TUNISIA: Correspondence & Memos 1988

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Office Memorandum

To: Mr. Anjaria October 7, 1988

From: P. Lenain

Subject: Tunisia--Balance of Payments

As you requested, please find attached revised estimates and projections for the 1988 and 1989 balance of payments of Tunisia.

The 1988 estimate is based on the latest data prepared by the Tunisian authorities and transmitted by Mr. Petersen. The overall balance of payments surplus is now estimated to be about SDR 180 million, as compared to SDR 77 million in the program. This improvement results mainly from better exports, tourist spending, and workers' remittances than earlier envisaged. These positive developments more than compensate for larger imports.

The 1989 estimate is based on the WEO commodity price projections, the volume of external trade envisaged earlier, the assumption of an agricultural rebound from the drought-affected present outcome, and on the assumption that "Lybian tourism" and related imports will slow down. Under these assumptions, the current account and the overall balance of payments are projected to reach better outcomes than previously envisaged.

The debt service and the debt outstanding data have not been revised. I will include the 1987 World Bank Debt report system estimates before the mission's departure.

Separately, Mr. Leipold (Consultation Practices Division) advised me that:

- A statistical appendix can be prepared instead of the RED if the authorities agree; this is encouraged by the Board.

- A compromise between an RED and a statistical appendix can be a brief summary of recent economic developments followed by statistical tables.

- Because the last Article IV discussion with Tunisia was completed on October 15, 1987, a notification of delay would have to be transmitted to the Board if the next discussion takes place after January 15, 1989.

cc: Mr. Khallouf
Mr. Petersen

October 7, 1988

Table 1 --Tunisia : Balance of Payments, 1985-93
(in millions of SDRs)

	1987	1988		1989
	estimate	prog.	est.	IMF
Trade balance	-563	-770	-934	-824
Exports	1,653	1,672	1,732	1,796
Imports, fob	2,216	2,442	2,666	2,621
Services and transfers	487	481	754	595
Non-factor services	473	512	763	616
Factor services	14	-32	-9	-21
Current account	-76	-289	-180	-230
Capital account	103.6	365.7	360.2	358.9
Non-debt-creating capital flows	98.1	112.6	117.1	131.5
Grants	26.7	27.0	31.5	35.6
Direct foreign investment (net)	71.4	85.6	85.6	95.8
Debt-creating capital flows	555.3	775.5	780.8	781.1
Long term capital	354.6	540.4	540.4	544.9
Contracted loans		486.4	486.4	340.0
Additional loans		54.0	54.0	204.9
Medium term capital	200.7	235.1	240.4	236.2
Contracted loans		63.0	63.0	26.2
Additional loans		172.0	177.3	210.0
Amortization	518.4	522.4	537.7	553.7
Long term capital	191.7	219.7	219.7	243.2
Medium term capital	326.7	302.7	318.0	310.5
Short term capital	-31.4	0.0	0.0	0.0
Overall Balance	27.4	76.6	180.1	129.1
Financing	-27.4	-76.6	-180.1	-129.1
Other foreign assets, net	-68.4	-123.5	-227.0	-192.9
Assets (incr. -)	-125.1	...	...	...
Liabilities (red. -)	56.7	...	...	...
Net use of Fund credit	41.0	46.9	46.9	63.8
Purchases	41.0	46.9	46.9	63.8
Repurchases	0.0	0.0	0.0	0.0
AMF	5.6	0.0	0.0	-7.0
Memorandum item				
Current a/c. in % of GDP	-1.0%	-3.4%	-2.1%	-2.4%
Debt service ratio	26.8%	26.4%	24.5%	25.7%
Gross Reserves 7/	376.9	500.4	603.9	789.8
in months of imports	2.04	2.46	2.72	3.62

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Table 2 --Tunisia : Exports of goods, 1985-1993
(in millions of SDRs)

	1987 estimate	1988 prog.	1988 est.	1989 IMF
Energy	390.4	299.9	297.3	276.9
volume at 1986 prices	294.8	274.9	265.8	235.8
unit values index	132.4	109.1	111.9	117.5
Phosphates and derivatives	307.0	336.0	382.7	392.3
volume at 1986 prices	320.5	321.6	323.3	331.3
unit values index	95.8	104.5	118.4	118.4
Agriculture	213.3	216.2	220.4	229.5
volume at 1986 prices	193.8	185.5	187.3	195.0
unit values index	110.0	116.5	117.7	117.7
Textile	514.9	567.8	569.6	614.3
volume at 1986 prices	429.8	445.8	440.5	458.1
unit values index	119.8	127.4	129.3	134.1
Mechanic and electric industry	131.5	148.2	153.7	167.9
volume at 1986 prices	109.8	115.6	118.7	125.1
unit values index	119.7	128.2	129.4	134.2
Other goods	95.5	103.6	108.0	115.3
volume at 1986 prices	80.3	81.1	84.0	86.6
unit values index	119.0	127.8	128.5	133.3
TOTAL Exports	1652.5	1671.6	1731.6	1796.3
volume at 1986 prices	1429.0	1424.5	1419.6	1431.9
unit values index	115.6	117.3	122.0	125.4

Source : Tunisian Authorities ; Ministry of Planning and Staff Project

October 7, 1988

Table 3 -- Tunisia : Imports of goods, 1985-1993
(in millions of SDRs)

	1987	1988		1989
	estimate	prog.	est.	IMF
Energy	246.1	217.1	211.3	221.9
volume at 1986 prices	228.6	222.5	197.8	197.8
unit values index	107.6	97.6	106.8	112.2
Capital goods	402.0	450.8	459.4	484.1
volume at 1986 prices	337.7	354.1	356.1	361.8
unit values index	119.0	127.3	129.0	133.8
Raw mat. & semi-finished products	850.9	945.9	1017.0	1087.4
volume at 1986 prices	762.5	807.2	844.0	870.2
unit values index	111.6	117.2	120.5	125.0
Food and agriculture	241.6	326.8	409.8	298.9
volume at 1986 prices	254.3	314.4	350.7	252.0
unit values index	95.0	103.9	116.8	118.6
Consumer goods	601.1	639.7	719.7	674.3
volume at 1986 prices	504.9	502.4	557.9	504.0
unit values index	119.1	127.3	129.0	133.8
TOTAL Imports, c.i.f.	2341.7	2580.2	2817.3	2766.4
volume at 1986 prices	2088.1	2200.5	2306.6	2185.8
unit values index	112.1	117.3	122.1	126.6
Freight and Ins.	125.7	138.6	151.3	145.7
TOTAL Imports f.o.b	2215.9	2441.6	2666.0	2620.7

Source : Tunisian Authorities ; Ministry of Planning and Staff Project

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Table 4 -- Tunisia : Services and Transfers, 1985-1993
(in millions of SDRs)

	1987	1988		1989
	estimate	prog.	est.	IMF
1. Non-factor services				
Tourism credits	530.1	586.4	855.6	733.3
volume at 1986 prices	501.5	547.0	726.0	600.0
unit values index	105.7	107.2	117.9	122.2
Other credits	426.9	461.1	467.0	489.1
volume at 1986 prices	369.9	373.8	375.0	378.7
unit values index	115.4	123.3	124.5	129.2
Tourism debits	73.5	90.1	90.1	100.0
Other debits	410.0	444.9	469.3	506.8
Balance of non-factor services	473.4	512.5	763.3	615.6
of which : Credits	957.0	1047.5	1322.6	1222.4
Debits	483.5	535.0	559.3	606.8
2. Factor Services				
Workers remittances	376.1	346.8	393.6	401.5
Other factor services credits	33.7	40.5	45.0	49.5
Interest payments	290.0	297.2	319.7	338.9
Of which : IMF charges	8.0	12.9	12.9	16.1
Other factor services debits	106.1	121.6	127.9	133.0
Total balance	13.7	-31.5	-9.0	-20.9
Factor services credits	409.8	387.3	438.6	451.0
Factor services Debits	396.1	418.8	447.6	471.9

October 7, 1988

Table 5 -- Tunisia : Medium-Term External Debt Projections, 19

	1987 estimate	1988 prog.	1988 est.	1989 IMF
(in millions of SDRs)				
1. Debt Service				
Med. & l.term (incl. AMF and g	800.4	806.8	844.6	876.5
Interest	282.0	284.4	306.9	322.8
Principal	518.4	522.4	537.7	553.7
IMF	8.0	12.9	12.9	16.1
Charges	8.0	12.9	12.9	16.1
Repurchases	0.0	0.0	0.0	0.0
Total debt service (incl.gap-f	808.4	819.6	857.4	892.6
Interest	290.0	297.2	319.7	338.9
Pricipal	518.4	522.4	537.7	553.7
2. Debt outstanding	4183.6	4492.4	4464.0	4757.9
Medium and long term debt	3,978	4,240	4,221	4,448
long-term	2,601	2,922	2,922	3,224
medium-term	1,376	1,317	1,299	1,224
AMF	15	15	5.6	8.3
Fund Credit	191	238	237.6	301.4
Debt service in % of curr. receipts				
Total debt service	26.8%	26.4%	24.5%	25.7%
Interest	9.6%	9.6%	9.2%	9.8%
Pricipal	17.2%	16.8%	15.4%	16.0%
Excluding IMF	26.5%	26.0%	24.2%	25.3%
Interest	9.3%	9.2%	8.8%	9.3%
Pricipal	17.2%	16.8%	15.4%	16.0%
Total interest % GNP	3.9%	3.9%	4.2%	4.1%
IMF debt service/reserves	0.1%	0.2%	0.2%	0.2%
Debt in % of GDP				
Medium and long term excl gap-fi	53.3%	55.7%	55.4%	53.9%
Fund credit	2.6%	3.1%	3.1%	3.7%
TOTAL incl IMF	55.9%	58.8%	58.5%	57.6%

Office Memorandum

To: Mr. Anjaria August 11, 1988

From: Pier Luigi Parcu

Subject: Tunisia: Consequences of Additional Financing Availability

As discussed, please find attached some new hypotheses on the possible consequences of the additional financing for Tunisia. Hypothesis 1 is clearly unattractive as it increases the debt service ratio and the debt/GDP ratio without any long-term benefit.

Hypothesis 2 is similar to Hypothesis 1 but with more financing, some reserve accumulation, and again a deterioration of the external indicators. Nonetheless, Hypothesis 2 can be used as our new baseline once it is assumed that the additional financing is forthcoming. In fact, Hypothesis 3 builds a growth hypothesis on the baseline of Hypothesis 2.

Hypothesis 3 presents a quite desirable scenario in which real growth accelerates, and by 1993 both the debt service ratio and the current account deficit are better than those projected in the EFF program.

Hypothesis 4 is presented only to demonstrate how the assumption of an iterative multiplier effect rapidly leads to unplausible scenarios.

In synthesis, the growth hypothesis without multiplying effects, Hypothesis 3, is quite favorable and certainly suggests that the additional financing should be actively sought. Of course, this hypothesis, like the others, hinges on many parameters on which we are very uncertain.

Attachments

cc: Mr. Pujol
Mr. Petersen (o/r)
Mr. Khallouf
Mr. Lenain

Hypothesis 1

1. Tunisia receives per year in 1989-91 additional financing of SDR 70 million with a five-year grace period.

2. An interest rate of 4 percent in yen, corresponding to 8 percent in dinar terms is paid on the loan.

3. All the additional financing goes into imports and all imports go into consumption.

4. GDP grows by 0.2 percent per year due to trade effects (no lag).

5. There is no additional export growth.

Table . Tunisia: Balance of Payments, 1986-93 01-Jan

	1985	1986	1987	1988	1989	1990	1991	1992	1993
		Actual	Estim.			Projections			
					(In millions of SDRs)				
Current account	-573	-601	-103	-289	-349	-322	-291	-268	-187
Trade balance	-829	-833	-563	-770	-851	-880	-916	-968	-963
Exports, f.o.b.	1703	1507	1653	1672	1783	1929	2056	2224	2455
Energy	712	365	390	300	289	279	224	192	194
Nonenergy	991	1142	1262	1372	1494	1649	1832	2032	2261
Imports, f.o.b.	-2532	-2340	-2216	-2442	-2633	-2808	-2973	-3192	-3417
Energy	-341	-202	-233	-205	-222	-252	-243	-258	-301
Nonenergy	-2190	-2138	-1983	-2236	-2411	-2557	-2730	-2934	-3116
Nonfactor services (net)	335	286	462	513	544	601	672	741	814
Of which: tourism receipts	491	414	517	586	631	682	740	802	871
Transfers (net)	-80	-54	-2	-32	-42	-43	-47	-42	-39
Of which: receipts from worker's remittances	266	308	352	347	353	363	375	385	397
Interest on ext. debt	-253	-277	-272	-297	-316	-334	-358	-370	-386
Capital account	433	410	220	366	423	373	341	320	236
Grants	36	35	29	27	30	30	25	24	24
Direct and portfolio invest.	137	132	78	86	96	127	148	161	172
Medium and long term borrowing (net)	248	177	46	253	297	216	168	135	40
disbursements	641	644	555	776	850	838	766	691	605
long term borrowing	342	311	355	540	614	603	544	465	364
medium term borrowing	299	333	201	235	235	235	222	226	241
amortization	393	467	510	522	553	622	598	557	565
Short-term capital (including valuation adjustment, and errors and omissions)	12	67	68	--	--	--	--	--	--
Overall surplus or deficit (-)	-140	-190	117	77	74	51	50	52	49
Changes in reserves (inc. -)	140	190	-117	-77	-74	-51	-50	-52	-49
Use of Fund resources	0	150	41	47	64	-18	-51	-21	-12
Other items ,net (inc.)	140	41	-158	-123	-138	-33	1	-31	-37
Memorandum items:									
Current account def. / GDP (%)	-7.1%	-8.0%	-1.4%	-3.8%	-4.2%	-3.6%	-3.1%	-2.6%	-1.7%
Gross reserves (in months of imports)	1.0	1.3	2.0	2.5	2.9	2.8	2.6	2.6	2.5
Debt service ratio	21.6	27.9%	26.2%	26.4%	26.3%	29.1%	27.6%	22.9%	21.3%
Debt / GDP ratio	48.7%	56.1%	57.8%	60.6%	60.3%	58.2%	55.6%	52.6%	49.2%
Total additional borrowing requirement 1/	0	0	0	226	484	601	597	595	542
Long term borrowing	0	0	0	54	205	313	313	299	300
New concessional loans	0	0	0	0	70	70	70	70	0
Medium term borrowing	0	0	0	172	209	218	213	226	241

1/ Projected drawings on loans not contracted as of end 1987. All projected drawings for 1988 have already been identified. Projected drawings for the following years are not identified and could benefit from the availability of new sources of concessional financing. Substitution of long term financing for costly medium-term commercial borrowing would also improve the debt profile.

	1985	1986	1987	1988	1989	1990	1991	1992	1993
	(Annual changes in percent)								
Principal assumptions									
Real GDP	5.7%	-1.6%	5.8%	0.9%	5.3%	4.5%	4.0%	4.8%	4.4%
Inflation (GDP deflator)	4.7%	3.3%	7.6%	4.8%	6.5%	6.0%	5.7%	5.3%	5.1%
Real effective exchange rate (- deprec.)	-0.6%	-14.5%	-13.8%	-1.9%	...	...	...	...	...
Export volumes	...	5.7%	9.1%	3.3%	3.9%	4.5%	3.3%	5.2%	6.4%
(Nonenergy exports)	...	11.8%	13.3%	6.2%	7.0%	6.6%	7.4%	7.2%	7.4%
Import volumes	...	2.0%	-2.9%	9.2%	4.6%	3.5%	2.4%	4.1%	3.7%
(Nonenergy imports)	...	1.0%	-8.8%	8.5%	8.5%	3.9%	6.2%	5.1%	2.6%

Hypothesis 2

1. Tunisia receives per year in 1989-91 additional financing of SDR 140 million with a five-year grace period.

2. An interest rate of 4 percent in yen, corresponding to 8 percent in dinar terms is paid on the loan.

3. A reserve accumulation that stabilizes reserves to 3.0 months of imports is implemented in 1989 and maintained thereafter. The rest of the additional financing goes into imports and all imports go into consumption.

4. GDP grows by 0.4 percent per year due to trade effects (no lag).

5. There is no additional export growth.

Table . Tunisia: Balance of Payments, 1986-93 01-Jan

	1985	1986	1987	1988	1989	1990	1991	1992	1993
		Actual	Estim.			Projections			
					(In millions of SDRs)				
Current account	-573	-601	-103	-289	-419	-392	-361	-338	-187
Trade balance	-829	-833	-563	-770	-918	-942	-973	-1019	-941
Exports, f.o.b.	1703	1507	1653	1672	1783	1929	2056	2224	2455
Energy	712	365	390	300	289	279	224	192	194
Nonenergy	991	1142	1262	1372	1494	1649	1832	2032	2261
Imports, f.o.b.	-2532	-2340	-2216	-2442	-2701	-2870	-3029	-3243	-3395
Energy	-341	-202	-233	-205	-222	-252	-243	-258	-301
Nonenergy	-2190	-2138	-1983	-2236	-2478	-2618	-2786	-2985	-3094
N[illegible]tor services (net)	335	286	462	513	544	601	672	741	814
[illegible]ich: tourism receipts	491	414	517	586	631	682	740	802	871
Transfers (net)	-80	-54	-2	-32	-45	-51	-60	-61	-61
Of which: receipts from worker's remittances	266	308	352	347	353	363	375	385	397
Interest on ext. debt	-253	-277	-272	-297	-319	-342	-372	-389	-408
Capital account	433	410	220	366	493	443	411	390	236
Grants	36	35	29	27	30	30	25	24	24
Direct and portfolio invest.	137	132	78	86	96	127	148	161	172
Medium and long term borrowing (net)	248	177	46	253	367	286	238	205	40
disbursements	641	644	555	776	920	908	836	761	605
long term borrowing	342	311	355	540	684	673	614	535	364
[illegible]lium term borrowing	299	333	201	235	235	235	222	226	241
amortization	393	467	510	522	553	622	598	557	565
Short-term capital (including valuation adjustment, and errors and omissions)	12	67	68	--	--	--	--	--	--
Overall surplus or deficit (-)	-140	-190	117	77	74	51	50	52	49
Changes in reserves (inc. -)	140	190	-117	-77	-74	-51	-50	-52	-49
Use of Fund resources	0	150	41	47	64	-18	-51	-21	-12
Other items ,net (inc.)	140	41	-158	-123	-138	-33	1	-31	-37
Memorandum items:									
Current account def. / GDP (%)	-7.1%	-8.0%	-1.4%	-3.8%	-5.1%	-4.4%	-3.8%	-3.3%	-1.7%
Gross reserves (in months of imports)	1.0	1.3	2.0	2.5	2.8	2.7	2.6	2.5	2.6
Debt service ratio	21.6	27.9%	26.2%	26.4%	26.4%	29.3%	27.9%	23.4%	21.8%
Debt / GDP ratio	48.7%	56.1%	57.8%	60.6%	61.0%	59.6%	57.5%	54.9%	51.3%
Total additional borrowing requirement 1/	0	0	0	226	554	671	667	665	542
Long term borrowing	0	0	0	54	205	313	313	299	300
New concessional loans	0	0	0	0	140	140	140	140	0
Medium term borrowing	0	0	0	172	209	218	213	226	241

1/ Projected drawings on loans not contracted as of end 1987. All projected drawings for 1988 have already been identified. Projected drawings for the following years are not identified and could benefit from the availability of new sources of concessional financing. Substitution of long term financing for costly medium-term commercial borrowing would also improve the debt profile.

	1985	1986	1987	1988	1989	1990	1991	1992	1993
	(Annual changes in percent)								
Principal assumptions									
Real GDP	5.7%	-1.6%	5.8%	0.9%	5.4%	4.7%	4.2%	5.0%	4.4%
Inflation (GDP deflator)	4.7%	3.3%	7.6%	4.8%	6.5%	6.0%	5.7%	5.3%	5.1%
Real effective exchange rate (- deprec.)	-0.6%	-14.5%	-13.8%	-1.9%	...	...	...	...	...
Export volumes	...	5.7%	9.1%	3.3%	3.9%	4.5%	3.3%	5.2%	6.4%
(Nonenergy exports)	...	11.8%	13.3%	6.2%	7.0%	6.6%	7.4%	7.2%	7.4%
Import volumes	...	2.0%	-2.9%	9.2%	7.2%	3.1%	2.1%	3.8%	1.4%
(No[illegible]y imports)	...	1.0%	-8.8%	8.5%	11.4%	3.5%	5.9%	4.8%	0.3%

Hypothesis 3

1. Tunisia receives per year in 1989-91 additional financing of SDR 140 million with a five-year grace period.

2. An interest rate of 4 percent in yen, corresponding to 8 percent in dinar terms is paid on the loan.

3. A reserve accumulation that stabilizes reserves to 3.0 months of imports is implemented in 1989 and maintained thereafter. The rest of the additional financing goes into imports and 70 percent of the additional imports goes into investment.

4. GDP grows by 0.4 percent per year due to trade effects (no lag) and by a factor of 3.0 linked to the new investment (with one-year lag). The econometric spreadsheet shows the derivation of the coefficient for the effect of the additional investment on income; a slightly more prudent coefficient of 3.0 is assumed in the calculations.

5. Export growth increases by the equivalent of 50 percent of the increase in GDP.

6. Imports will additionally increase as a consequence of export growth and this new import increase will go into consumption without any additional multiplier effect on either investment, GDP, or exports.

Table . Tunisia: Balance of Payments, 1986-93 01-Jan

	1985	1986	1987	1988	1989	1990	1991	1992	1993
		Actual	Estim.			Projections			
					(In millions of SDRs)				
Current account	-573	-601	-103	-289	-384	-345	-295	-285	-157
Trade balance	-829	-833	-563	-770	-883	-894	-906	-965	-910
Exports, f.o.b.	1703	1507	1653	1672	1783	2063	2310	2585	2910
Energy	712	365	390	300	289	279	224	192	194
Nonenergy	991	1142	1262	1372	1494	1784	2086	2393	2716
Imports, f.o.b.	-2532	-2340	-2216	-2442	-2665	-2958	-3217	-3550	-3820
Energy	-341	-202	-233	-205	-222	-252	-243	-258	-301
Nonenergy	-2190	-2138	-1983	-2236	-2443	-2706	-2974	-3292	-3519
Nc[illegible] or services (net)	335	286	462	513	544	601	672	741	814
Of which: tourism receipts	491	414	517	586	631	682	740	802	871
Transfers (net)	-80	-54	-2	-32	-45	-51	-60	-61	-61
Of which: receipts from worker's remittances	266	308	352	347	353	363	375	385	397
Interest on ext. debt	-253	-277	-272	-297	-319	-342	-372	-389	-408
Capital account	433	410	220	366	493	443	411	390	236
Grants	36	35	29	27	30	30	25	24	24
Direct and portfolio invest.	137	132	78	86	96	127	148	161	172
Medium and long term borrowing (net)	248	177	46	253	367	286	238	205	40
disbursements	641	644	555	776	920	908	836	761	605
[illegible]g term borrowing	342	311	355	540	684	673	614	535	364
[illegible]ium term borrowing	299	333	201	235	235	235	222	226	241
amortization	393	467	510	522	553	622	598	557	565
Short-term capital (including valuation adjustment, and errors and omissions)	12	67	68	--	--	--	--	--	--
Overall surplus or deficit (-)	-140	-190	117	77	109	98	116	106	79
Changes in reserves (inc. -)	140	190	-117	-77	-109	-98	-116	-106	-79
Use of Fund resources	0	150	41	47	64	-18	-51	-21	-12
Other items ,net (inc.)	140	41	-158	-123	-173	-80	-65	-85	-67

Memorandum items:

	1985	1986	1987	1988	1989	1990	1991	1992	1993
Current account def. / GDP (%)	-7.1%	-8.0%	-1.4%	-3.8%	-4.7%	-3.9%	-3.1%	-2.8%	-1.4%
Gross reserves (in months of imports)	1.0	1.3	2.0	2.5	3.0	3.0	3.0	3.0	3.0
Debt service ratio	21.6	27.9%	26.2%	26.4%	26.4%	28.3%	26.2%	21.5%	19.8%
Debt / GDP ratio	48.7%	56.1%	57.8%	60.6%	61.0%	57.8%	54.4%	50.9%	46.8%
Total additional borrowing requirement 1/	0	0	0	226	554	671	667	665	542
Long term borrowing	0	0	0	54	205	313	313	299	300
New concessional loans	0	0	0	0	140	140	140	140	0

1/ Projected drawings on loans not contracted as of end 1987. All projected drawings for 1988 have already been identified. Projected drawings for the following years are not identified and could benefit from the availability of new sources of concessional financing. Substitution of long term financing for costly medium-term commercial borrowing would also improve the debt profile.

	1985	1986	1987	1988	1989	1990	1991	1992	1993
	(Annual changes in percent)								
Principal assumptions									
Real GDP	5.7%	-1.6%	5.8%	0.9%	5.4%	7.9%	6.8%	7.2%	6.1%
Inflation (GDP deflator)	4.7%	3.3%	7.6%	4.8%	6.5%	6.0%	5.7%	5.3%	5.1%
Real effective exchange rate (- deprec.)	-0.6%	-14.5%	-13.8%	-1.9%	...	...	...	...	...
Export volumes	...	5.7%	9.1%	3.3%	3.9%	11.8%	8.4%	8.8%	8.5%
(Nonenergy exports)	...	11.8%	13.3%	6.2%	7.0%	15.3%	13.1%	10.9%	9.5%
Impo[illegible] lumes	...	2.0%	-2.9%	9.2%	5.8%	7.7%	5.2%	7.0%	4.2%
(No[illegible]gy imports)	...	1.0%	-8.8%	8.5%	9.7%	8.2%	9.2%	8.1%	3.2%

Hypothesis 4

1. Tunisia receives per year in 1989-91 additional financing of SDR 140 million with a five-year grace period.

2. An interest rate of 4 percent in yen, corresponding to 8 percent in dinar terms is paid on the loan.

3. A reserve accumulation that stabilizes reserves to 3.0 months of imports is implemented in 1989 and maintained thereafter. The rest of the additional financing goes into imports and 70 percent of the additional imports goes into investment.

4. GDP grows by 0.4 percent per year due to trade effects (no lag) and by a factor of 3.0 linked to the new investment (with one-year lag). The econometric spreadsheet shows the derivation of the coefficient for the effect of the additional investment on income; a slightly more prudent coefficient of 3.0 is assumed in the calculations.

5. Export growth increases by the equivalent of 50 percent of the increase in GDP.

6. Imports will additionally increase as a consequence of export growth.

7. The new increase in imports will start an iterative process. First, 70 percent of the new imports will go into investment, the increased investment will increase GDP by a factor of 3.0, and 50 percent of the increased GDP will induce additional export growth. The multiplier process is iterated until it converges.

Table . Tunisia: Balance of Payments, 1986-93 01-Jan

	1985	1986	1987	1988	1989	1990	1991	1992	1993
		Actual	Estim.			Projections			
				(In millions of SDRs)					
Current account	-573	-601	-103	-289	-384	-352	-284	-241	-51
Trade balance	-829	-833	-563	-770	-883	-902	-896	-921	-805
Exports, f.o.b.	1703	1507	1653	1672	1783	2027	2335	2817	3627
Energy	712	365	390	300	289	279	224	192	194
Nonenergy	991	1142	1262	1372	1494	1748	2111	2625	3433
Imports, f.o.b.	-2532	-2340	-2216	-2442	-2665	-2929	-3231	-3739	-4432
Energy	-341	-202	-233	-205	-222	-252	-243	-258	-301
[illegible]nergy	-2190	-2138	-1983	-2236	-2443	-2677	-2988	-3481	-4131
Nonfactor services (net)	335	286	462	513	544	601	672	741	814
Of which: tourism receipts	491	414	517	586	631	682	740	802	871
Transfers (net)	-80	-54	-2	-32	-45	-51	-60	-61	-61
Of which: receipts from worker's remittances	266	308	352	347	353	363	375	385	397
Interest on ext. debt	-253	-277	-272	-297	-319	-342	-372	-389	-408
Capital account	433	410	220	366	493	443	411	390	236
Grants	36	35	29	27	30	30	25	24	24
Direct and portfolio invest.	137	132	78	86	96	127	148	161	172
Medium and long term borrowing (net)	248	177	46	253	367	286	238	205	40
[illegible]rsements	641	644	555	776	920	908	836	761	605
[illegible]ng term borrowing	342	311	355	540	684	673	614	535	364
medium term borrowing	299	333	201	235	235	235	222	226	241
amortization	393	467	510	522	553	622	598	557	565
Short-term capital (including valuation adjustment, and errors and omissions)	12	67	68	--	--	--	--	--	--
Overall surplus or deficit (-)	-140	-190	117	77	109	91	127	149	185
Changes in reserves (inc. -)	140	190	-117	-77	-109	-91	-127	-149	-185
Use of Fund resources	0	150	41	47	64	-18	-51	-21	-12
Other items ,net (inc.)	140	41	-158	-123	-173	-73	-76	-128	-173
Memorandum items:									
Current account def. / GDP (%)	-7.1%	-8.0%	-1.4%	-3.8%	-4.7%	-4.0%	-3.0%	-2.4%	-0.5%
Gross reserves (in months of imports)	1.0	1.3	2.0	2.5	3.0	3.0	3.0	3.0	3.0
Debt service ratio	21.6	27.9%	26.2%	26.4%	26.4%	28.5%	26.0%	20.5%	17.3%
Debt / GDP ratio	48.7%	56.1%	57.8%	60.6%	61.0%	58.3%	54.2%	48.9%	41.6%
Total additional borrowing requirement 1/	0	0	0	226	554	671	667	665	542
Long term borrowing	0	0	0	54	205	313	313	299	300

Medium term borrowing	0	0	0	172	209	218	213	226	241

1/ Projected drawings on loans not contracted as of end 1987. All projected drawings for 1988 have already been identified. Projected drawings for the following years are not identified and could benefit from the availability of new sources of concessional financing. Substitution of long term financing for costly medium-term commercial borrowing would also improve the debt profile.

