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How Does the EU Agenda Influence Economies Outside the EU? The Case of Tunisia[*]

by

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Abstract

Economic and commercial relations between the countries of the southern Mediterranean and the European Union (EU) have been profoundly affected by the recent 'EU Initiative for the Mediterranean' and conditioned by the creation of European Monetary Union (EMU). The paper discusses the costs, benefits and prospects of these two processes in terms of their economic consequences on the countries of the southern Mediterranean, and in particular on the Tunisian economy. The association agreement between the EU and Tunisia is assessed in the light of its medium-period implications and of the EU's enlargement to include the countries of Eastern Europe. With regard to EMU, the paper discusses the influence and effects exerted by introduction of the euro on the Tunisian economy.

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1. Introduction

During the 1990s the European Union (EU) undertook numerous initiatives which redefined its economic and commercial relations with non-EU countries. Some of them were mainly concerned with ‘neighbouring’ countries, cases in point being the enlargement of the EU and the association agreements with a number of countries in Eastern Europe and the southern Mediterranean area. Other initiatives like the European Monetary Union (EMU) have had much wider repercussions by altering the structure of international monetary relations.

This paper examines the evolution of economic relations between the economies of the southern Mediterranean and the EU. It analyses the short- and medium-period economic consequences of two main processes: the association agreements between the EU and some southern Mediterranean countries, and the creation of EMU. Analysed in particular will be the costs, benefits and prospects of these processes regarding one on the most dynamic countries in the southern Mediterranean: Tunisia.

The paper is organized as follows. The next section briefly reviews the terms of the association agreement between Tunisia and the EU and analyses its benefits and costs for the Tunisian economy in the light of the enlargement of the EU towards the countries of Eastern Europe. Section 3 examines the main channels through which the introduction of the euro might affect Tunisia. Section 4 concludes and briefly discusses the economic policy responses best able to ensure that closer integration with the EU will generate concrete development opportunities for the Tunisian economy.

2. The association agreement between the EU and Tunisia

2.1. *The terms of the agreement*

The principles of the EU’s strategy for cooperation with the countries of the southern Mediterranean were ratified by the Barcelona Declaration of November 1995. By explicitly acknowledging the need to promote economic development in all the countries of the Mediterranean also through forms of cooperation with Europe,[1] this Declaration laid the basis for the creation of a free-trade area.

[1] For a detailed analysis of the evolution of the Euro-Mediterranean strategy and of the Barcelona agreements see Nosuli et al. (1996), Alonso-Gamo et al. (1997) and Gendarme (1999). For analysis of the relations with the three southern Mediterranean countries – Cyprus, Malta and Turkey – which have already begun negotiations to join the EU see Temparano-Arroyo and Feldman (1998).

As part of this strategy, again in 1995 an association agreement was signed with Tunisia with the objective of strengthening political and economic relations between the two areas[2]. The agreement provided for the liberalization of trade relations between the EU and Tunisia, greater technical and financial cooperation, and closer collaboration on political and cultural matters.

As regards commercial aspects, the agreement provided for a free-trade area in industrial goods to be gradually created over a period of twelve years. In effect, it is since 1976 that almost all Tunisian manufactured products have enjoyed free access to the European market, with the significant exception of textiles. Consequently, with the new agreement the EU has extended preferential access to the textiles sector as well, while Tunisia for its part has undertaken to remove all tariff and non-tariff barriers to industrial imports from the EU. Restrictions still apply to agricultural products, although the agreement has enabled some progress to be made as regards integration between the two areas, the intention being to review issues relative to this important sector in the course of the current year.

The agreement also envisages changes in the regulation, harmonization of the quality standards of Tunisian goods and the removal of all practices which hamper free competition and trade between the two areas, like the monopolies, public subsidies and fiscal and financial privileges still granted to state-owned enterprises in Tunisia.

Finally, to deal with the economic and social costs that inevitably arise during the adjustment period, the EU will increase the financial aid envisaged by the 'EU Initiative for the Mediterranean' and it will strengthen cooperation in the social and cultural fields.

2.2. *The benefits for Tunisia*

The benefits deriving to Tunisia from the association agreement with the EU should be substantial and should pass through various channels.

Firstly, according to the standard theory of international trade, following integration, incomes and employment should increase as a result of (i) the better allocation of existing resources (the static effect) and (ii) the greater competitiveness

[2] To be precise, the association agreement with Tunisia was signed in July 1995 and therefore predates the Barcelona Conference. However, the principles on which it is based are clearly the same as those established some months later in Spain

on markets of goods and factors, the expansion of potential markets, and the full exploitation of scale and scope economies (the dynamic effect).

As specifically regards the effects of the Euro-Tunisian agreement, the prediction is that it will lead to a significant increase in the domestic product. Despite all the shortcomings of attempts to quantify the long-term economic effects of agreements of this kind, Rutheford et al. (1995) calculate that the annual increase in GDP will be around 4.5%, while Brown et al. (1997) foresee a short-period fall in Tunisia's national income off-set by a 3.3% annual growth rate in the long period.[3] According to these authors, the benefits will pass through new investments and the re-allocation of production factors to sectors with greater competitive advantages. The new investments will be also fostered both by the harmonization of laws and regulations with consequent greater penetration of Tunisian products in European markets, and the improved transport and telecommunications made possible by EU aid. Both Rutheford et al. and Brown et al. believe that their forecasts are extremely prudent in that they do not include the effects of the technological spillovers that will presumably affect the Tunisian economy as a result of its greater openness to trade.

