INTERNATIONAL MONETARY FUND

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KIRIBATI

September 2016

2016 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR KIRIBATI

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 2016 Article IV consultation with Kiribati, 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 September 7, 2016 consideration of the staff report that concluded the Article IV consultation with Kiribati.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on September 7, 2016, following discussions that ended on May 18, 2016, with the officials of Kiribati on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 23, 2016.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the International Development Association.
- A **Statement by the Executive Director** for Kiribati.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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COMMUNICATIONS DEPARTMENT

Press Release No. 16/400
FOR IMMEDIATE RELEASE
September 9, 2016

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2016 Article IV Consultation with Kiribati

On September 7, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Kiribati.

Kiribati's recent economic performance has been strong. Growth is estimated to have reached 3.5 percent in 2015, supported by record high fishing revenue, donor financed infrastructure projects and reconstruction in the aftermath of cyclone Pam. Growth is projected to moderate somewhat to around 3 percent this year, while inflation remains subdued owing to low food and commodity prices.

The fiscal position has improved markedly in recent years. High fishing revenue contributed to a recurrent fiscal balance of almost 50 percent of GDP in 2015, more than offsetting the increase in government recurrent spending of 13 percent. Public debt increased from less than 10 percent of GDP in 2014 to 23 percent of GDP at the end of 2015 owing to the commencement of the Bonriki International Airport repair and upgrade project, financed by development partner concessional loans. The current account surplus reached 40 percent of GDP in 2015, with fishing revenue and a recovery in seamen remittances more than offsetting elevated imports related to donor financed projects.

Growth is projected to weaken further over the medium term with the projected decline in fishing revenue and the completion of large infrastructure projects. Climate change can have an impact on long-run prospects given the country's low elevation. Global financial market turmoil may feed into the domestic economy through the exposure to foreign assets of the Revenue Equalization Reserve Fund (RERF) and the Kiribati Provident Fund (KPF), the country's two main savings vehicles.

[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 Assessment[2]

Executive Directors welcomed the strengthening of Kiribati's current account and the balance of the Revenue Equalization Reserve Fund (RERF), and commended the good progress on structural reforms. They observed, however, that Kiribati faces development challenges stemming from its geographic location, the lack of economies of scale, and its vulnerability to climate change. Directors emphasized that building fiscal buffers and continued support from development partners will be important to mitigate the risks to economic growth.

Directors underscored that prudent management of public resources in the context of a medium-term fiscal framework remains the key policy priority. They considered a balanced structural budget an appropriate fiscal anchor in light of the projected decline in fishing revenue. Directors encouraged the authorities to formulate a target-level and a rule-based withdrawal mechanism for the RERF, which would enhance its role as an endowment fund for both current and future generations. They also underscored the importance of further enhancing tax collection and public financial management to facilitate the needed growth-friendly fiscal adjustment.

Directors welcomed the authorities' efforts to improve Kiribati's resilience to climate change. They highlighted that explicitly recognizing climate change adaptation costs and infrastructure maintenance needs in the budget would help ensure adequate provision of resources, including from development partners.

Directors noted the need to enhance financial deepening and address deficiencies in financial supervision. They encouraged steps to facilitate private sector access to credit while safeguarding the long-run sustainability of public financial institutions, given their critical role in the financial sector.

Directors emphasized that private sector development is vital to achieving more sustained and inclusive growth. They commended the progress on state-owned enterprise reforms and encouraged the authorities to maintain the momentum. Directors recommended further improvement in infrastructure, including air transportation and shipping services, enhancing the business climate by streamlining business licensing processes and improving land registration, as well as investing in human capital to better harness Kiribati's resources.

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[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.

Kiribati: Selected Economic Indicators, 2012–18

Nominal GDP (2014): US$186.1 million — GDP per capita (2013): US$1,656
Nominal GNI (2014): US$371.8 million — Population (2013): 109,366
Main export products: fish and copra — Quota: SDR 5.6 million

	2012	2013	2014	2015	2016	2017	2018
				Est.		Proj.	
Real GDP (percent change)	5.2	5.8	2.4	3.5	3.1	2.5	2.0
Real GNI (percent change)	14.1	16.4	13.4	18.3	-22.9	0.9	2.0
Consumer prices (percent change, average)	-3.0	-1.5	2.1	0.6	1.5	2.0	2.5
Central government finance (percent of GDP)							
Revenue and grants	84.2	96.2	137.1	165.4	121.2	90.9	90.0
Total domestic revenue	50.3	64.5	86.0	116.4	63.0	58.1	57.2
Grants	33.9	31.8	51.2	49.0	58.2	32.7	32.7
Expenditure and net lending	92.6	85.8	113.6	119.9	134.1	102.2	101.4
Current	59.1	54.5	58.3	64.0	66.9	65.6	64.9
Of which: wages and salaries	26.4	26.9	26.0	27.6	27.7	27.0	26.4
Development	33.5	31.4	55.4	55.9	67.2	36.5	36.5
Current balance 1/	-8.8	10.0	27.7	52.4	-3.9	-7.5	-7.7
Overall balance	-8.4	10.4	23.5	45.5	-12.9	-11.3	-11.5
Financing	8.4	-10.4	-23.5	-45.5	12.9	11.3	11.5
of which Revenue Equalization and Reserve Fund (RERF)	23.0	-10.0	4.1	-23.5	-39.4	4.4	5.9
RERF							
Closing balance (in millions of Australian dollars) 2/	614	661	679	756	866	880	891
Per capita value (in 2006 Australian dollars)	4,872	5,018	4,932	5,305	5,869	5,727	5,553
Balance of payments							
Current account including official transfers (in millions of US dollars)	-8.4	15.5	44.8	72.1	-11.9	-4.4	-2.9
(In percent of GDP)	-4.5	8.3	24.0	44.9	-7.2	-2.5	-1.6
External debt (in millions of US dollars)	14.3	14.3	14.3	35.7	45.3	51.6	58.1
(In percent of GDP)	7.5	8.2	8.4	23.1	27.0	29.4	31.9
External debt service (in millions of US dollars)	7.5	2.7	8.3	0.5	0.9	0.6	0.6
(In percent of exports of goods and services)	30.5	12.2	39.4	2.7	4.4	2.7	2.9
Exchange rate (A$/US$ period average)	1.0	1.0	1.1	1.3	...	...	...
Real effective exchange rate (period average) 3/	101.0	94.0	89.3	78.0	...	...	...
Memorandum item:							
Nominal GDP (In millions of US dollars)	188.1	187.7	186.3	165.7	175.6	182.5	187.7

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

1/ Current balance excludes grants and development expenditure.

2/ The Australian dollar circulates as legal tender.

3/ Index, 2005=100.

KIRIBATI

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION

August 23, 2016

KEY ISSUES

Context. Kiribati is a small and fragile state vulnerable to climate change. Record high fishing revenue in recent years has boosted growth, improved the current account, and strengthened the balance of the sovereign wealth fund, the primary vehicle for intergenerational saving. However, fishing revenue has declined in the early months of 2016 and is projected to remain at more modest levels over the medium term. Building fiscal buffers to enhance resilience and continued support from development partners are essential to mitigate downside risks to growth.

Key policy recommendations.

- **Fiscal policy.** Accommodating Kiribati's considerable public spending needs in a fiscally sustainable way calls for a strengthened fiscal framework. This should include committing to a balanced structural budget over the medium term in light of the declining fishing revenue, strengthening the role of the sovereign wealth fund as an anchor for long run fiscal sustainability, and maintaining an appropriately-sized cash reserve buffer to cope with revenue volatility and external shocks.

- **Climate change.** Continued efforts are needed to enhance resilience to climate change and mitigate its negative impact on long run growth. Budget provision should explicitly recognize climate change adaption costs and infrastructure maintenance needs.

- **Structural reforms.** Achieving more sustained and inclusive growth depends on creating conditions for private sector growth and employment. Key elements in this area include further strengthening of the SOEs' commercial mandate, continued investment in business climate and infrastructure and enhancing human capital to better harness Kiribati's marine resources.

- **Financial deepening.** Public financial institutions have a critical role in enhancing financial deepening. Ensuring their long-term sustainability calls for strengthened risk monitoring, addressing deficiencies in financial supervision and better aligning operations with their institutional roles.

Approved By
Patrizia Tumbarello (APD) and Peter Allum (SPR)

Discussions were held in South Tarawa during May 9–18, 2016. The staff team included Ding Ding (head) and Shi Piao (both APD), Arti Devi (IMF Regional Resident Office in Fiji) and Janne Hukka (FIN). Barry Sterland and Chris Stewart (OED) participated in the discussions. Mizuho Kida (the World Bank) and Lai Tora (Asian Development Bank) also joined part of the mission. Seble Abebe and Anh Van Le (both APD) assisted in preparing this report.

CONTENTS

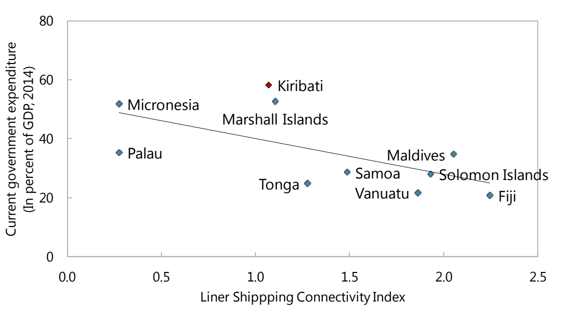
ANNEXES

CONTEXT

1. **Kiribati is a small and fragile state.** The country faces development challenges due to its geographical disadvantage and vulnerability to climate change. With a population of roughly 120,000 sharing a territory of 33 remote islands spread over 3.5 million square kilometers of ocean, lack of scale and high transportation cost limit production opportunities. Growth averaged around 1.8 percent in 1998-2014, compared to the average growth of 2.1 percent in other small island states in the Pacific. With the lowest income per capita in the region, about a fifth of the population lives below the basic needs poverty line and access to clean water and sanitation remains restricted for many. Long-run prospects are further clouded by sea level rise—low elevation of the atolls (1.8 meters on average) make them particularly vulnerable to coastal erosion and groundwater contamination.

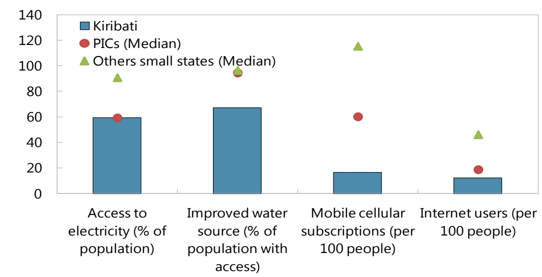
2. **Extreme remoteness and large dispersion underpin the high cost of public service delivery in Kiribati.** The public sector dominates the economy (text chart), while private sector activity—mostly fishery, subsistence agriculture and retail trade—remains limited. Weaknesses in infrastructure (text chart), business climate and financial intermediation pose further development obstacles. Limited job opportunities in the private sector, coupled with the fast growing labor force, has led to a high youth unemployment rate at around 50 percent.[1]

Government Spending and Connectivity



Source: IMF Working Paper 15/124.

Infrastructure Indicators, 2015 1/



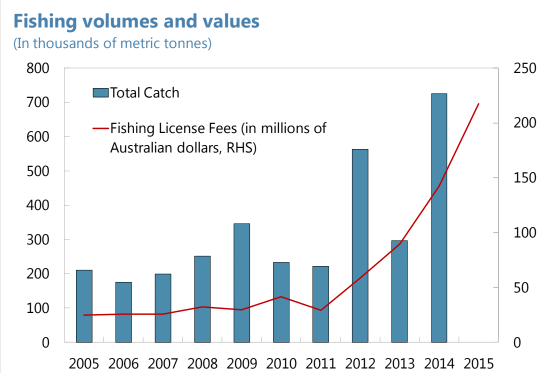
1/ Or latest data available
Sources: World Bank, WDI; U.S. Energy Information Agency; National Statistics Office of Solomon Islands; and IMF staff estimates.

3. **Fishing license fees and development partner assistance contribute the bulk of Kiribati's income.** The Revenue Equalization Reserve Fund (RERF), Kiribati's sovereign wealth fund, serves as the primary vehicle for intergenerational saving. Revenue from fishing license fees are historically volatile, but regional cooperation through the introduction of the Vessel Day Scheme (VDS) [2] and favorable weather conditions have significantly improved its performance in recent years (text chart). As the fishing license fees are collected in the U.S. dollar, the strengthening of the dollar

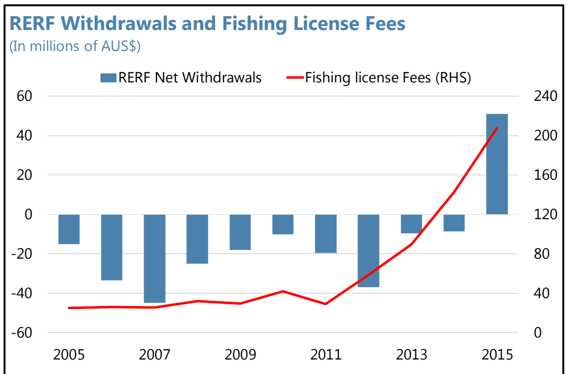
[1] According to the 2010 census.

[2] The VDS, established under the eight-country Parties to the Nauru Agreement (PNA) in 2012, limits the number of days that fishing vessels are licensed to fish in PNA waters and sets the minimum fee for the VDS days ($8,000 for 2015–16). The majority of Kiribati's fishing license fees are subject to the scheme, but it also has separate bilateral and multilateral agreements with other countries, including the European Union and the United States. The latter two agreements formed roughly 10 percent of Kiribati's total revenue from fishing agreements in 2014.

vis-a-vis the Australian dollar (A$), Kiribati's legal tender, also contributed to higher fees. The strong revenue in 2015, nearly 100 percent of GDP (A$220 million), halted a prolonged period of relying on drawdowns from the RERF to finance the budget deficit (text chart). Nonetheless, following lower receipts in early-2016, the authorities forecast the license revenue to halve to around A$100 million in 2016, in line with the historical average of the last seven years, leading to a decline in real gross national income (GNI) of about 20 percent following several years of strong growth. Donor grants amounted to nearly 50 percent of GDP in 2015, the highest in the Pacific region (Figure 1).



Sources: Kiribati Authorities, World Bank, and Forum Fisheries Agency



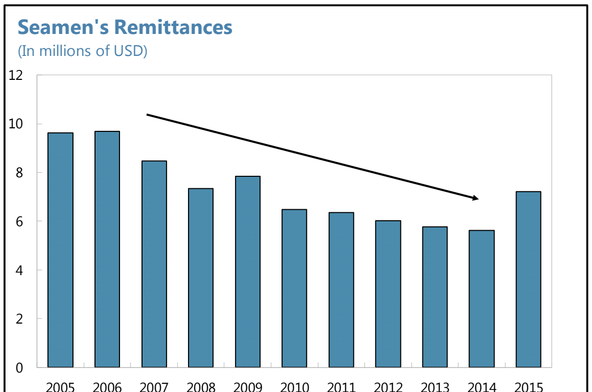
Source: Kiribati Authorities.

