



CHATHAM HOUSE

Chatham House, 10 St James's Square, London SW1Y 4LE

T: +44 (0)20 7957 5700 E: contact@chathamhouse.org

F: +44 (0)20 7957 5710 www.chathamhouse.org

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Yemen's Economy: Oil, Imports and Elites

Peter Salisbury

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SUMMARY POINTS

- The recent political crisis in Yemen has created a cycle of hyperinflation, currency depreciation and disruption to the supply of basic goods. This is already having a serious impact on the 10.3 million Yemenis living in poverty, with the prospect of worse conditions to come.
- Yemen's economy is in thrall to a complex, intertwined network of elites that control the oil industry, imports, processing, and packaging and distribution of goods. Worryingly, many members of these elite groups are also key actors in the current crisis.
- The country's economy is dominated by the production and export of crude oil, which generates 70–80 per cent of government revenues and most of the country's foreign exchange reserves. As a result, Yemeni consumers are highly vulnerable to shifts in international commodity prices, domestic oil output, the country's overall fiscal position and domestic security.
- The average middle-income rural household in Yemen spends 55 per cent of its total income on food, water and energy. Among the country's poor – some 43 per cent of the population – the figure is closer to 70 per cent.
- Until very recently, the price of these commodities was kept down by large government fuel subsidies, which placed an enormous financial burden on the state and reportedly encouraged corruption at the highest levels. In June 2011, gasoline subsidies were effectively abolished although diesel prices continued to be underwritten by the government.
- The prospects for political compromise are poor. Most current analysis suggests that Yemen faces months, if not years, of protracted stalemate while increasing violence brings with it the threat of out-and-out civil war.
- There is a need to reinforce existing social protection mechanisms and bolster humanitarian aid to ensure the availability of, and access to, basic commodities for the country's most vulnerable people. Western donors are demanding a swift political transition as a precondition for resuming the bulk of aid spending, but the transition process has already been lengthy and contested, and any resolution is likely to be protracted and complex.
- The current 'wait-and-see' approach to the situation being taken by some members of the international community will hamper a swift and effective response to the economic crisis, and is likely to exacerbate the human cost of the crisis.

1. INTRODUCTION

The political crisis of 2011 in Yemen has exposed a number of long-standing structural weaknesses in the country's economy, particularly the ability of its poorest people to access basic commodities – food, water, and energy – in times of economic and political strain. Some 43 per cent of the population lived on \$2 or less a day in 2010, according to the International Monetary Fund. This equates to roughly 10.3 million people on the basis of the World Bank population estimate of 24 million for the same year.¹ Yemen's population is growing at 2.9 per cent a year, according to the World Bank, making it one of the fastest-growing on the planet.

The state is excessively reliant on the production and export of oil and gas to generate revenues, build foreign currency reserves, fund subsidies to the cost of living and underwrite other costs, including state salaries. However, relative to its neighbouring Gulf Arab states, Yemen has low oil output and revenues – it is the world's 32nd largest exporter of oil – and a large population. Oil production is in terminal decline, and a lack of refining capacity meant that until 2010 Yemen imported around 20 per cent of its fuel needs.

Meanwhile, President Ali Abdullah Saleh has allocated control of large parts of the country's economy – including sectors related to the import, processing and distribution of basic commodities – to several small, intertwined but often conflicting elite groups, in return for their support. Their ability to maintain the country's commodity supply chain is in turn closely linked to the price and availability of fuel, diesel in particular, and the availability of foreign currency. To date, these groups have failed to agree on, much less implement, the kind of economic reforms that would serve the wider population's long-term interests.

The current system leaves Yemen's poor vulnerable to shifts in oil output and prices on international markets, and to volatility within the political system. Since February 2011, a number of the key players in Yemen's economy have been involved in an increasingly complex and violent dispute over the legitimacy of President Saleh's regime. This dispute is unlikely to end in the near future.

The longer the political crisis continues, the higher the likelihood that millions of Yemenis will be unable to access sufficient food, water or fuel without help from the state or foreign aid. At the time of writing the severity of some of these economic shocks had been mitigated to a degree by donations of oil and, reportedly, cash from Yemen's Gulf Arab neighbours. However, if the crisis continues and security worsens, further coordination will be required between Yemen's Western donors, the Gulf states and the elite Yemeni businessmen who control the country's commodity distribution networks. This paper analyses the country's commodity supply chain from the perspective of ordinary Yemeni householders and discusses the economic and humanitarian implications of the current crisis.

¹ See IMF Programme Note on the Republic of Yemen, 14 September 2011 (available via the IMF's website), and the World Bank databank (also available on the web) for these figures, the most up-to-date available. <http://www.imf.org/external/country/yem/index.htm>.

2. COMMODITY SUPPLY CHAINS

The ability of the average Yemeni household to access and pay for basic commodities is overwhelmingly dependent on a supply chain built around oil exports, food imports and fuel subsidies. This system is dependent on the government's ability to generate revenues and foreign currency reserves through the export of oil. This section discusses existing supply chains and highlights the potential for further systemic shocks.

Households and consumers

National unemployment figures for Yemen varied from 15 per cent to 40 per cent in 2010, depending on the data source, although unemployment may have reached a level as high as 70 per cent in 2011.² Yemenis based in rural areas, more than 70 per cent of the population, mostly work in agriculture.

Yemenis with jobs in urban environments are likely to work in manufacturing, trade or the provision of services. Many will send any excess earnings back to their villages of origin to help support their families' day-to-day expenses. Most households will also receive some income from family members abroad, through remittance agencies or banks. However, few will be able to open lines of credit – less than four per cent of the country's population use banks, and less than 130,000 people have access to credit.³

On average, rural Yemeni households spend around 55 per cent of their income on food, water and energy, although those living in poverty are likely to spend as much as 70 per cent.⁴

Despite high levels of employment in the agricultural sector, most food is imported while most drinking water, particularly in rural areas, is produced using diesel-powered pumps. Most energy needs are met from liquefied petroleum gas (LPG) canisters or, in the case of the poorest households, wood-burning fires.

