Country Report

Yemen

Yemen at a glance: 2005-06

OVERVIEW

The president, Ali Abdullah Saleh, supported by his party, the General People's Congress, will remain the dominant political force during the forecast period. Although political violence will persist, fuelled by opposition to the government's co-operation with the US in its "war on terror", the regime's security forces will be able to contain the threat. The government will remain hesitant about bringing its economic reform programme back on track, particularly in the face of a hostile parliament and public. Deteriorating economic fundamentals may force the government's hand in 2005, with the possibility that some cabinet members may be sacrificed for reform measures. Real GDP growth in 2004 is estimated to have fallen to 1.9%, as oil output has declined. Growth will rebound in 2005, driven mainly by stronger oil output and export volumes, but will slow again in 2006. Inflation will average around 13% in 2005-06.

Key changes from last month

Political outlook

- The Economist Intelligence Unit's political outlook is unchanged. Continued unrest, as exemplified by the recent outbreak of violence in the north of the country, is likely. The Yemeni political scene will remain volatile, as the government attempts to maintain both a hardened stance against extremists and co-operation with the US. Some members of the cabinet may lose their jobs as a result of the need to push through difficult reforms.

Economic policy outlook

- The government's economic policy outlook is unchanged, with economic reform still officially a priority, although the recent announcement of a postponement of the removal of the diesel subsidy demonstrates the government's lacklustre commitment to reform.

Economic forecast

- The outlook for the fiscal and external accounts has changed slightly for the worse on account of alterations to the oil price forecast. The current-account surplus will narrow sharply in 2006 and the fiscal deficit will widen considerably, ending the forecast period at 5.7% of GDP.

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Outlook for 2005-06

Political outlook

Domestic politics

The president, Ali Abdullah Saleh, supported by his party, the ruling General People's Congress (GPC), will remain the dominant political force, exercising full control over Yemen's national political institutions throughout the forecast period. His current mandate extends until the next presidential election in 2006. The government will not have an easy ride, however, as evidenced by growing friction in parliament recently. The opposition has grown increasingly outspoken over alleged government corruption, the lifting of subsidies and a deteriorating economy. The prime minister, Abdel-Qader Ba-Jammal, has borne the brunt of much of the vitriol. Given the growing tension, Mr Saleh may decide that the removal of some senior members of his cabinet is necessary to placate elements of the opposition; an important consideration given that some of its members are key local powerbrokers who can aid the struggle against the ever-present militant threat. A cabinet reshuffle may also offer the president some leeway in his desire to remove subsidies, providing scapegoats towards whom blame can be deflected.

Political unrest, triggered by tribal and Islamist elements, is unlikely to abate. Public opposition to the government's continuing co-operation with the US in its "war on terror", exacerbated by the US administration's policies in the wider region, will also add to the undercurrent of instability. However, the security forces appear able to contain major challenges to the regime. The threat Yemen faces is as much imported as home-made. Yemen's topography, coupled with a lack of central government control in its remoter governorates and weak border security, has made the country an obvious bolthole for fugitive militants from throughout the region. The inflow of militants has helped fuel pre-existing extremist Islamist sentiment within the country, as has the government's continuing co-operation with the US. Yemen is also the conduit for much of the arms flooding into Saudi Arabia and the wider region. These factors ensure that Yemen remains in the front line in the "war on terror" and place the Yemeni government in the middle of the ongoing struggle between Islamic militants and Western democracies.

As a consequence of this, and in spite of the government's claim of "victory" over the al-Qaida militant Islamist group in Yemen, sporadic and random outbreaks of violence will continue. The recent military campaign to quell a Shia revolt in the north of the country is an example not only of the current unpredictability of Yemen's political climate, but also of the disparate nature of the government's adversaries. It is probable that the government will be exercised by similar rebellions and skirmishes throughout the forecast period and beyond. Isolated large-scale attacks, such as the one against the *Limburg* supertanker in October 2002, remain a possibility.

In the short to medium term, therefore, the security situation will remain the single most pressing political issue. The Yemeni government will co-operate with the US in its "war on terror" partly because the authorities are keen to expunge militant violence from the country, but also because they have little choice but to acquiesce to US dictates, since they themselves could end up as a US target. However, the government will continue to publicly criticise the US in an attempt to demonstrate its own strength and independence. In particular, the authorities will resist at all costs any visible US military deployment within Yemen, aware that such a degree of co-operation would enrage public opinion. In treading this fine line, Mr Saleh's domestic policies will be predicated on limiting political damage, especially by appeasing key religious and tribal elements through the traditional means of patronage, thus helping to ensure that a degree of stability is maintained.

