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# ERF Policy Brief

## Debt and Stabilization in Tunisia: Building Resilience and Avoiding the Austerity Trap

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## In a nutshell

*Tunisia has been facing major disequilibria in its public finances. To stabilize its debt and foster a growth approach, Tunisian policymakers should:*

- *Refrain from adopting an approach that relies entirely on austerity, as this is likely to generate social resistance that undermines adjustment and further harms the growth process.*
- *Break away from the fundamentalist approach of austerity that penalizes potential growth and collective well-being.*
- *Develop a national program for adjustment and recovery that places greater importance on restarting the growth process.*
- *Elicit citizen support for reforms and build a coalition for change to guarantee the implementation of reforms without running the risk of a rise in social and political instability.*
- *Include climate change challenges in this national program by greening monetary and fiscal policy and strengthening research and development efforts to boost the circular economy.*

## Introduction

The Tunisian economy has been facing a major macroeconomic disequilibrium in public finance since the revolution. Public finance has been tightening, with a rising risk of public debt unsustainability. The fastest and largest increase in the debt-to-GDP ratio, which was driven by external debt, took place from 2010 to 2019. While the pace of the increase of the total public debt ratio has slowed down significantly since 2019, that of domestic debt has increased considerably. Tunisia has been increasingly relying on external short-term debt, and public debt has been the main driver of external debt. Several elements could trigger lower levels of future growth, such as the decrease in investment, capital accumulation, and labor force, along with the weak governance in the country. Furthermore, other risks are looming. For instance, the COVID-19 pandemic and prevailing political uncertainty have weighed on Tunisia's economic activity in recent years. The country faces major hurdles in raising external funding, and internal divides have caused delays in mobilizing the necessary resources.

This is even more important when the four main drivers of unsustainability are in eruption (Sarangi, 2021; Labidi, 2022), which is the present case. There was an increasing primary deficit reaching 4.3 percent of GDP in 2022; the widening current account deficit reached around 7.9 percent of GDP in 2022; the decline in foreign exchange reserves led to downward pressure on the domestic currency; and the IMF foresees an anemic growth of nearly 1.3 percent in 2023. Furthermore, there is a deterioration in the interest rate and growth differential (IRGDs), where the average interest rate on the Tunisian debt exceeds the growth rate, mainly because of the rise in the interest rate under the threat of inflation and the tightening of monetary policies.

In our paper (Baghdadi and Labidi, 2023), we use debt sustainability scenarios (DSA) to construct three hypothetical scenarios (A, B, and C) over the period 2023-27. DSAs allow for the assessment of debt sustainability at the end of the considered period. The first two scenarios are called 'business as usual approaches' as we assume that they will be similar to past experiences. In Scenario A, we assume that Tunisia will continue down the same path of the past three years, without an IMF agreement. In Scenario B, Tunisia reaches an agreement with the IMF; however, the lack of considerable progress on the reform agenda causes the ending of the IMF agreement. Finally, Scenario C is a proactive reform scenario.

## DSA Scenarios: A Business-as-Usual Approach

Since 2019, mobilizing external financing resources has proven increasingly difficult for several reasons, including the downgrading of the sovereign rating of Tunisia, the delay in concluding a new program with the IMF, and the delay in the implementation of reforms.

Project financing averaged 20 percent of external borrowing during 2020-22. It is a steady but small source of finance, at around USD 400 million per year. Access to the international financial market stopped in 2019 and its return is dependent on a credible IMF program and the confidence of the markets.

### *Scenario A: Baseline scenario without an agreement with the IMF*

In Scenario A, we assume that Tunisia will continue down the same path of the last three years (i.e., without an IMF agreement). This means that external financing will be extremely tight, with access to only average projected and targeted finance. We assume that budget finance will tighten because of the failure of an IMF deal. In addition, we assume limited budget finance from multilateral and bilateral sources.

This scenario would lead to a debt-to-GDP ratio of 111.5 percent in 2027, putting the country's public debt on an unsustainable path. In addition, the currency crisis would lead to major risks beginning in 2024, such as:

- The deindustrialization and destruction of productive capacities.
- Social instability due to the increase in unemployment and poverty.
- Proliferation of the informal sector.
- Deterioration of the financial situation of public enterprises.
- High exposure of banks to sovereign risk.
- Acute cash flow difficulties and recourse to disorderly adjustments at the level of the budget (salary cuts, increase in the prices of subsidized products…etc.).

