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FOR AGENDA

SM/07/395

December 26, 2007

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Algeria—Staff Report for the 2007 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 2007 Article IV consultation with Algeria, which will be brought to the agenda for discussion on **a date to be announced**. At the time of circulation of this paper to the Board, the Secretary's Department has received a communication from the authorities of Algeria indicating that they consent to the Fund's publication of this paper.

Questions may be referred to Mr. Fanizza (ext. 34069), Mr. Loko (ext. 37611), and Mr. Sensenbrenner (ext. 399965) in MCD.

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 Friday, January 4, 2008; 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.

This document, together with a supplement providing an informational annex, will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities. The supplement, which is not being distributed in hard copy, will also be available in the Institutional Repository; a link can be found in the daily list (http://www-int.imf.org/depts/sec/services/eb/dailydocumentsfull.htm) for the issuance date shown above.

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INTERNATIONAL MONETARY FUND

ALGERIA

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representatives for the 2007 Consultation with Algeria

Approved by Amor Tahari and Scott Brown

December 21, 2007

- **The 2007 Article IV consultation discussions took place in Algiers** during November 4–21, 2007. The team comprised Messrs. Fanizza (head), Bouhga-Hagbe, Loko, and Sensenbrenner, and Ms. Diouf (EP) (all MCD). Mr. Durand, the FSAP update mission chief (MCM), joined the mission. Mr. Tahari (MCD) participated in discussions and presented the Regional Economic Outlook to the press.

- **The mission met** Messrs. Djoudi (Minister of Finance), Khelil (Minister of Energy), Temmar (Minister of Industry and Investment Promotion), Djaaboub (Minister of Commerce), Laksaci (Governor of the Bank of Algeria), and Ms. Mentouri (Delegate Minister for Financial Sector Reform). The mission also met other government officials and representatives of the Senate and the private sector. Mr. Maherzi, Advisor to the Executive Director for Algeria, participated in the discussions. The mission issued a press statement and held a press conference.

- **Over the years, the Fund and the authorities have focused**, in the context of surveillance, on: macroeconomic policies to sustain growth while safeguarding stability; and structural reforms aimed at promoting private sector activity.

- **Algeria's exchange rate regime** is a managed float with no preannounced path. Algeria accepted the obligations of Article VIII, sections 2(a), 3, and 4, in 1997.

- **The political situation** remains stable, but the December 11 bombings in Algiers have rekindled security fears.

- The mission discussed with the authorities the recommendations of **the 2007 FSAP update.**

- **Algeria's statistical base** is broadly adequate for surveillance.

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EXECUTIVE SUMMARY

Algeria's market-oriented economic reforms over recent years started to bear fruits, with higher growth, low inflation, and strong fiscal and external positions. The country needs to sustain its recent favorable economic performance over the medium term to lessen the economy's dependence on hydrocarbon production, and further lower unemployment that remains too high, especially among the youth.

Key Issues and Policy Discussions

The expansionary fiscal stance has boosted liquidity in the banking system, calling for vigilance in monetary policy. So far the central bank has kept inflation in check by mopping up excess liquidity, but further increases in government spending may complicate this task. The central bank is considering an increase in reserve requirements on commercial bank deposits. Moreover, it stands ready to raise further its policy rates in case inflationary pressures intensify.

Algeria's fiscal and external positions continue to strengthen, thanks to high hydrocarbon world prices. If inflationary pressures persist, fiscal policy will need to support monetary policy by slowing the pace of the public investment program (PIP). The PIP's large size and the limited absorption capacity call for intensified scrutiny over expenditure quality and efficiency.

Algeria's policies have been consistent with external stability. Staff estimates are consistent with the central bank's analysis that the real exchange rate of the dinar is close to its equilibrium level.

Progress in tax policy and administration reform has started to yield results. The authorities are now considering a number of further steps toward simplifying and rationalizing the tax system, in line with FAD recommendations.

Financial sector reform is key to ensure the effective intermediation of the country's large savings, and strengthen the monetary policy transmission mechanism. The authorities intend to implement the recommendations of the 2007 FSAP update, and improve bank governance and credit risk management.

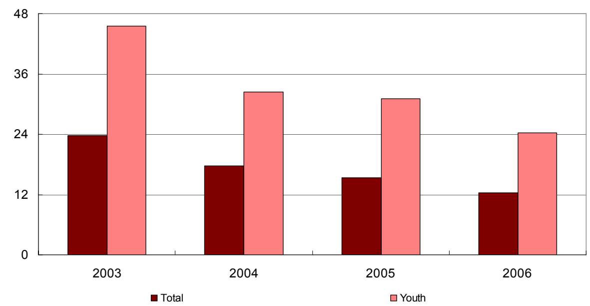
Algeria is close to securing WTO accession. The authorities plan to implement the action plans adopted by the conferences on Maghreb economic integration organized with Fund staff.

I. Introduction

1. **Prudent macroeconomic policies in a favorable external environment and headways in structural reforms have translated into an encouraging economic performance.** Average annual GDP growth reached about 5 percent and inflation remained under 4 percent over the past five years. Unemployment has declined steadily. Hydrocarbon receipts have strengthened the fiscal and external positions, and built up large savings in the hydrocarbon stabilization fund (FRR).[1] Algeria has repaid almost all the external debt, and launched a massive public investment program (PIP) to address the country pressing infrastructure and social needs.[2]

2. **However, the economy remains dependent on the hydrocarbon sector, productivity low, and unemployment high**, particularly among the youth. The hydrocarbon sector[3] represents almost half of GDP, nearly all exports of goods, and 3/4th of fiscal revenues, but only 2 percent of employment. Total factor productivity growth has turned slightly positive after remaining negative for an extended period of time.[4]

Unemployment Rates, 2003–06
(In percent)



Source: Algerian authorities.

3. **Looking ahead, Algeria's key challenge is to ensure long-term high and sustained nonhydrocarbon growth**, in order to (a) reduce Algeria's reliance on hydrocarbon production; (b) further lower unemployment; and (c) improve Algerians' standards of living by transforming the country into a dynamic emerging economy. Diversifying the economy is also essential to lessen the risk that volatile oil prices pose to external stability.

4. **Therefore the 2007 consultation discussions focused on**:

- The macroeconomic policy mix to sustain nonhydrocarbon growth in the context of large hydrocarbon receipts. In particular, how to ensure that the expansionary fiscal stance does not threaten macroeconomic stability and the quality of government spending; and

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[1] Algeria's stabilization fund (*Fonds de régulation des recettes*, FRR) is a sub-account of the government at the central bank in dinars. Inflows into the account are hydrocarbon budgetary receipts above the equivalent of $19 per barrel; outflows are to amortize debt and finance the nonhydrocarbon deficit.

[2] In 2004, the government launched a $50 billion PIP over 2005–09. The program was increased to $155 billion (120 percent of 2007 GDP).

[3] Algeria is the world's third largest exporter of natural gas and the tenth largest oil exporter.

[4] See IMF Country report No. 07/61.

- Promoting a dynamic private sector through: (a) financial sector reform, in light of the update of the 2003 FSAP; (b) tax reform to favor private sector activity; and (c) further integration in both the regional and global economy.

II. Economic and Financial backdrop

5. **Macroeconomic conditions are strengthening, and the short-term outlook is favorable:**

- *Overall GDP growth* is likely to reach 5 percent in 2008 (from 4½ percent in 2007) because of higher hydrocarbon production and accelerating activity in services, construction, and industry. The end of maintenance work and a likely rebound in European natural gas demand should lift hydrocarbon output. The momentum in nonhydrocarbon growth continues to reflect the impact of the ongoing PIP, but a surge in private sector credit confirms signs of recovering private sector activity.

