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To: Members of the Executive Board

From: The Secretary

Subject: **Algeria—Financial System Stability Assessment**

This paper provides further background information to the staff report on the 2003 Article IV consultation discussions with Algeria (SM/03/397, 12/17/03), which is tentatively scheduled for discussion on **Friday, January 16, 2004**. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of Algeria indicating whether or not they consent to the Fund's publication of this paper.

Questions may be referred to Mr. Durand (ext. 38555) and Mr. Sensenbrenner (ext. 39965) in MFD.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Wednesday, December 31, 2003; and to the African Development Bank, the Arab Monetary Fund, the European Commission, and the Islamic Development Bank, following its consideration by the Executive Board.

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ALGERIA

Financial System Stability Assessment

Prepared by the Monetary and Financial Systems and
Middle East and Central Asia Departments

Approved by Stefan Ingves and Julian Berengaut

December 18, 2003

This Assessment is based on the work of two IMF-World Bank missions that visited Algiers as part of the Financial Sector Assessment Program (FSAP) from March 11–22 and June 2–15, 2003. The missions met with senior management and staff of the Bank of Algeria (BA), the Ministry of Finance (MoF), and supervisory agencies, and with representatives of the financial sector. Findings were discussed with the authorities during October 2003, in the context of the 2003 Article IV consultation.

Over the past decade Algeria has courageously attempted to modernize its financial system despite social strife and challenges posed by the large hydrocarbon sector and an inefficient public sector. However, state-owned banks' lending to public entities still dominates intermediation, financial markets remain in their infancy, and implementation of otherwise laudable regulatory reforms is lagging. Because of hydrocarbon-funded state support to borrowers and lenders alike, the financial system appears "stable" although this kind of stability has been costly for taxpayers. However the way this "stability" is achieved distorts risk pricing and governance and leads to unsound banking. To enhance soundness and the role of finance in development, the authorities should push forward on three mutually reinforcing policy fronts: privatize public banks over the medium term; improve banks' operating environment to cut intermediation costs; modulate the hydrocarbon-induced liquidity and credit cycles that curtail banks' risk-taking.

The missions comprised Messrs. Christian Durand (Mission Chief, IMF) and Dimitri Vitas (Deputy Mission Chief, World Bank), Gabriel Sensenbrenner and Laurent Bouscharain, and Ms. Hannah Faux (Assistant) (all IMF/MFD); Messrs. Philippe Callier (MCD), Mazen Soueid (ICM), Michel Svetchine (French Banking Commission), Leon Chaize (Bank of France, retired), Najy Benhassine, Charlie Garrigues, Olivier Hassler, Aristomene Varoudakis (all World Bank) and James Bonnardeaux (Consultant, World Bank).

This report presents the main findings and overall assessment; an appendix contains a summary assessment of observance of standards and codes regarding banking supervision and transparency in monetary and financial policies.

The authors of this report are Messrs. Christian Durand, Gabriel Sensenbrenner, and Laurent Bouscharain.

FSAPs are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAPs do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.

Contents	Page
GLOSSARY	3
I. Summary and Conclusions	4
II. Background and Situation of Financial System.....	7
A. Market Environment	7
B. Financial System Structure and Soundness	9
III. Overarching Issues and Policy Advice	11
A. Privatize Public Banks over the Medium Term.....	11
B. Improve the Bank Operating Environment to Cut Intermediation Costs	15
C. Modulate Liquidity and Credit Cycles that Curtail Bank Risk-Taking.....	18
Tables	
1. Main Recommendations	7
2. Financial Ratios for Largest Public Enterprise.....	7
3. Firm Size (Number of Employees)	8
4. Days Late in Transmission to Supervisor	16
5. Procyclicality of fiscal policy	19
6. Structure of the Algerian Financial System	24
7. Selected Economic Indicators, 1999-2004.....	25
8. Financial Soundness Indicators	26
Figures	
1. Suspense Accounts	16
2. Terms of Trade Volatility	19
3. GDP Growth and its Components.....	19
4. Selected Autonomous Factors	20
Boxes	
1. Public Enterprises in Algeria	9
2. Bank Soundness and Forbearance	10
3. Standards and Codes.....	18
4. Quasi-Fiscal Operations and Contingent Liabilities.....	22
5. Regular Debt Issuance Helps Reduce Debt Costs Over Time.....	23
6. Increasing Treasury Domestic Debt—Simulations	24
Appendices	
I. Observance of Financial Sector Standards and Codes—Summary Assessments.....	28

Appendix Tables

1. Recommended Action Plan to Improve Observance of the Basel Core Principles.....	32
2. Recommended Plan of Actions to Improve Observance of IMF's MFP Transparency.....	34
3. Other Recommended Actions.....	37

GLOSSARY

CB	Commission Bancaire
CBB	Central Bank Bill
CMC	Conseil de la Monnaie et du Crédit
CNEP	Caisse Nationale d'Epargne Populaire
COSOB	Commission d'Organisation et de Surveillance des Opérations de Bourse
DA	Dinar Algérien
MoF	Ministry of Finance
SOE	State-Owned Entreprises

I. SUMMARY AND CONCLUSIONS

1. Over the past decade Algeria has courageously attempted to modernize its financial system despite social strife and challenges posed by the large hydrocarbon sector and an inefficient public sector. However, state-owned banks' lending to public entities still dominates intermediation, financial markets remain in their infancy, and implementation of otherwise laudable regulatory reforms is lagging. Because of hydrocarbon-funded state support to borrowers and lenders alike, the financial system appears "stable" although this kind of stability has been costly for taxpayers. However the way this "stability" is achieved distorts risk pricing and governance and leads to unsound banking. To enhance soundness and the role of finance in development, the authorities should push forward on three mutually reinforcing policy fronts:

- Privatize public banks over the medium term;
- Improve banks' operating environment to cut intermediation costs;
- Modulate the hydrocarbon-induced liquidity and credit cycles that curtail banks' risk-taking.

2. Algeria has undertaken various reforms since the early 1990s to transition from a planned to a market economy. Foreign trade and most non-energy prices have been liberalized and private sector activity has been trending upward. However, exports have barely diversified away from the volatile hydrocarbon sector.

3. Although 15 private banks have been licensed since 1998, public banks which have consistently incurred losses overwhelm the small financial sector. The authorities have hitherto provided unconditional liquidity to the public banks, as high as ½ of bank credit in 1998. The public banks have been repeatedly recapitalized (on average, over 4 percent of GDP per year from 1991–2002) as a result of public enterprises' inability to service their debts and banks' low earnings/poor management. Continuing loan losses, forbearance, and a passive shareholder have frustrated recent attempts at making public bank managers more accountable. The failure of the largest private bank in early 2003 also exposed gaps in fit-and-proper tests and tarnished the public's opinion of private banks. On this occasion, the authorities have not provided liquidity support to troubled private banks.

4. The following analysis should inform policy actions in the above three areas.

Privatize public banks over the medium term

5. Financial intermediation in Algeria will be bank-based for the foreseeable future and only politically difficult decisions to gradually sell state banks will eliminate the drag that current banking practices have on resource allocation. No system dominated by state banks has avoided large loan losses or contributed effectively to economic development. After several bailouts, Algerian public banks still need more financial

restructuring, but the key challenge lies in restructuring their operations to make them attractive to private buyers. The healthiest public bank should be privatized rapidly, followed by a second one soon thereafter. Remaining public banks that fail to attract bidders within five years should substantially curtail operations. Ceilings on private ownership for Algerian public banks are ill-advised because they may restrict the field of reputable bidders.

6. **In the meantime, there is considerable scope to improve the management and transparency of banks remaining in public hands.** Rapidly selling two small banks still leaves the government with the task of running two large generalist banks and three housing and agriculture/food processing specialists. Profitability could improve if the government focused on three areas. First, the state shareholder must become pro-active and enforce performance contracts on public bank managers. Second, public banks should be audited by reputable external agencies to reveal underlying value. Third, direct budget support should replace directed lending to unviable state-owned enterprises (SOEs) and financial support under public programs (housing, agriculture). If the government asks public banks to administer such activities, the banks should earn fees but not carry subsidized loans to SOEs on their balance sheets. The supervisor has a role to play in the operational restructuring of public banks by enforcing provisioning rules so as to clarify profitability. A parallel reform of public enterprises would reduce political pressures on the supervisor for forbearance.

Improve the bank operating environment to cut intermediation costs

7. **Forceful implementation of existing regulation, improved accounting standards, a modernized payment system, and more proactive supervision are essential to reduce intermediation costs and provide the right conditions for a healthy private banking sector to flourish.** Although most laws and regulations governing financial intermediation have been modernized, poor implementation inflates intermediation costs. Below-par auditing and accounting practices also compromise bank screening and monitoring of borrowers; true financial information is often concealed for tax reasons. Local accounting norms and regulations, some of which date back to the command economy, are vague and financial statements fail to give a true and fair view of company performance. Payment system inefficiencies also impose costs on financial intermediation in Algeria.

8. **The implementation of supervision needs strengthening in many core areas.** Even though laws and regulations underpinning bank supervision may not be formally deficient, the extensive state ownership of banks severely undermines regulatory governance, and question marks surround the preconditions for effective banking supervision. Moreover, the new ordinance on Money and Credit could reduce the Bank of Algeria's (BA's) financial and operational autonomy. Supervision suffers from crippling delays in the banks' submission of information, weak skills, and blurred lines of responsibility. Forbearance must be ended decisively, while enhancing the supervisors' job content and career prospects.

