Tunisia

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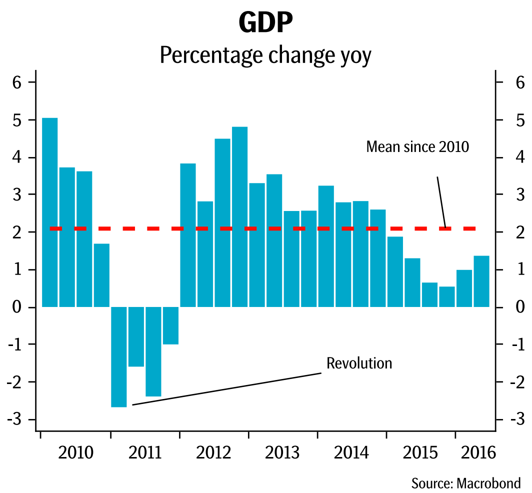
Although the democratic transition after the 2011 revolution was successful, the upheaval left the country suffering from slow economic growth. A gradual recovery is in the cards, but the risk that the country gets trapped in a vicious circle of poor economic performance and a deteriorating security situation should not be discarded.

Country Risk Analysis

No pick-up in growth. Tunisia has a history of strong resilience to various external and domestic shocks. However, 2015 was a particularly challenging year with several terrorist attacks and social unrest that generated a dismal economic expansion of less than 1%. A sharp deterioration in the tourism sector, still standing for 7.5% of GDP, was only partially compensated for a boom in the agriculture sector. It appears that Tunisia's fortunes have still note turned. Despite some improvement in the second quarter 2016 is likely to be yet another year of weak growth and rising unemployment. Indeed, most analysts have adjusted their near-term GDP forecasts downward. Our 1.2% projection for 2016, which is considerably lower than expected a year ago, appears to be close to the consensus view.

Inflation on the rise. Inflation was on a downward trend last year but nonetheless registered an average of 4.9% which is high given the low level of economic activity. Low growth has kept the unemployment rate stubbornly high at nearly 16% and twice as high in rural communities.

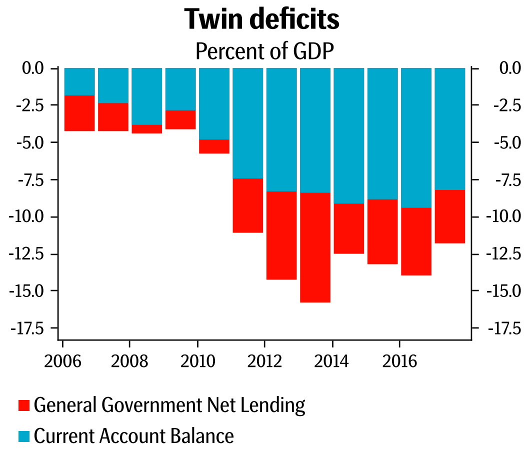


Poor external balances remain key weakness. The terrorist attacks in 2015 appear to have amplified a downward trend in the tourism sector thus further depriving the economy of vital foreign income. The current account deficit that had widened steadily up until 2014 improved marginally in 2015 but remained high at nearly 9% of GDP. A persistently high energy deficit explains a large share of the deficit.

The weak external balances put pressure on the exchange rate which has depreciated against both the USD and the EUR during 2016. International reserves have declined somewhat in the past months but are expected to cover roughly 4 months of imports by the end of 2016.

Renewed external financial support. Persistent twin deficits have generated a significant financing gap. Foreign direct investment (FDI) has been declining in recent years, similar to other economies across the Middle East region, and inflows during 2016 have been the lowest in several years. As portfolio inflows have been low too, over 90% of Tunisia's financing in 2016 is expected to come from multilateral sources, according to FitchRatings. In this respect, a USD 500 mn government bond issuance this summer provided a welcome addition to foreign reserves.

