Algeria

Unconventional financing: a strategy under control

In late 2017, the authorities decided to resort to direct financing of the Treasury by the central bank to stabilise a dangerously deteriorating macroeconomic situation. The injection of funds helped rebuild bank liquidity via the reimbursement of the debt of state-owned companies. In the absence of a real fiscal impulse, and thanks to prudent monetary policy, inflation remains under control. Without structural adjustments, however, the situation could become very risky.

No inflationary shock

In late 2017, the government announced that the Treasury would resort to direct central bank financing to cover a 25% budget increase. The decision was prompted by the depletion of the oil stabilization fund. Consequently, the central bank massively injected money into the Treasury's account: a total of DZD 4005 billion in September, the equivalent of 19% of GDP. Yet the much feared inflationary shock did not occur. In the first 11 months of 2018, inflation averaged only 4.4%, compared to 6.4% in 2016 and 5.6% in 2017. More significantly, non-food inflation decelerated sharply after peaking in late 2016 and early 2017. Two factors help explain part but not all of this trend: subsidies were maintained after a few cutbacks in 2016/17 (administered prices account for 26% of the consumption basket), and the dinar has held steady against the euro and the US dollar. In the end, a large part of the unconventional financing was allocated to state-owned companies, especially those in the energy sector (Sonatrach, Sonelgaz). These flows were sterilised by the central bank. Fiscal policy also proved to be more conservative than expected.

Fiscal policy aims for stability rather than growth

According to our estimates, the fiscal deficit was two times smaller than the figure in the 2018 financing law. With Brent crude oil averaging USD 72 a barrel over the full year, compared to a budget assumption of USD 50 a barrel, the government benefited from a major increase in hydrocarbon revenues. Dividend transfers from the central bank to the budget remained sizeable, reaching for the first time DZD 1000 billion (about 5% of GDP). These dividends correspond to the exchange rate gains that the monetary institution has reported since 2016 following the sharp depreciation of the dinar against the US dollar between mid-2014 and year-end 2015. Although the sustainability of this source of revenue is questionable, for the moment it is making a significant contribution to the budget (a quarter of non-fiscal revenues since 2017).

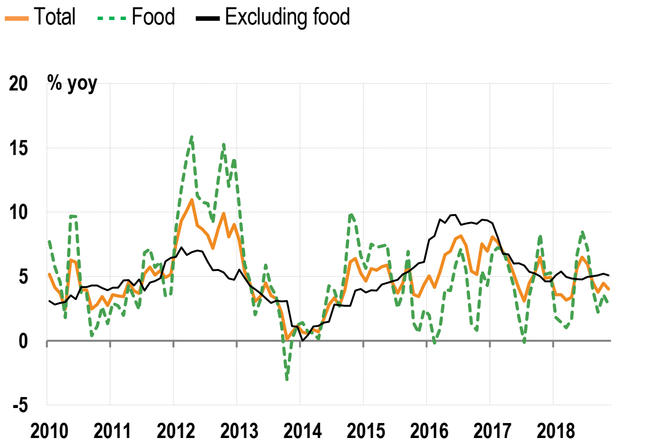
Yet several factors also suggest that there has been less pressure on spending. The bulk of the increase in the budget was attributed to higher capital spending (+76%), especially the "capital transactions" item due to special allocations to the National Social Insurance Fund (CNAS) to absorb the losses of the National Pension Fund (CNR) and settle the arrears accumulated since 2017. Public investment was also expected to increase (+35%). Yet in the first 9 months of the year, imports of industrial capital goods declined 10%, which points to another fall in public investment.

1- Forecasts

	2017	2018e	2019e	2020e
Real GDP growth (%)	1.4	2.5	2.8	2.2
Inflation (CPI, year average, %)	5.6	4.4	5.0	5.0
Gen. Gov. balance / GDP (%)	-6.4	-5.2	-7.7	-7.0
Central. Gov. debt / GDP (%)	31.6	42.9	47.9	54.9
Current account balance / GDP (%)	-12.4	-7.6	-10.9	-11.1
External debt / GDP (%)	2.6	2.3	2.6	2.8
Forex reserves (USD bn)	97	83	66	48
Forex reserves, in months of imports	19.7	16.2	12.7	9.2
Exchange rate USDDZD (year end)	114.7	119.0	121.7	126.0

e: BNP Paribas Group Economic Research estimates and forecasts

2- Inflation



Source: ONS, BNP Paribas calculations

Moreover, current spending, though elevated, is generally kept under tight control. All of this leads us to conclude that the authorities are seeking above all to stabilise a financial situation that deteriorated dangerously in 2017, instead of providing firm support for domestic demand. In other words, Algeria's fiscal policy can hardly be called expansionist.

