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3:45 p.m., July 6, 2018

4. Tunisia—Third Review Under the Extended Fund Facility, and Request for Waiver of Applicability and Modification of Performance Criteria

Documents: EBS/18/63 and Correction 1; and Correction 2

Staff: Rother, MCD; Kramarenko, SPR

Length: 36 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	Alternate Executive Directors
	A. Abdullahi (AE), Temporary
	M. Raghani (AF)
	C. Moreno (AG), Temporary
	G. Johnston (AP)
	M. Coronel (BR), Temporary
	X. Cai (CC), Temporary
	J. Montero (CE), Temporary
	N. Feerick (CO), Temporary
	C. Just (EC)
	A. Castets (FF)
S. Meyer (GR)	
	H. Joshi (IN), Temporary
A. Leipold (IT)	
	Y. Saito (JA)
J. Mojarrad (MD)	
H. Beblawi (MI)	
	V. Rashkovan (NE)
	K. Virolainen (NO)
	S. Potapov (RU), Temporary
	R. Alkhareif (SA)
	E. Villa (ST)
M. Panek (SZ)	
	V. White (UK)
	Rudolph (US), Temporary

C. McDonald, Acting Secretary
K. Hviding, Summing Up Officer
R. Smith Yee, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
Communications Department: W. Amr. Fiscal Affairs Department: O. Basdevant. Finance Department: A. Manzanera Escribano. Legal Department: H. Pham. Middle East and Central Asia Department: K. Gerling, S. Kalla, A. Kireyev, T. Koranchelian, M. Mendez Cintron, B. Rother. Strategy, Policy, and Review Department: V. Kramarenko. World Bank Group: K. Carey.

Alternate Executive Director: P. Trabinski (SZ). Senior Advisors to Executive Directors: P. Braeuer (GR), N. Jost (NE), S. Keshava (SA), M. Sidi Bouna (AF). Advisors to Executive Directors: K. Badsi (MD), P. Braeuer (GR), L. Cerami (IT), S. David (AP), A. Olhaye (AF), K. Osei-Yeboah (MD).

4. TUNISIA—THIRD REVIEW UNDER THE EXTENDED FUND FACILITY, AND REQUEST FOR WAIVER OF APPLICABILITY AND MODIFICATION OF PERFORMANCE CRITERIA

Mr. Mojarrad, Mr. Sassanpour and Ms. Saadaoui submitted the following statement:

Our Tunisian authorities extend their great appreciation to staff for the constructive dialogue and sound policy advice, and a well-written and balanced report, and to the Executive Directors and Fund management for their continued support.

Overview

Program implementation gained momentum in 2018 and has improved since the Second Review, despite the persistence of a challenging external environment, including spillover of the regional refugee crisis, greater risk aversion, and rising oil prices. Domestically, the difficulty of maintaining public support for the program should not be discounted as "reform dividend" is slow to emerge and austerity measures continue to squeeze the purchasing power of low to mid-income Tunisians and tax their patience.

Despite the unfavorable conditions, all Quantitative Performance Criteria (QPCs) for end-March were met; all Quantitative Indicative Targets were observed; all Quantitative Prior Actions for the Third Review were completed; and significant progress was made on structural reforms. Three of the nine of Structural Benchmarks (SBs) were met; two were not met on time, but one (on Banque Franco Tunisienne—BFT) will be met with delay in August; one was dropped as it was no longer important for the success of the program (elaborated below); and the remaining three were reprogrammed as the authorities sought to rationalize the number of SBs and prioritize their effective implementation. The authorities are requesting waiver of applicability for all end-June QPCs since relevant data will only be available after the Board discussion.

The authorities recognize that 2018 is a pivotal year for the turnaround of the Tunisian economy and are determined to stay on course with program implementation to address the economy's vulnerabilities and restore sound macroeconomic fundamentals, despite risks to the outlook. They are in broad agreement with staff on the sources of risks to the outlook, but are of the view that the staff's Risk Assessment Matrix could be better presented by not duplicating the refugee problem and risks to global growth and trade, which appear in the Metrix as both domestic and external risks.

Macroeconomic stabilization, ensuring adequate social protection during adjustment, and promoting private sector-led growth and job creation continue to be the pillars of the program. It is a home-grown-and-owned program and maintaining public support and political consensus for the program ultimately hinges on the conviction that there is indeed light at the end of the tunnel and that there are significant reform dividends for all Tunisians.

Recent Economic Development

Economic recovery has found traction, and real GDP growth in 2018 is now expected at 2.4 percent—the highest rate since 2014—benefiting from the revival of tourism, higher phosphate production, and growing exports due to gains in competitiveness and robust EU demand. Inflation, however, accelerated to 7.7 percent in May, the highest level since 1991, reflecting a number of one-off factors, as well as a combination of demand-pull and cost-push elements, including the pass-through of a sizable exchange rate depreciation, robust credit growth, past public-sector wage awards, and rising international oil prices. The fiscal deficit remained unchanged at 5.9 percent of GDP in 2017, largely due to higher subsidies and transfers, notwithstanding higher revenue. Recovery of tourism and higher exports and remittances narrowed the current account deficit, despite higher oil imports, but foreign reserves fell, reflecting large debt amortization. Both public debt and external debt ratios increased in 2017, which also reflected the impact of exchange rate depreciation.

Fiscal Policy

Fiscal retrenchment is at the core of macroeconomic stabilization, and the authorities are fully committed to the program's fiscal consolidation path that envisages a 1 percent of GDP per year reduction in the overall deficit to 2.5 percent of GDP by 2020, and anchors public debt on a firm downward path. In 2018, despite a 12 percent increase in tax receipts and a 9 percent cut in the wage bill during the first quarter, the deficit target of 5.2 percent of GDP came under pressure due to larger-than-anticipated international oil prices; lower-than-anticipated number of civil servants taking advantage of government's voluntary departure and early retirement schemes; higher transfers to the public pension fund to meet its larger-than-anticipated liquidity deficit; and higher social transfers.

To put the program back on track, the authorities are making additional fiscal effort—mainly through expenditure cutting measures—

equivalent to 2 percent of GDP during the second semester of 2018 or 4 percent of GDP on an annual basis. Specifically, the bulk of higher energy subsidies (0.8 percent of GDP) will be met through monthly adjustments in prices of automobile fuels starting in July on top of the June price hike; increases in gas and electricity tariffs for corporate consumers; and by controlling leakages. The authorities are prepared to make further fuel price adjustments in October should the subsidies exceed projections. The adjustment in June, the subsequent monthly adjustments, and the possible additional adjustment in October have already been publicly announced. Social transfers will increase by 0.1 percent of GDP to partially defray the impact of fuel price increases.

Containing the government wage bill—currently around 14 percent of GDP—is another key element of fiscal consolidation plans. Applications for voluntary departure and early retirement so far have been lower than expected. To reach the wage bill target of 12.4 percent of GDP by 2020, the government has called for a second round of voluntary departures next month and strict limits on new hires this year and next. The government is further committed not to grant any wage increases in 2018, and to consider increases in 2019 only if growth surprises on the upside, but even then, the 2020 target will remain the focus.

The government also adopted a comprehensive reform on June 20, 2018 to reduce the financial imbalances of the two pension funds (public CNRPS and private CNSS) and the medical insurance fund (CNAM). parliamentary approval is expected by end-September, effective retroactively from July 1. As mentioned earlier, the government will make an additional transfer of 0.4 percent of GDP in 2018 to CNRPS to meet part of its liquidity shortfall, with the remaining shortfall as well as the deficit of the CNSS to be covered by greater effort to collect contribution arrears, including from state-owned companies.

Looking beyond 2018, stronger focus will be placed on revenue generation. The authorities plan to converge the “onshore” and “offshore” tax regimes with the 2019 budget and to raise the VAT rate for liberal professions (including lawyers, doctors, accountants). Tax administration will be also strengthened, modernized and be made more efficient by merging the two ministry of finance departments dealing with tax assessment, accounting and collection along the French model. Since the reforms will serve the same purpose, the SBs on the new Large Taxpayers Unit were no longer deemed necessary and dropped.

Social Protection

The authorities believe that adequate social protection to alleviate the economic hardship of adjustment is critical for maintaining public acceptance of reforms. With that in mind, the program has a floor on social spending for vulnerable groups—mostly in the form of cash transfers, healthcare support, education scholarships and job training programs—which in fact was exceeded at end-March. Further, as a reflection of their strong commitment to social protection, the authorities intend to elevate the current indicative target on social spending to a QPC from September. They have already broadened the coverage of vulnerable families and are planning to finalize improvements in data base and targeting by end-2018, with the assistance of the World Bank.

Monetary and Exchange Rate Policy

Fighting inflation continues to be the main priority of the Central Bank of Tunisia (CBT), consistent with its mandate. Although, the key policy interest rate was increased twice in 2018 for a total of 175 basis points, money market rates remain negative in real terms, and private sector credit fueled by central bank refinancing is still growing, jeopardizing price stability. The authorities feel it is prudent to tighten monetary policy to avoid unhinging inflation expectations and eroding central bank credibility, and to that end, are determined to raise policy rates until the real money market rates are firmly in the positive territory, which would also help reduce central bank refinancing. The effectiveness of monetary policy will be further enhanced through better public communication and strengthening the monetary transmission mechanism by gradually relaxing interest rate caps on business loans, more frequent updating of effective lending rates, and encouraging commercial banks to fund their lending operations in the interbank market, instead through central bank refinancing.

The Tunisian dinar has depreciated substantially in recent years in terms of REER (13 percent since the start of the program) and NEER (30 percent), with the latter largely reflecting the depreciation of the dinar versus the euro. REER depreciation has helped improve the current account deficit, but the authorities recognize that greater exchange rate flexibility—especially in view of the increasing inflation differential with the main trading partners—would help achieve a more sustainable current account position and improve foreign reserves coverage. Strict observance of program targets on net foreign exchange sales by the CBT in April and May helped keep the dinar on a flexible path and preserve foreign reserves. The CBT intends to begin to set up the framework for conducting more competitive foreign exchange auctions—with the help of Fund TA—and gradually limit its interventions to smoothing excessive market volatility. The authorities reaffirm their commitment to remove the restrictions on financing of non-priority imports by end-2018.

Financial Sector Stability

Financial sector indicators and bank profitability have improved, and the authorities are committed to accelerating financial sector reforms to underpin the success of the program and facilitate economic and financial inclusion. Addressing the high level of NPLs is a key issue, and recent parliamentary adoption of a set of laws placing NPL restructuring of public banks on the same footing as private banks is expected to facilitate NPL resolution of public banks. Further, the banking resolution committee in its first meeting on June 28 began reviewing the situation of the BFT with the vote on its orderly resolution expected by August. The Ministry of Finance and the Financial Sector Reform Committee intend to publish a comprehensive report on NPL resolution by end-2018, and have also made significant progress towards developing a national strategy for financial inclusion. In the context of rising interest rates and the rapid growth of private sector credit, the CBT is committed to ensuring financial sector soundness by strengthening its supervisory capacity, and will be working closely with METAC to develop tools for monitoring market and interest rate risks and assessing bank capital adequacy. The authorities are also reinforcing their AML/CFT framework and are making good on their commitments under the action plan agreed with FATF in November 2017, including a set of preventive measures adopted in 2018 (¶21 MEFP) that should help facilitate Tunisia's exit from the FATF-enhanced surveillance list at an early date.

Supporting the Private Sector

Government support for the private sector has many dimensions, including facilitating investment, cutting administrative red tape, encouraging public-private-partnerships, and strengthening governance and fighting corruption. The new Tunisian Investment Authority has been set up as a "one-stop shop" for investors to ease burdensome administrative procedures and speed up approvals. A government decree in May significantly reduced the number of authorizations required for investment by establishing an eight-sector negative list where prior authorization is mandatory, but even then, authorization is granted after the lapse of 60-90 days on a "silence is consent" basis. For all other sectors, no prior authorization is required. Fighting corruption is another important government priority and, to that end, the High Anti-Corruption and Good Governance Authority will become functional once its board members are appointed by parliament following consultations among political parties—expected by September.

Conclusions

The challenging domestic conditions and heavy global and regional headwinds have not weakened the authorities' resolve to press ahead with macroeconomic stabilization and structural reforms to secure sustainable high levels of growth with widespread benefits for all Tunisians. Maintaining political consensus and public support for the program is critical to its success. Tunisia is pressing at the limits of its program absorption capacity, and any further hardening or frontloading of the program in sensitive areas runs the risk of its rejection by the public. Tunisia has already benefitted greatly from, and will continue to rely on, Fund policy advice and technical assistance, for which the authorities are thankful. They also express their appreciation for the financial and technical assistance provided by their partners during this crucial transition and look forward to their continued support. The authorities will be thankful for Board approval of completion of the Third EFF Review, and waiver of applicability and modification of performance criteria.

Mr. Beblawi and Ms. Choueiri submitted the following statement:

We thank staff for the comprehensive report and Mr. Mojarrad, Mr. Sassanpour, and Ms. Saadaoui for their helpful buff statement. Notwithstanding a difficult domestic and external environment, the authorities have accelerated their policy and reform efforts in recent months. These include an ambitious revenue package encompassing energy price increases and wage bill measures, several monetary and exchange rate policy measures, as well as structural improvements, among which the creation of a one-stop shop for investors and legislation in support of public bank restructuring. Growth strengthened considerably in the first quarter of 2018—supported by agriculture, tourism, and manufacturing—the current account deficit narrowed, and confidence improved. Continued strong implementation of the authorities' economic program should help contain inflation and reduce the twin deficits. Given the good performance under the program and the authorities' commitment to its objectives, we support the proposed decision.

It is essential for the program to take due consideration of the socio-political environment in Tunisia. The Risk Assessment Matrix identifies slow reform implementation—due to continued political uncertainty, social tensions, and opposition to reforms from vested interests—as a high-probability and high-impact risk. We therefore welcome the authorities' reiterated commitment to macroeconomic adjustment that seeks to preserve growth and fairness. We support the authorities' gradual and socially-balanced approach to adjustment and share their concern about a more front-loaded strategy, particularly given the potential adverse impact of a major exchange rate depreciation on inflation, the budget, and debt. The staff rightly underscore that the gradual approach underlying the EFF-supported program will require sustained discipline in policy and reform implementation.

We concur with the authorities' view, as conveyed in the buff statement, that the staff's Risk Assessment Matrix could be better presented by not duplicating the refugee problem and risks to global growth and trade, which appear in the Matrix as both domestic and external risks. We also consider that staff qualification of risks as being exceptionally high may be exaggerated, particularly compared to countries facing more difficult conditions.

