The Arab Gulf States Institute in Washington

Building bridges of understanding

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The Arab Gulf States Institute in Washington (AGSIW), launched in 2015, is an independent, nonprofit institution dedicated to increasing the understanding and appreciation of the social, economic, and political diversity of the Gulf Arab states. Through expert research, analysis, exchanges, and public discussion, the institute seeks to encourage thoughtful debate and inform decision makers shaping U.S. policy regarding this critical geostrategic region.

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About the Workshop

The humanitarian crisis in Yemen is the worst on the planet in sheer numbers, according to the United Nations. On October 18, 2017, AGSIW hosted a roundtable discussion on Yemen's economy. The discussion focused on policy options at a macroeconomic and local level to alleviate the suffering of Yemenis, as the war continues and a political deal is nowhere in sight.

About the Author

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Executive Summary

Yemen's humanitarian crisis is now the world's largest in terms of the number of people in need. The crisis is the result of long-simmering structural issues in Yemen's economy, the civil war, and the politicization of the economy during the three-year-old conflict.

The crisis cannot be resolved through humanitarian aid alone. Any improvement in the humanitarian environment will require an intervention in Yemen's macroeconomy, particularly its banking system. Presently, the human capacity required to run Yemen's central bank and Ministry of Finance is divided between rival institutions controlled by the de facto authorities in Sanaa and the government of President Abd Rabbu Mansour Hadi, based between Riyadh and Aden. International legitimacy lies with the Hadi government, but experience and technocratic capacity lies in large part in Sanaa-based institutions. If the two cannot be married, there is a real risk of systemic collapse.

These institutions face similar problems: a lack of foreign exchange reserves, poor access to the international banking system, a lack of revenue with which to pay an estimated 1.25 million public sector salaries, the falling value of the Yemeni riyal, and an internal debt crisis.

All too often, however, events on the ground impede progress made toward an improvement in the macroeconomic environment. A thaw in relations between the Hadi government, Sanaa-based technocrats, and commercial banks made in late 2017 has largely been undone by the death of Ali Abdullah Saleh, Yemen's former president, in December 2017. A mooted $2 billion injection of hard currency into the Central Bank of Yemen by Saudi Arabia, announced in January, has similarly been delayed due to infighting between rival factions in Aden.

Recommendations

- The United States, United Nations, and other international stakeholders in Yemen must move quickly to stage a meaningful intervention in the macroeconomy.
- An intervention would require addressing the lack of foreign currency reserves, a nearly nonexistent revenue base for salary payments, and the deep divisions between rival parallel institutions, along with a mounting internal and external debt crisis and rapidly depreciating Yemeni riyal.
- A new coordinating body should be formed with Yemeni officials and technocrats from across the political divide, with assistance and oversight from neutral international staff, based in a third country, most likely Jordan.
- The coordinating body should develop a detailed plan to address the concurrent crises in foreign exchange, revenue, debt service, and inflation, in coordination with international donors. Such a plan would include a detailed budget for 2018, and realistic mechanisms for oversight of currency management and salary distribution.
- In the longer term, the macroeconomy cannot and will not recover absent a meaningful, sustainable political solution to the conflict in Yemen.

- Failure to intervene, either due to ennui or overconfidence in other actors' willingness to act, can only lead to a deepening crisis.

Introduction

While much attention has been paid to issues of access and the impact of a brutal conflict on basic livelihoods during Yemen's civil war, aid officials are clear in saying that the country's humanitarian crisis cannot be solved through aid deliveries and commercial access alone. Unless crucial fiscal and monetary issues are resolved, wages will continue to go unpaid, imports will dry up, and a combination of a lack of employment and a sharp uptick in inflation will further limit the ability of the majority of Yemenis to pay for even the most basic goods.

Key fiscal and monetary issues include:

- A lack of liquidity of domestic and foreign currency – due to a collapse in state revenue – limiting the country's rival administrative bodies' ability to pay salaries and underwrite imports (this issue should be somewhat mitigated by the pending transfer of $2 billion to the Central Bank of Yemen by Saudi Arabia)
- A mounting and unsustainable domestic and international debt burden
- The rapid devaluation of the Yemeni riyal, further impacting Yemenis' purchasing power

This would be a calamitous range of issues for any economic system, but Yemen's problems are compounded by rival, parallel institutions, weak overall capacity, the politicization of the economy, fragmentation of the state, and widespread corruption across all levels of governance.

