



RETHINKING
YEMEN'S ECONOMY

ADDRESSING THE CRUSHING WEIGHT OF YEMEN'S PUBLIC DEBT



By:
Sana'a Center
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LIST OF ACRONYMS

CBY	Central Bank of Yemen
CCRT	Catastrophe Containment and Relief Trust
CDs	Certificate Deposits
CMEA	Council of Mutual Economic Assistance
DFC	Development Champions Forum
DMFAS	Debt Management and Financial Analysis System
DSSI	Debt Service Suspension Initiative
EFARP	Economic, Financial and Administrative Reform Program
GAIP	General Authority for Insurance and Pensions
GDP	Gross Domestic Product
IDA	International Development Agency
IMF	International Monetary Fund
MoF	Ministry of Finance

EXECUTIVE SUMMARY

For decades prior to the ongoing conflict, Yemen had been vulnerable to recurring budget deficits due to a lack of meaningful fiscal reform, high recurrent expenditures – mainly public sector salaries and fuel subsidies – and an overdependence on oil revenues. While foreign debt obligations remained low, the debt market was poorly diversified, with treasury bill holders narrowly concentrated within the banking sector and government bonds held almost exclusively by public pension funds.

The escalation of the ongoing conflict in 2015 has had a profoundly negative impact on Yemen's debt position. Large-scale oil exports ceased, leading to a collapse in public revenues, while banks and pension funds stopped purchasing government debt instruments. Management of the public debt became bifurcated between rival central bank administrations in Aden and Sana'a, both of which suspended payments on foreign and domestic debt obligations. Unable to receive interest payments, public debt holders faced a liquidity crisis, leaving banks unable to honor customer obligations and threatening their solvency, while pension funds have struggled to support retirees.

On January 25-27, 2021, senior Yemeni experts and professionals convened virtually for the 7th Development Champions Forum (DCF), as part of the Rethinking Yemen's Economy initiative, to discuss the evolution and structure of Yemen's public debt, the dynamics during the conflict that have led to its colossal expansion, and the macroeconomic risks it poses. This was followed a week later with a briefing for international stakeholders on February 2. These discussions formed the basis for the research presented in this paper and its recommendations for addressing Yemen's public debt crisis.

INTRODUCTION

For decades prior to the ongoing conflict, Yemen had been vulnerable to recurring budget deficits due to a lack of meaningful fiscal reform, high recurrent expenditures – mainly public sector salaries and fuel subsidies – and an overdependence on oil revenues. Within a year of becoming a unified republic in 1990, the country had already defaulted on its debt obligations to foreign creditors. While Yemen’s fiscal fortunes improved through the 1990s and most of the 2000s, overwhelmingly due to increased oil export earnings, the credit risk the county presented continued to restrict its access to international lenders. This helped keep its foreign debt obligations low, relative to other regional countries, with government budget shortfalls largely met through domestic means, such as overdraft from the Central Bank of Yemen (CBY) and issuing debt instruments priced in Yemeni rials, such as treasury bills, government bonds and Islamic sukuk. The debt market, however, remained poorly diversified, with treasury bill holders narrowly concentrated within the banking sector and government bonds held almost exclusively by public pension funds.

The escalation of the ongoing conflict in 2015, and the dramatic economic decline that ensued, have had a profoundly negative impact on Yemen’s debt position. Large-scale oil exports ceased, leading to a collapse in public revenues, while banks and pension funds stopped purchasing government debt instruments. To cover the Yemeni government’s expenses, the Central Bank in Aden has printed massive amounts of new currency bills, which has spurred exchange rate depreciation and inflation, eroded consumer purchasing power and led to a rapid deterioration in living standards. Management of the public debt became bifurcated between rival CBY administrations in Aden and Sana’a, affiliated with the Yemeni government and Houthi authorities, respectively, both of whom suspended payments on foreign and domestic debt obligations. Unable to receive interest payments, public debt holders faced a liquidity crisis, leaving banks unable to honor customer obligations and threatening their solvency, while pension funds have struggled to support retirees. The underlying value of their principal investments in treasury bills and bonds has also shrunk in step with the rial’s precipitous collapse, which has made existing foreign debt obligations far more onerous to meet as well.

THE HISTORY OF YEMEN'S PUBLIC DEBT

1990–1994: A Republic Born Indebted

The Yemen Arab Republic and the People's Democratic Republic of Yemen – colloquially known as North Yemen and South Yemen, respectively – unified on May 22, 1990. The newly minted Republic of Yemen was born indebted, inheriting a cumulative US\$9.9 billion worth of foreign obligations from its constituent parts, equivalent to 106 percent of gross domestic product (GDP).^[1] Of this, 65 percent was owed to the former Council of Mutual Economic Assistance (CMEA), though in reality, the Soviet Union had put up almost the entirety (97 percent) of the CMEA's loans to South Yemen.^[2] Other creditors included regional countries and international financial institutions. Yemen's debt servicing bill in 1990 amounted to US\$696 million, though it fell US\$270 million short on its payments that year. This placed the country in default before it was one year old.^[3] With Yemen's creditworthiness shaken internationally, the government began borrowing from its own central bank to bridge its budget deficit, with the Central Bank of Yemen (CBY) pursuing an expansionary monetary policy and printing new currency to allow the government to cover its high recurrent spending in the face of declining revenue.^[4]

Yemen's weak fiscal situation resulted from several factors, among them being the state's consistently poor exploitation of limited non-oil resources, weak oil exports and rising expenditures linked to a bloated public sector wage bill. This situation was compounded when, in 1991, close to one million Yemeni expatriate workers were expelled from Gulf Cooperation Council states in the wake of the Gulf war, meaning both a loss of remittances and a dramatic spike in the number of unemployed in Yemen as these workers returned home. Despite significant oil export increases in the period 1993-1994, Yemen's general export base remained weak (with oil constituting 90

1) Nada Choueiri et al., "External Environment: Politics, Oil, and Debt" in *Yemen in the 1990s: From Unification to Economic Reform*, International Monetary Fund, May 3, 2002, <https://www.elibrary.imf.org/view/IMF084/08020-9781589060425/08020-9781589060425/ch02.xml?redirect=tru>. Accessed March 8, 2022.

2) Ibid.

3) Ibid.

4) "Republic of Yemen - Poverty Reduction Strategy Paper (PRSP) 2003-2005," International Monetary Fund, May 2002, <https://www.imf.org/External/NP/prsp/2002/yem/01/index.htm>. Accessed April 11, 2022.

percent of all goods sent abroad), the country was heavily dependent on imports, and non-petroleum GDP shrank.^[5] In 1994, there was a civil war between southern secessionist forces and largely northern troops, with the latter prevailing. The public budget deficit for that year was equivalent to almost 15 percent of GDP.^[6]

1995–2000: Stifled Reforms, Oil Dependence and New Public Debt Instruments

In 1995, the Yemeni government, with support from the World Bank and the International Monetary Fund (IMF), launched the Economic, Financial and Administrative Reform Program (EFARP), which generally aimed to enhance public revenues and reduce public expenditures, specifically recurrent expenditures.^[7] Ostensibly, the reforms showed initial positive results. Yemen's fiscal deficit was cut from 14.9 percent of GDP in 1994 to 5.2 percent in 1995. The budget then recorded a fiscal surplus of 7.1 percent in 2000.^[8] Recurrent expenditures also improved slightly, from 81.3 percent of total public spending in 1995 to 76 percent in 2000.^[9] In 1997, the EFARP supported a favorable restructuring of Yemen's external debt on Naples terms,^[10] which succeeded in having 67 percent of Yemen's total foreign debts waived, including 80 percent of the debt owed to Russia.^[11] This brought Yemen's external debt down from US\$8.32 billion in 1995 to US\$4.93 billion in 2000.^[12]

5) "Republic of Yemen - Poverty Reduction Strategy Paper (PRSP) 2003-2005," International Monetary Fund, May 2002, <https://www.imf.org/External/NP/prsp/2002/yem/01/index.htm>. Accessed April 11, 2022.

6) Ibid.

7) Massoud Karshenas et al., "Macroeconomic Policies for Growth, Employment and Poverty Reduction in Yemen," UNDP, 2006, <https://eprints.soas.ac.uk/5805/1/Yemen.pdf>. Accessed March 8, 2022.

8) "Republic of Yemen - Poverty Reduction Strategy Paper (PRSP) 2003-2005," International Monetary Fund, May 2002, <https://www.imf.org/External/NP/prsp/2002/yem/01/index.htm>. Accessed April 11, 2022.

9) Ibid.

10) In December, 1994, Paris Club of creditor nations instituted a new form of debt treatment for the world's poorest countries that would allow, on a case-by-case basis, for the cancellation of roughly two thirds of a country's foreign debt. For details, see: "Naples Terms," Paris Club, n.d., <https://clubdeparis.org/en/communications/page/naples-terms>.

