YEMEN ECONOMIC MONITOR

Navigating Increased Hardship and Growing Fragmentation

Spring 2024

PROSPERITY
Middle East and North Africa
THE WORLD BANK

Yemen Economic Monitor

Navigating Increased Hardship and Growing Fragmentation

Spring 2024

Global Practice for Macroeconomics, Trade & Investment

Middle East and North Africa Region

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ACRONYMS

ACAPS	Assessment Capacity Project
CBY	Central Bank of Yemen
CEM	Country Economic Memorandum
FTO	Foreign Terrorist Organizations
FX	Foreign Exchange
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
HCI	Human Capital Index
IPC	Integrated Food Security Phase Classification
IRG	Internationally Recognized Government
JMMI	Joint Market Monitoring Initiative
KSA	Kingdom of Saudi Arabia
KYC	Know Your Customer
LPG	Liquefied Petroleum Gas
MICS	Multiple Indicator Cluster Survey
MOF	Ministry of Finance
MPO	Macro Poverty Outlook
ODA	Official Development Assistance
SDGT	Specially Designated Global Terrorists
SDR	Special Drawing Right
SOE	State-Owned Enterprise
UN	United Nations
WFP	World Food Programme
YBA	Yemeni Banking Association
YER	Yemeni Rial

PREFACE

The *Yemen Economic Monitor* provides an update on key economic developments and policies over the past six months.* It also presents findings from recent World Bank work on Yemen. The *Monitor* places these developments, policies, and findings in a longer-term and global context and assesses their implications for Yemen's outlook. Its coverage ranges from the macro economy to financial markets to human welfare and development indicators. It is intended for a wide audience, including policy makers, development partners, business leaders, financial market participants, and the community of analysts and professionals engaged in Yemen.

The *Yemen Economic Monitor* is a product of the World Bank's Yemen Macroeconomics, Trade, and Investment (MTI) team. This issue was prepared by Yasmine Osman (Country Economist) and Mohammad Al Akkaoui (Economist), supported by a group of experts from different global practices of the World Bank. The team included Omar Al-Aqel (Private Sector Specialist) and Alia Jane Aghajanian (Senior Economist). The *Yemen Economic Monitor* has been completed under the guidance of Eric Le Borgne (Practice Manager), Željko Bogetić (Lead Economist), and Dina Abu-Ghaida (Country Manager). Ebrahim Mohammed Yahya Al-Harazi (External Affairs Officer) is the lead on communications, outreach, and publishing.

The findings, interpretations, and conclusions expressed in this *Monitor* are those of World Bank staff and do not necessarily reflect the views of the Executive Board of The World Bank or the governments they represent.

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* The analysis presented in this edition reflects the situation as of the end of May 2024. Events occurring after this cutoff date are not included.

EXECUTIVE SUMMARY

Amid the continued blockade of Yemen's oil exports by the Houthis and escalating conflict in the Middle East including the Red Sea, Yemen navigates between glimmers of hope and a grim reality. The economic rebound in 2022 was short-lived, with 2023 witnessing a sharp 24 percent decline in nominal US$ GDP per capita (WB estimate). The outlook remains uncertain, with stalled peace negotiations and regional conflict further threatening hopes for recovery. The risk of increased economic fragmentation between Houthi-controlled and IRG-controlled areas is escalating due to recent currency and banking developments. While Yemen faces massive humanitarian and financing needs, hopes for a better future for the Yemeni people hinge on the resolution of the internal conflict and confrontations in the Red Sea, support from development partners, and the commitment of all parties to reconstruction.

Yemen's conflict, exacerbated by regional tensions and compounded by a Houthi imposed blockade, has resulted in a significant economic and humanitarian downturn (Chapter 1). Between 2015 and 2023, the country experienced a staggering 54 percent contraction in real GDP per capita. This has left a vast majority of Yemenis living in extreme poverty, grappling with food insecurity, and facing dire challenges in accessing basic education and healthcare. The economic situation worsened following the expiration of the UN-brokered truce in October 2022, which briefly provided a glimmer of hope but failed to yield a permanent political settlement. The subsequent Houthi-imposed blockade on the Internationally Recognized Government's (IRG) oil exports significantly hampered national growth in 2023, exacerbating fiscal and monetary challenges especially for the IRG. Structural issues such as reliance on external aid, remittances, and vulnerability to climate change further compound Yemen's economic woes, while deepening poverty pushes households to extreme coping measures such as child labor. The confrontations in the Red Sea since October 2023 and resulting slowdown in peace talks, have pushed the Yemeni economy further in a downspin. They have also had significant impacts on regional shipping and trade.

Yemen's future economic trajectory is highly uncertain, in part due to the escalating regional tensions and persistent conflict (Chapter 2). The resumption of oil exports, unrestricted internal transport, trade, and finance, and broader economic recovery seem remote in the current climate. Additionally, the United States sanctions on the Houthis introduce further layer of complexity, prompting follow-up reactions from the Central Bank of Yemen in Aden (CBY-Aden). These developments have the potential to disrupt critical sectors such as banking and aid. The risks of bifurcation between Houthi-controlled and IRG-controlled areas are also escalating, with political tensions driving greater economic and financial fragmentation, which in turn could deepen the social and humanitarian divide. Nevertheless, amidst these formidable challenges, the possibility of peace stands as a beacon of hope. World Bank analysis shows that sustained peace agreement holds the promise of rapid economic rebound and benefits for the Yemeni people, facilitated by external support, reconstruction, and post-conflict reforms. However, the realization of this potential hinges crucially on achieving a lasting truce and peace agreement.

1

RECENT ECONOMIC DEVELOPMENTS

The Economic and Social Context

Yemen's humanitarian crisis is deeply rooted in its conflict and the resulting economic contraction and fragmentation. Between 2015 and 2023, the country experienced a staggering 54 percent contraction in real GDP per capita (Figure 1.1), resulting in most Yemenis living in poverty and half of the population (17.4 million) facing food insecurity, as evidenced by the 2022 Integrated Food Security Phase Classification (IPC).[1] According to UNICEF, approximately 2.7 million children are projected to be acutely malnourished, including nearly 600,000 suffering from severe acute malnutrition, with malnutrition rates among women and children among the highest in the world.[2] In addition, data from the World Bank's Human Capital Project (2021) indicates that the mortality rate of youths aged 15-24 is 21.5 per 1,000, up from 12.5 in 2014 and considerably higher than the regional average (Figure 1.2).[3&4] Furthermore, a child who starts school at age four can expect to complete 8.1 years of school by their 18th birthday or 4.2 learning-adjusted years, the 9th lowest level in the world.[5] Depletion of the already low human capital of the country will be a long and scarring legacy of the conflict, as evidenced by the decline in Yemen's score on the Human Development Index (Figure 1.3). As of 2022, it ranked 186 out of 191 countries.[6] With the health system on the verge

1 Before the crisis, poverty already affected almost half of Yemen's population (49 percent in 2014). Today, it is expected to have reached significantly higher levels, with women being particularly vulnerable (World Bank, 2017).

2 https://www.unicef.org/yemen/stories/community-health-nutrition-volunteers-backbone-yemens-health-services.

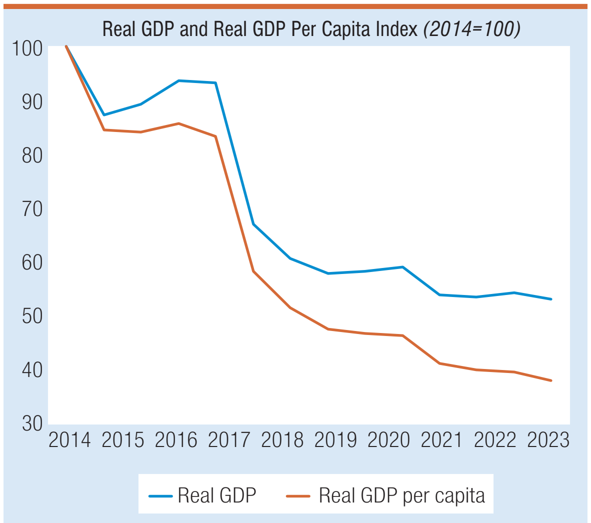
3 Republic of Yemen Human Capital Country Brief (worldbank.org).

4 Similarly, life expectancy at birth has declined since the onset of the conflict, standing at 63.7 years on average in 2021 compared to 67.4 years in 2014 (World Bank, 2022). Simultaneously, the Human Capital Index (HCI) underscores that a child born in 2020 is projected to be only 37 percent as productive in adulthood as they would have been with access to comprehensive healthcare and a complete education (World Bank, 2021).

