



## Yemen Economy in Lines

# Exchange Rate Crisis

## Causes ... Implications ... Priorities

### INTRODUCTION

Exchange rate is a key economic indicator that influences trade levels, relative incomes and competitiveness. To many it is a measure of the relative health of an economy.

Therefore, exchange rate fluctuations reflect immediately on prices of goods and services, purchasing power of the national currency and people's standards of living.

This makes central banks focus and pay attention to stability of currency's exchange rate as the monetary policy's prime target and an indicator that determines stability or instability of the macroeconomic situation. The monetary and fiscal policies use some of their tools to maintain exchange rate stability, including the maintenance of strategic foreign exchange reserves to protect and enhance confidence in the national currency.

The Central Bank of Yemen (CBY) has used all tools of monetary and non-monetary policy, including the recognized credibility of the bank's leadership, in addition to taking extraordinary measures to prevent violent fluctuations in the foreign exchange market. However, the pessimistic atmosphere of the current political, security and economic crises in Yemen have overshadowed the monetary situation. As a result, the national currency has lost close to 16.3 to 25.6% of its value and real income of individuals and their living standards have similarly eroded.

To control the deterioration in exchange rate and avoid worsening monetary and economic situations, this edition highlights urgent actions, most importantly getting a cash deposit at the CBY to recover the value of Yemeni Riyal and, to some extent, stabilize the economy.

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### FACTS AND FIGURES

- The Gross Domestic Product (GDP) is estimated to decrease by 34.6%, along with an escalating inflation rate by over 30% in 2015.
- The public budget's financing gap is estimated at \$5.8 billion in 2016 without reconstruction needs.
- The exchange rate in the parallel market reached 250 YR/USD at the end of March 2016, compared to 214.9 YR/ USD in March 2015.
- Power supply through the public grid has been completely suspended in Sana'a and many other governorates for about 7 months.
- Fuel imports covered 85% and 15% of the local market needs during January and February 2016 respectively. (OCHA, Shipments Snapshot, March 2016)
- 14.4 million Yemenis are food insecure, and 1.8 million children at risk of malnutrition (OCHA, Humanitarian Bulletin, Issue 8, Feb. 2016).
- 21.2 million Yemenis (82% of the population) are in need of humanitarian assistance, including 9.9 million children and 2.5 million IDPs (31% children). (UNICEF, SitRep, 13-26 Jan. 2016).

### HIGHLIGHTS:

*This edition highlights the exchange rate crisis, as follows:*

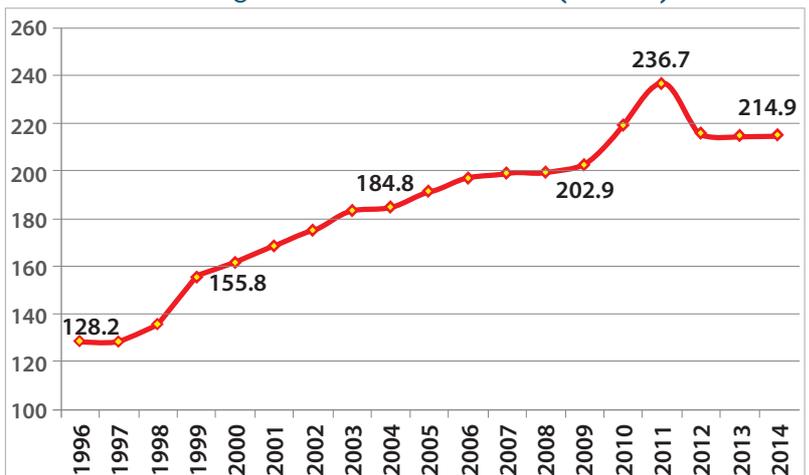
- **Trends:** The parallel exchange rate has experienced three shocks, increasing from YR214.9/USD in March 2015 to more than YR270/USD late February 2016. Recently, it was agreed to deal in accordance with a parallel exchange rate at YR250/ USD.
- **Causes:** The most important causes of exchange rate crisis include suspension of oil and gas exports, suspension of donor development support, difficulty to convert banks accumulated balances from Saudi Riyal to US dollar and erosion of the CBY's foreign exchange reserves.
- **Implications:** Increase in inflation rate, leading to declining currency's purchasing power; erosion of the real value of savings, income and consumption, and limited access to basic services and food among the poor people; thus, increasing poverty rates.
- **Priorities:** Putting a cash deposit in the CBY, providing direct support to the state budget deficit and resuming the oil and gas exports and donors' development support

### First: Exchange Rate Trends (Pre-War):

The exchange rate, in common use, means the amount paid in national currency (Riyal) to buy one US dollar. The exchange rate stability is a prerequisite to achieve economic and social development, attract investments and maintain the purchasing power of the national currency, while the sudden and sharp fluctuations in exchange rate reflect the severity of economic, political and security imbalances a country is going through.

