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CONFIDENTIAL

December 4, 1989

To: Members of the Executive Board

From: The Secretary

Subject: Tunisia - Second Review Under Extended Arrangement -  
Letter of Intent

Attached for consideration by the Executive Directors is a copy of the letter of intent from the Tunisian authorities in connection with the second review under the extended arrangement. The staff report will be circulated shortly.

Mr. Anjaria (ext. 8357) or Mr. Khallouf (ext. 8670) is available to answer technical or factual questions relating to this paper prior to the Board discussion which is tentatively scheduled for Wednesday, December 20, 1989.

Att: (1)

Tunis, December 1, 1989

Mr. Michel Camdessus  
Managing Director  
International Monetary Fund  
Washington D.C., 20431  
U.S.A.

Dear Mr. Camdessus:

1. In 1988, Tunisia's performance under the program supported by a three-year arrangement under the extended Fund facility (EFF) was fully satisfactory, and all performance criteria through end-December 1988 were observed. In early 1989, notwithstanding the corrective measures we had adopted, several factors, including adverse exogenous developments, caused performance to depart from program objectives in some respects. Although the subceiling on net credit to Government was observed, the two performance criteria on domestic credit and on the net foreign assets of the Central Bank were not met at end-March and end-June 1989. However, according to preliminary data, only the domestic credit ceiling was breached at end-September. Our recent discussions with the Fund staff have focused on the reasons for the observed deviations and on the additional measures required to correct them. In the remaining period of the extended arrangement, we will firmly implement corrective policies so as to make up for the slippages. In this way, over the full three years of the extended arrangement, economic and financial performance will remain consistent with the adjustment path envisaged in the EFF program. Meanwhile, we wish to request modifications of the December 1989 performance criteria as described in paragraph 4 below and in the attached Table 1. The proposed modifications will serve to re-establish realistic parameters for the conduct of macroeconomic policy in the current period while reconfirming our determination to pursue our goals of adjustment and economic recovery in the context of continued financial discipline.

2. The outturn thus far in 1989 has been marked by unexpected exogenous developments that have adversely affected both the domestic economy and the balance of payments. Contrary to earlier expectations, the severe drought of 1988 continued in 1989, and expenditures by Libyan visitors were much lower than expected. Benefiting from the adjustment policies pursued since 1986 (in particular the flexible exchange rate policy), export performance was strong for the third successive year and growth in real terms will exceed 10 percent in 1989. According to most recent projections, real GDP growth will register about 3 percent, which, while a significant improvement over last year's performance,

still falls short of the program target of 5.1 percent. The rate of inflation, projected to be about 8 percent in 1989, will be somewhat higher than initially targeted. Although the high unemployment rate remains worrying, the recovery in investment activity observed recently bodes well for continued economic growth. This has been reflected in a sharp growth in imports, reaching 23 percent at an annual rate in nominal SDR terms in the first half of this year. Taking into account the corrective financial policies already introduced, the external current account deficit, although substantially larger than envisaged, is expected to be contained within tolerable limits in 1989. Moreover, despite pressures on our external reserves position in the first half of the year, we expect to achieve an overall balance of payments surplus for the year as a whole. In addition, we are continuing to implement the planned structural reform measures in order to strengthen openness and competition in the economy, so as to achieve greater efficiency and improve our growth prospects.

3. Earlier this year, the fiscal position appeared to be coming under increasing pressure, owing chiefly to the continued burgeoning of the expenditures of the Caisse Générale de Compensation (CGC) on consumer subsidies. The prices of subsidized food products were significantly increased in August 1989 as a first step in the structural adjustment of the CGC. After falling below projections in the first half of the year, total revenue (including grants) recovered during the second half, although revenue from the value added tax remains below projections for the year. In addition, on October 31, 1989, the Chamber of Deputies passed a supplementary finance law for 1989, which includes measures aimed at bringing the overall deficit (including grants) on the consolidated operations of the Government in the current year to D391 million (4.1 percent of GDP), only slightly higher than the program objective of D380 million (3.9 per cent of projected GDP). Total expenditure will be stabilized at about 37 percent of GDP, despite the increase in CGC expenditure of about 1 percent of GDP over the amount programmed. Moreover, total revenue and grants for 1989 are estimated at 33 percent of GDP. Net domestic bank financing of the 1989 budget is expected to be limited to the amount programmed (D50 million).

