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TUNISIA

Selected Issues

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Approved by the Middle Eastern Department

May 17, 2002

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Glossary

AAEU	Association Agreement with the European Union
AMC	Asset management company *(Société de recouvrement)*
BCT	Central Bank of Tunisia *(Banque Centrale de Tunisie)*
BDET	*Banque de Développement Economique de Tunisie*
BNDA	*Banque Nationale de Développement Agricole*
BNDT	*Banque Nationale de Développement Touristique*
BNT	*Banque Nationale de Tunisie*
BOP	Balance of payments
BTA	*Bons du Trésor Assimilables*
BVMT	Tunisia Stock Exchange *(Bourse des Valeurs Mobilières de Tunis)*
CAR	Capital adequacy ratio
CDs	Certificates of deposit
CMF	Financial market board *(Conseil du Marché Financier)*
CPI	Consumer price index
CRERR	Constant real exchange rate rule
EU	European Union
EUV	Export unit value
FDI	Foreign direct investment
FSAP	Financial Sector Assessment Program
FTAA	Free Trade Association Agreement
GATT	General Agreement of Tariffs and Trade
GSM	Government securities market
HIC	High Investment Commission
IFS	International Financial Statistics
INS	Information Notice System
IOSCO	International Organization of Securities Commissions
MENA	Middle East and North Africa
NPLs	Nonperforming loans
OECD	Organization for Economic Cooperation and Development
OPCVM	Collective Investment Institutions *(Organisme de Placement Collectif en Valeurs Mobilières)*
REER	Real effective exchange rate
SIC	Standard Industrial Classification
SICAV	*Société d'Investissement à Capital Variable*
TARS	Trade Analysis and Reporting System
TMM	Money market rate *(Taux du marché monétaire)*
ULC	Unit labor cost
VAT	Value-added tax
WEO	World Economic Outlook
WTO	World Trade Organization

CHAPTER I: REAL EXCHANGE RATE TARGETING—TUNISIA'S EXPERIENCE[1]

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[1] This chapter was prepared by Domenico Fanizza, Nicole Laframboise, Edouard Martin, Randa Sab, and Izabela Karpowicz (all MED).

I. Introduction

1. During the past decade or so, Tunisia's foreign exchange policy has aimed at maintaining a stable real exchange rate against a basket of currencies weighted according to the country's main trading partners and competitors.[2] This policy amounted to a constant real exchange rate rule (CRERR) according to which the authorities adjusted periodically the nominal exchange rate so as to maintain the real exchange constant.

2. This approach has been fairly successful for Tunisia: inflation declined from over 5 percent in the early 1990s to 1.9 percent in 2001 and real GDP and real export growth (non-energy) averaged 4.8 percent and 7.4 percent between 1991 and 2001. During the 1990s, and particularly in the late 1990s, the authorities pursued the CRERR in conjunction with very prudent monetary and fiscal policies, restricted capital flows, and comprehensive structural improvements. More recently, the monetary authorities have relied on a broader set of competitiveness indicators to set the exchange rate, including market shares.[3] Moreover, Tunisia did not fall into the trap of a high and "plateau-type" inflation as predicted by the theoretical models on CRERR for a number of reasons: (i) the absence of significant shocks during the period; (ii) a prudent macroeconomic policy mix; and (iii) price and wage rigidities, including incomes policies.

3. While this approach has served Tunisia well, its limitations are beginning to emerge in the context of the opening of the economy, increased regional and global integration (catalyzed by the Association Agreement with the European Union (AAEU)), a more sophisticated market-based monetary policy, and the need to relax capital controls to diversify external financing sources and to maximize the benefits of foreign capital for investment and growth. As these changing conditions will make it more difficult for the authorities to gauge where the underlying equilibrium rate is, the authorities are now considering alternative regimes, particularly moving gradually to a floating exchange rate.

4. The main findings of the paper suggest that the Tunisian dinar is appropriately valued. A regression analysis estimating the equilibrium real exchange rate based on different fundamental variables indicates that Tunisia's real effective exchange rate was close to the equilibrium rate estimated by the model, and by 2000, was well in line with what would be predicted by the level of Tunisia's fundamental determinants at that time. Second, most measures of competitiveness suggest no evidence of a misalignment in the current level of the exchange rate: the consumer price index (CPI)-based real effective exchange rate appreciated only by 2 percent from 1990 to 2001; unit labor cost (ULC)-based exchange rate indices show that Tunisia is maintaining cost competitiveness relative to key partners; productivity in the late 1990s grew by about 2.2 percent per year in the manufacturing sector; the relative price of non-tradables to tradables has decreased; and Tunisia has increased its export shares to the European Union (EU).

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[2] Information on the basket of currencies is not disclosed.

[3] The real exchange rate depreciated by 0.6 percent and 2.5 percent in 2000 and 2001 respectively.

5. The paper is organized in the following manner: Section II presents a literary survey of the research on CRERR. Section III discusses other cases of CRERR and the degree to which theory on CRERR was borne out by these countries' experiences. Section IV assesses Tunisia's experience with CRERR in terms of inflation performance and discusses possible reasons for Tunisia's apparent success at avoiding the pitfalls of CRERR as predicted by the theoretical models. Section V presents a regression analysis estimating the equilibrium real exchange rate based on different fundamental variables and compares this to the path of the actual exchange rate. Section VI assesses Tunisia's external competitiveness over the past decade using a range of indicators, including export performance, market share, wage and price-based real exchange rate indices, and profit developments. Finally, Section VII draws some conclusions from the analysis.

II. Literature Survey and Main Conceptual Issues

6. Tunisia's experience with the CRERR has been fairly successful (see Section IV), especially compared to the experiences of other countries like Brazil or Yugoslavia. This section analyzes the economic mechanisms behind the CREER in order to assess the reasons for Tunisia's strong performance, which, at first glance, appears to contradict the main theoretical findings.

7. The choice of a CRERR in Tunisia reflected the authorities' willingness to index the nominal exchange rate to the domestic price level in an effort to avoid losses in competitiveness. However, a constant real exchange rate rule prevents the nominal exchange rate from serving as a nominal anchor: shocks to the domestic price level may be fully accommodated by a faster rate of exchange rate depreciation and a faster rate of monetary growth. Moreover, a CRERR does not permit any adjustment in the real exchange rate when the economy is subject to real (exogenous) shocks. It can therefore lead to a divergence between the actual real exchange rate and the equilibrium real exchange rate. This section elaborates further on this premise.

8. When a country is subject to a positive demand shock—which could, for example, be induced by an improvement in the terms of trade, an increase in government consumption, or a fall in the world nominal interest rate—excess demand for non-traded goods will occur. Under a floating exchange rate, demand pressures raise imports, thereby leading to a deterioration in the trade balance and a depreciation in the nominal exchange rate. Under a fixed exchange rate system, the balance of the non-traded goods market is restored through a relative increase of the price of non-traded goods compared to traded goods, that is, an appreciation of the real exchange rate. Under a real exchange rate rule, such an appreciation would not occur: when the prices of non-traded goods increase, the nominal exchange rate would depreciate at a rate that would maintain the real exchange rate constant. Thus, while the equilibrium exchange rate appreciates as a result of the shock, the actual value of the real exchange rate is kept constant. The adjustment that would have taken place through movements in the relative price of non-traded goods (under a fixed exchange rate regime) must occur through an adjustment in the overall level of prices. This would lead to hyperinflation.

9. However, Adams and Gros[4] found that, under a CRERR, the inflation rate will be whatever it was in the past, modified by shocks to prices in the current period (i.e. inflation follows a random walk). The intuition is that, as the exchange rate moves to fully accommodate all price shocks, de facto it has no long-run equilibrium value. However, more recent literature suggests that a new steady-state equilibrium can be reached in the aftermath of a demand shock, although at this new equilibrium, inflation would be higher than before the shock. Under real exchange rate targeting, changes in the inflation rate can arise from either a fiscal or external shock. In this sense, the CRERR has a bias toward higher rates of inflation, even if it does not lead to hyperinflation. This outcome has been observed in country cases targeting the real exchange rate. A number of developing countries have suffered through prolonged periods of high but stable inflation. In these cases, inflation often moves quickly to a higher, but stable "plateau." Jumps in inflation in Argentina, Brazil and Israel in the mid-1980s (preceding stabilization programs) are likely to have been prompted by exchange rate adjustments in response to adverse external shocks, followed by a period of real exchange rate targeting.

10. Among the more recent papers describing this phenomenon, Montiel and Ostry[5] show that real demand shocks can result in a permanent increase in inflation. In their model, the demand for non-traded goods depends positively on the real exchange rate and on real private wealth. When the economy is subjected to a positive shock, excess demand for non-traded goods results in an increase in their price. As the authorities adjust the nominal exchange rate in line with the increase in the price of home goods, the price of traded goods in local currency increases by an equivalent amount. If the general increase in the price level does not alleviate excess demand pressures in the non-traded goods market, there will be nothing to limit its rate of increase under a CRERR and hyperinflation would ensue. However, the general increase in prices alleviates excess demand pressures though a wealth effect on real consumption (equivalent to an inflation tax on consumption).[6] That is, increases in the price level involve a negative wealth effect, thereby lowering demand for all goods and helping to restore internal balance.

11. However, the rate of inflation will rise. This is because the improvement in the terms of trade results in a current account surplus, which raises the rate at which the private sector accumulates financial wealth. Over time, this creates additional demand pressure in the home goods market, and a new equilibrium is therefore reached only once this pressure from private sector wealth is offset by an ongoing increase in the general price level, i.e. inflation.

12. The nature of fiscal policy can influence the likelihood of hyperinflation. If the government uses the inflation tax to increase expenditure (or the central bank accumulates claims on the rest of the world), the higher inflation rate increases the inflation tax on real money balances paid by the private sector, thereby helping to offset the increase in the private sector's holdings of financial assets. However, if the inflation tax is used by the government to reduce

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[4] See Adams and Gros (1986).

[5] See Montiel and Ostry (1991).

[6] It is assumed that wealth is not fully indexed to price level changes.

taxes on the private sector, the accumulation of wealth is no longer offset by the erosion of wealth due to inflation (because the tax cut acts as a further accumulation of wealth by the private sector). Hyperinflation would ensue because continuous wealth accumulation would add to continuous demand and price pressures. Finally, a one-time increase in inflation could be avoided in theory by a fiscal response such as a cut in government spending on non-traded goods of an appropriate magnitude.

13. Moreover, Montiel and Ostry[7] show that monetary policy cannot be used to restore long-run price stability. For example, under perfect capital mobility, the money supply would be endogenous and sterilization policies could not be used to control the money supply. A reduction in credit would be fully offset by the private sector by a reduction in its holdings of foreign assets. While there would be some changes in the composition of the capital account, changes in credit growth would not affect inflation. The authorities could impose capital controls in an attempt to control the domestic money supply. However, in this case, a parallel foreign exchange market would be likely to emerge. A real shock would again cause a jump in the price level and a current account surplus, and the authorities would have to sterilize the associated increase in international reserves. If the terms of trade improvement is permanent, this policy is unsustainable in the long run since a permanent credit contraction would cause agents to sell foreign exchange in the parallel market. Given a fixed stock of foreign assets in the country and a contraction in credit, the parallel market exchange rate would appreciate. The increasing gap between the official and parallel market rates would in turn lead to a breakdown of capital controls. Thus, control of the money supply and inflation would also be compromised.[8]

14. To summarize, real shocks under a CRERR require an adjustment in the overall level of prices to restore external equilibrium. Increases in the price level help alleviate excess demand in the home goods market through a wealth effect on consumption. However, inflation will rise over time because the terms of trade improvement results in an increase in private wealth coming from the current account surplus. This creates additional demand pressure in the home goods market, and a new equilibrium is therefore reached only once this pressure is offset by an increase in inflation. Even under capital controls, monetary policy would be ineffective at controlling the money supply over the long term.

III. Country Experiences with CRERR

15. The past experience of other countries following a CRERR has been mixed. On the one hand, the CRERR followed by Yugoslavia during the 1980s has been blamed for playing an important role in the hyperinflation experience there in the late 1980s. While the restrictions on

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[7] See Montiel and Ostry (1992).

[8] Calvo et. al. (1995) have also defended the argument according to which, under a CRERR, the authorities can only target the exchange rate for a limited period of time.

external capital transactions could have allowed the authorities to pursue an independent monetary policy temporarily, the central bank's practice of underwriting the foreign currency losses (on foreign currency deposits redeposited by commercial banks with the central bank) circumscribed the scope for pursuing an independent monetary policy.[9] Consequently, monetary accommodation led, through a classic wage-price-exchange rate spiral, to hyperinflation.

16. In Brazil, CRERR implementation also led to rising inflation. Between August 1968 and February 1983, with a break in 1979, Brazil followed a real exchange rate rule under which the exchange rate was changed by small amounts at irregular intervals of time so as to keep the real exchange rate constant.[10] This system was mainly aimed at preserving the competitiveness of Brazilian production in a context of high and endemic inflation, while avoiding the speculative capital flows characterizing the previous system of infrequent and large parity changes. While successful in keeping the real exchange rate constant, it contributed, along with the indexation of wages to prices, and consistent with the theoretical literature (see paragraph 7), to inflation inertia: consumer price inflation increased progressively from about 20 percent in 1969 to more than 40 percent in 1978. Moreover, the depreciation of the equilibrium real exchange rate resulting from the 1972 oil shock led to a sharp deterioration in the current account. Thus, the authorities devalued the exchange rate by 30 percent in November 1979 and in February 1983. In the meantime, consumer price inflation increased to more than 100 percent.

17. On the other hand, Chile followed a CRERR from 1985 to 1992 and was able to target its real exchange rate while keeping inflation in check.[11] The CRERR came under pressure in 1992 when capital inflows placed upward pressure on the currency and the peso was revalued by 5 percent. During the 1986-92 period, inflation, which had averaged 130 percent in the 1970s, averaged 19 percent, slightly less than during the first half of the 1980s. Inflation declined to about 15 percent by mid-1992 (Figure 1). Calvo et al. argue that the lack of strong inflationary pressures could stem from the fact that, through most of the 1978-92 period, the actual real exchange rate was closely tracking the equilibrium real exchange rate.[12]

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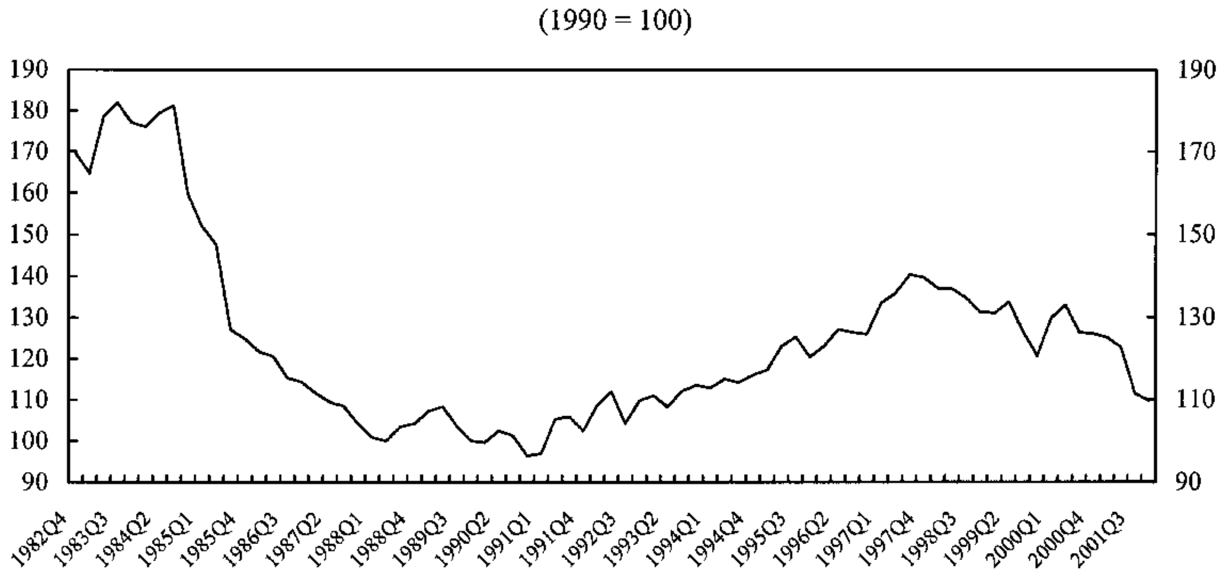
[9] Lahiri, Ashok K. (1991).

[10] Thus, for instance, between August 1968 and December 1976, the cruzeiro was devalued 81 times, or about once every 38 days. The mean devaluation was 1.5 percent. This crawling peg system, known in Brazil as *minidesvalorizações*, was implemented later for short intervals.

[11] In July 1985, an exchange rate was established whose central parity was adjusted daily according to a schedule based on inflation during the previous month less the estimated world inflation rate.

[12] Calvo et al. Ibid.

Figure 1. Chile: Real Effective Exchange Rate, 1982-2001



Source: International Financial Statistics (IFS).

IV. Tunisian Experience

18. Tunisia's experience with CRERR has thus far been fairly successful. During the 1990s, Tunisia was able to preserve competitiveness while reducing inflation. After fluctuating around 5 percent during the first half of the 1990s, CPI inflation declined from 6.3 percent in 1995 to 1.9 percent in 2001. Meanwhile, real GDP and real non-energy export growth averaged 4.8 percent and 7.4 percent respectively between 1991 and 2001. Moreover, no significant parallel foreign exchange market emerged during that period.

