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Yemen
Comprehensive Development Review
Private Sector Development Building Block

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I. Introduction

Purpose

The Private Sector Development Building Block has been prepared as part of the initial phase of the Comprehensive Development Review (CDR) for the Republic of Yemen. The block contains basic data and trends, international comparisons, development goals and trends and the next steps to move forward.

Gaps

The block defines the present state of the private sector in Yemen, as well as the issues and constraints the private sector faces. The major problems with the information available are:

- Dynamics: it does not give a sense of the real dynamics of the private sector. Is it growing?, how is it growing?, where is it contracting?
- Scope: whilst there is reasonable information on the industrial sector, there is no overall data on the services sector and limited data on other components of the private sector (construction)
- Microenterprises, very little is known about them (a survey is planned to develop further information)

As noted below there are many linkages between the other sectors, when these linkages are analyzed, further additional gaps in information may be identified.

Linkages

The Private Sector Development Building Block by its nature focuses on similar questions to the Macro block component on sources of economic growth. The block also has fundamental linkages with the infrastructure, financial, legal framework and education building blocks. (see the roadmap analysis in the Next Steps section). In other sectors there are also links but of a more indirect nature, e.g. in health there is the question of private participation in the provision of health services, in the cultural heritage/tourism block the role tourism can play to stimulate the private sector is an obvious question.

Scope

The report does not cover the following areas which are covered in other building blocks.

Area	**Building Block**
Labor Markets	Macro
Macroeconomic environment	Macro
Financial sector	Financial Sector
Telecommunications	Telecommunications
Electricity	Energy
Transportation	Transport
Water	Water

Bank Involvement and Strategy in the Sector

The Bank's principle involvement in private sector development has been allied with work in the areas of Privatization and Financial Sector strengthening. No specific private sector work has been undertaken since the early 90's when some industrial sector work was carried out. Nevertheless within the construct of the Bank and the IMF's structural economic assistance to Yemen private sector development is seen as a core strategy.

Bank PSD Assistance

Activity	Description
Privatization Technical Assistance and Privatization Support Project	Since 1995 the Bank has provided privatization technical assistance to the Government of Yemen. In 1997 preparation of a credit to support privatization began.
Infrastructure Reform	In 1997 a study entitled "Reforming Yemen's Utilities" was carried out. This study examined how competition could be introduced to Yemen's infrastructure sector.
Legal Reform Project	Since 1995 the Bank has supported the Governments efforts with Legal Reform
FIAS Investor's perceptions study	In 1997 FIAS undertook a study on investor's perceptions
Private Sector Support Project	In 1999, in conjunction with a PHRD grant work began on developing a Private Sector Support Project

The 1995 Private Sector Development Agenda

The need to promote the private sector through the establishment of a conducive policy and investment climate underlies the rationale for the structural reform project suggested in this report. This includes the following:

- Reforming the trade policy regime. A restrictive environment for trade – characterized by relatively high nominal import tariffs, quantitative restrictions, and cumbersome and inefficient customs administration has created distortions and inefficiencies.

- Improving the investment licensing regime. Investment licensing requirements should be replaced by automatic licensing (or simple registration), as in most other countries.

- Reforming the financial sector is essential if the banking system is to play its role in mobilizing and efficiently allocating resources.

- Improving the efficiency of public enterprises, especially public utilities providing power and water.

- Strengthening the privatization program. The privatization program is an important signal of the Government's intention to withdraw from the productive sector, encourage the development of the private sector, and promote greater efficiency in the allocation and use of resources.

Some progress has been achieved in regard this reform agenda. On trade reform there has been an elimination of most import bans and licensing (with minor exceptions) and rationalization of tariffs. In the privatization area a number of smaller privatization's have been completed and the Government is currently in the midst of trying to privatize a number of larger enterprises. In moving the agenda forward the recent CAS (1999) focused on the following areas, under the rubric of "Private Investment for Jobs and Sustainable Economic Base":

- Improving the private investment environment, by reducing the excessive presence of government in some areas (e.g., inefficient public enterprise monopolies, over-regulation) and weakness in other areas (e.g. justice, land tenure, banking regulation, information and promotion for potential investors)
- Exploiting the natural advantages of Aden as a magnet for investment
- Addressing sectoral constraints to growth in the infrastructure, social and financial areas

IFC was inactive in Yemen from the 1980's until FY98. Uncertain enforceability of contracts and unreliable jurisprudence were major disincentives. An investment dispute linked to these problems led to the hiatus in investment, but IFC began again with new investments in FY98 and FY99, and is now actively exploring new investment sectors.

II. Basic Data and Trends

Brief Statistical Overview

The table below details the basic data that defines the private sector in Yemen in terms of scale, scope and constraints

Key Indicators	Source	Basic data	Comparators
Scale			
Private Investment/GDP	CAS	16% of GDP	
Private Sector share of GDP	Ministry of Finance	65% of GDP	
Scope			
Exports/GDP (1998)	WDI	34%	Low Income avg: 24% Mena avg: 25%
Manufactured exports		1%	Low Income avg: 27.97%
Imports/GDP (1998)	WDI	54%	Low Income avg: 22% Mena avg: 28%
Tourism Revenue % of exports		4.0%	Low Income avg: 4.8% Mena avg: 7.8%
Oil and Gas Production		410,000 barrels per day	Saudi Arabia = 7,500,000 barrels per day
Growth in Output – Average annual growth (1990-98) Manufacturing	WDI 2000	1.6%	Low Income avg: 11.8% Mena avg: 3.1%
Growth in Output – Average annual growth (1990-98) - Services	WDI 2000	1.0%	Low Income avg: 7.0% Mena avg: 3.5%

Constraints			
Stock Market Capacity	MNSPS Staff Estimates	There is no formal stock market in Yemen. There are however a very small number of publicly held companies where some modest trading takes place. It is estimated the total market capitalization of these companies is less than $25 million and annual turnover of these stocks is less than $1million.	
Mean Tariff		16.2%	Low Income avg: 25.7%
Effective Rate of Protection		Not available	
Quality of Customs		The IMF has been involved in streamlining customs	
Pre Shipment Delays		Normal for country of this type	
Credit to Private sector (% of GDP-1998)	WDI 2000	6.3%	Low Income avg: 71.8% Mena avg: 34.1%
Foreign Direct Investment (% of GDP – 1998)	WDI 2000	-4.9%	Low Income avg: 10.4% Mena avg: 0.8%
Composite international country risk guide	WDI 2000	61.0	Low Income avg: 58.9 Mena avg: 68.5
Euromoney Credit worthiness rating	WDI 2000	26.2	Low Income avg: 28.1 Mena avg: 46.2
Paved roads	WDI 2000	8.1%	Low Income avg: 18.3% Mena avg: 50.2%
Power consumption per capita (kwh)	WDI 2000	93	Low Income avg: 448 Mena avg: 1158
Telephone lines per 1000	WDI 2000	13	Low Income avg: 32 Mena avg: 74
Internet hosts per 10,000 people	WDI 2000	0.01	Low Income avg: 0.17 Mena avg: 0.25
Adult illiteracy rate	WDI 2000	56%	Low Income avg: 31% Mena avg: 37%

Key Aspects of Our Knowledge Base

This section reviews our knowledge in the following areas;

- Description of the private sector
- General Business Environment
- Privatization
- Investment
- Areas of Potential for the Private Sector in Yemen

Description of the Private Sector

In defining the private sector in Yemen the main source of information is the industrial survey. There is no comprehensive survey of the private sector. (Refer Annex 1 for further information)

The Chamber of Commerce estimate there are about 90,000 private sector establishments in Yemen of which 60,000 are members of the Chamber of Commerce.

The characteristics of the Yemeni industrial sector are

- There are very few large enterprises, according to the industrial survey enterprises employing 10 or more people account for about 1% of total enterprises
- The large enterprises account for over 80% of value added
- The majority of local industrial activity is focused on domestic consumption
- Industrialization is centered around the major urban centers of Sana'a, Taiz, Aden and Hodeidah

General Business Environment

The Yemen Business environment can be categorized as weak.

The international credit rating agencies provide the following measures of the Yemen Business environment.

Country	Rating	Score	Political Risk	Economic Policy	Economic Structure Risk	Liquidity Risk
Yemen	C	52	E	C	B	B
Jordan	C	41	C	B	B	C
Syria	D	74	D	D	D	D
Morocco	C	41	C	C	C	B
Algeria	C	56	E	C	C	C

Source: EIU (2000)
Yemen is not rated by the major sovereign debt rating agencies; Moody's, Standard and Poor's, Duncan and Phelps.