The country's previous IMF agreement expired in December 2015, and in May 2016 the IMF granted a new four-year USD 2.8 bn Stand-By arrangement, despite some missing prior actions. The continued Fund cooperation paves the way for additional external funding from the US and the EU in the form of a loan and a loan guarantee of USD 500 mn respectively.

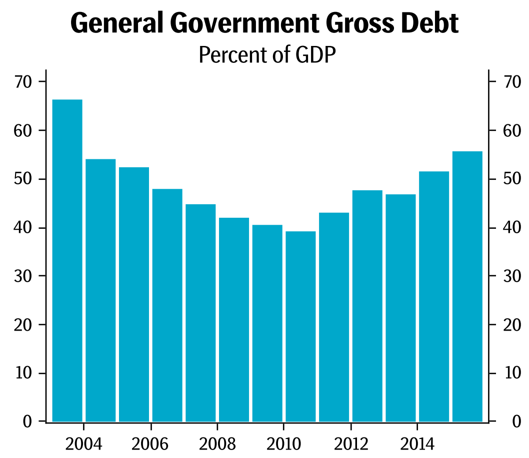


Source: Oxford Economics, IMF

External debt edging up. Tunisia's external debt declined in the years prior to the revolution but has risen gradually since then to just above 60% of GDP in 2015. The IMF expects it to peak at roughly 70% in the coming years making the economy relatively vulnerable to a large depreciation in the exchange rate.

Government aiming to consolidate finances. Fiscal consolidation efforts under the IMF programme focus on tax and civil service reform. The current budget aims at reducing the fiscal deficit to 3.9% of GDP which is slightly optimistic according to some observers. Although the government will be helped on the expenditure side by continued reductions in energy subsidies, consolidation is hampered by the structurally high costs for public sector wages. The public sector wage bill has roughly doubled in the last five years and now consumes more than 60% of tax revenues and is equivalent to 14% of GDP. This is among the highest ratios in the world, and continues to rise. Very strong labour unions and a tradition that the state should act as one of the main providers of employment lies behind this.

High share of rising government debt is foreign currency denominated. Expansionary fiscal policy in combination with low economic activity and a weaker currency has led to a rising general government debt. The government itself expects it to rise above 60% of GDP in 2016, up from about 55% in 2015. This is slightly higher than among peers. What may be of more concern is the rising share of FX debt, now around 60%, making public finances vulnerable to further currency depreciation. A mitigating factor is that the debt service is relatively modest as a very large part of the overall debt is on concessional terms and the average maturity is long. Tunisia has a clean debt service history.



Source: IMF

New political leadership, same challenges. Tunisia's successful four-year democratic transition following the revolution culminated in the nomination of a new government and President in early 2015. This accomplishment was a unique success in the region. However, last year's terrorist attacks and increasingly frequent protests and demonstrations created too strong headwinds for the government in their quest to come to grips with poor growth, high unemployment and the security situation. Consequently, a newly appointed prime minister, representing the same Nidaa Tounes party as the President, recently was tasked with formulating a new government with a broader political composition. Given the fiscal straightjacket that the government is in (through the IMF programme) most observers have low expectations of any near-term success in dealing with the country's fiscal challenges.

Security risks remain high. The difficult economic situation puts limits to the government's capacity to deal with the security situation. This in turn hampers economic growth thereby risking to create a vicious circle. Security risks are expected to remain elevated in the medium term, not least due to the instability of neighbouring Libya. Most observers expect that the number terrorist activities will remain high.

Public sector banks' health is stabilising. The sector is dominated by the three state owned banks standing for roughly 30% of total bank assets. These banks have also since long been the main source of weakness and vulnerability. While capital adequacy has improved following the recapitalisation of the two largest banks, the bank system remains vulnerable after decades of mismanagement. Non-performing loans, often originating in the tourism industry, averaged 16% in end-2015 and risks of further recapitalisation needs cannot be discarded.

