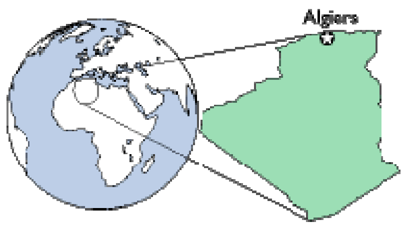
COUNTRY REVIEW

Algeria



23 October 2009

ANALYST: Andrew Atkinson

EULER HERMES COUNTRY RISK GRADE: C

Country Risk Grades are on a scale of AA, A, BB, B, C, D

where AA is the lowest and D the highest risk.

Strengths

- Strong hydrocarbon resources, with gas reserves estimated to last a further 52 years at current rates of extraction
- The hydrocarbon sector has been shielded from significant social unrest
- Strong liquidity indicators, supported by a period of sustained high oil prices in 2004 to Q3 2008
- The country adopted a foreign debt management policy in the 1990s that has resulted in declining debt levels and debt service ratio. In May 2006, agreement was reached (subsequently fulfilled) with the Paris Club for early repayment of all outstanding obligations

Weaknesses

- Regional dynamics are affected by continuing friction between Algeria and Morocco relating to the Western Sahara
- A track record of relatively poor political and social stability
- Interference of military elite in the democratic process
- High unemployment and underemployment that fuels social unrest
- Lack of economic diversification; exposure to trends in prices for world hydrocarbons (over 45% of GDP and 98% of export earnings)
- Weak banking system, dominated by state enterprises that have had to absorb large losses from public sector companies
- Limited private sector opportunities and restrictive business regulations

Key Risks

- **A collapse in the oil price**
- **A major terrorist attack on an oil installation or pipeline that seriously interrupted supplies of crude for a sustained period and thereby limited fiscal revenues and FX generation**

Country Risk Assessment

Ratings	**Algeria**		**Median**		**Peers**	
	Latest	**Previous**	**Grade C**	**Libya**	**Egypt**	**Morocco**
Systemic Political Risk:	**P3-**	**P3-**	**P2-**	**P3-**	**P3-**	**P3+**
Systemic Economic Risk:	**E5**	**E5**	**E5**	**E4**	**E4**	**E4**
ME rating:	ME4	ME3	ME5	ME3	ME4	ME3
Structure	*6.0*	*6.0*	*5.7*	*6.0*	*5.7*	*5.7*
Policy	*6.0*	*4.2*	*5.2*	*6.0*	*5.2*	*3.6*
Solvency	*1.0*	*1.0*	*2.8*	*1.0*	*2.8*	*2.3*
External Liquidity	*1.9*	*1.0*	*4.6*	*1.9*	*2.9*	*3.2*
SBE rating:	SBE5	SBE5	SBE4	SBE4	SBE3	SBE4
COUNTRY GRADE:	**C**	**C**	**C**	**C**	**C**	**B**

Nomenclature:
Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).
Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).
ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).
The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).
SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).
Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Algiers
Population:	34.37 mn (2008)
GDP:	USD 171097 mn (2008)
Currency:	Dinar (DZD)
Form of state:	Reoublic
Head of government:	President Abdelaziz Bouteflika
Next elections:	Presidential by April 2014; legislative by 2012

Major Industries (% of GDP at market prices, 2008e)	
Agriculture	8%
Industry	62%
Services	30%

Global Assumptions	2009f	2010f
Real GDP grth (% yr/yr) *	-3.9	0.9
Inflation (%, av) *	-0.1	1.3
Dated Brent (USD/b)	61	72

* major economies

Main Exports (% of total, 2008e)	
Hydrocarbons	98%

Main Imports (% of total, 2008e)	
Capital goods	34.0%
Semi-finished manufactures	24.0%
Food	17.0%

Lead Export Markets (% of total exports, 2007)	
US	29.4%
Italy	13.8%
Spain	9.6%
France	7.4%

Lead Import Markets (% of total imports, 2007)	
France	18.7%
China	9.0%
Italy	8.5%
Spain	6.0%

