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Republic of Yemen: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

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REPUBLIC OF YEMEN: LETTER OF INTENT

July 14, 2010

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Strauss-Kahn:

Yemen has maintained close cooperation with the IMF over the past many years. In the mid- and late-1990s, the government undertook efforts aimed at strengthening the foundations of a market-based and private sector-driven economy, and more closely integrating Yemen into world markets. These programs, supported by the IMF, were successful in lowering inflation, improving the state of public finances, and bolstering economic prospects. The cooperative relationship with the IMF also paved the way for successive debt rescheduling operations with the Paris Club. Since then, our relationship continued in the context of the annual consultations.

The past few years have been difficult for Yemen. Oil production—the mainstay of government revenues and the external accounts—dropped substantially in 2007. The collapse of international oil prices in late 2008–09 aggravated these pressures. Moreover, the impact of the global crisis was also felt on the external balance of payments—mainly via lower export receipts and weaker inward investment and remittance flows. These developments made the fiscal and external positions more difficult, contributing to the recent pressures on the exchange rate.

The government is committed to addressing the economic imbalances, re-stabilizing the economy, and placing it on a path of sustained high growth in order to accelerate the pace of progress toward the Millennium Development Goals. Specifically, our objectives are to (i) put public finances on a sustained footing in the medium-term, by combining fiscal consolidation with a restructuring of expenditures more toward capital and social outlay; (ii) boost non-hydrocarbon revenues through improvement in tax policy and administration to allow higher capital and social outlays over the medium-term; and (iii) contain inflation and exchange rate pressures.

The attached Memorandum of Economic Policies (MEFP) sets forth our policy intentions and measures we intend to implement to attain our objectives. In support of the policies in the MEFP, the government requests that the Executive Board of the IMF approve a three-year Extended Credit Facility (ECF) arrangement with access in the amount of SDR 243.50 million (100 percent of quota) and disburse the first tranche upon approval of the arrangement.

The government of Yemen will provide the information the Fund may request in connection with progress in implementing its 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 with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the IMF's policies on such consultations.

The Yemeni authorities consent to the release to the public of this Letter of Intent, the attached MEFP, and the attached Technical Memorandum of Understanding, as well as the IMF staff report relating to the request for an ECF arrangement. We hereby authorize their publication and inclusion on the IMF website, following approval of the IMF Executive Board.

Sincerely yours,

/s/
Mr. Noman Taher Alsuhaibi
Minister
Ministry of Finance

/s/
Mr. Mohamed Bin Humam
Governor
Central Bank of Yemen

**REPUBLIC OF YEMEN: MEMORANDUM OF ECONOMIC
AND FINANCIAL POLICIES**

JULY 14, 2010

I. INTRODUCTION

1. This memorandum outlines the economic and financial policies of the government of Yemen for 2010–13. Our program aims at achieving high and sustained levels of economic growth, reducing poverty, and maintaining macroeconomic stability in the face of a difficult global environment and declining oil production. These policies are also intended to form the basis for a three-year IMF-supported program under the Extended Credit Facility (ECF), which we hope will be facilitated by an expansion of donor budgetary support.

II. BACKGROUND

2. Yemen has had a long and productive relationship with the IMF. In the mid- and late-1990s, the government undertook efforts aimed at strengthening the foundations of a market-based and private sector-driven economy, and more closely integrating Yemen into world markets. The programs, supported by the IMF, aimed at restoring macroeconomic and financial stability and included strong fiscal adjustment measures, liberalization of most interest rates, and simplification of the exchange rate system. The programs were successful in lowering inflation, improving the state of public finances, and bolstering economic prospects. The cooperative relationship with the IMF also paved the way for successive debt rescheduling operations with the Paris Club.

3. We have continued to make macroeconomic and financial progress since the end of the last IMF-supported program in 2001. During 2001–07, non-hydrocarbon sector growth averaged over 5 percent per year, while core inflation remained under 11 percent per year. The LNG project is now operational, and will provide a steady source of government revenue and export earnings over the long-term. With relatively high oil prices and associated foreign exchange earnings, the government used the opportunity to further reduce external debt and to build a substantial cushion of foreign exchange reserves. Total government and government-guaranteed external debt fell from roughly 49 percent of GDP in 2001 to the current level of some 24 percent of GDP. Gross own foreign exchange reserves of the central bank climbed from \$3.6 billion in 2001 to \$7.3 billion in 2008, amounting to an average reserve cover of over 9-months of imports—a marked achievement for any country.

