DOCUMENT OF INTERNATIONAL MONETARY FUND AND FOR OFFICIAL USE ONLY

EXECUTIVE BOARD MEETING

SM/20/5
Correction 1

January 21, 2020

To: Members of the Executive Board

From: The Secretary

Subject: **Republic of Nauru—Staff Report for the 2019 Article IV Consultation**

Board Action:	The attached corrections to SM/20/5 (1/7/20) have been provided by the staff:
Factual Errors Not Affecting the Presentation of Staff's Analysis or Views	**Pages 6, 18, 31, 37**
Questions:	Ms. Kaendera, APD (ext. 39881)

to have returned to a surplus in FY2019 due to a spike in fishing revenue inflow. The sustainability of the external sector will depend critically on exogenous factors such as RPC activity, fishing license fees and donor support, while REER changes have only a limited impact.

8. 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 improved infrastructure and structural reforms. Average inflation is projected to remain low, in line with Australian inflation and stable commodity prices. The current account balance is expected to deteriorate over the medium term with an average deficit of around 5 percent of GDP due to reduced phosphate mining, reduced RPC activity, and normalizing fishing license fees.

9. Nauru and Australia have signed an agreement for a "hybrid" model of joint management of RPC commercial operations and services for the current financial year. Under the new hybrid model much of the core RPC activity is expected to remain under Australian control. However, Nauru will have responsibility for certain activities with corresponding profit-making opportunities. The authorities are also engaged in negotiations with Australia for increased revenues related to maintaining the RPC, even if activity is to decline. As part of the management arrangements for FY19/20 the authorities received ~~will receive~~ an additional A$21.1 million in the form of a "hosting fee", which has boosted ~~planned~~ spending for the year. However, arrangements for hosting fee payments in future years are currently unknown.

10. The fiscal surplus will be maintained in the near term but turn to deficit over the medium term. Over the medium-term staff projects revenue to decline as around 30 percent of revenue is linked to RPC operations and is unsustainable in the long run. At the same time, staff projects expenditure to revert to around the FY2018 level in terms of percent of GDP, meaning that the fiscal surplus declines through the projection period, until turning to deficit in 2024. As it declines, the fiscal surplus will no longer be available to fund Nauru's committed contributions to the Trust Fund. Staff projections assume that the planned Trust Fund contributions will continue, at first through reductions in the cash balance, and later through payment arrears and increased domestic debt.

In **FY2020** the fiscal surplus is too small to meet Trust Fund contributions, and government deposits are drawn down. →	In **FY2022** total government deposits fall to under two months of non-RPC spending. →	In **FY2023** total government deposits are depleted. →	In **FY2024** the budget balance enters deficit. Borrowing is needed to fund the Trust Fund contributions.

11. Risks are skewed to the downside (Annex III, RAM). Downside risks include a faster-than-expected scaling down of RPC activity, and delays in fiscal and structural 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. On the upside, positive spillovers from the RPC operations (such as small business development) and higher-than-expected fishing revenue would boost activity and improve fiscal space.

Box 2. Nauru's Superannuation Fund

In July 2018 the Government introduced Nauru Super, a defined-contribution superannuation scheme. The Nauru Super Scheme is governed by a Board of Trustees and managed by a New Zealand-based fund manager, Superlife. Payments from Nauru Super will be additional to existing pension payments for individuals over 60 years old. The scheme was originally made available only to Nauruan government employees, including those of SOEs. However, from January 1, 2019, the scheme was expanded to citizens residing in Nauru and government officials posted overseas, and all employers of ~~five~~one or more Nauruan staff. This scheme is not applicable to contract or expatriate employees.

Enrollment in Nauru Super is compulsory, and both employers and employees are required to contribute 5 percent of salaries to the fund. To encourage acceptance of the scheme, the government initially raised salaries by 5 percent, so there would be no change to take-home pay. Employees can make additional contributions to the fund on a voluntary basis at any time, but these will not be matched by the employer. Access to the funds will only be granted at the retirement age of 55 years or more. Currently, the scheme does not include options for life insurance cover or other insurance programs, but these can be evaluated and added at a later stage.

Box 3. Nauru's Financial Sector

The Bendigo Bank Agency (the "agency") is the sole financial institution and provider of financial services. The agency is a special project under the Ministry of Finance and Bendigo and Adelaide Bank Limited of Australia (Bendigo Bank). When it opened in 2015, it was the first bank operation in Nauru in over a decade. As part of Bendigo Bank, the agency falls under Australian bank supervision, and customers hold Australian bank accounts. It is the only Australian agent bank operating outside Australia. The agency recently opened its first U.S. correspondent bank account and is continuing efforts to open correspondent bank accounts in other major currencies. Nauru citizens have access to deposit accounts, ATMs, and internet banking through the agency, but there are currently no available credit or insurance products.

The agency has contributed to improvements in financial inclusion and payment services. The agency has 11,200 accounts, representing close to full account penetration among adults. The agency has installed 11 ATMs, processing up to 36,000 transactions per month. About 9,000 ATM cards have been issued – roughly the same as the number of smart phones in Nauru. Although the economy remains heavily cash-based, greater use is being made of online transaction facilities. For example, most large taxpayers make online tax payments. The agency is starting to install Point of Sale (POS) terminals, which are in strong demand. To help improve financial literacy, the agency is offering deposit accounts to students and is working with development partners on the potential introduction of financial education in schools.

The agency operates in accordance with Australian financial regulation, but it continues to face challenges in transferring funds internationally. The agency adheres to the Australian-standard AML/CFT requirements, and the parent bank 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 correspondent banks that prevent transferring funds internationally.