Food

Yemen is overwhelmingly dependent on imported food (e.g. 90 per cent of wheat and 100 per cent of rice are imported – staples in the national diet). Food imports generally arrive via one of the country's ports, with Aden in the south and Hodeidah on the Red Sea coast the busiest points of entry. They are then processed and packaged at (all diesel-fuelled) facilities at the ports or at factories in the manufacturing capital, Taiz, or the capital city, before being transported across the country or sold locally.⁵

Water

Because it is a major importer of food staples, Yemen is also consequently a major importer of 'virtual water'. In effect, the production of water-intensive goods is outsourced to foreign

2 Yemen's government-run Central Statistical Organization's *Statistical Yearbook 2009* (available via its website <http://www.cso-yemen.org/>), which was used as the statistical basis of the 'average' Yemeni household, estimated that unemployment among women was in excess of 40 per cent, while 11.3 per cent of working-age men were unemployed. According to the International Labour Organization, 88.1 per cent of women employed in Yemen work in the agricultural sector, emphasizing the importance of the sector.

3 Arab Credit Reporting Initiative, *An Assessment of the Status of the National Credit Reporting System in Yemen* (Abu Dhabi: Arab Credit Reporting Initiative, 2011).

4 World Bank, *Household Energy Supply and Use in Yemen* (Washington, DC: World Bank, 2005).

5 Despite the importance of the country's ports, Aden in particular, senior leaders in the south of the country regularly claim that senior figures in Sana'a have blocked further economic development around them because of fears that a more economically powerful south could also agitate for a greater say in the country's politics.

countries, meaning that the impact of droughts abroad on the cost and availability of key imports can be just as large as a drought at home, if not larger.

Yemen receives little rainfall and most of its domestic water supply is produced from subterranean aquifers. This requires the use of diesel-powered pumps (although some of these have been converted to allow for the use of a mix of diesel and LPG), which means the cost of extracting water is strongly affected by the cost and availability of diesel.

Over 90 per cent of its water is used for agricultural irrigation, and the narcotic leaf *qat* has become the cash crop of choice as it commands the highest price in local markets. As much as 40 per cent of available water resources are used for the irrigation of *qat* alone.⁶

In 2006, only 59 per cent of the urban population of Yemen and 38 per cent of its rural population were covered by government-run water supply, which is irregular at best – and there has been little improvement in coverage since then.⁷ This leaves the majority of the population at the mercy of unregulated businessmen who pump water from aquifers and wells before transporting it to markets by truck.⁸

'Trucked water' is considerably more expensive than public supply, when it is available. In 2006, government-run network prices for water were reported at YR20–180 (\$0.08–0.75)⁹ per cubic metre. Vendors charged YR400–700 (\$1.66–2.91). By early 2011, the price for trucked water was closer to YR2,000 (\$8.33), and at the height of this year's political crisis, prices topped YR7,000 (\$29.16), while government supplies were minimal at best. The unregulated, and inefficient, manner in which water is extracted from the country's aquifers, along with the rapidly growing population, mean that consumption outstrips production to the extent that Yemen is one of the most water-insecure countries on the planet.¹⁰

Energy

Many Yemenis – up to 93 per cent of the country's medium-income rural population – use gas canisters as their primary source of fuel.¹¹ Canisters are produced and refilled in-country, while most LPG is produced by Yemen Gas Company (YGC) at a specialist plant at Marib. The remainder of domestic supply comes from Aden refinery, run by the state-owned Aden Refinery Company, which is also a major site for cylinder refilling. LPG is also imported from neighbouring Gulf states, and Aden refinery can receive shipments of up to 12,000 tonnes of LPG to help refill its storage tanks.

Power supply, where available, comes from government-run plants, the majority of which run on diesel. New capacity additions have been slow, and the transmission network remains weak, leading to regular brownouts and blackouts.¹² Meanwhile, agriculture accounts for some 12 per cent of all fuel consumption in Yemen, largely because of the use of water pumps for irrigation.¹³

6 For a comprehensive discussion of the vicious cycle of diesel pumping and use of *qat* as a cash crop, see *Yemen's Water Sector Reform Program – A Poverty and Social Impact Analysis (PSIA)* (Washington, DC: World Bank, 2007), commissioned by the water and environment, and agriculture ministries of Yemen.

7 Ibid.

8 According to the UN's Food and Agriculture Organization, in 2008 there were 52,000–55,000 wells in active use in Yemen, with 800 drilling and production rigs in use across the country. Only 1,000 wells were registered and licensed for use, while 70 rigs were properly licensed.

9 On the basis of an exchange rate of \$1=YR240, roughly the exchange rate available in Sana'a at the time of writing.

10 In 2005, the World Bank found that Yemen had renewable water resources of around 2.1 billion cubic metres a year, but that around 3.5 billion cubic metres a year were being used.

11 World Bank, *Household Energy Supply and Use in Yemen*. Yemenis in greater poverty will use either kerosene, which can be bought in smaller quantities, or firewood gathered by members of the household.

12 Ibid.

13 World Bank, *Petroleum Subsidies in Yemen: Leveraging Reform for Development* (Washington, DC: World Bank, 2010).

Access to and availability of imports

Importers pay for goods using foreign currency, mainly US dollars, before selling them into the local market in a mix of Yemeni riyals and dollars through deals with retailers, traders and local merchants. Until recently, businessmen involved in the import trade converted much of their riyal income into dollars through local banks, currency traders or the central bank, often sending their dollars abroad or, less frequently, reinvesting them locally. Their ability to exchange riyals for foreign currency has been constrained sporadically since the financial crisis of 2008–09. Rising oil prices in 2010 improved the availability of foreign currency, but supply tightened once again during the 2011 transitional crisis.

