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BOARD
MEETING**

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April 8, 2021

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From: The Secretary
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***At the time of circulation of this paper to the Board, the authorities have indicated that they need more time to consider whether they will consent to the Fund's publication of this paper. Publication will only proceed upon the receipt by the Fund of the member's explicit consent.**



KIRIBATI

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION

April 6, 2021

KEY ISSUES

Context. At the onset of the COVID-19 pandemic, the authorities took preemptive containment measures that successfully limited the risk of a domestic outbreak but also put strains on economic activity. Real GDP is estimated to have declined by 0.5 percent in 2020 with fishing revenues declining by 16 percent. Restriction on movement will continue in 2021, still limiting labor mobility and port activity. Disappointing January fishing revenues suggest external factors may continue to weigh on growth in the near-term. While a recovery is expected in 2021, real GDP growth is expected to remain subdued at 1.8 percent, compared to the pre-COVID average of 4¾ percent in 2015–19. Uncertainty around the outlook is larger than usual and risks are tilted to the downside.

Main Economic Policy Recommendations

- Maintain supportive fiscal measures until the recovery is firmly underway, while ensuring measures are well-targeted and focused on social spending;
- Mobilize revenues once a durable recovery is underway to strengthen Kiribati's net financial worth and help finance the sustainable development goals (SDGs) and climate related spending priorities;
- Maintain fiscal discipline by formulating a sustainable medium-term fiscal framework and adhering to rules-based withdrawals from the sovereign wealth fund;
- Improve public financial management, particularly in the areas of budget planning as well as strengthening cashflow management and forecasting;
- Enhance financial sector stability by developing a framework for regulation and supervision of financial institutions, and establish an independent supervisor of financial institutions to ensure effective implementation of the new framework;
- Mitigate the long-term consequences of the pandemic by implementing structural reforms to support a dynamic private sector, encourage economic diversification, improve governance, and promote sustainable financial deepening; and
- Strengthen the institutional capacity to produce high-quality statistics in a timely manner to support data-driven policy formulation.

Approved By
**Nada Choueiri and
 Kevin Fletcher**

Discussions took place by video conference during February 11–28, 2021. The staff team comprised Sarwat Jahan (Head), Muhammad Shamil Akbar (APD), Danny Xufeng Jiang (SEC), and Jacinta Bernadette Shirakawa (STA). Leni Hunter (Resident Representative, PIC) and Paul Seeds (PFTAC) also participated in the discussions. Anna Robinson (WB) and Lily Homasi (ADB) joined some of the technical meetings. Chang Huh and Jinhyuk Yoo (both OED) also attended the meetings. The mission met with President Taneti Maamau, Vice President and Minister of Finance and Economic Development Teuea Toatu, Secretary of Finance and Economic Development Benjamin Tokataake, Secretary of Cabinet Naomi Biribo, other senior government officials, and representatives of the private sector and civil society. Yadian Chen, Enakshi Das, Ricardo Davico, Francis Landicho, and Kristine Laluces (all APD) provided excellent research and editorial assistance for the preparation of this report.

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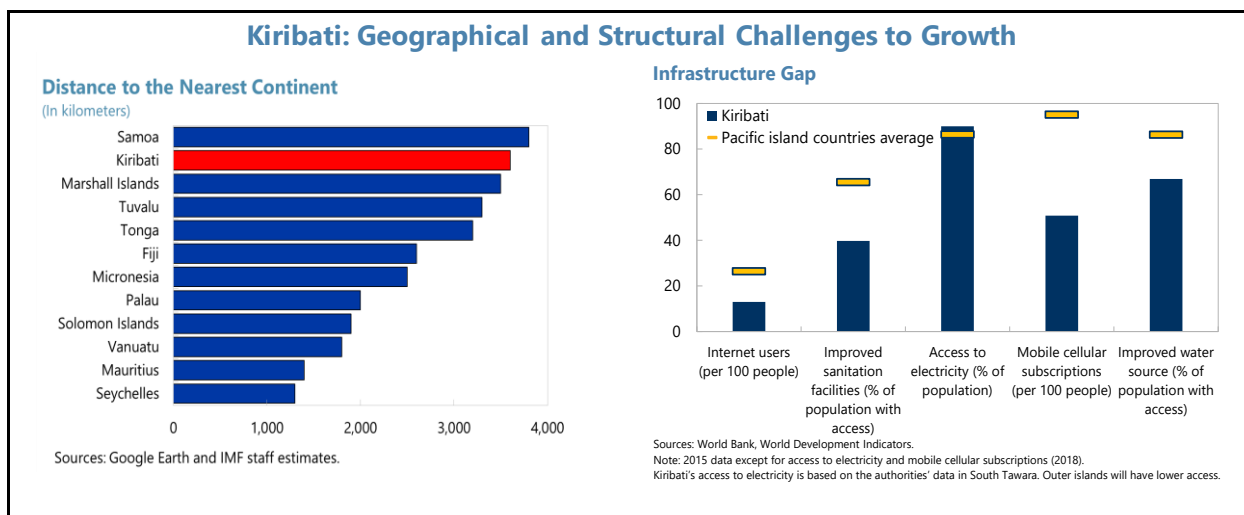
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THE PRE-COVID SCENARIO: FAVORABLE GROWTH BUT STILL LARGE DEVELOPMENT GAPS

- 1. Prior to the COVID-19 outbreak, Kiribati's economy was performing well.** Kiribati's average annual real GDP growth rate was 4¾ percent in 2015–19, up from about 1½ percent during 2000–14. The stronger growth reflected in part higher public spending financed by record-high fishing revenue—about 75 percent of GDP in 2015-19, up from a 25 percent historical average. Recent construction activities, driven by donor-financed infrastructure investment, also contributed to growth. Nonetheless, Kiribati ranked 134 out of 189 countries in the 2019 Human Development Index, suggesting still significant development gaps.
- 2. Kiribati's longer-term development is challenged by its remote location, infrastructure gap, and susceptibility to climate change.** The country's low-lying atolls are vulnerable to rising sea levels, storm surges, coastal erosion, and saltwater intrusion. Higher ocean surface temperatures may disrupt tuna fisheries (the country's largest economic resource)¹ with a direct impact on fiscal revenues, the current account, and growth. Infrastructure deficits in utilities, transport and communications compound the constraints imposed by distance and dispersion. Kiribati is about 4,000 kilometers from the nearest major cities in Australia and New Zealand, hindering foreign investment.



THE COVID SHOCK: IMPACT, OUTLOOK AND RISKS

- 3. At the onset of the COVID-19 pandemic, the authorities took preemptive containment measures that successfully limited the risk of a domestic outbreak.** Travel restrictions were introduced in January 2020. Subsequently, containment measures became more stringent. The authorities declared a state of emergency, closed borders except for delivery of essential goods,

¹ Unlike many other Pacific Island countries, tourism does not play a significant role in the economy.

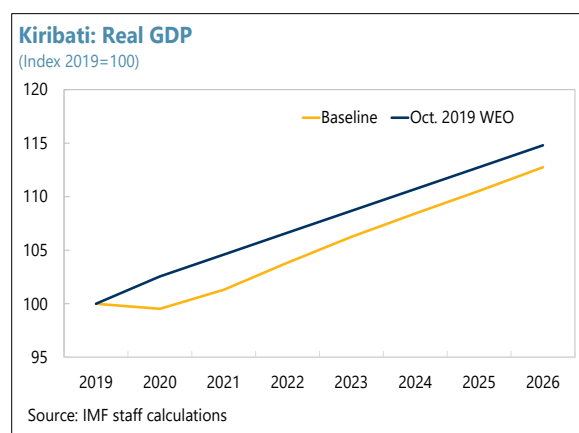
required mandatory quarantine at all ports, restricted fishing vessels under bilateral agreements with the Ministry of Fisheries and Marine Resource Development (MFMRD) to come onshore, and closed schools. Largely thanks to these measures, Kiribati has no confirmed case to date, allowing reopening of schools in April 2020 and repatriation of citizens stranded abroad in November 2020.

4. The pandemic and containment measures put strains on economic activity. The COVID-19 containment measures impacted growth directly through contraction in services including restaurant and hotel services, transportation, and other business activities. Planned large investment projects were delayed because of restrictions on the movement of personnel and materials. Strict containment measures and lower external demand led to a sharp drop in fishing revenues by about 16 percent in 2020. As a result, real GDP is estimated to have declined by 0.5 percent in 2020. Average inflation is estimated to have remained subdued at below 2 percent in 2020—consistent with major trading partners, given Kiribati’s use of the Australian dollar as legal tender.

5. Both the fiscal and balance of payments positions have weakened. The fiscal balance is estimated to have shifted from a surplus of 8 percent of GDP in 2019 to a deficit of 3 percent of GDP in 2020 due to a sharp fall in fishing revenues and the increase in current expenditures that ensued from the policy response. Correspondingly, the current account (CA) surplus is estimated to have narrowed from about 44 percent of GDP in 2019 to about 7 percent of GDP in 2020. This fall in the CA surplus was partially mitigated by low oil prices, declining imports due to the domestic demand contraction, and increased budget support from development partners.

6. A recovery is expected in 2021, although growth will remain subdued compared to the pre-COVID environment. The authorities expect to vaccinate 20 percent of the population in mid-

2021 but logistical challenges to vaccinate the entire adult population are significant. Restriction on movement will continue longer than previously expected, limiting labor mobility, and port activity has declined more than initially projected. Disappointing January 2021 fishing revenues suggest external factors may continue to weigh on growth in the near-term. As a result, real GDP growth for 2021 is projected at 1.8 percent, significantly lower than the pre-COVID performance. With the expected vaccine roll-out in most countries, growth is projected to reach 2.5 percent in 2022 but the GDP level will remain 2.6 percent below the pre-pandemic projected level. With economic recovery, imports will increase but the CA will continue to be in surplus with a gradual rise in fishing revenues. However, the continued high recurrent expenditure will keep the overall fiscal balance in deficit (see next section).



7. Notwithstanding significant uncertainty, the external balance is assessed to still be broadly in line with fundamentals and desirable policy settings. The real effective exchange rate (REER) has tracked the weakening of the Australian dollar against the U.S. dollar at the beginning of

the pandemic but has returned within historical norms. Given the idiosyncratic features of the Kiribati economy and gaps in data quality, there is substantial uncertainty around the external sector assessment, which is further complicated in 2020 by the pandemic. Adjusting for the pandemic related shock to fishing revenues, staff assess Kiribati's external position in 2020 to be in line with the level implied by fundamentals and desirable policy settings (Annex I).

8. Risks to the outlook are substantial and tilted to the downside, with greater uncertainty due to the COVID-19 pandemic. A worsening of the COVID-19 pandemic that prolongs costly containment measures would adversely impact economic activity as the planned resumption of infrastructure projects and activity in the services sector are further delayed. Global financial conditions could also tighten in response to adverse COVID-19 developments and may affect the expected return on the Revenue Equalization Reserve Fund (RERF) and the Kiribati Provident Fund (KPF), thus putting pressure on fiscal resources. A cyclical reversal of the favorable weather conditions could threaten fishing revenues, impacting the fiscal balance and the current account. Higher frequency and severity of natural disasters would further aggravate these risks (Annex II).

Authorities' Views

9. The authorities broadly agreed with staff's assessment of the outlook and risks, highlighting that lingering effects of COVID-19 will likely continue in 2021. They are intent on keeping Kiribati COVID-free and are cautious regarding reopening borders as domestic capacity to contain an outbreak is limited. Although they expect fishing revenues to improve from the disappointing January 2021 numbers, they remain concerned that global demand will not pick-up significantly compared to 2020, implying subdued growth in the near-term.

POST-PANDEMIC RESILIENCE: BUILDING BACK BETTER

A. Recovering from the Pandemic: Immediate Policy Measures

10. Kiribati took timely fiscal policy measures to mitigate the adverse effects of the pandemic. The government approved an economic relief package of AUD\$13.5 million in 2020 (about 5 percent of estimated 2020 GDP), which includes unemployment income support and stimulus for both private firms and state-owned enterprises (SOEs), and financial aid for cargo deliveries. About 60 percent of the relief package has been disbursed as of end-February 2021, which has helped to cushion the economic impact of the pandemic. Further disbursement of the relief package awaits (i) the completion of cross checks on the applicants for the unemployment income support (no disbursement has been made); and (ii) verification of private firms' applications to check they are operational, thereby qualifying them to receive funds from the Development Bank of Kiribati (state-owned bank) through the on-lending scheme at reduced interest rates to pay for utilities. The authorities do not envision a separate COVID-19 fiscal package in 2021, although the continued disbursement of the 2020 relief package will help support households and private firms, if timely executed. Nonetheless, the fiscal deficit is expected to widen in 2021 by about 9 ppts

reaching 12 percent of GDP partly due to increases in the wage bill, unemployment support scheme, land rent (government leasing), and senior citizen's benefits.

11. Supportive fiscal measures should remain in place until the recovery is firmly underway, but measures should be targeted and rationalized. Fiscal measures need to continue focusing on economic recovery in 2021. However, policy efforts should be retargeted to the most affected sectors and segments of the population. The current DSA shows that, while debt is sustainable in the baseline scenario, Kiribati remains at high risk of debt distress, underscoring the need to rationalize and prioritize spending. For 2021, staff recommends:

- evaluating the results of the recent payroll audit to recalibrate the wage bill appropriately and redirecting available resources to targeted social transfers in response to the pandemic;
- properly identifying those eligible for unemployment benefits to limit the increase in expenditure; and
- refraining from increasing expenditure through a supplementary budget if fishing revenues surprise on the upside.

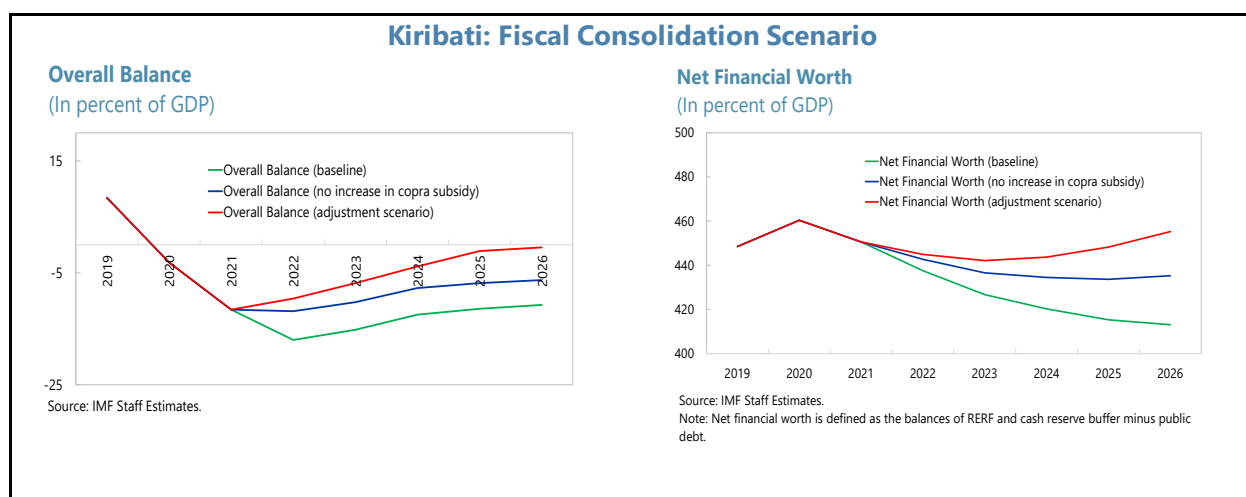
12. All public spending, including those allocated for the pandemic, should be governed by strict rules for transparency and accountability. The rapid scaling up of government spending can create risks of inefficiency and leakages, especially in the face of capacity constraints. Staff welcomes the authorities' efforts to ensure that the households and firms that have applied for COVID-relief funding are authenticated by a thorough review of their applications. Building on this, additional pandemic-related spending safeguards should be put in place. These safeguards could include: public access to procurement contracts for crisis-related spending, availability of beneficial ownership information for awarded entities, and publication of an ex-post audit report of emergency spending.