11) "Yemen: Debt treatment - November 20, 1997," Paris Club, November 20, 1997, <https://clubdeparis.org/en/traitements/yemen-20-11-1997/en>. Accessed March 8, 2022.

12) "Republic of Yemen - Poverty Reduction Strategy Paper (PRSP) 2003-2005," International Monetary Fund, May 2002, <https://www.imf.org/External/NP/prsp/2002/yem/01/index.htm>. Accessed April 11, 2022.

A lack of genuine political commitment to fiscal reforms, however, meant the state continued to suffer from low levels of tax compliance and poor customs administration,^[13] with the improvement in Yemen's public revenues almost entirely attributable to a rapid increase in oil revenues. Between 1995 and 2000, oil's contribution to public revenues rose from 19.4 percent to 74.9 percent.^[14] The non-oil economy remained anemic by comparison and the country was overwhelmingly dependent on imports for basic commodities and commercial goods.

By the end of 1995, the government started issuing treasury bills with one-month maturity; longer-term bills (three and six months) followed in 1996, and one-year bills were issued shortly thereafter.^[15] This allowed for exposure to the domestic debt beyond the central bank, facilitating the involvement of private sector actors, primarily commercial banks. This turn toward treasury bills as a non-inflationary financing tool came as the government's financial position improved and fiscal deficits shrank leading up to the year 2000, at which point the government began recording a series of budget surpluses that lasted until 2007. Conservative monetary policy helped reduce the domestic liquidity growth rate from about 48 percent in 1995, to an average of 15.6 percent in the following 10 years. Inflation consequently improved from 62.5 percent to an annual average of 11.2 percent over the same period.^[16]

13) Massoud Karshenas et al., "Macroeconomic Policies for Growth, Employment and Poverty Reduction in Yemen," UNDP, 2006, <https://eprints.soas.ac.uk/5805/1/Yemen.pdf>. Accessed March 8, 2022.

14) "The Republic of Yemen: Unlocking the Potential for Economic Growth A Country Economic Memorandum," World Bank, October 2015, <https://documents1.worldbank.org/curated/en/673781467997642839/pdf/102151-REVISED-box394829B-PUBLIC-Yemen-CEM-edited.pdf>. Accessed March 8, 2022.

15) "The Process Of Economic Reform And Creating An Investment Environment In Yemen [AR]," Arab Monetary Fund, August 16, 2007, <https://www.amf.org.ae/ar/content/مسيرة-الإصلاح-الاقتصادي-ونهيته-البيئة-الاستثمارية-في-اليمن>. Accessed 1 Feb. 2022.

16) Ibid.

2001–2010: Oil Boom Goes Bust and Domestic Debt Surges

In 2000, the amount the Yemeni government could legally borrow from the CBY was established under Law No. 14 of that year, which stated that the government's outstanding overdraft at the central bank could not exceed 25 percent of normal budget revenues averaged over the previous three years.^[17] The 2000s also saw various reform efforts announced, involving the public service and state finances, changes to fuel subsidies, a general sales tax, efforts to curb corruption, and social welfare programs; however, implementation was weak to non-existent. Rising oil prices after 2002 propelled an expansion in export earnings and allowed the CBY to build up foreign currency reserves that were sufficient to cover imports for 7.5 months.^[18] Importantly, the increasing price of oil helped mask the fact that production volumes peaked in 2001 and have declined subsequently since, albeit gradually.^[19] The oil boom in the early 2000s also allowed those in the country's power structure to ignore the need for reforms, with revenues sufficient to cover Yemen's high recurrent expenditures. From 1996 to 2014, recurrent expenditures accounted for 84 percent of total government spending, equivalent to some 28 percent of the GDP.^[20] Of total government spending in this period, 35.5 percent went to public sector salaries – the largest budget item – and 24.5 percent went to fuel subsidies.^[21] Comparatively, spending on capital expenditures was limited, representing 5.4 percent of GDP and 14 percent of total expenditures.^[22]

17) In Law 14 of 2000, Article No. 32 clause (2) stipulates that “in exceptional circumstances, the Bank may grant temporary financing to the government in the form of emergency loans, but only if such loans would not be inconsistent with the monetary objectives of the Bank and would not cause the aggregate principal amount disbursed on all Bank emergency loans to the government to exceed the equivalent of 25 percent of the annual average of the budget ordinary revenue for the three financial years immediately preceding for which accounts are available. “Law No. 14 of 2000 on the Central Bank of Yemen,” Central Bank of Yemen, n.d., http://www.centralbank.gov.ye/App_Upload/law14.pdf. Accessed April 15, 2022.

18) Abdulmajeed Al-Batuly et al., “Assessing Development Strategies to Achieve the MDGs in The Republic of Yemen,” United Nations Department for Social and Economic Affairs, July 2011, https://www.un.org/en/development/desa/policy/capacity/output_studies/roa87_study_yem.pdf. Accessed March 8, 2022.

19) “Yemen,” US Energy Information Administration, November 13, 2020, <https://www.eia.gov/international/analysis/country/YEM>. Accessed March 8, 2022.

20) “The Republic of Yemen: Unlocking the Potential for Economic Growth A Country Economic Memorandum,” World Bank, October 2015, <https://documents1.worldbank.org/curated/en/673781467997642839/pdf/102151-REVISED-box394829B-PUBLIC-Yemen-CEM-edited.pdf>. Accessed March 8, 2022.

21) “The Republic of Yemen: Unlocking the Potential for Economic Growth A Country Economic Memorandum,” World Bank, October 2015, <https://documents1.worldbank.org/curated/en/673781467997642839/pdf/102151-REVISED-box394829B-PUBLIC-Yemen-CEM-edited.pdf>. Accessed March 8, 2022.

22) Ibid.

Yemen's fiscal balance deteriorated between 2006 and 2007, when the budget slipped from a YR67 billion (US\$312 million) surplus to a YR285 billion (US\$1.3 billion) deficit. Notably, 46 percent of the deficit was financed by treasury bills.^[23] Yemen's fiscal health then deteriorated significantly in the wake of the 2008 global financial crisis and ensuing collapse in global oil prices, with the combined contribution of oil and gas to public revenues declining by 58 percent.^[24] This decline was compounded by the continued gradual contraction of oil production, as existing oil fields matured and a poor security environment derailed exploration for new ones.^[25]

This instigated a cycle of large borrowing, increasing debt and higher debt servicing payments. The gross public debt grew by almost 31 percent, from the equivalent of US\$9.8 billion in 2008 to the equivalent of US\$12.8 billion in 2009, or from 36.4 percent to 51 percent of GDP.^[26] During the same period, the domestic debt increased rapidly from 14.5 to 26.8 percent of GDP as the government sought to monetize – meaning to convert into new currency bills – much of the budget deficit through overdraft from the CBY.^[27]

In 2009, the government also started issuing government bonds to pension funds for a period of three years to finance investment projects in exchange for an annual interest rate of 7 percent, with this rate adjusted to 10 percent in subsequent years. In 2010, the IMF supported a stabilization program through its Extended Credit Facility to cut Yemen's budget deficit, largely through cutting fuel subsidies, increasing customs revenues and implementing a general sales tax. This helped reduce the gross public debt to 43 percent of GDP between 2009 and 2010.^[28]

23) Central Bank of Yemen database, 2007.

24) Abdulmajeed Al-Batuly et al., "Assessing Development Strategies to Achieve the MDGs in The Republic of Yemen," United Nations Department for Social and Economic Affairs, July 2011, https://www.un.org/en/development/desa/policy/capacity/output_studies/roa87_study_yem.pdf. Accessed March 8, 2022.

25) "Debt Management Performance Assessment: Yemen," World Bank, September 2011, <https://openknowledge.worldbank.org/handle/10986/33218?locale-attribute=es>. Accessed March 8, 2022.

26) Ibid.

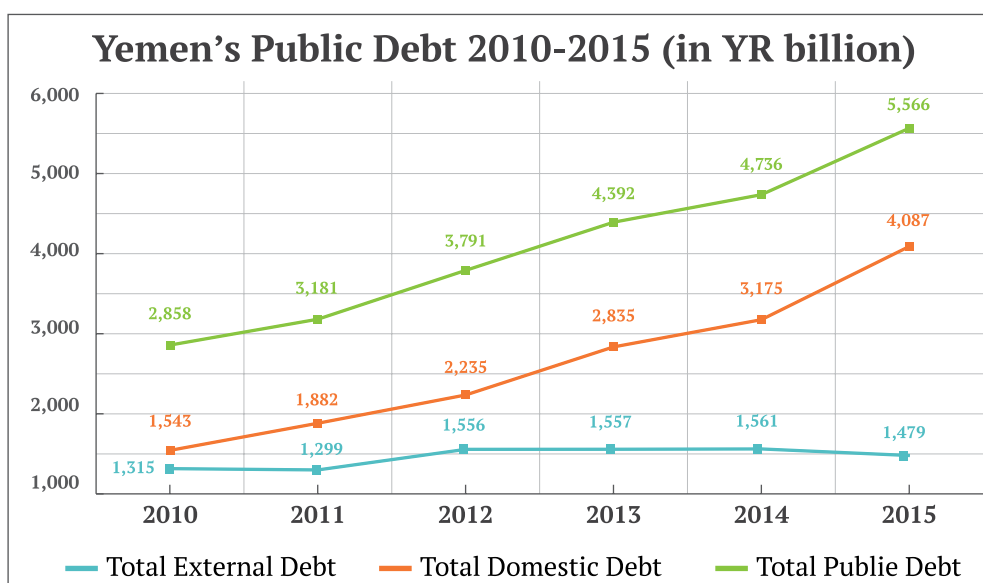
27) Ibid.

