FitchRatings

RATING ACTION COMMENTARY

Fitch Downgrades Tunisia to 'B'; Outlook Stable

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Fitch Ratings - Hong Kong - 12 May 2020: Fitch Ratings has downgraded Tunisia's Long-Term Foreign-Currency Issuer Default Rating (IDR) to 'B' from 'B+'. The Outlook is Stable.

A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS

The downgrade reflects the aggravation in Tunisia's persistent macroeconomic imbalances and deterioration in external and public debt trajectories due to economic disruptions from the coronavirus pandemic shock. Tunisia's economy will witness its sharpest contraction on record in 2020 while the current account deficit (CAD) will fail to narrow amid a temporary halt in fiscal consolidation, prompting a further significant rise in net external debt (NXD) and general government (GG) debt ratios from already high levels. The Stable Outlook balances continued strong support from official creditors against ongoing external vulnerability from large funding needs and risks to fiscal reforms from entrenched social tensions.

The hit to global trade, manufacturing and tourism from the pandemic-related shock will severely affect Tunisia's small open economy. Tourism is a major

growth engine and has generated 4% of GDP in gross foreign-currency (FC) earnings over the last three years. The shock will halt most activity in the sector, putting around 10% of existing jobs into jeopardy, based on official estimates. The contraction in the world economy in 2020, and particularly a 7% decline in the eurozone's GDP under our forecasts, will weigh on remittances which accounted for 4.8% of GDP over the last three years and on manufacturing exports, mainly from the automotive and textile sectors.

Tunisia's CAD will continue to exceed the current 'B' category medians over the coming two years, despite some relief from the collapse in benchmark oil prices, which we forecast to average USD35/barrel in 2020, down from USD64/barrel in 2019. We project the CAD to stabilise at 9% of GDP in 2020, well above the forecast 'B' median of 5.2%, as a decline in external receipts is offset by lower energy imports, alongside a contraction in domestic investment and demand compression. The CAD will narrow only moderately to 7.8% of GDP in 2021 (forecast 'B' median: 4.5%) as exports recover. Persistent wide CADs since 2011 have been mostly financed with borrowing, pushing Tunisia's NXD to 77% of GDP in 2019, one of the highest levels among all Fitch-rated emerging market sovereigns. NXD will further rise to 90% of GDP in 2021, well above the forecast 'B' median of 32%, under our forecasts.

Tunisia's gross external funding requirements (GEFR) are large, at 16% of GDP per year in 2020-2021 under our estimates, reflecting wide CADs and maturities coming due on external debt. This is double the forecast 'B' category median of 8% of GDP. Our GEFR forecast excludes short-term debt of 24.7% of GDP mostly consisting of trade credit and bank deposits, which we assume to be rolled over. Tunisia faces Eurobond maturities of USD2 billion (5.3% of the forecast 2020 GDP) coming due in 2020-2021.

External liquidity risks are mitigated by strong backing from multilateral and bilateral creditors, which will enable Tunisia to meet its financing needs over the coming two years. The government has already secured official loans of around 6.4% of GDP covering around 40% of GEFR and 56% of gross fiscal financing requirements in 2020. This includes a USD745 million emergency loan under the IMF's Rapid Financing Instrument in April. Additional official loans of around 3% of GDP could be agreed in the coming months, and Tunisia could issue new FC bonds with a guarantee from a higher-rated external partner. We also expect the government to secure a new IMF programme in the coming months, which would underpin the sovereign's external financial flexibility.