Authorities' Views

13. The authorities noted that their policy response in 2020 helped contain the economic downturn while the 2021 budget aims to provide continued support to the recovery. They also committed to review the recurrent expenditure items to contain fiscal risks and ensure that expenditure is well-targeted. In particular, they underscored that the unemployment benefit scheme was newly introduced in 2020 and there is scope to improve the system to close potential loopholes, bringing down recurrent spending. However, they also cautioned that a protracted pandemic could warrant an increase in fiscal support, especially if restricted labor mobility continued to limit normalization of employment opportunities. The authorities also underscored the safeguards put in place to govern pandemic-related spending, including the careful application and verification process that beneficiaries have to undergo.

B. Nurturing the Recovery: Reinforcing the Fiscal Framework

14. Fiscal consolidation will be necessary to reduce fiscal risks once the recovery is underway. Kiribati's recurrent spending is mainly financed by volatile fishing revenues and budget grants, with project grants used for development financing and no regular access to debt financing. Volatile revenue and dependence on donor grants underscore the importance of maintaining fiscal discipline and adequate cash buffers, as highlighted by the DSA. In addition to the recurrent spending introduced in 2021, the authorities plan to double the copra subsidy in 2022 (to AUD\$32 million), which would bring the 2022 deficit to 17 percent of GDP (an increase of 5 ppts over the 2021 fiscal deficit). This increase in copra subsidies would go against previous IMF advice as it would distort economic incentives. For 2022, provided that the recovery is firmly underway, it will be prudent to undertake fiscal consolidation that reduces the domestic recurrent spending to about 52 percent of GDP instead of the 59 percent in 2022 under the baseline. This can be achieved by keeping the copra subsidy at the current level and by unwinding unemployment benefits (conditional on a sustained pace of recovery). During 2023-26, reducing the domestic recurrent deficit by slightly above $\frac{3}{4}$ percent of GDP each year (over the baseline) would lead to a balanced budget in the medium-term. Under this adjustment scenario, net financial worth would recover towards pre-COVID levels, to about 455 percent of GDP over the medium-term.



15. Preserving the value of the RERF for future generations will also boost fiscal sustainability. In September 2020, with support from the World Bank, the authorities introduced a rule-based withdrawal policy (Box 1). Following this rule will help preserve the value of the RERF under current inflation and population projections. The authorities have withdrawn from the RERF (AUD \$40 million) to partly finance the 2021 deficit with the funds allocated towards rural development projects, such as building roads. The authorities should continue to ensure that RERF withdrawals increase development spending, and not substitute for funds that get reallocated from development to recurrent spending.

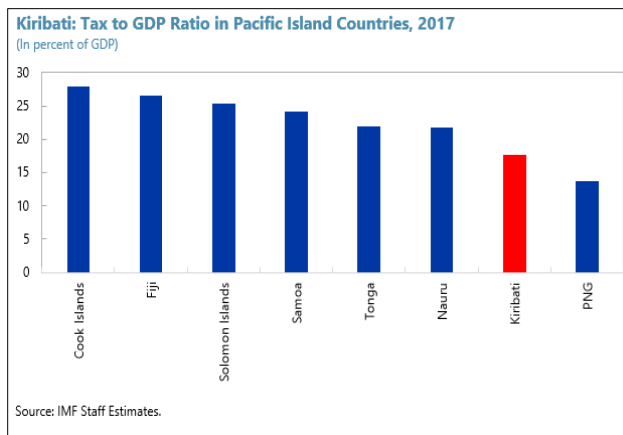
Box 1. Revenue Equalization Reserve Fund

Objectives: The capital value of the RERF over time is protected; The RERF is used more effectively for development purposes; and Intergenerational equity is not compromised.

Withdrawal Rules:

- The excess return over the target real growth rate of 5 percent can be withdrawn.
- The policy does not allow for withdrawals in years when the annual real return is equal to or below 5 percent.
- Withdrawals can be used only for development purposes.
- The Cabinet needs to approve the specific development projects that will be earmarked for financing through a RERF withdrawal.

16. Formulation of a sustainable medium-term fiscal framework (MTFF) will promote fiscal discipline thereby underpinning fiscal sustainability. Such a framework would help to better manage volatile, exogenous components of the budget (fishing revenue and grants) and promote recurrent expenditure stability by avoiding wasteful and unsustainable surges in spending resulting from temporary surges in fishing revenue, or unnecessary and harmful spending cuts due to temporary declines in fishing revenue. The MTFF should also ensure that (i) RERF withdrawals only finance development expenditure; and (ii) development expenditure itself is determined in the context of multi-year plans with clearly identified financing.



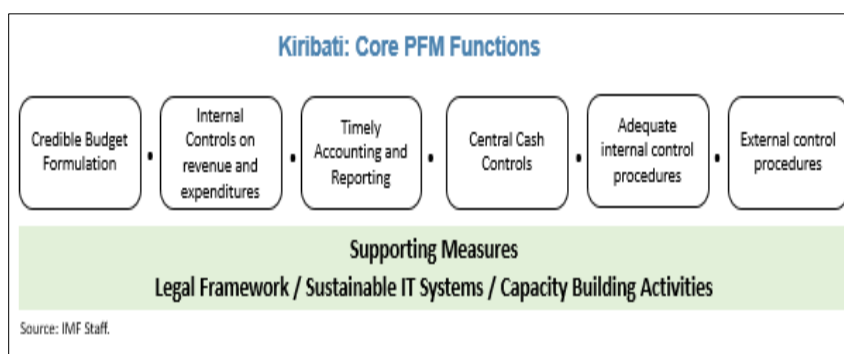
17. The pandemic has brought the importance of generating greater revenue mobilization to the forefront. The last tax reforms in 2014 implemented a value added tax (VAT), eliminated import duties, and modified personal income tax laws. As a result, the tax-to-GDP ratio improved from 15.4 percent in 2015 to 17.4 percent in 2019. Still, this ratio remains lower than that in most regional comparators (text chart) and there is scope for further improvement, particularly through protecting the tax base by eliminating discretionary exemptions on SOEs (Annex III). In addition, implementing medium-term reforms can put revenues on a more sustainable footing by:

- increasing the progressivity of personal income tax, streamlining the corporate income tax, and simplifying the tax regime for small businesses;
- increasing the excise tax on tobacco and fuel which also benefits the environment and help fund climate adaptation costs;
- leveraging Kiribati's participation in the Parties to the Nauru Agreement (PNA) to broaden the vessel day scheme to maximize fishing revenue potential;

- reviewing the tax policy to align Kiribati's tax rates to international levels to incentivize private sector investment; and
- formulating the deep seabed mining fiscal regime with a focus on aligning tax rates with regional peers to establish a more stable source of revenue.

18. Improving public financial management (PFM) is also necessary to make public spending more effective to boost post-COVID recovery. PFM reforms should focus on ensuring

that critical core functions are put in place in line with the measures identified by IMF technical assistance (Annex IV). As implementing measures for a sound PFM system takes time, staff recommends prioritizing the following reforms in the near-term:



- **developing credible budgets** by improving fishing revenue projections, ensuring both recurrent and development expenditure ceilings are binding, and avoiding supplementary budgets;
- **executing in-year controls over expenditure and revenue** by introducing a quarterly commitment system for non-salary payments, and ensuring all fishing revenue is deposited into a central government account;
- **executing central controls over cash balances** by consolidating government bank accounts and establishing a cash management planning committee with Ministry of Finance and Economic Development (MFED) representatives, which could lead to higher investment returns through efficient and effective cash management practices.

19. A greener post-COVID recovery will require adaptation to climate change including by making explicit provisions in the budget. Staff estimates additional annual spending needs to

meet Kiribati's sustainable development goals in roads, energy, and water, sanitation, and hygiene (WASH) at about 6 percent of GDP by 2030 (Annex V). Additionally, the World Bank estimates that annual adaptation costs for coastal protection and infrastructure adaptation ranges between 4 to 11 percent. Adaptation to climate change will require:

- an explicit provision for adaptation costs in the medium-term budget, of up to 2 percent of GDP annually to cover recurrent costs and increasing to 6 percent of GDP by 2030, in line with increasing capacity to raise additional revenues. Any remaining annual costs would need to be financed by development partners;

- increasing public expenditure efficiency and formulating a medium-term holistic infrastructure plan for roads, electricity, and water and sanitation facilities in lieu of ad-hoc projects; and
- stepping up efforts to gain greater access to financing from the Green Climate Fund (GCF).

Authorities' Views

20. The authorities broadly agreed on the need to maintain a prudent fiscal position. While concurring that the increase in recurrent spending would increase fiscal risks, their strategy for fiscal consolidation is more focused on revenue generation than expenditure control. Their strategy laid out plans for exploring new sources of tax revenues including taxing small businesses and deep-sea mining. Plans to increase non-tax revenues would focus on collecting dividends from SOEs and exploring options to increase fishing revenues. The authorities noted it would be politically challenging to discuss the option of not increasing copra subsidies, as it has been a means to support the population in the outer islands. To mitigate fiscal risks, they expressed strong commitment to review the recurrent expenditure items and incur no new debt².

21. The authorities reaffirmed that RERF withdrawals would fund development projects but expressed reservations regarding the elimination of supplementary budgets. The authorities underscored their commitment to preserve the real value of the RERF by limiting withdrawals for development projects that benefit both current and future generations. They recognized that fiscal sustainability could be enhanced by limiting the use of supplementary budgets and committing to a MTFE to lay a foundation for fiscal discipline. However, they were of the view that supplementary budgets would still be necessary until a MTFE was developed to underpin their fiscal strategy. The authorities were also keen to strengthen PFM including through reviewing their cash management strategy.

22. The authorities acknowledged the need for a green recovery and expressed their eagerness to access green financing. The authorities noted the need for explicit spending allocation in the budget for climate related adaptation costs. The authorities are keen to access climate financing and have set-up a Climate Finance Unit within the MFED as the focal point of contact to access and manage funds effectively and efficiently. However, they found the process of meeting the eligibility criteria for green financing (a water desalination project will be co-financed with grants from GCF) to be challenging as the procedures to access climate funds are complicated with strict conditions.

C. Mitigating Long-Term Consequences of the Pandemic Through Structural Reforms

23. Economic diversification through a more dynamic private sector would help weather future shocks. The production and export structures in Kiribati are highly concentrated, mainly

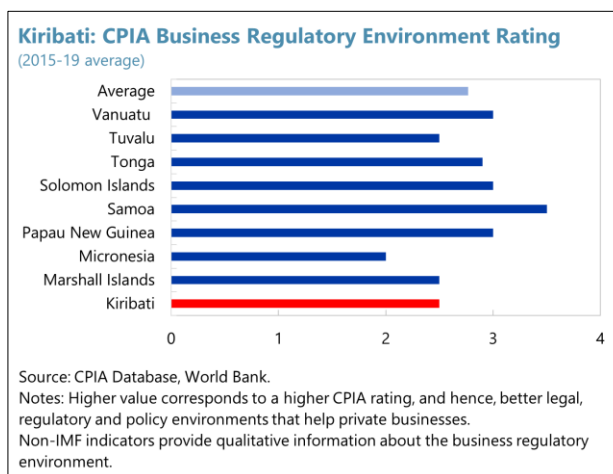
² Such reforms are not yet included in the baseline as they are still in the exploratory stage.

relying on fisheries and copra. Kiribati has the potential to diversify its economy through new product lines and quality upgrades:

- Upgrading fishing exports through investing in sustainable fishing methods and in state-of-the-art processing facilities could help improve quality. Upgrading copra and other coconut products such as coconut oil could also be a source of high-quality exports.
- The viability of complementary fishing activities—such as transshipment, aquaculture, fish farming, and processing facilities—could be explored, particularly in the periphery.
- The viability to excavate Kiribati’s manganese and copper resources through deep sea mining while ensuring environmental safety could be explored.
- Investing in renewable energy such as building the ocean thermal energy conversion (OTEC) plants could help generate power and supply cold ocean water for use in refrigeration.

24. Diversification will only be possible through appropriate steps to improve the business environment and build human capital.

The authorities have recently enacted several bills to ease business registration and address insolvency issues for firms. While these legal reforms will simplify conducting business, the focus should turn to removing structural bottlenecks. Improvements in connectivity through better air transport and shipping services could boost business by enabling access to a wider market. Completion of the submarine fiber-optic cables linking Kiribati to the global submarine cable network will also help improve business communications. Building human capital by enhancing training opportunities (including through further participation in overseas work schemes) will not only promote diversification but also create employment opportunities. Removing market distortions can encourage diversification. A case in point is the copra subsidy which has distorted incentives away from virgin coconut oil production (which Kiribati could export competitively without a subsidy).



25. Development of the private sector will require adequate sources of financing for productive investment. Access to credit would be best enhanced by improving land access procedures and dispute resolution mechanisms, to enhance property rights and enable lending against collateral. Mobile connectivity and mobile banking should be promoted, for their job-creation and financial-deepening benefits.

26. Strengthening financial regulation and supervision as well as risk management in financial institutions is critical. The authorities’ plan to formulate new legislation in the financial

sector is a welcome step. Two new pieces of legislation are currently being developed. The new banking act is expected to allow the entry of commercial banks into Kiribati, thereby fostering competition and reducing the cost of borrowing. A broader financial sector act aims to formulate a regulatory and supervisory framework covering all other financial institutions (Development Bank of Kiribati, KPF, and Kiribati Insurance Corporation). Staff recommends that the new legislation be founded on international best practice tailored to Kiribati's financial system by taking into account its specific features. Additionally, an independent supervisor of financial institutions should be established to ensure effective implementation of the new framework (Box 2).

Box 2. Formulating a Financial Institution Regulatory and Supervisory Framework

Context: Kiribati currently does not have either a designated supervisory authority for financial institutions or an underlying regime for the regulation and supervision of financial institutions. Efforts are underway to introduce these important reforms in Kiribati's legal framework.

Good Practice Measures:

- The supervisor should be vested with the legal powers to license banks, undertake ongoing regulation and supervision, carry out timely corrective actions and exercise enforcement powers to ensure compliance with the law as well as address safety and soundness practices.
- A robust legal framework for financial institutions should cover the objectives, functions, and powers of the supervisor as well as ensure independence of the supervisor. It should also provide the supervisor with effective powers to resolve or orderly wind down financial institutions.
- It is important to strike a balance between issues that are covered in the primary legislation and areas that can be dealt with through regulations. Kiribati is an observer at the Asia/Pacific Group on Money Laundering and has undertaken a commitment to implement the Financial Action Task Force standards (AML/CFT international standards). The design of a supervisory framework should align with the relevant FATF recommendations on AML/CFT supervision.