Politics has long taken precedence over economic issues in Yemen, both for the country's elite and international players. Yet, with attempts to remedy the wider conflict through political mediation stalled, some progress was made in late 2017 on issues of economic governance at national institutions.

On October 18, 2017, the Arab Gulf States Institute in Washington held a roundtable, under the Chatham House Rule, on Yemen's economy with representatives of the government of President Abd Rabbu Mansour Hadi and key international financial institutions to discuss key issues and opportunities for improving economic governance and cooperation between the rival authorities in Sanaa and Aden. Several participants cited an October meeting in Berlin between officials from Yemen's rival central banking institutions and private banks as well as other financial experts as a positive step. Events on the ground, however, dimmed this glimmer of hope.

In December 2017, former Yemeni President Ali Abdullah Saleh was killed in Sanaa by the Houthi rebels he had aligned himself with in 2014. Saleh's death has once again cast doubt on the willingness or ability of Yemen's government and the de facto authorities in Sanaa to cooperate, even on such a crucial issue.

The announcement in January that Saudi Arabia planned to inject $2 billion into the Central Bank of Yemen, and that the kingdom would also underwrite a U.N. humanitarian plan with $1.4 billion in aid, led to a brief surge of optimism that the macroeconomic situation might improve. Yet this news was similarly undermined by fighting between Hadi loyalists and Southern separatists in Aden in late January, and the Saudis' requirement that a new central bank governor be appointed. In early February, a new governor had been appointed but the transfer was still pending.

This report, based on the roundtable discussion, as well as a literature review and independent research, gives some historical economic context, provides an overview of the current situation and key challenges, and assesses the different approaches to improving the macroeconomic environment being employed by domestic and international actors.

Snapshot: Yemen's Humanitarian Crisis

In December 2017 the United Nations adjusted its needs assessment for Yemen,[1] which was already the Arab world's poorest country before its civil war deepened into an internationalized conflict with the intervention of a Saudi-led military coalition in March 2015.

Of a population of around 29.3 million people, the United Nations estimated that 22.2 million Yemenis – three quarters of the population – required some form of humanitarian assistance. This figure included 11.3 million people who were at risk of death if they were not given assistance, 2 million more than previous estimates. A cholera outbreak, which began in early 2017, has become the largest on record, claiming more than 2,190 lives and afflicting an estimated 900,000 people.[2]

Yemen's humanitarian crisis is now the world's largest in terms of sheer needs, according to the United Nations.[3] Since November 2017, the risk of famine has risen precipitously, driven by the Saudi-led coalition's decision to temporarily cut off access to all ports and airports in response to an attempted missile strike on Riyadh's King Khalid International Airport. In late November, the coalition lifted its ban on humanitarian relief supplies entering Yemen via Sanaa's rebel-held airport and the port of Hodeidah, and later agreed to allow port access. Even before this latest disruption to trade, the Famine Early Warning Systems Network, a leader in assessing and forecasting hunger crises, had warned of the possibility of food insecurity reaching the worst-case scenario of a catastrophic famine.[4]

The crisis requires an immediate and intensive humanitarian response. The U.N. funding requirement for Yemen in 2017 was $2.34 billion. Only $1.65 billion was received.[5] For the humanitarian decline to be arrested, full commercial access to Hodeidah will be needed.

1 "Humanitarian Needs Overview: Yemen at a Glance," U.N. Office for the Coordination of Humanitarian Affairs, December 2017.

2 Ibid.

3 "High-Level Pledging Event for the Humanitarian Crisis in Yemen," U.N. Office for the Coordination of Humanitarian Affairs, April 25, 2017.

4 "Yemen," Famine Early Warning Systems Network, January 2018.

5 "US$ 2.96 Billion Needed to Provide Life-Saving Assistance to 13.1 Million People in Yemen in 2018," U.N. Office for the Coordination of Humanitarian Affairs press release, January 21, 2018.

Longer-term and more aspirational goals include a peace deal or a sustainable cease-fire arrangement to allow for unfettered humanitarian access, and in the longer term the kind of security needed for the economy to grow again and jobs to be created.