Basic indicators

Selected economic indicators	2006	2007	2008	2009f	2010f
Nominal GDP (USD mn)	117,288	134,304	171,098	160,052	183,108
Population (mn)	33.35	33.86	34.37	34.89	35.41
GDP per capita (USD)	3,517	3,966	4,978	4,588	5,171
Real GDP growth (% yr/yr)	6.1	6.3	5.2	2.0	4.5
Inflation (%, average)	2.5	3.5	4.5	4.5	3.5
Fiscal balance (% of GDP)	14.1	6.4	9.0	-1.7	3.7
Current account balance (% of GDP)	24.7	22.3	20.5	6.2	10.4
External debt/GDP (%)	4.4	3.6	2.0	2.0	1.6
External debt/Exports of goods & services (%)	8.2	6.9	3.9	5.3	4.3
Debt-service ratio (%)	21.3	2.0	2.2	2.2	1.3
Foreign exchange reserves (USD mn)	77,781	110,180	143,102	135,000	140,000
Import cover (months)	28.0	33.1	32.0	30.0	28.5
Exchange rate assumption, DZD:USD (av)	72.6	69.3	64.6	72.8	74.0
f: CRU central forecast					

Sources: Central Bank, IMF, World Bank, Euler Hermes Country Risk Unit

Political Stability

Abdelaziz Bouteflika won a renewed mandate with over 90% of the vote (with a 74% turnout) in **presidential elections in April 2009** and, despite some health concerns, appears likely to serve a further full (third) five-year term. As some opposition parties had boycotted the polls, Bouteflika's nearest challenger was Louisa Hanoune of the Trotskyist Workers' Party, with only 4.22% of the vote. There were allegations of electoral malpractice but these, and the fact that Bouteflika engineered **constitutional amendments in November 2008 to allow a leader to remain in power for more than two terms**, received only muted international condemnation. This partly reflects a desire to maintain a more peaceful social climate that has been engendered under Bouteflika and also because Algeria is a **key supplier of oil and gas to world markets**; Algeria is the source of around 25% of the EU's annual gas imports. Overall, Bouteflika now has a renewed and firm mandate, which should result in **policy continuity**.

Under the constitution, the PM is responsible to parliament rather than the presidency, so Bouteflika tends to appoint confidants to the premiership so that he has more direct control over the legislature. He has also **used cabinet reshuffles to ensure that his power base will not be diluted**. However, the concentration of power within Bouteflika's tight-knit elitist group is likely to breed resentment in the wider political sector and this may cause problems going forward. However, the Front de libération nationale (FLN) and its allies won a clear majority in the May 2007 elections to the National Assembly (lower house of parliament) and this grouping is likely to form the bulk of the new parliament after elections in 2012, thereby suggesting that Bouteflika's hold on power will be secure for the foreseeable future. Nevertheless, the president's health has not been good and he undertook major surgery in France at the end of 2005 so that, while his retention of power in April 2009 promotes policy continuity, the opaqueness of succession leads to uncertainties relating to the longevity of existing policies. The **powerful vested interests (including the military)** that have controlled policy-making for decades show no sign of giving up their influence, although Bouteflika has managed to side-line several leading figures that had been obstructive of change. Nevertheless, Bouteflika's reformist tendencies will continue to be stymied by the deep **mistrust of—and opposition to—liberalisation** from the controlling military elite, known as 'le pouvoir'. Although this shadowy group has supported Bouteflika's presidential campaigns it has undermined several key policy initiatives, particularly relating to privatisation (a key bank privatisation—sale of a majority stake in CPA—was called off in November 2007).

The widespread civil violence dating from 1992 that has claimed at least 150,000 lives appears to have eased significantly, partly because of the hardline response of the security forces, but it has been replaced by **periodic acts of terrorism**. In reality, while the overall scale of violence is now much reduced, the groups perpetrating the acts have merely re-branded themselves. For example, one highly active and militant faction, the Salafist Group for Preaching and Combat (GSPC), is now operating under the umbrella organisation of al-Qaida in the Islamic Maghreb (AQIM).

In addition, there are domestic issues that have yet to be resolved. Violence in the Berber region of Kabilya remains a recurrent concern. The Berbers have demanded a greater degree of autonomy and have also protested because of relatively poorer social conditions, including a chronic housing shortage, poor water supplies and alleged police brutality.