4. Financial intermediation, market orientation, and integration with world markets have also improved over the past decade. Private sector credit as a share of GDP rose from just under 6 percent of GDP in 2001 to 8 percent of GDP in 2008, while the level of dollarization (foreign currency deposits as a share of total banking deposits) dropped sharply from 52 percent to 38 percent—signaling greater confidence in the rial. Yemen has maintained

one of the more open trade regimes in the region. Total trade (imports plus exports) rose from 61 to 66 percent of GDP during this period, denoting a greater degree of openness and integration with world markets. After many years of hard work, Yemen is also on the cusp of accession to the World Trade Organization (WTO). Continued progress on improving the investment environment is also evident, with Yemen's standing on the World Bank's Doing Business Index rising progressively over the years.

5. The government has consistently sought to maintain a sound and sustainable fiscal position over the last decade. Despite a secular decline in oil production, progressively higher international oil prices during 2001-08 allowed for the overall fiscal deficit (cash basis) to average under 2 percent of GDP. Overall capital expenditure also registered an impressive 7 percent of GDP on average during this period—reflecting government efforts to meet many pressing public investment needs. On the less positive side, however, and like many countries, the relative balance between current expenditure (wages and salaries, government operations and maintenance, subsidies, and transfers) and capital expenditure remained heavily weighted in favor of the former. Further, progress has been relatively slow in building non-hydrocarbon revenues. Total tax revenue as a share of non-hydrocarbon GDP has been essentially flat at just under 11 percent of GDP since 2001—reflecting continued difficulties which caused delays in implementing key measures in the area of tax policy and administration. Progress on improving public financial management—particularly commitment control and cash management—has also been mixed.

III. RECENT ECONOMIC DEVELOPMENTS

6. The past few years have been exceptionally difficult for Yemen. Oil production—the mainstay of government revenues and the external accounts—dropped substantially in 2007. Fast increases in international commodity prices brought benefits in terms of higher oil export revenues in 2008, but also resulted in record inflation—particularly for food. Given Yemen's heavy reliance on imports and low level of per capita income, this was particularly difficult for the most vulnerable segments of the population. Despite the recent decline in food prices, the government recognizes food insecurity as a serious potential risk and has taken steps to address it.

7. With the onset of the global financial crisis, we have encountered a new set of challenges. Economic activity has slowed, but inflation has been modest. Non-hydrocarbon sector growth fell from about 4.8 percent in 2008 to an estimated 4.1 percent in 2009—reflecting somewhat slower activity in construction, manufacturing, and real estate. Oil production continued to fall in 2009 (by 3.8 percent), and the start of LNG production was delayed until mid-November. Overall investment (foreign and domestic) was substantially lower than in 2008. Inflation hit record lows in 2009, largely due to the sharp decline in international food prices. Twelve-month core inflation fell to 1.9 percent by August 2009 in the wake of lower international commodity prices, but rose to 7.3 percent by year-end as commodities recovered.

8. The collapse of international oil prices in late 2008-09 had a strongly negative impact on our public finances. The sharp drop in average prices (\$60 per barrel in 2009 versus \$98 per barrel in 2008), combined with lower oil production and declining government share led to a substantial drop in government oil exports. The government realized early on the potential risks associated with the rising gap between planned expenditures and likely revenues, and moved to immediately curtail non-essential current spending. In the event, however, the magnitude of adjustment proved insufficient, and resulted in a record fiscal deficit of 10.2 percent of GDP on a cash basis in 2009. Critically, because of relatively limited external financing, the government was forced to draw heavily on the domestic debt market, place lower-yielding bonds with public pension funds, and resort to a high level of central bank financing. Net credit of the banking system to the government rose, overall public debt increased by 13 percent of GDP, and private sector credit ended the year with negative growth. While the 2010 budget is an improvement over the 2009 outturn, the gap between expenditures and likely revenues remains large—posing risks to macroeconomic stability.

