Yemen’s Economy During War and Conflict

**INTRODUCTION**

Yemenis have been living in fragile economic conditions for decades, which exacerbated unprecedentedly during the ongoing conflicts in Yemen. The cumulative contraction in real GDP was estimated at about 47.1% over the past three years\(^1\). Without achieving rapid, just and sustainable peace and neutralizing the economy from war, the cumulative losses in real GDP are likely to increase to $49.9 billion (without physical losses) by the end of 2018\(^1\).

In parallel, the public budget has collapsed under the influence of the division of state institutions and public resources, particularly division of the monetary authority, disruption of hydrocarbon revenues. State employees, with millions of dependent children and women, in several governorates haven’t received monthly salaries for more than 14 months and pensions of more than 41,000 retirees in the General Authority for Insurance and Pensions have stopped since March 2017\(^2\). In addition to the emergence of a severe liquidity crisis and a crisis of confidence that are besetting the banking system locally, amid its undermining credibility in the eyes of the global financial system. As of April 2018, the parallel exchange rate of US dollar increased by about 126% against national currency\(^3\), prices have soared and Yemen is currently facing one of the world’s largest humanitarian crises.

To avoid further losses and crises and out of mercy for Yemenis, it is important to ensure the unification of the humanitarian crises.

**Facts and Indicators**

- **YER 485 / USD**
  - The parallel exchange rate in April 2018.

- **22.2 million**
  - People in need of humanitarian assistance in 2018 *.

- **6 in 10**
  - People are food insecure in December 2017.

- **24.3 million**
  - 90% of the population lack access to public electricity.

- **Over 41,000 Retirees**
  - 33% of retirees in the GAIP without pensions since March 2017.

- **3 million**
  - People displaced (IDPs & returnees) as of September 2017.

- **47.1%**

**In this Edition:**

- **First: Importance of Neutralizing Yemen’s Economy**
- **Second: Yemen’s Economy During the War**
- **Third: Economy in Conflict-affected Countries.**
- **Fourth: Priorities and Requirements for the Neutralization of Yemen’s Economy**

**First: Importance of Neutralizing Yemen’s Economy:**

Neutralizing Yemen’s economy from the ongoing war and conflict is of great importance and represents a supreme interest for the Yemeni economy and population, summarized as follows:

- Establishing a unified monetary authority that exercises the monetary and banking policy throughout the country; boosts confidence in the banking sector and expands its communication channels with the global financial system.
- The possibility of mobilizing tax and hydrocarbon resources to finance the inevitable public expenditures, especially the monthly salaries of state employees and pensions.
- Resuming the cash flow cycle in the economy, which was interrupted by the suspension of hydrocarbon exports, and reducing the need for printing more banknotes to avoid the risk of inflationary financing in the medium and long term.
- Increasing foreign exchange supply by raising exports, thereby supporting the foreign reserves, slowing down the devaluation of the national currency, improving sustainable financing opportunities for basic food goods imports at the official exchange rate and calming down inflation waves.
- Assisting in the continuity of state institutions and basic social services facilities, even at the minimum levels.
- Protraction of the war and uncertainty about the future prospects, while the suffering of Yemenis is increasing every day, resulting in one of the world’s largest humanitarian crises.
- Embodiment of transparency over the public funds, and bolster confidence of the private sector in the economy.
- Proving the keenness of conflicting political parties on the national and social interest and benefiting all citizens nationwide without distinction.
Second: Yemen’s Economy during the War:

2.1 Economic Contraction and Higher Lost Opportunity Cost:

Conflicts usually affect the actual and potential economic growth and reduce and/or eliminate capital gains due to their consequences on the physical and human capital, internal displacement, national capital flight and brain drain. The adverse effects increase with the length of exposure to violence. After three years of conflict, the cumulative losses in GDP ranged between 6-15 percentage points in the Middle East and North Africa (MENA) region compared to 4-9 percentage points worldwide\(^{(4)}\) while they were estimated at 47.1 percentage points in Yemen during 2015-2017\(^{(1)}\).