4. Following the rapid monetary expansion associated with the large balance of payments surplus in 1988--a year in which M2, according to revised data, increased by 19.3 percent--the monetary program for 1989 aimed at limiting the expansion of M2 to about 2 percentage points less than projected GDP growth. In the early months of the year, in order to stimulate investment and promote economic recovery, we kept interest rates relatively low. As the strength of domestic demand became apparent, however, the Central Bank moved to tighten monetary policy: the money market interest rate, which had fallen to 8.6 percent at the beginning of the year, climbed to 10.6 percent by end-August 1989, and subsequently rose further to over 11 percent at the beginning of

November 1989. In order to control monetary expansion and bank liquidity, we plan issues of Treasury bills totaling some D165 million by year-end, of which D140 million (or more than 3 percent of money stock at end-1988) will be for subscription by nonbanks. In addition, banks are being required to constitute reserves for 100 percent of any increase in excess of 4 percent in their short-term deposits (sight deposits and certificates of deposit) between September and December 1989. The Central Bank is continuing to monitor economic developments and monetary conditions very closely with a view to taking prompt steps to ensure that bank credit expansion is not excessive in the period ahead. Taking into account the outturn thus far, and confident that the recent policy tightening will have the desired effect, we are requesting a modification of the end-December 1989 ceiling on total domestic credit from D5,144 million to D5,194 million. We are also requesting a modification of the performance criterion on net foreign assets of the Central Bank at end-December 1989 from SDR 490 million to SDR 452 million--a target which, in the light of the exogenous developments described above, appears both realistic and feasible. If the end-1989 program objectives are modified as suggested, the growth of M2 during 1989 is expected to be limited to 9.4 percent, or about 1 percentage point below the projected growth of nominal GDP.

5. External sector developments in early 1989 underline once again Tunisia's vulnerability to exogenous factors and confirm the appropriateness of the Government's structural adjustment strategy, based on diversification through the development of a modern, competitive external sector and perseverance in efforts to improve public finances. In the first eight months of 1989, merchandise exports continued to grow strongly. At the same time, merchandise imports expanded at an exceptional rate, owing to several factors. First, the drought added to our food import requirements both directly and indirectly--by reducing production available for subsistence farmers, thus obliging them to purchase marketed cereals--at a time of very high world prices. Second, as indicated earlier, domestic demand for investment, consumption, and rebuilding of stocks rebounded after several years of weakness, helping to sustain both a recovery in export-oriented sectors and a boom in imports. The acceleration of imports was also partly related to the strong export performance of sectors such as textiles and clothing, which have a relatively high import content. In the latter part of the year, as the tightening in financial policies takes hold and certain seasonal factors turn positive, the external balance is expected to improve. For 1989, as a whole, the trade deficit is projected to reach some SDR 975 million, or about 1 percent of GDP above the program target. The surplus in the services account is projected to be about 1.5 percent of GDP smaller than assumed in the program, owing in large part to the shortfall in receipts from Libyan tourism. The external current account deficit is projected to be about SDR 300 million, or 3.9 percent of GDP. This

wider-than-programmed current account deficit will require the Tunisian economy to rely more heavily on external financing than had been envisaged. However, the performance criteria on nonconcessional external debt contracted or guaranteed by the Government will be respected in 1989. Over the medium-term, despite the recent slippages in the external sector, the balance of payments objectives of the program remain attainable. The external current account deficit is projected at 2.3 percent of GDP in 1991, and the level of foreign exchange reserves is expected to rise further from its projected end-1989 level, i.e., the equivalent of 2.7 months of imports. As regards Tunisia's external debt, we intend, during the program period, to bring the debt/GDP ratio within the original parameters in the program.

