Policy Paper

Parallel Market & CBY Monitoring Role

Proposals and Solutions

Yemen- 2018

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Table of Contents

Summary

The paper discusses the parallel market and the role of the Central Bank of Yemen (CBY) in monitoring its performance and activities, and proposes a monitoring mechanism.

It describes the problem of the parallel market. It attempts to identify causes of its emergence, and determine its impact on the economic and fiscal aspects, and on the community at large, as a result of arbitrary exchange activities, and financing importation in ways that do not conform to regular banking practices. It seeks to determine the extent to which this phenomenon, together with other economic factors, contributes to depreciation of the local currency, increase of inflation rates, and the impact on the stable flow of imported goods into the country.

The paper proposes feasible alternatives to deal with the parallel market. These alternatives are aimed to reducing the negative parallel market impact on the economy. It also proposes a package of CBY actions in the short and long terms to ensure the banking sector abides by good practices and contributes positively to the local economy through reestablishing the monetary cycle in the banking sector, controlling cash supply, and attracting foreign capital. The paper concludes by proposing a mechanism to reduce the parallel market economic and fiscal effect, and suggesting methods of utilizing hard currency sources effectively.

Introduction

Parallel market is a widespread phenomenon, particularly in developing countries relying largely on imports. It has emerged in many developing countries due to arbitrary financial activities such as illegal speculative activities that evade government controls.

Money exchange businesses in Yemen have increased considerably during the war. The number of such businesses has risen to 1350 in 2018, compared to 600 in 2014, 565 in 2012, 517 in 2011. The number has increased by 161%. Of the 1350 exchange businesses, 800 are not licensed by the CBY.[1]

The parallel market, together with other economic factors, has contributed greatly to depreciation of the Yemeni rial (YER), through speculative activities which are not monitored by CBY. Such activities exploit the shortage of hard currency reserves in state coffers.

The parallel market, "represented by unlicensed exchange businesses and currency speculation," assume the banking sector role of financing imports of various goods and services through transfers without keeping records of such activities. Those transfers do not comply with anti-money laundering and counter-financing of terrorism laws, exposing the banking sector to pressure from foreign banks and financial institutions, and complicating the process of trade with other countries. All this takes place in the context of the current war and inefficient official monetary and fiscal policies.

This paper aims to characterize the problem and find possible solutions, and to examine the various alternatives to reduce the negative effects of the parallel market. It suggests feasible policies to control importation and to enforce foreign exchange law on those businesses, restoring the cash cycle to official channels, and controlling hard currency resources.

[1] “Economic Developments Newsletter,” Ministry of Planning and International Cooperation, no. 31, January 2018

Background and Causes

1. Political instability: This problem does not emerge overnight. Money exchange businesses have been operating under the prevailing laws for decades. The current war is has remarkably intensified parallel market activity in a way that violates the laws. Parallel markets often become vibrant in most poor developing countries which are characterized by instability, fragile governments, inefficient economic management, lawlessness, widespread corruption and social inequity. In each of the past decades, Yemen has experienced a war or a political crisis. According to the Worldwide Governance Indicators (WGI), which employs 6 indicators to measure government efficiency; namely voice and accountability, political stability, government effectiveness, regulatory quality, rule of law, and control of corruption. The report covers 213 countries.[2] Yemen is classified among countries which receive the lowest assessment. Between 1996 and 2016, Yemen score ranged between 0.48 points in 2016 and 14.2 points in 2000, in a scale ranging between 0 and 100 degrees. The higher the points, the greater the political and economic stability and vice versa.

