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Republic of Yemen—Program Note

IMF Engagement: A US$550 million loan under the Extended Credit Facility (ECF), approved by the IMF's Executive Board on September 2, 2014, expired in March 2016 because a first review could not be completed owing to the armed conflict that began in March 2015.

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Background

Yemen is a strategically important country in the Arabian Peninsula, overlooking the Mandab Strait, and has great economic potential with its large labor force, long shoreline, and agricultural and hydrocarbon resources. Yet, the country is one of the poorest and most fragile countries in the world. Poverty, malnutrition, and unemployment are widespread, and water resources are very scarce. The poor social indicators add to social tensions, complicate the management of the economy and contribute to security challenges. Furthermore, high dependence on hydrocarbon resources exposes the economy to external shocks.

Over the last few years, Yemen faced multiple severe shocks which imposed a heavy toll on economic activity. In particular, oil production declined sharply, and the social unrest and sabotage activities affected investment and resulted in frequent damage to oil pipelines and infrastructure. The 2011 political crisis aggravated the already difficult economic situation. Private sector activity suffered, public finances and official reserves came under pressure, and inflation surged. The economy eventually stabilized and started to recover in 2012 thanks in part to sizable external grants from Saudi Arabia and some reform implementation in the context of the IMF Rapid Credit Facility. The recovery, however, was short lived and pressures remerged in early 2014 due to frequent attacks on oil facilities, which reduced fiscal and export revenues, and delays in implementing fundamental reforms necessary for diversification. The resulting threats to macroeconomic stability prompted a new round of reforms that were supported by an ECF arrangement in September 2014. With the onset of armed conflict in March 2015, real activity collapsed, the country's human and real capital suffered, large external and internal imbalances emerged, and the fiscal deficit surged. As of April 2016, there were tentative hopes that the conflict could be settled in the near future and security be restored.

Yemen's overarching economic challenge is to achieve high and inclusive growth and create adequate job opportunities in a stable economic environment. This necessitates sustained efforts to overcome policy and structural impediments to achieving the full potential of the economy. In particular, it is essential to tackle the weak structure of public finances, avoid a return to pervasive fuel subsidies, address corruption, improve public service delivery and efficiency, enhance the business environment, promote human capital, facilitate access to finance, and strengthen assistance to poor.

Role of the IMF

The by now expired three-year ECF (2014-16) aimed at supporting the authorities' pro-growth pro-poor reforms that address Yemen's fundamental economic challenges, and at mobilizing further financial resources from international donors. The ECF took into account the constraints on institutional capacity and allowed adequate time to implement the reforms in consultation with key stakeholders.

Containing generalized fuel subsidies was a key reform under the ECF. It aimed to create fiscal space for infrastructure investments and targeted social transfers to the poor. These subsidies reached over 7 percent of GDP in 2013 and consumed more than half the country's hydrocarbon revenue. Furthermore, they disproportionately benefitted the rich and encouraged smuggling. To reduce these subsidies, the authorities increased the prices of diesel, gasoline, and kerosene by 50 percent, 20 percent, and 100 percent, respectively, in mid-2014. The de facto retail prices did not increase as these products were only available at parallel market prices. At the same time, the authorities increased the Social Welfare Fund transfers to the poor by 50 percent.

Steps were also taken to remove ghost workers from the payroll in order to contain the large wage bill. In particular, explicit efforts were made to generalize the use of biometric identification cards throughout the civil service and phase in wage payments through banks and post offices.

Yemen's low tax revenue to GDP ratio and high dependence on hydrocarbon revenues increase the vulnerabilities of government revenue to hydrocarbon prices and production shocks. Hence, fiscal reforms targeted an increase in tax revenues by fighting tax evasion and increasing compliance of large tax payers.

Reforms were also initiated to enhance governance and strengthen financial sector stability and resilience, and promote financial intermediation.

Challenges ahead

As the conflict comes to an end, it will be first of all important to take stock of the damages caused by the conflict and identify reconstruction needs. Another priority will have to be restoring security and initiating an inclusive political process that addresses the grievances that ignited the conflict. Restarting hydrocarbon production and exports will be key for raising fiscal revenues to reduce the deficit and earning foreign exchange to finance much-needed imports for reconstruction. Restoring quickly basic education and health services as well as resuming the operations of programs benefiting the poor would be important for building confidence. The adjustment and reform path that had a good start under the ECF will need to be re-assessed in light of the conflict, but the pre-existing challenges will also not disappear. The international community needs to be ready to move quickly to support economic recovery and resumption of reforms once the political and security uncertainties subside.