- *Algeria's external position* has continued to strengthen. Boosted by high world oil prices, international reserves have now passed the $100 billion mark, and the external current account is likely to be close to 25 percent of GDP in 2008 (23½ percent of GDP in 2007).

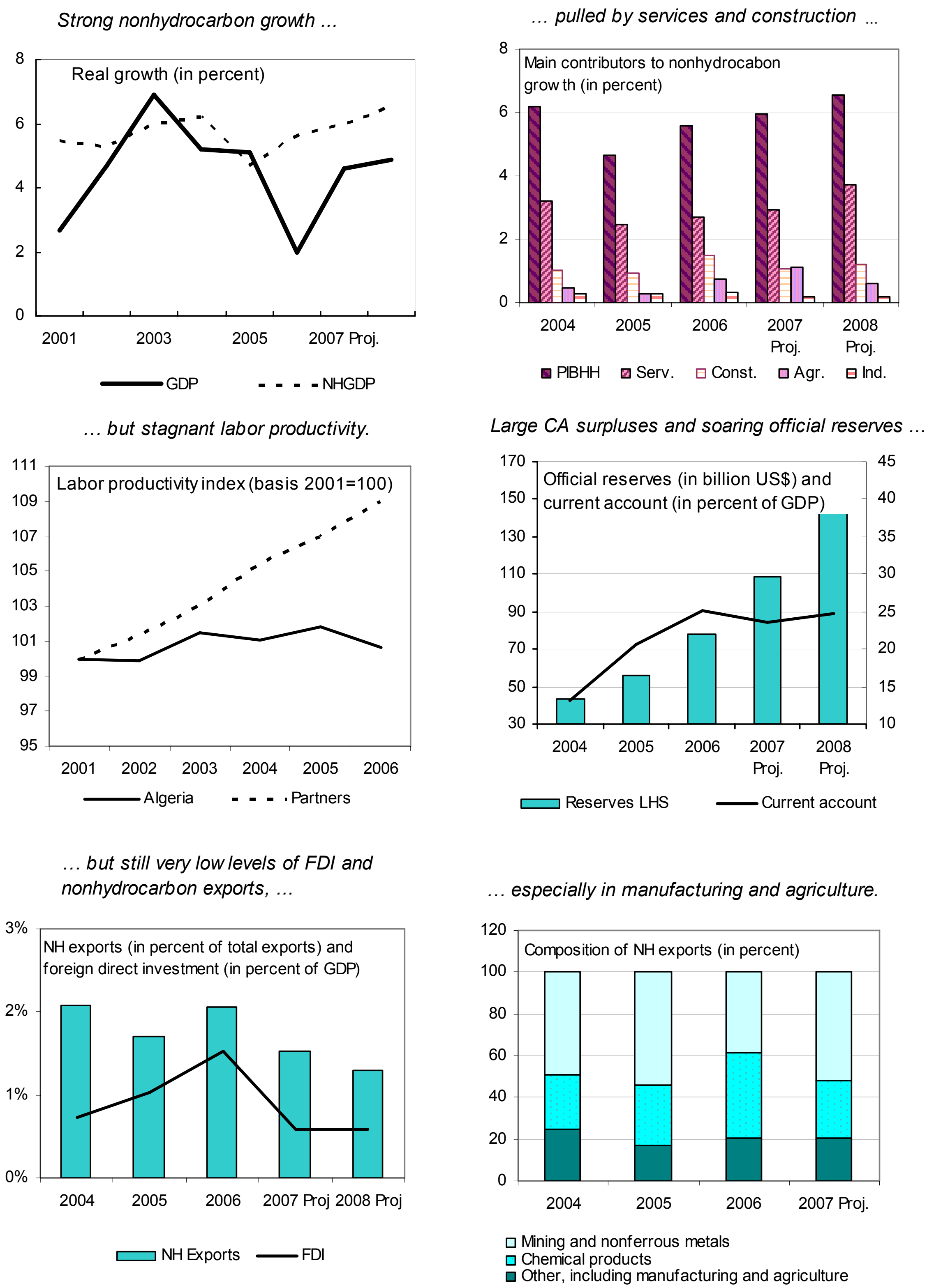
- *Inflation* picked up in the first half of the year reflecting mainly rising food prices and increasing liquidity in the banking system. In response, the Bank of Algeria (BA) raised its policy interest rates in June 2007 by 50 basis points to 2.5 percent. Since then, inflation pressures have somewhat eased, with year-on-year inflation declining from 5.5 percent in July to 4 percent in October. Thus, average consumer price inflation is likely to remain below 4 percent in 2007.

- The *real effective exchange rate* of the dinar has remained broadly constant in 2007. BA continues to be the predominant actor in the foreign exchange market, because of the surrender requirement on hydrocarbon receipts.

- *The fiscal policy* stance remains expansionary with a projected nonhydrocarbon deficit at about 40 percent of nonhydrocarbon GDP (NHGDP) in 2008, up from 37.5 percent in 2007. This stance results from accelerated implementation of the PIP and an increase in the wage bill. Nevertheless, higher hydrocarbon revenues would bring the overall surplus to 14 percent of GDP from 12 percent in 2007, further increasing the resources in the FRR.

6. **The medium-term outlook is also favorable,** based on WEO oil price projections. Real GDP is projected to grow close to 5 percent annually on average over the next five years, supported by continued strong activity in the nonhydrocarbon sector. This scenario assumes a steady implementation of the PIP and of ongoing structural reforms. Algeria's external position is likely to remain strong over the medium term although imports would increase significantly, driven by the PIP and large investments for hydrocarbon production.

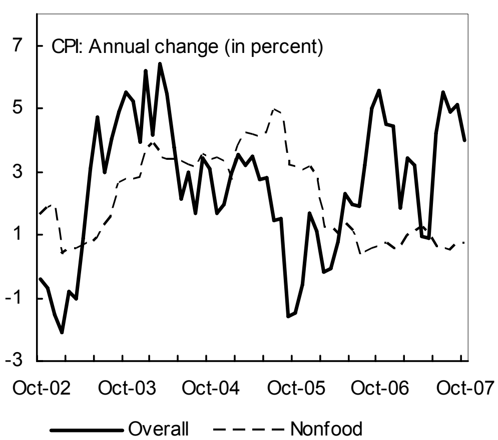
Figure 1. Real Sector and External Developments



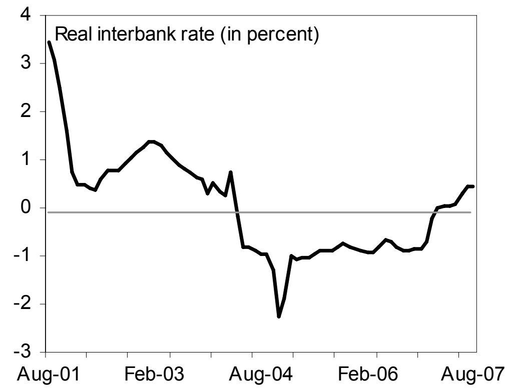
Sources: Algerian authorities; and Fund staff estimates and projections.

Figure 2. Monetary and Fiscal Developments

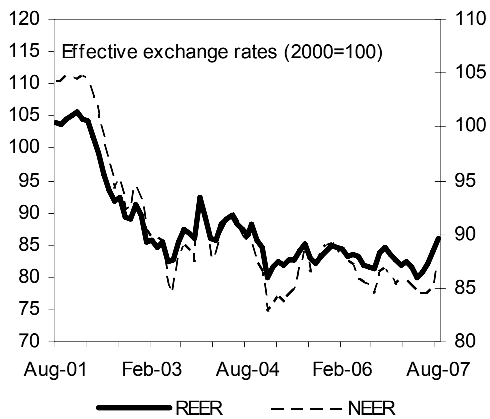
Inflation remains subdued ...



