USING IMF SUPPORT TO MITIGATE CURRENCY COLLAPSE

By:

The Sana’a Center Economic Unit

October 22, 2021

SANA’A
CENTER FOR STRATEGIC STUDIES
مركز صنعاء للدراسات الاستراتيجية

USING IMF SUPPORT TO MITIGATE CURRENCY COLLAPSE

By:

The Sana'a Center Economic Unit

October 22, 2021

COVER PHOTO: Bundles of YR 1,000 banknotes, issued by the Yemeni government-controlled central bank, sit on the counter at Bin Yazid money exchange in Al-Mansoura district, Aden, on October 1, 2020 // Sana'a Center photo by Ahmed al-Shutiri

This edition of the Yemen Economic Bulletin is part of the Sana'a Center project Monitoring Humanitarian Aid and its Micro and Macroeconomic Effects in Yemen, funded by the Swiss Agency for Development and Cooperation. The project explores the processes and modalities used to deliver aid in Yemen, identifies mechanisms to improve their efficiency and impact, and advocates for increased transparency and efficiency in aid delivery.

Schweizerische Eidgenossenschaft
Confédération suisse
Confederazione Svizzera
Confederaziun svizra

Swiss Agency for Development and Cooperation SDC

SANA'A
CENTER FOR STRATEGIC STUDIES
مركز صنعاء للدراسات الاستراتيجية

The Sana'a Center for Strategic Studies is an independent think-tank that seeks to foster change through knowledge production with a focus on Yemen and the surrounding region. The Center's publications and programs, offered in both Arabic and English, cover political, social, economic and security related developments, aiming to impact policy locally, regionally, and internationally.

© COPYRIGHT SANA´A CENTER 2021

INTRODUCTION INTRODUCTION

The value of the Yemeni rial (YR) has been collapsing dramatically since the end of August in areas nominally controlled by the internationally recognized Yemeni government. This has spurred a rapid deterioration in the living conditions of millions of people and widespread social unrest.

The International Monetary Fund (IMF) also recently allocated the Yemeni government substantial financial support that, if well used, could help stabilize the currency and mitigate the fallout from its collapsing value.

This paper aims to put the current situation in context and offer policy options to the Yemeni government and international stakeholders on the best use of the IMF support.

BACKGROUND

On August 23, the IMF allocated a total of US$665 million[1] worth of foreign currency reserves to Yemen. This came as part of the IMF's largest ever effort[2] to bolster the global economy, launched to help address the ramifications of the COVID-19 pandemic, which will see 190 countries allocated financial support worth a total of roughly US$650 billion.

The support is in the form of Special Drawing Rights (SDRs), which are IMF-maintained units of account that central banks hold as reserve assets and can convert into hard currency through other IMF member countries.[3]

In addition, the IMF will provide debt service relief for 29 low-income countries, as well as policy advice and capacity development support for over 175 nations.[4]

The circumstances within which the internationally recognized Yemeni government might use this financial support, however, began deteriorating rapidly from the last week of August onwards. An accelerating currency collapse has spurred price hikes for basic goods, worsening the humanitarian situation and instigating widespread protests against the government across southern and eastern areas of the country.

Currency stability is crucial to food security in Yemen, which imports up to 90 percent of the basic commodities the population consumes. Prior to the ongoing conflict, which began more than six years ago, Yemen's domestic currency traded at YR215 per US$1. The war subsequently created a monetary environment bifurcated across frontlines,[5] where by mid-October, currency volatility in nominally government controlled areas saw one US dollar trading for more than YR1,300. In areas controlled by the armed Houthi movement, the exchange rate was generally stable, at YR600 per US$1.[6]

The currency collapse in government-controlled areas has created an elevated level of urgency to ensure the IMF support is used wisely and effectively to restore currency stability, mitigate humanitarian suffering and regain social order. The ability of the Yemeni government's central bank to do this is in serious doubt, however, due to external pressures and internal weaknesses.