The authorities are to be commended for their commitment to their fiscal consolidation plan of 3 percent of GDP over 2018–20 despite pressures stemming from higher oil prices, lower-than-expected numbers of civil servants ready to leave their jobs, and delayed pension reform. We take note of the urgent measures agreed upon to remain within budget targets, including measures to contain energy subsidies and protect the poor from the impact of higher prices, avoid new wage increases in 2018, and ensure the financial viability of pensions. Timely implementation of the above measures will help the authorities achieve their objective of a gradual deficit reduction to reverse adverse debt dynamics. We take positive note of the government's comprehensive reform strategy to reduce the financial imbalances of the two pension funds and its expected approval by parliament by end-September, effective retroactively from July 1.

The central bank's tightening of monetary policy, together with the widening of the interest rate corridor send a strong signal of the authorities' commitment to contain inflation. We encourage the central bank to further tighten the monetary stance if inflation does not decelerate and key interest rates remain negative in real terms. Real exchange rate depreciation realized over 2017 started to reverse trends in the trade balance in early 2018. Nonetheless, staff call for more exchange rate flexibility to achieve a sustainable current account position by encouraging exports and compressing imports. Can staff elaborate on the impact of further exchange rate depreciation on debt ratios?

The authorities' focus on faster progress with reforming social policies is welcome. We also welcome their intention to increase social spending for the second half of 2018, to increase the number of vulnerable families benefitting from cash transfers, as outlined in ¶21. We support the conversion of the indicative target on social spending into a quantitative performance criterion in support of the authorities' commitment.

Mr. Meyer and Mr. Braeuer submitted the following statement:

We thank staff for an informative report and Mr. Mojarrad, Mr. Sassanpour, and Ms. Saadaoui for their helpful buff statement. We broadly concur with staff's assessment. Taking into account the overall improved program performance and the catalytic function of the Fund's engagement, we consent to the completion of the third review. While increasing economic growth and a firming current account represent welcome signs of a beginning recovery, the overall economic situation in Tunisia remains challenging. Some macroeconomic imbalances have built up even further and substantial vulnerabilities persist. Although subject to serious risks, we note that staff projects an ongoing economic upturn over the next years, conditional on steadfast policy implementation.

The welcome improvement in program performance since the last review sends an important signal of the authorities' determination. While all quantitative targets were met, progress on structural reforms was more limited, with only three out of nine of the structural benchmarks implemented on time We underscore that macro-critical structural reforms need to be implemented without further delay to reach key program objectives. As no additional structural benchmarks are set during this review, we trust that this can be interpreted as a commitment by the authorities to tackle the structural benchmarks still outstanding with even more determination.

The policy measures implemented since the beginning of the year represent welcome steps in the right direction. Stabilizing the economy should be of prime importance. Especially with a view to the country's high vulnerabilities and substantial risks, we caution against a too gradual approach towards the necessary macroeconomic adjustment. Determined fiscal consolidation and tighter monetary policies together with timely and meaningful progress in the structural reform agenda remain of the essence to facilitate a lasting recovery. In this context, we welcome Tunisia's reform commitments under the G20 Compact with Africa. Active engagement in the Compact can bring the focus of international investors on Tunisia and help foster private investment.

We call on the authorities to substantially strengthen their efforts towards expenditure restraint, while ensuring adequate protection of the poor. The fiscal adjustment achieved so far appears to have mainly rested on stronger revenues. At the same time, staff warns that the 2018 budget is already under substantial pressure from the spending side, while public debt is still high. Ambitious, timely and lasting efforts are necessary to reduce the excessive public wage bill, to restrain distortive and ill-targeted subsidies, and to set the pension system on a sustainable footing.

Ensuring markedly positive real interest rates will be key to rein in high inflation. The authorities should strengthen monetary transmission by fully removing interest rate caps and introducing a more risk oriented approach to the collateral regime, as suggested by staff. Higher exchange rate flexibility appears essential to tackle elevated external imbalances and to support the necessary build-up of foreign exchange reserves.

We call on the authorities to push ahead with the necessary governance reform. We trust that the High Anti-Corruption Authority will be fully established shortly and endowed with the power and the infrastructure necessary to effectively pursue its mandate.

With some concern, we take note that the Fund's financing share will increase markedly in 2019, to well over 30 percent, while the support from other multilateral or bilateral sources is projected to drop. Moreover, the stock of Fund credit will increase to close to 40 percent of gross reserves in 2020. Against this background, could staff provide additional background, including an outlook on the potential for additional financing sources / assurances over the medium term?

On the requested waiver of applicability for the quantitative targets for end-June, we would welcome additional comments by staff. We understand that a waiver of the applicability of a performance criterion can only be granted if there is no clear evidence that the performance criterion will not be met. For this review, the authorities are not only requesting waivers of applicability but also request the revision of quantitative targets for end-June 2018 at the same time. Could staff provide additional information on why the revision is deemed necessary?

Ms. Pollard and Mr. Rudolph submitted the following statement:

In March of this year, we abstained on the second review under the Extended Fund Facility (EFF) for Tunisia, due to weak program performance. Given the strong improvement in implementation, we are pleased to support the third review of the EFF. We recognize that Tunisia faces increasing challenges as it moves forward with reforms, but we urge the authorities to maintain their commitment to the macroeconomic policy reform agenda. We note that continued vigilance, particularly on controlling wages and other expenditures, will be needed in the coming months. We welcome the recognition by the authorities, as noted in Messrs. Mojarrad, Sassanpour, and Saadaoui's buff statement, that 2018 is a pivotal year for the turnaround in the economy and that they remain committed to implementation of the agreed program.

Fiscal Policy: We concur with staff on the importance of fiscal consolidation for macroeconomic stability, which in turn is the path to economic growth and jobs. We also recognize the increased difficulties facing the authorities due to higher oil prices, delayed pension reform, and a lower take-up of voluntary separation and early retirement by civil servants. Controlling expenditures will be key to meeting the authorities' fiscal deficit targets. We also recognize that providing protection for social programs and broadening the social safety net is necessary to protect the poor and gain public support for expenditure cuts.

We welcome the authorities' determination not to increase civil service wages, with the wage bill relative to GDP among the highest in the world. Implementation of this commitment over the next six months will be critical to reversing the upward public debt trajectory and creating scope for re-orienting government expenditures towards productive investment and social spending. Could staff provide an update on the work of the FAD TA mission to find further options to rationalize public expenditures, including the wage bill and benefits packages?

We welcome the actions by the authorities to increase energy prices and cap the subsidy at 2.5 percent of GDP for 2018. The concurrent increase in social transfers will limit the effect of higher prices on the most vulnerable. We underscore the importance of continuing with the monthly fuel price adjustments throughout the remainder of the year, along with upward revisions to electricity and gas rates. We also welcome the approval by the Council of Ministers of the comprehensive pension reform and we urge parliament to pass the package by September. Could staff provide an update on the outlook for pension legislation?

We are gratified to see further steps to increase tax revenue, and that revenues have modestly exceeded expectations. Looking beyond 2018, we agree with staff that efforts to boost revenue performance by improving tax administration and simplifying the tax system should be priorities. While we can support eliminating the structural benchmarks related to the Large Taxpayers Unit (LTU), we would appreciate more details on the new tax strategy. The authorities note the merger of the General Directorate off Taxes and the General Directorate of Public Accounting and Collections will take several years. We would appreciate staff comments on the technical assistance Tunisia is receiving to support this merger.

Monetary and Exchange Rate Policy: Despite recent interest rate hikes by the Central Bank of Tunisia (CBT), the continued elevated level of inflation means that real interest rates remain negative and monetary tightening is essential. In addition to its importance for macroeconomic stability, containing inflation is also important for limiting wage pressures and protecting the purchasing power of the poor and middle class. Thus, we welcome the commitment of the CBT to further actions as needed bring inflation under control. Annex III in the staff report provides a useful guide to strengthening its disinflation policies. We also agree that measures, including interest rate liberalization will help improve monetary policy transmission.

Strengthening monetary policy is also essential to supporting the flexible exchange rate regime. Relatedly, we welcome the authorities' adherence to the monthly FX intervention ceiling and their intention to remove the exchange restriction by end-2018. We agree with staff that moving to competitive FX auctions will help protect reserves, which remain below prudent levels.

Structural reforms: We are pleased to see the program incorporate our recommendation for focusing on a narrower set of structural benchmarks. This streamlining, however, should be accompanied by a strengthened commitment to implementation of the remaining benchmarks. We welcome steps to improve the business environment, as a thriving private sector is vital for boosting growth and job creation. However, we are concerned about the failure of parliament to approve board members for the Anti-Corruption Authority.

Mr. Mkwezalamba, Mr. Raghani, Mr. Abdullahi and Mr. Olhaye submitted the following joint statement:

I. We thank staff for the well written report, and Mr. Mojarrad, Mr. Sassanpour, and Ms. Saadaoui for their helpful buff statement, and broadly agree with the thrust of staff assessment. In view of the authorities' commitment to the reform agenda and recent efforts to strengthen policy implementation, we support the completion of the third review under the Extended Fund Facility (EFF), as well as the request for waiver of applicability and modification of Performance Criteria (QPCs). That said, we wish to make the following comments.

The socio-political tensions, security and migration spillover risks, and higher international oil prices pose significant risks to the successful implementation of the program. While taking positive note of the commitment of the authorities to a gradual and socially-balanced approach to macroeconomic adjustment, we strongly encourage them to redouble their efforts and forge the political consensus needed to advance their reform agenda. In addition, pursuing fiscal consolidation while preserving fiscal space for social outlays, taming inflationary pressures, and reducing external imbalances would be warranted.

Enhanced revenue mobilization and expenditure rationalization efforts should continue to ensure that the fiscal deficit remains on a downward path. In this regard, broadening the tax base and improving tax administration are important steps, and we commend the authorities for their efforts in these areas. Nevertheless, we wonder if staff discussed additional revenue measures with the authorities, and welcome staff comments. On the expenditure side, it would be essential to implement measures aimed at mitigating the pressures arising from the rising energy subsidies, driven by the increasing international oil prices. At the same time, increased liquidity deficit of public pensions, challenges in reducing the wage bill, and the contingency liabilities of state-owned enterprises (SOEs) pose significant fiscal risks. Therefore, we strongly urge the authorities to strictly implement the proposed measures to contain energy subsidies, control the wage bill, and timely carry out the recently adopted social security fund reform.

The current accommodative monetary policy stance and ineffective monetary policy transmission continue to contribute to higher than average inflation. Strong credit growth, fueled by a historically low and negative real interest rate and record level Central Bank of Tunisia (CBT) refinancing of banks, continue to put upward pressures on prices. We note that the successive rate hikes by the CBT did not achieve the desired results of tempering credit growth and inflationary pressure owing to the weak monetary policy transmission mechanism. However, we are comforted by the CBT's commitment to continue tightening monetary policy and implementing measures to improve the monetary policy transmission mechanism. Further, we agree with staff that reducing the large holdings of non-performing loans by public banks would help and encourage the CBT to finalize the implementation of 2016 safeguard recommendations.

We welcome the authorities' efforts to introduce greater exchange rate flexibility, but agree that more needs to be done to reduce the elevated current account deficit. While the recent reduction of CBT's interventions in the FX market is encouraging and the authorities' desire for a more gradual exchange rate correction as well as their intention to remove the exchange restriction are well noted, we agree with staff that a quick move to competitive FX auctions would be warranted.

Adequate social protection combined with a better targeted and increased efficiency of social welfare spending will contribute to alleviating fiscal pressures and protecting the poor. In this context, we take positive note of the ongoing initial measures to revamp the database of vulnerable households to improve efficiency and better target beneficiaries, and encourage the authorities to hasten reforms in this area. Further, we note that the liquidity needs of public and private pension funds are at unsustainable levels, and welcome the reforms being contemplated as well as concur with staff on ensuring financial stability of the pension funds.

Improving conditions in the business and governance landscape and financial sector reform progress continue to be encouraging. In this regard, we welcome the recent measures, such as the one-stop shop for large investors and the adoption of procedures for investment authorizations. In addition, we encourage the authorities to speed up the improvement of the regulatory framework for public procurement, enhancing stronger public-private partnerships regulatory frameworks, and deepening reforms of energy and natural resources legal structures. The recent parliamentary law to support reduction of NPLs is also commendable as is the improving AML/CFT regime. The staff's comments on the status of correspondent banking relationships is welcome.

Finally, recognizing that the program faces exceptionally high risks, we support staff proposal for closer program monitoring through quarterly reviews and additional QPCs to mitigate high implementation risks.

Ms. Villa and Mr. Sanoubane submitted the following statement:

We thank staff for their insightful report and Mr. Mojarrad, Mr. Sassanpour, and Ms. Saadaoui for the helpful buff statement.

Growth in Tunisia is on track to reach 2.4 percent in 2018 and performance under the program shows signs of improvement from the last Review. This Chair acknowledges the stronger policy implementation in recent months, despite a complex socio-economic environment. We would have been more comfortable with stronger program performance, nevertheless, we can appreciate the difficult balance that authorities have to strike to sustain public support. Thus, we can support the proposed decision. We consider the Fund's support through the EFF has been crucial in supporting the authorities' economic and structural reform efforts during this pivotal period, which will further catalyze donor support. Nevertheless, risks to the program implementation remain, as some macroeconomic indicators show alarming signs and weigh on the near-term outlook. Addressing these requires more urgent and aggressive fiscal consolidation, a more vigilant monetary policy stance, and greater exchange rate flexibility. The ongoing technical assistance from the Fund should help address capacity constraints and facilitate reform implementation. We see the quarterly review as appropriate to allow closer program monitoring. We agree with the thrust of the staff appraisal and would like to offer the following comments for emphasis.

Strong fiscal measures are crucial to maintain the consolidation path and lower public debt. We note several spending pressures, including containment of energy subsidies, warranted prompt implementation of adjustment measures to ensure achievement of the 2018 deficit target. Controlling the wage bill has been challenging due to the lower-than-expected voluntary program. Could staff share other measures to rationalize the wage bill and any preliminary findings from FAD's TA on expenditure rationalization? While broadening of social transfers is expected to add 0.1 percent of GDP to the budget, we see merit in this decision as it would not only help mitigate the social impact from high energy prices but also lay a foundation for enhancing productivity through better health and education. We are also delighted to note the agreement to elevate the status of the program floor on social spending to a QPC. In this regard, we encourage the authorities to work closely with the World Bank on improving targeting and the household database to ensure public resources reach the poorest and the most vulnerable.