The increase in economic losses in Yemen compared to the average losses of conflicts in the MENA region and the world is attributed to the closure of some air and land ports; restriction of the foreign trade; interruption of hydrocarbon production and exports which represent the lifeline of the national economy; total absence of electricity through the public grid in many areas of the country; division of the state institutions; emergence of a severe liquidity crisis in the public budget and banking system, which worsened since late 2016, leaving most of the state employees and retirees without salaries amid the disruption of public service programs and many economic activities.

In absolute terms, figure (1) indicates that the cumulative losses in real GDP at constant prices of 2010 were estimated at $34.6 billion during 2015-2017. Without achieving a speedy, just and sustainable peace and neutralizing the economy from conflict, losses are likely to increase and are expected to reach $49.9 billion by the end of 2018\(^{(1)}\).

2.2. Collapse of the Public Budget:

The public sector has played a vital role in turning the wheel of the economic activity in Yemen, where it contributed nearly half (45.3\%) of the GDP\(^{(5)}\), provided employment for 31\% of the total employed population\(^{(6)}\), covered social welfare assistances and monthly salaries of state employees nationwide until 2014. After that, the public finance deteriorated gradually due to the war repercussions and reached the stage of total collapse since late 2016. Below is a detailed analysis as follows:

Public revenues fell by about 60.6\% in 2016 compared to 2014 due to several factors, most notably the interruption of oil and Liquefied Natural Gas (LNG) revenues - which represented the largest source of funding for the public budget- suspension of donor support to the public budget and reduction in tax revenues. Since the last quarter of 2016, the liquidity crisis exacerbated sharply and revenues were mainly limited to surplus profits of some public institutions and taxes, which were already limited due to the suspension of income taxes on state employees’ salaries, damages to the private sector institutions and customs outlets, restriction of the foreign trade and contraction of economic activity in general.

\(^{(1)}\)Source: Ministry of Finance, 2016.
Under pressure from the declining public revenues, public expenditures have shrunk by about 36% in 2016 compared to 2014. Since 2015 to the third quarter of 2016, the public budget was forced to suspend the social welfare assistances to 1.5 million cases (households) of the most vulnerable and poorest groups\(^{(A)}\). Fuel subsidies and capital expenditures were negligible, and the operating expenses of public service facilities have shrunk. By the fourth quarter of 2016, the public budget sustained a severe liquidity crisis that hampered even the payment of monthly salaries to state employees. This crisis was further exacerbated by the division in public finance between Sana’a and Aden following the relocation of the CBY to Aden. Since then, Yemen was left without a unified and transparent public budget in the usual sense and control over the fiscal policy instruments was lost. Thus, state employees, with millions of dependent children and women, in many governorates haven’t received salaries for more than 14 months and pensions of 33.1% out of 124,015 retirees have stopped since March 2017\(^{(2)}\). Additionally, the operating expenses of state institutions and basic social services, such as education, health and water, have stopped, which has severely affected the continuity and quality of public services, in addition to the inability to pay the public debt interests, which jeopardized the banking sector.

To alleviate the financial and humanitarian crisis in the country, the Yemeni economy should be neutralized from the ongoing conflicts to ensure overcoming the current division in the public finance management; mobilizing resources, particularly oil and LNG, and donor support to pay monthly salaries, pensions and cash transfers to the poor cases on a regular basis throughout the country without exception.

**Does Hydrocarbon Revenues Cover Salary Bill of State Employees?**

In 2014, Yemen’s wage and salary bill stood at about YER75 billion per month (of which YER50 billion for civil servants) benefiting 1.25 million employees and their households, while the retirees’ pensions amount to YER5.4 billion per month, benefiting 124,015 retirees. Cash transfers for cases registered in the Social Welfare Fund (SWF) amounted to YER22.7 billion per quarter, covering 1.5 million cases (about 8 million people). In total, state employees’ salaries, retirees’ pensions and cash transfers stood at about YER1,055 billion annually (equivalent to $2.2 billion at a parallel exchange rate of YER485 /USD).

