and world economic activity.** Although government revenue and the balance of payments benefited from the high price of oil during the first half of 2008, the economy suffered from higher imported food and input prices. With the global slowdown and sharp decline in crude oil and other commodity prices, these risks have essentially reversed. Pressures expected to materialize over the medium term with declining oil production have become near-term considerations. Without substantial expenditure and revenue reforms, the fiscal deficit will become increasingly difficult to finance, and balance of payments pressures will mount (notwithstanding the CBY's substantial reserve cushion). Slower regional growth is also projected to bring lower levels of non-oil foreign investment than might have been expected (contributing to lower growth), as well as lower inward remittances from expatriate Yemeni workers in the Gulf and elsewhere.

B. Policies for 2008–09: Reducing Inflation, Containing the Deficit

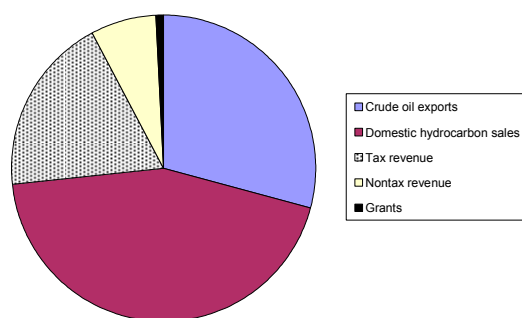
7. **The authorities recognized the need to further reduce inflation and address emerging imbalances.** Recent data suggest that the worst of the turbulence in international food prices has passed. Price pressures in Yemen should continue to ease with lower world commodity prices (and falling transport costs). Nevertheless, the authorities agreed additional efforts would be necessary to bring twelve-month inflation to 15 percent or less by end-year. The authorities also concurred that the risks to public finances and external sustainability had increased considerably since the end of the oil-price boom and that fiscal and monetary policy would need to be carefully coordinated to meet this challenge.

Box 2. Impact of the Global Financial Crisis on Yemen

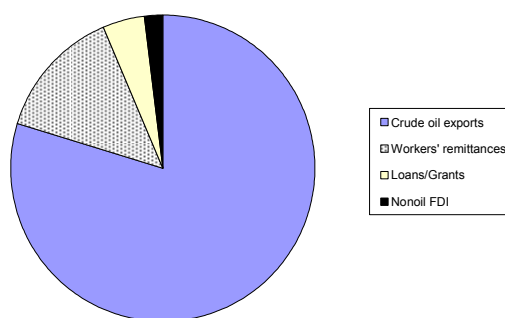
The risk of financial contagion from the global economic turbulence appears low. Yemen is not closely integrated with international financial and capital markets. The small size of the domestic banking system and low level of financial intermediation would also contain the direct impact, even if access to bank credit is restricted. Liquidity risk to the foreign exchange reserves of CBY also appears low, as these assets are mainly in the form of deposits at large commercial banks in Europe. The CBY increased foreign exchange auctions in September to maintain a stable exchange rate and calm market jitters about the availability of foreign exchange, but no additional action has yet been necessary.

Yemen does remain vulnerable to a real shock through lower oil prices. Oil exports account for a large share of government revenue and the bulk of foreign exchange receipts. The fiscal impact could be softened by a corresponding decline in fuel subsidies (even with unchanged domestic fuel prices). A further drop in international oil prices would increase pressure on Yemen's fiscal and external accounts. For each \$10/bbl decline, the overall fiscal balance and current account would deteriorate by almost 1 percentage point of GDP. Pressure on the external accounts may be partly alleviated if international commodity prices continue to decline.

Yemen: Sources of Government Revenue, 2008 (Proj.)



Yemen: Main Sources of Foreign Exchange, 2008 (Proj.)



Softer growth and financial distress in partner countries may also negatively impact Yemen's access to external financial resources—namely remittances, foreign direct investment (FDI) and concessional donor financing. While the likelihood or potential magnitude of these secondary effects are difficult to gauge (especially given data limitations in Yemen), stress tests prepared by staff suggest that:

- A 50 percent **decline in non-oil FDI** would likely soften growth, and reduce import demand and the current account deficit (each by around 0.5 percent of GDP).
- A 50 percent **fall in remittances** could widen the current account deficit by over 0.5 percent of GDP, notwithstanding some import compression, and marginally lower real GDP growth.
- Fifty percent **lower donor disbursements** would marginally widen the overall fiscal deficit and, assuming capital spending is maintained to avoid a negative impact on growth, domestic debt would increase by 1.2 percent of GDP.

Absent alternative financing, each of these scenarios could result in a loss of foreign exchange reserves of up to ½ a month of imports. Under a **combined loss of non-oil FDI, remittances, and donor financing**, the fiscal and current account deficits would deteriorate by 1–1½ percent of GDP, public sector domestic debt would rise by around 2½–3 percent of GDP, and international reserves would drop by one month of imports.

Fiscal policy

8. **The authorities indicated that they would seek to compress spending during the remainder of 2008 to reduce upward pressure on prices.** They noted that some fuel subsidies were reduced in August, when pressures began to emerge.³ Spending under the supplementary budget was largely constrained to the additional cost of the fuel subsidy, but also covered the ad hoc increase in wages, pensions, and social welfare transfers granted in March. Additional compression of some spending commitments under the original budget may be possible.

9. **The authorities concurred that the risks to public finances will be more pronounced in 2009.** Based on an oil price of \$55 per barrel, the approved government budget implies an overall deficit of about 8.6 percent of GDP—the highest since the oil price shock of 1998. Staff and the authorities agreed that a deficit of this magnitude would be difficult to finance and that additional actions would be necessary to preserve the credibility of public finances. With a view to keeping the overall deficit below 6 percent of GDP (consistent with domestic financing of 4.5 percent of GDP⁴), the staff offered a fiscal scenario based on a set of adjustment measures and the most recent WEO oil price (\$54.25 per barrel). Most significant among the adjustment measures were (i) a reduction in fuel subsidies by mid-year; (ii) a nominal freeze on the public sector wage bill;⁵ and (iii) overdue actions to boost tax revenues. The staff also urged the authorities to follow up on earlier pledges of donor support, and to seek concessional external financing, where possible.

Monetary and exchange rate policy

10. **Given the priority of reducing inflation, the CBY indicated it would continue to focus on exchange rate stability in the short term.** In addition to alleviating imported inflation, stability vis-à-vis the U.S. dollar appears to have helped confidence in the rial and lowered dollarization. The mission noted that the monetary stance and focus on exchange rate stability had been broadly appropriate, but that there remained some risk of inflation becoming entrenched. The CBY indicated it would remain vigilant in mopping up excess

³ In August 2008, the authorities raised the price of diesel for sales to selected industries (mainly concrete and steel companies). However, this accounts for only a small portion of subsidized domestic consumption.

⁴ Most domestic financing is through Treasury bills, with the remainder in the form of unsecuritized loans. Domestic debt is relatively short-term and expensive (3, 6, and 12 months maturities, with an average interest rate of about 16 percent). The scope for domestic financing of the 2009 budget deficit thus appears limited.

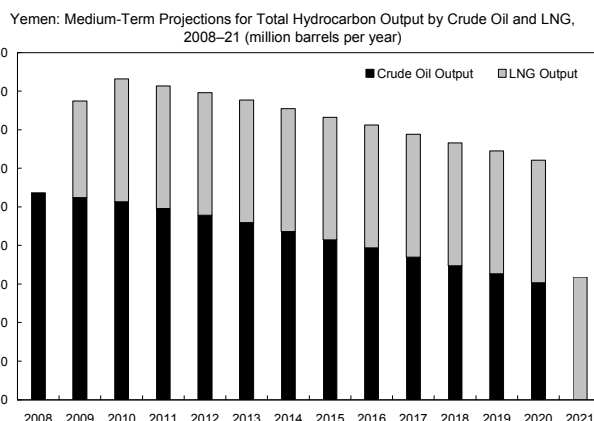
⁵ Public sector wages and salaries in the official budget are lower than that proposed by staff because the authorities used the 2007 budget as a base and did not take into account the one-off increase granted in March 2008 or the annual Ramadan bonus.

liquidity in the banking system. Given that it has already exhausted its yearly allowance of Treasury bills, the CBY would continue to issue CDs and conduct further foreign exchange auctions—even at the cost of international reserves. The CBY also indicated that other options, such as increasing the benchmark deposit rate, increasing reserve requirements, or using Islamic financial instruments,⁶ were also under discussion.