Central bank vigilance

The central bank's cautious approach faced with the inflow of liquidity in the banking sector has also played a key role. The aggregate of liquidity withdrawals and sight deposits of banks at the central bank, which had dropped to a low of DZD 500 billion in

October 2017, compared to nearly DZD 3000 billion in mid-2014, returned to DZD 1500 billion in 2018 thanks to the payment of government debt due to state-owned companies (about 40% of total banking system deposits).

At the same time, to ensure price stability the central bank has used three instruments to actively manage interbank liquidity. As of January 2018, it resumed liquidity withdrawal operations in the form of short-term deposit facilities. The reserve requirement ratio was also raised to 10%, from 4% in August 2017, at the height of the squeeze on domestic liquidity. Lastly, the central bank isolated part of the surplus liquidity furnished by Sonatrach, the national oil and gas company, which can use these funds according to its investment needs.

By doing so, the central bank has successfully anchored the interbank rate to its key policy rate. Monetary policy transmission channels had long been weakened by the excessive abundance of liquidity in the banking sector. Yet with the launch of open-market operations in early 2017, it was able to introduce a benchmark rate, set at 3.5%, which the central bank uses to steer the banks' needs. For the moment, this system seems to be working. After peaking at 4.2% in November 2017, the interbank rate has been fluctuating between 1.5% and 3.5% ever since. Moreover, the easing in the banks liquidity pressure helped maintain lending growth at a rather high level (+12.5% at the end of September 2018) without generating inflation.

We must nonetheless add some nuance. Although the loan-to-deposit ratio is now fluctuating at around 95%, after having hit the 100% threshold when unconventional financing was first launched, it is still 20 points above the level prior to the oil shock. Moreover, with bank loans outstanding equivalent to 47% of GDP (25% if we exclude loans to state-owned companies), compared to 80% for Morocco, the risks of overheating due to domestic factors generally seem limited.

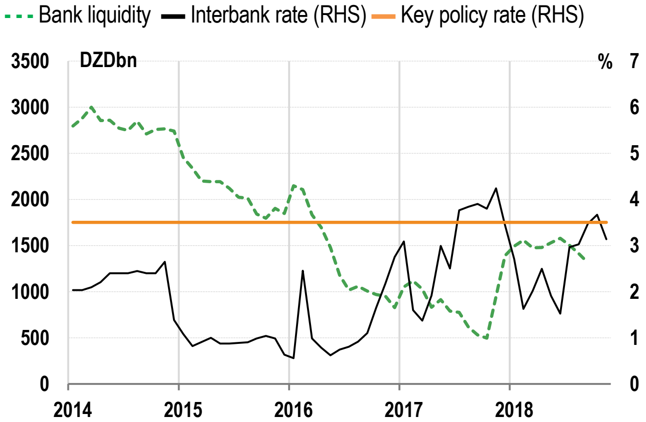
Latent risks

Although inflationary pressures have been contained so far, this strategy is not without risk. By turning to unconventional financing to cover the fiscal deficit, the authorities have bought some time – 5 years to be exact – to readjust the Algerian economic model to the new oil market situation. For the moment, however, the status quo seems to predominate.

The 2019 budget follows along the same lines as that of 2018. The subsidy system was maintained and no new taxes are planned. Once again, public investment might serve as the adjustment variable. Brent crude oil prices would have to surpass USD 90 a barrel to balance public finances, a level that seems unreachable in the current context. According to our estimates, the budget deficit would be substantial at nearly 8% of GDP in 2019.

The level of public debt offers some manoeuvring room, but it must be monitored closely, since government support to state-owned companies is driving public debt up rapidly. The dynamics of the external accounts is the main source of concern. Algeria is one of the region's few hydrocarbon producers that has not rebalanced its external position. The current account deficit is estimated to have reach USD 12 billion in 2018, and the 2019-2020 outlook is for a further widening due to downward pressure on global oil prices. The external position is hit not only by the downturn in hydrocarbon export volumes (down 9% in the first 9 months of 2018, after contracting 25% between 2005 and 2017), but also by the low level of capital inflows. The chances that this situation will improve are slim, at least in the short term, given Algeria's rather unattractive business climate and the authority's refusal to borrow externally. In this environment, foreign reserves are bound to erode further. They could reach less than USD 50 billion by year-end 2020 (9 months of imports of goods and services), compared to USD 195 billion at year-end 2013. Here too, Algeria enjoys comfortable manoeuvring room, but it is dwindling fast.

3- Liquidity in the banking system and interbank rate



Source: Bank of Algeria, IMF

Algeria is running the risk of a painful medium-term macroeconomic adjustment, either via the exchange rate or the compression of imports. Given the weakness of the industrial base, both options would have a severe impact on inflation. One positive point is that the authorities have made statements showing that are fully aware of the situation. Yet we must wait until the presidential elections due to be held in April to know more about their reform intentions.

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