EXECUTIVE BOARD MEETING

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March 9, 2017

To: Members of the Executive Board

From: The Secretary

Subject: **Republic of Nauru—Staff Report for the 2017 Article IV Consultation**

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***Unless an objection from the authorities is received prior to the conclusion of the Board's consideration, the document will be published.**

REPUBLIC OF NAURU

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION

March 7, 2017

KEY ISSUES

Context. This is the first Article IV Consultation since Nauru became the 189th Fund member in April 2016. Nauru's growth and government revenue have improved substantially in recent years owing to the Australian Regional Processing Center (RPC) to process asylum seekers, fishing license fees, and residual phosphate mining. However, Nauru faces daunting challenges in sustaining growth and ensuring fiscal sustainability due to its limited sources of growth and income. The country is also vulnerable to climate change, its antiquated infrastructure hampers trade and growth, and its health indicators are below those of peers due to high incidence of non-communicable diseases.

Outlook and risks. Economic activity is moderating in FY2017, while the medium-term outlook remains challenging due to the RPC scaling down which entails a substantial decline in government revenue. With limited access to borrowing, fiscal spending will have to adjust accordingly. The downside risks to the outlook include a more rapid process of RPC scaling down, weaker-than-expected global growth, climate change, and delays in implementing fiscal and structural reforms.

Key policy recommendations:

- **Fiscal policy.** Ensure fiscal liquidity and sustainability by maintaining adequate cash buffers and contributing to the trust fund, which was recently established to provide long-term fiscal financing. The build-up in savings should start from FY2017 while RPC revenue remains high. Implement tax and public financial management reforms to control spending and support the fiscal adjustment. Strengthen public debt management to ensure fiscal and debt sustainability, and improve access to credit markets.
- **Climate change**. Develop a fiscal policy framework that would enhance economic resilience by integrating climate change strategies in budget planning. Practical approaches should be adopted in the near term to match capital projects already in the pipeline with Nauru's climate change strategies, meet the climate proofing standards, and incorporate the projects in a multi-year budget plan.
- **Structural reforms**. Successful implementation of structural reforms would promote inclusive growth, economic diversification, and private sector development. The priorities include rebuilding the seaport and energy infrastructure, reforming the state owned enterprises, developing the financial sector, and addressing health-related challenges.

Approved By
Alison Stuart (APD) and Peter Allum (SPR)

Discussions were held in Nauru during January 16–27, 2017. The staff team included Tubagus Feridhanusetyawan (Resident Representative for Pacific Island Countries (RR-PIC, head), Reshika Singh (RR-PIC), Alexander Massara (STA), and Antoinette Kanyabutembo (APD), assisted in the preparation of this report. Heenam Choi and Gemma Preston (OED) participated in the discussions. The mission met with the President, the Cabinet, members of parliament, senior government officials, and representatives from public enterprises, the private sector, and development partners.

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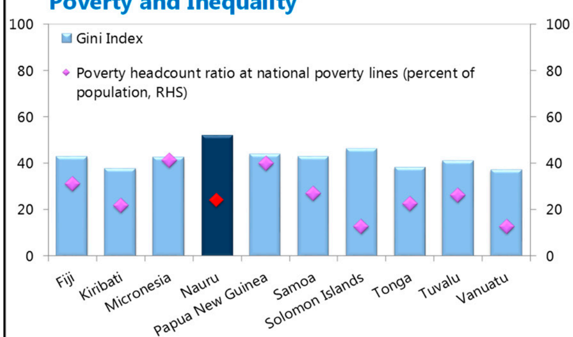
BACKGROUND: DEVELOPMENT CHALLENGES

1. **Background.** Nauru is an island state in the Pacific with a land area of about 8 square miles and population of around 12,500 in FY2015. The island is remote, surrounded by deep sea and coral reefs, making it difficult to build a seaport. Before joining the IMF and World Bank Group in April 2016, Nauru became a member of the Asian Development Bank (AsDB) in 1991 and the United Nations in 1999. The country has a parliamentary system, and during the last election in July 2016, thirteen out of nineteen parliament members were reelected. The parliament reelected President Baron Waqa, and all ministers returned to the cabinet. Nauru has no central bank, and uses the Australian dollar as the legal tender.

2. **Economic setting.** Nauru's economy followed the phosphate mining boom-and-bust cycle over the past decades. After the phosphate boom in the 1980s, Nauru became one of the rich nations in the 1990s with the Nauru Phosphate Royalty Trust (NPRT) fund worth more than A$1 billion (A$1 million per-capita). However, the decline in phosphate production and weak management of public finances led to economic deterioration during the 1990s–2000s. During the economic slump, the government defaulted on public debt and accumulated arrears. Most state owned enterprises (SOEs) including the Bank of Nauru collapsed. The NPRT assets were also depleted due to excessive spending and bad investments, and most of the remaining assets were returned to landowners by FY2014. The economy was mostly cash-based with no bank operating in the country until June 2015. Nauru's economic performance has improved substantially since FY2012 driven by the Australian Regional Processing Center (RPC) for asylum seekers (Box 1), residual phosphate mining, and revenues from fishing license fees. With donor support, Nauru established a new trust fund in FY2016 aimed at providing long-term fiscal financing (Box 2).

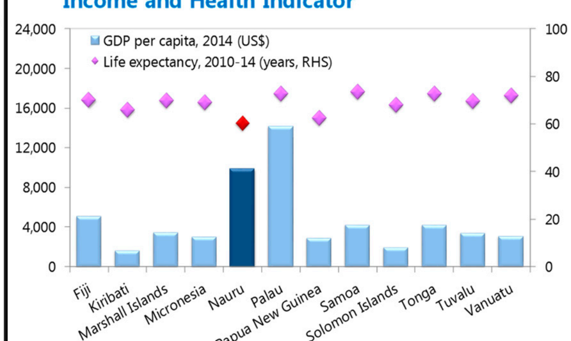
3. **Development challenges.** Despite its improved economic performance, Nauru is facing daunting challenges in sustaining growth and ensuring fiscal sustainability over the medium term. The RPC is expected to scale down and the primary phosphate deposits are almost exhausted, while below-surface mining requires substantial investment. Nauru is also facing challenges common to small islands: a narrow production base, remote location, high cost of public goods, small population, insufficient infrastructure, and climate change. Despite its relatively high per capita income, Nauru's income inequality and health indicators are worse than peers. Nauru is classified as a fragile state by AsDB.

Poverty and Inequality



Sources: World Bank Group, United Nations Development Program, and Country Authorities.

Income and Health Indicator



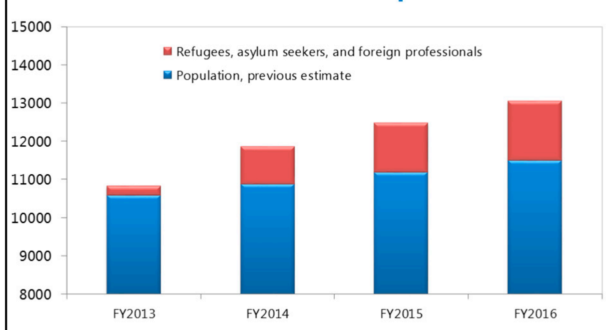
Sources: United Nations Development Program, Country Authorities, and IMF staff estimates.

4. Focus. Against this background, the consultation focused on: (1) ensuring fiscal sustainability, (2) improving resilience to climate change, and; (3) promoting inclusive growth.

Box 1. The Australian Regional Processing Center (RPC)

RPC operation. The first RPC in Nauru was opened in 2001 but it was closed in 2007. The current RPC was opened in late 2012, and under the agreement with Australia, Nauru would process asylum seekers that arrive to Australia by boat and provide temporary settlement for refugees. By mid-2014, the total number of asylum seekers (living inside the RPC) and refugees (living in the Nauru community) increased to around 1,300, and this level has been broadly constant since then. Because of the conversion to refugee status, the number of asylum seekers declined from 1,170 in June 2014 to 440 in June 2016 (including those under medical treatment in Australia) and the refugees increased to 920. Since October 2015, the RPC has become an "open center" as the asylum seekers are allowed to travel around the island. The refugees work and operate businesses, such as restaurants. The RPC has raised Nauru's population by more than 20 percent since FY2013 with the increasing number of asylum seekers, refugees, and foreign workers living in Nauru.

Nauru: The RPC and Nauru's Population



Sources: Nauru authorities, and IMF staff estimates.

Economic impact. The share of RPC-related services is estimated at around 35 percent of GDP. The RPC-related fiscal revenues comprise of visa fees (A$2,000/person/month for refugees and A$1,000/person/month for asylum seekers), withholding employment and services taxes on expatriates, and other taxes on RPC-related trade and services. In FY2017, the RPC revenue is estimated at nearly A$50 million (about 35 percent of revenue excluding grants). The medium-term impact of the RPC scaling down is uncertain and will depend on the magnitude and timing, and the potential additional support that Nauru might receive to compensate for revenue shortfalls.

RECENT DEVELOPMENTS AND OUTLOOK

5. Growth and inflation. Nauru's economy has performed relatively well compared to its peers for the past five years (Table 1, Figures 1 and 4). Real GDP grew by more than 20 percent annually on average during FY2011–14 boosted by phosphate mining, trade and services sectors related to the RPC, and rapid population growth. After moderating to around 3 percent in FY2015 due to seaport problems that lowered phosphate exports, growth is estimated to have rebounded to around 10 percent in FY2016 thanks to temporary seaport repair, robust service sectors, and a large increase in government spending. Inflation was generally low until FY2014, and mostly mirrored that of Australia, the main source of imports. However, inflation increased to about 9 percent on average during FY2015–16 owing to strong domestic demand, large cash payouts (A$78 million) to landowners from the liquidated NPRT assets in FY2014, and supply shortages caused by the seaport problem.

Box 2. The New Trust Fund

In April 2016, the Government of Nauru (GoN) established a new intergenerational trust fund with support from development partners. The goal is to save windfall income over the medium term into a trust fund that will generate revenue streams over the long term. The trust fund is designed to be perpetual, and cannot be withdrawn during the build-up period of 2016-33 unless the trust fund committee determines otherwise.

The trust fund is managed by a committee comprising the GoN and bilateral donors that contributed to the fund (Australia and Taiwan Province of China). The Asian Development Bank also contributed to the trust fund but it is not a committee member. The initial GoN contribution was A$20.4 million, followed by annual contributions ranging from 8 to 12 percent of domestic revenues in the previous year. The initial donors' contributions amounted to A$10.5 million, and these contributions are expected to continue during the life of the fund, although the amount may vary. Based on the trust fund documents, the principal value is expected to reach A$400 million by 2033, and a private company in Australia (Mercer) manages the assets.

After the trust fund is fully established by 2033, the payments from the trust fund's income streams will be provided based on a program and budget prepared by the GoN. This will be reviewed periodically based on the investment performance, contributions, and the fiscal situation. The distributed funds are expected to finance investments in education, health, environment, and infrastructure with sound monitoring and evaluation frameworks.

6. Outlook. In the near term, growth is projected to moderate to 4 percent in FY2017 due to weakened phosphate recovery, limited expansion of the RPC, and stabilized population growth. Average inflation would also moderate to 6 percent in line with slowing economic activities and stable food and fuel prices. Over the medium term, Nauru's outlook is vulnerable to the expected scaling down of the RPC as the refugees would be gradually transferred from Nauru to third countries. However, the magnitude and speed of the scaling down remain uncertain and subject to continued negotiations between Nauru and Australia, and between Australia and other countries. In view of this uncertainty, the mission and the authorities agreed that the Article IV Consultation prepare a baseline projection in which 350 refugees (about one third) would be transferred to other countries in FY2018, while the remaining refugees (about 600) and asylum seekers (about 250) would stay in Nauru over the medium term. Although the RPC-related revenue is projected to decline substantially in FY2018, total fiscal revenue and grants as well as total expenditure are projected to decline by about 9–10 percent in real terms thanks to larger disbursement of budget support and grants for infrastructure projects.[1] On balance, growth is projected to dip to minus 4 percent in FY2018 before rebounding to 2 percent over the medium term. Average inflation is projected to remain low in line with the economic slowdown, inflation in Australia, and stable commodity prices (Table 2).

7. External sector assessment. The current account deteriorated in FY2014 owing to lower phosphate exports and strong imports driven by buoyant domestic demand and the private inflows

[1] AsDB is projected to raise its grants including A$5 million budget support in FY2018 and about A$50 million infrastructure projects (for example, seaport construction (co-financed with Australia), internet connectivity, renewable energy, and urban development) during FY2018–21.

(NPRT cash payout), but it has improved since then thanks to exports recovery, fishing license fees, and RPC-related revenues (Table 3). The current account is projected to deteriorate in FY2018 as RPC-related inflows would decline along with the expected scaling down, but RPC-related imports would partially offset the decline in inflows, serving as an automatic stabilizer. Over the medium term, the scaling up of infrastructure projects would raise imports, but it would be compensated by larger grant disbursements to finance the projects and robust fishing license fees. As a result, the current account is projected to be in a small surplus in terms of GDP during FY2019–21 in line with the projected fiscal position and continued build-up of the trust fund. The external sustainability assessment indicates that the real exchange rate is moderately stronger than implied fundamentals due to elevated inflation, although factors other than the exchange rate plays greater roles in determining the external sector balance (Appendix I). The Australian dollar as the legal tender remains appropriate given strong economic linkages and limited capacity to run independent monetary operations.

8. **Risks.** Nauru's medium-term outlook is subject to downside risks (Appendix II). A more rapid RPC scaling down would lower growth and fiscal revenue, although on the upside, a slower scaling down and a potentially larger grant disbursement from donors to compensate for the RPC revenue shortfalls would provide some fiscal space. In addition, weaker-than-expected global growth and climate change shocks would hamper trade and growth and reduce Nauru's exports, remittances, and fiscal revenues. On the domestic side, delays in implementing fiscal reforms, infrastructure projects, and SOE reforms would lower growth prospect and jeopardize fiscal sustainability.