RECENT DEVELOPMENTS, OUTLOOK AND RISKS

4. Growth remained strong at 3½ percent in 2015, thanks to the record high fishing revenue. Donor-financed infrastructure investment and reconstruction in the aftermath of cyclone Pam further supported growth. Inflation remained contained at around 0.5 percent owing to low food and commodity prices, in line with the global trends.

5. High fishing revenue contributed to a recurrent fiscal balance of almost 50 percent of GDP in 2015, more than offsetting the increase in government recurrent spending of 13 percent. Public debt increased from less than 10 percent of GDP in 2014 to 23 percent of GDP at the end of 2015 owing to the commencement of the Bonriki International Airport repair and upgrade project, financed by development partner concessional loans.

6. The current account surplus reached 40 percent of GDP in 2015, with fishing revenue more than offsetting elevated imports related to donor financed projects. Seamen's remittances also recovered somewhat after years of decline with the slowdown in global trade (text chart). Reflecting developments in the Australian dollar, the exchange rate has depreciated in real effective



Source: South Pacific Marine Services, Kiribati.

terms to below the historical average. Nonetheless, competitiveness remains hindered by structural factors (Box 1).

7. A new government took office in March 2016 following the general and presidential elections. Mr. Taneti Maamau, a former finance secretary and candidate of the Tobwann Kiribati Party, became the country's fifth president since its independence in 1979. The new government pledged to pursue a more even distribution of sovereign wealth between the current and future generations, implying an increase in current spending and less savings into the RERF. The 2016 budget passed in May envisaged an increase in recurrent spending by 9 percent, mostly due to increased subsidies and grants including a doubling of the copra subsidy program[3].

8. Growth is projected to moderate to around 3 percent in 2016 as several large infrastructure projects come to completion and fishing revenue is projected to decline sharply. Inflation is expected to remain low at around 1.5 percent in 2016, while picking up to around 2.5 percent over the medium term, in line with trading partner inflation and international food and fuel price dynamics (the bulk of Kiribati's consumer price basket comprises imported items). With the expected fall in fishing license fees, the current account is expected to reverse to a deficit of 7 percent of GDP in 2016 and to converge to a near balanced position over the medium term.

9. Risks to the outlook are on the downside (Annex I). Changing climate cycle could increase uncertainty for fishing revenue over the medium term, as the VDS has not been tested in a low revenue environment for Kiribati since its implementation. Global financial market turmoil can feed into the domestic economy through the exposure to foreign assets of the RERF and the Kiribati Provident Fund (KPF), the country's two main savings vehicles. Given Kiribati's high reliance on imported goods, commodity price shocks and volatility in the Australian dollar could swing imports in ways hard to accommodate. Without a central bank, fiscal policy is the only macroeconomic policy lever and buffer against such shocks.

Authorities' views

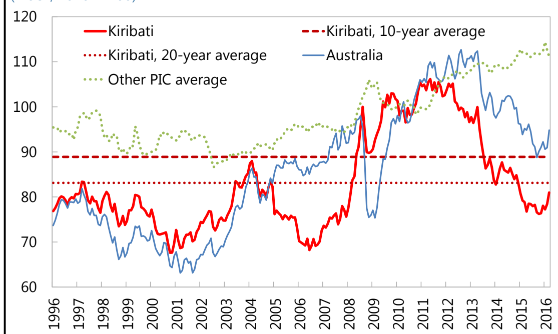
10. The authorities broadly shared staff's assessment of Kiribati's economic outlook. They pointed out that fishing revenue could be highly volatile with risks on both sides. They felt that it was appropriate to aim for a modest increase in public spending on subsidies, education, and health for long run economic and social returns. They also noted that the recent increase in copra subsidies was important to support more inclusive growth, including by providing income opportunities in the outer islands, and could help reduce health care costs due to overcrowding on Tarawa. They acknowledged Kiribati's vulnerability to natural disasters and climate change related shocks and were mindful of the need to maintain buffers against such shocks.

[3] Copra subsidies serve mainly as a livelihood subsidy to support inhabitants of outer islands. Previous Article IV consultations have concluded that, without job creation on the outer islands, alternative social transfer schemes are unlikely to reduce the cost in a significant way.

Box 1. Kiribati: External Competitiveness and Exchange Rate Assessment

Kiribati's real effective exchange rate (REER) continued to depreciate for much of 2015 and remains below its historical average after stabilizing since the beginning of the year. The REER has closely tracked changes in the Australian dollar circulating as the legal tender. Nonetheless, the real exchange rate has limited effect on Kiribati's current account developments. With a small and narrow export base (copra, fish and seaweed), receipts are dominated by fishing license fees, donor flows and RERF investment returns, all largely driven by exogenous factors. Kiribati is also heavily reliant on imported goods, and consequently sensitive to swings in global commodity prices. An assessment based on EBA-lite methodologies would therefore not be meaningful nor feasible due to data limitations.

Real Effective Exchange Rate
(Index, 2010 = 100)



Sources: IMF, *Information Notice System, APDCORE*; and IMF staff calculations.

Beyond the exogenous factors, Kiribati's competitiveness hinges on continued efforts to boost private sector development and addressing long-standing structural impediments. Lack of scale, high transportation costs and infrastructure deficits remain key structural challenges. Kiribati also continues to lag Pacific island countries on average under several of the World Bank's Ease of Doing Business rankings. Securing grant instead of loan financing for development investment remains critical for containing risks to external sustainability.

The use of Australian dollar as the legal tender remains appropriate. It provides a strong nominal anchor given close trade and financial linkages with Australia (high share of RERF assets are invested in Australian markets) and limited capacity to run an independent monetary institution. Kiribati has accepted the obligations under Article VIII of the IMF's Articles of Agreement and maintains an exchange system free of restrictions on payments and transfers for current international transactions.

ENHANCING SUSTAINABILITY AND RESILIENCE

11. **Prudent management of public resources remains the key policy priority.** The authorities have made remarkable progress in strengthening the fiscal position. Reforms to improve the RERF governance have also been important steps towards better aligning its investment strategy with the fund's long-term objectives. Nonetheless, the conditions underlying the strong fishing activity have started to wane. To support the government's long run development agenda, budget decisions need to be taken in the context of a medium term fiscal framework with prudent assessment of spending goals, revenue projections and wealth management targets. Given the expected decline in fishing revenue and Kiribati's susceptibility to climate change related shocks, this framework should embed adequate fiscal buffers which would likely imply saving much of the fishing revenue windfall. Further strengthening the RERF would also support the fund's capacity to provide sustainable future income for intergenerational equity.

A. Strengthening the Fiscal Framework

12. Accommodating Kiribati's considerable public spending needs in a fiscally sustainable way requires embedding policies in a medium-term fiscal framework. While the government's balance sheet is currently strong owing to large RERF assets and relatively low public debt, available fiscal space is limited by the projected decline in fishing revenue and Kiribati's continued high risk of debt distress. To support implementation of the authorities' development plan in a fiscally sustainable way, this fiscal framework should include: (i) committing to a balanced structural budget over the medium term; (ii) strengthening the RERF as an anchor for long run fiscal sustainability by formulating a rule-based withdrawal mechanism; and (iii) maintaining an appropriately-sized cash reserve buffer to cope with revenue volatility and external shocks.

- **Committing to a balanced structural budget over the medium term.** Steps are needed to ensure fiscal sustainability in the face of a projected moderation of annual fishing license fees to the A$100 million range over the medium term.[4] On current policies, staff's baseline projections envisage a widening of the recurrent deficit to around 10 percent of GDP over the medium term, resulting in a gradual depletion of the RERF (Box 2). A more sustainable outturn would be achieved by targeting a structurally balanced budget over the medium term, based on assumed fishing license fees of A$100 million (text table below). This would require fiscal adjustment of around 4½ percentage points of GDP in 2017 rising to 8½ percentage points by 2021 compared to the baseline scenario. The adjustment could comprise efforts to boost revenue collection (e.g., by phasing out VAT exemptions to restore tax revenue collection to the 2015 level) and steps to limit recurrent spending growth to under 1.5 percent per year. Staff advise to cap nominal spending on copra subsidies at the 2016 level and refrain from any increase in subsidies and grants beyond the 2016 budget commitment. Wage increases should also be set within the current wage policy framework which allows for a "wage drift" from the automatic promotion process without additional increases in salaries. The recommended structural budgeting approach would insulate spending from potential volatility in fishing license fees. In the event of a temporary surge in fees, the resulting fiscal surplus should be saved in the RERF, while any shortfall in fees relative to the A$100 million baseline could be met by transfers to the budget from the reserve buffer. As additional information is accumulated on license fee trends, the A$100 million baseline can be gradually adjusted, while preserving a structural balance to ensure fiscal sustainability.

[4] This projection is consistent with projected 2016 receipts and with the expected reversal of recently favorable climatic conditions. While the impact of the different factors contributing to strong fishing license revenue performance cannot be clearly delineated, the recent strong El Niño effect is believed to have attracted tuna to Kiribati's warmer waters, contributing to higher catch volumes and greater demand for Vessel Days. Since the peak at end-2015, the sea surface temperatures in Kiribati waters have started to rapidly cool. Forecasts of the El Niño Southern Oscillation cycle are highly uncertain due to historical irregularity, but the opposite phases of El Niño (implying warmer than normal surface water temperatures for Kiribati) and La Niña (cooler waters) occur on average every two to seven years. Prolonged peak episodes may last for years.

Medium-term Fiscal Projections (% of GDP)

	2016	2017	2018	2019	2020	2021
Baseline Scenario						
Revenue	63.0	58.1	57.2	56.9	56.5	56.1
Tax revenue	14.8	14.3	14.3	14.3	14.4	14.2
Nontax revenue	48.2	43.8	42.9	42.6	42.1	41.9
Current expenditure	66.9	65.6	64.9	65.9	66.4	66.4
Wages and salaries	27.7	27.0	26.4	26.2	25.9	25.6
Subsidies and Grants	18.4	17.9	17.4	17.2	16.9	16.6
Other current expenditure	19.9	19.8	19.8	20.1	20.2	20.5
Debt servicing	0.5	0.3	0.3	1.1	1.5	1.4
Contingency and maintenance	0.4	0.6	0.9	1.4	1.9	2.4
Recurrent fiscal balance with budget support	-0.5	-4.3	-5.7	-7.1	-8.1	-8.5
RERF balance (A$, million)	865.6	880.0	890.9	897.6	901.7	904.5
Adjustment Scenario: Balanced Budget						
Revenue	63.0	59.6	58.9	58.9	58.8	58.8
Tax revenue	14.8	15.9	16.0	16.3	16.6	17.0
Nontax revenue	48.2	43.8	42.9	42.6	42.1	41.9
Current expenditure 1/	66.9	62.5	61.0	61.2	61.0	60.2
Wages and salaries	27.7	26.7	26.0	25.5	25.0	24.5
Subsidies and Grants	18.4	17.7	17.2	17.0	16.7	16.4
Other current expenditure	19.9	17.1	16.6	16.3	15.9	15.6
Debt servicing	0.5	0.3	0.3	1.1	1.5	1.4
Contingency and maintenance	0.4	0.6	0.9	1.4	1.9	2.4
Recurrent fiscal balance with budget support	-0.5	0.3	-0.1	-0.4	-0.4	0.4
RERF balance (A$, million)	865.6	891.0	916.0	941.1	967.0	995.6

1/ The 2016 current expenditure includes a one-off payoff to the Ministry of Health of A$2.2 million.
Source: staff calculations.

- **Formulating a target-level for the RERF and a rule-based withdrawal mechanism.** After strengthening the RERF, the structural balance target discussed above could be adjusted over the longer term to allow moderate annual financing from the RERF. This process should be rule-based and transparent, to simplify budget planning and to ensure that the RERF is maintained as an endowment fund that can provide the population with a permanent and stable stream of income. The sustainable level of the RERF drawdown depends on the government's wealth management target (see Box 2 for a scenario analysis of the RERF). If the goal is to preserve the real value of the fund after reaching a certain level, the withdrawal rate should be limited to around 1–2 percent of the overall balance, assuming an average return rate on the fund of 3–

5 percent[5] and a long run inflation rate of 2.5 percent. The withdrawal could also be indexed to nominal GDP based on the projected long run average growth rate and the targeted return rate of the fund—under this approach the withdraw would be a more stable source of public financing, but it could also make the RERF balance more volatile depending on the return of the fund. In either case the drawdown from the RERF could be gradually adjusted if needed to preserve the real value of the fund in the event of shortfalls in investment returns. Maintaining the real value of the fund over the long run would also be consistent with the authorities' policy to ensure a more equitable distribution of the income from the RERF between generations while protecting the capital growth of the fund.

- **Limiting the complementary cash reserve buffer to three months of recurrent expenditure.** The sizeable cash reserves from the 2014–15 fishing license revenue in excess of this amount should be transferred to the RERF as soon as possible. On the basis of the 2016 level of current expenditure, this would leave a cash reserves buffer of roughly A$40 million (40 percent of the projected fishing revenue) against future temporary revenue shortfalls and external shocks. The policy of drawdowns from the cash buffer should be transparent and also ensure its replenishment when revenue exceeds expectations. Any fiscal surplus after replenishing the cash reserve buffer should be transferred to the RERF to expand its principal base.

13. The VAT introduced in 2014 was a key element in fiscal reforms to reverse a decline in the non-fishing revenue since 2008. Implementation of the VAT has been broadly successful in diversifying the revenue base, but there remains scope for further improvement. The revenue outcomes in 2014–15 were in line with expectations and the new tax also had positive spillover effects on other revenue collection through improved record keeping and tax compliance. However, the VAT implementation was partially hampered by reintroduced SOE exemptions in late 2015, which was estimated to have reduced VAT collection by around 15 percent in 2016. As such, staff urge the authorities to phase out the SOE exemptions to ensure the credibility of the tax system and maintain a level playing field for public and private entities. Further training of tax office staff, greater utilization of improved IT systems and increased emphasis on tax payer assistance would also improve the overall performance of revenue collection.

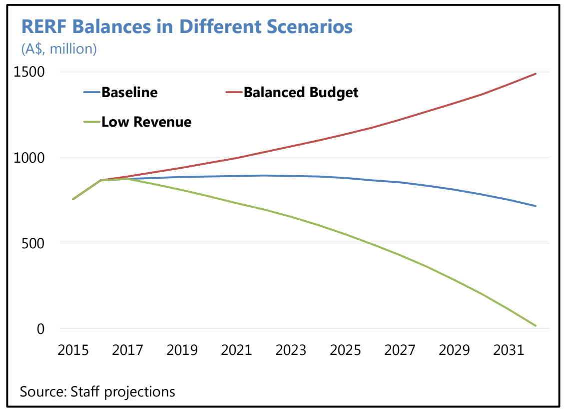
14. Kiribati remains at high risk of debt distress despite of the RERF assets. As the RERF serves as a vehicle for intergenerational saving, it is not viewed as buffer against debt distress risk. In this regard, containing the risk of debt distress will require ensuring fiscal sustainability and securing grants to finance the country's large development needs. Government borrowing through concessional loans should be closely monitored to safeguard long run debt sustainability.