11. **While there is no evidence of current misalignment, the rial is probably moderately overvalued from a medium-term perspective.** The prospective decline in oil production over the next 10–12 years suggests that the real exchange rate will need to decline over the medium term in order to render the economy more competitive and thereby generate non-oil export growth for Yemen. The current policy of maintaining broad stability for the rial seems appropriate for the short term given the need to keep inflation down. If fiscal consolidation proceeds as envisioned and inflation continues to fall, greater flexibility in the rial should be considered as the economy and the fiscal accounts adjust to lower oil revenue. (Box 3).

C. Macroeconomic Policies for the Medium Term

12. **Yemen’s medium-term outlook remains dominated by the expected depletion of oil reserves.** The latest information suggests that total recoverable oil (proven reserves plus a portion of probable and possible reserves) is about 1.1 billion barrels. Assuming oil production declines gradually (an average annual drop of about 5 percent per year), oil reserves will be exhausted by 2021. Starting in 2009, LNG production will help alleviate the impact on government revenue and exports, but will not make up for the loss of crude oil.



13. **There was broad consensus among government agencies that current policies are not sustainable.** The staff presented a scenario of unchanged macroeconomic policies to highlight the risks of inaction. Under this scenario, external financing and non-oil growth would be lower. The fiscal deficit would expand quickly to 15 percent of GDP by 2012; reserve cover would decline as the external current account deficit widened—raising the risk of a sharp adjustment in the exchange rate. Assuming that domestic and external financing gaps could be filled (which is doubtful given the limited appetite for domestic debt, Yemen’s lack of access to international capital markets, and tighter conditions for official financing),

⁶ The CBY has formally requested technical assistance from the IMF on how to design and make operational financial instruments compliant with Shari’a law.

public debt would rise from 38 percent of GDP in 2008 to over 65 percent in the medium term.

14. **The authorities acknowledged the need for a comprehensive adjustment to fiscal policy to ensure medium-term stability.** They agreed that the centerpiece of this adjustment lies in addressing the two largest components of current expenditure—the fuel subsidy and the public sector wage bill, which together account for about 50 percent of total spending. Staff prepared an adjustment scenario (Tables 1–6) to illustrate the extent and magnitude of actions necessary to maintain macroeconomic stability and prevent debt distress. The exercise was guided by a debt sustainability analysis (DSA) geared around keeping the public debt-to-GDP ratio below 50 percent over the medium and long term.

15. **Even with a front-loaded adjustment to fuel subsidies in 2009, the non-oil primary deficit⁷ would need to adjust by an average of 2 percent of GDP per year in the medium term** and by about 0.5 percent of GDP per year thereafter. Key measures in this adjustment process would include (i) gradually eliminating fuel subsidies in 2009–11, accompanied by increased (and better targeted) social welfare transfers; (ii) reducing the civil service wage bill by about 2 percentage points of GDP by 2013; (iii) implementing fully the GST in 2009, and increasing the rate from 5 percent to 10 percent in 2011, and to 12 percent in 2014; and (iv) streamlining the income tax through simultaneously lowering the rate from 35 percent to 20 percent while eliminating all exemptions in the customs, income tax, and investment laws. These measures would also need to be underpinned by more rapid progress on PFM reform to ensure tighter commitment control and careful debt management.⁸

16. **Staff emphasized the risk of debt distress illustrated in the DSA.** Staff highlighted that, even with full implementation of the envisioned reform agenda, one debt indicator (PV of debt-to-exports) violates the sustainability threshold over the long term. Other debt indicators are breached under the sensitivity analysis. Given Yemen's vulnerability to external shocks, low institutional capacity, and the downside risks associated with implementing the reform agenda, Yemen remains at a high risk of debt distress.

⁷ The non-oil primary deficit declines by 13 percentage points of GDP in 2009 under the staff's adjustment scenario. Of this, 10 percentage points relate to the change in the fuel subsidy bill, of which about 8 percentage points stem from the change in the international oil price versus the administered domestic price.

⁸ The full and effective implementation of the Accounting and Financial Management Information System (AFMIS) is a key element in advancing the PFM agenda. Other important elements include the full transition to budget accounting in line with GFSM 2001, and the introduction of a Treasury system.

Box 3. Assessment of the Exchange Rate Level

There is no evidence to suggest that the exchange rate is currently misaligned, but it seems likely that the real exchange rate will need to depreciate over the medium term.

Over the past ten years Yemen's real effective exchange rate (REER) has appreciated—consistent with movements in the price of oil—while the current account has generally been in surplus. In 2007, the REER appreciated (on average) by about 3 percent compared to 2006—mainly due to inflation, as the nominal value of the rial was steady vis-à-vis the U.S. dollar.

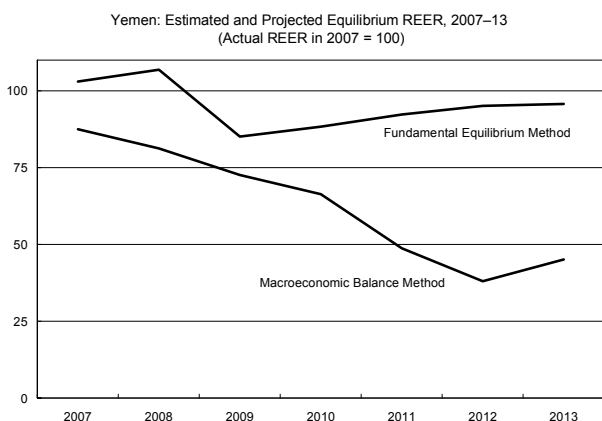
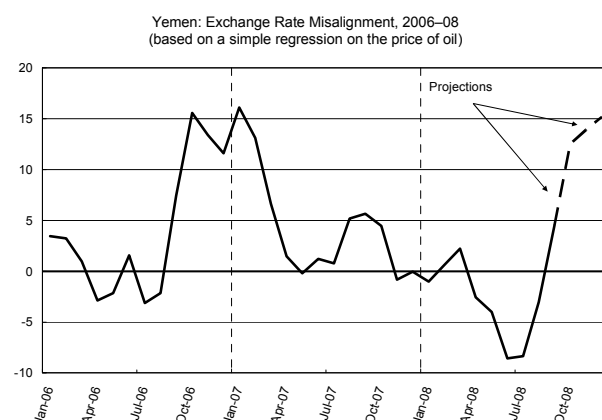
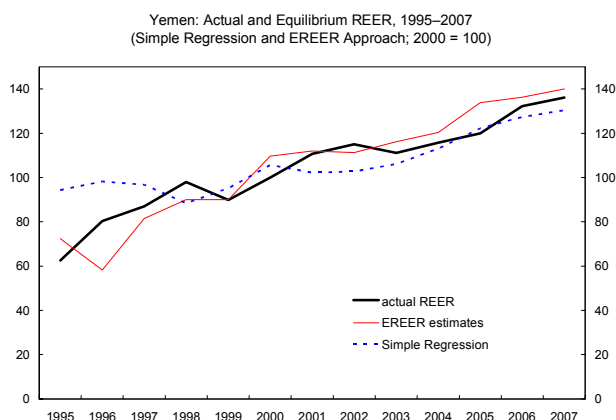
The current account balance net of imports related to hydrocarbon sector FDI registered a surplus of about 3 percent of GDP in 2007, allowing for a further buildup in central bank reserves. With the recent decline in oil prices, monthly foreign exchange auctions by the central bank have increased in size, suggesting that downward pressure on the rial will resume.

A simple regression of monthly real effective exchange rate data on the price of oil shows some undervaluation in early 2008, which began to reverse in September with the fall in oil prices.