5 Learning-Adjusted Years of School | World Bank Gender Data Portal.

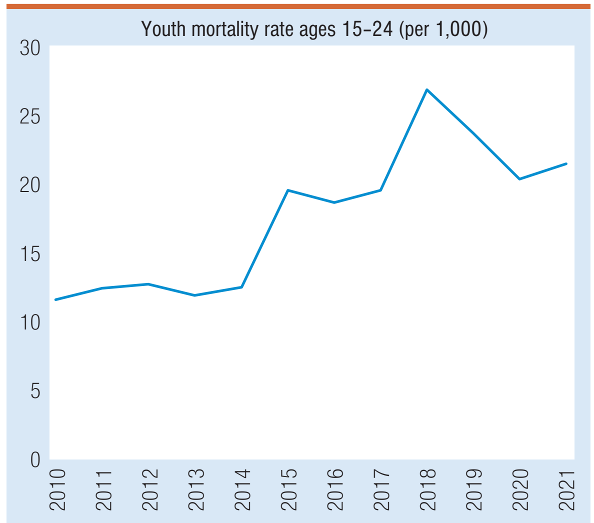
6 Specific country data | Human Development Reports (undp.org).

FIGURE 1.1 • The Conflict Led to a Sharp Decline in Economic Activity



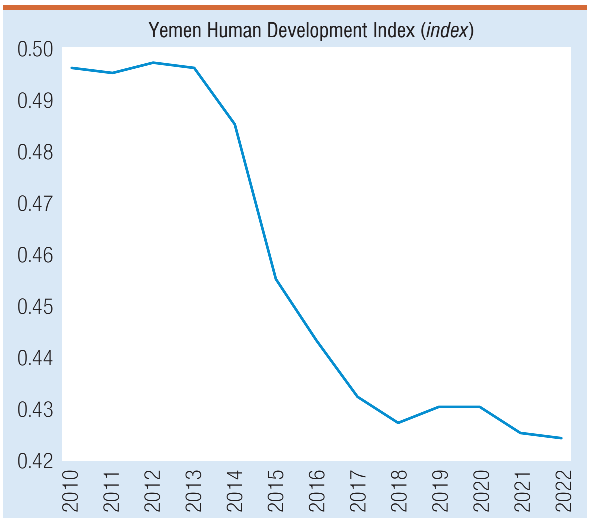
Source: WB and IMF Staff Calculations.

FIGURE 1.2 • Youth Mortality Increased Dramatically



Source: World Bank Human Capital Project.

FIGURE 1.3 • Resulting in a Sharp Decline in Human Capital



Source: United Nations Development Program.

of collapse and the education system in severe crisis according to the UNICEF, the prospects for human capital remain dire.[7]

The conflict has intensified the country's fragmentation into two distinct economic zones, each governed by its unique set of institutions. These include competing monetary authorities with their respective exchange rate and policies, resulting in increasing disparities.[8] Houthi-controlled areas are home to some 70 percent of the population and account for around half of the GDP, while IRG-controlled areas hold the country's oil and gas resources.[9]

The economy has further deteriorated since the expiration of the UN-brokered truce in late 2022. During 2022, the economy showed signs of improvement, supported by a UN-brokered truce in April 2022 that brought a glimmer of hope, albeit without the parties reaching a permanent political settlement. The truce temporarily halted offensive hostilities, reducing conflict-related fatalities (Figure 1.4). The truce expired in October 2022, and although an informal truce remained in place, the situation wors-

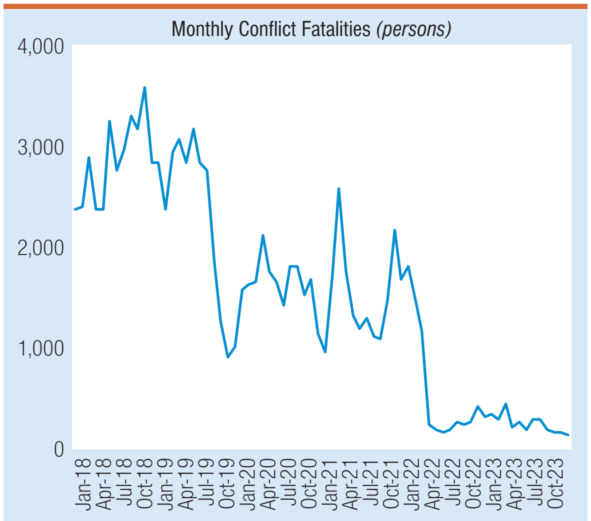
7 https://www.unicef.org/yemen/education.

8 The currency has different values depending on the banknote's date of printing: Yemen Economic Bulletin: Widening Exchange Rate Disparity Between New and Old Banknotes – Sana'a Center For Strategic Studies (sanaacenter.org).

9 Yemen: Population Estimates – Humanitarian Data Exchange (humdata.org).

10 The Houthis imposed an embargo on IRG oil exports through three drone attacks on Yemeni oil exports in the months following the expiration of the UN-sponsored truce. The Houthis demand that the Yemeni government pay the salaries of civil servants in Houthi-controlled areas: https://www.mei.edu/publications/houthis-embargo-yemens-oil-exports.

FIGURE 1.4 • Conflict Fatalities Remained Low during 2023, Reflecting the Informal Truce



Source: Armed Conflict Location and Event Data Project.

ened due to a Houthi-imposed blockade on IRG's oil exports.[10] This ongoing blockade dramatically impacted national growth in 2023 and exacerbated IRG's fiscal and monetary challenges. Since October 2023, the escalation of the conflict in the Middle East and its propagation to the Red Sea, further compromises the already precarious economic and social conditions of the Yemeni people.

Furthermore, Yemen continues to face deep structural challenges. Growth in the oil sector depends on Yemen's ability to attract foreign investment, especially given its aging oil fields, which remains contingent on improving security and achieving peace. Non-oil activity continues to be constrained by, in addition to the conflict itself, interruptions in essential service delivery, acute input shortages, double taxation, widespread corruption, market distortions from uncoordinated policies, and the multiplicity of Yemen's institutions.[11] Moreover, reliance on remittances, aid flows, and climate change vulnerability expose Yemen to external factors.

Living conditions are dire for most Yemeni people due to inadequate food security, limited dietary diversity, and access to health and education, as well as basic services.[12] The 2024 World Bank Yemen Poverty Assessment reports that Yemenis are often exposed to multiple shocks and forms of deprivations at the same time. The report further reveals that a quarter of the population are food insecure while also exposed to climate-related hazards including extreme temperatures, drought, or flooding. Similarly, a phone survey conducted in late 2023 shows that the burden of non-communicable diseases, such as hypertension and diabetes, is more prevalent among the food insecure (World Bank, forthcoming). Alarmingly, many of those afflicted with these diseases are not being treated or able to access medications, particularly the food insecure, largely because of the high costs.

Recent Economic Developments

Real Sector

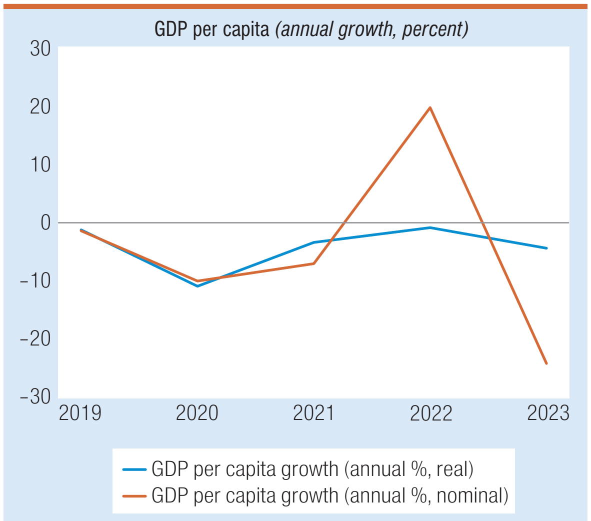
The Houthi blockade on IRG's oil exports and heightened tensions significantly impacted Yemen's economy in 2023. Overall, national GDP is estimated to have contracted by 2.0 percent in real terms in 2023, following a rebound of 1.5 percent in 2022. Concurrently, there was a notable decline of 4.1 percent in real GDP per capita. However, the nominal GDP per capita decline was even more pronounced, at 23.7 percent (Figure 1.5). This downturn was primarily attributed to the oil sector, which faced a substantial contraction (67 percent in real terms) due to the Houthi blockade on IRG's oil exports. This blockade more than halved crude oil production, dropping from an estimated 37.8 thousand barrels daily in 2022 to 17.0 thousand in 2023 (Figure 1.6). LPG production also saw a modest decline, attributed to the Houthi ban initiated in May 2023 on the utilization of LPG sourced from Marib.[13] Additionally, heightened uncertainties and

11 In 2023, Yemen was ranked 176th out of 180 countries on the Corruption Perceptions Index with a score of 16 out of 100, according to Transparency International.