But the association agreement should also act as a catalyst for economic growth. Firstly, within the country, the agreement should foster a general strategy for reform and modernization, while the closer relationship with the EU should help the Tunisian authorities to overcome political and social resistance against implementation of reforms. A striking example of this is the plan for industrial restructuring and modernization (*mise à niveau*). Begun in 1996 with the help of international funding, the aim of this plan is to prepare Tunisian manufacturing firms for the liberalization of markets and the greater competition that will ensue. The plan's results have so far been positive; a recent survey by the IMF (1999a) of a sample of firms involved in the modernization programme has shown that they have achieved increases in employment, sales and exports significantly above the national average.

Secondly, the agreement should increase Tunisia's ability to attract foreign capital and in particular direct investments. The increase in direct investments[4] will be

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[3] Brown et al. (1997) have also calculated the benefits to Europe. These, of course, will be much less substantial, and almost negligible at the European level, but closely concentrated on France, Italy and Spain.

[4] Tunisia has for some time pursued a policy of openness to direct foreign investments which has already attracted significant amounts of capital. For instance, in the early 1990s the energy sector had already received huge foreign investments. Since the second half of the 1990s there has been a revival of investments in manufacturing and in tourism. In 1996, around 88 percent of the foreign firms

stimulated by the less uncertain political and economic situation arising from implementation of the agreement and the greater confidence of foreign investors. The agreement has both strengthened the Tunisian authorities' commitment to the creation of a more extensive and open market economy, and has introduced provisions which make more vigorous enforcement possible.

Of the various forms of internationalization that will probably follow the agreement, particular attention should be paid to the so-called 'outward processing trade'. This is a phenomenon which involves the delocation by foreign firms of certain phases of their production processes to local firms, and the subsequent re-importing of the semi-finished or finished products so that they can undergo final processing or be marketed in the country of origin. It is therefore a form of international sub-contracting with the initial exporting and then importing of goods to which partial and more favourable tax treatment is applied by the EU regulations. This type of internationalization is obviously advantageous to the contractor; but it is also advantageous – and this is here the more interesting aspect – to the destination country. For the latter, the advantages take the form not only of an immediate increase in aggregate demand, but also of knowledge transfers, opportunities to gain professional expertise, and commercial contacts which if properly exploited may trigger enduring processes of industrialization in the areas of destination. Of course, these experiences must be take place in settings which are conducive to them in terms of entrepreneurial abilities, know-how, infrastructures and the availability of skilled labour. Tunisia is experiencing outward processing trade, and it may increase significantly in the future with spillovers on the domestic industrialisation. In fact, geographical proximity to contractors, relatively low labour costs, experience in relevant sectors are necessary conditions for outward processing trade which are already in place in Tunisia.

2.3. *The costs of the agreement for the Tunisian economy*

As in all integration processes, the benefits are necessarily associated with costs. Those accruing to Tunisia from the agreement are of essentially two types: fiscal costs

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operating in Tunisia were European, and of these 17 percent were French (Ferguéne and Ben Hamida 1999). For broader analysis of the role of direct investments in the countries of the southern Mediterranean see Bellon and Gouia (1998), Ferguéne and Ben Hamida (1999).

and reallocation costs which, during transition, may give rise to competitive difficulties and to larger amounts of unemployed resources.

As regards taxes, considering the structure of Tunisia's revenues (Table 1), the reduction of trade tariffs will lead to considerable loss of tax yield. In 1995, the year in which the agreement came into effect, the average effective tariff in Tunisia was around 20 percent, which was 2 percent higher than the average in the EU area.[5] It is estimated that when the agreement is fully operative, it will reduce the revenues from customs duties by around 50 percent. Bearing in mind that customs duties account for 4.3 percent of GDP, the trade agreement will reduce revenues by more than 2 percent of GDP.[6] Moreover, it is not certain that the loss of tax yield by the Tunisian government will increase consumer welfare. To the extent that Tunisian importers (one of which is the state itself) do not transfer the lower tariffs to final prices, and if the tariffs that remain on non-EU products allow increases in the prices of European exports, it is likely that Tunisian importers (not consumers) and European exporters will benefit most from the agreement.

[Insert Table 1]

In any case, although the negative effect on duties will be to some extent off-set by the additional fiscal revenues generated by economic growth, there is no doubt that, at least initially, the government will be confronted by a fiscal problem that, the public deficit remaining equal, will require greater tax revenues from other sources or reduced public spending.

In addition to the fiscal costs, Tunisia will have to bear the cost of reallocating resources towards new activities given that before the agreement the Tunisian economy enjoyed a high level of protection which enabled the survival in the market of non-competitive products which, with the new free-trade regime, will in many cases be forced out by European products. Moreover, although adjustment to European regulations and quality standards will favour the penetration of foreign markets by Tunisian products, it will result in significant increases in the production costs of Tunisian firms.

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[5] Values lower than Tunisia's are applied in other countries of other southern Mediterranean countries, like Algeria and Egypt, where the average effective tariff on trade was 17 percent, or Morocco, where it was 15 percent.

[6] Still in force are tariffs on imports from non-EU countries and tariffs on certain agro-food products imported from the EU. For detailed analysis of the problems and fiscal costs caused by the association agreement see Adeb (1998).

2.4. *The repercussions of enlargement of the EU*

As the majority of observers argue, although the adjustment phase will be prolonged and will give rise to considerable costs, Tunisia's initial situation and the current state of its economy should provide sufficient guarantees that the net benefits to the country from the agreement will be positive, and that in all likelihood they will be substantial.

In the light of the preceding discussion, there are clear grounds for being optimistic about the Tunisian economy's possibilities of growth and internationalization deriving from the integration with the EU countries, in line with the past experiences of the northern Mediterranean countries and the present ones of the countries of Eastern Europe. These experiences are certainly encouraging, and they clearly show that processes of greater openness and reform are generally accompanied by an increase in trade and a wave of direct investments which in turn help to accelerate integration and economic growth.