27. SOE reform momentum will need to accelerate. Significant reforms were implemented during 2017-18 including downsizing of the copra-linked SOEs and completing the sale of the telecom SOE. Since then, efforts have focused on liquidating more defunct SOEs, reform SOEs in the hotel sector, and review operations of SOEs in shipping and air transportation sectors (Box 3). However, these efforts have yet to translate into comprehensive strategies. The financial viability of several SOEs is in question and delayed publication of SOEs' audited financial reports hinders timely assessments of their performance to implement corrective measures.

28. An overall strategy for setting SOEs on a more commercial and sustainable footing will help strengthen public finances. Further strengthening the commercial mandate and governance framework of SOEs and developing a medium-term plan for a financially sustainable delivery of services remains crucial. Steps can be taken through:

- Recalibration of SOE tariffs and review of their economic implications will be essential to improve the SOEs' financial viability while protecting the most vulnerable. This review could cover all the SOE-provided services such as air travel, housing, fuel, ports, domestic shipping, and utilities. Appropriately setting tariffs in utility sectors, such as water and sanitation services, would also have the added benefit of protecting the environment.

- More timely publication of SOEs' audited financial statements is necessary. Audited financial statements can be collected into a database, which should be maintained for ongoing monitoring and analyses.
- Continued efforts are needed to strengthen SOE governance and oversight, including building capacity in the SOE Monitoring and Advisory Unit (SOEMAU) to produce sector-wide summary reports on SOE performance, profitability, return on equity, etc.
- Phasing out SOE exemptions from the VAT and reducing subsidies would help level the playing field with the private sector.

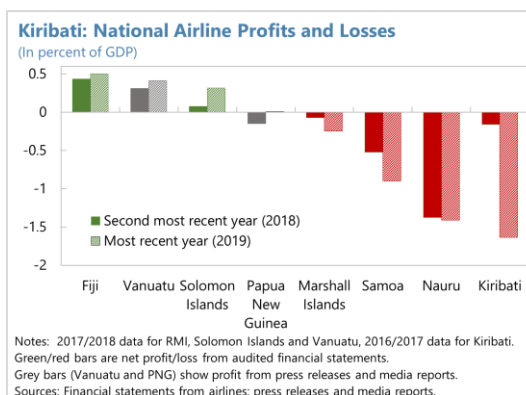
Box 3. Government Support to Air Kiribati Ltd.¹

COVID-19 has added to financial challenges with Air Kiribati Ltd (AKL).

Financial difficulties predated the pandemic: according to the most recent audited financial statements, AKL was unprofitable from 2014 to 2017 (text chart). Further information on AKL's loss is not available from 2018 onwards. The government has heavily subsidized the airline over the years, including in 2020, following reduced air-travel caused by COVID-19 and the costs of addressing maintenance needs with the existing aircraft fleet. Fleet maintenance problems necessitated the leasing of two planes, adding to the airline's costs. An administered ceiling on domestic ticket prices has, in part, prevented an improvement in profitability.

AKL aims to improve its financial performance by reforming domestic operations but the international operation is currently at a standstill. In AKL's view, a domestic fleet expansion funded by the government (planned purchase of five new planes at a total cost of approximately AUD \$30 million) is needed to return the airline to profitability and eliminate subsidies on its domestic operations. A strategy for international operations is still being formed as AKL does not have an air operator's certificate (AOC) to operate the two Embraers that the Cabinet approved for purchase in 2018 for delivery in 2019–20. The purchase of these airplanes was partly made with grants from a bilateral development partner. However, fiscal risks remain substantial as noted in the 2018 Article IV Staff Report, as there is potential for operating losses, given the established competitor (Fiji Airways), and as the E190-E2 model is a high-value aircraft that may have low utilization on the proposed routes.

An improved governance framework is required. AKL is subject to the provisions of the 2013 SOE Act and is monitored by the SOE Monitoring and Advisory Unit (SOEMAU) in the Ministry of Finance. Staff notes that the Strategic Plan 2020–2023 of the Ministry of Information Communication Transport and Tourism appropriately includes an objective to improve the financial viability of AKL.² A key performance indicator for this objective is "Monthly financial reports to the Board by the 15th of the following month". Monthly financial reports should be simultaneously shared with both the Board and SOEMAU, and audited financial statements should be published in a timely manner. Clear and rigorous government oversight and approval processes are required for AKL's annual plans, investment plans and borrowing, as well as for any new aircraft lease or purchase arrangements.



¹ Prepared by Leni Hunter. For more details see V. Balasundharam, L. Hunter, P. Seeds, I. Lavea "Managing fiscal risks from national airlines in Pacific Island countries", IMF forthcoming working paper.

² <https://www.micctd.gov.ki/sites/default/files/FINAL%20MICTTD%20MSP%202020-2023%20PRINT2.pdf>

29. Overall improvement in governance would boost public trust. Addressing governance deficiencies in budget outcomes and institutions would help improve efficiency and reduce vulnerabilities to corruption. Against the backdrop of an ambitious agenda, it is crucial to strengthen the governance of public investment so that the most beneficial projects are selected, execution is not disrupted, fiscal sustainability is ensured, and the best financing terms are obtained. The recent adoption of the Public Procurement Act 2020 should improve efficiency and consistency of procurement processes in accordance with the internationally recognized procurement policies and procedures. Transparency on fisheries management could be improved through timely publication of the fisheries report that provides critical information on the allocation of fishing days³.

Authorities' Views

30. The authorities acknowledged the importance of structural reforms to create a dynamic private sector and diversify the economy. They have developed strategies for several areas, but capacity and political constraints have slowed implementation:

- There was wide recognition on the need to level the playing field between SOEs and private firms, but there is no specific timeline to phase out the VAT exemption for the SOEs. Additionally, the authorities thought the cost of public service delivery is prohibitively high to justify phasing out SOE subsidies. However, they are committed to reviewing and reforming the operations of SOEs, including AKL and Public Utilities Board (PUB), to improve their financial performance.
- The authorities are optimistic about passing the legislations on the financial sector which they expect will facilitate greater access to credit by the private sector. They, however, would weigh the options on the structure of the supervisor, including whether it should be separate from all ministries.
- The authorities reaffirmed their commitment to improving governance and implementing anti-corruption measures. They underscored that Kiribati hosted the region's first conference on anti-corruption (February 2020) which produced a consensus on a roadmap to fight corruption (Annex VI). They highlighted that the approval of the Customs Act (2019) will help strengthen trade and border security, while the Public Procurement Act 2020 would improve transparency of public projects. They agreed that fishing reports should be published in a timely manner.

D. Capacity Development: Building Human Capital

31. Strengthening the institutional capacity to produce high-quality statistics in a timely manner will support data-driven policy formulation. Data shortcomings are prevalent especially in real sector statistics, government finance statistics, and financial sector data, with agencies responsible for compiling data often understaffed and requiring IMF TA to play a supplementary role. Restricted interagency data sharing, for example, the national statistics office's access to tax

³ See the 2018 Article IV staff report for further analysis and recommendations on governance and anti-corruption issues, which remain valid.

data necessary for GDP estimation, also hinders quick data compilation. The authorities need to further strengthen their own statistical capacity and adequately staff the units.

32. The authorities have maintained a strong engagement with the IMF through virtual delivery of TA (see Information Annex), particularly on public finance management and revenue administration. With multiple donors providing TA (Annex VII), there is a strong need to strengthen CD coordination to ensure a holistic approach in TA delivery while eliminating duplication. The recent joint matrix on identifying assistance from DFAT, MFAT, WB and ADB in different PFM priority areas is an example of efforts to improve coordination and collaboration among donor agencies.

Authorities' Views

33. The authorities expressed their appreciation for capacity building activities and requested continued IMF engagement. The authorities stressed the need for greater data coverage of Kiribati in IMF documents and websites, which underscores the need to enhance capacity to collect and produce data. In addition to developing statistical capacity in the areas of national accounts and government financial statistics, the authorities also discussed enhancing capacity in tax policy, tax administration, and PFM. They also requested the IMF to play an active role as a peer reviewer where TA experts from other institutions were engaged, including in reviewing the final draft of the new Banking Act and the Kiribati Financial Sector Oversight Act. They agreed on the need to produce high-quality and timely statistics while enhancing interagency information sharing to facilitate data-driven policy making.

STAFF APPRAISAL

34. Preemptive containment measures successfully limited the risk of a domestic outbreak but also put strains on economic activity. The authorities' supportive fiscal measures helped to cushion the economic downturn. While a recovery is expected in 2021, real GDP growth, projected at 1.8 percent, will remain subdued compared to the pre-COVID environment. Uncertainty around the outlook is large and risks are tilted to the downside.

35. Supportive fiscal measures should remain in place until the recovery is firmly underway, but measures should be well-targeted and focused on social spending. Evaluating the results of the recent payroll audit to recalibrate the wage bill appropriately and redirecting available resources to targeted social transfers will help boost the recovery. Properly identifying those eligible for unemployment benefits will help to protect the vulnerable while limiting the increase in expenditure.

36. Fiscal consolidation will be necessary to reduce fiscal risks once the recovery is underway. Kiribati's volatile fishing revenue and dependence on donor grants underscore the importance of maintaining fiscal discipline and adequate cash buffers. Once the recovery is firmly underway, the authorities will need to consider a cut in domestic recurrent spending to reduce fiscal risks. Fiscal sustainability could be further reinforced by greater revenue mobilization, strengthening

PFM, developing a MTF that integrates rules-based RERF withdrawals, and provisioning for climate change adaptation costs in the budget.

37. The authorities' on-going efforts to develop a regulatory and supervisory framework for the financial sector is a welcome step. Two new legislations — a banking act and a broader financial sector oversight act— will set the parameters of the framework. These legislations, a first for Kiribati, should be formulated based on international best practices. The authorities should follow through on their plans to establish an independent supervisor of financial institutions to ensure effective implementation of the new framework.

38. The authorities' strategy to diversify the economy is encouraging but needs to be augmented with strong structural reforms. Recent plans to enhance complementary fishing activities such as greater transshipment and more processing facilities are promising as they build on Kiribati's success in these areas. The recent adoption of several bills to ease business registration and address insolvency issues is commendable. However, a holistic approach to structural reforms is needed to improve the overall business environment, thereby encouraging greater private sector activity. These reforms include improving connectivity through better roads, ports and airports, boosting telecommunications network, building skilled and qualified workforce, and enhancing access to finance.

39. Accelerating the momentum of SOE reforms is critical to ensure their financial viability and reduce pressure on public finances. Further strengthening the commercial mandate of the SOEs and developing a medium-term plan for a financially sustainable delivery of services will reduce fiscal risk. Continued effort is needed to strengthen SOE governance and oversight, including building of capacity in the SOEMAU, and more timely publication of SOEs' audited financial statements. Phasing out SOE exemptions of the VAT and reducing subsidies will also help level the playing field with the private sector.

40. The authorities' commitment to improving governance is promising and calls for concrete actions. Building on the recent success of passing the Public Procurement Act 2020, the authorities should forge ahead with strengthening the governance of public investment so that the most beneficial projects are selected, execution is not disrupted, fiscal sustainability is ensured, and the best financing terms are obtained. It is crucial to address governance deficiencies in budget outcomes (spending and revenue outcomes, fiscal transparency, and PFM controls) to help improve efficiency and reduce vulnerabilities to corruption.

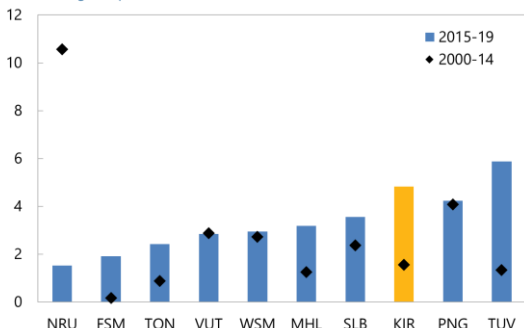
41. Continued efforts to build statistical capacity and enhance interagency collaboration will facilitate evidence-based policy making. The COVID-19 pandemic has increased the need to compile reliable data in a timely manner. Moving forward, the authorities need to invest more in human capital, promote inter-agency collaboration, and enhance information sharing to produce timely and high-quality statistics. These efforts will further improve monitoring of the economy and help formulate better policies founded on sound data.

42. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.

Figure 1. Kiribati: The Pre-COVID Scenario: Promising Growth

Kiribati posted strong real GDP growth pre-COVID...

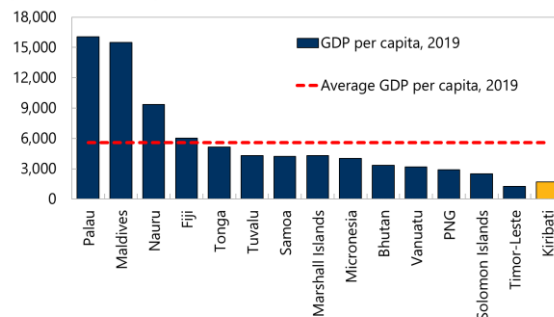
Real GDP Growth
(annual average, in percent)



Sources: IMF, *World Economic Outlook*.

... but GDP per capita remains among the lowest in the region.

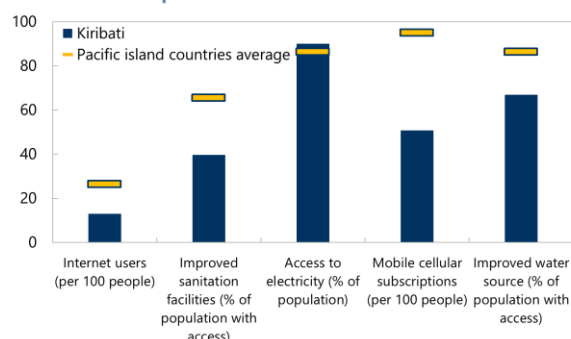
Per capita Income, 2019
(In current U.S. dollars)



Source: IMF, *World Economic Outlook*.

Kiribati is challenged by a significant infrastructure gap...

Infrastructure Gap



Note: 2015 data except for access to electricity and mobile cellular subscriptions (2018). Kiribati's access to electricity is based on the authorities' data in South Tawara. Outer islands will have lower access.
Sources: World Bank, *World Development Indicators*.

...and risks from climate change add to the challenges.

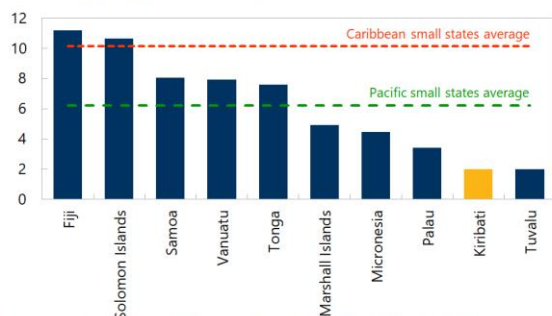
Long-Term Climate Risk Index for Pacific Island Countries



Source: Global Climate Risk Index 2019 and IMF Staff estimates.
Note: Countries with lower CRI scores are more impacted, a lower index value indicates higher risk.