12 Yemen Poverty and Equity Assessment: Living in Dire Conditions (Worldbank.org).

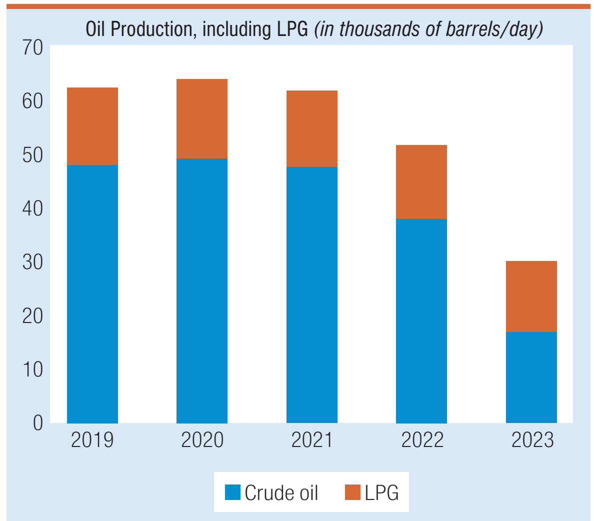
13 See ACAPS report "Yemen: an analysis of the major shift in liquefied petroleum gas (LPG) dynamics since April 2023", Dec. 2023.

FIGURE 1.5 • GDP Per Capita Trends Show Economic Instability



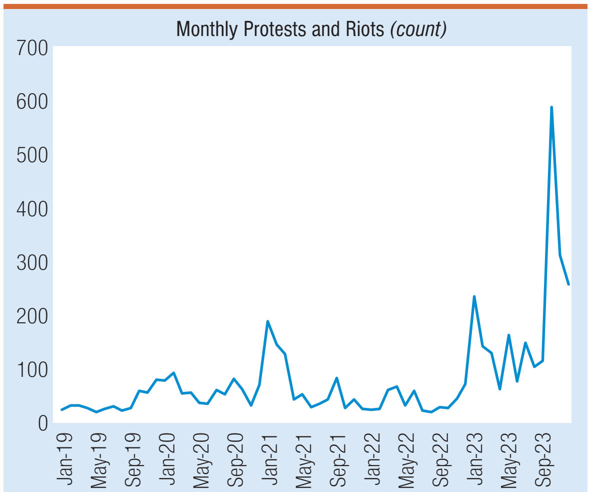
Source: Yemeni authorities; WB and IMF staff estimations.

FIGURE 1.6 • As Oil and LPG Production Declined during 2023



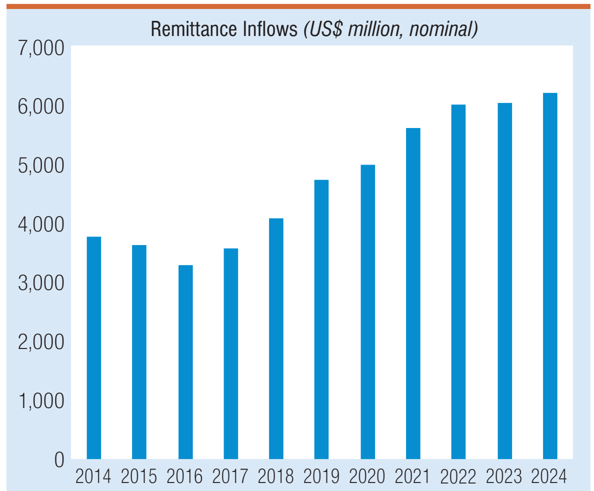
Source: Yemeni authorities; WB and IMF staff calculations.

FIGURE 1.7 • Meanwhile, Rising Protests and Riots Signal Escalating Social Unrest



Source: Armed Conflict Location & Event Data Project (ACLED).

FIGURE 1.8 • Steady Remittance Inflows Provided Economic Support during 2023



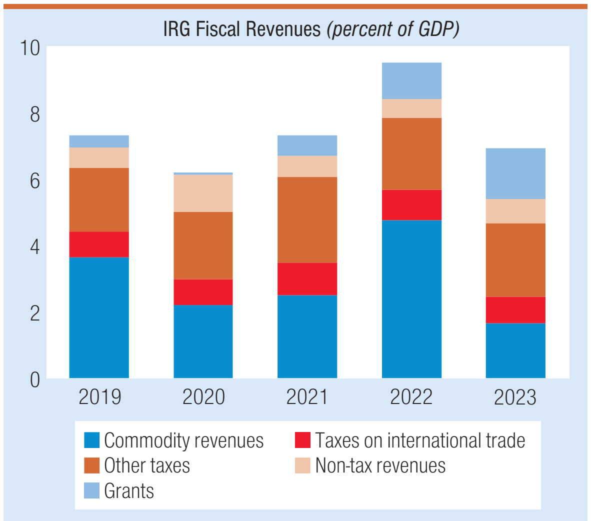
Source: Yemeni authorities, WB and IMF estimates.

renewed protests and riots further stifled activity in the non-oil sector, which contracted by 0.9 percent in real terms (Figure 1.7). The economy also suffered further setbacks due to Cyclone Taj in October 2023, affecting agriculture, fisheries, and infrastructure.[14]

Amid the tensions of 2023, remittances and official development assistance (ODA) played a pivotal role in preventing a deeper economic contraction. ODA inflows, which had declined by 13.4 percent in 2022 to US$2.7 billion, rebounded in 2023 with a 9.9 percent increase to US$3.0 billion, due to an uptick in direct Saudi budget support to the IRG, bolstering Yemen's balance of incomes and transfers. Despite the economic growth slowdown in

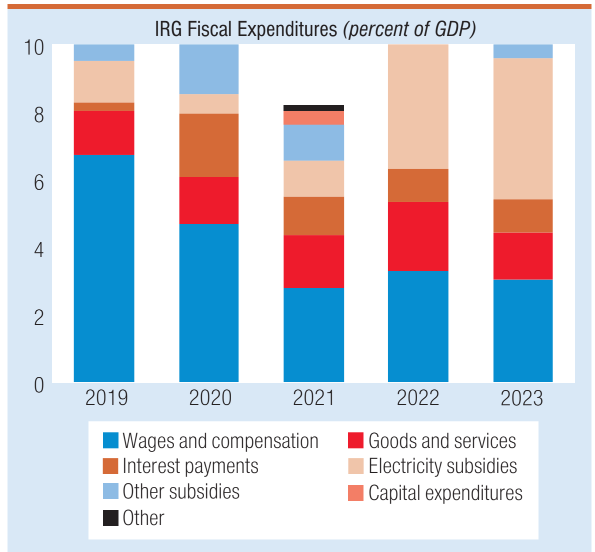
[14] On October 23, 2023, Cyclone Taj made landfall in Yemen, exacerbating the country's challenges. Approximately 75,000 individuals across 10,500 households were affected, with reported impacts on infrastructure, residential areas, and public buildings. The cyclone particularly disrupted economic activities in the essential agricultural and fisheries sectors, leading to reduced revenue generation in the affected regions.

FIGURE 1.9 • IRG Fiscal Revenues Declined by over 30 Percent



Source: MOF; WB and IMF staff calculations.

FIGURE 1.10 • In Response, IRG Cut Expenditures



Source: MOF; WB and IMF staff calculations.

Gulf Cooperation Council (GCC) countries, remittance inflows held steady at approximately US$6 billion, mirroring the figures from the previous year. This stability in remittances supported household consumption and sustained overall economic activity throughout the year (Figure 1.8).

Fiscal Developments[15]

The fiscal situation of the IRG deteriorated in 2023. According to the Ministry of Finance in Aden and World Bank staff calculations, IRG's fiscal revenues, including grants, declined by over 30 percent in 2023 (to 6.9 percent of GDP in 2023) (Figure 1.9). This decline is primarily attributed to a substantial drop in oil revenues due to the ongoing blockade, which decreased to 1.6 percent of GDP in 2023 from 4.8 percent in 2022. Additionally, customs revenues have diminished from 0.9 percent of GDP to 0.8 percent of GDP following the shift in import activity away from the port of Aden towards Red Sea ports, under Houthi control, despite an increase in the exchange rate used to calculate customs duties on imported goods.[16] On the upside, grants increased from 1.1 to 1.5 percent of GDP, driven by Saudi support through the disbursement of the first US$267 million tranche from its $1.2 billion budget support, announced in August 2023.[17] Tax revenues (excluding customs) remained low at 2.2 percent of GDP as several factors continued to impede their growth, including applying a below-market exchange rate for customs, low tax collection rates, and a small tax base in IRG-controlled areas.

