INTERNATIONAL MONETARY FUND

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REPUBLIC OF YEMEN

2014 ARTICLE IV CONSULTATION AND REQUEST FOR A THREE-YEAR ARRANGEMENT UNDER THE EXTENDED CREDIT FACILITY—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF YEMEN

September 2014

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2014 Article IV Consultation with the Republic of Yemen and its request for a three-year arrangement under the Extended Credit Facility, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on September 2, 2014, following discussions that ended on May 24, 2014, with the officials of Yemen on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 3, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Debt Sustainability Analysis** prepared by the IMF and the World Bank.
- A **Supplement to the Staff Report** of August 27 updating information on recent developments.
- **Press Releases** including a statement by the Chair of the Executive Board, and summarizing the views of the Executive Board as expressed during its September 2, 2014 consideration of the staff report on issues related to the Article IV Consultation and the IMF arrangement.
- A **Statement by the Executive Director** for Yemen.

The following documents have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Yemen*
Memorandum of Economic and Financial Policies by the authorities of Yemen*
Technical Memorandum of Understanding*

*Also included in Staff Report

The publication policy for staff reports and other documents allows for the deletion of market-sensitive information.

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REPUBLIC OF YEMEN

July 3, 2014

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION AND REQUEST FOR A THREE-YEAR ARRANGEMENT UNDER THE EXTENDED CREDIT FACILITY

KEY ISSUES

Background: Yemen has made good progress since the 2011 crisis in advancing the political transition. However, the fledgling economic recovery remained insufficient to make a dent in unemployment and poverty, and fundamental reforms were postponed for fear of derailing the National Dialogue that was central to the political transition. The macroeconomic situation weakened further since early 2014, with increased sabotage of oil facilities leading to a decline in oil revenue and, therefore, a deterioration in the fiscal and external positions and severe fuel and electricity shortages. To address the difficult economic situation, the authorities have adopted a bold reform agenda to preserve macroeconomic stability and set the stage for boosting growth, employment creation, and poverty alleviation. They requested Fund support under an ECF arrangement with access of 150 percent of quota in consideration of the strength of the reforms and large financing needs.

Outlook and Risks: Growth and other macroeconomic indicators are projected to improve steadily over the medium term as a result of the reform efforts and improvements in security. Institutional capacity constraints and/or deterioration in security or the political environment could delay reform implementation, in particular energy subsidy reforms. Such delays could destabilize the economy and necessitate even stronger adjustments later on.

Policy Discussions: Discussions focused mainly on sequencing and speed of reforms in view of the large financing needs of the budget. Since the successful implementation of the RCF in 2012, there has been an ongoing dialogue with the authorities and a broad agreement on priority reforms, with differences of views on the timing and feasibility of the various reforms during the political transition. After the recent progress achieved in advancing political transition, and the increased economic challenges, the authorities have decided to move ahead with a strong reform program. The program aims to reduce the fiscal deficit to more manageable levels and reorient public spending from generalized subsidies to infrastructure investment and direct social transfers, with the objective to generate growth and employment and better benefit the poor. The authorities also agreed with staff on the need to improve fiscal performance by eliminating ghost workers and double dippers from the civil service payroll, and by increasing nonhydrocarbon revenue. Other agreed reforms aim at ensuring financial sector soundness and improving intermediation and the business environment to support growth and job creation.

Other Article IV Issues: An updated debt sustainability analysis indicates that the risk of debt distress continues to be moderate. Plans to introduce fiscal federalism need to ensure appropriate expenditure and debt-contracting policies and controls. A gradual increase in exchange rate flexibility over the medium term would help protect competitiveness and reserves, and would support growth and job creation. More efforts are needed to further improve economic data and to strengthen capacity in AML/CFT.

Approved By
Daniela Gressani and Bob Traa

The mission took place during May 13-24 in Amman, Jordan. The staff team comprised Messrs. Khaled Sakr (head), Faisal Alotaibi, Nabil Ben Ltaifa, and Ms. Inutu Lukonga (all MCD); Ms. Wafa Amr (COM), Messrs. Valerio Crispolti (FAD) and Toshiyuki Miyoshi (SPR). The mission was joined by Messrs. Gazi Shbaikat (the Fund's resident representative), Fouad Al-Kohlany (the economist in the Sana'a office), and Guido Rurangwa (World Bank economist). Ms. Mira Merhi (Advisor to the Executive Director representing Yemen) participated in the policy discussions. The mission met with Minister of Finance Sakhr Al-Wageeh, Governor of the Central Bank Mohamed Bin Humam, Deputy Minister of Planning Mohamed Al-Hawri, and other senior officials. Discussions with representatives of the financial sector, civil society, and the business and donor communities were held by the resident representative in Sanaa, and by the team through teleconferences in the months preceding the mission.

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BACKGROUND

1. **Yemen's geopolitical situation is critical from a regional and global perspective**. It shares long borders with Saudi Arabia and overlooks al-Mandeb Strait across the Horn of Africa. High levels of poverty and unemployment are contributing to political tensions, with negative security spillovers. Security is also affected by the conflict with the Houthis and the Southern separatists, and by the strong presence of Al-Qaeda.

2. **The political transition is advancing, though the outlook remains challenging**. After some delay, the National Dialogue was concluded in January 2014 with an agreement to establish a six-region federal state.[1] The parliamentary and presidential elections have been postponed to 2015 to allow time to complete the transition process. A new constitution is being drafted and will determine the degree of autonomy that will be granted to the regional governments. Open confrontation with the different factions, and with Al-Qaeda, remains frequent. Recent increases in sabotage of oil pipelines and the electricity grid have led to severe shortages of fuel and electricity. These prompted large demonstrations and a limited reshuffle in the coalition cabinet in June 2014.

3. **Economic growth has been insufficient to meaningfully reduce the widespread poverty and unemployment**. The average growth rate in real per capita GDP was less than 1.5 percent a year in the decade preceding the 2011 crisis, and has declined since. Yemen ranks poorly in social indicators. Poverty and youth unemployment which are estimated at 54 percent and 35 percent, respectively, are among the highest in the world. About 60 percent of children under the age of five have chronic malnutrition, 35 percent are underweight, and 13 percent have acute malnutrition. In addition, maternal mortality, at 290 per 100,000 live births, is among the highest in the world. Infrastructure investment has continued to decline since the crisis, and foreign direct investment remains concentrated in the hydrocarbon sector, which employs a very small percentage of the labor force. Yemen also faces severe environmental challenges, especially a rapid depletion of its scarce water resources (Table 10).

4. **Faced with rapidly deteriorating fiscal and external positions in the first half of 2014, the authorities requested a three-year ECF arrangement in support of a bold reform program**. This program builds on reform plans that were discussed with staff over the past year. The reform package aims at reversing the recent deterioration in the macroeconomic situation and promoting inclusive growth and job creation. These objectives will be achieved through (i) reducing generalized subsidies and eliminating ghost workers and double-dippers from the public wage payroll; (ii) increasing infrastructure spending and social transfers; (iii) strengthening public financial

[1] In 2011, political and social unrest caused a crisis which led to a political agreement supported by the Gulf Cooperation Council. A National Unity Government was formed in December 2011 and President Hadi was elected in early 2012 to manage an initial two-year transition period. The transition period was extended in 2014 until the drafting of the constitution and the holding of Presidential and legislative elections.

management and governance; and (iv) improving financial intermediation and the business environment.

5. The authorities are fully committed to the reform agenda, and requested an ECF arrangement to support their strong program and help close the BOP and fiscal financing gap. Ad referendum agreement on an ECF arrangement was reached twice in 2013, but the program was not endorsed by the government at that time due to concerns about the impact of fuel price adjustments. However, following the sharp decline in oil production and domestic supply of fuel products in the first half of 2014, black market prices reached international prices and lack of financing reduced the availability of fuel at the subsidized prices. To resolve this situation, the political leadership made strong public commitments to implement the necessary reforms. A centerpiece of these reforms is a substantial adjustment in prices in October 2014, aiming at a reduction of about 50 percent of the subsidy. As a first step, the private sector has been allowed to import part of its diesel requirements at international prices starting in June 2014. In view of the strength of the program and the large financing need, the authorities requested access of 150 percent of quota.[2]

6. Yemen has a strong track record of implementing reforms supported by the April 2012 RCF. These reforms were successful in restoring macroeconomic stability, and included a substantial increase in diesel prices. The authorities also implemented important reforms that were recommended in the context of the 2013 Article IV consultation (Box 1), and which had underpinned initially two staff-level ad referendum agreements that had been reached in 2013 but not concluded. In particular, the authorities unified the domestic price of diesel, improved tax compliance, did not approve requests to extend tax exemptions, contained the wage bill, refrained from central bank borrowing, and introduced corporate governance reforms in the banking sector, including publishing the full audited accounts of the central bank.

7. A Fund-supported program would help unlock disbursements of substantial donor pledges. Total pledges by the Friends of Yemen to support Yemen's Transitional Program for Stability and Development (TPSD) totaled about $8 billion for the period 2012–15. Only one-third of these pledges have been disbursed thus far, including a $1 billion Saudi deposit at the Central Bank of Yemen (CBY).[3] Donor support is largely earmarked for capital spending and humanitarian needs, mostly outside the budget. The authorities established an Executive Bureau in February 2013 to speed up the implementation and funding of projects. More recently, with the urgent need for donor support to fill the financing gap, and in consideration of the strength of the reforms agreed by the authorities to address the macroeconomic situation, donors have agreed to shift and/or increase their disbursements, which are expected to fully finance the program supported by the proposed ECF arrangement.

[2] The access norm for ECF arrangement is 120 percent of quota per ECF arrangement for countries with total outstanding concessional IMF credit under all facilities of less than 100 percent of quota.

[3] In addition to its Friends of Yemen pledges, Saudi Arabia provided about $2 billion to Yemen in the form of an oil grant in late 2011 and in 2012.

Box 1. Implementation of Key Recommendations of the 2013 Article IV Consultation

In concluding the 2013 Article IV consultation on July 19, 2013, Directors encouraged the authorities to contain the fiscal deficit, improve the structure of revenue and expenditure, and enhance capacity to coordinate and execute donor-financed projects. They also called on the authorities to continue to improve bank supervision, financial intermediation, and the business environment.

Notwithstanding the substantial decline in hydrocarbon revenue in 2014, the authorities have thus far exercised expenditure restraint and thus contained the fiscal deficit. Good progress has also been made in improving tax revenue. Furthermore, the wage and generalized subsidy bills have been contained in relation to GDP. However, direct transfers and capital spending have also declined from their already low levels. Efforts continued to strengthen bank supervision, although progress has been hindered by delays in technical assistance due to security constraints. Financial intermediation remained very low, and structural reforms to improve the business environment have been lagging. Capacity to enhance collaboration with donors and execution of projects are being improved, including by strengthening and adequately empowering the management and staff of the Executive Bureau.

RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

A. Recent Developments

8. **The macroeconomic situation continued to be relatively stable in 2013, and growth remained moderate**. Nonhydrocarbon growth was steady at about 4 percent, while hydrocarbon growth picked up strongly, reversing part of the oil output decline in preceding two years. As a result, real GDP growth is estimated to have doubled to almost 5 percent. At the same time, average inflation edged up slightly to reach 11 percent (up from about 10 percent a year earlier), and the exchange rate remained stable.

9. **The overall fiscal deficit worsened only moderately in 2013 despite a large decline in grants**. Although grants declined by about 5 percent of GDP, the overall fiscal deficit deteriorated by only 0.6 percent of GDP, to reach 6.9 percent. This was achieved through a combination of expenditure restraint and an increase in nonhydrocarbon revenue. Subsidies and transfers were reduced by about 2.7 percent of GDP, mostly through limiting the supply of fuel products and shifting the schedule for payment of the subsidy bill by one month. Capital spending was also reduced by 1.3 percent of GDP. A 2012 decision to generalize an increase in civil servants' allowances was also not implemented, leading to a 0.9 percent reduction in the wage bill. As a result, the underlying fiscal deficit (defined as the nonhydrocarbon primary deficit, excluding grants) narrowed by about 6 percent of GDP. This adjustment was forced by the lack of financing and the authorities' determination to refrain from central bank borrowing.

10. The widening of the external current account deficit was also moderate in 2013. The large decline in grants was mitigated by healthy growth in exports and remittances. At the same time, capital outflows increased, reflecting large scheduled amortization of oil companies' past FDI and the nonrecurrence of the large Saudi deposit of 2012. As a result, gross reserves declined by about $740 million to reach $4,854 million, or 4.5 months of imports, despite the sale to the central bank of pension funds' holdings of about $250 million. On the other hand, the real effective exchange rate appreciated by 6.5 percent due to the relatively high domestic inflation and the nominal depreciation against the dollar of the currencies of Yemen's key trading partners.

11. Monetary policy continued to be generally prudent, but fiscal dominance remained high. Broad money growth was slightly slower than the growth of nominal GDP, mostly reflecting the decline in net foreign assets. However, net claims on central government continued to grow rapidly at about 28 percent. Private sector credit growth was also high, at 39 percent, from a very low base and after declining in the preceding two years. On February 7, 2013, the CBY reduced the benchmark deposit interest rate from 18 percent to 15 percent.

12. The banking system remained stable, but some vulnerabilities remain. Banks are profitable and liquid, and capital adequacy ratios are high, albeit in large part reflecting the large zero-risk-weighted government securities on banks' balance sheets. Nonperforming loans remain high, as does assets concentration in government securities. Islamic banks have high exposure to real estate markets abroad. The banking sector remains small, and financial markets and the payment system are underdeveloped, limiting financial intermediation and monetary policy transmission.

13. The recent wave of sabotage to oil pipelines has had strong adverse effects on macroeconomic developments in the first half of 2014. The frequent sabotage resulted in a significant decline in oil production and exports. This has led to pressures on the fiscal and external positions. In the absence of reforms, the fiscal deficit would reach 9 percent of GDP and reserves would decline to well-below three months of imports. In addition, severe fuel and electricity shortages have negatively affected economic activity, with real GDP growth expected to decelerate to less than 2 percent.

B. Outlook and Risks

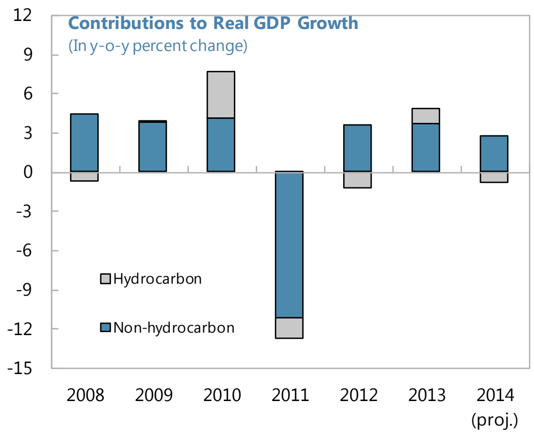
14. Yemen's medium-term outlook is largely predicated on the implementation of reforms under the ECF arrangement and on improvements in security. Growth is projected to recover gradually, reaching about 6 percent by 2018 partly reflecting utilization of the idle capacity created following the substantial slump of 2011, before decelerating somewhat to more moderate levels in the longer term. The planned increase in fuel prices in October is expected to raise inflation to the low double digits in late 2014 and throughout most of 2015. Inflation would then decline steadily starting in late 2015. The fiscal and external positions will improve gradually over the medium term as a result of reforms, the recovery of hydrocarbon exports, and upward revisions in the contracted low liquefied natural gas (LNG) export prices.

15. Timely implementation of reforms and concomitant donor support to the budget will be critical to this encouraging outlook. Delays in implementing reforms, particularly energy subsidy reforms, would destabilize the economy in the short run, and jeopardize the medium-term growth and poverty reduction objectives. The outlook is also predicated on the implementation of other strong reforms to help reorient the budget structure from inefficient expenditures to pro-growth and pro-poor expenditures. These include, in particular, civil service reforms, improvements in tax policy and revenue administration, enhanced public financial management, and structural reforms to improve financial intermediation and the business environment. Timely donors' support to the budget is also important, to reduce the crowding out of private sector credit, and to help catalyze domestic support for the reforms in the very difficult political and security environment.

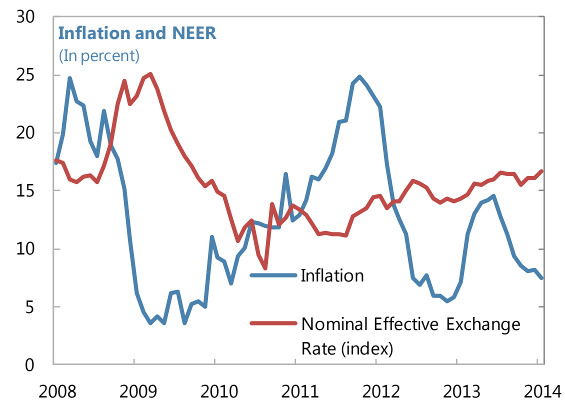
16. Global and country-specific risks to Yemen's economic outlook are detailed in the Risk Assessment Matrix (Box 3). Political and security risks constitute the main challenges because they could further affect oil production, disrupt policy implementation, and discourage investment. The prospective shift to fiscal federalism, if not well-designed and supported by institution- and capacity-building, could present fiscal and debt challenges. On the upside, the outlook could benefit from the recent renegotiation of higher LNG prices and from a faster improvement in security and oil production. The broad representation of all major political parties in the coalition government reduces the risk of policy disruptions after the elections, which are likely to take place next year. A clear public communication of the necessity and benefits of reforms would also help ensure continued national ownership of the program and reduce the risks of policy slippages.

Figure 1. Republic of Yemen: Recent Economic Developments

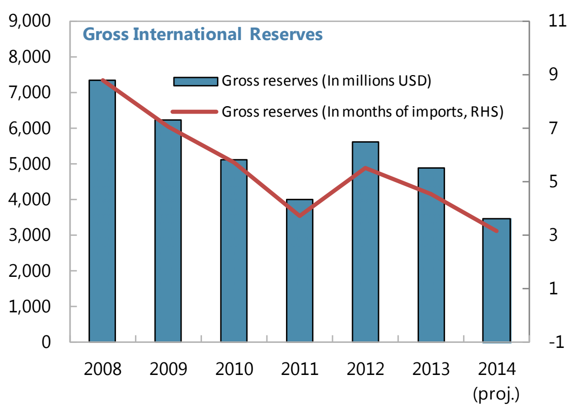
Recent fuel and electricity shortages are hindering growth.



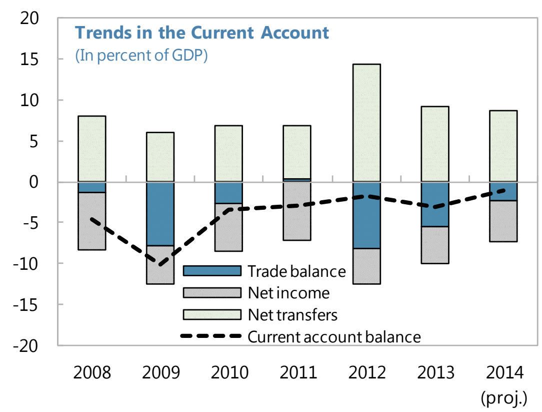
Inflation decelerated, while the appreciation of the effective exchange rate continued.



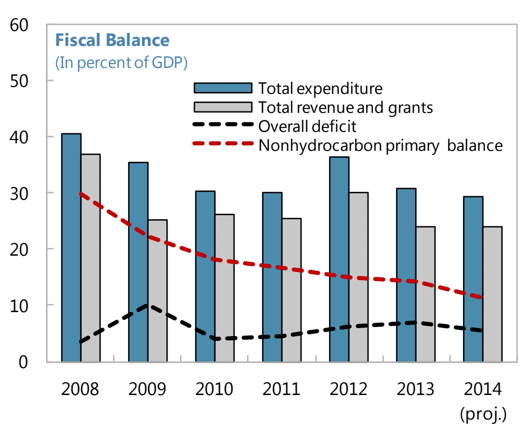
Gross reserves declined somewhat in recent years but remained at above three months of imports.



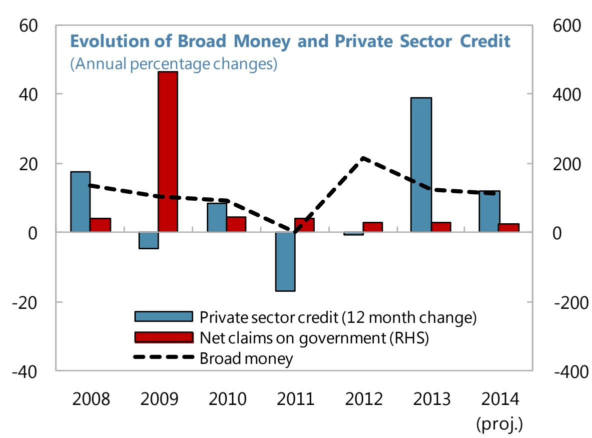
The increase of the current account deficit was moderate in 2013.



The widening in the overall fiscal deficit was also moderate despite the large decline in grants.



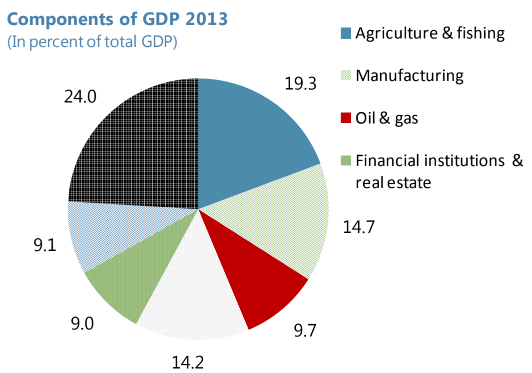
Broad money growth has been in line with nominal GDP notwithstanding the pick up in private sector credit.



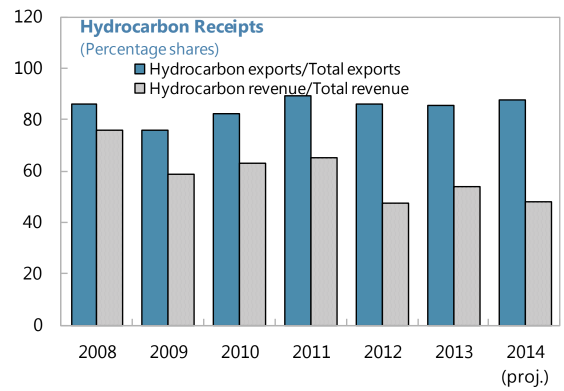
Sources: Yemeni authorities; and IMF staff estimates and projections.

Figure 2. Republic of Yemen: Selected Real Sector Indicators

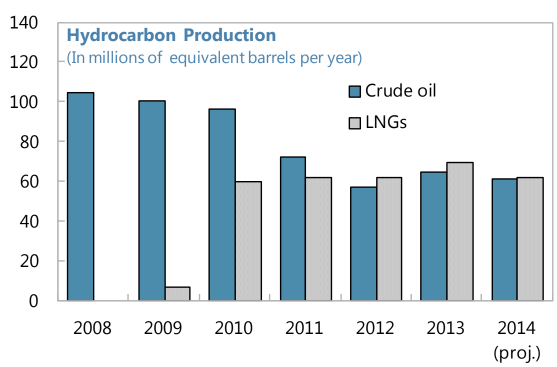
The production structure is fairly diversified.



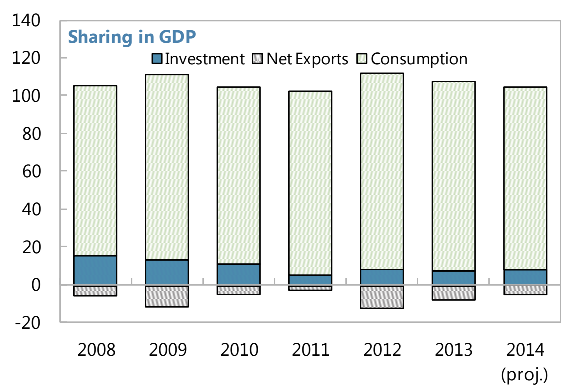
But hydrocarbons constitute the major component of exports and fiscal revenues.



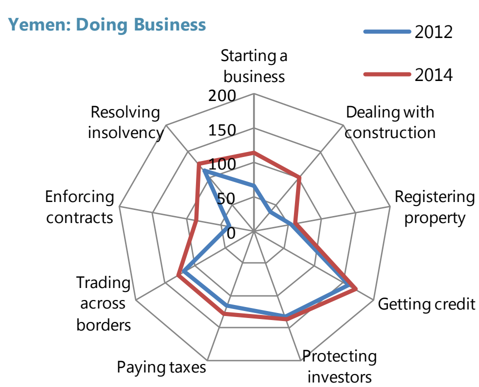
Hydrocarbon production picked up slightly in 2013 before declining in the first half of 2014.



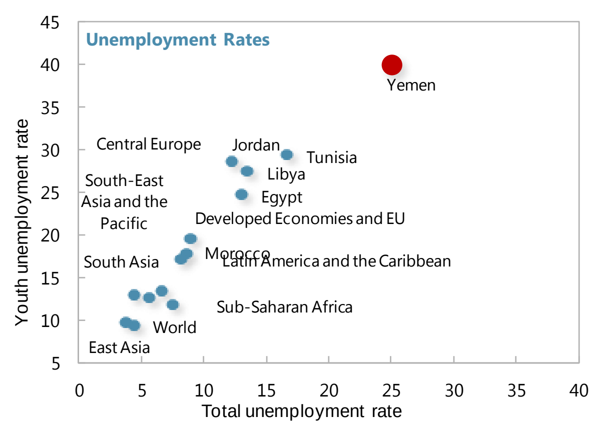
Investment levels are low.



The business environment has deteriorated further…



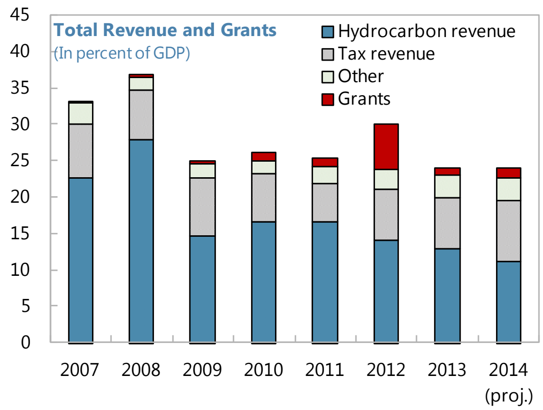
…and unemployment is very high.



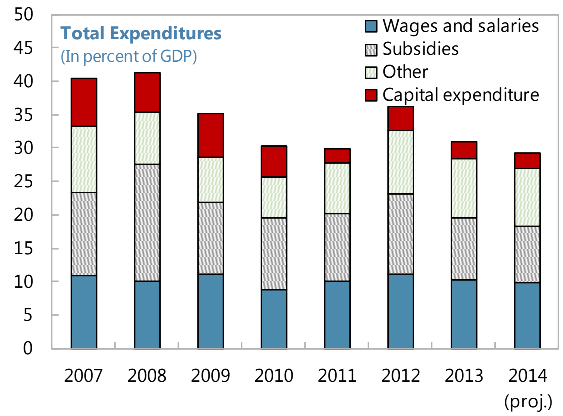
Sources: Yemeni authorities, World Bank, ILO; and IMF staff estimates and projections.

Figure 3. Republic of Yemen: Selected Fiscal Indicators

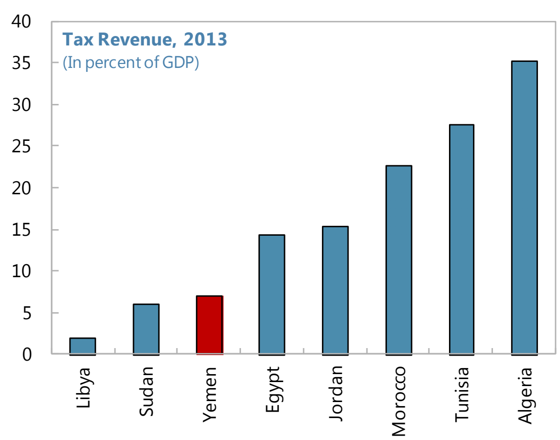
Total revenues and grants declined, but the tax revenue improved.



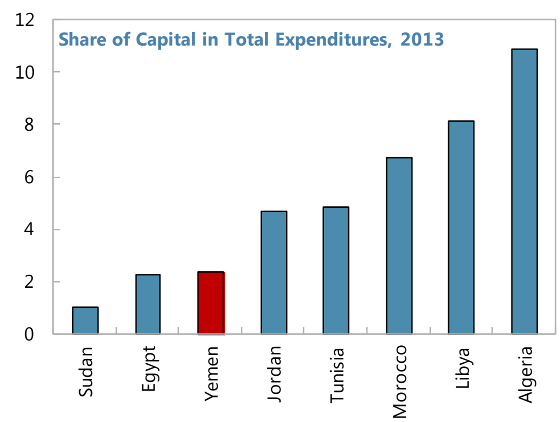
Expenditure also declined, reflecting spending restraint and lower public investment.



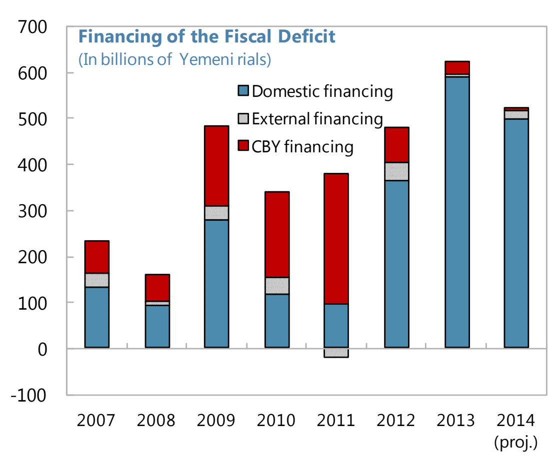
Tax revenue remains among the lowest in MENA...



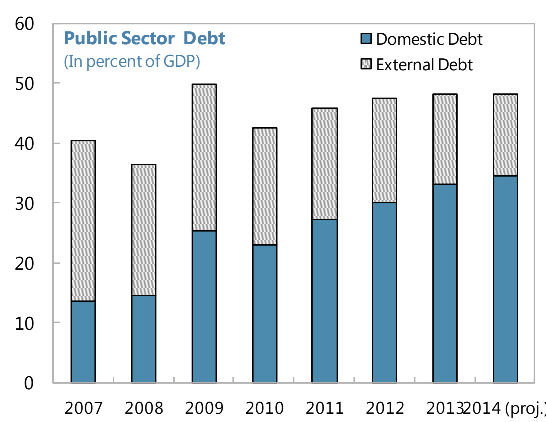
...as does public investment.



The deficit has been largely financed from domestic sources.



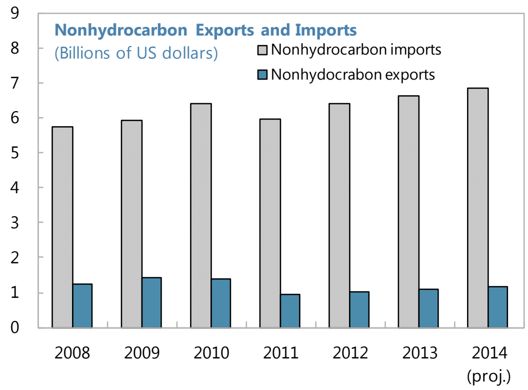
Public debt increased slightly in relation to GDP, while external debt remained moderate.



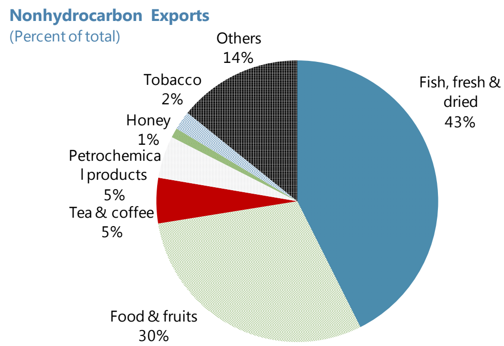
Sources: Yemeni authorities; and IMF staff estimates and projections.

Figure 4. republic of Yemen: Selected External Sector Indicators

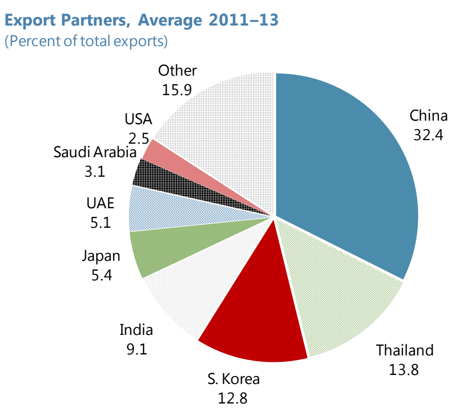
Nonhydrocarbon exports and imports have continued to recover.



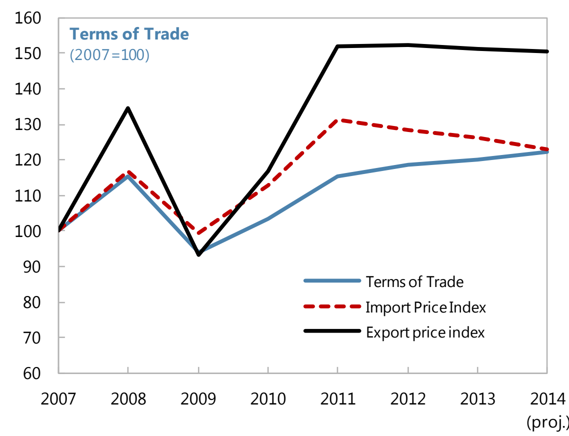
Nonhydrocarbon exports mainly consist of fish and food products.



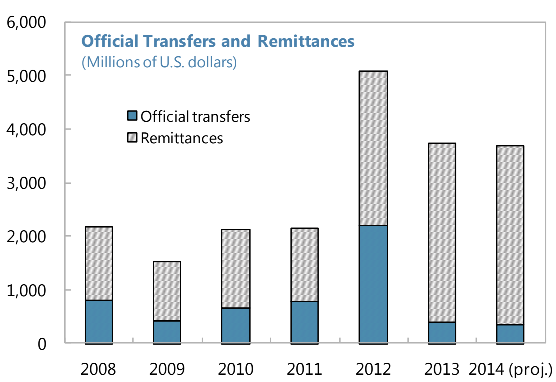
Asian countries are the main export destination.