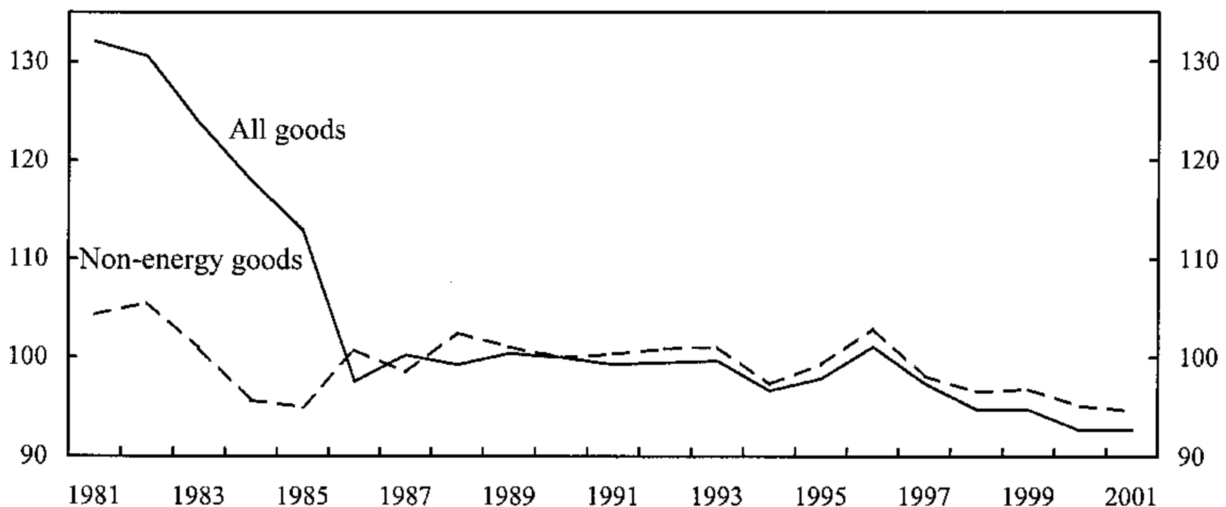
19. This experience does not reflect the outcome predicted by theoretical models. The following different factors appear to have helped Tunisia avoid the relatively high and "plateau-type" inflation described earlier: (i) the absence of significant shocks during the period; (ii) the

prudent macroeconomic policy mix followed by the authorities; and (iii) price and wage rigidities, including incomes policies.

20. After experiencing a sharp deterioration, in the range of 25 percent, in its terms of trade during the first half of the 1980s, Tunisia has not been affected by significant terms of trade shocks. The fact that Tunisia's energy trade has been broadly balanced during the last few years helped to protect it from oil price shocks.[15] The terms of trade remained almost unchanged during the first half of the 1990s, and then deteriorated gradually by about 8 percent during the second half. This deterioration, resulting partly from the decline of agricultural export prices, helped to keep inflationary pressures in the non-traded goods sector subdued. Moreover, the domestic prices of petroleum products and of some agricultural products are administered by the government. This allowed the government to limit the impact of international price fluctuations on Tunisian consumers, thus reducing the scope for the wealth effects described in Section III to take effect (see Figure 2).

Figure 2. Tunisia: Terms of Trade, 1981-2001

(Index, 1990=100)

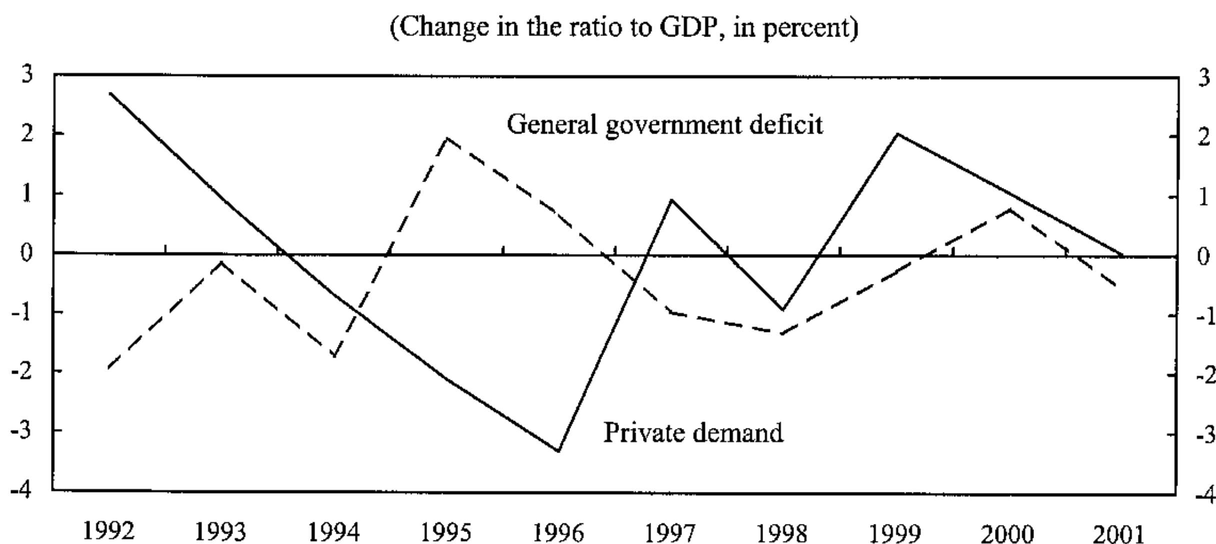


Source: Tunisian authorities and staff estimates.

[15] Tunisia exports oil but imports refined products. As a result, changes in oil prices do not modify significantly the country's wealth. Tunisia could become more sensitive to oil price fluctuations in the future as its oil production declines.

21. While the demand shocks experienced by Tunisia were limited, the macroeconomic policies followed by the authorities helped to limit the impact of shocks on the economy. The authorities have worked to rein in the budget deficit over the past decade: the consolidated central government budget deficit declined from 6 percent of GDP in 1991 to 2.4 percent in 2001. This adjustment was even sustained during the periods when private demand was growing quickly, between 1991-93 and 1997-99. This helped to reduce demand pressures for non-traded goods and to alleviate inflationary pressures (see Figure 3).

Figure 3. Tunisia: Budget Deficit and Private Demand, 1992-2001

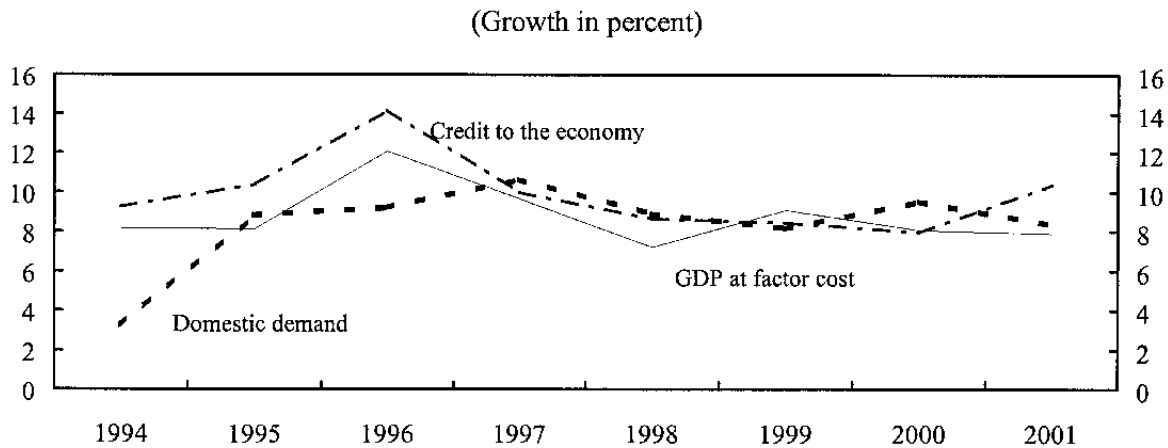


Source: Tunisian authorities, and staff estimates.

22. At the same time, extensive restrictions on capital inflows and outflows were aimed at ensuring that domestic savings financed domestic investment. This policy allowed the central bank to pursue an independent monetary policy that has been very prudent over the period: the authorities focused on setting the target rate of expansion in credit to the economy around the rate of nominal GDP growth, in effect also targeting growth in broad money. In this respect, the objectives set by the monetary authorities were met over the period, credit to the economy having been broadly in line with domestic demand. Moreover, the authorities have shown their willingness to tighten monetary policy in order to moderate domestic demand when necessary (see Figure 4).

Figure 4. Tunisia. Credit to the Economy, 1994-2001

(Growth in percent)



Source: Tunisian authorities, and staff estimates.

23. Despite the ongoing liberalization process, however, many prices are still administered. At end-2001, the prices of petroleum, water, basic commodities, electricity, telephone and public transportation were still controlled, while intermediation margins on some food products, including cereals, fruits, and vegetables, were regulated. In all, 19 percent of prices at the retail level, making up a third of the CPI basket, are still administered. At the same time, wages could be more flexible, since wage increases are set, at a sectoral level, every three years after centralized negotiations between the government and its social partners. This limited flexibility in prices and wages helped, at least in the short term, to prevent any wage-price spiral from occurring as a result of demand shocks.

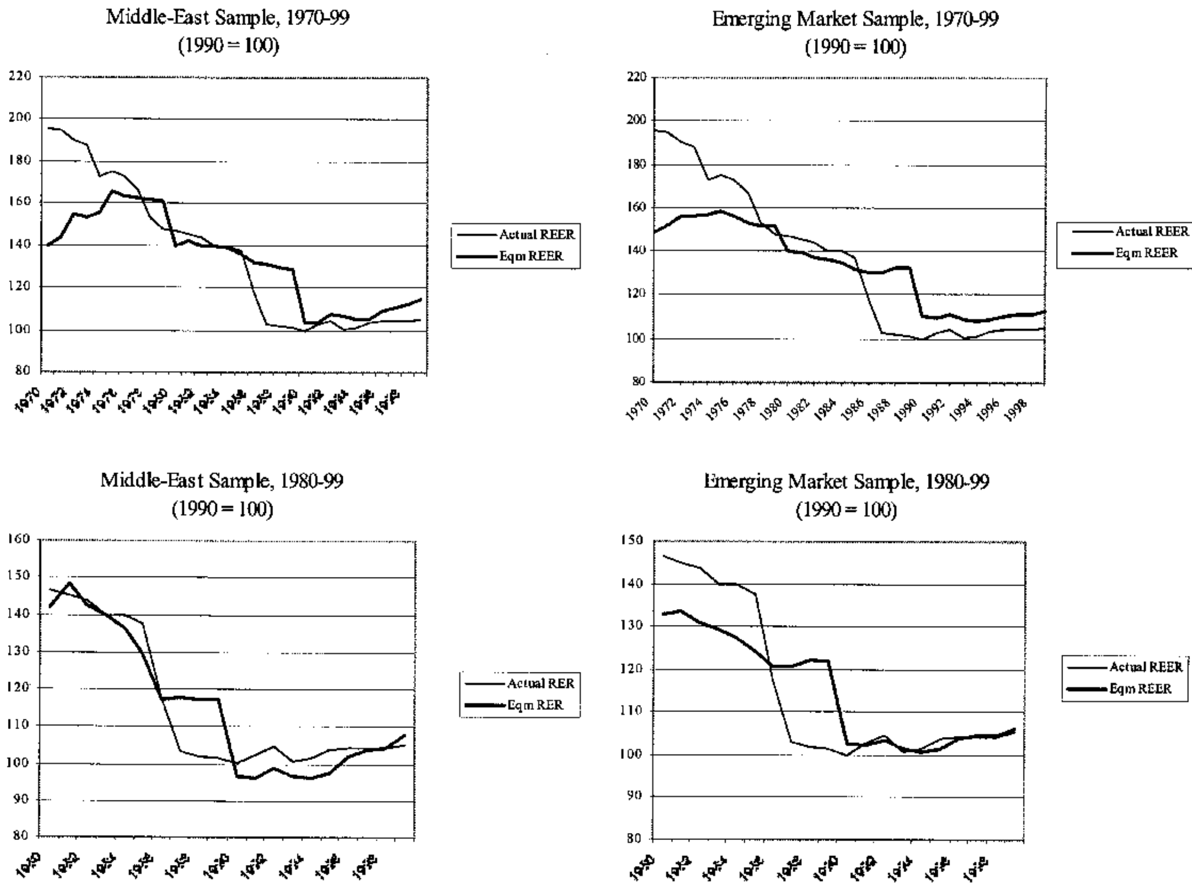
V. A Fundamental Model-Based Measure of Misalignment

24. A real appreciation of a currency is often interpreted as a loss of competitiveness for an economy. However, an appreciation may not signal a loss of competitiveness if the exchange rate is already misaligned or if the movement in the real rate is caused by a fundamental improvement in productivity. Competitiveness is affected, however, when the observed real exchange rate deviates significantly from its "equilibrium value." The equilibrium exchange rate is a function of many fundamentals, including factor productivity and relative factor endowments, the terms of trade, consumer taste, the composition of government spending, the tariff structure, access to capital markets, etc.

25. In this paper, a panel data analysis is used to measure misalignment of the exchange rate by computing the deviation of the observed real exchange rate from the "equilibrium" level that would be predicted on the basis of certain fundamental determinants. The three fundamental variables used to estimate the equilibrium exchange rate in this model are net external liabilities

of the country, the terms of trade, and GDP per capita relative to its partners.[16] Under this fundamental model-based measure, the evolution of the exchange rate is considered in conjunction with the exchange rate behavior of a group of Middle Eastern countries and a group of developing countries. The results indicate that the real effective exchange rate during the last decade has moved broadly in line with what would have been predicted on the basis of these fundamental determinants. According to this regression, the equilibrium exchange rate, after decreasing significantly in the 1980s, increased only moderately during the 1990s (see Figure 5). Moreover, the actual exchange rate was close to the equilibrium rate estimated by the model over the latter period.

Figure 5. Tunisia: Actual and Equilibrium Real Exchange Rate Indices
(Panel data estimation)



Source: IMF staff estimates.

[16] This analytical framework was developed by Lane, Philip R. and Gian Maria Milesi-Ferreti, (1999) and (2000).

26. The fundamental determinants in this model were chosen because of their important and comprehensive effect on the real exchange rate. The net external asset position of the country is used because it can affect the real exchange rate through a number of different channels. From a Keynesian approach, countries with large external liabilities would need to run large trade surpluses, and hence a more depreciated real exchange rate, to service them. Under an intertemporal optimizing model, the transfer effect can, for example, operate through the presence of a home preference for domestic tradables, in which case a transfer abroad implies a decline in demand for home goods. Alternatively, a transfer effect can operate through the impact of wealth effects on labor supply whereby a transfer abroad reduces domestic wealth and hence raises labor supply, leading to a decrease of the relative price of exportables. Tunisia's net foreign asset position was estimated using balance of payments data: the adjusted current account balance net of capital transfers (adjusted for valuation effects) is added to the stock of the preceding year's external asset position.

27. The second fundamental variable, GDP per capita, is used because changes in GDP per capita can result in important movements in the exchange rate over time. For example, an increase in relative GDP per capita can result in a more appreciated real exchange rate through a Balassa-Samuelson effect, i.e. an increase in the relative price of non-traded goods resulting from higher productivity gains in the traded goods sector. It could also result from a shift of household demand from traded goods to non-traded goods, notably to services. GDP per capita is calculated as the ratio of Tunisia's GDP per capita relative to its partners' GDP per capita weighted by their share in Tunisia's trade.

28. Finally, terms of trade developments are used as the third fundamental variable since they can be expected to affect the equilibrium exchange rate, for example through wealth effects.

29. This provides a different approach to the "equilibrium exchange rate" that is sometimes defined as the value consistent with internal and external balance over the medium term, where internal balance is defined normally as real growth at the level of potential output and external balance is defined, albeit vaguely, as an equilibrium position in the current and capital accounts.[17]

30. An intertemporal optimizing model of the transfer effect is used, resulting in the following equation:[18]

$$\log(RER) = \alpha + \beta_1 \frac{B}{Y_0} + \beta_2 \log(Y_T) + \beta_3 \log(P_T^x)$$

where RER is the real effective exchange rate, B is the net foreign asset position, Y_T is the output of tradables, and P_T^x is the terms of trade. Then cross-country estimates of the parameters are

[17] See Bartolini, Bayoumi, Clark, and Symanski (1994).

[18] See Lane and Gian Maria Milesi-Ferreti, Ibid. The results presented here are based on their parameter estimates.

obtained using the following specification (a panel version of the dynamic ordinary least square estimator developed by Stock and Watson):

$$\log(RER_{i,t}) = \alpha_i + \phi_t + \beta^{NFA} NFA_{i,t} + \beta^{YD} \log(YD_{i,t}) + \beta^{TT} \log(TT_{i,t}) + \sum_{k=-1}^{k=1} \nu_k^{NFA} \Delta NFA_{i,t+k} + \sum_{k=-1}^{k=1} \nu_k^{YD} \Delta \log(YD_{i,t+k}) + \sum_{k=-1}^{k=1} \nu_k^{TT} \Delta \log(TT_{i,t+k}) + \varepsilon_{i,t}$$

where $RER_{i,t}$ is the real effective exchange rate, α_i is a country dummy, ϕ_t is a year dummy, $NFA_{i,t}$ is the ratio of net foreign assets to GDP, $YD_{i,t}$ is GDP per capita relative to the country's trading partners, $TT_{i,t}$ is the terms of trade and $\varepsilon_{i,t}$ is a residual term.

31. These panel estimates are then applied to Tunisia to estimate the equilibrium exchange rate. The results correspond to (i) two different groups of countries: a group of Middle Eastern countries including Egypt, Israel, Jordan, Pakistan, Tunisia and Turkey, and a group of countries comprising mostly emerging markets from a diverse geographical nature; and (ii) to different time periods (see Figure 5). According to these results, the equilibrium exchange rate, after decreasing significantly in the 1980s, increased slightly in the 1990s. More importantly, the results indicate that Tunisia's real effective exchange rate was close to the equilibrium rate estimated by the model over the latter period, and by 2000, was well in line with what would be predicted by the level of Tunisia's fundamental determinants at that time. These results appear to be consistent with the analysis developed in Section IV explaining why Tunisia did not experience inflationary pressures.

VI. External Competitiveness and the Real Exchange Rate

A. Background

32. A range of indicators is examined over the last decade in an attempt to assess Tunisia's competitiveness. The indicators used in this analysis are real effective exchange rates (REERs) based on different prices, including consumer prices, GDP deflators, and the relative price of non-tradable to tradable goods.[19] In addition, indicators of export performance are examined to review the composition of exports and the development of market shares. An index of ULCs, a measure of REERs based on costs, is also analyzed.

33. Given the shortcomings of REER indicators and data deficiencies, results should be interpreted with some caution. This is also why many different REER indices are considered in drawing overall conclusions. In general, all REER indicators suggest that Tunisia has pursued an appropriate exchange rate policy, which is consistent with the findings from the fundamental

[19] Unless otherwise specified in the text, foreign prices for each REER indicator have been calculated on the basis of the weighted basket of 15 countries that include Tunisia's competitors and its major trading partners following the standard IMF methodology. All indices are expressed in U.S. dollar terms and period-average exchange rates are used. See Zanello and Desruelle, 1997 for more details on the IMF methodology.

model described in Section V. In this regard, Tunisia has gained export market shares in the EU over the last decade and has widened its export base in the manufacturing sector. In addition, gradual trade liberalization and comprehensive structural reforms appear to have produced positive results in terms of productivity.