Regional relations are affected adversely by the antipathy between Morocco and Algeria, which results from the latter's support for the Polisario Front, a rebel group demanding Sahrawi independence for Western Sahara. Until this issue can be resolved **little progress is likely in extending regional co-operation through the Arab Maghreb Union**. International relations focus on improved trading and diplomatic links with France and strengthening ties with the United States and, more recently, with China. As with some other countries, the US appears willing to overlook some alleged abuses of human rights where governments are willing to co-operate in campaigns against terrorist groups. In turn, this support helps underpin the domestic Algerian balance of power.

Economic Stability

Algeria is classified by the World Bank as an upper-middle income economy, having a GDP per capita of USD4,500-5,000. The **hydrocarbons sector—both oil and, increasingly, gas—dominates the economy, accounting for around 45% of GDP, 98% of exports and 70% of government revenues**. Annual real GDP growth rates averaged over 5% between 2000 and 2008, significantly above the average of only 1.6% for the 1990s (during the extended period of civil unrest). In addition to domestic security problems of that era, exposure to variable energy output and volatility in commodity prices limited long-term annual growth (1989-2008) in per capita incomes to 1.1%, indicating need for careful utilisation of windfall earnings during periods of high oil prices, and for economic diversification. We forecast that **real GDP growth will slow to around 2% in 2009**, reflecting much weaker global demand for oil and gas through the first half of the year, but work and expenditures relating to on-going large-scale infrastructure projects will help avoid recession. A currently-improving global outlook (but of uncertain sustainability) will enable **economic growth to register around 4.5% in 2010**.

Official estimates of unemployment suggest a rate of around 11% of the working-age population but our projections indicate that **unemployment and underemployment is probably nearer 25% and is particularly virulent as a social problem among the disaffected youth**. Recent improvements in economic data have reflected increased output from the capital-intensive hydrocarbons sector and little progress has been made to date in terms of job creation in labour-intensive sectors. Indeed, skills shortages result in importation of foreign labour, including a significant Chinese workforce employed in infrastructure projects.

Algeria is an active member of OPEC and is the **second largest oil producer in Africa**, after Nigeria, and possesses the **continent's fourth largest oil reserves** (after Libya, Nigeria and Angola), which will last for almost 17 years at current rates of extraction. However, it is gas that makes Algeria strategically important as it is the second largest source (after Russia) of EU imports, accounting for around 25% of the Union's imported gas requirements. Algeria possesses **2.4% of proved world natural gas resources**, with an estimated 52 years of additional production at current rates of extraction. Algerian output of gas is equivalent to approximately 2.8% of current global supply and the country is the **world's sixth largest producer**.

High oil and gas earnings usually enable Algeria to record a budget surplus, even in years when pre-election pump priming takes place. The **annual average budget surplus for 2006-08 was equivalent to almost 10% of GDP**. Revenues have been particularly buoyant following production coming on stream at the large gas-field at In Salah. However, vulnerability to fickle international fuel markets remains a long-term risk to public finance stability and government debt requires careful management. Indeed, weak global energy demand in 2009 and associated relatively weak oil prices in the first half of the year are likely to result in a **fiscal deficit of around 1.7% of GDP, although a surplus will re-emerge in 2010**.

The regime remains dirigiste in nature and this enables official annual inflation rates of below 5%, even in 2008 when inflationary pressures were experienced worldwide, partly reflecting high energy and commodity prices—**food accounts for around 17% of Algeria's annual import bill**. We forecast that **inflation will average 4.5% this year and around 3.5% in 2010**. The exchange rate is strong to stable, reflecting the central bank's policy of a managed float of the currency, capital account controls and substantial FX reserves (USD144bn in August 2009, compared with USD43bn at end-2004) that indicate an ability to provide a defence against undesirable dinar pressures. Reflecting trading patterns, the euro is the dominant currency in the dinar's basket.