Kiribati's remoteness hinders attracting foreign private investors...

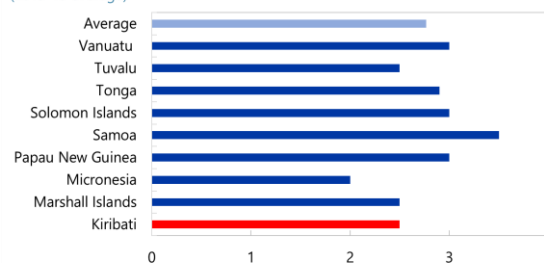
Liner Shipping Connectivity Index



Notes: A smaller number indicates lower connectivity and higher transportation costs. 100 is the maximum index value. 2019 data for all countries.
Sources: World Bank, *World Development Indicators*.

...and the domestic business environment hampers private sector development.

CPIA Business Regulatory Environment Rating
(2015-19 average)



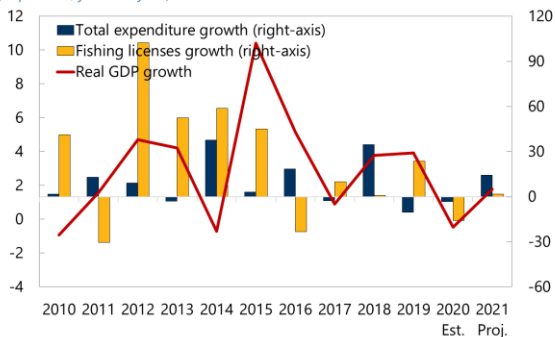
Source: CPIA Database, World Bank.
Notes: Higher value corresponds to a higher CPIA rating, and hence, better legal, regulatory and policy environments that help private businesses. Non-IMF indicators provide qualitative information about the business regulatory environment.

Figure 2. Kiribati: Recent Developments: The Impact of COVID-19

COVID-19 has interrupted the promising growth in recent years...

Growth rates

(In percent, year-on-year)

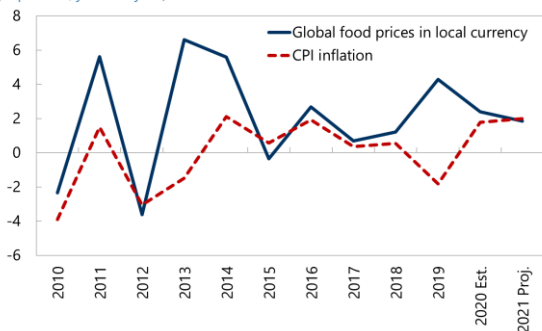


Sources: Country authorities; and staff calculations.

Inflation is expected to remain subdued in line with global food prices.

Inflation rates

(In percent, year-on-year)

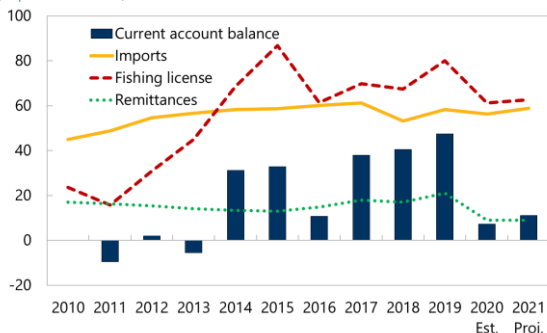


Sources: Country authorities; IMF, Global Assumptions; and staff calculations.

Despite the fall in imports, the current account surplus will narrow due to the drop in fishing revenues ...

Current account balance

(In percent of GDP)

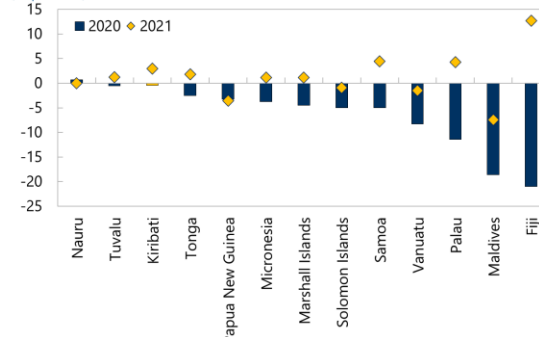


Sources: Country authorities; and staff estimates.

...but Kiribati is expected to perform better than tourism dependent PICs.

Real GDP Growth, 2020

(In percent)

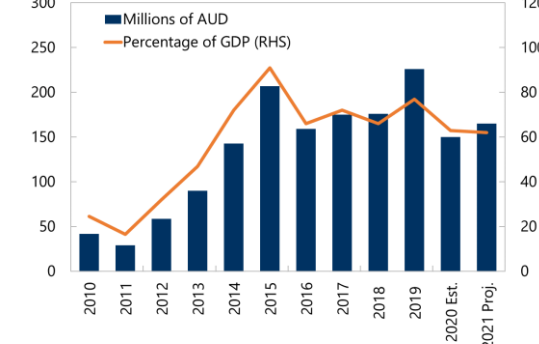


Source: IMF, World Economic Outlook.

Covid-19 is expected to adversely impact fishing revenues...

Fishing Revenue

(In percent of GDP)

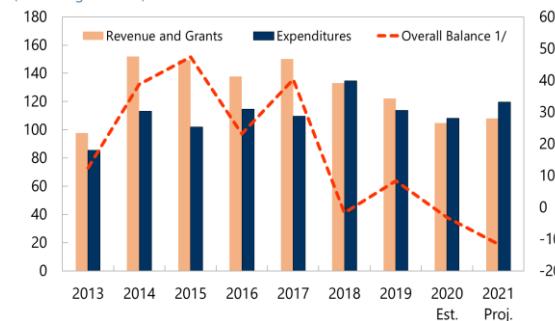


Sources: Country authorities; IMF staff calculations.

...and the fiscal balance will also turn negative due to both higher expenditure and lower revenues.

Revenue, Expenditures and Overall Balance

(Percentage of GDP)



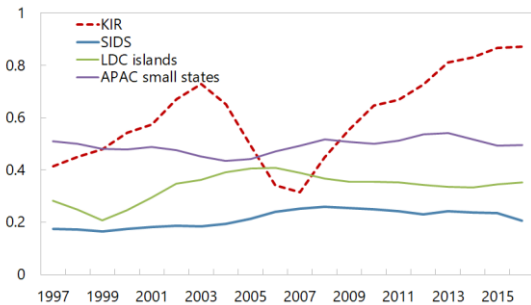
Sources: Kiribati authorities, and IMF staff estimates and projections.
1/ Overall balance in the table is different from official budget because loans are classified as financing.

Figure 3. Kiribati: Structural Reforms: Removing Bottlenecks to Build Back Better

Kiribati's export structure is one of the most concentrated in the world...

Concentration of Goods Exports

(Herfindahl-Hirschman index at the SITC 3-digit level, 3-year moving average)



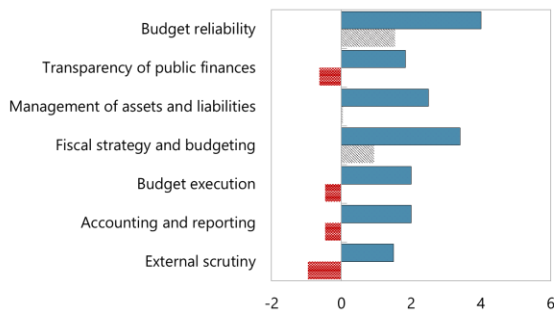
Sources: UNCTAD; IMF staff calculations.
Notes: Higher index indicates greater concentration.

Addressing governance deficiencies in budget outcomes and institutions would help improve efficiency...

Public Expenditure and Financial Accountability

(Grade, 11 highest and 0 lowest)

■ Absolute grade ■ Grade relative to average across all pillars

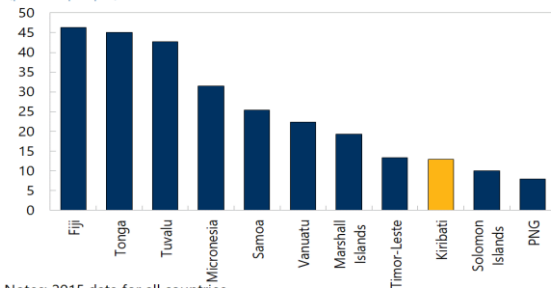


Sources: IMF Country Report No.19/26 .

Kiribati's remoteness can be somewhat mitigated by increasing its usage of the internet...

Internet usage

(per 100 people)

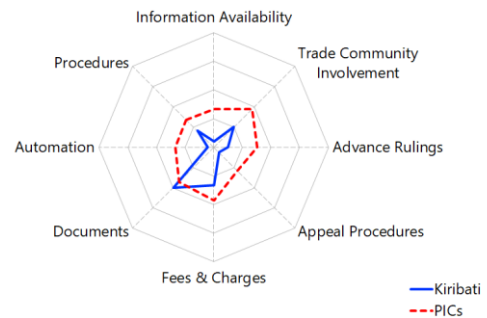


Notes: 2015 data for all countries.
Sources: World Bank, World Development Indicators.

...and lack of information availability and complexity of information hinders trade facilitation.

Trade Facilitation Indicators

(Farthest from center = best performance that can be achieved)



Source: OECD Trade Facilitation Indicators.

...as would improving project selection, and management.

Public Investment Management Assessment

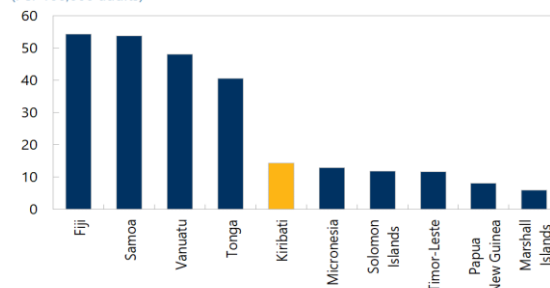


Note: Lower/worse scores are closer to the center.
Source: IMF Staff Report No. 19/26

...and improving connectivity could increase financial inclusion.

ATM Access

(Per 100,000 adults)



Notes: 2013 data for Kiribati; 2017 for Solomon Islands; 2018 for remaining countries.
Sources: IMF, Financial Access Survey.

Table 1. Kiribati: Selected Economic Indicators, 2018–26

	2018	2019	2020	2021	2022	2023	2024	2025	2026
		Est.	Est.			Proj.			
Real GDP (percent change)	3.8	3.9	-0.5	1.8	2.5	2.3	2.1	2.0	2.0
Consumer prices (percent change, average)	0.6	-1.8	1.8	2.0	1.8	1.9	1.8	1.6	1.5
Inflation (end of period)	-1.1	-0.9	1.3	1.8	1.9	2.1	1.9	1.7	1.4
Central government finance (percent of GDP)									
Revenue and grants	133	122	106	108	106	102	101	99	99
Total domestic revenue	87	95	84	82	83	83	82	83	84
<i>Of which: fishing revenue</i>	66	77	64	62	63	62	62	63	63
External grants	46	27	21	26	22	19	19	16	15
Expenditures	135	114	109	120	123	117	113	111	110
Current	56	54	68	78	80	77	75	75	75
Development	78	60	41	42	43	40	38	36	35
Domestic recurrent balance 1/	-35	-36	-48	-58	-59	-57	-55	-54	-54
Recurrent fiscal balance (incl. budget support grants)	36	41	19	9	9	11	12	13	14
Overall balance 2/	-2	8	-3	-12	-17	-15	-12	-11	-11
Financing	2	-8	3	12	17	15	12	11	11
<i>Of which: Revenue Equalization Reserve Fund (RERF)</i>	0	0	0	13	0	0	0	0	0
RERF									
Closing balance (millions of A\$) 3/	973	1153	1212	1231	1297	1366	1437	1511	1587
Per capita value (2006 A\$)	6440	7386	7577	7473	7623	7752	7850	7928	7998
Balance (in percent of (GDP))	363	406	422	411	417	421	427	433	441
Cash reserve buffer 4/									
Closing balance (millions of A\$)	159	173	164	185	159	139	124	114	106
Closing balance (in percent of (GDP))	59	61	57	62	51	43	37	33	30
In excess of 3-months of current spending (millions of A\$)	121	135	115	127	97	76	60	49	39
Balance of payments									
Current account including official transfers (millions of US\$)	76	87	14	25	27	29	31	33	34
(In percent of GDP)	38	44	7	11	11	12	12	12	12
External debt (millions of US\$) 5/	37	35	38	50	70	91	111	133	156
(In percent of GDP)	19	18	17	21	29	36	42	49	56
External debt service (millions of US\$)	0.8	1.4	1.7	1.9	2.2	2.5	2.8	3.1	3.4
(In percent of exports of goods and services)	0.5	0.8	1.0	0.9	1.0	1.1	1.1	1.2	1.3
Exchange rate (A\$/US\$ period average)	1.3	1.4	1.4	...	...	...	...	...	...
Real effective exchange rate (period average)	88	87	90	...	...	...	...	...	...
Memorandum items:									
Nominal GDP (millions of A\$)	268	284	287	299	311	324	337	349	360
Nominal GDP (millions of US\$)	200	198	198	...	...	...	...	...	...

Sources: Data provided by the Kiribati authorities; and Fund staff estimates and projections.

1/ Domestic recurrent balance excludes fishing revenue, grants, and capital expenditure.

2/ Overall balance in the table is different from official budget because loans are classified as financing.

3/ The closing RERF balance for 2020 does not show the withdrawal of AUD 40 million which is used for financing in 2021.

After withdrawal the balance would be AUD \$1172 million.

4/ Cash reserve buffer includes the government's operational account and cash reserve account.

5/ Kiribati's current debt portfolio is composed of external debt only, as all domestic debt was cleared in 2015.

