



## Public Debt in Yemen “Debt Restructuring or Default”

### INTRODUCTION

First of all, I would like to extend my warmest wishes and congratulations on the occasion of the Holy Month of Ramadan to all people of the Arab and Islamic nations and people interested in the development situation in Yemen, particularly readers of the Yemen Socio-Economic Update. May this Holy Ramadan bring prosperity, security and stability to Yemen.

This issue highlights the topic of public debt, which has been excessively relied on to finance the chronic gap in the public budget over the past years, reaching a peak (YR 906.4 billion or 15.4% of GDP) in 2015. The outstanding balance and burden of the public debt has grown to alarming levels, thereby hindering economic growth and development and placing heavy burden on the current and future generations.

The accumulating balance and burden of public debt has become a black hole that swallows the state's public resources and crowds out the private sector in the resources available for investment. Most of the new lending is used to pay off the principal and interest of the public debt instead investing in social and development projects. For example, interest payments on public debt accounted for 70.7% of the overall budget deficit financing resources in 2015, and 30.7% of the total public expenditure.

Despite the several risks associated with the accumulating balance and burdens of the domestic and external debt, the most risky thing is resorting to inflationary financing policy to finance the budget deficit through overdraft from the CBY, which undermines the economic stability. To rescue the economy from the inflationary financing risks, this edition provides a package of priorities, mainly the resumption of oil and gas exports, lifting the suspension of donor support, and restructuring the domestic and external public debt.

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Minister of Planning and International Cooperation

### FACTS AND FIGURES

- The public budget's financing gap is estimated at \$5.8 billion in 2016, apart from the reconstruction needs.
- The decline in GDP is estimated at 34.6%, and the inflation rate rose by over 30% in 2015.
- The exchange rate in the parallel market has fluctuated at around YR300/USD in May 2016, compared to YR225/ USD in May 2015.
- Power supply through the public grid has been totally suspended in Sana'a and several other governorates for about 9 months.
- Fuel imports covered 86%, 15%, and 8% of the local market needs during January, February and March 2016 respectively (OCHA, Shipment Snapshot, April 2016).
- 14.4 million Yemenis are food insecure (over 50% of the population). (FAO, Situation Report-Yemen, May 9, 2016).
- 21.2 million Yemenis (82% of the population) are in need of humanitarian assistance, including 9.9 million children, and 2.7million IDPs (31% children) (UNICEF, SitRep, May, 2016).

### HIGHLIGHTS:

- The total public debt has increased significantly in 2015 by 17.3% - from YR4,737 billion (equivalent to \$22.1 billion) in 2014 to YR5,564 billion (about \$25.9 billion) in 2015.
- The demand for treasury bills and government bonds, as well as the issuance of Islamic Sukuk, decreased in 2015 compared to 2014. Accordingly, the government debt to the CBY rose to 35% of the total domestic debt. To avoid the inflationary risks of this type of financing, real resources should be mobilized through the resumption of crude oil and gas production and exports, as well as donor support.
- In 2015, commercial banks were reluctant to increase their treasury bills' investments due to the decline in real interest rates on treasury bills and banks' need for liquidity to meet the requests of their clientele.
- The outstanding external debt stock declined from \$7.26 billion in 2014 to \$6.88 billion in 2015 due to the suspension of external loans and the repayment of the external debt service.
- The disbursement of external loans declined from \$550.9 million in 2014 to \$63.3 million in 2015, by about 88.5%, due to the suspension of donor support and the challenges encountered in the implementation of social and development projects.
- The public debt as a percentage of Gross Domestic Product (GDP) reached alarming levels of 94.4% in 2015, exceeding the safe limits of 60%. The public debt service (principal and interests) constituted 64.2% of the total public revenues and 34.6% of the total public expenditures in 2015. This means that the public debt burden has exceeded the safe limits (25%). Accordingly, the public debt service has taken more than the social expenditures (education, health, social protection and water).
- Payments of interests and principal of the external debt amounted to \$350.9 million, while the external loan disbursement reached only \$63.3 million in 2015. Service payments are expected to reach \$406 million in 2016. The scarcity of foreign exchange at present makes it necessary to mobilize external funds to repay the external debt service or to negotiate with the external creditors (especially countries and organizations that have suspended support to Yemen) to postpone the repayment of external debt to the post-war period.