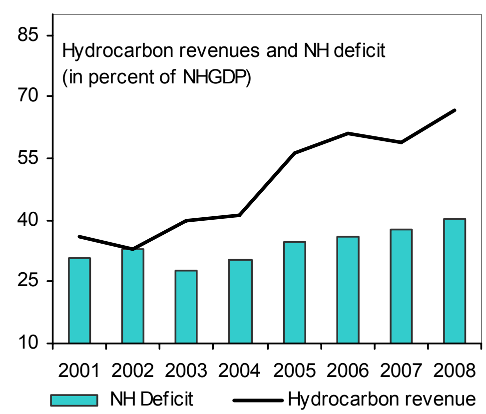
... and real interest rates turned positive.



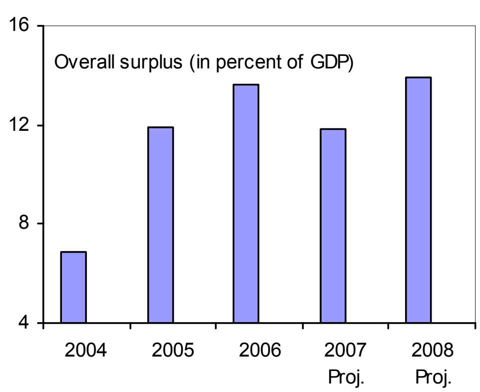
Both the REER and NEER appreciated slightly in 2007.



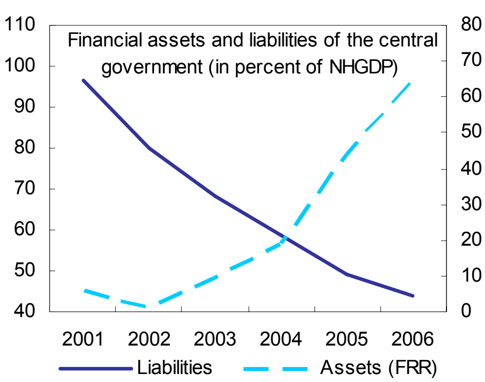
Widening NH deficit but, thanks to higher hydrocarbon revenues,...



... the fiscal position remains strong, with a substantial overall fiscal surplus...



... and large savings in FRR exceeding the level of public debt.



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

The external current account surplus, while gradually declining, would remain sizable and gross external reserves would reach about four years of import coverage by 2012. The main risks to this outlook relate to an acceleration of inflation, a limited absorption capacity that can affect the quality of public spending, a sharp decline in oil prices, and heightened terrorism activities. On the upside, accelerated structural reforms to improve the business environment could further spur private investment and growth in the medium term.

III. REPORT ON DISCUSSIONS

7. **Against the backdrop of favorable medium-term prospects, the main issues** were (a) whether the current stance of monetary, exchange rate, and fiscal policies can keep inflation under control and help sustain nonhydrocarbon growth; (b) whether Algeria's policies are consistent with external stability, in the sense that its balance of payments position does not, and is not likely to, give rise to disruptive exchange rate movements; and (c) how to improve the investment climate for private activity.

A. How to Sustain Nonhydrocarbon Growth While Safeguarding Stability

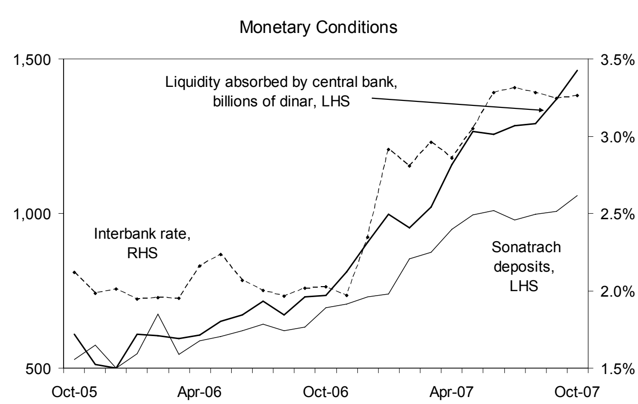
Monetary and Exchange Rate Policy

Background and Staff Analysis

8. **The expansionary fiscal stance has boosted liquidity in the banking system, calling for vigilance in monetary policy.**

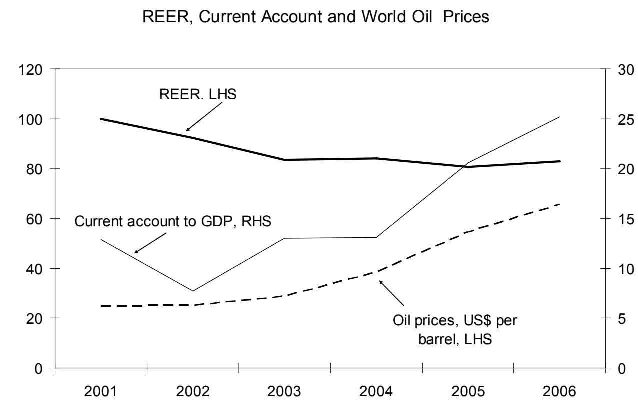
- Until mid-2006, the banking system's structural liquidity surplus reflected mainly the deposits of the national hydrocarbon company (Sonatrach) in Algeria's largest public bank, the *Banque Extérieure d'Algérie* (BEA). These deposits have grown since 2002 with hydrocarbon export prices. BA's absorption policy has successfully mitigated the liquidity impact on inflation. In addition, Sonatrach and BEA have contracted that the deposits must remain liquid and low risk to finance Sonatrach's upcoming investment outlays.

- Since mid-2006, the nature of the system's liquidity has changed, as fiscal policy has injected liquidity that affects all banks evenly, potentially contributing to inflationary pressures. Moreover, abundant liquidity in the banking sector hampers financial market development and weakens the monetary policy transmission mechanisms. Activity in the interbank market and in the secondary market for



government securities has become subdued. The need to absorb ever larger liquidity surpluses may lead to undue volatility in policy interest rates. Thus, the need for a more permanent absorption.

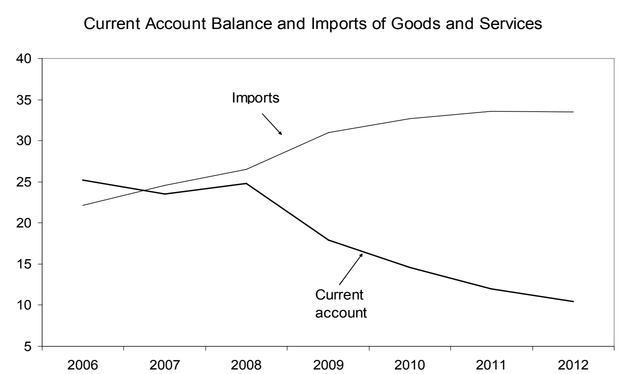
9. **Staff estimates are consistent with BA's analysis that the real effective exchange rate** (REER) of the dinar is close to its equilibrium level. Despite soaring hydrocarbon oil prices and the resulting large and increasing external current account the REER remains broadly constant since 2001. Staff and the authorities used three different approaches to estimate the equilibrium REER (Box 1).



Authorities' Views and Policy Intentions

10. **The authorities are fully aware that the ongoing fiscal expansion may generate inflationary pressures** to which BA would need to respond by tightening monetary policy. In this regard, BA stands ready to further increase its policy interest rate and keep it positive in real terms. They pointed out also that in order to keep inflation in check, they had started to refrain from depreciating the nominal rate to fully offset the inflation differential with partner countries. Finally, they noted that the latest data suggested an easing of inflationary pressures.

11. **The authorities believe that their policies are consistent with external stability**. The flexible exchange rate management has kept the REER of the dinar close to its equilibrium level. The authorities indicated that estimating the equilibrium REER remains inherently difficult due to volatile oil prices, and they emphasized their commitment to monitor developments closely. Current policies should erode the current account surplus as the implementation of the PIP boosts imports over the medium term, contributing to the unwinding of global imbalances. Algeria's weak productivity implies that a significant real appreciation of the dinar would counter the objective of diversifying the economy, and threaten external stability over the long term.