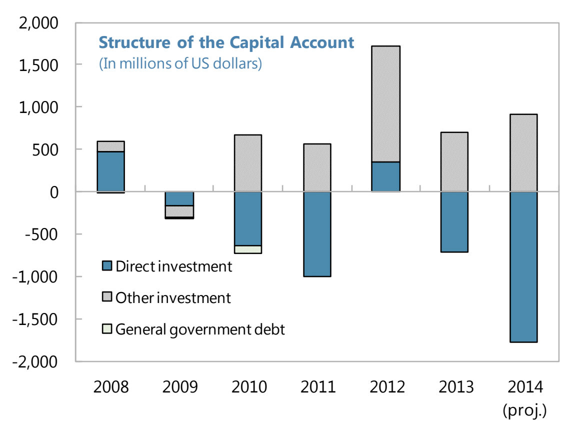
Terms of trade improved...



...and remittances increased.



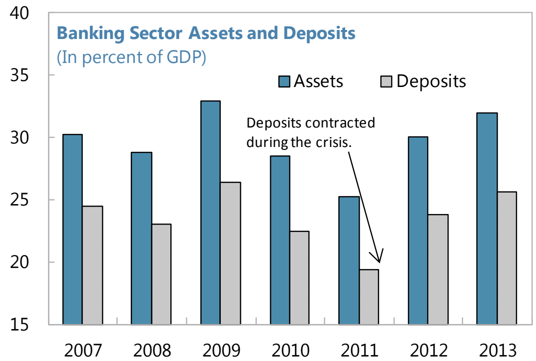
The capital and financial account has been affected by the nonrecurrence of the 2012 exceptional inflows and the recent scheduled FDI amortization.



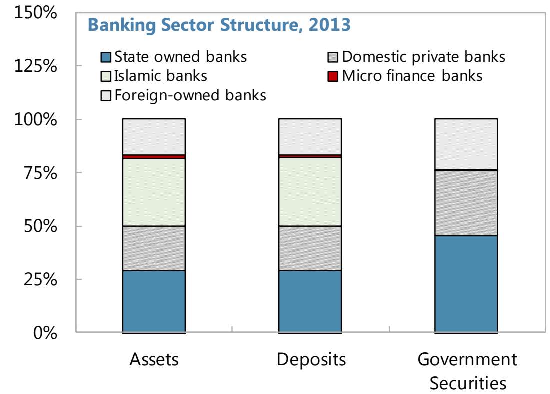
Sources: Yemeni authorities; and IMF staff estimates and projections.

Figure 5. Republic of Yemen: Monetary and Financial Developments

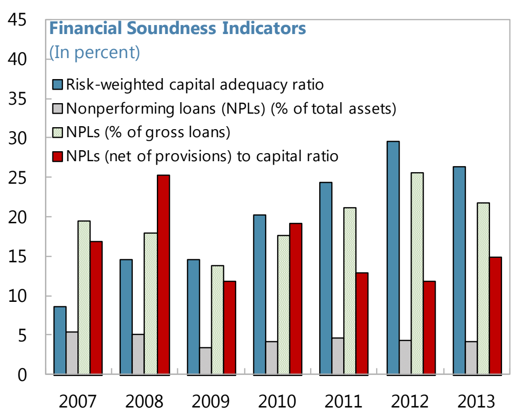
Yemen's banking system is steadily recovering from the impact of the political crisis.



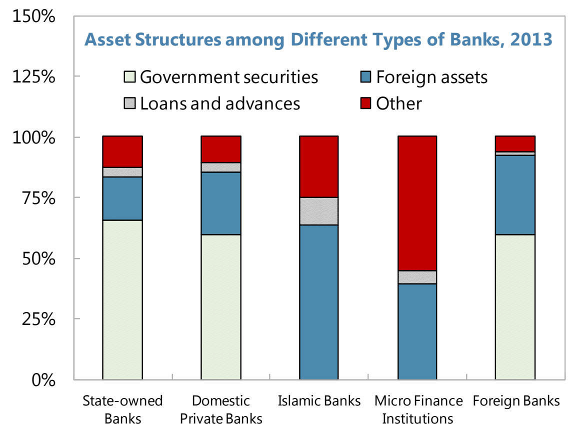
Banks' operations are segmented by ownership type.



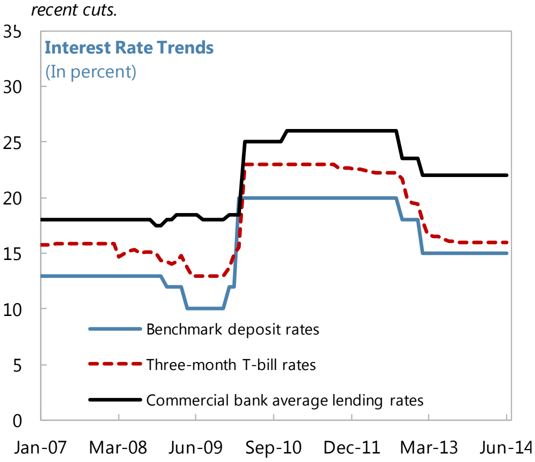
NPL ratios are the highest in the region, but CAR is also high…



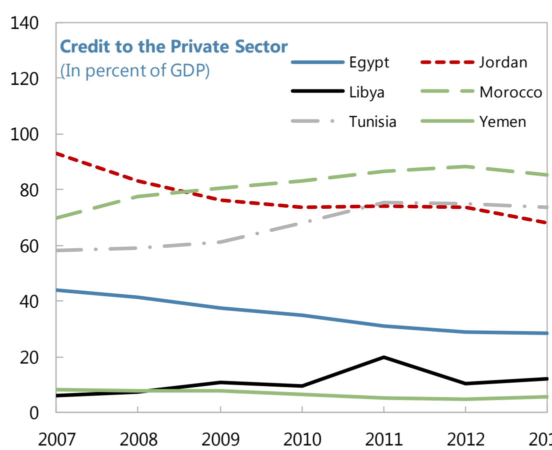
… reflecting the large proportion of bank assets invested in government securities.



Interest rates remain above pre-2010 levels, despite the recent cuts.



Bank intermediation is very low.



Sources: Yemeni authorities; and IMF staff estimates.

POLICY DISCUSSIONS

17. Reforms will aim to address both short-term challenges and lay the foundations for medium- and -long term inclusive and sustainable growth. The key objectives are to contain the negative macroeconomic impact of the recent oil shock, and to gradually reorient fiscal and monetary policies to create the conditions for high inclusive growth and poverty alleviation. Financial sector and structural reforms are also key to meeting these goals. While being strong, the design of the reform program takes into account the difficult social and political conditions through appropriate sequencing and protection of the poor. The structural measures that will help achieve these objectives and goals are listed in Table 2 of the MEFP (Appendix 1).

A. Fiscal Policy for 2014 and the Medium Term

18. The immediate challenge is to reduce the fiscal deficit for 2014 within the limits of the available financing, in a manner that will be consistent with preserving macroeconomic stability. In the absence of immediate corrective measures, the fiscal deficit could have widened to as much as 9 percent of GDP, from 6.9 percent a year earlier. This deficit would have been impossible to fill from available external financing and from own resources without jeopardizing the macroeconomic stability that has been in place since 2012. The authorities therefore decided to act promptly to reduce the 2014 deficit to 5.4 percent of GDP (and the underlying nonhydrocarbon primary fiscal deficit excluding grants to 12.7 percent of GDP from 15.2 percent in 2013). Even after this exceptional effort, there will still be a need for a sizable domestic financing effort, through new net issuance of government securities, greater external donor support, and recourse to Fund financing under the requested ECF arrangement. Disbursements under the ECF arrangement will go

Text Table 1. Republic of Yemen: Projected Financing Requirements and Sources, 2014–17

	2014		2015		2016		2017	
	Billions Yrls	Millions USD	Billions Yrls	Millions USD	Billions Yrls	Millions USD	Billions Yrls	Millions USD
A. Overall balance excluding grants	-660.5	-3073.6	-681.9	-3065.4	-696.8	-2940.5	-719.9	-2865.0
B. Domestic financing	506.5	2357.2	453.5	2038.4	458.5	1934.7	462.5	1840.7
C. Net external resource requirements: -(A+B)	154.0	716.4	228.5	1027.0	238.4	1005.9	257.4	1024.3
D. Projected/expected budget grants	135.8	632.0	114.1	513.1	96.8	408.6	107.6	428.2
Projected grants	86.4	402.0	103.0	463.1	96.8	408.6	107.6	428.2
Additional budget support contingent on the ECF arrangement	49.4	230.0	11.1	50.0				
Saudi Arabia	32.2	150.0						
World Bank 1/	10.7	50.0	11.1	50.0				
United States	6.4	30.0						
E. Projected net external borrowing (excluding IMF) 2/	2.0	9.3	58.7	263.7	115.2	486.0	124.0	493.5
F. Repayments to IMF	0.0	0.0	0.0	0.0	2.6	10.9	5.2	20.6
G. Residual financing gap (C-D-E+F)	16.1	75.1	55.7	250.2	28.9	122.1	31.0	123.2
H. ECF Disbursements	16.1	75.1	55.7	250.2	28.9	122.1	31.0	123.2
I. Remaining financing gap (G-H)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Yemeni authorities; and IMF staff estimates.
1/ The amount is part of allocation of IDA-17 to Yemen.
2/ Includes US$100 million loan from the Arab Monetary Fund for 2014.

directly to finance the Budget and help close the financing gap (Text Table 1). The CBY and Ministry of Finance will sign a Memorandum of Understanding on the use of Fund resources, which specifies responsibilities for timely servicing financial obligations to the Fund and for maintenance of a specific government account at the CBY to receive the Fund financing (prior action; MEFP, Table 2).

19. The program also aims at improving the structure of expenditure and revenue, and at further reducing the fiscal deficit over the medium term. The authorities agreed that the structure of expenditure is currently inconsistent with supporting growth, job creation, and social protection, and that fiscal consolidation needs to continue in the years ahead. The program therefore aims at steadily reducing the overall deficit to 4.2 percent of GDP over the medium term, by increasing nonhydrocarbon revenue and reducing lower-quality expenditures. At the same time, higher-quality public expenditure (such as direct social transfers and infrastructure investment) will be increased. The underlying fiscal position (nonhydrocarbon primary balance excluding grants), which is the fiscal anchor of the reform program, will thus improve during the program period by about 6 percent of GDP. This fiscal adjustment path is laid out in Text Table 2, and its supporting measures are detailed below. Public debt will be kept below 50 percent of GDP, and the need for domestic financing will decline by half to more than 3.5 percent of GDP, thus reducing fiscal dominance. The improvement in the fiscal deficit will also reduce the pressure on the external position and would therefore help protect gross reserves.

Text Table 2. Republic of Yemen: Summary of Fiscal Adjustment, 2014–18

(In percent of GDP)

	2013	2014	2015	2016	2017	2018
A. Saving measures	**3.0**	**2.4**	**4.2**	**0.6**	**0.7**	**0.7**
Increase in tax revenue	0.0	1.2	0.6	0.3	0.5	0.4
Reduction in wage bill	0.9	0.4	0.3	0.3	0.2	0.3
Reduction in subsidies	2.1	0.8	3.3	0.1	0.0	0.1
B. Transfers and capital expenditures	**1.9**	**0.2**	**-2.4**	**-0.2**	**-0.1**	**-0.1**
Increase in targeted transfers	0.6	0.2	-0.9	-0.3	-0.1	0.0
Increase in capital expenditures	1.3	0.0	-1.5	0.0	0.0	-0.1
A+B	**4.9**	**2.6**	**1.8**	**0.4**	**0.7**	**0.6**
Changes in other budget lines net: savings (+)	**0.94**	**-0.04**	**0.26**	**-0.08**	**0.18**	**0.05**
Decline in nonhydrocarbon primary balance excluding grants	**5.9**	**2.6**	**2.1**	**0.3**	**0.8**	**0.7**
Memorandum items:						
Overall fiscal deficit	-6.9	-5.4	-5.0	-4.7	-4.3	-4.2
Nonhydrocarbon primary balance	-14.3	-11.3	-9.6	-9.5	-8.7	-7.9
Excluding grants	-15.2	-12.7	-10.6	-10.3	-9.4	-8.8

Sources: Yemen authorities; and IMF staff etimates.

20. A centerpiece of the reform package is designed to respond to the recent decline in oil revenue and fuel shortages by reforming energy subsidies. Official fuel prices are currently at about half of international levels. The large subsidy has been benefiting the rich disproportionately and creating an incentive for smuggling, corruption, and inefficient use of fuel, including by the small electricity producers. At the same time, fuel is largely unavailable to the population at subsidized prices, and black market prices are reported to have reached international levels. As a first step toward eliminating these subsidies, the authorities agreed to allow the private sector to directly import fuel or buy it from the Aden refinery, for their own use at international prices. A decision to this effect was issued shortly after the mission and was implemented starting in June 2014. This measure will create savings of close to 0.3 percent of GDP, or $130 million in the remainder of 2014 (prior action; MEFP, ¶ 23). Second, the official fuel prices will be adjusted in October by about 50 percent on average (MEFP, ¶20). These price adjustments would reduce the subsidy bill by about 3.5 percent of GDP on an annual basis, although the saving in 2014 will be limited to 0.2 percent due to the two-month lag in settling the subsidy bill (Box 2; and MEFP, ¶23). Lastly, an asymmetric price adjustment mechanism will be introduced in mid-2015; this mechanism will allow domestic prices to increase in response to increases in international prices and gradually eliminate the residual subsidy over time. Staff initially suggested that the automatic price mechanism be put in place before end-2014. It was, however, agreed to first assess the impact of the October reforms, and then conduct a study to design the proposed system. The authorities requested TA from FAD to ensure proper design and implementation.

21. The authorities will also postpone implementation of a 2012 decision to increase wage allowances. This will generate about 0.4 percent of savings in 2014. The program entails a civil service reform that will be phased in over the medium term. The authorities believe that reforms on this front will require more time for preparations that include identifying ghost workers and double-dippers. Thus, immediate measures will aim to steadily move from cash payment of wages and salaries to payments using bank account and postal services (MEFP, ¶24, Table 2). Implementation of the biometric identification system will be gradually generalized throughout the civil service and the military, and a census of personnel will be implemented (MEFP, ¶24, Table 2).

22. The need to immediately improve social protection was also agreed. Yemen's Social Welfare Fund (SWF) already covers about 40 percent of the population and is considered one of the best-operating funds in the region. However, other large inefficient public expenditures have left little resources for the fund's transfers to the poor. The implementation of subsidy reform would free substantial resources for the SWF and other high-quality expenditures. The program, therefore, entails a 50 percent increase in SWF transfers to the poor, concurrent with the fuel price adjustments in October (MEFP, ¶23). This would allow for raising the average monthly transfer per family from about $18 to about $27. Coverage of the SWF will continue to be improved, with the help of the World Bank and other partners.

23. Another part of the savings from fuel subsidies reform will be used to increase infrastructure investment over the medium term. This would help spread the social impact of reforms beyond the SWF, and would boost job-creation and potential growth. Capital spending has been crowded out by fuel subsidies and the large wage bill. Since 2010, its level in relation to GDP was halved to reach a low of 2.4 percent. This contributed to the sharp decline in gross domestic investment, which fell to well below 10 percent of GDP. At the same time, Yemen's need for infrastructure investment, including roads, utilities, and irrigation, is large and increasing. The program will therefore aim at protecting capital spending in relation to GDP in the remainder of 2014, and then steadily increasing it to about 4 percent of GDP over the medium term. Priority will be given to infrastructure expenditures and efficient public works that are labor intensive. These will be geographically spread and transparently tendered, to improve inclusiveness and governance. Part of these investments will be implemented through the Social Development Fund (SDF) which has a good track record in supporting SMEs. Furthermore, the domestic component of foreign-financed projects will be secured and timely implemented in coordination with the Executive Bureau so as to maximize the catalytic effect of public investment.

24. On the revenue side, reforms will target enhancing tax revenue collection by about 1.2 percent of GDP in 2014. The authorities believed that passing new tax legislation would be very difficult before the writing of the constitution and the elections planned for next year. Therefore, for 2014, discussions focused on tax and customs administration measures to simplify procedures, enhance compliance, and fight fraud and smuggling (MEFP, ¶25). Tax compliance in Yemen is very low by regional and international standards (Figure 3). Yemen has shown a strong track record in this area in recent years and there remains substantial scope for continued improvement, building on the progress made thus far. The authorities are determined to continue to improve filing and payment compliance to 65 percent by end-2014. Furthermore, the authorities will produce an inventory of all existing exemptions and reduced tax rates, and refrain from introducing any measures that would expand the scope of tax and customs exemptions, including any amendments to the 2010 investment law. Reforms in 2015 will include a review of the GST law and the assessment of the revenue impact of existing tax exemptions, with a view to streamlining them.

25. The authorities have prepared a contingency plan to offset the impact of downside risks, should these materialize. The government will closely monitor developments in budget financing resources and expenditure implementation, and will adjust programmed spending plans as needed, should there be shortfalls in the financing. At the same time, the government will resist any new spending beyond the allocated spending envelopes in the revised framework, except for security and the requirements of political transition (MEFP, ¶21). Should there be need for emergency spending, authorization for such expenditure will be accompanied by simultaneous instructions for compensatory cuts on lower-priority spending. The government will also avoid accumulation of arrears. It will put in place a system to monitor and report expenditure arrears on a quarterly basis, and will adopt a gradual program to clear all outstanding arrears over the medium term (MEFP, ¶29).

26. Public finance management reforms will aim at strengthening budget execution and reporting. The authorities will complete the deployment of the Accounting-based Financial Management Information System (AFMIS) into 55 spending units by the end of 2014. In the following years, they will implement a strategy to transfer the treasury functions from the CBY to the

Ministry of Finance in line with past TA recommendations. In addition, ongoing reforms should take into account future plans to introduce fiscal federalism and ensure that appropriate expenditures and debt-contracting procedures and controls are introduced to safeguard fiscal discipline under the prospective federal system.

27. The authorities will strengthen infrastructure implementation capacity as well as donor aid coordination. To improve the quality of public sector investment and help catalyze donors' disbursements, the government has been undertaking reforms to strengthen project selection, procurement, implementation, and monitoring, in close coordination with the World Bank and other donors (MEFP, ¶27). To this end, it established the Executive Bureau in 2013, to help speed up disbursement of donor support and strengthen project management. Furthermore, the government, with the assistance of the World Bank, has set up the Mutual Accountability Framework to monitor progress in donors' assistance.

28. The risk of debt distress is currently assessed to be moderate (Supplement for Joint Debt Sustainability Analysis). Nevertheless, the government is committed to neither contract nor guarantee nonconcessional external debt, except from international and regional development institutions, from which it will only borrow at the most concessional terms these institutions provide. The government will also seek to speed up the promised support from donors. The focus will be on mobilizing budgetary grants in order to minimize the impact on the debt burden.

Box 2. Yemen: Reform of Fuel Subsidies

The government intends to raise domestic prices of several petroleum products in October 2014. Prices will increase by 50 Yemeni rials per liter for gasoline, kerosene, and diesel; and by 800 Yemeni rials per gas cylinder. This represents an average price increase of about 50 percent, which will halve the current gap with international prices. Although well-off households disproportionately benefit from fuel subsidies, the impact of their reduction cannot be ignored. According to past FAD TA, increasing fuel prices to full pass-through levels will lead to a reduction of about 10 percent in real household income for households in the bottom 40 percent of the income distribution. In addition, decision was made, and implemented, in June to allow the private sector to import part of its diesel requirements at international prices. The decision is expected to cover about 20 percent of total diesel consumption.

To mitigate the impact of higher prices on the poor, the authorities will increase allocations for the Social Welfare Fund (SWF) by 50 percent. Currently, the SWF provides cash transfers to more than 1.5 million households or roughly 40 percent of the total population. The government intends to use part of the savings from the subsidy reform to increase monthly cash transfers from about $18 to about $27 per household. At the same time, it will work in close collaboration with the World Bank to improve the coverage of the SWF, phasing out transfers to noneligible beneficiaries and include additional eligible beneficiaries. Savings from the reform will also be used to finance growth-enhancing and poverty-reducing capital spending.

The expected savings from the reform amount to 3.5 percent of GDP over the program period. In 2014, savings from fuel price increases will be limited to about 0.2 percent of GDP because government payments for subsidies generally take place with a delay of one to two months. Additional savings of $130 million in the remainder of 2014 will be generated from allowing private sector to import diesel at international prices. In 2015, the full impact of the reform is expected to reduce the subsidy bill by about 3.5 percent of GDP. Beyond 2015, additional savings would continue to be reaped from improvements in efficiency and reduced smuggling.

With TA from the Fund, the government is also planning to introduce an asymmetric fuel price adjustment mechanism to reflect movements in international fuel prices. This will help depoliticize pricing of energy and increase the expected savings from the subsidy reform over the medium term. In this context, the authorities will consider adopting a smoothing rule to avoid sharp increases in domestic prices and unsettle inflationary expectations.

B. Monetary and Exchange Rate Policies

29. Given the difficult fiscal and financing situation, the current monetary stance will be continued for the remainder of 2014. With inflation currently at around 8 percent, the real interest rate is rather high. It would, however, be prudent to postpone any reduction in the policy rate in order to contain the inflationary pressure expected from the necessary adjustments in fuel prices. Inflation is projected to increase to about 13 percent following the increase in fuel prices in October.

CBY will remain vigilant and will stand ready to adjust policies as needed to preserve macroeconomic stability (MEFP, ¶31). As the inflationary impact of the fuel price increases fades, and the macroeconomic policy mix improves with the decline in the fiscal deficit, there will be scope to gradually reduce interest rates. The authorities are also determined to strengthen the central bank's independence and to refocus its primary role on maintaining low inflation.

30. The CBY will aim to modernize its monetary policy framework and to strengthen the channels of transmission of its monetary policy instruments. The current framework of direct control of interest rates and reliance on the primary market of government paper would be gradually phased out in favor of a more efficient indirect approach to monetary policy that will give greater signaling role to the central bank policy interest rate and would help develop the interbank market and also enable banks to improve liquidity management. The Sukuk market, which was introduced in 2011, continues to develop, and provides Islamic banks with additional investment opportunities to place their liquidity. Progress on this front has been limited, in part due to delayed Fund TA because of the security concerns. The CBY requested a diagnostic mission and subsequent technical assistance to enhance its liquidity management capacity and improve inflation forecasting.

31. The Central Bank will refrain from lending to the government.[4] At the same time, the Ministry of Finance will sign a memorandum of understanding spelling out a schedule for bringing the government's outstanding debt to the CBY within legal limits (prior action; MEFP, ¶32, Table 2). Furthermore, and in line with the recommendations of the safeguards assessment mission, the CBY will finalize another agreement with the Ministry of Finance, specifying the repayment terms and interest rates on credit extended by the CBY to public sector enterprises. Given the plans to use the IMF disbursement for budgetary financing, CBY will formalize with the Ministry of Finance the respective responsibilities for servicing obligations to the Fund (see ¶18 above). Furthermore, the planned review of the central bank law will look at areas to further strengthen its independence.

32. Greater exchange rate flexibility over the medium term would help preserve reserves and support competitiveness. The CGER-type econometric analyses are not conclusive (Annex I). While the macroeconomic balance approach points to a possible moderate overvaluation of the real exchange rate, the external sustainability approach suggests a substantial undervaluation. These results should, be interpreted with caution, because of data limitations and the structure of the Yemeni economy—largely dominated by the hydrocarbon sector.[5] Although the real exchange rate appreciated somewhat in 2013, the performance of nonhydrocarbon exports and remittances appears not to have been affected. However, Yemen's relatively high domestic inflation and the recent depreciation in the currencies of its key trading partners have negative implications for

[4] The legal limit on government borrowing from the central bank is equivalent to 25 percent of the annual average of the budget's ordinary revenue for the three financial years immediately preceding for which accounts are available.

[5] There is a need to improve data on private sector financial flows and stocks, in particular those relating to net foreign assets of the economy as a whole and nonhydrocarbon FDI. Furthermore, reliable data on relative productivity are not available.

competitiveness. A gradual increase in exchange rate flexibility over the medium term is needed to help protect reserves and support exports and economic growth over the medium term, and to ease the pressure on monetary policy. A strengthened monetary policy framework as discussed in ¶30, would be important to increase exchange rate flexibility. CBY's intervention in the foreign exchange market will aim at smoothing out exchange rate volatility, while allowing the exchange rate to respond to market fundamentals (MEFP, ¶33). With reform implementation and increased external financing under the ECF arrangement, gross reserves are projected to remain above three months of imports over the medium term. The program sets a floor on net international reserves of the central bank to ensure this outcome.

C. Financial Sector Reforms

33. Bank supervision will be further strengthened to ensure the soundness of the system. Consolidated supervision will be introduced and the legal powers of the CBY strengthened to enable cross-border supervision. The CBY will also improve the enforcement of prudential regulations as well as the recently issued banking corporate governance guidelines. Furthermore, CBY will develop, in collaboration with METAC, prudential regulations that address the risks specific to Islamic banking. In addition, the banking and central bank laws will be strengthened to address gaps in the CBY's power to resolve banks (MEFP, Table 2). To this end, the CBY requested TA from the IMF Legal Department in drafting the necessary changes to the banking law, and will aim to complete the drafting of the amendments and submit them to parliament in 2015. Further reforms will aim at strengthening the Prompt Corrective Action, which specifies rule-based penalties against banks that exhibit progressively deteriorating capital ratios, in collaboration with METAC.

34. The program aims at improving access to financial services in order to support inclusive growth. Reforms in this area include strengthening the public credit registry and payments system. In 2009 the CBY issued a law on microfinance banks and licenses have been issued to two deposit-taking institutions to provide microfinance; a third, preliminary license has been issued. The authorities will build on this progress by promoting mobile and branchless banking, and will issue the required regulation in collaboration with CGAP and USAID. Furthermore, the insolvency regime and functioning of commercial courts will be improved to enhance the banking system's capacity to enforce foreclosure on collateral.

35. The authorities have made significant improvements to the AML/CFT legal framework. They brought into force amendments to the AML/CFT Law aimed at more comprehensive criminalization of money laundering and terrorist financing, and issued regulations on the freezing of terrorist assets, with a view to addressing the strategic deficiencies that were identified by FATF. Going forward additional resources should be allocated to bolster the effective implementation of the regime.

D. Structural Reforms and Other Issues

36. The structural reform agenda aims to improve the business environment and promote inclusive growth. In addition to the macro-critical structural reforms in the fiscal and financial sector areas, the program focuses on other structural reforms that are also macro-critical from the growth and job-creation perspective. In particular, Yemen's rank in the World Bank's report for doing business environment further deteriorated to 133 in 2013, from 129 a year earlier. The authorities will implement reforms to address the deficiencies identified in the underlying survey; these reforms include streamlining the procedures for starting new businesses, simplifying tax and customs processes, and strengthening property rights and contract enforcement. Structural benchmarks include specific measures to simplify the operations of customs and tax assessment and dispute processes (MEFP, Table 2) in order to address one of the lowest rated categories in the doing business survey. A Public-Private-Partnership law has been drafted and will be reviewed by the IFC to ensure that is in line with its earlier TA recommendations. The above structural reforms, as well as the reorientation of public expenditure to social transfers and infrastructure expenditure, will be instrumental in creating jobs and reducing poverty.

37. The Parliament recently ratified Yemen's accession to the WTO. In addition, Yemen has become fully compliant with the EITI requirements; its suspended membership has been restored. 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. The exchange rate regime is classified as a "stabilized arrangement."

38. Yemen participates in the GDDS and data are broadly adequate for surveillance. However, there is a need to improve statistics in the areas of national accounts and CPI, BOP and IIP, and financial soundness indicators.

39. The authorities have recently strengthened their outreach effort. The need for and benefits from the nationally-owned reforms have been highlighted by the President in high-profile statements and speeches. An interagency outreach coordination committee has been formed, and is being facilitated by the Executive Bureau. A societal dialogue has been launched, with seminars and public communication focusing on the necessity and benefits of subsidy reforms.

PROGRAM MODALITIES AND CAPACITY TO REPAY THE FUND

40. The proposed ECF-supported program will cover the three-year period 2014–17. It will be monitored through performance criteria, indicative targets, structural benchmarks, and semi-annual reviews. The first two six-monthly reviews will be conducted based on the proposed quantitative performance criteria and indicative targets through end-June 2015 (MEFP, Table 1), and structural benchmarks in the fiscal, monetary, and financial sector policy areas (MEFP, Table 2). The review test dates for these two reviews will be end-December 2014 and end-June 2015. The definitions of the quantitative performance criteria and related adjusters will be described in detail in the Technical Memorandum of Understanding (TMU) attached to the MEFP. The authorities will produce a poverty reduction strategy paper by the second review, building on the current Transitional Program for Stability and Development document.

41. Yemen's capacity to repay the Fund is adequate. Proposed access is 150 percent of quota (SDR 365.3 million), reflecting the balance of payments need and the strength of the reform program. There will be seven disbursements under the ECF arrangement designed to be commensurate with the reform efforts (Table 11). As of end-December 2013, the Fund's exposure to Yemen stood at SDR 95.7 million, equivalent to 3 percent of gross official reserves and 1.6 percent of exports of goods and services. The first repayment is not due until 2016 and is moderate at SDR 7 million; the peak of SDR 73 million in 2023 does not represent a significant burden. Given this initial low exposure and the macroeconomic projections under the program, capacity to repay the Fund will remain adequate, with repayments remaining below 6 percent of exports of goods and services (Table 12). The DSA also indicates that Yemen remains at moderate risk of distress, notwithstanding downside risks related particularly to security and, thus, oil output projections.

42. A safeguard assessment was completed in 2013. A new full safeguard assessment will be completed by the first review under a new ECF arrangement. Risks to the program are mitigated by the strong prior actions, the phased disbursement schedule commensurate with reform implementation, and the authorities' contingency plan to address downside risks should these materialize.

STAFF APPRAISAL

43. Yemen has made tangible progress in advancing the political transition, but the fledgling economic recovery remains vulnerable. The National Dialogue was concluded in early 2014, and an agreement was reached to establish a six-region federal state. A new constitution is being drafted, with a view to clarifying the degree of autonomy of the regions. The authorities have been successful in preserving macroeconomic stability; however, real GDP growth remained well below the level required to make a dent in the very high poverty and unemployment levels. Sabotage of oil pipelines has intensified since early 2014, weakening the fiscal and external positions, and leading to severe fuel and electricity shortages.

44. In view of these challenges, the authorities' decision to embark on a strong reform program is welcome. The program aims at reducing the large fiscal deficit and reorienting public expenditure to pro-growth, pro-poor outlays. It also aims at strengthening public financial management, enhancing governance and the business environment, and improving bank soundness and financial intermediation, to support inclusive growth and job-creation.

45. Staff supports the authorities' request for an ECF. The ECF arrangement will give an impetus to the implementation of the strong reform package, and has helped catalyze donor support to close the financing gap. The above-norm access of 150 percent of quota is proposed in consideration of the large financing needs and the strength of reforms to be introduced in the context of the difficult economic and political situation and high level of poverty. Staff urges the authorities to implement the agreed reforms according to the time plan, as any delay could destabilize the macroeconomic environment and undermine the program's short- and long-term objectives. ECF disbursements will go directly to finance the government budget and, together with donor support, will close the financing gap.

46. The ECF-supported program entails strong fiscal adjustment and effective measures to protect the poor. This is to be achieved through reforms to reduce untargeted subsidies, contain the wage bill, and enhance tax revenue mobilization. Staff therefore welcomes the recent decision to allow the private sector to import part of its diesel requirements at international prices. In addition to this measure, fuel prices will be increased in October 2014 by about 50 percent on average, thus eliminating half of the subsidy. Ghost workers and double-dippers will be removed from the payroll by steadily generalizing the use of biometric identification cards and making wage payments though bank accounts and post offices. It is also important to introduce measures to fight smuggling, and to gradually bring the compliance rate for tax filing and payment towards more reasonable levels, building on the recent promising progress achieved in this area. At the same time, targeted transfers to the poor will be increased by 50 percent concurrently with the adjustment in fuel prices. Infrastructure investment will be gradually increased from its current low level, in order to boost job creation and potential growth. The government will also improve public finance management, including completing the deployment of the Accounting-based Financial Management Information System (AFMIS) and implementing a strategy to transfer the treasury function from the CBY to the Ministry of Finance.

47. Monetary policy will remain prudent to limit the expected increase in inflation resulting from the necessary fuel price adjustments. Over the medium term, reform implementation will help reduce fiscal dominance and modernize the monetary policy framework with the view to enhancing the transmission mechanism and strengthening the role of the central bank in preserving low inflation and macroeconomic stability.

48. While the export performance and remittances appear not to have been affected so far, greater exchange rate flexibility in the medium term would help enhance competitiveness. The exchange rate assessment is inconclusive, partly due to data limitations. Gradually moving to a more flexible exchange rate, however, would help preserve foreign exchange reserves, and reduce the burden on monetary policy. In this connection, staff encourages the central bank to limit its intervention in the foreign exchange market to reducing exchange rate volatility.

49. Reforms of the financial sector aim at strengthening the regulatory and supervisory framework and enhancing financial sector infrastructure. Primary reforms aim at strengthening consolidated and cross-border supervision. Further regulatory reforms include developing regulation to address risks specific to Islamic banking, and to strengthening the CBY's powers to resolve banks AML/CFT supervision. There is also a need to strengthen the public credit registry, improve the working of commercial courts, and encourage the development of branchless and mobile banking.

50. Improving governance and public service delivery is another important pillar of the government agenda to encourage inclusive, private sector-led growth. Reforms in this area focus on improving the business environment and enhancing transparency and accountability. Additional reforms are aimed at enhancing the government's implementation capacity, to help better mobilize donor support and improve public infrastructure investment.

51. Staff underscores the importance of proper design and strengthening of institutional capacity to ensure a smooth transition to fiscal decentralization. The ongoing drafting of the constitution is expected to lay out the basis for the new federal system, and potentially have significant implications for the conduct of government financial operations and fiscal policy going forward. In this regard, staff highlighted the need to ensure adequate control of expenditure and debt contracting, and a clear devolution of responsibilities commensurate with the prospective transfer of resources. Furthermore, there will be need for gradualism during the implementation phase to allow sufficient time for capacity building, so as to safeguard fiscal discipline and adequate service delivery during the transition.

