

January 2020

Yemen's economy continues to suffer from the fragmentation of national institutions between the two conflicting parties and ad hoc decisions taken by them, which compound the economic crisis and human suffering resulting from the violent conflict.

On January 18, 2020, the *de facto* authorities in Sana'a began a strict enforcement of the ban on new banknotes issued by the Central Bank of Yemen (CBY) in Aden after 2016. Following the expiry of the 30-day grace period for exchanging the new banknotes, the use of new banknotes has become illegal and strictly prohibited/criminalized for individuals and financial institutions operating in areas controlled by the *de facto* authorities (the "north").² No official information is available regarding the amount of new banknotes exchanged for old banknotes and to e-rial. Reportedly, the suspension of pension and salary payments in the north, announced by the Aden government in late December in response to the currency ban, remains in place (the last salary payments to the north were for November). While there were concerns that the limited supply of old banknotes could hinder the delivery of various cash transfer programs in the north, as of end-January 2020 there were no reports of direct impact of the ban on donor programs.

The measures by the *de facto* authorities to ban use of newer currency have triggered a sharp depreciation of the rial in Aden. The monetary measures introduced in Sana'a have effectively distorted cash circulation (i.e., depressing liquidity in large domestic market) and encouraged speculation on the price of the new banknotes against the old, in turn widening the exchange rate differences in Aden and Sana'a. During the first month after the introduction of the new measure, the rial plunged sharply in Aden, at one point, reaching almost YR 680 per US dollar due likely to the influx of new banknotes from the north (Figure 1).³ In sharp contrast, the north witnessed a slight appreciation of the rial, as demand for foreign exchange has dried up due to the limited availability of old banknotes. Accompanying measures taken by the Sana'a CBY, including the suspension of foreign exchange trading, have also supported the stability of the rial in the north. Market reaction to differing values of the rial in two places has seen a surging cost of financial transactions between markets controlled by two warring parties. Sources suggest that as of end-January commercial banks in Sana'a were charging up to 17 percent for processing cash transfers from the areas controlled by the government in Aden ("the south").

¹ Prepared by Naoko Kojo (nkojo@worldbank.org) and Amir Althibah (aalthibah@worldbank.org) based on information available up to February 5, 2020 and inputs provided by Sharad Tandon and Nami Halewood.

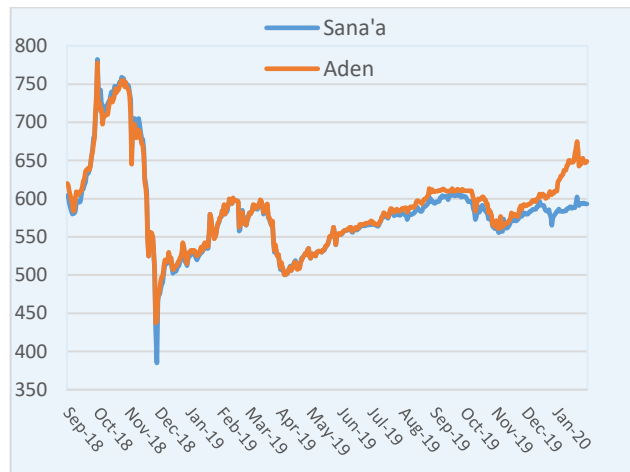
² On December 18, 2019, the *de facto* authorities in Sana'a tightened the ban on the use of new edition of banknotes printed since the CBY headquarters moved to Aden in 2016. Holders of new banknotes were required to surrender "illegal" cash within 30 days from the date of announcement for an exchange into an electric currency ("e-rial") or cash reimbursement in old banknotes, if available, for up to YR 100,000 (about US\$170) per person. 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. For further information, see the *Monthly Economic Update December 2019*.

³ During January 19-22, the exchange rate spread between Aden and Sanaa reached 12 percent.

Prices in Aden surged in January following the dramatic fall in the rial.

