

COUNTRY REVIEW

Yemen



4 June 2010

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EULER HERMES COUNTRY RISK GRADE: D

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

COUNTRY PROFILE

Capital city:	Sanaa
GDP:	USD29.1bn (2009e)
Population:	23.6mn (2009e)
GDP per capita:	USD1,230 (2009e)
Currency:	Rial (YER)
Form of state:	Republic
Head of state:	President Ali Abdullah Saleh
Next elections:	Presidential by September 2013; parliamentary April 2009 postponed for two years

President Ali Abdullah Saleh and the ruling General People's Congress (GPC) remain the dominant forces in mainstream politics. However, the state, as it currently stands, is not assured of a future and **disintegration remains a possibility in the medium term**. This results from a combination of economic and political threats:

- Dwindling oil and water reserves;
- Weak economic management;
- A Shia rebellion in the north (Zaydi or Houthis)
- Secessionist pressures in the south; and
- Al-Qaida activity.

Partly as a result of all these pressures, parliamentary elections originally scheduled for April 2009 have been postponed for two years. However, **much of the country away from the capital Sanaa is ruled by local armed tribal factions that are outside the effective control of the security forces** and parliament is a relatively ineffective form of governance. The country came into existence as recently as 1990, when North Yemen and South Yemen were united after two decades of political turmoil. Since then, a secessionist putsch was forcibly put down in the mid-1990s and there are **periodic incidents that indicate that the north-south divide remains a key challenge and that unification is not guaranteed to continue**. The country has **numerous tribes, political parties and religious factions providing a confusing range of alliances and allegiances**. **Armed violence is relatively common**. To that extent, political stability is fragile, at best.

Nevertheless, presidential elections in September 2006 resulted in a strong renewed mandate for Saleh, who won 77.2% of the vote. Saleh has been in power since 1979—initially as president of North Yemen—and there are **mounting concerns in relation to succession** as he has sidelined potential replacements and prevented other politicians from gaining significant experience at the executive level. For the interim, Saleh's continuation in power provides some semblance of policy continuity. This includes (at least at an official level) support for the US-led campaign against international terrorism, which has provided the regime with international support, including military assistance and economic aid. However, **alignment with the US has also increased domestic opposition to the government, reflecting a wider hostility to US regional intervention**. Moreover, the government's economic reform agenda (including reductions in subsidies and proposals for new taxes) has also engendered strong resistance and opposition from local communities.

Yemen remains vulnerable to high profile terrorist attacks from outside its borders, from within its deepest and lawless hinterland and through association with acts elsewhere in the world. In 1997, militants attacked the USS Cole, in the process killing numerous US military personnel. More recently, al-Qaida in the Arabian Peninsula (AQAP) claimed responsibility for the failed Christmas Day 2009 Detroit airline plot. Co-operation with Washington remains unpopular domestically but there is unlikely to be a policy reversal in the near future. Following success for the GPC in parliamentary elections in April 2003—when it won 228 out of 301 seats in the legislature, compared with 47 for the Islamist al-Islah group—political focus turned to economic reforms. However, **relations with the IMF are uneven and the reform agenda is uncertain of implementation and of full Fund support**. **Sanaa has a poor record in achieving interim IMF targets**, partly reflecting the difficult political and security outlook and a Poverty Reduction and Growth Facility (PRGF) has proved difficult to establish. However, external assistance is forthcoming from other sources, including the World Bank, IFC and IDA, regional development funds and non-governmental organisations.

Regional relations are also strained. At the end of 2009, Saudi Arabian military forces repelled Yemeni groups allegedly transgressing the porous and indeterminate border between the two

countries. Yemen is **not part of the Gulf Co-operation Council (GCC)** but its member states do not want a source of instability within the Arabian peninsula and may allow membership at some future date (outside the forecast period). In the interim, the GCC is likely to provide financial support and, perhaps, military assistance (in need) to try and prevent total political or economic collapse.

Yemen is the poorest economy in the Arabian peninsula, with per capita annual income of around USD1,200. **Dependence on volatile oil price cycles and variable agricultural output**, combined with rapid population growth (3.7% annual average 1975-2003, 2.9% since 2005), has resulted in relatively weak growth in real GDP per head over the long term. Moreover, **oil reserves are sufficient for only another 24 years at current rates of extraction and some fields are now experiencing production declines**, including the leading Masila and Marib sites. Without major new discoveries, the oil sector will not be able to generate high rates of growth.

The economic reform agenda has largely stalled, partly because of political/security constraints (difficult to implement subsidy cuts or reductions in the public sector wage bill), partly for electoral reasons and partly because high oil revenues (reflecting price rather than volume of output) lessen the need for immediate action. **Only when the IMF sees positive progress in reform implementation** (including reductions in the civil service wage bill, curbs on smuggling and removal of petroleum product subsidies) **will it be willing to extend its lending facilities**. However, there is little evidence to indicate that Saleh and the government have sufficient commitment to implement a reform strategy that will meet fully Fund requirements.

Public finances remain highly vulnerable to a sharp downward adjustment in oil prices. Therefore there is a downside risk to exposures requiring payments to be made from the public sector. Even when oil prices are high and provide a boost to government receipts, the fiscal balance is of concern. Limited tax revenues indicate that fiscal deficits will be difficult to finance, although they are unlikely to cause severe economic disruption while high oil revenues allow FX accumulation.

Monetary policy is conducted by the Central Bank of Yemen (CBY), which targets broad money supply (M2) as its policy anchor, partly because the economy's **rudimentary financial system** is generally unresponsive to short-term changes in interest rates. Rates of average annual inflation have been in double figures since 2001, although the global economic slowdown is likely to have resulted in only 5% average **inflation** last year. **We forecast double-digit growth to return this year.** Despite being an exporter of crude oil, Yemen imports the bulk of its energy needs. Government targets of less than 10% for inflation, as laid down in planning documents, have been missed for several years. A principal factor behind inflationary pressures is government expenditure, which moves in line with political rather than economic needs. A relatively large FX reserve cushion (see below) currently allows central bank intervention in support of the rial.

The external accounts are influenced heavily by trends in world energy markets—**crude oil accounts for over 90% of export earnings**. The recent sustained period of high oil prices in 2004-08 prevented the current account from turning to a deficit that would otherwise be warranted because of high import costs and declining oil export volumes but **we forecast current account deficits equivalent to around 8% of GDP for 2010 and 2011**.

FX reserves at almost USD7bn (end-2009) provide **healthy import cover of 6-9 months**, compared with an international benchmark minimum guide of three months. However, FX reserve levels mask the **fragility of the country's finances and Yemen will remain dependent on foreign assistance**.

The structural business environment is weak.

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