### *Scenario B: Scenario with an IMF agreement*

In this scenario, we assume that there is an IMF deal. However, the reforms register slow progress, which leads to the breakdown of the IMF agreement after two years, which is what happened in the Extended Fund Facility Agreement. Therefore, we assume that we will go back to Scenario A starting from 2025. This means that external financing would no longer be available from 2025 to 2027. The main source of financing would be domestic, following the hypothesis in Scenario A. There would be no major reforms and productivity growth would remain low.

Scenario B is not ambitious, with low growth rates starting at 1.5 percent in 2023 but increasing over the years until it reaches 1.8 percent in 2027. The inflation rate in this scenario ranges from 11.5 percent to eight percent in 2027. The depreciation of the exchange rate goes down from 8.6 percent in 2023 to six percent in 2027. This scenario implies an overall increase in the ratio of public debt to GDP during the period, going from 83.2 percent to 94.9 percent. The rising level of this ratio highlights the risks of such a scenario and the unsustainability of the public debt if Tunisia walks down this path.

The non-conclusion of the first reviews with the IMF in 2023 (before the end of the program) would result in the hardening of donors' positions and the revision of budget support funding. The delay in implementing the announced reforms as envisioned in the scenario will fuel resistance to these reforms. In addition, the recourse to domestic financing to compensate for the absence of external resources during the last three years would be increasingly difficult. In addition, the same risks of Scenario A would prevail.

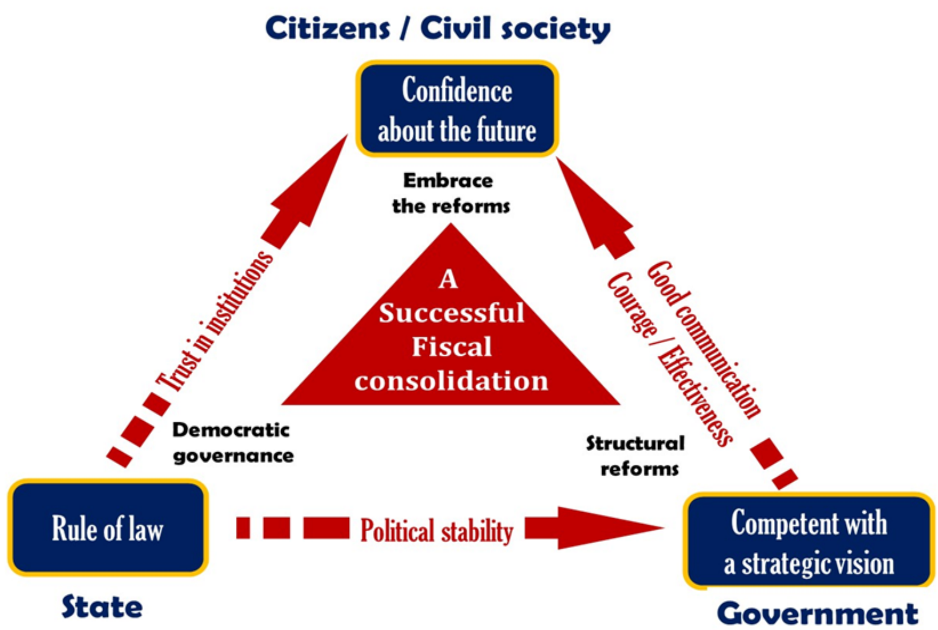
Considering the above analysis, continuing to rely on a business-as-usual approach (Scenarios A and B) cannot guarantee economic resilience or debt sustainability. We argue that there is a need for a broader approach to debt sustainability with reforms that would lead to resilience toward economic and non-economic shocks, such as climate change and pandemic crises (Labidi, 2022).

## DSAs: Toward a Novel Approach to Reform

Scenario C aims to break away from the accounting approach of fiscal consolidation, which continues to dominate the IMF's work and recommendations, The consolidation of public finances is essential to restore debt sustainability. However, an overemphasis on fiscal balances reinforces resilience only to economic shocks. As such, the economy is not able to resist the economic implications of social, pandemic, and environmental risks (Maldonado and Gallacher, 2022).

The dominant approach often offers a macroeconomic budgetary framework that relies on cutting investment spending as an adjustment variable to close a budget year. However, this approach has proven inadequate for the Tunisian economy, as shown by the suspension of two programs with the IMF (Stand-By Agreement 2013-16 and Extended Fund Facility Agreement 2016-20) and the inability to find common ground to conclude a third agreement. Several reasons explain these

*Figure 1. Prerequisites for a Dynamic Reform Process*




*Source: Authors.*

failures and highlight the challenges to the successful implementation of reforms: (i) the democratic transition and its cycle of political and social instability; (ii) strong resistance to reform nurtured by the climate of freedom and amateurism of the political class; and, finally, (iii) a lack of resilience to non-economic shocks. In its struggle to regain comfortable fiscal space, the Tunisian economy fails to mitigate the risks of climate change and pandemic crises.