52. The support of the international community will continue to be essential in the period ahead. Yemen is launching a strong reform program under very difficult conditions. Domestic financing is limited and the increase in and/or shift of part of donor support to finance the budget and close the fiscal/BOP gaps is essential to help the program go forward and enable the financing of much-needed investment and social expenditure.

53. If the Executive Board approves the proposed ECF arrangement, the next Article IV consultation with Yemen would be expected to take place under the 24-month cycle, in accordance with the Executive Board Decision on Article IV consultation cycle as applied to countries with a Fund Arrangement.

Box 3. Yemen. Risk Assessment Matrix [1/]		
Nature/source of main threats	**Overall Level of Concern**	
	Likelihood of realization in the next three years	**Expected impact on Yemen if risk is realized**
	Global Risks	
Sustained decline in commodity prices, particularly oil	**Medium:** Decline in oil prices may be triggered by deceleration of global demand and coming on stream of excess capacity in the medium term	**High:** Yemen's economy is highly dependent on oil for export and budget revenues. Thus, growth would decelerate noticeably, mainly due to reduced oil exports and a fall in oil-related capital flows. The Rial could come under sustained downward pressure.
Protracted period of slower growth in emerging markets, especially China	**High:** Emerging markets have been showing signs of slowing down.	**High:** China is a key trading partner and accounts for about 27 percent of exports. Yemen's growth would be affected through trade (lower external demand) channels
A reduction in domestic demand in Saudi Arabia	**Low:** The Saudi economy is currently performing well and substantial financial resources provide the fiscal space to respond to shocks	**High:** Saudi Arabia is the largest market for non-oil exports and the largest host of Yemenis working abroad. A reduction in demand would substantially affect Yemen's current account and unemployment.
	Country Specific Risks	
Political instability and/or a deterioration in security	**Medium**	**High:** The political transition is fragile as tensions persist and high unemployment, especially among the youth, persists. If the risks materialize, it would disrupt economic activity and test the political resolve to implement reforms.
Decline in oil production	**Medium**	**High:** Oil production has been affected by sabotage activities and inadequate investments. Oil production will remain dependent on the evolution of these two factors.

Box 3. Yemen. Risk Assessment Matrix 1/ (concluded)		
Shortfall in donor support	**Medium**	**High:** Shortfalls in disbursement of pledged donor funds would further reduce capital expenditures and increase domestic financing needs.
Political election cycle could lead to fiscal overruns.	**Medium:** Presidential and parliamentary elections are scheduled to take place in 2015 as soon as a new constitution is ratified; thus the potential for election-related expenditure pressures is high. Added to this are the wage negotiations for the South.	**High:** A further deterioration in the fiscal deficit could erode the government's capacity to service its debt, given the excessive exposure of the banking system to government debt.
Federalism could increase expenditure and debt	**Medium:** Yemen has decided to move to a federal structure of government	**High:** Fiscal federalism will need to be carefully designed and backed by adequate institution and capacity building, in order to support fiscal discipline and ensure prudent contracting of debt, sharing fiscal information among levels of government, quality of information to be shared and macrofiscal analysis, and enhancing expenditure policy coordination.

1/ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 percent and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Table 1. Republic of Yemen: Selected Economic Indicators, 2010–18

	2010	2011	2012	2013	2014	2015	2016	2017	2018
				Prel.	Proj.	Proj.	Proj.	Proj.	Proj.
	(Change in percent, unless otherwise indicated)								
Production and prices									
Real GDP at market prices	7.7	-12.7	2.4	4.8	1.9	4.6	4.7	5.2	5.9
Real nonhydrocarbon GDP	4.4	-12.5	4.0	4.0	3.0	4.5	5.0	5.5	6.5
Real hydrocarbon GDP	46.9	-14.5	-11.5	13.2	-8.3	5.4	1.4	1.6	-1.3
Consumer price index (annual average)	11.2	19.5	9.9	11.0	9.0	11.4	8.5	8.0	7.8
Consumer price index (eop)	12.5	23.2	5.8	8.1	13.0	9.0	8.0	8.0	7.5
Hydrocarbon production (1,000 barrels/day)	426	364	322	365	334	352	357	363	358
Crude oil 1/	264	197	155	175	167	185	190	196	191
LNG (oil equivalent)	162	167	167	190	167	167	167	167	167
	(In percent, of GDP)								
Government finance									
Total revenue and grants	26.1	25.3	29.9	23.9	23.9	22.7	22.9	23.0	22.4
Total expenditure	30.2	29.8	36.2	30.8	29.3	27.7	27.6	27.3	26.6
Overall fiscal balance (cash basis)	-4.1	-4.5	-6.3	-6.9	-5.4	-5.0	-4.7	-4.3	-4.2
Primary fiscal balance (cash)	-1.7	-0.2	-0.9	-1.5	-0.1	0.0	0.2	0.5	0.3
Nonhydrocarbon primary fiscal balance (cash)	-18.2	-16.7	-15.0	-14.3	-11.3	-9.6	-9.5	-8.7	-7.9
Excluding grants	-19.4	-17.9	-21.1	-15.2	-12.7	-10.6	-10.3	-9.4	-8.8
Gross Public Sector Debt	42.4	45.7	47.3	48.2	48.2	47.4	48.0	47.8	47.4
External debt	19.9	18.6	17.4	15.2	13.7	13.2	13.7	14.0	14.2
Domestic debt	22.5	27.1	29.9	33.0	34.5	34.2	34.3	33.8	33.2
	(Twelve-month change in percent)								
Monetary data									
Broad money	9.2	0.0	21.5	12.5	11.2	…	…	…	…
Reserve money	7.7	15.8	12.9	1.9	5.7	…	…	…	…
Credit to private sector	8.2	-16.9	-0.6	38.9	12.0	…	…	…	…
Benchmark deposit interest rate (percent)	20.0	20.0	18.0	15.0	15.0	…	…	…	…
Velocity (non-oil GDP/M2)	2.4	2.3	2.4	2.4	2.4	…	…	…	…
	(In millions of U.S. dollars, unless otherwise indicated)								
External sector									
Exports, f.o.b.	7,648	8,662	7,349	7,639	9,024	10,535	10,620	10,801	10,762
Hydrocarbon	6,279	7,731	6,332	6,537	7,880	9,328	9,340	9,439	9,304
Nonhydrocarbon	1,369	931	1,017	1,101	1,144	1,207	1,279	1,362	1,458
Imports, f.o.b.	-8,473	-8,543	-10,240	-9,892	-10,211	-10,283	-10,592	-11,088	-11,772
Hydrocarbon	2,073	2,578	3,840	3,265	3,373	3,138	3,089	3,136	3,303
Nonhydrocarbon	6,400	5,964	6,400	6,627	6,837	7,145	7,502	7,953	8,469
Current account (percent of GDP)	-3.4	-3.0	-1.7	-3.1	-1.3	-1.1	-1.4	-1.4	-1.7
Memorandum items									
Gross foreign reserves	5,081	3,974	5,590	4,854	3,448	3,465	3,988	4,570	4,966
In months of imports	5.7	3.7	5.5	4.5	3.2	3.1	3.4	3.7	3.8
Exchange rate (eop) (YRls per U.S. dollar)	213.8	213.8	214.89	214.89	…	…	…	…	…
Real effective exchange rate (2008 = 100)	98.9	116.2	122.5	130.3	…	…	…	…	…
Nominal GDP at market prices									
In billions of Yemeni rials	6,787	6,997	7,587	8,685	9,767	11,338	12,653	14,210	15,998
In millions of U.S. dollars	30,907	32,726	35,401	40,415	…	…	…	…	…
Per capita GDP (in U.S. dollars)	1,267	1,302	1,368	1,516	…	…	…	…	…
Population (in thousands)	24,398	25,130	25,884	26,660	…	…	…	…	…

Sources: Yemeni authorities; and IMF staff estimates.

1/ The sharp declines in crude oil production reflects sabotage of oil pipeline, in 2011, 2012, and 2014.

Table 2. Republic of Yemen: General Government Finances, 2010–18

(In Billions of Yemeni rials)

	2010	2011	2012	2013	2014			2015	2016	2017	2018
				Prel.	Gov. Approved Budget	Proj. without adjustment	Proj. With adjustment	Proj.	Proj.	Proj.	Proj.
Total revenue and grants	1,774	1,773	2,269	2,076	2,167	2,206	2,338	2,575	2,896	3,269	3,586
Hydrocarbon revenue	1,120	1,156	1,071	1,115	983	1,092	1,092	1,084	1,230	1,309	1,315
Of which:											
Crude oil exports	577	749	764	598	339	494	494	479	512	517	485
LNG exports	21	38	34	76	137	143	143	156	285	364	412
Hydrocarbon domestic revenue	522	369	273	440	508	455	455	449	433	428	417
Nonhydrocarbon revenue	571	533	734	879	1,059	1,027	1,110	1,377	1,569	1,853	2,136
Tax revenue	450	377	534	613	758	724	809	1,010	1,164	1,378	1,611
Income taxes	210	186	250	276	325	329	356	447	501	588	678
Taxes on goods and services	164	125	187	219	265	253	284	349	416	483	582
Custom taxes	65	55	85	104	150	131	151	194	226	283	325
Other taxes	11	12	13	14	18	11	18	20	22	24	26
Nontax	121	156	200	266	301	302	300	366	405	475	525
Grants	83	84	464	82	124	86	136	114	97	108	135
Total expenditure and net lending	2,050	2,088	2,748	2,675	2,813	3,083	2,863	3,143	3,496	3,882	4,251
Current expenditure	1,734	1,948	2,467	2,470	2,298	2,810	2,633	2,706	3,014	3,346	3,632
Wages and salaries	590	701	840	885	977	988	957	1,079	1,170	1,283	1,401
Goods and services	188	168	224	228	262	284	259	297	333	370	410
Operations and maintenance	27	26	33	24	31	31	30	36	40	44	47
Interest obligations	163	303	413	473	415	568	516	564	627	687	712
Domestic	148	288	398	457	396	547	495	542	602	660	684
External	15	15	15	15	19	20	20	22	25	26	28
Subsidies and transfers	734	713	912	812	561	904	817	676	779	888	988
Subsidies	591	567	708	629	386	708	629	361	394	438	484
Transfers	143	146	204	183	175	196	187	315	384	450	504
Social welfare fund				65	66	-	73				
Pensions and social security				70	78	-	78				
Exceptional spending				13	0	-	0				
Other				35	31	-	36				
Other	33	36	45	49	52	36	55	54	65	73	74
Capital expenditure	316	140	281	205	514	273	230	436	482	536	618
Of which: foreign financed	0	140	104	66	162	121	141	198	214	250	344
Net lending	0	0	0	0		0	0	0	0	0	0
Overall balance	-275	-315	-479	-599	-646	-878	-525	-568	-600	-612	-665
Discrepancy	17	-44	-2	-26			0	0	0	0	0
Financing	341	360	481	625		525	525	568	600	612	665
External	38	-21	40	8			18	114	142	150	157
Of which:											
IMF ECF	0	0	0	0			16.1	55.7	28.9	31.0	0.0
Domestic	304	380	441	618			507	454	458	463	507
Financing gap						352	0	0	0	0	0
Memorandum items:											
Nonhydrocarbon primary balance (cash)	-1,233	-1,168	-1,137	-1,241		...	-1,101	-1,088	-1,203	-1,234	-1,268
Excluding grants	-1,316	-1,252	-1,601	-1,323		...	-1,237	-1,202	-1,300	-1,342	-1,403
Gross public debt	2,876	3,199	3,589	4,183		...	4,708	5,373	6,071	6,796	7,578
Domestic	1,527	1,899	2,272	2,864			3,371	3,875	4,334	4,804	5,314
External	1,349	1,300	1,317	1,318			1,337	1,498	1,737	1,992	2,264

Sources: Yemeni authorities; and IMF staff estimates.

Table 3. Republic of Yemen: General Government Finances, 2010–18

(In Percent of GDP)

	2010	2011	2012	2013	2014		2015	2016	2017	2018
				Prelim.	Proj. without adjustment	Proj. with adjustment	Proj.	Proj.	Proj.	Proj.
Total revenue and grants	26.1	25.3	29.9	23.9	22.6	23.9	22.7	22.9	23.0	22.4
Hydrocarbon revenue	16.5	16.5	14.1	12.8	11.2	11.2	9.6	9.7	9.2	8.2
Of which:										
Crude oil exports	8.5	10.7	10.1	6.9	5.1	5.1	4.2	4.0	3.6	3.0
LNG exports	0.3	0.5	0.4	0.9	1.5	1.5	1.4	2.2	2.6	2.6
Hydrocarbon domestic revenue	7.7	5.3	3.6	5.1	4.7	4.7	4.0	3.4	3.0	2.6
Nonhydrocarbon revenue	8.4	7.6	9.7	10.1	10.5	11.4	12.1	12.4	13.0	13.4
Tax revenue	6.6	5.4	7.0	7.1	7.4	8.3	8.9	9.2	9.7	10.1
Income taxes	3.1	2.7	3.3	3.2	3.4	3.6	3.9	4.0	4.1	4.2
Taxes on goods and services	2.4	1.8	2.5	2.5	2.6	2.9	3.1	3.3	3.4	3.6
Custom taxes	1.0	0.8	1.1	1.2	1.3	1.5	1.7	1.8	2.0	2.0
Other taxes	0.2	0.2	0.2	0.2	0.1	0.2	0.2	0.2	0.2	0.2
Nontax	1.8	2.2	2.6	3.1	3.1	3.1	3.2	3.2	3.3	3.3
Grants	1.2	1.2	6.1	0.9	0.9	1.4	1.0	0.8	0.8	0.8
Total expenditure and net lending	30.2	29.8	36.2	30.8	31.6	29.3	27.7	27.6	27.3	26.6
Current expenditure	25.5	27.8	32.5	28.4	28.8	27.0	23.9	23.8	23.5	22.7
Wages and salaries	8.7	10.0	11.1	10.2	10.1	9.8	9.5	9.2	9.0	8.8
Goods and services	2.8	2.4	3.0	2.6	2.9	2.7	2.6	2.6	2.6	2.6
Operations and maintenance	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Interest obligations	2.4	4.3	5.4	5.4	5.8	5.3	5.0	5.0	4.8	4.5
Domestic	2.2	4.1	5.2	5.3	5.6	5.1	4.8	4.8	4.6	4.3
External	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Subsidies and transfers	10.8	10.2	12.0	9.3	9.3	8.4	6.0	6.2	6.3	6.2
Subsidies	8.7	8.1	9.3	7.2	7.2	6.4	3.2	3.1	3.1	3.0
Transfers	2.1	2.1	2.7	2.1	2.0	1.9	2.8	3.0	3.2	3.2
Social Welfare Fund				0.7	-	0.7				
Pensions and social security				0.8	-	0.8				
Exceptional spending				0.2	-	0.0				
Other				0.4	-	0.4				
Other	0.5	0.5	0.6	0.6	0.4	0.6	0.5	0.5	0.5	0.5
Capital expenditure	4.7	2.0	3.7	2.4	2.8	2.4	3.8	3.8	3.8	3.9
Of which: foreign financed	0.0	2.0	1.4	0.8	1.2	1.4	1.7	1.7	1.8	2.2
Overall balance	-4.1	-4.5	-6.3	-6.9	-9.0	-5.4	-5.0	-4.7	-4.3	-4.2
Discrepancy	1.0	0.6	0.0	0.3		0.0	0.0	0.0	0.0	0.0
Financing	5.0	5.1	6.3	7.2	5.4	5.4	5.0	4.7	4.3	4.2
External	0.6	-0.3	0.5	0.1		0.2	1.0	1.1	1.1	1.0
Of which:										
IMF ECF						0.2	0.5	0.2	0.2	0.0
Domestic	4.5	5.4	5.8	7.1		5.2	4.0	3.6	3.3	3.2
Financing gap					3.6	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Nonhydrocarbon primary balance (cash)	-18.2	-16.7	-15.0	-14.3		-11.3	-9.6	-9.5	-8.7	-7.9
Excluding grants	-19.4	-17.9	-21.1	-15.2		-12.7	-10.6	-10.3	-9.4	-8.8
Gross public debt	42.4	45.7	47.3	48.2		48.2	47.4	48.0	47.8	47.4
Domestic	22.5	27.1	29.9	33.0		34.5	34.2	34.3	33.8	33.2
External	19.9	18.6	17.4	15.2		13.7	13.2	13.7	14.0	14.2

Sources: Yemeni authorities; and IMF staff estimates.

Table 4. Republic of Yemen: Monetary Survey, 2010–14

(In Millions of Yemeni rials)

	2010	2011	2012	2013	2014
				Proj.	Proj.
Net foreign assets	1,693,179	1,380,298	1,569,802	1,393,530	1,145,244
Central Bank of Yemen	1,216,424	918,614	1,056,655	881,857	599,509
Commercial banks	476,755	461,684	513,147	511,673	545,734
Net domestic assets	573,970	887,966	1,186,960	1,708,371	2,305,513
Net domestic credit	1,319,762	1,637,180	2,060,696	2,615,833	3,142,756
Net claims on central government	780,456	1,092,435	1,409,893	1,809,925	2,277,515
Central Bank of Yemen	199,407	482,541	557,419	584,738	590,323
Commercial banks	581,049	609,894	852,473	1,225,187	1,687,191
Net claims on nongovernment enterprises	539,306	544,744	650,803	805,908	865,241
Claims on private sector by commercial banks	426,846	354,654	352,426	489,539	548,284
Claims on public enterprises	100,974	177,794	277,040	295,897	294,848
Claims on mixed enterprises	11,486	12,296	21,337	20,471	22,108
Pension fund deposits in CBY	-65,358	-59,437	-57,709	-17,982	-18,216
Other Items (net)	-745,792	-749,213	-873,735	-907,462	-837,243
Valuation adjustment	-236,203	-241,699	-256,292	-266,514	-266,514
Capital and reserves	-219,872	-227,994	-237,879	-261,056	-283,261
Other (net)	-289,717	-279,521	-379,564	-379,892	-287,468
Broad money	2,267,149	2,268,264	2,756,763	3,101,901	3,450,757
Money	786,560	993,031	1,104,820	1,116,921	1,165,736
Currency outside banks	547,284	777,407	803,336	785,108	767,180
Demand deposits	239,276	215,624	301,483	331,813	398,556
Quasimoney	637,268	613,548	857,689	1,098,558	1,299,158
Foreign currency deposits	777,964	602,249	736,545	868,440	967,647
Memorandum items:					
Broad money (annual percentage change)	9	0	22	13	11
Reserve money (annual percentage change)	8	16	13	2	6
Credit to private sector (annual percentage change)	8	-17	-1	39	12
Currency to broad money (in percent)	24	34	29	25	22
Foreign currency deposits to total deposits	45	40	38	37	36
Non-oil GDP velocity (average)	2	2	2	2	2

Sources: Central Bank of Yemen; and IMF staff estimates.

Table 5. Republic of Yemen: Summary Accounts of the Central Bank of Yemen, 2010–14
(In Millions of Yemeni rials)

	2010	2011	2012	2013	2014
				Est.	Proj.
Net Foreign Assets	1,216,424	918,614	1,056,655	881,857	599,509
Assets	1,270,278	968,792	1,323,208	1,149,732	867,459
Liabilities	-53,855	-50,178	-266,553	-267,874	-267,949
Net Domestic Assets	-392,109	35,894	20,886	216,110	561,363
Net claims on government	199,407	482,541	557,419	584,738	590,323
Claims	477,489	718,984	707,902	706,002	712,910
Budget financing	477,489	718,984	707,902	706,002	712,910
Deposits	-278,082	-236,443	-150,482	-121,264	-122,586
Net claims on nongovernment/nonbank entities	-118,681	14,637	101,703	166,506	173,272
Claims on public sector enterprises	82,862	157,365	259,692	265,875	273,851
Deposits and CDs	-201,543	-142,728	-157,989	-99,368	-100,579
Pension Fund Deposits	-65,358	-59,437	-57,709	-17,982	-18,216
Local Currency	-22,889	-16,702	-21,054	-12,757	-12,922
Foreign Currency	-42,469	-42,735	-36,655	-5,226	-5,294
Net claims on commercial banks	0	0	-91,890	0	0
Claims	0	0	0	0	0
Certificates of deposits held by banks	0	0	-91,890	0	0
Other Items (net)	-472,835	-461,283	-546,346	-535,135	-202,232
Valuation adjustment	236,203	241,699	256,292	266,514	266,514
Other	-709,038	-702,981	-802,639	-801,649	-468,746
Reserve Money	824,315	954,508	1,077,541	1,097,967	1,160,873
Currency outside banks	547,284	777,407	803,336	785,108	767,180
Currency with banks	24,114	22,878	29,390	36,786	37,890
Commercial bank deposits (reserves)	252,917	154,223	244,815	276,073	355,803
Local Currency	111,427	77,707	159,411	174,572	234,508
Foreign Currency	141,490	76,517	85,404	101,500	121,295
Memorandum Items					
Gross foreign assets	1,086,320	849,541	1,201,149	1,043,005	740,870
US$ million	5,081	3,974	5,590	4,854	3,448

Sources: Central Bank of Yemen; and IMF staff estimates.

Table 6. Republic of Yemen: External Financing Requirements and Sources, 2014–17

(In millions of U.S. dollars, unless otherwise indicated)

	2014	2015	2016	2017
Gross financing requirements	1,557	1,421	1,635	1,863
Current account deficit, excluding grants	1,235	1,068	1,243	1,322
Debt amortization	322	352	380	520
Fund repayments	0	0	11	21
Available financing	1,482	1,171	1,512	1,740
Grants	632	513	481	535
Financial inflows	-556	674	1,555	1,786
Foreign direct investment, net	-1,787	-1,191	-561	-478
Loan disbursements to public sector	332	615	866	1,014
Private sector net inflows	900	1,250	1,250	1,250
Change in reserves (+ decline)	1,406	-17	-524	-582
Financing gap	75	250	122	123
Residual financing (proposed ECF disbursements)	75	250	122	123

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

Table 7. Republic of Yemen: Balance of Payments, 2010–18

(In Millions of U.S. Dollars)

	2010	2011	2012	2013	2014	2015	2016	2017	2018
			Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Current account	-1,054	-982	-605	-1,241	-603	-555	-763	-787	-1,025
Goods and services	-1,359	-778	-4,119	-3,149	-2,294	-842	-1,056	-1,367	-1,755
Trade balance	-825	120	-2,891	-2,253	-1,187	252	28	-287	-1,010
Exports, f.o.b.	7,648	8,662	7,349	7,639	9,024	10,535	10,620	10,801	10,762
Hydrocarbon	6,279	7,731	6,332	6,537	7,880	9,328	9,340	9,439	9,304
Of which:									
Crude oil	5,303	6,260	5,282	4,553	4,055	4,499	4,518	4,613	4,456
Liquefied natural gas	976	1,471	1,051	1,984	3,825	4,829	4,823	4,826	4,848
Nonhydrocarbon	1,369	931	1,017	1,101	1,144	1,207	1,279	1,362	1,458
Imports, f.o.b.	8,473	8,543	10,240	9,892	10,211	10,283	10,592	11,088	11,772
Hydrocarbon	2,073	2,578	3,840	3,265	3,373	3,138	3,089	3,136	3,303
Nonhydrocarbon	6,400	5,964	6,400	6,627	6,837	7,145	7,502	7,953	8,469
Services	-534	-898	-1,227	-896	-1,107	-1,094	-1,084	-1,080	-744
Credit	1,622	1,267	1,453	1,398	1,544	1,703	1,881	2,038	2,414
Debit	-2,156	-2,165	-2,680	-2,294	-2,651	-2,797	-2,966	-3,118	-3,158
Income	-1,819	-2,337	-1,569	-1,815	-2,282	-3,584	-3,561	-3,346	-3,270
Of which: Hydrocarbon company profits	-1,614	-2,079	-1,213	-1,428	-1,847	-3,130	-3,125	-2,939	-2,896
Current transfers	2,123	2,134	5,083	3,723	3,973	3,871	3,855	3,926	3,999
General government transfer, net 1/	647	775	2,203	383	632	513	481	535	557
Workers' remittances, net	1,476	1,359	2,880	3,341	3,341	3,358	3,374	3,391	3,442
Capital and financial account	-60	-436	1,714	-16	-878	323	1,175	1,266	1,452
Direct investment, net	-646	-1,000	345	-710	-1,787	-1,191	-561	-478	-421
Hydrocarbon 2/	-852	-810	525	-651	-705	-913	-687	-723	-713
Of which: LNG sector	-219	-390	-480	-588	-1,683	-1,178	-774	-705	-708
Nonhydrocarbon	425	200	300	529	600	900	900	950	1,000
Medium- and long-term loans	145	-72	91	37	9	264	486	494	623
Disbursements 3/	300	103	273	230	332	615	866	1,014	1,050
Amortization	154	175	181	193	322	352	380	520	427
Commercial banks, net	-290	70	-229	7	150	300	300	300	300
Other, net 4/	731	566	1,506	650	750	950	950	950	950
Errors and omissions	-58	32	424	450	0	0	0	0	0
Overall balance	-1,172	-1,385	1,533	-807	-1,481	-233	412	479	427
Financing	1,172	1,385	-1,533	807	1,481	233	-412	-479	-427
Central bank net foreign assets (- increase)	1,057	1,410	-1,626	807	1,406	-17	-524	-582	-396
Net purchase from IMF	26	-25	93	0	75	250	111	103	-31
Purchases	53	0	93	0	75	250	122	123	0
Repurchases	27	25	0	0	0	0	11	21	31
Exceptional financing (Algeria debt relief)	88	0	0	0	0	0	0	0	0
Financing gap	-	-	-	-	0	0	0	0	0
Memorandum items:									
Current account (percent of GDP)	-3.4	-3.0	-1.7	-3.1	-1.3	-1.1	-1.4	-1.4	-1.7
Central bank gross foreign reserves 4/	5,081	3,974	5,590	4,854	3,448	3,465	3,988	4,570	4,966
(months of imports)	5.7	3.7	5.5	4.5	3.2	3.1	3.4	3.7	3.8
External public debt (percent of GDP)	19.9	18.6	17.4	15.2	13.7	13.2	13.7	14.0	14.2
Export oil price (U.S.$/barrel)	77.2	102.7	101.2	102.1	102.7	96.4	91.5	88.5	86.6
Nonhydrocarbon export growth (in percent)	-3.7	-32.0	9.3	8.3	3.8	5.5	6.0	6.5	7.0
Nonhydrocarbon imports growth (in percent)	8.4	-6.8	7.3	3.6	3.2	4.5	5.0	6.0	6.5

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

1/ Data includes Saudi grant in kind in 2011 of 3 million barrels of crude oil, and about US$ 1.8 billion of refined oil products in 2012. Figures from 2013 onwards reflect committed donor disbursements but do not reflect the identified budget support in 2014 contingent on a Fund-supported program.

2/ The negative direct investment numbers reflect cost recovery by foreign gas and oil companies. In 2012, this also reflectsthe expiration of the foreign concession of Masila oil block and the transfer of its ownership to government.

3/ Figures from 2014 do not reflect the identified budget support contingent on a Fund-supported program.

4/ includes a US$ 1 billion Saudi deposit in CBY in 2012.

Table 8. Republic of Yemen: Indicators of Banking System Financial Soundness, 2007–13

(In Percent; unless otherwise indicated)

	2007	2008	2009	2010	2011	2012	2013
Capital adequacy:							
Risk-weighted capital adequacy ratio	8.7	14.6	14.6	20.2	24.3	29.6	26.4
Capital (net worth) to assets	4.9	8.7	8.2	9.3	10.6	8.8	8.0
Portfolio quality:							
Nonperforming loans to total assets	5.4	5.2	3.5	4.2	4.7	4.4	4.2
Nonperforming loans to gross loans	19.5	18.0	13.9	17.7	21.2	25.5	21.7
Nonperforming loans net of provisions to capital	16.9	25.3	11.8	19.2	12.9	11.8	14.9
Provisions against problem loans/problem loans	44.0	62.3	70.3	57.0	70.6	76.2	71.4
Total capital and reserves/problem loans	123.4	168.2	251.4	223.7	227.5	202.0	192.3
Portfolio performance:							
Average return on assets	1.6	1.0	0.9	1.3	1.5	1.2	1.5
Average return on equity	19.7	11.4	9.6	14.1	14.2	13.6	18.9
Interest margin to gross income	33.7	33.9	33.4	30.5	33.4	28.6	25.3
Noninterest expenses to gross income	19.8	22.5	26.4	21.9	23.6	23.5	20.3
Trading and fee income to gross income	7.7	7.8	7.7	14.1	12.0	12.8	9.3
Exposure to exchange rate risk:							
Total foreign currency assets (in billions of rials)	576.3	646.4	754.4	900.2	769.4	868.9	1,002.4
Total foreign currency liabilities (in billions of rials)	520.1	557.1	635.2	795.7	655.7	785.1	971.0
Net exposure/total capital and reserves	65.1	75.1	83.2	59.2	62.6	43.2	14.5
Forex credits/forex deposits	42.3	45.1	37.4	33.6	36.2	32.8	38.0

Source: Central Bank of Yemen.

1/ Data refers to all banks except the Housing Bank and CACbank. 2006 data included CAC.

* Audited financial statements.

** Monthly data received from the banks.

Table 9. Republic of Yemen: Illustrative Medium-Term Scenario, 2010–18

	2010	2011	2012	2013	2014	2015	2016	2017	2018
	(In percent of GDP unless otherwise indicated)								
Real GDP growth rate (in percent)	7.7	-12.7	2.4	4.8	1.9	4.6	4.7	5.2	5.9
Real nonhydrocarbon GDP (in percent)	4.4	-12.5	4.0	4.0	3.0	4.5	5.0	5.5	6.5
hydrocarbon production (1,000 barrels/day)	426.0	364.1	322.2	364.7	334.5	352.5	357.3	362.9	358.0
Crude export oil price (U.S. dollar/barrel)	77.2	102.7	101.2	102.1	102.7	96.4	91.5	88.5	86.6
CPI (percent change; average)	11.2	19.5	9.9	11.0	9.0	11.4	8.5	8.0	7.8
Total revenue and grants	26.1	25.3	29.9	23.9	23.9	22.7	22.9	23.0	22.4
Hydrocarbon	16.5	16.5	14.1	12.8	11.2	9.6	9.7	9.2	8.2
Nonhydrocarbon	8.4	7.6	9.7	10.1	11.4	12.1	12.4	13.0	13.4
Grants	1.2	1.2	6.1	0.9	1.4	1.0	0.8	0.8	0.8
Total expenditure	30.2	29.8	36.2	30.8	29.3	27.7	27.6	27.3	26.6
Current	25.5	27.8	32.5	28.4	27.0	23.9	23.8	23.5	22.7
Capital	4.7	2.0	3.7	2.4	2.4	3.8	3.8	3.8	3.9
Overall budget balance (cash basis)	-4.1	-4.5	-6.3	-6.9	-5.4	-5.0	-4.7	-4.3	-4.2
Nonhydrocarbon primary budget balance	-18.2	-16.7	-15.0	-14.3	-11.3	-9.6	-9.5	-8.7	-7.9
Excluding grants	-19.4	-17.9	-21.1	-15.2	-12.7	-10.6	-10.3	-9.4	-8.8
Consumption	92.7	96.9	102.9	99.7	96.7	91.6	91.7	91.9	92.3
Private	80.9	84.1	88.5	86.6	83.9	79.1	79.5	79.9	80.7
Public	11.9	12.8	14.5	13.1	12.8	12.5	12.2	11.9	11.6
Gross Domestic Investment	11.7	5.5	8.7	8.1	8.4	10.1	10.3	10.5	10.6
Private	7.0	3.5	5.0	5.8	6.0	6.3	6.5	6.8	6.8
Public	4.7	2.0	3.7	2.4	2.4	3.8	3.8	3.8	3.9
Gross national savings	8.3	2.5	7.0	5.0	7.0	9.0	8.9	9.1	8.9
Private	7.6	5.0	9.6	9.6	10.0	10.2	9.8	9.7	9.2
Public	0.6	-2.5	-2.6	-4.5	-3.0	-1.2	-0.9	-0.5	-0.3
Saving/investment gap	-3.4	-3.0	-1.7	-3.1	-1.3	-1.1	-1.4	-1.4	-1.7
private consumption per capita (in US dollar)	1,025	1,095	1,210	1,313	1,389	1,425	1,457	1,508	1,576

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

Table 10. Republic of Yemen: Millennium Development Goals, 1990–2012

	1990	1995	2000	2005	2009	2010	2011	2012
Goal 1: Eradicate extreme poverty and hunger								
Employment to population ratio, 15+, total (percent)	...	39.7	39.799999	39.6	41.0	39.5	39.7	40.0
Employment to population ratio, ages 15-24, total (percent)		24.1	26.4	25.4	26.3	23.9	24.1	24.3
Poverty gap at $1.25 a day (PPP) (percent)	...	...	...	4.2	...	...	...	...
Poverty headcount ratio at $1.25 a day (PPP) (percentage of population)	...	...	...	17.5	...	...	...	...
Goal 2: Achieve universal primary education								
Literacy rate, adult total (percentage of people ages 15 and above)	...	...	...	...	...	...	65.3	...
Literacy rate, youth total (percentage of people ages 15-24)	...	...	...	...	...	...	86.4	...
Persistence to last grade of primary, total (percentage of cohort)	...	...	...		...	...	...	...
Primary completion rate, total (percent of relevant age group)	...	...	...	60.64	...	64.9	...	69.8
Total enrollment, primary (percent net)	...	...	...	76.53	...	82.4	...	87.1
Goal 3: Promote gender equality and empower women								
Proportion of seats held by women in national parliaments (percent)	4.1	...	0.7	0.3	0.3	0.3	0.3	0.3
Ratio of female to male primary enrollment (percent)	...	...	...	74.0	...	81.7	81.6	82.8
Ratio of female to male secondary enrollment (percent)	...	...	...	49.0	...	62.1	63.4	65.4
Ratio of female to male tertiary enrollment (percent)	...	...	27.3	36.5	...	43.8	44.1	...
Goal 4: Reduce child mortality								
Immunization, measles (perentage of children ages 12-23 months)	69	40	71	76	69	73	71	71
Mortality rate, infant (per 1,000 live births)	88.5	79.5	71.4	64.5	59.4	49.2	47.7	46.3
Mortality rate, under-5 (per 1,000)	126	111.9	99.1	88.2	80.2	64.3	62.1	60
Goal 5: Improve Maternal health								
Adolescent fertility rate (births per 1,000 women ages 15-19)	...	...	98.4	83.8	73.7	50.8	48.9	...
Maternal mortality ratio (per 100,000 live births)	610	520	370	330	...	290	...	...
Malaria cases reported	11,384	500,000	1,394,495	...	55,446	106,697	...	...
Goal 6: Combat HIV/AIDS, malaria and other disease								
AIDS estimated deaths (UNAIDS estimates)	100	100	500	1,000	1,400	1,000	1,000	1,000
Prevalence of HIV, total (percent of population ages 15-49)	0.1	0.1	0.1	0.2	0.2	0.1	0.1	0.1
Tuberculosis case detection rate (percent, all forms)	28.0	69.0	67.0	54.0	67.0	80.0	76.0	85.0
Tuberculosis death rate (per 100,000 people)	32.0	23.0	19.0	14.0	8.3	6.2	6.0	5.6
Tuberculosis treatment success rate (percent of registered cases)	...	52.0	72.0	80.0	88.0	87.00	88.00	...
Incidence of tuberculosis (per 100,000 people)	137	137	116	81	54	49	49	49
Goal 7: Ensure environmental sustainability								
Forest area (percent of land area)	1.04	...	1.04	1.04	...	1.04	1.04	...
Improved sanitation facilities (percent of population with access)	24.0	32.0	39.0	47.0	52.0	52.7	53.0	...
Improved water source (percent of population with access)	67.0	63.0	60.0	57.0	55.0	54.6	54.8	...
CO2 emissions (metric tons per capita)	0.80	0.74	0.83	0.97	1.03	0.96	...	...
Goal 8: Develop a global partnership for development								
Internet users (per 100 people)	0.00	...	0.08	1.05	10.0	12.4	14.9	17.4
Mobile cellular subscriptions (per 100 people)	0.00	0.05	0.18	11.03	35.63	46.09	47.05	54.36
Telephone lines (per 100 people)	1.04	1.23	1.96	4.37	4.27	4.35	4.33	4.32
General indicators								
Life expectancy at birth, total (years)	56.1	57.4	59.7	62.6	64.6	62.5	62.7	...
Fertility rate, total (births per woman)	8.66	7.62	6.49	5.76	5.31	4.50	4.35	...
Net ODA received per capita (current US$)	37.6	11.3	17.6	14.4	23.9	29.2	21.5	...