[1] "Yemen to get $665 mln of IMF reserves in new SDR allocation," Reuters, August 23, 2021, https://www.reuters.com/world/middle-east/yemen-get-655-mln-imf-reserves-new-sdr-allocation-2021-08-23/

[2] "Governors Approve a Historic US$650 Billion SDR Allocation of Special Drawing Rights," IMF, August 2, 2021, https://www.imf.org/en/News/Articles/2021/07/30/pr21235-imf-governors-approve-a-historic-us-650-billion-sdr-allocation-of-special-drawing-rights

[3] For details, see: "Special Drawing Rights", IMF, August 5, 2021, https://www.imf.org/en/About/Factsheets/Sheets/2016/08/01/14/51/Special-Drawing-Right-SDR

[4] "IMF Managing Director Announces the US$650 billion SDR ...." https://www.imf.org/en/News/Articles/2021/08/23/pr21248-imf-managing-director-announces-the-us-650-billion-sdr-allocation-comes-into-effect. Accessed 12 Sep. 2021.

[5] Anthony Biswell, "The War for Monetary Control Enters a Dangerous New Phase," Sana'a Center, January 21, 2020, https://sanaacenter.org/publications/analysis/8674

[6] "Daily exchange rate tracker," Yemen Economy Tracking Initiative, https://yemen.yeti.acaps.org/

THE YEMENI GOVERNMENT'S COLLAPSING RIAL

Yemen was experiencing a severe foreign currency shortage well before the COVID-19 pandemic began. The Aden-based Central Bank of Yemen (CBY), affiliated with the internationally recognized Yemeni government, had essentially exhausted its foreign currency reserves and thereby lost its ability to finance imports and meaningfully intervene in the currency market. The pandemic then saw the country's current largest source of foreign currency inflows – remittances – drop off dramatically,[7] as economic shutdowns reduced the funds Yemeni expatriates working abroad (mainly in Saudi Arabia) were able to send home. This magnified already existing downward pressures on the value of the YR.

While the country's currency has been in general decline since 2015,[8] the last period of rapid and dramatic decline occurred[9] between August and October 2018. Its value recovered just as dramatically, however, through November and December that year. This was due to the CBY-Aden issuing rapid tranches of import financing from a US$2 billion deposit Saudi Arabia had made at the bank earlier in the year for the express purpose of ensuring currency stability. These funds were used to issue letters of credit for five basic commodities: wheat, rice, sugar, milk and cooking oil.

Yet, with the central bank issuing a monthly average of US$97 million in import financing in 2019, more than half of the Saudi deposit was exhausted that year, during which the YR exchange rate and commodity prices were relatively stable. The remainder of the deposit was essentially exhausted by the end of 2020 – when just US$11.3 million of the original US$2 billion Saudi deposit remained – and Riyadh has since been reluctant to put forward more financial support. The CBY-Aden's attempts to source foreign currency by having international aid agencies channel their funds entering Yemen through the bank have also failed.

[7] "Yemen's Accelerating Economic Woes During the Covid-19 Pandemic," Sana'a Center Economic Unit, October 13, 2020, https://sanaacenter.org/publications/main-publications/11711

[8] "War's Elusive End," The Yemen Review, Annual Review 2019, Sana'a Center, January 30, 2020, https://sanaacenter.org/publications/the-yemen-review/8923#Volatile-Currency-Commodity-Markets-Expected-as-Saudi-Deposit-Runs-Out

[9] "Starvation, Diplomacy and Ruthless Friends," The Yemen Review, Annual Review 2018, Sana'a Center, January 22, 2019, https://sanaacenter.org/publications/the-yemen-review/6808#ED-CC-TF

As a result, the CBY-Aden has had few viable options for replenishing its foreign currency reserves or addressing commercial importers' demands for hard currency to purchase goods from abroad. Meanwhile, the Yemeni government faces massive budget and balance of payments deficits, and has been financing government spending – mostly salaries – largely through an expansionary monetary policy. Put another way, the internationally recognized government has been printing new banknotes to cover what it needs to spend. The shortage of foreign currency and the surplus of domestic bills are the primary factors driving the YR's declining value and spikes in food prices outside Houthi-control areas of the country. Houthi battlefield advances in recent months have also weakened local confidence in the currency issued by the CBY-Aden, leading to people in nominally government-held areas rushing to purchase hard currency.

