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## Country Report

# Algeria

### Algeria at a glance: 2003-04

#### OVERVIEW

The Economist Intelligence Unit continues to believe that the incumbent president, Abdelaziz Bouteflika, will win the presidential election scheduled for April 2004, but there is heavy negative risk attached to this forecast. His principal rival, the former prime minister, Ali Benflis, has the backing of most of the ruling party. However, in our opinion, Mr Benflis still does not have enough support from the military powerbrokers. Were Mr Benflis to win the election, economic reform would probably slow even further, although there have been precious few achievements under Mr Bouteflika's presidency. Only trade reform—driven by the Association Accord with the EU—shows any sign of momentum, but there is unlikely to be any real progress on privatisation or oil sector reform under either candidate.

#### Key changes from last month

##### Political outlook

- The political temperature is rising fast as the presidential election draws closer. Mr Bouteflika has purged the cabinet of supporters of his likely rival, Mr Benflis, and the security services have clamped down on newspapers that have been critical of his presidency. There is also talk of Mr Bouteflika planning to engineer the dissolution of parliament in a further effort to weaken the challenge of Mr Benflis.

##### Economic policy outlook

- The central bank has reduced its discount rate by a full point to 4.5%, leading to lower money market rates (although lending rates have stayed at an average of 8%). There are rumours that the central bank will be replaced by the Ministry of Finance as the main arbiter of interest rates following the Banque d'Algérie's poor handling of two recent banking scandals.

##### Economic forecast

- We have made slight downward revisions to our import spending forecast owing to lower than expected monthly data. We now expect current-account surpluses equivalent to 13.7% and 10.9% of GDP in 2003 and 2004 respectively. Our lower import forecast has also led us to nudge up our real GDP forecast for 2003, to 7.2%; real GDP growth will dip to a still healthy 5.4% in 2004.

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## Outlook for 2003-04

### Political outlook

#### Domestic politics

The political temperature is rising fast in Algeria as the presidential election scheduled for April 2004 draws closer. The incumbent, Abdelaziz Bouteflika, has purged the cabinet of supporters of his likely rival, Ali Benflis, and the security services have clamped down on newspapers that have been critical of his presidency. There is also talk of Mr Bouteflika planning to engineer the dissolution of parliament as a further means to weaken the challenge of Mr Benflis.

The two men were political associates for many years. Mr Benflis was Mr Bouteflika's campaign manager in the 1999 presidential election, and was rewarded the following year by being appointed prime minister. However, their relationship soured after their party, the Front de libération nationale (FLN), secured a 51% majority in parliament following a comprehensive victory in the 2002 legislative election. Mr Benflis, the party's secretary-general, became more assertive, challenging some of Mr Bouteflika's flagship policies, notably a law that would have opened the oil and gas industry to private investment. In March, the FLN congress declined to nominate Mr Bouteflika as its official candidate for next year's presidential election, and two months later Mr Benflis was dismissed as prime minister.

The row has deepened with the decision in early September by the FLN's central committee to hold a party referendum at the end of the month on a proposal to endorse Mr Benflis as its official candidate for the presidential election. This prompted a breakaway faction of the FLN to raise its profile by appointing Abdelaziz Belkhadem, the foreign affairs minister and a close associate of Mr Bouteflika, as its leader. On September 5th Mr Bouteflika carried out a radical reshuffle of his cabinet, dismissing seven ministers, of whom six were supporters of Mr Benflis. They have been replaced by figures regarded as loyal to the president.

As these battles have raged within the ruling party, newspapers that have been critical of Mr Bouteflika have been subjected to what they described in a September 6th statement as a campaign of pressure and intimidation. A number of journalists, including the editor of *Le Matin*, a leading French-language daily, have repeatedly been taken in for questioning by the police. The interior minister, Noureddine Zerhouni, has maintained that the affair is purely a police matter.

