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ALGERIA

December 2014

2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR ALGERIA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2014 Article IV consultation with Algeria, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on December 1, 2014, following discussions that ended on October 1, 2014, with the officials of Algeria on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 13, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Press Release** summarizing the views of the Executive Board as expressed during its December 1, 2014 consideration of the staff report that concluded the Article IV consultation with Algeria.
- A **Statement by the Executive Director** for Algeria.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

ALGERIA

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

November 13, 2014

KEY ISSUES

Inflation has subsided, but longstanding vulnerabilities are becoming increasingly apparent. Economic growth is holding up well, inflation has fallen below the central bank's target, and fiscal and external buffers remain large. But the economy's dependence on the hydrocarbon sector has led to serious vulnerabilities that are now coming to light. Stagnating hydrocarbon production and declining oil prices, combined with increasing domestic consumption of hydrocarbon products, are depressing export receipts. Public spending continues to increase, fueling imports and a loss of competitiveness, and placing fiscal policy on an increasingly unsustainable path. As a result, the current account is expected to record a deficit in 2014 for the first time in more than 15 years. Unemployment remains high among youth and women.

Algeria needs to consolidate macroeconomic and financial stability. A full-fledged fiscal rule, combined with an ambitious consolidation effort over the medium term, would help put the fiscal stance on a sustainable path. The decline in inflation experienced since the 2012 is a positive outcome that needs to be maintained through continued efforts to absorb liquidity and a more active use of interest rates. The exchange rate policy should avoid deviations of the dinar from its equilibrium level, and should support the deepening of forex markets. The implementation of FSAP recommendations should be pursued, notably to strengthen financial sector stability.

An export-oriented strategy is needed to ensure external sustainability. Export diversification is imperative to ensure external sustainability and reduce vulnerability to fluctuating oil prices. Diversification policies should focus on maintaining economic stability and improving competitiveness, increasing openness to trade and capital flows, (particularly FDI), and creating a more export-friendly business climate. Additional reforms are needed to increase hydrocarbon exports, including reforms to increase production and phase-out implicit subsidies on energy and electricity, which are fueling domestic consumption.

Algeria's significant growth potential needs to be more fully realized. Reforms are needed to reduce the dominance of the public sector and transform the private sector into an engine for growth, supported by a deeper financial sector. To increase employment, Algeria will need better-functioning labor markets, a workforce equipped with more relevant skills, and more effective labor market programs.

Exchange rate regime. The de facto exchange rate regime is classified as "other managed arrangement." Algeria has accepted the obligations of Article VIII Sections 2(a), 3, and 4.

Approved By
Daniela Gressani and Taline Koranchelian

The discussions were held in Algiers during September 17—October 1, 2014. The staff team comprised Mr. Zeidane (head), Ms. Lahreche, Mr. Jewell, and Ms. Pierre (all MCD). Mrs. Gressani (MCD) joined the discussion, as did Mr. Badsi (OED). Ms. Thompson and Mr. Auclair (all MCD) assisted in the preparation of this report.

CONTENTS

APPENDICES

Acronyms

ANSEJ	Agence Nationale de Soutien à l'Emploi des Jeunes
BA	Banque d'Algérie
CAMELS	Capital adequacy, Assets, Management Capability, Earnings, Liquidity Sensitivity
CNAC	Caisse Nationale d'Assurance Chômage
COSOB	Commission d'Organisation et de Surveillance des Opérations de Bourse
EBA	External Balance Assessment
EITI	Extractive Industries Transparency Initiative
ICT	Information and Communication Technology
FAD	Fiscal Affairs Department
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FRR	Fonds de Régulation des Recettes
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
LT	Long-Term
MENA	Middle East and North Africa
MCD	Middle-East and Central Asia Department
MCM	Money and Capital Markets Department
MoF	Ministry of Finance
MoJ	Ministry of Justice
MTBF	Medium Term Budget Framework
MT	Medium-Term
NH	Nonhydrocarbon
NPL	Non-Performing Loans
REER	Real Effective Exchange Rate
SME	Small and Medium Enterprises
SOE	State-Owned Enterprise
ST	Short-Term
TA	Technical Assistance

INTRODUCTION

1. Economic activity is expected to pick up in 2014. The hydrocarbon sector, which has been contracting in recent years, is expected to expand modestly, while nonhydrocarbon growth remains relatively robust. Inflation has fallen below the central bank's target, thanks in part to tighter monetary policy, but new pressures could emerge. External and fiscal buffers remain large, and the financial sector is generally healthy but underdeveloped.

2. Long-standing vulnerabilities are coming into light. For the first time in nearly 15 years, the current account will record a deficit, as strong domestic hydrocarbon consumption and lower oil prices weigh on exports while (largely investment-related) imports continue to grow. After some consolidation in 2013, the fiscal deficit is projected to widen once again, further jeopardizing long-term sustainability. The economy remains overly dependent on the hydrocarbon sector and public spending, and is therefore vulnerable to a protracted decline in oil prices. Unemployment has stabilized at high levels, especially among youth and women.

RECENT ECONOMIC DEVELOPMENTS

3. **Growth and inflation.** Real GDP grew by 2.8 percent in 2013, down from 3.3 percent in 2012, affected by a 5.5 percent contraction in hydrocarbon production—the eighth consecutive year of decline—and lower public spending. Nonhydrocarbon sector growth remained stable at 7.1 percent, supported by continued rapid growth in the agricultural and services sectors. Inflation declined from 8.9 percent in 2012 to 3.3 percent, reflecting the impact of fiscal consolidation, monetary policy tightening, softer international food prices, and high base effects. Average inflation continued to decline in 2014, reaching 1.5 percent in August, but was somewhat on the rise at 2.7 percent on a year-on-year basis.

4. **External position.** The current account surplus narrowed to 0.4 percent of GDP in 2013 from 5.9 percent in 2012. Hydrocarbon exports fell more than 10 percent because of softer prices and lower volumes. Imports expanded by nearly 7 percent, partly owing to the one-off effect of increased imports of petroleum products following the temporary shutdown of three refineries. Inflows of foreign direct investment remained weak, at less than 1 percent of GDP, and the level of foreign exchange reserves increased slightly, from US$191 billion to US$194 billion, mainly because of valuation effects. External debt stood at 1.6 percent of GDP at end-2013.

5. **Real effective exchange rate.** After depreciating by 1.7 percent in 2013, the real effective exchange rate (REER) weakened further in 2014, by 0.9 percent over the first seven months of the year. This was partly driven by a 0.3 percent nominal effective depreciation. However, the REER remains on the strong side, hurting Algeria's competitiveness (Appendix I).

6. **Fiscal.** After two years of significant fiscal stimulus, the government undertook some fiscal consolidation in 2013. Current spending declined as back-payments of civil service wage increases tapered, and limited absorptive capacity held back the execution of capital spending. As a result, the

budget deficit fell to 1.5 percent of GDP from 5.0 percent in 2012, despite lower revenues linked to weak hydrocarbon exports. Savings in the oil stabilization fund decreased slightly for the first time since the fund was created, though it is still standing at a comfortable 31.6 percent of GDP at end-2013. The consolidation trend was not continued into 2014, however: during the first half of 2014, capital expenditure increased by nearly 50 percent and current expenditure by 10.4 percent, while revenues grew by only 4.4 percent, slowed by a 2.4 percent decline in hydrocarbon revenues.

7. Monetary. Credit to the economy expanded by nearly 20 percent in 2013. Nevertheless, broad money growth slowed to 8.4 percent from 10.9 percent in 2012, largely because of slower accumulation of net foreign assets. Increases in the required reserve ratio and greater liquidity absorption helped reduce excess liquidity in 2013. Excess liquidity rebounded in 2014, increasing by 18 percent in the second quarter compared to the same quarter in 2013. Broad money grew by 7.7 percent in the first half of 2014, driven by credit growth and by a 10 percent decrease in government deposits at central bank.

8. Financial sector. The banking sector remained solvent and liquid. The overall capital adequacy ratio was 21.5 percent in 2013, down slightly from 23.4 percent in 2012. The ratio of nonperforming loans (NPLs) improved from 11.5 percent to 10.6 percent, helped by the growth in credit. Nearly 70 percent of NPLs are fully provisioned. Liquidity remains at a comfortable level. Credit to the economy reached 45.2 percent of nonhydrocarbon GDP in 2013, up from 41.3 percent in 2012, remaining weak compared to the region or other middle-income countries. Financial markets are underdeveloped, and little progress has been made in this area. One private company was listed on the stock exchange in 2013. Capitalization remained low at 0.1 percent of GDP, and the stock of outstanding bonds issued by the private sector continued to decline.

9. Employment. Following a slight uptick in 2012, the overall unemployment rate declined to 9.8 percent in 2013. It remained stable in the first quarter of 2014, as the decline in the participation rate offset the 2.1 percent fall in the volume of employment. Youth unemployment stood at 24.8 percent. The unemployment rate among women continued to fall, reaching 14.2 percent in the first quarter of 2014.

10. Outlook.

- *Real GDP growth is expected to increase to 4.0 percent.* The hydrocarbon sector should record slightly positive growth (0.4 percent) for the first time in nine years, driven by growth in domestic consumption and a less acute contraction in net hydrocarbon export volumes. Nonhydrocarbon growth is expected to slow modestly to 5.5 percent owing to a poor wheat harvest and a slowdown in industrial activity. Inflation should stabilize close to the 4 percent target of the central bank, but bears watching closely, given the potential for new inflation pressures to emerge.

- *The current account is projected to record a deficit (-4.0 percent of GDP) for the first time since 1999.* Over the medium term, current account deficits are expected to widen as lower oil prices outweigh modest growth in hydrocarbon export volumes. Foreign exchange reserves are projected to decrease by US$6 billion in 2014, reaching US$188 billion at the end of the year. Over the medium term, import coverage is projected to fall to 17 months, as low levels of capital inflows fail to finance current account deficits.

- *The fiscal deficit is expected to widen to 7.0 percent of GDP, mostly because of lower hydrocarbon and custom revenue and a sharp increase in capital expenditure.* With domestic bond issuance still limited, the deficit will be financed mainly by drawing from the oil savings fund (Fonds de Régulation des Recettes, FRR), which is projected to decline in absolute terms and fall from 31.6 percent to 27.1 percent of GDP. Fiscal deficits are expected to persist over the medium term as hydrocarbon revenues weaken. The nonhydrocarbon deficit is, however, expected to improve, helped by improved nonhydrocarbon revenue and contained current spending. Despite this consolidation, the fiscal path will remain unsustainable, and fiscal breakeven prices are expected to remain above projected oil prices.

- *Monetary sector.* Broad money should increase by 14.5 percent in 2014, largely because of rapid growth of credit to the economy (+21.7 percent) and a decline in government savings, while growth in net foreign assets should be limited to 0.5 percent. Over the medium term, slower credit growth, increased domestic issuance by the government (as opposed to drawing down deposits at the central bank), and a decline in net foreign assets should contribute to more moderate growth in the money supply.

11. Risks are mainly tilted to the downside (Boxes 1 and 2). Slower growth in Europe and emerging markets, or a sustained decline in hydrocarbon prices, would worsen external and fiscal balances. Heightened geopolitical risks in Ukraine or the Middle East could negatively affect the country should they lead to weaker global demand or an increase in the risk premium, but could constitute upside risks if oil and gas prices or demand for Algerian gas increased. On the domestic front, social pressures complicate the task of fiscal consolidation and therefore pose a continued threat to fiscal sustainability

Box. 1. Algeria: Risk Assessment Matrix

Source of Risks	Relative Likelihood	Expected impact	Source of impact	Policy response
I - Financial sector and capital market risks	Low/High	Low	Algeria's exposure to global financial market volatility is very limited. With a closed capital account preventing corporates and banks from borrowing internationally, risks related to both capital outflows and inflows are marginal. Algeria would mainly be affected by bond market volatility, as the country's sizeable reserves are invested in high-grade sovereign bonds--although risks are mitigated by the hold-to-maturity policy of the central bank. Protracted low international interest rates would lower interest earnings for the central bank, thereby hurting dividends paid to the government. Algeria does not borrow on international markets and would not be affected by a reassessment of its own risk	A prudent financial liberalization is needed to support the development of the country. Further enhancements to the reserve management framework would help strengthen resilience to bond market volatility. A full-fledged sovereign wealth fund could help increase returns from the sizeable external asset position.
Side-effects from global financial conditions				
Abrupt surge in global financial market volatility				
Financial imbalances from protracted period of low interest rates continue to build				
Bond market stress from a reassessment in sovereign risk				
II - Inconsistent and partial implementation of financial regulatory reforms	Low/ Medium	Low	Foreign bank subsidiaries are domestically financed with low risk of deleveraging.	Strengthen the prudential framework to maintain the stability and low vulnerability of the financial sector. Enhance coordination with national supervision agencies of parent banks.
III - Risks to growth				
Protracted period of slower growth				
In Europe	High	High	A further slowdown in growth in the euro area (Algeria's main gas export partner) would negatively affect the balance of payments, through both lower hydrocarbon prices and lower demand, and the fiscal balance.	A two-pronged diversification strategy would help contain risks. Algeria needs to diversify its hydrocarbon export markets, and has a large unmet export potential in the region and in Africa. The country also needs to develop nonhydrocarbon exports. Sound macroeconomic management, a well-aligned real exchange rate, and measures to enhance the business climate–including measures to support openness–are needed. Fiscal consolidation and a full-fledged fiscal rule would help shield the country from shocks arising from the hydrocarbon sector.
In other advanced economies and China	Low/High	Medium	A slowdown in growth in other advanced economies, emerging markets, or China would also affect the country through lower global demand and its potential impact on oil prices. In all cases, spillovers through capital markets would be limited given Algeria's very limited exposure to international financial markets.	

Box 1. Algeria: Risk Assessment Matrix (concluded)

Source of Risks	Relative Likelihood	Expected impact	Source of impact	Policy response
IV - Regional geopolitical risks				
Russia/Ukraine: sustained tensions depress business confidence and heighten risk aversion, amid disturbances in global financial, trade and commodity markets	Medium	Medium / high	Tensions leading to a slowdown in growth (notably in European countries) would adversely impact Algeria through lower demand for hydrocarbon products. Possible upside risks would stem from (1) an increase in hydrocarbon prices; or (2) a redirection of global demand for gas away from Russia. The limited trade and financial openness of Algeria to Ukraine and Russia limits the potential for direct impacts. Disruptions to cereal markets could, however, worsen the trade balance and fuel inflation, given Algeria's heavy dependence on wheat imports.	Fiscal consolidation and export diversification would help shield the country from shocks arising from the hydrocarbon sector. The possibility of increased demand from Europe is an opportunity for increased Algerian exports, which the authorities should stand ready to seize.
Heightened risk of fragmentation/state failure in the Middle East, leading to a sharp rise in oil prices, with negative spillovers to the global economy.	Medium	Medium / high	Higher oil prices would positively affect Algeria's external and fiscal balance, but could hurt the country if they resulted in a slower global demand, notably in European countries. Low trade and financial flows with the region limit the potential for direct impacts. Algeria's hydrocarbon infrastructure is located in the southern part of the country (close to Libya) and is vulnerable to terrorist attacks. Further security concerns, including through heightened tensions at the Mali border, may increase the risk premium of investing in the country.	To increase the attractiveness of Algeria for investor, a sound business environment will be key. Lifting the minority rule on FDI at least in non-strategic sectors would help.
V - Sustained decline in energy prices	Medium	High	Lower oil and gas prices would adversely affect both the current account and the fiscal balance, given Algeria's strong dependence on hydrocarbon exports.	A full-fledged fiscal rule, with a credible enforcement mechanism, would help shield the country from shocks arising from the hydrocarbon sector. Nonhydrocarbon exports need to be diversified (see III).
VI - Algeria-specific risks				
Further demands on the hydrocarbon rent	High	High	Despite large spending in 2011 and 2012, demands remain elevated in the population (lack of housing, unemployment). Additional current spending would further worsen the fiscal balance, increase Algeria's reliance on hydrocarbon rents, and possibly fuel inflation.	Maintain a prudent monetary and fiscal policy to tackle the risk of further inflation. Address social demands by setting up an effective cash tranfer system to shield the most vulnerable; improve the effectiveness of the labor market; support the diversification of the economy to spur a strong, private-sector based growth.
Domestic political uncertainty	Low	Medium	Domestic political uncertainty may slow down the pace of reforms, creating a risk for longer term growth prospects.	Priorize and sequence reforms that bring rapid improvements to the population and entail limited costs in terms of political capital.

Box 2. Algeria: Spillover Risks

Algeria's potential for external spillovers is limited. Financial flows are limited, and the share of Algeria's imports in its partners' exports is too small for a shock in Algeria to significantly affect its trading partners. With relatively well-supplied oil markets, a shock to Algeria's oil production is unlikely to trigger a significant adjustment in global oil prices. A negative shock to gas production may, however, trigger a tightening of prices in gas markets, notably in Europe, as Algeria's exports account for more than 10 percent of Europe's imports.

Hydrocarbon dependency and trade with Europe remain the principal source of internal spillovers. The capital account is almost closed, and external financing needs are covered by ample reserves. This insulates the country from the impact of shocks to global financial markets. Algeria is extremely dependent on hydrocarbon exports and is therefore highly exposed to shocks to oil prices. Europe accounts for more than 50 percent of Algeria's trade—a share that has been growing since 2007. Slower growth in Europe would negatively affect the country through a decline in demand and, potentially, in oil and gas prices, with both effects worsening the trade and fiscal balances. Recent tensions in Eastern European gas markets could, however, create positive spillovers if they increase demand for Algeria's gas exports and reinforce its reputation as a reliable gas partner.

Algeria: External and Fiscal Vulnerability to Oil Shocks

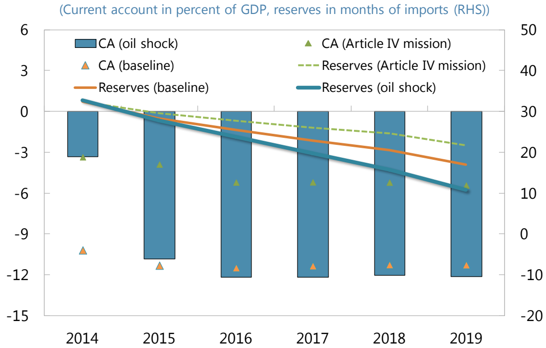
A decline in oil prices by one standard deviation from 2015 onward would lead to …

… a permanently negative current account, a decline in reserves…

… lingering fiscal deficits, and an erosion of the oil fund.