However, Tunisia's integration is distinguished by a number of important differences that should be borne in mind. Firstly, the country is characterized by an initial situation in which trade with the EU area is already very substantial, so that the advantages of closer integration will be less immediately apparent.

Secondly, unlike the cases of Spain, Portugal and Greece in the past, and of the Eastern European countries today, there is little prospect of Tunisia joining the EU. Furthermore, the association agreement is being implemented in a period when the EU is considering an enlargement of unprecedented proportions in its history. The historical, cultural, political and strategic reasons for the enlargement of the EU to include the countries of Eastern Europe are much less substantial in the case of the southern Mediterranean countries. Moreover, the Union's enlargement to the East is already creating problems for the southern Mediterranean countries, which are facing the increased competition in their main outlet market – Europe – raised by those countries that have aggressively entered international markets only in recent years, and have massively reoriented their trade towards the EU (Table 2).

[Insert Table 2]

The countries of Eastern Europe, in fact, share a number of features in common with those of the southern Mediterranean. They, too, are geographically close to the EU and have very low labour costs – in some cases even lower than in the southern Mediterranean (Ferguéne and Ben Hamida, 1999). However, the Eastern European countries have labour forces which are on average better skilled and culturally closer to the mentality of the European partners than their counterparts in the Maghreb countries. Moreover, they benefit from the more favourable political-economic relationships deriving from their concrete prospects of joining the EU. In fact, the prospect of being one of the next countries to join the EU and the EMU creates a climate of confidence and optimistic expectations which gives the Eastern European countries an important competitive advantage over those of the southern Mediterranean. Consequently, although it is at present difficult to assess whether the increased trade with Europe by the Eastern European countries has been at the expense of the southern Mediterranean countries (Chevallier et al., 1999), it is indubitable that the EU's enlargement to the East will expose Tunisia to a marked increase in competition on European markets and for European resources.

In the case of Tunisia, this competition raised by the countries of Eastern Europe is aggravated by the fact that the EU has also signed association agreements with other countries of the southern Mediterranean, like Egypt and Morocco, which are much larger in terms of the size of their outlet markets, and towards which resources and direct investments may be directed.

3. The euro and the Tunisian market

During the implementation of the association agreement between the EU and Tunisia, economic relations between the two areas are and will be conditioned by the advent of European Monetary Union. The introduction of the euro is an event of great importance both for the European economies and for other countries as well, especially those with close economic links with the EMU area, like those of the southern Mediterranean and Tunisia in particular.

This section examines the effects of introduction of the euro on the southern Mediterranean economies, also in the light of the association agreements between the two areas. Discussed in particular are the mechanisms that will transmit the effects of the introduction of the euro with the purpose of identifying the risks and opportunities created for the Tunisian economy.

3.1. *Economic relations between Tunisia and the EU*

The study of the effects of the introduction of the euro on non-EU countries must necessarily start with the analysis of the current economic relations between the euro area and the economies in question. Tunisia is a relatively small country with a population of around 10 million and an annual per-capita GDP of about 2500 dollars, but it nevertheless trades large quantities of goods with the rest of the world. In 1998, the last year for which figures are available, the country's degree of openness measured by the ratio between exports and imports on GDP was 0.73, which is a relatively high value when compared with that of countries of similar size and level of development (Table 3).

[Insert Table 3]

Again in 1998, 61 percent of Tunisia's current revenues derived from exports, with striking results achieved by specialization in the textiles sector (27.5 percent of the total) and in the food sector (5.1 percent). Other important items were tourism and remittances, which respectively accounted for 16 percent and 8.4 percent of total revenues (Figure 1). Debit items were instead concentrated in the commodities sector (the importing of commodities accounted for 78.1 percent of total debits in the year), but with a more even distribution among consumption goods (27.5 percent), raw materials and semi-finished goods (22.3 percent), and investment goods (18 percent; Figure 2).

[Insert Figure 1]

[Insert Figure 2]

However, it should be emphasised that Tunisia has economic relations mainly with the EU. The importance of the EU for Tunisia's international trade is highlighted by the incidence of the EU countries in each item of the Tunisian balance of payments (Tables 3 and 4). In 1998, the shares of exports and imports to and from the EU amounted respectively to 81 percent and 72 percent, while the EU accounted for 77 percent of Tunisia's revenues from tourism. These are extremely high values, not only compared with the other countries of the southern Mediterranean but also with trade in goods and services among the countries belonging to the European Union.

[Insert Table 4]

Another distinctive feature of the Tunisian economy is the concentration of trade. Just two countries, France and Italy, account for 50 percent and 47.3 percent of Tunisia's total exports and imports respectively (Figs. 3 and 4). As regards tourism, Germany and France contend for first place, with a combined share of 48.7 percent of total revenues of the sector.

[Insert Figure 3]

[Insert Figure 4]

It is important to note, however, that the high proportion of imports and exports with the EU is not matched by an equally widespread use of European currencies in contracts and international payments. Table 5 shows the structure of current payments on the basis of the currencies of denomination. Despite the slight increase in the use of European currencies in recent years, the commercial weight of the European countries is still much greater that the role performed by their currencies in the settling of international payments. The secondary role of European currencies is confirmed if one looks at the denomination currencies of Tunisia's foreign debt, of which 41.7 percent was denominated in dollars and 16.2 percent in Japanese yen at the end of 1998 (Figure 5).