	1985	1986	1987	1988	1989	1990	1991	1992	1993
	(Annual changes in percent)								
Principal assumptions									
Real GDP	5.7%	-1.6%	5.8%	0.9%	5.4%	7.0%	8.1%	11.2%	14.6%
Inflation (GDP deflator)	4.7%	3.3%	7.6%	4.8%	6.5%	6.0%	5.7%	5.3%	5.1%
Real effective exchange rate (- deprec.)	-0.6%	-14.5%	-13.8%	-1.9%	...	...	...	...	...
Export volumes	...	5.7%	9.1%	3.3%	3.9%	9.8%	11.6%	17.4%	24.1%
(Non[illegible]y exports)	...	11.8%	13.3%	6.2%	7.0%	13.0%	16.8%	20.2%	26.2%
Impo[illegible]umes	...	2.0%	-2.9%	9.2%	5.8%	6.6%	6.8%	12.2%	14.8%
(Nonenergy imports)	...	1.0%	-8.8%	8.5%	9.7%	7.1%	10.9%	13.4%	14.1%

Some quick econometrics for Tunisia

Years	GDP	Investmen	Time Trend	Log GDP	Log Inv.	Log Trend
1960	334.0					
1961	367.0	60.0	2.0	5.8	4.1	0.7
1962	374.0	68.0	3.0	5.9	4.2	1.1
1963	437.0	77.0	4.0	5.9	4.3	1.4
1964	464.0	94.0	5.0	6.1	4.5	1.6
1965	527.0	120.0	6.0	6.1	4.8	1.8
1966	554.0	145.0	7.0	6.3	5.0	1.9
1967	576.0	131.0	8.0	6.3	4.9	2.1
1968	634.0	134.0	9.0	6.4	4.9	2.2
1969	686.0	137.0	10.0	6.5	4.9	2.3
1970	759.0	148.0	11.0	6.5	5.0	2.4
1971	891.0	151.0	12.0	6.6	5.0	2.5
1972	1078.0	168.0	13.0	6.8	5.1	2.6
1973	174.0	214.0	14.0	7.0	5.4	2.6
1974	1527.0	248.0	15.0	5.2	5.5	2.7
1975	1744.0	315.0	16.0	7.3	5.8	2.8
1976	1922.0	461.0	17.0	7.5	6.1	2.8
1977	2199.0	558.0	18.0	7.6	6.3	2.9
1978	2487.0	665.0	19.0	7.7	6.5	2.9
1979	2940.0	765.0	20.0	7.8	6.6	3.0
1980	3510.0	894.0	21.0	8.0	6.8	3.0
1981	4162.0	982.0	22.0	8.2	6.9	3.1
1982	4804.0	1290.0	23.0	8.3	7.2	3.1
1983	5497.0	1635.0	24.0	8.5	7.4	3.2
1984	6240.0	1750.0	25.0	8.6	7.5	3.2
1985	6910.0	1920.0	26.0	8.7	7.6	3.3
1986	7025.0	1850.0	27.0	8.8	7.5	3.3
1987	7935.0	1675.0	28.0	8.9	7.4	3.3
1988	8455.0	1670.0	29.0	9.0	7.4	3.4

Regression GDP on investment at t-1

Regression Output:		
Constant		130.358
Std [illegible]f Y Est		569.008
R Sq[illegible]		0.955
No. of Observations		28.000
Degrees of Freedom		26.000
X Coefficient(s)	3.887	
Std Err of Coef.	0.166	

Regression GDP on investment at t-1 and time trend

Regression Output:		
Constant		-240.449
Std Err of Y Est		557.304
R Squared		0.958
No. of Observations		28.000
Degrees of Freedom		25.000
X Coefficient(s)	3.367	45.855
Std Err of Coef.	0.393	31.617

Regression log GDP on log investment at t-1

	Regression Output:	
Constant		1.919
Std Err of Y Est		0.371
R Squared		0.894
No. of Observations		28.000
Degrees of Freedom		26.000
X Coefficient(s)	0.902	0.010
Std Err of Coef.	0.061	0.047

Regression log GDP on log investment at t-1 and time trend

	Regression Output:	
Constant		2.179
Std Err of Y Est		0.378
R Squared		0.894
No. of Observations		28.000
Degrees of Freedom		25.000
X Coefficient(s)	0.830	0.010
Std Err of Coef.	0.329	0.047

Regression log GDP on log investment at t-1 and log time trend

	Regression Output:	
Constant		1.761
Std Err of Y Est		0.373
R Squared		0.898
No. of Observations		28.000
Degrees of Freedom		25.000
X Coefficient(s)	1.024	-0.222
Std Err of Coef.	0.147	0.241

IMF OFFICIAL MESSAGE

WASHINGTON, D. C. 20431

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MFS. JUNZ

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88 JUL 27 PM 5:25
EXCHANGE AND TRADE RELATIONS DEPT.

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B. P. 369
7 Place de la Monnaie
Tunis
Tunisia

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MR. SALEHKHOU
AFR
ETR
FAD
LEG
RES
TRE
MR. H. SIMPSON

Executive Board adopted following decision July 25:

Quote

1. The Government of Tunisia has requested an extended arrangement in an amount equivalent to SDR 207.3 million for a period of 36 months from July 25, 1988 to July 24, 1991.

2. The Fund approves the extended arrangement set forth in EBS/88/119, Supplement 1.

3. The Fund waives the limitation in Article V, Section 3(b)(iii). Unquote

Lang

Acting Secretary

INTERFUND

SPECIAL INSTRUCTIONS — TEXT MUST END HERE

French translation to follow

TELEX NO.:

DRAFTED BY NAME (TYPE): SYEAGER:PR EXT. 6706 DEPT.: SEC DATE: 25JUL1988

AUTHORIZED BY NAME (TYPE): JOSEPH W. LANG JR.

AUTHORIZED BY NAME (TYPE):

(**) TYPE ** ON LAST OR ONLY PAGE OF MESSAGE

Log A9666

SEC. 48 REV 1 11-18-82

SIGNATURE

IMF OFFICIAL MESSAGE

WASHINGTON, D. C. 20431

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1988 JUL 26 PM 7 08

MARK XX FOR CODE
(_______) CODE

BANQUE CENTRALE DE TUNISIE
B.P. 369
7, PLACE DE LA MONNAIE
TUNIS
TUNISIE

LE 25 JUILLET, LE CONSEIL D'ADMINISTRATION A ADOPTE LA DECISION SUIVANTE :

CITATION

1. LE GOUVERNEMENT DE TUNISIE A SOLLICITE UN ACCORD ELARGI DE CREDIT D'UN MONTANT EQUIVALANT A 207,3 MILLIONS DE DTS POUR LA PERIODE DE 36 MOIS ALLANT DU 25 JUILLET 1988 AU 24 JUILLET 1991.

2. LE FONDS APPROUVE L'ACCORD ELARGI DONT LE TEXTE FIGURE DANS LE DOCUMENT EBS/88/119, SUPPLEMENT 1.

3. LE FONDS AUTORISE UNE DEROGATION A L'APPLICATION DE LA LIMITE PREVUE PAR L'ARTICLE V, SECTION 3B III), DES STATUTS.

FIN DE CITATION

LANG
SECRETAIRE PAR INTERIM
INTERFUND

SPECIAL INSTRUCTIONS — TEXT MUST END HERE

TELEX NO.:

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EC. 48 REV. 2 8-14-87

SIGNATURE (PLEASE KEEP SIGNATURE IN SPACE ALLOWED) SIGNATURE

INTERNATIONAL MONETARY FUND

July 29, 1988

Mrs. Junz:

May I please have your views on the attached?

E. L. Bornemann

Office Memorandum

TO : Mr. Bornemann

DATE: July 26, 1988

FROM : Salam K. Fayyad, Assistant to Mr. Finaish

SUBJECT : Board Meeting 88/113 - Tunisia

At the Executive Board Meeting 88/113, Mr. Finaish requested a comment by the staff on the possible use of the contingency element under the compensatory and contingency financing facility. At the said meeting, he stated: "though we have covered, Mr. Chairman, a lot of ground in our deliberations leading to the establishment of the CCFF, I believe the Board has not considered cases, which, like the present one, involve a member entering into an arrangement, particularly a multiyear arrangement, with the Fund shortly before the new facility is in place. It would seem reasonable to give consideration in such cases to the possibility of enabling the member concerned to have potential access to the contingency element under the new facility by the time of the first program review, or at the latest by the time of the second review. The staff may wish to comment on such a possibility."

As the staff did not respond during the meeting, Mr. Finaish would appreciate receiving a response to this remark.

Statement by Mr. Jacques de Groote on
TUNISIA: Request for Extended Arrangement
EBM/88/113, July 25, 1988

Mr. Chairman,

Last year, with the help of favorable but obviously temporary conditions and the prudent pursuit of policies by the authorities, Tunisia had a year of glamour. The economy regained the path of growth, while the current account, fiscal position, and debt/GDP ratio all improved with the accumulation of gross foreign reserves.

It is clear that Tunisia is now in a much sounder position for engaging in its ambitious structural medium-term program, a program which represents the best candidate for Fund support under an extended arrangement. This program recognizes, as its first priority, the continued promotion of the foreign exchange earning sectors. Export-favoring exchange rates and tight demand management will be used to accelerate reorientation of the economy through further incentives to the tradable goods sector, while government revenues will rely on the nontradable goods sector and domestic consumption.

However, the implementation of this well-oriented program may run into certain difficulties which deserve further attention. First, certain bottlenecks can be expected to arise from present distortions in the economy. For a medium-sized country like Tunisia, with a limited domestic market, the establishment of export industries requiring a certain scale could improve its chances of growth and success provided foreign capital can be persuaded to participate. Under these conditions, Tunisia would benefit from the free transfer of technology and nearly guaranteed export markets. I see major disincentives to foreign direct investment at present, though, in the complexity of the taxation system and in the price distortions produced by government regulation. I therefore welcome the Tunisian authorities' intention of seeking assistance from the Fund in both these critical areas: one could even suggest that it would be to Tunisia's advantage to liberalize the pricing system more rapidly than is now planned. This suggestion is further supported by the fact that the problems and inefficiencies of the tax administration also affect the pricing system. Moreover, attempts at monitoring domestic monopolies by basing the prices they are permitted to charge on their capital expenditures have had the undesired effect of increasing capital expenditures and causing the selection of more capital intensive technologies, which is obviously no way to cure Tunisia's unemployment situation. The liberalization of the pricing system will bring the remaining state monopolies under the discipline of international competition.

It appears from the paper before us that based on an economic survey of present conditions, the staff and the authorities have decided that tourism has the potential to thrive in Tunisia. Experience elsewhere has shown that the receipts to be expected from tourism are as much affected by what the host country offers for tourists to purchase as by social tranquillity and political stability. Regressive income redistribution, leading to serious social pressures, can damage a country's image in the eyes of tourists for a long time. Mr. Salekhou, with his usual sense for basic issues,

indicates that the government is well aware of the delicate tradeoffs between improvement in the current account and the distribution of income.

The program, centered as it is on the development of the external sector and on further balance of payments improvement, will lead to a decline in the ratio of central government revenues to GDP, which will necessitate an even steeper decline in expenditures. Since such retrenchments would mostly affect current expenditures and transfers, I have some doubts about their effects on the quality of Tunisia's infrastructure, and thus on its ability to attract direct foreign investment and tourism. I would welcome some elaboration from the staff on this point.

A last concern is about the future implications of the present exchange rate risk guarantee. Excessive support from this system to the external sector, which already enjoys massive incentives under the program, might further widen the divergence between the tradable and nontradable goods sectors. There is a danger that excessive comfort for the external sector will be paid for by increased burdens on consumers, whether in the form of higher taxes, or of a higher inflation rate in case the deficit is monetized. I would therefore suggest to the authorities that they proceed gradually to phase out this system in as timely and brief a manner as possible.

Tunisia has a remarkable record of successful economic policies and good relations with the Fund. The Tunisian authorities have also demonstrated that they can respond quickly to the need for further corrective action. I am certain that they will therefore address the difficulties likely to arise in the structural area with the same vigilance they have shown in the implementation of the balance of payment policies. There is no doubt that to succeed, the program will have to be reinforced during its implementation; together with Mr. Riefel and Mr. Faria, I have made some suggestions that I am certain that the authorities will consider in due course. On that point, let me observe that I have never regarded the package of measures initially agreed on at the outset of a program as a closed matter. It is the very purpose of the reviews to incorporate, at later stages, all necessary actions for implementing the program's objectives.

Few countries have qualified up to now for a credible extended arrangement. Over the years, Tunisia undoubtedly has built credibility for its policies, and this credibility was recently reinforced by the extent of the structural measures which Tunisia has already implemented before the program takes effect, and by its decision not to draw its last tranche under the standby. Today's decision making Tunisia the first country since our discussion of Fund policies under the Extended Fund Facility to receive an arrangement under that facility should give a clear signal to the financial community and to friendly governments that in Tunisia, we have a case demonstrating that given appropriate capital inflows, the possibility exists for growth oriented adjustment.

Thank you, Mr. Chairman.

Office Memorandum

cc. Mr. Basu

TO: The Acting Managing Director — June 10, 1988

FROM: Helen B. Junz and Aarno Liuksila

SUBJECT: Tunisia : Request for an Extended Arrangement

Mr. Ouattara's memorandum to you notes that the staff report has been cleared in its present form by ETR and LEG Departments, except for the question of a multiple currency practice subject to Fund jurisdiction.

As indicated in the staff report, the Tunisian authorities intend to abolish an exchange rate guarantee fund maintained since 1981, replacing it by August 15, 1988 with a new scheme, which would appear to be self-financing and thus avoid giving rise to a multiple currency practice. The Board has not previously been asked to approve the multiple exchange rate features of the foreign exchange guarantee fund, but information obtained by the recent mission suggests that it involves a multiple currency practice subject to Fund jurisdiction. We would propose that the staff report state that the existing practice gives rise to a multiple currency practice, and include a decision stating that temporary approval is granted for the practice. In the meantime, a telex indicating the staff's understanding of the foreign exchange guarantee fund and that jurisdiction is involved would be sent to the authorities.

Although there is just one month before scheduled abolition, we feel that approval is justified on the usual basis of the temporariness of the scheme. In addition, there may be delays in implementation of the new arrangements, which are not entirely satisfactory owing to the intervention of the World Bank. The alternative proposed by AFR of neither mentioning the existing multiple currency practice nor extending approval for it in the meantime does not appear attractive, first, because the response from the authorities confirming the staff's understanding may well be delayed beyond the Board meeting or, second, if received affirmatively after issuance of the paper, focus undue attention on the matter. It is agreed by ETR and LEG that sufficient data exist on the workings of the scheme to establish that jurisdiction is involved, and that the Board should thus be informed of these findings.

cc: The Managing Director (on return)
Mr. Ouattara
Mr. Gianviti
Mr. Anjaria
Mr. Quirk
Mr. H. Simpson

Office Memorandum

ETR

cc. Mr. Basu
Mr. Quirk

RECEIVED
88 JUN 13 AM 9:21
EXCHANGE AND TRADE
RELATIONS DEPT.

TO: The Acting Managing Director June 10, 1988

FROM: A.D. Ouattara

SUBJECT: Tunisia - Request for Extended Arrangement

Attached for your approval is the draft staff report on Tunisia's request for an EFF. Except for the following point, it has been cleared with:

ETR (Mrs. Junz)
FAD (Mr. Nashashibi)
LEG (Mr. Elizalde)
TRE (Mr. Bhuiyan)

ETR, supported by LEG, is sending you a separate memorandum proposing a Board decision approving a possible multiple currency practice arising from the operation of the foreign exchange guarantee fund, which has been in existence since 1981. We feel that the course of action proposed by ETR is of little practical value and could weaken our credibility with the authorities. In particular, we are not convinced of the appropriateness of asking the Board to approve the presumed multiple currency practice now, for the first time, just one month before its scheduled abolition. We also consider that we do not have enough documentation about the practice to make a final assessment and therefore we should not prejudge a course of action to be taken. In addition, approval could well be counterproductive if the authorities interpret it as giving a green light to a type of practice which, we all agree, we should discourage. Instead of the proposal advanced by ETR, we would favor including a reference in the staff report to the effect that the staff is examining the jurisdictional aspects of the exchange rate guarantee fund (page 23 of the draft staff report).

The authorities have not yet formally signed the letter of intent, but we expect them to do so very shortly. We know that they are considering whether to request six-monthly purchases, based on six-monthly performance criteria, in accordance with the recently revised EFF decision. As noted in the draft staff report (page 42), the program is presently designed on a quarterly basis, but could be converted to a semiannual basis at the time of the first review. Should the authorities request conversion to semiannual basis from the outset, we would submit the amendments for your approval prior to issuance of this paper. On the basis of our latest contact with Mr. Rouai, Assistant to Mr. Salehkhou, it seems probable that the authorities would not request conversion until the first review.

Also attached is a short summary of the draft report.

May we please have your approval by June 16, 1988.

Attachment

cc: The Managing Director (on return)
ETR
LEG
Mr. H. Simpson

Office Memorandum

TO: Mr. Anjaria June 7, 1988

FROM: Helen B. Junz

SUBJECT: Tunisia--Draft Request for EFF
Some Further Minor Comments

Pages 10 and 12: How does the resumption of consumption growth affect consumer subsidies? How much of the positive effects in 1987 stems from changes in the composition of GNP and how much from the adjustment effort?

Table 4 implies a very low deflator for investment as with 3.7 percent real growth the nominal share in GDP remains stable (stock building effects seem negligible in 1988). Second, why is the resource gap shown with a negative sign--a negative gap, I believe, would indicate an excess of savings.

Page 12. Is it true that changes in relative prices that raise those for consumer goods and services have no negative impact on cost competitiveness given the high weight of tourism in external earnings?

Page 20. The central bank's intervention in the money market is effected in what way? There does not seem to be any treasury paper.

Page 29. Why does the drought cost 55,000 jobs <u>permanently</u>?

Attachment

cc: Mr. Johnson
Mr. Nashashibi
Mr. Pujol
Mr. Quirk

Mrs. Juz
File

Office Memorandum

June 7, 1988

To: Mr. Anjaria

From: K. Nashashibi KN

Subject: Tunisia--Request for Extended Arrangement

1. The EFF program is based on a substantial shift of resources from the government to the private sector. What was intended as a revenue neutral tax reform may in fact result in substantial government revenue losses. This is reflected in the projection of a sustained decline in government revenues to GDP ratio over the program period. Non-oil government revenues and grants declined from 30 percent of GDP in 1986 to 27 percent in 1987. In 1988, this ratio is likely to go down further as a result of the implementation of the VAT and other net revenue losses from the tax reform, and this declining trend is expected to continue until 1991.

While this may be a desirable strategy from an efficiency point of view, it has a number of implications and risks which should be made clear in the paper. One major implication of this strategy is that a deterioration in the income distribution is likely to occur. The losses in revenues detailed on page 31 mostly result from cuts in fees and taxes on capital transactions. Considering the rising unemployment and declining private investment (in real terms) in 1987, the paper would need to argue more convincingly that this strategy would eventually result in higher levels of private sector investment and activity.

Another implication of this strategy is that decline in government expenditure in relation to GDP would need to be steep enough to offset the envisaged decline in government revenue and to reduce the fiscal imbalance to 2.3 percent of GDP by the end of the program period. The staff paper should outline the areas of expenditure cuts and their potential contribution to the attainment of the deficit targets during the program period. Moreover, since the bulk of these expenditure cuts are likely to fall on transfers and subsidies, the paper should indicate some awareness of their implications on the poorer segments of the population. We would also suggest raising the possibility of exploring compensatory measures during the program reviews.

For the 1988 program, there is a real risk for expenditure overruns due to the following factors: (i) the extension by the authorities, of the exchange rate guarantees and the establishment of a new exchange rate risk cover scheme (pp. 22, 37-38, and 44); (ii) the impact on the budget of the public sector enterprise reform (p. 26); and (iii) the costs of the job creation schemes (p. 27). Moreover, there are also uncertainties about the financeability of the supplementary budget. Taken together, we feel that these risks could lead to

significant slippages in the fiscal area and should be brought out clearly in the staff appraisal.

2. On the exchange rate issue, it is not clear why the maintenance of the real exchange rate at its present level is the appropriate strategy. In fact, given the likelihood of high elasticity of tourism and non-oil exports to exchange rate changes, and in view of the decline in oil as a source of exports, a further exchange rate adjustment may be appropriate. In particular, increasing Tunisia's exports faster than aggregate partners' demand may, in fact, require a relative price adjustment in addition to the envisaged improvement in product quality and production capacity.

3. There is no information in the fiscal tables (pp. 13a and 29a) on grants and their time profile. Such information would be useful in assessing the degree of adjustment in the fiscal area.

4. Notwithstanding the inherent seasonality in Tunisia's export receipts, we find the targeted increase in gross reserves of three months of imports (p. 14) on the high side and does not seem to be consistent with the data presented, for example on page 34a.

Please find attached some additional comments.

cc: Mr. Tait (o/r)
Mrs. Ter-Minassian
Mr. Artus
Mrs. Junz
Mr. Chu

mmtuncomm

June 7, 1988

Tunisia--Additional Comments

1. It would be useful if the report could elaborate on the sharp increase (+67 percent) in domestic nonbank financing in 1987 compared to the programmed projections.

2. The new exchange risk cover scheme is a temporary mechanism to be phased out in the medium term. More indication on how the authorities intend to progress toward this during the program period would provide the needed assurance of the temporary nature of the scheme (p. 38).

3. The authorities will ensure that no new domestic arrears will be accumulated during the program period (p. 17). What are the steps taken to achieve this? In this connection, a discussion on the problems related to the complementary period (e.g., shortening its length, payment arrears) would be interesting to clarify whether the problems have been resolved, and if not, what are the steps to be undertaken during the program period.

4. It would be helpful to elaborate on the priority sectors for increasing investment (p. 32) as this would provide an idea about the impact of government expenditures on growth during 1988 and afterward.

5. Per capita income in 1986 should read SDR 1,018 instead of SDR 1,018 million (p. 3).

Office Memorandum

TO: Mr. Anjaria June 7, 1988

FROM: Helen B. Junz

SUBJECT: Tunisia--Draft Request for EFF

The draft staff report is quite clear on most of the salient points and I just have a few comments. From a presentational point of view, the report could benefit from editing out some of the detail, particularly some of the repetitions that occur in the Recent Development and the Program for 1988 sections.

First, it is my understanding from the discussions in the Board on the EFF that for a country with a good policy implementation record, the usual procedure will be for performance criteria and purchases from the Fund to be phased six-monthly. Therefore, I suggest that the paper explain that agreements were reached with Tunisia before the Board adopted the EFF decision and that the staff intends at the time of the first review to rephase both the purchases and the performance criteria.

Second, on the structural adjustment measures included in the proposed EFF, you may remember that several Directors at the discussion of the review under the SBA in April suggested that both price and import liberalization ought to proceed faster than had then been envisaged if an EFF were to be proposed. Therefore, both the narrative and the staff appraisal ought to set out why the staff feels that the current timetable represents an acceptable safe speed. In that connection, I would suggest dropping the last sentence on page 44 and top of page 45 of the staff appraisal that says that the staff believes that the authorities intend to avoid deviations from the intended course of action, and adding instead a statement urging the authorities to be prepared to be even bolder in their liberalization program as circumstances permit.

Further, with regard to price and import liberalization, there are repeated references to continued shielding of "infant industry and those enterprises that are weakly integrated." It would be important to provide some appreciation of what part of production stems from such enterprises, what the phrase "weakly integrated" means--monopolistic?--and at what point an industry is expected not to be an infant any longer. On the whole, the infant industry argument should be put in the mouth of the authorities rather than apparently be endorsed by the staff. Again, with regard to opening up the economy, it would help to state explicitly that the authorities accept a decline in activity and in investment in those sectors that likely need to release resources in favor of those that are export and import-substitution oriented. The reference to a possible recession in certain domestically oriented sectors in the second paragraph of page 10 could thus be amplified.

The text notes that the private sector has not yet responded forcefully to the adjustment policies of 1986/87. This is related particularly to the investment activity. However, since investment responds with a considerable lag and there has been a resource shift toward nontraditional exports, a rather broader assessment both in the text and the staff appraisal would be useful.

Third, not surprisingly, I have problems both with the description and the conclusions drawn regarding the changes in the exchange rate guarantee system. First, it should be made clear that the staff does not believe that relative interest rates reflect the full forward exchange risk (page 36); second, given that the scheme extends also to nonconcessional loans, interest rate differentials would not provide much of a contingency fund in that respect. It should also be made clear that the guarantee is currently fashioned to cover both development and commercial banks. Finally, both the text on page 39 and the staff appraisal should note that the whole scheme will be discussed further with the staff during the first review of the program. Such discussion would include both the fashioning of changes and/or additions to the scheme to make it more market oriented and the establishment of a timetable for its phasing out. In discussing the financing of the budget deficit in 1988, the nonrecurrent contribution of the banks to cover the contingent liabilities for the exchange rate guarantee scheme are, of course, included in revenues. However, if this fund is not to lodge at the central bank--where we thought it would be--but would go straight into the budget, it becomes even more important to ascertain what measures the authorities might take to cover budgetary losses arising from both the past scheme and the current one.

The following comments relate to possible restrictions and related problems associated with the forward cover arrangements:

Page 30, following paragraph - The non-recurrent special contribution by commercial banks to the special fund for the guarantee of exchange rate and interest rate risks raises questions of a multiple currency practice because commercial banks do not administer the fund. There is no device for having this levy passed on to the ultimate user of the exchange rate scheme. The subsidization of the central fund through this tax may therefore be subject to the Fund's Article VIII.

Pages 34 and 35, paragraph over page - The background to Tunisia's liberalization program has been a continuing depreciation of the real effective exchange rate. Because it is the counterpart of reduced restrictiveness, it should be mentioned in this context and the statement regarding the liberalization "having the same effect", i.e. resulting in larger imports, should be qualified accordingly.

Page 36, last partial paragraph - Given that lending rates are controlled, to what does the "dinar market interest rate" refer? For "implicitly expressed" substitute "indicated" as the relationship will

not be precise in the presence of exchange controls, and may need to be corrected in light of the ongoing experience with the fund.

Page 37, third sentence - Does the supply of foreign currency to the forward fund include any compulsory surrender of forward foreign exchange?

Page 38, first paragraph - The exchange cover scheme for development and other banks may give rise to a multiple currency practice, as did the previous scheme financed by levies on the credit system, depending on whether implicit spreads exceeding two percent arise. The sentence beginning "Any additional losses" should cease at "Central Bank" because the scheme will continue to give rise to distortions in external borrowing patterns by subsidizing World Bank and other lending to Tunisia.

Page 44, last sentence - After "scheme" add ", which could give rise to a multiple currency practice subject to approval under the Fund's Article VIII,"

The following are a number of minor questions:

Table 8 shows that external grants for 1988 are expected to be below their 1987 level, in line with the developing trend. However, the text states that additional external grants are expected to cover the expenditure associated with the drought and the locust losses. [More to come].

Other specific comments:

Can it be said that most interest rates are liberalized if lending rates remain subject to limits? A similar comment would apply to the description of the financial sector policies on page 20, and in the appraisal on page 43.

In the second full paragraph of page 12 the draft should state that an adjustment in administered prices and public tariffs leads to a one-time price increase rather than an increase in inflation.

In page 14, first full sentence, perhaps the reference to "aggregate partner demand" could be changed to "aggregate demand of trading partners".

In the description of the fiscal policies of the medium term program (pages 15 and 16), the draft states that central government total revenues and grants are projected to decline with the purpose of reducing the role of the Central Government gradually. However, it would appear from the second paragraph of page 16 that the decline in revenues and grants is related mostly to a decline in petroleum revenues.

The description in page 22 of the hedging facilities against exchange risk to be provided by the Central Bank should be supplemented with a description of the measures that the authorities intend to implement to reduce losses for the budget to a minimum. In any event, we would like to point out once again that we are seriously concerned by the potential problems that the proposed guarantee scheme involves. In this connection, perhaps the language of the staff appraisal on this particular issue should be strengthened further.

In page 29, the last part of the first sentence of the second paragraph could be changed to "..., the Governments feels that it is under an obligation to provide some relief to most of the affected sectors."

The second paragraph of page 30 should note that a reduction of bank financing through a "public loan" and bond issue does not solve the problem of the crowding out of the private sector from the flow of financial resources. The private sector is still providing the resources.

With the net Central Bank position (excluding the IMF) expected to improve by SDR 123 million in 1988, we wonder about the need for more than SDR 100 million margin in the short-term debt limit for the government and Central Bank. If there is a good reason, it should be noted in the text.

The reference on page 3 (item 4 (a) (iv)) of the extended arrangement should be to "limits", not "limit" on external debt.

Footnotes 3 through 5 are missing from our copy of Table 3; we presume they appear on the original.

cc: Mr. Gianviti
Mr. Bhuiyan
Mr. Johnson
Mr. Nashashibi
Mr. Pujol
Mr. Quirk

INTERNATIONAL MONETARY FUND

June 6, 1988

Mrs. Junz:

Tunisia--Draft Staff Report

Attached are our comments. I reviewed the paper.

cc: Mr. Pujol
Mr. Quirk
Mr. Parcu

José Braz

ETR4/CRT/TUN: cotuncrt June 6, 1988

Tunisia--Comments on Draft Staff Report for Extended Arrangement

This is an exceptionally clear, comprehensive and well written report. We have only a couple of queries and suggestions regarding external finance issues:

1. The discussion on exchange risk cover raises a couple of questions: a) Are the development banks not official institutions? If they are, how does the cost of meeting their exchange rate risk differ from that related to regular official borrowing such that a different treatment should be proposed? b) On this issue, the rationale for the staff appraisal recommendation (page 44) is not clear--why is it desirable to phase out at an early date guarantees on external debt contracted by banks at the direction of the government? If such borrowing can be justified, surely so can the guarantee on what is, after all, a substitute for official borrowing. c) The new scheme is to be financed by the differential between external and local interest rates (page 38). According to the data in Table 3, Tunisian money market rates in 1986 and 1987 did not differ significantly from rates abroad. Will the scheme be adequately financed? d) The notion that the differential between domestic and foreign interest rates implicitly expresses the expected relative movement of foreign currencies against the dinar is an overstatement, both in theory--numerous other factors influence the rate differential--and in practice (as indicated above for 1986 and 1987; Table 3). We would suggest more tentative language, perhaps replacing "as implicitly expressed by" with "a partial indicator of which is" (page 36, bottom).

2. With the net Central Bank position (excluding the IMF) expected to improve by SDR 123 million in 1988, we wonder about the need for more than SDR 100 million margin in the short-term debt limit for the government and Central Bank. If there is a good reason, it should be noted in the text.

3. The reference on page 3 (item 4 (a) (iv)) of the extended arrangement should be to "limits", not "limit" on external debt.

4. Footnotes 3 through 5 are missing from our copy of Table 3; we presume they appear on the original.

C

INTERNATIONAL MONETARY FUND

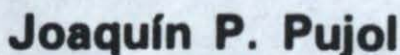
June 6, 1988

Mr. Basu:

Tunisia--Draft Staff Report

Attached are our comments on Tunisia which was reviewed by Mr. Jaramillo-Vallejo.

cc: Mr. Johnson
Mr. Quirk
Mr. Parcu


Joaquín P. Pujol

June 6, 1988

Tunisia--Comments on Draft Staff Report

The proposed program to be supported by an extended arrangement builds on the success of the preceding SBA, and emphasizes the undertaking of structural measures to achieve an increase in savings amounting to 4 percentage points of GDP between 1988 and 1991, and an increase in investment amounting to 2.5 percentage points of GDP during the same period. Although such an adjustment effort may not appear very ambitious for a three-year EFF, our main worry is more whether or not the strength of the structural measures included in the program will be enough to muster the private sector's savings and investment response assumed in the program.

We note that only 20 percent of the goods subject to caps on distribution margins will be liberalized by end-1989 and 50 percent by end-1991, that 40 percent of manufactured goods will still remain subject to controls by March 1989 and 25 percent by end-1990, and that agricultural products will be subject simultaneously to administratively set producer prices and a liberalization of the prices of inputs. Moreover, interest rates will be increased only enough to compensate for an increase on the tax burden to which they are subject, and high levels of effective protection will continue to be afforded to the so-called "infant" industries. As the experience of other countries has shown, lukewarm reforms of the pricing system usually fail to convince the private sector and bring about a strong enough response. We would suggest dropping the last sentence on page 44 and top of page 45 of the staff appraisal that says that the staff believes that the authorities intend to avoid deviations from the intended course of action, and adding instead a statement urging the authorities to be prepared to be even bolder in their liberalization program as circumstances permit.

From the presentational point of view, perhaps the report could be shortened somewhat by excluding so much detail about the characteristics of the country and the developments during the SBA. In addition, we have the following specific comments:

1. Repeated references to the infant industry argument are made in such a way as if the staff endorsed it. It would be preferable if these references were rephrased so that it comes out clearly that it is the authorities that stress the validity of the infant industry argument.

2. The second paragraph of page 10 states that the authorities want to avoid recessive effects in the sectors oriented toward the domestic market, i.e. those in which activity has been concentrated the most until now. In our view, it is precisely the worsening of the relative profitability of a particular sector the key signal that moves the private sector away from that sector (a recessive effect) and into other more profitable ones (an expansionary effect). If measures are designed

to preserve the relative profitability of the domestic market oriented sectors, why will the private sector shift its investment to the export-oriented sectors? A sentence may be added to this discussion stressing that one of the main objectives of the program is to shift resource allocation to export and import substitution activities, and that such a shift ought to have a favorable impact on the growth of production and employment as a whole.

3. In the second full paragraph of page 12 the draft should state that an adjustment in administered prices and public tariffs leads to a one-time price increase rather than an increase in inflation.

4. In page 14, first full sentence, perhaps the reference to "aggregate partner demand" could be changed to "aggregate demand of trading partners".

5. In the description of the fiscal policies of the medium term program (pages 15 and 16), the draft states that central government total revenues and grants are projected to decline with the purpose of reducing the role of the Central Government gradually. However, it would appear from the second paragraph of page 16 that the decline in revenues and grants is related mostly to a decline in petroleum revenues.

6. The description in page 22 of the hedging facilities against exchange risk to be provided by the Central Bank should be supplemented with a description of the measures that the authorities intend to implement to reduce losses for the budget to a minimum. In any event, we would like to point out once again that we are seriously concerned by the potential problems that the proposed guarantee scheme involves. In this connection, perhaps the language of the staff appraisal on this particular issue should be strengthened further.