Current Account and Reserves

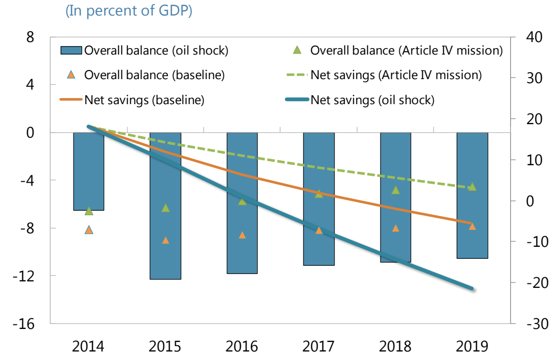
(Current account in percent of GDP, reserves in months of imports (RHS))



Source: IMF staff calculations.

Budget Balance and Net Savings

(In percent of GDP)



Source: IMF staff calculations.

The composition of Algeria's export partners is changing, giving rise to both new risks and opportunities. The shale oil production boom in the United States has led to a redirection of Algeria's light crude oil exports (for which shale oil is a substitute) away from the United States toward Asian countries (notably China). As a consequence, the profile of Algeria's external risks is changing. The broadening of the export partner base weakens the impact of a demand shock in Europe. At the same time, it exposes the country to new risks, especially to a slowdown in China.

1/ See *Algeria – 2013 Article IV consultations* for a detailed analysis of the spillover effects through the external and fiscal balances.

12. The main challenges for Algeria are to consolidate long-term macroeconomic stability and promote economic diversification and job creation. An integrated strategy is needed, whereby the policy mix supports both the stability and competitiveness of the economy; public investment and appropriate structural reforms foster private investment; openness and competitiveness policies prop up exports; and a well-functioning labor market, strong institutions, and a improved jobs-skills match help achieve a substantial decline in unemployment.

Box 3. Algeria: Authorities' Response to Past IMF Policy Recommendations

The authorities generally agree with staff's policy recommendations, but implementation suffers from slow decision-making processes. Progress continued to be recorded in macroeconomic management, with prudent monetary policy and fiscal consolidation bringing inflation well below the central bank target. There were also advances on technical but important measures aimed at improving macroeconomic management (such as the MTBF) and macro-financial stability (such as the recommendations of the 2013 FSAP). However, measures that require a stronger political commitment or that would weaken the State's control of the economy remained on hold; these include the relaxation of restrictions on FDI, the opening of SOEs' capital, and the phasing-out of implicit subsidies.

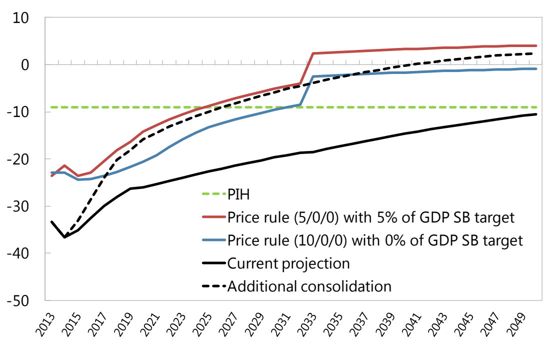
Implementation Status of the 2013 Article IV Recommendations

Recommendation	Implementation status
Strengthen macrostability	*Partial progress*
The monetary and fiscal policy mix should guard against a renewed rise in inflation	Monetary policy remained prudent and fiscal consolidation helped contain liquidity growth.
Further efforts are needed beyond the 2013 fiscal consolidation	Limited progress. The nonhydrocarbon fiscal balance is expected to worsen in 2014, following further increases in current spending and large capital outlays.
Ensure external and fiscal sustainability	*Partial progress*
Implement a full-fledged MTBF	Progress. The authorities plan to test a medium term budget framework (MTBF) in the 2016 budget law. FAD technical assistance was supplied to the authorities to support the implementation of the MTBF, notably its integration in the organic law.
Adopt a full-fledged fiscal rule	Not implemented.
Phase out implicit subsidies	Not implemented, but cost of implicit subsidies was disclosed in the 2014 budget law, and will be published in the 2015 budget law.
Spur a private-sector led, inclusive growth	*Partial progress*
Relax FDI restrictions	No progress.
Deepen the official foreign exchange market	No progress. An MCM TA mission was supplied to assess future TA needs.
Develop the financial sector	Partial progress. The credit registry is being installed; progress was recorded on FSAP recommendations.The 2015 budget law lifts the ban on consumer lending; the listing of SOEs to be brought to the stock market was published.
Improve the business environment	Limited progress. A committee has been put in place to follow performances on the Doing Business indicators.
Increase labor market flexibility and improve jobs/skills match	No progress. However, active labor market policies supported jobs creations and helped reduce unemployment in the population with higher education in 2013 and 2014.

THEME 1. CONSOLIDATING MACROECONOMIC AND FINANCIAL STABILITY

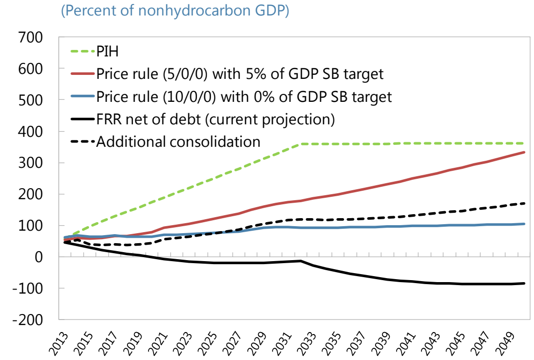
13. The current fiscal stance is unsustainable, and calls for the adoption of a full-fledged fiscal rule. Fiscal policy is procyclical, vulnerable to oil price volatility, and on an unsustainable path. Staff advised that a fiscal rule would help reduce vulnerability to oil price shocks, impose spending discipline, and ensure long-term fiscal sustainability. An appropriate fiscal rule would entail a realistic reference price (for instance, a 5- or 10-year backward-looking moving average), a floor on the structural primary balance, and a cap on drawings from the FRR. Staff also recommended converting the FRR into a sovereign wealth fund invested abroad and targeting a range of objectives, including macroeconomic stabilization and the accumulation of savings for future generations. It could be managed by the Bank of Algeria (BA), following an investment policy defined by the Minister of Finance and adhering to international best practices. The authorities expressed some interest in a fiscal rule, but remained reluctant to convert the FRR into a sovereign wealth fund. Given their lack of expertise in financial markets, the authorities prefer to maintain the existing arrangement, whereby the counterpart of the FRR is a subset of international reserves, which are managed prudently by the central bank.

Nonhydrocarbon Primary Balance
(Percent of nonhydrocarbon GDP)



Sources: Algerian authorities; and IMF staff estimates.

Cumulative Financial Savings
(Percent of nonhydrocarbon GDP)



Sources: Algerian authorities; and IMF staff estimates.

14. The fiscal rule suggests that Algeria needs determined and consistent fiscal consolidation beyond the limited fiscal adjustment achieved in 2013. Restoring sustainability according to the fiscal rule would require significant and sustained fiscal consolidation. The magnitude of the required consolidation is ambitious and should be undertaken immediately; to delay would necessitate even more ambitious consolidation in the future. Reforms are needed to:

- *Increase nonhydrocarbon revenues.* Staff estimates that Algeria's tax potential in 2013 was 3.3 percentage points of nonhydrocarbon GDP higher than actual collected tax revenues. Closing this gap will require broadening the tax base and strengthening tax administration. Tax exemptions should be eliminated or reduced, the distortive turnover tax should be replaced with well-targeted excise, and the property tax should be overhauled. Staff welcomed an increase in the ceiling for the corporate flat rate tax, which was announced in the 2015 budget law; it should lead to higher returns and free resources within the General Tax Directorate for expanding the tax base. While the authorities broadly agreed that nonhydrocarbon revenues need to increase, they saw merit in continuing to grant tax exemptions, notably to promote investment, and were cautious about introducing new taxes before first developing a broader domestic consensus, including with local governments, around a revenue strategy.

- *Limit current spending while preserving growth-enhancing capital spending.* Current spending has increased significantly since 2010 and is projected to reach 36.2 percent of nonhydrocarbon GDP in 2014, a level that constrains fiscal space. Staff advised the authorities to contain the wage bill by stabilizing the size of the civil service and limiting wage increases to productivity gains. Staff also cautioned against modifications to the labor code (Article 87 bis) that could lead to a significant increase in the wage bill. Current transfers are high, and their growth should be capped in real terms while the efficiency of public service provision should be improved. Capital spending should be preserved in real terms. The authorities stressed that any future wage increases linked to the modification of Article 87bis would be modest and phased in gradually.

- *Gradually phase out explicit and implicit subsidies and develop a targeted cash transfer system.* Total subsidies amounted to 18 percent of GDP in 2012, of which implicit hydrocarbon subsidies accounted for 10.9 percent of GDP. Staff recommended phasing out implicit subsidies—which are inequitable (Appendix 2), costly in terms of foregone revenue, and lead to episodic bailout of state-owned enterprises—and adjusting long-unchanged tariffs on public services. Furthermore, any remaining implicit subsidy should be accounted for in the budget. A subsidy reform should be accompanied by targeted cash transfers to shield vulnerable populations. While the authorities disclosed the cost of subsidies in the 2014 and 2015 budget laws, they underscored the difficulties of undertaking such a major reform and highlighted the need for careful preparation.

15. Full implementation of staff's recommendations is necessary to place fiscal policy on a sustainable path. In the baseline scenario discussed with the authorities, the government is assumed to achieve fiscal consolidation equal to 10.3 percent of nonhydrocarbon GDP over the medium term, based on a partial implementation of staff's recommendations. A consolidation of this size, while significant, is nevertheless insufficient to restore fiscal sustainability. Full implementation of staff's recommendations would

Recommended Fiscal Reforms: Estimated Yield over the Medium Term
(Percent of nonhydrocarbon GDP)

	Baseline scenario	Additional consolidation
Increase nonhydrocarbon revenues	1.0	2.3
Limit current spending and preserve capital spending	8.7	-
Gradually phase out subsidies	0.6	5.6
Total	10.3	7.9

Source: IMF staff estimates.

lead to an additional consolidation of nearly 8 percent of nonhydrocarbon GDP, which would place fiscal policy on a sustainable path and help contain the deterioration of the current account by constraining domestic demand.

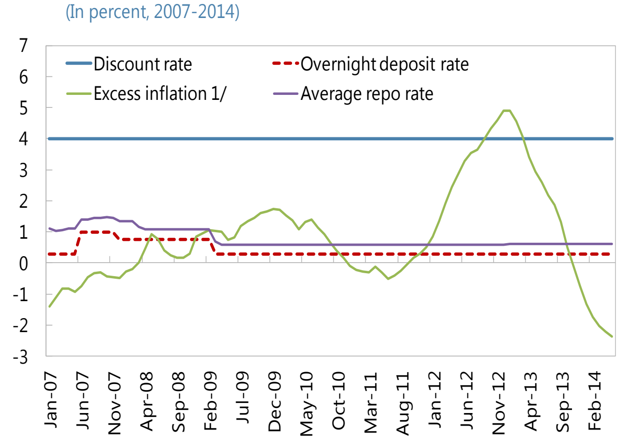
16. Public financial management needs to be modernized. The MTBF and performance-based budgeting is scheduled for introduction on a trial basis with the 2016 budget law. A revised organic budget law, adopted, ideally, in the first quarter of 2015, would help support this reform. Staff and the authorities agreed that progress in the implementation of an integrated public financial management system would be critical to the effective operation of the new framework. Finally, staff advised the detailed publication of hydrocarbon revenues, in a format similar to the EITI.

17. Monetary policy should remain prudent. Although inflation fell to 1.5 percent on average in August, year-on-year inflation has been on an upward trend since October 2013, reaching 2.7 percent in August. Strong credit growth, a surge in capital spending in the first half of 2014, the possibility of further wage increases, and an upturn in excess liquidity suggest that inflationary pressures could reemerge. In this context, the authorities and staff agreed on the need to maintain a prudent stance.

- *Efforts to absorb excess liquidity should continue.* The BA should increase liquidity absorption by auctioning central bank bills, thereby adding another instrument to a monetary policy toolkit that relies largely on the auctioning of deposit facilities. Enhanced coordination with the Ministry of Finance would help improve the liquidity management framework. The government's more ambitious program of Treasury bills issuance is a welcome development that has helped to partially normalize yields on short-term securities. Given the low level of domestic debt and excess demand on the financial markets, there is scope for more sovereign issuance. This would limit liquidity injections resulting from drawings on the FRR; help develop monetary and capital markets; and strengthen monetary policy transmission mechanisms.

- *A more active use of interest rates is warranted.* The interest rate corridor is wide and unresponsive to changes in monetary conditions, blurring the signaling of the policy stance. The authorities should take advantage of the current low-inflation environment to upgrade their monetary framework to allow for a more active use of interest rates, which would improve the central bank's ability to react to inflation shocks. Some easing in the discount rate could be implemented if inflation stays low, while a hike in the overnight and repo rates would be needed to signal a tighter stance if inflation picks up.

Interest Corridor
(In percent, 2007-2014)



Sources: Algerian authorities; and IMF staff calculations.
1/ Gap between the 4 percent central bank inflation target and actual inflation.

18. Exchange rate policy should aim to avoid a deviation of the dinar from its equilibrium level. International reserves are well above standard adequacy levels (Appendix I), but external stability is a growing concern, given a rapidly deteriorating current account and a relatively short time horizon for hydrocarbon resources. In this context, the authorities should keep the exchange rate in line with its fundamental equilibrium value. Staff estimates that the real effective exchange rate was overvalued by about 3.4 percent in 2014 (Appendix I), and by over 10 percent compared to its medium-term equilibrium value, given the projected fiscal consolidation and declining hydrocarbon prices. While they reiterated their commitment to avoid any misalignment, the authorities felt that staff's estimates overstated the degree of overvaluation.

- *The supply of foreign exchange needs to be diversified in order to create a deeper, more competitive foreign exchange market*. The BA is currently the main supplier of foreign exchange and ensures full coverage of current transactions. A more diversified supply of foreign exchange could be achieved by relaxing surrender requirements—including those for the hydrocarbon sector companies—and by lowering the de facto reserve requirement ratio on foreign currency deposits of companies and individuals. Competition in the interbank market could be strengthened by allowing private agents to place foreign exchange orders outside of the banks that handle their international trade transactions. The authorities agreed with staff's recommendations and have requested IMF technical assistance to develop the foreign exchange interbank market.

- *Decisive action is needed to remove the premium for foreign exchange on the parallel market.* Although foreign currency needs for current transactions are entirely covered by the BA, and the parallel market is illegal, the premium on the parallel market remains high, at about 40 percent. The premium is a source of distortion that impedes private sector development. The mission reiterated its recommendation that the authorities significantly raise the indicative foreign exchange allocation ceilings to more realistic levels. The authorities should also prepare to move toward a gradual and properly sequenced liberalization of the capital account, taking into account Algeria's financial and institutional infrastructure, and starting with FDI followed by portfolio flows.

19. The authorities should pursue further reforms to preserve the stability of the financial sector. The financial sector is solvent, well-capitalized, and stable. Its major vulnerability is the concentration of credit risk. Staff welcomed the adoption of three regulations related to capital adequacy, lending classification and provisioning, and concentration risk, which follow the 2013 Financial Sector Assessment Program (FSAP) recommendations related to Basel II/III. The authorities are also planning to introduce macro-prudential policies, strengthen the deposit guarantee system, and set up a crisis management framework. A dedicated bank resolution regime needs to be established, and the shift to risk-based supervision needs to take place by completing the CAMELS rating exercise by 2015, as currently envisioned. Finally, reforms are needed to encourage banks to write off old and fully provisioned NPLs. Such reforms include easing the obligation of banks to recover these NPLs and facilitating their transfer to an asset management company.

THEME 2. ENSURING EXTERNAL STABILITY

20. Algeria's external position has weakened in recent years, exposing risks to external sustainability under a no-policy-change scenario. Simulations show that, under current policies, long-term external sustainability is compromised, as the net international investment position is projected to turn negative when oil production ends and would later exceed 100 percent of GDP. While fiscal consolidation and an appropriate exchange rate policy would help, staff and the authorities agreed on the need to accelerate export growth through a two-pronged approach of diversifying the export base and preserving hydrocarbon exports.

21. Wide-ranging reforms are needed to spur export diversification, which is critical to ensuring external sustainability and reducing vulnerability to oil price shocks. Available information suggests that oil resources will be depleted by the early 2030s, and gas by the mid-2050. Yet with a nonhydrocarbon export-to-import cover ratio below 2 percent, Algeria's dependence on hydrocarbon exports is among the highest in oil-exporting countries. Nonhydrocarbon export capacities therefore urgently need to be expanded to cover the country's future imports.

- *Policies should focus on maintaining economic stability and improving competitiveness*. Macroeconomic policy should avoid real exchange rate overvaluation, strengthen the profitability of domestic production, and support exports. Public spending should be directed toward productivity-enhancing sectors, such as education and infrastructure, while salary increases should be kept in line with productivity gains.

- *Diversification requires trade and FDI opennes*s. Trade openness supports diversification through the lower cost of inputs, the incorporation of technical progress through imports, and competition. Staff welcomed the authorities' announced resolve to accelerate WTO accession, and advised increasing the number of free trade agreements to improve the country's access to foreign markets. In the meantime, staff underscored that trade restriction measures, such as import or export licenses, should be avoided because they introduce distortions in the economy. Staff reiterated its recommendation that the requirement of a minimum 51 percent Algerian ownership in foreign investments should be eliminated or at least limited to strategic sectors. The ongoing reform of the investment code is an opportunity to repeal this provision and give the government more flexibility in defining limits on foreign shareholding. While the authorities broadly agreed with staff recommendations, they prefer a gradual approach to liberalizing trade and easing FDI restrictions.

- *Reforms are needed to create a more export-friendly business climate*. In addition to the constraints faced by entrepreneurs in launching and operating a business, exporters face high trade costs, pervasive foreign exchange controls, and limits to their ability to invest overseas in support of exports. Staff recommended eliminating or relaxing these constraints and implementing an export promotion strategy aimed at developing capacities in areas where Algeria has significant development potential.

22. Energy policy needs to support growth of hydrocarbon exports. This entails implementing reforms aimed at reversing the decline in production and containing domestic consumption.

- *A more attractive environment for investment in the hydrocarbon sector is needed to achieve faster, sustained growth in production.* Staff expects the downward trend that has marked hydrocarbon production for the past eight years to start reversing in 2014. Production should increase moderately over the medium term as new projects come on line and gas production fully recovers from the 2013 attack on the In Amenas gas plant. However, a more robust recovery would require a significant contribution from foreign investment, particularly because Algeria plans to explore and develop its offshore and unconventional assets. More investment in the hydrocarbon sector will also help extend the time horizon for hydrocarbon resources and boost production and exports. Against the background of yet another disappointing round of exploration tenders, staff encouraged the authorities to continue implementing reforms to improve Algeria's attractiveness to FDI in the energy sector and to promote exploration, especially in the currently challenging context of lower oil prices. The authorities plan to assess the results of the recent bid round and launch a new bid round soon, with the hope of attracting more investors.

