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August 8, 2006

FROM: Vice President and Corporate Secretary

## Yemen - Country Assistance Strategy

### Final Text for Disclosure

1. The Country Assistance Strategy (CAS) for the Republic of Yemen was discussed at the meeting of the Executive Directors held on June 15, 2006. This report will be made publicly available after August 15, 2006. The full text of the final CAS is available on eboard only.
2. Minor changes have been made to the text following the Board discussion, and revised pages are attached. They include:
  - Currency equivalents. The word "rial" replaces the word "riyal".
  - Paragraph 3, page 1. The word "live" replaces the word "lives".
  - Paragraph 49, page 19. The phrase "rates the overall outcome as moderately unsatisfactory" replaces the phrase "rates the overall Bank performance as moderately unsatisfactory."
  - Paragraph 69, page 27. The phrase "approximately \$116 million has already been disbursed during the first ten months of FY06" replaces the phrase "as noted earlier, approximately \$104 million has already been disbursed during the first nine months of FY06" in order to ensure consistency with the same information in Box 5.
  - Paragraph 76, page 30. The title "Non-Lending Assistance: World Bank Institute" replaces the title "Non-Lending Assistance - World Bank Institute".
  - Paragraph 80, page 33. The extra word "Here" is deleted.
  - CAS Annex B7. The extra rows at the bottom of the table are deleted.
3. Questions on these documents should be referred to Mr. Tata (ext. 32175).

#### Distribution:

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**The date of the last Country Assistance Strategy was September 5, 2002**

**CURRENCY EQUIVALENTS**

(Exchange Rate Effective as of May 17, 2006)

Currency Unit = Yemeni Rials (YR)

US\$1 = YR 196.45

SDR 1 = US\$1.49348

**FISCAL YEAR**

January 1 – December 31

**ABBREVIATIONS AND ACRONYMS**

AAA	Analytical and Advisory Services	LNG	Liquefied Natural Gas
APL	Adaptable Program Lending	MDG	Millennium Development Goal
CAE	Country Assistance Evaluation	NWSSIP	National Water Sector Strategic Investment Plan
CASCR	Country Assistance Strategy Completion Report	PEC	Public Electricity Corporation
CBY	Central Bank of Yemen	PER	Public Expenditure Review
CFAA	Country Financial Accountability Assessment	PRSC	Poverty Reduction Support Credit
CPAR	Country Procurement Assessment Report	PSD	Private Sector Development
CPIA	Country Policy and Institutional Assessment	PWP	Public Works Project
CPR	Country Performance Rating	SFD	Social Fund for Development
DfID	Department for International Development	SME	Small and Medium Enterprise
ESW	Economic and Sector Work	TA	Technical Assistance
EU	European Union	UK	United Kingdom
GEF	Global Environment Facility	UNFPA	United Nations Population Fund
GPI	Gender Parity Index	UNICEF	United Nations Children's Fund
IBRD	International Bank for Reconstruction and Development	UNDP	United Nations Development Program
IDA	International Development Association	US	United States
IEG	Independent Evaluation Group	VAT	Value Added Tax
IFAD	International Fund for Agricultural Development	WBI	World Bank Institute
IsDB	Islamic Development Bank	WHO	World Health Organization

Vice President:	Christiaan Poortman
Director:	Emmanuel Mbi
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## II. COUNTRY CONTEXT

1. The Republic of Yemen was formed in 1990 by the unification of North and South Yemen. Yemen has a multi-party democratic system; two Parliamentary elections were held in the 1990s and the most recent Parliamentary elections were held in 2003. The current presidential system is based on direct elections and the current president was re-elected through a direct presidential election in 1999. The next presidential election will be held in September 2006. There is a relatively free press in Yemen.