Source: Millennium Development Goals database (the World Bank).

Table 11. Fund Disbursements and Timing of Review Under the Prospective Three-Year ECF Arrangement, 2014–17

Date of Availability	Conditions	Disbursements (in million SDR)	Disbursements (in percent of quota)
July 23, 2014	Board approval of the ECF arrangement	48.75	20.0
April 15, 2015	Completion of the first review (end-December 2014 quantitative performance criteria and relevant structural benchmarks)	80.35	33.0
October 15, 2015	Completion of the second review (end-June 2015 quantitative performance criteria and relevant structural benchmarks)	80.35	33.0
April 15, 2016	Completion of the third review (end-December 2015 quantitative performance criteria and relevant structural benchmarks)	38.95	16.0
October 15, 2016	Completion of the fourth review (end-June 2016 quantitative performance criteria and relevant structural benchmarks)	38.95	16.0
April 15, 2017	Completion of the fifth review (end-December 2016 quantitative performance criteria and relevant structural benchmarks)	38.95	16.0
July 15, 2017	Completion of the sixth review (end-March 2017 quantitative performance criteria and relevant structural benchmarks)	38.95	16.0
Total		365.25	150.00

Source: IMF staff calculations.

Table 12. Republic of Yemen: Indicators of Capacity to Repay the Fund, 2013–27

	2013 Actual	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Fund obligations based on existing credit (in millions of SDRs)															
Principal	0.0	0.0	0.0	7.0	13.1	19.1	19.1	19.1	12.2	6.1	0.0	0.0	0.0	0.0	0.0
Charges and interest	0.0	0.1	0.4	0.3	0.3	0.3	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Fund obligations based on prospective credit (in millions of SDRs)															
Principal	0.0	0.0	0.0	0.0	0.0	0.0	0.0	17.8	45.8	65.3	73.0	73.0	55.3	27.3	7.8
Charges and interest	0.0	0.0	0.3	0.6	0.9	0.9	0.9	0.9	0.8	0.7	0.5	0.3	0.2	0.1	0.0
Fund obligations based on existing and prospective credit (in millions of SDRs)															
Principal	0.0	0.0	0.0	7.0	13.1	19.1	19.1	36.9	58.0	71.3	73.0	73.0	55.3	27.3	7.8
Charges and interest	0.0	0.1	0.7	1.0	1.2	1.2	1.1	1.1	1.0	0.8	0.6	0.4	0.3	0.2	0.1
Total obligations based on existing and prospective credit															
In millions of SDRs	0.0	0.1	0.7	7.9	14.2	20.3	20.3	38.0	58.9	72.1	73.7	73.5	55.5	27.4	7.9
In millions of US$	0.1	0.1	1.1	12.4	22.5	32.4	32.6	61.0	94.7	115.9	118.3	118.1	89.2	44.1	12.7
In percent of Gross International Reserves	0.0	0.0	0.0	0.3	0.5	0.7	0.6	1.3	2.0	2.5	2.6	2.6	2.0	1.0	0.3
In percent of exports of goods and services	0.0	0.0	0.0	0.1	0.2	0.2	0.3	0.5	0.7	0.9	0.9	0.9	0.6	0.3	0.1
In percent of debt service	0.0	0.0	0.2	2.5	3.5	5.8	5.7	10.1	14.7	17.3	17.3	17.1	16.3	8.7	2.6
In percent of GDP	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.2	0.1	0.1	0.1	0.0	0.0
In percent of quota	0.0	0.0	0.3	3.3	5.8	8.3	8.3	15.6	24.2	29.6	30.2	30.2	22.8	11.3	3.3
Outstanding Fund credit, including prospective drawings															
In millions of SDRs	95.7	144.4	305.1	376.0	440.9	421.7	402.6	365.7	307.7	236.4	163.4	90.3	35.1	7.8	0.0
In millions of US$	147.2	223.6	476.6	592.0	700.0	674.8	649.2	589.7	496.2	381.2	263.4	145.6	56.5	12.6	0.0
In percent of Gross International Reserves	3.0	6.5	13.8	14.8	15.3	13.6	12.7	12.5	10.7	8.3	5.9	3.3	1.3	0.3	0.0
In percent of exports of goods and services	1.6	2.1	3.9	4.7	5.5	5.1	5.0	4.7	3.9	2.9	2.0	1.1	0.4	0.1	0.0
In percent of debt service	55.4	53.5	105.6	119.6	108.5	120.1	114.4	97.6	77.0	56.8	38.6	21.1	10.3	2.5	0.0
In percent of GDP	0.4	0.5	0.9	1.1	1.2	1.1	1.0	0.9	0.7	0.5	0.3	0.2	0.1	0.0	0.0
In percent of quota	39.3	59.3	125.3	154.4	181.1	173.2	165.3	150.2	126.4	97.1	67.1	37.1	14.4	3.2	0.0
Net use of Fund credit (in millions of SDRs)	0.0	48.7	160.7	70.9	64.9	-19.1	-19.1	-36.9	-58.0	-71.3	-73.0	-73.0	-55.3	-27.3	-7.8
Disbursements	0.0	48.7	160.7	77.9	77.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repayments and Repurchases	0.0	0.0	0.0	7.0	13.1	19.1	19.1	36.9	58.0	71.3	73.0	73.0	55.3	27.3	7.8
Memorandum items:															
Nominal GDP (in millions of US$)	40,415	45,452	50,966	53,395	56,551	60,187	63,684	67,573	71,306	75,241	79,450	83,950	89,078	94,560	100,416
Exports of goods and services (in millions of US$)	9,037	10,568	12,238	12,501	12,839	13,176	12,985	12,531	12,723	12,930	13,234	13,543	14,216	14,923	15,670
Gross International Reserves (in millions of US$)	4,854	3,448	3,465	3,988	4,570	4,966	5,102	4,720	4,638	4,568	4,490	4,462	4,446	4,431	4,422
Debt service (in millions of US$)	266	418	451	495	645	562	567	604	644	671	682	689	547	508	482
Quota (millions of SDRs)	244	244	244	244	244	244	244	244	244	244	244	244	244	244	244

Source: IMF staff estimates and projections.

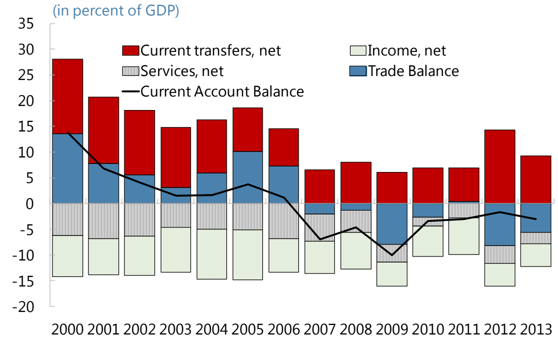
1/ Assumes a new ECF arrangement of 150 percent of quota (SDR 365.25 million).

Annex I. Yemen: External Sector Assessment[1]

A. Current Account

1. **Yemen has had a current account (CA) deficit since 2007, despite an expansion of the hydrocarbon sector in the 2000s**. Yemen's trade balance has been in deficit except for 2011 and its dynamics are dominated by hydrocarbon trade. Services and income balances have been consistently in deficit, while current transfers have been broadly stable at 6–8 percent of GDP. A large inflow of current transfers in 2012 reflected exceptional grants from Saudi Arabia amounting to nearly $2 billion, as well as a large increase in workers' remittances (which continued in 2013).

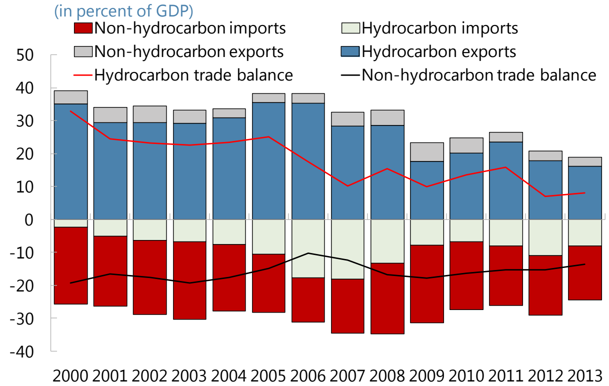
Yemen: Current Account Developments
(in percent of GDP)



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

2. **The results of regression analyses indicate that Yemen's projected CA deficit is larger than its norm in the medium term**. A CGER-type macroeconomic balance (MB) approach suggests a medium-term CA norm of -0.7 percent, compared to the underlying current account projection of -1.6 percent in 2018 that reflects the projected declining hydrocarbon exports in percent of GDP. An analysis under an alternative methodology put forth by Fund staff members,[2] which tries to capture the larger impact of oil sector developments on the fiscal and external balance, also suggests that the CA deficit is larger than the norm by 0.3 percent of GDP.

Yemen: Trade Developments
(in percent of GDP)



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

[1] Prepared by Toshiyuki Miyoshi (SPR).

[2] Bems, Rodolfs and Irineu de Carvalho Filho, 2009, *Exchange Rate Assessments: Methodologies for Oil Exporting Countries*. IMF Working Paper 09/281.

Republic of Yemen: Current Account Analysis
(In percent of GDP)

	Medium-term CA Norm	Underlying CA in 2018 (projection)	CA gap
Macroeconomic Balance (MB) Approach	-0.7	-1.6	-0.9
Modified MB approach by Bems and de Carvalho Filho (2009)	-1.3		-0.3
External Stability Approach 1/	0.3	3.7	3.4

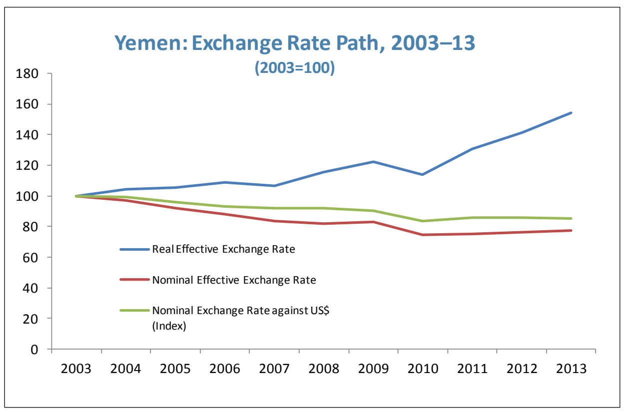
Source: IMF staff estimates.

1/ The figure in the first column represents the NFA-stabilizing level of the trade balance inclusive of services and current transfers, and the second column is the underlying trade balance in 2018.

3. **At the same time, the external stability (ES) approach points to a stronger trade balance than the level that would stabilize the ratio of net foreign assets (NFA) to GDP**. Assuming a potential growth rate of about 4 percent, a trade surplus (including services and current transfers) of 0.3 percent of GDP would be needed to maintain the projected level of the NFA-to-GDP ratio in 2018. Given the high level of current transfer inflows, the underlying trade balance is stronger than the trade balance norm by 3.4 percent.

B. The Exchange Rate

4. **The real exchange rate has been trending upwards, particularly since late 2010, while the nominal exchange rate has been broadly stable**. The nominal rate has been within a tight range of Yrl 214–215 per U.S. Dollar since 2011. Reflecting the inflation differential vis-a-vis Yemen's trading partners, the CPI-based real effective exchange rate appreciated by 35 percent in 2011–13. A CGER-type equilibrium real exchange rate (ERER) approach points to a relatively stable ERER in 2007–13.



Republic of Yemen: Assessment of the Real Effective Exchange Rate		
I. Macroeconomic balance 1/	II. External sustainability 2/	III. Equilibrium real exchange rate 3/
[Misalignment as percentage deviation from estimated equilibrium, overvaluation (+), undervaluation (-)].		
6.4	-25.3	61.8

Source: IMF staff estimates.

1/ Measures the adjustment needed to eliminate the gap between an estimated current account "norm"—obtained from applying CGER cross-country panel regression coefficients to Yemeni data—and the projected "underlying" medium-term current account balance for Yemen.

2/ Provides an estimate of the adjustment needed to stabilize Yemen's net foreign assets (NFA) to GDP ratio.

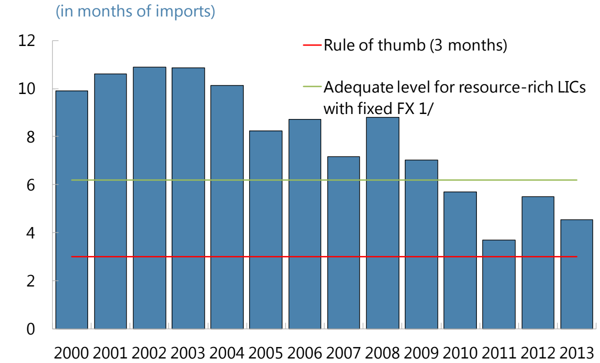
3/ Estimates the deviation between the actual and the "equilibrium" REERs. The latter is obtained by applying coefficients from the CGER cross-country panel regression to Yemeni data.

5. **CGER-type analyses are inconclusive**. According to the CA elasticity used in the CGER methodologies,[3] the MB approach points to an overvaluation of 6 percent. The ERER approach suggests a larger overvaluation (62 percent), while under the ES approach the real exchange rate is assessed as undervalued by 25 percent compared to the level that would stabilize the external position, excluding the income account. However, caution is warranted in interpreting the results of these two approaches because of data limitations, particularly on Yemen's international investment position.

C. International Reserves

6. **The level of Yemen's international reserves has been on a declining trend since the mid-2000s**. From 10–11 months of prospective imports in the early 2000s, the ratio dipped to just above three months in 2011 before recovering somewhat in 2012 thanks to Saudi Arabia's US$1 billion deposit at the Central Bank of Yemen.

Yemen: Gross International Reserves
(in months of imports)



1/ IMF, 2013, *Assessing Reserve Adequacy--Further Considerations*.
Sources: Central Bank of Yemen; and Fund staff calculations.

7. **Although reserves are projected to remain above the "rule of thumb" threshold of three months of imports in the medium term, Yemen should avoid further depleting reserves and replenish them to a higher level**. Recent research by Fund staff highlights that applying a uniform metric for reserve adequacy—including the traditional rules of thumb—across all LICs would not be appropriate, and indicates that the adequate level of reserves for LICs rich in resources, those with the fixed exchange

[3] Lee, Jaewoo et al., 2008, *Exchange Rate Assessments: CGER Methodologies*. Occasional Paper No. 261, Washington, DC: International Monetary Fund.

rate, and/or in fragile situations—all of which may apply to Yemen—could well be higher than the traditional metric.[4]

[4] IMF, 2011, *Assessing Reserve Adequacy;* and IMF, 2013, *Assessing Reserve Adequacy—Further Considerations*, IMF Policy Papers.

Annex II. Principles of Fiscal Federalism: The Yemen Case[1]

INTRODUCTION

1. **Following the 2011 crisis, Yemen initiated a National Dialogue (ND) process to reshape the institutional set-up of the country and redefine power sharing**. The ND concluded in early 2014 with the decision to transform the country into a six-region federal state, and grant each region more autonomy and influence on the distribution of resources. In February 2014, two commissions were established and given one year to draft a new constitution and design the new federal system.

2. **Drawing on FAD cross-country experiences, this note examines the fiscal implications of a federal reform in Yemen and provides general guiding principles on its design**. The main challenges faced by the Yemeni authorities in implementing fiscal decentralization are twofold: to preserve fiscal discipline and safeguard long-term fiscal sustainability in the context of greater autonomy at the regional level. The note recognizes that there is no "one size-fits-all" model. Hence, policy advice needs to be tailored to each country's specific circumstances, taking into account macroeconomic constraints, potential trade-offs between efficiency and equity, as well as relevant institutional factors. The Fund has provided advice to numerous member countries in this area and stands ready to support the reform efforts of the Yemeni authorities, including by providing comprehensive technical assistance.

3. **The note has the following structure**. Section II provides a quick overview of the key fiscal characteristics of the government's budget as well as reform challenges facing Yemen. Section III reviews briefly the basic agreements regarding the redistribution of resources and responsibilities to the regions as they agreed within the ND. Section IV discusses various aspects of fiscal decentralization based on other countries' experiences and best practices. Finally, section V offers a summary of main recommendations along with next steps.

[1] Prepared by Nabil Ben Ltaifa (MCD) and Valerio Crispolti (FAD)

BACKGROUND ON YEMEN FISCAL FRAMEWORK

4. **Yemen faces important fiscal challenges**. On one hand, there is the pressing need to secure long-term fiscal and external sustainability in the face of declining hydrocarbon revenues. On the other hand, the country urgently needs to increase public investment and social spending with the view to promoting sustainable growth and reducing poverty over the long term. Meeting these challenges will require steadfast progress in improving nonhydrocarbon revenue mobilization and restructuring public expenditure, so as to create fiscal space for growth-enhancing and poverty-reducing spending.

5. **Yemen's revenues are dominated by hydrocarbon-related resources**. In 2013, hydrocarbon revenues accounted for about half of total government receipts (12.8 percent of GDP), while tax revenues did not exceed 30 percent of total receipts (7.1 percent of GDP). Yemen's tax-to-GDP ratio appears low also by international comparison. This seems to reflect a range of factors, including: (i) a very low general sales tax (GST) rate of 5 percent, the lowest among peers; (ii) a high threshold for paying GST tax; (iii) serious capacity constraints in tax and customs administration; (iv) low tax compliance; and (v) limited collaboration between the tax authorities and the business community. Compared to peers, Yemen's structure of tax revenues seems to be heavily focused on the income tax (representing almost half of total taxes); whereas taxes on goods and services account for less than 3 percent of GDP, as opposed to an average of 5 percent of GDP in low-income countries.

6. **Recurrent spending represents the bulk of public expenditure in Yemen**. In 2013, current expenditures represented about 90 percent of total spending, with wages and subsidies accounting for about two-thirds of current spending. In the same year, fuel subsidies were 22 percent of total expenditures and about 6.7 percent of GDP. These levels are fairly high when compared to peers in the Middle East and North Africa (MENA) region. International comparisons are also not favorable to Yemen in terms of capital expenditure. In 2013, Yemen's public investment declined to 2.4 percent of GDP, a level significantly lower than the average of 9 percent of GDP for the MENA region.

7. **Against this background, the recent decision to move to fiscal decentralization is likely to add to the existing challenges and entail significant fiscal risks**. Therefore, it is critical that the authorities think carefully through the steps and design of this reform. In addition, developing adequate institutions and building capacity will be instrumental to maintaining fiscal discipline in the context of an overhaul of the roles/ responsibilities of various government levels.

THE ISSUES OF DECENTRALIZATION IN THE NATIONAL DIALOGUE

8. **The National Dialogue (ND) reached agreement to establish a federal state and draft a new constitution**. Last February 2014, a special committee headed by the President announced the decision to move to a six-region federal structure for Yemen (*Azal, Tihama, Saba, Aljanad, Hadraomout, and Aden*), in which each government tier (i.e., central and subnational governments) will have both executive and legislative bodies. On March 8, 2014, President Hadi announced a 17-member committee and gave it one year to draft Yemen's new constitution, which, among other things, will determine the relations governing the interactions between the central and subnational governments.[2] This committee will work also on drafting the new federal system of six regions.

9. **The ND agreement does not go into the intricacies of the fiscal arrangements among the central government and the regional authorities.** In addition to the management of oil and gas resources, these include the issues of assignments, collection, and management of taxes, customs revenues, and other nontax resources; as well as the assignment of spending responsibilities, including in areas such as health, education, and infrastructure.

10. **However, the ND establishes that natural resources belong to the people of Yemen**. The distribution of these resources will be decided in accordance to a formula and fair standards, which take into account the needs of the producing state as well as of the central government. The agreement envisages the establishment of an independent national authority in charge of developing policy for the extractive industry. The sharing of powers and responsibilities in managing oil and gas resources among various governments is expected to be defined in the constitution.

IMPORTANT ASPECTS OF DECENTRALIZATION

11. **The design of intergovernmental fiscal arrangements is one of the more complex areas of public finance**. It entails a number of policy and institution-building issues that require careful coordination and sequencing, and it is strongly influenced by historical, socio-political, and economic factors. As a result, there is no "one size-fits-all" model: due considerations must be given to each country's specific circumstances, macroeconomic and institutional constraints; as well as the need to strike a balance between efficiency and distributional considerations.

[2] The committee comprises Messrs Ismail Ahmed Al-Wazir, a former member of the Supreme Court (head), Najeeb Shameeri and Nihal Al-Awlaqi, a member of the Socialist party, as deputies, and Abdul Malik Ismail as rapporteur.

12. A fiscal decentralization reform should be guided by a number of general principles. Based on the experience of FAD involvement in member countries at different stages of economic development, the following guiding principles are identified:

- The sequencing of decentralization should ensure that resources are made available to subnational governments consistent with the assignment of spending responsibilities.

- The pace of decentralization should be closely linked to the capacity of subnational governments to fulfill their assigned spending responsibilities.

- Accountability and fiscal responsibility at the subnational level are reinforced by control over part of own-revenue resources. However, the assignment of own resources must take into account economic considerations (e.g., mobility of tax base) and institutional capacity constraints, particularly of subnational tax administrations.

- Intergovernmental transfers can offset possible vertical imbalances (i.e., across government levels) and moderate horizontal disparities (within government levels). These transfers should be designed to minimize the subnational government's fiscal vulnerability to cyclical fluctuations.

- Borrowing controls at the subnational level need to be designed carefully so as to ensure fiscal discipline. This may entail reliance on both market discipline and flexible fiscal rules, provided that timely and reliable information on subnational finances is available.

13. The effectiveness of fiscal decentralization may be undermined by two factors. First, failure by local policymakers to internalize the cost of local spending often results in overspending and deficit bias (i.e., the common pool problem). Second, the expectation of local politicians to be bailed out by the central government reduces incentives to exert fiscal responsibility (i.e., soft budget constraint).

A. Macrofiscal Implications of Decentralization

14. The macrofiscal implications of decentralization vary with the design of intergovernmental fiscal relations and with the degree of decentralization. Although fiscal stabilization is the responsibility of the central government, decentralization can affect in different ways the conduct of fiscal stabilization and medium-term fiscal sustainability, depending on subnational governments' ability to carry out increased responsibilities. For example, when local governments manage a significant share of revenues and/or spending, the central government may not have enough resources for fiscal stabilization or redistribution. Similarly, central government efforts to inject stimulus into the economy may be partly offset by subnational procyclical fiscal retrenchment during a downturn (as happened during the Great Depression). In certain conditions, more decentralized spending and taxation decisions may limit the central government's capacity to offset slippages at the subnational level. In this regard, nationally binding rules and/or effective intergovernmental cooperation mechanisms may be needed to promote both short-term fiscal stabilization and medium-term fiscal sustainability. Finally, the impact of subnational fiscal operations on fiscal procyclicality and discipline depends on how these operations are financed.

15. Maintaining fiscal discipline is a key challenge for countries that consider fiscal decentralization. In designing a reform, therefore, policymakers should give due consideration to the following questions:

- What should be the appropriate mix of expenditure and tax policies that supports fiscal discipline and a hard budget constraint?
- How should the intergovernmental transfer system be designed to ensure appropriate funding of subnational operations, without undermining the incentives to pursue sound policies?
- What type of institutional mechanisms can ensure accountability for good results?

B. Fund's Advice on Design and Management of Decentralization

16. A necessary condition for fiscal discipline is a broad matching of spending responsibilities with the overall resources at each level of government. This requires that the devolution of resources at the local level be defined in line with expected subnational expenditure needs. Once spending responsibilities are defined, it is possible to determine the appropriate mix of taxes and transfers for different government tiers. However, revenue assignments and transfers must be adequately clarified to impose effective fiscal discipline at the local level.

17. Delays in the devolution of spending responsibilities relative to resources may lead to a deterioration of subnational fiscal positions overtime. In the initial stages, subnational governments' spending may be constrained by their (weak) capacity. However, over time, the availability of resources will eventually lead to a rise in subnational spending with ensuing consequences for local fiscal balances. The emergence of deficits at the center may thus not be compensated by surpluses at the subnational level, leading to a deterioration of general government's budget and debt positions over time. On the other hand, stress at the central government level could trigger devolution of spending responsibilities to local governments without a corresponding transfer of resources, with the result that subnational governments' borrowing is placed on an unsustainable path.

18. **In light of these challenges, designing fiscal decentralization reforms requires a consistent and well-coordinated package of measures**. Typically, countries tend to change some specific aspects of their system of intergovernmental fiscal relations (e.g., introducing new revenue-sharing schemes or changing the transfer system). These changes, however, may eventually create imbalances across government levels and undermine the effectiveness of fiscal policy, if they are not designed as part of a comprehensive framework. Such a framework should: (i) define spending responsibilities; (ii) ensure sound public financial management; (iii) define intergovernmental revenue arrangements; and (iv) identify mechanisms to control borrowing.

19. **The definition of spending responsibilities entails theoretical and practical considerations.** In theory, the assignment of spending responsibilities should be driven by efficiency considerations (e.g., each public service should be provided by the jurisdiction that is capable of internalizing the benefits and costs of such provision). In practice, however, spending assignments also reflect political considerations. This often leads to an overlap of spending functions undertaken by different government levels; typical examples are health care, education, and social welfare, environment, infrastructure, and water and sanitation. In light of these overlaps, it is essential to define clearly which government level is responsible for what kind of expenditure, so as to ensure the appropriate balance between spending mandates and resources to fund them.

20. **A clear and transparent PFM framework facilitates consistent decision-making at all governmental levels and ensures accountability for effective use of public resources**. Sound PFM arrangements need to be supplemented by institutional mechanisms governing the responsibilities and financing of different levels of government, which will generate the incentives to manage resources in an efficient manner. In countries where subnational PFM systems do not meet minimum adequacy standards, strengthening PFM arrangements should be a prerequisite for increasing decentralization. The critical elements of adequate PFM systems and good governance at the subnational level include: (i) a realistic budget envelope prepared in a timely manner; (ii) an appropriate budget classification system; (iii) effective audit and control mechanisms; and (iv) requirements for timely and accurate reporting.

21. **The definition of intergovernmental revenue arrangements is guided by a number of considerations**. In theory, funds should follow functions so that the spending responsibilities of local governments would be adequately financed through a combination of own-source revenue, shared taxes, transfers, and borrowing. However, defining the right financing mix requires a delicate

balancing act. Although allowing access to own revenue at the margin through local taxation is essential to promote fiscal discipline and accountability, excessive tax autonomy may create inefficiencies and undermine the stabilization role of the central government. Normative theories of fiscal federalism identify a number of principles for "optimal" tax assignments:

- Taxes with large and elastic bases—such as income taxes—should be assigned to the central government for macroeconomic stabilization and income redistribution.

- Benefit taxation should be used by various government tiers: local services or services with local benefit zones should be financed with local taxes, while services with significant externalities should be financed with region wide taxes or transfers.

- Local tax bases should be relatively immobile to prevent revenue losses due to tax competition; bases should also be evenly distributed across jurisdictions to avoid horizontal fiscal imbalances.

- The definition of revenue assignments should take into account existing administrative and capacity constraints.

22. Options for intergovernmental revenue arrangements provide different degrees of subnational revenue autonomy. There are three types of arrangements:

- Own revenue assignments, which allow some degree of discretion to subnational governments.
- Revenue-sharing arrangements that allocate to local governments' shares of taxes whose bases and rates are defined (and typically administered) by the central government.
- Intergovernmental grants that transfer budgetary resources to subnational governments.

23. Natural resource revenues are better managed by the central government in light of their volatility and geographical concentration. Revenue-sharing arrangements on an origin basis can create significant horizontal disparities, and put additional burdens on local governments that are typically not well equipped to deal with the inherent volatility of resource revenues. High volatility in natural resource revenues can be a major cause of fiscal pro-cyclicality. The central government is better placed to carry out macroeconomic stabilization policies, while subnational authorities should focus on addressing local infrastructure needs and providing key social services.

24. Controls on subnational borrowing buttress fiscal discipline by preventing excessive borrowing. This could produce adverse externalities on the central government, including putting upward pressure on interest rates and risk premia on government bonds, or through the cost of bailouts. Borrowing controls can be grouped into four broad, not mutually exclusive, categories: (i) reliance on market discipline, which requires a number of preconditions seldom met in practice; (ii) cooperation between central and subnational governments in the setting of borrowing limits; (iii) rules-based controls; and (iv) administrative or direct controls on borrowing. In the early stages of decentralization, it is probably best to limit the subnational governments' capacity to borrow (both in the domestic as well as the international financial market) until a national debt management strategy is in place.

LESSONS LEARNED AND CHALLENGES

25. **An effective fiscal decentralization should strike the right balance among several considerations**. These include: (i) existing macroeconomic constraints; (ii) potential tradeoffs between efficiency and equity; (iii) institutional factors (e.g., constitutional and other legal constraints), and (iv) the capacity of local governments to entrench fiscal discipline, spend well, and raise own revenues.

26. **The experiences of countries at various levels of development suggest the following general lessons**:

- ***Decentralization should be carefully sequenced***. The objective is to ensure that resources are made available to subnational governments in parallel with the assignment of their spending responsibilities.
- ***The pace of decentralization should be closely linked to capacity***. This is instrumental for subnational governments to carry out effectively the functions assigned to them.
- ***The responsibilities in provision of services should be clearly attributed***. This is particularly important to avoid duplication, waste, and loss of accountability when spending responsibilities overlap across levels of government.
- ***Complementary reforms at the central government are often needed***. These would include an overhaul of the civil service, as well as other institutional and regulatory frameworks.
- ***Sound PFM systems are essential at all government levels***. They ensure transparency of the budget process in all its phases.
- ***Devolution of resources should be commensurate with spending responsibilities***. Subnational governments must be provided with a resource envelope that ex ante would allow them to carry out appropriately their assigned spending responsibilities.

- ***Responsibility over natural resource revenues should generally remain with the central government***. However, control over a portion of subnational resources is key to promoting local governments' fiscal responsibility and accountability.
- ***Intergovernmental transfers play a significant role***. They are needed to offset the resulting vertical imbalances and to moderate horizontal ones.
- ***Limits to subnational borrowing help ensure adequate fiscal discipline***. In addition, availability of relevant information is crucial to enforcing any form of control, including those on floating debt and contingent liabilities (especially guarantees and PPPs).

Box 1. National Dialogue: Highlights of the Signed Agreement [1/]

A new constitution is being drafted, specifying the governing relations between the different levels of the government, local, regional and central state. The NDC agreed to the following guiding constitutional guidelines:

1. Powers, functions, and responsibilities shall be allocated to each level of government, either exclusively or concurrently, as best serves and is closest to those affected. Each level of government shall have sufficient powers to function effectively and shall bear its fair share of common responsibilities.

2. The division of powers and responsibilities shall be clearly defined in the constitution of the federal state. The central authority shall not interfere with the exercise of authority of the executive, legislative, judicial and administrative bodies of the other levels of government in their areas of exclusive responsibility, except in exceptional circumstances as regulated by the constitution and law, and only for purposes of ensuring collective security, essential common standards or to protect one regional, authority from interference by another.

3. Powers unallocated to the federal authorities shall be presumed powers of other levels of government as provided for by the federal constitution. The competent judicial body defined in the federal constitution shall adjudicate on any dispute over the competencies of the central government, regions, and wilayas (governorate).

4. Each region shall have a leading role regarding its economic development. The federal system shall ensure adequate standards for a decent life for all people and an equitable sharing of national wealth.

5. Each level of government – central, regional, and wilayat—shall enjoy constitutionally defined autonomous executive, legislative (and representative in wilayas), administrative, and fiscal authority, including the appropriate power to tax.

6. Natural resources are the property of the people of Yemen. The management and development of natural resources, including oil and gas, and the award of exploration and development contracts, shall be the responsibility of the authorities of producing wilayas, jointly with the regional and federal authorities.

7. An independent national institution shall be established to include all concerned authorities at the wilayas, regional, and federal levels for the development of policies and to empower the producing wilayas and regions to manage natural resources efficiently. A federal law developed in consultation with the regions and wilayas shall define the criteria and formula for the sharing of revenues from natural resources, including oil and gas, in a transparent and equitable manner for all the people of Yemen, with due consideration to the specific needs of the producing wilayas and regions and the allocation of a share of the revenues to the federal government.