Modulate liquidity and credit cycles that curtail bank risk-taking

9. **Financial stability and development are hostage to hydrocarbon-induced liquidity and credit cycles.** Even assuming a supportive operational environment, well-run banks in Algeria would be justifiably cautious in extending credit to the poorly diversified and highly volatile economy.
10. **Improved public debt and expenditure management can support financial system stability and development by attenuating the effects of the oil cycle on bank liquidity and credit risks.** Although an oil stabilization fund was created in 2000, proceeds of hydrocarbon exports have continued to cause procyclical fluctuations in public spending and system liquidity, which amplify bank liquidity and credit risks. Modulating liquidity and credit cycles in Algeria rests partly on immunizing public expenditure from swings in hydrocarbon revenues and improving the transparency of quasi-fiscal operations and contingent liabilities.
11. **Higher “self insurance” reserves in the form of Treasury deposits at the central bank would help offset some of the impact of volatile public revenues, particularly during bad times.** Such reserves could be obtained without increasing debt service, by replacing the 20-year amortizable bank restructuring bonds with bullet securities staggered between one and ten years. Treasury could further increase dinar issuance by substituting domestic for relatively costly foreign debt. The resulting lower external debt ratios would improve prospects, all else equal, for an attractive sovereign rating, with benefits for domestic banks and borrowers.
12. **Assuming Treasury coordinates public debt management with BA, modulating the liquidity and credit cycles will also require strengthening monetary management.** Although central bank bills could be used, Treasury paper is better for the development of local debt markets. Once sufficient paper is available to absorb the current excess bank reserves, conditions would fall in place for competitive setting of interest rates along the yield curve, a building block of modern financial intermediation. However, competitive markets are unlikely to emerge as long as state banks dominate the financial system.

Table 1. Algeria: Main Recommendations

Policy Fronts	Actions
Privatize public banks over the medium term	Quickly sell the two healthiest public banks. Give remaining banks five years to prepare for privatization; curtail operations if no bidders. In the meantime, make shareholder control of managers much tougher. Fully finance unviable public enterprises and programs through budget appropriations; pursue public enterprise reform
Improve the bank operating environment to cut intermediation costs	Improve accounting and audit Make supervision proactive. Strictly enforce provisioning rules. Modernize payment system. Train magistrates in commercial and financial matters
Modulate hydrocarbon-induced liquidity and credit cycles that curtail banks' risk-taking	Increase domestic debt issuance to manage liquidity. Prepay some foreign debt by substituting domestic debt. Create the legal infrastructure for an interbank repo market.

II. BACKGROUND AND SITUATION OF FINANCIAL SYSTEM

A. Market Environment

13. **Algeria has not yet completed its transition to a market economy initiated in the late 1980s.** Growth and internal and external balances are highly dependent on the hydrocarbon sector. Although positive over the last 10 years, growth has remained below potential suggested by Algeria's high investment rate. The second half of the 1990s saw the achievement of macroeconomic stabilization and the launch of supply-side reforms. Algeria's exchange regime is a managed float with no pre-announced path for the exchange rate; controls on invisibles and capital and financial account transactions are extensive.

14. **The large public enterprise sector has struggled to limit losses.** Many state-owned enterprises (SOEs), mainly in intermediate sectors, have ceased to be viable as a result of more open competition and realistic treatment of costs mandated by the reforms. Although the non-oil public sector has contracted somewhat, unviable SOEs remain the dominant users of bank loans (mostly floating rate overdrafts). State guarantees

remove incentives for screening and monitoring borrowers. High leverage makes SOEs vulnerable to cash flow swings, including from increases in interest rates: debts are below 50 percent of assets in only 8 out of the largest 38 SOEs according to official figures. However, these vulnerabilities have been of little consequence for the financial system because of the authorities' hitherto unconditional liquidity support of SOEs and public banks.

Table 2. Algeria: Financial Ratios for Largest Public Enterprise

		Debt/Assets	Liquidity
Total		97%	117%
Profit-making	16	76%	150%
Loss-making	22	113%	93%
Notes: Thirty-eight out of 132 largest exposures reported by banks. Liquidity = short-term claims/short-term debts			
Sources: 2001 financial statements.			

15. The 97 percent of businesses that employ fewer than 100 persons are typically opaque family-owned enterprises in the construction, trade and service sectors.

More than half were created under the command economy. Three percent are

Table 3. Algeria: Firm Size (Number of Employees)					
	5-9	10-19	19-49	50-99	100+
Private	63	97	114	51	27
Public	0	2	4	7	42

Source: World Bank, representative sample of firms.

incorporated, the rest being limited liability firms, partnerships, or sole proprietors. Algeria's business density is low (one for 50 inhabitants; one for 20 in Europe). Foreign bankers note that borrowers are exceedingly costly to analyze and monitor because firms run several books. By default, arm's length credit is based on relationship banking—the costliest kind, with stringent non-price terms. A business-friendlier tax regime would improve the quality of financial information, but progress would also come from faster growth that would force constrained net worth owners to seek outside finance. Robust valuation practices and collateral systems, starting with land and real estate, are also needed.¹

Box 1. Public Enterprises in Algeria

Viable SOEs are found in two sectors: chemicals/plastics; construction materials. Losses of SOEs in metallurgy and machinery, leather and footwear, and food processing have been as high as their value added in the past five to seven years, and much higher in textiles and apparel. Distressed SOEs in these four industries accounted for 15 per cent of manufacturing value added in 2000 and employed 110,000 people (2 percent of the labor force; 60 percent of SOE workforce). Losses reflect the collapse in sales to as low as 20 percent of 1990 levels in textile and apparel, and 50 percent in food processing.

According to Ministry of Industry data, earnings in metallurgy, machinery and food processing do not cover debt service. The public banks' largest troubled exposures consist of two SOEs in textiles, seven in metallurgy and construction materials, four in machinery and consumer durables, eight in food processing, and two in transport.

According to the Ministry, 380 out of 1120 SOEs are salvageable. Although the authorities are open to privatization, there have been few significant transactions. There are twelve very large SOEs. Private sector activity represents less than half of value added in production (3/4th if oil is excluded), mainly in trade/services, agriculture, transport/telecom, and construction

¹Leasing remains well below penetrations observed in neighboring countries. A framework for tracking and recovery of assets is lacking.

B. Financial System Structure and Soundness

16. **The performance and soundness of Algeria's banks are distorted by pervasive state support and forbearance** (Box 2). Bank credit is 34 percent of GDP (60 percent of non-oil GDP), of which 80 percent extended by public banks. Private banks accounted for 26 percent of credit to the private sector before the failure of the largest private bank in 2003. Following its failure (it offered attractive deposit rates to fund related parties), retail depositors have become aware of risk and shifted deposits to public and foreign banks. A second small bank was also closed in 2003.

Box 2. Bank Soundness and Forbearance

Because of pervasive state support alternating with forbearance, the performance and soundness of the banking system is difficult to gauge from generally available data. BA inspected large exposures of the five largest public banks in early 2003 in preparation of the FSAP.

The inspection revealed a provisioning shortfall of 24 percent.. These provisions, if recognized, would bring solvency ratios to minus 6 percent. In contrast, generally available data put the solvency ratio at 14.8 percent for public banks, and 15 percent for the banking system as a whole. 3/4th of the provisioning shortfall is attributable to loans extended to major SOEs, 14 percent to private sector loans, and the balance to smaller SOE exposures. If provisions had been charged to earnings as and when they arose, they would have turned barely positive earnings into consistent large losses. Because the banks are already significantly undercapitalized and unprofitable, it was decided not to conduct a stress test. A stress test in the context of Algeria would be more about the sustainability of public finances than financial system resilience.

Generally available data show banks to have satisfactory liquidity. However, the restructuring bonds issued by the Treasury should be classified as fairly low-liquidity assets, because of the absence of secondary market. Furthermore, if one discounts the cyclically comfortable liquidity of the oil company, bank liquidity may well be border line.

While credit is the major risk, interest payments on public debt have a substantial impact on income. Interest from restructuring bonds represents one-third of bank income, and almost three times reported profits for 2002. If the government does not pay, as has happened, banks make losses simply from holding risk-free assets.

Direct currency risk is low on account of tight position limits. Extensive capital controls prevent borrowers from building FX exposures. Bank's interest rate risk is difficult to quantify on account of the lack of information on maturity gaps. However, the banks' sizable holdings of 20-year restructuring bonds are fixed-rate. That this risk is inadequately monitored, both by the supervisor and by the banks themselves, calls for measures to improve asset liability management of banks and to strengthen prudential rules.

17. **Public banks' losses averaged over 4 percent of GDP each year from 1991 to 2002.** Although the reported budget was almost balanced, on average, over the same period, financial restructuring of banks has occurred in three off-budget rounds in 1991–94, 1995–98, and 2001. The last one was intended to be the final round and brought the average reported capital ratio to 14 percent.² However, a BA audit of large exposures at end-2002 revealed that public banks still needed another 4 percent of GDP to maintain current capital ratios. The actual cost would be 3 percent if banks reduced their ratios to the local minimum of eight percent. It is worth noting that this minimum is below the 10-12 percent minimum typically imposed on systems with risks comparable to Algeria's and that 95 percent of non-internationally active US banks have ratios above 10 percent.

18. **Fixed-income and money markets are in their infancy.** Bonds swapped for SOE loans represent 90 percent of Treasury domestic debt, but these bonds were not designed for trading. Treasury also issues a few tradable series (2.5 percent of GDP) of short duration; yields beyond two years have little meaning because primary amounts remain symbolic. BA refinances banks on tap against eligible collateral when injecting liquidity and uses deposit auctions and reserve requirements when absorbing. The reference rate is currently BA's rediscount rate. As concerns offshore yields, Algeria represented 0.24 percent of the emerging market bond index and whatever debt is "tradable" has virtually no liquidity.