28) "Debt Management Performance Assessment: Yemen," World Bank, September 2011, <https://openknowledge.worldbank.org/handle/10986/33218?locale-attribute=es>. Accessed March 8, 2022.

2010–2014: T-Bills and Bonds Become Primary Debt Instruments

Similar to much of the region, 2011 heralded the beginning of widespread protests and a political crisis in Yemen. From 2010–2014, cumulative budget deficits fueled an increase in the total debt at an average annual pace of 13.5 percent.^[29] As a result, total public debt increased from YR2.86 trillion, equivalent to 43 percent of GDP, in 2010, to YR4.74 trillion, or 65 percent of GDP, in 2014.^[30]

Notably, due to Yemen's limited access to non-concessional borrowing, external debt remained relatively constant in real terms, standing at about US\$7.3 billion by the end of 2014.^[31] Between 2012 and 2014, during a period of political transition in Yemen, the public budget received US\$4.8 billion in external grants and loans, though mostly the former, which helped significantly improve the country's fiscal balance and macroeconomic stability. Between 2010 and 2014, external debt shrank as a share of overall debt. Meanwhile, increased domestic debt issuance in that period led domestic debt to rise from 22.8 percent to 43.5 percent of GDP.^[32]

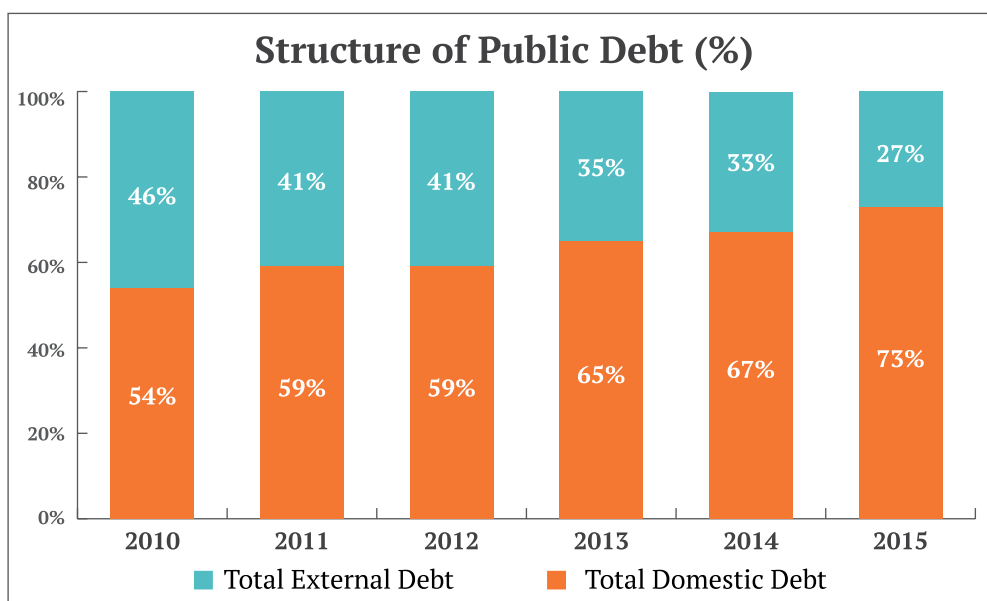


29) "Public Debt in Yemen 'Debt Restructuring or Default'," Ministry of Planning & International Cooperation, Yemen Socio-Economic Update, Issue 15, June, 2016, https://reliefweb.int/sites/reliefweb.int/files/resources/YSEU15_English_v6.pdf. Accessed March 8, 2022.

30) Ibid.

31) "The Republic of Yemen: Unlocking the Potential for Economic Growth A Country Economic Memorandum," World Bank, October 2015, <https://documents1.worldbank.org/curated/en/673781467997642839/pdf/102151-REVISED-box394829B-PUBLIC-Yemen-CEM-edited.pdf>. Accessed March 8, 2022.

32) "Public Debt in Yemen 'Debt Restructuring or Default'," Ministry of Planning & International Cooperation, Yemen Socio-Economic Update, Issue 15, June, 2016, https://reliefweb.int/sites/reliefweb.int/files/resources/YSEU15_English_v6.pdf. Accessed March 8, 2022.



Source: Ministry of Planning & International Cooperation^[33]

In 2011, the government introduced the sukuk Islamic financing tool to attract the financial assets of Islamic banks.^[34] From 2010 to 2014, almost all domestic debt was issued as treasury bills, government bonds and Islamic sukus, except for 2011, which saw an expansionary monetization of the fiscal deficit. In 2011 alone, the government aggressively financed almost 70 percent of its fiscal imbalance in loans from the central bank. In the following three years, demand for treasury bills as a non-inflationary financing tool increased, from YR640 billion in 2012 to YR1.46 trillion in 2014, to finance 61 percent of the fiscal budget deficit.^[35] The country's commercial and Islamic banks, which had seen these debt instruments as secure investments and were attracted by nominal interest rates around 16 percent, bought the largest share of domestic debt in this period. By contrast, from 2011 to 2014 the state paid down its dues to the central bank slightly, from YR708 billion to YR688 billion. Thus, by 2014, treasury bills and government bonds constituted 46 percent and 25 percent of the overall domestic debt, respectively. In total, between 2010 and 2014, domestic debt as a share of overall debt increased from 54 percent to 67 percent.^[36]

33) "Public Debt in Yemen 'Debt Restructuring or Default,'" Ministry of Planning & International Cooperation, Yemen Socio-Economic Update, Issue 15, June, 2016, https://reliefweb.int/sites/reliefweb.int/files/resources/YSEU15_English_v6.pdf. Accessed March 8, 2022.

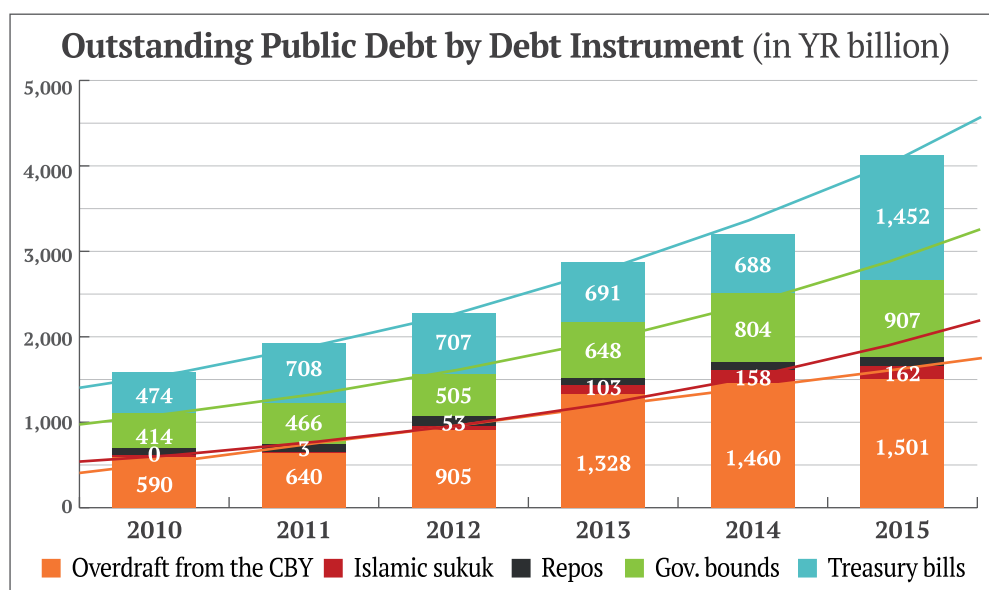
34) "A sukuk is an Islamic financial certificate, similar to a bond in Western finance, that complies with Islamic religious law commonly known as Sharia," as per Akhilest Ganti, "Sukuk," Investopedia, October 17, 2020, <https://www.investopedia.com/terms/s/sukuk.asp#:~:text=A%20sukuk%20is%20a%20sharia,indirect%20interest-bearing%20debt%20obligations>. Accessed April 11, 2022.

35) "Public Debt in Yemen 'Debt Restructuring or Default,'" Ministry of Planning & International Cooperation, Yemen Socio-Economic Update, Issue 15, June, 2016, https://reliefweb.int/sites/reliefweb.int/files/resources/YSEU15_English_v6.pdf. Accessed March 8, 2022.

