

THE IMPACT OF LOW OIL PRICES ON ALGERIA

By Gonzalo Escribano

OCTOBER 2016



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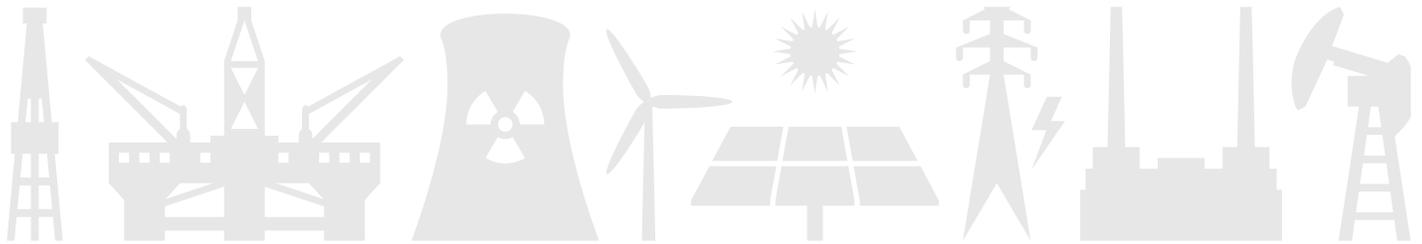


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By Gonzalo Escribano*

OCTOBER 2016

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EXECUTIVE SUMMARY

The collapse of global oil and natural gas prices has battered the Algerian economy at a time of degenerating security conditions in Northern Africa, raising concerns about the ability of the OPEC nation to weather the resulting economic, political, and security shocks, and inviting comparisons between the current situation and the catastrophic events experienced by the country during the 1986–1988 oil price collapse and in its aftermath. Algeria’s security and energy future are of critical importance: it holds a strategic position in the Western Mediterranean and was one of two North African countries that remained stable during the Arab Spring and the subsequent years. It is also the largest natural gas producer in Africa and a major LNG exporter. It is the number-two exporter of natural gas to Europe and a key supplier of oil to its Mediterranean countries.

This paper finds that there are both clear parallels and key differences between what Algeria is going through now and the chain of events that led to the bloody civil war of the 1990s. On balance, and notwithstanding the fact that some indicators have deteriorated to worrying levels, Algeria is better equipped altogether to weather a market downturn today than it was thirty years ago. Depending on how protracted the current period of low oil prices might turn out to be, these differences should mitigate the risks of a repeat of the mid-1980s oil shock that plunged the country into recession and triggered a spiral of revolts, Islamist electoral victories, and finally a military coup, repression, and civil war. While Algeria’s fiscal and current account balances clearly have worsened, its reserves remain substantial (even if rapidly decreasing) and its external debt is negligible. This is in contrast with the late 1980s, when a lack of reserves and high external debt were the two main factors that forced the government to adopt a traumatic shock-therapy approach to stabilization. In addition, despite the decline in oil and gas revenues, the Algerian economy has continued to grow during the current low price environment and has been able to avoid an economic recession like the one experienced in 1986–1988. This gives Algiers more short-term policy space to control the pace and depth of austerity and reform measures. The memories of the deadly civil war in the 1990s, the outcome of the 2011 Arab revolts, and the overall deterioration of regional security may also moderate the reaction of

Algerians toward austerity measures. Critically, the security forces are better trained, informed, and equipped than in the past, and defense and security expenses are not being affected by budgetary cuts.

The paper goes on to discuss the extent to which low oil prices could foster an environment for economic and political reforms, and the benefits that the international community, specifically Europe, could derive from taking advantage of this moment in time to press for new energy policies that improve both supply and overall security. The passing of a restrictive and moderately reformist budget that attempts to address the drop in hydrocarbon revenues is a sign that the current economic difficulties have—at least for now—shifted the balance of power in Algiers away from conservatives and toward reformists. Still, it seems likely that only limited economic and political reforms can be realized until a consensus on the successor to President Bouteflika has been reached.

The paper cautions that while a military coup or widespread popular unrest thus seems unlikely in the near term, Europe should nevertheless take note of the risk over the longer term of greater instability along its southern border. It recommends that the European Union look for ways to engage with Algeria that would benefit not only their mutual energy security but also prevent the creation of further unrest in the region. Energy constitutes the only driver available for the European Union to incentivize Algerian economic reforms that could increase its prosperity and enhance stability. A good balance would be offering prospects of increasing Algeria’s sales in the European Union’s gas market in exchange for improving the country’s energy governance. Low oil prices may have increased the Algerian appetite for reform, including in the energy sector; and the prospect of competition from US exports of liquefied natural gas may prove an additional driver for change. Such a window of opportunity may not last long and merits exploration.

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INTRODUCTION

The collapse of oil prices that began in mid-2014 has clearly had a major and sometimes destabilizing impact on nations heavily reliant on oil and natural gas export revenue. Algeria is no exception, and its ability to withstand the economic blow could have major implications for the world and especially Europe, the nation's largest trading partner, the top consumer of its oil and gas exports, and its neighbor in the Mediterranean.

Algeria is the largest country in Africa, with 5500 km of complicated borders with Morocco (1500 km), Tunisia (1000 km), Libya (1000 km), Mali (1400 km), Niger (1000 km), and Mauritania (500 km). It holds a strategic position in the Western Mediterranean and, along with Morocco, was one of two North African countries to maintain political stability during the Arab Spring and its aftermath. At a regional level, Algeria is the central Maghreb country, holds the region's highest population, and is its main economy and military power. Importantly, Algeria is also a strategic energy player. It is the biggest natural gas producer in Africa; a pioneer and leader in LNG exports; Europe's second-largest natural gas supplier after Russia; and a key hydrocarbon provider to Southern Europe. The country holds the world's tenth-largest proved natural gas reserves and the third-highest technically recoverable shale gas resources, as well as the third-largest proved crude oil reserves in Africa.¹ It is an OPEC member and an active promoter of the Gas Exporting Countries Forum (GECF). Hydrocarbons are the backbone of the economy, accounting for a quarter of GDP, 60 percent of budget revenues, and over 95 percent of export earnings.²

However, the fall in oil and natural gas prices, exacerbated by the decline in its domestic hydrocarbon production, has led Algeria to adopt modest austerity measures and increased the pressure for structural and institutional economic reform. The weakening economy has not only raised concerns about the country's capacity to maintain political stability, but also about Algeria's internal security in an unstable neighborhood. Politically, the country faces paralysis. The ailing President Bouteflika seems no longer physically able to address diverging factions across a number of critical fronts: the "revolutionary family"; reformists and conservatives; the economic and business elites; and the military, which is itself divided between security services and the army.

