

# VOLATILITY OF THE YEMENI RIYAL

## Drivers and impact of Yemeni Riyal's volatility

### Key findings

- Since escalation of conflict in 2015, the Yemeni Riyal (YER) has been losing its value against the US dollar (USD), negatively impacting prices and households' purchasing power along with humanitarian programmes.
- The interconnected drivers of economic structural weakness and political instability, including the war economy, are the main contributors to the volatility of the YER.
- The instable economic and political climate has made Yemen one of the most complex and challenging financial environments for humanitarian actors to operate in. Humanitarian organisations face major obstacles when it comes to implementing cash programmes.
- The context shows a direct correlation between currency depreciation and price inflation, especially when it comes to the cost of imported staple food. This is due to Yemen's dependence on imported goods and the dollarisation of the market.
- Currency depreciation is not the only driver of price inflation in Yemen. Other factors include inflated transportation and production costs due to limited infrastructures and fuel shortages/increase in price; increased risks for traders due to insecurity; shortage of commodities and consequent price speculation; and taxation of basic commodities.
- As the price of basic commodities increases, Yemeni households not only struggle to purchase food, but also to pay for transportation, electricity, and water. The soaring cost of these basic services is directly linked to increased fuel prices.

### Purpose

This report is the result of joint analysis process led by the Cash and Market Working Group (CMWG), which included cash experts, and consultants for the humanitarian sector working on Yemen together with the ACAPS YAH. It explores the drivers behind the volatility of the Yemeni Riyal (YER) and its consequences. This includes fluctuation of commodity prices in the market, the reduction of household purchasing power, and challenges to humanitarian response programmes in Yemen.

The main objective is to shed light on the issues that are behind currency volatility in order to have a better idea of how it can be avoided and, more importantly, what actions humanitarian stakeholders can take to limit its impact on households and humanitarian cash programmes. To support this, the CMWG has included a set of recommendations for advocacy and operations directed to the Cash and Market Working group members, as well as to other humanitarian actors, and donors involved in cash response in Yemen. The recommendations suggest the importance of coordinated action by humanitarian partners in advocating for unified economic regulations in Yemen, as well as in monitoring and reporting on currency exchange rates and basic commodity prices.

### RELIABILITY



This report is based on a review of secondary data (quantitative and qualitative), and on interviews with key cash actors, cash experts, and economic advisors. The CMWG has a high degree of confidence in the reliability of the findings presented here because of the quality of the information sources. Interviews and data analysis for this report was carried out from May – August 2019. Scenarios are based on a combination of secondary and primary data. It was particularly challenging to give projections of the value of the Yemeni Riyal against the USD in the next six months and to forecast a currency exchange rate for the upcoming semester.

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## Executive Summary

Since the outbreak of the Yemen conflict, the Yemeni Riyal (YER) has been steadily losing value against the US dollar (USD). By October 2018, the riyal had plummeted to its lowest level since 2015 – trading at YER800 to the USD, compared to YER250/USD prior to the start of the crisis. This depreciation has driven up prices of basic goods entering import-dependent Yemen and diminished the purchasing power of Yemeni households.

Both preexisting structural problems and conflict-related political maneuvering have driven down the value of the YER over the past five years. Foreign exchange reserves quickly dried up with the suspension of outside assistance to the Central Bank of Yemen (CBY) and the halting of oil and gas exports, upon which the economy was heavily reliant. Meanwhile, the Government of Yemen (GoY) and the Houthi authorities have implemented divergent policies through their respective central banks -- undermining the use of a single, coherent monetary policy required to support the national currency.

The volatile YER poses a challenge for humanitarian actors, particularly in terms of cash programming. This largely stems from the unpredictability that a volatile currency spreads; programmes are more susceptible to over or underfunding, while managers are required to balance potentially beneficial changes to programme design following a favourable shift in the currency against the risk of further depreciation down the line. Local communities consequently receive less than the expected value of assistance. All of these factors threaten the amount and quality of aid received by beneficiaries.

**Humanitarians can better navigate these pitfalls with the development of forecasting and monitoring mechanisms that could allow for detection of fluctuations and their impact on prices, while negotiating with Yemeni financial institutions to ensure favourable exchange rates for programming funds.** Advocacy teams should simultaneously highlight the role of competing GoY/Houthi policies and regulations that are detrimental to the YER's stability, while ensuring that foreign exchange entering the country in the form of humanitarian aid is not co-opted by any warring party.

**This report presents three scenarios regarding the outlook for the stability of the riyal over the next six months, with the continuation of gradual, yet relatively stable depreciation of the YER, being the most likely.** The value of the YER is very responsive to politically driven shocks. With the recent Riyadh Agreement between the GoY and southern separatists, ongoing Saudi-Houthi talks and reports of new UN-backed peace consultations in early 2020, there are a variety of variables in the short-term whose development would likely

be reflected in the value of the YER -- to either positive or negative effect. These developments should be monitored closely by humanitarian actors alongside the development of appropriate contingency planning

## Recommendations

### Coordination, planning, and monitoring

A joint approach has the greatest likelihood of providing viable ways to address this complex issue and to promote consistency in the way needs are addressed. A coordinated awareness of early signs of currency fluctuation and active response to mitigate challenges will positively impact the humanitarian response. The following actions are recommended:

1. Currency volatility<sup>1</sup> is largely due to political triggers. Establish a joint risk monitoring framework which could flag key triggers early and plan a coordinated response to mitigate an increase in needs
2. Study the increased use of Saudi Riyals in Yemen (could this offer an alternative for cash programming in some areas or does it risk further undermining the YER?)
3. Coordinate negotiations with Yemeni financial institutions and push for the best possible exchange rate conversions, on the basis of fair risk sharing. To the degree possible, sign agreements with multiple banks/exchange agents to provide flexibility and inject competition (though the Yemeni market is limited in terms of the extent to which healthy competition can be encouraged)
4. Track prices of essential goods in the markets on a monthly basis, together with currency exchange rates, in order to monitor price fluctuations that could have an impact on households' purchasing power
5. Hold regular joint reviews with program and finance teams to assess the risks related to cash programming (including, compliance, windfall gains and losses, transfer value, ethical concerns, choice of currency, transparency and communication with communities)

<sup>1</sup> Currency volatility is normally characterised by rapid and significant depreciation or appreciation of the currency compared to a fluctuation, where the change in value is minor and sustained. Since 2015 until August 2018, in Yemen we mostly talked about currency fluctuation, as decline in value of the YER against the USD was

gradual. However, between end of August and December 2018 the YER has a rapid and significant decline, showing its volatility. Although in 2019 the YER continued to be fluctuating, the materialisation of compounding political and economic triggers can determine its volatility.

6. Support the re-establishment of sub-working groups such as the Liquidity and Currency or the Financial Officers' Coordination working group to regularly share information on exchange rates, transfer value and choice of currency
7. Advocate for coordinated action plan and capacity building within Yemen's economic bodies (in the north and south of Yemen)
8. Set up a regular communication channel with donors to discuss programming decisions, price monitoring and currency trends to promote risk sharing

## Advocacy recommendations

### Economic policy needs to avoid measures that make it more difficult for vulnerable households to survive

Economic competition between the Houthis and the internationally recognised government of Yemen (GoY) has directly triggered currency instability, increased food and fuel prices and pushed Yemeni households into dangerous coping strategies such as child labour; child marriage, and begging. The Central Bank of Yemen (CBY) in Sana'a, controlled by the Houthis, and the GoY CBY in Aden must carefully review the likely humanitarian impact on vulnerable populations before introducing new economic policies.

### Humanitarian financing flows should not be a target for economic competition

Humanitarian aid is one of the largest sources of foreign exchange in Yemen. There has been increasing pressure from the GoY and the coalition authorities to direct aid deposits exclusively through the CBY of the GoY. This may increase challenges for funding transfers between the north and south, thereby increasing the risk for disruption to lifesaving cash, food, health and cholera prevention programming. Humanitarian aid may increasingly experience pressure to comply with new regulations, which would create a greater risk for the politicization of aid. Any policy changes around humanitarian financial flows should prioritise the continuity of life-saving humanitarian programming.

### Support economic authorities in Yemen to stabilise the currency

Stabilising the currency is crucial to prevent further pressure on food and essential commodities. A continued reduction in the purchasing power of households will push millions of Yemenis into food insecurity and dangerous coping strategies; every effort must be made to avoid this. Donors should support Yemeni economic decision makers through foreign exchange deposits and technical assistance.

## Acronyms and terminology

**Arbitrage (for the currency):** process by which a trader buys and sells a foreign currency simultaneously, benefitting by the price difference of the foreign currency in the two different foreign exchange markets (FXCM 28/08/2019).

**Black market:** Also known as a shadow or underground economy. It includes any economic activity (trade, money exchange, money transactions, etc.) that takes place outside government-sanctioned channels -- including price controls, taxation, or compliance with national and international laws (Investopedia 28/08/2019).

**Cartel (behaviour):** A cartel is an agreement among businesses to act together instead of economically competing against each other. Normally, cartels are designed to drive up the profits of the cartel members while maintaining the illusion of competition. For instance, if business working on the trade of X product come together in a cartel, they might want to decide on selling this X products at same prices. However, at the same time they will act together to control markets and restrict trade of the X product from members outside the cartel. In Yemen, the currency exchange market often behaves as a cartel (ACCC 2011).

**CBY:** Central Bank of Yemen. Overall, a central bank is the financial institution that has the role to control the production and distribution of money and credit for a nation, or a group of nations. The central bank is also normally in charge of formulating monetary policy and regulating member banks (Investopedia 28/08/2019). The Yemen CBY has historically served for four functions: the servicing of international debt; stabilisation of the YER against the USD; payment of public sector salaries; and guaranteeing food imports. (Iris 2017). In Yemen there are currently two central banks: one controlled by the Houthi, based in Sana'a (where the CBY Headquarters used to be before escalation of conflict in 2015), and one controlled by the internationally recognised government of Yemen (GoY) currently based in Aden.

