



RESTRUCTURING PUBLIC FINANCES IN YEMEN

EXECUTIVE SUMMARY

Even before the current conflict, Yemen's public finances suffered from an overdependence on energy exports, one of the lowest tax collection rates in the world, and chronic budget and balance of payments deficits. The government's consistent operating deficits were funded through domestic debt instruments – drawing investment away from the private sector – borrowing from its own central bank, and foreign loans. Meanwhile, current (or recurring) expenditures dominated government spending relative to capital investments, indicating the state's poor track record in development initiatives.

With the intensification of the conflict in 2015, energy exports and foreign grants were frozen, while general economic and state collapse saw a precipitous decline in tax revenues. Public debt has thus risen, while the fracturing of state institutions across frontlines has hobbled public revenue collection, as well as fiscal and monetary policy.

On April 27-29, 2019, a group of Yemen's leading socioeconomic experts convened the fifth Development Champions Forum in Amman, Jordan, as part of the Rethinking Yemen's Economy initiative. The Development Champions' in-depth discussions regarding restructuring public finances in Yemen resulted in the recommendations below for the internationally recognized Government of Yemen. These include:

- **Restart large-scale energy exports as soon as possible.**
- **Take steps to begin diversifying revenues away from energy exports.**
- **Improve the efficiency and effectiveness of Yemen's taxation and tariff system.** Means to achieve this include:
 - Open a dialogue with regional leaders to establish a new relationship between the central government and the governorates.
 - Offer training and resources to improve local tax collection capacity.
 - Implement new transparency and accountability mechanisms.
- **Develop mechanisms to enhance transparency and accountability of government expenditure.**
- **Reform the Public Service.**
- **Pursue reunification of the country's most important institutions.**

This policy brief was prepared by the Sana'a Center for Strategic Studies, in coordination with the project partners DeepRoot Consulting and CARPO – Center for Applied Research in Partnership with the Orient.



BACKGROUND ON YEMEN'S PUBLIC FINANCES

Before the Current Conflict

Public Revenues

For decades, Yemen has suffered from a fragile fiscal structure, given its overdependence on energy exports. Before the armed Houthi movement backed by former President Ali Abdullah Saleh took over the capital, Sana'a, in September 2014, the oil sector accounted for 25 percent of gross domestic product and 65 percent of the public budget.⁽¹⁾ While over the years the government has attempted to diversify the economy by adopting reform programs aimed at supporting non-oil sectors and foreign investment, these did little to wean public finances away from oil dependence.⁽²⁾

Yemen is one of the least tax-collecting countries in the world, with tax revenues accounting for less than 9 percent of GDP before the war, compared to an average of 17.7 percent in developing countries with similarly sized economies.⁽³⁾ Over the years, the state has sought to adopt reforms aimed at increasing the share of tax revenues to total public revenues; however, taxes remained below 30 percent as an average of the total public revenues from 2010-2015, according to the financial indicators.⁽⁴⁾

Meanwhile, grants and foreign aid accounted for 14.4 percent of total budget revenues from 2012-2014.⁽⁵⁾

Public Spending

Before the current conflict, Yemen's public sector contributed 45 percent of gross domestic product (GDP), with current (or recurring) expenditures dominating government spending.⁽⁶⁾ These budget items included public sector salaries, goods, services, maintenance and debt payments, with fuel subsidies alone accounting for 23 percent of the public budget between 2010-2014.⁽⁷⁾ Over this period, current expenditures represented more than 85 percent of total state spending, compared to only 13 percent of expenditure going to capital investment.⁽⁸⁾

1) "Yemen – Development Policy Grant for the Private Sector Growth and Social Development Protection Policy Grant," The World Bank, December 14, 2010, <http://www.worldbank.org/en/news/loans-credits/2010/12/14/yemen-development-policy-grant-for-the-private-sector-growth-and-social-protection-development-policy-grant>. Accessed July 20, 2019.

2) "Republic of Yemen : 2014 Article IV Consultation and Request For a Three Year Arrangement," International Monetary Fund, September 24, 2014, <https://www.imf.org/en/Publications/CR/Issues/2016/12/31/Republic-of-Yemen-2014-Article-IV-Consultation-and-Request-for-a-Three-Year-Arrangement-41901>. Accessed July 20, 2019.