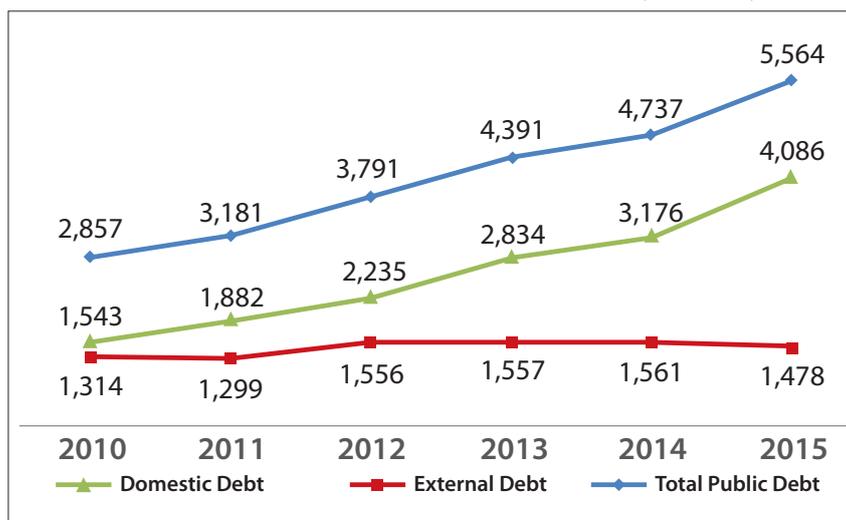
## First: Public Debt Trends

### 1- Total Public Debt Trends:

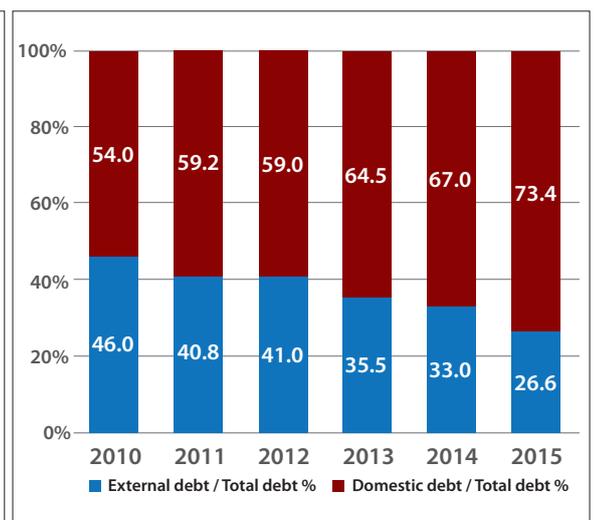
The total public debt outstanding (domestic and external) increased at an average annual growth rate of 13.5% during 2010-2014. However, the total public debt has increased significantly in 2015 by 17.3%, from about YR4,737 billion (*equivalent to \$22.1 billion*) in 2014 to YR5,564 billion (*about \$25.9 billion*) in 2015. This is due to the increase in the domestic debt only because the external debt has declined due to the suspension of external loans disbursement and the repayment of the external debt service.

As for the public debt structure, the domestic debt had been increasing year after year, reaching a peak of 73.4% of the total public debt in 2015. This is due to the growing reliance on domestic debt to finance the public budget deficit, since the domestic borrowing procedures are easier compared to conditions of the external borrowing, which requires complicated procedures, including the endorsement of the parliament and the necessity to use external loans to finance investment projects.

Outstanding Domestic and External Debt (Billion YR)