- *The rapid growth in domestic consumption, which weighs on the country's export capacity, needs to be contained.* A gradual phasing-out of implicit subsidies for hydrocarbon products and electricity is needed to slow down the growth of domestic consumption, including smuggling-related leaks. Staff also encouraged the authorities to design and implement a strategy to increase energy efficiency and develop alternative energy sources, including renewable energy, where Algeria has considerable potential.

THEME 3. ACCELERATING ECONOMIC GROWTH AND JOB CREATION

23. Algeria has impressive economic potential. Fully realizing this potential will require a shift toward a private sector-led growth model. Reforms are needed to strengthen the quality of public investment, reduce the public sector's footprint, promote private sector development, and foster productivity and competitiveness. Faster growth, combined with improved labor market effectiveness, would increase job creation.

24. Public investment will remain a significant source of growth in coming years. In a context of tighter financing conditions, the focus should be on efficiency. Efficiency could be increased by adopting an integrated public financial management system, together with tools to improve project selection, implementation, monitoring and evaluation. Staff recommended avoiding the use of negotiated contracts and relying fully on an open and competitive process for public investment, to enhance efficiency and transparency. The authorities should also establish a legal framework for public-private partnerships, which have started to be developed and could be an efficient way to increase the supply of infrastructure.

25. Faster and more sustainable growth will require structural reforms that transform the private sector into an engine for growth.

- *The business climate needs to improve.* Notwithstanding Algeria's 21-point advance (to 79th place) in the World Economic Forum's Global Competitiveness ranking, the business climate remains difficult. Staff welcomed the authorities plan to carry out an extensive program of reforms to improve the business climate and strengthen the economy's competitiveness, and advised streamlining administrative procedures for creating companies, obtaining title to property and construction permits, conducting international trade, and paying taxes. Developing e-government solutions would help, as would putting in place effective one-stop shops and strengthening anti-corruption efforts. Some of those improvements could be incorporated in the upcoming overhaul of the investment code. The authorities stressed that they have already simplified some procedures and are determined to improve Algeria's ranking in the World Bank's Doing Business report.

- *Increasing total factor productivity growth will require wide-ranging structural reforms.* In addition to increasing openness to facilitate technological transfers, staff advised the authorities to foster competition, design policies to promote entrepreneurship and innovation, improve the quality of education and training, and support the development of ICT industries.

26. Reforms are needed to develop the financial sector. The financial sector is generally healthy but underdeveloped, which hinders private sector-led growth. Staff underscored the importance of implementing the recommendations of the 2013 FSAP (Appendix 6), which the authorities already consider a priority. Key reforms include:

- *Improving access to finance.* Staff recommended strengthening competition, enhancing creditors' rights, modernizing the bankruptcy framework, and improving debt enforcement procedures. The governance of state-owned banks should be improved, and the possibility of criminal sanctions for lending decisions lifted. SME lending is impeded by high collateral requirements and difficulties dealing with NPLs. The guarantee system has so far failed to spur credit to SMEs and needs to be reformed. The credit registry, which is expected to be completed in 2015, should facilitate access to information and help to unlock credit. The lifting of the ban on consumer lending announced in the 2015 budget law is welcome. Staff also recommended that the government withdraw from direct mortgage financing, particularly for middle- and upper-income households, in order to facilitate the development of housing credit. To develop the payment system, the public sector should take a leading role in the use of banking payments.

- *Developing capital markets.* Underdeveloped markets deprive savers of investment opportunities and limit businesses' access to capital. Staff recommended swift implementation of the government's program to open up the capital of some large state-owned enterprises. In addition, the authorities should modify existing regulations to eliminate the government's right of first refusal and to define a threshold for the requirement of having to obtain prior agreement from the BA to participate in a bank's capital. To develop local debt markets, sovereign bond issuance should be increased and existing disincentives to corporate securities issuance, such as interest rate subsidies, should be removed.

- *Addressing gaps in the anti-money laundering and financing of terrorism (AML/CFT) framework.* In October 2014, the FATF concluded that Algeria had not made sufficient progress in implementing its action plan, and that strategic AML/CFT deficiencies remained, in terms of the criminalization of terrorist financing, freezing of terrorist assets, and customer due diligence requirements. Staff urged the authorities—and the authorities agreed—to address FATF's remaining concerns to avoid potential countermeasures and further economic impact of heightened due diligence on cross-border transactions.

27. Further progress in reducing unemployment will require not only more labor-intensive economic growth, but also better functioning labor markets. Labor market performance continues to be disappointing, with unemployment stabilizing at a relatively high level, low rates of participation and employment, and a sizeable informal sector.

- *High transaction costs in the formal labor market slow job creation and encourage the development of the informal sector.* Algeria's labor market is characterized by rigidities in terms of hiring and firing, high payroll taxes and excessive growth in wages with respect to productivity. Unemployment insurance is ineffective because of overly strict rules governing the collection of unemployment benefits. Labor market rigidities mean that firms have limited scope to adjust to changes in demand. For example, adjusting hours worked to seasonal changes in production is not allowed—contrary to the case in 93 percent of countries. Staff recommended reviewing labor market regulations and the cost-effectiveness of social protection, especially in order to facilitate the reallocation of labor to productive activities while enhancing protection for the risk of unemployment and income shocks. The authorities stated that they are reviewing the labor code with other stakeholders and intend to move in the direction recommended by staff.

- *The mismatch between labor demand and supply needs to be addressed.* There is evidence that employers have difficulties in finding applicants with an adequate level of technical or job skills. The authorities should develop a strategy for education and training to meet labor market needs. Ties between the educational system and the private sector should be strengthened, and the appeal to students of vocational training programs improved. Finally, the public sector needs to move away from its traditional role of employer of first choice in order to make employment in the private sector more attractive.

- *The net impact of active labor market policies on employment should be assessed to guide future policy.* Active labor market policies have focused mainly on supporting the creation of small enterprises, but the evaluation of those policies is still limited. A preliminary study of the national unemployment insurance fund (Caisse Nationale d'Assurance Chômage, CNAC) suggests that those enterprises have a relatively high survival rate but very limited growth.

A significant number of enterprises have been created with support from the national youth unemployment agency (Agence Nationale de Soutien à l'Emploi, ANSEJ), but there are also indications that NPLs have rapidly accumulated. Staff underscored that other active labor market policies could be usefully explored, such as training programs for low-skilled, vulnerable youth. The authorities should conduct a rigorous evaluation of active labor market policies to improve their effectiveness, and move towards a more targeted approach. The authorities indicated that they are in the process of carrying out an evaluation of the schemes that support entrepreneurship among the unemployed.

- *Women continue to be underrepresented in the labor market.* Female participation rates remain low, and women's unemployment rate is higher than men's. Women with jobs are more likely than men to be covered by social security, but they are also more likely to work on a part-time basis. In recent years, considerable progress has been made to improve parity between men and women in education, but this progress has yet to translate into significant improvement in female participation and employment rates. Economic and social policies can help—for example, improving transportation, increasing the availability of child care, and introducing greater flexibility in working arrangements.

STAFF APPRAISAL

28. Algeria's longstanding vulnerabilities are becoming increasingly apparent, exposing the unsustainable nature of current policies and increasing the urgency for reforms. Economic growth is expected to pick up in 2014, inflation has fallen below the central bank's target, and fiscal and external buffers remain large. However, current policies are unsustainable and have increased Algeria's vulnerability to oil price shocks. The current account is expected to record a deficit this year and through the medium term, the fiscal deficit is widening, and both fiscal savings and foreign exchange reserves are declining in absolute terms. These trends are expected to continue unless major reforms are undertaken to restore fiscal sustainability, diversify the economy, improve competitiveness, reduce dependence on hydrocarbon exports, and promote private sector-led growth.

29. Monetary policy should guard against possible renewed inflationary pressures. Strong credit growth, a surge in capital spending, the possibility of further wage increases, and an upturn in excess liquidity suggest that inflationary pressures could reemerge. The BA should use interest rates more actively and should continue to mop up excess liquidity, including by issuing central bank bills. The Ministry of Finance can limit liquidity injections by relying more on debt issuance and less on drawing from the FRR to finance the budget.

30. The widening of the fiscal deficit this year further undermines fiscal sustainability. Placing fiscal policy on a sustainable path will require ambitious and sustained fiscal consolidation. Staff recommends the adoption of a fiscal rule to help with this effort while reducing procyclicality. Fiscal consolidation will require mobilizing more nonhydrocarbon revenue and containing current expenditures—especially wages and transfers. Subsidies are costly and inefficient, and should be gradually replaced by a better-targeted cash transfer system. The authorities' intention to move to a medium-term budget framework and program budgeting is a welcome development, and should be supported by a sound integrated public financial management system.

31. Ensuring external sustainability will require boosting hydrocarbon exports and developing a more diversified export base. Algeria needs to attract foreign investment to expand oil and gas reserves and enhance production capacity. At the same time, raising the prices of hydrocarbon products and electricity is necessary to contain the growth of domestic consumption, which is weighing on hydrocarbon exports. In order to diversify its exports, Algeria should avoid exchange rate overvaluation, create a more export-friendly business climate, and foster more trade and capital openness.

32. The financial sector is generally healthy but underdeveloped. The transition to Basel II/III for supervision is welcome. The authorities should continue to implement the recommendations of the 2013 FSAP mission, especially accelerating the shift to risk-based supervision, developing financial safety nets, and setting up a crisis management framework. Reforms are needed to improve access to finance, especially for SMEs and households. Listing well-performing public companies would help to develop the stock exchange. To develop local debt markets, sovereign bond issuance should be increased and interest subsidies removed. Remaining shortcomings in the AML/CFT framework must be addressed to avoid potential countermeasures by FATF members.

33. Realizing Algeria's impressive economic potential will require wide-ranging reforms. The efficiency of public investment could be increased by developing tools to improve project selection, implementation, monitoring and evaluation, and by setting up a legal framework for public-private partnerships. To transform the private sector into an engine for growth, the business climate needs to improve. The authorities should also increase international openness so as to facilitate technological transfers and foster competition, and design policies to promote entrepreneurship and innovation, improve the quality of education and training, and support the development of ICT.

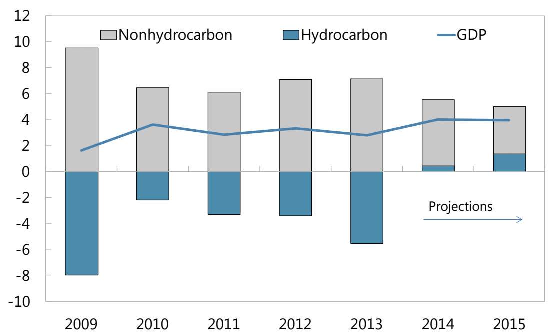
34. Labor market reforms are needed to reduce unemployment, especially among youth and women. Labor market regulations are overly rigid, limiting firms' ability to react to changes in demand. Closer ties between the educational system and the private sector would help ensure that graduates are equipped with the skills that firms are seeking. The authorities should undertake a thorough assessment of active labor market policies to gauge their effectiveness. Preliminary indications suggest that these policies have led to little job creation. Although progress has been made to improve parity between men and women in education, more needs to be done to increase female participation and employment rates.

35. It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

Figure 1. Algeria: Selected Macroeconomic Indicators

A modest rebound in the hydrocarbon sector should lift real GDP growth in 2014.

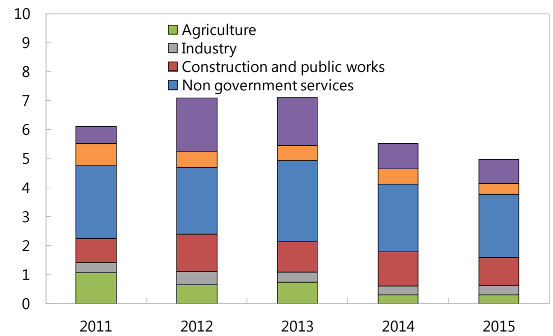
Hydrocarbon and Nonhydrocarbon Growth
(Percent)



Sources: Algerian authorities; and IMF staff calculations.

A poor harvest and weaker industrial activity is expected to weigh on nonhydrocarbon growth.

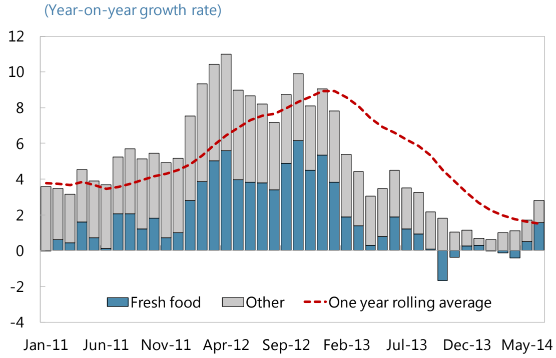
Sources of Nonhydrocarbon Growth
(In percent)



Sources: Algerian authorities; and IMF staff calculations.

Inflation slowed in 2013, but has started to pick up again in the first half of 2014.

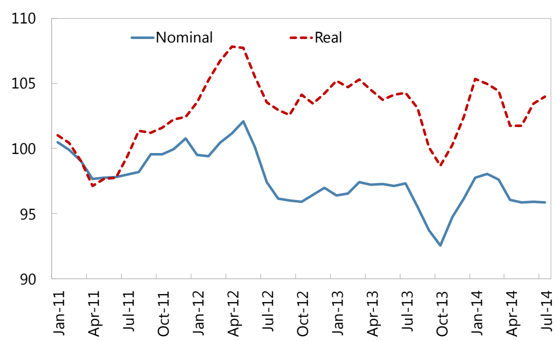
CPI Inflation
(Year-on-year growth rate)



Sources: Algerian authorities; and IMF staff calculations.

The depreciation of the exchange rate in the latter half of 2013 was largely reversed.

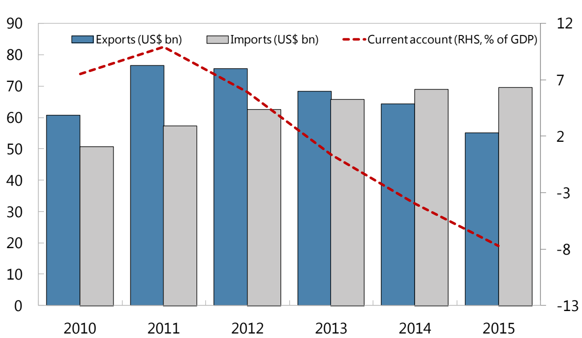
Effective Exchange Rate
(100=2005)



Source: Algerian authorities.

The current account is expected to move into deficit for the first time in 15 years.

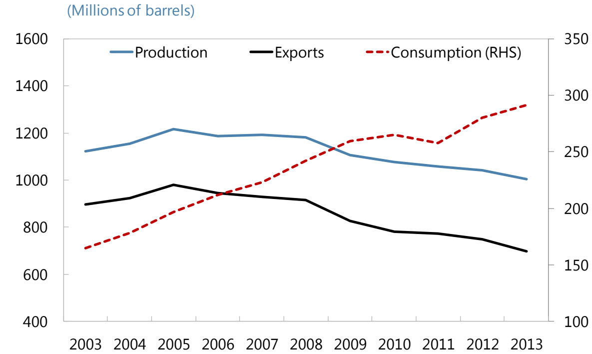
Current Account



Sources: Algerian authorities; and IMF staff calculations.

Domestic hydrocarbon consumption continued to grow quickly, weighing on exports as production declined.

Hydrocarbon Production, Consumption, and Exports
(Millions of barrels)

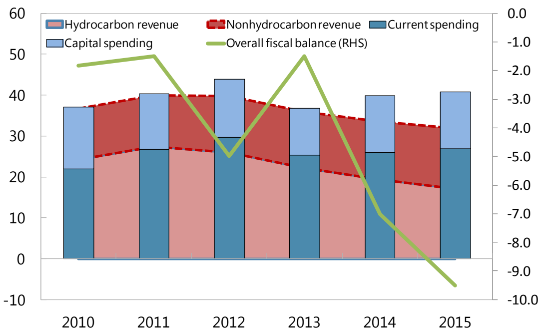


Source: Algerian authorities.

Figure 2. Algeria: Fiscal Indicators

The government undertook some fiscal consolidation in 2013, but the deficit is expected to increase again in 2014.

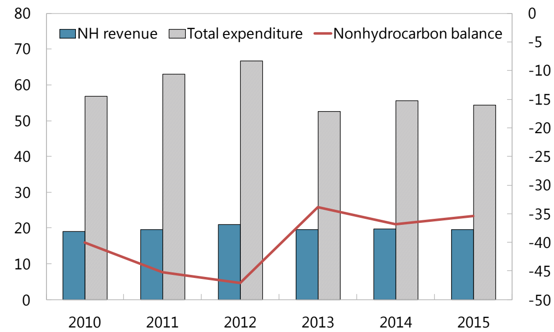
Overal Fiscal Balance
(In percent of GDP, 2010–15)



Sources: Algerian authorities; and IMF staff calculations.

The NH balance improved in 2013 thanks to lower spending, but NH revenues remain flat.

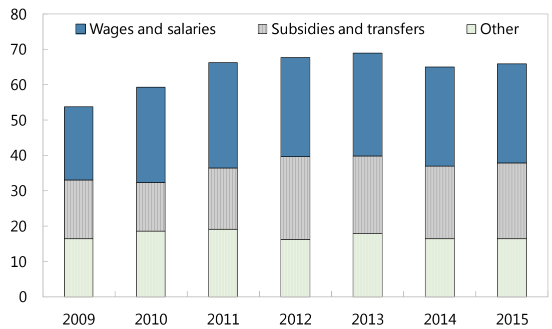
Nonhydrocarbon Fiscal Balance
(In percent of NHGDP)



Sources: Algerian authorities; and IMF staff calculations.

Current spending remains high as a share of total spending…

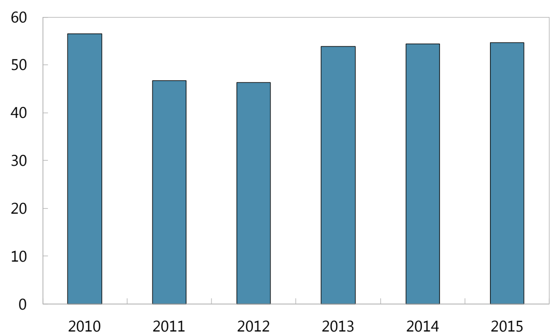
Current Spending Relative to Total Spending
(Percent)



Sources: Algerian authorities; and IMF staff calculations.

… financed only partially by nonhydrocarbon revenue.

