

Yemen's Economic Prospects and Challenges¹

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Yemen, the poorest country in the Middle East and North Africa and one of the most unstable politically, faces formidable development challenges. Multiple threats to Yemen's stability -- even, conceivably, to its continued existence -- derive from a weak central government, tribalism and a lack of social cohesion, high unemployment and limited economic opportunity for youths. Internal conflicts, some of which date from the merger of North and South Yemen in 1990, flare up from time to time. Recent incidents of kidnapping and murder of aid workers and tourists that are being attributed to Al Qaeda have added to Yemen's numerous challenges.

The level of poverty declined slightly up to 2005-2006 but remains high and probably increased in 2008. Yemen is a low-income country with GNI per capita of only \$870 in 2007. Its latest social indicators -- life expectancy at birth (62 years), infant mortality (75 per 1,000 live births), child malnutrition (41%), access to improved water (66%), adult literacy (54%), and gross primary school enrollment (87%) -- are all worse than the averages for Middle East and North African countries. Household survey data show that the percentage of families living in poverty fell from 40% in 1998 to 35% in 2005-2006, declining faster in urban than in rural areas. Owing to rapid population growth, however, the absolute number of poor people remained constant at about 7 million. For Yemen to reach the Millennium Development Goal of halving the incidence of poverty by 2015 would require much faster economic growth than has been occurring -- and also a different pattern of growth, since oil-driven growth has benefited urban but not rural households. The Social Welfare Fund, the government's main mechanism to alleviate poverty, has expanded but still covers only a small percentage of the poor and provides many of its benefits to the non-poor. Poor Yemenis suffered from the 60% spike in food prices in 2007-2008 and many were affected by the October 2008 floods in the south.

Unemployment is extraordinarily high and rising. Thirty-five percent of the labor force is thought to be unemployed. More than half of those who do work are employed in low-productivity agriculture. The labor force is growing at 4.2% a year. High rates of labor force growth will persist for some time into the future, as population is increasing at 3% a year and the total fertility rate (6.1 children per woman) is one of the highest in the world. These numbers could cause Yemen's population to grow from 22 million to 50 million over the next 25 years.

Oil provides some 90% of export earnings and a large portion of government revenue, but it is a wasting asset. Oil production is declining from year to year. The stock of recoverable oil (proven reserves plus a portion of possible reserves) is estimated at 1.1 billion barrels. At the current rate of extraction and barring significant new discoveries, Yemen's oil supply will be exhausted by 2021. Starting in 2010, LNG production will help alleviate the impact on government revenue and exports, but it will not make up fully for the loss of earnings from crude oil.

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The enabling environment for private business is somewhat better than many others in the region; the ease of starting a business in Yemen has improved dramatically. The World Bank's *Doing Business 2009* ranks Yemen 98th out of 181 countries on its ease of doing business index. This represents a sharp improvement over the previous year's ranking of 123rd. The improvement is entirely attributable to one aspect of the business environment – the ease of starting a business, in which Yemen's ranking jumped from 175th (one of the world's worst) to a creditable 50th. Yemen opened a new one-stop shop for investors and has made it easier to obtain municipal licenses and register with the chamber of commerce and tax office. Other reforms include a new procurement law, the establishment of an active anticorruption authority, and a review of labor and company laws. Yemen also ranks relatively high on three other aspects of the business environment: dealing with construction permits; enforcing contracts; and registering property. Weaker areas, in which Yemen still ranks lower, are protecting investors, trading across borders, paying taxes and getting credit.

Economic growth will be relatively high this year because of the opening of a large LNG facility, but the longer-term prospect is unfavorable. Real GDP apparently grew by 4.4% in 2008, compared to 4.2% the previous year (but the underlying statistics are said to be unreliable). Non-oil economic activity grew at 5.3% while oil output fell by 13.1%. Higher oil revenues and some progress in tax collections also helped to reduce the fiscal deficit to 4.3% of GDP and the current account deficit to around 2% of GDP. Given that oil prices were very high during the first nine months of the year, the World Bank regards overall economic performance in 2008 as disappointing and a sign that Yemen faces difficult economic challenges.