9. **The authorities' views.** The authorities agreed with the outlook and risks. They shared the view that despite strong economic performance in recent years, the economy is driven by limited sources of growth and income. They confirmed that refugee settlement in Nauru is only temporary, and the RPC is expected to scale down. They are aware of the potential adverse impact on the economy and the associated risks, but the timing and magnitude of the RPC scaling down are difficult to predict. Therefore, they appreciated that the Article IV consultation discussed a scenario in which some refugees would be transferred to other countries next year, so that they could prepare for any adjustments and policy responses. The authorities noted that discussions are ongoing with Australia to prepare for the refugee transfers, including on the proposal to shift from per-capita-based payments towards transitional grants to provide more certainty of revenues particularly when the refugee transfers start. They also plan to take more control of the RPC administration from Australia to provide more value added to the economy.

ENSURING FISCAL SUSTAINABILITY

10. **Recent developments.** Fiscal revenue has increased substantially since FY2012 supported by RPC-related revenues, fishing license fees, and increased tax collection, which has been driven by the implementation of employment and services tax and improvement in administrations since 2014. RPC-related revenues (excluding reimbursement of RPC expenses) have been particularly large at about 40 percent of revenues excluding grants starting in FY2016. In the meantime, non-RPC spending also increased substantially, particularly the wage bill as the authorities tried to retain key public employees, although goods and services and social benefits have also increased rapidly. As a result, the non-RPC current balance (non-RPC revenue plus current grants minus non-RPC expenses) deteriorated. Nonetheless, the overall fiscal balance remained in surplus and this has been used to clear arrears, build-up government deposits (cash buffers), and contribute to the trust fund. Total cash buffers and Nauru's trust fund contribution reached nearly 25 percent of GDP in FY2016 (Table 4, Figure 2).

11. Near-term fiscal outlook. The revised FY2017 budget increased substantially from the estimated FY2016 outturns, but non-RPC expenses increased by about 2 percentage points of GDP. The latest data indicate that the revenue targets would be broadly met. However, spending pressures remain strong, particularly on the wage bill and miscellaneous expenses such as special projects. The fiscal balance, after incorporating Nauru's contribution to the trust fund, is expected to be in deficit of about one percent of GDP, financed by a decline in cash buffers to about one month of non-RPC current spending.

12. Medium-term fiscal outlook. The transfer of refugees is projected to reduce RPC-related revenue from about A$50 million in FY2017 to around A$35 million during FY2018–21. Under this baseline scenario, domestic revenue is projected to decline by 20 percent in FY2018. Provided that the RPC-related revenues (for example, visa fees) stay broadly unchanged afterwards, domestic revenue will remain broadly constant at around 75 percent GDP over the medium term. Since Nauru has limited access to borrowing, current spending will have to adjust to the sharp decline in revenue. Current spending is projected to decline to slightly less than 70 percent of GDP over the medium term, which is broadly comparable to the average spending in FY2015–16. The fiscal position would be in surplus just enough to contribute to the trust fund that cannot be withdrawn before 2033, but the cash buffers would be depleted, jeopardizing fiscal sustainability and, therefore, further fiscal policy actions are needed (Figure 3).

13. Maintaining fiscal buffers. In view of this, staff recommended maintaining cash buffers of at least 2 months of non-RPC current spending (about 10 percent of GDP) in addition to the contribution to the trust fund following the trust fund rule (see text table below). This would provide funds to meet liquidity needs and ensure fiscal sustainability although, considering the uncertainty surrounding the magnitude and speed of the RPC scaling down, the appropriate level of buffers should continue to be reviewed. The authorities should start by replenishing the buffers to reach at least A$16 million by end-FY2017 while the RPC revenue remains high. The cash buffers could be maintained by cutting unnecessary spending, such as ad-hoc subsidies, travels, and special projects, while protecting priority spending on health and education. Spending restraint is also important to provide space for capital spending, maintenance costs of infrastructure projects, potential climate change adaptation costs, and clearing debt arrears. To minimize the impact on growth, the authorities could accelerate the implementation of grant-financed infrastructure projects. The commitment to preserve cash buffers and to contribute to the trust fund would also be critical in discussions with development partners for possible budget support. Staff agreed with the authorities that continued consultation with Australia during the period of fiscal adjustment would be important for macroeconomic management.

Nauru: Central Government Operations, Maintaining Fiscal Buffers Scenario, FY2015-21

	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021
	Prelim.		Proj.				
	(In millions of Australian dollars)						
Total revenue and grants	97.6	161.4	169.1	154.8	148.8	151.9	151.7
Expenditure	86.9	128.5	147.2	134.2	129.5	131.4	132.2
RPC expenses	6.0	16.6	27.9	20.8	20.9	21.1	21.2
Non-RPC expenses	68.3	97.2	99.6	82.9	80.7	83.1	88.4
Net acquisition of non-financial assets	12.6	14.6	19.7	30.5	27.9	27.2	22.6
Net lending (+) / borrowing (-)	10.7	33.0	21.9	20.7	19.4	20.6	19.5
Including trust fund contribution	10.7	2.1	4.7	0.1	2.1	3.1	1.7
Net acquisition of financial assets	5.1	18.9	19.1	17.7	16.5	17.7	18.3
Of which : Changes in government deposit	5.1	-12.0	1.9	-2.9	-0.8	0.3	0.5
Net incurrence of financial liabilities	-7.6	-4.6	-2.7	-3.0	-2.9	-2.8	-1.2
Statistical discrepancy	-2.0	9.4	0.0	0.0	0.0	0.0	0.0
Memorandum items:							
Non-RPC current balance (in percent of GDP)	-11.6	-21.2	-16.7	-9.0	-9.4	-8.8	-9.4
Stock of government deposits	25.9	13.9	16.2	13.8	13.4	14.1	15.0
In months of non-RPC current spending	4.5	1.7	2.0	2.0	2.0	2.0	2.0

Sources: Nauru authorities and IMF staff estimates and projections.

14. Structural fiscal reforms. Tax and public financial management (PFM) reforms are critical to help control spending and support the needed fiscal adjustment. Staff welcomed good progress in building the tax system, including the introduction of employment and services tax and business profit tax, and improvement in customs and tax administration. Staff emphasized that ensuring consistent implementation of the new tax system would help mobilize revenues and encouraged broadening the tax base over the medium term. For example, after the tax system is fully implemented, the authorities could consider lowering the tax-free threshold for residents.[2] On the spending side, staff advised implementing the recommendations of the 2016 Public Expenditure and Financial Accountability self-assessments (Box 3). Staff welcomed the submission of the FY2015 government financial statement for internal audit.

15. Public debt management. The latest data in June 2016 show that public external debt is estimated at about A$48 million (34 percent of GDP), comprising mostly of loans from Taiwan Province of China, overdue fees and obligations to international organizations, and the Yen bonds that were defaulted in the 1990s.[3] Public domestic debt is estimated at around A$43 million (31 percent of GDP), mostly longstanding liabilities related to the Bank of Nauru liquidation in

[2] The tax-free thresholds are set sufficiently high to exempt Nauru citizens partly due to their strong resistance when the tax system was introduced in 2014. Therefore, the tax reform strategy is to build the new tax system first and lower the threshold to broaden the tax base later after the system is fully established and implemented.

[3] The bonds of about A$16 million face value were issued in Japan in the late 1980s but were subsequently defaulted and sold in the market in the mid-1990s. The estimated current value is subject to negotiations.

the mid-2000s. Staff welcomed the continued reconciliation of public external debt and arrears including the liabilities to the Bank of Nauru's private creditors.[4] Most debt is in the form of old debt or arrears and, therefore, staff encouraged the authorities to resolve them including through good faith negotiation with creditors. Nauru's access to credit markets remains limited and no substantial new borrowing is expected over the medium term. The Debt Sustainability Analysis indicates that Nauru's debt is sustainable (Appendix III). Staff emphasized that sound public debt management, including the reconciliation and resolution of old debt, is critical to ensure debt sustainability and improve Nauru's access to credit markets.

Box 3. Public Financial Management (PFM) Reforms

Nauru has been reforming PFM supported by technical assistance (TA) from development partners. With donor support, Nauru acquired a Financial Management Information System (FMIS) in 2011 that is capable of basic budget control, management, accounting, and reporting, although not all basic features have been fully implemented. The Public Expenditure and Financial Accountability (PEFA) self-assessment took place in 2010 and 2016, supported by Australia, Pacific Financial Technical Assistance Center (PFTAC), and the Asian Development Bank.

The 2016 PEFA assessment identified areas of improvements and weaknesses. Good progress has been made in: (1) FMIS implementation; (2) Budget preparation, credibility and reliability; (3) Revenue administration and accounting, and; (4) Submission to audit for the first time of the annual financial statements for the year 2013–14. However, major weaknesses remain, including: (1) Absence of fiscal strategy, and macroeconomic and fiscal forecasts; (2) Absence of multi-year planning and budgeting; (3) Weak debt management; (4) Absence of fiscal risks assessment and monitoring; (5) Absence or delays in external audit, and (6) Lack of legislative scrutiny in Parliament.

Based on these assessments, the PFM TA developed a PFM reform roadmap. The sequence involves: (1) Establishing basic financial policies, rules, and regulations; (2) Improving basic internal control procedures such as debt and bank reconciliation, accounting and reporting; and (3) Catching up with the audit of the financial statements. The specific reform areas include:

- Revising budget classification and charts of account in line with Government Financial Statistics;
- Developing a comprehensive Medium-term Expenditure Framework (MTEF);
- Strengthening external and internal audit units;
- Establishing asset and debt management strategies;
- Improving reconciliation of government bank accounts;
- Identifying and monitoring fiscal risks especially arising from the state owned enterprises;
- Improving transparency, accountability, and auditing of financial reports/accounts.

16. The authorities' views. The authorities reiterated their commitment to fiscal and debt sustainability, and welcomed the recommendation to maintain fiscal discipline. They agreed to maintain adequate cash buffers, continue to contribute to the trust fund, and control spending, particularly on ad-hoc expenditures not related to infrastructure, health, and education. The

[4] Bank of Nauru's liabilities to NPRT (estimated at about A$26 million) are not fully reconciled and consolidated in the government' accounts partly because both Bank of Nauru and the NPRT have been liquidated. The government holds the remaining assets of the NPRT estimated at about A$25 million that are still in the process of liquidation.

authorities also plan to use their fiscal responsibility targets, such as tax to GDP ratio, public wages as a share of revenue, and the fiscal balance, to guide fiscal policy. On tax policy, the authorities would focus on implementing the current tax system including building administrative capacity before considering lowering tax-free thresholds, which would require public education and consultation. The authorities are also discussing with Australia how to better manage the RPC reimbursable expenses and ensure sufficient cash flows, by moving away from a reimbursement system to upfront payment. Trust fund contributions would also be paid quarterly instead of in a lump-sum to ensure sufficient liquidity. To improve transparency, the authorities will publish the FY2014 audited government financial statement and the details of the new trust fund, and will continue to work with the Organization for Economic Cooperation and Development on the automatic exchange of tax information.

IMPROVING RESILIENCE TO CLIMATE CHANGE

17. Challenges and strategies. Due to its location, Nauru is less vulnerable to cyclones than other small island states in the Pacific. However, Nauru is facing a number of long-term challenges such as rising sea levels, extreme tides, and coastal erosion, that threaten infrastructure in the coastal areas and reduce the land area for agriculture. Rising sea temperatures may threaten revenue from fishing license fees, while rising air temperatures will also increase energy demand. The costs of mitigating these challenges will weigh on fiscal balances, increasing the need to develop long-term planning. Nauru has incorporated these challenges in the National Sustainable Development Strategy (NSDS) 2005–25, and published the 2014 Framework for Climate Change Adaptation and Disaster Risk Reduction (RONAdapt) to provide a roadmap to address climate change vulnerabilities.[5] Nauru has also completed a study on climate change finance assessment to help make informed decisions and measures to improve access and manage climate change resources.[6] However, more work is needed to integrate these climate change strategies into medium-term budget planning.

18. Improving economic resilience. Staff welcomed the authorities' climate change efforts and encourages them to address weaknesses identified by the Pacific Island Forum study, such as improving information between line ministries, clarifying their roles and responsibilities on the climate change program, and quantifying financing needs. Since there is no estimate of climate change spending in the budget so far, staff encouraged the authorities to integrate climate change strategies into medium-term budget planning through PFM reforms in order to help implement the strategies. This could be the start of a long-haul process, and the authorities could make use of technical assistance (TA) from donors to increase capacity. Recognizing that first best practices may take years to implement, in the interim, the authorities and staff agreed on practical approaches that could be implemented immediately. These actions include identifying capital projects already in the pipeline, matching them with the climate strategies, determining the implementation sequence, and

[5] The RONAdapt priorities are: water, energy, and food security; healthy environment; healthy people, and productive and secure land resources. It identifies multiple avenues to achieve its objectives, including infrastructure development, policy reforms, and capacity development, and it will be updated every five years.

[6] Pacific Island Forum (2013) *Pacific Climate Change Finance Assessment: Nauru Case Study*.

working with donors to ensure that these projects meet climate-proofing standards. The authorities should also make a multi-year budget plan that covers both current and capital spending, and incorporates these projects, including their maintenance costs, in the budget. Staff emphasized that transparent budget management would help secure financing from donors.