Mr Bouteflika is now said to be preparing to submit to parliament a number of new laws likely to be opposed by the main body of the FLN. If the ruling party were to block the legislation, Mr Bouteflika would have the opportunity to dissolve parliament. This would remove an important plank of influence from Mr Benflis. In the event of a fresh parliamentary election, the FLN would be unlikely to repeat its feat of 2002, if only because of the deep splits that have opened up within the party.

There is no question of the determination of Mr Bouteflika to secure a second presidential term. However, it is not clear whether Algeria's military leaders will remain behind their erstwhile protégé, whose first term has been marked by constant political infighting, and the country has little to show for the extremely benign economic and financial circumstances it has enjoyed over the past three years.

On balance, the Economist Intelligence Unit still expects the wily Mr Bouteflika to retain enough support within the military and to undermine the position of Mr Benflis sufficiently to secure the presidency. However, there is heavy negative risk to this forecast. Mr Bouteflika's utility as "the acceptable face" of the Algerian regime has waned since the start of the US-led global "war on terror". Washington is keen to learn from Algeria's approach to its own decade-long Islamist insurgency, and questions of human rights abuses have been quietly shelved. For many in the Algerian military, Mr Bouteflika's usefulness is not so clear now. Were Mr Benflis to win, prospects for substantial economic reform would fade even further. Often classified as part of the "progressive" wing of the FLN, the former prime minister is in fact a pragmatist and will be reluctant to upset the military or the unions with radical economic reform at least for his first year in office.

Meanwhile, the Islamist insurgency, which is now in its eleventh year, will rumble on. Although confined largely to rural areas, there have been dark rumours that Islamists have "infiltrated" the capital, Algiers, and are now mobilising to support the recently released former deputy leader of the Front islamique du salut (FIS), Ali Belhadj, for a fresh offensive. This is impossible to verify, but we do not foresee an end in the next two years to the bloodshed that has claimed almost 200,000 lives.

### **International relations**

Recent months have seen signs of an improvement in ties between Algeria and Morocco, promising some movement on the vexed issue of Western Sahara. Algeria is a long-standing supporter of Polisario, the rebel group fighting for Saharawi independence from Morocco. A settlement of this issue would open the way for the revival of the Arab Maghreb Union (AMU), the moribund free-trade zone comprising a number of North African states. Despite recent signs of progress—such as a hint from the Moroccan king, Mohammed VI, that he might be willing to visit Algeria for talks—we believe that a settlement of the Western Sahara issue is unlikely in 2003-04: support for the Saharawi cause is embedded deep within the Algerian state, and the government has recently restated its commitment to "self-determination" for the Saharawis.

## **Economic policy outlook**

### **Policy trends**

In the wake of mounting social tensions in early 2001, the government announced an extra-budgetary Emergency Reconstruction Programme (ERP) aimed at reducing unemployment (28.8% in 2001), boosting real GDP growth to the 5-6% range, and improving infrastructure and agricultural productivity. The ERP proposed injecting around AD525bn (US\$6.6bn) into labour-intensive housing, road and water projects in 2001-04. (A further AD100bn has been

added to the regular budget to reconstruct housing damaged by the May 2003 earthquake.) However, implementation has been slow, a result of severe bureaucratic shortcomings at national and local levels along with the central government's tendency to seek outside financial assistance for development projects (despite having accumulated large financial assets since 1999). Consequently, the ERP seems likely to be extended to 2005, if not beyond.

Creating sustainable employment will also require a resolution of the economy's other supply-side inefficiencies. An example of this is the lack of credit for the private sector, which is a result of the underdeveloped state of the domestic banking sector, shallow capital markets and the domination of the economy by the state sector. The government has been recapitalising state-owned banks for several years, but badly needed progress on privatisation seems unlikely to proceed during the forecast period, especially given the recent sacking of the participation and investment promotion minister, Hamid Temmar (a vocal proponent of such privatisation). In addition, banks generate funds for the military elite's patronage networks, and Mr Bouteflika is unlikely to tamper with them, at least until after the 2004 presidential poll. Similar dynamics will slow the process of privatising other state-owned firms, and none of the 100 public-sector companies that the government had aimed to sell in 2002 was sold. Most damningly, the long-awaited hydrocarbons reform bill, which would have created a "level playing field" for foreign investors, has been abandoned after military and union opposition. These failures all drew sharp criticism from the IMF in its January 2003 Article IV assessment.