[Insert Table 5]

[Insert Figure 5]

Despite the high commercial integration, Tunisia's financial integration is much less developed.[7] Table 6 shows Tunisia's net foreign investment position, which displays a negligible role of portfolio investments and a larger amount of direct investments and medium- and long-term loans. The latter are mainly the result of measures by the international financial institutions or the government of individual countries, among which the European ones once again predominate.[8]

[Insert Table 6]

Much less substantial is recourse to the international capital market, where Tunisia makes few issues, mainly by its public institutions and in relatively small quantities (Fig. 6).

[Insert Figure 6]

[7] This is borne out by the restrictions on current payments and capital movements which, according to indices constructed by the International Monetary Fund, are still particularly pronounced in Tunisia, both in absolute values and when compared with other southern Mediterranean countries. Cf. IMF, 1999b.

[8] In 1998, loans from international financial bodies amounted to around 45 percent of Tunisia's total long-term loans, compared with the around 43 percent of financing obtained on a bilateral basis: of the latter, 71 percent has been provided by EU countries.

3.2. *The effects of the introduction of the euro on economic relations between Tunisia and the EU*

The introduction of the euro affects the Tunisian economy through various channels. In this section we analyse the effects that work through trade relations, the exchange rate, and financial integration between the two areas.

3.2.1. *The commercial channel*

It is well known that the main economic justification for introducing the euro is that monetary union – because of reduced transaction costs, increased competition, greater macroeconomic stability, and lower interest rates – should significantly boost the growth rates of the European economies. This expected higher growth and closer integration among the countries involved in EMU constitute two possible channels for the EMU's influence on the economies of non-EU countries.

Firstly, associated with European growth is an 'income effect' which will be to the benefit of the economies external to the EU. Of course, the extent of the income effect on the non-EU economies will depend on the level and nature of the integration between these countries and the EU. In the case of Tunisia, as we have seen, this integration is very close as far as trade in goods and services is concerned. However, because Tunisian exports are mainly concentrated in the textile and agro-food sectors –goods for which the elasticity of demand to income is relatively low – it is likely that the effects of EU income variations on the Tunisian economy will be relatively minor. More important, from this point of view, may be the consequences on tourist flows to Tunisia, although in this case it will be principally incomes variations in France and Germany that will be decisive. The income effect will also have to take account of the closer synchronization of the economic cycles of the European economies which is likely to come about as European economic integration proceeds. The implication of this process is that fluctuations in European demand for Tunisian exports will increase, given that they will not be (at least partially) off-set by the different cycles of the European economies.

Besides the income effect, growing intra-EU integration will engender a 'substitution effect'. Reduced transaction costs in intra-EU trade will give producers in the EMU a comparative advantage which may be accompanied by a decline in imports from non-EU countries. This channel becomes all the more important if viewed in the light of the EU's enlargement to include the Eastern European countries. Once again, however, the effective importance of this effect will depend on the patterns of specialization of the economies in question. In the case of Tunisia, there may be some repercussions on the textile sector, while the effects should be much less marked on tourism, a sector where integration is slower and constrained by the specific geographical and cultural features of each country, and also on the agro-food sector, where Tunisia produces goods which only partly compete with European ones.[9]

Feldman et al. (1998) have sought to measure the impact of the income and substitution effects on a group of countries in the southern Mediterranean. Their study shows that, of the Maghreb countries, Tunisia is the most sensitive to events in Europe, with markedly higher levels of the elasticity of exports to European GDP and to the increased competitiveness of European producers. Overall, however, the joint result of the two effects should be positive, stimulating an increase in Tunisian GDP of approximately 0.2 percent (Table 7).[10]

[Insert Table 7]

3.2.2. *The exchange rate channel*

A second channel through which EMU may influence the economies of the non-EU countries is the exchange rate between the euro and other currencies. While EMU by definition eliminates the problem of exchange rate variability within the EMU area, at the same time it will probably increase the euro's variability *vis-à-vis* the principal non-EU currencies, for two main reasons: first, the greater uncertainty that markets may associate in the short and medium period with the new monetary and political institutions of the EMU countries; second, the fact that the EMU area is much less economically integrated with the rest of the world than are the individual economies that belong to it, and is therefore less subject to influence by variations in its currency's exchange rate.

[9] It should also be pointed out that the agro-food sector is influenced by developments in EU agricultural policy, which in the medium and long period is set to introduce major changes which will reduce the protection now enjoyed by European agriculture and therefore open up opportunities for non-EU countries.

[10] More specifically, the income effect should produce increases of 1.9 percent and 0.6 percent in Tunisian exports and income respectively, while the substitution effect, on the hypothesis of a 3 percent elasticity to price and of a 5 percent reduction in costs to producers in the EMU area, should give rise to 1.3 percent and 0.4 percent reductions in exports and income (Feldman et al., 1998).

The importance of the exchange rate channel in transmitting the effects of EMU depends on the exchange rate regime adopted by each country, on the level of economic-financial integration with the euro area, and on the price elasticities of imports and exports. Those countries that tie their currencies to the euro will experience gains and losses of competitiveness in non-euro-regulated international trade according to the euro's oscillations with respect to the main currencies, first and foremost the US dollar. Likewise, in the case of oscillations in the euro's exchange rate, those countries whose currencies are tied to the dollar will experience variations in their competitiveness on European markets.

As regards Tunisia, its close economic integration with the EU may limit the effects of fluctuations by the euro. In this case, however, assessment of the importance of this channel is complicated by two factors. Firstly, as we have seen, the structure of Tunisia's currency payments is biased towards the dollar and, albeit to a lesser extent, the yen. Moreover, as Table 5 shows, the composition by currency of the country's current payments is significantly different from that of its receipts. More in particular, there is a greater quantity of payments in dollars (37.9 percent) than in European currencies (52.9 percent) compared with the respective receipts (20 percent and 35.7 percent). This implies that the oscillations of the euro will have an impact, albeit indirectly, on Tunisia's terms of trade.