A recent comparative study on the legal environment shows Yemen as having a relatively weak legal environment

	Weak	Fair	Moderate	Strong
Economic Freedom	Yemen Algeria	Egypt	Ghana	Chile
Taking of security	Yemen Rwanda	Egypt	Indonesia	Germany
Bilateral Investment Treaties	Yemen Uganda	Pakistan	Thailand	Egypt
Arbitration	Vietnam	Yemen Thailand	Egypt	Hungary
Confidence in Justice	Yemen Russia	Indonesia	Thailand	India

Source: International Law Development Institute (1997).

For its investment regime, Yemen has adopted a uniform treatment of both domestic and foreign investors. The focus of the General Investment Authority has shifted from regulation to promotion. Efforts are also being exerted to strengthen the Export Supreme Council's secretariat.

In Annex 2 details of the trade regime are set out.

Privatization

A comprehensive privatization program lies at the heart of the Government's private sector development agenda. The Bank is supporting this program with an IDA Credit (Privatization Support Credit). Full details of this project are attached as Annex 3. The program targets several large enterprises for privatization (Aden Refinery Corporation, The Yemen Cement Corporation, Yemen Drug Corporation, The General Land Transport Corporation and Airport ground handling services.) as well as a number of smaller enterprises. In addition preparatory work on the Public Telecommunication Company, Yemenia Airlines and the Port of Nashtoun will take place.

This program is estimated to provide a dramatic push to the private sector. The deatiled analysis is contained in Annex 4.

Investment

Foreign Direct Investment

FDI is a critical component of Yemen's growth prospects: given the low domestic savings rate and the high unemployment rate, FDI (along with the technology, management skills, and marketing links that accompany it) becomes a vital source of employment and growth for the country.

FIAS recently completed a major study on FDI in Yemen. They were not able to develop any quantitative findings. The Box below summarizes their findings based on an informal survey of business leaders.

The FIAS Survey

The Foreign Investment Advisory Services (FIAS) interviewed several investors, and concluded that they see Yemen as a country with promising investment opportunities based on its strategic location and natural resources. They expressed positive views about Yemen's economic and political reforms, but a cautionary message came across – with regard to the actual implementation of reform, as well as the routine responsibilities of the State, the Government is still viewed as lacking in credibility.

Investors indicated that the following areas help promise for FDI:

- The Aden Port and Free Zone
- Infrastructure
- Privatization
- Tourism, Fisheries, and Minerals (including marble and granite)

Investors indicated that the following represented obstacles to FDI:

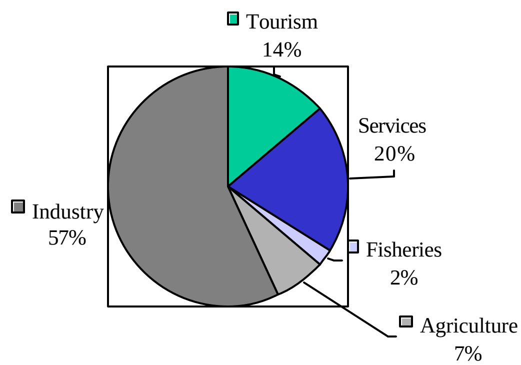
- Overlapping jurisdictions between different agencies of Government
- Discretionary application of laws and regulations
- Under-paid and unmotivated civil servants
- Lack of protection for property or enforcement of contracts
- General weakness of the State in many rural areas.

The Private Investment Challenge

Private investment outside the oil and gas sector and Aden Port is mostly small scale. Potential large-scale investors face a considerable amount of unnecessary regulations and licensing, a legal environment which is often unclear or not consistent with international norms, and an often unresponsive or corrupt civil service. They are also discouraged by the lack of dependable jurisprudence, enforceable contracts, secure land titles, predictable taxation or tariff protection, and in some cases physical infrastructure and physical security. Local investment will be further burdened by the lack of availability of loans and other financial services to most businesses.

For private investment to respond well to economic reform, it is necessary to improve corporate governance through a simpler legal and regulatory environment, dependable administration of justice and enforceable contracts, less discretion in decision-making and more transparency and rule of law.

Percentage distribution of investment in various sectors in 1998



Areas of Potential for the Private Sector in Yemen

The following areas of potential for the private sector can be identified in Yemen:

- Agro-Industry
- Aden Free Zone
- Tourism
- Minerals and Oil
- Private Provision of Infrastructure and Social Services
- Manufacturing
- Construction
- Services

The recent FIAS study notes a number of these sectors were identified by potential foreign investors as being of interest. In particular the Aden Free Zone, tourism, private provision of infrastructure and manufacturing low cost product for the local domestic market were noted. They further commented on the important role privatization could play in catalyzing foreign investment.

Agro-Industry

The Yemeni authorities have identified fisheries, fruits and vegetables as promising areas for export. As well they have an important role to play in the domestic private sector. For example the capacity of fisheries to contribute to the domestic economy in the areas of employment, repairs, provisions, transport, processing, and trading and fishing supplies represents more than 80 percent of the landed value of the catch.

Aden Free Zone

The Aden Free Zone has the potential to be a significant growth pole for the Yemeni economy.

The first phase of the Aden port development is now open. Despite huge investment and a great location, success is far from guaranteed. Three things encourage investors in the Aden Container Terminal (ACT) to believe in its eventual success: location, location and location. Aden is just 4 km away from the main east-west shipping lanes, making it a far more convenient stop than Dubai, or even the newly opened port at Salalah in Oman. And the new developments at the port ensure it can handle the largest container vessels in service or yet planned. But since the ACT's official opening in March, business has been slow. Total traffic during March amounted to around 300 20-ft equivalent units (TEUs); since then it has picked up to an average of 5,000 TEUs per month. But on an annualised basis this falls far short of the 500,000 TEU capacity of just the first phase of the project.

Singapore Port Authority (SPA) which is responsible for management of the facility and for marketing it, is continuing negotiations with several carriers. Pacific International Lines (PIL) of Singapore and American President Lines of the US have both signed agreements with SPA to send a number of containers through the ACT. However, the PIL contract poaches work from Ma'alla port just across the harbor, and thus brings no new business to Aden. Business with APL is through its feeder line service; SPA hopes to attract some of APL's "mother ships" through Aden. But a sudden upsurge in business is unlikely. Despite its location, ACT will need to establish a solid track record before shipping companies are willing to divert serious business from other established ports. And it cannot hark back to its glory days in the 1960s; work practices have changed considerably since then -- and the container business did not exist.

The container port is just one part of the overall plan for future development of the Aden Free Zone. Yeminvest, a joint venture between Yemen Holdings Ltd (51%), a part of the Saudi Bin Mahfouz group, and the SPA (49%), signed a 25- to 30-year concession to run the free-zone project in 1996. In addition to ACT, the plans also call for building the Aden Industrial and Warehousing Estate (AIWE). This will comprise some 1,550 ha of industrial zone along with infrastructure for manufacturing, warehousing and distribution. However, the masterplan is still incomplete, and AIWE consists of little more than a large area of empty cleared land. Power supply for AIWE would be available from the power plant built at the port, should there be demand. But the project will rely on local facilities for supply of water and for telecommunications. In addition, in May the government announced that there had been over 600 expressions of interest in the free-trade zone. Whether this interest will translate into any real development in the near future is open to question.

Tourism

The tourism industry in Yemen is at its early stages development. Although the county is endowed with natural resources such as untouched beaches; valley; and exquisite landscape, cultural, archeological and historical sites, the size of inbound tourism is relatively low when compared to countries in the region. This situation is due to:

- The negative effects of the two-month civil war in 1994 on inbound tourism
- Shortage of hotels that meet international standards, Sana'a, Aden, Mukalla and other tourist areas
- Limited accessibility to the country
- Lack of effective marketing and promotion plans
- The issues of safety and security in certain areas (kidnapping)
- Lack of highly qualified personnel in both public and private sectors
- Non-compliance with standards and specifications of hotels and other tourist establishments
- Undeveloped and uncoordinated tour operators

The number of international arrivals to Yemen dropped from around 70,000 in 1993 to around 40,000 in 1994. Most inbound tourism is from Europe, mainly from Germany, France, Italy, and the United Kingdom (See Table 1). Although the official statistics indicate that the average length of stay in the country is 5 nights, tour operators indicate that tourists arriving on package tours average length of stay range from 10-15 nights. Tourism receipts dropped drastically in 1994 (see table 1)

Number of arrival by region to Yemen 1990-1994

Number of arrival by region to Yemen 1990-1994					
Region	1990	1991	1992	1993	1994
Europe	30,081	21,689	43,777	46,466	26,809
Middle East	11,980	10,487	11,008	9,641	5,052
Americas	3,370	3,806	7,122	6,549	3,594
Africa	2,052	2,653	3,346	2,101	1,377
Asia	3,964	4,656	6,229	4,448	2,681
Australia	402	365	687	590	416
Total	51,849	43,056	72,169	60,795	39,929
Tourism receipts($000)	49703	20955	46907	45387	13327

Source: General Tourism Authority

The number of hotels in Yemen amount to 173 hotels with a capacity of 5,480 rooms and 11,727 beds in 1994, with three five star hotels; two in Sana'a and one in Aden, two four star hotels, most of other hotels in the other categories are of poor condition with a low level of Service (See table 2) . Although there are standards and specifications for hotels, they are not enforced, hence the inadequate level of service and the condition of hotels in the country.