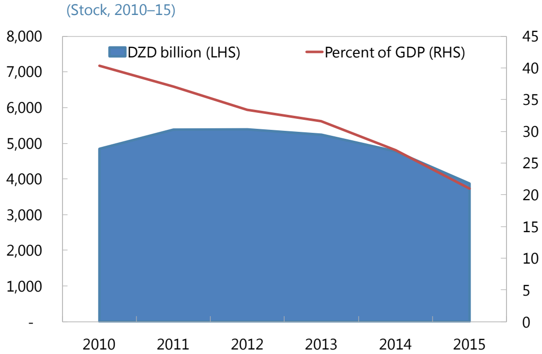
Current Spending and Nonhydrocarbon Revenue
(Share of nonhydrocarbon revenue to current spending, percent)



Sources: Algerian authorities; and IMF staff calculations.

Savings in the oil fund decreased in 2013, both in absolute terms and as a percent of GDP.

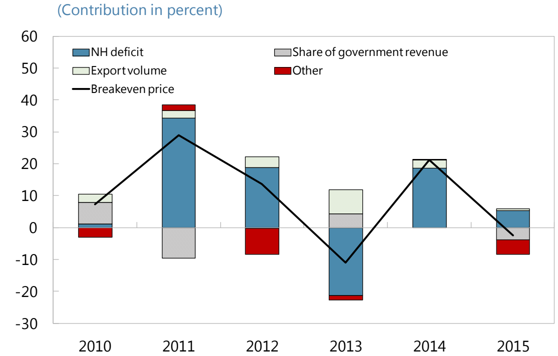
Oil Fund
(Stock, 2010–15)



Sources: Algerian authorities; and IMF staff calculations.

The breakeven price is projected to increase in 2014, after declining for the first time in 12 years in 2013.

Change in the Fiscal Breakeven Price
(Contribution in percent)

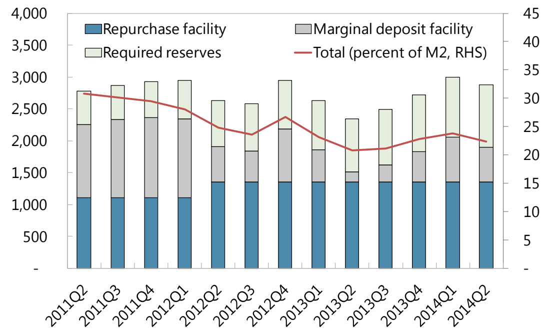


Sources: Algerian authorities; and IMF staff calculations.

Figure 3. Algeria: Monetary Indicators

The BA increased liquidity absorption and required reserves...

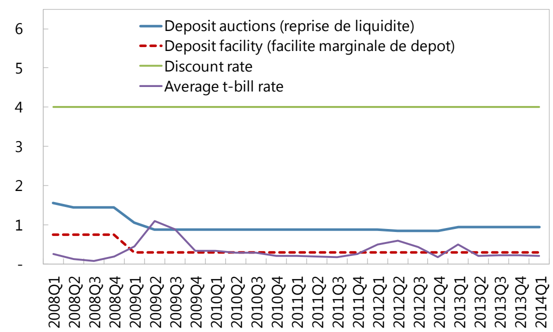
Liquidity Management
(Liquidity management in DZD bn and in percent of M2)



Sources: Algerian authorities; and IMF staff calculations.

...but shied away from raising interest rates.

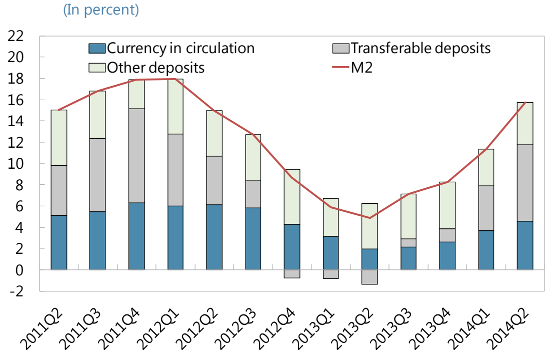
Interest Rates
(In percent, 2008Q4–2013Q2)



Sources: Algerian authorities; and IMF staff calculations.

Money growth bottomed out in 2013Q2 but has been on the rise since then....

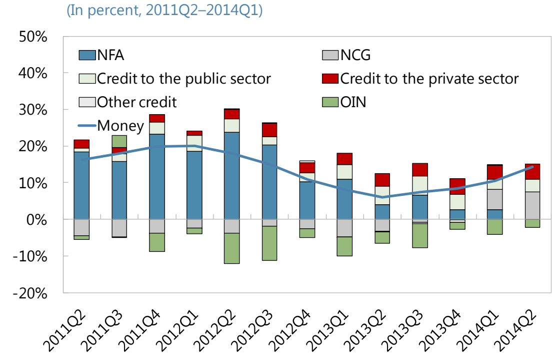
M2 Growth and Determinants
(In percent)



Sources: Algerian authorities; and IMF staff calculations.

...spurred by an increase in credit and draw-downs from government savings.

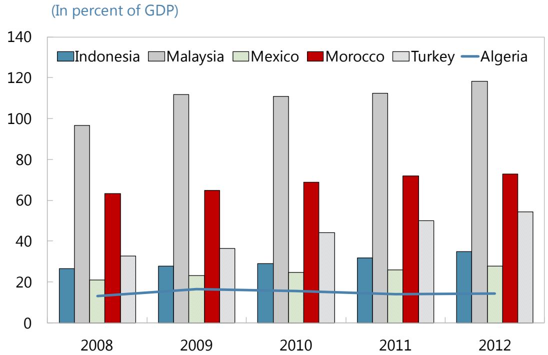
Contribution to M2 Growth
(In percent, 2011Q2–2014Q1)



Sources: Algerian authorities; and IMF staff computations.

Despite growing rapidly, credit remains low.

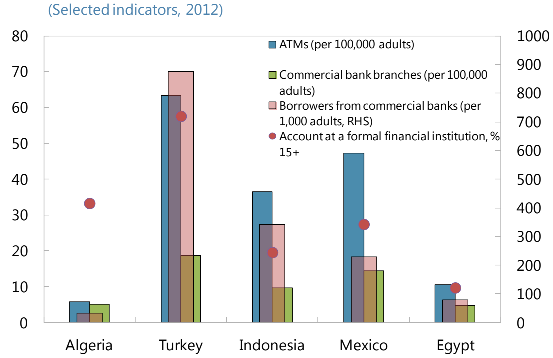
Credit to the Private Sector
(In percent of GDP)



Source: World Bank, *World Development Indicators*.

Financial services are underdeveloped.

Financial services
(Selected indicators, 2012)

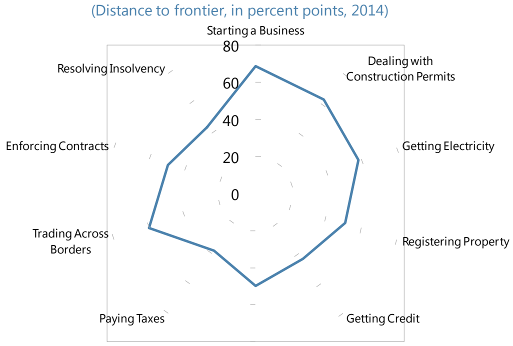


Source: World Bank, *World Development Indicators*.

Figure 4. Algeria: Structural Indicators

The business environment is weak, stifling private sector development…

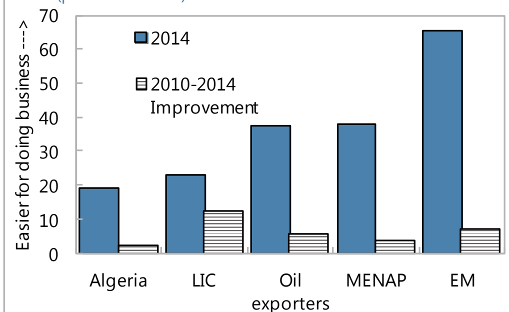
Doing Business
(Distance to frontier, in percent points, 2014)



Source: World Bank, Doing Business Indicators

… and there has been little improvement in recent years.

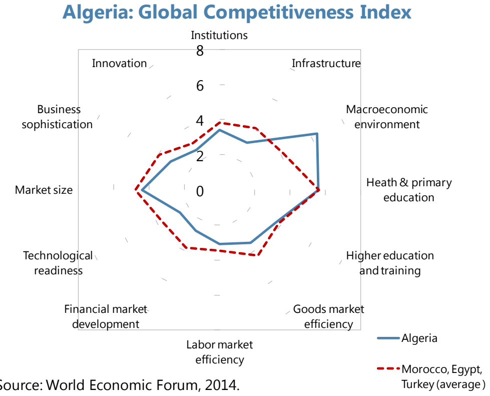
Ease of Doing Business
(percentile rank)



Sources: World Bank Doing Business (2014), and IMF staff calculations.

Businesses face many constraints.

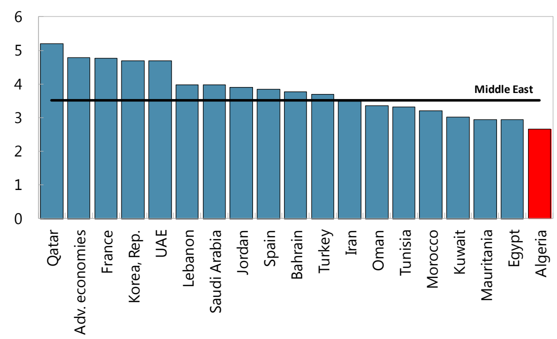
Algeria: Global Competitiveness Index



Source: World Economic Forum, 2014.

Algerian companies are ranked next to last in the world in terms of their capacity for innovation.

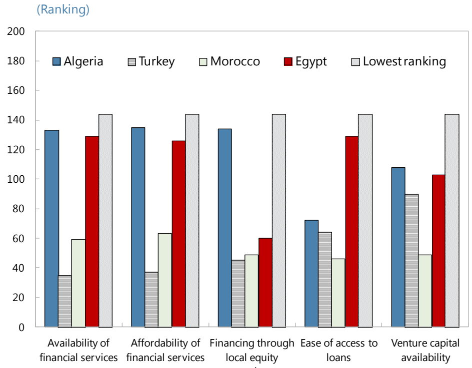
Capacity for Innovation
(1=not at all; 7=to a great extent)



Source: World Economic Forum, 2014.

Financial services are underdeveloped…

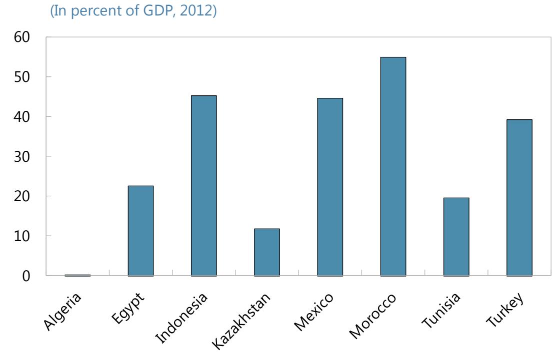
Financial Sector Development
(Ranking)



Source: 2014 WEF Competitiveness Report.

…and capital markets are nascent.

Market Capitalization
(In percent of GDP, 2012)

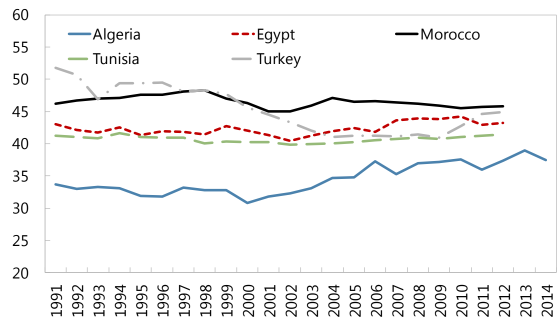


Sources: World Bank; and IMF staff calculations.

Figure 4. Algeria: Structural Indicators (concluded)

The employment ratio remains low by regional standards…

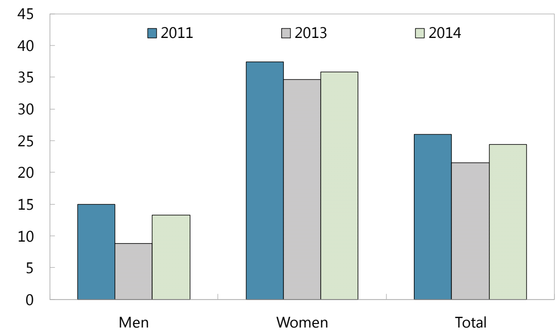
Employment Ratios
(In percent of population age 15 +)



Sources: Algerian authorities; and World Bank, *World Development Indicators*.

…and the share of youth that are neither employed, nor in school, nor in vocational training is high.

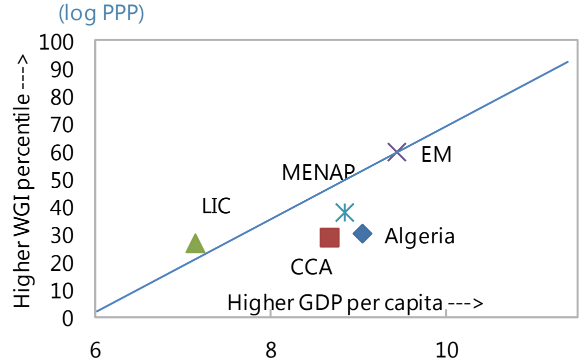
Youth Not in Education, Employment or Training
(In percent of 15-24 year old population)



Source: Algerian authorities.

Governance indicators are low, taking into account Algeria's per capita income…

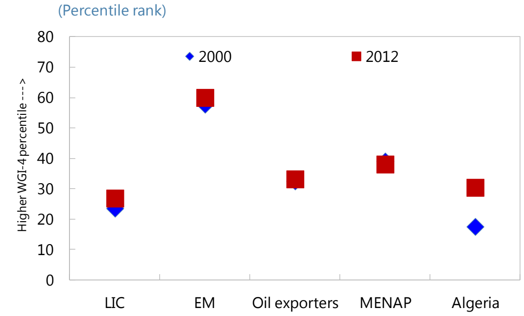
WGI-4 and GDP per capita
(log PPP)



Sources: Worldwide Governance Indicators (government effectiveness, regulatory quality, rule of law, and control of corruption); trend line is based on across country regression.

…despite some improvement since 2000.

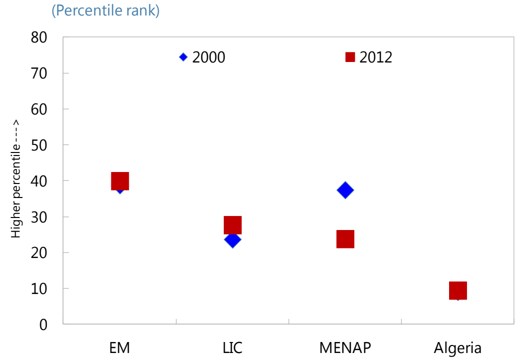
Changes in WGI-4
(Percentile rank)



Sources: Worldwide Governance Indicators (government effectiveness, regulatory quality, rule of law, and control of corruption), and IMF staff calculations.

Algeria ranks low in terms of political stability and no violence, deterring foreign investment.

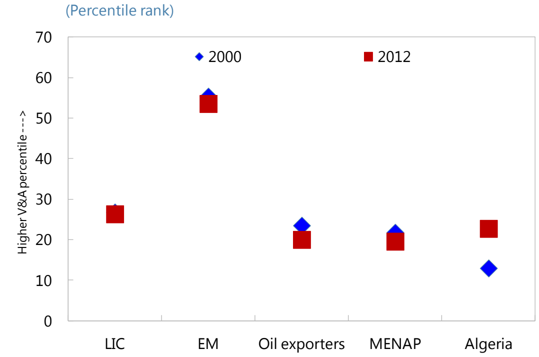
Political Stability and No Violence
(Percentile rank)



Sources: Worldwide Governance Indicators, and IMF staff calculations.

Voice and accountability is also well below emerging market standards, despite some improvement since 2000.

Changes in Voice and Accountability Index,
(Percentile rank)



Sources: Worldwide Governance Indicators; and IMF staff calculations.

Table 1. Algeria: Selected Economic and Financial Indicators, 2012–19

		Est.			Proj.			
	2012	2013	2014	2015	2016	2017	2018	2019
Oil and gas sector								
Hydrocarbon production (in ton oil equivalent)	142	137	138	139	142	144	147	149
Hydrocarbon exports								
Of which: liquid petroleum exports (in millions of barrels/day)	1.3	1.2	1.2	1.1	1.1	1.1	1.1	1.1
Of which: natural gas exports (in billions of m3)	51.7	46.3	44.9	45.5	46.3	47.1	47.9	48.6
Crude oil export unit value (US$/bbl)	110.8	109.5	104.1	89.0	90.2	90.1	89.7	89.5
Share of hydrocarbons in total exports (in percent)	98.4	98.4	97.5	96.8	96.5	96.2	95.9	95.6
National income and prices								
GDP at constant prices	3.3	2.8	4.0	3.9	4.1	4.0	4.0	4.0
Hydrocarbon sector	-3.4	-5.5	0.4	1.3	1.7	1.9	1.6	1.6
Other sectors	7.1	7.1	5.5	5.0	4.9	4.7	4.7	4.6
Consumer price index (period average)	8.9	3.3	3.0	4.0	4.0	4.0	4.0	4.0
External sector 1/								
Exports, f.o.b. (percent change)	-1.6	-10.2	-6.3	-14.7	2.1	0.8	0.4	0.6
Hydrocarbons	-1.5	-10.3	-7.2	-15.4	1.8	0.5	0.1	0.3
Nonhydrocarbons	-6.0	-8.9	44.3	9.9	11.1	9.7	8.4	7.3
Imports, f.o.b. (percent change)	14.9	6.6	5.0	0.9	5.3	1.1	2.0	2.5
Current account balance (in percent of GDP)	5.9	0.4	-4.0	-7.7	-8.2	-7.8	-7.5	-7.5
Money and credit								
Net foreign assets (percent change)	7.4	1.9	0.5	-3.5	-5.4	-6.8	-8.7	-11.5
Credit to the economy	15.1	19.9	21.7	12.0	10.8	10.2	8.6	8.3
Money and quasi-money	10.9	8.4	14.5	9.0	5.7	4.3	3.0	3.0
Velocity of broad money (GDP/M2)	1.5	1.4	1.3	1.2	1.3	1.3	1.4	1.4
				In percent of GDP				
Saving-investment balance	5.9	0.4	-4.0	-7.7	-8.2	-7.8	-7.5	-7.5
National savings	36.2	35.0	34.1	32.1	32.4	32.5	32.9	33.0
Government	9.1	9.9	6.9	4.4	5.1	5.6	5.9	6.0
Nongovernment	27.1	25.1	27.1	27.7	27.4	26.9	27.0	27.0
Investment	30.3	34.6	38.0	39.8	40.7	40.3	40.3	40.5
Government	14.1	11.4	13.9	13.9	13.3	12.7	12.4	12.1
Nongovernment	16.2	23.2	24.1	25.9	27.4	27.6	27.9	28.4
Central government finance								
Overall budget balance (deficit -)	-5.0	-1.5	-7.0	-9.5	-8.2	-7.1	-6.6	-6.1
Total revenue	39.7	35.9	33.5	31.8	31.6	31.2	31.1	30.9
Total expenditure (incl. net lendinc)	44.7	37.4	40.5	41.3	39.8	38.3	37.6	37.0
				In percent of nonhydrocarbon GDP				
Central government finance (in percent of NHGDP)								
Total revenue	60.5	51.2	46.7	42.4	41.8	41.1	40.3	39.5
Hydrocarbon	39.6	31.7	27.1	22.8	22.0	20.9	19.8	18.8
Nonhydrocarbon	20.9	19.5	19.7	19.6	19.8	20.2	20.5	20.7
Total expenditure	66.7	52.5	55.6	54.3	52.1	50.0	48.4	46.9
Current expenditure	45.2	36.2	36.2	35.8	34.5	33.2	32.3	31.4
Capital expenditure	21.5	16.3	19.4	18.5	17.6	16.8	16.1	15.5
Nonhydrocarbon primary balance	-46.8	-33.5	-36.6	-35.1	-32.6	-30.0	-28.0	-26.3
NH primary balance, net of one-off spendings	-41.9	-33.1	-36.6	-35.1	-32.6	-30.0	-28.0	-26.3
Nonhydrocarbon balance	-47.1	-33.8	-36.9	-35.5	-32.9	-30.3	-28.3	-26.6
Memorandum items:								
GDP (in billions of dinars at current prices)	16,115	16,569	17,646	18,422	20,010	21,725	23,141	24,641
NHGDP (in billions of dinars at current prices)	10,579	11,601	12,645	13,843	15,106	16,497	17,847	19,272
GDP (in billions of US$ current prices)	208	209	211	208	217	225	240	256
GDP capita per (in US$)	5,542	5,508	5,446	5,273	5,405	5,510	5,770	6,041
Exchange rate (DZD per USD)	77.6	79.4	...	...	...	...	...	...
Crude oil exports (in millions of barrels/day)	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Nonhydrocarbon exports (percent of total exports)	1.6	1.6	2.5	3.2	3.5	3.8	4.1	4.4
Gross official reserves (end of period)	191	194	188	173	157	142	127	110
In months of next year's imports of goods and services	35	34	32	28	25	23	21	17
Gross government debt (in percent of GDP)	10.0	8.3	8.8	9.0	8.9	8.8	8.7	8.6

Sources: Algerian authorities; and Fund staff estimates and projections.