In contrast,[10] the country's largest population and commercial centers in Houthi areas draw in the lion's share of Yemen's foreign currency stocks. Circulation of banknotes issued by the CBY-Aden since early 2017 is also banned in Houthi areas, limiting domestic currency supply there, with both factors supporting relative exchange rate stability in northern areas.

[10] "Widening Exchange Rate Disparity Between New and Old Banknotes," Yemen Economic Review, Sana'a Center Economic Unit, September 9, 2020, https://sanaacenter.org/publications/analysis/11562

YEMEN'S IMF SUPPORT AND CHALLENGES FACING ITS USAGE

IMF membership requires that a country pay a subscription quota. This is set based on the size of the country's economy relative to global peers. This quota helps determine a country's voting share relative to other members, as well as the amount of financial support it could potentially be allocated from the IMF. As part of the global campaign it launched in August, the IMF allocated a total of SDR456 billion, worth a total of roughly US$650 billion,[11] to countries around the world. Of this, Yemen was eligible for an allocation of SDR466.8 million, worth roughly US$665 million. This, however, comes in addition to a previous allocation of SDR the IMF put forward to countries following the 2009 Global Financial Crisis, bringing Yemen's net cumulative allocation of available IMF support to SDR699 million, worth almost US$1 billion.

The use of SDRs is based on the principle of "mutuality and intergovernmental cooperation," according to the IMF, where countries are able to trade SDRs for freely usable currencies (for example, the US dollar) by voluntarily entering into exchanges with other member countries of the IMF's SDR Department. In Yemen's case, the United States, United Kingdom and Saudi Arabia are the most likely candidates for carrying out the exchange, according to a Yemeni government official who spoke to the Sana'a Center Economic Unit on condition of anonymity, as he was not authorized to speak on the record. Should a voluntary exchange fail to materialize for a country to convert its SDR, the IMF can designate that a country in a stronger financial position carries out the trade with a country in a weaker position. The designation mechanism "serves as a backstop to guarantee the liquidity and reserve asset character of the SDR," according to the IMF.[12]

The SDR allocation for Yemen falls far short of the country's outstanding financial needs and obligations,[13] especially considering that the IMF support is limited and Yemen's foreign currency needs are extensive and recurrent. However, the SDR allocation can help relieve some of the economic and financial pressure that has contributed to making Yemen one of the world's worst humanitarian crises. Should the funds be used wisely and efficiently, it may also help coax further international financial support; whether the CBY-Aden can deploy the funds in this manner, however, is highly uncertain.

[11] The value in US dollars is calculated based on the SDR exchange rate as of July 1, 2021, which was SDR0.702283 per US$.

[12] "Special Drawing rights: Chapter 4 of IMF Financial Operations 2014" IMF, October 2014, p. 2, https://www.imf.org/external/pubs/ft/finop/2014/pdf/ch4.pdf

[13] Gross financing need is defined as the sum of the forecasted fiscal deficits, debt repayments and amortization.