On the other hand, the government’s share of crude oil production that it delivered to local refineries and exported abroad reached 34.3 million barrels in 2014\(^{(7)}\). Assuming that the decline in the current production capacity of oilfields is about 25% less than 2014, and that the price per oil barrel is $70, this means that it’s possible to mobilize $1.8 billion annually, representing 97% of the total salaries of state employees. In case of resuming LNG exports, of which the government’s share was $753.5 million in 2014\(^{(8)}\), it will be possible to cover not only salaries of state employees but also retirees’ pensions and cash transfers for cases registered in the SWF. In the worst case, oil and LNG revenues would be able to cover the salaries of state employees. The resumption of oil and LNG production and exports will not only have a positive impact on the payment of salaries but will also go beyond to all macroeconomic indicators and balances, including the financing of basic commodity imports at the official exchange rate, calming down

\(^{(A)}\)Till the moment, public budget is not able to pay the social welfare assistances.
the exchange rate fluctuations, reducing inflation waves, resuming the cash cycle in the economy and alleviating the humanitarian crisis in the country.

One of the proposals under discussion is that the World Bank provides a “Sovereign Guarantee Loan” to Yemen to be placed in the CBY in order to pay salaries of state employees while ensuring the allocation of revenues of crude oil exports “the sovereign resource” to repay the loan. The parties to the conflict shall pledge to providing the necessary security protection for oil and LNG production and pumping it to exporting ports in areas controlled by each party. This should be based on a neutral and transparent mechanism that gives confidence to all parties through the establishment of a technical unit in cooperation with the United Nations to market oil and LNG and deposit its revenues in the CBY to repay the sovereign loan.

2.3 Currency Crisis and Division of the CBY:

The US dollar exchange rate in the parallel market witnessed a significant increase from about YER215 in March 2015 to YER485 in April 2018\(^9\), with a cumulative change rate of 125.6% due to the limited flow of foreign exchange resources to Yemen, depletion of foreign reserves and the division in the monetary authority. The changes in the exchange rate were more severe following the depletion of the foreign reserves and relocation of the CBY’s operations to Aden, increasing by 61% during September 2016- March 2018, compared to 41% during March 2015-September 2016. Despite the importance of the recent $2 billion-deposit in easing the exchange rate fluctuations, the sustainability of the positive impact of this deposit requires the mobilization of more donor support, resumption of exports and unification of the CBY.

The national currency crisis is a very sensitive issue that affects the living conditions of Yemenis in all areas without exception, especially since Yemen depends on imports to cover most of its food and non-food needs. Therefore, the appreciation of the exchange rate is one of the most influential factors that affect the consumer prices. The cumulative inflation rate was estimated at 59.4 percentage points during December 2014 - December 2017\(^10\). This requires all parties to neutralize the monetary and banking situation from the ongoing conflicts. However, the monetary power in Yemen has unfortunately been divided and paralyzed since September 2016, posing a new challenge to the list of challenges facing the national currency. Below is an assessment of the strengths and weaknesses of the two CBY in Aden and Sana’a as follows:
Assessment of the Strengths and Weaknesses of the CBY in Aden

<table>
<thead>
<tr>
<th>Strengths / Opportunities</th>
<th>Weaknesses / Threats</th>
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<tr>
<td>• Recognized by regional and international financial institutions.</td>
<td>• Difficulty to practice the monetary policy throughout the country.</td>
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<tr>
<td>• Control of SWIFT system and ability to transfer foreign currency of banks to and from Yemen.</td>
<td>• Difficulty to transfer cash to and from Aden for security reasons.</td>
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<td>• Existence of networking with branches of the CBY in all governorates</td>
<td>• Faraway locations of main centers of banks and lack of networking with them.</td>
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<td>• Is relatively able to mobilize liquidity in foreign exchange, such as:</td>
<td>• Difficulty to export oil from Marib via the Ras Issa port, and the potential targeting of oil and LNG infrastructure.</td>
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<td>- Ability to export oil and LNG from Hadramout and Shabwa governorates.</td>
<td>• Economic squabbles affect the value of the national currency.</td>
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<tr>
<td>- Receipt of a $2-billion deposit to support the national currency.</td>
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<td>• Is committed to pay monthly salaries of state employees in all area and pay the public debt service.</td>
<td>• Depriving state employees in many governorates of their monthly salaries on the pretext of not supplying the revenues of those governorates to the CBY.</td>
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<tr>
<td>• Ability to issue banknotes, where it printed YER 600 billion in 2017.</td>
<td>• Lack of transparency and higher pressure on the value of the national currency.</td>
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Although the CBY in Sana’a lacks most of the strengths of the CBY in Aden, it has operational capabilities such as the availability of qualified staff, equipment, databases and information needed to perform the monetary and banking functions. In addition to its proximity to the main centers of commercial and Islamic banks and its association with them and its control over their balances “deposits and required reserves.”