International relations

The September 11th 2001 attacks provided the catalyst for strengthening official ties with the US—a relationship that the government will want to maintain, in spite of the unpopularity of US policies in the region. The Yemeni government values the military and financial support that the US can offer and the influence it wields over the IMF, with which Yemen has strained relations owing to its failure to implement economic reforms agreed under a programme drawn up with the Fund. The attacks and the subsequent global security concerns have also added impetus to Yemen's rapprochement with its neighbours, which began with the signing of the June 2000 border agreement with Saudi Arabia. Historically, however, relations between Yemen and its Gulf neighbours have rarely been close and ties will be subject to periods of friction. Notwithstanding this, given Yemen's position on the front line in the "war on terror", Saudi Arabia and other Gulf Co-operation Council states will be keen to ensure Yemen's political stability and economic solvency, and will therefore be a valuable source of financial support for the country.

Economic policy outlook

Policy trends

Yemen's economic policy has ostensibly been geared towards the renewal of its IMF poverty reduction and growth facility (PRGF), to which is attached the disbursement of US$300m in concessional financing. This amount is part of a US$2.3bn economic support package, pledged by a host of donors at a meeting in Paris in late 2002. However, discussions over the renewal of the PRGF continue, with the IMF unconvinced that the government is making sufficient efforts to meet its policy requirements. These include progress in civil service reform and measures to improve tax administration.

In early 2004 the government announced that it was intending to impose a general sales tax (GST) and remove the remaining diesel subsidy, both of which are key IMF requirements. The announcement hinted at Yemen's gradual shift towards the Fund's position and suggested that discussions over the renewal of the PRGF may acquire momentum. However, in June the government backtracked and declared that the removal of the diesel subsidy—planned for July 1st—was being shelved owing to the uncertain political climate. It also postponed the imposition of the GST. The government's reversal ruled out the renewal of the PRGF this year, and discussions with the Fund over the facility will only be resurrected when Yemen makes tangible moves towards reform. The somewhat opaque approach adopted by the Yemeni authorities towards fiscal accounting makes it difficult to predict the government's next move in terms of fiscal policy. It has little incentive to pursue sensitive economic reforms during the current period of heightened political instability, particularly as it continues to receive regular inflows of aid and grants from other donors and will continue to draw down tranches of the US$2.3bn support package. Furthermore, the Yemeni government has a track record of eschewing reforms during periods of high oil prices. However, the economic circumstances are such that pressure on the economy, through deteriorating fiscal and external accounts, will build to the point where the authorities have no choice but to act. The Economist Intelligence Unit expects this point to be reached some time in 2005, at which stage the government will move to lift the remaining diesel subsidies.

Fiscal policy

We have revised down only slightly our estimate and forecast for oil prices in 2004 and 2005. The estimate for 2004 has dropped by just 32 US cents to US$39.03/barrel, while the forecast for 2005 has been reduced by 75 US cents to US$36.75/b. Although higher oil prices have brought the government much-needed revenue, it has also entailed much greater expenditure, to fund the authorities' continuing policy of subsidising diesel, which in 2004 is estimated to have cost the budget US$800m. The higher subsidy expenditure, which resulted in an estimated 20% rise in overall spending, has offset a considerable portion of the 29% gain in oil revenue in 2004. Oil income would have been significantly greater were it not for falling oil production (which looks to be a medium- to long-term trend), while the negative impact of other policy shortcomings, such as the failure to implement the GST, helped restrain growth in overall earnings. Nevertheless, revenue growth outstripped that of expenditure and the budget deficit is estimated to have contracted slightly to YR60bn (US$323m), or 2.3% of GDP.

The 6% drop in oil prices in 2005 will partially negate production gains and consequently growth in government oil earnings will slow significantly to 3%. Sustained expansion of non-oil receipts, such as tax revenue, and continued inflows of grants will help to buoy earnings, however, and total revenue is expected to rise by around 6% to YR887bn. Expenditure is also forecast to increase, to YR944bn, as the government stays committed to its large-scale development projects and as progress remains slow on pushing through much-needed reform of the civil service, with the authorities still facing a large wage bill. We expect, though, that the government will move to lift some, if not all, of the remaining diesel subsidy at some stage during the year, and that overall expenditure will therefore rise by less than 5%. Accordingly, the budget deficit will narrow further—if only marginally—registering a shortfall of YR57bn, or 1.9% of GDP.

