



CHATHAM HOUSE

Chatham House, 10 St James's Square, London SW1Y 4LE
T: +44 (0)20 7957 5700 E: contact@chathamhouse.org.uk
F: +44 (0)20 7957 5710 www.chathamhouse.org.uk
Charity Registration Number: 208223

Middle East and North Africa Programme Meeting Summary

Tipping the Balance: A Regional Approach to Yemen's Economic Challenges

May 2010

The views expressed in this document are the sole responsibility of the author(s) and do not necessarily reflect the view of Chatham House, its staff, associates or Council. Chatham House is independent and owes no allegiance to any government or to any political body. It does not take institutional positions on policy issues. This document is issued on the understanding that if any extract is used, the author(s) and Chatham House should be credited, preferably with the date of the publication or details of the event. Where this document refers to or reports statements made by speakers at an event every effort has been made to provide a fair representation of their views and opinions, but the ultimate responsibility for accuracy lies with this document's author(s).

Introduction

This paper summarizes the discussion at a workshop held in Doha, Qatar in May 2010, organized by the Chatham House Yemen Forum and Brookings Center Doha. The purpose of the meeting was to discuss Yemen's combined economic challenges, including fiscal stability, aid disbursement, inward investment and labour market access for Yemeni workers. The participants examined whether a regional response, on top of existing efforts, would be beneficial in meeting these challenges, and if so, what form it would take.

The event was split into two sessions. The first session considered 'the fundamentals', looking at the current state of Yemen's fiscal stability, the depreciation of the riyal and the future for investment, and the second session looked at options for 'multilateralism and bilateralism' and the regional framework for addressing aid and security.

Key themes that emerged from the workshop:

- Yemen faces a deteriorating fiscal situation and current management techniques are unsustainable. Currency devaluation is contributing to high food prices
- There are no legal barriers to Yemeni employment in the GCC - GCC labour markets rely on private sector supply-and-demand mechanisms
- GCC donors are signalling a willingness to consider new spending priorities for their aid pledges, and considering the option of establishing a country co-ordination office in Yemen

The meeting was held under the Chatham House Rule and the views expressed are those of the participants. The following summary is intended to serve as an aide memoire to those who took part and to provide a general summary of discussions for those who did not.

The Chatham House Rule:

"When a meeting, or part thereof, is held under the Chatham House Rule, participants are free to use the information received, but neither the identity nor the affiliation of the speaker(s), nor that of any other participant, may be revealed".

ECONOMIC CHALLENGES

Depreciation of the Riyal

The current fiscal situation in Yemen is severe. There has been a significant depreciation of the riyal, most sharply in the past year where it declined by a total of 12%. This depreciation has occurred despite the Yemeni authorities' active intervention to support the riyal, a policy that had kept the exchange rate constant for the previous two and a half years at around 200 riyals to the dollar.

The depreciation of riyal follows both long-term pressures and short-term shock. The decline in oil production and prices has contributed to the long-term pressures, causing Yemen's current account to move into deficit (the IMF has predicted, however, that this will improve in 2011). The short-term pressure is the huge budget deficit, which currently stands at \$2.5 billion, a record 9% of GDP. Yemen is unable to access international capital markets so the government is currently funding this deficit by borrowing from the central bank and selling its foreign exchange reserves, but this cannot continue indefinitely.

The Impossible Trinity

Yemen has come up against the 'impossible trinity', which states that that a country cannot have a fixed (or managed) exchange rate, free capital movement and an independent monetary policy at the same time. By borrowing from the central bank, the government is essentially trying to increase the money supply. This violates the impossible trinity, and has forced the government to carry out a number of interventions to defend the riyal. The longer these extraordinary measures continue, the more Yemen risks the possibility of a speculative attack, contributing to further currency depreciation.

An alternative short-term measure includes financing for the deficit. However, the internal option for financing has already been exhausted, and will only lead to further depreciation of the riyal. Yemen is hopeful that international donors will step forward with direct budget support, giving ministers the time and space to address the underlying challenges. A proposed International Monetary Fund (IMF) programme aims to reduce expenditure by cutting diesel subsidies and increase revenue through the implementation of a

general sales tax, in return for support with balance of payments. The final terms of the IMF package are still under negotiation.

Food Security and Inflation

The consequences of the depreciation of the riyal are having a rippling effect across the economy. The impact is felt most sharply on rising import prices. This is particularly harmful to Yemen due to its high dependency on imported essentials, especially food staples. A lower value riyal quickly creates food price inflation, which has a significant impact on the poor.

Investment in Yemen

A further consequence of Yemen's current economic predicament is that it fails to create an attractive environment for investors. The depreciation of the riyal and the budget deficit are deterring private investment and 20% interest rates are strangling access to credit, as not many private firms will take up loans at this rate.

