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Tunisia: 2003 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Tunisia

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 Article IV consultation with Tunisia, the following documents have been released and are included in this package:

- the staff report and supplement for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 19, 2003, with the officials of Tunisia on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on July 9, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff supplement of **July 9, 2003** on strengthening the monetary framework and instruments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its July 25, 2003 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Tunisia.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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TUNISIA

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for the 2003 Consultation with Tunisia

Approved by Mohammad Shadman-Valavi and Matthew Fisher

July 9, 2003

- Discussions for the 2003 Article IV consultations were held in Tunis during May 6–19, 2003. The staff team comprised Mr. Fanizza (head-MED), Mr. Laurens (MFD), Ms. Laframboise, Ms. Koranchelian, Mr. Sarr, and Ms. Trumbic (all MED).

- The mission met with Governor Daouas (Central Bank of Tunisia), Minister Baccar (Finance), other cabinet members, and government officials. The staff also met with the main trade union, the private business association, and with representatives of the banking sector. Mr. Rouai, Advisor to the Executive Director, attended most of the meetings.

- At the conclusion of the last Article IV consultation on June 5, 2002, Executive Directors welcomed the authorities' plan to tighten macroeconomic policies in order to rein in domestic demand. They encouraged the adoption of a transparent monetary framework with price stability as the main objective. Directors also endorsed the move to a more flexible exchange rate and more open capital account over time, provided the ground-work is well prepared before moving forward. Other key priorities highlighted included the need to address fiscal rigidities, liberalize external trade and domestic prices more comprehensively, and reduce the role of the state in the economy.

- The authorities have continued to increase the transparency of their policies: They have published IMF Board documents and mission statements on Tunisia for several years, and intend to publish the 2003 Article IV Staff Report and supplement.

- Tunisia accepted the obligations of Article VIII, Sections 2–4 in January, 1993. Tunisia maintains a multiple currency practice resulting from exchange rate guarantees extended prior to 1998.

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EXECUTIVE SUMMARY

- The resilience of Tunisia's economy to recent shocks highlights the success of reforms since the mid-1990s. In addition, a prudent macroeconomic policy response in 2002 led to a stronger external position and improved vulnerability indicators.

- To help dampen strong domestic demand early in the year, the authorities maintained a tight fiscal policy in 2002. As economic activity decelerated later in the year, the central bank followed a more dynamic approach to monetary policy by adjusting the growth of monetary aggregates downward. However, credit to the economy grew faster than expected because of an easing in reserve requirements, although this did not lead to excessive pressures on the external position. Inflation remained subdued.

- While tourism is likely to remain weak, a rebound in agriculture and strong export growth during the first half of 2003 could push real GDP growth over 5 percent and result in an improvement in the external position. This outlook is premised on the maintenance of strict budget control, a slight easing in the monetary stance, and increased flexibility in exchange rate management.

- The policy agenda is driven by the medium-term objectives of raising growth and employment. To this end, the authorities should continue to liberalize the economy and to adapt the macroeconomic framework to the challenges of a more open economic environment. This should be accompanied by medium term fiscal consolidation and targeted structural reforms.

- Following the policy dialogue in 2002, the discussions focused on reform of the monetary framework as the prerequisite to moving to a floating exchange rate and further opening the capital account. The authorities agreed to adopt M3 as the intermediate target and reserve money as the operational target. The staff identified steps that could facilitate shifting away from the current regime of credit growth targeting.

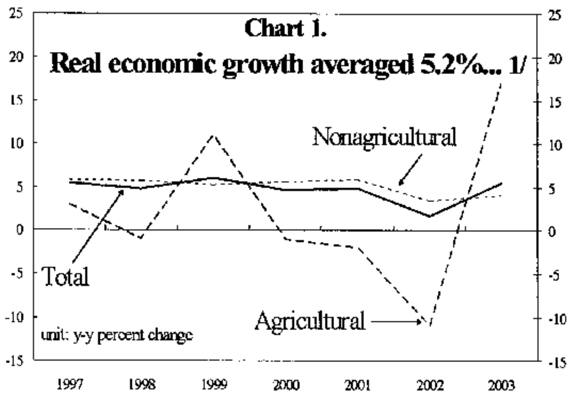
- The staff stressed that rehabilitation of the banking sector would be essential to allow monetary policy to operate effectively—existing weaknesses could limit the central bank's willingness to tighten monetary conditions.

- Fiscal consolidation over the medium term is essential in order to lower public debt, which remains relatively high. Lowering the wage bill should be the priority focus in order to reduce rigidities and allow fiscal policy greater leeway to respond to shocks.

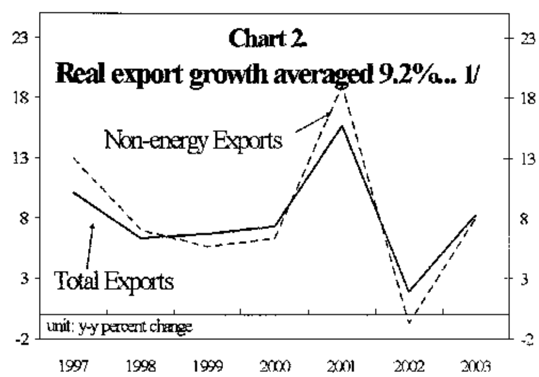
- The authorities should reduce the number and level of tariffs as well as the preferential tax and investment incentives extended to the offshore sector.

I. Background and Recent Developments

1. **Gradual economic liberalization, in a context of macroeconomic stability, has allowed Tunisia to seize the opportunities created by integration into the world economy**. Under an improved regulatory framework and a more liberal trade environment, the private sector has developed rapidly in the export and tourism sectors.

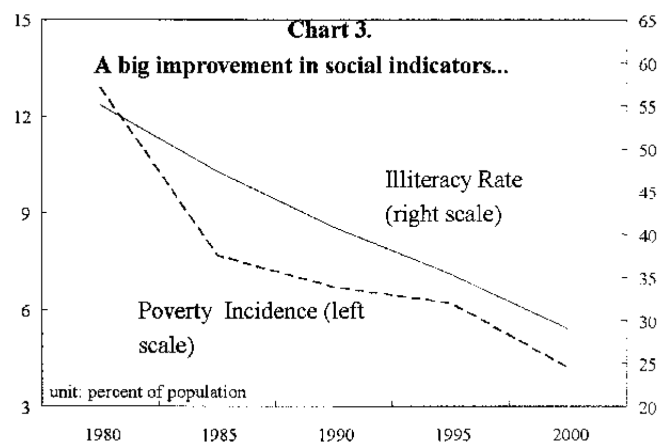


1/ Average for 1997-2001.



1/ Average for 1997-2001.

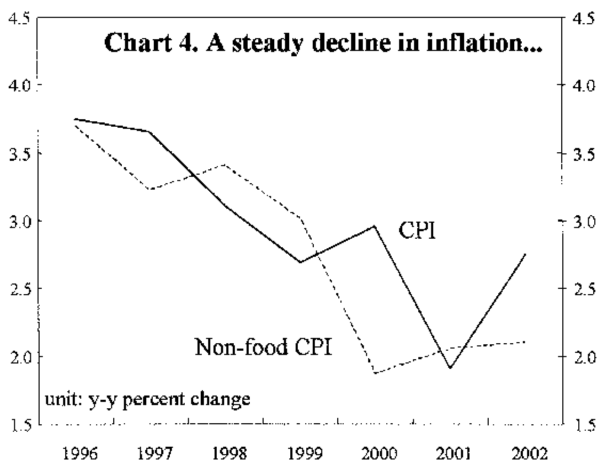
2. **Tunisia's successful performance since the mid-1990s has been based on a well-paced and coordinated policy approach**, consisting of appropriate macroeconomic policies, a forward-thinking but gradual opening of the economy, and well-targeted social policies. Prudent monetary policy helped keep prices stable, while fiscal policy was oriented towards consolidation and controlling demand pressures. The authorities followed a constant real effective exchange rate rule to help maintain competitiveness, which also benefited from active incomes policies. This rule was not problematic with respect to inflation because the authorities maintained strict macroeconomic policies and the exchange rate did not deviate from its equilibrium rate.[1] Capital flows were restricted in an effort to ensure that domestic savings were used to finance domestic investment.

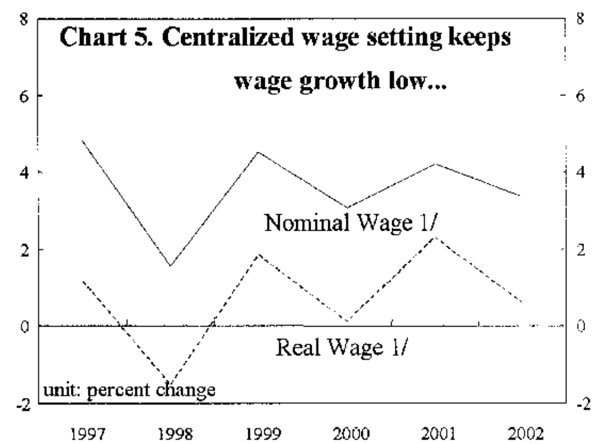


[1] A review of Tunisia's experience with real exchange rate targeting and an assessment of the level of the exchange rate were undertaken as part of the 2002 Article IV consultation (see the Selected Issues paper SM/02/155 and Working Paper WP/02/190).

Since 2001, the central bank has let the dinar depreciate by more than is required to keep the real exchange rate constant. This has led to a slight depreciation in the real effective rate. Consistent with staff recommendations, the authorities justified this greater flexibility with the need to partially offset the impact of reduced external protection on competitiveness.

3. **Under this policy framework, macroeconomic performance was favorable.** Between 1997 and 2001, real GDP growth averaged 5.2 percent annually, inflation remained low and stable, and the government deficit was reduced from 4.3 percent of GDP to 3.5 percent of GDP. External debt held steady at around 60 percent of GDP over the same period, while external reserve coverage was maintained close to the equivalent of three months of imports.





1/ Based on minimum wage (SMIG).

4. **Over the years, Fund surveillance focused mainly on the need to accelerate structural reforms, to which the authorities responded favorably.** However, to ensure country ownership, the authorities stressed that the pace of implementation would have to be tailored to fit Tunisia's particular conditions, especially the need to maintain social cohesion. With these concerns in mind, the authorities made significant progress in privatizing state enterprises, strengthening the banking sector, improving the investment climate, opening the economy under the Association Agreement with the European Union (AAEU), and enhancing the competitiveness of domestic industry to face the challenges posed by greater competition under the AAEU and the expiration of the Multi-Fibre Agreement.

5. **However, important structural problems persist, of which unemployment is the biggest symptom.** Unemployment is stubbornly high at 15 percent, despite active employment programs. In addition, growth has not been sufficient to meet the authorities' goal of raising real incomes to lower-tier OECD country levels. The main structural impediments are: high continued trade protection; a heavily-regulated onshore sector alongside a dynamic, export-oriented offshore sector; state control over a large part of the economy through price controls and state ownership, including in the banking sector; significant financial sector vulnerabilities; and labor market rigidities.

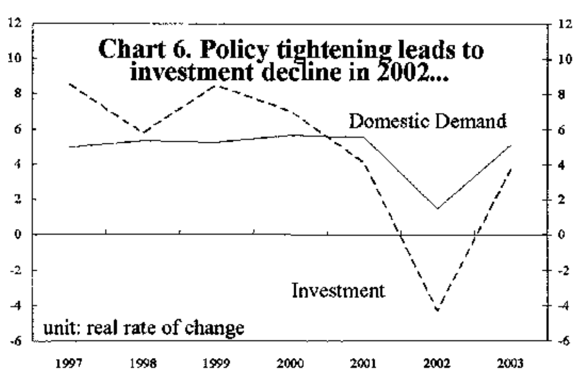
Box 1. Micro Financing in Tunisia

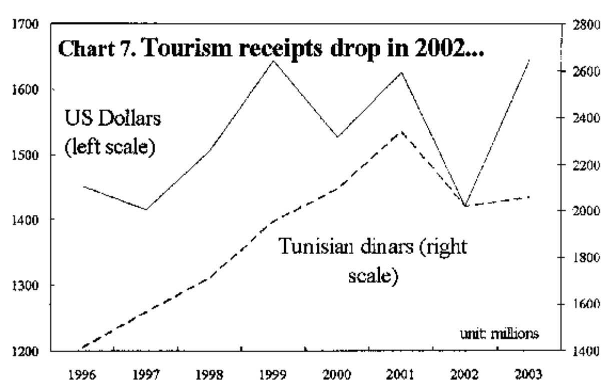
The *Banque Tunisienne de Solidarité* (BTS), which is 54 percent owned by the state, was founded in 1997 to promote micro financing. Its mission is to promote jobs by financing small entrepreneurs who lack access to credit or collateral for credit. Target clients are individuals exhibiting initiative, commitment, and the appropriate expertise. Borrowers must prove the viability of their project and its potential market. Preferred candidates are university graduates, technical professionals, and those seeking re-entry to the labor market.

Since its inception, over 100,000 projects have been financed. The maximum loan amount is TD 10,000 (US$7,500), or TD 20,000 for university graduates. Repayment ranges from six months to seven years; loans carry a grace period from 3 months to one year; interest rates are subsidized and capped at 5 percent. The BTS also administers a special line of credit *(système des micro-crédits)* established by the government in 1999 with the help of 26 approved agencies situated in remote localities. Loans under this program cannot exceed TD 2,000.

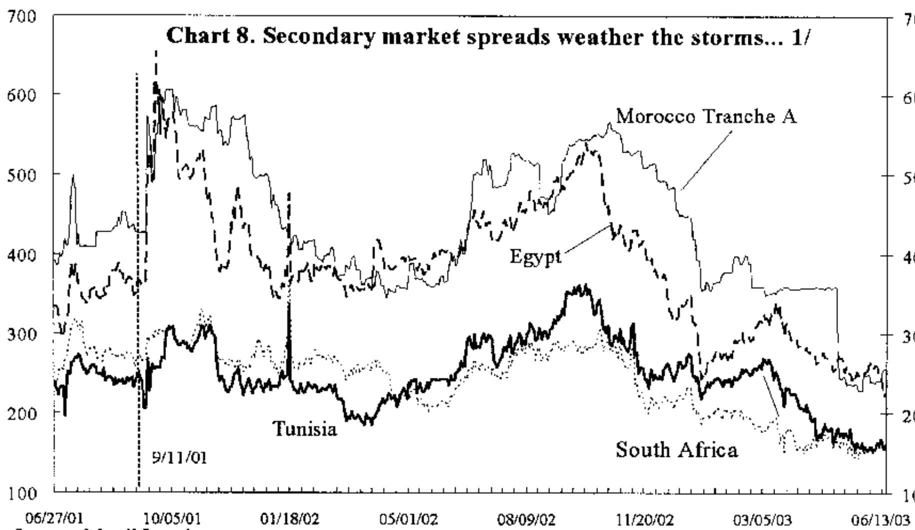
The average loan size by BTS is currently TD 3,900, and TD 790 under the *système des micro-crédits.* Loans are distributed in the following shares: 44 percent to small businesses (*petits métiers*), 34 percent to services, 16 percent to agriculture, and 6 percent to artisans. Roughly 31 percent of loans are to women. While the BTS is currently undertaking a study of the success rate of BTS-financed projects, loan recovery is higher for agencies in the field (80 percent) compared to the BTS (60 percent), and is also typically higher for university graduates and women borrowers. While the BTS is working to improve its collection rate, 90 percent of the bank's outstanding loans are covered by insurance funded by commercial banks through the *Fonds National de Garantie*.

6. **Following several years of favorable economic performance, the Tunisian economy experienced a difficult year in 2002**. In late 2001, domestic demand was booming and the external position was deteriorating at an unsustainable rate. In an effort to rein in demand, the authorities tightened monetary and fiscal policies. Meanwhile, the economy was hit by a succession of shocks: terrorist attacks abroad and in Tunisia, a slowdown in export markets, and a fourth consecutive year of drought. The tightening in demand policies, together with the worsening of the global outlook, led to a drop in investment and growth and a rapid correction in the external current account deficit, despite the sharp decline in tourism and export growth.





7. **Despite these circumstances, real GDP managed to advance by 1.7 percent.** This resilience bears witness to the economy's stronger foundation. Prudent macroeconomic policies have increased market confidence in Tunisia, as reflected in the performance of Tunisian paper in financial markets: secondary market spreads have fared relatively well since September 11, 2001, and Tunisia's Eurobond issue early this year was well received. In addition, Tunisia's investment grade rating was raised by Moody's after the Iraq war.



Source: Merril Lynch
1/ All spreads, in basis points, based on remaining maturities between 9 and 11 years.

Box 2. Tunisia: International Capital Market Experience

- Tunisia has had access to international capital markets at favorable terms since 1994.
- Bond placements were initially concentrated in the Japanese market to take advantage of low yields. Tunisia issued regularly in this market between 1994–2001 at maturities spread from 5 to 30 years.
- Capitalizing on its investment grade rating (see below), Tunisia has diversified into the American and European markets since 1997, broadening the country's investor base and establishing a reference in other major financial markets.
- Tunisia has a unified medium investment grade credit rating (BBB) with a stable outlook from all leading agencies. Tunisia was at the lower end of the medium grade rating until March 2000, when it was upgraded by Standard and Poor's (S&P) followed by Fitch in 2001. Moody's upgraded Tunisia's rating in April 2003.

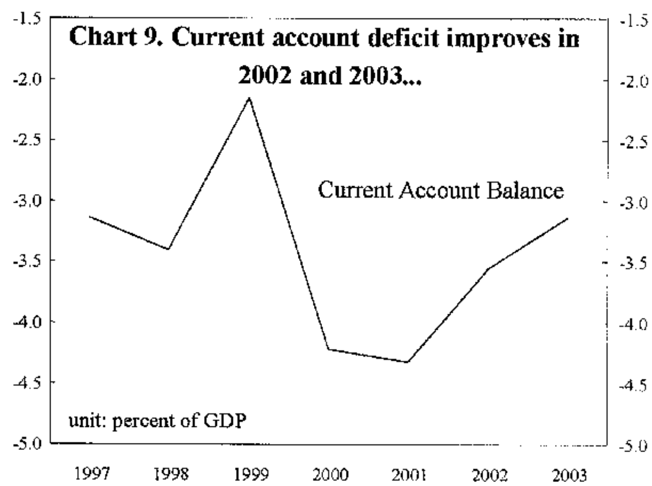
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
FITCH	...	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB	BBB	BBB
MOODY's	...	Baa3	Baa3	Baa3	Baa3	Baa3	Baa3	Baa3	Baa3	Baa2
S & P	...	...	...	BBB-	BBB-	BBB-	BBB	BBB	BBB	BBB

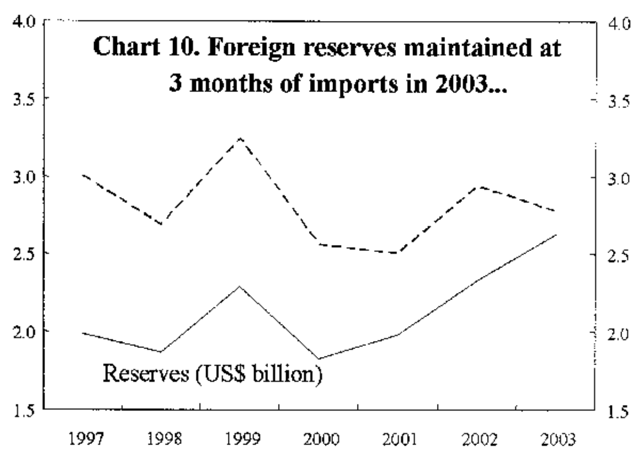
8. **Following the policy dialogue with the staff, the authorities turned their attention in 2002 to fundamental reform of the macroeconomic policy framework.** The authorities had recognized the need to revisit their policy framework in light of the AAEU. In this context, the staff suggested a sequenced approach to establishing a macro policy framework based on three pillars: a clearly defined monetary policy, a floating exchange rate, and an open capital account. The authorities agreed in principle with this proposal, noting that many steps were required along the way. They added that the increased flexibility in exchange rate management was consistent with this approach. The first big step would be the formulation of a transparent monetary policy framework with clear objectives and operating targets—the key topic of this year's consultation.