A further fall in oil prices in 2006 will have a negative impact on overall earnings, despite an additional—albeit limited—expansion in oil production. Government oil receipts will tumble by over 20%, causing a 12% drop in overall revenue, which will amount to just YR783bn. Expenditure will rise once more, as a lack of government will to press ahead with necessary economic reforms ensures that current spending continues to grow. Capital spending will also continue to rise as ongoing development projects require financing. As a result, total spending will rise by over 3% to YR976bn, leaving a much-increased fiscal deficit of YR193bn, or 5.7% of GDP.

Monetary policy

The government has stated publicly that broad money (M2) supply targeting is the most appropriate inflation anchor for the Yemeni economy. Given the relatively underdeveloped nature of Yemen's financial system, the impact on inflation of solely altering interest rates would be fairly limited. As it is, money supply targeting is not a cure-all strategy and despite a tightening of monetary policy in recent months—the Central Bank of Yemen (CBY) has slowed money supply growth—inflation has crept up. This has led to downward pressure on real lending rates, which are now around 6%. However, the government will continue to use open market operations to dampen liquidity and average M2 growth over the coming months is likely to be lower than the 18-20% level around which it has moved for the past three years. In the medium term, however, we expect monetary expansion to return to trend rates.

Economic forecast

International assumptions

International assumptions summary
(% unless otherwise indicated)

	2003	2004	2005	2006
Real GDP growth				
World	3.8	5.0	4.2	4.0
OECD	2.0	3.4	2.5	2.4
EU25	1.1	2.4	2.1	2.2
Exchange rates				
¥:US$	115.9	108.2	94.8	94.0
US$:€	1.132	1.242	1.385	1.400
SDR:US$	0.714	0.676	0.631	0.627
Financial indicators				
€ 3-month interbank rate	2.33	2.13	2.10	2.25
US$ 3-month Libor	1.21	1.59	3.36	4.75
Commodity prices				
Oil (Brent; US$/b)	28.8	39.0	36.8	29.0
Gold (US$/troy oz)	363.3	405.5	415.0	396.3
Food, feedstuffs & beverages (% change in US$ terms)	6.6	9.0	-6.0	-1.5
Industrial raw materials (% change in US$ terms)	13.0	20.5	-2.1	-4.7

Note. Regional GDP growth rates weighted using purchasing power parity exchange rates.

We estimate that global economic growth will have reached 5% in 2004 (on a purchasing power parity basis), the fastest rate of growth for 20 years. However, there are already signs that growth is decelerating in some major economies and the outlook for 2005-06 is for a more modest pace of expansion. We forecast that world GDP will slow to 4.2% in 2005 and to 4% in 2006.

Since breaking through the US$50/barrel mark in mid-October, the price of the benchmark dated Brent Blend eased in November and early December, falling below US$40/b for the first time in six months. The recent fall in prices reflects a softening of global demand, which earlier in the year recorded the strongest growth in 24 years and was a factor in pushing prices upwards. Increasing oil production in the Gulf of Mexico, as the recovery from hurricane damage continues, has allowed US oil stocks to rise, easing speculators' fears of an energy shortage in the US during the winter months and releasing the pressure on prices. However, prices remain extremely sensitive to both positive and negative supply- and demand-side events. This sensitivity is attributable to the ongoing tightness in the global oil market. With little spare global supply, and small changes in demand sufficient to have a dramatic impact on prices, future oil price movements will remain difficult to gauge. Notwithstanding this, we now estimate that Brent will have averaged US$39.03/b in 2004. In 2005, however, we expect prices to slip to US$36.75/b, in line with expanding production and a deceleration in global demand for crude. With global supply increasing and security worries receding, prices will ease to an average of US$29/b in 2006.

Economic growth

In 2004 real growth is estimated to have fallen to 1.9% from 3.1% in 2003, owing to a significant decline in oil production. Yemen's oil reserves are gradually dwindling and output from the country's older fields is falling. While this has been particularly evident this year, industry insiders believe that they will be able to raise output from Yemen's older fields temporarily over the next two years before a terminal decline sets in. Although new discoveries are being made, they are not sufficiently large to compensate for the medium-term loss from the older fields, and the more pessimistic analysts believe that Yemen will run out of oil by around 2012.

The decline in output during 2004 will have more than offset stronger domestic demand growth, which appears to have been driven mainly by public consumption. Lower levels of confidence, as a result of the government's failure to implement promised policies, have probably also dented investment. In 2005 real GDP expansion will be driven by exports, as volumes recover on the back of a rebound in oil production, pushing real GDP growth up to 5.6%. In 2006 domestic demand will continue to expand at recent historical rates, whereas export volume growth will slow considerably as oil output expansion peaks. Consequently, overall growth will slow to 4.3%.

