



EMBASSY OF  
THE REPUBLIC OF YEMEN

Washington, DC



# ECONOMY OF YEMEN: BACKGROUND, CHALLENGES AND KEY ISSUES

FEBRUARY 2017



## BACKGROUND

Yemen, an impoverished state that has been plagued by economic imbalances and fragile public institutions for the past decade, is currently facing unprecedented economic and financial challenges, precipitated by the intensification of conflict since September 2014. Since the Houthi's takeover of the capital, trust in the ability of government institutions to continue serving the public has deteriorated. Moreover, the impact from the conflict on Yemen's already underdeveloped and weak infrastructure has affected overall economic activity. Both the weakening of public trust and the damages to infrastructure have led to a severe economic contraction: during 2015, Yemen's economy contracted by 33%<sup>1</sup>. The coup destabilized Yemen's economy and presented the public with a challenging economic reality that has negatively affected citizens' quality of life.

## KEY ISSUES

### 1. Relocation of the Central Bank of Yemen (CBY)

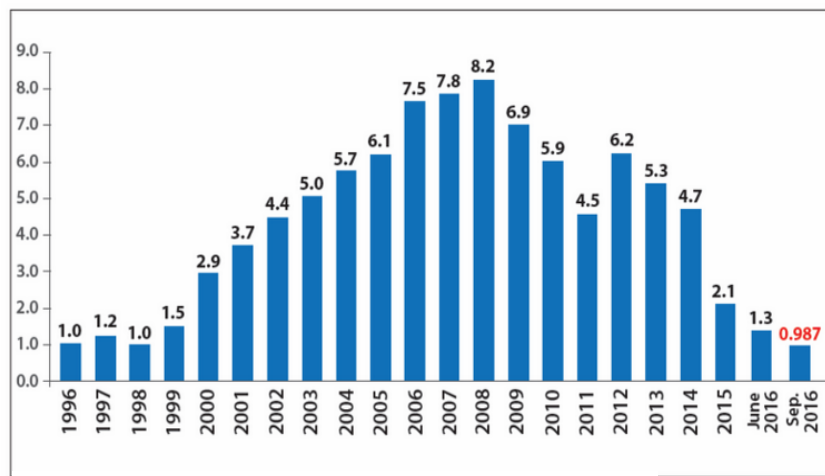


Figure 1 CBY Foreign Exchange Reserves (USD)

Source: CBY, 2016.

The Houthi hegemony over the capital imposed a new governance reality upon most public institutions, and the Central Bank of Yemen (CBY) was no exception. Prior to the coup, the CBY had managed to ameliorate its balance sheet. In fact, foreign exchange net reserves were standing at 5 billion US dollars at the beginning of 2013, before falling to nearly 600 million US dollars of net reserves by September 2016. This has led to the deterioration of trust between the public and the banking system, rendering the CBY unable to perform its basic functions. Moreover, the hegemonic supervisory presence of the Houthi militia in Sanaa undermined the independence of the CBY. Against the backdrop of the above-mentioned risks, President Hadi's decision in September 2016<sup>2</sup> to relocate the CBY from Sanaa to Aden was taken to avoid a complete collapse of Yemen's banking system. Preceding to the decision to relocate the CBY, unsound policies led to the hemorrhaging of banknote reserves, rendering the bank cashless and unable to pay salaries since June 2016.

One such counterproductive policy that the CBY continued to follow, despite multiple warnings from the GoY, was the continued disbursement of 25 billion riyals per month in cash to the Ministry of Defense. Such disbursement was deemed unlawful, since the funds were being channeled to the Houthi-controlled Ministry of Defense. In spite of multiple requests by the GoY to cease this monthly disbursement, the CBY continued

1- Department of Economic Forecasting, Ministry of Planning and International Cooperation



with this policy until it ran out of banknotes. The CBY's former leadership stated they had no choice but to continue disbursing such payments or face a Houthi reprisal. The bank was financing a majority of its disbursements by debiting the Government's general account, ballooning the Government's direct borrowing to an unprecedented amount of 2 trillion riyals – a strategy that raised inflationary pressure.

The newly installed CBY leadership, headed by Governor Monasser Al-Quaiti, and the relocation decision was recognized by all multilateral organizations, including the International Monetary Fund (IMF), which is currently providing the CBY with technical advice. Moreover, member states of the Gulf Cooperation Council (GCC) are assisting the CBY with capacity-building programs. It is worth noting that the GCC, traditionally Yemen's biggest donors, expressed reservations about providing any grants while the CBY was located in Houthi-controlled Sanaa.

The Governor has expressed the CBY's commitment to serve the public across all governorates from its new headquarters in Aden and to do its utmost to meet its domestic and external obligations. Moreover, the Governor clarified that the central bank in Sanaa, now deemed a branch, will be assigned a unique status given its relatively developed capacity, and will be delegated to perform a number of core functions.