Box 1. National Dialogue: Highlights of the Signed Agreement (continued)

8. During the first electoral cycle after the adoption of the federal constitution, the South shall have a 50 percent representation in all leadership structures in the executive, legislative, and judicial bodies, including the armed and security forces, and in levels where appointments are made by the President of the Republic or the Prime Minister. Similarly, the South shall have a 50 percent representation in the House of Representatives. Inequality in civil service and the armed and security forces in the central level shall be addressed through legislation and institutions that ensure elimination of discrimination and achieve equal opportunities for all Yemenis. For the purpose of addressing the disparities in employment, Southerners shall have priority in employment in vacant posts and qualification and training in the civil service and armed and security forces. Appointments shall respect relevant public service requirements in terms of the skills and qualifications needed. No employee shall be forcibly dismissed.

9. The federal constitution shall require all governments and state institutions in the federal state of Yemen to promote equality through legislation and other measures, including real steps to achieve representation of at least 30 percent women in high offices, elected bodies, and the civil service.

All the people of Yemen, irrespective of their native region, shall belong to one shared nationality and shall have equal rights and responsibilities. Each citizen of Yemen has the right to reside, own, trade, work, or pursue any other personal legal matters in any wilaya or region of the federal state without discrimination.

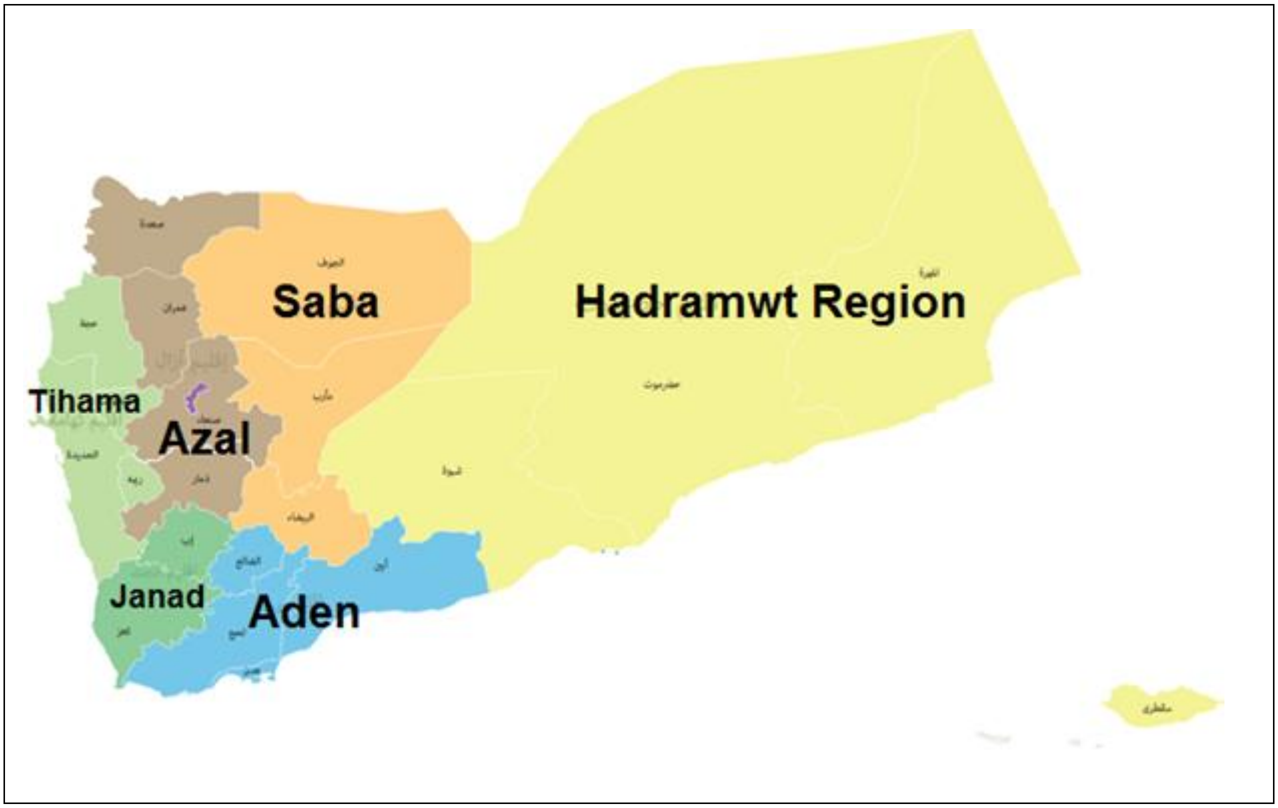
1/ Prepared by Gazi Shbaikat and Fouad Al-Kohlany.

Box 2. The New Federal Structure of Yemen [1/]

In line with the NDC recommendations, a committee headed by the President agreed on the structure of the country compromising six regions. The new structure will be imbedded in the constitution which will need to be endorsed in a referendum. The following are the agreed regions:

- **Azal**, which comprises the central and northern highland governorates of Sadah, Amran, Thamar, and the Sana'a governorate. Historically these governorates have played a prominent role in the political scene of Yemen for centuries.
- **Tihama**, which includes the northwestern governorates of Rayma, Mahweet, and the Red Sea coastal governorates of Hajaa and Hodida. Tehama is mostly dependent on fisheries and agricultural, and is much less tribal than Azal.
- **Saba**, which comprises the northern governorates of Marib, Aljawf, and Albayda. The Saba region is mostly desert with some farm land. Marib produces crude oil and is the location of Yemen's LNG gas upstream facilities.
- **Aljanad**, which covers the central/southern governorates of Taiz and Ibb. This is the most densely populated region in Yemen, and its land is highly fertile. Its inhabitants are more educated, and it has a large presence in the civil service and commerce.
- **Hadramout**, which includes the governorate of Shabwa, Hadramout, Almahra, and the island governorate of Suqatra. Hadramout has all the oil wealth in the country outside of Marib, and hosts the facilities that process the gas from Marib.
- **Aden**, which comprise the southern governorates of Aden, Lahj, Aldhalea, and Abyan. This region has little natural resources, and is more tribal than the western province of Hadramout. It has played a prominent role in the political, civil, and military scene of South Yemen.

1/ Prepared by Gazi Shbaikat and Fouad Al-Kohlany.


Saba
Hadramwt Region
Tihama
Azal
Janad
Aden

Appendix I. Letter of Intent

July 1, 2014

Madame Christine Lagarde
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Madame. Lagarde:

We would like to thank the International Monetary Fund (IMF) for the continued cooperation and policy advice over the past several years as the Government of Yemen has sought to maintain macroeconomic stability in a challenging political and security environment, and would like to request a three-year arrangement under the Extended Credit Facility (ECF) for budgetary support and to help close the BoP financing gap.

As you know, in 2011 Yemen experienced social unrest and political events that destabilized the macroeconomic environment and led to an output decline of more than 12 percent, and worsened already high unemployment and poverty levels. The stabilization efforts of the Government of Yemen—supported by the IMF in the context of the Rapid Credit Facility (RCF), and by donors including, in particular, Saudi Arabia—helped restore macroeconomic stability and promote a gradual recovery. However, energy subsidies and public sector wages absorb most fiscal revenues, leaving little scope for urgently needed growth-enhancing infrastructure investment and social expenditures. The contribution of the non hydrocarbon sector to growth remains low, hampered by a poor business environment and low private sector credit.

Macroeconomic stability has again come under threat in 2014. Sabotage activities reduced hydrocarbon revenues and exports, financing the larger fiscal deficit is challenging, and foreign exchange reserves are declining. In the absence of strong reforms and external budget support, the hard-won macroeconomic stability gains could be threatened and the high levels of poverty and unemployment could undermine the government's efforts to complete our political transition and achieve social stability.

The government is committed to preserving macroeconomic and financial stability and placing the economy on a path of sustained and inclusive growth. Our program is predicated on implementation of strong reforms, which include increasing nonhydrocarbon revenues, reorienting expenditures from generalized energy subsidies to growth-enhancing capital expenditures; effective protection of poor and vulnerable groups through well-targeted social protection schemes; strengthened public financial management and civil service reform; an appropriate macroeconomic policy mix of fiscal, monetary, and exchange rate policies to balance price stability and growth while maintaining adequate foreign exchange reserves; banking sector reforms to ensure financial stability; and structural reforms to improve the business environment, production and export diversification, financial intermediation and access.

The attached Memorandum of Economic and Financial Policies (MEFP) sets forth the policy measures the government intends to implement to attain its objectives. In support of the policies in the MEFP, the government requests that the Executive Board of the IMF approves a three-year arrangement under the Extended Credit Facility (ECF) with access in the amount equivalent to SDR 365.25 million (150 percent of quota) and disburse the amount equivalent to SDR 48.75 million (20 percent of quota) upon approval of the arrangement. Fund financing will help address the balance of payment problem including for closing the large financing gap directly, and will also provide a catalytic framework for the disbursement of donors' pledges and the better utilization of the disbursements.

The government of Yemen will provide data and information to the Fund on the progress in implementing the agreed economic and financial policies. It believes that the policies set out in the attached MEFP are adequate to achieve the objectives of the program, but will take any further measures that may be appropriate for this purpose. The government will consult in advance with the Fund should revisions be contemplated to the policies contained in the MEFP, in accordance with the IMF's policies on such consultations.

In line with our commitment to transparency, we consent to the publication of this Letter of Intent, the attached MEFP, and the attached Technical Memorandum of Understanding, as well as the IMF staff report relating to our request for the ECF arrangement, following approval of the IMF Executive Board.

Sincerely yours,

/s/	/s/
Mr. Mohamed Zemam	Mr. Mohamed Bin Humam
Minister	Governor
Ministry of Finance	Central Bank of Yemen

Attachments:

1. Memorandum of Economic and Financial Policies
2. Technical Memorandum of Understanding

Attachment I. Memorandum of Economic and Financial Policies

1. This memorandum reviews recent economic developments and summarizes the government's economic objectives and policy framework for 2014–17, for which we are seeking financial support under a new three-year arrangement under the Extended Credit Facility (ECF) with the IMF. Donors pledged about US$8 billion over the 2012–15 period to support the government program, and two thirds of these pledges remain to be disbursed.

2. Previous Fund-supported programs helped achieve macroeconomic stability. Our track record under the early stage of the 2010 ECF arrangement was strong. Following the political events of 2011 led to the cancellation of the 2010 ECF arrangement and IMF support under the Rapid Credit Facility (RCF) in April 2012, the government was able to meet all indicative targets under the RCF and implemented additional fiscal measures, including selected fuel price increases. These measures, together with financial support from Saudi Arabia and other donors, helped the government stabilize the macroeconomic environment, and was able to build on that progress and maintain macroeconomic stability during 2013.

3. Notwithstanding this progress, enormous challenges remain. Poverty is widespread and unemployment is very high, particularly among the youth. This contributes to undermining political and security stability, further compounded by internal conflicts and the presence of Al-Qaeda Movement. Worsening ground water shortages also depress economic activity, particularly agricultural output growth.

4. Recent sabotage activities on energy facilities curtailed hydrocarbon production , leading to lower hydrocarbon fiscal revenues and exports. As a result, fiscal pressures have increased, international reserves declined and financing needs have become very large. This has added to the urgent need for policies to enhance security of energy facilities and stem the deterioration in the fiscal and reserve positions. In addition, substantial fiscal and structural reforms are needed to create space for efficient pro-growth and pro-poor expenditures as well as to create a business environment conducive to private sector investment.

5. The government would like to build on the progress it has been making in the context of the Transitional Program for Stability and Development (TPSD) for 2012–2014. Its objectives are to mitigate the negative macroeconomic impact of the sharp decline in hydrocarbon production; ensure an appropriate mix of fiscal, monetary, exchange rate policies; and implement structural policies to create the conditions for sustained high and inclusive growth over the medium-to-long run. This will require substantial fiscal adjustment which will be achieved by reducing energy subsidies, containing public sector wages, and increasing non hydrocarbon tax revenues as well as external financing to close the financing gap in 2014. Sustained implementation of these reforms will help create fiscal space for growth, enhancing infrastructure expenditures, and targeted social transfers, as well as reduce dependence on oil revenues. Monetary policy will continue to aim to balance price stability and medium term growth objectives. Exchange rate policies will aim at minimizing volatility while preserving reserves and supporting competitiveness. Our structural policies will be designed to create a business environment conducive to private sector investment, support gradual output and export diversification, improve public financial management, and enhance governance.

6. Our policy framework will also be informed by the staff recommendations made in the context of Article IV Consultations and Technical Assistance.

I. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

7. Overall macroeconomic conditions: The macroeconomic situation has remained stable through 2013, but the economic recovery is fragile. Real GDP growth is estimated to have improved from 2.4 percent in 2012 to 4.8 percent in 2013, but was lower than potential due to continuing sabotage of oil facilities. Non-oil GDP growth continued to grow by about 4 percent. Average inflation edged up slightly to 11 percent in 2013, compared to 10 percent in 2012 while the nominal exchange rate remained stable at around Yrl 214.9 per US dollar.

8. Fiscal Developments: The overall fiscal position worsened moderately in 2013 where the budget deficit amounted to 6.9 percent of GDP compared to 6.3 percent in 2012 according to the IMF staff estimates (4.9 percent according to the Ministry of Finance classification), while the nonhydrocarbon primary balance excluding grants improved by about 6 percent of GDP. Underlying this outcome, hydrocarbon revenue declined in relation to GDP by about one percentage point, and external grants declined by about 5 percent of GDP from their exceptionally high level in 2012. To counter these adverse developments, the government reduced expenditures for subsidies and wages, and improved nonhydrocarbon revenue. Transfers and capital spending were also reduced by about 0.5 percent and 1.3 percent of GDP, respectively. The government faced significant challenges in financing the deficit with only Treasury bill and Sukuk issuance, and had to convert pension funds' foreign currency deposits into government bonds as well as advance central bank payment of the 2013 profit, which normally would have been paid in 2014.

9. External sector developments: Despite improvements in the trade balance and in remittances, the external current account deficit widened to 2.7 percent in 2013, due to the large decline in grants. The improvement in the trade balance mainly reflected a compression in fuel imports from their 2012 spike, increases in both hydrocarbon and non hydrocarbon exports, and the successful renegotiation of the price for a substantial part of our LNG exports. Workers' remittances also continued to grow. Financial flows were however at much lower levels than in 2012—when the Central Bank of Yemen benefited from a $1 billion deposit from Saudi Arabia—because of repatriation of part of initial direct investment by hydrocarbon foreign companies in 2013 (in line with the cost recovery arrangements in our hydrocarbon agreements). As a result of the higher current account deficit and lower financial flows, foreign exchange reserves declined by about US$800 million. The pension funds' sale of their foreign currency deposits to purchase treasury bonds helped moderate the decline in reserves.

10. Monetary and exchange rate developments: Money supply growth moderated to 12.5 percent compared to 21.5 percent in 2012, reflecting the decline in net foreign assets. Private sector credit expanded by 39 percent, from a very low base and after two years of consequent declines and net claim on central government continued to grow rapidly at about 28 percent. On February 7, 2013, the CBY reduced the benchmark deposit interest rate from 18 percent to 15 percent. The nominal exchange rate remained stable.

11. Financial sector performance: The banking system has remained stable, but important vulnerabilities remain. Banks are profitable, liquid and capital adequacy ratios (CAR) are high, albeit in large part reflecting the large zero-risk-weighted government securities on banks' balance sheet. However, nonperforming loans (NPLs) are high though covered and there is concentration of credit loans through bank investments in government securities, and exposure to real estate markets abroad. The banking sector is small and underdeveloped and contributes little to growth. The financial markets and the payment system are also underdeveloped and constrain monetary policy transmission and economic growth.

12. The environment for doing business: The environment for doing business remains difficult. The government shall seek to improve it, especially with regard to availability of funding for the private sector, protection of investors, liquidation procedures, and provision of electricity and other services. This would help to improve Yemen's rank in the World Bank's report for doing business environment.

13. Performance in the first quarter of 2014: Economic developments in the first quarter of 2014 were adversely impacted by sabotage attacks on the oil pipeline. The repeated attacks on oil facilities caused a decline in Yemen's hydrocarbon production and exports, and also in the quantities of crude oil allocated for domestic consumption, exerting new severe pressures on the fiscal and external positions, and causing severe electricity and fuel shortages and a slowdown in economic activity.

II. ECONOMIC OUTLOOK

14. The Outlook: The near term is likely to be very challenging but we expect to consolidate the macroeconomic gains over the medium term under the proposed program which anchors substantial reforms in the key fiscal areas of subsidies and the wage bill, assuming the security situation improves to reduce disruptions to hydrocarbon production. Uncertainties in the political and security situation cast a shadow over our reform efforts but we are resolved to implement the reforms as any delays, particularly in the fiscal area and/or in donors support, would risk destabilizing the economy in the short run and would jeopardize the medium-term growth objectives. The prospective shift to fiscal federalism will also require a careful design and institution and capacity building, to avoid fiscal and debt challenges and ensure that it delivers fairly on the needs of the population.

III. THE ECONOMIC PROGRAM FOR 2014–17

15. Program objectives: The program for which the government seeks support aims to maintain macroeconomic stability, enhance fiscal and external sustainability, and promote sustained and inclusive growth. The government strategy will be to: (i) reduce generalized fuel subsidies, contain wages, increase non hydrocarbon revenues so as to create fiscal space to increase growth enhancing infrastructure and social expenditures; (ii) ensure an appropriate mix of fiscal, monetary, and exchange rate policies to balance price stability with growth objectives, preserve reserves, improve export competitiveness and lay the basis for export diversification, and maintain debt sustainability; and (iii) implement structural reforms to improve the business environment and boost the recovery of the private sector investment; and (iv) strengthen public financial management to improve governance, transparency and efficiency in public expenditures. The success of our strategy will largely depend on the government’s ability to contain the fiscal deficit in 2014; the speed with which donors disburse the pledges made in the Friends of Yemen meetings for project financing; and the availability of external budget support.

16. Macro targets for 2014: Real GDP growth is expected to reach modest rates of 1.9 percent, reflecting the decline in the growth rates of hydrocarbon GDP by more than 8 percent in 2014. The fiscal deficit is projected to be contained around 5.4 percent, the current account deficit around 1.3 percent while reserves could decline to close to about 3 months of imports. Inflation will likely increase in the fourth quarter to reach 13 percent by end of year, reflecting the direct and indirect impact of fuel price adjustments that are planned for October 2014.

17. Medium term macroeconomic targets: Our goal is to attain and sustain real GDP growth of at least 5 percent over the medium term. This reflects increased utilization of idle capacity, donor supported investment, and the rekindling of private sector activity absorbing the growing labor force. We expect nonhydrocarbon production to recover to pre-political events levels and to grow steadily over the program period by 5 percent while oil production, which had declined because of sabotage activities, is expected to achieve modest positive growth until 2017, as security improves with progress in the political transition and the additional efforts the government is making to secure the oil pipelines in collaboration with the UN and international partners. Although inflation could edge up in the last quarter of 2014 to 13 percent because of the direct and indirect effects of the domestic oil price adjustment, we expect the second round effects to abate in the subsequent years and inflation to taper down to around 8 percent. The committed donor pledges if disbursed together with a stable economy should help support the balance of payments and keep international reserves at around 3 months of imports, provided the financing gap is filled. Given the planned fiscal measures that include reduction in subsidies, the fiscal deficit is projected to stabilize around 4 percent of GDP and public debt is expected to remain around 48 percent.

A. Fiscal Policies and Reforms

18. Our objectives in the fiscal area are to enhance fiscal sustainability while supporting growth and poverty reduction. The large size of subsidies and the wage bill constrains the fiscal space to increase capital expenditures that can generate growth as well as our capacity to extend targeted social transfers. The government will, therefore, focus our efforts at improving the structure and quality of public expenditures by reducing the inefficient generalized subsidies that do not adequately benefit the poor, and by addressing the problem of ghost workers and double dippers so as to contain the wage bill. We will also intensify efforts to increase non hydro carbon revenues by ensuring improved tax compliance and strengthening customs controls. The government will also increase growth enhancing capital expenditures and social transfers.

19. The immediate challenge is to address the difficult fiscal and external situation triggered largely by sabotage of the oil pipeline. In the absence of corrective measures, the fiscal deficit could widen from the 2014 budget projection of 6.8 percent to 9 percent of GDP. Under current policies and given current level of grants, a financing gap of about 3.5 percent of GDP would emerge.

20. Available financing options are inadequate to fund this magnitude of the deficit, and the government has therefore identified revenue and expenditure measures to reduce the financing gap. The objective is to undertake a fiscal adjustment of about 3.6 percentage points of GDP, which could reduce the deficit to close to 5.4 percent of GDP in 2014. On the revenue side, exceptional efforts will be made to improve tax revenues by about 1 percent of GDP including by recovering tax arrears, improving tax compliance and combating smuggling. The government will simplify the tax dispute procedures, activate the joint tax and customs coordination committee, improve payment compliance of registered large tax payers to 65 percent by end December 2014, enhance tax controls and strengthen coordination between the tax and customs authorities, and improve controls at customs stations. While our targets to increase tax revenue are ambitious, they are in line with the improvement we have achieved in recent years. On the expenditures side, corrective measures will produce savings for about 2 percent of GDP by allowing the private sector to import diesel for a substantial part of its requirement and reducing subsidies on petroleum products, effective as of October 1, 2014 (structural benchmark). The government will also keep capital expenditure at its 2013 level (2.4 percent of GDP) and postpone the payment of one off wage allowances, while keeping current on all other commitments on wages in line with the 2014 budget approved by Parliament. We shall be monitoring both expenditure and revenue closely and will revisit our planned expenditure should our tax revenue perform below its target.

21. The government will also enforce strict spending rules to avoid budgetary overspending and further deterioration of the financing gap. While budgetary resources are constrained, the government faces increased above-budgeted spending pressure for several reasons, mainly security and political reasons. In this regard, the Minister of Finance will instruct in writing government spending agencies, including line ministries and all other agencies, to strictly stay within their budget envelopes. When unavoidable, the authorization of spending over and above budgetary allocations has to be accompanied by simultaneous instruction for compensatory cuts on lower priority spending; the latter should be immediately communicated to the relevant government entities to integrate into their annual spending plans.

22. Over the medium term, the government will target reducing the fiscal deficit to about 4.3 percent by the end of the program. The nonhydrocarbon primary deficit, excluding grants, will decline steadily from 15.2 percent of GDP at end 2013 to about 9.4 percent by 2017. Continued consolidation would keep the debt to GDP ratio below 50 percent. The fiscal consolidation will be achieved through both expenditure restructuring and revenue enhancing measures. This will include further reducing the energy subsidies by adopting an adjustment pricing mechanism for petroleum products (a benchmark), containing the wage bill by addressing the issue of ghost workers and double dippers, and increasing non oil revenue mobilization through a reform of revenue administration in line with previous Fund TA, and improving transparency and accountability. These measures will free resources to increase capital expenditures and social transfers. Donor support will also be critical and the government will increase our outreach to development partners.

23. The government intends to reduce subsidies further and to increase capital expenditures and targeted transfers to the poor. We have already allowed the private sector to import a substantial part of its diesel usage at international prices either directly or through the Aden refinery starting in June 2014 (prior action). Additional subsidy reform measures, specifically price adjustment of fuel prices by an average of about 50 percent, will lead to a reduction in energy subsidies by about 4 percent of GDP over the program period. The government will also introduce an automatic fuel price adjustment mechanism to respond to increases in international prices in order to preserve and increase the savings from the subsidy reform. The government is cognizant of the potential adverse impact of these measures on the poor and therefore will concurrently increase the allocations for the Social Welfare Fund (SWF) by 50 percent starting in the last quarter of 2014. In collaboration with the World Bank, the government will continue to improve the coverage of the SWF and phase out transfers to noneligible beneficiaries. Some of the savings will also be applied towards capital expenditures that are designed to create employment.

24. Spending on wages and salaries will be capped to contain the wage bill while improving benefits for the civil service. The government is committed to seek savings through a reduction in ghost workers and double dippers. Reforms in this area will include the full implementation of the biometric identification system throughout the general civil service including the military and police, as well as the implementation of a census for the civil service and the military. We will also gradually move from cash payment of wages and salaries for civil servants to payments using bank accounts. As first step, the Council of Ministers will adopt soon an action plan to move progressively from cash payments for wages and salaries to payments using bank accounts and postal offices within two years (prior action).

25. The government is continuing its efforts to increase non oil revenues and reduce dependence on hydrocarbon revenues. We intend to increase tax revenue by about 0.5 percent of GDP annually, and to raise our tax-to-GDP ratio which currently remains low by regional as well as international standards. Towards this objective, we will implement measures to stabilize the GST and improve further on time filing and payment compliance of registered large tax payers to a target of 80 percent by December 2016 in line with FAD recommendations. The GST will be increased from

5 percent to 10 percent and unified at 90 percent for all tobacco produces while its coverage will be expanded to include all imported used vehicles and spare parts. A Ministerial directive will also be issued to establish a tax fraud investigation unit to strengthen ex post controls and improve tax compliance, and will establish procedures for the implementation of a new customs valuation system that meets the requirements of the WTO, with the assistance of reputable international institutions. The tax litigation process will be simplified by eliminating the dispute committee and limiting the appeal process to the court of first instance and the court of appeals. .

26. The government will review existing tax and customs exemptions and reductions with the view to limit them. It will produce an inventory of all existing tax exemptions and reduced tax rates. It will also define a reference tax system and identify all exemptions towards a full assessment of tax expenditures. It will not allow any new measures designed to expand the scope of tax and customs exemptions, including any amendments to the effective laws.

27. We will speed up reforms to strengthen capacity for project implementation and donor aid coordination. To improve the quality of public sector investment and help catalyze donors' disbursements, we will undertake measures to strengthen project selection, procurement, implementation and monitoring, in close coordination with the World Bank and other donors. We have already established an Executive Bureau to coordinate projects locally and with donors, and have strengthened its management. Furthermore, in coordination with the World Bank, we have set up the Mutual Accountability Framework to monitor progress in donors' assistance as well as follow up on our commitments.

28. We will maintain the momentum in implementing public finance management reforms. These reforms will aim at strengthening the treasury function at the Ministry of Finance and improving the process for planning and execution of government spending. We are currently deploying the Accounting-based Financial Management Information System (AFMIS) to bring the total to 55 units by the end of 2014. We will also adopt a strategy for transferring the treasury functions from the CBY to the Ministry of Finance in line with recent IMF FAD TA recommendations. These reforms and their time line are being coordinated with METAC experts that have been providing TA.

29. In addition, the government will adopt a gradual program to clear outstanding payment arrears over the medium term. In this regard, we will monitor expenditure arrears on a quarterly basis.

30. **The risk of debt distress is currently assessed to be moderate and the government will not contract or guarantee nonconcessional external debt, except from international and regional development institutions**, from which we will only borrow at the most concessional terms these institutions provide. The government will also seek to speed up the promised support by donors. Given the difficult political and social conditions of the country, the focus will be on mobilizing budgetary grants to help mitigate the budgetary pressures without further worsening the debt burden.

B. Monetary and Exchange Rate Policies

31. **Monetary policy will continue to aim at maintaining price stability and fostering private sector credit to support economic growth**. Despite the reduction in the benchmark deposit rate in February 2013, interest rates remain high and constrain the expansion of credit to the private sector which is necessary to ensure private sector led growth. In addition, large fiscal financing needs have led to crowding out the private sector and exert upward pressures on interest rates. The policy mix will need to be gradually rebalanced to allow for a reduction in the currently high interest rates over the medium term. Reducing fiscal dominance will be a key objective of our program in order to alleviate the constraints on monetary policy. We will also continue to remain vigilant to both upside and downside risks and we stand ready to adjust policies using the full range of our monetary policy instruments. We also remain committed to an independent central bank that sets monetary policy with a view to maintaining low inflation.

32. **The Central Bank will refrain from new lending to the government.** The political events and economic crisis of 2011 led the CBY to extend credit to the government beyond the limits specified in the Law. Going forward, we will avoid monetizing the fiscal deficit, and will develop a program to normalize the government's position. In this regard, the CBY will draw up a Memorandum of Understanding (MOU) with the Ministry of Finance that stipulates our agreement on the time schedule to bring down the government's outstanding credit within legal limits. We will also finalize an agreement between the CBY and the Ministry of Finance that stipulates repayment terms and interest rates for credit extended by the CBY to Public Sector Enterprises. Given the plans to use the IMF disbursement for budgetary financing, CBY will formalize with the Ministry of Finance in an MOU the respective responsibilities for servicing obligations to the Fund and for maintenance of a specific government account at the CBY to receive Fund resources.

33. **We will be reviewing our monetary policy framework and improve the design of our monetary policy tools.** We plan over the medium term to move from the current framework of direct control of interest rates and reliance on the primary market of government paper to a more

efficient indirect approach that helps develop the interbank market and also enables banks to improve liquidly management. The *Sukuk* market which was introduced in 2011 continues to develop and provides Islamic banks with additional investment opportunities to place their liquidity. We welcome further technical assistance to enhance liquidity management capacity and improve inflation forecasting.

34. Despite the moderate appreciation of the real exchange rate in 2013, competitiveness remains adequate. Output and export diversification is critical for external sustainability and inclusive growth and is a central objective of our development strategy. We will, therefore, continue to maintain an exchange rate system that allows the rate to be market determined and our interventions in the foreign exchange market will be limited to smoothing out volatility. Some exchange rate flexibility will also be permitted over the medium term to help protect reserves and support export and economic growth, and also ease the pressures on monetary policy. The fiscal policies and reforms that we will be taking will support our efforts to maintain adequate foreign exchange resources as an important buffer against external shocks.

C. Financial Sector Stability and Development

35. Our financial system has remained stable, but there is need to improve its resilience to shocks. Recent stress test results indicated liquidity and solvency risks stemming from credit risk, loan concentrations, and concentration of bank investments in government securities. This will be mitigated by enforcing prudential regulations and strengthening the regulatory and supervisory framework, including by introducing consolidated supervision and enhancing the legal powers of the CBY to enable it undertake cross border supervision. We will also develop prudential regulations that address the risks specific to Islamic banking in collaboration with METAC. We issued the banking corporate governance guidelines and we will be enforcing these regulations. We have benefitted from METAC in undertaking earlier reforms and will continue our collaboration to strengthen the regulatory and supervisory framework.

36. Sustained financial stability also requires orderly resolution of banks when stresses emerge and we will be strengthening our banking and central bank laws. The review of our banking law revealed significant gaps, particularly with respect to powers to resolve banks. We will collaborate with the IMF legal department in drafting the suggested changes to the law and will aim to submit the amended law to parliament by June 2015. We will strengthen the Prompt Corrective Action (PCA) in collaboration with METAC. We will also request a review of the Central Bank Law to ensure adequate powers to effectively execute our mandate.

37. To enhance our effectiveness in regulating and supervising the financial system, we will also reform the financial infrastructure. We are collaborating with the World Bank in strengthening the public credit registry and payments system and have already issued tenders for these projects. We are committed to strengthening the insolvency regime to enhance the banking system's capacity to enforce their rights to foreclose on collateral pledged by borrowers as security for loans and we will make efforts to improve the functioning of our commercial courts.

38. We will also undertake the reforms needed to improve access to financial services. Our financial system is small and underdeveloped, and credit intermediation is among the lowest in the world. In 2009, we issued a law on micro finance banks and since then we have given licenses to two deposit taking institutions to provide micro finance while another bank has been given a preliminary license. We will build on these efforts and promote mobile and branchless banking, and in this regard we will issue the required regulation in collaboration with CGAP and USAID. These initiatives together with the fiscal consolidation efforts to create space for private sector lending will contribute to deepening the financial system, promote financial intermediation and increase the financial system's contribution to growth.

39. We have made significant improvements to our AML/CFT legal framework. To meet our commitments stipulated in the action plan to address the strategic deficiencies that he FATF identified, we adopted and brought into force amendments to the AML/CFT Law that adequately criminalizes money laundering and terrorist financing and issued regulations on the freezing of terrorist assets. Going forward, we will require technical support to facilitate implementation.

D. Structural Reforms

40. We will implement structural reforms to diversify our production and export structure away from hydro carbons as part of our strategy to achieve inclusive growth. We will adopt a multi faceted strategy to improve the business environment, increase credit to small and medium sized enterprises, and coordinate with donors to support priority sectors such as electricity, tourism, fisheries, manufacturing and agriculture. We will introduce reforms to address the deficiencies in the business environment that were identified by the World Bank's Doing Business Survey, including reducing corruption and red tape and strengthening property rights. The Parliament ratified the WTO agreement; and with the submission of the 2011 EITI report the suspension of Yemen has been lifted so that Yemen is now fully EITI compliant. The government will ensure that the proposed Public-Private-Partnership legislation is in line with best practices.

41. Growth has been insufficient to reduce the widespread poverty and unemployment. Poverty and unemployment are high, and many social indicators are among the lowest. The government recognizes that economic growth is fundamentally important for poverty reduction and that growth-promoting policies must be environmentally, socially, and economically, sustainable. The government intends to address these challenges and will develop a Poverty Reduction Strategy (PRS) by the time of the completion of the second review under the ECF arrangement. A key objective of the PRS would be inclusive, diversified, and sustainable growth, which goes hand in hand with employment generation and income equality. Effective management of oil and LNG resources holds is key to unlocking wide-ranging socio-economic benefits to the population at large. The ECF-supported program seeks to underpin this effort by facilitating high quality public investment and growth enhancing reforms in the context of macroeconomic stability.

42. Donor support will be critical in enabling us achieve the program objectives. Yemen's development and poverty reduction needs are enormous and donor disbursement of the pledged support will be critical in facilitating the implementation of the projects included in the TPSD, help realize higher economic growth, reduce poverty and unemployment, and help meet the Millennium Development Goals. We will increase our outreach to donors to accelerate the disbursement of the pledged financial support and to convert some of the project finance into budgetary support. We will also ensure that financial support from our international partners is deployed in areas that can provide an enabling environment for private sector growth, including irrigation, telecommunications, road, water networks, and electricity.

E. Other Issues

43. We will be undertaking measures to improve the data for macro financial surveillance and program monitoring. Current delays in national accounts and other macro data impair policy formulation. We will make efforts to develop quarterly GDP data, monthly leading indicators of economic activity, and prices and macro financial data that could form part of an Early Warning System. The household survey is currently underway and we intend to undertake a labor survey in 2014, since the last one was conducted in 2009.

