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COMMISSION STAFF WORKING DOCUMENT

Ex-ante evaluation statement

Accompanying the document

Proposal for a Decision of the European Parliament and of the Council

providing further macro-financial assistance to the Republic of Tunisia

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Ex-ante evaluation statement

Further EU Macro-financial assistance to the Republic of Tunisia

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1.1 Introduction

In parallel to a protracted and fragile political transition process since the 2011 revolution, the Tunisian economy has suffered from continuous domestic unrest, regional instability (including the impact of the Libyan conflicts), and a weak international environment (particularly in the euro area). These unfavourable developments substantially weakened its growth performance, as well as its fiscal and balance of payments positions. In 2015, largely as a result of the negative economic impact of terrorist attacks (particularly on tourism, the transport sector and investment) and of production disruptions due to social unrest growth projections have been revised markedly down, while the situation is negatively affecting an already vulnerable balance of payments and fiscal position, creating important financing needs.

At the same time, the country has continued taking significant steps towards the consolidation of democratic mechanisms, including the approval of a new Constitution in January 2014, although the political transition has not been without difficulties and episodes of instability.

Tunisia reached in mid-April 2013 an agreement with the International Monetary Fund (IMF) on a 24-month Stand-By Arrangement (SBA) in the amount of USD 1.75 billion, which was approved by the IMF Board on June 2013, and which was subsequently extended until December 2015. It also requested in August 2013 complementary Macro-Financial Assistance (MFA) from the EU. In response, the European Commission proposed a MFA of EUR 250 million in December 2013 in the form of loans (MFA-I), which the co-legislators raised to EUR 300 million and approved in May 2014. The Memorandum of Understanding (MoU) defining the policy conditions related to this loan entered into force in March 2015.

Following the completion of the 6th review of the IMF programme last September, Tunisia requested a successor arrangement with the IMF, probably of a 4-year duration. The new IMF programme is still under negotiation but expected to be sent for IMF Board approval in the spring of 2016. The MFA-I operation is on track, despite some delays in its implementation. The first tranche was disbursed on 7 May 2015 and, with Tunisia having met the conditions agreed with the EU in the MoU, the second tranche was disbursed on 1 December 2015. The third and last tranche is expected to be disbursed in the second quarter of 2016, provided that the MoU conditions are met.

In this context, the Tunisian Prime Minister, in a letter sent to President Juncker in August 2015, and reiterated in December by a letter from the Minister of Development Cooperation and Investment, requested a second MFA operation from the EU in the amount of EUR 500 million, which would accompany the successor IMF programme. In view of the strong impact the security situation is having on Tunisia's economy and external financing needs during a period of consolidation of its political transition, and after an updated assessment of the country’s external financing needs conducted in liaison with the IMF, the European Commission is submitting to the European Parliament and the Council a proposal to grant a second MFA (MFA-II) to the Republic of Tunisia amounting to a maximum of EUR 500 million, in the form of medium-term loans. The proposed amount is also consistent with the expected size of the IMF programme, with the significant risks the Tunisian economy is currently facing, and with the strong commitment of the EU to support Tunisia's political and economic transition.

The proposed new MFA would help Tunisia cover part of its residual external financing needs, estimated at about USD 2.9 billion for the period 2016-17, in the context of the new

IMF programme. It would reduce the economy's short-term balance of payments and fiscal vulnerabilities, while coordinating with the adjustment and reform programmes to be agreed with the IMF and the World Bank, as well as with the reforms agreed under the EU's budgetary support operations, in particular the State Building Contracts *Programme d'appui à la relance* (PAR). The proposed MFA-II is consistent with the orientations of the European Neighbourhood Policy (ENP) and with efforts of the international community, including the G-7 Deauville Partnership initiative, to assist Tunisia in these challenging times.

1.2 Tunisia's macroeconomic situation

Following two years of stable, but low, *GDP growth*, in the context of the IMF programme (2.3% in both 2013 and 2014), growth for 2015 has been revised down to 0.5% compared to a forecast of 3% at the beginning of the year. Tunisia's economy has suffered a strong setback largely as a consequence of the terrorist attacks of 2015, which have affected key economic sectors. The negative effect of the attacks on the tourism sector (which contributes about 7% of GDP and accounts for around 15% of the workforce) and the transport sector (contributing also about 7% of GDP, 20% of which depends on tourism travel), as well as on foreign investors' sentiment, coupled with disruptions in phosphate production, transport and other sectors (due to work stoppages and strikes), have contributed to this downward revision. Tunisian authorities, and the IMF, expect growth to pick up in 2016, in the absence of additional shocks, supported by a slow recovery of the tourism sector and a normalisation of domestic production. Nevertheless, this baseline scenario has strong risks to the downside.

These low growth rates will, in any case, not suffice to make a significant dent on *unemployment*, which remains high at 15%, and is particularly high among the young and graduates (over 30%) and among women (21.6%). Furthermore, employment in the informal economy still accounts for around 50% of workers aged between 15 and 24.

Inflation averaged 5.5% in 2014 and is on a downward trend, in view of declining international commodity prices, stable domestic food production, the weakening of domestic demand and a prudent monetary policy. Headline inflation is expected to moderate to an average of 4.9% in 2015 and stay at around 4% over the next 5 years.

After tightening monetary policy between 2012 and mid-2014 in response to inflationary pressures and the deterioration in external and fiscal balances, the central bank cut its benchmark rate by 50 basis points (to 4.25%) last October, to help reignite the faltering GDP growth amid slowing CPI inflation.

Regarding the *public finances*, Tunisia achieved a certain degree of fiscal consolidation in 2014, reaching a fiscal deficit (central government balance excluding grants) of 4.1% of GDP compared to 6.2% of GDP in 2013, significantly over-performing the original fiscal target of 6.7% of GDP agreed under the IMF programme. This was, however, mainly due to two factors: (i) the underspending of the capital expenditure budget; and (ii) the postponement of the recapitalisation of the public sector banks to 2015. This second factor largely explains why the structural fiscal balance (which excludes banking recapitalisation costs) declined by much less (from 5.1% of GDP in 2013 to 4.2% of GDP in 2014). The latest assumptions from the IMF, calculated on the basis of the supplementary budget adopted in July 2015, point towards a fiscal deficit in 2015 of 5.8% of GDP. This deterioration largely reflects, as mentioned, the postponement of the banking recapitalisation costs from 2014, which is expected to amount to 1% of GDP. Excluding this factor, the deterioration was much more limited (the structural fiscal balance is forecasted to increase by only 0.5% of GDP to 4.7% of GDP).

The increase in the structural deficit has been driven by expenditure measures taken in the aftermath of the terrorist attacks, despite the lower than expected oil prices. As a result of lower oil prices and a weaker economic activity, revenues are expected to decline by 1.4% of

GDP. Expenditures are now expected to increase by 0.3% of GDP, despite the estimated savings of 1.6% of GDP generated by lower social compensation costs for energy price subsidies. These savings were used by the government to: address social tensions by increasing the wage bill (by 0.6% of GDP); to increase security spending (0.2% of GDP); and to finance an Economic Relaunch Programme (0.5% of GDP) to support sectors negatively affected by the terrorist attacks.

