MALCOLM H. KERR
CARNEGIE MIDDLE EAST CENTER

JANUARY 2024

The Buildup to a Crisis: Current Tensions and Future Scenarios for Tunisia

Ishac Diwan, Hachemi Alaya, and Hamza Meddeb

The Buildup to a Crisis: Current Tensions and Future Scenarios for Tunisia

Ishac Diwan, Hachemi Alaya, and Hamza Meddeb

This publication was made possible with the generous support of the Open Society Foundations.

Carnegie Endowment for International Peace
Publications Department
1779 Massachusetts Avenue NW
Washington, DC 20036
P: + 1 202 483 7600
F: + 1 202 483 1840
CarnegieEndowment.org

Malcolm H. Kerr Carnegie Middle East Center
Emir Bechir Street, Lazarieh Tower
Bldg. No. 2026 1210, 5th flr.
Downtown Beirut, P.O.Box 11-1061
Riad El Solh, Lebanon
P: + 961 1 99 15 91
F: + 961 1 99 15 91
Carnegie-MEC.org

This publication can be downloaded at no cost at Carnegie-MEC.org.

Contents

Introduction

Tunisia has been living beyond its means since 2011. External support and credit flowed into the country after the 2010–2011 uprising to support its nascent democracy, but this funding ended up largely financing a consumption boom that is unsustainable. To make matters worse, macroeconomic and political instability have begun to deeply harm the country's productive capacity. The risk of a serious financial crisis has risen and corrective action is needed to ward it off.

Tunisia's political system should be able to avoid such catastrophic outcomes. Most reasonable people agree that the risks are rising and that something needs to be done. However, the disagreement is over magnitude, timing, and the type of program required to address the country's problems. A hard economic adjustment risks unleashing a sociopolitical crisis. Not engaging in a correction, however, may well engender a future economic meltdown. Buying time is easiest politically, but it often means only postponing the crisis, leading to an even larger explosion. The challenge is to find the narrow path to escape a crisis by generating confidence in a national program that is politically acceptable and that can lead to a brighter future.

Faced with these negative dynamics—the lack of sustainability and economic regression—economic agents might not merely adjust to the new normal. Instead, they might try to push the burden elsewhere in the economy and by so doing unleash more destructive forces. Think of society, with its networked organizations, as a hydraulic system. As pressure mounts, weaker parts of the network are at risk. Pushing pressure out from one part, instead of addressing the root cause of the problem, only leads to more pressure on other parts. Ultimately, the system will burst at its most vulnerable point. Typically, deterioration is not linear. Pressure builds up in invisible ways until the system explodes in a generalized crisis.

There are several ways in which this can happen: foreign exchange reserves are used up slowly until a run takes place and the currency collapses; financing the state's losses drains the private sector, reducing investment, until there is a collapse in growth; taxes are raised or services reduced, or both, leading to a social explosion; fiscal losses are financed with new loans (or arrears) until creditors dry up, and printing money remains the only solution, leading to hyperinflation; or banks keep lending to the state until depositors lose confidence in the banking sector and there is a bank run. What is destroyed will have to be rebuilt from scratch at great cost.

It is in this context that Carnegie's new Tunisia Sustainability Lab is beginning its work. The objective is twofold. First, the lab will monitor the risks ahead and alert the public about developments. It will do so by preparing a regular scorecard of Tunisia's economic, financial, fiscal, external, and sociopolitical domains. Second, the lab will track proposals advanced by national and international parties on possible pathways to progress, reporting on and analyzing initiatives to avoid the worst of them. So far, several International Monetary Fund (IMF) proposals have been rejected by the Tunisian authorities. There are alternative proposals, some outlined by civil society actors, but they have not materialized. To support social dialogue, we will highlight the various initiatives and try to evaluate their impact. We will also develop scenarios to assess macroeconomic trends, which we will update over time.

Summary of Tunisia's Economic Performance in 2023

Tunisia's increasingly dire financial and economic situation has created a dilemma in the country. Relying on austerity alone risks generating a social explosion, as economic and financial conditions are already very difficult. However, Tunisia's inability to reach an acceptable deal with the IMF to address its financial gaps and restore investor confidence is pushing the country to the brink of a financial crisis.

- Among the major developments that have taken place in the past year, creating anxieties about Tunisia's trajectory, are the following:
- By 2023, the country's growth trajectory had ground to a halt, exacerbating a long-term pattern of poor economic performance. Tunisia finds itself mired in a troubling state of stagnation, aggravated by rising inflation. Despite the resilience of the population, social pressures are mounting.

- Imbalances in public finances have severely constrained the government's ability to maneuver. The fiscal situation could deteriorate due to accumulated arrears and the mounting burden of a publicly guaranteed debt.

- With no IMF agreement in place, Tunisia's reliance on external funding has steadily diminished. The increase in domestic borrowing has crowded out the private sector, exacerbating economic stagnation.

- Even more concerning is that, as the country has plunged into recession, its economic foundations have come under threat, undermining its long-term growth prospects.

- Tunisia is in a bind. Internal and external imbalances cannot be left unaddressed. Sooner or later, the status quo will lead to a financial crisis, while a sharp adjustment risks leading to a sociopolitical crisis. The most promising avenue is to grow out of the difficulties. But this would require a completely new style of leadership that builds a coalition for change, as well as sufficient social trust, to embark on an ambitious reform drive.

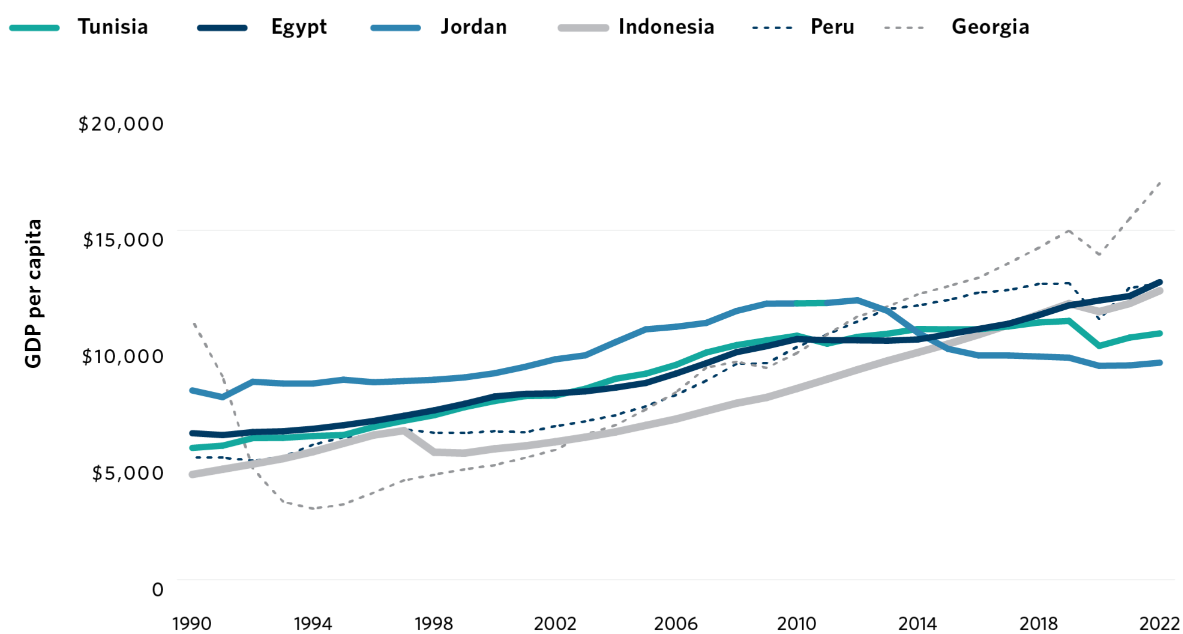
The Economy: The Growth Process Has Stalled

In 2023, financial policymakers and international partners expected that Tunisia's economy would rank high on the national agenda, because it was felt that an anticipated agreement with the IMF would spur an economic recovery after parliamentary elections in December 2022. However, this did not happen. Economic growth stalled, so that in the second quarter of 2023, real gross domestic product (GDP) growth was –1.3 percent, and for the first nine months of 2023, a slightly positive 0.7 percent. Estimates for real GDP growth for 2023 stand at 0.6 percent, the worst performance since 2011 (excluding the interlude when the COVID-19 pandemic hit the global economy). In addition to the absence of policy reforms, an exceptionally unfavorable agricultural season due to adverse climatic conditions resulted in a substantial reduction in the grain harvest, which plummeted to 80 percent below the previous year's. Despite a commendable recovery in the tourism sector during 2023, indicators remained below the levels prevalent before the coronavirus pandemic.

Tunisia's economy is performing well short of the country's potential. Tunisia was a growth champion in the 1960s and 1970s, when its economic model was based on import substitution, and again in the 1990s after it adjusted its model so that it became export-driven. The difficulties began in the first decade of the century, when the country was unable to upgrade productivity sufficiently and thereby missed out on a period of expansion in global markets. Since then, Tunisia's economy has been growing at a pace below that of comparable countries around the world (see figure 1), failing to create enough jobs to absorb new entrants into the job market and raise incomes. Tunisia's poor economic performance is a result of structural weaknesses. Its productive structure is frozen in low-value-added activities, firms are stagnating, and the economy is not dynamic enough to generate the numbers and types of jobs to which youths aspire.