36) Ibid.

THE EVOLVING DYNAMICS OF YEMEN'S PUBLIC DEBT DURING THE CONFLICT

Following the advent of the Yemen conflict in 2014, and regional military intervention in March 2015, Yemen experienced rapid economic deterioration. Consequently, private sector and pension fund purchases of domestic debt instruments ceased and remained minimal in the years following. In the first half of 2015, the banking sector ceased rolling over its maturing treasury bills and in the following years this type of debt instrument turned unattractive to Yemeni banks which, facing a liquidity crunch, were seeking to shore up their cash reserves. Borrowing from the CBY became the primary means for the government to cover its budget deficit, shattering the legal limit placed on such in 2000. In 2015, the CBY financed 84 percent of the total budget deficit^[37] through an expansion of its overdraft to the government via a mix of issuing new money and accumulating arrears. The government's dues at the CBY consequently jumped from roughly 22 percent of accumulated domestic debt in 2014 to 35 percent in 2015. Total debt for that year reached 94.4 percent of GDP, up from 65 percent in the previous year, exceeding the 60 percent limit which the CBY considered safe.^[38]



Source: Ministry of Planning & International Cooperation^[39]

37) Annual Report 2015, Central Bank of Yemen, December 31, 2015, http://centralbank.gov.ye/App_Upload/Ann_rep2015AR.pdf. Accessed March 8, 2022.

38) "Public Debt in Yemen 'Debt Restructuring or Default'," Ministry of Planning & International Cooperation, Yemen Socio-Economic Update, Issue 15, June, 2016, https://reliefweb.int/sites/reliefweb.int/files/resources/YSEU15_English_v6.pdf. Accessed March 8, 2022.

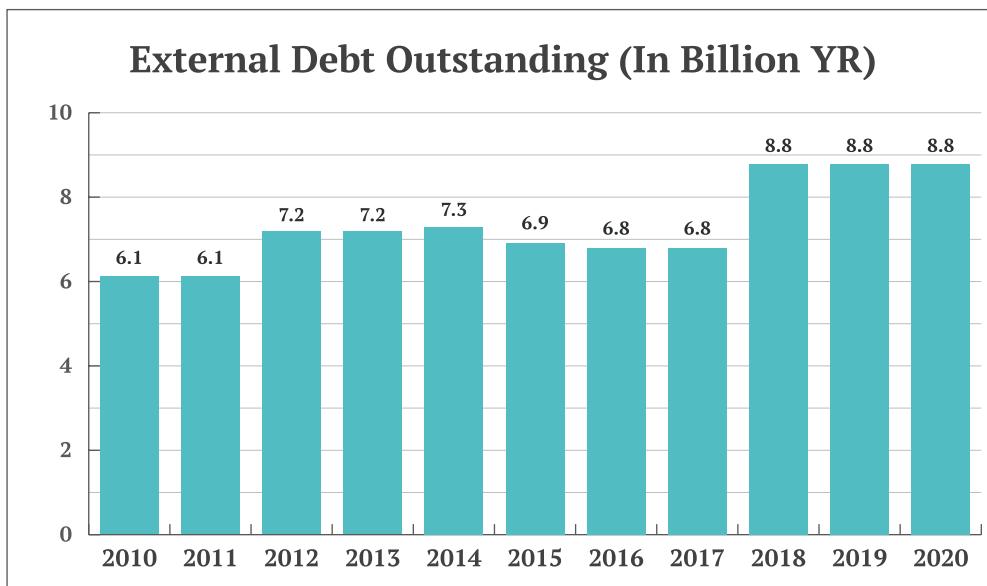
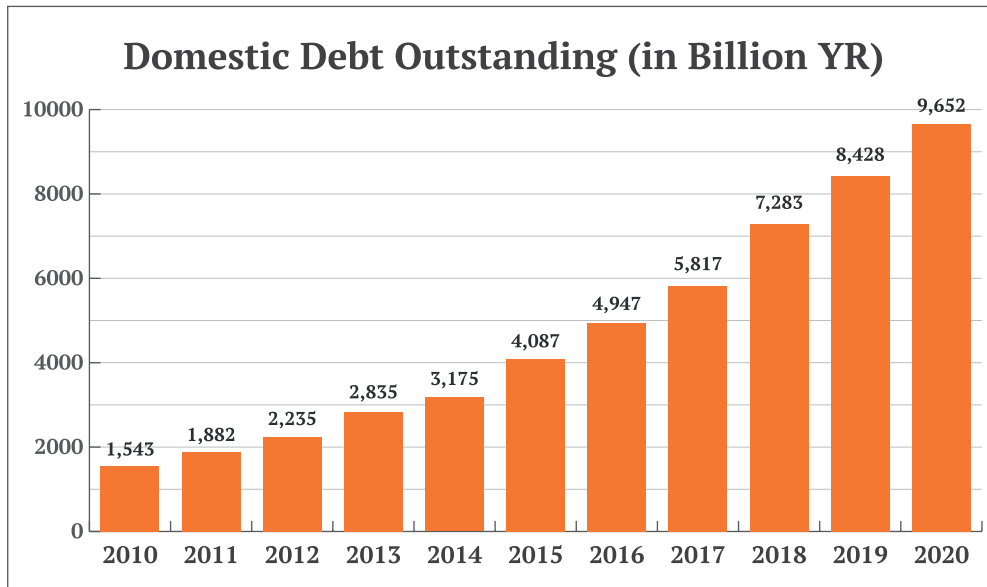
39) "Public Debt in Yemen 'Debt Restructuring or Default'," Ministry of Planning & International Cooperation, Yemen Socio-Economic Update, Issue 15, June, 2016, https://reliefweb.int/sites/reliefweb.int/files/resources/YSEU15_English_v6.pdf. Accessed March 8, 2022.

In 2016, CBY lending to the government accounted for 80 percent of total public revenues, clearly reflecting weak government revenue mobilization capacity. Yemen's public debt, in particular domestic debt, has risen significantly since. The exact stock of consolidated national indebtedness is unknown, however, given that public debt management has been institutionally fragmented since September 2016. This is when President Abdo Rabbu Mansour Hadi ordered the CBY headquarters relocated to Aden, resulting in the creation of two rival central bank entities in the country: one in Sana'a affiliated with the Houthi authorities and the other in Aden affiliated with the government, the former with sway over the country's largest population and financial centers but without international recognition, the later internationally recognized but with limited authority domestically.

Thus, while exact figures are unavailable, the Sana'a Center's Economic Unit estimates that consolidated public debt increased by roughly 226 percent between 2014 and 2020, from YR4.74 trillion to about YR15.3 trillion.^[40] The vast majority of this (205 percent) was domestic debt and primarily the result of the Yemeni government borrowing from the CBY-Aden, which has pursued an expansionary monetary policy of printing new currency to offset its vast budget deficits. Access to foreign credit was also inaccessible, given that the central bank suspended all foreign debt servicing shortly after the conflict began except that which was owed to the International Development Agency (IDA).^[41] The absolute value of external debt stabilized at close to US\$7 billion between 2015-2017. It increased by US\$2 billion in 2018 with a Saudi deposit made to the CBY-Aden to facilitate basic commodity import financing and exchange rate stabilization.

40) In order to reflect the annual growth of Yemen's overall public debt, the figures of domestic debt and external debt are represented in Yemeni rials. The value of external debt in the overall public debt figure was calculated by converting from US\$ into Yemeni rials using the prevailing national average of market exchange rates.

41) In 2019 and 2020, the total debt service to IDA equaled USD 78 and USD 85.9 million respectively. Of the total debt service paid in 2020, USD 74.8 million was principal repayments and USD 11.1 million in interest payments. During January-June 2021, total debt service paid to IDA was USD 46.1 million, with USD 40 million in principal repayments and USD 6.1 million in interest payment: "Economic Recovery & Livelihoods Program (ERLP) - Yemen, Quarterly Report, FY2021 Quarter 4 July 1 – September 30, 2021," USAID, November 9, 2021, p. 20, https://pdf.usaid.gov/pdf_docs/PA00Z39G.pdf. Accessed May 4, 2022.



Sources: Ministry of Planning and International Cooperation, Sana'a Center Economic Unit⁴²⁾

Despite the dramatic increase in the stock of debt denominated in Yemeni rials during the conflict, the structure of domestic debt as a share of total debt actually decreased from 73 percent in 2015 to 63 percent as of 2020, due to the rial's depreciation against the dollar. At the beginning of 2015, the prevailing exchange rate had been YR215

42) The Sanaa-based Ministry of Planning and International Cooperation figures were used for the period January 2010-June 2019. For the period 2017-2020, the Sana'a Center Economic Unit determined the total stock of public debt at the national level through the combination of its main components, the domestic debt and external debt. Domestic debt was calculated by estimating the developments in its components – mainly treasury bills, government bonds, and the CBY credit financing for public budget deficit – in both CBY-Sanaa and CBY-Aden. The external debt stock, which is dominated in US\$ and owed to foreign creditors, was converted to its equivalent value in Yemeni rial by using the annual national average market exchange rate and by also accounting for the divergent exchange rates in Sana'a and Aden. The national exchange rates used for the period 2017-2020 were YR454, YR528, YR590, and YR646, respectively.

per US\$1. By the beginning of 2020, the rial was trading at roughly YR600 per US\$1, meaning the Yemeni currency had lost two-thirds of its value in five years.

