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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 20/7-3

12:25 p.m., January 22, 2020

**3. Republic of Nauru—2019 Article IV Consultation**

Documents: SM/20/5 and Cor. 1; and Sup. 1

Staff: Kaendera, APD; Fletcher, SPR

Length: 34 minutes

## Executive Board Attendance

T. Zhang, Acting Chair

### Executive Directors

N. Ray (AP)

L. Levonian (CO)

A. Buisse (FF)

R. von Kleist (GR)

### Alternate Executive Directors

O. Odonye (AE), Temporary

F. Sylla (AF)

D. Vogel (AG), Temporary

P. Fachada (BR)

Y. Zhao (CC), Temporary

M. Mulas (CE), Temporary

S. Benk (EC), Temporary

Y. Indraratna (IN)

L. Cerami (IT), Temporary

K. Chikada (JA)

S. Belhaj (MD), Temporary

M. Choueiri (MI), Temporary

V. Rashkovan (NE)

J. Sigurgeirsson (NO)

D. Shestakov (RU), Temporary

J. Al Saud (SA), Temporary

K. Tan (ST)

P. Trabinski (SZ)

J. Freeman (UK), Temporary

S. Senich (US), Temporary

G. Bauche, Acting Secretary

K. Hviding, Summing Up Officer

B. Zhao, Board Operations Officer

M. McKenzie, Verbatim Reporting Officer

### Also Present

Asia and Pacific Department: A. Bauer, N. Kaendera, M. Madhu Nair, T. Schneider. Legal Department: C. Blair. Strategy, Policy, and Review Department: K. Fletcher. Statistics Department: S. Arslanalp. Executive Director: M. Mouminah (SA). Alternate Executive Director: N. Heo (AP). Senior Advisors to Executive Directors: L. Johnson (AP), G. Vasishtha (CO). Advisors to Executive Directors: M. Bernatavicius (NO), E. Boukpepsi

(AF), K. Carvalho da Silveira (AF), T. Iona (AP), G. Khurelbaatar (AP), A. Maciá (BR), A. Park (AP), M. Shimada (JA), J. Yoo (AP), A. Zaborovskiy (EC).

### 3. REPUBLIC OF NAURU—2019 ARTICLE IV CONSULTATION

The staff representatives from the Asia and Pacific Department submitted the following statement:

This statement contains information that has become available since the staff report was circulated to the Executive Board. This information does not alter the thrust of the staff appraisal.

**A fourth supplementary budget for FY2019/20 was issued on 20 December 2019, to appropriate A\$17.6 million (10 percent of GDP) in additional revenue.** The revenue was mainly due to Australian Regional Processing Centre (RPC) for asylum seekers operations and included A\$5.3 million additional RPC hosting fees and a A\$10.2 million payment for reimbursable RPC costs. The government also received a dividend paid by a telecom company (A\$1.5 million). The supplementary budget is expected to have a negligible impact on GDP growth and other key variables as fiscal multipliers are low given Nauru's openness.

**Most of the additional revenue has been appropriated as new spending,** including A\$10.9 million for operational costs at the Department of Multicultural Affairs (which has responsibility for the RPC). A further A\$4.2 million was paid in SOE subsidies and a windfall payment to government workers. The supplementary budget included a Nauru Trust Fund contribution of A\$ 0.6 million, and the remaining A\$2.0 million was spent on other areas.

**Staff has treated the revenue increase as windfall revenue, in the absence of further information.** However, the revenue gain over the four supplementary budgets has been significant, increasing revenue in FY2019/20 by 60 percent above the initial Approved Budget. The supplementary budgets have included total appropriations of A\$86 million (50.5 percent of GDP) for FY2019/20, comprised of new spending (A\$7.6 million) and appropriations to the Nauru Trust Fund and Fiscal Cash Buffer (A\$12.4million).

**While the revenue gains are positive, supplementary budget appropriation in FY2019/20 has included little spending on core areas of education and health.** Of the newly appropriated expenditure in FY 2019/20, 2 percent of GDP (A\$3.6 million) was spent on health and less than 1 percent of GDP (A\$0.4 million) was spent on education. Staff reiterates the advice to set aside windfall revenues for appropriation in the normal budget cycle rather than through a supplementary budget process. Windfall revenues should be used to boost resources for carefully planned spending.

**The authorities are making progress on public financial management reforms.** Following the Article IV discussions, the authorities have communicated that the financial statements for FY2016/17 have been submitted for audit and published on the official website. They are continuing efforts to improve bank reconciliation and have engaged a consultant to map the financial management information system (FMIS) to support GFS reporting. Other work is continuing to improve internal audit, establish a Finance and Audit Risk Committee, and recruit new staff to oversee reconciliation and SOE performance.

Mr. Ray and Ms. Park submitted the following statement:

Nauru is the world's smallest island nation with a population of around 12,500, on an island of 21 square km, located 40 km south of the equator, in the Pacific Ocean. The nearest neighbor is 300 km away. As a result, lack of scale and remoteness pose challenges for economic growth and development. Nauru's sources of revenue are narrow and uncertain. Phosphate mining activity has underpinned incomes since the early 1900s but is reaching the end of its economic life, while fees from fishing licenses can be volatile. The island's central plateau has been heavily mined, and the population is concentrated around the narrow coastal fringe, increasing vulnerability to climate change. Limited land availability contributes to a reliance on imported food and high incidence of non-communicable diseases.

Despite these challenges, progress is being made with the support of development partners. The establishment of a new Nauru Trust Fund is supporting fiscal sustainability by saving windfall income and investing it in a trust that will generate revenue to support future generations. Reforms at the Nauru Utility Corporation have improved the reliability of water and electricity provision. Important infrastructure projects, like the construction of a new port and undersea cable project, will encourage increased trade and economic activity. Banking services were re-established in 2015 (after almost 15 years without a functioning bank), and almost all adults now have access to a bank account. Improving school attendance and education and health outcomes is a priority for the government.

The authorities agree with staff's analysis and near-term outlook, and with the broad thrust of the advice. Nauru joined the IMF in 2016 and this is its second Article IV consultation. The authorities value the advice and technical assistance received from the Fund and look forward to further constructive engagement in future. They also welcome the coordination between IMF staff and the Asian Development Bank, who were invited to join

relevant meetings, facilitating knowledge sharing and making best use of the authorities' time.

### Economic Diversification and Sustainable Development

The authorities agree that broadening Nauru's sources of income is a key policy priority. But lack of scale, remoteness, limited arable land, the physical environment and infrastructure and capacity constraints pose challenges for economic diversification. Continued progress in this area requires ongoing support and technical assistance from donors and partners. The authorities would welcome further practical policy advice from the Fund on potential avenues for diversification. The authorities agree that private sector development may have a role to play and are open to reassessing measures that act as barriers to private sector growth. Nauru faces challenges associated with climate change and, with the support of development partners, work is underway on mitigation and adaptation measures.

### Prudent and Sustainable Fiscal Management

The authorities welcome the IMF's analysis of the fiscal position and will carefully consider the advice to ensure sustainability in the next budget. They understand that if revenues were to fall sharply, there would be a need to adjust spending. Strengthening revenues is also a priority. The authorities agree that any new revenue measures would need to be carefully designed and communicated in a context where most Nauruan citizens have not previously had to pay taxes. Strengthening revenue administration and compliance will also play a role, and ongoing IMF technical assistance in this area is appreciated.

The authorities are committed to maintaining fiscal discipline while making necessary investments in productive and social sectors. Under Nauru's fiscal framework, the budget balance must be positive and sufficiently large to meet the annual Trust Fund contribution. The authorities are also committed to maintaining a cash buffer for liquidity management purposes. The authorities will carefully consider staff advice to limit use of supplementary budgets but note that some flexibility in the framework is appropriate to respond to large and unpredictable variations, given the narrow revenue base. On debt management, the authorities are mindful of the need to take steps towards ensuring future debt sustainability by reconciling and resolving legacy debts.

## Enhancing Governance

The authorities are committed to improving public financial management to enhance fiscal discipline and improve the quality of public spending. The online publication of fiscal documents has been an important step forward, and work is underway to improve the quality of fiscal data. The authorities agree that some state-owned enterprises could pose fiscal risks and plan to progress public enterprise reforms and establish a new SOE monitoring unit. The authorities are also working to strengthen Nauru's AML/CFT framework; preparations are underway for the 2022 APG-FATF Mutual Evaluation.

Mr. Fachada and Ms. Mohammed submitted the following statement:

We welcome the second Article IV consultation with Nauru since the country became the newest IMF member in 2016 and thank staff for the interesting report. We also thank Mr. Ray and Ms. Park for their helpful statement. This consultation is a vivid reminder that the intensity of economic challenges and the importance of regular surveillance are not proportional to economic size of Fund members. Nauru is a micro-state with a narrow economic base, where limited capacity, insufficient infrastructure, diseconomies of scale, and vulnerabilities to climate change present major challenges to its development strategy and fiscal sustainability.

