

**FOR
INFORMATION**

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May 1, 2020

To: Members of the Executive Board

From: The Secretary

Subject: **Republic of Nauru—Assessment Letter for the Asian Development Bank**

Board Action: Executive Directors' **information**

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Questions: Ms. Das, RES (ext. 38590)

Republic of Nauru—Assessment Letter for the Asian Development Bank
May 1, 2020¹

Recent Developments, Outlook and Risks

1. Economic activity in Nauru will moderate due to the COVID-19 pandemic. Prior to the pandemic, growth had slowed to 1 percent (y/y) in 2019 from reduced phosphate mining, a moderation in fishing revenues and a slowdown in Regional Processing Center (RPC) activities. There are no confirmed cases of COVID-19 in Nauru as of the date of this letter. Under staff's baseline assumption that there is no local outbreak of the pandemic, the April 2020 *World Economic Outlook* projects growth at -1.7 percent in 2020. The projection reflects a decline in port construction activity from supply chain disruptions, a contraction in services from the departure of expatriate workers and the negative impact of domestic containment measures that include a near-total ban on international flights and strict quarantining of all entering passengers. Factors mitigating the growth impact of the pandemic include the softening of commodity prices, particularly fuel, and the significant size of the public sector as a source of aggregate demand and employment. The government has announced (on April 9) an extension of the state of emergency through mid-May. Growth is expected to recover in 2021 as local and global containment measures ease, and construction and fishing activities resume. The decline in fuel and other commodity prices will alleviate pressure on the external accounts in 2020 and the current account is projected to post a surplus despite the loss of fishing revenues.

2. The projected fiscal balance for FY2020 has been revised downwards to incorporate pandemic effects. The overall fiscal balance projection for FY2020 has been revised from a surplus of 15.5 percent of GDP to zero. The erosion of the projected fiscal balance reflects an anticipated revenue slowdown from fishing licenses and revenues related to expatriate workers (tax revenues, visas and flight-related revenues). At the same time, expenditures will rise due to health and containment needs and liquidity support to State Owned Enterprises (SOEs), mainly Nauru Airlines. The government has met its mandatory contributions to the Trust Fund for FY2020. The unexpected deterioration of the projected fiscal balance due to the pandemic has however led to a decline in the stock of government deposits which are projected to become negative in FY2022, earlier than projected during the previous consultation. The 2019 Article IV Debt Sustainability Analysis concluded that public sector debt in Nauru, which is estimated at 62 percent of GDP at end-FY2019, is unsustainable under existing policies. The fiscal impact of the pandemic is expected to add to debt vulnerabilities. Although Nauru has accumulated a large amount of assets in the Trust Fund (estimated at 64 percent of GDP at end-FY2019), these cannot be withdrawn or used as a buffer to mitigate the high level of debt.

¹ This assessment letter complements the staff assessment provided in the 2019 Article IV consultation and is based on the World Economic Outlook (WEO) projections published in April 2020.

3. Risks to the outlook are skewed to the downside. Given Nauru's geographic remoteness and isolation, the limited medical services on the island, and risk factors such as a high incidence of non-communicable diseases, managing a local outbreak would strain the health budget and health infrastructure, and adversely affect employment and growth. External downside risks include a more protracted global slowdown from the pandemic that would further hamper demand for fishing licenses and negatively impact fiscal revenues. Volatility in global commodity prices could raise additional downside risks for fishing activity. Nauru has been investing significantly in infrastructure and port development projects. Extended containment efforts and supply chain disruptions could delay these projects further with a stronger-than-expected impact on domestic activity.

Policy Response and Settings

4. The government has deployed a large fiscal package to respond to and mitigate the impact of the pandemic. The initial fiscal response, amounting to about 5.5 percent of GDP, has been funded from a re-prioritization of existing budget allocations, including the delay of aircraft purchases, drawing down cash reserves, and donor contributions. Key elements of this package include significant liquidity support for Nauru Airlines; budgetary support for other SOEs to improve inventory management given reduced cargo and freight services; further cash flow support payments to Ronphos; and the repatriation of Nauruans. A package of benefits to households to boost confidence and incomes is currently under consideration.

5. Comprehensive reforms over the medium term will be needed to confront rising fiscal risks. The expected scaling down of RPC activity as well as Nauru's ratification of the Pacific Agreement on Closer Economic Relations Plus (PACER Plus) will weigh heavily on revenues. Fiscal reforms should focus on identifying new revenue sources, including consideration of the introduction of a consumption tax. 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. Stronger monitoring and accountability of SOEs is needed to improve performance and lower reliance on budget transfers. Equally important is strengthening public debt management. Redoubling efforts to seek a reasonable resolution of the defaulted yen-denominated bonds would help put the public debt back on a sustainable path.

6. Fund relations. Nauru is a recipient of IMF technical assistance and capacity development, including from the Pacific Financial Technical Assistance Center (PFTAC) and the regional resident representative offices in Asia. 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 January 22, 2020.

Nauru: Selected Economic Indicators, 2015-2021 1/							
Per capita GDP (est 2018) : AUD 12,120							
Population (est. 2018) : 13,201							
Quota : SDR 2.8 million							
	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021
					Est.	Proj.	
Output							
Real GDP growth (%)	3.4	3.0	-5.5	5.7	1.0	-1.7	1.3
Real GDP per capita (%)	-1.8	-1.5	-8.7	7.4	5.1	-3.6	-0.6
Prices							
Consumer prices average (% change)	9.8	8.2	5.1	0.5	3.9	1.5	1.7
General government finances							
Fiscal balance (% of GDP)	10.5	21.4	21.4	32.5	16.1	0.0	4.3
Balance of payments							
Current account (% of GDP)	-21.3	2.0	12.7	-4.6	5.0	5.2	2.7
Sources: Data provided by Government of Nauru; and IMF staff estimates and projections.							
1/ The fiscal year ends in June.							