Secondly, it is difficult to assess Tunisia's exchange rate policy, which has to date pursued the objective of a quasi-fixed exchange rate with respect to a basket of currencies of both competing countries and trading partners. Although information on the basket's composition is not available, the importance of the euro is certainly very significant.[11] In any event, if, as is likely, the implementing of EMU will give the euro an important role as an international currency (Portes and Rey, 1998; Huisman et al., 2000), also the structure by currency of Tunisia's international transactions will shift towards the European currency, and this will alter the role of the euro in the reference basket of the Tunisian monetary authorities.[12] The overall outcome, also taking account of the geographical specialization of Tunisia's international trade, should be

[11] The major importance of the EU currencies is borne out by the oscillations in the real exchange rates of the Tunisian dinar with respect to the dollar and the European currencies. In the period 1993-96, for example, the standard deviation of the real exchange rate against the dollar was 6.3 and only 1.3 against the European currencies: cf. Feldman et al. (1998).

[12] According to Bénassy-Quéré and Lahréche-Révil (1999), all the Maghreb countries, if they are to fulfil the criteria of the theory of optimal monetary areas, should use the euro as their reference

the greater independence of Tunisian competitiveness from the euro's oscillations with respect to the other principal currencies.

As well as on trade, the exchange rate channel also works through its effects on servicing Tunisia's foreign debt. As we have seen, at the end of 1998 the share of Tunisian debt denominated in dollars and yen amounted to 57.8 percent, while the amount denominated in EU currencies was only 32.7 percent. It is evident that a composition of this kind, given the exchange rate regime currently in operation, exposes Tunisia to a significant exchange rate risk should the euro depreciate.

Finally, the increasing role of the euro in international markets, the structure of payments for commercial transactions and for servicing Tunisia's foreign debt will have repercussions on the management and composition of the country's official reserves, with a shift towards the euro.

3.2.3. *The financial channel*

Despite its high degree of openness and commercial integration, Tunisia does not exhibit close international financial integration. As regards capital movements numerous constraints still apply to both inflows and outflows in spite of the presence of a strategy for gradual financial liberalisation. Moreover, the financial system is still underdeveloped, although some progress has been made with the financial reforms of recent years. This general situation of relative closure to international financial transactions and of scant development of financial structures restricts the importance of the financial channels through which EMU could exert its effects on the Tunisian economy. It may have some repercussions on direct investments and on management of the foreign debt, but the impact of effects operating through portfolio investments will be much more modest.

As regards direct investments from abroad, there might be a substitution effect entirely similar to the one discussed with reference to trade flows. To the extent that EMU encourages the re-orientation of direct investments to the EU area, this may reduce the amount of investments directed towards non-EU economies. This channel is particularly important as regards investments intended to reduce costs, and especially in the light of the EU's enlargement to the East. This may be of some importance for Tunisia in that it receives foreign investments mainly in the

currency. In particular, on the basis of a number of simulations, the two authors argue that the euro should have a weight of 87 percent in Tunisia's optimal reference basket of currencies.

manufacturing sector,[13] which exports to the EU and is highly vulnerable to competition by the countries of Eastern Europe. Conversely, the consequences should be less marked, at least in the short and medium period, on investments made abroad either in order to enter new markets or to diversify risk. Of course, the stability of Tunisia's foreign investments will also depend on the economic and commercial strategies of the southern Mediterranean countries. Progress in commercial integration among these countries should reduce the incentives to relocate investments to the EMU area and thus promote direct investments in the countries of the southern Mediterranean.

As far as Tunisia's foreign debt is concerned, and in addition to the above discussion of the exchange rate effect, of importance are the variations of servicing the debt due to changes in the level of interest rates on the euro. It may happen, in fact, that the introduction of EMU will bring variations in interest rates with it: for example, in the medium and long period, there may be a reduction in rates to the extent that the EMU countries benefit from more liquid and efficient capital markets and from a more robust nominal anchor (Prati and Schinasi, 1997). Of course, the importance of this channel of influence depends on the amount and the composition of the foreign debt. For example, an index-linked debt strongly exposed to the euro will be more vulnerable to oscillations in European rates, whereas the reverse will be the case if a large share of the debt has been obtained on facilitated rates of interest. These effects can be counteracted to the extent that each country is able to gain access to the international capital markets in order to change the currency denomination of their debt .

Finally, the introduction of the euro may be followed by a portfolio composition effect. EMU, in fact, has already given rise to pronounced convergence in the returns on fixed-income securities in its member countries, where differentials in interest rates have practically disappeared, and on shares, where the correlation among stock market trends has grown substantially. In response to this convergence of returns, European investors may revise their portfolios in order to achieve greater diversification and higher returns. This recomposition is likely to benefit the emerging countries, especially those that already enjoy a certain amount of political and economic stability; which have undertaken institutional reforms to ensure the working

[13] In 1998, around 69 percent of direct investments from abroad were made in the Tunisian manufacturing sector, as opposed to 27 percent in the energy sector and 3 percent in tourism.

of a market economy; and which have reliable financial systems open to international financial integration.

At present the economies of the southern Mediterranean only partly fulfil these criteria, although there are important signals that they will be increasingly able to attract financial flows in the future. From this point of view, Tunisia occupies a leading position among the southern European countries. This is reflected in the risk indicators set out in Table 8, on the basis of which Tunisia displays a political risk, an economic performance, and a level of debt riskiness better than that of the other countries in the area.

