YEMEN

Economic Monitoring Brief

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OVERVIEW

Yemen has been experiencing political instability since 2011 and open conflict since late 2014. As a result, the social and institutional fabric in Yemen has witnessed increasing disintegration. Although official statistics are no longer available, anecdotal evidence suggests that Yemen's GDP contracted by an accumulated 40 percent since the end of 2014. The conflict has caused widespread disruption of economic activities, and has dramatically diminished employment and income opportunities in the private and public sector. Operating costs rose significantly due to insecurity and lack of supplies, while demand has fallen precipitously leading to mass layoffs in both, the formal and informal sectors. Oil and gas production and exports have come largely to a halt since 2015, running at about 10-15 percent of capacity. Remittances fell, partly due to restrictions and difficulties imposed on transfers for the Yemeni banking sectors and partly due to more restrictive immigration policies applied since early 2018 by major GCC member countries. Imports have declined sharply as foreign reserves fell below US$1 billion in 2016 while foreign debt obligations have not been serviced since May 2016 (except for obligations to the IMF and to IDA). Essential Central Bank functions have been disrupted due to the conflict and the split of the Bank along the conflict lines added to the economic challenges. Even delivery of humanitarian assistance has therefore become more costly and cumbersome. Furthermore, the ongoing conflict has led to deep divisions and fragmentations among national institutions. Partly due to the desperate economic situation throughout the country and the absence of state authority and legitimacy, numerous violent extremist groups have been created - filling the vacated space -that carry out attacks in the South and North of Yemen. Only the eastern part of the country, foremost Marib City and Hadhramout, is largely spared, although AlQaida is active in these areas. It is believed that it will take years of recovery and reconstruction to bring peace to Yemen and establish the status-quo ante.

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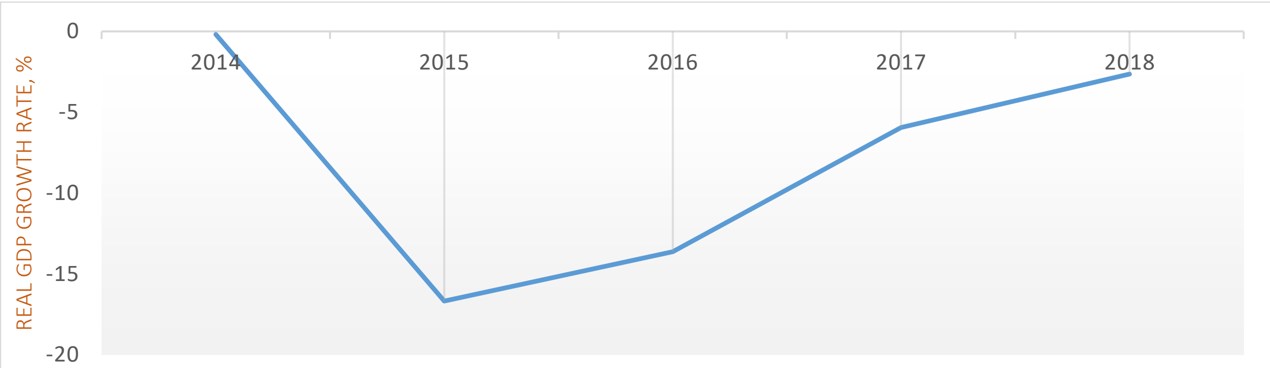
REAL SECTOR

Deterioration of the macroeconomic situation continues in 2018, while growth remains unlikely in 2019 in the absence of peace. Yemen's economy has contracted significantly as a result of the conflict's adverse impact on economic activities. Real GDP growth is estimated to have contracted by 6 percent in 2017, largely attributed to the reduction in the non-hydrocarbon output, which contracted by around 7 percent, although the decline of economic activity appears to be bottoming out for 2018 (Figure 1). Post-conflict or recovery growth would in an initial phase depend on: (1) resurrection of security; (2) reconstruction activity (presumably externally funded); and (3) eventually on the recovery in the oil sector and the financial flows the sector would generate for the benefit of the external and fiscal balance.

