الوكالة الإسلامية الدولية للتصنيف

Islamic International Rating Agency

ECONOMIC & BANKING SECTOR OVERVIEW

People's Democratic Republic of Algeria

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TRUST . TRANSPARENCY . INDEPENDENCE

ECONOMIC & SECTOR OVERVIEW - ALGERIA[1]

People's Democratic Republic of Algeria ('Algeria' or 'the country') is geographically[2] the largest country in Africa. It has borders with Tunisia, Libya, Morocco, Mauritania, Mali and Niger. Algeria has a population of 40m[3] and an estimated GDP of USD 170b[4], which translates in per capita GDP of USD ~3,900. 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

	FY14	FY15	FY16	FY17P
Real GDP Growth Rate (%)	3.8	3.8	3.5	1.3
Inflation (%)	2.9	4.8	6.4	4.8
Current Account Balance / GDP(%)	(4.4)	(16.6)	(16.9)	(11.9)
Fiscal Balance / GDP(%)	(7.3)	(15.4)	(13.7)	(2.7)
Gross Government Debt / GDP(%)	7.7	8.8	21.0	21.2
External Debt / GDP(%)	1.7	1.8	2.5	2.5
Reserves (In months of imports)	33	28	23	20

Source: IMF, BA

Algeria had demonstrated consistent economic performance with an average real GDP growth rate of 3.7% during 2014-2016, before tapering lower in 2017 with growth rate expectations falling below 1.5% for the year.On the back of an improved oil price scenario in the present year, economic growth is expected to pick pace in 2018, although the economy's fundamental dependence on hydrocarbon persists, and renders growth expectations volatile at best. The hydrocarbon sector weighs heavily on exports, government revenues, and has traditionally comprised about one-fourth of GDP, having declined to 19.4% of GDP as of H1'2017 from 27% in 2014. Although consolidated fiscal wealth with high level of reserves, has provided some support and economic sustainability, the effects of depleting foreign exchange reserves, reduced government spending and, in its aftermath, dwindling economic growth have been evident in recent 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; Mar'18: DZD/USD ~114). The country's inflation rate rose to ~7% (Mar'17-May'17) on account of the fiscal measures, such as the reduction in subsidies, and the uptick in price of fuel and electricity. This inflationary pressure forced Banque d'Algerie, (BA) to increase its policy rate to 3.75% in May'17 which is expected to rise further.

The current account deficit has increased to 16.9% of GDP in 2016 (2015: 16.6% and 2014: 4.4%); but is expected to move down to 11.9% in 2017 due to some recovery in oil prices. Major reason behind increasing current account deficit had been the heavy reliance on oil exports with hydrocarbon constituting 95.2% of exports in 2016. As oil prices declined, trade balance had also moved to a deficit of USD 20.4b in 2016 (2015: USD 18.1b); though expected to post some recovery in 2017 and further in the current year with the significant turnaround in oil prices posted thus far.

Moreover, high fiscal dependence on hydrocarbon revenue is evident, as these constituted more than 45% of total government revenue during 2014-2017. Hydrocarbon revenues reduced to DZD 1.8b in 2016, which was its lowest level since 2014 (2014: DZD 3.4b), and are estimated to have recovered partly to DZD 2.8b in 2017. In line with decreasing government revenues, fiscal deficit had reached a peak of 15.4% in 2015. However, by way of fiscal consolidation measures, such as the applied spending cuts, subsidy reforms and scaled down capital investments, fiscal deficit is expected to have declined to 7.5% of GDP in 2017 (2016: 13.7%) and with an expected revival in oil revenues, potentially end below 3% in 2018.

[1] *Following convention used in this report; Million=m; Billion=b; Algerian Dinar=DZD; Foreign (Reserve) Currency=FCY; Local Currency=LCY; Bank of Algeria=BA; International Monetary Fund=IMF;*
[2] *Area wise with an area of 2,381,741 square kilometers;*
[3] *Estimated using half year GDP at current prices given in Bank of Algeria's Q2 Statistical Bulletin. As per IMF Country Report – Algeria – June 2017, GDP in 2017 is projected to be USD 168b;*
[4] *Source: World Bank Dataset for Algeria.*

The external debt to GDP, at 2.5% in 2016, is low and expected to remain range bound during 2018. 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 had increased to 21% of GDP as of 2016 (2015: 8.8% of GDP),as a result of transfer of liability from a national utility company.