7. In page 29, the last part of the first sentence of the second paragraph could be changed to "..., the Governments feels that it is under an obligation to provide some relief to most of the affected sectors."

8. The second paragraph of page 30 should note that a reduction of bank financing through a "public loan" and bond issue does not solve the problem of the crowding out of the private sector from the flow of financial resources. The private sector is still providing the resources.

INTERNATIONAL MONETARY FUND

June 6, 1988

Mrs. Junz

Tunisia

Attached are comments on the draft request for an extended arrangement.

cc: Mr. Johnson
Mr. Pujol

Peter J. Quirk

Comments on Tunisia
Request for Extended Arrangements

Page 6, - Can it be said that most interest rates are liberalized if lending rates remain subject to limits? A similar comment would apply to the description of the financial sector policies on page 20, and in the appraisal on page 43.

Page 22, middle of paragraph - Rather than reducing costs of the hedging facilities to the budget "to a minimum", the aim should be to avoid them over time:

"The cost of these facilities however, will be borne by the recipient and sustained losses for the budget will be avoided".

The following comments relate to possible restrictions and related problems associated with the forward cover arrangements;

Page 30, following paragraph - The non-recurrent special contribution by commercial banks to the special fund for the guarantee of exchange rate and interest rate risks raises questions of a multiple currency practice because commercial banks do not administer the fund. There is no device for having this levy passed on to the ultimate user of the exchange rate scheme. The subsidisation of the central fund through this tax may therefore be subject to the Fund's Article VIII.

Pages 34 and 35, paragraph over page - The background to Tunisia's liberalization program has been a continuing depreciation of the real effective exchange rate. Because it is the counterpart of reduced restrictiveness, it should be mentioned in this context and the statement regarding the liberalization "having the same effect", i.e. resulting in larger imports, should be qualified accordingly.

Page 36, last partial paragraph - Given that lending rates are controlled, to what does the "dinar market interest rate" refer? For "implicitly expressed" substitute "indicated" as the relationship will not be precise in the presence of exchange controls, and may need to be corrected in light of the ongoing experience with the fund.

Page 37, third sentence - Does the supply of foreign currency to the forward fund include any compulsory surrender of forward foreign exchange?

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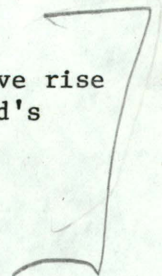
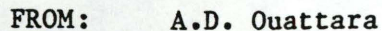


Page 44, last sentence - After "scheme" add ", which could give rise to a multiple currency practice subject to approval under the Fund's Article VIII,"

Mr. Aryaran

Office Memorandum

TO: The Acting Managing Director May 25, 1988



FROM: A.D. Ouattara

SUBJECT: Tunisia

Further to my memorandum of May 23, 1988, we have been unable to persuade the Tunisian authorities to include in the proposed exchange rate guarantee scheme the suggestion proposed by ETR that the interest rate differential to be paid for the exchange risk cover be subject to a minimum fee. This provision would, in effect, have confined the exchange rate cover to concessional loans.

While the inclusion of the minimum fee would clearly have been desirable with a view to making the scheme more fully self-financing, we believe that, at this stage, we should proceed without this assurance, as the matter is to be discussed in the context of the first program review. Moreover, we are concerned that further insistence on this point could have the effect of jeopardizing the spirit of cooperation that has prevailed in the discussions with the Tunisians thus far, and hence, possibly, the full implementation of the EFF program.

cc: The Managing Director (on return)
Mrs. Junz
Mr. H. Simpson

ETR3/CRT/TUN/notun01 May 25, 1988

Tunisia--Exchange Rate Risk Guarantee

As you know, this Department is concerned about the possible implications of the agreement reached with the Tunisian delegation on the issue of the exchange rate risk guarantee.

By the end of 1987 the existing Exchange Stabilization Fund in Tunisia had extended guarantees covering accumulated obligations of about D 400 million (5 percent of 1987 GNP). This significant amount was accumulated in a situation in which the guarantee was given only to a few development banks. The agreement reached with the Tunisians accepts that a new type of exchange rate guarantee will be extended by the Central Bank to all banks contracting lines of credit in foreign currencies under instruction of the Government. It is plausible to expect that under this arrangement the guarantee could be extended to a much larger number of loans and we have been unsuccessful in convincing the Tunisians to fix an overall limit on the commitments they can take during 1988.

It has been agreed that the source of financing for the eventual exchange rate losses would be the difference between the interest rate on the foreign liability and the money market interest rate in Tunisia. This differential, however, will be present only in the case of loans that have a concessional element. For this reason, ETR insisted at first that the guarantee be extended only to concessional credits and later, as a fallback position, that in the case of a guarantee extended to a nonconcessional loan a fee of at least 3 percent per annum--the assumed nominal depreciation of the dinar against the SDR in the program--be imposed on the recipient. We understand that the African

Department has now been informed by the Tunisians that they will not accept any change to the letter of intent in this sense. At this point, ETR does not think that on this issue only we should stop the EFF, but an assurance should be obtained that a tightening of the scheme will be a priority of the first review of the program and that by the time of the Board discussion we will be able to tell the overall amount for which a guarantee can be extended in the rest of 1988.

It should be emphasized that during the negotiation of this topic the Fund's hand has been weakened by the World Bank's positions on the issue; and, moreover, during the last phase of the negotiation, the Tunisians already had the Bank's blessing on a scheme that the Fund deemed unacceptable. We are worried that this issue of the exchange rate guarantees, and the World Bank's attitude on it, will haunt us in other cases in the near future.

Mrs. Tuaz
cc. Mr. Pazeu
I.O.

May 26, 1988

MEMORANDUM FOR FILES

SUBJECT: Tunisia - Exchange Rate Guarantee Scheme

As agreed previously, I telephoned Mr. Saddem, Directeur Général de la Planification, in Tunis yesterday morning to ascertain the authorities' reaction to our proposal to insert a phrase pertaining to the proposed exchange rate guarantee scheme in the draft policy memorandum. The insertion, initially proposed by ETR, would require that the interest rate differential paid for the exchange risk cover be subject to a minimum annual fee of 3 percent.

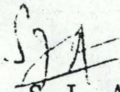
Mr. Saddem stated that the authorities had not received the suggestion well and were unprepared to accept the proposed insertion. He gave several reasons.

First, he recalled that during the course of the discussions held with the Fund staff in Washington recently, the delegation he headed had accommodated a number of the suggestions advanced by the Fund/Bank staffs, such as the establishment of the new scheme in the Central Bank rather than in the Treasury; a financing mechanism based on the interest rate differential between the cost of the external credit and the Tunisian domestic interest rates; and the agreement to discuss in detail with the Fund staff during the course of program reviews the proposed limits on exchange rate guarantees and the composition of external loans subject to guarantee. Upon his return, Mr. Saddem had explained to his superiors the various elements of the package of agreements reached in Washington; the authorities were now concerned that the latest Fund suggestion appeared to call into question the earlier understandings, and cast doubt on the confidence the Fund had always placed in their seriousness of purpose. Second, the authorities considered that the Fund staff's suggestion on the minimum annual fee was "nonoperational," in the sense that it would penalize development banks which were asked by the Government to take on relatively long-term external debt which happened to be subject to an interest rate of, say, 7 or 8 percent (the Tunisian money market rate is currently 9 5/16 percent). Third, Mr. Saddem assured me that the issue of exchange rate guarantees would be placed in the broader context of external debt management, for which the authorities were in the process of creating a new unit (to be located probably in the Central Bank).

I reiterated the reasons that had prompted our suggested insertion, while emphasizing that the Fund staff was not calling into question the other elements of the agreed package. While expressing sympathy for the position of the authorities, I expressed regret that, without the proposed addendum, the new guarantee scheme would appear to

be inadequately financed. To avoid the complications that the suggested new language had evidently posed for the authorities, I proposed that Mr. Saddem reconsider the inclusion of alternative language limiting the scope of the new exchange rate guarantee scheme to concessional credits. Mr. Saddem stated that he regretted not being in a position to accept such an amendment, as he had made clear even during his stay in Washington.

I agreed to inform Messrs. Ouattara and Bornemann of our discussion and to keep Mr. Saddem informed of further developments, including a reaction from management.



S.J. Anjaria
Assistant Director
North African Division

cc: Mr. Ouattara (on return)
Mr. Gondwe
Mrs. Junz
Mr. Bornemann
Mr. Artus (on return)

Office Memorandum

Mrs Junz
cc. Mr. Johnson
Mr. Puyol
I. O.

TO: The Acting Managing Director May 23, 1988

FROM: A.D. Ouattara

SUBJECT: Tunisia - Clearance of Letter of Intent for Extended Arrangement

Attached for your consideration and approval is the letter of intent in support of an extended arrangement for Tunisia. The letter has been cleared by Mrs. Junz (ETR), Mr. Nashashibi (FAD), Mr. Elizalde (LEG), and Mr. Bhuiyan (TRE).

You may recall that in his back-to-office report dated April 27, 1988, Mr. Bornemann indicated that the April mission reached agreement, ad referendum, on all but one element of a program for 1988-91. The remaining issue concerned the reform of the present system of guaranteeing the exchange risks of development banks. Negotiations on this topic were scheduled to be completed in early May, when a Tunisian delegation was to visit Washington to finalize the negotiation of an IBRD structural adjustment loan (SAL).

Discussions on this subject took place during the period May 5-13 in Washington in close collaboration with the World Bank. The reform of the exchange rate guarantee scheme was also one of the prior conditions for making the proposed SAL effective. Discussions on the subject were quite difficult and complicated by the fact that an agreement was reached between the Tunisian delegation and the Bank, which was not fully acceptable to us. In the end, it was possible to reach a compromise solution that, while not being optimal, could be considered acceptable. The agreed text is included in paragraphs 29 and 30 of the attached letter of intent.

In the agreed version, the authorities propose to improve the ability of borrowers to hedge against foreign exchange risk, as well as to provide for access to liquidity in cases where adverse exchange rate movements threaten the liquidity of otherwise viable enterprises. The existing scheme, financed by the proceeds of general fees on overdrafts and other financial transactions, will be terminated effective August 15; however, these revenues will continue to accumulate in a special treasury account set up for this purpose until all liabilities under the old scheme have been cleared. A new scheme would be established to guarantee exchange rate risk by development and other banks on loans contracted under the direction of the Government. It would be based in the Central Bank and would be financed primarily by the interest rate differentials between the cost of external and domestic credit. Thus, the new scheme will not involve the levying of parafiscal charges. For 1989 and subsequent years, a ceiling on the loan amounts covered will be included in the annual programs. While the delegation was not prepared to quantify the amount of guarantees in the remainder of 1988, the authorities are being asked to provide a figure

prior to Board consideration of the EFF. ETR has suggested that the provision of exchange risk cover be subject to a minimum fee, with the objective of confining exchange rate cover to concessional loans. The inclusion of an additional phrase for this purpose in paragraph 30 (underlined) has not yet been agreed by the Tunisian authorities.

On fiscal policy, the delegation indicated that, following the previous mission's departure from Tunis, the authorities had decided (presumably for political reasons) to seek parliamentary approval for the budgetary consequences of the drought and the locust infestation that had been discussed with the staff. A supplementary finance law, which would authorize additional expenditure in 1988 of about D 30 million, equivalent to about 0.4 percent of GDP, is being prepared. About one half of this amount is to be covered by additional external grants and by an exceptional levy on income in about a two to one ratio. Thus, the overall budget deficit for 1988 could reach D 365 million (4.3 percent of GDP), compared with the negotiated objective of D 350 million (or 4.1 percent of GDP). At the authorities' request, an additional paragraph 24 was inserted, describing the emergency expenditures and reiterating the authorities' commitment to stay within the agreed objective of D 350 million by seeking additional external grants or restraining other expenditure. The Tunisian authorities will provide us as soon as possible with the draft supplementary finance law and, prior to the Board discussion, with further details as to how the additional expenditures will be financed. Furthermore, the authorities will at that time provide the necessary detail on the expenditures so as to assure us that these will not carry over into the next budgetary year.

We were able at this time to convert the indicative targets for the net external assets of the Central Bank into a performance criterion, specified as desirable in the brief and as a quid pro quo for accommodating the authorities on the exchange rate guarantees and other issues. Thus, the letter of intent provides for the application of the performance criterion as from December 1988.

Attachment

cc: The Managing Director (o/r)
ETR ✓
FAD
Mr. H. Simpson

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Memorandum on the Economic and Financial
Policies of Tunisia During the Period of the 1988-1991
Structural Adjustment Program

1. Since the second half of 1986, Tunisia has been firmly implementing a program of economic recovery and liberalization. This adjustment program, which has been supported since November 4, 1986 by a stand-by arrangement from the Fund, has consisted of a policy package including strict demand management, an improvement in external competitiveness (specifically, a real depreciation of the effective exchange rate by 25 percent between late 1985 and late 1987), and a gradual liberalization (in particular of investment, imports, and prices) aimed at improving the efficiency and the growth potential of the economy. The initial results of this strategy have been encouraging. After experiencing a drought and a deterioration in the terms of trade in 1986, the Tunisian economy showed a considerable recovery in 1987, recording strong real growth in the context of a significant reduction in inflation and financial imbalances. Real GDP growth in 1987 was 5.8 percent; the current account deficit was reduced from 8.0 percent of GDP in 1986 to 1.4 percent in 1987; and the consolidated deficit of the Central Government (on a commitment basis) declined from 5.7 percent of GDP in 1986 to 3.6 percent in 1987.

2. However, Tunisia's economic recovery in 1987 was uneven. The growth of GDP resulted mainly from the strong performance of agriculture, tourism, and other exporting sectors, while activity in the rest of the economy was seriously affected by sluggish domestic demand. Stagnating private consumption (in real terms) reflected both the

success of measures to encourage financial savings, and the impact of incomes policy and other demand-management instruments. The decline in investment during the same year (13 percent in real terms) stemmed not only from the factors mentioned above, but also from lower investment by the public sector and a wait-and-see attitude on the part of private investors.

3. A number of factors reduced the current account deficit significantly in 1987. The abundant agricultural harvest and lower international prices led to a decline in net imports of agricultural and food products. The deterioration in real terms of the trade surplus in petroleum products was more than offset in 1987 by the rise in international prices. Also, a major structural adjustment that followed the depreciation of the exchange rate was reflected in an 18 percent real growth in exports of non-energy goods and services. In addition, the impact of the exchange rate depreciation and the change in importers' stockbuilding (owing to the liberalization of imports) explained in part the decline in imports despite their gradual liberalization. Nonetheless, the exceptionally low level of imports reflected the especially depressed levels of domestic demand and, in particular, of investment.

4. Fiscal performance in 1987 was better than programmed, owing essentially to the control of budgetary expenditures. Direct investment expenditures related to external financing were thus lower than expected, which was reflected in lower drawings on external lines of credit tied to projects. Provisional results also indicate savings on current transfers to households, on interest payments (especially abroad), and on expenditures on goods and services, while the wage bill

and consumer subsidies were in line with the program objectives. The strong growth performance was not reflected fully in fiscal revenue, however, because agriculture, tourism, and some exporting sectors are not heavily taxed. In fact, government revenue was affected slightly by low transfers by the state oil company (ETAP), and weak domestic demand and imports. The additional national income generated by growth in 1987 was thus largely channeled into private sector savings, with this sector contributing relatively more than the public sector to the reduction in the external imbalances.

5. The results obtained in 1987 indicate that the economic and financial policies are on the right track to bring about growth through structural adjustment. The latter is all the more necessary, given the importance of replacing the oil sector as a driving force to achieve sustained growth. While seeking to make rapid progress in this direction, the Tunisian Government believes that the inherent delays in the redeployment of the productive system, the significant real drop in the purchasing power of households in recent years, and the persistently serious unemployment situation call for caution in the management of domestic demand so as to avoid triggering an undesirable recession in certain sectors. Consolidation of the external adjustment should be sought chiefly by the diversification and steady growth of exports, as well as by sustained fiscal adjustment, which would make it possible to finance the investment required to restructure the productive system without jeopardizing the balance of payments.

Macroeconomic Framework and Objectives for the 1988-1991 Period

6. In accordance with the orientation of these policies and in light of the encouraging results in 1987, the authorities have set the following macroeconomic objectives for the remaining period of the Plan (1988-91):

(i) to achieve a real average growth of at least 3.5 percent, which is an ambitious objective in view of the required restructuring of the productive system;

(ii) to reduce price inflation to about 5 percent by 1991 and to the average level projected for Tunisia's trading partners afterward, taking into account the price liberalization process and the required adjustments in administered prices and public tariffs in the coming years;

(iii) to reduce the central government consolidated deficit (on a commitment basis) to 2.3 percent of GDP by 1991, despite the expected drop in oil revenues;

(iv) to reduce the current account deficit to 2.3 percent of GDP by 1991, after the deterioration to 3.8 percent in 1988 (attributable mainly to poor results in agriculture); this is an ambitious objective, given the investment effort and the rapid deterioration in the energy trade balance foreseen for the coming years.

7. During the 1988-91 period, private consumption is projected to grow by an annual average of 2.9 percent (in real terms)--or significantly less than the growth of GDP--which, combined with the reduction in the government deficit, should boost national savings from 17.5 percent of GDP in 1988 to 21.5 percent in 1991. This would make it possible to

finance a significant increase in investment (5.8 percent annual average at constant prices) in a manner compatible with the external adjustment objectives, which would be achieved through real average growth of 6.8 percent in non-energy goods exports and 6.2 percent in non-energy goods imports. The growth projection for exports is based on assumptions of increases in the production capacity and in productivity, and the preservation of external competitiveness. The agriculture, manufacturing, and services (especially tourism) sectors are expected to be the main contributors to GDP growth. The relative weight of other sectors in the economy (particularly oil, mining, and public services) should decrease gradually as a result of the redeployment of resources toward the tradable goods sector. Reflecting this restructuring, the ratio of exports of non-energy goods and services to GDP should increase from 26 percent in 1986 to 33 percent in 1991, and the private sector should account for more than half (52 percent) of total investment during the 1988-91 period, compared with 44 percent in 1986-87.

8. In accordance with this strategy of structural adjustment, the weight of the central government sector in the economy will gradually decrease: thus, budgetary revenue (including grants) would decline from 31.9 percent of GDP in 1987 to 29.2 percent in 1991, while budgetary expenditures (excluding amortization of debt principal) is expected to drop from 35.5 percent of GDP in 1987 to 31.5 percent in 1991. The more rapid decline in expenditures, combined with a reduction in the deficit of the social security system, should make it possible to bring the central government consolidated deficit from 4.1 percent in 1988 to 3.5 percent in 1989, 2.9 percent in 1990 and 2.3 percent in 1991. While

tax revenue (excluding social security contributions) should stabilize near 20.5 percent of GDP, nontax revenue would decrease, primarily as a result of the decline in oil revenue, which is expected to drop by 1.6 percentage points of GDP between 1987 and 1991.

9. The implementation of the structural and macroeconomic adjustment program will lead to a consolidation of the balance of payments viability and to an improvement in the external debt profile. The temporary deterioration in the current account deficit expected in 1988 must be attributed chiefly to exogenous factors. Thereafter, the deficit should drop steadily despite the following adverse factors: (i) the inevitable decline in oil revenue; (ii) the investment cycle required to restructure the productive system; and (iii) the increase in external interest payments. The current account deficit is thus expected to rise to 3.8 percent of GDP in 1988 before dropping back to approximately 2.3 percent by 1991. However, when the trade balance in petroleum products is excluded, the projections for the current account deficit show a decrease from 4.9 percent of GDP in 1988 to 2.0 percent in 1991, indicating a significant structural adjustment. After 1991, the authorities will seek as a minimum to maintain the current account deficit at a sustainable level. The deficit would be financed during the program period by net capital inflows that would allow a continued increase in gross reserves, which should increase from the equivalent of two months of imports in 1987 to the equivalent of three months by 1991. After relative stability in 1988-89, the debt service ratio (in terms of total exports of goods and services) should peak at close to 29 percent in 1990, before dropping rapidly in the 1990s. The outstanding

debt would thus be reduced from 58 percent of GDP in 1987 to approximately 52 percent in 1991.

Financial and Structural Policies for the 1988-91 Period

10. To achieve the medium-term objectives, the authorities' strategy focuses on the promotion of private initiative and rigorous management of public-sector resources by means of the following structural and financial policies.

11. As indicated above, the improvement in central government finances will result from a moderation of expenditures and an effort to stabilize tax revenue in relation to GDP, in a manner compatible with the reform of the incentive framework. During the program period, the average annual growth of the wage bill might reach 7 percent because of the revaluation of the productivity premium in two stages in 1988-89, and increases in the number of civil servants, which will not exceed 2 percent per year on average. Subsidies and transfers are projected to increase by 5.5 percent on average, with a reduction in real terms in the expenditures of the Caisse Générale de Compensation (which should drop from 2.3 percent of GDP in 1987 to 1.6 percent in 1991). Expenditures on goods and services would not grow in real terms. The small amounts of existing domestic arrears will be eliminated in 1988 and there will be no emergence of new domestic arrears during the program period. Capital expenditures and net government lending are expected to grow at an average annual rate of about 6 percent. The authorities have undertaken a tax reform, to be continued during the program period, that seeks to establish a simple and flexible tax structure while

streamlining the tax incentives granted to the private sector. The impact of the introduction of the value-added tax (VAT) as of July 1, 1988 (followed by an extension of the base to the wholesale trade on January 1, 1989) will be assessed by the authorities, who will adjust the rates and coverage in 1989, if necessary, to compensate for any shortfall in yield, given the objective of reducing the domestic excise taxes. Similarly, the objective of reducing the average level of customs duties will be achieved in such a way as to avoid a revenue shortfall for the Government, taking into account the progress made in this area in 1986-87. The authorities are also preparing the introduction of a single tax on individual income in January 1989 (applicable to 1988 incomes) and a reform of corporate profit taxation in 1990.

12. Interest rate flexibility will be used to regulate credit to the private sector and contribute to reducing inflationary pressures. The monetary authorities will seek to influence interest rates and the liquidity of the banking and financial system through intervention in the money market. In addition, they will seek to reduce the distortions in the interest rate structure and, consequently, the segmentation of the credit market by gradually eliminating the gap between preferential interest rates and the money market rate, and phasing out the service tax (TPS) and parafiscal levies on interest charges. Moreover, the authorities plan to introduce treasury bills on the money market, which would have a competitive interest rate and maturity structure and could be traded on a secondary market open to the public. The yield of these bills would help determine the general interest rate levels, and they

could gradually replace equipment bonds as a means of financing for the Government. In light of the progress achieved in the level of competition among credit institutions, the authorities are considering the gradual removal of the ceiling on lending rates. All of these issues will be examined in a study to be conducted with Fund technical assistance over the next few months, so that operational decisions may be implemented beginning in 1989.

13. Exchange rate flexibility will be guided by the need to maintain external competitiveness and to promote structural adjustment. The real effective exchange rate will be maintained at least at its end-1987 level. In addition, the authorities would consider exchange rate adjustments, should the balance of payments or foreign exchange reserves come under pressure. The authorities are also working, in collaboration with the Fund, on developing new instruments to promote an efficient allocation of foreign exchange, and to help develop an interbank foreign exchange market. It is in this context that the authorities are planning to introduce market mechanisms that will make it possible to improve the current exchange risk cover schemes, and are considering more flexibility in the norms governing the surrender of foreign exchange export proceeds.

14. The employment policy is geared toward favoring the restructuring of the economy, which would induce job creation, especially in the tradables sector. However, in order to reduce certain rigidities in the labor market, the authorities have developed a number of incentives for hiring young people and job creation schemes in the regions. The budgetary cost of these various initiatives will be limited. In

particular, the four-year program for the creation of 100,000 jobs (for the unskilled unemployed) will be financed essentially with concessional foreign aid. The objectives of these initiatives are not to place job seekers more or less permanently on the public sector payroll, but to create genuine employment opportunities in productive sectors.

15. The incomes policy will remain cautious, reflecting progress in reducing inflation and unemployment. The authorities will endeavor to avoid any slippage in wage policy that would harm external competitiveness and hamper job creation by raising production costs. To this end, the real increase in the wage index will remain, on average, below that of national income during the program period, and raises will continue to be linked to productivity gains. Social transfers to households will be subject to the same considerations, given the need to limit social charges borne by businesses, and to preserve a sound financial balance for the social security system.

16. Pricing policy will be guided by the desire to promote growth in supply while ensuring the efficient use of resources. The authorities will therefore continue to adjust the prices of agricultural inputs and products to reflect developments in costs. Similarly, regular adjustments will be made in public tariffs, consistent with the objectives of public enterprise reform. In accordance with the objectives of the Seventh Plan, and while seeking to reduce the expenditures of the Caisse Générale de Compensation by 5 percent annually during the program period, the authorities will undertake to limit these expenditures to a maximum of D 185 million per year. Moreover, the liberalization of industrial producer prices will be continued, with a view to increasing

the share of the relevant goods to at least 75 percent of manufacturing production by end-January 1991, compared with 55 percent at end-January 1988 (in accordance with the schedule in Table 2 attached). Thus, by 1991, all industrial prices will be free of control at the production stage, except for certain strategic or sensitive products that will continue to be controlled by the Government (specifically, petroleum products, water, electricity, transportation, and cereal derivatives). The process will be extended to the distribution sector, which will also be deregulated with a view to improving competition in this sector. The authorities anticipate at this stage that they will be able to free the distribution margins on commodities accounting for at least 50 percent of manufacturing production by end-January 1991 (an annual schedule is provided in Table 2). By monitoring the progress made in improving the competitive environment in the distribution sector, the authorities will be able to speed up, insofar as possible, the further liberalization of these margins.

17. The program of foreign trade liberalization will be continued, in order to help production management in enterprises using imported inputs, and to stimulate productivity gains and improvements in the quality of local production through increased exposure to foreign competition. Import liberalization will be continued with a view to freeing all imported goods during the program period, with the exception of a restrictive list comprising certain luxury items and other goods. This would bring the share of freely imported goods to some 80 percent of total imports by 1991 (Table 2). In addition, the further gradual reduction of import duties will aim at achieving a relatively uniform

rate of effective protection of about 25 percent by 1991.

18. The elaboration of a public enterprise reform is aimed at improving the management of those enterprises remaining in the public sector, and at divesting the rest by means of privatization or liquidation. Restructuring programs for enterprises remaining in the public sector will determine their strategy, including their activity portfolio, and will lay the foundations for autonomy in management on the basis of criteria of economic efficiency. This means, especially for enterprises in sheltered sectors, regular tariff adjustments aimed at achieving financial balance over time, including the self-financing required for their debt service and their investment program. Different financial restructuring options are currently being examined, in the context of the negotiation of a sectoral adjustment loan with the World Bank, in particular for the Compagnie des Phosphates de Gafsa (phosphates), the companies of the Groupe Chimique (phosphate derivatives) and the Société Nationale des Chemins de Fer (railroad). Special attention will be given to these issues during the first review of the program with the Fund.

19. The Tunisian authorities hope to obtain financial assistance from the international community in support of this structural adjustment program. The positive results obtained under the stand-by arrangement from the Fund demonstrate Tunisia's determination to achieve sustained growth that is compatible with a viable balance of payments position. In 1986-87, Tunisia obtained two sectoral adjustment loans totaling US$300 million from the World Bank in support of the agricultural policy reform and the industrial and foreign trade policy reforms. The

negotiation of a new structural adjustment loan (SAL) for $150 million is about to be completed, and a sectoral adjustment loan for the reform of public enterprises is under discussion.

The Program for 1988

20. Consistent with the medium-term framework, the macroeconomic objectives for 1988 are:

(i) to achieve real positive growth of GDP (1 percent) despite serious problems of drought and locusts in the agricultural sector;

(ii) to contain inflation (measured by the 12-month increase in the general consumer price index) at 6.5 percent (after 6.9 percent in 1987), taking into account the continued liberalization of prices and the required adjustment of certain administered prices and tariffs on public services, and in the context of a moderate upturn in domestic demand;

(iii) to limit the external current account deficit to 3.8 percent of GDP in 1988, despite a continued deterioration in the energy trade balance, and the impact of a poor agricultural harvest and the expected recovery in investment.

21. The Government's fiscal position will be much more difficult in 1988 than in 1987, reflecting an estimated revenue loss of some D 76 million stemming from various measures to reduce certain duties and taxes, including customs duties, the service tax (TPS) on interest charges, the taxation of income on securities, and registration fees. The expected shortfall does not allow for the possible impact of the introduction of the VAT in July 1988, as it is difficult to determine

whether a related revenue shortfall will occur. Nonetheless, the authorities expect that any potential shortfall will be offset by the broadening of the tax base and the positive effect of the tax amnesty. In spite of the projected losses, total revenue is estimated to increase by 7 percent, taking into account new measures such as an increase in petroleum prices and in public tariffs, a special contribution to the Special Fund for Exchange and Interest Rate Risks by commercial banks, and increases in certain excise taxes.

22. Total expenditure (including net lending) is estimated to increase by about 8 percent. After a four-year freeze, and taking into account the effect of promotions and recruitment, the planned increase of 10 percent in the wage bill reflects the revaluation of the productivity premium, the impact of which will be a 3 percent increase on average. The budget also includes an allocation of D 12 million to eliminate remaining domestic arrears and a 10 percent increase in the allowance for supplies so as to preclude any new domestic arrears. Consumer subsidies will be maintained at their 1987 levels, entailing a decline in real terms and requiring price increases for certain subsidized goods during the year. Expenditure forecasts for 1988 also include a total of D 34 million in current subsidies to public enterprises in the phosphates sector and a special payment of D 40 million from the Exchange and Interest Rate Risks Fund to development banks.

23. The central government consolidated deficit (including special funds and social security funds, and on a commitment basis) is thus estimated at D 350 million (4.1 percent of GDP). Net foreign financing is projected to increase sharply in 1988, on the basis of credit lines

already in place, to D 237 million. Taking into account the expected level of nonbank domestic financing ("emprunts nationaux" and subscriptions of equipment bonds outside the banking system), bank financing of the central government consolidated deficit should be reduced from D 94 million in 1987 to D 50 million in 1988.

24 The serious problems facing the agricultural sector in 1988, due to the drought and the invasion of locusts, necessitate certain changes to government expenditure plans. Accordingly the authorities intend to submit a supplementary finance law for parliamentary approval before July. The additional expenditure would relate to support of the small-scale livestock sector, the fight against the locusts, and the initiation of employment programs to offset in part the significant loss of employment opportunities in the agricultural sector estimated at the equivalent of 55,000 permanent jobs. The supplementary finance law under preparation estimates the expenditures involved at about D 30 million (equivalent to 0.4 percent of GDP). Of this amount, at least D 16 million would be financed by identified external grants and a national solidarity contribution. A strong effort is underway to ensure the financing of the remaining amount through additional grants and restraint on other government expenditure, in order to maintain the target of a central government consolidated deficit of D 350 million.

25. The rate of growth of broad money is projected at 9 percent, which is somewhat higher than that of domestic demand. Given the targeted increase in net foreign assets of D 85 million, domestic credit expansion should be limited to 8.7 percent. The bank financing of the consolidated deficit of the Central Government (D 50 million in 1988)

would be consistent with a 9 percent expansion of credit to the rest of the economy, which is considered the minimum level required to sustain the investment effort needed for the restructuring of the economy.

26. In early 1988, the monetary authorities improved the operation of the money market by authorizing interbank transactions and the participation of nonbank financial institutions and certain enterprises. With a view to liberalizing further the financial system, the requirement of prior approval from the Central Bank for refinanceable credits or credits of over D 5 million has been eliminated. Moreover, in order to promote a revival of private investment, the service tax (TPS) on interest charges was reduced from 14 percent to 6 percent in November 1987, bringing down the cost of credit by 1.1 percentage points. After the reorganization of the money market in January 1988, periodic interventions by the Central Bank were limited to meeting some 20 percent of the liquidity needs expressed by the banks, ths rest being met through interbank transactions. The central bank intervention rate dropped slightly, from 9 1/2 percent in January to 9 5/16 percent in mid-April, as a result of the moderation in the rate of inflation over the past few months. The rates for interbank transactions fluctuated daily according to supply and demand conditions, remaining on average 1/8 of 1 point above the central bank intervention rate. The authorities will pursue an interest rate policy consistent with the objective of reducing inflation. Finally, as indicated above, the study to be conducted in 1988 with the technical assistance of the Fund will help in particular to prepare for the introduction of treasury bills.

