

**FOR
INFORMATION**

FO/DIS/20/185

September 14, 2020

To: Members of the Executive Board

From: The Secretary

Subject: **Kiribati—Assessment Letter for the Asian Development Bank and the World Bank**

Board Action: Executive Directors' **information**

Publication: Not yet decided*

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***If the authorities consent to the publication of this assessment, it may be published by the AsDB and the World Bank.**

Kiribati—Assessment Letter for the Asian Development Bank and World Bank

September 11, 2020

This note provides the IMF staff's assessment of Kiribati's macroeconomic conditions, prospects, and policies, based on available information as of August 31, 2020. The assessment has been requested by the Asian Development Bank and the World Bank for processing of the Pacific Disaster Resilience Program (Phase 3) and the Second Inclusive Growth and Resilience Development Policy Operation for Kiribati respectively.

I. RECENT DEVELOPMENTS, OUTLOOK AND RISKS

- 1. At the onset of the COVID-19 pandemic, the authorities took preemptive containment measures that successfully limited the risk of a domestic outbreak.** Travel restrictions were introduced in January. Subsequently, containment measures became more stringent with the authorities declaring a state of emergency, closing borders except for delivery of essential goods, requiring mandatory quarantine at all ports, restricting fishing vessels under bilateral agreements with the Ministry of Fisheries to come onshore, and closing schools. Largely thanks to these early measures, Kiribati has no confirmed case, allowing the recent relaxation of selected measures such as the reopening of schools. The government's communication strategy has focused on preventing misinformation and raising awareness.
- 2. Kiribati's economy performed well in recent years, but the COVID-19 pandemic and related containment measures are putting strains on activity.** Kiribati's average annual real GDP growth rate was 4¼ percent in 2015–19 compared to about 1½ percent during 2000–14. The stronger growth reflected in part higher public spending financed by record-high fishing revenue, which averaged about 75 percent of GDP in 2015–19 (up from the historical average of 25 percent). Construction activity driven by donor-financed infrastructure investment also contributed to the recent high growth. Due to COVID-19, fishing revenues are projected to fall by about 30 percent in 2020. Planned large investment projects have been delayed, because of restrictions on the movement of personnel and materials. In addition, services including restaurant and hotel services, transportation, and other business activities are expected to contract sharply. As a result, real GDP growth is projected to drop to -1.1 percent in 2020. Growth is projected to pick-up to 3 percent in 2021 as the global economy gradually recovers. Inflation is expected to remain subdued at around 1½ percent in 2020—consistent with major trading partners, given Kiribati's use of the Australian dollar as legal tender.
- 3. Risks to the outlook are substantial and tilted to the downside.** The uncertainty around the near-term outlook is greater than usual due to the COVID-19 pandemic. A domestic outbreak of COVID-19 would further suppress domestic economic activity and could easily strain the health sector. A longer-lasting and deeper global COVID-19 outbreak could result in extended travel restrictions, further delaying planned infrastructure projects and lowering fishing revenues. A sharp tightening of global financial conditions could reduce the expected return on the Revenue Equalization Reserve Fund (RERF) and the Kiribati Provident Fund (KPF) putting pressures on fiscal resources. Looking further ahead, a cyclical reversal of the unusually long favorable weather conditions could threaten fishing revenues, with implications for the fiscal balance and the current account.

II. POLICY RESPONSE AND SETTINGS

4. **Kiribati has taken policy measures to mitigate the effects of the pandemic, but there will be temporary weakening of both the fiscal and balance of payments positions.** The government approved an economic stimulus package of AUS\$13.5 million (about 4.8 percent of GDP). The package includes unemployment income support, and stimulus for both privately owned businesses and state-owned enterprises. The fiscal balance is projected to shift from a surplus of 15 percent of GDP in 2019 to a deficit of 13 percent of GDP in 2020 due to a sharp fall in fishing revenues and an increase in current expenditures due to the policy response. This deficit will mainly be financed through the government's high cash reserves. Correspondingly, the current account is projected to shift from a surplus of about 32 percent of GDP in 2019 to a deficit of about 2 percent of GDP in 2020, mainly due to the fall in fishing license fees. However, this shortfall will be mitigated somewhat by falling oil prices, declining imports due to domestic demand contraction, and expected support from bilateral and multilateral partners.

5. **A preliminary Debt Sustainability Analysis (DSA) indicates that Kiribati remains at high risk of debt distress.** The COVID-19 pandemic will result in a fiscal deficit which is expected to be financed by cash reserves, without additional debt for 2020. Over the medium term, the baseline scenario assumes that fishing revenues gradually recover from the shock in 2020-21, the government maintains a conservative fiscal stance that adheres to a broadly balanced recurrent budget, and reliance on grants is eventually reduced. Under realistic shock scenarios, debt becomes unsustainable as the debt-to-GDP ratio would breach the indicative sustainability threshold within the next decade, broadly in line with the previous DSA despite the conservative fiscal stance over the medium-term. Containing the risk of debt distress will require further progress in structural and fiscal reforms, as well as continuing securing grants to finance the country's significant development needs. Other mitigating factors to the risk of debt distress would be the use of accumulated assets through cash reserves and the RERF. Government borrowing through concessional loans should be closely monitored to safeguard long-run debt sustainability.