Slow but fragile economic recovery is in the cards. Activity in the tourism sector is expected to continue falling in the near-term but recover during 2017 under the assumption that the regional risks subside. Meanwhile FDI flows should gradually start recovering, helping to generate rising GDP growth in 2017 and 2018. Investments are mainly expected in the energy sector. At the same time, sluggish demand in Tunisia's main export markets (more than 70% go to Europe) and fiscal consolidation is likely to limit growth to 2-3%.

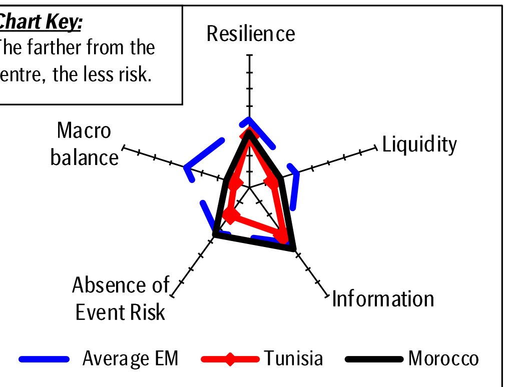
The security situation is a major downside risk to main scenario. A key risk to the outlook is a deterioration in the security situation, either domestically or in the form of events at the borders to Libya or Algeria that spill over on economic activity and on domestic policies. Tunisia also supplies a large number of fighters to ISIS and to jihadist groups in neighbouring countries. As these fighters will eventually return, they may bring terrorist activity to home soil. A worse than expected security situation would pull away attention and resources from structural reforms and thus risks trapping the economy in a vicious circle of poor economic growth and a challenging security and social situation.

Weak external balances are another risk. We assume a gradual decline in the current account deficit over the medium term based mainly on an improvement in external demand and a recovery in the tourism industry. Consequently, any deterioration of the external balances and further pressure on international reserves would weigh heavily on the country risk rating.

Tunisia: Risk Profile

Key ratios	2016
Population (mn)	11.1
GDP/capita, nominal (USD)	3632
Real GDP (% chg)	1.2
Inflation (%)	3.8
Current account balance (% of GDP)	-9.4
Reserves/imports (months)	4
Budget balance (% of GDP)	-4.8
Government debt (% of GDP)	62

Chart Key: The farther from the centre, the less risk.



External ratings:
Fitch: BB- / Stable
Moody's: Ba3 / Stable
S&P: Not rated

Peers:
Sri Lanka
Morocco
Bangladesh

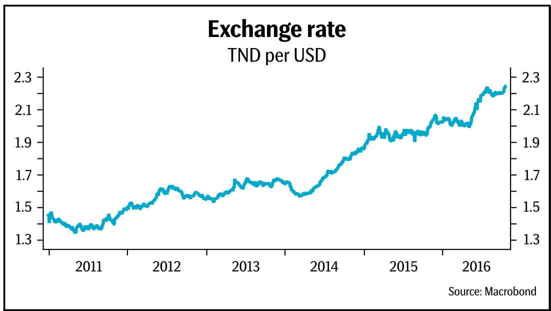
Graph: Tunisia scores about the same as EM average on resilience but significantly below on liquidity and macroeconomic balance. Uncertainty over the political transition following the revolution has declined but external security concerns keeps event risk elevated.