### **Fiscal policy**

The government's 2003 budget is predicated on a conservative projection for average oil prices for the year of US\$19/barrel, compared with our forecast for dated Brent Blend of US\$26.8/b. According to Algérie Presse Service (the official news agency), the government projects a budget deficit of AD336bn for 2003, based on revenue of AD1.5trn and expenditure of AD1.8trn. Given our higher oil price forecast and the expectation of a sharp increase in oil export volumes, we anticipate a far stronger revenue performance than that projected by the government. Nevertheless, we expect the deficit to widen from 1.4% of GDP in 2002 to 2.8% in 2003, as emergency spending on earthquake reconstruction more than offsets the impact of a 15% surge in hydrocarbons earnings (we no longer anticipate any privatisation proceeds in 2003 or 2004). The squeeze on hydrocarbons revenue in 2004, as prices slump in response to a glut in global supply, will be offset by increased gas earnings and reduced government expenditure, which will see the deficit narrow slightly to 2.3% of GDP.

Despite bureaucratic constraints, capital expenditure associated with the ERP is expected to accelerate, albeit haltingly, in 2003. As oil earnings dip in 2004, capital spending growth is likely to fall back, although the decline is unlikely to be sharp as it is a presidential election year. Current spending will probably accelerate strongly in both years, given simmering political unrest, high unemployment, union militancy and the pending presidential poll.

The substantial current-account surpluses expected in 2003-04 will be used mainly to build up international reserves and holdings of unofficial foreign assets. However, we also anticipate some increase in the oil stabilisation fund

in 2003, triggered by additional revenue generated by higher than budgeted oil prices, which could be used to finance the deficit in the forecast period. The other main source of funding will be concessional loans from abroad.

### Monetary policy

The Banque d'Algérie (BdA, the central bank) says that it is committed to striking a balance between allowing a depreciation in the value of the dinar—to boost export competitiveness—and maintaining a low inflation environment. In fact, the BdA has kept the dinar's nominal US dollar rate stable despite subdued inflationary pressures in the past six months. This policy is based on the fact that Algeria's largest market is the EU and the euro's growing strength against the dollar means that Algeria's exports are becoming more competitive in Europe. Data up to June 2002—the latest available—show modest M1 growth, but we expect some pick-up to have occurred in the second half of the year as the government began to release money for capital projects.

This trend is expected to continue in 2003, and the BdA will remain watchful. However, consumption growth is likely to be manageable and we do not anticipate an increase in the BdA's discount rate during the year (in fact the discount rate was reduced by a full percentage point in June to 4.5%). Only in 2004, when the US Federal Reserve (the central bank) is expected to raise its rates, do we expect the BdA to follow suit, with a 50-basis-point rise to 5%.

## Economic forecast

### International assumptions

#### International assumptions summary

(% unless otherwise indicated)

	2001	2002	2003	2004
<b>Real GDP growth</b>				
World	2.2	2.9	3.2	3.9
OECD	0.9	1.8	1.7	2.4
EU	1.5	1.0	0.7	1.9
<b>Exchange rates</b>				
¥:US\$	121.5	125.3	118.1	116.8
US\$:€	0.896	0.945	1.123	1.183
SDR:US\$	0.785	0.772	0.718	0.702
<b>Financial indicators</b>				
€ 3-month interbank rate	4.26	3.33	2.27	2.25
US\$ 3-month Libor	3.78	1.80	1.11	1.42
<b>Commodity prices</b>				
Oil (Brent; US\$/b)	24.5	25.0	26.8	18.9
Gold (US\$/troy oz)	271.1	310.3	343.3	317.5
Food, feedstuffs & beverages (% change in US\$ terms)	-1.9	12.7	2.1	1.8
Industrial raw materials (% change in US\$ terms)	-9.7	2.2	9.1	3.9

Note. Regional GDP growth rates weighted using purchasing power parity exchange rates.