However, Tunisia's mixed performance under the previous two arrangements with the IMF raises risks of weakening official creditor support. Tunisia received

only USD1.6 billion of a total allocation of USD2.9 billion under its now cancelled 2016-2020 arrangement with the Fund, illustrating the difficulty in reaching the agreed milestones despite recurrent waivers to performance criteria, mostly owing to social opposition and political hurdles. Delays in official loan disbursements, fiscal slippages or exogenous shocks could severely strain external liquidity

Despite sizeable official creditor support, the balance of payments will record a deficit in 2020, leading to a 20% drop in international reserves, which will still cover around four months of current account payments (CXP), slightly better than the current 'B' median of 3.6 months. Reserves have recovered from the low point of USD4.6 billion in August 2018, rising to USD7.65 billion in March 2020, supported by tighter monetary policy stance, regulatory restrictions on the loan-to-deposits ratio, a eurobond issuance and the disbursement of external loans.

The large CAD suggests the dinar remains over-valued, raising risks of further pressures on external liquidity, and the IMF estimates an over-valuation of 10%-15%. However, the authorities assess the currency to be adequately valued, pointing to its remarkable stability since 1Q19 and the 33% depreciation of the nominal effective exchange rate in the three prior years. Persistent large external funding needs will test the Banque Centrale de Tunisie's (BCT) commitment to enhanced exchange rate flexibility. Risks of disorderly exchange rate adjustment are mitigated by existing FC restrictions on overseas investments by residents.

Exchange rate pressures pose downside risks to GG debt sustainability given a high portion of FC liabilities of 73% of GG debt at end-2019. GG debt will surge to a record 86% of GDP in 2021 from 72.5% in 2019 under our baseline scenario, predicated on a moderate depreciation of the dinar alongside GDP contraction and widening GG deficit. An additional 10% depreciation of the dinar beyond our assumption would lead to an 8% of GDP rise in GG debt. GG debt has been on a steep upward trajectory over the last decade, with only a temporary fall in 2019, despite significant progress on fiscal consolidation.

The pandemic-related shock will cause the first deterioration in the budget balance in four years, with the GG deficit widening to 4.7% of GDP in 2020 from 3.9% in 2019, versus an initial target of 3%. Measures to combat the epidemic and provide economic relief will cost around 2% of GDP under our estimates and the economic downturn will take a toll on tax revenues. This will be partly offset by savings on the energy subsidy bill given the slump in hydrocarbons prices, an increase in regulated tobacco prices and spending reallocation. We expect the government to adjust investment spending to actual revenue collections to keep the deficit contained.

The authorities set out to achieve far-reaching fiscal reforms over the coming months but a track-record of strong social opposition and the fragility and heterogeneity of the coalition government's support base in parliament could thwart their plans. The government has implemented a fuel price adjustment mechanism and envisages a gradual phasing-out of costly energy subsidies. A recovery in hydrocarbon prices would test the ability of the government to follow through on these plans. The authorities also aim to achieve savings on payroll spending but the opposition of influential labour unions has stymied such measures in recent years. A 2019 pension reform will support consolidation efforts but little progress has been achieved on overhauling troubled state-owned enterprises (SOEs), which require continuous budget support.

Significant contingent liabilities from SOEs and the banking sector pose upside risks to the debt trajectory in the context of a severe economic shock. GG guaranteed SOE debt is high, at 15% of GDP, half of which is at the ailing electricity company STEG. The national airline Tunisair was facing serious financial difficulties even prior to the pandemic shock. Public banks account for one-third of the banking sector's assets and present weaker, albeit improving, financial health metrics than their private sector peers. The broad banking sector's health metrics are weaker than 'B' medians with a high proportion of non-performing loans of 13.9% of total loans at end-September 2019. Proactive monetary policy measures taken by BCT will reduce short-term liquidity pressures but a possible deterioration in asset quality could raise need for budget support to banks.