44. We will continue to strengthen governance arrangements at the CBY. We have implemented most of the measures that were recommended by the safeguard assessment mission, including strengthening the internal audit function and publishing the detailed audited accounts for 2011 and 2012. We will continue to publish detailed audited accounts of the CBY. We will also collaborate with safeguard mission in accordance with the requirement of a new ECF arrangement.

F. Program Modalities

45. The proposed ECF supported program will cover a three-year period beginning July 2014, with semi-annual disbursements from the IMF contingent upon successful completion of reviews. It will be monitored through performance criteria, indicative targets, structural benchmarks, and semi-annual reviews, and there will be seven disbursements designed to be commensurate with the reform efforts. Quantitative performance criteria are proposed for end-December 2014 and end-June 2015 to be monitored respectively at the first and second reviews. The proposed semi-annual targets for end-December 2014 and end-June 2015 (performance criteria) and end-September 2014 and March 2015 (indicative targets) are set forth in Table 1. These include: (i) a ceiling on domestic financing of the budget of the central government and local administrations; (ii) a ceiling on net domestic assets of the CBY; (iii) a floor on net international reserves of the CBY; and (iv) a continuous ceiling on the contracting or guaranteeing of non concessional external debt by the public sector; and (v) a floor on disbursements of benefits by the Social Welfare Fund.

46. A number of structural benchmarks are detailed in Table 2 and the first part of the program will include strong prior actions. We will closely monitor financial and economic developments in coming months and will implement any measures that may be needed to safeguard macroeconomic stability in consultation with IMF staff.

47. The attached Technical Memorandum of Understanding (TMU) sets out the modalities of program monitoring. These include definitions of performance criteria and indicative targets; application of adjustors for deviations from oil revenues and external financing; and data sources and frequency of data reporting. The Ministry of Finance will take the lead in collection, vetting, and provision of data to the IMF in a timely fashion for the purpose of program monitoring in line with the requirements as specified in the TMU and its Table 1 on reporting standards.

Table 1. Republic of Yemen: Quantitative Performance Criteria and Indicative Targets 1/

(In billions of Yemeni rials unless otherwise indicated)

Table 1. Republic of Yemen: Quantitative Performance Criteria and Indicative Targets, 2014–15

	2013	2014				2015	
	December	March	June	Sept	December	March	June
	Actual	Actual	Indicative targets	Indicative targets	Performance criteria	Indicative targets	Performance criteria
Ceiling on domestic financing of the budget of the central government and local administrations	…	141	54	180	131	115	88
(cumulative change)	618	141	196	376	507	115	203
Ceiling on net domestic assets of the central bank (stock)	216	233	471	501	561	573	576
(cumulative change)	…	16	255	285	345	11	15
Floor on net international reserves of the central bank (stock, US$ millions)	3,607	3,330	2,926	2,570	2,201	2,169	2,173
(cumulative change, US$ millions)	…	-277	-681	-1,037	-1,406	-32	-28
Ceiling on contracting or guaranteeing of new external non concessional debt with maturity of more than one year 2/ by the public sector (stock, US$ millions)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Floor on cumulative disbursements of benefits by the Social Welfare Fund	65	18	35	51	74	24	47
Memorandum Items							
Reserve money	1,098	1,022	1,222	1,171	1,161	1,176	1,191
Net external budget grants and loans (cumulative, Yrls billions)	54	-5	13	49	65	-6	20
Government oil and LNG export revenues (Yrls billions)	…	136	119	191	191	159	159
Cumulative government oil and LNG export revenues (Yrls billions)	674	136	255	446	638	159	318

1/ All the targets are cumulative changes from the beginning of the year, except continuous ceiling on contracting or guaranteeing of external nonconcessional debt by the government or the central bank. The targets for March and September are indicative.
2/ Continuous performance critreion.

Table 2. Republic of Yemen: Prior Actions and Structural Benchmarks		
	Objective	***Test Dates***
Prior Actions		
1. Council of Ministers to approve a decision allowing the private sector to import part of its diesel usage (in the range of 35,000-50,000 tons per month) at international prices by end-June 2014	Improve fiscal sustainability and ease fuel shortages	Prior Action
2. Council of Ministers to approve a decision requiring completion of the full implementation of the biometric identification system throughout the general civil service including the military and police by end 2014 .	Reduce ghost workers and double-dippers	Prior Action
3. Council of Ministers to adopt an action plan to move progressively from cash payments for wages and salaries to payments using bank accounts and postal offices within two years (1st year: for civil servants and Ministry of Interior; 2nd year: for Ministry of Defense).	Eliminate ghost workers and contain the wage bill	Prior Action
4. CBY and MOF to sign a Memorandum of Understanding for reducing the MOF central government debt to the central bank in line with legal limits over the coming seven years, by a minimum of 15 percent annually starting in 2017.	Enhance fiscal discipline	Prior Action
5. CBY and MOF to sign a Memorandum of Understanding on the use of Fund resources, which specifies responsibilities for timely servicing financial obligations to the Fund and for maintenance of a specific government account at the CBY to receive the Fund financing.	Safeguard Fund resources	Prior Action
6. CBY to publish on its website the full set of audited financial statements, including the audit opinion for the financial year 2013. Adopt a Board resolution to publish CBY annual statements within four months of the end of the financial year for all subsequent years.	Promote transparency and good governance of the central bank	Prior Action

Structural Benchmarks		
Fiscal Policy and Reform Measures		
7. Refrain from introducing any new measures that aim at expanding the scope of tax and customs exemptions, including through any amendments to the 2010 Investment Law.	Minimize distortions/ protect revenue base	Continuous
8. Cabinet to increase the domestic price of gasoline, diesel, and Kerosene by 50 Yrls per liter and Yrls 800 per gas cylinder (to Yrls 175, Yrls 150, Yrls 150, and Yrls 2000, respectively). Increase SWF monthly allocations per beneficiary by 50 percent.	Improve fiscal sustainability/ Protect the poor	October 1, 2014
9. Issue Ministerial directive to establish a tax fraud investigation unit to strengthen ex-post controls and improve tax compliance	Enhance revenue collection process	October 2014
10. Implement measures to stabilize the GST and increase filing and payment compliance of registered large taxpayers to 65 percent in line with FAD recommendations.	Enhance revenue mobilization	December 2014
11. Implement measures to stabilize the GST and increase filing and payment compliance of registered large taxpayers to 75 percent in line with FAD recommendations.	Enhance revenue mobilization	December 2015
12. Implement measures to stabilize the GST and increase filing and payment compliance of registered large taxpayers to 80 percent in line with FAD recommendations.	Enhance revenue mobilization	December 2016
13. MOF to complete the study to assess the revenue impact of the application of income tax to all interest earnings including individuals.	Enhance revenue collection process	December 2014
14. Cabinet to approve a strategy for transferring the treasury functions from the CBY to the Minister of Finance in line with recent FAD TA recommendations through the support of a resident expert.	Enhance fiscal institutional capacity	December 2014
15. MOF to complete the review of total arrears, develop a gradual program for settlement of these arrears, and prepare quarterly reports on the stock of arrears.	Enhance fiscal discipline	December 2014
16. Cabinet to adopt a fuel "pricing mechanism" that would allow domestic prices to move in response to increases in	Reduce impact on budget/ Improve	March 2015

international prices.	fiscal sustainability	
17. Introduce a post-clearance audit program at the customs in line with FAD recommendations.	Enhance revenue collection	June 2015
18. Complete a survey of SWF beneficiaries with a view to improve targeting (with donors support).	Protect the poor	June 2015
19. Simplify tax litigation process by eliminating the dispute committee and limiting the appeal process to the court of first instance and the court of appeals.	Enhance revenue collection process	June 2015
20. 55 Ministries and spending units shall submit to the Minister of Finance, the standard monthly reports, produced using the Automated Financial and Management Accounting System (AFMIS).	Improve budget execution and reporting	June 2015
21. Produce a full assessment of tax and customs exemptions and reduced customs and tax rates; and assess the impact on revenues.	Minimize distortions/ protect revenue base	September 2015
22. Convene periodic meetings (quarterly) with major donors to review and evaluate progress of projects implementation	Speed up disbursement of external funding	December 2014
Financial Sector Reforms		
23. CBY to put in place the prudential framework for Islamic banking, including reporting requirements.	Ensure financial stability	March 2015
24. CBY to implement the automatic data entry to supervisory reporting system, which includes the regular call reports sent by banks to the CBY.	Reduce human errors in the data used for assessing financial stability and improve risk assessment	June 2015
25. Integrate stress testing in the risk management practices of banks by issuing prudential regulations and guidelines.	Enhance financial stability	March 2015
26. Start the review of the Central Bank law with a view to further strengthen its independence, and incorporate the proposed amendments to the banking law, including amendments to strengthen bank resolution powers and present draft law to parliament.	Enhance financial stability	March 2015

Energy Sector Measures		
27. Expand the roll out of prepaid electricity meters to two additional districts in the Capital City.	Helping improve the financial position of the sector quickly.	June 2015
28. Revise the Independent Power Producers (IPP) fuel purchasing arraignments. Fuel to be purchased directly by the IPPs at the unified price.	Reduce inefficiencies in the fuel products supply chain.	December 2014
29. Change the mechanism of providing subsidized fuel to the EC to compute subsidy on energy sold and revenues actually collected from consumers.	Reduce inefficiencies in the fuel products supply chain.	December 2014

Attachment II. Technical Memorandum of Understanding

1. This Memorandum sets out the understanding reached between the Yemeni authorities and the Fund staff regarding the definitions of performance criteria and indicative targets, as well as data reporting requirements for the 2014–17 Extended Credit Facility (ECF) Arrangement (Table 1).

2. The ECF Arrangement is built upon five performance criteria for the end of semi-annual intervals (test dates) during December 2014–June 2017 period. Performance criteria and indicative targets are set out in Table A of Memorandum of Economic and Financial Policies. Performance criteria and indicative targets are set subject to adjustors as applicable, which will be monitored as memorandum items.

3. The exchange rate of Yemeni rial to the U.S. dollar for the purposes of the program is set at Yrls 214.89 = US$ 1.

I. PERFORMANCE CRITERIA AND INDICATIVE TARGETS

A. Floor on Net International Reserves of Central Bank of Yemen

4. For purposes of this criterion, net international reserves (NIR) of the CBY are defined as reserve assets minus reserve-related liabilities, consistent with the definition of the Sixth Edition of the Balance of Payments and International Investment Position Manual. Reserve assets are defined as those external assets readily available to, and controlled by, the CBY. Reserve-related liabilities of the CBY are defined as foreign currency liabilities of the CBY that can be considered as direct claims by nonresidents on the reserve assets of Yemen.

5. NIR of the CBY are defined for this purpose as readily available external assets of the CBY (this includes following categories: monetary gold, foreign exchange deposits held with nonresident financial institutions; foreign securities; SDR holdings; and reserve position in the International Monetary Fund) minus CBY external liabilities (this includes SDR allocations; liabilities to the Arab Monetary Fund (AMF) and the International Monetary Fund (IMF); the $1 billion deposit of Saudi Arabia, and other short-term liabilities to nonresidents). Pledged and otherwise encumbered assets, including, but not limited to, reserve assets used as collateral (or guarantees for third party external liabilities) are excluded from reserve assets, and (ii) external assets not controlled by the CBY (foreign currency deposits at CBY of banks', pension funds' and public enterprises'), are not included in reserve assets. The term "public enterprises" relates to all enterprises where the central government and local administrations combined have stake of 50 percent and above.

6. For program monitoring purposes, NIR of the CBY as of the test dates are measured as the change in millions of US dollars from the beginning of the calendar year.

B. Ceiling on Net Domestic Assets of Central Bank of Yemen

7. Net domestic assets (NDA) of the CBY are defined as reserve money minus net foreign assets of CBY.

8. Reserve Money is defined as the sum of currency in circulation (outside banks), banks' domestic cash in vaults, and banks' required and excess deposits with the Central Bank of Yemen (CBY). It includes commercial banks' required and excess reserves on foreign currency deposits valued at the program exchange rate. It does not include deposits held in the CBY by the central government and local administrations, pension funds, public enterprises, and counterpart funds. The term "banks" relates to all commercial and Islamic banks.

9. Net foreign assets are NIR as defined under paragraphs 4, 5 and 6 plus other external assets, including but not limited to: (i) capital subscriptions in international institutions; (ii) foreign assets in nonconvertible currencies; (iii) external assets that are in any way encumbered or pledged, and (iv) external assets not controlled by the CBY (foreign currency deposits at CBY of banks', pension funds' and public enterprises'), less any medium- and long-term foreign liabilities of the CBY.

For program monitoring purposes, NDA of the CBY as of the test dates are measured as the change in billions of Yemeni rials from the beginning of the calendar year. Reserve money, however, is measured in billions of Yemeni rials as a stock level at the test date.

C. Ceiling on Domestic Financing of the Budget

10. Budget refers to the budget of the central government of the Republic of Yemen and local administrations. It does not include extra budgetary funds (funds with independent or adjunct budgets), and public enterprises.

11. Domestic financing of the budget is defined as the sum of net claims of the CBY and domestic commercial banks on the central government and local administrations and net holdings of government securities by resident nonbanks. Net claims of the CBY and banks are defined as central bank and banks' advances and credits to the central government plus government paper held by the central bank and banks minus the central government's deposits at the central bank and banks. Government paper includes but is not limited to T-bills (at purchase value), T-bonds, Islamic bonds (sukuk and other), and repurchases of government securities of various maturities.

For program monitoring purposes, Domestic financing of the budget as of the test dates is measured as the cumulative change in billions of Yemeni rials from the beginning of the calendar year.

D. Floor on Disbursements by the Social Welfare Fund

12. This refers to the disbursements by the Social Welfare Fund (SWF) to the poor that have been identified and registered as regular beneficiaries of the SWF. For program monitoring purposes, disbursements of the SWF as of the test dates are measured as the cumulative change in billions of Yemeni rials from the beginning of the calendar year.

E. Ceiling on Contracting or Guaranteeing of New Nonconcessional External Debt with Maturities of More Than a Year by the Public Sector

13. For program purposes, the definition of debt is set out in Executive Board Decision No. 12274, Point 9, as revised on August 31, 2009 (Decision No. 14416-(09/91)). This performance criterion refers to the contracting or guaranteeing of new nonconcessional external debt with an original maturity of over one year. External debt is defined as debt contracted from nonresidents. The ceiling applies to debt and commitments contracted or guaranteed for which value has not yet been received. The term "public sector" relates to the government and public enterprises as defined in paragraph 5. Nonconcessional loans are defined as having a grant element equivalent to less than 35 percent calculated as follows: the grant element of a debt is the difference between the present value (PV) of debt and its nominal value, expressed as a percentage of the nominal value of the debt. The PV of debt at the time of its contracting is calculated by discounting the future stream of payments of debt service due on this debt. The discount rate used for this purpose is 5 percent.

The ceiling excludes the use of IMF resources. In addition, the ceiling excludes loans from the Arab Monetary Fund and those from regional developmental/financial institutions (specifically, the Arab Fund for Economic and Social Development (AFESD), the Islamic Development Bank, the Kuwait Fund, and the OPEC Fund for International Development (OFID)) that carries a grant element of 25 percent or more. Also excluded from the ceiling are debts incurred to restructure, refinance, or prepay existing debts, to the extent that such debt is incurred on more favorable terms than the existing debt and up to the amount of the actually restructured/refinanced/prepaid debt.

II. ADJUSTORS

A. External Budget Grants and Loans

14. Net external budget grants and loans consists of cash disbursements of external cash grants and budget support loans to the budget, less cash amortization payments for budget support loans. Transactions of external grants and loans are to be valued at the program exchange rate.

15. The floor on NIR will be adjusted downward, while the ceilings on NDA and domestic financing of the budget will be adjusted upward by the full cumulative amount of any shortfall in net external budget grants and loans. In case of excess net external budget grants and loans, ceilings on NDA and domestic financing of the budget will be adjusted downward for the portion of net external budget grants and loans that is not spent on capital expenditures, while the floor on NIR will be adjusted upward for the portion of net external grants and loans that is not spent on capital expenditures financed through imports.

B. Crude Oil and LNG Export Revenue of Government

16. The programmed quarterly crude oil and LNG export revenue of government shown in the Table A of the MEFP under memorandum item for the end of the quarter are compared to the actual government crude oil and LNG revenue reported by the CBY/ Ministry of Oil in order to determine the excess or shortfall in cumulative government crude oil and LNG receipts. The data on government crude oil and LNG revenue will be converted to rials at the program exchange rate.

17. The data on crude oil and LNG export revenues of the government for the end of the quarters are applied as adjustors to the floor on net international reserves and to the ceilings on net domestic assets and domestic financing of budget. The floor on NIR will be adjusted upward, while ceilings on NDA and domestic financing of budget will be adjusted downward by the full cumulative amount of any excess in cumulative government crude oil revenue and LNG export receipts vis-à-vis the programmed level. In the case of shortfall of cumulative government crude oil revenue and LNG export receipts, the floor on NIR will be adjusted downward by the full cumulative amount of any shortfall, while ceilings on NDA and domestic financing of budget will be adjusted upward for the 50 percent of any shortfall in cumulative government crude oil revenue and LNG export receipts vis-à-vis the programmed level.

Table 1. Reporting Standards

Reporting Agency	Type of Data	Description of data	Frequency	Timing within specified period
Central Bank of Yemen	Flash report	Weekly data for movement in main indicators of CBY balance sheet, own net international reserves, foreign assets, foreign liabilities, sale and purchases of foreign exchange, and exchange rate.	Weekly	Five working days of the end of each week (Wednesday).
	CBY balance sheet	Detailed balance sheet of Central bank of Yemen	Monthly	3 weeks after the end of each month
	Monetary survey	Banking system balance sheet and consolidated balance sheet of commercial and Islamic banks	Monthly	3 weeks after the end of each month
	Securities	Data of outstanding and redemption amount and interest rates on T-bills, T-bonds, CDS rates by maturity.	Monthly	3 weeks after the end of each month
	Bank and nonbank financing	Data on T-bills, T-bonds and repurchases	Monthly	1 month after the end of each month
	Domestic debt	Stock of central government domestic debt broken down into T-bills, T-bonds, repurchases, and loans that are owned to each of the following: CBY, commercial banks, pension funds, public enterprises, and other private sector	Monthly	1 month after the end of each month
	Banking indicators	Capital adequacy, portfolio quality, portfolio performance, exposure to exchange rate risk.	Quarterly	2 months after the end of each quarter
	Balance of payments	Detailed composition of exports, imports, services, transfers and capital account transactions.	Quarterly	4 months after the end of each quarter
Ministry of Finance	Central government	Revenues, grants, expenditures (current and development), financing – standard presentation	Quarterly	2 months after the end of each quarter
	Central government	Revenues, grants, expenditures, and financing as in GFSM 2001	Quarterly	2 months after the end of each quarter
	Short term	Data on all new borrowing and	Monthly	1 month after the

Reporting Agency	Type of Data	Description of data	Frequency	Timing within specified period
	debt	guarantees by central government, local governments and CBY		end of each month
	External financing	External debt service and payments	Monthly	1 month after the end of each month
	Crude oil and LNG exports	Crude oil and LNG export revenue received by the government	Monthly	3 weeks after the end of each month
	CPI	Disaggregated consumer price index	Monthly	5 weeks after the end of each month
	National accounts	National accounts data	Annual	Within 4 months after the end of each year.
	Crude oil and LNG production	Data on crude oil and LNG production by field	Monthly	1 month after the end of each month
	Consumption of refined fuel product	Data on domestic consumption of refined fuel product by category	Monthly	1 month after the end of each month
	Production of refined fuel products	Data on domestic production of refined fuel products by category	Monthly	1 month after the end of each month
	Imports of refined oil products	Data on imports of refined oil products by category	Monthly	1 month after the end of each month

INTERNATIONAL MONETARY FUND

REPUBLIC OF YEMEN

July 3, 2014

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION AND REQUEST FOR A THREE-YEAR ARRANGEMENT UNDER THE EXTENDED CREDIT FACILITY—INFORMATIONAL ANNEX

Prepared By: Middle East and Central Asia Department (In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of May 31, 2014)

Membership Status: Joined: May 22, 1990;		Article VIII
General Resources Account:	**SDR Million**	**%Quota**
Quota	243.50	100.00
Fund holdings of currency (Exchange Rate)	243.49	99.99
Reserve Tranche Position	0.01	0.01
SDR Department:	**SDR Million**	**%Allocation**
Net cumulative allocation	232.25	100.00
Holdings	140.44	60.47
Outstanding Purchases and Loans:	**SDR Million**	**%Quota**
RCF Loans	60.88	25.00
ECF Arrangements	34.79	14.29

Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
ECF	Jul 30, 2010	Apr 04, 2012	243.50	34.79
ECF [1/]	Oct 29, 1997	Oct 28, 2001	264.75	238.75
EFF	Oct 29, 1997	Oct 28, 2001	72.90	46.50

[1/] Formerly PRGF.

Projected Payments to Fund
(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2014	2015	2016	2017	2018
Principal			6.96	13.05	19.13
Charges/Interest	0.05	0.033	0.32	0.30	0.26
Total	0.05	0.33	7.28	13.35	19.39

Safeguards Assessment:

An update safeguards assessment was completed in June 2013 with respect to a disbursement made under the Rapid Credit Facility in April 2012. The updated assessment noted that steps have been initiated to strengthen the Central Bank of Yemen (CBY) governance and financial statements are prepared and audited in accordance with international standards. CBY has enhanced transparency with the publication of the full set of audited financial statements as recommended by the update assessment. The assessment also recommended that the CBY, in coordination with the Ministry of Finance, finalize an agreement on repayment terms for credit extended to the government and that the capacity of the internal audit function be further developed.

Exchange Arrangements:

The currency of Yemen is the Yemeni rial. The de facto exchange rate arrangement is classified as stabilized, and the de jure exchange rate arrangement is free floating.

Yemen has accepted the obligations of Article VIII, Sections 2, 3, and 4, of the Articles of Agreement and maintains an exchange system that is free of multiple currency practices and restrictions on the making of payments and transfers for current international transactions. In accordance with UN Security Council Resolutions, Yemen has taken measures to block the accounts of certain individuals and organizations and has notified the Fund of these measures in accordance with Decision 144.

Article IV Consultation:

The latest Article IV consultation was concluded on July 19, 2013. The next Article IV consultation with Yemen would be expected to take place under the 24-month cycle, in accordance with the Executive Board Decision on Article IV consultation cycle as applied to countries with a Fund Arrangement.

FSAP Participation:

FSAP (with the World Bank), October–November 2000.

Technical Assistance:

a. IMF:

FAD—Pension Reform, August 2001
FAD—Reform of the Budgetary Process, April 2002
FAD—Public expenditure management expert installation, September 2002
FAD—Tax policy, tax administration and customs reform, October–November 2002
FAD—Public Expenditure Management Advisor, August 2003-January 2004
FAD—Public Expenditure Management, March-April 2004
FAD—Support to LTO, April 2005
FAD—GST Implementation, April 2005
FAD—Support to LTO and GST Implementation, November 2005
FAD—Reforming Tax Administration and implementing GST, June 2006
FAD—Treasury Function and Related PFM Reforms, July 2007
FAD—Participation in World Bank Review Mission, June 2009
FAD—METAC revenue administration advisor and short term expert, June-July 2009

FAD—METAC revenue administration advisor and short term expert, May 2010
FAD—METAC revenue administration advisor and short term expert, August 2010
FAD—METAC revenue administration advisor and short term expert, November 2010
FAD—Developing Core Treasury Functions, December 2010
FAD—Revenue Administration Assessment Mission, February 2011
FAD—Energy Subsidy Reform, December 2012

LEG—AML/CFT Diagnostic, May 2006
LEG—AML/CFT Legal drafting, November 2006
LEG—Desk Review of Payment System, January 2011

MAE—Foreign reserves management, February-March 2001
MAE—Technical Assistance and Training Coordination and Expenditure Resource Mobilization, March 2005
MAE—ST Regional Expert Assignment, June-July 2005
MAE—ST Regional Expert Assignment, August 2005
MAE—Support for the regulatory framework of the Central Bank of Yemen, September-October 2005

MFD—Liquidity Management, March-April 2005
MFD—Regional Advisor, September 2005
MFD—Payment Systems and Monetary Operations, October 2005
MFD—Support for the Central Bank of Yemen credit Registry, November-December 2005

MCM—METAC – Technical Assistance on Banking Supervision, May 2006
MCM—Banking supervision, June-July 2006
MCM—Credit Registry, July 2006
MCM—METAC – Banking Supervision, December 2006
MCM—METAC – Needs Assessment Visit, March – April 2007
MCM—Payment systems, January – February 2008
MCM—Developing the Government Sukuk Market, July 2009
MCM—METAC- Banking Supervision, November 2009
MCM——Developing the Government Sukuk Market, May 2010
MCM—Developing the Government Sukuk Market, July 2010
MCM—METAC – Developing Debt Management Capacity, July 2010
MCM—METAC – Banking Supervision, August 2010
MCM—Developing the Government Sukuk Market, February 2011
MCM—METAC – Developing Debt Management Capacity, February 2011
MCM—METAC – Banking Supervision, October 2012
MCM—METAC – Strengthening Prompt Corrective Action (PCA), March 2013

OTM—TCAP Review, March 2004
OTM—Yemen – TCAP, March-April 2004

OTM—METAC – Needs Assessment Mission, February 2005

STA—Balance of payments statistics, January 2003
STA—Government Finance Statistics, January 2004
STA—National Accounts Statistics, January 2004
STA—National Accounts Statistics, May-June 2004
STA—Balance of payments statistics, September 2005
STA—Multisector Statistics Mission, August – September 2007
STA—Balance of Payments – January 2009
STA—Consumer Price Index/Producer Price Index Mission, June-July 2009
STA—Balance of Payments – July 2009
STA—National Accounts Statistics, July 2009
STA—Consumer Price Index/Producer Price Index Mission
STA—National Accounts Statistics, December 2010
STA—Producer Price Index Mission – February 2010
STA—METAC- Producer Price Index Mission, December 2012
STA–METAC- Consumer Price Index Mission, December 2012

b. UNDP/IMF/DFID Program:

FAD—LTE on budget management, March 1998–June 2001, and September 2002–January 2004
MAE—LTE on bank supervision, May 1997–May 2001
MED—LTE on debt management, July 1997–March 2001
STA—LTE on balance of payments statistics, February 1998–February 2000
FAD—Peripatetic experts on customs reform, July 1999–July 2001
STA—Peripatetic expert on national accounts, September 2001–August 2002
MAE—Peripatetic expert on foreign reserves management since April 2002

c. IMF/World Bank Program:

MAE—FSAP, October–November 2000
FAD—AFMIS Inspection Mission, September-October 2004

Resident Representatives:

Mr. Gazi Shbaikat.

WORLD BANK RELATIONS

1. As of April 2014, the active IDA and TF portfolio in Yemen includes 34 projects with US$983 million in commitments, of which about US$536 million in undisbursed balances remain. The Bank is pursuing efforts to restructure its portfolio in Yemen, with a view to improving implementation performance, which was affected by the political crisis. Bank's regular implementation support efforts are complemented by third-party monitoring and independent verification measures to ensure satisfactory progress and fiduciary integrity of its ongoing portfolio.

2. The framework for Bank support to Yemen (an ISN[1]) which was endorsed by the Board in November 2012 will be expiring at the end of June 2014. Given that the transition period has been extended in Yemen, the Bank team is exploring the possibility of extending the ISN for a few months and initiating the analytical work and consultations required for the preparation of the new Country Partnership Framework (CPF) in FY15. The strategy and the Bank program will be developed in line with Government of Yemen priorities and will focus on the economic development agenda in light of the outcomes of the National Dialogue (ND). The Bank has already fielded a multi-sectoral scoping mission in March 2014 and discussed an initial set of areas including definition of the structure of the state, fiscal decentralization, and local service delivery and governance. Bank work in the next 12 to 18 months is listed below.

[1] The strategic pillars of the ISN include: (i) achieving quick wins and protecting the poor by creating short-term jobs, restoring basic services, improving access to social safety nets, and revitalizing livelihoods; (ii) promoting growth and improving economic management by helping maintain macro stability, strengthening fiscal policies and public financial management, and improving the enabling environment for private sector growth and competitiveness; and (iii) enhancing governance and local service delivery by supporting transparency, accountability, capacity building, institutional strengthening, and improved citizen engagement.

YEMEN : Joint Management Action Plan (JMAP)

(As of May 31, 2014)

Title	Products	Provisional Timing of Missions (if relevant)	Delivery/Expected Date
A. Mutual information on relevant work programs			
Bank work program in next 12 months	Enhancing Financial Inclusion, Transparency and Stability Project (IDA)		July 2014 (A)
	Mocha Wind Power Project ($20 million IDA)		June 2014
	Corridor Highway Project ($150 million IDA)		July 2014
	Additional Financing for SFD ($50 million IDA)		July 2014
	Additional Financing for Labor Intensive Public Works ($50 million)		
	Water TA		FY14
	IFC Business Edge Advisory Program (IFC)		FY13-14
	Support to Post National Dialogue Implementation AAA		FY15
	Growth Study		September 2014
	IFC support for PPPs, MSME finance, and Corporate Governance (IFC)		FY14
IMF work program in next 12 months			
	Staff Visit – Review of macroeconomic development and policies, and discussions of the macroeconomic framework	October 2014	October 2014
	First Review of ECF	March-April 2015	March- April 2015

B. Request for work program inputs (as needed)

Fund request to Bank	DSA	June 2014	June 2014
	Reform of the Social Welfare Fund to make its targeting more effective, while strengthening its legal framework and bringing its operations in line with stated social objectives.		
	Improving efficiency and governance in oil refineries and retail to help reduce the subsidy bill. Civil service reform to control the wage bill. TA on the new hydrocarbon sector legislation and organization, and advise on tender system for exploration of reserves.		
Bank request to Fund			
	External Sector Assessment	June 2014	June 2014

C. Agreement on joint products and missions (as needed)

Joint products in next 12 months	DSA	June 2014	June 2014

STATISTICAL ISSUES

1. Data remain broadly adequate to conduct surveillance. However, some weaknesses persist (including delays in reporting). A broad effort is in place to address shortcomings in most data with technical assistance from the Fund and other donors. In particular, national accounts data should be a priority for improvement.

2. The Republic of Yemen has participated in the General Data Dissemination System (GDDS) since April 26, 2001. While some progress has been made, considerable scope remains to improve the collection and dissemination of economic statistics in line with Yemen's commitments under the GDDS.

3. The most reliable and timely data are those on the **monetary sector** produced by the Central Bank of Yemen (CBY). The CBY disseminates data on total official reserve assets and monetary statistics with a lag of one month. To strengthen monetary statistics further, a multisector mission in August 2000 recommended that: (a) repurchase agreements be treated as collateralized loans; (b) all nonstandard loans be reclassified as claims on the relevant sector; (c) counterparty for several monetary accounts be more accurately identified; and (d) a number of monetary accounts be disaggregated so as to present position on a single financial instrument. In June 2003, the authorities began reporting to STA a more disaggregated set of data that allowed for improved sectoral and instrument classification. Publication of the revised monetary statistics for December 1999 and onward, based on the more detailed data reporting, began in the August 2003 issue of *IFS*. In March 2007, with the availability of more detailed data, the definition of broad money was broadened to include the deposits of the pension funds, starting with data for December 1999. CBY does not yet report monetary data to STA using Standardized Report Forms (SRFs).

4. Although important progress has been achieved in terms of coverage, classification, and compilation methods of **national accounts** in accordance with the *System of National Accounts 1993 (1993 SNA)*, significant work remains to be done to improve quality of the data and the compilation methods. The Central Statistical Organization (CSO) has benefited from substantial TA in national accounts and price statistics provided by METAC and with the support of the IMF's Statistics Department (STA). A series of peripatetic missions have been conducted to date, with the most recent mission on national accounts conducted during December 2010. As a result of this support, the CSO has succeeded in (i) improving the GDP estimates at current and constant prices for the period 1999–2005; (ii) constructing the new GDP series for 2000–2008, which include GDP (public and private) by economic activities at current and constant prices, and expenditure components of GDP at current prices; (iii) partially solving fluctuations in the nominal GDP values as well as in the volume measures of GDP for select economic activities; and (iv) addressing various methodological issues including assumptions concerning the intermediate consumption in different activities. The assistance from United Nations Economic and Social Commission for West Asia (ESCWA) during 2007, 2008 and 2009, has resulted in a new National Accounts series, which the CSO has adopted and published on their website (June 2009).

5. However, the 2010 STA mission noticed a number of weaknesses. Notably the mission recommended improving data on the informal economy, updating the frame and the sampling design for economic survey, using an improved set of deflators for calculating the GDP and GDP expenditure components at constant prices, conducting small surveys to update assumptions as in agriculture for estimating the inputs, .and conducting a labor force survey since the last survey dates back to 1999. Regarding **price statistics**, some improvements have been made in the compilation of the consumer price index and the production of foreign trade price indices. As part of METAC's work program a technical assistance mission on price statistics visited Sana'a during December 2–13, 2012 to assist the CSO in developing and compiling a Producer Price Index (PPI). With the assistance of STA, the CSO has constructed a CPI that is consistent with international standards, with weights derived from the 1998 Households Budget Survey (HBS). The Consumer Price Index (CPI) has a broad geographic coverage and a sufficient number of consumption items, although some deficiencies remain in data collection practices. STA real sector missions have recommended further improving the sources of data in general, expanding the price statistics to cover different areas, and enhancing training and internal coordination within the CSO. Staff of CSO has updated the weights of the CPI basket to reflect the results of the 2005 HBS, and has reduced the number of commodities in the basket from the coverage of 900 goods in the basket to coverage of 435 goods. To address problems in the field, the CSO has introduced a new framework to ensure consistency in data collection according to the following criteria: timing, good specifications, and location.

6. **Fiscal** data reliability and timeliness are improving. Fiscal data are published in the quarterly *Bulletin of Government Finance Statistics (GFS Bulletin)* on the Ministry of Finance website (www.mof.gov.ye), which provides annual, quarterly, and monthly data with significant lags and irregularity. The authorities have reported data for publication in the *Government Finance Statistics Yearbook* from 2000 onwards; the latest data are estimates for 1999. No sub-annual data are reported for publication in *International Financial Statistics*. The GFS mission that visited Sana'a in January 2004 found that, while data coverage and detail had improved, there were still numerous departures from international standards in classification and coverage. The mission encouraged the authorities to include additional information on financing and debt in the *GFS Bulletin*. The mission also recommended that the authorities expand their data dissemination by communicating the *GFS Bulletin*, or the relevant data, to the IMF Statistics Department for re-dissemination and for renewing the dialogue and remote technical assistance for developing their GFS. The August-September 2007 Multisector Statistics mission found that many of the previously identified weakness data compilation and timeliness remained. The concepts and definitions used to compile GFS are in transition from GFS 1986 to GFSM 2001, and the authorities' *GFS Bulletin* reports fiscal data using a mixture of both.