B. Real Exchange Rate Indicators Based on Prices

34. The REER index compares nominal exchange rates between a country and its trading partners, adjusting for differences in inflation. REER indicators found in the literature include measures of REERs based on production prices, consumer prices, ULCs, wholesale prices, GDP deflators, and export-unit values.[20]

35. The most commonly used REER indicator is the one based on consumer prices. CPIs are constructed according to a basket of goods that is fairly comparable across countries. Also, they are published regularly, are easily available, and their construction is generally accurate. In order to gauge profitability in the tradable sector, CPIs may be used as an acceptable proxy for factor costs. According to Turner and Van't dack (1993), many productive inputs, such as labor, are priced in line with consumer prices. However, CPIs possess several shortcomings. In particular, Tunisia's CPI contains some prices that are controlled (one third of the index), and many of the services included in the CPI are not traded which may render the index inappropriate.

36. The GDP deflator-based REER may be regarded as a composite index of the cost of all primary factors of production. The main problem with the GDP deflator is that it is generally constructed using market prices which include indirect taxes, which leads to notable comparability problems.

37. Figure 6 displays three REER indicators for Tunisia for the period 1990-2001. In general, all indices show similar trends: a real appreciation at the beginning of the 1990s, a depreciation in 1993, a gradual appreciation which stabilizes during the second half of the 1990s, and a depreciation after 1999. Over the entire period, the CPI-based REER appreciated only by about 2 percent and in 2001, it returned to the level registered in 1991.[21] Given that 33 percent of the Tunisian CPI basket is subject to price controls, a REER based on an adjusted CPI has been

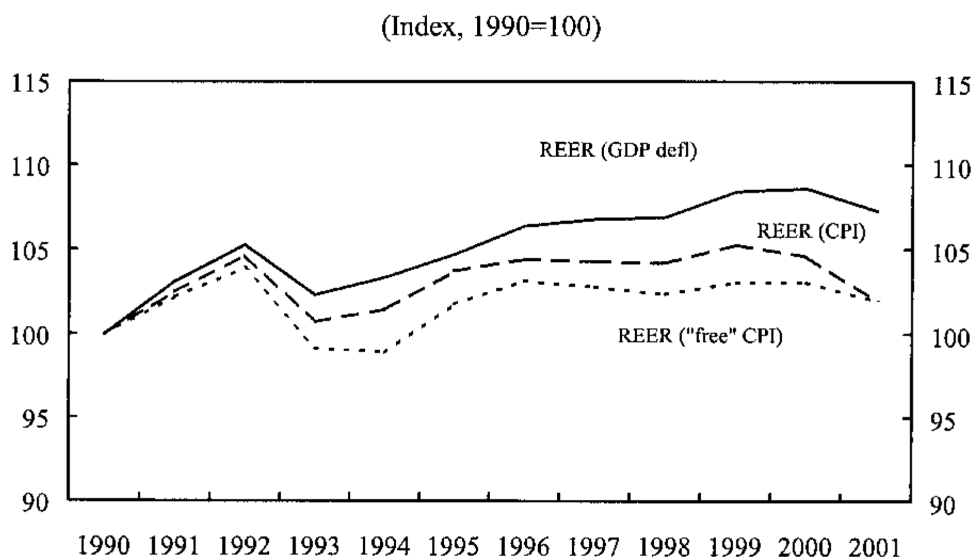
---

[20] For a comprehensive assessment of REER indicators, see Marsh and Tokarick (1994) and Maciejewski (1983).

[21] The REER based on export-unit values appreciated by about 19 percent over the last eleven years. However, this indicator is not very reliable as it assesses only export performance exclusive of import developments, providing an incomplete analysis of competitiveness. In addition, they represent average values which make comparisons across countries sensitive to the composition of exports.

constructed by removing goods with administered prices from the overall CPI basket. This "free" CPI-based REER moved very closely to the CPI-based REER drawn from the Information Notice System (INS). Finally, the GDP deflator-based REER appreciated by under 7 percent over the last eleven years.

Figure 6. Tunisia: Real Exchange Rate Indicators, 1990-2001



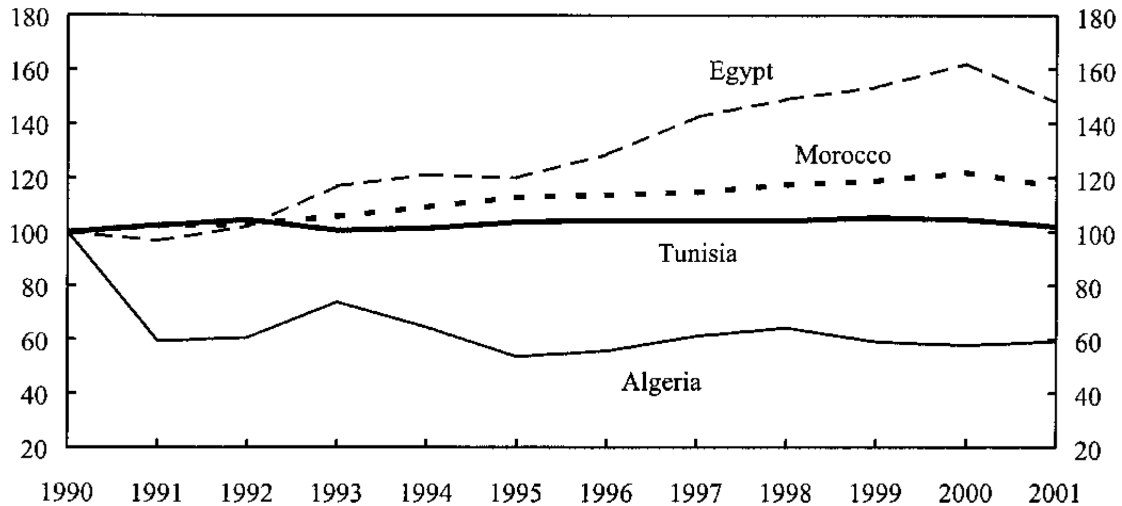
Source: INS, WEO, and staff estimates.

38. Figure 7 compares CPI-based REERs in selected Middle Eastern and North African (MENA) countries. Tunisia's REER was relatively stable, a result that is consistent with the CRERR pursued by the authorities. Morocco's REER appreciated by 20 percent over the last eleven years and Egypt's REER appreciated by 50 percent.[22] Overall, the REERs in Egypt, Morocco, and Tunisia followed a common trend, depreciating during the last two years. In contrast, the REER in Algeria depreciated by almost 40 percent and has experienced significantly volatile movements over the last eleven years. These findings indicate that Tunisia's competitiveness based on relative CPI measures performed favorably compared to countries in the region.

[22] In 2001, the nominal exchange rate in Egypt was devalued by about 9 percent and in Morocco by 5 percent.

Figure 7. Selected Middle East and North Africa (MENA) Countries: CPI-Based Real Effective Exchange Rates, 1990-2001

(Index, 1990=100)

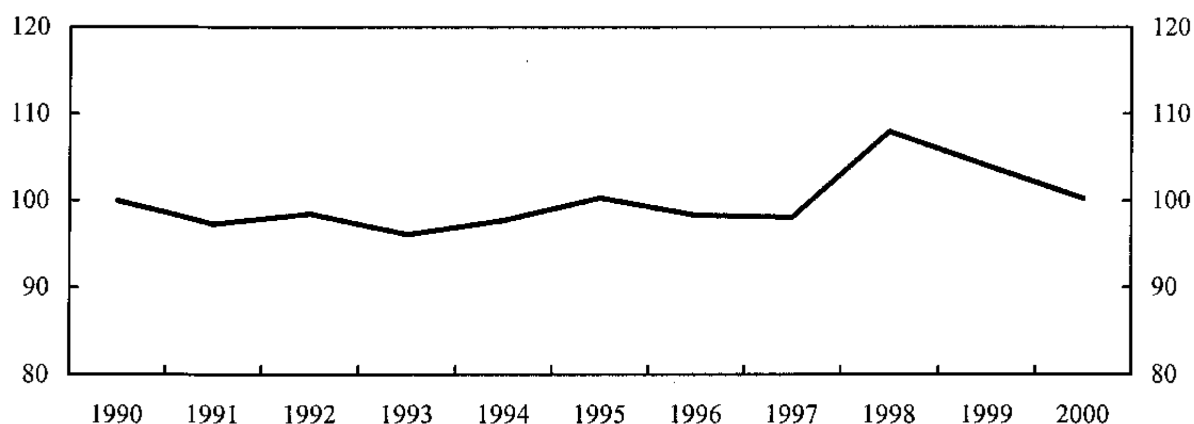


Source: INS.

39. A different CPI-based REER was constructed to reflect the evolution of the exchange rate with respect to Tunisia's competitors. This index was computed by using weights constructed on the basis of EU imports from Tunisia's major competitors during 1990-2000.[23] In order to avoid exaggerating changes in international price competitiveness, Turkey was excluded from the sample because of its high inflation rate and exchange rate appreciation during the second half of the 1990s. As shown in Figure 8, this index had a stable evolution until 1998, when it appreciated by about 10 percent. This was mainly due to the large devaluation of the nominal exchange rate of the Asian Tigers vis-à-vis the U.S. dollar. The indicator returned in 2000 to its initial 1990 level. This would suggest that, consistent with Figure 7, the dinar has not experienced significant real appreciation over the period.

[23] The competitors comprise Morocco, Spain, Greece, Hong Kong, Indonesia, Malaysia, Philippines, Portugal, Korea, Singapore, and Thailand.

Figure 8. Tunisia: EU Import-Weighted CPI-Based Real Effective Exchange Rate, 1990-2000
(Index, 1990=100)



Source: Trade Analysis and Reporting System (TARS), and staff estimates.

40. Productivity in the traded goods sector and the pattern of consumption between traded and non-traded goods in a country is another useful price-based indicator of competitiveness. A common measure used is the relative price of non-traded to traded goods. An increase in the ratio of non-traded to traded prices indicates a real exchange rate appreciation, which leads to an increase in the production of non-traded goods by shifting resources away from tradables to the non-tradable sector. On the demand side, the change in relative prices raises the domestic consumption of tradables, which is met by an increase in imports. Consequently, the trade account worsens. However, prices of non-traded goods generally tend to rise over time due to an increase in income per capita which, on its own, can boost the demand for non-traded goods. In other words, the move in relative prices is not a sufficient condition to conclude that the country is experiencing a loss of competitiveness (Marsh and Tokarick, 1994). If the increase in prices is matched by an increase in productivity, the exchange rate appreciation does not represent a loss of competitiveness for the country.

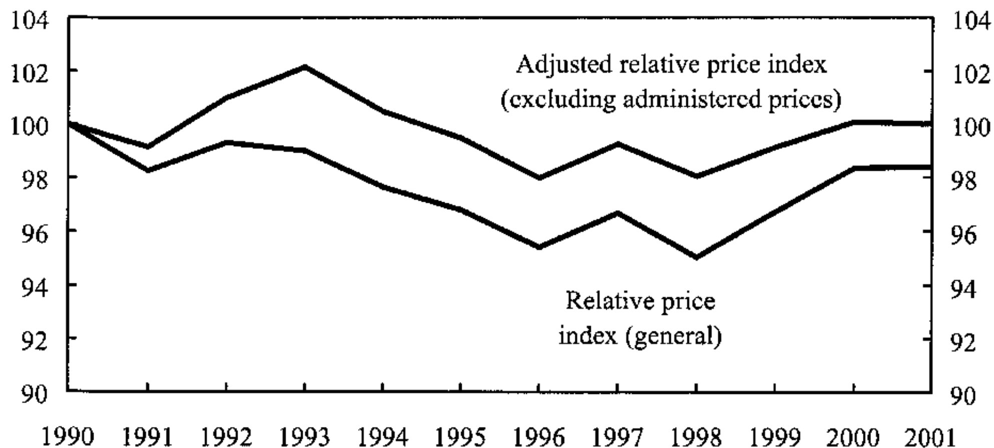
41. Given the difficulties in drawing a line between tradable and non-tradable goods, the Standard Industrial Classification (SIC) is often used as a first approximation.[24] The implicit

[24] According to the SIC, traded goods can be grouped according to the following three categories: (1) agriculture, hunting, forestry, and fishing; (2) mining and quarrying; and (3) manufacturing. Non-traded goods belong to the following six categories: (1) electricity, gas, and water; (2) construction; (3) wholesale and retail trade, restaurants, and hotels; (4) transport, storage, and communication; (5) financing, insurance, real estate, and business; and (6) community, social and personal services.

deflators of traded and non-traded goods are drawn from the national accounts in national currency. Traded goods are proxied with manufactured goods, while non-traded goods include hydrocarbons, electricity, water, services (transport, telecommunication, tourism, commerce, and government wages) and construction and public works. Agricultural products are excluded from this analysis since they suffer from price distortions due to subsidies and price controls.

42. Figure 9 shows the index of general relative prices of non-traded to traded goods and an adjusted measure excluding administered prices in the non-traded sector (electricity, water, and hydrocarbons). In general, both indicators moved in the same direction but with different magnitudes. The adjusted relative prices in 2001 remain unchanged compared to 1990, suggesting no real appreciation over the period. More importantly, the general indicator of relative prices, which shows a downward trend relative to 1990, also supports this conclusion.

Figure 9. Tunisia: Relative Prices of Non-Traded to Traded Goods, 1990-2001
(Index, 1990=100)



Source: Tunisian authorities, and staff estimates.

C. Indicators Based on Labor Costs

43. The most widely used indicators based on costs are real wages and unit labor costs. Wages denominated in a common currency have the advantage of being easily comparable across countries, although they may suffer from distortions due to exchange rate fluctuations. In addition, the differences in the definition of wages can hamper cross-country comparisons.

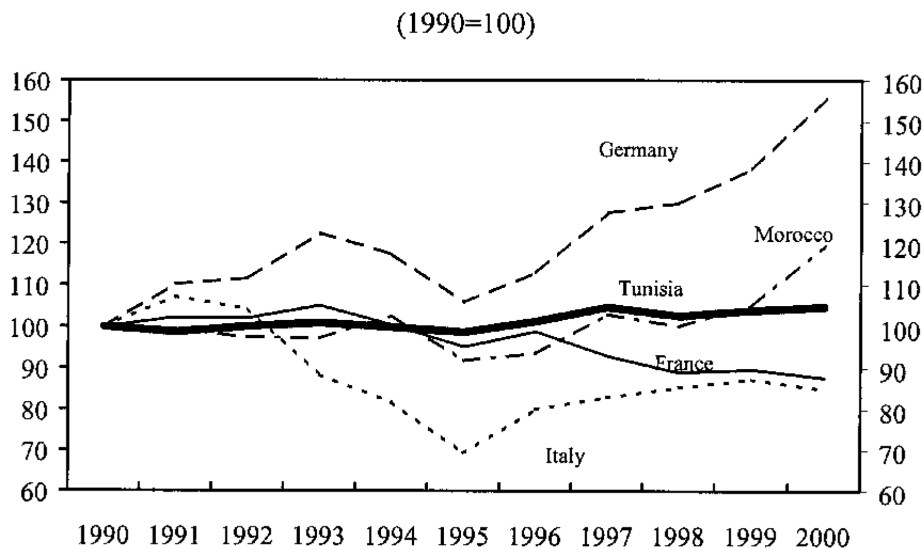
44. The ULC index is calculated as the wage bill in the manufacturing sector divided by real GDP in that sector. The ULC index in the manufacturing sector incorporates information on production costs, although it shows only a partial picture of a country's competitiveness since it neglects the role of capital, which can substitute for labor in the production process over the long

run. For example, if ULCs decrease and the cost of capital rises, the ULC index may overstate competitiveness. In particular, there are problems with data on ULCs in manufacturing. These data include only the costs of labor services incurred directly in manufacturing, thus excluding the costs of other important labor inputs such as labor contracted from the services sector (e.g., legal or marketing services) and indirect labor costs associated with intermediate inputs. Moreover, differences in the definition of the manufacturing sector could lead to problems of international comparability.

45. Figure 10 depicts ULC indices in the manufacturing sector for European and North African countries. Tunisia's ULC index was stable in the first half of the 1990s and increased slightly in the second half, probably reflecting productivity gains as a result of the industrial restructuring program. Tunisia's ULC index moved together with Morocco's until 1999, after which time Morocco's ULCs increased significantly. The ULC in Tunisia grew faster than in France and Italy, but slower than in Germany. These findings should be interpreted with some caution due to the shortcomings mentioned above.

Figure 10. ULC Indices in the Manufacturing Sector in Tunisia's Main Trading Partners and Morocco, 1990-2000

(1990=100)



Source: OECD, and staff estimates.

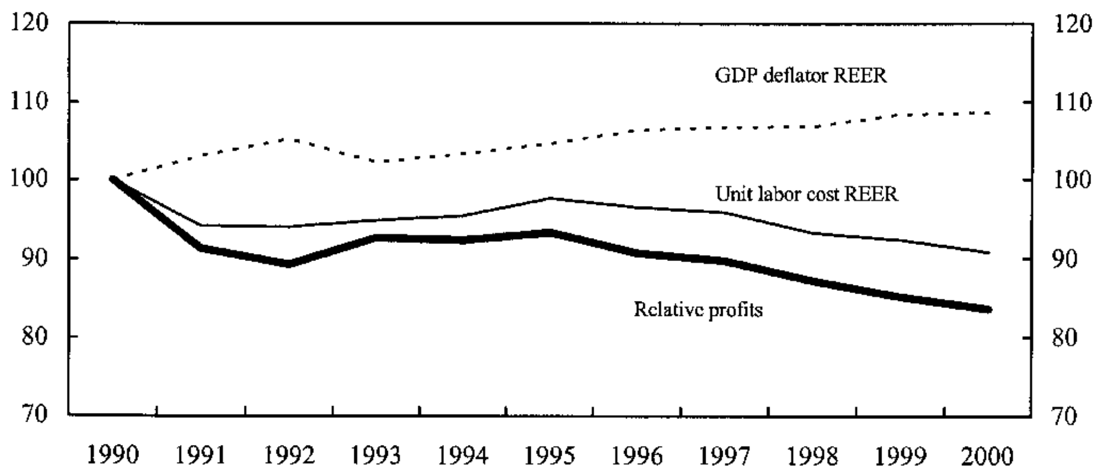
46. Given the risks of relying uniquely on the evolution of ULCs, this analysis reviews an alternative measure based on profitability, along the lines of the one developed by Lipschitz and McDonald (1991).[25] This index is calculated as the ratio of the ULC-based REER and the GDP

[25] See also Feldman and Maciejewski (1983).

deflator-based REER in the total economy.[26] A rise in the index is associated with a loss in competitiveness and a worsening in the trade balance because the share of labor costs in value added rises relative to that of competitors. Unlike the ULC index, this indicator captures losses in competitiveness which result from a rise in the price of an intermediate input.