[5] The projected RERF return rate reflects the more conservative investment strategy of the fund after its restructuring. Information was from the World Bank Treasury who has been providing technical assistance to the RERF reform.

Box 2. Kiribati: Fishing Revenue and the Impact on the RERF

The RERF forms the primary savings vehicle for the Kiribati people. It was initially capitalized with revenue from phosphate mining royalties until deposits were exhausted in 1979 and continued to grow through its investment returns and modest drawdowns. However, acceleration in drawdowns to finance a sharp increase in current expenditure since the turn of the millennium and periods of negative investment returns in early 2000s and during the global financial crisis significantly eroded the fund's capital base until recently.

Future growth of the fund will depend heavily on fishing revenue. Staff's simulations indicate that in the baseline scenario, due to the projected decline in fishing revenue to around A$100 million dollars leading to a widening deficit that needs to be financed by RERF drawdowns, the RERF nominal balance will decline gradually to below A$800 million dollars by 2030. If a balanced structural budget can be achieved over the medium term, the RERF balance will reach A$1 billion by 2021 thanks to the accumulation of investment returns. If the authorities set the target to preserve the real value of the fund at the A$1 billion level, this would allow a 1.5 percent annual withdrawal equivalent to 5.5 percent of GDP in 2021. On the other hand, if fishing revenue declines to A$60 million (average level since 2001), the current pace of spending would be unsustainable, leading to a depletion of the RERF in about 15 years.



Preservation of the RERF's real value would still imply some erosion in its value in per capita terms. Tolerance to this cost would ultimately depend on the authorities' policy preferences for intergenerational income distribution and would need to be weighed against investment needs for economic and social development. At the current low-yield environment, a real per capita target would limit any drawdowns from the RERF given the projected long-run annual rate of population growth of 1.5–2 percent.

15. **Any new investment expenditure plans should also be carefully framed within a stronger PFM framework.** Given limited resources, priorities of public investment should be placed on functions that yield high economic and social returns, namely, infrastructure investment, regulatory framework and business facilitation services. Scaling up of infrastructure spending through the budget should be assessed on a case-by-case basis. Consideration should also be given to enhancing the monitoring and reporting of fishing revenue and further improving the monitoring and auditing of SOE and joint-venture liabilities.

Authorities' Views

16. **The authorities welcomed staff's analysis on the medium term fiscal position and noted that the government had implicitly targeted a balanced budget historically.** While the new government was still formulating its medium term fiscal framework, they saw drawings from the

RERF as a last resort and then only for development, rather than recurrent, purposes. They welcomed staff's recommendation for a rule-based withdrawal mechanism for the RERF and would consider it in the context of the government's fiscal and development strategy. The authorities also expressed their intent to transfer the current cash reserves in excess of three months of recurrent spending to the RERF, a process that had been temporarily delayed given a change in wealth managers, in line with staff recommendations.

B. Enhancing Resilience to Climate Change

17. Climate change and natural disasters are macro critical for Kiribati. Kiribati's land area consists almost entirely of low elevation coral atolls and with limited fresh water supply, making it vulnerable to sea level rise. Although the probability of natural disaster occurrences in Kiribati is less than 10 percent, half the regional average of around 20 percent, the cost tends to be large relative to the size of the economy: the 2015 Budget included one-off expenditures—mainly for Cyclone Pam related damages—equivalent to around 4 percent of GDP. Staff's analysis of potential growth suggests that growth is likely to be 0.1 percent lower than the historical average of 1.8 percent over the long run due to climate change (Box 3).

18. Staff support the authorities' efforts to improve Kiribati's climate change resiliency, including through more explicit recognition of adaption costs. The authorities' adaption approach is embedded in the Kiribati Joint Implementation Plan for Climate Change and Disaster Risk Management 2014–23 (KJIP) that seeks to integrate climate change and disaster risk sensitivities and impacts across sectors, identify measures to reduce vulnerabilities and coordinate priorities for action. The 2016-19 Kiribati Development Plan (KDP) also identifies climate change as one of the key priority areas, in line with the United Nations 2030 Agenda for Sustainable Development. In support of this approach, staff recommend that the budget include an explicit provision for climate change adaption costs and that outturns be monitored. The allocation would cover coastal protection, damage repairing, and soil desalinization, and should amount to around 2 percent of GDP annually over the medium term. Tracking of spending on climate change adaptation would help ensure adequate provision of resources, and would help in seeking donor funding for climate change projects. Additional room within the budget envelope is also needed to accommodate maintenance costs of the newly constructed infrastructure (about 0.5 percent of GDP). The cash reserve buffer as outlined above can enhance Kiribati's ex-ante readiness to respond to natural disasters, backstopped by the RERF as a last-resort measure.

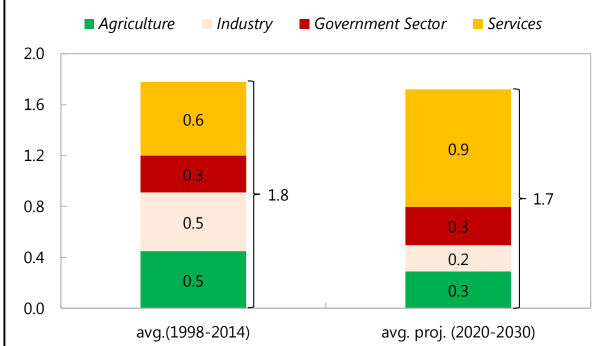
Authorities' Views

19. The authorities were open to identifying climate change adaption cost in the budget, noting that current adaption projects, largely financed by development partners, were probably already at or above 2 percent of GDP. They also agreed that budget plans need to consider the infrastructure maintenance cost. They noted the challenges of catalyzing external climate change financing sources, including capacity constraints to meeting the access requirements.

Box 3. Kiribati: The Growth Impact of Climate Change

Given Kiribati's susceptibility to climate change and natural disasters, staff's analysis of the baseline should explicitly reflect their long run impact. To the extent that the historical average growth already captures the average impact of periodical natural disasters[1], the key question is how to quantify the growth impact of climate change. AsDB (2013)[2] estimated that climate change is likely to have significant impact on agriculture, fisheries, tourism, environment protection and health, costing the Pacific 0.5–2.5 percent of GDP by 2050.[2] Applying these sectoral impact on the level of GDP to Kiribati's long run growth path, staff estimate that the average growth rate is likely to be 0.1 percent lower than the historical average of 1.8 percent, with the adverse impact of climate change on agriculture, fishing and tourism industries offsetting stronger growth in the service sector.

Climate Change Impact: GDP Growth by Sector
(Year-over-year percent change)



Source: IMF staff estimates.

While the largest component of GDP is the government sector, agriculture and fishing has the second largest share of economic activity. Due to higher incidences of climate related disasters, the output from the primary sector is declining and its share in total GDP has declined from one third in the 1990s to around 25 percent. An alarming issue is seawater intrusion from storm surges and high tides. This increases the saline content in soil (also a source of potable water for the people of Kiribati). The mining and quarrying industry is also affected by this. As arable and resource rich land depletes by rising sea waters, other sources of income generating activites are sought putting more strain on other sectors of the economy. Performance of other industries that are related to agriculture and fishing, and tourism, such as real estate, and wholesale and retail trade can be negatively affected. However, stronger aggregate demand places upward pressure on output thereby negating some, if not all of the unwanted spillovers.

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[1] Cabezon et al (IMF WP/12/125) showed that during 1980-2014, trend growth was 0.7 percentage point lower than it would have been without natural disasters in the Pacific region.

[2] The Economics of Climate Change in the Pacific, AsDB 2013.

PROMOTING PRIVATE SECTOR DEVELOPMENT

20. Achieving more sustained and inclusive growth in Kiribati depends on creating conditions for private sector growth and expanding employment opportunities. Building on the success of recent reforms, the newly launched Kiribati Development Plan (2016–19) identifies key medium-term priority areas staging a pathway toward achieving the Sustainable Development Goals (Table 5). The focus of the new Plan remains on investing in human capital, expanding connectivity infrastructure, building climate change resilience and strengthening public sector reforms.

A. Maintaining the Momentum of SOE Reforms

21. SOE reforms are important for creating space and a level playing field for private commercial operation and employment. The authorities have made commendable progress in SOE reforms through the adoption of the SOE Act in 2013, closure of underperforming SOEs, and measures to commercialize and improve operational efficiency (Box 4). Nonetheless, the costs of basic utilities—electricity, water and sanitation—remains high by regional standards, and improving the delivery of public utilities services is a key priority.

Box 4. Kiribati: Progress in SOE Reforms and Future Priorities[1]

The SOEs serve a vital role in the Kiribati economy. Kiribati has sixteen active SOEs involved in a range of commercial activities including utilities, transport, communication and finance. In 2014 the SOEs represented 18 percent of the total capital stock of the country and contributed 12 percent to GDP. Kiribati's SOE portfolio also achieved an average return on equity (ROE) of 3.8 percent and return on assets (ROA) of 2.9 percent for 2010–14, making the country a top performer in the region over that period.

The authorities have made substantial progress in improving SOE performance and reducing large and ad hoc subsidies. Most notable reforms include the reduction in operational SOEs from twenty-five to currently sixteen by 2016, the merger of the two SOEs in the copra sector, and the privatization of the telecom company. The government also plans to further reduce the number of SOEs to twelve over the next five years.

Considerations should be given to improve the compliance of the Community Service Obligations (CSO) policy. The lack of adequate compensation for CSOs has led to a flat trend in portfolio profitability in SOEs. While the SOE Act requires CSOs to be properly documented, and a price agreed with the government, it does not stipulate that the price allow SOEs to fully recover costs, including the cost of capital. Seven SOEs lodged CSO claims totaling $7 million for the 2014 financial year. Despite government allocating $4.5 million in the 2014 budget to fund CSOs, by October 2015 only $0.9 million had been paid. Inadequate funding and low utilization have hindered the government's efforts to improve SOE performance and service delivery. In this regard, regular learning events and briefings for government officials and senior civil servants will ensure that there is ongoing political and bureaucratic support for the CSO policy.

[1] Prepared by Lai Tora, AsDB.

22. Maintaining the momentum of SOE reforms is also important to contain the risk of contingent spillovers to the budget. The lack of funding for community service obligations (CSOs)—non-commercial services "purchased" by the government from the SOEs—remains a major issue undermining SOE performances. Although the budget recognized the subsidy to SOEs of A$5 million, it can fall short to cover the full cost of the CSOs based on previous years' experience. The financing gap for SOEs to breakeven may widen even further due to rising commodity prices. Against this background, the authorities should consider strengthening the commercial mandate of the SOEs and consolidating SOE ownership responsibility under a single minister for both the operational goals of SOEs and their financial management. Continued divestment and outsourcing of SOE activities to the private sector will also help improve efficiency and strengthen public finances.

Authorities' Views

23. The authorities reiterated their commitment to continuing SOE reforms with an aim to further reducing the number of SOEs while improving SOE performance and financial returns. They noted that the recent merger of the two SOEs in the copra sector would generate savings, partly offsetting the increased spending on copra subsidy.

B. Enhancing Infrastructure and Human Capital

24. Continued investment in business climate and infrastructure remain the key pillars for private sector growth and employment. Despite the substantial progress in improving physical infrastructure and connectivity, transportation needs still remain considerable while additional room for infrastructure spending within the budget envelope is needed. Promoting air transportation and shipping services could facilitate development of tourism as well as support recent private sector efforts to develop fishing and agricultural industries, while thorough feasibility analyses are needed to assess the economic benefits against the cost. Efforts to improve physical infrastructure should also go hand in hand with improving business climate, in particular through further streamlining of business licensing process by improving land registration.

25. Human resource development is one the key priorities of the government's structural reform agenda. The authorities have launched a new strategic plan for the education sector, developed in collaboration with Kiribati's development partners, focusing on improving the quality of teaching, refining the curriculum and improving related infrastructure. Staff welcome the authorities' focus on improving the quality of education and training. Given the growth potential in the fishing industry, building human capital especially through vocational and technical training would help Kiribati better utilize its marine resources. Further development in other domestic sectors including tourism and routine infrastructure maintenance would also offer employment possibilities. Finally, international labor mobility presents a substantial opportunity for overcoming geographical constraints to employment. Improving workforce skills and strengthening institutional framework could help increase Kiribati's participation in the overseas seasonal work schemes.

Authorities' Views

26. The authorities vigorously agreed on the importance of further improving infrastructure and the business climate for private sector development. They placed high priority on promoting air transportation and shipping services and agreed that the costs and benefits of any investment in this area would need to be carefully assessed. Here they noted the importance of development partner support to get multiple viewpoints and to make informed decisions. They emphasized challenges remaining in land registration given the customary land ownership system. They also saw ongoing efforts to improve educational outcomes as a key stepping stone for promoting private sector growth, including through intensive community involvement to ensure that graduating students are better suited to workforce demands.

C. Fostering Sustainable Financial Deepening

27. Private sector credit has continued to expand, supported by public financial institutions. The Kiribati financial sector essentially consists of one commercial bank (a joint venture between the ANZ and the Government of Kiribati) and two public financial institutions (the Development Bank of Kiribati, DBK, and the Kiribati Provident Fund, KPF).[6] The commercial bank primarily serves the public sector and larger private sector customers, with the public institutions financing most personal and small business loans. The credit expansion exposes these institutions to relatively high and correlated credit risks given borrowers' susceptibility to common shocks and weak supervisory and regulatory frameworks. The recent regional withdrawal of correspondent banking relations has so far had limited impact on financial services in Kiribati, notwithstanding anecdotal evidence of increased compliance costs.

Outstanding Loans by Public Financial Institutions (PFIs)

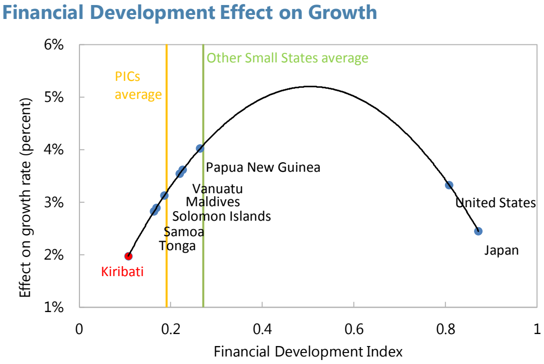
	2010	2011	2012	2013	2014	2015
	(In millions of Australian dollars)					
DBK 1/	10.4	10.4	10.2	10.4	10.6	11.4
Commercial	7.5	6.6	5.5	6.4	5.6	6.1
Personal	-	-	3.9	3.2	3.9	4.0
Other 2/	-	-	0.9	0.8	1.1	1.3
KPF small loans scheme 3/	2.1	2.6	10.0	11.3	12.6	13.3
PFIs Total	12.5	12.9	20.2	21.7	23.2	24.6
Annual change (in percent)	-	3.3%	56.3%	7.3%	7.0%	6.1%

1/ In gross terms before provisions.
2/ Consists mostly of housing and student loans.
3/ KPF's small loans scheme.