Figure 1: Real GDP Growth Rate

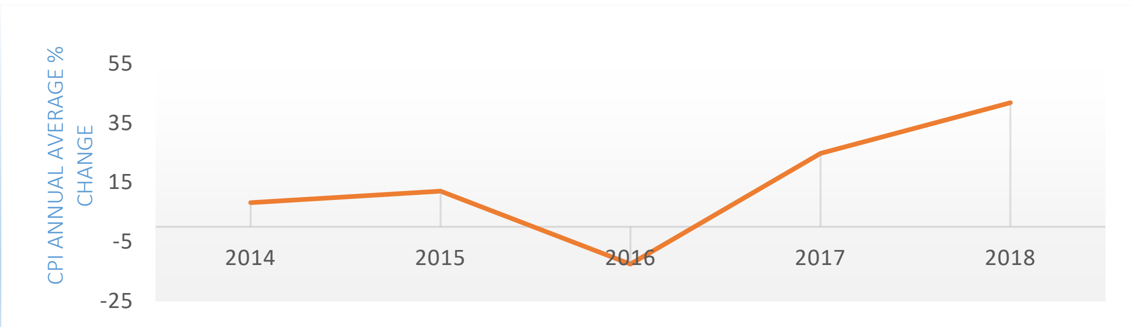


Source: MoF, IMF and staff estimates.

The conflict situation in Yemen continues to weigh heavily on economic activity. On the supply side, frequent disruptions in the supply of essential goods and services like fuel, electricity, intermediate goods, and food and non-food commodities, have hindered economic activities. On the demand side, growth contraction was underpinned by the country's failing institutional capacity due to conflict and lack of private sector income opportunities and public salary payments, aggravating since later 2016 by the overall deteriorating humanitarian situation. In line with this deterioration, the resulting tight fiscal envelope only permits spending at less than half *(*in terms of GDP) of 2014 public spending.

Inflation is rising in 2018. While inflation could be somewhat contained in 2017, partly because of non-payments of contractual obligation like public salaries, inflation is on the rise in 2018, estimated to have accelerated to over 40 percent, which is largely caused by the declining exchange rate, nominally moving from an annual average of around 320 Yemeni Riyal in 2017 for one dollar to over 600 Yemeni Riyal per dollar by end of August 2018 (Figure 2). However, with the continuing difficulty of limiting the fiscal deficit (see also Figure 3) coupled with expansive monetary policies (printing of new YR bills), inflationary pressures in 2018 are likely to continue. It is uncertain whether the ongoing efforts to restore the CBY functions and the recent $2 billion deposit by KSA, could lead to containing the inflationary pressures for the remainder of 2018, while a full institutional recovery of the CBY is unlikely to materialize in the short period without a tacit political consensus across the lines of conflict.

Figure 2: Inflation, Consumer price index



Source: GoY, IMF and Staff estimates.

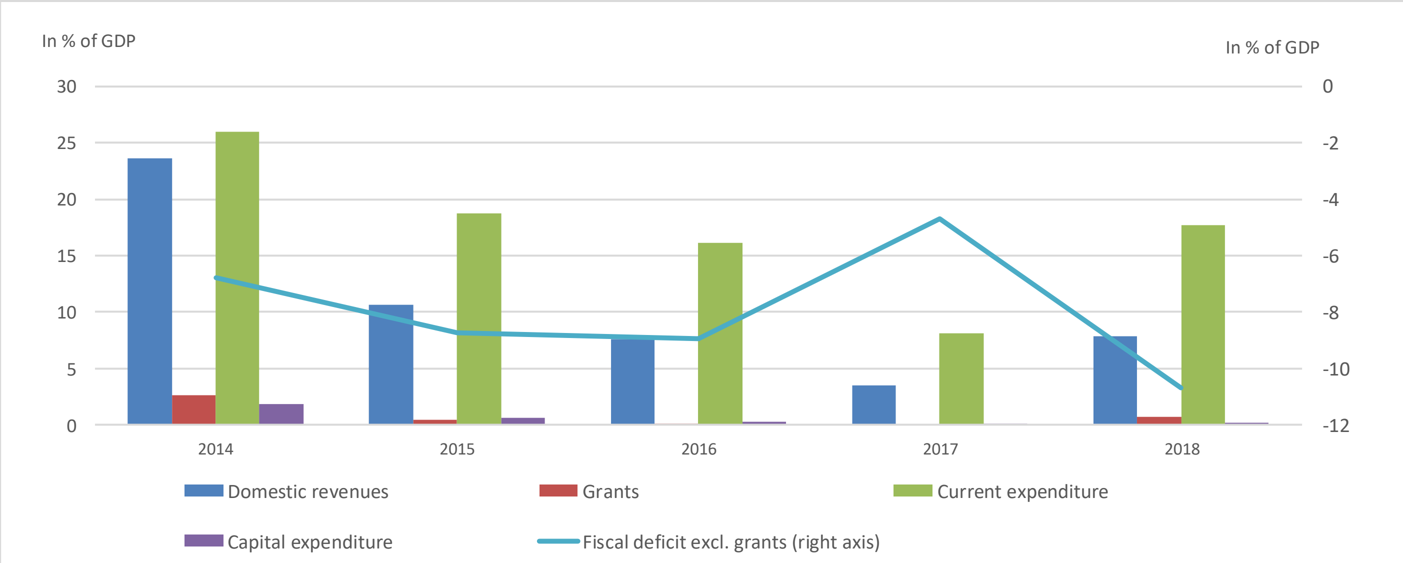
Political and security instability prevents the restoration of oil and gas industry. Oil and Gas production and exports have almost halted since conflict escalated in 2015 except for about 10-15 percent of the former production. The production losses have resulted in foregone fiscal revenues on a massive scale (they represented previously 50-60% of revenues). The conflict also inflicted large-scale destruction of infrastructure and led to the departure of foreign operators. Both factors will weigh on the speed of an eventual full recovery of the sector.