47. Figure 11 shows the real effective exchange rates and the relative profit indicator for the total economy. The relative profit indicator decreases over time as a result of a lower share of labor costs in value added in Tunisia relative to its competitors and partners. The decline in relative profits is associated with a gain in competitiveness, consistent with the relative price index indicator.

Figure 11. Tunisia: Effective Exchange Rates and Relative Profits, 1990-2000
(Index, 1990=100)



Sources: IFS, WEO, authorities, and staff estimates.

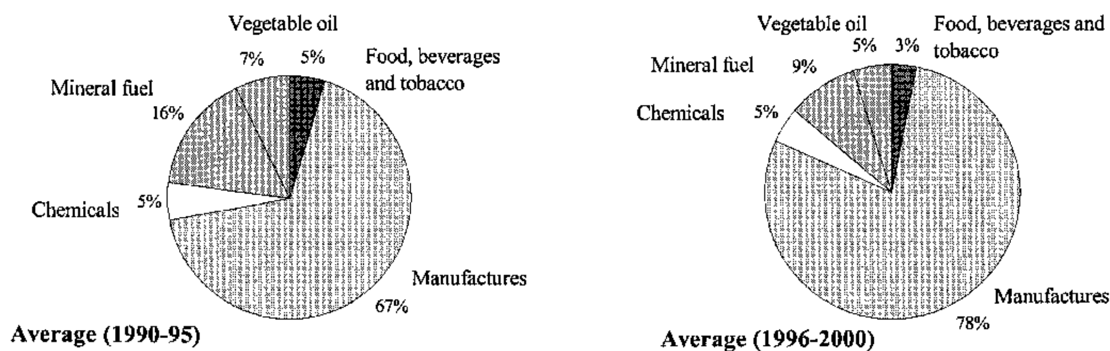
D. Indicators of Export Performance

48. The main indicators of export performance considered in this analysis are export composition and export market shares. The composition of trade provides some indication of diversification of the economy and thus some information on the country's vulnerability to sectoral shocks. Trade openness in Tunisia, measured as the sum of real exports and imports as a share of real GDP, increased from 98 percent in 1990 to 105 percent in 2001. The value of goods

[26] The best indicator for relative profits would be the one based on ULC and GDP deflator-based REERs in the manufacturing sector. However, due to data limitations, this index could not be constructed.

exports grew by 11 percent per year while the volume grew by 6 percent per year. Total exports as a share of GDP rose from 28.5 percent in 1990 to 33 percent in 2001. In conjunction with increased trade, the export composition also changed. Figure 12 illustrates the evolution in the composition of Tunisian exports to its main trading partners, Germany, Italy, and France.[27] Tunisia's share of exports of manufactured goods to these countries increased from 67 percent on average from 1990-95 to 78 percent from 1996-2000. This increase most likely reflected strengthened efforts to upgrade the industrial sector and liberalize external trade.

Figure 12. Composition of Tunisian Exports to its Main Trading Partners, 1990-2000

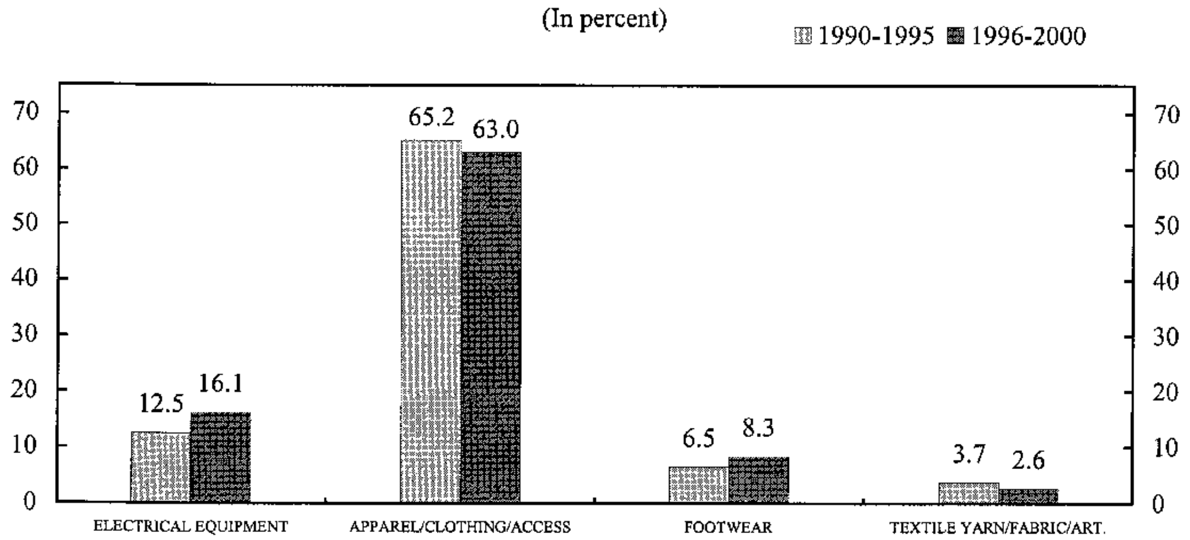


Source: Trade Analysis and Reporting System (TARS).

49. Tunisia has improved the diversification of its export base within the manufacturing sector. As indicated in Figure 13 (Panels A and B), the composition of Tunisia's manufactured goods exports to its main trading partners is relatively diverse. Its main manufactured exports consist of apparel/clothing/accessories, electrical equipment, textiles, and footwear. Electrical equipment has performed well, with the average share of exports to Tunisia's trading partners increasing from 12.5 percent over 1990-95 to 16 percent over 1996-2000. Similarly, the average share of Tunisia's exports of footwear to these trading partners increased from 6.5 percent to 8.3 percent. In contrast, other industries, such as textiles and apparel/clothing/accessories, have experienced a small decline in their export shares.

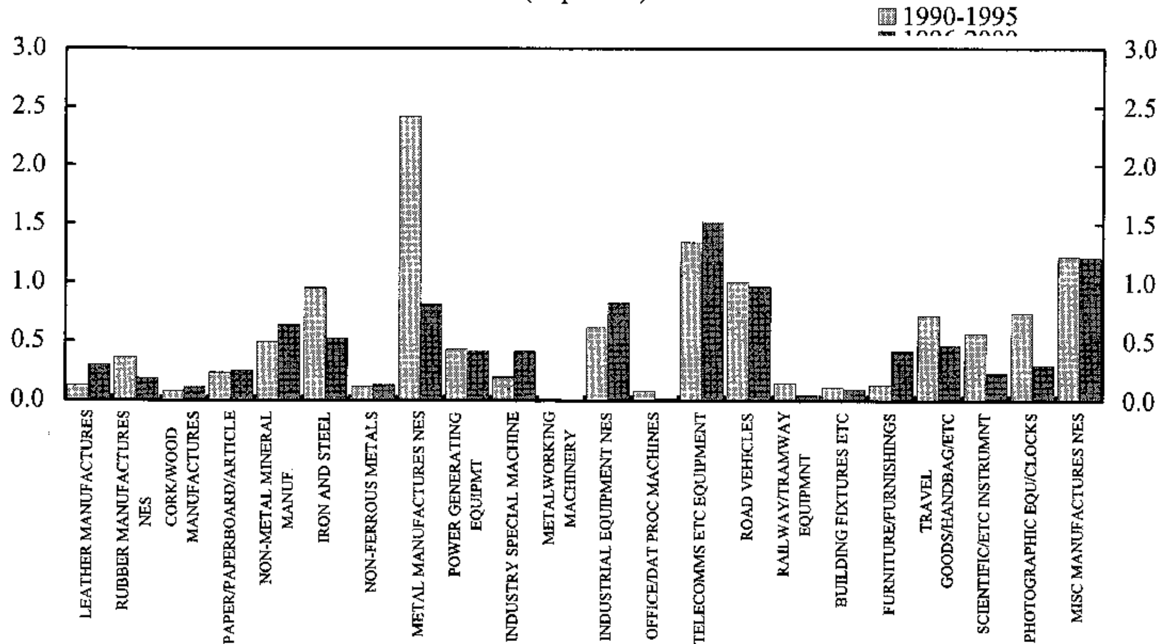
[27] About 74 percent of Tunisia's trade in 2000 was with the EU, in particular, Italy, Germany, and France accounted for 60 percent of Tunisia's exports.

Figure 13a. Tunisia: Manufacturing Export Shares of the Major Exporting Sectors, 1990-2000
(In percent)



Source: Trade Analysis and Reporting System (TARS).

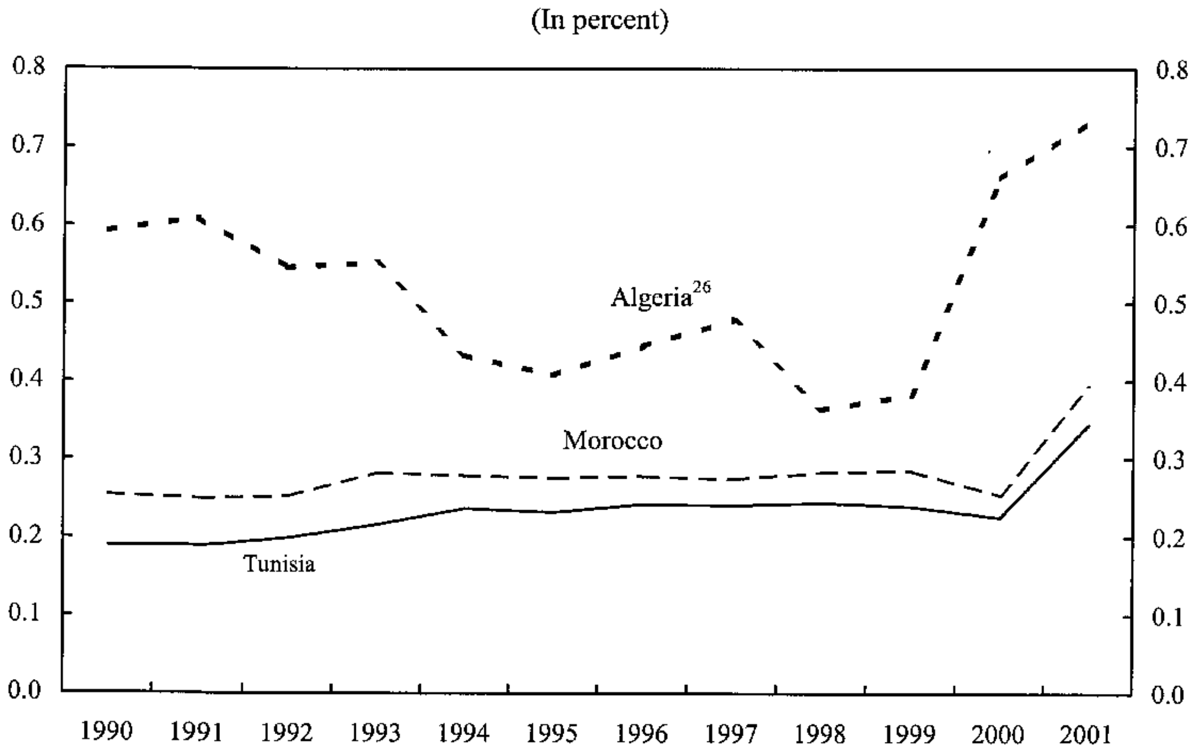
Figure 13b. Tunisia: Export Shares of Manufactures, 1990-2000
(In percent)



Source: Trade Analysis and Reporting System (TARS).

50. Figure 14 shows the evolution of export shares in North African countries with respect to EU imports. Export shares in Tunisia and Morocco both increased during the first half of the 1990s, stabilizing afterwards until 2001 when they experienced a significant rise following the REER depreciation. Algeria, however, had more volatile movements in export shares.[28]

Figure 14. Export Market Shares with Respect to EU Imports, 1990-2001



Source: Direction of Trade Statistics.

[28] Note that over 95 percent of Algeria's exports to the EU are hydrocarbon products.

VII. Conclusions

51. The CRERR worked well in Tunisia and the main findings of the paper suggest that there is no evidence of an overvaluation of the dinar exchange rate. Tunisia did not fall into the trap of a high and "plateau-type" inflation as predicted by the theoretical models on CRERR for a number of reasons: (i) the absence of significant shocks during the period; (ii) a prudent macroeconomic policy mix; and (iii) price and wage rigidities, including incomes policies. The actual exchange rate followed closely the path of the "equilibrium" rate estimated on the basis of the fundamental variable approach. Prudent macroeconomic policies combined with the structural reforms undertaken by the authorities in the last few years have helped Tunisia gain market share in the EU, particularly in exports of manufactured goods. Access to European markets has helped Tunisia integrate into the world economy, upgrade its industry and widen its export base.

52. The estimates of the equilibrium real exchange rate based on different fundamental variables indicate that Tunisia's real effective exchange rate followed closely the equilibrium rate estimated by the model, and by 2000, was well in line with what would be predicted by the level of Tunisia's fundamental determinants at that time. The analysis of a number of standard competitiveness indicators confirms that Tunisia has not experienced significant real exchange rate appreciation since 1990. Sizable improvements in labor productivity, the movement of the relative price of tradable and non-tradable goods, and the increase in export shares to the EU all point to evidence that Tunisia has maintained a competitive position in international markets.

53. While the CRERR approach has served Tunisia well, its limitations are now beginning to emerge in the context of the opening of the economy, increased regional and global integration, a more sophisticated market-based monetary policy, and the relaxation of capital controls. While the current level of the dinar parity does not give cause for concern, it is this new policy environment which makes it necessary to consider alternative approaches to exchange rate policy in the medium term.

Table 1. Description of Variables

Variable	Source
Consumer price index	IFS and staff estimates
Effective exchange rates	IFS and staff estimates
Exchange rates	IFS
Export unit values	WEO
Exports per partner	DOT
Exports per sector	TARS
GDP deflators	WEO
Minimum wage	Authorities
Prices of traded and non-traded goods	National accounts, staff estimates
Terms of traded and non-traded goods	Authorities, staff estimates
Unit labor costs	OECD and staff estimates

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CHAPTER II: LIBERALIZATION OF THE CAPITAL ACCOUNT IN TUNISIA—PROGRESS ACHIEVED AND PROSPECTS FOR FULL CONVERTIBILITY[29]

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Executive Summary

Achieving full convertibility of the dinar is an objective of the Tunisian authorities. This paper, which was prepared at the request of the authorities, offers general and Tunisia's specific considerations on the liberalization of the capital account, including a possible sequence of liberalization. It draws on the findings and conclusions of the Financial Sector Assessment Program (FSAP) for Tunisia that was undertaken by a joint Fund and World Bank team in 2001.

The convertibility of the dinar is already at a very advanced stage for nonresidents, in that they are allowed to establish deposits in convertible dinars with Tunisian banks. Nevertheless, because of the lack of liquidity in the debt securities market, the authorities have allowed nonresidents to invest in the domestic government securities market only on a limited basis via mutual fund (SICAV) investments. The authorities believe that total liberalization of portfolio investments requires a strengthening of market liquidity.

Great progress has also been achieved in terms of liberalizing residents' foreign direct investments as part of the process of opening up the Tunisian economy and integrating it with the world economy. However, portfolio investments abroad by residents are subject to prior approval and the authorities believe that a strengthening of international reserves is desirable before such operations can be liberalized.

However, with the aim of diversifying the balance of payments financing sources, it now appears possible to liberalize certain transactions by the following methods: (i) eliminating prior approval for foreign investors willing to acquire participations exceeding the 50 percent limit; (ii) allowing inward portfolio investments within a ceiling; and (iii) liberalizing medium- and long-term borrowings abroad for enterprises or banks which are either listed in the stock exchange or rated by a credit agency. Immediate actions aimed at stimulating the foreign exchange market may also be possible; they include: eliminating the requirement for *nivellement* (i.e., the obligation of commercial banks to transfer foreign currency holdings to the Central Bank of Tunisia (BCT) foreign correspondent banks at the end of the day) and the surrender requirement of export proceeds; and allowing all residents to hold foreign currency in accounts held with Tunisian banks.

Before embarking on more ambitious steps toward complete dinar convertibility, first there is a need to further reinforce the framework for the conduct of monetary policy, second to achieve greater flexibility of the dinar, third to strengthen the banking sector and the prudential rules as much as possible. One can identify two stages in this process:

(i) A first *stage* might include liberalizing direct investment by Tunisians abroad, permitting overseas portfolio investments by institutional investors up to a certain annual limit and portfolio investments by nonresidents in money market instruments and other debt securities. At this stage, the banking system would have to be on a solid footing to enable it to withstand international competition, including opening up the sector to foreign operators. At this stage, significant progress would need to have been made in the conduct of monetary policy and the development of the market for government securities.

(ii) Full capital account liberalization, that is essentially domestic portfolio investment abroad and loans by residents to nonresidents, would take place in a second *stage*. Prerequisites for a transition to this stage would be the establishment of a stronger international reserve position as well as the existence of a robust financial market.

I. Introduction and Overall Assessment

A. Introduction

1. The Tunisian authorities hope to achieve the full convertibility of the dinar. Its accomplishment will mark the completion of the financial reform program started in the mid-1980s aimed at reducing direct government intervention in the economy and strengthening the role of market forces in the allocation of financial resources. They expect the liberalization of the capital account to proceed in an orderly and integrated fashion; they intend to take account of the economic, financial, and social dimensions of the process.[30]

2. In the course of the last 10–15 years, key building blocks in support of a move to greater capital mobility have been laid down: (i) Tunisia has established a track record of sound macroeconomic policies; (ii) the prudential framework for the financial sector has been significantly strengthened; (iii) a modern legal framework has been established; (iv) the infrastructure for the capital market has been developed; (v) the trade regime has been significantly liberalized; and (vi) significant progress has been made in estasblishing strong systemic liquidity frameworks. These collective achievements have allowed Tunisia to gain access to the international capital markets under favorable conditions.

3. Greater integration with the international capital markets would have several benefits. It would allow Tunisia to diversify the balance of payment financing sources and would supplement domestic savings for the financing of the economy. Greater capital account mobility could be used to strengthen the efficiency of the domestic financial sector. Finally, full convertibility would allow portfolio diversification.

4. Tunisia, however, faces several challenges. The trade liberalization in the context of the agreement with the EU offers promissing prospects for the medium term, but poses new challenges to the economy in the short term. The financial sector exhibits several vulnerabilities which need to be addressed before achieving full capital account liberalization.