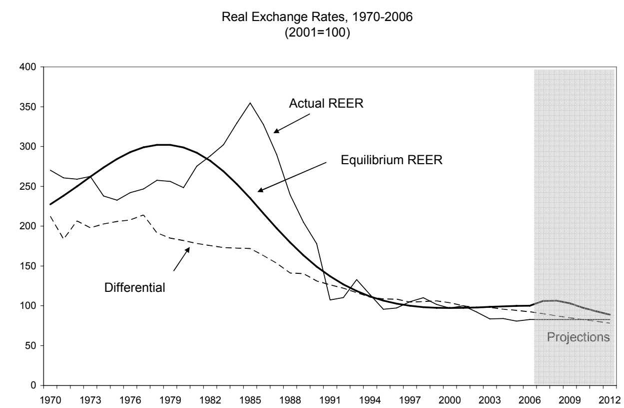
Box 1. Exchange Rate Assessment[1]

Staff and the authorities discussed the level of the real exchange rate (REER) of the dinar using three different approaches: two CGER-type methodologies (the *Equilibrium Real Exchange Rate* and the *Macroeconomic Balance* approaches) and a third approach based on the *Permanent Income Framework*. Consistent with the CGER, the projected medium-term values of the fundamentals for 2012 (WEO database) are used to compute the equilibrium real exchange rates and the current account norms. All three methodologies show that the REER is broadly in line with its equilibrium level. The results should be treated with caution because of well-known estimations difficulties for oil exporting countries.

- **The *Equilibrium Real Exchange Rate* approach.** Staff estimation was based on three key macroeconomic fundamentals: the real oil price (oil), the differential labor productivity with trading partners (prod), and government expenditure to GDP (G).

$$REER = 3.1 + 0.25oil + 1.53prod + 0.44G$$

The results show a small gap of about 7 percent between the actual exchange rate and its equilibrium level. The observed lack of appreciation of the real exchange rate appears to be an equilibrium phenomenon linked to the steady productivity decline in Algeria.



- ***The Macroeconomic Balance* approach**. Staff cross-country panel estimates were based on fiscal balance to GDP (FB), population growth, Net Foreign Assets (NFA), oil balance (OilB), and real per capita GDP growth (y).

$$CA = 0.8FB + 0.3Pop + 0.02NFA + 0.2OilB - 0.1y \qquad \text{(Pooled results)}$$
$$CA = 0.7FB - 0.01Pop + 0.3OilB - 0.02y \qquad \text{(Fixed effects results)}$$

The estimated current account norm (10.6 percent of GDP) is slightly above the underlying current account balance (10.4 percent of GDP, under current policies).

- **The *Permanent Income Framework* approach**. Two different arbitrary rules are used to derive the current account norm: (a) constant total real government wealth; and (b) total real government wealth constant in per capita terms. The estimated current account norm is 10.3 percent of GDP (under the first rule), slightly below the actual current account (10.4 percent of GDP). Under the second rule, the projected current account (10.4 percent of GDP) is well below the current account norm (15.3 percent of GDP).

Results

	MB Approach	PIF		Actual
		Rule 1	Rule 2	
2008	18.9	21.0	29.0	24.8
2009	19.8	15.0	23.0	17.9
2010	13.2	13.0	19.0	14.6
2011	11.9	11.3	17.0	12.0
2012	10.6	10.3	15.3	10.4

[1] See forthcoming Selected Issues Paper.

12. **The authorities believe that the liquidity of the banking system fuelled by public spending may complicate the conduct of monetary policy**, but pointed to two mitigating factors. First, substantial investment outlays by Sonatrach, much of which consists of imports, will take place in 2008, draining liquidity beyond Sonatrach's own deposits. Second, credit demand from public enterprises to finance infrastructure should also increase, however with limited impact on domestic demand because of high import content. Nevertheless, BA is considering increasing required reserves.

Fiscal Policy

Background and Staff Analysis

13. **The authorities intend to maintain their expansionary fiscal policy stance in support of nonhydrocarbon growth**. Driven mainly by the PIP, the nonhydrocarbon primary deficit would peak in 2009, and thereafter decline to about 35 percent of nonhydrocarbon GDP by 2012. High hydrocarbon revenue would keep the overall budget surplus above 5 percent of GDP through 2012.

- The 2005–09 PIP envisages building public infrastructure and housing, developing human capital, and improving public services. However, macroeconomic and social impact of the PIP depends critically on the quality of spending. Therefore, given the size of the PIP relative to absorptive capacity, there is a need for intensified scrutiny over expenditure quality and efficiency.

- Staff estimates show that the current fiscal stance is sustainable and consistent with the objective to keep hydrocarbon-related per capita wealth constant over time, based on prudent macroeconomic assumptions.

Nonhydrocarbon Primary Deficit, 2008–12

(In Percent of NHGDP)

	2008	2009	2010	2011	2012
Sustainable primary deficit	-42.3	-40.3	-38.5	-36.8	-35.2
Staff projections for actual primary deficit	-39.0	-39.6	-36.9	-35.4	-34.4
Crude oil export unit value (US$/bbl)	90.5	83.8	81.0	80.5	80.3

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

- Despite the strong fiscal position, fiscal policy will need to support monetary policy if inflationary pressures intensify, by withdrawing some fiscal stimulus.

Authorities' Views and Policy Intentions

14. **The authorities are aware of the need to intensify scrutiny over expenditure quality and efficiency.**

- They have started implementing the recommendations of the public expenditure review conducted with the World Bank in 2005–06. The National Investment Fund for Development (*Caisse Nationale d'Equipement pour le Développement)* has prepared a guidebook for selecting major investment projects in line with sectoral priorities and ensuring minimum standards. The authorities expect this to improve project implementation, monitoring, and evaluation by 2008.

- Substantial progress has been made to modernize budget management and strengthen fiscal governance. The authorities indicated that they are implementing the recommendations of the 2004 fiscal ROSC, including the completion of sectoral medium-term expenditure frameworks for several ministries. They also intend to submit the draft organic law on public finances to parliament in the coming months.

15. **The authorities intend to maintain a fiscal policy stance consistent with macroeconomic stability.**

- They reaffirmed their commitment to long-term fiscal sustainability. To that effect, they remained committed to link increase in real wages to productivity and economic performance in the nonhydrocarbon sector.

- They indicated that the envisaged increase in the wage bill in 2008 (by 20 percent) is part of a broad-based reform of the civil service to improve efficiency in the delivery of public goods, and to retain skilled staff. Moreover, this increase reflects also higher employment in security services.

- The authorities pointed out that the high import content of the PIP will likely limit its impact on inflation.

B. Reforms for Stronger Nonhydrocarbon Growth and Higher Employment

Deepening Financial Intermediation to Boost Private Sector Activity

Background and Staff Analysis

16. **Financial system reform will ensure a more effective intermediation over time of Algeria's large savings toward its investment needs.**

- The authorities conducted an FSAP update with a joint IMF/World Bank team. This update confirmed that the banking system does not pose a threat to macroeconomic stability, thanks to the financial wherewithal of the predominant owner of banks—the government that has repeatedly bought back from public banks NPLs to public enterprises. The update found some progress in the: (a) banking supervision; (b) operational environment for financial intermediation; and (c) public banks' governance framework. The main recommendations of the update are: (a) clarifying the role of public banks, including proceeding with planned bank privatization; (b) enhancing the operational environment of the financial sector; (c) developing nonbank financing; and (d) continuing to ensure effective liquidity management.