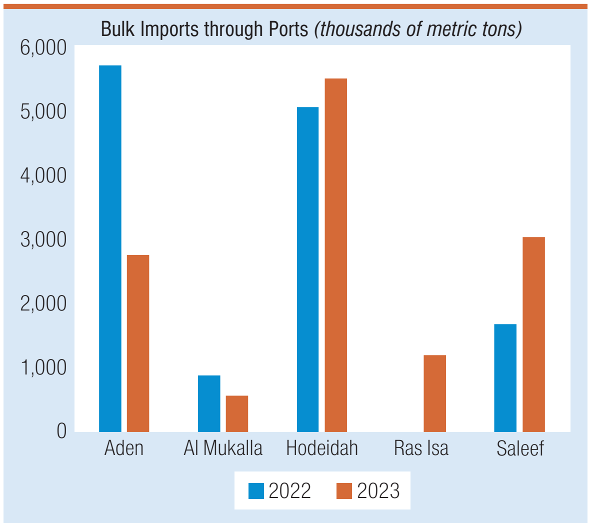
In response, the IRG has implemented severe cuts in fiscal expenditures. Fiscal expenditures were recorded at 10.9 percent of GDP in 2023, down from 12.2 percent in 2022 (Figure 1.10). This decrease was distributed across all IRG's expenditure categories but mostly concentrated in goods and services. Nonetheless, electricity subsidies rose to 4.2 percent of GDP during 2023 from 3.7 percent in 2022. This high level of electricity subsidies can be attributed to the electricity sector's below-cost recovery tariffs and limited collection rates. Capital expenditures declined to approximately zero percent of GDP during 2023 from 0.2 percent in 2022, raising concerns about the stock of physical capital of the coun-

15 The following figures only reflect the fiscal position of IRG and do not encompass areas controlled by Houthis, which is understood to operate a balanced cash-based budget system.

16 At start-2023, the IRG raised the USD exchange rate used to calculate customs duties on imported goods from YER 500 to YER 750 per US$1. Nonetheless, the rate remained below the YER's Aden market exchange rate.

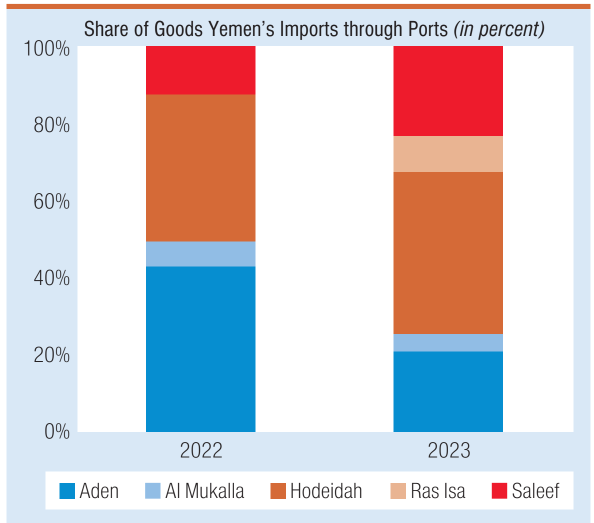
17 The Yemen Annual Review 2023 – Sana'a Center For Strategic Studies (sanaacenter.org).

FIGURE 1.11 • Imports Were Diverted Away from IRG Ports



Source: ACAPS – YETI.
Note: IRG controlled ports: Aden and Al Mukalla; Houthi controlled ports: Hodeidah, Ras Isa and Saleef.

FIGURE 1.12 • And Increasingly Shifted towards Houthi Ports



Source: ACAPS – YETI.
Note: IRG controlled ports: Aden and Al Mukalla; Houthi controlled ports: Hodeidah, Ras Isa and Saleef.

try—either depreciating fast due to a lack of adequate maintenance or of being damaged by the conflict.

IRG's public finances went under considerable stress. Overall, IRG's fiscal deficit expanded to approximately 3.9 percent of GDP in 2023 (on a cash basis) from 2.7 percent in 2022. The budget deficit was covered primarily by increased domestic financing through CBY-Aden. However, it is essential to highlight that this figure does not include arears to public contractors. On an accrual basis, the fiscal deficit is expected to be significantly wider. On the other hand, in contrast to the rest of the country, Houthi-controlled areas, which include some of Yemen's major commercial and financial centers, are understood to operate under a balanced, and cash-based, public budget system. Yet, no information is available on public finances in the Houthi-controlled areas.

External Sector Developments[18]

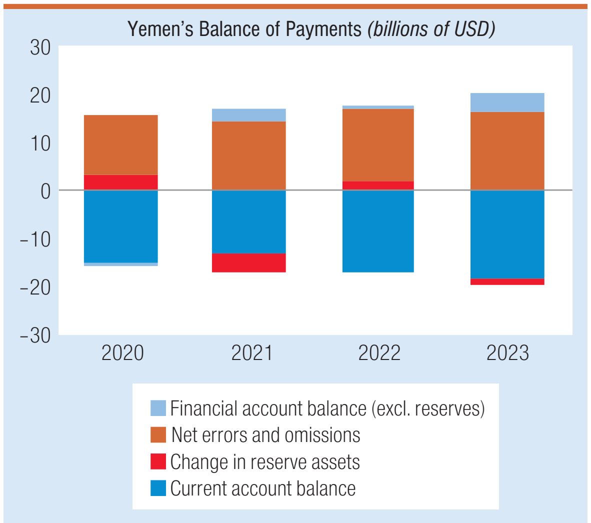
The halt in IRG's oil exports intensified pressures on the country's already large current account deficit. This deficit widened from 17.8 percent of GDP in 2022 to 19.3 percent of GDP in 2023, primarily driven by the escalating trade deficit, which surged to approximately 68.6 percent of GDP from 54.3 percent of GDP in 2022. The blockade on IRG's oil exports by the Houthis resulted in a 44 percent drop in exports, plummeting from 9.5 percent of GDP to 6.8 percent. The decrease in imports, due to the economic downturn, was less pronounced (–8 percent). A notable development was the diversion of imports from IRG-controlled ports to those under Houthi control in 2023, which were reopened as part of the UN-sponsored truce (Figure 1.11). The proportion of bulk imports (excluding containers) through IRG ports decreased from 49.5 percent in 2022 to 25.4 percent in 2023, while the share coming through Houthi-controlled ports increased from 50.5 to 74.6 percent during the same period (Figure 1.12).[19]

However, the conversion of IMF Special Drawing Rights (SDRs) and financing from part-

18 Note that the following figures reflect external accounts for the whole of Yemen.

19 The Houthis are actively promoting and incentivizing imports via the Red Sea ports under their control by offering benefits such as covering demurrage costs and providing advantageous customs rates. The Houthis are also simultaneously implementing measures to discourage imports via IRG-controlled seaports and land border crossings by imposing added taxes and customs fees on goods entering Houthi areas via these routes. See ACAPS report "Yemen: Increased DFA intervention in the private sector in DFA-controlled areas", February 2024.

FIGURE 1.13 • Yemen's Current Account Deficit Widened



Source: CBY-Aden and WB staff calculations
Note: Net errors and omissions reflect the imbalances resulting from imperfections in source data and compilation of the balance of payments accounts.

FIGURE 1.14 • Yet, Foreign Reserves Remained Relatively Stable

Source: CBY-Aden and WB staff calculations.

ners provided some foreign exchange support. Financial support from KSA played a pivotal role in this increase. Additionally, CBY-Aden bolstered its liquid foreign exchange reserves by acquiring US$187 million through the sale of 140 million IMF SDRs in June 2023. This inflow of funds resulted in the increase of the financial account balance to 4.1 percent of GDP from 0.9 percent in 2022 (Figure 1.13). Consequently, despite the widening current account deficit, CBY-Aden's foreign exchange reserves grew to approximately US$1.52 billion in 2023, up from US$1.25 billion in the previous year—though they remained below 1.5 months' worth of imports (Figure 1.14).