9. The impact of the global crisis was also felt on the external balance of payments—mainly via lower export receipts and weaker inward investment and remittance flows. Total hydrocarbon exports fell by about US\$3.4 billion in 2009—fundamentally shifting the balance of supply and demand for foreign exchange. Weaker inward remittances and a slowdown in investment inflows also contributed to external pressures. Gross own reserves of the Central Bank of Yemen (CBY) declined by US\$1.1 billion over the course of the year, and would have fallen even further were it not for some US\$300 million from the IMF as part of a general SDR allocation. Given these pressures and the need to limit the amount of foreign exchange reserve loss, the CBY opted to allow greater flexibility in the exchange rate. As a result, the rial depreciated by 3 percent against the U.S. dollar in 2009. Exchange rate pressures intensified in the first quarter of 2010. The CBY responded by increasing foreign exchange intervention, resulting in the loss of net international reserves (NIR) of US\$995 million in the first three months of 2010.

10. The focus of monetary policy in 2009 was on providing liquidity to the economy. With single-digit inflation, declining private sector credit, and a surge in government borrowing, the CBY lowered the benchmark interest rate (from 13 percent to 10 percent in two steps during January-May 2009). The CBY redeemed Yrls 256 billion in CDs from commercial banks—re-injecting liquidity into the banking system, which in turn purchased government T-bills. Lower yielding, longer maturity Treasury Bonds (T-bonds) were also created and placed with public pension funds—replacing their holdings of T-bills. The impact of these policies on money supply was muted by the large decline in net foreign assets and (possibly due to crowding out by government borrowing) negative private sector credit growth.

11. Renewed pressure on the exchange rate in early 2010 led to a decision to raise the benchmark deposit rate to 12 percent in January, and subsequently to 20 percent in March

and to institute intra-auction limits on the amount of foreign exchange that could be purchased by a single bank or foreign exchange dealer. These measures appear to have calmed the market, but foreign exchange reserves are on a declining trend given the fundamental shift in the supply and demand for foreign currency associated with declining oil production and exports.

IV. MEDIUM-TERM ECONOMIC POLICY FRAMEWORK

12. Yemen's medium-term prospects remain closely tied to the hydrocarbon sector. The government will continue to make every effort to extend the life of oil reserves. The production and export of LNG via the Yemen LNG project and other natural gas opportunities will offer some cushion. Nevertheless, new resources coming on-stream will likely be insufficient to compensate for the loss of oil. The government recognizes the need for a prudent approach going forward, and to plan on the basis of continued decline in hydrocarbon production. Given rising domestic consumption, the predominant trend suggests that Yemen will shift from being a net fuel exporter to a net fuel importer within the medium-term horizon.

13. Our main medium-term challenge is to facilitate a smooth adjustment to declining oil production, while bolstering prospects for non-hydrocarbon growth and poverty reduction. The government is committed to a strategy of achieving high and sustained level of economic growth within a framework of financial and external stability. Toward this end, our medium-term strategy will focus on (i) accelerating non-hydrocarbon economic growth while maintaining inflation within moderate levels; (ii) putting public finances on a medium-term footing, by combining fiscal consolidation with a restructuring of public spending to place a heavier emphasis on capital expenditures and social transfers; (iii) boosting non-hydrocarbon revenues through tax policy and administration measures; (iv) maintaining adequate foreign exchange reserve cover; and (v) creating a more attractive and market oriented business climate, and strengthening the ability of the banking system to support development of the real sector.

14. Our objective is to achieve average non-hydrocarbon sector growth of at least 5 percent through the program period (2010–13). Emphasis will be placed on promising sectors such as agriculture, manufacturing, fisheries, tourism, and transport. The government will, in cooperation with its development partners, map out a strategy to address these issues in the context of the new five-year development and poverty reduction plan, which is expected to be completed by the end of 2010. Essential to this endeavor will be sufficient levels of public investment to remove infrastructural bottlenecks and pave the way for private-sector led growth.