27. The current account deficit is projected at SDR 284 million in

1988, or SDR 181 million higher than the actual 1987 figure. Notwithstanding excellent results in exports of manufactured goods and in tourism, the expected deterioration in the food and energy trade balances largely explains the increase in the deficit. The latter also reflects an increase in interest payments and the recovery of imports of capital goods. Net capital inflows should total SDR 359 million, given the objective of increasing net foreign assets by SDR 75 million. Drawings on medium- and long-term borrowing should total SDR 762 million, of which SDR 540 million has already been contracted and the rest has been identified.

28. During 1988, the authorities will continue their flexible exchange rate policy with a view to keeping the real effective exchange rate at least at its end-1987 level and maintaining the competitiveness of the Tunisian economy. Moreover, the authorities will adopt an active foreign debt management policy with the goal of reducing the country's debt burden and its overall exchange risk. As a beginning, a monitoring unit will be constituted immediately, and will be responsible for centralizing the data available on the external debt structure (by creditor, by currency, and by interest rate and maturity terms).

29. In light of the strong volatility of currencies on foreign exchange markets, and given the flexible exchange rate policy pursued by Tunisia, the exchange risk cover scheme will be modified, so as to facilitate the assumption of exchange risks by the economic agents concerned, to limit to the maximum extent the cost to the Treasury, and to prepare the ground for applying a cover scheme based on market-determined instruments. On the basis of these principles, the Central Bank will

continue to manage a forward foreign exchange market (up to a maturity of one year), and will offer renewable foreign exchange options (with a maximum maturity of 12 months), taking into account the differential in interest rates on foreign currencies and the dinar market interest rate, which is determined competitively by supply and demand conditions in the money market. In providing forward cover for commercial transactions, the Central Bank will seek to achieve balance among market participants. In case of rapid and unexpected shifts in exchange rates that lead to liquidity problems for financially sound businesses, the banking system may intervene through normal credit channels, with the possibility of refinancing at terms prevailing on the money market. The authorities will examine periodically with the Fund staff the operation of these instruments of cover, as well as the possibility of developing other short-term hedging instruments for foreign exchange risk, and ways of associating banks and other financial institutions with the management of this system.

30. Given the projected cost to the budget of the present Exchange Rate Guarantee Fund, the guarantee extended by this fund will be eliminated from August 15, 1988, except for the settlement of claims on loans contracted by development banks before that date. Thereafter, the Central Bank will put in place an exchange rate cover scheme for external credit lines that are contracted by banks at the instruction of the Government and in the context of balance of payments support. The authorities will endeavour to ensure that the bulk of these resources is mobilized in the context of bilateral and multilateral cooperation at concessional terms. This scheme, which is only of a temporary nature,

will enable Tunisia to mobilize credit lines offered to the Government to finance development while meeting present budgetary constraints. The scheme will be financed by the proceeds of the differential between the interest rate on the external loans and the Tunisian money market rate or of a minimum annual fee of 3 percent, whichever is greater, as well as, if necessary, by central bank revenue. The overall annual limit on such loans and their composition will be identified in the context of each Economic Survey, and will be discussed with the Fund staff during the periodic program reviews.

31. In January 1988, the authorities liberalized imports of capital goods, following the liberalization in 1986-87 of raw materials, spare parts, and semi-finished products for all enterprises, with the exception of certain goods, specifically those produced by infant industries or imported by weakly integrated industries. The liberalization of import categories that remain subject to prior authorization, in particular all consumer goods, will be implemented gradually so as to stimulate the ability of relevant industries to adjust to foreign competition. The authorities will launch a further series of liberalization measures before the end of June 1989, raising the ratio of freely imported goods to total imports from the current 53 percent to 68 percent by end-June 1989.

32. The second stage of the customs tariff reform came into effect in January 1988, entailing reductions ranging from 1 to 9 percentage points, with a maximum tariff set at 43 percent and a minimum at 17 percent.

33. In January 1988, the authorities also liberalized producer prices

for various manufactured goods, thereby raising the proportion of industrial products for which prices have been liberalized since 1986 to about 55 percent. A further list of goods is to be liberalized in July 1988, bringing this proportion to approximately 60 percent. The first stage in the liberalization of distribution markups, planned for July 1988, will affect products representing 10 percent of manufacturing production.

34. A number of public tariffs as well as petroleum product prices will be increased during 1988 in order to mobilize resources for public enterprises and the Government. Moreover, some prices subsidized by the Caisse Générale de Compensation will be adjusted, thus limiting the deficit of the Caisse to its 1987 level.

Performance Criteria and Program Reviews

35. In order to review progress made under the program, the following performance criteria have been established: (a) a ceiling on net domestic credit by the banking system; (b) a subceiling on net credit to the Government by the banking system; (c) a minimum level of net foreign assets of the Central Bank, starting from December 1988; and (d) limits on external nonconcessional debt contracted or guaranteed by the Government with a maturity of less than 1 year, between 1 and 5 years, and between 1 and 12 years. There will be no accumulation of external payments arrears by the Central Government during the program period. In addition, the authorities do not intend to impose or intensify restrictions on payments and transfers for current international transactions, or introduce or modify multiple currency practices, or

conclude bilateral payments agreements which are inconsistent with Article VIII of the Fund's Articles of Agreement, or to impose or intensify restrictions on imports for balance of payments purposes. Moreover, the following indicative targets have been selected: (i) consolidated deficit of the Central Government; (ii) revenue and grants; (iii) total expenditures and net lending; (iv) bank credit to selected public enterprises; and (v) distribution of credit by the development banks.

36. Apart from the aforementioned performance criteria, there will be five program reviews with the Fund to be completed before March 15, 1989; August 15, 1989; March 15, 1990; August 15, 1990; and March 15, 1991. The completion of each of these reviews will be necessary to make further purchases under the stand-by arrangement from the Fund. The first, third, and fifth reviews will establish annual financial programs for the years 1989, 1990 and 1991, respectively, including the determination of performance criteria and indicative targets. All the reviews will entail an assessment of the progress made in the structural reforms, with particular attention given to the liberalization of prices and foreign trade, tax reform, financial sector reform, and exchange rate policy. Finally, the first review will specifically examine the restructuring program for the public enterprise sector and its impact on the central government budget.

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Table 1 Tunisia: Performance Criteria and Indicative Targets, December 1987-December 1988

	1987	1988			
	Dec. Performance	Mar. 1/	June 2/	Sept.	Dec.
A. Performance criteria		(In millions of dinars)			
1. Domestic credit	4600	4692	4796	4872	4999
2. Net credit to the Government	721	721	760	737	771
		(In millions of SDRs)			
3. Net foreign assets of the Central Bank	145	27 3/	64 3/	192 3/	220
4. Official borrowing abroad 4/					
a. 0-1 year (amount outstanding, excluding import-related credits)	...	120	120	120	120
b. New nonconcessional borrowing abroad (cumulative amounts since January 1, 1988)					
(i) 1-5 years	...	170	170	170	170
(ii) 1-12 years	...	450	450	450	450
5. External payments arrears (amount outstanding)	--	--	--	--	--
B. Indicative targets		(In millions of dinars)			
1. Consolidated budget deficit	-287	-47	-199	-206	-350
2. Total revenue and grants	2549	605	1252	1903	2716
3. Total expenditure and lending (excluding debt amortization)	-2836	-652	-1451	2109	3066
4. Credit by monetary system to selected public enterprises 5/	...	...	...	...	...
5. Credit by development banks 5/					
a. to selected public enterprises	...	...	...	...	...
b. to the rest of the economy	...	...	...	...	...

1/ As indicated in our letter of March 7, 1988.

2/ Indicative targets.

3/ Indicative targets; the end-March figure corresponds to a target of SDR 42 million for the monetary system as a whole, as indicated in our letter of March 7, 1988.

4/ Contracted or guaranteed by the Government or Central Bank.

5/ A procedure for monitoring these aggregates is being established; information will be sent monthly to the Fund from the beginning of the program, and indicative targets for 1989 will be established during the first review of the program.

Table 2. Tunisia: Summary of the Program to Liberalize Foreign Trade and Prices, 1988-1991

1. Price liberalization

a. Liberalization of producer prices for manufactured goods representing:

approximately	55 percent	of manufacturing production	in January 1988
"	60 percent	"	in July 1988
"	70 percent	"	in March 1989
"	75 percent	"	by January 1991

b. Liberalization of distribution markups for products representing,

approximately	10 percent	of the value of production	in July 1988
"	20 percent	"	in January 1989
"	35 percent	"	in January 1990
"	50 percent	"	in January 1991

2. Import liberalization

a. Imports of raw materials, semi-finished products and capital goods were liberalized in three stages (with exceptions relating to infant or weakly integrated industries) in January 1988.

b. Liberalization of all products, according to the following schedule:

approximately	53 percent	of imports (1987 base)	in January 1988
"	68 percent	"	in June 1989
"	75 percent	"	in June 1990
"	80 percent	"	in March 1991

INTERNATIONAL MONETARY FUND

May 18, 1988

Mrs. Junz:

Tunisia--Memorandum of Economic and Financial Policies

Attached are our comments on the above paper which was reviewed by Mr. Fajgenbaum. These comments are limited to the three paragraphs that have been added to the previous draft. However, we do not know what is the status of the earlier comments this Department made on that draft.

: Mr. Hino
Mr. Johnson
Mr. Parcu

Joaquín P. Pujol

ETR3/CRT/TUN/cotun02
May 18, 1988

Tunisia--Comments on Selected Paragraphs of the Memorandum of Economic and Financial Policies

We are concerned about the excessive exchange risks being undertaken by the Government and the associated potential exchange losses that may arise. Exchange rate guarantees have been a source of major inflationary pressures in many countries. An external shock could easily result in a very sharp expansion of liquidity and hence jeopardize the progress achieved so far. The proposed arrangements constitute a weakening of an already weak program. As we have pointed out in our earlier comments, it is really disappointing to initiate the revival of the EFF with a program as weak as this one.

We welcome the inclusion of the balance of payments test.

Paragraph 23 bis

We have two problems with this paragraph. The first relates to the nature of the employment programs. It is not clear from the text whether these programs are temporary or permanent. This doubt arises from the word "initiation" used at the beginning of line 7 of the paragraph and the word "permanent" used when referring to the number of jobs lost. If these are temporary programs, and the impact on expenditures is limited to 1988, the two words could be deleted to avoid confusion. However, if they are not temporary, the fiscal programs for 1989 and thereafter might be affected and additional revenue measures would be needed to maintain the original overall deficits.

The second problem relates to the last sentence of the paragraph. In view of the uncertainty regarding the maintenance of the deficit target that is raised by the wording of this sentence and the need to preserve the original target, which has already been weakened, we would suggest adopting a stronger language. A possible redrafting would be: "The remaining amount will be obtained through restraints on other government expenditures or additional grants . . .."

Paragraph 28

We wonder what is the operational meaning of "to the extent possible" at the beginning of line 5. Is there any understanding on a limit on this cost to the Treasury? We also have doubts regarding the forward cover for commercial transactions. Can the Central Bank really achieve a balance between purchases and sales of forward cover? Parenthetically, it would be useful if the sentence starting on line 13 explicitly specifies that the balance is between purchases and sales of forward cover.

While we have no difficulty with the banking system providing financial assistance to sound businesses in case of an unexpected shift

in exchange rates, we would have expected that a mention be made to the fact that the overall credit target will be maintained unchanged.

Paragraph 28a

This paragraph is a major source of concern for the possible large losses associated with the new exchange rate cover. In fact, potential losses are larger than under the previous arrangement because the proposed scheme will be available to all banks, rather than a few development banks, and nonconcessional loans may also be included, effectively reducing the interest rate differential that is supposed to cover potential losses to safeguard the program. There is a need to limit these losses. A possibility would be to set an absolute limit to the dinar amount per U.S. dollar (or SDR) per year that the scheme would be able to provide. This also would enable Tunisia to mobilize available external credit lines, which was a major objection of the Tunisian authorities to the staff proposals. While it is indicated that the scheme is of a temporary nature, as mentioned in the middle of the paragraph, there is no mention of its possible termination date.

We would like to suggest deleting the words "while meeting the budgetary constraints" in line 12, because even if the exchange losses were financed by the Central Bank's revenue, they will effectively affect the budget as the transfer of the Central Bank's profits to the Government would be lower than otherwise.

INTERNATIONAL MONETARY FUND

May 18, 1988

Mrs. Junz:

The attached is for your information.

Attachment

E. L. Bornemann

Office Memorandum

TO: Mr. Bornemann May 18, 1988

FROM: Arne B. Petersen

SUBJECT: Tunisia - Exchange Rate Risk Guarantee

The mission, throughout the negotiations, has been in agreement on the desirability of eliminating the exchange rate guarantee. As you know, it proved necessary to accept a compromise, which I nevertheless believe provides adequate safeguards as to the likely losses that may be incurred by the Central Bank. The Tunisian delegation agreed that the bulk, which they implied would mean virtually all, of the guaranteed loans would be on concessional terms. Also, they agreed to place limits on the amount of guarantees to be granted, as well as the composition of loans, in the context of the annual reviews with the Fund. Thus, only the period August 15-December 31 is not covered by a limit.

While each of the individual assumptions used in the illustrative calculations in the attachment to Mr. Parcu's memorandum of May 16, 1988 seems reasonable, together they combine to portray an unduly pessimistic picture of the likely losses from the proposed scheme, for the following reasons.

1. Considering the historical experience, I doubt if the authorities plan to extend guarantees to the tune of as much as SDR 200 million per year for the next 10 years; certainly, during the EFF period, the mission will seek to limit the annual amount of borrowing to be guaranteed to significantly less than SDR 200 million.

2. As the guaranteed debt will largely be concessional, the interest rate differential could well reach 5 percent, rather than 1 1/2 to 3 percent. Concessional loans in 1986 carried an average interest rate of 3 1/2-4 percent according to Mr. Parcu's rough calculations, and the money market rate at present stands at 9 1/2 percent. Thus, the scheme should be more fully financed on average than assumed by Mr. Parcu.

3. As agreed with the authorities, the scheme is temporary; thus, potential losses calculated on the assumption that guarantees will be extended until 1997 are probably exaggerated. In any event, it is inaccurate to include guarantees for 1987 in the calculation.

4. The assumed annual depreciation of the dinar vis-à-vis the SDR would imply a cumulative depreciation of 50 percent in real terms in terms of foreign currency over the period based on presently projected inflation differentials. Should our inflation objective not materialize, domestic interest rates and thus the interest differential would increase, thus providing more resources to finance the scheme, other things being equal.

Without adjusting for point 3 above, the cost of the scheme by 1997, assuming guaranteed borrowing of SDR 100 million per year and an annual depreciation of 10 percent, would range between D 35 million (0.14 percent of GDP) and D 81 million (0.40 percent of GDP). Assuming an annual depreciation of 5 percent, which would still imply a real depreciation of 17 percent, the annual outcome would range between a gain of D 5 million (0.02 percent of GDP) and a loss of D 23 million (0.12 percent of GDP).

cc: Mr. Anjaria
Mr. Khallouf
Mr. Tazi
Mr. Parcu

Mrs. Junz

Office Memorandum

May 18, 1988

To: Mr. Bornemann

From: K. Nashashibi

Subject: Tunisia - Amended Letter of Intent for Extended Arrangement

The proposed addition of the three paragraphs to the letter of intent would, in our view, contribute to a substantial weakening of the program.

1. Although the additional expenditure increase proposed by the authorities is 0.4 percent of GDP, it raises questions about the authorities' commitment to the program. They are proposing a supplementary budget less than a month after the mission was in Tunisia, on grounds (e.g., the drought and the invasion of locusts) which were known at the time of the staff's visit to Tunisia, and which in fact were included in the original letter of intent. Further, the staff has not been able to examine the draft supplementary finance law, and cannot assess the extent to which the proposed additional expenditure will be covered by additional grants and revenue. At present we do not know how, or indeed whether, the specified fiscal deficit target for 1988 can be reached. Therefore, we cannot agree to the inclusion of this paragraph until the staff has had an opportunity to review the supplementary budget and be satisfied that it is consistent with the achievement of the deficit target for 1988.

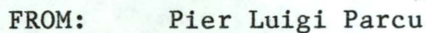
2. The paragraph on the exchange risk cover scheme opens the door to potentially much higher liabilities than incurred in the past by extending the scheme to all banks instead of limiting it to development banks. In addition, the proposed paragraph does not limit the scheme to concessional loans, which may result in substantial financing from central bank revenues instead of being limited to funding from the interest rate differential between concessional funds and domestic money market. The potential resort to budgetary support to finance these operations would constitute a further fiscal weakening. We would suggest that this paragraph be substantially tightened, possibly through the inclusion of a ceiling on such potential losses.

cc: Mr. Tait
Mrs. Junz
Mrs. Ter-Minassian
Mr. Chu

Office Memorandum

TO: Mrs. Junz May 16, 1988

FROM: Pier Luigi Parcu



SUBJECT: Tunisia--Exchange Rate Risk Guarantee

As you requested, please find below a discussion of the possible implications of the agreement reached with the Tunisian delegation on the issue of the exchange rate risk guarantee.

1. By the end of 1987 the Exchange Stabilization Fund in Tunisia has extended guarantees covering accumulated obligations of about D 400 million. The guarantees provided by this fund were limited to a few development banks. The resources of the fund, received in an extrabudgetary pool at the Treasury, were gathered through the imposition of different types of parafiscality on credit. After payment of arrears during 1988, through a special contribution of the budget of D 40 million, the Tunisian authorities evaluate that the fund will be able to discharge future losses of about D 20 million per year (0.25 percent of 1987 GDP) on its existing obligations through the maintenance of levies on credit. The agreement establishes that the fund will not assume new obligations after August 15, 1988.

2. The agreement accepts a new type of exchange rate guarantee to be extended by the Central Bank of Tunisia (CBT) to banks contracting lines of credit in foreign currencies under instruction of the Government. The source of financing for the eventual exchange rate losses would be primarily the difference between the interest rate on the foreign liability and the money market interest rate in Tunisia that will be transferred by the banks to the Government. If this interest rate differential proves to be insufficient to finance the loss, due to the appreciation of the liabilities in foreign exchange, the income of the CBT would used to cover the residual.

3. The new arrangement presents advantages and disadvantages with respect to the existing Exchange Stabilization Fund. The advantages are that the CBT should be more able than the Treasury to control the assumption of liabilities and that the interest rate differential explicitly identified between foreign and domestic money market interest rates constitutes a better method of financing than a general parafiscality on credit. The disadvantages are that the new agreement could give rise to the assumption of much higher obligations than in the past, as the guarantee is not limited only to few development banks but it is given to banks in general. Moreover, the failure to obtain assurance that the guarantee will be given only for concessional funds sheds doubts about the adequacy of the interest rate differential as the main source of financing for the eventual losses.

4. In the attached table some hypotheses on the possible cost of the guarantee are explored. In the most favorable case shown in the table, with an annual depreciation of the dinar against the SDR of only 3 percent and an interest rate differential also of 3 percent between the average cost of the foreign credits and the money market rate in Tunisia, the new scheme will be fully funded and might even realize a small surplus. In the least favorable case shown in the table, with an annual dinar depreciation against the SDR of 10 percent and an interest rate differential of only 1.5 percent, the uncovered loss for the CBT would reach in few years a level of about 0.8 percent of GDP per annum. Less favorable hypothesis on the depreciation of the dinar against the SDR, "catastrophic scenarios," would obviously imply much larger losses.

5. While the outcome of the scheme can vary widely under different assumptions, limiting the potential for losses is exactly what the agreement should have sought to achieve. In this context, having accepted that the guarantees can be extended to commercial loans and to all banks represents a serious weakening of the EFF program and sheds doubts on the ability of the present guarantee scheme to improve on the existing one.

It should be emphasized that during the negotiation of this topic the Fund's hand has been weakened by the World Bank's positions on the issue; and, moreover, during the last phase of the negotiation, the Tunisians already had the Bank's blessing on a scheme identical to the one finally accepted by the African Department.

Attachments

cc: Mr. Pujol
Mr. Anjaria
Mr. Petersen
Mr. Tazi
Mr. Khallouf

Tunisia 1987-1996 : Exchange rate guarantee hypotheses of cost

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Nominal GDP	7993	8455	9457	10456	11466	12635	13860	15246	16771	18448	20292
Nominal growth		5.8%	11.9%	10.6%	9.7%	10.2%	9.7%	10.0%	10.0%	10.0%	10.0%
Exchange rate hypotheses											
Case a											
Dinar/SDRs depreciation 3%	1.1218	1.1555	1.1901	1.2258	1.2626	1.3005	1.3395	1.3797	1.4211	1.4637	1.5076
Case b											
Dinar/SDRs depreciation 5%	1.1218	1.1779	1.2368	1.2986	1.3636	1.4317	1.5033	1.5785	1.6574	1.7403	1.8273
Case c											
Dinar/SDRs depreciation 8%	1.1218	1.1555	1.2479	1.3477	1.4555	1.5720	1.6977	1.8336	1.9802	2.1387	2.3098
Case d											
Dinar/SDRs depreciation 10%	1.1218	1.2340	1.3574	1.4931	1.6424	1.8067	1.9873	2.1861	2.4047	2.6451	2.9097
oan amounts											
Annual amount in SDRs	200	200	200	200	200	200	200	200	200	200	200
Ammortization (4 yearly ins 3 years grace).	0	0	0	50	100	150	200	200	200	200	200
Outstanding in SDRs	200	400	600	750	850	900	900	900	900	900	900
Case a											
Annual amount in Dinars	224.4	231.1	238.0	245.2	252.5	260.1	267.9	275.9	284.2	292.7	301.5
Ammortization	0.0	0.0	0.0	61.3	126.3	195.1	267.9	275.9	284.2	292.7	301.5
Ammortization original rat	0.0	0.0	0.0	56.1	113.9	173.4	234.7	241.7	249.0	256.4	264.1
Yearly loss	0	0	0	5.2	12.4	21.7	33.2	34.2	35.3	36.3	37.4
in percentage of GDP	0.000%	0.000%	0.000%	0.050%	0.108%	0.172%	0.240%	0.225%	0.210%	0.197%	0.184%
Interest differential 1.5%	3.4	6.9	10.7	13.8	16.1	17.6	18.1	18.6	19.2	19.8	20.4
Loss minus int. diff. 1.5%	-3.4	-6.9	-10.7	-8.6	-3.7	4.1	15.2	15.6	16.1	16.6	17.1
percentage of GDP	-0.042%	-0.082%	-0.113%	-0.082%	-0.032%	0.033%	0.109%	0.102%	0.096%	0.090%	0.084%
Interest differential 3.0%	6.7	13.9	21.4	27.6	32.2	35.1	36.2	37.3	38.4	39.5	40.7
Loss minus int. diff. 3.0%	-6.7	-13.9	-21.4	-22.4	-19.8	-13.4	-2.9	-3.0	-3.1	-3.2	-3.3
in percentage of GDP	-0.084%	-0.164%	-0.227%	-0.214%	-0.173%	-0.106%	-0.021%	-0.020%	-0.019%	-0.017%	-0.016%
Case b											
Annual amount in Dinars	224.4	235.6	247.4	259.7	272.7	286.3	300.7	315.7	331.5	348.1	365.5
Ammortization	0.0	0.0	0.0	64.9	136.4	214.8	300.7	315.7	331.5	348.1	365.5
Ammortization original rat	0.0	0.0	0.0	56.1	115.0	176.8	241.8	253.8	266.5	279.9	293.9
Yearly loss	0	0	0	8.8	21.4	37.9	58.9	61.9	64.9	68.2	71.6
in percentage of GDP	0.000%	0.000%	0.000%	0.085%	0.186%	0.300%	0.425%	0.406%	0.387%	0.370%	0.353%
Interest differential 1.5%	3.4	7.1	11.1	14.6	17.4	19.3	20.3	21.3	22.4	23.5	24.7
Loss minus int. diff. 1.5%	-3.4	-7.1	-11.1	-5.8	4.0	18.6	38.6	40.5	42.6	44.7	46.9
in percentage of GDP	-0.042%	-0.084%	-0.118%	-0.055%	0.035%	0.147%	0.279%	0.266%	0.254%	0.242%	0.231%
Interest differential 3.0%	6.7	14.1	22.3	29.2	34.8	38.7	40.6	42.6	44.8	47.0	49.3
Loss minus int. diff. 3.0%	-6.7	-14.1	-22.3	-20.4	-13.4	-0.7	18.3	19.2	20.2	21.2	22.3
in percentage of GDP	-0.084%	-0.167%	-0.235%	-0.195%	-0.117%	-0.006%	0.132%	0.126%	0.120%	0.115%	0.110%

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Case c											
Annual amount in Dinars	224.4	462.2	748.7	1010.8	1237.2	1414.8	1528.0	1650.2	1782.2	1924.8	2078.8
Ammortization	0	0	0	67.4	145.6	235.8	339.5	366.7	396.0	427.7	462.0
Ammortization original rat	0.0	0.0	0:0	56.1	113.9	176.3	243.6	260.3	281.2	303.6	327.9
Yearly loss	0	0	0	11.3	31.7	59.5	95.9	106.4	114.9	124.1	134.0
in percentage of GDP	0.000%	0.000%	0.000%	0.108%	0.276%	0.471%	0.692%	0.698%	0.685%	0.673%	0.660%
Interest differential 1.5%	3.4	6.9	11.2	15.2	18.6	21.2	22.9	24.8	26.7	28.9	31.2
Loss minus int. diff. 1.5%	-3.4	-6.9	-11.2	-3.9	13.1	38.3	73.0	81.6	88.2	95.2	102.8
in percentage of GDP	-0.042%	-0.082%	-0.119%	-0.037%	0.115%	0.303%	0.527%	0.535%	0.526%	0.516%	0.507%
Interest differential 3.0%	6.7	13.9	22.5	30.3	37.1	42.4	45.8	49.5	53.5	57.7	62.4
Loss minus int. diff. 3.0%	-6.7	-13.9	-22.5	-19.0	-5.4	17.1	50.1	56.9	61.4	66.3	71.6
in percentage of GDP	-0.084%	-0.164%	-0.238%	-0.182%	-0.047%	0.135%	0.361%	0.373%	0.366%	0.360%	0.353%

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Case d											
Annual amount in Dinars	224.4	493.6	814.4	1119.8	1396.1	1626.0	1788.6	1967.5	2164.2	2380.6	2618.7
Ammortization	0.0	0.0	0.0	74.7	164.2	271.0	397.5	437.2	480.9	529.0	581.9
Ammortization original rat	0.0	0.0	0.0	56.1	117.8	185.7	260.3	286.3	315.0	346.5	381.1
Yearly loss	0	0	0	18.6	46.5	85.3	137.2	150.9	166.0	182.6	200.8
in percentage of GDP	0.000%	0.000%	0.000%	0.178%	0.405%	0.675%	0.990%	0.990%	0.990%	0.990%	0.990%
Interest differential 1.5%	3.4	7.4	12.2	16.8	20.9	24.4	26.8	29.5	32.5	35.7	39.3
Loss minus int. diff. 1.5%	-3.4	-7.4	-12.2	1.8	25.5	61.0	110.3	121.4	133.5	146.8	161.5
in percentage of GDP	-0.042%	-0.088%	-0.129%	0.017%	0.223%	0.482%	0.796%	0.796%	0.796%	0.796%	0.796%
Interest differential 3.0%	6.7	14.8	24.4	33.6	41.9	48.8	53.7	59.0	64.9	71.4	78.6
Loss minus int. diff. 3.0%	-6.7	-14.8	-24.4	-15.0	4.6	36.6	83.5	91.8	101.0	111.1	122.2
in percentage of GDP	-0.084%	-0.175%	-0.258%	-0.144%	0.040%	0.289%	0.602%	0.602%	0.602%	0.602%	0.602%

Office Memorandum

chron

TO: Mr. Bornemann May 3, 1988

FROM: A. Basu

SUBJECT: Tunisia--Clearance of Letter of Intent for Extended Arrangement

I have the following general comments for your consideration:

1. Given the objectives of export diversification (including a rise in market shares for non-energy exports), trade liberalization, and the balance of payments and reserve build-up targets, we feel that the statement on exchange rate policy (in paragraph 13) should be stronger. A policy that involves "the maintenance of the real effective exchange rate at least at its end-1987 level" would not appear to be sufficient for achieving the objectives. In the same paragraph, the references to a separate "interbank foreign exchange market" and to "a mechanism that will allow exporters to retain a position of foreign exchange proceeds" are not clearly explained (especially, how they relate to the present exchange rate arrangements). The former could lead to a dual exchange rate system. Is there an intention to switch to a market-determined system?

2. The risks of not achieving the fiscal targets (for 1988 and the medium term) appear to be not insignificant, because of revenue shortfalls (paragraph 21), payments for exchange and interest rate risks (paragraph 22), and an (as yet) unknown amount of financing that the rehabilitation of public enterprises may require (paragraph 18). It would be useful to think in terms of the (contingency) measures that could be taken if the public sector's imbalance turns out later (during the review mission) to be larger than presently foreseen.

3. The targets for increase in broad money (9.3 percent) and domestic credit (8.8 percent) have been maintained unchanged from the last staff report and/or previous brief, even though the increase in nominal GDP being envisaged now is lower than earlier envisaged. It would be helpful to have a credit program that is somewhat tighter.

4. The liberalization of distribution markups seems to be much slower than the liberalization of producer prices of manufactured goods and of imports (Table 2, paragraphs 29-31). We feel that a faster pace of liberalization of these markups would be desirable.

5. Given our concerns under the first three points above, there is a substantial risk that balance of payments and reserve objectives will be difficult to achieve. We would suggest that net foreign assets of the Central bank be treated as a performance criterion, starting earlier than envisaged (December 1988).

6. By the end of the program, 20 percent of imports would still be subject to quantitative restrictions. Could we consider replacing these by tariffs?

7. Given the large differences between the fiscal deficits on commitment and payment order basis during 1984-87, we would suggest including an understanding that no domestic arrears will be incurred under the program. Please also consider converting the indicative target on the consolidated deficit of the Central Government into a performance criterion from 1989 onward.

8. Presentational points

a. There seems to be a consistency problem between current account deficits and S-I gaps (in the indicators table) for 1989-91.

b. There is a small difference in the bank financing of the Government between the fiscal (D 50 million) and monetary (D 53 million) tables.

cc: Mr. Gianviti
Mr. Tanzi
Mr. Bhuiyan
Mr. Johnson
Mr. Pujol
Mr. Parcu

INTERNATIONAL MONETARY FUND

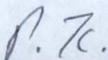
May 3, 1988

Mr. Basu:

Tunisia--Draft Letter of Intent

Attached are comments on the draft letter of intent for Tunisia which I reviewed.

cc: Mr. Pujol
Mr. Stuart
Mr. Parcu



Peter M. Keller

ETR4/CRT/TUN: cotuncrt May 3, 1988

Tunisia--Comments on Draft Letter of Intent

1. Why is the energy balance deteriorating so sharply? The letter of intent should indicate if this is due to rising domestic consumption (how are oil products priced domestically?), falling production, etc.

2. Paragraph 3, line 7

It would be helpful to add after "international prices" a clarification such as "of other export commodities."

3. Top of page 7

It would be useful to give the debt service ratio for 1988-89 to help the reader interpret the projected rise.

4. We welcome the proposal to make the NFA test a performance criterion. Why are the authorities resisting that it would be done immediately?

5. We would like to see assurances that the "additional borrowing requirements" for 1988 and beyond can indeed be filled. We assume that the debt service projections already take account of this additional borrowing. (What terms are assumed?)

INTERNATIONAL MONETARY FUND

May 3, 1988

Mrs. Junz:

Tunisia? Comments on
Letter of Intent

Attached are comments on the letter of intent for Tunisia which was reviewed by Mr. Fajgenbaum.

cc: Mr. Johnson
Mr. Stuart
Mr. Parcu

Joaquín P. Pujol

Tunisia: Comments on Letter of Intent

It is really disappointing to initiate the revival of the EFF process with a program as weak as the proposed one. As discussions with the Tunisian authorities will continue, we hope that some strengthening of the program could be achieved both in the macropolicies and structural adjustment areas. On the macropolicy area, we are concerned about exchange rate, fiscal, wages, and monetary policies. On the structural adjustment area, our concerns relate to trade liberalization and pricing policies. We have also some difficulties regarding the architecture of the program.