Key Fiscal and Monetary Issues

Yemen's current macroeconomic issues are not new. Deep-rooted structural problems were exacerbated by the war and deepening politicization of the economy, rather than directly caused by the conflict.

From the early to mid-2000s, Yemeni and foreign officials expressed mounting concern over the country's dependence on its limited oil and gas reserves. Fuel was subsidized and sold on the local market. This kept the cost of living down but also incentivized the unregulated use of diesel pumps to provide water supplies to urban households and to irrigate agricultural crops, particularly *qat*, a mild stimulant widely chewed at social gatherings in Yemen.

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Oil and gas exports generated most government revenue and foreign currency reserves, which were used to underwrite food imports. Some 90 percent of wheat and 100 percent of rice in Yemen was, and is, imported.[6] State income was largely used to fund current spending: 84 percent of revenue was used to pay for recurring expenses like goods, services, subsidies, and salaries, as opposed to capital spending on infrastructure and other economy- and employment-boosting projects.[7]

This lack of capital spending helped the government to limit the fiscal deficit for a time. But Yemen has run successive – and growing – deficits since 2007, pushing the government to rely increasingly on treasury bills and other debt to fund its spending, leading in turn to greater debt service commitments. Yemen has also slipped into a negative current account and trade balance since 2007, causing a depreciation in foreign currency reserves, despite sizeable hydrocarbon export revenue. Fuel subsidies absorbed as much as a third of state spending, costing Yemen $3.3 billion in 2013 – about 23 percent of government expenditure and 7 percent of gross domestic product.[8]

The World Bank, International Monetary Fund, and others urged the government to complete a series of reforms begun in the late 1990s: lifting fuel subsidies, consolidating the public sector payroll, and allowing the Yemeni riyal to float. In mitigation, they lent support to programs like the Social Fund for Development, Social Development Program, and Social Welfare Fund, which provided small cash payments to 1.5 million people on a quarterly basis.

6 Peter Salisbury, "Yemen's Economy: Oil, Imports and Elites," *Chatham House*, October 2011.

7 Ibid.

8 World Bank, *The Republic of Yemen: Unlocking the Potential for Economic Growth, A Country Economic Memorandum* (Washington, DC: World Bank, October 2015).

Public sector salaries also acted as a form of welfare for many Yemenis, with the 1.25 million state employees estimated to provide financial support to more than 6 million people across the country.[9]

Fiscal management, ad hoc and lacking real oversight, worsened after the 2011 uprising. By the end of 2014, officials warned that they would soon be unable to pay salaries, despite hiking fuel prices earlier in the year to ease the cost of subsidies. Social welfare payments were not made, despite the provision of a grant by Saudi Arabia for exactly this purpose, which was unaccounted for at the end of the year. (Another $350 million grant, given by Qatar to assist in reparations for the country's 1994 North-South civil war, also went missing over the course of the transition).

During this period – with oil exports constantly interrupted by attacks on key export pipelines – the Central Bank of Yemen worked to stabilize the Yemeni riyal, and thus limit the impact of inflation on society (a particularly acute issue given the country's reliance on imported food). External support helped keep the state afloat – Saudi Arabia alone gave Yemen as much as $4 billion between 2012 and 2014 – but unsustainably so.[10]

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Continued Decline: The Wartime Economy

The outbreak of war, triggered by the Houthi takeover of Sanaa in September 2014 and deepened by the entrance of the Saudi-led coalition into the conflict eight months later, had a deeply negative impact on Yemen's macroeconomy. Fighting in the south, as well as in Marib governorate (an oil-rich region in central Yemen that depends on pipelines cutting across multiple governorates to the south and west to export its oil and gas), caused a total halt in exports, leading to a fall in available foreign reserves.

Over the course of 2015, according to Yemeni officials, foreign currency reserves fell from $4.81 billion to $2.3 billion. As the conflict deepened, local and national revenue also fell sharply and many Yemenis withdrew cash from the formal banking sector leading to a tightening in money supply. Public debt also rose as economic output shrank. The country's total domestic and international debt pile was 7.1 trillion Yemeni riyals (around $28 billion at contemporary exchange rates) at the end of 2015, or 107 percent of GDP.