Internally, poor governance and weak institutional capacities have plagued the Aden-based central bank's operations since the Yemeni government officially relocated the CBY headquarters from Sana'a in 2016. A UN Panel of Experts' annual report[14] on Yemen, published in January 2021, accused the Yemeni government and the CBY-Aden of gross mismanagement and major corruption for embezzling nearly US$500 million[15] from the US$2 billion Saudi deposit. The report alleged that this was facilitated through the CBY-Aden's import financing mechanism, which offered traders an excessively preferential exchange rate when purchasing letters of credit for the five basic commodities that were subsidized. Although the UN panel later formally withdrew its accusation, the fact remains that the CBY-Aden's processes for utilizing foreign currency funds from the Saudi deposit were arbitrary and opaque and created a fertile environment for corruption. Meanwhile, the CBY-Aden has also faced increasing erosion of its authority from both the CBY-Sana'a, with which it is engaged in a war for national economic dominance, as well as groups within the anti-Houthi coalition – namely the Southern Transitional Council, which currently controls the interim capital Aden and much of southern Yemen.

[14] "Final Report of the Panel of Experts on Yemen," UNSC, January 25, 2021, https://reliefweb.int/sites/reliefweb.int/files/resources/S_2021_79_E.pdf

[15] "The CBY-Aden's Crisis of Confidence – Assessing the UN Panel of Experts' Corruption Allegations," Sana'a Center Economic Unit, March 26, 2021, https://sanaacenter.org/publications/analysis/13577

LOOKING AHEAD

The current circumstances demand immediate currency stabilization in areas of Yemen outside Houthi control, given that the YR's ongoing rapid depreciation in these areas is undermining social order, political stability and the humanitarian situation. To ensure the maximum positive impact over the longest period of time, however, the CBY-Aden's deployment of its SDR allocation must be more focused and limited than its previous deployment of funds from the $2 billion Saudi deposit. A restarted import financing mechanism using the SDR funds should be utilized to finance staple foods and not include sugar, which accounts for almost 10 percent of Yemen's food imports,[16] is not a staple commodity, and is an input in the manufacturing of other products such as candy, which means a portion of sugar subsidies would benefit manufacturers rather than consumers.

The Yemeni government should also maximize the total SDR allocation available for the CBY-Aden to access. To this end, the Yemeni government should seek to draw the full, 100 percent of its net cumulative allocation of SDR which, as noted above, is SDR699 million, worth roughly US$986 billion. Additional SDR funds could also be mobilized from the IMF's Poverty Reduction and Growth Trust, as well as countries that hold stronger financial positions in SDRs at the IMF and have contributed to Yemen's widespread humanitarian crisis today – namely members and supporters of the Saudi-led military coalition intervention in Yemen.

Should the CBY-Aden be able to demonstrate the efficient, effective and transparent use of Yemen's SDR allocation, this may help alleviate concerns currently preventing international actors – primarily Saudi Arabia – from providing the bank with access to further foreign currency reserve support. It would also be a positive step in restoring faith in the CBY-Aden among major business and financial actors in Yemen. This would help rebuild a foundation for further cooperation with the CBY-Aden's efforts to restore its basic monetary functions, such as monitoring and regulating the currency market. The current CBY-Aden governor and board of directors have lost the confidence of foreign and domestic stakeholders, however, given their mishandling of the Saudi deposit and inability to carry out the bank's mandate generally, and thus should be replaced.

Given the unreliable nature of foreign support, the Yemeni government must also redevelop large-scale domestic sources of foreign currency generation. The most obvious and feasible foundation for this is Yemen's oil and natural gas resources.

[16] "Yemen Food Supply Chain", ACAPS, December 2020, https://www.acaps.org/sites/acaps/files/products/files/20201216_acaps_yemen_analysis_hub_food_supply_chain.pdf

RECOMMENDATIONS

To Address Immediate Needs:

- The Yemeni government should immediately form a limited-duration Emergency Committee. In consultation with the IMF, this committee should establish a jointly coordinated, well governed, and transparent mechanism to utilize the SDR funds to support currency stabilization in southern and eastern Yemen (i.e. areas outside of Houthi control). The Yemeni government should ensure that this committee is composed of competent technocrats with a proven track record of integrity, political impartiality, and of acting in the public interest. Committee members should be selected from personnel at the CBY-Aden, the government's Economic Committee, the Ministry of Finance, the Ministry of Industry and Trade,[17] and from any other important bodies essential for the mechanism to function effectively.