3) "Yemen Socio-Economic Update - Issue 12," Ministry of Planning and International Cooperation, March 2016, https://reliefweb.int/sites/reliefweb.int/files/resources/yseu12_english_v4_final.pdf. Accessed July 20, 2019.

4) This is based on data collected from annual reports of the Central Bank of Yemen for the years 2010-2015.

5) Yemen Socio-Economic Update - Issue 12, March 2016.

6) "Yemen Socio-Economic Update - Issue 30" Ministry of Planning and International Cooperation, December 31, 2017, <https://reliefweb.int/report/yemen/yemen-socio-economic-update-issue-30-december-2017-enar>. Accessed July 20, 2019.

7) Ibid.

8) Ibid.

Such a lopsided ratio favoring current spending over capital investment is a strong indicator of the government's poor development efforts prior to the conflict.⁽⁹⁾ Sustainable economic development in any post-conflict scenario will almost certainly be undermined if capital investment spending does not receive an increased share of total public spending.

Prior to the ongoing conflict, the government also employed roughly 31 percent of the country's total labor force.⁽¹⁰⁾ In government budgets from 2010 to 2014, some 42 percent of public revenues were allocated to salaries for some 1.25 million civil and military employees, amounting to Yemeni rial (YR) 75 billion, or 10 percent of GDP.⁽¹¹⁾ Meanwhile, another 1.5 million Yemenis in the lowest income bracket received quarterly social subsidy distributions totalling YR23 billion.⁽¹²⁾

Consistent Budget Deficits

The government has also consistently run budget deficits, which increased from YR266 billion in 2010 to YR908 billion in 2015.⁽¹³⁾ The average annual growth of public debt was 13.5 percent from 2010-2014, with public debt then increasing substantially from YR4.74 trillion in 2014 (equivalent to about US\$22 billion) to YR5.56 trillion (US\$25 billion) in 2015.⁽¹⁴⁾

The government's consistent operating deficits have been funded through issuing domestic debt instruments, such as government bonds and treasury bills, borrowing from the Central Bank of Yemen (CBY), and foreign loans. Given the relatively high rate of return on domestic debt instruments,⁽¹⁵⁾ the Yemeni government's expansionary borrowing policies have also attracted the vast majority of commercial bank investments, which may otherwise have gone toward private sector development.

The Conflict's Impact on Public Finances

In August 2014, the Yemeni government, under pressure from the International Monetary Fund (IMF) during negotiations for a US\$560 million loan, issued a decree to repeal the public fuel subsidy. While being one of the largest expenses on the

9) Feridoun Sarraf, "Integration of Recurrent and Capital "Development" Budgets: Issues, Problems, Country Experiences, and the Way Forward", The World Bank, July 2005, www1.worldbank.org/publicsector/pe/StrengthenedApproach/CapitalRecurrentIntegration.pdf. Accessed July 19, 2019.

10) Yemen Socio-Economic Update - Issue 30, December 2017.

11) "Yemen Economic Monitoring Brief - Fall 2018," The World Bank, October 22, 2018, <https://www.worldbank.org/en/country/yemen/publication/yemen-economic-monitoring-brief-fall-2018>. Accessed July 20, 2019.

12) Yemen Socio-Economic Update - Issue 12, March 2016.

13) This is based on data collected from annual reports of the Central Bank of Yemen for the years 2010-2015.

14) "Yemen Socio-Economic Update - Issue 15," Ministry of Planning and International Cooperation, June 2016, <https://reliefweb.int/report/yemen/yemen-socio-economic-update-issue-15-june-2016-enar>. Accessed July 20, 2019.