Table 1: Tunisia– Selected Macroeconomic Indicators, 2013-2017

	2013	2014	2015 Proj.	2016 Proj.	2017 Proj.
	(Annual percentage change, unless otherwise indicated)				
National Accounts					
Real GDP growth	2.3	2.3	0.5	2.5	4.0
Consumer price index, period average	5.8	4.9	4.9	4.0	3.9
Unemployment rate (in per cent)	15.3	15.3	15.0	14.0	13.0
Population (million)	10.9	11.1	11.2	11.2	11.3
GDP per capita (USD)	4.317	4.415	4.075	4.106	4.201
	(In per cent of GDP, unless otherwise indicated)				
Consolidated government operations					
Revenue and grants	23.7	24.5	22.9	23.4	23.7
Total expenditure and net lending	29.8	28.1	28.4	27.5	27.4
Overall fiscal balance excluding grants	-6.2	-4.1	-5.8	-4.3	-3.9
Overall fiscal balance including grants	-6.0	-3.7	-5.4	-4.1	-3.7
Structural fiscal balance (1)	-5.1	-4.2	-4.7	-4.2	-3.4
General government gross debt	44.3	50.1	54.0	53.1	58.1
External sector					
Current account balance	-8.3	-8.9	-8.8	-7.9	-6.9
Gross international reserves, end of period (USD bn)	7.7	7.7	7.5	8.5	9.1
- In months of next year's imports of goods/services	3.4	4.0	4.1	4.5	4.6
Foreign direct investment, net (USD bn)	1.1	2.2	2.6	2.6	2.6
External debt	54.2	56.2	61.6	67.7	70.6

Source: latest IMF staff estimates (November 2015)
(1) Excludes banking recapitalisation costs, and one-off arrears paid for energy subsidies

The 2016 budget law, submitted by the government to parliament in October and adopted by parliament in December, has as overarching policy objectives to strengthen national security, and combat fiscal fraud, smuggling and the parallel economy. The budget draft implies, based on the latest IMF estimates, a reduction of 1.5% of GDP (to 4.3% of GDP) in the headline deficit (as measured by the central government deficit excluding grants), although much of this is explained by the recapitalisation costs incurred in 2015 (which were a one-off cost item that will not be repeated in 2016). Revenues in 2016 are projected to increase by 0.6% of GDP (largely on account of the introduction of a VAT), while total expenditures are expected to remain stable as a percentage of GDP (despite a 0.6% of GDP increase in wages and salaries).

The structural deficit, which as noted excludes recapitalisation costs, declines by much less (by 0.5% of GDP, to 4.2% of GDP). The reduction in the structural deficit is expected to be achieved largely through a lower expenditure on subsidies (due mostly to the assumptions of a lower international oil price, tabled at USD 55 per barrel on average for 2016, and a stable exchange rate), while it forecasts the hiring of around 15.000 additional public employees (mostly for the defense and security sectors), which will increase the wage bill. Some tax measures have also been included, such as a more comprehensive reform of the *regime forfataire* (an area of focus in the MFA-I operation), and a simplification of the VAT structure,[1] as well as general measures in the area of tax administration aimed at curbing fiscal fraud and the parallel economy. Consistent with the priority objective under the Recovery and Transformation Programme to foster public investment projects in the amount of USD 8-10 billion over the next five years, the draft 2016 budget envisages an increase in capital expenditure of 15% compared to 2015.

Meanwhile, the *debt of the general government* has continued to increase, reaching 50% of GDP in 2014 and is forecast to peak at 61% of GDP by the end of 2018 before starting to reverse the trend. Also, a substantial increase in public debt amortisations is scheduled to take place in the coming two years (from about USD 600 million in 2015 to more than USD 1.4 billion in 2017, and almost USD 1.2 billion in 2018).

Turning to the balance of payments, the *current account deficit* further widened in 2014, reaching 8.9% of GDP compared to 8.3% of GDP in 2013, and is expected to remain at an unsustainable large level in 2015, despite the decline in oil prices, weaker domestic economic activity and improved export performance. While in the first seven months of 2015, falling energy imports and rising food exports cut Tunisia's current trade deficit by 10% compared to the same period of 2014, the negative effects on tourism of the Sousse terrorist attack are expected to put additional pressure on the current account deficit, pushing the deficit back towards 8.8% of GDP. Tunisia is commonly considered an energy importer, but it also produces and exports substantial amounts of crude oil, the value of which has of course been significantly affected by the decline in oil prices. Tunisia's oil exports represented about 5% of GDP and 13% of total exports, while its oil imports stand at about 9% of GDP and 18% of total imports. The net effect of the fall in the oil price has therefore been positive, but much less so than in other net oil importers such as Morocco.

Private capital inflows in Tunisia have also weakened since 2011, contributing to the vulnerabilities of the balance of payments. Net foreign direct investments, which averaged almost 5% of GDP during 2005-2010, have declined to just over 2% of GDP in the last two years.

In this context of wide current account deficit and weaker capital inflows, Tunisia has had to increasingly rely on official financial inflows. In 2015, Tunisia also managed to cover part of its external financing gap through the issuance in January 2015 of a 10-year, USD 1 billion Eurobond at 5.75%, which was oversubscribed by international investors despite not including a sovereign guarantee by a foreign donor.

Official foreign exchange reserves ended 2014 at USD 7.7 billion, or the equivalent of barely 3 months of imports, which compares to an initial target of USD 9.0 billion under the IMF programme. The USD 1 billion international bond issued in January 2015 raised the reserve level but, by the end of October, reserves had dropped back to about USD 6.5 billion, or just under 4 months of imports, as tourism income fell in the wake of the terrorist attacks. The reserve level at the end of 2015 is now expected to be USD 7.5 billion. This is well below the USD 8.2 billion the IMF had foreseen for the end of the year in the context of the 6th review of the programme (completed in September 2015) and compares to a USD 10.1 billion reserve target under the original programme.

External debt increased from 48% of GDP in 2011 to an estimated 56.2% of GDP in 2014, and it is expected to peak at 72.3% of GDP in 2018 before starting to reverse this trend. Tunisia's sovereign ratings have been downgraded several times since 2011, the last time in 2014 (from Ba2 to Ba3 by Moody's and from BB to BB- by Standard & Poor's.

[1]The VAT in Tunisia is currently composed of three rates of 6%, 12% and 18%. The draft budget law 2016 will reduce them to two rates of 8% and 20%, and considerably reduce the products of the lower segment.

1.3 IMF and other donor support

On 7 June 2013, the IMF Board approved an USD 1.75 billion (400% of the Tunisian quota), two-year Stand-by Arrangement (SBA). Last May, the IMF and Tunisia agreed to extend the programme implementation period from June 2015 until December 2015, to better align it with the reform calendar of the new government and to provide more breathing space to Tunisia at a challenging economic and political juncture. The staff mission for the 6th SBA review took place in May 2015, with a follow-up mission in July after the Sousse terrorist attacks. The approval of the review by the IMF Board took place on 30 September, at which time the IMF released another USD 303 million tranche of the SBA to Tunisia. So far, Tunisia has drawn USD 1.5 billion under the IMF's SBA.

