



REPUBLIC OF NAURU

February 2022

2021 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; INFORMATIONAL ANNEX; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR NAURU

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2021 Article IV consultation with Nauru, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its February 2, 2022 consideration of the staff report that concluded the Article IV consultation with the Republic of Nauru.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 2, 2022 following discussions that ended on December 6, 2021, with the officials of the Republic of Nauru on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 14, 2022.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for the Republic of Nauru.

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IMF Executive Board Concludes 2021 Article IV Consultation with Nauru

FOR IMMEDIATE RELEASE

Washington, DC – February 7, 2022: On February 2, 2022, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with Nauru.

Nauru was expanding moderately prior to the pandemic and continued to expand during FY2020 and FY2021 owing to a sizeable pandemic policy response. Pandemic-related measures included freight support to ensure food and fuel security, quarantine measures, securing vaccines, and a scaling-up of intensive care facilities. Notwithstanding a delay in construction projects due to supply chain disruptions, the economy expanded by 0.7 percent in FY20 and 1.5 percent in FY21. As of December 2021, Nauru has not had any COVID-19 cases on the island, the adult population is nearly fully vaccinated, and vaccination for under-18-year-olds is expected to commence shortly.

Growth is expected to moderate, and the current account to narrow, in FY22, due to the expected slowdown in Regional Processing Center (RPC) activity. Despite ongoing fiscal support, the high COVID-19 vaccination rate, and the resumption of construction activity, real GDP growth is still expected to slow from 1.5 percent in FY21 to 0.9 percent in FY22. This largely reflects the anticipated scale-down of the RPC, which is an important source of economic activity on the island. The current account is expected to narrow to a smaller surplus of 1.2 percent of GDP in FY22 resulting from lower RPC-related export of services, departure of RPC-associated expatriate workers, and a lower goods balance from the increase in fuel prices.

Risks to the outlook are tilted significantly to the downside. Given limited medical facilities and a high incidence of risk factors such as diabetes, a local COVID-19 outbreak could have adverse health and growth implications. The medium-term fiscal outlook remains exceptionally uncertain pending clarity about RPC-related revenues when the facility moves to a model of “enduring capability”. As RPC employment is about 15 percent of the local labor force, a significant number of Nauruans could be at risk of long-term job loss under enduring capability if a labor reallocation strategy is inadequately implemented. External downside risks include a sharper-than-projected rise in commodity prices, natural disasters, and a more protracted global recovery that delays infrastructure projects on the island. Upside risks include an extension of RPC with no job losses, and successful commercialization of the port project.

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Executive Board Assessment²

Executive Directors commended the Nauruan authorities for their effective measures to prevent a domestic outbreak of COVID-19 and for their supportive policies, which have helped the economy continue expanding in FY2020 and FY2021. Directors also commended the authorities for the steps taken to restore debt sustainability. Noting that risks to the outlook are tilted to the downside, they underscored the importance of structural and fiscal reforms that promote sustainable, inclusive, and greener growth.

Directors agreed that near-term fiscal support should be calibrated to the state of the pandemic, and plans should be formulated to absorb or upskill workers employed in the Regional Processing Center. They concurred on the need to continue fiscal support for food and fuel security and emphasized the importance of reducing subsidies for state-owned enterprise as operations return to pre-pandemic levels. Directors also recommended shifting budget allocations away from non-transparent expenditures toward health, education, and further investments in climate resilience. Given that non-tax revenues rely on external sources, they encouraged the formulation of a medium-term tax reform strategy that widens the tax base and generates more reliable forms of revenue to help achieve fiscal self-reliance. Directors also called for further strengthening public finance management and the debt management strategy.

Directors recognized that Nauru faces many challenges common to microstates, which constrain potential growth and pose challenges for economic development. In this context, they stressed the need to identify new sources of growth to support long-term development, generate revenues, and create local employment. They recommended structural reforms to improve the business environment, address governance weaknesses, and attract private investment. To strengthen resilience to climate change, Directors called for integrating adaptation plans into a medium-term fiscal framework and continue pursuing donor support for green financing. They also encouraged sustained efforts to secure new donor commitments to address key infrastructure gaps. Directors supported the ongoing efforts to strengthen the AML/CFT framework and encouraged the consideration of regional solutions to correspondent banking relationship challenges. They recommended leveraging the Fund's and other development partners' capacity development assistance, including to continue improving the quality and availability of macroeconomic statistics.

² At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.IMF.org/external/np/sec/misc/qualifiers.htm>.

Table 1. Nauru: Selected Economic Indicators, FY2017-22 1/

Nominal GDP (US\$ million)				114.4		
Per capita GDP (US\$)				8,867		
Population				12906		
	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022
				Est.	Proj.	
Real sector						
Real GDP growth (percent change)	-5.5	5.7	1.0	0.7	1.5	0.9
Consumer price index (period average, percent change)	5.1	0.5	4.3	0.9	1.2	1.4
Population (thousand)	13.4	13.2	12.7	12.9	13.2	13.4
			(In percent of total)			
Structure of the economy						
Agriculture	4.4	3.8	4.7	4.7	4.7	4.8
Manufacturing	17.2	10.1	7.9	7.5	7.5	7.4
Services	71.8	77.0	73.7	73.3	73.3	74.4
			(In percent of GDP)			
Government finance						
Total revenue and grants	121.8	129.3	148.7	170.2	179.2	169.2
Revenue	100.6	108.5	136.0	151.4	137.0	151.5
Grants 2/	21.3	20.8	12.7	18.8	42.2	17.7
Total expenditure	101.7	95.6	118.9	134.5	135.5	139.9
Net lending (+) / borrowing (-)	20.1	33.6	29.9	35.7	43.8	29.3
Including Trust Fund contribution	11.9	24.4	21.1	21.7	24.9	17.2
Stock of government deposits 3/	7.0	24.2	35.5	52.0	44.1	57.6
Stock of Trust Fund	39.1	52.8	66.9	81.3	122.0	132.5
Balance of payments						
Current account balance	17.9	12.8	8.0	4.7	7.4	6.5
(In percent of GDP)	12.3	8.0	4.9	2.8	4.1	3.5
Capital account balance	12.4	44.2	40.5	45.1	85.1	52.6
Financial accounts balance and other flows	25.4	41.9	65.2	49.8	92.5	59.1
Government debt indicators						
External debt 4/	50.1	50.3	48.8	51.4	9.3	25.8
(In percent of GDP)	34.4	31.4	29.5	30.1	5.2	14.0
Domestic debt 5/	62.6	69.9	55.3	53.3	39.0	24.6
(In percent of GDP)	43.1	43.7	33.4	31.3	21.9	13.3
External debt service 6/	0.0	2.3	9.8	1.0	0.8	0.7
(In percent of exports of goods and services)	0.0	2.5	9.2	1.3	1.1	1.2
Exchange rates						
Australian dollar per U.S. dollar (period average)	1.33	1.29	1.40	1.49	1.34	...
Nominal GDP (in millions of Australian dollars)	145.3	160.0	165.7	170.5	178.5	184.5
Nominal GNI (in millions of Australian dollars)	202.9	217.7	238.1	264.0	296.9	320.8
Nominal GDP per capita (in US dollars)	8,152	9,399	9,365	8,867	10,138	...

Sources: Nauru authorities and IMF staff estimates and projections.

1/ Nauru uses the Australian dollar as the legal tender, and the fiscal year ends in June.

2/ In FY2021 grants include debt forgiveness for Yen Bonds.

3/ Stock of government deposits is under review by authorities and may be updated.

4/ Including the defaulted Yen bonds (until 2021 when the debt was settled), and use of Special Drawing Rights (SDR).

5/ Including the estimated government liability related to Bank of Nauru's liquidation.

6/ External debt service over the projection period is through bilateral grants.



REPUBLIC OF NAURU

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION

January 14, 2022

KEY ISSUES

Context. Early and decisive measures successfully prevented an outbreak of COVID-19 in Nauru, and as of January 2022 there have been no COVID-19 cases on the island. Strong pandemic policy measures supported the economy, which continued to expand in FY20 and FY21. Nauru's remoteness and size constrain potential growth and it is severely exposed to the negative effects of climate change on sea levels and the ocean stock of tuna. Development challenges are exacerbated by limited capacity and a high incidence of non-communicable diseases (NCDs).

Outlook and Risks. Growth is expected to moderate in FY22 owing to the anticipated scale-down of the Regional Processing Center (RPC) for refugees and asylum seekers. Risks to the outlook are significant and tilted to the downside. With limited medical facilities and a high incidence of NCDs, a local outbreak of the pandemic remains a critical risk. The medium-term macro-fiscal outlook is uncertain, pending clarity about revenues, economic activity, and jobs as the RPC scales down operations.

Main Policy Recommendations

- **Near-term Policies.** Extend vaccinations to the younger eligible population and calibrate fiscal support for food and fuel security to the state of the pandemic. Expediently formulate a plan to absorb or upskill current RPC workers.
- **Revenues.** Formulate a medium-term revenue strategy to generate more reliable forms of revenue, including by widening the tax base, raising excise taxes on goods tied to poor lifestyle habits, and introducing a consumption tax.
- **Governance and Public Financial Management.** Ensure that the SOE monitoring unit is adequately resourced, phase out subsidies to weakly-performing SOEs and enhance procurement processes in line with international standards. On PFM, formalize the fiscal responsibility ratios in a rules-based framework with mechanisms to manage deviations from those rules; phase out cash transactions; and formulate a new debt management strategy.

- **Financial Sector Reforms.** Continue efforts to align the AML/CFT framework with the revised 2012 FATF recommendations, accelerate implementation of legislated improvements to the AML/CFT framework, and measures to mitigate identified risks.
- **Diversification.** Diversifying the economy to obtain new sources of growth will require supporting policies to accelerate investment in human capital and infrastructure, and efforts to improve the business environment. Mitigating the effects of climate change can help the transformation required to raise potential growth and achieve fiscal self-reliance.

Approved By
**Krishna Srinivasan and
 Stephan Danninger**

Discussions took place remotely during November 15–December 6, 2021. The staff team comprised Mitali Das (head), Jermy Mudong and Natalija Novta (both APD), Nataliya Ivanyk (CDOT), Seruwaia Cagilaba (IMF Fiji Office) and Leni Hunter (Resident Representative, Pacific Islands). Heena Gupta and Jonathan Pampolina (both LEG) joined some mission meetings, and Chris Becker (OED) joined all mission meetings. Barend De La Beer (STA) provided expert statistical advice. The mission met with Minister of Finance M. Hunt, J. Petersen (Advisor, Ministry of Finance), other government officials, representatives from the private sector, development partners, and representatives of AUSTRAC and the Australian High Commission to Nauru. Hailey Ordal, Kristine Laluces, Yadian Chen and Raagini Chandra provided research and editorial assistance.

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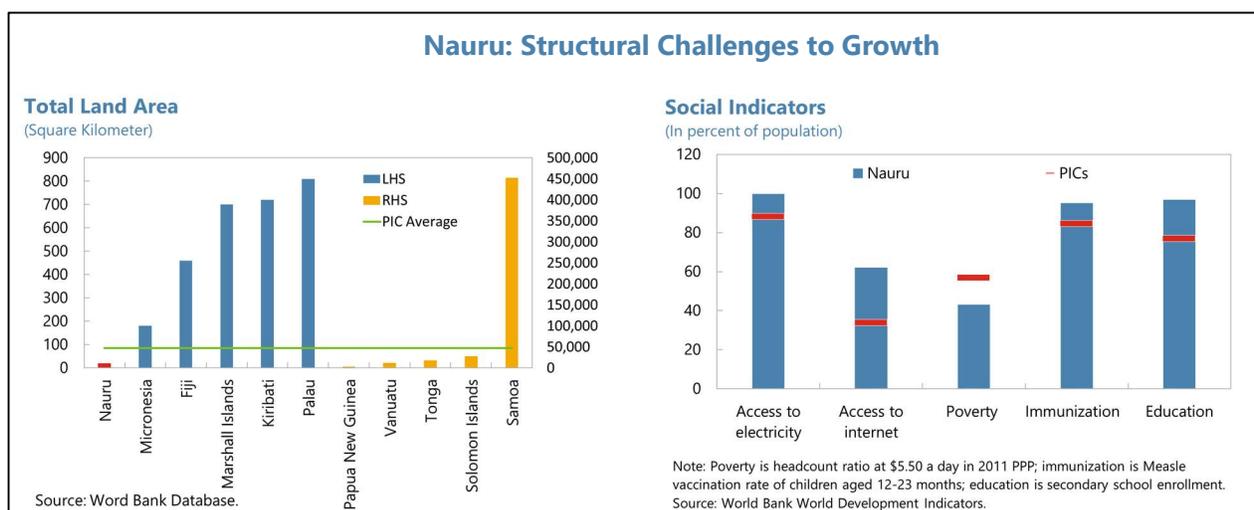
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CONTEXT AND PRE-PANDEMIC LANDSCAPE

1. Nauru's size and location pose challenges for economic growth and development.

Nauru is a remote island nation in the Pacific, with a land area of about 21 square kilometers and a population of approximately 12,000 people in 2021. Its size and remoteness constrain potential growth and raise its reliance on food and fuel imports. The revenue base—comprising sales of fishing licenses, residual phosphate mining and, since FY2012, revenues associated with the Australian Regional Processing Center (RPC) for asylum seekers—is narrow and volatile. Due to land degradation from phosphate mining in the 1980s, the population mainly resides along the narrow coastal land, raising vulnerability to climate change. Nauru's population also has a high incidence of non-communicable disease (NCDs).

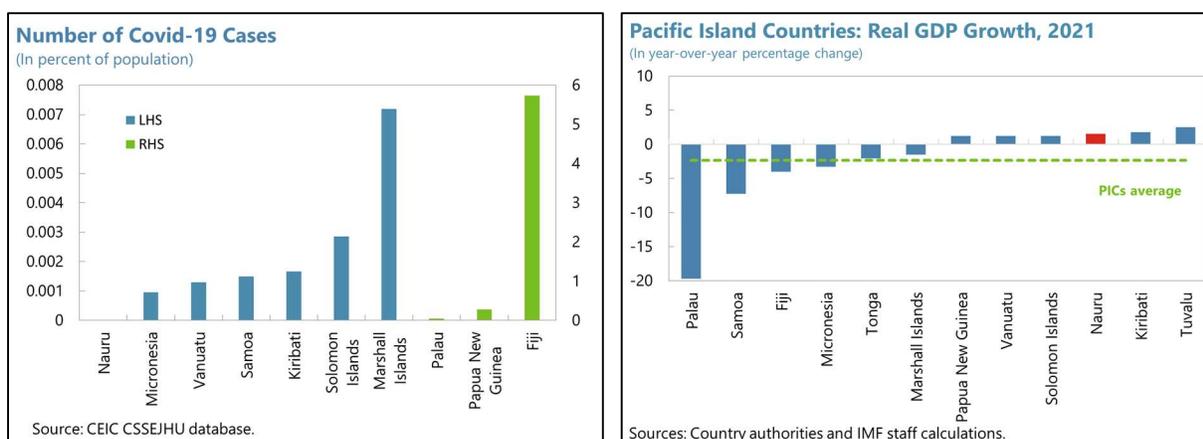
2. Nauru's economy was expanding modestly prior to the COVID-19 pandemic. In the years before the COVID-19 pandemic, real GDP growth slowed to 1.5 percent in 2015-19 from 19.8 percent in 2011-14 owing primarily to reduced phosphate mining. However, infrastructure investment, such as a new climate-resilient port, has supported activity and will improve trade and growth prospects. The establishment of the Nauru Trust Fund in FY2016 and reforms to state-owned enterprises (SOEs) helped strengthen public financial management. Following the resumption of banking services after over a decade in FY2015, Nauru achieved impressive gains in financial inclusion. Nonetheless, the poverty rate in Nauru remains high.



3. Nauru faces formidable challenges in raising long-term growth potential and confronting structural and fiscal risks. The anticipated scaling down of the RPC is expected to weigh on revenues and create job dislocations, underscoring the need to diversify Nauru's income sources. Efforts to boost potential growth and long-run fiscal sustainability face significant constraints from limited arable land, remoteness, infrastructure capacity limitations, and governance weaknesses. Nauru is vulnerable to climate change as its coastline is endangered by rising sea levels and rising ocean temperatures may affect tuna stocks, which are a vital economic resource. In addition, Nauru has limited financing options, though the country receives significant development partner support.

THE COVID-19 SHOCK: IMPACT, POLICY RESPONSE, OUTLOOK, AND RISKS

4. The authorities' early and decisive measures successfully contained COVID-19. The initial policy response focused on a total closure of Nauru's air and sea borders, quarantine protocols, and ensuring reliable delivery of fuel and food. The COVID-19 taskforce prioritized the expansion of intensive care capacity and securing vaccines through bilateral donors and the COVAX facility. As of early-January 2022, there have been no COVID-19 cases on the island, and 96 percent of the eligible adult population is fully vaccinated. A vaccination drive for 12–18-year-olds is expected to commence in 2022, and the taskforce also plans to extend vaccinations to 5–12 years-old in 2022.



5. The economy continued to expand in FY20 and FY21 owing to the sizeable policy response. Pandemic-related measures to support the economy are estimated at 8.5 and 11 percent of GDP in FY20 and FY21 respectively, including cash support to Nauru Airlines and Nauru Shipping Lines to ensure reliable food and fuel freight; quarantine expenditures; support to the COVID-19 taskforce to secure vaccines and distribute protective personal equipment (PPE); scaling up intensive care facilities; and ex gratia payments to government employees. Notwithstanding a delay in construction projects due to supply chain disruptions, the economy expanded by 0.7 percent in FY20 and 1.5 percent in FY21.

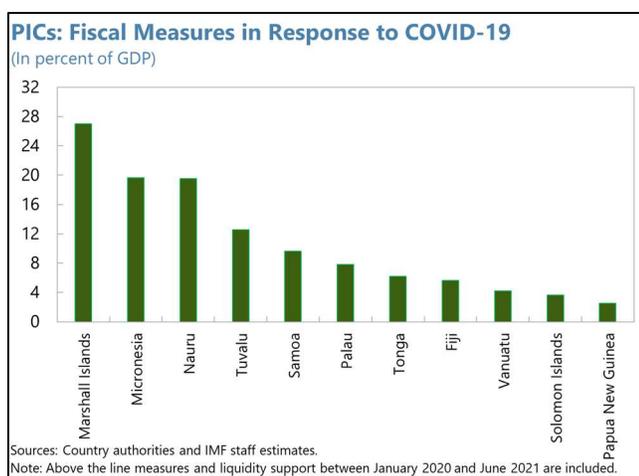
6. An unanticipated extension of the RPC and strong demand for fishing licenses underpinned the fiscal and external balances at the height of the pandemic and enabled generous supportive measures. Despite sizable COVID-19 expenditures and the purchase of a new aircraft, fiscal responsibility ratios were largely satisfied in FY20 and FY21,¹ reflecting large fiscal revenues owing to a delay in the scale-down of RPC and windfall revenues from fishing licenses. The

¹ The fiscal framework comprises three "fiscal responsibility ratios" and a commitment to Nauru Trust Fund contributions. The three fiscal responsibility ratios are: (1) the fiscal balance must be non-negative, according to the authorities' cash accounting; (2) personnel costs must be less than 30 percent of current expenditures; and (3) the fiscal cash buffer must be equal to at least two months of non-RPC expenditures..

moderation in fuel prices in 2020 helped keep inflation low and alleviated pressure on the external accounts, leaving the current account in surplus in FY21. Nauru’s external position in FY21 is assessed to be weaker than consistent with fundamentals and medium-term desirable policy settings (Annex I).

Policy Response to the COVID-19 Shock		
Policy Measure	Size (% of GDP)	
	FY20	FY21
Health	3.4	4.2
Hospital preparedness	1.3	1.2
Quarantine and isolation	1.2	2.8
Health Building and Structure	0.2	0
National measures (Fuel, logistics, other)	0.6	0.3
Air and Sea Freight	3.4	5.3
Nauru Airlines Cash Flow support	3	0.5
Nauru Airlines CSO (transport connectivity)	0	2.6
Nauru Shipping Line (transport connectivity)	0.4	2.2
COVID-19 ex-gratia	1.7	1.5
Total	8.5	11

Notes. Covid-19 ex gratia are stimulus payments to government employees.
Source: Nauru authorities



7. The resolution of a longstanding sovereign debt default has significantly lowered Nauru’s external debt.

The Government of Nauru (GON), as a guarantor, had a longstanding liability on bonds defaulted by the Nauru Phosphate Royalty Trust (NPRT) in the late 1980s with a face value of AUD 83 million. In March 2021, GON reached a substantially discounted settlement on these debt obligations to a U.S.-based hedge fund, *Firebird*, agreeing to a payment of AUD 4 million in exchange for all their bonds and an indemnity against legal actions on previous court orders or future claims against GON.

8. Nauru’s debt is sustainable under current policies.

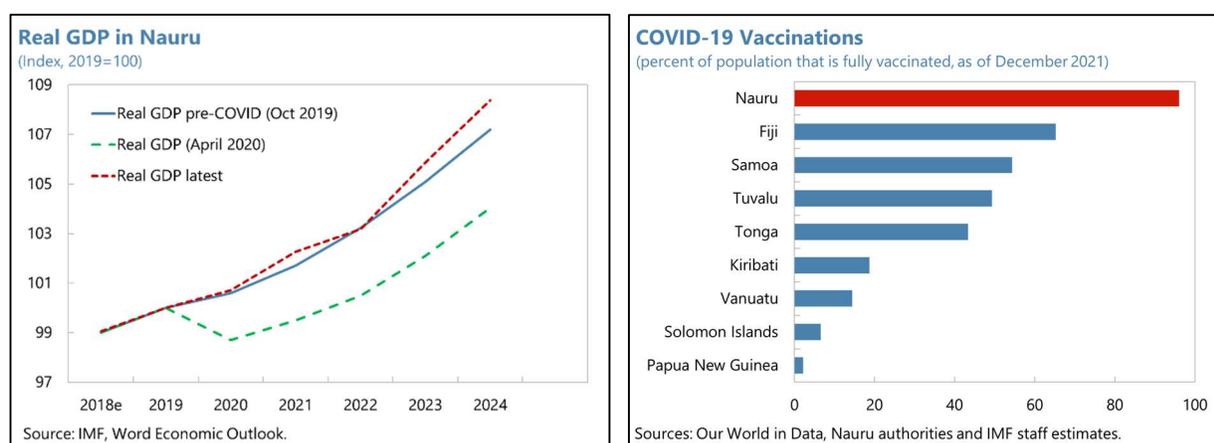
This is a significant improvement from the Debt Sustainability Analysis conducted during the 2019 Article IV consultations which assessed debt to be unsustainable. The two key factors that contribute to this improvement are the settlement of the *Firebird* debt and some repayment of domestic debt related to the liquidation of the Bank of Nauru (Annex II).

