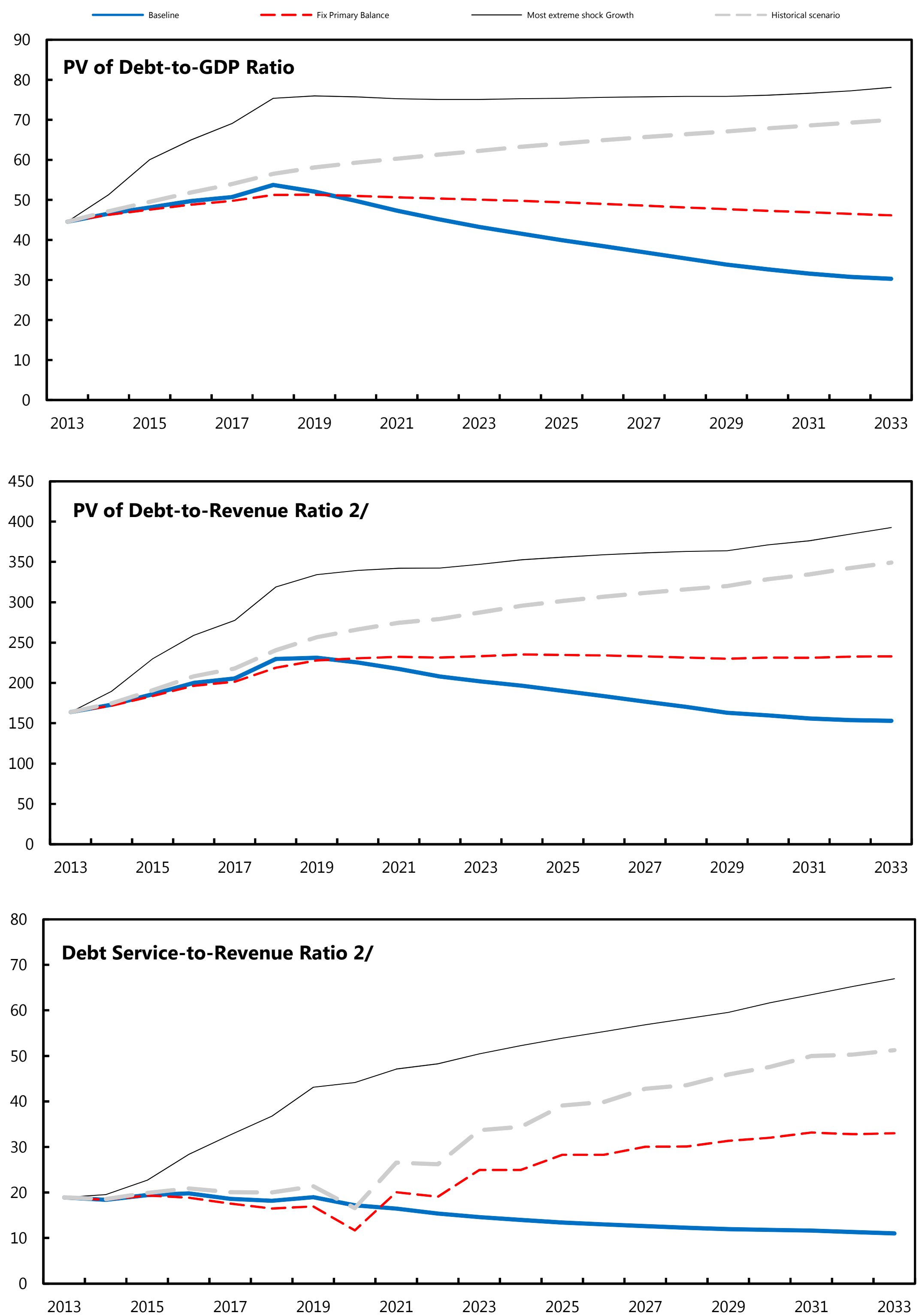
Figure 2.Yemen, Republic of: Indicators of Public Debt Under Alternative Scenarios, 2013-2033 1/



Sources: Country authorities; and staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio in 2023.
2/ Revenues are defined inclusive of grants.

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The IMF Concluded 2013 Article IV Consultation with the Republic of Yemen

On July 19, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Yemen.[1]

The macroeconomic situation stabilized in 2012 but the recovery remains fragile. After contracting by more than 12 percent in 2011, real GDP is estimated to have grown by 2.4 percent in 2012, reflecting an easing of supply bottlenecks and utilization of part of idle capacity. On the other hand, oil production declined further, due to continued sabotage of the pipelines. Average inflation declined to 9.9 percent from 19.5 percent in 2011, reflecting the appreciation of the rial to its pre-crisis level, the moderation of international food prices, and the easing of supply shortages. Money supply grew faster than nominal GDP, particularly in the second semester, partly driven by government borrowing, while private sector credit contracted marginally.

