Republic of Tunisia – Integration and Competitiveness Development Policy Loan

(Loan Number 76960)

Second Tranche Release Document

November 1, 2010

Recommendation

1. This memorandum summarizes progress in the implementation of the policy-based operation in support of Tunisia's integration and competitiveness reforms. The memorandum focuses on the actions taken by the government of Tunisia to meet the specific conditions of the second tranche release of the Integration and Competitiveness Development Policy Loan (ICDPL). The Government of Tunisia has made satisfactory progress overall in implementing the program supported by the Loan as set forth in its Letter of Development Policy dated February 17, 2009, and has fully met nine out of ten conditions of second tranche release actions. One condition, namely that "the Central Bank of Tunisia shall publish statistics for 2010 that shall show a decrease in the rate of non-performing loans to fifteen percent (15 percent), and an increase in provisioning of non-performing loans to seventy percent (70 percent) is partially met. Indeed, while the rate of non-performing loans has been brought down to 12.7 percent in June 2010, surpassing the program's target, the increase in provisioning of non-performing loan reached 58 percent, below the ambitious target of 70 percent.

2. In recommending the release of the second tranche, the Task Team agrees with the Government's request to waive the above condition. A more difficult environment linked to the global crisis largely explains that non-performing loans (NPL) provisioning levels do not yet meet the prudent 70% target set by the Program. The Tunisian authorities have indicated that the soundness of the banking sector has significantly improved in the period covered by the Program (lower and better provisioned NPLs, as well as higher profitability and capital adequacy) and announced their intention to pursue their efforts to meet the 70% target as soon as conditions permit.

Background

3. The Board approved the two-tranche ICLDPL in the amount of US$250 million on March 24, 2009. Following the Board approval, the Loan Agreement was signed on April 11, 2009 by the Borrower and the International Bank for Development and Reconstruction (IBRD). The Loan was declared effective August 11, 2009 with the first tranche of US$125 million being released upon effectiveness.

4. The ICDPL supports the key strategic elements of Tunisia's 11th National Development Plan (2007-11) which seeks to strengthen growth and ensure that this growth is translated

into employment. It is also a cornerstone the Country Assistance Strategy Progress Report (2007) that set out an indicative program for FY09-10. The main thrust of the program is to continue growth-enhancing reforms anchored around a deeper integration of Tunisia into the global economy. The ICL aims also to assist the Government in responding to the global financial crisis by accelerating reforms, sending a strong signal to investors and mitigating recession contagion risks in the coming years.

5. More specifically, the ICDPL's objective are to: (i) reduce trade transaction costs and deepen Tunisia's global economic integration; this involves both the move to a more global (i.e., non-preferential) integration and a deepening of the Association Agreement (AA) with the European Union to converge to EU safety and security norms and standards; (ii) further improve the business climate to enhance competitiveness of Tunisian firms, including services and; (iii) enhance the development of the financial sector to increase its capacity to finance private investment. By supporting reforms in these areas, the program aims to boost growth and maintain macroeconomic stability. It also contributes to the Government's structural reform in response to increased global competition and reduced trade protection, and to further a transition to an economy based on knowledge, innovation and diversification.

6. By February 2009, the Government of Tunisia has, as part of the prior actions for the first tranche release (i) revised the Customs tariff regime by reducing the number of Customs tariff rates from 9 to 6, including the tariff rate "zero"; (ii) adopted a draft law related to standards and quality norms applicable to all products imported or utilized in Tunisia, consistent with international best practices; (iii) adopted a draft Decree to mandate the National Council of Services (NCS) to prepare a strategy for services development, formalize the creation of thematic commissions within NCS, strengthen the role of the Permanent Secretariat of the NCS through the establishment of a performance-based budgeting unit; (iv) adopted a draft law amending the Urban and Regional Development Code (Code de l'aménagement du territoire et de l'urbanisme), in order to reduce the time necessary for businesses to acquire industrial land; (v) adopted a draft Law in order to ensure an effective updating of the information contained in the Registry of Commerce and (vi) changed the law regarding venture capital companies (Sociétés d'Investissement à Capital Risque), and mutual venture funds (Fonds Communs de Placement à risque), in order to (a) encourage venture capital companies' risk taking by eliminating pre-determined exit conditions and base exit from financed projects on the performance of the venture capital company at the time of the exit, (b) simplify taxation of venture capital companies; (c) encourage venture capital companies to invest in regional development areas and; (d) eliminate the requirement that mutual venture funds must liberate the totality of the subscribed funds in order to benefit from tax exemption.