Baseline Assumptions of the RPC Scale-Down

- The RPC will transition to “Enduring Capability” on July 1, 2022.
- No new asylees will be added to RPC in FY22-FY26.
- Temporary job dislocations will affect 5 percent of the labor force (one-third of current RPC workers) during the second half of FY22 and the first half of FY23.
- Remaining current RPC workers will either be retained in the Enduring Capability arrangement, reallocated into other local jobs, or sent abroad for training.
- Relative to FY21, in FY22 there is a decline of: 10 percent in business profit taxes, non-resident withholding taxes, and reimbursable costs & services fees, and about 75 percent in visa revenues.
- Relative to FY22, in FY23 there is a decline of: 50 percent in business profit taxes and non-resident withholding taxes, and a decline of 10 percent in reimbursable costs & service fees.
- FY23-FY26 assumes a continuation of the hosting fee and no visa revenues. There is a further 10 percent decline every year in FY24-FY26 in business profit and non-resident withholding taxes, and in reimbursable costs & service fees.

Source: Staff assumptions.

9. Growth is expected to moderate, and the current account to narrow, in FY22, due to the expected slowdown in RPC activity. Despite ongoing fiscal support, the high COVID-19 vaccination rate, and the resumption of construction activity, real GDP growth is expected to slow from 1.5 percent in FY21 to 0.9 percent in FY22. This largely reflects the staff’s baseline view of the scale-down of the RPC (text box), which is an important source of economic activity on the island, and some supply dislocations and travel restrictions resulting from the Omicron virus variant. Growth is expected to pick up in FY23, aided by the operationalization of the climate-resilient port. The current account surplus is expected to narrow to 3.5 percent of GDP in FY22, reflecting lower RPC-related services exports, some departure of RPC-associated expatriate workers, and the projected increase in fuel prices. Higher global commodity prices and Nauru’s import dependency are expected to raise inflation from 0.9 percent in FY20 to 1.7 percent in FY22. The new SDR allocation of SDR 2.68 million (about USD 4 million or 2.2 percent of GDP) will support foreign exchange reserves.



10. Risks to the outlook are tilted significantly to the downside. Given limited medical facilities and a high incidence of risk factors such as diabetes, a local COVID-19 outbreak could have adverse health and growth implications. The emergence of the Omicron variant risks worsening supply chain dislocations and maintaining border closures that delay infrastructure projects on the island. The medium-term fiscal outlook remains uncertain pending clarity about RPC-related revenues when the facility moves to a model of “enduring capability” in July 2022.² As RPC employment is about 15 percent of the local labor force, a significant number of jobs could be at risk if enduring capability results in a near-total shutdown of RPC facilities and a labor reallocation strategy is inadequately implemented. External downside risks include a sharper-than-projected rise in commodity prices. Upside risks include an extension of RPC with no job losses, and spillovers from commercialization of the port project.

² “Enduring capability” is the arrangement with Australia under which the RPC will retain physical presence in Nauru with a scale down of operations to an extent not currently known, and potentially no new refugees or asylees. Australia would continue to provide revenues, which are currently of an unknown magnitude, through a “hosting fee” which would compensate Nauru for keeping the facility capable of being scaled up at a future time.

Authorities' Views

11. The authorities broadly concurred with staff's assessment of recent developments, outlook, and risks. Authorities agreed that the scale-down of the RPC posed downside risks but were optimistic that the new arrangement under enduring capability would potentially retain some current RPC workers for facility maintenance, limiting job losses. Authorities were confident that strong revenues from fishing licenses in FY23 would support the budget as most fishing days have already been sold and Nauru is in negotiations to purchase additional days from other PNA members' allocations. While agreeing that sales of fishing licenses are in general volatile, the authorities expect lower volatility going forward due to stable partnerships. The authorities expressed concern about the budgetary implications of fuel price escalation due to Nauru's high dependence on fuel imports for desalination, electricity, and transportation needs. They confirmed their intention to hold the new SDR allocation as reserves.

HARNESSING NEW SOURCES OF ECONOMIC GROWTH AND BUILDING FISCAL SELF-RELIANCE IN A POST-PANDEMIC WORLD

A. Strengthening the Post-Pandemic Recovery

12. Despite no COVID-19 outbreak onshore, Nauru must remain vigilant in the post-pandemic recovery. An ongoing priority is a successful rollout of the vaccination drive to newly eligible under-18-year-olds. Authorities should calibrate containment measures to the state of the pandemic while scaling up preparedness, including enhancing medical facilities to meet both long-term needs and a possible public health emergency. The authorities should ensure timely delivery of materials for ongoing infrastructure investment in view of a potential continued tightness of global supply bottlenecks.

13. Fiscal support should remain calibrated to the state of the pandemic, and non-COVID spending should be contained to make room for priority social needs and climate-related expenditures. Given ongoing pandemic-related uncertainties, near-term fiscal support to ensure food and fuel security continues to be appropriate. While support for freight and inventory management was essential during the peak of the pandemic, these subsidies should be scaled back to the levels consistent with the Community Service Obligation (CSO) framework as operations return to pre-pandemic levels.³ Subsidies to Ronphos,⁴ whose profitability is uncertain and which

³ The SOE Community Service Obligation (CSO) is a program to support affordable electricity, regular air freight and affordable port charges. The CSO framework recognizes that these services are essential but cannot be provided at commercial rates. To avoid forcing SOEs to make losses or consumer hardship through high prices, GON covers a part of the cost, for example, the costs of flying an empty cargo plane to Australia to import goods.

⁴ The Republic of Nauru Phosphate Corporation (Ronphos) is an SOE established in 2005 that maintains and operates the phosphate industry in Nauru.

does not make its financial statements public, should be phased out in line with previous staff advice. The authorities should limit subsidies to SOE services that are consistent with the CSO framework and shift budget allocations away from non-transparent expenditures, such as the housing improvement allocations, toward improving the efficiency of health and education, and retraining of current RPC workers, prioritizing spending in accordance with the social and environmental goals of the National Sustainable Development Strategy (NSDS). Complementing measures to support climate-change resilience, such as investment in the seawalls and solar farms projects, the authorities should cost adaptation plans and integrate these plans into a medium-term budget framework (Annex VI).

14. A plan to absorb, relocate, or upskill current RPC employees should be expeditiously formulated. A decommissioning of the RPC could create job dislocations for a significant number of current RPC workers. Finding new employment will be challenging given Nauru's narrow economic base. Staff encouraged the authorities to implement a plan to limit long-term job dislocations for current RPC employees, including through technical education at universities abroad, which could also help address existing skill shortages in Nauru. Increased participation in regional employment schemes may also present opportunities, as in other Pacific Island nations (Annex V). Over the longer term, increased employment opportunities will become available through development of the port and fisheries.

Authorities' Views

15. Authorities stressed their strong commitment to supporting jobs and activity, including by reprioritizing expenditures. The authorities highlighted that subsidies allocated to Ronphos in the FY22 budget are at a multi-year low and future allocation will be dependent on a comprehensive cost-benefit assessment of secondary phosphate mining. They noted that under the CSO framework, subsidies to Nauru Utility Corporation (NUC) were likely to be retained due to the rising cost of fuel and GON's commitment to supply affordable electric power to low-income households. The authorities recognized the urgency of assisting current RPC workers, and noted that plans were underway to absorb some RPC workers into the local police force and provide upskilling to others through training programs in Australia and the University of the South Pacific. Authorities agreed with the importance of prioritizing expenditures towards Nauru's development needs and highlighted that the FY22 fiscal strategy was anchored in part to achieving the goals of the NSDS and Nauru Integrated Infrastructure Strategic Plans (NIISP).

B. Addressing Fiscal Challenges: Uncertain Revenues

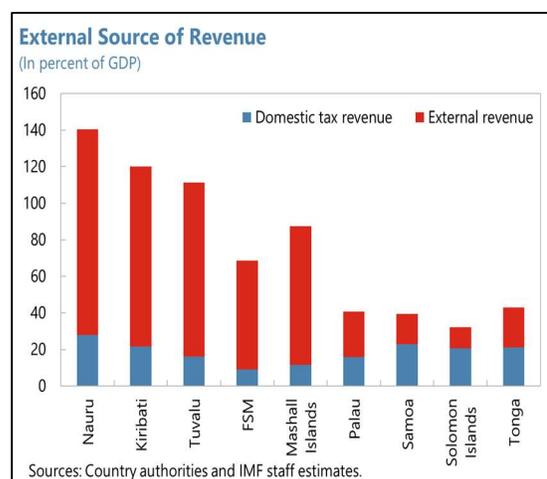
16. Nauru draws a large share of non-tax government revenues from external sources that are volatile and uncertain, undermining fiscal self-reliance.⁵ Nauru stands out for its dependence on external sources for non-tax revenues, even relative to regional peers. Non-tax revenues are

⁵ Fiscal self-reliance refers to the ability of a government to generate fiscal revenues without recourse to financial support from other governments, donors, or international organizations.

predominantly the RPC hosting fee, whose future magnitude is uncertain, and fishing license revenues that are volatile and vulnerable to adverse effects from climate change.

17. Past tax reforms have supported government revenues.

The authorities have reformed the tax code in recent years, including the introduction of the employment and services tax in FY2015 and the business profits tax in FY2017, and improved customs and tax administration. However, customs revenue is a relatively small share of revenues, and a significant share of business profit and employment services taxes are derived from RPC-related activity, which are vulnerable to a decline from the expected scale-down.



18. Further tax reforms are urgently required to generate more reliable sources of revenue.

Given the uncertainty and volatility of Nauru's external and domestic revenue streams, a renewed effort is needed to reform the tax code, including by identifying new forms of revenues, widening the tax base, improving compliance, and modernizing the tax administration. Drawing on Fund provided technical assistance (TA),⁶ specific reforms could include:

- **Broadening the personal income tax (PIT) base**, which is very narrow due to tax-free thresholds that are excessively high.⁷
- **Raising domestic excise taxes**, particularly on items tied to poor diet and adverse health, such as liquor, cigarettes, sugar products, and carbonated soft drinks that can simultaneously help address the high incidence of NCDs, such as diabetes.
- **Introducing a broad-based consumption tax** such as a value-added tax (VAT), with careful attention to its design, including the rate structure and tax base, to ensure that poorer households are not adversely affected.
- **Modernizing tax revenue administration and customs collection** by introducing, for example, the infrastructure to digitize business record-keeping and replacing the manual approach which is vulnerable to tax avoidance. The ASYCUDA system is currently planned for implementation, although this will cover digitization of only customs-related transactions.

⁶ In 2020, the Pacific Financial Technical Assistance Center (PFTAC) provided TA to Nauru authorities on a Tax Policy Reform strategy to assist in formulating a tax system which can provide sustained revenues while also improving equity.

⁷ The tax-free thresholds are set sufficiently high to exempt Nauru citizens partly due to their strong resistance when the tax system was introduced in 2014.

Staff's recommendation is to place tax reform in a comprehensive medium-term revenue strategy, with careful attention to the sequence and timing of changes to the tax code. In a context where most Nauruans have not previously paid taxes, the authorities should consider a gradual increase in existing income and excise tax rates before introducing new taxes. Carefully communicating the incidental health benefits of excise taxes on liquor, sugar products and cigarettes can help engender tax compliance. Over the medium term, once the tax administration capacity has developed further, the authorities should introduce a broad-based consumption tax, such as a VAT, to further address revenue concerns.

Authorities' Views

19. Authorities shared staff's views on rising fiscal challenges but expressed reservations about undertaking the tax reforms recommended by the mission. Authorities recognized the need for greater revenue mobilization. They informed the mission of the non-ratification of PACER Plus which will limit the need to recoup import duties that would have been lost from ratifying this regional trade agreement.⁸ However, authorities emphasized that tax collection is a politically sensitive issue in Nauru and expressed weak appetite for either a comprehensive broadening of the tax base or lowering the tax threshold, and were not in support of excise taxes in general on the grounds that it could raise consumer prices. They noted that the requisite digital infrastructure to support a VAT is prohibitively expensive for Nauru given its size, and the capacity to manage its implementation will take time to build up.

C. Structural Reforms to Further Improve Governance and Public Financial Management

20. Measures that improve governance are critical to achieving Nauru's medium-term growth and development objectives. Notwithstanding recent improvements to public financial management (PFM), Nauru's main governance risks stem from weaknesses in fiscal governance due the lack of timely, transparent, and audited financial statements of SOEs, inadequate financial controls from the high usage of cash transactions, lack of transparency in procurement processes, and gaps in the anti-money laundering/combating the financing of terrorism (AML/CFT) framework. These weaknesses result in inefficient management of resources, create vulnerabilities to corruption, and negatively impact growth.

21. Authorities have implemented important reforms in recent years to improve PFM. Following the 2019 Article IV consultations, the authorities implemented the Public Enterprise Act, introduced the CSO framework, and established an SOE monitoring unit, all with a view to improving SOE service delivery (Annex VIII). Authorities have significantly improved transparency with online publication of the budget and updates to the legal and tax frameworks. Authorities have welcomed

⁸ The Pacific Agreement on Closer Economic Relations (PACER) is an umbrella agreement between members of the Pacific Islands Forum along with Australia and New Zealand. The agreement provides a framework for the future development of trade cooperation.

capacity development and TA from the Fund in improving the collection and recording of macroeconomic data (Annex IX).

22. Annual contributions to the Nauru Trust Fund (NTF) are a strong pillar of the fiscal framework and have helped maintain fiscal discipline. Under Nauru's fiscal framework, the budget is expected to run a surplus sufficient to meet the mandatory annual contribution to the NTF, whose purpose is to support GON's post-2033 investments in education, health, environment, and infrastructure. Financial statements indicate that the NTF, whose portfolio is well-diversified, was valued at AUD 217.8 million at end-FY21 and is on track to reach its target of AUD 400 million by 2033 (Annex III).⁹ As per the MOU, early withdrawals from the NTF or changes to the contribution scale are decided in coordination with development partners. There is currently no discussion to revise the scale or schedule of contributions in light of the anticipated scale-down of RPC as the MOU already offers the flexibility to delay, reduce, or forgo contributions under extenuating circumstances, such as a large negative revenue shock. The FY22 budget has appropriated 10.1 percent of adjusted prior year revenue for the annual contribution to the NTF.

23. Notwithstanding improvements to PFM, further reforms are needed to improve fiscal discipline, the accountability of SOEs, and the transparency and efficiency of spending. These could include:

- **Further reforms to improve SOE accountability.** While the establishment of the SOE monitoring unit is an important step towards strengthening SOE accountability, authorities should ensure that the unit is well-resourced with adequate staffing of the required technical expertise,¹⁰ and that it can exercise the authority to publish the audited financial statements of all SOEs on an annual basis.
- **Phasing out subsidies to non-performing or weakly-performing SOEs and diverting them towards infrastructure development and reskilling workers.** With the heightened revenue uncertainty from RPC scale-down, authorities should take this opportunity to limit budgetary resources to poorly performing SOEs, redirecting them toward SOEs engaged in critical infrastructure development such as internet connectivity, waste management and worker retraining, particularly in the context of RPC worker reallocation (see paragraph 14).
- **Enhancing procurement procedures in line with international standards.** Measures should be taken to ensure the transparency of COVID-19 spending and procurement processes, including the publication of procurement contracts, names of awarded companies and their beneficial owners. The procurement of public goods and services in Nauru is governed under the Public Finance Control Act 2013. There is currently no publicly available information on

⁹ Annual Reports, the legal framework, financial statements including investment objectives, realized returns, portfolio composition, and minutes of quarterly meetings are available at the Republic of Nauru Department of Finance website: <https://naurufinance.info/intergenerational-trust-fund/>

¹⁰ The SOE monitoring unit is currently staffed with two individuals. The functions of the SOE monitoring unit are to provide analysis and advice to the government on the operation, performance, and governance of SOEs ([Public Enterprise Act, 2019](#)).

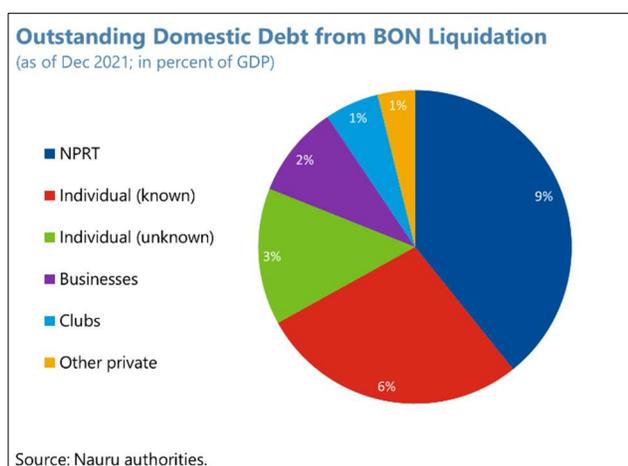
procurement. Authorities are in discussions with the ADB to review their procurement framework with TA expected in 2022.

- **Formalizing the fiscal responsibility ratios in a rules-based framework and introducing mechanisms to manage large, unexpected shocks and deviations from those rules.** Currently, the fiscal responsibility ratios are annual indicative targets within each budget. Authorities should consider further strengthening the fiscal framework, including by formalizing those ratios with a well-designed fiscal rule. The framework should have well-calibrated rule limits, and provisions of well-designed escape clauses and correction mechanisms to manage large, unexpected shocks and breaches from rule limits. In FY21, the fiscal balance was in deficit according to the authorities' cash accounting, largely due to the purchase of an aircraft for Nauru Airlines before an EXIM loan from Taiwan POC could be disbursed. Following the FY21 budget deficit, the government should aim for a return to a fiscal surplus in subsequent years to ensure that government deposits are replenished.
- **Phasing out cash for tax and other transactions.** Many individuals as well as government departments use cash for tax payments and other transactions. Authorities should accelerate a plan to phase out cash for tax collections and business transactions to strengthen financial controls and reduce corruption risks.

The planned PEFA assessment in 2022 by PFTAC is expected to provide a baseline against which to assess future reform progress.

24. The resolution of domestic debt should be expedited, and a new debt management strategy should be adopted.

As of December 2021, GON, as a guarantor of BON liabilities, has repaid about one-third of the original BON liability. Authorities should articulate a firm timeline and payout schedule for settling the remaining debt, and transparently communicate how they plan to treat that part of the debt where creditors cannot be identified. Going forward, new debt should be carefully assessed against Nauru's expected revenue streams and its ability to service the debt.



Authorities' Views

25. Authorities are committed to further strengthening governance and PFM. Authorities reaffirmed their intention to ensure that the SOE monitoring unit is sufficiently well-resourced to fill long-standing gaps in SOE accountability including in exercising the authority to publish the audited financial statements of all SOEs on an annual basis. They informed the mission of a newly created Project Steering Committee that will meet quarterly and assist the SOE monitoring unit on enforcement and policy decisions. In authorities' view, procurement is minimal for GON operational

requirements and managed adequately by Nauru Post and Eigigu Procurement, while donor-funded projects use donors' procurement processes. While there is no current plan to phase out cash transactions (due to limited banking services), authorities informed the mission of an EFTPOS terminal in place and active at the Revenue Department, with a rollout planned to Police, Transportation, and other cash collection departments as soon as the equipment becomes available. The authorities were receptive to the suggestion of formalizing the fiscal rules in a rules-based framework .

D. Financial Sector Reforms

26. Improving the perceived jurisdictional risk of Nauru is essential to lowering the cost of international transactions. International transactions can be made in Australian dollars through Bendigo Bank Australia. However, Nauru continues to have limited ability to undertake international transactions in non-AUD currencies, particularly USD. Staff was informed that transactions for Nauruan customers in USD and some other major currencies are not processed by Bendigo's U.S. correspondent bank, hampering local business, and resulting in significant exchange-rate-induced losses in revenues from the sales of fishing licenses (which are invoiced in USD). Several factors may have contributed to correspondent banking relationship (CBR) pressures in Nauru, including being affected by broader CBR challenges in Pacific island nations, profitability considerations, AML/CFT concerns, and legacy reputational issues (e.g., from an attempt to set up a financial center).

Box 1. Bendigo Bank Agency

Bendigo Bank Agency is the primary financial service provider in Nauru.¹ The Agency opened in Nauru in 2015, pursuant to an agency agreement between Nauru's Ministry of Finance and Bendigo and Adelaide Bank Limited of Australia. It operates under the Australian AML/CFT regulatory regime and is supervised by AUSTRAC, including for customer due diligence and suspicious transaction reporting. Nauru-based customers of the Agency have reported constraints with respect to their cross-border transactions denominated in US dollars. Such pressures may be attributable to ML/TF risks and profitability concerns. While there have been efforts to address the legacy reputational issues from the country's past offshore sector (since resolved), existing shortcomings in the AML/CFT framework are still critical factors. The size of the market in Nauru and expected profitability are also contributing to financial services providers' decisions especially when dealing with very small markets such as Nauru.

¹ Authorities noted that Western Union also operates as a low volume money remitter in Nauru, and is under New Zealand's regulatory and supervisory framework for AML/CFT purposes.