Strong and credible commitment to price stability will guide inflation expectations and help avoid larger adjustments down the road to contain inflation in medium term. The CBT's recent policy tightening is expected to enhance its credibility as an inflation fighter. We support further, but gradual, policy rate increases, as necessary, to contain inflationary pressures from the subsidy reform, dinar depreciation and acute pressures from banks' liquidity. Bringing the real interest rate into positive territory could also help dampen any financial stability pressures from very strong credit growth, and avoid a deanchoring of inflation expectations. The precarious international reserves and weak current account also call for greater exchange rate flexibility through market-determined FX market.

The financial sector is broadly stable but continued efforts to strengthen financial sector resilience are needed. The adoption of the legislation to support non-performing loans resolution, as well as strengthening the banks' supervision and oversight are crucial steps to improve resource allocation and preserve financial stability. In addition, we note positively the commendable progress made to address gaps in the AML/CFT framework and look forward to continued efforts to facilitate Tunisia's exit from the FATF and EU watch lists.

We encourage the authorities to further advance their progress in improving the business environment and private sector development. Streamlining administrative procedures to start a business through the recent establishment of the Tunisian Investment Authority as a "one-stop shop" and the reduction of the number of authorizations for new investment will facilitate greater competitiveness and in turn encourage greater job creation. However, we consider more ambitious structural reforms to foster the role of private sector is crucially important in the context of high unemployment in Tunisia. We welcome staff comments on labor market reforms and the strategy to integrate women and youth and graduates in labor market participation. We also welcome the recent establishment of the National Anti-Corruption Authority and encourage the authorities to expedite the process of selecting its board members.

Mr. Virolainen and Ms. Anni submitted the following statement:

We thank staff for the report and Mr. Mojarrad, Mr. Sassanpour, and Ms. Saadaoui for the informative buff statement. Tunisia's improved program performance since the Second Review of the EFF is encouraging but concern over the exceptionally high risks weighing on the outlook remain. While recognizing the fragile socio-political context, continuing disciplined reform implementation is critical for stabilizing the economy. Given the strong conditionality guiding program implementation and the authorities' readiness to take any additional measures necessary to achieve the program objectives, we support the completion of the Third Review under the EFF, and the modification and waiver of applicability of performance criteria. We are in broad agreement with staff's appraisal and offer the following remarks for emphasis.

An uptick in the economy and strong revenue performance in the first quarter have improved fiscal accounts. If sustained, this could support the gradual reorientation of fiscal policy toward social spending and much needed growth enhancing public investment. Despite the bulk of the adjustment now shifting to expenditure rationalization, revenue mobilization efforts should remain a priority. The planned merger of the collection and control functions of tax administration implies efficiency gains and a potential boost to the recovery rate. The staff's indicative estimate of the size of Tunisia's grey or parallel economy would be informative. On the expenditure side, there is urgency to improve the quality of public spending, making it more equitable and supportive of growth. We find the more ambitious containment of energy subsidies appropriate in further correcting the bias favoring wealthy households and delivering a drop in fraud. Tunisia's very high public wage bill is unsustainable and reducing it is critical for reorienting government expenditures. Fiscal stabilization needs to be accompanied by stepping up structural reforms to revive investment and redeploy the private sector in job creation.

We share the concern over accelerating inflation and stress the need to continue with policy rate hikes, bringing interest rates into positive territory in real terms. We take positive note of the latest raise in the benchmark interest rate last month. Nevertheless, Tunisia's hampered monetary policy transmission mechanism needs to be addressed with concrete and immediate measures to enable and ensure the intended delivery of monetary tightening. A commitment to exchange rate flexibility remains critical for correcting the remaining overvaluation of the exchange rate and for rebuilding international reserves.

Facing the public's forceful expectations of more immediate benefits from the reform process, we note the authorities' caution in deciding on the pace of implementing some of the more painful adjustments. This highlights not just the importance of a timely and effective public communication strategy but the priority of social policy reform to ensure adequate social protection to the poor and genuinely vulnerable. We also view the enduring regional disparities and inequalities in Tunisia as a serious impediment to competitiveness and more sustainable growth, reflecting the absence of a development policy capitalizing on specific local advantages. Lastly, we strongly support continued Fund TA on overcoming Tunisia's capacity constraints, upgrading economic institutions, and policy frameworks.

Mr. Mozhin, Mr. Palei and Mr. Potapov submitted the following statement:

We thank staff for their comprehensive report and Mr. Mojarrad, Mr. Sassanpour, and Ms. Saadaoui for their informative buff statement. The macroeconomic situation in Tunisia remains fragile, characterized by a very challenging socio-political and security environment. It is encouraging that, despite the non-trivial challenges, the authorities have strengthened performance under the EFF arrangement in recent months and growth is expected to pick up to 2.4 percent this year. At the same time, the acceleration of inflation, high unemployment rate, and a low level of international reserves are of serious concern. Moreover, as staff pointed out, exceptionally high risks continue to weigh on the outlook. We urge the authorities to advance economic policy reforms in line with their commitments in the MEFP. We agree with the proposed decision.

The Risk Assessment Matrix (Annex II) contains a comprehensive picture of risks for Tunisia's economic outlook. We agree with staff that slow consensus building is one of the key challenges that may delay reforms under the EFF arrangement. Could staff provide a further insight on the feasibility of achieving the near-term program objectives, given the recent divisions within the governing coalition? At the same time, garnering adequate support for the reform measures would require a delicate approach to designing the modalities and conditionality within the program, conducting proper consultations with the stakeholders, and ensuring adequate social protection and targeted support for low-income households. In this context, we can go along with the proposed modifications to the program, including elevating the status of the program floor on social spending to a QPC and removing several SBs. We encourage staff and the authorities to continue to improve a balance between the number of conditions and the program ownership.

We agree with the authorities and staff that the tightening of the macroeconomic policy mix is required to contain inflation, reduce the twin deficits, and preserve fiscal and debt sustainability. Substantial fiscal adjustment measures will be needed to achieve the authorities' fiscal deficit target of 2.5 percent of GDP by 2020. The authorities are well advised to further reduce energy subsidies, the wage bill, and pension transfers. Strengthening the oversight of state-owned enterprises (SOEs) is required to address significant fiscal risks and prevent the buildup of explicit and implicit liabilities. Creating additional fiscal space by strengthening tax administration and rationalizing public expenditures will be needed to increase priority capital and social spending. Given the remaining low interest of civil servants in voluntary departures, could staff elaborate on possible alternative measures to reduce the wage bill? The staff's comments on the interconnections between the restrictive hiring policy and the current high unemployment rate would also be appreciated.

Monetary policy should be sufficiently tight to address inflationary pressures and curb credit growth, as well as to prevent second round effects from the exogenous shocks. We highlight the importance of ensuring greater exchange rate flexibility, which would be helpful in accumulating adequate foreign exchange reserves and narrowing the current account deficit. Implementing a more competitive FX auction mechanism will facilitate convergence of the dinar toward the levels aligned with fundamentals. This might help in reducing the likelihood of disorderly exchange rate depreciation. At the same time, we agree with the authorities that transition to a market-based exchange rate system should address potential negative implications on public debt and the financial system.

Structural reforms should be focused on strengthening the social safety net, improving the business environment, enhancing governance, and facilitating the transition to a private sector-led growth. The recent improvements in these areas are encouraging, and we call on the authorities to maintain the reform momentum. On staff's recommendation to advance the operationalization of the High Anti-Corruption Authority, we would appreciate more detailed information on the envisioned institution, including its mandate, sources of financing, and procedures of appointing its management and staff.

Mr. Gokarn and Mrs. Dhillon submitted the following statement:

We thank staff for the comprehensive report and Mr. Mojarrad, Mr. Sassanpour and Ms Saadaoui for their candid buff.

The political transition, recurrent social tensions, domestic security shocks, the political and security situation in the Middle East and North Africa, including in neighboring Libya, and delays in implementing the needed reforms have negatively affected the Tunisian economy. Tunisia faces large fiscal and external deficits and high debt. We recognize Tunisia's difficult economic and political situation and hope that some of the recent gains are a sign of coming advancement and further acceleration in reform efforts. In this context of program performance, we note the following:

All Quantitative Performance Criteria (QPCs) for end-March and three out of nine Structural Benchmarks for the Third Review were met. The staff supports the authorities' request for the completion of the Third Review with the support for setting revised quantitative targets for end-June, end-September, and end-December 2018, as well as new targets for end-March 2019; altering the adjusters for QPCs on the primary balance and on current primary expenditures; converting the IT on social spending to a QPC; introducing a new QPC on FX interventions; waiving the applicability of all end-June performance criteria; and making all funds available for budget support. While an improvement over the second review, it is regrettable that program performance remains behind targets.

We would like to emphasize our concerns on the repeated use of waivers and resetting of timelines. We wonder how much of this is due to the fragilities of the system and how much stems from setting of performance criteria and structural benchmarks that are based on an over-optimistic assessment of the broader political and social situation. This, when seen with the political opposition to the reforms under the EFF, undermines the impression of an IMF program that is well planned, well implemented and promotes socially balanced reforms. Instead, we see continuous course correction and persisting hardships. We welcome staff comments on this.

Program risks remain exceptionally high and Tunisia continues to depend on strong engagement by its international partners and the grants or highly concessional loans to cover Tunisia's financing needs (about US$3.7 billion in budget support in the three remaining quarters of 2018). Could staff offer their assessment on meeting this target and the impact of these not fully materializing?

That said, we take comfort from the growth picking up to 2.5 percent in the first quarter, the strong corrective actions taken by the authorities and are reassured that the authorities' continued commitment towards reform is strong. Therefore, we can go along with the staff's decision to complete the third EFF review with the significant waivers and resetting of targets. We would like to make the following points for emphasis.

Fiscal Policy and Social Protection

Undoubtedly, macroeconomic stabilization calls for sustained fiscal consolidation with strong revenue generation and rationalization of expenditure. We note that the targeted fiscal consolidation of 1 percent of GDP per year came under pressure due to higher oil prices, lower-than-expected numbers of civil servants ready to leave their jobs, and delayed pension reforms. The authorities are committed to tackle this with additional fiscal efforts through fuel price adjustments, containing the government wage bill and reducing the financial imbalances of the pension funds. Strong revenue performance helped the fiscal accounts in the first quarter and we would like to hear more on the efforts being made this year for revenue generation as well as the adequacy of social protection measures being undertaken for maintaining the public acceptance to the reforms in face of spending cuts. Could staff elaborate on this.

Monetary Policy and Exchange Rate Policy

A tighter monetary policy will be required as inflationary pressures persist. We positively note that the central bank has increased the cost of borrowing to reduce monetary accommodation of inflationary pressures and is determined to raise rates to bring real interest rates into positive territory and to maintain banking sector stability. Have staff advised any limits on the raising of policy rates? Beyond this, exchange rate flexibility has a critical role with the dinar depreciating substantially since the start of the program at 13 percent. Exports will benefit from a return to normal activity in some sectors, such as mining, tourism and transport, from stronger activity in the euro area and from the depreciation of the dinar. Further efforts for taming the current account deficit and to protect reserves must continue. In this context, the CBT efforts to move to competitive FX auctions to promote market-based determination are welcome.

Supporting the Private Sector

Private sector growth will require capacities, both human and financial, to support the long-overdue implementation of legislative and judicial reforms identified by staff. Therefore, the one-stop shop for investors, the Start Up Act, and the pruning of the negative list for investment authorization do provide some optimism. This should be followed up by frameworks for public procurement and public private partnerships. We would urge the authorities to speedily address the delays in the appointment of the members of the High Anti-Corruption Authority and in addressing the challenges of corruption per se.

Financial Sector

Banking supervision, improving access to finance and strengthening the financial sector governance will be key to reforming the financial sector and proving the necessary backing for the progress of the private sector as well. We welcome the adoption by parliament of the laws supporting reduction of public banks NPLs and look forward to updates on its implementation. Lastly, we strongly urge the authorities to further strengthen the AML/CFT regime to facilitate Tunisia's exit from the FATF enhanced surveillance list, to mitigate consequential effects.

With this, we wish the Tunisian authorities the best in their endeavors.

Ms. Mr. De Lannoy, McKiernan, Mr. Feerick, and Mr. Jost submitted the following joint statement:

We thank staff for their very good report. Tunisia is making reasonable progress on the program objectives in the face of significant shocks and heightened uncertainty—and, so far, managing to retain necessary public support while achieving the goals of the program. With regard to the public support, we are fully cognizant of the sentiment expressed in the well-written buff of Mr. Mojarrad, Mr. Sassanpour, and Ms. Saadaoui that 'maintaining political consensus and public support for the program is critical to its success.' Balancing the 'exceptionally high' risks to the program with Tunisia's adequate capacity to repay and the authorities' commitment—including the improvement in program performance since the last review—we can support staff's recommendations and the completion of the third review. We add the following points for emphasis.

On fiscal policy, given a series of shocks, emerging pressures and continuing vulnerability of the economy, there is a need for urgent measures. As staff put it, business as usual is not an option. We are pleased to note that staff and authorities have identified a series of measures to be contained in a supplementary budget. Expenditure restraint is essential and a key element relates to containing energy subsidies, including monthly revisiting of domestic prices for automobile fuels. Complementing this, the move to protect the poor from the impact of higher prices and expenditure restraint is also warranted from a social protection perspective. Given the fiscal measures outlined in the staff report, we are surprised that the authorities intend to grant wage increases in 2018, if growth surprises on the upside. The staff's views on the merits of using upside revenues in a more prudent way would be welcome. Given that modernizing the tax system is a key pillar of the program, we note that the authorities are changing their preferred approach, away from the IMF-recommended one towards a French model. What is the genesis of this change and what are staff's views on this?

It is important that the need to focus on near-term fiscal targets does not lead to a loss of momentum on medium-term reforms. In this regard, we are pleased to note the significant technical assistance provided by the Fund, usefully outlined in Annex IV.

On monetary policy, we commend the authorities on their work so far but more needs to be done to contain inflationary pressures. Notwithstanding nominal interest rate increases totaling 175bps this year, the real interest rate remains in negative territory. In order to contain inflation and also enhance the credibility of the central bank, real interest rates need to be corrected and we note the authorities' stated commitment in this regard. In terms of structural reforms, interest caps are a long-standing feature that need to be abolished, in a well-planned sequence to safeguard the stability of the financial system. On the exchange rate, we note that the authorities remain committed to exchange rate flexibility and that notwithstanding a depreciation in the dinar, the authorities have remained within the FX intervention envelope.