The external position has strengthened substantially in 2012, due largely to exceptional Saudi support. The current account deficit narrowed in 2012 to about 1 percent of GDP compared to 4.1 percent in the preceding year. Imports and non-hydrocarbon exports showed a strong recovery from their sharp decline in the previous year, while oil exports suffered from frequent sabotage of the key pipeline. Transfers increased, reflecting a Saudi oil grant of around $2 billion and strong growth in workers' remittances. The capital account also benefited from a $1 billion Saudi deposit at CBY. Consequently, gross reserves increased to $5.6 billion, equivalent to about 5.5 months of imports

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The budget deficit widened to 6.3 percent of GDP due to higher spending, including on wages and subsidies. Notwithstanding some increases in domestic fuel prices, subsidies

[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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

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increased to about 9 percent of GDP. Furthermore, the hiring of additional government employees and the payment of retroactive wage settlements led to an increase in the wage bill to about 11 percent of GDP. Capital spending increased but remained below its pre-crisis level. On the revenue side, the decline in oil receipts was more than compensated for by an increase in tax collection and the exceptional level of Saudi grants. The non-hydrocarbon primary deficit excluding grants deteriorated to 21.1 percent of GDP, compared to 17.6 percent a year earlier. Public debt remained moderate at about 48 percent of GDP, with the external part constituting about 18 percent.

Money supply in 2012 increased by 21 percent, reflecting higher net foreign assets and net credit to the government. Most of this increase took place in the second semester, which was beyond the indicative benchmarks set under the RCF. With the deceleration in inflation, the CBY reduced the policy interest rate in October 2012 from 20 to 18 percent, and again to 15 percent in February 2013. However, and despite the substantial excess reserves in the banking system, private sector credit contracted slightly, reflecting the still high real interest rate, the fledgling recovery, and the high credit risk. On the other hand, net claims on government increased by almost 30 percent.

The banking system is stable, notwithstanding some vulnerabilities. Banks are on aggregate profitable and liquid with the capital adequacy ratio estimated at 29.6 percent at end December 2012, partly due to the large share of zero risk-weighted government securities in the banks' portfolios and the high interest rates earned on these securities. However, non-performing loans stood at 25.5 percent, reflecting the level of credit risk and some deficiencies in commercial banks' risk management capacities.[2] Islamic banks are also challenged by limited eligible domestic investment opportunities. Financial markets and the payment system are underdeveloped.

Executive Board Assessment

Executive Directors welcomed the authorities' progress toward macroeconomic stability. At the same time, they noted that the economic recovery is fragile and considerable challenges remain. Directors stressed the importance of sustained implementation of reforms to strengthen macroeconomic stability and promote strong growth, employment, and poverty reduction.

Directors urged the authorities to contain the widening fiscal deficit and continue fiscal restructuring. They supported the plans to reorient the budget toward pro-growth and pro-poor expenditures. They noted that a gradual reduction in the share in the budget of wages—including by eliminating ghost workers—and generalized subsidies would provide room for infrastructure investment and priority social spending. They also noted that the

[2] The large share of NPLs does not currently pose stability risks because private sector credit accounts for a small share of total assets.

untargeted fuel subsidies disproportionately benefit the rich and encourage smuggling. In this regard, they welcomed the recent decision to unify the price of diesel. They urged the authorities to build public support for a comprehensive, albeit gradual, reform of fuel prices. Increased targeted transfers will be important to mitigate the impact of fuel price increases on the most vulnerable. To that end, further concessional donor assistance will be needed, and Directors urged the authorities to secure timely donor disbursement through enhanced transparency and capacity in public finance management and program implementation.

Directors welcomed recent efforts to improve non-hydrocarbon revenue. They highlighted the need to strengthen tax and customs administration and to refrain from extending tax exemptions. They also cautioned that limiting nonconcessional borrowing will be important to safeguard debt sustainability.

Directors emphasized the need to achieve price stability while ensuring monetary policy support for growth. They underscored the importance of fiscal restraint to help reduce inflation and interest rates and avoid further crowding out credit to the private sector. Directors saw a need to improve the monetary policy framework and enhance central bank independence. Directors noted that the exchange rate is broadly in line with fundamentals. They noted that greater exchange rate flexibility would help preserve international reserves and provide a cushion against external shocks.

Directors highlighted the importance of safeguarding the health of the financial system and further developing financial intermediation. They encouraged the authorities to expedite efforts to strengthen the framework for bank supervision and resolution. They also called for measures to address the remaining shortcomings in the AML/CFT framework.

Directors emphasized the importance of structural reforms to support high and inclusive economic growth and diversification. Priorities include improving infrastructure, enhancing the business climate, expanding access to financial services, and strengthening public institutions and governance.

Directors called for further efforts to improve economic and financial statistics to facilitate economic analysis and policy formulation.