II. Policy Discussions

A. Short-term Prospects and Macroeconomic Policy Stance

9. **The outlook for the external position in 2003 is favorable.** Exports surged during the first five months of the year in response to increased capacity and restocking by European subcontractors. Recent indicators point to a resumption in tourism flows. The external current account deficit is forecast to narrow as slack domestic demand is likely to persist, while external reserves are projected to remain close to the equivalent of 3 months of imports. Tourism poses the main risk to this outlook, although projections are based on the cautious assumption of constant tourist flows in 2003. Agricultural production is forecast to advance by over 15 percent due to welcome rainfall following years of drought. With domestic demand growth remaining subdued, export growth and the rebound in agriculture could push real GDP growth over 5 percent.

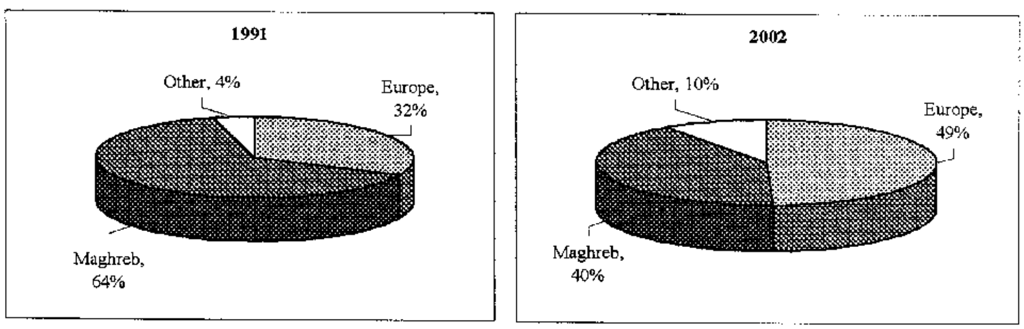




Box 3. Tunisia: Developments in the Tourism Sector

Tourism in Tunisia has expanded significantly, growing at an average annual rate of 12.5 percent since 1962. In absolute terms, the number of tourists increased from 50,000 in 1962 to more than 5.4 million in 2002. Tourism receipts account for 17 percent of external receipts and tourism represents over 6 percent of GDP. The industry employs directly and indirectly 13.5 percent of the labor force. Credit to the tourism sector constitutes 13 percent of total bank credit to the economy.

Distribution of tourists by country of origin

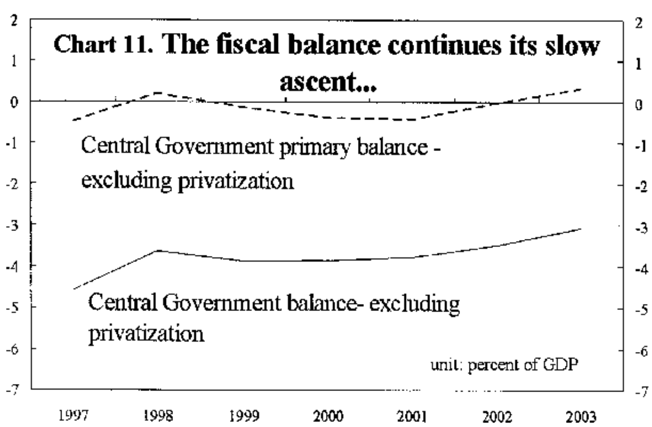


Since 2001, Tunisia's tourism industry has suffered. Following September 11, 2001, the April 2002 terrorist attack in Djerba, and the global economic slowdown, tourist arrivals and tourist nights dropped by 6 percent and 22 percent respectively in 2002. Tourism receipts fell by 13.5 percent.

The prospects for the remainder of 2003 tourism are more positive. With the end of the war in Iraq, tourists began to return and tourism receipts in 2003 are expected to meet or exceed the level in 2002. Moreover, a recent decision to reorient marketing efforts towards domestic and Arab tourists resulted in an increase in the share of tourists coming from Arab countries.

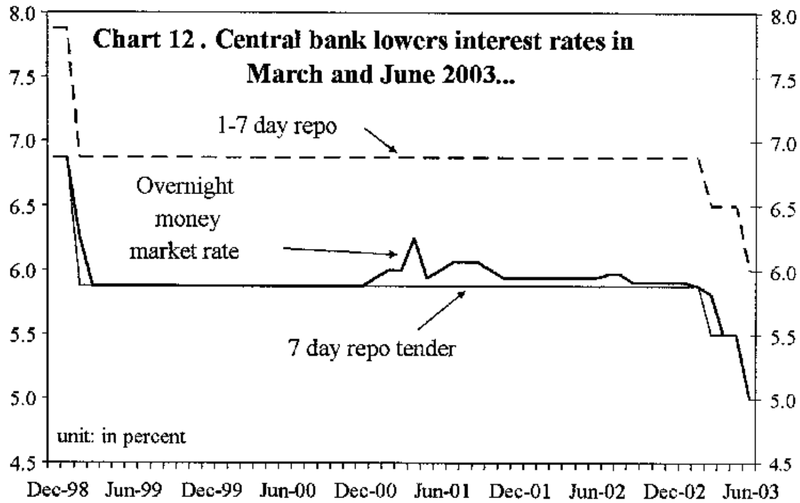
10. **Fiscal policy will continue to aim towards consolidation, although revenue growth was weak in the first quarter because of slow domestic activity and low import growth.** The authorities are aiming for a fiscal deficit (central government) of 3.1 percent of GDP in 2003, down from 3.5 percent of GDP in 2002. This should ensure a slight reduction in the government debt-to-GDP ratio to below 60 percent. To achieve the deficit target, the authorities intend to partially offset the expected decline in tax revenues (as a percentage of GDP) with lower than budgeted spending (both investment and current outlays) and higher non-tax revenues. In the staff's view, a reduction in the fiscal deficit is essential to signal the authorities' determination to bring the government debt-to-GDP ratio down over the medium term.

Chart 11. The fiscal balance continues its slow ascent...

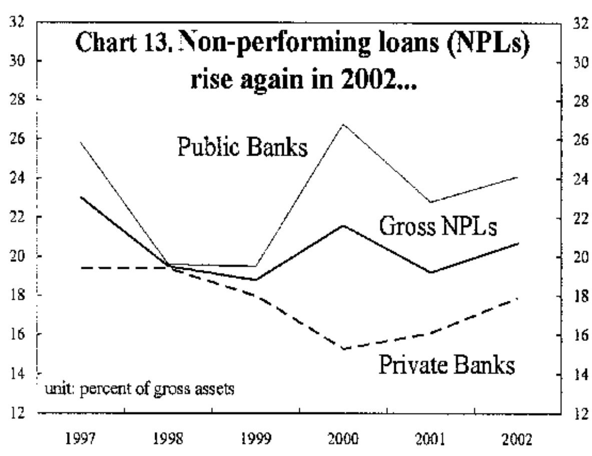


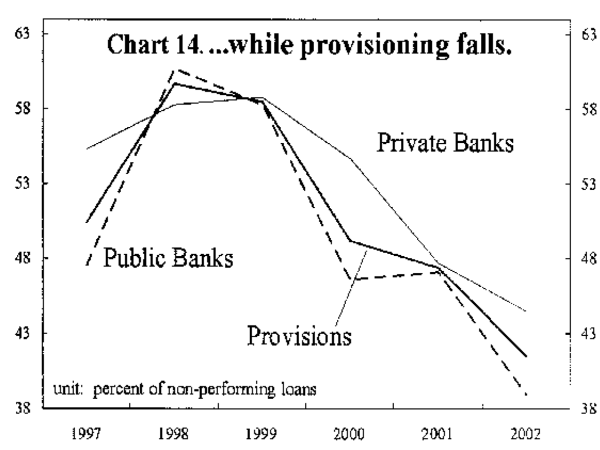
11. **The authorities' prudent monetary policy has contributed to keeping inflation under control.** With credit growth sluggish, the staff welcomed the central bank's decision to lower the credit auction interest rate in late-March. The staff noted that there may be scope

for even further monetary easing, but also urged the central bank to remain vigilant and alter its course should demand pressures arise. Consistent with the staff's views, the BCT reduced again this interest rate by 50 basis points in June.



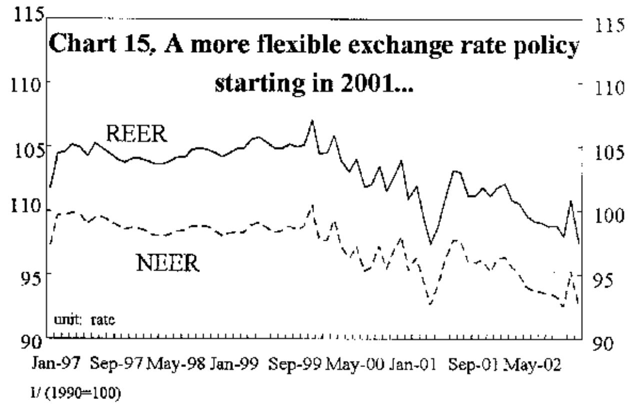
12. **Financial indicators in the banking sector deteriorated in 2002 because of the drop in tourism and weaker economic growth.** Non performing loans (NPLs) increased and the level of provisioning declined, but the authorities indicated that this largely reflected write-offs and the transfer of provisioned loans to asset recovery companies. They see this deterioration as just a pause in the progress achieved at strengthening the banking sector.[2] While understandable given the slump in economic growth, in the staff's view, this pause demonstrates instead the need to act vigorously to address banking sector weaknesses.





[2] Between 1994 and 2001, NPLs declined from 31.4 percent to 19.2 percent of gross assets, and provisioning increased from 29.5 percent to 47 percent of NPLs. See Table 1, page 18.

13. **The central bank continued to pursue a more flexible exchange rate policy in 2002.** This led to a further slight depreciation of the dinar in real effective terms. The authorities intend to continue this approach with the objective of gradually shifting, down the road, to a floating regime. The staff believes that this approach continues to be appropriate, in view of the robust export performance and absence of inflationary pressures during the first five months of 2003. The staff assessment of Tunisia's competitiveness in 2002, as discussed in detail in the 2002 Article IV Staff Report (SM/02/147) and Selected Issues paper (SM/02/155), found that the exchange rate was appropriately valued. The staff does not see any reason to alter this assessment, particularly given the depreciation of 3.5 percent in the real effective exchange rate over the last 12 months.



B. Medium-Term Policy Issues

14. **Since the impact of the Iraq war proved to be less severe than expected, fears about macroeconomic stability had subsided by the time of the Article IV mission.** Consequently, the policy discussions were framed in a medium-term context, taking into consideration the authorities' objectives of accelerating growth, lowering unemployment, and raising real incomes. In order to meet their job creation objectives, annual real GDP growth will need to average at least 6.1 percent in the 2004–08 period. Assuming a moderate annual increase in productivity growth of 0.4 percent, this implies an increase in investment of 2 percent of GDP over the period.

15. **These growth objectives will mean mobilizing more public and private savings and raising investment.** Accordingly, the mission recommended fiscal consolidation of 1.1 percent of GDP over the period to contribute to the savings needs of the economy, and selected structural reforms to encourage private investment. The mobilization of foreign savings should, in the staff's view, focus on investment flows that will help increase productivity and keep external debt as a share of GDP on a declining trend. Indeed, the findings of the external sustainability analysis suggest that Tunisia remains vulnerable to exogenous shocks. For example, the standard stress tests reveal that, in the event of a currency depreciation, the ratio of external debt to GDP would increase substantially (Table 9).

16. **In view of these savings and investment goals, the policy agenda** will need to focus on: (i) strengthening Tunisia's macroeconomic policy framework; and (ii) accelerating structural reforms. Higher economic growth can only be generated if policies succeed in both of these areas. Structural reforms are required to generate productivity growth and to enhance incentives for private sector activity. At the same time, the macroeconomic policy framework needs to be adapted to the new conditions created by greater economic and financial integration in order to sustain higher growth without endangering economic stability.

Macroeconomic Policy Reform

17. **In an effort to adapt to a more globally integrated, market-based economy, and in line with the recommendations of Fund surveillance, the authorities began in 2002 to explore alternatives to their macroeconomic policy framework.**[3] The initial force for change was provided by the AAEU, which has modified the structural and institutional environment for macroeconomic policies. The authorities had also recognized the potential benefits from gradually removing capital controls as a means to generating a higher growth path by tapping foreign savings. Opening the capital account, one of the three pillars of the reform, would also help to diversify the sources of balance of payments financing and promote efficiency in the domestic financial system. With regard to the exchange rate regime—the second pillar of reform—the authorities had begun to see the limitations of the constant real exchange rate rule. While it had served Tunisia well under the policy nexus of restricted trade and capital flows during the 1990s, it would become more problematic in an increasingly open, market-based economic environment.

18. **In discussing a well-sequenced reform path with the authorities, the staff recommended establishing a clearly defined monetary framework, the first pillar, as the starting point,** since a floating exchange rate will work only if the envisaged monetary framework becomes the nominal anchor for the economy. Price stability must in turn be the primary objective of monetary policy and the exchange rate should ensure external equilibrium. Moreover, a floating exchange rate is necessary to ensure an independent monetary policy when capital flows are unrestricted. Substantial steps towards capital account liberalization should wait for the monetary framework to be fully established and for the exchange rate to be floated.[4]

Reform of the Monetary Framework

19. **Under their existing approach, the monetary authorities target growth in credit to the economy to achieve their inflation and external objectives.** This occurs in the context of an exchange rate, that is, by and large, predetermined, and broad capital controls, which allow monetary policy a degree of autonomy. The central bank (BCT) determines the volume of refinancing banks need to meet their reserve requirements, and restricts refinancing if credit growth exceeds its target rate. The mission noted that the relation between the amount of bank refinancing and credit to the economy is far from stable, and is likely to become less so as the economy opens. In addition, the interest rate flexibility required under this approach has been limited. Thus, the staff recommended adopting broad money (M3) as an intermediate target and reserve money as the operational target, since the

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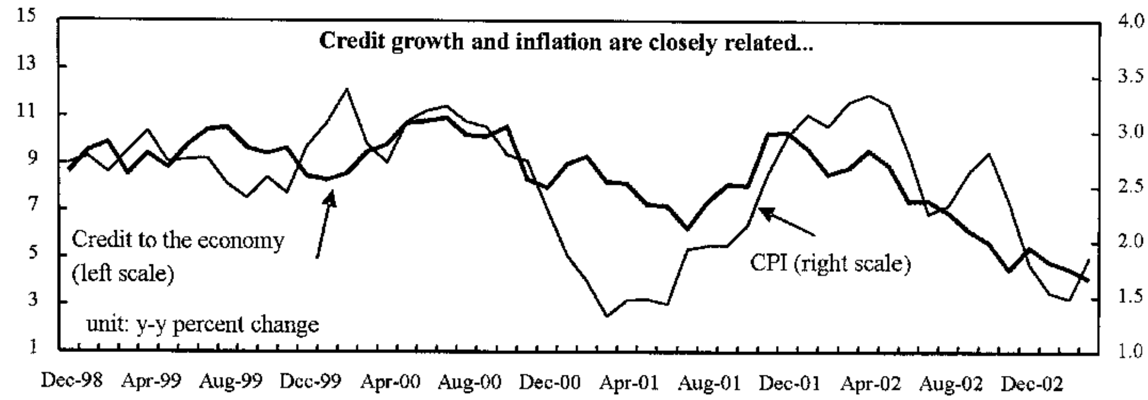
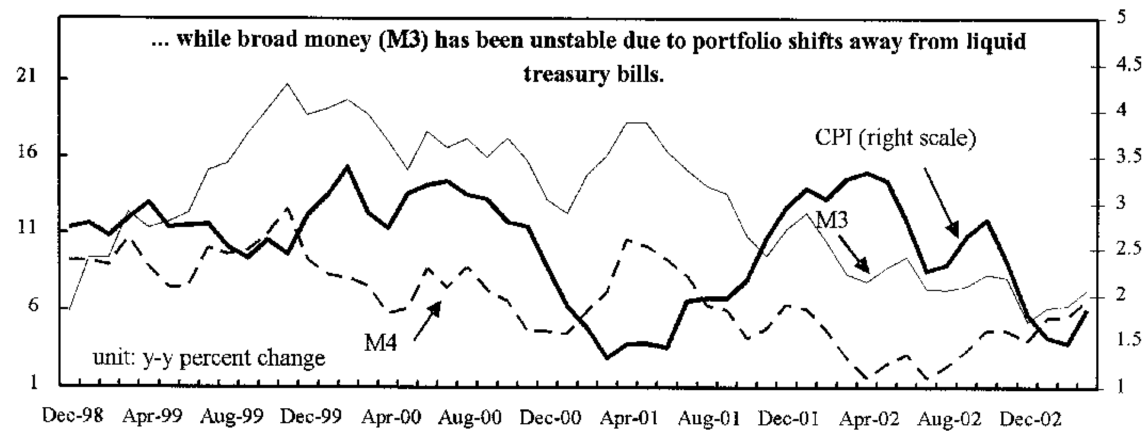
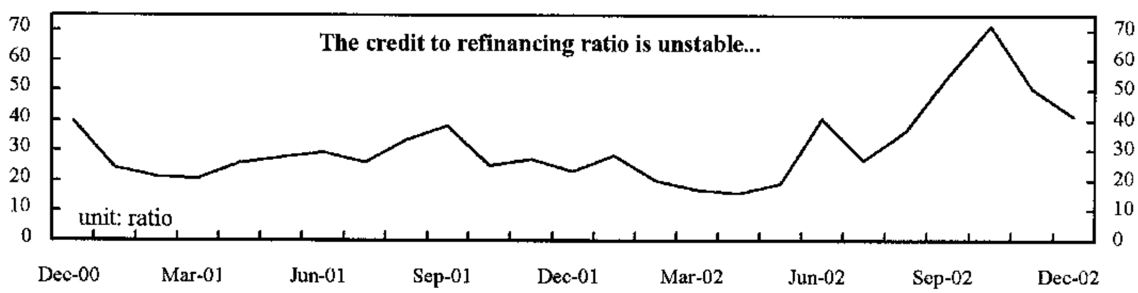
[3] See Tunisia—Staff Report for the 2002 Article IV Consultation (SM/02/147).

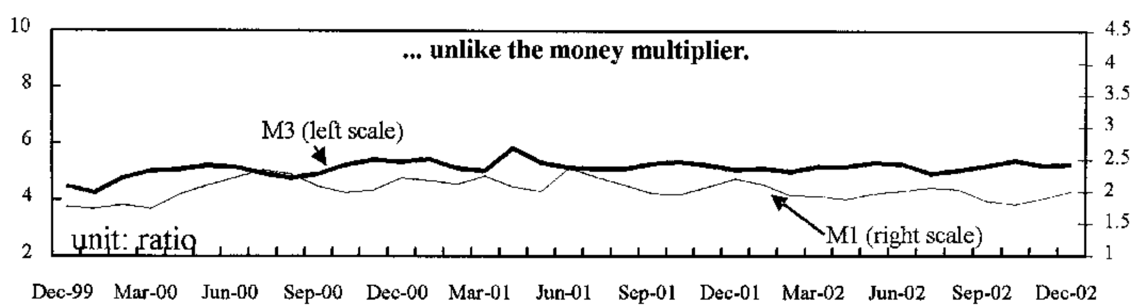
[4] The pace, the sequencing, and the conditions necessary for capital account liberalization in Tunisia were discussed in detail in the Selected Issues Paper, Chapter II, Liberalization of the Capital Account in Tunisia—Progress Achieved and Prospects for Full Convertibility (SM/02/155).

Chart 16. Monetary Sector









relationship between these two variables is stable (see Supplement to the Staff Report for details). Moreover, the staff and the authorities agreed that M3 should serve as a good predictor for inflation since the portfolio shift away from liquid treasury bills toward time deposits, a recent development that had caused instability in monetary aggregates, had run its course.[5]

20. **The staff and the authorities identified steps that could help to calibrate BCT interventions so as to meet reserve money targets**. These steps include:

- Translating the annual monetary program into monthly reserve money targets.
- Extending the liquidity forecasting horizon to distinguish temporary from permanent changes in liquidity conditions.
- Enhancing forecasts of government cash flows.

To foster money market development and allow interest rate flexibility, the BCT should limit its fine-tuning operations and establish a wider corridor for interbank interest rates. The BCT believes that these steps could be taken in the near future, but that IMF technical assistance would be useful, particularly to establish monthly targets for reserve money. Technical assistance in these areas would build upon recent work to improve liquidity forecasting.

21. **The remaining weaknesses in the banking system pose the main risk to the successful implementation of this framework.** The financial position of Tunisian banks could constrain the BCT from allowing upward movement in interest rates. Higher rates could cause bad loans to rise since almost all loans are indexed to the money market rate.