This trend continues. Early in the conflict, the central bank governor, Mohammed bin Humam, began to warn that the bank – which acts as the state treasury on behalf of the Ministry of Finance – would soon be unable to pay civil service salaries. Social welfare payments have not been paid since early 2016. As pressure mounted on foreign currency reserves, the bank limited the number of goods for which it would issue letters of credit, and restricted overall foreign exchange payouts, causing a decrease in already hampered import volumes.

9 World Bank, *The Republic of Yemen: Unlocking the Potential for Economic Growth, A Country Economic Memorandum* (Washington, DC: World Bank, October 2015).

10 Peter Salisbury, "Yemen's Astonishing Economic Meltdown," *Foreign Policy*, December 11, 2014.

Hadi's government in exile, meanwhile, began to argue that the central bank's management – which was operating from the 2014 budget, transferring funds to ministries with no assurance payments were being made to their intended recipients – was working to the benefit of what was at the time the Houthi-Saleh alliance. In mid-2016, the Hadi government blocked bin Humam's attempts to have a fresh supply of riyals printed in Russia. In September 2016, after instructing central banks and private banks in the United States, Europe, and elsewhere not to work with officials from the bank's Sanaa headquarters, the government announced it was removing bin Humam and would move the central bank to Aden, despite warnings from a number of foreign officials that such a move would only exacerbate the situation.

A number of foreign officials saw the move as being aimed at economically isolating the Houthi-Saleh alliance. Hadi government officials argue that they moved to prevent the collapse of the banking system, and that the decision was made after assurances that the Aden bank would receive financial and technical assistance from its two main backers in the war – Saudi Arabia and the UAE. Such support was not forthcoming, however, until Riyadh's January announcement of a $2 billion injection into the bank.

Foreign financial institutions, meanwhile, froze access to accounts held by the government citing confusion over which institution had legitimate authority to access accounts and fears over anti-money laundering and counterterror financing legislation. As a result, it was the third quarter of 2017 before access was restored to the government account at the U.S. Federal Reserve, U.K.'s Bank of England, and international SWIFT payments system.

The new bank governor, Monasser al-Quaiti, ordered the printing of 400 billion Yemeni riyals. In August 2017, the decision was made to allow the riyal to devalue, which officials argued the bank could no longer defend with currency reserves of $600-$700 million. The riyal had been pegged at 250 riyals to the dollar; in January 2018, it was valued at around 472 riyals to the dollar, having depreciated in value by almost 90 percent.

Despite several shipments of riyals since the beginning of 2017, most public sector salaries remain unpaid, both in the Houthi-held northwestern highlands and in areas under the nominal control of the Hadi government.[11] This has led to accusations of corruption and financial mismanagement, directed both toward Hadi and his Aden-based prime minister, Ahmed bin Daghr, contributing in late January to an outbreak of violence between Southern separatist forces and Hadi loyalist military units in the temporary capital.

The U.S. Department of the Treasury has also accused Iran's Islamic Revolutionary Guard Corps' Quds Force of counterfeiting "hundreds of millions of dollars" worth of Yemeni riyals, without giving an explanation of how they were being used.[12] But if the riyals were smuggled to Yemen, it is likely they were used to fund the Houthi militias.

11 The United Nations and World Bank estimate that at most one to two months of salary payments have been made to select state employees since June 2016; Yemen government officials argue that key employees have been paid in the south without providing further details.

12 "Treasury Designates Large-Scale IRGC-QF Counterfeiting Ring," U.S. Department of the Treasury press release, November 20, 2017.

The Houthi-led administration in Sanaa still uses the 2014 budget as the basis for spending as does the Hadi government. Neither has enough cash on hand to pay for salaries, officials say. The Sanaa central bank branch acts largely as a treasury. Hadi-affiliated officials are relatively open about the lack of capacity at the Aden central bank, but say they have been able to recruit a highly professional and experienced staff from across the region. The Hadi government, however, did not produce a budget until January, when the prime minister announced a budget of 1.5 trillion Yemeni riyals ($3.3 billion) with a projected deficit of $1.1 billion.[13] No further details were made publicly available.