Figure 1. GDP per Capita

Tunisia missed out on the global surge of the 2000s—it has fallen behind a diverse array of other middle-income economies

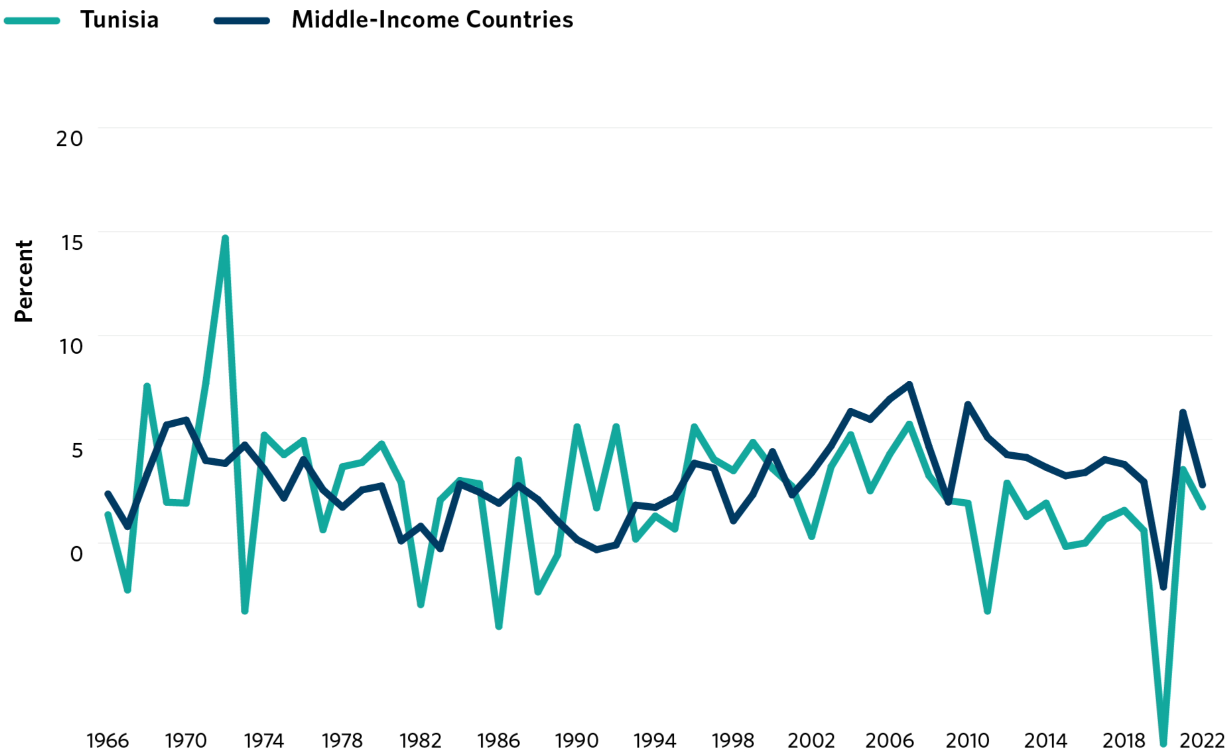


Source: World Bank indicators

This situation led to a rise in popular grievances and the 2011 uprising. But the economic weaknesses were only exacerbated during the decade after 2011, due to delayed reforms, exogenous shocks, and a dysfunctional political system. Throughout this decade, growth performance declined to only 0.9 percent. A recent series of negative economic shocks—COVID-19, higher food and fuel prices, a fall in European demand for Tunisian products, and rising global interest rates—sharply increased the magnitude of the deterioration (see figure 2).

Figure 2. GDP per Capita Annual Growth

Weaknesses in the growth process have been apparent since 2000, but 2011 marked a turning point

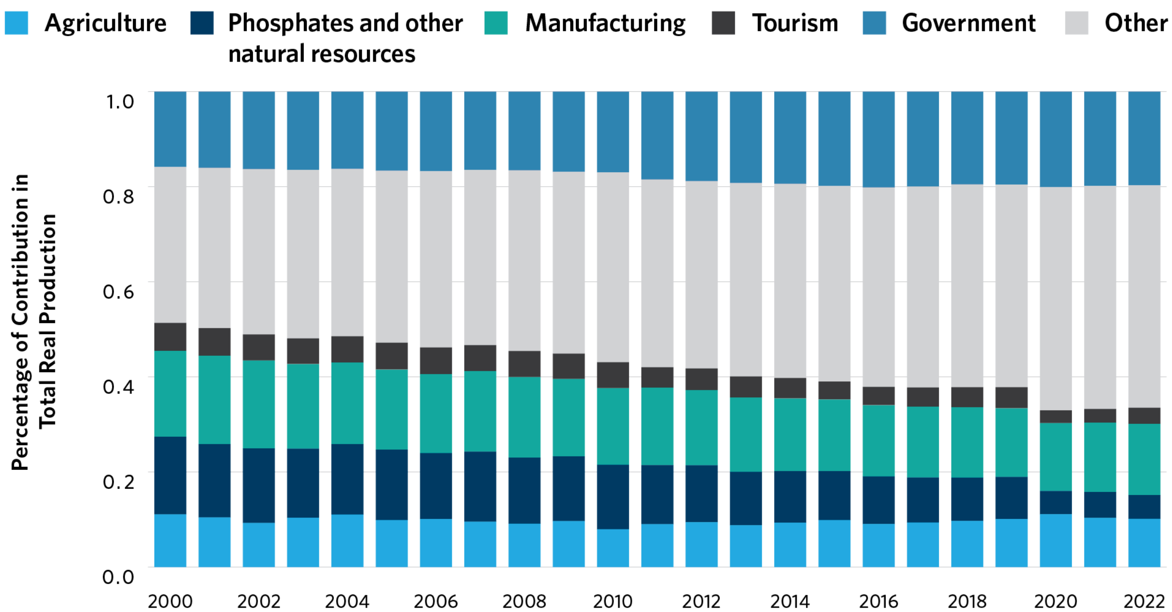


Source: World Bank indicators

The economy's poor performance in 2023 has only confirmed a decade-long trend in which the drivers of Tunisia's economy have been steadily eroding. Only the government and informal sectors of the economy have expanded, while the dynamic parts of the economy have contracted (see figure 3). Shocks and political instability harmed tourism, while a halt in the expansion of manufacturing and the collapse of phosphate production damaged several sectors.

Figure 3. Real Production by Main Sectors

Since 2000, nonmarket government spending and the informal economy have been the fastest-growing sectors

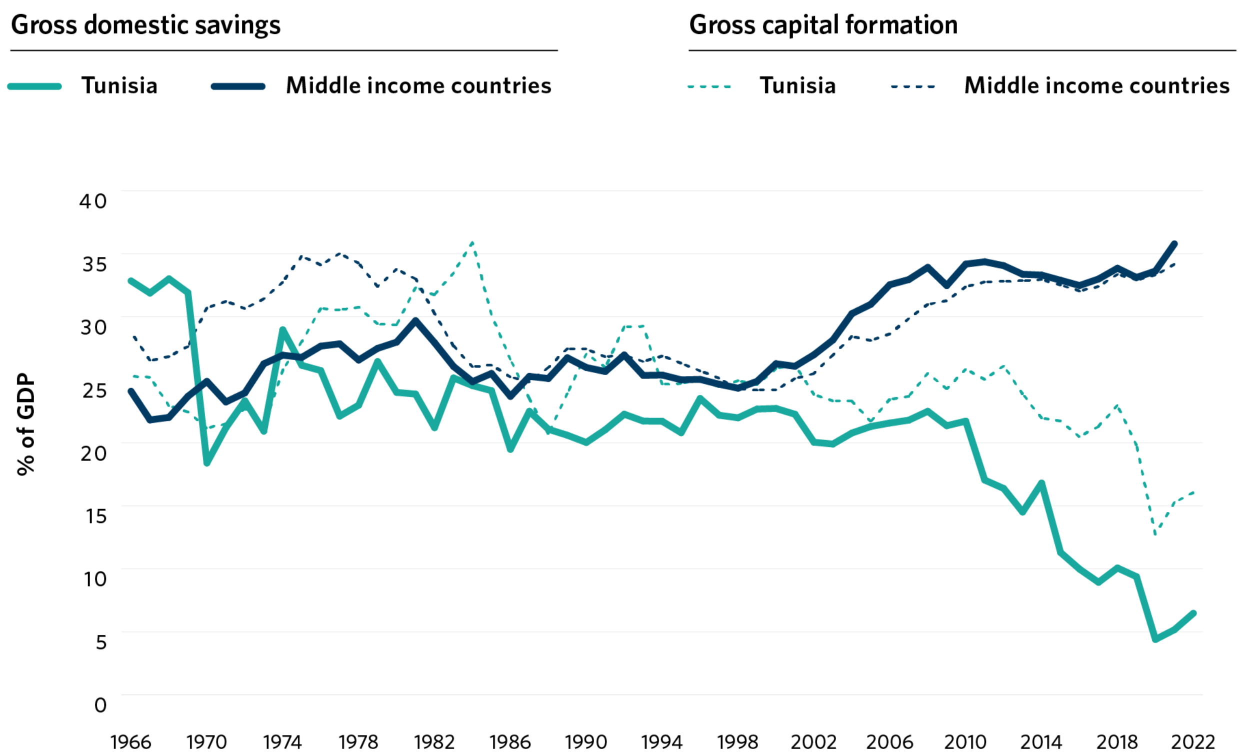


Source: TEMA's calculations based on official data

The sharp decline in growth coincided with a precipitous fall in private investment and national savings. The investment-to-GDP ratio has reached historically low levels—from 25 percent of GDP in the early 2000s to below 10 percent today (see figure 4). In 2022–2023, all investment categories continued to fall. Foreign direct investment (FDI) in the first half of 2023 stood at 0.8 percent of GDP, compared to 2 percent in 2012 and an average of 4 percent in the first decade of the twenty-first century. The sharp decline in FDI has been accompanied by a fall in domestic investment, which is closely related to a decline in savings. This, in turn, is due to large fiscal deficits and a reduction in household savings due to squeezed middle-class incomes.

Figure 4. Investment and National Savings.

The deterioration in investment and in savings has been dramatic since 2010

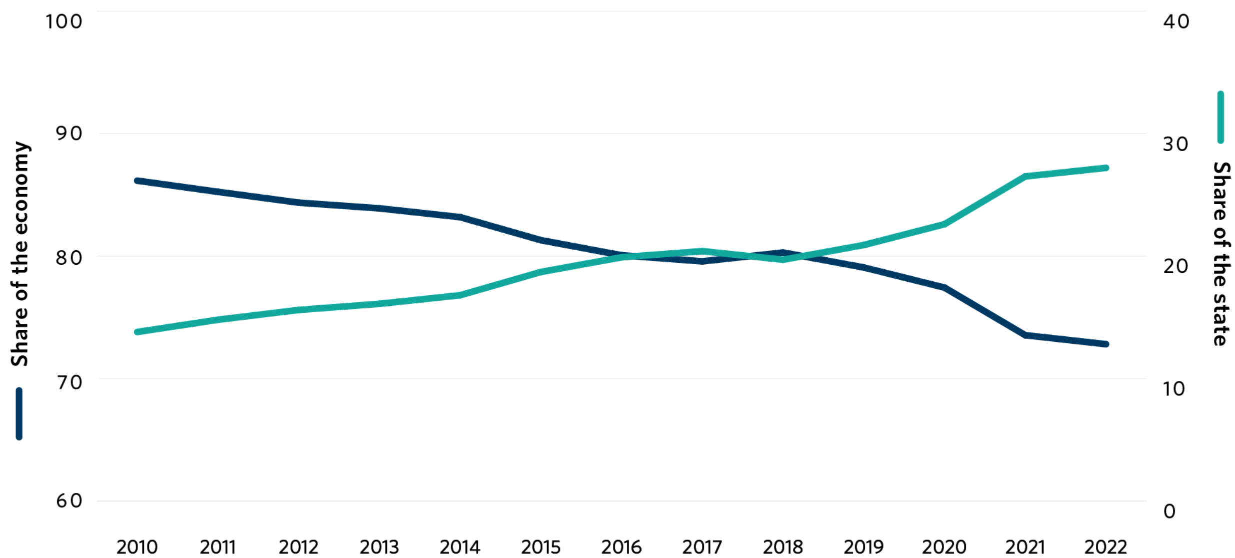


Source: World Bank indicators

The fall in investment has aggravated the decline of the private sector, the main creator of jobs and therefore provider of incomes. This decline has several sources. Internal borrowing by the public sector has increasingly crowded out the financing of the private sector. At the end of July 2023, the domestic banking system's financing of the private sector grew by only 3.2 percent, the lowest rate of growth in at least fifteen years and far below the 21 percent rise in credit granted to the state. By mid-2023, total credit for the private sector had fallen from its pre-2011 level of 90 percent of GDP to 76 percent (see figure 5). The 2020 World Bank enterprise survey confirmed that limited access to finance was the major constraint on firms' expansions (see figure 6).