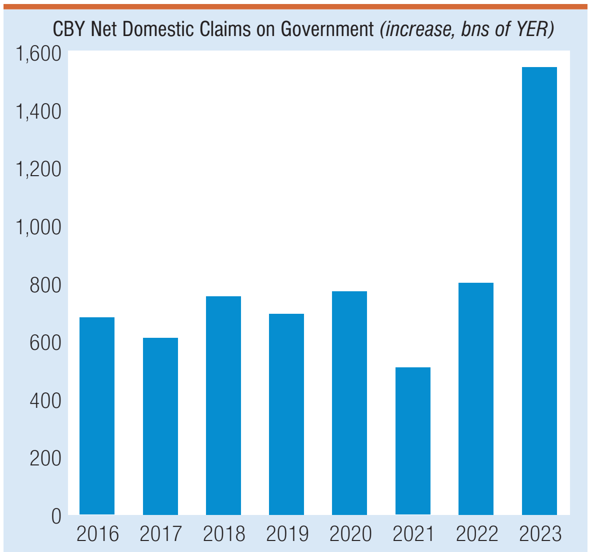
Monetary Policy and Inflation

The resumption of monetary financing by the IRG heightens the risk of inflationary pressures materializing over the next twelve months. With limited avenues for increasing revenues or cutting expenditures, IRG has resumed monetizing its fiscal deficit through withdrawals from its overdraft facility at CBY-Aden, leading to an uptick in the money supply. According to data from CBY-Aden, net domestic claims on the government, which serve as a proxy for the IRG's monetized fiscal deficit, have surged by 24.6 percent in 2023 (Figure 1.15). Consequently, currency in circulation witnessed a 4.8 percent increase during this period, rebounding from a 3.8 percent decrease in 2022 due to earlier tightening measures (Figure 1.16).[20] However, the impact of this upsurge in monetary financing on the money supply has been partially offset by foreign exchange auctions, which helped absorb a portion of the resulting excess liquidity (Figure 1.17). Nevertheless, while monetary financing might offer short-term relief for fiscal constraints, its uncontrolled continuation can escalate the risks of inflation and erode overall economic stability.

In contrast, in Houthi-controlled areas, the ban on newly issued banknotes by CBY-Aden serves as a means of regulating money supply while price caps on food commodities further help to control inflation. Implemented on

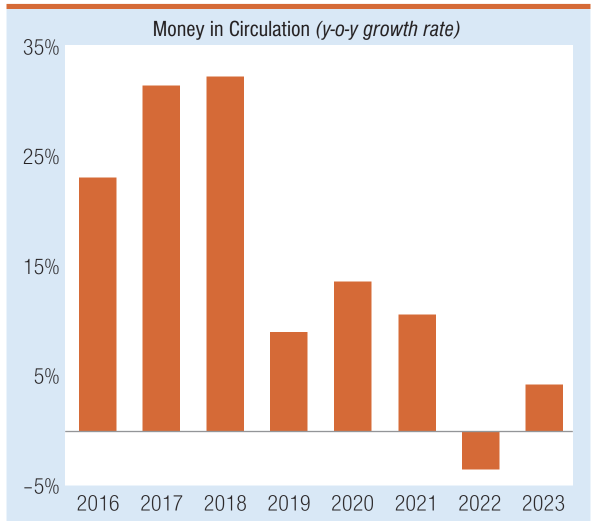
[20] In response to inflation and exchange rate instability in late 2021, IRG officials implemented decisive actions, including introducing a weekly foreign exchange (FX) auction mechanism to improve the efficiency and transparency of CBY FX transactions with the market, as well as the appointment of a new central bank governor. These auctions played a vital role in counteracting inflationary pressures by absorbing liquidity from the market.

FIGURE 1.15 • IRG Resumed Fiscal Monetization



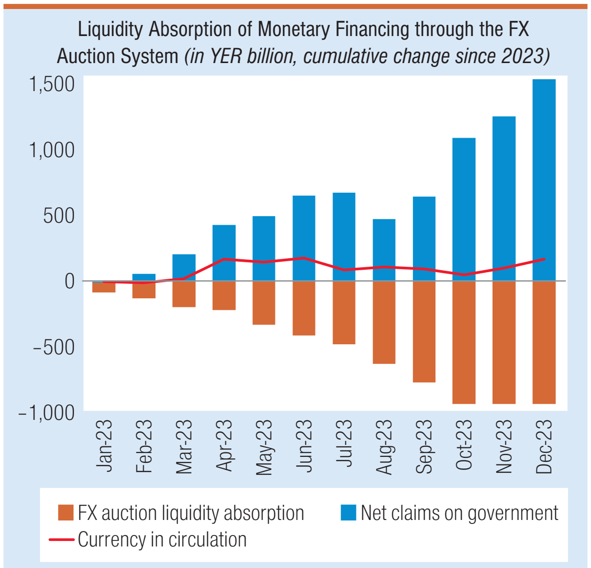
Source: CBY-Aden and WB staff calculations.

FIGURE 1.16 • As a Result, Currency in Circulation Increased



Source: CBY-Aden and WB staff calculations.

FIGURE 1.17 • FX Auctions Partially Absorbed the Liquidity Created



Source: CBY-Aden and WB staff calculations.

December 18, 2019, a directive from the Sana'a based central bank prohibited the use of new Yemeni rial banknotes issued in Aden, allowing only for the circulation of older banknotes.[21] This led to effectively severing monetary policy between the two regions and to the emergence of two distinct exchange rates: the exchange rate of old banknotes steadily appreciated, while that of the new banknotes depreciated due to their deterioration from daily use. Shortages of old rial banknotes in Houthi-controlled areas followed, prompting the Houthis to attempt issuing their own rial banknotes, which culminated in a significant development on March 30, 2024, when the CBY-Sana'a introduced a new 100-YER coin for circulation in their territories (see below). Additionally, in efforts to combat food inflation, the Houthis continue to impose price caps on essential food items to safeguard household affordability. However, this strategy places pressure on vendors and traders, contributing to frequent shortages of imported goods in local markets.[22]

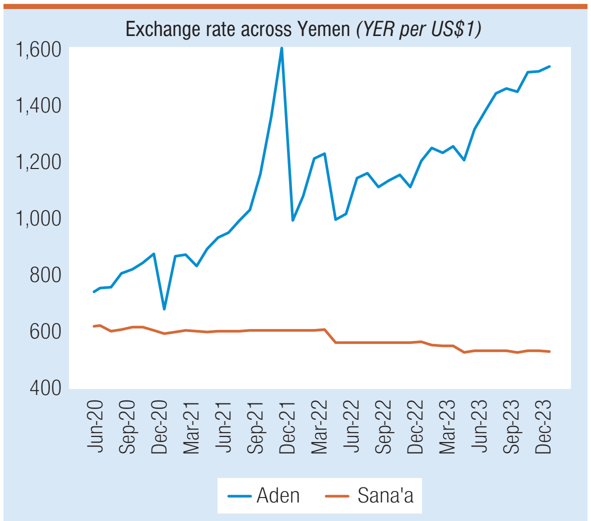
In 2023, inflation saw a notable decrease nationwide, although this trend differed across regions. The average inflation rate transitioned from 29.5 percent in 2022 to a deflationary rate of 1.5 percent in 2023.[23] However, the extent of this decline varied across regions, reflecting diverse factors (as detailed below).

21 The War for Monetary Control Enters a Dangerous New Phase, Sana'a Center for Strategic Studies, January 2020.

22 Yemen Food Supply Chain Update, ACAPS, August 2023

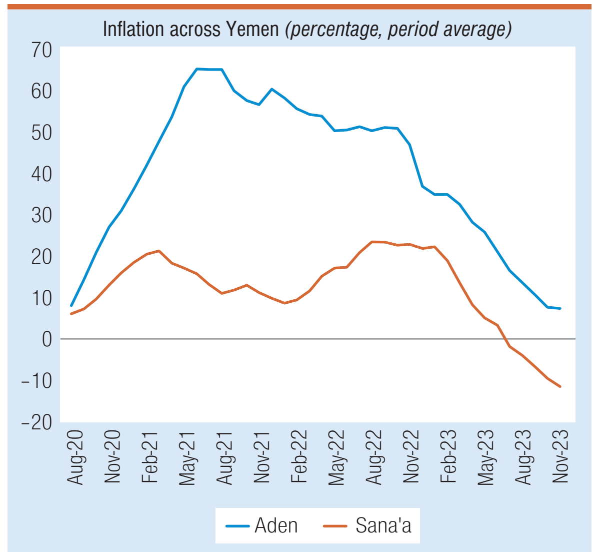
23 The national inflation rate is determined by calculating the simple average inflation rate between Aden and Sana'a.

FIGURE 1.18 • Exchange Rates Continued to Diverge



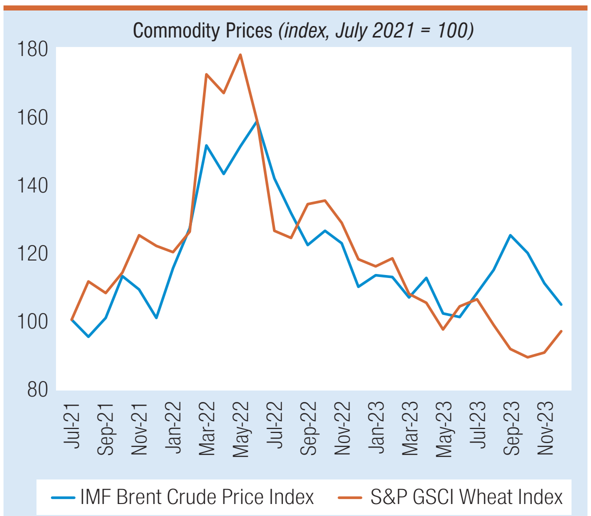
Sources: Telegram Exchange Market Group and WB Staff calculations.

