

# POSITION PAPER

## Decision to ban recently-printed banknotes and its implications on economic conditions in Yemen



ECONOMIC REFORM TEAM - YEMEN

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## **Decision to ban recently-printed banknotes and its implications on economic conditions in Yemen**

In this “Position Estimate” paper, we seek to review the background and humanitarian, economic, and political implications of the decision to ban the recently-printed banknotes. We will attempt to draw conclusions on this significant issue and how it will cast a shadow on all economic developments in the future.

## • Introduction

Yemen is currently undergoing the worst humanitarian crisis in the world. Most of the country's population lacks access to adequate food and medicine and are susceptible to various types of diseases and epidemics, which continue to claim the lives of hundreds of Yemenis every month. About 10 million Yemeni citizens are just a step away from starvation,<sup>1</sup> while 25% of the Yemeni population suffer from malnutrition, and most are suffering from acute malnutrition.

The results of this four-year-long war is a deteriorating humanitarian situation, a state of economic chaos, mismanagement, fragility of services, and duplicity of powers. This chaotic state of affairs has had dire consequences on the entire Yemeni economy and the private sector in particular.

As a result, key Yemeni economic indicators have fallen and the Yemeni economy has suffered a sharp contraction, with the cumulative rate of social output dwindling to 39%, compared to 2014.<sup>2</sup> The banking sector was particularly affected. This can be seen by the shift in currency exchange rates and the resulting commodity price inflation which directly affects the lives of citizens, as devaluation of the Yemeni rial against the US dollar is directly reflected in the level of inflation and price hikes, making crucial goods more expensive

Perhaps one of the most important manifestations of economic chaos engulfing the country are the arbitrary decisions taken by the various parties to the conflict with regards to very important sectors such as the banking sector. These decisions have plunged the banking sector into the ongoing conflict in Yemen. The Central Bank of Yemen (CBY) is still divided between Sana'a and Aden and decisions that place further restrictions on economic activity and aggravate economic challenges continue to be made.

The recent decision by the CBY in Sana'a to ban the circulation of the recently printed banknotes and taking practical steps to withdraw this so-called 'new currency' from the market is a step that further aggravates the suffering of citizens. Negative consequences of this decision are directly effect the lives of Yemeni citizens, especially as 90% of the country's food and medical requirements are imported at a cost of up to \$2.5 billion annually.<sup>3</sup> In contrast, the ill-considered step taken by the CBY in Aden to continue printing banknotes to cover government expenditures has contributed to the depreciation, indeed the collapse, of the Yemeni rial.

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<sup>1</sup> Humanitarian Response Plan, UN Office for Coordination of Humanitarian Affairs (OCHA), on behalf of Country Humanitarian Team and Partners, p. 5

<sup>2</sup> *Yemen Economic Monitoring Brief*, the World Bank, Winter 2019, p. 2

<sup>3</sup> Statement by the Commerce of Trade and Industry – Aden, 12/24/2019, accessed on 01/01/2020

Consequently, such a decision puts the lives of millions of people on the verge of the abyss, making them vulnerable to suffering due to a lack of access to basic food and medicine. This is further exacerbated by the fact that liquidity shortages is a prime issue as the old currency is too insufficient to cover the needs of the commercial sector to exchange it for US dollars and other hard currencies for import purposes, let alone the huge losses incurred by the private sector as a result of this decision.

In this paper, we seek to review the background of the decision and its repercussions at the humanitarian, economic, and political levels. We will also provide a summary of the liquidity issue, which will continue to cast a shadow on the overall economic development in the coming years.

## • Overview

Currency stability is an essential prerequisite for stability of all transactions in the context of economic activity at the domestic level and in international transactions. Fluctuation of exchange rates creates a state of economic instability where dealers in a collapsing currency lose a substantial part of their wealth as commodity prices rise and market transactions are disturbed. This results in imbalances in the economic sphere as a whole.

Therefore, a key and basic function of the central bank of a country is to administer a monetary policy that stabilizes the currency exchange rate and maintains a balance of supply and demand.

As a result of the ongoing war in Yemen, local currency has been subjected to recurring fluctuations, declining in value by 143%<sup>4</sup> during the past four years. Several crises arising from shortage in both local and foreign currency have occurred. Such developments reflected the fragile monetary policy which proved incapable of managing the banking sector according to market and economic activity requirements.

In addition to the decline in the value of the Yemeni rial during the past four years, the riyal has witnessed multiple crises. Some of these crises arise from the increasing demand for local currency, especially as an increasing number of depositors withdraw their bank deposits and exchange their funds into foreign currencies or spend their savings to meet the increasing costs due to the war and the decline in the level of income.

