

YEMEN

RISK ASSESSMENTS

| Risk Category | Year Ago | Current 08/08 | One Year Ahead | | Five Years Ahead | |
|------------------|-------------|---------------|----------------|------------|------------------|------------|
| | | | Worst Case | Best Case | Worst Case | Best Case |
| Political Risk | 63.0 | 61.5 | 58.0 | 64.0 | 55.0 | 69.0 |
| Financial Risk | 38.5 | 38.5 | 36.0 | 39.0 | 30.0 | 39.0 |
| Economic Risk | 25.5 | 25.5 | 35.0 | 37.0 | 30.0 | 38.0 |
| Composite Risk | 63.5 | 62.8 | 64.5 | 70.0 | 57.5 | 73.0 |
| Risk Band | Mod. | Mod. | Mod. | Low | High | Low |

POLITICS

Internal Conflict

Internal Threats Stabilize....For Now

Although neither President Ali Abdallah Salih's overall grip on power, nor the writ of his government, have really been at risk, Yemen has faced three severe threats to its internal security and stability over the first half of this year: an armed insurrection by al-Houthi Shiite rebels in the north of the country, which even threatened the regional capital, Saada, itself; violent civil disorder in the south; and attacks by terrorists affiliated with al-Qaida in both the north and the south.

By late July, however, it appeared that one of those threats, the al-Houthi insurrection, had been neutralized, at least for the time being.

President Ali Abdallah Salih announced the end of hostilities with the al-Houthi rebels on July 17. He did not say whether the rebels had been forced to surrender, which seems unlikely, or if negotiations had achieved another ceasefire.

Whether a real ceasefire has been achieved might take some time to discern, given that low-level clashes were still being reported in late July. If those clashes die down then a real cease-fire might have a chance. If they do not, then there is the likelihood that large-scale fighting will break out again, as has happened twice in the first half of this year.

Humanitarian organizations claimed that some 100,000 were affected by the violence, with over 40,000 displaced in Saada city alone.

But while the north may, or may not, be more peaceable at the moment, unrest continues in the south. Although there was trouble as early as January this year when a policeman was killed during a demonstration for greater rights in the port city of Aden, the troubles really kicked off at the end of March over alleged discrimination in government and army jobs.

With unemployment and poverty so high, the security of government employment in almost any capacity is a prize worth fighting for. And fight they

did. The demonstrations led to two weeks of clashes between protesters and the police in a number of southern cities. Reports suggest that one demonstrator was killed and tens of police and civilians injured.

Sporadic violence and clashes between police and demonstrators have continued, with the latest confrontation taking place on July 22.

And then there is the continuing threat from terrorist groups linked to al-Qaida, which began with an attack on a tourist convoy on January 18, in which three people were killed, including two Belgian tourists.

It has been all downhill from then on. On March 18, the al-Qaida-linked group Yemen Soldiers Brigades launched a mortar attack on the US embassy in the capital, Sanaa, wounding five soldiers and 13 girls at nearby school. Also in Sanaa, on April 6 rockets were fired at a foreigners' housing complex; later in the month a member of parliament was shot dead in the city, and on April 30 there was a failed mortar attack on the Italian embassy.

On May 2 a bomb attack on a mosque in Saada killed 15 people and on May 31 eight people were killed by gunfire in an attack on a mosque in Kohal. On the same day there was a mortar attack on an oil refinery.

June was apparently quiet as far as al-Qaida operations were concerned, but on July 25 a car bomb was detonated at a police station killing at least two people. An al-Qaida group claimed responsibility.

ECONOMY

Oil Buoy Economy, Inflationary Pressures Significant

Yemen faces myriad economic and social challenges: massive poverty, a birth rate that far outstrips the economy's ability to create jobs or to feed itself, high unemployment, and falling oil production.

Luckily for Yemen, if not for the oil consuming countries, the high oil prices of the past couple of years have more than compensated for falling production and enabled the economy to record an average real GDP growth of over 4% a year.

Growth did slip a little last year, to around 3.6%, but is expected to rebound to 4% this year and then to double to 8% in 2009 on the back of a predicted further surge in hydrocarbons earnings. This will be temporary, however, and real GDP growth is expected to fall back to about 5.3% in 2010.

| | 2008 ¹ | 2009 ¹ | 2010 ¹ |
|--|-----------------------------------|-------------------|-------------------|
| | <i>(Annual percentage change)</i> | | |
| Real GDP growth | 4.3 | 8.0 | 5.3 |
| Inflation rate (Core consumer price index) | 12.1 | 10.5 | 9.5 |

1. IMF Forecast.

Unfortunately, the growth in the economy has been consistently undermined by double digit inflation. The inflation rate peaked at 18.2% in 2006 and fell to 12.5% last year. This downward trend had been expected to continue, pulling the rate down to about 12.1% this year and to 10.5% in 2009. However, higher than expected food prices this year could push inflation higher this year. Yemen imports 75% of its food, so higher world food prices have a particularly strong impact.