We welcome the new Public Enterprises Act and encourage its implementation. State-owned enterprises (SOE) reforms are necessary to promote accountability, good governance, transparency and reduce the reliance on budget financing, but diseconomies of scale in the provision of public goods and services in a country with a population of barely 13,000 cannot be ignored. The authorities should prioritize SOE reforms to reduce fiscal risks and improve operational efficiency, including the establishment of the SOE monitoring unit and enforcing regular financial reporting. The opening of some of these enterprises to private sector management or ownership merit attention, although scale considerations may limit potential investors' interest.

Prudent fiscal policy is essential to maintain fiscal and external sustainability. Given the expected decline in revenues from the scaling down of phosphate mining and the uncertainties surrounding the future of the Regional Processing Center (RPC), we encourage the authorities to strengthen fiscal discipline and improve the quality of spending, while continuing to make progress on public financial management reforms. We welcome the

continued commitment to tax reforms, including the introduction of the consumption tax, and efforts towards strengthening revenue administration and compliance. We concur with staff that setting tax reform in a comprehensive medium-term revenue strategy could help coordinate reform efforts and better engage the domestic public. Separately, given large government deposits and assets in Nauru's Trust Fund, the debt sustainability analysis could have benefited from also considering the concept of net public debt rather than focusing only on gross public debt. In view of uncertainties regarding fishing license fees and revenues from the RPC, as well as large assets of the public sector, we are not totally convinced that public debt is unsustainable under current policies.

Structural reforms are necessary to promote private sector development, as well as sustainable and inclusive growth. We welcome the authorities' efforts to improve the infrastructure with the seaport development and the new undersea cable. This would not only enhance business conditions but also provide impetus for new growth opportunities. We welcome recent legislative amendments, including the Corporations Act and Business Licenses Act that will improve transparency and strengthen investor protection. The authorities are encouraged to continue to strengthen the AML/CFT framework and enhance financial literacy to develop the financial sector.

Nauru remains vulnerable to climate change related risks. We take note that the country has made progress with its mitigation and adaptation efforts. Given the constrained fiscal space in the near and medium term, integrating resilience to climate change into the macroeconomic framework in accordance with best practices may not be possible. Nevertheless, we encourage the authorities to adopt a transparent budget management approach that would help catalyze climate change financing and technical assistance from donors.

We are somewhat puzzled by the large gap between Nauru's GNI and GDP showed in Table 1. As noted in the "2017 Staff Guidance Note on the Fund's Engagement with Small Developing States", staff analysis of small states should pay special attention to the distinction between GDP and income accrued to nationals (GNI), which better captures their welfare. Could staff discuss the reason why GNI in Nauru is about 40 percent larger than GDP? Is such large gap also found in other Pacific small states?



Mr. Chikada and Mr. Shimada submitted the following statement:

We thank staff for their informative report and Mr. Ray and Ms. Park for their helpful Buff statement. It is encouraging that Nauru is making progress with the support of development partners. However, being a small island nation, and also due to its past mismanagement of natural wealth, Nauru continues to face many development challenges, including limited economic source of income, ineffective education system, prevalence of diabetes, and weak infrastructure. As we broadly agree with the staff appraisal, we would like to limit our comments to the following points.

Fiscal policy needs to be anchored to achieve a positive budget balance. The staff projection that the budget balance could enter deficit in FY2024 warrants great caution, considering that Nauru's public debt has already been assessed unsustainable. To keep the obligated contribution to the Trust Fund is essential, given Nauru's limited sources of income to meet growing needs of the economy in the future. We underscore the importance of effective management of the Trust Fund to make it a good source of income for the country in the future, and welcome that Nauru has completed a self-assessment of the Trust Fund in line with the Santiago Principles. We appreciate more information on this crucial fund, including its targeted return and how asset allocation and risks are managed as well as the results of the self-assessment? At the same time, to avoid further accumulation of public debt, it is indispensable to enhance revenue mobilization as well as prioritize spending. In addition, we highlight that the authorities need to make further efforts to improve public debt management to resolve old public external debt and arrears. In this regard, we wonder whether there is a plan and an expected timeline to resolve them?

We welcome that Bendigo Bank Agency has enhanced financial inclusion. We positively take note that the agency has 11,200 accounts, representing close to full account penetration among adults, and that it opened its first correspondent bank account in a US bank. We expect that the enhancement of financial inclusion could reduce inequality through the equal access to the credit. On the other side, Nauru is facing constraints on making international fund transfers, which is a burden for business sector development. Could staff elaborate the reasons behind these constraints despite the fact that the Nauru's AML/CFT has been improving and the Bendigo Agency adheres to the Australian standard AML/CFT and other requirements?

Structural reforms are essential and need to be well sequenced to enhance the developments of private sector. We agree with staff that private sector developments are key to diversify the Nauru's economy. However, the authority needs to tackle many impediments, including a very low literacy rate (despite compulsory free education), loss of arable land, shortage of infrastructures. Given Nauru's limited fiscal space and institutional capacity, these reforms need to be well sequenced and well supported by development partners.

Mr. Benk, Mr. Trabinski, Mr. Imashov and Mr. Zaborovskiy submitted the following joint statement:

We thank staff for the well-written report and Mr. Ray and Ms. Park for their informative Buff statement. Like many micro-state economies, Nauru is subject to high uncertainty and risks, including the unstable fishing revenues, volatile export prices, climate change. Also, the scaling down of the Australian Regional Processing Center for asylum seekers (RPC) will weigh on economic activity. With the factors underlying the rapid growth of previous years expected to be scaled down or exhausted over the medium term, policies need to be focused on promoting sustainable and inclusive growth. Moreover, the authorities should focus on preserving macroeconomic stability, reducing debt vulnerabilities and building policy buffers to absorb potential shocks.

Growth-friendly fiscal consolidation should be underpinned by public financial management reforms and greater fiscal transparency. We agree with staff's recommendations on sound fiscal and public debt management (DM) policies, including on the need for tax administration and public financial management (PFM) reforms. We call on the authorities to enhance spending prioritization in line with the National Development Strategy and to continue building capacity in DM and PFM. Given Nauru's significant needs of better infrastructure, health, education and climate change adaptation, could staff further elaborate on the immediate priorities within the prudent budget envelop? Strengthening governance is critical to raise the quality of public services and reduce vulnerabilities to corruption. Considering the short history of Nauru's Fund engagement in capacity development (CD), we encourage staff to continue supporting the authorities' efforts to advance Nauru's revenue system and budgetary framework. Could staff shed some light on the short-term CD objectives?

Further efforts are needed to develop the financial sector in order to facilitate private sector growth. After nearly a decadelong absence of deposit

taking services and of revoking of banking licenses, the recent steps in redeveloping Nauru's financial sector are welcome. We note that despite operating in compliance with the Australian financial regulations and supervision, regaining access to international transfer facilities has proven to be difficult, implying the need for continued strengthening of the AML/CFT framework. We encourage the Fund to assist the authorities in further boosting their capacity in this area.

Stabilizing the income and fostering economic diversification over the medium term remain critical for sustainable economic growth. Nauru's economy heavily depends on three main revenue sources: RPC, fishing licenses, and foreign grants. In this regard, the establishment of the Nauru Trust Fund is a step in the right direction, which could help to smooth fiscal cycle. Given that the economic outlook is largely dependent on limited resources, there are crucial needs to improve Nauru's physical and virtual connectivity, as well as to open new opportunities to rehabilitate the business environment and enhance economic diversification.

The economic viability of the secondary phosphate mining should be carefully evaluated. We note the difference of views between the authorities and staff about the risks associated with the secondary phosphate mining. Could staff elaborate more on the next steps envisaged by the authorities? A significant part of Nauru's territory is not arable. However, we did not find much in the report on the authorities' strategy to rehabilitate land. Staff's comments on this are welcome. Finally, exploring options for transferring good practice and know-how from donor countries could also be helpful.

With these remarks, we wish the authorities every success in their policy efforts.

Mr. Psalidopoulos and Ms. Cerami submitted the following statement:

We thank staff for the insightful report and Mr. Ray and Ms. Park for their candid Buff. We welcome the broad agreement and constructive engagement between staff and the authorities and support their call for further practical policy advice on potential avenues for diversifying the economy. As well emphasized in the report and in the Buff, broadening the sources of income and fiscal revenues is a key priority to promote sustainable growth and build macroeconomic resilience. We offer the following remarks for emphasis.

Developing a comprehensive strategy for diversifying the economy is paramount. Phosphate mining activity has been the primary engine of growth for a long time, supporting incomes at the cost of depleting large parts of the limited land for alternative uses. As primary phosphate reserves are almost exhausted and secondary mining would entail large upfront costs and uncertain production costs, as well as greater damage to the environment, we share staff's view that a deeper cost-benefit analysis should be undertaken before investing in new and untested mining technologies. We acknowledge that global demand for phosphate is projected to remain strong and that it is challenging to develop alternative high-yielding economic activities in a small and remote island. At the same time, we note that digitalization may lessen physical barriers to economic development. In this regard, we welcome the construction of a new undersea cable as well as of a new port. However, a more comprehensive strategy is needed to promote private sector development, including through measures to improve the business environment, strengthen the governance and performance of state-owned enterprises, develop the financial sector, and improve the quality of health services and education.