I. Macropolicies

1. Exchange rate policy

It seems to us that paragraph 13 does not address sufficiently the need for exchange rate policy to facilitate the trade liberalization and tariff reduction process. We would suggest that a specific reference be made, perhaps by adding in between commas "including the trade liberalization program" after structural adjustment in the second line. But our major concern in this area is the second part of the paragraph where it is hinted that the exchange rate is not entirely appropriate to promote an efficient allocation of foreign exchange. If this were the case, the realism and effectiveness of the import liberalization program and the feasibility of the projected export growth would be called into question. In addition, it would seem to us that the introduction of the interbank foreign exchange market could lead to a dual exchange rate system.

2. Fiscal policy

Although the fiscal targets are in line with the March brief, which represented a significant weakening of the previous briefs, the unresolved problems related to the public enterprises and the exchange rate risk coverage could jeopardize attainment of those fiscal targets. Although we appreciate that the authorities are negotiating a public enterprise reform program with the World Bank, we would have expected that as a minimum the letter of intent could have had an outline of the macroeconomic objectives of the reform that would be consistent with the overall program. As it stands, such consistency is lacking because the larger (smaller) the bank financing of these enterprises, the smaller (larger) the available financing to the private sector. In this connection, what is the operational significance of the last sentence of paragraph 18? What could the review mission do if it finds out that too much credit is needed by these enterprises? On exchange rate risk coverage, we would hope that the mission maintains

its position on the compromise solution, to avoid creating a major source of difficulties over the medium term, especially if there was already an agreement on the basic principles as noted in the debrief.

3. Wage policy

We are concerned about the sharp increase in public sector wages and the likely demonstration effect it may have on private sector wages. Such a development could risk attainment of the inflation target and add pressures on the exchange rate. Close monitoring of developments in this area will be needed.

4. Monetary policy

The monetary program for 1988 envisages a slowdown in velocity of circulation that needs to be explained (the first sentence of paragraph 25 appears inadequate), especially taking into account that the rate of growth of broad money is the same as in the previous brief, when real GDP was assumed to grow at 2.5 percent. The envisaged expansion of credit combined with a large wage increase could certainly result in a higher inflation rate than targeted under the program.

5. Medium-term macroframework

There seems to be a consistency problem between the external current account deficits and the savings investment gaps projected for 1989-91 (selected indicators table). In 1986-88, these deficits and gaps are quite similar; however, a difference of about one percent of GDP develops in each of the following years. Is this because the adjustment of the current account is too slow or because the increase in gross national savings is overoptimistic? In view of the projected central government savings, which increases only marginally from 1988 to 1991, the latter appears to be the case.

II. Structural Adjustment Policies

In our view, the structural content of the program, excluding the tax reform, is rather weak. We fail to understand why 20 percent of the imports would still be subject to qualitative restrictions by the end of the program. If for social or political reasons imports of luxury items need to be restricted, why not do it more efficiently through import duties? In addition, which are the other goods referred to in the middle of paragraph 17? Why should they be restricted. Furthermore, protection of infant industries is more efficiently achieved by tariffs than through quantitative import controls.

The proposed targets and timetable for price liberalization are rather disturbing, especially those on distribution markups. During 1988 and 1989, only 10 percent and 20 percent, respectively, of the manufactured goods, not even total goods, would be unrestricted (paragraph 31). Should the program not aim at a more ambitious enhancement of efficiency in resource allocation. Since this is an open

issue, according to the debrief, we hope that a substantially faster pace of price liberalization is agreed with the authorities.

III. Operational Aspects

We still believe that a balance of payments test would be a critical part of the architecture of the program, particularly in view of our comments on exchange rate policy. If the authorities were to insist that they want to introduce this as a performance criterion in 1989, we would suggest it should start in March (the last line of page 18 should be modified accordingly).

We would also suggest that the indicative target on the consolidated deficit of the central government be converted into a performance criterion in 1989.

Finally, in view of the large differences between the deficits on commitment and payment order bases during 1984-87, we would suggest including an understanding that no domestic arrears will be incurred under the program.

IV. Presentational Points

1. Paragraph 14

We wonder whether the cost of the 100,000 jobs is included in the consolidated central government accounts. Could this be clarified in the paragraph?

2. Paragraph 16

It would be helpful if a comment could be made as to whether the 25 percent of manufacturing goods subject to price controls includes products manufactured by the private sector.

3. Paragraph 26

Are the identified external flows likely to be forthcoming? It would be helpful if the classification were made.

4. Paragraphs 29 and 31

Are the liberalization of imports and prices based on a timetable within the year or only a one-shot annual operation?

5. There is a small difference in the bank financing of the government between the fiscal (D 50 million) and monetary (D 53 million) tables.

6. Some minor editorial comments were given to Mr. Parcu directly.

Office Memorandum

cc: Mrs. Junz o/r, Mr. Basu, Mr. Johnson, Mr. Puyol, Mr. Parcu

ETR

TO: The Managing Director
The Deputy Managing Director

April 27, 1988

FROM: E.L. Bornemann

SUBJECT: Tunisia - Extended Arrangement

A staff team comprising Messrs. Petersen and Khallouf (both AFR), Tazi (FAD), Parcu (ETR), Mrs. Klotz (secretary-Paris Office), and myself visited Tunisia during April 5-20, 1988, to complete the discussions on an extended arrangement. The discussions had been initiated in February during the third review of the present stand-by arrangement (which expires at end-May 1988). With one exception, the mission completed negotiations, ad referendum, on a program for 1988-91 in line with its brief. The only remaining issue relates to the guarantee of exchange rate risk, for which the authorities were not yet ready to formulate specific undertakings, although there was agreement on the basic principles to be followed (see below). Negotiations are expected to be completed in early May, when a Tunisian delegation visits Washington to finalize the negotiation of an IBRD structural adjustment loan.

1. Background and prospects for 1988

The assessment of developments in 1987 and prospects for 1988 remain broadly unchanged from that indicated in the staff report for the third review (EBS/88/57). You may recall that program objectives for 1987 were met or exceeded in most aspects, in particular for the external sector, partly on account of a good agricultural crop and a near-record year for the tourist sector, and that policies were implemented as scheduled.

For 1988, the drought is now assessed to be more serious than initially foreseen and, in addition, Tunisia, like much of North Africa, is plagued by an invasion of locusts. Thus far, vigilant countermeasures have prevented significant further damage to the crops, but the danger will not have passed until June. The unfavorable impact of these developments on the external side is likely to be offset by a better-than-expected tourist season; thus, the target for the current account deficit for 1988 remains unchanged at the equivalent of 3.8 percent of GDP (compared with 1.4 percent in 1987). However, the growth rate of real GDP has been revised downward from 2 percent to about 1 percent (compared with 5.8 percent in 1987), and the employment situation, particularly in agriculture, is expected to worsen further.

Given the broadly unchanged prospects for the economy both in the near and medium term, the program already negotiated for 1988 in the context of the third review of the present stand-by arrangement remains valid, and the negotiations focused mainly on the medium-term issues.

2. Objectives of the medium-term program and macroeconomic framework

The objectives of the program are (i) to achieve an average growth rate of 3.5 percent; (ii) reduce the rate of inflation from 6.5 percent in 1988 to about 5 percent in 1991 (which is ambitious in view of the needed increase in administered prices); (iii) reduce the consolidated central government deficit from 4.1 percent in 1988 to 2.3 percent in 1991; (iv) reduce the current account deficit to 2.3 percent in 1991, a level that is considered viable, given projected inflows of autonomous capital; and (iv) secure an adequate level of foreign reserves through an overall surplus of SDR 75 million in 1988 and additional moderate balance of payments surpluses thereafter.

Restrained wage policies should contribute to limiting the growth of private consumption to less than 3 percent, which, together with the reduction in the central government deficit, allows an increase in the saving ratio from 17.5 percent of GDP in 1988 to 21.5 percent in 1991. Thus, the program accommodates a significant increase in investment (5.8 percent in real terms on average) in support of the growth objectives and the reorientation of the economy toward the external sector while simultaneously reducing the current account deficit of the balance of payments. The private sector will need to carry an increased share of investment (56 percent in 1991 compared with 44 percent in 1987) given budgetary constraints.

The success of the program in terms of growth and employment creation rests on the assumption of a pickup in private investment in order to modernize the economy and to face the increased foreign competition. The authorities are concerned that data for the first few months do not yet firmly indicate a revival of investment, in spite of the measures taken at the end of 1987 and in early 1988. 1/ Accordingly, in mid-April they reduced the import tariff on capital goods and introduced certain measures in support of the housing sector to further stimulate private investment. In this connection, the mission stressed that the desired shift in the behavior of private investment would take time to materialize and that the appropriate climate would be assured best by the steady implementation of the structural policies aimed at liberalizing the economy.

3. Financial and structural policies

Fiscal policy aims at securing a decline in the consolidated overall deficit of the Central Government from 4.1 percent in 1988 to 2.3 percent in 1991 (compared with 2.5 percent in the brief). The deficits should be financeable at unchanged or slightly declining levels of domestic bank financing.

1/ These included a reduction in the parafiscal charges on lending rates, a liberalization of the investment code, the liberalization of imports of investment goods, and a tax amnesty.

As in 1988, revenue prospects for 1989 are difficult in view of the possible revenue impact of the various tax reforms, notably the introduction of the VAT in July 1988. The authorities expect that a better tax administration, together with the extension of the VAT to trade activities with a turnover of more than D 500,000 (with effect from January 1989), should be able to offset any shortfall, but they stand ready to take any offsetting measures that may be needed. Over the medium term, the authorities intend to keep the tax/GDP ratio unchanged at some 20.5 percent. On the basis of past revenue trends, this would require a further strengthening of tax administration and probably additional discretionary measures in 1990 and 1991.

To achieve the desired reduction in the overall deficit, the authorities will need to maintain a restrained expenditure policy. Accordingly, they intend to limit the average growth of total expenditures and net lending during the program period to the average rate of inflation, which would entail a decline of 4 percentage points in relation to GDP. Through a tight rein on recruitment, wages and consumer subsidies, it is expected that it will be possible to maintain investment expenditures roughly unchanged in real terms.

The mission examined in detail the projected cost of consumer subsidies to the budget. Without price increases, the costs would amount to D 1,250 million over the Plan period, or D 250 million per year. The authorities intend to reduce actual expenditures by 5 percent in nominal terms per year. However, in view of the magnitude of the required adjustment, they could only commit themselves firmly to maintaining consumer subsidies unchanged in nominal terms at their 1987 level (D 185 million), which would entail a reduction in relation to GDP from 2.3 percent to 1.6 percent over the period. The mission was provided with a list and the timing of scheduled price increases in 1988.

A new draft law is reducing the scope of direct control over public enterprises by limiting it to those cases where government participation exceeds 50 percent (compared with 34 percent previously). The process of rehabilitation/privatization has been strengthened by centralizing the review in one committee under the Prime Minister. Some 35 cases have been studied and it was decided to privatize nine, liquidate three, and to rehabilitate the remainder. The sector will be the subject of a World Bank public enterprise rehabilitation loan (PERL) scheduled to be approved by the end of 1988. Progress and plans for further reforms will be assessed in the first review of the EFF program.

The reform of the monetary and financial system will continue with the introduction of treasury bills at market-determined rates, which will also become an important element in the continued strengthening of the money market. These issues will be studied by a CBD technical assistance mission in July, and a specific timetable for further reforms will be established on the basis of its report. The authorities agreed with the proposed timing of the mission.

The process of liberalizing prices and imports will be continued during the program period, and detailed timetables were agreed with the authorities. The liberalization of industrial producer prices will be largely completed early in 1989 (70 percent of production), apart from certain products being produced under conditions of insufficient competition and goods subject to price control (such as bread and edible oil). Thereafter, only limited additional liberalization (equivalent to some 5 percentage points) is possible in line with the strengthening of competition in the relevant sectors, in part through opening them up to external competition. The liberalization of imports will be largely completed by 1991, when some 80 percent of imports will be free (compared with 53 percent in 1988). The exceptions will apply mainly to imports of those agricultural goods for which the consumer price is controlled and imports of petroleum products; in addition, the authorities expect that some exceptions will be needed for certain infant industries and weakly integrated industries.

In addition to the performance criteria and indicative targets contained in the previous stand-by arrangement, the monitoring of bank credit to key public enterprises and of credit from development banks will be included in the new program. The mission strongly urged that the indicative target for net foreign reserves be converted into a performance criterion. However, pointing to certain technical problems as well as to their demonstrated ability to successfully implement an economic and financial program, the authorities argued that this should not be done during the first year of the program. While the issue remains open, the mission would propose, as provided for in its brief, that it remains an indicative target in 1988, but be converted into a performance criterion in 1989.

4. Exchange rate guarantees

The authorities agreed with the mission that the present exchange rate guarantee scheme for development banks has become too costly and should be abolished. Accordingly, they are studying various forms of coverage at market-related costs on which agreement has been reached in principle. However, essentially for political reasons, they have committed themselves publicly to retain some form of guarantee for small- and medium-scale enterprises. The scheme could be limited to lending through the development banks, thereby reducing the coverage considerably. Moreover, part of the risk will be covered by the enterprises themselves through interest margins, charged by the development banks. However, the authorities were not yet able to elaborate on the scheme in detail. We expect that a satisfactory solution can be found when the Tunisian delegation visits Washington in early May.

5. Conclusion

As noted above, the authorities are concerned with the perceived lack of response of private sector investment to the structural measures taken thus far. The rate of unemployment has become an important political issue, which unfortunately has been aggravated by the drought in the first year of the new presidency. In response to the unemployment and the drought, several relief measures have been introduced, the cost of which for the 1988 budget should remain within the agreed budget target. In this light, the targeted reduction in the consolidated budget deficit for 1989 to 3.5 percent was the program element that proved most difficult to secure. While emphasizing their adherence to the reform program, the authorities initially argued for more flexibility in the phasing of certain structural reforms measures, notably import liberalization. Nevertheless, the mission is convinced that the present economic team is committed to the program outlined above.

The Governor of the Central Bank informed the mission that Tunisia would not make the last purchase under the current stand-by arrangement (although performance criteria for end-March are likely to have been observed), and that he does not expect to draw on the extended arrangement in 1988.

cc: ASD
CBD
ETR
EUR
EXR
FAD
GEN
INS
LEG
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PAR
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SEC
TRE
WHD
Mr. H. Simpson

Office Memorandum

TO: The Managing Director
The Deputy Managing Director

DATE: April 5, 1988

FROM: A.D. Ouattara and H.B. Junz

SUBJECT: Tunisia - Further Discussions on an Extended Arrangement

In response to the Deputy Managing Director's question on the briefing memorandum of March 31, 1988, we would like to note that there is no disagreement with the World Bank on the basic objective of eliminating the exchange rate guarantee scheme for the development banks. The World Bank, however, believes that the authorities will not be prepared to eliminate the present system outright and, therefore, is searching for a second-best solution. There is no disagreement on the basic principles of a replacement scheme if this should prove necessary. The World Bank would not insist on the implementation of their proposal, if the forthcoming Fund mission can develop a better alternative acceptable to the Tunisian authorities. The current brief attempts to do so.

The World Bank's attention was drawn to this matter in the context of their operational relations with the development banks through which part of their lending is channeled. The Bank's concern was motivated by the costs to the government budget and efficiency considerations for the enterprises who are the final borrowers, rather than by the implications for the exchange system. Cooperation with the World Bank on Tunisia has been good, and all aspects of the proposed medium-term program have been fully discussed with the Bank.

cc: Mr. H. Simpson

Office Memorandum

Mrs. Junz
cc. Ms. Dillon
Mr. Pujol
I. O.

TO: The Managing Director
The Deputy Managing Director

DATE: March 31, 1988

FROM: A.D. Ouattara and H.B. Junz

SUBJECT: Tunisia - Further Discussions on an Extended Arrangement

A staff team 1/ will visit Tunisia during the period April 6-19 to continue the discussions on a three-year program that could be supported by an extended arrangement. The mission will continue to be guided by the briefing paper of January 28, 1988, approved by management. The brief had proposed as an option to replace the remaining period of the stand-by arrangement by an extended arrangement (EFF). In the event, it was decided to postpone the discussion of the EFF and complete the third review of the stand-by arrangement, in part because of delays in policy preparation and in the discussions with the World Bank, but also because the authorities wanted to await the outcome of the discussions in the Executive Board on the revitalization of the EFF. The staff report on the third review (EBS/88/57) is scheduled for Executive Board discussion on April 4.

Since the return of the last mission, the World Bank and the Tunisian authorities have reached virtual agreement on the structural measures which will be supported by a SAL for $150 million. Formal negotiations are expected to take place in Washington in early May, with discussions in the World Bank Board scheduled for June. Except for a few relatively minor issues mentioned below, the structural measures included in the World Bank program are in line with our earlier understandings.

The macroeconomic framework remains broadly unchanged from that foreseen in the brief (Table 1). It entails a reduction in the external current account deficit from the equivalent of 3.7 percent of GDP in 1988 to 2.3 percent of GDP in 1991 (compared with the January target of approximately 2 percent), a level that is projected to be virtually offset by grants and direct investment and is considered to represent a viable external payments position. The mission will discuss with the authorities a fiscal medium-term scenario compatible with the growth and balance of payments targets, which the authorities were not ready to discuss in detail during the recent mission. The mission will seek a reduction in the consolidated deficit of the Central Government from the equivalent of 4.1 percent of GDP in 1988 to 2.5 percent in 1991, which would leave room for an improvement in private investment slightly in excess of the expected increase in private savings. The budgetary target is somewhat less ambitious than foreseen in January

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1/ Consisting of Messrs. Bornemann (head), Petersen, Khallouf (all AFR), Tazi (FAD), Parcu (ETR), and Mrs. Klotz (sec-PAR). Mr. Bornemann's last full day in the office is April 6.

(a total of 2.5 percent in 1990), reflecting partly a different perception of the impact on the budget of the adverse factors described below, but is nevertheless believed to be sufficient to support the achievement of the external targets.

The public finance position in 1988-91 is complicated by revenue losses from the various tax reforms currently in progress, payments from the exchange rate guarantee fund to cover exchange rate losses incurred by some development banks on their foreign borrowing, and by the budgetary funding of part of the losses of public enterprises. In addition, the budget is faced with a gradual decline in petroleum revenues (in line with the reduction in domestic oil production), which is projected at the equivalent of 2.0 percent of GDP between 1988 and 1991. Given this background, the medium-term fiscal targets are quite ambitious, requiring severe restraint on expenditures, but probably also revenue measures to prevent the presently projected decline in the ratio of revenues to GDP.

The authorities have started the process of restructuring the public enterprise sector by reducing the number of enterprises under direct administrative control. The World Bank has recently initiated discussions toward a public enterprise rehabilitation loan (PERL); elements of the program adopted by the authorities in this context will be included in the second-year program for 1989. In the meantime, the mission will emphasize that the overall deficit of public enterprises must be gradually reduced. It will urge that a system be established for the monitoring of the extension of credit to the public enterprise sector. This would initially be an indicative target, and the scope for converting it into a performance criterion will be assessed during the first review of the arrangement.

An area where progress may be difficult is that of consumer subsidies. As indicated in the earlier brief, the mission will urge the authorities to reduce consumer subsidies by 5 percent annually, as foreseen in their Seventh Plan, and will explore ways to achieve this target. Nevertheless, political resistance has proved very strong, forcing the World Bank to accept that consumer subsidies may remain unchanged in nominal terms through 1991. The mission will make every effort to reach agreement on the authorities' original proposal; as a fallback position, the mission will seek to obtain offsetting budgetary measures for any shortfall.

The mission will urge the authorities to re-examine the method used to price the forward cover contracts with the aim of eliminating the built-in loss for the Central Bank, expose importers to effective exchange rate changes, and attract exporters to the market. As to the exchange rate risk guarantee extended to development banks on their foreign borrowing, the mission will urge that it be eliminated for all new loans. The mission will seek to agree on a cut-off date of July 1.

Regarding the proposals for substituting the existing guarantee scheme with another, less expensive, scheme, the mission will continue to argue for the full assumption of the exchange rate risk by economic agents. If the Tunisian authorities insist on putting in place a new scheme, the mission will emphasize that a new scheme should: (a) limit the losses of the budget to the minimum; (b) pave the way for the promotion of a market-provided exchange rate guarantee facility; and (c) induce economic agents to take exchange rate risk into consideration in their economic decisions.

The mission understands that at this time there are two alternative schemes under discussion: (i) a lending scheme proposed by the World Bank, and (ii) an option scheme proposed by the Central Bank. The first would provide for long-term loans at market interest rates to finance exchange rate losses on foreign borrowing resulting from a depreciation in excess of a given level (the World Bank has been considering a threshold of 5 percent per year). The second scheme would introduce options to buy foreign exchange at a predetermined rate with a maturity of up to one year. Based on the information currently available, the mission will express a preference for the option scheme, which, if priced correctly, should not entail costs to the budget. Furthermore, this scheme will induce economic agents to take exchange rate risk into consideration and could later develop into a genuine market facility. The mission will discourage adoption of a financing scheme, which could have adverse complications for monetary policy and appears relatively complex to administer. However, if agreement on the latter scheme is essential to convince the authorities to eliminate the existing expensive scheme, the mission could accept it, on a trial basis, after assurance that access to the facility would be limited to an amount to be negotiated. Moreover, the mission would try to develop variants that assign more of the market risk to users of the financing scheme than implied in the World Bank proposal.

The proposed structural policy elements remain broadly unchanged, except for minor changes in the timetables for import and price liberalization. In the context of the discussions of the SAL, the World Bank has agreed with the authorities to extend the timeframe of the import liberalization process until 1992. The mission, however, will propose to complete the process by 1991 as originally envisaged. A revised policy matrix is attached.

This memo has been cleared by Mr. Nashashibi (FAD).

Attachments

cc: Mr. H. Simpson

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Table 1. Tunisia: Summary of Macroeconomic Targets

	1986 Act.	1988 Preliminary Actual	1988	1989	1990 Proj.	1991
			(In percent of GDP, January brief)			
GDP growth	-1.2	5.5	2.5	4.0	3.5	4.0
Current account deficit	8.1	3.1	3.9	3.0	2.5	2.0
Consolidated fiscal deficit (Commitment basis)	5.7	4.4	3.8	3.0	2.5	...
			(In percent of GDP, March brief)			
GDP growth	-1.2	5.8	2.1	4.1	3.8	3.0
Current account deficit	8.1	1.6	3.7	3.3	2.6	2.3
Consolidated fiscal deficit (Commitment basis)	5.7	3.6	4.1	...	...	2.5

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Table 2. Tunisia: Summary of Adjustment Program, 1986-1991

	1986		1987		1988	1989	1990	1991
	Prog.	Act.	Prog.	Act.			Proj.	
A. Objectives								
1. Annual growth of real GDP	0.7	-1.2	4.4	5.8	2.1	4.1	3.8	3.0
2. External current account deficit (percent of GNP)	9.0	8.1	6.9	1.6	3.7	3.3	2.6	2.3
3. Gross official reserves (in months of imports)	0.8	1.3	1.8	2.1	2.6	3.2	3.2	3.0
4. External debt (including IMF; percent of GNP)	55.2	54.8	60.8	56.3	59.3	58.6	55.9	53.0
5. External debt service (percent of current receipts)	25.3	27.9	27.0	26.7	26.7	26.1	28.4	27.3

B. Measures

1. Price liberalization

i. Services	Mostly free of administrative controls.
ii. Agriculture	
a. Subsidized consumer goods.	Price increases during 1986 significantly reduced annual subsidy bill in 1987. Expenditure to be maintained unchanged in nominal terms in 1988 and reduced thereafter by at least 5 percent annually.
b. Subsidized inputs.	Significant price increases in 1986-87. To be eliminated completely during program period in accordance with timetable agreed with the World Bank.
c. Producer prices.	Raised significantly in 1986-87 in agreement with World Bank. To be aligned with international levels in 1988.
iii. Manufactured goods	
Approximately 45 percent	Liberalized in three stages by July 1987.
" 55 percent	Liberalized by January 1988.
" 60 percent	To be liberalized by July 1988.
" 70 percent	To be liberalized by January 1989.
" 75 percent	To be liberalized by January 1990.
" 80 percent	To be liberalized by January 1991.
iv. Distribution margins	
Approximately 10 percent	To be liberalized by July 1988
" 20 percent	To be liberalized by January 1989
" 35 percent	To be liberalized by January 1990
" 50 percent	To be liberalized by January 1991

2. Investment liberalization and state enterprises

i. Liberalization of investments	A new investment code was introduced in August 1987 eliminating administrative controls on investments for which special advantages not requested from the Government. The granting of fiscal advantages was based on specific criteria and the distinction in granting advantages between new projects and replacements on items of existing capacity was eliminated.
ii. Public enterprises	
a. Reduction in controls and improvement of financial viability.	At the end of 1986, state control was limited to approximately 160 enterprises (from 550). The Government in August 1987 promulgated legislation authorizing the gradual sale of government shares to the private sector and this process has been initiated. A systematic review is under way with the view to improve the financial viability of those enterprises that are to remain in the public sector.
b. Additional measures.	The review of public enterprises and the privatization effort will be continued, and further recommendations and a quantified timetable will be drawn up in the context of the World Bank Public Enterprise Restructuring Loan (PERL).

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Table 2 Tunisia (continued). Summary of Adjustment Program, July 1986-December 1991

Measure	Status/Timing
3. Import liberalization	
i. Import liberalization	
a. Liberalization of imports of raw materials, semifinished goods, and investment goods.	Liberalized in three stages by January 1988 (with minor exceptions) taking the ratio of freely imported imports to total imports to 56 percent in 1988.
b. Liberalization of remaining imports except certain goods (essential goods, luxury goods and goods produced by import industries) estimated at the equivalent of 20 percent of imports.	
Approximately 56 percent	Liberalized by January 1988
" 70 percent	To be liberalized by January 1989
" 75 percent	To be liberalized by January 1990
" 80 percent	To be liberalized by January 1991
ii. Tariff reform Reform of import tariff to reduce effective protection to about 25 percent by 1991.	
a. Reduction of maximum import duties to 50 percent; reduction in intermediate rates by 6 percent and increase in minimum rates to 15 percent.	January 1987.
b. Reduction in maximum import duties to 41 percent and reduction in other rates by between 1 and 9 percent.	January 1988.
c. Reduction in maximum import duties to 35 percent and reduction in other rates by between 1 and 6 percent.	January 1990.
d. Additional measures to achieve an average rate of tariff protection of 25 percent.	January 1991.
4. Exchange rate, Exchange system and external debt	
i. Improvement in external competitiveness.	The real effective exchange rate of the dinar was depreciated by 20 percent during 1986 and by a further 4.7 percent during 1987.
ii. Maintenance of the real effective value of the dinar through periodic adjustment of the nominal value. Additional corrections if the balance of payments position requires.	To be implemented throughout program period.
iii. Elimination of present system of granting exchange rate guarantees to development banks.	July 1988
iv. Limit nonconcessional external debt of 1-12-year maturity, with sublimits on that in maturity range of 1-5 years.	To be established annually.
v. Limit short-term debt (of maturity up to one year) excluding import-related credit.	To be established annually.
5. Public finance	
i. Limit 1988 central government deficit (on a commitment basis) to D 350 million (4.1 percent of GNP).	Budget announced.
ii. Limit 1991 central government deficit to 2.5 percent of GNP.	
iii. Introduce VAT.	July 1988.
iv. Unify schedular taxes.	With effects on income earned in 1988.

Table 2 Tunisia (concluded). Summary of Adjustment Program, July 1986-December 1991

6. Credit and monetary policies

i. Liberalization of interest rates.	With effect from January 1, 1987, interest rates were liberalized subject to a cap of 3 percent over the money market rates with the exception of preferential lending rates and savings deposits rates (the latter related to the money market rate).
ii. Elimination of prior credit and refinancing approval by the Central Bank.	January 18, 1988.
iii. Strengthening of reserve loss provisions.	January 18, 1988.
iv. Strengthening of money market.	January 18, 1988.
v. Reduction by half of differential between interest rate on preferential credit and money market rate	July 1989.
vi. Increase in interest rate on loans d'équipement from 6.5 percent to 8.5 percent	July 1989.
vii. Introduction of market for treasury bills.	January 1990.
viii Elimination of differential between interest rate on money market and preferential credits	July 1990

Office Memorandum

March 24, 1988

MEMORANDUM FOR FILES

SUBJECT: Tunisia--Proposal for the Introduction of a Market-Approximating Forward Cover Scheme

This memorandum summarizes the conclusions regarding the technical aspects of a forward cover scheme to be proposed to the Tunisian authorities reached in a discussion on March 23, 1988 between mission members (Messrs. Petersen, Khallouf, and Parcu) and staff of ETR, Exchange Restrictions Division (Messrs. Quirk and Schoofs). 1/

A simple way of approximating market conditions for the setting of forward premia and discounts for administered forward cover to commercial importers and exporters for a maturity of up to one year would be to calculate the premia on the basis of interest differentials on comparable credits in domestic and foreign currency. Although interest rates in Tunisia are regulated, a bank lending rate on short-term credits of about 15 percent at an estimated rate of domestic inflation of 7 percent, and the absence of a kerb market for credit does not indicate an artificially low interest rate. In addition, available information on parallel exchange market rates for transactions related to tourism do not indicate that the official exchange rate is significantly overvalued, and there appears to be relatively little pressure on official foreign exchange reserves from the balance of payments.

Under these conditions, a forward premium based on the differential between the domestic rate of interest and the interest rate on credits in the respective foreign currency plus a margin of, e.g., 1 percentage point to cover the administrative cost associated with the forward cover scheme should be sufficient to avoid losses under the scheme over time, provided that domestic interest rates are kept at realistic levels.

Using the example of a domestic lending rate of 15 percent and a 12-month U.S. dollar LIBOR of 8 percent, and taking into account a margin of 1/2 percentage point to cover administrative cost, and a small premium/discount for the eventual elimination of the spot parallel exchange market spread, the premium on sales to importers of forward exchange under the scheme would be 7 1/2 percent, and the corresponding discount on purchases of forward exchange would be 7 percent. 2/ If it

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1/ The more general conclusions of the discussion have been summarized in a separate memorandum by Mr. Parcu.

2/ A smaller discount would be indicated by deposit rates available to exporters for their local currency receipts.

should turn out in the initial period of operation of the scheme that the discount is not sufficiently high to generate forward sales of foreign exchange by exporters (although the lower deposit rates suggest that it would be), the margin could be moved in favor of exporters.

A possible way to ensure appropriate monitoring of the scheme and timely adjustment of the premia beyond interest differentials would be to operate the scheme on the basis of a separate autonomous fund, whose operation could, at the earliest opportunity, be turned over to commercial banks. If the fund would incur losses over a continuing period of, say, three months, that exceed possible predetermined subsidies on purchases of forward exchange from exporters, this could be used as an indication to raise the percentage margin charged on top of the interest differential. On the other hand, if the fund would make continuing profits over a period of the same length, this should be viewed as an indication that the margin on top of the interest differential should be lowered. In the event the authorities pursue an exchange rate policy that aims at a real effective depreciation of the domestic currency over a given period of time, the respective rate of depreciation should be incorporated in the formula by adding it to the premium determined on the basis of interest differentials and percentage margin.

A scheme, as proposed by the World Bank, that would provide automatic financing to development banks to cover the domestic currency counterpart of external debt service payments if the exchange rate depreciates beyond a certain predetermined limit is not recommendable, as it is tantamount to the subsidization of increasing losses resulting from inappropriate economic calculations of profitability under the cloak of "financing."

Viktor Schoofs
Economist
Exchange Restrictions Division
Exchange and Trade Relations Department

cc: Mr. Bornemann
Mrs. Junz
Mr. Quirk
Mr. Petersen
Mr. Khallouf
Mr. Parcu

Office Memorandum

March 23, 1988

MEMORANDUM FOR FILES

SUBJECT: Tunisia--Exchange Rate Risk Guarantee

A meeting was held on Wednesday, March 23, 1988 on the strategy of the upcoming mission to Tunisia concerning the exchange rate risk guarantee. Present at the meeting were Mr. Quirk, Mr. Petersen, Mr. Schoofs, Mr. Khallouf, and myself. Several different aspects of the exchange rate risk problem in Tunisia were discussed and the following positions were agreed.

