Mohammed Laksaci: Impact of the oil price decline on the Algerian banking system

Keynote address by Mr Mohammed Laksaci, Governor of the Bank of Algeria, at a meeting with bank executives, Algiers, 26 April 2016.

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I would first like to point out that in terms of external shocks, the Algerian economy, which is closely linked to hydrocarbon sector resources, has particularly suffered from the shock inherent to the sharp and sustained fall in world oil prices. It is therefore from this perspective that I start my presentation. I shall talk first of the macroeconomic implications of this external shock, before outlining its impacts from the perspective of financial stability, in light of the new challenges for the banking system in the financing of non-hydrocarbon growth.

1. Macro-economic stance

Economic and financial performance during 2001-2008, particularly the significantly improved external financial position and a substantial accumulation of budget savings, enabled the Algerian economy to demonstrate resilience in the face of the severe external shock in 2009 inherent to the intensification of the international economic and financial crisis. Following the strengthening of the external financial position over 2010-2013, Algeria continued to preserve monetary and financial stability during 2014, in a context of persistent fiscal deficit and a return to a balance of payments deficit. The impact of the oil price decline on the Algerian economy can be examined through the main recent economic and financial developments.

First, following the sharp decline of hydrocarbon prices in 2014, the large contraction of hydrocarbon exports in 2015, in a context of still high imports after the significant increase of imports of goods over the period 2007-2014, resulted in a high external current account deficit (-16.4 percent of GDP). With hydrocarbons remaining Algeria's main export, the external shock resulted in a significant contraction in international reserves, from US$ billion 179 in 2014 to US$ billion 144 in 2015. Nonetheless, this level remains comfortable, representing 27 months of imports of goods and services, in a situation of historically low medium and long term external debt (1.8 percent of GDP) and the absence of any external indebtedness of the hydrocarbon sector for more than a decade.

Second, the exchange rate of the dinar vis-à-vis the US dollar depreciated by 20 percent in 2015, while it depreciated by only 3.8 percent vis-à-vis the euro. In view of the large depreciation of Algeria's main partners' currencies, the real effective exchange rate of the dinar remains close to its equilibrium level. Therefore, the exchange rate played, to a large extent, its role as an external shock absorber, reflecting its flexibility, supported by the Bank of Algeria's interventions in the interbank exchange market.

Third, as a result of the sharp contraction in fiscal oil revenue and the expansion of public spending, the fiscal deficit rose to 16 percent of GDP in 2015 from 7.3 percent in 2014. However, public debt has remained historically low, representing 13.6 percent of GDP at end 2015.

Fourth, the significant reduction in the Treasury's financing capacity in 2014 and 2015 is well reflected in the aggregate monetary survey, with the Treasury becoming a net borrower in 2015 vis-à-vis the banking system for the first time in many years. On the other hand, the decline in net external assets and the significant slowdown in the growth of credits to the economy more than offset the reversal of the Treasury's net position. Overall, monetary expansion, as measured by M2 growth, was only 0.12 percent in 2015, the lowest rate ever, mainly reflecting the magnitude of the impact of the oil price decline. Excluding hydrocarbon sector deposits, the money supply increased by 2.8 percent.

The credits to deposits ratio rose from 69.5 percent by end 2013 to 74.7 percent by end 2014 and 86.7 percent by end 2015, indicating a decline in the surplus of banks' collected resources compared to extended credits. The evolution of credits, in particular medium and long term credits, in a situation of stable deposits, is the main factor explaining the decline in the public banks' short term liquidity ratio. Deposits in the banking sector, which rose in 2013 (7.5 percent) and 2014 (17.5 percent), slightly declined in 2015 (-0.2 percent) as a result of the sharp contraction in the deposits of the hydrocarbon sector (-41 percent). Consequently, the banking sector's liquidity, in excess since 2002, declined gradually during 2015 to reach dinar billion 1833 by the end of the year (a decline of 33 percent), after relative stability in 2014 (dinar billion 2731 by end 2014).

With a milder recession in the hydrocarbon sector in 2014 and an upturn as of 2015, economic activity strengthened during these two years despite the external shock. Growth was 3.8 percent and 3.9 percent respectively (2.8 percent in 2013) and inflation rose from 2.9 percent in 2014 to 4.8 percent in 2015.

