Monetary and Financial Sector Policies

12. The Central Bank of Yemen (CBY) remains committed to the maintenance of price stability. However, the attempts at effecting a steady depreciation of the Yemeni *rial*, consistent with the gradual depletion of oil reserves, have resulted in an accommodative monetary stance in 2006. To help alleviate emerging inflationary pressures in 2007, the authorities have agreed to tighten monetary policy. In this respect, and consistent with staff's advice, they have slowed the rate of depreciation of the *rial* and even allowed for a modest appreciation. Nevertheless, the authorities are mindful that reserve accumulation and competitiveness considerations would prevail once inflationary pressures subside, with the exchange rate resuming a market-determined path.

13. The CBY is aware of the limitations of the present monetary framework that aims at controlling inflation through the targeting of monetary aggregates. Given the shallow financial intermediation and relatively high deposit dollarization, there is limited scope for a more active interest rate policy as an effective instrument to control inflation. The authorities recognize that deepening financial intermediation and removing structural impediments to private sector credit growth are essential to promote non-oil sector activities. To help identify vulnerabilities and develop an agenda for reforms, they have expressed interest in a Financial Sector Stability Update. In addition, a revised Anti Money Laundering law, prepared partly under the assistance of the Fund, is to be submitted to parliament for approval.

Other Structural Reforms

14. With oil production on a declining trend, the Yemeni government has stepped up efforts to diversify the economy and promote alternative sources of growth and employment generation. While the gas sector is of major strategic importance for Yemen, there is concurrent focus on strategies to promote the development of the country's tourism and maritime activities, to capitalize on the coastal location and cultural heritage. The authorities are aware that significant levels of investment are required for the effective development of these sectors. To this end, a number of initiatives have been undertaken to strengthen the investment climate. In particular, tax and administration reforms which resulted in the elimination of production taxes on businesses have earned Yemen the title of top reformer in 2005/06 according to the 2007 Doing Business Report. Moreover, and to further strengthen transparency in the oil sector, the authorities intend to join the Extractive Industries Transparency Initiative. Efforts will also be directed at strengthening the economy's regional linkages, particularly with the GCC countries, and global integration, through ongoing discussions on accession to the World Trade Organization.

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IMF Executive Board Concludes 2007 Article IV Consultation with the Republic of Yemen

On September 17, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Yemen.[1]

Background

Despite recent progress in poverty reduction, Yemen remains one of the poorest countries in the region and is far from achieving the Millennium Development Goals. Oil production has been declining since 2000, and in the absence of major discoveries, proven oil reserves could be depleted in some 10 years time. The start of a large liquefied natural gas project from 2009 will offer only partial compensation. Yemen faces considerable challenges to generate strong (nonhydrocarbon) growth to absorb the rapidly growing labor force and raise living standards, while ensuring fiscal and external stability in the context of declining oil reserves.

Economic performance in 2006 was generally favorable, but was accompanied by an increase in inflation. Overall real GDP growth reached 4 percent in 2006, with a 6 percent non-oil growth offsetting an 8 percent decline in oil production. After a decade of relatively stable rates in the 10–12 percent range, core inflation (excluding the volatile prices of the narcotic qat) increased to over 20 percent. This was partly due to higher world food prices, but buoyant domestic demand driven by increased government spending and rapid money growth, played a major role.

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[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.

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High oil prices helped reduce the overall budget deficit to about ½ percent of GDP in 2006, but spending remained high. As in previous years, a large supplementary budget was issued at the end of the year to validate spending overruns that had already taken place. Fuel subsidies continued to absorb a large part of the budget (8 percent of GDP) and the wage bill rose to over 9 percent of GDP, while the non-oil tax ratio fell further to less than 7 percent of GDP. Without corrective actions, the overall deficit would significantly widen in 2007 (to 5–7 percent of GDP) as the approved budget maintains high spending levels despite lower oil revenues due to declining production and prices.

Monetary policy was accommodative in 2006. With sizable government spending out of high oil revenues, the real exchange rate appreciated by 10 percent in 2006. The Central Bank of Yemen (CBY) continued its policy of targeting a slow and steady depreciation of the exchange rate, so the real appreciation manifested itself through higher inflation. Money growth accelerated to 28 percent in 2006, twice the rate of the previous two years.