Regarding the forward cover for commercial transactions that the Central Bank of Tunisia (CBT) provides, it was reaffirmed that the method of pricing forward premia presently followed will cause increasing losses for the CBT. Besides, this method is not conducive to the appropriate incorporation of expected exchange rate changes by importers in their economic decisions and discourages exporters to participate in the forward cover scheme. A decision was taken that the mission will insist with the authorities that the forward cover has to be correctly priced taking into account the expected depreciation of the dinar against different currencies as measured by inflation differentials and the rate of interest prevailing in different countries. Mr. Schoofs has prepared an indicative calculation of what could be a correct discount for the forward cover of the Tunisian dinar on the basis of the information received during the meeting.

The prospects for substituting a genuine market forward cover to the facility presently provided by the CBT will be investigated during the mission. In case the Tunisian authorities show a concrete interest in promoting a market-operated forward cover facility, the Fund could provide advice on its design.

On the issue of the exchange rate risk guarantee provided so far by the Government of Tunisia to selected development banks, it was agreed that the mission will insist on limiting government commitments to those already in existence. The mission will ask that a cutoff date be established after which no more loans will be guaranteed by the "Fund for the Exchange Rate Guarantee." The proposed date will be July 1, 1988.

Regarding the proposals for substituting the existing guarantee scheme with another less expensive scheme, it was decided that the Fund will, in principle, continue to argue for the full assumption of the exchange rate risk from the part of the economic agents. If the

Tunisian authorities insist on putting in place a new scheme, the mission will aim at a new scheme that should: (a) limit the losses of the budget to the very minimum; (b) pave the way for the promotion of a market provided exchange rate guarantee facility; and (c) induce economic agents to take exchange rate risk into full consideration in their economic decisions. On these scores, the World Bank proposal for financing exchange losses does not appear appropriate. While there were differences of opinion on how harmful this type of financing scheme could be, all those present agreed that it should be considered quite low in the list of our fallback alternatives.

The proposal of the Tunisian authorities for a renewable annual options scheme for financial transactions was considered substantially acceptable <u>if the options are correctly priced</u>. In the end, this proposal would simply extend short-term cover now available only for commercial transactions also to financial transactions, thus pragmatically recognizing that Tunisian operators cannot be guaranteed long-term cover.

Exchange rate losses realized by public enterprises were also discussed. It was agreed that if a system of exchange rate cover that does not cause any loss for the budget is put in place, it might be useful to require public enterprises to participate. However, considering uncertainties about the pricing of any exchange rate risk cover, the mission will seek to limit access to any new facility at least until financial consequences for the budget are clear.

Pier Luigi Parcu
Economist
Stand-by Operations Division
Exchange and Trade Relations Department

cc: Mr. Bornemann, Mrs. Junz, Mr. Pujol, Mr. Quirk, Mr. Schoofs,
Mission members

Office Memorandum

To: Mr. Bornemann — March 18, 1988

From: Pier Luigi Parcu

Subject: Tunisia--Exchange Rate Risk Guarantee

Please find attached a preliminary note on the status of the discussion concerning exchange rate risk guarantee in Tunisia. The solutions described in the note take into account discussions held in Tunisia and with the World Bank. As you know, we do not have a clear cut solution at this point and we have reservations on some of the proposals under discussion. I suggest that the mission team meets with the ETR division specializing in exchange rate problems next week before we finalize the briefing paper for the upcoming mission.

cc: Ms. Junz
Mr. Pujol
Mr. Quirk
Mr. Schoofs
Mission members

CRT\TUN\mmtun02
March 18, 1988

Tunisia--Exchange Rate Risk Guarantee

The problem of the exchange risk guarantee implicit in the forward market and granted for foreign borrowing of developing banks in Tunisia is emerging as a key factor of disequilibrium for the government budget. The general problem of future exchange rate-related losses has two components: (a) losses that will derive from guarantees already given, i.e., from commitments already assumed by the Tunisian Government, and (b) losses that may derive from the assumption of new commitments.

Concerning the first kind of loss, the only available option is to estimate their amount and prepare for their orderly payment. The second type of loss could, in principle, be avoided if the Government would decide not to provide any exchange guarantee in the future. This option, however, is strongly resisted by the authorities on the grounds that in a developing country, where market mechanisms for hedging the exchange risk are not available, economic agents cannot be left without protection against exchange rate fluctuation. The activist policy stance of the authorities on this topic leads to two important questions. Can the authorities adopt some kind of exchange risk cover that in the long-term is conducive to the development of market instruments? Can this cover be provided without the budget assuming any (or a very limited) new burden?

The following sections will describe the different exchange rate risk guarantee provided directly or indirectly by the Tunisian

Government and briefly discuss some possible immediate and long-term answers which have emerged so far in the course of the discussion.

1. Forward cover scheme

a. Description

The Central Bank of Tunisia (CBT) operates a forward cover scheme for bona fide commercial transactions that provides importers and exporters of goods and services with the possibility of purchasing or selling dinars forward. There are seven foreign currencies that are quoted daily by the CBT namely: U.S. dollar, French franc, Italian lira, Dutch guilder, German mark, Belgian franc, and pound sterling. Exporters are allowed to sell forward the proceeds of their activity up to six months before actual receipts. Proceeds from hotel services to foreigners can be sold forward up to twelve months before receipts are actually realized. Importers are allowed to purchase forward the currencies necessary for their importation activity up to eight months before the time of the payment.

The scheme has had a much larger success with importers due to the method through which premiums and discounts are calculated. The CBT establishes premiums and discounts on its forward contracts by taking into account the interest rate differentials on the rates internationally quoted on foreign currencies. As an example of the method used by the CBT, let us assume that the dinar is linked to a basket of currencies comprising only the U.S. dollar and the German mark. We further assume that these currencies have equal weights in the basket. If the dollar interest rate is quoted at 8 percent and the mark interest

rate is quoted at 3 percent, the CBT would proceed to price the forward cover by assuming that the implicit interest rate for the dinar is between these two rates. If the implicit rate for the dinar is set to be 5.5 percent, the forward contracts quoted by the CBT, on the basis of the existing method, will offer a 2.5 percent discount on the dollar and a 2.5 percent premium on the mark. As this method does not take into account the possible depreciation of the dinar or the effective marginal cost of borrowing in dinar, it can, at best, only compensate for the fluctuation among foreign currencies.

An exporter expecting a depreciation of the dinar against the currencies he is going to acquire will not sell forward unless the premium covers the expected depreciation. Given the bias in the method used by the CBT to price the forward contracts, this will not be the case for most of the currencies quoted and in most of the periods. The reverse is true for importers, which normally have a strong incentive to buy foreign currencies at the reduced premium that the CBT charges. In the event, the forward market is very imbalanced with purchases from importers being much higher than sales from exporters. The built-in losses in this method of quoting forward discounts and premiums is borne by the CBT. Even if the CBT, most of the time, is able to cover for its losses by an adequate placement of its reserves, operating the scheme causes a foregone profit on the part of the CBT and ultimately for the budget to which the CBT profits are transferred. In 1987 the losses derived from the forward cover scheme have been estimated by the CBT at D 4 million. Under the assumption that all importers would make use of the cover and the dinar depreciates on average by 3 percent, losses

could reach up to D 20 million to D 30 million per annum. The potential for losses, while limited by the short-term nature of the cover, appears to be susbtantial.

b. Long-term solution

The correct solution for covering the exchange risk of commercial transactions, is to entrust to the market the correct pricing of forward premiums and discounts of foreign currencies. In Tunisia, this would imply the creation of a fully operational forward market within the financial system. In such a market, demand and supply would guarantee that premiums and discounts for foreign currencies are fairly priced. The CBT should not intervene in the market and maintain only a regulatory role.

c. Short-term solution

The immediate problems of the forward cover scheme are the built-in losses for the CBT, the effective shielding of importers from the movements of the dinar against foreign currencies, and the "exclusion" of exporters from the system. The immediate solution to all these problems is to correctly price forward premiums and discounts, taking into account the expected depreciation of the domestic currency. As a first approximation, the CBT could simply add the expected depreciation of the dinar against the currencies in the basket of reference to the premium or discount arrived at using its method. The CBT, however, is in a difficult position in applying a correct pricing of forward contracts, as it could be perceived as speculating against its own currency and/or signaling to the market the amount of future dinar depreciations. In fact, this is the consequence of the inconvenient

institutional arrangement of having a forward market made by the central bank.

A possible way out would be for the CBT to openly quote the premiums and discounts on the basis of interest rate differentials between the domestic money market rate and international interest rates. Alternatively, the CBT could, somewhat more implicitly, take into account the expected depreciations of the dinar by charging an adequate commission for the use of the forward cover facility. If the premium charged or the premium plus commission were adequate they could eliminate the built-in losses, thus solving the fiscal problem caused by the scheme. Furthermore, the presence of a correct cost for the forward cover would oblige importers to take into full account in their economic calculations the effect of the expected dinar depreciation. The effect of these proposals differ in the way exporters would react to them. Charging of a commission obviously would further deter exporters from participating in the scheme. On the other hand, the possibility of inducing exporters to sell forward without applying correct pricing of the forward premiums is simply nonexistent.

2. Exchange rate guarantee for development banks

a. Description

The Government of Tunisia has provided exchange rate guarantee for foreign currency loans taken by the development banks through the establishment of the "Fund for the Guarantee of the Exchange Risk" (FGE). In practice, all the resources of the FGE are received through some form of taxation of the general activity of the banking system. The FGE has been financed by a 1 percent surcharge on all kinds of lending by the development banks (even if completely unrelated to the exchange risk) and by a 0.5 percent surcharge on overdrafts of commercial banks. A surcharge on rediscounting at the central bank has also contributed to the financing of the fund. The amount of resources gathered by the fund, D 43.2 million by end-1987, has been insufficient to cover accumulated commitments. While an exact calculation of the expected losses is not possible without a precise breakdown of Tunisia's external debt by debtors and currencies, it is estimated that the FGE at end-1987 has to cover losses for D 83.9 million. In 1988, the revenues are estimated at D 19 million and the amount of the losses to be covered, while uncertain, is likely to be much higher; it is expected that sizable losses from already existing commitments will continue into the medium term. Therefore, the imbalance in the financial position of the FGE will persist and aggravate even if no new commitments were assumed.

The working of the FGE can be summarized very simply: first, the development banks contract loans in foreign currencies; second, the Government assumes the full exchange rate risk by assuring the develop-

ment banks that they will be able to buy foreign currencies for servicing the loan at the same cost at which the surrender of the proceeds of the loan took place; finally, at the time of the amortization of the loan, the FGE provides the development banks with the resources necessary to cover the difference between the dinar cost of the foreign exchange calculated at the original exchange rate and the dinar cost calculated at current exchange rates. To date, access to the FGE has been limited to selected development banks.

b. A long-term solution

Tunisian economic agents should take exchange rate movements into full account in making their economic decisions. This requires that the Government or the CBT should not cushion the effect of exchange rate movements on economic incentives. This result in the long run can be achieved in two very different ways.

In the first case, the Government could simply leave exchange rate guarantees to market forces hoping that they would provide any hedging facilities for which there is a request from the economic agents. Conversely, the Government or the CBT could decide to develop and operate a hedging facility that would be priced at its effective cost. Because the risk of exchange market volatility is not an actuarial risk, this solution would always imply the possibility of losses or gains for the budget.

c. Short-term solution

The large and growing losses of the FGE apparently have convinced the Tunisian authorities of the necessity to search for a new system of exchange rate guarantee, implying a lower burden for the budget. The proposal designed by the CBT envisages a option mechanism that would allow development banks and other agents to buy the right of purchasing foreign exchange to be used in settling financial obligations, at a contracted price for a period of up to 12 months. The option could be renewed annually at an exchange rate related to the new ongoing spot rate. At the beginning of each year, the institution operating the scheme--a public insurance company in some proposals--would determine the cost of the facility for the agents. The price of the option would take into account the expected depreciation of the dinar and covered interest rate parities as determined on international capital markets. Naturally, any unexpected depreciation of the dinar would determine a loss for the agency operating the scheme. The initial contract with the operating agency, would establish the right for the buyer to renew annually his option for as long as payments relating to the foreign liabilities remain outstanding.

As a complementary proposal, the Tunisian authorities have been considering a financing scheme designed by the World Bank. This scheme would assure that borrowers of foreign currencies could obtain long-term financing from the domestic banking system in cases of unexpected losses due to exchange rate movements. This scheme would establish a threshold, say of 5 percent, above which a depreciation of the dinar would trigger access to a line of credit at money market rates for an

amount covering the additional loss. The borrower would be assured access to the line of credit during the life of his outstanding foreign liability. The threshold would be calculated cumulatively from the original exchange rate value, i.e., in the first year a depreciation of 5 percent would trigger the line of credit, in the second year only a depreciation of 10 percent would have the same effect, and so on. The cost of this facility is supposed to remain quite manageable as long as the interest rates charged on the lines of credit are market related and lenders could reserve the right to refuse credit to insolvent borrowers. The limits of this proposal are threefold. First, the administrative burden of determining for each loan if a depreciation has triggered the facility could be substantial. Second, the setting of a unique threshhold for all currencies could induce borrowers, especially if a subsidy is embodied in the interest rate charged on the line of credit, to prefer low coupon-high appreciation currencies. Finally, an perhaps more fundamentally, the automatic financing of exchange rate losses could compromise the prospects of a correct managing of foreign exchange risk and endanger monetary policy.

3. Exchange rate guarantee for public enterprises

a. Description

At present, public enterprises (PE) in Tunisia do not benefit from any direct exchange rate guarantee on their foreign liabilities. Nonetheless, important losses have been accumulating in the public enterprise system owing to the enterprises' disregard of the consequence of borrowing in appreciating foreign currencies. Realized losses of PE

on existing foreign liabilities have been estimated at D 120 million. To date these losses have not been assumed by the Government. The bulk of the losses is at present in the banking systém, which is extending credit to PE, or are financed through additional foreign borrowing. Even in the case of public enterprises, it is difficult to estimate precisely the potential for future losses without detailed information about the composition of the outstanding debt.

The present situation could lead the Tunisian authorities to a difficult choice between a very costly bail out of enterprises or a series of bankruptcies. The extent of the problem seems to show that the absence of an explicit exchange risk guarantee is not a solution in a situation in which economic agents, especially in the public sector, ignore the consequences of their choices in terms of the composition of their foreign currency liabilities.

b. Long-term solution

Public enterprises should take full account of the effect of exchange rate movements in their decisions concerning their foreign assets and liabilities. This result should not require the establishment of any special facility but the correct and continuous use of whatever hedging system the market is able to provide to the economy. In this respect, like in many others, the management of public enterprises should not be any different than that of private enterprises.

d. Short-term solution

Public enterprises could be required to participate in whatever scheme of foreign exchange risk guarantee the Government of Tunisia decides to adopt. Participation in the scheme could be mandatory. This

arrangement would oblige the managers of the enterprises to take into account the cost of the participation in the facility and would familiarize them with the economic calculations necessary for a balanced foreign portfolio.

Alternatively some forms of control on public enterprises foreign borrowing could be established by giving to the CBT an effective power of veto. A ceiling under the arrangement with the Fund on PE total nonconcessional foreign borrowing could help strengthening the CBT hand in this matter. This type of aggregate control would reduce the macro problem of "too much" foreign borrowing from the PE but could not assure that when a specific loan is undertaken the correct economic calculation of the foreign exchange risk is actually made.

Mrs. Junz
cc. Mr. Parsu

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البنك المركزي التونسي

Banque Centrale de Tunisie

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Tunisia

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TUNIS, le 16 MARS 1988

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Cher ami,

Suite à votre télex daté du 5 Mars 1988, je vous fais parvenir ci-joint la lettre comportant les conclusions de la 3ème Revue signée par Monsieur Le Gouverneur de la Banque Centrale de Tunisie, Monsieur Le Ministre des Finances et Monsieur Le Ministre du Plan.

En vous en souhaitant bonne réception et dans l'attente du plaisir de vous revoir bientôt à Tunis, je vous prie d'agréer, cher ami, l'expression de mes meilleures salutations.

ORIG: AFR
CC: MD
DMD
MR.SALEHKHOU
ETR
FAD
LEG
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TRE
MR.H.SIMPSON

LE DIRECTEUR DES FINANCES EXTERIEURES,

A. FREDJ

A-7

Monsieur Edwin L. Bornemann
Directeur Adjoint - Département Afrique
International Monetary Fund
700 19th Street, N.W
Washington D.C. 20431
U.S.A.

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INTERNATIONAL MONETARY FUND
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COMMUNICATIONS DIVISION

TUNIS, LE 7 MARS 1988

Monsieur Michel CAMDESSUS
Directeur Général
Fonds Monétaire International
Washington D.C. 20 431

Monsieur le Directeur Général,

1. Conformément aux dispositions de l'accord de confirmation, les discussions avec les services du Fonds au titre de la troisième revue du programme d'ajustement ont été tenues à Tunis du 4 au 19 février 1988. Les objectifs du programme pour 1987 en termes de croissance, d'inflation, et de balance des paiements ont été atteints et même dépassés, grâce à la conjonction de facteurs favorables et aux effets positifs des politiques d'ajustement structurel mises en oeuvre.

2. La croissance globale de l'économie a été soutenue en 1987 sous l'effet de la performance de l'agriculture (la production céréalière ayant presque triplé pour atteindre 1,8 million de tonnes), de l'excellente saison touristique, et de la croissance sensible d'autres secteurs d'exportation. Ainsi la croissance réelle du PIB en 1987 a été estimée à 5,8 pour cent.
Néanmoins, l'activité dans plusieurs secteurs a été affectée par le niveau déprimé de la demande intérieure qui a baissé de 1,1 pour cent en termes réels sous l'effet d'une diminution de 13 pour cent de l'investissement et d'une quasi stagnation de la consommation privée. Ces développements se sont traduits par des créations d'emplois inférieures à l'accroissement de la population active (35.000 contre 60.000) ce qui a aggravé le chômage estimé actuellement à 15 pour cent. En raison, notamment, de la faible demande intérieure, le taux d'inflation (mesuré par le glissement de l'indice général des prix à la consommation) n'a atteint que 6,9 pourcent, taux bien en dessous du niveau prévu de 8 pour cent.

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3. L'exécution du budget en 1987 a été plus favorable que prévue, entrainant ainsi un déficit consolidé des opérations financières de l'administration centrale (y compris l'Etat et les Caisses de sécurité sociale) de l'ordre de 3,6 pour cent du PNB, nettement inférieur à l'objectif revisé de 4,2 pour cent établi lors de la deuxième revue. Le léger manque à gagner au niveau des recettes imputable en partie à la faiblesse de la demande intérieure a été plus que compensé par le niveau plus bas que prévu des dépenses totales, en particulier les subventions et transferts, les paiements d'intérêts, et les investissements directs. Quant aux dépenses brutes de la période complémentaire pour l'exercice 1987, elles sont actuellement estimées à 220 millions de dinars, comparées à 256 millions de dinars pour l'exercice précédent.

4. En définitive, le déficit consolidé des opérations financières de l'administration centrale en 1987 est estimé à 287 millions de dinars au lieu de l'objectif revisé de 338 millions. Le financement de ce déficit a été sensiblement différent de ce qui avait été prévu du fait que le financement extérieur net a été de 106 millions de dinars plus bas que prévu dans le programme. En conséquence, malgré les efforts de maitrise du déficit et l'accroissement du financement intérieur non bancaire, le financement bancaire s'est élevé à 94 millions de dinars, soit 3 millions de plus que l'objectif du programme. Ce lèger dépassement du critère de réalisation fixé pour les créances nettes du système bancaire sur l'Etat est largement de nature technique, étant donné l'augmentation exceptionnellement élevée (10 millions de dinars) du montant des chèques en recouvrement pour le compte de l'Etat au 31 décembre 1987 qui ne constitue pas en fait un financement des opérations de l'Etat. Tous les autres critères de réalisation à fin décembre 1987 ont été respectés. Vu la faiblesse du dépassement du critère de réalisation sur les créances nettes sur l'Etat à fin décembre 1987, qui est d'origine purement technique, nous demandons au Fonds une dérogation à ce titre.

5. La croissance de 13,7 pour cent de la masse monétaire (au même taux que le PIB à prix courants) a été presque du même ordre que l'objectif de 13,1 pour cent prévu au programme. Le changement significatif intervenu dans la structure de la masse monétaire (l'agrégat M1 ayant baissé de 2 pour cent et la quasi-monnaie s'étant accrue de 40 pour cent) s'explique par la libéralisation des taux d'intérêt intervenue en début d'année. L'expansion de 7,9 pour cent du crédit intérieur a été bien inférieure au plafond de 10,6 pour cent, mais l'accroissement des avoirs extérieurs nets du système bancaire a dépassé de 22

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millions de dinars le niveau prévu dans le programme.

6. Les résultats de la balance des paiements ont été sensiblement meilleurs que ce qui était attendu. Le déficit du compte courant s'est limité à 1,6 pour cent du PNB, soit un niveau nettement plus bas que la projection de 5,8 pour cent pour 1987 et celui de 8 pour cent atteint en 1986. Cette performance s'explique par des facteurs structurels (croissance des recettes touristiques et de certaines exportations de biens manufacturés) mais aussi par des éléments exceptionnels tels que l'amélioration de la balance commerciale alimentaire, l'accroissement des transferts des travailleurs tunisiens résidents à l'étranger suite à la dévaluation de 1986, et le niveau particulièrement bas des importations. Ce dernier facteur est dû, en partie, à la faiblesse de l'investissement qui s'est traduite par une baisse de 19 pour cent des importations de biens d'équipement. Les entrées de capitaux en 1987 ont été moins importantes que prévu à cause de la faiblesse des importations, du retard dans la conclusion de nouvelles lignes de crédit, ainsi que du non recours à d'autres lignes en raison de la situation satisfaisante des réserves. L'excédent global de la balance des paiements s'est élevé à 116 millions de DTS, comparé à l'objectif de 95 millions de DTS. Compte tenu de la réévaluation due au taux de change, les avoirs extérieurs nets ont augmenté de 120 millions de DTS.

7. A la lumière de la situation préoccupante du chômage, les autorités tunisiennes ont, vers la fin de l'année 1987, introduit des mesures destinées à encourager l'investissement et l'activité dans les secteurs orientés vers le marché intérieur. Ceci comprend : (1) la réduction de 60 pour cent de la taxe sur les prestations de services (TPS) pour les charges d'intérêts (réduisant ainsi le coût du crédit de 1,2 point de pourcentage), et la réduction du taux d'intervention de la banque centrale sur le marché monétaire de 10 à 9,5 pour cent (au vu des résultats satisfaisants obtenus en matière d'inflation); (2) l'amnistie fiscale qui comporte, entre autres, des avantages fiscaux pour l'achat d'actions émises par des entreprises publiques et l'investissement dans les secteurs prioritaires ; (3) une augmentation de 5 pour cent des salaires minima (SMIG et SMAG) en novembre 1987 ; et (4) l'autorisation des caisses de sécurité sociale d'accorder, de nouveau, des prêts au logement et à la consommation.

8. Les mesures d'ajustement structurel ont été mises en oeuvre conformément au calendrier prévu dans l'accord de confirmation. Ainsi, à fin janvier 1988, pratiquement tous les biens d'équipement, produits semi-finis, matières premières

.../...

et pièces de rechange étaient devenus libres à l'importation, à l'exception des biens produits par des industries naissantes ou destinés à des industries faiblement intégrées. La part des biens librement importés, à la suite de ces mesures, s'élèvera à 53 pour cent des importations totales en 1988 au lieu de 37 pour cent en 1987. Simultanément, la deuxième phase de l'application de la réforme des droits de douane est entrée en vigueur en janvier 1988, se traduisant par une réduction de 1 à 9 points de pourcentage dans la plupart des taux et ramenant le taux maximum de 52 à 43 pour cent. En janvier également les autorités ont libéré plusieurs prix à la production, portant la part des produits dont les prix ont été libérés à 55 pour cent de la production manufacturière totale. Par ailleurs, les opérations interbancaires sur le marché monétaire et l'accès des institutions financières non bancaires et de certaines entreprises à ce marché (à travers l'émission de certificats de dépôts et de billets de trésorerie) ont été autorisés à compter du 18 Janvier 1988. Ceci permet aux facteurs d'offre et de demande de jouer un rôle plus important dans la détermination du taux d'intérêt. Les autorités entendent poursuivre la réforme du système monétaire et financier et demandent l'assistance technique du Fonds en la matière. Les autorités ont également poursuivi une politique de taux de change flexible qui a entrainé une dépréciation réelle de 4,7 pour cent (par référence aux indices des prix à la consommation) du taux de change effectif en 1987. Cette politique sera poursuivie afin d'assurer la compétitivité extérieure de l'économie tunisienne.

9. Les perspectives pour l'année 1988 s'annoncent bien moins favorables que les résultats exceptionnellement bons de 1987. La production agricole est fortement affectée par une sévère sécheresse, ce qui limitera probablement la croissance réelle du PIB à quelque 2 pourcent et ne favorisera pas la consolidation complète des performances enregistrées en 1987 en matière des paiements extérieurs courants.

10. La situation des finances publiques en 1988 sera bien plus difficile qu'en 1987 du fait d'un manque à gagner prévisible de quelque 76 millions de dinars, à la suite de diverses mesures de réduction de certains droits et taxes, dont les droits de douane, la TPS sur les charges d'intérêt, l'imposition des revenus sur valeurs mobilières et des droits d'enregistrement. Le manque à gagner attendu n'inclut pas, cependant, l'estimation de l'impact de l'introduction de la TVA en juillet 1988, dont la moins value éventuelle est difficile à déterminer. Les autorités s'attendent néanmoins à ce que tout manque à gagner éventuel à ce

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niveau soit compensé par un élargissement de l'assiette fiscale et l'impact positif de l'amnistie fiscale. En dépit de ce manque à gagner, les recettes sont projetées en hausse de 7 pour cent, compte tenu de nouvelles mesures dont notamment une augmentation des prix des produits pétroliers et des tarifs publics, une contribution exceptionnelle des banques de dépôts au Fonds de péréquation des changes et des taux d'intérêts, et l'augmentation de certains droits de consommation. Les dépenses totales (y compris les prêts nets) sont projetées en hausse de quelque 8 pour cent. Après 4 ans de gel des salaires, l'accroissement prévu de la masse salariale traduit, compte non tenu de l'effet des promotions et des recrutements, la revalorisation de la prime de rendement dont l'impact sera une augmentation de 3 pour cent en moyenne. Le budget inclut également une dotation de 12 millions de dinars pour l'élimination du solde d'arriérés intérieurs ainsi qu'une augmentation de 10 pour cent dans la dotation pour fournitures et matériels de manière à éviter l'apparition de nouveaux arriérés. Les subventions aux produits de consommation sont maintenues à leur niveau de 1987, ce qui signifie une baisse en termes réels et requiert l'augmentation des prix de certains produits subventionnés en cours d'année. Les prévisions de dépenses pour 1988 comprennent également des subventions d'exploitation d'un total de 34 millions de dinars aux entreprises publiques du secteur des phosphates et industries dérivées, et un paiement exceptionnel de 40 millions de dinars du Fonds de péréquation des changes et des taux d'intérêt en particulier aux banques de développement. Les autorités tunisiennes sont en train d'étudier en collaboration avec les services du Fonds et de la Banque Mondiale, les moyens de réduire au minimum à l'avenir les pertes au titre de la garantie du risque de change.

11. Le déficit consolidé des opérations financières de l'Administration centrale est ainsi projeté à 350 millions de dinars (4,1 pour cent du PNB). En excluant le paiement exceptionnel de 40 millions de dinars mentionné ci-dessus, le déficit s'élèverait à 310 millions de dinars (3,6 pour cent du PNB). Sur la base des lignes de crédit déjà contractées, il est prévu une hausse sensible en 1988 du financement extérieur net qui atteindrait 237 Millions de dinars. Compte tenu du niveau prévu pour le financement intérieur non bancaire (emprunt public et souscriptions de bons d'équipement hors système bancaire), le financement par le système bancaire serait ramené de 94 millions de dinars en 1987 à 50 millions dinars en 1988.

.../...

12. La masse monétaire est projetée en hausse de 9 pour cent en 1988, ce qui est quelque peu inférieur à la croissance de la demande intérieure. Conformément à l'objectif d'augmentation des réserves extérieures, la croissance du crédit intérieur est programmée au taux de 8,7 pour cent. Compte tenu de l'objectif de financement bancaire du déficit budgétaire, ceci permettrait une croissance de 9 pour cent du crédit au secteur privé, ce qui constitue le minimum requis pour soutenir l'effort d'investissement nécessaire à la relance de l'économie.

13. En 1988, le déficit courant de la balance des paiements s'élèverait à 320 millions de dinars ou 3,7 pour cent du PNB, ce qui, bien que dépassant le niveau exceptionnellement bas réalisé en 1987, reste nettement inférieur à l'objectif initial du programme pour 1988 (5,8 pour cent du P.N.B.). Plusieurs facteurs sont à l'origine de l'augmentation du déficit en 1988, en particulier une baisse de l'excédent commercial des produits pétroliers, l'impact négatif de la sécheresse sur la balance commerciale alimentaire, et la stagnation probable des transferts de fonds par les travailleurs tunisiens résidents à l'étranger, après le niveau exceptionnellement élevé en 1987. Les importations de biens non alimentaires (hors énergie) augmenteraient de 7 pour cent en termes réels, en réponse notamment à la forte reprise attendue de l'investissement. En dépit de l'accroissement prononcé des tirages sur les lignes de crédit déjà contractées, un besoin de financement supplémentaire de 250 millions de dinars subsiste mais serait notamment couvert par des financements commerciaux courants ainsi que par la première tranche du prêt d'ajustement structurel de la Banque Mondiale qui serait conclu vers le milieu de l'année 1988. Au total la balance des paiements dégagerait un excédent de 85 millions de dinars.

14. Les bons résultats obtenus à ce jour dans la mise en oeuvre du programme d'ajustement structurel renforcent notre détermination à appliquer la stratégie de développement identifiée dans le Septième Plan 1987-91. Nous nous proposons pour les années à venir de poursuivre la mise en oeuvre des diverses actions de réforme déjà engagées et, pour ce faire, nous entendons mettre au point un programme sur trois ans qui pourrait être soutenu par les ressources de la facilité

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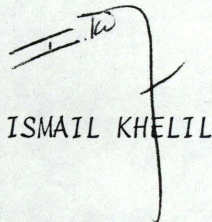
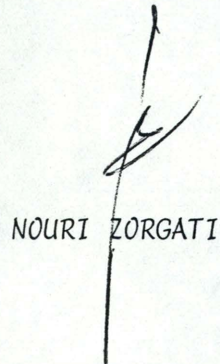
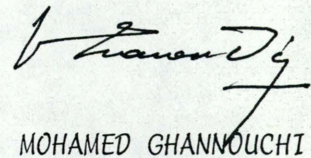
élargie du Fonds à la suite du présent accord de confirmation qui arrive à terme le 3 mai 1988. Entre temps, nous proposons que les critères de réalisation et les objectifs indicatifs du programme à fin mars 1988 soient établis comme indiqué au tableau ci-joint.

Le Gouverneur de la Banque Centrale	Le Ministre des Finances	Le Ministre Délégué auprès du Premier Ministre charge du Plan
		
ISMAIL KHELIL	NOURI ZORGATI	MOHAMED GHANNOUCHI

Tunisie - Critères de réalisation et objectifs indicatifs
Décembre 1987-Mars 1988

	1987 Décembre Prog.	1987 Décembre Réal	1988 Mars Prog.
	(Millions de dinars)		
A- Critères de réalisation			
1. Crédit intérieur	4.714	4.600	4.692
2. Créances nettes sur l'Etat	718	721	721
	(Millions de DTS)		
3. Dette extérieure publique*			
3.a. 0-1 an (encours à l'exclusion des crédits liés aux importations)	120	14	120
3.b. Nouveaux emprunts extérieurs non concessionnels (montants cumulés)			
i)- 1-5 ans	65	57	170
ii)- 1-12 ans	450	136	450
4. Arriérés des paiements externes (encours)	--	--	--
	(Millions de dinars)		
B- Objectifs indicatifs			
1. Déficit budgétaire consolidé	- 338	- 287	- 47
2. Total des revenus et dons	2.564	2.549	605
3. Total des dépenses et prêts nets (hors amortissements)	-2.902	-2.836	- 652
	(Millions de DTS)		
4. Avoirs extérieurs nets du système monétaire	134	173	42

* Contractée ou garantie par l'Etat.