- The Emergency Committee should abandon the CBY-Aden's previous preferential exchange rate mechanism for import financing and reduce the commodities covered. The new mechanism should set the import financing rate at YR10 less than the market weighted average exchange rate prevailing on the day each financing agreement is finalized, in order to both incentivize importer participation in the mechanism while also limiting opportunities for currency arbitrage. The basic commodities covered by the mechanism should not include sugar. The amount of SDR support available to the committee should be limited and this, as well as other details regarding SDR disbursement at this stage, should be agreed in consultation with the IMF. To promote and ensure transparency, the details of all the import financing deals should be made public immediately following agreement.

- The Yemeni government should replace the governor and board of directors at the CBY-Aden. The current CBY-Aden senior leadership has demonstrated that it does not have the capacity to carry out the central bank's basic monetary mandate, has resisted structural reforms to improve this capacity, and has lost the confidence of both domestic and international stakeholders in its ability to steward Yemen's monetary policy responsibly and transparently. Those selected to replace the current CBY-senior leadership should be competent technocrats with a proven track record of public service and political impartiality. The Emergency Committee should be disbanded as soon as the new governor and board of directors are in place.

[17] The Ministry of Industry and Trade could be represented on the envisioned committee to help in identifying commercial food importers eligible for SDR funds from the import financing mechanism to be established at CBY-Aden. The ministry could also help regulate the food market and ensure that subsidized food stuffs are being sold on the commodity market at agreed prices.

Beyond Immediate Needs:

- The Yemeni government and the new CBY-Aden senior leadership should consult with the IMF in developing plans and mechanisms around the use of the SDR funds. This is in line with the IMF's recently published guidance note on the use of the SDRs and would involve developing consistent frameworks for: assessing the macroeconomic implications of the allocation; prioritizing needs and where the new reserve SDR funds should be spent; and for the determination of potential costs and risks that could arise from inadequate and non-transparent use of allocated SDRs. If the new management foresees that an import financing mechanism at the CBY-Aden is crucially needed to continue the financing of the critical food staples, it should also evaluate the functionality of the previously established import financing mechanism for food imports and adopt a conservative foreign exchange rate policy. The aim should be to most effectively and efficiently exploit the CBY-Aden's limited holdings of foreign exchange reserves in supporting long-run price stability. The new CBY-Aden management must also take aggressive steps to reassert its ability to regulate the currency market, and thereby maximize the exchange rate stabilizing impacts of other monetary policies.

- The envisaged frameworks that the new management will pursue should be structured to equally benefit all Yemenis, in both the north and south. They should also ensure that SDR funds are not misdirected to cover non-developmental recurrent public expenditures in selected areas of Yemen, or to serve the narrow economic interests of the internationally recognized Yemeni government, nor any narrow interests pertaining to the public institutions operating under its nominal control. Nor should they go to serve the narrow interests of well-connected financial and commercial actors in Yemen.

- The CBY-Aden should remove restrictions related to its import financing mechanism and allow the underwriting of letters of credit (LoCs) at banks in both government- and Houthi-controlled areas. These LoCs should be issued at an exchange rate very close to the prevailing parallel market rate in the corresponding area, given the dual currency system prevailing in the country. Proceeds or rial liquidity collected from selling LoCs to importers in Houthi-controlled areas should be used to pay the salaries of public servants working and living in Houthi-controlled territories. The Yemeni government should commission a study to examine the most cost-effective means of rapidly increasing revenue, in particular through expanded oil and gas exports. This will likely involve financing promising development projects. In particular, this would include rehabilitating the hydrocarbon infrastructure, and maintaining and expanding export oil and gas pipelines to boost production. Proper consideration, however, will have to be given to evolving circumstances on the ground related to security and stability.

SANA'A
CENTER FOR STRATEGIC STUDIES
مركز صنعاء للدراسات الاستراتيجية

WWW.SANAACENTER.ORG