YEMEN ECONOMIC MONITOR

Peace on the Horizon?

Fall 2023

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Yemen Economic Monitor

Peace on the Horizon?

Fall 2023

Global Practice for Macroeconomics, Trade & Investment

Middle East and North Africa Region

1818 H Street NW
Washington DC 20433
Telephone: 202-473-1000
Internet: www.worldbank.org

All queries should be addressed to the lead author, at: gmele@worldbank.org.

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ACRONYMS

ACAPS	Assessment Capacity Project
AMF	Arab Monetary Fund
CBY	Central Bank of Yemen
CEM	Country Economic Memorandum
FX	Foreign Exchange
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
HCI	Human Capital Index
IPC	Integrated Food Security Phase Classification
IRG	Internationally Recognized Government
JMMI	Joint Market Monitoring Initiative
PLC	Presidential Leadership Council
KSA	Kingdom of Saudi Arabia
MOF	Ministry of Finance
NTL	Nighttime Light
ODA	Official Development Assistance
UAE	United Arab Emirates
UN	United Nations
UNVIM	United Nations Verification and Inspection Mechanism for Yemen
YER	Yemeni Rial

PREFACE

The *Yemen Economic Monitor* provides an update on key economic developments and policies over the past six months. It also presents findings from recent World Bank work on Yemen. The *Monitor* places these developments, policies, and findings in a longer-term and global context and assesses their implications for Yemen's outlook. Its coverage ranges from the macro economy to financial markets to human welfare and development indicators. It is intended for a wide audience, including policy makers, development partners, business leaders, financial market participants, and the community of analysts and professionals engaged in Yemen.

The *Yemen Economic Monitor* is a product of the World Bank's Yemen Macroeconomics, Trade, and Investment (MTI) team. This issue was written by Mohammad Al Akkaoui (Economist) and Yasmine Osman (Economist). The Special Focus entitled *Dim Prospects but Glimmers of Lights: Economic Trends across Yemen's Fragmented Regions* was prepared by Mohammad Al Akkaoui, Yasmine Osman, and Ali Ibrahim Almelhem (Consultant). The *Yemen Economic Monitor* has been completed under the guidance of Eric Le Borgne (Practice Manager), Željko Bogetić (Lead Economist), and Tania Meyer (Country Manager). Ebrahim Mohammed Yahya Al-Harazi (External Affairs Officer) is the lead on communications, outreach, and publishing.

The findings, interpretations, and conclusions expressed in this *Monitor* are those of World Bank staff and do not necessarily reflect the views of the Executive Board of The World Bank or the governments they represent.

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To be included on an email distribution list for this *Yemen Economic Monitor* series and related publications, please contact Ebrahim Mohammed Yahya Al-Harazi (ealharazi@worldbank.org). For questions and comments on the content of this publication, please contact Mohammad Al Akkaoui (malakkaoui@worldbank.org) or Yasmine Osman (yosman@worldbank.org). Questions from the media can be addressed to Ebrahim Mohammed Yahya Al-Harazi.

EXECUTIVE SUMMARY

Yemen's humanitarian crisis is deeply rooted in its conflict and complex political and economic landscape. From 2015 to 2022, the country experienced a staggering 52 percent contraction in real GDP per capita, leaving two-thirds of the population, approximately 21.6 million individuals, needing humanitarian assistance. The current level of poverty is anticipated to be significantly higher than in 2014 when nearly half of the population (49 percent) grappled with poverty. Since the onset of the conflict the surge in the cost of basic essential goods, especially food products, has propelled food insecurity to the forefront of concerns in Yemen. Moreover, the ongoing conflict has intensified the fragmentation of the country into two distinct economic zones, each governed by its unique set of institutions and policies, resulting in an increasing disparity despite the evident interconnections.

During 2022, Yemen's economy showed improvement, supported by a truce that brought a glimmer of hope, albeit without the parties reaching a permanent political settlement. The two-month UN-brokered truce between the Internationally Recognized Government (IRG) of Yemen and the Houti movement, popularly known as the Houthis, starting in April 2022 and extended twice, temporarily halted offensive hostilities, thereby providing some relief for civilians and allowing for limited economic recovery.[1] However, a lasting resolution remained elusive due to persistent disputes that prevented reaching a long-lasting ceasefire and initiating a peace process.

The formal truce expired in October 2022, and although an informal truce remained in place, the situation worsened in 2023 due to a Houthi-imposed blockade on oil exports. This blockade is severely impacting foreign currency liquidity, and exacerbating existing economic difficulties, including the fiscal position of the IRG. The depreciation of the Yemeni Rial (YER) and ongoing monetization of IRG's fiscal deficit through withdrawals from its overdraft facility in the Central Bank of Yemen in Aden (CBY-Aden) contributed to inflationary pressures, particularly in Aden. Moreover, the reopening of Western

[1] Yemen is divided among multiple competing power centers. The Houthis' fatal split from Saleh in December 2017 left them as the dominant force in northwest Yemen, where the bulk of the population lives. The international community has largely upheld the IRG as Yemen's rightful sovereign authority; on the other hand, the Houthi forces hold de facto control over large portions of the country, including Sana'a, the economic and financial center. Yet, the conflict extends beyond the often simplistic, binary view of a Houthi led government in Sanaa, and Yemen's IRG based in Aden. Disagreements among groups nominally united under either the Houthis or IRG banner are often as sharp as the conflict between the two overarching factions.

ports following the truce led to a decline in customs receipts as imports were diverted from Aden.

Yemen's future economic prospects depend on several factors. The economic outlook for 2024 remains uncertain due to oil export constraints and ongoing political negotiations. Nevertheless, positive developments, such as the recent rapprochement between regional powers and ongoing negotiations with the Houthis, could lay the groundwork for recovery. The World Bank's recent, in-depth country economic growth diagnostic, Country Economic Memorandum (CEM), outlines different recovery paths under various macroeconomic and political economy scenarios, emphasizing potential peace dividends.[2] Realizing the peace dividend and ensuring economic stability requires extensive efforts both domestically and from the international community by addressing immediate financial needs, capacity gaps, macroeconomic imbalances, and human capital erosion. Implementing structural reforms is crucial for sustainable and equitable growth, potentially laying a robust foundation for a resilient economy that meets citizens' needs. Ending the blockade and moving from truce towards a lasting political settlement is a crucial, necessary condition for a lasting recovery.

A special focus chapter using innovative nighttime light (NTL) emission data at the governorate level explores Yemen's economic performance during and after the 2022 UN-sponsored truce, shedding new light on the dividends for peace as highlighted in the Yemen CEM. The analysis reveals two key findings. First, at the national level, economic activity sharply increased during the temporary ceasefire but contracted even more starkly once the ceasefire lapsed. Second, both the gains and losses were much more pronounced in the Houthi-controlled areas, likely reflecting the fact that the ceasefire provided these areas with critical access to imports, including oil from the rest of Yemen. While short-term gains were evident during the truce, achieving Yemen's long-term prosperity depends on resolving political disputes that have fractured the economy along regional lines, with the potential of a decentralized model facilitating recovery if stability is achieved through a political resolution.

[2] World Bank. (2023). *Yemen Country Economic Memorandum: Glimmers of Hope in Dark Times*. Washington, D.C: World Bank.

1

THE ECONOMIC AND SOCIAL CONTEXT

The war in Yemen has inflicted massive human, economic, and social costs on the country and its people. From 2015 to 2022, the country experienced a 42 percent contraction in real GDP. When accounting for Yemen's rapid population growth, it is likely that per capita real GDP saw an even more severe decline, estimated at 52 percent during the same period (Figure 1). This contraction carried profound human implications, with around 21.6 million individuals, equivalent to two-thirds of the total population, now in need of humanitarian assistance.[3] Prior to the crisis, poverty was already a significant concern, affecting almost half of Yemen's population (49 percent). Today, it is expected to have reached significantly higher levels than in 2014, with women being particularly vulnerable.[4] Moreover, data indicates that life expectancy at birth has declined since the onset of the conflict, standing at 63.7 years on average in 2021 compared to 67.4 years in 2014 (Figure 2). Simultaneously, the Human Capital Index (HCI) underscores that a child born in 2020 is projected to be only 37 percent as productive in adulthood as they would have been with access to comprehensive healthcare and a complete education.[5]

Moreover, the ongoing conflict has intensified the fragmentation of the country into two distinct economic zones, each governed by its unique set of institutions and policies.[6] In 2016, the IRG relocated the (CBY) to Aden. However, the newly established CBY-Aden faced challenges. These included the struggle to secure sufficient foreign exchange liquidity, stemming from the decline in oil and gas exports. Additionally, the limited access to external financing coupled with the difficulties faced by domestic banks, and the absence of an enabling environment for effective monetary policy implementation, all presented considerable obstacles. On the other hand, Houthi-controlled Sana'a remained the

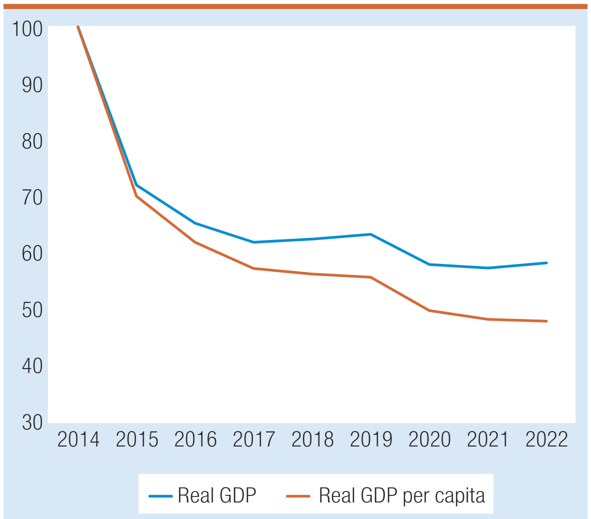
3 Yemen: Humanitarian Response Snapshot (OCHA, June 2023).