Tunisia's economic growth has consistently underperformed the 'B' category median since 2011, reflecting a combination of deteriorating competitiveness, disruptions to economic activity from social unrest and exogenous shocks. The worsening external backdrop and the lockdown measures taken to stem the spread of the coronavirus will cause a sharp 4.3% contraction in GDP in 2020. Growth will recover to 4.7% in 2021 under our forecast, supported by Tunisia's diversified economy, strong agricultural production and rich tourism resources, although fiscal consolidation will weigh on activity. We project inflation to average close to 6% in 2020-2021, above its long-term average of 4.5%

ESG - Governance: Tunisia has an ESG Relevance Score (RS) of 5 for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption, as is the case for all sovereigns. Theses scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model. Tunisia has a WBGI ranking at the 44th percentile versus a current 'B' median at the 33rd percentile, reflecting

established rights for participation in the political process, moderate institutional capacity, established rule of law and a moderate level of perceived corruption. These strengths are balanced against a low score on the "Political stability" pillar of the WGBI reflecting high social tensions and recurrent bouts of unrest impacting policymaking and the economy.

SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Tunisia a score equivalent to a rating of 'B+' on the Long-Term Foreign-Currency (LT FC) IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to rated peers, as follows:

- External finances: -1 notch. The addition of one negative notch on the 'External finances' pillar of the QO reflects significant external vulnerability from Tunisia's large external funding needs, steep upward net external debt trajectory and possible exchange rate overvaluation. External liquidity risks are somewhat mitigated by strong official support but slow progress on fiscal reforms amid entrenched social tensions and vulnerability to exogenous shocks could undermine external debt sustainability.

The removal of the -1 notch on the 'Structural factors' pillar of the QO reflects the rating committee's view that the impact of entrenched social tensions on policymaking and economic activity are now well captured in the SRM given a drop in the model's predicted rating to 'B+' from 'BB-'.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

-A fall in external financing needs and trend decline in the net external debt trajectory, for example due to significant narrowing in the current account deficit from an acceleration in exports of goods and services or demand compression reducing imports;

-Resumed fiscal consolidation following the pandemic shock supporting macro-economic stability and driving a decline in the general government debt/GDP ratio towards the 'B' medians over the medium term.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- Deterioration in external liquidity conditions illustrated by rising difficulties in meeting external financing requirements, sizeable drawdown in international reserves or significant pressures on the exchange rate;

-Failure to narrow the fiscal deficit beyond the pandemic shock, leading to a faster rise in government debt/GDP than our current forecast, for example from re-emergence of instability at the government level or social unrest hindering progress on fiscal reforms.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Public Finance issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

KEY ASSUMPTIONS

We expect global economic trends to develop as outlined in Fitch's most recent Global Economic Outlook published on 23 April 2020. We project eurozone GDP to fall by 7% in 2020 and recover by 4.3% in 2021. We project Brent prices to

average USD35/barrel in 2020 and USD45/barrel in 2021, down from USD64.1/barrel in 2019.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Tunisia has an ESG Relevance Score of 5 for Political Stability and Rights as World Bank Governance Indicators have the highest weight in Fitch's SRM. This is highly relevant to the rating and a rating driver.

Tunisia has an ESG Relevance Score of 5 for Rule of Law and Institutional and Regulatory Quality as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and a key rating driver with a high weight.

Tunisia has an ESG Relevance Score of 4 for Human Rights and Political Freedoms. Its score on the Voice and Accountability pillar of the World Bank governance indicators outperforms the 'B' median. This is relevant to the rating and a rating driver.

Tunisia has an ESG Relevance Score of 4 for Creditor Rights as willingness to service and repay debt is relevant to the rating and a rating driver, as for all sovereigns.

RATING ACTIONS

ENTITY/DEBT	RATING		
Tunisia	LT IDR	B	Downgrade
•	ST IDR	B	Affirmed
•	LC LT IDR	B	Downgrade

ENTITY/DEBT	RATING		
•	LC ST IDR	B	Affirmed
•	Country Ceiling	B+	Downgrade
• senior	LT	B	Downgrade

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 05 Jul 2019)

Sovereign Rating Criteria (pub. 27 Apr 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v1.7.1 (1)

Debt Dynamics Model, v1.2.0 (1)

Macro-Prudential Indicator Model, v1.4.0 (1)

Sovereign Rating Model, v3.12.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Tunisia	EU Endorsed

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