Figure 5. Credit to the Private and Public Sector (% share of total domestic credit).

State borrowing has unrelentingly crowded out private finance

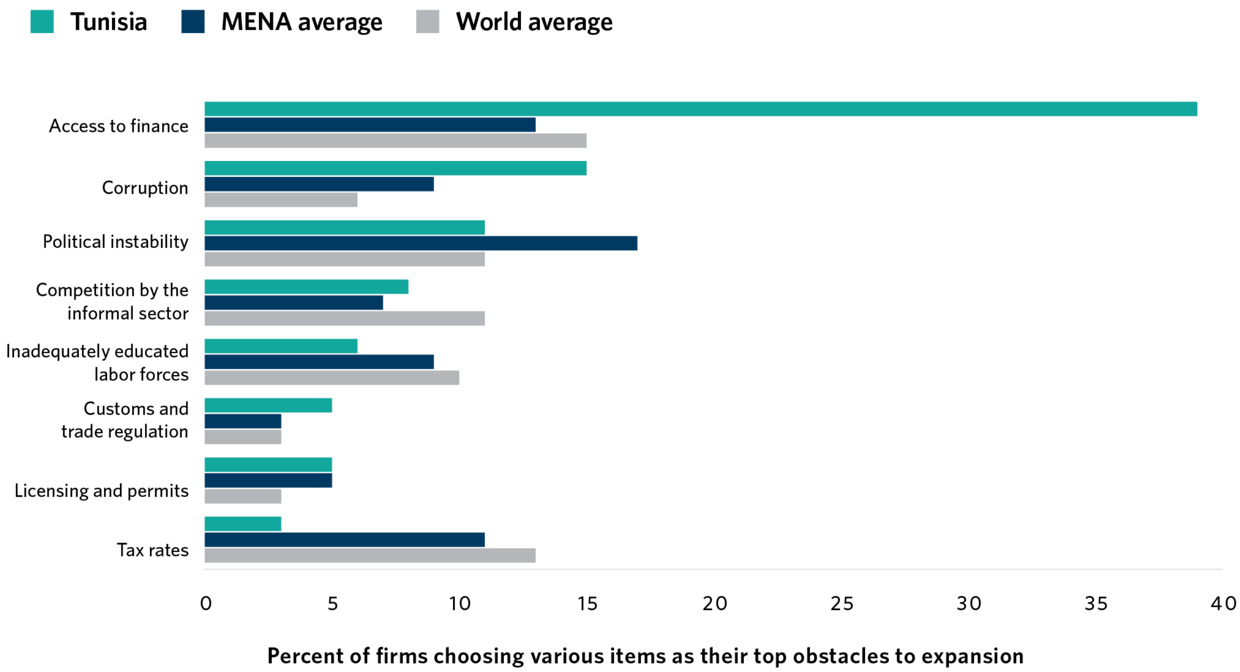


Note: Economy refers to private sector. State refers to public sector and state guaranteed debt to SOEs.
Source: TEMA's calculations based on official data

But the collapse in real GDP growth and the steady decline of the private sector are also the result of bureaucratic barriers and regulatory policies that limit competition and encourage rent-seeking. The World Bank enterprise survey reveals two other constraints faced by firms: high levels of corruption and a significant degree of political and macroeconomic risk. Cartels dominate key economic sectors, guarding against new entrants in core industries, services, and banking. A burdensome regulation system provides fertile ground for rent-seeking and corruption. State-business relations became extremely strained after President Kais Saied made the fight against corruption a priority following his power grab on July 25, 2021. Instead of seeking to reform regulations, the president's drive has focused on confiscating "illegally acquired fortunes," leading to suspicions that big business is being made to bail out the public sector's losses.

Figure 6. Top Obstacle to Firms' Expansion.

While access to finance is a dominant constraint, corruption and political instability also loom large



Source: World Bank Enterprise Survey, 2020

Reforms that improve competition, the rule of law, and the business climate are needed to inject dynamism into the private sector. Tunisia's corporate landscape is dominated by large monopolies, both public and private, and by a multitude of informal small firms. The economy sorely lacks medium-sized firms—which tend to be the most dynamic job-creators worldwide—due to unfair competition from both informal and dominant privileged firms. This discrepancy is highlighted by the distribution of private sector firms by size: 86 percent of all Tunisian firms are one-person enterprises. Meanwhile, large firms that employ more than one hundred workers represent only 0.4 percent of the total number of firms but account for more than a third of all jobs, equal to the share of jobs in the informal sector. The scarcity of medium-sized firms is the main reason for the low level of economic innovation.

The Fiscal Situation: Large Deficits, Shrinking Fiscal Space, and High Social Risks

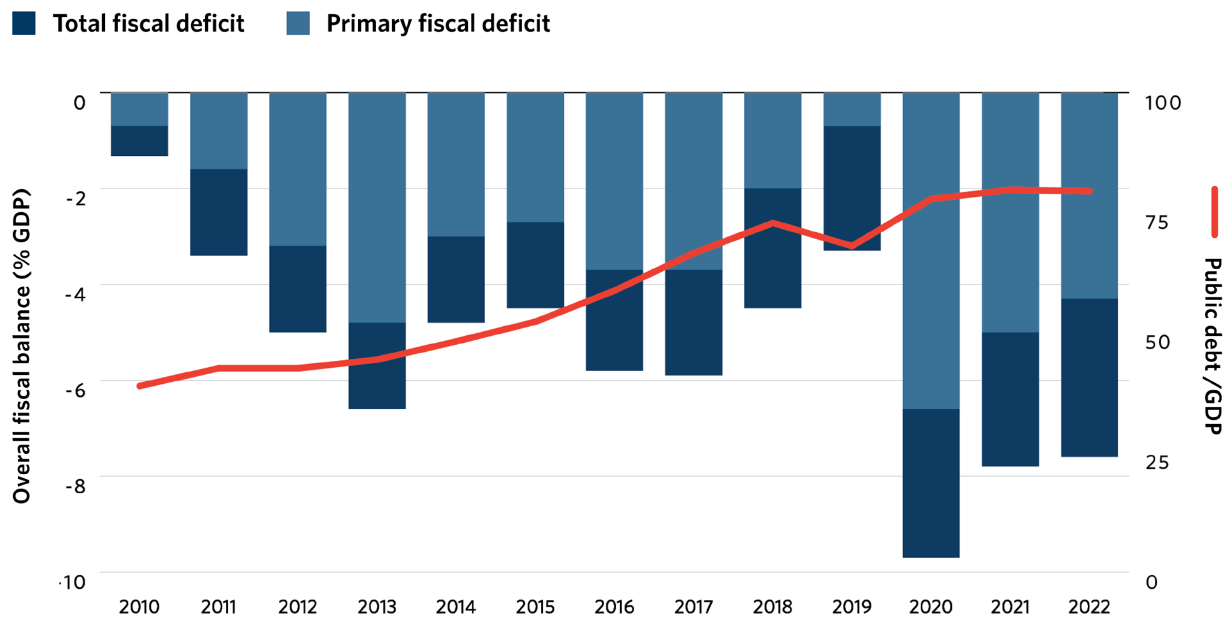
In 2023, despite large fiscal imbalances, Tunisia and the IMF were unable to agree on a new bailout program. In its budget for 2023, Tunisia's government planned to borrow around $5 billion from international partners to finance its primary deficit and service the public debt. But as the country risk ratings rose, Tunisia lost access to the Eurobond market and even to the bilateral and multilateral flows that were initially pledged to Tunisia and conditioned on an IMF agreement. As a result, Tunisia was unable to borrow more than half of what it needed, increasing pressure on the domestic financial market. The treasury is now short of liquidity to meet essential expenses, which is unprecedented. So far, it has managed by paying only "sensitive" expenses—salaries, pensions, and debt servicing—while postponing payments to certain suppliers. This decision has only delayed the day of reckoning, which may further slow the economy.

In the past decade, a modicum of economic growth was preserved solely through expansionary public spending, financed by loans. This process has run its course. In the absence of a deal with the IMF and given the rise in the country risk, as attested by rating agencies, Tunisia's access to international capital markets is now closed as markets refuse to lend it money. Tunisia's short-term debt needs to be rolled over. However, the lack of access to the international financial market is preventing the country from taking new loans that could be used to refinance the old loans that are coming to maturity. As a result, Tunisia not only has to service its debt today, but it also has to repay the principal on the debt without being able to roll it over. Servicing the debt is only possible by drastically squeezing public expenditures. The dramatic reduction in fiscal space would only exacerbate the government's policy dilemmas.

The country's primary fiscal balance was in deficit every year from 2011 until 2023. The deficit averaged around 4 percent of GDP since 2010 (see figure 7), in contrast to the surplus during the presidency of Zine el-Abidin Ben Ali before 2011. After 2017, Tunisia engaged in fiscal consolidation and shrank its deficit, but the COVID-19 pandemic led to a sharp reversal. The average deficit in 2020–2022 was equivalent to 9 percent of GDP.

Figure 7. Primary and Total Fiscal Deficit.