Outside the country's coastal cities, all goods are transported by road, leaving many remote communities at the mercy of the quality and security of the roads connecting them to the rest of the country. Around 40 per cent of the population live in 140,000 villages and small settlements that are ill served by existing road networks. It is no coincidence that these are also the country's poorest people.¹⁴ Meanwhile, the ability of distributors to transport basic commodities to rural areas is further constrained by the ability – and willingness – of the country's numerous transportation companies to run routes to remote destinations.

As a result, the price and availability of basic commodities – food, water and fuel – are heavily linked to the cost and availability of diesel and gasoline, the banking sector's ability to maintain a steady supply of foreign currency, and the quality and availability of roads and transport. All of these factors are affected by domestic security. In addition, until very recently, the cost of diesel, gasoline and LPG had been kept low only because the state was willing and able to underwrite costly subsidies for locally-produced and imported fuel; in July 2011, the subsidy on leaded gasoline was effectively removed when the government replaced sale of subsidized leaded gasoline with sale of unsubsidized unleaded gasoline. However, the government continues to subsidize the cost of diesel and LPG.¹⁵

Hydrocarbons and foreign exchange

Between 2000 and 2009, the hydrocarbons sector, including refining, accounted directly for 20–30 per cent of Yemen's overall gross domestic product (GDP), 80–90 per cent of its exports and 70–80 per cent of government revenues.¹⁶ The sector, which since 2010 has included the export of liquefied natural gas (LNG), is Yemen's main source of foreign exchange. However, oil production is in sharp decline, and in recent years several analysts have estimated that demographic and economic pressures, coupled with a fall in output, will turn the country into a net oil importer by 2020, if not sooner.¹⁷

Income from a major liquefied natural gas project, Yemen LNG, is likely to total little more than \$250–300m a year in the period 2010–15. It will provide a much-needed boost to government revenues, but will not be enough to cover the fall in revenues associated with lower oil output. Meanwhile, the cost of imports is rising in line with global commodity prices – which increased by 12.9 per cent annually between 2001 and 2010 on average, according to the IMF¹⁸ – while

14 See World Bank, *Republic of Yemen Road Sector Strategy Note* (Washington, DC: World Bank, 2010).

15 Although Yemen is a net exporter of oil, its refinery capacity is limited. The government has been exporting sweet, light oil, and buying key fuel products on international markets before selling fuel domestically at a considerable mark-down to international prices.

16 Government of Yemen Central Statistical Organization, *Statistical Yearbook 2009*.

17 In 2009, a Chatham House study, *The Dilemma of Oil Depletion* (<http://www.chathamhouse.org/publications/papers/view/109093>), projected a 'best-case' scenario for oil production where even though production had declined since 2004, a plateau was maintained between 2008 and 2013. Nevertheless, this showed terminal decline in exports from 2008, given domestic consumption growth, with Yemen becoming a net oil importer in 2019. Data collated for BP's *Statistical Review of World Energy 2011* (<http://www.bp.com>) show that production has been in decline since 2004, when output peaked at 420,000 barrels a day (b/d). Production in 2010 averaged 264,000 b/d, according to BP.

18 IMF, *Indices of Primary Commodity Prices, 2001-2011* (Washington, DC: IMF, 2011).

the country's trade balance has been negative since 2007. Yemen's trade deficit rose from \$1bn to \$2.7bn between 2008 and 2010.¹⁹

The government ran successive budget deficits in 2007–10 as spending overtook income, while the country's current account – the balance of international exchanges in goods, services, debt payments and remittances – has also been negative since 2007 as a result of falling oil output and increasing demand for commodities from abroad. Yemen has attracted little foreign direct investment (FDI), around \$1.9bn at its peak in 2008, with capital outflows understood to far outstrip this figure.²⁰

These factors have placed a strain on the value of the riyal, as well as foreign currency reserves at the Central Bank of Yemen, which fell from more than \$8bn in 2008 to around \$3.2bn in July 2011.²¹

Systemic vulnerabilities

The make-up of the country's commodity supply chain leaves the average Yemeni household susceptible to a series of intersecting systemic shocks, many of which have already been felt during 2011. Any further stresses will compound the existing pressure on householders and lead to a rapid deterioration in quality of life.

Oil output

Yemen's oil output is in long-term decline. Unless there are continued and sustained increases in international oil prices, falling output will continue to reduce the country's foreign exchange earnings, making it increasingly difficult to finance a rising import bill (resulting from both demographic pressures²² and slow growth in domestic agricultural production). Lower export income will also bite into government revenues, compromising the ability to balance the state budget and underwrite social protection mechanisms, including subsidies to the cost of living.

Increasing global commodity prices

Further increases in commodity prices on global markets will continue to mean higher prices for Yemeni consumers. The July decision to replace sales of subsidized leaded gasoline with unsubsidized unleaded gasoline in effect doubled the cost of gasoline for consumers, although given the political situation its reversal cannot be ruled out. Such a reversal would lead to lower consumer prices but a higher import bill for the government.

Currency depreciation

A further fall in the value of the Yemeni riyal will decrease domestic purchasing power against steady, or rising, commodity prices on international markets. Falling foreign currency reserves at the central bank, concerns over the country's balance of payments, the ability of the banking

19 This assertion is based on author interviews 2008–11 and internal government/World Bank documents seen by the author at varying stages of the project.

20 World Bank, *World Development Indicators Database* (Washington, DC: World Bank, December 2010).

21 Central Bank of Yemen, domestic and international sources interviewed by the author. Until 1991, cash flows into Yemen were high thanks to remittances from workers in the Gulf. However, following Saleh's decision to back Iraq's invasion of Kuwait an estimated one million Yemenis were deported from their host countries.

22 Yemen's population growth is among the highest in the world, at 2.9%, according to the World Bank.

system to service its international debts,²³ security problems and worries over the level of the government's external debt could all contribute to downward pressures on the riyal.

Deteriorating security conditions

Deteriorating security conditions affect access to commodities, particularly for the rural poor, who live at a distance from the main points of entry to the country. Reduced security will also mean an increase in risk for transportation companies, meaning that they would be likely to raise their prices or stop operating particularly dangerous supply routes. This could also place pressure on the riyal, and force the government to increase spending on both imports and security.

