INTRODUCTION

1. **The collapse in oil prices points to the urgent need to reshape Algeria's growth model**. Following a devastating civil war in the 1990s, Algeria experienced over a decade of relatively steady growth and social stability. Thanks to rapidly increasing oil prices, it was able to accumulate large fiscal savings and international reserves while paying off most of its debt. However, Algeria did not take advantage of over a decade of high oil prices to overcome the structural shortcomings in its growth model, as the economy remained overly dependent on hydrocarbons and public spending. From 2002 (when oil prices started to rise) until 2014 (when they started to fall), hydrocarbons on average accounted for 98 percent of exports, 69 percent of fiscal revenues, and 36 percent of GDP. Government spending swelled as the authorities granted wage increases and provided employment, social housing, and subsidies—most recently in the wake of the Arab Spring. Furthermore, the public sector remains a dominant actor in the economy through many and often large public enterprises, including in the energy and banking sectors. Indeed, public banks account for 87 percent of total banking assets. With the fall in oil prices, Algeria needs to confront an old challenge with new urgency: how to diversify the economy away from hydrocarbons and find new sources of growth that will create jobs for a youthful and fast-growing population.

RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

A. Recent Developments

2. **Growth was sustained in 2015 while inflation picked up.** After a decade of contraction, hydrocarbon production increased slightly last year (0.4 percent), while nonhydrocarbon growth was steady. Overall growth edged higher from 3.8 percent to 3.9 percent. Average inflation exceeded the central objective of the Bank of Algeria (BA), likely driven by supply effects and the depreciation of the dinar (Box 1). The unemployment rate increased from 10.6 percent in September 2014 to 11.2 percent in September 2015. It remains particularly high among the youth (29.9 percent) and women (16.6 percent).

3. **The budget deficit reached a record high in 2015 due to the collapse in hydrocarbon revenues and a significant fiscal expansion.** The overall budget deficit reached an all-time high of 16.4 percent of GDP. Lower oil prices translated into a 30 percent decline in hydrocarbon revenues, while spending grew by 10.2 percent, driven by a surge in capital spending. The deficit was mainly financed by drawings from the *Fonds de Régulation des Recettes* (FRR), Algeria's oil saving fund, which declined to 12.3 percent of GDP from 25.6 percent in 2014.

4. **The current account deficit also widened significantly, but foreign reserves remained at comfortable levels.** The current account deficit widened to 16.2 percent of GDP in 2015 from 4.4 percent in 2014, as hydrocarbon exports fell almost by half. Gross inflows of foreign direct investment remained weak at 1 percent of GDP. Foreign exchange reserves declined by nearly US$35 billion but remain substantial, equal to 2½ years of imports or 833 percent of the Fund's