Fiscal policy should remain geared towards sustainability. The authorities have prudently used the fiscal surplus to make mandatory contributions to the Trust Fund, build cash buffers as recommended by staff, and clear arrears. They have also introduced new taxes and improved customs and tax administration, following staff's advice. However, further measures to expand revenues, better prioritize spending, and enhance public financial management are needed to compensate for the declining revenues from the Regional Processing Center and improve the quality of public spending. In this regard, we welcome the ongoing technical assistance provided by the Fund. We note with concern that public debt remains elevated and assessed as unsustainable also due to a large share of external defaulted debt, which impairs Nauru's access to international credit markets. Could staff provide more information about ongoing negotiations for resolving legacy debts?

We fully support the authorities' engagement with development partners on mitigation and adaptation measures to address climate change challenges. Given the high vulnerability to climate change and limited financial resources and technical capacity, the active engagement with development partners and donors is strongly encouraged. We also support staff's recommendation to integrate climate change plans into the medium-term fiscal framework.

Finally, we emphasize the urgent need to improve Nauru's statistical capacity and greatly appreciate the Fund's technical assistance in this area.

Mr. Rashkovan and Mr. Zedginidze submitted the following statement:

We thank staff for the well-written report and Mr. Ray and Ms. Park for the informative Buff statement. We welcome the constructive engagement between staff and the authorities and staff's analysis on the risks of fiscal sustainability, corruption and climate change. We broadly agree with the staff appraisal and would like to make the following comments for the emphasis.

With the diminishing phosphate resources and the scaling back of the Regional Processing Center, income resources for the economy of Nauru are unsustainable. Moreover, private sector development is hampered by infrastructure and capacity limitations. Against this backdrop, Nauru would benefit from active support from the international community. In this context, we note that the direct assistance from the US government to Nauru is on hold as a result of the imposed sanctions. We encourage the authorities to step up efforts to gain support from development partners.

The new DSA indicates that debt is unsustainable under the current policies and requires significant fiscal adjustment. The report points out the challenges of governance and corruption that limit the efficiency of spending and increases contingent liabilities. In this regard, the planned implementation of the new Public Enterprise Act is a good sign. More generally, however, reducing corruption requires a broad-based approach and public support. The small scale raises governance issues that might require more tailor-made solutions that are specific for small states. Can staff comment on whether there has been or planned any diagnostic report on governance which can be followed up in the future?

Finally, staff's analysis indicates that Nauru is a country that is particularly vulnerable to climate change-related risks, like many other small island states. We agree that climate change can have profound downside effects and should be considered macro-critical for Nauru. Therefore, we welcome the planned construction of a new port to reduce carbon footprint and the integration of climate change plans into the national economic development strategy.

Ms. Levonian, Ms. McKiernan and Ms. Smith submitted the following statement:

We thank Mr. Ray and Ms. Park for a very informative Buff on the Republic of Nauru, as well as staff for their Article IV report. Despite persisting challenges – which are typical of many small island states – Nauru has continued to make progress in several key areas. With the growth-supportive factors of recent years expected to diminish significantly over the medium term, policies will need to focus on achieving more sustainable and inclusive growth. In this context, we welcome staff’s assessment and recommendations and will limit our comments to matters relating to fiscal policy, economic diversification, and climate change.

Ensuring fiscal sustainability should remain a key priority. Notwithstanding recent fiscal surpluses, the subdued outlook for growth, together with the mandatory Trust Fund contributions, rising non-priority spending, and declining Regional Processing Center (RPC) revenues may derail fiscal improvements. Against this backdrop, staff’s recommendation to decrease expenditure by minimizing unnecessary spending, holding public sector wages constant in real terms, and enhancing social programs are certainly valid. Further, the suite of tax reform measures put forward by staff – including enhancing revenue administration and introducing a carefully designed consumption tax – should assist in offsetting revenue losses from Nauru’s membership to the Pacific Agreement on Closer Economic Relations Plus (PACER Plus) and from reduced RPC activity. Some consideration may also be given to adjustments in the Trust Fund contribution, which may reduce the strain on revenues, as well as the treatment of windfall revenue to ensure that funds are spent on debt repayment and/or developmental needs.

Moreover, it is commendable that the authorities have made steady progress on previous recommendations regarding public financial management (PFM) as fiscal prudence will prove instrumental in maintaining a solid fiscal footing. The authorities’ consideration of staff’s suggestions to maintain a cash buffer, possibly limit the use of supplementary budgets, and work toward reconciling and resolving government accounts is also encouraging. In addition, continued strengthening of governance is imperative for successful PFM, therefore, authorities’ commitment in this regard is welcomed.

Acknowledging difficulties in formulation and implementation, reforms that promote economic growth and diversification for the long term are critical for sustaining the economy. In the context of a phosphate industry that is deteriorating, unpredictable refugee activity, and a fishing industry

dependent of external factors, staff's recommendations for structural reforms are pertinent. On finding new sources of economic growth, analysis can be taken a step further to include specific examples of industries that may be feasibly developed and/or carving out new and innovative product lines (or services) from existing sectors. Nevertheless, the need for policies that promote human capital development across demographics is crucial for sustaining growth that is also inclusive.

In light of Nauru's increasing vulnerability to climate-related risks, climate change resilience must be incorporated in the policy mix and developmental goals. We welcome the progress made on adaptation and mitigation measures, as evident from the features of the new port, work on solar power generation, and the move towards use of cleaner fuels. Integrating climate change adaptation measures into medium-term budget planning will also be important going forward. Likewise, access to affordable financing and technical assistance from donors is critical for building resilience to natural disasters and climate change. Despite Nauru's vulnerabilities, some of its economic indicators may make the country ineligible for concessional financing to deal with climate-related shocks. This highlights the need for the Fund and other multilateral agencies to continue to think of ways to offer meaningful and low-cost assistance for small island states that find themselves in this predicament.

Mr. Tan and Mr. Mahyuddin submitted the following statement:

We thank staff for the report and Mr. Ray and Ms. Park for their informative Buff statement. Nauru faces substantial medium- and long-term challenges given limited sources of economic activity and income, capacity limitations and climate change. To this end, we welcome the authorities' commitment in implementing the necessary reforms and the favorable progress highlighted in the staff report and the Buff statement. We also agree with the broad thrust of the staff appraisal and would like to offer the following comments for emphasis.

Promoting economic diversification and private sector development must be prioritized for sustainable medium-term development. We underscore the importance of infrastructure development, including land rehabilitation as well as reforms to ease the cost of doing business. Given the specific challenges highlighted in the Buff statement, practical policy advice from staff and closer engagement with the authorities and other international institutions to explore potential avenues for diversification are critical. We appreciate staff's comment on the comparative advantage of Nauru that can support new

economic activity as well as any lesson learnt from other small states that is useful for Nauru to consider. We note staff's recommendation on developing new credit legislation, to pave way for formal credit products that can support private sector growth. Could staff elaborate to what extent the current level of financial sector development may have impeded private sector development in Nauru? With proper governance reform, we see merit in opening SOEs to private sector management or ownership. Transformation of SOEs can support private sector growth and potentially create new sources of growth. We also support efforts towards integrating climate change plans into economic and development policies. These efforts, together with transparent budget management can attract donor and multilateral development institution and support Nauru's diversifications efforts, particularly for green projects, leveraging on the increasing support for climate change agenda by the international community. Could staff comment on the potential role of the Fund to further catalyze support from development partners?

Fiscal prudence and strong public finance management are needed to confront the growing fiscal risks. The introduction of consumption tax can enhance and sustain revenue collection given that most Nauruan are in waged employment, concentrated in the government, SOEs and RPC. This policy must be supported by appropriate social program to safeguard the vulnerable households. More importantly, further tax reform will require clear communication in the context where most Nauru citizens do not have experience of paying taxes. We also agree with staff that a multi-year fiscal adjustment plan is needed on both revenue and expenditure sides, considering the narrow and declining revenue and existing commitment on mandatory Trust Fund contributions. In this regard, technical assistance for the fiscal adjustment plan is critical. From Annex VI, current capacity development on fiscal focuses only on revenue issues. Is there any plan for TA on medium term fiscal strategy that takes into account Nauru's likely absorption constraint in particular?

Improving the quality and timeliness of macroeconomic data is important for better analysis and evident-based decision making. We welcome the ongoing TAs to strengthen the core economic statistics.

We wish the authorities all the success in their future endeavors.

Mr. Bhalla and Ms. Indraratna submitted the following statement:

We thank staff for an informative report and Mr. Ray and Ms. Park for a detailed Buff statement.