In order to tackle this phenomenon, in mid-2016, the CBY in Sana'a released its savings in local currency, estimated at more than 400 billion YR, in addition to reintroducing damaged banknotes into the market to meet demand. Although the amount was significant at the time, the demand was greater liquidity in the market, especially after

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<sup>4</sup> *Indicators of the Yemeni Economy*, Studies and Media Center (SEMC), January, 2019, p.

the Sana'a authorities' decision to float fuel imports in July 2015.<sup>5</sup> There was also the damage of a large part of the local currency, as the value of damaged banknotes rose to nearly 18.2 billion YR in just 2014 alone.<sup>6</sup> The shelf life of the local currency is 18 months and the last print of banknotes took place in 2012.

The liquidity crisis then led to a shift away from the banking sector to the parallel currency speculation market, and currency speculators resorted to saving large amounts of money outside of proper banking channels.

On the other hand, the CBY in Aden had banknotes printed in 2017 and 2018 to meet local currency shortages in the market and cover the budget deficit. By contrast, the CBY in Sana'a counteracted this step with a set of decisions which inflicted a heavy price on the banking sector. Banks and exchange businesses suffered raids, closures, and seizures of amounts of the recently printed currency that was issued by the CBY Aden.

The large volume of the 1.7 trillion YR issued by the CBY in Aden was a huge risk to the Yemeni economy, as it led to an increase in inflation, especially since the printed cash was not matched by an increase in foreign exchange reserves or an improvement in economic activity equivalent to the amount of printed cash. The Yemeni government in Aden resorted to using the printed cash to meet the increasing expenses of salaries, especially of the army and security forces, particularly as new recruits are constantly enrolled in these sectors, while no control mechanisms to rationalize those expenses are in place.

In sum, all options in relation to the decision to ban recently printed cash are costly and have been difficult to implement, given the lack of factors facilitating a shift to electronic currency and electronic payment and purchasing methods in Yemen. Similar steps had already been taken in the past and proved unsuccessful. Moreover, this decision paves the way for more risky scenarios, as two currencies of different values within the same country could have dire consequences for the Yemeni economy and threatens to create a more complex economic and political situation.

In the following sections, we will attempt a review of the implications and effects of these decisions.

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<sup>5</sup> "Houthis float fuel prices," Aljazeera net, last accessed on 01/02/2020, available at <https://www.aljazeera.net/news/ebusiness/2015/7/28/>

<sup>6</sup> "Yemenis baffled by the spread of damaged banknotes," Arabi21, 12/30/2019, last accessed on 01/02/2020, available at <https://arabi21.com/story/879983/>

- **Negative effects of the decision to ban and confiscate recently printed banknotes**

Usually, the role of central banks is to preserve stable currency rates and prevent devaluation according to well-calculated and planned policies that address the problem away from any random or subjective reactions. Therefore, the decision to ban recently printed cash by the Sana'a authorities is harmful to the currency and will result in negative repercussions at the humanitarian, economic, and political levels.. The most important repercussions can be summarized by the following categories.

### **1. Humanitarian Implications:**

Depriving thousands of civil servants of their monthly salaries: immediately after this decision was taken, the government in Aden suspended transfers of salaries of civil servants who received their salaries from Aden, including retirees, and employees of various sectors including the judiciary, the Central Agency for Control and Accounting, the health sector, and Hodeida governorate civil servants, due to scarcity of the old currency banknotes compared to availability of the recently printed banknotes. This further complicates the suffering of thousands of households with employees in these sectors.

- Such decisions will lead to further devaluation of the Yemeni rial as a result of transferring recently printed cash from areas under the control of the Sana'a authorities to areas controlled by the Aden authorities. This will result in a rise in supply, which in turn will lead to devaluation. Needless to say, this will affect commodity prices and thus broaden the scope of the humanitarian crisis, especially in view of widespread unemployment and poverty in Yemen.
- Meagre old banknote liquidity and lack of confidence in e-wallets may postpone some cash assistance and incentives provided by international organizations, in addition to an anticipated increase in the costs of operating expenses for domestic and international organizations working in the humanitarian field, represented by rising costs of financial transfers, transportation fees, service fees, etc. Consequently, a broad sector of the Yemeni community that has become dependent on assistance provided by those organizations will be affected.
- Suffering of Yemeni households with cash savings in the recently printed currency as they face difficulty in paying for the necessary services such as medical care and food supplies. In areas under control of the Sana'a authorities, hundreds of stories detailing the suffering of those households have been reported as merchants and service institutions stubbornly declined to accept the recently printed currency following the ban of the new currency by the

authorities in Sana'a.