- Risk management in the banking sector remains an issue, now also for loans to private entities. In fact, the recent surge in credit to the private sector has given rise to higher NPLs.[5]

17. **Algeria's already sizeable domestic corporate bond market could contribute to financing public entities undertaking infrastructure investments.**

- Thanks to policies pursued since 2003, Algeria has a domestic corporate bond market of significant size compared to other countries. Algerian public enterprises have launched significant investments in energy, water, and transportation systems, and new entities are being established for specific projects (*sociétés publiques de projet*). These developments could increase the number of bond issuers and the volume of issuance.

- Financing new infrastructure could partially flow through new public offerings of corporate bonds, instead of credit from public banks. More reliance on bond financing would free more lending capacity for SMEs. Launching fixed-income mutual funds and the commercial paper market would add texture to nonbank financing channels (Box 2).

18. **Public debt issuance policy plays a key role in sustaining a dynamic financial intermediation.** The treasury has decided to stabilize the stock of auctioned government debt by rolling over maturing securities. However, the absence of financing requirement and the abundant liquidity in the economy have pushed yields on government securities up to two years below the interest rate on three-month BA deposit auctions. These gaps interfere with the transmission of monetary policy to the real economy.

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[5] At end-2006, total NPLs stood at 34 percent (NPLs on loans to the private sector by public banks: 45 percent).

Box 2. Further Development of Capital Markets[1]

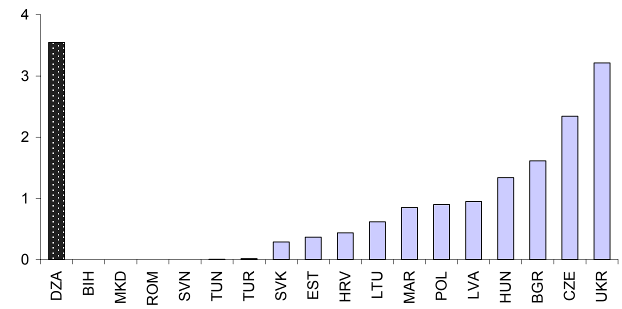
Algeria's market for domestic corporate bonds is already large, compared to other countries.

Maturities extend to 11 years. The market developed after the government started issuing its debt through auctions in 2002 and established a yield curve. The government then encouraged large public enterprises to issue corporate bonds.

The market competes with public banks for large borrowers, as bonds are cheaper than bank loans. There is scope for further issuance; the larger general public offerings for bonds were significantly over-subscribed. As yet, there is no market for commercial paper, reflecting legal and tax considerations.

Nonfinancial Corporate Bonds in Selected Countries, 2005–06 Average

(Outstanding in percent of GDP; except Algeria, in percent of NHGDP)



Sources: BIS; ECB; and Fund staff estimates.

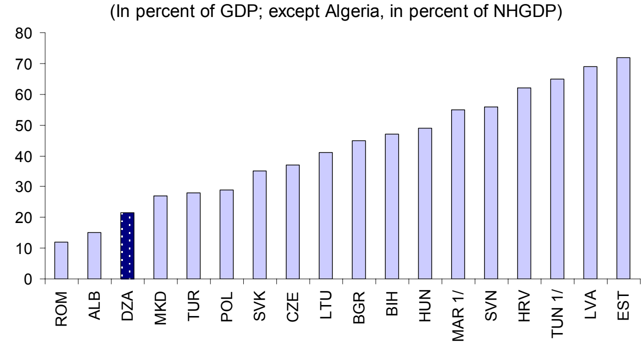
Public sector's investments are an opportunity to channel financing to bonds. Public enterprises undertake projects in energy, water, and transportation systems. The government has taken measures that allow public banks to provide the envisaged large new credits without breaching prudential rules. Guarantee schemes for loans to SMEs are expected to prevent crowding out credit to the private sector.

More bond financing would push banks to focus on credit to the private sector, which is low in Algeria compared to other countries.

The further development of Algeria's capital markets involves channeling more public enterprise financing to bonds, encouraging a commercial paper market and mutual funds, and ensuring a well-behaved yield curve for government securities.

Credit to the Private Sector 1/ in Selected Countries, 2005

(In percent of GDP; except Algeria, in percent of NHGDP)



Sources: ECB, and Fund staff estimates.

1/ Including public enterprises.

[1] See forthcoming Selected Issues Paper.

Authorities' Views and Policy Intentions

19. **The authorities indicated that improving the governance and performance of public banks is paramount, including through privatization.**[6] The authorities argued that government guarantee schemes are needed to support credit to SMEs at a time of strong credit to public enterprises for new infrastructures. Moreover, the envisaged revamping of a credit registry should reduce credit risk to the private sector. BA asked that the Fund intensifies its assistance on banking supervision.

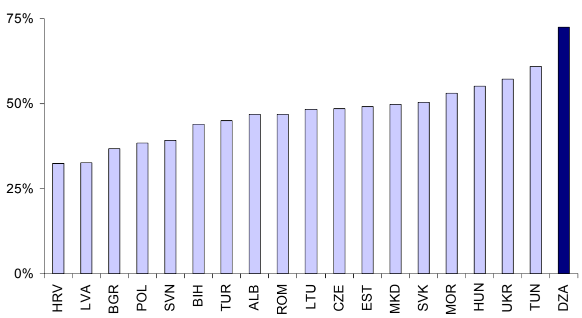
20. **The authorities believed that sustaining the market for corporate debt securities would strengthen financial intermediation and provide valuable competitive pressure to public banks**. They indicated that the regulatory framework for the commercial paper market is nearly finalized. They plan to list large corporate and government bonds on the Algiers Bourse in order to boost price transparency. The authorities indicated that yields on treasury securities reflected current market conditions. However, the expected tightening of liquidity conditions *via* both Sonatrach's investments and BA's absorption operations will gradually close the interest rate gap with BA instruments. Moreover, they indicated that in repaying, as envisaged, the domestic public debt that reflects NPL buybacks, they would take into account the impact on liquidity.

Accelerating Tax Reform to Improve the Business Environment

Background and Staff Analysis

21. **Algeria's strong fiscal position provides an opportunity to overhaul the tax system** to strengthen the business environment without much concern for its budgetary impact.[7] Algeria tax burden on businesses compares unfavorably with other countries.

Algeria and Comparators: Total Tax Rate (Percent of Commercial Profits), 2007



Source: World Bank/www.doingbusiness.org, Algeria's overall rank: 160 out of 178 countries.

Authorities' Views and Policy Intentions

22. **The tax administration has submitted proposals to the government** in line with FAD's recent technical assistance report on tax policy, namely: (a) eliminating special tax regimes; (b) further simplifying the

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[6] The first privatization (launched in 2006) has been delayed because of the impact of the recent turmoil in global financial markets on the international banks that were bidding.

[7] FAD estimated a short-term budgetary cost of tax reform on the order of 1½ percent of GDP.

corporate tax; (c) increasing the personal income tax threshold, with fewer brackets and lower rates; (d) eliminating VAT exemptions and speeding up refunds; and (e) replacing the turnover tax with direct budgetary transfers to local governments.

23. **The authorities indicated that the draft 2008 budget law already includes the reform of the personal income tax.** Eliminating the turnover tax requires addressing broader issues on sustainability of local finances. They noted the good performance of nonhydrocarbon tax revenues as a result of reforms in tax administration with Fund technical assistance.

Increasing Integration for Stronger Private Investment and Nonhydrocarbon Exports

Background and Staff Analysis

24. **Algeria has made progress toward both global and regional economic integration.**

- The country has undertaken increasingly market-based and outward-oriented policies. Trade liberalization includes a comprehensive tariff reform in 2001, the Association Agreement with the European Union (AAEU), which became effective in 2005, and progress toward accession to the World Trade Organization (WTO).

- Enhancing cooperation to establish a large regional market will help Algeria to better harness the benefits of trade liberalization. The country is actively involved in the economic integration of the Maghreb. It participated in the high-level conference on the role of the private sector in economic development and regional integration in the Maghreb, in Tunis in November 2007.