The Republic of Nauru is a micro state in the Pacific Ocean with distinctive characteristics and vulnerabilities that can have a significant impact on macroeconomic and growth performance. Features such as a narrow economic base, limited capacity, inadequate infrastructure, undeveloped financial markets and high vulnerability to weather related disasters weigh on the country's growth performance. The scaling down of the Australian Regional Processing Centre (RPC) for asylum seekers will impact the economy adversely going forward. Therefore, the authorities should focus on promoting macroeconomic stability and sustainable growth while reducing debt vulnerabilities and building up buffers to absorb potential shocks.

We note that ensuring fiscal sustainability is key to Nauru's survival especially in the context of declining RPC revenues, mandatory Trust Fund contributions and rising non-priority expenditure. In this regard, we agree with the staff on the need to follow a fiscal adjustment path with a combination of policies aimed at reducing current expenditures and raising taxes. However, on the expenditure front, we urge the authorities to refrain from expenditure cuts that could worsen key social indicators such as life expectancy, income inequality and the primary net enrollment ratio as the republic of Nauru lags behind other small and micro states in terms of these indicators. The fiscal space created through a reduction in recurrent expenditures can be utilized for investments in physical and social infrastructure. We welcome the authorities' continued interest to engage in tax reforms and strengthen revenue administration and compliance and encourage the use of IMF technical assistance to design the proposed consumption tax and improve tax administration. We also note positively the performance of the Trust Fund which will help fiscal sustainability over the longer term.

Given the strategic importance of state-owned enterprises, we welcome the new Public Enterprise Act and encourage its implementation as this would improve the performance and financial viability of SOEs. We also note that progress has been made in the area of public financial management with improvements in transparency through the online publication of fiscal documents.

The Republic of Nauru is highly vulnerable to natural disasters and climate change. Therefore, we welcome the country's active engagement with development partners on mitigation and adaptation measures. We are encouraged by the authorities' commitment to reduce the country's carbon footprint with the establishment of the new port and the move to solar power generation. Since climate change is macro critical for the country, we support the staff view that further measures are needed to integrate climate change

resilience into the budget process and medium- term framework to mobilize funding from donors.

Given the narrow economic base and the scaling down of RPC activity in the future, the authorities need to diversify the economy by identifying new growth drivers while encouraging private sector development. We concur with the staff proposal to improve the doing business environment by way of streamlining processes, deregulation and privatization. In the case of privatization, we would suggest initially, the divestment of well performing public enterprises to incentivize private sector entrepreneurs to adopt these entities.

With these comments, we wish the authorities success in their future endeavors.

Mr. Buisse, Mr. Rozan and Mr. Sode submitted the following statement:

We thank staff for the quality of their documents and Mr. Ray and Ms. Park for their Buff statement. Despite the past richness of its natural resources, Nauru is currently facing severe development challenges. We welcome the recent efforts of the authorities to adopt a sound macroeconomic framework and we encourage them to step up governance reforms. While we agree with the thrust of staff report, we would like to make the following comments for emphasis:

Given the forecasted decline in public revenues, fiscal consolidation measures should be planned accordingly. While we support the measures proposed by staff to reduce public spending, we wonder whether a more ambitious target for tax revenues could be considered. Staff comments are welcome. Following the 2016 PEFA recommendations, the PFM framework should be further reformed. Improving the management of SOE is a key pillar in this regard.

Strengthening governance to ensure the sound use of public resources is crucial. Weaknesses in PFM, SOE governance and the AML/CFT framework have created space for corruption and inefficient use of public resources. Building up on recent improvements, reforms in these areas should be stepped up.

Improving the prospect for inclusive growth calls for ambitious structural reforms and plans to continue secondary phosphate mining must be carefully evaluated. We notably support staff call for improving the business

climate and reinforcing health preventive measures. Concerning phosphate mining, we encourage the authorities to consider staff analysis that further mining is economically inefficient given the significant costs attached to secondary phosphate mining in an environment of decreasing phosphate prices. Environmental consequences of this decision should also be considered.

Concerning the adaption to climate change, could staff elaborate on the costing of adaptation plans?

Mr. Sigurgeirsson and Mr. Bernatavicius submitted the following statement:

We thank staff for the informative report and Mr. Ray and Ms. Park for their concise Buff statement. We note that Nauru is a small island nation with significant capacity constraints and a narrow economic base that would benefit from expansion. We generally concur with staff's appraisal and would like to provide a few additional points for emphasis.

We welcome the authorities' strong commitment to fiscal prudence. We welcome the progress achieved in improving tax administration and encourage the authorities to continue with further reforms in this area. A cash buffer of at least 2 months of non-RPC current spending should be maintained, as well as the commitment to Trust Fund contributions.

However, we note with concern that the sustainability of public debt remains under challenge based on current policies. We agree with staff on the need for a fiscal adjustment plan. We encourage the authorities to resolve long-standing debt arrears and take measures to improve performance of SOEs, which could help expand access to markets. We urge the authorities to step up preparations for the likely scaling down in RPC activity, which currently provides almost 1/3 of the receipts of the budget.

We agree with staff, that the use of the Australian dollar as the legal tender is appropriate for current conditions. We welcome recent efforts in reforming the financial sector and encourage the authorities to develop new credit legislation. The availability of formal credit products would contribute to economic diversification by increasing the opportunities for private sector development. We agree with staff, regarding plans to continue the secondary phosphate mining can be economically inefficient given the significant costs and the already high debt burden.

We support staff's recommendation on addressing the shortcomings in economic statistics and to strengthen weak statistical capacity. We encourage the authorities to take full advantage of development partner assistance to improve the quality and availability of statistics for surveillance purposes.

Ms. Pollard and Ms. Senich submitted the following statement:

We thank staff for their report. As the IMF's smallest member country, Nauru is subject to substantial challenges, as noted in Mr. Ray and Ms. Park's Buff. We broadly agree with the staff appraisal in the Article IV to invest in resiliency and help diversify the economy. Nevertheless, we agree with Mr. Ray and Ms. Park that more granular advice, particularly on how to achieve economic diversification and sustainability would have been helpful. Given Nauru's micro size and location, we wonder whether drawing on the expertise of member countries with remote communities could provide helpful development advice.

Fiscal: We note that many of Nauru's fiscal policies over the last two years have been in line with previous IMF advice including maintaining fiscal surpluses, creating a cash buffer, improving fiscal transparency, and strengthening revenue administration. We would reiterate staff's advice, however, to appropriate windfall revenues in the normal budget cycle rather than through a supplementary budget process such as the one that was recently undertaken.

With an anticipated decline in RPC revenues, we agree that Nauru will need to prioritize expenditures in line with the National Development Strategy and continue making progress on SOE reform to eliminate the diversion of government resources from other critical investments. We encourage the authorities to take advantage of the IMF advice on tax reform as offered through PFTAC.

Debt Sustainability: The assessment of debt sustainability has changed from the last Article IV review, and is now classified as unsustainable. Can staff confirm the change in classification from sustainable to unsustainable is due to a more complete accounting of outstanding debt or inclusion of SOE debt, rather than a rapid accumulation of additional debt? We encourage the authorities to expedite negotiations with the yen bondholders and to consolidate the liabilities of the Bank of Nauru to reduce overall debt levels.

Financial Sector: We welcome the gains in financial inclusion, with almost full bank account penetration among adults. Noting the removal of the

offshore financial sector, we also appreciate the progress Nauru is making on the AML/CFT framework in preparation for the 2022 mutual evaluation. Governance challenges are still significant, and we appreciate the authorities' commitment to further Public Financial Management reforms and greater accountability and monitoring of SOEs.

Mr. Palei and Mr. Shestakov submitted the following statement:

We thank staff for the informative report and Mr. Ray and Ms. Park for their well-written Buff statement. In recent years Nauru has seen a continued decline in phosphate mining and reduced scale of operations at the Regional Processing Centre (RPC) for refugees and asylum seekers, which resulted in an economic slowdown. Nauru is also vulnerable to climate change, which causes relocation of the tuna stock that hampers fishing industry and reduces fiscal revenues. Going forward, the authorities face a challenge to diversify the economy, build resilience to climate change, invest in human capital, and accumulate fiscal buffers against the adverse external shocks.

The authorities are committed to achieve a positive budget balance that is at least sufficient to meet the mandatory Trust Fund contribution of 10-12 percent of domestic revenue, and to create a cash buffer of at least 2 months of non-RPC recurrent spending. Both commitments are perceived by staff to be at risk. In the medium term Nauru's budget balance is projected to enter deficit, so borrowing would be required to finance the Trust Fund contributions. The Cash buffer account is currently at 0.9 months of non-RPC spending which is short of its 2 months target. We support staff's recommendation to create cash management institutions to smooth the payment profile and ensure fiscal targets. There is a space to increase tax revenue with the introduction of a consumption tax and strengthening tax administration.

According to staff, weaknesses in fiscal governance, and a lack of accountability of SOEs create inefficiencies, vulnerabilities to corruption, and hinder growth. Authorities are encouraged to take further steps in ensuring fiscal transparency, open the public sector's balance sheets, and improve data coverage. Could the Fund's technical assistance be leveraged in this area?