The newly appointed leadership of the CBY announced the following short-term strategic objectives: (a) restore the money cycle by securing and injecting new banknotes, (b) pay outstanding salaries, (c) replenish the CBY's reserves of foreign ex-

change from external grants and (d) bring down inflation by limiting the use of inflationary domestic financing tools.

## 2. Re-activation of Yemen's Hydrocarbon Sector

Historically, Yemen's economic activity relied on public spending derived from the proceeds of oil and gas sales. The decline of oil prices since 2008 has led to unsustainable budget deficits, requiring the Government of Yemen (GoY) to embark on an ambitious economic reform program in 2013. The GoY succeeded in eliminating inefficient fuel subsidies and redirecting unlocked savings to finance capital investments and targeted-subsidy programs. Investment in the infrastructure sector contributed to youth employment, a critical issue that was considered a catalyst for the 2011 Youth Revolution. However, since the coup of 2014, such progresses had been reversed; and since then, the hydrocarbon sector in Yemen had been severely damaged—contributing to the deterioration of the economy.

For that reason, the GoY has prioritized its activities to re-habilitate and re-start the hydrocarbon export sector. These efforts lead to jump-starting numerous oil production facilities in a number of governorates. Presently, rehabilitated facilities produce a combined production of 3 million barrels per month operated jointly by a number of multinational companies, including: OMV and Occidental Petroleum. Construction is underway to rehabilitate Yemen's Total LNG production facility that used to generate \$1 billion in revenue for the state.<sup>2</sup> Investment opportunities in Yemen's hydrocarbon sector remains lucrative, the GoY has sent invites to international companies to explore these opportunities in areas that have been stabilized.

3- Rehabilitation is expected to finish by the summer of 2017.

2- After subtracting commercial bank deposits of 300 million US dollars.





### 3. Alleviation of the Humanitarian Condition

Yemen's humanitarian condition has significantly deteriorated over the past couple years. Over 14 million individuals are considered food insecure, 3 million individuals have lost their homes and livelihoods; and thousands of people are dying of preventable health issues. Furthermore, the UN estimates that 400,000 children under 5 are acutely malnourished.

Food insecurity remains a pressing issue that has affected many vulnerable communities across Yemen, especially coastal areas in northwest Yemen that are currently occupied by the Houthis and whose locations while near ports to send in food supplies are hindered from doing so by the Houthis. The GoY has prioritized to achieve the normalization of the humanitarian condition and is extensively working with regional and international aid agencies to provide food, clean water, medicine and other basic needs to conflict-affected communities. Furthermore, the restoration of basic essential services such as electric power, medical facilities, and the rehabilitation of damaged key connecting roads have been prioritized.

### 4. Securing Payments of Public Salaries

The public sector is considered the biggest employer in Yemen's economy, with over 1.5 million registered state workers, the GoY has vowed to take any measures needed to secure the payment of government salaries and clear any outstanding arrears. Shortly after the relocation of the CBY, newly printed banknotes were secured and flown to Aden in the beginning of January 2017. Since then, the GoY has worked on securing payroll data from all governorates, including those that are not under the control

of the GoY. Despite Houthi's obstructions in trying to limit the GoY's ability to obtain payroll data in areas under the control of the Houthi militias, the government was able to initiate the first tranche of disbursement. Salary payments were first disbursed to the civil sector using domestic money service companies, such as Alkuraimi Co. The CBY used Alkuraimi Co to disburse its first payment of government salaries to the governorate of Sanaa – and is expected to use other mediums such as banks and the postal service to effect the remaining payments. The GoY has prioritized the civil sector, and beneficiaries in the educational sector have started receiving their salaries for January 2017. As CBY continue to receive new shipments of banknotes, it will continue to disburse funds for salary payments in accordance to Yemen's payroll 2014 budget and a scheduled framework plan, that will ensure an organized payment disbursement mechanism to the entire country, has been put in place.

### 5. Supporting Food Imports

Yemen imports 90% of its food needs, and in order to limit foreign exchange-driven inflation, the CBY subsidizes the foreign exchange rate for wheat and rice imports. These are the only two remaining products in the basket of the CBY's subsidized imports.<sup>4</sup> The CBY's net-reserves have fallen to 600 million US dollars, drastically limiting its ability to continue financing food imports. Moreover, its external current accounts have fallen to an unprecedented level of just 15 million US dollars, rendering it unable to settle outstanding letters of credit (LoCs). As of September 2016, more than 85 million US dollars' worth of LoCs have not been settled by the CBY.<sup>5</sup> The bank's policy permits

4- The CBY has excluded sugar and fuel derivatives since February 2016.