**CBR:** Correspondent Banking Relationship. A correspondent banking relationship occurs when a financial institution in a country (e.g. Yemen) signs an agreement or arrangement for the provision of services for a foreign financial institution (thus, in another country). Financial institutions can be a bank, a credit union, or a trust company. Through correspondent banking relationships, financial entities can access financial services and provide a wide range of cross-border payment services to their customers in different jurisdictions/countries. These services might include cash management (e.g. interest-bearing accounts in a variety of currencies), international wire transfers, cheque clearing, payable through account, and foreign exchange services (GoC 06/2017).

**Currency exchange rate:** Rate at which one currency will be exchanged for another. In the case of Yemen, we refer to the currency exchange rate as the value of the YER against the USD.

**Depreciation (of the currency):** The fall in the value of a currency in a floating exchange rate system. In other words, a loss of value determined by market forces, generated in the open market. The currency depreciates when the currency exchange market is willing to pay less than previously offered for a country's currency (Enotes 14/08/2019; Investopedia 14/08/2019).

**Devaluation (of the currency):** The fall in value of the currency as a consequence of a government policy, as the country's government sets the value of the money. The currency is devalued when the government decides to lower the worth or value of its currency. Devaluation may be pursued to make a country's exports more competitive or to reduce government-issued sovereign debt burdens (Enotes 14/08/2019; Investopedia 14/08/2019).

**Forex (also FX/FOREX):** The foreign exchange market, meaning the market in which currencies from all over the world are traded (Investing answers 28/08/2019; FXexchange Rate.cm 28/08/2019).

**Floating exchange rate:** A regime where the price of a local currency is set by the FOREX market based on supply and demand relative to other currencies. This is in contrast to a fixed exchange rate, in which the government entirely or predominantly determines the rate. The majority of world's largest economies have a floating exchange rate.

**Fixed Exchange Rate:** Where the currency exchange rate is fixed through intentional government policy and maintained within a small window of variation through legal and policy actions by economic authorities.

**Food basket:** the Food Basket or Minimum Food Basket in Yemen is established by the Food Security and Agriculture Cluster (FSAC) and, at 1 May 2019, included wheat flour, kidney beans, vegetable oil, and iodised salt. The Minimum Food Basket is designed to consist of what a household requires in order to meet basic needs. The food basket is part of the Survival Minimum Expenditure Basket (SMEB).

**Survival Minimum Expenditure Basket (SMEB) for Yemen:** Sits within the WASH cluster and as of May 2019 includes soap, laundry powder, sanitary napkins, and trucked water. The SMEB also includes the Minimum Food Basket as well as specific Non-Food Items. Although quiet standardised, the non-food items, as well as the food items, vary slightly from one crisis to another, based on the main needs of the affected population.

**FSP:** Financial Service Providers. Individuals, companies and businesses providing financial services or advice to clients.

**GDP:** Gross Domestic Product. The total monetary value of all final good and services produced and sold on the market, within a country during a period of time (usually one year) (Worldometers 01/09/2019).

**Hawala:** An ancient system for moving money common in Arab countries and South Asia. The system still exists outside the modern banking system. In Arabic, the term hawala comes from the verb (to transform, switch, change), and it is often translated to the word 'transfer'. The system is an informal way of transferring money based on trust and verbal guarantees, normally undocumented and without any actual transaction (MBN 19/08/2019; Transferwise 19/08/2019; ACFE 19/08/2019). In Yemen, hawalas are legal and semi-regulated.

**Inflation:** Sustained increase in the general prices of goods and services in an economy. Inflation usually leads to a general increased cost of living (Economics Help 14/08/2019).

**IBY:** International Bank of Yemen. Main commercial bank in Yemen based in Sana'a.

**Letters of Credit:** A document issued by a bank that guarantees a seller or exporter that the trader will pay the cost of imported goods by a specified date; otherwise the bank will pay the amount due. Letters of Credit, or foreign reserves (FX) credit lines ease cash flow problems and are necessary for the import of basic goods.

**Liquidity:** The ability to exchange an asset for another item of value. An example includes the ability to sell stocks for cash where there are ready buyers for each seller of a share (Investopedia 29/08/2019).

**Liquidity crisis:** lack of cash flow in an economy, causing a negative financial situation.

**Money exchanger:** A person that runs a currency exchange business. Normally, money/currency exchangers have the legal right to exchange one currency to another (Investopedia 29/08/2019).

**Remittances:** Money transferred from one party to another as a payment or a gift. Normally, remittances refer to money sent by a migrant worker to an individual or a family in his/her home country.

**Fluctuation:** The change in an exchange rate. Fluctuations occur naturally and constantly in floating exchange rate systems (Investopedia 14/08/2019). The opposite of a floating exchange rate is when the currency is "pegged" to a reference currency – these are fixed exchange rates.

**Volatility (currency):** Currency volatility, also known as foreign exchange (FX) volatility, is the unpredictable movement of exchange rates in global foreign exchange markets. Volatility of a currency is normally characterised by rapid, significant, and often ongoing depreciation or appreciation of the currency, as compared to a fluctuation, where the change in value is minor and sustained. Volatility can be caused by a number of different

factors, including geopolitical instability, conflict, monetary policy, import and export levels, and inflation levels (Kantox 14/08/2019).

## Yemen's economy at a glance

Since the escalation of the conflict in 2015, the **Yemeni Riyal (YER) has been losing value against the US dollar (USD)**. In 2017 alone, the YER lost around 40% of its value – from 250 YER/1 USD to about 500 YER/1 USD. In late 2018, the YER had a rapid significant devaluation, reaching 194% depreciation rate compared to its pre-crisis value and showing high levels of volatility (FAO 29/09/2018).

Yemen's economy is almost entirely **import-dependent**, any devaluation of the YER leads to **almost immediate inflation** and consequent increase in prices of basic goods, including food and fuel. This has an **impact on Yemeni households' purchasing power, as well as on humanitarian programmes**. Historically, Yemen has imported between 80 and 90% of its basic commodities (OCHA 13/11/2017). According to the World Bank, Yemen relies almost entirely on imports to fulfil the local demand of staple food (The World Bank 2017). In addition, the current conflict has damaged Yemen's domestic agricultural production sector and pushed Yemen to rely even more on imports.

Yemen's main export is hydrocarbons, mainly crude oil and gas. Before 2015, hydrocarbons represented 90% of all Yemen's exports, which also made up 40% of the government's revenues. Yemen depended on hydrocarbon exports for foreign currency reserves (USD), as well as to fund social subsidies and state salaries (Chatham House 09/2011). **Following escalation of conflict in 2015, hydrocarbon exports were suspended, depleting foreign currency reserves (USD)**.

**Yemen has an underlying trade deficit**. In other words, Yemen's imports historically exceed the value of its exports. As such, Yemen has always been dependent on foreign reserves (Forex/FX) to finance its imports through FX credit lines to importers, originally provided by the Central Bank of Yemen (CBY). From 2015, with the suspension of hydrocarbon exports, Yemen started using alternate sources of foreign reserves, trying to rely predominantly on remittances. Even before the escalation of conflict, remittances represented an important source of FX, preceded by hydrocarbons exports.

**Yemen's economic governance is currently divided into two** between the the North and the South<sup>2</sup>. This division strengthened following the GoY's relocation of the CBY headquarters from Sana'a to Aden in 2016, bringing with them documentation and some

of the national reserves of foreign currency. This was a fundamentally political decision, fuelled by the depletion of foreign currency reserves, alleged interference by Houthi authorities, and Saudi pressure. Therefore, there are currently two CBY: the internationally recognised government of Abdrabbuh Mansur Hadi controls the GoY CBY, currently based in Aden, following escalation of conflict in the south of Yemen since beginning of 2019. The Houthis control the CBY in Sana'a. There are also two currencies in circulation: an old currency (mostly used in the north, yet present and used in both the south and north of Yemen) and a new currency (mostly used in the south). Northern authorities are working to ban and limit the use and circulation of the newly printed YER. Both are called Yemeni Riyal (YER) and are affected by currency volatility and fluctuation.

With the escalation of conflict across the country in 2015, **currency devaluation and price inflation was compounded by a lack of security for investors and traders, damage to vital economic infrastructure, and sea and land blockades**. The conflict has had a direct impact on aggravated pre-existing poverty and structural economic challenges in Yemen. Years of conflict have seen Yemen's economic space shrink as foreign investors pulled out and the private sector shut down. Overall, since 2015, Yemen's economy has sharply deteriorated. The World Bank estimated that between 2015 and 2019 Yemen's GDP contracted by 39%, while poverty increased from 71 to 78% (The World Bank 01/04/2019).

## Sources of foreign exchange into Yemen

**Remittances:** Remittances from Yemeni expatriates contributed to around 10% of the country's GDP pre-crisis and up to almost 20% following the escalation of the conflict in 2015 (MoPIC 02/2018). Over USD 3 billion are estimated to enter Yemen every year as remittances, mainly from Yemenis in Saudi Arabia, the United States, and other Gulf states. Often, Yemeni expat workers send remittances into Yemen through or money exchangers, instead of transferring them through the formal banking system. While some of these transactions are traced and counted in the USD 3 billion of remittances sent to Yemen each year, others are not. This means it is likely that the value of remittances entering to Yemen every year is even higher (Sana'a Center 05/2019; MoPIC 02/2018).

**Bilateral support to stabilise Yemen's economy:** In 2018, Saudi Arabia provided the GoY CBY with a USD 2 billion to finance imports and another USD 200 million grant to help stabilise Yemen's currency.

**Military funding:** In addition to other support provided by Saudi Arabia, since the escalation of conflict in 2015, Saudi Arabia alone gives to the internationally recognised

<sup>2</sup> In this report, with the expressions north and south of Yemen, or simply north/south, we intend the historical north and south of the country, against the geographical north/south division. Namely, with north of Yemen we

mean the area that was under the Yemen Arab Republic between 1967 and 1990. With south of Yemen we mean the area under the People's Democratic Republic of Yemen, during the same period.