The completion of the 6th review by the IMF Board confirmed that the programme remains on track, and commended Tunisia's efforts and resilience despite the adverse economic shocks. It also noted, however, that the programme performance remained mixed, as the reform agenda has continued to lag the progress achieved in the quantitative performance criteria.

The 7th and final review will however not take place, since Tunisia has requested a successor arrangement to the IMF, for which discussion have started in December. A new programme is expected to be sent to the IMF Board in March 2016. It is likely to be a 4-year Extended Funding Facility and to be larger than the current SBA, although the final amount remains to be determined.

The World Bank has made available USD 500 million in the form of a Development Policy Loan (DPL) in 2011 (as part of PAR I; see below) and a further USD 500 million in 2012 (as part of PAR II). In 2013, it approved a Governance, Opportunities and Jobs Development Policy Loan Program (GOJ-1 DPL) of USD 500 million (which it disbursed between 2013 and 2014), as part of a programmatic series of three single-tranche multi-sector operations totalling USD 1.25 billion. In 2014, the World Bank approved and disbursed the second loan of this series (GOJ-2 DPL), amounting to USD 250 million. The third and last GOJ-3 DPL was approved in October 2015, amounting to USD 500 million.

The African Development Bank (AfDB), which has supported Tunisia with a number of policy-based loans in the past (including its contributions to the PAR), approved in November 2015 a budget support loan of EUR 183 million, targeting mainly the education and agricultural sectors.

Tunisia joined the EBRD in December 2011 and was granted full country of operations status in October 2013. Since the start of its activities, the bank has provided Tunisia with over EUR 212 million in 16 projects to date, mainly focused on restructuring and strengthening the financial sector and financing private enterprises, supporting energy efficiency and developing a sustainable energy sector, as well as facilitating non-sovereign financing for infrastructure development.

In 2014, the US provided guarantees for the issuance of a USD 500 million bond, after having guaranteed a similar amount in 2012 (USD 458 million). In September 2015, the US announced its support to a guarantee for a bond issuance of a similar amount if requested by Tunisia.

Japan provided a guarantee in 2014 for the issuance of USD 464 million in Samurai bonds (as it did in 2013 in the amount of USD 197 million and in 2012 in the amount of USD 303 million). No similar support for 2015 has been announced by Japan, but Japan is expected to contribute to closing the financing gap in the context of a new IMF programme in the coming years.

Additional official assistance in 2015 has been provided by Algeria (USD 100 million in budget support loans, USD 100 million as deposits at the central bank to help build reserve levels, and USD 50 million in grants). The total amount of USD 250 million would follow an identical operation from Algeria in 2014. The Arab Monetary Fund has also provided financial assistance in 2015 (USD 42 million).

The EU has provided significant assistance to Tunisia in recent years, in addition to the MFA-I. Financial assistance provided under the ENI (European Neighbourhood Instrument), and earlier under the ENPI, amounted to EUR 801 million for the period 2011-2015 (to date), which includes EUR 277 million under the SPRING and Umbrella funds (EUR 155 million and EUR 122 million, respectively). These funds were complemented by financing from other EU instruments such as the Instrument for Stability (IfS), the European Instrument for Democracy and Human Rights (EIDHR), the Neighbourhood Investment Facility (NIF) and thematic programmes under the Development and Cooperation Instrument (DCI).

The bulk of the EU's assistance has been channelled in the form of budgetary support as part of the multi-donor aid packages known as Programme d'appui à la relance (PAR), which aimed at supporting reforms in the areas of employment creation, regional development, social action programmes, good governance and economic recovery. The first three PARs were undertaken jointly with other IFIs, but the ongoing PAR-4 (and the future PAR-5, in preparation) are EU stand-alone operations. For the period 2014-2020, the indicative bilateral allocation for Tunisia ranges between EUR 725-886 million.

The EIB remains the largest external donor in Tunisia, where it has provided loans worth EUR 5.6 billion since 1979, EUR 1.3 billion of which since 2011. In 2015, the EIB has signed EUR 200 million in loans.

1.4 Progress under the ongoing MFA-I operation

Following the ratification of the legal documents by the Tunisian Parliament on 4 March 2015, the Commission was able to proceed with the implementation of the EUR 300 million of assistance under MFA-I. MFA-I is being disbursed in three equal tranches of EUR 100 million each. The disbursement of the first tranche took place on 7 May 2015, and was conditional on good progress under the IMF's SBA. The disbursement of the second tranche was delayed by a few months reflecting insufficient compliance with some of the policy conditions defined in the MoU, notably those referring to the submission of the new central bank law to parliament and the adoption of a statistics code. With these conditions having been satisfied in the course of October and November 2015, and the 6th review of the IMF programme having been successfully completed on 30 September 2015, the Commission decided on 16 November 2015 to disburse the second tranche of the assistance. The actual disbursement took place on 1 December.

The third and last tranche of the MFA-I, also of EUR 100 million, is expected to be disbursed in the first quarter of 2016, provided that the policy conditions under the MoU are met.

1.5 Tunisia's external financing needs

The revised projections that were produced in November by the IMF point towards significant balance of payments needs for the period 2016-2017, with the total external financing gap estimated at USD 5.1 billion (USD 2.7 billion in 2016 and USD 2.4 billion in 2017; see Table 2).

This financing gap can broadly be attributed to three factors: a persistently large current account deficit, the need to build up foreign exchange reserves over the period 2016-17, and the large debt amortization requirements expected, especially for 2017. The IMF foresees that the current account deficit will gradually narrow, reflecting a sustained increase in exports driven by improved competitiveness and the recovery of global demand, but to remain sizeable (declining to 7.9% of GDP in 2016 and to 6.9% of GDP by 2017, even assuming a gradual recovery of tourism revenues).

Despite its downward trend, the current account deficit is not expected to be covered by the surplus in the capital and financial account. Having dropped, as noted, in 2015 (to an estimated USD 1 billion), net FDI inflows are projected to recover only slowly in 2016 (to USD 1.1 billion) and 2017 (to USD 1.2 billion), reflecting the security situation and the related perception of high political and macroeconomic risks. This will still be significantly below its 2012 and pre-Arab spring levels as a percentage of GDP.

Regarding official reserves, and as mentioned earlier, these ended 2014 at USD 7.7 billion, or the equivalent of barely 4 months of imports; and the IMF expects them to end 2015 at USD 7.5 billion, well below the amounts originally programmed. The new IMF programme is expected to target a significant build-up of reserves.

The third key factor contributing to the estimated external financing gap is, as noted, the large debt amortisations foreseen, notably for 2017. While during the period 2013-2016 Tunisia's debt amortisation payments averaged about USD 630 million per year, in 2017 they will jump to USD 1.4 billion, in part due to the repayments of the IMF 2013-2015 loan.

Although the amounts of the new IMF programme are yet to be defined, the preliminary intention is to go for a 4-year Extended Arrangement starting in the second quarter of 2016 and of a similar yearly amount as the current SBA. However, IMF repurchase obligations stemming from the current SBA would be USD 35 million in 2016 and USD 322 million in 2017. Therefore, net IMF financing could amount to about USD 865 million in 2016 and USD 478 million in 2017, contributing to cover about 24% of the total projected external financing gap for the period 2016-2017.