19. **The insurance sector is insignificant.**³ Insurance, liberalized in 1995, comprises six state-owned, two mutual, six small private insurers, and one state-owned reinsurer. External reinsurance is with reputable firms. Premiums are 0.5 percent of GDP (1.5 percent in Tunisia and three in Morocco). Non-life accounts for 99 percent of them. With the exception of auto insurance which suffers from high expense ratios, lines are profitable and the sector meets local prudential requirements. Life insurance is not yet regulated.

20. **Institutional and informational (accounting) underpinnings for bringing companies to the equity market are absent.** Trading is almost nonexistent on the three listed stocks. The Surveillance Commission (COSOB), an independent authority, has expended major efforts since 1993 to develop the market. Brokers have been licensed and a central depository created, but highly opaque financial information, banks' inability to provide investors with information, and small institutional investors prevent issuance.

²The largest buy-back was of loans to SOEs, followed by agriculture and food processing, public housing, and small farmers' debt.

³The following paragraphs on insurance, housing and microfinance aim at completing the background on the financial system. Policy issues related to these activities are discussed in the Financial Sector Assessment paper prepared by World Bank staff for its Board.

21. **The value of Algeria's housing deficit is estimated at 25 percent of GDP, yet housing loans to households represent barely 1.5 percent of GDP.** Private houses are built on family funds, implying slow uneven completion. Multi-family units, generally developed by municipalities, are financed by the state-owned thrift, CNEP. Starting in 1996, tenants have been allowed to purchase apartments, including through financing from commercial banks. However, CNEP's 2002 portfolio still amounted to 97 percent of housing finance.

22. **CNEP has never foreclosed on a property, and by 1997, with 75 percent of its portfolio nonperforming, CNEP was restructured at a cost of 10 percent of GDP.** In its first thirty years of existence, CNEP's housing loans were de facto not secured by registered collateral. Since 1997, management has focused on profitability by rescheduling old loans, while maintaining high provisioning, liquidity,⁴ and solvency ratios (18 percent at end-2002). However, with one third of its credit extended to a wholly-owned subsidiary that is not consolidated, even solvency is questionable. CNEP's focus on its old portfolio has taken energy away from serving new demand. CNEP's financials were first certified in 2002.

23. **Microfinance is undeveloped**, with only a few programs based on government-run social services.

III. OVERARCHING ISSUES AND POLICY ADVICE

24. **Financial intermediation in Algeria will rest on banks for the foreseeable future.** To build sound institutions, the analysis has focused on three mutually reinforcing themes: privatize public banks over the medium term; improve the operating environment for banking; modulate the hydrocarbon-induced liquidity and credit cycles so that banks can gain confidence in the macroeconomic stability that they need to extend credit.

A. Privatize Public Banks over the Medium Term

25. **Repeated public bank bailouts could undermine other efforts to bolster foreign investor perceptions, including of debt sustainability.** Failures in the banks' incentives structure have cost 4 percent of GDP per year for an extended time now and losses continue to accumulate, perhaps at a slower pace.⁵ The cumulative cost of bank distress in Algeria may be compared to Turkey (40 percent), Thailand (30 percent), or Mexico (20 percent).⁶

⁴The liquidity of recent placements in some private banks may be illusory.

⁵For the analysis of debt sustainability, see Staff Report for the 2003 Article IV Consultation.

⁶See BIS Papers No. 20 "Fiscal Issues and Central Banking in Emerging Economies", October 2003.

Bank bailouts were not accompanied by cutting ties to SOEs and other operational restructuring.⁷

26. **Only politically difficult decisions to privatize public banks can eliminate the drag that banking places on resource allocation in Algeria.** There is ample cross-country evidence that large public bank sectors are rarely returned to profitability by a state shareholder; considerably undermine supervisory credibility; and are associated with low growth of GDP per capita and productivity.⁸ International experience suggests that well-supervised private banks—especially reputable foreign ones—boost financial services.

27. **Performance contracts for public bank managers, introduced in 2001 in conjunction with the last bailout, have not stopped new losses or solved governance problems.** Public banks' net income before provisions is barely positive. The performance contracts are not published, so criteria for evaluation are unknown. With Treasury eventually assuming losses on SOE loans, bank managers lack incentives to assess risk, condemning large parts of the economy to operate outside any credit culture.

28. **The healthiest public bank should be privatized rapidly, followed by a second one soon thereafter.** Two small public banks seem in better financial shape: provisioning of remaining impaired assets would push both into loss in 2002 but still leave them with solvency ratios of 17 and 6 percent. Selling them quickly will show a break with the past and the demonstration effect will help boost foreign interest.

29. **The state shareholder should give managers of the other state banks a timetable for privatization not to exceed five years.** If managers cannot make their banks attractive to reputable bidders, the shareholder should substantially curtail operations to remove the possibility of further bailouts.⁹ This approach, buttressed by the "demonstration" privatizations discussed above, can help show public bank managers that they either face dismissal or convince new owners to retain them by showing quality profits.

⁷SOE reform would improve the operating environment for banking but is beyond the scope of this report. The OECD in "Privatizing State-Owned Enterprises: An Overview of Policies and Practices in OECD countries", November 2003, notes that privatizing banks ahead of enterprises has helped enforce hard budget constraints on SOEs in transition economies.

⁸La Porta et al., "Government Ownership of Banks," *Journal of Finance*, 2002, report this evidence in a study of public bank ownership in 92 countries since 1970.

⁹Honohan et al., "Fiscal Implications of an Accommodating Approach to Banking Crises," *Journal of Banking & Finance*, 2003, in a study of 34 countries during 1970-2000, found that "strict" exit of weak banks is less costly than a gradualist approach, unless regulators have some other way of controlling risk-taking.

30. **Although bank privatization in Eastern Europe showed that initial ownership structures were less important than relinquishing management control, ceilings on private ownership for Algerian public banks are ill-advised because they may restrict the field of reputable bidders.** The government did invite foreign banks to bid for majority ownership of the strongest public bank in 2002. It then imposed a 49 percent ceiling and the main suitor withdrew. Most reputable buyers are willing to incur the cost of due diligence under three conditions: full management control; guarantees that the state assumes hidden liabilities that materialize within an agreed timeframe; a contract that obligates the state to sell its remaining shares within an agreed-upon timeframe. On the strength of such contracts, some investors might purchase less than 51 percent initially.

31. **Privatization should not attempt to recoup past budgetary outlays, but prevent future ones and let new owners decide on investments and cut costs.** Investors will focus on the level and volatility of a bank's profits, not on budgetary outlays sunk into restructuring it. The Algerian government has no comparative advantage in running banks, including investing in systems and skills and rationalizing branches and staff. Such outlays, while possibly making a bank more attractive, will be heavily discounted by bidders: new owners will introduce their own systems and practices. These uncertainties may be bypassed and time gained by selling the banks "as is."

32. **Privatizing two small banks still leaves the government with the task of running two large generalist banks and three specialist institutions (in housing and agriculture/food processing).** Some of them might yet become attractive to bidders if the government focused on: becoming a pro-active shareholder; increase transparency through audits by reputable agencies; putting on-budget all financing of public entities. In the meantime, the government must be prepared to provide yet more capital.

33. **The state shareholder must become proactive; it does not yet enforce performance contracts on public bank managers.** Ensuring profitability and safeguarding financial strength are responsibilities of the state shareholder, not of the supervisor. Managers that fail to keep their boards apprised of material developments affecting profits should be dismissed. Especially for impaired public banks, the shareholder should demand of managers frequent, timely, and accurate reports of compliance with restructuring plans. Management should inform the board of slippages in a timely manner because of their budgetary implications. The state shareholder will know that its system of information and control works if it knows of losses much earlier and in greater detail than the supervisor.

34. **Audit by reputable firms will help reveal the underlying value of the public banks.** The audit process will be costly and consume the time of banks' management and board. But the process will reveal intrinsic value to current and prospective shareholders. It will also focus managers and the Minister of Finance on the costs of various actions that they may take to restore value in the years before privatization.

35. **Direct budgetary support should replace lending to unviable SOEs and financial support to public programs such as housing or agriculture.** Since the last bailout, the

government has assumed credit risk of public banks more directly through guarantees and/or interest rate subsidies. For this to work, public banks need pricing data and underwriting procedures to decompose interest rates charged a given entity into cost of funds, operating expenses, compensation for default risk, value of guarantees if applicable, and profit margin. However Algerian public banks charge a single rate of interest for each type of loan to avoid discriminating among borrowers; at current margins, they would show losses even for minimal loan loss charges. Without banks' capacity to price risk, the government should therefore consider direct budgetary financing of unviable public entities. This would help to clean up banks' balance sheets and clarify that credit is extended at banks' own risk. Banks would swap their remaining credits to unviable SOEs for Treasury paper and not extend new loans. These distressed claims would be held directly by the Treasury.¹⁰

36. In managing their housing and agriculture finance programs, other methods than burdening public banks with difficult-to-monitor risks can be considered. Weak management and underwriting expose banks to unacceptable risks in running such programs. The concentration of housing finance in CNEP is also fraught with risk. Improved collateral systems and valuation practices would encourage well-run private banks to diversify toward viable housing and agriculture borrowers.

37. If nevertheless public banks were asked to administer such activities, the government should pay management fees. The government may wish to use its banks as disbursement agents, or even monitoring or collection agents.¹¹ However, the government should compensate banks for the provision of such services. Fees should be open to bidding, which public banks can win if they are competitive.

38. BA as supervisor can play a useful role in the operational restructuring of public banks by enforcing provisioning rules to gain a firm handle on bank profitability. All banks, and especially public banks, must strive to fully price their risks. Boards and managers must ensure and the supervisor must insist that interest rates charged borrowers reflect not only funding and operating costs, but also provisions and charge-offs. Only full pricing can reveal the underlying profitability that measures bank performance.