2. Since unification, Yemen has coped with several shocks. At the time of the first Gulf war, the country coped with the return of around 800,000 Yemenis working in the Gulf countries and a temporary suspension of most foreign aid. Subsequently, it overcame a civil war in 1994. Yemen has experienced other internal security problems (e.g. terrorist attacks on the USS Cole in 2000 and the French tanker Limburg in 2002 and more recently conflict in the Sada'a governorate in 2005). Yemen is considered a Fragile State i.e. it is among a group of countries whose policies and institutions are weak making them vulnerable in their capacity to deliver services to citizens, control corruption or provide for sufficient voice and accountability; and there are risks of conflict and political instability. Within the typology of Fragile States, Yemen exhibits most of the characteristics of a gradual reformer.<sup>1</sup>

3. Poverty is a nation-wide phenomenon with an estimated 42 percent of the population of 19.2 million (in 2004) living in poverty with a higher concentration in rural areas (where 73 percent of Yemenis live).<sup>2</sup> For nearly a decade after unification, Yemen achieved a reasonable annual GDP growth rate (5.2 percent), securing a decent 2 percent per-capita growth. Several factors helped in achieving growth in this period, such as the increased market resulting from the integration of North and South Yemen, an eighty percent increase in oil production as new oil wells came on stream in 1994, steady decline in internal conflicts after the end of the 1994 civil war and a successful macroeconomic stabilization and reform program in the second half of the 1990s with the support of the international community. The reform program focused on inflation control, price and trade liberalization, reduction in subsidies, unification of the exchange rate regime and financial sector reforms. All of these reform efforts were successful and private investment and growth responded well. The period 1995 to 1999 stands out clearly as a peak period of growth in post-unification Yemen.

4. Since 2000 GDP growth has steadily begun to slip as the Government became distracted from maintaining the momentum of reforms. First, pressures for fiscal

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<sup>1</sup> Yemen is among the initial group of countries where the OECD Principles for Good International Engagement in Fragile States are being piloted. The World Bank identifies Fragile States by weak performance (below 3.0) on the Country Policy and Institutional Analysis and as marginal Fragile States (if the CPIA is below 3.2). Using only CPIA benchmarks, Yemen would not be classified as a Fragile State as its CPIA rating is slightly above the marginal level. The typology of Fragile States consists of countries: in deterioration; prolonged crisis or impasses; post-conflict or political transition; and in gradual improvement. See *Fragile States – Good Practice in Country Assistance Strategies*, The World Bank, 2005.

<sup>2</sup> *Yemen Poverty Update*, The World Bank, 2002. Poverty estimates based on 1998 Household Budget Survey.

## IV. WORLD BANK ASSISTANCE STRATEGY

### A. Past Bank Assistance

48. The 2003-2005 World Bank Country Assistance Strategy for Yemen was designed to support the Government's first PRSP and the four pillars of the CAS were consistent with the five key areas in the PRSP. Seven projects (and commitments of US\$387 million) were added to the portfolio of projects under implementation. Over the period of the previous CAS, disbursements remained fairly constant (at around 16 per cent or approximately US\$85-95 million per annum). The quality of the portfolio improved significantly during the last year (with unsatisfactory projects and projects at risk as a percentage of the portfolio declining from 20 percent in June 2004 to 6 percent in June 2005). Several non-lending activities were undertaken though only a limited number were publicly disseminated.

49. *Country Assistance Evaluation FY99-FY05.* The CAE (undertaken by the Independent Evaluation Group of the World Bank) covers the last two Country Assistance Strategies and rates the overall outcome as moderately unsatisfactory. It concludes that there was unsatisfactory progress on governance; moderately unsatisfactory progress on the investment climate and on water resource management; and moderately satisfactory progress on social sector/gender issues. The principal lessons and recommendations are that the future Bank program should:

- *learn local conditions* by conducting adequate research and developing issue-specific knowledge to have country specific solutions (e.g. as in the water sector);
- *moderate optimism* by making more realistic assessments of ownership, speed of implementation and likely outcomes;
- *upgrade governance* as a central constraint to delivering public services and as a cross-cutting theme in its program;
- *conserve water* - Bank support to help conserve groundwater is essential;
- *counteract qat* by helping to investigate the economic, social and resource implications of producing qat and support education and public awareness campaigns.
- *improve population policy* by assisting in accelerating the demographic transition in Yemen.