According to preliminary information, the World Bank is expected to disburse to Tunisia a USD 500 million DPL in 2016, and a further USD 500 million DPL in 2017. In total, the budget support amounts provided by the World Bank would represent around 20% of the projected external financing gap for 2016 and 2017.

After deducting net IMF disbursements and disbursements of World Bank policy-based loans, this would leave a residual external financing gap of about USD 2.9 billion for the period 2016-2017. Thus, the proposed new MFA operation of EUR 500 million would cover 19.2% of the estimated residual financing gap. In addition, the third tranche of the ongoing MFA operation (EUR 100 million), which is expected to be disbursed during the first quarter of 2016, would represent about 3.8% of the gap. In total, the EU's combined MFA I and II operations would, therefore, cover 23% of the expected residual financing gap for the period 2016-2017.

In the absence of other pledges of official assistance, the Commission and the IMF assume, as shown in the table below, that Tunisia may have to access the international markets without any donor guarantees in order to cover part of the residual external financing gap, whether in the form of normal international bonds or of Sukuk bonds. This is particularly for 2017, where identified pledges of official assistance fall significantly short of the estimated residual financing gap. Tapping the international markets without guarantees may, however, prove difficult depending on the market conditions. On the other hand, it is likely that the USA and Japan, as in previous years, will provide additional support in the form of bond guarantees if necessary. The table below assumes that the USD 500 million in bond guarantees pledged by the USA in mid-2015 will be utilised in 2016. In addition, another USD 250 million budget support contribution from the African Development Bank has been included in the financing assumptions for 2016.

Table 2: Tunisia's External Financing Gap and Potential Financing Sources (USD million)

(USD million)	2015	2016	2017	Total 2016-17
1. Current account balance*	**-4.060**	**-3.659**	**-3.300**	**-6.959**
2. Capital and financial account*	1.577	1.976	1.469	**3.445**
3. Overall balance (1+2)	**-2.483**	**-1.683**	**-1.831**	**-3.514**
4. Reserves ("-" indicates increase)	200	-1.000	-600	**-1.600**
5. Overall External Financing Gap (3+4)	**-2.283**	**-2.683**	**-2.431**	**-5.114**
6. Exceptional Financing by IMF and WB	**802**	**1.265**	**978**	**2.243**
Net IMF Disbursements	302	765	478	**1.243**
Disbursements of World Bank's DPL	500	500	500	**1.000**
7. Residual Financing Gap (5+6)	**-1.481**	**-1.418**	**-1.453**	**-2.871**
Financing of the gap				
EU MFA-I	220	110	0	**110**
EU MFA-II	0	385	165	**550**
EU budget support grants	100	100	100	**200**
AfDB	200	250	0	**250**
AMF	42	0	0	**0**
US-guaranteed international bonds	0	500	0	**500**
Algeria	250	0	0	**0**
Total identified sources	**812**	**1.345**	**265**	**1.610**
Other financing sources (inc. Intl. Markets/ Sukuk)		*73*	*1.188*	*1.261*
Total MFA-II as % of the residual gap for 2016-2017			**19,2%**	
Total MFA I and II as % of the residual gap for 2016-2017			*23,0%*	

* Excludes official grants and loans provided in the form of policy-based budgetary support.
** An exchange rate of EUR 1.10 / USD 1 has been used to convert EU assistance into USD.
Sources: latest IMF staff estimates (November 2015) and Commission staff calculations

1.6 Structural reform challenges

Tunisia continues to face significant structural reform challenges. While the country enjoyed during 2000-2010 a period of relatively high per-capita economic growth (one of the highest among the oil importers in the Middle East and North Africa (MENA) region), it continues to suffer from a number of structural deficiencies. First, it has an excessive reliance on the development of an export-oriented, low-value added industry located near the coastline, to the detriment of other industries and the development of the interior. Second, it has a weak and inefficient banking sector and the pervasive use of capital controls and directed lending continues to constrain financial development and the allocation of saving to the most productive investments. Third, rigid labour markets and skill mismatches have contributed to high unemployment, particularly among the youth, while participation rates (particularly among women) are very low, as it is the case in most countries in the region. Fourth, transparency and economic governance are perceived as weak and the growth model has resulted in an unfair distribution of economic gains among the population. Finally, this model has also resulted in an unbalanced pattern of regional economic development, with the northern and coastal regions, including the metropolitan area of Tunis relatively high per capita income contrasting with the poverty and underdevelopment and high unemployment rates seen in the interior and southern regions, which helps explain why part of the 2010 Arab spring revolts originated here.

While Tunisia has adopted a number of encouraging reform measures in recent years, notably in the context of the programme agreed with the IMF and supported by the ongoing MFA-I, implementation has often been slower than programmed, partly reflecting the complex political transition and security problems the country has being going through. As in 2014, structural reform progress in 2015 has been mixed. While the parliamentary elections complicated reform implementation last year, in 2015 delays in the formation of the new government and, subsequently, the challenging political context created by the domestic security threats led to the postponement of certain reforms, although the reform agenda has gathered some momentum in the last quarter of 2015.

Ambitious reforms such as the new Investment Code have been marred by a protracted period of consultation of stakeholders that lasted about two years, with the code having been finally submitted to Parliament in 2014 but again withdrawn in March 2015. However, the latest revision of the Code prepared by the government, which has been praised for its quality and ambition by the IMF and World Bank, was adopted by a restricted Cabinet meeting on 22 October and adopted by parliament in December 2015 (structural benchmark under the IMF programme).

Similarly, following a two-year consultation process on Tax Reform (prepared with technical assistance of the IMF), some important measures have been incorporated in the 2016 budget law. Among these are: the introduction of the new VAT; the reduction of exemptions; the broadening of the tax base; and further steps towards the full convergence of on-shore and off-shore corporate tax rates.

Progress on the recapitalisation of the three public banks, which has been a centrepiece of the IMF programme since 2013, gathered momentum in 2015, with the passing by parliament on 6 August of the necessary recapitalisation law. Under the bill, the banks STB (Société tunisienne de banque, 50.5% state-owned) and BH (Banque d'Habitat, 57% state-owned) could receive public capital injections of up to TND 757m and TND 110m, respectively. No funds were foreseen for the third bank, BNA (Banque Nationale Agricole, 65% state-owned), because it was expected to raise the required funds (TND 300 million) through own-asset sales.

The recapitalisation process was structured in two phases. First, the capital increase was open to the existing shareholders, including the state, so that both were given the chance to avoid a dilution of their capital shares. In case the private sector stakeholders did not subscribe their share, a second phase allowed external private sector investors to subscribe to the capital increase. Since this was not a privatisation operation, at a minimum the state had to inject capital to maintain its capital share, thus avoiding a dilution of its share, and had to inject additional capital if the private sector did not subscribe enough to reach the recapitalisation targets. The recapitalisation process for the STB concluded on 30 October, with the State having subscribed the majority of the shares at a final cost of TND 678 million (TND 79 million less than the maximum amount authorised by parliament), which has led to its share participation increasing from 50.4% to 83.3%. The recapitalisation process for the BH finally did not take place as the bank is now expected to raise the required funds by selling assets.

