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Tunisia: 2007 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Tunisia

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2007 Article IV consultation with Tunisia, the following documents have been released and are included in this package:

- The staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 28, 2007 with the officials of Tunisia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 12, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its August 3, 2007 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for Tunisia.

The document listed below has been or will be separately released.

Selected Issues Paper

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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TUNISIA

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representative for the 2007 Consultation with Tunisia

Approved by Amor Tahari and Scott Brown

July 12, 2007

- Discussions took place in Tunis during May 14–28, 2007. The mission comprised Messrs. Senhadji (head), Kpodar, Saadi Sedik, Ms. Simard (all MCD), and Mr. Bayle (MCM expert). Mr. Tahari (MCD) attended some policy meetings. Mr. Rouai (OED) also joined the mission.

- Discussions were held with Governor Baccar and seven ministers, including Mr. Kechiche (Minister of Finance) and Mr. Jouini (Minister of Economic Development and International Cooperation); other government officials; and private sector and labor representatives.

- Tunisia continues its close dialogue with Fund staff, while retaining full ownership of its economic reform program.

- Tunisia accepted the obligations of Article VIII, sections 2, 3, and 4 in 1993; its exchange rate regime is a managed float with no pre-announced path; and it subscribed to SDDS in June 2001.

- Outreach efforts included a press conference on the MCD 2007 REO by Mr. Tahari, a press communiqué, an interview with *L'Economiste Maghrébin*, and a seminar on the preparations to inflation targeting, the subject of the forthcoming Selected Issues Paper.

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EXECUTIVE SUMMARY

Background

Good macroeconomic management and market-oriented reforms have placed Tunisia's economic performance over the past decade among the best in the region, with real GDP growth averaging almost 5 percent in a stable macroeconomic environment. Tunisia's key challenge is to create enough jobs for the rapidly increasing number of university graduates. This is the overarching objective of the recently released XIth Plan, which seeks to boost annual growth to more than 6 percent during 2007–11 by continuing to move the Tunisian economy toward a knowledge-based, high value-added economy, while deepening its global integration. Policy discussions centered on how to achieve higher growth and enhance the flexibility and resilience of the Tunisian economy.

Authorities' View

The authorities noted significant progress in debt reduction, and tax administration and policy reforms; recent measures should eliminate the deficit of the social security system over the coming years, pending its comprehensive reform.

They are making progress toward their objective of full capital account liberalization, a free-floating exchange rate, and an inflation targeting framework.

The authorities have adopted a comprehensive strategy, based on the 2002 Financial Sector Assessment Program (FSAP) and its 2006 update, to strengthen the financial system, including the adoption of a dual target of reducing the nonperforming loans (NPLs) ratio to 15 percent and increasing the provisions-to-NPLs ratio to 70 percent by end-2009. The authorities noted that their strategy has produced positive results with the NPLs ratio declining from 24 percent in 2003 to 19.2 percent in 2006.

Staff Recommendations

Fiscal consolidation should continue in order to address growing budget pressures, particularly from demographic changes and declining receipts from privatization and trade liberalization. In particular, the authorities should move ahead with the planned overhaul of the social security system.

Increased autonomy and adequate information to market participants are necessary to develop money and foreign exchange markets. The research and forecasting capacity of the Central Bank of Tunisia (*Banque Centrale de Tunisie*, BCT) should be strengthened.

Additional measures—including an injection of new capital in public banks—may be needed to attain the BCT's dual objective and yield a dynamic and efficient financial system that supports the objectives of the XIth Plan.

I. Background and Key Policy Issues

1. **Effective economic management has led to strong growth and macroeconomic stability, placing Tunisia among the leading performers in the region** and contributing to sociopolitical stability. This good performance has been recognized by international organizations such as the Davos Forum, which recently ranked Tunisia as the most competitive country in the region, and the Japanese agency R&I, which raised Tunisia's sovereign rating from BBB+ to A- in 2007.

2. **Nevertheless, Tunisia faces a common challenge with its neighbors—high unemployment, especially among the youth.** To bring the unemployment rate below 10 percent, annual growth must rise from 4¾ percent over the past decade to 6¼ percent over the next. This will require both a significant increase in private investment and total factor productivity. The XIth five-year Plan sets forth the authorities' medium-term strategy (Box 1).

Box 1. Main Elements of the XIth Plan

Objective:

- Accelerate annual **growth** from 4.8 percent during the past decade to 6.1 percent during 2007–11, while lowering the **unemployment rate** from 14.2 percent in 2006 to about 13.4 percent by 2011.

Strategy:

Keep moving the Tunisian economy toward a *knowledge-based*, high-value-added economy by:

- ***Consolidating Tunisia's macroeconomic position***. Reduce public debt and improve its structure, control the budget deficit by further rationalizing current expenditure and widening the tax base. Strengthen the financial system.

- ***Continuing the gradual opening-up of the economy.*** Extend the Association Agreement with the European Union (EU) to services and agriculture; continue trade liberalization through WTO and regional and bilateral free trade agreements (FTAs). Advance preparations for full convertibility and flexibility of the dinar.

- ***Stimulating private investment, particularly in high value-added sectors.*** Improve the business climate, attract more FDI, encourage public-private partnerships, and rationalize investment incentives.

- ***Reforming education and training systems to reduce skill mismatch in the labor market.***

3. **For this strategy to be successful in the context of the ongoing deeper integration into the world economy, Tunisia would need to consolidate its fiscal position, strengthen its monetary and exchange rate policy framework, and address the remaining weaknesses in the financial system to enhance the economy's flexibility and resilience:**

- ***While prudent fiscal policy over the past decade has contributed to macroeconomic stability, further consolidation is necessary to maintain long-term fiscal sustainability.*** Fiscal pressures, including from population ageing, are mounting and Tunisia's public debt—which stood at about 54.0 percent of GDP at end-2006—is still high relative to that of other emerging market economies with a similar sovereign rating.

- ***The preparations for moving to inflation targeting should be intensified in view of the increasingly open capital account.*** The authorities aim for full capital account liberalization and a free-floating exchange rate regime over the medium term.

- ***A sound and competitive financial system is essential for harnessing the full potential of the Tunisian economy.*** Despite a significant improvement in the past few years, the banking sector still suffers from relatively high NPLs—19.2 percent of total loans at end-2006. The authorities have been implementing a comprehensive strategy based on the key recommendations of the 2002 FSAP and its 2006 update.

II. Recent Economic and Financial Developments

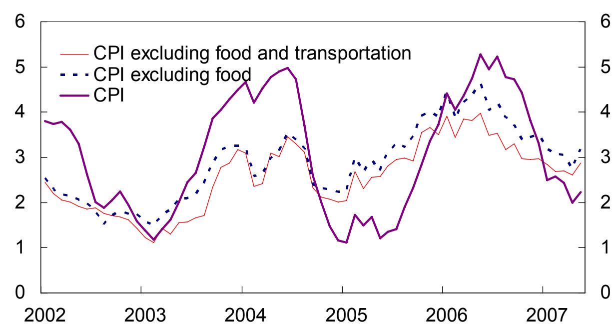
4. *Over the past two years, the Tunisian economy has shown resilience in the face of surging prices of oil and other imported commodities, sustaining relatively strong growth while maintaining macroeconomic stability.*

- **Real GDP growth accelerated** from 4 percent in 2005 to 5.4 percent in 2006 owing to a rebound in agricultural output, expansion of nontextile manufacturing, and vitality of the services sector. Robust income growth and abundant liquidity boosted domestic demand. The unemployment rate, however, remained unchanged at 14.2 percent in 2006.

- **Inflation has declined rapidly, after a spike in the first half of 2006.** The inflationary pressures in the first half of 2006 reflected increases in international prices for oil and basic commodities and episodes of excess liquidity. However, inflation has declined rapidly since the BCT's monetary policy tightening in the second half of the year, with the 12-month rate reaching 2.2 percent in May 2007, after peaking at 5.3 percent in May 2006. The BCT's actions to control inflation included raising its key interest rate by 25 bps in September 2006 and its reserves coefficient from 2 percent to 3½ percent in November.

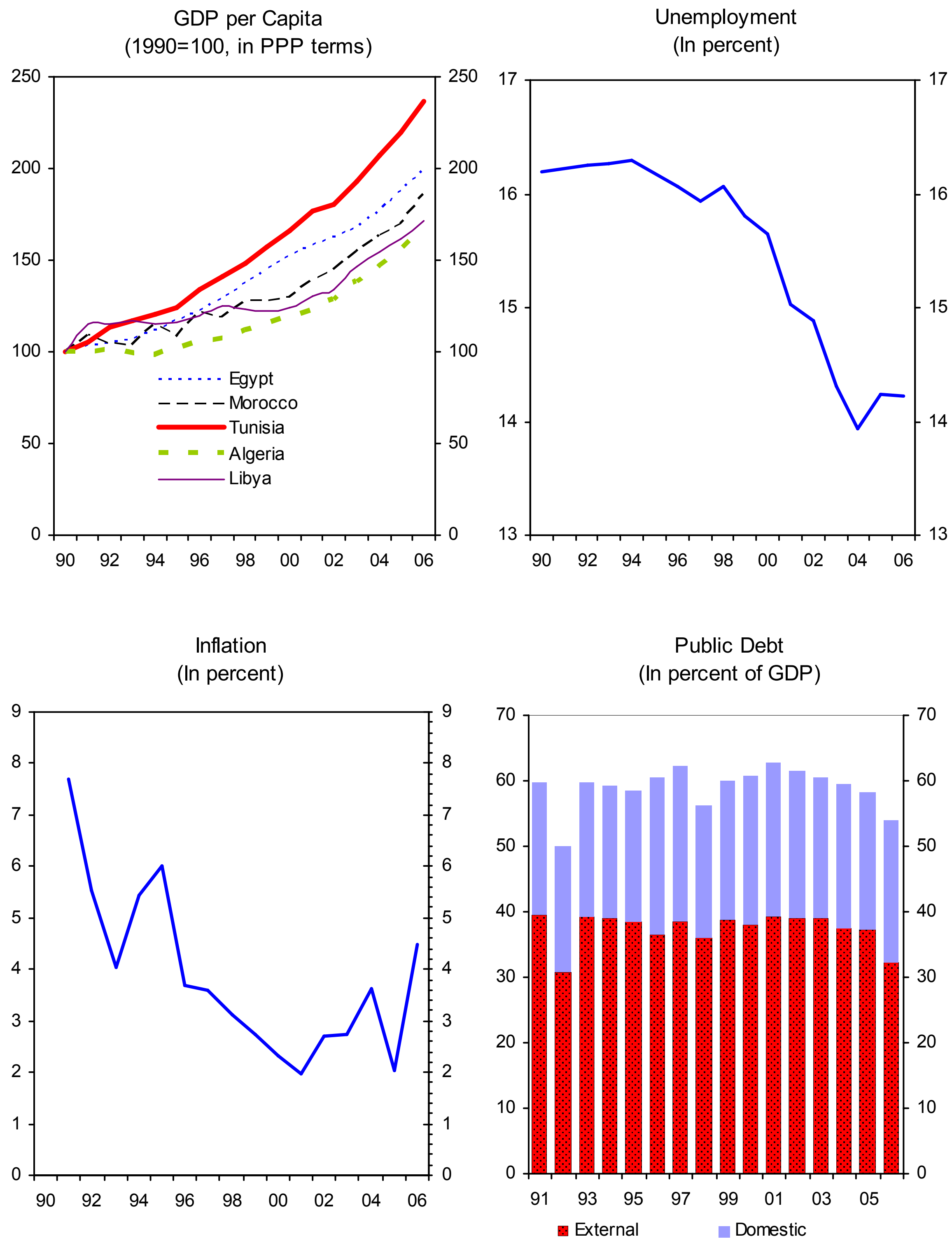
CPI , January 2002–May 2007

(y-o-y growth rate, in percent)



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

Figure 1. Selected Economic Indicators, 1990–2006



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

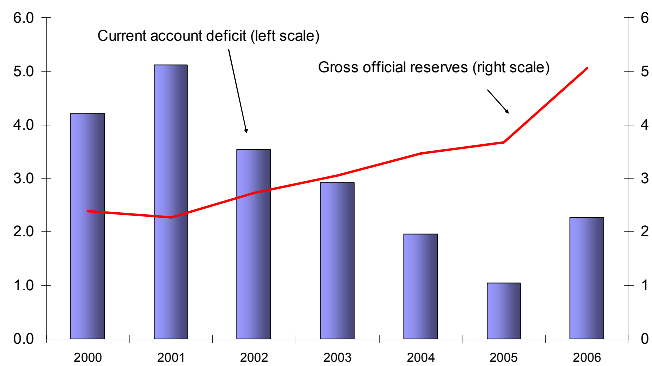
- **Asset prices are rising.** Equity markets have posted substantial gains—the TUNINDEX increased by 60 percent from January 2006 to mid-June 2007. Similarly, anecdotal evidence seems to suggest that real estate prices have also increased significantly, although lack of data hinders a proper assessment.

- **There are no obvious signs of exchange rate misalignment.** The depreciation of the dinar since 2002 reflects mainly worsening terms of trade, severe droughts, a sharp decline in tourism receipts following the events of September 2001 in the United States and April 2002 in Djerba, and tariff reductions resulting from trade liberalization. Market share analysis, current account dynamics, and staff's econometric analysis do not show evidence of a significant misalignment (Box 2). The BCT's exchange market interventions are mostly liquidity injections reflecting the structural trade and current account deficits and remaining restrictions on capital transactions. In addition, these interventions have declined significantly since 2000. The recent increase in reserves to about five months of imports of goods and services is largely due to privatization receipts, which are earmarked for debt reduction and infrastructure expenditures.