15. The government is committed to putting public finances on a sustainable path before the end of the program period (2013). Given the anticipated steady decline in oil production, it is clear that difficult but essential efforts must be undertaken to realign expenditures with a

shrinking revenue base and to ensure a higher degree of efficiency in government spending. To this end, the program will endeavor for a reduction in the overall fiscal deficit to about 3.5 percent of GDP by the end of the program period, consistent with a sustainable level of domestic financing and a significant reduction in the outstanding balance of central bank credit to the government. Central pillars underlying this strategy will include: (i) a reduction and the gradual removal of domestic fuel subsidies (ii) a notable reduction of the subsidy on electricity generation; (iii) civil service wage and salary restraint; and (iv) containment of nonessential current expenditures (goods and services, operations and maintenance) while allowing for an increase in social and capital spending. By the end of the program period, our hope is that the relative weight of current expenditures versus capital/social spending in total government expenditures will have shifted from the present around 70/30 balance to about 65/35—engendering a stronger social safety net and sustained higher levels of public investment needed to achieve the aforementioned growth objectives.

16. Increasing non-hydrocarbon revenues is the second essential element in ensuring sustainable public finances over the medium- and long-term. Government efforts in this area will be intensified, and tax policy and administration measures will be implemented, with a view to raising the tax-to-GDP ratio to at least 7.5 percent of GDP by the end of the program period. The government will be careful to balance revenue objectives with the need to maintain a fair, transparent, and efficient tax system. Key measures will likely include (i) full implementation of the General Sales Tax (GST); (ii) maintaining a policy of no new tax or customs (except for fixed assets and 50 percent of raw materials for industrial use) exemptions—offering instead non-distortionary incentives such as accelerated depreciation; (iii) greater efficiency in customs and tax administration; and (iv) consideration of new tax policy measures, as needed.

17. Monetary policy will focus primarily on price stability, while ensuring a sufficient level of private sector credit to support economic growth. The CBY will continue to target reserve money growth in line with non-hydrocarbon sector economic activity, while keeping a close watch on excess liquidity in the banking system or signs of upward pressure on prices from domestic sources. To enhance the efficacy of monetary policy, the CBY will move to enhance both liquidity forecasting (in conjunction with the Ministry of Finance), and will explore the possibility of phasing out the administered benchmark deposit rate in favor of greater use of indirect instruments of monetary policy. The objective is to minimize central bank financing of the budget to avoid inflationary pressures.

18. With regard to exchange rate policy, the CBY will seek to strike a balance between enhancing external competitiveness and limiting inflation. Yemen's heavy reliance on imports makes domestic prices sensitive to movements in the exchange rate. At the same time, the expected decline in oil exports makes exchange rate flexibility necessary to ensure external competitiveness and a sustainable external position. The CBY will continue to auction sufficient foreign exchange to meet market needs and smooth short-term volatility—

balanced against the necessity of maintaining a sufficient cushion of foreign exchange reserves.

V. POLICIES FOR 2010–11

19. Within the context of the medium-term framework noted above, the government is committed to implementing critical measures in 2010 to address growing current macroeconomic and financial imbalances. Specifically, measures will be implemented to (i) reduce the size of the overall fiscal deficit to a level consistent with available domestic and external financing; (ii) stem the recent pressures on foreign exchange reserves; and (iii) adopt a monetary framework that can help facilitate a recovery of private sector credit while protecting price stability, and facilitating lending to small and medium sized enterprises via expansion of microfinance institutions.

A. Fiscal Policy

20. With a view to realigning expenditures with actual revenues and reducing pressures on the external accounts and the exchange rate, the government is committed to reducing the overall size of the fiscal deficit to approximately Yrls 380 billion in 2010. The adjustment (approximately Yrls 143 billion relative to the budget adjusted for higher oil prices and the February increase in domestic fuel prices) will be accomplished through the following measures:

- Gradual adjustment of domestic fuel prices. Given the heavy burden that fuel subsidies place upon public finances and their low level of efficiency in assisting the poor, the government will seek to gradually reduce the subsidy on gasoline, diesel, kerosene, and LPG over the course of 2010 to achieve a net fiscal savings of about Yrls 56 billion (0.8 percent of GDP) (structural measure for December 31, 2010). An adjustment in domestic fuel prices of Yrls 5 per liter (0.5 percent of GDP) on derivative products (gasoline, diesel, kerosene) was implemented in May/June 2010 (prior action). This comes on the back of the adjustment implemented in February 2010. Our efforts to bring domestic fuel prices closer to world prices will be complemented by instituting a social safety net to help protect the most vulnerable segments of the population against the price increases. In this context, we plan to increase social transfers by Yrls 16 billion (0.24 percent of GDP) above budgeted amounts. We hope that donors will provide financial assistance for the Social Welfare Fund. We intend to review this in the context of the first review under the program.
- Full implementation of the General Sales Tax (GST). Building non-hydrocarbon revenues has consistently been an objective of the government over the years, but progress in this area had not proceeded as quickly as had been hoped. Full implementation of the GST offers the greatest prospect for increasing tax revenues in the short-term. Implementation of the law was enacted on July 1, 2010 (prior action).

Moreover, the government will not defer payments under the GST law for its own transactions beyond the fiscal year and will not grant new exemptions under the law.

- Reduction in the corporate income tax rate (from 35 percent to 20 percent and to 15 percent for investment projects)) while simultaneously eliminating all income tax and most customs (except for fixed assets) exemptions under the Investment Law (structural benchmark for end-September).¹ Existing exemptions will be grand-fathered. Moreover, procedural improvements will be undertaken to ensure that no new exemptions can be introduced by individual line ministries or agencies. Given the need to maintain revenue neutrality, the reduction in the rate on the personal income tax (the tax on public sector wages and salaries) will become effective on December 31, 2010.
- Implement administrative reforms at the Customs Authority focused on improving both the business climate and government revenues. Specifically, we intend to simplify and streamline customs procedures to encourage investment, particularly in the oil sector, and reduce processing time. We are proceeding with efforts to fully automate work procedures, including by upgrading ASCUDA software system. Moreover, we have created a unit at the Customs Authority to gather data on international commodity prices to address under-invoicing and reduce an area of friction with the business community. We will undertake a review of customs valuation and activate the Anti-Smuggling Committee with a view to addressing smuggling and under-invoicing.
- Create a cash management unit in the ministry of finance to more tightly control government spending should the need arise (structural benchmark for September 30, 2010). The unit will produce a first monthly report on cash outturns of the targeted units by December 2010, and start developing a cash management plan for the coming months.

21. The government will seek to create additional fiscal space through identification of inefficient practices and procedures. In this regard, we intend to utilize domestic natural gas for power generation instead of costly diesel fuel by 2013, with potential savings yet to be quantified. The rental power generators fueled by diesel will be replaced by generators fueled by natural gas during 2010.

22. Preparation for the 2011 budget has not started. Our preliminary thinking is that the overall fiscal deficit would be about 5.0 percent of GDP. We expect tax revenues to improve in the context of tax policy and administrative reforms to reduce reliance on the hydrocarbon sector. We intend to further streamline non-priority expenditures. The 2011 budget

¹ The only other exemption will be payment of 50 percent of customs duty on raw materials for industrial use.

parameters will be reviewed later in 2010, as the preparation of the 2011 budget advances. Specific measures for 2011 will be outlined at the time of the first review.

B. Monetary and Exchange Rate Policies

23. The CBY will seek to ensure price stability. Critical to this effort will be the process of fiscal consolidation noted above and the associated reduction of central bank financing of the government budget. The program envisages broad money growth of 15.5 percent, consistent with non-hydrocarbon GDP and inflation objectives, allowing for a notable growth of credit to the private sector. Reserve money is targeted to increase by 14.3 by limiting budget financing from the central bank to no more than Yrls 80 billion. Similarly, in 2011, broad and reserve money are programmed to grow at 16 percent and 15 percent, respectively. The CBY will continue to maintain a close watch on excess rial liquidity, and will seek to enforce prudential norms within a context of encouraging banks to devote the necessary resources to risk management to allow for a broader extension of private sector credit. To the extent possible, and consistent with inflation and balance of payments developments, the CBY will also seek to liberalize interest rates in an effort to encourage economic activity.

