Tunisia

A fragile stabilisation

The Tunisian economy has begun to show signs of stabilisation. Inflation is falling, exchange rate pressures are easing and the government finally managed to uphold its commitment to fiscal consolidation in 2018. Yet the country's prospects are still very fragile. Although the support of international donors is reassuring, the persistence of major external imbalances exposes the economy to shocks. Bank liquidity is already under pressure due to the tightening of monetary policy, and the high level of public debt calls for further reduction in budget deficits that could be hard to achieve. Above all, economic growth is still sluggish.

Tunisia will hold general elections in a few months that will be decisive for the consolidation of its democratic transition. Although the outcome is uncertain amid an increasingly fragmented political landscape, the roadmap is rather clear for future leaders: they must boost a sluggish economy, halt the surge in public debt and strengthen Tunisia's external-account stability. On the positive side, signs of stabilisation are finally seen after several years of overruns. The overall picture, in any case, is still very fragile.

Monetary policy: a necessary but difficult tightening

Inflation is still high at 7%, but has declined since the peak reached in June 2018 at 7.7% (chart 2) thanks to the tightening of monetary policy. Since February 2018, the key policy rate has been raised by 275 basis points (bp) to 7.5%. For the first time in three years, real interest rates are negative. The Central Bank of Tunisia (CBT) has also tightened refinancing conditions for banks and has capped the loan-to-deposit ratio at 120%.

Although the CBT has clearly shown its determination to fight against inflation, it has very little manoeuvring room. The overall volume of CBT refinancing has peaked since the beginning of the year (TND 16 bn, up from TND 10 bn one year earlier, with almost ¼ made of 24-hour marginal loan facilities), which leaves the banks highly sensitive to monetary policy tightening. It is not surprising that money market rates have soared to historical highs of nearly 8%, and that lending growth to the economy has slowed sharply. At the end of May 2019, banking credit growth had slipped to only 6.8% y/y, compared to 13% in early 2018. Expressed in real terms, lending growth even slipped into negative territory in May, for the first time since November 2003.

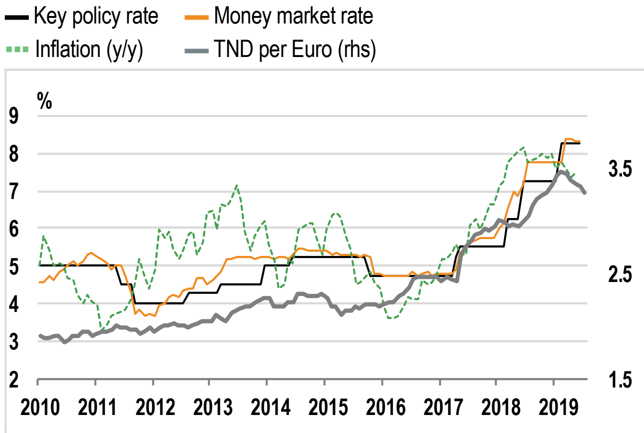
Inflationary pressures are likely to remain high. Fluctuations of the Tunisian dinar (TND) call question. After depreciating by nearly 30% against the euro in 2017-2018, the TND has been resilient since the beginning of the year. Over the past three months, it has even strengthened 6% against the single currency. One explanation is the dynamic momentum of tourism. After a long period of stability, the 16% depreciation in the real effective exchange rate over the past two years has partially reduced the over-valuation of the currency. Yet considering the magnitude of external imbalances, the dinar's upward momentum seems unsustainable. The Central Bank of Tunisia might have to tighten monetary policy further if new currency pressures arise.

1-Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	1.9	2.5	2.0	2.5
Inflation (CPI, year average, %)	5.3	7.3	7.0	5.7
Central Gov. balance / GDP (%)	-6.2	-4.8	-4.3	-3.6
Central Gov. debt / GDP (%)	70.5	77.0	78.1	77.8
Current account balance / GDP (%)	-10.2	-11.2	-9.7	-8.5
External debt / GDP (%)	84.0	84.6	95.3	96.3
Forex reserves (USD bn)	5,6	5,3	5,9	6,7
Forex reserves, in months of imports	3.0	2.6	2.9	3.1
Exchange rate USDTND (year end)	2.48	2.99	3.15	3.30

e: BNP Paribas Group Economic Research estimates and forecasts

2- Monetary environment



Source: CBT, INS, Datastream

External imbalances are still very high

Tunisia's external position is the main source of macroeconomic vulnerability. After reaching a record high of 11.2% of GDP in 2018, the current account deficit could finally begin to narrow this year. Even so, it will still hold at very high levels, at about 9% of GDP. Several factors continue to strain external-account dynamics. Despite currency depreciation, exports are still hit by the collapse of phosphate production and the ongoing loss of market share in Europe, by far its biggest trading partner. Although the tourism sector has rebounded strongly since the 2015 terrorist attacks, it now generates fewer revenues than in the past (USD 1.5 bn in 2018, down from USD 2.1 bn in 2014) despite an increase in the number of tourists. The ongoing decline in national hydrocarbon production also limits the gains generated by lower oil prices on the import bill. Net oil imports accounted for half of the current account deficit in 2018, up from 16% in 2010.