27. Efforts to improve the effectiveness of the AML/CFT framework are ongoing. In view of the 2012 Mutual Evaluation Report and upcoming comprehensive AML/CFT assessment, the authorities are aiming to align the AML/CFT framework with the revised 2012 FATF Recommendations. To address the remaining shortcomings, they are developing a national risk assessment (NRA) and national strategy, preparing amendments to the legal framework, including with TA provided by the Asia Pacific Group (APG) to improve technical compliance, and aim to increase the resources and capacity of the financial intelligence unit with technical assistance from AUSTRAC. The authorities continue to coordinate with the Australian supervisor (AUSTRAC) with

respect to AML/CFT compliance by the principal financial service provider in Nauru, Bendigo Bank Agency (Box 1).

28. Measures aimed toward addressing identified risks and concerns should contribute to alleviating CBR pressures. A robustly implemented AML/CFT framework should contribute to addressing correspondent banking relationship (CBR) pressures and mitigate reputational risks. Legislative improvements to the AML/CFT framework and development of the NRA should be swiftly put in place, followed by measures to mitigate the identified risks. Once technical compliance has improved through legislative drafting, implementation should follow and effectiveness should be significantly enhanced, notably in relation to ensuring AML/CFT compliance, analysis and dissemination of financial intelligence, and enforcement. Of importance is an environment that facilitates appropriate implementation of customer due diligence and timely suspicious transaction reporting by the financial sector. Given the unique circumstances of Nauru, the authorities are also encouraged to engage with external partners and stakeholders in pursuit of regional solutions (e.g., collective payment solutions, digital identities, regional know-your-customer utilities) which have the potential to leverage economies of scale and for accessing CBRs as a collective market.

Authorities' Views

29. Authorities highlighted their strong commitment and ongoing efforts to a robust AML/CFT framework. They noted that efforts to comply with the AML/CFT legal framework and its effectiveness were ongoing especially in view of Nauru's upcoming AML/CFT assessment of the 2012 FATF 40 Recommendations. The authorities' view is that CBR pressures are largely driven by legacy reputational issues from the country's past failed attempt to operate as an international financial center, and the profitability considerations that impact financial services providers' decisions, and that these continue to constrain access to international banking services. They recognize the importance of the upcoming AML/CFT assessment in addressing CBR pressures. Authorities also noted broader challenges in facilitating foreign currency transactions, and welcome engaging with external partners and stakeholders in developing regional solutions. Perceptions about compliance with international standards are a major source of concern for the authorities.

E. Reforms Needed for More Sustainable, Inclusive and Green Growth

30. New sources of economic growth and revenues are vital for Nauru's long-term development and growth potential. In line with the National Sustainable Development Strategy of 2019-30 (Annex IV), which highlights economic diversification as a key national development priority for Nauru, the below are potential long term growth areas that can generate additional government revenues and create more local employment:

- **Niche tourism:** While tourism is likely to remain limited in Nauru, a small increase in visitor arrivals could help to support demand for local businesses and handicrafts. Authorities could

also consider niche markets, such as astro-tourism.¹¹ Connectivity is available through Nauru Airlines, with regular flights to Australia and neighboring islands. In staff's view, efforts to increase visitors should focus on infrastructure improvements that would also benefit the local population (such as waste management).

- **Domestic fisheries.** Significant prospects lie in developing the fisheries sector, such as domestic fish processing facilities. Nauru's exclusive economic zone (EEZ) is one of the most favorable in the region for tuna purse seine fishing. The completion of the new port and related infrastructure, including refrigerated storage and container ships, can also help Nauru capitalize more on its EEZ (Annex V).
- **Greater participation in regional labor mobility schemes.** Nauru is part of Australia's Seasonal Worker Program (SWP) and Pacific Labor Scheme (PLS), but its remittances revenues to date are negligible. Such schemes have assumed greater importance with the jobs that are at risk with the anticipated scaling down of RPC. Remittances can be a valuable source of income and employment for Nauru, potentially raising the demand for financial services and developing the financial sector.

31. To develop new sources of growth, measures to lower structural barriers should be taken in the short-term. The authorities should take steps to improve the business environment and encourage private investment in Nauru. Authorities should redouble efforts for new donor commitments to address key infrastructure gaps such as access to clean water and an upgrade of dwelling facilities. The business environment should be improved, including by strengthening investor and property rights, lowering business visa fees, and streamlining new business registration procedures (Annex V). Issues pertaining to land tenure are complex, and the Lands Act requires the consent of at least 75 percent of landowners to gain access to land. Over time, a legal and regulatory framework that improves access to land will be needed to attract private sector investment in Nauru.

32. Addressing governance weaknesses would enhance long-term growth potential. In light of Nauru's size, usual third-party indicators are unreliable measures of corruption and rule of law issues. There is, however, an indication of potential governance weaknesses affecting PFM and the protection of property and contractual rights. The authorities are encouraged to implement transparency and accountability measures to further prevent risks of corruption in these areas.

33. Improving the quality of education and health in accordance with the SDG goals will need targeted investment.

- **Education.** Despite significant investments in the provision of free education for school-aged children, challenges persist in improving school attendance, literacy, and completion rates.

¹¹ Astro-tourism encompasses tourism undertaken to observe solar eclipses and meteor shows, and to stargaze or view dark skies. It is generally undertaken in remote or rural destinations with limited light pollution that give a clear picture of the night sky.

Authorities should strive to improve the efficiency of education expenditures by investing into understanding the underlying causes of poor educational outcomes.

- **Health.** The pandemic has brought the low life expectancy and high incidence of NCDs (a risk factor for COVID-19) in Nauru to the fore. NCDs, tied to poor diet and other lifestyle habits, weigh significantly on the budget (prescriptions and overseas referrals). Health expenditures should focus on preventative measures, including through health education, primary medical services and the promotion of physical activity and better nutrition.

34. A greener future requires Nauru to have a well-planned climate finance strategy.

Nauru is among countries most severely exposed to the negative effects of climate change, affected by droughts and scarce freshwater, coastal erosion, storm surges, flooding, and ocean acidification (Annex VI). To complement existing measures, additional steps authorities can take to accelerate its climate strategy include costing adaptation plans at the sectoral level and integrating these into the budget and medium-term framework; and securing new donor support for green financing by continuing to contribute to green and climate-proof projects.

Authorities' Views

35. The authorities were in strong agreement that economic diversification is important for Nauru's long-term development and higher growth potential. They agreed that developing fisheries sector and expanding the usage of the port would help support potential growth and fiscal self-reliance. The authorities were of the view that tourism might have limited potential in niche markets. They noted that, given the new state-of-the-art hospital facilities on the island, there could be a reduction in the cost of overseas medical support for Nauru citizens, but cautioned that imported labor may be required to meet the needs of such an endeavor. Authorities agreed on the importance of improving the efficiency of investment in education but noted that retaining university-trained students in Nauru was difficult due to the greater opportunities in neighboring countries. Authorities are committed to developing a climate finance strategy and highlighted that the FY22 budget has made provisions to support the new climate change unit. The authorities emphasized the costs associated with the economic diversification given the small population, high fixed costs, and capacity constraints.

STATISTICS AND CAPACITY DEVELOPMENT

36. Capacity Development. Capacity development is an ongoing challenge for Nauru. The national statistics office is understaffed with weak capacity to collect and process data. Capacity supplementation from PFTAC and TA has been needed for compilation of real sector and government finance statistics (GFS), and from CDOT for external sector statistics (Annex IX). Virtual delivery of TA has helped maintain engagement. The mission informed authorities that the Fund is committed to assisting with setting up a sustainable compilation program for macroeconomic accounts.

37. Statistics. Data are lacking or outdated in several areas which significantly hamper surveillance. Core macroeconomic accounts, such as national accounts, balance of payments and international investment positions are produced only during TA missions. The population census undertaken in November 2021 will provide important demographic data. Staff appreciated the authorities' assistance during the mission in reducing discrepancies in GFS and errors and omissions in the balance of payments. Staff encourages the authorities to leverage development partner assistance to continue improving the quality and availability of statistics. An external sector statistics remote TA mission was conducted in parallel with the 2021 Article IV consultation.

Authorities' Views

38. Authorities expressed their appreciation for the Fund's continued capacity development support and noted that progress in compiling macroeconomic statistics remains a government priority. The authorities welcomed the planned capacity development support in FY22 and expressed interest in continuing TA to support the collection and processing of macroeconomic data.

STAFF APPRAISAL

39. Strong and timely containment measures successfully prevented a local COVID-19 outbreak, and extending vaccinations to all eligible individuals is an ongoing priority. Despite a high adult vaccination rate of 96 percent, authorities should ensure a successful and timely rollout of the vaccination drive to newly eligible 12–18-year-olds.

40. Growth is expected to moderate in FY22 due to the anticipated scale-down in RPC activities. After expanding in FY20 and FY21, at respectively 0.7 percent and 1.5 percent, growth is projected to slow to 0.9 percent in FY22 due to the expected scale-down of the RPC, which is an important source of jobs and activity. Nauru's external position in FY21 is assessed to be weaker than the level consistent with fundamentals and desirable policy settings. The current account is expected to narrow to a surplus of 3.5 percent of GDP in FY22, owing to lower RPC-related services exports and a projected increase in fuel prices. Nauru's debt is sustainable under current policies.

41. Risks to the outlook are tilted significantly to the downside. A local COVID-19 outbreak could have severe growth implications due to the high prevalence of NCDs and limited medical facilities. The medium-term fiscal outlook is uncertain pending clarity about the magnitude of RPC-related revenues when the RPC is scaled down to a model of enduring capability, which also risks significant job dislocations. Due to its high dependence on fuel imports, Nauru is vulnerable to a sharper-than-projected escalation in commodity prices. A more protracted global recovery, including from supply chain dislocations due the Omicron virus variant, could slow activity on the island.

42. Fiscal support over the near term should be calibrated to the state of the pandemic. Near-term support to ensure food and fuel security due to ongoing pandemic-related uncertainty

continues to be appropriate. Subsidies to SOEs for freight and inventory dislocations initiated during the pandemic should be scaled back to levels consistent with the CSO framework as operations return to normal levels. To make room for more fiscal support to health, education and climate mitigation, spending should be shifted away from weakly-performing SOEs and non-transparent budget allocations. A comprehensive plan to absorb, relocate, or upskill current RPC workers must be formulated to limit local long-term job dislocations when the facility moves to a model of enduring capability.

43. Post-pandemic fiscal policy should focus on generating more reliable sources of revenues and implementing reforms to strengthen governance and PFM. Formulating a medium-term revenue strategy, sequenced to widen the tax base and gradually raise excise taxes before introducing a consumption tax, are important steps towards fiscal self-reliance. Adequately resourcing the SOE monitoring unit, enhancing procurement policies to international standards, formalizing the fiscal responsibility ratios in a rules-based framework, and articulating a new debt strategy are needed to improve fiscal governance and advance PFM.

44. Authorities should continue efforts to strengthen the effectiveness of the AML/CFT framework and pursue regional solutions for access to CBRs. Improvements to the AML/CFT framework and its implementation should be expedited in view of Nauru's upcoming FATF assessment, including the adoption of a risk-based approach to implementation based on a national risk assessment. Staff recommends that authorities continue to engage with external partners and stakeholders and undertake efforts in pursuit of regional solutions and approaches for access to CBRs as a collective market.

45. Structural reforms are needed to diversify Nauru's income sources and transition the economy toward an inclusive, and green growth model. Diversifying the economy to obtain new sources of growth will require near-term policies to accelerate investment in human capital, improve the business environment, and address infrastructure gaps in internet connectivity, water and waste management and dwelling facilities. Strengthening investor rights, access to land, and streamlining new business registration procedures will help attract private investment. To strengthen resilience to climate change, authorities should cost adaptation plans at the sectoral level in a medium-term framework and continue to pursue donor support for green financing.

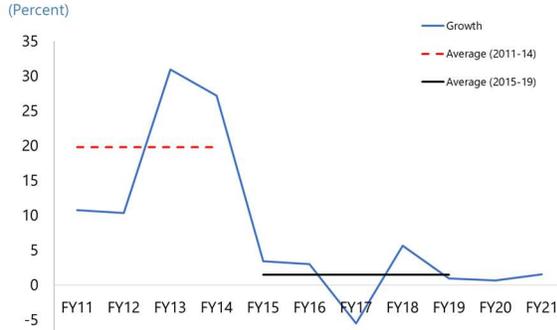
46. Nauru's data shortcomings are significant and present a hindrance to surveillance. Nauru's statistical capacity remains weak, and data suffer from shortcomings that prevent timely analysis and hamper surveillance. Addressing resource constraints is an imperative to developing a self-sustained compilation program for macroeconomic statistics. A remote external sector statistics mission conducted in parallel with the Article IV consultation exposed limitations of the virtual format, including due to connectivity challenges. Staff encourages the authorities to leverage development partner assistance to continue improving the quality and availability of statistics.

47. It is recommended that the Article IV Consultation continue to take place on the 24-month cycle.

Figure 1. Nauru: Recent Developments

Real GDP growth slowed in the years before the pandemic

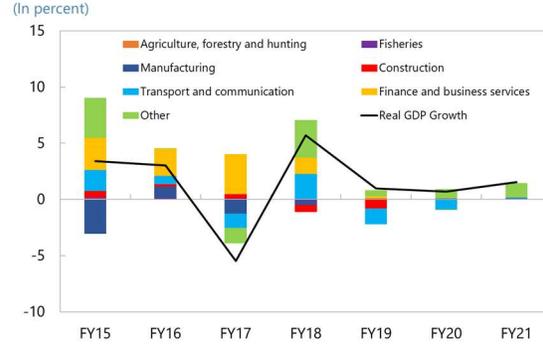
Nauru: Real GDP Growth



Source: IMF Staff Calculations.

...but remained positive during the COVID-19 pandemic

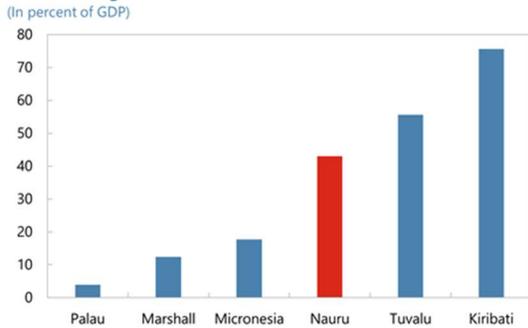
Real GDP Growth Contribution



Sources: Nauru authorities, IMF staff calculation.

Strong outturns of fishing license sales supported the budget...

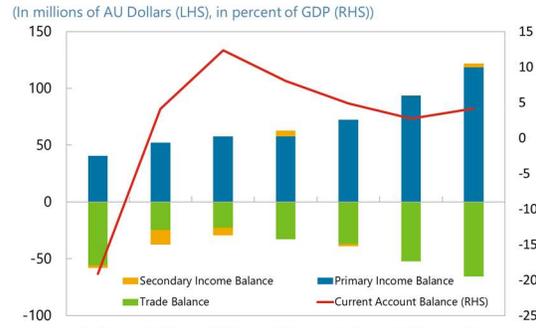
PICs: Fishing License Revenues, 2020



Source: IMF staff estimates.

... underpinned a current account surplus...

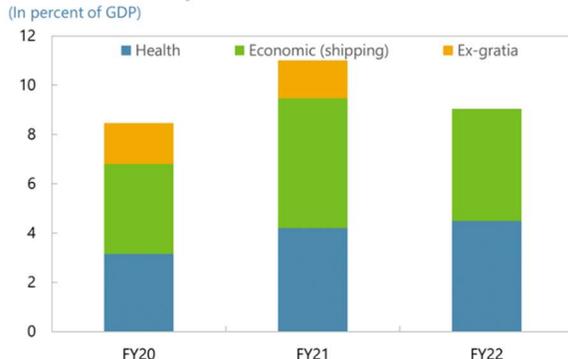
Current Account Balance



Sources: Nauru authorities, IMF staff calculation.

.. and enabled a strong fiscal response to the mitigation of COVID-19

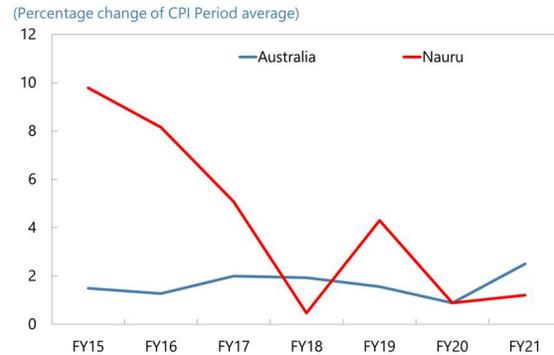
COVID-Related Expenditures



Sources: Nauru authorities, and IMF staff estimates.

Moderating domestic demand and low fuel prices during the pandemic kept average inflation low.

Inflation



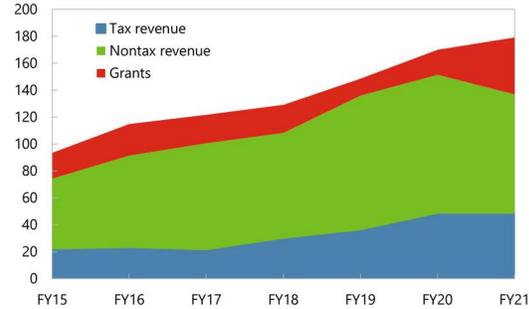
Source: IMF World Economic Outlook.

Figure 2. Nauru: Recent Fiscal Developments

Revenues have increased significantly in recent years...

Revenue

(In percent of GDP)

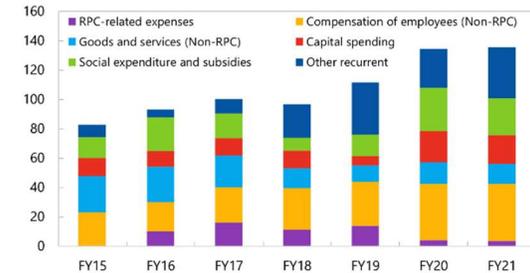


Sources: Nauru authorities, IMF staff estimates.

...enabling expenditures on infrastructure investment and recurrent spending such as the public wage bill

Fiscal Expenditure

(In percent of GDP)

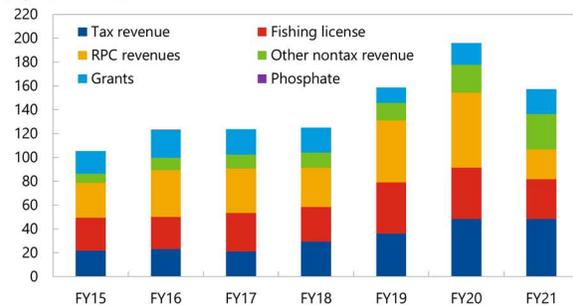


Sources: Nauru authorities, and IMF staff estimates and projections.

Anticipated closure of the RPC will weigh on revenues..

Fiscal Revenue

(In percent of GDP)

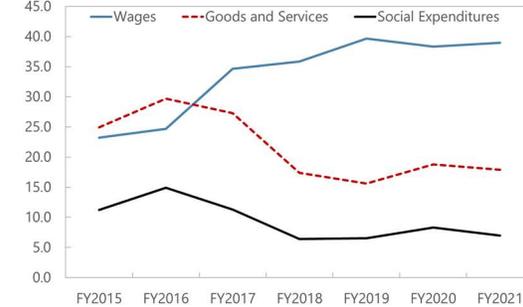


Sources: Nauru authorities, and IMF staff estimates and projections.

...leading to a recomposition of expenditures.

Recomposition of Fiscal Expenditures

(in percent of GDP)

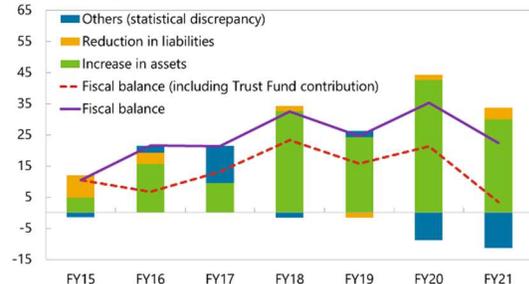


Source: Nauru Authorities.

Despite large expenditures induced by the pandemic ...

Fiscal Balance

(In percent of GDP)

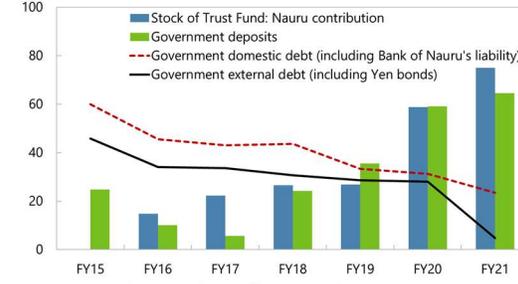


Sources: Nauru authorities, and IMF staff estimates and projections.

... the government has built up saving including in the Nauru Trust Fund

Government Deposits and Debt

(In percent of GDP)



Sources: Nauru authorities, and IMF staff estimates and projections.

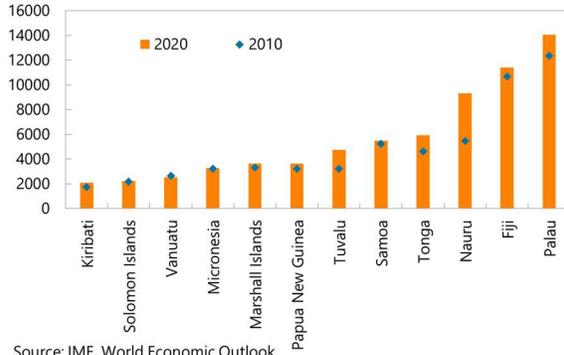
Figure 3. Nauru: Constraints to Raising Growth Potential

Nauru has among the highest real GDP per capita among Pacific island countries...

...but the poverty rate remains very high.