4 The World Bank in Yemen.

5 Yemen: Human Capital Index (2020).

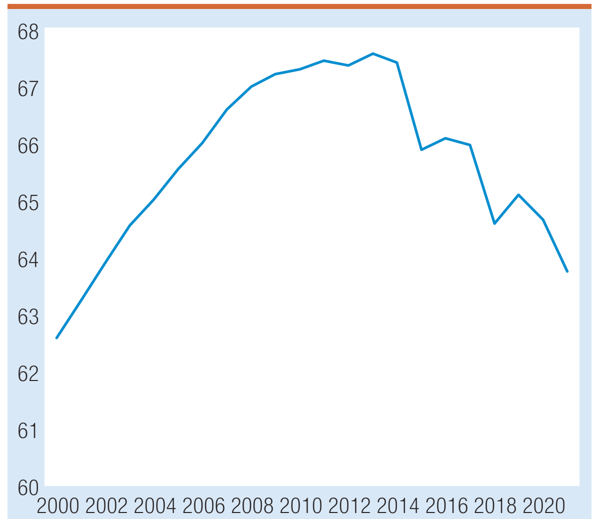
6 In reality, fragmentation of the political and economic landscape extends beyond the binary view of a Houthi led government in Sanaa and Yemen's IRG based in Aden, with disagreements extending even among groups nominally united under either the Houthis or IRG banner (CEM, 2023).

FIGURE 1 • Real GDP and Real GDP Per Capita Index (2014=100)



Source: WB and IMF Staff Calculations.

FIGURE 2 • Life Expectancy at Birth, Total (years)



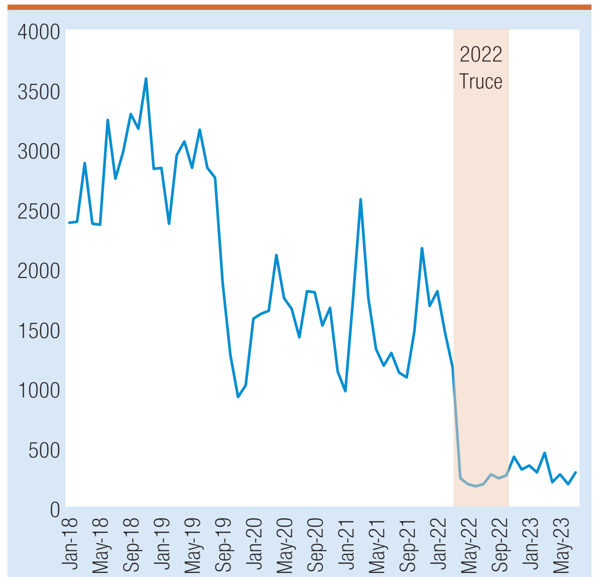
Source: World Development Indicators.

country's banking and trading center and, due to its larger population, benefitted from greater remittance inflows and aid-agency payments executed via the formal banking system.

During 2022, Yemen's economy showed improvement, supported by a UN-sponsored truce that brought a glimmer of hope, albeit without the parties reaching a permanent political settlement. The two-month UN-brokered truce between the IRG and the Houthis, starting in April 2022 and extended twice, temporarily halted offensive hostilities, thereby reducing conflict-related fatalities (Figure 3). Notable political changes included IRG President Hadi ceding power to the newly formed Presidential Leadership Council (PLC) to foster inclusivity. Shortly thereafter, the Kingdom of Saudi Arabia (KSA) and the United Arab Emirates (UAE) announced a financial aid package of US$2 billion deposited at CBY-Aden.[7] In November 2022, KSA announced that its US$1 billion support would be allocated to helping Yemen bolster economic, financial, and monetary reforms, with technical assistance from the Arab Monetary Fund (AMF) (Box 1).[8]

Unfortunately, the positive momentum was short-lived, as the formal UN-sponsored truce expired in October 2022. Although an informal truce remained in place (e.g., fatality levels in

FIGURE 3 • Monthly Conflict Fatalities (persons)



Source: Armed Conflict Location and Event Data Project.

7 Welcoming Saudi Arabia and the UAE's Economic and Humanitarian Support for Yemen - United States Department of State.

8 https://www.amf.org.ae/en/news/25-11-2022/kingdom-saudi-arabia-extends-billion-us-dollar-support-republic-yemens.

BOX 1. KSA FUNDED AMF PROGRAM FOR YEMEN

In November 2022, KSA announced a US$1 billion financial aid package to support Yemen's economic reform program, with technical assistance from the AMF. The program covers the period (2022–2025) and aims to establish economic and financial stability in Yemen, enhance fiscal stability and the external position, rebuild Yemeni institutions and support their governance and transparency, in order to enhance the macroeconomic environment, expand and diversify the productive base, support inclusive and sustainable economic growth, and create job opportunities.

The program focuses on three reform areas aiming at i) strengthening the fiscal position of Yemen, ii) developing the financial and banking sector, and iii) creating an enabling environment to enhance the role of the private sector while scaling up its role in achieving sustainable economic development.

- Public finance reforms include increasing domestic fiscal revenues, controlling and rationalizing government spending, enhancing public expenditure efficiency and governance while directing it toward urgent priorities, and rehabilitating vital infrastructure in the electricity, water, and road sectors, in a manner that supports fiscal sustainability and enhances confidence in the Yemeni economy.
- Financial and banking sector reforms include developing governance and banking supervision in a way that enhances transparency and accountability, enhancing financial inclusion to enable micro, small and medium enterprises, as well as targeted groups (especially youth and women in rural areas) to have access to financial services, supporting digital financial transformation to enhance the flexibility of payment means, improving the banking sector infrastructure to enhance its resilience and support its ability to mobilize resources to meet the financing needs of the economy, in addition to achieving financial and economic stability.
- Private sector reforms aim to enhance its role as an engine for inclusive and sustainable economic growth and creating job opportunities to improve living conditions and reduce unemployment and poverty rates, and at the same time enhance further integration in the global economy, increase foreign investment flows, and strengthen international partnerships.

Figure 3), the economic situation worsened with a Houthi-imposed blockade on oil export.[9] This blockade is having far-reaching consequences, including a complete halt in IRG's oil export, severely impacting fiscal revenues, and straining public-sector operations. Additionally, foreign currency liquidity conditions have been adversely affected, further exacerbating existing macroeconomic difficulties, and increasing disparity between the North and the South. By end-2022, CBY-Aden's liquid FX reserves had decreased to a month's worth of imports, and the Aden-YER has significantly depreciated (Figure 17). Consequently, while Sana'a experiences relative inflationary stability, Aden experiences high rates of inflation (Figure 18).

Yemen continues to face deep structural challenges. Growth in the oil sector depends on Yemen's ability to attract foreign investment, which remains contingent on improving security and achieving peace. Non-oil activity continues to be constrained by interruptions in essential service delivery, acute input shortages, double taxation, widespread corruption, market distortions from uncoordinated policies, and the multiplicity of Yemen's institutions. Moreover, reliance on remittances and aid flows, coupled with climate change vulnerability, leaves Yemen exposed to external factors.

In the face of escalating poverty and heightened food insecurity, numerous households, having exhausted traditional safety nets, now resort to dire measures. Since the onset of the conflict, the surge in the cost of basic essential goods, especially food products, has propelled food insecurity to the forefront of concerns in Yemen. Presently, over 17 million individuals are grappling with food insecurity.[10] A mobile phone survey conducted in 2023 revealed that, with limited viable

[9] The Houthis imposed an embargo on IRG oil exports through three drone attacks on Yemeni oil export in the months following the expiration of the UN-sponsored truce.

[10] Yemen Situation Report, WFP, July 2023. Furthermore, on two critical occasions (in late 2018/early 2019 and 2020), specific population segments were categorized under the "catastrophe" classification according to the Integrated Food Security Phase Classification (IPC).

options to navigate adverse shocks, households are now resorting to detrimental coping mechanisms, such as withdrawing children from school (33 percent) or engaging in precarious, high-risk work (19 percent).[11] Furthermore, while child marriage has long been an issue in Yemen, even before the conflict, an alarming three percent of respondents reported cases of female children being married off in the past three months alone as a means to alleviate financial strain.[12]

[11] World Bank. 2023. Monitoring Food Insecurity and Vulnerability in Yemen: Results from the Yemen Mobile Phone Monitoring Survey - Round II. © Washington, DC: World Bank. http://hdl.handle.net/10986/40266 License: CC BY-NC 3.0 IGO.