- **The current account deficit widened in 2006** due to rising petroleum prices, but the balance of payments recorded a large surplus owing to the partial privatization of *Tunisie Télécom*. At end-2006, international reserves represented five months of imports of goods and services. Total external debt fell from 65.4 percent of GDP in 2005 to 59.1 percent in 2006. A debt sustainability analysis did not detect any significant vulnerability (Table 6 and Figure 2).

Current Account Deficit (in percent of GDP) and Official Reserves

(In months of imports of goods and services)

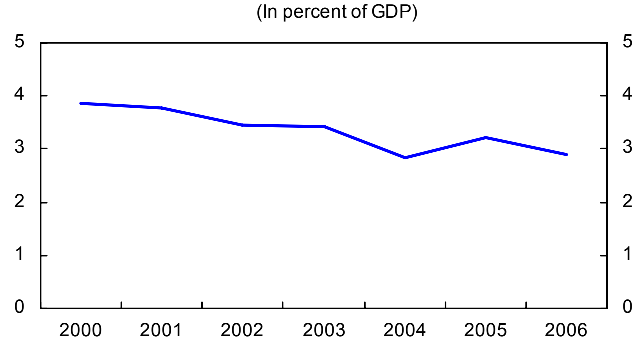


Source: Tunisian authorities.

- **Fiscal policy remained prudent.** The fiscal deficit for 2006 is 2.9 percent of GDP, well below the 3.6 percent budget forecast, owing to improved nontax revenues and restrained nonsubsidy expenditure. Using a portion of the privatization receipts for early debt repayment should reduce public debt from 58.3 percent of GDP in 2005 to 52.5 percent in 2007.

Fiscal Deficit (excluding grants and privatization receipts)

(In percent of GDP)

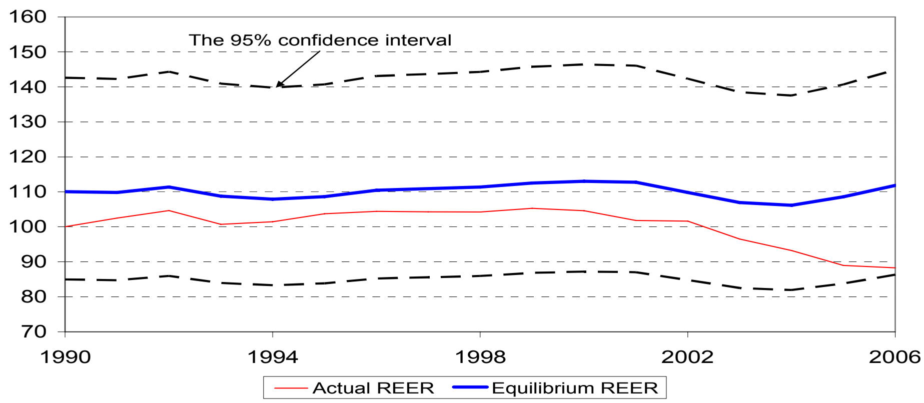


Source: Tunisian authorities.

Box 2. Assessment of the Real Effective Exchange Rate Level

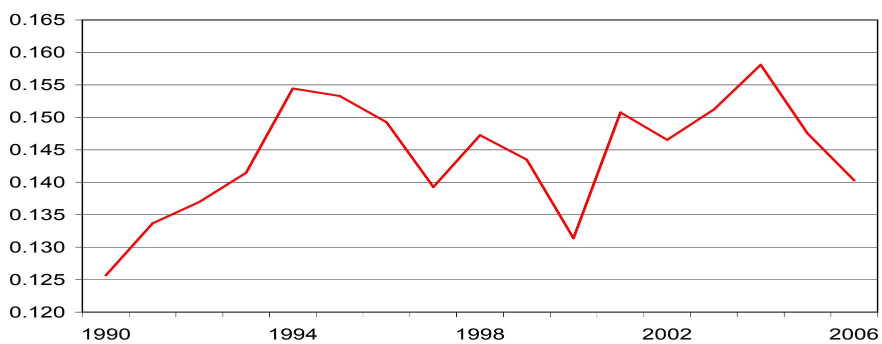
There are no clear signs of exchange rate misalignment. While estimates suggest that the real effective exchange rate appears to be somewhat undervalued relative to its longer-term equilibrium, the difference is not statistically significant.[1] Furthermore, the model does not take into account the ongoing reduction in effective tariffs—about 16 percentage points between 2002 and 2005.[2] Despite the trend depreciation during 2002–06, Tunisia's competitiveness did not improve markedly, as evidenced by its declining export market share and structural deficits in its trade and current accounts—respectively, 8.6 percent and 2.4 percent of GDP for the 2002–06 average.

Actual and Estimated Equilibrium Real Exchange Rates, 1990–2006



Sources: INS; and staff estimates.

Tunisian Export Market Shares with Respect to Main Trade Partners, 1990–2006 3/
(In percent)



Sources: IMF bilateral trade database; World Integrated Trade Solution.

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[1] Staff estimates of the equilibrium exchange real exchange rate are based on panel data analysis following the approach developed by P. Lane and G.M. Milesi-Ferretti in WP/99/115 and WP/00/123.

[2] Including preferential rates, UNCTAD.

[3] Belgium, Egypt, France, Germany, Greece, Italy, Japan, The Netherlands, Poland, Portugal, Spain, Sweden, the United Kingdom, and the United States account for about 80 percent of Tunisian exports.

III. OUTLOOK

5. **The short-term outlook is positive.** Growth is projected to accelerate to about 6 percent in 2007 owing to strong agricultural output, recovery in textiles and clothing, and buoyant services exports. This growth acceleration is presaged by a substantial increase in imports of capital goods and commodities at end-2006 and in early 2007. After decelerating rapidly to 2.2 percent on a year-on-year basis in May 2007, inflation may increase somewhat due to seasonal factors and the recent 6.3 percent increase in domestic prices of petroleum products but should remain around 3 percent in 2007. The fiscal and external deficits should remain broadly unchanged.

6. **The balance of risks is tilted to the downside.** The positive short-term outlook hinges on agricultural output returning to trend, oil prices remaining below $70 a barrel, and growth in the EU—Tunisia's main export market—not faltering.

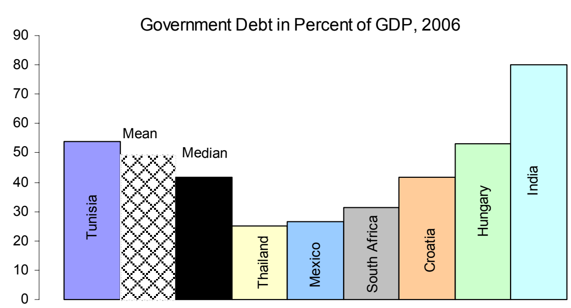
7. **The medium-term outlook remains favorable.** Potential growth over the medium term is estimated at about 6¼ percent, assuming continued effort with structural reforms.

IV. POLICY DISCUSSIONS

8. *The policy discussions centered on how to strengthen Tunisia's macroeconomic position and advance structural reforms to achieve higher growth and lower unemployment in the context of deeper integration to the world economy. More specifically, the discussions focused on: (a) consolidating the fiscal position; (b) adapting the monetary and exchange rate policy framework to the gradual liberalization of the capital account and transition toward inflation targeting; and (c) strengthening the financial system.*

A. Fiscal Consolidation

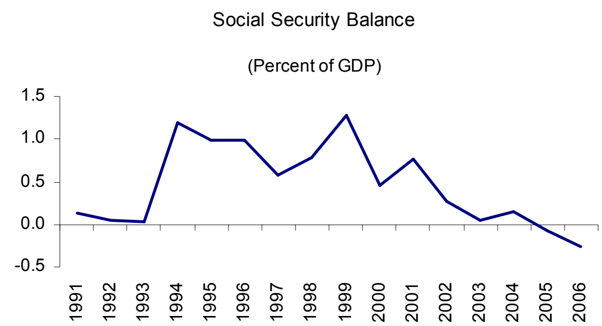
9. **Fiscal discipline has been maintained.** Despite the surge in prices of oil and basic commodities, the budget deficit was significantly lower than the budget forecast in 2006. Public debt over GDP declined significantly in part due to privatization receipts—two-thirds were earmarked for early debt retirement—but it still remains above the average of countries with a similar sovereign rating.



Sources: WEO; and Tunisian authorities.

10. **Further fiscal consolidation is necessary to counter mounting budget pressures** as a result of demographic changes and declining revenue resulting from privatization and trade liberalization.

- **The financial position of the social security system has steadily worsened since the end of the 1990s reflecting population ageing**. The social security system moved from a surplus of 1.3 percent of GDP in 1999 to a 0.3 percent deficit in 2006. The authorities noted that the recent health insurance reform and the increase in pension contributions in July 2007 should eliminate the deficit of the social security system over the coming years, pending a comprehensive reform planned for 2010 intended to ensure the system's viability at least through 2030.



Source: Tunisian authorities.

- **Given the sizable budgetary impact of medium- and long-term demographic changes, it is important to develop a fiscal framework that allows forward-looking analyses of these issues.** The authorities agree that a medium- and long-term outlook can be more effectively incorporated into fiscal policy provided they move from cash to accrual accounting, extend the horizon of fiscal projections, and examine periodically the budgetary impact of demographic changes.

- **Considerable progress has been made in tax administration and policy.** These reforms reflect most of the recommendations of the 2005 IMF technical assistance (TA) missions. Key measures include reducing the corporate income tax from 35 percent to 30 percent for most economic sectors, closer alignment of onshore/offshore regimes with exporters taxed at a 10 percent rate, simplifying the VAT rate structure by eliminating the maximum rate of 29 percent, establishing a large taxpayer unit, and the ongoing restructuring of the tax administration.

- **Fuel subsidies continue to weigh heavily on the budget**, despite the cumulative price increase of 51 percent since 2005. The authorities are aware of their inefficiencies and intend to gradually phase them out. However, they have not as yet specified a date for their removal.

B. Continue Adapting the Monetary and Exchange Rate Policy Framework

11. **The tightening of monetary policy in the second half of 2006 has eased inflationary pressures,** with inflation expected to remain in its historical range of 2–3 percent in 2007, barring another spike in oil or basic commodity prices. The authorities' monetary program for 2007 aims at significantly reducing broad money growth. Concerning the planned large infrastructure projects, the authorities noted that they would be phased in gradually to avoid fueling inflationary pressures.

12. **The authorities are pursuing a gradual transition toward an inflation targeting framework and free floating exchange rate in the context of capital account liberalization:**

- ***The transition toward inflation targeting continues.*** The BCT has adopted a broad money (M3) targeting framework with reserve money as its operating target and has increased its reliance on indirect monetary policy instruments, such as repos and open-market operations. The amendment to the BCT law in 2006 strengthened the central bank's independence and defined price stability as the main objective of monetary policy, hence establishing the legal framework for inflation targeting. The recent Fund TA mission assessed progress and outlined the remaining challenges toward an inflation-targeting framework (Box 3).

Box 3. Key Recommendations of the Fund TA Mission

- Enhance the *de facto* autonomy of the central bank.
- Clarify the role of the exchange rate in the monetary policy framework.
- Strengthen the central bank's research and forecasting capacity.
- Reduce the share of administered prices in the CPI (currently about one-third).

The authorities are mindful of the need to strengthen human resources capacity, develop appropriate statistical tools, and build necessary databases for the implementation of inflation targeting.[1] The BCT noted that it is in the process of strengthening its research and forecasting capacity, including through recruitment of staff with the requisite expertise.

- ***The authorities intend to continue increasing the flexibility of the exchange rate in both directions*** in view of the gradual liberalization of the capital account. They concurred with staff's assessment of the exchange rate level, and on the need for clarifying the role of the exchange rate in the monetary policy framework and coordinating more closely monetary and exchange rate policies.

- ***Deep and well functioning money and foreign exchange markets are essential for an efficient and flexible monetary policy.*** The BCT understands the importance of

[1] The issues related to capacity building and development of appropriate statistical tools and databases for inflation forecasting were discussed extensively during a seminar on inflation forecasting and exchange rate pass-through presented by staff during the mission (see the Selected Issues Paper).

enhancing the autonomy of the money and exchange markets for their development by allowing interest and exchange rates to better reflect market conditions. In particular, the decline in the BCT's fine-tuning operations since launching the Real Time Gross Settlements system in November 2006 has increased interbank activity, as evidenced by the enhanced variability of the money market interest rate (TMM). Similarly, the BCT noted that the volume of its interventions on the foreign exchange market has declined markedly, and are mainly for liquidity management.

C. Strengthening the Financial System

13. **The financial sector is expected to play a key role in the implementation of the XIth Plan.** The financial system plays a fundamental role in a country's economic growth via its direct influence on investment through project financing, and on productivity through the selection of quality projects. Therefore, the BCT's effort to reduce the stock of NPLs is of the utmost importance. While the FSAP Update concluded that they pose no systemic risk to financial stability, large NPLs dampen economic growth as they inhibit investment—by increasing financing costs—and delay productivity enhancing economic reforms.

14. **The authorities have recently adopted several measures to strengthen the legal framework (Box 4).** The authorities' strategy reflects the main recommendations of the FSAP and its update. A new banking law was adopted in 2006 designed to promote good governance and improve the credit culture. Furthermore, since 2004, the BCT has prohibited the distribution of dividends by banks that are inadequately provisioned. In addition, the BCT will soon require banks to provision new NPLs at a rate of 70 percent, independently of the collateral value.

Box 4. Government Strategy for Strengthening the Financial Sector

Objective:

- Achieve 70 percent for the provisions-to-NPLs ratio and 15 percent for the NPLs-to-total loans ratio by end-2009.

Key measures:

- Ban on dividends distribution if provisioning is deemed insufficient.
- Ensure full tax deductibility of provisions.
- Streamline legal procedures for collateral realization.
- New banking law to improve governance by expanding the authority of boards of directors and requiring the creation of an executive credit committee.
- New financial securities law to enhance transparency and reliability of accounting.