24. In the context of continued exchange rate flexibility, the CBY will act to maintain net international reserves (NIR) of no less than US\$4.17 billion by end-2010 and US\$3.77 billion by end-2011. While the CBY will continue to provide foreign exchange sufficient to meet market needs and smooth short-term volatility in the rial, the exchange rate will be allowed to adjust to fundamental shifts in the supply and demand for foreign exchange, consistent with the medium-term objective of ensuring an orderly adjustment of the balance of payments. To help meet these objectives, the CBY will enhance efforts to collect timely balance of payments and liquidity data. We have recently received technical assistance from the IMF to enhance the efficiency of liquidity management and the foreign exchange auction process.

25. We plan to issue *Sukuk* in the last quarter of 2010 to diversify budget financing, provide an additional monetary policy instrument, and give Islamic banks and other investors an opportunity to invest in securities that are compliant with Islamic finance principles. We have formed an entity, initially affiliated with the CBY, to set up the basic infrastructure and manage the *Sukuk* issuance. The entity will select investment projects and prepare the relevant documentation for *Sukuk* issuance. We will have contingency plans in the event that *Sukuk* issuance is lower than programmed and other forms of non-inflationary financing are not available.

C. Structural Reforms

26. Strengthening government capacity in the area of public financial management will be a linchpin in meeting fiscal targets in 2010 and beyond. Particularly in the current environment of volatile hydrocarbon revenues, there is the need to generate timely fiscal data, adjust expenditures, and/or enact cash control measures. In this context, the government

has already begun to accelerate implementation of the Automated Financial Management and Information System (AFMIS). In the remaining months of 2010, the system will be rolled out beyond the pilot ministries to five additional ministries. The government will start implementing the second phase of PFM strategy by end-year within the framework of the Public Finance Modernization Project, and with the technical support of the World Bank. The objective of the PFM is to improve budget formulation and execution, including enhancing commitment controls and cash management, and fully implement the classification and methodology of the *Government Finance Statistics Manual 2001 (GFSM 2001)*, and supporting the AFMIS system rollout plans to the central and local government as a whole. We are also fully committed to timely publication of fiscal data—via the government financial statistics bulletin. Finally, to further protect public finances and eliminate current and future drains on the budget, the government will undertake reform of the public pension scheme, and devise a strategy to deal with moribund public enterprises.

27. A renewed effort to reform the civil service will be needed to meet the aforementioned objectives with respect to lowering expenditure on the public sector wage bill. Essential steps in this area—such as completion of biometric identification for all public employees (including military and police), and processing of early retirements and redundancies through the Civil Service Fund—will be necessary to realize envisioned savings over the medium-term, and the government commits itself to complete these essential steps by end-2011.

28. Further progress in improving the business climate and deepening financial intermediation will be essential to achieving the growth objectives noted above. Over the medium-term, we will strive to eliminate the most serious deficiencies in the business environment. Efforts will focus on, among other issues, measures to clarify property rights, improve the functioning of commercial courts, and the judicial processes for recovery of bank and other debts (including legal procedures for executing judgments and repossessing and disposing collateral) would enhance prospects for growth and investment over the medium-term. These measures will, inter alia, encourage deeper financial intermediation. But in addition, the CBY will seek to enhance financial sector development through enforcement of prudential criteria, improving the functioning of national credit registry, encouraging the establishment of an active intra-bank market, and proceeding with the issuance of Islamic financial instruments.

D. Data Issues

29. Broad access to timely macroeconomic data will be an essential pillar in improving macroeconomic management and policy coordination. Progress in data collection and dissemination has improved considerably in recent years, but there remain a number of priority areas where greater efforts are needed. In particular, we intend to complete work on a revised national accounts series by end-2010, proceed with the establishment of a producer price index, establish monthly reporting on the trade balance and quarterly reporting on the

balance of payments, release official fiscal data via the government financial bulletin with a lag of no more than two months, and complete the transition to *GFSM 2001* for the government fiscal accounts over the medium term. We look to the IMF and the donor community for assistance in reaching these objectives.

VI. OTHER

30. We would like to emphasize that Yemen's development and poverty reduction needs are enormous. In the absence of significant and predictable donor budgetary support, we will not be able to make a significant dent in fighting poverty and meeting Millennium Development Goals. We request that donors move quickly in helping Yemen meet these goals and provide significant and predictable budgetary support.

