الوكالة الإسلامية الدولية للتصنيف
Islamic International Rating Agency

ECONOMIC & BANKING SECTOR OVERVIEW

People's Democratic Republic of Algeria

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ECONOMIC & SECTOR OVERVIEW - ALGERIA[1]

People's Democratic Republic of Algeria ('Algeria' or 'the country') is geographically the largest country in Africa. With a population of 41.5m and an estimated GDP of USD 170b , per capita GDP stood at USD ~4,033 in 2017.Algeria 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.

Table 1: Economic Indicators							
%	2014	2015	2016	2017	2018	2019F	2020F
Real GDP Growth Rate	3.8	3.7	3.2	1.4	1.5	2.7	1.8
Inflation (CPI year-end)	2.9	4.8	6.4	5.6	2.7	6.7	6.0
Current Account Balance/ GDP	-4.4	-16.5	-16.5	-13.2	-9.1	-7.9	-6.3
Fiscal Balance / GDP	-8.0	-15.7	-13.0	-6.5	-5.2	-5.0	-3.7
Gross Government Debt / GDP	7.7	8.8	20.4	27.5	32.9*	38.8	40.8
External Debt / GDP	1.7	1.8	2.4	2.4	2.1*	1.9	1.8
Gross Official Reserves (USDb)	177.0	143.0	113.0	97.0	80.0	64.0	49.0

Political changes have been noted with the resignation of former president Abdelziz Bouteflika in April, 2019,just before the presidential elections that were initially scheduled for July. However, the elections have not been held as yet and uncertainties related to succession, policy continuity and stability remain.

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.

Algeria had demonstrated consistent economic performance with an average real GDP growth rate of 3.7% during 2014-2016, before tapering lower in 2017 to 1.4% and a similar 1.5% in 2018, as the hydrocarbon production contraction of 6.2% (2017: -2.4%), effected in lieu of OPEC imposed curbs, weighed negatively on overall economic activity. Non-oil GDP growth meanwhile improved over prior year, registering a 3.4% annual growth (2017: 2.2%) on the back of 6.0% and 4.5% growth posted in agriculture and services sectors respectively. Industrial sector grew by 3.7% during 2018 marking a deceleration vis-a-vis4.4% growth a year earlier.

Economic growth expectations remain muted for 2019 with volatility in hydrocarbon prices, a slower global growth outlook and political uncertainty on the home-front. Continued fiscal consolidation would also curb non-oil growth potential, with overall growth to remain below 2% for the year. Inflationary pressures are likely to remain moderate as does business sentiment.

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 flexible exchange rate regime has allowed the country to partially absorb the impact of oil price shock through currency depreciation during the period 2015-2017 (Dec'14: DZD/USD 87.9; Dec'18: DZD/USD :118.2). Inflation was registered at 3.6% as of May'19 which indicates a moderate uptick compared to year-end 2018 reading of 2.7%, yet below the peak levels observed in 2017 at 7.1%. Eased pressures on currency followed a pickup in energy prices,resulting in weakening of exchange rate pass through effects on headline inflation. Thus, after increasing its policy rate to 3.75% in May'17, Banque d'Algerie ("BA") has held it constant since then.With the recent drop in Fed rates, upward pressure on local benchmark rates stands considerably alleviated. Drop in value of DZD against the USD hasbeen rather contained in the last two years registering 3.8% and 2.6% depreciation in USD respectively in 2017 and 2018.Combined with low rates of inflation, policy rates are expected to remain stable, with possibility of rate cuts also on the horizon.

Up until September 2018, around 92% of total exports of the country for the year were derived from hydrocarbons (2017: 94.5%). With a general fall in hydrocarbon prices, current account deficit surged to a peak of USD27.3bn in 2015. In 2018,

[1] *Source:IMF World Economic Outlook, October 2018 &IMF Country Report, June 2018*

[2] *Area wise with an area of 2,381,741 square kilometers;*

[3] *Source:IMF Country Report, June 2018*

the deficit retreated by 24% to USD16.7bn, being 9.2% of GDP, as exports surged 19% owing to higher average oil prices, while imports were down 1%. The increasing exports revenue was despite the 7.7% contraction in terms of volumes which was more than compensated by over 30% rise in oil prices. In tandem, we observed continued fall in FCY reserves which dipped to USD79.9bn vis-a-vis USD97.3bn at the end of 2017, - a trend which is likely to continue with persistent deficit as expected.

Moreover, high fiscal dependence on hydrocarbon revenue is evident, as these constituted around 44% of total government revenue during 2014-2017. Hydrocarbon revenues reduced to DZD 1.7trn in 2016, which was its lowest level since 2014 (2014: DZD 3.4trn), and recovered to DZD 2.4trn in 2017. In line with decreasing government revenues, fiscal deficit had reached a peak of 15.7% of GDP in 2015. However, by way of fiscal consolidation measures, such as the applied spending cuts, subsidy reforms and scaled down capital investments, fiscal deficit declined to 5.2% of GDP in 2018 (2017: 6.5%).The budget deficit was registered at DZD993bn in Q1'19 indicating a 22% contraction compared to Q1'18, however, meaningful improvement is not expected to materialize this year, given continued downside volatility in hydrocarbon prices.