15. **This strategy has already produced positive results** (see table below). Prudential indicators show a significant improvement in 2006 compared to 2003, with the NPLs ratio declining from 24 percent to 19.2 percent, the provisioning ratio rising from 43.1 percent to 49.2 percent, and capital adequacy ratios remaining at comfortable levels. This improvement was recorded by both private and public banks.

Commercial Banks Soundness Indicators

	2000	2001	2002	2003	2004	2005	2006 1/
Capital adequacy ratio	13.3	10.6	9.8	9.3	11.6	12.4	11.8
Private banks	11.5	10.4	10.0	8.4	12.4	13.5	12.8
Public banks	15.0	11.0	9.4	10.8	10.1	10.0	9.2
NPLs (percent of gross assets)	21.6	19.2	20.9	24.0	23.7	20.9	19.2
Private banks	15.3	16.1	18.1	21.6	20.4	20.0	18.7
Public banks	26.8	22.8	24.3	26.7	27.4	22.1	19.7
Provisions (percent of NPLs)	49.2	47.4	43.9	43.1	45.8	47.4	49.2
Private banks	54.7	47.7	44.9	39.9	43.5	45.9	48.4
Public banks	46.6	47.1	42.9	46.2	47.6	49.1	50.0
Return on assets	1.3	1.1	0.7	0.6	0.4	0.5	0.2
Return on equity	13.7	14.0	8.0	7.6	5.1	6.5	9.1

Source: Tunisian authorities.

1/ Preliminary.

16. **The authorities remain confident that both of their objectives will be achieved by 2009**, particularly the objective of a 15 percent NPLs ratio. They acknowledged, however, that the goal of 70 percent provisioning ratio will be more difficult to attain without an increase in capital, especially in public banks. Box 5 proposes additional measures that could support the authorities' strategy.

17. **The authorities are carefully monitoring the significant increase in asset prices but do not believe it poses a systemic risk.** The appreciation in the equity market poses no systemic risk for the financial system—total capitalization represents only 14 percent of GDP and P/E ratios average 16. The risk could be more important in the real estate market, although the existence of administered prices benefiting a substantial part of the population would limit the impact of a potential correction.

Box 5. Suggestions to Support the Authorities' Strategy

Additional measures from FSAP Update:

- Develop a strategy for restructuring the tourism sector NPLs, on the basis of a realistic assessment of borrowers' debt repayment capacity.
- Reduce delays in judicial proceedings and increase reliance on out-of-court settlements.
- Allow full tax deductibility for partial write-offs.
- Strengthen management of public commercial banks and consider privatization and mergers of former development banks.
- Promote creation of private credit bureaus.

Other measures:

A key challenge is that the banking sector's current profitability and capital are insufficient to support adequate provisioning of NPLs or their sale at an appropriate price. Given the cost of carrying NPLs, the following actions could be considered:

- Ease capital constraints, including through issuance of tier 2 capital.
- Revitalize the credit culture of the banking sector by developing internal rating systems to enhance the selectivity of their lending policies, ensuring appropriate pricing of their risks, and enhancing the monitoring of their portfolios.
- Open up debt collection firms' capital to nonbank investors to enhance their capacity to absorb NPLs.
- Banks should prepare for the de-indexation of their balance sheets to the TMM by enhancing their risk management systems.
- Further enhance financial transparency, particularly through the Balance Sheet Register.

D. Other Issues

18. **The authorities continue their efforts to integrate the Tunisian economy regionally and globally:**

- ***Tunisia is actively involved in the discussions on the integration of Maghreb countries***. Tunisia participated in the high-level conferences on trade facilitation and on financial integration in the Maghreb, and will host the third conference on the Role of the Private Sector in Economic Development and Regional Integration in November 2007. The Agadir Agreement, signed in 2005 with Egypt, Jordan, and Morocco, was implemented in March and a number of bilateral FTAs were recently concluded.

- ***The Tunisian industry is ready for the tariff dismantling on manufactured products scheduled for 2008 in the context of the free trade agreement with the EU.*** The restructuring program initiated in 1995 and the steady reduction of customs duties have allowed the Tunisian industry to adjust. The maximum customs duty on imports of manufactured products from the EU is now 5 percent, compared to over 100 percent in 1995. The authorities noted that the Tunisian industry withstood its biggest shock in 2005 with the expiration of the Multi-Fiber Agreement. Despite the recent 3 percentage point cut to 29 percent, average MFN tariffs remain significantly higher than preferential tariffs, which could lead to trade diversion.

- ***The gradual liberalization of the capital and current accounts continues.*** New measures were adopted since the beginning of 2006, including authorization to nonresidents to purchase up to 10 percent of the obligations issued by rated or listed firms and to buy land in industrial and tourism zones; liberalization of medium- and long-term external borrowing for listed firms; increase in the amounts transferable without restriction by exporters for their investments abroad; increase in allowances for personal and business travel; relaxation of restrictions on foreign exchange accounts; and closer alignment of onshore and offshore regulatory regimes.

19. **In addition to strengthening Tunisia's macroeconomic position and financial systems, the authorities agreed that reforms in the following areas are also essential for maximizing the benefits of economic integration:**

- ***Enhancing labor market flexibility.*** Mounting empirical evidence highlights the importance of complementary policies in maximizing the benefits of economic integration. The welfare gain from trade reforms under flexible factor markets can be as much as six times the gain under rigid ones.[2] The authorities observed that 1995–96 labor code reforms have greatly improved labor market flexibility.

- ***Improve the investment climate***. The authorities announced a series of measures in addition to the ongoing efforts to simplify administrative and tax regulations, enhance the efficiency of customs administration, and improve the road and telecommunications infrastructure.

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[2] Allen Dennis, (2006), "Trade Liberalization, Factor Market Flexibility, and Growth: The Case of Morocco and Tunisia," World Bank Policy Research Working Paper 3857.

- ***Continue liberalizing the services sector.*** The services sector—the main engine of growth under the XIth Plan—remains heavily regulated as well as largely closed to foreign participation. The authorities noted that some sectors, including the financial sector, have been liberalized and opened up to foreign investors and that progress in other sectors is underway.

20. **The authorities are pursuing their efforts to combat money laundering and the financing of terrorism (AML/CFT).** The discussion of the World Bank assessment report at the Middle East and North Africa Financial Action Task Force (MENAFATF) plenary in April 2007 resulted in some upgrades of Tunisia's ratings. Tunisia highlighted its continuing progress between the date of the assessment and the MENAFATF plenary. Tunisia continues to implement its AML/CFT regime, particularly in the banking sector through training and adoption of detection and internal control systems. Tunisian banks have formed AML/CFT compliance units, are planning to set up the needed internal processes and IT, and are undertaking adequate training for the effective implementation of the AML/CFT requirements. To help with implementing these improvements, the authorities requested TA.

V. Staff Appraisal

21. **Skillful macroeconomic management and an outward-oriented development strategy have contributed to placing Tunisia's economic performance over the past decade among the best in the region.** This good performance notwithstanding, Tunisia faces a common challenge with its neighbors—relatively high unemployment, especially among university graduates. To boost growth and employment, Tunisia has to accelerate the pace of reforms, particularly in the financial sector, and strengthen its macroeconomic position to enhance the flexibility and resilience of the Tunisian economy as it pursues deeper integration into the world economy.

22. **Fiscal policy has been prudent but further fiscal consolidation is necessary to maintain long-term fiscal sustainability,** in view of growing budget pressures, particularly from population ageing and declining nontax and tariff receipts. Therefore, fiscal consolidation through a broadening of the tax base, more efficient spending, and early debt retirement should continue. In particular, the costly fuel subsidies should be phased out given that oil prices are expected to stay high in the medium to long term.

23. **Staff welcomes the recent measures to restore the financial position of the social security system over the medium term but recommends accelerating its comprehensive reform.** The health insurance reform and the raise in pension contributions should help eliminate the social security deficit over the coming years. However, the system's long-term viability hinges on its comprehensive reform planned for 2010. In view of the increasing importance of medium- and long-term demographic-related budgetary issues, it is important to continue developing a more forward-looking fiscal framework where these issues can be more effectively analyzed.

24. **The short-term monetary policy stance remains appropriate but some risks of overheating exist.** The BCT should remain vigilant considering the increase in petroleum product prices in May, the likely structural nature of excess liquidity, and the impact from sizable infrastructure investment projects. Close coordination of fiscal and monetary policies will be necessary.

25. **There is no clear evidence of exchange rate misalignment and macroeconomic policies are consistent with external stability.** The recent depreciation of the real effective exchange rate reflects a significant terms of trade deterioration and a structural, but sustainable, current account deficit.

26. **Staff encourages the authorities to continue enhancing the flexibility of the exchange rate and the autonomy of the money and foreign exchange markets.** While the volume of interventions has declined, the flexibility of the exchange rate remains limited, particularly considering the move to inflation targeting over the medium term. In addition, money and foreign exchange markets development would benefit from improving liquidity management in order to better anticipate the impact of volatile treasury operations upon bank liquidity, eliminating the requirement that banks transfer daily foreign exchange balances to the BCT (*nivellement*), and delaying the quotation of the daily exchange rate as a first step prior to eliminating this practice. Ultimately, the de-indexation of bank assets and liabilities from the TMM should give the BCT greater flexibility in using it as a policy instrument. Accordingly, it is important to continue informing economic agents—particularly banks—of these changes and their implications to ensure adequate preparation.

27. **The BCT's objective of moving toward inflation targeting over the medium term requires strengthening the research and forecasting capacity of the BCT.** Preparations should be accelerated given the time lags necessary to build adequate human capacity and develop the required statistical tools.

28. **Staff welcomes the authorities' comprehensive strategy based on the FSAP and its update to strengthen the banking sector, yet believes that additional measures may be needed to attain simultaneously the BCT's dual objective set for 2009 and the objectives of the XIth Plan.** If the decline in the NPLs ratio continues at its present rate, the authorities' objective of 15 percent by 2009 should be achievable but additional capital is likely to be needed, especially in public banks, in order to reach 70 percent provisioning ratio. Furthermore, a dynamic and efficient banking sector is crucial for higher growth and full capital account liberalization. The authorities are encouraged to consider the additional measures proposed by staff.

29. **The authorities' efforts to integrate the Tunisian economy regionally and globally are laudable.** Staff supports further progress in simplifying and reducing MFN tariffs.

30. **Some complementary reforms are critical for maximizing the benefits of economic integration.** Further labor market flexibility would help improve the competitiveness and flexibility of the Tunisian economy and facilitate labor reallocation in response to structural change. In particular, dismissal rules remain cumbersome and should be relaxed further. Regarding the investment climate, staff welcomes the ongoing efforts and encourages the authorities to continue increasing transparency, improving governance, and facilitating access to financing for SMEs. Finally, the services sector remains heavily regulated and largely closed to foreign participation. Therefore, the preparatory work for liberalizing trade in services with the EU is encouraging.

31. Staff welcomes the progress in the implementation of the AML/CFT report recommendations and supports the authorities' goal of moving toward full compliance.

32. It is proposed that the next Article IV consultation take place on the standard 12-month cycle.

Table 1. Selected Economic and Financial Indicators, 2005–12

		Est.	Projections					
	2005	2006	2007	2008	2009	2010	2011	2012
Production and income (percent change)								
Nominal GDP	7.0	9.2	8.4	9.2	8.6	8.7	8.9	8.7
Real GDP	4.0	5.4	6.0	6.2	6.1	6.2	6.3	6.3
GDP deflator	2.9	3.6	2.3	2.8	2.3	2.4	2.4	2.2
Consumer price index (CPI), average	2.0	4.5	3.0	2.6	2.5	2.5	2.5	2.5
Gross national savings (in percent of GDP)	20.9	21.5	21.8	21.5	21.6	22.0	22.9	23.2
Gross investment (in percent of GDP)	22.0	23.8	24.3	24.3	24.2	24.5	25.0	25.2
External sector (percent change)								
Exports of goods, f.o.b. (in $)	8.4	9.5	17.3	7.8	7.6	8.1	9.8	9.9
Imports of goods, f.o.b. (in $)	2.9	12.4	16.1	8.8	8.0	8.6	9.9	9.7
Exports of goods, f.o.b. (volume)	1.6	-1.6	10.4	6.2	7.5	6.5	8.2	8.4
Import of goods, f.o.b. (volume)	-5.7	-2.6	12.2	10.6	12.5	11.6	9.6	9.9
Trade balance (in percent of GDP)	-6.8	-8.2	-8.2	-8.6	-8.7	-8.9	-9.0	-9.0
Current account, excluding grants (in percent of GDP)	-1.1	-2.3	-2.5	-2.8	-2.7	-2.5	-2.1	-2.0
Foreign direct investment (percent of GDP)	2.6	10.3	2.6	2.8	2.8	2.8	2.8	2.8
Terms of trade (deterioration -)	-2.3	-3.6	...	...	...	...	...	...
Real effective exchange rate (depreciation -) 1/	-4.5	-0.8	...	...	...	...	...	...
Central government (percent of GDP, unless otherwise indicated) 2/								
Total revenue, excluding grants and privatization	23.6	23.8	22.9	22.4	22.4	22.4	22.4	22.3
Total expenditure and net lending	26.9	26.7	25.8	25.2	24.6	24.5	24.3	24.2
Central government balance, excluding grants and privatization	-3.2	-2.9	-2.9	-2.8	-2.3	-2.2	-2.0	-1.8
Central government balance, including grants, excluding privatization	-3.0	-2.8	-2.7	-2.6	-2.1	-2.0	-1.8	-1.7
Total government debt (foreign and domestic)	58.3	54.0	52.5	51.2	49.3	47.4	45.3	43.4
Foreign currency public debt (percent of total debt)	63.9	59.8	56.1	53.9	51.7	49.2	46.2	43.1
Money and credit (percent change)								
Credit to the economy	6.3	6.7	7.9	...	...	...	...	...
Broad money (M3) 3/	11.0	11.5	9.1	...	...	...	...	...
Velocity of circulation (GDP/M3, deposit money banks)	1.8	1.8	1.8	...	...	...	...	...
Velocity of circulation (GDP/M3)	1.6	1.5	1.5	...	...	...	...	...
Interest rate (money market rate, in percent, e.o.p) 4/	5.0	5.3	5.2	...	...	...	...	...
Official reserves								
Gross official reserves (US$ billions, e.o.p)	4.4	6.8	7.8	8.5	9.1	9.9	10.9	11.9
In months of imports of goods and services, c.i.f.	3.7	5.1	5.0	5.0	5.0	5.0	5.0	5.0
Total external debt								
External debt (US$ billions)	18.1	18.7	20.0	20.9	21.9	23.3	24.4	25.8
External debt (in percent of GDP)	65.4	59.1	58.9	56.6	54.7	53.5	51.3	49.8
Debt service ratio (percent of exports of GNFS)	15.2	19.0	13.4	12.0	12.0	11.6	11.6	11.4
Financial market indicators								
Stock market index 5/	1,615	2,331	2,529	…	…	…	…	…
Memorandum items:								
GDP at current prices (TD millions)	37,664	41,121	44,590	48,683	52,851	57,428	62,530	67,968
GDP at current prices (US$ billions)	27.6	31.7	34.0	37.0	40.1	43.6	47.5	51.8
GDP per capita (US$)	2,751	3,117	3,298	3,545	3,791	4,066	4,380	4,710
Unemployment rate (in percent)	14.2	14.2	14.1	14.0	13.8	13.6	13.4	13.2
Population (millions)	10.0	10.2	10.3	10.4	10.6	10.7	10.9	11.0
Exchange rate: dinar/US$ (average)	1.30	1.33	...	...	...	...	...	...

