Yemen Monthly Economic Update[1]

December 2019

The current political context is as follows. On November 5, 2019, President Hadi's government and the Southern Transitional Council (STC) signed a power-sharing agreement brokered by the Kingdom of Saudi Arabia (KSA) to end escalating tensions and instability in southern provinces since August. The agreement, referred to as the "Riyadh Agreement", laid foundations for political and security stabilization in the South through recognizing the STC's formal role in the political process and managing security and economic responsibilities in the South. Specifically, the Agreement stipulated: the formation of a new technocrat government with up to 24 ministers (of which half from the South) within 30 days from the signing; the strengthening of parliamentary oversight over public spending; and the reactivation of national institutions to strengthen government transparency and accountability. Reorganization of military and security forces is another key feature of the Riyadh Agreement (Annex 1).

During 2019 Yemen's economy continued to suffer from protracted and spasmodic conflict. Early in the year, the economy was projected to grow at around 2 percent in 2019, underpinned by a gradual recovery in the oil sector, resumption of gas production, and relative macroeconomic stability. However, this scenario may not materialize given the prevailing economic and security conditions, especially in the latter half the year, which witnessed escalating conflicts and repeated disruptions to oil production and exports, resumption LNG exports, and supply of foreign exchange to import essential inputs.

The oil sector continued to recover gradually throughout the year but the production target for 2019 was likely missed. Efforts to restore the oil production and export industry made progress in 2019, in particular, the return of foreign investors/operators (OMV and Calvalley) and the gradual resumption of oil production and exports from Marib-Shabwa basin in the last quarter (Table 1).[2] Achievements also include continued production from the Masilah basin by PetroMasila Company, a state-owned operator at about 33 thousand barrels per day (on average) in 2019.[3] However, the gradual recovery of production does not appear to have translated into a significant boost to oil exports and government revenue. Official estimates suggest that Yemen exported about 6.7 million barrels of crude oil during the first half of 2019, compared with an estimated 5.99 million barrels for the same period in 2018.[4] Considering the frequency of production halts and sabotage activities in the second half of the year, it is unlikely that the Yemen's total crude exports reached 20 million barrels for the whole year, as envisaged in the 2019 State Budget. In 2018, Yemen exported an estimated 10.8 million barrels.

Efforts are being made to increase export capacity from the Marib-Shabwa basin. Ongoing projects include the construction of an 82 km pipeline in Marib to facilitate export from an export terminal in

[1] Prepared by Naoko Kojo and Amir Althibah based on information available up to January 10, 2020.

[2] Official estimates indicate to resumption of oil production and exports from three key blocks in Marib-Shabwa basin to more than 50 thousand barrels per day in December 2019 (Blocks 5 - up to 25 thousand barrels per day; Block S1 - up to 12 thousand barrels per day; and Block 18 - 20 thousand barrels of crude oil in the last quarter of 2019 of which, up to half was allocated for domestic refining).

[3] Yemen Ministry of Oil and Minerals.

[4] Yemen Socio Economic Update, Issue 44, August 2019, Ministry of Planning and International Cooperation.

Shabwa province (Arabian-Sea) and to replace an existing (damaged) pipeline from SAFER to Ras-Issa's export terminal on the Red-Sea, which suffered from repeated sabotage attacks in the past.

Table 1. Yemen: Status of Oil Production

Basin	Block	Operator	Output in 2014 ('000 b/year)	Production Status (March 2019)	Production Status (December 2019)
Marib-Shabwa	18	SAFER	13,720	Halted	Active
	4	YICOM	60	Halted	In progress
	S1	Petsec (formerly Occidental/TransGlobe)	310	Halted	Active
	5	Jannah Hunt	9,660	Halted	In progress
	43	Jannah Hunt	440	Halted	Halted
	S2	OMV	5,740	Active	Active
Masila (Hadramout)	14	PetroMasila	10,040	Active	Active
	10	PetroMasila (Conceded from TOTAL in 2016)	13,240	Active	Active
	32	DNO / Conceded to Government of Yemen in 2016	560	Halted	Unknown
	53	PetroMasila (Conceded from DOVE in 2016)	1,450	Halted	Active
	9	Calvalley	1,120	Halted	In progress
	51	Nexen	680	Halted	Halted

Note: Output is based on estimated net state's share in 2014 (production share + taxes + royalties).
Source: Ministry of Oil and Minerals.