Table 2a. Kiribati: Summary of Central Government Operations, 2018–26
(in millions of Australian dollars)

	2018	2019	2020	2021	2022	2023	2024	2025	2026
		Est.	Est.			Proj.			
Total revenue and grants	356	347	304	324	329	331	340	347	357
Revenue	234	270	243	246	259	268	277	291	301
Tax revenue	49	49	49	50	52	55	57	60	62
Nontax revenue	185	220	194	196	207	213	220	231	239
<i>Of which: fishing revenue</i>	176	218	183	186	196	202	209	219	227
Project grants	108	77	52	63	52	46	45	39	38
Budget support grants	14	0.5	9	14	17	17	17	18	18
Total expenditure	361	323	313	358	382	381	382	387	396
Current expenditure 1/	151	153	196	233	248	251	254	261	270
Wages and salaries	75	80	89	105	104	104	104	106	108
Subsidies and grants	61	42	79	93	106	106	106	109	112
<i>Of which: copra subsidy</i>	35	16	16	16	32	32	32	33	34
<i>Of which: unemployment benefit</i>	0	0	20	27	27	27	27	27	27
<i>Of which: senior citizen benefit</i>	3	3	12	19	19	19	19	19	19
Other current expenditure	14	29	20	24	25	25	26	26	27
Debt service	1	2	2	2	3	3	4	4	4
Contingency and maintenance rel. to climate change adaptation	...	0	6	8	10	12	14	16	19
Infrastructure maintenance	...	...	6	7	7	7	7	8	8
Other climate change adaptation costs	...	...	...	1	3	5	7	9	11
Development expenditure 2/	210	170	117	126	134	130	128	126	126
<i>Of which: local contribution to development fund</i>	72	93	64	47	55	55	56	56	57
Net lending	0	0	0	0	0	0	0	0	0
Domestic recurrent balance 3/	-93	-101	-137	-173	-185	-185	-185	-189	-195
Recurrent fiscal balance (excl. grants)	83	117	46	14	11	17	23	30	32
Recurrent fiscal balance (incl. budget support grants)	98	117	55	28	29	35	41	47	49
Overall balance 4/	-4	24	-9	-35	-53	-49	-42	-40	-39
Financing	4	-24	9	35	53	49	42	40	39
Domestic financing	4	-24	9	19	26	20	15	9	8
Revenue Equalization Reserve Fund (RERF)	0	0	0	40	0	0	0	0	0
Cash reserve buffer	4	-24	9	-21	26	20	15	9	8
Project loans (net)	0	0	0	16	27	29	27	30	31
Memorandum items (percent of GDP unless otherwise noted):									
Net financial worth incl. RERF 5/	403	448	462	452	439	428	422	417	415
Net financial worth excl. RERF	39	43	40	40	22	7	-5	-16	-26
RERF balance	363	406	422	411	417	421	427	433	441
RERF real per capita value (2006 A\$)	6440	7386	7577	7473	7623	7752	7850	7928	7998
Cash reserve buffer (in millions of A\$)	159	173	164	185	159	139	124	114	106
Cash reserve buffer 6/ (in percent of GDP)	59	61	57	62	51	43	37	33	30
Cash reserve buffer in excess of 3-months of current spending	45	47	40	42	31	23	18	14	11
Public debt (in millions of A\$)	53	52	50	64	89	117	142	171	200
Public debt (in percent of GDP) 7/8/	20	18	17	21	29	36	42	49	56
Nominal GDP (millions of A\$)	268	284	287	299	311	324	337	349	360

Sources: Data provided by the Kiribati authorities; and staff estimates and projections.

1/ Projections for the current expenditure for 2017 included the supplementary budget.

2/ Development expenditure equals grants plus loans for development projects.

3/ Domestic recurrent balance excludes fishing revenue, grants, and capital expenditure.

4/ Overall balance in the table is different from official budget because loans are classified as financing.

5/ Balances of RERF, cash reserves account minus public debt.

6/ Cash reserve buffer includes the operational account and the cash reserve account.

7/ In this table, it is assumed that Kiribati will continue to benefit from its grants-only status. This assumption is consistent with MDB's grant decision rules given the DSA rating and assuming the realization of such grants and their impact on the DSA. On the other hand, in LIC- DSA, for World Bank (IDA) and other MDBs, regular credit terms on all lending is assumed for all years in the projection period for which grant finance has not already been committed. This is because the DSA serves to test a country's capacity to take on WB and ADB financing on credit terms.

8/ The coverage of public sector debt is the central government and social security fund. Kiribati's current debt portfolio is composed of external debt only, as all domestic debt was cleared in 2015.

Table 2b. Kiribati: Summary of Central Government Operations, 2018–26
(in percent of GDP)

	2018	2019	2020	2021	2022	2023	2024	2025	2026
		Est.	Est.	Proj.					
Total revenue and grants	133	122	106	108	106	102	101	99	99
Revenue	87	95	84	82	83	83	82	83	84
Tax revenue	18	17.4	17	17	17	17	17	17	17
Nontax revenue	69	78	67	66	66	66	65	66	66
<i>Of which: fishing revenue</i>	66	77	64	62	63	62	62	63	63
Project grants	40	27	18	21	17	14	13	11	11
Budget support grants	5	0.2	3	5	6	5	5	5	5
Total expenditure	135	114	109	120	123	117	113	111	110
Current expenditure 1/	56	54	68	78	80	77	75	75	75
Wages and salaries	28	28	31	35	34	32	31	30	30
Subsidies and grants	23	15	28	31	34	33	31	31	31
<i>Of which: copra subsidy</i>	13	6	6	5	10	10	10	9	9
<i>Of which: unemployment benefit</i>	0	0	7	9	9	8	8	8	8
<i>Of which: senior citizen benefit</i>	1	1	4	6	6	6	6	5	5
Other current expenditure	5	10	7	8	8	8	8	8	7
Debt Service	0	1	1	1	1	1	1	1	1
Contingency and maintenance rel. to climate change adaptation	...	0	2	3	3	4	4	5	5
Infrastructure maintenance	...	...	2	2	2	2	2	2	2
Other climate change adaptation costs	...	...	...	1	1	2	2	3	3
Development expenditure 2/	78	60	41	42	43	40	38	36	35
<i>Of which: local contribution to development fund</i>	27	33	22	16	18	17	17	16	16
Net lending	0	0	0	0	0	0	0	0	0
Domestic recurrent balance 3/	-35	-36	-48	-58	-59	-57	-55	-54	-54
Recurrent fiscal balance (excl. grants)	31	41	16	5	4	5	7	8	9
Recurrent fiscal balance (incl. budget support grants)	36	41	19	9	9	11	12	13	14
Overall balance 4/	-2	8	-3	-12	-17	-15	-12	-11	-11
Financing	2	-8	3	12	17	15	12	11	11
Domestic financing	2	-8	3	6	8	6	4	3	2
Revenue Equalization Reserve Fund (RERF)	0	0	0	13	0	0	0	0	0
Cash reserve buffer	2	-8	3	-7	8	6	4	3	2
Project loans (net)	0	0	0	5	9	9	8	9	9
Memorandum items (percent of GDP unless otherwise noted):									
Net financial worth incl. RERF 5/	403	448	462	452	439	428	422	417	415
Net financial worth excl. RERF	39	43	40	40	22	7	-5	-16	-26
RERF balance	363	406	422	411	417	421	427	433	441
RERF real per capita value (2006 A\$)	6440	7386	7577	7473	7623	7752	7850	7928	7998
Custodial account balance (in millions of A\$)	46	58	49	61	69	71	67	68	78
Cash account balance (in millions of A\$)	113	115	115	124	90	68	57	46	28
Cash reserve buffer 6/	59	61	57	62	51	43	37	33	30
Cash reserve buffer in excess of 3-months of current spending	45	47	40	42	31	23	18	14	11
Public debt 7/8/	20	18	17	21	29	36	42	49	56
Nominal GDP (millions of A\$)	268	284	287	299	311	324	337	349	360

Sources: Data provided by the Kiribati authorities; and staff estimates and projections.

1/ Projections for the current expenditure for 2017 included the supplementary budget.

2/ Development expenditure equals grants plus loans for development projects.

3/ Domestic recurrent balance excludes fishing revenue, grants, and capital expenditure.

4/ Overall balance in the table is different from official budget because loans are classified as financing.

5/ Balances of RERF, cash reserve buffer accounts minus public debt.

6/ Cash reserve buffer includes the custodial account and the cash account.

7/ In this table, it is assumed that Kiribati will continue to benefit from its grants-only status. This assumption is consistent with MDB's grant decision rules given the DSA rating and assuming the realization of such grants and their impact on the DSA. On the other hand, in LIC- DSA, for World Bank (IDA) and other MDBs, regular credit terms on all lending is assumed for all years in the projection period for which grant finance has not already been committed. This is because the DSA serves to test a country's capacity to take on WB and ADB financing on credit terms.

8/ The coverage of public sector debt is the central government and social security fund. Kiribati's current debt portfolio is composed of external debt only, as all domestic debt was cleared in 2015.

Table 3a. Kiribati: Balance of Payments, 2018-2026
(in millions of Australian dollars)

	2018	2019	2020	2021	2022	2023	2024	2025	2026
		Est.	Est.				Proj.		
Current account	102.0	124.8	19.8	32.0	35.0	37.5	39.8	42.7	43.8
Balance on goods	-123.2	-135.6	-142.8	-153.8	-155.9	-156.6	-164.1	-170.8	-180.6
Goods, credit (exports)	11.2	17.7	12.6	15.9	20.8	27.5	32.8	35.9	37.8
Goods, debit (imports)	134.4	153.4	155.3	169.7	176.7	184.1	196.9	206.7	218.5
Balance on services	-79.1	-72.7	-75.2	-76.5	-78.5	-80.8	-83.1	-85.6	-88.1
Services, credit (exports)	14.4	29.0	26.8	28.6	30.9	33.3	35.9	38.8	41.8
Services, debit (imports)	93.5	101.7	102.0	105.2	109.5	114.1	119.1	124.3	129.8
Balance on goods and services	-202.3	-208.4	-218.0	-230.3	-234.4	-237.4	-247.3	-256.3	-268.7
Balance on primary income	225.5	279.6	205.3	220.6	231.9	241.1	253.9	269.2	282.7
Primary income, credit	229.3	282.8	208.5	223.9	235.2	244.4	257.3	272.7	286.3
<i>of which:</i> Fishing license fees	170.2	210.6	169.0	180.8	190.8	196.5	202.4	212.5	221.2
<i>of which:</i> Investment income	43.2	55.6	24.6	25.7	26.1	28.5	34.3	38.7	42.6
Income from RERF	38.1	47.8	19.8	20.8	21.1	23.0	27.7	31.3	35.1
<i>of which:</i> Remittances (COE)	16.0	16.6	14.9	17.3	18.3	19.4	20.6	21.5	22.5
Primary income, debit	3.9	3.1	3.2	3.2	3.3	3.4	3.4	3.5	3.6
Balance on secondary income	78.9	53.5	32.5	41.8	37.4	33.8	33.2	29.8	29.8
Secondary income, credit	82.6	56.8	35.8	45.1	40.8	37.2	36.7	33.3	33.3
General Government, credit	71.6	44.1	31.3	39.5	35.6	32.4	32.2	29.1	29.0
Secondary income, debit	3.8	3.3	3.3	3.4	3.4	3.4	3.5	3.5	3.5
Capital account	34.4	34.2	28.2	36.1	32.4	29.3	29.1	26.0	25.9
Capital transfers	34.4	34.2	28.2	36.1	32.4	29.3	29.1	26.0	25.9
General Government, Credit	36.0	36.0	30.0	37.9	34.2	31.1	30.9	27.9	27.8
General Government, Debit	1.6	1.8	1.8	1.8	1.8	1.9	1.9	1.9	1.9
Financial account	101.2	119.5	54.1	47.6	45.8	50.2	58.5	50.9	63.4
Direct investment, net	1.7	0.9	1.2	0.1	0.1	-0.3	-0.3	0.2	0.0
Direct investment, assets	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Direct investment, liabilities	-1.5	-0.8	-1.1	0.1	0.1	0.6	0.5	0.0	0.2
Portfolio investment, net	2.6	5.4	2.1	2.2	3.5	3.2	3.4	3.5	3.7
Portfolio Investment, assets	2.6	5.4	2.1	2.2	3.5	3.2	3.4	3.5	3.7
Portfolio Investment, liabilities		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investment, net	96.9	113.2	50.8	45.2	42.3	47.3	55.4	47.2	59.7
Other investment, assets	104.1	104.5	50.8	60.7	69.0	76.3	82.6	77.7	90.4
Other investment, liabilities	7.2	-8.6	0.0	15.5	26.7	28.9	27.2	30.4	30.7
Loans, liabilities	-0.8	-1.3	0.0	15.5	26.7	28.9	27.2	30.4	30.7
Net Errors and Omissions	-2.5	-0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Reserve Assets	33.6	38.9	-6.1	20.6	21.6	16.6	10.4	17.8	6.3
Net International Investment Position	1342.5	2015.9	...	...	...	...	...	...	...

Sources: Data provided by the Kiribati authorities; and staff estimates and projections.

Table 3b. Kiribati: Balance of Payments, 2018–26
(in percent of GDP)

	2018	2019	2020	2021	2022	2023	2024	2025	2026
		Est.	Est.				Proj.		
Current account	38.1	43.9	6.8	10.7	11.2	11.5	11.8	12.1	12.1
Balance on goods	-46.0	-47.7	-49.3	-51.4	-50.0	-48.2	-48.5	-48.6	-49.7
Goods, credit (exports)	4.2	6.2	4.3	5.3	6.7	8.5	9.7	10.2	10.4
Goods, debit (imports)	50.2	54.0	53.6	56.7	56.6	56.6	58.2	58.8	60.1
Balance on services	-29.5	-25.6	-26.0	-25.6	-25.2	-24.8	-24.6	-24.4	-24.2
Services, credit (exports)	5.4	10.2	9.2	9.6	9.9	10.3	10.6	11.0	11.5
Services, debit (imports)	34.9	35.8	35.2	35.1	35.1	35.1	35.2	35.4	35.7
Balance on goods and services	-75.5	-73.3	-75.2	-76.9	-75.1	-73.0	-73.1	-72.9	-73.9
Balance on primary income	84.2	98.4	70.9	73.7	74.3	74.1	75.1	76.6	77.7
Primary income, credit	85.6	99.5	72.0	74.8	75.4	75.2	76.1	77.6	78.7
<i>of which:</i> Fishing license fees	63.5	74.1	58.3	60.4	61.2	60.4	59.9	60.5	60.8
<i>of which:</i> Investment income	16.1	19.6	8.5	8.6	8.4	8.8	10.2	11.0	11.7
<i>Income from RERF</i>	14.2	16.8	6.8	6.9	6.8	7.1	8.2	8.9	9.7
<i>of which:</i> Remittances (COE)	6.0	5.8	5.1	5.8	5.9	6.0	6.1	6.1	6.2
Primary income, debit	1.4	1.1	1.1	1.1	1.1	1.0	1.0	1.0	1.0
Balance on secondary income	29.4	18.8	11.2	14.0	12.0	10.4	9.8	8.5	8.2
Secondary income, credit	30.8	20.0	12.3	15.1	13.1	11.5	10.8	9.5	9.2
General Government, credit	26.7	15.5	10.8	13.2	11.4	10.0	9.5	8.3	8.0
Secondary income, debit	1.4	1.2	1.1	1.1	1.1	1.1	1.0	1.0	1.0
Capital account	12.9	12.1	9.7	12.1	10.4	9.0	8.6	7.4	7.1
Capital transfers	12.9	12.1	9.7	12.1	10.4	9.0	8.6	7.4	7.1
General Government, Credit	13.5	12.7	10.4	12.7	11.0	9.6	9.1	8.0	7.6
General Government, Debit	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.5	0.5
Financial account	37.8	42.1	18.7	15.9	14.7	15.4	17.3	14.5	17.4
Direct investment, net	0.6	0.3	0.4	0.0	0.0	-0.1	-0.1	0.1	0.0
Direct investment, assets	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Direct investment, liabilities	-0.6	-0.3	-0.4	0.0	0.0	0.2	0.1	0.0	0.1
Portfolio investment, net	1.0	1.9	0.7	0.7	1.1	1.0	1.0	1.0	1.0
Portfolio Investment, assets	1.0	1.9	0.7	0.7	1.1	1.0	1.0	1.0	1.0
Portfolio Investment, liabilities		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investment, net	36.2	39.8	17.5	15.1	13.6	14.6	16.4	13.4	16.4
Other investment, assets	38.9	36.8	17.5	20.3	22.1	23.5	24.4	22.1	24.8
Other investment, liabilities	2.7	-3.0	0.0	5.2	8.6	8.9	8.0	8.7	8.4
Loans, liabilities	-0.3	-0.5	0.0	5.2	8.6	8.9	8.0	8.7	8.4
Net Errors and Omissions	-0.9	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Reserve Assets	12.5	13.7	-2.1	6.9	6.9	5.1	3.1	5.1	1.7
Net International Investment Position	501.1	709.4	...	...	...	...	...	...	...