Sources: Tunisian authorities; and staff estimates and projections.

1/ Information Notice System.
2/ Excludes the social security accounts.
3/ Financial system (deposit money banks and development banks).
4/ 2007 data from June 21, 2007.
5/ TUNINDEX (1000 = 4/1/1998). 2007 data from June 22, 2007.

Table 2. Balance of Payments, 2005–12

(In millions of U.S. dollars, unless otherwise indicated)

		Est.	Projections					
	2005	2006	2007	2008	2009	2010	2011	2012
Current account	-306	-700	-847	-1,028	-1,067	-1,072	-1,011	-1,022
Trade balance	-1,971	-2,523	-2,790	-3,170	-3,484	-3,860	-4,260	-4,650
Exports	10,489	11,486	13,470	14,517	15,622	16,889	18,538	20,366
Energy	1,355	1,513	1,849	1,904	1,956	1,934	2,001	2,145
Nonenergy	9,135	9,973	11,621	12,613	13,666	14,955	16,537	18,221
Imports	-12,461	-14,009	-16,260	-17,687	-19,106	-20,750	-22,798	-25,016
Energy	-1,748	-2,144	-1,942	-2,083	-2,150	-2,233	-2,348	-2,530
Nonenergy	-10,712	-11,865	-14,319	-15,605	-16,956	-18,516	-20,449	-22,486
Of which: Nonfood	-10,595	-11,690	-13,947	-15,196	-16,514	-18,039	-19,932	-21,891
Services and transfers (net)	1,666	1,823	1,944	2,142	2,417	2,789	3,249	3,628
Nonfactor	1,876	1,917	2,092	2,294	2,554	2,872	3,260	3,604
Of which: Tourism	1,995	2,063	2,294	2,523	2,780	3,082	3,441	3,656
Factor Services and Transfers (net)	-211	-94	-148	-152	-137	-83	-11	23
Of which: Workers' remittances	1,393	1,475	1,622	1,766	1,917	2,070	2,217	2,325
Interest payments on external debt	-731	-694	-685	-777	-858	-940	-1,037	-1,078
Capital and financial account	1,243	2,783	1,894	1,705	1,714	1,811	1,924	2,029
Excluding grants	1,114	2,658	1,765	1,614	1,623	1,728	1,848	1,953
Capital account	119	125	129	86	86	78	70	71
Financial account	1,124	2,658	1,765	1,620	1,629	1,733	1,853	1,958
Direct foreign investment (net)	725	3,257	887	1,028	1,139	1,214	1,329	1,456
Medium and long term loans (net)	192	-818	289	574	543	575	387	556
Disbursement	1,638	1,439	2,002	2,119	2,198	2,266	2,255	2,626
Amortization	-1,446	-2,257	-1,713	-1,545	-1,655	-1,691	-1,868	-2,069
Short term capital	207	219	589	18	-53	-56	137	-54
Errors and omissions	0	0	0	0	0	0	0	0
Overall balance	937	2,083	1,048	677	648	739	913	1,007
Changes in gross reserves 1/	-409	-2,364	-970	-699	-670	-774	-959	-1,058
Use of IMF resources	0	0	0	0	0	0	0	0
Other assets, net (increase -)	-409	-2,364	-970	-699	-670	-774	-959	-1,058
Memorandum items:								
Current account balance/GDP (in percent)	-1.1	-2.3	-2.5	-2.8	-2.7	-2.5	-2.1	-2.0
Reserves (in billions of $)	4.4	6.8	7.8	8.5	9.1	9.9	10.9	11.9
Reserves in months of imports of goods	4.0	5.5	5.4	5.4	5.4	5.4	5.4	5.4
Reserves in months of imports of goods and services	3.7	5.1	5.0	5.0	5.0	5.0	5.0	5.0
Reserves/total short term external debt (percent) 2/	141.2	191.4	167.5	175.7	178.9	173.6	175.4	175.6
Excluding nonresidents deposits	208.5	273.4	216.7	224.7	225.0	212.7	211.1	207.8
Reserves/short-term debt including current amortization (percent)	98.1	115.7	122.3	133.1	135.1	133.9	134.7	134.5
Excluding nonresidents deposits	126.5	141.3	146.5	159.4	159.9	156.0	154.8	152.7
External medium-and long-term debt (in billions of $)	14.9	15.2	15.4	16.1	16.8	17.6	18.2	19.0
External medium-and long-term debt/GDP (in percent)	54.1	47.9	45.2	43.6	42.0	40.4	38.3	36.6
External short-term debt (in billions of $)	3.1	3.5	4.6	4.8	5.1	5.7	6.2	6.8
External short-term debt/GDP (in percent)	11.3	11.2	13.6	13.0	12.7	13.1	13.0	13.1
Debt service ratio (as percent XGS, including IMF)	15.2	19.0	13.4	12.0	12.0	11.6	11.6	11.4
Real goods export growth (in percent)	1.6	-1.6	10.4	6.2	7.5	6.5	8.2	8.4
Nonenergy	1.3	-0.6	7.4	8.0	8.3	7.7	8.7	8.4
Real goods import growth (in percent)	-5.7	-2.6	12.2	10.6	12.5	11.6	9.6	9.9
Nonenergy	-5.6	-3.3	14.7	11.8	12.8	11.8	9.6	9.9

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

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

2/ Short term defined as 1 year and less.

Table 3. Central Government Financial Operations, 2005–12 1/

		LdF	Est.	LdF	Projections					
	2005	2006	2006	2007	2007	2008	2009	2010	2011	2012
	(In millions of dinars)									
Total revenue and grants and privatization	9,146	9,640	12,837	10,303	10,363	11,110	12,037	13,062	14,196	15,402
Total revenue	8,906	9,396	9,789	10,153	10,213	10,890	11,817	12,842	13,976	15,182
Tax revenue	7,904	8,282	8,470	8,862	8,892	9,630	10,451	11,415	12,454	13,562
Direct taxes	2,886	3,022	3,107	3,427	3,427	3,742	4,062	4,414	4,806	5,224
Trade taxes	506	560	490	415	425	450	437	475	521	571
VAT	2,301	2,488	2,466	2,704	2,714	2,920	3,219	3,557	3,887	4,240
Domestic	1,189	1,226	1,252	1,390	1,378	1,483	1,662	1,864	2,029	2,206
Imports	1,112	1,262	1,214	1,314	1,336	1,437	1,557	1,693	1,857	2,034
Excise	1,212	1,290	1,255	1,285	1,295	1,320	1,432	1,556	1,700	1,853
Domestic	741	794	759	815	820	798	867	942	1,026	1,115
Imports	471	496	496	470	475	522	565	614	674	738
Other taxes	999	922	1,152	1,031	1,031	1,198	1,300	1,413	1,539	1,674
Domestic	928	870	1,065	981	981	1,108	1,202	1,307	1,423	1,546
Imports	72	52	87	51	51	90	98	107	117	128
Nontax revenue	996	1,106	1,314	1,289	1,319	1,258	1,366	1,427	1,522	1,620
Capital income	6	8	6	2	2	2	0	0	0	0
Total expenditure and net lending	10,119	10,831	10,977	11,512	11,512	12,274	13,026	14,085	15,214	16,435
Total expenditure	10,103	10,780	10,865	11,502	11,502	12,254	13,006	14,065	15,194	16,415
Current expenditure	7,693	8,301	8,317	8,804	8,804	9,296	9,795	10,576	11,395	12,286
Wages and salaries	4,560	4,898	4,901	5,378	5,378	5,782	6,277	6,820	7,426	8,072
Goods and services	713	676	744	719	719	755	925	1,120	1,345	1,530
Interest payments	1,062	1,150	1,130	1,120	1,120	1,191	1,215	1,273	1,332	1,390
Domestic	473	521	499	520	520	553	586	642	705	778
External	589	629	631	600	600	638	629	631	626	612
Transfers and subsidies	1,359	1,441	1,542	1,527	1,527	1,498	1,378	1,363	1,292	1,294
CGC	244	260	307	315	315	363	373	383	393	403
Petroleum subsidies	414	500	500	450	450	400	260	170	80	0
Other	701	681	736	762	762	735	745	810	819	891
Other expenditure (nonallocated)	0	136	0	60	60	70	0	0	0	0
Capital expenditure	2,409	2,479	2,548	2,698	2,698	2,958	3,211	3,489	3,799	4,129
Direct investment	1,259	1,379	1,422	1,448	1,448	1,561	1,848	2,008	2,186	2,376
Capital transfers and equity	1,150	986	1,127	1,120	1,120	1,256	1,363	1,481	1,613	1,753
Other expenditure (nonallocated)	0	114	0	131	131	141	0	0	0	0
Net lending	16	51	112	10	10	20	20	20	20	20
Central government deficit (-) (excluding grants and privatization)	-1,213	-1,435	-1,189	-1,359	-1,299	-1,384	-1,210	-1,243	-1,239	-1,253
Grants	70	94	48	100	100	120	120	120	120	120
Privatization proceeds 2/	170	150	3,000	50	50	100	100	100	100	100
Central government deficit (-) (including grants and privatization)	-973	-1,191	1,860	-1,209	-1,149	-1,164	-990	-1,023	-1,019	-1,033
Financing	973	1,191	-1,860	1,209	1,149	1,164	990	1,023	1,019	1,033
Foreign	284	-106	-1,222	-292	-292	145	-125	-251	-437	-519
Domestic	689	1,297	-637	1,501	1,441	1,019	1,115	1,275	1,456	1,552
Memorandum items:										
Balance of the central government (including grants, excluding private)	-1,143	-1,341	-1,141	-1,259	-1,199	-1,264	-1,090	-1,123	-1,119	-1,133
Central government primary balance	89	-41	2,989	-89	-29	27	225	249	313	357
Central government primary balance (excluding grants and privatization)	-151	-285	-59	-239	-179	-193	5	29	93	137
General government debt 3/	21,949	24,357	22,219	23,969	23,398	24,935	26,070	27,222	28,349	29,485
Of which: Domestic	7,923	9,958	8,936	10,844	10,273	11,488	12,580	13,831	15,260	16,783
External	14,026	14,399	13,283	13,125	13,125	13,447	13,490	13,391	13,089	12,702
Nominal GDP	37,664	40,305	41,121	44,245	44,590	48,683	52,851	57,428	62,530	67,968
Nominal nonagricultural GDP	33,574	36,728	36,728	40,035	40,035	43,695	47,562	51,830	56,623	61,735
Oil price ($/barrel)	53	60	64	70	61	65	65	64	64	63
Imports	16,161	18,681	18,681	21,354	21,354	23,233	25,165	27,360	30,021	32,870