Annex IV. Debt Sustainability Analysis[1]

Staff assess debt as unsustainable under current policies. Sound fiscal and public debt management policies and policies to generate and diversify economic activity would help ensure debt sustainability and improve Nauru's access to credit markets.

1. **Total public debt is estimated at 86.8 percent of GDP (A$138.8 million) in FY2018 and is mostly denominated in local currency**. External public debt is estimated at A$49 million (30.6 percent of GDP) comprising mostly of the defaulted yen bonds (A$38.2 million), loans from the EXIM bank (A$3.9 million), and miscellaneous debt that includes overdue membership obligations to international organizations (A$6.8 million).[2] Domestic public debt is estimated at A$69.9 million (43.7% of GDP), made up of long-standing arrears from the Bank of Nauru liquidation and ~~overdue salaries~~from the Nauru Phosphate Corporation (RONPHOS).[3] The total debt stock includes an estimate for SOE debt, of which a significant portion is for financing secondary phosphate mining and also includes legacy debt relating to the Nauru Phosphate Royalty Trust (totaling A$21 million).

2. **Public debt remains very high and is assessed as unsustainable under existing policies.** Under the baseline scenario, the public debt-to-GDP ratio is expected to decline temporarily as the government runs down deposits. Once these deposits are depleted, public debt is projected to begin rising sharply from already high levels. Given this and the government's existing arrears, debt is considered unsustainable under current policies. Although Nauru has accumulated a large amount of assets in the Trust Fund (around 64 percent of GDP), these cannot be withdrawn or used as a buffer to mitigate the high level of debt.[4] The level of debt is vulnerable to the RPC scaling down, lower than expected fishing revenues, and increased commodity prices.

3. **The standardized alternative scenarios show improving debt dynamics.** Debt would fall to a more sustainable level of 38.9 percent of GDP by 2024 if real GDP growth, the primary balance, and real interest rates are set to their ten-year historical average. If the primary balance is set at the projected 2019 level for the entire projection period, public debt would fall but still hover at around 60 percent of GDP by 2024. However, attaining the improved dynamics is highly unlikely over the medium term as the key macro indicators in the alternative scenarios reflect a period of unusually strong economic activity with phosphate mining and exports at a peak.

---

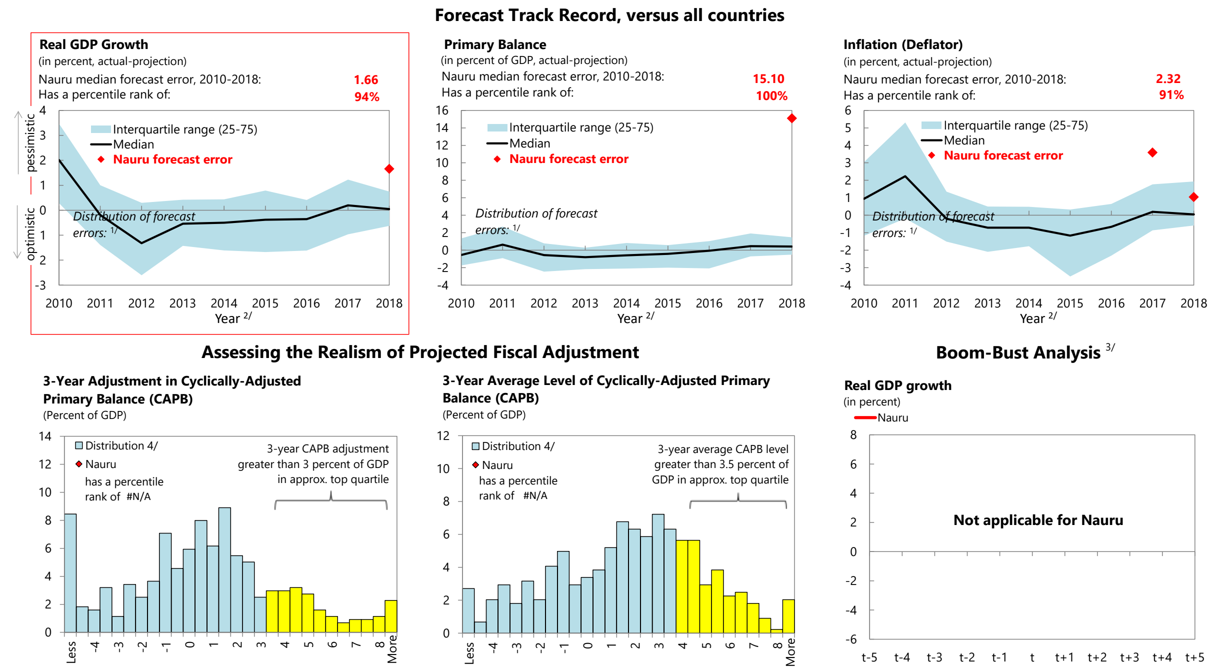
[1] Prepared by Ananya Shukla and Medha Madhu Nair. The MAC DSA is used because Nauru is upper middle income although it does not have market access.

[2] 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.

[3] Domestic public debt does not include the SOE debt numbers and unconsolidated debt relating to NPRT. The SOE debt numbers were calculated separately and added to the total debt stock.

[4] The trust fund is perpetual, the charter does not provide for withdrawals in the short run or in the forecast horizon and hence, has little or no bearing on improving the debt trajectory.

Figure 4. Nauru: Public DSA – Realism of Baseline Assumptions



Source : IMF Staff.

1/ Plotted distribution includes all countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Nauru, as it meets neither the positive output gap criterion nor the private credit growth criterion.

4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.