However, increased investment in Yemen could provide the cash injection that is needed to revive the economy and reduce unemployment. Currently investment in Yemen is very low on a global scale, although forecasting suggests this is likely to improve over the next decade. There are some major infrastructure investments projected, although spending is weighted towards the oil and gas sector and the planned projects do not necessarily reflect the needs of the country. For example, there is also a firm onus on luxury real estate development.

There are a multitude of issues that adversely affect the investment climate in Yemen, including security fears and perceptions of corruption. Other issues are more practical, such as the lack of a guaranteed return on investment, the lack of infrastructure and skilled labour, and problems with supply chain management.

Infrastructure, Poverty and the Qat Issue

Infrastructure in Yemen is inadequate, and the water crisis is critical. As a result of water depletion, agriculture is suffering. Poverty is endemic in Yemen: the numbers suggest that over half of the population live on less than \$2 per day. Similarly, there are three million students outside of schools, the

quality of education is poor and the gender disparity is getting worse not better.

Qat is also a potential barrier to investment, as it is seen to reduce the amount of time Yemenis are willing to work in a day. Revenue is going into buying qat rather than food, and, perhaps most importantly, it is a massive drain on the already strained water resources.

There is the appetite and drive in the public sector to confront these challenges, but there is a big gap between appetite and capacity.

SECURITY CHALLENGES

Perception versus Reality

While it is clear that economic challenges can be linked to security challenges, and vice versa, security threats are often exaggerated. The security situation is severe, but it is not as bad as it is being portrayed in the media. There is a risk that the perceived security threat will become a self-fulfilling prophecy, scaring off potential international investors and only worsening the situation. There are investors in Pakistan, Afghanistan and Iraq – why not Yemen?

This tendency towards fatalism needs to be tackled in order to encourage Yemen's investment prospects. The GCC states should view Yemen less as a security problem and more as a potential partner and future candidate for full integration.

The Regional View

The GCC states tend to view Yemen as a security problem, fearing the regional fall-out from a weak and failing state. Despite a contentious history, Saudi Arabia has shifted its position considerably since Yemen's unification in 1990. There is now high-level Saudi recognition of the urgent nature of Yemen's challenges, combined with Saudi Arabia's growing sense of its own vulnerability from al-Qaeda in the Arabian Peninsula (AQAP), which is headquartered in Yemen, as well as ongoing concerns about instability in the border province of Saada.

Saudi Arabia's anxiety about the potential over-spill from Yemen was demonstrated last year, when the Ministry of Defence deployed troops to the Yemeni border to quash incursions by the Saada rebels. There is now a semi-permanent military complex around the Saudi city of Najran and the Saudi population is being resettled away from the border area. Saudi Arabia is providing security advisers to the Yemeni government, as well as economic advisers.

In certain aspects, Yemen shares Saudi Arabia's assessment of its own internal security issues, such as the alleged link between the Saada rebels and Iran. However, this claim is inaccurate and blaming Iran for stoking the conflict in Saada is escaping responsibility. Yemen's government needs to look at internal identity politics and how it responds to the demands of its own people. Identity politics are central to the current internal security challenges.

The government should sponsor a genuine national dialogue to address identity-based grievances, encourage economic development and respond to demands for social justice.

THE ROLE OF THE GCC: BRIDGING THE GAP?

The Yemeni government is attempting to address all these challenges, but external help is undoubtedly needed. Yemen is calling strongly for its neighbours in the Gulf Cooperation Council (GCC) to offer support by providing short-term help to manage the fiscal crisis, opening their labour markets to Yemeni workers, helping with training and skills to equip Yemeni labourers, investing across Yemen's economy, encouraging further exploration for oil and opening their markets to Yemeni produce. In order to enable Yemeni goods to reach Saudi markets, it might be possible to consider a unilateral tariff cut to replace the current bilateral customs agreement.

Absorbing Yemeni Labour

Yemeni politicians and commentators repeatedly call for the GCC states to open their labour markets to Yemeni workers, but Yemen is already a full member of the GCC labour organisation. At present there are 800,000 legal Yemeni workers in Saudi Arabia and there is currently no rule prohibiting the employment of Yemeni workers in Saudi Arabia. It is a laissez faire market and arrangements can be made for any number, so long as there is demand.