These three public banks have systemic importance, representing about 40% of banking assets and 30% of banking sector deposits. While the recapitalisation process will no doubt provide a lifeline to these banks, it remains to be seen how the new demand shock in the tourism sector (to which the three public banks are heavily exposed) will affect their volume of non-performing loans, and whether additional funds will be necessary to sustain the banks in the medium-term.

There have been delays in the creation of an Asset Management Company (AMC), which was supposed to take over banks' non-performing loans, particularly from the tourist sector. Although the AMC was already created by the 2014 revised budget law, an additional law and operational decrees needed to make the AMC fully operational are still pending parliamentary approval. However, the idea of an AMC has been almost abandoned, given the AMC would have as main task to manage and work-out the bad loans to the tourist sector, which would lead to the closure or downsizing of quite a few hotels or resorts. With the tourist sector now immersed in a serious crisis because of the terrorist attacks, it is politically harder to create now a bank that will increase pressure for restructuring, much as this may be economically necessary. The central bank is working, with World Bank assistance, on possible alternatives.

A new central bank law, prepared with technical advice from the IMF, has been submitted to parliament in November (as foreseen under the MFA-I second tranche conditions). The proposed law contains provisions aimed at bringing it in line with the provisions of the new 2014 Constitution, including amendments to strengthen its governance and establishing its function as a lender of last resort. A revised banking law, including key aspects such as a banking resolution mechanism, new prudential regulations and improved governance and new bank bankruptcy provisions, which is a condition in the MoU for the disbursement of the 3rd tranche of the EU's ongoing MFA-I, is also pending parliamentary approval. This law also includes the creation of a deposit guarantee scheme, which is also part of MFA I's conditionality.

There has been some progress with the reform of the regressive and inefficient price subsidy system but not as much as originally intended. Energy price increases (on electricity and gas, as well as fuel products) were implemented in 2012, 2013, and 2014, but the decline in international oil prices has in part reduced the need for further price increases (in fact, in some cases international fuel prices have fallen below domestic ones). A key reform in the current political and economic context that should be actively pursued by government, also urged by the IMF, is the introduction of an automatic price adjustment formula for electricity prices (which remain on average about 20% below cost-recovery).

The social safety net needed to compensate poorer households for the impact of the energy price subsidy reform is not yet in place, although, in the meantime, provisional measures have been taken to strengthen the performance of the existing cash-transfer programmes, mainly by increasing the monthly allocations and the number of beneficiaries. As foreseen under the MFA-I policy conditions for the 2nd and 3rd tranches, the government is working on improving the targeting of the existing social programmes, including by conducting a large evaluation of the current programmes, and by advancing in the completion of a unified registry for users. A more comprehensive and better targeted cash transfer compensation scheme is supposed to be introduced once work on the development of a unified registry for users is completed.

Other economic reforms, particularly related to the business climate, have been hampered by the delays in the legislative agenda, although the recent adoption in August 2015 of the law on competition, and progress made on the bankruptcy and Public Private Partnership (PPP) laws, which have both been adopted by Cabinet in November 2015, are encouraging developments.

Another area where structural reforms continue to be needed is public finance management (PFM). One key challenge in the area of PFM reform is to increase the transparency, accountability and effectiveness of external and internal audit. Also, the management of the investment budget suffers from very slow and sometimes arbitrary procedures to identify, select, and formulate projects. The EU's PAR-5 programme (to be adopted in December 2015) is specifically targeting the improvement of the budget structure by supporting the implementation of the GBO (Gestion budgetaire par objectives) programme. In addition, an updated Public Expenditure and Financial Accountability (PEFA) assessment, based on the World Bank's methodology, is expected to be finished by the end of 2015 (the last one dates from 2010).

Progress has been made in the reform of the statistical system, partly reflecting the policy conditionality in the EU's MFA-I and PAR-4 operations, which built on the comprehensive assessment of Tunisia's statistical system produced by Eurostat in 2014. A new code of statistics has been adopted by the government, and represents a significant step towards improved governance of the national statistics system, where further reform is nevertheless needed.

While Tunisia already has a relatively open trade regime, it could benefit from further trade liberalisation. Following the Sustainability Impact Assessment (SIA) carried out by an independent contractor in 2013, the preparatory process ("scoping exercise") for the launch of Deep and Comprehensive Free Trade Agreement (DCFTA) negotiations with the EU has now been completed and formal negotiations were finally launched in October 2015. MFA-I is also supporting the preparations for the negotiations of an Agreement on Conformity Assessment and Acceptance (ACAA) of industrial products, including by reforming of the institutional framework for market surveillance in order to better align it with the legislative framework in the area adopted by the EU in 2008.

The conditionality of the proposed new MFA operation would continue to support the country's structural reform agenda, particularly the Strategic Development Plan for the period 2016-2020 to be launched in February 2016, and in close coordination with the conditionality of the new programmes to be agreed with the IMF, the World Bank and other donors, as well as with the budgetary support operations financed by the ENI.

2. OBJECTIVES AND MONITORING INDICATORS OF THE MACRO-FINANCIAL ASSISTANCE

2.1 Objectives

The objectives of the proposed MFA operation are to:

i) Contribute to covering the external financing needs of Tunisia in the context of a significant deterioration of the country's external accounts brought about by the on-going political transition and developments in the region, which has been exacerbated by the impact of the terrorist attacks.

ii) Alleviate Tunisia's budgetary financing needs.

iii) Support the fiscal consolidation effort and external stabilisation in the context of the IMF programme.

iv) Support structural reform efforts aimed at improving the overall macroeconomic management, strenghening economic governance and transparency, and improving conditions for sustainable growth.

v) Facilitate and encourage efforts by the Tunisian authorities to implement measures identified under the EU-Tunisia Action Plan, supporting regulatory convergence and economic integration with the EU and strengthen the EU's economic policy dialogue with the authorities.

2.2 Monitoring indicators

The fulfilment of the objectives of the assistance will be assessed by the Commission, including in the context of the ex-post evaluation (see below), on the basis of the following indicators:

i) Progress with macroeconomic and financial stabilisation, notably by assessing the degree of adherence to the IMF-supported programme.

ii) Progress with the implementation of structural reforms, notably the specific policy actions identified as conditions for disbursement of the assistance, which will be included in a Memorandum of Understanding to be negotiated between the Commission and the Tunisian authorities.

3. DELIVERY MECHANISMS AND RISK ASSESSMENT

3.1 Delivery mechanisms

The MFA-II operation under consideration would amount to maximum of EUR 500 million. Given the proposed size of the operation, the European Commission is considering releasing the assistance in three instalments of EUR 200 million, EUR 150 million and EUR 150 million. The first instalment would be disbursed in the middle of 2016, the second in the last quarter of 2016 and the last in the first quarter of 2017.