Number of Existing Main Tourism Establishments in Yemen 1994

	Number of Existing Main Tourism Establishments in Yemen 1994								
City/ Est.	Hotels							Travel Agencies	Rest Hours
	5 star	4 star	3 star	Others	Total No. of Hotels	Total No. of Rooms	Total No. of Beds		
Aden	1	0	1	11	13	675	1,251	22	1
Hadramout	0	0	0	8	8	137	341	0	0
Hudaidah	0	0	7	5	12	347	820	10	0
Ibb	0	0	0	10	10	157	405	2	0
Lahj	0	0	0	1	1	19	49	0	2
Sana'a	2	1	14	77	94	3256	7,029	92	0
Taiz	0	0	3	19	22	555	1,127	10	0
Others	0	1	3	9	13	334	705	2	0
Total	3	2	20	140	173	4580	11,727	136	3

** Includes non-operating establishments*
Source: GTA

The issue of safety and security in certain tourist areas has contributed to the decline of Tourism in Yemen. Since 1992 to 1996, 58 tourists and in 1997 42 kidnappings occurred. The government of Yemen has tried to enforce a hard-line "zero" tolerance approach to kidnapping in an effort to make Yemen more attractive to Tourists and Investors. The tourism industry ranks only second in revenue only to be preceded by the oil industry with a revenue of US$80 million in 1998. Oil revenue in 1998 was US$1,231 million.

Minerals and Oil

In the minerals area in addition to the petroleum sector developments set out below, there are significant mineral deposits rumored (zinc and gold).

The government has announced plans to offer six new exploration blocks -- in Tihama and Shabwa and on the island of Socotra -- to foreign oil companies. The goal is to increase crude production to 500,000 barrels/day in 2000. However, production has remained in the range of 400,000-410,000 b/d this year amid rumors of production problems in the aging Marib field.

Private Provision of Infrastructure and Social Services

Private Provision of Infrastructure and Social Services has significant potential in Yemen particularly in generating FDI. Two examples of recent developments in this area that will stimulate the private sector are set out below.

Private Power

The government will invite offers for Yemen's first private power plant, which will be built in two stages -- first, a 500mw plant, and a later expansion to 800mw. The government's aim is to double its electricity generating capacity. Yemen faces continuing serious power shortages due to low user tariffs, which encourage excess demand, and technical constraints, which have left many plants operating below capacity

Telecommunications
With two GSM licenses to be awarded, Yemen will finally join the region's "GSM club". This will provide a major boost to the country's cellular market, by virtue not only of the stimulation of national competition, but also to the expected introduction of GSM roaming with neighboring countries. The new GSM operators will find in roaming a major revenue stream when Yemeni expatriates (estimated at more than 500,000) residing in the much richer neighboring Arabian Peninsula countries return to spend their vacations in Yemen. The tender is a major part of the government's policy to restructure its telecoms market and allow private sector participation to attract much-needed investment to the country.

Manufacturing
In the manufacturing area the following particular types of industries have potential in Yemen:

- Those industries where there is strong internal demand and that are shielded by the high costs of internal transportation in Yemen, for example cement
- Industries that can avail themselves of export “quota” rights into OECD countries, and use low cost labor e.g. textiles
- Industries that can piggyback off the “aid driven” development of infrastructure and social services, e.g. the manufacture of certain types of water pipes

Construction
The construction sector can be anticipated to benefit from the further development of Yemen’s physical and social infrastructure.

Services
Generally there is significant scope to expand the services sector in Yemen. Most areas of the service sector are weak, e.g. financial services, professional services, etc. If the export sector is to develop, significant improvements in the export service sector will be required which represent private sector opportunities. Two areas stand out, packaging and freight forwarding and export finance.

III. International Comparisons

The attached tables provide some international benchmarks, in addition to those noted previously.

Gross Domestic Investment and Gross Domestic Saving as Percentage of GDP, 1998

	Gross Domestic Investment (% of GDP)	Gross Domestic Saving (% of GDP)
Algeria	27	33
Egypt	19	10
Jordan	27	6
Morocco	22	18
Saudi Arabia	20	35
Yemen	22	2

Source: World Development Indicators, World Bank, 1999/2000.

Low Level of Credit to Private Sector

	Yemen	Low Income Countries
Credit to Private Sector (% of GDP)	3.4%	15.94%

Source: FPSI's Competitiveness Database.

Average Age, Dependency Rates and Female Labor Force Participation

Country	Median Age (years)			Dependency Ratio (per 1000)			Women in Labor Force	
	1965	1995	2025	1965	1995	2025	1980	1996 % total
Algeria	16.7	19.7	29.7	993	748	439	21	25
Bahrain	14.7	27.3	36.0	1,126	517	516	-	-
Egypt	18.4	20.9	31.0	912	730	464	26	29
Gaza Strip	17.4	14.8	18.2	942	1171	836	-	-
Iran	17.1	18.5	32.0	980	854	459	20	25
Iraq	16.7	18.4	24.5	955	845	566	17	18
Israel	23.6	27.3	34.9	681	632	546	34	40
Jordan	17.4	18.1	24.5	942	853	550	15	22
Kuwait	21.4	20.4	33.7	664	683	501	13	29
Lebanon	18.8	23.0	32.6	952	656	451	23	28
Libya	18.4	18.7	28.8	886	796	451	19	21
Morocco	17.2	21.6	31.9	975	646	450	34	35
Oman	18.0	17.1	20.8	871	937	746	7	15
Qatar	22.2	33.0	35.3	616	400	673	-	-
Saudi Arabia	18.0	19.1	24.6	897	793	615	8	14
Sudan	17.7	18.8	25.2	892	818	557	27	29
Syria	15.6	17.3	27.5	1,139	915	464	23	26
Tunisia	17.2	22.8	33.5	995	652	459	29	31
Turkey	19.0	23.8	34.2	858	567	461	35	36
UAE	20.7	30.2	36.0	685	473	630	5	14
Yemen	18.4	16.2	19.8	851	997	720	33	29

Source: Median Age – UN Population Division, World Population Prospects: 1998 Revision; Female Labor Force Participation – Population Reference Bureau, 1998 Women of Our World, and World Bank's World Development Indicators.

IV. Development Goals and Prospects

The private sector characterized

The key points concerning the private sector in Yemen are:

- The general business environment the private sector operates within is not conducive to growth. There are significant administrative barriers to entry, exit and operation and the legal environment is ineffective.
- There are significant weaknesses in the areas of financial capital, human capital and physical infrastructure which act as powerful constraints to growth
- Local demand is very thin
- The structure of the private sector is very immature, most enterprises are very small, there are remarkably few middle sized enterprises and there are hardly any publicly held corporations.
- To date international competitiveness has not been established in any industrial or service sector
- The institutional underpinnings to the private sector are underdeveloped.

Governments strategy

The Government's response in developing private sector growth in addition to implementing macroeconomic stabilization measures includes;

- Privatization
- Strengthening Private Support Agencies e.g. GIA, Export Promotion Agency, Small Business Development Agency
- Developing Industrial Estates
- Participating in the WTO
- Development of the Aden Free Zone, and
- Improving Quality Standards

As noted below many of these responses are well thought out and make sense at Yemen's stage of development. However little progress has been achieved to date, and there are no noticeable results. This is for two main reasons:

- Implementation has been poor and not approached with any real sense of urgency
- Insufficient focus has been given to remedying the underlying problems in the business environment

The most promising area is privatization where work in the current pipeline indicates over the next three years the government is likely to complete their planned privatization program.

A strategy forward

The way forward for government requires a balanced strategy that incorporates some targeted tactical interventions that can help build momentum together with a serious sustained attack on the underlying impediments to private sector development.
In terms of tactical interventions:

- Privatization accompanied with sector liberalization in the financial and infrastructure areas has the potential for immediate and significant pay backs
- Industrial Estates/Economic Zones developed in partnership with the private sector would provide businesses with the basic infrastructure they need for operation and freedom from administrative constraints. The Aden Free Zone is the obvious starting point.