Crude oil price volatility on the back of regional turbulence should not be allowed to distract attention away from the longer-term picture—oil prices are expected to decline sharply in late 2003. Uncertainty over the Iraq situation will have fully dissipated and Venezuelan oil production will gradually come back on stream. These factors will act to drive oil prices down over the coming months. By the end of 2003 we expect Brent Blend to reach US\$20/b, giving an

average for the year of US\$26.8/b, an upward revision to our previous forecast, but still substantially down on its pre-war high and equal to the levels seen at the beginning of 2001. In 2004 prices will dip sharply, averaging US\$18.9/b for the year.

### **Economic growth**

We expect real GDP growth to accelerate to 7.2% in 2003, up from an official 4.6% in 2002, before easing to 5.4% in 2004. Growth will be driven by the new-found determination to press ahead with the expansion of crude oil production, apparently regardless of OPEC dictates. According to the International Energy Agency, Algerian crude production reached 1.11bn barrels/day in June, some 43% over its OPEC quota. The resultant surge in real exports is expected to prove more than adequate to offset the impact of weak manufacturing output. Growth will also be driven by the reconstruction drive following the devastating earthquake in May 2003, as well as by more general construction as the government belatedly moves to address the critical national housing shortage. Real export growth will continue in 2004, but will be driven principally by gas expansion as the In Salah development comes on stream. Oil output seems likely to be reined in (temporarily) as OPEC finally recovers some production discipline in the second half of 2004. Negative risk to the export performance is attached to sluggish European economic expansion, which might have some impact on demand for Algerian gas.

Growth will also be driven by increasing investment, both domestic and foreign. The bulk of foreign investment is in hydrocarbons, where foreign prospectors have not been put off by over a decade of brutal Islamist insurgency. Energy parastatals, such as Sonatrach and Sonelgaz, will invest to expand and modernise, although the imperative for Sonatrach to do so has been dulled now that the hydrocarbons reform bill has been scrapped. For much of 2002 government non-oil investment was weak, although, as expected, there appears to have been a pick-up in the second half of the year. We also anticipate high rates of public consumption growth, as the government is forced to address acute levels of unemployment by creating public-sector jobs and raising public-sector wages (probably in October). This expansion will be most notable this year, but a presidential election will ensure that recurrent expenditure continues to grow in 2004, even as crude prices decline. Consumer confidence will be brittle in the face of serious political problems, and private consumption growth will therefore be subdued, despite the increase in nominal wages.

### **Inflation**

Half-yearly data from the Office national des statistiques show that consumer prices have remained subdued. We still expect the impact of high oil prices in 2002-03 and government-led capital spending to finally feed through into the local economy, but the effect on prices will be slight and we anticipate that average inflation will reach only 2.6% this year. In 2004 the government's reluctance to tighten the purse strings will see price growth remain at 2.6%. Inflation will be held in check by good harvests (food has a total weighting of 44% in the consumer price index), while the gradual reduction in trade barriers will continue to relax supply constraints on consumption goods. Tariff reduction completed so far has lowered import prices and increased competition between domestic products and imports. It should be noted that

the consumer basket was compiled some years ago and the IMF has been pushing, so far without success, for a revision to its contents.