This paper addresses three concerns related to the political economy of low oil prices in Algeria: (i) whether they may lead to a repeat of the events of the mid-1980s, when a recession eroded political stability and contributed to a bloody civil war in the 1990s; (ii) to what extent the economic and the political crisis could block or encourage much-needed economic and political reforms; and (iii) the implications for relations with Europe, specifically why the region should look at the current price environment as an opportunity to improve and redefine its energy strategy with Algeria that would not only bolster its energy supplies but also its overall security.

This final piece is important because, in the author's experience, analysis of the shifting political balances occurring in Algeria caused by the decline in hydrocarbon revenues frequently stresses the narrow energy implications over the broader geopolitical impacts. However, if the worst scenarios seen in the 1980s were to be repeated, energy security would be a secondary threat compared to that posed by the spread of the geopolitical unrest currently stretching from the Middle East to the Maghreb. As such, this paper approaches Algerian energy reform as a driver for the country's economic modernization and for regional stability, rather than a goal in itself for the sake of European energy security.



A TALE OF TWO COUNTERSHOCKS: 1984–1986 VERSUS 2014–2016

Background

As with the current period of low oil prices, the collapse that occurred in the 1980s was caused by a period of sustained oversupply and later aggravated by Saudi Arabia's decision to boost output to retain or recapture market share. The Algerian economy was cash-strapped and the country had to undergo a tough stabilization and structural adjustment process, which exacerbated already mounting social discontent. This paved the way for the victory of the Front Islamique de Salut (FIS) in the 1990 local elections, the first free elections in Algeria. Subsequently, in the first round of the December 1991 legislative elections, FIS gained over 80 percent of the seats. On January 11, 1992, the army forced President Bendjedid, who had taken office in 1979, to resign and cancelled the electoral process, dissolved the local and regional assemblies controlled by the FIS, and jailed their representatives in the legislative elections.

The repression by the military pushed Islamist militants toward violence. By the mid-1990s, armed Islamist groups had around 30,000 insurgents that were not only fighting against the army and paramilitary forces, but

also perpetrating indiscriminate attacks against civilians. Plausible estimations put the death toll from this violence above 150,000 people.

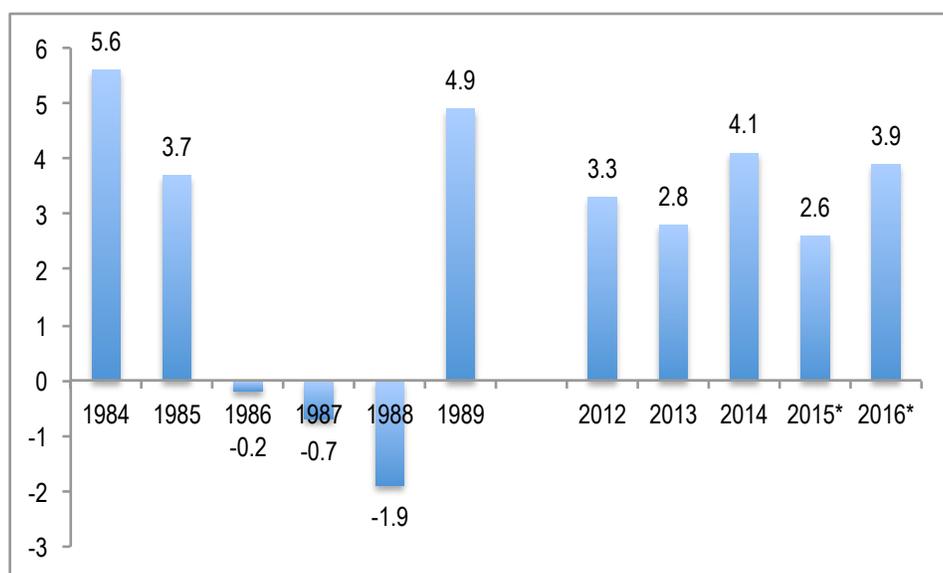
The economy of today versus the 1980s

While the Algerian economy has unquestionably been hard hit by the steep decline in hydrocarbon revenues, the inevitable comparison between the economic situation in the 1980s and today may not hold up. This section will outline the economic problems facing Algeria, and then detail the economic and political factors that should mitigate the need for the deep stabilization measures that contributed to unrest following the oil price crash three decades ago.

Economic concerns

GDP: Since 2014, while economic growth has slowed, it has still remained positive and well above 2 percent. Figure 1 shows IMF GDP growth estimations for 2015 and 2016 are at 2.6 percent and 3.9 percent, respectively; the latest Economist Intelligence Unit (EIU) estimates are 3.5 percent and 1.5 percent for the same years, reflecting the impact of a stricter-than-expected 2016 budget. If the latter 2016 estimate proves right, it will be the lowest growth rate for Algeria in twenty years.

Figure 1: Algeria's GDP growth rate (1984–1989; 2012–2016)
(In percent)



Source: (1) 1984–1989: World Bank, Algeria, Country Economic Memorandum: The Transition to a Market Economy, Statistical Annex, May 25, 1994. (2) 2012–2016: IMF, Regional Economic Outlook: Middle East and Central Asia, 2015; (*) estimates.

Fiscal balance: Algeria's fiscal balance has deteriorated very fast, to levels comparable to 1986–1988 (Figure 2). These are significant imbalances that have made fiscal adjustment unavoidable in spite of the political cost. The post–Arab Spring strategy of appeasing the population by increasing subsidies, other social transfers, and public jobs and wages no longer seems fiscally sustainable.