The Commission proposes providing the full amount of the assistance in the form of a medium-term loan. This is consistent with the methodology for determining the use of grants and loans in EU MFA, as endorsed by the Economic and Financial Committee in January 2011, which takes into account the following criteria:

Firstly, Tunisia is a middle-income country with a relatively high per capita income level. Tunisia’s per capita Gross National Income (GNI) of USD 4,210 is the sixth highest per capita income in the Southern neighbourhood, after Israel, Lebanon, Libya, Algeria and Jordan.

Secondly, while Tunisia’s public debt ratios have significantly increased in recent years, the public debt dynamics are judged to be sustainable and debt ratios remain at a significantly lower level than those of its regional peers. The public debt-over-GDP stood at 50% of GDP at the end of 2014 and is expected to peak at 61.2% in 2018 before reversing the trend. Total external debt, for its part, stood at 56% at the end of 2014 and is also expected to peak in 2018, at 72.3% of GDP.

Thirdly, Tunisia is not eligible for concessional financing from either the IDA or the IMF's Poverty Reduction and Growth Trust.

3.2 Risk assessment

There are fiduciary, credit, policy and political risks related to the proposed MFA operation.

There is a risk that the macro-financial assistance, which is not dedicated to specific expenses (contrary to project financing, for example), could be *used in a fraudulent way*. In general terms, this risk is related to factors such as the quality of management systems in the central bank and the ministry of finance, administrative procedures, control and oversight functions, the security of IT systems and the appropriatedness of internal and external audit capabilities.

To mitigate the risks of fraudulent use several measures will be taken. First, the Memorandum of Understanding and the Loan Agreement will comprise a set of provisions on inspection, fraud prevention, audits, and recovery of funds in case of fraud or corruption. Also, the assistance will be paid to a dedicated account of the Central Bank of Tunisia. Moreover, the Commission services have conducted, in January 2014, with the support of external consultants, an Operational Assessment, in order to assess the reliability of financial circuits and administrative procedures that are relevant to this type of assistance and that determined that the framework for sound financial management of macro-financial assistance is sufficiently effective in Tunisia. The Commission is also using budget support assistance to help the Tunisian authorities improve their public finance management systems and these efforts are strongly supported by other other donors. Against this background, special conditionalities on improving public finance management will potentially be required. Finally, the assistance will be liable to verification, control and auditing procedures under the responsibility of the Commission, including the European Antifraud Office (OLAF), and the European Court of Auditors.

A second risk stems from the possibility that the Tunisia will fail to service the financial liabilities towards the EU stemming from the proposed MFA loans (*default or credit risk*), which could be caused by a significant additional deterioration of the balance of payments and fiscal position of the country or/and by unforeseen political events. This risk is mitigated however by the fact that the EU's MFA would be part of an international package of official assistance led by the IMF that is supporting an adjustment and reform programme aimed at restoring fiscal and balance of payments sustainability through the implementation of a series of policy measures, included those listed in the MoU attached to the proposed MFA from the EU. Moreover, the risks for the EU budget are covered by the provisioning of the EU's Budget Guarantee Fund for External Actions.

Another key risk to the operation stems from the *domestic security situation*, in particular related to possible terrorist attacks, which could further destabilise key economic sectors, weaken the authorities' political determination to implement the necessary economic reforms and fuel social unrest. A derailment of the adjustment process could put the objectives of the IMF-supported programme in jeopardy, endanger macroeconomic stability and prevent the effective disbursement of MFA-II. There are also considerable risks from the regional political situation conflict, notably the conflict in Libya, which is having a negative impact on Tunisia's economic and social situation, including through the flow of Libyan refugees.

Finally, there are risks stemming from a possible weakening of the *European and global economic environment* (taking into account Tunisia's high dependence on the EU market) and an increase in international energy and food prices, which would have an important effect on Tunisia's fiscal and balance of payments situation.

Having made a thorough assessment of the risks, the Commission services consider that there are sufficient grounds and guarantees to proceed with the proposed MFA to Tunisia.

The Commission services will maintain close contacts with the authorities during the implementation of the macro-financial assistance in order to address quickly any concerns that may arise.

4. ADDED VALUE OF EU INVOLVEMENT

The Union's financial support to Tunisia reflects the country's strategic importance to the EU in the context of the European Neighbourhood Policy. The instrument of macro-financial assistance is a policy-based instrument directed to alleviate short- and medium-term external financial needs. As a part of the overall EU package of assistance, it would contribute to support the European Union's objectives of economic stability and economic development in Tunisia. By helping the authorities' efforts to establish a stable macroeconomic framework, the proposed assistance would help improve the effectiveness of other EU financial assistance to the country, including budgetary support operations.

By helping the country overcome the economic difficulties caused by the political transition and the regional crisis, the proposed MFA will contribute to promoting macroeconomic stability and political progress in the country. By complementing the resources made available by the international financial institutions, bilateral donors and other EU financial institutions, it contributes to the overall effectiveness of the package of financial support agreed by the international donor community in the aftermath of the crisis.

In addition to the financial impact of the MFA, the proposed programme will strengthen the government's reform commitment and its aspiration towards closer relations with the EU. This result will be achieved, inter alia, through appropriate conditionality for the disbursement of the assistance. In a larger context, the programme will signal to the other countries in the region that the EU is ready to support countries like Tunisia, embarking on a clear path towards political reforms, in challenging economic circumstances.

5. ASSESSMENT OF CRITERIA APPLICABLE TO MACRO-FINANCIAL ASSISTANCE[2]

5.1 Exceptional Character and Limited Timeframe

The MFA-II operation would be exceptional, aiming to support the restoration of a sustainable external finance situation of Tunisia. It would run in parallel to the IMF arrangement succeeding the current SBA programme, which is expected to be in place by the spring of 2016. The proposed MFA-II would only be implemented if such an IMF arrangement is put in place, and only during a strict timeframe covering part of the new IMF programme period. Against this background and given the expected time of approval of the programme, the assistance is expected to be implemented in 2016-2017. The disbursement of the first tranche could take place in the middle of 2016 provided that the IMF program has been signed and remains on track. The second and third tranches, conditional on a number of policy measures, agreed with the EU, could be disbursed in the fourth quarter of 2016 and first half of 2017, respectively. While in the short-term the country faces substantial balance of payments financing needs, the macroeconomic and structural adjustment programme agreed with the IMF and supported by the proposed MFA is expected to produce a gradual strengthening of the balance of payments and fiscal positions.

5.2 Political preconditions and EU-Tunisia relations

MFA is reserved to geographically close third countries that respect effective democratic mechanisms (including a multi-party parliamentary system) and the rule of law and that guarantee human rights, and with which the EU maintains close political and economic links. Countries that are covered by the ENP are eligible for MFA.