[Insert Table 8]

This finding is confirmed by the assessments of the principal rating agencies (Table 9) which assign an 'investment grade rating' to Tunisia, while they do not classify Algeria and give a 'below investment grade rating' to Morocco (Moody's and Standard & Poor's) and to Egypt (Moody's). However, all these countries still have extremely low access to capital markets. Scant international integration, especially as regards portfolio investments, is a feature shared by all the southern Mediterranean countries. However, although this feature impedes them from receiving financial resources which can be used to finance their domestic economies, on the other hand it insulates them against the events that influence international capital movements. In this sense, therefore, the volatility of European interest rates which, in one direction or the other, may be associated with the arrival of the euro, should not have significant consequences on the countries in question.

[Insert Table 9]

4. Concluding remarks

This paper has sought to assess the impact on Tunisia's economy of the association agreement with the EU and of the introduction of EMU. The association agreement has led to a greater freedom in trade and in international investments that has exposed the Tunisian economy to the pressures of international competition as never before. It is important that the Tunisian authorities should continue with reform so that the country's economy can strengthen its capacity to withstand competitive pressures – and also in the light of EU initiatives towards the countries of Eastern Europe, which are the direct competitors of Tunisian producers in important markets. From this point of view, measures are required to improve the country's infrastructures, give greater efficiency to the financial system and the administrative apparatus, reduce state involvement in the economy, and maintain macroeconomic equilibria.

The prospects of enduring economic growth, however, also depend on progress in economic and commercial integration among the countries of the southern Mediterranean, with a view to creating a single market for average-income countries characterized by similar cultures and patterns of consumption. The creation of a more integrated area would also increase the capacity of these countries to attract international investments. Overall, therefore, the association agreement is a significant opportunity for Tunisia's development, and if suitably exploited it may lead Tunisia towards more complete integration with Europe.

The introduction of EMU, too, offers opportunities for growth, albeit more indirectly and less significantly. In the short and medium period, the effects of EMU on the Tunisian economy will closely depend on the effects of EMU on the European countries. To the extent that the euro is able to foster the growth of the European economies, there will be repercussions on countries closely integrated with the EU like Tunisia. In the longer period, however, the effects will depend mainly on the type of economic integration that these countries are able to achieve with the countries of the EMU area, and on their ability to implement reforms.

The euro will assume an increasingly important role as an international currency, and this will have major repercussions on Tunisia, which, if it wants to limit the risks connected with oscillations of the European currency, will have to redenominate in euros a large part of its earnings and payments, of its debt, and of its official reserves.

Further progress should also be made as regards financial integration. The challenges now facing Tunisia require resources to finance investments and reorganization, and as a consequence closer financial ties with the rest of the world, Europe in particular. This progress will further highlight the importance attaching to choice of exchange rate regime, and in particular the extent to which Tunisia should be anchored to the euro.

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Table. 1: Structure of Fiscal Revenues

(average values 1994-96; as percent of GDP)

	Total Revenues	Taxes on Income and Profits	Taxes on Goods and Services	Import Duties	EU Import Duties
Tunisia	20.06	4.69	9.82	4.45	3.18
Algeria	11.52	2.78	4.91	3.45	2.21
Egypt	17.05	6.16	4.57	3.37	1.34
Morocco	24.52	5.9	10.61	4.3	2.53

Source: Abed (1998)

Table 2: EU Trade with Eastern European Countries

(as percent of total export/import of each country)

	Exports to EU		Imports from EU	
	1993	*1998*	*1993*	*1998*
Albania	71.3	88.6	87.3	81.3
Bulgaria	48	47.9	43.4	44.6
Croatia	56.7	47.1	55.4	59.2
Czech Rep	55.5	60.2	51.1	59.7
Estonia	48.3	61.7	60.4	75.7
Hungary	57.9	68	54.6	70.8
Macedonia	34.5	44.6	33.5	42.4
Poland	69.3	62.9	64.8	69.9
Romania	41.4	60.2	45.3	56.1
Slovak Rep.	29.6	51.3	27.9	48.1
Slovenia	61.6	65.5	62.1	69.4

Source: IMF Direction of Trade Statistics

Table. 3: Trade Openness and Trade with EU Countries (1998)

	(X+M)/GDP	IMPORT EU shares	EXPORT EU shares	IMPORT EMU shares	EXPORT EMU shares
Tunisia	73.15%	70.49%	79.87%	66.65%	79.01%
Algeria	41.00%	64.00%	62.51%	61.44%	61.08%
Egypt	32.69%	40.01%	47.58%	33.51%	30.00%
Morocco	25.41%	55.00%	58.60%	49.95%	53.57%

Source: IMF Direction of Trade Statistics, Datastream

Table 4: Balance of Payments (Current Account,1998)

	Credit	Debit
Goods	6518 [5408]	8968 [6775]
Services	3139 [2382]	1430 [1023]
Transportation	721 [594]	673 [535]
Travel	1887 [1616]	267 [166]
Tourism	1712 [1324]	162 [128]
Other Services	420 [288]	372 [255]
Income	1005 [856]	1093 [544]
Compensation of employees	901	

Notes:
° Trade with EU in brackets;
° Millions of Tunisian dinars.