[12] Child marriage has long been an issue in Yemen, even before the current conflict began. According to the 2013 Demographic Health Survey, 16 percent of women between ages 20–49 were married before age 15. Notably, the survey found the median age of marriage was lower among younger women at the time, potentially signaling improvements in child marriage rates for the future. However, today any progress is likely being reversed, as more families are compelled to marry off their young daughters due to financial desperation amidst the country's dire living conditions (World Bank, 2023).

2

RECENT ECONOMIC DEVELOPMENTS

A Modest Recovery in 2022, Driven by the Non-Oil Sector

Output and Demand

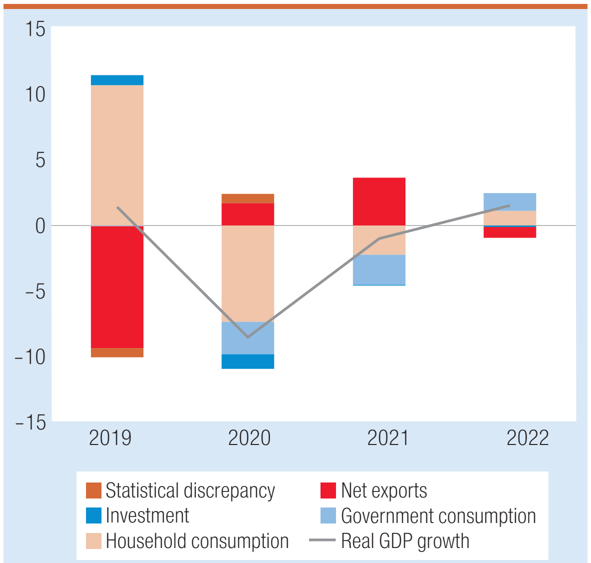
Yemen's economy exhibited a modest recovery in 2022, driven by notable growth in the non-oil sector (Table 1).[13] Following two years of economic contraction, Yemen's real GDP expanded by 1.5 percent in 2022 (Figure 4). This positive development was primarily driven by the non-oil sector, which grew by 1.9 percent in real terms. In contrast, the oil sector faced a significant contraction of 16.5 percent in real terms attributed to the blockade on oil exports, which resulted in average daily total hydrocarbon production (crude oil and LPG) declining from 61,600 barrels in 2021 to 51,400 in 2022 (Figure 5). Growth in the non-oil sector was supported by increased households and government consumption expenditure, contributing 1.1 and 1.3 percentage points, respectively, to overall real GDP growth.[14] Yemen's net trade balance and gross fixed investment negatively impacted overall economic growth during the same period.

Increased remittances and official development assistance (ODA) played a major role in supporting domestic consumption in Yemen. An uptick in economic growth in Gulf Cooperation Council countries (GCC) led to a rise in remittances sent to Yemen, substantially boosting domestic consumption. Overall, official remittances rebounded in 2022, growing by approximately 10.7 percent in nominal dollar terms. According to donor data, ODA grew by 9.7 percent during the same period.

[13] The Central Statistical Office (CSO) has been unable to collect data necessary to update key indicators since before the conflict escalated in 2015. Thus, growth numbers presented in this section have been estimated based on national accounts data provided by the authorities for 2014.

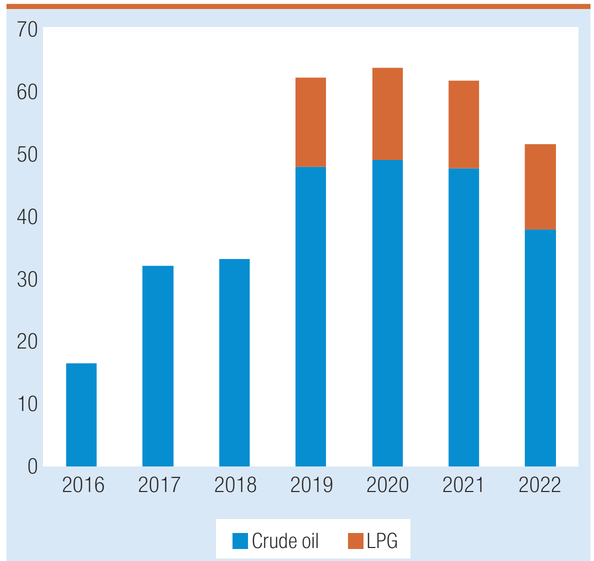
[14] Household consumption is estimated for the entire population of Yemen. Government consumption refers to IRG fiscal expenditure sourced from Ministry of Finance data in Aden.

FIGURE 4 • Real GDP Growth Decomposition
(percentage points)



Source: Yemeni authorities; WB and IMF staff estimations.

FIGURE 5 • Oil Production
(In thousands of barrels/day)



Source: Yemeni authorities; WB and IMF staff calculations.

IRG Fiscal Developments[15]

Despite the oil export blockade in the last quarter of 2022, the IRG managed to increase its revenues during that year. According to World Bank staff estimates based on data from IRG's Ministry of Finance (MOF), total revenues rose to 10.3 percent of GDP in 2022, up from 7.8 percent in the previous year (Figure 6). This revenue increase was primarily driven by oil revenues, which rose to 5.1 percent of GDP in 2022 from 2.7 percent in 2021, reflecting higher prices as well as the adoption of the market exchange rate for oil revenues in January 2022, despite the decline in production.[16] Additionally, grants provided by KSA increased from 0.6 to 1.2 percent of GDP (YER 274 billion in fuel grants for electricity and YER 10 billion in scholarship grants). However, tax revenues slightly decreased to 2.4 percent of GDP in 2022 from 2.8 percent in 2021. Several factors continue to impede tax revenue growth, including applying a below-market exchange rate to customs, low tax collection rates, and a small tax base in IRG-controlled areas.

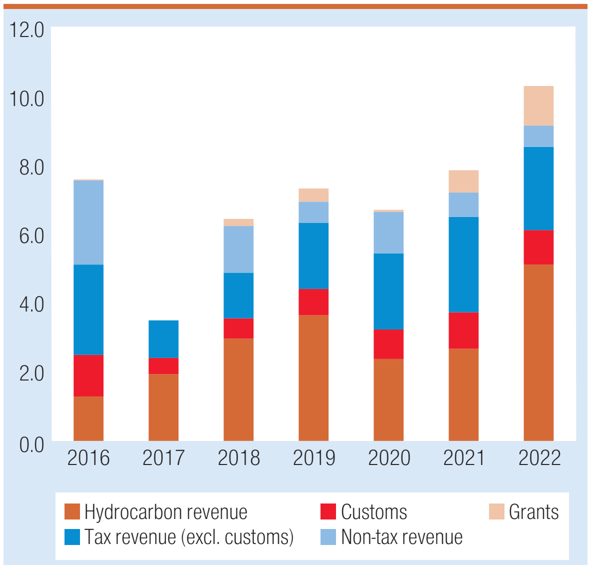
Similarly, fiscal expenditures increased in 2022, propelled by electricity subsidies. Overall, total IRG expenditures rose to 13.1 percent of GDP in 2022, up from 8.8 percent in 2021 (Figure 7). This increase was primarily due to higher current expenditures, with the electricity sector being a significant cost center. The combination of rising global oil prices (Yemen is a net oil importer), below-cost electricity consumer tariffs, and limited collection rates led to a substantial increase in electricity subsidies, reaching as much as 4.0 percent of GDP in 2022 compared to 1.1 percent in 2021.[17] Furthermore, goods and services expenditures and wages and salaries, grew by an additional 0.5 percentage point, reaching 2.2 and 3.5 percent of GDP, respectively. Capital expenditures, in contrast, remained highly constrained, decreasing

15 The following figures only reflect the fiscal position of IRG and do not encompass areas controlled by Houthis, which is understood to operate a balanced cash-based budget system.

16 In January 2022, the authorities adopted the market exchange rate for oil revenues. Before that change in policy, foreign exchange was valued at the official rate of 400 YER/USD, against a market value of 1032.5 YER/USD on average in 2021, meaning a discount of 158 percent.

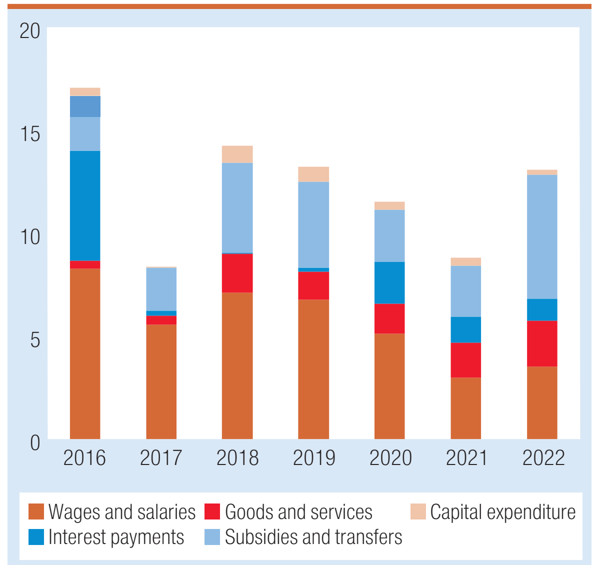
17 Energy subsidies in Yemen place an unsustainable burden on public finances. Yet, international experience has shown that electricity subsidies often benefit wealthier households, distort price signals, foster inefficiency, and facilitate corruption.