[2] For more information, visit http://info.worldbank.org/governance/wgi/#home

2. Low foreign exchange reserves: the persistent in the balance of trade and the balance of payments deficit during the past years has contributed to state failure to build a substantial cash reserve that ensures uninterrupted flow of goods and services in case of hard currency shortages. Yemen has experienced a total deficit, mostly a trade deficit (increase of imports and decrease of exports). For example, the deficit reached $2.9 and $5.2 billion in 2013 and 2014, respectively. The deficit was due to inefficient fiscal policies and the fundamental distortions in the financial structure. Hard currency resources were concentrated in oil and gas exports, [3] which accounted for 90.6% and 82.8% of total exports in 2010 and 2014, respectively. Interruption of this sector means creating a huge hard currency crisis, and this has already occurred as a result of the cessation of oil exports. The only sources of hard currency were migrants' remittances, grants and aid, representing about 31.2% of the total foreign currency resources as of 2014.

> **<u>Impact of Parallel market on the various sectors</u>**
>
> The parallel market impact was not restricted to the banking sector, but also affected economic and social sectors.
>
> **Commercial Sector**
>
> This sector suffered price fluctuations and unabated depreciation of the YER. Several businesses and importers declared bankruptcy due to failure to cope with the parallel market speculation activities. Losses are also incurred by this sector due to high import costs, extra taxes, and high freight and transport costs.
>
> Capital migrated abroad mainly due to political instability and insecure environment. Capital flourishes in stable banking sector environments to guarantee financing of projects.
>
> **Society**
>
> Inflation rates have persistently risen. According to SEMC Report, inflation rate exceeded 72% in 2017, compared to 2014.[1]

3. Inconsistent fiscal policies, mainly injecting foreign currency to the market to maintain stable exchange rates, have contributed to the expansion of the parallel market and the depletion of cash reserves. In 2015 and 2016, CBY injected an estimated $1 billion which alleviated deterioration in the short term, but failed to take into account ling-term effects. Intervention policies have proved a failure in several countries which much better off than

[3] CBY Reports, 2010-2014

Yemen. For example, the Egyptian experience in 2016 and 2017 only resulted in further depreciation of the Egyptian Pound.

4. Increasing cash supply outside the banks: Yemen has suffered from parallel market for exchange outside the banking sector. Low banking awareness of the people who prefer having their savings in cash rather than bank deposits has contributed to the flourishing of parallel market. Foreign currency circulated outside the banking network accounted for 95.9% in 2010, compared to 94.8% in 2014. The figure has reached YER 810.9 billion, in addition to the recently minted YER 1.4 trillion received recently by CBY. The proportion of currency speculation outside the banking network may exceed 95%, leading to further depreciation of the YER. CBY recent decision to issue certificates of deposit without taking any effective measures to rebuild confidence of depositors in local banks will not yield significant results in absorbing liquidity and reducing inflation. The difference rate in the ratio of currency circulated outside the banking network between 2010 and 2014 was merely 1.1% in spite of the recurrent issues of treasury bills and government bonds. These policies did not work. Instead, internal public debt inflated from YER 1264.9 billion in 2010 to YER 3100 billion, with an increase of 145%.[4]
5. Suspension of import transfers in US dollar by local banks because of the credit classification of the country as a conflict zone, with high risks of money laundering and terrorist financing. This measure increased the share of the parallel market, and facilitated payments in different methods at the expense of the share of local banks in financing imports, in spite of the fact that bank transfers are the most preferred method of payment for many importers. Documentary credits decreased by 76.9% between 2013 and 2016, declining from YER 77.5 billion in 2013 to YER 17.9 billion in 2016. This indicates the expansion of the parallel market at the expense of the banking sector.[5]
6. Insufficient attention to migrants' remittances as an important factor in the development process: this resource is leaked to parallel market and unlicensed exchange businesses. Migrants' remittances are an important economic resource, especially in developing countries like Yemen. Remittances flow to developing countries are three times higher than official development aid.
7. The split of CBY has greatly affected its ability to control the banking market. No clear vision or effective mechanisms were developed for the post-split phase.

[4] Ibid.