Source: Tunisian Central Statistical Office

Table 5: Current Transactions – Shares by currency

	Credit		Debit	
	1992	*1998*	*1992*	*1998*
US dollar	31.2	20	36.5	37.9
French franc	17.5	18	28.9	25.8
German mark	9.8	8.7	8.6	8.9
Italian lira	4.9	5.2	7.6	10.4
Sterling	1.6	1.9	1.3	1.4
Other EU currencies	3.4	3.8	5.7	7.8
Total EU currencies	35.6	35.7	50.8	52.9
Other currencies	31.6	42.4	11.4	7.8

Source: Tunisian Central Statistical Office

Table 6 International Investment Position (1998)

(Million of Tunisian dinars)	
Direct Investment Abroad	-13435
Portfolio Investment	-1219
Other Investment	
Long-term Loans	-10525
Short-term Loans	-524
Reserve Assets	2149

Source: Tunisian Central Statistical Office

Table 7: Effects of EMU on Selected African Countries Exports and GDP

	Relative price elasticity	Export elasticity with respect to EU GDP	Impact of 5% rise in EU competitiveness on:		Impact of 1% rise in real EU GDP on:	
			Export (percent)	*GDP* (percent)	*Export* (percent)	*GDP* (percent)
Tunisia	-0.34	2.36	-1.3	-0.4	1.9	0.6
Algeria	-0.23	0.42	-0.7	-0.2	0.3	0.1
Egypt	-0.23	1.93	-0.6	0	1	0.1
Morocco	-0.26	1.64	-0.9	-0.2	1.1	0.2

Source: Feldman (1998)

Table. 8: Risk Indicators (*)

	Ranking Sept. '99 (1)	Total score (2)	Political risk	Economic performance	Debt in default or rescheduled	Access to bank credit	Access to capital markets
Maximum score		100	25	25	10	5	5
Algeria	117	35,58	7,24	6,70	9,00	0,00	1,00
Egypt	58	55,47	13,95	9,38	9,91	0,00	2,56
Morocco	56	55,05	14,06	8,64	10,00	0,11	3,89
Tunisia	49	59,1	15,69	10,67	10	0,02	2,56

(*) Higher values are associated with lower risk
(1) Ranking among 180 countries based on 9 indicators analysed by Euromoney .
(2) Total score based on nine Euromoney indicators.

Fonte: Euromoney

Table 9: Financial Indicators

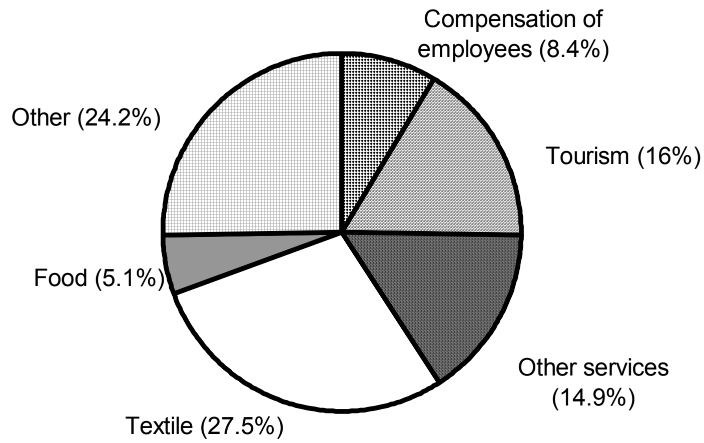
	Foreign debt/GDP (*)	Foreign debt in EU currencies (*)	Share of concessional debt (*)	Net private capital flows/GDP (*)	Rating of foreign debt (**)		
					Moody's	Fitch IBCA	Standard & Poor's
Algeria	60,4	27,7	10,1	-0,2	ND	ND	ND
Egypt	41,4	37,3	64,9	2,4	Ba1	BBB-	BBB-
Morocco	61,0	36,9	24,3	3,8	Ba1	ND	BB
Tunisia	52,8	32,7-	37,2	2,0	Baa3(+)	BBB-	BBB

(*) 1997

(**) 2000

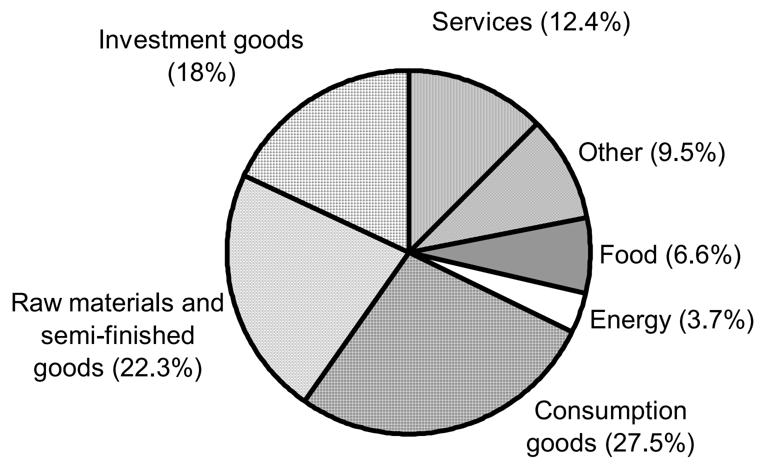
Source: IMF, Moody's, Fitch IBCA, Standard & Poor's

Figure 1: Composition of Trade: Exports (1998)



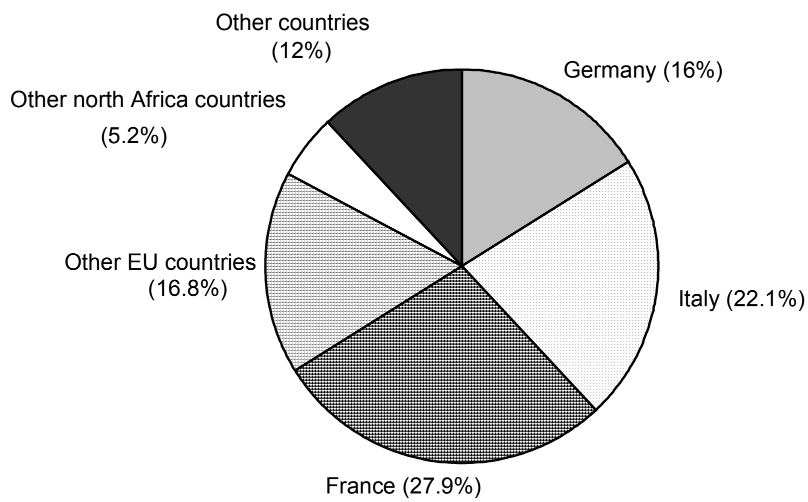
Source: Tunisian Central Statistical Office