It’s evident from the foregoing that it’s difficult to exercise the monetary power in the country without the unification of the CBY, which has been divided for more than 20 months and resulted in many imbalances and risks, most notably the following:

● The lack of a comprehensive and transparent database of monetary and banking developments due to the division in the CBY’s branches into two parts, which hindered the preparation of the CBY’s balance sheet and money supply.

● Difficulty to take and implement the monetary and banking decisions and procedures, thereby, losing control over the monetary and banking policy tools and difficulty to implement them throughout the country. As well as the lack of coordination between fiscal and monetary policies. This contributes to widening the imbalances of the macroeconomic balances and indicators, including the exchange rate.

● Inability of the CBY to meet its obligations, such as allowing banks to withdraw from their balances at the CBY, providing the necessary liquidity nationwide and paying the domestic and external debt service. Therefore, banks were not able to meet their obligations to their clients and refrained from depositing their money in the CBY. Consequently, the crisis of confidence in the Yemeni banking system has emerged domestically, and the credibility and creditworthiness of the banking system has been undermined in the eyes of the regional and global financial system.

● Confusing banks with instructions issued by two inconsistent monetary powers and reluctance of banks to purchase the newly issued treasury bills, government bonds and Islamic Sukuk to finance the public budget from non-inflationary sources. Due to the high risks of investment in Yemen, banks with financial surpluses tended to speculate in foreign exchange market to make revenues.
● Accumulation of cash liquidity in specific areas (Sana’a, Aden, Marib and Hadramout) away from the control of the monetary power, and prohibition of large remittances in local and foreign currencies between areas under the control of the parties to the conflict. This facilitates speculation in the exchange rate and, thus, raises inflation.

● Isolation of Yemen’s banking system from the global financial system. This is clearly reflected in the reluctance of foreign banks to deal with Yemeni banks in US dollar remittances or open documentary credits; closure of Yemeni banks accounts at the American banks and refusal to deal with them because the CBY has not been able to oblige banks and money exchange dealers to apply the compliance standards and international standards against money laundering and terrorist financing since before the war. The situation became more complicated following the division of the CBY and suspension of the SWIFT system, in addition to the difficulty to transfer foreign exchange to and from Yemen.

● The high lost opportunity cost on the private sector and ordinary citizens because foreign banks that agree to open documentary credits require cash insurance by 100% of Yemeni banks’ balances for these credits, which raises the costs of importing. Additionally, part of the humanitarian relief funds carried out in local currency goes to banks in terms of the exchange rate variances, while those funds should have gone to the poor.

● The division of the CBY, among other factors, contributed to accelerating the depreciation of the Yemeni Riyal, which lost 55.7% of its value against the US dollar during March 2015- April 2018\(^{3}\) and the continuity of the salary crisis in many Yemeni governorates. This has deteriorated the purchasing power of the national currency and deepened the humanitarian crisis in the country.

To overcome the risks and challenges that are besetting the banking system and to alleviate the humanitarian crisis in Yemen, an economic settlement should be reached to restore the integrity of the CBY to be able to perform its functions in all areas of the country in a neutral and independent manner, away from the ongoing conflicts.

**Third: Economy in Conflict-affected Countries:**

This component reviews the experiences of Syria and Libya, which are undergoing wars and conflicts like Yemen, in order to identify the developments in economic conditions during the war in those countries and draw the most important lessons learned, as follows:

**Syria’s Experience (2011-2018):**

The cumulative contraction in real GDP was estimated at two-thirds during 2010-2016\(^{11}\) due to the repercussions of conflict and war in Syria. However, the public expenditure increased from 29% of GDP in 2010 to 30% in 2015\(^{12}\) as a result of increase in current war expenditures and continuous coverage of state employees’ salaries. Due to the collapse of oil and gas revenues, the contraction of economy and foreign trade, as well as the division of areas between the parties to the conflict, public revenues declined from 21% of GDP in 2010 to 6% in 2015. It seems that the main source of income came from the two telecommunications operators in Syria\(^{12}\).