15) The treasury bills offer high yields at a nominal interest rate of about 16%. This high rate had attracted the investments of commercial banks to take over around 80% of the total value of treasury bills during 2010-2014. See: Yemen Socio-Economic Update- Issue 15, June 2016.

government budget, the repeal was ill-planned and failed to balance fiscal needs with social impacts: fuel prices jumped immediately and the public saw none of the proposed plans to redistribute and reinvest the promised revenue savings. As a result, the move was deeply unpopular. It immediately paved the way for the armed Houthi movement to launch a campaign lambasting the government and to veil its armed seizure of the capital the following month as part of a populist agenda. Public revenues have since declined steadily. In 2014, Yemen's energy exports plunged by 77 percent to US\$1.35 billion from a 10-year average of US\$5.76 billion between 2004 and 2013 and never recovered after that.⁽¹⁶⁾

As the conflict intensified in 2015, energy exports were totally suspended by April 2015, which had represented the majority of Yemen's exports and government revenue in previous years. From 2011 to 2013, Yemen's energy exports accounted for more than 90% of the country's total exports, contributing an average of 40 percent to the total government revenue – excluding government revenue from grants.⁽¹⁷⁾⁽¹⁸⁾

Furthermore, grants and foreign aid were frozen, which had provided significant support post-2011. The war also precipitated general economic and state collapse, leading to a decline in tax revenues. The public revenue ratio (ie. total public revenues/GDP) was 24 percent just prior to the conflict; by 2018 it had declined to 8 percent of the GDP.⁽¹⁹⁾

The collapse in public revenues resulted in a decrease in public expenditure of 36 percent between 2014 and 2016.⁽²⁰⁾ This involved the suspension of social benefits to 1.5 million of the poorest households in the country in 2015, the total suspension of expenditures on development projects, and declining spending on the operating costs of public services such as education, health and water, all of which exacerbated the humanitarian crisis. An escalating liquidity crisis led to the suspension of salaries for hundreds of thousands of people on the public payroll in August 2016.

The World Bank also estimated that the public debt ratio rose to 75 percent of GDP in 2017.⁽²¹⁾ The actual 2018 government deficit was later estimated at YR660 billion, which was almost entirely funded through borrowing from the central bank.⁽²²⁾ Roughly

16) International Trade Centre (ITC), Market Analysis and Research. "Trade Map." An online database of monthly, quarterly, and yearly trade statistics from the most aggregated level to the tariff line level for international business development, covering import and export values, volumes, growth rates, and market shares. It provides indicators on export performance, international demand, alternative markets and competitive markets, as well as a directory of importing and exporting companies. It covers 220 countries and territories and 5,300 products of the Harmonized System. Hydrocarbon products are classified under the Harmonized System (HS) code 27. Under this group, the two main hydrocarbon exports from Yemen to the world are crude petroleum oil (HS code 2709) and petroleum gas (HS code 2711). <http://www.trademap.org/Index.aspx>.

17) Central Bank of Yemen (CBY). 2012 Annual Report, 29. http://www.centralbank.gov.ye/App_Upload/Ann_rep2012_en.pdf.

18) Central Bank of Yemen (CBY). 2013 Annual Report, 27, 106, and 107. http://www.centralbank.gov.ye/App_Upload/Ann_rep%202013_EN%20.pdf.

19) Yemen Economic Monitoring Brief - Fall 2018 - The World Bank.

20) Yemen Socio-Economic Update, Issue 30 - December 2017.

21) Yemen Economic Monitoring Brief - Fall 2018 - The World Bank.

22) "Starvation, Diplomacy and Ruthless Friends: The Yemen Annual Review 2018", Sana'a Center for Strategic Studies, January 22, 2019, <https://www.sanaacenter.org/publications/the-yemen-review/6808#ED-macro>. Accessed July 19, 2019.

60 percent of this spending was used to pay the public wage costs, 17 percent to operational expenses, 14 percent to social benefits, and the rest to the acquisition of assets and payment of liabilities.⁽²³⁾

In regard to overall macroeconomic indicators, Yemen's real GDP growth rate declined from 3.3 percent in 2010 to -30.3 percent in 2015, and it stood at -10.9 percent in 2017.⁽²⁴⁾ Cumulative losses in GDP were estimated at 47 percent for the three years following the onset of the war.⁽²⁵⁾

Fractured Finances and Regionalized Economic Realities

In September 2016, the internationally recognized Yemeni government officially transferred the CBY headquarters from Sana'a to Aden, effectively creating two rival central bank authorities on either side of the frontlines.⁽²⁶⁾ This meant that there was no longer a unified entity in the country to collect public revenue, or to control fiscal and monetary policy. The fracturing of the official financial authorities in Yemen has also allowed for the black market to grow and thrive, drawing vast sums of money out of the formal economy.