31. We will update our Poverty Reduction Strategy Paper (PRSP) in the context of drafting the new Development and Poverty Reduction Plan (DPPR) covering 2011–15, which is now under preparation and expected to be completed by end-2010. The expected shift towards more capital and social spending, as envisaged in our program, should contribute to a reduction in poverty.

VII. PROGRAM MONITORING

32. The program will cover a three year period beginning July 28, 2010, with semi-annual disbursements from the IMF contingent upon successful completion of reviews. The proposed semi-annual targets for end-December 2010 and end-June 2011 (performance criteria) and end-December 2011 (indicative targets) are set forth in Table A. These include (i) a ceiling on domestic financing of the central government; (ii) a sub-ceiling on financing by the CBY; (iii) a ceiling on net domestic assets of the CBY; (iv) a floor on net international reserves of the CBY; and (v) a continuous ceiling on the contracting or guaranteeing of nonconcessional external debt. A number of structural benchmarks are detailed in Table B. 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.

33. 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 adjusters for deviations from oil revenues and external financing; and data sources and frequency of data reporting.

Table A. Republic of Yemen: Quantitative Performance Criteria and Indicative Targets 1/ 2/
(In billions of Yemeni rials unless otherwise indicated)

	2009		2010		2011			
	Dec.		Sep.	Dec.	Mar.	Jun.	Sep.	Dec.
			I.T.	P.C.	I.T.	P.C.	I.T.	I.T.
Ceiling on domestic financing of the central government	440		83	79	66	66	66	66
<i>Ceiling on domestic financing of the central government (cumulative change)</i>			252	331	66	133	199	265
<i>Of which, the central bank</i>			20	-57	5	4	3	9
<i>Central bank (cumulative change)</i>			137	80	5	9	12	20
Ceiling on net domestic assets of the central bank (Stock)	-759		-360	-252	-188	-119	-54	2
<i>Net domestic assets of the central bank (cumulative change)</i>			399	507	65	134	199	254
Floor on net international reserves of the central bank (stock, US\$ millions)	5,677		4,244	4,170	4,070	3,970	3,870	3,770
<i>Net international reserves of the central bank (cumulative change, US\$ millions)</i>			-1,433	-1,507	-100	-200	-300	-400
Ceiling on contracting or guaranteeing of external nonconcessional by the government or the central bank (stock, US\$ millions)	0		0	0	0	0	0	0
Floor on social spending (cumulative) (indicative target)	387		388	517	158	315	473	631
Memorandum Items								
Reserve Money	765		832	875	883	890	948	1,006
External Financing (cumulative)			37	49	35	70	105	140
Government oil and LNG export revenues (US\$ millions) 1/	1,890		661	661	559	559	559	559
Cumulative Government oil and LNG export revenues (US\$ millions)			1,983	2,645	559	1,118	1,677	2,235

1/ The performance criteria (P.C.) (on cumulative changes from the beginning of the year) are: (i) domestic financing of the central government; (ii) net domestic assets of the central bank; (iii) net international reserves of the central bank; and (iv) ceiling on contracting or guaranteeing of external nonconcessional debt by the government or the central bank (continuous). End-December 2010 and end-June 2011 targets are P.Cs., while others are indicative targets (I.T.).

2/ The PCs on NIR and NDA of the central bank, and on domestic financing of the budget have adjustors which are defined in the attached Technical Memorandum of Understanding (TMU).

Table B. Republic of Yemen: Extended Credit Facility—Prior Actions and Structural Benchmarks

Measures Under the ECF	Objective	Timing
Increase domestic fuel prices by Yrls 5 per liter on petroleum derivatives.	Expenditure Control	Prior Action (Done)
Full implementation of the General Sales Tax (GST) law.	Broaden Tax Base and Improve Revenue	Prior Action (Done)
Reduce corporate income tax rate from 35 percent to 20 percent (15 percent for investment projects), while simultaneously eliminating tax and customs (except for fixed assets and 50 percent of raw materials for industrial use) exemptions under the Investment Law.	Broaden Tax Base and Improve Revenue	Structural Benchmark, September 30, 2010
Create a cash management unit in the ministry of finance in order to better control government spending.	Expenditure control/Budget Execution	Structural Benchmark, September 30, 2010
Gradual adjustment of fuel prices to achieve net fiscal savings of Yrls 56 bln (0.8 percent of GDP).	Expenditure Control	Structural Benchmark, December 31, 2010