1/ In U.S. dollars terms.

Table 2. Algeria: Balance of Payments, 2012–19

		Est.	Proj.					
	2012	2013	2014	2015	2016	2017	2018	2019
	(In billions of U.S. dollars; unless otherwise indicated)							
Current account	12.3	0.8	-8.3	-16.0	-17.9	-17.5	-18.0	-19.2
Trade balance	20.2	9.4	2.6	-6.8	-8.8	-9.1	-10.0	-11.3
Exports, f.o.b.	71.7	64.4	60.3	51.4	52.5	52.9	53.2	53.5
Hydrocarbons	70.6	63.3	58.8	49.8	50.7	50.9	51.0	51.1
Volume change (in percent)	-3.8	-7.1	-2.3	-1.0	0.5	0.5	0.5	0.5
Price change (in percent)	2.4	-3.4	-5.0	-14.5	1.3	-0.1	-0.4	-0.2
Other	1.2	1.1	1.5	1.7	1.9	2.0	2.2	2.4
Imports, f.o.b.	-51.6	-55.0	-57.7	-58.2	-61.3	-62.0	-63.2	-64.8
Volume change (in percent)	15.1	7.1	5.8	2.5	5.2	0.8	1.6	2.5
Price change (in percent)	-1.9	-1.8	-2.5	-2.5	0.2	0.1	0.2	-0.1
Services and income (net)	-11.0	-11.3	-14.0	-12.4	-12.4	-11.9	-11.6	-11.7
Services (net)	-7.1	-6.8	-7.3	-7.6	-8.1	-8.2	-8.3	-8.5
Credit	4.0	3.9	4.0	3.8	3.9	3.9	4.0	4.1
Debit	-11.1	-10.7	-11.3	-11.4	-12.0	-12.1	-12.3	-12.6
Income (net)	-3.9	-4.5	-6.7	-4.8	-4.3	-3.8	-3.2	-3.2
Credit	3.9	3.5	3.1	2.2	2.8	3.3	3.8	3.9
Debit	-7.8	-8.1	-9.8	-7.0	-7.1	-7.1	-7.1	-7.1
Interest payments	-0.3	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.0
Other, including profit repatriation	-7.5	-8.0	-9.6	-6.9	-7.0	-7.0	-7.0	-7.1
Transfers (net)	3.2	2.8	3.0	3.2	3.3	3.5	3.6	3.8
Capital account	-0.2	-0.7	1.1	1.6	2.1	2.2	2.3	2.4
Medium- and long-term capital	0.9	1.5	1.3	1.5	2.1	2.2	2.3	2.4
Direct investment (net)	1.5	2.0	1.5	1.5	2.1	2.2	2.3	2.4
Loans (net)	-0.6	-0.4	-0.2	0.0	0.0	0.0	0.0	0.0
Drawings	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Amortization	-0.9	-0.4	-0.2	0.0	0.0	0.0	0.0	0.0
Short-term capital and errors and omissions	-1.1	-1.0	-0.2	0.1	0.0	0.0	0.0	0.0
Overall balance	12.1	0.1	-7.2	-14.5	-15.9	-15.3	-15.7	-16.8
Financing	-12.1	-0.1	7.2	14.5	15.9	15.3	15.7	16.8
Official reserves (increases -)	-12.1	-0.1	7.2	14.5	15.9	15.3	15.7	16.8
Memorandum items:								
Current account balance (in percent of GDP)	5.9	0.4	-4.0	-7.7	-8.2	-7.8	-7.5	-7.5
Algerian crude oil price (US$/barrel) 1/	110.8	109.5	104.1	89.0	90.2	90.1	89.7	89.5
Gross official reserves (in billions of US$)	190.7	194.0	187.6	172.6	157.1	142.3	126.9	110.4
Idem, in months of next year's imports	34.8	33.7	32.3	28.3	25.4	22.8	20.5	16.9
Gross external debt (in billions of US$)	3.6	3.4	4.0	3.2	2.5	2.1	1.7	1.5

Sources: Algerian authorities; and Fund staff estimates and projections.

1/ Weighted average of quarterly data.

Table 3. Algeria: Summary of Central Government Operations, 2012–19 1/

		Est.	Proj.					
	2012	2013	2014	2015	2016	2017	2018	2019
				In DZD billion				
Budget revenue and grants	6,395	5,941	5,908	5,865	6,314	6,776	7,194	7,606
Hydrocarbon revenue 2/	4,184	3,678	3,423	3,158	3,328	3,446	3,537	3,619
Nonhydrocarbon revenue	2,211	2,263	2,485	2,707	2,985	3,330	3,657	3,987
Tax revenue	1,965	2,018	2,212	2,462	2,723	3,029	3,313	3,604
Taxes on income and profits	886	817	914	965	1,073	1,188	1,304	1,424
Taxes on goods and services	685	737	818	971	1,072	1,211	1,332	1,458
Customs duties	338	402	410	451	496	540	579	616
Registration and stamps	56	62	69	76	82	90	98	107
Nontax revenues	246	244	273	244	262	301	343	382
Fees	78	80	76	79	82	85	89	92
Bank of Algeria dividends and interests	115	112	123	85	92	120	149	176
Other	53	52	74	81	88	96	105	114
Grants	0	0	0	0	0	0	0	0
Total expenditure	7,058	6,092	7,033	7,515	7,871	8,243	8,639	9,047
Current expenditure	4,783	4,204	4,575	4,958	5,212	5,478	5,763	6,056
Personnel expenditure	1,980	1,778	1,976	2,104	2,221	2,344	2,475	2,612
Mudjahidins' pensions	185	226	231	238	245	252	260	267
Material and supplies	135	116	121	128	135	144	153	164
Current transfers	2,441	2,039	2,217	2,444	2,565	2,691	2,825	2,963
Interest payments	42	44	30	44	46	47	50	50
Capital expenditure	2,276	1,888	2,459	2,557	2,659	2,766	2,876	2,991
Budget balance	-663	-151	-1,125	-1,650	-1,557	-1,468	-1,445	-1,442
Overall balance	-804	-248	-1,237	-1,750	-1,648	-1,549	-1,518	-1,508
Primary overall balance	-762	-204	-1,207	-1,706	-1,602	-1,502	-1,468	-1,457
Nonhydrocarbon balance	-4,988	-3,926	-4,660	-4,908	-4,976	-4,995	-5,056	-5,126
Financing	804	248	1,237	1,750	1,648	1,549	1,518	1,508
Domestic	806	250	1,240	1,754	1,652	1,552	1,521	1,511
Bank 3/	-107	-26	576	1,037	913	824	822	871
Nonbank	914	276	665	717	739	728	699	640
Foreign	-3	-2	-4	-4	-4	-3	-3	-3
				(In percent of GDP)				
Total revenue	39.7	35.9	33.5	31.8	31.6	31.2	31.1	30.9
Hydrocarbon	26.0	22.2	19.4	17.1	16.6	15.9	15.3	14.7
Nonhydrocarbon	13.7	13.7	14.1	14.7	14.9	15.3	15.8	16.2
Of which: Tax revenue	12.2	12.2	12.5	13.4	13.6	13.9	14.3	14.6
Total expenditure	43.8	36.8	39.9	40.8	39.3	37.9	37.3	36.7
Current expenditure	29.7	25.4	25.9	26.9	26.0	25.2	24.9	24.6
Of which: wages and salaries	12.3	10.7	11.2	11.4	11.1	10.8	10.7	10.6
Of which : wages and salaries (excluding backpayments 2010	9.1	10.5	11.2	11.4	11.1	10.8	10.7	10.6
Of which : current transfers	15.1	12.3	12.6	13.3	12.8	12.4	12.2	12.0
Capital expenditure	14.1	11.4	13.9	13.9	13.3	12.7	12.4	12.1
Budget balance	-4.1	-0.9	-6.4	-9.0	-7.8	-6.8	-6.2	-5.9
Overall balance	-5.0	-1.5	-7.0	-9.5	-8.2	-7.1	-6.6	-6.1
				(In percent of nonhydrocarbon GDP)				
Total revenue	60.5	51.2	46.7	42.4	41.8	41.1	40.3	39.5
Hydrocarbon revenue	39.6	31.7	27.1	22.8	22.0	20.9	19.8	18.8
Nonhydrocarbon revenue	20.9	19.5	19.7	19.6	19.8	20.2	20.5	20.7
Of which: Tax revenue	18.6	17.4	17.5	17.8	18.0	18.4	18.6	18.7
Total expenditure	66.7	52.5	55.6	54.3	52.1	50.0	48.4	46.9
Current expenditure	45.2	36.2	36.2	35.8	34.5	33.2	32.3	31.4
Of which: Personnel expenditure	18.7	15.3	15.6	15.2	14.7	14.2	13.9	13.6
Capital expenditure	21.5	16.3	19.4	18.5	17.6	16.8	16.1	15.5
Nonhydrocarbon overall balance	-47.1	-33.8	-36.9	-35.5	-32.9	-30.3	-28.3	-26.6
Memorandum items								
Oil stabilization fund								
in billions of Algerian dinars	5,389	5,239	4,774	3,869	3,037	2,295	1,542	740
in percent of GDP	33.4	31.6	27.1	21.0	15.2	10.6	6.7	3.0
Net savings	23.4	23.3	18.2	12.0	6.3	1.8	-2.0	-5.6

Sources: Algerian authorities; and Fund staff estimates and projections.

1/ On cash basis.

2/ Including Sonatrach dividends.

3/ Bank financing after 2013 includes domestic debt issuance and a drawdown of the oil stabilization fund and other government deposits at the central bank.

Table 4. Algeria: Monetary Survey, 2012–19

	2012	Est. 2013	2014	2015	Proj. 2016	2017	2018	2019
	(Billions of Algerian dinars; at end of period)							
Net foreign assets	14,811	15,099	15,180	14,651	13,856	12,913	11,791	10,440
Of which: Bank of Algeria	14,807	15,145	15,227	14,701	13,908	12,967	11,846	10,496
Foreign assets (BA)	15,051	15,260	15,374	14,847	14,055	13,113	11,992	10,642
Foreign liabilities (BA)	197	146	146	146	146	146	146	146
Foreign assets (comm. banks)	79	48	50	53	55	56	58	59
Foreign liabilities (comm. banks)	76	94	98	103	107	110	113	115
Net domestic assets	-3,798	-3,158	-1,501	258	1,899	3,517	5,127	6,982
Domestic credit	-343	500	2,216	4,021	5,709	7,342	8,918	10,575
Credit to government (net) 1/	-4,716	-4,742	-4,166	-3,129	-2,216	-1,392	-570	301
Credit to the economy 2/	4,373	5,242	6,382	7,150	7,925	8,734	9,488	10,274
Of which: Private sector	2,271	2,747	3,221	3,624	4,036	4,468	4,875	5,304
Other items net	-3,455	-3,658	-3,717	-3,763	-3,810	-3,825	-3,790	-3,593
Money and quasi-money (M2)	11,013	11,942	13,679	14,908	15,755	16,431	16,919	17,422
Excluding Sonatrach deposits	10,374	11,432	13,188	14,487	15,324	15,970	16,442	16,934
Money	7,682	8,250	9,486	10,454	11,058	11,524	11,866	12,221
Quasi-money	3,330	3,692	4,193	4,454	4,697	4,906	5,053	5,201
	(Percent change over 12-month period)							
Money and quasi-money (M2)	10.9	8.4	14.5	9.0	5.7	4.3	3.0	3.0
Excluding Sonatrach deposits	16.6	10.2	15.4	9.8	5.8	4.2	3.0	3.0
Of which: Money	7.6	7.4	15.0	10.2	5.8	4.2	3.0	3.0
Credit to the economy	15.1	19.9	21.7	12.0	10.8	10.2	8.6	8.3
Of which: Private sector	13.5	20.9	17.3	12.5	11.3	10.7	9.1	8.8
Memorandum items:								
Liquidity ratio (average M2/GDP)	68.3	72.1	77.5	80.9	78.7	75.6	73.1	70.7
Liquidity ratio (e.o.p. M2/NHGDP)	104.1	102.9	108.2	107.7	104.3	99.6	94.8	90.4
Idem, excluding deposits of Sonatrach	98.1	98.5	104.3	104.7	101.4	96.8	92.1	87.9
Sonatrach deposits	638	510	490	422	432	461	476	487
M2 velocity	1.463	1.388	1.290	1.236	1.270	1.322	1.368	1.414
Credit to the economy/GDP	27.1	31.6	36.2	38.8	39.6	40.2	41.0	41.7
Credit to the economy/NHGDP	41.3	45.2	50.5	51.6	52.5	52.9	53.2	53.3
Credit to private sector/NHGDP	21.5	23.7	25.5	26.2	26.7	27.1	27.3	27.5

Sources: Bank of Algeria; and IMF staff estimates and projections.

1/ Net credit to government excludes Treasury postal accounts ("dépôts CCP") deposited at the BA.

2/ The projections including the public credit bought by the Treasury in 2010 and 2011 are 14.4 and 15.1 for 2010 and 2011, respectively.

Table 5. Algeria: Financial Soundness Indicators, 2009–13
(In percent)

	2009	2010	2011	2012	2013
Capital adequacy ratio	26.15	23.64	23.67	23.41	21.49
- Public Banks	23.87	21.70	21.91	21.55	19.95
- Private Banks	35.16	31.64	31.16	31.92	28.48
NPLs/total loans	21.14	18.31	14.45	11.46	10.56
- Public Banks	23.63	20.47	16.06	12.35	11.41
- Private Banks	3.84	4.08	4.00	5.16	4.80
Provisions/classified loans	65.41	76.48	69.78	69.54	68.19
- Public Banks	65.02	73.69	69.64	69.41	67.43
- Private Banks	82.01	66.68	75.90	71.73	80.32
NPLs net of provisions/total loans	7.31	4.86	4.35	3.49	3.36
- Public Banks	8.27	5.39	4.88	3.78	3.72
- Private Banks	0.69	1.36	0.96	1.46	0.95
Return on equity	26.01	16.70	24.67	23.27	18.97
- Public Banks	27.85	29.77	26.07	22.69	17.93
- Private Banks	20.87	20.34	21.39	24.75	21.64
Liquid assets/Short-term debt	114.52	114.29	103.73	107.51	93.52
- Public Banks	118.37	118.14	106.60	110.49	95.69
- Private Banks	89.00	88.47	84.61	93.47	84.06

Source: Bank of Algeria

Appendix I. External Sector Assessment

Algeria's external position is highly vulnerable to a sustained decline in oil prices. Despite efforts to diversify, Algeria's external position is determined largely by the performance of hydrocarbon exports, which accounted for 98 percent of merchandise exports in 2013. Lower oil prices, combined with strong domestic hydrocarbon consumption and continued import growth, are expected to lead to growing current account deficit over the medium term. International reserves, however, are well above standard adequacy levels and sufficient to cover medium-term external financing needs. There are virtually no capital flows in Algeria, given a closed capital account.

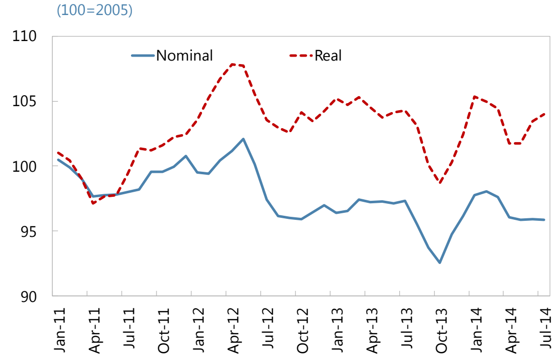
Algeria: Reserve Adequacy Measures

	2012	2013	2014 proj.	2015 proj.	Threshold
Reserves in					
US$ billion	190.7	194.0	187.6	172.6	...
Months of imports	34.8	33.7	32.3	28.3	3
Percent of short-term debt	16,464.7	4,523.5	4,034.9	3,162.7	100
Percent of broad money	134.3	128.9	109.1	95.5	20
Percent of IMF metric	862.6	867.7	799.0	...	100 to 150

Sources: Algerian authorities; and IMF staff calculations.

The real effective exchange rate stabilized in the first months of 2014 compared to its 2013 level. Following a 5.3 percent depreciation between June and November 2013, the real effective exchange rate appreciated again in December 2013 and January 2014, before oscillating over the first half of 2014. Over the first seven months of 2014, the nominal effective exchange rate depreciated slightly (0.3 percent) on average compared to the same period in 2013, while the average real effective exchange rate depreciation reached 0.9 percent.