Pacific Islands Countries: GDP per Capita

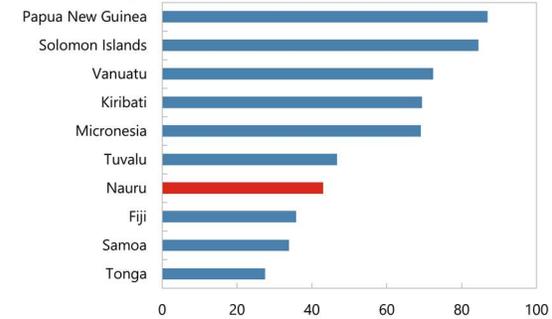
(Purchasing power parity; international dollars)



Source: IMF, World Economic Outlook.

Poverty Headcount Ratio

(Below \$5.50 a Day, 2011 PPP, In percent of Population)



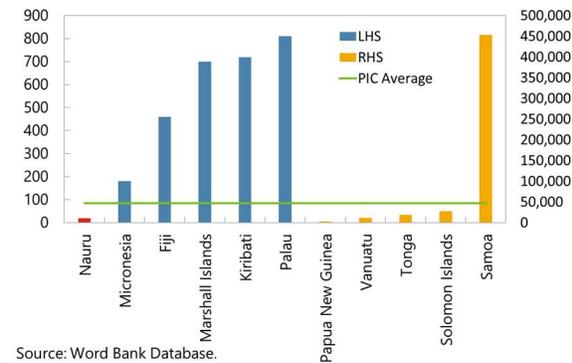
Sources: CEIC, World Bank.

Limited arable land is a constraint on diversification...

...and Nauru's remoteness hinders foreign investment...

Total Land Area

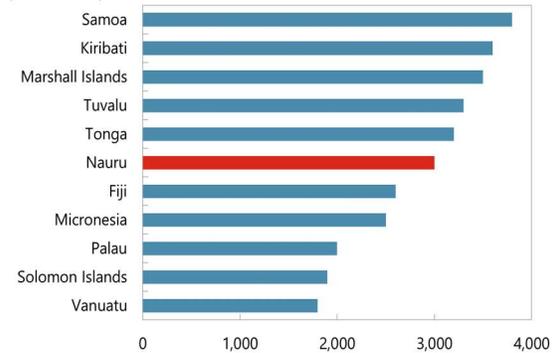
(Square Kilometer)



Source: World Bank Database.

Distance to the Nearest Continent

(In kilometers)

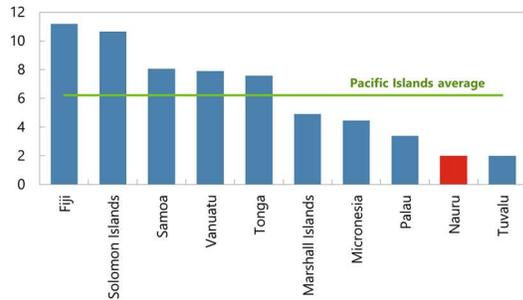


Sources: Google Earth and IMF staff estimates.

Nauru faces high transportation costs which limits export potential.

Greater internet connectivity will mitigate the effects of Nauru's remoteness on trade and tourism

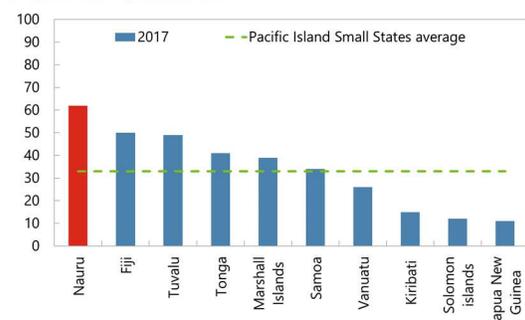
Liner Shipping Connectivity Index



Notes: Lower values indicate lower connectivity. Source: World Bank, World Development Indicators.

Individuals Using the Internet

(In percent of population)



Source: World Bank, World Development Indicators.

Table 1. Nauru: Selected Economic Indicators, FY2017-22 1/

	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022
				Est.	Proj.	
Nominal GDP (US\$ million)				114.4		
Per capita GDP (US\$)				8,867		
Population				12906		
Real sector						
Real GDP growth (percent change)	-5.5	5.7	1.0	0.7	1.5	0.9
Consumer price index (period average, percent change)	5.1	0.5	4.3	0.9	1.2	1.4
Population (thousand)	13.4	13.2	12.7	12.9	13.2	13.4
(In percent of total)						
Structure of the economy						
Agriculture	4.4	3.8	4.7	4.7	4.7	4.8
Manufacturing	17.2	10.1	7.9	7.5	7.5	7.4
Services	71.8	77.0	73.7	73.3	73.3	74.4
(In percent of GDP)						
Government finance						
Total revenue and grants	121.8	129.3	148.7	170.2	179.2	169.2
Revenue	100.6	108.5	136.0	151.4	137.0	151.5
Grants 2/	21.3	20.8	12.7	18.8	42.2	17.7
Total expenditure	101.7	95.6	118.9	134.5	135.5	139.9
Net lending (+) / borrowing (-)	20.1	33.6	29.9	35.7	43.8	29.3
Including Trust Fund contribution	11.9	24.4	21.1	21.7	24.9	17.2
Stock of government deposits 3/	7.0	24.2	35.5	52.0	44.1	57.6
Stock of Trust Fund	39.1	52.8	66.9	81.3	122.0	132.5
(In millions of Australian dollars, unless otherwise indicated)						
Balance of payments						
Current account balance	17.9	12.8	8.0	4.7	7.4	6.5
(In percent of GDP)	12.3	8.0	4.9	2.8	4.1	3.5
Capital account balance	12.4	44.2	40.5	45.1	85.1	52.6
Financial accounts balance and other flows	25.4	41.9	65.2	49.8	92.5	59.1
Government debt indicators						
External debt 4/	50.1	50.3	48.8	51.4	9.3	25.8
(In percent of GDP)	34.4	31.4	29.5	30.1	5.2	14.0
Domestic debt 5/	62.6	69.9	55.3	53.3	39.0	24.6
(In percent of GDP)	43.1	43.7	33.4	31.3	21.9	13.3
External debt service 6/	0.0	2.3	9.8	1.0	0.8	0.7
(In percent of exports of goods and services)	0.0	2.5	9.2	1.3	1.1	1.2
Exchange rates						
Australian dollar per U.S. dollar (period average)	1.33	1.29	1.40	1.49	1.34	...
Nominal GDP (in millions of Australian dollars)	145.3	160.0	165.7	170.5	178.5	184.5
Nominal GNI (in millions of Australian dollars)	202.9	217.7	238.1	264.0	296.9	320.8
Nominal GDP per capita (in US dollars)	8,152	9,399	9,365	8,867	10,138	...

Sources: Nauru authorities and IMF staff estimates and projections.

1/ Nauru uses the Australian dollar as the legal tender, and the fiscal year ends in June.

2/ In FY2021 grants include debt forgiveness for Yen Bonds.

3/ Stock of government deposits is under review by authorities and may be updated.

4/ Including the defaulted Yen bonds (until 2021 when the debt was settled), and use of Special Drawing Rights (SDR).

5/ Including the estimated government liability related to Bank of Nauru's liquidation.

6/ External debt service over the projection period is through bilateral grants.

Table 2. Nauru: Illustrative Medium-Term Baseline Scenario, FY2017-26 1/

	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025	FY2026
	Est.					Proj.				
Real sector										
Real GDP growth (percent change)	-5.5	5.7	1.0	0.7	1.5	0.9	2.6	2.4	2.0	1.8
Consumer price index (period average, percent change)	5.1	0.5	4.3	0.9	1.2	1.4	1.7	1.9	2.0	2.0
(In percent of GDP)										
Government finance 2/										
Total revenue and grants	121.8	129.3	148.7	170.2	179.2	169.2	122.8	117.8	113.7	109.2
Total expenditure	101.7	95.6	118.9	134.5	135.5	139.9	100.2	99.1	97.8	94.8
Current expenditure	89.9	83.6	99.9	113.0	115.8	113.2	91.1	89.6	87.7	84.9
Net acquisition of non-financial assets	11.8	12.1	6.4	21.5	19.7	26.7	9.1	9.5	10.1	10.0
Net lending (+) / borrowing (-)	20.1	33.6	29.9	35.7	43.8	29.3	22.6	18.7	15.9	14.3
Including trust fund contribution	11.9	24.4	21.1	21.7	24.9	17.2	7.7	8.0	5.6	4.5
Stock of government deposits	7.0	24.2	35.5	52.0	44.1	57.6	58.9	60.9	60.7	59.5
of which: Cash buffer requirement				26.3	24.6	29.9	24.3	24.8	25.0	24.9
Stock of Trust Fund	39.1	52.8	66.9	81.3	122.0	132.5	151.3	166.7	182.2	197.3
(In millions of Australian dollars, unless otherwise indicated)										
Balance of payments										
Current account balance	17.9	12.8	8.0	4.7	7.4	6.5	0.1	-0.6	-0.4	-0.3
(In percent of GDP)	12.3	8.0	4.9	2.8	4.1	3.5	0.1	-0.3	-0.2	-0.1
Capital account balance	12.4	44.2	40.5	45.1	85.1	52.6	31.0	28.0	28.0	28.0
Financial accounts balance and other flows	25.4	41.9	65.2	49.8	92.5	59.1	31.1	27.4	27.6	27.7
Government debt indicators										
External debt 3/	50.1	50.3	48.8	51.4	9.3	25.8	23.7	21.6	19.6	17.5
(In percent of GDP)	34.4	31.4	29.5	30.1	5.2	14.0	12.5	11.2	9.9	8.7
Domestic debt 4/	62.6	69.9	55.3	53.3	39.0	24.6	23.6	22.6	21.6	20.6
(In percent of GDP)	43.1	43.7	33.4	31.3	21.9	13.3	12.5	11.7	11.0	10.3
External debt service	0.0	2.3	9.8	1.0	0.8	0.7	2.5	2.4	2.4	2.4
Exchange rates										
Australian dollar per U.S. dollar (period average)	1.33	1.29	1.40	1.49	1.34	...	...	...	...	...
Nominal GDP (in millions of Australian dollars)	145.3	160.0	165.7	170.5	178.5	184.5	189.6	193.6	197.1	200.7

Sources: Nauru authorities and IMF staff estimates and projections.

1/ Nauru uses the Australian dollar as the legal tender, and the fiscal year ends in June.

2/ Fiscal year runs from July 1 to June 30.

3/ Including the defaulted Yen bonds (until 2021 when the debt was settled), and use of Special Drawing Rights (SDR).

4/ Including government liability related to Bank of Nauru's liquidation.

Table 3. Nauru: Balance of Payments, FY2017-26 1/

	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025	FY2026
				Est.				Proj.		
	(In millions of Australian dollars)									
Current account balance	17.9	12.8	8.0	4.7	7.4	6.5	0.1	-0.6	-0.4	-0.3
Goods (f.o.b.)	-44.8	-73.6	-75.8	-98.9	-103.0	-97.9	-99.6	-99.0	-95.9	-94.8
Credit	25.3	22.1	27.8	10.8	22.4	25.0	21.0	15.0	10.0	10.0
Debit	70.0	95.7	103.6	109.7	125.4	122.9	120.6	114.0	105.9	104.8
Services balance	12.2	20.9	14.4	9.9	-14.1	-31.4	-44.6	-39.9	-37.3	-37.3
Credit	61.6	70.4	77.9	70.3	50.2	37.0	18.5	17.0	17.0	17.0
Debit	49.4	49.5	63.5	60.3	64.3	68.4	63.1	56.9	54.3	54.3
Primary income balance	57.6	57.7	72.4	93.5	118.3	136.2	124.7	120.7	116.8	116.8
Credit	59.8	63.1	79.4	106.6	131.9	149.9	139.0	136.0	133.0	133.0
Debit	2.2	5.5	7.0	13.1	13.5	13.6	14.3	15.3	16.2	16.2
Secondary income balance	-7.1	7.9	-3.0	0.1	6.1	-0.6	19.6	17.6	16.0	15.0
Credit	14.6	22.0	17.0	20.0	28.6	15.8	39.0	33.9	32.0	30.0
Debit	21.7	14.0	19.9	19.9	22.5	16.4	19.4	16.3	16.0	15.0
Capital account balance	12.4	44.2	40.5	45.1	85.1	52.6	31.0	28.0	28.0	28.0
Credit	12.4	44.2	40.5	45.1	85.1	52.6	31.0	28.0	28.0	28.0
Debit	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net lending / borrowing	30.3	57.0	48.5	49.8	92.5	59.1	31.1	27.4	27.6	27.7
Financial account balance	25.4	41.9	65.2	49.8	92.5	59.1	31.1	27.4	27.6	27.7
Assets	26.9	33.0	68.6	138.5	76.8	79.9	50.3	45.1	45.1	41.0
Liabilities	2.7	11.5	4.0	88.6	-15.7	20.9	19.2	17.7	17.5	13.3
<i>Memorandum items:</i>										
Nominal GDP	145.3	160.0	165.7	170.5	178.5	184.5	189.6	193.6	197.1	200.7
Current account balance (in percent of GDP)	12.3	8.0	4.9	2.8	4.1	3.5	0.1	-0.3	-0.2	-0.1
Stock of external government assets	79.3	135.0	195.2	308.9	387.2	418.9	438.2	478.3	511.4	541.7
Reserves	8.2	31.2	47.7	71.4	72.0	89.9	78.0	80.2	78.5	75.1
Trust Fund	56.8	84.4	110.8	138.5	217.8	244.6	286.9	322.7	359.0	396.0
Others, including donor funds	14.3	19.4	36.7	99.0	97.3	84.4	73.3	75.4	73.8	70.6
Change in external government assets	13.7	55.7	60.2	113.7	78.3	31.7	19.3	40.1	33.1	30.4
External debt 2/	50.4	50.6	49.2	51.6	9.7	31.5	29.5	27.4	25.4	23.3
Medium-and long-term loans	6.3	3.9	7.1	6.6	5.2	21.7	19.6	17.5	15.4	13.3
Yen bond	35.7	38.2	39.4	40.5	0.0	0.0	0.0	0.0	0.0	0.0
Short term government debt and arrears	6.8	6.8	1.0	2.9	2.9	2.9	2.9	2.9	2.9	2.9
SDR allocations	1.6	1.6	1.7	1.7	1.6	7.0	7.1	7.1	7.1	7.1
SDR allocations net of SDR holdings	1.2	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
External debt service	0.0	2.3	9.8	1.0	0.8	0.7	2.5	2.4	2.4	2.4
Principal	0.0	2.1	9.8	0.7	0.6	0.6	2.1	2.1	2.1	2.1
Interest	0.0	0.2	0.0	0.3	0.2	0.1	0.4	0.4	0.3	0.3
International Investment Position	128.4	186.8	244.7	311.4	456.7	499.9	529.7	557.1	584.7	612.4
Assets	185.2	254.9	319.2	471.7	570.3	638.8	689.1	734.2	779.3	820.3
Liabilities	56.8	68.1	74.4	160.2	113.6	138.9	159.4	177.1	194.6	207.9

Sources: Nauru authorities and IMF staff estimates and projections.

1/ The fiscal year ends in June.

2/ Including the defaulted Yen bonds, until 2021 when the debt was settled and total SDR allocation

Table 4. Nauru: Central Government Operations, FY2017-26 1/

	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025	FY2026
				Est.				Proj.		
(In millions of Australian dollars)										
Total revenue and grants	177.1	206.8	246.4	290.2	320.0	312.2	232.7	228.0	224.0	219.1
Revenue	146.2	173.6	225.3	258.2	244.6	279.6	204.9	200.0	195.5	191.5
Of which: RPC related revenue excl reimbursement	54.3	52.6	85.9	107.3	87.2	125.4	80.6	79.1	77.8	76.5
Tax revenue	30.8	47.4	59.8	82.5	86.4	76.1	48.1	46.2	44.4	42.8
Nontax revenue	115.3	126.2	165.6	175.7	158.3	203.5	156.8	153.7	151.0	148.6
Of which: Fishing license fees	46.9	46.4	71.4	73.3	59.8	59.9	53.5	53.5	53.5	53.5
Phosphate revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Components of RPC revenue										
Revenues from RPC-generated activity	54.3	52.6	85.9	107.3	44.5	39.2	20.6	19.1	17.8	16.5
Hosting fee	...	...	...	...	37.0	84.7	60.0	60.0	60.0	60.0
Visa fees	34.8	28.4	20.3	21.1	5.8	1.5	0.0	0.0	0.0	0.0
Reimbursement for RPC expenses	16.9	31.3	49.4	41.8	39.8	35.8	32.2	29.0	26.1	23.5
Other nontax	16.7	20.2	24.6	39.6	15.9	21.6	11.1	11.2	11.4	11.6
Grants 2/	30.9	33.3	21.1	32.0	75.4	32.6	27.8	28.0	28.6	27.6
Budget support (current)	6.1	7.3	4.3	10.5	21.3	12.3	6.0	6.0	6.0	6.0
Development fund (capital)	17.2	19.3	10.6	14.4	10.8	14.1	14.2	14.4	14.9	14.0
Trust fund: Donor contribution	7.6	6.6	6.2	6.4	8.0	6.2	6.2	6.2	6.2	6.2
Expenditure	147.8	153.0	196.9	229.4	241.9	258.2	189.9	191.9	192.7	190.4
Expenses	130.7	133.7	165.6	192.7	206.7	208.9	172.7	173.5	172.8	170.3
Of which: Non-RPC expenses	100.2	98.5	130.8	157.9	147.8	179.7	145.9	148.8	150.1	149.4
Compensation of employees	50.4	57.3	65.8	65.4	69.0	72.6	55.0	56.2	56.8	57.4
Goods and services	39.6	27.9	25.9	32.1	31.2	36.7	35.8	35.0	33.3	31.8
Social expenditure	16.5	10.3	10.9	14.1	13.9	20.1	20.7	21.1	21.5	21.9
Subsidies and donations	8.1	3.8	12.8	35.9	30.8	12.6	11.6	10.7	9.8	10.0
Other	16.1	34.5	41.3	45.2	61.8	66.9	46.5	47.4	48.3	49.2
Net acquisition of non-financial assets	17.2	19.3	31.4	36.7	35.1	49.3	17.2	18.4	19.9	20.0
Donor financed	17.2	19.3	10.6	14.4	10.8	14.1	14.2	14.4	14.9	14.0
Government capital expenditure	...	...	20.8	22.3	24.3	35.2	3.0	4.0	5.0	6.0
Net lending (+) / borrowing (-)	29.3	53.8	49.5	60.9	78.1	54.0	42.8	36.1	31.3	28.8
Including Nauru trust fund contribution	17.3	39.0	34.9	36.9	44.4	31.7	14.6	15.4	11.1	9.0
Net financing	29.3	53.8	49.5	60.9	78.1	54.0	42.8	36.1	31.3	28.8
Net acquisition of financial assets	15.8	50.0	40.8	60.3	31.8	56.1	39.8	33.1	28.2	25.7
Changes in government deposit 3/	-3.8	28.7	20.0	29.9	-10.0	27.6	5.3	6.2	1.9	-0.2
Trust fund: Nauru contribution	11.9	14.8	14.6	23.9	33.7	22.3	28.2	20.7	20.2	19.7
Trust fund: Donor contribution	7.6	6.6	6.2	6.4	8.0	6.2	6.2	6.2	6.2	6.2
Net incurrence of financial liabilities	0.0	-2.6	2.8	-3.7	-53.3	2.1	-3.1	-3.1	-3.1	-3.1
External 2/	0.0	-2.1	3.6	-0.7	-42.2	16.5	-2.1	-2.1	-2.1	-2.1
Domestic	0.0	-0.5	-0.8	-3.0	-11.0	-14.4	-1.0	-1.0	-1.0	-1.0
Statistical discrepancy	13.5	1.1	11.4	-3.2	-7.0	0.0	0.0	0.0	0.0	0.0
(In percent of GDP)										
Total revenue and grants	121.8	129.3	148.7	170.2	179.2	169.2	122.8	117.8	113.7	109.2
Revenue	100.6	108.5	136.0	151.4	137.0	151.5	108.1	103.3	99.2	95.4
Of which: RPC revenue 4/	37.3	32.9	51.8	62.9	24.9	21.2	10.9	9.9	9.0	8.2
Tax revenue	21.2	29.6	36.1	48.4	48.4	41.2	25.4	23.9	22.6	21.3
Nontax revenue	79.4	78.9	99.9	103.1	88.6	110.3	82.7	79.4	76.6	74.1
Grants	21.3	20.8	12.7	18.8	42.2	17.7	14.7	14.5	14.5	13.8
Expenditure	101.7	95.6	118.9	134.5	135.5	139.9	100.2	99.1	97.8	94.8
Expenses	89.9	83.6	99.9	113.0	115.8	113.2	91.1	89.6	87.7	84.9
Of which: Non-RPC expenses	68.9	61.6	79.0	92.6	82.8	97.4	76.9	76.9	76.1	74.4
Net acquisition of non-financial assets	11.8	12.1	6.4	21.5	19.7	26.7	9.1	9.5	10.1	10.0
Net lending (+) / borrowing (-)	20.1	33.6	29.9	35.7	43.8	29.3	22.6	18.7	15.9	14.3
Including trust fund contribution	11.9	24.4	21.1	21.7	24.9	17.2	7.7	8.0	5.6	4.5
Net acquisition of financial assets	10.8	31.3	24.6	35.4	17.8	30.4	21.0	17.1	14.3	12.8
Net incurrence of financial liabilities	0.0	-1.6	1.7	-2.2	-29.9	1.1	-1.6	-1.6	-1.6	-1.5
Statistical discrepancy	9.3	0.7	6.9	-1.9	-3.9	0.0	0.0	0.0	0.0	0.0
<i>Memorandum items:</i>										
Nominal GDP (in millions of Australian dollars)	145.3	160.0	165.7	170.5	178.5	184.5	189.6	193.6	197.1	200.7
RPC balance (in percent of GDP) 5/	16.4	10.9	49.0	42.5	53.3	71.5	45.4	43.1	41.2	39.4
Non-RPC balance (in percent of GDP) 6/	-13.1	-1.0	-22.0	-22.5	-26.0	-26.6	-25.2	-26.3	-26.6	-25.9
Stock of government deposit (includes cash buffer) 3/	10.1	38.8	58.8	88.7	78.7	106.3	111.6	117.8	119.7	119.4
In percent of GDP	7.0	24.2	35.5	52.0	44.1	57.6	58.9	60.9	60.7	59.5
In months of non-RPC current spending 8/	1.2	4.7	5.4	6.7	6.4	7.1	9.2	9.5	9.6	8.4
Required cash buffer in Australian dollars	...	0.0	0.0	26.3	24.6	29.9	24.3	24.8	25.0	24.9
Required cash buffer in months of non-RPC spending	...	0.0	0.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Stock of Trust Fund	56.8	84.4	110.8	138.5	217.8	244.6	286.9	322.7	359.0	396.0
In percent of GDP	39.1	52.8	66.9	81.3	122.0	132.5	151.3	166.7	182.2	197.3
Use of Special Drawing Rights (SDRs) 7/	1.2	1.3	1.3	1.4	1.3	1.3	1.3	1.3	1.3	1.3
Stock of government debt (percent of GDP) 8/	77.5	75.1	62.8	61.4	27.1	27.3	25.0	22.9	20.9	19.0
Stock of government external debt	50.1	50.3	48.8	51.4	9.3	25.8	23.7	21.6	19.6	17.5
External debt (in percent of GDP)	34.4	31.4	29.5	30.1	5.2	14.0	12.5	11.2	9.9	8.7
Stock of government domestic debt	62.6	69.9	55.3	53.3	39.0	24.6	23.6	22.6	21.6	20.6
Domestic debt (in percent of GDP)	43.1	43.7	33.4	31.3	21.9	13.3	12.5	11.7	11.0	10.3

Sources: Nauru authorities and IMF staff estimates and projections.