As a result, the public budget deficit increased from -8% of GDP in 2010 to -24% in 2015\(^{12}\). This deficit was financed through internal borrowing from commercial banks and also from the central bank through printing new banknotes and using the foreign reserves, as well as foreign support- in the form of credit facilities and assistance- which had a vital impact in supporting the public budget. Therefore, the total public debt increased from 30% of GDP in 2010 to 150% in 2015\(^{12}\). To further contain the fiscal crisis, a package of austerity measures was adopted and negative adjustment mechanisms were resorted to, such as reducing both capital spending and subsidies for food, fuel, water and electricity. In addition to delaying the payment of due debt securities for 10-15 years. The accumulation of domestic arrears on the government is likely, including delayed payment of salaries.
In Syria’s experience, the public finance and management and the central bank weren’t divided as happened in Yemen. Foreign exchange reserves have been sacrificed and fell from about $20 billion in 2010 to less than $1 billion in 2016. This resulted in the collapse of the Syrian currency value, where the official exchange rate rose from 47 Lira/ USD in March 2011 to 514.4 Lira / USD on 10 March 2017(11). This contributed to increasing the cumulative inflation in consumer price to more than 300% during March 2011-May 2015(12).

• **Libya’s Experience (2011-2018):**

It is estimated that GDP has lost half its pre-conflict size. The per capita income of GDP fell to less than $5,000 in 2016, compared to about $13,000 in 2012(11). However, public spending increased from 59.3% of GDP in 2011 to 105.2% in 2015 and then dropped to 70.9% of GDP in 2016(13) due to the removal of more than 100,000 double-dippers and ghost employees from the government payroll, as well as the reduction of the subsidy bill due to the removal of food subsidies and the decline in imported fuel prices, but the salary and subsidy bill still accounts for more than 60% of GDP(11). Public revenues fell gradually from 72.3% of GDP in 2012 to 17.5% in 2016(13). This is mainly due to the decline in oil revenues - the main supplier of the Libyan budget - by about 90% during 2012-2016 due to the repercussions of the war on oil production and the fall in global oil prices.

As a result, the public budget deficit reached record levels during the war period, reaching a peak when it exceeded -75% of GDP in 2015 and -50% of GDP in 2016(13). Most of the public budget deficit was financed through direct overdraft from the Central Bank of Libya, where foreign reserves constituted the main source of financing for the public budget deficit. To further contain the budget deficit, development spending was reduced, food subsidies were removed and payroll bill was reformed.

In Libya’s experience, the state institutions were divided between the two sides of the conflict, but the central bank continued to pay monthly salaries, relying on the foreign reserves (without gold), which fell from $115.2 billion in 2013 to $65.9 billion in 2016, with a decline rate of 42.8%(14). This increased the pressures on the exchange rate, where the change rate in the official exchange rate of the Libyan dinar against the USD amounted to about 13.5% during 2011-2016(15), while the Libyan dinar in the parallel market lost about 85% of its value(16). This contributed to escalating the inflation rate to about 26% in 2016 compared to 10% in 2015(15).

♦ **Lessons learned:**

• It’s important to notice that public expenditures in Syria and Libya have increased during the war while they declined to the lowest levels in Yemen. While salaries of state employees in Yemen have been suspended, monthly salaries continued to be paid in Syria, and also in Libya where the war has destroyed most of the institutions between the two sides of the conflict.

• Libya’s public finance crisis has led to the reform of the wage bill by removing the double-dippers. This is a lesson that Yemen should have taken in parallel with the liberalization of fuel prices.

• Oil exports in Syria and Libya have fallen to the lowest levels, but they have almost completely stopped in Yemen since April 2015, thus exacerbating the economic, financial, monetary and humanitarian conditions in Yemen.