FIGURE 1.19 • Inflation Decreased



Sources: Reach Joint Market Monitoring Initiative and WB Staff calculations.

FIGURE 1.20 • Supported by a Global Commodity Price Decline



Source: S&P, IMF, and WB staff calculations.

In IRG-controlled areas, despite the currency depreciation, with the depressed economy, inflation eased during 2023, also due to a drop in global commodity prices. The easing of monetary conditions—to finance the growing fiscal deficit—coupled with a growing current account deficit due to the halt of oil exports, placed the YER under strain in the Aden market, leading to its depreciation to 1,532 YER per US$1 by the end of 2023, mirroring levels last seen in 2021 (Figure 1.18). Yet, inflation rates in IRG territories decelerated markedly to 7.0 percent from the previous year's 36.4 percent (Figure 1.19), attributed to the contraction in domestic demand and the drop in global commodity prices (Figure 1.20).

In the Sana'a market, the YER marginally appreciated, bolstered by increased revenues. This, along with global food price trends, led to deflation. Houthi-controlled regions recorded a deflation rate of 11.8 percent, a sharp contrast to the 21.6 percent inflation rate observed in the preceding year. The diversion of international trade away from IRG ports towards Houthi-controlled ones should be a significant factor driving the appreciation. This shift not only introduced foreign currencies but also spurred additional economic activity, consequently increasing fiscal revenue. Moreover, with more goods flowing into their areas at reduced costs, there was a deflationary effect, as products destined for Houthi territories no longer incurred the substantial transaction costs associated with crossing between different areas of control.

Although data for a comprehensive analysis of the economy in Houthi-controlled areas remains limited, certain trends suggest that the situation might be worse than it appears. While increasing revenues from the diversion of trade to

Houthi-controlled ports might fuel some activity, other indicators point to potential economic distress. These include deflation, a shrinking money supply, financial sector repression, price controls, and shortages, which suggest an increasingly barter-based economy. Deflation, in particular, can trigger significant adjustments in consumption and investment behaviors with adverse impacts on the economy. Households, anticipating further price declines, may postpone spending on non-essential goods and services, leading to decreased overall consumption. Simultaneously, businesses may reduce investment due to lower expected returns and uncertainty about future price levels, as falling prices diminish profit margins and make new investments less attractive.

Financial Sector

In Yemen, confidence in the conventional financial sector continues to be limited. Prior to the conflict, the provision of credit by banks was primarily focused on government debt instruments denominated in the local currency. These instruments have been in a state of technical default since the beginning of the war. The ongoing economic crisis and the increase in non-performing loans among banks established before the war have further eroded confidence in the banking sector. In contrast, non-bank financial service providers, especially money exchangers, have experienced a rise in trust, regardless of their location. This shift is evident in the decrease of local currency deposits in commercial banks, which dropped from 15.1 percent of GDP in 2014 to 8.6 percent by the end of 2022. Nevertheless, there was a slight recovery to 9.4 percent of GDP in 2023, following the introduction of new banks in Aden.

Money exchangers, with their strong liquidity position, more than offset the banking sector's negative net foreign assets. Money shops typically maintain net foreign assets that outstrip their foreign liabilities, as they are the main beneficiaries of remittances and also because they actively hedge against fluctuations in the local currency. The World Bank analyzed the financial statements of ten of the largest money exchangers in Aden, which showed that the liquidity-focused business model of money exchangers grants them a significant advantage over banks in Yemen's predominantly cash-based economy. As a result, money exchangers have become pivotal in providing the economy with access to foreign-currency liquidity. Despite this, they have not replaced the banking sector as facilitators of trade payments for key commodities like wheat and rice because they do not have access to correspondent banking or SWIFT, which is a requirement to buy from the international market.

In March 2023, the Houthi authorities enacted, effective immediately, a law prohibiting interest-based banking transactions, facing resistance and proposed amendments from their legal committee. Since then, banks have moved most saving deposits to current accounts and have stopped paying interest. However, depositors are unable to withdraw their money due to liquidity constraints. There are unanswered questions regarding whether Islamic products like Murabaha will still be permitted. Given the diversity in asset portfolios and capital structures, the law's impact is expected to vary across different banks. For example, government securities represent the largest share of assets among commercial banks versus Islamic banks, and public banks versus private banks. Thus, public commercial banks' balance sheets are the most vulnerable to changes in the value of outstanding domestic debt.

The CBY in Aden has implemented a series of reforms aimed at fostering digital transformation and enhancing financial inclusivity. Key initiatives include joining the Buna platform for Arab payments and launching the National Switch system, which are instrumental in facilitating financial transfers. CBY Aden has also permitted non-bank service providers to offer e-rial services and introduced new payment instruments such as prepaid cards. The issuance of digital banking Know Your Customer (KYC) instructions highlights CBY Aden's dedication to regulatory compliance and the security of financial operations. These reforms are designed to support the digitization of government salary payments, which the Ministry of Finance began in August 2023. However, there are constraints to fully benefiting from digitization due to the existing payment infrastructure.

TABLE 1.1 • Selected Economic Indicators (2019-2023)

	2019	2020	2021	2022	2023
Real Sector			*(Annual percentage change)*		
Real GDP	2.1	−8.5	−1.0	1.5	−2.0
Real GDP per Capita	−1.0	−10.6	−3.1	−0.7	−4.1
Money and Prices			*(Annual percentage change, unless stated otherwise)*		
Consumer Prices (period average)[a]	15.7	21.7	31.5	29.5	−1.5
Aden	22.6	30.5	59.8	36.4	7.0
Sana'a	11.4	15.6	9.4	21.6	−11.8
Base Money[b]	3,485	3,948	4,491	4,689	4,944
Exchange rate (YER per US$1, average)[c]					
Aden	576	743	1,028	1,114	1,355
Sana'a	567	603	599	572	535
Exchange rate (YER per US$1, eop)[c]					
Aden	612	669	952	1,205	1,518
Sana'a	581	591	600	560	528
Central Government Finances (IRG)			*(In percent of GDP)*		
Total Revenues and grants	7.3	6.2	7.3	9.5	6.9
Commodity Revenues	3.6	2.2	2.5	4.8	1.6
Total Expenditures	13.2	10.6	8.2	12.2	10.9
Current Expenditures	12.5	10.3	7.8	12.0	10.8
Capital Expenditures	0.7	0.3	0.4	0.2	0.0
Overall Fiscal Balance	−5.9	−4.5	−0.9	−2.7	−3.9
Financing	5.9	4.5	0.9	2.7	3.9
External (net)	−0.1	−0.3	−0.2	−0.4	−0.4
Domestic	6.0	4.8	1.1	3.1	4.3
General Government Debt	103.5	104.8	93.6	77.9	100.5
External[d]	41.1	44.4	46.0	38.6	54.5
Domestic	62.3	60.4	47.6	39.3	46.0
External sector			*(In percent of GDP)*		
Current Account	−4.2	−15.6	−14.2	−17.8	−19.3
Imports, Goods & Services	54.2	61.7	72.4	63.8	75.4
Exports, Goods & Services	8.7	9.5	13.1	9.5	6.8
Hydrocarbon Exports	4.0	3.2	5.1	4.2	0.0
Remittance Inflows	21.6	24.6	28.9	25.5	32.8
Capital & Financial Account (excl. res.)	0.1	0.3	−3.2	−0.9	−4.1
Net Errors and Omissions	1.0	12.6	14.3	15.1	16.7
Other memo items					
GDP nominal in US$ (millions)	21,888	20,220	19,256	23,54	18,374
Gross Reserves in US$ (millions)	1,654	970	1,688	1,251	1,519

Source: ACAPS, Central Bank of Yemen, IMF staff estimates, IRG Ministry of Finance, REACH, UN, and World Bank staff estimates.
Note: Excluding the central government's fiscal accounts and gross reserves, this table encompasses data for whole of Yemen.
[a] The national inflation rate is determined by calculating the average inflation rate between Aden and Sana'a. Inflation rates are used using a modified version of REACH's Minimum Expenditure Basket (MEB). The MEB includes essential commodities and services vital for survival, such as food, shelter, healthcare, and support from various humanitarian organizations.
[b] The monetary base includes the total supply of the Yemeni Rial (YER), encompassing both old and new banknotes in circulation across the country. It represents the sum of currency outside the Central Bank of Yemen, including the holdings of the public, commercial banks' reserves, and any other financial institutions.
[c] Data on market exchange rates are derived from ACAPS's Yemen Economic Tracking Initiative (YETI), which sources its information from Telegram currency exchange groups.
[d] External debt comprises arrears and foreign deposits.