5- The number of outstanding LoCs is expected to grow as more reimbursement requests are submitted to the CBY.







commercial banks to open LoCs for wheat and rice traders at the subsidized exchange rate of 250 YER/1 USD. Commercial banks are subsequently reimbursed for the difference in the foreign exchange rate obtained from the private market. Due to severe shortages of hard currency in the CBY’s external accounts, the bank will be unable to reimburse commercial banks fully without replenishing its foreign exchange reserves. It is worth noting that many of the CBY’s correspondent accounts have been suspended since early 2015 due to de-risking policies and falling balances. In order for the CBY to continue with its food import subsidy program, and meet its other pressing external obligations, its foreign exchange reserves will require an injection from a donor in order to bring it to an adequate level. In the event that the CBY fails to honor outstanding LoCs, commercial banks will cease to provide food traders with the subsidized exchange rate. Commercial banks will rather open LoCs using the market’s

foreign exchange rate, which would expose the prices of these essential food products to fluctuations in the foreign exchange market. Misleading reports disseminated online stated that the CBY’s relocation to Aden and its discontinuation of the food import subsidy program hampers the ability of the private sector to import food. In fact, the CBY had almost stopped providing this sort of subsidy program before the relocation to Aden due to the depletion of its foreign exchange reserves. Traders are able to continue the importation of food products by securing the required foreign exchange from the markets. Additionally, traders are able to open LoCs with commercial banks. Nonetheless, the CBY is mindful of its humanitarian role in protecting vulnerable consumers from foreign exchange-driven inflation. Therefore, the CBY will work on replenishing its foreign exchange reserves in order to resume its food import subsidy program.

**6. Resumption of External Donor Assistance**

The coup of September 2014 led to the closure of numerous embassies in Sanaa, most notably those belonging to the G18<sup>6</sup> member states. Additionally, most international organizations closed their offices and left the country, including the World Bank Group (WBG). The WBG, considered to be a major multilateral donor, suspended its 32 projects in Yemen, worth more than 500 million US dollars across various sectors. Furthermore, bilateral aid organizations, such as the United States Agency for International Development (USAID), suspended their programs, and most external grants and drawing rights were put on

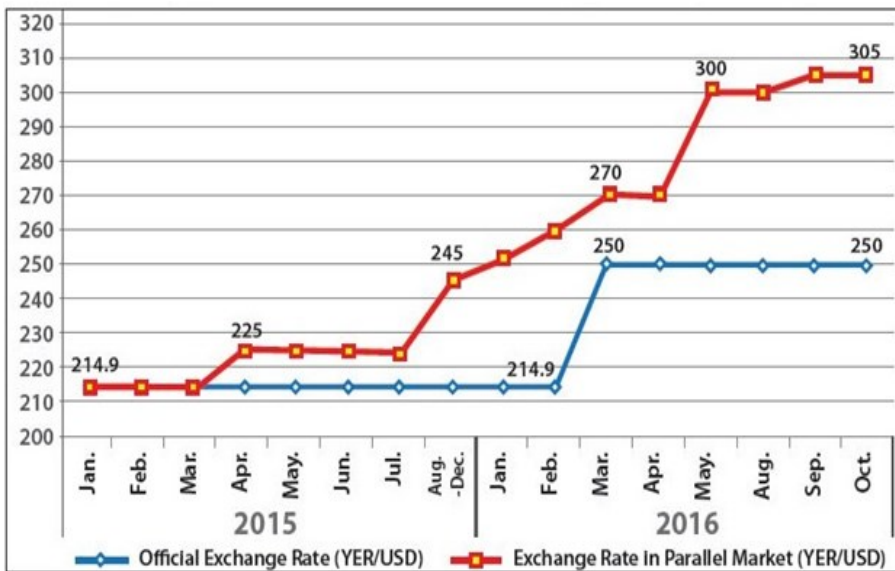


Figure 2 Official and Parallel Exchange Rate

Source: CBY, 2016

6- G18 Member countries comprise of the states from Gulf Cooperation Council; the five Permanent U.N Security Council members (i.e., China, France, Russia, United Kingdom and United States); and Egypt, Germany, Netherlands, Turkey and Japan.





hold, curbing external aid relief to Yemen.

The suspension of many of these assistance packages was mainly due to concerns raised by the international donor community vis-à-vis the inability of the GoY to exercise control over the country. Since the return of the political leadership to Yemen, the GoY has called upon the international donor and diplomatic community to reopen their offices and to operate from the city of Aden and restart their development assistance, projects and related activities as undertaken prior to the coup.

The WBG has recently completed a “Damage and Needs Assessment” report that outlines Yemen’s needs for post-conflict rehabilitation projects. The Ministry of Planning and International Cooperation has estimated that Yemen would require at least 100 billion US dollars. Yemen would essentially require a comprehensive post-conflict reconstruction plan to rebuild and support Yemen.