We welcome the gains achieved by the authorities in financial inclusion through the Bendigo Bank Agency, which would help to promote credit opportunities for the Nauruan population. Structural reforms should focus on improving business environment, overcoming barriers to land use,

and opening non-performing SOEs to the private sector. We commend the authorities for making progress on its AML/CFT legislation. Nauru's remote location also highlights a high payoff from infrastructure improvement, and we agree with staff that the new port development and the undersea cable, as well as land rehabilitation, would support long-term economic development. What are the most promising areas for further development of the Nauruan infrastructure? Could staff elaborate on the authorities' plans on launching secondary phosphate mining, and risks of these projects for the SOE debt sustainability?

With these remarks, we wish the authorities success in facing challenges ahead.

Mr. Moreno and Ms. Mulas submitted the following statement:

We thank staff for its insightful report and Mr. Ray and Ms. Park for their informative Buff statement. We commend the authorities for their consideration and adoption of the policy actions recommended in Nauru's first Art. IV consultation in 2017, despite its capacity constraints. We encourage authorities to continue with the reform track, particularly on key policy recommendations for structural reforms, as diversification is paramount for Nauru's sustainable and inclusive growth.

We encourage authorities to accelerate structural reforms, as they are essential to private sector-led growth and economic diversification. Nauru is at a point of transition with a decline in phosphate mining and activity associated with the Australian Regional Processing Center (RPC) for refugees and asylum seekers. Besides, staff notes in its informative and interesting Annex V that the easily extractable and high-quality phosphate has been all mined and a secondary mining pose several and relevant risks. Against this background, we encourage authorities to move away from those activities and look for new sources of growth. Could staff advice which other sources of growth could Nauru develop? We strongly agree with staff on the need to improve the business environment. Efforts to improve infrastructure are steps in the right direction and we encourage fostering internet connectivity which is particularly important given Nauru's remote location.

Revenue measures are desirable but need to be well communicated. We agree with staff that a fiscal adjustment plan is needed to ensure fiscal sustainability. We see merit on the proposal to introduce a consumption tax in the near term; however, it is highly important to ensure that any new revenue measure is carefully designed and communicated, as most Nauruan citizens

have not previously had to pay taxes, as noted in the Buff statement. We welcome recent information regarding the fourth supplementary budget. We note that revenue gains are positive, but it has included little spending on core areas of education and health. Further comments are welcome. We commend authorities for their progress with public management reforms and we share staff's view on the need to improve monitoring and accountability of SOEs. To this end, we look forward to the full and timely implementation of the new Public Enterprises Act.

Climate change policies are necessary due to Nauru's vulnerability. We commend authorities for their efforts to improve mitigation and adaptation policies. Going forward, we agree on the need to integrate climate change plans into economic and development policies.

Further efforts are needed in the financial sector. The Bendigo Bank agency has helped in reestablishing trust in the financial sector, however cash is still widely used. Against this backdrop, we see a need to promote financial literacy. We also consider relevant to develop new credit legislation to foster micro-finance and other forms of credit, as we fully agree that formal credit is needed to support private sector growth.

Mr. Raghani and Mr. Carvalho da Silveira submitted the following statement:

We thank staff for the insightful report and Mr. Ray and Ms. Park for their helpful buff statement.

Nauru faces several development challenges, including volatile revenue sources, limited capacity and infrastructure. Despite these challenges, the authorities are making good effort to improve the country's growth prospects. In 2019, economic activity continued to expand, on the back of the service sector. Inflation remained moderate and fiscal balance registered large surplus for the third consecutive year. However, we note that the external position is weaker than implied by medium-term fundamentals.

Going forward, considering that risks to the outlook are still tilted to the downside, the authorities' policy efforts should be directed towards preserving fiscal sustainability, strengthening governance and transparency, and facilitating diversification and inclusive growth. We concur with the trust of staff appraisal and will limit our comments to the following points.

Swift implementation of tax and public financial management reforms is critical to ensure fiscal sustainability and reduce public debt. We welcome

the progress made over the recent years on tax reform which has helped improve tax revenue collection. In light of the foreseeable decline in Regional Processing Center (RPC) revenues, we agree that further efforts will be necessary to broaden the sources of revenue. In this context, focus should be placed on the implementation of an appropriate consumption tax and promotion of tax compliance, all within a medium-term revenue strategy as recommended by staff. This effort should be complemented by a target cash buffer to help absorb shocks. In addition, it would be helpful to give due consideration to the inclusion of costs related to climate change adaptation into the budget and medium-term fiscal framework. We encourage the authorities to advance with the PFM reforms and the implementation of the new Public Enterprise Act for monitoring and accountability of SOEs. Regarding the debt issue, we urge the authorities to vigorously pursue the resolution of old debts, including those contracted by SOEs, with a view to put public debt on a downward path.

Tackling structural bottlenecks to growth will be essential to encourage economic diversification. This will help foster higher, durable and inclusive growth. In this regard, we welcome the authorities' commitment to remove impediments to promote private sector development. Authorities' efforts should also continue to improve education, vocational training, and infrastructure, including for climate change mitigation and adaptation. Moreover, we encourage the authorities to continue addressing governance gaps as well as those related to the AML/CFT framework.

With these comments, we wish the Nauruan authorities success in their future endeavors.

The Acting Chair (Mr. Zhang) made the following statement:

As you know, Nauru is a country in the Pacific and is remote and is also one of our smallest members. The country is exposed to significant risks from declining revenues and climate change. These issues are highlighted in your gray statements, including how to move forward to meet these challenges, ranging from how to preserve fiscal and debt sustainability and foster economic diversification and improved governance and transparency. All these are quite important, and you have already highlighted them. I am sure in the remaining time of this session we will have a discussion on all of these issues.

Ms. Al Saud made the following statement:

We thank staff for the insightful report and Mr. Ray and Ms. Park for the helpful buff statement. We did not issue a gray statement since we broadly



agree with the thrust of the staff appraisal and would like to limit our remarks to the following points.

First, we agree that the lack of scale and remoteness pose challenges for economic growth and development in Nauru. In this context, we welcome that the authorities agree on the need for broadening economic activity and the income base. Notably, a fiscal adjustment is required, with measures to improve revenue administration, reduce spending in nonpriority areas, and implement tax reforms. Here, we welcome staff's update that the authorities are making progress on public financial management reforms. Most importantly, immediate governance improvements are needed to reduce vulnerabilities to corruption, while renewed efforts are needed to reconcile and resolve longstanding debt arrears.

Second, the Fund should provide practical policy advice on potential avenues for diversification. In this context, we agree with staff that policies should be implemented in the near term to support private sector activity while ensuring the effectiveness of education and health spending to meet development goals. Given the high frequency and severity of natural disasters, enhancing both mitigation and adaptation measures will support Nauru's development agenda.

Finally, Fund technical assistance should continue to play an important role in resolving data shortcomings to strengthen analyses and policy formulation.

With these remarks, we wish the authorities further success.

Mr. von Kleist made the following statement:

We thank staff for the informative report and Mr. Ray and Ms. Park for the very helpful buff statement. As we broadly agree with staff's assessment and policy recommendations, I would like to only make three points.

First, in light of the challenges presented by the reduced phosphate activity, a prudent management of the transition is of the essence. To address the associated fiscal revenue loss, a proactive adjustment plan appears warranted. In this context, staff depicts a viable reform scenario with a view to avoiding a breach of the fiscal anchor and preventing the heightened debt projected over the medium term. Complementarily, we encourage the authorities to continue their efforts to strengthen public financial management and address governance and corruption-related risks.

Secondly, looking ahead, we concur with the staff's emphasis on improving the business environment and providing opportunities for economic

diversification. In this context, we take positive note of the new seaport project which, according to staff, can support growth while simultaneously reducing Nauru's carbon footprint by as much as 30 percent.

Lastly, we join the staff in encouraging the authorities to further improve the quality of official statistics, including through technical assistance.

With this, we wish the authorities all the best for their future endeavors.

Mr. Odonye made the following statement:

We did not issue a gray statement because we were, more or less, in agreement with the views of the staff. We decided that we would really add a few thoughts on the evolution going on in this newest member of the Fund.

We note that the recent economic transformation has been met by declining activity in phosphate mining and the Regional Processing Center over the medium term, alongside the country's longstanding challenges. In this regard, we urge the authorities to prioritize policies on preserving fiscal and debt sustainability, fostering economic diversification, and strengthening governance and transparency.

Furthermore, we note Mr. Ray and Ms. Park's statement, emphasizing that the authorities look forward to continued support and technical assistance from both donors and partners to sustain the progress on broadening the revenues and diversifying the economy. We would appreciate a further elaboration on the areas the Fund could really make a major impact in this regard.

With these expressions, we wish Nauru great achievements in the years ahead.