39. Practically all public banks rely on old, decentralized systems to measure and manage risks. The systems deliver neither timely nor reliable accounting (e.g., large suspense accounts), nor adequate customer service (processing loans can take up to 18 months), let alone risk management. Because making a new system operational can take 18 months, managers should not hesitate to buy off the shelf. The market offers a range of

¹⁰Options for managing distressed assets are discussed in Enoch et al., *Building Strong Banks*, IMF, 2002.

¹¹Prior to disbursement, budgetary funds are booked as government deposits that the banks invest in Treasuries. After disbursement, the funds vanish from banks' balance sheets altogether.

options that are tried-and-tested, virtually universal, and relatively affordable. However, upgrading systems will not pay off unless built, especially at headquarters, around modern procedures governing the control of operations.

40. **The migration to new information systems and underwriting procedures will cost considerable sums for staff training.** The state shareholder should be fully aware of these costs in deciding whether to continue to run its remaining banks or sell them “as is.”

B. Improve the Bank Operating Environment to Cut Intermediation Costs

Governance, payments system, and accounting/audit

41. **Since the end of the 1980s, Algeria has embarked upon a wide-ranging and creditable modernization of laws and regulations governing financial intermediation.** Exceptions are bankruptcy and life insurance. Nevertheless, Algeria remains in the bottom two quintiles of countries for regulatory quality, rule of law, and control of corruption.¹²

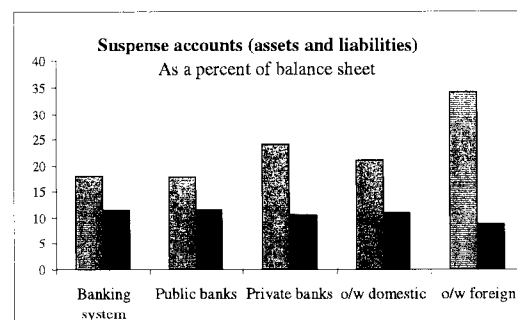
42. **Poor implementation of the new texts has failed to dent intermediation costs.** Court proceedings remain lengthy, magistrates and attorneys lack training in commerce and finance, decisions are costly to enforce, and extra-judicial arbitration is underutilized. Rights of shareholders and creditors seem well protected, but have not been tested because ownership and control are one and the same in state or family-based business entities, and a modern bankruptcy framework is lacking.¹³ Certain provisions of the central bank law concerning its independence do not meet international standards.

¹²See www.worldbank.org/wbi/governance/govdata2002.

¹³Levine et al., “Regulations, Market Structure, Institutions, and the Cost of Financial Intermediation” NBER WP No. W9890, 2003 finds that higher economic freedom or better property rights protection explain lower bank interest margins and overhead expenditures using data for 1,400 banks across 72 countries.

43. **Payment inefficiencies also impose major costs on financial intermediaries.**¹⁴ Manual procedures and numerous paper-based controls “limit” the build-up of risk by slowing down flows, contributing to large suspense accounts (Figure 1). By contrast, payments within the postal network (6 million accounts in 3000 outlets), which is centralized and owns its network, are cheap and reliable. Payment system participants have launched various initiatives to boost performance but sustained leadership is lacking.

Figure 1



44. **Costs of screening and monitoring borrowers are inflated by sub-par auditing and accounting, with financial information often concealed for tax reasons.** Accounting and audit partnerships are highly fragmented and training is limited. Auditing falls far short of international practice; the industry association does not effectively enforce even local standards. There are minor exceptions to this general pattern as certain companies expand efforts to increase transparency and some auditors work on improving practices.

45. **Local accounting norms and regulations, some of which date back to the command economy, are overly vague and financial statements fail to give an accurate and fair view of company performance.**

Algerian accounting standards do not require the preparation of consolidated financial statements (CNEP being a prominent example) and fail to set out the accounting treatment for a number of important transactions and events. Observance of existing standards is not effectively enforced and a framework of sanctions and penalties is missing. Public banks use no less than three methods for computing loan provisions. Prudential returns and other financials are received with long delays (Table 4) and are replete with inconsistencies, making surveillance virtually impossible.

Table 4. Algeria: Days Late in Transmission to Supervisor (asset weighted)			
	End-Year Statements	Auditor's Report	Prudential Returns
Public banks	31.0	247.8	122.2
Private banks	4.4	170.2	17.6
o/w domestic	6.0	94.8	14.5
o/w foreign	3.1	235.7	20.3
Banking system	29.8	244.5	117.7
Note: Delays relative to regulatory requirements.			

¹⁴The Algerian Post offers non-interest-bearing accounts that provide basic payment services. In the medium term, the postal network may be used to distribute savings or insurance products.

46. A World Bank team performed a comprehensive evaluation of the legal, regulatory and operational AML/CFT framework of Algeria in October 2003 and a ROSC is being prepared. Algeria lacks an AML/CFT legal framework and has not signed the relevant international conventions. In agreement with the authorities, the World Bank will provide technical assistance to strengthen the AML/CFT regime in all sectors.

Bank licensing and supervision

47. **Although supervision is entrusted to three institutions, it is the central bank which, in practice, gives the system its overall consistency and provides resources to the other bodies.** The Governor of BA also chairs the Banking Commission and the Monetary and Credit Board, in addition to having discretionary intervention powers.

48. **Laws and regulations underpinning bank supervision may not be formally deficient (Box 3), but the extensive state ownership of banks severely undermines regulatory governance.** Many uncertainties also surround the preconditions for effective banking supervision: sound and sustainable macroeconomic policies; well-developed public infrastructure; effective market discipline; efficient resolution of problems banks; appropriate level of systemic protection.

49. **Licensing, now tightened, should be kept under close scrutiny.** Licenses had been given to individuals lacking experience, owners' net worth could not be reliably established, and the 1990 Law on Money and Credit did not require that capital be fully paid-in. This culminated in the failure of the largest private bank in 2003 with assets of 3 percent of GDP.

Box 3. Standards and Codes

Core Principles for Effective Banking Supervision

Compared to the first assessment carried out in 1999 (see www.imf.org/standards), progress has been made in completing the legal and regulatory framework for banking supervision. However, the authorities still need to make greater use of all supervisory tools and sanctions in order to ensure implementation of the rules. They must also expedite sanctions with respect to banks that fail to meet their obligations. Delays in implementation must be overcome in a number of areas: analysis and monitoring of licenses and bank shareholders, reliability and punctuality of regulatory reporting, efficiency of off-site and on-site inspections, consolidated supervision.

Code of Good Practices on Transparency in Monetary and Financial Policies

The assessment revealed two areas for strengthening the institutional framework.

First, BA's objective for monetary policy should be clarified to improve accountability.

Second, BA and the Monetary and Credit Council would greatly strengthen their independence through the specification of clear timeframes for the terms in office of the governor and members of the Council, as well as by giving an indication of the criteria under which they may be removed from office.

50. **Supervision needs strengthening in many core areas.** BA still does not have a permanent system to detect difficulties in individual institutions and scrutinize prudential returns in a formalized way. Inspections—although they now exist and are better focused on material risks—fail to systematically assess asset quality, guarantees, provisions, or related party activities. Generally speaking, resources and budgets allocated for the various aspects of supervision are insufficient. Within BA, supervisors should have exclusive responsibility for assessing observance of norms and their job content and career prospects should be enhanced. Assuming lending to non-viable SOEs is terminated, regulatory governance will have meaning, BA supervisors can become stronger and more responsive to warning signs, and prescribed remedies can be applied.

51. **The ordinance on Money and Credit of October 2003 contains some improvements, but other provisions could undermine BA's financial and operational autonomy.** The ordinance aims at a better coordination between MoF and BA. At the same time, it could give rise to interference by MoF in BA's day-to-day management. It could also undermine BA's financial autonomy, by providing that the Treasury may obtain an "exceptional" advance from BA for external debt management operations. Central bank financing of such operations will not address the current excess liquidity nor support the development of instruments that allow banks to price risk.

Managing banking crises

52. **Although laws and regulations to address solvency concerns at individual institutions exist, the authorities have hesitated to apply them.** This was particularly evident when dealing with certain private banks. The recently incorporated Deposit Insurance Corporation has neither functional nor budgetary independence.

53. **The market in its current form may not fund private banks facing liquidity pressures, and BA lending is formally constrained by the availability of eligible paper.** Although there is excess systemic liquidity, it is concentrated in public banks. Public banks mistrust domestic private banks, making them vulnerable to sudden withdrawal of retail deposits. BA has provided liquidity to public banks on demand in the past.

C. Modulate Liquidity and Credit Cycles that Curtail Bank Risk-Taking

54. **Even assuming a supportive operating environment, and minimal state ownership in banking, well-run banks operating in Algeria should remain justifiably cautious in extending credit in a poorly diversified and volatile economy.** Banks in Algeria face two risk factors that cannot presently be diversified: hydrocarbon prices and agriculture (Figures 2 and 3).¹⁵ The history of financial systems suggests that these risk factors have also been among the hardest to manage. In this environment, bankers will

¹⁵Source: World Bank Country Assistance Strategy papers.