7. The CBY is responsible for compiling and disseminating **balance of payments** statistics, and more recently, the international investment position (IIP) statistics based on the IMF's *Balance of Payments Manual, fifth edition*. Compilation tasks are performed on ad hoc basis, mostly relying on survey-based questionnaires with a response rate that is generally poor. The quality of the questionnaires themselves is also weak due to the limited expertise and experience in developing such material. There are also inadequacies in documented sources and methods, and the limited financial and material resources dedicated to balance of payments compilation. The CBY publishes quarterly external debt statistics within one quarter of the reference period for the banking sector, general government, and monetary authority. Successive STA balance of payments statistics missions (2002, 2003, and 2005) have sought to facilitate implementation of the action plan recommended by the IMF's resident advisor on balance of payments statistics (1998–2000), with limited success. Coverage of the oil and gas industry transactions remains weak. Data questionnaires on Foreign Direct Investment (FDI) and selected items in services have either been discontinued or not followed up. The shortage of qualified staff dedicated to the compilation as well as coordination shortcomings between the CBY and other government agencies (such as the customs authority, the CSO, and the ministry of oil and mining resources) are partly responsible for the slow progress. STA missions have consistently called for better coordination between the CBY and other government agencies for timely and effective data collection and compilation, improved staffing and training, and the reinstitution of discontinued surveys. A balance of payments mission in September 2005 found that the CBY had made some progress on increasing manpower and equipment in the balance of payments division, as well as training through the Arab Monetary Fund. The mission also focused on the present method of estimating inward worker's remittances. Yemen has submitted quarterly balance of payments data to STA until end-2006, although the latest data published in the *IFS* and *Balance of Payments Statistics Yearbook (BOPSY)* relate to end-2005. Quarterly IIP data has also been supplied to STA for 2003 and 2004.

Table of Common Indicators Required for Surveillance
(As of June 10, 2014)

	Date of Latest Observation	Date Received	Frequency of Data 6/	Frequency of Reporting 6/	Frequency of Publication 6/
Exchange rates	Jun 2014	Jun 2014	D	D	D
International reserve assets and reserve liabilities of the monetary authorities 1/	Jun 2014	Jun 2014	W	W	Q
Reserve/base money	Apr 2014	Jun 2014	M	M	M
Broad money	Apr 2014	Jun 2014	M	M	M
Central bank balance sheet	Apr 2014	Jun 2014	M	M	M
Consolidated balance sheet of the banking system	Apr 2014	Jun 2014	M	M	M
Interest rates 2/	Mar 2014	Mar 2014	M	M	M
Consumer price index	Apr 2014	May 2014	M	M	M
Revenue, expenditure, balance and composition of financing 3/—general government 4/	Apr 2014	Jun 2014	M	I	Q
Revenue, expenditure, balance and composition of financing 3/—central government	Apr 2014	Jun 2014	M	I	Q
Stocks of central government and central government-guaranteed debt 5/	Dec 2013	Feb 2014	M	M	M
External current account balance	Dec 2013	Feb 2014	A	A	A
Exports and imports of goods and services	Dec 2013	Feb 2014	A	A	A
GDP/GNP	2013	Jan 2014	A	A	A
Gross external debt	2013	Feb 2014	Q	Q	Q
International Investment Position	2010	2010	Q	A	A

1/ Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

2/ Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

3/ Foreign, domestic bank, and domestic nonbank financing.

4/ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

5/ Including currency and maturity composition.

6/ Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).

REPUBLIC OF YEMEN

July 3, 2014

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION AND REQUEST FOR A THREE-YEAR ARRANGEMENT UNDER THE EXTENDED CREDIT FACILITY—DEBT SUSTAINABILITY ANALYSIS

Approved By
Daniela Gressani and Bob Traa (IMF) and Bernard Funck and Jeffrey D. Lewis (IDA)

Prepared by the Staffs of the International Monetary Fund and the International Development Association

Risk of external debt distress:	Moderate
Augmented by significant risks stemming from domestic public debt and/or private external debt?	**Yes (domestic debt)**

This debt sustainability analysis (DSA) updates the joint IMF/IDA DSA from July 2, 2013. The results indicate that Yemen continues to face a moderate risk of debt distress. Although the level of public and publicly guaranteed external debt is modest, it is vulnerable to shocks to export receipts. Public domestic debt is large, leading to increased vulnerabilities, particularly to a growth shock.[1]

[1] This analysis is based on the joint Fund-Bank debt sustainability framework for conducting debt sustainability analysis in low-income countries. Under IDA's Country Policy and Institutional Assessment (CPIA), Yemen's three-year average score in 2010–12 is 3.04 and its policy performance is categorized as weak. This DSA update uses the indicative thresholds for countries for this category.

A. Underlying Assumptions

Apart from short-term projections, no major changes have been made to macroeconomic projections compared to the previous DSA (Box 1). Over the long term, real GDP growth is assumed to be about 4.5 percent, while exports and imports of goods and services are assumed to grow by about 5.5 percent and 3 percent, respectively. Inflation is assumed to stabilize at 6.5 percent. Projections for workers' remittances have been revised upwards in view of their strong performance in recent years, and LNG exports will be boosted by upward revisions to export prices in the contracts recently concluded or expected to be concluded.

B. External DSA

Under the baseline scenario, all public and publicly guaranteed (PPG) external debt indicators are below the policy-dependent thresholds over the projection period (2014–2034). The present value (PV) of debt-to-exports ratio is projected to peak at about 65 percent in 2026 before declining to 57 percent, compared to the threshold applied to Yemen (100 percent) (Table 1). In terms of the composition of public external debt, no contracting of commercial debt is assumed under the scenarios. However, about 40 percent of official debt is assumed to be semi-concessional (loans with a grant element of 25-35 percent) or reflecting obligations owed to the IMF and the Arab Monetary Fund.

Under the alternative scenarios and stress tests, all indicators remain below the thresholds, with one exception (Table 2 and Figure 1). The PV of debt-to-exports ratio is projected to rise above 100 percent in 2016 under the most extreme shock to export receipts and to remain so throughout the projection period. These findings highlight Yemen's high dependence on oil exports for its external sustainability.

Yemen's international investment position has not been published since 2008. Data on private sector flows and stocks, including nonhydrocarbon FDI and other private investment flows need to be improved. Existing shortcomings result in substantial unidentified flows that can be better classified if data improve.

C. Public DSA

Yemen's public debt-to-GDP ratio exceeds the policy-dependent benchmark in 2013[2] and remains above it through 2034 (Table 3). Even though the level of public and publicly-guaranteed external debt is comfortably low (about 8–16 percent), the PV of total public debt-to-GDP ratio amounts to 49 percent in 2013, exceeding the benchmark of 38 percent applied to Yemen. The public debt-to-GDP ratio increased

[2] Yemen's public debt at end-2013 was about 49 percent of GDP; 15 percentage points in external debt and 34 percentage points in domestic debt. All external debt is concessional, long term, and mostly denominated in US dollars. Domestic debt is all in local currency. About 25 percent of it is owed to the central bank in the form of loans that will be reduced by about 15 percent annually starting in 2017. About 30 percent is owed mostly in 5 years bonds to the corporate sector, insurance companies, and pension funds. Finally 45 percent is owed to the banking sector, most of which are in six months bills held by conventional banks, and only 5 percentage points are in 5–14 years sukuk held by Islamic banks.

Box 1. Assumptions for the Macroeconomic Framework

Growth: In the medium term (2014–19), real GDP growth is projected to average about 4.6 percent, which is slightly higher than the 10-year historical average before the political crisis (4.3 percent). This reflects projected recovery from the recent economic slowdown because of the supply shock, increased international assistance, including the proposed ECF arrangement, and utilization of idle production capacity. For the long term growth is projected to average 4.5 percent (2020–34). Given the gradual decline in oil production, non-hydrocarbon growth is essential. Following the political transition and under the ECF-supported program, the government will undertake structural reforms to improve the business environment and attract sizeable donor-funded public investment. Reprioritization of expenditures should support infrastructure investment, while reduction in crowding out would lead to growth in credit to the private sector, boosting non-hydrocarbon growth. The assumptions on nonhydrocarbon growth rates average 5.2 percent in 2014–19 and 4.7 percent in the long term. These are broadly in line with the historical experience.

Hydrocarbon Sector: As in last year's DSA, oil production is assumed to continue towards the end of projection period, in line with the authorities' projections and consistent with the assessment of main credible independent sources (e.g. British Petroleum Oil Statistics, *Oil & Gas Journal*, and Economic Intelligence Unit), which put Yemen's proven oil reserves at about 3 billion barrels. Assuming a partial recovery in oil production over the medium term, and subsequent declines of 3 percent per year over the long-term, Yemen would use only about half of its proven reserves by 2034. Yemen has a large potential in the LNG sector. The DSA assumes no increase in LNG production over the medium-term and an average annual increase at 7 percent from 2025 onwards.

Inflation: Inflation is projected to edge up in 2014–15 owing to the impact of higher fuel prices following reforms, and to gradually decline to single digits in the medium term with the recovery of economic activities. It would then moderate to an average of 6.5 percent in the long term, assuming that the central bank refrains from financing the government budget and ensures the stability of the real exchange rate.

Public finance: Despite the pressure on the fiscal position following the shock to oil production in early 2014, strong fiscal adjustment will be undertaken under the ECF-supported program and will continue at a more gradual pace over the projection period. The ratio of total revenues (excluding grants) to GDP would thus hover around 20 percent. On the expenditure side, the government's efforts to control the public wage bill and fuel subsidies, including by removing ghost workers and double dippers as well as increasing domestic petroleum prices, are expected to lead to a reduction in overall expenditures from 29.6 percent of GDP in 2014 to 22.1 percent in 2034. As a result, the overall fiscal deficit would gradually decline to around 3 percent of GDP by 2034.

External sector: Exports are expected to decrease in the medium term, reflecting a declining oil production. However, a gradual increase in non-oil exports and, more importantly, LNG exports, will offset the decrease in oil exports in the long run. The value of LNG exports will be boosted by higher LNG prices on account of recently renegotiated LNG export contracts. Nonhydrocarbon export growth would be around 6.4 percent in 2015–19, and would stabilize at around 5.5 percent in the long run. Import growth is projected at a conservative average of 2.9 percent over the projection period, reflecting fiscal adjustment. The current account deficit would gradually increase to about 2 percent of GDP in the medium term and would slowly widen over the projection period to about 3–4 percent of GDP. Official creditors are expected to continue providing financing on favorable terms. Improved security conditions and business environment would attract more foreign direct investment.

by 12 percentage point of GDP from 2008 to 2013. Most of the debt remained denominated in local currency. The maturity of domestic debt is shorter than external debt. The creditor base is domestic and very narrow. Key holders of domestic debt are commercial and Islamic banks, the Pension Fund, and a telecommunication company. These facts suggest substantial rollover and interest rate risks when facing a shock. The expansion of domestic public debt also resulted from financing of the budget by the central bank in the aftermath of the 2011 crisis. Data on contingent liabilities are not available, but there is some anecdotal evidence that indicates the existence of such liabilities.

The alternative scenarios and stress tests point to the importance for Yemen to embark on fiscal consolidation (Table 4 and Figure 2). They suggest that Yemen's public debt position is particularly vulnerable to GDP growth shocks.

D. Conclusion

Based on an assessment of PPG external debt, Yemen continues to face a moderate risk of debt distress. The assessment of the risk is reinforced by significant vulnerabilities related to a high level of public domestic debt. While the debt profile remains sustainable in a scenario of recovery and stability under continued prudent policies, it is subject to substantial downside risks, including a deterioration of the security environment and a decline in oil production and exports.

The authorities broadly agreed with staff's assessment. However, they highlighted the downside risks, especially in view of the potential impact of the projected decline in oil production, and the risk of deterioration in the fiscal and external accounts in case of slippages in policy implementation that might result from deterioration in the security situations.

Table 1. Republic of Yemen: External Debt Sustainability Framework, Baseline Scenario, 2011–34

(In percent of GDP, unless otherwise indicated)

	Actual			Historical 6/ Average	Standard 6/ Deviation	Projections									
	2011	2012	2013			2014	2015	2016	2017	2018	2019	2014-2019 Average	2024	2034	2020-2034 Average
External debt (nominal) 1/	**19.9**	**18.7**	**16.4**			**16.4**	**16.5**	**17.6**	**18.5**	**19.0**	**19.7**		**20.2**	**16.3**	
of which: public and publicly guaranteed (PPG)	18.6	17.4	15.2			13.7	13.2	13.7	14.0	14.2	14.4		13.2	9.8	
Change in external debt	-0.3	-1.2	-2.3			0.0	0.1	1.2	0.8	0.6	0.7		-0.1	0.0	
Identified net debt-creating flows	4.9	-0.8	2.5			5.0	2.8	1.7	1.4	1.4	1.7		3.5	3.7	
Non-interest current account deficit	**2.8**	**1.5**	**2.9**	**2.3**	**4.2**	**1.1**	**0.8**	**1.1**	**1.0**	**1.3**	**2.1**		**4.4**	**4.2**	3.9
Deficit in balance of goods and services	2.4	11.6	7.8			5.0	1.7	2.0	2.4	2.9	4.1		5.7	3.3	
Exports	30.3	24.9	22.4			23.3	24.0	23.4	22.7	21.9	20.4		16.1	14.7	
Imports	32.7	36.5	30.2			28.3	25.7	25.4	25.1	24.8	24.4		21.8	18.0	
Net current transfers (negative = inflow)	-6.5	-14.4	-9.2	-8.4	2.5	-8.7	-7.6	-7.2	-6.9	-6.6	-6.4		-5.1	-2.9	-4.4
of which: official	-2.4	-6.2	-0.9			-1.4	-1.0	-0.9	-0.9	-0.9	-0.9		-0.7	-0.4	
Other current account flows (negative = net inflow)	6.9	4.2	4.3			4.8	6.8	6.4	5.6	5.0	4.5		3.7	3.7	
Net FDI (negative = inflow)	**3.1**	**-1.0**	**1.8**	**-0.6**	**3.1**	**3.9**	**2.3**	**1.1**	**0.8**	**0.7**	**0.1**		**-0.6**	**-0.2**	-0.4
Endogenous debt dynamics 2/	**-0.9**	**-1.3**	**-2.1**			**-0.1**	**-0.4**	**-0.4**	**-0.5**	**-0.6**	**-0.5**		**-0.3**	**-0.2**	
Contribution from nominal interest rate	0.2	0.2	0.2			0.2	0.2	0.3	0.4	0.4	0.5		0.6	0.5	
Contribution from real GDP growth	2.4	-0.4	-0.8			-0.3	-0.7	-0.7	-0.9	-1.0	-1.0		-0.8	-0.7	
Contribution from price and exchange rate changes	-3.6	-1.1	-1.5			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	**-5.2**	**-0.5**	**-4.8**			**-5.0**	**-2.7**	**-0.6**	**-0.6**	**-0.8**	**-1.0**		**-3.6**	**-3.7**	
of which: exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	17.0			17.1	17.3	18.1	18.5	18.7	18.9		18.7	14.7	
In percent of exports	...	...	76.1			73.4	72.0	77.2	81.5	85.5	92.8		115.9	99.8	
PV of PPG external debt	**...**	**...**	**15.8**			**14.3**	**14.0**	**14.2**	**14.1**	**13.8**	**13.7**		**11.7**	**8.2**	
In percent of exports	**...**	**...**	**70.5**			**61.7**	**58.5**	**60.5**	**62.0**	**63.2**	**67.0**		**72.4**	**55.8**	
In percent of government revenues	**...**	**...**	**68.6**			**63.6**	**64.7**	**64.0**	**63.2**	**64.2**	**63.5**		**55.8**	**43.4**	
Debt service-to-exports ratio (in percent)	**2.8**	**2.9**	**3.0**			**4.0**	**3.9**	**4.4**	**5.8**	**5.4**	**6.0**		**8.9**	**5.5**	
PPG debt service-to-exports ratio (in percent)	**2.8**	**2.9**	**2.9**			**4.0**	**3.8**	**4.1**	**5.2**	**4.6**	**4.8**		**6.9**	**3.6**	
PPG debt service-to-revenue ratio (in percent)	**3.5**	**3.0**	**2.9**			**4.1**	**4.2**	**4.3**	**5.3**	**4.7**	**4.6**		**5.3**	**2.8**	
Total gross financing need (Billions of U.S. dollars)	2.2	0.4	2.1			2.7	2.1	1.7	1.8	1.9	2.2		4.4	7.3	
Non-interest current account deficit that stabilizes debt ratio	3.1	2.7	5.1			1.1	0.8	0.0	0.2	0.7	1.5		4.5	4.1	
Key macroeconomic assumptions															
Real GDP growth (in percent)	-12.7	2.4	4.8	2.6	5.6	1.9	4.6	4.7	5.2	5.9	5.6	4.6	4.3	4.6	4.5
GDP deflator in US dollar terms (change in percent)	21.3	5.6	8.9	10.8	8.8	10.4	7.2	0.1	0.7	0.5	0.2	3.2	1.3	1.7	1.5
Effective interest rate (percent) 5/	1.2	1.1	1.1	1.2	0.3	1.6	1.7	1.9	2.1	2.4	2.6	2.0	2.9	3.0	2.9
Growth of exports of G&S (US dollar terms, in percent)	7.1	-11.4	2.7	9.7	20.6	16.9	15.8	2.1	2.7	2.6	-1.4	6.5	2.3	5.5	3.8
Growth of imports of G&S (US dollar terms, in percent)	0.7	20.7	-5.7	11.4	14.5	5.5	1.7	3.7	4.8	5.1	4.3	4.2	4.1	3.5	3.9
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	39.1	37.9	39.6	39.7	39.9	39.9	39.4	40.2	40.2	40.2
Government revenues (excluding grants, in percent of GDP)	24.1	23.8	23.0			22.5	21.7	22.1	22.3	21.6	21.5		21.0	18.9	20.4
Aid flows (in Billions of US dollars) 7/	0.5	2.4	0.6			0.8	0.9	0.9	1.0	1.2	1.2		1.2	1.3	
of which: Grants	0.4	2.2	0.4			0.6	0.5	0.4	0.4	0.5	0.5		0.4	0.5	
of which: Concessional loans	0.1	0.3	0.2			0.2	0.4	0.5	0.6	0.7	0.7		0.8	0.8	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			1.7	1.7	1.5	1.6	1.5	1.4		1.0	0.6	0.9
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			76.1	61.0	57.3	56.2	60.2	59.3		58.1	59.0	58.2
Memorandum items:															
Nominal GDP (Billions of US dollars)	32.7	35.4	40.4			45.5	51.0	53.4	56.6	60.2	63.7		84.0	154.2	
Nominal dollar GDP growth	5.9	8.2	14.2			12.5	12.1	4.8	5.9	6.4	5.8	7.9	5.7	6.4	6.1
PV of PPG external debt (in Billions of US dollars)			6.4			6.5	6.9	7.3	7.7	8.1	8.5		9.6	12.3	
(PVt-PVt-1)/GDPt-1 (in percent)						0.4	0.9	0.8	0.7	0.7	0.6	0.7	0.2	0.3	0.3
Gross workers' remittances (Billions of US dollars)	1.4	3.0	3.4			3.4	3.4	3.5	3.5	3.6	3.6		3.9	4.2	
PV of PPG external debt (in percent of GDP + remittances)	...	...	14.5			13.3	13.1	13.3	13.3	13.1	12.9		11.2	8.0	
PV of PPG external debt (in percent of exports + remittances)	...	...	51.1			46.6	45.6	47.4	48.7	49.8	52.4		56.3	47.0	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	2.1			3.0	2.9	3.2	4.1	3.6	3.8		5.4	3.0	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Assumes that PV of private sector debt is equivalent to its face value.

5/ Current-year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

7/ Defined as grants, concessional loans, and debt relief.

8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Table 2. Republic of Yemen: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2014–34

(In percent)

	Projections							
	2014	2015	2016	2017	2018	2019	**2024**	2034
PV of debt-to GDP ratio								
Baseline	14	14	14	14	14	14	**12**	8
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	14	13	12	11	10	9	**2**	-7
A2. New public sector loans on less favorable terms in 2014-2034 2	14	14	15	15	15	15	**15**	13
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	14	15	16	16	16	16	**13**	9
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	14	17	22	21	21	21	**18**	10
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	14	14	14	14	14	14	**12**	8
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	14	15	17	16	16	16	**14**	9
B5. Combination of B1-B4 using one-half standard deviation shocks	14	16	19	18	18	18	**16**	10
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	14	19	19	19	19	19	**16**	11
PV of debt-to-exports ratio								
Baseline	61	58	61	62	63	67	**72**	56
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	61	54	51	49	47	46	**12**	-47
A2. New public sector loans on less favorable terms in 2014-2034 2	61	58	62	66	69	75	**92**	86
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	61	57	59	60	62	65	**71**	54
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	61	90	136	139	142	150	**167**	106
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	61	57	59	60	62	65	**71**	54
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	61	61	71	73	74	79	**86**	60
B5. Combination of B1-B4 using one-half standard deviation shocks	61	73	90	92	94	100	**110**	75
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	61	57	59	60	62	65	**71**	54
PV of debt-to-revenue ratio								
Baseline	64	65	64	63	64	63	**56**	43
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	64	60	54	50	48	44	**10**	-37
A2. New public sector loans on less favorable terms in 2014-2034 2	64	64	66	67	70	71	**71**	67
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	64	67	72	71	73	72	**63**	49
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	64	78	98	96	97	96	**87**	55
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	64	66	64	63	64	64	**56**	43
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	64	68	75	74	75	74	**66**	47
B5. Combination of B1-B4 using one-half standard deviation shocks	64	74	84	83	84	83	**74**	51
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	64	87	86	85	87	86	**75**	58

Table 2. Republic of Yemen: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2014–34 (continued)

(In percent)

Debt service-to-exports ratio								
Baseline	4	4	4	5	5	5	**7**	4
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	4	4	4	4	4	4	**3**	-1
A2. New public sector loans on less favorable terms in 2014-2034 2	4	4	4	5	5	5	**8**	6
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	4	4	4	5	5	5	**7**	4
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	4	5	7	9	8	8	**12**	9
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	4	4	4	5	5	5	**7**	4
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	4	4	4	6	5	5	**7**	4
B5. Combination of B1-B4 using one-half standard deviation shocks	4	4	5	7	6	6	**9**	6
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	4	4	4	5	5	5	**7**	4
Debt service-to-revenue ratio								
Baseline	4	4	4	5	5	5	**5**	3
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	4	4	4	4	4	3	**2**	-1
A2. New public sector loans on less favorable terms in 2014-2034 2	4	4	4	6	5	5	**6**	5
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	4	4	5	6	5	5	**6**	3
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	4	4	5	6	5	5	**6**	5
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	4	4	4	5	5	5	**6**	3
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	4	4	4	6	5	5	**6**	3
B5. Combination of B1-B4 using one-half standard deviation shocks	4	4	5	6	5	5	**6**	4
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	4	6	6	7	6	6	**7**	4
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	40	40	40	40	40	40	**40**	40

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.

2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.

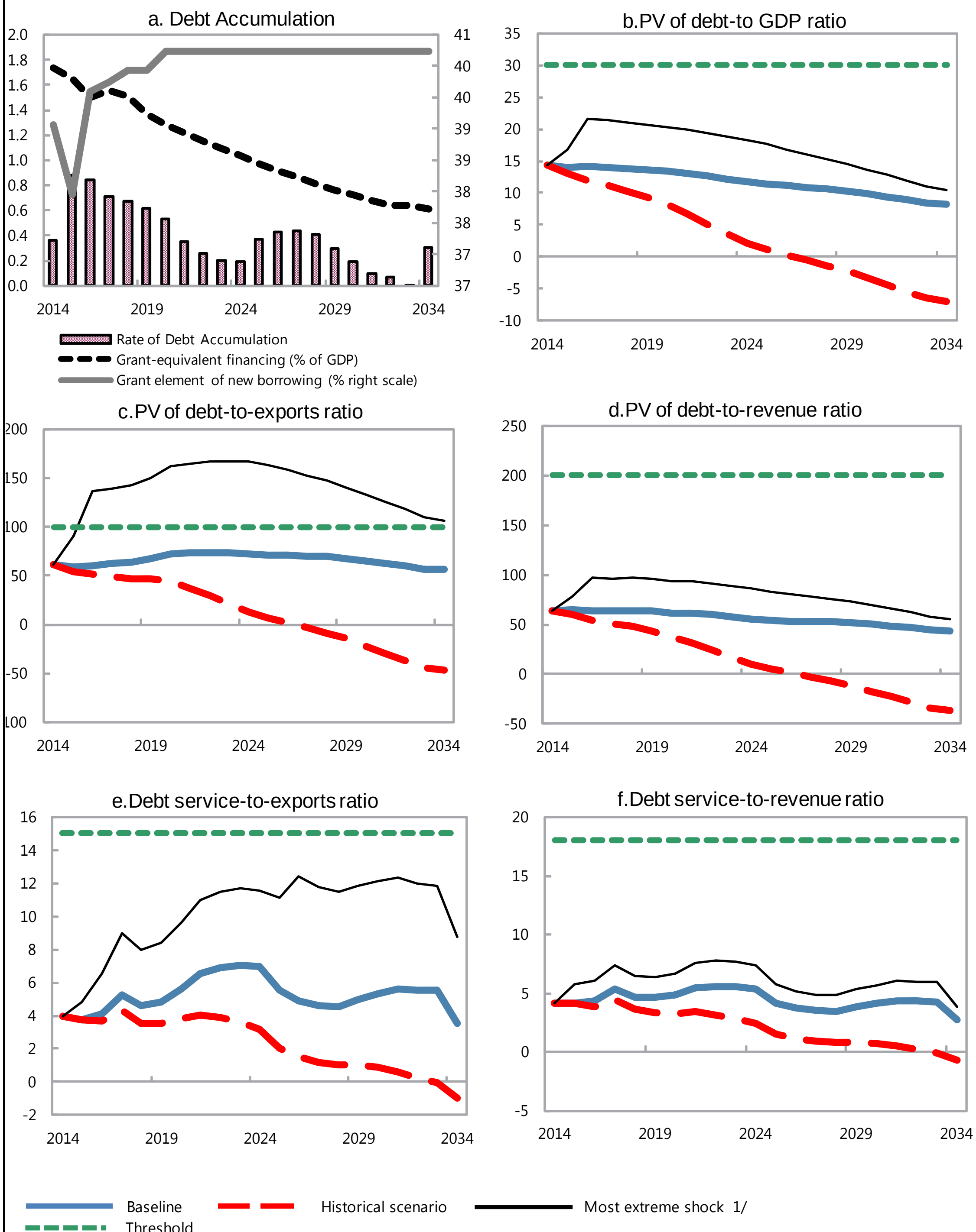
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

4/ Includes official and private transfers and FDI.

5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.

6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Figure 1. Republic of Yemen: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2014-2034 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2024. In figure b. it corresponds to a Exports shock; in c. to a Exports shock; in d. to a Exports shock; in e. to a Exports shock and in figure f. to a One-time depreciation shock.

Table 3. Republic of Yemen: Public Sector Debt Sustainability Framework, Baseline Scenario, 2011–34

(In percent of GDP, unless otherwise indicated)

	Actual			Average 5/	Standard Deviation 5/	Estimate	Projections								
	2011	2012	2013			2014	2015	2016	2017	2018	2019	2014-19 Average	2024	2034	2020-34 Average
Public sector debt 1/	45.7	47.3	48.2			48.2	47.4	48.0	47.8	47.4	46.9		42.2	30.4	
of which: foreign-currency denominated	18.6	17.4	15.2			13.7	13.2	13.7	14.0	14.2	14.4		13.2	9.8	
Change in public sector debt	3.3	1.6	0.8			0.0	-0.8	0.6	-0.2	-0.5	-0.5		-1.3	-1.1	
Identified debt-creating flows	3.2	2.8	0.9			0.0	-0.8	0.6	-0.2	-0.5	-0.3		-1.1	-0.7	
Primary deficit	0.2	0.9	1.5	0.7	3.4	0.1	0.0	-0.2	-0.6	-0.4	-0.5	-0.3	-1.1	-0.6	-0.9
Revenue and grants	25.3	29.9	23.9			23.9	22.7	22.9	23.0	22.4	22.3		21.5	19.2	
of which: grants	1.2	6.1	0.9			1.4	1.0	0.8	0.8	0.8	0.7		0.5	0.3	
Primary (noninterest) expenditure	25.5	30.8	25.4			24.0	22.7	22.6	22.4	22.1	21.8		20.4	18.6	
Automatic debt dynamics	3.1	2.0	-0.5			0.0	-0.8	0.8	0.4	-0.1	0.2		0.1	-0.1	
Contribution from interest rate/growth differential	6.1	2.6	0.6			1.2	-0.6	0.7	0.2	-0.3	0.0		0.0	-0.2	
of which: contribution from average real interest rate	-0.1	3.7	2.8			2.1	1.5	2.8	2.6	2.4	2.5		1.8	1.2	
of which: contribution from real GDP growth	6.2	-1.1	-2.2			-0.9	-2.1	-2.1	-2.4	-2.6	-2.5		-1.8	-1.4	
Contribution from real exchange rate depreciation	-3.0	-0.6	-1.2			-1.2	-0.2	0.2	0.2	0.2	0.2		...	...	
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	0.1	-1.3	-0.1			0.0	0.0	0.0	0.0	0.0	-0.2		-0.2	-0.3	
Other Sustainability Indicators															
PV of public sector debt	...	...	48.7			48.8	48.2	48.4	47.9	47.1	46.1		40.7	28.8	
of which: foreign-currency denominated	...	...	15.8			14.3	14.0	14.2	14.1	13.8	13.7		11.7	8.2	
of which: external	...	...	15.8			14.3	14.0	14.2	14.1	13.8	13.7		11.7	8.2	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	5.1	6.8	7.4			6.7	6.3	6.0	5.8	5.5	5.2		4.0	3.2	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	203.9			204.1	212.3	211.5	208.1	209.9	207.1		189.3	150.2	
PV of public sector debt-to-revenue ratio (in percent)	...	...	212.3			216.7	222.2	218.9	215.2	218.1	214.3		194.1	152.8	
of which: external 3/	...	...	68.6			63.6	64.7	64.0	63.2	64.2	63.5		55.8	43.4	
Debt service-to-revenue and grants ratio (in percent) 4/	19.6	19.9	24.8			27.6	27.5	27.4	27.8	26.2	25.7		24.0	19.8	
Debt service-to-revenue ratio (in percent) 4/	20.5	25.0	25.8			29.3	28.8	28.4	28.8	27.2	26.6		24.6	20.2	
Primary deficit that stabilizes the debt-to-GDP ratio	-3.2	-0.7	0.6			0.0	0.8	-0.8	-0.4	0.1	0.0		0.1	0.5	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	-12.7	2.4	4.8	2.6	5.6	1.9	4.6	4.7	5.2	5.9	5.6	4.6	4.3	4.6	4.5
Average nominal interest rate on forex debt (in percent)	2.4	2.3	2.3	2.2	0.3	3.2	3.4	3.3	3.2	3.1	3.0	3.2	3.1	3.1	3.1
Average real interest rate on domestic debt (in percent)	-0.5	13.5	9.4	3.8	9.7	5.6	4.0	8.0	7.5	7.0	7.5	6.6	5.7	5.4	5.8
Real exchange rate depreciation (in percent, + indicates depreciation)	-13.7	-3.4	-7.1	-7.3	8.6	-8.0	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	18.1	5.9	9.2	12.6	9.2	10.4	11.0	6.6	6.8	6.4	5.5	7.8	6.4	6.8	6.6
Growth of real primary spending (deflated by GDP deflator, in percent)	-19.9	23.6	-13.6	-1.0	11.2	-3.4	-1.1	4.3	4.2	4.1	4.2	2.1	2.7	3.8	3.4
Grant element of new external borrowing (in percent)	...	...	...	...	...	39.1	37.9	39.6	39.7	39.9	39.9	39.4	40.2	40.2	...

Sources: Country authorities; and staff estimates and projections.

1/ [Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.]