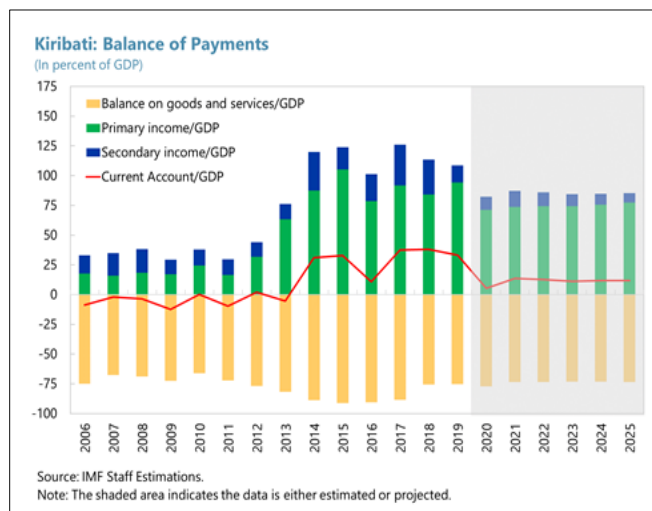
Sources: Data provided by the Kiribati authorities; and staff estimates and projections.

Annex I. External Sector Assessment¹

Based on preliminary data, Kiribati's external position in 2020 is assessed to be in line with fundamentals and desirable policy settings. However, there is substantial uncertainty around this assessment, given data gaps for FY2020 and substantial uncertainty regarding the impact of the COVID-19 pandemic, in addition to the usual concerns of data quality. Kiribati can improve its competitiveness and boost its export capacity through structural reforms aimed at improving the environment for private sector development, closing the infrastructure gap and addressing governance weaknesses.

1. The external sector assessment for 2020 is heavily influenced by the global COVID-19 pandemic and the consequent global economic downturn. In the recent past, Kiribati has posted large current account surpluses driven by fishing revenues and income from RERF—the main components of the primary income balance, although the trade balance has consistently been negative given the large import needs of the country, in contrast to its narrow export base. The COVID-19 pandemic is estimated to have caused a temporary decline in the current account surplus:

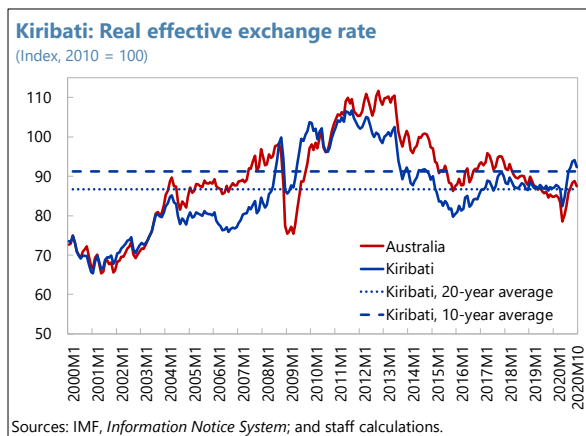
- The current account surplus is estimated to have declined, from an average of 32.6 percent of GDP from 2015-19 to 6.8 percent in 2020. The subdued domestic demand, particularly the slowdown in construction activity has compressed imports. However, this has not outweighed the expected loss in fishing revenues and other sources of income from strict safety measures implemented in Kiribati's ports, leading to a smaller surplus in the current account.



- The Kiribati current account is projected to remain in surplus in 2021 alongside the recovery in the global economy. As the recovery takes hold, pent-up domestic demand including a resumption in construction activity is expected to increase imports. However, normalization of fishing activity will push the current account to a higher surplus in 2021, which will continue into the medium-term.

¹ Prepared by Jacinta Bernadette Shirakawa.

2. After an initial decline at the on-set of the pandemic, the REER has moved back within its historical band. The Kiribati dollar is pegged to the Australian dollar and mirrors its movements. The REER has generally remained stable over the past few years in line with its historical average. However, the REER declined by about 5.7 percent between January and March 2020 but has recovered since then.



3. Staff assesses that the external position is broadly in line with fundamentals and desirable policy settings.

The idiosyncratic features of the Kiribati economy, most notably the large volatility of its fishing revenue and the substantial current transfers related to donor grants, makes the standard model-based approaches for the assessment not fully suitable for Kiribati, with data gaps further complicating such exercises. However, the broad stability of the REER suggests an absence of large external imbalances. Consistent with this, staff estimates the current account norm to be broadly in the range of 10 percent of GDP—approximately what staff estimates the current account to be in 2020 once the temporary effects of COVID-19 are stripped out (i.e., accounting for the temporary decline in fishing revenue and some associated decline in imports) and also staff's current account projection for the medium term. However, the idiosyncrasies and data gaps noted above imply a substantial degree of uncertainty around this assessment.

4. Kiribati could improve its competitiveness and buttress external sustainability through appropriate structural reforms. The government's cash reserves (61 percent of GDP at end-2019) and the RERF (406 percent of GDP at end-2019) are the main instruments to absorb liquidity shocks as the country has no central bank and uses the Australian dollar as its official currency. While the large size of the RERF relative to external debt limits immediate risks, the RERF could be significantly depleted over the longer run in downside scenarios to fishing revenue. Closing the infrastructure gap and addressing governance weaknesses would expand the country's export capacity while increasing efficiency. In this context, securing donor grants for development spending is critical and borrowing through concessional loans should be closely monitored.

5. Maintaining prudent fiscal policy over the medium term would help build-up fiscal buffers and preserve external balance. In the absence of monetary and exchange rate policies, Kiribati relies on fiscal policy and structural reforms to ensure external sustainability. Therefore, a fiscal adjustment in the domestic recurrent balance in line with staff's advice would provide some cushion to Kiribati's external sustainability. Alternatively, such adjustment could provide additional space for high-priority investment spending if such projects are identified.

6. The use of the Australian dollar as the legal tender remains appropriate. It provides a strong nominal anchor given close trade and financial linkages with Australia (a high share of RERF assets is invested in Australian markets) and limited capacity to run an independent monetary authority.

Sources of Risk	Relative Likelihood	Expected Impact	Policy Recommendation
Domestic Risks			
Heavy Fiscal Reliance on Volatile Fishing Revenues Government revenues are highly concentrated on a single source of fishing revenues which are volatile, vulnerable to fishing cycle and climate change.	High	High: A period of protracted low fishing revenues may jeopardize long-run fiscal sustainability. The cash reserve buffer can mitigate the shock, if the decline is temporary.	Strengthen revenue mobilization through exploring additional avenues of tax collection, such as seabed mining. Continue to strengthen tax revenues by eliminating tax exemptions and by improving tax administration.
External Risks			
Unexpected shift in the Covid-19 pandemic. Asynchronous progress. Limited access to, and longer-than-expected deployment of, vaccines in some countries—combined with dwindling policy space—prompt a reassessment of their growth prospects. Prolonged pandemic. The disease proves harder to eradicate, requiring costly containment efforts and prompting persistent behavioral changes that renders many activities unviable. Faster containment. Pandemic is contained faster than expected due to the rapid production and distribution of vaccines.	Medium	High: Asynchronous progress and prolonged pandemic. Containment efforts that close borders could limit income from fishing license and remittance. Negative impact on the domestic economy could also manifest through the financial channel if weak global growth is reflected in a decline in global returns, affecting RERF/KPF assets. Faster containment. Resumption of economic activity could normalize more quickly if the pandemic is contained faster.	Continue targeted fiscal measures to affected households and businesses. Seek early procurement and distribution of vaccines including through coordinated efforts with countries in the region for the provision of vaccination. Continue to seek grants, if needed.
Higher frequency and severity of natural disasters related to climate change Cause severe economic damage to smaller economies susceptible to disruptions and accelerate emigration from these economies (medium probability). Disasters hitting key infrastructure or disrupting trade raise commodity price levels and volatility (low probability).	Medium/Low	High: Kiribati will be among the first countries to see its islands disappear as the sea level rises. Volatile weather conditions caused by global warming can lead to large losses and damages to production and potential growth.	Contingency plans should include maintaining a strong cash buffer, seeking cost-effective insurance, channeling donor grants to climate adaptation projects, and establishing contingent financing plans with development partners.
Accelerating de-globalization Despite renewed efforts to reach multilateral solutions to existing tensions, geopolitical competition leads to further fragmentation. Reshoring and less trade reduce potential growth.	Medium	High: Given Kiribati's high reliance on imported goods, disruptions to trade and exchange rate volatility could have a strong impact on inflation and growth.	Prudent management of public resources and, in the longer run, seeking to diversify the economy would help improve resilience.
The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authors. Non-mutually exclusive risks may interact and materialize jointly.			

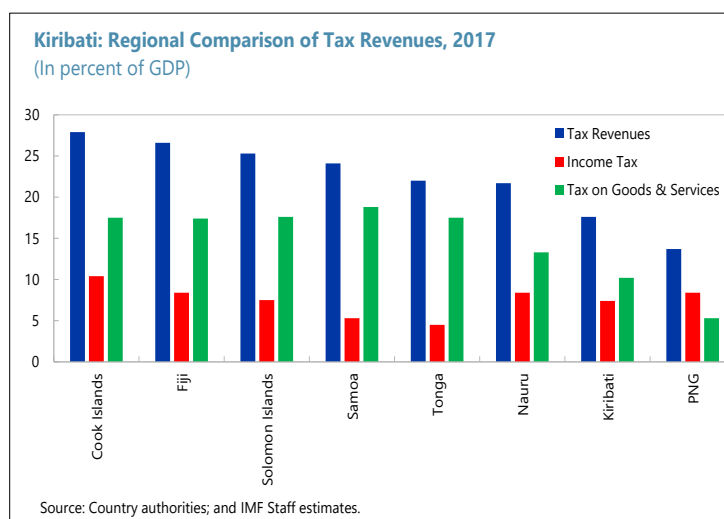
Annex III. Boosting Revenue Mobilization to Finance Post-Pandemic Recovery¹

The pandemic has brought the importance of revenue mobilization to the forefront. While Kiribati benefitted from the 2014 tax reforms, there is scope for further improvement. In particular, the tax base can be protected by eliminating discretionary exemptions, the progressivity of personal income tax can be increased, the corporate income tax can be streamlined, and the tax regime for small businesses can be simplified. Given the heavy reliance on fishing revenues, Kiribati could benefit from leveraging its participation in the Parties to the Nauru Agreement. Focusing on more stable sources of revenue such as formulating the deep seabed mining fiscal regime, while aligning tax rates with regional peers will also boost revenues.

A. Tax Policy

1. Kiribati's tax revenue has gradually been increasing since the last tax reforms in 2014, but there is scope for improvement.

The 2014 tax reforms were successful in achieving implementation of value added tax (VAT), elimination of import duties and modification of personal income tax laws exempting lower income group from direct taxation. These measures have gradually improved the tax-to-GDP ratio from 15.4 percent in 2015 to 17.4 percent in 2019, albeit lower than most regional economies (text chart). To generate higher tax revenues, Kiribati can adopt several reforms in both direct tax (personal income tax, corporate income tax, and small business tax regime), as well as indirect tax (VAT and excise tax), and find new sources of revenue.



2. Once COVID-19 abates, increasing the progressivity of the personal income tax (PIT) system can help address future revenue needs. Increasing Kiribati's top PIT rate by about 3 percentage points will help align this rate with the regional average and generate greater revenue. In the long term, a review of the taxation of pension income (as part of the government's overall retirement savings strategy), could help identify sources of revenues while ensuring pensions continue to be adequate.

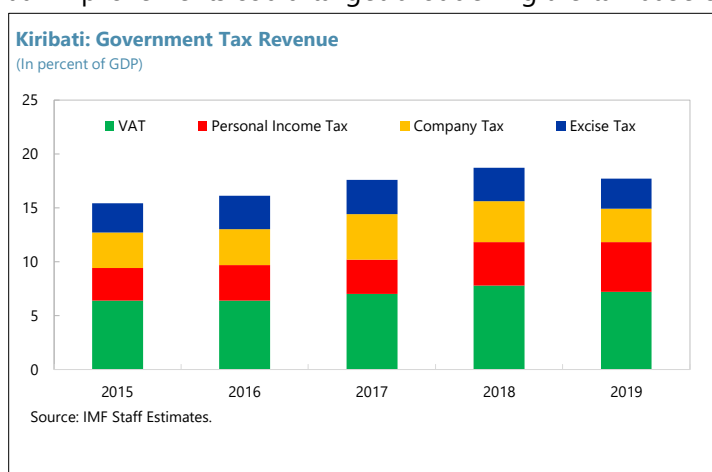
3. The corporate income tax (CIT) should be reformed by consolidating the CIT rates and reducing income tax exemptions. The authorities should consolidate the three progressive CIT

¹ Prepared by M. Shamil Akbar based on the IMF TA.

rates into one CIT rate, which would simplify the system. In the long term, the CIT rate could be reduced to around 25 percent, aligning it to the regional average. This could increase competitiveness and help attract foreign investors by reducing the tax burden on businesses. The discretionary power of the government to provide income tax exemptions or lower CIT rates should also be removed, and the Income Tax Act (ITA) clarified to ensure exemptions can only be granted under tax laws.

4. Introducing the small businesses tax regime can increase compliance by simplifying the tax system for small and micro businesses. A turnover tax in lieu of the usual income tax, and a flat tax for micro businesses, can make it easier for small and micro businesses to comply as they only have to determine their turnover and also reduces the administrative burden on the tax administration (as they only have to verify turnover).

5. The introduction of the VAT has provided a stable source of revenue and broadening the tax base could further increase VAT revenues. Around 40 percent of tax revenue comes from the VAT, with the revenue gradually increasing as a share of GDP since the introduction of the VAT in 2014. Building on this success, potential improvements could target broadening the tax base of the VAT to protect this revenue source. The VAT base in Kiribati has been gradually narrowed through increasing exemptions. The authorities should review the existing exemptions to ensure they are still necessary and resist any pressure to narrow the VAT tax base further. Additionally, the authorities should resist pressures to reduce the VAT rate as Kiribati's rate is currently in line with regional rates.



6. A potential source of raising revenue is to remove exemptions for imports and supplies provided by SOEs, especially those that are in competition with the private sector. Since 2016, services supplied or provided by SOEs are exempt from VAT whereas private businesses have to pay VAT including on their business inputs such as fuel and motor vehicles. This creates an uneven playing field. Following best practices would be to apply VAT to SOEs and private enterprises alike; this protects the VAT while also encouraging SOEs to adopt good governance and financial practices similarly to a commercial enterprise.

7. There is scope to increase excise taxes on tobacco and fuel, which would also help the environment. Kiribati has lower excise taxes on tobacco and fuel compared to other countries in the region. An increase in fuel taxes may be appropriate at this time—given the current low prices, and also as a mechanism to assist in addressing environmental issues, especially pollution. The excise

rates have not changed since 2014 and should be regularly reviewed. Furthermore, as in the case of VAT, excise exemptions for SOEs should be removed.