On the financial sector, indicators of financial soundness have improved. We welcome the move by parliament to adopt a law facilitating NPL restructuring of the public banks. We consider action on enhancing the AML/CFT framework an absolute priority for the Tunisian authorities, in order to facilitate continued FDI flows and increase growth. We note from the buff that the authorities consider they are making progress on their commitments under the action plan agreed with FATF in November 2017, including a set of preventive measures adopted in 2018 that should help facilitate Tunisia's exit from the FATF-enhanced surveillance list at an early date.

Mr. Alogeel and Mr. Keshava submitted the following statement:

We thank staff for a well-written report and Mr. Mojarrad, Mr. Sassanpour, and Ms. Saadaoui for their helpful buff statement. We are in broad agreement with staff's analysis and policy recommendations and would limit our remarks to a few issues.

We welcome the improved performance under the EFF-supported program since the last review and, in this regard, we commend the Tunisian authorities for the important measures taken in recent months, despite the challenging environment. Notably, all quantitative performance criteria (QPCs) for end-March have been met and progress has been made in advancing structural reforms. We also welcome the authorities' readiness to take measures, as needed, to achieve the program's objectives. We are encouraged by the agreement to elevate the status of the program floor on social spending to a QPC from September, which reflects the authorities' strong commitment to adequate social protection as part of their reform agenda. Against this background, we support the completion of the third review and the associated decision.

To maintain macroeconomic stability, the program rightly continues to emphasize strong fiscal adjustment. In this context, we are reassured by the authorities' commitment to remain within 2018 budget targets, despite spending pressures. We also welcome the focus on sustaining the consolidation efforts to reduce the deficit to 2.5 percent of GDP by 2020 while creating space for more investment and social spending. In this connection, mobilizing more revenue, reforming the pension system, addressing contingent fiscal risks especially from SOEs, and containing the wage bill are some of the important priorities. On social protection, we are encouraged by the broadening of the social safety net for the poorest families and the most vulnerable, and encourage the authorities to continue their efforts to improve targeting.

We welcome the agreement between staff and the authorities on a tighter monetary policy stance to contain price pressures and guide expectations. Given the need to protect international reserves, we are reassured to note in the buff statement that "the Central Bank of Tunisia (CBT) intends to begin to set up the framework for conducting more competitive foreign exchange auctions—with the help of Fund TA—and gradually limit its interventions to smoothing excessive market volatility." In the financial area, the recent adoption of a set of laws to facilitate NPL restructuring of public banks is a welcome development, as a faster resolution of NPLs would help improve access to finance, including for SMEs, and support growth objectives. On AML/CFT regime, the authorities should continue their efforts to address the deficiencies to facilitate an early exit from the FATF-enhanced surveillance list.

Finally, the authorities should maintain the momentum to improve the business environment to help attract new domestic and foreign investment.

We encourage the appointment of members of the High Anti-Corruption and Good Governance Authority at the earliest to make the Authority functional, which will be a major step forward in the fight against corruption and help in strengthening governance.

With these remarks, we wish the authorities further success.

Mr. Johnston and Mr. David submitted the following statement:

We thank staff for their report and Mr. Mojarrad, Mr. Sassanpour and Ms. Saadaoui for their informative buff statement. Tunisia is going through a difficult process of reforming and liberalizing the economy after a long period of State control. We take note that while growth has rebounded, macroeconomic imbalances remain. We are nonetheless encouraged that policy and reform implementation have improved recently under the Extended Fund Facility (EFF) program. We also note that Tunisia's capacity to repay the Fund remains adequate. We therefore support the completion of the third review of the EFF and the associated requests.

We acknowledge the authorities' three-pillar policy framework of maintaining macroeconomic stability, ensuring adequate social protection and creating private sector opportunities. We note the challenges in dealing with the macroeconomic imbalances of accelerating inflation, low levels of international reserves and fiscal and balance of payments deficits. We agree with staff's assessment that strong policy implementation is needed to ensure continuing growth. We are encouraged that the authorities and staff have agreed on additional measures of reducing energy subsidies, voluntary lay-off of civil servants, pension reform, further tightening of monetary policy, enhancing protection to the vulnerable from price increases, and strengthening private-sector led growth.

The current monetary policy stance feeds inflation and the authorities have agreed with staff to further tighten monetary policy to contain price pressures. Given the ineffective monetary transmission channels, a strong communication effort will be required to influence inflation expectations. Could staff elaborate on the communication strategy the authorities would use to influence inflation expectations, given that core inflation is on an upward trend?

We note the low level of international reserves and the important role exchange rate policy has on external sector adjustment, as well as on inflation. Achieving increased exchange rate flexibility through a more competitive auction mechanism is a structural benchmark (SB). However, we note authorities' view that a more competitive process may require larger FX interventions to smooth exchange rate movements and suggest a gradual approach. The staff have suggested that TA support could work on the auction mechanism. We would be interested to know if such a request was made by authorities and if not, whether this would impact on achieving the SB?

Finally, given that the risk assessment matrix identified a number of high and medium risks, we encourage the authorities to develop mitigation strategies that would generate broad societal and political buy-in to the reforms, build fiscal and external buffers, and achieve structural reforms. On-going dialogue with civil society is important to not only ensuring greater buy-in and ownership of the authorities' policies but to ensure the benefits of reforms are shared by all.

Mr. Leipold and Ms. Cerami submitted the following statement:

After a weak and slow start, Tunisia's macroeconomic stabilization program supported by the Fund's Extended Fund Facility (EFF) is now bearing fruit. With the help of the ongoing economic recovery as well as of the authorities' policies, program performance has also improved. Encouraged by these positive developments and by the authorities' renewed commitment to the program's full implementation, as highlighted in Mr. Mojarrad, Mr. Sassanpour, and Ms. Saadaoui's buff, we support the completion of the third review under the EFF. We also support the revised quantitative targets and the waiver of applicability of all end-June performance criteria.

At the same time, we recognize that Tunisia's outlook remains subject to elevated external and internal risks, which may jeopardize a successful transition to a sustainable growth path. As a result, we urge the authorities to follow through on their commitments and take decisive actions to correct fiscal and external imbalances, contain inflation and inflation expectations, and maintain adequate social protection.

We concur with the policy priorities clearly outlined in the staff report and shared by the authorities, and provide the following comments for emphasis.

Monetary policy should be further tightened to rein in inflation and anchor inflation expectations. Having reached 7.7 percent in May 2018, "inflation has become a major concern," as recognized by the authorities in the Memorandum of Economic and Financial Policies. The central bank has already raised the policy rate twice this year; however, additional hikes will be needed to steer interest rates to a positive level in real terms. In a positive step toward enhancing the transmission of monetary policy, the central bank has tightened its collateral framework by raising the haircut on private assets; however, government securities should also be subject to haircuts. Monetary policy transmission could also benefit from improved communication, focused on the centrality of price stability among the central bank's objectives. Finally, we call for the swift passage of the envisaged law to raise the ceiling on "excessive interest rates" and for more frequent adjustment of the reference money market rate.

Greater and sustained exchange rate flexibility is required to correct the external imbalance. The high elasticity of Tunisia's current account to the real effective exchange rate would support external adjustment under a more flexible exchange rate regime. In this regard, we commend the central bank for complying with the ceiling on foreign exchange interventions and welcome its intention to introduce more competitive foreign exchange auctions, with the technical assistance of the Fund. We highlight that allowing further depreciation of the dinar would also help rebuild foreign reserves up to the Fund's recommended coverage ratio. Greater exchange rate flexibility should be complemented by a tighter monetary policy stance to offset the inflationary pressures stemming from the exchange rate depreciation.

A steadfast fiscal consolidation is urgently needed to restore stability and build confidence among creditors and investors. To achieve the agreed consolidation targets for 2018, additional corrective measures, as detailed in text table 3 in the staff's report and endorsed by the authorities, should be fully implemented. Those immediate measures which target Tunisia's long-standing fiscal weaknesses—energy subsidies, pension funds, public wages—should be followed by further reforms and close vigilance to ensure their fiscal sustainability over the long term, and create fiscal space for public investments and social protection. Going forward, the authorities plan to complement spending restraint with greater revenue mobilization, including through the convergence of the "onshore" and "offshore" tax regimes. Could staff comment on this measure and its estimated fiscal impact?

Greater emphasis on social protection is necessary to alleviate the adjustment burden on the most vulnerable and build public support for reforms. In this vein, we welcome the increased budget for social spending, the broader population coverage, and the focus on healthcare and education. Furthermore, we support the elevation of the current indicative target on social spending to a quantitative performance criterion.

Important reforms to improve the business climate and strengthen the financial sector have been introduced but more efforts are needed to support private-led growth. The simplification of the administrative procedures for businesses through the establishment of the Tunisian Investment Authority as a “one-stop shop,” the liberalization of investments in most sectors, and greater certainty over the processing time for those which still require authorization, are welcome steps. We look forward to an impact assessment of these measures in the next report, with a view to identifying possible refinements in support of domestic and foreign investments. We also welcome the recent legislative steps, which will pave the way for the restructuring of NPLs of public banks and for the orderly resolution of Banque Franco Tunisienne. We regret that other important reforms have not been implemented. These include the appointment of the newly established High Anti-Corruption and Good Governance Authority, which is now expected by September and should not be further delayed. We also emphasize the importance of strengthening the AML/CFT framework to address the shortcomings identified by the Financial Action Task Force (FATF) and the EU and facilitate Tunisia’s exit from the FATF-enhanced surveillance list.

Ms. Erbenova, Mr. Just and Mr. Varga submitted the following statement:

We thank staff for the report, and Messrs. Mojarrad and Sassanpour, and Ms. Saadaoui for their helpful buff statement. While significant macroeconomic imbalances persist in Tunisia, growth has recovered on the back of improved security and external factors, while stronger revenue helped mitigate the impact of higher oil prices and the slower progress in the wage bill reduction. We highly welcome the authorities’ renewed commitment to further reforms, and for implementing strong corrective measures following the second review. This has contributed to the significant improvement in program performance. We therefore support the completion of the third review under the Extended Fund Facility. We also support the waiver and proposals for modification of performance criteria. In view of the exceptionally high program risks, we fully agree with staff that “business as usual” is not an option. The road ahead will continue to be difficult and will require a difficult balancing act between maintaining adequate social protection and sustained tightening of macroeconomic policies.

We welcome the additional fiscal measures and the supplementary budget to offset the higher oil prices on the budget. The agreed measures, such as further reducing the wage bill and containing energy subsidies are helpful to ease the pressure on the budget in the short term. However, without reforms of the private and public pension funds and of SOEs, the fiscal drain will continue unabated. Further, we strongly recommend the authorities to mobilize further tax revenues by streamlining the tax system and reforming tax administration to ensure fiscal consolidation efforts over the medium term. We welcome the increase in social spending, which will ensure that the most vulnerable are protected from the adverse impact of fiscal consolidation.

The Central Bank of Tunisia (CBT) has to overhaul its monetary policy framework to curb inflation, achieve full exchange rate flexibility and restore reserves to safe levels. We echo staff's advice that further monetary tightening and the elimination of FX interventions are needed to mitigate inflation pressures, but we understand that the CBT is still in a transitory period from exchange rate to inflation targeting, and more time is required to establish the effective new monetary policy instruments. In order to improve the transmission mechanism, legacy tools for exchange rate interventions should be phased out, and central bank refinancing recalibrated, complemented by enhancing the analytic and communication capacity on inflation forecasting. In this regard, we welcome the planned technical assistances on monetary policy and we encourage the authorities to tap into the Fund's vast expertise in this field.

Reforms to better target social spending and improve the business climate should be accelerated. We encourage the authorities to progress further with reviewing the database of vulnerable households to improve the historically poor targeting of their social safety net. Ghost entries and non-eligible households should be removed, while the missing segment of the poor, especially in rural areas, should be included. Without significant reforms in the business climate, it will be difficult to achieve higher growth and in turn, reduce poverty. We welcome the recent simplification of the administrative procedures for large investors, which is likely to boost FDI and should be used as a blueprint to simplify procedures for SMEs as well. We urge the authorities to accelerate the operationalization of the Anti-Corruption Authority, which is essential to improve governance, reduce corruption and create incentives for private sector investment.

Mr. Hurtado and Mr. Montero submitted the following statement:

We thank staff for its candid report and Mr. Mojarrad, Mr. Sassanpour and Ms. Saadaoui for their informative buff statement. We acknowledge that policy and reform implementation have improved notably since the last review, despite the challenging socio-political environment. We commend the authorities for strengthening performance in conditionality, by meeting all quantitative targets and most structural benchmarks, and for completing three prior actions for this third review. This notwithstanding, program risks remain exceptionally high, as stressed by staff and illustrated in the Risk Matrix, thus, continued close program monitoring will be essential for risk mitigation.

We concur with staff that the three-pillar policy framework backed by the EFF program remains pertinent, so we support the completion of the third review of the program, including the requested modifications.

On macroeconomic stabilization, like staff we see a need to tighten policies to control twin deficits, build reserves and reduce the debt.

The gradual approach underlying the EFF-supported program will require sustained discipline in policy and reform implementation in view of Tunisia's high vulnerabilities. This is particularly evident in the fiscal sphere. The budget faces several pressures from the spending side which will require the implementation of forceful measures to balance those pressures in the areas of the wage bill, energy subsidies and the pension funds. Efforts to contain the wage bill still depend too much on the scheme for voluntary separations and early retirement of civil servants, despite having proved unsuccessful so far. Have staff and the authorities considered alternative options to cut the wage bill?

We welcome recent steps to tighten monetary policy but we are concerned about inflation, which continues to accelerate and remains higher than historical levels. Despite that, interest rates remain historically low and credit growth is buoyant. Monetary policy must be tightened more decisively and additional measures are needed to enhance its transmission channels. We note that interest rate hikes are having a limited effect on the Tunisian economy, so we wonder if there is scope to explore other types of measures operating through quantities rather than prices─e.g. reserve requirements, caps to CBT refinancing, etc. Moreover, a tighter monetary policy stance will help ease the transition towards greater exchange rate flexibility to support external sector adjustment.

We take note of the mixed progress with measures to ensure adequate social protection ─aimed at improving targeting, regressiveness and fragmentation─. We reiterate our view that this is essential to achieve more economic prosperity and fairness for all Tunisians and, therefore, to secure social consensus on the reforms and mitigate social discontent. Finally, we welcome progress to strengthen the financial system and enhance access to finance, as well as recent steps to improve the business environment. We encourage the authorities to step up efforts to facilitate the transition to a private-sector-led growth model and to press ahead with governance reforms, in particular, by allocating enough resources to the High Anti-Corruption authority to start its operations.