To face the external shock and the resulting drop in fiscal oil revenue, the Government initiated a programme of spending rationalisation in 2015, notably through the prioritisation of investment projects. In 2016 fiscal consolidation further included a relatively low reduction in current expenditure (-3.3 percent) and a more substantial reduction in capital spending (-16 percent), totalling a 9 percent reduction in public spending. Furthermore, the 2016 budget includes an upward adjustment of the tax on energy products (petroleum, diesel, electricity and gas). This is aiming at reducing public finances' vulnerability to oil price decline and lies within the strategic objective of ensuring medium term fiscal sustainability. Moving ahead, the gradual fiscal adjustment should also rely on increasing non-hydrocarbon revenue.

2. Impact on financial stability

Like other central banks, the Bank of Algeria faced the need to strengthen the surveillance of systemic risk, particularly in relation to the volatility of hydrocarbon prices in international markets and the interconnectedness of financial institutions within the banking sector. To address these concerns, banking legislation, as amended in 2010, has extended the central bank's mandate to include the objective of financial stability.

With this amendment, the financial stability mandate becomes of equal importance to the price stability mandate. In practice, it is worth noting that the contribution of monetary policy to monetary and financial stability in Algeria is crucial in view of the dominance of the banking sector in the financial system and its potentially important role in the development of financial intermediation. This contribution is of particular importance in the context of persistent excess liquidity in the money market since 2002.

To strengthen the operational framework of financial stability, and following the introduction, in 2010, of new accounting rules of international standard, risk assessment rules with regard to new financial products and the introduction, in 2011, of new regulations regarding liquidity risk identification, measurement, management and control, the Council of Money and Credit (the monetary authority) promulgated in 2014 a new prudential framework to ensure conformity of the prudential rules to the new Basle norms and standards. Within this new regulatory framework, the minimum tier one capital adequacy ratio is set at 9.5 percent, exceeding the minimum ratio recommended by the Basle Committee, and the adequacy ratio, based on regulatory equity, is set at 12 percent.

An assessment of financial soundness indicators at end 2015 shows that the Algerian banking sector soundness is relatively well preserved despite the boom phase of the credit cycle in the context of the ongoing external shock.

Capital adequacy ratios remained comfortable in 2015, standing at 14.5 percent in relation to tier one capital and 17 percent in relation to regulatory equity. The quality of banks' capital, essentially comprising tier one capital, and the substantial increase in the required minimum capital for banks and financial institutions, implemented in December 2009, significantly contributed to maintaining financial soundness indicators at a comfortable level. By end 2015, the banking system remained well capitalised and profitable. Return on equity and on assets strengthened to 24.6 percent and 2.2 percent respectively, in a situation of still comfortable liquidity. However, the acuity of the impact of the external shock in terms of banking liquidity contraction, following its relative stability in 2014, is such that some banks no longer met the requirements in terms of short term liquidity ratio in 2015. Medium and long term credit expansion, in a situation of a small reduction in collected deposits, is the main factor explaining the decline in public banks' short term liquidity ratio to below the regulatory ratio of 100 percent.

The oil price decline has engendered new challenges to financial stability in Algeria, notably with regard to the substantial impact on the balance of payments, which affects the external financial position and weighs on external financial stability, even if the banking sector has no external debt and is only marginally impacted by depreciation of the dinar, as banks can only have limited open foreign exchange positions.

The resilience of the Algerian banking system to the external shocks in 2014 and 2015, supported by banks' still comfortable financial soundness indicators, calls for more efficient resource allocation, notably to benefit productive investment. In view of the low levels of banking intermediation, the bank credit channel remains potentially important in financing non-hydrocarbon potential growth, as it places less dependency on the budget in the medium term.

Based on audits of the banks, a wide stress testing exercise has been recently completed, allowing the assessment of the resilience of the banking sector in the face of recent economic developments. In the context of strengthening bank supervision, the new approach, more prospective and risk-based, will be more focused on the process of banks' credit allocation with a view to containing both the re-emergence of risk concentration and increase in non-performing loans. In the pursuit of this objective, the Bank of Algeria will use all of the available data provided by the new credit bureau, which complies with the international standards and was fully implemented in September 2015.

Given the expected reversal of the liquidity cycle during 2016, the role of the Bank of Algeria as a lender of last resort, following fourteen years of structural excess liquidity, will be reactivated in the second half of the year to refinance the banking sector. This will contribute to the activation of the role of interest rates as a transmission channel of monetary policy, in the context of an active interbank money market. To mitigate the liquidity stress some banks are starting to face, the Bank of Algeria may reduce the reserve requirement rate, which now stands at 12 percent.

In this situation of external shock coupled with an emerging acceleration of the credit cycle, the use of macro-prudential tools will support the conduct of monetary policy, itself being in transition as of 2016, with credit risk remaining the main risk to financial stability in the medium term.