FIGURE 6 • IRG Fiscal Revenues
(percent of GDP)



Source: MOF; WB and IMF staff calculations.

FIGURE 7 • IRG Fiscal Expenditures
(percent of GDP)



Source: MOF; WB and IMF staff calculations.

to around 0.2 percent of GDP compared to 0.4 percent of GDP in 2021.

Yemen's public finances went under considerable stress, regardless of the area of control. The country's division between Sana'a and Aden and complex local-level institutional power dynamics added to challenges in managing fiscal policy. Overall, IRG's fiscal deficit expanded to approximately 2.8 percent of GDP in 2022 (on a cash basis), a notable increase from 1.0 percent in 2021. The budget deficit was covered primarily by increased domestic financing through the CBY-Aden.[18] However, it is essential to highlight that this figure does not account for arrears to public contractors. On an accrual basis, the fiscal deficit is expected to be significantly wider. On the other hand, in contrast to the rest of the country, Houthi-controlled areas, which include some of Yemen's major commercial and financial centers, are understood to operate under a balanced cash-based public budget system. Yet, no information is available on Houthi-controlled areas public finances.

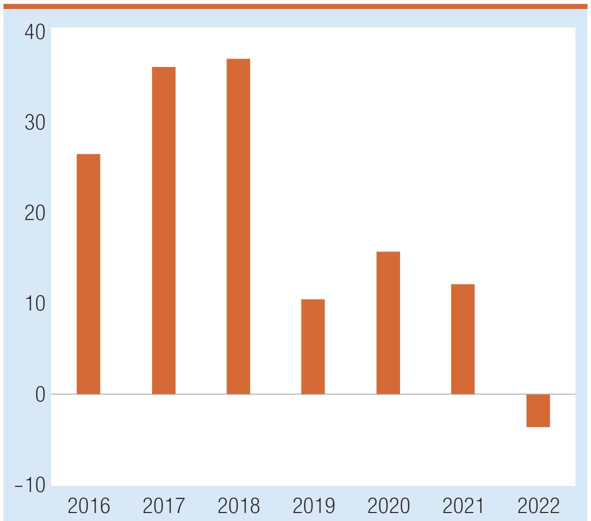
Monetary Developments

The improvements in monetary policy commenced in late 2021 continued throughout 2022. In response to inflation and exchange rate instability in late 2021, IRG officials implemented decisive actions, including introducing a weekly foreign exchange (FX) auction mechanism to improve the efficiency and transparency of CBY FX transactions with the market, as well as the appointment of a new central bank governor. These auctions played a vital role in counteracting inflationary pressures by absorbing liquidity from the market, created when the government's CBY account is credited with oil revenues in local currency. As a result of those measures, money in circulation witnessed a decrease of 3.5 percent in 2022, following a significant 12.1 percent increase in 2021 (Figure 8).

Inflation followed diverse paths across Yemen during 2022. CBY-Aden's measures aimed at stabilizing the exchange rate exerted downward pressure on prices in IRG-controlled areas. Simultaneously, external factors, particularly rising global commodity prices, contributed to increased

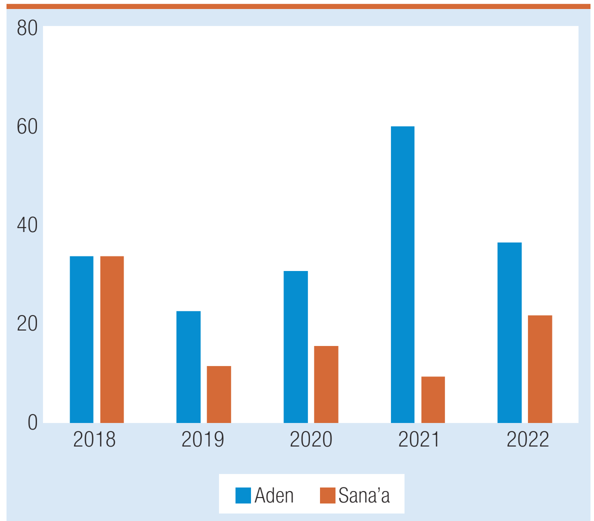
[18] Data from CBY-Aden reveals that claims on the government, which serve as a proxy for the IRG's monetized fiscal deficit, witnessed a substantial increase of 14.6 percent on average in 2022 compared to 2021, despite a decrease in the first quarter of the year.

FIGURE 8 • Money in Circulation
(y-o-y growth rate)



Source: CBY- Aden and WB staff calculations.

FIGURE 9 • Inflation across Yemen
(percentage, period average)



Source: CBY-Aden , JMMI, and WB staff calculations.

domestic prices across Yemen. This dual dynamic led to distinct inflation trends across the country, with inflation in Houthi-controlled areas surging from 9.4 percent in 2021 to 21.6 percent in 2022. In contrast, in IRG regions, it markedly decelerated from 59.8 percent to 36.4 percent (Figure 9). Overall, the inflation rate across Yemen slightly decreased from 31.5 percent in 2021 to 29.5 percent in 2022.

External Accounts[19]

Throughout 2022, Yemen faced significant challenges in its external account, primarily driven by the widening current account deficit due to the increasing domestic demand for costly foreign goods. This deficit expanded from US$3.1 billion in 2021 to US$3.6 billion in 2022, equivalent to 16.5 percent of GDP. This growth was primarily attributed to the escalating trade deficit, which rose from US$11.5 billion to US$13.0 billion, roughly 60 percent of GDP (Figure 10). The increase in imports resulted from factors like the reopening of the Hodeida port[20] and rising food prices. Simultaneously, exports declined, notably oil exports due to the Houthi-imposed blockade.

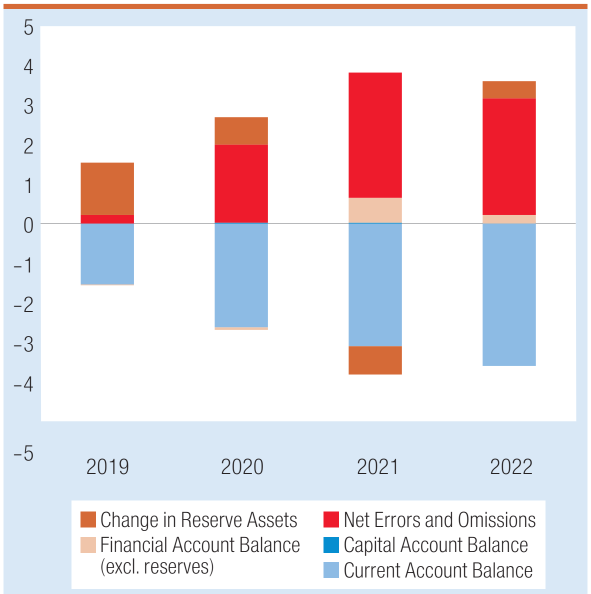
In 2022, Yemen's reserves declined to a level equivalent to a month's worth of imports. Although anticipated one-off FX reserve inflows from KSA and UAE did not materialize during the year, CBY-Aden managed to bolster its liquid FX reserves by converting approximately US$300 million in IMF Special Drawing Rights[21] (SDRs) and liquidating a frozen FX account at the Bank of England. However, the reduction in unofficial transfers weighed on Yemen's balance of payments, with a decrease in net errors and omissions from US$3.2 billion to US$3.0 billion

19 Note that the following figures reflect external accounts for the whole of Yemen.

20 The initial two-month UN-sponsored truce in Yemen allowed 18 fuel ships to enter the ports of Hodeida without inspection by the United Nations Verification and Inspection Mechanism for Yemen (UNVIM). As part of extending the truce for a second time, 18 more tankers were permitted to unload at Hodeida's ports without UNVIM oversight. Additionally, in February 2023, the restrictions on commercial goods coming into the port of Hodeida were relaxed.

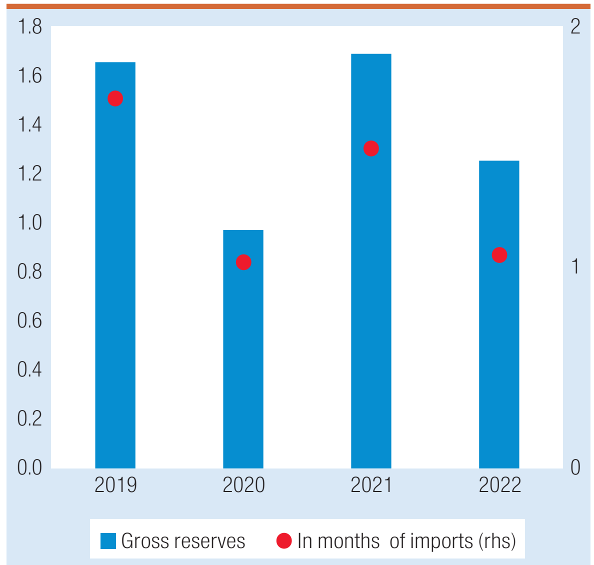
21 In August 2021, Yemen received a significant amount of SDRs 466.8 million (equivalent to US$650 million) as part of the IMF's general SDR allocation in response to the COVID-19 crisis. Subsequently, in November 2022, the IRG converted half of this allocation into US dollars, amounting to approximately SDRs 234 million. This conversion was undertaken to provide funding for CBY-Aden to support its weekly FX auction operations. In June 2023, CBY-Aden acquired a sum of US$187 million through the sale of an additional SDRs 140 million. As of August 31st, 2023, Yemen's SDR holdings were recorded at SDRs 70.6 million.