Figure 2: Composition of Trade: Imports (1998)



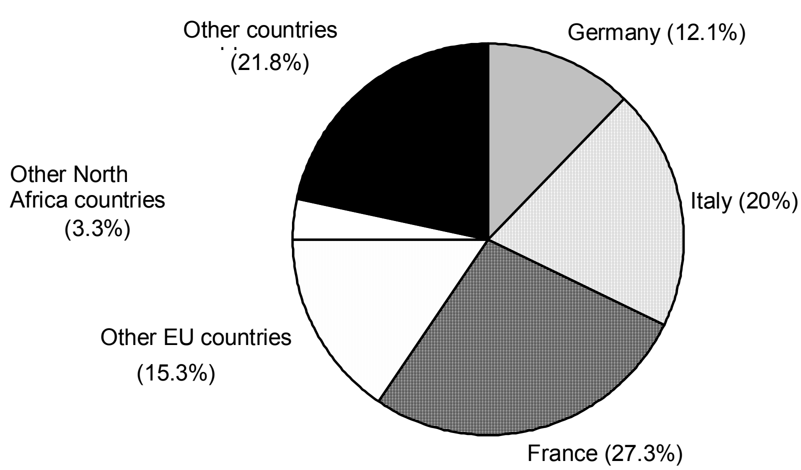
Source: Tunisian Central Statistical Office

Figure 3: Exports by Country (fob, 1998)



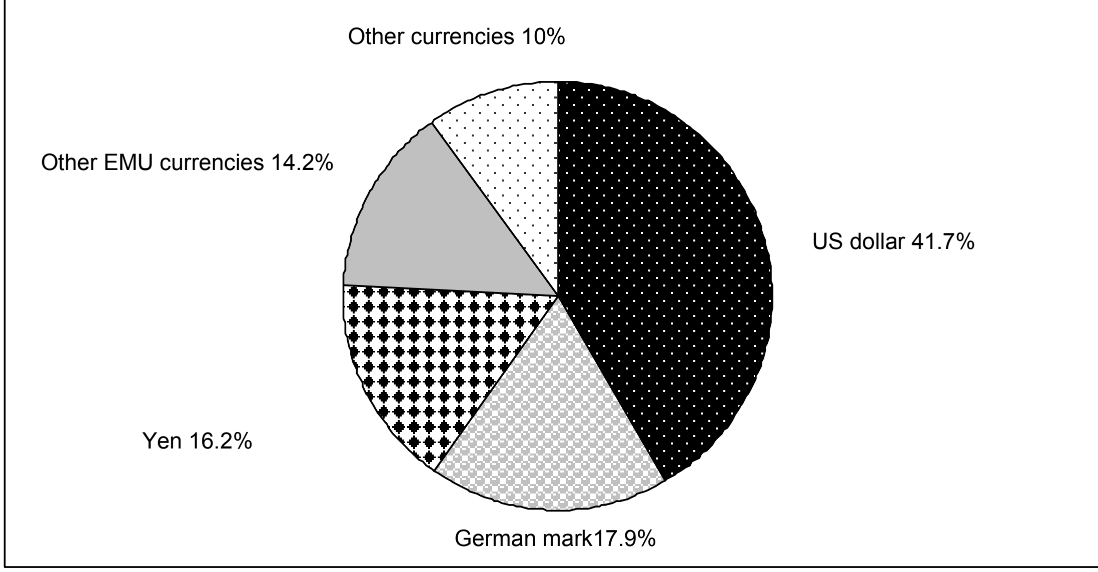
Source: Tunisian Central Statistical Office

Figure 4: Imports by Country (cif, 1998)



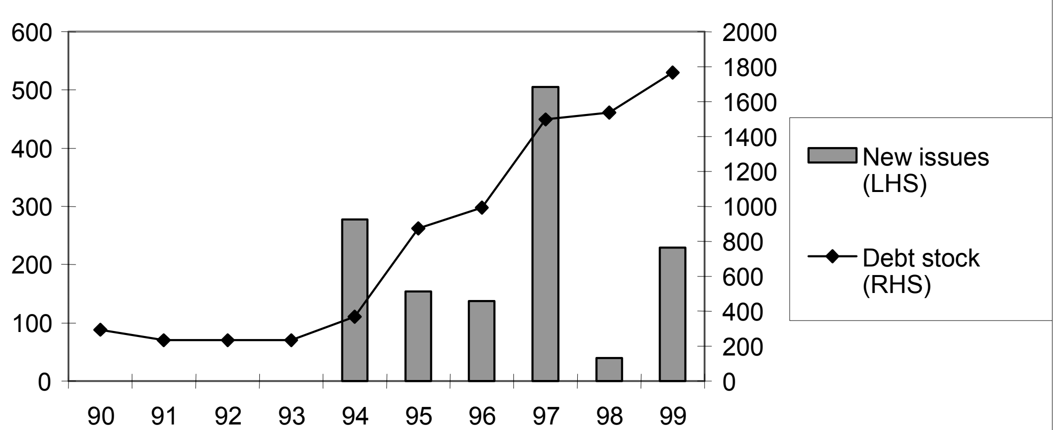
Source: Tunisian Central Statistical Office

Figure 5: Foreign Debt by Currency (1998)



Source: Tunisian Central Statistical Office

Figure. 6: International Bond Issues



Source: Capital Data