REPUBLIC OF YEMEN: 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 2010–13 Extended Credit Facility (ECF) Arrangement (Table 1).
2. The ECF Arrangement is built upon four performance criteria for the end of semi-annual intervals (test dates) during December 2010–June 2013 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, which will be monitored as memorandum items along with broad, reserve money and social spending.
3. The exchange rate of Yemeni rial to the U.S. dollar for the purposes of the program is set at Yrls 225 = US\$ 1.

I. PERFORMANCE CRITERIA AND INDICATIVE TARGETS

A. Reserve Money

4. 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 excludes deposits held in the CBY by the central government and local councils, pension funds, public enterprises, and counterpart funds. The term "banks" relates to all commercial and Islamic banks. The term "public enterprises" relates to all enterprises where government has stake of 50 percent and above. The term "counterpart funds" refers to, but is not limited to, all other extrabudgetary funds related to the government or public enterprises.

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

5. For purposes of this criterion, net international reserves (NIR) of the CBY are defined consistent with the definition of the Balance of Payment Manual 6, as external assets readily available to, and controlled by, the CBY, net of external liabilities of the CBY. Pledged and otherwise encumbered assets, including, but not limited to reserve assets used as collateral (or guarantees for third party external liabilities), are excluded.
6. 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 non-resident financial institutions; foreign securities; SDR holdings; and reserve position in the International Monetary Fund) minus (i) CBY external liabilities (this includes liabilities to the Arab Monetary Fund (AMF), the International Monetary Fund (IMF), and other

liabilities to non-residents) and (ii) external assets not controlled by the CBY (foreign currency deposits at CBY of banks', pension funds' and public enterprises'). 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.

C. 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. Net foreign assets are external assets of the CBY as defined under paragraph 5 and 6 minus external liabilities of the CBY.

D. Ceiling on Domestic Financing of the Budget

8. Budget refers to the budget of the central government of the Republic of Yemen and local councils. It does not include extrabudgetary funds and public enterprises.

9. Domestic financing of the budget is defined as the sum of net claims of the CBY and commercial banks' on the central government and net holdings of government securities by non-banks. 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, T-bonds, Islamic bonds (sukuk and other), and repurchases of government securities of various maturities.

E. Floor on Social Spending

10. Social spending is defined as a total of budget current and capital social spending including spending on the Social Welfare Fund, health, education and social protection, as recorded in the government's Financial Statistics Bulletin.

F. Ceiling on Contracting of Non-concessional External Public Sector or Publicly-Guaranteed Debt

11. 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 non-concessional external debt with an original maturity of over one year. External debt is defined as debt contracted from non-residents. 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 4. Non-concessional 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 rates used for this purpose are the currency-specific commercial interest reference rates (CIRRs), published by the Organization for Economic Cooperation and Development (OECD). The ceiling excludes the use of IMF resources..

II. ADJUSTORS

A. External Financing of Budget

12. Net external financing of the budget consists of cash disbursements of loans, less cash amortization payments. External financing transactions are to be valued at the program exchange rate.

13. 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 financing. In case of excess net external financing, ceilings on NDA and domestic financing of the budget will be adjusted downward for the portion of net external financing that is not spent on capital and social expenditures, while the floor on NIR will be adjusted upward for the portion of net external financing that is not spent on capital expenditures financed through import.

B. Crude Oil and LNG Export Revenue of Government

14. 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. LNG revenues are defined as LNG export revenues net of the amount of loan service. The data on government crude oil and LNG revenue will be converted to rials at the program exchange rate.

15. 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 non-bank 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 debt	Data on all new borrowing and guarantees by central government, local governments and CBY	Monthly	1 month after the end of each month
	External financing	External debt service and payments	Monthly	1 month after the end of each month
	Crude oil and LNG	Crude oil and LNG export revenue received by the government	Monthly	3 weeks after the end of each

	exports			month
Central Statistical Office	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.
Ministry of Oil	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