FIGURE 10 • Yemen's Balance of Payments *(billions of USD)*



Source: CBY- Aden and WB staff calculations.

FIGURE 11 • CBY-Aden Gross FX Reserves *(billions of USD and in months of imports)*



Source: CBY-Aden , JMMI, and WB staff calculations.

in 2022. Moreover, Yemen's net financial and capital account balance experienced reductions. Coupled with a growing current account deficit, this decline pushed CBY-Aden's FX reserves to a month's worth of imports by the end of the year (Figure 11).

Financial Sector

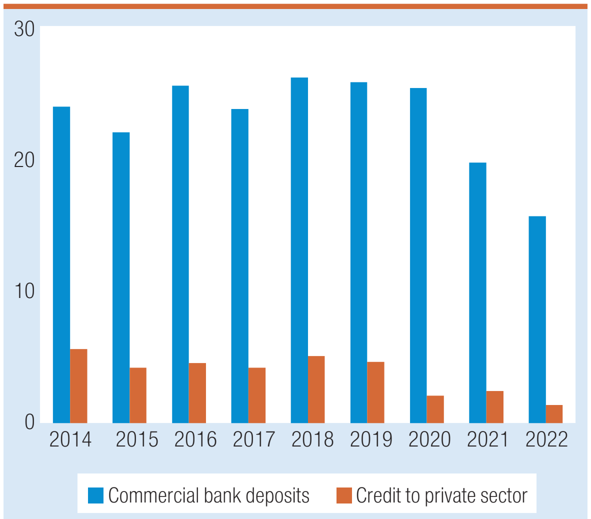
In Yemen, trust in the traditional financial sector remains low, leading to a growing market of unregulated financial service providers. Credit predominantly revolves around government debt instruments, denominated in local currency, which have been in a state of technical default following the conflict.[22] The ongoing economic crisis and rising non-performing loans have further eroded confidence in the formal banking sector. This is evident from the decline in deposits in commercial banks, dropping from 24.0 percent of GDP in 2014 to 15.6 percent by the end of 2022 (Figure 12). Instead, more savers are turning to microfinance services, and exchange and remittance firms have experienced a surge, with the number of such firms growing from 876 in 2017 to 3,244 in 2019.[23] These firms have become unregulated hubs for informal deposits and credit provision, despite some efforts to regulate money exchanges over the past year. Other non-bank financial institutions (such as insurance companies, pension funds, post offices, microfinance institutions, and e-wallet service providers), play a more marginal role in the economy.

The financial sector in Yemen faces challenges arising from divergent regulations and inadequate intermediation of savings into investments, hindering economic growth. The competing authorities, with the Houthis overseeing banks in their territories (including Sana'a, Yemen's

[22] Before the onset of the conflict, approximately 45 percent of the assets held by banks were allocated to government Treasury bills (TBs) to support the financing of the public deficit. However, with the emergence of the conflict in 2015, the CBY (responsible for managing debt and liquidity on behalf of the government) ceased its repayments and servicing of public debt, opting instead to annually roll over all outstanding public debt ever since. The CBY froze the assets of the banking sector that were invested in TBs, compelled banks to reduce their risks and limit credit to the private sector. Furthermore, depositors could not withdraw their savings. These actions triggered a liquidity crisis in the north and eroded trust in the banking sector.

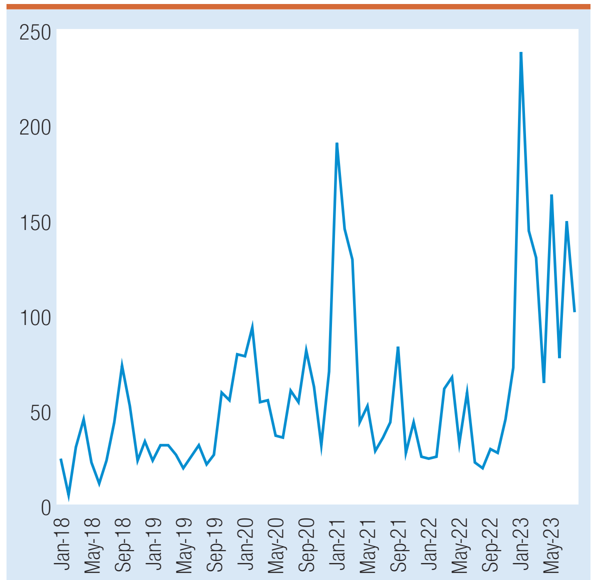
[23] Abdulghani Mohamed Al Samawi et al., "Electronic Payment Services in Yemen: Challenges and Opportunities for Success," Institute of Banking Studies, May 2020.

FIGURE 12 • Commercial Bank Deposits and Credit to the Private Sector *(percent of GDP)*



Source: CBY-Aden and WB staff calculations.

FIGURE 13 • Monthly Protests and Riots (count)



Source: Armed Conflict Location and Event Data Project.

commercial hub) and the IRG in Aden, have created a challenging operating environment. Their contradictory regulations, threats of non-compliance consequences, and complex requirements have increased operational costs, promoted currency speculation, and impeded cross-border transactions. Moreover, the financial sector's capacity to channel savings into investments is hampered by the absence of credit reporting systems, weak legal enforcement, and political instability. Consequently, credit provided by the banking sector to the private sector has dwindled from 5.6 percent of GDP in 2014 to 1.4 percent by the end of 2022 (Figure 12). These challenges have hindered the sector's ability to contribute effectively to economic growth.[24]

Adverse Macroeconomic Developments in 2023

The expiration of the UN-sponsored truce triggered a series of adverse economic events that have significantly and negatively impacted Yemen's economy in 2023 pushing the economy back to a contractionary recession. These include: (1) the blockade of oil exports by the Houthis, resulting in a complete cessation of exports and a sharp drop in oil production (with limited domestic market capacity to absorb the excess supply); and (2) a strategic move to import household butane gas into markets in Houthi-controlled areas, thereby reducing the demand for domestically extracted butane gas (originating from non-Houthi controlled areas). At the same time, a more volatile currency on the Aden FX market, soaring inflation, and escalation in protests and riots are weighing on non-oil activity within the private sector (Figure 13). Considering these events, Yemen's GDP is projected to contract by 0.5 percent in real terms in 2023, following a 1.5 percent rebound in 2022.

Another significant challenge emerged with a notable decline in customs receipts as imports decreased and were increasingly diverted to Houthi-controlled ports, reopened as part of the UN-sponsored truce. Data from the Assessment Capacities Project (ACAPS) Yemen Economic Tracking Initiative reveals a sharp decline in imports

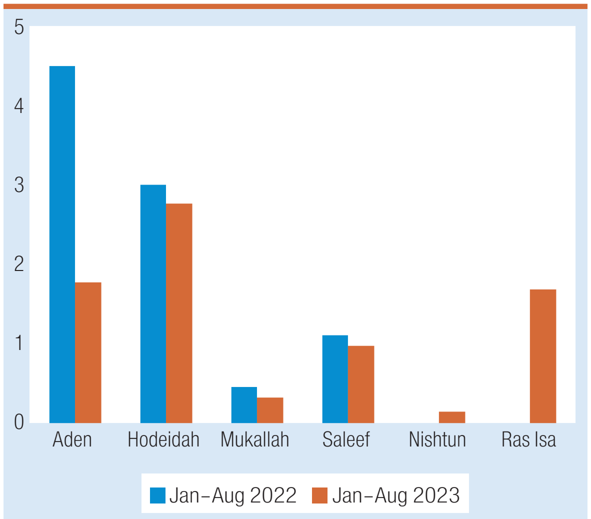
[24] Yemen's banking sector provides limited participation in development and credit to the private sector. As of December 2019, 42 percent of banking sector credit was allocated to import financing, while almost the same percentage of all bank credit portfolios to non-government credit were classified as non-performing loans.

