Moody's
INVESTORS SERVICE

Rating Action: Moody's downgrades Tunisia's ratings to B3, maintains negative outlook

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New York, February 23, 2021 -- Moody's Investors Service ("Moody's") has today downgraded the Government of Tunisia's long-term foreign-currency and local-currency issuer ratings to B3 from B2 and maintained the negative outlook.

Moody's has also downgraded the Central Bank of Tunisia's senior unsecured rating to B3 from B2 and the senior unsecured shelf rating to (P)B3 from (P)B2, and maintained the negative outlook. The Central Bank of Tunisia is legally responsible for the payments on all of the government's bonds. These debt instruments are issued on behalf of the government.

The downgrade to B3 reflects weakening governance in the face of rising social constraints that increasingly inhibit the government's flexibility to implement fiscal adjustment and public sector reforms that would stabilize and eventually reverse a marked increase in its debt burden. Fiscal consolidation and reform of the public sector will require reaching a broad agreement with civil society institutions on both the direction and specific mode of implementation of a wide range of measures, which is likely to be a protracted process at best.

The rating is supported by a relatively stable external position through the pandemic shock so far, thus providing some backstop to upcoming external debt service payments, although refinancing risk remains.

The negative outlook captures downside risks related to further delays with the negotiation and implementation of a funded IMF program, an objective outlined by the government. Such delays would increase uncertainty around the government's capacity to secure continued access to official external funding sources and maintain international capital market access at affordable terms in order to meet high funding requirements over the next few years.

Tunisia's country ceilings have been lowered by one notch. Namely, Tunisia's local-currency country ceilings were lowered to Ba3 from Ba2. The three-notch gap to the sovereign rating reflects relatively predictable institutions and government actions, tampered by a large public sector footprint, external competitiveness constraints and a challenging political and social environment which hamper the business environment. The foreign-currency ceiling was lowered to B2 from B1. The two-notch gap to the local currency ceiling reflects persistent external imbalances and reliance on foreign inflows which increase firms' exposure to potential transfer and convertibility risks.

RATINGS RATIONALE

RATIONALE FOR THE DOWNGRADE TO B3

SOCIAL ENVIRONMENT WEAKENS GOVERNANCE STRENGTH BY INHIBITING DECISION MAKING ON MEASURES THAT WILL UNDERPIN DEBT SUSTAINABILITY

While the smooth presidential and parliamentary elections held in October 2019 attest to Tunisia's established democratic processes as a mechanism for voicing priorities by various groups, the ensuing parliamentary fragmentation and the increasingly contentious political environment, including in relation with civil society institutions, weighs on the government's decision making capacity.

This is reflected in a weaker assessment of governance, as the strength of civil society and fiscal policy effectiveness are less supportive of Tunisia's credit profile than previously assessed by Moody's.

The prolonged government formation process over the past year is indicative of this dynamic. Renewed social protests, ahead of the announcement of specific measures, suggest that the definition and implementation of fiscal consolidation and public sector reforms is likely to be a highly protracted process.

A consensus on essential, albeit socially and politically difficult, reforms will be challenging to secure among all stakeholders, including civil society institutions. Such reforms are critical to rebalance Tunisia's fiscal accounts

and ensure debt sustainability in the future, amid a subdued growth outlook. The reforms are also challenging in that they will involve both protecting the most vulnerable part of the population while achieving financially significant results that help the government regain some fiscal flexibility.

Long-standing reform efforts under sequential IMF programs over the past decade include control of the wage bill, which has increased to over 17% of GDP in 2020 -- one of the largest globally -; completion of energy subsidy reform in favor of more targeted and cost-effective income support measures to qualifying households; in addition to the reorganization and/or restructuring of loss-making state-owned enterprises.

MATERIAL ECONOMIC AND FISCAL PANDEMIC IMPACT DRIVES DEBT BURDEN TO HIGH LEVELS AND INCREASES ITS SHOCK SENSITIVITY

Tunisia's economy and population have been hit by a severe shock during the pandemic, which has negatively affected the sovereign's fiscal and debt metrics. Post pandemic, a prolonged period of subdued growth and most likely gradual fiscal consolidation will raise the debt burden to over 90% of GDP in the next few years, reducing Tunisia's resilience to future shocks.

End of 2020 data show an output contraction of 8.8% taking into account renewed lockdown measures in the fourth quarter, a deeper fall in GDP than assumed at the time of Moody's last rating action on Tunisia in October 2020. Consequently, the fiscal deficit widened to 10.1% of GDP in 2020, also worse than previously expected -- albeit slightly narrower than the revised budget at 11.5%.

Looking forward, Moody's expects a gradual fiscal consolidation to 7.7% of GDP this year and to 6.2% in 2022, primarily as a result of spending reductions geared toward energy subsidy reform as the main spending adjustment variable in the short term.

Taking into account an expected economic expansion by 4% this year, followed by a return to growth of 2-3% thereafter, Moody's expects the debt/GDP ratio to increase to almost 90% of GDP this year from the estimated 84.7% in 2020 and 72.3% in 2019, edging slightly higher in the next few years.