High oil and gas prices in the period 2004 to Q3 2008 improved the **traditional current account surplus**. In 2002, the surplus was equivalent to a healthy 8% of GDP but this increased to an annual average of over 20% in 2005-08, despite strong import growth. For **2009, we forecast that the current account surplus will be limited to around 6% of GDP, reflecting weak global demand for energy and continuing strong import volumes, particularly related to large infrastructure projects**. Import costs are likely to maintain a growing trend going further forward but we forecast that the current account surplus will increase to **over 10% of GDP in 2010** and there will be further FX accumulation (see above) so that **import cover will register at least 28 months through to end-2010**. Other liquidity indicators are also strong, with ST debt plus principal repayments on MT and LT debt due within twelve months equivalent to less than 1% of FX reserves. High earnings from oil and gas exports have enabled Algeria to prepay its outstanding obligations to Paris and London Club creditors and foreign debt ratios are now all very low (see charts). Accordingly, Algeria's overall **liquidity and external solvency indicators are extremely healthy at this stage of development**.

Structural Business Environment

The structural **business environment remains well below the average of all the countries we assess**. A broad measure of the institutional environment in which economic activity (and by extension businesses) may or may not flourish is the Heritage Foundation's 2009 Index of Economic Freedom. Algeria is rated 'mostly unfree' and is ranked 107 out of 179 countries assessed by this methodology, above Zambia, Serbia and Senegal, but below Philippines, Brazil and Cambodia. Algeria ranks 104 out of 182 countries covered by the UN Human Development Index 2009, which provides a proxy for the overall level of development and sophistication of the country concerned. Transparency International's 2008 Corruption Perceptions Index rates Algeria 92= (with Bosnia & Herzegovina, Lesotho and Sri Lanka) out of 180 countries covered (above Benin, Gabon and Guatemala but below Panama, Senegal and Serbia). In the World Bank Doing Business 2010 survey Algeria ranks 136 out of 183 countries in terms of the overall ease of doing business. Enforcing contracts involves more procedures than the regional average but the cost of doing so (and time taken) is much lower. Insolvency proceedings can be completed more rapidly and less expensively than on average for the region and the recovery rate is substantially better than the regional average, although recourse to the courts is likely to be involved.

The transport infrastructure is relatively well developed, but business travel is hindered by security uncertainties. Although there is full exchange convertibility for the trade in goods and an Association Agreement with the EU, **overall trade policy is restrictive, with significant non-tariff barriers**. Property rights are perceived as poorly protected and the nominally independent (but politicised) judiciary is stifled by executive decrees. The **government plays a dominant role in the banking sector, accounting for an estimated 95% of total bank assets**, and the industry has large exposure to loss-making state-owned enterprises. Privatisation of elements within the banking sector has been lacklustre.

Bureaucratic complications and delays are commonly cited as difficulties in trading with Algeria. Regulation, oversight and governance are perceived as inadequate in relation to the ease of doing business. As well as tightening regulations relating to foreign direct investment (to ensure greater participation by Algerian interests in joint ventures) amendments to the Law of Finance in July 2009 specify that in future dealings with the country **payments for imported goods will *only* be made if the trade is made using documentary credits.** The intention appears to be to restrict imports—local banks cannot now issue consumer loans, except for mortgages—and small- and medium-sized businesses will be particularly affected. Although it is now reported that some exemptions will be allowed under the new import legislation this merely adds further confusion and regulatory burden to an already weak business environment.