With these comments, we wish the Tunisian authorities the best in dealing with these endeavors.

Mr. Sun and Ms. Ma submitted the following statement:

We thank staff for the candid report and Mr. Mojarrad, Mr. Sassanpour, and Ms. Saadaoui for the helpful buff statement. We take positive note that program performance has greatly improved since the second review despite a challenging domestic and external environment. All the Quantitative Performance Criteria (QPCs) and one third of the Structural Benchmarks (SBs) were met, demonstrating the authorities' renewed commitment. There are also early signs of a broad-based economic recovery as confidence recovers. We broadly concur with staff's assessment and support the proposed decision.

Since exceptionally high economic and political risks continue to weigh on the economic outlook and the program, it is paramount for staff to follow a parsimonious approach in program design while calibrating program conditions with the authorities' priorities, and for the authorities to remain steadfast in reform implementation to keep the program on track. We are concerned about the implications of the recent local elections and the national elections in 2019, and encourage staff to share their assessment during the next review.

In view of new budget pressures due to higher-than-programmed energy, wage, and pension bills, urgent and additional measures are needed to achieve the 2018 deficit target of 5.2 percent of GDP. We generally agree with the adjustment measures in Text Table 3, and welcome the authorities' commitment to further fuel price adjustments should the subsidies exceed projections. To contain the wage bill, the authorities intend to reopen the departure schemes that targets 8,000 volunteers. Given the less satisfactory outcome of the departure schemes so far, the plan might be overly ambitious, and the successful implementation would critically hinge on private sector job opportunities. The staff's comments are welcome.

Further monetary tightening and exchange rate flexibility would anchor inflation and support external adjustment. To increase exchange rate flexibility, which is essential to enhance competitiveness and build reserves, tight and credible monetary policy is warranted to contain inflationary pressures. Monetary tightening and measures to strengthen monetary transmission would help raise the real interest rate, and break the self-reinforcing cycle among negative real interest rate, rapid credit growth, and inflation.

Adequate social protection is an essential pillar in the program to strengthen social cohesion. We take positive note that the program floor on social spending is elevated to a QPC, but emphasize the importance of better targeting. As further delays in reforming the two pension funds would generate liquidity risks, we urge the authorities to step up the parametric reforms.

A vibrant private sector is key to achieving strong and sustainable growth. We welcome the establishment of a one-stop shop for large investors, and the adoption of a negative list for foreign investment. To further improve the investment environment, we encourage the authorities to make the High Anti-Corruption Authority operational as soon as feasible.

With these remarks, we wish the Tunisian authorities every success in their reform endeavors.

Mr. de Villeroché, Ms. Riach, Mr. Castets, Ms. White, Mr. Chotard, and Miss Chen submitted the following joint statement:

We thank staff for their insightful report and Mr. Mojarrad, Mr. Sassanpour, and Ms. Saadaoui for their informative buff statement. We commend the authorities for the stronger program implementation achieved over the last three months, and support the completion of the third review under the EFF program. However, growth is still fragile due to the accentuated macro-economic vulnerabilities, and risks remain high, as highlighted by staff. Therefore, we encourage the authorities to remain firmly committed to the program and accelerate the implementation of the necessary reform agenda. We share the thrust of the staff report and make the following comments for emphasis:

Program Implementation

We agree with the assessment that Tunisia has made good progress since the second review, and therefore we support the completion of the third review. We positively note that, for the third review, the three prior actions, all quantitative performance criteria and 4 out of 9 structural benchmarks were met, though one with delay. We commend the authorities for this and, going forward, encourage the authorities to continue delivering the program satisfactorily. One key aspect in this regard will be to maintain "political consensus and public support for the program,' as emphasized by Mr. Mojarrad in his buff statement. Clear and transparent communication with the Tunisian people about the nature and content of reforms will be critical to their success. Recent initiatives by the Tunisian authorities, supported by technical assistance from international partners, such as the public information campaign, which encourages citizens to engage with the Tunisian government on economic reforms have been relatively successful in increasing the number of citizens that want to learn about economic issues and reforms.

Fiscal Policy

We praise the Tunisian authorities' efforts to put fiscal consolidation on track, with courageous energy price increases and measures to contain the wage bill. We positively note that, against the backdrop of budget pressures for 2018, the authorities and staff agreed on a fiscal package to be implemented via a supplemental budget. We support the energy price increases agreed, as well as the commitment to contain the wage bill, by refraining from proceeding to any salary increases unless favorable growth surprises, and to extend the departure scheme as the results were inferior to the expectations. Could staff detail for which reasons the departure scheme gave little results so far? We also welcome the adoption of the first phase of the pension reform, although we note that a second phase with parametric modifications will be necessary. The staff's update on the planned calendar and issues at stake for this second phase are welcome. We lastly encourage to pursue State-Owned Enterprises reforms without further delay.

Regarding the social protection measures, we welcome the authorities' intention to mitigate the impact of the recent energy price increases on the most vulnerable, by better targeting their social safety nets and by increasing social transfers. We however would appreciate deeper analysis on whether these measures are sufficient to fully compensate the poorest, and invite the authorities to work closely to provide all necessary data to assess it. We also invite staff to ensure that the poorest are adequately compensated, and to report to the Board on this issue in the program reviews to come. The staff's comments are welcome. On the revenue side, we encourage the authorities to continue the modernization of the tax administration and to continue efforts to tackle tax evasion.

Monetary Policy

We support the authorities' objective to continue to tighten monetary policy to curb inflation. We share the view that the current monetary stance is still too accommodative and feeds inflation, and welcome that the authorities intend to further tighten it until market rates turn positive in real terms. Adequate communication from the central bank to convey this stance to the public will be important.

In addition, we support the authorities' commitment to a gradual transition to a market-based exchange rate system. We encourage the authorities to continue reducing foreign exchange interventions and respect the ceilings set under the program, at it will facilitate the external adjustment. Reserves are currently below IMF adequacy requirements. We would encourage the authorities to build this up to serve as a buffer in case of capital outflows given structural vulnerabilities.

Structural Reforms

Alongside budgetary and monetary efforts, structural reforms key to elevate Tunisian's growth path. In this regard, we welcome the authorities' progress on facilitating investment with the establishment of the one-stop shop for large investors and the adoption of a negative list regarding investment authorizations for certain sectors. We encourage the authorities to pursue in this direction. We underline that in our view strengthening fight against corruption should be an important part of the reform agenda. In this regard, it is regrettable that the operational start of the High Anti-Corruption and Good Governance Authority was delayed but welcome the authorities' confirmation that the fight against corruption remains a government priority. It is essential to adopt the economic emergency law and strengthen the regulatory framework for PPPs to boost private and public investments. It is also important to speed up the finalisation of the energy sector strategy.

On the financial sector, we commend the authorities for the improvement of financial soundness indicators. We praise the progress made on strengthening the financial system, facilitating MSMEs access to finance as well as enhancing the AML/CFT regime. It is important to continue supporting modernizing banking supervision, improving SMEs access to finance and strengthening financial sector governance.

Mr. Panek and Mr. Trabinski submitted the following statement:

We support the completion of the third review and the authorities' request for modification of performance criteria and the waiver of applicability. Economic performance has improved, driven by strong agriculture, industry, and growing tourism. Nevertheless, the outlook remains subject to significant risks, including dinar depreciation, high inflation, public debt, and potential socio-political tensions. We share staff's assessment that the reforms and policy discipline need to be continued in order to strengthen macroeconomic stability and to lift growth prospects, as well as to keep the Fund-supported program on track. We thank staff for their interesting report, and Mr. Mojarrad, Mr. Sassanpour and Ms. Saadaoui for their informative buff statement. We share the thrust of the staff appraisal, and offer the following comments for emphasis.

Further fiscal consolidation is needed to reduce existing vulnerabilities. We commend the authorities for implementing fiscal measures aimed at achieving a fiscal surplus, including the energy price increase, the revenue package, and public wage containment. While proposed fiscal reforms are consistent with the program, the budgetary pressures related to the increase in international oil prices, and the potential delay in the implementation of the public pension fund reform, could derail fiscal targets. Therefore, we urge the authorities to maintain a prudent fiscal stance and to use available space to re-orient spending towards debt reduction and investment. While we note the authorities' intention of replacing the Large Taxpayers Unit by a more comprehensive tax administration reform, we would much appreciate staff's comment on when this reform could be implemented.

Monetary tightening is necessary to contain inflation and anchor expectations. Dinar depreciation, public wage increases, the strong expansion of credit to the economy, and the accommodative stance of monetary policy all contributed to high inflation, as indicated in Annex I. We agree with staff that the central bank should continue to raise the policy rates, and reduce refinancing of the banks in order to achieve the medium-term inflation objective. While the authorities are improving the monetary transmission mechanism, we share staff's advice regarding the necessity of removing interest rate caps, and the need for a more comprehensive financial sector reform. We also call on the authorities to remove exchange restrictions.

Reform efforts should focus on improving the business climate, enhancing the social safety net, and strengthening the banking sector. We take positive note of the recent implementation of the one-stop shop for investors, the StartUp Act and limitations on investments that require public authorization. The current favorable momentum should encourage the authorities to further reform the business environment, while maintaining an adequate level of pro-poor spending. We agree with staff that the appointment of the Anti-Corruption Authority members, strengthening of the PPP framework and improving the database of vulnerable households, will be necessary to achieve more inclusive growth. Finally, we encourage the authorities to strengthen the AML/CFT framework, and use recently adopted legal framework to reduce the public banks' NPLs.

Mr. Saito, Mr. Ozaki and Mr. Minoura submitted the following statement:

We thank staff for the informative paper and Mr. Mojarrad, Mr. Sassanpour, and Ms. Saadaoui for their statement. We welcome that growth has picked up to 2.5 percent in the first quarter. In the medium term, we take note that staff prospect higher growth compared to the recent outcomes. We would appreciate it if staff could elaborate more on assumptions in the medium term and drivers behind the growth pick-up. While we commend that the government has strengthened policy and reform implementation in recent months, Tunisia still faces macroeconomic imbalances—notably accelerating inflation, low international reserves, and high twin deficits— as well as risks of security and migration spillovers from Libya, and higher international oil prices. In light of the improvement in reform implementation and the authorities' strong commitment to the agreed reforms, we support the completion of the third review under the Extended Fund Facility (EFF) and requests for modification of Performance Criteria (PCs) and waiver of Applicability. As we basically concur with the thrust of the staff's appraisal, we will limit our comments to the following points:

Fiscal Policy

We agree with staff that the authorities' envisaged fiscal consolidation of 3 percent of GDP between 2018 and 2020 remains indispensable for macroeconomic stabilization. While strong revenue performance helped the fiscal accounts in the first quarter, it is critical to control spending through monthly fuel price adjustments until the end of the year, maintain the policy of not granting new wage increases in 2018 and move ahead quickly with further measures to ensure the financial viability of pensions against new spending pressures. In the medium term, we concur with staff that priority areas include expenditure rationalization, parametric reform of the pension system and treasury cash management. Moreover, fiscal risks associated with contingent liabilities stemming from state owned enterprises (SOEs) should be monitored carefully. Could staff elaborate more on the potential magnitude of the contingent liabilities to the budget and the debt sustainability? On the revenue side, we encourage the authorities' further efforts to make the tax system simpler and fairer and modernize the tax administration. These measures are indispensable to reduce debt and achieve the desired re-orientation of spending towards more investment and outlays on health and education. In particular, ensuring adequate social protection is a key for success of the program. In this regard, we urge the authorities to swiftly complete the database of vulnerable households to improve the targeting of social services.

Monetary and Exchange Rate Policy

Against the current juncture, tighter monetary policy and greater exchange rate flexibility will contain inflation, support export, and preserve reserves. Negative real interest rates under the current accommodative monetary policy have fueled strong expansion of credit, which feeds inflationary pressures. In this light, further monetary tightening is essential to mitigate a risk that inflation expectations adjust upward and jeopardize the credibility of the Central Bank of Tunisia (CBT). Furthermore, given the limited monetary policy transmission channels, we encourage the authorities to strengthen transmission mechanism by fully removing interest rate caps and tightening a generous collateral framework to reduce liquidity demand from banks.

We also agree with staff that exchange rate flexibility has a critical role to play in achieving external balance. In this regard, we welcome the authorities' commitment to comply with monthly net FX intervention ceilings, introduction of more competitive FX auctions and intention to remove the exchange restriction introduced last October 2017 by end-2018.

Financial Sector Policy

We positively take note that financial soundness indicators have improved and the progress in reforms to strengthen the financial system and enhance access to finance have progressed, notably parliament adoption of a set of laws facilitating NPL restructuring of public banks. Going forward, efforts in support of financial sector stability and access to credit need to be continued. In addition to the NPL reduction of public banks, we encourage the authorities to modernize banking supervision, improve access to finance especially for SMEs, and strengthen financial sector governance. We welcome that the authorities advanced on improving Tunisia's Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) regime, in response to the shortcomings identified by the Financial Action Task Force (FATF) and the EU,

Structural Reform

We encourage the authorities to continue their efforts to improve the business environment and governance. While we welcome the recent steps to facilitate investment, and recommended follow-up measures, we take note with concern that the operational start of the High Anti-Corruption Authority encountered delays and encourage the authorities' steadfast implementation.

Finally, regarding the structural benchmarks (SBs), we take note of the authorities' request to drop two SBs on the Large Taxpayers Unit (LTU) and their intention to replace it with a broader reform that seeks to integrate all tax administration functions within one umbrella structure. We appreciate staff's elaboration on the new approach and evaluation for it.

Mr. Saraiva and Mr. Coronel submitted the following statement:

We thank staff for the report and Mr. Mojarrad, Mr. Sassanpour, and Ms. Saadaoui for their insightful statement. We support the third review Tunisia's Extended Fund Facility (EFF), as well as the requested modification and waiver for the end-June Quantitative Performance Criteria (QPCs).

We welcome the revision of the list of structural benchmarks (SBs) with the purpose of rationalizing their number and prioritizing their implementation. With a wide-ranging reform agenda, it is critical that Tunisia establishes a viable roadmap with clear priorities and a well-thought sequencing. This is particularly true, given the inherent vulnerabilities to oil and commodity price volatility, and a weak external position, which compound the country's high-risk profile.

The prospected growth path does not seem strong enough to meaningfully lower Tunisia's high unemployment rates, particularly among the youth. Growth for 2018 remains forecasted at 2.4 percent, slowly trending towards potential thereafter. Restoring macroeconomic stability in the medium term remains necessary to the country to start rebuilding buffers and to increase resilience. Advancing long-term reforms, such as the ongoing global and sectorial public-private strategies will be pivotal to enhance potential growth—and ultimately start to tackle poverty and unemployment beyond the timeframe of the EFF program.