7. The design and implementation of the ICDPL was strongly affected by the global crisis which hit Tunisia in the early stages of preparation of this program. By December 2008, it had become evident that the real economy could not escape the effects of the emerging recession in Europe. Growth in the volume of exports declined sharply in the second semester to 1.5 percent (against 14 percent in 2007). This triggered a swift government response. A series of "Presidential Measures" were announced following a Cabinet meeting on December 23, 2008. These included both emergency measures aimed at assisting exporting firms already adversely affected by the slowdown in Europe and measures to be implemented in 2009 and 2010, discussed with the Bank, the EU and the AFDB and contained in the matrix of this ICDPL program. The emergency measures included: (i) a subsidy of 50 percent of the employer's cost of social security for firms witnessing a dramatic fall in exports to Europe; (ii) a subsidy of 100 percent of the employer's cost of social security for firms that had to stop production and run down stocks; (iii) a subsidy of 50 percent of the cost of export insurance.

Recent macroeconomic performance and medium-term macroeconomic framework

8. Leveraging the benefits of the reform program and sound macroeconomic policies implemented in recent years, the Tunisian authorities were able to mitigate the impact of the worsening of the international environment, which was particularly acute among Tunisia's main trading partners, and strengthen growth in the first half of 2010. The economy slowed down significantly to at 3.1 percent (against 6.3 percent in 2008) but a contraction was avoided. Strong growth in agriculture and steady expansion in public and commerc[ia]l services more than offset a contraction in manufacturing induced by a slump in nominal exports (- 22 percent). Consumer price inflation slowed to an estimated 3.7 percent mainly due to a decline in food and energy prices. The decline in international prices of food and energy, combined with increased tourism receipts and workers' remittances helped narrow the current account deficit to 2.8 percent against 4.2 percent in 2008. Despite a considerable fall in FDI during 2009 (-32 percent), Tunisia remained in a solid external position, with comfortable reserves level of US$ 9.8 bn (around 5.5 months of imports) thanks to a 43 percent increase in public and private overseas borrowing.

9. The fiscal deficit increased to 3 percent in 2009, from a marked improvement in the fiscal position in 2008 when it stood at 1 percent of GDP. The comfortable fiscal position of 2008 allowed Tunisia to respond adequately to the crisis with a fiscal stimulus package (1.4 percent of GDP), while maintaining fiscal prudence. The overall fiscal deficit (excluding grants and privatization receipts) rose by 2 percentage points of GDP, and was financed almost entirely from domestic sources (external budgetary grants remained stable at 0.3 percent of GDP). Public investment increased by 20.5 percent during the year both fiscal revenues and subsidies expenses declined (respectively by 3 percent and - 25 percent) during 2009 (subsidies and transfers dropped from 5 percent to 3.7 percent of

GDP). Despite the widening fiscal deficit, the public debt ratio continued to fall in 2009 from 43.3 percent of GDP in 2008 to 42.8 percent of GDP in 2009.

10. Real growth was driven by the upturn in demand for manufacturing sector exports, especially mechanical and electrical goods (+35 percent in the first 7 months of 2010 with respect to the same period in 2009) and, to less extent, textiles (+5 percent). This increase was only partially offset by the slowdown in agricultural sectors (-2 percent in monthly exports between July 2010 and the same month in 2009). Domestic demand was sustained by persistently buoyant consumption fuelled by the steady rise in per capita income. Growth can be expected to be supported by a recovery of industrial activity (industrial production expanded by 7.3 percent in the first half of 2010 compared with a contraction of 4.3 percent in the same period of 2009) and investment (particularly in construction and infrastructure projects).