Estimates obtained using the CGER methodology¹ are mixed (and thus merely indicative) owing to data weaknesses and other shortcomings. The equilibrium real effective exchange rate (EREER) approach does not yield evidence of misalignment, and predicts a moderate depreciation of the EREER in the medium term. The macroeconomic balance (MB) approach shows some undervaluation in 2007, and predicts a more marked medium-term depreciation.

The drop in oil export receipts induced by the recent fall in oil prices and by the expected medium-term decline in oil production will add downward pressure on the equilibrium exchange rate, supporting the view that the rial will have to depreciate in real effective terms to maintain external sustainability. The magnitude of adjustment is uncertain, and will depend partly on the pace and scope of fiscal consolidation and inflation reduction.

¹ For an illustration of the CGER methodology see www.imf.org/external/pp/longres.aspx?id=3957).



Yemen: Nonadjustment Scenario, 2006–13

	2006	Prel. 2007	Projections					
			2008	2009	2010	2011	2012	2013
(In percent of GDP)								
Government finances								
Total revenue and grants	38.6	33.2	37.4	24.0	23.3	22.1	20.7	24.4
Hydrocarbon revenue	28.9	22.6	27.5	14.4	13.8	12.6	11.0	14.3
Non-hydrocarbon revenue	9.3	10.3	9.5	9.0	9.1	9.2	9.3	9.7
Tax revenue	7.1	7.3	7.0	7.0	7.1	7.3	7.4	7.8
Nontax	2.2	2.9	2.5	2.0	2.0	2.0	1.9	1.9
Grants	0.4	0.3	0.4	0.6	0.4	0.3	0.4	0.4
Total expenditure and net lending	37.4	40.3	43.0	33.8	34.6	35.1	35.7	38.6
Current expenditure	28.2	31.4	34.6	25.4	26.2	26.8	27.4	30.4
Of which:								
Wages and salaries	9.9	10.9	10.4	10.0	10.0	10.0	10.0	10.0
Interest obligations	2.3	2.3	2.2	2.5	3.1	3.9	4.8	6.0
Subsidies and transfers	11.1	12.4	18.0	8.8	8.9	8.7	8.3	10.1
Of which:								
Petroleum	8.1	9.3	14.5	5.5	5.6	5.4	4.9	6.7
Social welfare fund	0.7	0.7	1.1	0.7	0.7	0.7	0.7	0.7
Capital expenditure	7.3	7.2	7.1	7.2	7.2	7.2	7.2	7.2
Net lending	1.8	1.8	1.3	1.2	1.2	1.1	1.1	1.0
Overall balance (cash basis) 1/	-0.7	-5.8	-5.6	-9.8	-11.3	-13.0	-15.0	-14.2
Non-hydrocarbon primary fiscal balance (cash) 2/	-42.0	-37.8	-45.2	-28.3	-29.0	-27.8	-26.2	-30.0
Gross Public Sector Debt	40.8	40.4	38.1	44.9	47.5	52.9	59.8	67.3
(Change in percent)								
Production and prices								
Overall real GDP at market prices	3.2	3.3	3.9	7.2	4.1	3.0	2.7	2.3
Real non-hydrocarbon GDP	4.7	5.3	4.8	3.9	3.8	3.7	3.3	2.8
Real hydrocarbon GDP	-8.3	-13.1	-5.4	44.5	7.4	-2.2	-2.1	-2.4
Core consumer price index (annual average) 3/	20.3	15.8	16.3	16.3	17.6	17.9	18.3	23.3
Core consumer price index (12-month) 3/	22.0	9.3	15.0	17.5	17.8	18.1	18.5	28.0
(In percent of GDP)								
External sector								
Current account	1.1	-7.0	-2.0	-2.6	-1.7	-2.4	-3.2	-4.8
External debt	28.7	26.9	22.3	21.7	19.3	17.9	16.7	26.6
Central Bank own gross foreign reserves (months of imports)	10.0	10.2	13.3	9.9	8.5	6.7	4.5	3.0

Sources: Yemeni authorities; and Fund staff estimates and projections.

1/ Includes statistical discrepancy.

2/ In percent of non-hydrocarbon GDP, includes statistical discrepancy.

3/ The core CPI is defined as the CPI excluding qat.

17. On the DSA, the authorities highlighted that, for now, the debt-to-GDP ratio remains relatively low, and that a public debt law with ceilings for domestic, external, and overall public debt is currently under discussion. Staff noted these points, but emphasized the recent deterioration in key macroeconomic aggregates, the forward-looking nature of the macroeconomic framework and the DSA, as well as the recent increase in risks. The staff urged the authorities to consider an average increase in domestic fuel prices of 65 percent by mid-2009 to help keep the budget deficit below 6 percent of GDP.

18. **The authorities were particularly conscious of the need to boost non-oil revenues, but implementation of key reforms remains in flux.** The long-delayed GST was implemented in 2007, but as a concession to the powerful business community, was applied

to a relatively narrow segment of taxpayers.⁹ Full implementation is planned for early 2009. The ongoing income tax simplification is moving ahead but has not been aligned with the 2009 budget. The required package of income tax rate reductions and elimination of exemptions is at some risk, as revisions to the income tax, customs, and investment laws were submitted separately to parliament. Staff emphasized that action on non-oil revenues was critical to addressing the looming budget shortfall in 2009 and beyond.

19. Monetary and exchange rate policy will have to adjust to shifting fundamentals.

The external current account pressures expected in 2009 are unlikely to diminish. Steady progress in fiscal consolidation should provide some relief and help curb inflation. However, staff believe that Yemen's real effective exchange rate will have to depreciate over the medium term in line with its equilibrium. The prospective decline in oil output may bring downward pressure on the exchange rate—which could lead to a rapid and excessive depletion of the central bank's foreign exchange reserves and necessitate a depreciation of the nominal exchange rate. Minimizing the inflationary impact of a depreciation of the rial, however, will require steady fiscal consolidation, structural reforms that enable markets to adjust quickly to changes in relative prices, sound debt management, and an effective monetary framework focused on price stability.

D. Promoting Sustained Non-Hydrocarbon Growth

20. New sources of growth will need to be developed to ameliorate the expected decline in hydrocarbon output. Investment in infrastructure will be vital, and the authorities have also focused on creating an environment conducive to private sector investment. Yemen has launched a new one-stop shop for investors in the past year, and has made it easier to obtain municipal licenses and to register with the chamber of commerce and tax office. Other reforms include a new procurement law, the establishment of an active anticorruption authority, and a review of labor and company laws. Yemen's ranking on the World Bank's *Doing Business* report jumped from 113 in 2008 to 98 in 2009.

21. The authorities concurred that a sound and vibrant financial system will be essential to non-oil economic growth. They noted a range of financial sector reforms initiated or implemented over the past year, including (i) passage of a deposit insurance law and establishment of a deposit insurance corporation; (ii) amendments to the 1994 Islamic Banking Law (submitted to parliament) to eliminate limits on foreign ownership and allow commercial banks to open an Islamic branch; and (iii) a microfinance law, expected to be passed by parliament in 2009. Further work needs to be done to establish a credit registry,

⁹ The GST was implemented in February 2007 at a rate of 5 percent (compared to the recommended 10 percent) and with only partial coverage (in practice, it applies only to importers and manufacturers, and traders are subject to administrative assessment of their liabilities).

liberalize interest rates,¹⁰ establish an active interbank market, and address the weaknesses in contract enforcement that have encouraged banks to focus their lending on a relatively small number of well-known clients. Enforcing existing prudential standards also remains critical to further reducing NPLs. The authorities expressed some interest in an update to the 2000 FSAP but have yet to make a formal request.

22. **The authorities continue to pursue closer ties with the region and the world economy.** Working party discussions on Yemen's accession to the WTO have been in train since 2004. Bilateral negotiations on goods and services have been concluded with China and are ongoing with Australia, Canada, the EC, Japan, Korea, and the U.S. Yemen continues to pursue membership in the Gulf Cooperation Council (GCC)—primarily through the Yemeni-Gulf Technical Committee. In mid-2008, GCC members tasked the Secretary General to conduct an integrated study on the prospects for Yemen's accession into the bloc.