While government revenues have been buffered by high oil prices, pressures on public finances and the balance of payments are mounting as oil price and production decline. Although the real GDP growth rate is expected to be favorable in 2009 (the World Bank forecasts 7.7%, the EIU 4.8%), much of the growth will be attributable to the one-time effect of the coming on stream of LNG production. The non-oil sector, the main source of employment, is expected to grow by no more than 4%, less than in 2008. With falling government revenue from hydrocarbons, the fiscal deficit is expected to rise to 10-12% of GDP. In the slightly longer term, Yemen faces clouded prospects because of depressed oil prices, slower growth in the Gulf, instability in the Horn of Africa, and domestic political challenges.

Efforts to reform economic policy and management have been made but their implementation has been stymied by lack of consensus over some of the reforms.

According to the IMF, the government remains committed to fiscal consolidation, including elimination of fuel subsidies, a smaller wage bill, and higher non-oil revenues, but social stability concerns appear to block reform. A number of reforms have been undertaken in recent years – including civil service and public financial management reforms, a major adjustment of fuel subsidies in 2005, a new general sales tax, and an anti-corruption drive – but most have been only partially implemented and with significant delays.

Although Yemen is well insulated from global financial contagion, its economy remains vulnerable to commodity shocks and the effects of slower regional and world economic activity. The financial system is underdeveloped and the economy is largely cash-based. The

main foreign assets, the central bank's reserves, are highly liquid and are kept as deposits in international banks. During 2008 the Yemen economy benefited from high oil prices but suffered from higher prices for imported food and inputs. This year, oil and import prices are both lower. Without substantial reform of the public finances, the IMF expects that the fiscal deficit will become harder to finance and balance of payments pressures will mount. Slower regional growth is also projected to bring lower levels of non-oil foreign investment than previously anticipated, as well as lower inward remittances from Yemeni workers in the Gulf and elsewhere.

The emerging challenges have prompted new thinking within the government. A mid-term review of the Development Plan for Poverty Reduction (DPPR) is underway. It aims at policy revisions to take account of challenges such as the persistence of poverty, unemployment, and the poor outlook for domestic oil production. Emphasis is reportedly being placed on promoting economic diversification, improving energy efficiency, and strengthening social safety nets. New laws on customs, income taxes, investment, telecommunications and land registration are said to be in the works.

Yemen has a severely limited supply of arable land and one of the world's worst levels of water availability. More than one-third of Yemen's agricultural land and one-quarter of its water are devoted to the production of *qat*, a mild narcotic which competes with food production. The United Nations World Food Program regards Yemen as the most food-insecure country in the Middle East and one of the worst afflicted in the world. Currently the nation is suffering a severe drought, which has affected all the major grain-producing areas and may require increased food imports that could drain foreign exchange reserves. Moreover, Yemen suffered a swarm of locusts earlier this year and more locust swarms are expected.

Fishing, a significant industry in Yemen, is threatened by exhaustion of fish stocks as well as by piracy. Catches are showing signs of leveling off, owing to destructive fishing practices, lack of private investment, and rising sea piracy. The government is drafting new regulations that include measures to protect the marine environment from destructive fishing practices.

Shipping through the Aden Container Terminal dropped markedly in early 2009. This reflects not only the reduced volume of global trade but also the impact of piracy and related sharp rise in insurance premiums.

Yemen needs and will seek increased foreign support. Yemen maintains close cooperation with the donor community, but a substantial portion of the 2006 Consultative Group pledges have yet to be translated into actual disbursements or commitments, largely because of security issues. The government works closely with the World Bank Group (IDA and IFC) and USAID and also continues to press for full membership in the Gulf Cooperation Council.

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