Authorities' Views and Policy Intentions

25. **The authorities intend to continue liberalizing external trade and remain engaged in regional integration efforts.** Algeria expects to finalize its accession to the WTO soon. The authorities indicated that a new accession offer will be discussed in January 2008. Moreover, they have initiated in September 2007 the second phase of the AAEU with the elimination of tariffs on imports of agricultural and industrial products.

26. **The authorities emphasized their determination to press ahead with reforms that maximize the benefits of existing free trade agreements**. The authorities intend to step up efforts to upgrade the domestic industry with the view of improving its competitiveness in international markets.

IV. Staff Appraisal

27. ***Achievements:*** Algeria's market-oriented economic reforms are starting to bear fruits. Nonhydrocarbon growth is accelerating, employment is on the rise, and inflationary pressures have been kept in check. The authorities' massive investment program has started to improve infrastructures and living conditions.

28. ***Challenges:*** Algeria needs to sustain its recent favorable economic performance over the medium term to lessen the economy's dependence on hydrocarbon production, and further lower unemployment that remains too high, particularly among the youth. The objective is to transform Algeria into a dynamic emerging market economy.

29. ***Risks:*** In the short term, the ongoing fiscal stimulus could generate inflationary pressures that could derail the recovery in private sector activity. In the medium term, the acceleration in nonhydrocarbon growth could prove short lived, if the public investment program does not generate a lasting domestic supply response by improving productivity.

30. ***Monetary policy:*** Monetary policy has so far succeeded in containing inflationary pressures by absorbing the banking system's structural liquidity surplus. Looking ahead, monetary policy may bear a heavier burden because the continuing fiscal stimulus is bound to further boost liquidity and domestic demand. The current monetary stance remains appropriate, but the central bank should stand ready to further raise interest rates if inflationary pressures intensify. The growing liquidity in the banking system not only heightens inflationary risks, but also interferes with the monetary policy transmission mechanism, and hampers the development of financial intermediation. Absorbing this liquidity permanently would require a combination of: (a) raising the reserve requirement on bank deposits, with adequate remuneration; (b) providing the central bank with government securities to conduct open market operations; and (c) gradually easing controls over capital outflows.

31. ***Exchange rate policy:*** Algeria's policies have been consistent with external stability and the real effective exchange rate of the dinar has so far remained close to its equilibrium level. The authorities should continue to monitor developments closely to minimize the risk of misalignment. Moreover, if Algeria's inflation rises above that of its trade partners, the central bank should not respond with an offsetting nominal depreciation that could fuel inflationary pressures.

32. ***Fiscal policy:*** Algeria's fiscal position continues to strengthen despite the substantial public investment efforts that have widened the nonhydrocarbon deficit. Nevertheless, if inflationary pressures persist, fiscal policy will need to support monetary policy by slowing the pace of the public investment program and identifying possible savings in the current spending. The 2008 budget envisages a sizeable increase in the wage bill that reflects a broad reform of the remuneration system for the civil service. This reform should improve efficiency in the public administration, a key factor to strengthen the climate for private

economic activity. However, the authorities should continue to keep public-sector real wage increases in line with productivity gains in the nonhydrocarbon sector in order to preserve competitiveness and long-term fiscal sustainability.

33. ***Quality of public investment:*** The economic and social impact of the public investment program (PIP) depends crucially on the quality of spending. The PIP's large size and the limited absorption capacity call for intensified scrutiny over expenditure quality and efficiency. In this regard, staff welcomes that the National Fund for Investment and Development has started to operate.

34. ***Tax reform:*** Progress toward strengthening tax administration and simplifying the tax system has been encouraging. The strong performance of nonhydrocarbon revenues despite lower income tax rates and external tariffs augurs well. However, to produce noticeable effects on the business climate, the tax-reform policy agenda needs to move forward to gradually reduce exemptions, tackle VAT design, and eliminate the turnover tax. Staff supports the reform proposals that the tax administration has put forward, following technical assistance from the Fund.

35. ***Financial sector reform:*** Expanding nonhydrocarbon activity requires effective financial intermediation. The financial sector has strengthened, but the need for further progress is pressing. Staff encourages the authorities to implement the recommendations of the 2007 FSAP update. Improving bank governance and risk management are priorities, given the strong growth in private sector credit that should not translate into higher nonperforming loans. In this sense, it will be important to ensure that the guarantee schemes on credit to small and medium enterprises do not distract banks' from assessing credit risk. Staff also encourages the authorities to press ahead with the planned bank privatizations.

36. ***Corporate bond market:*** Further developing Algeria's already sizeable corporate bond market would both heighten competition in the financial sector and lower bank exposures to public enterprises. Staff welcomes the authorities' decision to list large corporate and government bonds on the Algiers' Bourse and encourages them to finalize the regulatory framework for the commercial paper market. Continued public debt issuance is essential for market development because capital markets need a reliable yield curve.

37. ***Regional and global integration:*** To maximize the benefits from the Association Agreement with the EU, Algeria needs to push forward with both global and Maghreb integration. The authorities should soon secure WTO accession, an important step to ensure access to international markets. Staff encourages the authorities to implement the action plans adopted by the conferences on Maghreb economic integration organized with the Fund staff.

38. Staff welcomes the ongoing implementation of the AML/CFT framework and encourages the authorities to enact the regulations on the size of cash transactions.

39. Staff encourages the authorities to expedite Algeria's participation as a creditor in the **Enhanced HIPC Initiative**.