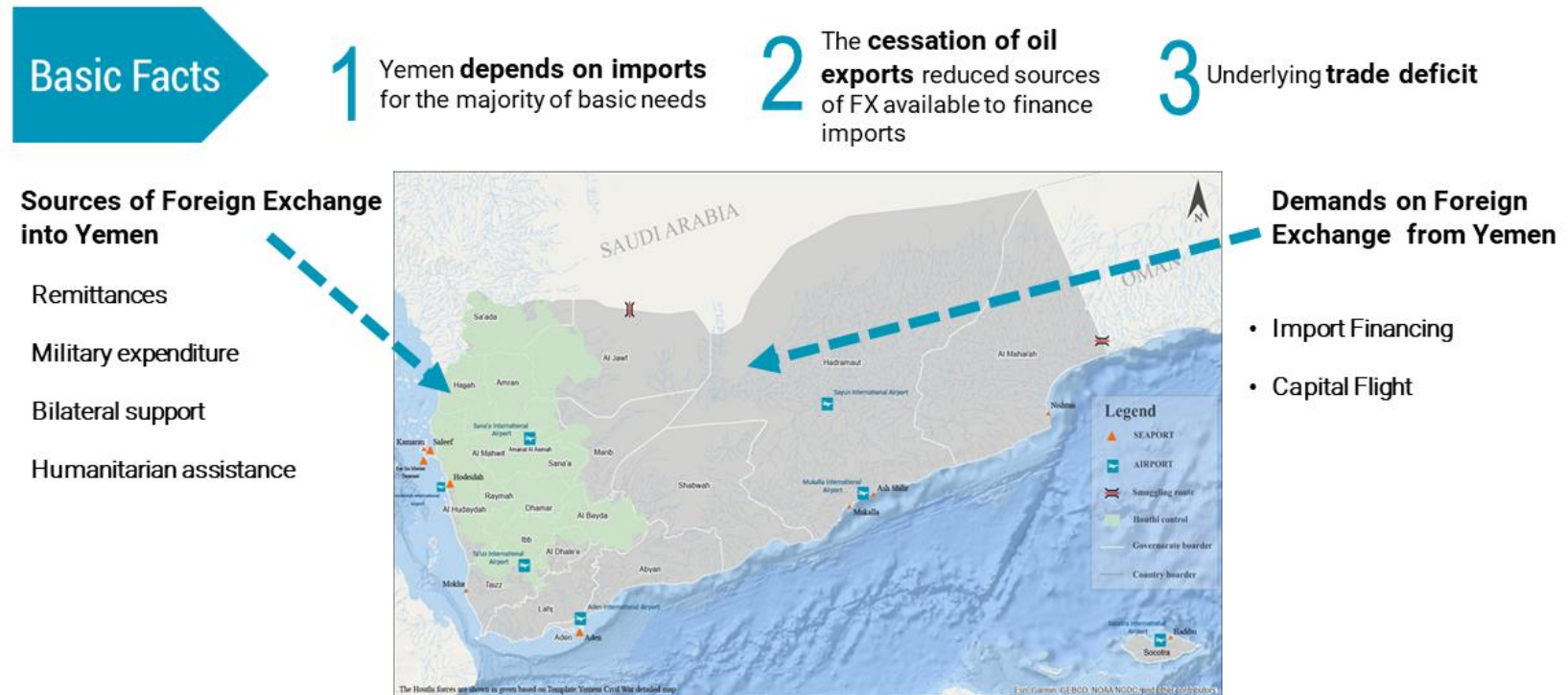
government of Yemen an estimated 350 million Saudi riyals (over USD 90 million) per month to support military expenditure. This money flows into Yemen through the GBY of the GoY.

**Foreign humanitarian assistance:** Makes up a significant source of foreign reserves transferred into Yemen. In 2018, the contribution to the humanitarian sector to Yemen amounted to USD 5.2 billion. ACAPS estimates that the sector has likely spent half of that sum to pay aid suppliers and staff contributing to the response but residing outside of Yemen, while the other half directly flowed into Yemen's economy (FTS Yemen 2018).<sup>3</sup> The humanitarian response is concentrated on the north, home to the vast majority of those with the highest level of assessed need. ACAPS estimates that at least USD 2 billion flowed into the north compared to USD 500 million in the south in 2019 alone.

## Demands of foreign exchange out of Yemen

Yemen mainly uses its **FX reserves to finance imports**. Fuel is one of the largest drains on the foreign exchange markets, followed by food and other basic commodities.

Since escalation of conflict, there has been capital flight from Yemen. It is estimated that billions of USD have left the country since 2015. Wealthy Yemenis have invested or secured their capital abroad, for instance, purchasing real estate in Cairo.



<sup>3</sup> ACAPS estimates that at least half of the USD 5.2 billion contribution to the humanitarian response in Yemen was spent outside Yemen: paying international suppliers to import medicines, food and emergency kits, and for support costs (these funds would be handled directly through international clearance mechanisms without passing through the Yemeni financial system). As for the humanitarian aid money directly flowing into Yemen, we assumed that 80 percent of funding disbursed in Yemen is managed through financial institutions in Houthi-

controlled areas given the higher population and higher levels of population in need in the north. As such, we estimated that aid spending in north in 2018 was around USD 2 billion (USD5.2bn x 0.5 disbursed inside Yemen x 0.8 disbursed in north = USD 2bn). Aid spending in the south was estimated at USD 500 million (USD5.2bn x 0.5 disbursed in Yemen x 0.2 disbursed in south = \$500 million).

## Structural Drivers of volatility of the Yemeni Riyal

**Economic structural weaknesses** and **political dynamics in Yemen**, including the war economy, are closely related and together have been the main drivers of volatility of the YER.

### Depletion of foreign reserves

Following escalation of conflict in 2015, Yemen's foreign reserves started depleting for a number of reasons. Key among them were:

- the cessation of exports,
- the relocation of the CBY;
- increasing international restrictions to Yemen's financial system.

Being an import-dependent economy and a country with a trade deficit, the depletion of foreign reserves had a significant impact in destabilising the country's economy and its currency (Sana'a Center for Strategic Studies 31/03/2017).

It is estimated that foreign currency reserves fell more than 80% from \$4.81 billion at the end of 2014 to an estimated \$600-850 million in 2017 (Yemen Peace Project 27/07/2018).

**Whenever there is a shortage in foreign currency, the foreign currency increases in value relative to the local currency.**

**Suspension of hydrocarbon exports:** Pre-crisis, hydrocarbon (mainly gas and crude oil) exports represented the main source of foreign currency into Yemen. From 2015, hydrocarbon exports were suspended; foreign oil companies shut down operations and pulled out of the country due to instability and insecurity. Many exports terminals have also been damaged by the war and/or are in control of the Houthi authorities (such as the oil terminal in Ras Issa) (Bloomberg 12/10/2018). The suspension of hydrocarbon exports contributed to the depletion of Yemen's foreign reserves.

**Exacerbation of international restrictions to the Yemeni financial system:** Already in place since 2008. In 2015, with the consolidation of presence of Houthi in the north, more foreign banks terminated or severely restricted their Correspondent Banking Relationship (CBR) with Yemeni banks due to the necessity to comply with anti-money laundering and countering financial terrorism laws. Yemeni commercial banks were no longer able to transfer money abroad or receive money from banks outside the country (Sana'a Center for Strategic Studies 15/02/2019). From this point, people started to transfer forex to Yemen mainly through money exchangers or through electronic money in accounts opened abroad, in foreign commercial banks or sister banks of the International Bank of Yemen (IBY).

**Relocation of the CBY to Aden:** The division of the Yemeni banking system also contributed to the depletion of foreign reserves. With the move to Aden, the CBY lost access to its "vault cash" reserves of reign exchange, which remained in the CBY in Sana'a, and temporarily lost access to its remaining electronic FX reserves. The split of the CBY into two separate banks lead many Yemenis holding a bank account to increasingly mistrust the banking system. Account holders started withdrawing money from commercial banks and investing them abroad, eventually withdrawing USD in order to do business (before the announcement of the liquidity crisis). Financial flows migrated from the formal to informal economy and commercial banks started to have liquidity shortages, which corresponded with a reduction in commercial banks deposits in the CBY. (Sana'a Center for Strategic Studies 16/08/2019; Reuters 30/08/2018; Al Bawaba 15/09/2016).

From a purely economic point of view, normally, the role of a Central Bank's interest rates also affect the depreciation of the currency exchange rate. Central banks lend money to national commercial banks at fixed interest rates when they need liquidity. Normally, the higher the interest rate set by the central bank, the higher the value of the local currency against the currency of countries with lower interest rates. However, due to the predominance of informal financial flows in Yemen, the role of supply and demand in determining the value of the riyal plays a bigger role. In Yemen, it is not only the central bank, which fixes interest rates and lends money to commercial banks; the black market rate also influences the value of the Yemeni riyal.

### Letters of credit

Letters of credit or foreign reserves credit lines ease cash flow problems and are necessary for the import of basic goods.

A letter of credit is a document, issued by a bank, guaranteeing to a seller or exporter that the trader will pay on time the amount of the imported goods. In the case that the trader is not able to pay for the order/purchase, the bank agrees to pay the total amount or the remainder due. Normally, the trader will repay the bank once the imported good is sold on the local market. (Investopedia 18/08/2019).



## Reliance on imports and challenges providing lines of credit to importers

The **challenges of both CBYs to provide FX credit lines**, also known as letters of credit (LoC) to importers also **contributed to the depreciation of the YER because it pushed economic actors to rely on the informal economy, which entailed greater transaction costs and higher risks of currency instability.**

In 2016, when the CBY moved to Aden and cut off its access to foreign reserves, it became more challenging to provide LoC to importers. As Yemen is an import-dependent economy, one of CBYs main functions pre-crisis was providing LoC to importers. When they could no longer obtain LoC from the CBY without major constraints, importers had to resort to the money exchange market in order to secure foreign exchange to pay exporters. The FX rate was already higher than the fixed FX rate before the CBY decision to float the Yemeni riyal in August 2017.