5. In this context, Tunisia's main challenge at this juncture is to capitalize on the achievements of the past years and to fill the still remaining gaps. This exercise will require designing a broad strategy for sequencing and coordinating the remaining reforms. It involves setting policy priorities (consistent with the overall economic objectives of the authorities) by applying general principles for sequencing learned in other countries and drawing on an assessment of strengths and vulnerabilities; coordinating the main steps; reaching a tentative judgment on time needed to achieve a critical mass of reforms; and organizing the measures accordingly along a time line.

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[30] See Speech of the Governor of the BCT on the occasion of the Forum International, *L'Economiste Maghrébin:* "La Convertibilité Totale du Dinar," May 24, 2001.

B. Overall Assessment

6. In deciding on the speed and sequencing at which the liberalization of the capital account can proceed, the Tunisian authorities have to take account of the need for the process to go hand in hand with progress in strengthening supporting policies. While the process may be gradual, it is also important to note that time is of the essence. In particular, the ongoing trade liberalization and Tunisia's reliance on the international capital markets to finance the balance of payments have set a clear direction toward liberalizing the external sectors.

7. It is also important to note that strong incentives for circumvention may reduce the effectiveness of capital controls. In this context, it is important to ensure that differentials between domestic and foreign interest rates cover the market's perception of exchange risk.

8. The liberalization of the capital account could be used to support broad economic objectives such as a diversification of the financing sources of the balance of payments and fostering the effectiveness of financial intermediation. Some measures to this effect could be implemented immediately. However, the overall weak position of the banking system, together with shortcomings in the systemic liquidity framework precludes an immediate and full liberalization of the capital account.

9. Four areas should be addressed irrespective of the pace and sequencing of capital account liberalization: (i) the banking system needs to be placed on a sound footing; (ii) prudential supervision needs to be strengthened; (iii) the systemic liquidity framework needs to be further upgraded (free completely monetary policy from credit policy considerations and develop a robust government securities market); and (iv) the exchange rate should be fully flexible in the face of ongoing structural changes in the economy.

10. The proposed sequencing for the liberalization of the capital account distinguishes three stages. Stage I takes account of progress achieved to date in establishing a sound macroeconomic framework and in strengthening the financial sector. It includes measures that can be implemented immediately to enhance the effectiveness of financial intermediation and diversify balance of payments financing sources. Stage II builds on further progress in strengthening systemic liquidity arrangements and related monetary and exchange operations, as well as in strengthening the financial position of the financial and corporate sectors. Stage III builds on further progress in establishing a robust capital market.

11. The remainder of the study is organized as follows. Section II offers a brief overview of progress achieved so far in building supporting policies and of the challenges ahead. It draws on the findings and conclusions of the FSAP for Tunisia that was undertaken by a joint Fund and World Bank team in 2001. Section III offers general and Tunisia's specific considerations on the liberalization of the capital account. Section IV outlines the policy responses to fill the still remaining gaps. Section V discusses a sequence for liberalization, which distinguishes three stages along a timeline.

II. Progress Achieved and Challenges[31]

A. External Sector Liberalization

Achievements

12. Tunisia made significant progress in opening the external sectors during the 1990s. The strategy aimed at ensuring a competitive environment for domestic enterprises by following an exchange rate policy aimed at targeting a constant real exchange rate. Capital controls were utilized to ensure that domestic savings would be used to finance domestic investment (rather than the acquisition of foreign assets), and to limit reliance on short-term external financing. In this context, Tunisia accepted the obligations of Article VIII of the Fund's Articles of Agreement in January 1993.

13. Regarding capital account liberalization, convertibility of the dinar is already well advanced for nonresidents: inward foreign direct investments by nonresidents are to a great extent, but not fully liberalized; nonresidents are allowed to bring foreign exchange into the country and keep it in bank accounts denominated in foreign currency or in convertible dinar. However, nonresidents are not allowed to invest in domestic money- or capital market-debt instruments, except through mutual funds shares invested in such securities. In contrast, the regulatory framework for outward capital transactions is still fairly restrictive with the exception of export-oriented activities and corporations (Box 1).

14. The trade regime was also significantly liberalized: Tunisia joined the World Trade Organization (WTO) in 1994, and a far-reaching liberalization of trade and services is under way. The Association agreement with the EU will result in the elimination of tariffs imposed on European goods by 2007. Regional and bilateral trade agreements have been signed with Middle Eastern countries which, in the medium term, will lead to the creation of a regional free-trade zone.

Challenges

15. The first challenge is to achieve a smooth implementation of the trade agreement with the EU. The agreement will significantly change the access of Tunisian companies to foreign markets as well as the access of foreign companies to Tunisian markets. The resulting change in comparative advantages is likely to have two effects that could impact the soundness of the banking sector.[32] Tunisian companies that have enjoyed advantages—either export companies that have had special access to markets in the EU, as for instance the textile companies under the multifiber agreement that will end in 2005, or local companies that have benefited from protection against competition—will be forced to compete on less favorable terms. Some of them may not be able to withstand the competition, which could increase the

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[31] Appendix I summarizes the main policy measures during the period 1987–2001.

[32] Box 2 describes the impact of trade liberalization on the Greek financial sector.

risk of loan defaults.[33] In addition, changes in the structure of trade will cause new industries to emerge or old ones to contract. This will complicate risk analysis in those sectors and hence the evaluation of their creditworthiness. The vulnerabilities heighten the need for making provisions against future nonperforming loans (NPLs) (equivalently establish a capital cushion), while at the same time covering NPLs inherited from the past.

Box 1. Summary of Exchange Arrangements

(Position as of End-2001)

Exchange rate structure and market. Since 1994, the exchange rate of the dinar is determined in the interbank market, with BCT intervention aimed at keeping it at its targeted level. Banks are allowed to provide forward contracts to exporters, importers and service providers, and for financial operations.

Foreign currency bank accounts. Residents are allowed to open: (i) *comptes spéciaux*: open to new or returning residents who wish to repatriate assets form abroad and keep the proceeds in foreign currency; (ii) *comptes professionnels*: open to exporters. Accounts holders may keep up to 50 percent of export proceeds without BCT authorization; and (iii) *comptes devises bénéfices exports*: open to individuals and businesses with income in foreign currency other than export proceeds. Account holders may keep 5-10 percent of foreign currency earnings without BCT authorization. Nonresidents may bring foreign exchange into the country and keep it in bank accounts denominated in foreign currency, and take it out at any time; earnings from work or investments in Tunisia (except for 50 percent of export earnings) must be deposited in non-convertible dinar-denominated accounts. Remuneration on foreign currency-denominated bank accounts is regulated by the BCT.

Capital transactions. Stock purchases in Tunisian companies by nonresidents do not require prior approval unless a controlling share or voting rights are acquired, in which case approval from the High Investment Commission (HIC) is required; investment proceeds can be freely repatriated. Investments by nonresidents in domestic debt instruments are restricted except through the purchase of shares issued by mutual funds invested in such securities. The accumulation of assets abroad by residents requires prior authorization, however exporters may transfer limited amounts annually to finance business related expenses. Commercial credits to nonresidents by residents require BCT approval. Corporations may freely contract foreign currency loans from nonresidents up to an annual limit.

Provisions specific to financial institutions. Commercial banks may (i) borrow abroad up to the equivalent of D 10 million equivalent per year; (ii) open correspondent accounts with foreign banks but are required to transfer their foreign currency holdings (and those collected from residents) to BCT foreign correspondents [*nivellement*] at the end of the day; (iii) provide forward covers for trade-related and financial operations (up to 12 months); (iv) engage in foreign currency/dinar swap operations and in forward rate agreements to hedge against interest rate risk. BCT authorization is required to grant loans to nonresidents. Institutional investors are not allowed to purchase assets abroad. Offshore banks are not subject to exchange controls.

Source: Annual Report on Exchange Arrangements and Exchange Restrictions, IMF. See Appendix II for a detailed description of the regulatory framework.

[33] Aware of the impact trade liberalization will have on many sectors the authorities initiated a modernization program (*programme de mise à niveau*) in order to prepare Tunisian companies for a more competitive environment.

Box 2. Effects on the Banking System of Increased Trade Competition: The Case of Greece

At the start of the 1980s, the Greek banking system was highly concentrated, had a high degree of government involvement, and allocated credit inefficiently. Two state-controlled banks accounted for almost three quarters of all loans at end-1981, and specialized credit institutions, financed by the bank of Greece, accounted for about half of all lending in the country. Banks in general had been compensated for preferential credit to the government or to certain priority sectors, and state-controlled banks had extended credit without regard for profitability criteria. In particular, they favored larger enterprises at the expense of smaller, but better-performing, ones.

In 1981, Greece joined the EU. Prior to entry, Greece's import regime had been highly restrictive, with most imports requiring approval prior to shipment and being subject to a complex system of special import licenses. The resulting change in the openness of the Greek economy to the rest of Europe drastically changed the pattern of imports. Between 1980 and 1985 the proportion of imports originating in the rest of Europe increased from 41 percent to 49 percent, the share of non-EU industrial countries in imports fell from 24 percent to under 12 percent, and the share of non-oil developing countries declined from 20.5 percent to 8 percent. The increase in imports from more advanced countries represented increased competition in modern sectors that would have been more likely to receive preferential credit.

Meanwhile, exchange rate policy aimed at controlling inflation led to a real appreciation of the drachma, weakening the position of Greek exporters. Despite a devaluation in January 1983 followed by two years of nominal effective exchange rate management and another depreciation in October 1985, the drachma followed a trend of appreciation. Exports responded erratically to these changes, falling sharply in 1981–82, surging by 39 percent in 1983–84, and remaining flat in 1985.

In the years after the entry into the EU and the changing patterns of trade, many enterprises heavily indebted to banks incurred losses and were unable to service their debts. Efforts by the authorities to moderate the problem—including enacting a law in 1983 to set up the Business Reconstruction Organization, which would close nonviable enterprises and convert their outstanding debt into equity— and would offer problem enterprises a moratorium on domestic debt obligations—did not alleviate the problem.

As a result, the profitability of commercial banks declined. In 1984 their profits were at 0.4 percent of total assets after provisions, and in 1985 there was a further deterioration as banks were no longer allowed to include deferred interest payments in their profits. This deterioration occurred even though the Bank of Greece provided support by granting in 1985 a retroactive increase in interest rates on banks' compulsory deposits with it. Commercial bank capital also deteriorated, declining from about 4 percent in 1982 to 2.5 percent in 1985. Data are less comprehensive for the specialized credit institutions, but the available information supports a similar story. Bank profitability remained low for the rest of the decade as financial liberalization progressed steadily but slowly.

At the end of 1990, commercial bank financing dominated the capital markets, and while there had been strong growth in credit to the private sector during the second half of the 1980s, it was surpassed by the growth in credit to the public sector, particularly state-run enterprises. About two-thirds of bank deposits were earmarked, mostly for lending to the public sector, and in many cases to loss-making companies that were supported by government policies. The banking system remained heavily state-controlled and heavily concentrated, with two banks accounting for about two-thirds of activity in the sector. The strong state presence in the system discouraged foreign competition (which at least helped to increase spreads and protect profits somewhat), and (perhaps because of the high level of concentration) small customers were charged high fees. The Greek banking system lagged behind EU standards on capital adequacy, with several large and dominant banks (including the largest bank) not meeting minimum capital requirements.

B. Macroeconomic Stabilization

Achievements

16. Stabilization and structural reform programs implemented since the mid-1980s have allowed Tunisia to establish strong macroeconomic performances. During the past ten years, GDP growth averaged nearly 5 percent with limited fluctuation; CPI inflation (annual average) has been kept under control, averaging 4.4 percent, and following a steadily declining trend during the decade towards about 3.0 percent. Fiscal management was strengthened in the most recent period, with a consolidated deficit (excluding grants and privatization proceeds) during the period 1998–2000 about 3 percent of GDP. This represents a moderate medium-term improvement over the somewhat higher deficits of the past several years, including a deficit equal to about 5 percent in 1996. Monetary policy has been prudent.

Challenges

17. Management of the macro economy is facing the challenge of containing the momentum of domestic demand, which has put pressure on the external balance and lowered foreign exchange reserves. In this context, there is a need to review the exchange rate regime in light of the opening of the economy.

18. In particular, the opening of the economy will have unpredictable effects on the equilibrium exchange rate. Competitiveness will be affected by the tariff reductions envisaged by the final stage of implementation of trade agreement with the EU. It will also be affected by the growing role of market forces and increased integration of the Tunisian economy with the EU as a result of the harmonization of rules, standards and legislation with that of the EU. Exchange rate flexibility would also be consistent with the planned move to greater mobility of capital flows to avoid speculative capital inflows that may rely on an implicit exchange rate guarantee.

C. Financial Sector Liberalization

Achievements

19. In the mid-1980s, the authorities embarked on wide-ranging stabilization and structural reform programs with the support of the IMF and the World Bank to address the imbalances that had followed the directed credit policies of the 1970s and 1980s.[34] Structural reforms involved a gradual deregulation of the financial system and promotion of a market-based and private sector-driven economy. The initial phase of financial reforms (1987–93)

[34] During the 1970s and much of the 1980s, Tunisia pursued inward-looking development strategies emphasizing the key role of the state in accelerating economic development and ensuring national control over strategic sectors.

aimed at a *gradual dismantling of the debt economy*. It involved a gradual liberalization of interest rates, a gradual dismantling of directed credit policies, and a strengthening of the prudential framework for the financial sector. Banking supervision was also strengthened leading to significant compliance with the Basel Core Principles for Effective Banking Supervision.

20. Thereafter, financial reforms aimed at paving the way for the *development of a financial market economy* (1994-present). These reforms involved the following: (i) the lifting of all restrictions on lending rates and the elimination of mandatory lending requirements to priority sectors; (ii) a gradual shift to indirect instruments of monetary control; (iii) a modernization of the public debt management framework; (iv) the establishment of an interbank foreign exchange market; and (v) a further strengthening of the legal, judicial, and prudential framework for the banking and securities sectors. Concurrently, the authorities implemented a plan to restructure NPLs to public enterprises, banks were allowed greater freedom in undertaking foreign currency operations, and the modernization of the capital market has broaden corporate sector financing sources. Considerable progress was also made in securities market supervision with most of the IOSCO Core Principles implemented or partially implemented.

Challenges

21. The large amount of non-interest bearing assets in bank portfolios increases the cost of bank intermediation and places affected banks at a competitive disadvantage against new banks and existing banks that do not have to carry this burden.[35] Assuming a risk-free rate of interest of 7 percent, the impact of unproductive assets on bank margins could be between 100 and 200 basis points. In this context, a rapid opening of the financial sector to foreign investors could lead to pressures on the domestic banking system. In this context, the high level of profitability in the banking system provides a window of opportunity to strengthen provisioning and to reduce the size of non-interest bearing assets.

22. The level of NPLs was reduced in half between 1992 and 1999, but the continuing high level of NPLs suggests the need for further improvements in bank credit policies. Significant room appears to be available for improving credit policies by adopting modern methods of credit appraisal, relying on realistic cash flow projections rather than the availability of collateral security, and avoiding situations of excessive leverage in the corporate sector.

23. The institutional framework for financial sector supervision could be improved in several areas. Consolidated supervision is absent despite the emergence of large financial

[35] Non-interest bearing assets include the net NPLs (i.e., about 10 percent of loans) and past NPLs to public enterprises that have been taken over by the government and replaced with non-interest bearing claims on the government repayable over a 25-year period.

conglomerates. Formal procedures of cooperation between supervisory agencies are also not yet in place despite some overlap in financial institutions' activities. The operational independence of the agencies in charge of the supervision of banking and securities markets could also be improved to increase their accountability. This would further enhance confidence in the financial sector.

D. Systemic Liquidity Framework

Achievements

24. The BCT has developed a comprehensive set of indirect policy instruments to manage banking system liquidity. The weekly credit auctions (*appel d'offres*) are the main discretionary instrument. They are supplemented by standing facilities which allow banks, at their own initiative, to obtain or place liquidity at the official (but higher compared to market conditions) intervention rates, and by non-remunerated reserve requirements set at 2 percent of sight and term deposits. The combination of the weekly liquidity auctions with the standing facilities creates a corridor for money market rates (Box 3).

Box 3. Instruments of Monetary Policy

Weekly collateralized credit auctions (*appels d'offres*): the central bank invites bids for its weekly volume auction. Maturities are set at seven days and the amounts are not announced in advance. The BCT decides the amount to be injected and the bids are all satisfied at the same official intervention interest rate. In addition, currently BCT credit is allocated equally against the following categories of collateral: claims on priority sectors, claims good standing enterprises (i.e., performing loans), and government securities.

Three-month government securities reverse repurchase operations *(prise en pension à 3 mois de bons du Trésor)*: the central bank invites bids for monthly three-month reverse repurchase operations against government securities only.

One to seven-day reverse repurchases operations (*prises en pension de 1 à 7 jours)*: banks may request additional liquidity at a premium over the official intervention rate (currently 100 basis points). Any bank with the necessary collateral can get credit under this facility.

End-of-day settlement operations (*opérations de fin de journée* or *opérations ponctuelles)*: commercial banks may, at their own initiative, obtain or place liquidity at the official intervention rate, during the day.

Weekly deposit auctions *(appel d'offres de reprise de liquidité)*: when the banking system as a whole is over liquid, they are used instead of the liquidity auctions to mop up excess liquidity by accepting bids for the placement of liquidity over seven days. The demands are ranked and satisfied according to the rate that is proposed; the rate cannot exceed that of the weekly liquidity auctions.

Reserve requirements *(réserves obligatoires)*: they are calculated as monthly averages, and must amount to 2 percent of dinar sight and term deposits, as well as other financial products and certificates of deposit. They are not remunerated, and are not actively used as a monetary policy instrument.

25. Recent changes in the implementation of monetary policy are expected to stimulate the development of the money market and to provide incentives for banks to upgrade their liquidity management skills. Since early 2001, the BCT no longer systematically meets bank requests under its standing facilities and it has curtailed reliance on end-of-day settlement operations (*opérations ponctuelle)* allowing market rates to fluctuate within the corridor. These measures have already led to increased interbank market activity.

Challenges

26. Significant progress was made in freeing the conduct of monetary policy from credit policy considerations, and the BCT has scaled back its readiness to accommodate bank liquidity needs. However, the money market is still shallow, and the use of open market operations is made difficult by the limits on the BCT holding of government securities, and by the BCT credit policy considerations in allocating its refinancing to the banking sector.