External debt to GDP at 2.4% in 2017, is low and not expected to significantly increaseover the next few years, although there is looming pressure on funds availability, given the persistent current account deficit. In the third quarter of 2018, total external debt reached USD3.97bn from USD3.99bn at the end of 2017. Algeria paid off its entire debt to IMF and Paris Club of creditors in 2006. African Development Bank (AfDB) provided its first loan of EUR 900m in 12 years as a budget support loan in Nov'16. However, gross government debt has been trending up reaching 27% and is expected to continue to rise, given its rather high fiscal deficit.

Algeria's policy of building large fiscal wealth reserves and utilizing it in times of stress has worked well so far. It has also provided the time required to adjust to the new oil price dynamics and diversify the country's economic base. However, Algeria's fiscal consolidation efforts are expected to depress economic growth; this, compounded by a large current account deficit,high unemployment rate, and political instability, poses real challenges to the economy in short to medium term. Despite lower labour force participation, unemployment rate reached 11.7% as of September 2018 while youth unemployment stands at a much higher level of 29.1%.

Banking Sector

The Algerian banking sector constitutes 20 banks, which include 14 private and 6 public banking institutions. The sector is dominated by the public sector banks, which control ~88% of the market, in terms of financings and deposits. In addition, these banks also operate majority (>¾th) of the banking branches in the country. Nonetheless, the private banks operating in the country have posted relatively better profitability, as depicted by the higher return on assets, largely being attributable to their specific focus on corporate & trade finance business. The public sector banks, on the other hand, 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 agriculture development.

The infrastructure in place to protect contractual rights of banking entities requires reinforcement. The BA maintains a credit risk registry, thus providing the banks with historical information of credit risk profile of clients. Lately, the scope of the registry has been enhanced to include individuals. The Algerian Banking Law provides protection of depositor funds, as all deposits under DZD 2.0mn (increased from DZD0.6mn in June 2018) are insured by the country's Deposit Insurance Company, which would be utilized in the

Table 2: Banking Sector – Key Performance Indicators [6]

DZD'b / %	2013	2014	2015	2016	2017
Gross Impairment Ratio	10.6	9.2	9.8	11.9	12.3
Net Impairment Ratio	3.4	3.2	4.0	5.4	6.0
tier 1 CAR	15.5	13.3	15.8	16.3	15.2
Capital Adequacy Ratio	5.0	16.0	18.4	18.9	19.6
Liquid Asset to Total Assets	40.5	38.0	27.2	23.5	23.7
Return on Assets	1.7	2.0	1.8	1.9	2.0

[4] *Article 715 of the Algerian Commercial Code stipulates that an institution becomes bankrupt if its net assets decline below a quarter of its capital and 15% of the Bank's deposits exceed the insurance threshold.*
[6] *Source:IMF Country Report, June 2018*

event of bank failure[4]. In lieu of the same, all banks are required to incur an annual charge, equaling 0.25% of average deposits during the year, which is deposited in the Public Banking Risk Fund.

As of June 2018, 49.3% of the banking sector's credit was allocated to the public sector having increased over time, given government's rising financing needs, and consequent crowding out of the private sector. Total credits expanded by 11.1% (2017: 12.3%), showing strong growth. Deposit access is strong with 54% of total deposits being held as current accounts.

The sector's asset quality has come under pressure with NPL sreaching12.3% of gross financings as at 2018 end, partly caused by delayed payments from the government to its suppliers on account of lower energy prices since 2014 and more recently on account ofa challenging economic environment, partly reflecting the ripple effect of the government's arrears to its suppliers. These trends are noteworthy and require urgent address to prevent systemic stress.

The sector's capitalization indicators suggest sufficient buffers, with the Capital Adequacy Ratio (CAR) standing at 19.8% for public banks and 18.7% for private banks as of 2017. Meanwhile, private banks post higher tier-1 ratios in aggregate. However, deterioration in asset quality can quickly erode buffers. So far, all recommendations of BASEL II have been implemented whilst BA's guidelines on BASEL III implementation are limited to the periodic reporting of Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR).