Rising unemployment

All of these shocks bring with them the threat of even greater levels of unemployment. The disruption of diesel and LPG supplies to rural communities will affect water supplies, and hence the ability of farmers to irrigate their land. Deteriorating security conditions will also affect Yemen's urban and coastal centres, where much of the country's import and manufacturing capacity is located. Any further fall in manufacturing output will lead to local businesses further reducing their workforce to offset the risk of losses, increasing unemployment and reducing urban-to-rural remittances. This will encourage Yemenis to return to villages to avoid the expense associated with urban life, thereby increasing demand for commodities in rural areas while household income tightens.

²³ Debt service is not a major issue for Yemen *per se*. The banking system is indebted by around \$6.5bn. However, this could still affect the valuation of the currency.

3. CORRUPTION, REFORM AND COMPETITION

A great deal of time and effort has been spent in recent years in attempting to address Yemen's many social and economic problems, and to reduce the degree of household vulnerability to the shocks detailed above. However, Yemen's economy is dominated by a complex, intertwined network of elites that control the oil industry, imports, processing, and packaging and distribution of goods. Some members of these elite networks are also alleged to have lucrative informal interests such as the smuggling of diesel, arms and people.²⁴

Reform and elite competition

There has been some recognition in Sana'a in recent years that extensive reforms are needed in order to prevent major financial and economic crises. In 2006, President Saleh sponsored an ambitious reform agenda to free up government resources, which was put together by members of the technocratic elite, many of whom were associated with his son, Ahmed Ali. Progress was slow, but aspects of this plan were later integrated into a wide-ranging 10-point programme.²⁵

Four years later, the government managed to arrange an extended credit facility with the IMF. Key conditions were the gradual eradication of fuel subsidies and the implementation of a new general sales tax.²⁶ As of early 2011, fund officials were reporting good progress: a tax reform law was passed in 2010 and fuel subsidies were being gradually cut, first for industrial consumers and then for general sales. However, the subsequent removal from sale of subsidized leaded gasoline in July 2011 reflected short-term fiscal pressure, despite being consistent with a longer-term strategic plan.

During this period, Sana'a worked with the World Bank to build social safety nets to protect the country's poorest people from the impact of the planned reforms, particularly reform of fuel subsidies, which threatened to increase levels of absolute poverty unless they were coordinated with targeted welfare payments.²⁷ Protection measures in place before the current crisis include the Social Welfare Fund, which transfers \$9–18 a month per household to one million families,²⁸ and the Social Fund for Development, which hires poor, able-bodied Yemenis to work on local infrastructure projects.²⁹ NGOs in the country also work to provide emergency assistance through the multi-agency Emergency Response Fund, which has been particularly active during 2011.

It is worth bearing in mind that sales taxes and subsidy reforms have formed the heart of negotiations between the government and the IMF since the late 1990s, and similar steps were taken in the past before being reversed after rioting and, reportedly, pressure from elite

24 For a discussion of illicit trade in Yemen see Sally Healy and Ginny Hill, *Yemen and Somalia: Terrorism, Shadow Networks and the Limitations of State-Building* (London: Chatham House, October 2010); Sarah Phillips, 'Al-Qaeda and the Struggle For Yemen', *Survival: Global Politics and Strategy*, Vol. 53, No. 1, February–March 2011, pp. 95–120.

25 See 'Reform Priorities for Yemen and a 10-Point Agenda' (London: Chatham House, February 2010). USAID and April Longley Alley, *Shifting Light in the Qamariyya: The Reinvention of Patronage Networks in Contemporary Yemen* (Washington DC: Georgetown University, 2008). All have interesting points to make on the power, and will, of the young reformers to instigate genuine change in Yemen.

26 IMF, 'Republic of Yemen: Request for a Three-Year Arrangement Under the Extended Credit Facility – Staff Report', September 2010. <http://www.imf.org/external/pubs/ft/scr/2010/cr10300.pdf>.

27 The World Bank estimated in 2009 that instantly removing fuel subsidies could hugely increase levels of absolute poverty in Yemen, by up to 8 per cent.

28 Sources at NGOs maintain that far greater attention should have been paid to the Social Welfare Fund, citing appropriation of funds by well-off families, and to the 500,000 Yemenis they feel should be included in the programme.

29 For a discussion of social protection measures in place, see IMF, 'Republic of Yemen: Request for a Three-year Arrangement', Box 3.

groups.³⁰ Reform is, and will remain, extremely difficult to implement if the network of economic and political elites constructed by President Saleh during his 12 years as head of North Yemen and two subsequent decades as president of the unified North and South remains in place. Meanwhile, the July decision to abolish gasoline subsidies would appear to have been motivated by the government's weak fiscal position and, reputedly, a desire to weaken opposition morale. Subsidies could well be reinstated by either the current Saleh regime or a new government in Sana'a.

Elite corruption

Because of the way the country's economy is structured, Yemenis – rightly or wrongly – see almost all business activity as being corrupt in some way. The country was ranked 148th out of 178 countries in Transparency International's 2010 *Corruption Perceptions Index*.³¹

Favoured actors in Yemen are allowed access to key sectors of the economy, including import and export licences, control of oil concessions, oil distribution rights, and more recently lucrative licences to provide mobile telephone and internet services. The degree of access they are afforded has often been directly proportional to the importance President Saleh has placed on their political support.³²

These actors have been rewarded through government contracts and the allocation of resources from the government budget to their home regions. Competition between these elites, and the fragility of the country's status quo, have made effective reform or improvements to the rule of law extremely difficult.