**Table 3: PREVIOUS LENDING PROGRAM AND IMPACT ON COUNTRY DEVELOPMENT GOALS**

Existing Portfolio at start of 2003-05 CAS	FY appr	FY close	Country Development Goals: 2006-09 CAS			
			Non-oil growth	Human Development	Fiscal Sustainability	Resource Sustainability
Southern Governorates Agricultural	1998	2006	X			
Civil Service Modernization	2000	2008			X	
Child Development	2000	2006		X		
Basic Education Expansion	2001	2007		X		
Rural Access Improvement APL I	2001	2006	X	X		
Rural Water Supply & Sanitation	2001	2008		X		
Irrigation Improvement APL I	2001	2007	X			
Taiz Municipal Development & Flood Protection	2002	2007			X	X
Health Reform Support	2002	2008		X		
Higher Education	2002	2007		X		
Port Cities APL I	2003	2007	X		X	
Sana'a Basin Water Management APL I	2003	2009	X			X
Urban Water Supply & Sanitation APL I	2003	2008		X	X	
Social Fund For Development III	2004	2009		X		
Third Public Works	2004	2009		X		
Groundwater & Soil Conservation	2004	2010	X			X
Basic Education Expansion	2005	2010		X		

The table above shows that the earlier portfolio was heavily focused on the human development goal and had a limited focus on the three other goals.

69. **Existing Portfolio.** At the start of the new CAS period (July 2005), the Bank had 17 active IDA credits in Yemen with an undisbursed balance of US\$567 million; approximately US\$116 million has already been disbursed during the first ten months of FY06. There is only one project (Health Reform Support) rated unsatisfactory for achievement of Development Objectives as well as on Implementation Progress; after extensive discussions with the Government, this project is being formally restructured to reflect the revised strategic approach and better address implementation capacity constraints.

70. **New Lending.** The total volume of lending based on Yemen's IDA allocations is declining. IDA allocations are determined utilizing a Country Performance Rating that takes into account the country's policy performance (as measured through the Country Policy and Institutional Assessment); the country's governance environment; and the performance of the existing IDA portfolio. The FY06-08 IDA allocation was determined based on Yemen's calendar year 2004 CPIA ratings and 2004 portfolio performance. Given reduction in 2004 Country Performance Rating, Yemen's IDA allocation declined to SDR 187.9 million for the three year period which represents a 34 percent reduction from its FY05-07 allocation. Given that the FY07-09 IDA allocation is not yet available, the lending program has been designed on the basis of earlier allocations and set at US\$100 million per annum or a total of US\$400 million over the CAS period. The IDA

financial management staffs and systems are being put in place during project preparation; projects are not considered ready for implementation until this has occurred.

**74. *Development Policy Lending.*** There are two development policy loans in the lending program. The Institutional Reform Credit (in the second year of the CAS period) would focus on improving governance (including for growth). The Poverty Reduction Support Credit (in the last year of the CAS period) would commence programmatic lending after an extensive program to reduce fiduciary risks has been undertaken and after a rigorous assessment conducted to confirm that key fiduciary risks have been lowered. Specifically,

- To assist the Government in dealing with the immediate reform agenda, the Institutional Reform Credit would primarily support the Government's National Agenda For Reform (including actions on governance, public sector reform and private sector development actions) as well as sector-specific actions supporting improved governance. The emphasis will be on a credible program of prior actions and establishment of specific financing needs for the program (e.g. with regard to the costs of retrenchment in support of the civil service reform program).
- To assist the Government in dealing with the longer-term development agenda, the Poverty Reduction Support Credits would be based on the Government's Second PRSP and its translation into a prioritized program in the context of a Medium-Term Expenditure Framework planning process and strengthening of procurement and financial management systems (in line with existing Government plans supported by donor funding). An assessment of progress will be made in the context of several upcoming pieces of Economic and Sector Work (PER, CFAA and CPAR) prior to the final decision to move to programmatic lending in FY09. Four key fiduciary risks in the Government's systems would need to be reduced from current High Risk ratings (budget transparency; internal auditing; preparation of final accounts; and external auditing). As has been the case with PRSCs in other countries, in addition to the overall emphasis on addressing fiduciary risks, each PRSC would focus in depth on one or more sectors. Specifically, given the importance of rural water issues (irrigation, groundwater management and water supply and sanitation), the First PRSC would commence with this sector in FY09. Subsequently, beyond the CAS period, the Second PRSC could have an additional focus on education sector. This sequencing is determined in part by the closure of existing Bank projects providing support in these two areas.

**75. *Non-lending assistance - Economic and Sector Work and Technical Assistance.*** In designing the non-lending assistance, priority was given to Economic and Sector Work which is considered to be part of the core country diagnostics and needs to be updated at least once every four to five years. Further, given past fragmentation of the program, further attention was given to narrowing down the list of studies and Technical Assistance activities.