Source: Development Bank of Kiribati and Kiribati Provident Fund; IMF staff calculations.

28. Enhancing financing deepening is an essential element to promote growth and employment. Unsecured household lending by the commercial bank is constrained by problems with obtaining collateral and recovery in case of default. In this regard, facilitating private sector access to credit would be best achieved by removing structural impediments and improving financial education, land access procedures, dispute resolution mechanism and loan recovery processes. The potential growth benefits are particularly large given the low level of financial deepening in Kiribati (text chart). The public financial institutions have a critical role in supporting access to financial services, but ensuring their long-term sustainability calls for strengthened risk monitoring and more decisive efforts to address long-standing weaknesses in their balance sheets.

Financial Development Effect on Growth



Source: IMF Staff estimates, based on the methodology in SDN 15/08 and Cihak and others (2012).

29. A more comprehensive approach is needed to address the KPF's persistent funding deficit. Broadly positive investment performance over recent years has failed to close the KPF's sizeable funding deficit that opened as result of negative returns incurred in 2008 (Box 5). To shore up the KPF's long-term sustainability, staff encourage consideration of a more rules-based crediting policy linking the interest rates on member balances more closely to the fund's investment returns.

[6] Others include the Kiribati Insurance Corporation and a few credit unions that remain very small in size and whose operations are largely limited to their membership.

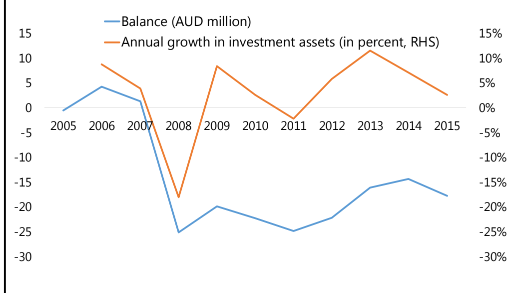
Box 5. Kiribati: Addressing the Financing Deficit of the Kiribati Provident Fund

The Kiribati Provident Fund (KPF) is a national compulsory saving scheme set up in 1977 and is de facto served as a savings fund for its participating members. Participation in the KPF is mandatory for all citizens employed in the public or private sector and the plan is funded by equal contributions from the employee as well as the employer. Citizens employed outside Kiribati, the unemployed, or the self-employed can participate on voluntary basis. KPF is the second-largest sovereign fund of Kiribati after the RERF, with most of the assets managed and invested overseas by external fund managers.

The persistence of the deficit reflects KPF's high crediting rates that are inconsistent with sustainable rate of return on its investments. The KPF operates similarly to a cash-balance pension plan, where members are in effect owners of a balance that is carried forward year to year and accrues interest at rate determined annually by the KPF Board (crediting rate). Notwithstanding the fund's persistent deficit, recent years' crediting rates have been set substantially above the minimum rate of 4 percent, with the latest rate for 2015 set at 7.5 percent. In nominal terms interest on KPF members' accounts amounted to AUD 9.5 million in 2015, substantially above the AUD 3 million increase in total investment assets, contributing to the widening deficit in 2015 to nearly A$18 million, roughly 15 percent of KPF's total investments.

KPF's investment returns are unlikely to remain consistently high to match the recent level crediting rates. While more buoyant investment returns over 2012–14 reduced the deficit somewhat, the current low interest rate environment and market volatility lowers average returns over the longer term. The average annual increase in the fund's investment assets over past ten years was only 3 percent (roughly 5 percent over the past five years, excluding the nearly 20 percent loss incurred in 2008). Moreover, return expectations going forward may be further dampened by the current uncertain global investment environment. In this light, setting the crediting rate to its minimum 4 percent level would only gradually reduce the deficit.

KPF Balance and Investment Performance
2005-2015



Source: Kiribati Provident Fund, IMF staff calculations.

Introduction of a rules-based crediting policy could therefore be considered to secure the KPF's long-term sustainability. As the KPF operates on a cash-balance basis, additional member contributions would be ineffective in reducing the deficit, since they simply increase the fund's liabilities by the same amount. The deficit could in principle be eliminated by recapitalization by the government, but the fund's financial position would remain vulnerable to further shocks in absence of additional measures to address the underlying drivers of its asset-liability imbalance. Crediting rates should therefore be explicitly linked to the fund's investment returns to secure its long-term sustainability. To reduce annual volatility, the rates could be guided by multi-year average investment returns, e.g. over a 3-year period. In view of past volatility in returns, this may require lowering the minimum floor below its current 4 percent level, as well as symmetrically introducing a maximum cap that allows the fund to be replenished in years of high returns.

Concerning KPF's overseas investments, consideration should be given to switching to a fully passive and potentially more conservative asset allocation. Vast majority (nearly 90 percent) of KPF's investments are in diversified overseas portfolio and under external management. In light of the recent performance of the fund, a more conservative investment strategy may be more appropriate for KPF's institutional investor role, where determination of risk-tolerance should put more emphasis on the need to protect the value of its assets, particularly in current absence of financial buffers to absorb losses. A fully passive mandate for both managers could also help reduce management fees.

Under such a policy the crediting rates could be guided by multi-year average returns to reduce year-to-year volatility. The minimum floor for the crediting rate could be accompanied by a maximum cap to allow for the fund's replenishment in years of higher returns. Staff also recommend reviewing the KPF's investment strategy to ensure its consistency with the KPF's institutional role and closely monitoring the recent growth in the KPF's exposure to the domestic economy, particularly through the small loans scheme offered to its members against their accrued balances.

30. While DBK's recent performance has been positive, slow progress in addressing legacy doubtful loans raise concerns over asset quality. Further efforts are needed to address the persistently high share of doubtful loans in DBK's loan portfolio, standing at roughly 23 percent of total loan stock (A$2.6 million) at the end of 2015. Staff also recommend reviewing that these loans' current provisioning practice adequately reflects their expected rate of recovery. Further commercialization of DBK into deposit taking should accordingly be carefully weighed against its current risk monitoring capacity, including its ability to meet potentially correlated depositor demands in periods of stress, and limited reserves. Commercialization would also warrant development of the regulatory and supervisory frameworks and an assessment how it fits with the bank's developmental objectives, including ensuring continued affordable access to financial services.

Authorities' Views

31. The authorities saw the need to address the issues of the public financial institutions including the DBK's financial situation and the sustainability gap of the KPF. They also pointed out that most household borrowings were backed by their provident fund savings and therefore did not constitute a systemic risk to financial stability. They stressed the importance of further enhancing financial deepening especially for the outer islanders.

STAFF APPRAISAL

32. Kiribati's recent economic performance has been strong. Record high fishing revenue has boosted growth, improved the fiscal position and strengthened the current account. Growth is projected to moderate somewhat to around 3 percent this year, while inflation is projected to remain subdued owing to low food and commodity prices. Risks to the economic outlook are largely related to external factors and on the downside.

33. Prudent management of public resources remains the key policy priority, especially against the projected decline in fishing revenue. Budget decisions need to be taken in the context of a medium term fiscal framework that could entail achieving a balanced structural budget in the medium term, strengthening the RERF as an anchor for long run fiscal sustainability, and maintaining a cash reserve buffer to deal with revenue volatility and external shocks. After strengthening RERF balances, the authorities should consider formulating a rule-based mechanism for RERF withdrawal with the aim to preserving the RERF as an endowment fund that can provide the population with a permanent and stable stream of income, with the government's spending plans aligned to this mechanism.

34. Budget provision needs to explicitly recognize climate change adaption costs. Additional room within the budget envelope is also needed to accommodate infrastructure maintenance. Given the fiscal constraint and the high risks of debt distress, Kiribati needs continued support from development partners.

35. Maintaining the momentum of SOE reforms is important to support private sector growth. The authorities should consider further strengthening the commercial mandate of the SOEs and consolidating SOE ownership responsibility under a single minister responsible for both the operational goals of SOEs and their financial management. Continued divestment and outsourcing of SOE activities to the private sector will help improve efficiency and strengthen public finances.

36. Further improvement in infrastructure, business climate and human capital remains critical for private sector development and employment. This includes promoting air transportation and shipping services, streamlining business licensing process and improving land registration. Building human capital especially through vocational and technical training would help Kiribati harness its marine resources. Further development in other domestic sectors including tourism and routine infrastructure maintenance would also offer employment possibilities.

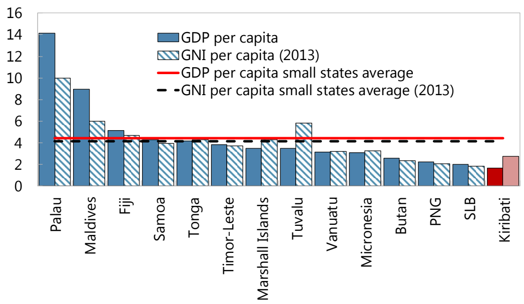
37. Financial deepening needs to be implemented in a more sustainable way. Long-term sustainability of the operations of public financial institutions calls for strengthened risk monitoring and addressing deficiencies in financial supervision. Plans to expand the DBK activities into deposit taking should be carefully assessed against its track record in recovering nonperforming loans and its capacity to assume the increased liability risk, while the crediting rates for KPF member balances should be more closely guided by its investment returns to address the financing deficit.

38. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.

Figure 1. Kiribati: The Cross Country Setting

Kiribati has the lowest per capita income in the region…

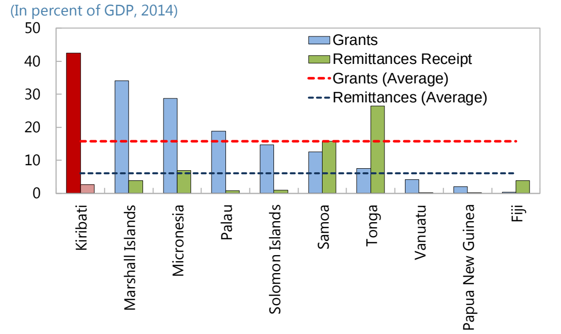
Per Capita Income, 2014
(In thousands of U.S. dollars)



Sources: Kiribati Authorities; IMF, *World Economic Outlook*; and IMF Staff Estimates.

… and is highly dependent on donor support.

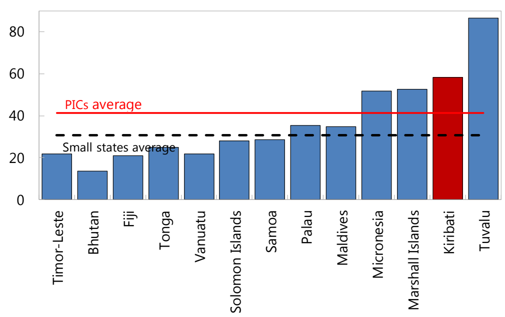
PICs: Grants and Remittances
(In percent of GDP, 2014)



Notes: Grants exclude allocations in kind. Remittance data for Fiji and Tuvalu are only available until 2013.
Sources: Country authorities; and IMF staff estimates.

Public sector is large even by regional standard…

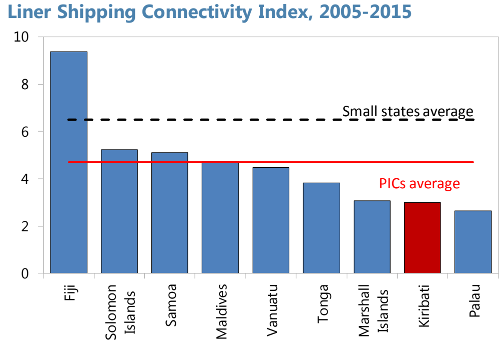
Government Expenditure, 2014
(In percent of GDP)



Sources: Kiribati Authorities; IMF Databases; and IMF Staff DE

…in part due to the country's remoteness.

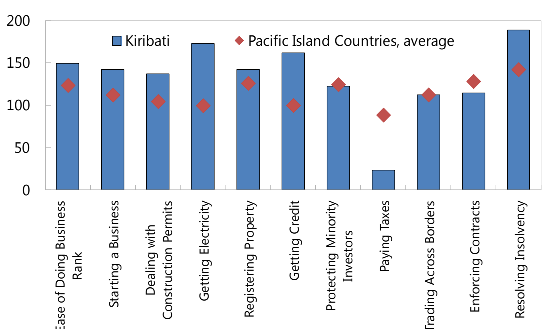
Liner Shipping Connectivity Index, 2005-2015



Note: A smaller number indicates lower connectivity/high transportation costs. Countries with maximum connectivity=100.

Kiribati lags behind on doing business indicators…

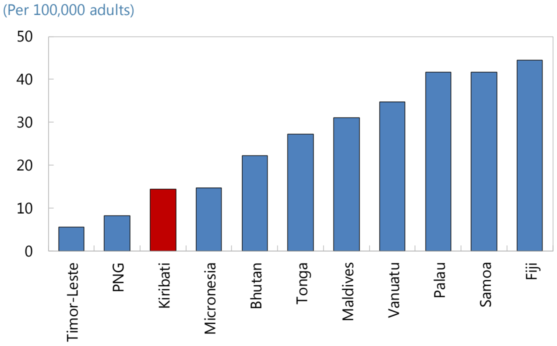
Doing Business, 2015
(Ranking, scale 1 -189 with lower number means more conducive regulatory environment)



Sources: World Bank, *Doing Business Reports 2016*; and IMF staff calculations

… as well as on access to finance.

ATM Access, 2014 1/
(Per 100,000 adults)

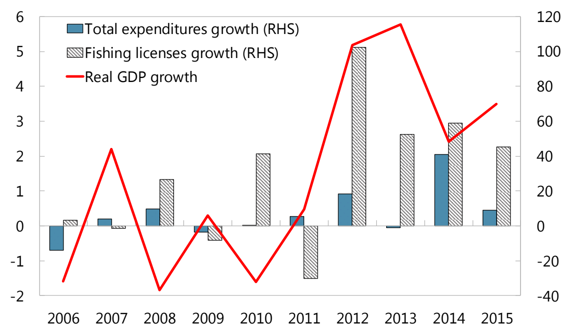


1/Kiribati, Papua New Guinea, and Tonga figures are 2013 data.
Source: IMF, *Financial Access Survey*.