PUBLIC FINANCE

Fiscal policy has been determined by the conflict conditions. Prior to the ongoing conflict, public spending on wages of both, civil and military sectors, amounted to around 42 percent of the total public revenues in 2010-2014, or nearly 10 percent of GDP. However, since the conflict started the public wages and salary bill represents more than 100 percent of the total actual public expenditures in 2015-2017, reflecting the build-up of arrears.

Improving fiscal policies and accounts in 2018 remains subject to improving the country's political and security environment. The latest preliminary data (Figure 3 below) show the level of public revenues collection continuing to decline from nearly 24 percent of GDP prior to the conflict, to an estimated 8 percent of GDP in 2018, with non-hydrocarbon tax collection being the key source for revenues, amounting to around 5 percent of a much-reduced GDP. Revenues were boosted in 2017 by an oil grant in kind from KSA amounting to about $1 billion. The grant is also expected to support revenues in 2019. Some revenues – uncaptured by the treasury - originate from domestic oil and gas sales – are estimated at around 1 percent of GDP. Public expenditures in 2017 declined to a record low of around 8 percent of GDP as almost all non-wages public spending has been suspended (Figure 3 below). The overall resulting fiscal deficit in 2017 is estimated to reach around 5 percent of GDP (cash basis), implying accumulating arrears and unpaid commitments. The situation in 2018 will only improve if a peace perspective prevails. The shrinking since end 2014 of the state's share in the economy – which itself has diminished - is indicative of the deepening fragmentation, waning capacity and legitimacy of the state.

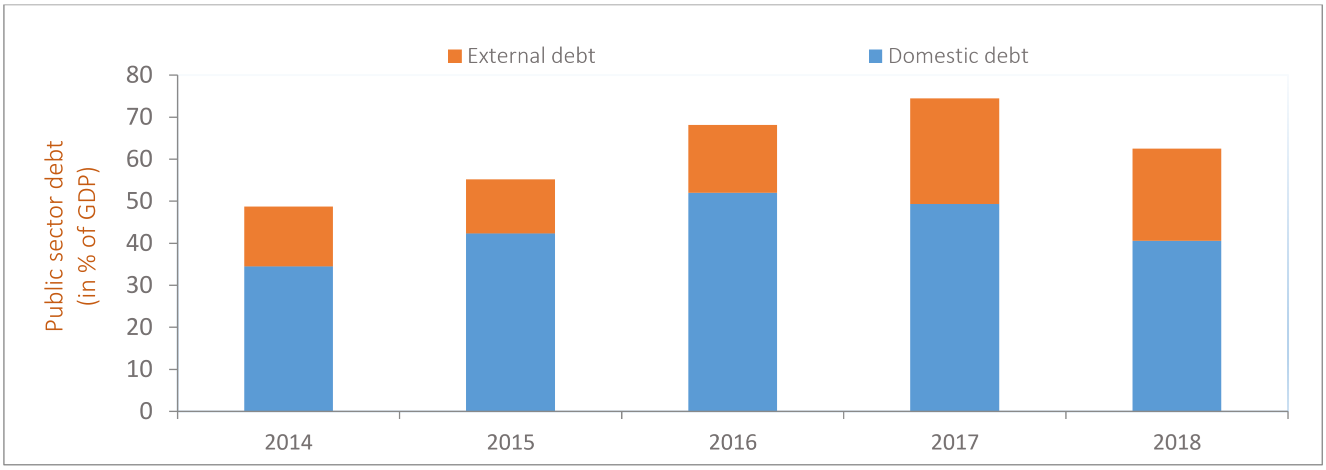
Figure 3: Yemen Public Finances



Source: GoY, IMF and Staff estimates.