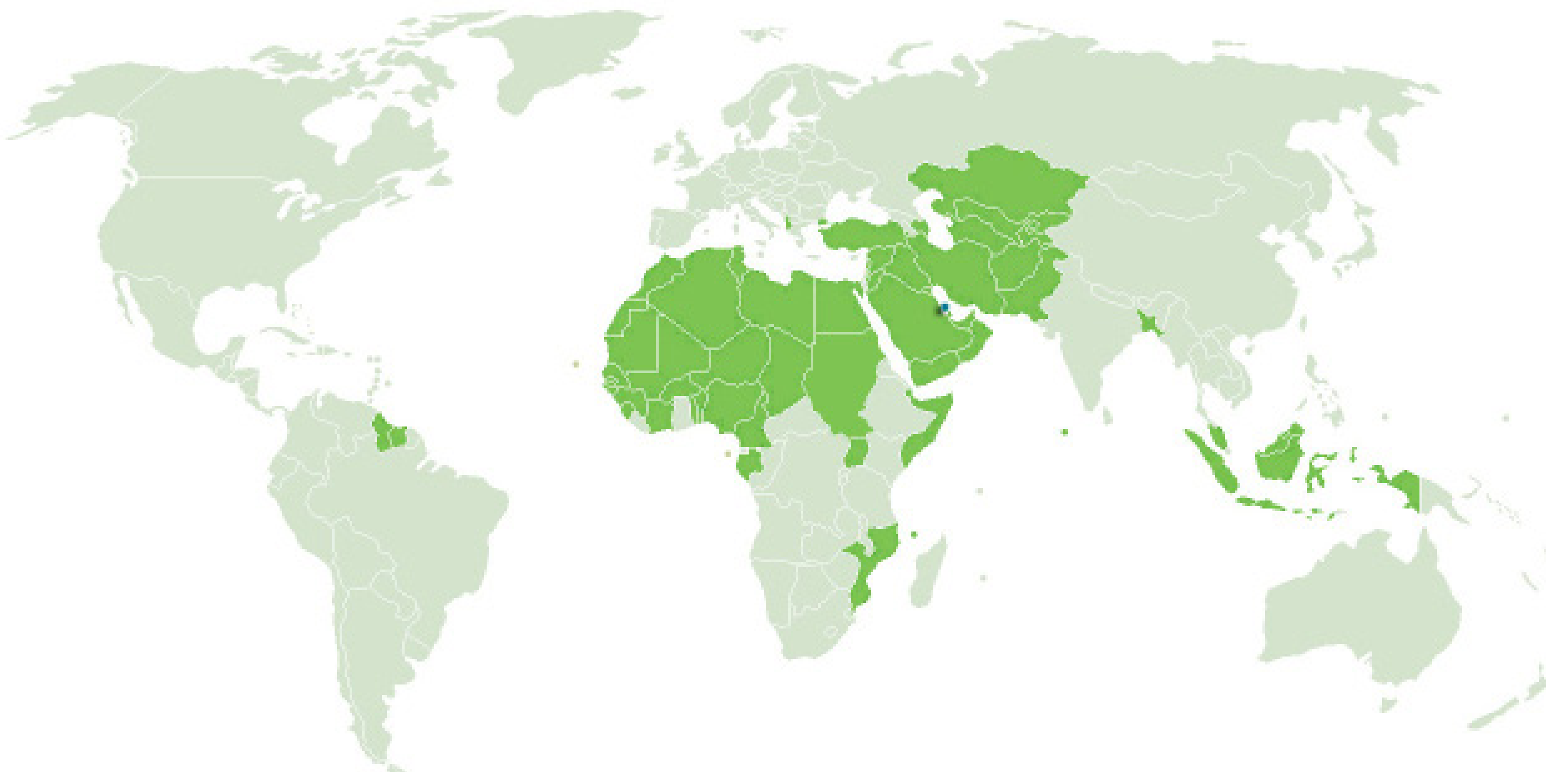
The Central Bank has been managing liquidity proactively and increased the required reserve ratio for banks from 8% to 12% in March 2019, based on the stability of the domestic liquidity conditions after the declines registered in 2015 and 2016, due to the crisis triggered by low oil prices. This was BA's third intervention to required reserve ratios within a timeframe of 18 months. The banks are remunerated at 0.5% on such reserves.

In conclusion, the sector's risk profile is characterized byadequate capitalization indicators, subpar asset quality, sound profitability, and supportiveof our overall 'moderate' assessment of banking sector risks.The banking sector is expected to face headwinds in short to medium term mainly due to heightened credit risk with slowing economic growth pressuring already high impairment levels further up.

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. In November 2018, the BA introduced the regulations for Participation Banking, following which the number of banks with a PB window is expected to increase.

So far, provision of participation banking services has been limited to subsidiaries of Bahrain based 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 and Trust Bank, also offer Islamic banking services. Going forward there are plans in place to introduce participation banking products through 6 public banks. Until now, three of these institutions have introduced participation finance products including Banque de l'Agriculture et du Développement Rural – the parent bank of ABA, the Caisse Nationaled' Epargne et de Prévoyance and the Banque de Développement Local. Furthermore, in order to provide an efficient liquidity management solution for participation banks and alleviate fiscal stress, the government plans to issue its debut sukuk, which has not materialized yet due to political uncertainties.



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