The practical barriers to increased employment for Yemeni labourers, however, are four-fold:

- GCC labour markets are privately supplied, relying predominantly on Asian recruitment agents. GCC governments cannot force private employers to hire Yemeni workers over other nationalities. Any solution requires improved coordination between Yemeni recruitment agencies and GCC employers
- Many GCC states are trying to encourage the nationalisation of their own work force and there is a potential conflict of interest and resources in trying to improve a neighbouring work force at the same time. Despite this, Saudi has already played a substantial role in training Yemeni labour by building 19 technical schools
- There are widespread security concerns regarding Yemeni workers. As there is no centralised identification system in Yemen, it is hard for GCC employers to have confidence in current clearing and screening processes. I.e in the current system, if a Yemeni worker is deported for committing a crime, they are easily able to return under a different name.

- Finally, market conditions are not attractive. Very few Yemeni workers would accept \$100 a month for unskilled labour, which is the going rate in Saudi Arabia and the Gulf states. Skilled labour receives higher wages but there is a shortage of skilled labour in Yemen

Aid and Donor Relationships

The GCC sees its overall development approach to Yemen as fairly coordinated; the difficulties lie at the technical level between the bureaucrats. In the past, joint work has succeeded in mobilising resources and in 2006 a convincing package was prepared that generated an unprecedented amount of pledges. If those pledges had been dispersed, the average per capita in aid would have risen to \$56, which signifies a substantial increase. However, only a small percentage of these pledges have actually been dispersed.

The problem with aid in Yemen has three elements:

- The gap between desire of the GCC donors to help and the capacity of the Yemeni government ministries to deal with the aid
- An inability to design and choose projects that accurately reflect the greatest needs of the country
- The lack of effective communication and coordination between Yemen and the donors, and between the donors themselves

On the first point, there is a mismatch between the stringent requirements of the GCC donors and the capacity of the Yemeni government to handle aid. Recommendations for improved distribution go to the same government agencies in Yemen, who, in turn, are unable to implement them. At the same time, donors are unwilling to relax their own rules because they are concerned about corruption. The Yemeni government has called for the GCC donors to manage hands-on implementation of their own development projects but, so far, there has been little interest, partly attributed to fear of creating parallel delivery structures to existing government mechanisms.

On the second point, it is important for GCC donors to design and choose projects that accurately reflect the need of Yemenis, as opposed to large-scale projects that often stall and are difficult to implement. For example, Yemen needs more well-resourced community clinics, rather than state-of-the-art hospitals. The GCC has not previously been aware that other donors were expressing doubts about GCC-sponsored infrastructure projects, but communications within the donor community are steadily getting better. GCC

donors are signalling a willingness to consider new priorities – such as humanitarian aid and measures to address social sector issues, such as severe malnutrition – in the next round of decisions, which starts in July.

Thirdly, resolving this problem also requires improved communication between the GCC donors and the Yemeni government, as GCC donors have tended to defer to the Yemeni government's chosen priorities for spending development aid. GCC donors should not be shy of testing Yemen's priorities, in order to have a more candid discussion about the allocation of donor funds and improve the decision-making process. Yemen needs this openness; the government needs candid advice and real solutions.

A Collective Response?

Some Western analysts perceive problems with GCC policy-making, including consultation, strategic planning, implementation and follow up. Within the GCC as an institution, there is a tendency for member states to handle foreign policy on a bilateral basis. Key decision makers within the GCC states are seen to be pursuing divergent agendas, and there is a lack of practical integration to give substance to the notion of a collective response. These perceptions are not shared by GCC member states, who are currently considering the option of establishing a country co-ordination office in Yemen.

However, there is still great potential for policymakers to consult or empower Yemen experts within the GCC, and to foster an inclusive dialogue between these experts.

Final Thought: Friends of Yemen

The 'Friends of Yemen' process is designed to emphasise the importance of regional and international support for Yemen, while at the same time challenging Yemen to identify priorities and implement decisions. The Friends of Yemen working groups offer a space where the GCC and Western donors can voice concerns, and present an opportunity to build consensus around the response. This raises a number of interesting new possibilities. For example, the GCC donors have significant resources and an inclination to support infrastructure projects, while the Western donors bring valuable 'soft' skills to build capacity and deliver services. It may be possible to develop new delivery partnerships that combine these different approaches.

ABOUT THE ORGANISATIONS

Chatham House Yemen Forum

The Yemen Forum is part of the Middle East and North Africa Programme at Chatham House. It aims to raise awareness, stimulate debate, share expertise and support policy-makers and professionals addressing regional and transnational issues affecting stability and development in Yemen.

www.chathamhouse.org.uk/yemen

Brookings Doha Center

The Brookings Doha Center, a project of the Saban Center for Middle East Policy at Brookings, undertakes research on the socio-economic and geopolitical issues facing the Muslim world and encourages greater understanding between policy-makers in the United States and the Muslim world.

<http://www.brookings.edu/doha.aspx>