11. The current account deficit has worsened in the first semester of 2010, as growth in imports outpaced exports, and remittances from Tunisians abroad and tourism revenues stagnated. Despite an 8 percent increase in foreign direct investment (FDI) relative to the same period in 2009, international reserves have declined but remain comfortable at around US$9 billion at end-May 2010. Inflation rose back to its 2008 level (5 percent year-on-year) as a result of rising commodities prices (food and crude oil). The current account deficit, which had narrowed in 2009, widened again considerably in early 2010 (-3.8% in the first 6 months of 2010) following deterioration in the trade balance and stagnating tourism revenues.

12. The Tunisian financial sector has been largely spared from the global financial crisis. Credit to the economy has held steady, thanks to the ongoing strength of deposit mobilization at banks, and the Tunis stock exchange continues to record exceptional growth. In addition, the authorities have pursued their long-term strategy for restructuring the banking sector, which has lead the rate of nonperforming loans (NPL) as a percentage of total loans to decline from 15.5 percent in 2008 to 13.2 percent in 2009 and the provisioning rate to raise from 56.8 percent in 2008 to 58 percent in 2009.

13. The IMF's recent article IV report supports the government's fiscal and monetary policy stance in 2010, which are designed to maintain macroeconomic stability while providing further support for economic activity and maintaining the room for maneuver needed to address the risks associated with the international environment. On this basis, the target of 3.8 percent GDP growth in 2010 may be achieved, provided that there are no further delayed repercussions from the global crisis.

14. Tunisia's macroeconomic medium-term outlook and prospects rests on government's strategy for fiscal consolidation, the Central Bank's vigilance towards inflation, pursuit of structural reforms and remaining risks in the global economy. Table1 reflects the government's policy stance in the years leading to 2013. With gradual economic recovery in Europe, the need to maintain the fiscal stimulus will fade and the authorities intend to revert to fiscal consolidation as of 2011 as they seek to quicken the decline in the rate of public indebtedness and maintain room for maneuver if necessary. This approach will rely on control of current fiscal spending, particularly through reform of the social security system to ensure the financial sustainability of the pension funds. The fiscal deficit is expected to decline to about 2.8 percent of GDP in 2011 thanks to the above policies and more vigorous growth (4.8 percent). Both the current account balance and foreign direct inflows are expected to improve.

15. To avoid a resurgence of inflationary pressures (partly from a rise in international commodity prices) and preserve macroeconomic stability, the Central Bank of Tunisia has indicated its intention to adopt a vigilant monetary policy. At the same time, further gradual liberalization of the Tunisian economy—with the goal of achieving convertibility for the dinar by 2014—will continue to create a sound environment conducive to private investment. Tunisia is also taking further steps to improve the business climate, in particular by simplifying customs procedures and creating better infrastructures with a view to promoting investment, innovation and international trade. The World Bank supports these efforts through an Integration and Competitiveness DPL II and a Third Export Development Project.

16. Risks to the outlook are related to the significant downside risks to growth in Tunisia's European partners, entailing a possible escalation of financial stress and contagion and a more severe impact than currently expected of the planned fiscal consolidation on still-weak domestic demand. The strength of the recovery in Europe will determine to a large extent the pace of Tunisian exports growth, tourism receipts and remittances. On the other hand, the recent depreciation of the euro could boost exports of the euro area, and could benefit Tunisian exports in sectors such as electrical and mechanical industries. The medium-term outlook is subject to similar risks, with Tunisia's traditional partners expected to be a less buoyant source of external demand than prior to the crisis.