The large twin deficits and high inflation rates that prompted the authorities to seek Fund support, continue to require fiscal consolidation and monetary tightening, neither of which contributes in the short run to the prevalent need of expanding employment. Nevertheless, we expect that this year's increase in tourist inflows and FDI, as well as ongoing efforts to improve security and business climate will help restore confidence in the economy and provide an avenue for further investments and stronger job creation.

Moreover, a tighter stance on monetary and fiscal policies will be key to contain inflation pressures and place it into a decisively downward path. Considering the prevailing negative real policy rate, the Central Bank of Tunisia (CBT) must remain ready to further tighten its stance as warranted. Enhancing exchange rate flexibility will contribute to a more balanced and resilient external sector. However, a bolder move towards a more flexible exchange rate regime, while a crucial medium-term goal, should be well communicated and carefully devised.

On the fiscal front, plans to curtail public spending, increase revenue mobilization, reduce energy subsidies and increase the efficiency of capital spending are welcome. Nevertheless, they will call for close monitoring to ensure that the significant three percentage points of GDP adjustment is delivered by 2020. Other essential actions to ensure that the EFF's fiscal targets will be reached involve keeping a tight rein on the wage bill and addressing pending measures to assure the viability of the social security system.

We tend to agree with staff's views that the program risks remain "exceptionally high," which calls for closer and consistent engagement with the authorities. However, we are mindful of the burden associated with quarterly reviews, considering that the timeframe seems too short to assess substantial material progress, especially when the program is heavily loaded on structural reforms. In such cases, a lighter and more continuous mechanism of policy engagement could be more efficient.

We wish the Tunisian authorities success in the continuation of the program.

Mr. Armas and Ms. Moreno submitted the following statement:

We thank staff for the informative paper and Mr. Mojarrad, Mr. Sassanpour, and M. Saadaoui for their statement. We support the completion of the third review under the Extended Fund Facility (EFF) and requests for modification of Performance Criteria (PCs) and waiver of Applicability. We agree with the thrust of the paper and offer some comments for emphasis.

Tunisian economic growth has rebounded but macroeconomic disbalances remain, like the twin deficits. Likewise, some developments are becoming increasingly a source of risk, like rising inflation pressures and lower reserve coverage. Against this background, the authorities have remained committed to taking the necessary corrective actions and we commend their efforts to stay strongly aligned with staff´s recommended reform agenda.

We encourage the authorities to maintain prudent fiscal stance and keep the focus on debt reduction and investment. Risks arising from contingent liabilities from SOEs should be closely monitored and contained. Can staff comment on the implementation of the comprehensive tax administration reform? We are pleased that social protection is a priority and that measures to alleviate the cost of reforms will be taken, thus protecting the more vulnerable groups of the population.

Inflation pressures are arising and the agreed recommendation to further increase policy rates is welcome. Further increases, along with a tightening of the central bank's collateral framework, will help increase real interest rates which are now at negative levels. Efforts to improve the effectiveness of the transmission of monetary policy are needed. We agree that eliminating the ceiling on "excessive interest rates" and arranging more frequent updates of the reference interest rate for the calculation of maximum borrower rates work in the correct direction. In addition, the authorities´ proposals to advance into a more flexible exchange rate regime are commendable, as they will also help to improve monetary policy transmission. Fund capacity development activities should continue to reinforce the transition towards a more competitive FX market, with limited interventions.

Financial sector reforms should be accelerated to facilitate financial and economic inclusion. The so far accommodative monetary policy has encouraged a continued strong expansion of credit. The banking sector has showed resilience, with adequate capital and liquidity ratios. Nevertheless, NPLs are at high levels and its resolution should be a priority to clean the balance sheet of banks and do not jeopardize the confidence on the banking system. Finally, Tunisia´s exit from the FATF-enhanced surveillance list should be done earlier than later; this entails further efforts to reinforce the AML/CFT framework.

We agree with staff on the main pillars to protect growth and the key reforms going forward. In particular, improving the business climate, enhancing the social safety net and strengthening the banking system. Strong conditionality should continue to guide program implementation, but as this review shows, flexibility should be allowed if some targets could be complemented or replaced by others more pertinent to the current economic and political situation.

We agree with other directors that the duplication of security risks in the domestic and external risk sections of the risk matrix could be reorganized. If not, the differences that justify the different classification should be clearer. Regarding the overall assessment of risks, can staff comment why in Tunisia's case these are classified as 'exceptional'? There are mid-term risks to growth and inflation, but as staff indicates, the capacity to repay the Fund is maintained. A comparison with peers would make it clearer as to why in Tunisia 's case the risks these appear to be relatively higher.

With these comments, we wish the Tunisian authorities and their people the best on their future endeavors.

Mr. Castets made the following statement:

I thank the staff for the detailed, precise, and pointed report. I also thank them for the written answers to our questions. I thank Mr. Mojarrad for his insightful buff statement. I published a gray statement with my British colleague, so I will limit myself to a few points for emphasis.

Generally speaking, we are pleased that the authorities achieved stronger program implementation over the last three months. We commend them for this, given that this result was obtained in a still-challenging political, social, and economic environment.

Therefore, I support the completion of the third review under the Extended Fund Facility (EFF) program. Yet the situation is still fragile, and risks remain high as the country faces significant macroeconomic vulnerabilities, as also well underlined by the staff report. Against this backdrop, the next months will be both challenging and crucial for the country. We encourage the authorities to remain firmly committed to the program and to accelerate the implementation of the necessary reform agenda.

We will now turn to a few points where more progress is progress warranted. First, on fiscal policy, we welcome that the authorities and the staff agreed on a fiscal package to compensate the budgetary pressures for 2018. We support the agreed energy price increases, as well as the commitment to contain the wage bill. Continuing efforts in the following months will be necessary to achieve fiscal targets, notably by pursuing energy price adjustments and by deepening the pension reform.

Regarding the social protection measures, we welcome the authorities' recent measures to compensate the most vulnerable. The robustness of the social safety net is a crucial element of the program, particularly its acceptability in Tunisia. We invite both the authorities and the staff to ensure that the poorest are adequately compensated and to report to the Board on this issue in the program reviews to come.

On the monetary policy, we support the authorities' objective to continue to tighten monetary policy to cap inflation. We share the view that the current monetary stance is still too accommodative and feeds inflation. We welcome that the authorities intend to further tighten the monetary policy stance until market rates turn positive in real terms. In addition, we support the authorities' commitment to a gradual transition to a marked-based exchange rate system. This notably concerns the auction system, which is well described in the report.

Lastly, on structural reforms, we invite the authorities to continue and accelerate their efforts to foster private sector development. We also underline that strengthening the fight against corruption should be an important part of the reform agenda. In this regard, it is regrettable that the operational start of the High Anti-Corruption and Good Governance Authority was delayed, but we welcome the fact that the authorities confirm that the fight against corruption remains a government priority.

Mr. Meyer made the following statement:

I thank the staff for the report and for the outreach to our authorities in Germany, which was helpful for us to understand the program and the way forward. I thank Mr. Mojarrad and his team for the buff statement.

We have issued a gray statement, and I will focus on our key messages. Program performance has improved, as all quantitative performance criteria and three out of nine structural benchmarks were met. This has been a significant step up from the performance on the second review, and this is to be commended.

However, as the French chair has emphasized, the overall economic situation in Tunisia remains challenging. We encourage and urge the authorities not to rest on recent achievements but to sustain their commitment and continue on a steadfast reform path. It will be important to reach out to all stakeholders to secure the broadest support possible for the program.

Determined fiscal consolidation will be important. As the fiscal adjustment achieved so far has rested mainly on stronger revenues, the authorities should increase their efforts toward expenditure restraint. In particular, this will require reducing the very high public wage bill and restraining distortive targeted subsidies. Effective expenditure restraint will also allow for more productive investment and better protection of the poor.

Finally, macro-critical structural reforms need to be implemented without further delay. Progress on structural reforms has so far been limited. We take note that no additional structural benchmarks are set and expect the authorities to tackle the outstanding structural benchmarks with even more determination.

With this, I wish all the best to the authorities.

Mr. Leipold made the following statement:

All the gray statements clearly deliver a common message: that Tunisia is at a critical juncture, where sustained and decisive action along the lines of the staff’s recommendations stand to lead to a virtuous circle. This is notwithstanding the significant domestic and external challenges facing the country.

In this regard, the authorities’ strengthened program implementation in the recent past provides comfort; and Tunisia has made progress since the second review, which has induced chairs that had abstained at that time to be supportive now. That is most welcome. The authorities ought to be commended for this renewed resolve, as was just done also by Mr. Castets and Mr. Meyer.

Strengthening domestic resolve alone will not suffice in this challenging environment. Tunisia will continue to depend on strong engagement by its international partners. It will continue to require sizable fiscal financing from outside sources. Grants or highly concessional loans will remain indispensable to cover the country's financing needs. It is this message of the need for continued international support, which also includes technical assistance (TA) engagement to overcome severe capacity constraints. It is this message that needs to be a central part of the Fund's message to the international community from our discussion today, and we look for this to be reflected in the summing up.

Indeed, a key function of Fund lending—in this case, the EFF—is to be a catalyst for the mobilization of additional resources. In this regard, we note that the staff, in its written responses, mentions what it calls challenges for several international financial institutions (IFIs) as regards their head room for further lending, given their current risk exposure to Tunisia and the region generally. We would be interested to have more details on what constraints IFIs are facing.

At the same time, we are heartened to read in the same response from the staff that some bilateral donors are increasing lending to Tunisia; notably, the KfW, and for that, we thank our German colleagues.

Finally, we would stress, along with several other chairs, the crucial importance of ensuring adequate social protection in order to, as Mr. Mojarrad puts it in his buff statement, maintain the political consensus for the program, which is critical for its success. The January street protests delivered a cautionary note in that regard; and in this area, we would join Mr. de Villeroché and Ms. Riach in inviting the staff to ensure that the poorest are adequately compensated for the recent energy price increases and to report to the Board on this matter in the program reviews to come.

More generally, as a broader comment and following on this morning's discussion of the Independent Evaluation Office (IEO), we also look forward to next week's joint IEO-staff seminar on social protection, which will be chaired by management, and the related development of a strategic framework for the Fund's engagement on social spending leading up to a Board paper to be discussed in February of next year.

Mr. Rudolph made the following statement:

We issued a gray statement, so I will reiterate that we were pleased to see that program performance improved significantly with this review and that there is much more work to be done in the months ahead, especially around fiscal implementation.

Given the additional budgetary pressure from the rise in oil prices, the recent difficult steps taken by the authorities to increase energy prices were essential; and it remains critical that they stay on this path, with monthly fuel price adjustments throughout the rest of the year, along with upward revisions to electricity and gas rates and measures to protect the poor.

It is also critical that they refrain from wage increases, as the Tunisian public wage bill, relative to GDP, remains among the highest in the world. We welcome the authorities’ determination not to increase civil service wages. It is imperative for the success of the program that they continue to receive political support to make good on that pledge.

Beyond fiscal consolidation, it is also important to continue with policies to contain inflation and promote exchange rate flexibility. We commend the authorities for the degree to which they have ramped up implementation and urge them to keep up the positive momentum.

Mr. Alkhareif made the following statement:

We thank the staff for their work and Mr. Mojarrad for his informative buff statement. We issued a gray statement and support the proposed decision.

We welcome the improved program performance and continued economic recovery. In this regard, we commend the Tunisian authorities for the important measures taken, despite the challenging environment. We also welcome the authorities’ strong commitment to the agreed policy measures in the period ahead. Notably, strong fiscal adjustment and further monetary tightening will be important to safeguard macroeconomic stability and social protection.

Like Mr. Castets, we are encouraged by the broadening of the social safety net for the poorest families and the most vulnerable. We encourage the authorities to continue their efforts to improve targeting. In this regard, we support the transformation of the floor on social spending from an indicative target to a performance criterion.

With these remarks, we wish the authorities further success.

Ms. Villa made the following statement:

We thank the staff for the report and Mr. Mojarrad and his team for the informative buff statement.

We join other Directors in welcoming the authorities' improvements in program performance as a result of the strong commitment to pursue challenging reforms following the second review. While we would have been more comfortable with more frontloaded reforms to keep the program on track, we see merit in the authorities' socially balanced approach to macroeconomic adjustments. Still, we urge the authorities to remain focused on reform implementation, and in parallel to this, to put in place a strong, credible communication strategy. Given the still-fragile state of the economy, communicating policy intent clearly and in a timely manner will help raise public acceptance of the difficult reforms and, thus, help to ease implementation bottlenecks.

Second, we note from the past review that the public investment efficiency is relatively low due to inadequate cost-benefit analyses, weak program monitoring, and limited capacity for project implementation.

Public investment remains a priority to boost long-term growth in Tunisia, and the authorities have reiterated their commitment to expand the capital spending once there is ample fiscal space. Considering this, we would appreciate the staff's views on the authorities' measures to strengthen the selection and efficiency of public investment projects. A staff update on the Public Investment Management Assessment (PIMA) exercise would also be welcome.

Finally, we encourage the authorities to build on the recent gains and not to let up on reforms, and to continue to reach out to international partners, as emphasized by Mr. Leipold and Mr. Meyer, as this combination would help address macroeconomic imbalances sooner, transform the economy, and deliver better prospects for the Tunisian people, who wait to see the fruits of their sacrifice.

Mr. Raghani made the following statement:

I thank the staff for the informative report and for their written responses to the questions raised by Directors. I also thank Mr. Mojarrad, Mr. Sassanpour, and Ms. Saadaoui, for their insightful buff statement.

We issued a joint gray statement with Mr. Mkwezalamba. We support the proposed decision and would like to add the following comments.

First, we are pleased to note that the Tunisian authorities and staff fully agree on the pillars of the EFF-supported program; namely, macroeconomic stabilization, ensuring adequate social protection during the adjustment, and promoting private sector-led growth and job creation.

Second, however, we also note that the emphasis in the report is on the risks to Tunisia's outlook, as well as the call for stronger and more urgent measures to preserve growth.

Third, we share the authorities' concern that maintaining a political consensus and public support for the program is critical to its success and that any further hardening or frontloading of the program runs the risk of its rejection by the public, as expressed in their buff statement. This includes the impact of a major exchange rate depreciation on inflation.