Effective Exchange Rate
(100=2005)



Source: Algerian authorities.

The real exchange rate assessment is based on two methodologies:

- The equilibrium real effective exchange rate methodology, which estimates the equilibrium exchange rate as a function of a set of medium-term fundamentals, and derives the exchange rate adjustment needed to restore equilibrium over the medium term. The equilibrium real effective exchange rate model was reestimated in 2014 (see Box).

- The EBA-lite methodology, which estimates a country's current account norm based on economic fundamentals, cyclical factors, and desirable policy levels. The exchange rate misalignment is then derived as the adjustment necessary to bring the actual current account balance to its norm, using a calculated elasticity.[1]

Both methodologies suggest that the real exchange rate is on the strong side:

- The equilibrium real exchange rate methodology (both the old and newly estimated models) suggests that the real effective exchange rate in 2014 was overvalued by about 3.4 percent and by over 10 percent compared to its medium-term equilibrium value.

- The EBA-lite methodology, which estimates the misalignment in 2013, also suggests a real effective exchange rate on the strong side. There are no significant domestic policy gaps; the 1.1 percent policy gap that contributes to the current account gap is mainly driven by global policy gaps.

Exchange Rate Assessment

Methodology	Misalignment 2013	Misalignment 2014	Misalignment Medium term
Equilibrium real effective exchange rate[1]		5.5	16.8
Reestimated equilibrium real effective exchange rate		1.2	8.5
EBA-lite	12.6		
Average misalignment	12.6	3.4	12.7

Source: IMF staff calculations.

[1]One of three methodologies developed by the IMF's Consultative Group on Exchange Rate issues (CGER). The CGER methodologies are being replaced by the External Balance Assessment methodologies (EBA and EBA-lite).

Summary of EBA-lite Methodology's Findings

(1)	Current account-actual	1.1%
(2)	Current account-fitted	4.9%
(3)	Policy gap	1.1%
(4)=(2)-(3)	Current account-norm	3.8%
(5)=(1)-(4)	Current account-gap	-2.7%
(6)	Elasticity of CA to REER	-0.22
(7)=(5)/(6)	Real exchange rate gap	12.6%

[1] The EBA-lite approach extends the External Balance Assessment (EBA) approach, as developed by IMF staff, to a much broader group of countries. See http://www.imf.org/external/np/res/eba/index.htm.

New Estimates of the Equilibrium Real Effective Exchange Rate for Algeria

Models used to assess the level of the real exchange rate need to be updated on a regular basis. This is particularly important in Algeria, where the BA's exchange rate policy targets the equilibrium level of the real effective exchange rate. Against this background, staff updated and developed the existing exchange rate assessment framework.

The 2014 update of the model is estimated over 1990-2013.[1] The real effective exchange rate is explained by the relative productivity of Algeria compared to its main export partners (RELPROD); terms of trade (TOT); the country's openness ratio (OPEN); and the share of public spending in GDP (SPEND), with the following coefficients (all significant at the 1 percent level, except for the terms of trade):

$$\log(REER) = -0.03\log(TOT) + 1.43\log(\mathrm{RELPROD}) - 0.003\, log(OPEN) + 0.19 log(SPEND) + 1.60$$

Consistent with the existing literature, an increase in relative productivity is related to an appreciation of the real effective exchange rate (Balassa-Samuelson effect); an increase in public spending leads to a real equilibrium appreciation; an increase in openness is related to a depreciation of the currency. Terms of trade increases have an unexpected but statistically non significant negative relation to the real exchange rate.

The analysis is complemented with a panel-data estimation of the real effective exchange rate, run on 31 MCD countries over 1990-2013. A panel data approach has the advantage of estimating the typical reaction of the real effective exchange rate to a range of determinants across multiple countries, and can serve as a useful check for the results of an Algeria-specific model. The panel data approach proposed is a useful tool for verifying that the exchange rate is not departing in a systematic way from the behavior suggested by the average behavior in the sample. The model tests the behavior of the real effective exchange rate against current and capital spending, relative productivity, terms of trade, reserves and changes in NFA. The analysis broadly confirms that the dinar has remained close to its fundamental value, pointing, depending on the estimated specification, to some strength toward the end of the estimation period.

Panel data estimates

	1991-2013	2000-13
Current spending/GDP	**0.002**	**0.007**
	0.049	0.001
Capital spending/GDP	**-0.017**	**-0.012**
	0.000	0.000
Relative productivity	**0.232**	**0.242**
	0.000	0.000
Terms of trade	**0.143**	**0.243**
	0.000	0.000
Reserves (months of imports)	**-0.007**	**-0.006**
	0.000	0.000
Change in NFA	**0.002**	**0.002**
	0.196	0.099
Constant	**3.055**	**2.815**
	0.000	0.000
Country fixed effects	YES	YES
R-sq		
Within	0.233	0.194
Between	0.004	0.026
Overall	0.003	0.008
no. obs.	415	321

p-value shown below estimated coefficients.

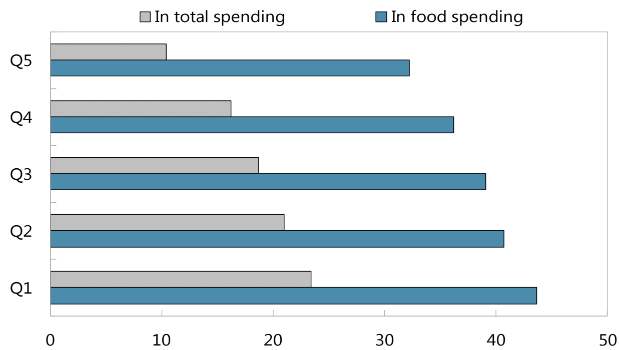
[1]The model is estimated on annual data, and relies on cointegration analysis to identify the long-run relationship between the real exchange rate and its determinants. The results are robust to the use of alternative variables.

Appendix II. How Effective Are Generalized Subsidies?

Over the years, Algeria has developed a generous system of subsidies. Those range from implicit subsidies on hydrocarbon products to price controls on some products (such as wheat for bread or powdered milk) to price regulation mechanisms (for oil and sugar). These subsidies—especially the subsidies on basic food products—benefit the poorest. However, because they are not targeted, generalized subsidies also support consumption by the highest quintiles of the income distribution, which consume considerably larger quantities of both hydrocarbon products and food than does the poorest quintile, and thus constitute an inefficient and costly approach to reducing poverty.

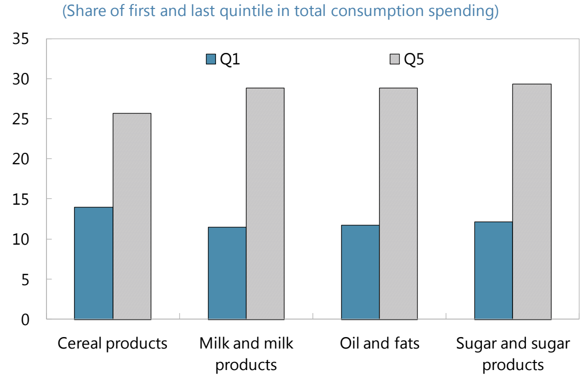
Although food subsidies reach the poorest, they disproportionately benefit the better-off and therefore represent a significant cost to the community. Because the lowest quintile consumption structure is tilted towards food items, subsidies do provide purchasing power support to the poorest segment of the population. At the same time, the largest part of subsidized products is consumed by the highest quintile, which therefore reaps the greatest benefits from the existing subsidies[1]

Share of Broad Food Categories with Subsidies
(In percent, 2011)



Sources: Algerian authorities; and IMF staff calculations.

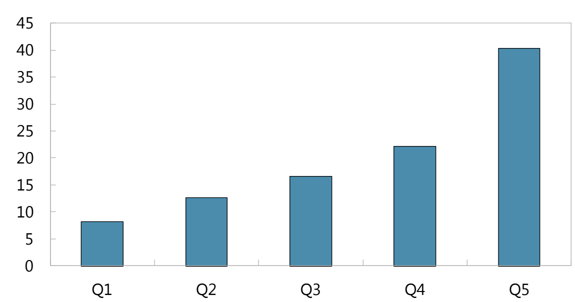
Distribution of Subsidy Benefits
(Share of first and last quintile in total consumption spending)



Sources: Algerian authorities; and IMF staff calculations.

The impact of the generalized implicit subsidy on hydrocarbon products appears to be even more distortive. The lowest quintile only accounts for 8.2 percent of total spending in transport and communication (outside of vehicle purchase and maintenance), while the highest quintile absorbs 40 percent of total consumption (more than 60 percent for the last two quintiles). The subsidy—in the form of foregone revenue from selling hydrocarbon products well below international market prices—therefore overwhelmingly benefits the better-off.

Distribution of Transport and Communication Spending
(In percent of total consumption)



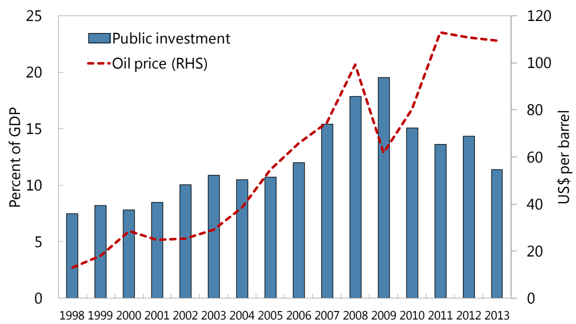
Sources: Algerian authorities; and IMF staff calculations.
Note: excludes vehicule purchases.

[1] The level of detail currently available does not allow to identify precisely the subsidized products. The extent of the subsidy is therefore lower than the share of the broad categories in consumption.

Appendix III. Improving Algeria's Investment Efficiency

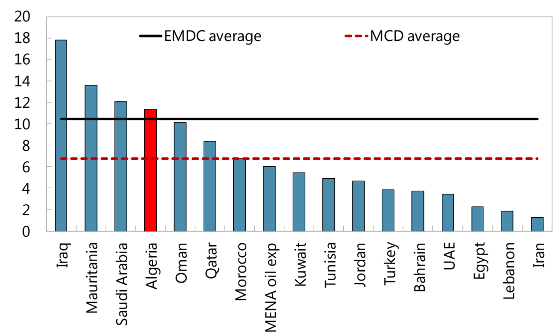
Like other oil-exporting countries in the MENA region, Algeria took advantage of strong revenues from rising oil prices over the past decade to scale up public investment. Public investment rose from 7.8 percent of GDP in 2000 to a peak of 19.5 percent in 2009. It has since declined to 11.4 percent, giving way increasingly to current expenditures, but remains well above the average in MCD countries and higher than the average in emerging market and developing economies. High levels of public investment are needed to address infrastructure gaps and enhance economic growth prospects. Ianchovichina and others (2013) estimate that non-GCC oil exporters in the MENA region will need almost 11 percent of GDP per annum to maintain and improve their infrastructure.[1]

Public Investment and Oil Prices



Sources: Algerian authorities; and IMF staff calculations.

Public Investment, 2013
(Percent of GDP)



Sources: National authorities; and IMF staff calculations.

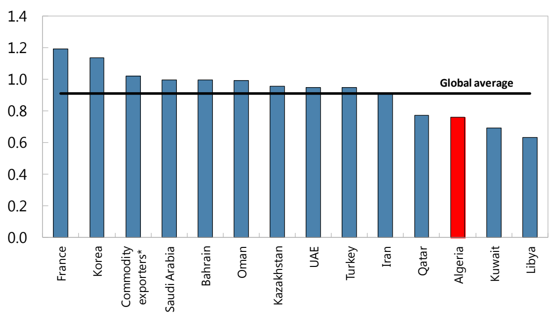
High levels of public investment call for more focus on investment efficiency. Increased public investment, while appropriate, has contributed to a weaker fiscal position and exacerbated Algeria's vulnerability to a decline in oil prices. In this context, improving the efficiency of public investment should be a policy priority. Higher investment efficiency would help address infrastructure gaps faster and would boost growth dividends. Improving investment efficiency is especially critical given Algeria's relatively short time horizon for hydrocarbon resources and the need for public investment to support the diversification of production and export.

Algeria's investment efficiency is relatively weak. Albino-War and others (2014) use efficiency frontier analysis to assign investment efficiency scores to individual countries.[2] The investment efficiency score reflects how far a country is from the frontier determined by the best performers. Efficiency is measured in terms of both the *quality* (measured with the infrastructure sub-component of the global competitiveness indicator of

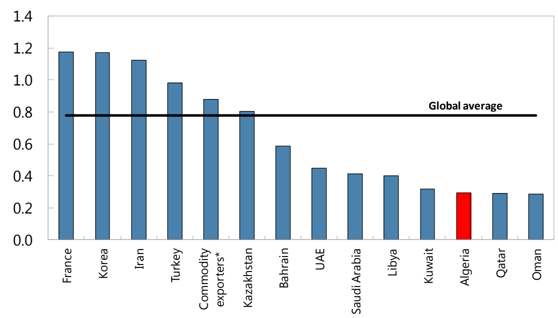
[1] Ianovichina, Elena, Antonio Estache, Renaud Foucart, Gregoire Garsous, 2013, "Job Creation through Infrastructure Investment in the Middle East and North Africa," *World Development* Vol. 45.

[2] Albino-War, Maria, Svetlana Cerovic, Francesco Grigoli, Juan Carlos Flores, Javier Kapsoli, Haonan Qu, Yahia Said, Martin Sommer, Bahrom Shukurov, SeokHyun Yoon, 2014, "Making the Most of Public Investment in Oil-Exporting Countries," IMF Staff Discussion Note.

the World Economic Forum) and the *quantity* (measured as an index of physical infrastructure) of infrastructure. According to this methodology, Algeria's investment efficiency is weak compared to other oil exporters in the region and well below the global average. It also ranks well below commodity exporters with strong institutions (as measured by the World Bank's Worldwide Governance Indicators), indicating that high public investment efficiency is generally associated with good institutional quality. Algeria's investment efficiency score of 0.29 (in terms of investment quantity) suggests that, under ideal circumstances, Algeria could have built up to 71 percent more infrastructure with the same amount of investment.



Source: Albino-War et al. (2014).
*Commodity exporters with strong institutions (WGI>90).



Source: Albino-War et al. (2014).
*Commodity exporters with strong institutions (WGI>90).

To increase investment efficiency, Algeria needs to improve public financial management. The authorities need to improve the selection and budgeting process (objectives, costs, ex-ante assessment), as well as the implementation and ex-post evaluation of investment projects (open and transparent procurement, physical and financial monitoring, ex-post assessment). An assessment of infrastructure needs and an in-depth assessment of the management framework for public investment, supported by development partners such as the World Bank, should be given priority.

Over the medium term, the focus should be on revamping the overall framework for managing public expenditure. Algeria's intention to move to a medium-term budget framework and result-oriented budget programs is critical for addressing fiscal vulnerabilities and aligning investment projects with strategic government priorities. In addition, the government should foster a public debate about government investment decisions. These reforms will require capacity building to ensure effective implementation of the new framework for managing public investment.

Appendix IV. Public Sector Debt Sustainability Analysis

Algeria: Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario

(in percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

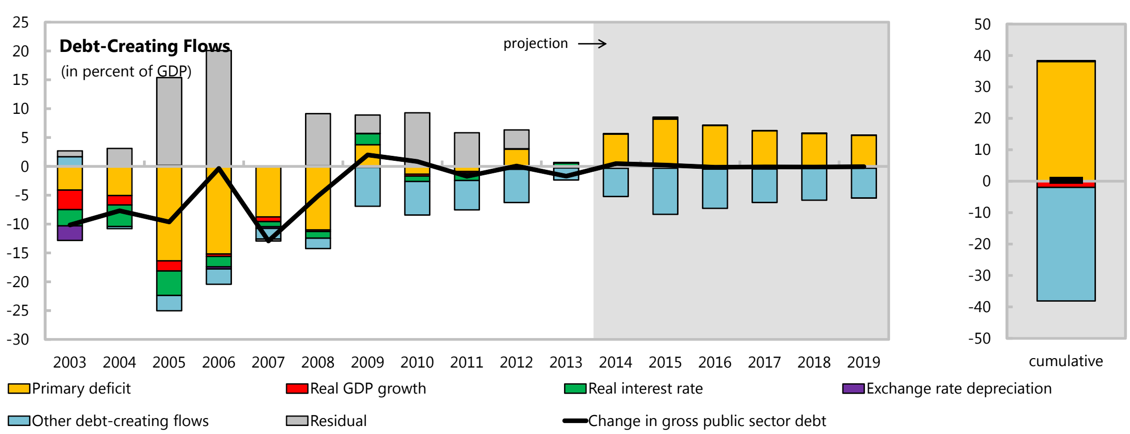
	Actual			Projections					
	2003-2011 [2/]	2012	2013	2014	2015	2016	2017	2018	2019
Nominal gross public debt	21.2	10.0	8.3	8.8	9.0	8.9	8.8	8.7	8.6
Public gross financing needs	n.a.	4.9	4.4	7.1	10.4	10.2	9.1	9.2	8.7
Real GDP growth (in percent)	3.7	3.3	2.8	4.0	3.9	4.1	4.0	4.0	4.0
Inflation (GDP deflator, in percent)	10.2	7.4	0.1	2.4	0.4	4.3	4.4	2.5	2.4
Nominal GDP growth (in percent)	14.3	10.9	2.8	6.5	4.4	8.6	8.6	6.5	6.5
Effective interest rate (in percent) [4/]	3.7	2.9	2.7	2.2	3.0	2.9	3.0	3.0	3.1
Oil savings fund	30.6	33.4	31.6	27.1	21.0	15.2	10.6	6.7	3.0

As of August 30, 2013

Sovereign Spreads		
EMBIG (bp) 3/		n.a.
5Y CDS (bp)		n.a.
Ratings	Foreign	Local
Moody's	n.a.	n.a.
S&Ps	n.a.	n.a.
Fitch	n.a.	n.a.