Political preconditions: A pre-condition for granting MFA is that the eligible country respects effective democratic mechanisms, including a multi-party parliamentary system and the rule of law, and guarantees respect for human rights. Following the revolution and the ousting of President Ben Ali on 14 January 2011, a political transition ensued that culminated in 2014 with the approval of a new Constitution, parliamentary and presidential elections. Tunisia's successful progress in transitioning towards a democratic political system represents a unique case in the region, in particular when compared with other Arab countries that attempted a similar path following the 2011 Arab Spring. In this context, the political preconditions for MFA are considered to be satisfied.[3]

EU-Tunisia relations: The EU and Tunisia have developed a close political and economic relationship. In 1995, Tunisia became the first country in the Southern Mediterranean to sign an Association Agreement with the EU, which entered into force in 1998. This agreement continues to be the legal basis for bilateral cooperation. Bilateral relations have been further reinforced under the EU's ENP, including through the adoption of five-year ENP Action

[2] Established Commission practice in line with the Joint Declaration by the European Parliament and the Council adopted together with Decision No 778/2013/EU of the European Parliament and of the Council of 12 August 2013 providing further macro-financial assistance to Georgia, OJ L 218, 14.8.2013, p. 15.

[3] A complete assessment of the satisfaction of the political precondition for MFA is provided by the European External Action Service, as it is standard practice, as an annex to this document.

Plans establishing strategic objectives for this cooperation, the latest of which covers the period 2013-2017. Tunisia is also a member of the Union for the Mediterranean. Economic ties with the EU are very important. In 2014, the EU was the source of about 65% of Tunisia's imports and the destination of about 73% of its exports, the highest shares observed in the entire EU neighbourhood. Tunisia has also a high dependence on the EU in terms of FDI and other financial flows, remittances and tourism inflows. Tunisia finalized the dismantling of tariffs for industrial products in 2008. The ambitious relation the EU and Tunisia are building is also symbolised by the agreement the two parties signed in 2014 on a "Privileged Partnership" and by the launching on 13 October 2014 of the negotiations on a Deep and Comprehensive Free Trade Agreement, which should eventually allow Tunisia to fully access the EU's single market.

In sum, Tunisia has taken very important steps towards establishing a fully-fledged democratic system. The country has also adopted a comprehensive economic stabilisation and reform agenda, supported by the IMF, the EU and other donors, and enshrined also in the government's Recovery and Transformation Programme for 2016-2020, which aims at developing a sustainable, employment generating and equitable growth model. In this context, the EU is strongly committed to supporting Tunisia in its transition process. There is also a solid and intensifying framework of bilateral relations between the EU and Tunisia under the Association Agreement, the ENP and other recent initiatives, including the plan to conclude a DCFTA.

5.3 Complementarity

The proposed MFA-II would complement the assistance provided by other multilateral and bilateral donors in the context of the new IMF-supported economic programme. The total financing to be provided by donors other than the EU remains has yet to be fully identified but, based on the information currently available and assuming an IMF of a structure as described in the previous section, multilateral and bilateral donors are expected to cover at least 62% of the estimated external financing gap for the period 2016-17, ensuring a reasonable burden-sharing. The EU's MFA-II would also complement the standard EU aid packages mobilised under the ENI and the Umbrella programme, and in particular the conditionalities envisaged under the PAR-5 package. By supporting the adoption by the Tunisian authorities of an appropriate framework for macroeconomic policy and structural reforms, the EU's MFA-II would enhance the added value and effectiveness of the EU's involvement through other financial instruments.

5.4 Conditionality

Disbursements under the proposed MFA-II operation would be conditional on successful programme reviews under the IMF programme and on the effective drawing by Tunisia of the funds available under the IMF financial arrangement. In addition, the Commission and the Tunisian authorities would agree on a specific set of structural reform measures, to be defined in a Memorandum of Understanding. These reform measures would support the authorities' reform agenda and complement the programmes agreed with the IMF, the World Bank and other donors, as well as the policy programmes associated with the EU's budgetary support operations. They would be consistent with the main economic reform priorities agreed between the EU and Tunisia in the context of the ENP Joint Action Plan and other strategic documents. They will also build upon the structural reforms implemented under MFA-I.

The Commission will seek a broad consensus with the Tunisian authorities, so as to ensure a smooth implementation of the agreed conditionality. These policy conditions should address some of the fundamental weaknesses accumulated over the years by the Tunisian economy. Possible areas of conditionality could in principle include: public finance management; tax reforms; reforms to strengthen the social safety net; labour market reforms; financial sector reforms; and measures to improve the regulatory framework for trade and investment, including measures that could prepare the ground for the future DCFTA agreement.

5.5 Financial Discipline

The planned assistance would be provided in the form of a loan and should be financed through the borrowing operation that the Commission will conduct on behalf of the EU. The budgetary costs of the assistance will correspond to the provisioning, at a rate of 9%, of the amounts disbursed in the guarantee fund for external lending of the EU, from budget line 01 03 06 ("the provisioning of the Guarantee Fund"). Assuming that the first and second loan disbursements (amounting to EUR 250 million and EUR 150 million respectively) are made in 2016 and the third loan disbursement (amounting to EUR 150 million) in 2017, and in line with the rules governing the guarantee fund mechanism, the provisioning will take place in the 2018-19 budgets. This somewhat frontloaded distribution of tranches takes into account the pressing external financing needs of Tunisia, concentrated in 2016.

To ascertain that the beneficiary has in place a sound financial management in line with the requirements of the Financial Regulation, the European Commission services undertook in 2013 (in preparation of the MFA-I operation for Tunisia) an Operational Assessment that provided a broadly satisfactory assessment of the reliability of the financial circuits and administrative controls at the Ministry of Finance and the Central Bank of Tunisia. This assessment remains valid, and developments in this area are closely monitored thought regular progress reports on PFM reforms produced by the EU Delegation in Tunis. In addition, the results of the new Public Expenditure and Financial Accountability (PEFA) assessment of Tunisia (produced by the World Bank, the African Development Bank and the EU), which is expected to be completed in February 2016, will also help to monitor progress and identify remaining challenges in the area of PFM in Tunisia.

6. EVALUATION AND COST-EFFECTIVENESS

This assistance is of exceptional and macroeconomic nature and its evaluation will be undertaken in line with the standard Commission procedures.

6.1 Evaluation

Ex-post evaluations of macro-financial assistance operations are foreseen in the Multi-Annual Evaluation Programme of the Commission's Directorate-General for Economic and Financial Affairs. An ex-post evaluation of the proposed macro-financial assistance to Tunisia will be launched within a period of two years after the completion of the operation. A provision for the ex-post evaluation is included in the proposed Decision for the assistance, and will also be included in the Memorandum of Understanding. Budget appropriations from the macroeconomic assistance budget line will be used for this evaluation.

6.2 Achieving cost-effectiveness

The proposed assistance would entail a high degree of cost effectiveness for several reasons:

i) Since the assistance would be leveraged by that provided by the international financial institutions, with which, as noted, it would be closely coordinated, its ultimate impact could be very significant compared to its cost. Moreover, in negotiating specific policy conditions, the Commission will be able to draw on the expertise of those institutions, including the International Monetary Fund and the World Bank, and to influence their conditionality as well in ways that will take into account the EU's views.

ii) Providing a coordinated macroeconomic support to Tunisia on behalf of the EU countries, the MFA would be more cost efficient than the provision of a similar total amount of financial support by EU Member States individually.

iii) All of the assistance would be provided in the form of loans, the budgetary impact of which is more limited.

iv) Finally, the Commission will aim at achieving synergies with other EU policies and instruments used to support the implementation by the beneficiary of the relevant measures (notably in the area of public finance management).