6. In keeping with our objective of steady improvement in the public finances, the draft 1990 Finance Law, submitted to the Chamber of Deputies on November 20, 1989, aims at (i) limiting the consolidated 1990 deficit, including grants, to D388 million, or 3.6 percent of projected GDP, and (ii) reducing the weight of government finances relative to GDP. Total expenditures are projected at D3,578 million. The decline in expenditure in real terms will be obtained through a substantial reduction in CGC spending and prudent management of other expenditure, including wages and salaries. Although grants are expected to fall substantially, total receipts (including grants) are estimated at D3,190 million, representing an increase of about 2.9 percent. The increase is based mainly on receipts from indirect taxes, while direct tax receipts are projected to remain at their 1989 level, taking into account the measures outlined below to ensure that the reform of direct taxes is fiscally neutral. The projected improvement in indirect tax receipts is based in part on an increase in the sales tax on fuels that may be introduced before the end of 1989, as well as on the projected strong performance of economic activity and imports in 1990. Domestic bank financing of the budget will continue to be limited in 1990, and the Government will place increasing reliance on negotiable debt instruments at market interest rates. In any case, we will persevere in our efforts to bring the projected budget deficit down closer to the original program objectives.

7. The tax reform process that was initiated in 1988 with the introduction of a value added tax (VAT) will be completed in 1990 with a far-reaching reform of direct taxation. While limited, our experience with the VAT has been positive overall; the apparent shortfall in VAT revenue in early 1989 is being closely monitored and examined with a view to putting in place the necessary measures to maintain the VAT's revenue neutrality. Beginning in October 1989, the VAT was extended de jure to all wholesalers except in the food sector. The reform of the direct tax code is aimed not only at simplifying direct taxation but

also at creating a system that is more equitable, transparent and better adapted to a modern economy with improved management and resource allocation, while ensuring the availability of financial resources to support needed government activities. To ensure the success of the reform of direct taxes, the reduction in the tax burden on individual taxpayers is to be offset by enlarging the tax base and improving tax administration. Various individual income taxes are being replaced by a single tax to be levied on a base that will include heretofore tax-free fringe benefits. The new schedule of tax rates ranges from 18 to 35 percent. The tax credit on company dividends is also being generalized. The corporate income tax reform is designed to reduce the corporate tax burden, with the establishment of two tax rates instead of the current six, one at 10 percent for agricultural and fishing activities, and the other at 35 percent for other activities. The new rules on determining the tax base also provide for accelerated depreciation of specific capital goods and more generous reserves against bad debts. At the same time, certain tax exemptions granted for new investments will be reduced and the system of income-tax withholding at source will be expanded. As the success of this tax reform will depend on the strict application of the new measures, during 1990 we will strengthen tax administration both materially and procedurally. Also, it is our hope that these measures conducive to greater equity will encourage wider tax compliance. Finally, with a view to maximizing government revenues, we plan subsequently to simplify the schedule for the individual income tax, to unify corporate tax rates, and to extend Social Security contributions to self-employed workers. In addition, taking into account the results achieved by the reform, we will eliminate the corporate "Contribution de Solidarité" as soon as possible. We will limit the grossing up of salaries of public servants facing increased tax burdens as a result of the new income tax with a view to containing its impact on the public sector wage bill in 1990.

8. We consider that a complete overhaul and structural reform of the operations of the Caisse Générale de Compensation (CGC)--which subsidizes domestic sales of basic food products, as well as certain animal feeds and fertilizers--is essential on financial, equity, and efficiency grounds. On the one hand, the Government accords high priority to maintaining food subsidies for the least privileged segments of the Tunisian population. On the other hand, following two years of drought and high prices on world markets, the expenditures of the Caisse Générale de Compensation have reached alarming levels that threaten to divert substantial resources away from productive investment. Accordingly, we have undertaken to limit the present open-ended subsidies by means of careful targeting, to be supported by cost-cutting reorganization of the compensation system and by price increases. To ensure their effectiveness, the reforms are being preceded by a public information campaign designed to build a strong

consensus. The first step toward reducing subsidies, taken in August 1989, consisted of 6-32 percent price increases for staples subsidized through the CGC; these will result in estimated savings of D17 million in 1989, and D60 million on a full-year basis. In addition, the 1990 budget will incorporate price measures and other savings totaling about D100 million (1 percent of GDP). To develop the options for comprehensive reform of the compensation system, we have launched a study in cooperation with the U.S. Agency for International Development (USAID) and the World Bank; its recommendations will be implemented beginning in 1990. Moreover, a Higher Council on Price Compensation has been created under the chairmanship of the Prime Minister to oversee all aspects of the reform.