A further complicating factor emerged in January 2020 when the Houthi authorities began strict enforcement of a ban preventing the circulation of newly printed banknotes (i.e. those issued by the CBY-Aden after 2017) in Houthi-controlled territories.^[43] Since then there has been an increasing divergence in the exchange rate between 'old' and 'new' bills, circulating in Houthi- and government-controlled areas, respectively. This saw 'new' bills depreciate to as low as YR1,724 per US\$1 in December 2021 before recovering somewhat, while the exchange rate for 'old' banknotes has remained relatively constant at YR600 per US\$1. Without this depreciation, the real value of public debt would be much larger. The current value of the consolidated public debt of YR15.4 trillion in 2020 is close to US\$24 billion;^[44] without depreciation, it would be around US\$54 billion, of which 84 percent would be domestic debt.

There is an important distinction, however, between debt the state can and cannot default on. Given that the Yemeni state owns the CBY, debt that the government owes its central bank is essentially owed to itself and thus there is no threat of default. By contrast, debt issued in treasury bills, government bonds and Islamic sukuk is held outside of the state and thus must eventually be paid back or defaulted on. In principle, using the depreciated currency exchange rate for repayment of the domestic debt instruments would make it less costly for the government post conflict, especially when considering that its main source of revenue is likely to be hydrocarbon exports, priced in US\$. However, such would result in massive losses for debt holders, both private and public institutions, as well as individual investors.

Treasury bills and government bonds in Yemen are fixed-income assets and their interest payments have not been adjusted to balance out the adverse effects of high inflation and decreased purchasing power of the national currency. As of August 2020, the cumulative inflation rate was roughly 145 percent higher than December 2014.^[45] High inflation

43) Anthony Biswell, "The War for Monetary Control Enters a Dangerous New Phase," Sana'a Center for Strategic Studies, January 21, 2020, <https://sanaacenter.org/publications/analysis/8674>. Accessed March 8, 2022.

44) The Yemeni rial lost more than two thirds of its value between 2014 and the end of 2020, with the national average exchange rate depreciating from YR214 to YR646 per US\$1 over that period.

45) "Economic Recovery, Reconstruction and Sustainable Peacebuilding in Yemen," Ministry of Planning & International Cooperation, Yemen Socio-Economic Update, Issue 51, August 2020, https://reliefweb.int/sites/reliefweb.int/files/resources/YSEU51_English.pdf. Accessed March 8, 2022.

has substantially cut into the assets and earnings of domestic debt securities holders and diminished their confidence in both banks as financial intermediaries and in debt securities generally, leading to a shrinking customer base. The government's continued nonpayment of domestic debt principals also leaves commercial banks exposed to further financial losses in the probable context of continued rial depreciation.

Losses on this scale would have the potential to bankrupt many banks and debt holders, destroy faith in Yemen's banking sector and formal financial system, upend the rial-based monetary system – with normal financial transactions in Yemen likely to migrate to hard currencies or the Saudi riyal – and the CBY losing seigniorage for the foreseeable future. Yemen pension funds, as heavy investors in government bonds, have also been vulnerable to the inflation risks, with beneficiaries facing under-funded retirements as inflation and increased costs of living are not factored into retirement savings plans. As well, by the end of May 2021, at least YR2 trillion (nearly US\$3.3 billion at the YR600-US\$1 exchange rate) in debt has been accumulated in salary arrears to public servants in Houthi-controlled areas.^[46]

46) Sana'a Center Economic Unit estimates, May 2021.

YEMEN'S DOMESTIC DEBT

Composition and Characteristics

In Yemen, as laid out above, domestic debt is issued and managed by the CBY on behalf of the central government, namely the Ministry of Finance (MoF), and is fully denominated in local currency. Treasury bills, government bonds and Islamic sukuk, as well as overdraft from the CBY, make up the overall domestic debt structure.

Since 2015, the decreased use of domestic debt instruments to cover government budget deficits reflects the reluctance in the market – mainly banks and pension funds^[47]– to continue investment in them, given the sharp decline in their real interest rates (in light of YR depreciation) and the liquidity crisis that emerged in Yemen.^[48] By contrast, between 2015 and 2020, central bank lending to the public budget has surged to form the largest component (63 percent) of the domestic public debt, consolidated between Sana'a and Aden CBY branches. It increased by almost 778 percent from YR688 billion in 2014 to an estimated YR6 trillion by the end of 2020.^[49] Nearly 48 percent of this domestic debt was created by the CBY-Aden since 2017 through the aggressive issuance of new rial banknotes to fund the public budget deficit. CBY-Aden loans to the Yemeni government amounted to YR3.5 trillion at the end of 2021,^[50] making up the vast majority of the government's total internal debt stock of YR3.69 trillion, with the remaining 5 percent constituted by a rollover of wakalas and certificates of deposit held by commercial and Islamic banks.^[51]

47) Government bonds are primarily issued in three-year maturities to Yemeni pension funds: the General Authority for Insurance and Pensions, the Pension Fund of the Security Sector, and the Pension Fund of the Military Sector. The nominal interest rate on government bonds was set at 10 percent in December 2012. By comparison, the treasury bills are short-term government debt instruments with maturities ranging from three months to one year and have a nominal interest rate of roughly 16 percent. Commercial banks held most of the outstanding treasury bills, with the remainder issued to pension funds, public and private institutions, and individuals.

48) Farea al-Muslimi, "Revitalizing Yemen's Banking Sector: Necessary Steps for Restarting Formal Financial Cycles and Basic Economic Stabilization," Sana'a Center for Strategic Studies, February 15, 2019, <https://sanaacenter.org/publications/analysis/7049#:~:text=Facing%20Yemeni%20Banks-,Prolonged%20Liquidity%20Crisis,-Spurs%20Loss%20of>. Accessed March 8, 2022.

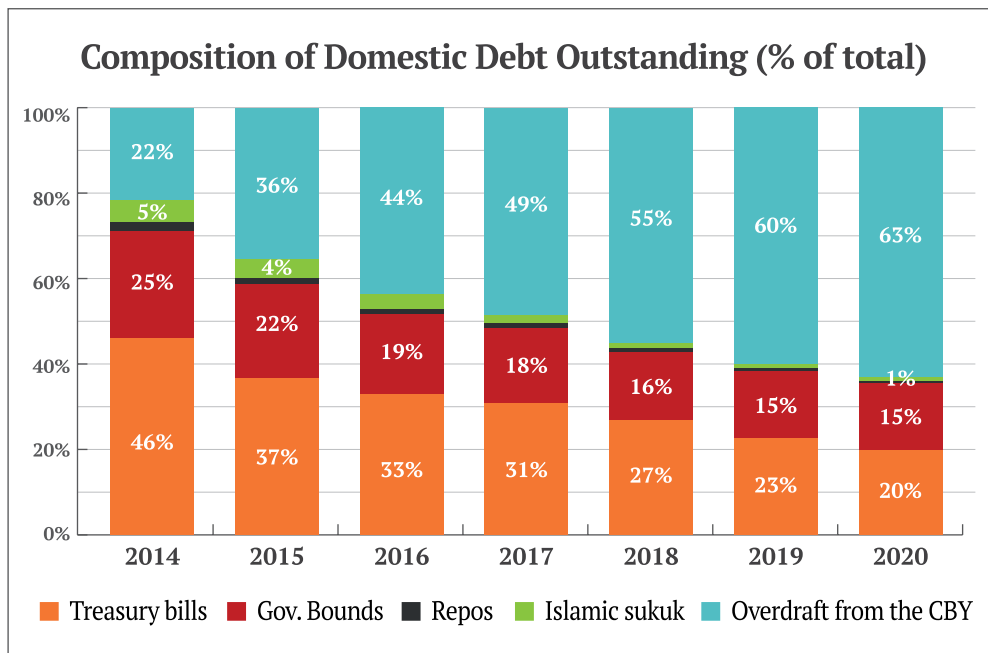
49) Sana'a Center Economic Unit estimates, May 2021

50) "Quarterly Bulletin Economic and Monetary Developments", Central Bank of Yemen (Aden), Issue No.3, February 2022, <https://www.cby-ye.com/files/626d802d63a84.pdf>. Accessed May 24, 2022.