Customs revenue is being collected at Yemen's ports, airports, and border crossings, while some local markets are being taxed. Revenue is also being generated through the sale on the local market of fuel and liquefied petroleum gas (used as cooking gas and as a fuel source for some vehicles) produced from a refinery and gas bottling plant in Marib governorate, and, since late 2016, from the sale of oil produced in southern Yemen. Yet there is no mechanism for tracking who collects this revenue or how it is used, not least because of the fractured nature of governance in Yemen.

Revenue from oil and gas sales in Marib governorate is transferred directly to the local central bank branch, which is under the control of the governor, Sultan al-Aradah, who uses the funds exclusively to pay local salaries and finance local projects, despite repeated requests from the Hadi government that he transfer revenue to Aden. Similarly, the governor of Hadramout collects customs duties at Mukalla port and taxes local markets, using the income to fund the local government. It is not clear where customs revenue from other ports or the Shahen and al-Wadea land borders with Oman and Saudi Arabia, respectively, are stored. Income from oil exports, meanwhile, reportedly are transferred to a private bank account held under Hadi's name at the AlAhli bank in Saudi Arabia.[14]

The Houthi rebels tax goods entering the territory they control at a series of checkpoints, and also earn revenue from customs duties at Hodeidah and Salif ports, along with taxes imposed on local markets and businesses. The Houthis are reputed to play a major role in smuggling fuel into northwest Yemen, earning large profits. Yet the central bank in Sanaa sees little of this revenue, and struggles to maintain a reasonable supply of physical riyals.

The lack of transparency and repeated accusations of corruption have been a cause for concern for foreign officials, who believe that in addressing the humanitarian crisis they must also be careful not to erode what institutions and capacity Yemen still has available.

13 "Yemen Sets First Budget since 2014," *Reuters*, January 21, 2018.

14 Author interviews with Hadi government officials, Saudi officials, and diplomats, 2017-18.

Domestic and International Responses: Glimmers of Hope?

With the humanitarian crisis being taken increasingly seriously in Western capitals and aid agencies warning of famine, the international community has taken steps to address the issue in a manner that it believes is mindful of the political context. The official position of the IMF and World Bank is that they cannot work in Yemen under standard programming arrangements because there is no functioning government with which to partner.

The World Bank has been able to circumvent this issue by providing in excess of $1 billion in funding for 2017 through the International Development Association, a World Bank program designed to help the institution work in the poorest and worst-governed countries.[15]

The World Bank is working with the United Nations to directly fund social welfare payments, local infrastructure development, education, and health care initiatives, including a large-scale nutrition program, working largely with local partners. Another World Bank subsidiary, the International Finance Corporation, is responsible for oversight of a $500 million Trade Finance Facility for Food Import, which Yemeni traders describe as a crucial mechanism if imports are to continue.[16] The IMF does not currently provide funds to the Hadi government, but is in talks over providing technical support, particularly to the central bank team in Aden. The IMF and World Bank both believe an important solution to the issue of weak central bank capacity in Aden is to improve relations between staff in Sanaa and Aden, and see the October 2017 meeting in Berlin as a positive first step toward this goal.

The Hadi government has been critical of the World Bank's approach, arguing that it has a responsibility to help support institutions by channeling funds through ministries and helping develop much-needed technical capacity. World Bank staff in turn argue that the government does not have the capacity to implement projects, and that its priority is ensuring that Yemen's poorest people receive direct support.

Many foreign officials had expected Saudi Arabia and the UAE to play a more prominent role in supporting the central bank and other government institutions, most importantly with some kind of hard currency loan or block grant. Despite promises of $1-2 billion before the relocation of the central bank headquarters, it wasn't until January that Riyadh made a clear commitment to provide a $2 billion injection of hard currency into the bank. The cash injection, however, was part of a wider deal on internal reform that may have been derailed by fighting between Hadi government loyalists and Southern separatists late in the month. Hadi government officials say that the transfer was in part contingent on the appointment of a new governor. On February 11, the government announced that Mohammed Zammam, a former finance minister, would replace the incumbent Quaiti.[17] However, the transfer has not yet been made. The government has earned some hard currency through oil exports, meanwhile, but it is unclear how the estimated $1 billion earned since late 2016 has been deployed.