Table 3 (concluded). Central Government Financial Operations, 2005–12 1/

	LdF compl 2005	LdF 2006	Est. 2006	LdF 2007	Projections 2007	2008	2009	2010	2011	2012
	(In percent of GDP)									
Total revenue and grants and privatization	24.3	23.9	31.2	23.3	23.2	22.8	22.8	22.7	22.7	22.7
Total revenue	23.6	23.3	23.8	22.9	22.9	22.4	22.4	22.4	22.4	22.3
Tax revenue	21.0	20.5	20.6	20.0	19.9	19.8	19.8	19.9	19.9	20.0
Direct taxes	7.7	7.5	7.6	7.7	7.7	7.7	7.7	7.7	7.7	7.7
Trade taxes	1.3	1.4	1.2	0.9	1.0	0.9	0.8	0.8	0.8	0.8
Trade taxes (in percent of imports)	3.1	3.0	2.6	1.9	2.0	1.9	1.7	1.7	1.7	1.7
VAT	6.1	6.2	6.0	6.1	6.1	6.0	6.1	6.2	6.2	6.2
Domestic	3.2	3.0	3.0	3.1	3.1	3.0	3.1	3.2	3.2	3.2
Imports	3.0	3.1	3.0	3.0	3.0	3.0	2.9	2.9	3.0	3.0
Imports (in percent of imports)	6.9	6.8	6.5	6.2	6.3	6.2	6.2	6.2	6.2	6.2
Excise	3.2	3.2	3.1	2.9	2.9	2.7	2.7	2.7	2.7	2.7
Domestic	2.0	2.0	1.8	1.8	1.8	1.6	1.6	1.6	1.6	1.6
Imports	1.3	1.2	1.2	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Imports (in percent of imports)	2.9	2.7	2.7	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Other taxes	2.7	2.3	2.8	2.3	2.3	2.5	2.5	2.5	2.5	2.5
Domestic	2.5	2.2	2.6	2.2	2.2	2.3	2.3	2.3	2.3	2.3
Imports	0.2	0.1	0.2	0.1	0.1	0.2	0.2	0.2	0.2	0.2
Imports (in percent of imports)	0.4	0.3	0.5	0.2	0.2	0.4	0.4	0.4	0.4	0.4
Nontax revenue	2.6	2.7	3.2	2.9	3.0	2.6	2.6	2.5	2.4	2.4
Capital income	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditure and net lending	26.9	26.9	26.7	26.0	25.8	25.2	24.6	24.5	24.3	24.2
Total expenditure	26.8	26.7	26.4	26.0	25.8	25.2	24.6	24.5	24.3	24.2
Current expenditure	20.4	20.6	20.2	19.9	19.7	19.1	18.5	18.4	18.2	18.1
Wages and salaries	12.1	12.2	11.9	12.2	12.1	11.9	11.9	11.9	11.9	11.9
Goods and services	1.9	1.7	1.8	1.6	1.6	1.6	1.8	2.0	2.2	2.3
Interest payments	2.8	2.9	2.7	2.5	2.5	2.4	2.3	2.2	2.1	2.0
Domestic	1.3	1.3	1.2	1.2	1.2	1.1	1.1	1.1	1.1	1.1
External	1.6	1.6	1.5	1.4	1.3	1.3	1.2	1.1	1.0	0.9
Transfers and subsidies	3.6	3.6	3.8	3.5	3.4	3.1	2.6	2.4	2.1	1.9
CGC	0.6	0.6	0.7	0.7	0.7	0.7	0.7	0.7	0.6	0.6
Petroleum subsidies	1.1	1.2	1.2	1.0	1.0	0.8	0.5	0.3	0.1	0.0
Other	1.9	1.7	1.8	1.7	1.7	1.5	1.4	1.4	1.3	1.3
Other expenditure (nonallocated)	0.0	0.3	0.0	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Capital expenditure	6.4	6.2	6.2	6.1	6.1	6.1	6.1	6.1	6.1	6.1
Direct investment	3.3	3.4	3.5	3.3	3.2	3.2	3.5	3.5	3.5	3.5
Capital transfers and equity	3.1	2.4	2.7	2.5	2.5	2.6	2.6	2.6	2.6	2.6
Other expenditure (nonallocated)	0.0	0.3	0.0	0.3	0.3	0.3	0.0	0.0	0.0	0.0
Net lending	0.0	0.1	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Central government deficit (-), (excluding grants and privatization)	-3.2	-3.6	-2.9	-3.1	-2.9	-2.8	-2.3	-2.2	-2.0	-1.8
Grants	0.2	0.2	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Privatization Proceeds 2/	0.5	0.4	7.3	0.1	0.1	0.2	0.2	0.2	0.2	0.1
Central government deficit (-), (including grants and privatization)	-2.6	-3.0	4.5	-2.7	-2.6	-2.4	-1.9	-1.8	-1.6	-1.5
Financing	2.6	3.0	-4.5	2.7	2.6	2.4	1.9	1.8	1.6	1.5
Foreign	0.8	-0.3	-3.0	-0.7	-0.7	0.3	-0.2	-0.4	-0.7	-0.8
Domestic	1.8	3.2	-1.6	3.4	3.2	2.1	2.1	2.2	2.3	2.3
Memorandum items:										
Balance of the central government (including grants, excluding privatization)	-3.0	-3.3	-2.8	-2.8	-2.7	-2.6	-2.1	-2.0	-1.8	-1.7
Central government primary balance	0.2	-0.1	7.3	-0.2	-0.1	0.1	0.4	0.4	0.5	0.5
Central government primary balance (excluding grants and privatization)	-0.4	-0.7	-0.1	-0.5	-0.4	-0.4	0.0	0.1	0.1	0.2
General government debt 3/	58.3	60.4	54.0	54.2	52.5	51.2	49.3	47.4	45.3	43.4
Of which: Domestic	21.0	24.7	21.7	24.5	23.0	23.6	23.8	24.1	24.4	24.7
External	37.2	35.7	32.3	29.7	29.4	27.6	25.5	23.3	20.9	18.7

Sources: Tunisian authorities; and staff estimates.

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

2/ Privatization receipts from Tunisie Telecom (TT) were about TD 3000 millions. Only about TD 1069 millions have been used in 2006 (of which TD 919 millions from TT receipts), and about TD 415 millions in 2007 (of which TD 365 millions from TT).

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

Table 4. Monetary Survey (Financial System), 2002–07

	2002	2003	2004	2005	2006	Proj. 2007
	(In millions of dinars)					
Foreign assets (net)	1,909	2,279	3,126	4,112	6,876	8,252
Foreign assets	4,154	4,547	5,802	7,341	10,234	11,610
BCT	3,134	3,629	4,843	6,060	8,837	10,213
Foreign liabilities	-2,246	-2,268	-2,675	-3,229	-3,358	-3,358
Net domestic assets	16,392	17,178	18,340	19,708	19,674	20,721
Domestic credit	23,744	24,669	26,366	28,149	30,765	33,156
Credit to the government (net)	2,790	2,758	3,283	3,611	4,589	4,911
Central bank net credit	-290	-504	-597	-636	-243	-243
Commercial banks	1,642	1,746	2,180	2,275	2,609	2,932
Credit to the economy	20,954	21,911	23,083	24,538	26,177	28,245
Other items (net)	-7,352	-7,491	-8,026	-8,441	-11,091	-12,435
Money plus quasi-money (M2)	16,681	17,859	19,846	22,129	24,839	26,913
Money (M1)	6,618	6,992	7,686	8,742	9,870	10,612
Currency	2,518	2,663	2,968	3,478	3,873	4,164
Demand deposits	4,100	4,328	4,718	5,263	5,997	6,448
Quasi-money	10,063	10,868	12,161	13,388	14,969	16,301
Long-term deposits (M3-M2)	1,619	1,598	1,620	1,691	1,712	1,840
Broad money (M3) 1/	18,301	19,457	21,467	23,821	26,551	28,973
	(Annual rate of change in percent)					
Foreign assets (net)	19.5	19.4	37.2	31.5	67.2	20.0
Domestic credit	6.4	3.9	6.9	6.8	9.3	7.8
Credit to government (net)	4.4	-1.2	19.0	10.0	27.1	7.0
Credit to the economy	6.7	4.6	5.3	6.3	6.7	7.9
Money and quasi-money (M2)	3.9	7.1	11.1	11.5	12.2	8.4
Broad money (M3)	5.2	6.3	10.3	11.0	11.5	9.1
	(Changes in percent of initial stock of M3)					
Foreign assets (net)	1.8	2.0	4.4	4.6	11.6	5.2
Domestic credit	8.2	5.1	8.7	8.3	11.0	9.0
Credit to the government (net)	0.7	-0.2	2.7	1.5	4.1	1.2
Credit to the economy	7.6	5.2	6.0	6.8	6.9	7.8
Other items (net)	-4.9	-0.8	-2.7	-1.9	-11.1	-5.1
Memorandum items:						
Velocity (GDP/M3)	1.64	1.65	1.64	1.58	1.55	1.54
Multiplier (M3/M0)	5.70	5.74	5.65	5.14	4.88	4.54
GDP	29,924	32,170	35,192	37,664	41,121	44,590
Nominal GDP growth	4.1	7.5	9.4	7.0	9.2	8.4

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

1/ M2 plus long term deposits.

Table 5. Medium-Term Growth Scenario, 2004–12

	2004	2005	2006	2007	2008	2009	2010	2011	2012
				(In percent)					
Real GDP growth	6.0	4.0	5.4	6.0	6.2	6.1	6.2	6.3	6.3
Agriculture 1/	10.1	-7.0	2.5	1.1	6.8	3.5	3.3	3.0	3.0
Nonagriculture	5.5	5.6	5.7	6.6	6.1	6.4	6.5	6.7	6.7
Unemployment rate	13.9	14.2	14.2	14.1	14.0	13.8	13.6	13.4	13.2
Inflation	3.6	2.0	4.5	3.0	2.6	2.5	2.5	2.5	2.5
Real export growth 2/	8.5	4.9	4.1	6.4	5.7	6.3	6.7	7.8	8.1
				(In percent of GDP)					
Gross national savings	22.5	20.9	21.5	21.8	21.5	21.6	22.0	22.9	23.2
Consolidated government 3/	4.5	3.3	3.2	3.0	3.6	4.1	4.2	4.4	4.5
Rest of the economy	18.0	17.6	18.3	18.8	17.9	17.5	17.8	18.5	18.7
Gross investment	24.5	22.0	23.8	24.3	24.3	24.2	24.5	25.0	25.2
Consolidated government	7.0	6.4	6.2	6.1	6.1	6.1	6.1	6.1	6.1
Rest of the economy	17.5	15.6	17.6	18.1	18.2	18.1	18.4	18.9	19.0
Savings-investment gap	-2.0	-1.1	-2.3	-2.5	-2.8	-2.7	-2.5	-2.1	-2.0
Consolidated government	-2.5	-3.1	-3.0	-3.1	-2.6	-2.0	-1.9	-1.7	-1.6
Rest of the economy	0.5	2.1	0.8	0.6	-0.2	-0.6	-0.5	-0.4	-0.4
Memorandum items:									
Balance of the consolidated government	-2.5	-3.1	-3.0	-3.1	-2.6	-2.0	-1.9	-1.7	-1.6
External current account	-2.0	-1.1	-2.3	-2.5	-2.8	-2.7	-2.5	-2.1	-2.0
Gross fixed capital formation	22.8	22.3	23.5	23.6	23.6	23.6	23.8	24.4	24.5

Source: IMF staff estimates from 2003.

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

Table 6. External Debt Sustainability Framework, 2002–12

(In percent of GDP, unless otherwise indicated)

	2002	2003	2004	2005	2006	Projections 2007	2008	2009	2010	2011	2012	Debt-stabilizing noninterest current account 6/
Baseline: External debt	67.5	66.8	66.5	65.4	59.1	**58.9**	**56.6**	**54.7**	**53.5**	**51.3**	**49.8**	**-4.9**
Change in external debt	1.0	-0.7	-0.3	-1.1	-6.4	-0.2	-2.3	-1.9	-1.2	-2.2	-1.6	
Identified external debt-creating flows (4+8+9)	-8.7	-10.0	-6.5	2.5	-16.5	-3.5	-3.4	-3.4	-3.5	-3.8	-3.9	
Current account deficit, excluding interest payments	1.0	0.6	-0.3	-1.5	0.0	0.5	0.7	0.5	0.3	-0.1	-0.1	
Deficit in balance of goods and services	3.7	3.4	2.6	0.3	1.9	2.1	2.4	2.3	2.3	2.1	2.0	
Exports	42.1	40.7	44.9	51.9	48.9	52.7	52.3	52.2	52.2	52.7	53.2	
Imports	45.8	44.1	47.4	52.3	50.8	54.8	54.7	54.5	54.5	54.8	55.3	
Net nondebt creating capital inflows (negative)	-3.6	-2.1	-2.2	-2.7	-10.3	-2.7	-2.9	-2.9	-2.8	-2.8	-2.9	
Automatic debt dynamics 1/	-6.1	-8.5	-4.0	6.8	-6.2	-1.3	-1.2	-1.0	-0.9	-0.9	-0.9	
Contribution from nominal interest rate	2.3	2.1	2.2	2.6	2.2	2.0	2.1	2.1	2.2	2.2	2.1	
Contribution from real GDP growth	-1.0	-3.2	-3.7	-2.8	-3.1	-3.3	-3.3	-3.2	-3.1	-3.1	-3.0	
Contribution from price and exchange rate changes 2/	-7.4	-7.5	-2.5	6.9	-5.3	...	...	...	...	...	...	
Residual, including change in gross foreign assets (2-3) 3/	9.7	9.3	6.2	-3.7	10.2	3.2	1.1	1.6	2.3	1.6	2.3	
External debt-to-exports ratio (in percent)	160.3	164.1	148.4	126.0	120.9	111.7	108.1	104.8	102.4	97.3	93.5	
Gross external financing need (in billions of U.S. dollars) 4/	4.5	4.7	5.3	5.1	6.1	6.1	7.2	7.5	7.9	8.6	9.3	
In percent of GDP	20.1	17.7	18.2	18.5	19.2	18.0	19.5	18.8	18.1	18.1	17.9	
Scenario with key variables at their historical averages 5/						**58.9**	**57.7**	**56.8**	**56.9**	**56.4**	**56.7**	**-4.3**
Key macroeconomic assumptions underlying baseline												
Real GDP growth (in percent)	1.7	5.6	6.0	4.0	5.4	6.0	6.2	6.1	6.2	6.3	6.3	
GDP deflator in U.S. dollars (change in percent)	12.6	12.5	3.9	-9.4	8.9	1.2	2.6	2.1	2.4	2.6	2.4	
Nominal external interest rate (in percent)	4.0	3.8	3.6	3.7	3.8	3.7	3.9	4.1	4.3	4.5	4.4	
Growth of exports (U.S. dollar terms, in percent)	0.0	14.7	21.4	9.0	8.0	15.6	8.1	8.1	8.7	10.1	10.0	
Growth of imports (U.S. dollar terms, in percent)	-1.7	14.4	18.4	3.8	11.5	15.6	8.7	8.0	8.6	9.7	9.8	
Current account balance, excluding interest payments	-1.0	-0.6	0.3	1.5	0.0	-0.5	-0.7	-0.5	-0.3	0.1	0.1	
Net nondebt creating capital inflows	3.6	2.1	2.2	2.7	10.3	2.7	2.9	2.9	2.8	2.8	2.9	