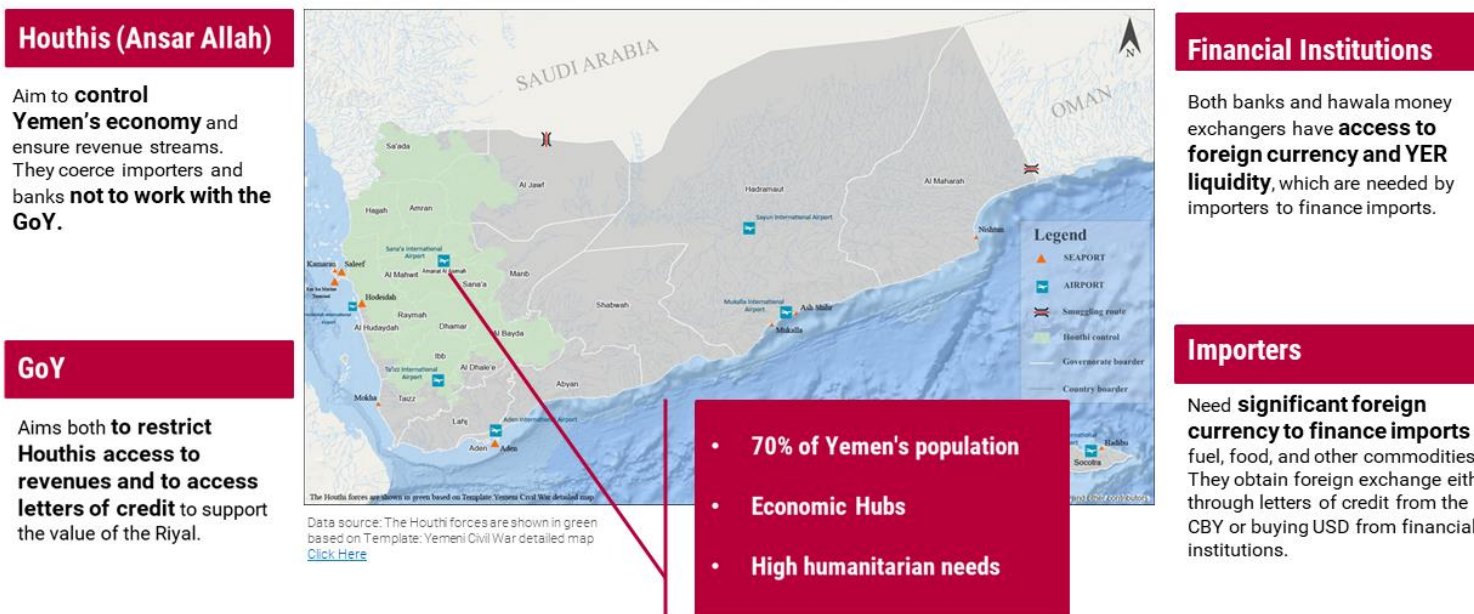
As a result, it became increasingly difficult for importers to secure FX to pay for imported goods. Traders had to start to rely on hawalas and other financial service providers in the informal economy to access foreign reserves and be able to pay imports. The reliance of importers on the informal economy, or informal money transfer services, entailed higher transaction costs and higher risks of currency instability due to currency speculation and non-fixed interest rates. **Currently there are two divergent and conflicting sets of economic policies coming out of Sana'a and Aden over the provision of credit to importers.**

## Exacerbated liquidity crisis

In June 2016, the CBY anticipated a liquidity crisis due to insufficient physical banknotes to facilitate transactions. Ironically, the liquidity constraints acted as a break on riyal depreciation. This is because, generally, less local currency in circulation would need less FX reserves in the country. The situation changes whenever the CBY of the GoY (which has the capacity to print new notes) prints significant quantities of new notes, as there will not be sufficient foreign currency to back the local currency, as seen in the last months of 2017 (Save the Children 23/10/2018).

The liquidity crisis in Yemen happened following the relocation of the CBY from Sana'a to Aden. When moving to Aden, the GoY CBY lost access to its national currency reserves to pay government salaries and also its foreign currency reserves to finance imports (In addition, due to conflict, the country began to see an overall decline in economic activity, leaving it without enough cash in circulation).

Yemen is a cash economy. Very few people have a bank account and most transactions are conducted in cash through currency exchangers, hawalas, and other financial service providers (FSP). The international banking system was only established in 1995. In this environment, the liquidity crisis had a significant impact on Yemen's economy.



## Political drivers of currency instability

Houthi and GoY authorities are implementing divergent monetary policies. The stakes are increasingly high and both sides have their own set of economic and political levers. These **divergent economic policies have had a negative impact on the stability of the YER, and the economy in Yemen overall.**

Beneath the armed conflict and the economic drivers of humanitarian needs in Yemen is the struggle for economic legitimacy, which has had implications for currency stability that are as significant as the structural drivers.

Following the relocation of the CBY in 2016, both the GoY and the Houthi authorities made significant effort to cement their control over the economy and the value of the currency. Unsurprisingly, these efforts were often designed to deliver an economic hit to the opposing side, the consequences of which have been severely destabilising for the economy at large. The battle for the economy is being waged by the warring parties on a number of fronts; one of the core issues is access to foreign exchange to finance imports and the impact of this on YER stability. From this, stem specific issues such as regulating fuel imports, financial flows, providing letters of credit at subsidised rates to importers, and issuing regulations around both the formal banking sector and the “informal” money exchange sector.

### Political and economic levers of key actors

GoY economic institutions have the advantages of:

- being internationally recognised institutions,
- having better access to foreign exchange due to Saudi support,
- having control over sea access to Hudaydah port,
- having the ability to legally print currency, and
- being able to either facilitate or block access between financial institutions in Yemen to those abroad (e.g. using its connections with Gulf allies to limit access of Yemeni exchangers with their Gulf-operating counterpart) (Interview conducted by ACAPS partner in 2019).

Houthi authorities have their own, unique set of advantages, which are largely linked to their territorial control. This gives them:

- control over a large portion of Yemen’s population,
- control over the lucrative northern markets, and the capital – where most businesses (and their assets) are located. Sana’a specifically, and north of Yemen more broadly, see the greatest share of daily economic activity. This is

owing to the greater population density and Sana’a’s status as the place that banks and businesses have traditionally set up shop and operated. In addition, most economic actors in the south, as well as GoY figures, are linked to Sana’a by either business connections, family ties or property

- control over physical infrastructure of the former CBY headquarters and the majority of Yemen’s banks and financial institutions (of the seventeen main banks and financial institutions currently operating in Yemen, sixteen of them are headquartered in Sana’a), and
- the ability to leverage its dominance of the security sector, and to conduct punitive actions against members of the financial sector (e.g. money exchangers being regularly arrested if unwilling to comply with Houthi regulations).

### Policy decisions in Aden and Sana’a

Policy decisions in Sana’a and Aden can have direct implications for the stability of the YER, some of these include:

#### 1. Printing of new YER banknotes by the Aden-based CBY

Restricted access to physical cash has a detrimental impact on the private sector economy in Yemen. Much of the currency in circulation is in the form of poor quality, old and damaged notes. To address this, the GoY CBY printed new YER notes on a number of occasions in recent years. While this can be beneficial to local markets, an injection of new liquidity into the market puts downward pressure on the YER, causing depreciation. Houthi authorities have responded by banning the use of some of the new notes in the north.

#### 2. Competing regulations over banks and money exchangers

Since late 2018, the GoY CBY has become increasingly active in its efforts to regulate the banking system and informal money exchange networks. Houthi authorities see these regulations as targeted at them and have threatened, and implemented, punitive action against anyone attempting to comply with the GoY CBY’s rules. These dynamics threaten the functionality of the key banking institutions and make it impossible to implement policies to stabilise the YER.

If the formal banks and the informal money exchange networks are unable to function, the impact will be significant. Remittances – money sent home by Yemenis working abroad – are an increasingly vital lifeline. During 2018, at least \$3.4 billion in remittances flowed into the hands of Yemenis struggling to survive inside the country. This often surpasses the amount of money entering the country as humanitarian or development assistance. Most remittances come in through informal financial service providers.

Financial service providers are caught between the internationally recognised Central Bank of Yemen (CBY), currently headquartered in Aden, and the Houthi financial authorities in Sana'a, the pre-war capital.

Throughout 2019, both the GoY and the Houthis have implemented tough registration and compliance regimes for formal and informal financial actors. However, the rules in the north and the rules in the south are not the same. Both authorities threaten punitive action if money exchangers or commercial banks do not comply with their particular rules. The money exchangers' professional association has repeatedly warned that these regulations limit their ability to operate, and stressed the need for consistent policies across the entire financial sector.

### 3. Conflicting policies over financing imports

The GoY CBY supports imports through the provision of foreign exchange to importers. They are able to do this because of an injection of funds from Saudi Arabia delivered in 2018. Without this support, importers will go to the open market for foreign currency, putting pressure on the YER. To access Letters of Credit (LoC), importers are required to apply through the GoY CBY systems and comply with GoY Economic Committee regulations. The Economic Committee has blocked fuel importers from accessing Yemen's ports without permissions, as outlined in Decree 75.

The GoY argues that these regulations are necessary to combat money laundering and Iranian support to the Houthis. In response, Houthi authorities have blocked importers (from the north) and stopped associated financial actors from applying for importation financing through the GoY CBY. Therefore, Yemeni fuel importers struggle to access LoC from the GoY CBY, as most imports enter Yemen through Hudaydah's ports (in the north). For this reason, importers have to rely on the market for foreign exchange financing and increasing pressuring on the YER.

### The *hawala* system in Yemen

Hawalas are a traditional informal financial service providers (FSP) which transfer money nationally or internationally.