Structure of Public Debt %

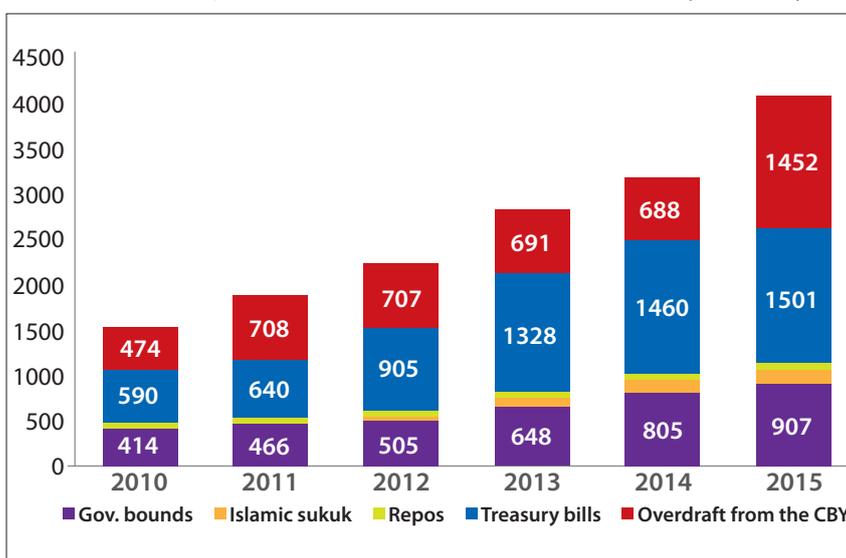


### 2. Domestic Debt Trends:

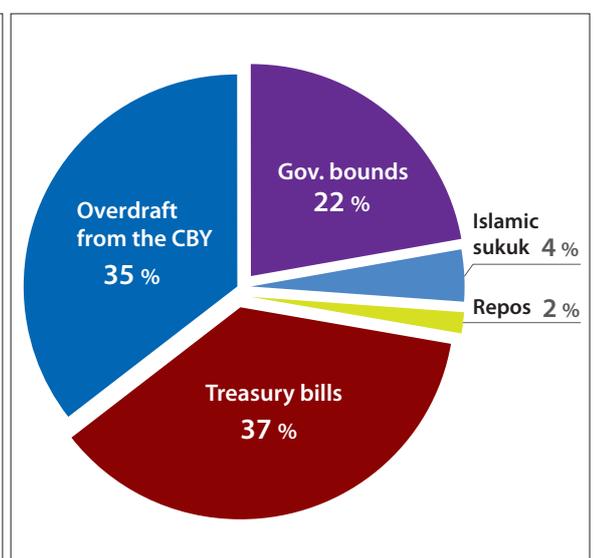
The public budget has been facing difficulties and challenges since 2009, thereby exacerbating the public budget deficit during most of the subsequent years. The public budget's net deficit is financed through the domestic debt that rose by about 20.1% during 2010-2014. The net deficit exceeded the safe limits of 15.4% of GDP in 2015. Therefore, the outstanding domestic debt increased by about 28.7% during the same year, reaching alarming levels.

Treasury bills, government bonds and Islamic Sukuk, as well as overdraft from the Central Bank of Yemen (CBY) are instruments of the domestic debt. The two figures below indicate the evolution of the outstanding domestic debt (accumulative) based on the debt instruments, as well as the domestic debt structure.

Outstanding Domestic Debt by Debt Instruments (Billion YR)



Structure of Domestic Debt in 2015

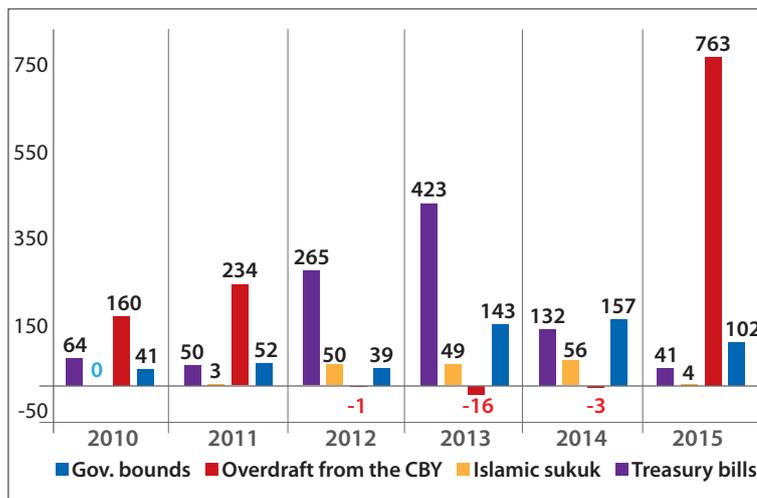


Each column in the figure below shows the amount contributed by each instrument of the domestic debt in financing the budget's net deficit each year during the period 2010-2015. The budget deficit has increased significantly (YR 906.4 billion) in 2015. However, the demand for treasury bills and government bonds has decreased compared to the preceding years. Similarly, the issuance of Islamic Sukuk has declined<sup>(1)</sup>.