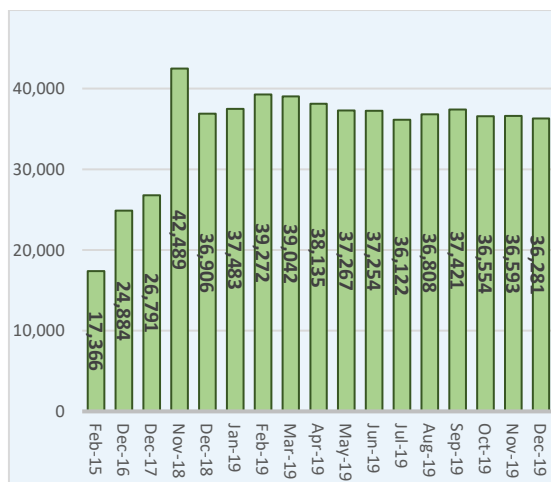
The widening exchange rate spread appears to have affected retail food prices in Yemen both in level and trend since the ban on new banknotes in the north. According to the Yemen Food Security and Agriculture Cluster, in January retail prices of food increased markedly in southern governorates (controlled by the government in Aden) but by less than the magnitude of the rial depreciation.⁴ The FAO cost of the Minimum Food Basket (MFB) in December 2019 does not yet reflect the impact of the exchange rate developments (Figure 2), consistent with the observation based on the WFP Vulnerability Analysis and Mapping data, which indicates a declining share of population experiencing food deprivation in December (Figure 3).⁵ Going forward, major price increases in commodities could come into effect with new shipments of commodities, where the current exchange rate will be a major determinant.

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



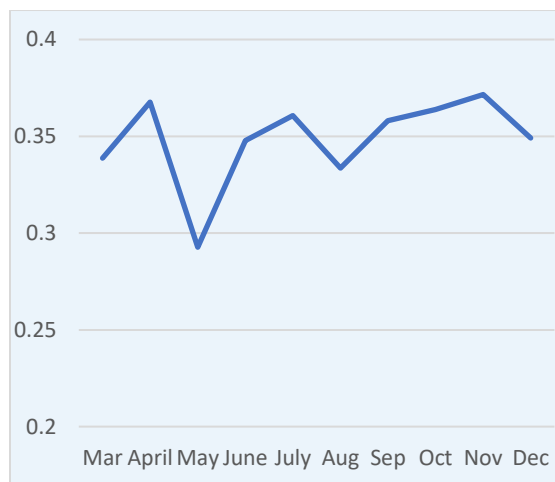
Source: Data collected from Informal exchange rate markets and staff estimates.

Figure 2. Average Monthly Cost of Minimum Food Basket (7 persons/ Yemeni rials)



Source: FAO-MOPIC Market Monitoring Bulletin (December 2019).

Figure 3. Share of Respondents Experiencing Food Deprivations (2019)



Source: WFP Vulnerability Analysis and Mapping.

Mounting pressures on the rial in Aden eased marginally in late January following the approval of the withdrawal from Saudi Arabia’s deposit to support import financing for key commodities. On January

⁴ Yemen Food Security and Agriculture Cluster, Minutes of National FSAC Coordination Meeting (February 4, 2020), available from https://fscluster.org/sites/default/files/documents/mom-fsac-national_cluster-2020204.pdf.

⁵ The WFP in collaboration with the World Bank conducts remote phone-based data collection and food security monitoring in Yemen using the mobile Vulnerability Analysis and Mapping (mVAM) approach.

22, the Central Bank in Aden announced that US\$227 million from the 33rd-35th application cycle would be approved for withdrawal at a preferential exchange rate of YR 440/US\$. At the same time, additional US\$50 million was approved for the importation of fuel and food outside the KSA import financing facility, allowing importers to access foreign exchange at another preferential exchange rate of YR 570/US\$ (Box 1).⁶ However, the near-term risk of a new collapse of the rial remains high, in light of dwindling foreign reserves and approaching seasonal demands for increased national import consumptions (Ramadan month). The renewal of the KSA deposit remains uncertain.

Stabilizing the exchange rate requires addressing the severe policy inconsistencies.

As long as the overhang of recent and prospective monetary expansions remains, there will be a continual drain from the rial into hard currency. Anytime that the monetary authorities attempt to set a fixed exchange rate for specific purposes (e.g. preferential rate for essential imports), there will be immense pressure from traders to access that rate, leading to administrative complexity and risks of corruption. The fragmentation of the cash rial market due to the currency restrictions in the north will only exacerbate this tendency.

Box 1. Yemen's Multiple Exchange Rate Regime

Although Yemen's exchange rate management is officially a floating regime, multiple exchange rate prevails: (i) a fixed rate for few internal government transactions and accounting purposes (i.e., YR 251/US\$ under the *de facto* authorities in Sana'a); (ii) a rate for selected food imports covered under Saudi Arabia's import financing facility (YR 440/US\$); (iii) a rate for commodities outside the Saudi Arabia import financing facility (revised to YR 570/US\$ from YR 506/US\$ on January 8, 2020); and (iv) two parallel market exchange rates, one in Aden and the other in Sana'a.

