

**FOR
INFORMATION**

FO/DIS/19/183

November 12, 2019

To: Members of the Executive Board
From: The Acting Secretary
Subject: **Nauru—Assessment Letter for the Asian Development Bank**

Board Action: Executive Directors' **information**

Publication: Yes*

Questions: Ms. Kaendera, APD (ext. 39881)

Nauru—Assessment Letter for the Asian Development Bank
November 11, 2019¹

1. Growth is moderating. Nauru is at a point of transition with a decline in phosphate mining and activity associated with the Regional Processing Centre (RPC) for refugees and asylum seekers. In FY2018, a higher-than-expected refugee presence, alongside strong fishing activity, and the Pacific Island Forum preparations, drove a pick-up in growth to 5.7 percent. However, lower numbers of refugees and asylum seekers since then have reduced activity and growth is estimated to have slowed to 1.0 percent in FY2019. Inflation moderated to 0.5 percent in FY2018 from 5.1 percent in FY2017, mirroring low inflation in Australia. Nonetheless, inflation rose to 3.9 percent in FY2019, reflecting a pick-up in oil prices and one-off salary bonuses for all civil servants.

2. Budget surpluses have been maintained, but public sector debt is high and unsustainable. The FY2019 budget surplus is estimated at 16.1 percent of GDP. The surplus reflects a 12 percent of GDP spike in fishing revenue partly offset by expenditure growth from subsidies and a wage increase related to the new superannuation fund. Surpluses have been used to contribute to the Trust Fund, build government deposits, and reduce arrears. However, total public sector debt—including SOE debt—increased to A\$138.8 million (86.8 percent of GDP) in 2018 reflecting new loans for secondary phosphate mining.²

3. Nauru’s external position in FY2018 was substantially weaker than implied by medium-term fundamentals and desirable policies. The current account balance (CAB) deteriorated in FY2018 due to weakening RPC-related activity and reduced phosphate mining. It recorded a deficit of around 4.6 percent of GDP in FY2018 after a surplus of 12.7 percent of GDP in FY2017. The CAB is estimated to have returned to a surplus in FY2019 due to a spike in fishing revenues. Looking ahead, external sustainability will rely critically on factors such as RPC activity, fishing license fees, and donor support.

4. The macroeconomic outlook depends on RPC activity, fishing revenues, and completion of infrastructure projects. It is estimated that 300 refugees and asylum seekers will remain in Nauru in FY2020. On this basis growth is expected to moderate further to 0.6 percent in FY2020. Medium term growth is projected to strengthen to around 2 percent, supported by public infrastructure investment and structural reforms. The key economic challenge is to develop new sources of economic activity and income. Preparing for and managing the scaling down in RPC activity is a policy priority. While increased fishing license revenues have provided a welcome diversification, private sector development is hampered by regulatory costs, aging infrastructure, and capacity limitations in the workforce.

¹ This assessment letter is based on information available as of September 2019.

² Public sector debt is significantly higher than the level reported in the 2017 Article IV staff report due to inclusion of SOE debt and legacy debt pending resolution.

5. Risks to the outlook are substantial and skewed to the downside. Downside risks include a faster-than-expected scaling down of RPC activity, and delays in structural reforms, including public financial management reforms. Adverse spillovers from global developments are likely to be limited, but weaker-than-expected global growth and volatility in commodity prices could affect fishing revenue. Nauru is vulnerable to climate change and faces worse health and education indicators than its peers. On the upside, positive spillovers from the RPC operations (such as small business development) and higher-than-expected fishing revenue could boost activity and improve fiscal space.

6. The authorities need to confront the rising fiscal risks. Revenue is likely to decline significantly over the medium term as around 30 percent of the receipts of the budget are linked to RPC operations. At the same time, current spending policies are expected to continue. A fiscal adjustment plan is needed to avoid breaching the fiscal anchor, meet the mandatory Trust Fund contributions, and avoid further debt accumulation. The authorities should also redouble efforts to seek a reasonable resolution of the defaulted yen-denominated bonds, which would help put the public debt back on a sustainable path.³

7. Fiscal reforms should focus on strengthening revenues and public financial management (PFM) to increase fiscal discipline and lift the quality of spending.

Consideration is being given to the introduction of a consumption tax to offset revenue losses from a scaling down in RPC activity as well as Nauru's ratification of the Pacific Agreement on Closer Economic Relations Plus (PACER Plus). To yield good results, clear policy goals for tax policy reform should be set and the sequencing, together with tax administration modernization, needs to be carefully thought through. A medium-term revenue strategy could help set policy goals, provide a governance structure to coordinate reforms, engage stakeholders and foster cooperation among development partners. On public financial management, stronger monitoring and accountability of SOEs is needed to improve performance and reduce reliance on budget transfers. Equally important is strengthening public debt management.