Scenario C needs some prerequisites for triggering a dynamic reform process. The first condition is to find the optimal balance between austerity and growth. Tunisia has been struggling for several years to find the right balance between accountable fiscal austerity and a macroeconomic stabilization policy crowned by an economic recovery in the medium and long term. This struggle highlights the complexity of balancing fiscal austerity and more in-depth reform. Second, three pillars are required to split from the "accounting approach" of the fiscal consolidation and trigger a dynamic reform process: the soundness of the rule of law, a government with a vision for a sustainable future, and broad popular support for the structural reforms.

Tunisia needs a new contract to be part of a reform dynamic (Loewe and Albrecht, 2022). An open dialogue is needed to frame such a contract in the presence of various stakeholders without being exclusive to the most important organizations as was the case with the National Dialogue in 2013. This contract is unlikely to emerge in a context undermined by a lack of confidence. The current challenge of the new social contract is twofold: political and economic. At the political level, the challenge will be to avoid the trap of populism and successfully restore the democratic transition. At the economic level, the challenge will be to avoid the risks of being pushed into defaults on payment and set the country on the path of economic reforms. Hence, it gives priority to economic issues.

Under this scenario, we assume growth-enhancing policies, a sustained increase in productivity and investment, and less constrained growth on public expenditures. This scenario is based on the adoption of a structural reform package with an impact on growth (direct and indirect) and on the promotion of medium- and long-term sustainability. The goal is to restore confidence, improve public service performance, ensure energy and food security, and the right conditions for a return to strong and inclusive growth, thereby making the Tunisian economy more resilient (Figure 2). To achieve these objectives, government action involves four instruments: fiscal policy, monetary policy, innovation, and regulations and laws.

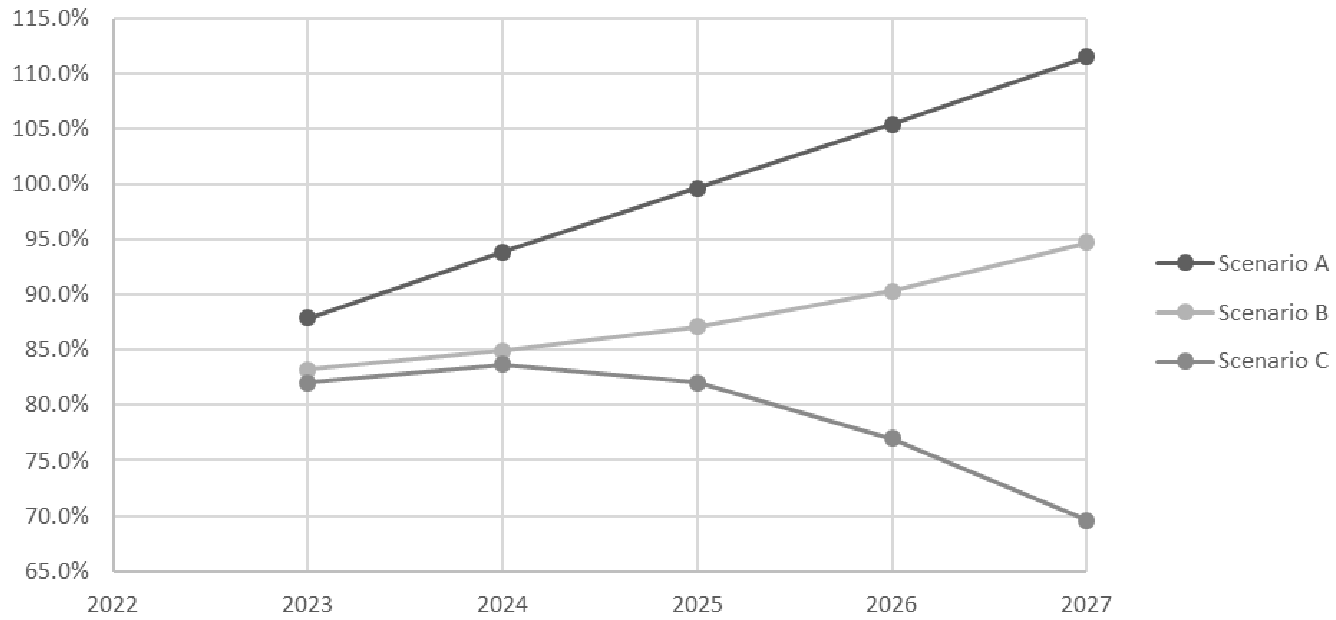
Scenario C, which refers to the adoption of a proactive, coherent, and holistic reform program with an assumed political portage and a broad consensus, would lead to a higher level of growth with a rate of 7.9 percent by 2027, and it would guarantee sustainability in the medium and long term.