Planned resumption of LNG production did not happen in 2019. Despite the government's hope to restart LNG production in 2019, TOTAL–the largest shareholder of Yemen LNG project—announced at the beginning of November that the anticipated resumption of LNG production in 2019 was not possible due to concerns from the security and political environment at both national and local levels. The company cited the sabotage in June on its 320 km-long transmission pipeline as an example of the severity of the operational risks.[5] Earlier in the year, the government projected around 7 percent of its total revenue in the 2019 Budget (YR158.4 billion) to come from resumed LNG exports.

On December 19, 2019, the *de facto* authorities in Sana'a tightened the ban on the use of the new edition of banknotes printed since the Central Bank of Yemen (CBY) moved to Aden in 2016. Throughout 2019, the ban on the new notes has been imposed by the authorities in Sana'a on financial institutions operating in the areas under their control ("the north"). However, now the new banknotes have been invalidated, and holders of new notes must surrender "illegal cash" within 30 days from the date of announcement for an exchange into an electronic currency ("e-rial") or cash reimbursement in old

[5] https://www.ep.total.com/en/innovations/best-innovators-2016/yemen-lng-teams-successfully-produce-ethane-despite-production

banknotes, only if available, for up to YR 100,000per person (about US$150-170 at the prevailing parallel market exchange rate). Compensation in old notes is being offered at over 300 agents points located in all governorates nationwide. Electronic payment services are offered by three commercial banks: *MFloos* operated by Al Kuraimi bank; *Floosk* operated by Yemen Kuwait Bank; and *Mobile Money* operated by CAC bank. The *de facto* authorities claimed that that large-scale monetization of the fiscal deficits over the past years had caused a collapse in the Yemeni rial, and that the new measure was necessary to stop currency speculation and protect the value of the currency.

The sudden announcement of the new measure has contributed to a payment crisis, further disrupting economic activity and aggravating humanitarian conditions. The measure to invalid the new banknotes has mostly affected individuals and small businesses, as the use of new notes was already constrained in the formal sector. One semi-official estimate is that around one-third of currency currently in circulation in the north has been invalidated. Reportedly, successful reimbursement in cash is rare, leaving no option but exchange for the e-rial. However, the acceptance of (unsecured) electronic currency is not widespread at present, effectively eroding the purchasing power of the holders of e-rial.[6] Cash-based businesses (e.g., restaurants, small retailers, local transport) are being hit hard by the demonetization measure, as cash trading has become constrained due to reduced supply of old banknotes. Popular discontent in the affected areas is high. Reportedly many traders in Sana'a went on a partial strike on January 1 in protest of the demonetization measure. The short-term effect of the new measure is certain to be contractionary. Cash payments as a vital coping mechanism are now facing serious disruption. See Annex 2 for further analysis.

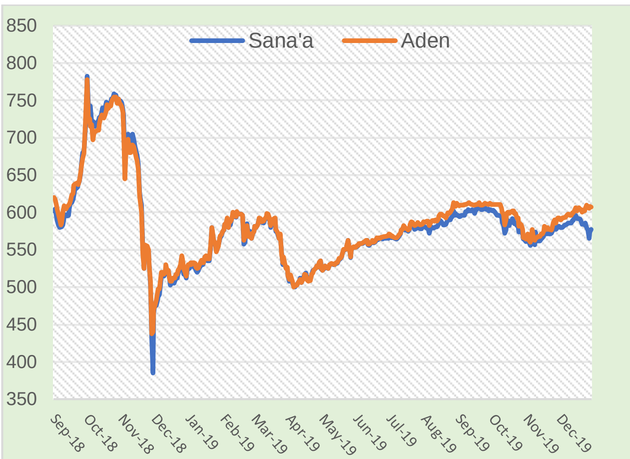
The government in Aden has suspended the payments of civil servants' salaries and pensions in the north, citing refusal by financial institutions to process payments as a result of the new measures announced in Sana'a. However, the allegation was quickly dismissed in a joint-statement from the Banks and Exchangers Associations, which also reiterated commitment to continue providing support to monthly pension and salary payments in all governorates without further complications or delay. Also, the statement urged all responsible authorities for keeping the economy off politics and without adding further restrictions, and for sustaining salary and pension payments out of concerns over social impacts.