Fourth, we agree with the authorities' gradual approach to macroeconomic adjustment; in particular, their efforts to gradually transition to a market-based exchange rate system to contain the increase in the prices for imported goods.

The staff representative from the Middle East and Central Asia Department (Mr. Rother), in response to questions and comments from Executive Directors, made the following statement:[1]

I wanted to take up three issues that were raised by Directors: first, the issue of the safety nets; second, external partner engagement; and third, public investment.

On the safety nets, it is clear that in order for this program to succeed, given the high social political risks in the country, it is imperative to always

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

think about the impact of the program on the poor and how to protect the vulnerable. This has two structural components that are guiding our efforts in the longer run. One is to build the infrastructure for better targeting of social policies. That has to do with the database on vulnerable households and then the question of: How do you leverage this apparatus to become more efficient in the provision of public goods to the poor? Second, and as important, it is about data provision. That will be a key issue. For example, the adequate availability of household surveys to gauge the impact of subsidy reforms on the poor.

However, while we wait for this infrastructure to be built, we have to act today. We do that. We emphasized the need to take some immediate steps, like the strengthening of the transfers to the vulnerable, both the increase in transfers and the broadened coverage.

There was a question of whether we would be able to provide an assessment of the full impact on the poor of these recent steps. It is impossible, given the data we currently have. But just to provide an order of magnitude, the price increases in fuels, if one looks at filling a car with gas, is about US$1 per fueling incident. This US$1 is essentially 1 percent of the minimum wage.

On the external partner engagement and the question of headroom, it is important to interact with the agencies in question. But, for example, the African Development Bank has issues with the risk concentrations on the Middle East and North Africa (MENA) region and on Tunisia, in particular. The question beyond 2018 is still to be raised: How much lending space will there be? For the World Bank, it is also a fact that they are close to their prudential limits for lending to Tunisia, and they are looking into options for how to move ahead with this constraint.

Other than that, on external partner engagement, the Fund's collaboration with external partners is excellent. There will be an IFI mission to Tunisia next week, chaired by Commissioner Hahn from the European Commission, with all the institutions around him. There is a significant amount of work being done to make sure that there is alignment in the policy messages and complementarity in the support for reforms, including in the context of the Compact with Africa.

Finally, on public investment, it is a priority. Job creation will depend on better infrastructure for the private sector. That has to come also from public sector engagement. With regard to the PIMA process—improvements are underway, helped by World Bank TA. Also, public-private partnerships and the regulatory framework that support those is an area of priority.

Mr. Mojarrad made the following concluding statement:

I thank Directors for their candid views and recommendations, which will be faithfully conveyed to my authorities. The staff has ably addressed the questions raised by Directors, and I will limit my remarks to a few issues.

First, in their gray statements, Directors have recognized that the authorities are implementing the program under very difficult circumstances. Domestically, the austerity measures are squeezing the incomes of all Tunisians, and it would be difficult to maintain public support for reforms when the benefits are slow to emerge. Externally, the spillovers from the regional conflict and refugee crisis, rising oil prices, and the hardening of international financial conditions have created a challenging environment, adding to the cost of reforms.

Although Tunisia's own democratic and economic transitions have not been easy or smooth, and there are many headwinds, the authorities are firmly determined to press ahead with program implementation, with the conviction that stabilizing the macroeconomic fundamentals lays the foundation for high, sustainable growth that benefits all Tunisians in the end.

My authorities have no major disagreement with the staff on the nature and sources of risks to the outlook, but are of the view that that staff's presentation of the risk assessment matrix exaggerates the risks by duplication, as was also observed by some other Directors. Additionally, the qualification of risks is subjective, and qualifying risks to the outlook as "exceptionally high" in Tunisia may be an exaggeration, particularly compared to countries facing more difficult conditions, a point also highlighted by Mr. Beblawi and Ms. Choueiri. The risk assessment matrix is probably the most important piece of information for market participants, and the authorities request that staff keep that in mind in future reviews.

Turning to the economy, real GDP growth is on track this year to record its highest rate since 2014. The recovery of tourism and higher exports and remittances also contributed to growth and narrowed the current account deficit despite higher oil prices. Inflation, however, has remained stubbornly high, but the authorities stand ready to take corrective actions, including increasing further the policy rate and strengthening the monetary transmission mechanism.

My authorities believe that fiscal consolidation is at the core of macroeconomic stabilization and are committed to the program's fiscal adjustment path and its 2020 target. The 2018 fiscal program went off track in the first half of the year, primarily because of larger-than-expected international oil prices. The authorities responded by implementing an additional fiscal package, equivalent to 4 percent of GDP on an annual basis, primarily through a series of unpopular measures, including increases in domestic fuel prices and in gas and electricity tariffs, and containing the government wage bill by freezing wages and reducing the head count. From 2019, more effort will be placed on revenue generation and strengthening tax administration.

Alleviating the economic hardship of austerity measures is key to preserving public support for the reforms, as indicated by many Directors. Social spending was raised this year to partially compensate for higher fuel prices; the coverage of vulnerable families was broadened; and plans are underway to improve the database and targeting with the help of the World Bank.

Significant real effective exchange rate depreciation in the past few years has improved external competitiveness and helped external rebalancing, albeit at the cost of higher inflation in the absence of sufficient tightening of monetary policy to absorb the second-round effects. The authorities recognize that greater exchange rate flexibility may be needed to put the current account balance on a firmer footing. The central bank is planning to set up a framework for conducting more competitive foreign exchange auctions and will be seeking Fund TA.

A number of important steps have been taken in support of private sector activity and job creation, including reducing administrative red tape, establishing a one-stop-shop for investors, easing investment authorization and approvals, improving governance, and fighting corruption. It is expected that the High Anti-Corruption and Good Governance Authority will become functional in September. On Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) issues, the authorities are fully committed to the action plan agreed with the Financial Action Task Force (FATF) in November 2017 and look forward to exiting from the FATF-enhanced surveillance list at an early date.

Finally, I would like to conclude by thanking Mr. Rother and his team for the constructive dialogue and sound policy advice, and the TA missions for the efficient technical support. My Tunisian authorities are also grateful for the support from management and the Board. They are also appreciative of the generous financial and technical assistance provided by other partners during this difficult transition and look forward to their continuous support.

The following summing up was issued:

Executive Directors welcomed the resumption of growth and commended the authorities for accelerated reform implementation since the Second Review. Risks are, however, high with elevated inflation, large fiscal and current account deficits, international reserves that need to be increased, as well as social and political uncertainties. While acknowledging the recent strengthening in program implementation, Directors called for 2018 to be a decisive year for reducing vulnerabilities and rebuilding buffers.

Directors noted that the planned fiscal consolidation of 3 percent of GDP from 2018 to 2020 is essential for macroeconomic stabilization. They stressed, however, that firm control on spending, including limits on public-sector wage increases, would be necessary due to the higher international oil prices and delays in public service and pension reforms. Directors welcomed the recent fuel price increases and called on the authorities to proceed with the monthly adjustments to limit subsidies.

Directors underlined the role of monetary tightening in curbing inflation and guiding expectations. They commended the authorities for the recent policy rate increase and the tightening of the collateral framework for bank refinancing. Further monetary tightening would be warranted if inflation remains high, especially as key interest rates are still negative in real terms.

Directors underscored that exchange rate flexibility is critical for achieving external balance. They welcomed the central bank's successful efforts to limit foreign exchange interventions and encouraged the authorities to quickly move to more competitive foreign exchange auctions.

Stressing the importance of well-targeted social programs, Directors welcomed the broadened coverage and increase in social transfers to vulnerable families. Directors emphasized the need to bolster the financial viability of private and public pension funds, and called for swift adoption of the necessary reforms.

Directors commended the progress in business environment and governance reforms. They encouraged the authorities to upgrade the frameworks for public procurement and public-private partnerships, and to quickly appoint the members of the High Anti-Corruption Authority. Directors also underlined the importance of further strengthening the AML/CFT regime.

Against the background of economic and political risks to the program, Directors stressed the importance of maintaining the quarterly review cycle and welcomed the introduction of new quantitative performance criteria on foreign exchange interventions and social spending. Directors called on the international community to continue supporting Tunisia's reform efforts.

The Executive Board took the following decision:

Tunisia—Third Review Under the Extended Fund Facility, and Request for Waiver of Applicability and Modification of Performance Criteria

1. Tunisia has consulted with the Fund in accordance with Paragraph 3(c) of the Extended Arrangement for Tunisia (EBS/16/33, 05/20/2016, as amended) (the
"Arrangement") in order to review program implementation.

2. The letter dated June 22, 2018 from the Minister of Finance and the Governor of the Central Bank of Tunisia (the "June 2018 Letter") with its Memorandum of Economic and Financial Policies ("June 2018 MEFP") and Technical Memorandum of Understanding (the "June 2018 TMU") shall be attached to the Arrangement, and the letter dated May 2, 2016 from the Minister of Finance and the Governor of the Central Bank of Tunisia, together with its attachments, as supplemented and modified, shall be read as further supplemented and modified by the June 2018 Letter and its attachments.

3. Accordingly, the Arrangement for Tunisia shall be amended as follows:

(a) Paragraph 3(a) of the Arrangement shall be revised to include two new sub-paragraphs 3(a)(v) and 3(a)(vi) as follows:

"(v) the floor on social spending, or
(vi) the ceiling on net foreign exchange interventions of the Central Bank of Tunisia,"

(b) The performance criteria for end-June 2018, end-September 2018, end-December 2018 and end-March 2019 set forth in Paragraph 3(a) of the Arrangement shall be as specified in Table 1 of the June 2018 MEFP and as further specified in the June 2018 TMU.

(c) In Paragraph 3(b), the reference to “the March 2018 MEFP” shall be amended to read “the June 2018 MEFP” and the reference to “the March 2018 TMU” shall be amended to read “the June 2018 TMU”.

4. The Fund decides that the Third Review contemplated in Paragraph 3(c) of the Arrangement is completed and that Tunisia may make purchases under the Arrangement up to a cumulative amount of SDR 808.1485 million until July 13, 2018 and thereafter in accordance with the provisions of the Arrangement, notwithstanding the unavailability of the information necessary to assess observance of the end-June 2018 performance criteria on the floor on net international reserves of the Central Bank of Tunisia, the ceiling on net domestic assets of the Central Bank of Tunisia, the floor on the primary balance of the central government and the ceiling on the total current primary expenditure of the central government, as specified in Paragraphs 3(a)(i), (ii), (iii) and (iv) of the Arrangement, respectively, on the condition that Tunisia has accurately represented that such information is unavailable, and on the further condition that the information provided by Tunisia on the implementation of the measures specified as prior actions in Table 2 of the June 2018 MEFP is accurate. (EBS/18/63, 06/25/18)

Decision No. 16412-(8/62), adopted
July 6, 2018

APPROVAL: April 8, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook and Risks

1. ***Could staff elaborate more on assumptions in the medium term and drivers behind the growth pick-up.***

- Growth is expected to accelerate further over the medium term to 4 percent by 2022, as security continues to improve, political uncertainty declines, and structural reforms show their impact. The main sectors driving the recovery will be tourism and related services, mining given the rebound of phosphate and energy production (including alternative energies), and electrical and mechanical industries. A shift in demand from consumption to investment and exports, supported by structural reforms and improved price competitiveness, will support this expected growth.

2. ***Regarding the overall assessment of risks, can staff comment why in Tunisia's case these are classified as 'exceptional'?***

- Risks to the program remain manifold and high, most notably the risk of delays with policy and reform implementation that could emanate from socio-political tensions after the recent suspension of the Carthage II process. Major fiscal decisions are particularly at risk, including those on reducing energy subsidies, public wage restraint, and pension reform. Notwithstanding recent improvements, security and migration risks also remain high, including from spillovers of conflicts in Libya and elsewhere in the region. Finally, a further rise in oil prices could jeopardize the fiscal and external adjustment targets (absent an adjustment in domestic prices, each increase in the international oil price by US$1 worsens the budget by 0.15 percent of GDP and the current account by 0.08 percent of GDP). Tighter global financial conditions would likely only have a limited effect on Tunisia, given its strong reliance on concessional financing from official donors (Debt Sustainability Analysis, Second Review). Strong commitment by the authorities to the agreed reforms, a strong program monitoring framework, and continued donor support will remain essential as mitigation strategies for the significant risks weighing on program objectives.

Fiscal Policy and Debt Sustainability

3. ***While we can support eliminating the structural benchmarks related to the Large Taxpayers Unit (LTU), we would appreciate more details on the new tax strategy.***

4. ***While we note the authorities' intention of replacing the Large Taxpayers Unit by a more comprehensive tax administration reform, we would much appreciate staff's comment on when this reform could be implemented.***

5. Regarding the structural benchmarks (SBs), we take note of the authorities' request to drop two SBs on the Large Taxpayers Unit (LTU) and their intention to replace it with a broader reform that seeks to integrate all tax administration functions within one umbrella structure. Could the staff elaborate on the new approach and evaluation for it?

6. Given that modernizing the tax system is a key pillar of the program, we note that the authorities are changing their preferred approach, away from the IMF-recommended one towards a French model. What is the genesis of this change and what are staff's views on this?

7. Can staff comment on the implementation of the comprehensive tax administration reform?

8. The authorities note the merger of the General Directorate off Taxes and the General Directorate of Public Accounting and Collections will take several years. We would appreciate staff comments on the technical assistance Tunisia is receiving to support this merger.

- The authorities' revised strategy still intends to deliver the efficiency-enhancing changes in tax administration initially discussed with staff, notably the establishment of a full service large taxpayer unit. The main risk of the new approach is the complexity that may be involved because the reform plan is now much broader and affects not only select functions but the entire tax administration. The staff understand that the authorities are already in contact with the French authorities on how to proceed with the implementation of the new strategy. The main reason for the change in approach is that the originally intended fast track to establishing the large taxpayers' unit lacked political traction, both among the tax administration function that has strong labor union representation and in parliament.

9. ***Broadening the tax base and improving tax administration are important steps, and we commend the authorities for their efforts in these areas. Nevertheless, we wonder if staff discussed additional revenue measures with the authorities, and welcome staff comments.***

10. ***Strong revenue performance helped the fiscal accounts in the first quarter and we would like to hear more on the efforts being made this year for revenue generation as well as the adequacy of social protection measures being undertaken for maintaining***

the public acceptance to the reforms in face of spending cuts. Could staff elaborate on this.

11. ***We also invite staff to ensure that the poorest are adequately compensated, and to report to the Board on this issue in the program reviews to come. Could the staff comment?***

- The stronger-than-expected revenue performance in the first half of 2018 reflects mainly the tax policy reforms enacted in the 2018 budget law, and higher-than-expected non-tax revenue (including profits from the central bank and transfers from energy companies due to higher-than-budgeted oil prices). The authorities have more aggressive targets for tax and tax arrears collection, including with regard to those from state-owned enterprises.