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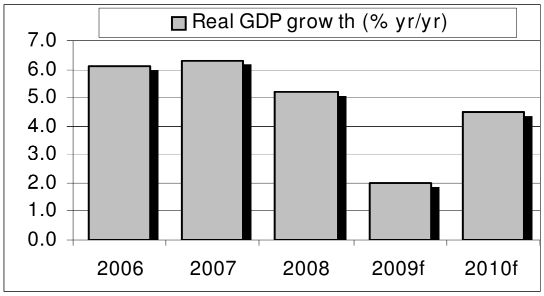
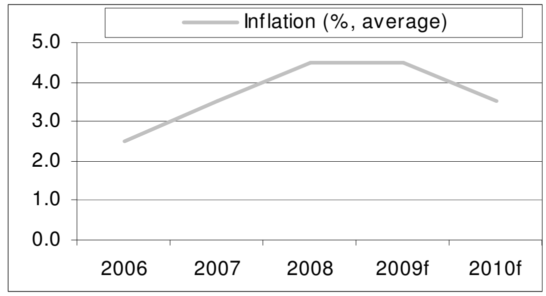
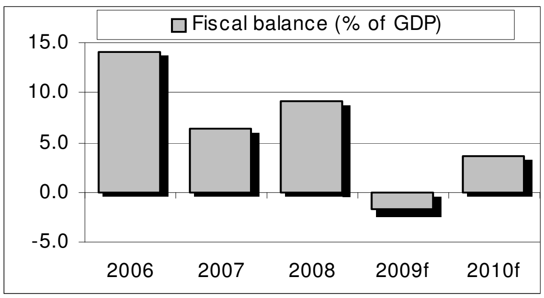
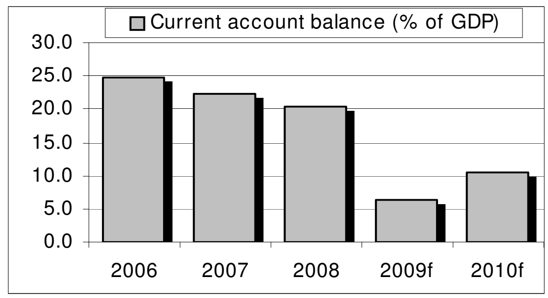
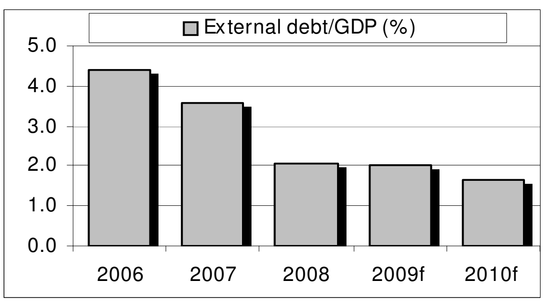
Charts


Real GDP grow th (% yr/yr)
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
2006
2007
2008
2009f
2010f

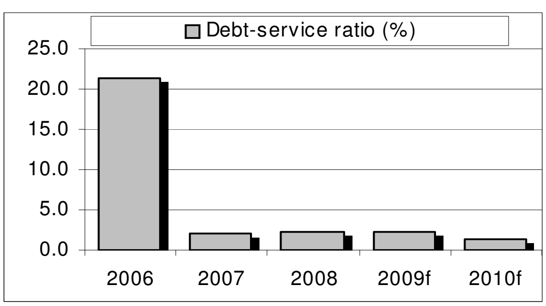

Inflation (%, average)
5.0
4.0
3.0
2.0
1.0
0.0
2006
2007
2008
2009f
2010f

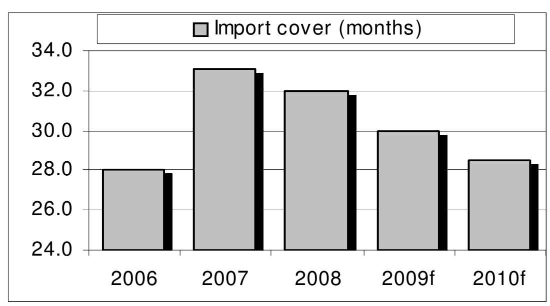

Fiscal balance (% of GDP)
15.0
10.0
5.0
0.0
-5.0
2006
2007
2008
2009f
2010f


Current account balance (% of GDP)
30.0
25.0
20.0
15.0
10.0
5.0
0.0
2006
2007
2008
2009f
2010f


External debt/GDP (%)
5.0
4.0
3.0
2.0
1.0
0.0
2006
2007
2008
2009f
2010f


External debt/Exports of goods & services (%)
10.0
8.0
6.0
4.0
2.0
0.0
2006
2007
2008
2009f
2010f


Debt-service ratio (%)
25.0
20.0
15.0
10.0
5.0
0.0
2006
2007
2008
2009f
2010f


Import cover (months)
34.0
32.0
30.0
28.0
26.0
24.0
2006
2007
2008
2009f
2010f