Ms. Levonian made the following statement:

Thank you to staff for the informative report and Mr. Ray and Ms. Park for the very useful buff statement. We have elaborated our major points in our gray statement, so my remarks will be very brief.

First, I would like to reiterate how important it is for small island states to take necessary steps toward building resilience against the vulnerabilities associated with climate change. This requires a combination of policy formulation and reforms, as well as an investment in physical adaptation measures, both of which require human capital and funding. Therefore, we

welcome the continued dialogue on how the Fund can offer meaningful assistance to Nauru and other member countries in similar circumstances.

Second, on the matter of diversification, understanding that this is a very challenging objective for many small economies, I wish to emphasize that practical advice that is tailored to the special features of Nauru's economy will be most helpful to the authorities.

Lastly, I support the points raised in the gray statement of Mr. Moreno and Ms. Mulas, as well as others, relating to the development of the credit sector and related legislation. I believe that this is particularly important for the objectives of diversification, as it will help local businesses get the funding needed to be innovative and foster inclusive growth, and should assist in giving persons across the varying demographics within Nauru an opportunity for fair and transparent financing.

With that, I wish the authorities well.

Mr. Chikada made the following statement:

We thank staff for the well-written report and Mr. Ray and Ms. Park for the informative buff statement. As we have issued a gray statement, I will be brief and would like to make one comment.

We appreciate staff for their answers to our technical questions. We particularly appreciate additional information on the intergenerational trust fund. On this point, however, we note with concern that its targeted total returns are 3.5 percent per annum in real terms, excluding fees and inflation, so their targeted nominal return is presumably 6 percent or higher. Of course, the trust fund could benefit from their long-term investment horizon, but the level of the targeted returns could be quite challenging in the lower-for-longer environment. Against this background, and given the critical role of the trust fund in Nauru's fiscal sustainability, we would encourage the staff to continue to carefully monitor their investment performance and risk management and to give appropriate advice to the authorities.

Mr. Fachada made the following statement:

I thank staff for the report and engagement with our office. I also thank Mr. Ray and Ms. Park for the buff statement.

I commend the authorities for their policy implementation. In spite of the enormous obstacles to Nauru's development, the authorities continue to persevere in their efforts to promote economic sustainability and ensure long-term growth. At this point, I just want to raise two specific issues.

First, I consider this report very useful, with clear analyses and clear recommendations that can effectively be implemented. This is a point that we have raised many times here in the Board; that is, it is important that the narrative and policy recommendations in Article IV staff reports be aligned with the reality of what is actually achievable by the authorities, especially in the context of a microstate with a population of only 13,000 people and very limited capacity. Overall, I think that the staff has managed to provide useful guidance in this report.

Second, one issue that is prevalent in the report is the large volatility of the macroeconomic variables and the large uncertainty about economic prospects. In this context, I think that staff's analysis could benefit from making clear this enormous uncertainty. This is recognized, for instance, in the external sector assessment, where staff considers Nauru's external position as substantially weaker than medium-term fundamentals and desired policies but recognizes the high level of uncertainty around this assessment. This is also true, for instance, in relation to GDP projections, in relation to government revenues, fiscal outcomes, et cetera. So I think that the importance of recognizing uncertainties in a country that has a very limited economic base and whose the track record of the Fund with the country is very recent should be highlighted in the staff report.

Mr. Sigurgeirsson made the following statement:

Coming from a very small country myself, I am particularly pleased to discuss Nauru. I would underline that Plato considered the optimal size of a state to be 10,000 people, and it is important that we know that.

We thank Mr. Ray and Ms. Park for their concise buff statement. We note that Nauru is, of course, a very small island with significant capacity constraints and a narrow economic base, something that we are very familiar with, and a base that could benefit from expansion. Perhaps it will be helpful to look at other countries that have managed to diversify their economic base.

I would also like to say with some regret that their natural fund was invested quite heavily in the Icelandic banks 10 or 20 years ago and incurred significant losses, and we are very sorry for that.

Our main concern has to do with fiscal policy and fiscal policy sustainability. We very much welcome the authorities' strong commitment to fiscal prudence and the progress achieved in improving tax administration. We encourage the authorities to continue with further reforms in this area.

Mr. Tan made the following statement:

We thank staff for the helpful report and responses to our questions. We also thank Mr. Ray and Ms. Park for the clear and concise buff statement.

We have issued a gray statement and would like to just add one quick comment. This is in response to one of the written questions, where staff has highlighted that low financial sector development has hindered growth in the private sector, to a significant extent through the lack of funding for working capital and investment and an absence of microfinance to support potential microbusinesses.

Similar to the comment made by Ms. Levonian earlier, given the important role that private sector development plays in broadening the sources of economic growth for Nauru, we see room for a more comprehensive assessment in this area going forward.

We would also like to echo the authorities' call for practical policy advice from staff to better help the authorities overcome the challenges impeding economic diversification. On that note, we wish the authorities well.

Ms. Indraratna made the following statement:

We thank staff for the informative report and Mr. Ray and Ms. Park for the comprehensive buff statement. We have issued a detailed gray statement; therefore, my comments are only for emphasis and are restricted to the fiscal sector.

We all know that fiscal sustainability is key to Nauru's survival. The authorities need to cut current expenditures and raise revenue. However, we would like to stress that expenditure cuts should not worsen key social indicators, such as life expectancy, income inequality, and primary net enrollment ratios, as Nauru lags behind other microstates in terms of social indicators. The fiscal space created through a reduction in recurrent expenditures can be utilized for investments in physical and social infrastructure.

We also welcome the authorities' continued interest to engage in tax reforms and strengthen revenue administration and compliance. We encourage the use of IMF technical assistance to design the proposed consumption tax and improve tax administration. We also welcome the new Public Enterprise Act and encourage its implementation, as this would improve the performance and financial viability of state-owned enterprises.

The staff representative from the Asia and Pacific Department (Ms. Kaendera), in response to questions and comments from Executive Directors, made the following

statement<sup>1</sup>:

I would like to thank Executive Directors for the thoughtful statements. I will keep my remarks short, as you have already seen most of the responses that we have provided. I only have a few remarks on new sources of growth and diversification, an issue that has arisen in most of the gray statements.

Directors asked staff about advice on new sources of growth and areas that could support new economic activity. We agree that this is a major challenge. Diversification opportunities are relatively limited, and the transition from phosphate mining to new areas of activity may not be smooth. The authorities are keenly aware of this. The president and the finance minister raised these issues during the Article IV mission.

As highlighted in the buff statement from Mr. Ray and Ms. Park, the authorities see the assistance of development partners as important in helping them to advance potential avenues for diversification and improve basic infrastructure.

In the near term, fishing and potential opportunities from an efficient new seaport will provide a welcome avenue for diversification. Establishing the internet undersea cable could also have significant implications for growth by improving connectivity, given Nauru's remote location and reliance on internet access for financial services. However, to harness the benefits from improved connectivity, it will be especially important to put in place a strong regulation and policy environment for the information and communications technology (ICT) industry.

In the medium term, the authorities could consider investing in agriculture to contribute to growth and to improve nutrition. This, however, will require accelerating land rehabilitation. There is also potential for game fishing and specialized tourism, for example, game tourism, building on the previous events that have been hosted in Nauru. This, however, would require investments in tourism infrastructure.

In staff's view, it is important for small and remote economies to foster a constructive dialogue between the government and the private sector. Without such communication, the private sector may not raise concerns, and impediments to the business environment may go unaddressed. Staff encourages the authorities to engage with the private sector on a regular basis, with the aim of increasing the ease of doing business.

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<sup>1</sup> Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

Finally, barriers to land use are often cited as a constraint to investment and a limiting factor to diversify economic activity in Nauru. This is an issue common in most of the Pacific island small states. Nauru will need to find solutions that will work for all parties.

Mr. Ray made the following concluding statement:

Thank you to colleagues for both your statements and your remarks this afternoon. We will convey your views, suggestions, and encouragement to our Nauruan authorities. This is Nauru's second Article IV process, and it is a new government, and they are taking it quite seriously.

Let me begin by extending my authorities' appreciation to Ms. Kaendera and her team for their positive engagement and constructive dialogue. Nauru is not a particularly difficult place to go to, but it is not without its challenges for a Fund mission team. And based on my own visit separately to Nauru, I appreciate what you would have gone through. And I believe that this is your first mission chief role, so you should take a lot of credit for the very good outcome.

I have got three points to make, mainly around this question about how the Fund could best help small island states like Nauru.

First, on the policy advice generally, and the points made by Mr. Fachada and Ms. Levonian here were completely aligned to the way we think about it. It needs to be practical and carefully tailored to the circumstances. Nauru has got a population of around 12,000, so it is sort of the size of a small town. And when we refer to the financial sector in Nauru, we are talking about 11 ATMs that are managed by an agency of an Australian bank. That Australian bank is regulated by the Australian authorities and is limited in what it can do on Nauru. So the economy is cash-based. There is no credit available, not just for business but for anybody.