Individual governorates have thus experienced vastly different economic realities and public service provision as a result of the conflict. For example, oil and gas-producing governorates, such as Marib, Hadramawt and Shabwa, are receiving 20 percent or more of the revenues from resource sales, while many other governorates and public institutions under Houthi control lack funds to cover even basic operating costs. Houthi authorities also divert available state resources to the group's war effort.

Balance of Payments Deficit

Yemen's balance of payments has for decades suffered deficits in the current account. Pre-conflict oil exports accounted for about 83 percent of total exported goods, while oil receipts accounted for about 65 percent of total foreign exchange flows into Yemen.⁽²⁷⁾ At the same time, prior to the conflict Yemen imported roughly 90 percent of its food needs from abroad, as well as most of its fuel needs and other commercial products.

Since the beginning of the conflict, there have been various new factors both weighing on, and supporting, Yemen's balance of payments.

23) Ibid.

24) Yemen Socio-Economic Update - Issue 30, December 2017.

25) Ibid.

26) Mansour Rageh, Amal Nasser and Farea Al-Muslimi, "Yemen Without a Functioning Central Bank: The Loss of Basic Economic Stabilization and Accelerating Famine", Sana'a Center for Strategic Studies, November 2, 2016, <https://www.sanaacenter.org/publications/main-publications/55>. Accessed July 19, 2019.

27) "Yemen Socio-Economic Update - Issue 14," Ministry of Planning and International Cooperation, May 2016, https://reliefweb.int/sites/reliefweb.int/files/resources/yseu14_english_final_1.pdf. Accessed July 20, 2019.

The cessation of energy exports in 2015 meant the loss of oil receipts. The central bank thus began depleting its foreign reserves to support basic commodity imports, with CBY reserves falling from US\$5.23 billion in early 2014 to less than US\$1 billion at the end of 2016.⁽²⁸⁾ As well, between September 2012 and March 2015, 27 different international donors pledged financial aid to Yemen exceeding US\$10 billion, however only 44 percent was eventually disbursed. The suspension of this financial support in 2015 and the loss of oil receipts exacerbated the balance of payments deficit, with the current account deficit reaching about 9 percent of GDP in 2018.⁽²⁹⁾

The Aden central bank's expansive monetary policy – printing new banknotes to cover Yemeni government borrowing – helped drive accelerated deterioration in the Yemeni rial's value between 2016 and 2018,⁽³⁰⁾ in turn spurring rapid inflation⁽³¹⁾ and increased poverty.⁽³²⁾ These factors, however, led to a decreased consumer demand, with imports of goods dropping 46 percent in value between 2014 and 2017, from US\$12.3 billion to US\$6.6 billion.⁽³³⁾

Following the agreement signed on March 15, 2018, between Yemen and Saudi Arabia, the central bank in Aden received a deposit of US\$2 billion, in addition to another Saudi aid payment of US\$200 million and oil grants. This support has led to tangible stability in the value of the Yemeni rial, with the exchange rate improving to YR500 per US\$1 in late 2018 from YR800 in early October the same year.⁽³⁴⁾

Remittances by Yemeni expatriates working abroad during the conflict, estimated at US\$3.4 billion in 2017 after reaching a record US\$3.7 billion in the previous year,⁽³⁵⁾ have been the most important source of foreign exchange inflows into the country during the conflict, while donor pledges to support Yemen's humanitarian plan, which the United Nations hopes will amount to US\$2.6 billion for 2019, are also significant. Both of these factors have contributed to reducing the current account deficit in the balance of payments.

28) "Yemen Socio-Economic Update - Food Security Cluster," Ministry of Planning and International Cooperation, October 2015, http://fscluster.org/sites/default/files/documents/yseu8_english2.pdf. Accessed July 20, 2019.

29) "Starvation, Diplomacy and Ruthless Friends: The Yemen Annual Review 2018", Sana'a Center for Strategic Studies, January 22, 2019, <https://www.sanaacenter.org/publications/the-yemen-review/6808#ED-macro>. Accessed July 19, 2019.