E. Government Securities Market

Achievements

27. The government securities market dominates the bond market (i.e., 85 percent of the stock of bond instruments) and was modernized with the introduction of standardized instruments, their systematic auction-based issuance, and the establishment of a group of primary dealers. About two-thirds of domestic debt is in negotiable and book-entry form; transactions are tax-neutral; and investors may subscribe through their bank or mutual fund. The risks associated with debt management were limited by financing approximately 40 percent on the domestic market, keeping the short-term portion of the debt under one-third of the negotiable debt, spreading out maturities over 10 years, and avoiding variable-rate instruments.

Challenges

28. From the perspective of capital account liberalization, the government securities market plays a critical role since it is the market of choice for foreign investors. Tunisia's "investment grade" rating, as reflected in its ability to raise funds on the international capital markets, suggests that an opening of the market to foreign investors could generate capital inflows.

29. However, the primary market has persistent shortcomings, and the secondary market is in its infancy. Therefore, opening the government securities market to foreign investors, while beneficial in the short-term, could be a source of external vulnerability in the event of changing international capital market conditions caused by a deterioration of domestic conditions or contagion. Sudden or large-scale reversals in the capital inflows, in the absence of a large base of domestic investors, could generate a boom-bust pattern in asset prices that can spill over to domestic demand and the exchange rate.

F. Corporate Sector Restructuring

Achievements

30. In 1997, the authorities started the implementation of wide-ranging reforms to restructure the state-owned corporate sector, which reduced the vulnerabilities that had arisen in the financial sector from past-directed credit policies. The plan involved a government guarantee of banking claims on public enterprises that were to remain publicly owned and active, and the purchase by the state of the banking claims on public enterprises liquidated or to be liquidated or privatized. Under the program, about 80 percent (5 percent of GDP) of NPLs to public and semi-public enterprises were restructured or removed from bank balance sheets; 70 percent of the loans to be settled were concentrated in three public sector banks.

31. Following the implementation of these measures, indicators of bank soundness improved significantly, and the BCT was able to raise the banks' minimum capital adequacy ratio requirement from 5 percent to 8 percent in 1999. Following the restructuring of bank claims on state-owned enterprises, over 90 percent of commercial bank credit goes to the private sector, and the average contribution of the main economic sectors to value added is well diversified and balanced: the agriculture and non-manufacturing (including mining and construction) sectors jointly accounted for almost one-third of total value added, and the share of manufacturing was equal to one-fourth and that of the service sector to 45 percent.

Challenges

32. Banking sector dominance in the financial sector is mirrored by a highly leveraged corporate sector. Data from corporations listed on the stock exchange or having made a public issue of securities shows a ratio of total debt to total assets of 47 percent, a value comparable to those observed in countries with a similar degree of financial depth. However, the leverage ratio (92 percent) is somewhat high, as is the ratio of short-term debt to total debt (74 percent).

33. Aware of these weaknesses, the authorities have designed a wide-ranging modernization "*mise à niveau*" program to help Tunisian manufacturing industry upgrade and modernize its operations and meet the growing challenge of international competition. A 1999 survey of the benefits of this kind of program showed promising early results: participating firms increased sales and profits significantly, and employment among participating firms grew. However, emphasis of the "*mise à niveau*" on improving the financial structure of enterprises could be increased. Current eligibility conditions require firms to have a level of debt that does not exceed 70 percent of total assets, whereas the average ratio is at 66 percent. Adopting a more stringent ratio would help reduce the burden of financing costs on the productive sector and provide an incentive for a diversification of financing sources away from bank credit.

G. Legal Framework

Achievements

34. Tunisia has the benefit of well-developed and well-established legal institutions. The commercial legislation is sophisticated and well drafted and in the mainstream of European

commercial law. Most of the laws covering the financial sector have been revised in the past decade and have been expanded to adopt modern concepts and practices. The framework laws are supplemented by special laws and subsidiary legislation.

35. The promulgation of the new Code on Commercial Companies in 2000 marked a major legislative breakthrough. The emphasis has been placed on transparency, collegiality, accountability of managers, and greater shareholder rights. Regarding the financial sector, the new management structure of business corporations holds out the possibility of transferring responsibility for the supervision of public-sector banks from the line ministry to the bank's own supervisory board, which could enhance the operational efficiency of public banks.

36. Considerable efforts have been made since the mid-1990s to modernize accounting rules and to bring them more closely into line with international accounting principles. Recently, draft accounting standards were published on the preparation of consolidated accounts and the treatment of business groups and holdings companies. Provided the new accounting and auditing standards are enforced, the transparency, accuracy, and reliability of the financial information of commercial firms and financial institutions would be substantially improved.

Challenges

37. Tunisia suffers from long court delays with respect to debt recovery and the recovery of collateral. Furthermore, while the legal framework for the collection of bad debts has been greatly improved by the enactment of legislation authorizing the creation of asset management companies (AMCs), their success would depend on progress in strengthening the debt collection legal and judicial framework.

38. Also, while the legal framework governing the securities market is modern and sound, the enforcement of rules remains inadequate. The CMF focuses its efforts on combating insider trading, market manipulation, and fraud, all of which are highly complex issues. In accordance with European tradition, a criminal approach is adopted which makes prosecution and deterrence even more complicated. Alternative methods should be studied, notably the imposition of administrative penalties, a broadening of the options for recourse to civil action, and possibly the establishment of a court specializing in stock market offenses.

H. Gaining Access to International Capital Markets

Achievements

39. The track record of sound macroeconomic policies during the 1990s and the government's commitment to structural reforms have allowed Tunisia to obtain investment-grade ratings by leading rating agencies, even though individual ratings for the banks are generally weak (Box 4). The ensuing access to international capital markets under favorable conditions was mostly utilized by the government to raise funds in the international capital markets to finance the budget deficit and support Tunisia's international reserves.

Box 4. Rating Agencies' Appraisal of the Tunisian Banking System and Economy

Sovereign debt

Standard and Poor's, Moody's, and Fitch IBCA all gave a positive overall assessment of the Tunisian's sovereign risk (as shown in the Table below which reports on Tunisia's Long-term foreign currency rating) with Standard & Poor's and IBCA upgrading Tunisia's rating following the 1997–98 restructuring of bank's portfolios. Moody's has had its Baa3 rating on positive outlook since February 2000.

Agency	1995	1996	1997	1998	1999	2000	2001
IBCA	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB
Moody's	Baa3	Baa3	Baa3	Baa3	Baa3	Baa3	Baa3
S & Poor's			BBB-	BBB-	BBB-	BBB	BBB

The overall assessments of the macroeconomic environment were also positive. The rating agencies noted the strong growth rates of the economy, the shift of revenue reliance from oil and trade taxes toward VAT and income taxes, the privatization program, the growth of manufactured exports and tourism, the falling current account deficit, the steady investment and financing inflows, the containment of interest payments on external debt, and the Free Trade Association Agreement with the EU (FTAA). Concerns, which were listed mainly by S&P, included the high level of unemployment, the increase in the fiscal deficit in 2000, the slow pace of the privatization program, and the reliance of many industries on protection.

The outlook for the future was also positive, largely because projected further reductions in the fiscal deficit are expected to allow for increases in the gross national savings rate, permitting investments rates that would support high growth. Several risks were noted, however, including how the FTAA will be perceived by investors and whether steady capital flows will continue, the social and political risks of economic changes especially including privatization, and whether the government will be able to maintain the pace of liberalization.

Banking system

The reports from the rating agencies noted weaknesses in the banking sector, including the problems with loan quality and provisioning: S&P was particularly critical of this, while Moody's indicated that bank solvency had improved over the past few years. Consequently, individual ratings for the banks are generally weak, reflecting modest or very modest intrinsic financial strength. Following the merger of two weak development banks (*Banque Nationale du Développement Touristique* and *Banque de Développement Économique de Tunisie*) with *Société Tunisienne de Banque* (STB), Moody's downgraded STB's financial strength rating to E+ from D- because of weak asset quality and excessive reliance on collateral, primarily hotel properties, that could impose a significant provisioning burden on the bank if these properties do not improve within a reasonable timeframe. Other concerns that were noted included the slow pace of reforms, the risks of trade liberalization, the high public sector debt, the high public sector involvement in the banking system, and the low levels of reserves.

The written assessments, particularly Moody's, had a positive tone, but one of the key factors in the Moody's assessment was **the high likelihood that public support would be provided to banks if needed**. This was believed to be true because (a) loss of confidence in the banking system would threaten economic growth, (b) the political cost of allowing a bank failure would be too high, and c) a bank collapse would weaken Tunisia's ability to attract foreign investment. Other factors that entered into these positive assessments were: (i) approval of the program to liberalize the financial sector; (ii) the limited competitive environment; and (iii) the high level of profitability and large spreads that banks enjoy.

Sources: Moody's, Standard and Poor's, and Fitch IBCA.

Challenges

40. The preference given to sovereign external borrowing, however, has resulted in limited diversification of balance of payments (BOP) financing sources. As of end-2000, the public sector accounted for 97 percent of the Tunisia's medium- and long-term external debt (central government: 74 percent; public enterprises: 23 percent), resulting in an exposure of the public sector to exchange rate volatility. In this context, a diversification of the BOP financing is desirable to allow greater access by the private sector.

III. Overall Approach to Liberalization

A. Sequencing: Insights from Country Experiences[36]

41. Country experiences support the view that while there is no unique approach to sequencing and coordinating capital account liberalization with other policies, it is possible to derive certain general principles from these experiences. First, there are interdependencies among different areas of policy and an understanding of these relationships is essential to developing an operational plan for sequencing. Second, some countries suffered severe financial system and external crises even though they had a broad range of capital controls (Korea). Third, the countries that avoided financial system and external crisis in the process of liberalizing their capital account had sustainable macroeconomic policies and a systematic approach to safeguarding financial sector stability, in particular, the exchange rate regime was consistent with other macroeconomic policies. However, the speed and timing of capital account liberalization in relation to financial sector reforms differed widely among countries.

42. The countries that experienced serious crises have certain features in common, including most notably weaknesses in their financial systems and shortcomings in policies to redress those weaknesses. Unsustainable exchange rate policies also played a key role in precipitating the crises in a number of countries.

43. The experience of countries shows that capital account liberalization needs to be accompanied by and coordinated with an appropriate sequencing of other reforms. The following are key considerations in this regard:

- Macroeconomic policies need to be sound and sustainable. In particular, the exchange rate regime needs to be consistent with other macroeconomic and structural policies before lifting controls.

- Market-based monetary arrangements should be implemented early in the reform sequence, and strong public debt management practices are also essential to managing the risks from short-term capital flows.

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[36] This section relies on Shogo Ishii and Karl Habermeier, *Capital Account Liberalization and Financial Sector Stability*, IMF Occasional Paper (forthcoming) (Washington: International Monetary Fund).

- Particular attention should be paid to prudential regulations and supervision of liquidity and market risks associated with short-term foreign currency borrowing.
- The pace of reforms should take into account the conditions relating to the financial structure of non-financial corporations and their effects on the quality of the loan portfolios and capital base of financial institutions.
- Reforms need to take into account the effectiveness of the controls on capital flows in place.
- The pace, timing, and sequencing of liberalization all need to take account of regional considerations. In particular, commitments to economic and financial integration in regional associations or unions may constraint the sequencing and pace, and timing of liberalization.
- The operational and institutional arrangements for policy transparency and data disclosure need to be adapted to support capital account opening. Adequate disclosure of the financial conditions of banks and nonbanks, and adequate transparency of the objectives, operational procedures, and integrity in major policy areas can shape market expectations, reduce uncertainly, and facilitate financial reform by reinforcing public support for reforms.

B. Considerations on Speed and Sequencing for Tunisia

44. The speed at which the liberalization of the capital account can proceed is a matter for the Tunisian authorities given the many considerations at play, some of which have a political or social dimension. In addition, liberalization has to go hand in hand with progress in strengthening supporting policies as discussed above. In this context, one can highlight a desirable sequence of actions so that the risks involved are minimized and the process is orderly.

45. In addition, while the process may be gradual, Tunisia's commitments to trade liberalization and reliance on international capital markets suggest that liberalization should proceed as fast as conditions allow. Furthermore, one cannot expect to ever reach a level of confidence such that any step will be entirely free of risks. Here what matters most is for the authorities to be confident that the policy instruments to deal with shocks will be available when needed.

46. Finally, it is also important to note that Tunisian nationals have the possibility of engaging in arbitrage between the dinar and foreign currencies indirectly on account of the sizable remittances from Tunisian workers abroad.[37] In this context it is critical to ensure that the structure of incentives does not encourage capital flight, in particular that the level of remuneration on savings invested in Tunisia is attractive. In practice, the authorities have to ensure that differentials between domestic and foreign interest rates cover the market's

[37] A similar analysis applies to capital flight through over- or under-invoicing.

perception of exchange risk. Such a need reinforces the urgency to strengthen the financial structure of the Tunisian corporate sector so that it can withstand a corresponding level of interest rates. Lowering the leverage ratio of Tunisian corporations would help in this regard.

C. Liberalization in Support of Some Immediate Policy Objectives

47. The liberalization of the capital account can be used to support the policy objectives of ensuring diversifying balance of payments financing sources and enhancing the effectiveness of financial intermediation.

Diversification of balance of payments financing sources

48. Tunisian corporations are subject to an annual limit on their borrowing abroad. Freeing external borrowing would help diversify balance of payment financing currently skewed towards public sector financing. Following the approach of Chile, in order to reduce external vulnerability, which arises from the default of a large borrower, only financially sound corporations should be allowed to borrow abroad (Box 5). This could be achieved by placing a prudential requirement whereby only listed corporations or those rated by international rating agencies could borrow freely abroad.

Box 5. Lessons from Chile's Experience

Prudential Limits on External Borrowing in Chile. In 1992 banks and corporations willing to borrow abroad were required to secure a favorable rating from the National Risk Classification Commission. In 1993 the previous requirement was replaced by the requirement to obtain from an international agency a rating equal to or better than that assigned to Chile. In 1994, the previous requirement for corporations was replaced by the requirement that they be rated BBB, and the previous requirements for banks by the requirement that they be rated BBB+. Consequently, resident enterprises borrowing on the international capital markets were made subject to the best-accepted international practices regarding disclosure and accounting standards. Only sound corporations, or those with a business structure enabling them to rely on external borrowing without taking excessive risks, were allowed to tap international capital markets; and the requirement for banks to secure a rating higher than for corporations prevented the loophole of poorly rated corporations borrowing at a sizable amount from banks relying heavily on external financing.

Source: Bernard Laurens and Jaime Cardoso, "Managing Capital Flows: Lessons from the Experience of Chile," Working Paper, IMF Working Paper, 98/168 (Washington: International Monetary Fund), 1998.

49. Tunisian financial institutions borrowing abroad are also subject to an annual limit. Such a practice is sensible given that ratings for the banks are generally weak. However, financial institutions with high ratings could be allowed to borrow abroad without any limitation.

50. Serious consideration should also be given to allowing nonresidents to acquire controlling shares or voting rights in all the sectors, with the only exception of sectors critical for national security. Removing the 50 percent approval ceiling on foreign holdings of domestic enterprises, by allowing greater scope for foreign direct investments (FDIs) would

help diversify balance of payments financing sources. It would also be beneficial for the development of the capital market and for the diversification of corporate sector's financing sources.

Effectiveness of financial intermediation

51. The liberalization of several items of the capital account could help enhance the effectiveness of financial intermediation in Tunisia. First, greater foreign involvement in the sector could help. Several foreign financial institutions have subsidiaries or branches in Tunisia that are mostly involved in "niche" activities (trade financing and the like) with limited spillover effects on credit culture. Seeking foreign partnerships (i.e., twinning arrangements or equity participation) in the retail banking business, as illustrated by the example of Hungary (Box 6), would facilitate a transfer of know-how and the development of modern concepts of risk management. Participation of financial institutions from advanced financial markets in the financial sector would generate greater competition and the dissemination of modern management and risk analysis skills, which in turn would strengthen the resilience of the domestic financial system and the overall efficiency of financial intermediation.

Box 6. Lessons from Hungary's Experience

Foreign Ownership and Market Discipline in Hungary. The risk management experience provided by foreign institutions from advanced financial markets and their consolidated supervision by their home-country supervisors can help limit the risks in the financial system. Foreign financial institutions were allowed to invest in the Hungarian financial sector beginning early in the transition process during the early 1990s. This strategy led to increased competition, early transfer of know-how, and a decrease in intermediation margins. By mid-1999, the share of foreign ownership in commercial banks exceeded 70 percent of their registered capital. Allowing foreign financial institutions to participate in the privatization process increased the resilience of the Hungarian banking system and helped mitigate the spillover effects of the 1998 Russian crisis.

Source: Shogo Ishii and Karl Habermeier, *Capital Account Liberalization and Financial Sector Stability*, IMF Occasional Paper (forthcoming) (Washington: International Monetary Fund).

52. Second, the overall effectiveness of banks in intermediating foreign exchange could be enhanced by eliminating the requirement that banks transfer daily all their correspondent account foreign exchange holdings to the BCT [*nivellement*]. The requirement implies that the BCT manages the foreign exchange reserves of the private sector, which is not conducive to building the correspondent skills at the commercial banks. The practice goes well beyond the normal role of a central bank, inasmuch as it is not a practice, which is required to ensure the effectiveness of exchange controls. Also, the centralization of all bank foreign exchange holdings at the BCT creates confusion about the respective roles of the BCT and the banks, which may contribute to diluting the responsibility of the banks. Eliminating the requirement would enhance competition for exporters' deposits as banks will be able to manage these deposits more aggressively than at present. As banks gain experience in managing foreign exchange assets, they could, in turn, transfer this experience to the local foreign exchange market. This modification will not lead to unauthorized capital movements as banks foreign exchange operations will still be closely monitored by the BCT. A related measure would be

to allow domestic banks to set freely the conditions of remuneration of foreign currency denominated accounts.

53. Third, the surrender requirement for export proceeds could be further reduced or even eliminated. In 1999, the authorities reduced to 50 percent (from 60 percent previously) the portion of export proceeds that must be surrendered to the market. Since the surrender requirement on aggregate does not appear to be binding, an additional reduction, or even its elimination, would not be likely to generate pressures on the exchange rate, and it would foster market development.

IV. Policy Responses

A. General Considerations

54. The overall weak position of the banking system, together with shortcomings in the systemic liquidity framework (including the government securities market) precludes advocating an immediate and total liberalization of Tunisia's capital controls. Indeed, if a full opening of the capital account were to lead to large capital inflows, the lack of preparedness of the commercial banks or the domestic markets which would be called to intermediate these flows could generate significant vulnerabilities in the event of a sharp and sudden reversal. Furthermore, in a context of limited flexibility for the exchange rate, the inflows would result in a monetary expansion if not sterilized, and if sterilized the possible rise in the interest costs of sterilization could induce speculative capital inflows. Conversely, if capital outflows were to follow the liberalization of the capital account, the already fragile reserve position of the BCT would be further weakened.