9. Our public enterprise reform program is being implemented, as envisaged, in accordance with the budgetary targets of our program. Thus, the CPG (the phosphate company), the Groupe Chimique (the chemical company), and the SNCFT (the rail transport company) are implementing their restructuring programs by rationalizing their operations and investment programs, and by reducing short-term indebtedness. In addition, under the auspices of the Commission for Rehabilitating and Restructuring Enterprises with Public Ownership (CAREPP), more than 30 privatization operations relating to enterprises involving public ownership have been conducted through the partial or total sale of their assets and the settlement of their liabilities. As these operations mainly involved enterprises in difficulty, the Government was obliged to waive or consolidate certain of its claims on them and to take over a portion of their debt service. The Fund for Public Enterprise Restructuring (FREP) is expected to contribute to the settlement of the liabilities of privatized enterprises within the limits of its available resources, which consist of (i) the counterpart of disbursements under the IBRD's Public Enterprises Reform Loan (PERL), and (ii) the net proceeds from the sale of assets of certain enterprises after their liabilities have been settled.

10. We are continuing to implement the planned financial sector liberalization. In early 1989, the spread between the money market rate and the preferential below-market interest rates was reduced, and we intend to further reduce the spread over the program period. The structure of interest rates, including the question of the ceiling on lending rates, will be further discussed during the next program review. In October 1989, we began to issue three-month Treasury bills at market-related interest rates determined at auction. In order to mop up a part of the excess liquidity in the economy and thereby strengthen monetary control, it has been decided to direct the bulk of the Treasury bill issue toward subscriptions by nonbanks. As of November 14, 1989, subscriptions of Treasury bills had reached D94 million, of which amount D17 million was taken up by the public. We are aiming at developing, in

due course, a secondary market in government debt instruments with varying maturities, which will enable the Central Bank to rely increasingly on open market operations in conducting monetary policy.

11. Tunisia continues to maintain a flexible exchange rate policy, which has played a crucial role in strengthening our balance of payments position and favoring the diversification of the tradable goods sector. By end-1989, the real effective exchange rate will be at the level of end-1988. Furthermore, in keeping with the objectives of the program, the prices of approximately 70 percent of manufactured goods are now free of controls at the producer level, and, as called for in the program, nearly 20 percent of all distribution margins are no longer controlled. The latter proportion will reach 35 percent in January 1990. Also, by end-June 1989 the share of imports not subject to quantitative restrictions had been raised to approximately 64 percent of total imports. Further liberalization of imports is planned for June 1990, when about 75 percent of imports will be free of quantitative restrictions. In addition, we will examine the possibility of extending to indirect exporters (i.e., to suppliers or subcontractors of exporting firms) the import privileges granted to exporting industries. By 1992, we hope to move from a "positive list" of permitted imports to a "negative list" of restricted imports. The recent introduction of foreign exchange options for the dinar and the continued development of a forward market in foreign exchange are intended to facilitate foreign trade. Certain exporters are now permitted to retain 20 percent of export earnings for purposes of financing their own foreign trade activities under the recently introduced system of "professional foreign exchange accounts," but the impact of this measure on market conditions has remained limited.

12. Recent experience has convinced us that, as Tunisia begins to rely more and more on market instruments of macroeconomic management, we will be called upon to fine-tune our financial policies frequently in the light of developments. The effectiveness of this fine-tuning will be determined by the availability of reliable data on a timely basis. Accordingly, we have recently stepped up our program monitoring and surveillance functions and have improved coordination to this end between the Central Bank and the Ministry of Planning and Finance. In addition, we will request a Fund technical assistance mission to help us improve the procedures for compiling and reporting monetary statistics, with a view to enhancing our capacity to monitor monetary and financial developments. The forthcoming third program review will devote particular attention to the 1990 financial program and to assessing the effectiveness of the policy corrections introduced in 1989. The Government believes that the policies set forth in this letter are adequate to achieve the objectives of its program but will take any further measures that may become appropriate for this purpose. Tunisia

will consult with the Fund on the adoption of any measures that may be appropriate, in accordance with the policies of the Fund on such consultation.