On January 5, the *de facto* authorities in Sana' introduced several economic reform measures under the Economic Revival and Recovery Strategy 2019-20. The Strategy—which aims at accelerating economic recovery, restoring the role of state institutions and fighting corruption, amongst many other goals—is the first implementation phase of the “National Vision for the Modern Yemeni State 2019-30” inaugurated in 2019. The announced reform measures include key initiatives such as: (i) the provision of tax exemptions (and thus reduce the burden of double taxation by two authorities) to support small businesses, new business start-ups, and local pharmaceutical production, and to facilitate renewable energy investment to enhance agricultural production; (ii) the establishment of a national bank to support agricultural and manufacturing exports; and (iii) legislative revisions to enhance efficiency, governance and accountability of the government. Several proposed amendments to tax and customs legislations have already been submitted to the Parliament in Sana'a.

The *de facto* authorities' Strategy also includes the disbursement of salaries to all civil servants not receiving salaries from the government in Aden. According to the announcement, recipients will receive half a monthly salary every two months starting in January 2020, and this appears to have temporarily mitigated public resentment against the monetary measures introduced in December. Payments of salaries began in late January. Sources suggest that salaries were paid through bank transfer, and recipients were able to withdraw salaries in cash.

⁶ On January 8, the CBY in Aden announced the revision of the exchange rate for another import financing support from YR 506 to YR 570 per US dollar.

In January Yemen suffered a major internet outage nationwide, which exposed the fragility of communication infrastructure's dependence on a single cable. According to TeleYemen—the Yemen's sole operator of international gateway for internet based in Sana'a—on January 9, 2020, the country's main submarine cable (so-called Falcon cable) on the seabed of the Suez Canal suffered two major cuts. While a number of countries in the region (Ethiopia, Kuwait, Saudi Arabia, Sudan and others) were affected, the impact was most acutely felt in Yemen with an 80 percent drop in the internet capacity for almost a week, as it does not have any other routes for connecting the country to the global network (see Annex 1). Part of the internet service has been restored since, but only on an emergency basis with an estimated capacity of 20-30 percent. TeleYemen announced that the repair of the Falcon cable and a complete return of the service would take weeks.

The sudden outage of the internet has paralyzed commercial and financial transactions, including financial transfers from overseas, and caused widespread socio-economic disruptions in Yemen. The interruption of the internet service knocked out banks, money exchange shops, and critical business and official functions across Yemen, exacerbating the chaos related to the ban on the new banknotes. Although Yemen is a cash-based economy, access to cash depends heavily on ATMs and money exchange shops. Without an active internet connection, the applications on smartphones, such as the e-rial payment system, stopped working. Remittances, a crucial lifeline for many Yemenis, were significantly constrained and sometimes suspended, as liaison with international exchange companies and correspondence and dealings with the international financial sector, highlighting that internet service has important humanitarian implications.

Amid ongoing conflict, communication infrastructure has been targeted and destroyed, and efforts to strengthen the internet connectivity has been hampered by the political divide. Asset and revenue loss experienced by all the operators, combined with regulatory and market fragmentation, would be difficult to reverse and could result in the loss of national coverage and market competition. Furthermore, TeleYemen has been unable to use a large capacity it purchased in 2017 due to disputes over the management of the sector between the two political rivals and the lack of access to Hudaydah for the construction of landing station, forcing the company to rely solely on the old Falcon cable with limited capacity for providing internet service in Yemen.⁷ In January, TeleYemen made several appeals to the international community for urgent support to prevent the sector from politicization and a complete collapse (see Annex 1).⁸

A recovery progress in the oil industry raises hope for improved external and fiscal accounts during 2020. In early January, the Ministry of Oil and Minerals (Aden) confirmed the government's ambitious target to increase the country's oil export capacity to about 80 thousand barrels per day in the first quarter of 2020, from about 50 thousand barrels in December 2019. The Ministry projects that this will generate US\$5 million export proceeds per day. While the continued recovery of oil exports is expected to ease pressures on the external and fiscal accounts, sustaining the level of crude production could be influenced by protracted violence and instability on the ground.

⁷ According to TeleYemen, requests for security permits have been repeatedly refused by the coalition.

⁸ Letters from TeleYemen addressed to the UN Special Envoy of the Secretary General for Yemen, dated January 23, 2020 (Ref: EX.C. 16); January 29 (Ref: EX.C. 21); and January 30 (Ref: EX.C. 30). Similar letters were also sent to other key donors.

Annex 1. Yemen Telecom Sector

Since the conflict began in 2015, Yemen’s telecom sector has suffered from growing losses and systematic targeting on its communications infrastructure. Since all sides of the conflict rely on communication technologies, communication infrastructure has served as strategic targets in the conflict. Apart from the direct damage to their infrastructure, operators face a number of other challenges: (i) double taxation; (ii) import embargo on telecommunications equipment, which increases the time and cost for operators to replace and maintain their networks; (iii) a significant rise in operational and security costs, which is compounded by the recent collapse of the Yemeni rial, putting new pressures on operators who must pay for their imported in foreign currencies; (iv) lack of reasonable power generations alternatives; and (iv) pressures from the authorities to maintain retail prices low, which means operators must bear all the aforementioned rise in costs. The marked increase in doing business has led some to operate losses for the past five years.

