الوكالة الإسلامية الدولية للتصنيف
Islamic International Rating Agency

ECONOMIC & BANKING SECTOR OVERVIEW

People's Democratic Republic of Algeria

December, 2020

TRUST . TRANSPARENCY . INDEPENDENCE

Economic Overview

People's Democratic Republic of Algeria ('Algeria' or 'the country') is geographically the largest country in Africa. It is a member of African Union, the Arab League, OPEC, United Nations, Organisation of Islamic Corporation (OIC) and a founding member of Arab Maghreb Union.With a population of 43.4m and an estimated GDP of USD 173b , per capita GDP stood around USD ~4000in 2019.In July 2020, World Bank downgraded Algeria from an upper-middle-income country to a lower-middle-income country, one of only three countries to move to a lower income category in 2020 as Gross National Income per capita fell from $4,060 in 2018 to $3,970 in 2019.

Although consolidated fiscal wealth with high level of reserves, has provided support and economic sustainability during the lows of the oil cycle, the effects of depleting foreign exchange reserves, reduced government spending and in its aftermath, dwindling economic growth have been evident in recent years.Economic activity continued to slow down in 2019 due to various factors. Non-hydrocarbon sector activity retarded due to political uncertainty that lingered for most of the year. In addition, several business executives in various sectors have been investigated on account of corruption which led to disruption in corporate activity, due to sudden changes in management. Hydrocarbon sector activity was also impacted from political uncertainty as the delay in hydrocarbon law did not lead to higher production as initially expected and lower oil prices weighed on negatively.

As per the Algerian Statistics Institute, the economy grew 0.8% in the year 2019 and below 1.4% in the prior year. As the non-hydrocarbon GDP increased 2.4% though still lower than 3.3% in 2018, the hydrocarbon economy contracted by 4.9% (2018: -6.4%). Industrial activity was more robust, posting 4.3% (2018: 4.1%) growth, whereas trade segment (transportation, communication, tourism) posted 3.1% growth on top of 3.7% in 2018. Other services, mainly financial services and real estate decelerated to 1.8% growth from 2.7% in 2018.

In the ongoing year, the economy of Algeria will be severely strained by twin shocks being the spread of COVID-19 and the sharp decline in oil prices. The government announced its intention to lower current spending by 30% (8% of GDP or USD 15bn), while keeping wages intact and protecting health and education spending. To reduce business losses, a supplementary finance law has been drafted, which will incorporate measures to mitigate the economic impact of the virus. Within this context, payments of income taxes for individuals and enterprises were postponed.

For the current year, IMF foresees a GDP contraction of 5.2% because of declining oil production capacity and loss of export market share. In the year 2021, the economy is expected to post recovery with expected GDP growth above 6%.

In Q1'2020, GDP declined 3.9% compared to Q1'19 as hydrocarbon segment plummeted 13.4%, tradeable and nontradeable services registered annual declines of 2.8% and 1.6%, while the reduction in manufacturing industry segment was more muted at 0.5%. On the other hand, agriculture segment posted 2.3% increase YoY.

The hydrocarbon sector weighs heavily in exports as well as government revenues and has traditionally comprised about one-fifth of GDP on the average over five years. The current account deficit is high and estimated to remain stable at 9.6% of GDP during 2019. As oil prices have declined significantly during 2020 due to COVID-19, Algeria's exports are expected to get severely impacted. To manage the current account deficit, the government announced several measures to cut the import bill by USD10bn or 6% of GDP. The government has also imposed a ban on exports of several products, including food, medical and hygiene items. Consequently, the country's FCY reserves trended down to as low as USD60bn as of March 2020, denoting around 20 months of imports, compared to USD80bn at the end of 2018 and peak of USD194bn in 2014.In Q1'2020, trade deficit of Algeria registered at USD1.5bn up from USD1.2bn in Q1'19 as exports dropped 24.9% to USD7.6bn even as imports declined 19.5% to USD9.1bn.