Contribution to Changes in Public Debt

	Actual			Projections							
	2003-2011	2012	2013	2014	2015	2016	2017	2018	2019	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-5.0	0.1	-1.7	0.5	0.2	-0.2	-0.1	-0.1	-0.1	0.3	
Identified debt-creating flows	-12.3	-3.2	-1.8	0.4	0.1	-0.2	-0.1	-0.1	0.0	0.0	
Primary deficit	-6.6	3.0	0.1	5.6	8.2	7.1	6.2	5.7	5.4	38.1	-5.4
Primary (noninterest) revenue and grants	39.6	39.7	35.9	33.5	31.8	31.6	31.2	31.1	30.9	190.0	
Primary (noninterest) expenditure	33.1	42.7	35.9	39.1	40.0	38.7	37.4	36.8	36.2	228.1	
Automatic debt dynamics [5/]	-3.0	-0.4	0.2	-0.3	-0.1	-0.5	-0.5	-0.3	-0.3	-2.0	
Interest rate/growth differential [6/]	-2.7	-0.5	0.2	-0.3	-0.1	-0.5	-0.5	-0.3	-0.3	-2.0	
Of which: real interest rate	-1.7	-0.2	0.5	0.0	0.2	-0.1	-0.1	0.0	0.0	0.0	
Of which: real GDP growth	-1.0	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-2.0	
Exchange rate depreciation [7/]	-0.3	0.1	0.0	...	...	...	...	...	...	...	
Other identified debt-creating flows	-2.8	-5.8	-2.1	-4.9	-8.0	-6.8	-5.8	-5.5	-5.2	-36.1	
Deposits of public entities (negative)	-2.8	-5.8	-2.1	-2.0	-2.8	-2.6	-2.4	-2.3	-1.9	-14.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Drawdown of govt deposits at BA (incl. FRR)	0.0	0.0	0.0	-2.9	-5.2	-4.2	-3.4	-3.3	-3.3	-22.2	
Residual, including asset changes [8/]	7.4	3.3	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.3	

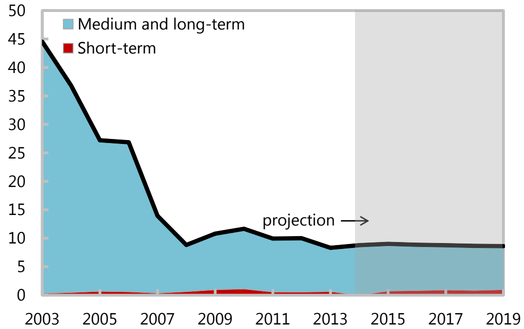


Source: IMF staff.
1/ Public sector is defined as central government.
2/ Based on available data.
3/ Long-term bond spread over German bonds.
4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.
5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.
7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

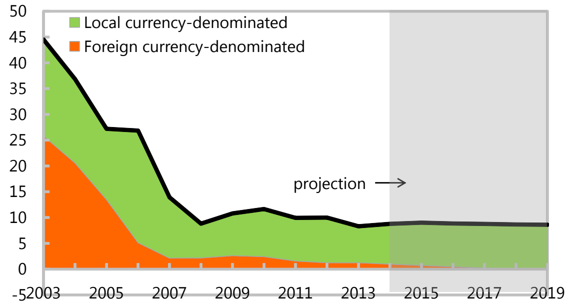
Algeria: Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



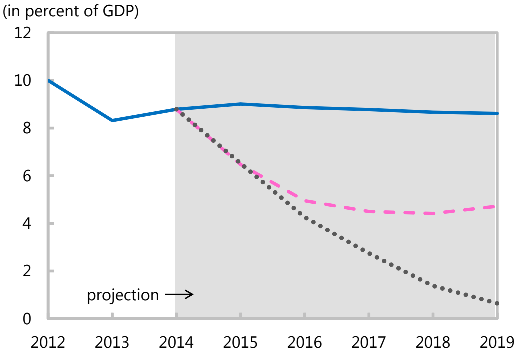
By Currency
(in percent of GDP)



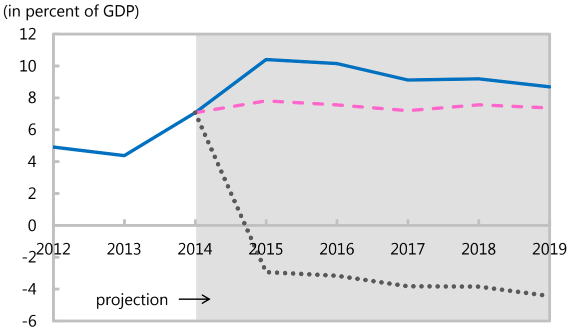
Alternative Scenarios

Baseline — Historical — Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

Baseline Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	4.0	3.9	4.1	4.0	4.0	4.0
Inflation	2.4	0.4	4.3	4.4	2.5	2.4
Primary Balance	-5.6	-8.2	-7.1	-6.2	-5.7	-5.4
Effective interest rate	2.2	3.0	2.9	3.0	3.0	3.1
Constant Primary Balance Scenario						
Real GDP growth	4.0	3.9	4.1	4.0	4.0	4.0
Inflation	2.4	0.4	4.3	4.4	2.5	2.4
Primary Balance	-5.6	-5.6	-5.6	-5.6	-5.6	-5.6
Effective interest rate	2.2	3.0	3.2	3.5	3.5	3.7

Historical Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	4.0	3.2	3.2	3.2	3.2	3.2
Inflation	2.4	0.4	4.3	4.4	2.5	2.4
Primary Balance	-5.6	5.2	5.2	5.2	5.2	5.2
Effective interest rate	2.2	3.0	3.2	3.7	4.5	6.8

Source: IMF staff.

Appendix V. External Debt Sustainability Analysis

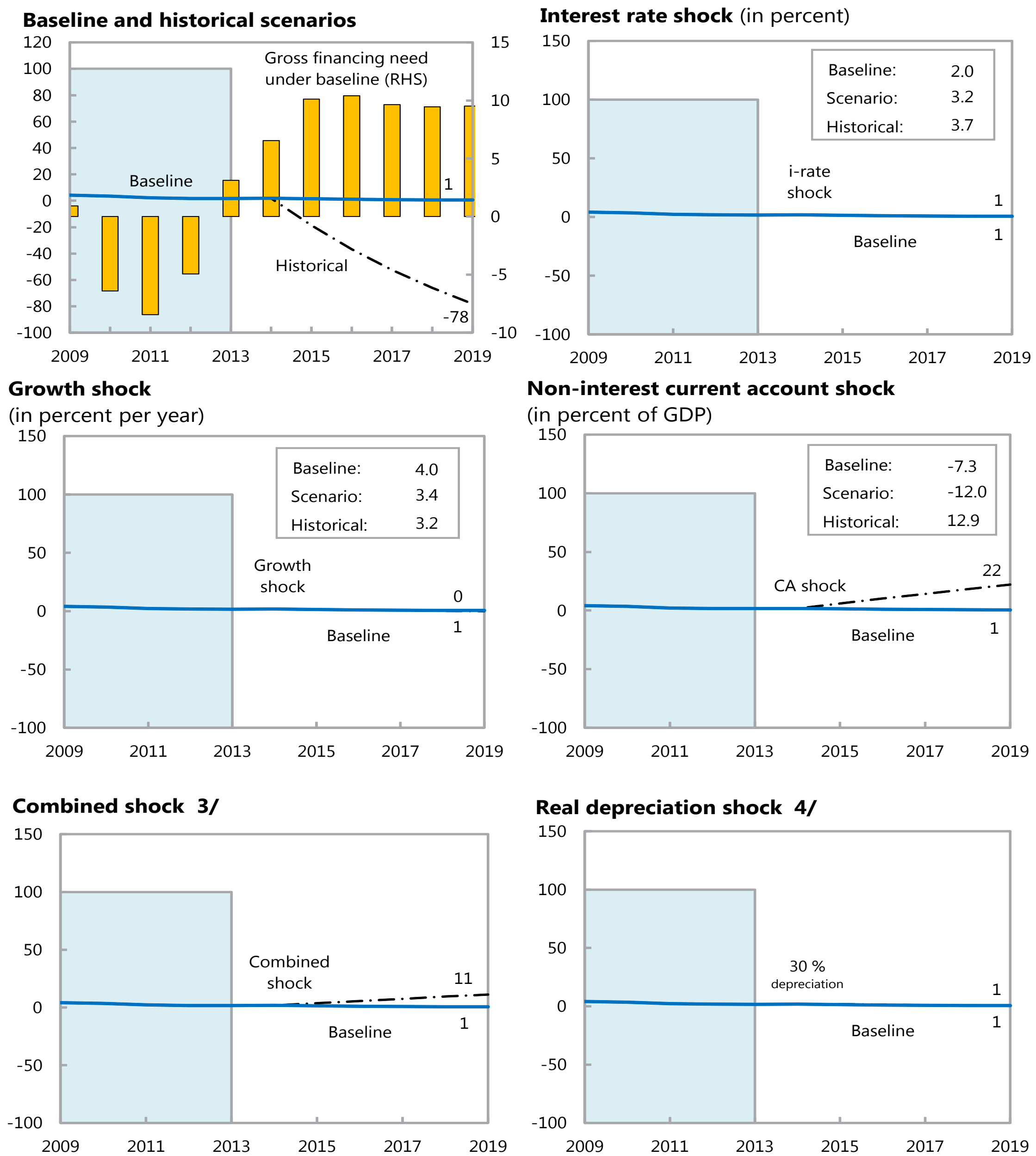
Algeria: External Debt Sustainability Framework, 2009-2019
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2009	2010	2011	2012	2013	10-Year Historical Average	10-Year Standard Deviation	2014	2015	2016	2017	2018	2019	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	4.1	3.5	2.2	1.8	1.6			**1.8**	**1.4**	**1.1**	**0.9**	**0.7**	**0.6**	**-0.9**
Change in external debt	0.7	-0.6	-1.3	-0.5	-0.1			0.2	-0.4	-0.3	-0.2	-0.2	-0.1	
Identified external debt-creating flows (4+8+9)	-1.3	-9.5	-11.6	-6.7	-1.3			3.0	6.5	6.8	6.3	6.2	6.4	
Current account deficit, excluding interest payments	-0.4	-7.6	-10.1	-6.1	-0.4			3.7	7.2	7.8	7.2	7.1	7.3	
Deficit in balance of goods and services	-71.0	-69.1	-67.2	-66.6	-64.2			-60.1	-56.6	-56.3	-53.9	-52.6	-51.3	
Exports	35.1	37.6	38.4	36.4	32.7			29.0	25.0	24.5	23.4	22.7	21.9	
Imports	-35.8	-31.5	-28.8	-30.2	-31.5			-31.1	-31.6	-31.8	-30.5	-29.9	-29.4	
Net non-debt creating capital inflows (negative)	-1.8	-1.3	-1.0	-0.7	-0.9			-0.7	-0.7	-0.9	-0.9	-0.9	-0.9	
Automatic debt dynamics 1/	1.0	-0.6	-0.6	0.1	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Contribution from nominal interest rate	0.1	0.1	0.1	0.2	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Contribution from real GDP growth	-0.1	-0.1	-0.1	-0.1	0.0			-0.1	-0.1	-0.1	0.0	0.0	0.0	
Contribution from price and exchange rate changes 2/	0.9	-0.5	-0.6	0.0	0.0			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	2.0	8.8	10.3	6.3	1.2			-2.8	-6.9	-7.2	-6.5	-6.4	-6.5	
External debt-to-exports ratio (in percent)	11.8	9.4	5.7	4.8	5.0			6.2	5.7	4.5	3.6	3.0	2.5	
Gross external financing need (in billions of US dollars) 4/	1.3	-10.3	-16.9	-10.3	6.5			14.5	22.3	24.0	23.4	23.8	25.1	
in percent of GDP	0.9	-6.4	-8.5	-4.9	3.1			6.6	10.1	10.4	9.6	9.5	9.5	
Scenario with key variables at their historical averages 5/								**1.8**	**-18.6**	**-36.7**	**-52.4**	**-66.0**	**-78.2**	**6.1**
Key Macroeconomic Assumptions Underlying Baseline														
Real GDP growth (in percent)	1.6	3.6	2.8	3.3	2.8	3.2	1.3	4.0	3.9	4.1	4.0	4.0	4.0	
GDP deflator in US dollars (change in percent)	-21.1	13.5	20.3	0.9	-2.2	9.3	13.5	2.2	-4.3	0.3	1.3	0.0	0.4	
Nominal external interest rate (in percent)	2.9	1.9	4.2	7.4	-1.8	3.7	2.4	1.6	2.4	2.2	2.0	1.8	1.6	
Growth of exports (US dollar terms, in percent)	-41.3	25.9	26.3	-1.2	-9.8	13.2	24.8	-5.9	-14.2	2.2	0.9	0.6	0.7	
Growth of imports (US dollar terms, in percent)	-0.1	3.5	13.1	9.1	4.9	15.9	16.0	5.0	0.9	5.3	1.1	2.0	2.5	
Current account balance, excluding interest payments	0.4	7.6	10.1	6.1	0.4	12.9	9.3	-3.7	-7.2	-7.8	-7.2	-7.1	-7.3	
Net non-debt creating capital inflows	1.8	1.3	1.0	0.7	0.9	1.2	0.3	0.7	0.7	0.9	0.9	0.9	0.9	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Algeria: External Debt Sustainability: Bound Tests 1/ 2/

(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2010.

Appendix VI. Implementation of FSAP Recommendations

Recommendation	Responsible	Timeline	Implementation	Staff recommendation
Leverage hydrocarbon revenue for financial sector development: Improve intergenerational smoothing of hydrocarbon revenue (full-fledged fiscal rule, sovereign wealth fund (SWF)).	BA/MoF	MT-LT	Partial. An FAD TA mission supported the authorities implementing a medium term budget framework, including its integration into the organic law	Design and implement a fiscal rule
Exchange controls: Gradually reduce restrictive measures on foreign exchange transactions.	BA/MoF	MT-LT	No progress	Ease forex controls and progressively liberalize the capital account
FX market: Allow non-hydrocarbon exporters to sell directly into the foreign exchange market, to stimulate its development, including for forward contracts	BA	ST	No progress. An MCM TA mission helped identify the TA needs for the development of FX markets	Develop the FX market
Liquidity management: Create a structural liquidity shortage to facilitate monetary policy implementation.	BA	ST	Partial progress: t-bill and t-bond issuance increased somewhat at mid-2014	Issue central bank bills, rely on T-bills to finance government spending
SOB reform: Complete corporate governance reform agenda	MoF	ST-MT	No progress. A governance improvement program is being prepared	Improve governance; increase competition; open capital of SOBs
Consumer lending: Replace consumer lending restrictions with prudential measures; introduce an effective public credit registry for households, and introduce a personal bankruptcy framework.	BA	MT	Partial. The new credit registry should be operational by end-2015. The 2015 budget law is expected to lift the ban on consumer lending. No progress on personal bankruptcy.	Lift the ban on consumer lending; establish a full-fledged credit registry
Banking Supervision: Facilitate the write-off of NPLs; improve operational framework for supervision; continue towards Basel II/III; develop stress-test expertise.	BA	ST MT	Partial. Transition to Basel II/II for supervision scheduled for October 2014. Ongoing TA on stress testing. New regulations allow fully-provisioned, small NPLs to be wiped off. No progress on the current NPL stock.	Achieve the transition to Basel II; allow banks to write off old and fully-provisioned NPLs.
Small and medium-sized enterprise (SME) lending: Revisit existing government support programs for microenterprises and SMEs, including partial credit guarantee funds.	MoF	MT	No progress	Reform the guarantee scheme.
Insurance: Adapt MTPL premiums and reduce compulsory	Insurance Dir.	MT	No progress	

reinsurance.				
Insolvency Regime: Modernize the insolvency regime to mitigate risk and strengthen the credit environment.	MoJ, MoF	MT	No progress	Modernize the bankruptcy framework
Collateral Regime: Improve debt enforcement procedures.	MoJ, MoF	ST–MT	No progress	Improve debt enforcement procedures.
Criminal Sanctions: Clarify Criminal Code sanctions on mismanagement of funds in state-owned enterprises (SOEs), with judicial training on implementation.	MoJ	ST	No progress. However, the September 2014 tripartite meeting agreed on the principle of lifting the criminal sanctions for management errors	Lift criminal sanctions for bank managers' normal lending activities.
Payment Systems: Set-up a payment system council to monitor the modernization of payment systems and formalize a plan to decrease the proportion of fiduciary money in M2.	BA	MT	Partial progress. A system is in place for the development of electronic payments, and a draft law on electronic certification has been adopted	The public sector leads the use of banking payments.
Capital market development: Finance budget deficits through the issuance of t-bonds along the yield curve and revisit the issuance policy at the MoF to foster liquidity.	MoF	LT	Partial progress. Positive net t-bill and t-bond issuances over the first half of 2014	Reduce reliance on FRR drawdowns to finance the deficit and increase Treasury issuances. Remove interest subsidies
Stock exchange: Implement the modernization program set-up by the COSOB in 2012.	COSOB/MoF	LT	Partial progress. The State shareholding body approved capital opening for eight SOEs	Open the capital of large and well performing SOEs, including SOBs
Crisis management: Establish (i) special resolution regime (SRR) for failing financial institutions; (ii) memorandum of understanding (MoU) outlining principles for financial crisis management; and (iii) MoU between safety net participants on information exchange and decision-making processes.	BA, MoF	LT ST	No progress. TA has been requested on macroprudential policies, banking crisis resolution and deposit guarantee	Enhance financial sector safety nets, set up a crisis management framework, establish a dedicated bank resolution regime
AML/CFT: Implement action plan established with the FATF International Cooperative Review Group.	BA, MoF, MoJ	ST	Partial progress	Address shortcomings in the AML/CFT framework.

INTERNATIONAL MONETARY FUND

ALGERIA

November 13, 2014

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

The Middle East and Central Asia Department
(In collaboration with other departments)

CONTENTS

RELATIONS WITH THE FUND

(As of November 5, 2014)

A. Financial Relations

Membership Status: Joined: September 26, 1963; Article VIII.

General Resources Account

	SDR Million	Percent Quota
Quota	1,254.70	100.00
Fund holdings of currency	785.92	62.64
Reserve position in Fund	468.78	37.36

SDR Department

	SDR Million	Percent Allocation
Net cumulative allocation	1,198.18	100.00
Holdings	1,074.73	89.70

Outstanding Purchases and Loans

None

Financial Arrangements (In millions of SDR)

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	5/22/95	5/21/98	1,169.28	1,169.28
Stand-by	5/27/94	5/22/95	457.20	385.20
Stand-By	6/03/91	3/31/92	300.00	225.00

Projected Obligations to Fund
(SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2014	2015	2016	2017	2018
Principal	0.00	0.00	0.00	0.00	0.00
Charges/interest	0.02	0.06	0.06	0.06	0.06
Total	0.02	0.06	0.06	0.06	0.06

Implementation of HIPC Initiative: Not Applicable.

B. Nonfinancial Relations

Exchange Rate Arrangement

1. From January 21, 1974 to October 1, 1994, the exchange rate of the dinar was determined on the basis of a fixed relationship with a basket of currencies, adjusted from time to time. On October 1, 1994, the Bank of Algeria introduced a managed float for the dinar through daily fixing sessions that included six commercial banks. This system has been replaced by an interbank foreign exchange market as of January 2, 1996. On November 5, 2014, the average of the buying and selling rates for the U.S. dollar was US$ 1 = DZD 84.02, equivalent to SDR 1 = DZD 123.47. No margin limits are imposed on the buying and selling exchange rates in the interbank foreign exchange market, except for a margin of DA 0.015 between the buying and selling rates of the Bank of Algeria for the dinar against the U.S. dollar.