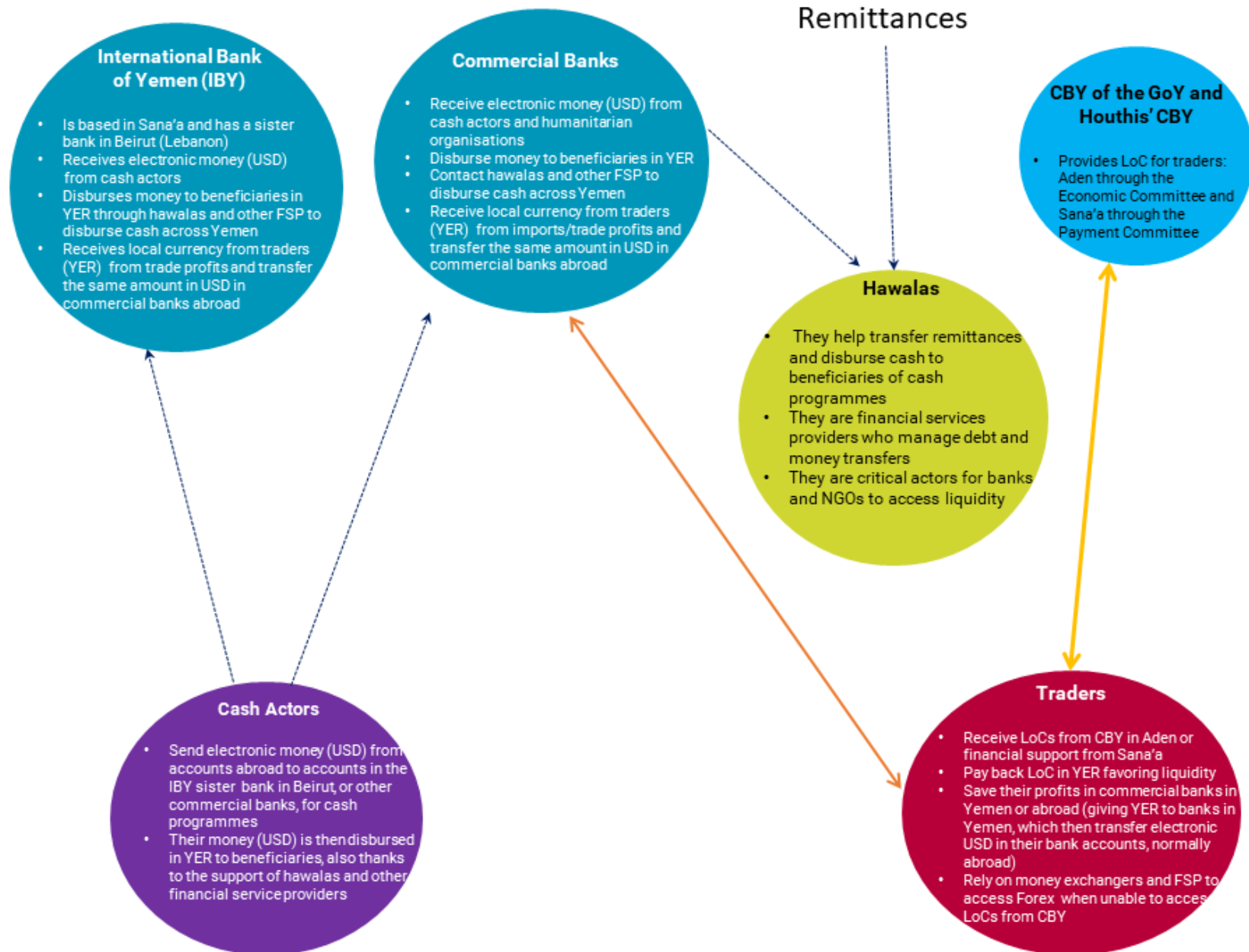
In Yemen, registered hawalas are legal and operate openly. Normally, hawalas and other informal FSPs operate where the formal banking system is weak, absent, or unsafe. Yemen became connected to the international banking system only recently (around 1995) and an estimated 45 percent of Yemenis hold a bank account. The population traditionally relied on hawalas, especially when there was a need to transfer money from abroad (remittances), and this reliance continues today.

The hawala system in Yemen is based on trust and relies on the use of interpersonal connections across the country and abroad. Normally, an agent outside Yemen is connected to agents in Yemen who are able to arrange the disbursement or transfer of cash in the recipient's location. Prominent hawala families have operated for centuries and have extensive networks.

Hawalas, relative to banks, have access to more remote areas of Yemen due to their networks, and are essential for private cash transfers as well as for humanitarian cash programming in areas not served by the formal banking sector.

Sources: Investopedia 21/08/2019; UNHCR 26/10/2018; Chatham House 25/07/2017; Interview 12/06/2019.

## Financial sector in Yemen



4 Remittances are predominately sent in USD and Saudi Riyals

## Direct impact of the war economy on Yemen and the humanitarian sector

### The war economy both causes and complicates economic challenges

An increasingly complex and parasitic war economy is compounding the economic challenges in Yemen as much as the direct challenges of the conflict.

For instance, challenges facing the effective importation of basic commodities such as fuel for local consumption and electricity production are political as well as financial, as are those facing the restarting of oil and gas exports. Trade and the movement of goods is limited throughout the country by a combination of blockades, and revenue extraction efforts by a range of armed actors.

Many large national companies face the challenge of paying taxes to both the internationally recognised government, and Houthi authorities in Sana'a. Major importers face the challenge of Saudi led-coalition port restrictions, with one importer reporting that in Aden, where the GoY has been based so far, was so difficult to operate in that they now used land routes from Oman for all imports despite the higher logistical costs.

### Impact on humanitarian actors

**The volatile economic and political climate makes Yemen one of the most complex and challenging financial environments for humanitarian actors to operate in.** Humanitarian organisations struggle to remain untouched from the ongoing economic war between the governing authorities in Sana'a and Aden. Funds flowing into the country tied to the humanitarian response is the second largest source of foreign currency. Currency inflows from humanitarian actors are thus at risk of becoming an increasingly important part of the war economy between the GoY and the Houthis.

### Potential challenges to cash programming

While cash transfer programming is often considered the first choice for humanitarian partners seeking to implement a dignified and cost-effective response, in the case of Yemen, there are significant obstacles and challenges to implementing cash programming. Key to these challenges are:

- The complex war economy
- Constraints on access (both of humanitarian actors and people in need)
- Beneficiary selection

There is a growing consensus that cash programming is far more appropriate and effective in Yemen than in-kind assistance. While cash transfers may not be the complete answer to the problem of food insecurity, ACAPS found that, in the large majority of cases, the main food insecurity problem in Yemen is not food availability but the households' inability to access the food market due to lack of money and assets to pay for it. As such, cash assistance<sup>5</sup> seems to be the most suitable tool to respond to food insecurity, in contrast to food delivery. However, at the same time, cash programming could be more likely motivate interference by local armed actors and authorities. Overall cash and vouchers remain an extremely important part of a wider strategy to combat food insecurity, rather than a strategy in of itself.

## Main sources of import financing in Yemen

The north of Yemen remains the economic hub, where the majority of business operate and trade continues despite the conflict (Reuters 20/12/2019). The majority of the population (between 70-90%) live in the north of Yemen and around 70% of monthly food imports and 40-50% of fuel imports enter Yemen through Hudaydah and Saleef ports, in the north of Yemen (OCHA 20/05/2019; FEWS NET 12/2018). The economic dominance of the north is in spite of the fact that, according to CBY Sana'a Houthi officials, 80% of all food traders in Yemen are based in Sana'a.<sup>6</sup>

As previously noted, authorities in Sana'a and Aden have conflicting regulations and measures over import financing. The Houthis support and control importers through the payment committee. The Government of Yemen (GoY) support imports through the Economic Committee.

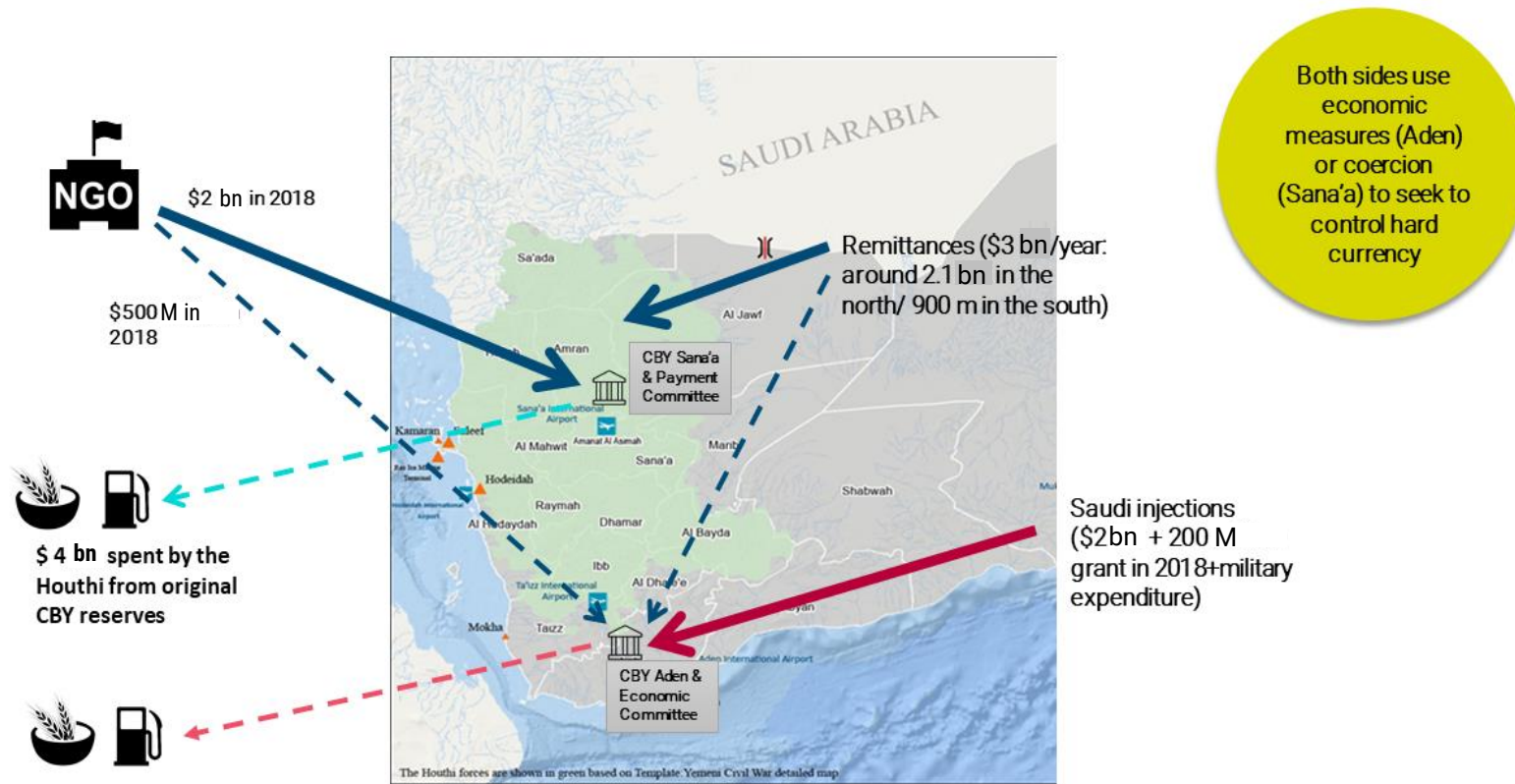
The CBY in Sana'a and CBY of the GoY use difference sources to finance imports. CBYs finance imports through their own reserves, but the import financing at a subsidised rate is largely done by the GoY CBY, including for imports to the north (that receive the Economic Committee's approval).