The key constraints that require addressing are listed below. There is no clear place to start, rather all issues need to be dealt with simultaneously as progress in one area will be constrained without addressing other areas. In many areas, particularly in the financial sector, infrastructure, human resource and macroeconomic areas the Government and the Bank have active programs underway to resolve the constraints identified. However very little attention has been given to developing an overall policy framework for private sector development and to strengthening the legal and policy framework.

Institutional Policy Framework

- The Government response to the private sector is not coordinated
- There is no accountability from the public sector to the private sector
- Government policies lack credibility
- There is very little statistical information available on the private sector in Yemen

Financial Sector

- Credit access is limited, the private sector makes relatively little use of formal credit markets.
- Very little access for small and micro enterprises.
- Lack of efficient system to create and enforce collateral securities
- There is a limited range of credit facilities.
- There are no export credit facilities.
- The real cost of capital is high
- There is little competition in the banking sector and bank ownership is still largely in the hands of the state.
- Capital markets are quite immature. There is no stock market and as yet no bond market.

Legal and Regulatory Framework

- The general commercial regulatory environment is very immature.
- Regulation tends to be burdensome and ineffective.
- Security and enforcement of property and contractual rights is weak.
- No regulation of anti-competitive behavior
- Judicial system has a strong anti commercial bias
- Quality standards require strengthening

Human resource and labor markets

- Low technical skills of Yemeni workforce

Macroeconomic Framework

- Internal demand is quite weak and the majority of Yemeni consumers are limited to a few basic necessities and qat
- Smuggling is a major problem
- Very small number of large enterprises who contribute the majority of value added, with very few enterprises classed as middle sized
- Non oil and AFZ FDI is virtually non existent
- The Foreign trade regime is weak

Infrastructure

- Low tele-density, high international tariffs, large unsatisfied demand, low internet and Value added network services usage.
- Significant and regular brown outs.
- Roads serving main centers are barely adequate and roads serving remote areas are quite inadequate
- Urban transport is very congested
- Availability of land with infrastructure services is limited
- Water is a scarce resource that is presently being depleted.

V Next steps

The data available on Yemen's private sector is poor and limiting. This is, in part, a reflection on the poor state of the private sector in Yemen. In a nutshell, the sector is struggling. Intuitively, we can extrapolate that the sector is also somewhat static. Furthermore, Yemeni officials expressed their views to a visiting Bank Mission in December 1999 that the sector is deteriorating.

To make better use of what scare information is available, and to gain a better understanding of the direction of forces within the sector (e.g. areas of potential growth/stagnation, if any) this building block plans to liaise closely with other building blocks, especially the macroeconomic building block. In discussions with members of the building block, arrangements were made to share the results of work that has been commissioned on topics such as the effective rates of protection.

We have identified several obstacles which constrain the development of the private sector, and to promoting investment and exports. However, we cannot single out a clear set of factors that are directly responsible for the private sector's lack of dynamism. Again, intuitively, political economic conditions appear to be most relevant. This matter warrants significant attention during the next phase of CDR work on the sector. We hope that by establishing linkages with other building blocks we will develop a better understanding of this issues at hand.

We anticipate having better data over the next few months, largely as a result of planned work on a PHRD Grant for Private Sector Support Services which will focus on potential strategic sectors of the Yemeni economy where growth seems possible such as: the Aden Free Zone, exports, and investment. We also hope to develop a better sense of the relative "weight" of conditions in the macro and micro realms in Yemen's private sector.

Annexes

Annex 1 Private Sector

Public sector's contribution to GDP 1995-1999

(YR millions)

Year	Public and Mixed Sectors	GDP	Public sector's contribution to GDP
1995	125860	447753	27%
1996	216244	655192	33%
1997	220131	740636	29.7%
1998	247791	701274	35%
1999	285674	N/A	N/A

Source: Ministry of Finance.

The contribution of the public sector to GDP has been approximately one third for the last 5 years.

The Indebtedness of Public Enterprises

(YR millions)

Sector	1995	1996	1997
Production	8120	6241	14617
Services	N/A	2188	1654
Mixed	3384	1951	5220
Total	11504	10,380	21,491

Source: Ministry of Finance.

The indebtedness of public enterprises increased drastically in 1997 to approximately 200% of its 1996 value. Unofficial estimates put the level of indebtedness of some public enterprises at about 23 times the initial capital investment.

Fiscal impact of privatization

(YR millions)

	1995	1996	1997	1998	1999
Government subsidies to public projects	6316	20,871	19,283	180,788	17,895
Public expenditure	119,180	232,755	307,568	350,055	422,000
Percentage of Total	5.3%	8.9%	6.3%	5.4%	4.2%

Source: CSO, Statistical Yearbook 1998 and Ministry of Finance.

Distribution of Industrial Establishments by Activity and Size

	Large (>10 workers)		Medium (5-9 workers)		Small (1-4 workers)		Total	
	No. of Establ.	Ratio (%)	No. of Establ.	Ratio	No. of Establ.	Ratio	No. of Establ.	Ratio
Total	363	100	1191	100	31730	100	33,286	100
Mining and Extraction	30	8.26	84	7.05	368	1.16	482	1.45
Mines and Other Quarries	30	8.26	84	7.05	368	1.16	482	1.45
Manufacturing	272	74.93	1016	85.31	28,545	89.96	29,835	89.63

Foods and Beverages	70	19.28	303	25.44	15,873	50.03	16,246	48.81
Tobacco Products	4	1.1	11	0.92	118	0.37	133	0.4
Textile manufacture	15	4.13	36	3.02	676	2.13	727	2.18
Dressmaking and Dying Fur	6	1.65	44	3.69	2,650	8.35	2,700	8.11
Leather Products and Tanning	9	2.48	10	0.84	214	0.67	233	0.70
Wood Products (excl. Furniture)	9	2.48	86	7.22	2,001	6.31	2,096	6.30
Paper and Paper Products	8	2.20			1	0	9	0.03
Printing and Publishing	17	4.68	36	3.02	28	0.09	81	0.24
Refined Petroleum Products	4	1.1					4	1.1
Chemical Products	14	3.86	5	0.42			19	0.06
Plastics	22	6.06	3	0.25	3	0.01	28	0.08
Structural Non-Metallic Products	36	9.92	265	22.25	2,516	7.93	2,818	8.47
Mixed Metal Products	41	11.29	166	13.94	3,190	10.05	3,397	10.21
Machinery	3	0.83	3	0.25	5	0.02	11	0.03
Electrical Equipment	3	0.83	2	0.17			5	0.02
Medical Equipment	1	0.28			1	0	2	0.01
Transport Equipment	2	0.55	31	2.6	20	0.06	53	0.16
Furniture	8	2.2	7	0.59	631	1.99	646	1.94
Goldsmithery			8	0.67	617	1.94	625	1.88
Electricity and Water	61	16.8	91	7.64	2,817	8.88	2,969	8.92
Electrical Supplies	29	7.99	41	3.44	926	2.92	996	2.99
Water Accumulation, Purific, and Distrib.	32	8.82	50	4.2	1,981	5.96	1,973	5.93

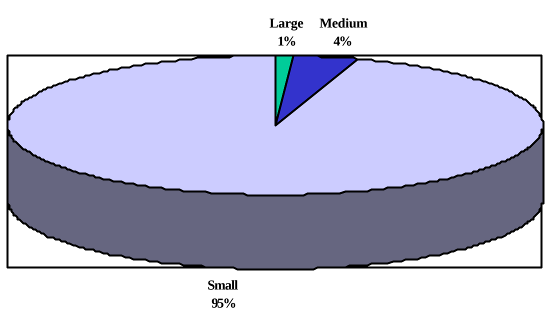
Source: Final Report & Results of the First Industrial Survey 1996, CSO, Ministry of Industry.