**Exchange rates** We believe that the BdA is likely to continue its policy of maintaining the dinar's stability against the US dollar, while allowing a nominal depreciation against the strengthening euro (the bulk of Algeria's exports head to the euro zone). Interest rate alterations will therefore follow those made by the US Federal Reserve. In any case, owing to capital controls and other financial rigidities, such as the absence of a fully functioning foreign-exchange market, the impact of market forces on the exchange rate has so far been limited, and an expected increase in interest rates in 2004 is not likely to result in upward pressure on the dinar. We anticipate that the nominal value of the dinar will average AD79.9:US\$1 in 2003 and AD80.3:US\$1 in 2004.

**External sector** We expect export earnings to accelerate to US\$22.9bn in 2003, as oil and gas production increases and prices stay high, before contracting slightly to US\$22.5bn in 2004, as oil prices slump and output stays flat. The effect of weakening oil revenue will be almost totally offset by the start of production at the In Salah gas project. Import spending will be driven by construction activity related to hydrocarbons development and other infrastructure projects, and by sharp increases in government consumption in 2003. We estimate that import spending rose to US\$10.6bn in 2002, and anticipate further hikes to US\$12.1bn in 2003 and US\$13.2bn in 2004 (as inputs are required for the In Amenas gas project due to start in 2005), leading to trade surpluses of US\$10.8bn and US\$9.3bn respectively.

Around one-third of non-goods inflows consists of workers' remittances from Europe, especially France, where we anticipate only moderate economic growth in the next two years, certainly in comparison with 2000-01. We still expect the current transfers balance to stay firmly in surplus, although it will be dwarfed by other non-merchandise outflows, particularly services debits, as investment in energy projects will require considerable foreign input. The size of the income deficit will be determined primarily by interest payments on external debt, which are forecast to dip in 2003 in line with global interest rates, before increasing again in 2004. The impact of this will be partly offset by income earned on substantial foreign reserves and foreign assets, although this in turn will be outweighed by the expected repatriation of healthy profits by foreign energy companies. The deficit in the income balance will be compounded in 2004 as, despite an expected dip in oil prices, income debits attached to the In Salah gas project are likely to be substantial. These trends will result in a current-account surplus of US\$8.3bn (13.7% of GDP) in 2003, which will narrow to US\$6.6bn (10.9% of GDP) in 2004.

**Forecast summary**

(% unless otherwise indicated)

	2001 <sup>a</sup>	2002 <sup>b</sup>	2003 <sup>c</sup>	2004 <sup>c</sup>
Real GDP growth	2.1	4.6	7.2	5.4
Gross agricultural production growth	13.2	4.5	3.0	2.0
Unemployment rate (av)	28.8	29.1	28.4	28.0
Consumer price inflation (av) <sup>d</sup>	3.5	2.3 <sup>a</sup>	2.6	2.6
Consumer price inflation (year-end)	6.4	0.0 <sup>a</sup>	2.5	2.7
Government balance (% of GDP)	4.2	-1.4	-2.8	-2.3
Exports of goods fob (US\$ bn)	19.1	19.8	22.9	22.5
Imports of goods fob (US\$ bn)	9.5	10.6	12.1	13.2
Current-account balance (US\$ bn)	7.1	6.9	8.3	6.6
Current-account balance (% of GDP) <sup>e</sup>	13.4	12.8	13.7	10.9
External debt (year-end; US\$ bn)	22.5	21.7	22.2	21.3
Exchange rate AD:US\$ (av)	77.22	79.68 <sup>c</sup>	79.90	80.30
Exchange rate AD:US\$ (year-end)	77.82	79.72 <sup>c</sup>	78.05	78.40
Exchange rate AD:¥100 (av)	63.54	63.57 <sup>c</sup>	67.65	68.78
Exchange rate AD:€ (av)	69.16	75.29 <sup>c</sup>	89.71	94.95

<sup>a</sup> Actual. <sup>b</sup> Economist Intelligence Unit estimates. <sup>c</sup> Economist Intelligence Unit forecasts. <sup>d</sup> Break in series: 1982 & 1990. <sup>e</sup> Break in series: 1988.

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