IV. OTHER ISSUES

23. **The quality and timeliness of Yemen's economic data remain a concern.** There have been a number of improvements to the provision of monetary data in the past year, although data on financial sector indicators are typically available only during missions. Balance of payments data are also weak and suffer from long lags, making timely assessments of the supply and demand for foreign exchange difficult. Provision of fiscal data is improving slowly, although the timeliness and consistency of the quarterly financial bulletins could be improved. Additional technical assistance on shifting to GFSM 2001 should facilitate this process. National accounts and inflation data are, for the time being, in a state of transition. A revised and rebased set of national accounts was formulated in cooperation with an external expert in 2008, and is now being reviewed and finalized. A similar overhaul of the CPI is underway, in consultation with a technical expert from METAC. Similar efforts should be accorded to developing a PPI, to enhance the accuracy of the national accounts.

24. **Yemen is working on establishing an anti-money laundering/combating the financing of terrorism (AML/CFT) framework.** An AML law was passed in 2003 but was broadly considered inadequate. A new unified draft law covering both AML and CFT issues is with parliament for approval.

¹⁰ The benchmark interest rate on deposits has been fixed at 13 percent for the last nine years. In the staff's view, the minimum interest rate on deposits has distorted market signals and outlived its usefulness. It was originally intended to mobilize deposits in the mid-1990s, when inflation was high and exchange rate depreciations frequent.

V. STAFF APPRAISAL

25. **Yemen faces serious short-term and medium-term risks to economic and financial stability.** These risks have been present for some time (and were expected to intensify with the depletion of oil reserves) but have been masked by high oil prices in recent years. The sharp drop in oil production in 2007 and the current fall in international oil prices have brought these risks back to center stage, highlighting the need for early adjustment.

26. **Fiscal policy needs urgently to adapt to a changing environment.** Even if oil prices recover from current lows, the expected depletion of oil reserves will require a steady reduction in the non-oil primary deficit to maintain economic and financial stability. The agenda of key expenditure and revenue reforms discussed in successive Article IV missions needs to be implemented without further delay. In this context, staff attach particular importance to the following:

- **An increase in domestic fuel prices** by an average of 65 percent as soon as feasible in 2009, followed by further increases to align domestic and international prices by 2012. The impact on the poor should be cushioned by parallel increases in, and better targeting of, social welfare spending.
- **Holding the wage bill constant in nominal terms in 2009**—preferably through attrition, restructuring, and elimination of ghost workers rather than a wage freeze. The wage bill should be reduced further over the medium-term, ideally to a level equivalent to about 8 percent of GDP by 2013.
- **Implementing fully the GST** in January 2009, followed by successive increases in the GST rate in later years.
- **Implementing the tax simplification project** by eliminating tax exemptions in the customs, income tax, and investment laws in exchange for a reduction in the tax rate from 35 percent to 20 percent, effective January 2009.

27. **Monetary policy was broadly appropriate in 2008, but will also need to respond to increased risks.** Fiscal consolidation will be a critical step in alleviating pressure on the external accounts. However, given the expected decline in oil production (only partially offset by the advent of LNG), the external current account is likely to remain in deficit in 2009 and beyond. In this environment, maintaining the rial steady vis-à-vis the U.S. dollar could come at the expense of central bank international reserves. While the CBY should continue to intervene to reduce short-term volatility in the value of the rial, greater exchange rate flexibility may become necessary to avoid a dramatic decline in international reserves. The central bank should closely monitor monthly cash flows in this respect and, in the context of lower inflation, be prepared to allow the rial to move in line with fundamental shifts in the equilibrium exchange rate. While there is no evidence to suggest that the

exchange rate is currently misaligned, it appears likely that the real exchange rate will need to depreciate over the medium term.

28. **The adjustment path outlined by staff is ambitious, but reflects the reality of recent changes to the outlook and charts a course that should help to ensure macroeconomic stability.** The sharp and sustained reduction in oil prices, the likely downturn in regional growth, and the downside risks to investment and external financing all highlight the need for action on a long overdue agenda of reforms. Nonetheless, the staff recognize that the outlook is subject to considerable risks. The need to provide humanitarian relief (to address recent flooding in the south) and a desire to ensure social and political stability may constrain budgetary reform. Insufficient progress on fiscal consolidation could threaten the authorities' inflation objectives, or potentially crowd out private sector credit, with attendant risks to non-hydrocarbon growth. A corresponding increase in public debt and loss of reserves could quickly erode fiscal and external sustainability. Moreover, the potential for a sharper-than-expected decline in oil prices (or loss of other foreign financing) in a rapidly changing global environment would compound these pressures, necessitating further adjustment.

29. **As fiscal consolidation proceeds, the central bank should focus more closely on price stability and establishing a more effective monetary framework.** The staff notes efforts to strengthen liquidity forecasting at the CBY and coordination with the MOF. To enhance the role of monetary policy, the CBY should also consider such steps as (i) making a public commitment to price stability; (ii) liberalizing interest rates to remove the current distortion to the cost of capital in Yemen, facilitate an increase in private sector lending, and (in the context of fiscal consolidation and lower inflation) reduce the high interest cost of public debt; and (iii) developing a broader range of monetary policy instruments.

30. **Deepening financial intermediation remains critical for medium-term growth.** Recent initiatives by the CBY have concentrated on (i) raising banks' minimum capital requirements to ensure safety and soundness; (ii) introducing a deposit insurance scheme; and (iii) seeking to level the playing field between conventional and Islamic banks by adjusting reserve requirements and remuneration of reserves. More remains to be done. Liberalizing interest rates, establishing a credit registry, and encouraging a domestic interbank market would be critical next steps. Enforcement of existing prudential regulations and standards will also be key—particularly given that NPLs remain high (albeit declining). An update to the 2000 Financial Sector Assessment (FSAP) could be useful as a roadmap for further financial sector reform.

31. **Data provision remains adequate for surveillance, but Yemen is in a transitional phase in several areas.** Long overdue work on the national accounts and prices is now coming to fruition, but further TA is needed to ensure the provision of robust and credible data. The transition to GFSM 2001 for the fiscal accounts has advanced but remains a work in progress and could benefit from additional TA. Finally, improving the balance of

payments is now more essential than ever, given the need for a timely and accurate assessment of foreign exchange flows.