TABLE 1 • Selected Economic Indicators (2018-2022)

	2018	2019	2020	2021	2022
Real Sector			(Annual percentage change)		
Real GDP	0.8	1.4	−8.5	−1.0	1.5
Real GDP per Capita	−1.7	−1.0	−10.6	−3.1	−0.7
Money and Prices			(Annual percentage change, unless stated otherwise)		
Consumer Prices (period average)	33.6	15.7	21.7	31.5	29.5
Aden	33.6	22.6	30.5	59.8	36.4
Sana'a	33.7	11.4	15.6	9.4	21.6
Base Money	28.0	11.5	13.3	13.7	4.4
Exchange rate (YER per US$1, average)	535.9	576.0	743.0	1035.5	1114.3
Exchange rate (YER per US$1, eop)	535.0	612.0	669.0	952.0	1242.0
Central Government Finances (IRG)			(In percent of GDP)		
Total Revenues and grants	6.4	7.3	6.7	7.8	10.3
Commodity Revenues	3.0	3.6	2.4	2.7	5.1
Total Expenditures	14.3	13.2	11.5	8.8	13.1
Current Expenditures	13.4	12.5	11.1	8.4	12.9
Capital Expenditures	0.8	0.7	0.4	0.4	0.2
Overall Fiscal Balance	−7.8	−5.9	−4.8	−1.0	−2.8
Financing	7.8	5.9	4.8	1.0	2.8
External (net)	−0.1	−0.1	−0.3	−0.2	−0.4
Domestic	8.0	6.0	5.2	1.2	3.2
General Government Debt	103.5	106.7	116.0	99.2	83.1
External	40.6	39.8	46.4	48.1	40.5
Domestic	62.9	66.9	69.6	51.1	42.6
External sector			(In percent of GDP)		
Current Account Balance	−1.0	−7.0	−14.1	−17.3	−16.5
Imports, Goods and Services	47.3	54.2	66.8	78.2	70.8
Exports, Goods and Services	8.8	8.7	10.2	13.8	11.1
Hydrocarbon Exports	5.2	5.2	3.4	5.5	4.5
Remittance Inflows	18.3	20.9	25.8	30.2	27.4
Capital Account Balance	0.0	0.0	0.2	0.2	0.0
Net Foreign Direct Investment	−9.1	0.1	0.3	−3.5	−0.9
Net Portfolio Investment	0.0	0.0	0.0	0.0	0.0
Net All Other Flows	−0.1	−0.1	−0.3	−0.2	−0.4
Net Errors and Omissions	1.5	1.0	10.6	17.7	13.5
Other memo items					
GDP nominal in US$ (millions)	21606.2	21887.6	18676.7	17930.1	21912.0
Gross Reserves in US$ (millions)	2983.2	1653.6	969.6	1688.0	1251.0

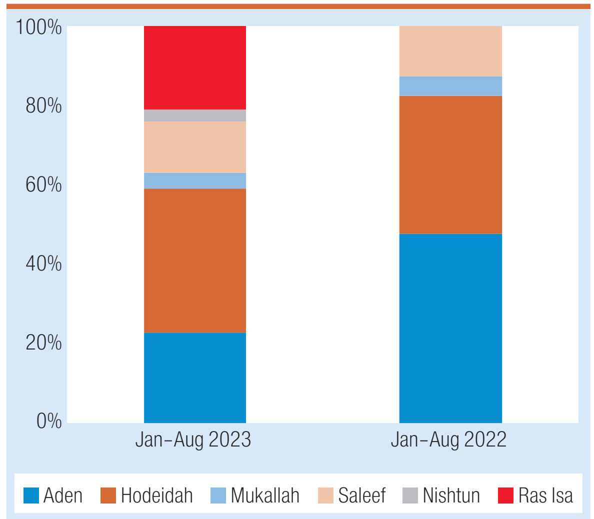
Source: Central Bank of Yemen Aden, Ministry of Finance, and World Bank staff estimates

FIGURE 14 • The Flow of Yemen's Imports of Goods through Ports *(in millions of metric tons)*



Source: ACAPS - Yemen Economic Tracking Initiative.

FIGURE 15 • Share of Yemen's Imports of Goods through Ports *(in percentage)*



Source: ACAPS - Yemen Economic Tracking Initiative.

through the port of Aden.[25] Between January 2023 and August 2023, imports through Aden decreased by 61 percent or 2.73 million metric tons compared to the same period in the previous year (Figure 14). In contrast, imports through Hodeida port experienced a lower decline of 8 percent, amounting to 0.24 million metric tons. Consequently, Aden's share in Yemen's overall imports declined by 25.1 percentage points, dropping from 47.8 percent to 22.7 percent (Figure 15). On the other hand, Hodeida's share of Yemen's imports saw a slight increase of 1.6 percentage points, rising from 34.6 percent to 36.2 percent. Meanwhile, Ras Issa port observed an even more substantial increase of 20.9 percentage points.

The halt of oil exports has exacerbated already high fiscal pressures in IRG controlled areas. Data from the Aden MOF reveals a substantial decline in IRG revenues in the first half of 2023, confirming World Bank staff estimate of a potential 40 percent decrease for the year. This decline is primarily attributed to a substantial drop in revenues from crude oil export due to the ongoing blockade. Additionally, customs revenues are expected to diminish following the shift in import activity away from the port of Aden, despite an increase in the exchange rate used to calculate customs duties on imported goods.[26] In response, the IRG has implemented severe cuts in fiscal expenditures (cash basis), which World Bank staff estimate could reach up to 30 percent in 2023. Key areas of adjustment include reductions in electricity subsidies and spending on goods and services, potentially impacting the quantity, quality, and timeliness of public service delivery. Furthermore, cuts in capital expenditures may have long-term implications for economic growth. Despite these cuts, the fiscal deficit (on a cash basis) is expected to hover around 2.9 percent of GDP in 2023. Financing of this deficit is expected to come from domestic financing via the CBY (as detailed below). Additionally, the recent announcement of US$1.2 billion in budget support from Saudi Arabia, including the recent deposit of US$250 million as the first tranche, could contribute to covering these financial needs.[27]

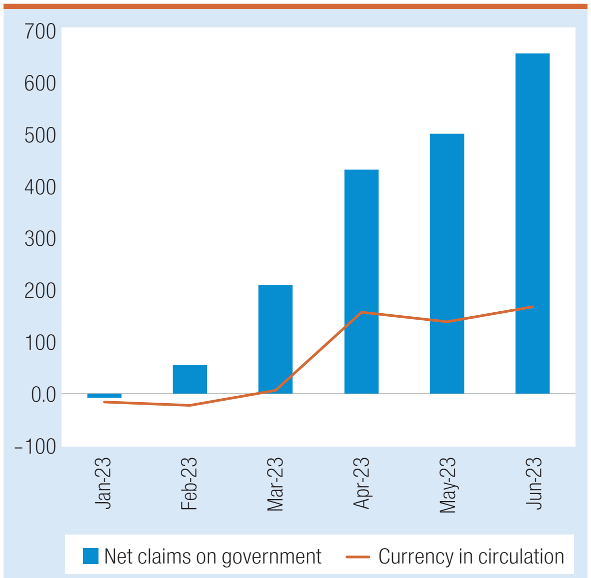
With limited avenues for increasing revenues or cutting expenditures, IRG has resumed monetizing its fiscal deficit through withdrawals from its overdraft facility at CBY-Aden, lead-

25 ACAPS, "Imports", YETI | Yemen Economic Tracking Initiative, accessed on September 10th, 2023.

26 At start-2023, the IRG raised the USD exchange rate used to calculate customs duties on imported goods from YER 500 to YER 750 per US$1. Nonetheless, the rate remained below the YER's Aden market exchange rate.

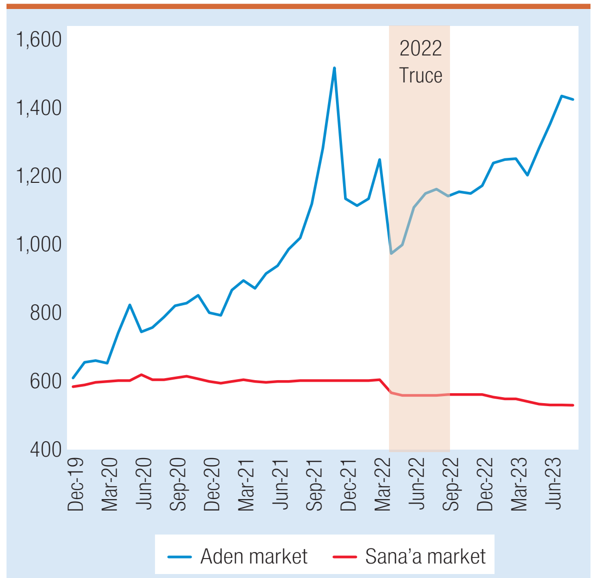
27 https://press.un.org/en/2023/sc15383.doc.htm.

FIGURE 16 • Net Claims on Government and Currency in Circulation *(billions of YER)*



Source: CBY-Aden and WB staff calculations.

FIGURE 17 • Exchange Rate Trend: Sana'a and Aden *(YER per US$1)*



Source: Telegram Exchange Market Group and WB staff calculations.

ing to an uptick in the money supply (Figure 16). According to data from CBY-Aden, claims on the government, which serve as a proxy for the IRG's monetized fiscal deficit, have surged by 10 percent in the first half of 2023. Consequently, currency in circulation witnessed a 5 percent increase during this period, rebounding from a 3.5 percent decrease in 2022. Nevertheless, the impact of this upsurge in monetary financing on the money supply has been partially offset by FX auctions, which helped absorb a portion of the resulting excess liquidity.[28]

Additionally, the blockade of oil exports has widened the current account deficit, heightened external pressures, and led to a loss of confidence in the currency on the Aden market. The current account deficit is estimated to reach 21.8 percent in 2023, up from 16.5 percent in 2022. In addition, the halting of oil exports has limited FX receipts, threatening the overall level of reserves, which is anticipated to reach less than a month's worth of imports in 2023. At the same time, confidence in the currency has been eroding. As of end-August 2023, the YER depreciated to YER 1,418 per US$1 on the Aden market, returning to end-2021 levels (Figure 17). Meanwhile, the YER appreciated slightly on the Sana'a market. While the downward trend on the Aden market initially began in mid-April 2023, possibly due to a drop in remittance inflows following the end of Ramadan,[29] the trend accelerated on June 8th after a statement by government officials regarding declining CBY FX reserves.

