Algeria: political tensions likely to increase currency risk and economic volatility in 2019

Large demonstrations in Algeria have followed the official announcement of President Bouteflika's decision to run again for President in the forthcoming April elections. Despite still resilient external financial conditions, both economic and political factors suggest a risk of currency depreciation and volatility in economic activity in 2019-2020. The possibility of unchecked tensions and political violence cannot be discarded, though the complex (and opaque) Algerian political apparatus should be able to absorb the short-term tensions, while international actors' imperative of keeping Algeria stable will ensure sufficient support.

Rising tensions under opaque leadership and complex political apparatus

The official announcement of Algerian President Bouteflika that he will run for another 5-year presidency in the next elections scheduled for April 2019 was a trigger for a wave of demonstrations across the country, ringing similarities with initial protests at the 2011 Arab Spring. From an outsider's perspective, the prospect of a 80-year old, ailing and poor-health President looking for another 5-year mandate in a country where 44% of the population is below 25 looked indeed like a provocation.

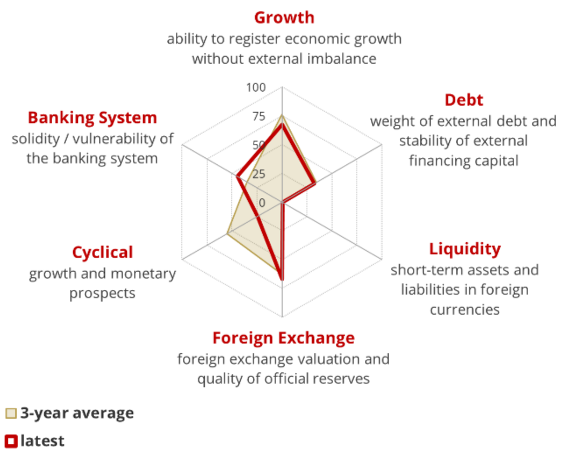
Standard metrics point to substantial political risk, with our Political & Governance Risk rating at 64-d. Adding the extreme opacity of decision-making within the inner circles of power and underlying tensions across competing clans (the security apparatus and military, the Bouteflika family and close allies, technocrats / reformists…), this suggests that the ability to respond to (the current) combination of political tensions and economic / financial challenges will be seriously constrained. This does not mean that a change in regime is imminent, as it has shown before an ability to adapt when needed as well as a strong controlling / repressive capability.

We assume that despite its opacity and implied risks, the regime is unlikely to be toppled and has readied itself for alternative route, including Bouteflika's backtracking from his presidential bid. For most international partners, the priority given to keeping Algeria stable will remain a key element of potential support if needed. We recognize however that the repressive nature and inertia of Algeria's regime and a widely unsatisfied youth makes a "sudden and widespread popular revolt" plausible, especially if the political response to the current demonstration was perceived as completely inadequate.

Deteriorating Economic & Financial Risk Ratings moderated by very large Fx reserves

The average Economic & Financial Risk rating for Algeria was at record / very favorable level below 30 at the beginning of the 2010s, before drifting upwards up to 2014, and then deteriorated more rapidly after the collapse in energy prices in 2014-15. As of 2018Q4, the average rating was still a positive 40.1, with no early warning indication for a plausible systemic shock.

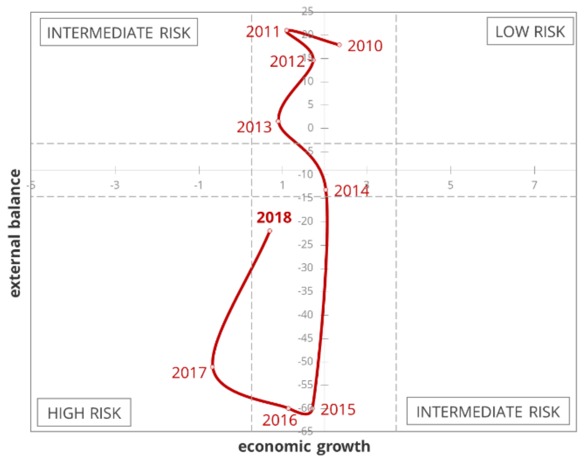
Scores on Fundamental Balances
From 0 (lowest risk) to 100 (highest risk)



Source: TAC ECONOMICS

Algeria's favorable risk measures stem directly from extremely positive performances on the Liquidity Balance and average readings for Debt, Cyclical and Banking System Balances.