The **core elites** in Yemen's economy are:

- A small group of technocrats, some of them reform-minded, but constrained by their relative lack of power compared with other actors with vested interests, and their need for patronage from the president and his family; often known as the '**young reformers**'.
- The **security services**, largely dominated by members of Saleh's family and his Sanhan clan, including former ally General Ali Mohsin. Serving military personnel control a major company, Yemen Economic Corporation (Yeco), which is subsidized by the state, and some members of the military reputedly play a role in illicit economic activities including diesel and arms smuggling.³³
- **Tribal groups**, such as the al-Ahmar family, which heads the Hashid tribal confederation (of which Saleh's Sanhan clan is a part). Members of this elite group have increasingly used their social positions to obtain import licences, work as partners to international firms, win government contracts and enter into the formal economy through control of banks and the telecommunications sector.
- **Politicians** within both the ruling party, the General People's Congress, and the opposition coalition, the Joint Meeting Parties, who have been able to use their positions in a similar manner to the tribal elites.

30 BBC News, 'Dozens dead in Yemen fuel riots', 22 July 2005, http://news.bbc.co.uk/1/hi/world/middle_east/4707145.stm.

31 Transparency International, *Corruption Perceptions Index 2010* (London: Transparency International, 2010), p. 2.

32 For example, despite an ostensible state monopoly on the oil and gas sector, a single actor, who is reputed to be Saleh's business partner, is the sole private-sector distributor of oil derivatives both to government facilities, including the state utility Public Electricity Corporation, and to many private businesses. Meanwhile Yeco, a company run by active military personnel, is one of the country's biggest food importers.

33 United States Agency for International Development, *Yemen Corruption Assessment* (Washington, DC: USAID, September 2006).

- The country's small, traditional **merchant elite**, which pre-dates Saleh's rule, and is based around a core of a few commercial families and several businessmen who have close personal relationships with the president. This group has been one of the biggest investors into Yemen's productive industries and the greatest advocate for reform.³⁴

The importance of these elite commercial networks cannot be understated. A survey undertaken for this paper shows that less than ten major groups from the tribes, military and business elite control more than 80 per cent of the country's import, manufacturing and processing businesses, local commercial banks, telecommunications firms and transport companies. In addition they control the commercial networks that import and supply basic goods crucial to householders, and in many cases also the state apparatus required to implement economic reforms.

Groups such as the young reformers have been successful in convincing officials working for international institutions that they have the country's long-term interests at heart, but have chosen to work from within the existing system and hence cannot upset the current balance of power unduly by cutting off key players' access to income. By allying themselves, as many have, with Saleh's son Ahmed Ali, they hoped to have some influence on the country's future direction, but generational transition is likely to be as complex as the current move towards regime change, if the two are not in fact one and the same.³⁵

Meanwhile, Yemeni businessmen do not always seem fully to trust the institutions they control, largely because of the country's many political tensions. Even in times of relative stability, around 40 per cent of all riyal money supply is kept outside the formal banking system.³⁶

During a conversation with the author in 2009, a senior official from a Gulf-based real estate developer confided that a study performed earlier that year had shown that most foreign currency held by the Yemeni elites was either held in physical form locally, in the 'hundreds of millions if not billions' of dollars, or in banks and investments abroad in even greater volumes. Yemeni-held assets abroad are understood to far exceed total foreign currency reserves in the local banking system.³⁷ This makes it easier for many of the merchant elite in particular to leave, or significantly reduce their presence in, the country during periods of political instability.

Competition between different elite factions and different generations within them occurs on both a political and an economic level. The ultimate prize for many political, tribal and military leaders is the capture of a larger share of the state apparatus and the economy, and this will affect their calculations during the current crisis. At the time of writing, the balance of power between these competing factions was in flux, with many elite actors including General Ali Mohsen and Hamid al-Ahmar, the most prominent economic player in his own family, opposing Saleh's stranglehold on political and economic life in Yemen.

Pay-offs

The needs of less powerful players have also been attended to under the existing system, through subsidies and patronage networks. The most obvious example of a social pay-off is the subsidy on fuel, which in 2009 accounted for 22.2 per cent of all government expenditures.³⁸

34 These delineations strongly resemble those outlined by USAID and Alley's discussion of patronage networks in her indispensable doctoral thesis (*Shifting Light in the Qamariyya*).

35 Officials at international institutions and senior figures within Yemen interviewed by the author remain sceptical as to whether potential leaders from the next generation have a genuine interest in reform or use the notion of reform as a gambit to earn a greater role in public life.

36 US Library of Congress Federal Research Division, *Country Profile: Yemen* (August 2008).

37 The banking system also provides an indicator of the total size of the major economic elites, and of which groups are most likely to have access to credit in the country. In a 2010 report, *An Assessment of the Status of the National Credit Reporting System in Yemen*, the Arab Credit Reporting Initiative estimated that 800,000 people in the country had a relationship with the country's formal banking system, while only 129,905 firms and individuals had access to credit. If these numbers represent the elites, then they make up as little as 0.5 per cent of the country's total population.

38 World Bank, *Petroleum Subsidies in Yemen*.

However, even when social protection systems are in place, they are often exploited by elite economic actors. The subsidy system in particular has helped to swell the coffers of those elite members involved in diesel smuggling. In 2008, Sarah Phillips found that around 50 per cent of subsidized diesel, which cost the state \$3.5bn – or 12 per cent of that year's GDP – went to smuggling rings within Yemen.³⁹

Other, less formal, subsidies are also in place. As mentioned above, while the government no longer officially subsidizes food there is strong reason to believe that the reported \$100m a year it gives to the military-run conglomerate Yeco is used to help keep food prices at affordable levels for the population.⁴⁰

The blurring of lines between the country's economy, political system, tribal and military elites, state corruption, the illegal economy and the provision of what little social goods are available in Yemen has meant that any move towards reform that could damage the power and wealth of any single elite group will generally engender reprisals. This makes any reform highly complex, and may mean that sustained reform is virtually impossible. Further, some reforms – such as removing fuel subsidies – have to be coordinated with social safety nets to make sure that the country's most economically vulnerable people are not too badly affected by them. This was not done when gasoline subsidies were halted in July 2011 and is likely to be extremely difficult to implement during the current crisis, given the requirement for the involvement of most of the elite groups involved in the current transitional conflict.