Since 2010, and especially in recent years, fiscal deficits have been large

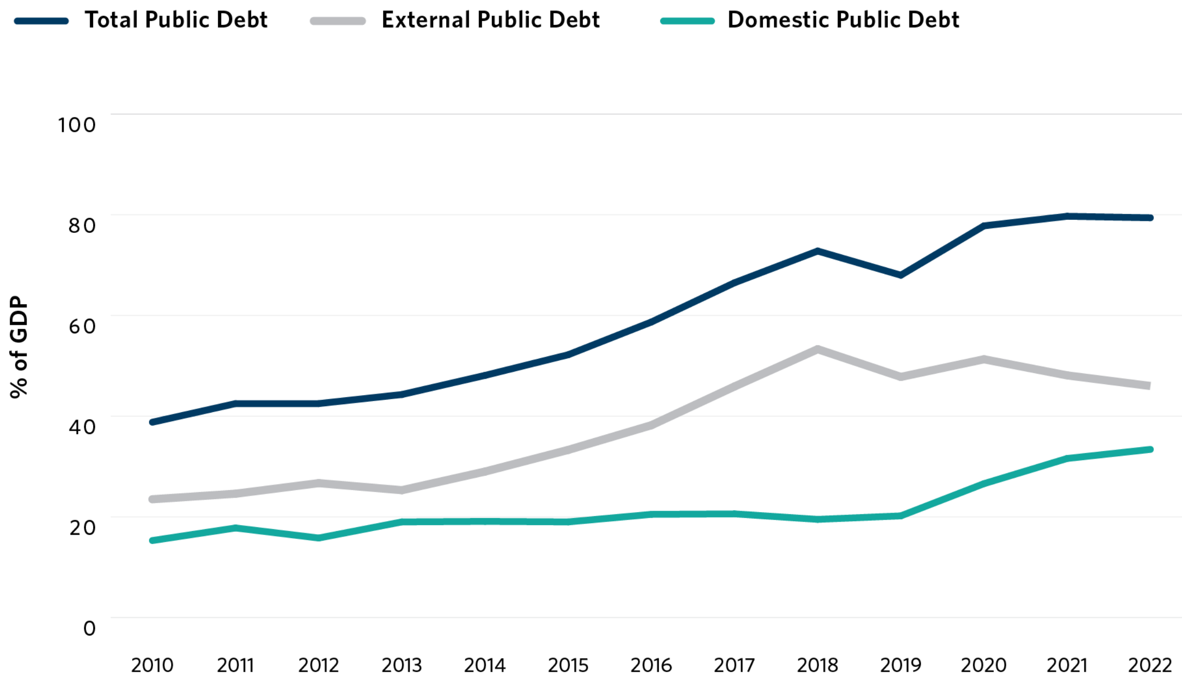


Source: TEMA's calculations based on official data

Financing the fiscal deficit has become very onerous. Initially, financing was provided through generous loans from bilateral donors and multilateral development banks. This financing was supplemented by loans from the Eurobond market at the low interest rates prevalent during the second decade of the century. But deficits have remained large despite two IMF programs, in 2013 and 2016. As external loans became harder to attract, especially after 2017, a larger share of the deficit had to be financed domestically, further crowding out private investment. In 2022, the public debt reached 80 percent of GDP compared to 68 percent in 2019, with internal and external debts roughly equal (see figure 8).

Figure 8. Public Debt.

Domestic borrowing rose faster after 2017, when external finance dried out



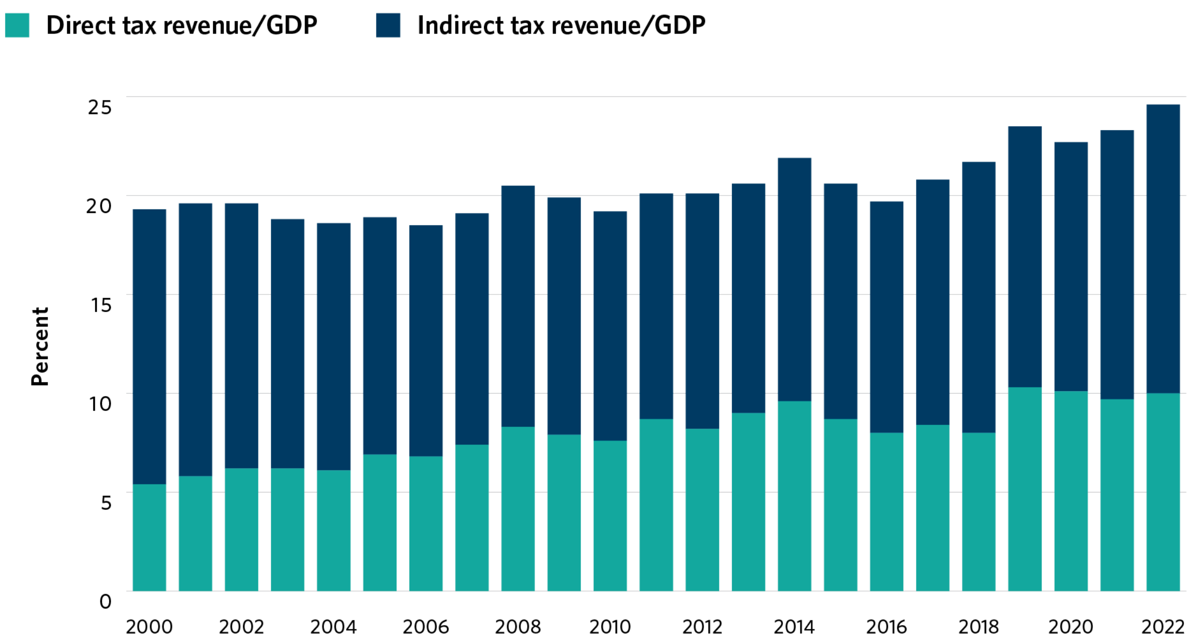
Source: TEMA's calculations based on official data

The shrinking fiscal space has left Tunisia's government with a limited margin of maneuver. There are three ways to reduce the budget deficit: raising taxes, reducing expenditures, or growing the economy faster. Growth is unlikely to pick up sufficiently in the short term for Tunisia to avoid at least some austerity measures.

Tax revenues are high by international standards, at 25 percent of GDP in 2023 (see figure 9). While there is limited room to increase revenues, proposals have been made to render taxation more progressive. Since fiscal reform in 2016, taxes on high-income earners have been capped at 35 percent. Indirect taxes, which mainly affect the middle class, make up more than half of tax resources. Reforming the value-added tax system by eliminating loopholes, increasing the rate on luxury goods, and reducing it on basic commodities would improve the distribution of the tax burden. A new tax on property wealth was introduced in the 2023 budget law, but it is not expected to collect much in the short term.

Figure 9. Composition of Tax Revenues.

Tax revenues reached an all-time high of 25 percent GDP in 2022, one of the highest rates in the Middle East and Africa

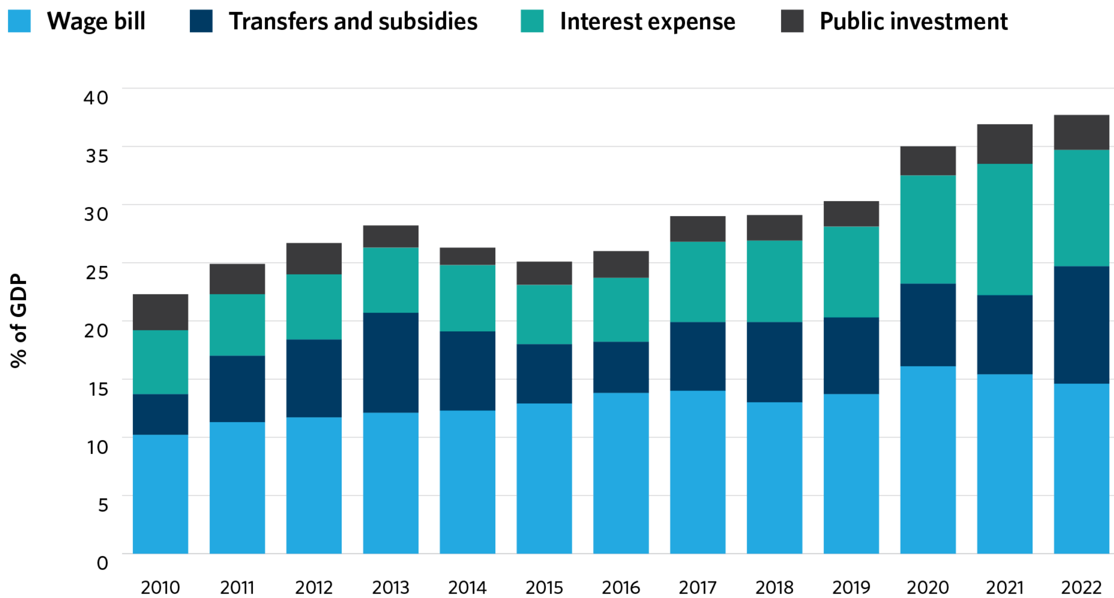


Source: TEMA's calculations based on official data

There are no easy answers on the expenditure side either. At best, cutting back on the government's wage bill (as a share of GDP) is a slow process; reducing transfers to state-owned enterprises in charge of supplying the market with food and energy and cutting subsidies are politically charged issues; and lowering the debt service bill is just as challenging. So far, public investment has been the only variable that could be adjusted, which is why it has decreased to below 3 percent GDP in recent years (see figure 10).

Figure 10. Composition of Expenditures.

The large rise in expenditures since 2010 is due to the rises in debt service, subsidies, and wages, in that order



Source: TEMA's calculations based on official data

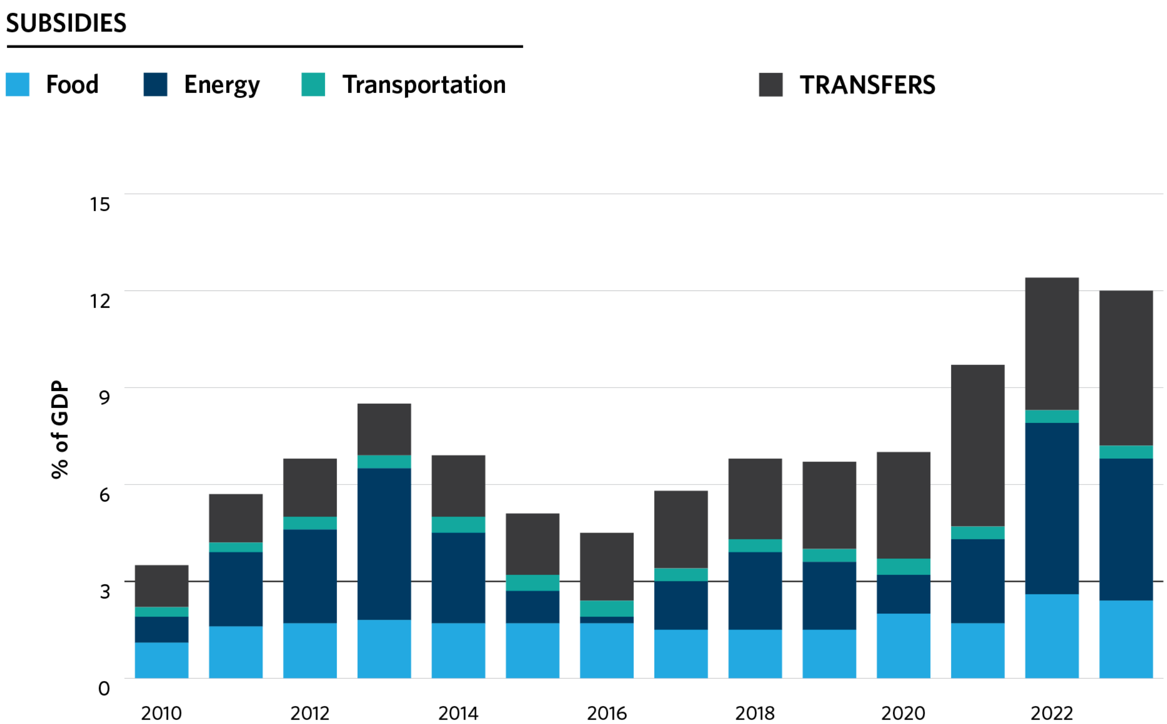
The wage bill has started to decline, after growing greatly during the past decade. When both wages and hiring were rising quickly, the wage bill reached 16.1 percent of GDP in 2020, before falling to 14.6 percent GDP in 2022 (see figure 10), which is still high by international standards. In the medium term, no reform program can ignore the need to reduce the wage bill, but in the short term, challenging social conditions make large cutbacks difficult. In September 2022, the government and the Tunisian General Labor Union signed an agreement on a salary increase of only 3.5 percent for public sector employees for the following three years (2023–2025). This increase is likely to remain below inflation, meaning that real wages will gradually go down. Saied has recently launched a campaign to revisit the hirings made during the previous decade, which might end up in a wave of layoffs from the public sector.