22. **In the medium term, interest rates will take on a more prominent role in the transmission mechanism as financial instruments and markets develop.** This will make it possible to rely on interest rates in due course as the operating target in the context of a floating exchange rate regime. At that time, the authorities will be able to assess whether the initial conditions in support of inflation targeting exist.

Fiscal Policy Priorities

23. **Recent experience highlights the need to tackle Tunisia's fiscal rigidities.** The difficult economic conditions in 2002 and 2003 forced the authorities to meet their budget commitments by cutting investment expenditure and drawing on the resources of public enterprises. While the authorities' efforts to meet the budget targets are commendable, the experience demonstrated that room to maneuver in the event of adverse shocks is limited. The wage bill and interest payments together account for 64 percent of total revenues, while

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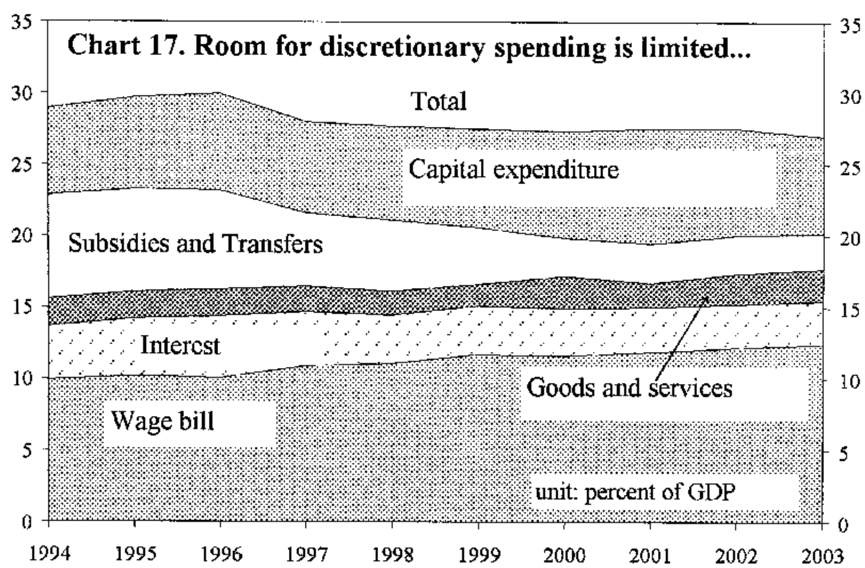
[5] Liquid treasury bills (*Bons du trésor cessibles)* were a substitute to savings and time deposits because they enjoyed a liquidity guarantee from commercial banks. They were discontinued in 1999 and all the outstanding bills have come to maturity.

current discretionary spending has narrowed to 4.4 percent of GDP in 2003 from around 10 percent of GDP in 1993.[6] Cutting public investment is not a sustainable approach to fiscal management given the role of public investment in economic growth.

24. **The main fiscal policy priority should be to reduce these rigidities.** The wage bill now exceeds 12 percent of GDP and shows no sign of declining. The authorities indicated that new recruitment has been limited to higher education and to the health sector. They also stated that the rate of recruitment has decelerated in recent years, but that the qualifications and average salary of those recruited have risen. Thus, they explained that an improvement in the quality of the civil service has not permitted a decline in the wage bill. The staff nevertheless emphasized the importance of lowering the overall wage bill, perhaps in the short term by freezing new net hires. This would also send a clear signal to the labor market that the public sector can no longer absorb excess employment demand. However, in the final analysis, the authorities should consider a comprehensive civil service reform to ensure a fundamental improvement in the structure, cost, and efficiency of the civil service.



25. **On the revenue side,** the authorities believe that their tax reform efforts since the mid-1990s should increase tax buoyancy and offset in part the impact of lower external tariffs over the medium-term.

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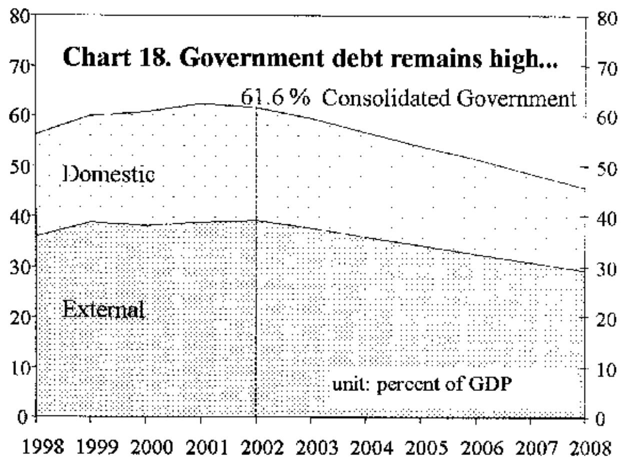
[6] Current spending excluding wages, interest payments and social security transfers.

26. **The level of public debt, at 61 percent of GDP in 2002, is still relatively high.** Indeed, public debt was cited by rating agencies as the key indicator setting Tunisia apart from comparator countries in the BBB rating category. In this respect, fiscal consolidation makes sense as part of efforts to raise public savings over the medium-term and to lower government debt to a level well below 50 percent of GDP. The fiscal sustainability analysis supports this view: at least two stress tests result in high debt levels which fall to only 60 percent of GDP by 2008 (Table 8).



27. **Finally, the authorities must face the projected decline in the social security funds,** both of which suffer from structural imbalances related to a rising dependency rate and generous pension benefits. A fundamental reform of the system was to be launched in 2002 with the preparation of an important, wide-ranging study. For now, the authorities have placed the results of the study and reform plans on the back burner while focusing on rehabilitating the medical insurance system. They expect to turn their attention to the pension system in a few years. Until 2006, the social security funds will maintain near balance as a result of temporary measures introduced in 2002.

Structural Reforms

28. **The authorities are implementing a broad program of structural reforms with support from the World Bank, the EU and the AfDB under the Economic Competitiveness Adjustment Loan (ECAL III).** The loan deals mainly with the private investment climate, telecommunications, and the banking and insurance sectors. The World Bank is also preparing a comprehensive strategy paper on employment and a study on public debt management, on which Fund staff have been consulted. This year, the discussions focused on three key areas that complement the work on macroeconomic policy reform: the financial sector, trade liberalization, and the offshore onshore issue.

Financial Sector

29. **As noted earlier, banking sector financial indicators deteriorated in 2002 owing to weakness in tourism and slow economic growth.** As highlighted in the recent FSAP report, the existing amount of NPLs does not constitute a significant threat to macroeconomic stability. However, it represents a source of inefficiency and distortion in the banking system which needs to be addressed.

Table 1. Tunisia: Commercial Banks Financial Soundness Indicators, 1997–2002

	1997	1998	1999	2000	2001	Prel. 2002
	(In percent; unless otherwise indicated)					
Capital adequacy ratio						
Commercial Banks	6.3	11.7	11.6	13.3	10.6	10.6
Private	6.8	8.9	10.3	11.5	10.4	10.4
Public	5.9	14.6	12.8	15.0	11.0	11.0
Asset Quality						
Gross Nonperforming Loans (in percent of gross assets)	23.0	19.5	18.8	21.6	19.2	20.7
Private	19.4	19.4	18.0	15.3	16.1	17.9
Public	25.8	19.6	19.5	26.8	22.8	24.1
Provisions (in percent of nonperforming loans)	50.4	59.7	58.5	49.2	47.4	41.5
Public	47.5	60.7	58.3	46.6	47.1	38.9
Private	55.3	58.3	58.8	54.7	47.7	44.5
Liquidity ratio (liquid assets/liquid liabilities)	...	...	...	...	97.2	105.1
Sensitivity to Market risk						
Net open position in foreign exchange (in percent of capital)	...	...	1.5	0.1	0.4	0.6
Management Soundness						
Return on Assets	0.8	1.2	1.2	1.2	1.1	0.7
Return on Equity	12.3	13.2	12.7	14.9	14.0	7.4

Source: Central Bank of Tunisia

30. **The mission stressed that public banks, which hold more than half of all NPLs, continue to weigh disproportionately on the system.** Provisioning is low because of over-reliance on collateral, although realization of collateral is difficult. The mission urged the authorities to: (i) expedite the realization of collateral by reforming the judicial process; (ii) increase provisioning and allow its full tax-deductibility; and (iii) further reduce government ownership in the financial sector. The staff underscored the importance of strengthening the banking sector as a prerequisite to greater capital account opening.

31. **The authorities have made progress in implementing the FSAP/FSSA recommendations, particularly in the area of banking sector restructuring.** The government privatized *Union Internationale des Banques* (UIB), and is privatizing its remaining shares in *Banque du Sud.* Steps have been taken to increase the transparency of monetary policy, namely by publishing the conclusions of the monthly BCT board of directors' meetings. The BCT has received technical assistance for the establishment of a deposit insurance system; the regulations on the consolidation of supervision are at an advanced stage; and a draft law on money laundering and the financing of terrorism is being prepared with Fund assistance. In addition, the BCT has started to conduct open market operations. The authorities are considering ways to coordinate the three financial supervisory

agencies.[7] The staff agreed that a liaison committee for the various agencies would be useful, but cautioned that each agency should maintain its independence.

32. **More developed money and foreign exchange markets would reduce the volatility of interest rates and exchange rates.** Efforts to deepen these markets would thus help monetary policy focus on price stability as its overriding objective. To that end, the authorities have taken a number of measures, including opening a small share of the treasury bill market to foreign investors and easing the requirements for opening *bureaux de changes*. The authorities intend to take further measures shortly, including eliminating the obligation to clear foreign exchange positions and phasing out the surrender requirements on export proceeds.

Trade Liberalization

33. **The Tunisian authorities reiterated to the staff their commitment to trade liberalization.** Implementation of the AAEU is on track, with roughly 55 percent of the tariff reductions already in place. A new free trade agreement with Libya entered into force in February 2002, and an electronic trade system (*Tunisie Trade Net*) is operational. Furthermore, negotiations with the World Trade Organization (WTO) for further tariff dismantling are ongoing and the authorities are harmonizing the various regional and bilateral trade agreements in place.

34. **In other respects, Tunisia's external trade regime remains restrictive and complex.** The IMF trade restrictiveness index assigns Tunisia a high rating (8 out of 10) due to high top marginal rates (215 percent), a large number of rates (52 rates), and various types of nontariff barriers. The authorities believe that this index provides a misleading picture of Tunisia's trade regime since it is calculated with unweighted tariffs on a most-favored-nation basis, and hence does not capture the fact that 70 percent of Tunisia's imports come from Europe and are thereby subject to low rates under the AAEU. They stressed that trade liberalization efforts in the context of the AAEU and other bilateral agreements had raised Tunisia's trade openness (the sum of exports and imports as a share of GDP) to 80 percent in 2002. Furthermore, they emphasized that they were lowering actual tariffs well below their committed levels, which are the ones used as a basis for the WTO negotiations. The mission noted that, despite significant progress in trade liberalization under the AAEU, trade openness could increase substantially by reducing non-tariff barriers and streamlining customs procedures, which remain cumbersome.

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[7] The *Conseil du Marché Financier*, the *BCT*, and the *Direction Générale des Assurances*.

Table 2. Tunisia: Summary Tariff Statistics, 2000–02

	MFN Tariffs			EU-Preferential Tariffs		
	2000	2001	2002	2000	2001	2002
Average	35.9	35.9	34.5	28.5	25.6	24.3
Agricultural	77.1	77.1	71.6	77.2	76.7	76.6
Non-agricultural	25	25	22.8	16	12.5	10.9
Maximum	220	220	215	n.a.	n.a.	n.a.

Source: National authorities and staff estimates.

35. **In addition, the mission emphasized that lowering tariffs is essential to reduce distortions and reap the full benefits of trade liberalization.** The staff encouraged the authorities to seek global integration and liberalization beyond the EU. In particular, it recommended:

- Simplifying the tariff system by reducing the number of tariff rates.
- Lowering the average tariff rate applied to products from countries outside the European Union.
- Reviewing technical controls with a view to reducing their number.

Offshore-Onshore Regimes

36. **Tunisia established attractive tax and investment incentives as a key element in their strategy to promote exports.**[8] Since this offshore regime was designed when the trade regime was very restrictive, these advantages contributed to developing a more diversified, competitive export sector, particularly in re-export industries. However, they are now hindering the development of onshore industries. With tariff reductions placing domestic and exporting firms on the same competitive footing with respect to tariff-free imports, the advantages extended to the offshore sector are not justified. The effective tax rate is estimated to vary from 0 percent for offshore companies to 36 percent for full onshore enterprises. This difference has implications for investment decisions and resource allocation, not least because of costs related to administrative complexity and confusion about exemptions. The system has led to a dual economy characterized by a vibrant export sector

[8] Offshore entities are majority foreign-owned (at least 66 percent of equity) and export at least 80 percent of production. They enjoy full tax exemption on profits for the first 10 years, 50 percent reduction in taxes on profits thereafter, and full tax exemption on reinvested profits and revenue; duty-free import of capital goods that have no local equivalents; and full tax and duty exemption on the raw materials, semi-finished goods and services necessary for business. Additional incentives are available to promote investment in certain areas.

and a protected domestic sector. The authorities are aware of the distortions created by the system, and agreed on the need to bring the two regimes closer together.

37. **The staff underscored the need to create a level playing field for all enterprises by phasing out this institutional separation.** Indeed, since offshore companies can access the local market freely, their preferential tax status gives them a competitive advantage vis-à-vis onshore companies. The authorities have introduced measures to align the systems in 2007 by taxing all export activities at 50 percent of the prevailing rate and raising the minimum tax rate. They also put in place a one-stop-shop (*guichet unique*) to simplify and reduce the cost of doing business in Tunisia. The staff encouraged the authorities to move to an even simpler and more transparent system, including moving toward a unified tax rate, and eliminating the release authorization request and technical import controls for the onshore sector.

III. Other Issues

38. **Tunisia's record at improving the quality and dissemination of statistical data and at increasing the transparency of their economic policies is outstanding**. Tunisia's subscription to the Special Data Dissemination Standard (SDDS) in 2001 has improved the frequency and coverage of statistics in all areas. However, information regarding the performance of non-financial public enterprises is not sufficient, although there appears to be no major financial imbalance in the public enterprise sector taken as a whole. More information on the operational and financial position of individual enterprises is needed to assess their viability and to identify possible contingent liabilities for the budget.

39. **The staff discussed with the authorities the inclusion of Collective Action Clauses (CACs) in future bond issues.** The authorities responded positively, indicating that they would consider the issue.

40. **In line with their policy of raising the transparency of economic policy discussions, the staff held their first press conference at the conclusion of the Article IV consultation mission.** The conference attracted interest from both the local and international press. The staff also held other outreach activities, including meetings with trade unions and contacts with two local research institutes, the *Observatoire National de la Conjoncture Économique* and the *Institut d'Économie Quantitative*, with a view to identifying areas for future collaboration in policy analysis and research.

IV. Staff Appraisal

41. **The authorities should be proud of the resilience of the Tunisian economy to the severe shocks experienced in 2002.** Real GDP advanced, despite a fourth year of drought, and the external position improved, despite a drop in tourism and weaker export markets. Tunisia's economic reform strategy has resulted in a more diversified economy and vibrant non-agricultural sector. Even under difficult conditions, non-agricultural activity more than offset the drop in agricultural production in 2002. The key elements of this strategy have been gradual economic liberalization, increased openness, macroeconomic stability, investment in social progress, and inclusive policies aimed at building consensus on reforms

so as to maintain social cohesion. This has led to steady progress in living conditions and enviably low poverty levels.

42. **Macroeconomic management has been impressive.** The authorities used fiscal and monetary policies to ensure that domestic demand growth did not exceed output growth. As a result, Tunisia's external position improved in 2002, at a time when difficulties in both the regional and global environment could have generated a sizable deterioration. These policies also helped Tunisia weather the storm in early 2003.

43. **Prudent macroeconomic management has started to pay dividends**: secondary market spreads on Tunisia's sovereign debt have evolved favorably and its credit rating improved again in 2003. The outlook for 2003 looks favorable, even with the authorities' cautious assumptions on tourism and export growth.

44. **The authorities are targeting a fiscal deficit reduction in 2003, notwithstanding the adverse impact of weak imports and slack domestic demand on government revenues.** This is reassuring given the need to bring the government debt-to-GDP ratio well below 50 percent over the medium-term. Continued fiscal consolidation will also further enhance Tunisia's status on international financial markets.

45. **The central bank's decision to relax monetary conditions in March and June 2003, by lowering the interest rate on refinancing to commercial banks, appears justified given the absence of inflationary pressures and the improved external outlook.** The scope for further easing will depend on domestic demand developments, which the authorities will have to monitor closely.

46. **The resumption in export growth during the first months of the year reaffirms the wisdom of the authorities' decision to let the dinar depreciate by slightly more than needed to maintain the real exchange rate constant.** This has enhanced competitiveness without generating inflationary pressures and is consistent with the authorities' plans for eventually floating the dinar. In the staff's view, they should continue with this approach.

47. **The main risks facing Tunisia relate to the outlook for tourism and prospects in Tunisia's export markets.** Tourism constitutes 17 percent of Tunisia's external receipts and exports have become the main engine of growth. These risks highlight the importance of continuing to follow cautious macroeconomic policies with an increasingly flexible exchange rate. Intensifying structural reforms will help to diversify the economy and further improve its resilience

48. **The authorities are focusing on their medium-term goals:** accelerating growth to bring Tunisia's income level close to that of industrial countries, and reducing unemployment. To meet these challenges, structural reforms will need to be accelerated and macroeconomic policies will need to be adapted to increasing economic and financial integration.

49. **In close collaboration with the staff, the authorities have spelled out a well-sequenced plan to gradually liberalize the capital flows and float the dinar.** This will allow Tunisia to tap foreign savings to finance the investment required to accelerate growth,

to attract foreign direct investment, and to foster financial market development. The first two steps of this plan are: (a) to establish a well defined monetary framework; and (b) to achieve further progress toward fiscal consolidation. These steps will be important to lower vulnerabilities in the transition toward a floating exchange rate regime and open capital account.

50. **Under a well-defined monetary framework, price stability should become the overriding objective for monetary policy, while a floating exchange rate would ensure external equilibrium.** The central bank should adopt broad money as the intermediate target and reserve money as the operational target. Further progress toward strengthening the banking system would be essential to implement this monetary framework in a credible manner. The central bank plans to implement the steps needed to shift the conduct of monetary policy away from the existing practice of credit growth targeting, in particular by translating the annual monetary program into monthly targets for reserve money. The adoption of an explicit inflation-targeting framework will have to wait until financial markets develop sufficiently to provide the central bank with a monetary transmission mechanism that centers on an interest rate as the instrument to directly influence inflation.

51. **Fiscal policy has aimed consistently, albeit gradually, toward consolidation and has achieved a sustainable position.** Further progress would reduce vulnerabilities and should be designed to create room for fiscal maneuvering. The most pressing issue remains the size of the wage bill. While the continuous deceleration in net hiring is welcomed, it does not appear sufficient to lower the wage-bill burden. The authorities should consider a broad-based civil service reform that could yield expenditure savings as well efficiency gains.

52. **Tunisia has achieved substantial progress in structural reform under the World Bank ECAL III, although important structural impediments to growth persist.** In the context of reform of the macroeconomic framework, an intensification of the reform efforts in three key areas is essential to achieve the authorities' ambitious growth objectives.

53. **First, banking sector weaknesses hamper the efficient functioning of the financial system and could constrain monetary policy, even if they do not constitute a threat to macroeconomic stability.** While the deterioration in banks' financial positions reflects the difficulties in the tourism sector and the slowdown in economic activity in 2002, it nevertheless underscores the urgency to move forward with full provisioning of NPLs.

54. **Second, trade protection could be lowered.** It is true that the authorities have pursued trade liberalization in the context of the AAEU and remain committed to multilateral liberalization in the context of the WTO negotiations. However, the openness of the Tunisian economy could be raised significantly with a lower number of tariff rates, simpler and fewer technical controls, and streamlined customs procedures. These measures would not only reduce costly trade distortions but also greatly facilitate domestic private activity.

55. **Third, the special tax and administrative regime for the offshore sector has produced significant distortions, even though it has helped Tunisia's export performance.** The authorities have introduced measures that will reduce, in 2007, the preferential tax treatment accorded to the offshore sector. In the short-term, a rationalization

of the administrative procedures and controls that burden the onshore sector, especially with respect to customs, could go a long way toward improving their export performance.

56. **The authorities continue to advance the transparency of economic policy.** Tunisia has published the concluding statements of Fund missions and routinely publishes staff reports on article IV consultations. The central bank's decision to publish the conclusions of its board meetings should be commended.