The fiscal breakeven price of oil per barrel which was slightly over USD100 in the last couple of years is estimated to be around USD140 for Algeria in 2020. The fiscal deficit is also estimated to have increased to 9.3% of GDP during 2019 (2018: -6.9% of GDP) mainly because of lower hydrocarbon related revenues and delayed fiscal consolidation measures due to lingering political uncertainty. High fiscal dependence on hydrocarbon revenue is structural impediment to fiscal reforms, as these constituted around 44% of total government revenue during 2014-2017.

For the year 2020, the initial budget of the government foresaw a GDP growth of 1.8% and budget deficit of despite a plan of 9.2% reduction in fiscal spending. In an attempt to ease social pressure, the budget kept politically sensitive subsidies unchanged at 8.4% of GDP.

Budget deficit is expected to increase sharply to 20% as a proportion to GDP.On 4th of June 2020, a Supplementary Finance Law (SFL) was introduced which includes DZD70bn support to mitigate the impacts of Covid-19, around DZD30bn of which is allocated to the health sector, DZD20bn to people who became unemployed due to the Covid-19 and DZD11.5bn for transfers to lower income households. To adjust for the new low oil price environment, the SFL plans for a reduction in current and capital spending by 2.2% of 2019 GDP compared to the initial 2020 budget law.

Starting from June 2020, there has been an increase to the minimum wage in Algeria for the first time since 2012,having risen to DZD20k (around USD170) from DZD18k. In the same vein, income taxes onsalaries that are less than or equal to DZD30k were eliminated as of June.

With more than one-third of revenues generated by the hydrocarbon sector and much lower oil prices in the year 2020, budget revenues will be quite strained. Despite tax hikes, including an increase in the tax rate for the importation of services, weak growth is expected to have a negative impact on revenues. In addition, operating expenses, particularly the public sector wage bill, and social transfers is targetedto be maintained with savings to stem from restraints on capital investment spending. The deficit should continue to be mainly financed through domestic resources, but the use of non-standard financing (monetary creation) is expected to slow down in accordance with the 2020 Budget.

Following the resignation of former president Mr. Abdelziz Bouteflika in April 2019, the country held the presidential elections and Mr. AbdelmadjidTebboune became the new President.

In his statements in May 2020, President Mr. AbdelmadjidTebboune ruled out borrowing from IMF or other international institutions despiteeconomic challenges. The external debt of Algeria remains minimal corresponding to less than 2% of GDP while the domestic national debt as a proportion of GDP rose from 26% in 2017 to 45% in 2019.

Given the stable currency and lower energy prices, inflation remained muted at 2.0% in 2019 as against4.3% a year earlier. In the current year, annual inflation inched up to 3.0% as of June 2020 with food inflation remaining relatively muted at 1.7% and non-food inflation accelerating, led by clothing, health expenditure, and furniture segments with respective readings of 4.9%, 3.6%, and 3.5%.DZD has been relatively stable in the last few years, registering around 2% depreciation against USD in the 2017-2019 period. However, so far in 2020, DZD trended weaker in tandem with other emerging market currencies,losing around 8% against the USD.

In order to attract new investment, the 51/49 rule governing foreign investments was abolished in June 2020, while still being applicable to strategic sectors in the economy. Further economic reforms may be on the anvil to strengthen the external account, protect foreign exchange reserves and reinforce the banking sector with revitalized plans for beefing up the Islamic finance sector of the economy to galvanize the local economy into the formal sector.Government's "economic and social revival plan" aims at reducing reliance on the energy sector which accounts for 60% of the state budget and 93% of total export revenues. Measures were also recently taken to protect small businesses by allotting them financial aid worth DZD30,000 for a period of three months in order to weather the impact of the coronavirus pandemic on SMEs.