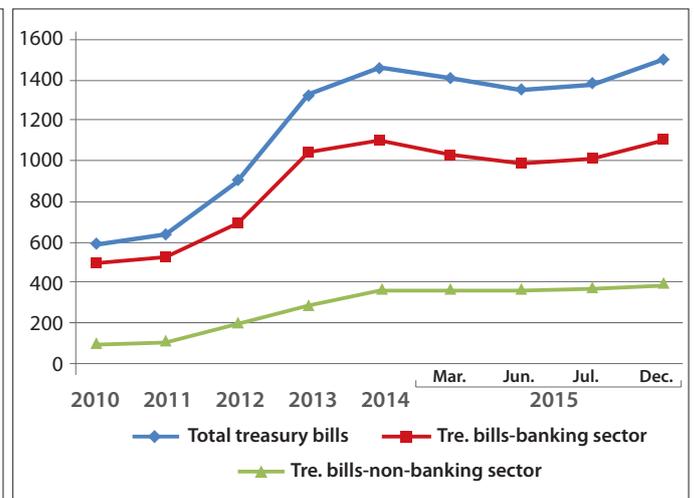
Therefore, the budget deficit was funded through overdraft from the CBY by 84% of the total deficit in 2015. The overdraft from the CBY represents increasing of the money supply and so poses several threats to the economic situation: mainly, the increase in pressure on the balance of payments, decline in the value of the national currency, higher inflation levels and lower living standards and increase in the public debt burdens. This makes it imperative to accelerate the mobilization of the real resources necessary to fund the inevitable expenditure, most notably the resumption of crude oil and gas production and exports.

Treasury bills are considered a secured investment that offers high yields (*The nominal interest rate is about 16%*). This makes them attractive to investments of commercial banks, which increased their demand for treasury bills year-after-year and taken around 80% of the total value of treasury bills during 2010-2014. In 2015, banks sold part of their financial assets of treasury bills during the 1st half of the year. By the end of 2015, the value of the banks' treasury bills remained the same as in 2014. This indicates the reluctance of banks to increase their treasury bills' investments due to the decline in real interest rate on treasury bills and banks' need for liquidity to meet the requests of their clientele. This has exacerbated the difficulty of financing the budget deficit from real sources.

Contribution of Domestic Debt Instruments in financing Net Budget Deficit (billion YR)



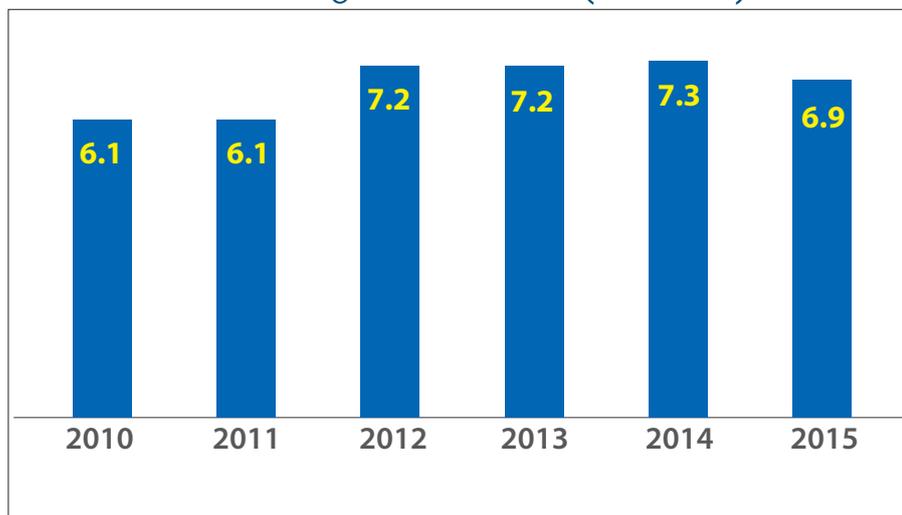
Treasury Bills (Billion YR)