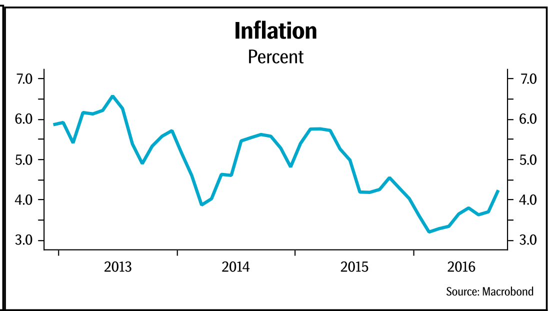
Tunisia: Key Indicators

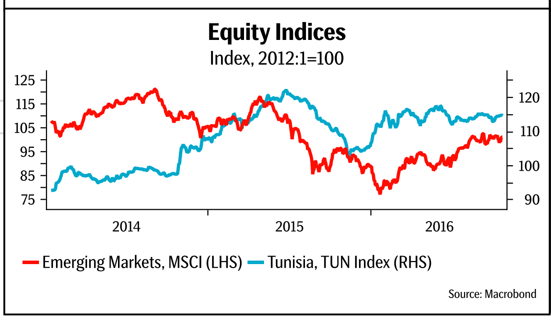
Macroeconomic	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
GDP real (chg)	25.3%	2.3%	2.3%	0.8%	1.2%	2.0%	2.7%	3.1%
GDP (bn USD)	45.0	46.3	47.6	43.0	41.3	39.8	41.7	43.9
GDP/capita (USD)	4 138	4 202	4 277	3 822	3 632	3 464	3 597	3 749
Investments/GDP	22%	22%	20%	19%	18%	17%	16%	16%
Trade/GDP	101%	97%	95%	85%	83%	90%	92%	94%
Money & Prices								
CPI inflation	5.1%	5.8%	4.9%	4.9%	3.8%	4.7%	4.9%	4.9%
Money, M2 (chg)	69.3%	57.7%	51.3%	43.2%	40.2%	40.6%	43.3%	45.4%
Interest rates	3.8%	4.6%	4.8%	4.7%	4.5%	4.9%	5.5%	5.6%
Stock prices (chg)	94%	55%	30%	7%	22%	16%	33%	41%
Exchange Rate (USD)	1.6	1.6	1.7	2.0	2.1	2.4	2.4	2.5
Government Finances								
Budget balance/GDP	-2.7%	-4.6%	-4.5%	-4.4%	-4.8%	-4.4%	-4.2%	-4.0%
Govt debt/GDP	47%	47%	49%	54%	62%	64%	65%	63%
Balance of Payments (USD bn)								
Current account	-3.7	-3.9	-4.3	-3.7	-3.9	-3.2	-3.1	-3.0
(% of GDP)	-8.3	-8.4	-9.1	-8.6	-9.4	-8.2	-7.4	-6.8
Export of goods	22.3	22.1	21.7	17.6	16.3	17.3	18.8	20.3
Imports of goods	23.1	23.0	23.4	19.1	18.0	18.4	19.6	20.9
Other current acct flows	-2.9	-3.0	-2.6	-2.2	-2.2	-2.2	-2.3	-2.5
Net FDI	1.6	1.1	1.0	1.0	0.8	1.0	1.2	1.3
External Debt & Liquidity (USD bn)								
Reserves	8.4	7.3	7.2	6.7	6.3	6.6	7.2	8.0
Gross external debt (% of GDP)	56	57	61	64	74	82	84	85
Gross External Debt	25.3	25.7	26.4	28.2	30.5	32.8	35.0	37.3
o/w short term debt	6.2	6.6	6.8	7.3	7.9	8.5	9.1	9.7
Oil price (USD, Brent)	112	109	99	52	44	50	52	59

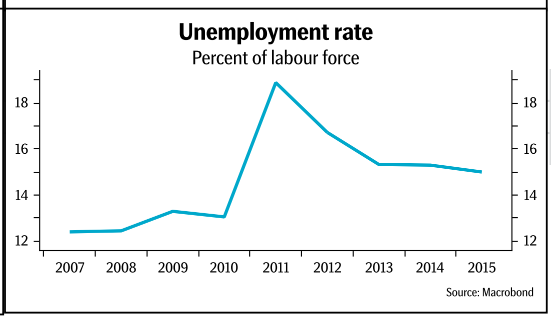
Source: Oxford Economics, IMF, FitchRatings

Type of government:	Presidential system
Next elections	Presidential 2019, parliamentary 2019
Other:	
Latest PC deal	None
Latest IMF arrangements:	Extended Fund Facility of USD 2.9 bn expiring in 2020









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