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

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

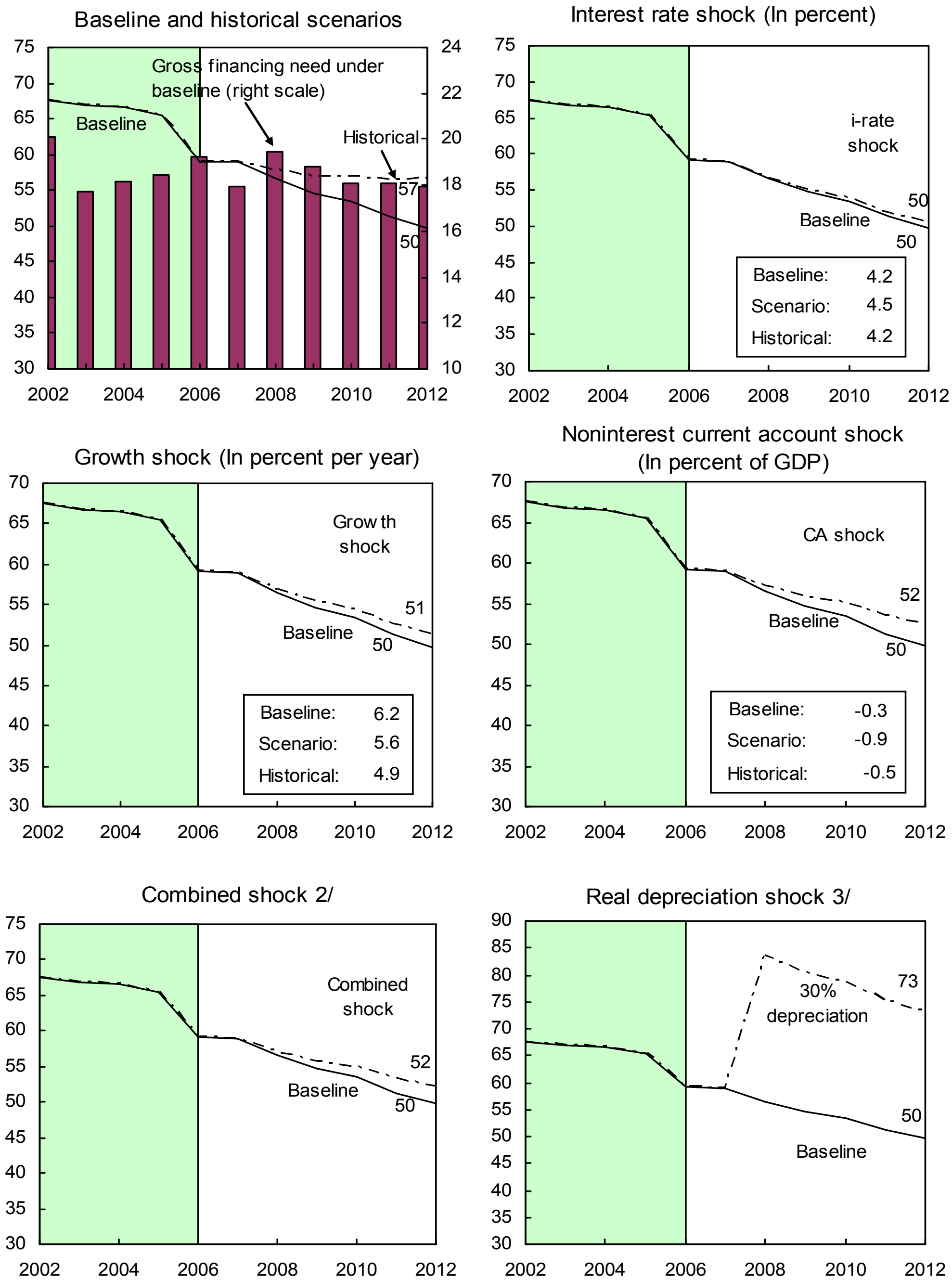
3/ For projection, line includes the impact of price and exchange rate changes.

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

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and nondebt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 2. External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2008.

Table 7. Public Debt Sustainability Framework, 2002–12

(In percent of GDP, unless otherwise indicated)

						Projections						Debt-stabilizing primary balance 9/
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	
Baseline: Public sector debt 1/	61.5	60.5	59.4	58.3	54.0	**52.5**	**51.2**	**49.3**	**47.4**	**45.3**	**43.4**	**1.2**
Of which: Foreign-currency denominated	39.1	38.9	37.5	37.2	32.3	29.4	27.6	25.5	23.3	20.9	18.7	
Change in public sector debt	-1.2	-1.0	-1.1	-1.2	-4.2	-1.6	-1.3	-1.9	-1.9	-2.1	-2.0	
Identified debt-creating flows (4+7+12)	-4.4	-4.8	-3.3	3.8	-10.9	-1.2	-2.1	-2.2	-2.2	0.9	0.8	
Primary deficit	-0.3	0.3	-0.3	0.3	0.3	0.6	0.1	-0.3	-0.3	-0.4	-0.4	
Revenue and grants	30.3	29.8	29.8	29.4	29.8	29.0	29.0	28.9	28.9	28.9	28.9	
Primary (noninterest) expenditure	30.1	30.1	29.5	29.7	30.0	29.6	29.1	28.7	28.6	28.5	28.4	
Automatic debt dynamics 2/	-3.0	-5.1	-2.7	3.9	-3.9	-1.7	-2.0	-1.7	-1.7	-1.7	-1.6	
Contribution from interest rate/growth differential 3/	0.6	-1.5	-2.4	-1.1	-2.2	-1.7	-2.0	-1.7	-1.7	-1.7	-1.6	
Of which: Contribution from real interest rate	1.6	1.7	1.0	1.1	0.7	1.3	1.0	1.1	1.1	1.0	1.1	
Contribution from real GDP growth	-1.0	-3.2	-3.3	-2.2	-2.9	-3.0	-3.0	-2.9	-2.8	-2.8	-2.6	
Contribution from exchange rate depreciation 4/	-3.6	-3.6	-0.3	5.0	-1.7	...	...	...	...	...	...	
Other identified debt-creating flows	-1.1	0.0	-0.4	-0.5	-7.3	-0.1	-0.2	-0.2	-0.2	3.0	2.8	
Privatization receipts (negative)	-1.1	0.0	-0.4	-0.5	-7.3	-0.1	-0.2	-0.2	-0.2	-0.2	-0.1	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.6	1.5	
Other (specify, e.g., bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.6	1.5	
Residual, including asset changes (2-3) 5/	3.2	3.8	2.3	-4.9	6.7	-0.3	0.8	0.3	0.3	-3.0	-2.7	
Public sector debt-to-revenue ratio 1/	202.7	203.4	199.2	198.0	181.6	181.1	176.8	170.4	163.9	156.9	150.3	
Gross financing need 6/	6.3	5.8	6.0	6.1	7.2	6.4	4.7	4.3	4.3	4.0	3.9	
In billions of U.S. dollars	1.3	1.5	1.7	1.8	2.2	2.2	1.7	1.7	1.9	1.9	2.0	
Scenario with key variables at their historical averages 7/						**52.5**	**51.7**	**50.5**	**49.2**	**48.0**	**46.7**	**1.8**
Scenario with no policy change (constant primary balance) in 2007–12						**52.5**	**50.8**	**49.8**	**48.8**	**47.7**	**46.6**	**1.1**
Key macroeconomic and fiscal assumptions underlying baseline												
Real GDP growth (in percent)	1.7	5.6	6.0	4.0	5.4	6.0	6.2	6.1	6.2	6.3	6.3	
Average nominal interest rate on public debt (in percent) 8/	5.1	4.9	5.1	5.1	5.1	5.0	5.1	4.9	4.9	4.9	4.9	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.8	3.1	1.9	2.1	1.5	2.7	2.3	2.5	2.5	2.5	2.7	
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	10.1	10.4	0.7	-12.0	5.1	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	2.3	1.9	3.2	2.9	3.6	2.3	2.8	2.3	2.4	2.4	2.2	
Growth of real primary spending (deflated by GDP deflator, in percent)	4.0	5.5	4.0	4.7	6.5	4.3	4.4	4.6	6.0	5.9	6.1	
Primary deficit	-0.3	0.3	-0.3	0.3	0.3	0.6	0.1	-0.3	-0.3	-0.4	-0.4	

Source: IMF staff estimates.

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

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

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

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

5/ For projections, this line includes exchange rate changes.

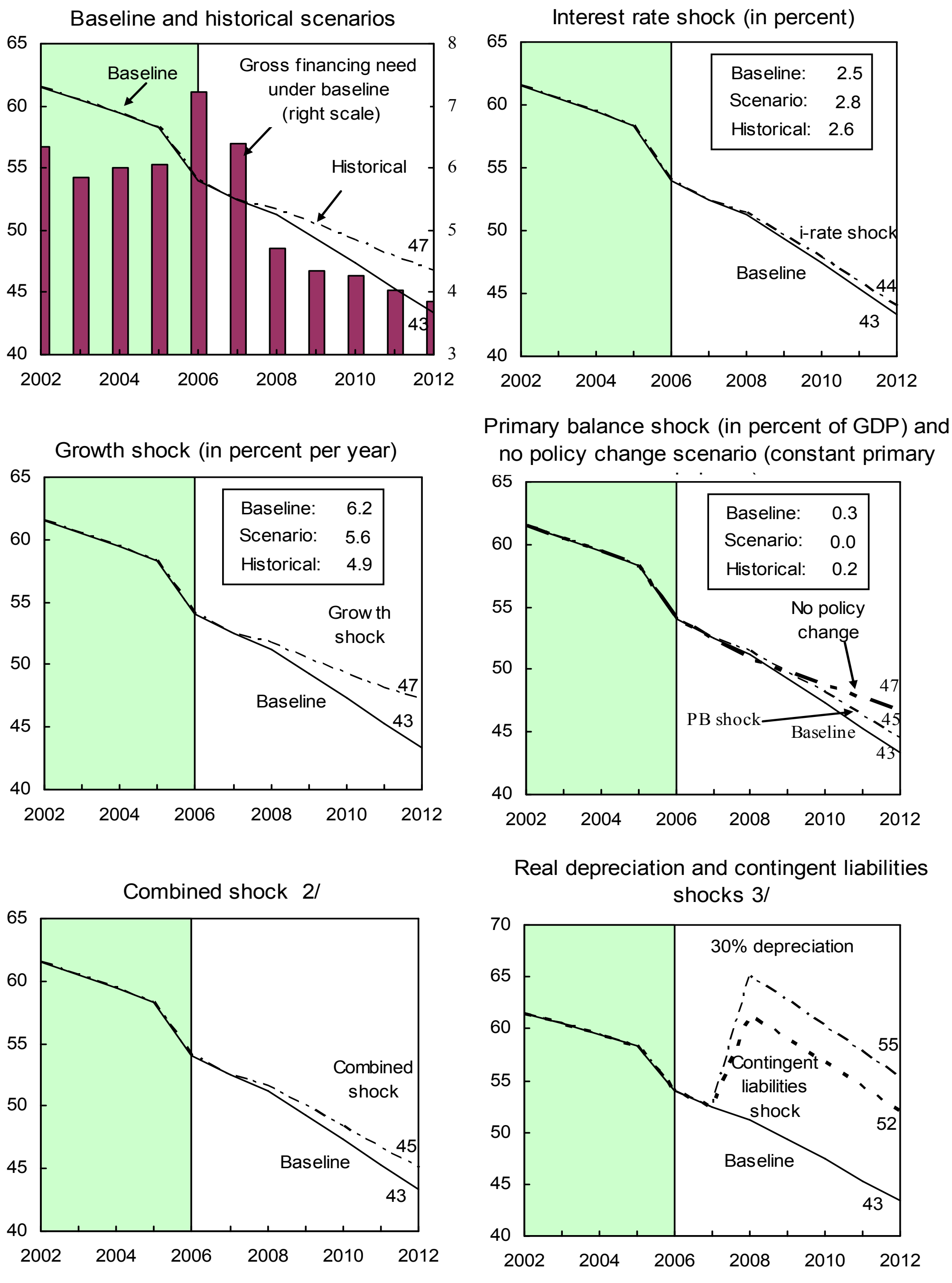
6/ Defined as public sector deficit, plus amortization of medium- and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

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

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 3. Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2008, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

ANNEX I. FUND RELATIONS

As of May 31, 2007

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

II. **General Resources Account:**	SDR Million	%Quota
Quota	286.50	100.0
Fund Holdings of Currency	266.27	92.94
Reserve position in Fund	20.25	7.07

III. **SDR Department:**	SDR Million	%Allocation
Net cumulative allocation	34.24	100.0
Holdings	1.02	2.98

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

V. **Financial Arrangements:**

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

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

	Forthcoming				
	2007	2008	2009	2010	2011
Principal					
Charges/Interest	0.71	1.42	1.42	1.42	1.42
Total	0.71	1.42	1.42	1.42	1.42

Exchange Rate Arrangement and Exchange System

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

Since March 1, 1994, the market rates are determined in an interbank foreign exchange market. On June 21, 2007, the interbank rate of the dinar vis-à-vis the U.S. dollar was $1=TD 1.3071, equivalent to SDR 1= TD 1.97266.