Yemen has adopted the free exchange rate system (Managed System) since the beginning of the Economic Reform Program in July 1996. The Central Bank of Yemen (CBY) defends the exchange rate against any large fluctuations that aren't economically justified. The figure below indicates that continuous increase in exchange rate is a dominant feature except for short periods. Therefore, ordinary citizens have been suffering from declining purchasing power of the national currency and deteriorating living standards.

Exchange Rate in Parallel Market (YR/USD)



## Second: Exchange Rate Shocks (2015-2016):

During 2015 and the 1st quarter of 2016, the exchange rate has experienced sharp fluctuations and severe shocks, as follows:

### First shock:

The exchange rate in the parallel market increased from YR214.9/USD in March 2015 to about YR225/USD in April 2015, as a result of the conflict that created panic among people, where depositors began to withdraw their dollar deposits, fearing that banks might be at risk, and some others had changed their deposits from Yemeni Riyal to US dollar.

As proactive measures to protect the national currency, banks operating in the country have reduced dealing with foreign currency and only allowed withdrawals of the Yemeni Riyal (While allowing withdrawals of foreign currency occasionally, according to the availability of foreign currency in banks).

### Second shock:

The increase in exchange rate from YR225/USD in July 2015 to around YR255/USD at the beginning of August 2015, after the private sector was permitted to import fuel and the CBY stopped covering the fuel import bill at official exchange rate (YR214.9/ USD).

Given the fuel shortage and the subsequent increase in local fuel prices to very high levels at that time, there was a high feasibility to purchase foreign currency (dollar) needed to import fuel even at high prices. This has created excess demand for US dollar in the exchange market, leading to further increase in the exchange rate.

### Third shock:

Given the severe decline in the inflow of foreign exchange to Yemen and the erosion of foreign reserves, CBY was forced to stop the provision of foreign exchange to finance imports of sugar at official exchange rate (YR214.9/dollar), leading to higher pessimistic expectations of dealers in foreign exchange market. This procedure means putting more pressure on the foreign exchange market, which is already suffering from lack of foreign currency (US dollar). As a result, the exchange rate in the parallel market increased from about YR253/USD in February 20th, 2016 to over YR270/USD at the end of February 2016. Consequently, the national currency lost about 26.6% of its value against foreign currencies between March 2015 and February 2016. This has led to declining purchasing power of the national currency and high levels of poverty.

**Recently**, in order to control fluctuations in exchange rate, the CBY agreed in March 19th, 2016 with representatives of the Yemen Bank Association and Foreign Exchange Dealers Association on a number of measures to ensure exchange rate stability, including: adopting the parallel exchange rate at YR250/USD. This agreement represents a step to fix exchange rate at a more realistic level and prevent exchange speculations for the benefit of specific groups at the expense of ordinary people. Some argue that this measure undermines the credibility of monetary policy in maintaining the exchange rate and believe it could push the parallel exchange rate towards further increase.

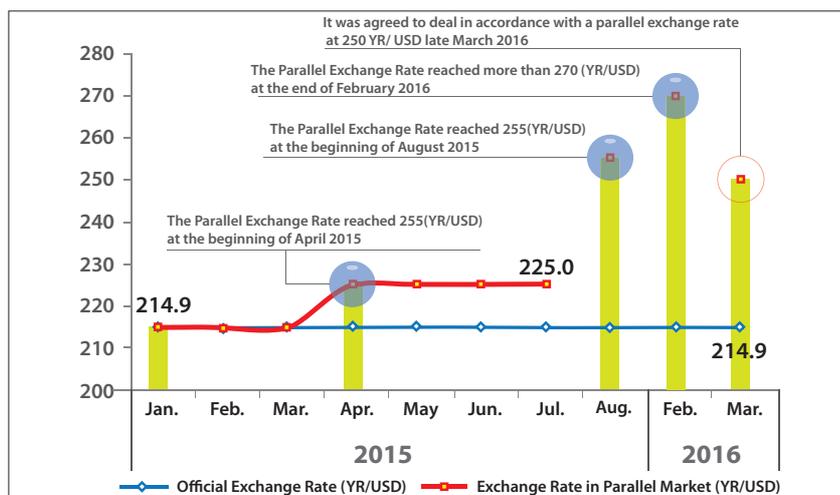
## Third: Causes of Currency Crisis:

The real roots of currency crisis are attributed to political, security, psychological and economic reasons, as follows:

### 3-1 The political, security and psychological causes has resulted in:

- Existence of a repulsive environment for local and foreign investments and higher concerns about the future business climate. A manifestation of this is that:
  - 46% of large businesses owners in Yemen planned to move their businesses abroad (*SMEPS, Business Climate Survey, June, 2015*), meaning that they have started to liquidate their fixed assets to foreign currencies and smuggle them abroad.
  - 76% of business owners have pessimistic anticipations or ambiguity about the future of their businesses (*SMEPS & GIZ, Business Climate Survey, Aug.-Oct., 2015*). This means that they would prefer to maintain foreign currencies.
  - Lack of foreign investments coming to Yemen and disruption of tourism activities; thus contributing to a decline in foreign exchange supply.
- Suspension of donor support to development projects and the state budget.
- Inability of Yemeni banks to transfer their accumulated balances in Saudi Riyal to US dollar, making it difficult to grant letters of credit to importers in US dollar.
- Damages to infrastructure, such as airports and seaports, leading to declining foreign exchange revenues of seaports and airports services.
- Pessimism about the future of development and the lack of confidence in the national currency, thereby boosting the demand for foreign currencies.

Official and Parallel Exchange Rate (YR/USD)



### Yemeni Expatriates' Remittances and Currency Crisis

Remittance transfers made by Yemenis working abroad represent the second source of foreign exchange in Yemen after the oil and gas exports. During 2012-2014, these transfers reached \$3.3 billion on average per year, of which over 90% in Saudi Riyals.

Yemeni banks usually collect their balance in Saudi Riyals and send them to Bahrain on a monthly basis. This money is then sent to Dammam to be transferred into US dollar in the Saudi Arabian Monetary Agency. After that, these US dollar funds are added to the Yemeni bank accounts in international banks in order to be able to finance and provide letters of credit to traders to purchase and import goods.

Since 2015 to February 2016, Yemeni banks weren't able to get a plane to transport the accumulated funds to Bahrain or the Saudi Arabian Monetary Agency to be transferred to US dollar due to the ongoing war in the country. As a result, the balances of banks and exchange companies in Saudi Riyal have accumulated against US dollar shortage. This has affected banks' ability to cover import credits, which has contributed to exacerbating the currency crisis.

## 3-2 Economic causes of currency crisis:

### 3-2-1 International Economic causes:

- Precipitous decline in the flow of foreign exchange resources from trade and aid to Yemen (See the table) due to the suspension of goods and service exports, disruption of tourism and foreign investments, suspension of development grants and loans, departure of embassies and donor organizations.
- Decline in foreign exchange resources derived from support to the public budget (external grants, loans and oil and gas exports) by 82% since April 2015, falling from \$4.0 billion in 2014 to \$0.7 billion in 2015.
- Existence of obstacles regarding cash transfers in US dollar and external banks' suspension of dealing with Yemeni banks in the field of transfers and letters of credit.

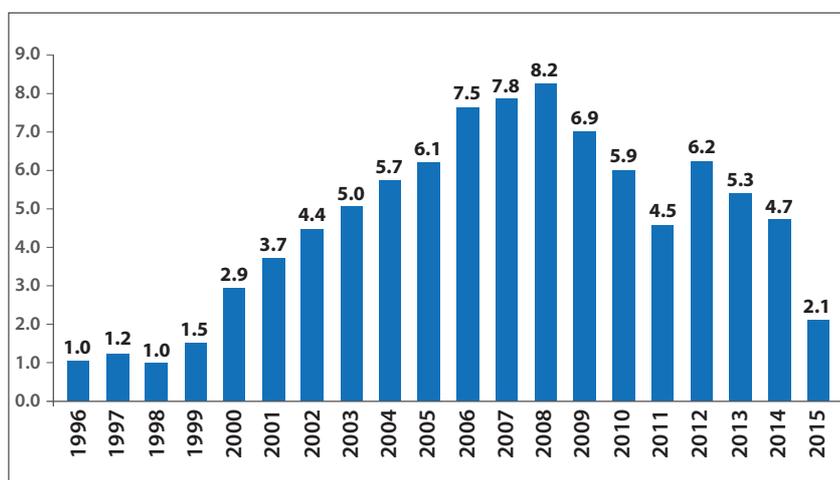
Inflow of Foreign Exchange Resources to Yemen during 2014-2015 (Billion USD)