Transfers and subsidies have continued to rise and stood at 12 percent of GDP in 2022 (see figure 11), among the highest in the Middle East and North Africa region. There was a gradual expansion of social policies after 2011; however in recent years there has been a sharp increase in subsidies to smooth over the impact of higher international food and fuel prices. Subsidies mainly cover petroleum products, electricity, gas, and cereals. Their cost has risen from 2.4 percent of GDP in 2010 to 6 percent in 2018 to over 10 percent in 2022 (see figure 11). Transfers—both social transfers and funding for state-owned enterprises (SOEs)—were around 5 percent of GDP in 2022 (see figure 11).

Aside from their high cost, subsidies also tend to be unfair, as they benefit high-income social groups more than others, encourage inefficiently high levels of consumption, and fail to improve living conditions for the poor, who are supposedly the main beneficiaries. That said, to shift reforms from a universal subsidy regime to a targeted one is politically challenging. In 2023, expenditures on subsidies were reduced through rationing, generating shortages. During the first three months of 2023, state spending on food subsidies was ten times less than it was during the same period of 2022. Such rationing is socially unsustainable. A better solution is to replace universal subsidies with a large, targeted social safety net. A narrow safety net would harm the middle class and might trigger social anger and labor protests. Past attempts to eliminate subsidies resulted in widespread protests, in 1978 and again in 1984.

Figure 11. Subsidies and Transfers.

Subsidies and transfers have continued to grow and are now at a historically high level



Source: TEMA's calculations based on official data

Financing the budget deficit has become a real challenge, as sources of external debt have almost dried up at a time when debt servicing has become a major burden. At the end of October 2023, external debt servicing exceeded $3.2 billion, or 6.9 percent of GDP (compared to 5 percent of GDP in 2022). The decline in external sources of financing has increased reliance on domestic financing, further crowding out private investment. It is also leading to a vicious circle of rising debt.

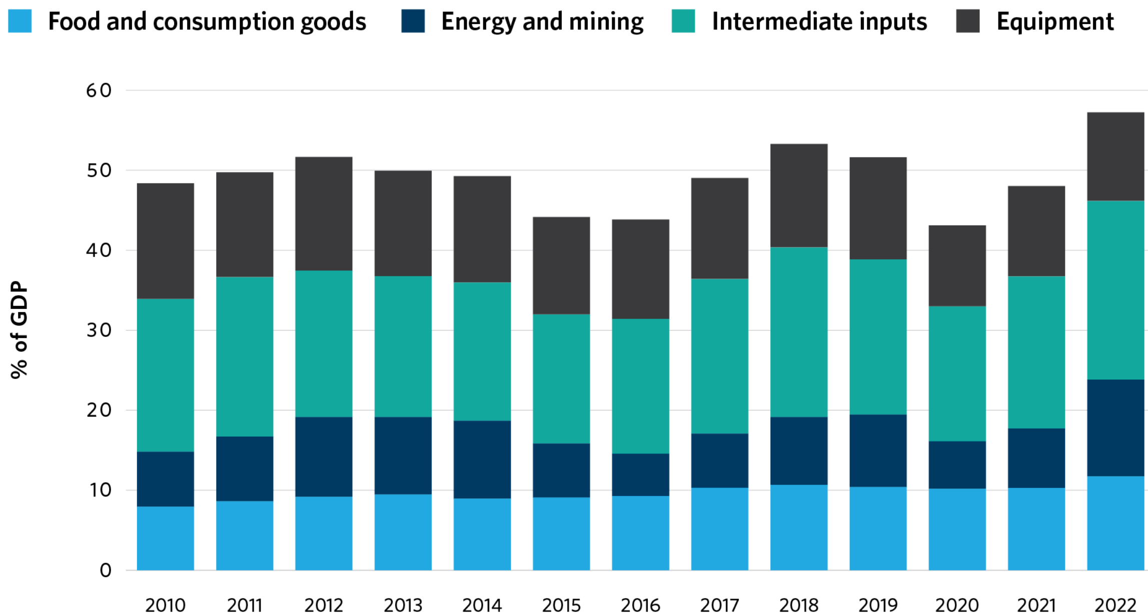
Tunisia's public finances situation has further deteriorated because of the accumulation of arrears and the rise in contingent liabilities linked to publicly guaranteed loans to SOEs. The size of either is not known with precision. Arrears are thought to run in the hundreds of millions of U.S. dollars. The debt of SOEs guaranteed by the state is broadly estimated to be in the range of 20–40 percent of GDP. The Tunisian government reports 110 SOEs operating in a wide range of sectors—import and distribution, transport, manufacturing, and finance. The debt buildup is related to increasing losses among some of these SOEs due to their high wage bills, the unfunded subsidies they must deliver, and price controls that are not reimbursed by the state. Losses are mainly connected to the Tunisian Company of Electricity and Gas, Tunisian Company of the Refining Industries, and the Cereals Office.

External Accounts: A Growing Financing Gap Amid Uncertainty

In recent years, Tunisia's external balance has also been deteriorating, and by 2023 it was impossible for the government to finance a large external deficit. To conserve foreign currency reserves, the government began artificially compressing imports in 2023, using administrative controls. The import of goods fell during the first half of the year by 0.6 percent compared to the same period in 2022—a decline that mainly affected fuel (–20.9 percent), intermediate products (–3.0 percent), and food (–3.9 percent) (see figure 12). The decrease in the purchase of basic food products has led to recurring shortages of subsidized food products and a rise in prices. The cutback in imports of intermediate products, caused by administrative restrictions and the decline in domestic consumption, is slowing the output of Tunisia's factories. Without a long-term energy-management policy, power cuts remain the only way for the government to lower its energy bill.

Figure 12. Imports by Type of Good.

Imports continued to rise in 2021–2022, driven by rising food and fuel prices



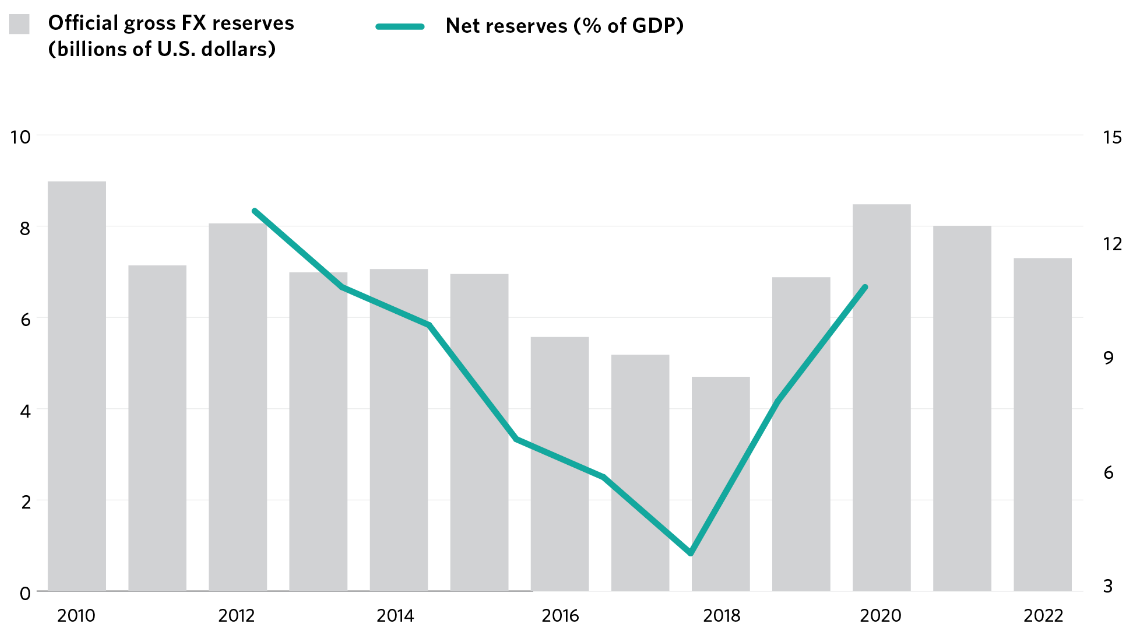
Source: TEMA's calculations based on official data

Acute commodity shortages are a novel phenomenon in Tunisia. These shortages are due to the combination of a very poor agricultural season and the scarcity of foreign exchange, which has made it difficult to compensate by increasing imports. This is particularly the case with products distributed by SOEs. Because these SOEs were already highly indebted and had not received sufficient budgetary transfers, they were unable to increase their purchases abroad. For example, as drought reduced Tunisia's durum wheat harvest by two-thirds in 2023 compared to the previous year, and the Cereals Office was unable to increase imports sufficiently, the quantity of durum wheat in the market fell by 18 percent over the first nine months of 2023 compared to the previous year.

The deterioration of the external balance led to a steady decline in foreign currency reserves between 2012 and 2018 putting pressure on Tunisia to proceed to some adjustments and rebuild its reserves (see figure 13). After hitting an all-time high of $8 billion in 2020 , foreign currency reserves began to decline in early 2023, falling to $7 billion by the end of the second quarter of 2023, a decline of 5.5 percent year on year. Foreign currency reserves were around $8 billion in December 2023.

Figure 13. Foreign Exchange Reserves.