57. It is proposed that the next Article IV consultation will take place within the standard 12-month cycle.

Table 1. Tunisia: Selected Economic and Financial Indicators, 1999–2003

	1999	2000	2001	Est. 2002	Proj. 2003
Production and income (percent change)					
Nominal GDP	9.3	8.2	7.7	4.0	7.7
Real GDP	6.1	4.7	4.9	1.7	5.5
GDP deflator	3.1	3.3	2.7	2.3	2.1
Consumer price index (CPI), average	2.7	3.0	1.9	2.8	2.5
Gross national savings (in percent of GDP)	24.1	23.1	23.5	21.8	22.3
Gross investment (in percent of GDP)	26.3	27.3	27.8	25.3	25.5
External sector (percent change)					
Exports of goods, f.o.b. (in US$)	2.3	-0.4	13.2	3.8	15.8
Imports of goods, f.o.b. (in US$)	1.6	1.0	11.3	-0.2	13.4
Exports of goods, f.o.b. (volume)	6.7	7.3	15.7	1.9	8.3
Import of goods, f.o.b. (volume)	5.8	6.5	13.6	-2.4	3.8
Trade balance (in percent of GDP)	-10.3	-11.6	-12.0	-10.1	-9.2
Current account, excl. grants (in percent of GDP)	-2.2	-4.2	-4.3	-3.5	-3.1
Terms of trade (deterioration -)	-0.1	-2.2	0.2	-0.7	...
Real effective exchange rate (depreciation -) 1/	1.0	-1.7	-2.4	-1.2	...
Central government (percent of GDP) 2/					
Total revenue, excluding grants	23.9	24.0	24.4	24.4	24.0
Total expenditure and net lending	27.8	27.8	28.1	27.9	27.1
Central government balance, excl. grants and privatization	-3.9	-3.8	-3.8	-3.5	-3.1
Central government balance, incl. grants, excl. privatization	-3.5	-3.7	-3.5	-3.1	-2.8
Total government debt (foreign and domestic)	60.0	60.7	62.4	61.6	58.9
Money and credit (percent change)					
Credit to the economy	8.5	8.0	10.3	5.4	7.4
Broad money (M3)	18.6	13.2	11.3	5.2	8.4
Velocity of circulation (GDP/M3)	1.79	1.71	1.65	1.63	1.62
Interest rate (money market rate, in percent, end-of-period)	5.88	5.88	5.94	5.91	...
Official reserves					
Gross official reserves (US$ billions, end-of-period)	2.3	1.8	2.0	2.3	2.6
In months of imports of goods, c.i.f.	3.2	2.6	2.5	2.9	2.9
Total external debt					
External debt (US$ billions)	11.8	11.5	11.8	13.7	14.7
External debt (in percent of GDP)	60.1	59.7	60.2	61.0	60.3
Debt service ratio (percent of exports of GNFS)	18.5	22.6	15.6	17.2	16.4
Financial market indicators					
Stock market index 4/	1193	1443	1267	1119	1157
Memorandum items:					
GDP at current prices (US$ billions)	20.8	19.5	20.0	21.3	24.4
Exchange rate: dinar/US$ (average)	1.19	1.37	1.44	1.42	...

Sources: Data provided by the Tunisian authorities; includes Fund staff projections for 2002, 2003

1/ Information Notice System.

2/ Excludes the social security accounts.

3/ Includes grants, excludes privatization.

4/ TUNINDEX. (1000 = 4/1/1998). For 2003: June 13, 2003

Table 2. Tunisia: Balance of Payments, 1999–2003

(In millions of U.S. dollars)

	1999	2000	2001	Est. 2002	Proj. 2003
Current account	-447	-821	-863	-746	-765
Trade balance	-2,146	-2,251	-2,391	-2,124	-2,246
Exports	5,862	5,836	6,606	6,857	7,938
Energy	419	705	610	637	720
Nonenergy	5,443	5,131	5,996	6,220	7,219
Imports	-8,008	-8,087	-8,997	-8,981	-10,184
Energy	-540	-874	-885	-846	-920
Nonenergy	-7,468	-7,214	-8,112	-8,134	-9264
Services and transfers (net)	1,699	1,430	1,528	1,378	1481
Nonfactor	1,744	1,609	1,550	1,328	1,379
Of which: Tourism	1,644	1,527	1,627	1,422	1,561
Factor services and transfers (net)	-45	-178	-22	49	102
Of which: Workers' remittances	858	795	927	1,070	1,182
Interest payments on external debt	-530	-515	-485	-517	-576
Capital and financial account	1,139	578	1,123	885	1,052
Excluding grants	1066	569	1068	802	923
Capital account	59	3	53	76	129
Financial acount	1,079	575	1,071	810	923
Direct foreign investment (net)	357	730	443	801	504
Medium and long-term loans (net)	468	223	883	791	685
Disbursement	1,501	1,596	1,842	1,899	1,871
Amortization	-1,032	-1,373	-959	-1,108	-1,185
Short-term	250	-348	-231	-749	-266
Errors and omissions (including financing gap)	5	-30	-24	-34	0
Overall balance	692	-243	260	139	287
Changes in gross reserves 1/	-423	465	-154	-349	-291
Use of IMF resources	50	40	31	0	0
Other assets, net (increase -)	-473	425	-185	-349	-291
Memorandum items:					
Current account balance/GDP (in percent)	-2.2	-4.2	-4.3	-3.5	-3.1
Reserves (in billions of US$)	2.3	1.8	2.0	2.3	2.6
Reserves in months of imports	3.2	2.6	2.5	2.9	2.9
External medium- and long-term debt (in billions of US$)	10.3	9.9	10.2	12.1	13.0
External medium- and long-term debt/GDP (in percent)	52.2	51.5	52.3	53.8	53.1
External short-term debt (in billions of US$)	1.6	1.6	1.6	1.6	1.8
External short-term debt/GDP (in percent)	7.9	8.3	7.9	7.2	7.2
Debt service ratio (as percentage of exports GNFS)	18.5	22.6	15.6	17.2	16.4
Real goods export growth (in percent)	6.7	7.3	15.7	1.9	8.3
Nonenergy	5.6	6.3	19.0	-0.8	7.9
Real goods import growth (in percent)	5.8	6.5	13.6	-2.4	3.8
Nonenergy	4.1	7.4	13.6	-4.0	3.3

Sources: Tunisian authorities; and Fund staff estimates and projections.

1/ Differs from the overall balance because of valuation effects.

Table 3. Tunisia: Central Government Financial Operations, 1999–2003 1/

	1999	2000	2001	2002	Proj 2003
	In millions of Dinars				
Total revenue and grants and privatization	5,984	6,773	7,096	7,746	7,863
Total revenue	5,900	6,396	7,006	7,289	7,729
Tax revenue	5,208	5,678	6,222	6,436	6,725
Of which: income taxes	1,387	1,597	1,831	2,031	2,161
VAT	1,625	1,770	2,101	1,895	2,056
trade taxes	731	642	876	595	612
Nontax revenue	692	718	785	853	1,004
Total expenditure and net lending	6,854	7,423	8,090	8,330	8,716
Total expenditure	6,786	7,288	7,929	8,231	8,516
Current expenditure	5,079	5,308	5,590	5,997	6,332
Wages and salaries	2,886	3,103	3,425	3,645	3,923
Goods and services	373	604	491	628	602
Interest payments	840	887	885	915	1,008
domestic	390	396	396	380	415
external	450	491	489	535	593
Transfers and subsidies	981	714	789	809	799
Capital expenditure	1,707	1,980	2,340	2,234	2,184
Direct investment	1,072	1,161	1,416	1,323	1,299
Capital transfers and equity	635	820	924	911	885
Other expenditure (non allocated)	0	0	0	0	49
Net lending	68	135	161	99	150
Central Govt deficit (-), excluding grants and privatization	-955	-1,027	-1,084	-1,041	-987
Grants	83	34	79	118	84
Privatization Proceeds 2/	1	342	11	339	50
Central Govt deficit (-), including grants and privatization	-871	-650	-995	-584	-853
Financing	871	650	995	584	853
Foreign	350	-51	1,089	683	882
Domestic	521	701	-95	-99	-29
Memorandum items:					
Balance of the central Gov., (incl. grants, excl. privatization)	-871	-993	-1,006	-923	-903
Central government primary balance	-32	-105	-121	-8	105
Central govt primary balance excl grants+priv.	-115	-140	-199	-126	21
Central government debt	14,794	16,201	17,926	18,397	18,960
Of which: domestic	5,218	6,041	6,774	6,715	6,920
external	9,576	10,160	11,152	11,682	12,040
Nominal GDP	24,672	26,685	28,741	29,886	32,188

Table 3. Tunisia: Central Government Financial Operations, 1999–2003 1/ (concluded)

	1999	2000	2001	2002	Proj. 2003
	(In percent of GDP)				
Total revenue and grants and privatization	24.3	25.4	24.7	25.9	24.4
Total revenue	23.9	24.0	24.4	24.4	24.0
Tax revenue (excludes Social Security Contributions)	21.1	21.3	21.6	21.5	20.9
Of which: income taxes	5.6	6.0	6.4	6.8	6.7
VAT	6.6	6.6	7.3	6.3	6.4
trade taxes	3.0	2.4	3.0	2.0	1.9
Nontax revenue	2.8	2.7	2.7	2.9	3.1
Total expenditure and net lending	27.8	27.8	28.1	27.9	27.1
Total expenditure	27.5	27.3	27.6	27.5	26.5
Current expenditure	20.6	19.9	19.4	20.1	19.7
Wages and salaries	11.7	11.6	11.9	12.2	12.2
Goods and services	1.5	2.3	1.7	2.1	1.9
Interest payments	3.4	3.3	3.1	3.1	3.1
domestic	1.6	1.5	1.4	1.3	1.3
external	1.8	1.8	1.7	1.8	1.8
Transfers and subsidies	4.0	2.7	2.7	2.7	2.5
Capital expenditure	6.9	7.4	8.1	7.5	6.8
Direct investment	4.3	4.3	4.9	4.4	4.0
Capital transfers and equity	2.6	3.1	3.2	3.0	2.7
Other expenditure (non allocated)	0.0	0.0	0.0	0.0	0.2
Net lending	0.3	0.5	0.6	0.3	0.5
Central Govt deficit (-), excluding grants and privatization	-3.9	-3.8	-3.8	-3.5	-3.1
Grants	0.3	0.1	0.3	0.4	0.3
Privatization Proceeds 2/	0.0	1.3	0.0	1.1	0.2
Central Govt deficit (-), including grants and privatization	-3.5	-2.4	-3.5	-2.0	-2.6
Financing	3.5	2.4	3.5	2.0	2.6
Foreign	1.4	-0.2	3.8	2.3	2.7
Domestic	2.1	2.6	-0.3	-0.3	-0.1
Memorandum items:					
Balance of the central gov, (incl. grants, excl privatization)	-3.5	-3.7	-3.5	-3.1	-2.8
Central government primary balance	-0.1	-0.4	-0.4	0.0	0.3
Central government debt 3/	60.0	60.7	62.4	61.6	58.9
Of which: domestic	21.1	22.6	23.6	22.5	21.5
external	38.8	38.1	38.8	39.1	37.4
Nominal GDP	24,672	26,685	28,741	29,886	32,188

Sources: Tunisian authorities, and Fund staff estimates

1/ Includes special funds, *fonds de concours*. Does not include the social security system (CSS).

2/ Privatization in 2002 includes sale of GSM license (US$454 million) and sale UIB (TD 100 million)

3/ Gross debt: includes debt held by social security funds (CSS); excludes debt of public enterprises.

Table 4. Tunisia: Monetary Survey, 1999–2003 1/

	1999	2000	2001	2002	Staff Proj. 2003
	(In millions of dinars; end of period)				
Foreign assets (net)	1,842	1,408	1,597	1,900	2,255
Net domestic assets	11,965	14,226	15,805	16,414	17,593
Domestic credit	18,380	20,576	22,311	23,495	25,017
Credit to the government (net)	1,892	2,773	2,674	2,793	2,783
Credit to the economy	16,488	17,804	19,637	20,703	22,235
Other items (net)	-6,415	-6,351	-6,506	-7,081	-7,425
Money plus quasi-money (M2)	12,816	14,550	16,052	16,696	17,982
Money	5,554	6,128	6,745	6,622	7,132
Currency	1,994	2,228	2,378	2,517	2,711
Demand deposits	3,560	3,899	4,367	4,105	4,421
Quasi-money	7,262	8,423	9,307	10,074	10,850
Long-term deposits	991	1,083	1,350	1,619	1,866
Broad money (M3) 2/	13,806	15,634	17,402	18,315	19,847
Liquid treasury bills	1,800	815	265	54	0
Short-term commercial paper	627	511	381	402	457
Liquidity aggregate (M4) 3/	16,234	16,960	18,048	18,770	20,304
	(Annual rate of change in percent)				
Foreign assets (net)	34.1	-23.5	13.4	19.0	18.6
Domestic credit	11.7	11.9	8.4	5.3	6.5
Credit to government (net)	51.2	46.5	-3.6	4.4	-0.4
Credit to the economy	8.5	8.0	10.3	5.4	7.4
Broad money (M3)	18.6	13.2	11.3	5.2	8.4
Liquidity aggregate (M4)	9.4	4.5	6.4	4.0	8.2
	(Changes in percent of initial stock of M3)				
Foreign assets (net)	4.0	-3.1	1.2	1.7	1.9
Domestic credit	16.5	15.9	11.1	6.8	8.3
Credit to the government (net)	5.5	6.4	-0.6	0.7	-0.1
Credit to the economy	11.0	9.5	11.7	6.1	8.4
Other items (net)	-2.0	0.5	-1.0	-3.3	-1.9
Memorandum items:					
Velocity (GDP/M3)	1.79	1.71	1.65	1.63	1.62
Velocity (GDP/M4)	1.52	1.57	1.59	1.59	1.59
Multiplier (M2/M0)	4.51	5.39	5.08	5.18	5.18
GDP (in millions of dinars)	24,672	26,685	28,741	29,886	32,188
Nominal GDP growth (percent)	9.3	8.2	7.7	4.0	7.7

Sources: Tunisian authorities; and Fund staff estimates and projections.

1/ Monetary survey data includes development banks.

2/ M2 plus long term deposits.

3/ M3 plus liquid treasury bills (*bons cessibles*) and short-term commercial paper (*billets de trésorerie*).

Table 5. Tunisia: Indicators of External Vulnerability, 1999–2003

	1999	2000	2001	Est. 2002	Proj. 2003
Balance of payments					
Exports (percent change, 12-month basis in US$)	2.3	-0.4	13.2	3.8	15.8
Imports (percent change, 12-month basis in US$)	1.6	1.0	11.3	-0.2	13.4
Exports of goods, f.o.b. (volume percent change)	6.7	7.3	15.7	1.9	8.3
Imports of goods, f.o.b. (volume percent change)	5.8	6.5	13.6	-2.4	3.8
Terms of trade (percent change, 12 months basis)	-0.1	-2.2	0.2	-0.7	-2.0
Trade balance (in percent of GDP)	-10.3	-11.6	-12.0	-10.1	-9.2
Current account balance (in percent of GDP)	-2.2	-4.2	-4.3	-3.5	-3.1
Capital and financial account balance (in percent of GDP)	5.5	3.0	5.6	4.2	4.3
Short-term foreign assets and liabilities of the banking and corporate sector					
Gross official reserves (in billions of US$)	2.3	1.8	2.0	2.3	2.7
Gross official reserves (in months of imports goods, cif)	3.2	2.6	2.5	2.9	2.9
Central bank short-term foreign liabilities (in billions of US$)	0.1	0.2	0.2	0.1	0.1
External debt and debt service					
External debt (in billions of US$)	11.8	11.5	11.8	13.7	14.7
Medium and long-term public debt (in billions of US$)	10.3	9.9	10.2	12.1	13.0
Short-term debt (in billions of US$)	1.6	1.6	1.6	1.6	1.8
Total external debt /GDP (percent)	60.1	59.7	60.2	61.0	60.3
Medium and long-term public debt/GDP (in percent)	52.2	51.5	52.3	53.8	53.1
Short-term debt/GDP (in percent)	7.9	8.3	7.9	7.2	7.2
Reserves/total short term external debt (percent) 1/	149.1	116.0	128.8	146.6	150.8
excluding non-residents deposits	290.5	259.2	316.5	417.3	379.0
Reserves/short term debt including current amortization (percent)	91.3	62.6	80.2	84.4	89.8
excluding non-residents deposits	130.2	89.1	127.2	134.7	140.0
Debt service ratio (debt service as percent of exports GNFS)	18.5	22.6	15.6	17.2	16.4
External interest payments (as percent of exports GNFS)	6.1	6.0	5.1	5.5	5.4
External amortization payments (as percent of exports GNFS)	12.4	16.5	10.5	11.7	11.0
Exchange rate (per U.S. dollar, period average)	1.19	1.37	1.44	1.42	...
REER appreciation (+, percent change 12 months basis)	1.0	-1.7	-2.4	-1.2	...
Financial market indicators					
Stock market index 2/	1,193	1,443	1,267	1,119	1,157
Foreign currency debt rating 3/	BBB-	BBB	BBB	BBB	...
Spread over benchmark bonds (basis points, end of period)	250	130	170	230	...

Sources: Tunisian authorities, and Fund staff estimates.

1/ Short-term defined as 1 year and less.
2/ TUNINDEX. (1000 = 4/1/1998); 2003 from June 13, 2003
3/ S&P long-term foreign currency rating.

Table 6. Tunisia: Medium-Term Growth Scenario, 2002–2008

	2002	2003	2004	2005	2006	2007	2008
				(In percent)			
Real GDP growth	1.7	5.5	5.8	6.0	6.0	6.3	6.6
Agriculture 1/	-11.0	17.0	6.0	4.0	4.0	4.0	4.0
Nonagriculture	3.4	4.1	5.8	6.3	6.3	6.6	6.9
Unemployment rate	14.9	14.7	14.1	13.6	13.2	12.6	12.0
Inflation	2.8	2.5	2.5	2.5	2.5	2.6	2.6
Real export growth 2/	-1.7	6.4	6.1	6.8	6.4	6.2	6.3
				(In percent of GDP)			
Gross national savings	21.8	22.3	22.6	23.2	23.8	24.3	24.9
Consolidated government 3/	5.1	4.9	5.0	5.2	5.4	5.5	5.6
Rest of the economy	16.6	17.4	17.5	18.0	18.4	18.8	19.4
Gross investment	25.3	25.5	25.7	26.2	26.7	27.0	27.6
Consolidated government	7.5	6.8	7.1	7.2	7.3	7.3	7.3
Rest of the economy	17.8	18.7	18.6	19.0	19.4	19.8	20.3
Savings-investment gap	-3.5	-3.1	-3.2	-3.0	-2.9	-2.7	-2.6
Consolidated government	-2.4	-1.9	-2.1	-2.0	-1.9	-1.8	-1.7
Rest of the economy	-1.2	-1.2	-1.1	-1.0	-1.0	-0.9	-0.9
Memorandum items:							
Balance of the consolidated government 4/	-2.4	-1.9	-2.1	-2.0	-1.9	-1.8	-1.7
Balance of the central government 5/	-3.1	-2.8	-2.5	-2.3	-2.1	-1.9	-1.7
External current account	-3.5	-3.1	-3.2	-3.0	-2.9	-2.7	-2.6
Gross fixed capital formation	24.8	25.3	25.6	26.1	26.7	26.9	27.4

Source: IMF staff estimates from 2001.

1/ Based on average growth of agricultural output from 2001 onwards.
2/ Goods and nonfactor services.
3/ Includes social security, excludes privatization receipts and net lending.
4/ Includes social security and net lending, excludes privatization receipts.
5/ Excludes social security and privatization receipts.