55. The recommendations in the following sections for the sequencing of capital account liberalization are based on Tunisia's circumstances and benefit from other country experiences, especially transition economies. Most of the transition economies that liberalized their capital accounts and avoided financial crises proceeded in a gradual way, and the sequencing of their steps followed similar paths. Long-term capital account transactions were liberalized before short-term movements, as the risks from large short-term capital movements were perceived to be larger than those from long-term flows.

56. Another fairly general approach was that FDI inflows were among the first categories of transfers to be liberalized, given the lower probability of reversal of these flows in the event of a change in market sentiment owing to the lack of depth of equity markets in transition economies. Thus FDI inflows (especially those that are not securitized) can be considered more stable than other capital movements. Foreign direct investment outflows were also among the forerunners in the liberalization process, sometimes tied to prior registration to check the authenticity of the investment and usually defined as obtaining a predetermined share in an enterprise (the cut-off point in most cases was 10 percent or more) to differentiate them from portfolio investments.

57. The transfer and use of domestic currency abroad was usually limited in the early phases of liberalization in order to avoid a loss of monetary policy autonomy. Restrictions on international transactions in domestic currency, inter alia by limiting convertibility for

nonresidents, by imposing direct or indirect controls on the balance sheets of financial institutions, can make it more difficult for market participants to build up speculative positions against the currency and may help limit the risk of an external crisis. Therefore, these are typically the last items to be liberalized.

58. Furthermore, deposit transactions abroad were classified as short-term capital movements irrespective of the maturity of deposits, since it was difficult for the foreign exchange authority to affect the activities of residents in their foreign accounts.

B. Supporting Measures for Liberalizing the Capital Account

59. A precondition for the successful liberalization of capital controls is a sound and well-regulated financial system, robust systemic liquidity arrangements, and an effective set of monetary and fiscal policy instruments. There are four areas that should be addressed disregarding the pace and sequencing of capital account liberalization. In the case of Tunisia, that would mean: (i) placing the banking system on a sound footing; (ii) further strengthening prudential regulations and supervision; (iii) further reinforcing the systemic liquidity framework; and (iv) moving to a flexible exchange rate regime in the face of ongoing structural changes in the economy.

60. An assessment of Tunisia's conformity with relevant general principles for capital account liberalization identified above and the policy responses looking forward is provided in Table 1 and further discussed in the following paragraphs.

Soundness of the banking system

61. The level of unprovisioned NPLs and other non-interest bearing assets in bank portfolios would need to be reduced to a level allowing the cost of bank intermediation to be in line with those observed in matured financial systems. This would mean cutting by at least half net NPLs from their current level to bring them down to 5 percent of bank loan portfolios.[38]

[38] On average, NPLs (net of provisions) are less than 5 percent of total credits in OECD countries. In France, net NPLs at the end of 2000 reached 1.8 percent of total credits: gross NPLs were 4.7 percent and provisioning reached 64 percent; NPLs in small and medium-sized banks were higher than in the largest banks (8.2 percent against 4.6 percent); however, the levels of provisioning were comparable (69 percent for the small and medium-sized banks against 67 percent for the largest banks).

Table 1. Tunisia's Conformity with General Principles for Sequencing

General Principles	Assessment	Policy Responses
Sound and sustainable macroeconomic policies	There are strong macroeconomic performances, but fiscal policy flexibility may suffer from contingent liabilities in the financial sector.	Policy mix may need to be amended to introduce full flexibility of the exchange rate.
Supportive exchange rate regime	Exchange rate flexibility is desirable in view of ongoing structural changes in the economy.	Achieve full flexibility of the exchange rate before moving to full convertibility
Strong monetary arrangements	Credit policy considerations in the conduct of monetary policy exist, as does limited reliance on open market operations.	Eliminate credit policy considerations and establish a clear monetary framework before moving to full convertibility.
Strong public debt management	Persistent shortcomings occur in primary market and secondary market still in its infancy.	Strengthen policies before allowing short-term capital inflows.
Sound financial sector	The banking sector not yet on a sound footing, Large non-interest bearing assets result in high cost of intermediation. Credit culture needs further improvement.	Reduce level of NPLs by at least half; allow greater foreign participation; further strengthen supervisory framework.
Sound corporate sector	There is high leverage and large exposure to interest rate risks.	Reduce leverage: develop the capital market, eliminate all obstacles to inward FDIs, and privatize public enterprises.
Effectiveness of capital controls	Large remittances of Tunisian abroad create significant scope for circumvention.	Ensure that interest rates differentials cover market's perception of exchange risk.
Economic and financial regional or international integration	Trade integration with EU poses challenges to the corporate sector. Concentration on public sector external borrowing has resulted in limited diversification of BOP financing sources.	Seek diversification of BOP financing by encouraging inward FDIs and liberalizing external borrowing for financially sound corporations.

62. Until these reforms are satisfactorily completed, liberalization of the capital account would create incentives for domestic agents to seek intermediation services from foreign-based banks, a move which could destabilize the domestic financial system.

63. The credit culture in the banking sector needs also to be upgraded so that distortions in credit allocation are minimized.[39] Discontinuing credit policy considerations in the implementation of monetary policy would provide incentives to develop a credit culture, as would greater participation of foreign financial institutions from advanced financial markets.

Prudential regulation and supervision

64. The regulatory framework for handling of foreign exchange and country risk needs to be enhanced to help accommodate the liberalization of the capital account. Regarding

[39] See Box 6 for an analysis of the adverse consequences on the banking sector of longstanding involvement of the Korean government in the financial system.

exchange risks, commercial banks are subject to prudential limits on their open position which are conservative, but liquidity management could be strengthened with a view to prevent the build up of maturity mismatches in foreign exchange in the banks. This could be achieved by the implementation of a maturity ladder approach, as was done in Korea (Box 7).

Box 7. Lessons from Korea's Experience

Credit Culture and the Macroeconomy. In Korea, a lack of efficiency in the financial sector and the poor credit culture played an important role in the deterioration of the corporate sector. In particular, banks used to financing the expansionary plans of corporations based on the availability of collateral rather than on risk assessment, and without adequate capital and provisioning for possible loan losses. In the period preceding the 1997 crisis, growth was driven more by factor accumulation than by productivity increases, and capital accumulation was reaching rapidly diminishing returns. That implied that credit was not allocated to the sectors with the best returns. The high leverage ratios of the chaebols (business conglomerates) and their low profitability made them vulnerable to shocks. The health of the banking system, in turn, was extremely dependent on the viability of the chaebols.

Furthermore, the government's longstanding involvement in the financial system led to a lack of efficiency and distortions in credit allocation. In particular, government intervention in the commercial banks was frequent even after they were privatized in the early 1990s. Consequently, financial institutions lacked independence and had no incentives to develop a credit culture. Government involvement may also have led to the widespread perception that banks and corporations would be bailed out if they encountered difficulties while pursuing government-directed initiatives.

Maturity Ladder Approach. Following the 1997 crisis, Korean embarked on a comprehensive overhaul of the regulatory and prudential framework for the financial system. A critical component of the program was the implementation of measures to strengthen foreign exchange liquidity management. It included the introduction of a maturity ladder approach whereby commercial banks and merchant banks have to report maturity mismatches for different time buckets (from sight to 7 days, 7 days to 1 month, 1 to 3 months, 6 months to 1 year, and over 1 year), and maintain positive mismatches for the first period. From sight to 1 month, any negative mismatch should not exceed 10 percent of total foreign currency assets, and from sight to 3 months it should not exceed 20 percent. It is likely that the measure has considerably reduced the vulnerability of the Korean financial system to the type of crisis it suffered in 1997.

Source: Shogo Ishii and Karl Habermeier, *Capital Account Liberalization and Financial Sector Stability*, IMF Occasional Paper, (Washington: International Monetary Fund), forthcoming.

Systemic liquidity framework

65. Freeing monetary policy from credit policy considerations would greatly enhance the development of the money market and the development of a modern credit culture. It would need to be achieved in advance of the full liberalization of the capital account. In this context, a case can be made that exclusive reliance on government securities for the conduct of monetary policy, in a context of a renovated the government securities market (GSM) as suggested below would help. By allowing full reliance on open market operations in the conduct of monetary policy, such a policy would enhance systemic liquidity frameworks, and send a strong signal regarding the BCT's determination to move away from credit policy considerations. In turn, it would provide a strong incentive for banks to enhance their credit culture.

66. Current actions to improve the liquidity-forecasting framework will facilitate the conduct of BCT's discretionary monetary interventions. They will also make it possible to ensure that they are consistent with the monetary program.[40]

67. Assigning the BCT with a clear primary objective of price stability would go a long way toward freeing monetary policy from credit policy considerations. With such a primary objective, the exchange rate would be determined by fundamentals, which are currently uncertain given the many structural changes the Tunisian economy is undergoing.

Government securities market development

68. A robust primary market and a deep and liquid secondary market need to be developed before nonresidents are allowed to enter the market. A firmer commitment, backed by definitive steps, to market funding of the government would help develop the GSM. Various areas for improvement should also be considered including formalizing and publicizing the debt management strategy; developing a more professional approach and creating an appropriate institutional structure; adhering to the issues timetable; introducing repurchase operations; and boosting transparency efforts among investors.

Corporate sector

69. Measures to strengthen the corporate sector would need to give greater priority to improving the financial structure of Tunisian enterprises. There is a risk that focusing on short-term goals such as the level of activity and on factor accumulation in a context of a poor credit culture, capital accumulation may reach diminishing returns. That would mean that credit is not allocated to the sectors with the best returns. In such a context, high leverage ratios would make Tunisian corporations vulnerable to shocks.

70. Privatization of state-owned companies could also help inject equity in the corporate sector, improve allocative efficiency and help develop further the private securities market. Indeed, the continuing presence of large state-owned companies, especially in the public utilities sector, deprives the securities markets of large and viable issuers.

V. Proposed Sequencing

71. The proposed sequencing for the liberalization of the capital account distinguishes three stages. Stage I takes account of the progress achieved in building the appropriate macroeconomic and financial sector infrastructure. It includes measures that can be implemented immediately to enhance the effectiveness of financial intermediation and diversify balance of payments financing sources. Stage II would build on progress in strengthening systemic liquidity arrangements and related monetary and exchange operations, as well as contribute to progress in strengthening the financial position of the financial and

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[40] Implicitly, the provision of the liquidity needed for the banks to comply with reserve requirements implies an interest rate objective. Conversely, a determination of monetary interventions on the basis of the monetary program would imply supply the system with a given amount of liquidity which banks would then trade at the resulting market rate.

corporate sectors. Stage III would build on progress in establishing a robust capital market. The main measures are summarized in Table 2 and discussed in the following paragraphs.

A. Immediate Measures (Stage I)

72. Stage I builds on progress already accomplished in stabilizing the macroeconomic framework, developing the foundations of a market-based economy, and establishing key pillars for the regulation and supervision of the financial sector. It includes measures, which could be implemented immediately in order to enhance the overall effectiveness of financial intermediation and diversify the balance of payments financing sources.

73. The measures identified above (Section III, Section C) regarding the *effectiveness of financial intermediation* could be implemented immediately. They include: the elimination of the "*nivellement*" and surrender requirements. In parallel, the BCT should discontinue posting buying and selling rates on the foreign exchange market in order to foster market development.

74. However, the opening of the domestic banking sector to foreign participation would need to proceed gradually. In particular, in order to avoid destabilizing the domestic banking sector a full opening of the sector would need to be preceded by a reduction in the cost of bank intermediation in Tunisia so that it becomes comparable to the levels observed in advanced financial markets. In the meantime, partnerships aimed at facilitating a transfer of know-how could be arranged which, in due time, could lead to greater foreign equity participation and a fuller representation of foreign financial institutions in the domestic market.

75. Regarding the diversification of *balance of payments financing sources*, all the measures identified above (Section III, Section C) could be implemented immediately and in full, including allowing institutions listed in the stock exchange, or rated by a rating agency to contract external medium- and long-term loans freely, and liberalizing the conditions for inward FDIs in the corporate sector. Concomitantly, prudential rules would need to be established to measure and limit maturity mismatches in the balance sheets of financial institutions from external borrowing. Also, the liberalization of external borrowing for banks should be accompanied by a liberalization of their lending in foreign exchange to domestic corporations. The authorities, however, would need to make sure that the banks do not undertake excessive foreign currency lending to risk borrowers. While banking soundness (i.e., proper credit analysis and prudent lending practices) is meant to address this issue, a conservative approach in this area would be desirable. In this context, the BCT could require a minimum amount of foreign currency assets to be maintained in liquid form, where the definition of "liquid" excludes short-term loans. While the measure would create a disincentive for banks to borrow externally, it may be appropriate until banking soundness is firmly established. In addition, the BCT could develop an early warning system of developing problem based on information collected through its framework for reporting external borrowing by corporations and financial institutions.

B. Medium-Term Measures (Stage II)

76. During Stage II the authorities could envisage the liberalization of outward FDIs and of selected outward portfolio investments, most notably for institutional investors and the liberalization of inward portfolio investments (including money market and other short-term debt instruments). The limitations placed on foreign currency accounts in domestic banks could also be simplified. At this stage, the banking system would need to be on a sound footing and able to withstand international competition therefore, all barriers to entry in the financial sector could be eliminated.

77. Exporters are already allowed to transfer abroad limited amounts annually to finance business-related expenses, including *outward FDIs* related to their line of business. Liberalizing all outward FDIs (with appropriate mechanisms to prevent disguised portfolio investments)[41] would benefit the country in the long run as it would help diversify residents' asset portfolios internationally thereby reducing their portfolios' systemic risk.

78. Uncertainties regarding the impact of a liberalization of *outward portfolio investments* on Tunisia's external position and the relatively low external reserves of the BCT may call for a cautious approach to liberalizing such flows. Similar to the approach followed by South Africa (Box 8) a strategy to preserve the countries' external position would be to subject outward portfolio investments to quantitative limits, which could be progressively raised over time, to the point where they become nonbinding and can be abolished without adverse consequences for the balance of payments. The measure could be directed to institutional investors in the first place, and consideration could be given to introducing prudential rules for such investments to ensure that investments are sound. In particular, investments could be restricted to the purchase of securities issued by institutions with an "investment grade" rating.

Box 8. The Experience of South Africa

South Africa put in place a sound domestic financial infrastructure before liberalizing virtually all restrictions on nonresidents' capital flows in 1995. Controls on residents were lifted more gradually, owing in part to the Reserve Bank's weak foreign exchange reserve position. The strategy has been to allow a wider array of transactions, with each subject to a quantitative limit, which has been progressively raised over time, to the point where many have become nonbinding and in some cases have been abolished. A number of controls remained in place at the time of the emerging markets crises of 1997–98. Despite contagion from those crises, South Africa suffered no financial crisis, owing largely to the soundness of macroeconomic policies, a well-capitalized banking system, and low corporate debt.

Source: Shogo Ishii and Karl Habermeier, *Capital Account Liberalization and Financial Sector Stability*, IMF Occasional Paper (forthcoming) (Washington: International Monetary Fund).

[41] 10 percent equity participation could be required for investments to quality as FDIs.

79. With the benefit of strong systemic liquidity arrangements, including a robust GSM and a large base of domestic investors and a flexible exchange rate regime, *inward portfolio investments*, including money market and other short-term instruments, could also be allowed.

80. The conditions currently placed on the operations of *foreign currency bank accounts* opened in domestic banks could be simplified with a view of allowing greater scope for arbitraging foreign and domestic currency investments. Greater scope for arbitrage possibilities would provide an opportunity for the monetary authorities to gain greater experience with the signals of asset substitution in the money and exchange markets. Allowing all residents to hold foreign currency denominated account in the domestic banking system, which they could purchase in the domestic foreign exchange market, could be a first step to allowing them to invest abroad.

81. The liberalization of the capital flows outlined above needs to be preceded by a strengthening of systemic liquidity arrangements and related monetary and exchange operations, as well as progress in strengthening the financial position of the financial and corporate sectors. This would require full reliance on open market operations for the conduct of monetary policy. At this stage, the existence of a full yield curve based on a well-developed GSM would help monetary policy to better manage the impact of capital flows, as would the presence of a large base of domestic investors on this market. Critical for the proposed simplification of the conditions attached to foreign currency bank accounts would be to ensure that differentials between domestic and foreign interest rates cover the market's perception of exchange risk.

82. Finally, moving to Stage II would require bringing the cost of bank intermediation to be comparable with levels in advanced financial markets so that the banks are in a position to offer attractive levels of remuneration to depositors. At this stage, all the barriers to entry in the financial sector could be removed. It would also require reducing leverage in the corporate sector by bringing the debt equity rations to sustainable levels.

83. Controls on derivative instruments would still be maintained. This is because in a sophisticated market with a full range of derivative instruments, transactions can be synthesized in any number of ways so that it would be difficult to enforce remaining capital controls.

C. Full Convertibility (Stage III)

84. The implementation of Stage III would lead to the full liberalization of the capital account, including all investment abroad by residents and lending to nonresidents; at this stage Tunisia would have reached the full convertibility of its currency.[42] However, prudential regulations that may have an element of capital control, such as open foreign exchange position limits and requirements aimed at managing cross-border liquidity and credit risk would be retained.

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[42] Limitations of inward FDIs on sectors critical for national security could still be retained.

85. Critical for moving to Stage 3 would the establishment of robust channels for transforming savings into productive investments, thus reducing reliance on bank intermediation (the "spare tire" argument).[43] At this stage, macroeconomic conditions should also be sound, to the point where the risks associated with high capital mobility can be effectively managed.

86. The removal of all controls on the use of derivative instruments by financial institutions would have to be accompanied by a suitable accounting rules to properly measure the associated risks, proper reporting by financial institutions on derivative risks, and the development of a risk management capacity in the financial institutions.

[43] A wide variety of well-functioning financial markets can make the financial market more resilient in the face of shocks. This observation has been made, most notably, by U.S. Federal Reserve Chairman Alan Greenspan.