19. The authorities' views. The authorities shared the views that addressing climate change challenges is critical for Nauru's sustainable development. They agreed that matching various development projects in the pipeline with Nauru's climate change strategies would be the starting point to integrate the climate change strategy in medium-term budget planning. In view of this, the authorities have reestablished the National Development Planning Committee to advise Cabinet on the NSDS review incorporating the new Sustainable Development Goals and climate change strategies. With the support of the Global Climate Fund, the authorities are also developing the climate change National Adaptation Plan, which will provide inputs in updating the NSDS.

PROMOTING INCLUSIVE GROWTH

20. Priorities. Discussion focused on critical reforms that could support growth and make it more inclusive during the period of fiscal adjustment over the medium term, namely: rebuilding antiquated infrastructure; reforming SOEs; developing the financial sector; and addressing health-related challenges. Successful implementation of these reforms would provide more opportunity for economic diversification and private sector development.

21. Rebuilding infrastructure. Constructing a new seaport facility and continuing energy sector reforms are critical to address infrastructure bottlenecks. The current seaport based on mooring system is antiquated and has suffered from climate change, hampering trade and creating supply shortages. Staff welcomed the authorities' plan to develop a new seaport financed by grants, and recommended to integrate the maintenance cost in budget planning. Staff also welcomed recent improvements to Nauru's power generation system despite ongoing fuel subsidies. The Nauru Utility Corporation (NUC) has increased revenue and cut costs, resulting in a more financially sustainable operation. The authorities should continue to work with development partners to further transform the NUC into an independent SOE that operates based on commercial principles, including by reforming the tariff system and reducing government subsidies.

22. Reforming state owned enterprises. The SOEs play an important role in the economy, contributing about half of GDP and one third of employment, but SOE governance and monitoring remain a challenge. Staff emphasized that SOE reforms will reduce fiscal burdens, safeguard fiscal sustainability, and facilitate private sector development, and encouraged the authorities to improve SOE governance, accountability, and transparency. In line with the AsDB's TA recommendations, the priorities include appointing Boards that are best suited to assist SOEs achieve their mandates, producing timely annual accounts, and holding the Board accountable for the SOEs' performance (Box 4).

Box 4. State Owned Enterprises (SOEs)

Nauru's SOEs play a major role in various economic sectors. The main SOEs are: (1) Nauru Utilities Corporation (NUC); (2) Nauru Air Corporation; (3) Republic of Nauru Phosphate Corporation (RONPHOS); (4) Nauru Rehabilitation Corporation (NRC); and (5) Eigigu Holdings Corporation. Other SOEs include the Nauru Port Authority (NPA), Cenpac Net Incorporated (internet services), and Nauru Phosphate Royalties Trust (NPRT), of which most of its assets have been liquidated.

Based on limited information available, SOE performance is mixed. The NUC's performance has recently improved by expanding the coverage of the electrical grid, reducing theft, and increasing the share of solar power. The main challenges are reforming the tariff system and reducing fuel subsidies. Nauru Air Corporation, which operates Nauru Airlines, has improved its performance partly reflecting elevated passenger traffic linked to the Regional Processing Center. RONPHOS and NRC, which operate phosphate exporting and mining activities respectively, are reporting financial losses. The NRC is also responsible for land rehabilitation, sanitation, and road maintenance, which are community-service oriented activities. Eigigu Holdings Corporation has several subsidiaries including hotel, retail, and construction.

The governance and performance monitoring of SOEs remain a challenge. Responsibilities for specific SOEs are assigned to individual ministers, while government officials are prominent on SOE boards. There is no central unit for monitoring the performance of the SOE portfolio. Only Nauru Air Corporation and the NUC produce annual financial statements.

The authorities requested technical assistance (TA) from the Asian Development Bank to develop an SOE reform agenda. Based on preliminary TA recommendations, the priorities include: (1) Appointing Boards that are best suited to assist SOEs achieve their mandates, (2) Produce timely annual accounts, and (3) Hold the Board accountable for the SOEs' performance. The authorities should also consider an SOE reform policy that:

- Clarify why the government owns SOEs, establish unambiguous commercial mandate, and define a robust community service obligation framework;
- Appoint one minister responsible for all SOEs, and require all directors to be appointed through skill-based selection process;
- Establish an accountability framework that requires current audited accounts and forward-looking performance-based business plans;
- Define the role of an effective SOE ownership monitoring agency.

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Source: Asian Development Bank

23. Developing the financial sector. Staff welcomed the good progress made in developing the financial sector by setting up a Bendigo bank agency that has promoted financial inclusion by providing basic deposit-taking services on behalf of Bendigo Bank of Australia (Box 5). Compliance with the requirements of the Australian financial supervision authorities is important to maintain financial stability. Staff agreed that the inability to transfer funds to and from countries other than Australia has hampered the flow of remittances and forced some trade-related payments processed through informal channels, creating a challenge for customs verification. The authorities consider that Bendigo agency has implemented a sound know-your-customer framework and monitored money transfers. Nonetheless, staff emphasized that continued strengthening the Anti Money Laundering/Combating the Financing of Terrorism (AML/CFT) framework would help regain access to international transfer facilities. In addition, the authorities should expedite the steps in improving tax transparency to ensure that Nauru is not listed as a non-cooperative jurisdiction by G20.

Box 5. Bendigo Bank Agency

Since opening in June 2015, Bendigo agency is the first bank operating in Nauru for more than a decade. The other financial institution was Western Union, and most transactions on the island were cash-based. Bendigo runs as a special project under the Ministry of Finance and Bendigo and Adelaide Bank Limited of Australia (Bendigo Bank).

The agency provides basic financial services on behalf of Bendigo Bank, promoting financial inclusion in the country. The agency provides ATM access, checking, savings, and time deposits equivalent to those in Australia, but it does not extend loans or wealth-management products. Within 18 months, the number of accounts increased to more than 7,600 and the deposits grew to A$67million (about 50 percent of GDP) by end-2016. The agency aims to expand electronic payments provided the telecommunication network becomes more reliable. Another challenge on financial inclusion is limited financial literacy, partly due to prolonged cash-based economy during the past decade.

The agency indicated that it operates in accordance with the Australian financial regulation but it continues to face challenges in transferring funds internationally. The agency noted that it adheres to the Australian-standard AML/CFT requirements and the parent branch in Australia carries out regular internal audits. For example, it implements transaction monitoring by Bendigo's financial crimes department, which is in regular contact with Nauru's Financial Intelligence Unit. Nonetheless, the agency continues to face restrictions imposed by correspondence banks that prevent transferring funds to and from countries other than Australia.

24. Addressing health-related challenges. Although there is no food poverty, Nauru has high levels of hardship and vulnerability, inequality, and non-communicable diseases (NCDs) (Box 6). Public spending on health is relatively higher than those in other Pacific island countries, and the authorities should continue to protect public spending on health during the period of fiscal adjustments over the medium term.[7] Staff welcomed the completion of hospital development financed by grants, and recommended to ensure adequate funding for future maintenance including by seeking donor support. Nauru has recently adopted the NCD Strategic Action Plan 2015-20 to reduce NCD incidence over the medium term. In this context, the mission also encouraged them to prioritize spending towards preventive measures and strengthen the monitoring and evaluation of health-related spending in line with the 2014 Pacific NCD Roadmap.

[7] Government spending on health is about A$13 million (9 percent of GDP) in FY2016-17, while Australia provides additional funding up to A$5.5 million through various health programs.

Box 6. Nauru: Public Health Developments and Policies

The 2012–13 Household Income and Expenditure Survey indicates that Nauru has relatively high levels of hardship and vulnerability. The survey showed that 24 percent of the population have consumption levels below the national basic-needs poverty line (BNPL) and an additional 28.5 percent are classified as 'highly vulnerable' or 'vulnerable' to falling below this benchmark. Less than half of people aged 15–29 are employed and high proportion of the remainder (student, unemployed, or unpaid worker) live below the BNPL.

The survey also found that Nauru's inequality is high by global standards, and there appears to be a linkage between inequality and poor nutrition. For example, households in the bottom three deciles allocate a significantly higher proportion of their total food expenditure to imported and unhealthy food. Although there is no evidence of food poverty, poor nutrition is widespread. The high level of inequality and the reliance on unhealthy food imports, partly due to limited arable land, have contributed to high incidence of non-communicable diseases (NCDs).

Nauru has recently adopted the NCD Strategic Action Plan (2015–20) to reduce NCD incidence. The plan indicates that the prevalence of NCD risk factors (for example, poor diet, inactivity) in Nauru is among the highest in the world. To reduce these risk factors, the plan outlines action areas such as improving leadership and governance for NCD prevention and control, strengthening health systems, and improving monitoring and surveillance. The plan aims for a 15 percent reduction in NCD mortality rates by 2020.

Public health policies need to address the NCDs through multiple channels. Both the Nauru NCD strategy and the World Bank 2014 Pacific NCDs Roadmap emphasize a multi-sectoral approach and set out a number of affordable strategies to combat NCDs. These policies include: reducing consumption of unhealthy food; reallocating health resources toward prevention measures; and strengthening the evidence base to improve investment planning and program effectiveness.

Sources: The World Bank; *Nauru: Hardship and Poverty Report – Analysis of the 2012/13 Household Income and Expenditure Survey* by the Government of Nauru and UNDP; *Nauru NCD Strategic Action Plan (2015-20)* by the Government of Nauru.

25. The authorities' views. The authorities recognized the challenge in diversifying the economy and the importance of implementing structural reforms. They indicated that the estimated cost of the new seaport is larger than expected, partly due to climate-proofing, but remain cautiously optimistic in securing additional funding. While the privatization of fuel purchasing and distribution operations has provided more reliable supply and improved efficiency, the reform of public utilities will continue. The authorities agreed that SOE reform will reduce fiscal burdens and expected to start receiving dividends from the SOE profits. The operation of Bendigo agency has increased the level of financial inclusion, although the difficulties in transferring money to and from countries other than Australia remain a challenge. Health and education will continue to be their top priorities. They recognized the challenges, and shared some initiatives to address them, including developing the Nauru healthy household standard, establishing health centers for prevention measures across the island, and incorporating health issues in school curriculum.

OTHER ISSUES

26. Exchange arrangement. Nauru has accepted the obligations of Article VIII, Sections 2, 3, and 4, and there are no changes in the exchange arrangement since last year.

27. Statistics. Nauru's economic statistics have improved substantially although serious shortcomings remain. For example, the statistics compilation suffers from the lack of actual data, and the reliance on external support creates delays in data update and prevents timely analysis. In this context, the authorities requested further Fund TA on national accounts and balance of payments statistics, government financial statistics, and PFM. Staff urged the authorities to implement TA recommendations, strengthen data sharing among government institutions, publish data regularly, and participate in the IMF's enhanced General Data Dissemination System.

STAFF APPRAISAL

28. Recent developments. Growth and government revenue improved substantially in recent years owing to RPC operations, fishing license fees, and residual phosphate mining. The use of fiscal surpluses to build up fiscal buffers, contribute to the new trust fund, and clear some arrears is welcome. Despite its improved economic performance, Nauru faces daunting challenges in sustaining growth and ensuring fiscal sustainability due to limited sources of growth and income.

29. Outlook and risks. Economic activity is expected to moderate in the near term due to weakened phosphate recovery and limited RPC expansion. The medium-term outlook is vulnerable to the scaling down of the RPC as refugees are expected to be transferred to other countries, entailing a substantial decline in RPC revenue. With limited access to borrowing, fiscal spending would have to adjust accordingly. The outlook is also subject to downside risks including weaker-than-expected global growth, climate change, and delays in implementing fiscal and structural reforms.

30. Fiscal sustainability. Maintaining sufficient fiscal cash buffers while continuing to build the new trust fund with donors' support will be critical to ensure fiscal liquidity and sustainability. The authorities should continue to implement tax and PFM reforms to help control spending and support the needed fiscal adjustment, and strengthen public debt management to preserve fiscal and debt sustainability.

31. External sector policy. Prudent fiscal policy and successful implementation of structural reforms would help ensure external sustainability. The use of the Australian dollar as the legal tender remains appropriate.

32. Climate change. Nauru faces a number of long-term climate change challenges and developing a medium-term fiscal framework that would enhance economic resilience to climate change is important. Since this may take a number of years, the authorities could adopt practical approaches in the meantime to match capital projects in the pipeline with Nauru's climate change strategy, meet the climate proofing standards, and incorporate the projects in a multi-year budget plan.

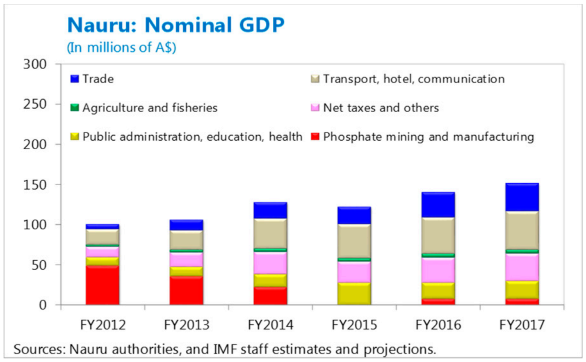
33. Structural reforms. Successful structural reforms will promote inclusive growth and provide opportunity for economic diversification and private sector development. The plan to build a new seaport and the improved performance of public utility company are welcome. The authorities should continue to reform the SOEs to strengthen their governance, transparency, and accountability. The return of banking services in Nauru has improved financial inclusion, and strengthening of AML/CFT and tax transparency frameworks would promote confidence and financial stability. The authorities would be well advised to continue addressing health-related challenges by maintaining adequate public spending on health and implementing the action plans to combat NCDs.

34. Statistics. Nauru's data quality has improved substantially in recent years, but it suffers from shortcomings that prevent timely analysis and hamper surveillance, and the statistical capacity remains weak. Technical assistance will continue to play an important role.