Table 1: Key Medium-Term Macro Indicators

	2008	2009	2010	2011	2012	2013
	actual		(est.)	(proj)	(proj)	(proj)
Real GDP (% growth)	4.5	3.1	3.8	4.8	5.0	5.6
Consumer price index (CPI), average (% growth)	5.0	3.7	4.8	3.5	3.3	3.1
Gross National Savings (in percent of GDP)	22.1	21.8	23.1	23.3	24.0	24.4
Gross investment (in percent of GDP)	25.9	24.8	27.6	27.4	27.8	27.8
Export of goods, f.o.b (volume), (% growth)	6.9	1.2	3.6	2.9	2.5	3.1
Trade balance (in percent of GDP)	-8.9	-8.5	-10.9	-10.4	-10.0	-9.7
Current account (in percent of GDP)	-3.8	-2.9	-4.5	-4.1	-3.7	-3.3
Foreign direct investment (percent of GDP)	5.7	3.3	3.3	3.9	4.0	4.0
Terms of trade (deterioration-)	0.8	8	-4.1	1.3	0.1	0.4
Central government balance, excluding grants and privatization 1/	-1.0	-3.0	-3.0	-2.8	-2.6	-2.5
Central government balance, including grants, excl. privatization 1/	-0.7	-2.7	-2.9	-2.5	-2.4	-2.4
Total government debt (foreign and domestic), (percent of GDP)	43.3	42.8	43.1	42.7	42.3	41.6
Gross officials reserves (US$ billions,e.o.p)	9.0	10.6	10.1	10.6	11.2	11.9
In months of imports of goods and services, c.i.f 2/	44.4	6.7	6.0	6.1	6.1	6.2
External debt (US$ billions)	20.6	21.4	19.9	20.2	20.3	20.4
External debt (in percent of GDP)	48.8	48.1	47.9	46.4	44.4	42.2
Debt service ratio (percent of exports of GNFS)	8.6	11.9	10.7	11.6	10.5	9.6

Sources: Tunisian authorities; and staff estimates and projections

1/ Excludes the social security accounts.

2/ End of year reserves over current year imports of goods and services

Progress on ICDPL Second Tranche Release Actions

17. The Government of Tunisia has made satisfactory progress in implementing the ICDPL. Out of the ten actions listed in the Loan Agreement as second tranche release conditions, nine and a half have been implemented satisfactorily according to the task team. Here is a summary.

18. **Condition 1**. *The Borrower's budget law for 2010 which shall revise the Customs tariff regime by reducing the number of Customs tariff rates from 6 to 5, including the tariff rate "zero", shall be enacted.* **This action is considered met**. The enacted 2010 Budget Law has indeed reduced the number of rate from 6 to 5. At the same time, the 7 percent rate that applies on pharmaceutical products has been replaced by a zero rate. As a result of these changes, Tunisia's average tariff rate at 6 digit of the Harmonized System was brought down to 16.6 percent in 2010, from 18.6 percent in 2009.

19. **Condition 2.** *The Ministry of Commerce shall put in place a system of selective management of imports control based on the risks presented by the imported products and the importers in order to allow speedier controls for non-risks products and importers.* **This action is considered met.** Following a decree signed by the President that indicates that selectivity is the guiding principle for controls, the task team has had the chance to comment on a Ministry of Commerce's draft arrête aimed at indicating precisely the new selectivity-driven control procedures that Ministries and Agencies should now use for import controls. The revised draft took full account of the task team comments. The new text. The arrête has been published in the Journal Officiel (Gazette) under the reference JORT n° 76 dated November 1, 2010.

20. **Condition 3**. *The Customs Authorities and the Rades Port Authorities shall make the first one-stop trade control procedures office (guichet unique) at Rades Port operational and the Ministry of Transport shall make the electronic platform (liasse transport) which shall connect all operators in the transport chain operational.* **This action is considered met**. The one-stop trade control procedures office is operational since July 2009 and is conveniently located in the Rades Port, Tunisia's largest port, which handle 90 percent of national merchandise container traffic and 22 percent of total maritime traffic. Banks, technical control services, customs and other institutions involved in imports and exports are all represented in the one-stop trade office. The electronic platform for trade documents ("liasse de transport") that electronically interconnects maritime agents, the Port authority (Office de la Marine Marchande), customs, freight forwarders, trade intermediaries, etc. is also fully operational since January 2010. Now document transmission and approval of about 80 percent of maritime transactions are undertaken through this platform.

21. **Condition 4**. *The Inter-Ministerial Council shall adopt an action plan to reform the regulatory framework of the services sectors, to be prepared on the basis of a regulatory assessment to be carried out by NCS.* **This action is considered met**. The Inter-Ministerial Council adopted in August 19, 2010 the action plan for the reform of the regulatory framework of services sectors as as attested by the Letter to the World Bank country director sent by the Legal counsel of the Tunisia Government on August 26, 2010. The action plan is based on a satisfactory study and the reforms included in the action plan reflect it.