Moody's expects the affordability of the debt stock to decline amid increasing borrowing costs while the high foreign currency share of the debt stock at over 65% exposes the debt trajectory's sensitivity to adverse currency movements. In addition, outstanding guarantees to state-owned enterprises at over 15% of GDP in 2020 add to contingent liability risks.

CONTINUED BUILD-UP OF FOREIGN EXCHANGE RESERVE BUFFER OFFERS SOME CREDIT SUPPORT, ALTHOUGH FINANCING RISK REMAINS

Tunisia's external accounts have adjusted in a more balanced way to the pandemic impact than initially assumed, preserving the sovereign's external buffers ahead of sizeable external debt maturities in the next few years.

Foreign exchange reserves stood at $8.7 billion (5.3 months of import cover) as of December 2020 from $7 billion in December 2019 (3.6 months). Scheduled market debt maturities this year include two $500 million Eurobonds that carry a 100% USAID guarantee and a $250 million Qatari loan instalment.

Looking forward, higher fiscal deficits and a more onerous commercial debt service calendar with maturities at over $1 billion in 2021 and 2024 point to sizeable, albeit not exceptionally large, gross financing needs around 15-17% of GDP from about 10% of GDP before the pandemic.

Overall, elevated external borrowing costs in international capital markets and the continued reliance on external official funding sources to meet the higher gross financing needs underpin Tunisia's refinancing risks that are reflected in the B3 rating.

RATIONALE FOR THE NEGATIVE OUTLOOK

The negative outlook captures downside risks related to further delays in the negotiation and implementation of a funded IMF program, thus increasing uncertainty around the government's capacity to secure continued access to official external funding sources and to international capital markets at affordable terms to meet its gross funding requirements.

Downside risks also relate to a potentially higher degree of reform resistance than currently anticipated as a result of diverging interests among stakeholders and social interest groups. In this scenario, fiscal policy

effectiveness would be weaker still, undermining the government's capacity to stabilize Tunisia's fiscal accounts and debt dynamics.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE CONSIDERATIONS

Tunisia's ESG Credit Impact Score is highly negative (CIS-4), reflecting high exposure to social risks and a moderate governance profile. While remittances partially compensate for weak income prospects, the sovereign's capacity to respond to social risks is increasingly threatened by the government's balance sheet constraints.

Tunisia's credit profile is moderately exposed to environmental risks, reflected in its E-3 issuer profile score and driven by its exposure to rising sea levels in coastal areas and to increasing water and desertification risks in internal regions. Coastal regions account for 80% of total output, driving exposure. Climate variability, erratic precipitation patterns and severe droughts pose threats to Tunisia's agricultural sector, which accounts for more than 15% of total employment.

Exposure to social risks is high (S-4 issuer profile score) and is mainly related to rigid labor markets and weak employment generation which result in high unemployment rates, including among young graduates. These constraints make it difficult to absorb the well-educated workforce, contributing to negative net migration flows every year and to brain drain. In addition, recurring social tensions inhibit the business environment and reduce foreign investment incentives.

Tunisia has a moderate governance profile score (G-3 issuer profile), supported by the administration's track record of functioning even during times of social unrest and major societal and political change. The country's consensus-building governance orientation has been instrumental in securing the successful democratic transition with all stakeholders involved. However, it can slow the policy decision making process. In addition, recurring social tensions inhibit policy effectiveness by reducing political consensus for reform, including from the part of civil society institutions.

GDP per capita (PPP basis, US$): 11,125 (2019 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 1% (2019 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 6.0% (2019 Actual)

Gen. Gov. Financial Balance/GDP: -3.5% (2019 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -8.5% (2019 Actual) (also known as External Balance)

External debt/GDP: 98.3% (2019 Actual)

Economic resiliency: ba3

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 18 February 2021, a rating committee was called to discuss the rating of the Tunisia, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's institutions and governance strength, have materially decreased. The issuer's fiscal or financial strength, including its debt profile, has materially decreased. The issuer's susceptibility to event risks has not materially changed.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

Given the negative outlook a rating upgrade is unlikely. The outlook would likely be changed to stable if Moody's concluded with sufficient confidence that the government's fiscal and public sector reform implementation capacity will lead to a stabilization and eventual reduction in the debt trajectory in the near term. Similarly, high confidence in Tunisia's ability to access official and capital market funding to meet its upcoming debt service payments in the next few years at affordable costs would also support the rating at the current level.

Conversely, a downgrade would be likely if fiscal and public sector reform implementation is even more protracted, keeping the debt burden rising higher and for longer than Moody's currently expects, potentially raising debt sustainability concerns. Delays in the availability of or marked increases in the cost of external funding would also put negative rating pressure, potentially related to further protracted negotiations for a new

IMF program and/or insufficient progress on agreed reform implementation. Continued social unrest and political discord would further compound negative rating pressure.

The principal methodology used in these ratings was Sovereign Ratings Methodology published in November 2019 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1158631 . Alternatively, please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1243406 .

At least one ESG consideration was material to the credit rating action(s) announced and described above.

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