Table 7. Tunisia: Balance of Payments, 2002–2008

(In millions of U.S. dollars)

	Est.	Projections					
	2002	2003	2004	2005	2006	2007	2008
Current account	-746	-765	-836	-853	-877	-898	-943
Trade balance	-2,124	-2,246	-2,515	-2,776	-2,957	-3,156	-3,368
Exports	6,857	7,938	8,514	9,169	9,927	10,763	11,689
Energy	637	720	745	716	684	665	653
Non-energy	6,220	7,219	7,769	8,453	9,243	10,097	11,036
o/w nonfood	5732	6590	7077	7694	8415	9198	10059
Imports	-8,981	-10,184	-11,029	-11,944	-12,884	-13,918	-15,057
Energy	-846	-920	-999	-1,074	-1,156	-1,240	-1,329
Non-energy	-8,134	-9,264	-10,031	-10,871	-11,727	-12,678	-13,728
o/w nonfood	-7,860	-9,025	-9,792	-10,620	-11,462	-12,400	-13,438
Services and Transfers (net)	1,378	1,481	1,679	1,923	2,080	2,258	2,425
Nonfactor	1,328	1,379	1,562	1,786	1,967	2,134	2,316
o/w Tourism	1,422	1,561	1,770	2,013	2,238	2,421	2,606
Factor Services and Transfers (net)	49	102	117	137	113	124	109
o/w Workers' remittances	1,070	1,182	1,271	1,333	1,410	1,518	1,634
Interest payments on external debt	-517	-576	-634	-688	-754	-820	-885
Capital and financial account	885	1,052	1,047	1,187	1,152	1,146	1,251
Excluding grants	802	923	933	1,074	1,040	1,035	1,141
Capital account	76	129	106	105	104	104	103
Financial account	810	923	941	1,082	1,048	1,042	1,149
Direct foreign investment (net)	801	504	919	832	837	846	880
Medium and long term loans (net)	791	685	44	272	233	220	292
Disbursement	1,899	1,871	1,527	1,684	1,890	1,830	1,761
Amortization	-1,108	-1,185	-1,483	-1,412	-1,656	-1,611	-1,469
Short term capital	-749	-266	-22	-23	-23	-24	-24
Errors and omissions	-34	0	0	0	0	0	0
Overall balance	139	287	211	334	275	248	309
Changes in gross reserves 1/	-349	-291	-201	-325	-265	-234	-293
Use of IMF resources	0	0	0	0	0	0	0
Other assets, net (increase -)	-349	-291	-201	-325	-265	-234	-293
Memorandum items:							
Current account balance/GDP (in percent)	-3.5	-3.1	-3.2	-3.0	-2.9	-2.7	-2.6
Reserves (in billions of US$)	2.3	2.6	2.8	3.1	3.4	3.6	3.9
Reserves in months of imports	2.9	2.9	2.9	3.0	3.0	3.0	3.0
External medium-and long-term debt (in billions of US$	12.1	13.0	13.0	13.3	13.5	13.7	13.9
External medium-and long-term debt/GDP (in percent)	53.8	53.1	49.5	46.9	44.2	41.3	38.5
External Short-term debt (in billions of US$)	1.6	1.8	1.9	2.0	2.1	2.3	2.5
External short-term debt/GDP (in percent)	7.2	7.2	7.1	7.1	7.0	6.9	6.8
Debt Service Ratio (as percentage of exports GNFS)	17.2	16.4	18.2	16.5	17.5	16.2	14.6
Real goods export growth (in percent)	1.9	8.3	5.2	5.7	5.7	6.0	6.4
Non-energy	-0.8	7.9	5.8	7.3	7.2	7.2	7.4
Real goods import growth (in percent)	-2.4	3.8	5.7	6.1	5.9	5.9	5.9
Non-energy	-4.0	3.3	5.6	6.1	5.9	5.9	5.9

Sources: Tunisian authorities; and Fund staff estimates and projections.

1/ Differs from the overall balance because of valuation effects.

Table 8. Tunisia: Public Sector Debt Sustainability Framework, 1997–2007

(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
I. Baseline Medium-Term Projections											
1 Public sector debt 1/	62.2	56.3	60.0	60.7	62.4	61.6	58.9	56.1	53.4	50.8	48.1
o/w foreign-currency denominated	37.5	34.9	38.4	39.3	39.1	38.3	37.4	35.6	33.9	32.3	30.5
2 Change in public sector debt	1.6	-5.9	3.7	0.7	1.7	-0.8	-2.7	-2.8	-2.7	-2.6	-2.7
3 Identified debt-creating flows (4+7+12)	3.8	-5.5	2.2	3.5	0.7	-4.7	-3.2	-2.2	-2.2	-2.1	-2.3
4 Primary deficit	0.4	-0.6	-1.1	-0.1	-0.3	-0.7	-1.2	-0.9	-0.8	-0.8	-0.7
5 Revenue and grants	28.7	29.6	29.5	29.4	30.1	30.6	30.2	29.5	29.3	29.3	29.3
6 Primary (noninterest) expenditure	29.1	28.9	28.3	29.4	29.9	30.0	29.0	28.6	28.5	28.5	28.6
7 Automatic debt dynamics 2/	3.4	-3.0	3.3	2.8	0.9	-2.9	-1.8	-1.3	-1.4	-1.4	-1.6
8 Contribution from interest rate/growth differential 3/	-1.9	-1.5	-1.4	-1.2	-1.3	0.7	-1.3	-1.6	-1.7	-1.6	-1.8
9 Of which contribution from real interest rate	1.1	1.2	1.7	1.4	1.5	1.7	1.9	1.6	1.5	1.4	1.1
10 Of which contribution from real GDP growth	-3.0	-2.8	-3.1	-2.6	-2.7	-1.0	-3.1	-3.2	-3.1	-3.0	-2.9
11 Contribution from exchange rate depreciation 4/	5.2	-1.5	4.7	4.0	2.2	-3.6	-0.5	0.3	0.2	0.2	0.2
12 Other identified debt-creating flows	0.0	-1.9	0.0	0.7	0.0	-1.1	-0.2	0.0	0.0	0.0	0.0
13 Privatization receipts (negative)	0.0	-1.9	0.0	-1.3	0.0	-1.1	-0.2	0.0	0.0	0.0	0.0
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3)	-2.2	-0.4	1.5	-2.7	1.0	3.9	0.5	-0.6	-0.5	-0.5	-0.5
Public sector debt-to-revenue ratio 1/	216.6	190.5	203.5	206.3	207.1	200.8	195.0	190.0	182.2	173.5	164.3
Gross financing need 5/	9.8	8.2	5.4	8.4	5.9	5.9	5.0	5.7	4.8	5.1	4.4
in billions of U.S. dollars	1.9	1.6	1.1	1.6	1.2	1.2	1.2	1.5	1.4	1.6	1.5
Key Macroeconomic and Fiscal Assumptions											
Real GDP growth (in percent)	5.4	4.8	6.1	4.7	4.9	1.7	5.5	5.8	6.0	6.0	6.3
Average nominal interest rate on public debt (in percent) 6/	6.2	5.3	6.6	6.0	5.5	5.1	5.5	5.5	5.3	5.3	5.3
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.3	2.3	3.5	2.7	2.8	2.8	3.4	3.1	2.9	3.0	2.6
Nominal appreciation (increase in US dollar value of local currency, in percent)	-13.0	4.2	-12.1	-9.6	-5.7	10.1	1.4	-0.9	-0.7	-0.7	-0.8
Inflation rate (GDP deflator, in percent)	4.0	3.0	3.1	3.3	2.7	2.3	2.1	2.4	2.4	2.4	2.7
Growth of real primary spending (deflated by GDP deflator, in percent)	-1.5	4.2	3.8	8.5	6.6	1.9	2.0	4.5	5.7	6.1	6.4
II. Stress Tests for Public Debt Ratio											
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2007						61.6	59.8	57.9	56.1	54.4	52.8
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004						61.6	59.4	57.3	54.5	51.9	49.1
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						61.6	61.4	61.3	58.4	55.6	52.7
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004						61.6	61.4	60.8	58.0	55.3	52.4
5. Combination of 2-4 using one standard deviation shocks						61.6	62.1	62.6	58.2	54.0	49.6
6. One time 30 percent real depreciation in 2003 7/						61.6	77.3	74.1	71.0	67.9	64.7
7. 10 percent of GDP increase in other debt-creating flows in 2003						61.6	68.9	65.9	63.0	60.1	57.1

Historical Statistics for Key Variables (past 10 years)	Historical Average	Standard Deviation	Average 2002-07
Primary deficit	-0.2	0.7	-0.9
Real GDP growth (in percent)	4.8	1.9	5.2
Nominal interest rate (in percent) 6/	6.5	0.9	5.3
Real interest rate (in percent)	2.5	0.9	3.0
Inflation rate (GDP deflator, in percent)	4.1	1.0	2.4
Revenue to GDP ratio	30.0	0.8	29.7

1/ General government debt, in gross terms.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

6/ Derived as nominal interest expenditure divided by previous period debt stock.

7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 9. Tunisia: External Debt Sustainability Framework, 1997–2007

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
I. Baseline Medium-Term Projections												
1 External debt	58.7	58.4	57.0	59.1	59.0	64.8	61.9	57.6	54.5	51.4	48.1	44.8
2 Change in external debt	0.4	-0.4	-1.4	2.1	-0.1	5.8	-2.9	-4.2	-3.1	-3.1	-3.3	-3.2
3 Identified external debt-creating flows (4+8+11)	2.9	-2.8	-2.2	4.3	1.3	-2.7	-5.5	-4.2	-3.7	-3.5	-3.5	-6.3
4 Current account deficit, excluding interest payments	0.0	0.4	-0.6	1.4	1.9	1.1	0.8	0.8	0.6	0.4	0.2	0.2
5 Deficit in balance of goods and services	2.3	3.0	1.9	3.3	4.2	3.8	3.6	3.7	3.5	3.3	3.1	2.9
6 Exports	43.1	42.6	42.0	43.9	47.3	44.8	45.1	45.1	45.3	45.3	45.0	44.5
7 Imports	45.4	45.6	44.0	47.2	51.5	48.6	48.7	48.8	48.8	48.6	48.1	47.4
8 Net non-debt creating capital inflows (negative)	-2.4	-3.4	-1.7	-3.8	-2.1	-3.8	-2.1	-3.6	-3.0	-2.8	-2.6	-5.3
9 Net foreign direct investment, equity	1.8	3.3	1.7	3.9	2.2	3.8	2.1	3.6	3.0	2.8	2.5	2.4
10 Net portfolio investment,equity	0.6	0.2	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	2.9
11 Automatic debt dynamics 1/	5.2	0.2	0.2	6.7	1.6	0.0	-4.2	-1.5	-1.3	-1.1	-1.2	-1.2
12 Contribution from nominal interest rate	3.1	3.0	2.8	2.9	3.1	3.2	3.3	3.3	3.3	3.1	3.1	3.0
13 Contribution from real GDP growth	-3.3	-2.7	-3.4	-2.8	-2.8	-0.9	-3.1	-3.3	-3.2	-3.0	-3.0	-2.9
14 Contribution from price and exchange rate changes 2/	5.4	-0.1	0.8	6.6	1.3	-2.2	-4.3	-1.5	-1.3	-1.3	-1.4	-1.3
14 Residual, incl. change in gross foreign assets (2-3)	-2.5	2.5	0.8	-2.2	-1.4	8.5	2.6	0.0	0.5	0.4	0.2	3.0
External debt-to-exports ratio (in percent)	136.3	137.1	135.6	134.6	124.8	144.4	137.1	127.7	120.4	113.4	106.7	100.8
Gross external financing need (in billions of US dollars) 3/	3.1	3.2	3.1	3.7	3.4	3.4	2.0	2.3	2.3	2.5	2.5	2.4
in percent of GDP	16.5	16.1	14.8	19.2	17.1	16.3	8.2	9.0	8.1	8.3	7.6	6.6
Key Macroeconomic and External Assumptions												
Real GDP growth (in percent)	5.4	4.8	6.1	4.7	4.9	1.7	5.5	5.8	6.0	6.0	6.3	6.6
Exchange rate appreciation (US dollar value of local currency, change in percent)	-12.0	-2.7	-4.3	-13.3	-4.7	1.6	4.9	0.0	0.0	0.0	0.0	0.0
GDP deflator in US dollars (change in percent)	-8.5	0.2	-1.3	-10.4	-2.1	3.9	7.1	2.4	2.4	2.4	2.7	2.8
Nominal external interest rate (in percent)	5.1	5.3	5.0	4.7	5.4	5.7	5.7	5.8	6.1	6.3	6.7	6.9
Growth of exports (US dollar terms, in percent)	0.3	3.7	3.3	-2.0	10.5	0.2	13.6	8.4	8.9	8.6	8.5	8.1
Growth of imports (US dollar terms, in percent)	3.0	5.5	0.9	0.7	11.9	-0.3	13.3	8.5	8.5	8.0	8.1	7.8
II. Stress Tests for External Debt Ratio												
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in 2003-2007						64.8	66.5	65.7	65.4	64.9	64.3	66.5
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004						64.8	62.3	58.5	55.4	52.2	48.9	45.6
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						64.8	64.5	63.2	59.9	56.7	53.2	49.9
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004						64.8	78.1	89.8	85.9	82.2	78.1	74.2
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004						64.8	66.9	67.7	64.4	61.0	57.5	54.0
6. Combination of 2-5 using one standard deviation shocks						64.8	76.5	85.6	81.8	78.1	74.2	70.3
7. One time 30 percent nominal depreciation in 2003						64.8	92.1	87.1	83.3	79.6	75.6	71.7

Historical Statistics for Key Variables (past 10 years)	Historical Average	Standard Deviation	Average 2002-07
Current account deficit, excluding interest payments	1.4	2.2	0.6
Net non-debt creating capital inflows	2.7	1.0	3.0
Nominal external interest rate (in percent)	5.5	0.5	6.0
Real GDP growth (in percent)	4.8	1.9	5.2
GDP deflator in US dollars (change in percent)	-0.2	7.7	3.5

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

TUNISIA: FUND RELATIONS

[As of April 30, 2003]

I. **Membership Status:** Joined: 04/14/1958; Article VIII

II. **General Resources Account:**	SDR Million	%Quota
Quota	286.50	100.0
Fund Holdings of Currency	266.34	92.96
Reserve position in Fund	20.17	7.04

III. **SDR Department:**	SDR Million	%Allocation
Net cumulative allocation	34.24	100.0
Holdings	5.66	16.52

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
EFF	07/25/1988	07/24/1992	207.30	207.30
Stand-by	11/04/1986	05/31/1988	103.65	91.00

VI. **Projected Obligations to Fund:** (SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2003	2004	2005	2006	2007
Principal					
Charges/Interest	0.38	0.50	0.50	0.50	0.50
Total	0.38	0.50	0.50	0.50	0.50

Exchange Rate Arrangement and Exchange System

Tunisia accepted the obligations of Article VIII Sections 2,3, and 4 effective January 6, 1993 and maintains an exchange system that is free of restrictions on the making of payments and transfers on current international transactions, except for certain restrictions relating to Iraq and the Federal Republic of Yugoslavia (Serbia and Montenegro), pursuant to UN Security Council Resolutions. These are subject to notification to the Fund in accordance with Decision 144 (52/51). Tunisia also maintains a multiple currency practice resulting from honoring exchange rate guarantees extended prior to August, 1988 to development banks, which will automatically expire after the existing commitments have matured.

The Central Bank of Tunisia sets the daily official exchange rate in the context of its policy of broadly keeping constant the real effective exchange rate. Since March 1, 1994, the market rates are determined in an interbank foreign exchange market. On June 23, 2003, the interbank rate of the dinar vis-à-vis the U.S. dollar was US$1=TD 1.261, equivalent to SDR 1=TD 1.777.

Article IV Consultation

Tunisia is on the 12-month cycle. The last discussions of the Article IV consultation were held in Tunis from February 26 to March 11, 2002 and the consultation was concluded by the Executive Board on June 5, 2002.

Technical Assistance

January 31-February 14, 1996: FAD – assessment of revenue impact of Association Agreement with EU.

March 31-April 4, 1997: STA – introduction of new methodological guidelines according to fifth edition of *Balance of Payments Manual*.

September 9-12, 1998: MAE – monetary management and development of the money market.

May 11-21, 1999: STA – quarterly national accounts.

May 13-18, 1999: STA – SDDS.

October 12-15, 1999: MAE – Debt management practices.

October 17-27, 2000: STA – quarterly national accounts.

October 25-31, 2000; STA – SDDS meta data finalization.

December 17-21, 2001: MAE – Management of central bank liquidity.

Resident Representative: None.

TUNISIA : FINANCIAL RELATIONS WITH THE WORLD BANK

(As of June 23, 2003)

1. The World Bank's portfolio in Tunisia has a total of 21 active operations and 105 closed loans, of which 10 International Development Agency (IDA) credits amounting to US$75.2 million net of cancellations. Cumulative net commitments represent US$4.8 billion. Of this total, US$2.5 billion has been repaid. Net commitments for the 21 current investment operations amount to about US$1.2 billion.

2. The current CAS centers on the following: (i) consolidating long-term development through activities in sectors of traditional World Bank involvement, mainly human resource development, natural resource management, transport, and rural and urban development; (ii) supporting economic reforms to enhance competitiveness and increase employment, with safeguards against transitional costs of adjustments; and (iii) new initiatives of a catalytic nature to strengthen local institutions, launch new development niches (e.g., information technology), and mobilize external finance.

3. Bank lending at first emphasized support for long term investment in infrastructure, social sector financing, and industrial financing. More recently, Bank lending increasingly supported policy reforms at the sector and macroeconomic levels. Recent loans have included an Education Quality Improvement Project and a Water Sector Investment Loan in FY00; a second-phase Transport Sector Project, a Cultural Heritage Project and an Agriculture Support Services Project in FY01. In FY02, a Third Economic Competitiveness Adjustment Loan (ECAL III) has been approved by the Board of Directors for US$252.5 million. The loan is co-financed with the European Union and the African Development Bank. The ECAL III supports the Government's Five Year plan (2002–06), focusing on sub-sectors within the framework of an acceleration of structural policies to increase investment and employment creation, while maintaining a sound macroeconomic framework and preserving social stability. The first tranche of the loan (US$130 million) was disbursed on December 27, 2001. The project is scheduled to close on December 31, 2003, with three tranches remaining to be disbursed if conditionalities are met.

4. Two projects were presented to the Board of Directors this FY: a North West Mountainous and Forestry Areas Development project (US$34 million) and a Third Municipal Development project (US$78.4 million).

5. Despite the fact that the quality of the portfolio is satisfactory, cumbersome procurement procedures and slow implementation pace—especially in the health and education portfolios—are affecting the portfolio performance. A Country Portfolio Performance Review (CPPR) is currently being carried out to assess the systemic factors for slow implementation and hence repetitive closing date extensions.

6. Two policy notes on trade and IT sectors were issued in FY02. Policy notes on tourism strategy, environmental strategy, Public Debt Management strategy, and a Poverty update are being prepared in FY03. The Employment strategy note which was completed this FY could be converted into a programmatic Economic and Sector Work, a new multi-year instrument for knowledge work and policy dialogue.

7. A new Country Assistance Strategy (CAS), along with a Development Policy Review, will be prepared next FY and will assess to what extent the knowledge approach would be one suitable for Tunisia.

TUNISIA: FINANCIAL RELATIONS WITH THE WORLD BANK

(As of June 23, 2003)

	Total Net Commitments	Undisbursed Balance
	(In million of U.S. dollars)	
IBRD lending operations		
105 loans closed 1/	3,611.8	
21 active loans		
-GEF Solar Water Heating	7.4	0.2
-MP Ozone Depleting Subs.	3.8	0.6
-Water Supply & Sewerage	58	6.4
-Greater Tunis Sewerage	53	28.1
-Natural Resource Mgmt.	26.5	7.7
-Higher Education Reform Support I	80	45.8
-2nd Employment & Training	60	8.3
-Health Sector Loan	50	7.0
-Agric. Support Services	21.3	23.9
-Water Sector Invt. Project	103	92.7
-Industry Support Institution	32.4	13.6
-Transport Sector Invt.	50	11.1
-Municipal Devt. II	80	1
-GEF Protected Areas Mgmt.	5.6	5.6
-Cultural Heritage	17	20.4
-Education PAQSET I	99	70.6
-Export Development	35	15.3
-ECAL III	252.5	132.5
-Transport Sector Invt. II	37.6	31.6
-NW Mountainous & Forestry Areas Devt.	34	38.2
-Municipal Devt. III	78.4	90.8
Total active loans	1,184.5	651.5
Repayments 2/	2,550.7	
Debt outstanding 2/	1,667.4	

	1997	1998	1999	2000	2001	2002	2003 2/
Net lending by the World Bank (by fiscal year) 3/							
Commitments	241.5	222	194	202	75.9	252.5	112.4
Disbursements	202.8	132.7	208.6	147.1	174.6	226.7	140.5
Debt service	283.1	277.5	270.6	246.5	223.1	229.8	258.0
Principal	174.9	180.9	175.9	163.1	146.3	149.6	175.9
Interest 5/	108.2	96.6	94.7	83.4	76.8	80.2	82.1
Net transfer 6/	-80.3	-144.8	-62	-99.4	-48.5	-3.1	-117.5

1/ Less cancellations, includes adjustment lending, does not include guarantees.
2/ As of June 23, 2003.
3/ Fiscal years start July 1 and end June 30.
4/ Does not include US$184 million for guarantee on Jorf Lasfar electricity project
5/ Includes charges.
6/ Equal to disbursement minus debt service.