When we talk about barriers to land use in Nauru, we are talking about the fact that 80 percent of the island has been mined for phosphate, which leaves behind an uneven surface of limestone pinnacles that are up to 15 meters high, and they are very hard. This land is simply unusable without expensive rehabilitation, and the rehabilitation is complicated by a patchwork of ownership that is passed down through families.

When we talk about infrastructure, we are mainly talking about one paved road which runs 17 kilometers around the island and through the airport. The road has to close when a plane lands or takes off so that the plane can taxi across it. And it is on a coastal strip, and it is regularly inundated from the Pacific Ocean. There is no continental shelf. There is no barrier reef. It is quite a different type of location. In that context, it is very tricky to think

about the policy advice, particularly if you have been trained as a Fund macroeconomist, so I really thank the staff team for trying to think hard.

Second, fiscal policy advice looks different in small states. And one topic that I worry about very much in the Pacific and you have heard me on this. Nauru's history is a very good example of what can go wrong, which is the management of trust funds. Mr. Chikada really hit this nail on the head. For these funds to be a good source of future income, they have to be very well managed. They are pots that, as they grow, will attract various people who will come along with get-rich-quick schemes, particularly if the investment mandate is such that it is encouraging excessive risk taking. I strongly encourage Fund staff teams to scrutinize these trust funds very carefully.

Similarly, while the standard advice is to limit the use of supplementary budgets, my Nauruan authorities reiterate that they need some flexibility to respond to what can be large and unpredictable variations in revenue, given the very narrow revenue base.

Lastly, Nauru is grappling with the challenges associated with climate change. The Fund has got a role to play in assisting small states to understand and manage the expected economic impact of climate change in a way that safeguards long-run fiscal and external sustainability, for example, through working with the World Bank on Climate Change Policy Assessments. But I also tend to think that the Fund has a role to play in assisting small states in navigating the global climate funding bureaucracy, which is challenging. Access to climate funding should not be entirely dependent on income. And my authorities have re-enforced to me that Nauru needs financing and investment in order to basically stop the coastal strip from being inundated. And the coastal strip is where everybody lives because the pinnacles are uninhabitable, unless you are in a jail built by the Australians, which has not actually ever had an inmate.

Just one last comment. Ms. Pollard, in her gray statement, raised a thought about whether or not there are lessons that could be gained from larger countries that have remote communities. I thought that was a very interesting to do and certainly would be worth thinking about. Perhaps staff could think about working with some authorities such as the Canadian authorities or the Australian authorities in that regard.

The Acting Chair (Mr. Zhang) noted that the Republic of Nauru is an Article VIII member, and no decision is proposed. The 2019 Article IV consultation with the Republic of Nauru is hereby concluded.



The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the improved economic performance in recent years, but noted that significant challenges remain, including volatile revenue sources, capacity and infrastructure constraints, and climate change. To help address these challenges, Directors urged the authorities to press ahead with reforms to preserve fiscal and debt sustainability, foster economic diversification, and strengthen governance and transparency.

Directors agreed that Nauru's medium-term fiscal outlook is vulnerable to the scaling down of the operations of the Australian Regional Processing Center (RPC) for asylum seekers, entailing a substantial decline in government revenue. They stressed the importance of a timely adjustment of fiscal plans to avoid breaching the fiscal anchor, meet the mandatory Trust Fund contributions, and prevent further accumulation of debt. Directors highlighted that maintaining adequate fiscal buffers would be critical to ensure fiscal liquidity and sustainability, and to allow flexibility in responding to shocks.

Directors urged sustained fiscal reforms, including continued tax and public financial reforms to support fiscal adjustment and help control spending. They underscored the need for continued improvement in public debt management to resolve legacy debt and contain debt accumulation, including within state-owned enterprises (SOEs). Directors urged the authorities to limit the use of supplementary budgets and to set aside windfall revenues for appropriation in the normal budget cycle to boost resources for carefully planned investment spending. They welcomed the new Public Enterprises Act, including establishment of the SOE monitoring unit.

Directors noted that Nauru faces long-term climate change challenges and emphasized the importance of a medium-term fiscal framework that enhances resilience to climate change. They welcomed recent measures in adaptation and mitigation, including the new seaport that will reduce Nauru's carbon footprint. They encouraged the authorities to fully cost adaptation plans and incorporate the projects into a multi-year budget plan.

Directors agreed that prospects for inclusive growth and private sector development can be lifted through improvements in the business environment. They welcomed progress in financial inclusion and called for further strengthening of the anti-money laundering/combating the financing of terrorism (AML/CFT) framework. Directors urged the authorities to seek to

improve the quality of health and educational outcomes, and continue to combat non-communicable diseases. Directors strongly encouraged the authorities to improve the quality and timeliness of macroeconomic data for surveillance.

It is expected that the next Article IV consultation with the Republic of Nauru will be held on the 24-month cycle.

APPROVAL: September 23, 2022

CEDA OGADA  
Secretary

## Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

### Growth, Outlook and Risks

1. ***Could staff elaborate on the authorities' plans on launching secondary phosphate mining, and risks of these projects for the SOE debt sustainability? We note the difference of views between the authorities and staff about the risks associated with the secondary phosphate mining. Could staff elaborate more on the next steps envisaged by the authorities?***
  - Secondary phosphate mining is proving to be an increasingly expensive project. Phosphate prices have fallen recently with other competitors providing phosphate at cheaper prices.
  - The authorities remain positive about the prospects of secondary phosphate mining in Nauru. It is believed that around 60 million tons of phosphate could be mined through secondary phosphate mining. This would translate into close to \$5 billion worth of phosphate that is left to be mined, at today's price. There has also been interest from Japanese buyers for dolomite (mineral) coming out of Nauru. Ending phosphate mining in Nauru is difficult due to strong historical associations and the about 400 jobs that would be lost.
  - Mining equipment has been purchased and the authorities plan on mining around the island and rehabilitating the mined land by covering it up with top soil that would be suitable for agriculture.
  - Secondary phosphate mining poses risks for public debt sustainability. The SOE responsible for phosphate mining (RONPHOS) does not have access to concessional financing. In 2018, the government contracted a US\$5 million loan from Taiwan, on behalf of RONPHOS.
2. ***A significant part of Nauru's territory is not arable. However, we did not find much in the report on the authorities' strategy to rehabilitate land. Staff's comments on this are welcome.***
  - The SOE responsible for land rehabilitation is the Nauru Rehabilitation Corporation (NRC) but it lacks resources to fulfill its mission. NRC is currently focusing on generating income through the sale of rocks and aggregate, and road rehabilitation. Until recently the SOE had also been tasked with phosphate mining. At the time of the Article IV mission in September 2019, NRC had leveled 5 hectares, in two different areas. It has also commenced a project to clear 6 hectares of land for a solar farm, with funding from the Asian Development Bank (ADB).

**3. *What are the most promising areas for further development of the Nauruan infrastructure?***

- Staff agrees with the Australian-commissioned Nauru Infrastructure Report 2018, which identified the following areas for further development: renewable energy, water and sanitation, drainage and roads, health, education, waste management, and land rehabilitation.

**4. *We appreciate staff's comment on the comparative advantage of Nauru that can support new economic activity as well as any lesson learnt from other small states that is useful for Nauru to consider. Could staff advice which other sources of growth could Nauru develop?***

- Nauru faces a number of constraints common to small islands that are microstates: a narrow production base, remote location, high cost of public goods, small population, and insufficient infrastructure. Capacity constraints, low access to credit by the private sector, and very limited international market access are key impediments to activity. The authorities see scope for diversification by investing in agriculture to contribute to growth and improve nutrition, but this will require accelerating land rehabilitation. The new sea port and undersea cable have the potential to support growth and provide new growth opportunities.