Figure 2

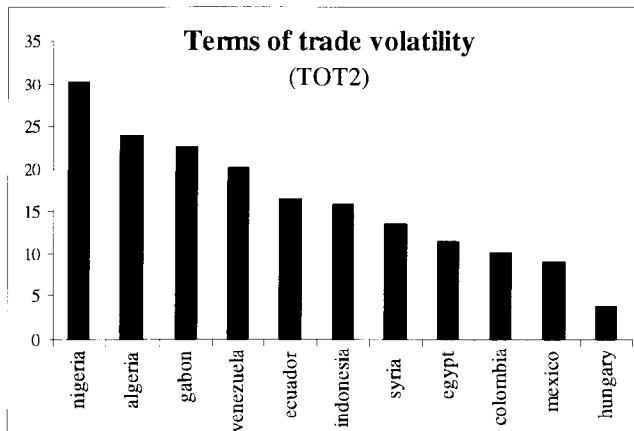
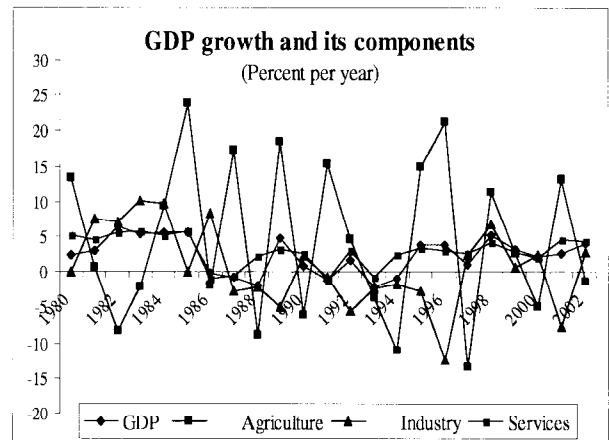


Figure 3



naturally focus on heavily secured short-term lending such as trade finance. Foreign banks specialize in this type of intermediation where local risk-taking is tightly controlled by headquarters.

55. **Algeria's procyclical fiscal policy intensifies the business cycle, particularly in bad times, discouraging banks from risk-taking.** Emerging market governments face incomplete markets, which prevent them from borrowing to sustain public expenditures through bad times, forcing procyclical fiscal adjustment

(Table 5).¹⁶ Algeria's procyclicality is particularly pronounced. Moreover, expenditure contractions in bad times are two to three times greater than expansions in good times. Fiscal policy only augments credit risk, in contrast to advanced countries where public policies tend to dampen the business cycle.

Table 5. Algeria: Procyclicality of Fiscal Policy

	Correlations with real GDP (annual data)	
	Public expenditures	Share of public expenditures in GDP
G-7	0	-0.6
Non-industrial developing countries	0.4	-0.0
Algeria	0.3	-0.1

Note: correlations of real GDP growth with the growth rates of public expenditures or of the share of public expenditure in GDP.
Sources: Riascos and Vegh (2003); and staff calculations.

56. **The volatility of liquidity is a major uncertainty for banks.** During the 1998 trough in oil prices, BA liquidity provision was about half of banking system credit. Since then, hydrocarbon export proceeds have grown rapidly. Although Treasury has accumulated

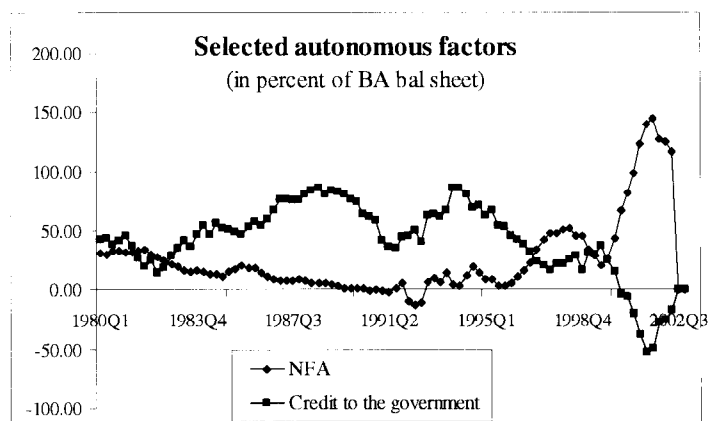
¹⁶For a recent exposition, see Riascos and Vegh (2003) "Procyclical Government Spending in Developing Countries: The Role of Capital Markets Imperfections," IMF Annual Research Conference.

large offsetting deposits at BA (partly through the oil stabilization fund),¹⁷ banks have excess liquidity on the order of 30 percent of banking system credit. From 1980-2002, the standard deviation of autonomous factors was 16 percent of BA balance sheet with peak absorption needs of 40 percent (Figure 4). To deal with those liquidity swings, the authorities could have combined three measures: (i) leaving some of the oil proceeds abroad (prohibited by law); (ii) smoothing expenditures through the existing oil stabilization fund; and (iii) constitute a stock of treasury bills at BA to help liquidity management. Assuming no policy changes and that a comfortable absorption capacity by BA requires a buffer of two standard deviations of autonomous factors, BA would need a portfolio of treasury paper of DA 500 billion. This amount is to be compared to the present stock tradable Treasury debt of only DA 100 billion, none of which BA holds.

57. Modulating banks' liquidity and credit risks in Algeria rests partly on immunizing public expenditures from swings in hydrocarbon revenues. If oil prices dropped to US\$15 per barrel and remained there, Treasury deposits at BA (currently DA 650 billion, or 13 percent of GDP) would sustain expenditures for a year at unchanged policies.¹⁸ Self-insurance to fund a year's worth of spending seems low given the effects pro-cyclical spending cuts have had on bank liquidity and credit risks.

The authorities have much higher self-insurance in hard currency: foreign reserves cover almost two years of imports. The state oil and gas company also shows high self-insurance. Because it mostly invests (in exploration and transformation) under multi-year joint-venture contracts, the company has built significant term deposits in a public bank to immunize contracted payments from cash flow swings. Expenditure immunization for the government includes specifying a sensible

Figure 4



¹⁷About 70 percent of oil and gas export proceeds revert to the budget in taxes and duties, the rest being deposits of the state oil and gas company in domestic banks.

¹⁸Assuming full roll-over of maturing domestic debt.

medium-term target for the *non-oil* primary deficit (keyed off of the permanent income from hydrocarbon resources) and improving the transparency of quasi-fiscal activities (Box 4).¹⁹

Box 4. Quasi-Fiscal Operations and Contingent Liabilities

Transparency of fiscal and quasi-fiscal operations and other contingent liabilities makes Treasury borrowing more predictable, thus reducing debt costs over time. In Algeria, approximately 12 percent of public expenditure flows through hundreds of special earmarked funds whose existence weakens the budget process. This undermines public debt management and Treasury-BA coordination for liquidity management.

Transparent budget appropriations should replace directed credit to loss-making SOEs, to better pinpoint the underlying Treasury borrowing requirement. Nearly all of the domestic public debt (about 20 percent of GDP) comprises swapped public banks' claims on SOEs. Loans to distressed SOEs from 2001 onward carry more explicit Treasury guarantees or financing arrangements, but these remain largely extra-budgetary and their contingent value is unclear.²⁰

The PAYG pension funds face growing shortfalls unless made less generous. Treasury has funded shortfalls of 1 percent of GDP each year since 1999. The gradual increase in contribution rates (from 7 percent of reported wages in 1985 to 17.5 percent in 2001) has increased under-reporting (partial data suggests two-thirds under-reporting). The finances of the system are threatened by a deteriorating dependency ratio, overly generous validation rates and benefits, and ill-advised deposits in private banks.

58. Increasing public debt issuance to constitute higher Treasury deposits at BA would help immunize expenditures. The authorities wish to take advantage of current low financing needs to reduce debt service. However, the primary objective of public debt managers following best practices is to meet financing needs at the lowest cost *over time*. Given the high likelihood of “surprises” in Algeria’s public finances and the cost of borrowing during bad times, best practices would imply increasing issuance across the curve now. Any additional upfront cost is an insurance premium against higher future financing costs in the event of cyclical shocks to revenue (or expenditure shocks from quasi-fiscal surprises). There are other arguments for issuing debt when fundamentals are supportive, rather than being forced to market under duress (Box 5).²¹

¹⁹For a discussion of fiscal reform as precondition for successful financial sector liberalization, see Ito and Krueger, eds. 1996, “Financial Deregulation and Integration in East Asia.”

²⁰Contingent liabilities would raise public debt by 10 percentage points in Brazil and the Czech Republic. See BIS Papers No. 20 “Fiscal Issues and Central Banking in Emerging Economies”, October 2003.

²¹The stock of traded government securities was 2.5 percent of GDP at end-2002 compared to 35 percent in Singapore and 20 percent in Norway, other countries with comfortable financial positions.

Box 5. Regular Debt Issuance Helps Reduce Debt Costs Over Time

A government that cuts issuance of debt too fast when times are good risks seeing the savings from doing so absorbed by the cost of boosting issuance when the cycle will turn. A regular presence in domestic and international markets minimizes costs over time by maintaining liquid and orderly debt markets and sustaining their infrastructure and investor base. Regular, predictable issuance also reduces debt costs for other borrowers, although these externalities are not easy to quantify. Any comprehensive debt management strategy should comprise both external and local debt to ensure complementarities and avoid creating vulnerabilities or costs.

Irrespective of the country's financing needs, regular and predictable domestic issuance

- **Provides an investment vehicle with little default risk**
- **Provides a benchmark yield curve for pricing corporate credit**
- **Encourages the development of skills relating to fixed income instruments**
- **Assists the central bank in managing liquidity**

Irrespective of the sovereign external financing needs, international issuance:

- **Increases investors' familiarity with the sovereign.** Only sovereign bonds greater than US\$500 million are included in the major emerging market indices. Inclusion ensures that a dedicated investor base will maintain continuous exposure in the issuer's bonds regardless of overall market conditions. This stabilizes the investor base and improves liquidity whereas issuances of less than US\$500 million attracts more opportunistic investors whose trading may exacerbate price volatility.
- **Imposes capital market discipline on the authorities,** by forcing them to obtain a rating, establish an investor relations office, and regularly and punctually disseminate information to investors.
- **Provides a real-time independent market pricing of country risk**
- **Provides a benchmark off-shore yield curve to price foreign-currency denominated corporate debt.**

59. **Self-insurance in the form of higher primary issuance will not necessarily increase debt service if the amortizable bank restructuring bonds are replaced with bullet securities.** At prevailing primary market yields, Treasury could issue DA 150 billion more along the 10-year curve (Box 6), thereby increasing its cash reserves at BA by a fourth and halving banks' excess liquidity. These amounts would be lower if primary yields rose, but only if yields almost doubled would the effect vanish altogether.