After a brief period of appreciation, the Yemeni rial began to weaken in December and the dual exchange rates between Aden and Sana'a have widened since the new measures were announced. Prospects of reinforced supply of foreign exchange and political stability following the signing of the Riyadh Agreement in early November appear to have temporarily eased downward pressures on the rial on the parallel market. During November, the rial appreciated by nearly 3 percent against the US dollar, to approximately YR572/US$ (Figure 1). However, in early December, this trend reversed, amid rising concerns over foreign exchange supply and delayed implementation of the Riyadh Agreement. The recent monetary decision by the *de facto* authorities in Sana'a have effectively reduced the circulation of the rial, and encouraged speculation on the price of the new banknotes against the old and in turn widening the

[6] As early as 2017, amid liquidity crisis the *de facto* authorities launched the e-rial even to pay for public salaries amid liquidity crisis. However, the initiative was not very successful, because of its limited acceptance as a form of payment in a predominantly cash based economy.

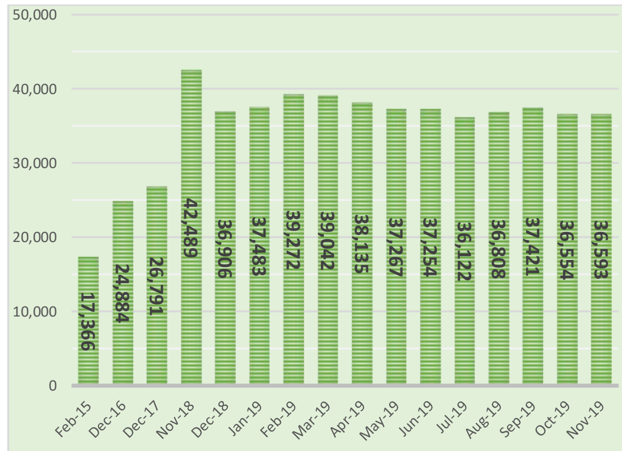
exchange rate differences in Aden and Sana'a.[7] The parallel market premium in Aden (and most of the south) has grown significantly higher—sometimes by up to 5-7 percent (YR 30-40 per US dollar)—than that in Sana'a. Preliminary estimates suggest that during December the rial depreciated by approximately 4 percent to around YR 590-595 per US dollar. With the near depletion of the KSA deposit, near-term risk of a new collapse in the currency is elevated, raising concerns about the impact on the economy and humanitarian conditions.

Figure 1. Parallel Market Exchange Rates
(Daily Average, YER/US$)



Source: Data collected from Informal exchange rate markets and staff estimates.

Figure 2. Average Cost of Minimum Food Basket
(7 persons/month)



Source: FAO-MOPIC- Market Monitoring Bulletin - November 2019.

Food prices have remained broadly stable in recent months (Figure 2). The latest monthly estimates for the UN's Minimum Food Expenditure Basket indicate a moderate price stability with basket cost at around YR36,593 in November, less than one percentage point increase compared with October (but falling by nearly 14 percent since November 2018).[8] Continued import financing support by the CBY Aden has played a vital role in stabilizing the prices of essential food during 2019, although a range of other factors—parallel market exchange rate, political and security instability, uncertainties in trading and import arrangements, dual taxation, and fuel availability—also affect food prices. On November 20, the CBY in Aden announced the approval of the 32nd import application cycle for an estimated total of US$56 million targeting selective food import commodities under the KSA's import-financing facility (i.e. wheat, rice, powder milk, sugar, vegetable oil).[9] However, the frequency and speed of processing import-financing applications appear to have declined in recent months.

New efforts aimed at easing major fuel crisis in the North has allowed increased discharge of fuel vessels at Hodaidah port and raised central revenue collection from fuel imports.[10] Previously, compliance with

[7] A temporary decline in demand for foreign exchange from large importers and businesses may have also contributed to the widening of the exchange rate wedge.
[8] Estimates are based on meeting 80 percent of the Yemen minimum food basket for 7 persons per month.
[9] On January 8, the CBY in Aden announced the adjustment of the exchange rate for importation of commodities outside the KSA import financing scheme from YR 506/US$ to YR 570/US$.
[10] https://www.vimye.org/doc/OSMonthly/Operational_Snapshot_December2019.png

fuel import regulations (i.e., Decree #49 of 2019 and Decree #75 of 2018) required government's fees to be paid or processed at the CBY in Aden for import shipments to be discharged or permitted into the country. However, the recent progress with the implementation of the UN-sponsored peace-building agreement in Sweden has resulted in easing restrictions on fuel importation through Hodeida port, the country's largest seaport. The new arrangements allow importers in all areas, including the areas controlled by the *de facto* authorities, to process their import permits and deposit taxes, customs, and fees on fuel imports at the CBY branch in Hodaidah through a special account overseen by the UN for public salary payments in the north. Recent data from the Economic Committee suggest results from the implementation fuel import regulations have increased central collections from fuel imports to around YR 33 billion (between mid-August to mid-December), out of which an estimated YR 15 billion was collected from Hodaidah. However, payment of public sector salaries from this bank account has yet to occur. The speed, efficiency and transparency over the management of state revenues for the delivery of public salary payment would be key for enhancing conditions for a more sustainable peace-building context.