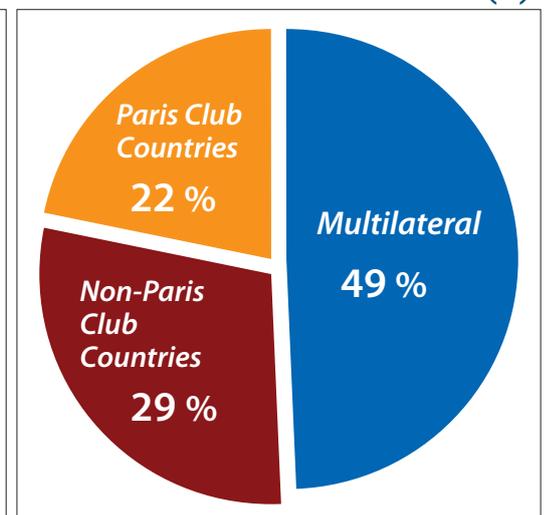
### 3. External Debt Trends:

The outstanding external debt declined from \$7.26 billion in 2014 to \$6.88 billion in 2015 due to the suspension of external loans and the CBY's payment of the debt service due on the external debt. The figure below indicates that Yemen's external debt is relatively stable and is mainly in the form of concessional loans. According to the External Debt Law, external loans should be directed toward investment projects rather than current expenditures. This makes them more rewarding than the domestic debt with high interest rates, which isn't necessarily directed toward development projects.

Outstanding of External Debt (billion USD)



Structure of External Debt in 2015 (%)

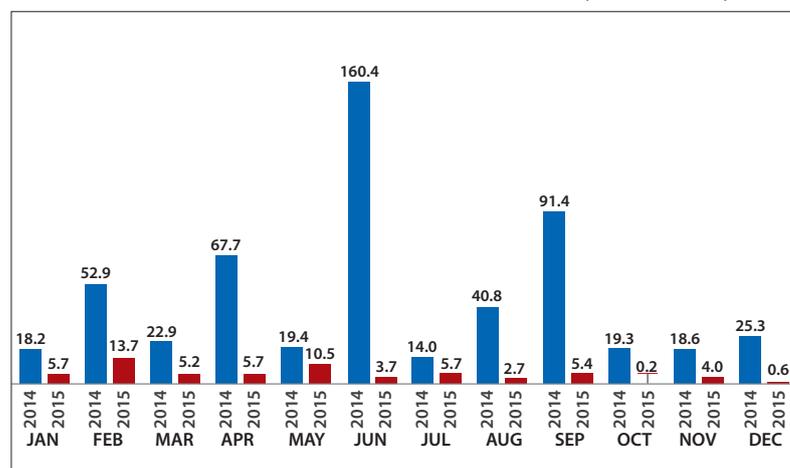


(1) Islamic bank are currently demanding the CBY to absorb their excess liquidity by issuing Islamic sukuk to finance some projects in the public budget or enable them to participate in financing fuel imports, for example.

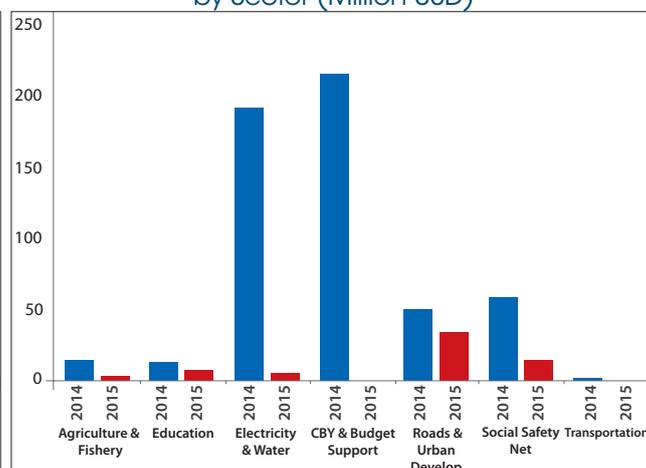
## 4-Disbursement of External Loans:

According to the data base of the CBY, The disbursement of external loans declined from \$550.9 million in 2014 to \$63.3 million in 2015, by about 88.5% due to the suspension of the donor support, and the challenges encountered in the implementation of projects, mainly the lack of security in some areas, fuel crisis and scarcity of material inputs for construction projects, such as cement. The suspension of donor support included even the basic social programs such as the elementary education, reproductive health and the social safety net. This has had a negative impact on the various social groups, without exception, in Yemen.