Distribution of Industrial Establishments Included in Survey and Operating in the Industrial Sector According to Governorates in 1995

	Large (10 workers +)		Medium (5-9 workers)		Small (1-4 workers)		Total		Total (exc. Electric. & water)	
	No.	%	No.	%	No.	%	No.	%	No.	%
Capital Secretariat	82	22.6	312	26.2	4668	14.7	5062	15.2	4954	16.3
Sana'a	32	8.9	67	5.6	3537	11.1	3636	11	3023	10
Aden	32	8.9	54	4.5	717	2.3	803	2.4	801	2.6
Taiz	57	15.8	120	10.1	2801	8.9	2978	9	2671	8.9
Al-Hodeidah	57	15.8	236	19.8	2065	6.6	2358	7.1	1972	6.6
Lahj	37	10.2	130	10.9	2466	7.8	2633	8	2548	8.4
Ibb	8	2.2	45	3.8	4157	13.1	4210	12.7	3718	12.2
Abyan	9	2.5	18	1.5	868	2.7	895	2.7	799	2.7
Dhmar	10	2.8	48	4	2609	8.2	2667	8	2504	8.2
Shabwah	8	2.2	28	2.4	1295	4.1	1331	4	1178	3.9
Hajjah	8	2.2	29	2.4	1329	4.2	1366	4.1	1257	4.1
Albaidah	2	0.6	42	3.5	979	3.1	1023	3.1	834	2.8
Hadramout	8	2.2	10	0.8	1546	4.9	1564	4.7	1512	5
Sa'adah	7	1.9	24	2	1314	4.1	1345	4.0	1293	4.2
Almahweet			3	0.3	603	1.9	606	1.8	511	1.7
Almahara	3	0.8	16	1.3	116	0.4	135	0.4	125	0.4
Marib	2	0.6	3	0.3	369	1.2	374	1.1	352	1.1
Aljawf	1	0.3	6	0.5	291	0.9	298	0.9	263	0.9
Total	363	100	1191	100	31730	100	33286	100	30314	100

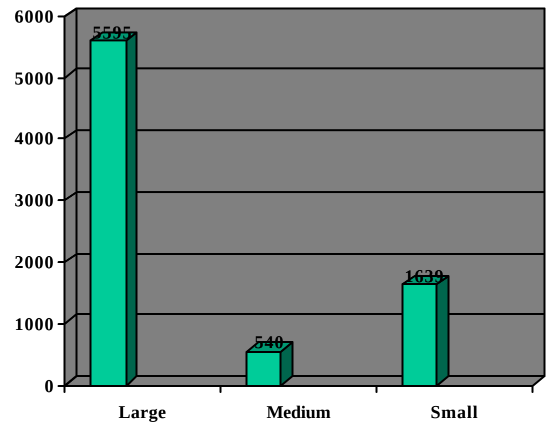
Source: Final Report and Results of The First Industrial Survey 1996, Ministry of Industry.
Note: Numbers may not add due to rounding up.

Percentage of Industrial Establishments By Type
(in millions of Yemeni Riyals)



Source: Final Report and Results of The First Industrial Survey 1996, Ministry of Industry.

Total Wages of Labor in Industrial Establishments According to Size (in millions of YR)



Source: Final Report and Results of The First Industrial Survey 1996, Ministry of Industry.

The industrial survey of 1996 notes the following matters are the top ten difficulties identified by the private sector:

Ranking	Issue
1	Currency fluctuations
2	Electricity cuts
3	Electricity costs
4	Cost of Raw Materials
5	Local Competition
6	Taxes
7	Availability of Water
8	Availability of parts
9	Lack of training of labor
10	Low technical skills of labor

Source: Industrial Survey

Trade Liberalization

Yemen has created a more open and transparent regime. Traders now face a more simple and less protective tariff structure which incorporates all import fees into one rate, as well as streamlined custom procedures and documentation requirements, and far fewer import bans, export restrictions, and trade licensing requirements.

Trade Policy

	Yemen	Low Income Countries
Mean Tariff (%)	16.2%	25.7%
% of Products covered by Non-Tariff Barriers	28.7%	35.5%

Source: FPSI's Competitiveness Database.

The export sector has shown strong growth since 1994, when exports accounted for only 16% of GDP. In 1997 exports reached 43% of GDP. In 1998 this figure fell to about 36%, as oil prices collapsed. Imports are also denominated in hard currency. With the exception of 1994, when imports were low as a result of the civil war, this component of GDP has been relatively stable over the past five years at about 50% of GDP.

Yemen's main export is petroleum. It accounted for over 90% of total Yemeni sales abroad in 1998. Given the country's lack of industrialization, and otherwise limited resource base, oil is likely to continue to dominate the export basket, particularly as the immediate prospects for liquefied natural gas (LNG) remain bleak. Non-oil exports are mainly agricultural products. These are generally in minimally processed form, such as food and hides. The table below compares Yemen's export structure to that of Low Income countries.

Export Structure

	Yemen	Low Income Countries
Manufactured Exports (% of total exports)	1%	27.97%
Percentage Change in Share of Manufactured Exports (%) 1980-93	-92.16%	174.70%
High Tech. Exports (% of manufactured exports)	0%	11.25%

Source: FPSI's Competitiveness Database.

Yemen purchases a wide range of goods from abroad. The country is a net importer in all major categories of products except fuels. Its factories produce basic consumption items for local use and require a high proportion of imported inputs. Because of this imbalance between imports and exports, Yemen's trade account is particularly vulnerable to a fall in world oil prices.

Smuggling forms a large and unrecorded part of trade, and official collusion is not uncommon. Alcohol and firearms land on the Red Sea coast and some are re-exported to Saudi Arabia. Consumer durables, including cars, spare parts and household appliances, come back from Saudi Arabia, often as remittances in kind. Excessively complex customs procedures encourage this practice and, as the tolerance of smuggling is used as an instrument of foreign policy in relations between Yemen and Saudi Arabia, smuggling is unlikely to diminish soon.

Foreign Trade, 1998
(YR m)

	Exports	Imports
Food & livestock	6,742	83,667
Tobacco & beverages	530	5,920
Raw materials	3,358	6,605
Mineral Fuels and Lubricants	186,152	18,997
Vegetable and animal oils	943	11,274
Chemicals & chemical products	857	28,690
Processed materials	737	50,939
Machines & transport equipment	2,480	71,357
Other manufactures	1,489	15,542
Unclassified goods	192	1,540
Total	203,480	294,510

Source: Central Statistical Organization (CSO).

Exports by commodity
(YR m)

	1994	1995	1996	1997	1998
Food & livestock	739	907	4,446	8,711	6,742
Tobacco & beverages	39	154	336	411	530
Raw materials	290	883	1,587	3,512	3,358
Mineral fuels and lubricants	9,978	74,913	242,336	307,322	186,152
Vegetable & animal oils	31	81	105	346	943
Chemicals and chemical products	60	108	263	452	857
Processed materials	26	376	747	591	737
Machines & transport equipment	5	558	1,489	1,354	2,480
Other manufactures	46	321	464	932	1,489
Unclassified goods	2	0	7	85	192
Total	11,216	78,301	251,780	323,716	203,480

Source: CSO, Statistical Yearbooks.

Imports by commodity
(YR m)

	1994	1995	1996	1997	1998
Food & livestock	7,982	13,943	56,000	74,329	83,667
Tobacco & beverages	1,988	4,808	13,228	4,625	5,920
Raw materials	746	1,840	5,151	6,685	6,605
Mineral fuels and lubricants	1,301	5,096	18,801	28,876	18,977
Vegetable & animal oils	3,568	10,232	30,009	9,445	11,274
Chemicals and chemical products	1,940	4,303	15,441	21,523	28,690
Processed materials	5,334	59,090	33,887	46,805	50,939
Machines & transport equipment	5,139	14,917	42,314	54,936	71,357
Other manufactures	1,440	4,062	9,500	12,534	15,542
Unclassified goods	1	16	109	573	1,540
Total	29,439	118,307	224,440	260,331	294,510

Source: CSO, Statistical Yearbooks.

The main market for Yemeni crude is Asia. China, Korea and Thailand top the list, accounting for almost 80% of Yemeni exports in 1998. Japan constitutes another important market, although its share of Yemeni exports has fluctuated in recent years.

The top five suppliers in 1998 accounted for less than 40% of total imports. In part, this is the result of the lack of development of Yemen's industrial and manufacturing bases which means that Yemen must import a wide variety of goods. In addition to neighboring Saudi Arabia and UAE, the US, France and Italy play an important role in supplying goods to Yemen. A substantial proportion of products from the UAE are re-exports from industrialized countries.

Main trading partners, 1998

Exports to:	% of total	Imports from:	% of total
China	30.6	US	8.9
South Korea	25.4	UAE	7.7
Thailand	22.1	France	7.6
Japan	5.0	Italy	7.3
South Africa	2.1	Saudi Arabia	7.0

Source: IMF, Direction of Trade Statistics.

Main trading partners

Exports ($ m)

	1994	1995	1996	1997	1998
Exports to:					
China	23	454	1035	767	657
South Korea	195	372	842	480	547
Thailand	0	133	653	422	474
Japan	124	238	569	132	107
South Africa	0	57	58	40	45
Total exports incl. others	932	1,942	4,538	2,479	2,150

Source: IMF, Direction of Trade Statistics.