- Increase in transport fares for Yemeni citizens moving across cities, especially moving from Aden-based government areas to areas controlled by the Sana'a authorities and vice versa. Banning the recently printed cash constitutes an additional burden for travelers in securing transport fares.
- The high costs of spending on healthcare, education, and other expenses that require the movement of citizens from the south to the north. Citizens seeking healthcare, education, and other services in Sana'a need to purchase old cash at a higher rate and this encourages the creation of an appropriate environment for a black market of local currency. Exchange rates of old currency to new currency have hit unanticipated levels, with a hundred thousand rials of the new currency exchanged for seventy-eight thousand rials of the old currency.
- The decision will also lead to shortages in commodity stock. This increases the risks posed to food security, especially as about 20 million people (or 76% of the population) suffer from acute food insecurity in the absence of humanitarian food assistance, according to the latest IPC food insecurity analysis. The analysis estimates that 9.15 million people (53% of the population) suffer from acute food insecurity despite the persistence of humanitarian food assistance, including nearly 5 million people on the brink of starvation in the IPC phase IV. Yemen is among the three most affected countries in the world suffering from acute food insecurity.<sup>7</sup> It is expected that most merchandise imports will decline due to the implementation of this decision, and this will further exacerbate the decline that has already been caused by the war. A statement by the United Nations indicates a decline in imports authorized to enter the country through the United Nations Verification and Inspection Mechanism for Yemen (UNVIM). The average monthly volume of imports decreased to 262 metric tons in 2018, thus recording a decrease of 18% compared to 2017, and 25% compared to the pre-war period.<sup>8</sup>

## 2. Economic Implications

- Such decisions lead to further fragmentation and duplicity in decisions related to monetary and financial policies. In its first reaction to the Sana'a authorities' decision, the CBY in Aden issued a circular stating that it is "the only entity authorized to grant permits to issue an electronic currency by virtue of the international legitimacy of its powers, confirming that recently printed banknotes can be circulated in all governorates."<sup>9</sup>
- The decision leads to the emergence of a black market for speculation in local

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<sup>7</sup> *Yemen Economic Monitoring Brief, Op. Cit.*, p. 2

<sup>8</sup> *Yemen Economic Monitoring Brief, Op. Cit.*, p. 5

<sup>9</sup> A circular issued by the CBY Aden, published by *al-Sharq al-Awsat*, 12/24/2019, last accessed 01/02/202, <https://aawsat.com/home/article/2049951/>



currency, exchanging new currency for old currency. This decision resulted in currency exchanges that allowed huge losses to be incurred by citizens and merchants who had big new currency savings. For example, a sum of a hundred thousand rials of the new currency is exchanged for seventy-eight thousand rials of the old currency.

- The decision further increases the devaluation of the Yemeni rial against the dollar and other hard currencies in Sana'a and Aden. This allows speculators to benefit from this situation and thus the parallel market (the black market) thrives again after it had retreated to some extent following the interventions of the CBY in Aden, who provided basic commodity and fuel importers with hard currency. These interventions had positive results, as the Chamber of Commerce and Industry in Aden stated that prices of food items and medicines fell by 30-35% after the Saudi deposit and opening documentary credits to finance basic commodity and fuel imports.<sup>10</sup>
- These decisions push citizens to convert their savings to foreign currencies, such as US dollars, Saudi Arabian rials, etc., to preserve the value of their savings in anticipation of fears that the new, depreciated currency will remain in their hands. This also represents a risk for the rate of the Yemeni rial against the dollar and other hard currencies. Such concerns are fed by the fact that Yemen runs a shortage of hard currency reserves due to the decline in foreign exchange resources since the outbreak of the war in Yemen.
- Direct losses were incurred by citizens and merchants having new currency cash reserves. Such losses are incurred through devaluation of the new currency in the market, through resorting to the saving of new currency for the longest possible period, or smuggling it to government-controlled areas in Aden.
- Rising money transfer rates, both domestic and international, and the consequent loss of large amounts of money, have only worked to the advantage of currency speculators. A concomitant outcome will involve the emergence and spread of currency smuggling across the different regions of Yemen. Operations of smuggling of new currency will be active from the northwestern areas under the control of the Sana'a authorities to areas controlled by the government in Aden. Conversely, smuggling of old currency will be active in the opposite direction. Such smuggling operations constitute a high risk to the Yemeni economy. The cost of such operations will be reflected in increased prices of goods and services provided to citizens.
- The decision leads to an increase in the smuggling of hard currency from the markets under the control of the Sana'a authorities to the markets in the south and east where higher exchange rates are offered.