<sup>5</sup> Special consideration needs to be given to the currency for cash assistance (USD vs YER) and its impact on the value of the YER.

<sup>6</sup> This percentage is only an estimation and has not been confirmed by other sources.

CBY Sana'a mostly uses money from remittances (around USD 3 billion per year across Yemen, possibly with around 2.1 billion going to the north and 900 million to the south)<sup>7</sup>, as well as money coming from the humanitarian aid sector (estimated 2 billion to the north in 2018). The Houthis also financed imports with money from CBY reserves, following the relocation of the CBY to Aden. It is estimated that the Houthi have spent around USD 4 billion dollars from the original CBY reserves to finance imports since 2015. This gradually drew down CBY Sana'a reserves (Abaad Studies 17/04/2019; Reuters 20/12/2018).

The CBY of the CBY finances its imports because of access to foreign reserves, coming from international support from allies, such as that of Saudi Arabia. Saudi Arabia injected USD 2 billion in 2018, specifically to finance imports of basic goods, including food and fuel.



<sup>7</sup> Absent any sources to suggest otherwise, ACAPS assumed that remittances into Yemen could be split along similar lines to the population (70% in the north, 30% in the south), as we did for calculating the flow of humanitarian aid into Yemen's market.

## Currency exchange rate fluctuation and major events

In Yemen, the depreciation of the currency is linked to the ongoing economic structural weaknesses and the competing economic policies of the GoY CBY and the CBY in Sana'a. Experience has shown that rapid depreciation or volatility of the YER is an expected consequence of major economic and political events.

Monitoring specific variables can help stakeholders to forecast a change in the value of the YER against the USD (positive or negative) and be ready to mitigate any resulting humanitarian impact. ACAPS identified three main factors or events that could prompt a depreciation of the YER:

- announcements from either CBY of new regulations on imports and money exchangers,
- import restrictions due to closure of ports,
- depletion of USD available in the formal and informal market.

The main factor found to help stabilise the currency was the injection of FX into the GBY in Aden.

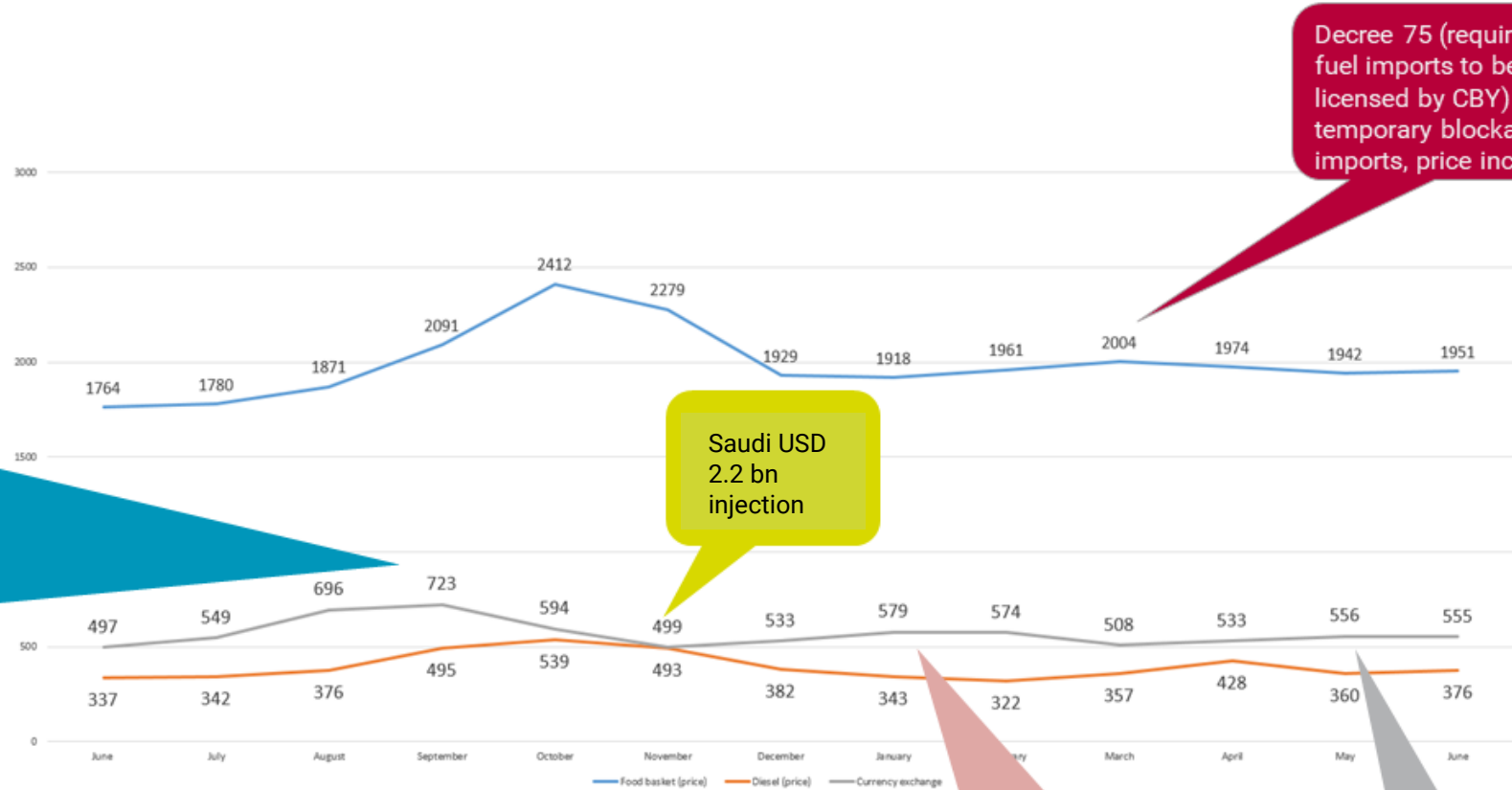
Prior to the current crisis, the local currency sat at YER 215 against the USD. Following escalation of conflict in Yemen, between 2015 and 2017, the YER was relatively stable on the formal market, oscillating between 250 YER/USD to 290 YER/USD, due to efforts of the CBY Aden and commercial banks to keep the rate stable. However, as the black-market value of the YER continued to decline and prices started to rise due to the depletion of foreign reserves and need to finance imports, the GoY CBY decided to float the YER in August 2017. Since then, the YER's value has fluctuated in both the black market and the formal market.

In 2017 alone, the YER lost around 40% of its value, going from 250 YER/USD to about 500 YER/USD. Between September and November 2018, the YER experienced rapid and significant depreciation. (FAO 29/09/2018). At the end of September 2018, the average depreciation rate of the YER was 194% compared to the pre-crisis rate (215 YER/USD), reaching YER 633 to the USD (FAO 29/09/2018). The main reasons for the 2018 depreciation were the ongoing economic structural weaknesses placing downward pressure on the value of the YER combined with actions by political and economic actors to weaken the supply of foreign exchange on the market; further compounded by market panic and speculation.

## 2019 depreciation

Despite the efforts to stabilise the currency, and a slight appreciation of the YER by the end of 2018, from the beginning of 2019, the value of the YER on the black market continued to depreciate gradually. By the end of March 2019, the value of the YER had fallen to YER 590 to the USD, having an impact on people's purchasing power, which is one of the main drivers of the food crisis in Yemen. By the end of August 2019, the rate reached YER 600 to the USD on the black market in Sana'a, and 610 in Aden (FEWS NET 31/08/2019; SC Report 14/04/2019). Escalation of conflict in the south of Yemen at the beginning of August is likely to have contributed to the significant depreciation.

If Yemen's currency see another rapid and significant depreciation, prices of food, fuel and other essential commodities will further increase and become inaccessible or difficult to access for Yemeni households. This will result in increased level of food insecurity for vulnerable households, as well as increased limited access to services and inability to meet basic needs.



- Incoherent monetary policy between CBY Aden and Sana'a and conflicting policies over importations
- Importers and exchangers in the north buy large amounts of USD to finance imports, weakening supply and contributing to speculation
- Al Hudaydah battle and port closure (Sept 2018)

Decree 75 (requiring all fuel imports to be licensed by CBY) causes temporary blockage to imports, price increases

Saudi USD 2.2 bn injection

Withdrawal from the Saudi deposit to support food basket and exchangers in the South. Speculation on foreign currency.