2

OUTLOOK AND RISKS

Outlook

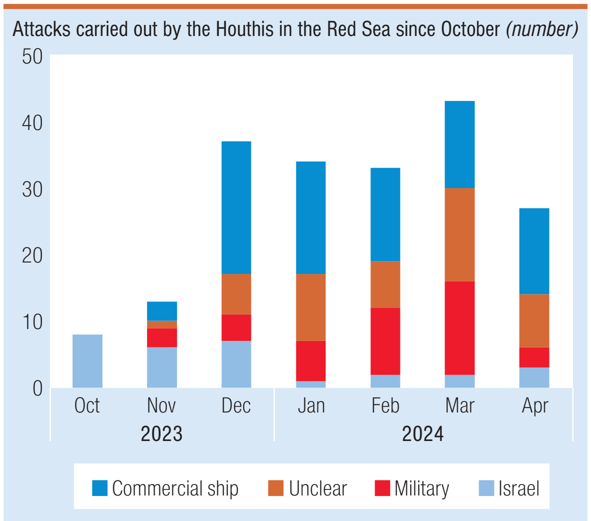
The macroeconomic outlook for the region is clouded by the ongoing conflict (World Bank Middle East and North Africa (MENA) Economic Update).[24] The MENA region is projected to grow at a modest 2.7 percent in 2024 before rebounding to 4.2 percent in 2025, and thereafter to return to the low growth that prevailed in the decade before the global pandemic. The magnitude of the conflict's regional and global impact is still unfolding and will depend on whether the conflict expands and on the resilience of neighboring economies. The conflict in the Middle East is taking place in a global economy that is in its third year of a growth deceleration, following the recovery from the COVID pandemic. The conflict has increased uncertainty regionally, at the same time when existing issues—especially a rising debt burden—have curtailed the ability of many countries in the region to navigate shocks. On average, over the past half century, armed conflict has been associated with slowing growth and rising debt; the same could happen in the Middle East if the current situation were to escalate further.

The prospects for Yemen are also overshadowed by the Middle East conflict, notably with the Houthis' involvement and the escalation of tensions in the Red Sea since October 2023. The Houthis have been launching attacks since October 19, declared in support of the Palestinians, targeting both Israeli-affiliated and Israel-bound ships in the Red Sea. In response, after repeated warnings to the Houthis to cease the attacks, on January 12, 2024, the United States and the United Kingdom began retaliatory military strikes on Yemen, targeting areas and launch sites under Houthi control, also shooting down Houthi-launched missiles and drones.[25] Despite the damage sustained, the Houthis asserted their intent to continue their attacks until Israel ceases its military actions in Gaza. As of the end of March 2024, the ACLED Dashboard for Red Sea Attacks has recorded

[24] World Bank Middle East and North Africa Economic Update – April 2024.

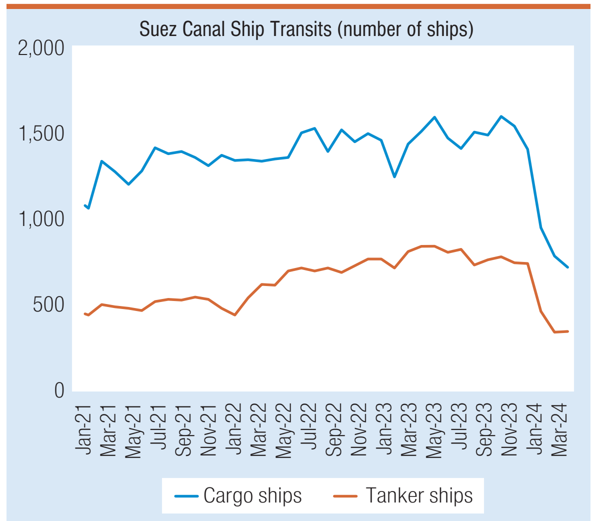
[25] Joint Statement from the Governments of Australia, Bahrain, Canada, Denmark, Germany, Netherlands, New Zealand, Republic of Korea, United Kingdom, and the United States.

FIGURE 2.1 • Houthi Attacks in the Red Sea Escalated Amid Regional Tensions



Sources: ACLED.

FIGURE 2.2 • As a Result Traffic through the Suez Canal Has Collapsed



Sources: IMF Port Watch.

around 170 incidents of political violence and interceptions linked to Houthi actions in the Red Sea, including 67 attacks on commercial ships (Figure 2.1).[26]

These actions have both disrupted shipping in the Red Sea and dampened the MENA growth forecast. The significant disruptions to international shipping in the Red Sea, the corridor for 30 percent of world container shipping, underscore the severity of the situation.[27] As of March 2024, traffic through the strategic Suez Canal and Bab El-Mandeb Strait has halved while the Cape of Good Hope route has seen a twofold increase in navigation (Figure 2.2).[28] The detours necessitated by the crisis have not only inflated the journey distances for cargo and tankers by up to 53 percent, but also the environmental toll, with a surge in CO2 emissions from the additional fuel consumed by ships rerouting around the Horn of Africa (World Bank MENA FCV Economic Series Brief[29]). Financial repercussions are acute: freight rates have risen and the cost of shipping insurance has reached unprecedented heights, delivering a blow to both regional and international shipping economies. This increase in shipping costs would also add pressure on inflation. The Red Sea ports and associated economies are enduring most of this upheaval, with most grappling with diminished volumes and only a select few benefiting from the diverted traffic. As a result, the World Bank forecasts a decline in the overall growth in the MENA region in 2024, downgraded by 0.8 percentage points to 2.7 percent compared to the October 2023 projection.

These developments are also expected to significantly affect economic growth in Yemen. While data remains limited, available indicators suggest tangible risks could materialize. The resumption of IRG's oil exports in 2024 seems unlikely due to the slowdown in peace negotiations amid the conflict. While Yemen's imports and prices have so far shown relative stability, with continued conflict, there are risks of supply shortages and rising import costs due to reduced and more costly imports, increased shipping expenses, including due to rising war premiums and insurance costs; this risk is more prominent in IRG-controlled areas than in Houthi ones, given the latter's control of ports of entry (Figure 2.3).[30]

26 https://acleddata.com/yemen-conflict-observatory/red-sea-attacks-dashboard/#1707908374225-329692ad-51d5.

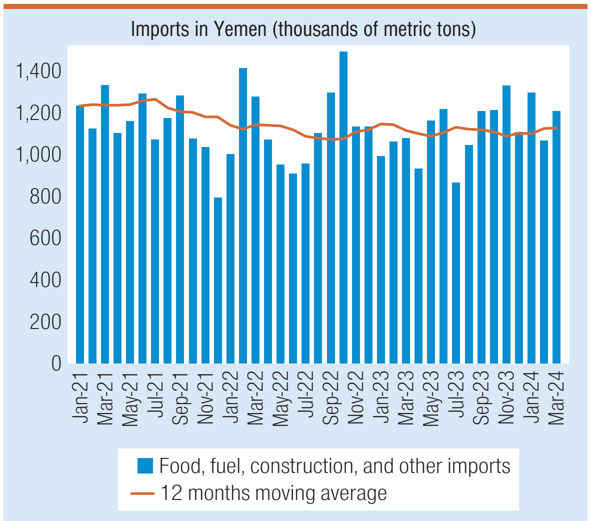
27 Higher Shipping Freight Rates to Offset Costs of Re-Routing from Suez (fitchratings.com).

28 Port Monitor – Suez Canal | PortWatch (imf.org).

29 World Bank MENA FCV Economic Series Brief — April 2024.

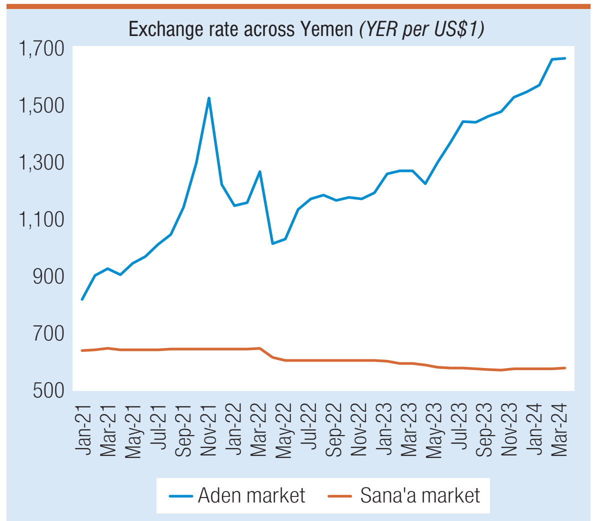
30 On January 16th, 2024, the war risk premium increased to approximately 1 percent of a ship's value, up from 0.5 percent-0.7 percent on 18 December 2023, and just

FIGURE 2.3 • Imports in Yemen have also Been Impacted by the Conflict



Sources: ACAPS YETI & WB staff calculations.