30) Ibid.

31) Yemen's inflation rate rose from roughly 11 percent in 2010 to more than 40 percent in 2018 according to the World Bank's estimation. Yemen Economic Monitoring Brief - Fall 2018, The World Bank.

32) Yemen's poverty rate increased from 49 percent in 2014 to around 79 percent in 2017; over the same period average annual per capita income declined from US\$1,247 in 2014 to US\$485, a cumulative change of -61 percent. See: Yemen Socio-Economic Update - Issue 30, December 2017.

33) Yemen Economic Monitoring Brief - Fall 2018, The World Bank.

34) "Starvation, Diplomacy and Ruthless Friends: The Yemen Annual Review 2018", Sana'a Center for Strategic Studies, January 22, 2019, <https://www.sanaacenter.org/publications/the-yemen-review/6808#ED-CC-TF>. Accessed July 20, 2019.

35) "Migration and Remittances Data," The World Bank, November 16, 2017, <https://www.worldbank.org/en/topic/migrationremittancesdiasporaissues/brief/migration-remittances-data>. Accessed July 20, 2019.

RECOMMENDATIONS

The restructuring of the state budget is a long-term project, one which cannot be completed while the conflict is ongoing. There are short-term measures, however, that can begin the process, which can be followed by medium- and long-term steps as circumstances permit. To this end, the Development Champions have identified the following recommendations for restructuring public finances in Yemen for the internationally recognized Yemeni government and supporting international stakeholders:

- **Restart large-scale energy exports as soon as possible.** The Yemeni government has an immediate need for revenue to cover its large budget deficit. Yemen's oil and gas reserves are the most viable option to raise enough revenues in the short term to stabilize government finances, expand public service provision, and restock foreign currency reserves. Thus, an effective strategy must be developed to encourage oil companies to restart work in Yemen. Among the many benefits of reducing the budget deficit through oil receipts are: 1) it will allow the government to refrain from borrowing from the central bank (ie. printing new currency) and avoid the inflationary impacts of such; 2) it will allow the government to depend less on issuing debt instruments, allowing it to lower interest rates on public debt and, potentially, encouraging Yemeni financial institutions to invest in private sector firms and development.

At the same time, and while there is a pressing need to resume Yemen's energy exports, the potential for post-war oil and gas revenues should not be overstated given the significant changes in the global energy landscape and the steady prewar decline in Yemen's oil production since 2002. Increasing Yemen's oil and gas production is a long-term process that will require significant investments in exploration activities and is not expected to be achieved in the short term.

- **Take steps to begin diversifying revenues away from energy exports.** The structural imbalances in public sector finances have largely been the result of an overdependence on oil revenues. The primary means to achieve this is through promoting private sector development [please see 'Priorities for Private Sector Recovery in Yemen: Reforming the Business and Investment Climate'], overhauling the government's tax and tariffs systems, developing new sectoral policies that improve the attractiveness of Yemen's key non-oil economic sectors, and attracting significant foreign direct investments into the country's capital-starved economy to support a broad spectrum economic transformation.
- **Improve the efficiency and effectiveness of Yemen's taxation and tariff system.** Corruption, tax evasion, a weak bureaucracy and rivalries between the various levels of government have long obstructed the country's ability to collect dues from individuals and companies. Given the assortment of challenges, there are a variety of potential solutions that should be pursued in tandem:

- *Open a dialogue with regional Yemeni leaders to establish a new relationship between the central government and the governorates.* Leaders in many areas across Yemen have long felt that the central government has collected revenues from their areas and provided them little in return. This has created a disincentive for the governorates to turn over locally collected tax revenues to the central government. The central government should thus seek to open a dialogue with local authorities to address these grievances. Among the things the central government can offer to incentivize the regions to collect and submit taxes is to allow them to keep a certain share within the governorate (such as has been agreed with Marib, Hadramawt and Shabwa regarding oil and gas revenues). The central government can also offer to devolve certain legal powers to the governorates to grant them more autonomy. This would also be in line with the general principle of federation discussed at the 2013-14 National Dialogue Conference.
 - *Offer training and resources to improve local tax collection capacity.* A major impediment to tax and tariff collection is the lack of skilled civil servant staff as well as the lack of computerized systems to help facilitate their work. The Yemeni government should seek international assistance to help provide and finance the necessary training and equipment necessary to modernize the country's tax collection system.
 - *Implement new transparency and accountability mechanisms.* Corruption in the Yemeni public service is almost taken for granted by many Yemenis. However, the modernization and computerization of the tax collection system could represent a major step toward increasing transparency and accountability of staff, while better training could also help shift cultural norms away from accepting corrupt practices.
- **Develop mechanisms to enhance transparency and accountability of government expenditure.** A major impediment to efficiently deploying public funds in Yemen is the scourge of corruption. Thus, new mechanisms should be developed and implemented through existing state institutions – such as the Ministry of Planning and International Cooperation, the Ministry of Finance, and the Executive Bureau – to oversee how government funds are distributed at the local and central level to help ensure transparency, control and accountability. Existing frameworks for cooperation and coordination – such as the Executive Bureau – should also be enhanced to improve transparency between different levels of government, donors and civil society organizations in Yemen. Such would help encourage international donors to provide financial assistance, and in particular the prospect of international support directly for capital investment items in the budget that promote long-term socio-economic development.
 - **Reform the Public Service.** Due to decades of corruption and patronage appointments, the inflated public sector payroll is fiscally unsustainable and threatens to undermine economic recovery and future stability in Yemen. Thus, it is necessary to conduct an assessment to evaluate the conflict-driven growth of the public sector payroll; reduce administrative corruption through the biometric registration of all public sector workers; and develop a strategy to demobilize and

reintegrate fighters into society without absorbing them into the public sector. Long-term reforms to achieve a fiscally sustainable, efficient public sector also include an audit of public services, payroll reduction through attrition and the development of transparent hiring procedures. (For details, see ‘[Inflated Beyond Fiscal Capacity: The Need to Reform the Public Sector Wage Bill](#)’ and ‘[Economic Confidence Building Measures – Civil Servant Salaries](#)’.)

- **Pursue reunification of the country’s most important institutions.** These would include the Central Bank of Yemen and the Ministry of Finance. While total reunification is unrealistic while the conflict is ongoing, indirect coordination on crucial issues can and should be sought out. Such is necessary to ensure macroeconomic stability, which is dependent on such things as the flow of remittances and aid funds into the country continuing uninterrupted.

Beyond reunification of the state’s vital institutions, the deep marks left by decades of conflicts and poor management call for an institutional assessment of existing structures that leads to sweeping, deep and aggressive structural reforms on a national scale spearheaded by a strong political leadership. Initiatives to deal with Yemen’s post-war challenges can have limited success unless they integrate with Yemen’s already existing institutions and falls within a broader far-sighted reform vision. Economic transformation and true reforms are a paradigm shift and a national political process of the highest degree.

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ABOUT THE “RETHINKING YEMEN’S ECONOMY” INITIATIVE

This two-year project, which was launched in March 2017, is an initiative to identify Yemen’s economic, humanitarian, social and developmental priorities in light of the ongoing conflict in Yemen and to prepare for the post-conflict recovery period. The project aims to build consensus in crucial policy areas through engaging and promoting informed Yemeni voices in the public discourse, and to positively influence local, regional and international development agendas.

The project has four components: (1) in the Development Champions Forums, Yemeni experts and professionals in social and economic development will identify key issues for intervention and provide recommendations towards tackling these issues; (2) in the Research

Hive, the project consortium will – based on the issues and recommendations of the Development Champions – conduct research and identify best practices and lessons learned from international experiences to create knowledge capital for the Rethinking Yemen’s Economy initiative; (3) in the public outreach component, the consortium will implement consultation workshops with local stakeholders, including the private sector, youth and civil society organizations; moreover, campaigns through both traditional and social media outlets will be conducted to engage the wider Yemeni public; (4) and through regional and international engagement the consortium will inform stakeholders of project outcomes and aim to motivate and guide the international community’s policy interventions to the greatest benefit of the people of Yemen.

For more information and previous publications: www.devchampions.org

Implementing Partners

The project is implemented by a consortium of the following three partners:



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