Statement by the IMF Staff Representative on the Republic of Yemen
February 23, 2009

1. This statement summarizes information on recent developments in Yemen that has become available since the staff report was issued to the Board on January 22, 2009. This information does not change the thrust of the staff appraisal.

2. The WEO oil price baseline was revised in January. The average international oil price is now projected at $50 per barrel in 2009, compared with the previous assumption of $54.25 per barrel. As a result, under the adjustment scenario outlined in the staff report, the 2009 fiscal deficit is now projected at 6.1 percent of GDP (up from 5.7 percent of GDP) and the current account deficit at 2.8 percent of GDP (up from 2.4 percent).

3. In December, the cabinet approved an adjustment to the 2009 budget based on reductions in nonpriority current expenditures, a postponement of selected investment projects, and intensified efforts at non-oil revenue mobilization. The adjustment aims at containing the deficit if oil prices remain below the initial budget assumption of $55 per barrel. The authorities estimate that this adjustment would reduce public expenditure by about 1.3 percent of GDP. However, this adjustment does not incorporate the full range of measures envisaged in the adjustment scenario outlined in the staff report, and further fiscal efforts would be needed to contain the deficit in line with this scenario.

4. Coverage of the General Sales Tax (GST) has not yet been widened, although work continues on simplifying GST administration and identifying and registering new taxpayers. Work also continues on the income tax simplification project, with the assistance of the World Bank's Foreign Investment Advisory Service (FIAS).

5. The authorities have adopted a revised CPI series with technical assistance from the Fund. Under the new series, overall inflation was 11.2 percent in December 2007, rising to a peak of 24.7 percent in March 2008, and then declining to 10.8 percent in December 2008. The decline since March has been driven mostly by lower food prices. Monetary aggregates continued to slow in December, with reserve money, broad money, and private sector credit growth ending the year at 8.3 percent,14.2 percent, and 17.5 percent, respectively. The central bank's own gross reserves have remained stable, ending 2008 at approximately $7.3 billion, compared with the staff projection of $7 billion—suggesting less pressure on the balance of payments than earlier anticipated. In January, the central bank reduced the floor on deposit-interest rates for the first time since 2000 from 13 to 12 percent.

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

On January 16, 2008, 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 10-12 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 non-oil 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 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 26 percent by March 2008, largely reflecting a similar increase in world commodity prices and local drought conditions.

[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.

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 non-oil 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 was lowered from 13 percent to 12 percent in January 2009.

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

Executive Directors noted that Yemen's non-oil GDP growth has been solid in recent years. Progress has been made on a number of structural reforms, and Yemen's financial system has remained resilient to the global financial crisis.

At the same time, Directors noted that downside risks to macroeconomic stability and fiscal and external sustainability have risen considerably in recent months as a result of the slowdown in global economic growth and the decline in oil prices. In addition, the authorities face the medium-term challenge of diversifying the economy and the government revenue base in light of the expected exhaustion of oil reserves and revenue. Their task will be complicated by rapid population growth, inadequate infrastructure, and weak institutional capacity.

Directors were encouraged by the authorities' recognition of the challenges ahead, and welcomed the recent actions to adapt to the rapid fall in oil revenue. However, a determined policy response, involving further macroeconomic adjustment and accelerated structural reforms, is needed in the period ahead. These efforts need to be supported by adequate assistance on concessional terms from the international community.

Directors noted the high risk of debt distress illustrated in the Debt Sustainability Analysis. They considered an ambitious fiscal consolidation effort to be the linchpin of successful adjustment to declining oil prices and production. They agreed that the fiscal stance for 2009 may need to be tightened further, and called for the early implementation of key revenue and expenditure reforms and development of a prudent debt management strategy.

Directors welcomed the authorities' commitment to reduce expenditure in the event that oil prices remain below the benchmark price in the 2009 budget. They stressed the need to strengthen public financial management and further prioritize public spending. This should involve the gradual elimination of fuel subsidies in the current environment of low international fuel prices, accompanied by a public education campaign and strengthening of the social safety net. Directors also called for continued civil service reform and wage restraint to reduce the large public sector wage bill.

On revenue, Directors welcomed the commitment by the authorities to fully implement the General Sales Tax. They encouraged further efforts to broaden the tax base and to strengthen tax administration in order to expand the non-oil revenue base.

Directors supported the commitment of the central bank to continue to focus on price stability. They encouraged the authorities to improve the monetary policy framework, including through improved coordination with fiscal policy and the broadening of the range of monetary policy instruments. The recent reduction of the benchmark deposit rate is welcome, and should be followed by further liberalization of interest rates and development of an inter-bank money market.

Directors supported the current policy of maintaining a stable exchange rate to help achieve the authorities' inflation objective. However, they believed that greater exchange rate flexibility allowing for a real effective depreciation of the currency may be needed in the medium term to preserve external sustainability.

Directors welcomed the improvement in financial sector indicators. They observed that the low level of financial intermediation remains a constraint on economic growth, calling for continued financial sector reforms. The strengthening of minimum capital requirements and the establishment of a deposit insurance scheme are welcome in this regard. Directors highlighted the need to strengthen bank regulation and supervision, and encouraged the authorities to request an FSAP update.

Directors underscored the importance of further structural reforms aimed at expanding non-oil production and enhancing Yemen's competitiveness. They welcomed the improvement in Yemen's investment environment, and urged the authorities to keep up the pace of reform with a focus on transparency and good governance. Directors supported ongoing progress in introducing a microfinance law, in developing a framework for combating money laundering and terrorism financing, and seeking closer economic integration through discussions with the GCC and the WTO.

Directors welcomed the efforts to improve the quality and timeliness of macroeconomic statistics, and saw a need for continued technical assistance in this area.

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