Growth Balance
The Growth Balance measures the ability to register a sufficient economic growth without triggering unsustainable external imbalances.



Source: TAC ECONOMICS

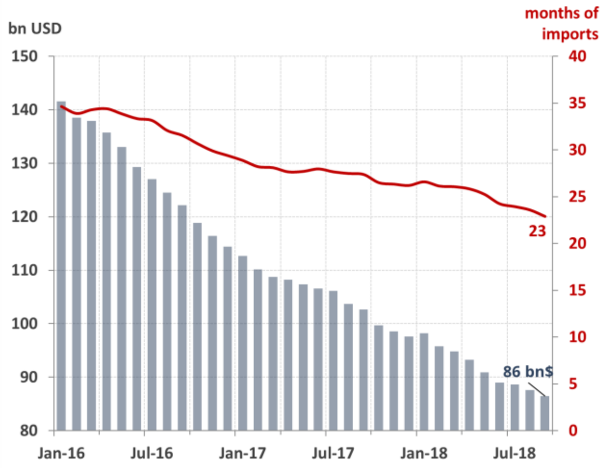
Conversely, Growth and Foreign Exchange Balances are very poor: Algeria's structural inability to engineer fast growth even when oil and gas prices were booming is more revealing over the medium-term than the ability to smooth the negative impact of sharply lower oil prices since 2015. Indeed, they induced a major deterioration in external and fiscal accounts: this would make sense if either oil prices were expected to bounce back to higher levels over the medium-term, or if Algeria's non-oil economy was already competitive enough to develop over a few years period.

As neither appears realistic, it mechanically suggests that the relationship between absorbing political tensions and the ability to accelerate growth is critical.

In a scenario where oil prices are unlikely to move above the current levels and are expected to decline substantially during 2019H2, the political imperative of fostering growth will converge with the necessity of a currency depreciation, notwithstanding a (so far) neutrally valued exchange rate. This is shown by the steady and large deterioration in the *quality* of foreign exchange reserves, our Foreign Exchange Balance indicator aiming at measuring central banks' ability and willingness to use their international reserves when facing negative funding pressures.

Though reserves held by Algeria's central bank remain very comfortable (USD 86bn, i.e. 23 months of imports), the pace of decline makes it imperative to reduce market intervention. As the parallel exchange rate in Algiers is around 60% higher than the official rate, the margin for depreciation is large, though symmetrically the abundance of reserves makes it very possible to ensure a smooth depreciation and avoid a brutal shock.

Algeria's Fx reserves excluding gold
bn$ and months of imports



Source: TAC ECONOMICS

The impact of currency depreciation in a commodity exporting country is more complex than in manufacturing exporters. The main channel is through fiscal / public revenues, as 40% of the total in Algeria is directly related to the energy sector, with a medium-term and indirect channel through stronger revenues and investment for domestic (and international) energy companies.

Improved fiscal revenues could temporarily enable Algerian authorities to support domestic demand and try to alleviate the negative impact of accelerating inflation. Overall, our quantitative tools suggest that economic activity is likely to be very irregular over the next 18-month under the combination of political uncertainties, negative oil prices and likely currency depreciation.

A favorable medium-term perspective could emerge if such adjustment policies were accompanied by substantial reforms encouraging larger investment in non-energy / non-public spending activities. Such a scenario will be dependent on the next episodes of political tensions and reactions.