[5] A Study of a Sample of Domestic Banks based on Financial Statements for the Year 2013 and 2016

Problem Description

When the war broke out in early 2015, the country had already been rocked by political unrest and intermittent armed conflicts. These developments have affected the various sectors. The financial and economic sector was particularly affected. With the outbreak of the war, exports of goods and services in general were interrupted. In 2014, export value stood at $7.9 billion, which accounted for 44% of the total foreign exchange resources, including oil exports that are estimated at $6.4 billion (36% of the total), according to CBY financial reports, 2014.[6]

A wave of fear and panic permeated the various sectors, especially financial institutions and businesses importing foreign goods and services, with an overwhelming feeling of an emerging foreign exchange crisis due to the suspension of those exports in a country importing 90% of its goods and services.[7]

Businessmen, importers and other individuals bought what they could of foreign currencies. Pressure on exchange rate started in the midst of reservation by banks and exchange businesses to sell foreign currency. Exchange rate in the parallel

Parallel Market Experiences

The Egyptian Experience

The parallel market distortions in Egypt led to depreciation of the Egyptian pound. The government tried to intervene by injecting foreign currency to the market to limit foreign exchange premium several times. This measure proved impractical. The government resorted to floating the currency, issuing government bonds in foreign currency and boosting its foreign currency reserves; besides suspending accessories imports and cutting down imports of some non-basic goods. These measures reduced depreciation of the Egyptian pound - at least as a matter of urgency - but more holistic fiscal measures had to be taken to fully tackle the problem.

The Sudanese Experience

The Sudanese government has dealt with parallel market premium during the past decades by passing strict legislation, imposing severe penalties that amounted to the death penalty against manipulators of exchange rates. It also resorted to minting a new currency, but this did not work well due to the peculiar case of the Sudan. Sudanese banks suffer isolation due to US-imposed. More recently, the government has tried to benefit from migrants' remittances through introducing a package of incentives to this vital sector.

The Moroccan Experience

Morocco is ranked third among Arab countries in terms of migrants' remittances which constitute 10% of its GDP. Morocco has fostered this resource by absorbing it through the banking sector and creating migrants' services.

[6] CBY Reports, 2014
[7] Ministry of Planning and International Cooperation Reports, January 2018

market escalated to YER 251/US dollar by the end of 2015. CBY intervened and injected foreign currency ($667 million) at different intervals in 2015, at an average of $55.5 million per month,[8] but such intervention failed to reduce parallel market premium, and meet the increasing demand for foreign exchange.

As the dollarization phenomenon proved persistent, purchase of foreign currencies outside the banking sector, and the increasing pace of withdrawing liquidity in local currency by banks while suspending exchange transactions, liquidity crisis began to emerge in early 2016. Liquidity in local banks declined by 50% between 2013 and 2016.

Leakage of local and foreign currency outside the banking sector, and the long position of some exchange businesses and speculators were among the main reasons for the emergence of the parallel market[9] in its current form. Businesses and speculators began to speculate in foreign currency, creating supply and demand outside the framework of laws governing the exchange market.

When CBY launched a campaign in coordination with the security apparatus and Public Prosecution to control exchange businesses which violated the law and withdraw

Malaysian Experience

Malaysia suffered from currency speculation in the 1990s. Malaysian President Mahathir Mohamad accused speculators of being responsible for the depreciation of the Malaysian ringgit, accurately characterizing the problem. Speculator demand for foreign currency led to depreciation of ringgit . He The Central Bank issued a circular to local banks and financial institutions to stop all exchange transactions from ringgit to foreign currency to control the speculator activities.

East Asian Experiences

A parallel market crisis emerged in East Asian countries in the 1990s, and led to depreciation of local currencies. Tackling this problem differed from one country to another. Some countries lost much of their foreign currency reserves because of their intervention, and some resorted to raising interest rates, but caused collapse of the stock market. Some governments floated local currency, and introduced multiple solutions such as austerity, regulating imports, and reducing government spending. IMF prescriptions were introduced in some countries, but proved a failure. What matters here is that identifying the problem may vary from one country to another and so do solutions. Moreover, ready-made prescriptions are impractical.

[8] Ibid.

