Algeria

Economic transition, the other challenge

With anaemic growth, strong pressure on hydrocarbon revenue and substantial twin deficits, the macroeconomic situation is worrying. For the time being, forex reserves remain at comfortable levels but the speed and scale of their contraction is a major source of vulnerability over the short to medium term. Meanwhile, although certain decisions suggest a change of tack in the government's position after years of economic protectionism, this progress is still too hesitant given the challenges. It is also of limited effectiveness whilst the business climate has not yet stabilised.

2019 ended with presidential elections, won in the first round by Mr Tebboune against a background of low turnout and continued mass demonstrations. Although they filled a constitutional vacuum, these elections have not brought to an end the transitional period into which Algeria plunged following the resignation of President Bouteflika on 22 February 2019, under pressure from the street. The authorities, in addition to reshape the political system, face another major task: restoring the sustainability of an economic model that has been undermined by the collapse in hydrocarbon revenue and a loss of investor confidence. The period that is now beginning will therefore be decisive and full of uncertainty.

The economy has stalled

According to the ONS, economic growth reached only 1.2% in Q3 2019, having all but stagnated at 0.3% in Q2. This slight uptick came mainly from the 1.4% increase in hydrocarbon real GDP, which had previously seen eight successive quarters of contraction. At an average of 1.03 million barrels per day over the first nine months of the year, crude oil output had thus been at its lowest level since 2003, whilst gas output posted a 7.5% contraction compared to 2018. Given the fall in global oil prices, hydrocarbon nominal GDP thus declined by 18% in Q3 despite the dinar's stability against the dollar. It is hard, therefore, to see the hydrocarbon sector providing much support at a time when whole sections of the economy are suffering from political uncertainty.

Non-hydrocarbon real GDP growth decelerated to 1.4% in Q3 2019, from 3.7% a year earlier (chart 2). All sectors have been affected with the exception of manufacturing activity, which has shown surprising resilience (+ 4.7% on average over the first nine months of the year) but which makes up only a small part of the economy (5% of nominal GDP). For the rest, growth in construction (12% of GDP) was halved to 3%, whilst those in non-tradable services (15%) fell by nearly three-quarters, from 3.4% in Q3 2018 to 0.9% in Q3 2019. Despite inflation of just 2% over the year as a whole thanks to the significant role played by subsidised products (26% of the consumer basket) and the high level of imports, tradable-services were also hit by the marked slowdown in consumer spending (+0.3% in Q3 2019, from 3.1% a year earlier).

Most importantly, investment has been sluggish over the period (+0.9% in Q2 and +0.7% in Q3), preventing any prospect of recovery until the business climate stabilises. All the more so the 2020 budget includes significant cuts in public investment (see below). At 1.7% in 2020 from 1.1% in 2019, economic growth will thus only improve thanks to a slight increase in gas production, with non-hydrocarbon GDP growth barely exceeding 1.5%. But beyond the difficulties of reviving the economy, the deterioration of public finances and external accounts is a great cause for concern.

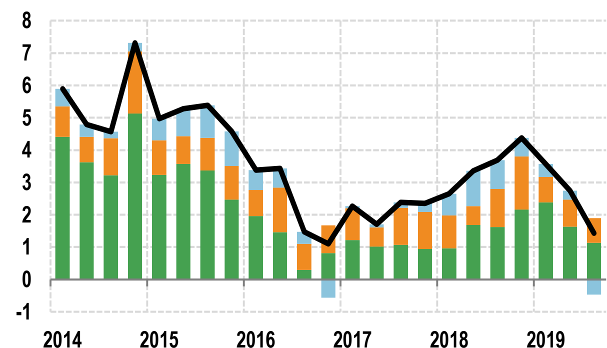
1- Forecasts

	2018	2019e	2020e	2021e
Real GDP growth (%)	1.5	1.1	1.7	2.0
Inflation (CPI, year average, %)	4.3	2.0	3.5	4.0
Gen. Gov. balance / GDP (%)	-8.1	-9.9	-10.8	-10.0
Central. Gov. debt / GDP (%)	44.3	51.5	57.2	61.2
Current account balance / GDP (%)	-9.4	-11.5	-11.7	-11.3
External debt / GDP (%)	2.4	2.3	2.7	3.4
Forex reserves (USD bn)	80	61	42	25
Forex reserves, in months of imports	16.1	12.6	8.7	5.3
Exchange rate USDDZD (year end)	119.0	121.9	125.0	130.5