Very truly yours,

/s/

Ismail Khelil  
Governor  
Central Bank of Tunisia

Mohamed Ghannouchi  
Minister of Planning  
and Finance

Attachment

Table 1. Tunisia: Performance Criteria and Indicative Targets,  
December 1988-December 1989

	December 1988			1989							
	Prog.	Act.	Rev. Actual	March		June		September		December	
				Prog.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Rev. Prog.
(In millions of dinars)											
A. Performance criteria											
1. Domestic credit	4,999	4,617	4,693	4,733	4,835	4,916	5,003	4,949	5,117	5,144	5,194
2. Net credit to the Government <u>1/</u>	771	677	677	785	689	810	758	815	740	817	775 <u>2/</u>
(In millions of SDRs)											
3. Net foreign assets of the Central Bank	220	427	427	366	301	411	338	500	519	490	452
4. Official borrowing abroad <u>3/</u>											
a. 0-1 year (amount outstanding, excluding import-related credits)	120	11	11	100	5.9	100	9.8	100	6.8	100	100
b. New nonconcessional borrowing abroad (cumulative amounts since beginning of each year)											
i. 1-5 years	170	118	118	170	62.5	170	62.5	170	104.0	170.0	170
ii. 1-12 years	450	398	398	400 <u>4/</u>	113.7	400 <u>4/</u>	114.3	400 <u>4/</u>	207.9	400 <u>4/</u>	400 <u>4/</u>
5. External payments arrears (amount outstanding)	—	—	—	—	—	—	—	—	—	—	—
(In millions of dinars)											
B. Indicative targets											
1. Consolidated budget deficit	-350.0	-368.3	-386.5 <u>5/</u>	-52.3	49.6 <u>6/</u>	-178.5	-1.0 <u>6/</u>	-227.3	-101.8 <u>6/</u>	-380.0	-390.7
2. Total revenue and grants	2,716.3	2,784.0	2,743.6 <u>5/</u>	732.7	752.8 <u>6/</u>	1,481.5	1,485.6 <u>6/</u>	2,313.7	2,266.7 <u>6/</u>	3,069.7	3,101.3
3. Total expenditure and net lending (excluding debt amortization)	3,066.3	3,152.3	3,130.2 <u>5/</u>	785.0	703.2 <u>6/</u>	1,660.0	1,486.6 <u>6/</u>	2,541.0	2,368.5 <u>6/</u>	3,449.7	3,492.0
4. Credit from monetary system to selected public enterprises	...	426.0	426.0	439.0	457.1	449.0	424.8	466.0	441.7	474.0	474.0
5. Credit from development banks	...	20.0	20.0	20.0	30.0	20.0	22.9	20.0	29.4	20.0	20.0
a. To selected public enterprises	...	791.0	791.0	803.0	870.0	833.0	898.0	862.0	—	886.0	886.0
b. To the rest of the economy	...										

1/ The change in net credit to the Central Government in 1989 takes into account the settlement in the first quarter of: (i) D48 million for external debt service at end-1988; and (ii) D42 million for the repayment of bank credits to public agencies used to finance the deficit of the Caisse Générale de Compensation (CGC) in 1988. Should these bank credits prove to be less than D42 million, the criteria for net credit to the Central Government at end-September 1989 and end-December 1989 will be reduced accordingly.

2/ In the context of the structural adjustment of the CGC, a rationalization of the operation of public agencies acting on behalf of the CGC has been initiated. The appropriateness of certain charges to the CGC is therefore being checked, including the D42 million previously allowed for in the performance criterion, which, therefore, will not be settled in 1989.

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

4/ Excluding US\$80 million in loans for the purchase of two aircraft which may be concluded in 1989.

5/ Changes in gross revenue and gross expenditure for 1988 reflect, in part, a change in the budget presentation following a Fund technical assistance mission on government finance statistics in July 1989. The change in presentation does not alter the deficit.

6/ Data excluding social security and extrabudgetary spending.