[9] Parallel market in this paper means all speculators in foreign exchange, exchange businesses and individuals alike, in methods which violate Yemeni laws regulating the exchange market.

their licenses in accordance with Law No. 19 of 1995,[10] articles 21, 22, and 23, the parallel market had already disrupted the stable and smooth flow of goods and services into the country. It had thus affected community price controls. World Labor Group Report advised the government to facilitate financing basic food commodity imports. This requires supplying importers with cash and recovering CBY capacity to finance trade.[11]

There is a lack of effective investment alternatives that can attract capital and migrants' remittances, absorb liquidity in local and foreign currencies, and reduce leakage to the parallel market. Remittances constitute the second most important foreign exchange resource, and account for 15% of GDP.

Given the impacts of parallel market on the various economic aspects such as depreciation of the Yemeni rial, increase of inflation rates, deviation of foreign currency sources from formal channels, and difficulties with the flow of commodities into the country, it is imperative that feasible alternatives that can contribute to reducing the short- and long-term impacts of the parallel market are introduced.

[10] The Regulation of Exchange Transactions in Yemen Law is attached.

[11] The World Bank Group, Policy Memo no. 3, "Readiness of the Private Sector to Contribute to Reconstruction and Recovery in Yemen," May 2017.

Policy Alternatives

The paper presents alternatives consistent with its objective of finding solutions and appropriate proposals to reduce parallel market premium and recover CBY role in adopting coherent and secure monetary policies in the short and long terms. CBY can control the supply of local and foreign currencies, and develop foreign currency resources through exports and migrants' remittances. Alternatives are presented in the following sections.

Alternative # 1: Recovering the role of commercial banks in financing imports

Basic commodity imports represent 50%[12] of total imports. Instead of injecting foreign exchange into the parallel market through public auctions or intervention, all flows coming from these resources can be invested by injecting monetary flows into local banks and covering their assets abroad. A list of imported commodities may be developed and CBY shall guarantee uninterrupted imports of those commodities. CBY shall inject foreign currency to banks on a monthly basis to finance those imports. The sum can be around $100 million per month, and can be adjusted according to CBY estimates (as an intervention to stop currency depreciation). Importers shall be supplied with foreign currency through the banking network at lower rates than those of the parallel market (the rate has to be determined by CBY). Domestic banks shall comply with importation conditions and procedures, which are demonstrated in the following mechanism:

- Setting up a Crisis Management Unit (chaired by the Prime Minister) to manage monetary policies in partnership with the private sector, domestic banks and other relevant bodies such as the Ministry of Finance, and Ministry of Trade and Industry.
- Restricting imports of crucial commodities and services - classified into commodity groups or sectors such as medicine, medical supplies, electrical appliances, basic and non-basic food commodities, raw materials, etc. - through local banks (the proposed unit).
- Creating a portfolio of foreign currency cash flows that the CBY can benefit from. The portfolio shall be managed transparently by the proposed unit.
- The crisis management unit shall coordinate with the Humanitarian Support Center in Yemen to ensure that all foreign currency remittances are mediated by the CBY. CBY shall undertake to cover the needs of relief organizations with adequate liquidity in local and foreign currencies and in ways that are consistent with their mechanisms of distribution of aid. The bank shall not intervene with their methods of distribution. Liquidity will be provided through local banks or through the methods specified by those organizations in ways consistent with their activities.
- Importers will be supplied with hard currency through commercial banks at prices lower than the parallel market price or according to the fixed price determined by the CBY.
- The proposed unit shall determine the goods and services to be imported by the private sector. Banks will have to provide proof of such transactions upon the arrival of imported goods to Yemeni ports, including official bank statements, swift numbers or credit issued

[12] The World Bank Group Report, May 2017.

by the bank concerned, shipping policies and customs declaration. CBY shall undertake to transfer the same amounts to the concerned bank assets abroad.