8. Transparent budget management would catalyze climate change financing and technical assistance from donors. Nauru's mitigation and adaptation efforts are commendable, including the new seaport which will reduce Nauru's carbon footprint while improving climate resilience. However, to strengthen resilience to climate change, the authorities need to fully cost adaptation plans and integrate them into the budget and medium-term framework, ensure new infrastructure is climate proof, and, seek donor funds for green projects.

9. Efforts in financial sector reforms are commendable but challenges remain. Bendigo Bank agency has helped in reestablishing trust in the financial sector, contributing to

³ A significant share of government debt in Nauru relates to the yen-denominated bonds which are in default. 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.

improvements in financial inclusion and payment services. The agency recently opened its first U.S. correspondent bank account and is continuing efforts to open correspondent bank accounts in other major currencies. However, cash is still widely used in the country due to lack of point of sale devices. Efforts to improve financial literacy should continue.

10. Creating an environment for a more dynamic private sector would help achieve inclusive prosperity. Steps should be taken to improve the ease of doing business. The new sea port and undersea cable have the potential to support growth and provide new opportunities for private sector activities.

11. Fund relations. Nauru is on a 24-month Article IV consultation cycle and has no outstanding purchases or loans and no financial arrangements with the IMF. The last Article IV consultation was concluded by the Executive Board on March 24, 2017 and the 2019 Article IV consultation is expected to be concluded in early 2020.

Nauru: Selected Social and Economic Indicators 2015–21 1/

I. Social and Demographic Indicators 2/							
GDP (FY2018 est.) (in millions of Australian dollars)	160.0			Poverty rate		24 percent (2013)	
Per capita GDP (FY2018 est.) (in Australian dollars)	12,120			Life expectancy at birth		60.4 years (2011)	
Population (FY2018 est.)	13,201			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							
	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021
				Preliminary		Proj.	
Real sector							
Real GDP growth (percent change)	3.4	3.0	-5.5	5.7	1.0	0.6	1.1
Consumer price index (period average, percent change)	9.8	8.2	5.1	0.5	3.9	2.8	2.3
Population (thousand)	12.5	13.0	13.4	13.2	12.7	12.9	13.2
(In percent of total)							
Structure of the economy							
Agriculture	2.7	2.9	4.4	3.8	4.7	4.7	4.8
Manufacturing	12.9	22.2	17.2	10.1	7.9	7.7	7.6
Services	72.9	65.8	71.8	77.0	73.7	73.2	72.7
(In percent of GDP)							
Government finance							
Total revenue and grants	93.5	114.9	121.8	129.3	141.7	110.4	98.0
Revenue	74.5	91.6	100.6	108.5	126.6	89.3	82.7
Grants	19.1	23.3	21.3	20.8	15.1	21.1	15.3
Total expenditure	83.1	93.4	100.5	96.8	125.6	99.6	93.5
Net lending (+) / borrowing (-)	10.5	21.4	21.4	32.5	16.1	10.8	4.5
Including Trust Fund contribution	10.5	-2.8	7.9	23.2	7.3	-1.9	-8.3
Stock of government deposits	24.8	10.1	5.6	24.2	35.7	33.2	24.3
Stock of Trust Fund	...	24.6	39.1	52.8	63.6	76.8	89.9
(In millions of Australian dollars, unless otherwise indicated)							
Balance of payments							
Current account balance	-22.2	2.8	18.4	-7.3	8.3	-7.3	-8.5
(In percent of GDP)	-21.3	2.0	12.7	-4.6	5.0	-4.3	-4.9
Exports (goods)	24.9	47.8	25.3	15.9	6.0	6.0	6.0
Imports (goods)	82.3	76.7	70.0	81.1	83.8	84.6	84.7
RPC-related inflows	35.8	32.6	42.3	36.5	32.6	22.4	
Capital account balance	4.6	17.0	12.4	8.4	5.0	7.2	6.8
Financial accounts balance and other flows	-17.7	19.8	30.8	1.1	13.3	-0.1	-1.7
Government debt indicators							
External debt 3/	47.8	46.8	48.8	49.0	47.4	48.6	49.7
(In percent of GDP)	45.8	34.0	33.6	30.6	28.7	28.5	28.3
Domestic debt 4/	62.6	62.6	62.6	69.9	55.3	54.3	53.3
(In percent of GDP)	60.0	45.5	43.1	43.7	33.5	31.9	30.4
External debt service	2.3	2.2	0.0	2.3	9.8	0.0	0.0
(In percent of exports of goods and services)	4.2	3.1	0.0	5.6	29.9	0.1	0.1
Exchange rates							
Australian dollar per U.S. dollar (period average)	1.20	1.37	1.33	1.29	1.40
Real Effective Exchange Rate (period average)	98.2	101.7	113.5	111.1
Nominal GDP (in millions of Australian dollars)	104.3	137.5	145.3	160.0	165.3	170.2	175.4
Nominal GNI (in millions of Australian dollars)	142.4	187.0	203.4	214.6	243.5	236.6	241.4
Nominal GNI per capita (in US dollars)	9,551	10,439	11,409	12,605	13,764

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.