51) "Economic Recovery & Livelihoods Program (ERLP) - Yemen, Quarterly Report, FY2021 Quarter 4 July 1 – September 30, 2021," USAID, November 9, 2021, p. 20, https://pdf.usaid.gov/pdf_docs/PA00Z39G.pdf. Accessed May 4, 2022.

By comparison, the total internal debt stock held by the CBY-Sana'a increased 23 percent from the end of 2016 to June 2019, from YR4.88 trillion to YR6.02 trillion.^[52] When the central bank was split in 2016 between Sana'a and Aden branches, the YR2.15 trillion the government had then owed to the bank continued to be managed by the CBY-Sana'a, a figure which increased to more than YR3 trillion by late 2020 through lending to the de facto Houthi authorities.^[53]

The following graph shows how the stocks of each domestic debt instrument has developed and their respective share of the total domestic debt structure:



Source: Ministry of Planning & International Cooperation^[54]

52) “Macroeconomic Developments,” Ministry of Planning & International Cooperation, Yemen Socio-Economic Update, Issue 44, August 2019, https://reliefweb.int/sites/reliefweb.int/files/resources/YSEU44_English_final.pdf. Accessed March 8, 2022.

53) According to the Sana'a-based Ministry of Planning and International Cooperation, the total internal debt stock held by the CBY-Sana'a increased by YR1.14 trillion from when the central bank split in 2016 to June 2019. While this figure was not broken down by creditor, given the severe liquidity crisis in Houthi-controlled areas that has made public financing through treasury bills and government bonds difficult, it is likely that this increase was the result of CBY-Sana'a lending to the de facto authorities. Added to the YR2.15 trillion in government arrears prior to the central bank split and the lack of repayments since, total CBY-Sana'a lending to the de facto authorities had exceeded the amount of YR3 trillion by the end of 2020.

54) “Public Debt in Yemen ‘Debt Restructuring or Default’,” Ministry of Planning and International Cooperation, Yemen Socio-Economic Update, Issue 15, June 2016, https://reliefweb.int/sites/reliefweb.int/files/resources/YSEU15_%D9%90English_v6.pdf. Accessed May 24, 2022; “Macroeconomic Developments,” Ministry of Planning and International Cooperation, Yemen Socio-economic Update Issue 44, August, 2019. https://reliefweb.int/sites/reliefweb.int/files/resources/YSEU44_English_final.pdf. Accessed May 24, 2022; Sana'a Center Economic Unit data and estimates.

There is poor diversification among the holders of tradable domestic debt instruments, with treasury bill holders being narrowly concentrated within the banking sector and government bonds being held almost exclusively by public pension funds. Since 2017, almost no debt obligations have been paid, meaning the MoF, on whose behalf the central bank works, is now in default. Though the 16 percent nominal interest rate on treasury bills had enticed heavy investment from commercial banks, which bought up roughly 80 percent of the public treasury bills issued between 2010-2016,^[55] the real return on investment has since become negative due to the rapid currency devaluation and associated surge in inflation. Since late 2016, commercial banks have been essentially barred from liquidating the nominal value of their invested principals and denied regular interest rate payments, compounding the banking sector's liquidity crisis.

Investment in government bonds has come almost entirely from public pension funds, namely the General Authority for Insurance and Pensions (GAIP), the Pension Fund of the Security Sector, and the Pension Fund of the Military Sector. As of 2018, these institutions collectively held around 99 percent of government bond investments, with the GAIP alone holding 75 percent. In 2016, the GAIP invested about 95 percent of its YR736 billion pension assets in government bonds.^[56] Since early 2017, the GAIP has been almost entirely unable to collect proceeds due on government bond investments, thus leaving about 41 percent of its 124,000 retirees in Houthi-controlled areas without regular payments.^[57]

Claiming management over debt, both the government and Houthi authorities have adopted policies to freeze repayment of accumulated debt obligations and arrears, deepening the liquidity crisis of domestic debt holders. In August 2019, the CBY-Sana'a froze interest accumulation on treasury bills, thus bill holders (mostly commercial banks) lost the 16 percent annual accumulation on their investments and the opportunity to reinvest such. Similarly, in August 2019, the CBY-Sana'a took a decision to reset the interest rate due on government bonds held by public pension funds from 10 percent to zero.

55) "Public Debt in Yemen 'Debt Restructuring or Default'," Ministry of Planning & International Cooperation, Yemen Socio-Economic Update, Issue 15, June, 2016, https://reliefweb.int/sites/reliefweb.int/files/resources/YSEU15_English_v6.pdf. Accessed March 8, 2022.

56) OCHA, Humanitarian Bulletin Yemen, Issue 29, November 20, 2017, <https://reliefweb.int/report/yemen/yemen-humanitarian-bulletin-issue-29-20-november-2017-enar>. Accessed March 8, 2022.

57) Ibid.

In October 2018, and as an indicator of the public debt management schism, the CBY-Aden introduced new domestic debt instruments – such as certificate deposits (CDs), government bonds and wakala Islamic contracts – with higher interest rates than previous debt instruments.^[58] As of June 2021, however, the CBY-Aden had generated only YR100 billion in certificates of deposits and Wakalas deposits from Yemeni banks to assist in budget deficit financing.^[59]

The Major Drivers of Domestic Debt Increase

The conflict-related factors impacting the domestic debt have been numerous and profound. They include: the near shutdown of oil production; the large decline in global oil prices; the dramatic decline in non-oil tax revenues due to the widespread economic collapse; the freezing of external grants and loans, which had accounted for 15 percent^[60] of total state revenues in 2014; and continuously increased budget spending, leading to ballooning fiscal deficits.

Since April 2015, oil and gas production was virtually halted except for some limited production at the Safer field in Marib and Al-Masila basin in Hadramawt.^[61] This led to a dramatic decline of 60 percent in total state revenues and a 95 percent decline in hydrocarbon revenues in 2016 alone, compared to 2014.^[62] The gap between public revenues and spending grew by 163 percent between 2014 and 2015, from YR345 billion to YR908 billion, with 84 percent of this financed by drawing on CBY overdraft.

The fracturing of key economic institutions, such as the central bank and the MoF, between the belligerent parties fiercely intensified in late 2016, with each claiming its legitimacy over state resources and

58) The interest rate on certificate deposits (CDs) was increased by 10 percentage points to 27 percent, while the interest for government bonds and wakala Islamic contracts was increased to 17 percent and 25 percent, respectively.

59) “Economic Recovery & Livelihoods Program (ERLP) - Yemen, Quarterly Report, FY2021 Quarter 4 July 1 – September 30, 2021,” USAID, November 9, 2021, p. 20, https://pdf.usaid.gov/pdf_docs/PA00Z39G.pdf. Accessed May 4, 2022. For simplicity, in the graphs included in this paper, investments in certificate deposits (CDs) have been included in the outstanding balances of treasury bills, as CDs are reserved for banks, which are also the major investors in treasury bills.

60) “Public Debt in Yemen ‘Debt Restructuring or Default’,” Ministry of Planning & International Cooperation, Yemen Socio-Economic Update, Issue 15, June, 2016, https://reliefweb.int/sites/reliefweb.int/files/resources/YSEU15_English_v6.pdf. Accessed March 8, 2022.

61) “Yemen Economic Monitoring Brief- Winter 2019 - World Bank Group,” 14 Mar. 2019, <https://www.worldbank.org/en/country/yemen/publication/yemen-economic-monitoring-brief-winter-2019>. Accessed April 11, 2022.

62) Central bank statistics regarding state budget fiscal figures, 2016.

representation. This further impaired public debt sustainability, increased revenue leakage and inhibited official reporting of national public finance figures, including debt calculations.^[63]

It is thus difficult to obtain accurate figures reflecting the dramatic fiscal expansion of public spending inside the national consolidated budget. It is clear, however, that during the conflict combined public spending nearly doubled between 2016 and 2020 as both parties have added large numbers of new personnel to the public payrolls, particularly in the military and security apparatuses, which has caused expenses to balloon. In 2015, the domestic debt exceeded safe limits for the public budget as it was equivalent to almost 385 percent of public revenues and more than 200 percent of total public expenditures, respectively.^[64] The Sana'a Center Economic Unit estimates that in 2016 domestic debt interest obligations alone constituted 85 percent of the total revenues and 44 percent of the total public expenditures, reflecting the dire fiscal situation the public budget faces, even before taking external debt into account.

Over the course of conflict, both belligerent parties have had access to central bank overdraft to compensate for the dramatic drop in public revenues that has come in parallel with a dramatic expansion in spending, most in the form of increased military and security services payrolls.