The telecom/internet sector in Yemen is on the verge of fragmentation between the two warring parties. The legal, policy and regulatory framework for the telecom sector is no longer adhered to. Private operators are having to follow instructions from and pay taxes to both the Ministry of Telecoms in Sana’a and Aden. The licenses for the largest private mobile operators—MTN and Sabafone—expired in 2015, and have since been negotiated for short-term extensions. Asset losses (including staff) experienced by all operators, combined with regulatory and market fragmentation, would be difficult to reverse and could result in the loss of national coverage and market competition. This would have severe impact on accessibility and affordability of voice and data services for Yemenis.

Internet services in Yemen are weak in terms of quality and offered prices, and there is large unmet demand for internet services. Yemen’s internet penetration rate is the lowest in MENA (Figures A1 and A2). During the conflict, internet provision has relied primarily on one limited and costly source for internet capacity (Falcon submarine cable), effectively depriving competitiveness and impairing local Internet operators from offering affordable prices to the end users.

Figure A1. Broadband subscription per 100 inhabitants

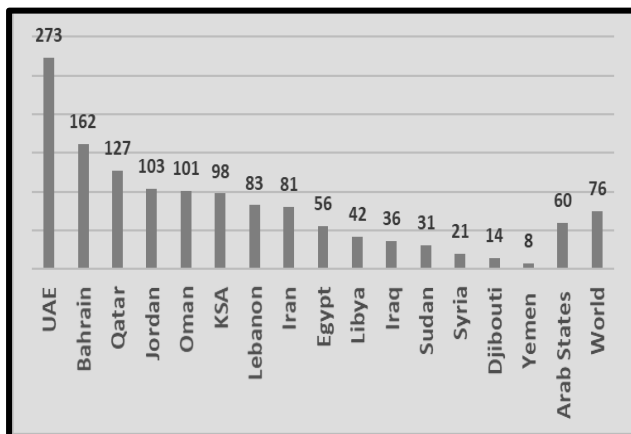
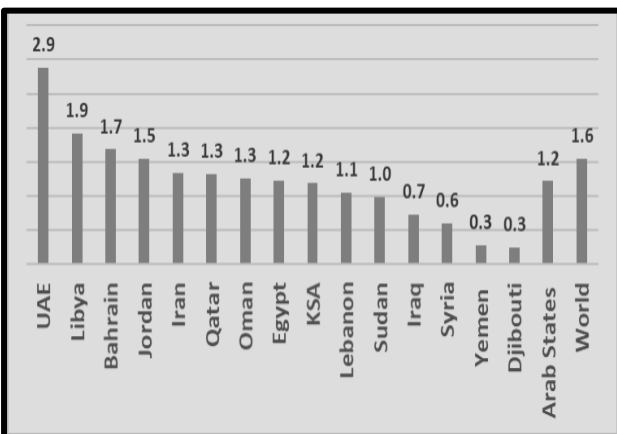


Figure A2. Broadband Subscriptions per Internet User



Source: TeleYemen & International Telecommunication Union 2019.

The recent country-wide internet outage demonstrates the country's vulnerability of easily becoming disconnected to the global internet. Escalating political divides in the country have resulted in counterproductive measures, including attempts to establish a second international gateway (which would fragment access instead of being a source of redundancy). The political divide has also hampered TeleYemen's operational capacities (i.e., freeze on its foreign bank accounts). Since 2018, the company has reported political disruptions on its attempts to restore internet services as well as sabotage attacks on its infrastructure. Furthermore, since January 9, 2020, Yemen's already low internet capacity has been reduced by more than 80 percent due to accidental damage to the FALCON submarine cable connecting Yemen to the global network, a link vulnerable to accidental disruption due to its proximity to heavy shipping traffic in relatively shallow waters.

There is an immediate need to keep the telecom sector afloat and undivided during this conflict and to bring attention to this situation to the broader development community. Some of the reasons being: (i) voice and SMS communications as well as access to the internet are all critical services both during conflict and reconstruction (critical for individuals, households, emergency relief, social services, markets and jobs); (ii) the telecom sector has significant fiscal implications in Yemen as, prior to the conflict, the sector telecoms was second to the oil and gas sector in terms of bringing in foreign currency and as a source of fiscal revenues; and (iii) any digital ambitions—whether it be mobile money and cash transfers—digital identification or smart rural power grids will rely heavily on the availability and robustness of the national telecom infrastructure.