Monthly Disbursement of External Loans (Million USD)



Disbursement of External Loans during 2014-2015 by Sector (Million USD)



## Second: Public Debt Burden

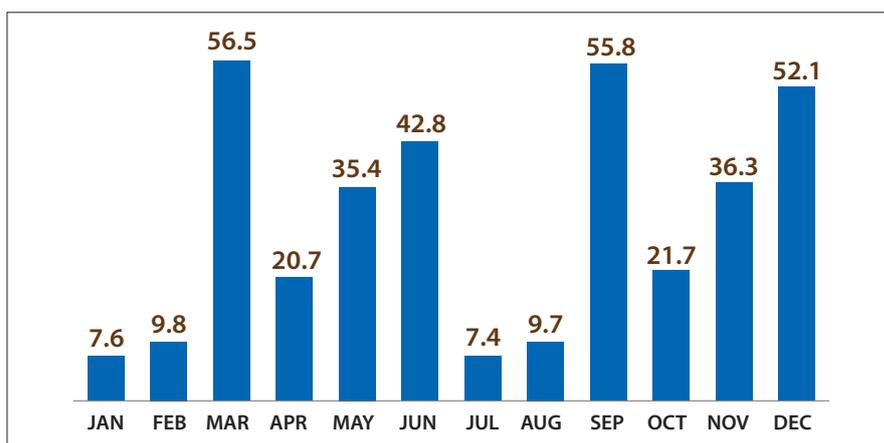
The economic and fiscal burden of the public debt is measured through several indicators that reflect the extent of the economy's ability to withstand the debt and assist in monitoring the risks of financial solvency and liquidity associated with the public debt. By calculating the most important indicators in the table below, it's noted that:

|  | 2010  | 2011  | 2012  | 2013  | 2014  | 2015  |
|--|-------|-------|-------|-------|-------|-------|
| <b>Public Debt %</b>                       |       |       |       |       |       |       |
| Total Public Debt/GDP                      | 42.5  | 47.8  | 55.0  | 58.7  | 65.0  | 94.4  |
| Total Public Debt/Budget Revenue           | 156.5 | 180.5 | 151.7 | 201.2 | 207.1 | 523.6 |
| Public debt service / GDP                  | 3.2   | 4.3   | 6.8   | 7.1   | 8.2   | 11.6  |
| Public debt service / Budget Revenue       | 11.7  | 16.4  | 18.7  | 24.3  | 26.2  | 64.2  |
| Public debt service / Budget Expenditure   | 10.2  | 13.8  | 16.6  | 18.8  | 22.9  | 34.6  |
| <b>Domestic Debt %</b>                     |       |       |       |       |       |       |
| Domestic Debt/GDP                          | 22.8  | 28.3  | 32.5  | 38.0  | 43.5  | 69.3  |
| Domestic Debt/Budget Revenue               | 83.9  | 106.8 | 89.8  | 130.1 | 138.7 | 384.6 |
| Domestic debt service / GDP                | 2.2   | 3.3   | 5.8   | 6.1   | 6.9   | 10.0  |
| Domestic debt service / Budget Revenue     | 8.0   | 12.4  | 16.0  | 21.0  | 22.1  | 55.5  |
| Domestic debt service / Budget Expenditure | 7.0   | 10.4  | 14.1  | 16.2  | 19.3  | 29.9  |
| <b>External Debt %</b>                     |       |       |       |       |       |       |
| Domestic Debt/GDP                          | 19.7  | 19.5  | 22.4  | 20.7  | 21.5  | 25.1  |
| Domestic Debt/Budget Revenue               | 72.6  | 73.7  | 62.0  | 71.0  | 68.4  | 139.0 |
| Domestic debt service / GDP                | 0.8   | 0.9   | 0.8   | 0.8   | 1.1   | 1.3   |
| Domestic debt service / Budget Revenue     | 3.0   | 3.3   | 2.2   | 2.6   | 3.4   | 7.2   |

- The public debt to Gross Domestic Product (94.4 %) reached alarming levels in 2015, exceeding the safe limits (60%).
- The public debt service (*principal and interests*) constituted 64.2% of the total public revenues and 34.6% of the total public expenditures in 2015. This means that the public debt burden has exceeded the safe limits (25%). Accordingly, the public debt service has taken more than the social expenditures (*education, health, social protection and water*) and did not leave space for spending on the social welfare programs and investment programs.
- The domestic debt service has taken 29.9% of the total public expenditures and 55.5% of the total public revenues in 2015. It has also constituted 65.1% of the net budget deficit in 2015. This means that two-thirds of the new domestic debt is used to pay off the interest of domestic debt. Thus, the current situation of the domestic debt is unsustainable.