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 4. Republic of Yemen: Sensitivity Analysis for Key Indicators of Public Debt 2014–34

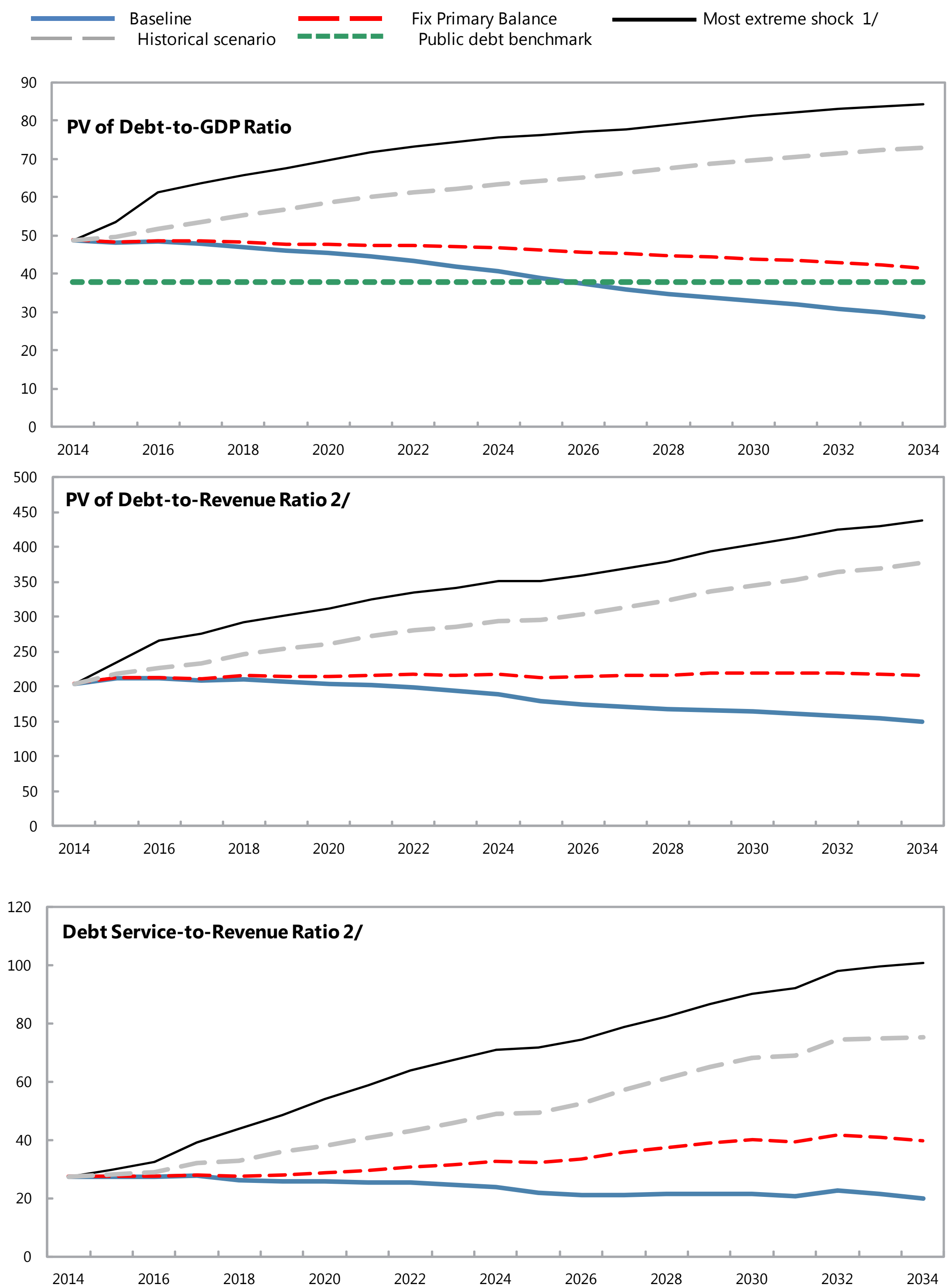
	Projections							
	2014	2015	2016	2017	2018	2019	2024	2034
PV of Debt-to-GDP Ratio								
Baseline	49	48	48	48	47	46	41	29
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	49	50	52	54	55	57	63	73
A2. Primary balance is unchanged from 2014	49	48	49	49	48	48	47	42
A3. Permanently lower GDP growth 1/	49	49	50	51	52	52	59	83
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	49	54	61	64	66	68	76	84
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	49	52	56	55	54	53	47	34
B3. Combination of B1-B2 using one half standard deviation shocks	49	53	58	59	60	61	63	64
B4. One-time 30 percent real depreciation in 2015	49	55	55	54	53	52	46	36
B5. 10 percent of GDP increase in other debt-creating flows in 2015	49	57	58	57	56	54	48	35
PV of Debt-to-Revenue Ratio 2/								
Baseline	204	212	212	208	210	207	189	150
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	204	219	226	233	246	255	293	377
A2. Primary balance is unchanged from 2014	204	213	213	212	215	215	217	216
A3. Permanently lower GDP growth 1/	204	216	219	221	230	234	272	433
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	204	235	266	276	292	302	351	439
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	204	229	245	241	242	239	220	179
B3. Combination of B1-B2 using one half standard deviation shocks	204	232	252	257	267	272	294	332
B4. One-time 30 percent real depreciation in 2015	204	242	239	234	235	232	216	188
B5. 10 percent of GDP increase in other debt-creating flows in 2015	204	253	251	246	248	244	225	183
Debt Service-to-Revenue Ratio 2/								
Baseline	28	28	27	28	26	26	24	20
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	28	28	29	32	33	36	49	75
A2. Primary balance is unchanged from 2014	28	28	27	28	27	28	33	40
A3. Permanently lower GDP growth 1/	28	28	28	30	30	31	45	99
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	28	30	33	39	44	49	71	101
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	28	28	29	42	43	38	33	27
B3. Combination of B1-B2 using one half standard deviation shocks	28	29	31	39	40	43	55	71
B4. One-time 30 percent real depreciation in 2015	28	29	30	32	31	31	34	33
B5. 10 percent of GDP increase in other debt-creating flows in 2015	28	28	32	57	35	46	33	28

Sources: Country authorities; and staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.

2/ Revenues are defined inclusive of grants.

Figure 2. Republic of Yemen: Indicators of Public Debt Under Alternative Scenarios, 2014-2034 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2024.
2/ Revenues are defined inclusive of grants.

REPUBLIC OF YEMEN

August 27, 2014

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION AND REQUEST FOR A THREE-YEAR ARRANGEMENT UNDER THE EXTENDED CREDIT FACILITY—SUPPLEMENTARY INFORMATION

Approved By: **Daniela Gressani and Bob Traa**

Prepared by MCD

1. Staff wishes to highlight developments since the staff report was circulated to the Executive Board on July 7, 2014. This information does not alter the thrust of the staff appraisal.

2. The Executive Board meeting on Yemen was postponed from July 18, 2014 to allow time for the authorities to implement key prior actions. Regarding prior action 1, as described in the staff report, the authorities allowed the private sector to import or buy diesel for their own use at international prices as a first step to reduce the subsidy bill. Accordingly, the private sector began buying part of the diesel for its own use at international prices from the Aden Refinery. A formal decision to this effect was taken and implemented in June, although some unsubsidized private sector purchases took place as early as May. Consequently, staff considers that the objective of prior action 1 has been achieved, although the decision was approved by the Prime Minister, not the Council of Ministers. Moreover, On July 30, 2014, the authorities raised domestic retail prices for gasoline, diesel, and kerosene to levels higher than the MEFP had envisaged for October and sufficient to eliminate subsidies on these products—which make up the bulk of fiscal subsidies—at current international prices. The price per liter of gasoline was raised from Yrls 125 to Yrls 200, diesel from Yrls 100 to Yrls 195, and kerosene from Yrls 100 to Yrls 200, exceeding the planned increases to Yrls 175, 150, and 150, respectively, indicated in the MEFP. Accordingly, the fiscal burden of subsidies that prior action 1 sought to address has been further alleviated by retail price increases.

3. On August 3, 2014, the Council of Ministers approved a plan to enforce the use of a biometric identification system throughout the general civil service, including the

military and police, and the making of all wage payments through bank accounts and post offices. Accordingly, prior actions 2 and 3 have been implemented.

4. Prior actions 4, 5, and 6 have also been met (as described in Table 1 of this supplement).

5. The fiscal outlook has improved relative to the assessment in the staff report in light of subsidy removal for the above fuel products, as well as higher-than-programmed grants from Saudi Arabia. The authorities have confirmed that the savings from subsidies reform, as well as the grants, will be used in line with the MEFP, mostly to increase capital expenditure and social transfers.

Table 1. Republic of Yemen: Status of Prior Actions

Prior Action	*Objective*	*Status*
1. Council of Ministers to approve a decision allowing the private sector to import part of its diesel usage (in the range of 35,000-50,000 tons per month) at international prices by end-June 2014.	Improve fiscal sustainability and ease fuel shortages	Private sector started as early as May to buy part of the diesel for its own use at international prices from the Aden Refinery. A formal decision to this effect was taken and implemented in June on the basis of an agreement reached in a joint meeting of representatives of the government and the private sector and approved by the prime minister. Diesel subsidies eliminated on July 30, 2014.
2. Council of Ministers to approve a decision requiring completion of the full implementation of the biometric identification system throughout the general civil service including the military and police by end 2014.	Reduce ghost workers and double-dippers	Met, August 3, 2014
3. Council of Ministers to adopt an action plan to move progressively from cash payments for wages and salaries to payments using bank accounts and postal offices within two years (1st year: for civil servants and Ministry of Interior; 2nd year: for Ministry of Defense).	Eliminate ghost workers and contain the wage bill	Met, August 3, 2014
4. CBY and MOF to sign a Memorandum of Understanding for reducing the MOF central government debt to the	Enhance fiscal	Met, July 7, 2014

central bank in line with legal limits over the coming seven years, by a minimum of 15 percent annually starting in 2017.	discipline	
5. CBY and MOF to sign a Memorandum of Understanding on the use of Fund resources, which specifies responsibilities for timely servicing financial obligations to the Fund and for maintenance of a specific government account at the CBY to receive the Fund financing.	Safeguard Fund resources	Met, July 7, 2014
6. CBY to publish on its website the full set of audited financial statements, including the audit opinion for the financial year 2013. Adopt a Board resolution to publish CBY annual statements within four months of the end of the financial year for all subsequent years.	Promote transparency and good governance of the central bank	Met, June 17, 2014

INTERNATIONAL MONETARY FUND
COMMUNICATIONS DEPARTMENT

Press Release No. 14/526
FOR IMMEDIATE RELEASE
September 24, 2014

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

IMF Executive Board Concludes 2014 Article IV Consultation with the Republic of Yemen

On September 2, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Yemen.

The macroeconomic situation continued to be relatively stable in 2013 and growth remained moderate. Nonhydrocarbon growth was steady at about 4 percent, while hydrocarbon growth picked up strongly, reversing part of the oil output decline in the preceding two years. As a result, real GDP growth is estimated to have doubled to almost 5 percent. At the same time, average inflation edged up slightly to reach 11 percent (up from about 10 percent a year earlier), and the exchange rate remained stable.

The overall fiscal deficit worsened only moderately in 2013 despite a large decline in grants. Although grants declined by about 5 percent of GDP, the overall fiscal deficit deteriorated by only 0.6 percent of GDP to reach 6.9 percent. This was achieved through a combination of expenditure restraint and an increase in nonhydrocarbon revenue. Subsidies and transfers were reduced by about 2.7 percent of GDP, mostly through limiting the supply of fuel products and shifting the schedule for payment of the subsidy bill by one month. Capital spending was also reduced by 1.3 percent of GDP. A 2012 decision to increase civil servants' allowances was not implemented, leading to a 0.9 percent reduction in the wage bill. As a result, the underlying fiscal deficit (defined as the nonhydrocarbon primary deficit excluding grants) narrowed by about 6 percent of GDP. This adjustment was forced by the lack of financing and the authorities' determination to refrain from central bank borrowing.

[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.

The widening of the external current account deficit was also moderate in 2013. The large decline in grants was mitigated by a healthy growth in exports and in remittances. At the same time, capital outflows increased, reflecting large scheduled repatriation of past oil companies' foreign direct investment and the nonrecurrence of the large Saudi deposit of 2012. As a result, gross reserves declined by about US$740 million to reach US$4.9 billion, or 4.5 months of imports despite the sale to the central bank of pension funds' foreign currency holdings of about US$250 million. On the other hand, the real effective exchange rate appreciated by 6.5 percent due to the relatively high domestic inflation and the nominal depreciation against the dollar of the currencies of Yemen's key trading partners.

Monetary policy continued to be generally prudent, but fiscal dominance remained high. Broad money growth was slightly slower than the growth of nominal GDP, mostly reflecting the decline in net foreign assets. But net claims on central government continued to grow rapidly at about 28 percent. Private sector credit growth was also high at 39 percent, from a low base and after declining in the preceding two years. On February 7, 2013, the Central Bank of Yemen reduced the benchmark deposit interest rate from 18 percent to 15 percent.

The banking system remained stable, but some vulnerabilities remain. Banks are profitable, and liquid and capital adequacy ratios are high, albeit in large part reflecting the large zero-risk-weighted government securities on banks' balance sheet. Nonperforming loans remain high, and so is asset concentration in government securities. Islamic banks have high exposure to the real estate markets abroad. The banking sector remains small and underdeveloped, and financial markets and the payment system are underdeveloped, limiting financial intermediation and monetary policy transmission.

The recent wave of sabotage of oil pipelines has had strong adverse effects on macroeconomic developments in the first half of 2014. The frequent sabotage resulted in a significant decline in oil production and exports. This has led to pressures on the fiscal and external positions. In the absence of reforms, the fiscal deficit would reach 9 percent of GDP and reserves would decline well below 3 months of imports. Severe fuel and electricity shortages have negatively impacted economic activity, with real GDP growth expected to decelerate to less than 2 percent.

Executive Board Assessment[2]

Executive Directors commended the authorities for policies that have preserved macroeconomic stability in a challenging political and security environment. Directors

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[2] 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.

agreed, however, that GDP growth continues to be insufficient to bring down Yemen's high unemployment and pervasive poverty. Accordingly, they welcomed the authorities' ambitious reform program to be supported by an arrangement under the Fund's Extended Credit Facility which will boost the pace of activity, address the country's fiscal and external imbalances, and catalyze donors' support.

Directors concurred that a substantial overhaul of the poorly targeted and distortionary system of energy subsidies needs to be the centerpiece of the reform package. They considered that the recent adjustment in the prices of key fuel products is an important step in this direction. Directors also welcomed the authorities' plan to use part of the savings from subsidy reforms to finance high-quality infrastructure investment and to increase social transfers to the poor.

More broadly, Directors encouraged the authorities to reduce the fiscal deficit over the medium term by continuing to improve the structure of expenditures and revenues. In this regard, they endorsed plans to further reduce untargeted subsidies, better control the public sector wage bill, and improve tax compliance and administration. Directors also underscored the importance of strengthening public financial management, as well as the institutional capacity to implement fiscal decentralization.

Directors cautioned that, in the period ahead, monetary policy should aim at containing the impact of subsidy reforms on prices and encouraged the authorities to adjust the stance as needed to preserve macroeconomic stability. In this regard, reforms to strengthen central bank independence remain an important policy priority. While taking note that data limitations and other factors hamper the staff's assessment of the real effective exchange rate, Directors were of the view that greater exchange rate flexibility would help protect reserves and support competiveness.

Directors recommended further strengthening prudential oversight of banks and enhancing financial market infrastructure. Priorities include addressing gaps in cross-border supervision, the regulation of Islamic banking, and the bank resolution framework, as well as strengthening the enforcement of the regime to combat money-laundering and the financing of terrorism.

Directors encouraged the authorities to improve governance and public sector service delivery to support inclusive, private sector-led growth. They also noted that improved economic and financial statistics would help guide economic policy making and surveillance.

Republic of Yemen: Selected Economic Indicators, 2010–18

	2010	2011	2012	2013	2014	2015	2016	2017	2018
				Prel.	Proj.	Proj.	Proj.	Proj.	Proj.
	(Change in percent, unless otherwise indicated)								
Production and prices									
Real GDP at market prices	7.7	-12.7	2.4	4.8	1.9	4.6	4.7	5.2	5.9
Real nonhydrocarbon GDP	4.4	-12.5	4.0	4.0	3.0	4.5	5.0	5.5	6.5
Real hydrocarbon GDP	46.9	-14.5	-11.5	13.2	-8.3	5.4	1.4	1.6	-1.3
Consumer price index (annual average)	11.2	19.5	9.9	11.0	9.0	11.4	8.5	8.0	7.8
Consumer price index (eop)	12.5	23.2	5.8	8.1	13.0	9.0	8.0	8.0	7.5
Hydrocarbon production (1,000 barrels/day)	426	364	322	365	334	352	357	363	358
Crude oil 1/	264	197	155	175	167	185	190	196	191
LNG (oil equivalent)	162	167	167	190	167	167	167	167	167
	(In percent, of GDP)								
Government finance									
Total revenue and grants	26.1	25.3	29.9	23.9	23.9	22.7	22.9	23.0	22.4
Total expenditure	30.2	29.8	36.2	30.8	29.3	27.7	27.6	27.3	26.6
Overall fiscal balance (cash basis)	-4.1	-4.5	-6.3	-6.9	-5.4	-5.0	-4.7	-4.3	-4.2
Primary fiscal balance (cash)	-1.7	-0.2	-0.9	-1.5	-0.1	0.0	0.2	0.5	0.3
Nonhydrocarbon primary fiscal balance (cash)	-18.2	-16.7	-15.0	-14.3	-11.3	-9.6	-9.5	-8.7	-7.9
Excluding grants	-19.4	-17.9	-21.1	-15.2	-12.7	-10.6	-10.3	-9.4	-8.8
Gross Public Sector Debt	42.4	45.7	47.3	48.2	48.2	47.4	48.0	47.8	47.4
External debt	19.9	18.6	17.4	15.2	13.7	13.2	13.7	14.0	14.2
Domestic debt	22.5	27.1	29.9	33.0	34.5	34.2	34.3	33.8	33.2
	(Twelve-month change in percent)								
Monetary data									
Broad money	9.2	0.0	21.5	12.5	11.2	...	...	...	...
Reserve money	7.7	15.8	12.9	1.9	5.7	...	...	...	...
Credit to private sector	8.2	-16.9	-0.6	38.9	12.0	...	...	...	...
Benchmark deposit interest rate (percent)	20.0	20.0	18.0	15.0	15.0	...	...	...	...
Velocity (non-oil GDP/M2)	2.4	2.3	2.4	2.4	2.4	...	...	...	...
	(In millions of U.S. dollars, unless otherwise indicated)								
External sector									
Exports, f.o.b.	7,648	8,662	7,349	7,639	9,024	10,535	10,620	10,801	10,762
Hydrocarbon	6,279	7,731	6,332	6,537	7,880	9,328	9,340	9,439	9,304
Nonhydrocarbon	1,369	931	1,017	1,101	1,144	1,207	1,279	1,362	1,458
Imports, f.o.b.	-8,473	-8,543	-10,240	-9,892	-10,211	-10,283	-10,592	-11,088	-
Hydrocarbon	2,073	2,578	3,840	3,265	3,373	3,138	3,089	3,136	3,303
Nonhydrocarbon	6,400	5,964	6,400	6,627	6,837	7,145	7,502	7,953	8,469
Current account (percent of GDP)	-3.4	-3.0	-1.7	-3.1	-1.3	-1.1	-1.4	-1.4	-1.7
Memorandum items									
Gross foreign reserves	5,081	3,974	5,590	4,854	3,448	3,465	3,988	4,570	4,966
In months of imports	5.7	3.7	5.5	4.5	3.2	3.1	3.4	3.7	3.8
Exchange rate (eop) (YRls per U.S. dollar)	213.8	213.8	214.89	214.89	...	...	...	...	...
Real effective exchange rate (2008 = 100)	98.9	116.2	122.5	130.3	...	...	...	...	...
Nominal GDP at market prices									
In billions of Yemeni rials	6,787	6,997	7,587	8,685	9,767	11,338	12,653	14,210	15,998
In millions of U.S. dollars	30,907	32,726	35,401	40,415	...	...	...	...	...
Per capita GDP (in U.S. dollars)	1,267	1,302	1,368	1,516	...	...	...	...	...
Population (in thousands)	24,398	25,130	25,884	26,660	...	...	...	...	...

Sources: Yemeni authorities; and IMF staff estimates.

1/ The sharp declines in crude oil production reflects sabotage of oil pipeline, in 2011, 2012, and 2014.

Press Release No. 14/408
FOR IMMEDIATE RELEASE
September 2, 2014

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves a 3-Year, US$552.9 Million Extended Credit Facility Arrangement with Yemen

The Executive Board of the International Monetary Fund (IMF) today approved a three-year Extended Credit Facility (ECF) arrangement with the Republic of Yemen for an amount equivalent to SDR 365.25 million (US$552.9 million; or 150 percent of Yemen's quota) to help maintain macroeconomic stability and promote inclusive growth. As a result of the Board's decision, an amount equivalent to SDR 48.75 million (about US$73.8 million) is available for immediate disbursement. The remaining amount will be phased in semi-annual disbursements, subject to six reviews.

Following the Executive Board discussion on Yemen, Mr. Naoyuki Shinohara, Deputy Managing Director, and Acting Chair, said:

"The Yemeni authorities have made commendable efforts to support macroeconomic stability and growth. Nonetheless, political and security challenges have continued to weigh on the policy environment and economic outcomes. In particular, fiscal and external balances have weakened due to delays in key reforms and increased sabotage of oil facilities. Looking ahead, the main challenges are to improve the fiscal and external positions, as well as support inclusive growth and job creation.

"The authorities have launched an ambitious economic program to meet these challenges and durably reduce Yemen's high unemployment and widespread poverty. The authorities' program, to be supported by a three-year arrangement under the Fund's Extended Credit Facility, is designed to address balance of payments needs, close the fiscal financing gap, and maintain macroeconomic stability while protecting the most vulnerable groups.

"The centerpiece of the authorities' reform package is phasing out large and inefficient fuel subsidies. A first step in this direction has already taken place and will be complemented by well targeted social transfers to the poor. Additional fiscal measures will aim at reducing the budget deficit over the medium term by reforming the civil service and improving tax compliance. These measures will also free budgetary resources for needed infrastructure and social spending.

“To preserve macroeconomic stability in the near term, the central bank needs to adjust monetary policy as needed to limit the impact of subsidies reform on inflation. It should also continue to improve its monetary framework to strengthen policy transmission and support greater exchange rate flexibility. The financial sector reforms planned by the authorities aim at strengthening bank regulation and supervision as well as at enhancing market infrastructure.”

ANNEX:
Recent Developments:

The macroeconomic situation continued to be relatively stable in 2013, and growth remained moderate. Non-hydrocarbon growth was steady at about 4 percent, while hydrocarbon growth picked up strongly, reversing part of the oil output decline in the preceding two years. As a result, real GDP growth is estimated to have doubled to almost 5 percent. At the same time, average inflation edged up slightly to reach 11 percent (up from about 10 percent a year earlier), and the exchange rate remained stable. Inflation moderated in the first half of 2014, but oil production declined due to sabotage activities, leading to severe fuel and electricity shortages.

Yemen has progressed in its political transition since the 2011 crisis. However, the economic recovery remained insufficient to reduce the high levels of unemployment and poverty. The average per capita GDP growth rate was less than 1.5 percent a year preceding the 2011 crisis and has declined since. Poverty and youth unemployment, at about 54 percent and 45 percent respectively, are among the highest in the world. Infrastructure investment has also continued to drop, and foreign direct investment remains concentrated in the hydrocarbon sector that employs a small percentage of the labor force.

Program Summary:

Faced with a rapidly deteriorating economic situation in the first half of 2014, the authorities have initiated a bold economic reform program to reverse the recent deterioration in macroeconomic conditions and to support growth, encourage job creation, and protect the poor. Notwithstanding political challenges, the authorities’ program combines a package of strong policy measures and structural reforms with external financing support.

Key elements of the Fund-supported program are to:

Strengthen fiscal adjustment and protect the poor. This is to be achieved through reforms to reduce untargeted subsidies, contain the wage bill, and enhance compliance of large tax payers. Targeted cash transfers to the poor will be increased by 50 percent following the adjustment in the fuel prices. Infrastructure investment will be gradually increased in order to boost job creation and potential growth. The government will also improve public finance management.

Maintain prudent monetary and exchange rate policies. These will aim at containing inflation, enhancing competitiveness, and avoiding exchange rate volatility while preserving foreign exchange reserves.

Reform the financial sector, improve governance, and encourage inclusive, private sector-led growth. Primary reforms aim at strengthening consolidated and cross border supervision, developing regulation to address risks specific to Islamic banking, and strengthening the Central Bank of Yemen's powers to resolve banks. Governance reforms include improving the business environment, transparency and accountability. Additional reforms are aimed at enhancing the government implementation capacity to help mobilize donor support and improve public infrastructure investment.

The support of the international community will continue to be essential in the period ahead.

Republic of Yemen: Selected Economic Indicators, 2010–18

	2010	2011	2012	2013	2014	2015	2016	2017	2018
				Prel.	Proj.	Proj.	Proj.	Proj.	Proj.
	(Change in percent, unless otherwise indicated)								
Production and prices									
Real GDP at market prices	7.7	-12.7	2.4	4.8	1.9	4.6	4.7	5.2	5.9
Real nonhydrocarbon GDP	4.4	-12.5	4.0	4.0	3.0	4.5	5.0	5.5	6.5
Real hydrocarbon GDP	46.9	-14.5	-11.5	13.2	-8.3	5.4	1.4	1.6	-1.3
Consumer price index (annual average)	11.2	19.5	9.9	11.0	9.0	11.4	8.5	8.0	7.8
Consumer price index (eop)	12.5	23.2	5.8	8.1	13.0	9.0	8.0	8.0	7.5
Hydrocarbon production (1,000 barrels/day)	426	364	322	365	334	352	357	363	358
Crude oil 1/	264	197	155	175	167	185	190	196	191
LNG (oil equivalent)	162	167	167	190	167	167	167	167	167
	(In percent, of GDP)								
Government finance									
Total revenue and grants	26.1	25.3	29.9	23.9	23.9	22.7	22.9	23.0	22.4
Total expenditure	30.2	29.8	36.2	30.8	29.3	27.7	27.6	27.3	26.6
Overall fiscal balance (cash basis)	-4.1	-4.5	-6.3	-6.9	-5.4	-5.0	-4.7	-4.3	-4.2
Primary fiscal balance (cash)	-1.7	-0.2	-0.9	-1.5	-0.1	0.0	0.2	0.5	0.3
Nonhydrocarbon primary fiscal balance	-18.2	-16.7	-15.0	-14.3	-11.3	-9.6	-9.5	-8.7	-7.9
Excluding grants	-19.4	-17.9	-21.1	-15.2	-12.7	-10.6	-10.3	-9.4	-8.8
Gross Public Sector Debt	42.4	45.7	47.3	48.2	48.2	47.4	48.0	47.8	47.4
External debt	19.9	18.6	17.4	15.2	13.7	13.2	13.7	14.0	14.2
Domestic debt	22.5	27.1	29.9	33.0	34.5	34.2	34.3	33.8	33.2
	(Twelve-month change in percent)								
Monetary data									
Broad money	9.2	0.0	21.5	12.5	11.2	...	...	...	...
Reserve money	7.7	15.8	12.9	1.9	5.7	...	...	...	...
Credit to private sector	8.2	-16.9	-0.6	38.9	12.0	...	...	...	...
Benchmark deposit interest rate (percent)	20.0	20.0	18.0	15.0	15.0	...	...	...	...
Velocity (non-oil GDP/M2)	2.4	2.3	2.4	2.4	2.4	...	...	...	...
	(In millions of U.S. dollars, unless otherwise indicated)								
External sector									
Exports, f.o.b.	7,648	8,662	7,349	7,639	9,024	10,535	10,620	10,801	10,762
Hydrocarbon	6,279	7,731	6,332	6,537	7,880	9,328	9,340	9,439	9,304
Nonhydrocarbon	1,369	931	1,017	1,101	1,144	1,207	1,279	1,362	1,458
Imports, f.o.b.	-8,473	-8,543	-10,240	-9,892	-10,211	-10,283	-10,592	-11,088	-11,772
Hydrocarbon	2,073	2,578	3,840	3,265	3,373	3,138	3,089	3,136	3,303
Nonhydrocarbon	6,400	5,964	6,400	6,627	6,837	7,145	7,502	7,953	8,469
Current account (percent of GDP)	-3.4	-3.0	-1.7	-3.1	-1.3	-1.1	-1.4	-1.4	-1.7
Memorandum items									
Gross foreign reserves	5,081	3,974	5,590	4,854	3,448	3,465	3,988	4,570	4,966
In months of imports	5.7	3.7	5.5	4.5	3.2	3.1	3.4	3.7	3.8
Exchange rate (eop) (YRls per U.S. dollar)	213.8	213.8	214.89	214.89	...	...	...	...	...
Real effective exchange rate (2008 = 100)	98.9	116.2	122.5	130.3	...	...	...	...	...
Nominal GDP at market prices									
In billions of Yemeni rials	6,787	6,997	7,587	8,685	9,767	11,338	12,653	14,210	15,998
In millions of U.S. dollars	30,907	32,726	35,401	40,415	...	...	...	...	...
Per capita GDP (in U.S. dollars)	1,267	1,302	1,368	1,516	...	...	...	...	...
Population (in thousands)	24,398	25,130	25,884	26,660	...	...	...	...	...

Sources: Yemeni authorities; and IMF staff estimates.

1/ The sharp declines in crude oil production reflects sabotage of oil pipeline, in 2011, 2012, and 2014.

Statement by A. Shakour Shaalan, Executive Director for Yemen
September 2, 2014

1. On behalf of the Yemeni authorities, I would like to thank staff for their continued engagement with Yemen and the valuable policy advice during both the Article IV mission and the program negotiations.

Recent Developments and Request for an ECF

2. In spite of a challenging political and security environment, the authorities have maintained macroeconomic stability in the past year, thanks to their prudent policies and continued support from the Gulf Cooperation Council and particularly from Saudi Arabia, which provided last month an additional sizable support to the government of about $1.2 billion, about a third of it earmarked for social spending. However, the country continues to face significant social and development needs, with more than 50 percent of the population living below the poverty line. In addition, the recent attacks on oil pipelines and the electricity grid led to severe fuel and electricity shortages and resulted in a rapid deterioration in the fiscal and external positions in the first half of 2014. In response, the authorities took bold measures under difficult social and political circumstances in order to preserve macroeconomic stability. These included the removal of subsidies on key fuel products at the end of July 2014.

3. The Yemeni authorities are requesting an Extended Credit Facility (ECF) in support of their strong economic program which aims at responding to the country's urgent balance of payments needs and closing the fiscal financing gap. Under the program, the authorities plan to restore macroeconomic stability while protecting the most vulnerable groups and laying the foundation for inclusive and sustainable growth. The authorities have already demonstrated strong ownership and commitment to this program by implementing or exceeding all of the prior actions, including the removal of fuel subsidies at a critical juncture, ahead of schedule and beyond what was agreed in the Fund program.

4. It is hoped that the ECF arrangement will continue to catalyze additional support from donors and international institutions. So far, only a third of the Friends of Yemen's pledged resources have been disbursed. The authorities are particularly grateful to all the donors who are supporting their transition efforts. Speeding up donor disbursement remains essential to help Yemen address its challenges and promote stability in the near future.

The Government's Economic Program for 2014-2017

5. In response to the challenging economic situation, the authorities have started implementing a reform program aimed at (i) maintaining macroeconomic stability, (ii) enhancing fiscal and external sustainability, and (iii) promoting sustained and inclusive growth.

Fiscal Reforms

6. The authorities' fiscal strategy is focused on the need to contain the deteriorating fiscal position in the wake of repeated sabotage of the country's oil and gas pipelines. They plan to reduce the fiscal deficit to more manageable levels while creating the space needed for poverty reduction and development spending. Fiscal adjustment will be mainly achieved by significantly reducing energy subsidies, containing the wage bill, and increasing non-oil tax revenues. The negative impact on the most vulnerable will be offset by increasing targeted social transfers.

7. On the revenues side, the authorities will continue their efforts to increase tax revenues, which are low compared to regional and international standards, thereby reducing their dependence on oil revenues. They will increase the revenue of the General Sales Tax and expand its coverage while improving payment compliance of the registered large tax payers in line with FAD recommendations. Exceptional efforts will be made to recover tax arrears, improve tax compliance, strengthen customs controls to combat smuggling, and reform the revenue administration. In addition, the authorities will review all existing tax and customs exemptions with the objective of limiting them.

8. On the expenditures side, corrective measures will produce considerable savings mainly through reducing by more than half petroleum subsidies, and controlling the growth of wages and capital expenditures. In addition, the government has adopted an action plan to pay wages and salaries using bank accounts and postal offices. This will contain the wage bill by reducing the number of ghost workers and double dippers. Moreover, a presidential decision has been taken recently to cut government spending including by freezing recruitment at all state institutions, and modifying government officials' travel and transport benefits.

9. Public financial management reforms will continue to be implemented to improve the efficiency and transparency in public expenditures, throughout the strengthening of the treasury at the Ministry of Finance, as well as the improvement of processes for planning and execution of government spending. The authorities are well aware that the shift to fiscal federalism would require careful design and adequate capacity building, and will take all the necessary measures for a smooth and well planned transition. In order to avoid budgetary overspending, the authorities will enforce strict spending rules. They will resist any new spending request that exceed the allocated spending envelopes, except for any necessary requirements.

10. Energy subsidies reform measures are the centerpiece of the program and will lead to a reduction in subsidies of more than 5 percent of GDP over the program period compared to an initial saving of 4 percent of GDP under the Fund program. The domestic price of gasoline, diesel, and kerosene were increased respectively by 60 percent, 95 percent, and 100 percent beyond what was agreed initially. In addition to these significant fuel price adjustments, the government will work on introducing an automatic fuel price adjustment mechanism to respond to fluctuations in international prices in order to preserve the savings from the energy subsidies reforms. More importantly, and in order to offset the impact of the price increases on the poor, the authorities will increase the Social Welfare Fund (SWF) transfers by fifty percent starting with

the last quarter of 2014. In parallel, the government will continue to improve the coverage of the SWF in collaboration with the World Bank and other development partners.

11. The government will adopt a program to clear outstanding payment arrears over the medium-term. Given the pressing development and social needs of the country, the focus will be on mobilizing budgetary grants to avoid increasing the debt burden.

Monetary and Financial Sector Policies

12. Monetary policy will continue to aim at maintaining price stability and supporting economic growth while preserving reserves. The Central Bank of Yemen (CBY) has lowered its benchmark interest rate last year in order to encourage credit to the private sector. However, and given that inflation is projected to increase to double digits as a result of the fuel price increases, the CBY will continue to monitor economic developments and stands ready to adjust policies as needed.

13. The authorities are committed to preserve the independence of the CBY and will refrain from monetizing the fiscal deficit going forward. In this regard, the CBY has signed a memorandum of understanding with the Ministry of Finance to bring down the government's outstanding credit within the CBY legal limits. In addition, the CBY has recently published the full set of its audited financial statements, in an effort to enhance transparency and good governance.

14. While the banking system remains stable and profitable, the CBY is committed to ensure its soundness and to increase consolidated and cross-border supervision. The CBY will also continue to improve prudential regulations especially those related to Islamic banking.

Other Structural Reforms

15. The Yemeni government will continue its diversification efforts as well as promoting alternative sources of growth and employment generation. The authorities are committed to improve the business environment and promote private sector investment. They have identified the main challenges to doing business in Yemen and have launched several actions to address them.

16. The reform of the electricity sector remains a top priority for the government. The Public Electricity Corporation has been asked to review all the ongoing power lease contracts as well as unify and lower the cost price of purchasing power. The government is working on expanding gas and coal powered plants to replace diesel plants. In this regard, plans to install and operate Mareb's second gas powered station will be expedited. In addition to resolving outstanding security problems at production sites, the cost of drilling and extracting oil will be reviewed with the aim of bringing costs down to the global averages.