Yemen's Economic Prospects and Challenges[1]

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Yemen's growth is correlated with hydrocarbon sector income. Yemen's GDP grew by an estimated 3.9% in 2009, up from 3.6% in 2008 (IMF estimates). It is forecasted to expand by 8% in 2010 (IMF estimate, although the Economist Intelligence Unit (EIU)'s estimate is much lower, at 5.2%). In 2011, GDP is expected to grow by 4.1% according to the IMF (the EIU's estimate for 2011 is 3%). Non-hydrocarbon GDP grew by 4.1% in 2009 (against 4.8% in 2008) and is expected to grow by 4.4% in 2010 and 4.8% in 2011. The oil sector suffered from lower oil prices (from $97.7/barrel to $61.9/barrel) and a slight reduction in output, but the start of Liquid Natural Gas (LNG) production in November helped real hydrocarbon GDP (oil and LNG) grow by 1.6% (against a 8.1% contraction in 2008). In 2010, the first full year of LNG production, real hydrocarbon GDP is anticipated to grow by 51%. Oil production is forecast to amount to 275,000 barrels/day in 2010 and 269,000 barrels/day in 2011, lower than the average 317,000 barrels/day produced in 2006–2008. The decline in oil production reflects the fact that Yemeni oil reserves are depleting rapidly (the IMF estimates that Yemen will become a net oil importer in the medium-term). Despite continuing oil production and high LNG output, real hydrocarbon GDP growth is expected to contract by 1.4% in 2011, owing to falling oil and gas prices.

The current account deficit is expected to narrow in 2010 before widening in 2011. From $8,977 million in 2008, nominal exports fell to $5,812 million in 2009. Exports are forecast to rise by 31% in nominal terms in 2010 (to $7,620 million) owing to LNG exports and higher oil prices, but are expected to fall to $7,257 million in 2011 due to lower oil prices and production. Imports remained high in 2009 (at $7,518 million) and are expected to rise in 2010 and 2011 (to $8,350 million and $8,640 million, respectively). The trade deficit is therefore expected to narrow markedly in 2010 (to $730 million against $1,706 million in 2009) before rising to $1,383 million in 2011. Although improvements are expected in the net income balance and the current transfers balance in 2010 and 2011, they will not be sufficient to offset the worsening trade deficit in 2011. The fluctuations in the current account and their causes underscore the importance of the hydrocarbon sector to Yemen's economy.

The IMF has recommended that Yemen implement economic reforms. Yemen's heavy dependence on hydrocarbons—in terms of GDP growth, export performance and fiscal revenue—threatens its medium- and long-term development. In addition to the risks inherent in any undiversified economy, oil reserves are projected to decline. In its latest recommendations to Yemen (September), the IMF has emphasized developing the non-hydrocarbon sector and strengthening the fiscal sector. On July 30, 2010, it approved a $369.8 million, three-year

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Extended Credit Facility Arrangement (ECFA) for Yemen to support a three-year economic reform program that will focus its first initiatives on consolidating the budget. To increase non-hydrocarbon fiscal revenue in preparation for a gradual decline in oil sector revenue, in July the government imposed the General Sales Tax (GST), a 5% tax applied to sales by importers, manufacturers, wholesalers, retailers, service providers, as well as other private sector entities. As an estimated 80% of private sector taxes are unpaid, measures to improve tax collection rates are planned, in addition to phased reductions of electricity and fuel subsidies (the government already increased fuel prices in June and September) and the elimination of exemptions on custom duties. On the public management side, the government has begun implementing the Automated Financial Management and Information System in pilot ministries, and the system is expected to be implemented in an additional five ministries. A cash management unit was also expected to be created in the ministry of finance by the end of September. Finally, the government is scheduled to realize savings through service reforms that will streamline services and eliminate spending redundancies by the end of 2011.Whether the government will carry out its reforms in totality remains to be seen.