Yemen's total public debt increased considerably in 2017 as a result of rising domestic debt. Total public debt had been relatively low in pre-conflict years but the financing of the rising fiscal deficit with credit taken from the Central Bank (overdraft) has propelled the public debt ratio to approximately 75 percent of GDP in 2017 of which 49 percent of GDP is representing domestic public debt. External public debt remained relatively stable in real terms but increased as a ratio of GDP to 25 percent. In addition, accumulated arrears since 2015 are currently estimated at around US$3 billion (the last available estimate dates from 2016), including unpaid goods and services, salaries and debt arrears. As new debt is not being issued in the absence of proper fiscal and monetary operations, arrears could still build-up but the domestic debt build-up - on the whole - has likely reached a temporary peak.

Figure 4: Yemen's Public Debt

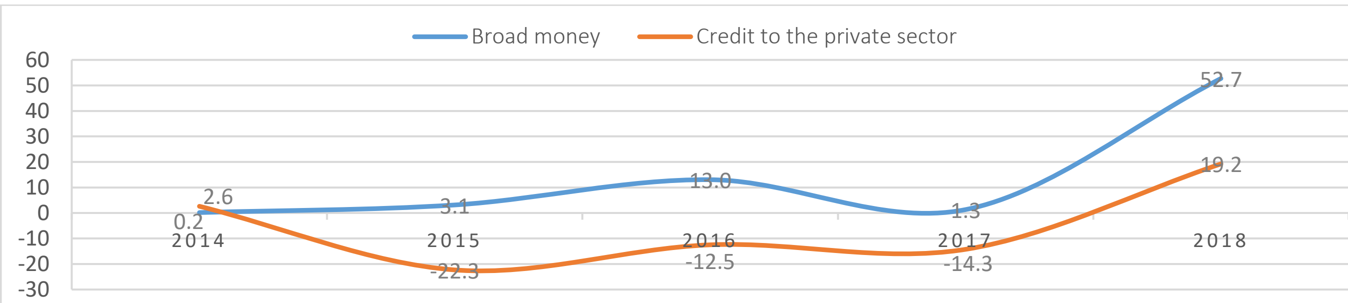


Source: Central Bank of Yemen and IMF staff estimates.

MONEY AND BANKING

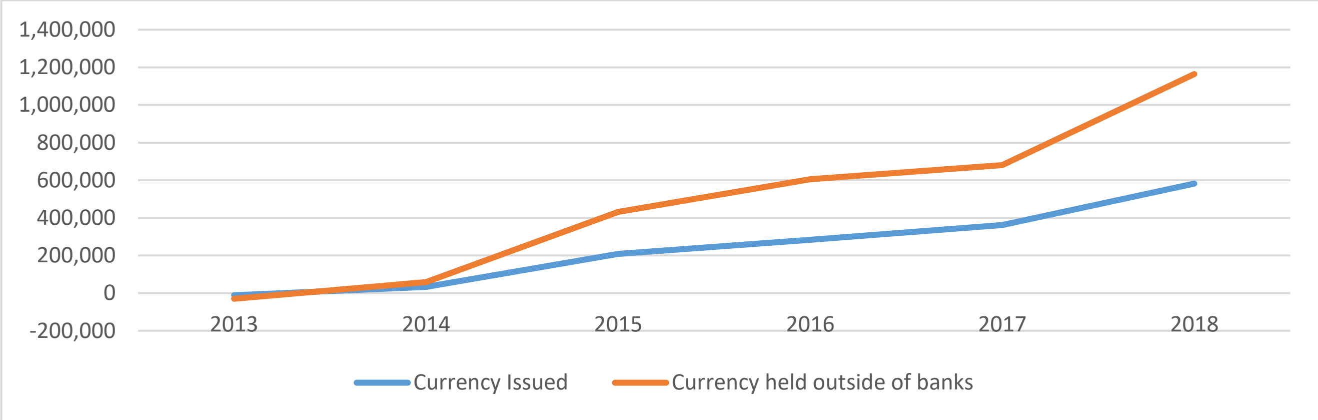
Money supply is accelerating in 2018. Total money supply is expected to grow to around 53 percent in 2018, compared to 1.3 percent in 2017 (Figure 5), reflecting *massive issuing of new bank notes since 2017* and the corresponding steep increase of currency circulation outside banks, which is estimated to have increased by over 100 percent since 2014. Private sector credit contracted by 14 percent in 2017 but is projected to show a gradual recovery in 2018. Furthermore, the currency in circulation outside banks is estimated to have increased from YR810.9 billion in 2014 to YR1,673 billion by the end of 2017. Money in circulation is expected to grow by a further 10-20 percent in 2018 following the injection of new banknotes up to end August 2018. In early September, in an effort to regain better control over monetary policies, the Government issued three carefully calibrated decrees (no. 75, 76, and 77) accompanied by guidance letters from the Central Bank of Yemen, Aden, which aim collectively to re-establish the Central Banking System in Yemen led by the Central Bank in Aden by (1) raising the interest rates - for various products - of up to 27%, and (2) by offering a limited convertibility for (a) Yemeni Riyal holders through supporting the financing of petroleum products and food imports, and for (b) medical treatment abroad (limited to $2000 per case). The offer is conditional to commercial banks that work with the CBY in Aden and operate under its supervision. While the decrees are a step into the right direction to restore the integrity of the financial system in Yemen, it needs to be seen whether they can do so in the given fragmented financial market context in Yemen. These measures could be more effective, if also accompanied by appropriate fiscal policy measures.