Until 2022, the Central Bank had managed to keep foreign exchange reserves at a comfortable level, the real exchange rate competitive, and inflation under control



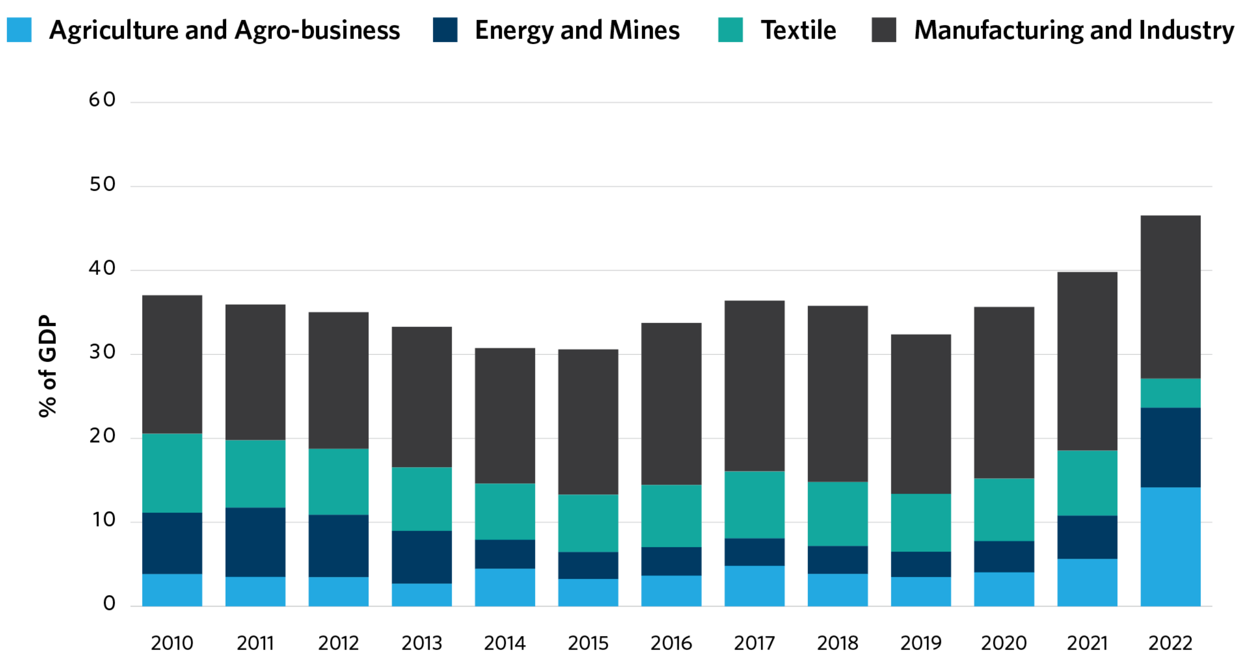
Source: International Monetary Fund

Thus far, priority has been given to securing debt solvency instead of focusing on boosting economic activity. The decline in imports is aggravating the growth collapse. Tunisia is a small, open economy that imports a large part of what it consumes, as well as the indispensable resources and semifinal products required to fuel its economy. To pay for this, the country must export. It must also export to grow, as its local market is too small to support specialized production, which is a sine qua non for gains in productivity. In the 1990s and 2000s, Tunisia's export-driven model was the most successful of its region, as the country managed to increase and diversify its export base over time in areas as diverse as manufacturing, agriculture, natural resources (phosphates), and tourism. This relative success was due in large part to monetary policy rather than to a well-thought-out industrial policy. Since the 2000s, the exchange rate has remained competitive and Tunisia has avoided the common mistake of overappreciating its currency.

In recent years, the deficit in the trade balance has risen largely due to the rise in international prices of fuel and food. Exports have also risen due to price inflation, but prices have risen even as the quantity of exported products has declined. The poor performance of exports reflects the rise in financing constraints on the private sector, weak demand from Europe for Tunisian products, and falling foreign investment in Tunisia as an export platform. The decline of the offshore industry is due to ongoing deindustrialization—industry's share of value-added products fell from 25.2 percent in 2010 to 20 percent in 2022 (see figure 14). In part, this decline in manufacturing exports reflects Tunisia's failure to increase the sophistication of its export bundle over time due to a lack of innovation, research and development, and skill development. The country's association agreement with the European Union (EU), which was signed in 1995, has not allowed for more agricultural exports, and phosphate exports have collapsed due to years of decreasing investment and labor disputes.

Figure 14. Exports by Type of Good.

In 2021–2022, the rise of export revenues was due to improved agricultural and phosphate prices—but quantities exported have not risen



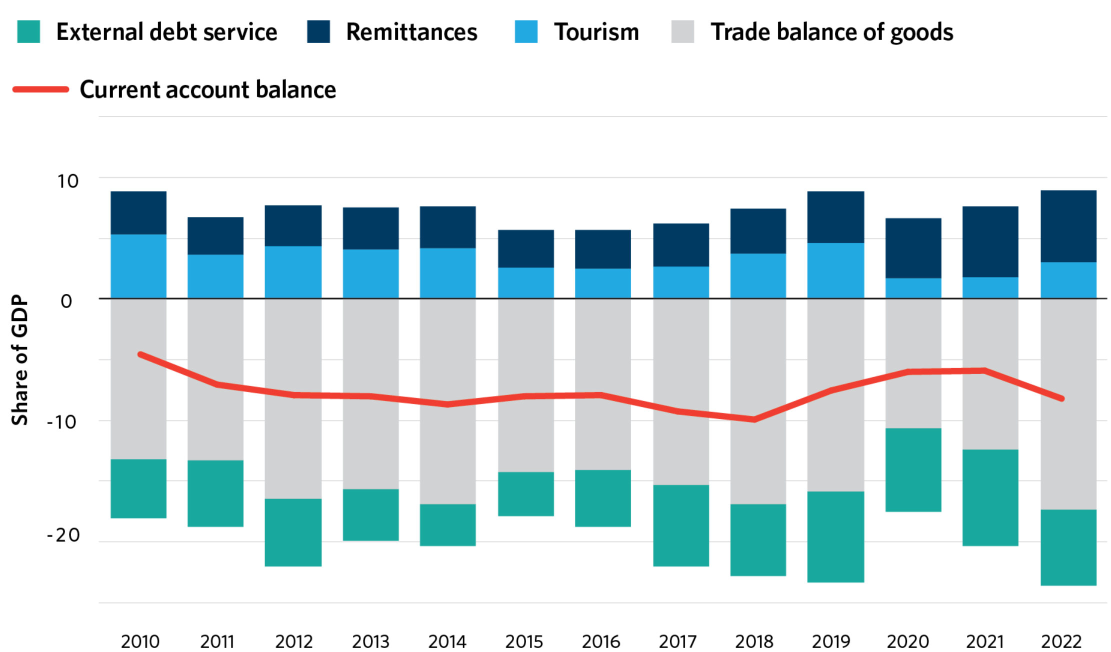
Source: TEMA's calculations based on official data

Tunisia's current account deficit, which was already high over the past two decades, has now become unsustainable. Traditionally, Tunisia had a modest trade deficit, but post-2011, due to the country's expansionary policies and its access to easy credit, its trade deficit rose massively, hitting 17 percent of GDP by 2018 (see figure 15). That same year, its current account deficit stood at 11 percent of GDP. Some adjustment took place during 2017–2019, alongside the fiscal effort. But the shock from the coronavirus pandemic reduced tourism receipts sharply. The Ukraine war, which began in February 2022, also increased the cost of food and fuel imports. Bad weather conditions since 2021 have necessitated more food imports. As a result of all this, the current account deficit rose to around 9 percent of GDP in 2022 (see figure 15). External debt servicing also grew, reaching 5 percent of GDP that year (see figure 15).

Traditionally, Tunisia was able to finance a modest trade deficit through a positive balance in the services sector boosted by tourism and remittances from Tunisians abroad. After the 2011 uprising, tourism declined sharply because of the deterioration of the security situation caused by several terrorist attacks, whereas remittances remained constant, at 4.2 percent GDP in 2019 (see figure 15), and even started to increase in 2021. Remittances reached $2.2 billion in November 2023, compared to $1.9 billion in 2022 for the same period. Tourism revenues began to recover in 2019, reaching 4.4 percent GDP (see figure 15). However, the recovery was halted by the COVID-19 pandemic, which kept tourism revenues below the pre-2019 level for three years—2020, 2021, and 2022. Tunisia had to wait until 2023 to see recovery in the tourism sector. On November 22, 2023, the sector's revenues reached $2.1 billion, surpassing the 2019 (prepandemic) level of $1.8 billion. This performance represents an increase of $500 million (32 percent) compared to the first eleven months of 2022.

Figure 15. External Accounts.

The current account deficit remains very large despite a recovery of tourism and a historically high level of remittances—due both to a large debt service on external debt and a large trade deficit

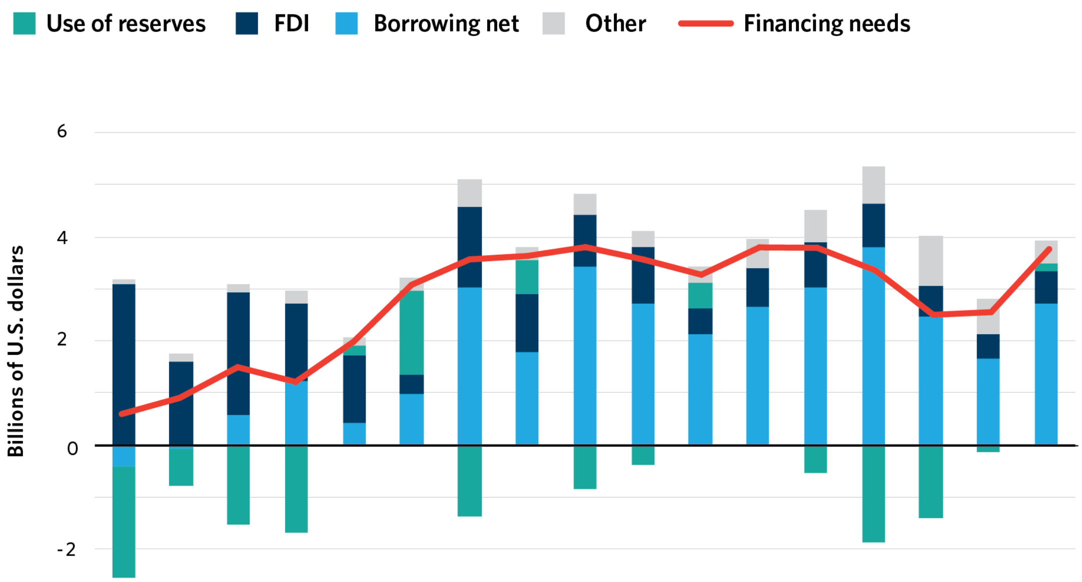


Source: TEMA's calculations based on official data

In 2010, net external borrowing replaced FDI as the main source of financing for the current account deficit. FDI financed on average around 80 percent of the current account deficit until 2010 (see figure 16). FDI fell to around 0.5 percent of GDP in 2022 ($625 million), down from 3 percent in 2010 ($1.5 billion). Moreover, the external deficit, which reflects the country's financing needs, grew and was largely financed by net foreign borrowing of $2–3 billion annually (see figure 16). External capital flows came from multilateral development banks, bilateral donors, and the financial market. By 2022, however, net inflows had collapsed as Tunisia lost access to the Eurobond market.