Article IV Consultation

Tunisia is on the 12-month cycle. The last discussions of the Article IV consultation were held in Tunis from December 5 to 19, 2005 and the consultation was concluded by the Executive Board on May 24, 2006.

Technical Assistance

January 31–February 14, 1996: FAD—assessment of revenue impact of Association Agreement with EU.
March 31–April 4, 1997: STA—introduction of new methodological guidelines according to fifth edition of *Balance of Payments Manual*.
September 9–12, 1998: MAE—monetary management and development of the money market.
May 11–21, 1999: STA—quarterly national accounts.
May 13–18, 1999: STA—SDDS.
October 12–15, 1999: MAE—debt management practices.
October 17–27, 2000: STA—quarterly national accounts.
October 25–31, 2000; STA—SDDS meta data finalization.
December 17–21, 2001: MAE—management of central bank liquidity.
December 12–19, 2003: LEG—AML/CFT.
May 18–19, 2004: MFD—technical assistance needs assessment.
July 1–15, 2004: STA—government finance statistics.
January 24–February 5, 2005: FAD—tax policy.
April 7–22, 2005: STA—ROSC, data module.
September 8–21, 2005: FAD —tax administration.
January 16–31, 2006: MFD —FSAP update (mission 1).
March 27–31, 2006: MFD —FSAP update (mission 2).
February 5–15, 2007: MCM—monetary policy.

Resident Representative: None

ANNEX II. FINANCIAL RELATIONS WITH THE WORLD BANK

(As of May 31, 2007)

1. The World Bank's portfolio in Tunisia has a total of 18 active operations and 118 closed loans, of which 10 International Development Agency (IDA) credits amounting to $75.2 million net of cancellations. Cumulative net commitments represent $5.1 billion. Of this total, $3.8 billion has been repaid. Net commitments for the 18 current operations amount to about $0.8 billion.

2. The Country Assistance Strategy (CAS) was approved by the Board on June 3, 2004. It proposes to assist the Government of Tunisia (GOT) in addressing three key challenges: (a) strengthen the business environment to support the development of a more competitive, internationally integrated private sector and improve competitiveness of the Tunisian economy; (b) enhance skills and employability of graduates and labor force in a knowledge economy; and (c) improve the quality of social services through enhanced efficiency of public expenditures. The CAS progress report is currently being prepared, with a Board presentation scheduled in end-August 2007. It notes that, while the CAS is overall on track and remains fully relevant for Tunisia's key development challenges, the low level of private investment constitutes a major concern, threatening growth and job creation.

3. Bank lending is a mix of long-term investments in infrastructure and social sector financing, and development policy lending to support reforms at the sectoral and macroeconomic reforms. Recent loans include: Tunis West Sewerage ($66.8 million) approved in July 2006 and Sustainable Solid Waste Management ($22.0 million) approved in March 2007. This latter project is the first of its kind in Tunisia, which will incorporate, as part of a Bank investment project, a component on carbon emission reduction and provide Bank assistance in accessing the emerging global market of carbon finance under the Clean Development Mechanism of the Kyoto Protocol. An additional financing of $6.0 million is scheduled to be approved in July for the Export Development II project.

4. Preparation is ongoing for the following projects: Water Sector Investment II, Energy Efficiency and Capacity Building Rural Development.

5. Despite the fact that the quality of the portfolio is satisfactory, cumbersome procurement procedures and slow implementation pace—especially in the rural development portfolio—are affecting the portfolio performance. A Country Portfolio Performance Review (CPPR) was carried out in May 2005 with special focus on procurement issues. An action plan was designed to address the key constraints identified and is being implemented jointly by the Bank and counterpart teams.

6. Past analytical work includes studies of employment challenges, poverty trends, private participation in infrastructure, public debt management, and tourism. The last Development Policy Review (DPR) was prepared in 2003 in order to assess Tunisia's key

challenges and policy priorities in the years ahead. It provided the analytical basis for the current Country Assistance Strategy. GOT has requested a new DPR for FY08.

7. Recent work includes Country Financial Accountability and Procurement Assessments, a Report on the Observance of Standards and Codes (ROSC), audit and accounting module, and analytical work in education, health and agriculture. An update of the Financial Sector Assessment Program (FSAP) conducted jointly with the IMF has just been completed. Three subregional Maghreb studies (covering Tunisia, Morocco, and Algeria) were completed in 2006 and 2007. These studies focus on: (a) the textiles and clothing sector and the impact of MFA dismantling; (b) economic diversification; and (c) a subregional study on Maghreb regional economic integration and on the link between policy reforms in the service sectors and economic performance in the region.

8. Ongoing analytical work includes studies on service liberalization and export competitiveness, small and medium enterprises (efficiency of technical centers, access to land and access to finance), firm competitiveness (survey of firm leaders) and on skills development, social insurance and employment.

9. In addition, the World Bank is providing technical assistance on a regular basis on issues such as public debt management, performance-based budgeting, the promotion of the knowledge-based economy and productivity analysis. The Bank also provides multi-year support on employment and labor market issues as part of a Programmatic Economic and Sector Work.

Financial Relations with the World Bank

(As of May 31, 2007)

	Total Net Commitments	Undisbursed Balance
	(In million of U.S. dollars)	
IBRD lending operations		
118 loans closed 1/	4,346.9	
18 active loans		
-MP Ozone Depleting Substitutes	5.1	1.6
-Agric. Support Services	18.1	12.8
-Water Sector Investment Project	103.0	7.4
-GEF Protected Areas Management.	5.1	3.0
-Cultural Heritage	17.0	18.4
-Transport Sector Investment II	37.6	26.9
-NW Mountainous & Forestry Areas Development	34.0	30.2
-Municipal Development III	78.4	31.2
-Export Development II	35.8	26.2
-Education PAQSET II	130.3	77.1
-ICT Sector Development	13.1	10.9
-ECAL IV	150.0	72.2
-GEF Energy Efficiency Program/Industry	8.5	6.7
-GEF Gulf of Gabes	6.3	5.4
- Urban Water Supply	38.0	40.5
- Higher Education Reform Support II	76.0	80.0
- Sustainable Solid Waste Management	22.0	22.4
- Tunis West Sewerage	66.8	68.9
Total active loans	845.1	541.8
Repayments 2/	3,825.9	
Debt outstanding 2/	1,460.3	

	2001	2002	2003	2004	2005	2006	2007
Net lending by the World Bank (by fiscal year) 3/							
Commitments	75.9	252.5	112.4	166.3	163.1	114.0	88.8
Disbursements	174.6	226.7	142.5	238.6	119.4	190.7	83.2
Debt service	223.1	229.8	258.0	305.1	303.1	301.4	399.2
Principal	146.3	149.6	175.9	224.8	230.5	236.4	328.9
Interest 5/	76.8	80.2	82.1	80.3	72.6	65.0	70.3
Net transfer 6/	-48.5	-3.1	-115.5	-66.5	-183.7	-110.7	-316.0

1/ Less cancellations, includes adjustment lending, does not include guarantees.
2/ As of March 31, 2007.
3/ Fiscal years start July 1 and end June 30.
4/ Does not include $184 million for guarantee on Jorf Lasfar electricity project.
5/ Includes charges.
6/ Equal to disbursement minus debt service.

ANNEX III. STATISTICAL ISSUES

1. Overall, available economic and financial data are adequate for surveillance and have generally been provided to the Fund on a regular and timely basis. Most of those data are also made available to the public. Tunisia subscribed to the SDDS in June 2001 and its metadata are posted on the Dissemination Standards Bulletin Board (DSBB). A data ROSC was published in August 2006, following a mission that took place in April 2005.

Real Sector Statistics

2. Data on GDP by economic sector are disseminated at current and constant prices. Work is well advanced toward the full adoption of the *System of National Accounts 1993* (*1993 SNA*). Statistical techniques are adequate for the annual accounts but need some refinement for the quarterly estimates. Source data for the quarterly national accounts could be further diversified to improve coverage. Currently, an outdated base year (1990) is used for the constant price series. A new series using 2000 as base year is expected to be released in the near future.

3. Data provided for publication in the *International Financial Statistics (IFS)* on real sector developments is satisfactory and most data are reported in a timely manner, although export and import price and volume indices are reported with a long lag. Data on employment, unemployment, and wages should be collected and reported on a more frequent basis.

Government Finance Statistics

4. In addition to the information reported in the SDDS, government finance data are collected by the staff at the time of the Article IV consultation mission. Regarding data for publication, GFS cash data up to 2006 have been published in the *Government Finance Statistics Yearbook 2006.* Data cover budgetary central government and consolidated central government. Tunisia does not report monthly or quarterly data for publication in the *IFS*.

External Sector Statistics

5. Statistics for balance of payments (BOP) and international investment position (IIP) are compiled by the Central Bank of Tunisia (CBT), following the methodology of the fifth edition of the *Balance of Payments Manual,* (*BPM5)*. The BOP statistics are prepared on a quarterly basis and the IIP on an annual basis, complying with SDDS requirements. However, Tunisia does not report quarterly data for redissemination in IMF publications. The CBT issues preliminary monthly statistics, mostly prepared on the basis of banks' settlements with nonresidents. BOP statistics are generally adequate for annual surveillance, although greater detail on the financial account would be desirable. However, the 2005 data ROSC mission noted that remittances of Tunisian workers abroad are classified as income instead of current transfers in national publications (while they are correctly classified in data reported

to STA), and that reinvested earnings of foreign direct investments are not recorded in the balance of payments. As an SDDS subscriber, Tunisia reports reserves data following the *International Reserves and Foreign Currency Liquidity—Operational Guidelines* (*Reserves Template*) since June 2001.

Monetary and Financial Statistics

Monetary statistics compiled by the CBT are broadly based on the *1984 Guide to Money and Banking Statistics in International Financial Statistics*. Although monetary statistics meet SDDS requirements, there is room for improvement. For example, banks' claims on the rest of domestic sector (other than central government and financial corporations) are not fully sectorized; monetary gold is valued at a fixed price; and accrued interest on deposits is not included in the outstanding value of these deposits. The CBT has initiated a plan to migrate to the methodology recommended in the *Monetary and Financial Statistics Manual* (2000). The CBT reported to STA test data on 1SR, which is the Standard Report Form for central bank data for December 2004 and October 2005. For publication in *International Financial Statistics-Supplement,* the CBT also could report to STA the Standard Report Forms (at least forms 1SR, 2SR, and 5SR) on a regular monthly basis.

Tunisia: Table of Common Indicators Required for Surveillance

AS OF JUNE 28, 2007

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]	Memo Items: Data Quality – Methodological soundness[7]	Data Quality – Accuracy and reliability[8]
Exchange Rates	Current	Current	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	May 2007	Jun. 2007	M	M	M		
Reserve/Base Money	May 2007	6/14/07	M	M/W	M	LO, O, LO, LO,	LO, O, O, O, LO
Broad Money	Apr. 2007	5/21/07	M	M/W	M		
Central Bank Balance Sheet	May 2007	6/14/07	M	M/W	M		
Consolidated Balance Sheet of the Banking System	Apr. 2007	5/21/07	M	Q	Q		
Interest Rates[2]	Current	Current	D	D	D		
Consumer Price Index	May 2007	6/15/07	M	M/W	M		
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2006	Apr. 2006	A	A	A	LO, LO, LO, O	O, O, O, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	May 2007	Jun. 2007	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q1 2007	Apr. 2007	Q	Q	Q		
External Current Account Balance	Q1 2007	Apr. 2007	Q	Q/W	Q	LO, O, LO, LO	O, O, O, O, LO
Exports and Imports of Goods and Services	May 2007	Jun. 2007	M	M	M		
GDP/GNP	Q4 2006	Apr. 2007	Q	Q/W	Q	LO, O, LNO, LNO	LO, O, LO, O, LNO
Gross External Debt	Q4 2006	Apr. 2007	Q	W	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), weekly (W), monthly (M), quarterly (Q), annually (A), irregular (I); and not available (NA).
[7] Reflects the assessment provided in the data ROSC Substantive Update (published on August 7, 2006, and based on the findings of the mission that took place during April 7-22, 2005) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[8] Same as footnote 7, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

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IMF Executive Board Concludes the Article IV Consultation with Tunisia

On August 3, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Tunisia.[1]

Background

Effective economic management and an outwards-oriented development strategy have contributed to placing Tunisia's economic performance over the past decade among the best in the region, with real GDP growth averaging almost 5 percent in a stable macroeconomic environment. Over the past two years, the Tunisian economy has shown resilience in the face of surging prices of oil and other imported commodities, sustaining relatively strong growth while maintaining macroeconomic stability.

Real GDP growth accelerated from 4 percent in 2005 to 5.4 percent in 2006 owing to a rebound in agricultural output, expansion of nontextile manufacturing, and vitality of the services sector. Robust income growth and abundant liquidity boosted domestic demand. However, the unemployment rate remained unchanged at 14.2 percent in 2006. Inflation declined rapidly after a spike in the first half of 2006, following the monetary policy tightening by the Central Bank of Tunisia's (BCT) in the second half.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the August 3, 2007 Executive Board discussion based on the staff report.

The current account deficit widened, but the balance of payments recorded a large surplus owing to privatization receipts, which helped reduce total external debt from 65.4 percent of GDP in 2005 to 59.1 percent in 2006. Fiscal policy has been prudent. Strong nontax revenue and expenditure restraint reduced the 2006 budget deficit to 2.9 percent of GDP, significantly lower than the 3.6 percent budget forecast.

Prudential indicators significantly improved in 2006 relative to 2003 with nonperforming loans (NPLs) as a ratio of total loans declining from 24 percent to 19.2 percent and provisions-to-NPLs ratio increasing from 43.1 percent to 49.2 percent.