Table 2. Selected Economic Indicators

	2014	2015	2016	2017	2018 e
Real GDP growth, at constant market prices	-0.2	-28.0	-9.4	-5.1	0.8
Private Consumption	0.1	-16.7	0.1	1.3	-3.2
Government Consumption	-7.1	-26.2	-26.7	-31.7	15.1
Gross Fixed Capital Investment	-3.6	-84.0	-24.8	37.6	174.9
Exports, Goods and Services	-4.1	-65.2	-67.5	4.4	34.9
Imports, Goods and Services	-6.1	-36.3	-5.2	15.3	5.3
Real GDP growth, at constant factor prices	-0.4	-28.7	-10.2	-4.9	0.9
Agriculture	1.0	-24.9	-5.6	-5.7	0.7
Industry	-3.2	-36.2	-21.2	-2.5	1.3
Services	1.0	-24.9	-5.6	-5.7	0.7
Inflation (Consumer Price Index)	8.2	22.0	21.3	30.4	27.6
Current Account Balance (% of GDP)	-0.7	-7.1	-3.2	-0.2	-1.8
Fiscal Balance (% of GDP)	-4.1	-10.0	-9.3	-5.3	-6.3
International poverty rate ($1.9 in 2011 PPP)[a,b]	42.6	...	...	...	...
Lower middle-income poverty rate ($3.2 in 2011 PPP)[a,b]	75.0	...	...	...	...
Upper middle-income poverty rate ($5.5 in 2011 PPP)[a,b]	91.8	...	...	...	...

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.
Notes: e = estimate, f = forecast.
(a) Calculations based on 2014-HBS. Actual data: 2014. Nowcast: 2015-2018. Forecast are from 2019 to 2021.
(b) Projection using neutral distribution (2014) with pass-through = 1 based on GDP per capita in constant LCU.

Annex 1. The Riyadh Agreement

A successful timely implementation of the Annex 1 of the Riyadh Agreement, covering economic and political arrangements, is hoped to restore the functioning of the state and its government institutions in Aden needed for improving public policy management and implementation capacities on ground. In particular, the timely formation of a new political technocrat cabinet stipulated in the political agreement would enable preparation of the 2020 State Budget and a more coherent macro-fiscal policy framework. For example, the new Cabinet supported by political consensus and restructuring of military and security measures, could strengthen control by the central government over the security of the oil and gas upstream located in Marib, Hadhramout and Shabwa governorates, reinforcing prospects of for accelerating economic recovery and improving fiscal space in 2020. the expected financial flows from the recovery of oil and gas export industry are expected to benefit the external and fiscal balance and support the CBY's financial stabilization efforts especially in view of depleting foreign reserves.

Preparation of the 2020 Budget Law awaits the formation of a new Cabinet in Aden. According to the Riyadh agreement, the new Cabinet will be expected to submit the new budget to the Parliament for enactment in line with the Yemeni constitution. Such progress would indicate a strong commitment to restore orderly fiscal management, improve accountability and prepare conditions for making progress in the political and security realms, especially when the success in budget implementation requires forging effective fiscal cooperation among the warring parties at the national level.

In addition, the implementation of the Riyadh Agreement targets improvement in the 2020 Budget structure together with an expected increase in the underlying fiscal deficit. The successful implementation of the agreement is expected to improve institutional capacities (i.e., enhancing local governments and empowering the role of auditing and anticorruption agencies) as well as to improve efficiency, accountability and transparency over public finance management (i.e., regular reporting and disclosure of public finances to the Parliament). However, possible downside consequences from the implementation could lead to further deficit widening as results of increasing wage spending on account of merging the STC's security and military forces under the government administration and payroll. Furthermore, public spending on defense and security is estimated at YR529 billion, accounting for 43 percent of total wage spending and nearly 17 percent of total public expenditures in the 2019 budget.

Restructuring the military and security forces will be key in addressing deep security challenges for economic recovery in 2020. The deteriorated security conditions have prevented recent efforts to restore production capacity and exports in the oil and gas industry. However, success in implementing the security and military arrangements stipulated in the Riyadh Agreement is expected to improve security in the oil fields, strengthen government oversight and management, and encourage the return of foreign investments that are required to enable quick economic recovery in the oil and gas industry.