1/ The fiscal year ends in June.

2/ In 2021, the government settled the defaulted Yen Bond debt of \$41.6 million for \$4million. Debt forgiveness of \$37.6 million was recorded as revenues under grants in FY2021.

3/ Change in government deposits reflects Nauru contribution to the Trust Fund. Stock/changes of government deposits are under review by the authorities and may be updated.

4/ Excluding reimbursement for RPC expenses.

5/ Includes only revenue and expense items directly related to RPC.

6/ Non-RPC revenue plus current grants or budget support minus non-RPC expenses.

7/ For purposes of debt sustainability, external debt includes only the difference between SDR cumulative allocation and SDR holdings.

8/ Includes the defaulted Yen bond until it was settled in 2021, use of SDRs, and the government's liability to Bank of Nauru's liquidation.

Annex I. External Sector Assessment

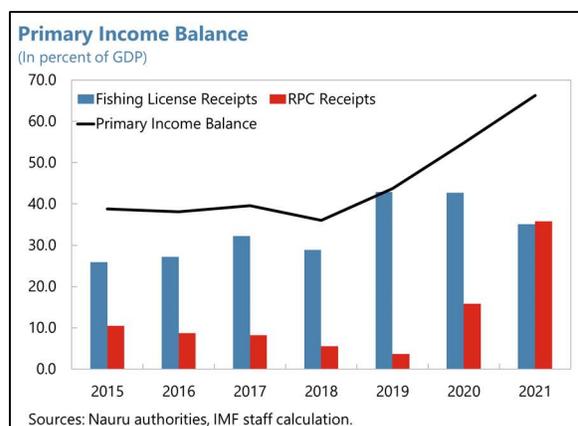
1. Overall Assessment. The external position of Nauru in FY21 is assessed to be weaker than the level consistent with fundamentals and desirable policies. However, this assessment is subject to high uncertainty owing to significant data gaps, the high dependence of current account (CA) determination on exogenous and volatile factors, and available indicators pointing in different directions. As EBA-Lite estimates of the CA gap and real effective exchange rate (REER) gap are unavailable due to data shortcomings, the assessment is largely factual.

2. Context. Nauru's competitiveness is hampered by its remoteness and scale which limits its export base and is associated with high transport costs, its large infrastructure gaps, and capacity limitations. It is vulnerable to swings in global commodity prices due to its heavy reliance on imported goods. Mitigating factors are the large share of imports from Australia and the use of the Australian dollar as legal tender. The CA is driven by factors exogenous to the domestic economic cycle including the sales of fishing licenses, RPC activities, grants, and donor-funded infrastructure projects.

3. Current Account. Nauru's historical CA has been driven by large and offsetting movements in the trade and income balance. The FY21 CA is estimated at 4.1 percent of GDP. The surplus results from a primary income surplus of 66 percent of GDP, a nearly offsetting goods and services trade deficit of 65 percent of GDP and small a secondary income surplus of 3 percent of GDP. The magnitudes and diverging signs of the trade and primary income balance suggest that the CA as a whole may be less reliable as an indicator of competitiveness than its components.

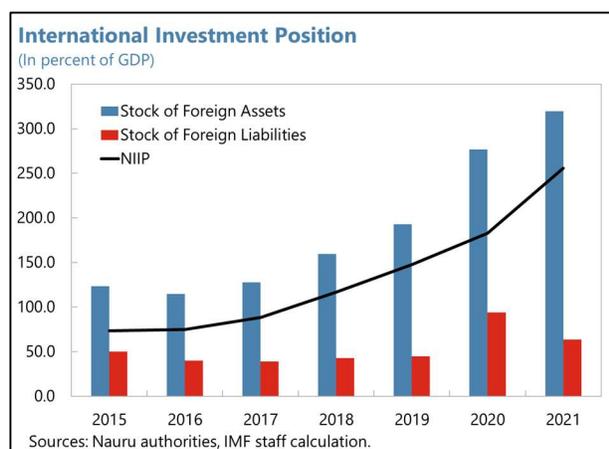
4. Trade Balance. Historically, Nauru's trade balance has been determined largely by phosphate exports and fuel imports, with a services surplus from RPC activity largely tied to expatriate workers on the island. With rapidly declining phosphate production, the trade balance has shifted to steadily rising deficits since FY14. In FY21, the trade deficit of 65 percent of GDP is primarily a result of large fuel imports (43 percent of GDP) and a pandemic-induced decline of travel into Nauru which has kept the services balance in deficit. However, the trade balance is expected to shift to a smaller deficit over the medium term as fuel imports subside as the port project and solar farms become operational.

5. Primary Income Balance. Large surpluses in the primary income balance have financed the trade deficit. The primary income balance is driven by the sale of fishing licenses and RPC related flows, including the RPC hosting fee since FY20. In FY21, the primary income surplus is estimated at 66 percent of GDP. In our baseline, it only modestly narrows as the RPC moves into enduring capability. Large revenues from fishing activity do not necessarily represent underlying



competitiveness, as fishing activity in the region is regulated by the eight member nations of the Parties to the Nauru Agreement (PNA), including Nauru. The PNA annually set the price of fishing licenses and total fishing days through the Vessel Day Scheme (VDS) in their combined exclusive economic zones (EEZ) (which accounts for approximately 30 percent of the world's raw canning material), giving significant pricing power in the region to the PNA.

6. External Sustainability. Following the resolution of a longstanding external debt default in March 2021, external assets (including the Trust Fund) amount to 319 percent of GDP and external liabilities to 63 percent of GDP, implying a FY21 net lending position to the rest of the world of 255 percent of GDP. Under staff's baseline assumptions the CA deficit is projected to narrow over the medium-term to a small deficit in FY26 owing to the anticipated closure of RPC, the departure of expatriate workers, still high dependency on fuel imports, and a decline in phosphate exports. Under the forecasted evolution of growth and rates of returns on the stocks of foreign assets and liabilities, the external position is sustainable under the baseline.



7. REER. Fluctuations in the REER largely mirror movements in the Australian dollar, which is the legal tender in Nauru. Movements in the REER have little impact on competitiveness because trade is predominantly in Australian dollars.

8. Desirable Policies. Adherence to the fiscal responsibility ratios, setting aside windfall revenues to build cash buffers, and robust implementation of the Public Enterprise Act to minimize SOE reliance on subsidies will help support the external balance, particularly if the enduring capability model of RPC results in lower revenues. As residual phosphate reserves approach depletion, economic diversification such as by expanding the usage of the new port facilities and growing a tourism sector could raise the trade balance. Improvements in competitiveness will need structural policy measures that promote the growth of a private business sector, improve the efficiency of SOEs, and increase investment in human capital development.

9. Currency. The use of the Australian dollar as legal tender remains appropriate in view of Nauru's small size and its close economic linkages with the Australian economy. In the absence of a monetary authority, the Australian dollar provides a nominal anchor.

Annex II. Debt Sustainability Analysis

Staff assesses debt as sustainable under current policies.¹ This is a significant improvement from Nauru's 2019 Debt Sustainability Analysis, which found debt unsustainable. Two key factors contributed to this improvement: 1) the settlement in March 2021 of the long-defaulted external debt (yen bonds); and 2) reductions in domestic debt inherited from the liquidated Bank of Nauru. A continuation of sound fiscal and public debt policies, which is expected in the baseline, will help maintain public debt sustainability.

1. Total public debt is estimated at 27.1 percent of GDP (A\$48.3 million) in FY21 and is primarily denominated in domestic currency. External public debt (5.2 percent of GDP or A\$9.3 million) is now composed of a Taiwan POC EXIM bank loan (A\$5.2 million) which is being paid off through grants from Taiwan POC, informal debt (estimated at A\$2.9 million), which includes membership arrears to international institutions, and debt related to the use of Special Drawing Rights (A\$1.3 million), which Nauru is using for its reserve position at the Fund.² Domestic debt consists entirely of the liability that the Government of Nauru undertook as the guarantor of the Bank of Nauru, which went into liquidation in 2006. This liability was quantified in the Deloitte 2014 Report submitted to the District Court and was then estimated at A\$62.7 million. At end-FY21, domestic public debt was estimated at 23.4 percent of GDP (A\$39.0 million), and is owed to individuals, Nauru Phosphate Royalties Trust (NPRT) and other clubs and businesses. Nauru has not had access to international financial markets in recent years.³

2. In March 2021, the Government of Nauru reached a settlement with a U.S.-based hedge fund, Firebird, lowering Nauru's external debt by about 83 percent, according to Fund estimates. The Government of Nauru (GON), as a guarantor, had a longstanding liability on bonds defaulted by the Nauru Phosphate Royalty Trust. NPRT served as a sovereign wealth fund for GON in the 1980s, issuing in 1988-89 two series of yen-denominated bonds with a face value of A\$83 million, before it went bankrupt. Firebird acquired some of the defaulted bonds at a discount in 2009. Several court cases were subsequently filed seeking repayment, and while rulings were in favor of GON, GON's liability remained. In FY20, this debt was estimated at A\$41.6 million (23.3 percent of GDP). Negotiations on a settlement started in 2015 and agreement was reached in March 2021. Under the terms of the final settlement, Firebird was paid A\$4 million in exchange for all their bonds and an indemnity against legal actions on previous court orders or future claims against GON. Due to passage of time, any potential remaining obligation related to the Yen bond are now considered expired.

¹ Current policies include a scale-down of the RPC starting in FY22, labor dislocation is in the baseline RPC assumptions, no tax reforms, and continued adherence to fiscal responsibility ratios.

² Informal debt stock includes membership arrears, which is mostly to the International Postal Union. Nauru is seeking to resolve these arrears with the respective institutions. The amount of SDRs used by Nauru is the difference between its cumulative SDR allocations and SDR holdings at the Fund.

³ Note that even though Nauru does not currently have access to international financial markets, because of its high-income status staff applies the Market Access Debt Sustainability Analysis template for Nauru.

3. GON has been paying off the Bank of Nauru (BON) debt in recent years, whenever fiscal space permits, including during FY21. In FY22, GON is planning further significant reductions in domestic debt, with a budgeted A\$12 million repayment to NPRT, and A\$2.4 million repayment to individual bank book holders. GON is also undertaking a BON Debt Reconciliation Project, with support from the Asian Development Bank (ADB), to identify all remaining known creditors and outstanding balance amounts. GON expects that the recognized outstanding amounts will decrease after the debt reconciliation exercise. For example, preliminary estimates suggest that A\$5.9 million (3 percent of GDP) is owed to individuals who can no longer be identified and whose current Bendigo bank accounts are unknown.

4. With the settlement of the Yen bonds and steady decline in domestic debt, Nauru's public debt is now assessed as sustainable under existing policies. In Nauru's last debt sustainability assessment (DSA) in the 2019 Article IV, public debt was estimated at 86.8 percent of GDP (A\$138.8 million). Public debt can be regarded as sustainable when the primary balance needed to at least stabilize debt under both the baseline and realistic shock scenarios is economically and politically feasible. This condition is expected to be satisfied under current policies in Nauru. Nauru's main external debt (EXIM loan) is small and paid off through grants from Taiwan POC. Nauru's domestic debt is still relatively large, but it is being gradually paid off and there is no rollover risk. Moreover, with Nauru's consistently contributing about 10 percent of annual revenues to the Nauru Trust Fund (Annex III) since 2015, it has started to build a track record of responsible fiscal stewardship.

5. Nauru's public debt remains sustainable under alternative scenarios in the Debt Sustainability Analysis. Nauru's public debt has the following characteristics: i) relatively low share of debt held by non-residents (19 percent); ii) low share of foreign currency denominated debt (13 percent);⁴ iii) no short-term debt; iv) low external financing requirement (-4 percent); and v) no known remaining contingent liabilities, as SOEs cannot access international financial markets. Given the current debt level and debt characteristics, Nauru would normally not require an in-depth assessment under the DSA guidelines for high-income countries. However, as Nauru's debt was previously assessed as unsustainable, Nauru was treated as a high-scrutiny case in this DSA. Under additional stress tests and alternative scenarios debt mostly remained sustainable.

6. In FY22 Nauru plans to obtain a new EXIM loan equivalent to A\$17.2 million to cover the cost of a much-needed aircraft, with a possible additional loan for a second aircraft purchase. The EXIM loans are paid off directly through grants from Taiwan POC, but are classified as 12-year loans, denominated in USD, with grant support reviewed every three years. Continued grant support for loan repayment is expected thanks to a strong bilateral relationship with Taiwan POC. The planned EXIM loan in FY22, along with the budgeted repayments of domestic debt, are expected to rebalance the amount of debt held by non-residents, and debt denominated in foreign

⁴ Nauru's EXIM loans pose no exchange rate risk, as they are repaid directly through USD-denominated grants from Taiwan POC.

currency. However, it is not expected to change the debt sustainability assessment under current policies, given the grant nature of the EXIM loan arrangement.

7. Nauru faces substantial downside risks to revenue and GDP growth which, in the absence of prudent fiscal policy, has the potential to endanger future debt sustainability. The Regional Processing Center (RPC) is a major source of revenue and activity in Nauru through hosting fees, service fees and tax revenues from related activity on the island. If RPC revenues decline substantially, expenditures would have to be reduced accordingly in order to meet the fiscal responsibility ratios. A significant reduction in revenues and expenditures is anticipated in the baseline, in anticipation of RPC closure, and GON is still projected to meet its Nauru Trust Fund payments without running fiscal deficits. Fishing licenses are a second important source of revenue, and their projections in the baseline are conservative, based on performance in recent years. In the baseline, low positive GDP real growth is expected, and is sufficient to maintain debt sustainability. However, a large GDP contraction could negatively impact debt dynamics.

8. To maintain debt sustainability continued sound fiscal and public debt management policies are needed, as well as policies to generate and diversify economic activity. Starting with the FY22 budget, the authorities are transparently reporting details of their domestic and external debt. They are also working towards strengthening their debt management and monitoring arrangements, including management of fiscal risks, with assistance from the ADB. In terms of economic activity, the authorities are both developing contingent plans for RPC scale-down or closure, and at the same time negotiating the terms of an RPC “enduring capability”, for its continued presence on the island. In addition, the authorities should use the climate-resilient port, expected to be completed in 2022, to generate commercial activity and bring in new sources of revenue. Other options for diversification are discussed in Annex V. Given still significant levels of domestic debt, Nauru should carefully consider the possibility of taking on new debt and only do it when the expected growth benefits significantly outweigh the (potential) burden of future debt repayments.

Authorities’ Views

9. The authorities agreed with the staff’s analysis and assessment that Nauru’s debt is sustainable. Authorities underscored their commitment to responsible debt management and noted the actions they have taken toward reining in debt levels since FY20, including resolving the long-standing external debt to Firebird in March 2021, the ongoing BON liquidation payments to individuals and the NPRT, and resolving accounts payable arrears for Eigigu Holdings. Authorities stressed that repayment and servicing of the planned EXIM loan to upgrade the Nauru Airlines fleet would be met by committed budget support from Taiwan POC.

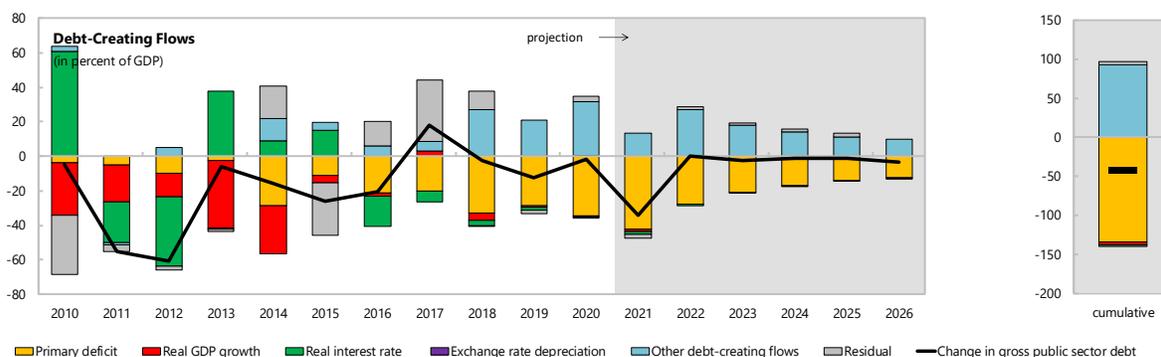
Figure 1. Nauru: Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario
(In percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators^{1/}

	Actual			Projections						As of December 15, 2021		
	2010-2018 ^{2/}	2019	2020	2021	2022	2023	2024	2025	2026			
Nominal gross public debt	119.9	62.8	61.4	27.1	27.3	24.8	23.4	22.1	18.8	Sovereign Spreads		
Of which: guarantees	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	EMBIG (bp) 3/		
Public gross financing needs	-3.2	-15.1	-34.1	-37.2	-21.1	-20.2	-16.4	-12.9	-10.7	5Y CDS (bp)		
										Ratings	Foreign	Local
Real GDP growth (in percent)	10.8	1.0	0.7	1.6	0.9	2.6	2.4	2.0	1.8	Moody's	n.a.	n.a.
Inflation (GDP deflator, in percent)	2.8	2.6	2.2	3.1	2.5	0.1	-0.3	-0.2	0.1	S&P's	n.a.	n.a.
Nominal GDP growth (in percent)	12.8	3.6	2.9	4.7	3.4	2.7	2.1	1.8	1.8	Fitch	n.a.	n.a.
Effective interest rate (in percent) ^{4/}	0.7	0.0	0.3	0.1	0.1	0.7	0.7	0.6	0.6			

Contribution to Changes in Public Debt

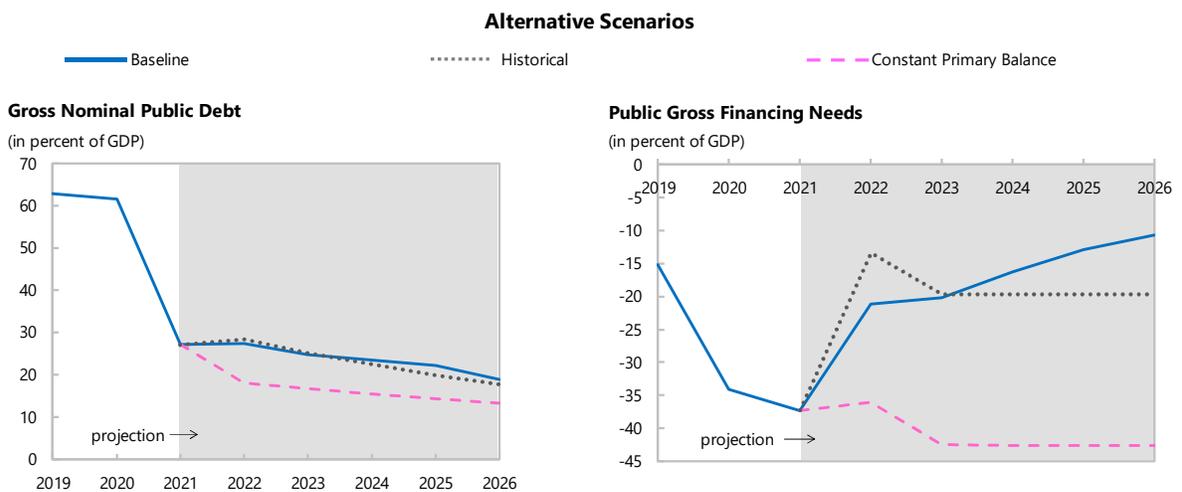
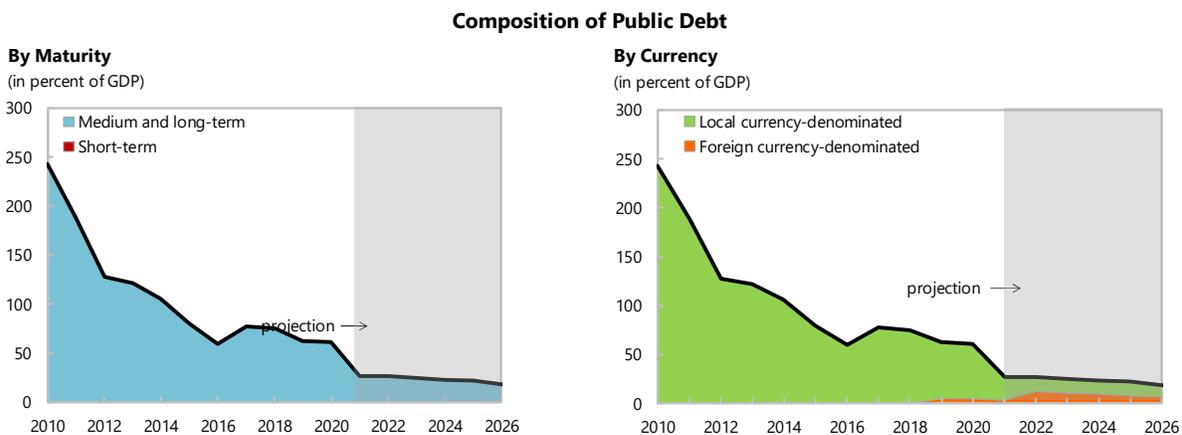
	Actual			Projections						cumulative	debt-stabilizing balance ^{9/}
	2010-2018	2019	2020	2021	2022	2023	2024	2025	2026		
Change in gross public sector debt	-19.2	-12.3	-1.5	-34.3	0.2	-2.4	-1.4	-1.3	-3.3	-42.6	primary
Identified debt-creating flows	-20.0	-10.5	-4.1	-31.9	-1.4	-3.7	-3.4	-3.2	-3.1	-46.7	balance ^{9/}
Primary deficit	-15.1	-28.8	-34.5	-42.5	-27.6	-20.9	-16.9	-14.1	-12.6	-134.5	9.4
Primary (noninterest) revenue and grants	87.4	147.7	168.8	177.9	167.5	121.0	116.0	111.9	107.4	801.6	
Primary (noninterest) expenditure	72.3	118.9	134.4	135.4	139.9	100.1	99.1	97.7	94.8	667.0	
Automatic debt dynamics ^{5/}	-11.8	-2.5	-1.3	-2.7	-0.9	-0.5	-0.4	-0.3	-0.3	-5.0	
Interest rate/growth differential ^{6/}	-11.8	-2.6	-1.6	-2.7	-0.9	-0.5	-0.4	-0.3	-0.3	-5.0	
Of which: real interest rate	3.6	-1.9	-1.2	-1.8	-0.6	0.2	0.2	0.2	0.1	-1.8	
Of which: real GDP growth	-15.4	-0.7	-0.4	-0.9	-0.2	-0.7	-0.6	-0.5	-0.4	-3.3	
Exchange rate depreciation ^{7/}	0.0	0.1	0.3	...	...	...	...	...	...	...
Other identified debt-creating flows	6.9	20.9	31.6	13.3	27.0	17.7	13.9	11.2	9.7	92.8	
Fiscal: Net acquisition of financial assets: Changes in government deposit (negative)	6.9	20.9	31.6	13.3	27.0	17.7	13.9	11.2	9.7	92.8	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes ^{8/}	0.8	-1.8	2.7	-2.4	1.6	1.3	1.9	1.9	-0.2	4.2	



Source: IMF staff.