40. It is proposed that the next Article IV consultation with Algeria take place on the standard 12-month cycle.

Table 1. Algeria: Selected Economic and Financial Indicators, 2004–12

			Est.	Projections					
	2004	2005	2006	2007	2008	2009	2010	2011	2012
	(Annual percentage change; unless otherwise indicated)								
Oil and gas sector									
Liquid petroleum exports (in millions of barrels/day)	1.7	1.8	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Natural gas exports (in billions of m3)	58.9	64.0	61.8	58.0	58.0	58.3	58.9	59.4	60.0
Crude oil export unit value (US$/bbl)	38.5	54.6	65.7	74.7	90.5	83.8	81.0	80.5	80.3
Share of hydrocarbons in total exports (in percent)	97.9	98.3	97.9	98.5	98.7	98.6	98.4	98.3	98.3
National income and prices									
GDP at constant prices 1/	5.2	5.1	2.0	4.6	4.9	4.9	5.1	5.1	5.1
Hydrocarbon sector	3.3	5.8	-2.5	-1.0	1.1	1.6	2.0	2.1	2.1
Other sectors	6.2	4.7	5.6	6.0	6.5	6.4	6.3	6.2	6.2
Consumer price index (end of period)	2.0	1.7	4.4	4.4	4.2	3.9	3.5	3.0	2.9
External sector 2/									
Exports, f.o.b.	31.7	43.8	18.2	9.4	25.4	-5.3	-2.3	0.5	0.8
Hydrocarbons	31.5	44.3	17.7	10.0	25.7	-5.5	-2.4	0.4	0.7
Nonhydrocarbons	42.6	17.9	43.0	-19.2	6.0	6.1	6.1	6.1	6.2
Imports, f.o.b.	34.5	10.6	4.1	21.6	25.9	19.2	9.6	7.9	4.8
Current account balance (in percent of GDP)	13.1	20.6	25.2	23.6	24.8	17.9	14.6	12.0	10.4
Money and credit									
Net foreign assets	33.1	34.0	31.9	33.5	42.5	...	...	...	...
Domestic credit 3/	-8.6	-17.8	-5.9	-16.0	-18.8	...	...	...	...
Credit to the government (net) 3/ 4/	-13.2	-24.4	-8.9	-21.4	-24.5	...	...	...	...
Credit to the economy 4/	11.2	15.9	7.1	13.8	16.0	...	...	...	...
Money and quasi-money	11.5	11.1	18.7	23.1	24.1	...	...	...	...
Velocity of broad money (GDP/M2)	1.6	1.8	1.7	1.5	1.4	...	...	...	...
	(In percent of GDP)								
Saving-investment balance	13.1	20.6	25.2	23.6	24.8	17.9	14.6	12.0	10.4
National savings	46.2	51.8	54.4	54.5	56.2	54.0	52.2	50.3	48.7
Of which : Nongovernment	31.5	29.2	28.8	29.9	29.8	29.9	29.9	29.1	28.8
Investment	33.2	31.2	29.2	31.0	31.4	36.1	37.6	38.3	38.3
Of which: Nongovernment	25.3	20.4	17.1	18.1	18.9	21.8	23.7	24.2	24.3
Central government finance									
Overall budget balance (deficit-)	6.9	11.9	13.6	11.8	13.9	9.8	8.4	7.2	6.0
Total revenue	36.1	40.9	43.0	42.7	44.8	43.1	41.5	40.4	39.4
Total expenditure	29.2	29.0	29.4	30.9	30.8	33.3	33.1	33.3	33.4
Of which: Capital expenditure	7.9	10.7	12.0	12.8	12.5	14.3	13.9	14.0	14.0
	(In percent of nonhydrocarbon GDP)								
Central government finance									
Total revenue	58.0	73.6	79.5	77.5	85.9	77.6	71.4	67.4	63.9
Total expenditure	47.0	52.2	54.4	56.0	59.2	60.0	57.0	55.5	54.2
Nonhydrocarbon primary balance	-27.9	-33.0	-34.5	-36.2	-39.1	-39.7	-37.0	-35.8	-34.8
Nonhydrocarbon balance	-30.1	-34.7	-36.0	-37.6	-40.1	-40.6	-37.8	-36.4	-35.4
Memorandum items:									
GDP (in billions of dinars at current prices)	6,136	7,544	8,461	9,110	10,884	11,342	12,009	12,832	13,691
Gross official reserves (end of period)	43.1	56.2	77.8	108.5	145.6	173.4	197.5	218.9	238.9
In months of next year's imports of goods and services	21.0	26.5	29.1	32.2	36.3	39.4	41.6	44.0	45.9
Gross government debt (in percent of GDP)	36.6	27.3	23.8	19.0	15.1	13.6	12.3	11.1	10.3
Of which: External	25.6	16.7	4.9	3.5	2.5	2.2	2.0	1.8	1.6
Real effective exchange rate (percent change) 5/	0.6	-3.9	-0.3	-0.5	...	...	...	...	...
Exchange rate (DA/US$) (end of period) 6/	72.6	73.4	71.2	67.7					
Population (in millions)	32.4	32.9	33.5	...	...	...	...	...	...
Unemployment rate (in percent) 7/	17.7	15.3	12.3	...	...	...	...	...	...

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

1/ In constant 2001 prices.

2/ In U.S. dollars terms.

3/ In percent of beginning money stock.

4/ Including the impact of the financial restructuring in 2006 involving the swap of government bonds for bank claims on public enterprises.

5/ Annual average changes in trade-weighted INS index. A decrease implies a depreciation. For 2007, as of June.

6/ For 2007, as of October.

7/ Derived from a survey conducted once a year in September. In 2004, reflects a sharp increase in work at home and temporary employment.

Table 2. Algeria: Balance of Payments, 2004–12

(In billions of U.S. dollars; unless otherwise indicated)

				Projections					
	2004	2005	2006	2007	2008	2009	2010	2011	2012
Current account	11.12	21.18	28.95	30.76	37.88	27.82	23.55	20.33	18.54
Trade balance	14.27	26.47	34.06	34.71	43.39	33.31	28.05	25.13	23.53
Exports, f.o.b.	32.22	46.33	54.74	59.87	75.06	71.05	69.42	69.75	70.29
Hydrocarbons	31.55	45.54	53.61	58.95	74.09	70.02	68.33	68.59	69.06
Volume change (in percent)	2.8	5.7	-2.8	-2.5	0.0	0.5	1.0	1.0	1.0
Price change (in percent)	27.4	36.6	21.0	12.8	25.7	-6.0	-3.4	-0.6	-0.3
Other	0.67	0.79	1.13	0.91	0.97	1.03	1.09	1.16	1.23
Imports, f.o.b.	-17.95	-19.86	-20.68	-25.16	-31.67	-37.74	-41.37	-44.62	-46.76
Volume change (in percent)	21.9	7.7	-4.0	20.9	28.3	21.5	11.1	7.9	4.7
Price change (in percent)	10.3	2.7	7.6	1.4	-1.9	-1.9	-1.3	0.0	0.1
Services and income (net)	-5.61	-7.35	-6.72	-6.07	-7.70	-7.76	-6.85	-7.25	-7.53
Services (net)	-2.01	-2.27	-2.20	-4.36	-5.76	-7.45	-8.41	-9.23	-9.73
Credit	1.85	2.51	2.58	2.61	3.01	3.00	3.04	3.12	3.21
Debit	-3.86	-4.78	-4.78	-6.96	-8.77	-10.45	-11.45	-12.35	-12.94
Income (net)	-3.60	-5.08	-4.52	-1.71	-1.94	-0.31	1.56	1.98	2.20
Credit	0.99	1.43	2.42	3.72	5.90	8.14	10.82	12.30	13.61
Debit	-4.59	-6.51	-6.94	-5.43	-7.84	-8.45	-9.26	-10.32	-11.42
Interest payments	-1.29	-1.03	-0.76	-0.22	-0.18	-0.15	-0.14	-0.13	-0.13
Other, including profit repatriation	-3.30	-5.48	-6.18	-5.22	-7.67	-8.30	-9.12	-10.18	-11.29
Transfers (net)	2.46	2.06	1.61	2.12	2.19	2.27	2.35	2.44	2.54
Capital account	-1.87	-4.23	-11.22	-1.51	-0.92	-0.50	-0.06	0.16	0.39
Medium- and long-term capital	-1.61	-1.99	-10.13	-0.41	0.18	0.60	1.04	1.26	1.49
Direct investment (net)	0.62	1.06	1.76	0.76	0.90	1.06	1.23	1.42	1.63
Loans (net)	-2.23	-3.05	-11.89	-1.17	-0.72	-0.45	-0.19	-0.16	-0.14
Drawings	2.12	1.41	0.98	0.54	0.64	0.71	0.75	0.76	0.77
Amortization	-4.35	-4.46	-12.87	-1.71	-1.36	-1.16	-0.94	-0.92	-0.90
Short-term capital and errors and omissions	-0.26	-2.24	-1.09	-1.10	-1.10	-1.10	-1.10	-1.10	-1.10
Overall balance	9.25	16.95	17.73	29.24	36.96	27.32	23.49	20.48	18.93
Financing	-9.25	-16.95	-17.73	-29.24	-36.96	-27.32	-23.49	-20.48	-18.93
Official reserves (increases -)	-8.88	-16.32	-17.73	-29.24	-36.96	-27.32	-23.49	-20.48	-18.93
Memorandum items:									
Current account balance (in percent of GDP)	13.1	20.6	25.2	23.6	24.8	17.9	14.6	12.0	10.4
Algerian crude oil price (US$/barrel) 1/	38.5	54.6	65.7	74.7	90.5	83.8	81.0	80.5	80.3
Gross official reserves (in billions of US$)	43.1	56.2	77.8	108.5	145.6	173.4	197.5	218.9	238.9
Idem, in months of next year's imports	21.0	26.5	29.1	32.2	36.3	39.4	41.6	44.0	45.9
Gross external debt (in billions of US$)	21.8	17.2	5.6	4.5	3.8	3.4	3.2	3.1	2.9
Of which: Short term	0.4	0.7	0.5	...	...	...	...	...	...
External debt/exports (in percent)	64.0	35.2	9.8	7.3	4.9	4.6	4.4	4.2	4.0
External debt/GDP (in percent)	25.6	16.7	4.9	3.5	2.5	2.2	2.0	1.8	1.6

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

1/ Weighted average of quarterly data.