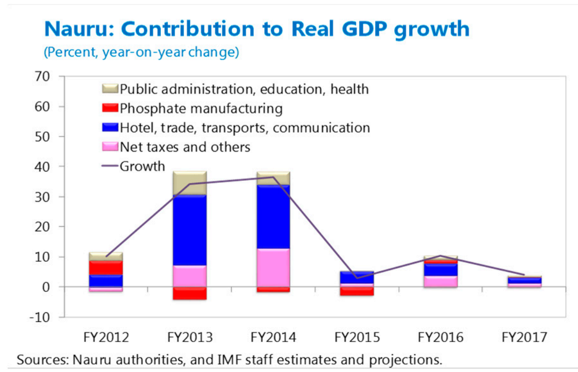
35. It is recommended that the next Article IV consultation take place on the 24-month cycle.

Figure 1. Nauru: Real and External Sector Developments

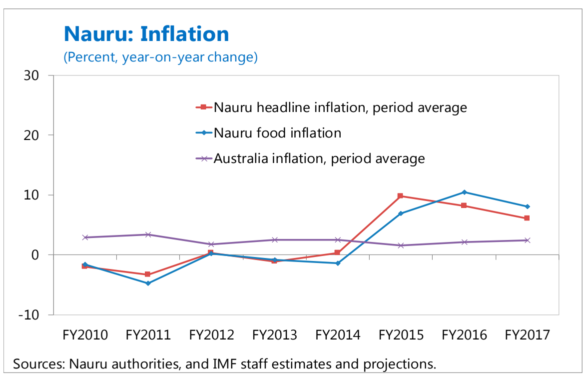
The economy expanded for the past five years driven by trade and service sectors related to the operation of the Regional Processing Center (RPC).



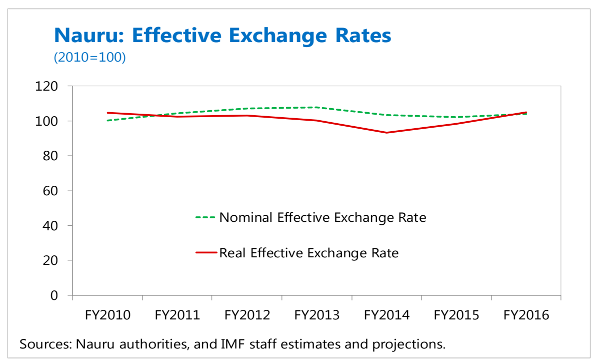
The services sectors have replaced the phosphate industry as the main source of growth.



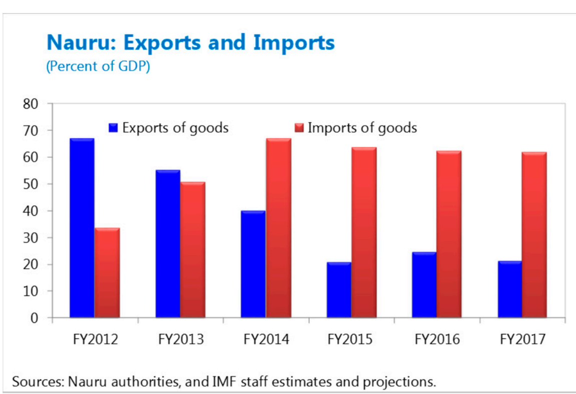
Inflation picked up during FY2015-16 owing to robust domestic demand, large cash payouts from the phosphate trust funds, and supply shortages due to seaport problems.



As a result, the real effective exchange rate increased to its 2010 level despite the depreciation of the Australian dollar.



Phosphate exports declined in FY2014/15 partly due to seaport problems, while imports remain strong owing to buoyant domestic demand and the RPC operation…



… but the current account balance has improved supported by large RPC-related inflows and fishing license fees.

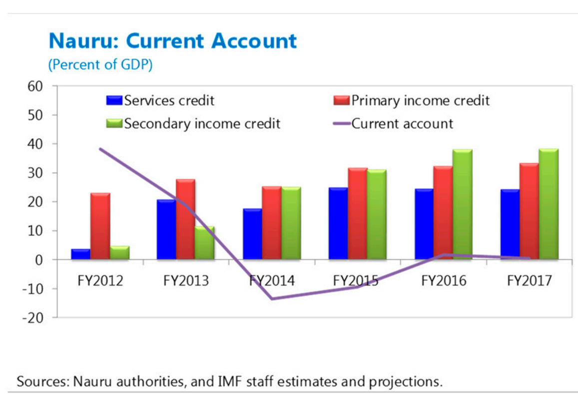
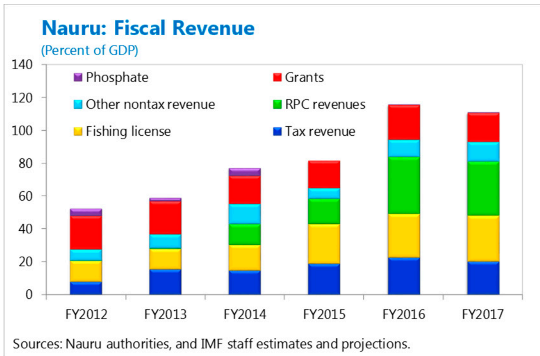


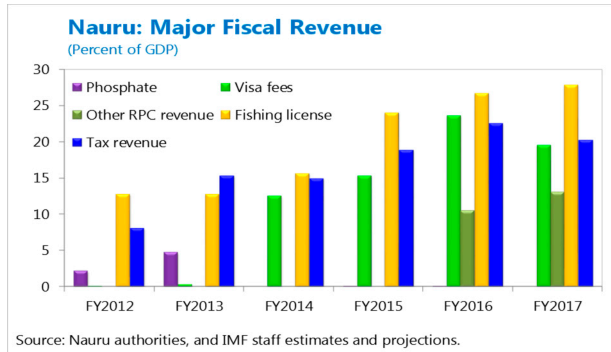
Figure 2. Nauru: Fiscal Sector Developments

Revenues have increased substantially for the past five years owing to …



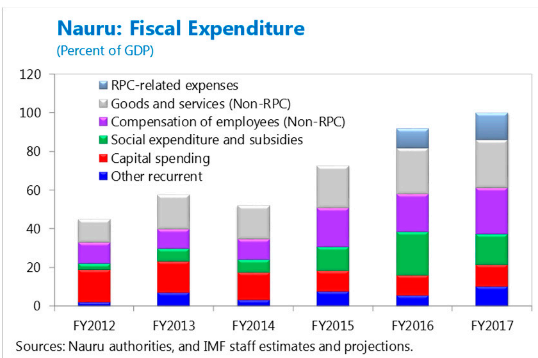
Sources: Nauru authorities, and IMF staff estimates and projections.

… large RPC-related revenues and fishing license fees, while phosphate-related revenues have diminished.



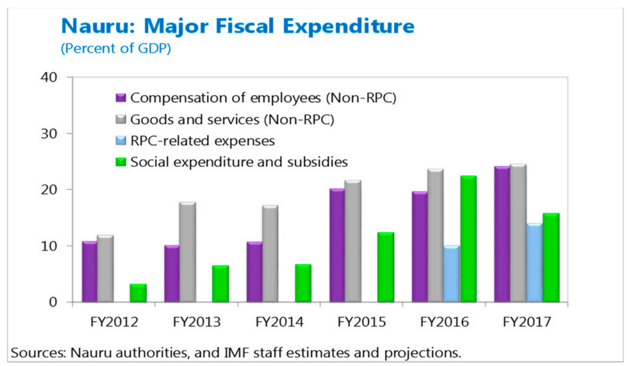
Source: Nauru authorities, and IMF staff estimates and projections.

Government spending has also increased rapidly since FY2015 …



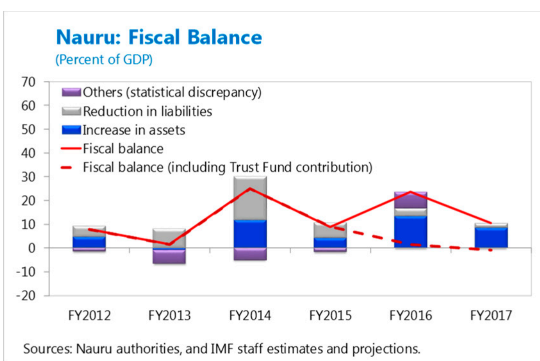
Sources: Nauru authorities, and IMF staff estimates and projections.

… driven by the wage bill in order to retain public sector employees, goods and services, and social expenditure.



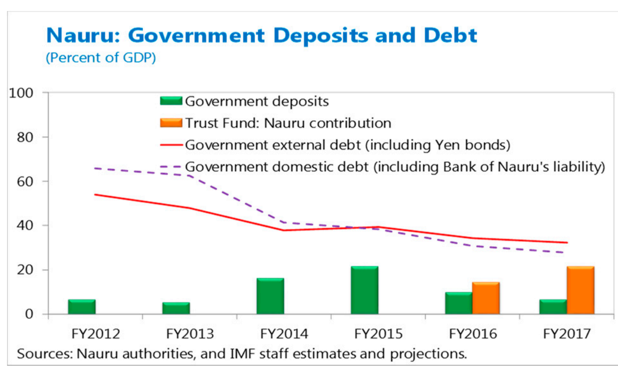
Sources: Nauru authorities, and IMF staff estimates and projections.

Despite large spending increase, the fiscal balance has recorded large surpluses that have been used to …



Sources: Nauru authorities, and IMF staff estimates and projections.

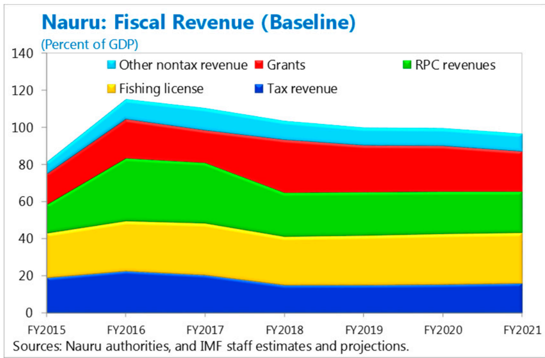
… build up government deposits, contribute to new Nauru trust fund, and reduce government debt by clearing arrears.



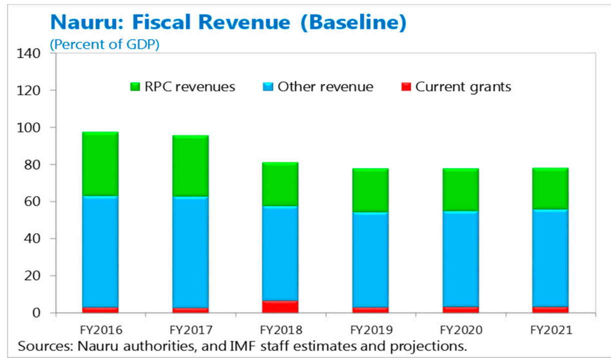
Sources: Nauru authorities, and IMF staff estimates and projections.

Figure 3. Nauru: Medium-term Fiscal Outlook

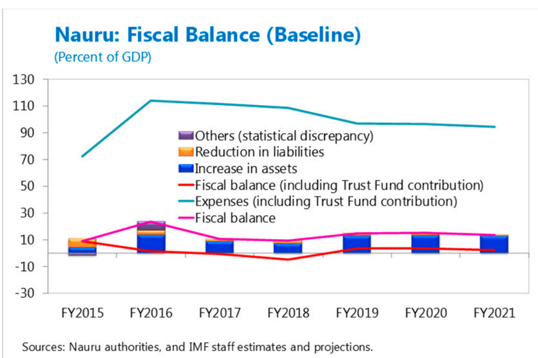
Fiscal revenues are projected to remain robust over the medium term driven by fishing license fees, tax collection, and grants, although the RPC revenue is …



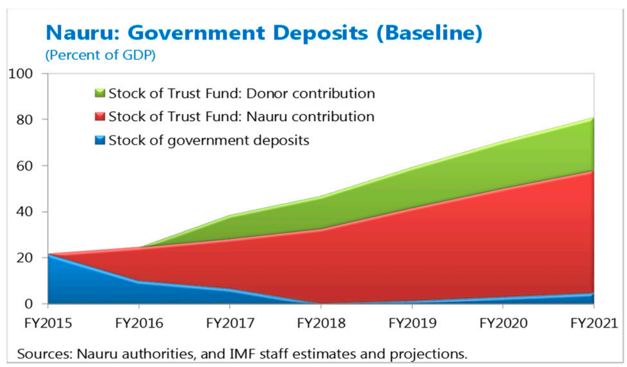
… projected to decline starting in FY2018 due to the resettlement of some refugees to other countries.



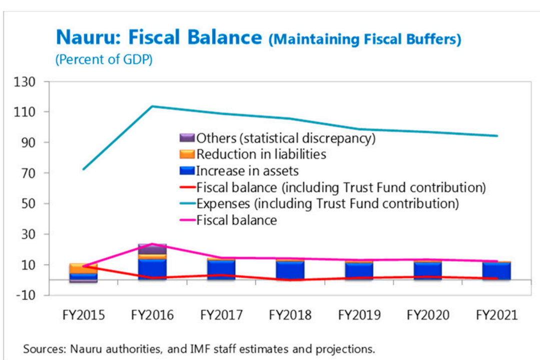
Without spending restraint, the fiscal surplus would be just enough to build the trust fund…



… but insufficient to maintain cash buffers over the medium term.



By controlling spending growth, starting from FY2017 when the RPC revenue remains high, …



…the cash buffers could be raised to provide fiscal space and ensure short-term liquidity.