The short- and medium-term outlook remain positive. Real GDP growth is projected to continue to accelerate to reach about 6 percent in 2007, owing to strong agricultural output, a recovery in textiles and clothing, and buoyant services sector exports. Inflation should remain subdued and the fiscal and external deficits would be broadly unchanged. However, the positive short-term outlook hinges on agricultural output returning to trend, oil prices remaining below $70 a barrel, and growth in the EU—Tunisia's main export market—not faltering.

Tunisia's key challenge is to create enough jobs for the fast-growing university graduate population while reinserting the already large number of unemployed. This is the overarching objective of the recently released XIth Plan which seeks to boost annual growth to more than 6 percent during 2007–11 by continuing to move the Tunisian economy toward a knowledge-based, high value-added economy while deepening its global integration.

Tunisia continues to improve the quality and dissemination of statistical data and increase the transparency of its economic policies. Tunisia has published all Executive Board documents and staff mission statements in recent years.

Executive Board Assessment

Executive Directors agreed with the thrust of the staff appraisal. They commended the Tunisian authorities for their skillful macroeconomic management and commitment to structural reforms, which contributed to Tunisia's strong economic performance over the past decade. Growth has been steady, inflation has been contained, financial sector vulnerabilities are being addressed, and the public debt has been placed on a downward path. In the period ahead, the key challenge will be to reduce the relatively high level of unemployment, particularly among university graduates. Directors agreed that the authorities should continue their efforts to accelerate the pace of reforms and further strengthen the macroeconomic position, in order to raise growth and reduce unemployment, while enhancing the economy's flexibility and resilience as it becomes more integrated into the world economy.

Directors assessed the short- and medium-term outlook as positive, and the current macroeconomic policy mix as appropriate and consistent with external stability. They encouraged the authorities to remain vigilant to risks of overheating considering the recent increase in the price of petroleum products, the likely structural nature of excess liquidity, and the impact of sizable infrastructure projects. Close coordination of fiscal and monetary policies is important.

Directors praised the authorities for their prudent fiscal policy. Fiscal consolidation should continue in order to maintain long-term fiscal sustainability in the face of growing budget pressures, particularly from population ageing and declining nontax and tariff receipts. Accordingly, the tax base should be broadened, more efficient spending promoted, and early debt retirement pursued. Given expectations of persistently high oil prices in the medium to long term, increasingly costly fuel subsidies should be phased out.

Directors welcomed the recent measures to restore the financial position of the social security system over the medium term, and noted the importance of accelerating the planned comprehensive reform of the system. They observed that a more forward-looking fiscal framework would assist in the analysis of medium- and long-term budgetary issues related to population ageing.

Directors considered that the current level of the exchange rate is broadly appropriate. In view of the plans to move to inflation targeting over the medium term, Directors called on the authorities to continue enhancing the flexibility of the exchange rate and promoting development of the money and foreign exchange markets, by reducing the central bank's role in these markets. They also advised further price liberalization as the relatively high share of administered prices in the consumer price index could complicate the conduct of monetary policy, particularly in the context of an inflation targeting framework. Finally, Directors encouraged the central bank to continue informing market participants of the reform process and its implications, and to strengthen its research and forecasting capacity.

Directors welcomed the authorities' comprehensive strategy to reform the financial system based on the Financial Sector Assessment Program and its update, which has already had positive results. They supported the objectives of reducing the incidence of nonperforming loans and increasing provisioning on remaining nonperforming loans by end-2009, although the latter may require some bank recapitalization. A dynamic and efficient banking sector will be essential for higher growth and sound transition to a fully liberalized capital account. Directors encouraged the authorities to consider additional measures to strengthen bank management, revitalize credit culture, improve risk management, and further enhance financial transparency.

Directors commended the authorities for the progress made in integrating the Tunisian economy into the regional and global economy. They looked forward to further progress in simplifying and reducing multilateral tariffs. Continued efforts to make the labor market more flexible, liberalize the services sector, and improve the investment climate would strengthen the economy's competitiveness and overall flexibility, and help Tunisia take full advantage of the benefits of trade liberalization.

Directors welcomed the progress made in implementing measures to combat money laundering and the financing of terrorism, and supported the authorities' request for Fund technical assistance in this area.

It is expected that the next Article IV consultation with Tunisia will be held on the standard 12-month cycle.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise

Table 1. Selected Economic Indicators, 2002–07

(Quota: SDR 286.5 million)
(Population: 10.0 million; 2005)
(Per capita GDP: $3,117; 2006)
(Poverty rate: 4.1 percent; 2000)
(Main export: textiles, electronic and mechanical goods, tourism; 2006)

	2002	2003	2004	2005	Est. 2006	Proj. 2007
Output and Prices	(Annual percentage change)					
Real GDP (market prices)	1.7	5.6	6.0	4.0	5.4	6.0
Consumer price (end of period)	1.6	4.5	1.2	3.7	3.3	3.0
Consumer price (period average)	2.7	2.7	3.6	2.0	4.5	3.0
Investment and Saving	(In percent of GDP)					
Gross capital formation	25.7	25.0	24.5	22.0	23.8	24.3
Of which: Government 1/	7.5	7.2	7.0	6.4	6.2	6.1
Gross national savings	22.1	22.1	22.5	20.9	21.5	21.8
Of which: Government 1/	4.7	4.1	4.5	3.3	3.2	3.0
Public Finances 2/	(In percent of GDP)					
Total revenue, excluding grants and privatization	24.4	23.7	23.8	23.6	23.8	22.9
Expenditure	27.8	27.1	26.6	26.9	26.7	25.8
Central government balance (excluding grants and privatization receipts)	-3.5	-3.4	-2.8	-3.2	-2.9	-2.9
Central government primary balance (excluding grants and privatization receipts)	-0.4	-0.6	0.0	-0.4	-0.1	-0.4
Total government debt	61.5	60.5	59.4	58.3	54.0	52.5
Monetary Sector	(Annual percentage change, unless otherwise indicated)					
Credit to the economy	6.7	4.6	5.3	6.3	6.7	7.9
Base money	1.8	5.5	12.2	21.9	17.5	17.1
Broad money	5.2	6.3	10.3	11.0	11.5	9.1
Velocity of broad money	1.6	1.7	1.6	1.6	1.5	1.5
Three-month treasury bill rate (period average, in percent)	6.1	5.5	5.1	5.1	5.1	...
External Sector	(In percent of GDP, unless otherwise indicated)					
Exports of goods (in US$, percentage change)	3.8	17.1	20.6	8.4	9.5	17.3
Imports of goods (in US$, percentage change)	-1.9	14.7	17.6	2.9	12.4	16.1
Merchandise trade balance	-10.1	-9.1	-8.6	-6.8	-8.2	-8.2
Current account excluding official transfers	-3.5	-2.9	-2.0	-1.1	-2.3	-2.5
Current account including official transfers	-3.2	-2.7	-1.6	-0.6	-1.9	-2.1
Foreign direct investment	3.6	2.1	2.1	2.6	10.3	2.6
Total external debt	67.5	66.8	66.5	65.4	59.1	58.9
Gross reserves (in US$ billions)	2.3	3.0	4.0	4.4	6.8	7.8
In months of next year imports of goods and services	2.7	3.0	3.5	3.7	5.1	5.0
In percent of short-term external debt (on remaining maturity basis)	56.9	67.4	81.7	98.1	115.7	122.3
Memorandum Items:						
Nominal GDP (in US$ billions)	22.4	26.6	29.3	27.6	31.7	34.0
Unemployment rate (in percent)	14.9	14.3	13.9	14.2	14.2	14.1
Net imports of petroleum products (in US$ millions)	221.7	328.8	407.1	393.5	631.0	92.8
Local currency per U.S. dollar (period average)	1.4	1.3	1.2	1.3	-3.6	...
Real effective exchange rate (annual average, percentage change)	-0.2	-5.0	-3.4	-4.5	-0.8	...
Stock market index 3/	1119.2	1250.2	1331.8	1615.1	2331.1	2529.0

Sources: Tunisian authorities; and Fund staff estimates.
1/ Excluding public enterprises.
2/ The fiscal year is the calendar year.
3/ TUNINDEX (1000 = 4/1/1998). The 2007 data as of June 22, 2007.

Statement by Abbas Mirakhor, Executive Director for Tunisia and Sadok Rouai, Senior Advisor to Executive Director August 3, 2007

Our Tunisian authorities wish to thank staff for the balanced report and the insightful Selected Issues Paper (SIP) and express their gratitude for the valuable support and guidance they have received from the Executive Board, management and staff. As usual, the authorities consent to the publication of the staff papers. The 2007 Article IV consultation discussions coincided with the final stage of the adoption of authorities' medium-term strategy under the XI^{th} five-year Plan covering the period 2007–11 (detailed in Box 1) and allowed a mutual assessment of the progress achieved and the challenges ahead.

Macroeconomic and financial developments in 2006 are encouraging and short- to medium-term outlook is favorable. GDP growth reached 5.4 percent in 2006, reflecting a more resilient and diversified economy, and is projected to accelerate to 6 percent in 2007, benefiting from strong export performance, including in the textiles and clothing sector which is performing reasonably well despite strong world competition since the expiration of the Agreement on Textiles and Clothing. Inflation has been brought back to below 2.5 percent for the first half of 2007 following tightening of monetary policy by the Central Bank of Tunisia (Banque Centrale de Tunisie, BCT) in the second half of 2006. Prudent fiscal policy and improved nontax revenues contained the fiscal deficit under 3 percent despite high oil prices. Using the bulk of privatization receipts to prepay external debt in 2006/07 has been helpful in improving debt indicators and the assessment by rating agencies of Tunisia's external position.

In recent years, the Fund's surveillance agenda has been aligned with the authorities' medium-term reform program. The overriding objectives of the authorities, reiterated in the XI^{th} Plan, are job creation for an increasing number of university graduates and improvement in living standards. To reach these objectives, the authorities' strategy centers on safeguarding macroeconomic stability and on continued implementation of comprehensive structural reforms, particularly financial liberalization, to promote private investment and further integrate Tunisia into the world economy. Since the completion of the 2002 FSAP, discussions between the authorities and staff have been focused on three major policy areas i.e. fiscal consolidation, modernization of the monetary and exchange rate policy framework, and strengthening the banking sector. These discussions are being complemented by targeted technical assistance for which the authorities are grateful.

Within the context of better than projected fiscal position, progress in tax reform and administration, gradual oil prices adjustments, and improvement in debt indicators, the discussions on fiscal policy centered on medium- to long-term issues, in particular social security reform. The authorities agree with staff on the importance of ensuring long-term financial sustainability for the social security funds in view of the rapid demographic changes and population aging as well as their objective of raising the coverage from 90 percent of active population in 2006 to 95 percent by 2009. Given the complexity of the reforms required to reestablish the long-term sustainability of the system, the authorities have adopted a two-pronged strategy. First, to eliminate the recent deficit of the social security funds, the authorities have taken a number of corrective measures including an increase in pension contributions and the adoption by Parliament of an ambitious health care reform package designed to contain health care costs and improve the delivery of health services. These measures should eliminate the deficit over the next few years. Second, the authorities have undertaken a consultative process with all stakeholders to agree on a package of reforms that will ensure the viability of the system through 2030.

The BCT will continue to conduct monetary policy with a tightening bias to ensure that monetary expansion remains manageable and inflation under control. Concomitantly, the BCT is pursuing its strategy of gradual move toward full capital account liberalization, free-floating exchange rate, and an inflation-targeting framework. The Fund's contribution in these areas were very helpful, including a recent MCM technical assistance mission to help the BCT progress toward an inflation-targeting framework and a workshop conducted by staff in the context of the Article IV consultation discussions based on the background studies to the staff report. The authorities consider that the recent amendment of the BCT law to set price stability as the main objective of monetary policy and to strengthen the independence of the central bank are important steps that need to be consolidated along the lines of staff recommendations summarized in Box 3 of the report. They also recognize the need to develop their technical capacity in the areas of research and forecasting. The authorities share staff's assessment regarding the exchange rate level and agree that, going forward, there is a need to clarify the role of the exchange rate in the monetary policy framework. It is important to note that discussions on exchange rate regime and policies between the staff and the authorities have always been characterized by analytically-based and candid exchange of views and relevant data. The authorities consider that the current managed float as an intermediate step toward a floating exchange rate regime and are committed to strengthen their analytical capacity and to increase the flexibility of the exchange rate in both directions consistent with their medium-term strategy of gradual capital account liberalization.

To build on the significant improvement in banking soundness indicators of the past few years, including the trend reduction in the level of NPLs, the authorities remain committed to banking sector reform in view of the importance and contribution of this sector to the promotion of private investment and the increasing integration of the economy into global financial markets. They agree with staff that the level of NPLs remains relatively high. They consider, however, that under the policies agreed upon in the context of the 2006 FSAP update, as detailed in Box 4, the intermediate objective of reducing NPLs to 15 percent of total loans by 2009 is achievable. They recognize, however, that further efforts are needed to raise the provisioning ratio to 70 percent but consider that the growing role of private banks, including through further privatizations, will contribute to strengthening the banking sector.

Finally, the authorities consider that improvement in the investment climate and additional investments in infrastructure are important to support the private sector and the further opening of the economy. In this regard, while they are gratified with the ranking received from international organizations, such as the World Economic Forum, and the first rating upgrade to A- by the Japanese agency R&I[1], they see room for further improving the competitiveness of the economy and promoting private investment. Thus, they are seeking to improve their ranking in the World Bank's "Doing Business." A high-level inter-departmental committee has been set up with the objective of reviewing scores and rankings by international organizations and proposing the necessary reforms to the government.

[1] The BCT took advantage of this upgrade to sell recently 30 billion yen in 3.2 percent 20-year Samurai bonds.