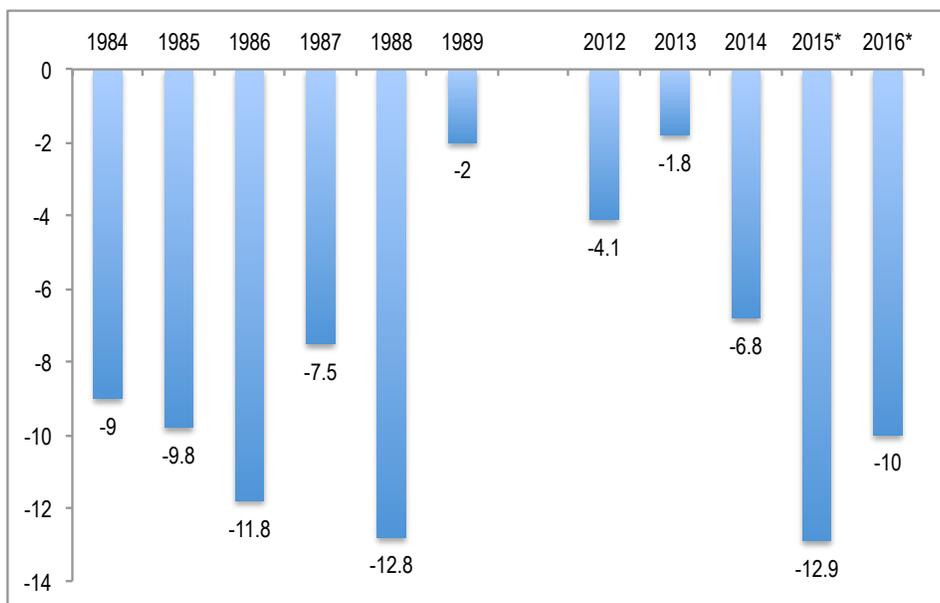
External balance: The external balances have deteriorated more rapidly and to a bigger extent than it did in 1986–1988 (Figure 3). The current account deficit has reached record levels in 2015, according to IMF estimates. The decline in export revenue due to lower oil and gas prices and the difficulties in curbing imports have become the main economic concern of the government.

Foreign reserves: Since June 2014, foreign reserves have plunged by more than US\$35 billion, the Oil Fund (Fond de Régulation des Recettes, or FRR) by more than 30 percent, while the Algerian dinar has fallen against the US dollar by more than 30 percent. The government itself expects the FRR to fall to a third of its 2014 level by the end of 2016.

Mitigating factors

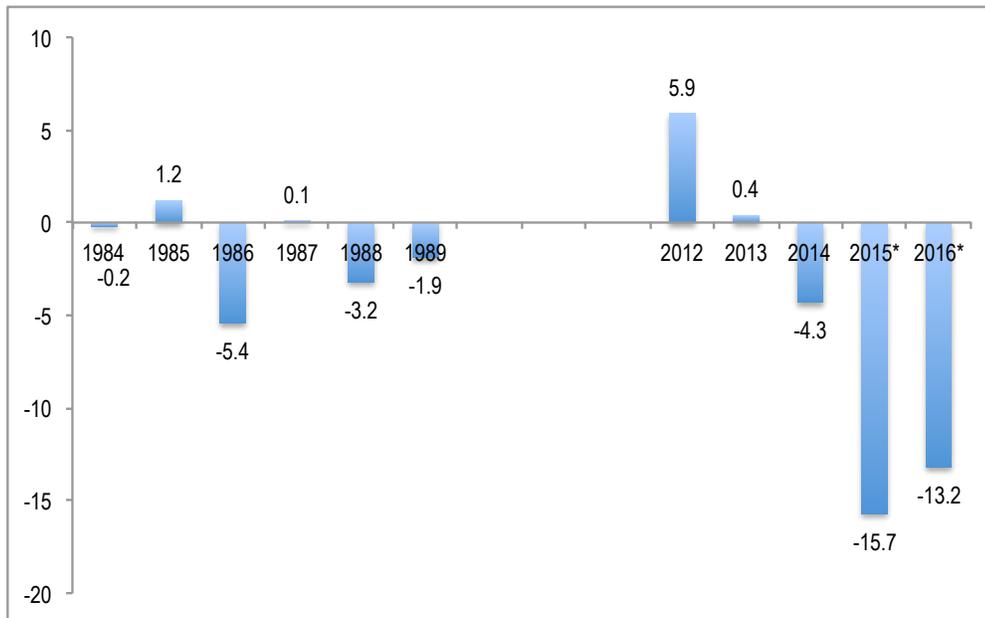
While the decline in GDP growth is worrying, it is not as bad as the severe and prolonged recession the Algerian economy faced in 1986–1988, which saw a 1.7 percent decline in GDP in 1988. Perhaps more importantly, the current slowdown in growth is not occurring during a transition from a socialist system to a market economy, which was the case in the late 1980s and which undoubtedly exacerbated political opposition and social unrest.

Figure 2: Algeria's fiscal balance
(Percent of GDP)



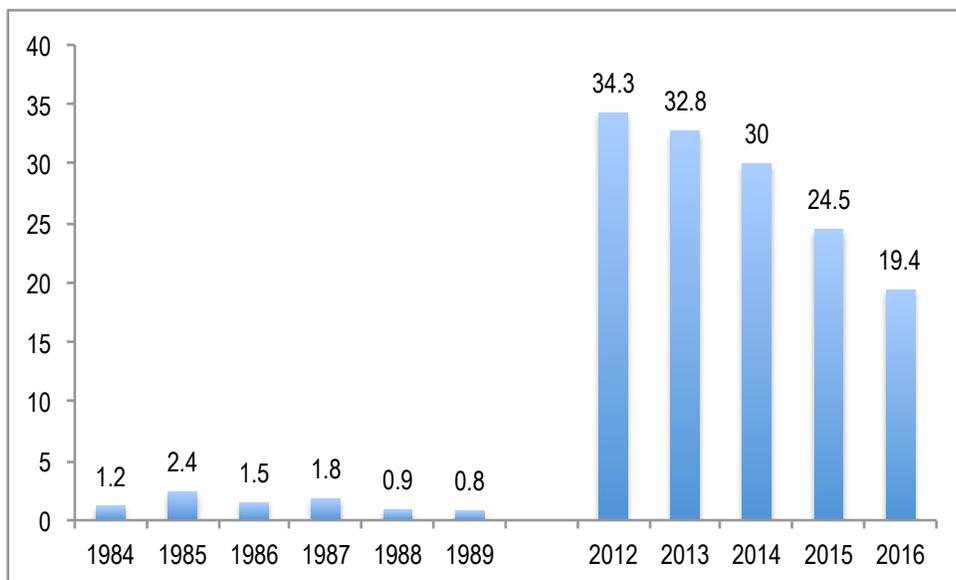
Source: (1) 1984–1989: World Bank, Algeria, Country Economic Memorandum: The Transition to a Market Economy, Statistical Annex, May 25, 1994. (2) 2012–2016: IMF, Global Economic Prospects database.

Figure 3: Algeria's current account balance
(Percent of GDP)



Source: (1) 1984–1989: World Bank, Algeria, Country Economic Memorandum: The Transition to a Market Economy, Statistical Annex, May 25, 1994. (2) 2012–2016: IMF, Global Economic Prospects database.