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

Table 1. Republic of Yemen: Selected Economic Indicators, 2005–13

	2005	2006	Prel. 2007	2008	2009	Projections 2010	2011	2012	2013
(Change in percent)									
Production and prices									
Real GDP at market prices	5.6	3.2	3.3	3.9	7.7	5.0	4.4	4.5	4.5
Real non-hydrocarbon GDP	6.5	4.7	5.3	4.8	4.4	4.8	5.2	5.3	5.3
Real hydrocarbon GDP	-0.8	-8.3	-13.1	-5.4	44.5	7.4	-2.2	-2.1	-2.4
Consumer price index (annual average)	11.8	18.2	12.5	16.6	14.0	12.3	11.6	7.4	5.6
Core consumer price index (annual average) 1/	14.5	20.3	15.8	16.3	15.0	13.6	12.7	11.6	9.5
Core consumer price index (12-month) 1/	20.2	22.0	9.3	15.0	15.0	12.3	13.1	10.0	9.0
Hydrocarbon production (1,000 barrels/day)	393	357	310	293	424	456	446	435	426
(In percent of GDP)									
Investment and savings									
Gross domestic investment	18.5	16.4	17.2	16.9	15.5	16.5	17.4	18.3	19.0
Government	7.9	7.3	7.2	7.1	6.0	6.0	6.4	6.8	7.0
Other	10.6	9.1	10.0	9.8	9.5	10.5	11.0	11.5	12.0
Gross national savings	22.3	17.4	10.2	14.9	13.0	15.3	15.9	16.3	17.5
Government	8.1	10.3	1.8	2.8	1.3	2.2	4.5	5.7	5.8
Other	14.2	7.1	8.5	12.1	11.7	13.2	11.4	10.6	11.8
Government finance									
Total revenue and grants	34.9	38.6	33.2	37.4	24.9	24.6	26.0	25.1	24.7
Total expenditure and net lending	36.8	37.4	40.3	43.0	30.6	29.5	28.7	27.1	26.9
Overall balance (cash basis) 2/	-0.6	-0.7	-5.8	-5.6	-5.7	-4.8	-2.8	-2.0	-2.2
Non-hydrocarbon primary fiscal balance (cash) 3/	-38.4	-42.0	-37.8	-45.2	-23.0	-21.8	-17.4	-14.6	-14.2
Gross Public Sector Debt	43.8	40.8	40.4	38.1	41.1	38.7	36.1	33.6	32.6
External debt	30.9	28.7	26.9	22.3	21.8	19.4	18.0	17.1	17.2
Domestic debt	12.9	12.1	13.5	15.9	19.3	19.3	18.1	16.5	15.4
(Twelve-month change in percent)									
Monetary data									
Broad money	14.4	28.8	17.4	23.9	14.0	...	...	...	...
Reserve money	17.8	17.1	11.3	15.6	11.4	...	...	...	...
Credit to private sector	21.3	16.7	35.7	23.0	25.9	...	...	...	...
Benchmark deposit interest rate (percent p.a.)	13.0	13.0	13.0	13.0	...	...	...	...	...
Velocity (non-oil GDP/M2)	2.1	2.0	2.0	2.0	2.1	...	...	...	...
(In millions of U.S. dollars, unless otherwise indicated)									
External sector									
Exports, f.o.b.	6,413	7,316	7,050	8,628	6,312	7,441	7,752	7,802	7,832
Of which: hydrocarbon (oil and gas)	5,952	6,733	6,264	7,771	5,395	6,461	6,693	6,637	6,527
Of which: non-hydrocarbon	461	583	786	856	916	981	1,059	1,165	1,305
Imports, f.o.b.	-4,713	-5,926	-7,490	-7,473	-5,716	-6,271	-6,822	-7,340	-7,696
Current account (in percent of GDP)	3.8	1.1	-7.0	-2.0	-2.4	-1.2	-1.5	-1.9	-1.5
Memorandum items:									
Crude export oil price (U.S. dollar/barrel) 4/	51.2	62.8	72.3	96.0	52.8	63.3	69.8	73.5	76.0
Central Bank own gross foreign reserves 5/	5,338	6,798	6,969	7,016	6,697	6,427	5,971	5,385	4,946
In months of imports 5/	11.6	10.0	10.2	13.3	10.3	9.4	8.5	7.5	6.5
Real effective exchange rate (2000 = 100)	120.4	133.0	137.7	...	...	...	...	...	...
Nominal GDP at market prices									
In billions of Yemeni rials	3,209	3,760	4,309	5,308	5,693	6,905	8,004	9,137	10,356
In millions of U.S. dollars	16,732	19,064	21,653	26,585	28,463	34,527	40,018	45,684	49,317
Per capita GDP (in U.S. dollars)	798	882	971	1,157	1,202	1,415	1,592	1,765	1,850
Population (in thousands)	20,975	21,622	22,290	22,978	23,687	24,398	25,130	25,884	26,660

Sources: Yemeni authorities; and Fund staff estimates and projections.

1/ The core CPI is defined as the CPI excluding qat.

2/ Includes statistical discrepancy.

3/ In percent of non-hydrocarbon GDP; includes statistical discrepancy.

4/ The price of Yemeni oil differs from the WEO price because it sometimes trades at a discount.

5/ Gross reserves minus commercial bank and pension fund foreign exchange deposits held with the Central Bank of Yemen.

Table 2. Republic of Yemen: General Government Finances, 2005–13
(In billions of Yemeni rials)

	2005	2006	2007	2008	2009		2010	2011	2012	2013
			Prel.	Proj.	Budget 1/	Proj.	Proj.	Proj.	Proj.	Proj.
Total revenue and grants	1,121	1,450	1,429	1,985	1,446	1,419	1,701	2,078	2,298	2,560
Hydrocarbon revenue	842	1,085	973	1,461	835	822	979	1,057	1,094	1,167
Of which:										
Crude oil exports	482	612	510	584	253	276	300	283	245	255
Non-hydrocarbon revenue	265	349	442	505	532	554	692	982	1,147	1,333
Tax revenue	235	266	315	371	396	421	531	795	934	1,091
Income taxes	89	123	144	178	...	200	246	293	344	397
Taxes on goods and services	89	101	118	136	...	163	219	430	512	605
Custom taxes	52	36	44	48	...	48	53	56	60	68
Other taxes	6	6	8	9	...	10	13	16	19	21
Nontax	31	83	126	134	136	133	161	187	213	242
Grants	14	15	15	19	79	43	30	38	57	60
Total expenditure and net lending	1,180	1,405	1,739	2,281	1,933	1,744	2,035	2,300	2,479	2,786
Current expenditure	862	1,062	1,352	1,835	1,435	1,345	1,550	1,716	1,774	1,961
Wages and salaries 2/	281	373	470	550	538	550	612	689	761	841
Goods and services	93	128	167	159	177	160	198	233	271	312
Operations and maintenance	15	19	35	27	31	28	38	46	56	66
Interest obligations	69	87	97	115	106	143	184	212	220	213
Domestic	60	76	87	101	90	128	168	193	199	188
External	9	11	10	15	16	15	17	19	21	24
Subsidies and transfers	385	418	534	957	554	435	483	494	420	476
Subsidies	286	309	408	773	369	213	193	134	0	0
Of which:										
Petroleum products (including LPG)	280	303	402	767	337	207	187	128	0	0
Electricity	6	6	6	6	6	6	6	6	0	0
Transfers	99	109	126	184	185	222	290	360	420	476
Of which: social welfare fund	22	26	31	57	...	89	129	174	207	235
Other	19	37	50	28	29	29	36	41	47	53
Capital expenditure	254	274	310	378	409	340	417	509	618	727
Of which: foreign financed	...	...	60	62	161	106	137	176	212	235
Net lending	63	69	76	69	90	59	69	75	86	98
Overall balance (commitment)	-58	45	-309	-296	-487	-325	-335	-222	-181	-226
Pending obligations	0	0	0	0	0	0	0	0	0	0
External interest paid	0	0	0	0	0	0	0	0	0	0
Overall balance (cash)	-58	45	-309	-296	-487	-325	-335	-222	-181	-226
Discrepancy	38	-71	60	0	0	0	0	0	0	0
Financing	20	26	250	296	487	325	335	222	181	226
External	13	53	47	35	52	68	100	107	122	138
Domestic	7	-26	203	261	436	257	235	115	59	88
Memorandum items:										
Overall balance (cash), excluding grants and foreign-financed capital expenditure 3/	...	...	-205	-254	...	-262	-228	-84	-27	-51
Primary balance (cash) 3/	49	61	-153	-181	...	-182	-150	-10	39	-13
Non-hydrocarbon primary balance (cash) 3/	-793	-1,025	-1,125	-1,642	...	-1,004	-1,129	-1,067	-1,055	-1,180
Non-hydrocarbon primary balance (cash), excluding grants and foreign-financed capital expenditure 3/	...	...	-1,065	-1,580	...	-898	-992	-891	-843	-946
Social spending 4/	239	278	...	...	...	478	600	720	831	942
Gross public debt 5/	1,405	1,535	1,741	2,024	...	2,341	2,670	2,888	3,068	3,372
Net public debt 5/	1,189	1,240	1,518	1,801	...	2,119	2,448	2,665	2,846	3,149

Sources: Ministry of Finance; Ministry of Planning; and Fund staff estimates.

1/ The 2009 budget estimates are based on the Yemeni authorities' oil price (US\$55/barrel) and volume assumptions.

2/ The 2009 budgeted wage bill is based on the original 2008 budget figure. Staff estimates also include a one-month Ramadan bonus and account for the wage increases announced in March 2008.

3/ Based on overall (cash) balance and statistical discrepancy, with relevant exclusions.