- Ramadan  
- Saudi Riyals deposit to CBY Aden for salaries (disbursed in YER)

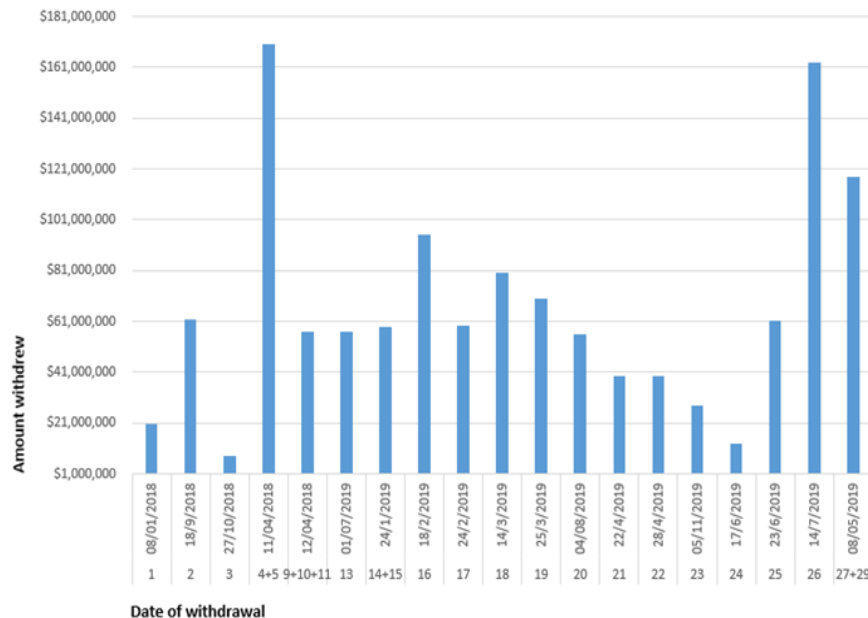
Source: [WFP VAM](#); [Telegram Currency Exchange channel](#)



## Impact and use of Saudi Arabia’s injection in Yemen’s economy

Foreign support, particularly Saudi Arabia’s FX injections (which represent the most consistent form of support to Yemen’s economy in terms of money disbursed to the GoY CBY), are one of the current main sources of foreign currency into Yemen. Saudi Arabia financial support mainly consists in USD donations and grants to help the GoY CBY finance imports, through providing LoC, and stabilising the currency. The GoY is gradually spending the money given by foreign countries. If the support to the GoY CBY by Saudi Arabia and other Gulf States ends, this will most likely increase challenges for the GoY CBY in terms of the provision of LoC for importers in the south, the ability to pay salaries for government officials, and stabilising the local currency.

Saudi injection and grant contributed positively to Yemen’s economy. The USD 200 million grant allowed the CBY to finance imports of basic goods and stabilised the YER for a short period. The CBY of the GoY was able to provide LoC to importers following the depletion of its foreign reserves owing to Saudi Arabia’s support.



**In total USD 1,288,299,105 has been withdrawn so far**

**How is the over USD 2 billion and 200 million grant assistance being used by the CBY?**

- To cover imports of food (Letters of Credits to importers) (from the \$2 bn)
- To stabilize the Yemeni Riyal (withdrawal number 6 and 7; amount not specified)

\*No public statement regarding withdrawal n. 8 and 12

## Link between currency exchange rate and prices

### Currency depreciation and price inflation In Yemen

In Yemen, the currency exchange rate has a direct impact on prices because Yemen is an import dependent economy. Depreciation normally contributes to price inflation because it affects the costs of imported goods and materials. This has a visible impact on households’ purchasing power and their ability to access basic commodities and services.

Internal trade (trade with consumers) in Yemen is in YER. Yet, international trade is in USD. Trade between governorate and district level is also in USD; normally one trader transfers USD electronically to the other trader (business to business is dollarised). Given that traders pay exporters and other traders in USD, although they sell locally their commodities in YER, they have to convert their cash flow back in USD.

ACAPS has run statistical correlation between currency exchange rate and prices and found a very strong statistical correlation between decreases in the value of the YER and increases in the cost of the food basket. Currency drops are quickly reflected in increased food prices. This reflects Yemen’s high import dependence and the de facto dollarisation of the market. There is a less direct correlation between the currency exchange rate and fuel prices (likely due to cartel behaviour and economic policies around fuel imports).

Source: CBY Aden press releases; [The New Arab](#) 19/08/2019; [Debrief](#) 24/06/2019

In Yemen, in addition to the devaluation of currency, price inflation of both imported and locally produced commodities is also impacted by other factors, such as:

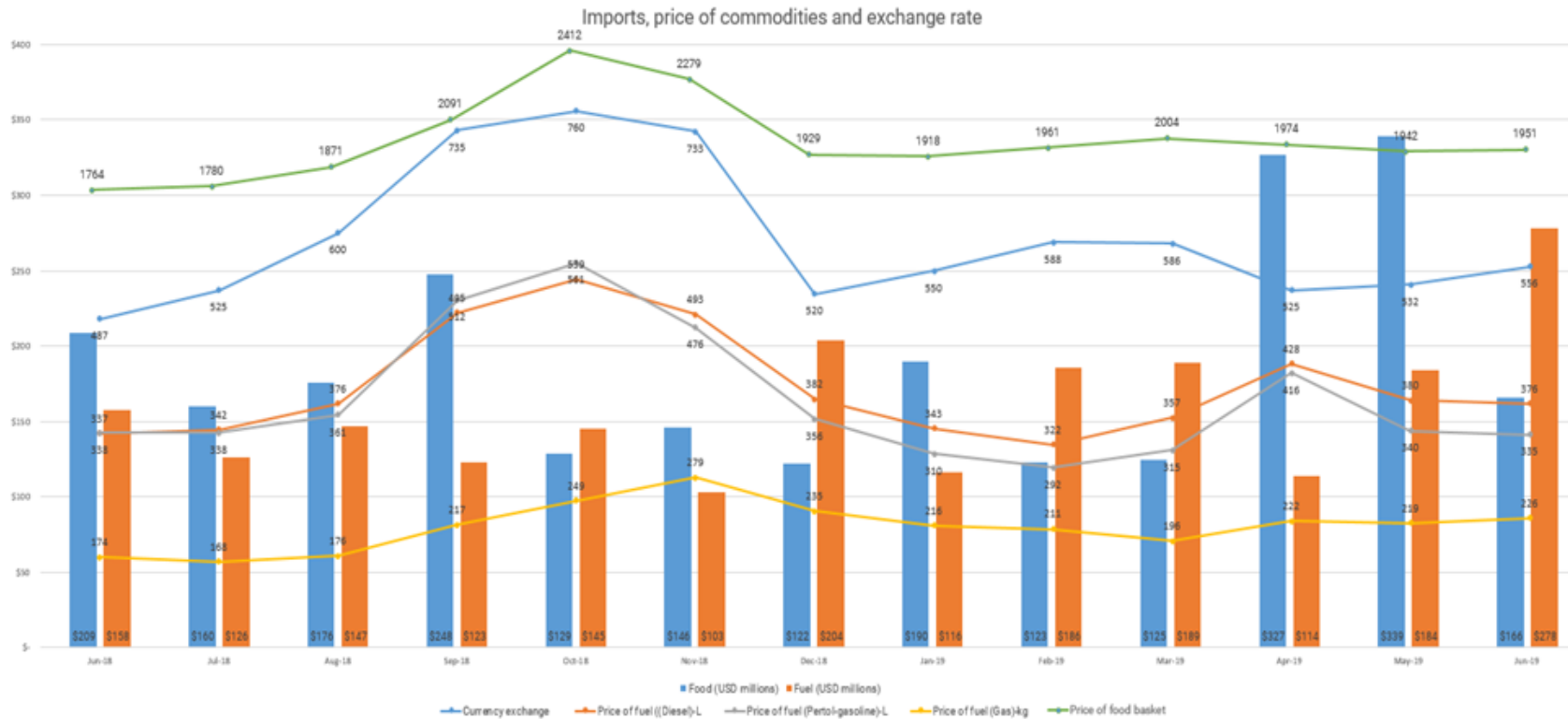
- **Inflated transportation and production costs** due to limited access and lack of or limited infrastructure, as well as fuel shortages or increase in fuel prices (this normally has an impact on locally produced commodities).
- Increased **risks for traders** due to insecurity.
- **Shortage of commodities** (particularly fuel and cooking gas): which offers the opportunity for black market actors and speculators to trade at high rates.
- **Taxation** imposed by different local authorities that traders have to pay to transport commodities across geographic areas. These taxes add to the final costs of commodities in the local market.

### Trade money flows in Yemen

Normally, traders give their profits in YER to hawalas or they put them in accounts in commercial banks in Yemen or the International Bank of Yemen. In exchange, they receive electronic USD from the hawalas or commercial banks into their accounts abroad (e.g. the sister bank of IBY is in Beirut). This process allows commercial banks in Yemen, the International Bank of Yemen (IBY), the hawalas and other FSP to have liquidity available for cash disbursement.

In Yemen, the loss of value in the currency leads to immediate increases in the price of basic commodities. Usually price increases due to currency weakening take up to two/three months to be realised on the local economy. It is likely that the immediate changes are due to the increasing dollarisation/Saudi riyalisation that has occurred throughout the course of the conflict.

# Value of imported commodities



Very direct link between YER and food price fluctuation due to Yemen's dependence on imports. Less direct correlation between currency exchange rate and fuel prices due to cartel behavior

Political triggers (Al Hudaydah offensive Sept 2018, decree 75 Apr 2019) directly impact YER and commodity prices (especially fuel)

Source: [WFP VAM](#); [UNVIM](#)

## Impact of currency fluctuation and price inflation on households

The correlation between currency depreciation and price inflation, and the consequent impact on households, was evident during the 2018 rapid depreciation of the YER. The **minimum/survival food basket increased 94% from pre-crisis (Feb 2015) to Sept 2018** (YER 17,366 to YER 33,775). This had a dramatic impact on **households' purchasing power**, making it more difficult for them to meet basic needs. Increased prices of food as a result of YER depreciation exacerbate the needs of food insecure households as their purchasing power decreases. 15.9 million people across the country (53 percent of the population) were already facing IPC Phase 3 (crisis) food security levels and above at the beginning of 2019 (IPC 07/12/2019).

The price of fuel (diesel, gas, and petrol) normally increases or decreases following a change in the value of the YER. As with food, fuel is one of the main imported commodities in Yemen. There is a less direct correlation between YER depreciation and fuel prices compared to food prices due to fuel cartel behaviour and GoY CBY policies around fuel import. Although the price of fuel itself may not increase significantly, **any minimum increase in fuel prices has a direct impact on households' purchasing power, ability to access basic services, and mobility.**

For instance, the Yemeni population heavily depends on piped water networks or trucked water. Whenever the price of fuel increases, local water corporations are unable to afford pumping costs. As a consequence, Yemeni households try to supplement their water supply with trucked and bottled water, but **transportation costs make the prices of trucked and bottled water very high.** This has a negative impact on households' access to clean water, making the population more vulnerable to the risk of waterborne diseases and issues around hygiene due to insufficient water supply for washing and bathing.