Office Memorandum

TO: Mr. Bornemann March 4, 1988

FROM: Helen B. Junz

SUBJECT: Tunisia--Draft Staff Report

I am attaching my colleagues' comments on the draft, with which I am in agreement. I want to particularly underscore the difficulty that we see with the description of the fiscal plan for 1988, which talks about an "underlying fiscal position," that to my mind is misleading. The expenditures that have been excluded in order to arrive at this "underlying" concept in fact are part of the basic problem and also are most likely to be both recurrent and open-ended. This point is made in the attached comments and, as noted above, I think it is an exceedingly important one.

Attachment

Mr. Gianviti
Mr. Bhuiyan
Mr. Nashashibi
Ms. Dillon
Mr. Pujol

March 4, 1988

Tunisia--Comments on Draft Staff Report

A large increase in the contracting of loans of 1-5 years maturity has been programmed for the first quarter of 1988--SDR 170 million compared to SDR 57 million for the whole of 1987 (see table on page 9 of the letter of intent). A brief explanation of this increase should be given (perhaps on page 19), and the capital flows that will arise out of these new contracts should be identified and distinguished from those resulting from the "credit lines put in place, but not yet utilized, in part as a result of the donors' meeting in Paris in February 1987."

cotun01
3/4/88

Tunisia--Comments on Third Review Under Stand-By Arrangement

This is a very well written paper about a success story so we have relatively few comments to make.

The only issue of substance concerns the way the mission is presenting the fiscal plan for 1988 by using a concept of "underlying fiscal position" (1st paragraph of page 13 and last paragraph of page 23 in the staff appraisal). Given the likely recurrent character of the operating losses of certain state enterprises and the exchange losses of development banks--in the absence of fundamental changes in the way their operations are conducted--we do not believe that the way in which the impact of these expenses on the fiscal situation is being characterized is appropriate. It would be better for the report to come out and say that these are problems that exist, that they are likely to increase future deficits (in fact their future impact could be quite substantial in the absence of changes in the system), and that the authorities need to address them promptly and forcefully. The paper can then go on to indicate that the authorities are aware of the problem and are studying ways to solve them, with our assistance and that of the World Bank.

Other minor points

The issue of nonpayment of petroleum purchases by certain public enterprises is mentioned on page 5 and then repeated on page 6, but the report could explain more (page 6) the nature of the problem and indicate possible solutions that are being contemplated.

On page 11, the last sentence in the second paragraph that refers to further reforms of the monetary system adopted in January could be elaborated further.

On page 13, mention is made about a Special Fund for the Guarantee of Exchange Rate and Interest Rate Risks. Could the nature of this fund be explained somewhat elsewhere in the paper?

Reference is made on page 14 to a VAT rate of 29 percent. This seems very high to us (the experience in other countries with such high VAT rates is that they tend to encourage evasion), and we wonder what is the view of the Fiscal Affairs Department on the specific proposal that is being advanced for Tunisia. The report gives the impression that the Fund is in agreement with the introduction of these specific rates.

We would propose deleting the remarks that praise the tax amnesty on page 15. We question whether tax amnesties are really an appropriate tool for eliminating tax evasion and we think the Fund should not appear to be encouraging its use.

We would expand the explanation given on page 16 for the losses experienced by state-owned enterprises and the exchange losses of development banks. We think this paragraph should explain why these losses appear all of a sudden reflected in the fiscal accounts and should examine the likelihood of their recurrence.

Office Memorandum

TO: Mr. Bornemann February 26, 1988

FROM: S.J. Anjaria

SUBJECT: Tunisia--Letter of Intent

Our only comment reflects our concern regarding the actual and potential exchange losses which are being borne by the budget. The budget deficit for 1988 is now programmed to amount to 4.1 percent of GDP compared to the briefing paper target of 3.6 percent. This appears to reflect a "special payment" of D 40 million to the development banks to cover exchange losses (page 6). How certain are we that this is a "special payment" only and not just the "tip of the iceberg"? Is it reasonable to assume that such losses would recur as the external debt of the development banks continues to mature and the monetary impact of such losses worsens with further real depreciation?

We recognize that this issue may be of limited importance for the present SBA, which expires in May. As we prepare for a possible EFF, however, it would be important in our view to keep it in mind. Would it be helpful to prepare a comprehensive analysis of potential exchange losses for the next 3-5 years in order to identify the true public sector deficits and the monetary impact of these deficits?

cc: Mrs. Junz

bcc: Ms. Dillon
Mr. Pujol

INTERNATIONAL MONETARY FUND

February 26, 1988

Ms. Junz:

Tunisia: Comments on
Letter of Intent

Attached are comments on the letter of intent for Tunisia which was reviewed by Mr. Thomsen.

cc: Ms. Dillon
Mr. Johnson
Mr. Parcu

Joaquín P. Pujol

Tunisia: Comments on Letter of Intent

1. The budget deficit for 1988 is now programmed to amount to 4.1 percent of GDP compared to the briefing paper target of 3.6 percent. This appears to reflect a "special payment" of D 40 million to the development banks to cover exchange losses (page 6). Is the mission assured that this is a "special payment" only and not just the "tip of the iceberg"? One would expect such losses to reoccur as external debt of the development banks continues to mature and the monetary impact of such losses continues to worsen with a further real depreciation. While this issue is of limited importance for the present SBA, which expires in May, a comprehensive analysis of potential exchange losses for the next 3-5 years must be undertaken when preparing for the envisaged extended arrangement in order to identify the true public sector deficits and the monetary impact of these deficits.

2. While the proposal to waiver the end-December performance criterion on public sector credit certainly is justified in light of the general overperformance and the size of the excess over this ceiling, the request for the waiver ought to be accompanied by an explanation of why nonbank domestic financing has exceeded the target by almost half a percent of GDP.

Office Memorandum

January 29, 1988

MEMORANDUM FOR FILES

SUBJECT: Exchange System Reform in Tunisia

A meeting was held on January 27, 1988 with Mr. Rachid Sadek, Advisor to the Central Bank of Tunisia. The staff representatives were Mr. Quirk, Mr. Petersen, Mr. Schoofs, and myself.

Mr. Sadek stated that the reason for the meeting was to have a preliminary discussion with the Fund about priorities and possibilities for the reform of the exchange system in Tunisia. He made it clear that he was actually calling on Fund expertise and that any proposals from this discussion would have to be considered at the appropriate political level when the Fund mission visits Tunisia. Mr. Quirk noted that the environment appears favorable for the liberalization of the exchange system in Tunisia, thanks in part to the recent liberalization steps in the trade and monetary systems. In a sense, it was possible to say that at present the exchange system in Tunisia is lagging behind other components of the trade and financial system. On the basis of a preliminary examination of the present exchange system, some possible steps for reform could be easily identified. Among these, a simplification of the foreign currency and foreign-denominated accounts could be realized without necessarily relinquishing appropriate controls. A first step in this direction could be to shift more responsibilities from the Central Bank to the commercial banks in the matter of exchange controls. Liberalization could also be foreseen in the field of invisible payments and, in particular, travel allowances are considered inadequate to the present situation. The most important reform is that of the exchange rate and this requires a careful study of the possibilities. The present institutions of the banking system in Tunisia appear, in principle, adequate for the establishment of an interbank exchange market. A unified market would be preferable; but transitional dual arrangements could also be envisaged. For example, the supply of foreign exchange to such a market could come from retained export proceeds, tourism receipts, and other transfers, while the demand could be from OGL trade and bona fide invisibles and capital transactions.

Mr. Sadek asked about the experience of other countries with the reform of the exchange system, particularly in the field of capital inflows. He noted that liberalization steps undertaken up to this point had not produced results as positive as expected. He also specifically asked about the wisdom of adopting an export retention scheme, underlining that while this might facilitate the position of currently exporting companies, it might not be in the best interest of new potential exporting companies. Finally, he asked about what would be the final goal of the liberalization process.

Mr. Quirk illustrated some other cases of liberalization of the exchange system, emphasizing the strengthening effect that the liberalization had on the balance of payments, particularly in the area of reversing capital flight. He, however, underlined that in the case of Tunisia, where capital flight does not appear to be a primary area of concern, the benefit could be less dramatic at the start. However, the efficient allocation of resources that would follow from the correct pricing of foreign exchange would, in the end, favor economic growth and ensure external viability.

Referring to the export retention scheme, it was noted that the essential point is that the market should be in a position of efficiently allocating foreign exchange by giving economic agents the freedom of buying and selling the available foreign currency to the highest bidder. In some cases, the Fund has encouraged a two-step process through which a secondary market is created and the exchange rates are unified as soon as the system becomes understood, widespread, and efficient. In general, this unification has been called for within the program period.

Finally, the Fund staff raised the issue of the exchange rate risk guarantee, apparently given by the Tunisian Government without cost to development banks and nonfinancial enterprises. It was emphasized that this scheme could expose the Government to important losses. Mr. Sadek asked how the Government could ensure the long-term currency risk of economic agents. The Fund representative explained that hedging facilities for long-term currency risk did not exist to any significant extent, even in industrial countries. Appropriateness of long-term real interest rate differential would ensure that economic agents choose the currencies in which to own assets and liabilities in an optimal way. Short-term risk can be covered by an efficient forward exchange rate market. The building of such a market would be linked to the reform of the spot exchange rate market and evolution of the banking and financial system of Tunisia.

Mr. Sadek asked if the Fund could consider providing technical assistance in the field of exchange rate reform to Tunisia. Mr. Quirk answered that the Fund, of course, would be pleased to assist the Tunisian authorities and that the matter could be taken up in the forthcoming mission.

Pier Luigi Parcu
Economist
Stand-By Operations Division
Exchange and Trade Relations Department

cc: Mr. Bornemann, Mrs. Junz, Mr. Kanesa-Thasan, Mr. Pujol, Mr. Quirk, Mr. Schoofs, Mission members

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: 27 January 1988

TO: Distribution

FROM: Dimitri Vittas, CECFP

EXT.: 61553

SUBJECT: TUNISIA: TREATMENT OF FOREIGN EXCHANGE RISK

1. I attach a revised copy of a paper that discusses the treatment of foreign exchange risk in Tunisia and considers possible solutions to the scheme that is currently in operation. The revised version incorporates comments received from colleagues at the CECFP division and other parts of the Bank.

2. The present Tunisian scheme could be described as the classic case of "HOW NOT TO COVER FOREIGN EXCHANGE RISK". Its major shortcoming is that it provides strong incentives to borrowing entities (development banks and non-financial corporations) to raise loans denominated in low coupon currencies. Although some mitigating factors are in effect, the impact of the scheme on the burden of debt servicing is considered to be large.

3. The paper considers the need to replace the existing scheme with one that encourages efficient decentralized foreign currency borrowing, exposes local economic agents to developments in international financial markets and avoids large financial subsidies to borrowing entities.

4. Four possible solutions are briefly discussed. Of these, the first two - eliminating the scheme altogether without

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Distribution:

Dervis, P Hasan, Michalopoulos, Shilling, Grais, Rahim, Hinds, Long, Gelb, Hutcheson, Dailami, Honohan, M de Melo, Corbo, Johnson, Opper (IBRD)
Dooley, Petersen, Sheehy (IMF)
Dommenge (IFC)

cc. Funck, Hubert, Castellanos, Claudet, Glaessner, Rajasingham, Rocha, van Wijnbergen, Behbehani, Cho

putting anything else in its place and concentrating all foreign currency borrowing in the hands of the government - would not meet the above objectives. Of the last two, both of which would meet these objectives, one would involve offering properly priced long-term hedging facilities through a loan swap (converting the foreign currency loans into local currency ones) to cover potential losses from changes in foreign exchange rates whilst the other would involve offering long-term financing facilities to cover the liquidity needs from such losses.

5. Hedging facilities based on loan swaps appear to be available in Mexico and Brazil although there is some uncertainty about their operational relevance (the Mexican scheme, which has been introduced to encourage the renegotiation of private sector loans after the 1982 crisis, is briefly described in the annex to the paper). Long-term financing facilities to meet the liquidity needs caused by foreign exchange losses have been used on an ad hoc basis in some countries.

6. The paper discusses the merits and demerits of the two alternative solutions and examines the implications of the long-term financing facilities for corporate leverage, government finance and monetary policy. Whilst either scheme could be acceptable if its cost was reasonable, the paper considers the financing facility to be preferable, mainly because of the difficulty of pricing correctly a risk that is not amenable to "actuarial" assessment.

6. The paper incorporates a number of changes from the earlier version that reflect the comments received. For instance, to minimize the danger of "moral hazard" on the part of the authorities, it is suggested that administration of the scheme could be delegated to commercial or development banks, other than for foreign currency loans obtained by the banks themselves. In addition, the banks could be asked to assume a part of the credit risk involved. Moreover, greater flexibility is suggested in the determination of the "trigger" rate that would activate the facility.

7. Many commentators have expressed the view that the "no-scheme" solution would be preferable. This is mostly because they are concerned about the monetary implications of the financing facility or they do not trust government-sponsored schemes. The latter view could be taken to imply that governments in general are neither risk averse nor risk neutral but rather risk perverse.

8. In economies with closed foreign exchange markets, the "no-scheme" solution would lack credibility whilst, as stated in the paper, the second solution - centralising foreign currency

borrowing - would require a continuation, and perhaps even intensification, of financial repression. Perhaps, if we are to push for a "no-scheme" solution, we should also argue for opening up the foreign exchange market and encouraging the development of market-based hedging facilities. Otherwise, the long-term financing solution, in which the authorities would not underwrite the losses of borrowing entities but only provide liquidity assistance, would still make sense, subject to the caveats set out in the attached paper.

DVITTAS/

TREATMENT OF FOREIGN EXCHANGE RISK IN TUNISIA

INTRODUCTION: THE CURRENT SCHEME

The Tunisian authorities operate a foreign exchange risk guarantee scheme whereby development banks and non-financial corporations that obtain foreign currency loans from the international financial markets are covered completely for the risk of devaluation of the dinar without having to pay any risk premium. Beneficiaries of this scheme have to incur only the foreign currency rate of interest on their foreign debt and have, as a result, a strong incentive to borrow in low coupon hard currencies, irrespective of the risk of future appreciation which is normally much higher for low-coupon than for high-coupon currencies. Inevitably, there has been much borrowing in yen and other strong currencies at rates of interest as low as 5 to 7 per cent against local lending rates of 13 to 16 per cent.

To cover the possible losses from changes in the value of the dinar vis-a-vis various international currencies, the Tunisian authorities have established an exchange equalization fund, Fonds de Perequation des Changes, which is funded with special commission charges levied on all overdraft loans granted by commercial banks (0.5 per cent) and on all term loans granted by development banks (1 per cent). These charges are flat fees, not periodic annual fees, and the accumulated fund is generally considered to be inadequate for the purposes for which it has been created.

The Tunisian scheme involves potentially very large subsidies in favor of entities obtaining foreign currency loans. The size of the subsidies depends on the differential between the coupon of the foreign currency loans and the opportunity cost of local currency finance. Because of the way in which the exchange equalization fund is structured, the subsidies are paid in the first place by local currency borrowers but are covered in the last analysis by taxpayers.

The effective cost for the Tunisian economy is given by the coupon and expected rate of appreciation of different foreign currencies. For short-term and even for medium-term loans, the effective total cost is dominated by the timing of the loans in relation to the timing of the expected appreciation (or depreciation) of foreign currencies. A loan in a low coupon currency that is near its turning point, and should not therefore be expected to appreciate much over the life of the loan, may well prove to be a particularly cheap source of finance. Normally, however, low coupon currencies would have a higher probability of appreciation than high coupon ones. For long-term loans, the effective cost of low and high coupon currencies should be the same, unless low coupon currencies benefit from a systematic risk discount (negative risk premium) in which case loans in low coupon currencies could turn out to be cheaper.

There are two main reasons that Tunisian officials offer in support of the scheme. The first rests on the belief that managers of development banks and non-financial corporations are in a position to secure foreign currency loans on better terms than government officials seeking foreign currency loans in the name of the Tunisian government. This probably explains why, in addition to the free foreign exchange risk guarantee, the entities involved also receive a flat commission, equal to 2 per cent of the loan amount, to cover their costs for negotiating these loans.

It is not clear why non-government entities should be able to borrow in the international markets on better terms than the Tunisian government. Yet given the imperfections and shortsightedness that characterize the functioning of international financial markets, this argument should not be dismissed lightly. For instance, two explanations that could be used in support of this argument are: first, the possibility that managers of development banks and non-financial corporations may have stronger motivation to secure a foreign currency loan and better contacts and greater leverage with the international financial community to obtain it on good terms than government officials; and, second, the possibility that international banks may perceive project-related finance to be economically more worthwhile than finance for balance-of-payments purposes. Whatever the reason, to the extent that this argument is valid, it calls for a continuation of the policy of encouraging non-government entities to raise funds directly overseas but on different, less distorted, terms than the current scheme.

The second rationale for the scheme rests on the fact that there is no free foreign exchange market in Tunisia, the capital account is closed, and entities with foreign currency liabilities have no way of hedging effectively their foreign currency exposures. Again, this underlines the need for some long-term hedging facilities, but not necessarily on the terms of the current scheme.

Although the scheme provides incentives for borrowing in hard currencies, the fact that foreign currency borrowing, especially when it involves the granting of foreign exchange risk guarantee, has been subject to the approval of the central bank, has perhaps operated to contain its size and mitigate its impact. The authorities can, in principle at least, keep under control the overall exposure in hard and soft currencies. However, Tunisia has a strong demand for foreign currency and decisions to approve particular foreign currency loans are dictated by the availability of foreign currency funds rather than their cost. This implies that the control of the Tunisian authorities on the currency composition of the foreign debt is more limited than is

sometimes claimed by officials of the central bank. The bargaining power of the borrowing entities may therefore be quite strong, forcing the authorities to accept hard currency loans that have the greatest benefit for the borrowers concerned.

The provision of financial subsidies that are determined by the ability of borrowers to raise low coupon foreign currency loans, rather by any economic or social objectives, is perhaps the strongest argument against the scheme. Any concern about the currency composition of total external debt and possible large exposure to hard currencies could, in principle at least, be met by the government acting in countervailing fashion through its own borrowing program and through more active management of its foreign debt. However, even if feasible, countervailing operations have their own costs and constraints that would need to be taken into account.

Before discussing possible alternatives to the present scheme, it may be useful to consider the broader economic rationales that may justify the operation of foreign exchange risk schemes. The first such rationale relates to the intended use of the proceeds of a foreign currency loan. This implies that there is a system of foreign exchange allocation in operation and that obtaining a foreign currency loan may determine whether a particular project goes ahead or not. In such cases, the opportunity cost of not getting the foreign currency loan is not just the cost of local currency finance, but whatever cost is involved in not implementing the project concerned. Foreign exchange allocation systems raise complex issues that go beyond the objectives of this paper. It is assumed here that there is no foreign exchange allocation system in operation and that the opportunity cost of not obtaining a foreign currency loan is the cost of local currency finance.

Another broad economic rationale relates to the allocation of foreign exchange risk. The increased volatility of foreign exchange rates has raised the level of uncertainty with regard to the effective cost of foreign currency loans. Most economic agents other than the government are usually assumed to be risk averse, which means that, in the absence of any hedging or other risk transfering facilities, they would reduce their recourse to foreign currency loans. On the other hand, the government is considered to be risk neutral so that efficient allocation of risk would imply that governments should assume the foreign exchange risk but pass on to final borrowers the expected cost of foreign currency loans. Much of the rest of this paper discusses alternative schemes for risk-transfering or risk-sharing facilities. However, it is fair to mention at this stage that in a dynamic (rather than static) sense, many commentators would argue that governments, far from being risk neutral, behave in a

manner that increases risk for which they generally tend to charge a low price. The implication is that any involvement of governments in running foreign exchange risk sharing schemes is likely to lead to inefficiencies and scheme abuse. Instead, governments should concentrate on implementing sound macroeconomic policies, including maintenance of a fairly valued exchange rate.

POSSIBLE REFORMS

The current scheme suffers from a number of important weaknesses and disadvantages that call for major reform:

a. It provides strong incentives for borrowing in low coupon currencies that will minimize the financial costs (and maximize the implicit financial subsidies) of borrowing entities, irrespective of the total effective cost for the economy as a whole;

b. It may therefore result in a very high effective cost of foreign currency debt;

c. It insulates local entities from the implications of changes in international currency and financial markets.

d. By providing free foreign exchange cover, it may constitute a multiple currency practice, although the concept of multiple currency practices in the context of transactions over time is not as clear as in the context of different exchange rates for different types of transactions of a given term (spot or forward).

There is a need to replace the existing scheme with one that encourages efficient decentralized foreign currency borrowing by exposing local economic agents to developments in international financial markets, achieves a more efficient allocation of foreign exchange risk and avoids large financial subsidies to borrowing entities.

There are four possible solutions to the problems caused by the current foreign exchange risk guarantee scheme:

a. No scheme: The first is to eliminate the scheme altogether and let borrowing entities assume completely the foreign exchange risk. The no-scheme solution has many advantages and is the situation that prevails in nearly all advanced countries, where economic agents are free to determine their individual exposure in different curencies and to arrange

for hedging and other risk transferring and risk sharing facilities through the marketplace. It avoids both the problems of administration and the implications of potential abuse that other solutions may have.

However, the no-scheme solution has two major shortcomings. Development banks and non-financial corporations may be unable to sustain the losses that may result from a large depreciation of the local currency (or, as in the recent history of the yen, a large appreciation of the foreign currency concerned). The increase in debt servicing costs may cause serious liquidity problems and endanger the continuing existence of otherwise sound enterprises. The government may then be forced to intervene to assume the foreign exchange losses on an ex post basis. Once this happens, the credibility of this approach would be seriously compromised. The fact that governments in many developing countries in Latin America and Africa have been compelled to intervene in this fashion may have already undermined the feasibility of this solution even in countries, such as Tunisia, where it has not been tried until now.

In addition to the lack of credibility, the no-scheme solution has another shortcoming: the discouragement of recourse to foreign currency finance that may result in the absence of free foreign exchange markets. In some cases, especially if there is substantial foreign debt overhang and borrowing entities have been imprudent in their foreign currency borrowings, this may not be a shortcoming at all. However, if there is an objective to encourage decentralised foreign currency borrowing, then the discouragement of such financing would be a weakness.

b. Centralised foreign currency borrowing: The second solution is for all foreign currency borrowing to be concentrated in the hands of the government which will then convert the proceeds of such loans into local currency and onlend them at the prevailing local rates of interest, either directly to the ultimate beneficiaries or through the commercial and development banks. Such a solution would be more consistent with the fact that there is no free foreign exchange market and capital controls prevent economic agents from having access to hedging facilities in the domestic or international financial markets. The rationale behind this approach would be that if a government has effectively nationalized the foreign exchange market, it might as well nationalize foreign currency borrowing and with it the assumption of foreign exchange risk.

Centralised foreign currency borrowing may result in higher total borrowing costs. In addition, it insulates local economic agents from developments in international financial markets and prevents financial markets from playing any direct part in the determination of the exchange rate and the handling of the foreign exchange risk. It also fails to prepare economic agents for the exigencies of freer financial markets and implicitly assumes a continuing reliance on financial repression.

c. Long-term hedging facilities: A third solution is for the government to offer appropriately priced long-term hedging facilities to local economic agents. The current scheme operated in Tunisia falls under this heading but its major shortcoming is that the facility is provided cost-free. One way to charge for the hedging facility is to levy a risk premium equal to the differential between the domestic and foreign currency interest rates on loans of comparable size, risk and maturity. However, if the level of domestic loan interest rates does not reflect market expectations of a future depreciation in the local currency, the risk premium may be inadequate. On the other hand, levying a higher risk premium to take account of expectations of future devaluation may render hedged foreign currency loans unduly expensive by comparison with the cost of local currency loans and may discourage local entities from seeking to borrow in foreign markets. The fact that the forward rates that result from prevailing interest differentials are more often than not very bad predictors of future exchange rates is a major weakness of this solution.

The authorities in developing countries have been reluctant to offer hedging facilities involving explicit risk premiums, perhaps because such premiums, and especially variations in them, may be seen to provide official indications of expected devaluation. An alternative scheme offering long-term hedging facilities that appears to have been tried in Mexico and Brazil is some kind of back-to-back swapping arrangement whereby the foreign currency loan of a local entity is converted into a local currency one.

The FICORCA scheme operated in Mexico, which has been used to support the renegotiation of private sector loans obtained prior to 1982, is described briefly in the attached annex. The Brazilian scheme appears to be based on similar principles, although there is some uncertainty (ie difference of opinion) as to whether it is a genuine hedging facility rather than a disguised import deposit scheme.

Generally the economics of loan swapping arrangements depend on the valuation of the currency at the time the swap takes place and the interest differential between the local and foreign currencies concerned. One major problem concerns the ability of local entities to go in and out of the scheme. This creates a certain asymmetry in the fortunes of the scheme since borrowers have an incentive to join it when the local currency is overvalued (and a devaluation may be considered to be imminent) but to withdraw from it when the currency is undervalued.

One solution to discourage short-term speculation against a long-term hedging scheme would be to charge the risk premium in the form of up-front fees payable at the time of entry into, or exit from, the scheme. The difficulty here is in determining the level of the up-front fees and whether borrowing entities in developing countries can cope with such more complex arrangements.

Back-to-back loan arrangements do not avoid the difficulties of pricing a risk that is not amenable to "actuarial" assessment but seem to overcome the political embarrassment that may be caused by explicit risk premiums. Provided the local currency is not seriously overvalued (at least not for prolonged and frequent periods) and the level of local interest rates is not significantly out of line with international rates, such arrangements could be both economically and politically viable. However, if these conditions are not met, swap facilities could prove very costly.

d. Long-term financing facilities: The fourth possible solution is to introduce a scheme offering long-term financing facilities to meet the increased debt servicing requirements that would ensue from a currency devaluation but without providing any hedging for the foreign exchange risk and therefore not requiring the determination of implicit or explicit risk premiums on an ex ante basis. Under this scheme, entities obtaining foreign currency loans would in the first place assume fully the foreign exchange risk of their foreign currency loans but if the depreciation of the local currency in any one year were to exceed a given rate, the central bank could provide a long-term loan in local currency to meet any liquidity problems resulting from the increased debt servicing burden.

Unlike schemes offering long-term hedging facilities, a long-term financing facility would not provide any cover against potential future foreign exchange losses but rather a means for financing such losses and spreading their impact over a longer period. It would in effect involve an ex post

calculation of the cost of foreign currency borrowing since the servicing and amortization of the long-term local currency loan would impact the ongoing operations of the entities concerned.

Introduction of such a scheme would have a number of implications for corporate leverage, government finance and monetary policy, all of which appear to be related to the rate of interest and amortization conditions that should be applied to the local currency loan. Before implementing it, the following detailed questions would need to be addressed:

a. What should be the annual rate of depreciation that should trigger use of the facility?

b. Who should be administering the scheme and what, if any, should be the role of commercial banks in its administration?

c. Should access to the facility be automatic to borrowing entities affected by the devaluation or should the agency that administers the scheme have the right to refuse accommodation of borrowers with unduly high leverage or limited prospects of long-term survival?

d. What should be the maturity of the local currency facility and how should its amortization be arranged?

e. What rate of interest should be charged on the facility?

f. What are the implications for government finance of the funding costs of the scheme?

g. Are there any implications for the conduct and effectiveness of monetary policy?

h. Under what conditions would the scheme be considered to constitute a multiple currency practice?

i. What should happen to the gains from reduced debt servicing burden in the event of a local currency appreciation? Should participation in the scheme be mandatory for all non-commercial foreign currency borrowing? Should borrowing entities have the option to join, and withdraw from, the scheme at any time during the life of their foreign currency loan(s)?

j. Finally, what are the merits and demerits of long-term financing facilities vis-a-vis the other possible solutions and especially long-term hedging facilities?

Although complete answers to these questions would require extensive analysis and discussion, the following seem to follow from a preliminary consideration of the main issues listed above:

a. The "trigger" rate of devaluation should not be too high since a high level would undermine the purpose of the scheme but it should not be too low either because a low level may give rise to frequent utilization, raising the administrative costs of the scheme. The appropriate level should depend on the probability distribution of expected exchange rate changes but in the absence of any robust ideas on this, a realistically acceptable figure for a country with the moderate inflation experience of Tunisia could be between 5 and 10 per cent per annum. For other countries with a higher inflation differential over the average inflation of major industrialized countries, a higher trigger rate would be more appropriate. Perhaps, the "trigger" rate should be expressed in real rather than nominal terms in the case of countries with inflation in excess of 20 per cent. In general, the "trigger" rate, like most other features of the scheme, should be kept under review.

b. The agency that should be responsible for the administration of the scheme should be the central bank. However, day-to-day operations, and especially the appraisal of future prospects of borrowers, could be delegated to commercial banks. Commercial banks could also be called upon to share in the credit risk involved, if that was deemed desirable. The scheme may create long-term relationships between the monetary authorities and large borrowing entities. This may constrain the central bank from taking corrective action on the exchange rate or on interest rates, because of the likely impact on large borrowers. Delegating the administration of the scheme to commercial banks, under central bank supervision, may reduce this danger. Delegating to commercial banks may be justified on other grounds. If firms are facing liquidity problems but are otherwise sound, commercial banks should in a well functioning market be prepared to lend to them on their own account without the need of an official scheme. However, commercial banks may be reluctant to do so becasue of a high degree of uncertainty. An official scheme, operating like a credit guarantee scheme with the banks assuming some of the credit risk, could encourage banks to provide the required

liquidity assistance. Another question regarding the administration of the scheme is how disbursements under the scheme should be made. In principle, disbursements should be made until the final maturity of the foreign currency loan but various provisions could be made to streamline the functioning of the scheme.

c. An important consideration is whether the loan should be extended on an automatic basis when depreciation of the local currency above a certain limit occurs or whether the central bank should have the right to refuse accommodation of a borrower if its leverage is deemed to be unduly high. Much will depend on the ability of borrowing entities to recoup the increased cost of debt servicing from their basic operations and on the impact of depreciation on the local currency value of their assets. To forestall future difficulties from inability of borrowing entities to meet their local currency obligations, access to the facility should not be automatic but the conditions of eligibility should be established at the time participation in the scheme is sought by individual entities. This would allow the central bank to exercise greater control on the assumption of foreign currency liabilities by individual development banks and non-financial corporations. It may also allow the central bank to require that participating entities take explicitly into account, especially in their costing and pricing decisions, the need to cover possible future losses from currency changes.

d In principle, the local currency facility should be a long term one, repayable over say 12 years or more, allowing borrowing entities to amortize over a long period the foreign exchange losses suffered from the depreciation of the local currency. This should not, however, preclude the need for taking into account in an ex ante sense expected future foreign exchange losses when making pricing and other management decisions.

e. The economics of the scheme would clearly depend on the rate of interest payable on the local currency loan and on the ability of the borrowing firm to repay its increased long-term debt. Ideally, the local currency loan should bear interest at the marginal cost of government borrowing. In high inflation countries, the rate of interest should also be variable and linked to the rate on long-term government bonds, provided the latter is a free market and is not based on funds from captive sources. As a compromise during the introduction of the scheme, a lower rate of interest equal to the rate applicable on preferred credits could be used. However, a move to a rate reflecting the marginal cost of

government funds should be envisaged if the size of this scheme were to have a major impact on the net funding costs of the government.

f. The implications for government finance would depend on the rate of interest charged on the local currency facility and the marginal cost of government borrowing as well as on the way in which the government funds the required loans. It would also depend on the level of overvaluation of the local currency and the level of domestic interest rates in relation to international rates. It is assumed here that the government will fund any loans in a non-inflationary way, i.e. in a way that will not give rise to an increase in reserve balances that will allow banks to engage in a multiple expansion of credit. As regards the net funding costs of the scheme, if any, these could be kept under control by the government retaining the option to vary the cost of the local currency facility to ensure that the impact on the budget would not become unduly large.

g. Apart from the impact on the government borrowing requirement and its implications for the level of interest rates, introduction of a scheme offering long-term financing facilities should not have any direct implications for the conduct and effectiveness of monetary policy. This is because the proceeds of the local currency loan would be absorbed in purchasing the foreign currency needed to service the foreign debt concerned and would not be available for spending for investment or other purposes. There should therefore be no direct impact on the level of domestic demand and no immediate inflationary pressures should be generated. However, if the existence of the scheme were to encourage foreign currency borrowing that was not compensated by an equivalent reduction in domestic credit expansion, then there would be an indirect impact on the level of domestic demand with potentially adverse implications for internal and external balance. Moreover, the lending facility by mitigating the impact of exchange rate depreciation would also soften its liquidity and income (wealth) effect, though not any price effect. However, it is a primary objective of the scheme to enable borrowing entities to soften the impact of depreciation by amortizing the losses over a longer period of time.

h. As already noted above, the concept of multiple currency practices is not very clear for transactions that take place over different time periods. Nevertheless, use of a heavily subsidized rate on the local currency loan would give rise to allegations of multiple currency practices. The question may be one of legal definitions since if the government were

to raise the foreign currency funds in its own name and use the proceeds for onlending in local currency, it could charge any rate of interest it chose without being accused of engaging in multiple currency practices.

j. Symmetricity in the treatment of appreciating and depreciating currencies would require that in the event, however unlikely, of an appreciation of the local currency against a given foreign currency by more than the "trigger" rate, the entity involved should grant a long term loan to the central bank at the same rate and conditions as the loan it would have obtained under the scheme had there been a depreciation against that same or another foreign currency. This is linked to the issue whether participation in the scheme should be mandatory for all entities that obtain foreign currency loans or for all foreign currency loans of participating entities or whether it should be voluntary for each different case of foreign currency borrowing. A further question relates to the ability to go in and out of the scheme. Probably, the easiest solution would be to make participation voluntary for all loans that meet some specified conditions of eligibility (i.e those in excess of a given short maturity which should exclude all credits relating to short-term commercial transactions). As regards the conditions of scheme entry and exit, it would be necessary to lay down terms and conditions that discouraged short-term speculation against the scheme but, otherwise, entry and exit should perhaps be allowed on a liberal basis to allow sufficient flexibility to participating entities in managing their financial affairs. If the cost of the local currency financing facility was reasonable, the incentive for abuse of the scheme would be weak, causing less concern about the impact of a possible lack of symmetricity in the operations of the scheme.

i. Finally, the question of the merits and demerits of the hedging anf financing facilities is a complex and difficult one to answer. First, with regard to the no-scheme solution, the long-term facility should enjoy a higher degree of credibility, provided it is widely used. This is because there will be less pressure on the authorities to assume ex post the losses of those entities that may have decided not to seek cover under the scheme. The no-scheme solution would be credible if the authorities pursue sound interest rate and exchange rate policies and avoid substantial overvaluation of the exchange rate. But then the long-term facility would would not be triggered. Centralised foreign currency borrowing would probably be a superior solution if the authorities wish to discourage recourse to the international markets because of concern

about the debt overhang. However, this solution implies a continuation, or perhaps even intensification, of some sort of financial repression.