Finally, the role of the committee on financial stability will shortly be strengthened, notably with regard to the regular assessment of banks' financial soundness using relevant indicators and stress tests. This will be supported by a strengthening of the Bank of Algeria's capacities in conducting macro-prudential policy.

3. Transition to a new investment financing pattern

In the context of structural excess savings over investment, which characterised the period 2000-2013, the structure of investment financing in Algeria during 2008-2014 showed a very high level of self-financing (84 percent), particularly with regard to the Government's and the national oil company's investments.

Investment in the economy (excluding the hydrocarbon sector) has also been, to a large extent, self-financed (59.7 percent over 2008-2014), while the financial savings of private firms and households have significantly increased. In particular, the years 2010 and 2011 recorded a substantial increase in self-financing (71.4 percent and 24.1 percent respectively), which contributed to the significant recovery of investments in the non-hydrocarbon sectors. In the meantime, the relative share of medium and long term domestic bank credit in the financing of investments in the productive non-hydrocarbon sectors increased substantially between 2012 and 2014, up from 38.4 percent to 45.2 percent.

Reflecting dynamic medium and long term bank financing, credit to the economy recorded strong growth in 2013 (20.3 percent) and 2014 (26.1 percent), following already high growth in 2012 (15.1 percent). Improved credit conditions, together with Government support measures with regard to credit to SMEs, which improved their access to bank credit as of 2010, have contributed to the sustained expansion of overall credits to the private sector, which recorded an average annual growth rate of 19.4 percent over the period 2001–2014. In the context of a greater expansion of credits to the economy during the past two years, particularly in real terms, the net flow of credits to private enterprises has mainly consisted of medium and long term credits extended to finance investment. Overall, excluding credits repurchased by the Treasury, bank credits to the private sector (enterprises and households) stood at dinar billion 3120 by end 2014, with the share of medium and long term credits increasing from 62.3 percent by end 2013 (61.3 percent by end 2012) to 64.3 percent.

The dynamism of bank credit to the economy, mainly for the benefit of private enterprises, clearly reflects the improvement in the financing structure and conditions as a result of the measures taken by the Government to boost medium and long term credits to the private sector, notably measures implemented in 2013 to facilitate SMEs' access to bank credit. In parallel, banks improved information provided to SMEs on required investment credit documentation and made notable progress in reducing processing times.

After fourteen years of savings surplus, 2014 and 2015 recorded a cycle reversal. The drastic oil price fall as of mid-2014 resulted in a widening savings-investment gap. Six years after the international economic and financial crisis, the Algerian economy, like other oil exporting countries, has been affected by the resource contraction as of 2015. However, credits to the economy continued to expand (15.9 percent in 2015), mainly for the benefit of private enterprises.

Despite the significant excess liquidity contraction in 2015 and the re-emergence of the crowding out effect in 2016, bank credit remains a potentially important channel in financing productive investment. This highlights the importance of effective bank intermediation to benefit inclusive, non-hydrocarbon growth, with the objective of attaining in the medium term a target ratio of investment financing and SME loans to non-hydrocarbon GDP. To this end, and in parallel with the gradual development of the financial market, banks should diversify their financing tools whilst pursuing their efforts in improving credit risk analysis, monitoring and control. The new credit bureau will be most helpful in this regard. Banks should also further develop their advisory activity for SMEs, particularly with regard to investment projects analysis.

To bolster the new financing scheme of non-hydrocarbon growth, where the recourse to external borrowing should be gradual, banks must expand their medium and long term resources through the promotion of attractive financial products, notably in terms of real returns for savers. The substantial level of currency in circulation (30 percent of GDP in 2015) provides a valuable opportunity to improve banking intermediation during this period of a resources gap. To reduce the impact of the crowding out effect associated with the Treasury's financing needs as of 2016, in a context of significant contraction in the hydrocarbon sector's self-financing capacity, the Bank of Algeria will provide liquidity to the economy to stimulate the dynamism of sound credits, whilst preserving the sustainability of the net external position. This is dictated by the need to strengthen growth potential.

Achieving the non-hydrocarbon growth potential will rely on productive investment, notably in the private sector, in a context of continued public investment programme implementation at an appropriate pace, given the constraints imposed by the acuity and persistence of the external shock.

The development and dissemination of economic information for the benefit of economic agents, particularly SMEs, is key to better investment orientation. In particular, appropriate ministerial departments should focus on promoting advisory structures to improve the provision of accurate information on investment sectors and markets.

Sustained improvement in the business environment is crucial to boost the private sector's contribution to high and inclusive non-hydrocarbon growth. In this regard, improving investment effectiveness and increasing its impact on employment should be a strategic objective.