Figure 16. Capital Account and its Financing.

Until 2022, the external deficit remained financed for the most part by large, new net loans

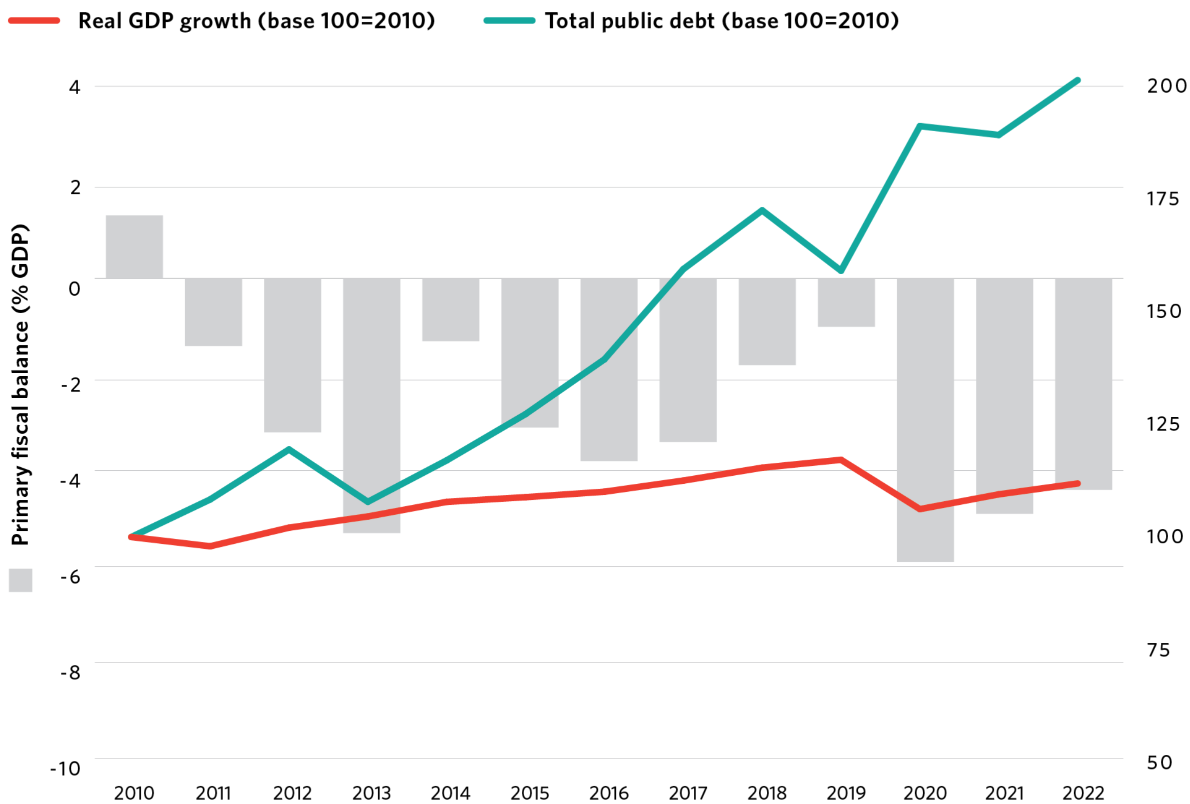


Source: TEMA's calculations based on official data

Debt sustainability analysis reveals that, without new loans to cover the current account balance deficit, and with economic growth remaining unchanged, the Tunisian public debt has reached unsustainable levels. The rise in the public-debt-to-GDP ratio is due to the accumulation of large fiscal deficits throughout the period after 2011, as well as slower economic growth (see figure 17). Moody's downgraded Tunisia's credit rating at the beginning of 2023, and Fitch Ratings followed suit in June. As a result, the interest rates demanded by the international bond market have risen so much that Tunisia has effectively lost market access. This loss means that it will have to refinance maturities by drawing on its reserves.

Figure 17. Public Debt Dynamics.

The rise of the public debt ratio was due both to large fiscal deficits and low growth rates—despite two IMF reform programs (in 2013 and 2016)



Source: TEMA's calculations based on official data

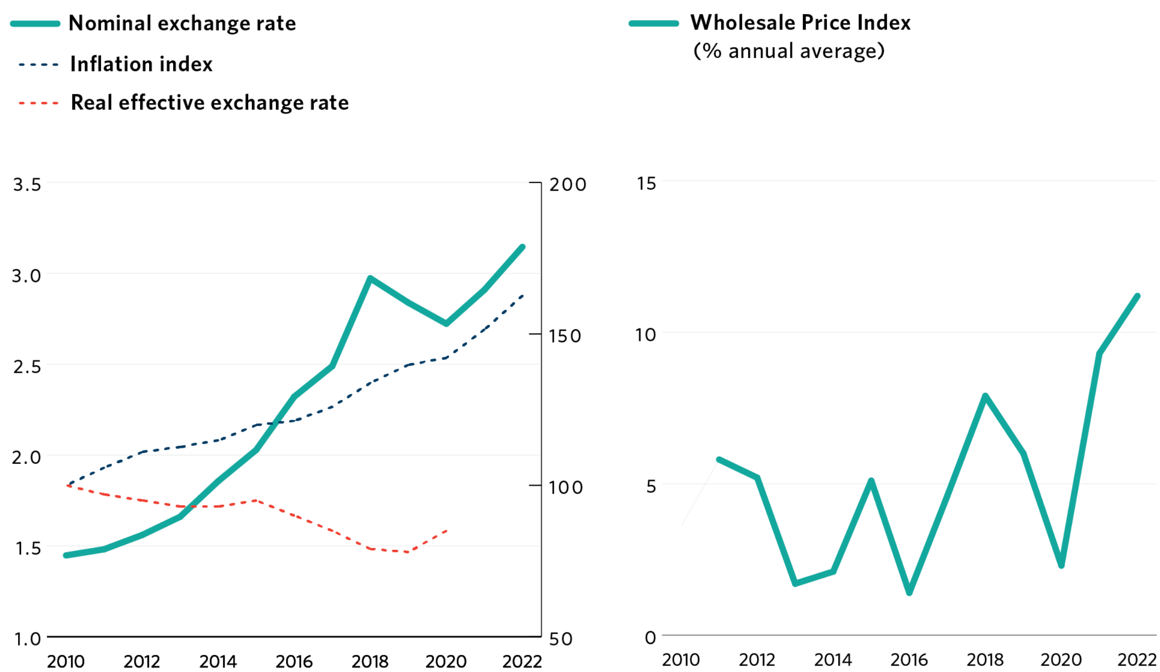
In recent years, support from the IMF has played an important role in financing Tunisia's current account deficit. In 2013 and 2016, the IMF supported two separate reform programs, with loans of $1.78 billion for the first and $2.8 billion for the second. Neither program improved the performance of the economy. Growth remained sluggish and unemployment and inflation stayed high. In 2020, the IMF approved a $745 million emergency support program to combat the effects of the COVID-19 pandemic. In 2021, Tunisia was allocated $552 million in Special Drawing Rights by the IMF. As a result of these programs, the IMF provided Tunisia with large disbursements in recent years—around $200–300 million per year in 2017 and 2019 and over $700 million between 2018 and 2020.

Historically, Tunisia prioritized controlling inflation. Yet inflation rose to around 9–10 percent in 2023, driven by the rise in food prices, which went up by 15.3 percent in the first two quarters of 2023. However, in the third quarter there was no inflation, as the dinar had not depreciated against the main currencies. Moreover, global prices for basic imported food products have been falling. Rising prices in Tunisia thus clearly reflect domestic food scarcities and the effect of monetary creation generated by the indirect financing of deficit by the central bank.

The real exchange rate has appreciated in recent years (see figure 18), as the nominal rate was fixed at a time of rising inflation. This trend is dangerous and can create larger external imbalances. Instead of making gradual adjustments to the exchange rate, as was the practice in the past, imports have been restricted in recent months through rising nontariff barriers. If this trend continues, a large correction in the exchange rate might become necessary, with all its recessionary and socially costly side effects.

Figure 18. Inflation.

In recent years, inflation rose faster than the nominal exchange rate, leading to an appreciation of the real exchange rate. This appreciation reflects the decrease of Tunisia's competitiveness and macroeconomic imbalances that could become unsustainable



Source: International Monetary Fund's and TEMA's calculations based on official data

Looking for a Financial Bailout

With the current democratic backsliding, Tunisia has lost the "democratic rent" that allowed it to gain access to cheap and plentiful financial assistance from Western partners and institutions. For all its efforts, Tunisia has not managed in the past two years to attract large enough funds from new sources to make an economic difference. Since 2022, it has attracted only $500 million in Saudi financial assistance, a $200 million loan ($100 million of which was deposited in the Tunisian central bank) from Algeria, and $330 million (€300 million) in macro financial assistance from the EU. It might be possible for the state to find resources to postpone engaging in thorough-going reform. A sale of state assets—for example, the Tobacco National-Agency—could buy a year or so. Expensive loans with high interest rates have already been secured (for example, from the African Export-Import Bank), and more could be secured, but this would only hasten insolvency.

Tunisian authorities and the IMF initially agreed to a $1.9 billion loan in October 2022. However, Saied rejected the deal, saying "foreign diktats" would only lead to more poverty. The World Bank temporarily ceased its budget support operations for Tunisia in 2022 and paused discussions on its future work in the country after Saied's statements on migrants from African countries triggered racist harassment and violence in March 2023. EU funding has become scarce, as further financial support is largely contingent on an IMF program.

For its part, the EU has been trying to link any financial deal with Tunisia to a partnership on controlling migration flows. It is in the EU's interest to preserve Tunisian stability so as to stem African migration through Tunisia toward Europe. As increasing numbers of migrants look to enter Europe through Tunisia, the EU has softened its line on rights and governance issues in the country. In July 2023, the EU and Tunisia signed a memorandum of understanding that included a macro financial assistance loan of €900 million ($980m), conditional on an IMF program. This included budget support of €150 million ($160 million) for 2023, strengthening economic and trade ties, support for green energy and people-to-people projects, and a financial package of €105 million ($115 million) to fight irregular migration. The delays in implementing the agreement were followed by a sharp rise in illegal departures from Tunisia's shores, evidently an intentional step to put further pressure on the EU to be more flexible on its conditions for the deal.