Main trading partners

Imports ($ m)

	1994	1995	1996	1997	1998
Imports from:					
US	189	121	263	134	195
UAE	219	224	294	165	170
France	123	67	232	109	167
Italy	86	54	72	64	159
Saudi Arabia	219	153	260	149	154
Total imports incl. others	2,087	1,572	3,443	1,837	2,188

Source: IMF, Direction of Trade Statistics.

Yemen experienced a trade deficit in 1997 which was large compared with the preceding two years. This deficit was later dwarfed by the 1998 trade deficit of $700.5m. This was a reflection almost exclusively of the fall in world prices, which prompted a 34% decline Yemeni oil export earnings. The value of imports also fell, but only by 8.5%. The inability to reduce imports further, even in years where there is a substantial downturn in exports and a fall in the value of the local currency reflects Yemen's dependence on imports for virtually the full range of consumer and industrial products.

Export finance represents a constraint to Yemen. On a basic level, there is a lack of funds. There is not a bank or financial institution that specializes in export finance. There is also a lack of technical expertise in financial services that cater to export development. Infrastructural weaknesses pertaining to the exports sector contribute to the problem. The lack of expertise and know-how in marketing and administrative matters dealing with potential markets for Yemeni goods represents and additional weakness.

Annex 3 Detailed Description of Privatization Support Project

<u>Introduction</u>

The proposed Privatization Support Project will assist the Government in implementing its Privatization Program covering the period from 1999 to 2002. It's primary development objectives comprise: (i) efficient and transparent management by the Government of its Privatization Program (1999-2002); and (ii) completed privatizations of public enterprises and assets. The project comprises four main components:

a) Institutional Support for Program and Project Management (US$3.7 Million): Local and foreign consulting and technical assistance services, training, facilities and equipment to strengthen the Technical Privatization Office (TPO) and the concerned sector ministries managing the implementation of the Project and the privatization transactions. In accordance with the Privatization Law, the TPO will serve as the Secretariat to the High Committee for Privatization (HCP), coordinate the Government's overall privatization program, review all privatization proposals submitted to the HCP, formulate privatization strategies, and advise and assist the sector ministries in the implementation of privatization transactions. The initial staff of the TPO will comprise: (i) Chief Operating Officer (COO), who will be assisted by one internationally recruited Transaction Advisor; (ii) Program Managers; (iii) Manager, Accounting and Financial Administration; and (iv) Manager, Legal Affairs. Privatization Steering Committees (PSCs) will also be established in the concerned sector ministries. The Project will provide funding for competitively recruited, international and local consultants to staff and support the TPO and the PSCs in carrying out the privatization transactions. The component's deliverable/output objective is a strengthened TPO and sector ministries capable of managing and implementing the Government's Privatization Program (1999-2002).

b) Transactions Support – Large Enterprises (US$7.1 Million): Financial and legal transactions advisory services for the preparation for sale of large enterprise assets, which are expected to require the assistance of international consulting firms. Consulting services will also be provided to help address associated policy and regulatory issues necessary for creating a competitive market environment and efficient and effective operations of the newly privatized enterprises, and for the marketing and tendering of the enterprises. The component's deliverable/output objective is bringing to the point of sale at least three of the five large enterprises targeted by the Project, including any necessary legal, regulatory, environmental and labor restructuring measures. The following large enterprises will be targeted by the Project:

(i) Ministry of Industry:
- Yemen Corporation for Cement Production and Marketing (viz., Yemen Cement Company)
- Yemen Drug Company

(ii) Ministry of Oil and Mineral Resources:
- Aden Refinery Company

(iii) Ministry of Transport:

- Airport passenger and cargo ground-handling services at international airports
- General Land Transport Corporation

Privatization strategies for these enterprises have been prepared and endorsed by the Government. Each enterprise strategy identifies the likely mode and process of privatization, the associated issues in the business environment that would be addressed during the course of privatization, and the implementation process and schedule. The policy and regulatory measures are expected to include initial preparatory work for a simple stock market for trading of shares in enterprises such as the Yemen Cement Company and the Yemen Drug Company. The strategies will be revalidated by transactions consultants during the course of project implementation.

c) Transactions Support – Small and Medium Enterprises (US$3.8 Million): Financial and legal transactions advisory services for the preparation for sale of about 50 small and medium-sized enterprise assets, and for the marketing and tendering of the assets. Such services could include those required for any associated policy and regulatory issues should that be necessary for creating a competitive market environment and efficient and effective operations of the newly capitalized/privatized enterprises. The enterprise transactions supported under this component will be selected in agreement with IDA out of approximately 70 small and medium-sized enterprises included in the Government's Privatization Program. The component's deliverable/output objective is to bring to the point of sale about half of these enterprises and assets. Priority in the utilization of the IDA credit will be given to the more difficult and complex assets included in the Privatization Program, such as the Yemen Economic Corporation, Foreign Trade and Grain Corporation, National Dockyards Company, Canning Factories in Mukallah and Shagra, and the Marib Oil Refinery. Invitations for expressions of interest to consultants have been issued for many small and medium enterprise transactions; e.g. National Tanning Factory (Aden), Agricultural Machinery Rental Station (Abyan), Yemen Navigation Lines and Shagra Fish Canning Factory.

d) Pre-Privatization Strategy Work on Large Enterprises (US$1.4 Million): Financial advisory services for pre-privatization work on three large transactions – Port of Nashtoun, Public Telecommunications Company, and Yemenia Airlines.

Summary of Privatization Strategies for the Large Enterprises

a) Process and Methodology. In consultation with the concerned sector ministries, Bank staff assisted the Government in preparing privatization strategies for each of the five large enterprises included in the Project. The strategies were then reviewed and endorsed by the Yemeni Cabinet. It is important to note, however, that changes and adjustments may need to be made as the actual privatization process unfolds. Furthermore, the privatization strategies do not seek to resolve longer-term sector reform strategy issues, but have been structured so as not to forestall future sector reforms. In most cases, the objective of each strategy is to initiate steps towards developing a comprehensive policy and institutional framework that is consistent with a long-term vision of the concerned sector.

b) Aden Refinery. The Aden Refinery Company (ARC) is a government-owned enterprise that reports to the Ministry of Oil and Mineral Resources. It is the largest employer in Yemen with a staff of over 4000. It is poorly designed, and not configured to process local hydrocarbons. Therefore it operates well below its capacity, and needs technological and operational modernization. ARC sells all of its product to Yemen Petroleum Company (YPC), and YPC in turn, is the sole distributor of petroleum products in the domestic market.

The Government's objectives for privatizing ARC are to:

- finance the modernization of the refinery; and
- eliminate subsidies in the refining sector.

The proposed privatization strategy entails:

- issuing new shares in return for capital contribution by new investors;
- inviting an experienced internationally recognized refinery operator to take a controlling interest in the refinery;
- using the proceeds from selling shares as well as new corporate debt to finance investments in ARC; and
- promoting market principles and the eventual deregulation of downstream activities in the petroleum sector.

c) Airport Ground-Handling Services. Yemeni Airlines, the national flag carrier, currently carries out all ground handling operations such as passenger traffic; luggage handling; aircraft cleaning; airport cleaning; catering and equipment support and service. There are six international airports in Yemen, in Sana'a, Taiz, Aden, Sayun, Hodeidah and Al Mukallah. Ground handling has the potential to be one of the most profitable components of the aviation sector.

The Government's objectives for privatizing ground handling operations are to:

- provide more efficient ground handling services at international airports in Yemen;
- improve the quality of services provided by introducing competition;
- increase density of traffic destined to and originating from Yemen; and
- compete with regional airports for transit and air traffic as well as other services such as package delivery (e.g. DHL and Federal Express).

The proposed privatization strategy entails:

- joint share-holding and/or revenue sharing between the government and commercial entities;
- bidding out services thereby stimulating market competition and realizing gains in areas such as government revenue (fees and charges), efficiency gains, and rents;
- increasing traffic to/from Yemen, thereby generating increased airport revenues; and
- developing Sana'a into a regional transit hub by enabling airlines to provide their clients with timely service in an efficient and high quality manner.

d) General Land Transport Company. The General Land Transport Company (GLTC) is a publicly-owned enterprise that provides bus and freight (trucking) services in Yemen, and is supervised by the Minister of Transportation. GLTC has been successful at providing a large array of services thereby connecting urban and remote parts of the country. However, it continues to suffer from financial difficulties and its vehicle fleet suffers from acute depreciation.

The Government's objectives for privatizing GLTC are to:

- achieve efficiency in operations by drawing upon the private sector's entrepreneurial skill;
- attract immediate investment;
- provide affordable transportation to the population; and
- reduce the government's fiscal burden through subsidies and unfruitful services.