In a positive development, the WBG jump-started a relief program in coordination with the GoY in the summer of 2016. The WBG’s Emergency Crisis Response Project is funding a number of economic relief activities, implemented by the Social Fund for Development (SFD) and the Public Works Project (PWP) with an initial funding of 50 million US dollars. Furthermore, the WBG will be expanding its financing envelope for this project by 400 million US dollars during 2017. Furthermore, regional donors, such as the Arab Fund, have resumed some of their funding activities for relief aid projects in coordination with the United Nations Development Program (UNDP).

## CONCLUSION

Noting all the challenges that have faced Yemen recently as delineated above, Yemen faces a colossal task for its post-conflict reconstruction and financing needs. Indeed, there is an urgent need for the donor community to support economic development – and particularly with development projects rather than solely focusing on short-term humanitarian needs.

Ultimately however, the international community will need to harness more resources and to devise long-term and firm commitments to support Yemen until it has been adequately rehabilitated and to fully normalize its economy – and which will also help with Yemeni society to recover from the trauma that it has been dealt at the hands of the Houthis. Indeed, post-conflict reconstruction will help to reinforce post-conflict reconciliation.

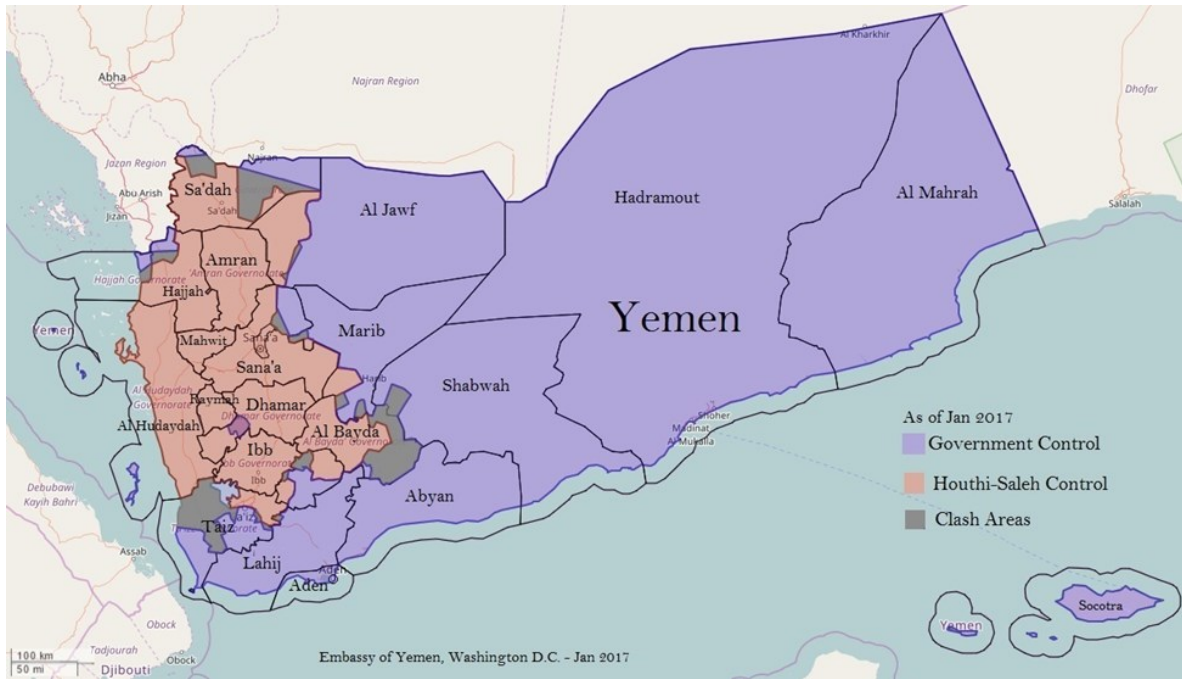
Therefore, with the demonstrable improvements in the security situation on the ground in the vast majority of Yemen’s territory<sup>7</sup>, which is under the full control of the legitimate and internationally recognized government, further stability has been achieved in Yemen. It is now safe enough for foreign personnel, organizations and companies to work from Aden, where the government is also currently headquartered. While further successes will be achieved over time in the military front to liberate those other parts of Yemen still occupied by the Houthi forces with their domestic and foreign allies supporting them, it is hoped that a peaceful settlement will be reached so that conditions will be conducive to spur foreign investments and international development projects. Nonetheless, the time is right for the international community and global private sector to return to Yemen.

7- As of January 2017, 80% of Yemen’s land is under the control of the GoY, see annex for map reference.





# ANNEX



Areas Under the Control of the Government of Yemen

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