39 As described in Sarah Phillips, 'Al-Qaeda and the Struggle for Yemen'.

40 Discussions with Yemeni businessmen, diplomats, officials at international institutions and other sources have all yielded a similar result. Yeco is a 'big' and 'important' player in the economy, but to what extent remains unknown. Until 1999, it was the country's sole importer and distributor of wheat. In that year, Sana'a opened up the import rights on commodities to other businesses in the country, while Yeco continued to import wheat and other foodstuffs for sale at military-run shops. Black-market trade in these goods is understood to act as an informal price-setting mechanism.

4. THE 2011 TRANSITION CRISIS

Yemen's transitional crisis began in January as small numbers of demonstrators took to the streets to protest about the lack of prospects for young people, weak rule of law and the regime's capture of the economy. Later, under the banner of the country's 'youth movement', growing numbers of protestors demanded that Saleh resign as president and members of his family be removed from all senior military posts before the installation of a new political order.

Over time, leaders of the opposition coalition, the Joint Meeting Parties (JMP), came out in support of the protestors, as did senior tribal and economic actors, including Ali Mohsen and Hamid al-Ahmar, each with their own, somewhat opaque, agendas.⁴¹

The Saleh regime responded with the violent suppression of protest. This in turn led to open conflict between a series of actors including the al-Ahmars, military units controlled by Ahmed Saleh and Saleh loyalists, and General Ali Mohsin, as well as secessionist and Islamist movements in both the north and south of the country.

In early June, an explosion at the presidential compound in Sana'a left Saleh severely wounded, forcing his evacuation to Saudi Arabia for treatment. After a three-month hiatus, fighting between factions in Sana'a intensified in September, while control of vast swathes of the country was taken from the central government by a variety of local power-brokers.

These events led to the worst economic conditions of the year, with international aid agencies warning of the threat of a major humanitarian crisis.

In March, tribesmen blew up a crucial pipeline linking an oil concession in the central province of Marib with export facilities at the Red Sea port of Ras Issa, cutting off a key source of government revenue. In normal conditions, the oil from Block 18 in Marib, which is a valuable light sweet crude, is both sold on to international markets and refined at Aden for domestic consumption.⁴² The government uses some of the export proceeds to buy heavier, cheaper grades of oil to feed Aden refinery.

Following the attack in March, Aden refinery was shut for more than two months, and the government struggled to find the cash to import enough fuel after exhausting the oil reserves held by a state-owned storage terminal at Aden.⁴³

In June, Saudi Arabia began shipping a one-off donation of three million barrels of oil to the refinery, while Oman and the United Arab Emirates also committed to donating oil supplies to the country.⁴⁴ These measures restored a degree of economic stability, and as of September 2011 the pipeline had reportedly been repaired, although payments for exports were not expected to filter through until October or November.⁴⁵ At the time of writing – mid-October – all of the promised Saudi oil had arrived in Yemen, along with around three-quarters of the crude pledged by the UAE.

It is impossible to know how much the Central Bank of Yemen holds in foreign currency reserves, but in early July executives with ties to the bank's management estimated that it had access to \$1.2bn in liquid assets and a further \$2bn tied up in assets that were less accessible, while

41 For a more in-depth discussion of the various factions involved and protestors' demands, see Peter Salisbury, 'What Next for Sanaa?', *Middle East Economic Digest*, Issue 18, 6–12 May 2011.

42 A source with knowledge of the Aden refinery's operations suggests that 75 per cent of the Marib field's output was refined while the remainder was sold on to international markets

43 The government increased the prices of petrol and diesel in July. Gasoline prices increased from YR75/litre to YR170/litre late in the month, reaching international prices pre-tax. Reports from Aden and Mukalla indicated that the price increases were being resisted, but in Sana'a, Hodeidah and Taiz they were more readily accepted.

44 The Saudi donations were made in shipments of 600,000–700,000 barrels at a time. Sources with knowledge of the operation say that the Saudi oil is heavy and sulphur-rich, and that the ageing Aden refinery has had difficulties processing it.

45 Adal Mirza, 'Yemen Oil Production Coming Back Online', *MEED*, 18 July 2011, <http://www.meed.com/sectors/oil-and-gas/oil-upstream/-yemen-oil-production-coming-back-online/3104628.article>.

private banks held around \$700m in foreign currency and assets. A combination of economic woes, civil strife, reported printing of money to meet state expenditures and a perceived inability on the part of the central bank to protect the value of the riyal saw the national currency fall from around YR213 against the dollar in January to more than YR240 in early July.⁴⁶ The riyal has subsequently stabilized, although black-market currency exchange rates are understood to remain excessively high owing to restricted supplies of US dollars in particular.

Economic impact and aid response

In July, Sana'a raised the price of unleaded gasoline to YR175 (\$0.73) while halting the sale of cheaper leaded fuel which had previously cost around YR75 (\$0.31). This effectively brought consumer prices up to the cost of production. It was unclear at the time of writing whether or not this was a temporary or permanent measure, or if opposition groups would reinstate subsidies if they were to take control of the state.

Earlier in the month, the waiting time for fuel at petrol stations had reached 6–7 hours in Aden to three days in Sana'a.⁴⁷ Electricity supply in major urban centres also became increasingly unreliable, while manufacturing in some parts of the country began shutting down because of a lack of fuel and of security.⁴⁸

Humanitarian workers reported that the cost of food and water had increased, varying from location to location, despite attempts by government ministers to persuade local traders to regulate prices, and that transport costs had soared owing to the shortage, and higher costs of fuel. In Sana'a, bread prices doubled between April and July, from YR10 (\$0.04) to YR20 (\$0.08), while water prices increased from YR2,000 to YR7,000. LPG prices soared from around YR1,000 (\$4.16) per cylinder to YR3,000 (12.5).⁴⁹

In an August interview with the UN newswire IRIN, UNICEF's head of mission, Geert Cappelaere, warned that the level of malnutrition among children was 'as big as it is in the Horn of Africa', citing acute malnutrition among 39 per cent of displaced children in several governorates.⁵⁰

In September, the UK charity Oxfam reported that food prices had increased by 15–60 per cent in the district of Hodeidah between January and July 2011,⁵¹ while local businessmen interviewed for this paper estimated an increase in food prices of 60–70 per cent nationwide and an increase in the price of fuel on the black market of up to 500 per cent.