The proposed privatization strategy entails:

- restructuring the company strategically, and down-sizing to match current market realities, then recapitalizing with private sector capital;
- developing a detailed business plan which clearly identifies strategic assets and steps that should be taken to protect and maximize these assets;
- privatizing GLTC creating a joint-stock limited liability company that is partially funded by capital from GLTC and by government funding. Additional funds may be provided by employees through an employee stock ownership plan (about 10 percent) and other strategic investors (60 percent) which would choose management staff. The remaining 30 percent equity position held by the Government may later be sold to employees, strategic investors and/or to the public by way of a stock flotation.

e) Yemen Cement Company. The Yemen Cement Company (YCC) is a 100 percent state-owned enterprise that is composed of three profitable plants in Amran, Bajel and Albarh in northern Yemen, that have access to unlimited raw materials and adequate water supplies. Furthermore, they have training facilities and skilled personnel. In some cases, the technology in the plants is out-dated and environmentally detrimental. The accounting system is manual, and outdated.

The Government's objectives for privatizing YCC are to:

- increase the sector's overall efficiency and output level;
- improve the balance of payments strain caused by importing significant quantities of cement;
- attract investment and create new employment opportunities for Yemeni nationals; and
- maintain and update existing technology bringing about greater efficiency, consumer welfare, and cleaner production.

The proposed privatization strategy entails:

- conducting detailed assessments of the plants' operational, financial, management and engineering structures;

- carrying out comprehensive feasibility studies on the potential for expanding production taking into account market, financial and technological factors;
- determining the value of each plant and recommending the debt and equity investment required for each plant; and
- capitalization by way of issuing shares to strategic investors and the sale of government equity to a broad base of shareholders.

f) Yemen Drug Company. The Yemen Drug Company (YDC) is part of the mixed sector, with 40 percent of its shares owned by the Ministry of Industry; 35 percent owned by the Yemen Bank for Reconstruction and Development (YBRD) and 25 percent privately owned. It is a profitable enterprise with a broad base of operations including producing drugs, serving as an import agent for leading drug companies in Europe, printing drug labels, and distributing products to pharmacies around the country.

The Government's objectives for privatizing YDC are to:

- ensure that a wide range of high quality drugs are available;
- encourage competition in the industry by removing import and price controls;
- increase the efficiency and effectiveness of YDC; and
- develop the wealth base in the country by expanding the public shareholding of YDC from 25 percent to 100 percent.

The proposed privatization strategy entails:

- attracting a strategic investor who will have considerable management control;
- supporting the development of a simple stock exchange, and, when possible,
- floating the remaining company shares on the stock exchange in order to promote a broad-based shareholding.

The CAS-level objective of the Project is to attract private sector-led growth and investment, raise enterprise efficiency, and reduce the fiscal and monetary burden of public enterprises. Within this objectives framework, the main sector benefits expected to be received from the privatization of the large enterprises targeted by the Project are as follows:

a) **<u>Private Provision of Infrastructure</u>.** The privatization of utilities and other large enterprises through direct sales to strategic investors can attract private investment for expansion and generate immediate revenues that can be utilized for other public sector investments. Such transactions are often accompanied by agreements with new investors and owners to meet specified investment or output targets. This is expected to apply to the Aden Refinery and the Yemen Cement Company transactions in particular.

b) **<u>Enterprise Efficiency</u>.** Although little evidence is available to compare pre- and post-privatization performance in Yemen, public enterprises in Yemen generally confront the same kinds of problems as do public enterprises in other countries (e.g., administrative interventions, excessive focus on procedures, poorly designed incentive systems, limited autonomy, and inadequate capital). A large body of research tends to support the thesis that privatization should lead to greater enterprise efficiency.

c) **Fiscal Consolidation**. The budgetary burden of some of the large enterprises targeted by the Project is high (e.g., General Land Transport Corporation). Given the Government's commitment to check public expenditures, further reduce the fiscal deficit, and "grow out" of external debt, privatization is expected to be instrumental in consolidating the fiscal situation and improving public finances. The Privatization Law requires privatization proceeds to be transferred to the Treasury where they can be used to further reduce fiscal pressures.

Privatization is expected to have a significant positive fiscal impact. Loss-making and inefficient public sector enterprises impose a considerable strain on the Government's budget and on society as a whole. Privatization in Yemen should improve the government's financial flows by: raising revenue from the sale of assets and shares; reducing the need for operating subsidies and investment capital; and increasing tax revenues as a result of improved enterprise performance.

Annex 4 Estimated Benefits and Fiscal Impact of Privatization

The proposed Privatization Support Project is expected to benefit the economy in various ways, including attracting more investment, encouraging competition, and bringing about greater consumer welfare. Public enterprise operations are often ineffective and inefficient. Privatization is expected to help the economy by generating revenue for the government and alleviating fiscal pressures; reducing consumer costs and increasing choice; improving efficiency, productivity and profitability across sectors; and contributing to the development of a capital market for debt and equity. These potential benefits are summarized for the large enterprises in a qualitative manner in Table A below. Similar kinds of benefits are expected to be generated by the Project's transactions support for the privatization of small and medium enterprises.

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Privatization is expected to have a significant positive fiscal impact. Loss-making and inefficient public sector enterprises impose a considerable strain on the Government's budget and on society as a whole. Privatization in Yemen should improve the government's financial flows by: raising revenue from the sale of assets and shares;

reducing the need for operating subsidies and investment capital; and increasing tax revenues as a result of improved enterprise performance.

The Net Present Value of the expected fiscal benefits is estimated to be approximately US$500 million, assuming a discount rate of 10 percent. This estimate excludes the fiscal benefits expected to be generated by the Project's transactions support for the privatization of small and medium enterprises. Since the total project cost is estimated at US$16 million, the transaction cost of around 3 percent of total benefits falls within an acceptable range of 1 to 10 percent. Moreover, it can be further hypothesized that, should the margin of error of the analysis be in the range of 50 percent, the fiscal benefits and pay-back on the privatization would still be substantial.

Summary of Potential Benefits of Large Enterprise Privatizations

	Airport Ground Handling Facilities	General Land Transport Company	Yemen Drug Company	Yemen Cement Company	Aden Refinery Company
Economy:					
Incremental value added	Yes	Yes	Yes	Yes	Yes
Promote investment in new facilities	Yes	Yes	Yes	Yes	Yes
Assist budget through fiscal savings or increased revenues	Yes	Yes	Yes	Yes	Yes
Promote foreign direct investment in ownership	Yes	No	No	Yes	Yes
Contribute positively to balance of payments	Yes	No	No	Yes	Yes
Increase share of local private sector	No	Yes	Yes	Yes	No
Assist development of capital market	No	Yes	Yes	Yes	No
Raise enterprise efficiency and effectiveness	Yes	Yes	Yes	Yes	Yes
Consumers:					
Improve services	Yes	Yes	Yes	Yes	Yes
Increase choice	Yes	Yes	No change	Yes	No change
Improve safety/environment	Yes	Yes	No change	Yes	Yes
Maintain or reduce prices	Yes	No	No change	Yes	No change
Workers:					
Increase productivity	Yes	Yes	Yes	Yes	Yes
Improve working conditions	Yes	Yes	Yes	Yes	Yes
Increase employment opportunities	Yes	Yes	Yes	Yes	No
Investors:					
Increase enterprise value	Yes	Yes	Yes	Yes	Yes

Fiscal Evaluation

A quantitative discussion of the estimated fiscal benefits from the privatization of the large enterprises is given below and summarized in Table B. In carrying out this analysis, a number of assumptions have been made. In instances where data was limited, or not available, staff estimates have been based on conservative evaluations and on research and data collected from the privatization of similar enterprises in other countries. Staff assumptions related to Yemeni market conditions have also been taken into account. Therefore, the estimates should be treated as approximate indicators only. The counterfactual is implied in this analysis, and then summarized separately.

a) Aden Refinery Company

Privatization of the Aden Refinery Company (ARC) is expected to encourage investment which could be used for maintaining existing technology, and to facilitate a move towards newer, more efficient facilities. Investment is also necessary for ARC to address critical environmental and safety issues, and improve overall operational efficiency. The privatization of ARC is also expected to promote deregulation of downstream activities, inviting increased competition. Currently, ARC sells all of its product to the Yemen Petroleum Company (YPC) which has a monopoly on the distribution of petroleum products in domestic markets.

Labor productivity and working conditions in the refinery are also expected to improve with privatization, and a Labor Redundancy Fund has been established to assist affected workers. Proceeds from privatization may be injected into the Fund in the short-term.