As per the latest official figures released by the National Statistics Institute in December 2019, the unemployment rate in Algeria reached 11.4% in May 2019, against 11.7% in September 2018, registering a decline of 0.3 point, with a substantial decline in male unemployment. The number of unemployed population was estimated at 1.45mn people against 1.46mn people last September. The labor force participation rate of the population aged 15 and over, reached 42.2%, registering a gain of 0.5%.

Banking Sector

Algerian Banking sector has been historically dominated by the public banks which commanded around 85%-90%of systemwide assets despite being fewer in number (6 out of 23 total). Public banks are specialized banks offering services to large-sized state-owned corporations, mainly from the oil & gas sectors, and other government priority areas of the economy such as agricultural development.

Interest rates have been relatively low, and the banking sector is well capitalized and profitable. Impairment levels have been high, but provisioning levels are satisfactory. In the current year, credit growth should be negatively impacted from weakness in domestic demand despite support from the lowering of the policy rate by the Bank ofAlgeria aswell as lower reserve requirement.The banking sector is expected to face headwinds in short to medium term mainly due to sharp contraction in economic activity which is likely to increase credit risk.

Total assets of the Banking Sector reached DZD16.2trn as of March 2019, denoting a 4.6% increase compared to December 2018, following yearly asset growth in 2018at 10.0%. Share of foreign borrowings quite minimal at 1.1% with share of FCY deposits in total deposits also being low at 5.4% as of March 2019. Total credits grew 3.3% in Q1'2019 following 12.4% growth in 2018.

The Central Bank raised the minimum paid in capital requirement for the banks to DZD20bn from DZD10bn in November 2018 and granted two years to comply with the regulation. Thus, the banks will have to adjust their capitals this year, if they fall below the regulatory minimum.

As per the IMF report , the Algerian Banking Sector had comfortable capital levels, CAR at 19.6% and tier1 ratio at 15.2%, and healthy profitability as indicated by return on average asset metric of 2.0% as of year-end 2017. Relatively high nonperformance levels pose risk with gross impairment levels of 12.3%. The main driver of the NPLs is the government's late payments to its suppliers as oil prices have been subdued since 2014. Banking Sector has applied the recommendations of BASEL II until now, whereas the Bank of Algeria'sguidelines on BASEL III implementation are limited and restricted to the periodic reporting of Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR).

Bank of Algeria lowered the reserve requirement ratio by 4pps to 6% while cutting the main policy rate by 50bps to 3.00% in March and April consecutively as proactive measures ata challenging macroeconomic juncture.The decline in reserve ratios are estimated to free up around DZD400bn in liquidity to the sector. The Central Bank also lowered the haircuts on government securities used in refinancing operations. We have observed that the Bank of Algeria has been adjusting the required reserve ratio proactively depending on the overall liquidity conditions in the market and had increased the ratio by 4pps in March 2019 as the liquidity conditions stabilized.

By Instruction no. 05-2020 of 6 April 2020 relating to exceptional measures to lighten prudential provisions applicable to banks and financial establishments, the Bank of Algeria took exceptional and cyclical measures to help businesses. Accordingly,at their discretion, banks and financial institutions can postpone the payment of loan instalments reaching maturity, or reschedule the debts of their customers who have been impacted by the crisis induced by Covid-19.In application of this measure, public and private banks may arrange the repayments of the credits they have granted to the affected companies in exceptional circumstances.Banks and financial institutions may also grant new loans to any borrower who has already benefited from these deferral or rescheduling measures. Within this perspective, the Professional Association of Banks and Financial Institutions instructed on 8 April 2020 the banks and financial institutions to consider the above instruction by taking the measures listed below:

I. Postpone and / or renew the maturities of loans due on 31 March 2020 and beyond;

II. Reschedule unpaid debts on 31 March and beyond;

III. Extend the time periods for loans and deferred payments;

IV. Eliminate late payment penalties for debts due on 31 March 2020 and beyond;

V. Maintain and / or renew working capital loans.

In addition, the Bank of Algeria announced further measures in April aimed at easing solvency, liquidity and NPLs related regulationsin banks. Accordingly, the liquidity ratio requirements werereducedto 60% from 100%;banks and financial institutions are exempt from the obligation to constitute the safety cushion (2.5%)relating to the capital adequacy levels.