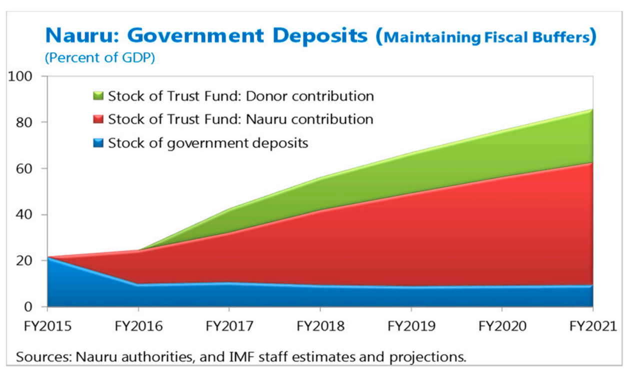
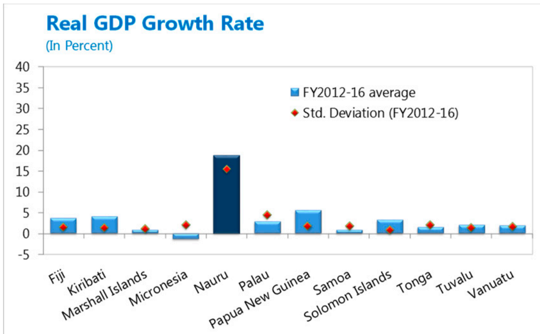


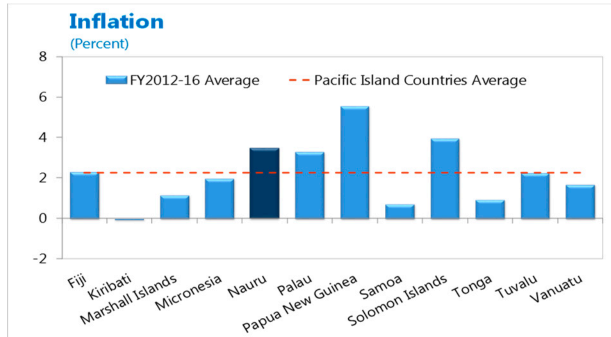
Figure 4. Nauru: Recent Economic Developments in the Regional Context

Nauru's growth over the past decade was stronger than peers, but it was also the most volatile due to its reliance on limited sectors.



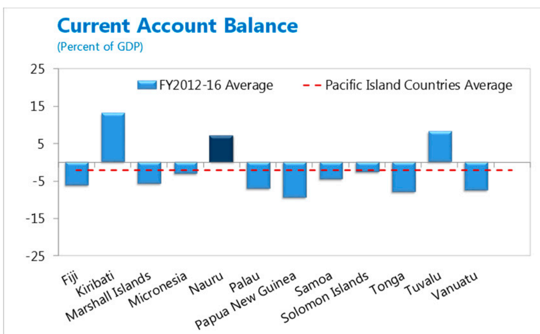
Sources: IMF World Economic Outlook, and staff estimates.

Nauru's inflation was above the Pacific average mainly due to the increase in inflation over the past two years.



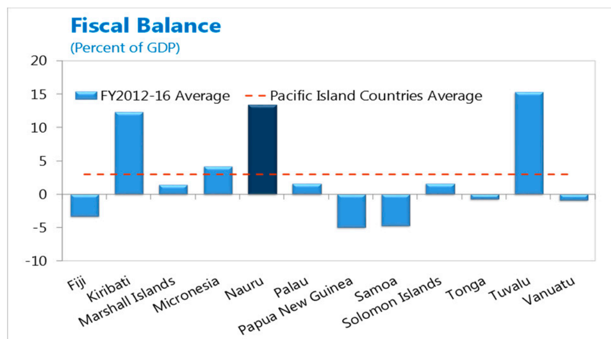
Sources: IMF World Economic Outlook, and staff estimates.

Nauru's strong economic performance over the past five years is reflected by relatively large current account surplus …



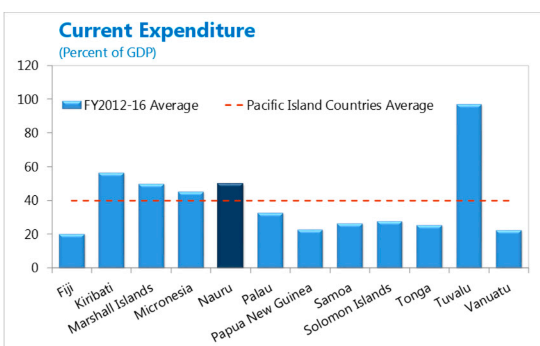
Sources: IMF World Economic Outlook, and staff estimates.

… and large fiscal surplus compared to other Pacific island countries.



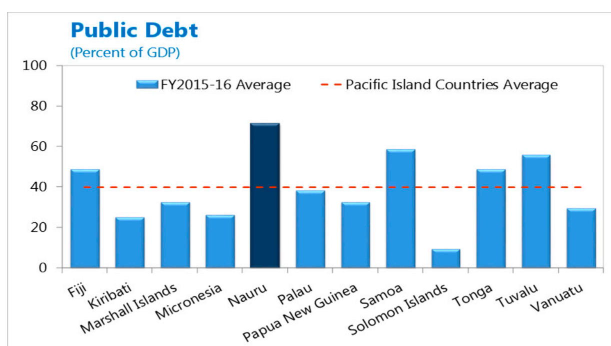
Sources: IMF World Economic Outlook, and staff estimates.

The government current expenditure is slightly above the Pacific average.



Sources: IMF World Economic Outlook, and staff estimates.

Nauru's public debt is relatively high compared to peers, although three quarters of it comprises of longstanding arrears.



Sources: IMF World Economic Outlook, and staff estimates.

Table 1. Nauru: Selected Social and Economic Indicators, FY2012–17 1/

I. Social and Demographic Indicators 2/

GDP (FY2015 est.) (in millions of Australian dollars)	120.1	Poverty rate	24 percent (2013)
Per capita GDP (FY2015 est.) (in Australian dollars)	9,631	Life expectancy at birth	60.4 years (2011)
Population (FY2015 est.)	12,475	Total fertility rate	4.3 births per woman (2011)
		Infant mortality rate	29.9 per 1,000 live births (2013)
		Adult literacy rate	96.5 (2011)

II. Economic Indicators

	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017
				Preliminary		Proj.
Real sector						
Real GDP growth (percent change)	10.1	34.2	36.5	2.8	10.4	4.0
Consumer price index (period average, percent change)	0.3	-1.1	0.3	9.8	8.2	6.0
Population (thousand)	10.3	10.8	11.9	12.5	13.0	13.3
			(In percent of total)			
Structure of the economy						
Agriculture	4.9	4.7	4.2	2.5	4.4	4.3
Manufacturing	49.2	35.3	20.9	6.6	11.7	11.6
Services	43.2	52.6	63.4	81.6	74.7	74.6
			(In percent of GDP)			
Government finance						
Total revenue and grants	52.6	58.9	76.8	81.2	115.2	110.3
Revenue	31.9	39.1	60.0	64.6	94.1	92.6
Grants	20.7	19.9	16.8	16.6	21.0	17.7
Total expenditure	44.7	57.4	51.8	72.3	91.6	99.9
Net lending (+) / borrowing (-)	7.9	1.5	25.0	8.9	23.5	10.4
Including Trust Fund contribution	7.9	1.5	25.0	8.9	1.5	-1.0
Stock of government deposits	6.7	5.5	16.3	21.5	9.9	6.7
Stock of Trust Fund	…	…	…	…	22.7	33.4
			(In millions of Australian dollars, unless otherwise indicated)			
Balance of payments						
Current account balance	38.4	19.9	-17.2	-11.4	2.4	0.8
(In percent of GDP)	38.1	18.8	-13.5	-9.5	1.7	0.5
Trade balance	33.8	4.6	-34.6	-51.6	-52.9	-61.5
Exports	67.4	58.2	50.7	25.0	34.4	32.0
Imports	33.6	53.6	85.3	76.5	87.3	93.5
Capital account balance	0.9	2.5	3.2	4.3	5.9	5.3
Financial accounts balance and other flows	39.2	22.3	-13.9	-7.1	8.3	6.1
Government debt indicators						
External debt 3/	54.4	50.8	48.1	47.2	48.1	48.9
(In percent of GDP)	54.0	48.0	37.7	39.3	34.3	32.4
Domestic debt 4/	66.1	66.1	52.5	46.1	42.9	41.9
(In percent of GDP)	65.6	62.4	41.2	38.4	30.6	27.8
External debt service	5.9	4.7	3.6	3.0	1.9	2.2
(In percent of exports of goods and services)	8.2	5.9	5.0	5.6	2.8	3.2
Exchange rates						
Australian dollar per U.S. dollar (period average)	0.97	0.98	1.09	1.20	1.37	…
Real Effective Exchange Rate (period average)	103.0	100.1	93.4	98.2	104.9	…
Nominal GDP (in millions of Australian dollars)	100.7	105.9	127.5	120.1	140.2	151.0
Nominal GNI (in millions of Australian dollars)	120.7	129.5	152.1	148.9	175.8	191.6
Nominal GNI per capita (in US dollars)	12,104	12,270	11,783	9,978	9,811	…

Sources: Nauru authorities and IMF staff estimates and projections.

1/ Nauru uses the Australian dollar as the legal tender, and the fiscal year ends in June.
2/ The social indicators are taken from United Nations Development Program and Secretariat of the Pacific Community.
3/ Including the defaulted Yen bonds.
4/ Including the estimated government liability related to Bank of Nauru's liquidation.

Table 2. Nauru: Illustrative Medium-term Baseline Scenario, FY2014–21 1/

	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021
		Preliminary				Proj.		
Real sector								
Real GDP growth (percent change)	36.5	2.8	10.4	4.0	-4.0	0.2	1.5	2.0
Consumer price index (period average, percent change)	0.3	9.8	8.2	6.0	2.0	2.0	2.0	2.0
				(In percent of GDP)				
Government finance								
Total revenue and grants	76.8	81.2	115.2	110.3	103.5	100.1	99.7	96.7
Total expenditure	51.8	72.3	91.6	99.9	94.5	85.2	84.7	83.2
Current expenditure	37.7	61.8	81.2	88.5	75.7	66.5	66.3	67.7
Net acquisition of non-financial assets	14.2	10.5	10.4	11.4	18.8	18.7	18.4	15.5
Net lending (+) / borrowing (-)	25.0	8.9	23.5	10.4	9.0	14.8	14.9	13.5
Including trust fund contribution	25.0	8.9	1.5	-1.0	-5.0	3.2	3.6	2.3
Stock of government deposits	16.3	21.5	9.9	6.7	0.0	1.3	3.0	4.5
Stock of Trust Fund	...	...	22.7	33.4	49.9	62.7	74.3	85.4
			(In millions of Australian dollars, unless otherwise indicated)					
Balance of payments								
Current account balance	-17.2	-11.4	2.4	0.8	-2.6	0.2	2.5	3.2
(In percent of GDP)	-13.5	-9.5	1.7	0.5	-1.8	0.1	1.6	2.0
Exports	50.7	25.0	34.4	32.0	32.2	32.6	32.5	33.2
Imports	85.3	76.5	87.3	93.5	93.2	93.8	94.8	95.7
Capital account balance	3.2	4.3	5.9	5.3	8.5	7.6	7.7	7.0
Financial accounts balance and other flows	-13.9	-7.1	8.3	6.1	5.8	7.8	10.2	10.2
Government debt indicators								
External debt 2/	48.1	47.2	48.1	48.9	49.6	50.6	51.8	54.9
(In percent of GDP)	37.7	39.3	34.3	32.4	33.8	34.0	33.8	34.5
Domestic debt 3/	52.5	46.1	42.9	41.9	40.9	39.9	38.9	37.9
(In percent of GDP)	41.2	38.4	30.6	27.8	27.9	26.8	25.4	23.9
External debt service	3.6	3.0	1.9	2.2	2.3	2.1	2.0	0.4
(In percent of exports of goods and services)	5.0	5.6	2.8	3.2	3.8	3.5	3.2	0.6
Exchange rates								
Australian dollar per U.S. dollar (period average)	1.09	1.20	1.37	...	...	...	...	...
Real Effective Exchange Rate (period average, 2010=100)	93.4	98.2	104.9	...	...	...	...	...
Nominal GDP (in millions of Australian dollars)	127.5	120.1	140.2	151.0	146.7	148.7	153.4	159.0
Nominal GNI (in millions of Australian dollars)	152.1	148.9	175.8	191.6	190.3	196.2	204.1	212.3

Sources: Nauru authorities and IMF staff estimates and projections.

1/ Nauru uses the Australian dollar as the legal tender, and the fiscal year ends in June.
2/ Including the defaulted Yen bonds.
3/ Including government liability related to Bank of Nauru's liquidation.