ARC currently represents a fiscal drain on the Government, due to product subsidies and operational inefficiencies. Privatization is expected to lead to greatly reduce this fiscal drain, which is estimated to total somewhere between US$40 million and US$100 million per annum.[1] Furthermore, the refinery has potential to contribute an additional US$10 million to the budget, through revenue from dividends and taxes in the medium term.

b) Airport Ground-Handling Services

Airport passenger and cargo ground-handling services have the potential to become a more significant source of income for the Government and the economy. It is one of the most profitable components of the aviation industry, and more efficient ground handling services could lead to increases in the frequency of flights landing in Yemen's six airports, generating more revenue in the form of service fees. Through competitive contracting, ground handling services could be provided in a more cost-effective, timely manner that contributes to route profitability and the maintenance of airlines' service quality profiles. This would increase labor productivity, raise enterprise efficiency and improve consumer welfare. Improved ground handling facilities, by encouraging airlines to increase flight availability and frequency, can also be an impetus for increased tourism.

Assuming flight frequency and seat availability increase by about 10 percent as a result of privatization, a direct revenue increase estimated at about US$1 to 2 million per annum could potentially be realized.[2] Should Sana'a become a regional transit hub for a foreign

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[1] Available data is scarce. Staff estimates suggest the total subsidy could possibly reach about US $200 million equivalent based on 1997 prices of oil. Some sources, however, suggest that the total subsidy may be less, possibly between US$40 million and US$100 million.

[2] Ground handling charges currently total about US$15 million per annum. Landing and parking fees currently total about US$3 million per annum.

airline, a possibility given its attractive location relative to African markets, traffic could increase by a further 20 percent, or about US$3 million. Approximately 50 percent of this revenue increase could potentially accrue to the Government through tax dividends and/or revenue shares, and provide an estimated fiscal benefit of approximately US$2 million per annum over the medium term. The direct fiscal benefits, however, are expected to be neutral in the short-term, with any proceeds from the transaction being absorbed by redundant workers.

c) General Land Transport Company

The General Land Transport Company (GLTC) has been plagued by economic losses for several years. Privatization is expected to improve economic efficiency, and, in the long term, profitability, by way of eliminating non-essential and non-operating assets. Competition in the market would come about through unbundling and the privatization of services and route structures. Privatization is expected to encourage new sector investment and revitalize the routes operated by the GLTC.

The expected fiscal benefits are modest. No immediate proceeds are anticipated after addressing labor redundancy costs. In the longer-run, once the infrastructure is reestablished, a modest fiscal benefit estimated at less than US$1 million per annum may be expected.

d) Yemen Cement Company

The Yemen Corporation for Cement Production and Marketing (viz., Yemen Cement Company (YCC)) comprises three cement plants that currently supply about 50 percent of the domestic demand for cement. According to unofficial estimates, an additional 30 percent of domestic demand is supplied by cement imports, adding a considerable strain on Yemen’s balance of payments. It is estimated that the remaining 20 percent of domestic demand is met by illegal imports.

The establishment of three separate cement companies through privatization is expected to encourage competition, thereby increasing consumer welfare through the advent of more efficient market pricing. Additionally, the product is expected to become lower cost and, through improved manufacturing techniques, possibly more suited to local conditions and specifications in the construction sector. New investment is expected to flow from privatization that should increase production and efficiency by way of technological and operational improvements while also decreasing adverse environmental externalities. New employment opportunities for Yemeni nationals should also arise as a result of increasing the capacity of existing plants and building new plants.

Privatization of the YCC is expected to generate fiscal benefits in several ways. The country’s balance of payments position should improve with the expansion of local cement production, the lower costs incurred by the construction sector, and the expected decrease in imports. The additional value added promoted by the privatization is estimated at about US$50 million. Assuming a mix of sale of government equity (25 percent) and the introduction of new investment (25 percent) by way of a capitalization program and an enterprise value of not less than US$50 million, the proceeds from the sale are estimated at about US$12 to 13 million.[3] An estimated increase in annual production is expected to generate an additional US$8 to 9 million per annum in taxes and dividends. The Government's removal of fixed prices should also have a positive fiscal impact.

e) Yemen Drug Company

The Yemen Drug Company (YDC) is a profitable enterprise with an existing private shareholding base of 25 percent. The company is currently profitable and is sizeable in the Yemeni context. The privatization of YDC is expected to be integrated with the development of a rudimentary stock market for which it will assist in setting disclosure standards, establishing procedures and identifying institutional needs.[4]

This transaction could lead to positive health externalities since a wider range of drugs may be made available through local production and at lower costs. The removal of import and price controls should pave the way for further competition which will benefit the consumer and result in a better quality product.

The Government is expected to receive approximately US$7 to US$8 million in sales proceeds, and incremental tax flows arising from improved profitability are estimated at about US$1 million over the medium term.

The Counterfactual

The Aden Refinery, in the absence of privatization, would continue to represent a fiscal strain on the economy. Moreover, its continued inefficient operation without the necessary investments poses serious environmental and safety hazards, especially since the refinery's design is not best-suited to process local hydrocarbons. Sub-optimal labor productivity would continue, constituting further strain on the government in the form of wages.

In the aviation sector, if privatization of the various services is not introduced, Yemen will be overlooking its potential to develop airports such as that of Sana'a into a regional hub. Ground handling in particular, is a service that has a high profitability rate. Moreover, the provision of efficient and prompt service in this sector provides airlines with a key incentive to increase the frequency of their flights to and from Yemen, and this in turn provides Yemen with the ability to absorb this demand as a result of a rapid aircraft turnaround rate. The opportunity cost of not implementing this strategy is very high due to the large profit margin in the sector, and to the unrealized fiscal revenue in taxes and fee-based services.

In the cement industry, if privatization and consequently competition are not introduced, adverse practices such as monopoly-based, non-market prices will continue to prevail. Cement will continue to be brought into the country illegally, robbing the country of

[3] Enterprise values can be estimated in the range of US$50 to $150 million depending on the assumptions made.

[4] The Government has requested the Arab Monetary Fund, in coordination with the IFC, to formulate proposals for establishing a simple stock market.

revenue in value added. The illegal importation of cement may also continue to have an adverse impact on the balance of payments. From a consumer's point of view, local consumers such as construction companies and/or contractors would be unable to increase their welfare with lower prices, and with products that meet local specifications more closely.

The Yemen Drug Company, although already profitable, stands to gain much from further investments. In the absence of privatization, these potential benefits would be substantially foregone. More drugs can be manufactured, and at lower prices. Not only could this have a net positive economic impact in the health sector, there is also potential for spill-over of expertise and technology in other manufacturing sectors.

The continued operation of the GLTC in its present form would imply a continuation in economic loss due to the operation and deterioration of assets. It would also make GLTC assets less attractive to potential investors in the future.

Summary of Fiscal Impact

The table below illustrates the fiscal impact of the privatization. Currently, the large enterprises are a significant fiscal drain.

Summary of Fiscal Benefits of Large Enterprise Privatizations

Enterprise	Short-Term Benefits (Estimated net sale proceeds) (US$ million)	Medium-Term Benefits (Estimate of additional annual fiscal flow in taxes and dividends to Government) (US$ million)	General Fiscal Impact (Estimate of non-enterprise generated flows; e.g. new competitors) (US$ million)
a) Aden Refinery	Nil	50	Nil
b) Airport Ground Handling	Nil	2	1
c) General Land Transport Corporation	Nil	1	1
d) Yemen Cement Company	12-13	8-9	5
e) Yemen Drug Company	7-8	1	Nil
Total Indicative Estimate:	20	62	7

The Net Present Value of the expected fiscal benefits is estimated to be approximately US$500 million, assuming a discount rate of 10 percent. This estimate excludes the fiscal benefits expected to be generated by the Project's transactions support for the privatization of small and medium enterprises. Since the total project cost is estimated at US$16 million, the transaction cost of around 3 percent of total benefits falls within an acceptable range of 1 to 10 percent, which is reasonable. Moreover, it can be further hypothesized that, should the margin of error of the analysis be in the range of 50 percent, the fiscal benefits and pay-back on the privatization transactions would still be substantial.

Factors Which May Influence Estimates

There are many factors that may affect the accuracy and reliability of estimates given above. Much of the required data is outdated, inaccurate or not available. In the absence of concrete data, staff estimates have been used, and are to be treated as rough indicators. Some benefits, such as those resulting from the development of a stock market, and from positive health and environmental externalities, have not been quantified. The estimates have also been based on assumptions related to the privatization strategies that will be pursued, and these are subject to significant change as the privatization processes proceed.

Another important factor is the timing of benefits. While assumptions can be made about time-lines, schedules are ultimately influenced by market conditions, as transactions may encounter obstacles. It may become necessary in some instances to reject all bids, and make significant modifications before starting a new bidding process.

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