As regards hedging facilities, they should be preferable if they could be properly priced since they would allow economic decisions to be made on a forward-looking basis. However, given the likelihood of mispricing and its asymmetric impact on a hedging scheme (utilization of underpriced facilities would far exceed that of overpriced ones), the long-term financing facility may be preferable, especially if the dangers of automatic access and excessively high leverage could be kept under control. The weakness of the long-term financing facility scheme is that it would be a backward-looking operation in the sense that it would rely on future profits to pay for past losses.

Clearly, no system would offer a perfect solution but given the existing constraints on operating a perfect system, either scheme would be acceptable if the cost to direct beneficiaries was reasonable. After all no scheme, however perfect, would be required if there were no macroeconomic and political constraints on interest and exchange rate policies, necessitating the maintenance of a closed foreign exchange market.

CONCLUDING REMARKS

The Tunisian authorities operate a scheme for covering the foreign exchange risk of foreign currency loans by development banks and non-financial corporations that provides strong incentives for borrowing in low coupon hard currencies. Although the impact of the scheme is mitigated by the controls that the central bank exercises over all cases of long-term foreign currency borrowing, a very strong case can be made for reforming the current scheme and replacing it with one that would incorporate the right incentives to encourage efficient decentralised foreign currency borrowing without providing large financial subsidies to borrowing entities. A further basic objective would be to expose local economic agents to developments in international financial markets.

This note has briefly examined four possible solutions to this problem. Of these four, the first two - eliminating the scheme altogether without putting anything else in its place and centralising all foreign currency borrowing in the hands of the government - would fail to meet the above objectives. The third and fourth solutions - offering properly priced long-term hedging facilities to cover potential foreign exchange losses and offering long-term financing facilities to cover the liquidity needs from such losses - would on the other hand meet these objectives.

Further consideration of the merits and demerits of the third and fourth solutions would be advisable before specific recommendations are made to the Tunisian authorities, but in designing a scheme, the need for simplicity should also be kept in mind. On balance, the scheme offering long-term financing facilities would seem preferable given the difficulties of setting the right risk premiums that would be required for any hedging facilities.

Dimitri Vittas
CECFP
26 January 1988

ANNEX

THE FICORCA SCHEME IN MEXICO

The FICORCA scheme was introduced in Mexico in 1983 to cope with the effects of the 1982 crisis. Its primary purpose was to provide an incentive to Mexican firms to renegotiate their pre-existing foreign currency loans on more acceptable terms by offering a long-term hedging facility against foreign exchange risk. Eligibility has been limited to loans meeting certain criteria with regard to maturity, grace period and interest cost. There is some uncertainty as to whether FICORCA can be used for new loans but, given the paucity of new lending to Mexican firms, the question is perhaps academic.

FICORCA operates four different systems which vary by the extent of foreign exchange risk coverage offered and by the financing arrangements involved:

a. System 1 covers the foreign exchange risk for the repayment of principal only. Participating firms assume the foreign exchange risk for the interest payments on their foreign currency loans. The scheme requires participating firms to purchase foreign currency for future delivery at a special exchange rate. FICORCA undertakes to deliver the foreign currency when repayment of the principal is due. The cost of hedging for the participating firm is the foregone interest income on the peso funds used to purchase the foreign currency for future delivery. To offset partly this cost, the rate of exchange used is better than the prevailing spot controlled rate at the time the transaction is taking place by a margin that reflects the interest cost of the hedge. (Mexico operates a two tier exchange rate system - a controlled rate reserved for official transactions and a free rate.) An arithmetical example quoted by FICORCA shows that if the spot controlled rate is, for instance, 100 pesos per US dollar, the special rate for a System 1 transaction may be as low as 94 pesos for a six-year loan with a three-year grace period or 82 pesos for an eight-year loan with a four-year grace period.

b. System 2 also covers the foreign exchange risk for the repayment of principal only and uses the same special rate of exchange for the purchase of foreign currency for future delivery as System 1 contracts. System 2 contracts differ from System 1 in that they offer a credit facility in pesos to cover the value of the contract. The rate of interest of

this credit is variable and is linked to the arithmetical average of the rates available on three- and six-month peso deposits. The cost of the hedge is the interest cost of the FICORCA credit offset by the foreign exchange premium involved in the special rate used for such transactions.

c. System 3 differs from the first two in that it offers to cover the foreign exchange risk of both principal and interest payments. It involves the purchase of foreign currency at the prevailing spot rate in the controlled market for immediate delivery to the participating firm and the lending back to FICORCA of such foreign currency at a rate equal to LIBOR. The cost of the hedge is now the interest differential between the foregone interest income on the peso funds and LIBOR. FICORCA undertakes to make interest payments at LIBOR to the foreign lender. If the foreign loan bears interest at a spread over LIBOR (which eligibility criteria limit to a maximum of 2 percentage points), a surcharge is calculated on the controlled rate of exchange used for this transaction. The surcharge varies with the size of the spread.

d. System 4 contracts offer a peso credit facility in addition to covering both the principal and interest payments of the foreign currency loan and requiring a relending of the foreign currency to FICORCA. System 4 provides a complete back-to-back arrangement and effectively amounts to a swap transaction converting a foreign currency debt into a local currency one.

The FICORCA scheme has some special provisions for the amortization of peso credits which reflect the high inflation experience of Mexico and aim to maintain a constant repayment pattern in real, rather than nominal, terms. It also allows participating firms to join, and withdraw from, the scheme at any time during the life of a foreign currency loan provided the firm concerned pays the redemption value of the contract at the time of withdrawal. The ability to go in and out of the scheme affects its economic performance since participating firms may join when the peso is overvalued and withdraw (or not join) when it is undervalued. The economics of the scheme clearly depend on the relationship between the valuation of the exchange rate and the interest rate and inflation differentials.

A basic eligibility criterion for participation in the FICORCA scheme was the negotiation with foreign lenders of a grace period of 3 to 4 years. It is interesting to note that by the time the grace period was over, FICORCA entered into direct negotiations with foreign lenders in order to reschedule the foreign currency liabilities it has taken over from private borrowers. The

restructuring that has recently been agreed has provided for a lengthening of maturities to 20 years among a number of other changes, but it has continued to allow private borrowers to leave the scheme on the basis of the redemption value of the loans. It appears that several borrowers have agreed with their foreign bankers to repay their loans at substantial discounts to their book value and there has been a considerable exit from the scheme.

Because FICORCA has been created to deal with the legacy of the overvaluation of the peso of the early 1980s and the foreign currency loans obtained before the major correction of 1982, its relevance for ongoing schemes is rather limited. However, the basic idea is quite interesting and merits further consideration and analysis. Its economics must have been affected by the impact of asymmetric expectations and by the use of a deposit, rather than a loan, rate for the peso credit and of the controlled, rather than the free, exchange rate for the swap, but because real interest rates have been very high in Mexico, the net impact on FICORCA may not have been unduly large. Unfortunately, detailed data on the financial performance of FICORCA is not readily available.

Dimitri Vittas
CECFP
26 January 1988

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Tunisia

DATE: 7 January 1988

TO: Distribution

FROM: Dimitri Vittas, CECFP DV

EXT.: 61553

SUBJECT: TUNISIA: TREATMENT OF FOREIGN EXCHANGE RISK

1. I attach a paper that discusses the treatment of foreign exchange risk in Tunisia and considers possible solutions to the scheme that is currently in operation.

2. The present Tunisian scheme could be described as the typical case of "HOW NOT TO COVER FOREIGN EXCHANGE RISK". Its major shortcoming is that it provides strong incentives to borrowing entities (development banks and non-financial corporations) to raise loans denominated in low coupon currencies. Although some mitigating factors are in effect, the impact of the scheme on the burden of debt servicing is considered to be large.

3. The paper considers the need to replace the existing scheme with one that meets two specific objectives: providing the right incentives to local economic agents to seek finance in the international markets on the most advantageous terms for the economy as a whole; and, not insulating local economic agents from developments in international financial markets.

4. Four possible solutions are briefly discussed. Of these, the first two - eliminating the scheme altogether without putting anything else in its place and concentrating all foreign currency borrowing in the hands of the government - would clearly not meet both of the above objectives. Of the last two, which would meet both objectives, one would involve offering properly priced long-term hedging facilities through a loan swap (converting the foreign currency loans into local currency ones) to cover potential losses from changes in foreign exchange rates whilst the other would involve offering long-term financing facilities to cover the liquidity needs from such losses.

5. Hedging facilities based on loan swaps are operated in Mexico and Brazil (the Mexican scheme is briefly described in the annex to the paper). Long-term financing facilities to meet the liquidity needs caused by foreign exchange losses have been used on ad hoc basis in some countries. The paper discusses the merits and demerits of the two alternative solutions and examines

the implications of the long-term financing facilities for corporate leverage, government finance and monetary policy. Whilst either scheme could be acceptable if its cost was reasonable, the paper considers the financing facility to be preferable, mainly because of the difficulty of pricing correctly a risk that is not amenable to "actuarial" assessment.

6. Any comments and reactions would be most welcome.

Distribution:

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DVIITAS/

TREATMENT OF FOREIGN EXCHANGE RISK IN TUNISIA

INTRODUCTION: THE CURRENT SCHEME

The Tunisian authorities operate a foreign exchange risk guarantee scheme whereby development banks and non-financial corporations that obtain foreign currency loans from the international financial markets are covered completely for the risk of devaluation of the dinar without having to pay any risk premium. Beneficiaries of this scheme have to incur only the foreign currency rate of interest on their foreign debt and have, as a result, a strong incentive to borrow in low coupon hard currencies irrespective of the risk of future appreciation which is normally much higher for low-coupon than for high-coupon currencies. Inevitably, there has been much borrowing in yen and other strong currencies at rates of interest as low as 5 to 7 per cent against local lending rates of 13 to 16 per cent.

To cover the possible losses from changes in the value of the dinar vis-a-vis various international currencies, the Tunisian authorities have established an exchange equalization fund, Fonds de Perequation des Changes, which is funded with special commission charges levied on all overdraft loans granted by commercial banks (0.5 per cent) and on all term loans granted by development banks (1 per cent). These charges are flat fees, not periodic annual fees, and the accumulated fund is generally considered to be inadequate for the purposes for which it has been created.

The Tunisian scheme involves potentially very large subsidies in favor of entities obtaining foreign currency loans. The subsidies, which are open-ended and unpredictable, are paid in the first place by local currency borrowers but, given the inadequacy of the exchange equalization fund, they are covered in the last analysis by taxpayers.

There are two main reasons that Tunisian officials offer in support of the scheme. The first rests on the belief that managers of development banks and non-financial corporations are in a position to secure foreign currency loans on better terms than government officials seeking foreign currency loans in the name of the Tunisian government. This probably explains why, in addition to the free foreign exchange risk guarantee, the entities involved also receive a flat commission equal to 2 per cent of the loan amount to cover their costs for negotiating these loans.

It is not clear why non-government entities should be able to borrow in the international markets on better terms than the Tunisian government but, given the imperfections and

shortsightedness that characterize the functioning of international financial markets, this argument should not be dismissed lightly. For instance two explanations hat could be used in support of this argument are: first, the possibility that managers of development banks and non-financial corporations may have stronger motivation to secure a foreign currency loans and better contacts and greater leverage with the international financial community than government officials to obtain it on good terms; and, second, the perception among international banks that project-related finance may be more worthwhile than finance for balance-of-payments purposes. Whatever the reason, to the extent that it is valid, this argument calls for a continuation of the policy of encouraging non-government entities to raise funds directly overseas but on different, less distorted, terms than the current scheme.

The second rationale for the scheme rests on the fact that there is no free foreign exchange market in Tunisia, the capital account is closed, and entities with foreign currency liabilities have no way of hedging effectively their foreign currency exposures. Again, this underlines the need for some long-term hedging facilities but not necessarily on the terms of the current scheme.

Although the scheme provides incentives for excessive borrowing in hard currencies, the fact that foreign currency borrowing, especially when it involves the granting of foreign exchange risk guarantee, has been subject to the approval of the central bank, has perhaps operated to contain its size and mitigate its impact. The authorities can, in principle at least, keep under control the overall exposure in hard and soft currencies. However, Tunisia has a strong demand for foreign currency and decisions to approve particular foreign currency loans are dictated by the availability of foreign currency funds rather than their cost. This implies that the control of the Tunisian authorities on the currency composition of the foreign debt is more limited than is sometimes claimed by officials of the central bank. The bargaining power of the borrowing entities may therefore be quite strong, forcing the authorities to accept hard currency loans that have the greatest benefit for the borrowers concerned.

POSSIBLE REFORMS

The current scheme suffers from a number of important weaknesses and disadvantages that call for a major reform:

a. It provides strong incentives for borrowing in the wrong currencies and may result in substantial increases in the debt servicing burden of foreign currency debt.

b. It insulates local entities from the implications of changes in international currency and financial markets.

c. By providing free foreign exchange cover it may constitute a multiple currency practice, although the concept of multiple currency practices in the context of transactions over time is not as clear as in the context of different exchange rates for different types of transactions of a given term (spot or forward).

There are four possible solutions to the problems caused by the current foreign exchange risk guarantee scheme:

a. No scheme: The first is to eliminate the scheme altogether and let borrowing entities assume completely the foreign exchange risk. The weakness of this solution is that development banks and non-financial corporations may be unable to sustain the losses that may result from a large depreciation of the local currency (or, as in the case of the yen, a large appreciation of the foreign currency concerned). The increase in the debt servicing costs may undermine the viability of otherwise sound enterprises and may cause the government to intervene and assume the foreign exchange losses on an ex post basis. Once this happens, the credibility of this approach would be seriously compromised. The fact that governments in many developing countries in Latin America and Africa have been compelled to intervene in this fashion may have already undermined the feasibility of this solution even in countries, such as Tunisia, where it has not been tried until now.

b. Government foreign currency borrowing: The second solution is for all foreign currency borrowing to be concentrated in the hands of the government which will then convert the proceeds of such loans into local currency and onlend them at the prevailing local rates of interest either directly to the ultimate beneficiaries or through the commercial and development banks. Such a solution would be more consistent with the fact that there is no free foreign exchange market and capital controls prevent economic agents from having access to hedging facilities in the domestic or international financial markets. The rationale behind this approach would be that if a government has effectively nationalized the foreign exchange market, it might as well nationalize foreign currency borrowing and with it the assumption of foreign exchange risk. A major weakness of this solution is that it insulates local economic agents from developments in international financial markets and also prevents market forces from playing any direct part in the determination of the exchange rate and the handling of the foreign exchange risk. It also fails to prepare economic agents for the exigencies of freer financial markets and implicitly assumes a continuing reliance on financial repression.

c. <u>Long-term hedging facilities</u>: A third solution is for the government to offer appropriate long-term hedging facilities to local economic agents. The current scheme operated in Tunisia falls under this heading but its major shortcoming is that the facility is provided cost-free. One way to charge for the hedging facility is to levy a risk premium equal to the differential between the domestic and foreign currency interest rates on loans of comparable size, risk and maturity. However, if the level of domestic loan interest rates does not reflect market expectations of a future depreciation in the local currency, the risk premium may be inadequate. On the other hand, levying a higher risk premium to take account of expectations of future devaluation may render hedged foreign currency loans unduly expensive by comparison with the cost of local currency loans and may discourage local entities from seeking to borrow in foreign markets. The fact that the forward rate that results from prevailing interest differentials is often a very bad predictor of future exchange rates is a major weakness of this solution.

The authorities in developing countries have been reluctant to offer hedging facilities involving explicit risk premiums, perhaps because such premiums, and especially variations in them, may be seen to provide official indications of expected devaluation. An alternative scheme offering long-term hedging facilities that has been tried in Mexico and Brazil is some kind of back-to-back swapping arrangement whereby the foreign currency loan of a local entity is converted into a local currency one. The FICORCA scheme operated in Mexico is described briefly in the attached annex but generally the economics of such arrangements depend on the valuation of the currency and the interest differential between the local and foreign currencies concerned. One problem that such arrangements have concerns the ability of local entities to go in and out of the scheme. This creates a certain asymmetry in the fortunes of the scheme since borrowers have an incentive to join the scheme when the local currency is overvalued (and a devaluation may be considered to be imminent) but to withdraw from it when the currency is undervalued. Back-to-back loan arrangements do not avoid the difficulties of pricing a risk that is not amenable to "actuarial" assessment but seem to overcome the political embarrassment that may be caused by explicit risk premiums. The experience of Mexico and Brazil shows that, provided the local currency is not seriously overvalued (at least not for prolonged and frequent periods) and the level of local interest rates is not significantly out of line with international rates, such arrangements could be both economically and politically viable.

d. <u>Long-term financing facilities</u>: The fourth possible solution is to introduce a scheme offering long-term financing facilities to meet the increased debt servicing requirements that would ensue from a currency devaluation but without providing any hedging for the foreign exchange risk and therefore not requiring the determination of implicit or explicit risk premiums on an ex ante basis. Under this scheme, entities obtaining foreign currency loans would in the first place assume fully the foreign exchange risk of their foreign currency loans but if the depreciation of the local currency in any one year were to exceed a given rate, say 5 per cent, the central bank could provide a long-term loan in local currency to meet any liquidity problems resulting from the increased debt servicing burden. Unlike schemes offering long-term hedging facilities, a long-term financing facility would not provide any cover against potential future foreign exchange losses but rather a means for financing such losses and spreading their impact over a longer period. It would in effect involve an ex post calculation of the cost of foreign currency borrowing since the servicing and amortization of the long-term local currency loan would impact the ongoing operations of the entities concerned. Introduction of such a scheme would have a number of implications for corporate leverage, government finance and monetary policy, all of which appear to be related to the rate of interest and amortization conditions that should be applied to the local currency loan.

Before implementing a scheme offering long-term financing facilities, the following detailed questions would need to be addressed:

a. What should be the maturity of the local currency facility and how should its amortization be arranged?

b. What rate of interest should be charged on the facility?

c. Should access to the facility be automatic to borrowing companies affected by the devaluation or should the agency that administers the scheme have the right to refuse accommodation of entities with unduly high leverage or limited prospects of financial survival?

d. What are the implications for government finance of the funding costs of the scheme?

e. Are there any implications for the conduct and effectiveness of monetary policy?

f. Under what conditions would the scheme be considered to constitute a multiple currency practice?

g. What should happen to the gains from reduced debt servicing burden in the event of a local currency appreciation? Should participation in the scheme be mandatory for all non-commercial foreign currency borrowing? Should borrowing entities have the option to join, and withdraw from, the scheme at any time during the life of their foreign currency loan(s)?

h. Finally, a most interesting question, what are the merits and demerits of long-term financing facilities vis-a-vis long-term hedging facilities?

Although complete answers to these questions would require extensive analysis and discussion, the following seem to follow from a hurried consideration of the main issues listed above:

a. In principle, the local currency facility should be a long term one, repayable over say 20 years, allowing borrowing entities to amortize over a long period the foreign exchange losses suffered from the depreciation of the local currency. This should not, however, preclude the need for ex ante provisioning for future foreign exchange losses (see (c) below.

b. The economics of the scheme would clearly depend on the rate of interest payable on the local currency loan and on the ability of the borrowing firm to repay its increased long-term debt. Ideally, the local currency loan should bear interest at the marginal cost of government borrowing. In high inflation countries, the rate of interest should also be variable and linked to the rate on long-term government bonds, provided the latter is a free market and is not based on funds from captive sources. As a compromise during the introduction of the scheme, a lower rate of interest equal to the rate applicable on preferred credits could be used. However, a move to a rate reflecting the marginal cost of government funds should be envisaged if the size of this scheme were to have a major impact on the net funding costs of the government.

c. An important consideration is whether the loan should be extended on an automatic basis when depreciation of the local currency above a certain limit occurs or whether the central bank should have the right to refuse accommodation of a borrower if its leverage is deemed to be unduly high. Much will depend on the ability of borrowing entities to recoup the increased cost of debt servicing from their basic operations. To forestall future difficulties from inability of borrowing entities to meet their local currency obligations, access to the facility should not be automatic but the conditions of eligibility should be established at the time participation in the scheme is sought by individual entities. This would allow the central bank to exercise

greater control on the assumption of foreign currency liabilities by individual development banks and non-financial corporations. It may also allow the central bank to require that participating entities make appropriate provisions in their annual accounts, and especially in their costing and pricing decisions, to cover possible future losses from currency changes.

d. The implications for government finance would depend on the rate of interest charged on the local currency facility and the marginal cost of government borrowing. It would also depend on the level of overvaluation of the local currency and the level of domestic interest rates in relation to international rates. In general, the net funding costs of the scheme, if any, could easily be kept under control by the government retaining the option to vary the cost of the local currency facility to ensure that the impact on the budget would not become unduly large.

e. Apart from the impact on the government borrowing requirement and its implications for the level of interest rates, introduction of a scheme offering long-term financing facilities should not have any direct implications for the conduct and effectiveness of monetary policy. This is because the proceeds of the local currency loan would be absorbed in purchasing the foreign currency needed to service the foreign debt concerned and would not be available for spending for investment or other purposes. There should therefore be no direct impact on the level of domestic demand and no immediate inflationary pressures should be generated. However, if the existence of the scheme were to encourage additional foreign currency borrowing that was not compensated by an equivalent reduction in domestic credit expansion, then there would be an indirect impact on the level of domestic demand with potentially adverse implications for internal and external balance.

f. As already noted above, the concept of multiple currency practices is not very clear for transactions that take place over different time periods. Nevertheless, use of a heavily subsidized rate on the local currency loan would give rise to allegations of multiple currency practices. The question may be one of legal definitions since if the government were to raise the foreign currency funds in its own name and use the proceeds for onlending in local currency, it could charge any rate of interest it chose without being accused of engaging in multiple currency practices.

g. Symmetricity in the treatment of appreciating and depreciating currencies would require that in the event of an appreciation of the local currency against a given foreign currency by more than 5 per cent per annum, the entity involved should grant a long term loan to the central

bank at the same rate and conditions as the loan it would have obtained under the scheme had there been a depreciation against that same or another foreign currency. This is linked to the issue whether participation in the scheme should be mandatory for all entities that obtain foreign currency loans or for all foreign currency loans of participating entities or whether it should be voluntary for each different case of foreign currency borrowing. A further question relates to the ability to go in and out of the scheme. Probably, the easiest solution would be to make participation voluntary for all loans that meet some specified conditions of eligibility (i.e those in excess of a given short maturity which should exclude all credits relating to short-term commercial transactions). As regards the conditions of scheme entry and exit, it would be necessary to lay down terms and conditions that discouraged short-term speculation against the scheme but, otherwise, entry and exit should perhaps be allowed on a liberal basis to allow sufficient flexibility to participating entities in managing their financial affairs. If the cost of the local currency financing facility was reasonable, the incentive for abuse of the scheme would be weak, causing less concern about the impact of a possible lack of symmetricity in the operations of the scheme.

h. Finally, the question of the merits and demerits of the hedging anf financing facilties is a complex and difficult one to answer. If hedging facilities could be proprerly priced, they should be preferable since they would allow economic decisions to be made on a forward-looking basis. However, given the likelihood of mispricing and asymmetric impact on a hedging scheme (since utilization of underpriced facilities would far exceed that of overpriced ones), the long-term financing facility may be preferable, especially if the dangers of automatic access and excessively high leverage could be kept under control. The weakness of the long-term financing facility scheme is that it would be a backward-looking operation in the sense that it would rely on future profits to pay for past losses. Clearly, neither system would offer a perfect solution but given the existing constraints on operating a perfect system, either shceme would be acceptable if the cost to direct beneficiaries was reasonable. After all no scheme, however perfect, would be required if there were no macroeconomic and political constraints on interest and exchange rate policies, necessitating the maintenance of a closed foreign exchange market.

CONCLUDING REMARKS

The Tunisian authorities operate a scheme for covering the foreign exchange risk of foreign currency loans by development banks and non-financial corporations that provides strong

incentives for borrowing in the wrong currencies, i.e. in low coupon hard currencies. Although the impact of the scheme is mitigated by the controls that the central bank exercises over all cases of long-term foreign currency borrowing, a very strong case can be made for reforming the current scheme and replacing it with one that incorporates the right incentives to encourage recourse to the international markets on the most advantageous terms for the economy as a whole and does not insulate local economic agents from developments in international financial markets.

This note has briefly examined four possible solutions to this problem. Of these four, the first two - eliminating the scheme altogether without putting anything else in its place and concentrating all foreign currency borrowing in the hands of the government - would clearly fail to meet both of the above objectives. The third and fourth solutions - offering properly priced long-term hedging facilities to cover potential foreign exchange losses and offering long-term financing facilities to cover the liquidity needs from such losses - would on the other hand meet both objectives.

Further consideration of the merits and demerits of the third and fourth solutions would be advisable before specific recommendations are made to the Tunisian authorities. However, it would seem that the scheme offering long-term financing facilities may be preferable given the difficulties of setting the right risk premiums that would be required for any hedging facilities.

Any comments and further elaboration on the above would be most welcome.

Dimitri Vittas
CECFP
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ANNEX

THE FICORCA SCHEME IN MEXICO

The FICORCA scheme was introduced in Mexico in 1983 to cope with the effects of the 1982 crisis. Its purpose was to provide an incentive to Mexican firms to renegotiate their pre-existing foreign currency loans on more acceptable terms by offering a long-term hedging facility against foreign exchange risk. The scheme can be used both for renegotiated loans and for new loans obtained after 1983. Eligibility is available to loans that meet certain criteria with regard to maturity, grace period and interest cost.

FICORCA operates four different systems which vary by the extent of foreign exchange risk coverage offered and by the financing arrangements involved:

a. System 1 covers the foreign exchange risk for the repayment of principal only. Participating firms assume the foreign exchange risk for the interest payments on their foreign currency loans. The scheme requires participating firms to purchase foreign currency for future delivery at a special exchange rate. FICORCA undertakes to deliver the foreign currency when repayment of the principal is due. The cost of hedging for the participating firm is the foregone interest income on the peso funds used to purchase the foreign currency for future delivery. To offset partly this cost, the rate of exchange used is better than the prevailing spot controlled rate at the time the transaction is taking place by a margin that reflects the interest cost of the hedge. (Mexico operates a two tier exchange rate system - a controlled rate reserved for official transactions and a free rate.) An arithmetical example quoted by FICORCA shows that if the spot controlled rate is, for instance, 100 pesos per US dollar, the special rate for a System 1 transaction may be as low as 94 pesos for a six-year loan with a three-year grace period or 82 pesos for an eight-year loan with a four-year grace period.

b. System 2 also covers the foreign exchange risk for the repayment of principal only and uses the same special rate of exchange for the purchase of foreign currency for future delivery as System 1 contracts. System 2 contracts differ from System 1 in that they offer a credit facility in pesos to cover the value of the contract. The rate of interest of this credit is variable and is linked to the arithmetical average of thes rates available on three- and six-month peso deposits. The cost of the hedge is the interest cost of the FICORCA credit offset by the foreign exchange premium involved in the special rate used for such transactions.

c. System 3 differs from the first two in that it offers to cover the foreign exchange risk of both principal and interest payments. It involves the purchase of foreign currency at the prevailing spot rate in the controlled market for immediate delivery to the participating firm and the lending back to FICORCA of such foreign currency at a rate equal to LIBOR. The cost of the hedge is now the interest differential between the foregone interest income on the peso funds and LIBOR. FICORCA undertakes to make interest payments at LIBOR to the foreign lender. If the foreign loan bears interest at a spread over LIBOR (which eligibility criteria limit to a maximum of 2 percentage points), a surcharge is calculated on the controlled rate of exchange used fro this transaction. The surcharge varies with the size of the spread.

d. System 4 contracts offer a peso credit facility in addition to covering both the principal and interest payments of the foreign currency loan and requiring a relending of the foreign currency to FICORCA. System 4 provides a complete back-to-back arrangement and effectively amounts to a swap transaction converting a foreign currency debt into a local currency one.

The FICORCA scheme has some special provisions for the amortization of peso credits which reflect the high inflation experience of Mexico and aim to maintain a constant repayment pattern in real, rather than nominal, terms. It also allows participating firms to join, and withdraw from, the scheme at any time during the life of a foreign currency loan provided the firm concerned pays the redemption value of the contract at the time of withdrawal. The ability to go in and out of the scheme affects its economic performance since participating firms may join when the peso is overvalued and withdraw (or not join) when it is undervalued. The economics of the scheme clearly depend on the relationship between the valuation of the exchange rate and the interest rate and inflation differentials.

Because the peso was suffering from considerable overvaluation when FICORCA was first introduced, initial experience was not very satisfactory but, for new credits, FICORCA is said to be working well and to be succeeding in providing a useful long-term hedge for foreign currency loans by Mexican entities. Its economics must have been affected by the impact of asymmetric expectations and by the use of a deposit, rather than a loan, rate for the peso credit and of the controlled, rather than the free, exchange rate for the swap, but because real interest rates have been very high in Mexico, the net impact on FICORCA may not have been unduly large. Unfortunately, detailed data on the financial performance of FICORCA is not readily available.

Dimitri Vittas
CECFP
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