***Figure 5: Money and Credit** (annual % change)*



Source: Central Bank of Yemen and IMF staff estimates.

Figure 6: Currency outside banks (annual growth)



Source: Central Bank of Yemen and IMF staff estimates

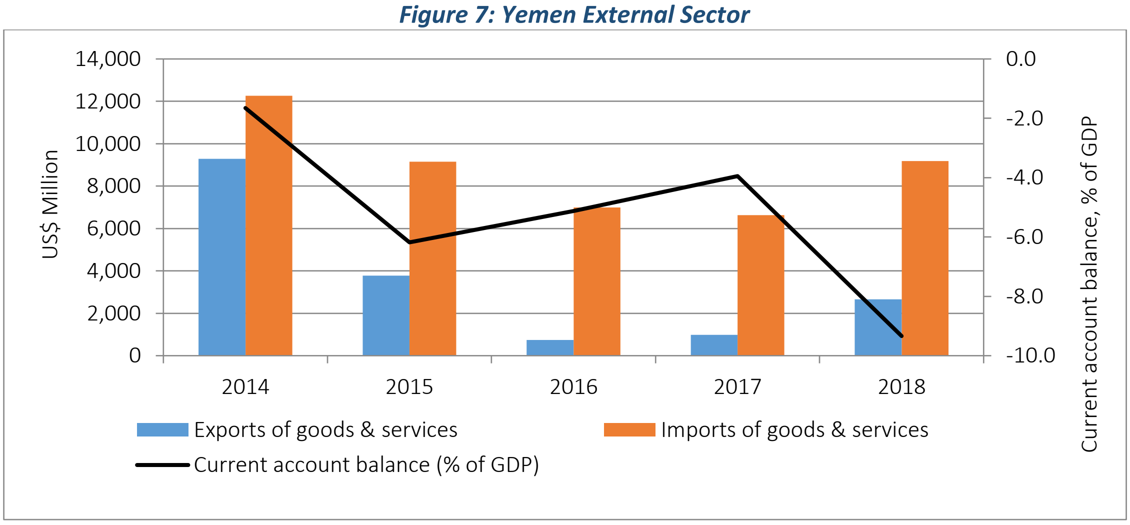
Financial sector vulnerabilities are on the rise. In addition to the overall difficulties, the commercial banks face difficulties in coping with the consequences of the prolonged political crisis. Their range of operations and financial products continue to diminish in 2018. Import-financing has diminished; a sizeable part of the exchange market and other financial market transaction has been conceded to informal so-called *money traders*, which have mushroomed in the country during the conflict. In the given uncertain world in Yemen, banks continue to witness deposit withdrawals in combination with a rationed supply of dollars. Both trends have continued to put the bank's balance sheets under stress, adding to the perceived liquidity shortages. The effect is compounded by the experienced massive Yemeni Riyal devaluations during late 2017/early 2018 and again in August 2018, revaluing foreign debt obligations.