Items	2014	Structure %	2015
<b>Goods Exports of which:</b>	7.6	45.6	<b>Suspended</b>
- Oil and gas	6.328	38.0	
<b>Services Exports of which:</b>	1.706	10.2	<b>Suspended</b>
- Tourism returns	0.949	5.7	
<b>Remittances</b>	3.303	19.8	<b>Continuous</b>
<b>External grants to Gov.</b>	1.585	9.5	<b>Suspended</b>
<b>Government Loans</b>	0.545	3.3	
<b>Oil companies investment</b>	1.9	11.4	<b>Sporadically</b>
<b>Others</b>	0.027	0.2	
<b>Total inflow of foreign exchange resources</b>	16.666	100.0	

### 3-2-2 Domestic Economic causes:

- Inflationary financing from the CBY putting additional pressure on the exchange rate. The public budget deficit was financed through overdraft from the CBY by \$3.6 billion in 2015. This contributes to higher money supply, increasing inflation and further deterioration of the national currency.
- The weak supervision and control over the process of buying and selling US dollar in banks and exchange companies, which facilitates speculation in foreign currencies. It is noted that the number of exchange offices and companies (About 400) exceeds the size of the exchange market, making it difficult to control the activities of these companies and offices.
- Low real interest rate (the nominal interest rate minus inflation), that has already become negative. In response a Central Bank would usually seek to raise interest rates. However, it's not recommended to raise interest rates at this time since it's not expected to restore the confidence of individuals in Yemeni Riyal, encourage them to deposit in Riyal or even influence investments because the political, security and psychological variables are the most influential over the decisions of individuals. Additionally, raising the interest rate will further exacerbate the burden of public debt service on the state budget.
- Declining confidence in the national currency even before the war, where the foreign currency deposits reached 44% of total deposits on average, despite the lower interest rates on US dollar deposits (4%) compared to (15-19%) on deposits in Yemeni Riyal. However, this percentage fell to 35.5% of the total deposits in 2015 as several foreign currency deposits had been withdrawn.
- Chronic causes of currency crisis include: the weak productive base of the national economy, lack of export diversity and existence of structural imbalances in the balance of payments and the state public budget.
- The rapid decline in the CBY's foreign exchange reserves from \$4.7 billion in December 2014 to \$2.1 billion in December 2015, thereby leading to:
  - Declining ability of the CBY to continue providing foreign currency needed in the exchange market in order to protect the exchange rate. The foreign exchange sales made by the CBY to banks and exchange companies have risen from \$404 million in 2014 to \$667 million in 2015. However, exchange rate continued to increase.
  - Difficulty to continue providing the necessary foreign exchange to cover the bill of fuel imports and basic commodities at official exchange rate (YR214.9/USD), as it provided about \$1.9 billion in 2015, compared to around \$3.1 billion in 2014.
  - Weak creditworthiness of the national economy and lower customers' confidence in the national currency.

Total Foreign Reserves of CBY in Billion USD



## *Exchange Rate Management*

*The CBY has taken a package of measures to reduce the exchange rate fluctuations, including:*