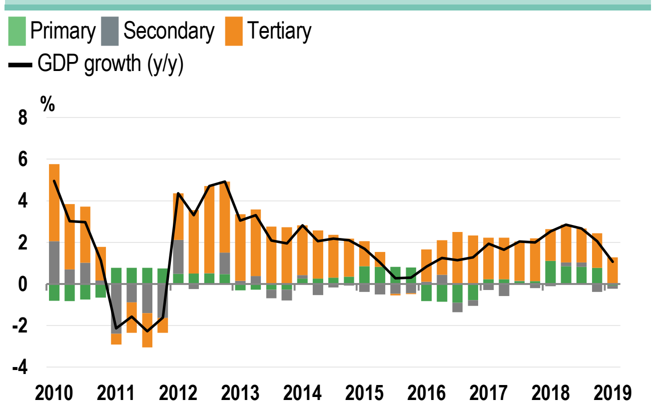
The recent conclusion of the sixth tranche of the IMF programme provides grounds for relief. Net flows of foreign direct investment (FDI) have been stable at 2-2.5% of GDP, but they only account for 20% of the current account deficit. By keeping the IMF programme on track, not only is Tunisia ensured of the support of other international donors but this also paves the way for an upcoming Eurobond issue of EUR 500 mn, which should be sufficient to cover external financing needs. Yet, with foreign exchange reserves now below the warning threshold of three months of imports of goods and services and a sizeable major current account deficit, the economy is still highly exposed to exogenous shocks.

Public finances: progress must be kept in perspective

The consolidation of public finances also promises to be difficult, even though some reforms are beginning to bear fruit. According to preliminary estimates, the fiscal deficit was cut from 6.2% of GDP in 2017 to 4.8% in 2018 thanks essentially to the increase in tax revenue (+1.2% of GDP). Ambitious goals have been set for 2019, with a deficit reduction target of 3.9% of GDP. We do not think this target will be met due to pressures created by the electoral campaign. Even so, the fiscal deficit should continue to narrow to 4.3% of GDP, which would mark a break from the fiscal overruns of recent years. However, nothing guarantees that the authorities will be able to maintain the cap in the longer term.

Contrary to IMF recommendations, the government granted wage increases to public sector employees for an estimated cost of 0.5% of GDP in 2019 and 2020. Although new cutbacks in energy subsidies should help absorb part of the cost, the decision further accentuates the rigidity of public spending. Despite a freeze on hiring since last year, the public sector payroll could absorb nearly 65% of fiscal revenues in 2019, up from 54% in 2010. To meet their fiscal commitments, the authorities could have no option but to use public investment as an adjustment variable, to the detriment of economic activity. Above all, the government debt trajectory is still not showing any significant signs of improvements. Government debt (77% of GDP) is a source of concern, although the high share of debt contracted on concessional terms (63% of foreign currency debt) has helped limit the debt servicing cost so far. Significant contingent liabilities also arise from government guarantees for financially challenged state-owned companies (15.6% of GDP). Moreover, government debt is exposed to exchange rate fluctuations (75% of the debt stock is denominated in foreign currency). Lastly, external assistance from international donors is supposed to cover 60% of domestic financing needs in 2019 and 2020. Although the risk of disruption is rather limited, disbursements are subject to conditionality, which reduces the government's manoeuvring room in the absence of any alternative sources of financing (the local capital market is shallow).

3- Sector contribution to growth



Source: INS

Economic prospects: towards a mild recovery

Q1 figures confirmed Tunisia's economic difficulties. After a mild recovery over the past two years (+2% in 2017 and +2.5% in 2018), real GDP growth slowed to 1.1% in Q1 (see chart 3). With the exception of tourism, most sectors have stalled (construction) or contracted (agriculture and manufacturing). Although public-sector wage increases effective since March should boost household consumption as of Q2, the overall impact on growth will be small. With GDP growth estimated at 2% this year and 2.5% in 2020, the Tunisian economy will not be in a position to bring down the official unemployment rate, which has culminated at 15%. Looking beyond exogenous factors (regional instability, weak European demand) and security risks, which are all very real, it is critical to accelerate structural reforms to improve growth prospects. The challenge is daunting. Between 2010 and 2018, the investment rate fell by 5 points to 20% (compared to 28% in Morocco). It is also very telling that Tunisia has lost 50 places on the World Economic Forum's global competitiveness ranking over the same period, illustrating the fundamental problems the authorities must face.

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