The political and security crisis makes Yemen's future monetary path and exchange rate development uncertain. While the financial market in Yemen is still highly fragmented due to the conflict, the CBY in 2018, stepped up efforts to restore its operational capacity and monetary functions. The recent appointment of a new CBY Governor in February 2018, is being followed by tentative steps to resurrect the central bank's vital role as a policy making institution. Some partners of CBY are already providing technical support under the leadership of the IMF. However, the rehabilitation of the CBY will also require significant efforts to rebuild consensus and unity, or alignment of interests, in order to overcome the current fragmentations within this Yemen Central Bank system.

EXTERNAL POSITION

Import compression is the outcome of the structural current account deficit. The conflict brought an end to hydrocarbon exports since early 2015, leading to an estimated current-account deficit of about 9 percent of GDP in 2018. Imports contracted by about 64 percent in 2017 compared to 2014, including due to the lack of foreign reserves. Imports are likely to recover somewhat in 2018, also aided by the KSA deposit of $2 billion to the Central Bank of Yemen. While the level of imports generally adjusted to the economic implications of the conflict, food and hydrocarbon imports have been less elastic. The pressure on the balance of payments has been compounded by the decline in remittances, and the lack of FDI. International restrictions imposed on transactions to Yemen from abroad have contributed to the drop in receipts from remittances.

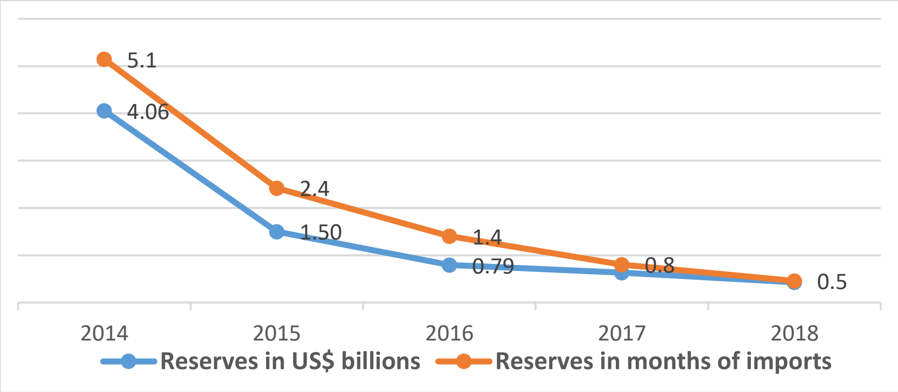
Figure 7: Yemen External Sector



Source: Central Bank of Yemen and IMF staff estimates.

Yemen's foreign reserves flows depend currently largely on a dwindling flow of remittances and conflict related flows. The quasi suspension of regular exports and foreign assistance flows, the latter being estimated at about $2 billion annually during the years prior to 2011, has now left only remittances as the main source for foreign exchange earnings. Remittances initially maintained their level but have since 2016 declined. Their estimated amount does currently not exceed more than USD1.4 billion[1], annually.

Figure 8: International Reserves



Source: Central Bank of Yemen, IMF and staff estimates.

CBY is stepping up its efforts to boost remaining foreign reserves by maintaining a flexible albeit managed exchange rate regime. CBY management in Aden reverted in August 2017 to a flexible exchange rate policy stance. The policy reversal followed a March 2016 decision to fix the exchange rate in combination with a devaluation from 215 to 250 YR per dollar, aiming to stem dwindling reserves. As a result of CBY's August 2017 decision, all foreign exchange operations, including for essential food imports on which the urban population traditionally depends upon, has been subjected to the market rate as a reference.

Since July, the value of the Yemeni Riyal is witnessing significant depreciation against the US dollar with alarming repercussions on the country's already deteriorating humanitarian situation. By January 2018, the Yemeni Riyal (YR) nominal exchange had devalued to around YR450/1US$, nearly 40 percent nominal devaluation compared with its value of a year earlier. In July 2018, the Yemeni Riyal faced alarmingly rapid devaluation pressures. By end-August, the Yemen Riyal's nominal exchange value exceeded YR600/1USD. In the meantime, the rate stabilized at 585 per dollar initially but continues its slide downward since mid-September. The issuing of new bank notes that were added to the existing money stock preceding EID celebrations in 2018, is seen by some observers as a kay source for the rapid devaluation since July 2018.