Figure 2. Kiribati: Recent Developments

Growth strengthened since 2013 on the back of high fishing revenue…

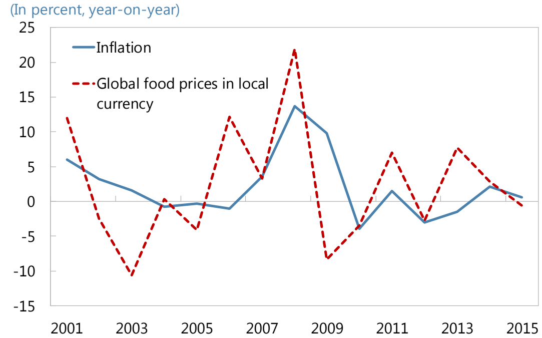
Growth
(In percent, year-on-year)



Sources: Kiribati Authorities; and IMF staff calculations.

… while inflation remains contained thanks to low commodity prices, in line with the global trends.

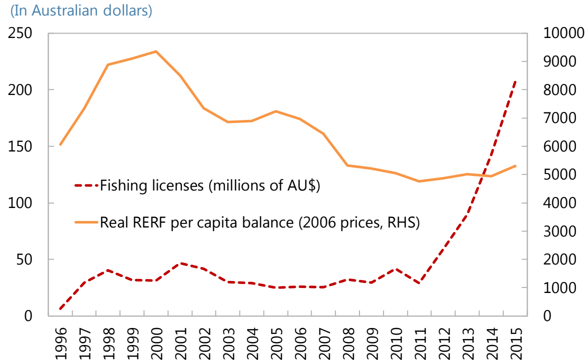
Inflation
(In percent, year-on-year)



Sources: Kiribati Authorities; IMF, *Global Assumptions;* and IMF staff calculations.

Fishing license fees increased more than four fold since 2013.

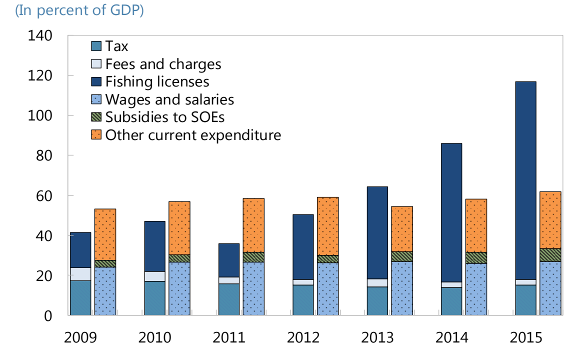
Evolution of Fishing License Fees and RERF Balance
(In Australian dollars)



Sources: Kiribati Authorities; and IMF staff calculations.

Expenditure remains contained despite of increased revenue.

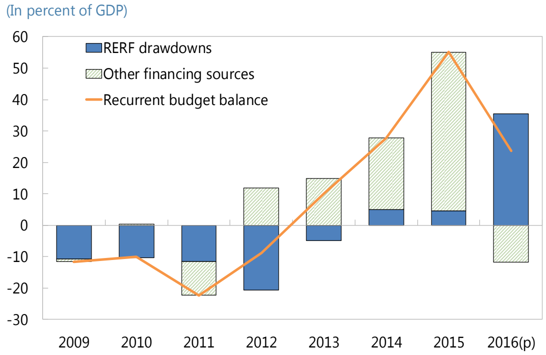
Revenue and Expenditure
(In percent of GDP)



Sources: Kiribati Authorities; and IMF staff estimates.

Fiscal balance improved significantly…

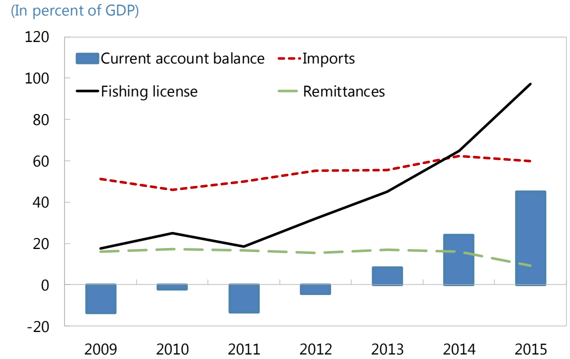
Fiscal Balance and Financing
(In percent of GDP)



Sources: Kiribati Authorities; and IMF staff estimates.

… and so did the current account.

Current Account Balance
(In percent of GDP)

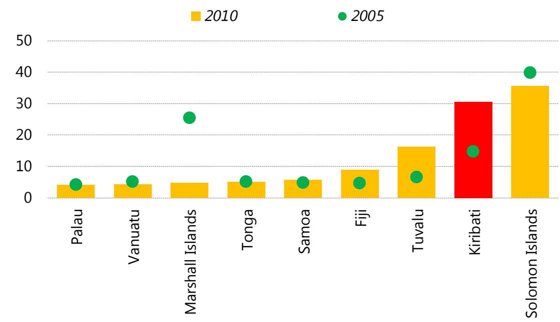


Source: Kiribati Authorities; and IMF staff estimates.

Figure 3. Kiribati: Labor Market Indicators

Kiribati has a relatively high unemployment rate.

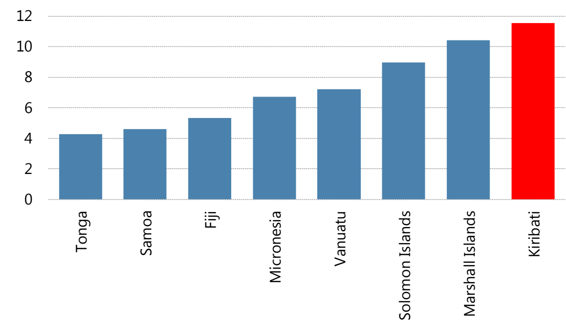
Selected Pacific Small states: Unemployment Rate
(In percent)



Sources: International Labour Organization; and IMF staff calculations.

… despite large public spending on education.

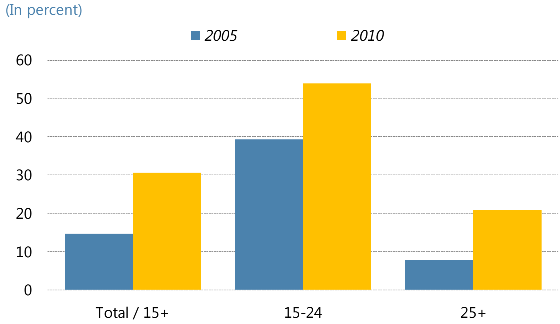
Selected Pacific Small states: Public Spending on Education
(In percent of GDP; average since 2000)



Sources: World Bank, *World Development Indicators*; and IMF staff calculations.

Unemployment rate is particularly high in the 15–24 age group…

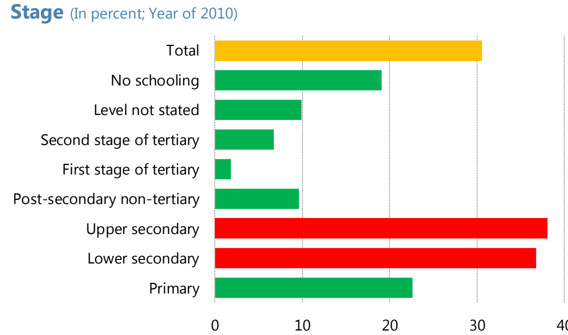
Kiribati: Unemployment Rate by Age
(In percent)



Sources: International Labour Organization; and IMF staff calculations.

…as well as those with lower education levels.

Kiribati: Unemployment Rate by Education Completion Stage (In percent; Year of 2010)



Sources: International Labour Organization; and IMF staff calculations.

Table 1. Kiribati: Selected Economic Indicators, 2012–18

Nominal GDP (2014): US$186.1 million
Nominal GNI (2014): US$371.8 million
Main export products: fish and copra

GDP per capita (2013): US$1,656
Population (2013): 109,366
Quota: SDR 5.6 million

	2012	2013	2014	2015	2016	2017	2018
				Est.		Proj.	
Real GDP (percent change)	5.2	5.8	2.4	3.5	3.1	2.5	2.0
Real GNI (percent change)	14.1	16.4	13.4	18.3	-22.9	0.9	2.0
Consumer prices (percent change, average)	-3.0	-1.5	2.1	0.6	1.5	2.0	2.5
Central government finance (percent of GDP)							
Revenue and grants	84.2	96.2	137.1	165.4	121.2	90.9	90.0
Total domestic revenue	50.3	64.5	86.0	116.4	63.0	58.1	57.2
Grants	33.9	31.8	51.2	49.0	58.2	32.7	32.7
Expenditure and net lending	92.6	85.8	113.6	119.9	134.1	102.2	101.4
Current	59.1	54.5	58.3	64.0	66.9	65.6	64.9
Of which: wages and salaries	26.4	26.9	26.0	27.6	27.7	27.0	26.4
Development	33.5	31.4	55.4	55.9	67.2	36.5	36.5
Current balance 1/	-8.8	10.0	27.7	52.4	-3.9	-7.5	-7.7
Overall balance	-8.4	10.4	23.5	45.5	-12.9	-11.3	-11.5
Financing	8.4	-10.4	-23.5	-45.5	12.9	11.3	11.5
of which Revenue Equalization and Reserve Fund (RERF)	23.0	-10.0	4.1	-23.5	-39.4	4.4	5.9
RERF							
Closing balance (in millions of Australian dollars) 2/	614	661	679	756	866	880	891
Per capita value (in 2006 Australian dollars)	4,872	5,018	4,932	5,305	5,869	5,727	5,553
Balance of payments							
Current account including official transfers (in millions of US dollars)	-8.4	15.5	44.8	72.1	-11.9	-4.4	-2.9
(In percent of GDP)	-4.5	8.3	24.0	44.9	-7.2	-2.5	-1.6
External debt (in millions of US dollars)	14.3	14.3	14.3	35.7	45.3	51.6	58.1
(In percent of GDP)	7.5	8.2	8.4	23.1	27.0	29.4	31.9
External debt service (in millions of US dollars)	7.5	2.7	8.3	0.5	0.9	0.6	0.6
(In percent of exports of goods and services)	30.5	12.2	39.4	2.7	4.4	2.7	2.9
Exchange rate (A$/US$ period average)	1.0	1.0	1.1	1.3	…	…	…
Real effective exchange rate (period average) 3/	101.0	94.0	89.3	78.0	…	…	…
Memorandum item:							
Nominal GDP (In millions of US dollars)	188.1	187.7	186.3	165.7	175.6	182.5	187.7

Sources: Data provided by the Kiribati authorities; and Fund staff estimates and projections.
1/ Current balance excludes grants and development expenditure.
2/ The Australian dollar circulates as legal tender.
3/ Index, 2005=100.

Table 2. Kiribati: Summary of Central Government Operations, 2014–21

	2014	2015	2016	2017	2018	2019	2020	2021
		Est.			Proj.			
	(In millions of Australian dollars)							
Total revenue and grants	283.1	352.5	270.3	211.8	218.1	223.5	229.4	235.0
Revenue	177.4	248.2	140.5	135.5	138.7	141.8	145.2	148.4
Tax revenue	28.4	35.0	32.9	33.4	34.6	35.6	36.9	37.6
Of which: Personal income tax	7.0	6.9	7.0	7.1	7.3	7.5	7.7	7.8
Company tax	4.5	7.5	7.6	7.8	8.0	8.3	8.9	9.0
VAT & Excise	16.9	20.6	18.3	18.5	19.3	19.9	20.4	20.8
Nontax revenue	149.0	213.2	107.6	102.1	104.1	106.2	108.3	110.7
Of which: Fishing revenue	142.7	207.1	101.4	95.8	97.7	99.7	101.7	103.7
External grants	105.7	104.4	129.8	76.3	79.4	81.6	84.2	86.6
Total expenditure	234.6	255.6	299.1	238.1	245.9	255.4	264.6	272.3
Current expenditure	120.3	136.5	149.1	153.0	157.3	164.3	170.7	175.6
Wages and salaries	53.7	58.9	61.7	62.9	64.0	65.2	66.5	67.7
Subsidies and Grants 1/	26.2	29.2	41.0	41.7	42.3	42.8	43.4	43.9
of which: Copra price subsidy	5.3	8.0	17.2	17.2	17.2	17.2	17.2	17.2
Community Support Obligations	5.0	5.0	5.0	5.4	5.5	5.6	5.7	5.7
Other current expenditure	30.3	47.0	44.5	46.3	48.1	50.0	52.0	54.1
Debt servicing	10.1	0.7	1.2	0.7	0.8	2.8	4.0	3.6
Contingency and maintenance	…	0.7	0.8	1.4	2.1	3.4	4.8	6.3
Development expenditure 2/	114.3	119.1	150.0	85.2	88.6	91.1	93.9	96.7
Net lending	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Recurrent fiscal balance 3/	57.2	111.7	-8.6	-17.4	-18.6	-22.4	-25.4	-27.3
Overall balance 4/	48.5	96.9	-28.7	-26.3	-27.8	-31.9	-35.2	-37.3
Financing	-48.5	-96.9	28.7	26.3	27.8	31.9	35.2	37.3
Domestic financing	-67.6	-116.4	1.2	10.1	13.9	17.8	20.8	22.6
Of which: Revenue Equalization and Reserve Fund (RERF)	8.4	-50.0	-87.9	10.3	14.3	18.7	21.5	23.0
Custodial account 5/	0.0	-70.7	89.0	-0.2	-0.3	-0.9	-0.8	-0.4
Cash account	-83.9	4.3	0.0	0.0	0.0	0.0	0.0	0.0
Project loans (net)	8.6	14.7	20.1	8.9	9.2	9.5	9.8	10.1
Budget support	10.4	4.8	7.5	7.3	4.7	4.7	4.7	4.7
	(In percent of GDP)							
Total revenue and grants	137.1	165.4	121.2	90.9	90.0	89.6	89.2	88.8
Revenue	86.0	116.4	63.0	58.1	57.2	56.9	56.5	56.1
Tax revenue	13.8	16.4	14.8	14.3	14.3	14.3	14.4	14.2
Nontax revenue	72.2	100.0	48.2	43.8	42.9	42.6	42.1	41.9
Of which: Fishing license fees	69.1	97.2	45.5	41.1	40.3	40.0	39.5	39.2
External grants	51.2	49.0	58.2	32.7	32.7	32.7	32.7	32.7
Total expenditure	113.6	119.9	134.1	102.2	101.4	102.4	102.9	102.9
Current expenditure	58.3	64.0	66.9	65.6	64.9	65.9	66.4	66.4
Development expenditure	55.4	55.9	67.2	36.5	36.5	36.5	36.5	36.5
Net lending	0.0	0.0	0.0	0.0	0.0	47.6	36.5	36.5
Recurrent fiscal balance (excl. grants)	27.7	52.4	-3.9	-7.5	-7.7	-9.0	-9.9	-10.3
Overall balance	23.5	45.5	-12.9	-11.3	-11.5	-12.8	-9.9	-10.3
Financing	-23.5	-45.5	12.9	11.3	11.5	12.8	13.7	14.1
Of which: RERF	4.1	-23.5	-39.4	4.4	5.9	7.5	8.4	8.7
Cash and custodial accounts	-40.7	-29.4	39.9	-0.1	-0.1	-0.4	-0.3	-0.1
Project loans (net)	4.2	6.9	9.0	3.8	3.8	3.8	3.8	3.8
Budget support	5.0	2.2	3.3	3.1	1.9	1.9	1.8	1.8
Memorandum items:								
RERF closing balance (in millions of Australian dollars)	679.0	756.3	865.6	880.0	890.9	897.6	901.7	904.5
Real per capita value (in 2006 A$)	4931.8	5305.4	5868.9	5726.7	5553.0	5353.0	5144.0	4959.4
Real GDP (percentage change)	2.4	3.5	3.1	2.5	2.0	1.5	1.7	1.8

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

1/ Includes subsidies to copra production.