B. Non-tax Revenue

8. Given fishing revenues are a significant source of revenue, Kiribati should adopt measures to maximize its fishing revenue potential. In this context, leveraging its participation in the PNA through the following measures could generate greater revenue²:

- Broadening participation in the Vessel Day Scheme (VDS) beyond the PNA to include major resource owners such as the Philippines and Indonesia;
- Ensuring compliance with robust catch limits to maintain valuable tuna fisheries stocks, including limits in the high seas;
- Flexible access (including through easier trading of vessel days among countries and companies and eventual pooling of access rights among countries) and a gradual move from a vessel-based to a catch-based system;
- Significant investments in skills and capacity, and inclusion of coastal communities in the fisheries where feasible, through dedicated access (i.e., a dedicated portion of the total limit on fish catch and effort could be allocated to coastal fishing communities to prevent a food fish gap) and inshore fish-aggregating device (FAD) networks;
- Targeted investments to maintain food security; and
- Additionally, the authorities should also consider the fishing revenues as part of broader public financial management reforms, to ensure fiscal rules address the volatility of the fishing revenues and its impact on government spending.

9. Deep sea mineral (DSM) mining could potentially help to diversify Kiribati's revenue source away from volatile fishing licenses and fees. Kiribati has a potentially significant natural resource in the manganese and copper nodules located on the ocean floor within its exclusive economic zone (EEZ). While mining for the nodules is still some years away, the authorities are drafting the legislation for a seabed mining fiscal regime³ with a goal to maximizing revenue from deep sea mining to fund its development goals. Through fiscal regime being formulated correctly, Kiribati could generate significant revenues once exploration starts:

² For more details, see World Bank (2017), *Pacific Possible: Long-term Economic Opportunities and Challenges for Pacific Island Countries*.

³ Two other Pacific Island countries have introduced a seabed mining fiscal regime: Tonga and Cook Islands.

- Income tax in the fiscal regime should clearly define the rules for tax deductions for exploration, mining and rehabilitation expenditure; ring fencing of mining losses; taxation of payments to non-resident subcontractors and leasing companies; taxing gains on sale of mining rights; and an additional profits tax;
- Royalties in the fiscal regime for Kiribati should broadly be similar to that applying in the other Pacific Island countries, as this will have the added benefit of keeping Kiribati competitive to attract foreign investors; and
- Given the uncertainty around DSM mining including on the environmental impact, a precautionary approach should be adopted which requires continuous updating of information, monitoring and stakeholder consultations. The formation of a regional technical advisory body would also help to close information gaps.

Annex IV. A Sound Public Finance Management to Boost Post-Covid Recovery¹

A sound PFM system can help boost post-COVID recovery through efficient delivery of government services and public investment and reduced vulnerabilities to corruption. A recent IMF TA suggests that Kiribati would benefit from a PFM system centered around six critical core functions that are enforced through laws and regulations in a transparent and non-arbitrary manner. This note summarizes the prioritization of targeted PFM reforms, consistent with the authorities' implementation capacity.

A. Developing Credible Budgets

1. Budget credibility requires budget execution to closely follow the originally approved budget and to rely on: (i) sound revenue forecasting; (ii) improving expenditure policy decisions; and (iii) comprehensive analysis and management of fiscal risks.

- **Sound revenue forecasting** for Kiribati is difficult due to the large share of volatile fishing licensing revenue in the budget. Ministry of Finance and Economic Development (MFED) will need to develop technical capacity to adequately forecast revenue and closely work with the MFMRD who currently provides the forecasts of fishing associated revenue with little critical analysis being applied to those figures.
- **Expenditure policy decisions** should be multi-year and aim to ensure that both recurrent and development expenditure ceilings for the budget are approved by Cabinet prior to the budget circular being issued to line ministries. A system should be maintained to record changes to the set of estimates between one budget and the next.
- **Comprehensive analysis and management of fiscal risks** can help ensure sound fiscal PFM and assist with macroeconomic stability. Examples of risks are the volatility in fishing license revenue, and implicit or explicit SOEs' guarantees. These potential risks and management measures should be disclosed in the budget.

B. Maintaining In-Year Controls over Expenditure and Revenue

2. In highly centralized PFM systems, such as in Kiribati, simple commitment and payment controls should be applied prior to a transaction taking place. Undertaking a more systematic approach to controlling expenditure commitments will lead to better cash management and improved returns on unused balances. In Kiribati, cash reserves have been sufficient to manage payment requests. However, the opportunity cost of having large cash reserves sitting in operational bank accounts is not having them invested in financial instruments with higher return. Reforms in controls over expenditure and revenue include:

¹ Prepared by Danny Xufeng Jiang based on IMF TA.

- evaluating the results of the recent payroll audit to ensure the payroll system's integrity and integrate personnel and payroll databases;
- introduce a quarterly commitment system for non-salary payments to enable improved cash management and improve measures against over-expenditure; and
- ensure all fishing revenue is promptly deposited into a central account of the government.

C. Establishing Timely Accounting and Reporting

3. Robust in-year controls require timely and comprehensive accounting and reporting which can support more effective budget execution controls. Comprehensive accounting requires coverage of all government units and accounting for expenditure at both the commitment and payment stages, with possible arrears being monitored. Quarterly in-year reports should be produced and provided to line agencies to monitor budget execution. Publishing quarterly execution reports will lead to improved reporting quality and ease the burden on production of financial statements at the end of the fiscal year for examination by the external auditor.

4. Annual financial statements should be timely, complete, and consistent with generally accepted accounting principles and standards. Financial statements should be comparable with the approved budget, and include information on all revenues and expenditures. They should also outline fiscal risks arising from public corporations. SOEs should be required to provide the MFED with audited financial statements within six months after the completion of the fiscal year. This would then allow these risks and contingent liabilities to be included in the annual financial statements of government.

D. Ensuring Central Controls over Cash

5. Central control over cash should ensure government bank accounts are consolidated for more efficient and effective cash management practices. Consolidating cash balances allows government to ensure enough cash is available to meet obligations. In Kiribati, this could also lead to an increase of investment returns. Consolidation requires government to have complete information on balances and be able to switch unused balances to meet overdrawn balances and minimize its borrowing costs. In addition, Kiribati would benefit from investing the (current) significant surpluses and deciding whether to transfer money into the RERF. This entails establishing a cash management planning committee that includes representatives from MFED and ensure that all commercial accounts can be consolidated for operational and cash management purposes.

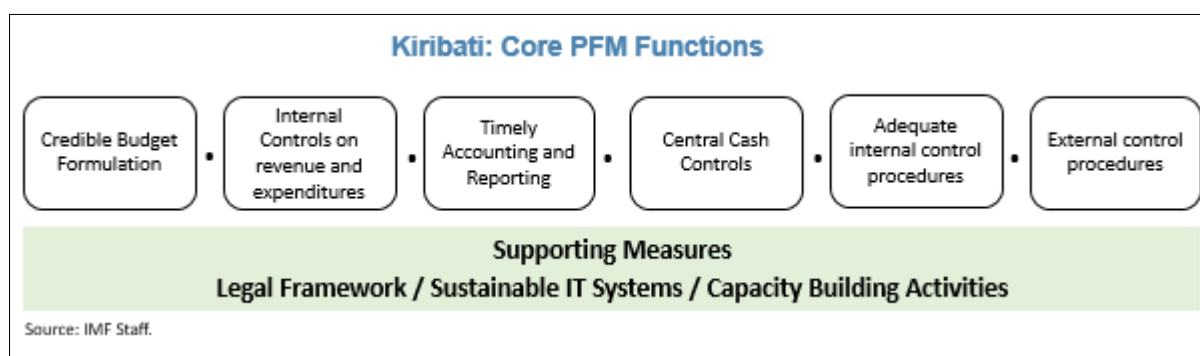
E. Establishing Adequate Internal Control Procedures

6. A sound internal control system is critical to reducing operational risks which can have financial consequences. The MFED should maintain a database for contracts (goods, services, and works) which includes information on: (i) the item procured; (ii) the value of the procurement; (iii) and details on who the contract was awarded to. Exceptions to the competitive process should be minimized. Public access to procurement information, as a start, should be made available on the

MFED website and include information on: (i) the legal and regulatory framework; (ii) government procurement plans; (iii) bidding opportunities; and (iv) contract awards.

F. External Control Procedures

7. External control procedures require timely submission of financial statements to the Kiribati Audit Office (KAO) with follow-up processes by the legislature. Financial statements should be comprehensive and timely. The KAO should aim to provide timely delivery of audit reports to the legislature and follow up on the implementation of previous audit recommendations.



8. PFM reforms take time and Kiribati will need to ensure that the national PFM system can reliably perform the core functions by adopting the following supporting measures:

- development of the legal and regulatory framework necessary to implement the required changes;
- detailed design of the new systems and procedures and the associated IT systems and human resource requirements; and
- development of operational guidelines and capacity building activities.

Annex V. Reaching Sustainable Development Goals and Improving Climate Resilience in the Post-Pandemic World¹

High vulnerability to the effects of climate change and related disasters adds to already significant challenges in meeting Kiribati's commitment to its sustainable development agenda. Additional spending requirements to meet the sustainable development goals (SDGs) and increase climate resilience in physical infrastructure remain substantial, requiring additional spending about 6 percent of GDP by 2030. Staff recommends gradually allocating additional costs in the medium-term budget while increasing public expenditure efficiency. A medium-term infrastructure plan for roads, electricity, water and sanitation facilities can also help to minimize ad-hoc non-priority projects. Additionally, Kiribati can leverage support from development partners and benefit from pursuing arrangements with the Green Climate Fund, Global Environment Facility, and Climate Investment Funds.

A. The Setting

1. Kiribati—a low-lying, resource-poor Pacific atoll nation—is one of the most vulnerable countries in the world to the impacts of climate change. The specific climate change phenomena that pose risks for Kiribati include sea-level rise, increasing air and sea-surface temperatures, ocean acidification, altered rainfall patterns, and the unpredictability of events such as droughts, storm surges and extreme high winds. Some of these changes can be seen already: ambient air temperatures (closely related to sea-surface temperatures in the case of Kiribati) have increased by approximately one degree Celsius since 1950, and since 1992 sea-level around Kiribati has risen by 3.9 mm per year, three times faster than the global average.

2. The fiscal risk from climate change in Kiribati is significant as it threatens both revenues and expenditures. On one hand, the disruption of tuna supply brought about by climate change has substantial implications for Kiribati's fiscal revenues. On the other hand, climate change poses significant costs to reaching the sustainable development goals.

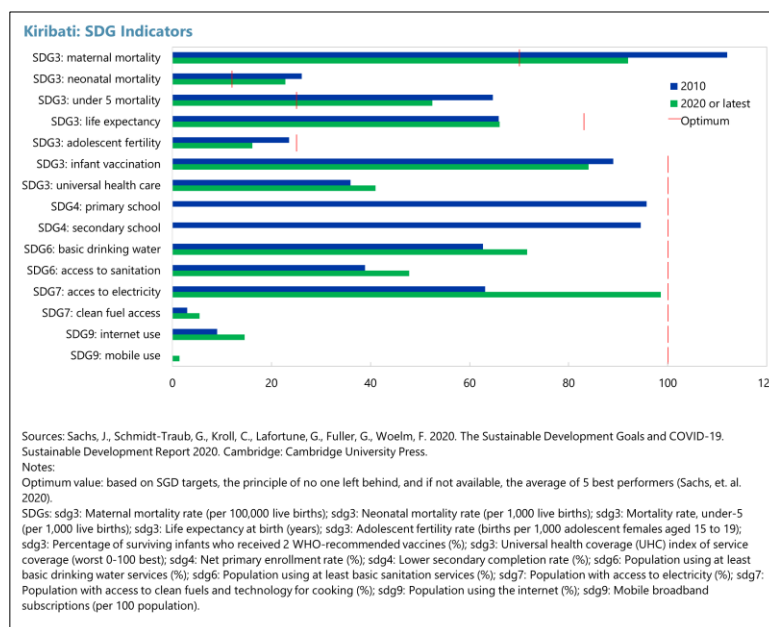
- **Revenues.** Fishing licenses and fees are the main sources of financing for government expenditure which, in turn, also influences growth and the attainment of SDGs. In the case of Kiribati, the climate cycle heavily influences the supply of tuna. A La Niña phenomenon shifts tuna supply towards the Western Pacific away from Kiribati, while an El Niño phenomenon brings tuna to the Central and East Pacific, where the Kiribati maritime borders are located. Additionally, higher ocean surface temperature affects migration and spawning patterns of tuna (Selina et. al, 2018). Changes in ocean conditions are expected to benefit Kiribati until 2050 when tuna is expected to shift eastward within Kiribati's maritime border, but the trend will reverse during 2050 to 2100 (Selina et. al, 2018).

¹ Prepared by Jacinta Bernadette Shirakawa (lead, STA) with inputs from Aleksandra Zdzienicka (FAD). The numbers are based on end-2019 data.

- **Expenditures.** Kiribati already faces extreme weather events affecting infrastructure, food and water security, disruption of education and health services, and population displacement. Adapting to these events (including through improving disaster risk management) requires—among many others—increasing spending. Even more so, as the frequency and magnitude of climate-related events are likely to increase over time.

3. While Kiribati is committed to reaching its SDGs, climate change poses challenges which are likely to have been exacerbated by the pandemic.

Kiribati has made significant advances in getting closer to its SDGs over the years, however gaps remain (text graph). The challenge of meeting the SDGs is further aggravated by the high costs of physical and social infrastructure delivery associated with the dispersed population of about 116,000, living on 21 islands. Climate risks also raise costs associated with building and maintaining climate resilient infrastructure. Further progress requires additional resources which may come under stress if the supply of tuna is also impacted by climate change.



B. Identifying the Challenges and Costs

4. Additional spending needs to meet selected SDGs in physical infrastructure are significant. Assessing the future cost of climate change comes with a great deal of uncertainty. Different models provide different estimates of climate change scenarios—stemming from various projections of ocean conditions, degree, and frequency of extreme weather events, to their adverse impact on the geography and economy of a country. The differences in cost estimates reflect, for instance, the focus and scope of the models. The extent of adaptive measures, which may cushion the effects of climate change, also depends on the authorities' priorities and financial constraints. Regardless of the model used, adapting to climate change will impose a high cost on Kiribati.

- **Tiedemann and others (2021)** estimate that additional annual spending needs to meet Kiribati's SDGs in roads, energy, and water, sanitation, and hygiene (WASH) at about 6 percent GDP by 2030 (text graph). This approach adapts *the IMF SDG Costing model* (Gaspar et al. 2019) to Kiribati's climate vulnerabilities. It also estimates additional spending needs for physical

infrastructure as a function of inputs, their unit costs, and other country-specific factors (e.g., economic and population growth). Based on these estimations, construction and maintenance of roads comprise the biggest portion of the spending needs, estimated to be 4.2 percent of 2030 GDP.