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 the high unemployment rates and political instability, poses real challenges to the economy in short to medium term. Despite lower labour force participation, unemployment rate reached 10.5% in 2017. Considering the hiring freeze in civil service, specifically in non-strategic sectors, unemployment rate is expected to further increase in short to medium term.

BANKING SECTOR OVERVIEW

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 share, 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 areas of the economy such as agriculture development.

Table 2: Banking Sector – Key Performance Indicators

	2014	2015	2016	Sep'17
Total Assets (In DZD' Billions)	**11,976**	**12,509**	**12,881**	**13,897**
Total Assets (In USD' Billions)	136	117	117	123
Financings (Net) to Deposits Ratio	69.9%	80.1%	91.2%	94.7%[5]
Growth in Credit to the Economy	23.1%	12.2%	8.9%	9.7%[5]
- Non-Financial Public Institutions	32.5%	9.5%	7.5%	7.4%[5]
- Private Sector	14.7%	15.0%	10.3%	11.9%[5]
Liquid Assets to Total Assets	38.0%	27.2%	27.5%	25.2%
RoAA	2.0%	1.9%	1.9%	N/A
- Public Banks	1.8%	1.8%	1.8%	N/A
- Private Banks	3.3%	3.2%	2.8%	N/A
RoAE	23.6%	21.6%	19.4%	N/A
CAR	16.0%	18.7%	18.9%	N/A
Tier I CAR	13.3%	15.9%	16.4%	N/A
Gross Impairment	9.2%	9.8%	11.4%	N/A
- Public Banks	9.7%	9.9%	12.0%	N/A
- Private Banks	5.1%	8.8%	7.8%	N/A
Provisioning Coverage	65.2%	61.2%	55.4%	N/A
Net Impairment	3.2%	3.8%	5.1%	N/A

Source: IMF, BA

The infrastructure in place to protect contractual rights of banking entities is considered to be weak, given deficiencies in the judicial system that result in delayed contract disputes and bankruptcy proceedings. 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 0.6m are insured by the country's Deposit Insurance Company, which would be utilized in the event of bank failure[6]. 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.

[5] *For the period Jan-Sep'2017*

[6] *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.*

In recent years, the banking sector has experienced a liquidity squeeze, precipitated by the drop in oil prices. As a result, liquid placements with BA have shrunk and interbank borrowing has picked up,causing an increase in interbank lending rates. Furthermore, a slowdown in growth of credit to private sector has been observed.

The sector's asset quality has come under pressure, largely as a result of delayed payments from the government to its suppliers, which is a temporary phenomenon. However,given adequate provisioning,net impairment is moderate. As financing of the public sector and related entities largely rests with the public sector banks, the deterioration in asset quality has been limited to these banks, with private banks having posted a contrary trend. Unless stemmed, these risks could spill over in the private sector.