Statistical Issues

1. Available economic and financial data have generally been provided to the Fund on a regular and timely basis; most of those data are also made available to the wider public. Tunisia subscribed to the SDDS in June, 2001 and its metadata are posted on the Dissemination Standards Bulletin Board (DSBB).

Real Sector

2. IFS coverage of data on real sector developments is satisfactory and most data are reported in a timely manner, although export and import price and volume indices are reported with a long lag. Data on employment, unemployment, and wages should be collected and reported on a more frequent basis.

Government Finance

3. In addition to information reported in the SDDS, government finance data are collected by the staff at the time of the Article IV consultation mission. Regarding data for publication, GFS data up to 2000 are published in the *Government Finance Statistics Yearbook 2002*. Data cover consolidated central government. Tunisia does not report monthly or quarterly data for publication in IFS.

Balance of Payments

4. Statistics for Tunisia's balance of payments (BOP) and international investment position (IIP) are compiled by the Central Bank of Tunisia (CBT), following the methodology of the *Balance of Payments Manual, Fifth Edition* (*BPM5*). The BOP statistics are prepared on a quarterly basis and the IIP on an annual basis, complying with SDDS requirements. The CBT issues preliminary monthly statistics, mostly prepared on the basis of banks settlements with non residents. BOP statistics are generally adequate for annual surveillance, although greater detail on the financial account, particularly external debt, would be desirable. Efforts have been made to collect data on short-term external debt. As an SDDS subscriber, Tunisia reports reserves data following the *International Reserves and Foreign Currency Liquidity – Operational Guidelines* (*Reserves Template*) since June 2001.

Money and Banking

5. Money and banking statistics are adequate for annual surveillance.

TUNISIA: CORE STATISTICAL INDICATORS

As of June 20, 2003

	Exchange rate	International reserves	Reserve/ base money	Central bank balance sheet	Broad money	Interest Rate	Consumer price index	Exports/ Imports	Current account balance	Overall government balance	GDP/ GNP	External debt and debt service
Date of latest observation	06/03	May 03	May 03	April 03	April 03	June 03	May 03	May 03	Q1/03	2001 1/	Q4/02	Q1/02
Date received	06/03	June 03	June 03	May 03	June 03	June 03	June 03	June 03	May 03	Mar. 03	Mar. 03	Mar. 03
Frequency of data	D	M	M	M	M	D	M	M	Q	A	Q	Q
Frequency of reporting	D	M	M/V	M/V	M/V	D	M/V	Q/V	Q/V	/V	Q/V	V
Source of data	Central Bank/ SDDS	Central Bank/ SDDS	Central Bank/ SDDS	Central Bank/ SDDS	Central Bank/ SDDS	Central Bank/ SDDS	Central Bank/ SDDS	Central Bank/ SDDS	Central Bank/ SDDS	Ministry Econ. Dev /SDDS	Central Bank/ SDDS	Ministry Econ. Dev. /SDDS
Mode of Reporting	Cable	Fax	Fax	Fax	STA rpt./ MED	STA rept./ MED	STA rept./ Mission	Fax/ Mission/ Annual report	Fax/ Mission/ Annual report	Fax/ Mission	Mission	Mission
Confidentiality	U	U	U	U	U	U	U	U	U	U	U	U
Frequency of Publication	D	M	M	M	M	D	M	M	Q	A	Q	Q

A= annually; D= daily; M= monthly; Q= quarterly; U= unrestricted; V= during mission; W= Weekly
1/ Central government, April 2003.

INTERNATIONAL MONETARY FUND

TUNISIA

Strengthening the Monetary Framework and Instruments

Prepared by the Monetary and Financial Systems and Middle Eastern Departments

Approved by Charles Enoch and Mohammad Shadman-Valavi

July 9, 2003

- **Monetary policy decisions to achieve inflation and external position objectives have been based on growth in credit to the economy in the context of a predetermined exchange rate.** The Central Bank of Tunisia (BCT) adjusts its refinancing so that banks can meet reserve requirements, and restrains the volume if credit growth exceeds targets. At the same time, the BCT attempts to influence the marginal cost of bank funds by varying volumes of refinancing at its various facilities. This strategy, combined with prudent fiscal policy and capital controls, has contributed to price stability.

- **Credit to the economy is a good predictor of inflation but the relationship between BCT refinancing and the credit aggregate is unstable.** This implies that refinancing, although under the control of the BCT, has an unpredictable relationship with credit to the economy and cannot be a reliable operating target.

- **Clarifying the monetary framework is essential in view of Tunisia's goal to liberalize the capital account and adopt a flexible exchange rate regime.** This implies that monetary policy would provide the new nominal anchor and greater interest rate flexibility would thus be needed.

- **The authorities should explicitly adopt M3 as the intermediate target of monetary policy in view of the instability of the relationship between BCT refinancing and credit to the economy relative to the broad money multiplier.**

- **In the short-term, the authorities would rely on base money as the operating target of monetary policy in view of its direct and predictable impact on M3.** Limiting fine-tuning monetary operations to cases of extreme deviations from liquidity forecasts, and relying on a corridor arrangement for interbank market rates would support the needed interest rate flexibility for such a monetary strategy. Interest rate flexibility also calls for strengthening the financial sector and developing a yield curve. Extending the time frame of liquidity forecasts, which involves improving the cash flow forecasting capacity at the Treasury, is also needed.

- **It is only in the medium term that the authorities may adopt a short-term interest rate as the operating target,** since the deepening and diversification of financial markets are likely to involve a greater role for interest rates in the transmission channels of monetary policy. When Tunisia floats its currency, all the conditions in support of inflation targeting may not be met. In the interim, M3 may continue to be the intermediate target, but structural changes in the economy will further accentuate the need to rely on other indicators. The BCT will need to have an enhanced understanding of the transmission mechanisms of monetary policy.

- The authors of this paper are Bernard Laurens (MFD) and Abdourahmane Sarr (MED).

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I. Introduction and Background

1. **This paper assesses how Tunisia's monetary policy framework could be strengthened in a context of a changing environment for policy design and implementation.** The declared objective of the Central Bank of Tunisia (BCT) is to keep inflation under control. In the current policy environment, prudent fiscal management, the adoption of a constant real exchange rate rule (CRERR), and the maintenance of capital controls have brought Tunisia price stability and sustained growth. This impressive performance has also been accompanied by significant progress at strengthening the financial system, increasing the transparency of monetary policy, and modernizing monetary policy instruments and operating procedures.[1] However, the increased openness of the economy will pose new challenges to the BCT.

2. **The exchange rate regime—the CRERR—followed during the past decade or so has served Tunisia well, but its limitations will begin to emerge in the context of greater opening of the economy and regional and international integration.**[2] Thus, since 2001, the authorities have adopted a more flexible approach and, as a result, the dinar depreciated by more than required to keep the real effective exchange rate constant. They have also indicated their desire to liberalize capital flows and to eventually adopt a floating exchange rate regime.

3. **The Financial System Stability Assessment (FSSA) for Tunisia that was discussed in the context of the 2002 Article IV consultation concluded that the remaining vulnerabilities in the financial system needed to be addressed before the capital account is fully liberalized** (Box 1). A subsequent study by the Staff on the progress achieved and prospects for liberalizing the capital account noted that, before embarking on ambitious steps toward full convertibility, the monetary framework and instruments needed to be reinforced, and the financial markets needed to be developed further. (Box 1).[3]

4. **The remainder of this paper is organized in the following manner:** Section II offers a brief overview of the current monetary framework and instruments and discusses the challenges ahead. It sets the rationale for a strengthening of the monetary framework and instruments, and offers recommendations on how this could be achieved. Section III discusses how the recommended measures could be implemented to establish a well defined monetary framework that could provide a nominal anchor in the context of a move to a floating exchange rate regime. It proposes a two stage process: the *Interbank Market Deepening Stage (Stage 1),* and the *Financial Market Diversification Stage* (Stage 2).

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[1] See IMF (2002a).

[2] See IMF (2002b).

[3] See IMF (2002b).

Box 1. Tunisia: Main Conclusions of the FSSA and Subsequent Work

The FSSA noted that, over the past decade, the Tunisian financial system had been extensively modernized. This has involved an overhaul of the legal and accounting frameworks, both of which today embrace modern concepts, a strengthening of supervision, and a shift to more market-oriented policies.

The FSSA also noted that significant progress had been achieved toward placing the banking system (which dominates the financial sector) on a sound footing, although vulnerabilities remain, particularly in the state controlled sector. Despite large exposure to credit risk, the system appears unlikely to suffer from a generalized crisis for several reasons; exposure to foreign currency risk is limited; most of the weaker banks are under state control; and capital mobility is low. However, a weak credit culture, inadequate provisioning policies, and high levels of nonperforming loans place domestic banks at a disadvantage, particularly as Tunisia moves to greater integration with international markets. Furthermore, high credit exposures to sectors subject to cyclical shocks (i.e., tourism) generate vulnerabilities, particularly for the state-owned banks.

The FSSA noted that the implementation of monetary policy had been significantly strengthened, but there was a need to improve systemic liquidity arrangements. In particular, the study noted that credit policy considerations now play a lesser role and the BCT has greatly curtailed its readiness to accommodate banks' liquidity needs. Adopting a fully transparent monetary framework, which validates price stability as the primary objective, together with a firmer commitment to market funding of the budget, would help build stronger systemic liquidity arrangements.

In a subsequent study, IMF staff noted that capital account liberalization required strengthening the financial sector and markets, as well as increasing the role of market forces in monetary policy conduct. Liberalization of direct investment by Tunisians abroad, and allowing overseas portfolio investments by institutional investors and portfolio investments by nonresidents in debt instruments (*Stage 1*) require the banking system to be on solid footing to enable it to withstand international competition. At this stage, progress would be needed in the conduct of monetary policy and the development of government securities markets. Full capital account liberalization (*Stage 2*) would involve liberalizing domestic portfolio investment abroad and loans by residents to nonresidents. Prerequisites for moving to this stage would be the establishment of a stronger international reserve position as well as the existence of a robust financial market.

II. Current Monetary Framework and Challenges

A. Current Monetary Framework

5. **The objectives of the BCT, as defined in its charter, are to defend the value the currency, support the economic policies of the government, and ensure proper functioning of the financial system.** Price stability is not clearly defined as the primary objective and it is unclear, in the BCT charter, whether the value of the currency refers to its

internal or external value.[4] However, as mentioned earlier, the BCT's declared goal is to keep inflation close to that of competing and partner countries.[5] The BCT's announced intermediate target is to correlate money growth with economic activity, while at the operational level it pledges to give priority to interest rates. Interest rates are viewed as playing a vital role in savings mobilization and credit allocation.

6. **In practice, targeting a constant real effective exchange rate has resulted in the nominal exchange rate being, by and large, predetermined.** In this context, and with capital controls allowing some scope for monetary policy, the BCT has in fact targeted credit growth to meet its inflation and external objectives. Within this framework, the BCT determines the overall volume of refinancing to achieve its intermediate target. At the same time, the BCT attempts to influence the marginal cost of bank reserves by varying the cost of the refinancing banks need to meet reserve requirements. To do that, the central bank combines refinancing through its seven-day tender for repos with the more costly, recently introduced, three-month tenders for repurchase operations (repos) (Box 2).[6] This marginal increase in the cost of refinancing is, however, unlikely to have a significant impact on credit demand.

7. **The central bank's practice of targeting credit growth is consistent with an institutional framework characterized by a predetermined exchange rate in which fluctuations in base money reflect balance of payments flows.** Under such a framework, the exchange rate peg takes precedence over the monetary aggregates. The liquidity effects of foreign exchange inflows become a concern only if they allow banks to fund excessive credit expansion. Conversely, foreign exchange outflows that decrease bank reserves should trigger central bank intervention to offset the contractionary effect on bank liquidity and ensure adequate financing of the economy for a given foreign reserves target. Under these circumstances, the real effective exchange rate rule and continued fiscal consolidation in Tunisia have contributed to balance of payments sustainability, monetary stability, and low inflation. The success of these policies is reflected in the high rate of foreign exchange coverage of base money (90–100 percent), although this was not a deliberate policy (Chart 1).

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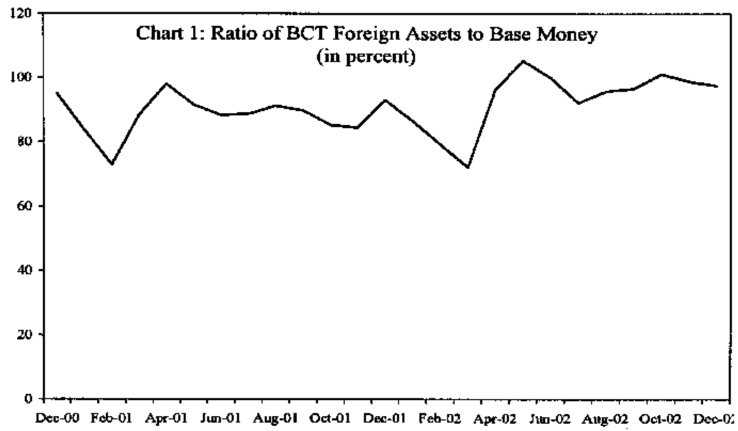
[4] The BCT Website, http://www.bct.gov.tn/english/presentation/index.html, indicates that it is both.

[5] Available via the BCT Website: http://www.bct.gov.tn/english/politique/index.html.

[6] Since the BCT discontinued giving priority to claims on strategic sectors in the seven-day tender for repos (June 2001), all refinancing is allocated through competitive volume tenders.



Box 2. Tunisia: Monetary Policy Instruments

Reserve requirements. These are calculated as monthly averages. The reserve requirement ratio is 2 percent for sight deposits and deposits liabilities of less than 3 months, 1 percent for deposit liabilities with maturities between 3 and 24 months, and 0 percent for longer maturities. They are not remunerated.

Standing facilities
One- to seven-day repurchase operations: Banks may request liquidity against collateral at a premium over the official intervention rate (+ 100 basis point). Accepted collaterals include treasury bills, and prime quality banks' claims on all sectors.

Discretionary monetary operations
Seven-day tender for repurchase operations: Every week, the BCT invites bids for seven-day repos. The BCT decides on the amount to be injected; successful bids are all satisfied at the *official intervention rate* (i.e., volume/fixed rate tenders). Accepted collaterals include treasury bills, and prime quality claims on all sectors.
Deposit auctions: These are used to mop up excess liquidity. Bids are ranked and accepted according to the rate that is proposed (i.e., interest rate/multiple rates tenders). Rates cannot exceed that of the seven-day tender for repos.
Three-month tender for repurchase operations: The BCT invites bids for three-month repos. It decides on the amount to be injected and the bids are satisfied at the interest rates requested by participants (interest rate/multiple rates tenders). Accepted collaterals include treasury bills only.

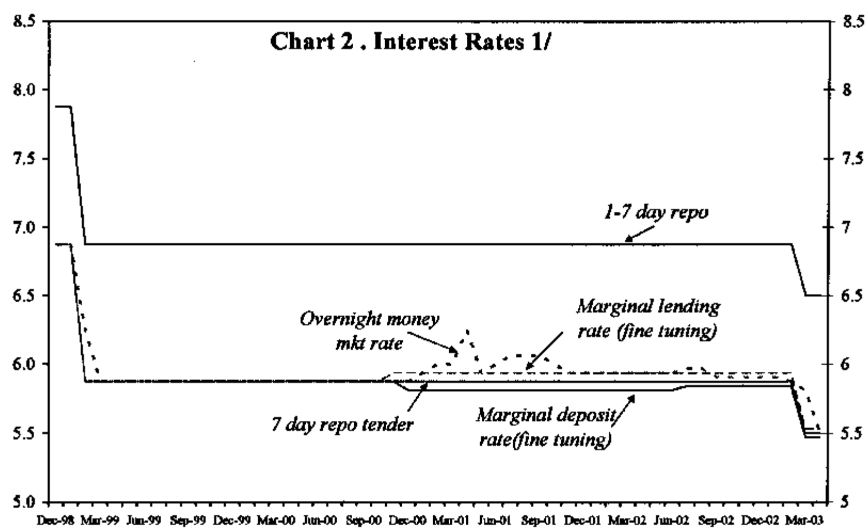
Fine-tuning overnight operations: The BCT may decide to inject/withdraw liquidity based on liquidity conditions of the day. The BCT conducts these operations at the official intervention rate plus/minus a spread (currently ±1/32 percent). Accepted collaterals include treasury bills, and prime quality banks' claims on all sectors.

8. **Empirical evidence shows that credit growth is a good leading indicator for inflation (Box 3, Figure 1).** Monetary aggregates have not been closely related to inflation because portfolio shifts between aggregates have contributed to their instability. Broad money growth (M3) has on average been significantly higher than nominal GDP growth during 1998–2002, but inflation has remained low. High money growth reflected in part a decline in M3 velocity as the demand for savings and time deposits rose. This was due to

investor portfolio shifts away from government securities which enjoyed a liquidity guarantee from commercial banks (*Bons du Trésor Cessibles or BTCs*), but which have now been discontinued. As investors shifted to M3, the velocity of the broader liquidity aggregate (M4), which includes BTCs, rose. Changes in monetary aggregates also reflected unsterilized foreign exchange flows on base money.

9. **It is difficult to establish the extent to which monetary policy has contributed to keeping inflation low** because the interest rate flexibility called for under the current monetary policy approach has been limited. During the period 1998–2002, money market rates remained broadly stable, even in periods of external or domestic shocks, and they did not follow the evolution of interest rates in the leading world economies. Taking advantage of its position as a structural liquidity provider vis-à-vis the banking system, the BCT has succeeded in limiting volatility in short term interest rates by implementing a narrow interest rate corridor through fine-tuning operations (Chart 2). In addition, the relationship between BCT refinancing and credit to the economy has been unstable (Figure 1). This implies that refinancing, although under the control of the BCT, has an unpredictable relationship with credit to the economy.

10. **Recently, the BCT took various steps to strengthen monetary policy implementation**. In particular, following the recommendations made in the Financial Sector Assessment Program (FSAP) and the 2002 Article IV consultation, and with Fund technical assistance, the BCT has improved its liquidity forecasting framework by strengthening its ability to determine how much liquidity to provide or withdraw from the market on a daily basis to ensure that liquidity in the system is consistent with banks' needs. Monetary instruments have also been strengthened: government securities now play a more prominent role in support of refinancing operations than they did in the past; and the BCT has just launched its first open market operation. Finally, responsibility for setting the BCT's official rates lies exclusively with its Board of Directors. Significant challenges, however, lie ahead.



1/ The marginal deposit and lending interest rates and the liquidity auction rate differ starting in late 2000.

Box 3. Tunisia: Leading Indicators of Inflation [1/]

Granger causality tests indicate that credit to the economy (CE) is the best leading indicator for inflation. The leading indicator property of the credit aggregate (one to three-quarter horizon) in the bivariate model is strongest at the first quarter lag. The predictive power of CE for inflation is highest in the trivariate regression when the real effective exchange rate is included. This result supports the argument that excess credit growth causes inflation for a given exchange rate level in Tunisia's current monetary framework. The trivariate model also suggests that a depreciation of the nominal effective exchange rate is a leading indicator of inflation for a given level of credit growth. The predictive power of CE is, however, stronger.