Figure 4: Algeria's reserves
(Months of imports)



Source: (1) 1984–1989: World Bank, Algeria, Country Economic Memorandum: The Transition to a Market Economy, Statistical Annex, May 25, 1994. (2) 2012–2016: IMF, Global Economic Prospects database and own calculations.

The country today also has significant buffers and a macroprudential framework that, while far from perfect, did not exist in the 1980s. The government thinks it still has some room to maneuver through a gradual and incremental approach to austerity that would prevent an abrupt deterioration of the social climate. Public debt is extremely low, around 15 percent of GDP, and the budget deficit should be manageable if adequate measures are taken.

The Algerian external position is stronger than in the 1980s. As can be seen in Figures 4 and 5, the Central Bank has accumulated a significant amount of reserves, and the external debt service is negligible. In the mid-1980s, the country had less than two months of imports in reserves, and external debt service represented between 60–80 percent of exports of goods and services, and primary income. Algeria is expected to continue to draw on its reserves because they yield less than what external debt would cost. In March 2016, the government announced that it would resort to a compulsory national public debt issuing remunerated at a 5 percent interest rate. Even if Algiers wanted to tap international debt markets, and discounting unfavorable rates, the country's prudent debt policies put it in a more solid position than during the 1980s external-debt crisis.

Importantly, the authorities are aware of the economic challenges that lie ahead and are technically better prepared to deal with them. They remember how not addressing the macroeconomic imbalances in a timely manner forced a deep, abrupt adjustment program with restrictive fiscal and monetary measures with the discreet support of the IMF, as well as the resulting sense of loss of economic sovereignty and national autonomy. The country also has learned the economics of Dutch Disease and can count on competent technical staff. While the government has shown a clear reluctance to accept the austerity narrative and has delayed fiscal tightening, it adopted a more restrictive budget for 2016: public spending will drop by 9 percent in 2016, compared with a 1.5 percent cut in the revised 2015 budget. This is a significant fiscal adjustment, equivalent to more than 3 percent of GDP, comparable in size to the one that followed the 1986 oil price collapse.

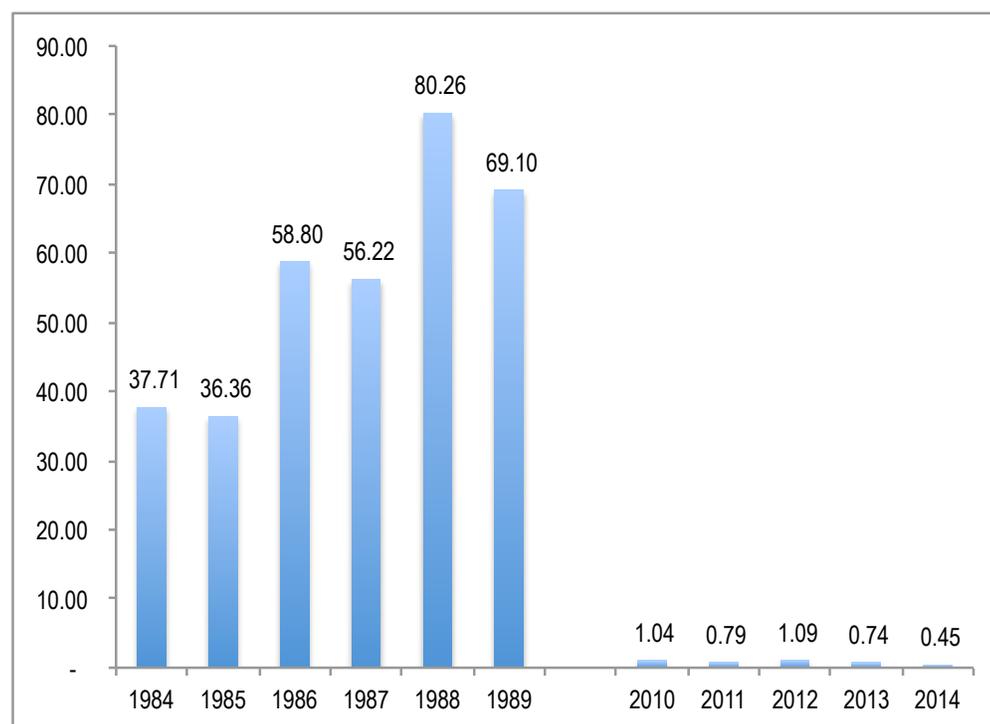
Moreover, for the first time in years, current expenditures are being cut by more than 3 percent, although these reductions try not to substantially affect either social benefits or the main subsidies (food, housing, and energy). In fact, the 2016 budget includes an over 7 percent increase in the cost of direct subsidies, accounting for 23 percent of total public spending. If indirect subsidies in the form of low energy prices are added in, the figure exceeds 40 percent of public spending. In fact, the bulk of the adjustment falls on public investment, which suffers a 19 percent reduction under the budget. This will have a negative impact on economic growth and employment, both of which are highly dependent on public investment. Regarding external imbalances, reserves depletion will be contained through depreciation and new import restrictions.

In short, the deterioration of Algeria's fiscal and current account balances is noteworthy, but it does have some buffers that should—assuming the fall in oil prices is not a long-term event—provide it with cover, including substantial (even if rapidly decreasing) reserves and a negligible external debt. These were two major factors that forced the traumatic shock-therapy approach to stabilization in the late 1980s. The country continues to grow and has thus far avoided an economic recession like the one experienced in 1986–1988.

Social and political differences

Besides the economic contrast between the late 1980s and today, there are also important social and political differences. The population has doubled from 20 million to nearly 40 million people, and is now dominated by young people facing difficulties in finding employment. At the same time, the Algerian society has undergone a modernization process, including urbanization and the extension of local middle classes. The population is well connected to global trends and patterns through the Internet and social networks.³ While it has become more demanding and less tolerant to governance failures, it is equally conscious of the value of political stability in an unstable region.