Meanwhile, Bank of Algeria, has taken some measures regarding the fees charges by banks on March 2020, discontinuing fee charge on basic banking services, while at the same time determining the level of commissions to be charged on foreign trade transactions.These measures may impact the profitability of the sector negatively in the year 2020 onwards.

The key concern regarding the Algerian Banking Sector has been liquidity which is quite susceptible to the volatility of the oil prices. According to the statement of Bank of Algeria, liquidity in the system has declined to DZD917bn at the end of May 2020 from DZD 1,101bn at December 2019 and DZD1,557bn at the end of year 2018. We reckon that year-to-date decline in liquidity is despite DZD400bn liquidity relief provided by the Bank of Algeria via the decline in required reserve ratios which was not sufficient to balance out the system-wide liquidity crunch. The drop in liquidity will resultin reduced financings and higher cost of banking resources.

Overall, the Algerian Banking Sector is defined by sufficient capitalization and healthy profitability, which are mitigated by subpar asset quality and pressured liquidity which is highly linked to oil prices.Historically inadequate corporate governance standards are another factor weighing negatively on the sector.

…Participation Banking Sector

In the North African region, Algeria trails behind its neighboring countries. However, of late, the government has demonstrated heightened interest in the area. The industry is in early stages of development and the government has committed to introduce relevant regulations to establish a national Shari'a board.A regulation of the Bank of Algeria defining the operations relating to Islamic finance and the conditions for their exercise by banks and financial institutions, was published in the Official Journal No. 16 of March 24, 2020.

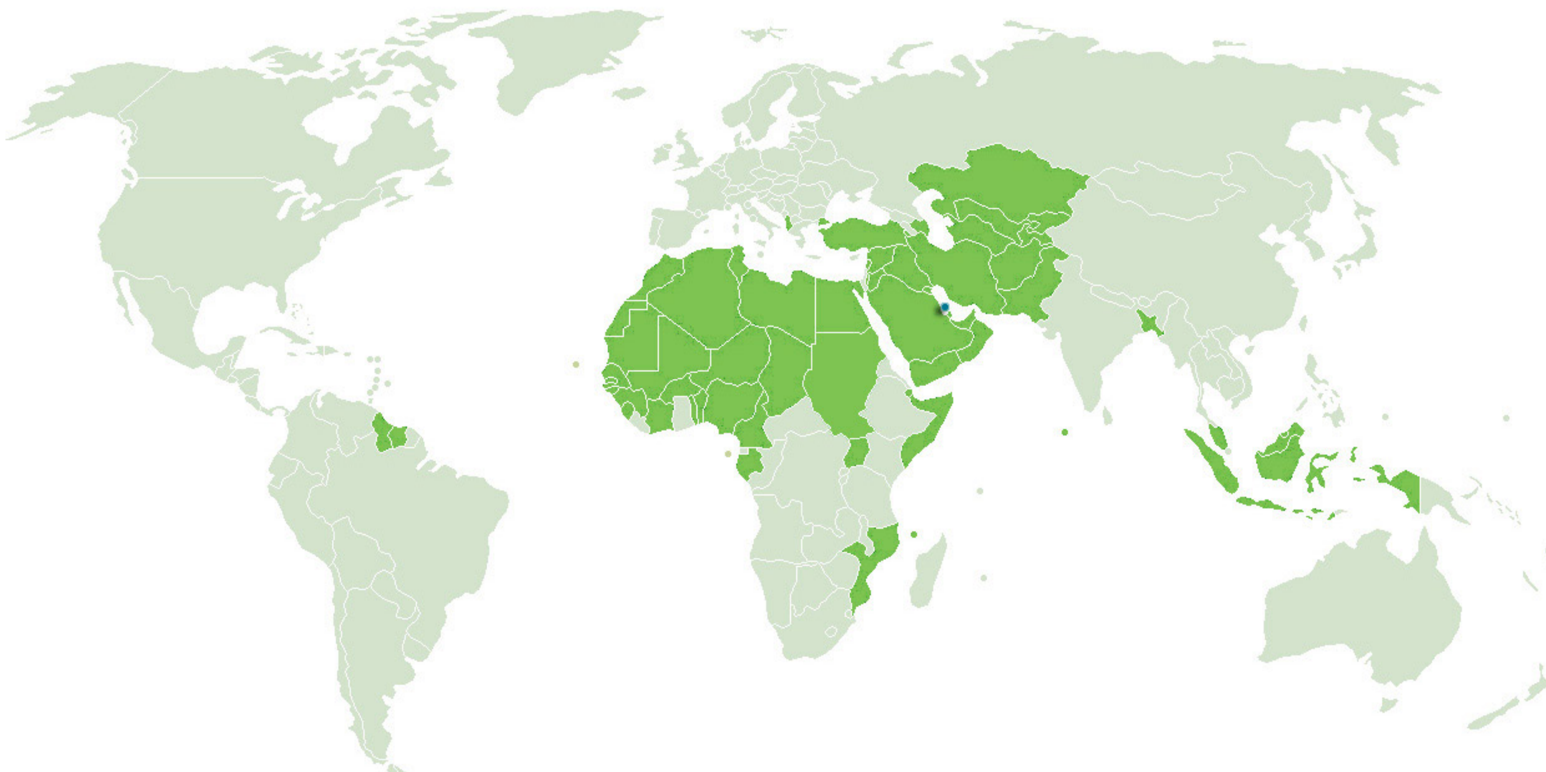
Banks or financial institution operating in the participation banking sphere need to set up a Sharia Supervisory Board of at least three members, appointed by the General Assembly. The goal of this board is particularly, to ensure conformance to the framework Shari'a compliant banking and products, and to control the activities of the bank.