2/ Development expenditure equals grants plus loans for development projects.

3/ Current balance excludes grants and development expenditure (see footnote 2 above).

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

5/ Projections assume the custodial account maintains cash reserves buffer of three months of current expenditure.

Table 3. Kiribati: Medium-Term Projections, 2014–21

	2014	2015	2016	2017	2018	2019	2020	2021
		Est.			Proj.			
Real sector								
Real GDP (percentage change)	2.4	3.5	3.1	2.5	2.0	1.5	1.7	1.8
Inflation (period average)	2.1	0.6	1.5	2.0	2.5	2.5	2.5	2.5
Nominal GDP at market prices (in millions of A$)	206.4	213.1	223.0	233.1	242.5	249.4	257.1	264.6
Government finance				(In percent of GDP)				
Total revenue and grants	137.1	165.4	121.2	90.9	90.0	89.6	89.2	88.8
Revenue	86.0	116.4	63.0	58.1	57.2	56.9	56.5	56.1
External grants	51.2	49.0	58.2	32.7	32.7	32.7	32.7	32.7
Total expenditure and net lending	113.6	119.9	134.1	102.2	101.4	102.4	102.9	102.9
Current expenditure	58.3	64.0	66.9	65.6	64.9	65.9	66.4	66.4
Of which: Wages and salaries	26.0	27.6	27.7	27.0	26.4	26.2	25.9	25.6
Development expenditure	55.4	55.9	67.2	36.5	36.5	36.5	36.5	36.5
Current balance	27.7	52.4	-3.9	-7.5	-7.7	-9.0	-9.9	-10.3
Overall balance	23.5	45.5	-12.9	-11.3	-11.5	-12.8	-13.7	-14.1
RERF balance (end of period; in millions of A$)	679	756	866	880	891	898	902	904
Real per capita balance (in 2006 A$)	4932	5305	5869	5727	5553	5353	5144	4959
Balance of payments				(In percent of GDP)				
Current account balance	24.0	44.9	-7.2	-2.5	-1.6	0.1	1.6	2.2
Trade balance	-56.4	-53.7	-59.3	-43.0	-42.7	-42.5	-42.3	-41.9

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

Table 4. Kiribati: Balance of Payments, 2014–21

	2014	2015	2016	2017	2018	2019	2020	2021
		Est.			Proj.			
				(In millions of Australian dollars)				
Current account balance	49.6	95.8	-15.9	-5.8	-3.9	0.3	4.2	5.8
Trade balance	-116.5	-114.5	-132.3	-100.2	-103.6	-106.0	-108.6	-110.9
Exports, f.o.b.	12.3	12.8	11.7	12.5	13.0	13.4	13.8	14.2
Imports, f.o.b.	128.8	127.3	144.0	112.8	116.7	119.4	122.5	125.2
Balance on services	-46.3	-65.0	-66.9	-68.0	-68.6	-67.6	-66.7	-65.6
Credit	13.3	13.8	14.4	15.1	15.9	16.8	17.7	18.6
Debit	59.6	78.7	81.3	83.1	84.5	84.4	84.4	84.3
Balance on factor income 1/	175.8	238.0	129.9	130.0	135.1	140.0	144.9	147.1
Credit	179.3	241.8	134.0	134.3	139.7	144.9	150.2	152.7
Fishing license fees	133.5	207.1	101.4	95.8	97.7	99.7	101.7	103.7
Investment income	33.2	19.6	19.1	24.4	27.3	30.2	33.0	33.0
Remittances and compensation of employees	12.5	15.1	13.5	14.1	14.6	15.1	15.5	16.0
Debit	3.5	3.8	4.0	4.3	4.6	4.9	5.3	5.6
Balance on current transfers	36.6	37.2	53.3	32.4	33.3	33.9	34.6	35.3
Credit	37.9	38.6	54.8	33.9	34.9	35.5	36.3	37.1
Of which: Government	29.5	25.3	37.2	22.2	23.0	23.7	24.4	24.9
Debit	1.2	1.1	1.1	1.2	1.2	1.2	1.3	1.3
Of which: Government	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial and capital account balance	-64.2	43.5	32.7	14.8	12.3	8.4	5.5	3.5
Government	44.0	48.3	53.6	28.6	29.7	30.6	31.5	32.4
Capital transfers	35.4	33.6	33.5	19.7	20.5	21.1	21.7	22.4
Loans (net)	8.6	14.7	20.1	8.9	9.2	9.5	9.8	10.1
Direct investment	-0.4	-0.5	-0.5	-0.5	-0.5	-0.5	-0.6	-0.6
Financial institutions 2/	-107.8	-4.4	-20.4	-13.3	-16.8	-21.6	-25.5	-28.4
Errors and omissions	23.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	9.1	139.2	16.7	9.0	8.5	8.7	9.7	9.3
Change in external assets (increase -) 3/	-9.1	-139.2	-16.7	-13.1	-12.3	-11.4	-11.4	-9.7
Revenue Equalization Reserve Fund	-9.1	-68.5	-105.8	-12.8	-11.9	-10.5	-10.6	-9.3
Custodial account	0.0	-70.7	89.0	-0.2	-0.3	-0.9	-0.8	-0.4
				(In percent of GDP)				
Current account balance	24.0	44.9	-7.2	-2.5	-1.6	0.1	1.6	2.2
Trade balance	-56.4	-53.7	-59.3	-43.0	-42.7	-42.5	-42.3	-41.9
Exports, f.o.b.	6.0	6.0	5.2	5.4	5.4	5.4	5.4	5.4
Imports, f.o.b.	62.4	59.7	64.6	48.4	48.1	47.9	47.6	47.3
Balance on services	-22.4	-30.5	-30.0	-29.2	-28.3	-27.1	-26.0	-24.8
Credit	6.5	6.5	6.4	6.5	6.6	6.7	6.9	7.0
Debit	28.9	36.9	36.4	35.6	34.8	33.8	32.8	31.8
Balance on factor income 1/	85.2	111.7	58.3	55.8	55.7	56.1	56.4	55.6
Credit	86.9	113.4	60.1	57.6	57.6	58.1	58.4	57.7
Fishing license fees	64.7	97.2	45.5	41.1	40.3	40.0	39.5	39.2
Investment income	16.1	9.2	8.6	10.5	11.3	12.1	12.8	12.5
Remittances	6.0	7.1	6.0	6.0	6.0	6.0	6.0	6.0
Debit	1.7	1.8	1.8	1.8	1.9	2.0	2.0	2.1
Balance on current transfers	17.7	17.4	23.9	13.9	13.7	13.6	13.5	13.3
Credit	18.4	18.1	24.6	14.6	14.4	14.3	14.1	14.0
Debit	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Financial and capital account balance	-31.1	20.4	14.7	6.3	5.1	3.4	2.1	1.3
Government	21.3	22.7	24.0	12.3	12.3	12.3	12.3	12.3
Capital transfers	17.1	15.8	15.0	8.4	8.4	8.4	8.4	8.4
Loans (net)	4.2	6.9	9.0	3.8	3.8	3.8	3.8	3.8
Direct investment	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Financial institutions 2/	-52.2	-2.1	-9.2	-5.7	-6.9	-8.7	-9.9	-10.7
Errors and omissions	11.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	4.4	65.3	7.5	3.9	3.5	3.5	3.8	3.5
Change in external assets (increase -) 3/	-4.4	-65.3	-7.5	-5.6	-5.1	-4.6	-4.4	-3.7
Revenue Equalization Reserve Fund	-4.4	-32.1	-47.4	-5.5	-4.9	-4.2	-4.1	-3.5
Custodial account	0.0	-33.2	39.9	-0.1	-0.1	-0.4	-0.3	-0.1

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

1/ Includes fishing license fees, which would be shown as current transfers under conventional international guidelines.

2/ Including errors and omisions for projections.

3/ Excludes valuation changes.

Table 5. Kiribati: Key Priority Area and SDGs

Key Priority Area (KPA)	Sustainable Development Goals
KPA 1 : Human Resource Development	Goal 4: Ensure inclusive and quality education for all and promote lifelong learning
KPA 2: Economic Growth and Poverty Reduction	Goal 1: End poverty in all its forms everywhere Goal 2: End hunger, achieve food security and improved nutrition and promote sustainable agriculture Goal 8: Promote inclusive and sustainable economic growth, employment and decent work for all Goal 10: Reduce inequality within and among countries
KPA 3: Health	Goal 3: Ensure healthy lives and promote well-being for all at all ages
KPA 4: Environment	Goal 11: Make cities inclusive, safe, resilient and sustainable Goal 12:Ensure sustainable consumption and production patterns Goal 13: Take urgent action to combat climate change and its impacts Goal 14: Conserve and sustainably use the oceans, seas and marine resources Goal 15: Sustainably manage forests, combat desertification, halt and reverse land degradation, halt biodiversity loss
KPA 5: Governance	Goal 5: Achieve gender equality and empower all women and girls Goal 16: Promote just, peaceful and inclusive societies
KPA 6: Infrastructure	Goal 6: Ensure access to water and sanitation for all Goal 7: Ensure access to affordable, reliable, sustainable and modern energy for all Goal 9: Build resilient infrastructure, promote sustainable industrialization and foster innovation
Means of Implementation	Goal 17: Revitalize the global partnership for sustainable development

Source: Kiribati Development Plan 2016-19

Annex I. Risk Assessment Matrix 1/

Sources of Risks	Likelihood and Transmission Channels	Potential Impact and Policy Response
Global risks		
Tighter and more volatile global financial conditions	**Medium** Investors withdraw from specific risk asset classes as they reassess underlying economic and financial risks in large economies, or respond to unanticipated Fed tightening, and increase in U.S. term premia, with poor market liquidity amplifying volatility.	**Medium** The RERF invests in foreign financial assets mostly in the Australian market. This exposure constitutes a significant channel through which global financial market turmoil can feed into the domestic economy. A lower return on investments and smaller RERF balance would require a stronger medium-term fiscal stance commensurate with smaller steady-state RERF drawdowns.
Weaker-than-expected global growth	**Medium/High** Significant slowdown in EMs/frontier economies (Medium) and structurally weak growth in key advanced and emerging economies (Medium/High). The spillover impact could be larger-than-expected, and would reverberate largely through the trade channel as well as through contagion to global financial markets.	**Medium** Fishing license fees and seamen's remittances could be negatively affected if demand for fish and shipping declines due to weaker than expected global growth. A decline in global returns and valuations would have a negative impact on RERF assets. In addition to fiscal adjustment to preserve the RERF (see above), structural reforms should be accelerated to underpin competitiveness.
Dislocation in capital and labor flows	**Medium** Reduced financial services by global/regional banks ("de-risking").	**Low/Medium** The withdrawal of correspondent banking relations has been associated with higher transaction cost for remittances in small island countries in the Pacific. In the short run, fiscal deficits from lower fishing fees can be financed through RERF drawdowns. If license fees decline on a sustained basis, steps should be taken to strengthen the budget through additional revenues and expenditure savings.
Domestic risks		
Risks to fishing license fees	**Medium** Fishing license fees decline more than projected due to changing weather conditions.	**High** This would lead to higher fiscal deficits. A sustained decline in fishing revenue may jeopardize long run fiscal sustainability. Steps to strengthen banking oversight will help maintain international banking linkages.
Natural disasters and increased uncertainty due to climate change	**Low** While long-term sea level rise is predictable, the near-term probability of a natural disaster is less than 10 percent for Kiribati.	**High** Historical experience suggests that natural disasters can cause large loss and damages to production and potential growth. Contingency plans for natural disasters should include maintaining a strong cash buffer, seeking cost-effective insurance, and establishing contingent financing plans with development partners.

1/ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. "Short term" and "medium term" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.

Annex II. Main Recommendations of the 2015 Article IV Consultation

Fund Recommendations	Policy Actions
Fiscal Policy	
• Contain nominal expenditure growth to around 1½ per annum over the next five years.	• The 2016 Budget envisaged a 9 percent increase in nominal current expenditure. The authorities, however, expressed their intention to maintain a balanced budget going forward.
• Transfer the excess reserve buffer into the RERF.	• The authorities expressed their intent to transfer the current cash reserves in excess of three months of recurrent spending to the RERF, a process that had been temporarily delayed given a change in wealth managers, in line with staff recommendations.
• Improve the management of RERF.	• The authorities have made remarkable progress in improving the management of the RERF. New asset managers have assumed the management of the RERF portfolios.
• Improve tax compliance and collection.	• Implementation of the VAT was partially hampered by reintroduced SOE exemptions in late 2015.
Other Policies	
• Implement SOE reforms.	• The authorities have made commendable progress in SOE reforms through the adoption of the SOE Act in 2013, closure of underperforming SOEs, and measures to commercialize and improve operational efficiency.
• Invest in human capital.	• The 2016 Budget included a free education subsidy of A$2.6 million.

INTERNATIONAL MONETARY FUND

KIRIBATI

August 23, 2016

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By | The Asia and Pacific Department (In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

(As of July 31, 2016)

Membership Status: joined June 3, 1986; accepted Article VIII.

General Resources Account:	SDR Million	Percent Quota
Quota	5.60	100.00
Fund holdings of currency	5.60	100.02
Reserve position in Fund	0.00	0.08

SDR Department:	SDR Million	Percent Allocation
Net cumulative allocation	5.32	100.00
Holdings	5.39	101.29

Outstanding Purchases and Loans: None.

Financial Arrangements: None.

Projected Obligations to Fund: None.

Implementation of HIPC Initiative: Not Applicable.

Implementation of Multilateral Debt Relief Initiative (MDRI): Not Applicable.

Exchange Rate Arrangement: The Australian dollar circulates as legal tender.

Article IV Consultation: The last Article IV consultation was concluded by the Executive Board on June 29, 2015; the relevant document is IMF Country Report No. 15/207. The 2016 Article IV consultation discussions with Kiribati were held in Tarawa during May 9–18, 2016. Kiribati is on a 12-month consultation cycle.

Technical Assistance (TA), 1995–2016: STA, LEG, MCM, FAD, and PFTAC have provided TA on statistics, tax administration and policy, budget management, Revenue Equalization Reserve Fund (RERF) and Pension Fund (KPF) management, financial sector reform and supervision, and combating financial crime and financial system abuse.

Resident Representative: The resident representative office in the Pacific Islands was opened in September 2010 in Suva, Fiji. Mr. Tubagus Feridhanusetyawan is the Resident Representative.

RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE (PFTAC)[1]

(As of 31 May, 2016)

During the current funding cycle (May 2011 to May 2016), PFTAC assistance to Kiribati has included 39 advisory missions. Kiribati also sent 47 officials to regional seminars and workshops.

Tax Administration and Policy

There is generally a strong commitment to reforming tax administration in Kiribati with many of PFTAC's recommendations having either been completed or currently being acted upon. Significant achievements include the design and implementation of a new function-based structure which includes a bigger focus on taxpayer services, new position descriptions and a plan to improve core tax functions. The Kiribati Tax Department maintains that these changes are already positively impacting on operations and an increase in revenue collections.

Although VAT, introduced in April 1, 2014, is performing well and exceeded budget projections in 2015, compliance remains an issue with a high percentage of outstanding returns and increasing debt levels. PFTAC technical assistance to mitigate these risks has been provided and is currently being acted upon by the authorities. Additional PFTAC technical assistance in FY2017 will be provided to develop a Compliance Improvement Strategy and increase audit capability.

Public Financial Management (PFM)

An August 2011 mission to Kiribati assisted the Ministry of Finance in prioritizing its PFM reform activities (RBM 1.2), and provided a framework for the current joint AusAid/AsDB long-term TA. Prior to the inception of that TA, two PFTAC/IMF missions worked with the Ministry of Finance officials to modify their chart-of-accounts (RBM 1.4) to capture more information on donor-funded projects, to improve the integration of planning and budgeting (RBM 1.5), and to provide options for better cash and debt management (RBMs 1.3 & 1.6). In addition, PFTAC's PFM Advisors participated in the August 2012 AsDB/AusDFAT Technical Assistance inception mission, and a concurrent donor forum. During 2013 several missions were conducted with multiple focuses including training budget analysts (RBM 1.5) in the National Economic Planning Office (NEPO), recommending a new organizational structure for NEPO, supporting the Team Leader of the joint Australia/ADB Treasury Reform TA (RBM 1.4), and assisting the authorities to develop an improved debt/cash management

[1] PFTAC in Suva, Fiji is a multi-donor TA institution, financed by IMF, AsDB, AusDFAT, Korea and NZAID, with the IMF as Executing Agency. The Centre's aim is to build skills and institutional capacity for effective economic and financial management that can be sustained at the national level. Member countries are: Cook Islands, Federated States of Micronesia, Fiji, Kiribati, Marshall Islands, Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Tokelau, Tonga, Timor-Leste, Tuvalu, and Vanuatu.

policy (RBMs 1.3 & 1.6) with support from IMF's APD and MCM Divisions. PFTAC PFM Advisors have also participated in interview/CV review teams for both Australian and EU-funded TA.

A PEFA review is tentatively scheduled for early 2017.

PFTAC is ready to provide additional technical support on budget preparation, cash/debt management, and other aspects of budget execution. Officials from Kiribati have regularly participated in PFTAC's regional PFM Workshops.

Financial Sector Regulation and Supervision

The Resident Technical Advisor is engaged with the Registrar of Credit Unions with the implementation of the Credit Union Act, which became in force on January 1, 2015. A mission was held in January 2015, aimed at introducing a credit union financial reporting system. A number of workshops were held on this topic and the Registrar's staff received training on how to properly complete the reports. While the credit unions are being registered with the Ministry, the Registrar is implementing the reporting program. An additional mission is planned for 2017 to review the progress of the implementation of the Act and the reporting system. It is anticipated that more workshops will be held on the subject of financial reporting and analysis.

It was further recommended that Kiribati consider establishing a Banking Commission which could undertake the oversight of the financial sector. Discussions will be held with the Ministry of Finance on this approach to sector surveillance.

Economic and Financial Statistics

GDDS metadata was first published on the IMF website in April 2004 and subsequently updated in March 2013, following assistance by PFTAC. The balance of payments (BOP) compiler benefited from training provided in regional courses in 2005 and 2010. PFTAC provided TA on balance of payments in 2008, 2010 and 2012, improving compilation methods and use of source data, as well as providing training, and helping with the transition to BPM6. From 2012 to 2015, TA was provided on BOP and government finance statistics (GFS was provided by related IMF JSA projects).

PFTAC has provided regular TA on national accounts since 2008, assisting the authorities in making significant improvements in methodology and use of source data. Beginning in 2012, PFTAC has increased its TA with the development of an expenditure measure of GDP and with the preparation of statistical procedures for the incorporation of VAT data; the last mission was in late 2015. However, progress has been slow due to resource and capacity constraints. The NA compilers benefited from regional courses in 2009, 2012, 2013, and 2014. PFTAC also sponsored a one-month attachment for the BOP compiler with Statistics New Zealand in May 2009.

Macroeconomic Analysis

Two missions in 2011 provided assistance in building capacity related to basic forecasting techniques, using the medium-term fiscal framework developed as part of AsDB assistance, and assessing sustainable levels of draw-downs from Kiribati's Reserve Equalization Reserve Fund. A regional financial programming workshop held jointly in 2012 by PFTAC and the Singapore Regional Training Institute provided training in financial programming techniques to two economists of the Ministry of Finance and Economic Development. In 2015 PFTAC supported authorities during the IMF Article IV consultation and discussed TA and training going forward in particular following the departure in 2016 of a DFAT funded resident advisor, who is heading the National Economic Planning Office. Economists from the Ministry of Finance and Economic Development participated in workshops on incorporating disaster risk into fiscal planning, forecasting tax revenues and medium-term planning for sustainable development in 2015 and 2016.

BANK-FUND COLLABORATION[2]

A. World Bank-IMF Collaboration

(As of May 31, 2016)

The Fund and the Bank teams maintain close cooperation in various areas and consult frequently. During the current cycle, the Bank staff has joined the IMF missions, including IMF staff visits and the 2015 and 2016 Article IV missions. The IMF staff and the World Bank staff maintained continuing close dialogue on economic developments and all aspects of the government reform program.

During the current cycle, the teams have produced a Joint DSA. The IMF team provided analysis and advice on the overall macroeconomic and fiscal framework, including fiscal and RERF sustainability. The IMF and World Bank have also been engaged in provision of technical assistance and advice in public financial management and debt management and policy. The Fund also provided technical assistance on tax administration and policy, budget management, and on statistical issues, including Government Finance Statistics and Balance of Payments. The Bank has been engaged in various infrastructure projects, including road rehabilitation, airport improvement, solar energy, and adaptation to climate change. Bank staff provided technical assistance on government expenditures, reforms of copra subsidy, liberalization of telecommunication sector, and management of the RERF. During this cycle the Bank has continued to work closely with the government on the comprehensive program of priority economic reforms and building resilience against external shocks, and supported coordination of donor TA around the reform agenda. Reforms identified through this process are now being supported under joint donor budget support, coordinated by the World Bank, with the third operation currently prepared in close consultation with the Government and donors.

The IMF and World Bank teams will continue close cooperation going forward, in particular in the context of the government reform program. As agreed earlier, the Fund will continue to lead on macro issues, in particular overall macroeconomic framework, including in the medium-and-longer term, and the Bank on macro-critical structural reform issues. The Fund and the Bank staff will also continue to cooperate with regard to follow up TA, including on the RERF management and public financial and debt management.

B. Relations with the World Bank Group

Kiribati became a member of the World Bank Group (WBG) in 1986. Since then, the WBG has provided strong support to Kiribati, including 13 IDA/ IBRD, Global Environment Fund, and Institutional Development Fund projects in different sectors totaling US $114 million.

[2] Prepared by the World Bank staff.

The World Bank is currently preparing a Regional Partnership Framework for 9 Pacific Islands, including Kiribati. The new Framework will focus around three broad themes: (i) fully exploiting the limited set of economic opportunities available to the PIC9, (ii) enhancing access to public services and employment opportunities; and, (iii) protecting incomes and livelihoods.

Both IDA and IFC are significantly increasing engagement. Consistent with Kiribati's limited repayment capacity highlighted in the DSA, IDA-financing are being provided on 100 percent grant terms. IFC is playing an important role in strengthening investment climate in countries across the Pacific, and is similarly scaling up technical assistance to Kiribati to strengthen the business environment and to support specific PPP transactions or asset sales as the government moves to rationalize SOEs.

Key components of WBG engagement include:

- Supporting better fiscal and natural resource management. Through a programmatic budget support operation, the World Bank has supported the Government's implementation of a medium-term strategy to restore the country's fiscal sustainability. The first and second operations have been completed in 2014–15. The third and fourth operations are currently being prepared in close consultation with the Government and other donors. The operations will support two main policy priorities—first, fiscal sustainability by encouraging greater transparency in managing fisheries revenue and the RERF, and second, private sector led growth by improving the quality and expanding the coverage of essential public services (electricity, water, sewage, and telecommunications).

- Improving connective infrastructure. To mitigate Kiribati's geographical disadvantage, the World Bank has scaled up support for basic infrastructure that connects the people of Kiribati to the outside world. Infrastructure investments integrating climate change adaptation planning has started in parallel with efforts to develop coordinated and more comprehensive multi-donor adaptation interventions. A South Tarawa road improvement investment (US$26 million in IDA and Trust Fund financing) is being undertaken jointly with the Asian Development Bank. The World Bank has also mobilized significant grant resources with New Zealand and other development partners to help bring Kiribati airports up to international safety standards.

- Building climate resilience. Since 2003, the World Bank has been supporting climate change mitigation through the Kiribati Adaptation Program, with activities such as seawall construction, mangrove planting, and water conservation. Beyond climate change adaptation, the World Bank has been committed to addressing wider issues of vulnerability in Kiribati, including supporting renewable energy generation to reduce reliance on volatile imported diesel.

RELATIONS WITH THE ASIAN DEVELOPMENT BANK[3]

The Asian Development Bank has approved eight project loans to Kiribati amounting to US$34.7 million, all from Asian Development Fund (ADF) resources since Kiribati joined the AsDB in 1974. In addition, TA amounting to US$37.3 million has been provided for 46 projects. The latest AsDB loan to Kiribati, for South Tarawa Sanitation Improvement Sector project, was approved in October 2011. The AsDB most recently approved an US$0.8 million TA grant for enhancing economic competitiveness through state-owned enterprise (SOE) reform in October 2013.

In line with the broad objective of the Kiribati Development Plan 2016-19, which focuses on a better educated, healthier, more prosperous nation with a higher quality of life, ADB's engagement aims to strengthen governance, improve infrastructure, maintain a stable macroeconomic framework, improve access to basic services, strengthen climate change adaptation and reduce poverty. As many infrastructure services are provided by SOEs, improving corporate governance arrangements and the commercial focus of these enterprises is a key objective of ADB's support to the government's structural reform program. Technical assistance to improve economic management and public sector reform has helped improve SOE performance. In October 2011, ADB approved a loan for the South Tarawa Sanitation Improvement Sector Project that has improved sanitation and hygiene practices in South Tarawa and will increase access to sanitation from 64 percent to 80 percent by 2019. Additional financing of $610,000 was approved in 2014. The Road Rehabilitation Project, approved in December 2010, has rehabilitated 32.5 kilometers of main roads and about 8 kilometers of feeder roads on South Tarawa. Additional financing of $8.4 million in 2015 and 2016 will help complete the rehabilitation and allow the upgrade of the road network on Betio, the largest township on South Tarawa and the site of the country's main port. Cofinanced by the Government of Australia, the World Bank and the Pacific Regional Infrastructure Facility, the project will improve socioeconomic conditions for the people of South Tarawa. ADB also provided its first policy grant of $3m to Kiribati in 2014, which focused on helping Kiribati increase fiscal sustainability by improving public expenditure quality, revenue performance, management of public assets and liabilities, and the business environment.

ADB's strategic engagement in Kiribati in the medium term will continue to focus on major transformative infrastructure investments with the scope to mobilize significant co-financing, and given the improvement in Kiribati's fiscal situation, limited policy financing to further build buffers and demonstrate confidence in the government's reform agenda.

[3] Prepared by the Asian Development Bank Staff.

Kiribati: Loan, Grant and Technical Assistance Approvals (2009–16)1/

	2009	2010	2012	2013	2014	2015	2016
Loan Approvals							
Number	0	1	1	0	0	0	0
Amount (US$m)	0	12	7.56	0	0	0	0
Grant Approvals							
Number	0	0	0	0	2	1	1
Amount (US$m)	0	0	0	0	3.6	2.4	6
TA Approvals							
Number	2	2	1	2	1	0	0
Amount (US$m)	0.8	0.85	0.2	0.8	1	0.22	0

1/ Prepared by the Asian Development Bank Staff.

STATISTICAL ISSUES

<table>
<tr><th colspan="2">Assessment of Data Adequacy for Surveillance</th></tr>
<tr><td colspan="2">(As of July 11, 2016)</td></tr>
<tr><td colspan="2">General: Data provision has some shortcomings, but is broadly adequate for surveillance. Balance of Payments and to some extent Government Finance Statistics could be further improved.</td></tr>
<tr><td colspan="2">National Accounts: With PTFAC assistance, GDP estimates have improved. There was one TA mission in 2015 to improve the national data accounting system, with updates and revisions to GDP data for 2012–14. However, further capacity building would be needed to continue to improve the quality of GDP estimates, particularly expenditure-based GDP estimates. Presently, only current and constant 2006 prices GDP data is compiled using the Value-Added approach.</td></tr>
<tr><td colspan="2">Price statistics: The monthly retail price index (2006=100) is produced with a short lag (about a month), based on a survey in South Tarawa (a national index is not available). There are no producer, wholesale, or trade price indices.</td></tr>
<tr><td colspan="2">Government finance statistics: A Government Finance Statistics mission took place in June 2014 to integrate GFS requirements into the ongoing Chart of Accounts and approaches to extend coverage to include donor-financed projects. The mission also explored possibilities to reclassify existing GFS data for consolidated central government to create a historical time series. While a complete review of government units, statutory extra budgetary units, and state-owned enterprises (SOE) was completed, a gap still remains regarding donor-financed project funds. A PEFA review is tentatively scheduled for early 2017.</td></tr>
<tr><td colspan="2">Monetary statistics: The balance sheets of all the financial institutions (Bank of Kiribati, Development Bank of Kiribati, Kiribati Provident Fund, and Kiribati Insurance Corporation) are available with lags, but the consolidated balance sheet of the financial sector is not available. Data on interest rates are reported with a long lag.</td></tr>
<tr><td colspan="2">Balance of payments: Kiribati is part of the Pacific Region module of the JSA project on Improvement of External Sector Statistics (ESS) in the Asia and Pacific region. Three ESS missions were undertaken during 2014. Data are compiled quarterly in the BPM6 format. However, the quality of the data is improving only marginally due to capacity constraints, and quality of source data. The shortcomings pertain to adjustments to trade data, recording of investments income, direct investment and foreign aid data.</td></tr>
<tr><th colspan="2">DATA STANDARDS AND QUALITY</th></tr>
<tr><td>Kiribati has been a participant in the General Data Dissemination System (GDDS) since 04.</td><td>No data ROSC are available.</td></tr>
<tr><th colspan="2">REPORTING TO STA (OPTIONAL)</th></tr>
<tr><td colspan="2">No data are currently reported to STA for publication in the Government Finance Statistics Yearbook, the Balance of Payments Statistics Yearbook or in the IFS.</td></tr>
</table>

Kiribati: Table of Common Indicators Required for Surveillance

	Date of latest observation	Date received	Frequency of Data	Frequency of Reporting /7	Frequency of publication /7
Exchange Rates	6/4/2016	6/4/2016	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities /1	NA	NA	NA	NA	NA
Reserve/Base Money	NA	NA	NA	NA	NA
Broad Money	NA	NA	NA	NA	NA
Central Bank Balance Sheet	NA	NA	NA	NA	NA
Consolidated Balance Sheet of the Banking System	NA	NA	NA	NA	NA
Interest Rates /2	3/31/16	5/7/16	A	A	I
Consumer Price Index	3/2016	4/2016	M	Q	Q
Revenue, Expenditure, Balance and Composition of Financing/3 - General Government /4	11/2015	2/2016	A	A	I
Stocks of Central Government and Central Government-Guaranteed Debt /5	2016	5/2016	A	A	I
External Current Account Balance	2014	5/2016	A	A	I
Exports and Imports of Goods and Services	2014	5/2016	A	A	I
GDP/GNP	2014	11/2015	A	A	I
Gross External Debt	2016	5/2016	A	A	I
International Investment Position /6	2015	5/2016	A	A	I

1/ 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.