NGO and international institution workers in Yemen interviewed for this paper highlighted the fact that most of the goods distributed by aid agencies in the country are bought on local markets and distributed by local transport companies. This means NGO budgets and logistics are susceptible to the same challenges faced by Yemeni consumers. In the past, the cost of distribution for NGOs had been kept low by subsidized diesel sold by the government, while the supply of goods depended on the elites who dominate import-related trade.

46 Author interviews May–July 2011.

47 Author interviews.

48 Sana'a residents noted that electricity supply, erratic before the presidential compound bombing, was cut off after Saleh's departure and reappeared only when foreign diplomats were in the city or after a ceasefire was brokered between al-Ahmar and Saleh militias in May. Along with the disconnection of the Sabafon telephone network, owned by Al Ahmar Group, in June, many observers have seen poor supply of electricity and fuel as a deliberate tactic by the Saleh regime, using its economic power to weaken opposition.

49 Author interviews, World Food Programme data. Reports from Sana'a in particular also suggest that the size of the average loaf has decreased since early 2011.

50 IRIN, 'Yemen: violence threatens children's health', 18 August 2011. <http://irinnews.org/report.aspx?reportid=93532>.

51 Oxfam, *Yemen: Hungry Lives in Fragile Times* (London: Oxfam, September 2011).

<http://www.oxfam.org/sites/www.oxfam.org/files/bp152-yemen-fragile-lives-hungry-times-190911-summ-en.pdf>.

At the time of writing, violence was continuing to flare up sporadically across the country between a series of factions, while potential political solutions were largely disputed by opposing elite actors. The provision of oil from the Gulf states had led to some economic stability, and the availability of food, water and fuel were all reported to have stabilized.

However, productivity remained low, with some businessmen citing unemployment rates as high as 60–70%, meaning that although goods were available, an increasing number of Yemenis lacked the means to pay for them. In rural areas, water shortages and late rainfall saw farming output fall, with stored supplies slowly drying up and subsistence living becoming increasingly difficult.⁵²

Access to some areas of the country had been cut off, and fighting in the south, initially expected to create 40,000–50,000 internally displaced persons (IDPs), may well have displaced around 100,000 people who will have to be cared for by the state and humanitarian organizations.⁵³ According to aid officials, as access to different areas becomes more difficult, the provision of aid will become increasingly constrained, as will any monitoring exercises to evaluate the impact of the crisis.

The threat of further pipeline attacks remains on the minds of oil and gas executives interviewed for the paper. Indeed, in late August, the government reported that the Marib pipeline, repaired in July, had again been attacked, cutting off oil supplies to the Aden refinery and a vital source of foreign reserves. Sources in Sana'a asserted in September, however, that oil was still flowing from Marib to Ras Issa.

Even the limited number of Yemenis with savings in the country's banks were finding it harder to access them in July and August, as many financial institutions were either affected by erratic electricity supplies or unwilling to return funds to depositors from fear that they could run out of cash.⁵⁴ Foreign currency supply was reportedly increasingly hard to access through the formal banking system, pushing up the exchange rate on the black market.

Given the local preference, particularly in times of crisis, for cash over bank deposits, many commercial and public banks faced significant levels of withdrawals from deposits in July and August. Demand for stable foreign currencies increased while local supply dried up, further limiting the banking system's ability to protect the national currency or meet exchange demands for imports.

This placed further pressure on the country's commercial elites, who control much of the banking sector along with manufacturing capacity, to again cut costs and reduce risk, letting more employees go and reducing the availability of credit to all but the most trusted of local businesses. Small and medium-sized enterprises were said to be suffering the most from such constraints, and many had already closed. Meanwhile, businessmen interviewed for this paper said that they were unlikely to return any capital to the country without visible improvements in stability.

In early October, Sana'a was once again experiencing major conflict, following Saleh's return from Saudi Arabia on 23 September, with attacks being made on the homes of several leading members of the al-Ahmar family. Reports from the state news agency, Saba, suggested that the Marib pipeline had been attacked again in late September, slowing the flow of oil to 35,000 b/d from 120,000 b/d.

⁵² Interviews with Yemeni businessmen and NGO officials.

⁵³ Based on Yemeni government estimates as of 1 August. Independent sources in Aden already report that the government's capacity is strained. Food and water for many IDPs from Abyan province and refugees from Africa are largely being provided by local families.

⁵⁴ Some accounts suggest that foreign currency is available, but that banks do not want to hold money on-site in case of robbery. Customers are asked to call the bank the day before, and the bank arranges for the funds to be delivered on the morning they are required.

International response and policy

Although limited sums of aid have continued to flow into Yemen during 2011, the UN reports that some of its programmes in the country, particularly for the provision of humanitarian assistance to IDPs in the north of the country, are seriously underfunded.⁵⁵

As of early September, 55 per cent of the \$290m of funding requested by the UN-run Yemen Humanitarian Response Plan had been pledged and the Emergency Fund Group, mentioned above, had only \$1.5m remaining in cash. Meanwhile, much humanitarian planning to date has been focused on providing food and accommodation to IDPs, along with improving the quality of potable water in refugee and IDP camps. Other Yemenis will also need help. UN officials noted in early August that access to conflict-affected areas was extremely limited, making it hard to assess the situation or the needs of the people living in these areas.

The quickest response to the economic nature of the current crisis thus far has come from three Gulf states – Saudi Arabia, the UAE and Oman. As mentioned above, the three pledged to donate millions of barrels of crude oil in order to keep the country's economy afloat. However, these donations will not last forever and the current political crisis is unlikely to be settled in the coming months, meaning that the threat of further economic decline will be ever-present.