OUTLOOK

In the current conflict situation and the given political uncertainty, it is not possible to provide a detailed, sound outlook. However, Yemen's medium-term outlook will depend ultimately on whether an end to the on-going conflict can be found and the rebuilding of the Yemen economy and social fabric is facilitated. In the short-term, there is no substitute for external financial support for initial macroeconomic stabilization given the interdependency of external financing, the fiscal expenditure program, and early stabilization. Finally, if violence can be contained before the end of 2018, GDP is predicted to begin its recovery in 2019 (i.e., via the gradual resumption of hydrocarbon export). However, little of the economic recovery is estimated to translate into a meaningful reduction of the high poverty rate in Yemen (approximately 80 percent in 2018).

1 The assessed decline is largely attributed to the dwindling trust in the Yemen financial system; the dwindling capacity to absorb in the absence of the Central Bank of Yemen services.

YEMEN: KEY ECONOMIC INDICATORS

	2014	2015 Prel.	2016 Prel.	2017 Proj.	2018 Proj.
National Income and Prices	(Change in percent, unless otherwise indicated)				
Nominal GDP, market prices (billions of YR)	9,289.4	9,797.6	5,099.7	5,283.6	7,114.5
Real GDP growth	-0.2	-16.7	-13.6	-5.9	-2.6
CPI (period average)	8.2	12.0	-12.6	24.7	41.8
Hydrocarbon production (in thousand barrels per day)	324	126	16	32	90
Central Government Finances	(in percent of GDP)				
Revenue and Grants	23.6	10.7	7.6	3.5	7.8
of which hydrocarbon revenue	11.2	2.4	1.3	1.9	5.0
of which grants	2.7	0.4	0.0	0.0	0.7
Expenditure and net lending	27.8	19.4	16.4	8.2	17.9
Current, of which:	25.9	18.8	16.1	8.1	17.7
wages and salaries	10.0	9.4	8.3	5.6	7.3
subsidies	5.6	0.6	0.1	0.9	1.8
Capital	1.8	0.6	0.3	0.1	0.2
Overall fiscal balance (excl. grants)	-6.8	-9.2	-8.9	-4.7	-10.7
Primary non-oil fiscal balance (cash)	-9.7	-5.0	-4.9	-6.4	-9.5
Gross Public Sector Debt	48.7	55.2	68.1	74.5	62.5
Domestic debt	34.5	42.3	52.0	49.4	40.6
External debt	14.3	12.8	16.1	25.1	21.9
Monetary data	(end-of-period annual growth rate)				
Broad money	0.2	3.1	13.0	1.3	52.7
Reserve money	1.4	27.4	23.8	18.2	28.1
Credit to private sector	2.6	-22.3	-12.5	-14.3	19.2
Benchmark deposit interest rate (percent)	15.0	15.0	15.0	15.0	15.0
Velocity (non-oil GDP/M2)	2.4	2.4	2.4	2.4	2.4
External Sector	(In millions of U.S. dollars, unless otherwise indicated)				
Exports (goods & services)	9,287	3,772	747	982	2,655
of which hydrocarbon (oil and gas)	6,774	2,440	248	599	2,175
of which nonhydrocarbon	1,123	501	125	125	188
of which services	1,390	830	374	257	292
Imports (goods & services)	12,257	9,146	6,992	6,627	9,183
of which services	2,525	1,843	1,144	920	1,367
Current account balance (in percent of GDP)	-1.7	-6.2	-5.1	-4.0	-9.3
Reserves					
Central Bank own gross reserves (billions US$ end-period)	4.1	1.5	0.8	0.6	…
Central Bank own gross reserves (in months of imports)	5.1	2.4	1.4	0.8	…
External Debt					
External debt (in billions YR)	1,325	1,258	1,436	2,512	3,213
External debt (in percent of GDP)	14.3	12.8	16.1	25.1	21.9
Exchange Rate					
Exchange rate (per US$, official rate)	214.9	214.9	244.0	320.0	…
Memo Items					
Nominal GDP in billion US$	43.2	45.6	36.4	31.3	28.5
Population (in millions)	26.3	26.9	27.6	28.3	29.0
Nominal per capita GDP (US$)	1,647	1,694	1,318	1,104	985

Source: Ministry of Finance, Central Bank of Yemen, IMF and staff estimates.

Source: GoY, IMF and WB-MFMod.