The 2010 and 2011 budgets are expected to be in better shape than in 2009, although still in deficit. Although the government reduced hiring, froze wages and spending bonuses, and cut back nonessential expenditures, the budget deficit worsened in 2009 following sharp reductions in oil export revenues. From the equivalent of 1.1% of GDP in 2008, the 2009 deficit increased to 9.4% of GDP, a large portion of which was financed by the central bank. The planned phasing out of fuel and electricity subsidies and the implementation of the GST should reduce the 2010 and 2011 deficits, which are expected to be the equivalent to 5.1% and 6.4% of GDP, respectively. In addition, the second LNG train[2] in Yemen was inaugurated in June. The government is also expected to issue *sukuk* (Islamic fixed-rate notes) with IMF budgetary support, even though it postponed its initial plans to do so in the third quarter of this year due to capacity issues. However, the 2010 and 2011 budgets were forecast as negative because, in addition to falling oil and gas prices in 2011, defense spending is not expected to decline and the government has increased the minimum wage for government workers in June to allay their discontent over the oil and electricity subsidy reform.

Disagreements among political parties add to the constraints faced by the government. Pending electoral and political reforms have prevented the country from holding parliamentary elections, which the recent start of a "national dialogue" should facilitate in April 2011. Discussions within the national dialogue framework have been in a deadlock over the status of the Supreme Commission for Elections and Referendums, although in a concessionary move, the president has agreed to the drafting of constitutional amendments that would liberalize the political and electoral system (one of the opposition’s main demands). The lack of cohesion in the political sphere threatens to undermine government economic reforms and policy initiatives.

[2] An LNG train describes the liquefaction and purification facilities in a liquefied natural gas plant.

Yemen faces a number of security threats, most of which are tied to socioeconomic inequalities across regions and political groups. Zaydi rebels (also known as Houthis) in the north went to war with the government for the sixth time in six years in late 2009 due to perceived economic disenfranchisement. In the south, the slow pace of government initiatives to improve economic conditions and governance has given rise to an increasingly intense secessionist sentiment. Lastly, Al-Qaida in the Arabic Peninsula remains increasingly active in spite of recent government military operations. The formal ceasefire signed with Houthi rebels in the north in February, after a six-year conflict, has regularly been breached. Despite the recent intervention of the Qatari government to strengthen both parties' resolve towards peace (resulting in another agreement in June), the outlook remains uncertain. In addition, perceptions of economic dominance by the northern elite have provoked growing—and, recently, violent—unrest in the south, culminating in a loosely organized southern movement. These issues pose considerable challenges to the government, as they divert resources into defense and security spending and hamper policy implementation, already constrained by weak institutional capacity. The instability caused by the Houthi rebellion in the north and the unrest in the south stem from socioeconomic grievances, but the government's ability to address them is hindered by the security problems they generate, lack of changes in governance to address political and economic inequalities, and a narrow fiscal space.

Public discontent over the subsidy reforms, should they not be accompanied by social spending measures, could add to instability. The phasing out of subsidies is a socially sensitive reform. The discontent (in the form of a general strike) that prompted the government to raise the minimum wage in June indicates that further unrest may be likely should the reforms proceed without any compensatory measures. In addition, according the World Bank, an increase in fuel prices of 30% would cause a 1% rise in the poverty incidence. In this context, the IMF has recommended that the government increase the Social Welfare Fund (SWF) to offset the impact of the subsidy reform on the poor and cover the additional 500,000 families eligible for SWF transfers as identified by a recent household survey. The latter brought the total number of eligible families to 1.5 million. In its latest country report, the IMF indicates that the 2010 budget includes Yemeni riyal (YR) 59 billion for the SWF. The IMF estimates the amount to be sufficient to make up for the losses incurred by the poor owing to the subsidy.