To obtain authorization from the Bank of Algeria, the bank or financial institution must also clarify the procedures to be followed to ensure the administrative and financial independence of the "Islamic finance window" from the rest of the activities. The accounts of the Islamic finance window must be completely separate from the accounts of conventional segment of any bank or financial institution offering both services and products.The regulations also require banks and financial institutions that have obtained authorization to market Islamic finance products to inform their customers of specific conditions that apply.Depositors, in particular those holding investment accounts, must be informed of the risk and return expectations linked to the nature of their accounts, according to the regulations.

So far, provision of participation banking services has been limited to subsidiaries of Bahrainbased Al Baraka Bank and Al Salam Bank; these cumulatively hold close to ~2.5% of the market share, in terms of deposits. Islamic windows of conventional banks, such as Gulf Bank Algeria, Trust Bank, and Housing Bank also offer Islamic banking services. On July 2020, Minister of Finance stated that two state banks, Banque Nationaled'Algérie (BNA) et de la Banque de l'Agriculture et du développement rural (BADR), will introduce Shari'a compliant products starting from August as the process of obtaining fatwa from the High lslamic Council in the country, was concluded. BNA has commenced its Islamic finance activities on August 4th, 2020.The government hopes to attract savings to the banking system via expansion of Islamic windows. Opening of Islamic Banking windows in these two state banks shall help popularization of the concept of Islamic finance in the Country, increase the penetration rate of the banking system, increasing the opportunities for interbank placements within Islamic Banks and windows and generallyaccelerating the establishment of the Islamic finance ecosystem in the

In order to diversify its funding sources Algeria plans to issue sukuk and develop its relatively small stock exchange. If materialized, the sukuk issuance shall help the Islamic banks to utilize the surplus liquidity.

[5] *Liquid assets include investment deposits, sukuk, cash & cash equivalents and equities (subject to a 20% haircut)*



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