6. **The pandemic has underscored the importance of a sustainable medium-term fiscal policy framework given Kiribati's considerable public spending needs.** Given the uncertainty surrounding the pandemic, crisis mitigation related expenditure could further rise. Contingency measures to accommodate such additional spending could be prepared in advance, including possible reallocation of non-essential spending and plans to secure additional concessional financing. Once the pandemic ends, focus should revert to formulating a sustainable medium-term fiscal framework that abstracts from volatile, exogenous components of the budget (fishing revenue and grants, plus their associated capital spending) and promotes current expenditure stability. In the event of a surge in fishing revenue, supplementary budgets should be avoided, with the windfall being allocated only after evaluating projects in a comprehensive medium-term framework. Adherence to rules-based withdrawals from the RERF will ensure fiscal discipline.

7. **Kiribati will need to continue to adapt to climate change through reforms, including by making explicit provisions in the budget.** The country's low-lying atolls are vulnerable to rising sea levels, storm surges, coastal erosion, and saltwater intrusion. Higher ocean surface temperatures will potentially disrupt the country's largest economic resource—the tuna fishery. These would then have a direct impact on the fiscal position and potential growth. The budget should include an explicit provision to cover the recurrent costs of climate change adaptation. Capital projects for climate change adaptation, however, require access to donor financing.

8. **Economic diversification through a more dynamic private sector would help weather future shocks.** Further improvement in connectivity through infrastructure investment in air transportation and shipping services could boost business development by enabling access to a wider marketplace. Transforming the economy to foster growth in the service sector (particularly in infrastructure maintenance, and renewable energy) could open-up diversification opportunities for the private sector and enhance resilience of the economy. Facilitating private sector access to credit would be best achieved by improving land access procedures and dispute resolution mechanisms (to enhance property rights and enable lending against collateral). Mobile connectivity and mobile banking should be promoted more, for their job-creation and financial-deepening benefits. Such financial deepening should be accompanied by strengthening of financial regulation and supervision as well as risk management in public financial institutions.

III. IMF RELATIONS

9. **Fund relations.** Kiribati is on a 12-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 11, 2019.

Table 1. Kiribati: Selected Economic Indicators, 2016–21

	2016	2017	2018	2019	2020	2021
			Est.	Proj.		
Real GDP (percent change)	5.1	0.9	2.3	2.3	-1.1	3.0
Consumer prices (percent change, average)	1.9	0.4	0.6	-1.9	1.5	2.0
Central government finance (percent of GDP)						
Revenue and grants	138	150	135	126	98	97
Total domestic revenue	84	92	89	102	74	79
<i>Of which: fishing revenue</i>	66	72	67	81	53	58
External grants	53	58	46	25	23	18
Expenditures	115	110	137	111	111	106
Current	54	63	57	57	69	71
Development	61	47	80	54	41	35
Domestic recurrent balance 1/	-36	-43	-35	-36	-48	-51
Recurrent fiscal balance (incl. budget support grants)	34	37	37	48	10	13
Overall balance 2/	23	40	-2	15	-13	-10
Financing	-23	-40	2	-15	13	10
<i>Of which: Revenue Equalization Reserve Fund (RERF)</i>	0	0	0	0	0	0
RERF						
Closing balance (millions of A\$)	868	943	973	1137	1193	1251
Per capita value (2006 A\$)	6132	6442	6440	7283	7465	7614
Cash reserve buffer 3/						
Closing balance (millions of A\$)	116	150	171	300	263	260
In excess of 3-months of current spending (millions of A\$)	84	112	133	260	214	207
Balance of payments						
Current account including official transfers (millions of US\$)	19	71	76	62	-3	6
(In percent of GDP)	11	38	39	32	-2	3
External debt (millions of US\$)	39	40	37	35	36	54
(In percent of GDP)	22	21	20	18	18	25
External debt service (millions of US\$)	0.4	0.7	0.8	1.4	1.7	2.0
(In percent of exports of goods and services)	0.2	0.3	0.5	0.9	1.0	1.1
Exchange rate (A\$/US\$ period average)	1.3	1.3	1.3	1.4
Real effective exchange rate (period average)	84	89	88	87
Memorandum items:						
Nominal GDP (millions of A\$)	240	244	263	280	282	296
Nominal GDP (millions of US\$)	178	187	197	195	194	219

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

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

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

3/ Cash reserve buffer includes the government's custodial account and cash account.