Poverty is relatively high, especially compared to other countries in the MENA region. According to the IMF, the gains in poverty reductions achieved during the first half of the 2000s were reversed during the economic turmoil of 2007-2009. The IMF further estimates that 47% of the Yemeni population lives under $2/day (the MENA average is 17%). Poverty is higher in rural areas; the poverty reduction gains of the early 2000s largely bypassed the 72% of the Yemeni population that lives outside the cities. Agriculture, while accounting for approximately 10% of

GDP, employs most of the population.[3] It is plagued by increasing groundwater shortages made worse recently by a drought in major grain producing areas. The World Bank's 2010-2013 Country Assistance Strategy estimates that water shortages are due to climate change, increasing water usage for agricultural activities, and rapid urbanization; the World Bank warned that lack of a sufficient water supply could pose serious problems in the future. Yemen's high dependence on imports for food (which, due to increases in food prices, caused the number of food insecure people to rise in 2008) is also worrying. In this regard, it is also worth noting that an estimated 10% of the average household income is spent on *qat*, the leaves of which are chewed as a stimulant; its cultivation, for which agricultural land is increasingly used, draws one-third of the available groundwater.

While the central bank's policy stance for 2009 was expansionary, it has been reversed since March 2010. In response to declining private sector credit and rising government borrowing, the government lowered the benchmark interest rate from 13% to 10% between January and May of 2009. An 8% depreciation of the riyal against the U.S. dollar during the first quarter of 2010—caused by a declining external balance and loss of confidence in riyal-denominated assets due to political instability— prompted the central bank to reverse its stance in order to increase the demand for riyal-denominated deposits. During March of 2010, it raised the benchmark rate from 12 to 20%. As a result, foreign exchange reserves continued to fall in the second quarter of 2010, but at a lower speed. However, the riyal is expected to continue to decline in 2010 and 2011 (to YR226.64/dollar and YR242/dollar, respectively).

Inflation is forecasted to rise. Inflation, having accelerated to 12.2% in 2010 (from 5.4% in 2009), is expected to accelerate further in 2011 (by 13.3%) as import costs rise due to a lower exchange rate, increases in food prices, and the phasing out of subsidies. Central bank authorities are expected to monitor price variations caused by domestic factors and levels of liquidity in the banking sector, while also ensuring that credit growth is sufficient to enable private sector activity and banks are devoting sufficient resources to risk management.

It is anticipated that the current account deficit will narrow in 2010 before widening in 2011. From $8,977 million in 2008, nominal exports fell to $5,812 million in 2009. Exports are forecast to rise by 31% in nominal terms in 2010 (to $7,620 million) owing to LNG exports and higher oil prices, but are expected to fall to $7,257 million in 2011 due to lower oil prices and production. Imports remained high in 2009 (at $7,518 million) and are expected to rise in 2010 and 2011 (to $8,350 million and $8,640 million, respectively). The trade deficit is therefore expected to narrow markedly in 2010 (to $730 million against $1,706 million in 2009) before rising to $1,383 million in 2011. Although improvements are expected in the net income balance and the current transfers balance in 2010 and 2011, they will not be sufficient to offset the

3 According to the CIA World Factbook 2010, less than one-fourth of the labor force is employed in services, construction, industry, and commerce.

worsening trade deficit in 2011. The fluctuations in the current account and their causes underscore the importance of the hydrocarbon sector to Yemen's economy.

External support has increased. Concerns over Yemen's economic health and political stability have recently spurred increasing commitments of external assistance and investment from Western countries and Gulf States. The U.S. government announced an increase in its annual aid budget for Yemen to $300 million in August, while in July the U.K. minister of state for international development revealed the allocation of a £50 million ($78 million) annual grant for Yemen's various development goals. That same month, the EU stated that it would provide Yemen with €32.5 million (approximately $41.3 million) in funding. Lastly, the Kuwait-based Arab Fund for Economic and Social Development committed to provide $500 million from 2011 to 2015 in support of the country's development. Yemen's neighbors are also a large source of investment. In 2009, an estimated $500 million flowed into Yemen from the Gulf States. Saudi government investment over the next five years is expected to reach $1 billion. The EIU believes that the signing of the ECFA with the IMF in July will likely enable Yemen to obtain additional assistance in the short-term. IMF support is an implicit recognition of the Yemeni government's commitment to economic reforms, and the IMF has encouraged donor assistance to ensure the success of the reforms.

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