Saudi Arabia, it should be noted, also provides direct budgetary support to Sana'a, allegedly running to billions of dollars a year, along with payments to tribal leaders. Saudi Arabia is likely to become an increasingly important player in the country in the current crisis and after, given its willingness to provide speedy financial support not just to Sana'a but to a number of different actors within the country.

Discussions with Western diplomats, bureaucrats and analysts reveal two dominant policy priorities – a continued focus on the security threat posed by AQAP and a general 'wait-and-see' approach to the current political situation. The UK's Department for International Development (DFID) allocated around £15.4m for humanitarian relief to Yemen in May and June 2011, the bulk of which is understood to have been delivered. However, part of DFID's funding was channelled through the Dutch government, which has effectively halted its aid work in Yemen. Longer-term planning appears to be on hold until an indefinite date in the future 'after' the crisis, which could be quite some time. In an 11 July interview with the *Yemen Times*, John Wilks, the British ambassador, summed up this sentiment: 'We are ready to increase our aid to Yemen because Yemen will need increased support, but first we need a political transition process and a government.'

This may go some way towards explaining why the existing multilateral contact group for assessing Yemen's needs – the Friends of Yemen group – has not met since September 2010. Meanwhile, many diplomats and aid workers based in Yemen are being repatriated, and are being reassigned to other tasks while their employers wait for a resolution of the current political and military stand-off. This is particularly worrying, as vital institutional knowledge of the country's highly complex inner workings is likely to be lost. Crucially, the current 'wait-and-see' approach hampers a swift and effective response to the economic crisis, exacerbating the potential human cost.

⁵⁵ See World Food Programme, 'WFP Resumes Food Assistance in the Northern Yemeni Governorate of Sa'ada', 31 May 2011. <http://www.wfp.org/news/news-release/wfp-resumes-food-assistance-northern-yemeni-governorate-saada>.

5. CONCLUSION

This paper highlights the vulnerability of the 10.3 million people living in poverty in Yemen to the current crisis. The availability of basic goods, and the average household's ability to access them given lower income and higher commodity prices, have both been constrained. The seriousness of the situation requires urgent action and an agreement to afford high-priority treatment to Yemen, despite turbulence and competing distractions right across the region.

One of three basic scenarios is likely to play out in Yemen over the coming months.

- **Civil war.** The political situation deteriorates into an extremely complex, long and multifaceted civil war. This would be a disaster for the country's economy, as it would probably lead to all hydrocarbon exporting activities being shut down along with most major manufacturing capacity. The humanitarian impact of this scenario would be severe – supplies of food, water and energy would be cut off across the country as hundreds of thousands of more people were displaced.
- **Continued stasis.** A continued decline in economic output, with elite actors leaving the country and transferring their wealth abroad. Continued sporadic and localized violence and territorial fragmentation would see local areas (and their economies) become increasingly politically and economically independent of one another. This is widely seen as the most likely sequence of events.
- **Compromise reached.** Some kind of deal is brokered between the president and opposition leaders. This is the most desirable outcome, but is likely to be flawed if it is achieved, with violence continuing to flare up erratically for the foreseeable future and the country's economy continues to struggle.

In all three scenarios, Yemen's poorest households are likely to bear the brunt of the economic strain created by ongoing political instability. The international community should consider the following measures, to begin to offset the worst effects of the crisis.

In the short term, the supply of basic commodities must be maintained. First and foremost, this means making significant funds available, running into tens if not hundreds of millions of dollars. The international community should consider working with key private-sector and state actors to make sure that food imports continue to reach the country through established supply routes. This also means making sure that there is enough diesel for trucks to run on and for pumping water, as many Yemenis now report that the military and government are stockpiling much of the diesel and gasoline they produce. Dialogue with private-sector actors should be opened as quickly as possible, and run in conjunction with existing humanitarian responses. Key considerations should also include the best way of transporting commodities cross-country.

Cooperation with local actors is likely to be highly complex given Yemen's reputation for corruption and the intricacies of the ongoing conflict, and it will be important to put in place at least some form of monitoring system to ensure that funds and goods make their way to their intended recipients. Realistically, monitoring and evaluation work will require in-country staff engagement with local actors on a detailed, day-to-day basis.

Equally crucial is work with existing social protection funds to make sure that the country's poorest people continue to receive payments, and that, if at all possible, these payments are increased to take account of higher commodity prices and the risk that money transfer networks could be cut off.

In the longer term further research is required to improve understanding of the key vulnerabilities outlined in this paper. A series of sector-level political economy studies should be commissioned, drawing on existing work and new primary research, to identify the key protagonists in the country's formal and informal economies, map the connections between them and describe their evolution in response to the current political transition. These sector-level studies, addressing banking and the commodity supply chain, should be used to guide and support private-sector collaboration on emergency stabilization measures, as well as identifying drivers for longer-term change.

Finally, should Yemen's political situation stabilize in the near future, there will be a huge temptation for policy-makers to shift their attention away from the country, particularly given the number of serious issues they are dealing with in the Middle East. This would be a mistake, and could have terrible consequences for the many poor people who are currently struggling to subsist in Yemen at even the most basic level.

ABOUT THE AUTHOR

Peter Salisbury is a London-based freelance journalist and analyst. Until September 2010 he was energy editor at MEED, the Middle East Economic Digest, working out of the magazine's Dubai bureau. He has written widely on the topics of energy and political economy in the Middle East and first covered Yemen in 2008. In September 2011, Peter completed an MSc in International Politics at the University of London's School of Oriental and African Studies. He continues to write for MEED, and contributes articles to *The Ecologist*, *The Gulf*, *Gulf States Newsletter*, Chatham House's *The World Today* magazine, and works on research projects for MEED Insight.

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The Yemen Forum at Chatham House is a specialist global network that pursues policy solutions for Yemen. The collective knowledge and influence of Yemen Forum members raises awareness, shares expertise and supports governments in forming policies that directly address the causes of conflict, poverty and poor governance in Yemen. The current phase of the project has two major strands: political economy analysis, and the politics of inclusion and legitimacy.

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