Bivariate Granger Causality Tests

	Number of Lags						
	1	2	3	4	5	6	7
DLCE	0.0129	0.0285	0.0307	0.107	0.4443	0.5206	0.2205
DLM0	0.3856	0.7827	0.5449	0.4555	0.4254	0.3844	0.4841
DLM1	0.8203	0.6366	0.7434	0.8920	0.9770	0.3609	0.6716
DLM2	0.4372	0.4192	0.4529	0.529	0.5825	0.7074	0.8892
DLM3	0.5492	0.3915	0.4562	0.5303	0.607	0.7526	0.8847
DLNEER	0.9297	0.2384	0.4449	0.092	0.0751	0.0819	0.4008
DR	0.1910	0.3557	0.5979	0.7954	0.7488	0.9458	0.7958

Trivariate Model Granger Causality Tests [2/]

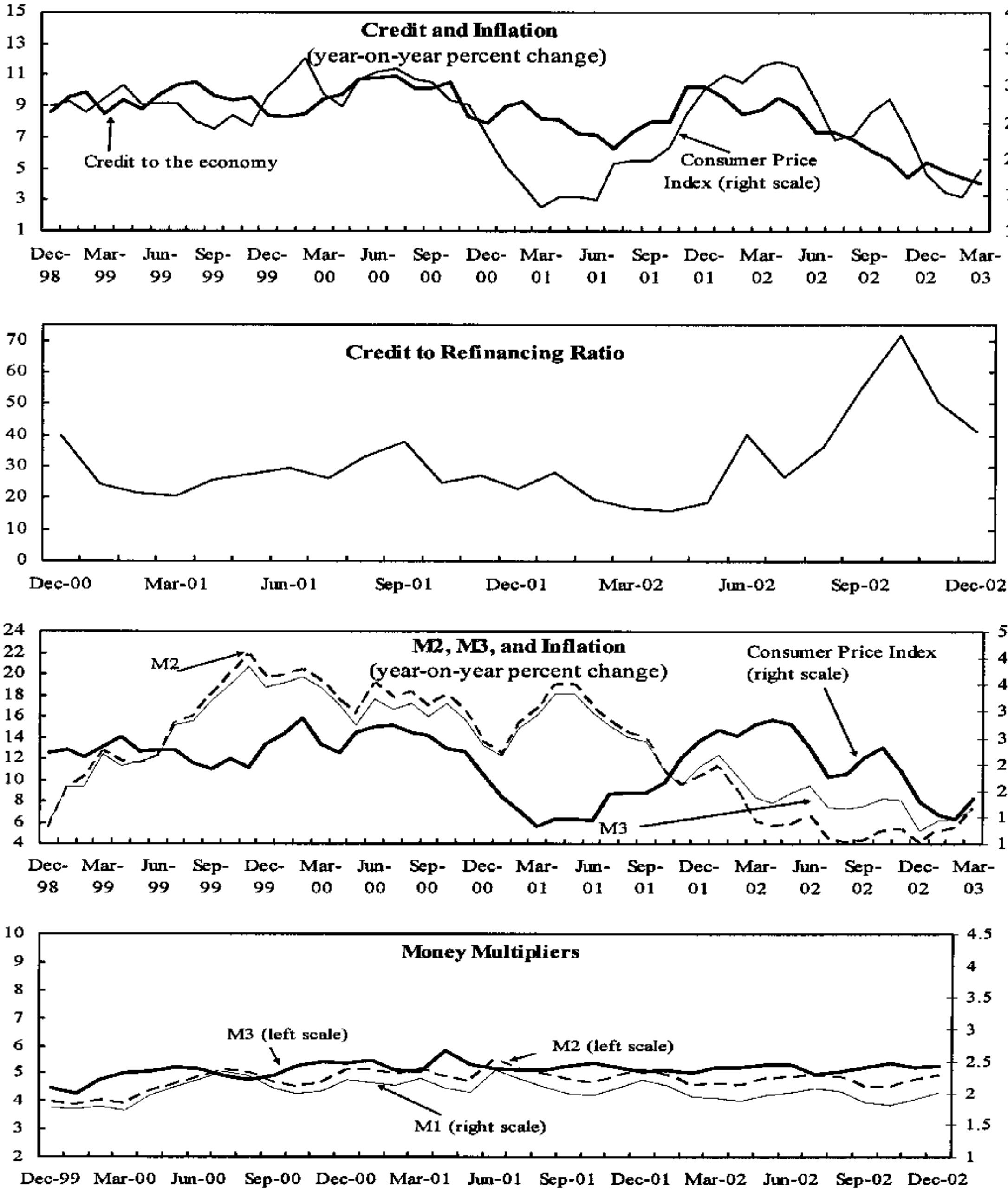
	Number of Lags			
	1	2	3	4
DLCE	0.0139	0.0053	0.0065	0.2054
DLNEER	0.5648	0.0311	0.0488	0.1903

[1/] P-values shown for the F-tests of the null hypothesis that the indicator variable does not granger cause inflation beyond inflation itself.

[2/] Block exogeneity tests showed that neither the overnight interest rate nor the real effective exchange rate was required in VARs of inflation and money aggregates. Tests showed that the real effective exchange rate should be included along with the credit aggregate in the inflation equation.

L : Logarithm
D : First difference
CE : Credit to the Economy
M0 : Reserve Money
R : Overnight Money Market Rate
NEER: Nominal Effective Exchange Rate
Sample: 1996 Q4–2002 Q4 , Central Bank of Tunisia

Figure 1: Money, Credit, and Inflation

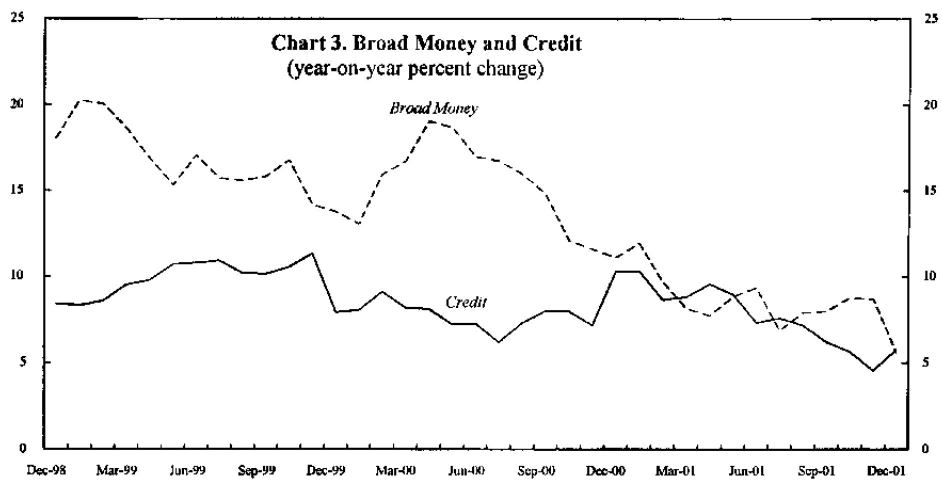


B. Challenges

Monetary framework

11. **A clarification of the monetary framework is necessary in view of the authorities' intention to adopt a more flexible exchange rate policy and eventually move to a floating regime**. Clarifying the monetary framework means defining the primary objective of monetary policy and the means to achieve it. The best contribution monetary policy can make to the economy is to maintain price stability. Therefore, the central bank law should recognize price stability as the primary objective of monetary policy.

12. **As noted earlier, credit to the economy is currently a good leading indicator of inflation, but its relationship to BCT refinancing is unstable.** The extent to which credit could be targeted using a BCT interest rate is also difficult to determine since interest rates have historically been relatively stable. On the other hand, the relationship between M3 and base money is stable, and the BTCs, which had weakened the link between M3 and credit to the economy, and therefore inflation, have been discontinued and have come to maturity (Chart 3). M3 should therefore be a good indicator for future inflation under an explicit base money target, which implies that the effects of foreign exchange flows on base money would be sterilized. A base money operating target would also be preferable to an interest rate target to reach M3 since it is a quantity variable and the money multiplier is stable.



13. **A base money target would imply interest rate flexibility**. In this context, a reserve money program would serve as the monetary policy-operating framework to manage the central bank's balance sheet. Since the data on base money required to operate such a framework is available with a shorter lag than data on broader monetary or credit aggregates, such a framework would allow the BCT to respond more rapidly to shocks than it could under a framework (e.g., credit growth) based on data collected from the banks' balance sheets.

14. **A base money program would still allow banks to meet their immediate liquidity needs from the BCT as is presently the case.** In the event of a shortage of liquidity to meet reserve requirements, banks could still access the standing facilities since, from the BCT's point of view, the trends in base money are what matters rather than meeting a daily target for base money. However, frequent access to the standing facilities should prompt a reassessment of policy interest rates and the monetary program, or trigger corrective action on the part of the banking supervision department.

15. **In the medium term, the increasingly open Tunisian economy and the gradual liberalization of capital movements will modify the environment for monetary policy design and implementation.** Once controls on capital flows are abolished, independent monetary policy will only be compatible with a floating currency. Conversely, a floating exchange rate policy will only work if monetary policy becomes the nominal anchor of the economy. In that scenario, monetary policy must be geared to achieving price stability and a clear nominal anchor will have to be adopted. The exchange rate would be responsible for achieving balance of payments objectives. Whether monetary policy will be able to continue to rely on M3 or on an inflation targeting framework will need to be assessed on the basis of progress made at the time to meet the initial conditions for inflation targeting.

16. **Regardless of the nominal anchor adopted, it is most likely that, in the medium-term, interest rates will play a greater role in the transmission mechanism of monetary policy than they currently do.** This may allow a shift to a short-term interest rate as the operating target of monetary policy. In this context, the usefulness of the base money program as the monetary policy-operating framework may decline.

Financial system

17. **Remaining vulnerabilities in the financial sector could induce reluctance on the part of the BCT to accept the necessary movements in interest rates.** Despite the progress made in strengthening the banking system, significant vulnerabilities remain. The capital base of banks, in particular government-owned banks, may be overestimated because of reliance on real estate collateral for provisioning policies in a context where the realization of collateral is difficult. Furthermore, a significant increase in interest rates could translate to an increase in nonperforming loans given the high exposure of borrowers to interest rate risk because loan agreements are indexed to the money market rate.[7]

18. **The dominant position of the BCT in the interbank market is an obstacle to money market development and interest rate flexibility.** Currently, the BCT provides banks every week with the liquidity they need to meet reserve requirements and supplements this practice with fine-tuning operations during the week. As a result, interbank market

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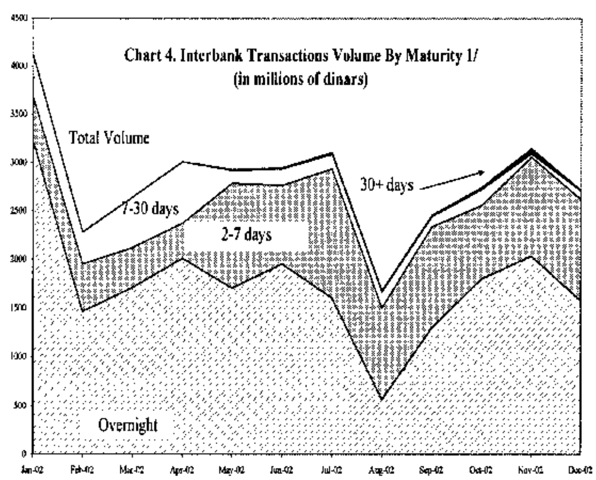
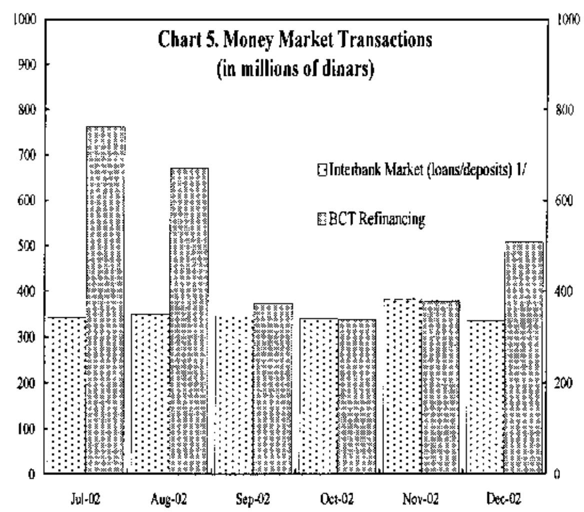
[7] The interest rates of many loans agreements are indexed on the money market rate (TMM "*taux du marché monétaire*"), that is overnight interbank rates. Therefore, changes in the monetary policy stance are likely to be reflected quickly in the cash flow and profitability of corporations (see IMF 2002a).

transactions are mostly confined to maturities of 7 days or less (Chart 4) and interest rates are remarkably stable. The volume of outstanding BCT refinancing to banks relative to the outstanding volume of interbank transactions is also significant. This reflects the dominant position of the BCT in the interbank market (Chart 5).

19. **The legal and supervisory frameworks for securities markets have been significantly strengthened although markets remain shallow.**[8] In particular, Tunisia has made only limited progress in developing a benchmark bond yield curve. Consequently, market pricing of financial instruments and risk management in financial markets are difficult. One of the implications of the absence of a yield curve, as mentioned above, is the prevalence of the use of short-term money market rates (in practice the overnight interbank rate) in loan agreements. Country experiences suggest that developing benchmark government securities has benefits not only for the government, but also for broader securities market development.[9] In this context, the Tunisian authorities should consider strengthening public debt management, in line with the recommendations of the Guidelines for Public Debt Management, with a view to developing an efficient benchmark yield curve and the risk-free rate of return necessary for the proper pricing of financial assets and the development of capital markets.[10] This would require a firm commitment to market funding of the public sector borrowing requirement.



1/ Turnover



1/ Average stock.

[8] IMF (2002a).

[9] For instance, in Singapore, the rationale for developing a government securities market has been to provide a benchmark for the corporate bond market, and encourage the development of skills relating to fixed income financial services.

[10] See IMF and The World Bank (2001).

III. Proposed Action Plan

A. General Considerations

20. **The channels through which monetary policy operate are complex and subject to changes over time,** particularly when financial markets become diversified and integrated with international financial markets. Most emerging market economies are characterized by a rapid pass-through from the exchange rate to inflation, and a strong transmission of inflation through the credit availability channel.[11] The latter characteristic seems to play a predominant role in Tunisia (see Box 3). As the role of financial markets in the allocation of resources grows, the interest rate channel would be expected to play a larger role.

21. **Developing a well functioning financial market that can respond to the central bank's monetary policy decisions appropriately is key. In the context of Tunisia, it will also require a collaborative effort between the monetary and fiscal authorities.** The strengthening of Tunisia's banking system will require the direct involvement of the fiscal authorities in view of the weak financial position of the public banks which represent a significant part of the banking system. Strengthening their financial position will be critical to enable them to withstand market discipline when monetary policy is called upon to play a more prominent role in macroeconomic management than it plays today. Furthermore, a strengthening of the liquidity forecasting framework at the BCT calls for an improvement in government cash flow management and projections. Finally, an efficient benchmark yield curve is necessary to deepen financial markets and can be facilitated by the development of an appropriate public debt management strategy.

22. **Deepening the foreign exchange market would also be desirable as it would help limit volatility when the exchange rate is allowed to float.** In view of the tight link between money and foreign exchange markets under a floating regime, low volatility in the foreign exchange market allow monetary policy operations to focus on the pursuit of price stability. The authorities should therefore move forward with their plans to relax foreign exchange receipt surrender requirements and eliminate banks' obligation to deposit their end-of-day foreign exchange balances at the central bank *(nivellement)* so banks can have a greater role in the foreign exchange market.

23. **The authorities could envisage a two-stage action plan to establish a well defined monetary framework that could provide a nominal anchor in the context of a move to a floating exchange rate regime.** In the short-term, it is essentially a matter of developing the interbank market so it can play a more prominent role in the recycling of base money (*Interbank Market Deepening Stage*). In the medium-term, the monetary framework, monetary instruments, and operating procedures should evolve as a function of the changes

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[11] See BIS (1998).

in the relative importance of the different monetary policy transmission channels resulting from the diversification of financial markets (*Financial Markets Diversification Stage*).[12]

B. Interbank Market Deepening Stage

24. **The authorities should establish a framework that would allow the implementation of base money targeting.** The liquidity forecasting framework currently used to determine the quantity of base money to be provided to banks to allow them to meet reserves requirements should be modified. The objective would be to adjust BCT's monetary interventions in order to meet the quantitative targets for base money.

25. **A successful base money targeting framework will require extending the liquidity forecasting exercise to longer time horizons than is presently the case.** Currently, the BCT undertakes a one-week liquidity forecasting exercise, which it uses to decide the amount of liquidity to inject at its weekly seven-day tenders for repos. In order to link the liquidity forecasting exercise to monthly base money targets, which would be derived from the annual monetary program, the BCT should extend its liquidity forecasting capacity.

26. **The BCT will also have to enhance the accuracy of the liquidity forecasts.** Small deviations from the forecasts may be automatically corrected thanks to the averaging provisions which apply to reserve requirements. The standing facilities can also operate as automatic stabilizers, although they involve a cost for banks since the rates applied by the BCT are penal compared to market rates, as they should be. However, at times, large discrepancies between the government's cash flow projections and the actual outcomes have led to situations of stress in the interbank market. In those cases, the BCT has intervened in the market to withdraw/inject liquidity to prevent market rates from reaching the edges of the corridor, so that banks can avoid any penalties related to such discrepancies. Fine-tuning monetary operations should be restricted solely to this type of case of extreme discrepancy in liquidity projections for the system as a whole.

27. **The authorities should rely on an interest rate corridor that is wide enough for interbank market interest rates. This would encourage the deepening of the interbank market and enhance its role in recycling base money.** The interest rate corridor would be created by the marginal refinancing facility (1–7 day repos) and a permanent short-term deposit facility (to be established). This would help reduce the dominant role of the BCT in the interbank market.

28. **Pursuit of the base money operational target should not be overly rigid. To that end, the monetary program could be defined in terms of target ranges for broad money growth.** Base money targeting should be accompanied by close monitoring of macroeconomic indicators to gauge the appropriateness of correcting a deviation from the

[12] An Action Plan is presented in Appendix.

monetary program. Inflation should be given top priority in this monitoring. The transparency of monetary policy will be boosted by making efforts to inform the public of the reasons for deviations from the program and will thereby motivate monetary policy measures. This would enhance credibility and accountability.

C. Financial Markets Diversification Stage

29. **As changes in the transmission channels of monetary policy occur, the BCT will need to consider shifting to interest rates as the operating target of monetary policy**. As financial markets develop, the role of banks in financing the economy will decline, allowing the financial markets to play a greater role. Similarly, the ongoing liberalization of the capital account will diversify the sources of funding for the economy. Financial market deepening and diversification will involve a greater role for interest rates in the transmission channels of monetary policy.

30. **Diversification of the financial instruments that can act as substitutes for currency may lead to instability in monetary aggregates**. At the very least, it could make it harder for the BCT to identify a monetary aggregate that adequately reflects the demand for money. In such an environment, the BCT may no longer be in a position to rely solely on a monetary aggregate as the nominal anchor.

31. **However, to be in a position to adopt full-fledged inflation targeting when Tunisia moves to a floating exchange rate regime, a number of conditions will need to be met.** International experience has shown that several initial conditions need to be in place to support an inflation targeting framework (Box 4).[13]

32. **Some of the pre-conditions for inflation targeting are already in place in Tunisia.** They include the absence of fiscal dominance and, more generally, a stable macroeconomic framework characterized by low inflation. However, although the BCT has developed a set of market-based monetary instruments, financial markets are shallow.

33. **It would be desirable to amend the Central Bank Law to specify that price stability is the primary objective of monetary policy**. This would ensure that the BCT has the necessary legal basis to allow the inflation target to take precedence over other objectives. In this context, exchange rate objectives must be clearly subordinated to the inflation target, and foreign exchange market interventions, or changes in policy interest rates intended to influence the exchange rate, should only aim at smoothing the effects of temporary shocks.

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[13] See IMF (2002c).

Box 4. Tunisia: Initial Conditions for Inflation Targeting

- **Objective of monetary policy.** Inflation should be the primary objective of monetary policy, and the central bank should be accountable in meeting this objective. The central bank law should ensure that price stability is the primary objective of monetary policy, and the central bank should have sufficient autonomy to set monetary instruments accordingly and be transparent in policy formulation and implementation.

- **Macroeconomic conditions.** The inflation target must not be subordinated to other objectives. Monetary policy should not be dominated by fiscal priorities (absence of fiscal dominance), and fiscal policy and public debt management activities should be coordinated in support of the inflation target. The country should also have sufficient stability in its external position to enable monetary policy to focus on achieving the inflation target. In this context, exchange rate objectives must be clearly subordinated to the inflation target, and foreign exchange intervention, or changes in policy interest rates intended to influence the exchange rate, should only aim at smoothing the effects of temporary shocks.

- **Monetary policy tools.** The financial system should be developed and stable so that monetary policy is not sidetracked by concerns about the health of financial institutions. Markets should be sufficiently well developed to enable monetary policy to be implemented using market-based instruments;

- **Inflation forecasting.** The central bank needs the proper policy tools to be in a position to influence inflation. These should be based on a reasonable understanding of the links between the stance of policy and inflation.

Source: IMF (2002c).