Figure 5: Algeria's total debt service
(Percent of exports of goods, services, and primary income)



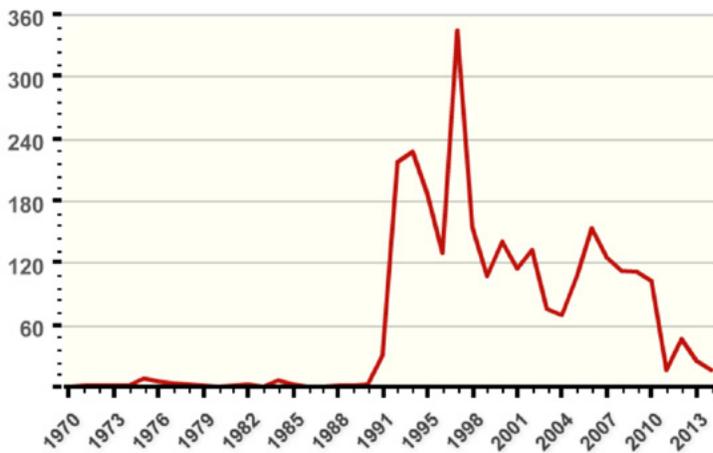
Source: World Bank Development Indicators database.

The traumatic civil war of the 1990s looms large in the collective memory of many Algerians, and may have helped damp the spread of the Arab Spring uprisings to Algeria. Among the younger generation, however, the civil war is less of a factor, thus raising the economic cost for the government in maintaining political stability. Fiscal imbalances started with the pro-cyclical budgets adopted in reaction to the 2011 demonstrations, and illustrate the macroeconomic cost of staving off the unrest of the Arab Spring.⁴ The IMF had already expressed concern about the unsustainable fiscal path of Algeria's fiscal policies even before the 2014 oil price collapse. Since 2003, the Algerian fiscal break-even oil price ballooned from \$20/barrel to \$130/barrel in 2014. Even at the lower projected levels of around \$110/barrel in 2015 and 2016, it remains one of the highest break-even oil prices in the region.⁵

While some analysts have warned a prolonged period of economic stress could eventually lead the country to “degenerate into a pattern of urban violence last seen

in 1988, in the riots that forced political change,”⁶ the importance the government has placed on security is clearly reflected in the 2016 budget, in which only the defense and education ministries saw their allocations growing. Algeria is probably the best-prepared country in the Maghreb to resist instability at its borders, and it is viewed as a key partner for ensuring regional security. The security forces are better trained, informed, and equipped to prevent generalized episodes of urban violence or rural insurgencies such as those of the 1990s. Although regional security has become a far more challenging issue,⁷ overall the security situation has improved (Figure 6).

Figure 6: Terrorist incidents in Algeria
(Number of incidents)



Source: START, [Global Terrorism Database](#).

Thirty-nine hostages, including several expatriates, died as a result of the attack, and both BP and Statoil, which operate the facility, evacuated their personnel. It was the first significant jihadist action on an Algerian energy infrastructure and increased the risk premium of the country. In March 2016, Al Qaeda in the Islamic Maghreb (AQIM) conducted a failed attack against another gas facility in Kherichba. The facilities were not damaged and the security forces killed four terrorists, but BP and Statoil had to evacuate their personnel.⁸

Bouteflika's succession and political divides

While there are many differences with the past, there are some similarities, perhaps the most worrying being those observed in political economy balances, especially the divide between the so-called “affairistes” (business elites) and the conservatives (closer to the military). In the mid-1980s they represented two different approaches to the crisis within the regime. Conservatives thought that the crisis was temporary and that minor adaptations in economic policies would suffice until oil prices recovered. In contrast, business leaders saw a structural crisis in the making due to the failures of the socialist economic model and the need to implement fundamental reforms in the Algerian “rentier” state.⁹

The mid-1980s recession and the subsequent external debt crisis eventually forced the conservatives to accept economic stabilization and market-oriented reforms reluctantly. Central planning was abandoned and several microeconomic reforms were implemented, like gradual internal and external liberalization, and even some institutional reforms, like increasing Central Bank independence. Ultimately, however, the market transition was incomplete, insofar as it did not tackle the needed economic institutional reforms (regulatory, administrative, and judiciary) to ensure market efficiency, transparency, and competitiveness; an efficient public sector; credibility in the fight against corruption; and fewer politically motivated entrance barriers.

By the mid-2000s when oil prices were rising again, the Algerian government had succeeded in stabilizing the Algerian economy but not in modernizing it.¹⁰ The lack of an adequate institutional framework prevented a fair redistribution of the reform benefits, which accrued disproportionately to the well connected. This could be channeled through a myriad of mechanisms from import and operating licenses, public contracts and jobs, preferential and unrecovered loans, or intermediating with foreign firms, among many others. President Boudiaf had denounced the existence of a political–

financial mafia before his assassination in 1992, and similar accusations have intensified in recent years. Corruption scandals among the economic elites have further increased popular opposition to reforms. Now that the drop in oil prices has made reforms more urgent, the government not only has to convince the people that reforms are necessary, but also that the reforms are not just another strategy for the elites to capture even more rent for their own benefit.

In fact, Bouteflika's first reactions to the Arab Spring was the promise to "deepen the democratic process," lifting the state of emergency in place since 1992, and presenting a road map for political reform. While a verifiable commitment to good economic governance should have been the starting point of the reforms from 2011 onward, this was not the case. The government has been unable to bridge the reformist–conservative divide and develop a convincing discourse on economic reform, and has instead merely adopted an austerity narrative. It has been argued that in oil-exporting countries, oil price uncertainty tends to exacerbate lobbying among conservatives and reformists.¹¹ This would imply changing political economy balances is more difficult during times of high price volatility.

There are also specific political issues that explain the difficulties to advance reform. The political climate is strained by both the unresolved issue of who will succeed Bouteflika as well as tensions within the "regime." The president is no longer seen in public and there are serious concerns about whether he is even in charge of the country anymore, with former friends saying he has been in effect "captured" by his entourage. However, in spite of his poor health, Bouteflika's inner circle has consolidated his grip on power, rather than committing to democratization and good economic governance, and has focused on eroding the role of both the military and the intelligence services by exploiting their divisions.¹²

The most significant evidence of this was the dismissal in September 2015 of General Mediène, who had led the intelligence services (*Département du Renseignement et de*

la Sécurité, DRS) for twenty-five years. There have also been ministerial reshuffles and changes in the military, including the de facto dismantling of the DRS at the beginning of 2016 and its replacement with a new body, the *Direction des Services de Sécurité*, that directly reports to the presidency. Mediène, once the most secretive person in the country, appeared in the public debate suggesting that the main threat to Algeria is not the power struggle for Bouteflika's succession nor even his illness, but the way money has intruded into the country's decision-making centers.¹³

Mediène's removal has been interpreted as a strategy by the presidency to ensure a smooth succession, as well as a sign of the waning influence of the security services in Algerian policymaking. Others see it as a historic moment that has put an end to the fluctuations in the government structure between the civilian and military branches of the "revolutionary family" that have characterized Algeria since independence, and ultimately as a real step toward democratization.¹⁴ However, it has also been interpreted as a sign that the regime is facing tough problems.¹⁵

ENERGY AND SECURITY: OPPORTUNITIES AND RISK

Energy sector reforms

The questions over presidential succession and skepticism about the motivation of reform efforts mean that deep economic and political reforms—including a more attractive investment, contractual, and tax framework in the energy sector—seem unlikely. Reinvigorating investment in the sector is viewed as critical to boosting flagging hydrocarbon production and exports critical to the economy, which have been crimped in part due to rising domestic consumption of natural gas and the decline of mature fields. Recent hydrocarbon bidding rounds have failed to attract oil majors, especially as low oil and gas prices and rising regional instability add to the reticence of companies to invest.