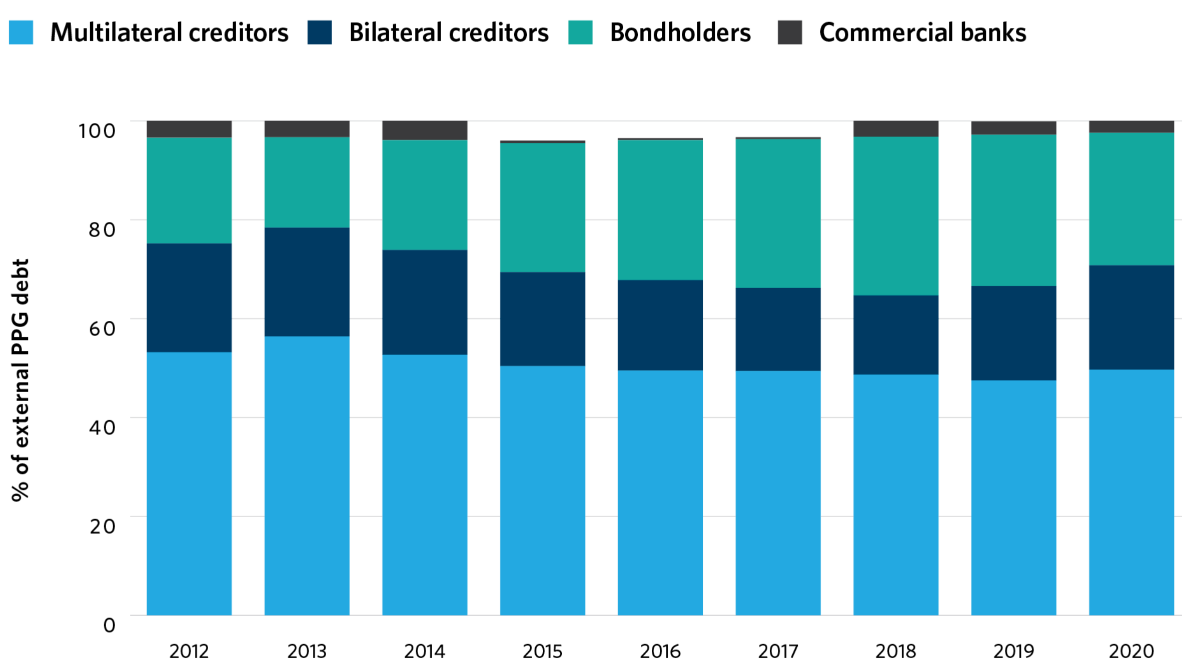
Disagreement between EU member states led the Council of Europe to delay implementation of the agreement. This delay created tensions with the Tunisian authorities. In October 2023, Saied announced his rejection of EU financial aid. Disassociating the EU agreement from the IMF deal has become a central pillar of Tunisia's strategy. This disassociation has been rejected by Europe so far, as it considers that increased funding should be tied to reforms. The disassociation would transform the funding into a sort of geopolitical rent that might encourage Tunisia and potentially countries in Europe's southern neighborhood to weaponize migration flows.

A restructuring of Tunisia's debt might relieve the situation. However, the debt's inflexible structure means that there is little room for restructuring. A large share of external debt is due to multilateral creditors (see figure 19). These creditors do not engage in debt workouts, reducing the impact of any possible Paris Club–like agreement. At the same time, commercial debt represents a small share of total public debt (see figure 19). As a result, restructuring external commercial debt would not significantly alleviate the debt burden. Moreover, it would cut Tunisia off from the capital market for years to come and probably end up harming the capital account balance.

Notably, a reduction in the burden of domestic debt—which represents 40 percent of public debt—could provide fiscal space. This could be implemented through "financial repression," meaning imposing interest rates that are lower than inflation rates (making real interest rates negative) on the domestic debt. It could also be done by proceeding to non-negotiated rescheduling of the domestic debt, thereby shifting the burden to local investors, who would have no choice but to accept, given legal restrictions on the outflow of capital from Tunisia. But financial repression risks weakening the banking system and exacerbating the mistrust between the authorities and financial elites. The problem is that national savings are already low (see figure 4), and they risk being further reduced due to the exacerbation of mistrust.

Figure 19. Structure of External Public Debt.

External debt is inflexible and difficult to restructure



Source: TEMA's calculations based on official data

Perspectives for the Future

In the coming months, it will be more difficult for Tunisia to reduce its overall debt, in part because the cost of servicing its external debt is rising. In 2023, debt servicing amounted to around $2 billion. With debt servicing for 2024 projected to be around $4 billion in 2024, the challenge will be even greater. This cost includes repayment of the principal on Eurobonds, which are bond payments to the financial market in the amount of €850 million ($930 million). As Tunisia faces these challenges, policymakers should consider three possible scenarios.

One scenario is that there will be neither reforms nor an IMF program. In this scenario, Tunisia's internal and external deficits will remain relatively large. The fiscal deficit will have to be financed through domestic loans, a delay in payment of arrears, and printing banknotes. With very little external financing forthcoming, the authorities will have to make some painful adjustments. Even with imports reduced, the balance of payments deficit will remain large—estimated by the authors at $3–4 billion—and will have to be financed largely from reserves. Shortages are already affecting the domestic market and demand is declining sharply. But without an IMF program, covering the financial needs of the government as well as SOEs would exacerbate the most acute dilemmas. With no hope for a better future, relying on austerity alone to gain more time (by taxing more and cutting expenditures) risks provoking a social explosion. However, inaction would inevitably lead to a large devaluation, which would, in turn, cause social pain. Poverty and inequality would increase, and illegal migration to Europe would accelerate. The authorities might be tempted to default on some payments of Tunisia's foreign debt. By late 2024 and 2025, the risks of a forced devaluation would rise. This would create financial ripple effects—financial assets losing their value, the need to increase interest rates to compensate for risk, and capital flight. The economy would then move into a deeper recession, with heightened risks of social instability.

The second scenario is an IMF program with some reforms. Internal tensions among Tunisia's political and security elites might create growing pressures on the president to embrace an IMF program with a view to quelling escalating social discontent. An IMF-backed adjustment program would benefit from additional bilateral financing, reducing pressure on the country's external accounts. To be acceptable to the authorities, the program should avoid heavy austerity. Such a program could see the light of day before the 2024 elections. While it would be unlikely to succeed at turning around the economy, the program may limp along, as similar programs have done in Egypt and Pakistan, and attract modest external capital inflows. Reforms—themselves modest—would be primarily designed to ensure the country's solvency and secure access to bilateral and multilateral financing. It is unlikely that these reforms would bring about a fundamental transformation of the economy.

A third scenario would see Tunisia launch reforms and succeed in generating growth. This could solve its debt problem. A national program of reforms could reduce the cost of adjustment while attracting new finance. One way to do this would be to attract new financing from multilateral development banks and to support such a program with a preemptive restructuring of private and bilateral debt. A voluntarist program of pro-growth reforms would include macro adjustment, market liberalization, fair competition, and public sector reform. This program would take advantage of new opportunities for nearshoring in Europe, as well as for green energy.

Political or Economic Entry Points for a Revival: The Bigger Picture

Tunisia has been on the brink of crisis for several years, yet the economy has shown a good deal of resilience. Many observers have argued that the cause of its difficulties is eminently political and that progress requires, first and foremost, political reform. The 2011 uprising ended up worsening the country's economic situation. For all its faults, the Ben Ali regime managed to keep a tight rein on the country's macro balances and maintain public order and its own authority. After 2011, progress on the political front came at the cost of the economy. The messy, competitive political system that emerged gave priority to securing the transition to democracy and had to accommodate demands for wage hikes, public sector employment, and the improvement of living standards. As a result, the thirteen short-lived governments that followed the uprising failed to balance the books, leading to large fiscal deficits throughout the period and a rising public debt. The resulting public dissatisfaction led to a surge in populism and a system unable to implement the unpopular reforms that would allow Tunisia to fully develop its economic potential.

That said, it is important to note that the 2011 uprising was driven by economic grievances. The Ben Ali regime was unable to create the thousands of good jobs needed every year to absorb a more educated population. Driven by a logic of survival, the regime had also failed to reform the money-losing SOEs and the increasingly burdensome subsidy system. The competitive system that followed inherited these structural problems but had to focus on short-term challenges, so it was unable to upgrade the economy by implementing the required economic reforms. The current, populist Saied regime is again being challenged by similar short-term pressures.

In the coming years, economic developments will have important but uncertain political consequences. The presidential election scheduled for late 2024 is of great significance. Saied's prospects will hinge on the extent to which the social and economic landscape deteriorates in the period leading up to that election. A rapid deterioration in economic and social conditions before June 2024 might increase the chances of victory for Saied's opponents. Conversely, if the economy exhibits resilience, Saied's reelection chances will rise.

The challenges that Tunisia faces to improve its economic conditions will continue to matter in its medium-term political evolution. These conditions are themselves related to the eminently political challenge of moving beyond the "middle-income trap"—the failure to manage economic transformation and move beyond the category of a middle-income country. Progress requires going beyond catch-up economic growth and building institutions. It requires collective action to improve the quality of education; boost labor productivity; increase the level of innovation, research, and development; and, more generally, move up the ladder in global value chains. All such reforms are politically difficult and require a large dose of trust between constituent elements of the nation as well as a sound political coordination and leadership.

Currently, Tunisia has a window of opportunity to make important progress on improving its growth prospects by tapping into what can make economic reform worthwhile. The EU and Gulf Cooperation Council are attempting to bring the production of strategically important global value chains closer to home. Tunisia is well-placed to benefit from this phenomenon. A focus on economic reform could increase the size of the economic pie more than in the past, making pro-growth reforms a more attractive wager than before. However, to achieve this, Tunisia needs a change-oriented coalition led by a committed political leadership.

About the Authors

Ishac Diwan is the research director at Finance for Development Lab (FDL) at the Paris School of Economics.

Hachemi Alaya is an economist and the founding director of TEMA, a Tunisian think tank, and the editor of the macroeconomic newsletter ECOWEEK

Hamza Meddeb is a research fellow at the Malcolm H. Kerr Carnegie Middle East Center in Beirut, where he co-leads the Political Economy Program.

Malcolm H. Kerr Carnegie Middle East Center

The Malcolm H. Kerr Carnegie Middle East Center draws on regional experts to provide in-depth analysis of political, socioeconomic, and security issues in the Middle East and North Africa. Founded in 2006, the Beirut-based center delivers on-the-ground research of the region's challenges, examines long-term geopolitical trends, and proposes innovative policy options. As freedom of expression has become increasingly restricted in the wider Middle East, the center also creates a space for people across the region to convene and share diverse perspectives.

Carnegie Endowment for International Peace

The Carnegie Endowment for International Peace is a unique global network of policy research centers around the world. Our mission, dating back more than a century, is to advance peace through analysis and development of fresh policy ideas and direct engagement and collaboration with decisionmakers in government, business, and civil society. Working together, our centers bring the inestimable benefit of multiple national viewpoints to bilateral, regional, and global issues.

MALCOLM H. KERR
CARNEGIE MIDDLE EAST CENTER

Carnegie-MEC.org