Measures	Comments
- In April 2015, dealing with foreign currency has been reduced and withdrawals of foreign currency deposits have been suspended (temporarily) for some months.	- It contributed to the protection of national currency during the first shock, but weakened the confidence in the banking system.
- In March 2016, banks and exchange companies were obliged to sell all their stock of foreign currency to meet the needs of their clientele.	- This procedure requires regulations
- A ceiling of amounts remitted outside Yemen was set at \$10,000. In March 2016, this ceiling was raised to \$15,000	- Contributed to the reduction of smuggling of foreign currency abroad.
- The CBY suspended financing the fuel and sugar imports at official exchange rate in July 2015 and February 2016 respectively. - In March 2016, banks and exchange companies have been obliged not to sell foreign currency to fuel importers unless they have a license from the Yemen Petroleum Company and prior approval of the CBY.	- It increases the pressure on the exchange market. - A single window is proposed to be established receive financing requests of fuel and basic commodities imports and finance them in order of priority .
- Provision of personal remittances from abroad to beneficiaries in Yemeni Riyal and at the official exchange rate instead of the original currency of the remittance. This decision had a negative impact on the inflow of remittances and; therefore, has been suspended in March 19th, 2016.	- It has caused a decline in foreign remittances made through the formal market.
- In march 2015, it was agreed to deal in accordance with a parallel exchange rate (YR250 /USD). - Exchange companies have been prevented from selling foreign currency by over YR 2 million per transaction.	- It seeks to peg the parallel exchange rate at a realistic level to curb speculations in exchange rate.

## **Fourth: Socio-Economic Implications of Currency Crisis:**

*The increase in exchange rate results in several negative effects, mainly:*

- Immediate increase in the prices of key staple items for Yemenis, particularly food and fuel...etc.
- Additional uncertainty for importers of key products, as (Rial denominated) revenues fail to meet (dollar/euro denominated) import costs and as the Central Bank find it harder to support imports.
- Increase in prices of imported intermediate and capital goods which will lead to higher domestic production costs, thereby affecting the economic growth.
- A pre-crisis IMF paper indicated that a 1% rise in the exchange rate causes an increase in the inflation rate range between 0.44%-2%. This weakens the purchasing power of the national currency, leading to erosion of savings and decline in the real value of income, which means declining real consumption and increasing poverty levels.
- Increase in income and wealth inequality in favor of the wealthy class that own assets in foreign currencies and may raise the prices of their commercial products stocked in warehouses. In contrast, the middle class income shrinks in real terms due to the rigid of wages in the face of higher inflation.
- Increase in costs of basic education, health, water and transportation services. Spending priorities on education are expected to decrease in poor and low-income household as being crowded out by spending on essential goods. This will exacerbate the already high school dropout, since inability to afford educational costs is a major cause that makes children leave school.
- Theoretically, the increase in exchange rate has many advantages such as: stimulating exports and weakening the competitiveness of imported goods, stimulating the domestic production and reducing imbalances of the current account balance, in addition to raising the budget revenues from oil and gas exports, external grants and loans (when calculated in local currency). However, this doesn't necessarily apply to Yemen's economy because of the low elasticity of exports and imports in normal conditions and within the ongoing war.

### ***Will financing the social welfare cash assistance ease pressure on exchange rate?***

The exchange rate has experienced extreme fluctuations resulted in further deterioration of currency's purchasing power and erosion of people's real income. Beneficiaries of the Social Welfare Fund (SWF) cash assistance have been affected, not only by the declining currency purchasing power, but also by the suspension of SWF's cash assistance since early January 2015, despite its scant amount, ranging between YR 3000-6000 (Equivalent to about \$14-28) per beneficiary case [Household] each month. The total number of SWF beneficiary cases is nearly 1.5 million, including 39% disabled and orphan children and women without breadwinner. 70% of those cases depend mainly on the cash assistance as a source of income to purchase food and the suspension of assistance

make them unable to have access to food.

In recognition of this, UNICEF is exerting unremitting efforts with other donors to mobilize the necessary financing needs to resume the disbursement of cash assistance to the SWF beneficiary cases. Providing a one year financing for SWF beneficiary would require the mobilization of \$430 million. If such amount is mobilized, it would be enough to cover 48% of the imported basic food commodities (wheat flour, rice and sugar) for one year. As a result, the mobilization of donor support to finance the SWF cash assistance will contribute, not only to alleviate the suffering of the poorest people, but also to ease the pressure on foreign exchange market and, temporarily, soothe the exchange rate fluctuations.