- 1/ Public sector is defined as central government and includes public guarantees, defined as Arrears.
- 2/ Based on available data.
- 3/ Long-term bond spread over German bonds.
- 4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.
- 5/ Derived as $[(r - \pi)(1+g) - g + ae(1+r)] / (1+g+\pi+gr)$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
- 6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as $-g$.
- 7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.
- 8/ Includes changes in the stock of guarantees, asset changes, and interest revenues (if any). For projections, includes exchange rate changes during the projection period.
- 9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 2. Nauru: Public DSA – Composition of Public Debt and Alternative Scenarios



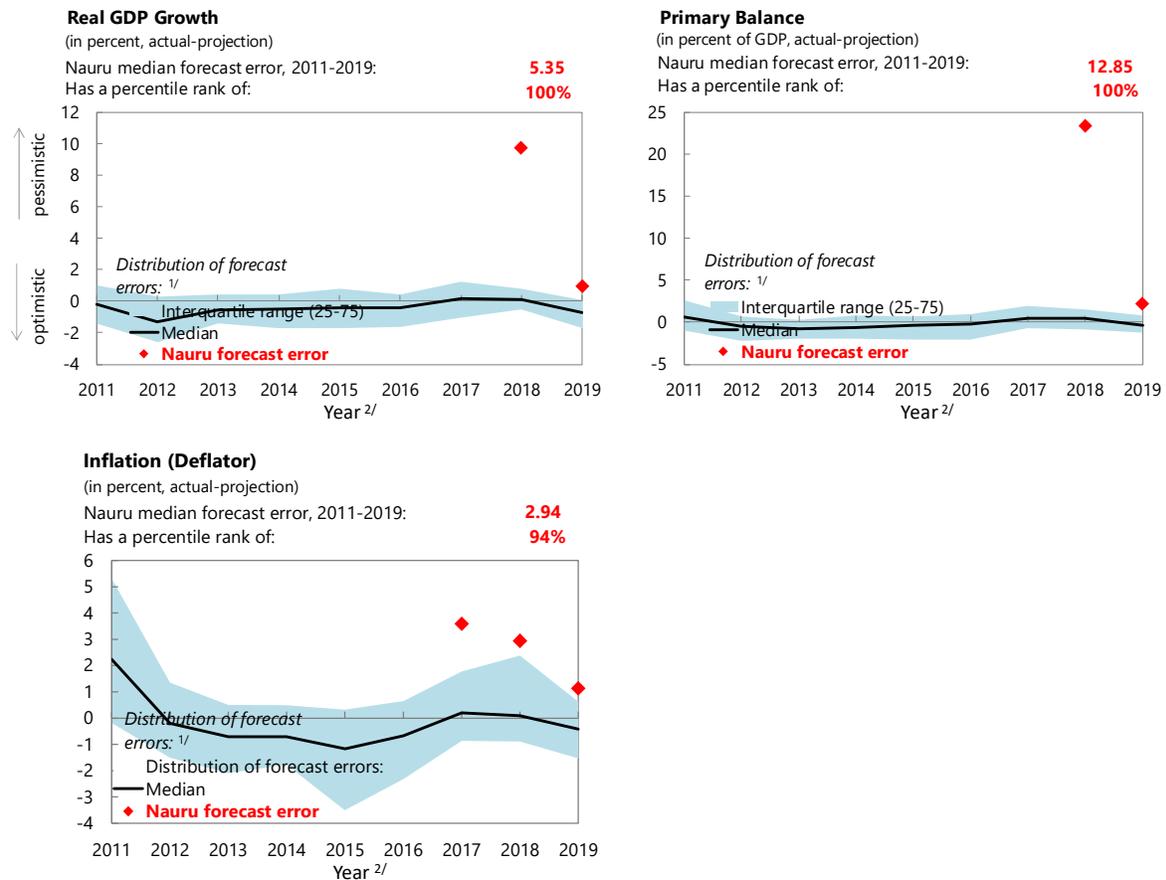
Underlying Assumptions (in percent)

Scenario	2021	2022	2023	2024	2025	2026
Baseline Scenario						
Real GDP growth	1.6	0.9	2.6	2.4	2.0	1.8
Inflation	3.1	2.5	0.1	-0.3	-0.2	0.1
Primary Balance	42.5	27.6	20.9	16.9	14.1	12.6
Effective interest rate	0.1	0.1	0.7	0.7	0.6	0.6
Constant Primary Balance Scenario						
Real GDP growth	1.6	0.9	2.6	2.4	2.0	1.8
Inflation	3.1	2.5	0.1	-0.3	-0.2	0.1
Primary Balance	42.5	42.5	42.5	42.5	42.5	42.5
Effective interest rate	0.1	0.1	1.1	1.0	0.9	0.9
Historical Scenario						
Real GDP growth	1.6	8.8	8.8	8.8	8.8	8.8
Inflation	3.1	2.5	0.1	-0.3	-0.2	0.1
Primary Balance	42.5	19.5	19.5	19.5	19.5	19.5
Effective interest rate	0.1	0.1	0.0	-0.1	-0.1	-0.2

Source: IMF staff.

Figure 3. Nauru: Public DSA – Realism of Baseline Assumptions

Forecast Track Record, versus all countries

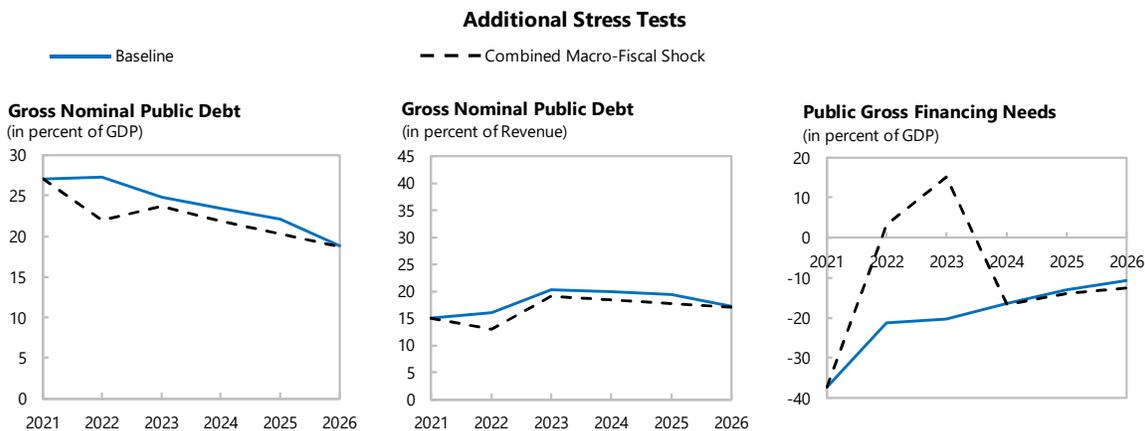
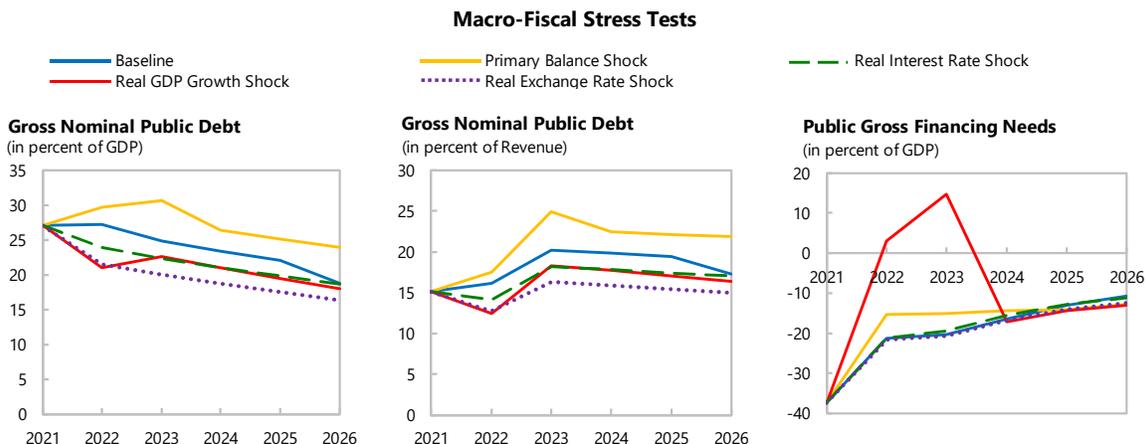


Source : IMF Staff.

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

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

Figure 4. Nauru: Public DSA – Stress Tests

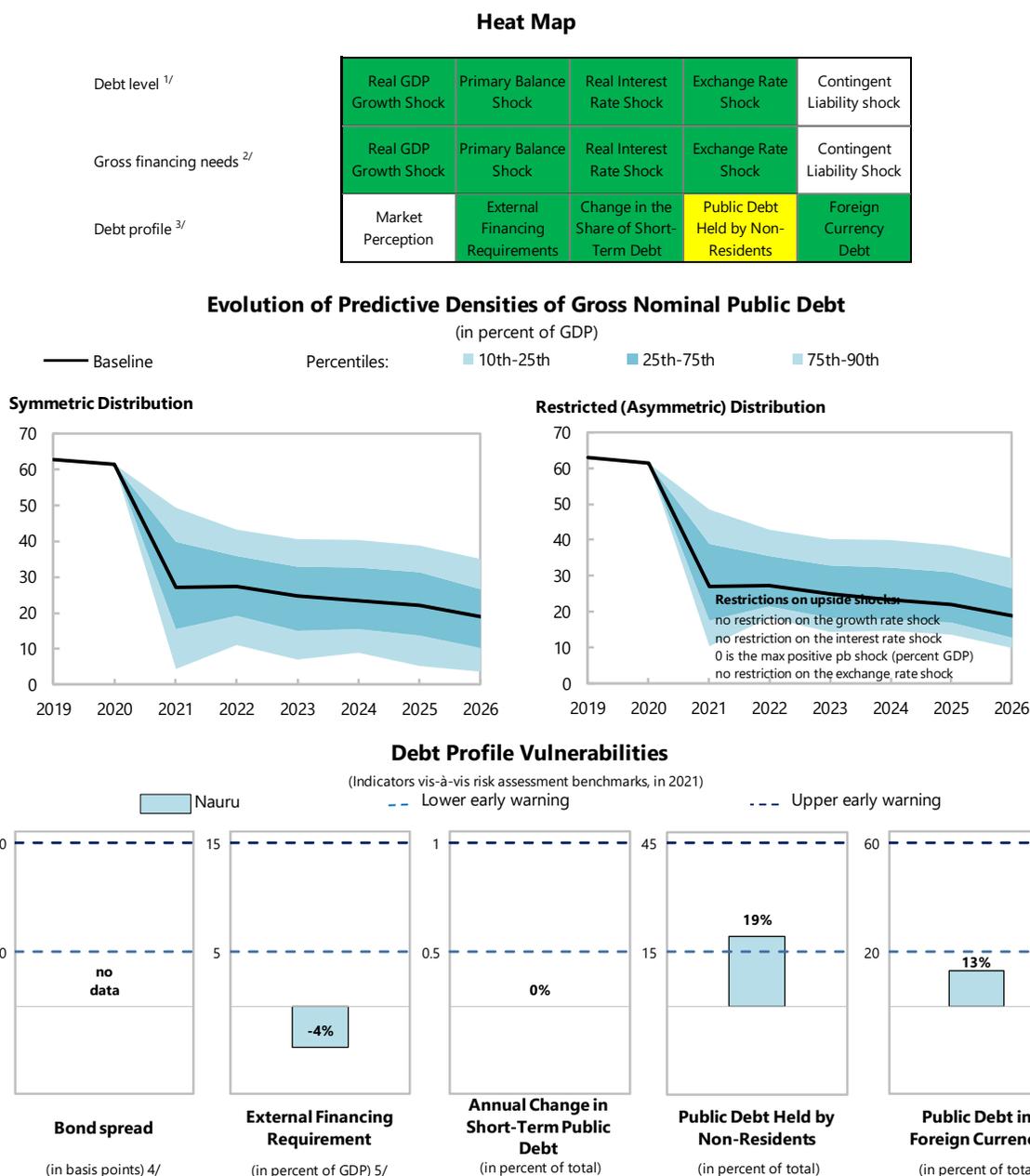


Underlying Assumptions (in percent)

	2021	2022	2023	2024	2025	2026
Primary Balance Shock						
Real GDP growth	1.6	0.9	2.6	2.4	2.0	1.8
Inflation	3.1	2.5	0.1	-0.3	-0.2	0.1
Primary balance	42.5	21.7	15.2	17.0	14.2	12.7
Effective interest rate	0.1	0.1	1.2	1.2	1.2	1.1
Real Interest Rate Shock						
Real GDP growth	1.6	0.9	2.6	2.4	2.0	1.8
Inflation	3.1	2.5	0.1	-0.3	-0.2	0.1
Primary balance	42.5	27.6	21.0	17.0	14.2	12.7
Effective interest rate	0.1	0.1	8.2	8.4	8.6	9.0
Combined Shock						
Real GDP growth	1.6	-10.8	-9.2	2.4	2.0	1.8
Inflation	3.1	-0.5	-2.8	-0.3	-0.2	0.1
Primary balance	42.5	4.5	-14.6	17.0	14.2	12.7
Effective interest rate	0.1	0.2	1.3	1.2	1.2	1.1
Real GDP Growth Shock						
Real GDP growth	1.6	-10.8	-9.2	2.4	2.0	1.8
Inflation	3.1	-0.5	-2.8	-0.3	-0.2	0.1
Primary balance	42.5	4.5	-14.6	17.0	14.2	12.7
Effective interest rate	0.1	0.1	1.1	1.0	0.9	0.9
Real Exchange Rate Shock						
Real GDP growth	1.6	0.9	2.6	2.4	2.0	1.8
Inflation	3.1	9.5	0.1	-0.3	-0.2	0.1
Primary balance	42.5	27.6	21.0	17.0	14.2	12.7
Effective interest rate	0.1	0.2	1.1	1.0	0.9	0.8

Source: IMF staff.

Figure 5. Nauru: Public DSA Risk Assessment



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.

Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

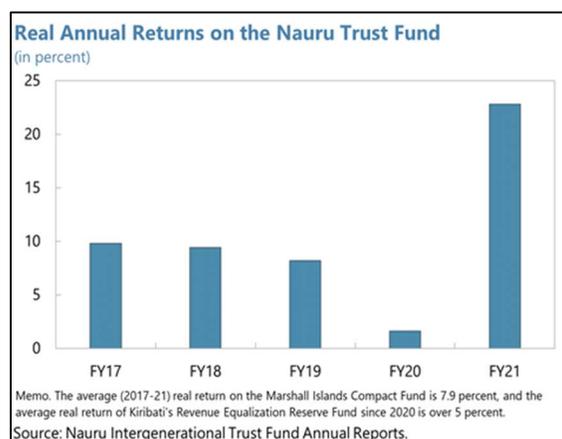
4/ Long-term bond spread over German bonds, an average over the last 3 months, 16-Sep-21 through 15-Dec-21.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Annex III. An Update on the Nauru Trust Fund

1. In recent years, following the depletion of phosphate reserves, the Government of Nauru (GON) has become more reliant on the revenues received from sales of fishing licenses and the Australian Regional Processing Center (RPC). The Nauru Intergenerational Trust Fund was established in 2015 with the goal to replace dwindling phosphate mining revenues and supplement volatile government revenues over the medium term. The Trust Fund (TF) is perpetual and is expected to become available to GON after 2033. Its objectives are to achieve a return of inflation plus 4.5% over rolling 10-year periods and have a risk of negative returns of no more than 4 years in every 20 years.

2. Under the memorandum of agreement, GON and its development partners (Australia, Taiwan Province of China, and New Zealand) commit to making annual contributions to the TF. The contribution range is guided by domestic revenues in that year, with a maximum contribution of 12 percent of annual revenues. The framework has an allowance of no contributions in years where revenues are lower than AU\$ 24 million. An allowance is also made to delay, reduce, or forgo contributions under rare and extenuating circumstances. Nevertheless, annual contributions to the TF were not dampened by the Covid-19 pandemic, with a total of AU \$41.7 million contributed in FY21, 62.9 percent higher than in FY20.

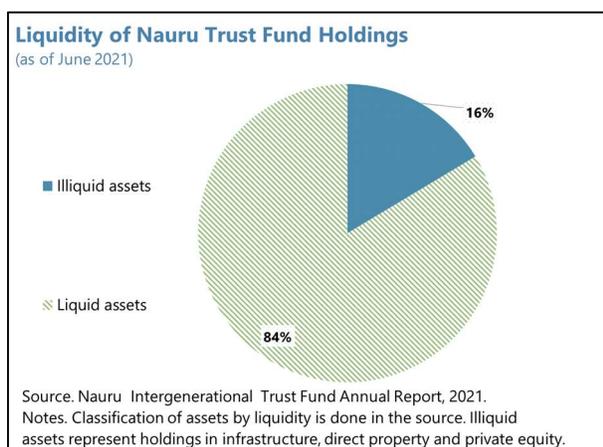
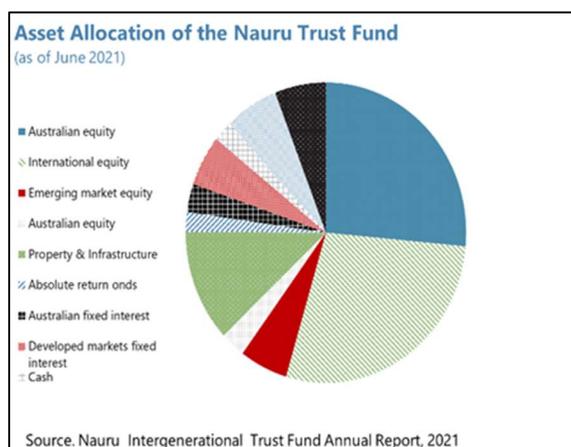


3. The NTF is managed by a committee consisting of representatives from the GON and each of the development partners that contributes to the Fund. The committee is supported by an investment fund manager, an executive administrator that coordinates committee activity and administers the NTF on their behalf, an accountant, an auditor, and a review consultant to evaluate the Fund against international best practices and benchmarks. The NTF has completed a self-assessment in line with the Santiago Principles which identify a framework of practices that reflect appropriate governance and accountability arrangement. In 2017, the NTF became a member of the International Forum of Sovereign Wealth Funds.

4. By end-FY21, the TF was valued at AU\$218 million and is on track to achieving its target AU \$400 million by 2033. Year-to-date cash contributions into the TF amount to A\$166.6 million, reflecting contributions by Nauru (AU\$119.4M), Australia (AU\$19.9M), the ADB (AU\$2.6M), New Zealand (AU\$5.6M) and Taiwan Province of China (AU\$19.1M).

5. The NTF is well diversified across asset classes with investments in Australian, developed market and emerging market equity and bonds. Over the years, the TF has invested in unlisted unit trusts and private equity investment including a recent AU\$10 million investment in

Global Unlisted Infrastructure. The TF entered Stage 2 of its investment strategy in FY18, after which it began to allocate more than 75 percent of its portfolio to growth assets to improve returns potential. The financial performance of the TF picked up in FY21 as the real annual returns recovered from the market volatility and the global downturn in equity markets in FY20. The 12-month return (22.8%) was well above the return objective (8.3%) in FY21.