**(Staff will also address this orally at the Board meeting)**

**Fiscal Policy and Debt Sustainability**

**5. *We appreciate more information on this crucial fund, including its targeted return and how asset allocation and risks are managed as well as the results of the self-assessment?***

- The investment policy statement (effective June 2016) states that “the investment return objective is to achieve a total return of 3.5 percent per annum (after fees) over inflation (as measured by the Australian Consumer Price Index) over rolling 10 year periods.” The policy further states that “This rate of return is sought with the following risk objective: to limit the number of negative returns to less than 4 negative years in 20; to limit the severity of negative returns to less than -18 percent.” <http://www.naurugov.nr/government/departments/departments-of-finance/intergenerational-trust-fund-for-the-people-of-the-republic-of-nauru.aspx>
- The trust fund is governed by a committee comprised of representatives from the government of Nauru and development partners contributing to the fund. The committee appointed Mercer International as the investment fund manager. The latest governance self-assessment (2019) is available on the International Forum of Sovereign Wealth Funds and finds that the Nauru Trust Fund adheres to the Santiago Principles. <https://www.ifswf.org/assessment/nauru>

6. ***We highlight that the authorities need to make further efforts to improve public debt management to resolve old public external debt and arrears. In this regard, we wonder whether there is a plan and an expected timeline to resolve them? Could staff provide more information about ongoing negotiations for resolving legacy debts?***
  - The authorities indicated that the negotiations with the Yen bond holders made substantial progress but have stalled pending further negotiations on the estimated current value of the debt. On domestic arrears, reconciliation of the outstanding royalty payments to landowners by the Nauru Phosphate Trust Fund and RONPHOS is at an advanced stage. Once finalized, the findings will be submitted to the Ministry of Finance and Parliament. The government has made a commitment to resolve these debts. The authorities have also contacted various international organizations to resolve outstanding membership fees.
7. ***Can staff confirm the change in classification from sustainable to unsustainable is due to a more complete accounting of outstanding debt or inclusion of SOE debt, rather than a rapid accumulation of additional debt?***
  - A large part of the change in the classification from sustainable to unsustainable is attributable to the inclusion of earlier contracted SOE debt plus the defaulted yen bonds, the effective face value of which remains uncertain. In addition, there was a new loan of US\$5 million contracted on behalf of RONPHOS for secondary phosphate mining.
8. ***In view of uncertainties regarding fishing license fees and revenue from RPC, as well as large assets of the public sector, we are not totally convinced that public debt is unsustainable under current policies.***
  - The level of debt is judged to be unsustainable under current policies, over the medium term, due to vulnerabilities relating to the scaling down of RPCs, lower fishing revenues, and increased commodity prices. Our assessment on debt sustainability could change if the negotiations with the yen bond holders and the clearing of any past arrears associated with Bank of Nauru and NPRT lead to debt forgiveness or a reduction in debt. However, recent borrowings taken on behalf of SOEs for secondary phosphate mining pose a threat to debt sustainability given the risks from non-performing SOEs.
  - While it is true that Nauru has accumulated substantial assets in its trust fund, these cannot be withdrawn these resources cannot be used until 2033. While the Trust Fund is perpetual, the charter does not provide for withdrawals over the forecast horizon and hence, has little or no bearing on improving the debt trajectory in the medium term.

9. ***Given Nauru's significant needs of better infrastructure, health, education and climate change adaptation, could staff further elaborate on the immediate priorities within the prudent budget envelop?***

- The new government is committed to prioritizing infrastructure (including climate resilient infrastructure), health and education spending to catalyze growth, build capacity and reduce income inequality. The current budget envelope has scope for expenditure reprioritization to increase expenditure on health and education and making it more effective. Infrastructure spending is largely undertaken with financial and technical support from development partners given the current budget envelope may not be able to support the large project financing needs. The recent realization of windfall revenues gave the government an opportunity to appropriate additional expenditure towards the priority areas of health and education, but this did not materialize.

10. ***Can staff comment on whether there has been or planned any diagnostic report on governance which can be followed up in the future.***

- There is no governance diagnostic report for Nauru planned by IMF staff, but there is recognition of the need for governance reform in particular areas. Available evidence based on indicators and qualitative reports points to governance vulnerabilities in fiscal governance, rule of law, SOEs and AML/CFT. Timely implementation of the SOE Act would help to improve governance within the SOEs, for example the provision of financial statements and reporting. Staff will continue to focus on these topics during surveillance discussions.

11. ***While we support the measures proposed by staff to reduce public spending, we wonder whether a more ambitious target for tax revenues could be considered. Staff comments are welcome.***

- Staff focused more on expenditure given that the recent realization of windfall revenues has resulted in a corresponding increase in expenditure. In view of the expected scaling down of RPC operations and related decline in revenue, expenditure cut is necessary and should commence as early as FY2021. There is certainly scope for more ambitious revenue targets. However, this would be more appropriate over the long run as benefits from broadening the tax base and new taxes, such as a consumption tax, would take time to materialize. In the near term, strengthening revenue administration and compliance would yield some benefits but gains from expenditure cuts would support fiscal consolidation over the medium-term.

12. ***We note that revenue gains are positive, but it has included little spending on core areas of education and health. Further comments are welcome.***

- Most of the total supplementary budget appropriation (around one-third) was for increased spending on public sector salaries and contracts, SOE subsidies and travel. Staff encourages greater prioritization of spending on education and health to address

the high rates of non-communicable diseases, long standing problems with school attendance, low literacy rates and retain qualified teaching staff who speak the Nauruan language, in order to provide an inclusive learning environment for children who are not English speakers.

## **Financial Sector**

**13. *Nauru is facing constraints on making international fund transfers, which is a burden for business sector development. Could staff elaborate the reasons behind these constraints despite the fact that the Nauru's AML/CFT has been improving and the Bendigo Agency adheres to the Australian standard AML/CFT and other requirements?***

- The challenges faced by Nauru are not unique since the trend in reduction of correspondence banking relationship has led to restricted access to financial services, such as money transfers, in many small countries including in the Pacific. In the context of Fund Staff's work on the withdrawal of correspondent banking relationships, it has been found that the drivers are multiple and interrelated and could include both risk and profitability considerations. Clearly communicating achievements in strengthening the financial sector and AML/CFT framework could be key in dissipating perceived risk.

**14. *Could staff elaborate to what extent the current level of financial sector development may have impeded private sector development in Nauru?***

- Low financial sector development has hindered growth in the private sector to a significant extent through the lack of internal funds for working capital and investment, and the absence of microfinance to support potential micro-businesses. The lack of an insurance product also increases challenges to firms. Staff sees access to financial services and products as an important step towards improving prospects for future private sector development.

## **Climate Change**

**15. *Concerning the adaption to climate change, could staff elaborate on the costing of adaptation plans?***

- Nauru published the 2014 Framework for Climate Change Adaptation and Disaster Risk Reduction (RONAdapt) to provide a roadmap to address climate change vulnerabilities. Nauru also completed a study on climate change finance assessment to help make informed decisions and measures to improve access and manage climate change resources. However, more work is needed to cost and integrate these climate change strategies into medium-term budget planning. Staff recognizes that first best practices may take years to implement. In the interim, staff has recommended practical approaches for near- and medium-term implementation. These actions include identifying capital projects already in the pipeline, matching them with the

climate strategies, determining the implementation sequence, and working with donors on financing and ensuring that these projects meet climate-proofing standards.

## **Fund Engagement**

### **16. *Could staff shed some light on the short-term CD objectives?***

- Short term CD objectives include assistance with fiscal transparency and data. CD plans for FY2021 are being finalized, but broad objectives for FY2021 are to:
- Strengthen revenue administration management and governance arrangements. This will include drafting of an Excise Act and Goods Tax Act.
- Build capacity in compilation and dissemination of data, including work to update and rebase GDP.
- Improve Government Financial Statistics (GFS), including by mapping the national chart of accounts to GFS.
- Improve the quality and coverage of fiscal reporting.
- Strengthening macroeconomic statistics

### **17. *Could staff comment on the potential role of the Fund to further catalyze support from development partners?***

- During the membership mission in May 2015, the authorities emphasized that Nauru's developmental challenges are daunting and hoped that the Fund and other development partners could support their medium-term reform agenda. Against this background, the Fund is focusing on strengthening the authorities' capacity in the areas of public financial management with the aim of increasing the development impact of fiscal policy. In addition, the Fund's macroeconomic assessments inform the lending decisions of other development partners, including the Asian Development Bank (ADB).

### **18. *Technical assistance for the fiscal adjustment plan is critical. From Annex VI, current capacity development on fiscal focuses only on revenue issues. Is there any plan for TA on medium term fiscal strategy that takes into account Nauru's likely absorption constraint in particular? Authorities are encouraged to take further steps in ensuring fiscal transparency, open the public sector's balance sheets, and improve data coverage. Could the Fund's technical assistance be leveraged in this area?***

- The authorities have made progress in improving revenue administration and implementing new income tax supported by PFTAC technical assistance, but stronger control of spending growth is needed.
- Staff agrees that a strong public financial system, including a medium-term fiscal strategy is crucial to ensure that Nauru will be able to meet its development policy priorities. While no plans have been made on delivering TA on medium term budget planning and fiscal strategy, previous Fund TA was sequenced to assist in establishing basic financial policies, rules, and regulations; improving basic internal



control procedures such as debt and bank reconciliation, accounting and reporting; and ensuring fiscal transparency, including catching up with the audit of financial statements. In the meantime, the Fund continues to support the authorities in strengthening their spending policies to ensure fiscal sustainability. Staff will consult the authorities and other technical assistance providers on sequencing the next phase of reforms to ensure that there is no duplication of assistance.

## Statistics

19. ***Could staff discuss the reason why GNI in Nauru is about 40 percent larger than GDP? Is such large gap also found in other Pacific small states?***
  - GNI includes GDP and primary income from BOP. For Nauru, main source of income in BOP is fishing revenue, which is quite substantial (41 percent of GDP in FY2019). Although not explicitly presented in the Staff Report, Pacific countries that have a large share of fishing revenue in BOP, contribute to a large primary income balance and have a large gap between GDP and GNI. For example, Kiribati, Tuvalu, and FSM.