Box 6. Increasing Treasury Domestic Debt—Simulations

Total public debt was DA 971 billion at end-2002, of which DA 108 billion was formally tradable, while DA 863 billion represented bonds issued to public financial institutions to swap impaired assets. Of that amount, DA 498 billion could be transformed into traded government securities.

These DA 498 billion are presently amortized in yearly tranches of DA 25 billion until 2019, while paying a 6 percent coupon. Instead of paying DA 25 billion yearly on principal, Treasury could use it to pay interest on a higher amount of bullet securities. Under the current yield curve (1-year 2 percent; 2-year 2.5 percent, 5-year 3.5 percent, and 10-year 5 percent), Treasury could issue DA 290 billion 1-year, DA 170 billion 2-year, DA 140 billion 5-year, and DA 50 billion 10-year bullet notes—a total of DA 650 billion for a debt service in the first year of DA 17 billion (the two debt structures are comparable in net present value terms). Banks would pay for the DA 650 billion bullet securities by tendering their restructuring bonds and drawing down their deposits at BA by DA 150 billion. Treasury would increase its self-insurance by DA 150 billion. The securities would typically be rolled over at maturity as part of a modern debt management program.

Increasing issuance could result in higher primary yields, which would reduce issuance of bullet securities below DA 650 billion. But yields would have to almost double for issuance to drop to DA 500 billion. Even in this situation, banks would now have tradable securities to manage liquidity.

60. **Treasury could further increase primary issuance by substituting domestic for relatively costly foreign debt.** Algeria's external debt amounted to US\$22.6 billion in 2003, of which US\$2.7 billion could possibly be pre-paid at par without protracted negotiations or penalties. Using reserves (instead of new debt) to pre-pay some of it would reduce the import ratio, but the resulting lower external debt and service ratios would improve prospects, all else equal, for an attractive sovereign rating.²² Treasury buying dollars from BA by issuing new dinar securities on top of the previous operation would put banks short liquidity. Secondary trading would then become feasible and conditions would fall in place for competitive setting of interest rates along the yield curve, a building block of modern financial intermediation.

61. **Assuming Treasury coordinates public debt management with BA, modulating the cycles will also require strengthening BA's monetary management.** Lack of Treasuries in its portfolio has forced BA to use deposit auctions, but its liquidity absorption is only 60 percent of the amount needed, which stifles the money and fixed-income markets.²³ BA could also issue central bank bills (CBB) if its financial independence were safeguarded through appropriate understanding with Treasury. But the cyclical nature of a CBB market in

²²Algeria's reserve cover of imports is three times that observed in east Asia, where countries have considerably increased reserves since the Asian crisis—see IMF World Economic Outlook (2003).

²³The extent to which the 40 percent remaining is truly "excess" appears debatable, because the state oil and gas company needs to perform under its joint-venture contracts and may accordingly instruct its bank to invest its cash reserves in Algerian dinars conservatively, or in deposits at BA.

Algeria is the main argument against it. BA would have to issue at least DA 300 billion to absorb current liquidity, making CBB by far the largest securities market in Algeria, only to disappear altogether when the oil cycle turns again. Such stop-and-go would be debilitating for market development and would hold back the building of a government yield curve.

62. **BA can encourage the development of the interbank repo market.** BA is presently broker to all trades, even rejecting certain matches for prudential reasons. Interest rates bear little relation to counterparty risk. Revitalizing the market could include authorizing direct dealing among banks; using screen-based technology to improve price discovery; setting up a legal framework for repurchase operations (repos); keeping the system short liquidity to develop the use of BA repos of government securities. Once bank treasurers internalize the repo technique for regular borrowing from BA, market conventions will emerge for using repos to structure interbank trades. Interbank repos help minimize counterparty risk and increase the demand for treasury paper.

Table 6. Algeria: Structure of the Algerian Financial System

	Assets (In Algerian dinars)	Share of Total Assets (In percent)	Share of GDP (In percent)
Banks	3231.8	92.8	75.7
Public banks	2903.2	83.4	68.0
Private banks	328.6	9.4	7.7
Insurance	96.0	2.8	2.2
Financial institutions (Other)	153.0	4.4	3.6
Total	3480.8	100.0	81.5

Table 7. Algeria: Selected Economic and Financial Indicators, 1999–2004

	1999	2000	2001	Est. 2002	Proj. 2003	2004
(Annual percentage change)						
National income and prices						
GDP at constant prices	3.2	2.2	2.6	4.1	6.7	4.3
Hydrocarbon sector	6.2	4.9	-1.6	3.7	7.4	2.7
Other sectors	2.2	1.2	5.4	4.2	6.4	4.8
GDP deflator	11.2	23.5	0.8	0.9	7.4	-0.9
Consumer price index (average)	2.6	0.3	4.2	1.4	2.3	3.8
External sector 1/						
Exports, f.o.b.	21.5	75.7	-11.8	-2.0	29.8	1.4
Real effective exchange rate 2/	-7.9	-2.5	2.8	-7.8
(Changes as a percent of beginning stock M2)						
Money and credit						
Net foreign assets	-7.0	33.9	26.4	18.0	11.0	12.2
Domestic credit	23.1	-18.3	-1.2	8.0	-2.9	7.6
Credit to the government (net) 3/	7.8	-9.5	-5.3	0.4	-7.2	2.8
Credit to the economy 3/	15.3	-8.8	4.2	7.6	4.4	4.8
Money and quasi-money	12.1	13.2	22.2	17.4	16.0	17.6
Liquidity ratio (M2/nonhydrocarbon GDP)	75.9	81.6	88.5	97.1	103.5	110.2
(In percent of GDP)						
Central government finance						
Overall budget balance (deficit -)	-2.0	9.7	3.4	0.2	3.5	-2.6
Revenue	29.9	38.5	34.9	36.0	38.4	33.8
Of which: hydrocarbon 4/	18.1	29.6	23.6	22.6	26.6	22.1
Of which: nonhydrocarbon	11.7	8.9	10.9	13.4	11.7	11.6
Expenditure 5/	31.9	28.8	31.5	35.7	34.9	36.4
Of which: current expenditure	23.7	20.9	22.7	24.6	22.7	24.0
Of which: investment	8.2	7.9	8.4	10.2	11.5	12.3
Domestic bank financing	2.0	-9.9	-3.4	0.3	-4.1	1.8
(In billions of dollars; unless otherwise specified)						
External sector						
Exports, f.o.b.	12.3	21.7	19.1	18.7	24.3	24.6
Of which: hydrocarbon	11.9	21.1	18.5	18.1	23.6	23.9
Imports, f.o.b.	9.0	9.3	9.5	12.0	13.3	14.9
Interest payments	1.9	1.7	1.5	1.3	1.2	1.1
Current account (deficit -)	0.0	9.1	7.1	4.4	7.6	5.6
Overall balance (deficit -)	-2.4	7.6	6.2	3.6	6.9	4.9
Gross official reserves (end-period)	4.4	11.9	18.0	23.1	31.5	36.1
External current account (in percent of GDP)	0.0	16.8	12.9	7.8	11.5	7.4
External debt	28.3	25.3	22.6	22.6	21.8	19.9
External debt (in percent of GDP)	58.0	46.4	41.1	40.5	32.9	26.1

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

1/ In U.S. dollars terms.

2/ Annual average changes in the total trade-weighted INS index. A decrease in the index implies a depreciation.

3/ Including the impact of financial restructuring package involving the swap of government bonds for public enterprises' commercial debt.

4/ Including dividends on current profits paid by Sonatrach.

5/ Including special accounts, net lending, and allocation to the Rehabilitation Fund.

Table 8. Algeria: Financial Soundness Indicators

(In percent)

	1998	1999	2000	2001	2002
Regulatory equity (as a share of risk-weighted assets)	N/A	N/A	8.7	11.3	N/A
Public banks	N/A	N/A	8.4	11.1	N/A
Private banks	N/A	N/A	14.8	14.7	N/A
Equity as a share of assets	N/A	N/A	4.5	5.6	N/A
Nonperforming loans as a share of gross lending					
Public banks	N/A	N/A	27.4	26.1	N/A
Private banks	N/A	N/A	N/A	N/A	N/A
Nonperforming loans as a share of equity					
Public banks	N/A	N/A	107.2	61.5	N/A
Private banks	N/A	N/A	N/A	N/A	N/A
Provisioning as a share of nonperforming loans					
Public banks	N/A	N/A	70.5	96.3	N/A
Private banks	N/A	N/A	N/A	N/A	N/A
Major risks as a share of capital	N/A	N/A	N/A	N/A	N/A
Related party lending (as a share of equity)	N/A	N/A	N/A	N/A	N/A
Foreign exchange lending (as a share of total lending)	N/A	N/A	N/A	N/A	N/A
Off balance sheet exposure (as a share of equity)	N/A	N/A	4.3	2.9	N/A
Average return on assets (ROA)	-1.1	1.5	0.6	0.8	N/A
Public banks	-1.1	1.5	0.7	0.8	N/A
Private banks	0.0	0.0	0.0	0.0	N/A
Average return on equity (ROE)	-22.0	30.6	10.5	10.9	N/A
Public banks	-24.5	3.3	0.3	3.3	N/A
Private banks	33.0	21.7	28.3	31.9	N/A
Non-interest expenditure (as a share of gross revenues)	28.2	49.9	40.1	32.5	N/A
Personnel expenditure (as a share of gross revenues)	18.3	30.6	21.9	16.7	N/A
Average interest spread between deposits and loans	4.1	3.7	3.8	3.1	N/A
Liquid assets (as a share of assets)	N/A	N/A	N/A	N/A	N/A
Financing for the central bank (as a share of assets)	11.1	12.9	7.3	0.0	0.0
Banking deposits (as a share of assets)	54.7	51.7	58.1	63.0	63.3
Borrowing from foreign financial institutions (as a share of assets)	2.0	1.8	1.2	1.2	1.0
Bank deposits (as a share of bank credit)	95.1	83.9	105.8	154.3	160.1
Open position in foreign exchange (as a share of equity)	N/A	N/A	N/A	N/A	N/A
Spread between min. and max. interbank rates	2.5	0.8	4.4	4.9	N/A
Money market rate	10.0	10.0	9.6	5.5	N/A
Spread between short-term rate and long-term rates	N/A	N/A	N/A	N/A	N/A

OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES— SUMMARY ASSESSMENTS

This section contains summaries of the reviews of adherence to and consistency with major international standards and codes relevant for the financial sector. Specifically, it reviews observance of (a) the Basel Core Principles for Effective Banking Supervision and (b) the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies.