6. Nauru has relied mainly on windfall revenues from RPC operations, which accounts for a quarter of GDP, to make its mandated annual contributions to the Trust Fund. However, with the RPC potentially closing its current form in December 2021, there are concerns around the sustainability of government revenues and government's ability to continue financing its annual contributions to the Trust Fund.

7. Securing new sources of growth will be crucial to achieving the Trust Fund targets. Since inception, GON contributions to the TF, often falling at the high range of suggested contributions, have been facilitated by strong albeit volatile sales of fishing licenses and the stable receipt of RPC revenues. With the rising impact of climate change on ocean fish supply and the anticipated closure of RPC in its current form in end-2021, it is increasingly important for GON to secure new sources of growth and revenue to ensure that it will continue to meet the TF targets.

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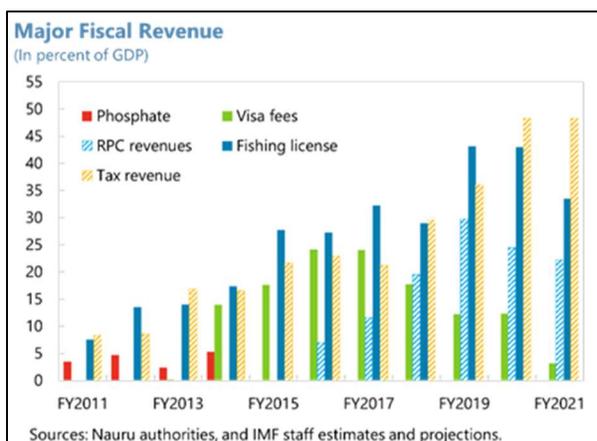
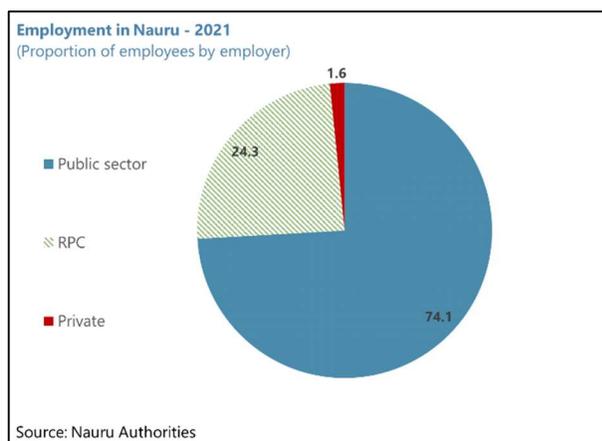
Annex IV. SDGs Identified in the 2019-30 National Sustainable Development Strategy

Key development objectives identified by the NSDS	Corresponding SDGs ^{1/}		Role of the IMF
Sustained and inclusive economic growth	1 No Poverty	8 Inclusive Economic Growth & Decent Work	<ul style="list-style-type: none"> ✓ Surveillance and policy advice on macroeconomic policies; ✓ Technical assistance on domestic revenue mobilization; ✓ Technical assistance on financial sector stability to support financial deepening and inclusion ; ✓ Technical assistance on developing a sound medium-term macroeconomic framework and improve macroeconomic analysis for policy making.
	2 Zero Hunger	10 Reduced Inequality	
	5 Gender Equality		
Infrastructure	6 Clean Water & Sanitation	9 Resilient Infrastructure & Innovation		✓ Surveillance and policy advice on public investment management
Access to quality social services and culture	3 Good Health and Well Being	4 Quality Education	<ul style="list-style-type: none"> ✓ Coordination with ADB, World Bank and development partners
Resilient and environmental sustainable development	7 Affordable and Clean Energy	12 Responsible Consumption	<ul style="list-style-type: none"> ✓ Surveillance and policy advice on climate-change adaptation and access to climate finance ✓ Technical assistance through the Climate Macroeconomic Assessment Program (CMAP)
	11 Sustainable Cities & Communities	13 Climate Action	
	14 Sustainable Use of Oceans	15 Life on Land	
Governance	16 Peace, Justice, and Strong Institution	17 Partnerships for the Goals	<ul style="list-style-type: none"> ✓ Technical assistance on revenue administration, focusing on compliance improvement; ✓ Technical assistance on PFM with a focus on improving the budget document and developing a medium term fiscal framework; ✓ Surveillance, policy advice and technical assistance on improving AML/CTF framework;

1/ Staff compilation.

Annex V. Long Term Growth Opportunities for Nauru¹

1. With the depletion of phosphate mining, the Nauru economy has become more reliant on the Australian Regional Processing Center and fisheries for revenues. Historically, phosphate mining was the main catalyst for growth and the major source of government revenues until the early 2010s at which time phosphate reserves dried up. Within the last decade, growth has shifted to being largely services driven, following the reopening of the Regional Processing Center (RPC). Over the years, the RPC has contributed about a third of government revenues. About a quarter of those currently employed in Nauru are involved with the RPC and the rest are mostly absorbed by the public sector. Businesses are predominantly state-owned (SOEs) which suggests that Nauru's private sector is rather small and underdeveloped. Agriculture in Nauru is mainly focused on fisheries, namely the sale of fishing licenses under the Parties to Nauru Agreement. In recent years, Nauru's fishing license revenues have risen substantially to an average AU\$3.5M per year providing yet another vital source of government revenue.



2. There are opportunities for economic diversification by encouraging greater private sector development to enable a more sustainable medium-term growth. The RPC is expected to downsize in the near future, which emphasizes the need for Nauru to explore alternative sources of growth and prioritize the development of its private sector. The National Sustainable Development Strategy of 2019-2030, highlights economic diversification and improvements in business environment as part of Nauru's key national development priorities. In line with this, there are three potential areas of future growth that Nauru should consider:

- **Domestic fisheries:** Opportunities for crop and livestock production in Nauru are limited due to its very small land mass size of only 21 km² that has been made infertile by years of phosphate mining. Nauru's prospects in agriculture, therefore, lies in the fisheries sector, where it can explore the possibility of having its own domestic fish processing facilities. With an area of 320,000 km², Nauru's Exclusive Economic Zone (EEZ) is one of the most favorable for Tuna purse seine fishing. However, illegal transshipment at sea is a significant threat to Pacific island

¹ Prepared by Seruwaia Cagilaba.

countries (PIC) fisheries, as an estimated US\$142 million per year is lost to illegal tuna fishing activity within the Western and Central Pacific Ocean ([Pacnews, 2021](#)). With the expected completion of its new port, Nauru may engage in domestic fish processing of Tuna, which could help counter illegal transshipment at sea. Nauru could capitalize more on its EEZ by closely monitoring transshipment at sea and investing in better domestic fish processing facilities including refrigerated container ships for transshipment of fish to port. The development of domestic fish processing facilities in Nauru would help generate additional government revenues and create more local employment.

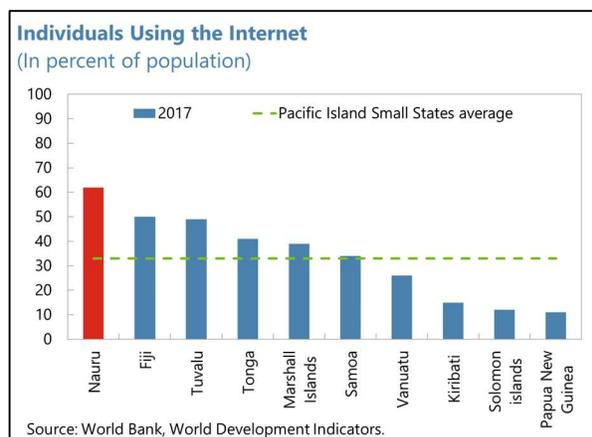
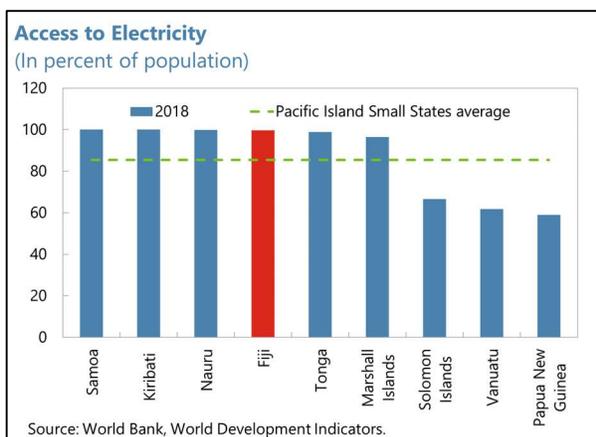
- **Niche tourism:** Tourism in Nauru is relatively underdeveloped with less than 200 people visiting the country annually. With the expected scaling down of RPC, the government could prioritize niche tourism and focus on reskilling RPC workers for reemployment in the hospitality industry. Given its remote location, ability to control light pollution, and its year-round tropical weather, Nauru has vast untapped potential for niche tourism. The massive ocean body and surrounding reefs are potential tourist attractions that can be used for game fishing and tourist diving, along the lines that Vanuatu and Fiji have done. Connectivity is available largely through its own national carrier, Nauru Airlines, with regular flights to Australia and neighboring PICs. Niche tourism in Nauru would not only provide new employment opportunities and tax revenues for government but stimulate demand for small businesses like traditional handicrafts markets. To raise Nauru's potential as a niche tourist destination, the government needs to improve infrastructure including medical services, potable water, waste management services and financial services. Long term investment towards improving access to education and skills to develop the tourism and hospitality industry is also important.
- **Increased participation in international labor mobility schemes:** Remittances revenue from international labor mobility schemes could be a potential source of national income and employment for the country. Nauru is part of Australia's Seasonal Worker Program (SWP) and Pacific Labor Scheme (PLS), but its remittances revenue to date are negligible. The government could encourage greater participation in international labor mobility schemes, as both, a source of employment, and an opportunity to reskill the labor force. International labor mobility schemes are a source of remittance revenue that can help support local consumption and drive economic activity. This could potentially raise the demand for more financial services in Nauru.

3. The removal of structural barriers and key infrastructure constraints are essential for facilitating better long-term growth. To fully recognize its long-term growth potential Nauru needs to address the following existing macro critical issues that are hindering private sector investment and development:

- **Gaps in key infrastructure exacerbates the costs of doing business.** Authorities should address key infrastructure gaps constraining access to proper drinking water, waste management and health services in Nauru. The country has limited rainfall and is heavily reliant on imported water or desalination of ocean water, both of which are costly for businesses. Health services in the country are limited and recent investment in better quality hospitals and

medical services are welcome, to reduce the cost and need for overseas repatriation. Proper waste management is also an area of concern that authorities need to address.

- Structural labor market issues constrain the quality of human capital creating undue reliance on expat skills and labor skills mismatch.** The low pass rates, as well as low completion and retention rates is a concern in Nauru. This is contributing to a lack of formal education amongst young people that can limit their access to formal employment. There are also limited opportunities for domestic technical skills development. The authorities should reform the labor market by improving access to education and improving technical skills training to strengthen the quality of Nauru’s human capital and reduce the skills gap. The focus needs to change to using expats to retrain locals with skills in areas where there are skills shortages such as health professionals. This will also reduce the cost of doing business and government’s fiscal expenditures.
- Weak business environment.** Structural gaps in the business environment will also need to be addressed. Information provided by authorities suggests significant barriers to private sector development in Nauru which include limited access to land, lack of financial services (including insurance and formal credit), high costs of utilities (electricity and desalination of water), and high costs for starting up a business (AU6,000 per person for business visa). Land management issues in Nauru is an ongoing concern as securing private land and renewing of land leases is rather difficult requiring the consent of many private individuals. The government should prioritize reforms that reduce the cost of doing business and strengthen property rights and regulatory environment to attract more private sector investment. Nauru should also digitize the provision of its services as 100 percent of the population have access to electricity and there is also a high level of internet connectivity. When coupled with financial sector development, digitization of payments and other essential services will help improve access to key services that can reduce the cost of doing business.



4. Governance and corruption vulnerabilities can reduce the efficiency of public investment and deter quality private sector investment including FDI. There are governance weaknesses in the public sector that may be raising vulnerability to corruption risks. For example, internal controls and financial reporting on the use of public funds budgeted for housing

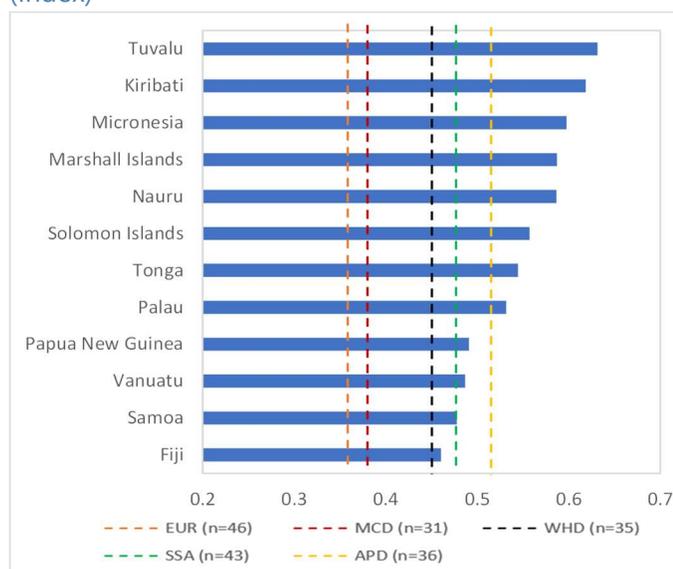
improvements may need to be strengthened² While there is publicly available information on the central government's budget and audited financial statements, the audit reports are lagging, constrained by issues with archiving. Authorities are encouraged to continue with reforms that strengthen financial transparency and accountability including better reporting on SOEs. Corruption can be a hindrance to quality private sector development in Nauru, therefore authorities should also consider strengthening anti-corruption legislation, and the efficacy and independence of its anti-corruption bodies.

² See page 20 of the 2018 Republic of Nauru Annual Audit Report of the Auditor General. Available here: <https://naurufinance.info/wp-content/uploads/2021/06/Audit-certificateaudit-report-Mgmt-letter-2017-18.pdf>

Annex VI. Improving Resilience to Climate Change

1. Nauru is a remote volcanic atoll with scarce freshwater and arable land. Nauru has an area of only 21 km², with extensive land degradation from decades of phosphate mining, and nearly all the population and infrastructure is concentrated around the coast. The nation is dependent on maritime and air cargo for food and fuel. Prohibitive costs of fresh food and produce contribute to higher incidence of non-communicable diseases (NCDs), such as diabetes, and lower life expectancy. Sea level rise—which could be up to 0.63m by 2100—threatens to exacerbate coastal erosion and flooding and increase saltwater intrusion into already very scarce groundwater reserves (ABM and CSIRO, 2014). Predicted changes in rainfall patterns are also expected to negatively affect water scarcity. Fish stocks could be depleted by rising ocean temperature and acidification (GON, 2015).

Figure 1. Exposure to Climate Change (Index)



Source: Notre Dame Global Adaptation Index (2018).

Note: Dotted lines show regional averages, with the number of countries shown in parentheses (EUR – Europe; MCD – Middle East and Central Asia; WHD – Western Hemisphere; SSA – Sub-Saharan Africa; APD – Asia Pacific).

2. Measures of exposure to climate change place Nauru among countries most severely exposed to the negative effects of climate change, both in the region and in the world (Figure 1).¹Exposure to climate change and the current state of existing infrastructure together determine countries' adaptation needs. As a point of reference, IMF (2021a) estimates that investment of 6 ½ to 9 percent of GDP annually for at least 10 years is needed to climate-proof infrastructure in other Pacific islands, for which data are available.

3. Nauru has identified national adaptation priorities, including at the sectoral level, but needs a detailed costing of priority projects, which would allow a more strategic pursuit of climate finance. Adaptation priorities are outlined in RonAdapt, Nauru's national adaptation plan and include water, energy and food security, healthy environment and people, and productive and secure land resources. These goals are pursued through various projects in the National Sustainable Development Strategy 2019-2030, and yearly development fund projections. Nauru's climate

¹ The exposure index is taken from the ND-Gain index of the Notre Dame Adaptation Initiative (Chen et al 2015). The exposure index measures the extent to which human society and its supporting sectors are stressed by the future changing climate conditions. It captures the physical factors external to the system that contribute to vulnerability.

projects are financed by both bilateral partners (primarily Australia, New Zealand, Japan, Taiwan POC) and multilateral donors (primarily ADB), as well as Nauru contributions.

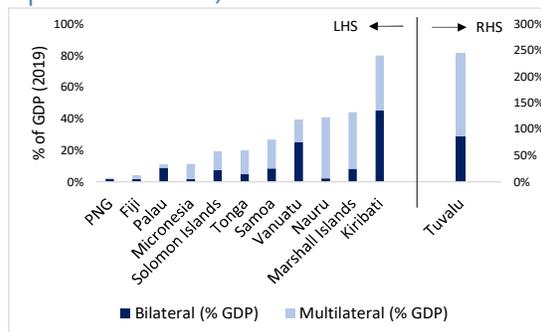
4. As a share of GDP, Nauru has been relatively successful at securing climate finance (Figure 2), though for its level of exposure to climate change, it has done no better than other Pacific Islands, on average (Figure 3).

Nauru’s biggest climate project so far is the climate-resilient port, financed via the Green Climate Fund, ADB, Australia and Nauru. The new climate resilient port will allow ships to safely dock year-round, significantly lowering the cost of shipping and thereby the cost of essential imports. The port will also offer new growth opportunities for the island, as well as additional local employment. Nauru has also advanced climate mitigation projects. For example, Nauru’s solar power development project, financed by ADB, involves installment of a 6MW solar energy farm, which will significantly increase Nauru’s energy security. In addition, an ADB project to improve water supply, sanitation and solid waste management is in development.

5. To ensure success in pursuing its climate finance strategy Nauru relies on two local institutions: Planning and Aid Division at the Department of Finance and the recently established Climate Change Department.

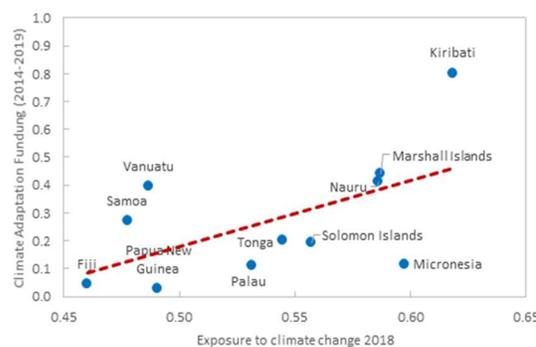
International best practice suggests that having a unit dedicated to climate finance is a key element of a successful climate finance strategy. Nauru has also undertaken significant reforms in preparation for major climate projects. For example, to prepare for the port project, the Nauru Port Authority was reformed, strengthening its legal framework, and bringing in a new competitively selected CEO. These preparatory steps and productive collaboration with the ADB have been crucial for successful project implementation. Once the port project is completed, it is expected to be commercially viable. Further reforms in Public Financial Management and Public Investment Management would ensure that implementation of future projects continues smoothly as well (IMF, 2021b).

Figure 2. Approved Climate Adaptation Funding (2014-19)
(In percent of GDP)



Source: OECD Climate-related Development Finance Database.

Figure 3. Exposure to Climate Change and Approved Climate Adaptation Funding
(percent of GDP)



Source: Notre Dame Global Adaptation Index (2018) and OECD climate adaptation approved funding 2014-2019.
Note: Tuvalu is not shown on chart, as it is an outlier in terms of amount of approved climate adaptation funding as percent of GDP, at over 200 percent.

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Annex VII. Risk Assessment Matrix

Sources of Risk	Relative Likelihood	Expected Impact	Policy Recommendations
Significant Scale-down of RPC. Large share of government revenues and local employment are derived from RPC, which could both be significantly lower under the Enduring Capability model of RPC after 2021.	Very High	Up to 15 percent of the labor force risks job loss. A model that leaves revenues significantly lower under Enduring Capability would adversely impact growth, potentially lower contributions to the NTF, and deplete government saving.	Accelerate plans for the upskilling, reallocation and retraining of RPC workers. Maintain prudent fiscal policy and build sufficient fiscal buffers to minimize the adverse impact on growth and mobilize donor support if needed.
Sales of Fishing Licenses Underperform. Revenues are highly dependent on volatile fishing revenues, which are also vulnerable to climate change effects on tuna stock.	High	A protracted period of weak fishing activity will weigh heavily on revenues, potentially requiring cuts in essential expenditures or risk debt sustainability.	Implement tax reforms to lower reliance on external sources of revenue, including by raising tax compliance, lowering the personal income tax threshold and introducing a VAT.
Continued absence of a Correspondent Banking Relationship. The lack of a CBR for USD transactions limits the economic growth and diversification of Nauru.	Very High	Continued exchange rate losses from alternative arrangements, for example for fuel purchases, to ensure all transactions are in Australian dollars.	Among others, measures to improve Nauru's credibility and standing in international credit markets should continue. The AML/CFT framework should be strengthened and implemented.
Delays in restructuring Ronphos. The largest recipient of government subsidies has an incoherent business model and non-transparent financial statements.	High	Delays in implementing needed reforms of Ronphos will weigh on the budget, lower growth prospects and threaten fiscal sustainability.	Accelerate progress on the SOE monitoring unit, and ensure that Ronphos complies with the Public Enterprise Act; work with development partners to improve the business climate to stimulate private sector development
Higher frequency and severity of natural disasters related to climate change. Causes severe damage to smaller economies; destroys infrastructure, disrupts trade, raises commodity prices and the risk of fires.	Medium	Will adversely affect import prices, tuna stock, supply of water and utilities, health, infrastructure, inhabitable land, and current and long-term growth. Fires will be disastrous given Nauru's isolation and lack of access to medical treatments, power, and water supplies.	Improve disaster preparedness including: seek cost-effective insurance; establish contingent financing from bilateral partners; earmark funds for disaster relief in the cash buffer; scale-up medical preparedness; investing in climate-resilient infrastructure.
Rising commodity prices amid bouts of volatility. Nauru imports nearly all its food and fuel.	Medium	An increase in commodity prices above its projected level and price volatility will weigh on the budget and could risk food shortages.	Scale-up preparedness by establishing plans for steady delivery of food and fuel through futures contracts.
COVID-19 Outbreak in Nauru. Population is significantly at-risk due to high incidence of diabetes (a risk factor) and extremely dense living conditions (11 th highest in the world).	Low	While the risk of an outbreak is assessed to be low, the human and economic impact will be catastrophic due to limited medical facilities, high risk factors and population density. Nauru would require significant medical and financial assistance.	Maintain quarantine and border control protocols in line with global best practice. Accelerate the construction of medical facilities for long-term purposes as well as a health emergency.