The debate on the energy sector reform dates back at least to the beginning of the 2000s, when several licensing rounds opened the country to international oil companies. Then Energy Minister Chakib Khelil pushed for the improvement of the Algerian natural gas export infrastructure, like the Medgaz pipeline to Spain and the Arzew LNG liquefaction facility. In 2005, Khelil reformed the hydrocarbon law to emulate the most attractive global regulatory frameworks in order to further expand exploration and production. The law was passed in 2005 by the parliament, but its more liberal provisions were watered down by amendments by the time it was published in 2006. While the liberalization of the Algerian oil and gas sector can be seen as part of a wider trend, it had very specific consequences. In subsequent years, the intelligence services unveiled different corruption scandals incriminating Khelil (a close ally of Bouteflika) and many other Sonatrach top executives, which almost paralyzed the company. It discredited the biggest reform measures ever introduced in the Algerian energy sector and was followed by the reluctance of the DRS to swallow Bouteflika's fourth term. It is widely believed that this scandal also exacerbated the tensions between his inner circle and the rest of the “revolutionary family.”

Despite the obstacles, there are signs that the current economic difficulties could spark some life back into the energy reform agenda. In February 2016, President Bouteflika presided over a restricted council intended to provide some economic policy orientations with a

special focus in the energy sector. The discussion itself seemed to provide little new insight, focusing on the need to increase exploration and production, improve the efficiency of national companies like Sonatrach and Sonelgaz (entailing a restructuring that will be fiercely opposed), and rationalize energy subsidies. However, in March 2016, Prime Minister Sellal announced a shift in the Algerian economic model. While the details have yet to be revealed, they are expected to include long-awaited energy reforms.¹⁶

An effective reform of the Algerian energy sector to attract foreign investments and increase production would require a drastic overhaul of the hydrocarbon law and the investment code. This would likely include the elimination of the 49–51 rule, under which foreign companies cannot hold a majority stake in any Algerian investment project. The only alternative to boost Algeria's production would be for Sonatrach and Sonelgaz, the electricity and natural gas distribution state-owned utility, to return to international capital markets to finance their investments. However, it is highly debatable that this would be financially feasible for Sonatrach and it would certainly prove impossible for Sonelgaz, which faced an 80 billion dinar (around US\$1 billion at the time) deficit in 2015 due to low consumer prices.¹⁷

While pressures are mounting to adopt reforms to draw foreign investment, such changes would require a solid and undisputed leadership, together with a credible commitment from the government to ensure that the benefits of any reforms will not be captured by the business elites and that their costs and benefits will be fairly shared. However, it is not even clear how an executive devoid of the leadership of an ailing president could embark on significant stabilization and structural reforms without being overwhelmed by popular uprisings or palace plots. The presidential wing may have scored some tactical gains, but its economic leeway has greatly decreased. As with the political opening, the regime will face increasing difficulties if it continues to pursue a “reforms without change” strategy.¹⁸

Algerian security in a regional context

While Algeria should be able to withstand low oil

prices in the short term, it is important to look at the risks to its neighbors and the region should the nation become destabilized. To keep border control in a region surrounded by conflict, the country has reinforced its army and has almost doubled its border police (Groupement des Gardes-Frontières, GGF) since 2011 to reach 135,000 men. In 2014, Algeria's military spending was the highest in Africa, having increased by 175 percent between 2004–2014.¹⁹

While Algerian officials tend to pay lip service to the idea that the wars in the Middle East are a Western ploy to destabilize the region, the government has continued to deepen bilateral security ties with the European Union and the United States, from providing logistical support for France's intervention in Mali to sharing counterterrorism intelligence.²⁰ The strategic relevance of Algeria has increased since the security crisis in the Sahel, the growing presence of Daesh in Libya, and Tunisian security difficulties. In this regard, the country has become not only a key partner in the fight against jihadist terrorism in the region, but also an indispensable broker of stability in North Africa and the Sahel.²¹

Furthermore, it remains the regional actor most capable of preventing the security situation in North Africa from degenerating into a Syrian- or Iraqi-like scenario. The Algerian government is well aware of this and is ready to play this card in the international arena, especially with European neighbors concerned about another potential refugee crisis, this time in the Western Mediterranean. A weakened Algeria unable to secure its territory could create tough spillovers in the Maghreb, the Sahel, and Europe.

For the European Union, such a scenario along its southern border would be very negative, especially at a time when it is already dealing with problems with Russia in the east. The worsening of the security situation in the Maghreb has shifted EU strategic priorities in the region from energy security to preventing systemic security threats. In recent years, the most common European question about Algeria in 2014 was to what extent the country could displace Russian gas supplies. In 2016, the relevant question has become what the European Union itself could do to enable Algeria to contribute more to European energy security, rather than becoming its next problem.