ANNEX

EUROPEAN EXTERNAL ACTION SERVICE

Head of Division

Middle East and North Africa
MENA.4. Maghreb

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ASSESSMENT ON TUNISIAN POLITICAL REFORMS

Following the political crisis of 2013-2014 (the period of the first MFA programme's inception), 2014 finally saw the adoption of the new progressive Constitution. On its basis, legislative and presidential elections were held in the end of 2014 and in February 2015 the new President and the new government took office.

Democratic transition continues despite daunting challenges

Following the revolution and the ousting of President Ben Ali on 14 January 2011, a political transition ensued that culminated in 2014 with the approval of a new Constitution, parliamentary and presidential elections. Tunisia's progress in transitioning towards a democratic political system, despite substantial challenges, represents a unique case in the region, in particular when compared with other Arab countries that attempted a similar path following the 2011 Arab Spring. Consequently, the political preconditions for Macro-Financial Assistance may be considered to be satisfied.

The year 2015 brought to the forefront all the serious interconnected challenges that the Tunisian democratic transition is facing: a critical security situation, the need to pursue the democratic transition in an increasingly challenging environment both internally and regionally (notably impact of the Libyan crisis) and a dire socio-economic situation.

The social and political climate has deteriorated in the second part of the year, with a number of strikes and difficult negotiations over reforms between government and social partners, including the social dialogue on salaries. Despite the attribution of the Nobel Peace Prize to the Tunisian National Dialogue Quartet (the Tunisian General Labour Union (UGTT), the Tunisian Confederation of Industry, Trade and Handicrafts (UTICA), the Tunisian Human Rights League (LTDH), and the Tunisian Order of Lawyers) the general climate between the social partners is tense; moreover, in the absence of a strong reform agenda on the government side, much needed socio-economic reforms have not been adopted in 2015.

It is hoped that by the beginning of 2016 the resolution of the on-going political crisis within the major political party, Nidaa Tounes (of which the President is the main founder) and that following the adoption of the 2016 budget, the announced government reshuffle will contribute to strengthen government action so that much waited reforms could finally see the light. The long-awaited new 5 years development plan is now announced for.

The three major terrorist attacks in 2015 (Bardo Museum in March, Sousse hotel beach in June and presidential guard's bus in Tunis in November) have exposed the difficulties in implementing security sector reform at the same time as tackling major security threats. They have aggravated current difficulties, by exposing the weaknesses of authorities in dealing with this critical situation, with the risk that short term (authoritarian) reflexes will prevail, at the expense of the long term interests of the transition. Following the terrorist attack, the already weak economy is further suffering from the collapse of tourism (7% of GDP, 15% with tourism-related activity), affecting the growth (expected around 0% for 2015) and unemployment rates (the latter over 30% among youth). Civil society actors are increasingly concerned by the growing number of reported cases of torture and mistreatment in detention, and more generally by their diminishing influence in a public debate that reveals the absence of a strong democratic culture in society.

If Tunisians today generally enjoy all major fundamental freedoms, the genuine consolidation of democracy continues to face strong resistance from parts of the political and economic elites as well as institutional structures. The implementation of the new Constitution is taking longer than planned; nonetheless two organic laws creating the Constitutional Court and the High Judicial Council were adopted by Parliament in November. A number of reforms are still needed to create the independent bodies foreseen by the new constitution, and ensure that the justice and security sectors inherited from the dictatorship implement in practice all constitutional rights. The independence of the judiciary, access to justice and right to a fair trial, prohibition of torture, fight against domestic violence, rights of migrants, are among the issues where urgent measures are needed.

EU-Tunisia relations

The EU and Tunisia have developed a close political and economic relationship. In 1995, Tunisia became the first country in the Southern Mediterranean to sign an Association Agreement with the EU, which entered into force in 1998. Bilateral relations have been further reinforced under the EU’s ENP, including through the adoption of five-year ENP Action Plans establishing strategic objectives for this cooperation, the latest of which covers the period 2013-2017. Tunisia is also a member of the Union for the Mediterranean. Economic ties with the EU are very important. The ambitious relation the EU and Tunisia are building is also symbolised by the agreement the two parties signed in 2014 on a "Privileged Partnership" and by the launching on 13 October 2015 of the negotiations on a Deep and Comprehensive Free Trade Agreement, which should eventually allow Tunisia to fully access the EU’s single market.

During 2014-2015 the EU-Tunisia relations progressed to a varying degree on a number of issues, with important EU mobilisation in the second half of 2015, following the Sousse attack.

Negotiations towards the <u>EU-Tunisia Deep and Comprehensive Free Trade Area</u>: The Tunisian PM officially announced Tunisia's readiness to start DCFTA negotiations during his visit to Brussels on 27 May and confirmed in July. This decision comes despite the strong divisions among the Tunisian political class, civil society and social partners. Commissioner Malmstrom launched the negotiations on 13th October 2015 with the preliminary technical round held already in October. The next round is expected in March 2016.

<u>Agriculture and olive oil quotas</u>: In response to the major economic losses suffered by the Tunisian tourism sector after the Sousse attack, and due to the importance of the olive oil industry in the country’s economy, in September 2015 the Commission has put forward a proposal for a unilateral increase of annual quota by 35.000 T. It should be adopted by the EP and the Council in February, despite resistance of some Member States, themselves concerned by olive oil production. COM has already facilitated the management of the quota for olive oil

for the 2015 campaign by reorganising monthly quotas and the same measure will be applied for the 2016 campaign. (In Tunisia, olive oil production provides direct and indirect employment to more than one million people and represents one-fifth of the country’s total agricultural employment).

Following an official request by Tunisia in January 2015, and a number of negotiation rounds, the EU and Tunisia signed the agreement on Tunisia's association to the Horizon 2020 Research and Innovation programme on 1 December 2015. Pending Tunisian parliament's ratification, Tunisian researchers are eligible to participate in the H2020 calls for proposals as of 1 January 2016.

Preparations by Tunisia for negotiations of an Agreement on Conformity Assessment and Acceptance of Industrial Products (ACAA) in the fields of construction materials and electrical products are very advanced but not completed.

The negotiations on the Air Services Euro-Mediterranean Agreement to liberalise air transport have not progressed in 2015, mainly due to the Tunisian economic concerns.

The Mobility Partnership between the EU, ten Member States (Belgium, Denmark, Germany, Spain, France, Italy, Poland, Portugal, Sweden and the United Kingdom) and Tunisia was signed on 3 March 2014 through the signature of a Joint Declaration. The implementation of the Declaration includes negotiations and an agreement on visa facilitation and readmission. Tunisia might be ready to start this process in the first semester of 2016. The readmission of third country nationals is the major irritant.

In sum, while major political, security, economic and social challenges intensify, Tunisia has made substantial progress towards establishing a fully-fledged democracy based on the rule of law and respect for human rights. The EU is fully committed to support Tunisia in this challenging transition process. In this context, the political preconditions for Macro-Financial Assistance may be considered to be satisfied, although they will have to be closely monitored during the life of the proposed Macro-Financial Assistance operation.