- Foreign currency shall be supplied to importers by commercial banks in exchange for Yemeni rials in cash and the latter has to be deposited at CBY accounts at 1-2% rate to boost its assets, contribute to gradual recovery of clearing, and restore confidence in checks.
- CBY will re-inject that liquidity, along with the various state revenues, to the local market in the form of salaries, wages and operating activities. This will result in reviving the purchasing power in the local market. The monetary cycle is thus restored to official channels and subjected to official control.
- The goods and services received according to this mechanism shall be controlled at all land and sea ports. Bank statements and attached documents shall be delivered to the proposed unit, to ensure that importation is carried out according to the mechanism. (proposed unit)
- Prices of these commodities in local markets shall be monitored by offices of industry and commerce, chambers of commerce and local authorities to prevent manipulation of prices and protect consumers.
- Offering customs privileges and incentives to support imported goods and services according to the mechanism, and imposing customs on goods and services imported outside the banking network and those which are not included in the approved commodities list, such as fireworks and other non-basic luxuries at the present time. (Ministry of Finance)

Advantages of this Alternative:

1. Supplying importers with foreign currency for purposes of importing basic commodities at a lower rate than that of the parallel market will contribute significantly to unification of exchange rates and reduce depreciation of the Yemeni rial, as importers will go to banks instead of the parallel market, reducing demand for foreign exchange in the parallel market.
2. Concentration of imports of commodities in general and basic commodities in particular in the banking network will contribute to a stable flow of goods and services, and will enhance the share of the official banking sector in financing imports at the expense of the parallel market.
3. Reducing money supply (currency circulated outside the banking sector) will recover bank holdings of local currency liquidity, and will help local banks to finance the private sector and stimulate local investment in place of their present speculation activities.
4. This alternative will help CBY take effective monetary policies if the banking sector reclaims its role in controlling cash supply, financing imports and other functions.
5. This alternative will help break the isolation of the banking sector through reopening accounts of local banks at international financial institutions and resuming international transactions, if CBY succeeds in restoring control of trade transactions.

Prerequisites of success:

- An estimated sum of $1.7 billion, which is the value of international organizations annual humanitarian aid and relief (2015 and 2016 average).[13] We can assume that this average will apply in 2018 if it does not increase, as UN offices in Yemen tend to raise the amounts dedicated to humanitarian aid emergency response, allocating $1 billion to cover basic commodity and oil imports. Thus, $83.3 million per month will be dedicated to covering imports. (a renewable resource subject to adjustment). CBY shall undertake to supply local and foreign currency liquidity to the organizations in Yemen in line with their requirements at a rate determined by CBY in coordination with the donors. This measure will reduce YER depreciation and limit depletion of the Saudi deposit.
- Migrants' remittances estimated at $3.4 billion as of 2014 may be affected due to the nationalization of many jobs in Saudi Arabia, which embraces the vast majority of Yemeni migrants. These remittances account for about 70% of the sources on which local banks rely in covering their assets abroad at present. A mechanism coordinated by CBY and commercial banks to absorb remittances can reduce depreciation and help isolate the parallel market. (an important renewable resource)
- The $2 billion Saudi deposit at the CBY may cover imports in line with this mechanism for a period of approximately 20 months (fixed resource) in case CBY adjusts its procedures of covering basic commodity imports.
- The oil shipments exported intermittently will play a role in supporting and strengthening the mechanism.

This alternative allows importers to freely finance imports of other commodities according to current sources.

Alternative # 2: Controlling the Cash Supply

As cash is the backbone of exchange transactions, whoever controls the cash supply will be able to control exchange rates. Here lies the importance of the sound monetary policy to absorb excessive cash supply. Being the regulating authority of this process, CBY has a significant role to play in this respect, along with the government which is responsible for fiscal and trade policies. Integration of these monetary, financial and trade policies is the optimal alternative to control inflation. Instead of chasing currency speculators, the government must invest in the security aspect in areas free from military conflict to reestablish a safe investment environment. Such a course will accelerate production and stimulate financial resources. The following mechanism may be adopted:

Step 1: YER Cash Supply

- Issuing Islamic bonds at attractive profit rates. Islamic banks have a great capacity to attract deposits from the public. The purpose is to finance reconstruction projects and the operation of some important institutions, such as oil refineries and power plants, at attractive profit rates in both YER and foreign currencies.