Annex 2. Monetary Decision Imposed by the *de facto* Authorities in Sanaa

The *de facto* authorities in Sanaa have recently tightened its ban on the use of newer Yemeni rial bank notes in all territories under their control. Specifically, all currency printed with new banknote design have been declared invalid and holders have been offered only exchange into an electronic currency (e-rial) at a maximum balance that is far below current likely holdings.[11] While the ban on the new notes in Sanaa has been in place throughout 2019, the escalation in enforcement has contributed to a payments crisis in the areas controlled by the *de facto* authorities and seen the widening of dual exchange rates between old and new notes in the areas controlled by the *de facto* authorities ("the north") and those controlled by the government in Aden ("the south"). Preliminary official estimates suggest that around one-third of currency in circulation in areas controlled by the *de facto* authorities in Sanaa, has been invalidated.

The announcement has led to an emergence of a new black market. Roughly since August, the parallel market premium has been higher in Aden and the southern cities by nearly 2 percent (YR 5-10/$US) in comparison to the average trading in Sanaa. This trading gap appears to have further widened since the ban on the circulation of new banknotes was announced on December 18, reflecting severe distortion in the cash cycle. Costs of financial transactions have increased to around 5-8 percent.[12] This has created distorted incentives and allowed for the emergence of new currency trades in the parallel money markets for an emergence of new markets. In the past, new banknotes in the Sana'a-controlled areas were often used for making payments in the areas controlled by the Aden government such as for fuel products from Marib (i.e., LPG cooking gas) or for paying customs and taxes in Aden. These arrangements - which existed before the new ban with possible 'informal' facilitation by the authorities in Sana'a- appear to have mitigated the impact of legal tender stance on cash circulation and are likely to continue as *de facto* authorities attempts to strengthen control over the cash cycle and money market.

The *de facto* authorities are presenting the enforcement measure as related to "financial inclusion" of a big market segment traditionally outside the formal banking sector (i.e. individuals with YR 100,000 cash). The new ban imposed by the *de facto* authorities provides a compensation mechanism for new banknotes through over 300 authorized agents in all governorates, including in Aden and Marib. Individuals participating in the compensation mechanism are theoretically offered reimbursement either in cash (old notes), only if available, or electronic payment (e-rial) via 3 e-wallet providers: *MFloos* operated by Al Kuraimi bank; *Floosk* operated by Yemen Kuwait Bank; and *Mobile Money* operated by CAC bank. However, there are rare reports of successful reimbursement in cash. The participation of the 3 large banks appears to have created some momentum around the switch in payment systems. With generally declining confidence in banks, the enforcement has significantly widened the net of the banking

[11] The total currency printed since the Central Bank officially moved to Aden in late 2016 is estimated to reach YR 1.6 trillion, of which YR 1.2 trillion was printed in new banknote design that are targeted by the current ban from the *de facto* authorities in Sanaa.

[12] For example, since last December, customers are asked to pay up to higher fees for domestic payment transfers to areas where the ban is imposed, sometimes up 8 percent (i.e., YR 15,000 fee to send YR 200,000 money wire from Taiz or Aden to Sana'a, compared to under YR 1,000 if receiving or sending the same amount from within the Sanaa-controlled territories).

system to cover a sizable cash-based economy. Despite cash losses, the e-rial becomes perceived as safer compensation and can be used to pay some public utility, phone and internet bills.

It remains to be seen if (unsecured) electronic currency will be accepted widely as a form of payment and saving. For the *de facto* authorities in Sanaa, a broader financial system with expanding electronic payments is likely an option to cope with liquidity crisis with the potential for use in salary payments. However, the system seems not ready to operate at the scale needed to make salary and pension payments in cash based on transfers initiated by the authorities in Aden alone. Increasing the acceptance of e-rial requires, among other things, widespread trust in the safety of electronic currency. There was a partial strike by Sanaa traders on Wednesday 1 January in protest at the cash restrictions, and the recognized government in Aden has called on the *de facto* authorities in Sanaa to lift the ban considering the need to make salary and pension payments and to relieve pressure on the independence of CBY.

The demonetization seems to lay the groundwork for more autonomy in monetary and exchange policies, which would further fragment Yemen's economy. Furthermore, the *de facto* authorities may perceive the switch to electronic currency as a solution to the liquidity crisis, but the liquidity crisis is in fact related to macroeconomic fundamentals – inconsistent monetary and fiscal policies in Yemen as a whole. Ultimately, the cycle of exchange rate depreciation, inflation, liquidity shortages, and contrived monetary expansions could lead to the complete dollarization of the economy.