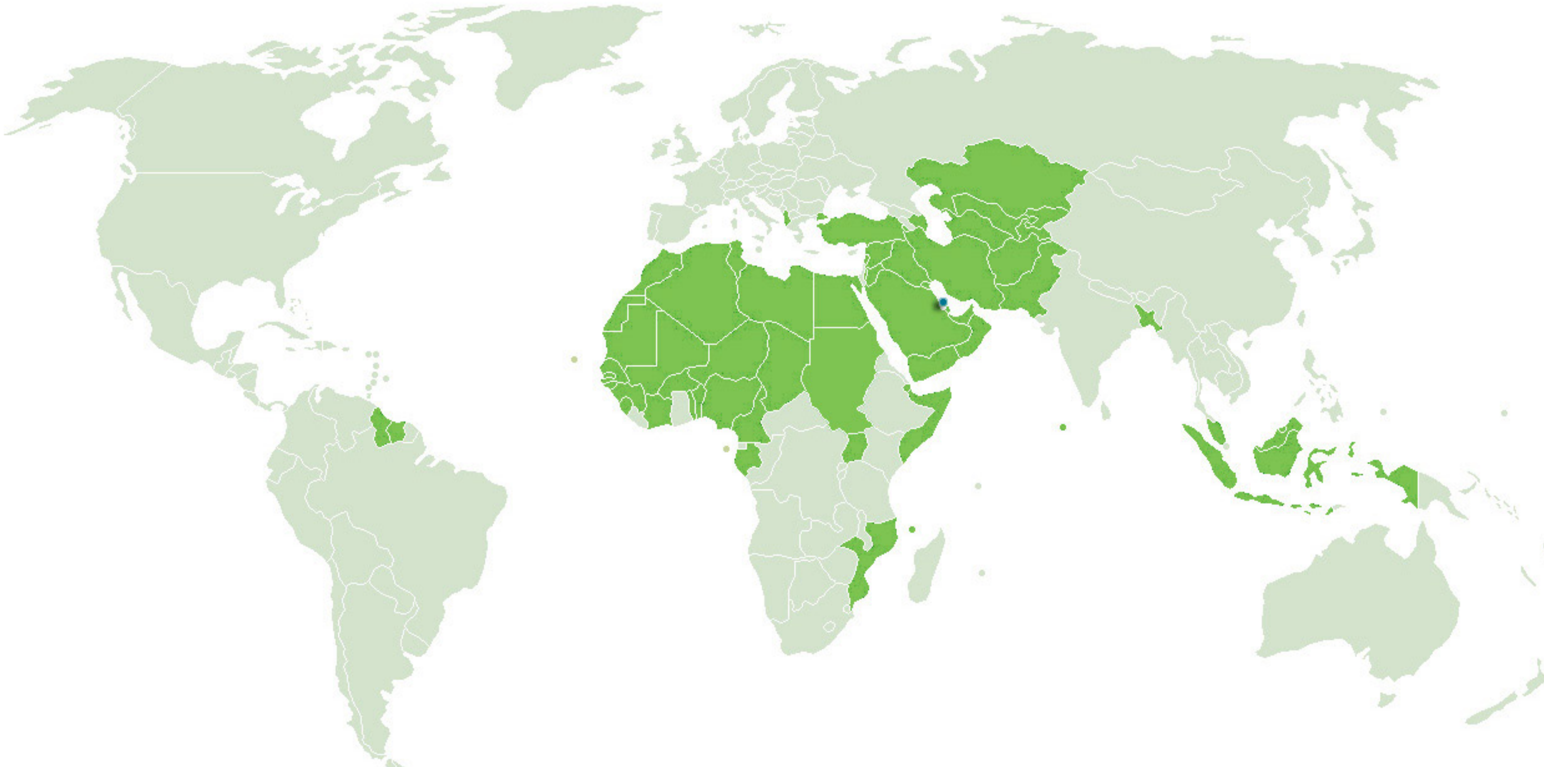
The sector's capitalization is considered adequate, given the comfortably high Capital Adequacy Ratios (CAR). In contrast to public banks, the private banks have better capitalization, on both tier I and aggregate basis, as depicted in Table 2. So far, all recommendations of BASEL II have been implemented 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).

In conclusion, the sector's strength is characterized by strong capitalization, adequate asset quality, sound profitability, supporting our overall assessment of the banking sector. In overview of the prevailing economic slowdown, the banking sector is expected to face headwinds in short to medium term resulting in higher liquidity, interest rate and credit risks.

…Participation Banking Sector

In the North African region, Algeria trails behind its neighboring countries such as Tunisia and Morocco, which have already begun developing participation finance legislation under the supervision of a central religious board. However, of late, the government has demonstrated heightened interest in developing participationfinance legislation. The industry is in early stages of development and the government has committed to introduce relevant regulations andto establish a national Shari'a board.

So far, provision of participation banking services has been limited to foreign branches 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 participationbanking products through 6 public banks. To date, 2 of these institutions have already introduced participation finance products. Furthermore, in order to provide an efficient liquidity management avenue for participation banks and alleviate its fiscal stress, the government has plans to issue its debut sukuk instrument in the ongoing year.



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