4/ Consists of education, health, social assistance, and social welfare fund transfers; covers central and local government units.

5/ Refers to central and local governments.

Table 3. Republic of Yemen: General Government Finances, 2005–13
(In percent of GDP)

	2005	2006	2007 Prel.	2008 Proj.	2009		2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.
					Budget 1/	Proj.				
Total revenue and grants	34.9	38.6	33.2	37.4	25.4	24.9	24.6	26.0	25.1	24.7
Hydrocarbon revenue	26.2	28.9	22.6	27.5	14.7	14.4	14.2	13.2	12.0	11.3
Of which:										
Crude oil exports	15.0	16.3	11.8	11.0	4.4	4.9	4.3	3.5	2.7	2.5
LNG exports	0.0	0.0	0.0	0.0	0.8	1.0	1.0	0.8	0.7	0.7
Non-hydrocarbon revenue	8.3	9.3	10.3	9.5	9.3	9.7	10.0	12.3	12.6	12.9
Tax revenue	7.3	7.1	7.3	7.0	7.0	7.4	7.7	9.9	10.2	10.5
Income taxes	2.8	3.3	3.4	3.4	...	3.5	3.6	3.7	3.8	3.8
Taxes on goods and services	2.8	2.7	2.7	2.6	...	2.9	3.2	5.4	5.6	5.8
Custom taxes	1.6	1.0	1.0	0.9	...	0.8	0.8	0.7	0.7	0.7
Other taxes	0.2	0.2	0.2	0.2	...	0.2	0.2	0.2	0.2	0.2
Nontax	1.0	2.2	2.9	2.5	2.4	2.3	2.3	2.3	2.3	2.3
Grants	0.4	0.4	0.3	0.4	1.4	0.8	0.4	0.5	0.6	0.6
Total expenditure and net lending	36.8	37.4	40.3	43.0	34.0	30.6	29.5	28.7	27.1	26.9
Current expenditure	26.9	28.2	31.4	34.6	25.2	23.6	22.4	21.4	19.4	18.9
Wages and salaries 2/	8.7	9.9	10.9	10.4	9.4	9.7	8.9	8.6	8.3	8.1
Goods and services	2.9	3.4	3.9	3.0	3.1	2.8	2.9	2.9	3.0	3.0
Operations and maintenance	0.5	0.5	0.8	0.5	0.5	0.5	0.5	0.6	0.6	0.6
Interest obligations	2.2	2.3	2.3	2.2	1.9	2.5	2.7	2.6	2.4	2.1
Domestic	1.9	2.0	2.0	1.9	1.6	2.3	2.4	2.4	2.2	1.8
External	0.3	0.3	0.2	0.3	0.3	0.3	0.2	0.2	0.2	0.2
Subsidies and transfers	12.0	11.1	12.4	18.0	9.7	7.6	7.0	6.2	4.6	4.6
Subsidies	8.9	8.2	9.5	14.6	6.5	3.7	2.8	1.7	0.0	0.0
Of which:										
Petroleum products (including LPG)	8.7	8.1	9.3	14.5	5.9	3.6	2.7	1.6	0.0	0.0
Electricity	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0
Transfers	3.1	2.9	2.9	3.5	3.3	3.9	4.2	4.5	4.6	4.6
Of which: social welfare fund	0.7	0.7	0.7	1.1	...	1.6	1.9	2.2	2.3	2.3
Other	0.6	1.0	1.2	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Capital expenditure	7.9	7.3	7.2	7.1	7.2	6.0	6.0	6.4	6.8	7.0
Of which: foreign financed	...	...	1.4	1.2	2.8	1.9	2.0	2.2	2.3	2.3
Net lending	2.0	1.8	1.8	1.3	1.6	1.0	1.0	0.9	0.9	0.9
Overall balance (commitment)	-1.8	1.2	-7.2	-5.6	-8.6	-5.7	-4.8	-2.8	-2.0	-2.2
Discrepancy	1.2	-1.9	1.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing	0.6	0.7	5.8	5.6	8.6	5.7	4.8	2.8	2.0	2.2
External	0.4	1.4	1.1	0.7	0.9	1.2	1.4	1.3	1.3	1.3
Domestic	0.2	-0.7	4.7	4.9	7.7	4.5	3.4	1.4	0.6	0.9
Memorandum items:										
Overall balance (cash), excluding grants and foreign-financed capital expenditure 3/	...	...	-4.7	-4.8	...	-4.6	-3.3	-1.1	-0.3	-0.5
Primary balance (cash) 3/	1.5	1.6	-3.5	-3.4	...	-3.2	-2.2	-0.1	0.4	-0.1
Non-hydrocarbon primary balance (cash) 3/	-24.7	-27.2	-26.1	-30.9	...	-17.6	-16.4	-13.3	-11.5	-11.4
Non-hydrocarbon primary balance (cash), excluding grants and foreign-financed capital expenditure 3/	...	...	-24.7	-29.8	...	-15.8	-14.4	-11.1	-9.2	-9.1
Defense spending	4.9	5.6	...	...	...	5.6	5.6	5.6	5.6	5.6
Social spending 4/	7.4	7.4	...	...	...	8.4	8.7	9.0	9.1	9.1
Gross public debt 5/	43.8	40.8	40.4	38.1	...	41.1	38.7	36.1	33.6	32.6
Net public debt 5/	37.1	33.0	35.2	33.9	...	37.2	35.4	33.3	31.1	30.4

Sources: Ministry of Finance; Ministry of Planning; and Fund staff estimates.

1/ The 2009 budget estimates are based on the Yemeni authorities' oil price (US\$55/barrel) and volume assumptions.

2/ The 2009 budgeted wage bill is based on the original 2008 budget figure. Staff estimates also include a one-month Ramadan bonus and account for the wage increases announced in March 2008.

3/ Based on overall (cash) balance and statistical discrepancy, with relevant exclusions.

4/ Consists of education, health, social assistance, and social welfare fund transfers; covers central and local government units.

5/ Refers to central and local governments.

Table 4. Republic of Yemen: Monetary Survey, 2005–09
(In millions of Yemeni rials)

	2005 Dec.	2006 Dec.	2007 Dec.	2008 Dec. Proj.	2009 Dec. Proj.
Net foreign assets	1,271,390	1,675,068	1,733,844	1,776,212	1,737,275
Central Bank of Yemen	1,112,629	1,419,174	1,483,230	1,525,234	1,486,045
Commercial banks	158,761	255,894	250,614	250,979	251,230
Net domestic assets	-221,881	-323,638	-147,623	189,682	502,882
Net domestic credit	132,511	117,508	376,518	728,208	1,042,688
Net claims on central government	-34,944	-88,825	66,936	241,748	454,882
Central Bank of Yemen	-215,066	-291,442	-222,191	-99,582	-13,449
Commercial banks	180,123	202,617	289,128	341,331	468,331
Net claims on nongovernment enterprises	167,455	206,333	309,582	486,460	587,806
Claims on private sector by commercial banks	222,648	259,940	352,622	433,726	546,017
Claims on public enterprises 1/	43	3,063	15,220	100,000	80,000
Claims on mixed enterprises	3,135	6,179	6,855	7,850	8,905
Pension fund deposits in CBY	-57,772	-62,349	-65,116	-55,116	-47,116
CBY certificates of deposit held in nonbanks.	-600	-500	0	0	0
Other Items (net)	-354,392	-441,146	-524,141	-538,526	-539,806
Valuation adjustment	-152,579	-203,746	-234,442	-234,442	-234,442
Capital and reserves	-60,640	-83,590	-112,896	-139,061	-149,142
Other (net)	-141,173	-153,811	-176,803	-165,023	-156,222
Broad Money	1,049,509	1,351,430	1,586,221	1,965,894	2,240,156
Money	442,464	558,461	613,748	707,722	806,456
Currency outside banks	330,620	412,520	425,840	481,251	532,261
Demand deposits	111,844	145,941	187,908	226,471	274,195
Quasi-money	251,531	338,761	456,190	648,745	761,653
Foreign currency deposits	355,514	454,209	516,284	609,427	672,047
Memorandum items:					
Broad money (annual percentage change)	14.4	28.8	17.4	23.9	14.0
Reserve money (annual percentage change)	17.8	17.1	11.3	15.6	11.4
Credit to private sector (annual percentage change)	21.3	16.7	35.7	23.0	25.9
Currency to broad money (in percent)	31.5	30.5	26.8	24.5	23.8
Foreign currency deposits to total deposits	49.5	48.4	44.5	41.0	39.3
Non-oil GDP velocity (average)	2.1	2.0	2.0	2.0	2.1
Central Bank own gross foreign assets (US\$ millions) 2/	5,338	6,798	6,969	7,016	6,697

Sources: Central Bank of Yemen and Fund staff estimates.