**76. *Non-Lending Assistance - World Bank Institute.*** Yemen is one of the WBI focus countries in MNA and has therefore been receiving a higher level of support. The focal areas are expected to continue including: human development (health; education and

Sana'a, co-located with the World Bank. The focus is on four main areas: financial markets; SME development; gender; and Business Enabling Environment.

- In financial markets, IFC has been active in leasing programs (including work with the Central Bank on leasing registration and legislation and the organization of an international leasing conference in-country) and is initiating microfinance TA to support the initiatives of the second largest Yemeni bank to service this sector.
- In SME development, IFC has focused on management training through Business Edge, including Train-the-Trainer programs for companies in Yemen, Chambers of Commerce, and the Social Fund for Development.
- IFC's gender program work has included a scoping and analysis exercise and is preparing to launch a two-year TA program focusing on gender and entrepreneurship.
- In Business Enabling Environment, IFC is initiating a "Business Start-Up Simplification" project which will focus on simplifying administrative procedures to start new businesses. This work is linked to the planned simplification efforts under the Port Cities Development Program. In addition, the Government has requested PEP-MENA assistance to improve the policy framework for private investments in mining. This work would be carried out in close collaboration with other units of the World Bank Group, and include assistance to the Granite and Marble Association to strengthen SMEs in the industry.

80. **Gender.** The operational mainstreaming of gender issues in human development will continue in the new CAS. Outcomes for education include a focus on gender equity including increasing girl's enrolment in basic education and increasing female completion ratios in secondary education. Health and population outcomes also emphasize improvements in maternal health. Further, though there are no separate gender specific outcomes, improvements in water supply (particularly in rural areas) are also likely to primarily benefit women and girls. The main focus of efforts for the economic empowerment of women will be on addressing the top ranked investment climate constraints; the ICA findings reveal that female entrepreneurs are affected to a greater extent by these top ranked constraints. The IFC gender program will also provide targeted support for the economic empowerment of women (paragraph 79). Finally, through periodic stocktaking (e.g. as undertaken as part of the 2006 IEG CAE and in a proposed FY09 Gender Report), the Bank would assess how well this mainstreaming is working and make recommendations for improvement.

81. **Qat.** The CAS has addressed this difficult multi-sectoral issue differentially across its many dimensions. First, CAS activities that focus on improving the economic viability of other agricultural and off-farm activities – including through improving the productivity of water use - will begin to narrow the profitability differential vis-à-vis qat. Second, given that there is limited social consensus on the negative health and social impact of chewing qat, the CAS will continue to invest in the long-term process of raising social awareness of qat's negative impacts. Specifically, a survey on qat use will be undertaken and its findings will be used to re-engage Government and civil society on a public dialogue on the impact of qat.

## Yemen, Rep. - Key Exposure Indicators

Indicator	Actual			Estimate			Projected		
	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total debt outstanding and disbursed (TDO) (US\$m) <sup>a</sup>	4870	4973	5301	5335	5218	4959	5053	5129	5208
Net disbursements (US\$m) <sup>a</sup>	-167	53	126	96	89	146	82	63	35
Total debt service (TDS) (US\$m) <sup>a</sup>	219	146	143	162	227	242	275	270	243
Debt and debt service indicators (%)									
TDO/XGS <sup>b</sup>	141.7	129.8	126.7	107.4	75.5	67.7	74.6	82.6	77.2
TDO/GDP	51.1	50.5	44.2	39.4	34.0	30.5	28.6	26.7	23.4
TDS/XGS	6.4	3.8	3.4	3.3	3.3	3.3	4.1	4.3	3.6
Concessional/TDO	85.9	88.8	87.3	88.2	88.1	87.9	88.1	88.0	88.0
IBRD exposure indicators (%)									
Preferred creditor DS/public DS (%) <sup>c</sup>	62.4	65.3	61.6	66.8	52.5				
IDA TDO (US\$m) <sup>d</sup>	1237	1384	1568	1701	1803	1873	1919	1979	2056
<p>a. Includes public and publicly guaranteed debt, use of IMF credits and net short-term capital.</p> <p>b. "XGS" denotes exports of goods and services, including workers' remittances.</p> <p>c. Preferred creditors are defined as IBRD, IDA, the regional multilateral development banks, the IMF, and the Bank for International Settlements.</p> <p>d. Includes present value of guarantees.</p> <p>e. Includes equity and quasi-equity types of both loan and equity instruments.</p>									