The detailed assessments for each of these standards and codes formed an integral part of the FSAP, a critical component of the FSSA.²⁴ They have helped to identify the extent to which the supervisory and regulatory framework has been adequate to address the potential risks in the financial system. These assessments have also provided a source of best practices in financial regulation and supervision in various areas.

The detailed assessments of standards were undertaken based on a peer review process, as part of the FSAP missions. This section contains a summarized version of the assessments included in the FSAP report.

Basel Core Principles for Effective Banking Supervision

General

63. The Algerian banking system currently has 28 active lending institutions, of which 21 are banks and 7 are financial institutions (there is also one development bank and one offshore bank). The total number of lending institutions has increased from end-1999 when there were 21 as a result of private-sector development. There are now 15 private banks. However, the public sector remains predominant.

64. The public banks, which have long been mere instruments of state policy, have undergone radical changes recently; in particular, they have been striving to develop management principles similar to those of the private sector and have been trying to implement more effective decision-making procedures and instruments.

65. Public banks continue to account for a high proportion of total banking sector activity. In particular, they represent 86.5 percent of the banking sector's aggregate balance sheet, 91 percent of loans extended, and 84 percent of deposits taken (as of end-2002). The public sector continues to receive a majority of loans extended (some 60 percent), although the proportion has fallen. The restructuring of public enterprises which have been insufficiently productive and not very profitable continues. However, government banks still carry a significant volume of nonperforming and poorly provisioned loans to the public sector.

²⁴The Basel Core Principles were issued in September 1997 and the Core Principles Methodology was released in October 1999 by the Basel Committee on Banking Supervision. The IMF Code of Good Practices on Transparency in Monetary and Financial Policies was adopted by the Interim Committee in September 1999 and the supporting documentation was approved by the Executive Board in July 2000.

66. The fiscal cost of bank restructurings in recent years has been considerable (direct recapitalizations totaled DA 74.4 billion and the outstanding stock of treasury bonds issued to convert bank claims on insolvent public enterprises DA 672.1 billion at end-2002).

67. Progress with privatization is slow. However, a decision has been made to privatize one of the large public banks by .

Institutional and macroeconomic setting for banking supervision

68. The banking law of April 10, 1990 established the principles and modalities of banking system surveillance in Algeria. Supervisory functions are entrusted to three institutions, each of which enjoys operational independence in practice, mainly because of the professionalism of their members. The institutions consist, first, of two collegiate bodies, the Monetary and Credit Board, which licenses lending institutions and exercises regulatory authority, and the Banking Commission, which is in charge of off-site and on-site supervision and has jurisdiction for imposing sanctions. The third institution is the Bank of Algeria (the central bank or BA), which prepares legislation that essentially regulates all bank regulatory matters and carries out audits—either directly or as delegated by the Banking Commission. Naturally, BA has the right to request any information it may consider necessary in drawing up this legislation. The Governor of BA, who chairs the three institutions, assumes ultimate responsibility for policy implementation and for consistency within the group.

69. The surveillance authorities are anxious to manage the current transition phase in the most efficient manner. On-site supervision of lending institutions has been strengthened and off-site supervision is being expanded. However, ongoing quantitative and qualitative resource limitations, as well as the sometimes unresponsive reaction of the authorities to instances of failure to observe the regulations, undermine the full effectiveness of the prudential system.

70. Development of the Algerian private banking sector is still modest, and because of its size still suffers a number of shortcomings as a result—for example, some banks are family businesses whose operations and accounts often lack transparency. This is a great weakness in an emerging private sector, which can partially be overcome by strictly adhering to the strict application of the principles of proper supervision, particularly regarding licensing and on-site and off-site supervision is very important. The same is true of the need to impose sanctions on institutions that fail to observe prudential regulations. In this connection, the collapse of a private bank that had expanded considerably in recent years weakened the Algerian private sector as a whole. Such an incident is also capable of tarnishing the image of the authorities.

Preconditions for effective banking supervision

71. Supervision would be strengthened by improving control and surveillance resources and tools, raising the operational capacity of the public banks, improving the legal and accounting environment, and privatizing one or more of the large state-owned banks.

72. Based on the information obtained, it would appear that the banking system continues to struggle with the inadequacies of payments, collections, and the poor quality of telecommunications systems. The system also has internal weaknesses related in particular to inadequate accounting, analysis, risk management, and internal control systems. However, the bankers interviewed recounted the considerable efforts that have been made or are being developed in terms of procedures for more effective analysis, management, and supervision. The recently issued regulations on internal controls are one example.

73. In general, the effectiveness of state banks, and the entire Algerian banking system, can only be achieved by making the capital of all institutions available to private investment, particularly investment from abroad. Indeed, given the money and time needed to develop countrywide bank branch networks, the newly established private banks cannot in and of themselves create a sufficient and sound foundation for revitalizing the banking sector as a whole.

Main findings

74. The legal framework and implementation of bank supervision appear to observe or largely observe 11 of the 25 Core Principles.. The shortcomings encountered essentially have to do with effective implementation of prudential regulations, especially those related to management standards and risk surveillance. However, the authorities have made significant efforts to improve supervision in the past three years, so much so that only one Core Principle was not observed, compared with six that occurred in the 1999 assessment.

75. Supervision resources and techniques are currently being developed in the Bank of Algeria. Clear progress has been made with respect to on-site and off-site supervision, although the off-site audits are inadequate for regular assessment of the exposure of financial institutions.

76. It is important for the authorities to continue efforts to correct the violations noted in the enforcement of prudential regulations without delay by making full use of the legal and regulatory framework at its disposal.

Comments on implementation of Core Principles

77. *Objectives, autonomy, powers, and resources of the authorities (CP 1).* The term of office of the Governor and that of the members of the Monetary and Credit Board are no longer fixed. Grounds for dismissal of the Governor have not been disclosed.

78. ***Licensing and ownership structure (CPs 2–5)***. The authorities acknowledge that often only a quarter of the minimum capital is paid up when an institution's license is granted, and often they must wait one or even more fiscal years for the full amount. Information on direct and indirect stockholdings is imperfect. Not all the data needed for adequate knowledge of the stockholders are periodically updated.

79. ***Prudential regulations and requirements (CPs 6–15)***. The authorities do not routinely verify that banks have adequate tools with which to monitor and evaluate their exposure. In practice, the lending policies of the major banks are not adequately based on sound assessment of the risks of nonrecovery of payments due. Moreover, provisions against doubtful claims are not adapted to the real risk of incurring losses. Furthermore, loans to groups of related borrowers are not clearly defined, and often reporting requirements are not met. In addition, while there are now prudential regulations regarding internal controls for banks, they are too recent to be in place in financial institutions and overseen by the authorities. Finally, there are not yet any practical arrangements in force that oblige banks to adopt surveillance procedures against money laundering.

80. ***Methods of ongoing banking supervision (CPs 16–20)***. The resources and methods employed for off-site surveillance need to be strengthened further so that banks can be fully in observance of these Principles. There are no procedures for consolidated audits. The information available on direct and indirect owners of bank stock is irregular.

81. ***Accounting standards (CP 21)***. The chart of accounts needs to be completed. Moreover, the banks' accounting systems have serious flaws that make it difficult to determine their exact exposure and financial condition. The banks often remit their financial statements to the authorities with a considerable time lag.

82. ***Corrective measures (CP 22)***. The authorities do not always take immediate corrective action on numerous institutions failing to observe prudential regulations, in some cases, on a routine basis.

83. ***Control of cross-border banking (CPs 23–25)***. The authorities can strengthen this aspect of supervision by entering into information-sharing agreements with Algeria's principal banking sector partners.