*Figure 2. Impact of Reforms*

| Reforms | Winners (+) / Losers (-) | | | Impact on growth | | Impact on the budget | |
|---|---|---|---|---|---|---|---|
| | Households | Unions | Firms | Immediate | Delayed | Revenues | Expenditures |
| **Restore confidence** | | | | | | | |
| •Restoring the rule of law | + | + | + | | + | + | |
| •Fair and equitable tax system | ++ | + | +/- | | + | +/- | |
| •An agile administration | + | | +/- | + | + | + | - |
| •Fair competition | + | +/- | + | + | + | + | |
| •Renew the Exchange Control Regulation Act | + | | + | | + | + | |
| **Improve the quality of public services** | | | | | | | |
| •Strengthening good governance in SOEs | + | - | + | | + | + | - |
| •Promoting a shift towards sustainable and connected city | + | + | | | + | + | - |
| **Energy and environmental security** | | | | | | | |
| •Greening fiscal policy | +/- | +/- | +/- | | + | + | +/- |
| •Greening monetary policy and Banking supervision | | | +/- | | + | + | |
| •Strengthening good governance in the hydrocarbon sector | | - | + | | + | | |
| •Accelerating renewable projects through PPP | + | - | + | + | ++ | + | |
| **Food security** | | | | | | | |
| •Accelerating seawater desalination projects | + | | + | | ++ | + | |
| •Enhancing resilience of the agriculture sector to climate change | + | | + | | + | + | |

*Source: Authors.*

*Figure 3. Public Debt % GDP, 2023-27*




The key findings relate to stabilizing the inflation trend at manageable levels close to the long-term average. This is in addition to the improving the status of public finances along with a firm forecast that public investment would rise between 2023 and 2027.

A positive primary balance of 0.8 percent of GDP in 2026 and 3.2 percent in 2027, as well as a reduction in the pressure on cash management due to the mobilization of the required funds, particularly external financing, are the characteristics of a budgetary balance.

Scenario C shows a downturn trend of public debt, implying that the debt is on a sustainable path (Figure 3). The public debt ratio would be around 69.8 percent of GDP in 2027, with a more acceptable structure. The share of domestic debt would be around 29.1 percent, reflecting reduced pressure on both the level of refinancing and the banks' exposure to sovereign risk. At the same time, the trend of external debt, supported by Tunisia's return to the international financial market and the mobilization of resources from international financial institutions, shows the positive perceptions of Tunisia's partners about the relevance of the reform momentum for quickly putting the crisis behind.
A limited implementation of reforms, albeit sufficient to generate a growth rate within the interval of 4.1 percent to 4.8 percent during the last three years (2025-27), would lead to a reduction of the debt-to-GDP ratio to 74.6 percent in 2027. In this case, the debt to GDP would certainly be reduced. Nonetheless, the economy would still be facing risks (including debt unsustainability) if reforms are not fully implemented in the medium term.

The rise to a new level of growth and the completion of the economic transition are both likely to strengthen decision-makers, partners, and economic operators in regard to the relevance of the newly agreed reform path. This is in addition to economic performance and a more attractive and competitive ecosystem promoting the development of a productive private sector supported by a more resilient banking sector that's less exposed to sovereign risk. The implementation of a reform program would make it possible to identify a more important fiscal space to support efforts to improve public services and adopt a green and pro-growth fiscal policy for better resilience to non-economic shocks.

## Conclusion

The time has come to quickly and thoroughly break away from inaction and hesitation in order to reform an economy that is largely distorted by political considerations (government instability, amateurism, terrorist attacks, populism…etc.), strong trade union resistance to reforms, and a regulatory framework that supports non-competitive practices and doesn't necessarily promote sufficient innovation and competitiveness.

This policy brief pleads, first, for a new reform approach that places greater importance on improving citizens' support for fiscal consolidation, decoupling from the "accounting approach" that remains stuck to the major macroeconomic balances. The DSA exercise allows us to show the limits of the two business-as-usual scenarios (A and B). Scenario C has the merit of integrating both economic and non-economic risks. It is reassuring for the return of growth, the sustainability of debt (a debt ratio on a downward trend), financial stability (a decrease in the banks' exposure to sovereign risk), and social stability (through the confidence-building package).

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