[13] Ministry of Planning and International Cooperation publications, Jan 2018, p. 4.

- Raising the interest rate of deposits at CBY, provided that such deposits are in cash rather than existing balances. The rate shall be determined by the CBY and shall be reviewed periodically according to monetary developments and inflation rates.
- Issuing investment portfolios at attractive profit rates to finance early phase of reconstruction, in which the private sector shall play a vital role.
- Re-introducing electronic payment methods, which will significantly reduce the cash supply, especially with regard to salaries and other important services.

Step 2: Foreign Currency Cash Supply

- Accepting commercial bank foreign currency deposits at CBY which shall credit accounts of those banks abroad with the same. To do so, CBY may use the sources identified in the alternative no. 1 above. This will enable CBY to build a foreign currency stock that allows it to control exchange rates through re-intervention. Commercial banks and importers will be supplied with foreign currency - deposited in their CBY accounts rather than in cash – at exchange rates lower than those of the black market. Thus, CBY will absorb foreign exchange cash supply and at the same time supply commercial banks with foreign currency to cover oil and commodity imports.

This alternative will have a great potential of success in view of the package of decisions that shall be taken in a sequence to ensure CBY control of cash supply. Potential obstacles include CBY split between Sana'a and Aden, but the CBY in Aden has ripe opportunities to adopt those monetary policies with a substantial measure of success.

Alternative # 3: Attracting and investing migrants' remittances

This important resource can be invested in many ways. The most important of these is the establishment of a specialized bank to attract and invest migrants' savings. The bank shall be partly state-owned, while priority shall be given to licensed exchange businesses. Similar experiences have succeeded. The Moroccan experience has been the most prominent in this respect. It involved the establishment of different banks and networks with various financial institutions in the diaspora. This will contribute to absorbing a large portion of the local and foreign liquidity from the black market which exploits those flows in speculation, with no additional costs incurred by state budget.

Globally, in 2016, migrants' remittances to their countries of origin were estimated at $574 billion. Such remittances are important economic resources, especially in developing countries. Remittance flows to these countries more than tripled ODA, according to the World Bank 2016 report,[14] and tend to be more stable than other types of external capital flows, such as private investment or development assistance.

Egypt tops the list of Arab countries with $20 billion in remittances, followed by Lebanon ($8 billion), Morocco ($7.5 billion), Jordan ($4.4 billion), Yemen ($3.4 billion), Algeria ($2.1 billion), the West Bank and Gaza Strip ($2 billion), Tunisia ($1.9 billion), and Syria ($1.6 billion).

[14] http://www.pewglobal.org/interactives/remittance-map/

Yemen ranks fifth among the Arab countries in remittances, which puts it in a good position to capitalize on this important resource. Incentives shall be made to absorb remittance flows that can contribute to local development and commercial banks shall be motivated to introduce banking services that meet migrants' needs and channel their remittances through the banking sector, away from the parallel market and illegal channels.

This medium- and long-term alternative will have a high potential of success in enhancing the country's foreign exchange resources, contributing to gross domestic product and diversifying the revenue base of state budget.

Recommendations

All alternatives listed above can contribute to solving the parallel market problem in varying degrees of success in the short, medium and long terms. The first two alternatives applied together can provide short- and medium-term solutions to the parallel market problem. Recommendations may be summarized as follows:

- Monitoring the parallel market, imposing strict control procedures and using all deterrent methods to prevent currency speculation.
- Financing budget deficits by money creation should be avoided.
- Resuming oil and gas exports, and creating a safe environment for oil companies to enable them to resume activities in oil fields under government control.
- Reducing foreign currency expenditure, particularly public office expenditures.
- Creating stable and secure environments in provinces free from armed conflict to operate savings of individuals and businesses in real estate and local production rather than currency speculation. Absence of investment opportunities plays into the hands of the parallel market.

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