- ***The World Bank's Climate Change and Disaster Management*** report (2016) estimates the cost of coastal protection and infrastructure adaptation due to rainfall and temperature increases. It finds that the range of annual adaptation costs for coastal protection for Kiribati is 4 to 11 percent (best-case to worst-case scenario based on sea level rise and cyclone intensity as a percentage of projected 2040 GDP). Additionally, the report shows that pre-emptively adapting climate resilient infrastructure, such as, power and telecommunication, water and sewers, urban, roads and other transport infrastructure, hospitals, schools and housing, would cost 20.9 percent more relative to design standards not adapted to climate change. The main differences between the World Bank (2016) estimate and the IMF SDG costing model lay on the focus and scope. The IMF SDG costing model focuses on meeting the SDGs amid climate change by 2030. Additionally, the World Bank covers a broader range of climate costs, including coastal protection.

C. Implementing the Solutions

5. While the authorities need to budget the climate adaptation costs, improving the efficiency of spending can also help lower the cost of reaching SDGs. The SDG costing model shows that in selected sectors Kiribati spends more than its comparator countries—countries that have similar economic characteristics and similar climate vulnerabilities but perform better in SDGs. For example, Kiribati's health spending (in percent of GDP) is highest among its comparator group, yet Kiribati has one of the lowest doctors to population ratio, resulting in poor health outcomes such as high infant mortality rates. Increasing the number of doctors per 1,000 population from 0.2 to 0.8, the mean figure among its comparator countries, can help improve health outcomes. Kiribati can consider linking target health outcomes, such as pre-natal care, to conditional cash transfers. Similarly, Kiribati can examine areas of inefficient expenditure in the education sector and realign spending by linking provision of subsidies and grants to improving education outcomes.

6. Kiribati needs to adopt a gradual and strategic approach in incorporating the adaptation costs in its medium and long-term fiscal planning. Echoing the recommendations from the 2018 Article IV Consultations, part of the costs should be included in Kiribati's operating budget and its capital projects. The medium-term budget can slowly build-up climate change adaptation and mitigation costs from 2 percent initially until the target of 6 percent of GDP is reached. Kiribati would have to turn to development partners to finance any additional costs. A solid medium-term infrastructure plan for roads, electricity, and water and sanitation facilities can outline government priority projects for financing to minimize ad-hoc projects that do not align with the country's priorities.

7. To ensure fiscal space for climate change adaptation, Kiribati needs to seek new sources of government revenue, streamline expenditure, and increase public spending efficiency. The authorities should specifically consider limiting increases in public wages and salaries and copra subsidies (2018 AIV) to make room for spending on climate goals and SDGs. At the same time, the authorities need to ensure effective spending, that is designing, constructing, and maintaining infrastructure in line with climate resilience. Boosting domestic revenue mobilization and improving PFM practices (see Annex III and IV) remains critical to ensuring adequate fiscal space.

8. Kiribati should continue to seek support from and collaborate with development partners for stronger institutional and financial capacity. Development partners can help finance the substantial additional costs to meet SDGs and concurrently provide institutional and technical capacity support for resource and project management. Kiribati will benefit from pursuing arrangements with the Green Climate Fund, Global Environment Facility, and Climate Investment Funds.

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Annex VI. Pacific Unity Against Corruption: Teieniwa Vision

In February 2020, Pacific leaders¹ adopted the 'Teieniwa Vision', which is a commitment of their collective efforts to tackle corruption in all levels of society. It recognizes the importance of strong leadership and building political will to unite against corruption. Commitments were made to:

- Govern in an accountable manner wherein all leaders, persons with authority, cabinets, parliamentarians and public servants adhere to their leadership codes and/or codes of conduct;
- Develop and maintain independent integrity bodies or appropriate coordination mechanisms that prevent and fight corruption;
- Support the right to information, the need to protect genuine whistle-blowers and for an independent civil society and responsible media to be involved in national and regional anti-corruption efforts;
- Combat money-laundering and its facilitators and the enabling environment in the region;
- Further strengthen good practices in public financial management and to conduct corruption risk assessments in vulnerable sectors;
- Partner with non-state actors through a Pacific network of anti-corruption champions to elevate and strengthen the shared vision of Pacific unity against corruption;
- Draw on regional mechanisms for greater collaboration through regional architecture and development partners;
- Develop and review national anti-corruption strategies and policies and implementation arrangements, including within the national plans, through a participatory process which includes the civil society, youth, private sector, parliamentarians and other stakeholders;
- Document anti-corruption impact by developing and maintaining anti-corruption measures tools and data, and address implementation gaps in relation to SDG16 on peace, justice and strong institutions; and
- Support a strong Pacific engagement with the UN General Assembly Special Session on Corruption and its implementation.

¹ Leaders from Australia, Cook Islands, Fiji, Kiribati, Marshall Islands, New Zealand, Samoa, Solomon Islands, and Tonga committed to Pacific Unity Against Corruption and adopted the Teieniwa Vision.

Source: The Teieniwa Vision.

Annex VII. Integration Matrix of Surveillance Issues and Capacity Development

Surveillance Issues	Asian Development Bank			International Monetary Fund			World Bank		
	Past	FY2020	Planned/ Ongoing	Past	FY2020	Planned/ Ongoing	Past	FY2020	Planned/ Ongoing
Fiscal Sector									
Public Financial Management	✓	✓	✓	✓	✓	✓	✓	✓	✓
Expenditure framework			✓	✓	✓	✓			✓
Revenue Framework			✓	✓	✓	✓			✓
Macro-Financial Issues									
Financial supervision and regulation				✓	✓	✓			
Financial market development									
Correspondent Banking									
Macro-Structural issues									
Infrastructure	✓	✓	✓				✓	✓	✓
Private sector development	✓	✓	✓						
Governance issues	✓	✓	✓						
Poverty/Gender/Inequality	✓	✓	✓						✓
Climate change	✓	✓	✓						
Natural Disaster Management									
Financial Inclusion									
Labor markets									
Land									
Business Climate	✓	✓	✓						
Statistics									
Data Enhancement			✓	✓		✓		✓	✓
Sources: Asian Development Bank, IMF and World Bank.									
Note:									
*The Fund is reviewing TA on financial supervision and regulation provided by an external TA expert funded by the government of New Zealand.									
**In addition to the TA activities listed above, the EU is providing TA on tax policy.									

Annex VIII. SDGs and Strategic Surveillance Matrix

Pillar in KV20	Key Priority Areas	Corresponding SDGs	Key Outcomes	Role of the IMF
Pillar 1: Wealth--Human Capital	1. Education	4. Quality Education	1. Promote education by increasing enrollment, improving pupil-teacher ratio, boosting retention ratio in primary education, and enhancing competency of teachers 2. Increase access to vocational training including through increasing the number of islands with vocational training centers	Policy advice on human capital development
	2. Health	3. Good Health and Well-being	1. Reduce the prevalence of common noncommunicable diseases 2. Reduce the child mortality and fertility rate 3. Improve hospital and health centers services 4. Reduce prevalence of communicable diseases	Coordination with the World Bank and development partners
	3. Employment Opportunities	8. Decent Work & Economic Growth 10. Reduced Inequalities	1. Increase overseas decent employment opportunities by increasing the number of overseas seasonal workers and creating access to overseas labor markets 2. Increase domestic decent employment opportunities including by increasing fisheries employment opportunities	Policy advice on development of the private sector to generate employment
Pillar 1: Wealth--Natural Capital	4. Economic Growth and Poverty Reduction	1. No Poverty 2. Zero Hunger 8. Decent Work & Economic Growth 10. Reduced Inequalities	1. Accelerate macroeconomic stability for long term sustainable development 2. Develop sustainable tourism 3. Maximize returns from sustainable fisheries and marine resources 4. Develop inclusive sustainable trade and private sector 5. Sustainable management and protection of marine and natural resources 6. Improve land use and planning for sustainable development	Surveillance and policy advice on macroeconomic policies Technical assistance on public investment management Technical assistance and training on statistics
	5. Environment	11. Sustainable Cities and Communities 12. Responsible Consumption and Production 13. Climate Action 14. Life Below Water 15. Life on Land	1. Strengthen national capacity to effectively respond to the impacts of global climate change 2. Promote food and nutrition diversity 3. Improve biodiversity including by identifying pest and disease problems, developing and promoting control methods, and strengthening capacity to respond to pest problems 4. Enhance measures to address land development issues 5. Foster behavioral change through education, awareness raising, and research that promotes best waste management and pollution prevention practices 6. Improve quality of the environment in urban areas	Surveillance and policy advice on climate-change-related vulnerabilities Analytical framework on how to incorporate climate change adaptation costs into the macroframework
Pillar 2: Peace and Security	6. Secure, safer and peaceful Kiribati	16. Peace, Justice and Strong Institutions	1. Strengthen national security governance – policy frameworks 2. Institutional strengthening including through reviewing and updating legislation	Coordination with the World Bank and development partners
Pillar 3: Infrastructure for Development	7. Economic infrastructure and social infrastructure	7. Affordable and Clean Energy 6. Clean Water and Sanitation 9. Industry, Innovation, and Infrastructure	1. Improve air, land and sea transport infrastructure 2. Harmonize infrastructural development for tourism 3. Improve ICT infrastructure development 4. To improve access to quality utility and social infrastructure, including through greater energy service coverage, access to portable water, and suitable toilet facilities	Surveillance and policy advice on diversification, including through renewable energy and infrastructure maintenance Technical assistance on public investment management with a focus on improving project selection and procurement
Pillar 4: Governance	8. Corruption free society	5. Gender Equality 16. Peace, Justice and Strong Institutions	1. Foster, and strengthen the integrity and independence of institutions mandated to promote good governance and eliminate corruption 2. Institutionalize anticorruption and good governance principles in the public service and education systems in Kiribati	Surveillance and policy advice on fiscal institutions and on governance of fisheries

Sources: Kiribati 20-Year Vision 2016-36; and Kiribati Development Plan 2016-19.



Appendix I. Draft Press Release

IMF Executive Board Concludes 2021 Article IV Consultation with Kiribati

FOR IMMEDIATE RELEASE

Washington, DC – [Month dd, YYYY]: The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with Kiribati.

Kiribati’s economy performed well prior to the COVID-19 outbreak but the pandemic has put strains on economic activity. Kiribati had an average annual real GDP growth rate of 4¾ percent in 2015-19, up from about 1½ percent during 2000-14. The stronger growth reflected in part higher public spending financed by record-high fishing revenue. The COVID-19 containment measures impacted growth directly through contraction in services including restaurant and hotel services, transportation, and other business activities. Planned large investment projects were also delayed. Strict containment measures and lower external demand led to a sharp drop in fishing revenues by about 16 percent. As a result, real GDP is estimated to have declined by 0.5 percent in 2020.

A recovery is expected in 2021, although growth will remain subdued compared to the pre-COVID environment. The vaccine roll-out is expected to start in mid-2021 but it will take time to inoculate the entire population. As a result, restrictions on movement and reduced port activity will continue, weighing on growth. Nonetheless, the fiscal stimulus is expected to support domestic demand resulting in a projected real GDP growth of 1.8 percent in 2021. Economic activity is projected to reach 2.5 percent in 2022 as both domestic and external conditions normalize. Growth should converge to slightly below 2 percent over the medium-term. The current account is projected to reach a surplus of about 12 percent in the medium-term with a gradual rise in fishing revenues, but the continued high recurrent expenditure will keep the overall fiscal balance in a deficit.

Risks to the outlook are substantial and tilted to the downside, amid great uncertainty. A worsening of the pandemic that prolongs containment measures would adversely impact economic activity as the planned resumption of infrastructure projects and activity in the services sector are further delayed. Global financial conditions could also tighten in response to adverse COVID-19 developments and affect the expected return on the sovereign wealth fund and the Kiribati Provident Fund, putting pressure on fiscal resources. A cyclical reversal of the favorable weather conditions could threaten fishing revenues, impacting the fiscal balance and the current account. Climate change would further aggravate these risk.

¹ Under Article IV of the IMF’s Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country’s economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Executive Board Assessment²

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² At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.IMF.org/external/np/sec/misc/qualifiers.htm>.

Table 1. Kiribati: Selected Economic Indicators, 2018–26

	2018	2019	2020	2021	2022	2023	2024	2025	2026
		Est.	Est.			Proj.			
Real GDP (percent change)	3.8	3.9	-0.5	1.8	2.5	2.3	2.1	2.0	2.0
Consumer prices (percent change, average)	0.6	-1.8	1.8	2.0	1.8	1.9	1.8	1.6	1.5
Inflation (end of period)	-1.1	-0.9	1.3	1.8	1.9	2.1	1.9	1.7	1.4
Central government finance (percent of GDP)									
Revenue and grants	133	122	106	108	106	102	101	99	99
Total domestic revenue	87	95	84	82	83	83	82	83	84
<i>Of which: fishing revenue</i>	66	77	64	62	63	62	62	63	63
External grants	46	27	21	26	22	19	19	16	15
Expenditures	135	114	109	120	123	117	113	111	110
Current	56	54	68	78	80	77	75	75	75
Development	78	60	41	42	43	40	38	36	35
Domestic recurrent balance 1/	-35	-36	-48	-58	-59	-57	-55	-54	-54
Recurrent fiscal balance (incl. budget support grants)	36	41	19	9	9	11	12	13	14
Overall balance 2/	-2	8	-3	-12	-17	-15	-12	-11	-11
Financing	2	-8	3	12	17	15	12	11	11
<i>Of which: Revenue Equalization Reserve Fund (RERF)</i>	0	0	0	13	0	0	0	0	0
RERF									
Closing balance (millions of A\$) 3/	973	1153	1212	1231	1297	1366	1437	1511	1587
Per capita value (2006 A\$)	6440	7386	7577	7473	7623	7752	7850	7928	7998
Balance (in percent of GDP)	363	406	422	411	417	421	427	433	441
Cash reserve buffer 4/									
Closing balance (millions of A\$)	159	173	164	185	159	139	124	114	106
Closing balance (in percent of GDP)	59	61	57	62	51	43	37	33	30
In excess of 3-months of current spending (millions of A\$)	121	135	115	127	97	76	60	49	39
Balance of payments									
Current account including official transfers (millions of US\$)	76	87	14	25	27	29	31	33	34
(In percent of GDP)	38	44	7	11	11	12	12	12	12
External debt (millions of US\$) 5/	37	35	38	50	70	91	111	133	156
(In percent of GDP)	19	18	17	21	29	36	42	49	56
External debt service (millions of US\$)	0.8	1.4	1.7	1.9	2.2	2.5	2.8	3.1	3.4
(In percent of exports of goods and services)	0.5	0.8	1.0	0.9	1.0	1.1	1.1	1.2	1.3
Exchange rate (A\$/US\$ period average)	1.3	1.4	1.4	...	...	...	...	...	...
Real effective exchange rate (period average)	88	87	90	...	...	...	...	...	...
Memorandum items:									
Nominal GDP (millions of A\$)	268	284	287	299	311	324	337	349	360
Nominal GDP (millions of US\$)	200	198	198	...	...	...	...	...	...

Sources: Data provided by the Kiribati authorities; and Fund staff estimates and projections.

1/ Domestic recurrent balance excludes fishing revenue, grants, and capital expenditure.

2/ Overall balance in the table is different from official budget because loans are classified as financing.

3/ The closing RERF balance for 2020 does not show the withdrawal of AUD 40 million which is used for financing in 2021. After withdrawal the balance would be AUD \$1172 million.

4/ Cash reserve buffer includes the government's operational account and cash reserve account.

5/ Kiribati's current debt portfolio is composed of external debt only, as all domestic debt was cleared in 2015.