In any event, Yemen isn't expected to see single digit inflation until 2010 at the earliest, and even then it will be only just below 10%.

Diversification Necessary

The major worry for the government is the hydrocarbons sector. Oil has been the mainstay of the economy, but production is falling fast and reserves could be completely exhausted within the next ten years. Over the past couple of years that falling output has been masked by the surge in oil prices. In addition (LNG) production will start to make up for some of the shortfall in oil output from next year.

However, LNG production is expected to stabilize at about 174,000 b/d from 2010 while oil output will continue to fall. On that basis, total oil and gas production is expected to peak at about 459,000 b/d in 2011 and then to fall steadily year on year.

In short, this means that Yemen has to completely transform the basis of its economy over the next five years or so to reduce its dependence on oil revenues. The government has a detailed reform strategy and some significant progress has been made. Unfortunately, the much higher-than-expected earnings from oil exports have tended to introduce some complacency and there are concerns that the pace of reform has slowed.

| | 2008 ¹ | 2009 ¹ | 2010 ¹ |
|---|----------------------------|-------------------|-------------------|
| | <i>(1,000 barrels/day)</i> | | |
| Crude oil output | 316 | 306 | 300 |
| Liquefied natural gas output (oil equivalent) | 0 | 137 | 174 |
| Total hydrocarbon production | 316 | 443 | 474 |

1. IMF Forecast.

Terms of Trade

The critical importance of hydrocarbons in the economy can be seen from the foreign trade figures, where they currently account for over 90% of the total value of exports. However, by as early as 2012 the contribution of hydrocarbons to total exports earnings is expected to fall to below 90% and to keep falling thereafter.

| | 2008 ¹ | 2009 ¹ | 2010 ¹ |
|--------------------------------------|------------------------|-------------------|-------------------|
| | <i>(US\$ billions)</i> | | |
| Exports (fob) | 6.740 | 7.688 | 7.760 |
| <i>Of which hydrocarbons</i> | <i>6.144</i> | <i>7.056</i> | <i>7.089</i> |
| Imports (fob) | 6.933 | 6.997 | 7.359 |
| Trade Balance | -0.253 | 0.691 | 0.401 |
| Current Account Balance | -0.343 | 0.192 | 0.0 |
| Current Account Balance ² | -1.3 | 0.6 | 0.0 |

1. IMF Forecast. 2. As a percentage of GDP

Poverty, Unemployment, and Population Growth

Yemen's ability to transform its economy away from oil dependency has critical implications for the country's high poverty and unemployment levels, and therefore its overall social stability.

Although some progress has been made, poverty is still very high, with about 35% of the population living below the poverty line. The economic and social difficulties this presents are compounded by the high fertility rate, which at 6.1% is one of the highest in the world.

According to the government, the population is currently growing by some 700,00 a year, an expansion that is not only way beyond the job-creating capacity of the economy, but is also putting an enormous strain on the education and health systems, water supply, and agriculture.

The government's National Population Council (NPC) has approved a plan aimed at reducing the national fertility rate to 4.0 by 2015 through family planning awareness campaigns. However the plan depends on securing foreign funding for at least half the estimated \$8 million cost.

If the population continues to grow at current rates it will triple to about 60 million by 2050, a growth that would require the creation of 2.2 million new jobs while 490,000 teachers would be needed to cater for 14.7 million primary school children.

As for unemployment, it is running at an official 16% or so, and shows no signs of falling significantly anytime soon.

Public Finances

The public finances are basically sound. The budget deficit is manageable, the debt burden is relatively low, and foreign exchange reserves are healthy. However, as hydrocarbon revenues fall (as they inevitably will despite the likelihood of continuing rises in oil prices) the government's finances will come under increasing strain.

Currently oil revenues constitute 75% of government revenues, a clearly unsustainable level. Consequently, there is a growing pressure to increase non-oil revenues and to rationalize spending. On the income side this will require a

shake up of the tax system and tax collection, while on expenditure side there is growing pressure for the government to eliminate fuel subsidies.

However, both these approaches face formidable difficulties. The business sector is opposing efforts to improve tax collection, and the social risks of removing the fuel subsidy are just too great at the present time.

| | 2008 ¹ | 2009 ¹ | 2010 ¹ |
|---|---------------------------------|-------------------|-------------------|
| | <i>(As a percentage of GDP)</i> | | |
| Overall government balance | -4.5 | -2.9 | -2.6 |
| Gross public sector debt | 40.0 | 36.2 | 36.7 |
| <i>1. European Commission forecast.</i> | | | |

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