34. **The BCT should further improve, and seek to better understand, the effectiveness of the transmission mechanisms of monetary policy.** The speed at which financial market deepening will lead to changes in the transmission mechanisms of monetary policy in Tunisia can only be assessed on the basis of country specific analysis and research. This will be a challenging task given the uncertainties in the transmission of monetary policy to inflation in a moving environment.

35. **During the transition period, the BCT could continue to be guided by a monetary aggregate as an intermediate target**. However, it will need to complement M3 with the monitoring of inflation and other macroeconomic indicators, such as current and projected inflation, total credit to the economy, and the exchange rate. When a monetary framework of that kind is put in place, accompanied by a firm commitment on the part of the monetary authorities to pursue price stability, it may be qualified as implicit, or "lite" inflation targeting.[14]

[14] See Stone (2003).

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Detailed Action Plan to Strengthen Monetary Policy

	Stage 1: Interbank Market Deepening		Stage 2: Financial Markets Diversification	
	Measures	Comments/Objectives	Measures	Comments/Objectives
Opening-up of the capital account; foreign exchange market, and exchange regime*	Abolish the surrender requirement and banks' foreign exchange deposit at the BCT *nivellement*. Liberalize foreign borrowing, allow nonresidents to purchase government securities, liberalize direct investment abroad; initiate liberalization of portfolio investments for residents.	Stimulate foreign exchange market in preparation for floating the exchange rate. Diversify sources of BOP financing. Facilitate activity of domestic corporations abroad, and the diversification of residents' portfolios.	Complete liberalization capital account by the end of this stage. Establish fully flexible exchange rate.	Prudential norms are observed (limits on open positions and on maturity mismatch). Greater openness of the economy calls for exchange rate flexibility.
Banking system	Continue strengthen the financial structure of banks.	Ease the constraint on monetary policy that could stem from weaknesses in the banking system.	The banks need to have a sound financial structure to be able to withstand market discipline.	Monetary policy needs to be freed from microeconomic considerations.
Monetary framework	Set the intermediate target: M3; the operating target as base money	The phasing out of liquid treasury bills should ensure adequate correlation between M3 and inflation, and the relationship between M3 and base money appears stable.	Intermediate target: M3 and additional indicators monitored. Operating target: interest rate.	The demand for money could become unstable. The development of markets will lead to interest rates playing a more prominent part in transmission channels.
Financial Markets	Adjust of monetary instruments in order to develop the interbank market. Strengthen public debt management	Strengthen public debt management based on the recommendations in the "Guidelines for Public Debt Management." That will help create a yield curve.	Deepening of the public debt and bond markets.	Emergence of a yield curve will allow banks to discontinue the practice of indexation of loan agreements on short-term money market rates.
Monetary instruments	Combine reserve requirements and competitive base money auctions. BCT fine-tuning should be the exception rather than the rule.	Scale back BCT interventions in the interbank market in order to boost its role in the recycling of base money.	Reserve requirements can be maintained. Monetary policy relies mainly on open market operations.	Fine-tuning operations become more important for steering interest rates within the corridor.
Interest rate management	Let interbank rates fluctuate within the corridor created by combination of standing deposit and lending facilities.	Scale back BCT interventions in the interbank market; strengthen the part played by the interbank market in recycling base money.	Use interest rate tenders for allocation of base money at the periodic refinancing operations. Monitor short-term interest rates within the corridor.	Interest rates will play a more prominent role in monetary policy transmission channels.

* The steps taken to liberalize the capital account are specified in the aforementioned IMF study: "Liberalization of the Capital Account in Tunisia—Progress Achieved and Prospects for Full Convertibility."

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IMF Concludes 2003 Article IV Consultation with Tunisia

On July 25, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Tunisia.[1]

Background

Tunisia's favorable economic performance since the mid-1990s has been based on appropriate macroeconomic policies, a forward-thinking but gradual opening of the economy, particularly under the Association Agreement with the EU (AAEU), and well-targeted social policies. Until 2001, the authorities followed a constant real effective exchange rate rule to help maintain competitiveness. Since then, the central bank has let the dinar depreciate by more than required to keep the real exchange rate constant in order to partially offset the impact of reduced external protection on competitiveness.

The year 2002 was difficult for the Tunisian economy. Monetary and fiscal policies were tightened in response to excessive demand growth, while the economy was hit by a series of shocks: terrorist attacks, a slowdown in export markets, and a fourth year of drought. The policy tightening led to a rapid correction in the external balance, despite a drop in tourism and export growth. Even under these circumstances, real GDP advanced by 1.7 percent, and market confidence in Tunisia did not wane. Tunisian debt performed well in financial markets after September 11, 2001, and the country's investment grade rating was raised by Moody's in 2003 after the Iraq war. The external reserve position rose to the equivalent of three months of

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

imports by the end of 2002 and has remained there since. External vulnerability indicators have improved.

The outlook for 2003 is favorable: GDP growth could once again exceed 5 percent with a rebound in export growth and agriculture. Recent indicators point to a resumption in tourism flows, although tourism poses a key risk to the outlook. The external current account deficit is forecast to narrow, in part because of continued slack domestic demand, while external reserves are projected to remain close to three months of imports. The exchange rate depreciated by 3.5 percent in real effective terms over the last 12 months.

The government will keep a tight rein on expenditures in 2003 in an effort to lower the budget deficit by 0.3 percent of GDP, although revenue growth was weak in the first quarter because of slow domestic activity and low import growth. This consolidation should reduce government debt as a share of GDP to below 60 percent. The central bank has eased monetary policy in response to slack credit growth, lowering the credit auction interest rate in March and June. There are no signs of inflationary pressures. Financial conditions in the banking sector have weakened with the drop in tourism and slower growth, but at present do not constitute a threat to economic stability.

The authorities turned their attention in 2002 to formulating a new macroeconomic policy framework based on three pillars: a well-defined monetary policy with clear objectives and operating targets, a floating exchange rate, and an open capital account. As a first step, the authorities began in 2002 with measures to deepen financial markets, including opening a small share of the treasury bill market to foreign investors and easing the requirements for opening bureaus de changes.

Unemployment remains high at 15 percent and economic growth has not been sufficient to meet the authorities' goal of raising real incomes to lower-tier OECD country levels. In this context, the authorities are implementing structural reforms with support from the World Bank, the EU and the African Development Bank under the Economic Competitiveness Adjustment Loan. The loan deals mainly with the private investment climate, telecommunications, and the financial sector. The World Bank is also preparing strategy papers on employment and the tourism sector, as well as a study on public debt management. Structural impediments to growth include labor market rigidities, an excessive state presence in the economy through price controls and government ownership, financial sector vulnerabilities, high overall trade protection, and a heavily-regulated onshore sector.

Tunisia continues to improve the quality and dissemination of statistical data and increase the transparency of its economic policies. Tunisia has published all Executive Board documents and staff mission statements in recent years, and intend to publish the 2003 Article IV Staff Report and Supplement.

Executive Board Assessment

Executive Directors commended Tunisia's solid economic performance since the mid-1990s, with robust economic growth, an improving external position, subdued inflation, and declining poverty. These results stemmed from sound and transparent macroeconomic policies, an improved regulatory framework, progress in trade liberalization, and well-targeted social policies. As became evident over the past two years, these advances have contributed to a more diversified economy better able to withstand shocks as well as enhanced Tunisia's credit rating and access to international capital markets. A key challenge going forward will be to accelerate steps to strengthen an open market economy in order to address remaining challenges, including the high levels of public debt and unemployment. Directors therefore welcomed and endorsed the authorities' plans to upgrade the policy framework. They applauded Tunisia's close cooperation with the Fund, viewing Tunisia as a worthy example of the effectiveness of partnership between national authorities and the Fund based on mutual trust.

Directors endorsed the authorities' plans to aim for fiscal consolidation over the medium term as part of the effort to increase public saving and lower the government debt. They commended the targeted reduction in the budget deficit in 2003 despite the adverse impact of sluggish domestic demand on government revenue. Directors noted that the authorities' room for fiscal maneuver in the event of adverse shocks is limited owing to the large wage and interest bills. They accordingly viewed the removal of fiscal rigidities as a key priority in the near term. In this context, Directors highlighted the need for reform of the civil service to increase its efficiency and cost-effectiveness as well as reduce the government wage bill. They also urged faster progress with the planned reform of the social security system.

Directors agreed that the proposed reform of the macroeconomic policy framework is appropriate in view of Tunisia's increasing integration with the world economy. They welcomed the planned move to a floating exchange rate regime as well as an open capital account, and considered the decision to allow the exchange rate to depreciate somewhat in real effective terms to be a first step in this direction. Directors stressed that full capital account liberalization should be delayed until the proposed revised monetary policy framework is established and the transition to a floating exchange rate is completed. They noted that the monetary framework should provide a nominal anchor for price stability—which would become the primary objective of monetary policy—and that exchange rate flexibility should help foster external equilibrium and enhance the economy's resilience to external shocks. Directors cautioned against continued external borrowing solely for the purpose of bolstering external reserves, and suggested that the adequacy of international reserves may be judged in relation to short-term indebtedness rather than only in relation to imports.

Directors welcomed the recent easing of monetary policy given the absence of inflationary pressures and the sluggish demand for credit. Going forward, most Directors generally supported the use of broad money (M3) as an intermediate target and reserve money as the operational target, and the discontinuation of credit growth targeting. Directors believed that further development of financial markets and effective flexibility of interest rates will be needed before interest rates can play a more prominent role in monetary policy transmission channels. They welcomed measures taken to deepen money and foreign exchange markets, including the limited opening of the treasury bill market to foreign investors and the easing of requirements for opening exchange bureaus. These measures should help foster competition and reduce the volatility of interest rates and the exchange rate.

Directors considered that structural reforms will need to be accelerated to reduce the role of the state in the economy, foster private sector activity, and boost productivity as well as investment. This will help to achieve a lasting rise in the rate of economic growth and create employment opportunities in the context of increasing economic integration. They attached high priority to financial sector reform, trade liberalization, and the creation of a level playing field for all economic participants.

In the financial sector, Directors welcomed the ongoing efforts to implement banking sector reforms based on the Financial System Stability Assessment (FSSA) report. They noted the FSSA's conclusion that the current level of nonperforming loans does not threaten macroeconomic stability. Directors nevertheless recommended that the authorities should move vigorously to strengthen the banking sector, so as to increase its efficiency, allow the proper functioning of the proposed new monetary framework, and, in due course, permit capital account liberalization. Actions to strengthen bank balance sheets could include expediting the collection of collateral, increasing provisioning and allowing its full tax-deductibility, and further reducing government ownership in the financial sector.

As regards the foreign trade sector, Directors welcomed the liberalization achieved by Tunisia in the context of its Association Agreement with the European Union, but expressed concern that in many other respects its trade regime remains complex and restrictive. In order to secure the full benefits of progressively greater economic integration, Directors urged the authorities to lower tariffs on products from non-EU countries, reduce the number of tariff rates, and review and adapt regional and bilateral trade accords to eliminate trade distortion. They also urged a reduction of nontariff barriers and a streamlining of customs procedures.

Directors reviewed the contribution that attractive tax and investment incentives have made to promote exports through the offshore regime during a period when the onshore sector remained subject to very high protection. They agreed with the view that the incentives extended to the offshore sector are no longer justified in view of the tariff reductions that place domestic and exporting firms on the same competitive footing with respect to tariff-free imports. Directors welcomed the authorities' plans to align the two systems in 2007, and several suggested that the authorities consider introducing an even simpler and more transparent system.

Directors commended the authorities' commitment to transparency, which has been reflected in substantial improvements in the quality and dissemination of data, subscription to the Fund's Special Data Dissemination Standard, and the decision to publish the conclusions of the Central Bank's Board meetings. They urged the authorities to address deficiencies in the reporting of data on nonfinancial public enterprises.

Directors noted the authorities' intention to consider including collective action clauses in future bond issues. They also urged the authorities to move forward vigorously with the proposed new legislation on anti-money laundering and combating the financing of terrorism.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2003 Article IV Consultation with Tunisia is also available.

Tunisia: Selected Economic and Financial Indicators, 1998–2003

	1998	1999	2000	2001	Est. 2002	Proj. 2003
Production and income (percent change)						
Real GDP	4.8	6.1	4.7	4.9	1.7	5.5
GDP deflator	3.0	3.1	3.3	2.7	2.3	2.1
Consumer price index (CPI), average	3.1	2.7	3.0	1.9	2.8	2.5
Gross national savings (in percent of GDP)	23.5	24.1	23.1	23.5	21.8	22.3
Gross investment (in percent of GDP)	26.9	26.3	27.3	27.8	25.3	25.5
External sector (percent change)						
Exports of goods, f.o.b. (in US$)	3.1	2.3	-0.4	13.2	3.8	22.1
Imports of goods, f.o.b. (in US$)	4.9	1.6	1.0	11.3	-0.2	19.6
Trade balance (in percent of GDP)	-10.9	-10.3	-11.6	-12.0	-10.1	-9.2
Current account, excl. grants (in percent of GDP)	-3.4	-2.2	-4.2	-4.3	-3.5	-3.1
Real effective exchange rate (depreciation -) 1/	-0.1	1.0	-1.7	-2.4	-1.2	...
Central government (percent of GDP) 2/						
Total revenue, excluding grants	24.3	23.9	24.0	24.4	24.4	24.0
Total expenditure and net lending	27.9	27.8	27.8	28.1	27.9	27.1
Central government balance, excluding grants and privatization	-3.6	-3.9	-3.8	-3.8	-3.5	-3.1
Central government balance, including grants, excluding privatization	-3.2	-3.5	-3.7	-3.5	-3.1	-2.8
Total government debt (foreign and domestic)	56.3	60.0	60.7	62.4	61.6	59.2
Money and credit (percent change)						
Credit to the economy	8.7	8.5	8.0	10.3	5.4	7.4
Broad money (M3)	6.0	18.6	13.2	11.3	5.2	8.4
Velocity of circulation (GDP/M3)	1.9	1.79	1.71	1.65	1.63	1.62
Liquidity aggregate (M4)	9.3	9.42	4.47	6.42	4.00	8.17
Interest rate (money market rate, in percent, end of period)	6.9	5.88	5.88	5.94	5.91	...
Official reserves						
Gross official reserves (US$ billions, end of period)	1.9	2.3	1.8	2.0	2.3	2.6
In months of imports of goods, c.i.f.	2.7	3.2	2.6	2.5	2.9	2.8
Total external debt (Short, medium and long term)						
External debt (in percent of GDP)	56.5	60.1	59.7	60.2	61.0	57.2
Debt service ratio (percent of exports of GNFS)	19.2	18.5	22.6	15.6	17.2	16.4

Sources: Data provided by the Tunisian authorities; includes IMF staff projections for 2002, 2003

1/ IMF Information Notice System (average).

2/ Excludes the social security accounts.

3/ Includes grants, excludes privatization.

Statement by Abbas Mirakhor, Executive Director for Tunisia and Sadok Rouai, Advisor to Executive Director July 25, 2003

We thank the staff for the concise and balanced reports on the 2003 Article IV consultations with Tunisia. Our authorities agree with the thrust of the staff report and appreciate staff and management advice and support.

The discussions with the staff were held against a backdrop of a slowdown in economic growth in 2002 (1.7 percent against an average of 5.2 percent during the period 1997-2001). Substantially lower growth was due to security-related events in the region, four consecutive years of drought, and sluggish demand in Tunisia's main export markets. Close contact with staff, in the context of the mid-year visit, allowed the authorities to adapt their policy stance to the prevailing macroeconomic conditions and changing outlook, while preserving the thrust of the reform process.

Our authorities firmly believe their relations with the IMF since the end of the EFF in 1992, built on mutual trust, as close to ideal and have no hesitation in giving credit to the Fund for their success in achieving macroeconomic stability, building a resilient economy, and achieving a measure of success in a smooth process of integration with the global economy. They are also grateful for the assistance they have received from the World Bank in their efforts at structural reforms. They also believe that the Fund/Bank collaboration in case of Tunisia has been very effective. Since our authorities consider the role of close collaboration with the Fund crucial in the transformation of the Tunisian economy, this statement departs from tradition to focus on the effectiveness of this partnership in meeting policy challenges emanating from external shocks in 2002 as well as providing a framework for policy going forward.

Since 1992, Tunisia has maintained close relations with the Fund outside the regular Article IV surveillance exercise in the form of semi-annual staff visits, participation in the FSAP and the related ROSCs, and transparency initiatives, as well technical assistance. The authorities firmly believe that this has been decisive in strengthening macroeconomic management, enhancing private-sector confidence, and contributing to the improvement of terms and conditions of Tunisia's access to the international capital markets.

The 2002 mid-year staff visit took place last October against heightened tensions in the Middle-East and the weak outlook for the global economy. The staff and the authorities developed a number of scenarios to adapt the short-term macroeconomic stance with the objective of alleviating the adverse impact of changing international circumstances on the increasingly open, and, therefore, more vulnerable Tunisian economy. Building on this policy dialogue, the authorities created high-level, follow-up committees under the chairmanship of the Prime Minister. These committees identified and proposed to the government a number of actual and contingent fiscal measures as well as other sectoral reprioritization actions.

The authorities' readiness to take prompt and decisive measures based on Fund advice to meet potential and emerging imbalances was helpful in safeguarding the macroeconomic stability achieved in recent years. Indeed, with the easing of the geopolitical tensions, the final outturns for 2002 were rather encouraging, reflecting an improvement in the fiscal and external positions. The budget and current account deficits were reduced, and inflation was kept under 3 percent. However, because of the significant decline in tourism receipts, external borrowings increased to maintain the reserves coverage around three months of imports. For 2003, growth is projected to pick up to 5.5 percent, and both the budget and current account deficits will be further reduced to 3.1 percent of GDP.

With macroeconomic stability achieved, the authorities' reform agenda is focused on strengthening the monetary framework and the financial sector, liberalizing the capital account, and integrating the economy more rapidly with the global system. In this context, the FSAP and the follow-up work conducted in 2001–2003 have been extremely helpful in designing the reform agenda for the financial sector and in setting up priorities for further opening of the capital account.

As detailed in paragraphs 31-32 of the staff report, the authorities continued with the implementation of the FSAP/FSSA recommendations, achieving further progress in the privatization of public banks and in enhancing the conduct of monetary policy and its transparency in line with the recommendations of staff (staff report, supplement 1). The authorities are aware of the deterioration in 2002 in the main financial indicators of the banking sector and, to a great part, attribute this to the slowdown in economic activity, particularly tourism. In addition, some of the deterioration originates from the development of assets-recovery companies and from the increase in the write-off of NPLs. The authorities remain committed to further strengthening the banking system and modernizing its infrastructure.

The FSAP exercise has also been very helpful in the development of a coordinated strategy toward achieving greater economic and financial integration of the Tunisian economy into the world economy. As a follow-up, this year discussions allowed the authorities and the staff to agree on three major stages of reforms: the first stage is to better define the monetary framework before moving to the second stage of adopting a floating exchange rate regime and, third, opening the capital account. The authorities are implementing this strategy and are reassured by staff's conclusion that the increased flexibility in exchange rate management is *"consistent with the authorities' plans for eventually floating the dinar."* The focus of this year's discussions on strengthening the monetary framework and instruments, detailed in Supplement 1 to the staff report, constitutes another helpful contribution from the Fund to the medium-term reform of the macroeconomic policy framework. The authorities agree with staff's technical analysis to establish a well-defined monetary framework that could provide a nominal anchor to a floating exchange rate regime, and they are in the process of implementing the recommendations after careful preparatory work supported by technical assistance.

Achievement of higher rates of economic growth to reduce unemployment remains the overriding objective of the policy agenda, and the authorities agree with staff on the importance of accelerating the implementation of structural reforms to remove the remaining impediments to growth. Moreover, the authorities will consider carefully staff's specific recommendations to expand trade liberalization outside the Association Agreement with the European Union (AAEU) and other regional agreements, as well as to address the dichotomy between the offshore and onshore sectors of the economy. The authorities appreciate the support of the World Bank, in particular the preparation of important strategic studies on tourism, employment, and environment. They are committed to finalizing before year-end the structural reform agenda, agreed under the Third Economic Competitiveness Adjustment Loan (ECAL3).

The authorities are also focusing on external debt management; the sustainability analysis confirms that the country remains vulnerable to exogenous shocks, despite the progress achieved in diversifying the economy. The authorities consider that fiscal consolidation, in particular the easing of budget rigidities, is essential. They are developing, with technical support from the World Bank, a strategy for public debt management.

As always, our Tunisian authorities are grateful for Executive Board's support and look forward to the views of Executive Directors.