15 "World Bank Approves $150 Million to Restore Services in Yemeni Cities," *Reuters*, November 16, 2017.

16 "Statement by World Bank Group Senior Vice President Mahmoud Mohieldin at the High-Level Pledging Event for the Humanitarian Crisis in Yemen," World Bank, April 25, 2017.

17 "Yemen's President Hadi Names New Central Bank Governor," *Reuters*, February 11, 2018.

Commercial banks find themselves increasingly embattled, starved of access to the international banking system, and to hard currency, and facing diminishing liquidity, with the government and de facto authorities in Sanaa effectively defaulting on treasury bills and other forms of debt. The riyal's loss of value since January, despite the announced Saudi injection of funds, has placed further inflationary pressure on an already embattled population. While the government claims it is paying some salaries in southern Yemen, the United Nations and World Bank assess that "most" of the 1.25 million salaries for public sector workers have gone unpaid since June 2016.[18]

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In late 2017, thawing relations between senior Hadi government central bank and Finance Ministry staff on the one hand and skilled technocrats and private sector bank staff based in Sanaa on the other had been a source of some qualified optimism. The Berlin meetings were cordial, and relationships were apparently improving. Access to skilled and experienced technocratic staff based in Sanaa would have helped bridge the capacity deficit within the Hadi government, while improved relations and trust between the central bank and private banks would have been crucial to maintaining the integrity of the financial system.

However, the death of Saleh severely dented hopes of continued improvements in relations and cooperation. The day-to-day operations and even the private communications of staff at government institutions and commercial banks in Sanaa are being closely monitored by the Houthis, who have adopted an increasingly repressive and autocratic approach to governance. Hadi government officials believe that the Houthis' complete takeover could lead to a number of defections, but there haven't yet been any examples of moves from Sanaa to Aden. It is unclear, meanwhile, whether the new central bank governor will continue the dialogue begun by his predecessor.

Conclusions and Recommendations

Yemen's fiscal and macroeconomic situation is in dire shape, and the banking system in the north is in danger of collapse. Unpaid salaries, inflationary pressures, and the ongoing foreign currency crisis each present what would be intractable challenges in peacetime.

Politics has long taken precedent over economics in Yemen, but the economic and humanitarian crisis the country now faces has reached a scale that threatens to be one of the worst disasters the United Nations has had to contend with in half a century. "Unless the situation changes, we're going to have the world's worst humanitarian disaster for 50 years," Mark Lowcock, the U.N. undersecretary general for humanitarian affairs, told Al Jazeera in January.[19]

18 "Under-Secretary-General for Humanitarian Affairs and Emergency Relief Coordinator, Mark Lowcock: Briefing to Member States on Yemen," U.N. Office for the Coordination of Humanitarian Affairs, November 6, 2017.

19 "Unless the Situation Changes, We're Going to Have the World's Worst Humanitarian Disaster for 50 years," *Al Jazeera*, January 5, 2018.

If the macroeconomic environment worsens, foreign exchange reserves are exhausted entirely, or the banking sector collapses, the crisis can only deepen. If salaries are not paid, poverty and indebtedness can only get worse. This creates a powerful argument for a meaningful intervention, by the United States, United Nations, and other countries and international organizations with a stake in the conflict, which goes beyond current gradual and iterative approaches.

First, the banking sector needs an infusion of foreign capital, the deployment of which will need to be carefully overseen. The Saudi $2 billion, if and when it is transferred, is a good step and should be managed in a transparent manner. Second, if regular wage payments are to be made in the short to medium term, it is clear that the $2.65 billion a year cost will have to be underwritten by a third party, and, again, lent careful oversight. As part of this process, the Hadi government should produce a detailed budget. The announcement of a budget is a good step, but the full plan should be made public and progress against the budget should be reported on a regular, perhaps quarterly, basis.

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All efforts should be made to build on existing efforts to improve relations, cooperation, and trust between Hadi government officials at the central bank and finance ministries, and technocrats and commercial bank staff in Sanaa. This could be encouraged by the formation of some kind of coordinating office under international supervision in a second country, perhaps Jordan.

Finally, as with all other aspects of the conflict, triage efforts can only go so far. The Yemen conflict needs to be brought to an end as part of an actively mediated process led by the United Nations.

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