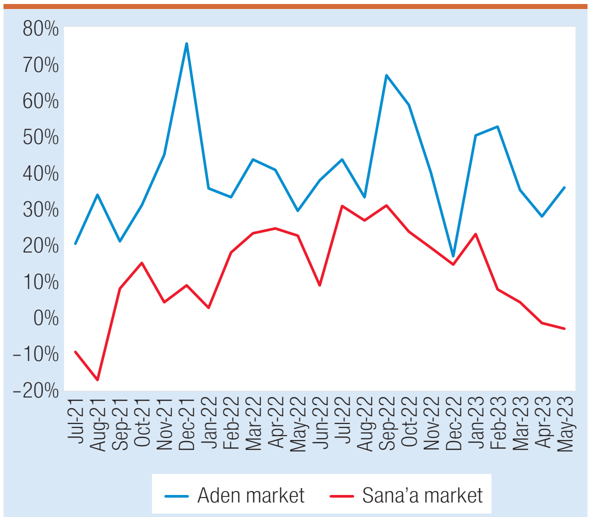
Inflationary dynamics have continued to diverge significantly across regions in 2023, reflecting the distinct impacts of Yemen's bifurcated macroeconomic policies. Notably, Sana'a has witnessed a sharp reduction in consumer price inflation during the first seven months of 2023, averaging around 2 percent, compared to 21.6 percent in 2022.[30] This reduction can be attributed to a relatively

28 In 2022, the FX auction did not counterbalance the deficit financed by money, as the government received local currency in exchange for FX obtained from oil exports. However, with the suspension of oil exports due to the blockade, the market has been supplied with FX from existing reserves and foreign FX assistance. This action has helped absorb excess liquidity and restrain to some extent the expansion of the money supply.

29 According to ACAPS (2021), Ramadan is typically the peak time for remittances to Yemen.

30 The REACH Joint Market Monitoring Initiative's Survival Minimum Expenditure Basket survey is used as a proxy to a CPI basket.

FIGURE 18 • Inflation Rate in Aden Versus Sana'a



Source: Reach JMMI and WB staff calculations.

steady money supply and the base effects of the commodity price shock in 2022. Conversely, inflation in Aden has remained elevated, at around 35 percent during the first seven months of 2023, compared to an average of 36.4 percent in 2022 (Figure 18). This situation can directly be linked to the significant depreciation of the YER in 2023, as mentioned earlier.

In March 2023, the Houthis enacted a law banning "usury transactions" within their controlled regions. The law, effective immediately, aims for a complete overhaul of the commercial banking sector practices to align with Sharia principles. It consists of thirteen articles that prohibit both commercial and financial usury. The introduction of this new law may pose risks to the stability of the local currency and potentially disrupt banking operations, particularly trade financing, lead to a fragmentation of the banking and financial sector in Yemen, reduced financial inclusion, limited access to credit, especially affecting SMEs and low-income households, and a reduced capacity for the CBY's to utilize monetary policy tools, complicating efforts to manage inflation and liquidity.[31]

Uncertain Outlook, High Risks

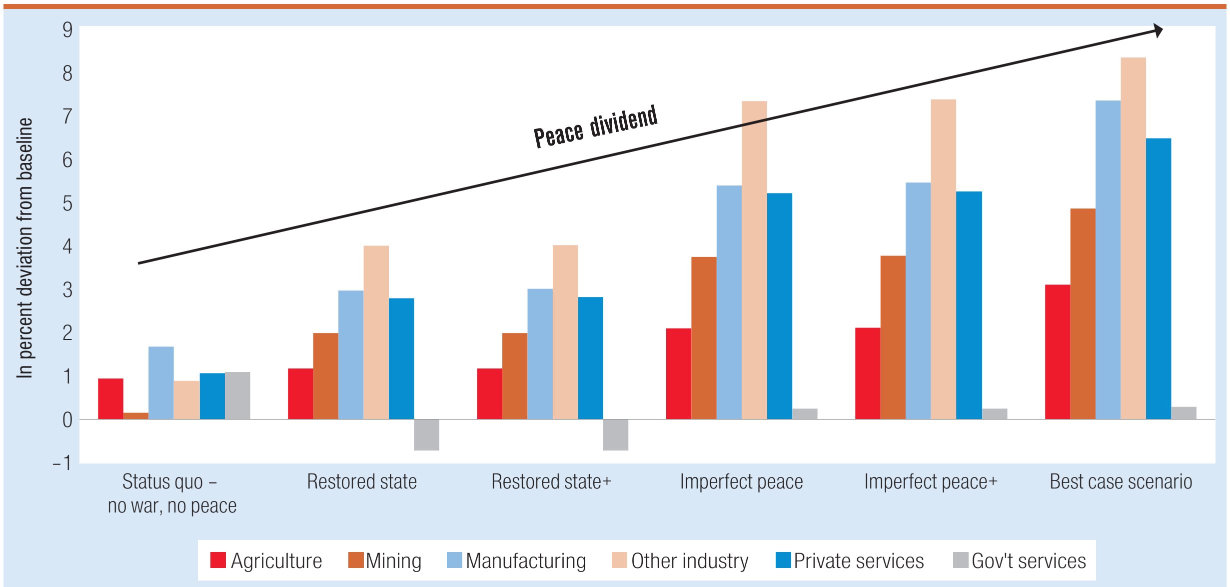
The economic outlook for 2024 remains highly uncertain, given the oil export constraints and ongoing truce negotiations. Economic stability in the short run hinges heavily on predictable and sustainable hard currency inflows and political/military developments. Should a lasting truce or peace arise, Yemen's economy could resume growth within months of such an agreement, driven by an expected rapid rebound of transport, trade, financial flows, and reconstruction financing. Over the medium term, growth is conditional on a peace agreement, prudent policymaking, and a robust reform and recovery effort backed by international reconstruction financing. Ensuring that this growth trickles down to the most vulnerable will require sustained investments in human capital that has been severely impacted by many years of protracted conflict.

Despite some positive developments, risks to Yemen's economic outlook remain high. The recent rapprochement between regional powers marks a significant step towards alleviating longstanding regional tensions that have hindered Yemen's development prospects. Additionally, the ongoing negotiations between KSA and the Houthis could change the dynamics on the ground, laying the groundwork for recovery. However, risks persist, including the potential resurgence of hostile activities triggered by regional or domestic tensions, new adverse terms of trade shocks, and new natural disasters posing a significant threat to Yemen's fragile economy. Most significantly, the reduction in humanitarian aid will result in significant increases in the prevalence of the food poor. Moreover, policy inaction due to political gridlock among various parties remains a paramount risk. It could potentially yield adverse repercussions on the fiscal front, particularly considering the sluggish momentum of reforms. Such inaction might lead to an escalation in monetary financing, which in turn could exacerbate inflationary pressures. Maintaining a sustained focus on monetary and macroeconomic stability while strengthening policy and institutional capacity can help improve the immediate macro prospects.

Moving forward, the future scenarios for Yemen can be envisioned based on different trajectories of the conflict and post-conflict environ-

[31] See the communique sent to Sana'a by the Yemen Banking Association, the Chamber of Commerce and Industry, and several business consortiums.

FIGURE 19 • Projected Sectoral GDP Growth by Scenario



Source: Yemen CEM (2023).

ments. The World Bank's recent Yemen CEM provides insights into various recovery scenarios, considering different political, institutional, and economic dynamics. The "Status Quo/Base" scenario depicts a continuation of the war with a similar trajectory to the past eight years, with violence fluctuating. The "No War, No Peace/Limbo" scenario envisions a decline in conflict intensity, possibly due to a ceasefire, but without a political settlement. Alternatively, the "Restored State/Limited Recovery" scenario entails authority consolidation around a single centralized set of state institutions. On the other hand, the "Imperfect Peace/Enhanced Recovery" scenario envisages a possible political settlement based on power-sharing, agreed upon by national elites. Each of these scenarios represents potential pathways for Yemen's future. Which pathway the Yemenis choose will crucially determine social and economic outcomes.

Crucially, achieving peace holds substantial dividends for Yemen's economy and its people. Economic projections from the above scenarios reveal that shifting from lower to higher recovery scenarios yields remarkable peace dividends. For instance, in the enhanced recovery scenario, GDP growth can reach up to three times the levels observed in the "status quo/base scenario," with an expected average growth of 6 percent through 2030. This would permit a rapid increase in overall real GDP in Yemen by one-third over the next six years, translating into major increases in employment, incomes, and a reduction of poverty for the Yemeni people. Moreover, other than in the "status quo/base scenario," gains in productivity, driven by improved security and policy changes, have an almost immediate effect in boosting GDP across all sectors in all scenarios (Figure 19). These productivity gains also boost income levels, generating higher household consumption, savings, private investment, exports, and imports, with the investment increases feeding back to higher growth.