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<sup>10</sup> Statement by the Commerce of Trade and Industry – Aden, *Op. Cit.*



- The re-emergence of the local currency liquidity crisis in the areas under the control of the Sana'a authorities, due to the scarcity of old currency and the fact that a large part of available old currency cash in circulation is damaged.
- Many businesses and manufacturers will resort to dealing in foreign currency (US dollar, Saudi Arabian rial, etc.) to face exchange rate fluctuations. This poses high risks to the local currency.
- The decision has created a state of confusion in the market for companies and small merchants alike. Traders and distributors are unable to recover their money from the market, given that new and old currency were both in circulation. This will have dire consequences on economic activity, and will result in economic contraction, which in turn will contribute to the cessation of economic activities in the various sectors and cause severe shortages in jobs, private sector activities, and new job opportunities. Some factories have already stopped some production lines due to faltering sales processes arising from the scarcity of the cash in circulation in the northern regions.
- Citizens are refraining from purchasing goods as they are incapable of using their new currency holdings, and the traders are facing difficulty in obtaining sufficient old currency funds to exchange for hard currencies. This will cause traders to refrain from importation in anticipation of any negative developments that may arise as a result of such decisions. This will lead to further economic decline in the country, job losses, and a further decline in per capita income in Yemen.
- The decision will lead to a decline in expatriate remittances due to the high transfer fees and scarce liquidity, thus encouraging alternate transfer channels such as informal (black market) financial transfer networks and personal remittances through individuals.
- Citizens having new currency savings in cash were subjected to direct losses, as they suddenly found themselves in possession of banned currency. Therefore, they were forced to exchange their reserves for less than their real value.

### **3. Political Implications**

- The decision will widen the scope of political division between the various factions in Yemen. It undermines the positive steps initiated by the two parties by allocating an account for tax and customs revenue at the CBY branch in Hodeidah dedicated to the payment of civil servants' salaries under the supervision of the United Nations.
- The decision furthers the fragmentation and division already ravaging the country, paving the way for dealing with two different currencies. This creates fertile ground for a clear division among the components of the Yemeni people.

- The decision creates additional impediments to rapprochement between the conflicting parties in Yemen and impedes any steps towards peace in the country and increases the cost of peace.

## • Conclusion

In conclusion, the decision has humanitarian, economic, social, and political consequences. Therefore, the economic sector must be kept away from the conflict by all parties as the Yemeni citizen will be the primary victim of an economic war.

Addressing these decisions comes within the framework of a comprehensive political resolution of the conflict that Yemenis are supposed to seek as soon as possible. Continuation of the conflict leads only to further deterioration at all levels and there will be no winning party apart from warmongers.

It is important to underscore the fact that an urgent solution is vital to avoid more dire consequences and losses at the humanitarian, economic, social and political levels, and the consequent emergence of more tragic phases of starvation and the spread of deadly epidemics and disasters.

Reviewing the catastrophic implications of such decisions leads us to emphasize the crucial need of assuming legal and moral responsibility and avoiding such decisions because they hinder economic activity and further complicate the movement of goods and money transfers across the Yemeni governorates at a time when Yemenis are experiencing the worst conditions of poverty and stagnation.

The need to unify monetary policy decisions, to neutralize the financial and banking sectors from conflict, and to lift all restrictions on the circulation of national currency cannot be overemphasized. These reconciliatory steps shall be taken within the framework of a settlement that guarantees the adoption of professional approaches in managing the monetary policy and the entire economic file. The interests of the Yemeni citizen shall be the only criterion governing the designing of policies and decision-making processes.

## **Issued by**

### **Economic Reform Team (ERT) January 12, 2020**

The Economic Reform Team (ERT) is a voluntary initiative, comprising elite members of the private sector and economic experts. It aims to enable the private sector to contribute positive inputs to a unified and effective decision-making process, and to participate in the development of visions, strategies and policies to promote economic reforms and motivate economic growth in Yemen, through mobilizing individual capacities in the various sectors in all parts of the country.

Since its establishment, ERT has played an important role in rectifying economic policies in Yemen by presenting many visions and proposals to Yemeni decision-makers aimed at promoting economic reforms.