22. **Condition 5**. *The Prime Minister shall sign an executive order (arrêté) reducing by half the number of activities where operators are required to obtain a prior authorization in order to start their businesses.* **This action is considered met**. In 2008 (baseline), prior authorization was required to operate in 95 sectors. Following the elimination of prior

authorization requirement in 2009 and the first semester of 2010, by July 2010, prior authorization was required in only in 48 sectors.

23. **Condition 6**. *The Inter-Ministerial Council shall adopt an action plan for the establishment of a unique common identification number for businesses to be used by the National Statistics Institute, the tax authorities and the social security authorities, based on a feasibility study to be conducted with the support of the Bank.* **This action is considered met**. The Bank study was undertaken and presented to the authority in March 2010. Following various interactions between the involved technical department and the Bank team, the action plan was drafted in August 2010 and adopted by the Inter-Ministerial Council on August, 24 2010 as attested by the Letter to the World Bank country director sent by the Legal counsel of the Tunisia Government on August 26, 2010.

24. **Condition 7**. *The Competition Council shall be requested by the relevant sector Ministries to conduct a regulatory and competition assessment of businesses in two new sectors within the services sector*. **This action is considered met**. In 2009, regulatory and competition assessments of businesses were realized by the Competition Council upon request in 5 services sectors (assurance, pesticide distribution, seeds distribution, livestock food distribution, microelectronic and small retail shops). The Competition Council has also shared with the task team its regulatory and competition assessments in 3 additional services sectors realized in 2010 (public transportation, professional services and audiovisual sector).

25. **Condition 8**. *The Central Bank of Tunisia shall publish statistics for 2010 that shall show a decrease in the rate of non-performing loans to fifteen percent (15%), and an increase in provisioning of non-performing loans to seventy percent (70%).* **This action is partially met.** A waiver is requested. The soundness of the banking sector has significantly improved with lower and better provisioned non performing loans (NPLs) as well as higher profitability and capital adequacy. NPL ratios declined to 13.2% in December 2009 and 12.7% in June 2010, well below the 15% target. However, NPLs were only covered by specific provisions up to 58.3% at the end of 2009 (latest data available), below the 70% target. The Central bank (BCT) indicated that although all banks complied with provisioning requirements for individual loans, this did not translate in four cases in overall provisioning levels meeting the prudent 70% target. In a more difficult environment, the BCT indicated that this target was unlikely to be met in the short term. The global crisis has indeed led to a slowdown in economic growth in Tunisia which affects banks' profitability and ability to constitute additional buffer to cover NPLs. The BCT also emphasized that the Tunisian authorities remained committed to

meeting this target when conditions normalize, as evidenced by objectives set in the 2009 Presidential program (NPL ratios below 7% and provisioning rate above 70% buy 2014).

26. **Condition 9**. *The Stock Market shall publish its annual reports that shall show an increase of the stock market capitalization to at least twenty percent (20%) of the Borrower's Gross Domestic Product, due in particular to the increased number of privatizations implemented through the stock market.* **This action is considered met**. The Stock Market capitalization reached 22.9 percent in 2009 against 16.5 percent in 2008. By July 2010, the stock market capitalization witnessed an increase of 17 percent (year-on-year) indicating further improvement. While in 2009 privatizations played a minor role in boosting the stock market capitalization (growth was driven by an increase in the value of listed firms and the creation of two new investment funds), in 2010, 3 public companies were privatized via the stock market.

27. **Condition 10**. *The Borrower shall adopt institutional and regulatory provisions in order to improve the performance of the Borrower's micro-finance market, to be adopted on the basis of a study to be carried out by the Ministry of Finance.* **This action is considered met**. Based on a study completed by the Ministry of Finance in May 2010, a satisfactory action plan containing institutional and regulatory reforms of the microfinance market was adopted by the Inter-Ministerial Council. Importantly, the action plan includes a provision to modify by the end of 2010 the arête of the Minister of Finance that so far has imposed a low interest rate ceiling on micro-finance companies (with the exception of one NGO that obtained a waiver) except for micro-finance institutions that receive public (Treasury) money. This particular measure is a major step toward fully liberalizing entry into the micro-finance sector (the low interest rate ceiling acted as a barrier to entry).