1/ The increase in credit to public enterprises reflects primarily a new revolving credit line to finance the importation of refined fuel products.

2/ Gross reserves minus commercial bank and pension fund foreign exchange deposits held with the Central Bank.

Table 5. Republic of Yemen: Balance of Payments, 2005–13
(In millions of U.S. dollars)

	2005	2006	Prel. 2007	Proj.					
	2005	2006	2007	2008	2009	2010	2011	2012	2013
Current account	633	206	-1,507	-531	-690	-414	-582	-882	-732
Non-hydrocarbon current account 1/	-3,128	-3,721	-4,499	-5,257	-4,282	-4,982	-5,331	-5,610	-5,491
Goods and services	840	84	-1,583	125	-496	21	-238	-761	-1,123
Trade balance	1,700	1,390	-440	1,155	596	1,171	930	462	136
Exports, f.o.b.	6,413	7,316	7,050	8,628	6,312	7,441	7,752	7,802	7,832
Hydrocarbon exports	5,952	6,733	6,264	7,771	5,395	6,461	6,693	6,637	6,527
Non-hydrocarbon exports	461	583	786	856	916	981	1,059	1,165	1,305
Imports, f.o.b.	4,713	5,926	7,490	7,473	5,716	6,271	6,822	7,340	7,696
Hydrocarbon sector imports	1,750	3,375	3,914	3,621	2,302	2,524	2,842	3,111	3,115
Other imports, f.o.b.	2,963	2,551	3,576	3,852	3,414	3,747	3,980	4,229	4,580
Services, net	-860	-1,306	-1,143	-1,030	-1,092	-1,149	-1,167	-1,223	-1,259
Income, of which:	-1,612	-1,234	-1,350	-2,138	-1,492	-1,654	-1,714	-1,729	-1,595
Hydrocarbon company profits	-1,525	-1,365	-1,352	-2,074	-1,402	-1,699	-1,758	-1,732	-1,606
Current transfers	1,406	1,356	1,426	1,482	1,298	1,218	1,369	1,609	1,986
Workers' remittances, net	1,246	1,242	1,281	1,376	1,071	1,061	1,167	1,307	1,386
Capital & financial account	-124	710	1,320	781	526	170	149	294	291
Direct investment, net, of which	-302	1,121	1,152	463	129	-329	-388	-316	-364
LNG sector	0	1,200	1,785	875	115	-189	-189	-193	-328
Medium- and long-term loans, net	111	236	238	176	338	499	537	609	655
New disbursements	271	349	355	316	487	669	727	813	877
Amortization	160	113	117	140	149	171	190	203	222
Commercial banks, net	22	-475	33	154	40	0	0	0	0
Others, net	45	-172	-102	-12	19	0	0	0	0
Errors and omissions	-181	536	482	0	0	0	0	0	0
Overall balance	328	1,452	296	251	-164	-245	-433	-588	-441
Financing									
Central Bank net foreign assets (- increase)	-508	-1,462	-304	-270	159	242	431	586	439
Exceptional Financing	180	10	8	19	6	2	2	2	2
Financing gap (+ deficit)	0	0	0	0	0	0	0	0	0
Memorandum items:									
Current account including grants (percent of GDP)	3.8	1.1	-7.0	-2.0	-2.4	-1.2	-1.5	-1.9	-1.5
Non-hydrocarbon current account (percent of GDP)	-18.7	-19.5	-20.8	-19.8	-15.0	-14.4	-13.3	-12.3	-11.1
Central bank own gross foreign reserves 2/	5,338	6,798	6,969	7,016	6,697	6,427	5,971	5,385	4,946
(months of imports) 3/	11.6	10.0	10.2	13.3	10.3	9.4	8.5	7.5	6.5
Total External Debt (percent of GDP) 4/	30.9	28.7	26.9	22.3	21.8	19.4	18.0	17.1	17.2
Export oil price (US\$/barrel)	51.5	63.0	72.3	96.0	52.8	63.3	69.8	73.5	76.0
Non-hydrocarbon export (growth)	23.8	26.4	34.8	9.0	7.0	7.0	8.0	10.0	12.0
Imports (growth)	22.1	25.7	26.4	-0.2	-23.5	9.7	8.8	7.6	4.8

Sources: Central Bank of Yemen; and Fund staff estimates and projections.

1/ Hydrocarbon sector includes oil and LNG exports less corresponding imports, expenses and repatriation.

2/ Includes central bank SDR holdings, foreign exchange held abroad, foreign securities, gold, silver and foreign currencies; excludes commercial bank required foreign exchange reserves with the central bank against their foreign currency deposits and pension fund reserves.

3/ Imports are c.i.f. for next year and exclude oil sector imports.

4/ Public external debt, including central bank foreign liabilities. There is limited information on private external debt, which is deemed to be modest.

Table 6. Republic of Yemen: Millennium Development Goals, 1990–06

	1990	1995	2000	2001	2002	2003	2004	2005	2006
1. Eradicate extreme poverty and hunger									
Population below U.S.\$1 a day (percent)	...	...	...	...	...	15.7	...	...	...
Poverty gap ratio at \$1 a day (percent)	...	...	...	...	...	...	...	...	...
Percentage share of income or consumption held by poorest 20 percent	...	...	...	...	...	...	...	...	...
Prevalence of child malnutrition (percent of children under 5)	...	...	...	...	...	45.6	...	...	...
Population below minimum level of dietary energy consumption (percent)	...	...	33.0	...	...	36.0	...	...	...
2. Achieve universal primary education									
Net primary enrollment ratio (percent of relevant age group)	51.7	...	59.7	67.7	65.0	73.1	75.3	...	...
Percentage of cohort reaching grade 5 (percent)	...	...	74.5	74.5	75.9	73.2	...	...	...
Youth literacy rate (percent ages 15–24)	50.0	...	...	...	67.9	...	...	...	...
3. Promote gender equality									
Ratio of girls to boys in primary education (percent)	35.0	...	54.0	54.0	...	59.0	61.4	...	66.0
Ratio of girls to boys in secondary education (percent)	...	...	42.0	...	...	60.0	...	...	66.0
Women to men parity index, as ratio of literacy rates (percent ages 15–24)	34.0	...	...	...	60.0	...	...	...	...
Share of women employed in the nonagricultural sector (percent)	8.9	7.6	6.3	...	5.8	6.1	...	...	...
Proportion of seats held by women in national parliament (percent)	4.0	1.0	1.0	...	1.0	0.3	...	0.3	0.0
4. Reduce child mortality									
Under 5 mortality rate (per 1,000)	142	126	117	...	114	113	113	...	100
Infant mortality rate 0–1 year (per 1,000 live births)	98	89	84	...	83	...	...	76	75
Immunization, measles (percent of children under 1 year old)	69	46	71	79	65	66	76	76	80
5. Improve maternal health									
Maternal mortality ratio (per 100,000 live births)	1,400	1,471	570	...	...	...	...	...	...
Births attended by skilled health staff	...	...	...	...	...	26.8	...	...	...
6. Combat HIV/AIDS, malaria and other diseases									
Prevalence of HIV (percent ages 15–49)	...	...	...	...	...	0.1	0.1	...	...
Contraceptive prevalence rate (percent of women ages 15–49)	...	...	...	...	...	23.0	23.0	...	...
Number of children orphaned by HIV/AIDS	...	...	...	...	...	...	...	...	...
Tuberculosis prevalence rate (per 100,000 people)	...	...	102.0	99.0	95.0	91.0	86.0	82.0	...
Tuberculosis cases detected under DOTS (percent)	...	...	56.0	...	49.0	43.3	43.3	...	43.0
7. Ensure environmental sustainability									
Forest area (percent of total land area)	1.0	...	0.9	...	...	...	...	1.0	...
Nationally protected areas (percent of total land area)	...	...	...	...	...	...	...	...	...
GDP per unit of energy use (PPP U.S.\$ per kg oil equivalent)	...	...	2.9	2.7	2.9	3.0	2.8	...	...
CO2 emissions (metric tons per capita)	...	0.7	0.5	...	0.7	...	...	...	...
Access to an improved water source (percent of population)	69.0	...	...	...	69.0	69.0	67.0	...	66.0
Access to improved sanitation (percent of population)	21.0	...	...	...	30.0	30.0	43.0	...	88.0
Access to secure tenure (percent of population)	...	...	...	...	...	...	...	...	...
8. Develop a global partnership for development									
Youth unemployment rate (percent of total labor force ages 15–24)	...	...	...	...	...	...	...	...	...
Fixed line and mobile telephones (per 100 people)	1.1	1.3	2.1	2.0	7.6	10.2	14.8	...	...
Personal computers (per 100 people)	...	...	0.2	...	0.7	0.7	0.8	...	...
General indicators									
Adult literacy rate (percent of people ages 15 and over)	...	40.0	46.0	...	...	49.0	...	...	...
Total fertility rate (births per woman)	...	6.7	6.5	...	6.2	6.0	...	5.9	5.6
Life expectancy at birth (years)	...	53.0	59.3	...	60.3	...	...	61.7	62.0
Aid per capita (current US\$)	...	...	14.6	24.7	30.5	11.9	12.5	16.0	13.0