Table 3. Nauru: Balance of Payments, FY2012-21 1/

	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021
				Preliminary		Proj.				
				(In millions of Australian dollars)						
Current account balance	38.4	19.9	-17.2	-11.4	2.4	0.8	-2.6	0.2	2.5	3.2
Goods (f.o.b.)	33.8	4.6	-34.6	-51.6	-52.9	-61.5	-61.1	-61.3	-62.2	-62.5
Credit	67.4	58.2	50.7	25.0	34.4	32.0	32.2	32.6	32.5	33.2
Debit	33.6	53.6	85.3	76.5	87.3	93.5	93.2	93.8	94.8	95.7
Services balance	-13.6	-7.8	-29.9	-16.1	-21.3	-22.9	-30.6	-30.7	-30.9	-31.0
Credit	3.7	21.8	22.3	29.5	34.1	36.5	28.1	28.5	29.3	30.4
Debit	17.3	29.6	52.2	45.6	55.3	59.4	58.7	59.2	60.2	61.4
Primary income balance	20.0	23.6	24.7	28.7	35.6	40.6	43.6	47.4	50.7	53.3
Credit	23.0	29.2	32.1	38.0	45.1	50.1	51.4	55.4	58.8	61.6
Debit	3.0	5.6	7.4	9.3	9.5	9.5	7.8	8.0	8.1	8.4
Secondary income balance	-1.8	-0.5	22.6	27.5	41.0	44.5	45.5	44.8	44.9	43.5
Credit	4.6	12.1	32.0	37.2	53.1	57.6	58.2	57.6	58.2	57.2
Debit	6.4	12.6	9.3	9.6	12.1	13.1	12.7	12.9	13.3	13.8
Capital account balance	0.9	2.5	3.2	4.3	5.9	5.3	8.5	7.6	7.7	7.0
Credit	0.9	2.5	3.2	4.3	5.9	5.3	8.5	7.6	7.7	7.0
Debit	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net lending / borrowing	39.2	22.3	-13.9	-7.1	8.3	6.1	5.8	7.8	10.2	10.2
Financial account balance	35.0	17.7	2.3	9.9	19.1	6.1	5.8	7.8	10.2	10.2
Assets	31.9	16.2	1.2	9.7	20.0	16.7	12.4	24.0	26.9	28.7
Liabilities	-3.1	-1.6	-1.1	-0.2	0.9	10.6	6.6	16.2	16.7	18.5
Errors and omissions	-4.2	-4.6	16.3	17.0	10.8	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Nominal GDP	100.7	105.9	127.5	120.1	140.2	151.0	146.7	148.7	153.4	159.0
Current account balance (in percent of GDP)	38.1	18.8	-13.5	-9.5	1.7	0.5	-1.8	0.1	1.6	2.0
Stock of external assets	18.4	24.3	38.5	53.5	79.9	94.5	107.0	129.0	152.4	176.7
Government deposits	6.8	5.8	20.8	25.9	13.9	9.8	-0.4	1.5	4.1	6.6
Trust Fund	…	…	…	…	31.8	50.5	73.2	93.2	114.0	135.8
Others, including donor funds	11.6	18.5	17.7	27.7	34.2	34.2	34.2	34.2	34.2	34.2
Change in external assets	9.0	5.9	14.2	15.1	26.4	14.6	12.5	21.9	23.4	24.3
External debt (in millions of Australian dollars) 2/	54.4	50.8	48.1	47.2	48.1	48.9	49.6	50.6	51.8	54.9
Medium-and long-term debt	46.4	43.1	40.9	40.4	41.3	42.8	43.9	45.3	46.9	50.1
Informal debt (overdue fees and obligations)	7.9	7.7	7.2	6.9	6.9	6.1	5.6	5.3	5.0	4.7
External debt service	5.9	4.7	3.6	3.0	2.0	2.2	2.3	2.1	2.0	0.4
Principal	4.6	3.7	2.8	2.4	1.5	1.7	2.0	1.9	1.8	0.2
Interest	1.3	1.0	0.8	0.6	0.5	0.5	0.4	0.3	0.2	0.1
International Investment Position	105.1	126.4	116.4	121.6	138.2	152.1	161.0	180.7	202.5	223.7
Assets	164.1	182.8	170.7	175.6	193.1	207.7	217.3	238.0	261.0	285.3
Liabilities	59.0	56.4	54.3	54.0	54.8	55.6	56.3	57.3	58.5	61.6

Sources: Nauru authorities and IMF staff estimates and projections.

1/ The fiscal year ends in June.

2/ Including the defaulted Yen bonds.

Table 4. Nauru: Central Government Operations, FY2012-21 1/

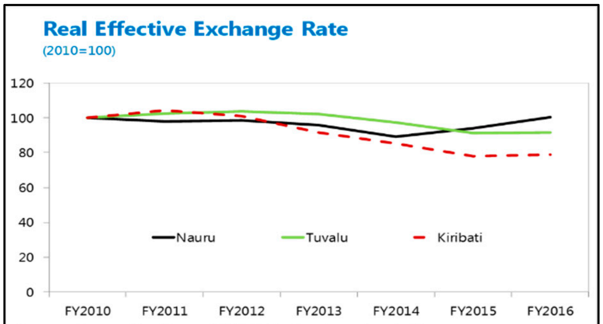
	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017		FY2018	FY2019	FY2020	FY2021
				Preliminary		Budget	Proj.		Proj.		
	(In millions of Australian dollars)										
Total revenue and grants	52.9	62.4	97.9	97.6	161.4	160.0	166.6	151.8	148.8	152.9	153.7
Revenue	32.1	41.4	76.5	77.7	131.9	138.5	139.8	109.6	111.1	114.6	118.9
Of which : RPC revenue 2/	...	...	24.0	30.7	54.1	...	50.1	34.6	34.2	34.9	35.3
Tax revenue	8.1	16.2	19.0	22.6	31.6	28.4	30.6	21.8	22.4	23.7	25.3
Nontax revenue	24.0	25.2	57.5	55.1	100.4	110.1	109.2	87.8	88.7	90.9	93.5
Of which: Fishing license fees	12.8	13.5	19.9	28.9	37.4	42.1	42.1	38.4	39.7	41.4	43.3
Visa fees	0.1	0.3	16.0	18.4	33.1	29.6	29.6	19.8	19.8	19.8	19.8
Grants	20.8	21.0	21.4	19.9	29.5	21.5	26.7	42.3	37.8	38.3	34.9
Budget support (current)	4.0	4.0	3.4	7.3	4.4	4.3	4.3	9.5	4.7	4.9	5.1
Development fund (capital)	16.8	17.0	18.1	12.6	14.6	17.2	17.2	27.5	27.9	28.2	24.6
Trust fund: Donor contribution	...	...	...	...	10.5	...	5.2	5.2	5.2	5.2	5.2
Expenditure	45.0	60.8	66.0	86.9	128.5	152.6	150.8	138.6	126.8	130.0	132.2
Expenses	28.2	43.8	48.0	74.3	113.8	135.4	133.7	111.1	98.9	101.8	107.7
Of which : Non-RPC expenses	...	...	48.0	68.3	97.2	107.5	105.8	90.3	78.0	80.7	86.4
Compensation of employees	10.9	10.7	13.7	24.2	33.9	49.5	49.5	42.9	43.1	44.0	45.6
Goods and services	12.0	18.8	21.9	26.0	40.8	45.8	45.3	40.3	34.7	35.8	37.1
Social expenditure	2.6	4.7	7.6	11.7	20.5	14.5	14.4	13.5	13.2	13.6	14.1
Subsidies and donations	0.7	2.2	1.0	3.2	11.0	9.4	9.4	5.8	3.6	3.7	3.8
Other	2.0	7.4	3.9	9.1	7.6	16.1	15.0	8.6	4.3	4.8	7.0
Net acquisition of non-financial assets	16.8	17.0	18.1	12.6	14.6	17.2	17.2	27.5	27.9	28.2	24.6
Net lending (+) / borrowing (-)	7.9	1.6	31.8	10.7	33.0	7.4	15.7	13.2	22.1	22.9	21.5
Including trust fund contribution	7.9	1.6	31.8	10.7	2.1	-4.5	-1.4	-7.4	4.8	5.5	3.6
Net financing	7.9	1.6	31.8	10.7	33.0	7.4	15.7	13.2	22.1	22.9	21.5
Net acquisition of financial assets	4.7	-1.0	15.0	5.1	18.9	6.4	13.0	10.3	19.2	20.1	20.3
Changes in government deposit	4.7	-1.0	15.0	5.1	-12.0	-5.5	-4.2	-10.3	1.9	2.7	2.4
Trust fund: Nauru contribution	0.0	0.0	0.0	0.0	20.4	11.9	11.9	15.4	12.1	12.2	12.6
Trust fund: Donor contribution	...	...	...	...	10.5	...	5.2	5.2	5.2	5.2	5.2
Net incurrence of financial liabilities	-4.6	-8.5	-23.3	-7.6	-4.6	-1.0	-2.7	-3.0	-2.9	-2.8	-1.2
Statistical discrepancy	-1.4	-6.0	-6.4	-2.0	9.4	0.0	0.0	0.0	0.0	0.0	0.0
	(In percent of GDP)										
Total revenue and grants	52.6	58.9	76.8	81.2	115.2	105.9	110.3	103.5	100.1	99.7	96.7
Revenue	31.9	39.1	60.0	64.6	94.1	91.7	92.6	74.7	74.7	74.7	74.8
Of which : RPC revenue 2/	...	...	18.8	25.5	38.6	...	33.2	23.6	23.0	22.7	22.2
Tax revenue	8.1	15.3	14.9	18.8	22.5	18.8	20.3	14.9	15.0	15.4	15.9
Nontax revenue	23.8	23.8	45.1	45.8	71.6	72.9	72.3	59.8	59.6	59.3	58.8
Grants	20.7	19.9	16.8	16.6	21.0	14.2	17.7	28.8	25.4	25.0	21.9
Expenditure	44.7	57.4	51.8	72.3	91.6	101.0	99.9	94.5	85.2	84.7	83.2
Expenses	28.0	41.3	37.7	61.8	81.2	89.7	88.5	75.7	66.5	66.3	67.7
Of which : Non-RPC expenses	...	...	37.7	56.8	69.4	71.2	70.0	61.6	52.4	52.6	54.4
Compensation of employees	10.8	10.1	10.7	20.2	24.2	32.8	32.8	29.3	29.0	28.7	28.7
Goods and services	11.9	17.7	17.1	21.7	29.1	30.4	30.0	27.4	23.3	23.3	23.3
Social expenditure	2.6	4.4	6.0	9.8	14.6	9.6	9.6	9.2	8.9	8.9	8.9
Subsidies and donations	0.7	2.1	0.8	2.7	7.9	6.2	6.2	3.9	2.4	2.4	2.4
Other	2.0	7.0	3.0	7.6	5.4	10.7	10.0	5.9	2.9	3.1	4.4
Net acquisition of non-financial assets	16.7	16.1	14.2	10.5	10.4	11.4	11.4	18.8	18.7	18.4	15.5
Net lending (+) / borrowing (-)	7.9	1.5	25.0	8.9	23.5	4.9	10.4	9.0	14.8	14.9	13.5
Including trust fund contribution	7.9	1.5	25.0	8.9	1.5	-3.0	-1.0	-5.0	3.2	3.6	2.3
Net acquisition of financial assets	4.7	-0.9	11.8	4.2	13.5	4.2	8.6	7.0	12.9	13.1	12.7
Net incurrence of financial liabilities	-4.5	-8.1	-18.3	-6.3	-3.3	-0.7	-1.8	-2.0	-1.9	-1.8	-0.8
Statistical discrepancy	-1.3	-5.7	-5.0	-1.6	6.7	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:											
Nominal GDP (in millions of Australian dollars)	100.7	105.9	127.5	120.1	140.2	151.0	151.0	146.7	148.7	153.4	159.0
Non-RPC balance (in percent of GDP) 3/	...	...	6	-12	-21.2	...	-20.8	-14.0	-7.6	-7.3	-8.2
Stock of government deposit	6.8	5.8	20.8	25.9	13.9	...	10.1	0.1	1.9	4.7	7.2
In percent of GDP	6.7	5.5	16.3	21.5	9.9	...	6.7	0.0	1.3	3.0	4.5
In months of non-RPC current spending	2.9	1.6	5.2	4.5	1.7	...	1.1	0.0	0.3	0.7	1.0
Stock of Trust Fund	...	...	...	...	31.8	...	50.5	73.2	93.2	114.0	135.8
In percent of GDP	...	...	...	...	22.7	...	33.4	49.9	62.7	74.3	85.4
Stock of government debt (percent of GDP) 4/	119.6	110.4	79.0	77.7	65.0	...	60.1	61.7	60.8	59.1	58.4
External debt	54.0	48.0	37.7	39.3	34.3	...	32.4	33.8	34.0	33.8	34.5
Domestic debt	65.6	62.4	41.2	38.4	30.6	...	27.8	27.9	26.8	25.4	23.9

Sources: Nauru authorities and IMF staff estimates and projections.

1/ The fiscal year ends in June.
2/ Excluding reimbursement for RPC expenses
3/ Non-RPC revenue plus current grants or budget support minus non-RPC expenses.
4/ Including the defaulted Yen bond and the government's liability to Bank of Nauru's liquidation.

Appendix I. External Sustainability Assessment

Real Effective Exchange Rate (REER). Nauru is using the Australian dollar as the legal tender. Nauru's REER depreciated by nearly 10 percent in FY2013-14 following the Australian dollar, and then appreciated by 12 percent during FY2015-16 due to inflation. This recent appreciation marks the deviation from the trend of REER in other Pacific island countries that use the Australian dollar as legal tender. The EBA lite assessment suggests that the REER is moderately stronger, or the external balance weaker, than implied by fundamentals due to elevated inflation. Nonetheless, the REER plays a limited role in determining external sustainability since the current account balance is mostly driven by exogenous factors such as the RPC operation, fishing license fees, well-functioning seaport, and donor inflows.



Sources: Nauru authorities, and IMF staff estimates and projections.

Nauru: Real Exchange Rate (RER) Assessments
(EBA-Lite approaches, FY2016, in percent)

Approaches		ER Misalignment
Current Account (CA) Model		5.6
Underlying CA	1.7	
CA Norm	3.2	
CA Gap	-1.5	
External Sustainability (Scenario 1)		4.9

Ensuring external sustainability. Without monetary and exchange rate policies, Nauru relies on fiscal policies and structural reforms to ensure external sustainability. The strong fiscal performance in recent years has raised government deposits to about A$34 million (4 months of non-RPC spending) in FY2016, including trust fund contribution of about A$20 million. Over the medium term, maintaining prudent fiscal policy is critical to ensure fiscal and external sustainability. In line with fiscal policy recommendations, Nauru should continue to build up the trust fund and maintain fiscal cash buffers of about 2 months of non-RPC spending. Containing the growth of current spending, particularly the wage bill, will help control inflation and lower the REER. Despite the expected decline in RPC-inflows, the current account is projected to remain sustainable thanks to lower imports, larger grant disbursements, the projected fiscal surplus, and continued build-up of Nauru trust fund. Successful implementation of structural reforms is also important to improve competitiveness and external balance. Rebuilding the seaport and improving utility infrastructure would prevent supply shortages and reduce costs, while reforming state owned enterprises would improve their efficiencies and help preserve fiscal sustainability.