The price of trucked water directly affects the price of the whole Survival Minimum Expenditure Basket (SMEB). Whenever the prices of trucked water increases, the overall cost of the SMEB increases.

Higher costs of fuel also mean high transportation costs and constraints in accessing markets and services; affecting electricity to run schools and health facilities.

## Impact of currency fluctuation on humanitarian programmes

Until September 2017, when both INGOs and UN agencies adapted their cash programmes to the floating exchange rate, the International Bank of Yemen (IBY) and other commercial banks made significant gains from humanitarian cash transferred at a fixed rate. Banks kept the UN agencies and INGOs exchanging at a rate approximate to 250 YER/USD (with some exceptions), while reselling the foreign currency transferred by the organisations at the market rate. The Sana'a Centre for Strategic Studies estimated that **between January and August 2017 one of the most used banks for cash activities in Yemen gained almost USD 80 million due to currency arbitrage.** This profit was likely shared between a range of actors, given the dependence of Yemeni banks on local money exchangers for liquidity.

**Poor exchange rates ultimately mean less YER dispersed to beneficiaries.**

The main problems organisations face due to currency volatility are:

- **Unpredictable under or overspending** in some budget periods, which entails the **obligation to return funds to donors, sometimes resulting in expensive disallowances.** As programme budgets are in USD or other foreign currencies, the reduction in the value of USD leads to underspending by humanitarian actors
- **Lack of confidence from local communities** which may receive lower amounts than specified at the beginning of a project due to currency volatility. Humanitarian organisations plan cash transfer programs in USD but disburse YER to beneficiaries. If the YER appreciates, there will be less YER disbursed for the same amount of USD on which the programme is designed/based.
- **Limitations imposed on the amount that organisations give to beneficiaries** (to avoid overspending or changes in the amount of money disbursement due to fluctuation) which **does not allow flexibility.** Sometimes, even though the YER devaluates, UN agencies and INGOs are not allowed to add beneficiaries to their list or to increase the amount of money disbursed in order to spend the total amount provided for by the programme budget. Sometimes there are limitations over adjusting programme budgets during the disbursement/programme cycle.
- **Limitations of capacity of partner financial institutions** due to market panic affecting liquidity rates: FSP or banks -- on which cash actors rely to disburse cash in hand to beneficiaries -- may not always have access to this cash due to liquidity problems.

- **Negative effect on programs**, when it comes to trying to integrate exchange rate forecasting into projections, which influence programme design. E.g. Sometimes if the YER is projected to increase in value, so program managers might decide to increase the number of beneficiaries. However, if the rate unexpectedly falls again, there will not be enough money to go around to the increased caseload. Inaccurate forecasting of currency exchange rates can cause **shortfall in budgets**. **Overall, it is challenging to forecast in such an unstable context.**
- **Programme activities are delayed, or implementation is affected**, including activities that do not include cash or voucher distribution due to the need to re-adjust programmes following a rapid depreciation of the YER to avoid over or underspending.

## Scenarios

### Scenario 1 (High likelihood):

#### Continuation of gradual, yet relatively stable decline in YER value over the next six months

Possible Indicators/Triggers:

1. Continuing political competition among economic authorities between the GoY and authorities in Sana'a preventing any consistent or effective countrywide monetary policy aimed at stabilizing or strengthening the YER.
2. Ongoing limited external financial support to the GoY CBY, combined with the ongoing inability for the CBY to effectively balance market demand for foreign exchange due to a restrictive regulatory framework for interventions.
3. Continuing inability of authorities in Yemen to regain foreign exchange revenues through exporting oil and gas, or other resources.
4. Decreasing forex inflows such as from remittances.
5. Continuing challenges for importers attempting to access foreign exchange and LoC through the GoY CBY.

**Likelihood of the scenario occurring: High** - Given the current political competition between Houthi and GoY authorities over the economy, a deal remains unlikely. As a result, importers will continue to struggle to gain access to foreign exchange due to competing regulations. Likewise, the ability of the GoY CBY to boost its own foreign exchange reserves domestically is unlikely, given internal political struggles over areas containing oil and gas fields. The GoY CBY will thus continue to rely on foreign support, being it humanitarian aid (most likely) or new financial support from Gulf country (less likely, as Saudi Arabia nor other Gulf states have announced any new injection of forex for the GoY CBY).

**Impact: Moderate negative humanitarian impact** through gradual erosion of the purchasing power of Yemenis. **Moderate programmatic impact** on humanitarian agencies.

Expected decline of the YER between 550-700 riyals to the USD.

### Scenario 2 (Moderate likelihood):

#### Significant short-term currency instability over the next six months

Possible Indicators/Triggers:

1. Escalating competing economic policies between the GoY CBY and the CBY in Sana'a, notably over regulation of financial actors or importation of key commodities such as fuel or food, negatively affecting the ability of either to stabilise the YER.
2. Depletion of GoY CBY currency reserves without further international financial support.
3. Inability of importers to access foreign exchange from the GoY CBY due to competing regulatory frameworks forcing them to draw on the informal market, leaving it vulnerable to sudden shocks or economic cycles.
4. Increase in cartel/currency speculation activities by political or economic actors in the absence of any countervailing policy options by economic authorities in the north or south.
5. Dramatic long-term competing market interventions by CBY actors in Sana'a or Aden, either pulling or dumping foreign exchange on the market, or in the case of the GoY CBY, the printing of new currency (actions that could either stabilise or de-stabilise the YER depending on political purpose and on the response of the opposing side).

**Likelihood of the scenario occurring: Moderate to high**

**Impact: Very high negative impact** on the purchasing power of the Yemeni population, resulting in increased levels of food insecurity, reduced access to services, and limited mobility. Very high negative impact on the ability of humanitarian actors to avoid significant programmatic disruption due to sudden rapid depreciation; due to the inability to adjust cash transfer programmes during the cash disbursement cycle.

Expected short-term disruption to the value of the Yemeni riyal, either depreciation or appreciation, between YER 550-900 to the USD.

### Scenario 3 (Low likelihood):

#### Stabilisation or gradual improvement of the YER over the next six months

Possible Indicators/Triggers:

1. Political agreement between GoY and Houthi authorities allowing for coordinated monetary policy aimed at stabilising the riyal and the suspension of competing regulatory frameworks for business and financial actors.
2. Increase in external financial support from international actors to the GoY CBY in the form of foreign exchange injections.
3. Improved capacity of the GoY CBY of the GoY to boost its foreign reserves, such as through any significant boost in oil and gas exports.
4. Improved capacity for importers to apply and receive importation financing through the internationally recognised CBY.

**Likelihood of the scenario occurring: Low** - Given the current political competition between Houthi and GoY authorities over the economy, a deal remains unlikely. As a result, importers will continue to struggle to gain access to foreign exchange due to competing regulations. The ability of the GoY CBY to boost its own foreign exchange reserves domestically is unlikely due to internal political struggles over resources. The internationally recognised CBY will likely continue to rely on foreign support. Nonetheless, economic authorities in both Houthi and GoY controlled areas have shown some improvement in their ability to manage the currency with the resources at hand. The GoY has improved systems around the allocation of credit to importers and access to sources of forex such as military salaries paid by the Saudi led coalition to the GoY military. This may allow the GoY CBY to manage a relatively stable decline in the currency despite the deep structural issues.

**Impact: High positive impact** on the purchasing power of the Yemeni population and no negative impact on humanitarian programming.

Expected stabilization of the Yemeni riyal between 450-550 riyals to the USD.

## Methodology

This report has the objective to explore the drivers of fluctuation and volatility of the Yemeni Riyal (YER) and the consequent fluctuation of commodity prices in the market. It also analyses the impact of currency and price fluctuation on households, in terms of purchasing power and households' ability to meet their basic needs, as well as on humanitarian programmes in Yemen, with a specific focus on cash transfer programmes (CTP).

The Cash and Market Working Group (CMWG) in Yemen commissioned this report. Although its main targeted audience are INGOS and UN members of the CMWG in Yemen, the report addresses the issue of the volatility of YER and price fluctuation in Yemen more broadly. As such, it also aims to inform donors, decision-makers, practitioners, and other organisations involved in the humanitarian response in Yemen. The main objective is to help understand the issues around currency volatility so humanitarian stakeholders can be better prepared to see the signs of currency fluctuation early and identify actions that will limit its impact on households and humanitarian cash programmes.

This report is based on the review of secondary data, analysis of quantitative data, and interviews with key cash actors, cash experts, and economic advisors. Both interviews and secondary data review were conducted between May June and August 2019. The main sources consulted for qualitative data analysis date back to 2015, from the beginning of escalation of conflict in Yemen and the consequent collapse of the country's banking system. For quantitative data, the report is based on data collected/recorded between 2014 and 2019 for both prices and exchange rate of the YER. This was necessary to be able to run comparative analysis of prices and currency exchange rate pre-crisis and during the crisis.

Our findings on the link between currency exchange rate and prices of basic commodities were based on secondary data review, primary data analysis, as well as statistical correlation. The scenarios were based on a combination of secondary and primary data. Assigning the level of likelihood and severity based on expert judgement.

There was a lack of available public information on the value of remittances and humanitarian aid flowing respectively in the north and south of Yemen in 2018, as well as on the value in USD of imports entering Yemen. The calculation of these was possible using other data available (the number of tons of basic commodities entering into Yemen per month, prices of items included in the food basket, prices of fuel for value of imports in USD; value of remittances flowing into Yemen each year; and money from the humanitarian sector allocated to Yemen in 2018 ). Although the calculations' results are mathematically accurate, they should be considered an estimate.

## Limitations

- Overall, the sources on the actual money flowing into Yemen through imports, remittances, humanitarian aid, and foreign assistance are dispersed and limited. This is due to the fact that money flows into Yemen from a set of very diverse sources and for equally diverse reasons, and not all financial flows enter in Yemen through the formal banking system and can be tracked easily.
- It was very difficult to project the currency exchange rate in Yemen for the upcoming six months. Overall, currency depreciation is very difficult to predict as it depends on unpredictable market behaviours. It is also very difficult to understand the immediate link between CBYs policies and regulations and currency fluctuation, as their actual implementation is often unclear.

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