- For 2019, and based on TA recommendations from the Fund, further tax policy reforms could focus on improving fairness through strengthening the taxation of liberal professions and starting the convergence of the tax regimes for offshore and onshore businesses. Broadening the base of the value-added tax remains another priority.

- The staff strongly welcome the measures recently taken to strengthen protection of the vulnerable from the loss of purchasing power. While transfers to the poorest households increased considerably in 2018 (an increase of 20 percent in January and an extension of the coverage of vulnerable families by 14 percent decided in June), the middle class experiences a significant reduction in real income due to price hikes for many items in the consumption basket, while wage increases remain below inflation and unemployment remains high. The staff urged the authorities to update household surveys to improve data needed to monitor the impact of macroeconomic adjustment on welfare.

12. ***The staff's indicative estimate of the size of Tunisia's grey or parallel economy would be informative.***

- The authorities agree that the informal sector has grown significantly in recent years and now constitutes a major part of the economy. There is, however, no generally accepted measure of the sector's size due to methodological issues and poor data availability. Estimates of its size typically range between 30-60 percent of total GDP. The staff carried out an analysis based on electricity usage in early 2018, which pointed to a share in total output of at least 30 percent.

13. ***Going forward, the authorities plan to complement spending restraint with greater revenue mobilization, including through the convergence of the "onshore" and***

"offshore" tax regimes. Could staff comment on this measure and its estimated fiscal impact?

- The convergence of the onshore and offshore regimes for corporate income tax has been a long-standing priority. The onshore/offshore regime involves an undesirable distortion in the tax code that encourages misdeclaration among firms. Together with investment incentives, it gives rise to significant tax expenditures (on the order of up to 2 percent of GDP based on a 2015 World Bank study) that may not be efficient as firms often quote factors other than taxation as key determinants of investment decisions.
- Convergence would include a gradual increase of taxation for offshore firms, in a first step from 10 percent to 15 percent; and a gradual decrease of taxation for onshore firms from 25 percent to 20 percent. Further steps could follow over time. The revenue impact would initially be negative, given the low base of offshore firms, many of which are exempted from taxation in the first place due to long grace periods. To compensate the initial negative impact, staff will discuss with the authorities' further revenue measures for 2019.

14. ***Could staff detail for which reasons the departure scheme gave little results so far?***

15. ***Given the less satisfactory outcome of the departure schemes so far, the plan might be overly ambitious, and the successful implementation would critically hinge on private sector job opportunities. The staff's comments are welcome.***

- The efforts in early 2018 suffered from (1) difficulties in ensuring that all civil servants had adequate information about the offered packages; and, more importantly (2) poor outside job opportunities. The authorities are confident that these challenges can better addressed going forward, including though training schemes and an improving outlook for private sector growth.

16. ***Could staff provide an update on the work of the FAD TA mission to find further options to rationalize public expenditures, including the wage bill and benefits packages?***

17. ***Controlling the wage bill has been challenging due to the lower-than-expected voluntary program. Could staff share other measures to rationalize the wage bill and any preliminary findings from FAD's TA on expenditure rationalizatio*****n?**

18. ***Given the remaining low interest of civil servants in voluntary departures, could staff elaborate on possible alternative measures to reduce the wage bill? The staff's comments on the interconnections between the restrictive hiring policy and the current high unemployment rate would also be appreciated.***

19. ***Have staff and the authorities considered alternative options to cut the wage bill?***

- The authorities' civil service strategy is based on three pillars: voluntary separations; strict hiring limits (only a 25 percent replacement rate in 2018 for natural attrition and a lower target in 2019; no replacement for volunteer departures); and the absence of new wage increases unless growth significantly surprises on the upside. Furthermore, the finalized functional reviews of the main ministries will facilitate redeployment of employees from areas of surplus to areas of shortages. The authorities are also considering a streamlining of benefits that could create room for additional savings, but this will take time given the complex nature of Tunisia's benefits regime for civil servants.

- The 2018 FAD TA mission pointed out further options to rationalize the wage bill over the medium term, which include: (1) aligning public sector compensation to that paid in the private sector and eliminating existing pay disparities across government employees; (2) strengthening the link between employee performance and pay compensation; and (3) eliminating duplications in governmental functions to support the reduction of headcount without undermining the delivery of public services.

- It is difficult to establish a clear link between public sector employment and overall unemployment; and most countries in the MENA region that employ a larger share of the workforce in the public sector have not achieved lower overall unemployment. These findings, discussed in a recent MCD departmental paper, casts doubts on a negative relationship, and show that higher public employment is not a long-term solution to reducing unemployment.

20. ***Given the fiscal measures outlined in the staff report, we are surprised that the authorities intend to grant wage increases in 2018, if growth surprises on the upside. The staff's views on the merits of using upside revenues in a more prudent way would be welcome.***

- The authorities' commitment has not changed since the Second Review, when the MEFP (EBS/18/17) describes their intention as "no further salary increases over 2018–20 unless growth substantially improves relative to baseline projections and provided the wage-bill-to-GDP ratio can be maintained on a downward trajectory towards 12.4 percent of GDP." The staff do not think that growth would improve beyond the baseline to an extent that would support wage increases; any fiscal space will likely need to be used to compensate for the higher-than-expected energy subsidy bill.

21. ***Could staff elaborate more on the potential magnitude of the contingent liabilities to the budget and the debt sustainability?***

- The bulk of contingent fiscal risks emanate from government guarantees (mostly to state-owned enterprises, SOEs) amounting to 12 percent of GDP and, to a lesser extent, from the social security system.

- Tunisia's public debt remains sustainable (see Debt Sustainability Analysis, EBS/18/17). Central government debt is expected to peak at 70.5 percent of GDP in 2018 (compared to an average 45 percent of GDP over 2010–14), before declining as a result of fiscal consolidation and higher growth. The debt level breaches the emerging market benchmark of 70 percent of GDP under the baseline, but Tunisia continues to benefit from long maturities and a stable creditor base with a high share of debt owed to international financial institutions and bilateral donors. Stress scenarios confirm the sustainability of debt, but identify risks from contingent liabilities and exchange rate depreciation, especially if combined with permanently lower growth. Strong policy implementation will be critical to mitigate these risks.

22. ***Can staff elaborate on the impact of further exchange rate depreciation on debt ratios?***

- The baseline scenario in the staff report assumes sustained exchange rate depreciation to eliminate the residual real overvaluation in 2019. The reported debt ratios are consistent with this scenario. The public debt ratio would decrease slightly in 2019 as the effect of strengthened GDP growth and a lower fiscal deficit dominate the impact of the depreciation; the increase in the external debt ratio would be contained to 2.5 percent of GDP. More broadly, however, the shock scenarios of the DSAs published in the documentation for the Second Review (EBS/18/17) show that a large real depreciation would have a significant impact on debt sustainability.

23. ***Could staff provide an update on the outlook for pension legislation?***

24. ***We also welcome the adoption of the first phase of the pension reform, although we note that a second phase with parametric modifications will be necessary. The staff's update on the planned calendar and issues at stake for this second phase are welcome.***

- The law to reform the public pension fund is now being transmitted to parliament. The authorities expect parliamentary passage by September 30, with retroactive effect from July. The reform decree for the private pension fund is expected to be signed by the Prime Minister after parliament passage of the law for the public pension fund. These efforts seek to increase contribution rates, change the indexation of pensions, and raise retirement age gradually. These first steps toward ensuring pension sustainability will need to be quickly followed by more ambitious parametric reforms. The authorities intend to start discussions on these with social partners by the fall.

Monetary and Exchange Rate Policies

25. ***Have staff advised any limits on the raising of policy rates?***

- The authorities and staff share the view that the policy interest rate should become positive in real terms to curb inflation. At current inflation levels, this implies a remaining gap of about 100 basis points. At the same time, both sides agreed that next steps with tightening should be data dependent based on inflation developments over the next months.

26. ***We note that interest rate hikes are having a limited effect on the Tunisian economy, so we wonder if there is scope to explore other types of measures operating through quantities rather than prices —e.g. reserve requirements, caps to CBT refinancing, etc.***

- The CBT and staff explored additional options. Increased reserve requirements would not limit credit growth in Tunisia's environment of structural liquidity shortages, but rather increase the liquidity needs of banks in the short run—which in part explains the recourse to central bank refinancing. CBT refinancing has been capped in nominal terms since July 2017 (at TD 7 billion) to direct residual demand towards more expensive refinancing options. However, this quantity cap has not prevented refinancing from reaching record-high levels.

- The authorities and staff believe that changing the price of central bank financing is the best way to fight inflation, ensure adequate liquidity, and improve financial intermediation, flanked by strong communication. There will be a continuous dialogue to react to inflation and credit trends in a timely way.

27. ***Could staff elaborate on the communication strategy the authorities would use to influence inflation expectations, given that core inflation is on an upward trend?***

- The authorities agree with staff on the need to move to a more systematic communications strategy, with upgraded regular reporting on recent inflation trends and the macroeconomic outlook. As in other developing economies, this communication could take the form of published monetary policy and inflation reports or more frequent press releases summarizing the views of the monetary policy council. The staff also emphasized vis-à-vis the authorities the benefits of regularly conducting surveys of inflation expectations as a basis for policy-making.

28. ***Achieving increased exchange rate flexibility through a more competitive auction mechanism is a structural benchmark (SB). However, we note authorities' view that a more competitive process may require larger FX interventions to smooth exchange rate movements and suggest a gradual approach. The staff have suggested that TA support could work on the auction mechanism. We would be interested to know if such a request was made by authorities and if not, whether this would impact on achieving the SB?***

- The authorities have made an oral request to staff at the time of the last mission and we expect them to formally follow-up with a written request in the next weeks, in accordance with the intentions stated in the MEFP.

Financial Sector Policies

29. ***The staff's comments on the status of correspondent banking relationships is welcome.***

- Commercial banks and the central bank did not report any obstacles to international transactions due to issues with Tunisia's AML/CFT regime or any loss in relationship status linked to the FATF and EU listing. To mitigate any increased pressures on correspondent banking relationships, the authorities' efforts to strengthen the AML/CFT regime in line with international standards needs to be sustained.

Structural Reforms

30. ***We welcome staff comments on labor market reforms and the strategy to integrate women and youth and graduates in labor market participation.***

- The authorities and staff concurred that labor market reform should receive more attention, including measures to reduce skill mismatches and strengthen incentives to hire into formal sector jobs. The authorities confirmed that the national employment strategy will be the vehicle to advance this agenda over the next three years. A milestone of this strategy was the adoption of the start-up act in February, which facilitates job creation in the Information and Technology sector that will particularly benefit young job seekers.

31. ***On staff's recommendation to advance the operationalization of the High Anti-Corruption Authority, we would appreciate more detailed information on the envisioned institution, including its mandate, sources of financing, and procedures of appointing its management and staff.***

- The High Anti-Corruption and Good Governance Authority will replace a temporary institution that performs preventive work on corruption awareness, but also investigates specific corruption cases. It will be funded directly from the central government budget. parliament will appoint its Board, following a transparent and competitive selection process. The Board will appoint the senior management of the Authority, who will in turn select its employees through open recruitment.

Fund/Program Issues

32. ***With some concern, we take note that the Fund's financing share will increase markedly in 2019, to well over 30 percent, while the support from other multilateral or bilateral sources is projected to drop. Moreover, the stock of Fund credit will increase to close to 40 percent of gross reserves in 2020. Against this background, could staff provide additional background, including an outlook on the potential for additional financing sources / assurances over the medium term?***

- The conservatively projected outlook for multilateral financing partially reflects challenges among several IFIs regarding their headroom for further lending given current risk exposure to Tunisia and/or the region. At the same time, some bilateral donors are increasing lending to Tunisia, notably the KfW. The outlook underscores the need for continued strong donor coordination and sustained strong implementation of policies and reforms to maintain macroeconomic stability as a prerequisite of adequate market access.

33. ***For this review, the authorities are not only requesting waivers of applicability but also request the revision of quantitative targets for end-June 2018 at the same time. Could staff provide additional information on why the revision is deemed necessary?***

- The revision is suggested to adjust end-June targets for realized outturns up to March, without changing qualitatively the level of ambition for the end-June targets.

34. ***Could staff provide a further insight on the feasibility of achieving the near-term program objectives, given the recent divisions within the governing coalition?***

- The main counterparts for the Fund have remained in power and are firmly committed to the program, notwithstanding recent disputes among the parties represented in the unity government. Strengthened commitment has been demonstrated recently by several difficult policy actions, notably energy price hikes, the adoption by the Council of Ministers of the pension reform law, and the adoption by parliament of laws in support of public banks' restructuring of non-performing loans.

35. ***We would like to emphasize our concerns on the repeated use of waivers and resetting of timelines. We wonder how much of this is due to the fragilities of the system and how much stems from setting of performance criteria and structural benchmarks that are based on an over-optimistic assessment of the broader political and social situation. This, when seen with the political opposition to the reforms under the EFF, undermines the impression of an IMF program that is well planned, well implemented and promotes socially balanced reforms. Instead, we see continuous course correction and persisting hardships. We welcome staff comments on this.***

- The waiver of applicability for end-June targets became necessary as the Board meeting had to be scheduled in July rather than in June because of the change in the timeline of structural reforms partly reflects challenges with parliament consideration of draft laws because of a large backlog on the legislative agenda. Program design has responded to this issue by avoiding new Structural Benchmarks on items requiring parliamentary approval. Progress was stronger than in the past on other SBs. The staff are aware that reform progress will remain a challenge in the difficult socio-political environment, but remains confident that the recently improved momentum can be sustained in the context of a strengthening recovery.

36. ***Program risks remain exceptionally high and Tunisia continues to depend on strong engagement by its international partners and the grants or highly concessional loans to cover Tunisia's financing needs (about US$3.7 billion in budget support in the three remaining quarters of 2018). Could staff offer their assessment on meeting this target and the impact of these not fully materializing?***

- The World Bank's successful consideration of a DPL in June as well as financing assurances by the European Union and Tunisia's other official partners will cover a significant share of the remaining financing needs for 2018, together with the programmed Fund disbursements. In addition, the authorities have started preparations for a large Eurobond issuance, which will be followed by a second one at the end of the year. If the costs of accessing international debt markets became prohibitively expensive, the authorities could resort to eliminating contingent spending and delay the execution of lower-priority public investment.