Appendix II. Risk Assessment Matrix 1/

Likelihood and Sources of Risk	Potential Impact	Policies to Minimize Impact
Weaker than expected global growth: (1) **Low-Medium**. Significant China slowdown and its spillovers; (2) **High/Medium**. Structurally weak growth in key advanced and emerging economies.	**Medium.** Slower global growth and reduced demand in Asia and the Pacific could reduce Nauru's phosphate exports, fiscal revenues, and remittances, although a weak Australian dollar would help improve Nauru's competitiveness.	Expedite infrastructure spending financed by donors to address infrastructure bottlenecks, stimulate domestic demand in the short term, and generate employment. Accelerate structural fiscal reforms to help preserve fiscal sustainability.
Medium. Global climate change.	**High.** Extreme weather conditions could damage the seaport and other infrastructure, hampering trade and growth. Global climate change could lead to relocation of tuna stock, reducing revenues from fishing license. Coping with climate-change effects would further strain the budget.	Enhance ex-ante adaptation measures (improving infrastructure, fiscal buffers, and planning), improve ex-post disasters management, and seek global/regional climate-change financing opportunities.
Medium. Changes in the Australian policy on the Regional Processing Center (RPC) in Nauru.	**High**. Policy changes that lead to more rapid process the RPC scaling down would reduce growth and fiscal revenues. On the upside, a slower process or larger grant disbursements from Australia would provide some policy space to minimize its adverse impact on the economy.	Maintain prudent fiscal policy and build sufficient fiscal buffers to minimize the adverse impact on growth and mobilize donor support if needed. Accelerate structural reforms and expedite the implementation of grant-financed infrastructure projects to support growth.
Medium. Delays in fiscal reforms.	**High**. Delays in implementing tax and public financial management reforms would jeopardize fiscal sustainability.	Seek technical assistance from donors, and monitor the reform progress on a regular basis in consultation with development partners.
Medium. Delays in implementing structural reforms.	**High**. Delays in implementing infrastructure projects and reforming state owned enterprises would lower growth prospect and threaten fiscal sustainability.	Work with development partners to prioritize reform agenda, project selection and implementation, and improve business climate to stimulate private sector development.

1/ 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 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 between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. "Short term" and "medium term" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.

Appendix III. Debt Sustainability Analysis (DSA)

Nauru's public debt. During the economic downturn in the 1990s-2000s, Nauru defaulted on most of its public debt and accumulated arrears. Since FY2012, the economic situation has improved substantially, and the government has been using fiscal surpluses to accumulate deposits and clear some domestic arrears. The reconciliation of external and domestic public debt is ongoing, and the latest data in June 2016 show that the total public debt is estimated at about A$91 million (65 percent of GDP). External public debt is estimated at A$48 million (34 percent of GDP), mostly comprising of loans from Taiwan Province of China, overdue membership obligations to international organizations, and the defaulted Yen bonds in the 1990s. The estimated value of the Yen bonds is subject to negotiations with bond holders. Domestic debt is estimated at A$43 million (31 percent of GDP), mostly unpaid deposits related to Bank of Nauru's liquidation.

Medium-term outlook. Nauru's medium-term outlook is vulnerable to the RPC scaling down as the refugees would be transferred to other countries, entailing a substantial decline in RPC revenue. With limited access to borrowing, Nauru is not expected to tap substantial amount of new borrowing for financing, and fiscal spending will have to adjust accordingly. Under this baseline scenario, total public debt would decline to about 58 percent of GDP. The stock of public debt would be lower over the medium term if the ongoing negotiation with creditors, such as the Yen bonds holders, would be able to reduce the amount of Nauru's longstanding arrears. The results of the DSA (below) indicate that Nauru's public debt is sustainable over the medium term.

Policy implications. Maintaining prudent fiscal policy by contributing to the trust fund and preserving sufficient cash buffers will be critical to ensure fiscal and debt sustainability. Since most of Nauru's debt is in the form of long-standing arrears, continued good-faith negotiations with creditors could lower debt levels, reduce uncertainty, and help regain access to credit markets. Developing capacity to reconcile and manage debt, and to analyze debt sustainability will be important before taking on new public debt.[1]

[1] The authorities plan to recognize the Nauru Phosphate Royalty Trust (NPRT) losses during the 1980s-2000s as public debt to landowners although the details including the repayment plan remain unclear. Since the amount could be potentially large and subject to reconciliation and negotiations between the government and landowners, the mission and the authorities agreed that any future plan to convert the NPRT losses into government debt should be considered carefully in order to preserve Nauru's debt sustainability.

Nauru: External Debt Sustainability Framework, 2012–2022

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2012	2013	2014	2015	2016			2017	2018	2019	2020	2021	2022	**Debt-stabilizing non-interest current account 6/**
	54.0	48.0	37.7	39.3	34.3			**32.4**	**33.8**	**34.0**	**33.8**	**34.5**	**35.9**	**15.8**
Change in external debt	-26.7	-6.0	-10.2	1.6	-5.0			-2.0	1.4	0.2	-0.2	0.7	1.4	
Identified external debt-creating flows (4+8+9)	-54.3	-15.6	-48.4	20.6	22.1			12.0	20.5	15.5	13.9	13.8	14.2	
Current account deficit, excluding interest payments	-39.4	-19.7	12.9	9.0	-2.1			-0.8	1.5	-0.3	-1.7	-2.1	-2.3	
Deficit in balance of goods and services	-20.0	3.0	50.6	56.3	52.9			55.9	62.5	61.8	60.7	58.8	57.6	
Exports	70.6	75.5	57.3	45.4	48.8			45.4	41.1	41.0	40.3	40.0	39.4	
Imports	50.6	78.6	107.8	101.7	101.8			101.2	103.6	102.9	101.0	98.8	97.0	
Net non-debt creating capital inflows (negative)	7.9	5.6	-58.5	4.9	24.5			13.8	17.4	15.7	16.1	16.5	17.0	
Automatic debt dynamics 1/	-22.9	-1.4	-2.8	6.7	-0.2			-0.9	1.6	0.1	-0.4	-0.6	-0.6	
Contribution from nominal interest rate	1.3	1.0	0.6	0.5	0.4			0.3	0.2	0.2	0.1	0.1	0.1	
Contribution from real GDP growth	-5.7	-17.7	-16.3	-1.2	-4.0			-1.2	1.4	-0.1	-0.5	-0.7	-0.7	
Contribution from price and exchange rate changes 2/	-18.4	15.3	12.8	7.5	3.4			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	27.7	9.5	38.2	-19.0	-27.1			-14.0	-19.1	-15.3	-14.2	-13.1	-12.8	
External debt-to-exports ratio (in percent)	76.4	63.5	65.9	86.7	70.3			71.3	82.3	82.9	83.7	86.3	91.2	
Gross external financing need (in billions of US dollars) 4/	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
in percent of GDP	-32.3	-14.4	16.3	12.0	-0.3	7-Year	7-Year	1.0	3.4	1.3	-0.4	-1.8	-2.0	
Scenario with key variables at their historical averages 5/								**32.4**	**-3.6**	**-30.3**	**-51.8**	**-69.3**	**-83.6**	**10.5**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	10.1	34.2	36.5	2.8	10.4	17.0	13.0	4.0	-4.0	0.2	1.5	2.0	2.0	
GDP deflator in US dollars (change in percent)	29.6	-22.1	-21.1	-16.5	-7.9	-1.1	23.0	7.2	0.4	1.0	1.3	1.0	1.6	
Nominal external interest rate (in percent)	2.3	1.9	1.4	1.2	1.0	1.9	0.8	1.0	0.7	0.5	0.3	0.3	0.2	
Growth of exports (US dollar terms, in percent)	79.7	11.8	-18.3	-32.0	9.4	11.7	44.8	3.5	-12.8	1.2	1.1	2.1	2.0	
Growth of imports (US dollar terms, in percent)	18.6	62.4	47.9	-19.1	1.7	27.0	43.1	10.9	-1.4	0.6	1.0	0.7	1.7	
Current account balance, excluding interest payments	39.4	19.7	-12.9	-9.0	2.1	16.8	24.2	0.8	-1.5	0.3	1.7	2.1	2.3	
Net non-debt creating capital inflows	-7.9	-5.6	58.5	-4.9	-24.5	-0.5	26.9	-13.8	-17.4	-15.7	-16.1	-16.5	-17.0	

II. Stress Tests for External Debt Ratio							**Debt-stabilizing non-interest current account 6/**
A. Alternative Scenarios							
A1. Key variables are at their historical averages in 2017-2022 4/	**32.4**	**-3.6**	**-30.3**	**-51.8**	**-69.3**	**-83.6**	**10.5**
B. Bound Tests							
B1. Nominal interest rate is at historical average plus one standard deviation	**32.4**	**33.9**	**34.3**	**34.2**	**35.0**	**36.5**	**16.0**
B2. Real GDP growth is at historical average minus one standard deviations	**32.4**	**36.1**	**38.9**	**41.7**	**46.1**	**52.1**	**25.5**
B3. Non-interest current account is at historical average minus one standard deviations	**32.4**	**45.9**	**58.1**	**69.4**	**81.2**	**93.2**	**14.0**
B4. Combination of B1-B3 using 1/2 standard deviation shocks	**32.4**	**41.0**	**48.7**	**56.1**	**64.7**	**74.2**	**20.1**
B5. One time 30 percent real depreciation in 2017	**32.4**	**48.5**	**48.8**	**48.5**	**49.5**	**51.6**	**22.9**

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

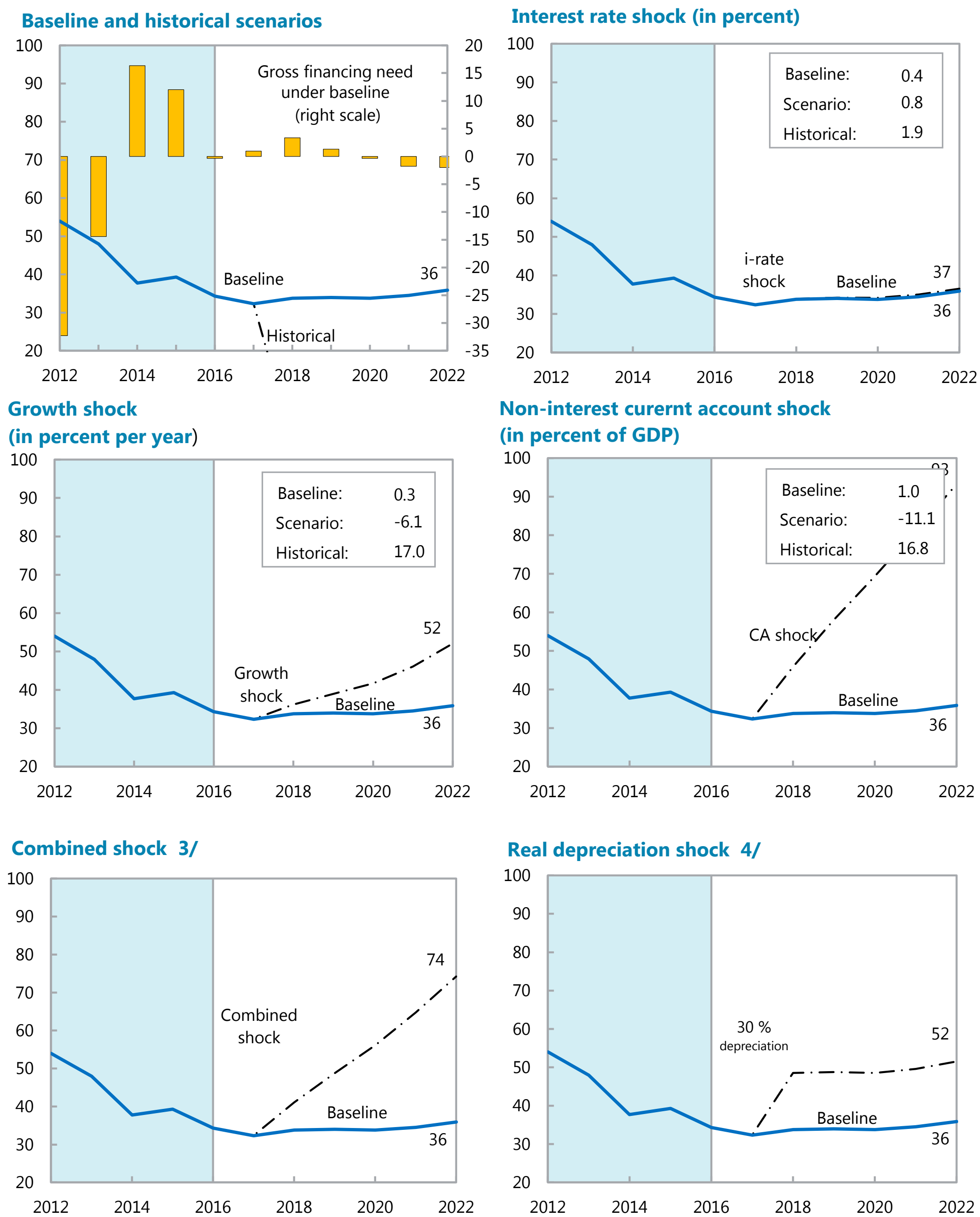
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Nauru: External Debt Sustainability: Bound Tests 1/ 2/

(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2017.