The external account surplus remained broadly unchanged at over 3 percent of GDP in 2006, with record-high oil receipts partially offset by imports related to sizable investments in the gas sector. With the latter financed trough foreign direct investment, the high oil revenues resulted in a large reserve accumulation by the CBY. Gross reserves at the CBY increased by $1.5 billion to $6.8 billion by year end, the equivalent of about 11 months of imports.

Relations with the international community have strengthened. A Consultative Group meeting held in November 2006 in London succeeded in generating almost $5 billion in pledges (about one-fourth of 2006 GDP), underwriting a large part of Yemen’s Public Investment Program for 2007–10. Half of the pledges came from Gulf Cooperation Council countries. Also, Yemen was reinstated in the U.S.’s Millennium Challenge Corporation’s threshold program. The Yemeni authorities recently committed to join the Extractive Industries Transparency Initiative.

Executive Board Assessment

The Executive Board welcomed Yemen’s generally favorable recent economic performance, including the decline in the poverty rate, as well as the progress being made on a number of structural reforms. Nevertheless, Directors concurred that the authorities face considerable macroeconomic and structural policy challenges to promote strong economic growth, create ample employment opportunities, and reduce poverty, while ensuring fiscal and external sustainability. In this regard, Directors welcomed the authorities’ strategy of basing policies on existing hydrocarbon reserves, while recognizing that the country’s economic outlook could be significantly altered by the discovery of new oil and gas resources.

Directors, noting that inflationary pressures have not fully abated, were encouraged by the authorities’ commitment to reducing inflation. They agreed that monetary policy should focus closely on price stability and welcomed the CBY recent efforts to keep the exchange rate of the rial vis-à-vis the U.S. dollar broadly stable, which should help limit imported inflation. Given the limitations of monetary policy in Yemen, Directors generally considered it to be appropriate for the CBY to continue to rely substantially on the exchange rate as a nominal anchor, in order to achieve lower inflation. While the exchange rate currently appears to be broadly in line with fundamentals, over time and in view of the expected decline in oil production, it will be important for the exchange rate to reflect evolving economic conditions.

Directors observed that the shallow financial intermediation, along with a relatively high level of dollarization, is limiting the effectiveness of monetary policy. They viewed that the removal of the minimum interest rate for rial deposits would allow the CBY to conduct a more active interest rate policy and enhance financial intermediation.

Directors noted that fiscal restraint, including public sector wage restraint, should provide an important complement to monetary policy in reducing inflationary pressures. They also underscored that frontloading fiscal adjustment will be needed, given the prospective decline in oil production and revenues.

Directors agreed that the gradual phasing out of domestic fuel subsidies will be central to fiscal adjustment, while recognizing that this will require political support. They noted that raising fuel prices should go hand-in-hand with strengthening the social safety net, in order to cushion the impact on the poor, including through persevering with ongoing efforts aimed at improving the Social Welfare Fund. Directors also were of the view that, if the authorities wished to cushion the impact of high wheat prices on the poor, it would be preferable to do so through the SWF. Strong efforts will also be needed to increase the government's non-oil revenues, reorient spending towards priority areas, and improve the quality and effectiveness of capital spending. Directors supported the progress being made towards strengthening the budgetary framework and improving fiscal transparency.

Directors underscored the importance of productivity-enhancing reforms to strengthen Yemen's competitiveness in non-oil exports. Further efforts are needed to improve the investment climate and the quality of labor, enhance governance and reduce red tape, including in tax and customs administration. Directors stressed that deepening financial markets will be essential for ensuring strong non-oil performance, and also recommended further strengthening of banking supervision. In this regard, they encouraged the authorities to request an Financial Sector Assessment Program update, which would help to assess potential risks in the financial system and to develop an agenda for financial sector reforms. Directors welcomed the revised Anti-Money Laundering law, and looked forward to its approval by parliament.

Directors looked forward to further efforts to improve the quality and timeliness of macroeconomic statistics, to better facilitate the formulation and monitoring of economic policies.

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