e: BNP Paribas Group Economic Research estimates and forecasts

2- Non-hydrocarbon GDP growth, contribution by sector

GDP, y/y in %, and contribution in percentage points



Source: ONS, BNP Paribas

Worrying deterioration of forex reserves

According to the IMF, Algeria will need a Brent at USD106/barrel to balance its current account in 2020. Not only is this unattainable in the current climate, but it is also a much higher figure than for other oil exporters in the region. There are many reasons for this, starting with the difficulty in reducing the country's import bill. Imports have been relatively stable since 2016, at USD 46 bn, and customs

statistics do not suggest any change of trend in 2019, despite the 16% fall in imports of industrial capital goods. More significantly, exports have also come under pressure. Exports, more than 90% of which are hydrocarbons, contracted by 12.5% in the first 10 months of 2019 due to the combined effect of falling hydrocarbon price and lower volume exported especially for gas (saturation of European market, strong domestic demand). For the first time in decades, therefore, Algeria probably consumed more gas at home in 2019 than it sold abroad (chart 3).

With a current account deficit of around USD 20 bn (11% of GDP) and no significant capital flows (net foreign direct investment fluctuates around USD 1 bn), external liquidity will continue to erode rapidly. FX reserves fell from a peak of USD 195 bn at the end of 2013 to USD 60 billion at the end of 2019. They are still comfortable, covering 12.6 months of imports of goods and services. However, they could just reach USD 25 bn at end-2021, which would be a worrying development given the Algerian economy's dependence on imports.

Public finances remain under pressure

Public finances are hardly in a more comfortable situation. With a fiscal 'break-even point' estimated at USD 109/barrel for 2020 (IMF), Algeria compares unfavourably to regional peers despite the fiscal consolidation measures included in the budget. The authorities plan a 9% cut in spending this year driven entirely by a 20% cut in capital spending. Current spending will remain fairly stable (down 1.2%), which creates a number of problems.

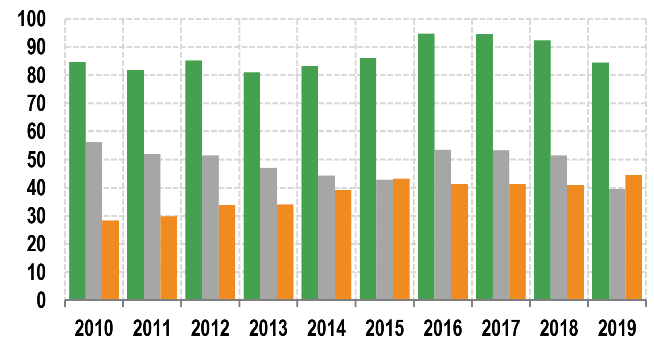
With the fiscal adjustment only supported by public investment, the adverse impact on the economy is expected to be significant. Moreover, even after these measures the budgetary deficit will remain high, at 10% of GDP, due to downward pressure on hydrocarbon revenues. Thus the question of how the deficit is to be financed will soon rear its head, particularly as the authorities have indicated that they will not reactivate its non-conventional financing policy introduced at the end of 2017. Of the USD 55 bn injected by the central bank, less than half was truly spent. Of the remaining USD 26 bn, the Treasury has a creditor account of USD 8 bn at the central bank, half of the expected budget deficit for 2020, whilst the lack of depth in the Algerian capital market raises doubts about its ability to absorb significant financing needs.

Last but not least, government debt looks set to continue its rapid growth and could rise above 60% of GDP in 2021, from just 7% in 2014. Debt servicing costs remain manageable thanks to the very favourable conditions enjoyed by the government under the "non-conventional financing" programme and the negligible level of external debt. But the current debt dynamic is yet another reminder that an overhaul of the Algerian economic model is crucial.

Reforms making progress, but timidly

The government appears to have woken up to the dangers of the situation. Red lines are moving. From this year, the government could borrow abroad to finance key projects. The "51/49" rule limiting foreign investors to a minority position in any investment project has also been relaxed for non-strategic sectors, and a new hydrocarbon law has just been approved to increase the attractiveness of the sector. After years of protectionist policies this seems like a change of direction.

3- Gas sector performance



Source: JODI, MEES

However, the scope of these measures is limited given the number of constraints that still weigh on the attractiveness of Algeria and, more generally, the development of the private sector. Most importantly, challenges linked to macroeconomic stabilization are far from being addressed. The reform of the subsidy system, particularly for energy, is a priority but one that is difficult to carry out in the current climate. In the absence of any lasting solution, the authorities could thus be obliged to reduce imports through the introduction of tariffs measures, or even through tighter capital controls. A depreciation of the dinar would be another option to limit the erosion of external liquidity and increase hydrocarbon revenues in local currency, but would bring considerable inflation risks. In any event, decisions need to be made in order to protect Algeria from a severe macroeconomic adjustment over the short to medium term.

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