• The budget deficit amounted to record levels in Libya and Syria. It was financed through the banking system and external credit facilities in Syria and through foreign reserves in Libya. In contrast, the CBY and public finance management in Yemen have been divided since late 2016. The performance of the monetary power has been paralyzed and Yemen lacked a public budget in the usual sense.

• Libya succeeded in preventing the collapse of the official exchange rate, relying on its large foreign reserves, unlike Syria and Yemen, where the modest foreign reserves have run out, currency crisis has exacerbated and inflation rates have escalated.
In general, the experiences of many conflict-affected countries— including Syria, Libya, Iraq and Lebanon during the civil war—confirm that no agreements were reached to neutralize the economy from the conflict, and that the deterioration of economic, financial and monetary indicators has been a common denominator among all the experiences of conflict-affected countries. Nevertheless, central banks continued to exercise their functions impartially and independently and pay salaries to public employees in those countries except Yemen. In order to address the salary crisis in Yemen, discussions are currently being held on exporting oil to cover salaries, similar to the oil-for-food mechanism that was implemented in Iraq under the supervision of the United Nations during the period of economic embargo on Iraq following the second Gulf War in the last decade of the twentieth century.

**Fourth: Priorities and Requirements for Neutralizing Yemen’s Economy:**

Any hole in the Yemeni economy ship will drown everyone without exception. In order to spare the Yemeni citizens more economic and living crises, parties to the conflict must bear responsibility toward this country and its people by reaching economic settlements to neutralize the economy from the ongoing conflicts and to avoid deepening the rift in the unity of the national economy. The following are the outlines of the priority areas proposed to be neutralized and requirements of neutralization:

**Priority areas proposed for neutralization from the ongoing conflict:**

- Giving priority to the economic file in the agenda of the expected political settlement negotiations, through the allocation of meetings to rescue the economic situation and adopt measures to build economic confidence.
- Mobilizing the public resources, mainly the production and export of oil and LNG to cover the salary bill and restore the cash cycle in the economy.
- Resuming the operation of the Marib gas power station and providing the necessary fuel to operate the other power plants, along with studying the appropriate formula to lease the power plants to the private sector. In addition to operating Aden refinery and provide it with light crude oil at its global price from Marib via Ras Issa. This will ensure the collection of public revenues transparently to pay the salaries of state employees, revive the economy and ease pressures on the national currency.
- Neutralizing the economic and financial institutions, mainly the CBY to enable it to perform its functions impartially and independently in all areas of the country, away from the ongoing conflicts.
- Facilitating the transfer of foreign currency of banks to and from Yemen and lifting the restrictions imposed on cash transfers between areas controlled by the parties to the conflict.
- Lifting the restrictions imposed by the global financial system on banks operating in Yemen in the area of documentary credits and US dollar transfers and opening the closed bank accounts by taking the necessary arrangements to ensure their compliance with the global standards against money laundering and terrorist financing.
- Mobilizing donor support for the humanitarian situation and development projects in stable areas and holding dialogue with the World Bank to continue its support to the cash transfers for the poor cases registered in the SWF.
- Opening the land, air and sea ports to the movement of individuals and foreign trade, especially food, medicine and fuel imports.
**Requirements for neutralizing the economy:** most notably the following:

- Identifying the revenue sources agreed to be neutralized, most notably oil and LNG revenues.
- Identifying the inevitable items that will be funded, especially the salaries of state employees and pension based on the 2014 payrolls, and also the cash transfers for cases registered in the SWF should there be a surplus of resources.
- Ensuring the distribution of resources to beneficiaries in accordance with objective criteria in all areas without distinction.
- Financing basic commodity imports at the official exchange rate for all areas without exception.
- Ensuring control and accountability in the collection and disbursement of resources and depositing them in the CBY.
- Reflecting transparency on resources and expenditures and publishing periodic reports on the website.
- Staying away from political interference in the management of financial and economic institutions agreed to be neutralized.
- Sharing databases and information and facilitating the relocation of staff between areas as needed.
- Implementing necessary reforms such as applying the biometric fingerprint system to remove the double-dippers and ghost employees from the payroll.
- Agreeing on the appropriate mechanism to neutralize the economy from the conflict and establish clear and specific terms of reference. It’s possible to consider the selection of impartial national figures who are known for their competence and integrity.
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