Sources: World Bank; and Yemeni authorities.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Appendix I. Draft Public Information Notice (PIN)

Public Information Notice (PIN) No. 09/xx
FOR IMMEDIATE RELEASE
February [xx], 2009

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

**IMF Executive Board Concludes 2008 Article IV Consultation
with the Republic of Yemen**

On February [23], 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Yemen.¹

Background

Yemen remains one of the poorest countries in the region and is far from achieving the Millennium Development Goals. Oil production has been in decline since 2000. In the absence of major discoveries, reserves could be depleted in about ten to twelve years. The start of a new liquefied natural gas (LNG) project from 2009 will only partly compensate for the expected decline in crude oil. Yemen faces considerable challenges in dealing with the transition to a non-oil economy, generating strong non-hydrocarbon economic growth, ensuring fiscal and external sustainability, and reducing poverty and unemployment.

Recent economic performance in Yemen has been mixed. Overall real GDP grew by about 3.3 percent in 2007, reflecting real nonoil growth of 5.3 percent and a 13.1 percent decline in oil output. Overall growth is expected to pick up somewhat in 2008, with non-oil growth around 4.8 percent and a smaller decline in oil output. Inflation has

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

been a serious concern. After falling to about 9 percent at the end of 2007, core inflation (excluding the volatile prices of the narcotic qat) surged to 27 percent by May 2008, largely reflecting a similar increase in world commodity prices and local drought conditions.

A sizeable fiscal deficit emerged in 2007. A sharp decline in oil production, coupled with inflexible government expenditure and only marginal improvement in the tax-to-GDP ratio led to an overall fiscal deficit of 5.8 percent in 2007. For 2008 a deficit of around 5-6 percent of GDP is possible in the wake of the recent drop in international oil prices, continued rigid expenditures, and limited nonoil revenue improvements. As in previous years, a large supplementary budget was approved toward the end of the year to validate additional spending on fuel subsidies and an increase in wages, pensions, and social welfare transfers. Fuel subsidies continued to absorb a large part of the budget (about 14 percent of GDP), and together with the public sector wage bill account for about 50 percent of government expenditure.

Monetary policy in 2008 focused on exchange rate stability and controlling excess liquidity in the domestic banking system. The rial has remained steady against the US dollar since mid-2007, helping to mitigate imported inflation. In real effective terms, the rial appreciated by 8.5 percent in the twelve months to October. The Central Bank of Yemen (CBY) used its full allowance of Treasury bills to absorb domestic liquidity in the first nine months of the year, and has since relied on central bank certificates of deposit (CDs) and additional foreign exchange auctions. Broad money and reserve money growth through October were 15.5 percent and 10.9 percent, compared to 17 and 11 percent, respectively, at end-2007. The benchmark deposit rate remains fixed at 13 percent.

The external current account shifted to a deficit of 7 percent of GDP in 2007, compared with an average surplus of about 2.4 percent during 2002-06. This shift reflected mainly FDI-financed imports for a liquefied natural gas (LNG) plant. The external accounts benefited from record oil prices during the first part of the 2008, but pressures appear to be emerging in the wake of declining oil prices. The current account is projected to remain in deficit (about 2 percent of GDP) in 2008. Gross reserves of the CBY were about \$6.8 billion at end-2007, and are likely to be close to that level by end-2008.

Some progress has been made on structural reforms. The long-delayed General Sales Tax (GST) was implemented in 2007, but was only applied to a relatively narrow segment of taxpayers—full implementation is slated for 2009. A tax simplification process is currently in train which should eliminate exemptions in the customs, income tax, and investment laws as a precursor to lowering the income tax rate from 35 percent to 20 percent. Other important measures include the passage of a deposit insurance law, and the submission of a microfinance law to parliament. Efforts were also made to improve the investment climate through launching a one-stop shop (making it possible

to complete business start-up at a single location) enacting a new procurement law, establishing an anticorruption authority, and reviewing labor and company laws.

Executive Board Assessment

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Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Republic of Yemen: Selected Macroeconomic Indicators, 2004–08

Quota = SDR 243.5 million

Population = 22 million (2007)

Per capita income = US\$ 970 (2007)

	2004	2005	2006	Est. 2007	Proj. 2008
(Annual percentage change)					
National income and prices					
Real GDP	4.0	5.6	3.2	3.3	3.9
Real non-hydrocarbon GDP	5.4	6.5	4.7	5.3	4.8
Real hydrocarbon GDP	-5.0	-0.8	-8.3	-13.1	-5.4
Core consumer price index (end of period) 1/	14.5	20.2	22.0	9.3	15.0
(In millions of U.S. dollars, unless otherwise indicated)					
External sector					
Exports, f.o.b.	4,676	6,413	7,316	7,050	8,628
Of which: hydrocarbon (oil and gas)	4,303	5,952	6,733	6,264	7,771
Imports, f.o.b.	3,859	4,713	5,926	7,490	7,473
Current account, including official transfers (in percent of GDP)	1.6	3.8	1.1	-7.0	-2.0
Overall balance (deficit-)	648	328	1,452	296	251
(In percent of GDP)					
Fiscal variables					
Overall balance (cash basis) 2/	-2.0	-0.6	-0.7	-5.8	-5.6
Non-hydrocarbon primary balance (cash basis)	-22.4	-24.7	-27.2	-26.1	-30.9
Debt Ratios					
Total government (gross) debt	52.1	43.8	40.8	40.4	38.1
Total external debt	38.5	30.9	28.7	26.9	22.3
(Annual percentage change, unless otherwise indicated)					
Monetary sector					
Broad money	15.0	14.4	28.8	17.4	23.9
Credit to private sector	33.5	21.3	16.7	35.7	23.0
Benchmark deposit interest rate (percent per annum)	13.0	13.0	13.0	13.0	13.0
Central bank own gross foreign reserves 3/					
In millions of U.S. dollars	5,068	5,338	6,798	6,969	7,016
In months of next year imports of goods and services	15.0	11.6	10.0	10.2	13.3

Sources: Yemen authorities; and Fund staff estimates and projections.

1/ Core CPI is defined as the overall CPI less the CPI for qat.

2/ Includes statistical discrepancy.

3/ Gross reserves minus commercial bank and pension fund foreign exchange deposits held with the central bank.