However, realizing the peace dividend will require extensive efforts from the authorities and the international community. While a comprehensive peace agreement is vital for Yemen's growth, addressing immediate financial needs, capacity gaps, and macroeconomic imbalances is equally crucial. As such, maintaining a robust dialogue and effective coordination of foreign financing commitments emerges as a key factor in enhancing Yemen's economic stability in the short to medium term. Moreover, ongoing reform efforts, including those through the AMF-supported reform program, play an essential role and could provide a well-developed gateway for a broader economic recovery agenda. This recovery agenda could potentially extend to involve official multilateral and bilateral donors, helping Yemen tackle debt challenges, including recurrent arrears, and lay a robust and resilient economic foundation supported by much larger financial assistance for economic reconstruction from the international community. Such a foundation would enable the country to withstand future shocks and effectively meet the needs of its citizens. This collaborative approach with various stakeholders will be instrumental in shaping Yemen's path toward post-conflict economic prosperity and sustainable development.

3

PEACE DIVIDENDS AND THEIR DISTRIBUTION ACROSS YEMEN: EVIDENCE FROM THE TEMPORARY 2022 CEASEFIRE

Over the span of six months in 2022, a UN-sponsored ceasefire was in effect. Our analysis, using innovative night-time light (NTL) emission data at the governorate level as a proxy for economic activity[32] *reveals the following findings: (1) at the national level, economic activity sharply increased during the temporary ceasefire but contracted even more starkly once the ceasefire lapsed; and (2) both the gains and losses were significantly more pronounced in areas under Houthi-control, likely reflecting the fact that the ceasefire provided these areas with critical access to imports, including oil from the rest of Yemen. While short-term gains were evident during the truce, achieving Yemen's long-term prosperity depends on resolving political disputes that have fractured the economy along regional lines. Ultimately, the findings suggest that a decentralized model could facilitate recovery if stability is achieved after a political resolution.*

In April 2022, Yemen experienced a six-month UN-brokered truce between IRG and Houthis after years of conflict. Although the truce brought about economic opportunities and temporary relief for civilians, it failed to result in a lasting

[32] Studies have validated satellite NTL data as a useful proxy for tracking economic growth when statistics are limited, as greater nighttime illumination corresponds to higher production, consumption, and GDP growth (see Henderson, Storeygard, and Weil. Measuring economic growth from outer space, 2011). However, factors like power shortages can complicate measurement (see Bundervoet, Maiyo, and Sanghi. Bright lights, big cities: Measuring national and sub-national economic growth in Africa from outer space, with an application to Kenya and Rwanda, 2015). With appropriate caution, changes in NTL indicate shifts in production, consumption, and overall GDP. This offers empirical insights into Yemen's economic patterns amidst data scarcity.

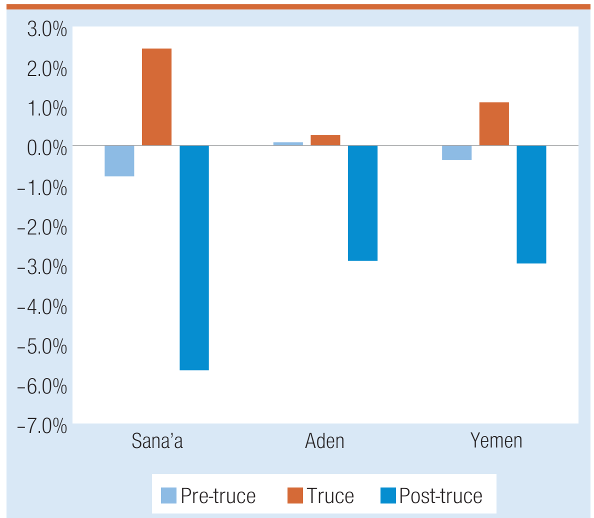
political resolution due to underlying disputes over revenue sharing, public salary payments, and other deep-rooted issues. As the truce expired in October 2022, new economic dynamics emerged, starting with the Houthis attack on al-Dhabba oil terminal in Hadhramaut province in late November, disrupting crude oil exports and choking state revenues.

This special focus note utilizes NTL satellite data to examine economic trends surrounding Yemen's 2022 temporary ceasefire. By assessing NTL emissions, we gain insights into how Yemen's economy responded during and after the truce. Comparing NTL-based trends in measures of economic activity before, during, and after the truce allows us to understand whether reduced hostilities facilitated a tentative economic recovery and how economic activity performed after the truce amidst resumed pressures. Leveraging NTL data is crucial as traditional statistics on economic activity face limitations in analyzing Yemen's economic patterns.

The empirical analysis of NTL data at the *national level* reveals that economic activity sharply increased during the temporary ceasefire but contracted even more starkly once the ceasefire lapsed. The Yemen NTL-based GDP index indicates significant economic expansion during the 2022 UN-sponsored truce, with an average monthly growth rate of 1.1 percent from April 2022 to September 2022. This contrasts with the average monthly contraction of 0.4 percent in the year preceding the truce. However, in the two months following the truce's expiration (November-December 2022), Yemen's aggregated NTL-based GDP index contracted at an average monthly pace of 3.0 percent, erasing the gains made during the truce period (Figure 20).

Overall, the findings confirm that temporary ceasefires can lead to short-term economic gains. Yet, unlocking a sustainable peace dividend requires a lasting political agreement. The 2023 World Bank CEM underscores that a peace deal could result in significant economic benefits, including an increased real GDP growth rate (refer to Section 2.3 Uncertain Outlooks, High Risks). However, realizing these gains hinges on addressing conflict-related issues comprehensively and implementing economic reforms alongside capacity building to stabilize fiscal conditions, enhance governance, and foster private sector growth. Without a concerted effort toward political and economic reconstruction, growth prospects will remain limited.

FIGURE 20 • The Heterogeneous Gains and Losses from the 2022 Temporary Ceasefire across Regions *(average growth in estimated national GDP Index)*



Source: WB staff calculations.

The analysis of NTL data at the governorate level further reveals that both the gains and losses were significantly more pronounced in areas under Houthi-control, likely reflecting the fact that the ceasefire provided these areas with critical access to imports, including oil from the rest of Yemen. In Houthi-controlled areas, the monthly expansion during the truce stood out significantly at 2.5 percent. Conversely, these same areas also experienced a more pronounced contraction of 4.9 percent in the two months following the ceasefire's expiration. This likely reflects the significance of the ceasefire in granting these areas critical access to imports, including oil from the rest of Yemen. For instance, in Sana'a, a Houthi-controlled region, the monthly growth plummeted sharply from 2.4 percent during the truce to an alarming –5.7 percent post-expiration. In contrast, Aden's monthly growth declined from 0.3 percent during the truce to –2.9 percent after the ceasefire's expiration.

Overall, the results underscore Yemen's economic fragmentation along conflict lines. The variance in governorate-level economic performance during and after the 2022 truce reveals significant fragmentation, with Houthi-controlled areas experiencing more pronounced contractions after the truce's expiration compared to IRG regions. A similar result was observed in the CEM report's longer-term analysis when comparing the pre- and post-2014 conflict, indicating a slower recovery in Houthi areas, likely attributed to differences in governance capabilities and access to hydrocarbon resources.

Moving forward, data and lessons from other post-conflict contexts suggest that implementing a decentralized governance model could be pivotal in empowering economic recovery across Yemen's regions. Yemen has undergone a de facto, unmanaged localization process during the years of conflict that is unlikely to be reversed. A decentralized approach post-conflict, building on this emergent reality, could empower governorates to rebuild based on local strengths. By providing greater policy autonomy within a unified framework, this approach can catalyze growth driven by area-specific resources. However, successful decentralized recovery requires first restoring stability after years of division. Relevant international examples demonstrate that embracing proper localization, rather than attempting to reverse it, can facilitate reconstruction in a post-conflict environment. Ultimately, Yemen's governance model should align with and leverage its transformed political economy while promoting national reconciliation.

To fully harness the potential benefits of decentralized recovery, targeted policies, and coordination are essential to avoid exacerbating divisions. Achieving an appropriate balance between national and local governance will be crucial. An inclusive model could empower greater accountability of local authorities to their constituencies by giving them more autonomy over local affairs. While the central state should coordinate key monetary and fiscal policies to ensure macroeconomic stability, certain aspects, such as the management of fuel subsidies and public sector salaries, should remain handled nationally. With adequate central coordination, decentralized flexibility would allow governorates to tailor public investment, service delivery, regulatory policies, and capacity building to suit their local economic conditions and priorities. When coupled with national reconciliation efforts, this balanced localization model could foster inclusive growth across Yemen's heterogeneous regions. However, if the model implemented is unbalanced, with inadequate revenue sharing and coordination on national priorities, it risks exacerbating regional inequalities and threatening stability.

THE WORLD BANK
1818 H Street, NW
Washington, DC 20433