- The external loans are characterized by being concessional loans with low interest rates (*up to 1.5% on average*) and long grace period. Payments of interests and principal of the external debt amounted to \$350.9 million, while the external loan disbursement reached only \$63.3 million in 2015. The external debt service payments are expected to range between \$400-600 million per year during 2016-2022. Although the external debt burden's indicators are still acceptable compared to the domestic debt burden, the scarcity of foreign exchange at the time being makes it difficult to pay the external debt service.

External Debt Service in 2015 (million USD)



## Third: Policy Options

### Debt Restructuring or Default

Debt restructuring can be divided into two main elements: *debt rescheduling*, defined as a lengthening of maturities of the old debt, possibly involving lower interest rates; and *debt reduction*, defined as a reduction in the nominal value of the old instruments. **However, is there a point in restructuring the public debt now?**

The domestic debt can be restructured by entering into a friendly dialogue with local creditors to lengthen the maturities of the debt, whether treasury bills or government bonds. In principle, this procedure will be very useful to relieve the pressure on the state public budget in the short term.

However, this has to be done carefully. The domestic creditor base is narrow and dominated by the banking sector that contributes 67.4% of the total domestic debt. Given the damage and restrictions imposed on the banking sector due to the war and conflicts, the write-downs on its books will exacerbate the banking sector crisis, impact its ability to provide finance to the private sector and weaken the creditability of the Central Bank of Yemen. This may make these banks withdraw their financial investments in treasury bills and government bonds, particularly since the real interest rate is negative at the present time.

**External debt forgiveness:** could be possible after reaching a political settlement. However, this is likely to have only a limited impact because most of the Yemen's external debt is concessional (*Yemen's external debt is 22% of Paris Club, 29% of non-Paris Club, and 49% multilateral*), whereas the external debt restructure would have significant impact in reducing the burden on servicing debt if the external debt is non-concessional.

Either way, the scarcity of foreign exchange at the time being makes it necessary to mobilize external funds to repay the external debt service or to negotiate with the external creditors (*especially countries and organizations that have suspended support for Yemen*) to postpone the repayment of external debt to the post-war period.

|                      | Challenges  | Policy Options  | Policy Effectiveness | Potential Risks |
|----------------------|---|---|----------------------|-----------------|
| <b>Domestic Debt</b> | Exacerbate the burden of domestic debt. Payments of interest on the domestic debt reached YR590 billion in 2015.                                  | 1- Domestic debt rescheduling.  | Good                 |                 |
|                      |   | 2- Issuing new currency, and increase interest rate.  | Strong               |                 |
|                      |   | 3- Resumption of oil and gas exports.   | Strong               |                 |
| <b>External Debt</b> | The scarcity of foreign exchange at present makes it difficult to pay the external debt service which is expected to reach \$406 million in 2016. | 1- Negotiating with the external creditors to postpone the repayment of the external debt service dues (default). | Strong               |                 |
|                      |   | 2- Mobilizing foreign loans to pay off external debt service  | Strong               |                 |
|                      |   | 3- Resumption of oil and gas exports.   | Strong               |                 |
|                      |   | 4- Increasing humanitarian and social donor support   | Will help            |                 |

| Key issues   | Medium Term Priorities   |
|--|--|
| <b>Managing the public debt and reducing its burdens</b> | <ul style="list-style-type: none"> <li>- Holding an international conference to exempt Yemen from external debt and/or reschedule it, as well as inviting not only members of the Paris Club, but also countries and international institutions that are not members at the club to participate in the conference.</li> <li>- Shifting the public treasury functions (including the public debt issuance and service) from the CBY to the Ministry of Finance.</li> <li>- Issuing an act by the Parliament to regulate the local government debt.</li> <li>- Finalizing the establishment of the stock market in order to mobilize savings, expand the medium and long term financing instruments such as the Islamic Sukuk and bonds that are used to finance investment projects.</li> </ul> |