Aggressive Monetary Financing of Fiscal Deficits

As the internationally recognized monetary authority for Yemen, the CBY-Aden has the exclusive right to order new rial banknotes from abroad (given that Yemen lacks domestic printers). Since early 2017, CBY-Aden has pursued a colossal expansion of the monetary base to offset government budget shortfalls, printing close to YR3 trillion worth of new rial bills by the end of 2021. For context, in the two decades preceding the conflict the CBY had issued into circulation YR1.3 trillion worth of new currency bills.^[65] The expansionary monetary policy has

63) The CBY and MoF operating from Aden, the interim capital of the internationally recognized government, have retained control over remaining oil production and revenues; meanwhile, the rival CBY and MoF branches operating under the de facto Houthi authorities in Sana'a have maintained extensive control over the country's major non-oil revenues, in particular public taxes, state financial systems, and major economic activities.

64) "Public Debt in Yemen 'Debt Restructuring or Default'," Ministry of Planning & International Cooperation, Yemen Socio-Economic Update, Issue 15, June, 2016, https://reliefweb.int/sites/reliefweb.int/files/resources/YSEU15_English_v6.pdf. Accessed March 8, 2022.

65) "Too Many Rials, Too Few Dollars," in "The Graveyard of Hubris – Yemen Annual Review 2021," Sana'a Center for Strategic Studies, March 3, 2022, https://sanaacenter.org/publications/the-yemen-review/16768#too_many_rials. Accessed March 8, 2022.

been one of the critical factors driving rial depreciation in government-controlled areas. This has driven rapid inflation, eroded consumer purchasing power and led to a deterioration in living standards and the humanitarian situation.

The exchange rate has remained stable in Houthi-controlled areas since early 2020 due to the inherently limited supply of 'old' banknotes circulating in the market – and indeed the supply is shrinking as the bills wear out over time and become unusable – and the strictly-enforced ban against the use of new rial banknotes printed by CBY-Aden. Nevertheless, the Sana'a Center estimates that CBY-Sana'a lending to Houthi de facto authorities has risen by over 31 percent from 2017 to 2020, from YR2.3 trillion to over YR3 trillion as previously indicated, through the drawing down on the deposits in accounts, of both public and private institutions, held at the central bank.

FOREIGN DEBT STRUCTURE, TRENDS, AND BURDENS

In 2015, the CBY's largest source of foreign currency, oil exports, effectively ceased. Compounding this, external grants and loans declined sharply by 93.5 percent to roughly \$94.1 million, relative to 2014.^[66] Running out of sufficient foreign reserve stocks, the CBY experienced major difficulties in continuing debt servicing on behalf of the government. In 2015, some US\$351 million was disbursed to service external debts (interests and principals), which fell by two-thirds the following year,^[67] and since then almost all debt servicing has been either missed or delayed. Only US\$230 million in foreign obligations has been paid since the CBY headquarters was relocated to Aden, with the International Development Association (IDA) the sole recipient.^[68] This has placed the country in default, weakened its creditworthiness internationally and thus prevented it from borrowing further from abroad.

Complicating matters, the country's Debt Management and Financial Analysis System (DMFAS) foreign debt database, and original external debt document agreements, are still held by the CBY-Sana'a, which has refused to share the data with the CBY-Aden, even while the latter is responsible for managing foreign debt and debt servicing payments. To address this lack of detail on Yemen's external debt, the Yemeni government formed a working group that includes representatives of the CBY-Aden, the Ministry of Finance and the Ministry of Planning and International Cooperation, and is supported by experts from the Pragma Corp and financed by the USAID and UK Aid, to collect data from lenders and to help restart DMFAS debt management system.^[69]

From a numerical standpoint, Yemen's external debt is relatively low compared to other countries in the Middle East and North Africa, and is mostly based on concessional terms. The absolute value of external debt was stable at less than US\$7 billion from the beginning of the

66) "Public Debt in Yemen 'Debt Restructuring or Default'," Ministry of Planning & International Cooperation, Yemen Socio-Economic Update, Issue 15, June, 2016, https://reliefweb.int/sites/reliefweb.int/files/resources/YSEU15_English_v6.pdf. Accessed March 8, 2022.

67) Ibid.

68) "Economic Recovery & Livelihoods Program (ERLP) - Yemen, Quarterly Report, FY2021 Quarter 4 July 1 – September 30, 2021," USAID, November 9, 2021, p. 20, https://pdf.usaid.gov/pdf_docs/PA00Z39G.pdf. Accessed May 4, 2022.

69) "Economic Recovery & Livelihoods Program (ERLP) - Yemen, Quarterly Report, FY2021 Quarter 4 July 1 – September 30, 2021," USAID, November 9, 2021, p. 20, https://pdf.usaid.gov/pdf_docs/PA00Z39G.pdf. Accessed May 4, 2022.

conflict until 2017, increasing only in 2018 with the US\$2 billion Saudi deposit to CBY-Aden. As of 2020, Yemen's foreign debt stood at close to US\$8.8 billion. However, when measured relative to national economic output the external debt-to-GDP ratio has more than tripled between 2015 and 2020. General economic collapse and the depreciation of the national currency have been the major factors that have propelled Yemen's external debt-to-GDP ratio from 22 percent in 2014 to 77 percent in June 2019.^[70]

In 2020, around 18 percent of Yemen's foreign debt was owed to Paris Club countries and 46 percent to non-Paris Club countries.^[71] The remaining portion (nearly 36 percent) was owed to regional and international development organizations, with the IDA holding about half (18 percent) of this debt stock.^[72] Saudi Arabia is Yemen's largest bilateral creditor, holding around 39 percent of Yemen's external debt outside Non-Paris Club countries.^[73] Russia is the largest creditor among Paris Club countries, holding around 72 percent of the debt owed to the Paris Club, or almost 13 percent of Yemen's total foreign debt.^[74]

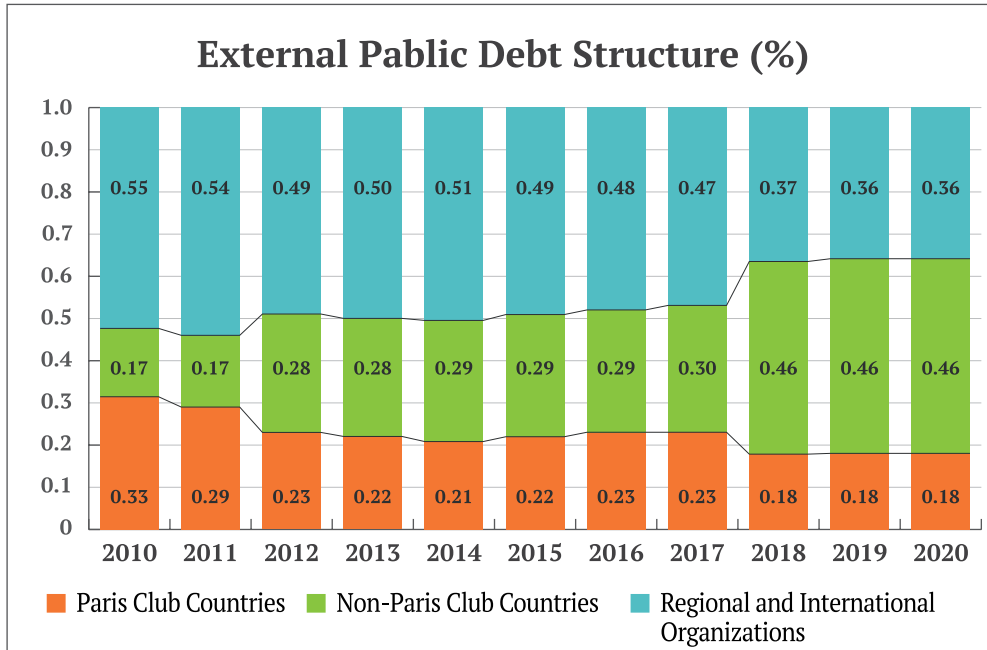
70) "Macroeconomic Developments," Ministry of Planning & International Cooperation, Yemen Socio-Economic Update, Issue 44, August 2019, https://reliefweb.int/sites/reliefweb.int/files/resources/YSEU44_English_final.pdf. Accessed March 8, 2022.

71) According to Sana'a Center Economic Unit estimates as well as "Public Debt in Yemen 'Debt Restructuring or Default'," Ministry of Planning & International Cooperation, Yemen Socio-Economic Update, Issue 15, June, 2016, https://reliefweb.int/sites/reliefweb.int/files/resources/YSEU15_English_v6.pdf. Accessed March 8, 2022, and "Economic Recovery & Livelihoods Program (ERLP) - Yemen, Quarterly Report, FY2021 Quarter 4 July 1 – September 30, 2021," USAID, November 9, 2021, p. 20, https://pdf.usaid.gov/pdf_docs/PA00Z39G.pdf. Accessed May 4, 2022.

72) Ibid.

73) In 2012, Yemen had a total external debt of US\$7.2 billion. Of this debt, US\$1.2 billion was owed to Russia and US\$1.4 billion owed to Saudi Arabia including a \$1 billion Saudi deposit made available to CBY in August 2012 (<https://www.imf.org/external/pubs/ft/scr/2013/cr13246.pdf>). In 2018, the CBY also received another \$2 billion Saudi deposit and this has made Saudi Arabia the largest creditor to Yemen with close to \$3.4 billion in debt, thus representing 39% of Yemen's US\$8.8 billion in total external debt stock.