Algerian production and exports

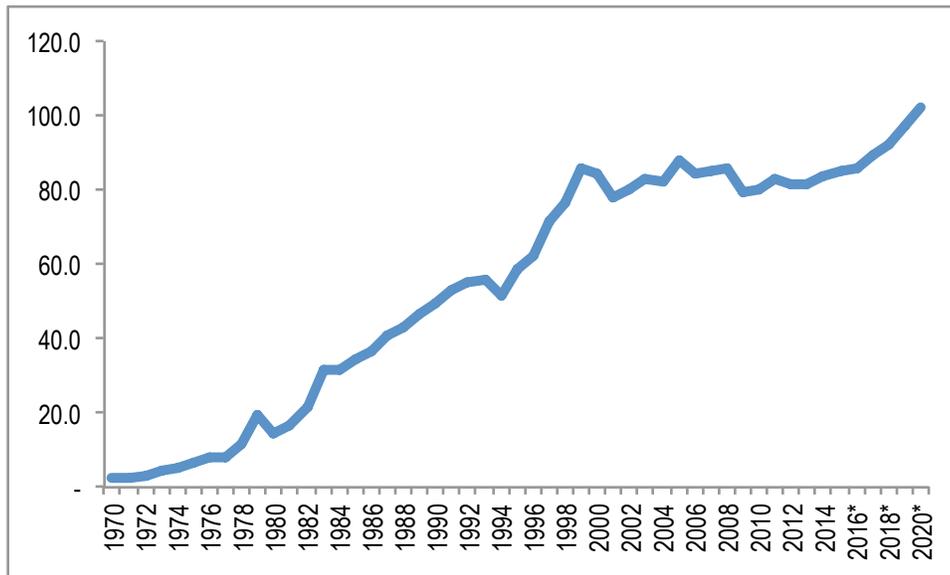
Some authors have argued that Algeria has limited potential to raise gas exports due to declining production and growing internal consumption. They point out that new projects scheduled to come on stream in the coming years will not be sufficient to compensate for the decline from Algeria's mature production fields in the medium term.²² This is not a new development, but rather a continuation of a trend observable since at least the beginning of the present decade.²³ In addition, while Algeria's shale gas reserves are impressive and have become a topic of debate, Boersma et al. conclude that any development is years off.²⁴

Algerian natural gas production peaked in 2005 at 88 billion cubic meters (bcm) before declining to around 80 bcm/year in 2009–2010. Output rebounded to an estimated 85 bcm in 2015, and is expected to reach 100 bcm by 2020 with the startup of the new southwest gas projects. According to the projections from the Observatoire Méditerranéen de l'Energie, natural gas production in Algeria will increase to some 135 bcm in 2035.

However, rising levels of domestic consumption are eroding its export capacity. The country's gas export potential fell from over 50 bcm in 2010 to below 40 bcm in 2013. Estimates for 2030 are only slightly more than levels seen in 2010, and only 35 bcm in 2040 in OME's conservative scenario. In the proactive scenario, Algeria's export potential could double by 2030 and remain above 60 bcm by 2040.²⁵ For sure, much grimmer prospects for Algerian gas production project a reduction in Sonatrach's gas exports to some 15 bcm/year by 2030 in a moderate domestic demand growth scenario, and even disappearing in a higher demand growth scenario.²⁶

With Russia supplying roughly 160 bcm of natural gas into Europe, it is clear that even under the most optimistic scenarios Algeria would not be able to fully substitute for Europe's imports of Russian gas. But notwithstanding the obstacles preventing Algeria from more fully realizing its gas potential, it can be part of the solution to diversify some of Europe's reliance on Russia. More attractive upstream terms could potentially help develop Algeria's resources, including shale gas in the longer term. This is what happened in the 2000s when investments grew due to the pragmatic and liberal policies introduced by Khelil,

Figure 7: Algeria's natural gas production
(In billion cubic meters)



Source: BP Statistical Review of World Energy 2015; and (*) EIU, Algeria Country Report, February 2016 (2015, estimates; 2016–2020, forecasts).

not because of the perennially exaggerated optimistic government forecasts regarding gas production.²⁷

In addition to its role as a natural gas supplier to Europe, Algeria is also an important exporter of oil. Its light sweet crude is popular with Mediterranean refineries, especially with volumes of similar quality crude from Libya facing disruptions in recent years. However, Algeria's oil production has declined after peaking in the mid-2000s and is expected to continue to fall (Figure 8).

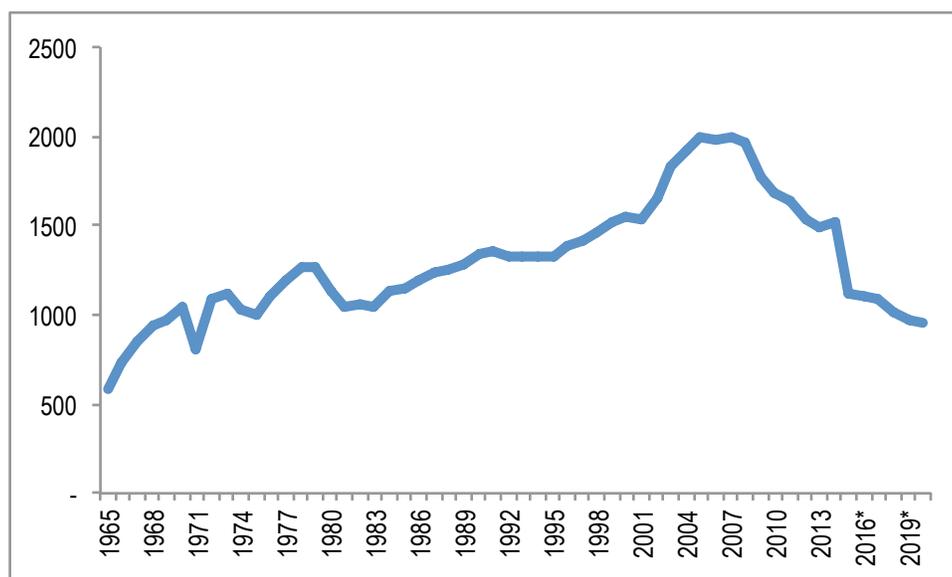
Improving energy ties with Europe

This leads back to the fundamental question of what the European Union can do for Algeria to contribute to European energy security and, from a more general perspective, to Western Mediterranean security. From Europe's perspective, increasing investment in Algeria's energy sector is a way to improve Algeria's economy and by extension help increase stability in its southern neighbor. However, from a political economy perspective, the European Union lacks the tools and incentives to induce a comprehensive reform of the Algerian energy sector. Algiers does not favor any of the current vehicles of EU policy toward the Mediterranean: the European Union-Mediterranean Partnership, the Union for the Mediterranean, and the Neighbourhood Policy.²⁸ Contrary to the cases of Morocco, Tunisia, or Egypt, EU tariff

preferences do not provide any leverage in altering internal political economy balances in Algeria. The country only exports oil and gas, which do not have entry tariffs in the European Union. There are also signs of potential strains in the European Union–Algeria relationship, including a rumor in mid-February 2016 that the government would suspend the free trade agreement with the European Union. While authorities later clarified and said it was a mistake, the incident does indicate the Algerian dissatisfaction with the results of trade liberalization. The process of dismantling tariffs had already been postponed in 2011 under Algerian allegations that the flow of European goods was hurting the local economy, though balance of payment issues was likely a factor as well. The 2015 deepening of the current account deficit in spite of significant depreciation of the dinar further revealed the rigidities of Algerian imports, turning the government's feet colder on trade liberalization.