Table 3. Algeria: Summary of Central Government Operations, 2004–12 1/

			Prel.	Projections					
	2004	2005	2006	2007	2008	2009	2010	2011	2012
	(In billions of Algerian dinars)								
Budget revenue and grants	2,215	3,083	3,640	3,890	4,871	4,883	4,983	5,186	5,389
Hydrocarbon revenue 2/	1,571	2,353	2,799	2,964	3,786	3,659	3,642	3,720	3,804
Nonhydrocarbon revenue	644	730	841	926	1,084	1,224	1,341	1,467	1,586
Tax revenue	580	640	721	800	954	1,091	1,204	1,327	1,443
Taxes on income and profits	148	168	241	284	339	376	418	460	507
Taxes on goods and services	274	309	341	357	421	484	532	585	633
Customs duties	139	144	115	131	164	196	216	239	256
Registration and stamps	20	20	24	27	31	34	38	42	46
Nontax revenues	64	90	120	126	130	134	137	140	143
Total expenditure	1,892	2,052	2,453	2,812	3,357	3,777	3,979	4,269	4,569
Current expenditure	1,245	1,241	1,434	1,642	1,997	2,156	2,309	2,469	2,659
Personnel expenditure	447	492	531	620	810	895	984	1,070	1,156
Mudjahidins' pensions	69	80	93	119	117	116	115	113	111
Material and supplies	72	76	96	105	131	159	177	196	216
Current transfers	573	520	646	732	880	930	981	1,038	1,125
Interest payments	85	73	69	66	59	56	53	51	50
Capital expenditure	646	811	1,019	1,170	1,360	1,621	1,670	1,800	1,910
Budget balance	323	1,031	1,187	1,078	1,513	1,106	1,004	918	820
Special accounts	110	-129	-4	0	0	0	0	0	0
Net lending by the treasury	12	5	32	0	0	0	0	0	0
Nonhydrocarbon primary balance	-1,064	-1,383	-1,580	-1,820	-2,214	-2,497	-2,585	-2,751	-2,935
Primary balance	507	970	1,219	1,144	1,573	1,162	1,057	969	869
Nonhydrocarbon balance	-1,149	-1,456	-1,648	-1,886	-2,273	-2,553	-2,638	-2,802	-2,984
Overall balance	421	897	1,151	1,078	1,513	1,106	1,004	918	819
Financing	-421	-897	-1,151	-1,078	-1,513	-1,106	-1,004	-918	-819
Bank 3/	-435	-1,002	-1,165	-1,054	-1,488	-1,087	-988	-903	-805
Nonbank 4/	67	221	173	0	0	0	0	0	0
Foreign	-53	-116	-159	-24	-25	-19	-16	-14	-14
	(In percent of GDP)								
Total revenue	36.1	40.9	43.0	42.7	44.8	43.1	41.5	40.4	39.4
Total expenditure	29.2	29.0	29.4	30.9	30.8	33.3	33.1	33.3	33.4
Overall balance	6.9	11.9	13.6	11.8	13.9	9.8	8.4	7.2	6.0
	(In percent of nonhydrocarbon GDP)								
Total revenue	58.0	73.6	79.5	77.5	85.9	77.6	71.4	67.4	63.9
Hydrocarbon revenue	41.2	56.1	61.1	59.0	66.8	58.2	52.2	48.3	45.1
Nonhydrocarbon revenue	16.9	17.4	18.4	18.4	19.1	19.5	19.2	19.1	18.8
Of which: Tax revenue	15.2	15.3	15.7	15.9	16.8	17.3	17.3	17.2	17.1
Total expenditure	47.0	52.2	54.4	56.0	59.2	60.0	57.0	55.5	54.2
Current expenditure	32.6	29.6	31.3	32.7	35.2	34.3	33.1	32.1	31.5
Capital expenditure/5	12.6	19.3	23.1	23.3	24.0	25.8	23.9	23.4	22.7
Other 6/	1.7	3.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Nonhydrocarbon primary balance	-27.9	-33.0	-34.5	-36.2	-39.1	-39.7	-37.0	-35.8	-34.8
Nonhydrocarbon overall balance	-30.1	-34.7	-36.0	-37.6	-40.1	-40.6	-37.8	-36.4	-35.4

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

1/ On cash basis.
2/ Including dividends of Sonatrach.
3/ Includes the savings/housing bank CNEP.
4/ Including privatization receipts.
5/ Including special accounts related to capital spending.
6/ Including special accounts (not related to capital spending) and net lending.

Table 4. Algeria: Monetary Survey, 2004–8

(In billions of Algerian dinars; at end of period)

	2004	2005	2006	Projections 2007	2008
	(In billions of Algerian dinars; at end of period)				
Net foreign assets	3,119	4,179.7	5,515.0	7,365	10,493
Of which : Bank of Algeria	3,109	4,151	5,526.3	7,375	10,505
Net domestic assets	623	-21.3	-578.4	-1,289	-2,956
Domestic credit	1,514	846.6	601.5	-189	-1,330
Credit to government (net) 1/ 2/	-21	-933	-1,304	-2,358	-3,846
Idem, excluding treasury advance 3/	...	...	-1,931	-2,864	-4,213
Credit to the economy 1/	1,535	1,779.8	1,905.4	2,169	2,516
Of which : Private sector	676	896	1,056	1,191	1,357
Other items net 4/	-891	-868	-1,180	-1,100	-1,626
Money and quasi-money (M2) 5/	3,743	4,158.3	4,936.6	6,076	7,537
Excluding Sonatrach deposits	3,404	3,659.2	4,206.7	4,918	5,874
Money	2,161	2,421	3,167	4,126	4,928
Quasi-money	1,582	1,736.9	1,769.1	1,950	2,609
	(Percent change over 12-month period)				
Money and quasi-money (M2) 5/	11.5	11.1	18.7	23.1	24.1
Excluding Sonatrach deposits	9.7	7.5	15.0	16.9	19.5
Of which : Money	32.5	12.1	30.8	30.2	19.5
Credit to the economy 1/	11.2	15.9	7.1	13.8	16.0
Of which : Private sector	5.8	32.5	17.8	12.8	13.9
Memorandum items:					
Liquidity ratio (e.o.p. M2/GDP)	61.0	55.1	58.3	66.7	69.3
Liquidity ratio (e.o.p. M2/NHGDP)	98.1	99.2	107.8	121.0	133.0
Idem, excluding deposits of Sonatrach	89.2	87.3	91.9	97.9	103.7
Sonatrach deposits	339	499	730	1,158	1,663
M2 velocity	1.6	1.8	1.7	1.5	1.4
Credit to the economy/GDP	25.0	23.6	22.5	23.8	23.1
Credit to the economy/NHGDP	40.2	42.5	41.6	43.2	44.4
Credit to private sector/NHGDP	17.7	21.4	23.1	23.7	23.9

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

1/ Includes impact of public banks' restructuring packages. The conversion of public banks' claims on public enterprises into claims on the government results in a decrease in credit to the economy and an equal increase in credit to government. The adjustment amounted to DA 213 billion in 2006.

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

3/ The advance of BA to the treasury is in respect of early payments by the government of rescheduled debt to the Paris and London Clubs in 2006.

4/ Includes the debt rescheduling proceeds blocked in special accounts at the BA.

5/ Includes postal accounts ("dépôts CCP") and deposits of nonbank financial institutions.