Annex VIII. Authorities' Response to Fund Policy Advice

Fund Recommendation	Policy Actions
Fiscal Policy	
Resolve the yen-denominated sovereign bond default and reconcile domestic debt from the liquidation of BON. Strengthen debt management to ensure fiscal and debt sustainability.	The authorities reached a resolution of the yen-denominated bonds in March 2021, lowering external debt by 83 percent of its value. A stocktaking and reconciliation of the BON debt was initiated in FY21 and scheduled for completion by end-FY22. In part due to these measures, debt is assessed to be sustainable under current policies.
Maintain a cash buffer of at least two months of non-RPC current spending.	The authorities have maintained the recommended level of the cash buffer since the last consultation.
Implement fiscal adjustment to avoid a breach of the fiscal anchor by reducing spending in non-priority areas and implementing tax and PFM reforms.	The fiscal balance was in deficit in FY21, owing to a delay in the timing of an EXIM loan from Taiwan POC, breaching one of the fiscal responsibility ratios. SOE subsidies were raised in FY21 to manage pandemic-induced dislocations but have been significantly scaled back in the FY22 budget, including to Ronphos whose future allocations will depend on a cost-benefit assessment of secondary phosphate mining (see below for tax and PFM reforms).
Tax Reforms	
Introduce a consumption tax and lower the tax thresholds to offset lost customs revenues from scaling-down of RPC and ratification of the PACER Plus. Modernize tax administration and revenue measures.	The authorities are not ratifying PACER Plus, which will limit the need to recoup customs revenues from ratification. There has been little progress on recommended tax reforms, owing to concerns they will raise consumer prices and be politically costly. Authorities stress that the digital infrastructure for modernizing tax administration is too expensive and the capacity to manage its implementation too low.
Governance and PFM Reforms	
Implement the Public Enterprise Act and establish a SOE monitoring unit. Limit the use of supplementary budgets and set aside windfall revenues for appropriation in the normal budget cycle.	Authorities implemented the Public Enterprise Act and established an SOE monitoring unit, which however should be more adequately resourced to improve accountability. A CSO subsidy framework was introduced to ensure affordable provision of SOE services to citizens. Further effort to limit supplementary budgets is needed, which were issued in FY21 and FY22. A PEFA review is scheduled in FY22.
Strengthen governance by increasing fiscal transparency and availability of audited financial statements of SOEs. Enhance procurement practices and phase out cash transactions for tax and other purposes.	Timely online publication of budget and updates to the tax and legal frameworks have improved transparency. More effort is needed to make available audited financial statements. Procurement processes, including publication of procurement contracts, names of awardees and beneficial owners remain non-transparent. Plans are underway for a limited rollout of EFTPOS terminals to some cash collection departments of the GON.
Financial Sector Reforms	
Efforts to strengthen the AML/CFT framework and enhance financial literacy should continue.	Authorities are developing a national risk assessment strategy, preparing amendments to the legal framework, including with TA provided by the APG to improve technical compliance, and aim to increase resources and capacity of the FIU with TA from AUSTRAC.

Structural Reforms	
Implement structural reforms that promote economic diversification, improve the business environment, and encourage private sector development. Priorities include investing to close infrastructure gaps, streamlining the procedures for doing business, and improving the efficiency of education and health investment.	The climate-resilient port is scheduled to be operational in FY23, a solar farms project, co-financed by the ADB, is expected to be completed in FY24, and the GON has invested in a seawalls project. Plans are underway for an undersea cable financed by Australia, Japan and the United States to enhance digital connectivity. More effort is needed to close infrastructure gaps, including in waste management and dwelling quality. Steps have been taken to improve education quality in the FY22 budget, including new initiatives for improving teacher-student ratios, school facilities and rations. A significant effort has been deployed to upgrade medical facilities since FY20, partly by the COVID-19 taskforce.
Climate Policies	
Develop a fiscal policy framework that would enhance economic resilience by integrating climate change strategies in budget planning.	GON established a Department of Climate Change and National Resilience and a Climate Change Policy and Institutional framework in FY21, which are important initial steps needed for the integration of climate change strategy into budget planning.

Annex IX. IMF Capacity Development in Nauru

Nauru: IMF Capacity Development		
Provided by:	Topic:	Period:
PFTAC	Statistics - National Accounts	July 2018
CDOT	Statistics - External Sector Statistics	October 2018
PFTAC	PFM – Transition to IPSAS Cash Reporting	February 2019
PFTAC	Revenue – Review of tax administration reforms	April 2019
PFTAC	Statistics - National Accounts – Building independent compilation capacity	May 2019
PFTAC	Revenue – Review organizational arrangements and core tax functions	September 2019
PFTAC	PFM – Financial Reporting on IPSAS Cash	November 2019
PFTAC	Government Finance Statistics	December 2019
PFTAC/FAD	Tax Policy Review	January 2020
PFTAC	Revenue – Organizational arrangements and core tax functions	March 2020
PFTAC	Macroeconomic Analysis Program	August-September 2020
PFTAC	Revenue – Revenue Administration Program	November 2020
CDOT	External Sector Statistics	November – December 2020
PFTAC	Government Finance Statistics	November – December 2020
PFTAC	Statistics – National Accounts	January 2021
PFTAC	Revenue – review administrative reforms	April 2021
PFTAC	Statistics – National Accounts	July 2021
PFTAC	Macroeconomic Program – Macro-fiscal model	August 2021
CDOT	External Sector Statistics	November – December 2021



REPUBLIC OF NAURU

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

January 14, 2022

Prepared By

The Asia and Pacific Department
(In consultation with other departments).

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FUND RELATIONS

(As of January 11, 2022)

Membership Status: Joined April 12, 2016; Article VIII

General Resources Account:

	SDR Million	Percent Quota
Quota	2.80	100.00
IMF's Holdings of Currency	2.12	75.71
Reserves Tranche position	0.68	24.32

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocations	3.55	100.00
Holdings	2.86	80.79

Outstanding Purchases and Loans: None

Financial Arrangements: None

Projected Payments to Fund

(SDR Thousands; based on existing use of resources and present holdings of SDR):

	Forthcoming				
	2021	2022	2023	2024	2025
Principal					
Charges/Interest		0.372	0.371	0.371	0.371
Total		0.372	0.371	0.371	0.371

Exchange Arrangements

The de jure and de facto exchange rate arrangements are classified as no separate legal tender. Nauru's legal tender is the Australian dollar. There is no central monetary institution. Nauru has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions and multiple currency practices.

Technical Assistance

Nauru has been benefitting from the Pacific Financial Technical Assistance Centre's (PFTAC) and from the Capacity Development Office in Thailand (CDOT) technical assistance (TA) in recent years.

In FY2020, technical assistance provided by PFTAC included National Chart of Accounts mapping to GFS and compilation of institutional unit table for public sector; support for IPSAS cash reporting; and a review of tax administration and core tax functions. In FY2021, technical assistance provided by PFTAC has offered additional support for national chart of accounts mapping to GFS and compilation of institutional unit table for public sector; compilation of draft 2018-2019 GDP estimates and collection of improved industry data; support on macro forecasting to strengthen medium term macroeconomic framework; and a tax policy review to identify potential revenue reform options. External sector statistics TA delivered via CDOT is setting up compilation program for the balance of payments and IIP statistics including addressing institutional issues. Annex VIII lists all IMF technical assistance and CD provided to Nauru since July 2018.

Resident Representative

The Regional Resident Representative Office for Pacific Islands is based in Suva, Fiji and was opened on September 13, 2010. The office covers Fiji, Kiribati, Marshall Islands, Micronesia, Nauru, Palau, Papua New Guinea, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu. Ms. Leni Hunter is the current resident representative.

RELATIONS WITH OTHER INTERNATIONAL FINANCIAL INSTITUTIONS

Information on the activities of other institutions in Nauru can be found at:

- World Bank Group:
<https://projects.worldbank.org/en/projects-operations/projects-list?searchTerm=nauru>.
- Asian Development Bank:
<https://www.adb.org/countries/nauru/main>.

STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance	
<p>General: Data provision has serious shortcomings that significantly hamper surveillance. Nauru became an IMF member in April 2016, and during the membership preparation in 2014-15, the authorities compiled data with the support of PFTAC technical assistance (TA). Most macroeconomic data remain unpublished and compiled during TA mission by PFTAC and CDOT. Despite additional recruitment, no staff is assigned for compilation of external sector statistics, the capacity of the National Bureau of Statistics (NBS) is limited, and Nauru has continued to rely on TA, capacity supplementation, and donor support in compiling data.</p>	
<p>National Accounts (NA): Annual GDP estimates have improved with the support of PFTAC TA. In July 2020, TA was provided to update the real sector statistics. The 2021 TA missions assisted the NBS with the rebasing of the national accounts and the implementation of new data sources (for construction, house rental data and financial services). The NBS should increase the number of suitably-skilled technical staff for compiling NA as currently only 1 staff is working part-time on NA.</p>	
<p>Price Statistics: The NBS compiles the quarterly CPI with the reference year 2015. However, the latest PFTAC TA in 2019 found that the CPI data has some shortcomings related to the prices of imported motor vehicles. There are no producer, wholesale, or trade price indices.</p>	
<p>Government Finance Statistics (GFS): The MoF with the assistance of contractual expatriates currently aim to compile and disseminate GFS. Nauru reported budgetary central government GFS for the first time in 2018 with significant assistance of PFTAC. Authorities have published central government GFS on a quarterly basis since 2018 and on an annual basis since 2019. The MoF relies on TA from PFTAC to ensure data are compiled and disseminated. The last TA GFS mission was in December 2020.</p>	
<p>Monetary and Financial Statistics: There are no monetary and financial statistics available since the financial sector is still in early stage of development. Nauru uses the Australian dollar as legal tender and does not have a central bank. There was no financial institution in Nauru over the past decade until Bendigo Bank agency opened in Nauru in June 2015. The agency provides financial services (mainly deposits, but no loans and no foreign exchange transactions) on behalf of Bendigo and Adelaide Bank Limited of Australia.</p>	
<p>External Sector Statistics (ESS): Absence of the ESS data hampers surveillance. There are no staff in the NBS assigned to compile ESS, therefore data are compiled during CDOT TA missions, with limited prospects of developing a self-sustained compilation program over the medium-term due to capacity constraints and unresolved institutional issues. In the absence of domestic data sources for important ESS components (including cross-border trade), there is a need to rely on partners' data, which apart from well-known limitations of relevant databases, have additional drawbacks including due to confidentiality concerns due to the size of Nauru's economy. A November 2021 ESS TA mission set up and documented a detailed ESS compilation program and outlined action plan to go forward.</p>	
II. Data Standards and Quality	
At present, Nauru does not participate in any of the IMF's Data Standards Initiatives.	No data ROSC are available.

**Nauru: Table of Common Indicators Required for Surveillance
(As of December 2021)**

	Date of Latest Observation	Date Received	Frequency of Data ⁷	Frequency of Reporting ⁷	Frequency of Publication ⁷
Exchange rates ¹	12/04/2019	12/04/2019	D	NA	NA
International reserve assets and reserve liabilities of the monetary authorities ²	NA	NA	NA	Q	NA
Reserve/base money ³	NA	NA	NA	NA	NA
Broad money ³	NA	NA	NA	NA	NA
Central bank balance sheet ³	NA	NA	NA	NA	NA
Consolidated balance sheet of the banking system	NA	NA	NA	NA	NA
Interest rates	NA	NA	NA	NA	NA
Consumer price index	12/2020	06/2021	Q	Q	Q
Revenue, expenditure, balance and composition of financing ⁴ —general government ⁵	FY2021	NA	NA	NA	NA
Revenue, expenditure, balance and composition of financing ⁴ —central government	FY2021	06/2021	M	Q	NA
Stocks of central government and central government-guaranteed debt ⁵	FY2021	06/2021	A	A	NA
External current account balance	FY2021*	11/2021	A	A	A
Exports and imports of goods and services	FY2021*	11/2021	A	A	A
GDP/GNP	FY2021*	08/2021	A	A	NA
Gross external debt	FY2021	10/2021	A	A	NA
International investment position ⁶	FY2021*	11/2021	A	A	A

¹ Nauru uses the Australian dollar as its legal tender.

² Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

³ Foreign, domestic bank, and domestic nonbank financing.

⁴ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) state and local governments.

⁵ Including currency and maturity composition.

⁶ Includes external gross financial asset and liability positions vis-à-vis nonresidents.

⁷ Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

* Compiled by experts during TA missions.

**Statement by Angelia Grant, Alternate Executive Director for Nauru,
and Chris Becker, Advisor to the Executive Director
February 2, 2022**

Our authorities in Nauru appreciate the open and constructive engagement with the mission team during the virtual 2021 Article IV consultations. Nauru is one of the Fund's newest, smallest, and most vulnerable members, with severely limited capacity for economic diversification. The authorities attach significant value to the policy advice and assistance received through their Fund membership. The authorities also broadly concur with staff's assessment, analysis, and most policy recommendations.

Geography and the challenge of isolation. Nauru is remotely located around 2,000 miles north-east of Australia in the Pacific Ocean. The total land mass of just 8 square miles is about the same size as JFK Airport and is inhabited by a population of less than 12,000 people. However, including the vast territorial waters, the exclusive economic zone is almost as large as Germany. Both the economic opportunities, and sources of fragility, are related to being an isolated island microstate. Many of the usual summary metrics, such as income per capita, are misleading in the case of microstates as they do not meaningfully reflect the high cost of living and fixed costs of providing infrastructure and government services.

Fishing-related activities and shipping are important to Nauru, but its small size make it difficult to capitalize on the benefits of the blue economy. Transport costs are extremely high, and almost all consumer goods, materials, and services are imported. Lack of arable land means that vegetables are not readily available, and there are no domestic fish processing facilities.

Exposure to natural disasters and the effects of global warming represent an ever-present downside risk to the economic outlook. A new stand-alone department for the environment is addressing some of these issues through several initiatives and new port facilities are being built to be climate resilient.

Financial sector and associated arrangements. Nauru uses Australian dollars as its legal tender and does not have a central bank or commercial banks. However, in 2015, after years of no access to financial services, the government entered into an 'agency' arrangement with an Australian bank. The accounts and transactions of Nauruans are ultimately managed abroad by the parent bank and most of the associated financial infrastructure is not physically located in Nauru. Agency staff are accredited financial

service providers and must abide by requirements of the licensing regime in the parent jurisdiction. Australian regulators supervise the operations of the agency.

In addition, the government has put in place AML legislation and is looking forward to the outcome of the APG-FATF mutual evaluation. In its previous assessment, the group noted that Nauru faces low risks of money laundering and terrorist financing. The money laundering regulatory authorities in both Australia (2017) and New Zealand (2021) have characterized the overall risks in the Pacific to be low-medium. Nauru was removed from the OECD list of uncooperative tax havens almost 20 years ago, reflecting its commitment to transparency and information exchange. The implementation of further AML-CTF financing compliance must be a consultative process that considers the multi-jurisdictional nature of Nauru's agency arrangement with the parent bank.

As is the case with other agencies operated by the parent bank, the Nauru agency cannot have direct Correspondent Banking Relationships (CBR) that would allow it to conduct crossborder transactions in its own right. Fostering indirect CBRs therefore involves explaining the benefits and safeguards of the agency arrangement. Unfortunately for Nauruan residents, it continues to be both expensive and difficult to conduct foreign exchange transactions in US dollars, euros, British pounds, and more recently Fiji dollars. The authorities are frustrated by the inability of the international financial system to look beyond the financial mismanagement of 20 years ago. The lack of connectivity to the international payments system makes inbound investment almost impossible and curtails all aspects of economic development. Even the receipt of donor aid and grants is complicated and expensive.

On the island there is a degree of financial inclusion and access to cash through Automatic Teller Machines, but the agency does not lend to households or businesses, and no insurance products are available.

Fiscal position and indebtedness. The fiscal position has improved dramatically since the authorities were able to reach a substantially discounted settlement on legacy debt obligations. This is reflected in a shift in the debt sustainability analysis, with debt now assessed to be sustainable.

The authorities note that support for the national airline, phosphate mining, and fuel subsidies bring indirect benefits in terms of food security, employment, and ongoing access to trade in goods and services. The Nauru Utilities Corporation provides electricity at a discount to the cost of generation to ensure that low-income households remain

included in accessibility to power. Similarly, the national carrier is the sole supplier of critical air travel services that connect Nauru to the rest of the world because the market is too small to be commercially viable. Given that there is no lending to finance private sector commercial or household activity, there is considerable reliance on State-Owned Enterprises (SOE) either through direct provision of goods and services, or through subsidies to support community services. The authorities are committed to further strengthening governance and public financial management, including ensuring that the SOE monitoring unit is sufficiently resourced to fill gaps in accountability.

Economic development, diversification, and infrastructure. The Regional Processing Center (RPC) is the single largest source of economic activity, government revenue and employment. The arrangement to host the facility was recently extended to the end of June 2022, with a move to ‘enduring capability’ in July 2022. The authorities are engaged in finding ways to accommodate this transition. Plans are underway to absorb some RPC workers into the local police force and to provide upskilling through training for others.

Infrastructure projects are supporting growth, although we note that only a handful of initiatives are possible at one time given capacity constraints. The biggest project currently underway is the new maritime port and container storage facility. This infrastructure is promising to confer significant benefits and might pave the way for related industries such as fish processing. However, the port currently faces staffing difficulties. Around 70 per cent of workers are illiterate, few are numerate, and most lack training in computers. The current maritime traffic (one container ship every 4 weeks and one tanker every 6 weeks) is insufficient to make the port a viable venture. The authorities are hoping to boost traffic by promoting the new port as a regional shipping and container storage hub. The aim is to establish a trade route from Australia to Nauru and then onward to the rest of the central pacific. A major challenge will be to limit costs since containers that arrive with goods almost always return empty given the lack of exports.

A solar farm project is also progressing, albeit subject to battery storage limitations. The move to renewable sources of energy achieves the dual purpose of moving away from generating electricity by burning expensive fossil fuels (such as diesel), while meeting environmental targets. Other priority infrastructure projects will involve resurfacing the ring road and tarmac on the airport landing strip.

Broadening the economic base is difficult. Remittance revenues are negligible given limited participation in regional worker initiatives as there is little domestic application for farming skills. Given that much of the labor force is not work ready, few are able to

participate in seafaring or fruit picking in Australia or New Zealand. There might be some limited scope to broaden the provision of medical services given the recent upgrade to equipment, but this is likely to be dependent on imported labor.

Nauru is unlikely to be able to develop a comparative advantage in tourism. Other Pacific islands like Fiji and New Caledonia are well-established tourist destinations, with associated infrastructure, including more frequent flights that are around six times cheaper than a flight to Nauru. The island is currently also not a particularly desirable holiday destination due to environmental degradation related to phosphate mining, absence of hotels, waste management challenges, strong coastal currents that make swimming dangerous, and a lack of entertainment. Developing a tourism industry would be a long-term venture that would divert scarce investment funds from higher priority areas such as health, education, and infrastructure.

Economic diversification is also hindered by the inability to tap into economies of scale. Both the amount of economic activity and the number of industries that can be sustained are limited on a small land mass with few inhabitants. The arrangements for property rights are a further obstacle. Land rights are often inherited in a manner that splits ownership equally between a large number of relatives, who in turn leave their rights to the next generation, leading to minute fragmentation of land ownership titles which is difficult to overcome when negotiating the laying of pipelines or acquisition of larger tracts of land.

Education, cost of living, health, and social safety net. Education outcomes in Nauru have improved in recent years with supportive initiatives such as government-provided lunches at schools and cash benefits for attendance, but gaps remain. Many foreign teachers do not speak the local language and find it difficult to communicate with students who have not learned English. There is a shortage of skills and well-educated workers often migrate to more developed countries in the region. The government is actively engaged in deepening the pool of talented students who complete secondary schooling and those who seek tertiary education abroad. Creating opportunities domestically is also important for retaining talent.

Non-arable land leads to challenges in having to import most fresh food. This is not only very costly but also puts at risk basic food security for the population. The high cost of living considerably diminishes the purchasing power of income. It also represents a major political barrier for broadening the tax base by introducing a Value Added Tax, which would put further upward pressure on prices.

These factors combine to manifest themselves in poor health outcomes. Non-communicable diseases such as diabetes are a major source for concern. Life expectancy for Nauruans is estimated at only around 55 years. These poor health outcomes have made the authorities' early and decisive measures to contain Covid-19 even more critical. The island remains free of Covid-19 and vaccinations are progressing.

The social safety net is largely delivered through employment in subsidized industries and there are no unemployment benefits. As in other developing countries, Nauru relies heavily on the support of the extended family, although this also limits the productivity and mobility of workers – particularly females.

Capacity development. The authorities welcome the capacity development and technical assistance from the Fund. The progress in compiling macroeconomic statistics remains a priority. The authorities appreciate that the virtual delivery of technical assistance has allowed engagement to be maintained, but there have been some connectivity challenges. The authorities look forward to further constructive engagement with the Fund, and they value the assistance and policy advice that they have received to date.