Even though energy remains the cornerstone of trade between the European Union and Algeria, the European Union has lacked an attractive model to manage its energy interdependence with Algeria. The European Union is eager to increase the security of its gas supply, especially given its problems with Russia. Algeria, on the other hand, sees securing demand, especially through pipelines, as

Figure 8: Algeria's oil production
(In thousands of barrels per day)



Source: BP Statistical Review of World Energy 2015; and (*) EIU, Algeria Country Report, February 2016 (2015, estimates; 2016–2020, forecasts).

crucial, which has become more difficult due to declining European consumption.²⁹ Another major hurdle is the lack of pipeline capacity to ship gas from Spain through the Pyrenees, which limits Algeria's ability to reach significant parts in the European Unionropean market.

Indeed, lack of access to the wider European market has contributed to an increase in the amount of unused capacity to import Algerian gas. Spain has two gas pipelines that supply gas from Algeria (the Maghreb–Europe gas pipeline transiting Morocco, and the Medgaz pipeline that links Spain and Algeria directly) with a combined capacity of around 23 bcm. In 2015, Spain and Portugal only imported 15 bcm through these lines, leaving over 8 bcm of idle capacity. The addition of new compressors could quite easily increase the Medgaz capacity by some 4 bcm, bringing combined pipeline spare capacity to some 12 bcm. Total spare capacity could be increased to over 25 bcm when these pipeline volumes are combined with underutilized LNG capacity.

While this volume does not represent enough gas to replace European gas imports from Russia, it nevertheless represents more than the volume of Russian gas imported by Italy (some 20 bcm) and more than half the volume imported by Germany (under 40 bcm). Furthermore, since

its inception, the Medgaz was designed to add a parallel pipeline at a minimum cost, making it the most efficient addition to European gas pipeline import capacity. No doubt, any of the options above would make a significant, fast, and efficient contribution to the diversification of EU gas imports. The proposed Galsi pipeline project linking Algeria and Italy has similar potential. But at least equally important in the current North African context is the incentive for Algeria to reform its energy sector in order to increase production and match new European marketing opportunities. The project has stalled due to the idle capacity currently afflicting Algerian gas export infrastructure and the uncertainties regarding future European gas demand. As discussed earlier, the benefits for the Algerian economy would be very positive, but the impact on regional security would be invaluable.

There have been some promising steps in this direction, like the political agreement signed in the summer of 2015 among France, Portugal, and Spain to increase exports of Algerian gas into Europe. However, to be credible these political efforts should come with specific projects and financing, including an attractive offer for Algeria. The recent proposals from the commission to regulate gas contracts in the Energy Union framework send mixed signals to Algerian policymakers.³⁰ For instance, Algeria

would be interested in participating in a diversified EU LNG market. However, Algiers has expressed its reluctance to shift away from long-term contracts to spot prices set at European gas trading hubs, arguing this would harm Algerian demand security. Russia has expressed similar concerns but finally accepted to relax its contract terms, and Algeria will likely have to follow suit. In fact, there have been recent rumors about Sonatrach showing its readiness to improve them in both prices and quantities in its 2015 negotiations with ENI: volumes are supposed to increase, while the oil-linked gas price formula would be adjusted to the current price environment.³¹

Aside from the previously mentioned issues, there is another factor adding pressure to the Algerian hydrocarbon sector that Europe could help address. Growing US LNG gas exports will likely increase the pressure Algerian gas is facing in the shrinking European market. According to Bordoff and Hauser, African natural gas exporters will be the main losers of US LNG exports to Europe, with a 35–40 percent reduction in export gas revenues, compared with a 27–38 percent reduction for Russia.³² Together with unclear prospects regarding EU gas policies, this could influence Algerian natural gas production and export strategy. While weak signals from the European Union certainly reduce the incentives for energy reform and increased investments, the changing pattern of gas markets is somewhat ambivalent: on the one hand it fosters new, more flexible contract terms; on the other, uncertainty over its real impact fosters a wait-and-see attitude regarding new investments. In this regard, measures that improve Algerian access to European gas markets would send a strong signal that could encourage reforms that would increase investment.

CONCLUSION

While Algeria's economic situation has greatly deteriorated, there are many factors that suggest that, unless oil prices remain depressed for an extended period of time, the country is not going to repeat the mid-1980s oil countershock that led to recession, massive popular revolts, an Islamist victory in local and legislative elections, and ultimately a military coup, political repression, and a bloody civil war.³³ The Algerian economy is in a far better situation today to weather the oil price collapse than in the mid-1980s and 1990s. However, while the current economic difficulties have slightly shifted the balance of power in favor of the reformers, the ability of the government to withstand the crisis over the near term encourages only modest political and economic reforms, such as passing a restrictive and moderately reformist budget, and some changes to the Algerian economic model. More expansive reforms, especially in the energy sector, are needed for the longer-term benefit of the country. While more adverse scenarios cannot be ruled out, the Bouteflika entourage seems likely to retain power. Indeed, the hold of the regime may have increased following its move to reduce the influence of security services and the military.

Taking a longer view, the risk of instability in Algeria should the economy sink further due to prolonged low oil prices should spur Europe to rethink its energy relations with Algeria. There may exist an opportunity for Europe to press for energy reforms that could weaken—but not eliminate—the sway Russian gas holds over the continent's energy security, while simultaneously providing a boost to the Algerian economy that could prevent a dangerous downward spiral. Europe should recognize that recent European Commission proposals to regulate gas contracts can be viewed as a warning signal to Algeria, which is already concerned about the growing competition it is facing for a shrinking European market. European commitments to take more Algerian gas could be used as leverage to elicit better upstream terms for international energy companies, boosting export volumes. There already exists spare export capacity to send more Algerian gas to Europe, but the region could further commit to increasing this capacity by investing in an expansion of the Medgaz line and potentially through the stalled Galsi project. Additional pipelines that would increase the interconnectedness of European

markets would also provide more outlets for Algerian gas. In addition, Europe should consider compensations to ensure that new volumes of LNG entering into the global market over the next few years—especially US LNG—do not push the Algerian economy over the edge and put the stability of the nation into question, creating more chaos along Europe's southern border.

NOTES

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