FIGURE 2.4 • Yemeni Rial Depreciates in Aden Amid Economic Pressures



Sources: Telegram Exchange Market Group and WB Staff calculations.

With the depreciation of the YER on the Aden market, these factors are anticipated to exert upward pressure on consumer prices, particularly in IRG-controlled areas lacking comprehensive price controls.[31] As a result, estimated real GDP growth for 2023 has been downgraded from –0.5 percent in the Fall 2023 Yemen Economic Monitor, to –2.0 percent in the current Spring 2024 edition. Furthermore, the growth forecast for 2024 has also been reduced from 2.0 percent to –1.0 percent.[32]

The ongoing tensions will also likely exacerbate high fiscal, monetary and external pressures in IRG-controlled areas. The fiscal deterioration, particularly if coupled with potential decreases in financing from donors, could lead the Central Bank in Aden to resort to additional monetization of the fiscal deficit, exacerbating already high inflation, and resulting in further currency depreciation. Notably, the Yemeni Rial (YER) continued to depreciate throughout 2024 in Aden, reaching YER 1,685 per US$ on February 29th, the lowest since monetary reforms were implemented in 2021; it has recovered slightly since then and has been trading at YER 1,679 per US$1 as of mid-April (Figure 2.4). Meanwhile, the Sana'a YER has shown some resilience by appreciating slightly. CBY-Aden has resumed foreign exchange auctions in early 2024 following the disbursement of the second tranche of the US$250 million budget support which KSA provided to the IRG.

The sanctions imposed on the Houthis by the US administration in February 2024 could have several repercussions. On January 17, 2024, the U.S. administration classified the Houthis as

0.07 percent in early December: https://www.acaps.org/fileadmin/Data_Product/Main_media/20240119_ACAPS_Yemen_analysis_hub_Import_flows_following_the_escalation_in_the_Red_Sea.pdf. The war risk premium remained around 1 percent since: https://www.reuters.com/markets/war-insurers-shrug-off-rubymar-sinking-red-sea-rates-stable-2024-03-04/.

31 The impact in Houthi-controlled areas remains uncertain, primarily due to the presence of price caps on certain commodities like wheat. Reports indicate reinforced enforcement of these price caps in strategic locations such as Hodeidah and Sana'a. While the sustained enforcement may burden traders with heightened operational costs, the extent to which these costs will be absorbed solely by traders or passed on to consumers remains uncertain. If price caps continue to be enforced, the increased costs will hurt producers and traders which will lead to a reduction in food supply and availability. Food security is already a major challenge, and Yemenis are vulnerable to changes in prices as their coping strategies are running out.

32 https://www.worldbank.org/en/news/press-release/2023/10/26/yemen-economic-monitor-highlights-ongoing-challenges-amid-renewed-hope.

specially designated global terrorists (SDGT).[33] While aggregate economic and social data, along with anecdotal evidence, suggest that the impact of the SDGT designation has been relatively contained thus far in Yemen, it could nonetheless serve as a deterrent to commercial engagements with the Houthis and may impede the flow of remittances and complicate aid delivery in northern Yemen. Any disruptions to humanitarian aid, essential imports, remittances, and sources of livelihood will exacerbate Yemen's economic and social conditions, particularly in a society plagued by widespread poverty, deprivation, and food shortages. Yemenis have already been struggling to get the aid they need, in part due to low humanitarian funding. The United Nation's US$4.34 billion aid appeal for Yemen in 2023 was only 40.7 percent funded, marking the lowest funding percentage for a UN Yemen appeal since at least 2008.[34] The risks regarding food insecurity are alarming, exacerbated by the suspension of aid and food distribution by the World Food Programme (WFP) in Houthi-controlled areas in late 2023. The conflict has already inflicted profound and far-reaching economic, social, and humanitarian consequences on Yemen.

On the domestic front, notable adverse developments such as the decision of the CBY-Sana'a in March 2023 to introduce a new 100-riyal coin to replace damaged YER100 banknotes will require close monitoring. YER100 banknotes currently account for only one percent of the currency in circulation in Houthi-controlled areas. As such, the monetary and economic effects of this measure alone are limited.[35] However, uncertainties remain regarding the legality and acceptance of this decision, further deepening fragmentation in the monetary and institutional setup between Sanaa and Aden. Moreover, the potential printing of money by the Houthis could exacerbate inflationary pressures. Regarding the financial sector implications, YER100 banknotes primarily circulate outside the banking sector, yet potential legal repercussions on banks necessitate careful examination. It will be crucial to monitor any further issuance, particularly the printing of banknotes, which may signal a more active use of monetary policy to generate seigniorage revenues.

Furthermore, in response to the decision by CBY-Sana'a, on April 2, 2024, CBY-Aden mandated that banks in Sana'a relocate their headquarters to Aden within two-months, citing AML/CFT regulations. This mandate could have significant economic, financial and social implications. Banks attempting to relocate within the given timeframe might face technical challenges and potential retaliatory actions from the Houthis. Conversely, banks that refuse to relocate risk disconnection from SWIFT, which could negatively impact financial flows in and out of Yemen, a lifeline for the economy and for the Yemeni people, and threaten the financial viability of the smallest banks. Yet, transfers through Aden-based banks and alternative actors such as money exchangers could mitigate some impacts. So far, it is reported that some banks are resisting relocation, highlighting the need for continued close monitoring of the situation. On May 30, 2024, CBY-Aden flagged these banks in a directive, mandating the suspension of dealings with them.[36] On the same day, CBY-Aden also issued a directive requiring all Yemenis to deposit old paper currency printed before 2016 within sixty days.[37] On May 31, 2024, CBY-Sana'a retaliated by issuing a directive to ban cooperation with thirteen banks headquartered in Aden.

Risks

Overall, the macroeconomic outlook for Yemen remains predominantly leaning towards the downside. This is largely attributed to the ongoing and looming risk of further Houthi attacks in the Red Sea within the next twelve months. Continued attacks and retaliations will severely disrupt vital

33 In February 2021, the current U.S. administration delisted the Houthis as foreign terrorist organizations (FTO), citing the humanitarian crisis in Yemen as the reason for the removal. This decision came after the previous administration had listed them as FTOs in January 2021.

34 Yemen Humanitarian Response Plan 2023.

35 YER 500 and YER 1,000 notes continue to dominate the market. These denominations represent over 95 percent of the total volume of currency in circulation, while the YER 100 coin represents just one percent.

36 https://cby-ye.com/news/691.

37 https://cby-ye.com/news/692.

trade flows and remittances through the strategic Red Sea region, thus depressing economies not only in Yemen but also across the wider Red Sea region. Other downside risks include the potential escalation of hostile activities and further economic fragmentation fueled by domestic tensions, adverse terms of trade shocks, and new natural disasters that pose significant threats to Yemen's fragile economy. The risks of bifurcation between Houthi-controlled and IRG-controlled areas are escalating, with political tensions driving greater economic and financial fragmentation. This could, in turn, deepen the social and humanitarian divide. In addition, the potential upgrade to the FTO designation is tangible, signifying a more rigorous sanction in contrast to the existing SDGT classification.[38] However, on the upside, if the situation in the Red Sea normalizes, real GDP growth could accelerate with the resumption of trade, remittances, and aid.

However, if a lasting truce or peace agreement is achieved, Yemen could experience sustained growth within months. While heightened domestic and regional tensions pose significant risks to its economic, social, and humanitarian situation, the attainment of a lasting truce or peace agreement holds the promise of rapid economic recovery. With strong external financial assistance and reconstruction efforts supported by Yemen's development partners, along with post-conflict reform, the country could achieve accelerated growth within a short timeframe. In such a favorable scenario, growth would be expected to be driven by a swift rebound in domestic transportation, trade, financial inflows, and reconstruction efforts. Such efforts are essential for overcoming the current crisis and laying the foundations for a unified and prosperous future for all Yemenis. The World Bank's in-depth country economic growth diagnostic, Country Economic Memorandum (CEM), outlines different recovery paths under various macroeconomic and political economy scenarios, emphasizing policy recommendations to unlock peace dividends.[39]

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[38] For details, see Congressional Research Service description of the FTO and related information: https://crsreports.congress.gov/product/pdf/IF/IF10613.

[39] World Bank. (2023). Yemen Country Economic Memorandum: Glimmers of Hope in Dark Times. Washington, D.C: World Bank.

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