2. The de jure exchange rate arrangement is managed floating and the de facto exchange regime is classified as other managed arrangement with no preannounced path for the exchange rate. Algeria maintains an exchange system free from restrictions on the making of payments and transfers for current international transactions.

Latest Article IV Consultation

The discussions for the 2013 Article IV consultation with Algeria were held in Algiers during November 12-25, 2013. The consultation was concluded without a meeting on January 27, 2013. The Staff Report (IMF Country Report 14/32) was published on February 4, 2014.

Technical Assistance

- An STA mission visited Algiers in April 2012 to provide assistance on monetary and financial statistics and financial stability indicators.
- An MCM mission visited Algiers in September 2012 to provide assistance on banking supervision, macro-prudential policy and monetary policy.
- An FAD mission visited Algiers in September 2012 to provide assistance on public financial management.
- An FAD mission visited Algiers in March 2013 to provide assistance on expenditure policy.
- An FAD mission visited Algiers in November 2013 to provide assistance on tax administration
- An STA mission visited Algiers in September 2014 to provide assistance on international investment position statistics.
- An MCM TA mission visited Algiers in September 2014 to provide assistance on foreign exchange market development.

- An FAD FA mission visited Algiers in September 2014 to provide assistance on the medium term budget framework

Financial Sector Assessment Program

Algeria participated in the FSAP in 2003. The FSAP was updated in 2007 and in 2013. The Executive Board discussed the Financial System Stability Assessment on January 14, 2004 (see IMF Country Report No. 04/138)..

Resident Representative/Advisor

None.

RELATIONS WITH THE WORLD BANK GROUP

JMAP Implementation, FY14

As of November 5, 2014

Title	Products	Provisional timing of missions	Expected delivery date
A. Mutual Information on Relevant Work Programs			
Bank work program in next 12 months	a. **Sector work** on: • State-owned Banks for Ministry of Finance • Subsidy analysis • Reviewing Social Protection Programs • Climate change • Integrated desert management, • Support for rural renewal • Agricultural development b. **Technical assistance** on • Credit Registry with Central Bank • Financial Crisis simulation (FIRST) • RAMP • Social Programs Evaluation • Support to analysis and evaluation of the Household Survey • Agricultural Program • Competitiveness Poles • Agricultural Statistical Capacity • Algeria Telecom strategic and operational support • Broadband Strategy		
IMF work program in next 12 months	2014 Article IV Consultation Preparing analytical work on • External sustainability • Fiscal consolidation • Labor markets	September 17-October 1, 2014 Ongoing	December 2014 December 2014

	Staff visit 2015 Article IV consultation Technical assistance missions on: • FAD: Medium term budget framework (MTBF) • FAD: Follow-up on MTBF • MCM: Foreign exchange market development • MCM: Follow up on foreign exchange market development • STA: IIP data	March 2015 September 2015 September 2014 First quarter 2015 September 2014 December 2014 September 2014	March 2015 December 2015 September 2014 First quarter 2015 September 2014 December 2014 September 2014
B. Requests for Work Program Inputs			
Fund request to Bank	Developments on the subsidy reform Sectoral analysis	As needed As needed	
Bank request to Fund	Assessment of macroeconomic stance and prospects Data sharing	Semiannual (and on ad hoc basis if requested) At least 1 operation predicted Ongoing	Following Article IV and staff visits
C. Agreement on Joint Products and Missions			
Joint products in next 12 months	Continuous close coordination on the reform agenda	Ongoing	

STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance
General: Data provision has some shortcomings, but is broadly adequate for surveillance.
National Accounts: Following STA recommendations, the NSO is now compiling annual national accounts (ANA) at prior year prices. The ANA broadly follow the 1993 SNA recommendations, but nonprofit institutions serving households are not taken into account. Work is ongoing to compile quarterly national accounts. **Price Statistics:** Data are published with a delay of less than one month.
Government finance statistics: Key shortcomings include insufficient institutional coverage (coverage is limited to Budgetary Central Government, albeit in a wide sense, including the general budget, the annexed budget, and the special treasury accounts), classification problems, long lags for production of statistics, and lack of reconciliation of financing with the monetary accounts. Key factors behind these weaknesses include the lack of financial resources allocated to the compilation of statistics, insufficient interagency coordination, and concern about accuracy that give rise to reluctance to publish provisional data.
Monetary statistics: Monetary statistics compiled by the authorities are largely in line with the methodology in the Monetary and Financial Statistics Manual, 2000 and its companion Compilation Guide, 2008. Timeliness of reporting by state-owned commercial banks has significantly improved over the last two years; consequently, data on depository corporations—as well as finance companies—are usually available within a period of two to three months. Reporting formats (balance sheet and appendices) applied to commercial banks and finance companies were updated in 2009 and the updated version was enforced in 2010. All respondents now provide all requested data, thus making the monetary statistics more meaningful than before. Data on insurance corporations are not yet collected, but the Banque d'Algérie, with the continuing support of the IMF Statistics Department, launched in 2009 a project to this end.
Balance of payments: Balance of payments statistics are generally of good quality. International investment position data are not available, mainly because of capacity issues in compiling FDI stocks. An STA mission will visit Algiers in September to support the authorities in building BPM6-compliant IIP data.

II. Data Standards and Quality	
Algeria began participation in the General Data Dissemination System (GDDS) on April 21, 2009.	No data ROSC is available.

ALGERIA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
As of November 5, 2014

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of publication[7]
Exchange Rates	09/14	19/17/14	D	M	W
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	09/14	19/17/14	D	M	M
Reserve/Base Money	09/14	19/17/14	M	M	M
Broad Money	09/14	19/17/14	M	M	M
Central Bank Balance Sheet	09/14	19/17/14	M	M	A
Consolidated Balance Sheet of the Banking System	09/14	19/17/14	M	M	A
Interest Rates[2]	09/14	19/17/14	M	M	M
Consumer Price Index	09/14	19/17/14	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]—Central Government[4]	09/14	19/17/14	M	I	A
Stocks of Central Government and Central Government-Guaranteed Debt[5]	09/14	19/17/14	Q	I	A
External Current Account Balance	09/14	19/17/14	Q	Q	A
Exports and Imports of Goods and Services	09/14	19/17/14	Q	Q	A
GDP/GNP	09/14	19/17/14	A	A	A
Gross External Debt	06/14	19/17/14	A	A	A
International Investment Position[6]	...	...	PA	PA	PA

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes, and bonds.

[3] Foreign domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents. Data are partial, because of shortcomings in the compilation of FDI.

[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); and Not Available (NA), Partially available (PA)

Press Release No. 14/566
FOR IMMEDIATE RELEASE
December 11, 2014

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2014 Article IV Consultation with Algeria

On December 1, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Algeria.

Economic activity has picked up in 2014, with real GDP growth projected to reach 4.0 percent following 2.8 percent growth in 2013. The hydrocarbon sector is expected to expand for the first time in eight years, while nonhydrocarbon growth remains supportive. Inflation has decelerated sharply to 2.1 percent, thanks in part to tighter monetary policy.

Algeria continues to enjoy substantial external and fiscal buffers, but threats to macroeconomic stability are growing. For the first time in nearly 15 years, the current account is expected to record a deficit. Deficits are projected to widen over the medium term, as strong domestic hydrocarbon consumption and lower oil prices weigh on exports, while imports continue to grow, driven by public spending. The export base is undiversified, and Foreign Direct Investment (FDI) is hampered by restrictions on ownership.

The fiscal deficit is expected to widen to over 7 percent due to lower hydrocarbon revenue, a sharp increase in capital expenditure, and continued high current spending. Nonhydrocarbon revenues are below their potential, the wage bill is high, and subsidies and transfers are costly, amounting to about 26 percent of GDP. Fiscal savings are expected to decline for the second consecutive year.

Although Algeria has enjoyed macroeconomic stability, faster and more inclusive growth is necessary to provide enough jobs for the country's youthful population. Public investment efficiency is low, and private sector growth is hindered by a cumbersome business climate, an underdeveloped financial sector, and limited international integration. Finally, rigidities in the labor market and skills mismatches reduce the impact of economic growth on job creation.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Executive Board Assessment[2]

Executive Directors welcomed the rebound in economic activity, the further decline in inflation, and the sizeable policy buffers. At the same time, Directors noted increasing vulnerabilities against the backdrop of falling oil prices, from the deterioration of the fiscal and current accounts and the decline in fiscal savings and foreign exchange reserves. They called for prompt action to preserve macroeconomic stability, complemented with broad-based reforms to diversify the economy, enhance competitiveness, and promote inclusive growth and job creation.

Directors underscored the need for sustained fiscal consolidation anchored in credible fiscal rules to address the growing fiscal deficit and ensure fiscal sustainability. They saw scope to increase non-hydrocarbon revenues, by broadening the tax base, strengthening tax administration, and reducing tax exemptions. On the expenditure side, further efforts are needed to contain current spending, including the wage bill, and to gradually replace subsidies with a targeted cash-transfer system to protect the poor. Directors welcomed the authorities' intention to move to a medium-term budget framework and continue to strengthen public financial management. A few pointed to the merits of establishing a sovereign wealth fund with oil savings aimed at supporting economic stabilization efforts and ensuring intergenerational equity.

Given the risk that inflationary pressures could reemerge, Directors encouraged the monetary authorities to remain prudent and stand ready to increase liquidity absorption and interest rates. They supported increasing the issuance of treasury bills to help mop up liquidity, reducing the need to use the oil savings fund for budget financing while also deepening the capital market. Directors welcomed the planned development of new monetary policy instruments, with Fund assistance, for liquidity management.

Directors agreed that safeguarding external stability is a priority, and requires an effective strategy aimed at diversifying the export base while enhancing the export capacity of the hydrocarbon sector. They recommended greater efforts to increase trade openness, relax restrictions on foreign direct investment, and create a more export-friendly business climate. They also welcomed the authorities' commitment to allow the exchange rate to reflect fundamentals.

Directors highlighted the importance of broader structural reforms to accelerate private-sector-led growth and further reduce unemployment. These include reforms to improve infrastructure, productivity, and public investment efficiency. Directors also encouraged further efforts to relax labor market regulations, address skills mismatch, and promote female and youth employment. A

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

thorough assessment of active labor market policies would also be useful to assess their overall effectiveness.

Directors welcomed ongoing efforts to further strengthen the stability of the financial sector, including steps recently taken to transition to risk-based supervision and capital requirements under Basel II/III. They looked forward to further progress in implementing the recommendations of the 2013 FSAP. Directors also emphasized the need to improve small- and medium-sized enterprises' access to finance and address remaining deficiencies in the Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) framework.

Algeria: Selected Macroeconomic Indicators baseline scenario, 2013–15

	2013 Prel.	2014 Proj.	2015 Proj.
	(Annual percentage change)		
Output			
Real GDP	2.8	4.0	3.9
Nonhydrocarbon real GDP	7.1	5.5	5.0
Employment			
Unemployment rate (in percent)	9.8	10.7	...
Prices			
Consumer prices (end of period)	1.1	5.6	4.0
Consumer prices (period average)	3.3	3.0	4.0
	(In percent of GDP)		
Public finances			
Revenue	35.9	33.5	31.8
Hydrocarbon	22.2	19.4	17.1
Expenditure and net lending	37.4	40.5	41.3
Budget balance	-1.5	-7.0	-9.5
Nonhydrocarbon primary balance (in percent of NHGDP)	-33.5	-36.6	-35.1
Total government debt	8.3	8.8	9.0
	(Annual percentage change, unless otherwise indicated)		
Monetary sector			
Credit to the economy	19.9	21.7	12.0
Broad money	8.4	14.5	9.0
Velocity of broad money (level)	1.4	1.3	1.2
	(In percent of GDP, unless otherwise indicated)		
Balance of Payments			
Hydrocarbon exports of goods (in US$, percentage change)	-10.3	-7.2	-15.4
Hydrocarbon exports of goods (in percent of total exports of goods)	98.4	97.5	96.8
Imports of goods (in US$, percentage change)	6.6	5.0	0.9
Current account	0.4	-4.0	-7.7
Foreign direct investment	0.9	0.7	0.7
Total external debt	1.6	1.9	1.5
Gross reserves (in billions of U.S. dollars)	194.0	187.6	172.6
In months of next year's imports of goods and services	33.7	32.3	28.3
Exchange rate			
Real effective exchange rate (2005 = 100)	103.6	...	...
Local currency per U.S. dollar (period average)	79.4	...	...
Oil and gas sector			
Total exports of oil and gas products (in billions of U.S. dollars)	63.3	58.8	49.8
Hydrocarbon production (in mn TOE)	137.0	137.5	139.3
Average crude oil export price (in U.S. dollar/barrel)	109.5	104.1	89.0
Average hydrocarbon export price (change, in percent)	-3.4	-5.0	-14.5
Investment and Saving			
Gross capital formation	34.6	38.0	39.8
o/w: Nongovernment	23.2	24.1	25.9
Gross national savings	35.0	34.1	32.1
o/w: Nongovernment	25.1	27.1	27.7
Memorandum Items:			
Nominal GDP (in billions of U.S. dollars)	209	211	208

Sources: Algerian authorities; and IMF staff estimates and projections.

Statement by Jafar Mojarrad, Executive Director for Algeria;
and Kamel Badsi, Advisor
December 1, 2014

Our Algerian authorities thank staff for a constructive report and a useful Selected Issues Paper (SIP). They highly value the Fund's policy advice and support to their policies and reforms, and are appreciative of its technical assistance.

Since the last Article IV consultation, Algeria has been striving to preserve macroeconomic stability, achieve sustainable growth and employment creation, and strengthen the resilience of its economy. After averaging 3 percent in 2012–2013, growth is expected to increase to 4 percent in 2014 and over the medium term. While non-hydrocarbon GDP growth has remained buoyant, reaching 7 percent in 2012 and 2013, activity in the hydrocarbon sector has declined in 2013, but is expected to pick up from 2014. Although still high among youth and women, the unemployment rate has been gradually decreasing from a peak of 30 percent in 2000 to 9.8 percent in 2013. Inflation dropped sharply from 8.9 percent in 2012 to 3.3 percent in 2013, which is lower than the floor of the medium-term objective adopted by the Council of Money and Credit. Inflation has maintained its downward trend, reaching 1.5 percent in August 2014. External and fiscal buffers at end-2014 are large, with foreign exchange reserves covering more than 32 months of imports and gross public debt estimated at less than 9 percent of GDP, while accumulated savings in the stabilization fund (FRR) amount to 27 percent of GDP. Despite the sharp downturn in oil prices, our authorities remain committed to preserving macroeconomic stability as a matter of priority.

Significant fiscal adjustment was made in 2013, despite the decline in hydrocarbon revenue, with the overall deficit falling to 1.5 percent of GDP from 5 percent of GDP in 2012. Cuts in current expenditures accounted for 2/3 of the 7 percent of GDP reduction in expenditures, with capital spending accounting for the remaining 1/3, mainly reflecting limited implementation capacity. In 2014, however, the deficit is expected to widen, largely reflecting lower hydrocarbon revenue and the sharp increase in capital spending following accelerated payments under the public investment program (PIP) 2009–2014. A new PIP covering the period 2015–2019 is under preparation with the objective of supporting growth with due consideration to macroeconomic stability, while ensuring more efficiency in public investment.

The authorities are fully aware of the increasing uncertainties surrounding the sharp fall in oil prices. Against this background, they are ready to prepare a series of measures to mitigate the likely fiscal impact by further streamlining current spending and strengthening tax collection. They are also cognizant of the need to deepen structural reforms to support fiscal consolidation, including by improving spending efficiency and reducing fiscal rigidities. In this regard, Fund technical assistance to the Ministry of Finance on fiscal rules, multiyear budgeting, investment spending management, and the organic budget law (OBL) will support the authorities' efforts to strengthen the fiscal framework.

The authorities fully agree on the adverse impact of wage increases and back payments, and concur with staff recommendations in this area. However, it should be noted that the back payments process ended in 2013, and the adverse effects arising from the 2012 civil service reform have dissipated earlier than expected, as reflected in the absence of second round effects on inflation. As a consequence, after a slight increase in 2015, the wage bill as a share of GDP is projected to be on a declining trend over the medium term. The authorities are keenly aware of the need to rethink the subsidy system and carry out a comprehensive reform. To this effect, they appreciate the recent Fund technical assistance, which will help them identify an optimal strategy to carry out a smooth exit from the current subsidy regime, while strengthening the social safety net. The authorities attach high priority to strengthening tax administration and building capacity in support of the ongoing tax policy reform, which aims at fighting tax evasion and avoidance, while reducing the burden on taxpayers, in particular SMEs, through simplification of procedures and unification of tax regulations within a single tax code.

Against a backdrop of continuous excess liquidity, the authorities remain committed to maintaining a prudent monetary policy and containing inflation around the 4 percent target. Steady enhancement of liquidity management under available monetary policy instruments has been successful in bringing inflation down from a peak of 8.9 percent in 2012 to 3.3 percent in 2013, and has also significantly improved the inflation outlook, with stable medium-term inflation expectations. Moreover, in close coordination with the Central Bank, the Finance Ministry is committed to further issuing treasury bills, while limiting recourse to the FRR, thereby contributing to absorbing excess liquidity. Going forward, with IMF technical assistance, the Bank of Algeria intends to develop new monetary policy instruments, including central bank securities, in order to better manage liquidity and deepen the money market. The authorities take positive note of staff's assessment that the real effective exchange rate (REER) of the Algerian Dinar is broadly in line with fundamentals.

As evidenced by the financial soundness indicators, the banking system is well capitalized, liquid, and profitable. Over the five past years, the NPL ratio declined by 50 percent to reach 10.5 percent in 2013. It should be noted that NPLs largely relate to old private debts, which are fully provisioned. Banking supervision has been steadily strengthened with Fund and World Bank technical assistance. The CAMELS rating system will be generalized to all banks in 2015, and new regulations related to capital adequacy, loan classification and provisioning, and concentration of risk have been recently adopted by the Council of Money and Credit. The implementation of the upgraded credit registry will be completed in 2015, and would coincide with the reactivation of consumer lending activity.

In the authorities’ view, economic diversification is crucial to ensure high and sustainable growth and job creation. They are committed to laying the foundations for strong private-sector-led growth, and are working to foster an attractive business climate and facilitate foreign investment. In this regard, efforts are underway to identify the main impediments to investment, in close collaboration with all stakeholders. Significant progress has being made in reducing administrative costs, shortening delays for building permits, modernizing the judiciary system, and improving access to land. A new draft bill is being prepared to promote investment, and new provisions facilitating investment abroad by resident companies have been recently introduced.