Table 1. Recommended Action Plan to Improve Observance of the Basel Core Principles

Reference Principle	Recommended Action
1-2 Independence of the authorities	Establish a fixed term of office for the Governor and the members of the Monetary and Credit Board. Publish grounds for dismissal of the Governor.
3 Licensing criteria	Require that the minimum capital be fully paid up at the time the license is granted.
4 Equity ownership	Acquire detailed knowledge of direct and indirect stockholders and keep the information up-to-date.
7-8 Credit policies, loan evaluations	Carry out regular on-site supervision in order to evaluate credit policies, loan portfolio quality, and the adequacy of provisions.
10 Loans to related borrowers	Clarify what is meant by loans to related parties. Insist that institutions remit the returns required by law.
13-14 Sundry risks, internal controls and audit	Verify implementation of the new regulations on internal controls.
15 Money laundering	Adopt regulations establishing banks' obligations under existing legal provisions of a general nature.
18 Off-site surveillance	Increase off-site supervision resources in personnel and material. Develop the methodology for analyzing banking supervision documents. Introduce early warning systems. Improve coordination between off-site supervision and actions taken by other departments.
29 Consolidated group audits	Clarify banks' obligations concerning consolidation.
21 Accounting standards	Insist that the documents required by the supervisory authorities be delivered on time. Involve outside auditors in accounting controls. Update the chart of accounts.
22 Corrective measures	Expedite the adoption of corrective measures. Impose appropriate sanctions for breaches of the prudential regulations and requirements.
24-25 Cross-border controls	Reach exchange-of-information agreements with counterparty countries.

Authorities' response

84. The authorities' comments have been incorporated in the final version of this assessment.

MFP Transparency Code–Monetary Policy

General

85. Philippe Callier and Laurent Bouscharain²⁵ conducted this assessment of Algeria's practices with respect to transparency in monetary policy in the framework of the Financial Sector Assessment Program (FSAP) for Algeria. It will form an integral part of the FSAP Report. The assessment is based mainly on the Law on Money and Credit (Law 90-10 of April 14, 1990 on Money and Credit, as amended and supplemented by Ordinance 01-01 of February 27, 2001), publications by the Bank of Algeria (BA), information available at the BA's website, discussions with senior staff of the Bank of Algeria, and replies to questionnaires submitted to the authorities.

Main findings

86. The legal and institutional framework is defined by the Law 90-10 of April 14, 1990 on Money and Credit, as amended and supplemented by Ordinance 01-01 of February 27, 2001.

- Regarding the **clarity of responsibilities, and objectives of the central bank** for monetary policy, It would seem that the Law on Money and Credit is insufficiently precise on the ranking of the central bank's main objectives, since Article 55 places equal emphasis on domestic stability, external stability, and orderly development of the national economy. Further, there is no satisfactory definition of institutional responsibility for exchange policy, as the sharing of institutional responsibilities in the area of monetary and exchange policy between the Bank of Algeria and the Council on Money and Credit (CMC) is not clearly defined by the law. The problem is mitigated in practice, however, by the fact that the governor of the Bank of Algeria chairs the CMC. Finally, the BA's independence may be limited by the absence of a fixed term for the governor and the absence of explicit criteria for revocation, with the exception of revocation for gross misconduct.
- The process for **announcing and preparing monetary policy decisions** could be strengthened with press releases that provide more thorough explanations of the reasons underlying decisions that are taken. Further, recent progress in the publication of the Bank of Algeria's annual report might be supplemented with the dissemination of more explicit information on monetary policy objectives. This would improve the economic developments in relation to the announced monetary policy objectives.

²⁵The authors are economists from the Middle Eastern Department and the Monetary and Financial Systems Department, IMF, respectively. The assessment benefited greatly from information compiled by the General Directorate of Research, Bank of Algeria.

Before it issues important regulatory texts, the BA should more systematically hold prior consultation and explanatory meetings with the financial community.

- The law on money and credit requires that **information on monetary policy** be publicly available, because it provides that the BA should publish an annual report presenting its activities and balance sheet. It would appear, however, that there are substantial lags in publishing this report and regulatory texts adopted by the BA at its website. Further, publication of central bank debt data has yet to meet the IMF data dissemination standards.
- **Accountability and assurances of integrity** by the central bank would benefit from the disclosure of its internal management procedures as well as its code of good conduct and professional ethics for its staff.

Table 2. Recommended Plan of Actions to Improve Observance of IMF's MFP Transparency Code Practices—Monetary Policy

Reference Practice	Recommended Action
I. Clarity of Roles, Responsibilities and Objectives of Central Banks for Monetary Policy	The Law on Money and Credit should clearly and explicitly define the ranking of the Bank of Algeria's monetary policy objectives. The current provisions give the BA three potentially contradictory objectives, which limit the legibility and transparency of monetary policy decisions. The law should explicitly provide the ranking of the objectives underlying the BA's decisions.
	The law should define the sharing of institutional responsibilities for exchange policy. In the present situation, the CMC seems to play a substantial role in defining exchange policy, although the texts essentially cover regulatory responsibility. The law simultaneously gives the BA the responsibility to oversee the external stability of the currency.
	The law should explicitly define the length of the governor's term, so as to enhance the BA's independence, thereby improving the transparency of its decisions. In the present framework, the absence of a fixed term for the governor can inherently limit his or her independence from the executive branch, with potential effects on the transparency of the monetary policy definition process.

Reference Practice	Recommended Action
II. Open Process for Formulating and Reporting Monetary Policy Decisions	The BA should strengthen its process of announcing its decisions and providing details on them. The information transmitted to the market is in fact often insufficient, with no announcement requirements or deadlines for explaining monetary policy decisions. This situation affects the public understanding of the decisions, and as a result, the transparency of the process of preparing and announcing monetary policy decisions.
	Consultation practices with the financial community might be improved with the introduction of systematic prior consultations with the industry, to explain monetary policy decisions and ensure that they are feasible. Such practices should lead to a better understanding and facilitate implementation of the BA's decisions.
III. Public Availability of Information on Monetary Policy	The BA's current publications do not permit a systematic assessment of monetary policy performance. While the annual report gives a detailed presentation of recent macroeconomic developments, it allows only limited scope for the definition of present and future monetary policy objectives, making assessment of results against objectives a difficult process.
	There is room for improvement in the BA's information dissemination practices through reduced publication lags.
IV. Accountability and Assurances of Integrity by Central Bank	The BA should publish a code of good conduct and professional ethics for its staff. The professional attributions of BA staff, in particular, are a potential source of conflicts of interest that should be regulated by a publicly disclosed code of ethics that includes provisions for penalties.

Authorities' response

87. This assessment has been discussed with the authorities and their comments have been incorporated in the final version of this transparency assessment. There are no significant disagreements outstanding with respect to the findings and recommendations of this evaluation.

MFP Transparency Code—Banking Supervision

Introduction

88. Laurent Bouscharain (of the IMF) and Michel Svetchine (of the French Banking Commission) conducted this assessment of Algeria's practices with respect to transparency in banking supervision was conducted by in the framework of the Financial Sector Assessment Program (FSAP) for Algeria. It will form an integral part of the FSAP Report. The assessment is based mainly on the banking law (Law 90-10 of April 10, 1990—Law on Money and Credit) as well as regulations, circulars, reports, data, and other information

available in the body of texts of the Council on Money and Credit (CMC), Bank of Algeria (BA), and the Banking Commission (CB), most of which are available at the Bank of Algeria's website.

Legal and institutional framework—overview

89. The banking law defines the principles and modalities for oversight of the Algerian banking system. This mission is shared among three institutions:

- The Council on Money and Credit (CMC) is responsible for issuing licenses and regulations;
- The Banking Commission (CB) is responsible for on- and off-site supervision and is vested with power to issue penalties; and
- The Bank of Algeria, the central bank, is responsible for enforcing current legislation, which it implements directly or by delegation of the Banking Commission for ongoing supervision of banks and financial institutions. The Bank of Algeria is responsible for on- and off-site supervision on behalf of the Banking Commission.

Conclusions

90. **Clarity of roles, responsibilities and objectives of financial agencies responsible for financial policies.** The definition of responsibilities among the different authorities is clearly established by the legislation. The texts, however, do not indicate the duration of the terms for the governor and members of the CMC, or the criteria for their revocation, should this be required. Further, there are no arrangements covering the exchange of information between the three authorities (BA, CMC, and CB). A final point, the authorities do not engage in periodic comprehensive public reporting on their activities.

91. **Open process for formulating and reporting of financial policies.** Financial communication is based substantially on straightforward public access to all prudential texts. By contrast, the process of preparing the texts by the authorities does not include coordination with the industry and measures taken are not systematically explained to the institutions to which they apply. The supervision authority does not present measures that it intends to take in exercising its supervision duties.

92. **Public availability of information on financial policies.** While the regulatory texts are available to the public, the authorities have not established any communication program. In particular, the aggregate data on the banking system and developments in this connection are not publicly disclosed according to a regular timetable and are incomplete (no profit and loss accounts).

93. **Accountability and assurances of integrity by financial agencies.** The governor and vice governors are accountable for bank supervision policy. The rules governing the integrity of persons responsible for supervision are identical to those applied to all staff of the BA (see code on transparency in monetary policy).

Table 3. Other Recommended Actions

Reference	Recommended Action
V. Clarity of roles, responsibilities, and objectives of financial agencies responsible for financial policies	The terms of the Governor and members of the CMC should be defined and the conditions for their revocation should be specified and publicly disclosed.
VI. Open process for formulating and reporting of financial policies	<p>Arrangements should be established and publicly disclosed to specify the modalities for exchanging information between the control authorities.</p> <p>Preparation of prudential texts should include a consultation of the professionals involved; the texts should be systematically explained to those to whom they apply.</p>
VII. Public availability of information on financial policies	According to a predetermined schedule, the authorities responsible for supervising credit institutions should present the information on their supervisory objectives, be accountable for their actions, and regularly publish complete aggregate data on the key features of the financial system and relevant developments (performance of banks, in particular).
VIII. Accountability and assurances of integrity by financial agencies	<p>Information on operating expenditure of the authorities in charge of bank supervision should be disclosed.</p> <p>The BA should publish a code of good conduct and professional ethics for its staff, including the bank supervision authority.</p>

Authorities' response

94. The authorities discussed this evaluation with the mission, and their comments have been incorporated into the final version of this evaluation.