MAIN POLICY MEASURES IN THE MONETARY, FINANCIAL AND EXTERNAL SECTOR, 1987–2001

Year	Monetary Sector	Financial Sector	External Sector
1987	- Lending rates are liberalized (expect for priority sectors) but retention of ceiling of 3 percentage points above TMM. - Rates for deposits of at least three months are free. Rates on special savings accounts set at TMM – 2.	- Introduction of comprehensive bank prudential regulations.	- Launching of a program of trade liberalization.
1988	-Rediscount operations limited to priority sector loans. - BCT introduces: (i) credit auction (*appel d'offres*); (ii) refinance standing facility (*prises en pension*); and (iii) end of day repo operations (*opérations de fin de journée*).	- Merger of BNT and BNDA into BNA. - Reform of legislation on investment and collective investment institutions and funds, which are granted fiscal and financial incentives. - BCT prior approval for granting bank loans is eliminated. - Introduction of interbank transactions, CDs and CP.	
1989	- Reactivation of non-remunerated reserve requirement.	- Introduction of treasury bill auctions.	- Creation of money market in foreign exchange.
1990			- Accession to the GATT. - An offshore bank allowed to set up onshore bank to support competition.
1991		- Relaxation of mandatory bank holdings of government securities. - Minimum term for CDs increased from 10 to 90 days, and introduction of treasury bills with maturity over 1 year.	
1992	- Ceiling on individual lending rates replaced by ceiling on average lending rates per bank set at TMM + 3 percentage points. - Reduction of scope of credits at preferential rates.	- Strengthening of prudential regulations (exposure limits, loan classification, loan loss provisions, and 5 minimum CAR). - New financial instruments are introduced (investment trusts, priority shares and equity loans).	- Extension of operations in the money market in foreign exchange.
1993		- Adoption of new auditing standards for the financial statements of banks.	- Participation in Uruguay Round. - Current account convertibility (Article VIII acceptance). - Exporters can open accounts in foreign exchange and retain up to 40 or export proceeds. - Banks/firms allowed to borrow abroad up to D10/D3 million.

Year	Monetary Sector	Financial Sector	External Sector
1994		- New banking law sets a framework for a more-market oriented system; strengthened prudential framework (on- and off-site supervision); commercial banks are allowed to grant medium- and long-term credits; development banks are allowed to grant short-term credits. - New stock exchange legislation sets private stock market and creates independent supervisory body (CMF). - Audits of all commercial banks are completed; restructuring plans are being implemented. - Introduction of negotiable treasury bills and investment trusts (*OPCVM*).	- Membership in the WTO. - Creation of interbank foreign exchange market: BCT continues to announce a central rate; banks can hold open foreign exchange positions within prudential limits. - Liberalization of outward FDI for exporting enterprises within an annual ceiling.
1995		- Venture capital companies are authorized.	- Free trade agreement with the EU is signed. - Inward portfolio investment partially liberalized.
1996	- Lifting of all restrictions on lending rates. - Elimination of mandatory lending requirements to priority sectors (*ratio des activités prioritaires*).		
1997	- BCT intervention in money market becomes main monetary instrument.	- Implementation of a plan to restructure NPLs on public enterprises. - BTS is created (microfinance). - Implementation of "*mise à niveau program.*" - Adoption of general regulations of BVMT. - Creation of Maghreb Rating.	- Forward covers introduced for trade related transactions. - Maximum buying/selling spread for spot transactions eliminated. - Domestic banks allowed to perform cross transactions with foreign banks. - Inward portfolio investment in shares liberalized up to 50 of voting rights.
1998		- Minimum capital adequacy ratio rose from 5 to 8. - Issue of fungible treasury bills (BTA).	
1999		- Capital adequacy ratio rose to 8. - Exposure to a single group reduced to 25 percent of capital. - New statute for market intermediaries. - Adoption of CMF regulation covering public offer of securities.	- Surrender requirement reduced from 50 to 60 percent.
2000		- Merger of BDET and BNDT with STB. - Enactment of a new Business Corporation Code.	
2001		Enactment of a new banking law and law on collective investment institutions. Preparation of draft laws on holdings and business groups and on consolidated accounts.	- Onshore banks allowed to offer forward cover for financial operations up to 12 months and engage in foreign currency/D-swap operations. - Banks and nonbanks allowed to hedge against interest rate risk in foreign exchange through FRAs.

Source: BCT, Ministry of Economic Development; and IMF Annual Report on Exchange Arrangements and Exchange Restrictions.

DETAILED DESCRIPTION OF EXCHANGE REGULATIONS[44]

The liberalization process of foreign exchange regulation that began in 1987, led in December 1992 to the dinar current account convertibility. Since then, resident corporations can freely transfer the amounts of their imports of goods and services. They were aligned, on this level, to fully exporting corporations, which have gained, since 1972, total freedom for operations pertaining to their production activities.

This process was accompanied, for capital transactions, with the freedom given:

- To resident corporations partly or fully exporting to invest abroad in order to back up their exporting effort;
- To banks and corporations to borrow in foreign currencies for their activities needs within the limits of TD10 and TD3 million per year respectively; and
- To foreign investors to take portfolio participations accounting at least for 50 percent in listed or unlisted Tunisian corporations.

A. Basic Principles

Foreign trade and foreign exchange regulation is based on the foreign exchange code.[45] Foreign exchange regulation is based on the following principles:

- Free transfer of current transactions and net real proceeds, as well as the value added from sale or liquidation of capital invested previously through foreign currency import. All other transactions and commitments of which a transfer arises or may arise as well as any clearing of debts with foreign countries are submitted to prior authorization;
- Assets movements between Tunisia and foreign countries have to be executed through the Central Bank of Tunisia or, on the authority of the latter, by chartered banks;
- Any individual or legal entity must deposit at a bank foreign banknotes, checks, evidence of indebtedness denominated in foreign currencies as well as foreign securities that it holds in Tunisia. Travelers are authorized to hold in their possession the imported currencies to meet their current expenditures during their stay in Tunisia;

[44] Source: Central Bank of Tunisia (website).

[45] Law No. 76–18 of January 21, 1976 and Law No. 94–41 of March 7, 1994 relating to foreign trade and their enforcement texts.

- Resident individuals of Tunisian nationality as well as legal entities have to declare their holding abroad to the Central Bank of Tunisia; and
- Residents have to repatriate and, with exceptions provided for by the regulation in force, sell on the foreign exchange market currencies arising from goods export, remuneration of offered services abroad and, more generally, any income, or proceeds coming from abroad.

B. Exchange Rate Regulation

- Tunisia accepted on January 6, 1993 the obligations provided for by Article VIII of the International Monetary Fund Status;
- The exchange rate of the Tunisian dinar has been determined freely on the foreign exchange market since March 1, 1994 between official intermediaries of the Tunis area including offshore banks operating on behalf of their resident customers;
- The Central Bank of Tunisia intervenes on this market and publishes the interbank exchange rate of currencies and banknotes at the latest the following day;
- Importers and exporters may cover themselves against exchange risk on the forward interbank market. Forward rates are freely negotiated between operators and the counterpart bank;
- To cover themselves against exchange risk, residents that contract loans in foreign currencies may buy 3-, 6- and 12-month options.

C. Residency

Foreign exchange regulation is applied to individuals according to their residence.

Residents: Tunisian or foreign legal entities carrying out activities in Tunisia; individuals of Tunisian nationality residing in Tunisia; Tunisian civil servants working abroad whatever the duration of their stay is; individuals of foreign nationality residing in Tunisia for more than two years and carrying out their activities in Tunisia. These individuals lose their quality of residence as soon as they leave Tunisia for good.

Nonresidents: Tunisian or foreign legal entities carrying out their activities abroad; individuals of foreign nationality not residing in Tunisia; foreign civil servants working in Tunisia whatever the duration of their stay is; individuals of Tunisian nationality residing abroad for more than two years and carrying out their activity. These individuals may have the status of residence to execute a number of transactions in Tunisia (loans in dinars, opening accounts in Tunisia, purchase of real estate in Tunisia). As soon as they return to Tunisia for good they reintegrate their resident status.

Derogatory regime: Nonresident status is granted to financial and banking bodies dealing essentially with nonresidents, created in the form of limited companies under Tunisian law or companies set up in Tunisia and which head office is abroad. An option may be taken to acquire this status by totally exporting companies created within the investment incentive code or set up in the economic free zones of Bizerte and Zarzis as well as international trade companies when their capital is held by Tunisian or foreign nonresidents through an import of convertible currencies equal at least to 66 percent of the capital.

D. Import and Re-Export of Settlement Means

- Import and export of Tunisian currency in banknotes or coins are forbidden.
- Nonresident travelers may import freely unlimited amounts of foreign banknotes, checks and any other settlement means denominated in foreign currencies.
- Imported foreign currencies must be declared to customs when entering the Tunisian territory if they are intended to be deposited in an account in foreign currency or convertible dinars or if the non-resident traveler intends to re-export an amount higher than the counter value of 1,000 Tunisian dinars.
- The trading in foreign banknotes and travelers checks in foreign currency is ensured by chartered banks, customs offices entitled in this regard as well as individuals authorized by a chartered bank (such as hotel and restaurant owners, travel agencies and handicraft shops).
- Non-resident travelers may reconvert unlimited amounts of Tunisian dinars on presentation of an exchange note delivered to them when assigning foreign currencies if the amount to be reconverted is less than 1,000 Tunisian dinars and this same note is accompanied by the customs declaration if the amount to be reconverted is higher than 1,000 Tunisian dinars;
- They may re-export without voucher:
    - Foreign banknotes the exchange value of which does not exceed 1,000 dinars;
    - All other means of payment denominated in foreign currencies made abroad and bearing their name.
    - Imported foreign banknotes exceeding 1,000 Tunisian dinars on presentation of the customs declaration made at their arrival in Tunisia.
    - Foreign banknotes received from abroad by checks, transfer, money order or any other evidence of indebtedness as well as foreign banknotes arising from a debit of a foreign account in foreign currencies or convertible dinars on presentation of an exchange note that is worth an authorization of foreign currency transfer.

E. Residents' Accounts

Special accounts in foreign currency or convertible dinars: they can be opened freely by: individuals of Tunisian nationality changing their usual place of residence from abroad to Tunisia; individuals of foreign nationality residing in Tunisia; Tunisian diplomats and civil servants that are seconded abroad; resident individuals and legal entities for their untransferable assets regularly received abroad. These accounts are freely credited in foreign currencies arising from income or proceeds of assets regularly earned abroad.

Professional accounts: In convertible currencies: they can be opened freely by resident exporters of goods and services for their activity requirements. These accounts are intended essentially to help their holders cover themselves against exchange risk. In convertible dinars: they are opened, on authorization of the Central bank of Tunisia, by any resident individual or legal entity having foreign currency resources.

Special accounts "export-profit" in convertible dinars: they are opened, on an authorization of the Central Bank of Tunisia, in the name of resident individuals who make profit in their own export activities of goods or services and/or are shareholders or partners in resident companies that make profit in export transactions of goods or services. They are freely debited for any transfer in foreign currency for matters of traveling abroad or acquiring "benefits" abroad other than real estate.

F. Nonresidents' Accounts

Foreign accounts in foreign currency or convertible dinars: they can be opened freely by resident individuals or legal entities whatever their nationality is. They are freely credited and debited in foreign currency.

Nonresidents' internal accounts "INR:" these accounts, the opening of which is free, are intended to the use by foreign individuals residing temporarily in Tunisia and earning an income in dinars.

Special accounts in dinars: they may be opened freely by non-resident foreign enterprises that stroke bargain in Tunisia in order to place the share of these bargains payable in dinars intended to cover their local expenditures.

Suspense accounts: these are accounts in dinars that may be freely opened by nonresidents of any nationality to place all receipts falling to them in Tunisia while awaiting the Central Bank of Tunisia to decide whether to allocate these receipts to a capital account or their transfer.

Capital accounts: they are intended to receive assets in dinars of nonresidents that do not have any transfer guarantee. Their opening is free for non-resident foreign individuals or legal entities. It is submitted to a prior approval of the Central Bank of Tunisia for Tunisian nonresidents or their husband and wife.

G. Transfers for Current Transactions: Principle

Transfers regarding current transactions are free (trade transactions, transactions related to enterprise production, transport, insurance, capital income, operations concerning banking and financial expenditures, public sector operations, general operations such as subscriptions, advertising, entertainment and show contracts).

H. Foreign Trade

Imports

Regime and procedures:

- All imports are free except those concerning public order, hygiene, morality, fauna and flora protection and cultural heritage. Import of some products such as some types of cars, remains temporarily submitted to prior authorization.
- Imports are submitted to the obligation of payment by bank order through a chartered intermediary.
- Products under the regime of free foreign trade are imported through an import certificate accompanied with documents required by the regulation in effect.
- Products excluded from the regime of free foreign trade are set by a list fixed by decree; they are imported through an import authorization delivered by the Ministry of Trade.

Totally exporting enterprises of goods and services as well as enterprises established in economic free zone may import freely without foreign trade formalities, all necessary products to their production subject to their customs declaration.

Settlement

- Import settlement is freely executed by the chartered paying agent after the effective entry of goods justified by customs charging.
- Imports may give rise to down payments subject of the issue in favor of the importer of a down payment restitution guarantee on request by the supplier's bank.
- The settlement of goods may be executed before their reception subject to justifying their direct and exclusive shipment to Tunisia.

Exports

Regime and procedures

- All exports are free except those provided for in a list fixed by decree.
- Exports of products benefiting from the regime of free foreign trade are made on presentation of a final invoice to customs.
- Exporters must pay the charged invoice by customs through a chartered intermediary at the latest, eight days after the shipment of goods.
- Excluded products from the regime of free foreign trade are exported on presentation of an authorization delivered by the Ministry of Trade and paid through a chartered intermediary.

Settlement

- Sales for cash (at the latest 30 days from the date of shipment) may be paid by any means of settlement.
- Sales on credit providing for settlement periods up to 180 days starting from the date of shipment are executed freely when accompanied with a payment guarantee, an irrevocable letter of credit or stand by letter of credit, an endorsed draft or an insurance policy of credit at export.

Export receipts

- Export proceeds have to be repatriated in the 10 days that follow the due date.
- Totally exporting nonresident enterprises, international trade nonresident enterprises as well as nonresident enterprises established in economic free zones are neither bound to repatriate nor to assign their export receipts.
- Resident exporters may keep in their foreign currency professional accounts up to 50 percent of the proceeds of their exports.

I. Foreign Investments in Tunisia

Direct foreign investments

Foreign investment in projects in Tunisia is free at the level of creation and expansion. If is submitted to prior authorization for projects achieved in some sector activity.

Portfolio foreign investments

Are submitted to authorization:

- The purchase by nonresidents of foreign nationality of businesses and real estate situated in Tunisia.
- The purchase by foreigners of shares conferring a voting right or shares of companies established in Tunisia if it raises the foreign participation to 50 percent or more of these companies capital
- The purchase by nonresidents of foreign nationality of bonds issued by the State or resident companies.

Nonresidents having made investments, pursuant to the regulation into force, are free to transfer net real proceeds and added value of the assignment or liquidation of their invested assets through foreign currency import.

Tunisian investments abroad

In order to support their exporting activities, resident enterprises may freely invest abroad in terms of their foreign currency turnover of the previous year:

- From D 20 thousand to D 100 thousand per annum for financing representative offices.
- From D 40 thousand to D 200 thousand per annum for financing branches, subsidiaries and participation intake.

J. External Loans

Resident enterprises may, for their activities needs, borrow freely from nonresidents in foreign currencies or convertible dinars up to 10 million dinars per civil year for financial institutions and 3 million dinars per civil year for other enterprises. Transfers related to principal reimbursement and interest payment of these loans are free.

STYLIZED SEQUENCE OF LIBERALIZATION

Item	Measure	Comments
	Stage 1	
Surrender requirement	- Eliminate	- Not binding. Therefore elimination unlikely to generate pressure on international reserves. Will help develop foreign exchange market.
Foreign exchange accounts		
- Residents	- Allow all residents to keep foreign exchange holdings in domestic banks and align rules on those in place for nonresident accounts.	- Will encourage repatriation of foreign holdings, and help build experience with signals from asset substitution (within domestic financial system) and develop foreign exchange market.
Foreign direct investments		
- Inward (non-financial sector)	- Fully liberalize underlying transactions (including for equity mutual funds). Limitations son sectors related to national security may be maintained.	- Will help diversify BOP financing sources and strengthen financial structure of corporations. Maintain monitoring system.
- Inward (financial sector)	- Can be opened on case-by-case basis.	- Full opening requires placing banks on sound footing and bringing intermediation costs to levels prevailing in advanced financial markets.
Domestic debt instruments-ST		
- Inward	- Allow direct purchases on limited basis.	- Strengthen systemic liquidity arrangements (including government securities market) to prepare full opening in Stage 2.
Borrowing abroad-MT/LT		
- Inward	- Free borrowing abroad is allowed for listed or rated corporations.	- Prevent excessive foreign exchange risk taking by Tunisian corporations.
Commercial and financial credits		
- Inward	- Allow gradual liberalization.	- Full opening requires bringing bank intermediation costs to levels prevailing in advanced financial markets. Limits could be gradually increased to maintain competitive pressure on banks.
Commercial banks		
- *"Nivellement"*	- Eliminate. In tandem, BCT discontinues posting bid/ask prices to banks on foreign exchange market.	- Will help develop foreign exchange market and bank skills.
- External borrowing	- Free borrowing abroad allowed for listed banks.	- Implement prudential framework to measure and limit liquidity mismatch (maturity ladder).

Item	Measure	Comments
- Financial credits in foreign exchange to corporations	- Allow banks to grant financial credits in foreign exchange to resident corporations.	- Foreign exchange risk hedging to be provided by the market.
- Open position limit	- Consider raising overall limit to 30 percent of capital.	- Will help develop foreign exchange market.
Stage 2		
Foreign direct investments		
- Inward (financial sector)	- Full opening allowed.	- Requires placing banks on sound footing and bringing intermediation costs to levels prevailing in advanced financial markets.
- Outward (non financial sector)	- Full opening allowed.	- Monitoring necessary to prevent disguised portfolio investments.
Portfolio investments		
- Inward	- Full opening allowed.	- Need for robust systemic liquidity arrangements and government securities market.
Institutional investors		
- Outward investments	- These are allowed within annual limit (to be increased gradually) and prudential rules to ensure soundness of investments.	- Portfolio diversification will help reduce systemic risk and foreign exchange market development.
Stage 3		
Portfolio investments		
- Outward	- Full opening allowed.	- Maintain compliance with best international practices, sound macroeconomic framework and robust systemic liquidity frameworks.
Commercial, financial credits		
- Outward	- Full opening allowed.	
Institutional investors		
- Outward investments	- Full opening allowed within prudential limits.	- Prudential rules may be maintained to ensure soundness of investments.
Commercial banks		
- Lending to nonresidents	- Full opening allowed.	- Full convertibility of the dinar permitted.