Nauru Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario

(In percent of GDP unless otherwise indicated)

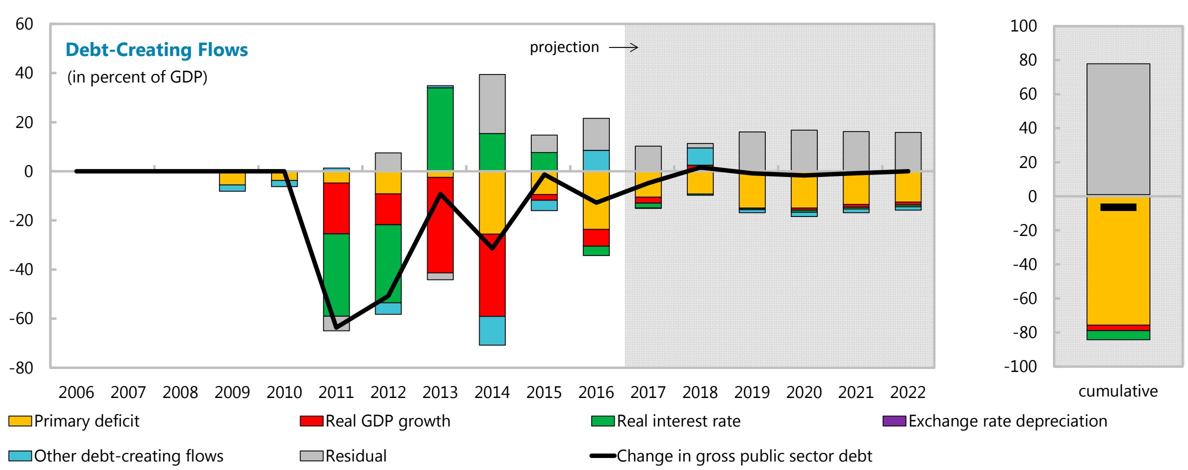
Debt, Economic and Market Indicators 1/

	Actual			Projections					
	2011-2014 2/	2015	2016	2017	2018	2019	2020	2021	2022
Nominal gross public debt	119.8	77.7	65.0	60.1	61.7	60.9	59.3	58.5	58.5
Of which: guarantees	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Public gross financing needs	-0.3	-2.6	-20.3	-8.6	-7.0	-12.9	-13.0	-12.6	-11.7
Real GDP growth (in percent)	23.1	2.8	10.4	4.0	-4.0	0.2	1.5	2.0	2.0
Inflation (GDP deflator, in percent)	2.2	-8.3	5.7	3.6	1.2	1.2	1.6	1.6	1.6
Nominal GDP growth (in percent)	23.5	-5.7	16.7	7.7	-2.9	1.4	3.1	3.6	3.6
Effective interest rate (in percent) 4/	1.0	0.6	0.6	0.5	0.4	0.3	0.3	0.3	0.3

As of January 31, 2017		
Sovereign Spreads		
EMBIG (bp) 3/		n.a.
5Y CDS (bp)		n.a.
Ratings	Foreign	Local
Moody's	n.a.	n.a.
S&Ps	n.a.	n.a.
Fitch	n.a.	n.a.

Contribution to Changes in Public Debt

	Actual			Projections							
	2011-2014	2015	2016	2017	2018	2019	2020	2021	2022	cumulative	debt-stabilizing primary balance 9/
Change in gross public sector debt	-38.7	-1.3	-12.8	-4.8	1.6	-0.8	-1.6	-0.7	0.0	-6.4	
Identified debt-creating flows	-44.4	-8.3	-25.8	-15.1	-0.2	-16.9	-18.4	-16.9	-15.8	-83.3	
Primary deficit	-10.5	-9.4	-23.6	-10.5	-9.3	-15.0	-15.0	-13.5	-12.5	-75.7	-3.3
Primary (noninterest) revenue and grants	57.8	81.2	114.9	110.1	103.5	100.0	99.6	96.6	94.5	604.3	
Primary (noninterest) expenditure	47.3	71.8	91.3	99.6	94.3	85.1	84.6	83.1	82.0	528.6	
Automatic debt dynamics 5/	-30.4	5.3	-10.7	-4.4	2.0	-0.7	-1.7	-1.9	-1.9	-8.5	
Interest rate/growth differential 6/	-30.4	5.3	-10.7	-4.4	2.0	-0.7	-1.7	-1.9	-1.9	-8.5	
Of which: real interest rate	-4.0	7.7	-3.8	-2.0	-0.5	-0.5	-0.8	-0.8	-0.8	-5.3	
Of which: real GDP growth	-26.4	-2.4	-6.9	-2.4	2.5	-0.1	-0.9	-1.2	-1.1	-3.2	
Exchange rate depreciation 7/	0.0	0.0	0.0	...	...	...	...	...	...	...	
Other identified debt-creating flows	-3.6	-4.2	8.6	-0.2	7.1	-1.3	-1.7	-1.5	-1.4	0.9	
Fiscal: Net acquisition of financial assets	-3.6	-4.2	8.6	2.8	7.1	-1.3	-1.7	-1.5	-1.4	3.9	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euroare	0.0	0.0	0.0	-3.0	0.0	0.0	0.0	0.0	0.0	-3.0	
Residual, including asset changes 8/	5.7	7.1	13.0	10.3	1.8	16.1	16.7	16.2	15.9	76.9	



Source: IMF staff.

1/ Public sector is defined as central government and includes public guarantees, defined as Arrears.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as $-g$.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

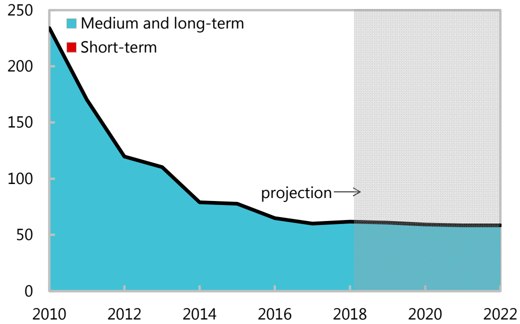
8/ Includes changes in the stock of guarantees, asset changes, and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

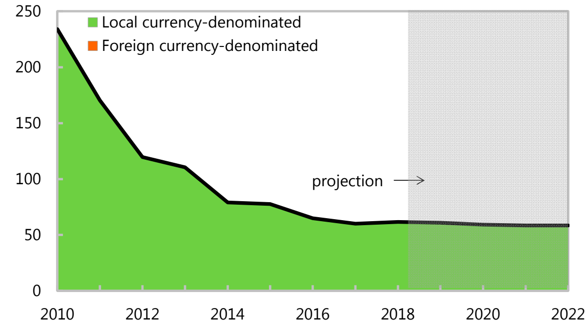
Nauru Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



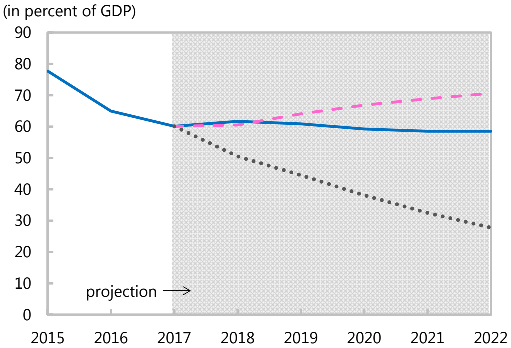
By Currency
(in percent of GDP)



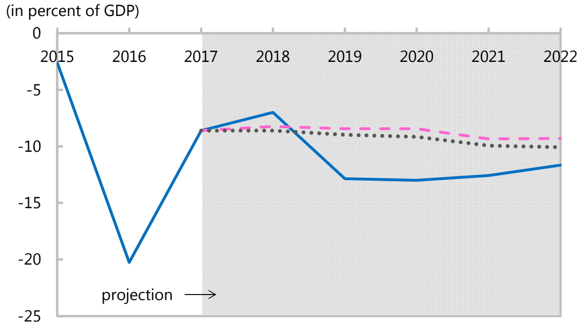
Alternative Scenarios

Baseline   Historical   Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

Baseline Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	4.0	-4.0	0.2	1.5	2.0	2.0
Inflation	3.6	1.2	1.2	1.6	1.6	1.6
Primary Balance	10.5	9.3	15.0	15.0	13.5	12.5
Effective interest rate	0.5	0.4	0.3	0.3	0.3	0.3
Constant Primary Balance Scenario						
Real GDP growth	4.0	-4.0	0.2	1.5	2.0	2.0
Inflation	3.6	1.2	1.2	1.6	1.6	1.6
Primary Balance	10.5	10.5	10.5	10.5	10.5	10.5
Effective interest rate	0.5	0.4	0.3	0.3	0.4	0.4

Historical Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	4.0	13.7	13.7	13.7	13.7	13.7
Inflation	3.6	1.2	1.2	1.6	1.6	1.6
Primary Balance	10.5	10.5	10.5	10.5	10.5	10.5
Effective interest rate	0.5	0.4	0.3	0.4	0.5	0.5

Source: IMF staff.

INTERNATIONAL MONETARY FUND

COMMUNICATIONS DEPARTMENT

Appendix IV. Draft Press Release

Press Release No. [XX]	International Monetary Fund
FOR IMMEDIATE RELEASE	700 19th Street, NW
March [XX], 2017	Washington, D.C. 20431 USA

IMF Executive Board Concludes 2017 Article IV Consultation with the Republic of Nauru

On March 24, 2017, the Executive Board of the International Monetary Fund (IMF) concluded the first Article IV Consultation[1] with Republic of Nauru after the country became the 189th IMF member country in April 2016.

Nauru's growth and government revenue have improved substantially in recent years owing to the Australian Regional Processing Center (RPC) to process asylum seekers, fishing license fees, and residual phosphate mining. In the near term, GDP growth is projected to moderate to 4 percent in FY2017 (ending June 30) mainly due to a slowdown in phosphate exports and limited expansion of the RPC. Inflation is projected to decline to around 6 percent along with moderating economic activities and stable food and fuel prices.

Despite the improved economic performance in recent years, Nauru continues to face challenges in sustaining growth and ensuring fiscal sustainability due to its limited sources of growth and income. The country is also vulnerable to climate change, its antiquated infrastructure hampers trade and growth, and its health indicators are below those of peers due to high incidence of non-communicable diseases.

The medium-term outlook is vulnerable to the scaling down of the RPC as refugees are expected to be transferred to other countries, entailing a substantial decline in RPC revenue. With limited access to borrowing, fiscal spending would have to adjust accordingly. Inflation is projected to remain low, in line with the economic slowdown, inflation in Australia, and low commodity prices.

Executive Board Assessment[2]

<   >

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.

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

Table 1. Nauru: Selected Economic Indicators, FY2012–17 1/

I. Social and Demographic Indicators 2/

GDP (FY2015 est.) (in millions of Australian dollars):	120.1	Poverty rate:	24 percent (2013)
Per capita GDP (FY2015 est.) (in Australian dollars):	9,631	Live expectancy at birth:	60.4 years (2011)
Population (FY2015 est.):	12,475	Adult literacy rate:	96.5 (2011)

II. Economic Indicators

	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017
				Preliminary		Proj.
Real sector						
Real GDP growth (percent change)	10.1	34.2	36.5	2.8	10.4	4.0
Consumer price index (period average, percent change)	0.3	-1.1	0.3	9.8	8.2	6.0
Population (thousand)	10.3	10.8	11.9	12.5	13.0	13.3
			In percent of GDP			
Government finance						
Total revenue and grants	52.6	58.9	76.8	81.2	115.2	110.3
Revenue	31.9	39.1	60.0	64.6	94.1	92.6
Grants	20.7	19.9	16.8	16.6	21.0	17.7
Total expenditure	44.7	57.4	51.8	72.3	91.6	99.9
Net lending (+) / borrowing (-)	7.9	1.5	25.0	8.9	23.5	10.4
Stock of government deposits	6.7	5.5	16.3	21.5	9.9	6.7
Stock of Trust Fund	…	…	…	…	22.7	33.4
		(In millions of Australian dollars, unless otherwise indicated)				
Balance of payments						
Current account balance	38.4	19.9	-17.2	-11.4	2.4	0.8
(In percent of GDP)	38.1	18.8	-13.5	-9.5	1.7	0.5
Trade balance	33.8	4.6	-34.6	-51.6	-52.9	-61.5
Exports	67.4	58.2	50.7	25.0	34.4	32.0
Imports	33.6	53.6	85.3	76.5	87.3	93.5
Capital account balance	0.9	2.5	3.2	4.3	5.9	5.3
Financial accounts balance and other flows	39.2	22.3	-13.9	-7.1	8.3	6.1
Government debt indicators 3/						
External debt	54.4	50.8	48.1	47.2	48.1	48.9
(In percent of GDP)	54.0	48.0	37.7	39.3	34.3	32.4
Domestic debt	66.1	66.1	52.5	46.1	42.9	41.9
(In percent of GDP)	65.6	62.4	41.2	38.4	30.6	27.8
Exchange rates						
Australian dollar per U.S. dollar (period average)	0.97	0.98	1.09	1.20	1.37	…
Real Effective Exchange Rate (period average)	103.0	100.1	93.4	98.2	104.9	…
Nominal GDP (in millions of Australian dollars)	100.7	105.9	127.5	120.1	140.2	151.0

Sources: Nauru authorities and IMF staff estimates and projections.
1/ Nauru uses the Australian dollar as the legal tender, and the fiscal year ends in June.
2/ The social indicators are taken from United Nations Development Program and Secretariat of the Pacific Community.
3/ Including the defaulted Yen bonds and the estimated government liability related to Bank of Nauru's liquidation.