74) Ibid.



Sources: Ministry of Planning & International Cooperation,^[75] Sana'a Center Economic Unit

Vulnerabilities and debt sustainability challenges remain high in the wake of prolonged economic collapse. Left on its own, Yemen will struggle to repay its foreign obligations without the restoration of large-scale oil exports, given the depreciation of the Yemeni rial and the lack of viable options beyond energy resources to boost the country's exports and build its foreign currency reserves.

Historically, Yemen has considerable experience in restructuring foreign debt with creditors, in particular Russia. In 1998, Yemen was able to cancel 80 percent of its debt to Russia, accounting for 60 percent of Yemen's foreign indebtedness, while having the other remaining 20 percent paid on Naples Terms.^[76] Yemen's success in having its debt to Russia reduced from US\$5.9 billion in 1995 to close to US\$1 billion today bodes well for future potential debt forgiveness negotiations with external creditors.^[77]

75) "Public Finance Developments in Yemen", Ministry of Planning and International Cooperation, Yemen Socio-economic Update Issue 12, March 2016, https://reliefweb.int/sites/reliefweb.int/files/resources/yseu12_english_v4_final.pdf. Accessed May 24, 2022; According to Sana'a Center Economic Unit estimates as well as "Public Debt in Yemen 'Debt Restructuring or Default'", Ministry of Planning & International Cooperation, Yemen Socio-Economic Update, Issue 15, June, 2016, https://reliefweb.int/sites/reliefweb.int/files/resources/YSEU15_English_v6.pdf. Accessed March 8, 2022; "Macroeconomic Developments," Ministry of Planning & International Cooperation, Yemen Socio-Economic Update, Issue 44, August 2019, https://reliefweb.int/sites/reliefweb.int/files/resources/YSEU44_English_final.pdf. Accessed March 8, 2022.

76) "Poverty Reduction Strategy Paper (PRSP) 2003-2005," IMF/Republic of Yemen, May 31, 2002, <https://www.imf.org/External/NP/prsp/2002/yem/01/053102.pdf>. Accessed March 8, 2022.

77) CBY internal database regarding the stock of external debt outstanding over the period 1995-2010.

More recently, Yemen benefited from the IMF's COVID-19-related Catastrophe Containment and Relief Trust (CCRT), under which Yemen received US\$42.45 million worth of debt service relief between April 2020 and October 2021. Yemen also benefited from the Debt Service Suspension Initiative (DSSI), endorsed by G20 nations. Under this Initiative, Paris Club creditor countries agreed to provide the Yemeni government with a time-bound suspension of debt servicing from May 1 to December 31, 2020, which was later extended through December 31, 2021. The Yemeni government also signed bilateral agreements with some Paris Club creditors, and others, including Italy, France, the United States and Kuwaiti Fund for Arab Economic Development, to suspend debt service payments and set a new payment schedule starting in June 2022.^[78] All of above-mentioned examples indicate that the Yemeni government has negotiated with the external creditors to provide debt service relief through debt restructuring and rescheduling.

Yemen's public external debt stock is moderate and overwhelmingly concessional in nature due to its limited access to non-concessional borrowing. Also, it is almost completely owed to bilateral creditors (sovereign countries) or to multilateral creditors such as international institutions, regional funds and organizations. Thus, the best option for Yemen during the conflict is to continue negotiations with potential external creditors to secure further debt relief agreements for postponing the payment of debt obligations. With nearly 63 percent of Yemen's current external debt outstanding borrowed from official bilateral creditors (i.e. other countries) as of 2020,^[79] Yemen could benefit from a potential series of debt rescheduling arrangements in a post-conflict setting, either under Paris Club terms or through any bilateral agreements to waive debt burdens. Debt relief on a bilateral basis is handled directly through negotiations between the creditor and the borrower. For example, Yemen could be forgiven from paying most of the \$3.4 billion in debt owed to Saudi Arabia as part of its financing share to reconstruct Yemen after the conflict.

78) Ibid.

79) Sana'a Center Economic Unit estimates for the year 2020 based on the fact that the only significant change in the stock of outstanding external debt was the \$2 billion Saudi deposit at the CBY-Aden in 2018, which thus increased the share of official bilateral creditors in Yemen's external debt by the same amount.

RECOMMENDATIONS

Priorities during the conflict

- Strengthen domestic debt management and implement a well-focused analysis of domestic debt to develop a strategy to contain its build-up and negative implications for macroeconomic stability. To this end, a special committee should be formed to bring together fiscal and monetary specialists from Sana'a and Aden, together with representatives from private sector financial institutions, to exchange data on existing domestic debt and suggest a plan for servicing domestic debt payments, while limiting any inflationary measures. Any measures to address domestic debt should aim to restore confidence in the banking and financial system in the country.
- To make this feasible, the CBY-Aden and the MoF should improve the level of coordination and integration among fiscal and monetary policies. The Yemeni government should gradually reduce its dependence on central bank financing (new rial printing) for budget financing, as this monetary expansion in the current environment will invariably contribute to inflation, rial exchange rate depreciation, and carries a multitude of macroeconomic risks.
- It would be unrealistic during the conflict for the CBY-Aden to adhere to the legal limits of its direct overdraft financing to the government, established under law No. 14 of 2000. However, alternative debt policy options should be explored to effectively manage and contain the outstanding overdraft. One viable option is to restructure the outstanding government debt accumulated in the CBY overdraft account by converting it into a long-term debt instrument.
- The Yemeni government should increase its fiscal capacity and develop effective mechanisms to mobilize due public resources including taxes, customs fees, electricity bills, etc., and adopt strict contractionary policies to reduce recurrent and unnecessary public spending, and foster the restoration of crude oil and gas production and exports to generate additional revenues and help eliminate further accumulation of inflationary debt financing burdens.
- The fiscal and monetary institutions that are split between the parties during the conflict should refrain from the introduction and institutionalization of new legal arrangements and decrees that change the legal framework of domestic debt securities established prior to the conflict, or undertake other policies that would make repayment of these debt securities more complex, as this would compound the liquidity crisis facing debt holders (primarily banks and pension funds).

- International stakeholders should investigate possible ways to support the reunification of Yemen public debt management through encouraging coordination among the monetary and public finance institutions in Sana'a and Aden, and providing both sides with technical assistance to strengthen the debt management function and help mitigate any adoption of conflicting public debt financing options and policies in the country.
- Implement debt relief arrangements with local creditors to reschedule the repayment of domestic debt securities (treasury bills and government bonds) through lengthening debt maturities. Local debt creditors should be granted fair access to cash stocks on limited amounts of interest due on the principals of the domestic debt securities they hold in order to help relieve their liquidity crisis and increase their credibility in the market. In the meantime, the Yemeni government should foster the establishment of an effective mechanism to mobilize additional debt financing at acceptable and less costly fiscal terms.
- The Yemeni government should continue its existing efforts to negotiate with external debt creditors for debt service relief. This should be through suspending the debt service payments of loans and setting a new payment schedule, incorporating terms and conditions that effectively reflect the financial constraints already faced by the Yemeni government to relieve pressure on the public budget over the short term while ensuring long term debt sustainability. This should involve creating a regulated mechanism to allocate sufficient foreign currency funds to repay necessary external debt installments and obligations on a regular basis. This would be critical to restore the trust of external debt creditors and maximize the chances of securing foreign currency loans from potential creditors.

Post-Conflict Priorities

- The Yemeni government should continue exploring options to minimize external debt servicing burdens through negotiating the possibility of debt forgiveness with external creditors, or seek debt restructuring that involves lengthening the maturities, lowering interest rates, or reducing the nominal value of the old debts.
- Study the feasibility of converting the banking sector-dominated treasury bills into longer-term financing debt tools. This should be implemented in parallel with constructive efforts to address the liquidity crisis in the banking system through granting commercial banks regular and adequate access to cash stocks to increase the credibility of their operations and provide finance to private sector creditors. Future strategic plans should foster the issuance of new public debt instruments to attract the financial assets of the banking sector and allocate them to support development-oriented projects.
- Foster the establishment of an independent national commission for managing the public debt. The new commission should foster alternative options to manage the existing debt obligations and lay down foundations for issuing, regularizing and managing public debt in a post-conflict setting.
- Hand over central government debt management activities and debt-related functions from the CBY to the envisioned commission or to the MoF. While the CBY has been responsible for recording and executing all debt transactions, the future institutional setup should clearly distinguish debt management objectives from monetary policy implementation.
- Strengthen governance capacity through a comprehensive legal framework to regulate various aspects and functions of public debt management. Parliament should pass legislation to regulate and contain the accumulation of domestic government debt.
- Formulate a strategy to manage public debt structure, reduce the cost of borrowing and maximize additional benefits through considering a broader range of creditors and borrowing terms.

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