Inflation

In response to a pick-up in inflation in the earlier part of 2004, the CBY moved to tighten money supply, although it appears the move has had limited impact on consumer prices. Accordingly, we estimate that average annual inflation in 2004 will have risen slightly compared with last year, reaching 11.3%. The government is expected to lift subsidies at some stage in 2005 and we believe that this will exert upward pressure on prices. However, it is difficult to gauge the extent of the impact the measure will have, and our forecast for average annual inflation of 12.1% may prove to be conservative. In 2006 the price increases from the lifting of subsidies will be more fully felt, particularly if the government decides to remove them in stages. With domestic demand growth remaining fairly strong, we envisage that inflation will accelerate slightly to 14.2%.

Exchange rates

Following downward pressure on the currency during the first quarter of 2003 (as war jitters led to an increase in demand for US dollars), the CBY intervened to support the Yemeni riyal. With little detectable movement in the currency since then (the rate in mid-December 2004 was YR185.5:US$1 compared with YR184.3:US$1 in December 2003), we estimate that the annual average rate in 2004 will have been YR184.8:US$1. In 2005 we expect the CBY to allow the riyal gradually to resume its recent annual average level of depreciation of around 4%, a trend that will continue into 2006. Consequently, the currency is expected to average YR192.5:US$1 in 2005 and YR200.5:US$1 in 2006.

External sector

A slightly revised oil price forecast has resulted in minor changes to the current-account outlook. Despite the decline in average oil production, export revenue is now estimated to have risen by 25% in 2004, as oil prices remained high. Imports will have increased by just 3%, mainly on account of lower import volumes. This will result in an enlarged trade surplus of US$1.3bn, up from US$377m in 2003. The import bill will expand faster in 2005, in line with continued expenditure on capital projects, whereas growth in the value of exports will slow considerably, as a 6% fall in oil prices largely offsets a rise in oil production. An increase in non-oil exports will fail to make a significant impact on total revenue, as their value constitutes less than 7% of overall exports. As a result, the trade surplus will narrow—albeit marginally—to US$1.2bn. In 2006 a further drop in oil prices will result in a decline of almost 20% in export values and, with imports continuing to rise at similar levels to 2005, the trade surplus will contract to a negligible US$15m.

Non-merchandise transactions will follow past trends, with the services and income balances remaining firmly in deficit. Yemen's services and income balances have been in deficit since 1989, and although the joint deficit will—on aggregate—narrow slightly over the forecast period, as a reduction in foreign companies' profit repatriation outweighs higher interest costs and as services debits associated with imports grow, it will still record a deficit of US$1.7bn at the end of 2006. The current transfers surplus will rise steadily throughout the forecast period, as aid inflows augment higher workers' remittances (as sustained high oil prices provide greater job opportunities for Yemenis in the Gulf states). Overall, Yemen's current-account surplus will have expanded to US$766m (5.5% of GDP) in 2004. In 2005 the surplus will remain unchanged in absolute terms, but will fall to 4.9% as a proportion of GDP. In 2006 the current-account surplus will contract sharply to US$31m, or 0.2% of GDP.

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Forecast summary

(% unless otherwise indicated)

	2003[a]	2004[b]	2005[c]	2006[c]
Real GDP growth	3.1[b]	1.9	5.6	4.3
Oil production ('000 b/d)	465	423	456	462
Crude oil exports (US$ m)	3,697[b]	4,689	4,830	3,886
Consumer price inflation (av)	10.8	11.3	12.1	14.2
Deposit rate	13.0	13.0	13.0	13.0
Government balance (% of GDP)	-3.3	-2.3	-1.9	-5.7
Exports of goods fob (US$ bn)	3.9	4.9	5.1	4.1
Imports of goods fob (US$ bn)	3.6	3.7	3.9	4.1
Current-account balance (US$ bn)	0.1	0.8	0.8	0.0
Current-account balance (% of GDP)	1.3	5.5	4.9	0.2
External debt (year-end; US$ bn)	6.0[b]	6.6	7.2	7.7
Exchange rate YR:US$ (av)	183.4	184.8	192.5	200.5
Exchange rate YR:¥100 (av)	158.3	170.8	203.2	213.3
Exchange rate YR:€ (av)	207.7	229.4	266.6	280.7
Exchange rate YR:SDR (av)	257.0	273.5	304.9	319.8

[a] Actual. [b] Economist Intelligence Unit estimates. [c] Economist Intelligence Unit forecasts.