## Fifth: Key Priority Interventions:

To reduce the exchange rate fluctuations in the short term and to ensure its stability in the medium and long terms, several key priority interventions should be taken, most notably:

Key issues	Priorities	Expected Impact	Timeframe
<b>Integrating economy into the political settlement agenda</b>	<ul style="list-style-type: none"> <li>- Reaching a sustainable peace agreement, and ensuring the restoration of security and stability.</li> <li>- Considering economy a high priority in the anticipated political settlement agenda.</li> <li>- Adopting measures to build the economic confidence, such as putting a \$5 billion cash deposit at the CBY, and providing direct support to finance the state budget deficit.</li> </ul>	<ul style="list-style-type: none"> <li>- Boosting confidence in the Yemeni economy and national currency.</li> </ul>	<b>Urgent and medium term</b>
<b>Resuming the flow of foreign exchange resources</b>	<ul style="list-style-type: none"> <li>- Facilitating a periodic transportation of the Saudi Riyal funds accumulated at banks in Yemen to Bahrain to be converted to US dollar.</li> <li>- Providing cash grants from donors to disburse the cash assistance to the Social Welfare Fund beneficiaries.</li> <li>- Resuming the flow of foreign exchange resources, mainly the oil and gas exports and the donor development support.</li> <li>- Raising awareness among Yemeni expatriates of the importance of making remittance transfers in US dollar and motivating them to increase their remittances to Yemen at this period.</li> <li>- Searching for external support in-kind assistance (fuel) to reduce pressure on foreign exchange reserves.</li> </ul>	<ul style="list-style-type: none"> <li>- Reducing the exchange rate fluctuations, and improving the living standard of the poorest in society.</li> </ul>	<b>Urgent</b>
<b>Managing the economic and exchange rate policies</b>	<ul style="list-style-type: none"> <li>- Forming a team to manage the economic and currency crises, including the key players in the foreign exchange market and parties concerned about drawing the macroeconomic policies (CBY, commercial and Islamic banks, exchange companies, private sector, Ministry of Planning and International Cooperation and Ministry of Finance).</li> <li>- Developing supervision and oversight mechanisms on the activities of banks and exchange companies, and ensuring the provision of accurate information through the automated link.</li> <li>- Studying the feasibility of raising the legal reserve on Foreign currency deposits.</li> <li>- Limiting the possession of banks and exchange companies of large sums of US dollar that exceed their needs.</li> </ul>	<ul style="list-style-type: none"> <li>- Controlling the exchange rate fluctuations.</li> <li>- Getting parties of the financial and private sectors to support the decisions and policies.</li> <li>- Curbing the departure of foreign exchange.</li> </ul>	<b>Urgent</b>
<b>Financing imports of fuel and basic commodities</b>	<ul style="list-style-type: none"> <li>- Adopting the single window system to receive requests to finance imports of fuel and basic goods that require large sums of money, and fund them in an order of priority.</li> <li>- Estimating the financing requirements to import fuel and basic goods (Ex: each two months) and oblige banks and exchange companies to contribute to the provision of finance according to objective criteria such as the accumulation of foreign exchange at each bank and company exchange.</li> <li>- Raising the custom tariffs on imports of luxury goods that exhaust foreign exchange and have good local alternatives.</li> </ul>	<ul style="list-style-type: none"> <li>- Providing fuel and basic goods on a regular basis and reasonable prices.</li> <li>- Curbing the speculation in foreign currencies under the pretext of financing fuel and basic goods.</li> </ul>	<b>Urgent</b>
<b>Structural reforms</b>	<ul style="list-style-type: none"> <li>- Promoting the CBY independency, separating the public treasury system, and dedication to the monetary policy issues.</li> <li>- Restructuring the public spending, mobilizing sustainable resources and having control over the state budget deficit and financing it from real sources.</li> <li>- Providing effective security protection to oil companies and oil and gas pipelines and electricity transmission lines.</li> <li>- Intensifying oil and gas exploration efforts, and stimulating the oil companies to develop the existing fields of oil production.</li> <li>- Stimulating private investments to establish new refineries to refine crude oil, in addition to the renovation and expansion of the Aden Refinery.</li> <li>- Supporting ambitious investment programs to enhance the production and export capacities in promising sectors.</li> <li>- Promoting the benefit from Yemeni expatriates' remittances and establishing the Bank of Expatriates.</li> <li>- Promoting the state building, activating integrity and accountability institutions and improving the investment climate and doing business environment.</li> </ul>	<ul style="list-style-type: none"> <li>- Diversifying sources of national income, and maintaining the exchange rate stability.</li> </ul>	<b>Medium term</b>