2/ Both market-based and officially-determined, including discounts rates, money market rates, rates on treasury bills, notes and bonds.

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) and 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).

INTERNATIONAL MONETARY FUND

KIRIBATI

August 23, 2016

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

Approved By
Patrizia Tumbarello and Peter Allum (IMF) and Mathew Verghis (IDA)

Prepared by the Staff of the International Monetary Fund and the World Bank

This update of the Debt Sustainability Analysis (DSA) indicates that Kiribati remains at high risk of debt distress. While the fiscal position has improved, underpinned by robust fisheries sector revenue, containing the risk of debt distress will require continued fiscal sustainability through further progress in structural and fiscal reforms; securing grants to finance the country's large development needs will also be needed.

BACKGROUND

1. **Kiribati is a Pacific microstate and one of the remotest nations in the world.** It consists of 33 geographically dispersed coral atolls and islands over an ocean area of 3½ million square kilometers giving the country one of the largest Exclusive Economic Zones (EEZs). It has a population of around 120,000, with the population growth rate projected to decline from the current 2 percent to below 1.5 percent over the long run. The country's narrow production and export base, limited to tuna fishing and copra, makes it highly dependent on fishing license fees and donor support. Kiribati's sovereign wealth fund, the Revenue Equalization Reserve Fund (RERF), was established in 1956 from phosphate mining proceeds. Mining ceased in 1979 and in recent years, fishing revenues have been used to replenish the fund.

2. **Climate change continues to pose significant challenges**. Kiribati is one of the island states which stands to lose the most from the effects of climate change, including but not limited to drought, heightened incidences of natural disasters, loss of groundwater, and rising sea levels leading to coastal erosion. This could potentially lead to the relocation of people from the most affected parts of Kiribati to neighboring Pacific Islands. To this end, the previous government had purchased land for resettlement in Fiji in 2014. The costs of mitigating the adverse effects of climate change can partially be met by Kiribati's operating budget. Capital projects, however, require continued support from development partners.

THE BASELINE SCENARIO

3. **Under the baseline scenario, it is assumed that the government will continue with structural and other economic reforms**; while the major source of revenue, fishing license fees, is based on historical averages. The following are the key macroeconomic assumptions used for the baseline scenario:

- GDP and population growth are projected to moderate over the long run. Economic growth is expected at 3.1 percent in 2016, decelerating to 2.0 percent in the medium term, and moderating to 1.7 percent over the long run, underpinned by the negative impact of climate change on long run growth. Population growth is projected to decline from 2 percent to below 1.5 percent over the long run (based on the United Nations' World Population Prospects).
- Prices are anticipated to rise, albeit marginally in the short term but to increase and remain stable in the long run. Inflation is projected at 1.5 percent in 2016, increasing to 2.5 percent in the long term. This is in line with trading partner inflation and international food and fuel price dynamics, given that the bulk of Kiribati's consumer price basket comprises imported items.
- Following strong growth in the past four years, fishing revenue is expected to moderate in the medium term. Fishing license receipts grew at an average rate of 65 percent during 2012–15. This is partly due to the mid-2012 implementation of the Vessel Day Scheme and its proper

management thereafter; and a stronger U.S. dollar recently.[1] In 2015, fishing revenue was around 97 percent of GDP, however, it is expected to decline to around 45 percent of GDP this year as the positive effects of the El Niño phenomenon have started to wane. Fishing revenue is assumed to normalize at around A$100 million in the medium to long term. While staff projections place fishing license fees at a stable level, it should be noted that tuna is a highly migratory species, and therefore receipts from the sector can be volatile.

- Some improvement in government's fiscal position in the short run but weak position in the medium to long term. After registering more than a decade of deficit, the government's fiscal position improved since 2013. Overall balance stood at 23.5 and 40.1 percent of GDP, respectively in 2014 and 2015. This was consistent with government's efforts to rein-in expenditure, supported by large external grants; and tax reforms, particularly the introduction of Value Added Tax (VAT). Fiscal position is expected to deteriorate in the near term due to the projected fall in fishing revenue. In the long run, fiscal outturns will likely be weaker stemming from relatively higher spending growth. RERF drawdown is expected to provide 70–80 percent of government's financing needs. RERF returns are expected at 3.0–5.0 percent in the longer term.[2]
- External grants are projected to decline from 58 percent of GDP in 2016 to around 30 percent of GDP over the medium term as many donor-supported projects are near completion, and to stabilize at around 20 percent of GDP in the long run.
- Higher recurrent spending. Operating expenditure is projected to grow at 9 percent in 2016, and at average rate of 3.6 percent until 2020. In the long run, recurrent spending is projected to grow in line with nominal GDP. Operating expenditure related to climate change contingencies, together with new infrastructure maintenance costs are collectively assumed at around 2–3 percent of GDP.
- Development expenditure will fall in the medium term. Development expenditure is estimated at 45 percent of GDP in 2015 with a significant portion financed by external grants and around 10 percent by external borrowing. Development expenditure is assumed to increase to 67 of GDP this year, average around 37 percent of GDP in the medium term as many donor-supported projects are near completion, and stabilize at around 25 percent of GDP in the long run. The grant element of new borrowing is anticipated at 50 percent in the medium to long term.
- External balance. The current account surplus widened post 2013 underpinned by strong fishing license fees; but will weaken considerably in 2016–17 following the projected slowdown in the fisheries sector. In the medium term, the current account balance will likely improve on account of relatively higher investment returns from RERF and modest increase in fishing license fees. In addition, the completion of large donor financed infrastructure projects will see imports fall in the medium term.

[1] Fishing license fee is denominated in the U.S. dollar.

[2] This is in line with the lower expected returns from the Australian market.

Kiribati: Key Macroeconomic and Fiscal Assumptions		
	2015 DSA 2015-20 avg	2016 DSA 2016-21 avg
Real GDP growth (in percent)	2.0	2.1
Average nominal interest rate on forex debt (in percent)	1.4	1.2
Average real interest rate on domestic debt (in percent)	11.7	11.4
Inflation rate (GDP deflator, in percent)	1.2	1.6
Growth of real primary spending (deflated by GDP deflator, in percent)	-3.2	2.0
Grant element of new external borrowing (in percent)	37.6	44.2
Source: staff estimates.		

RESULTS

4. As in previous Article IV findings, the current DSA analysis indicates that Kiribati continues to be at high risk of debt distress.

- Historically, Kiribati's debt portfolio constituted mainly external debt. On average 94 percent of overall debt, equivalent to 22 percent of GDP in 2015 included foreign currency denominated debt, while domestic debt averaged around 3.5 percent of GDP as reflected in the text table. Government cleared domestic debt by end-2015 with the sale of the state telecom company. The DSA does not include potential SOE liabilities related to the Community Service Obligations (CSO).

- Sensitivity analyses of external debt alludes to higher relative risk. In 2014–15, the present value (PV) of external debt rose substantially as a result of increased loan disbursements. The growth trajectory remains the same however, it will slow down in the medium term. Consequently, the baseline results show that the PV of the external debt-to-GDP ratio breaches the indicative threshold (30 percent) by 2026; while the PV of external-debt-to-exports ratio breaches the threshold (100 percent) after 2036. The expected trend is due mainly to high imports as a percent of GDP as well as the dependence on external financing for development investment.

- Anticipated extreme shocks tend to weigh significantly on external debt stress projections. Under the extreme stress test scenario, the PV of debt-to-GDP and PV of debt-to-export ratios breach their thresholds by 2023 and 2028, respectively. These ratios are vulnerable to shocks emanating from debt financing terms and conditions, and expected trend of exports.

- Public sector debt downside risks remain elevated. Current fiscal surpluses are driven largely by windfall fishing license revenues. However, the PV of total public debt is

Kiribati: Stock of Debt ($, million)				
	2012	2013	2014	2015
External debt	13.9	16.7	22.9	35.3
Percent of GDP	7.4	8.9	12.3	22.0
Multilateral	13.9	16.7	19.8	26.5
Percent of GDP	7.4	8.9	10.6	16.5
Bilateral	0.0	0.0	3.1	8.7
Percent of GDP	0.0	0.0	1.6	5.4
Commercial	0.0	0.0	0.0	0.0
Percent of GDP	0.0	0.0	0.0	0.0
Domestic debt	6.5	8.0	7.3	3.8
Percent of GDP	3.4	4.2	3.9	2.4
Source: Kiribati Ministry of Finance and Economic Development				

projected to breach its indicative threshold (38 percent of GDP) before 2031, under the baseline scenario.

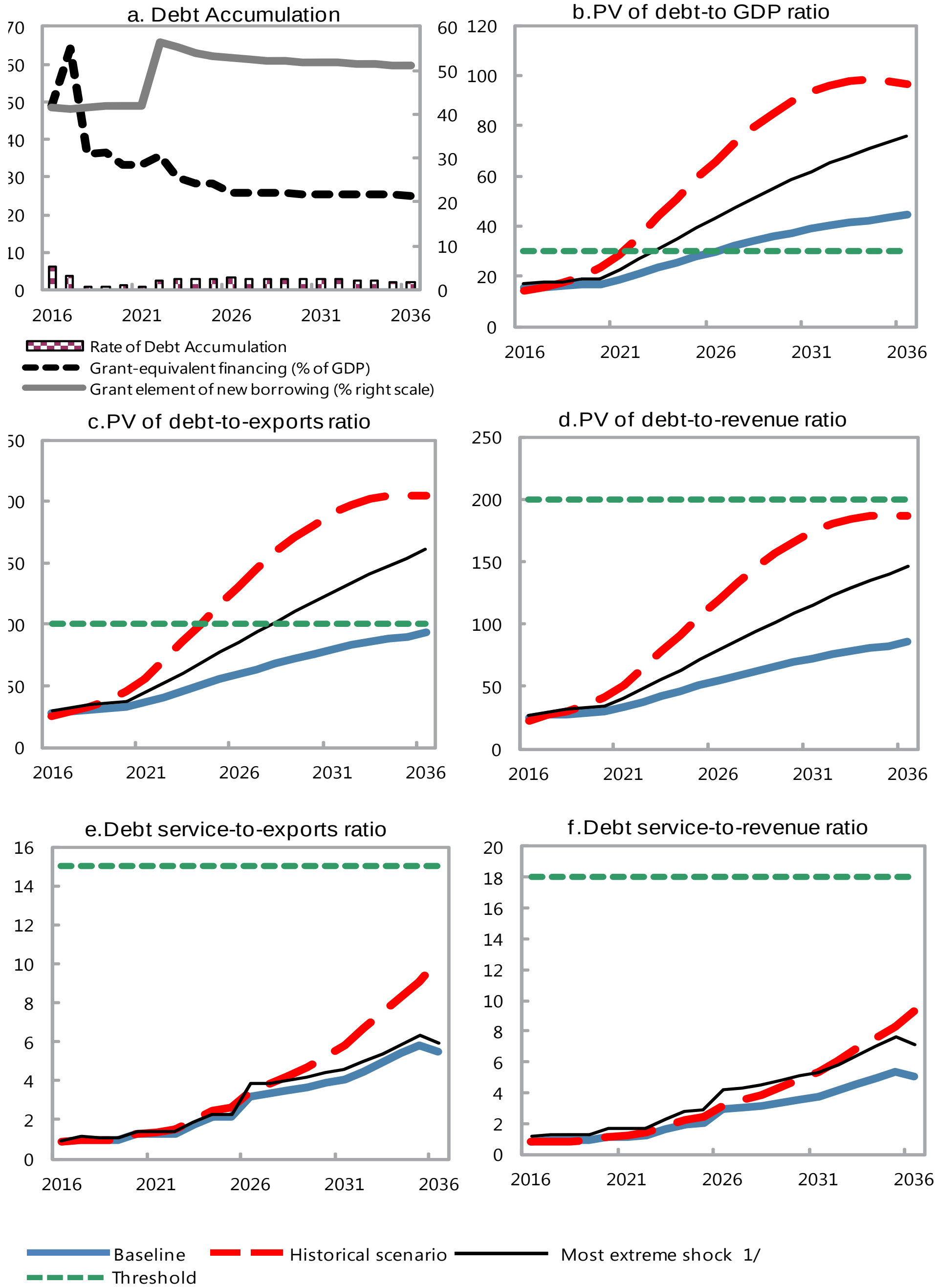
- Public debt is unsustainable under the extreme shock scenario. The most extreme stress test scenario predicts the PV of public-sector-debt-to-GDP ratio breaches the threshold by 2017; and will likely double in the following decade. This is attributed to higher projected borrowings and financing needs of the government.

CONCLUSION

5. Risks of debt distress remain high. The DSA results continue to suggest that Kiribati has limited scope for external borrowing. To build fiscal buffers, immediate to medium term focus should be on revenue management (tax administration and compliance related to VAT), recurrent expenditure restraints, financing of capital expenditure by increasing grant element, and progressing with structural reforms. Windfall revenue from fishing license fees should be invested in RERF to build its long term sustainability and for intergenerational equity. There is significant scope for Kiribati to support its fiscal stance and climate adaptation projects through additional finance from global climate funds, but this may require investment in terms of readiness programs specific to climate financing modalities, and project proposals and management.

6. The authorities broadly agreed with this assessment. They expressed strong commitment to preserving the net value of RERF by efficient management; avoiding non-concessional external borrowing; strongly pursuing state-owned-enterprise (SOE) reforms; and mapping and following a prudent fiscal path.

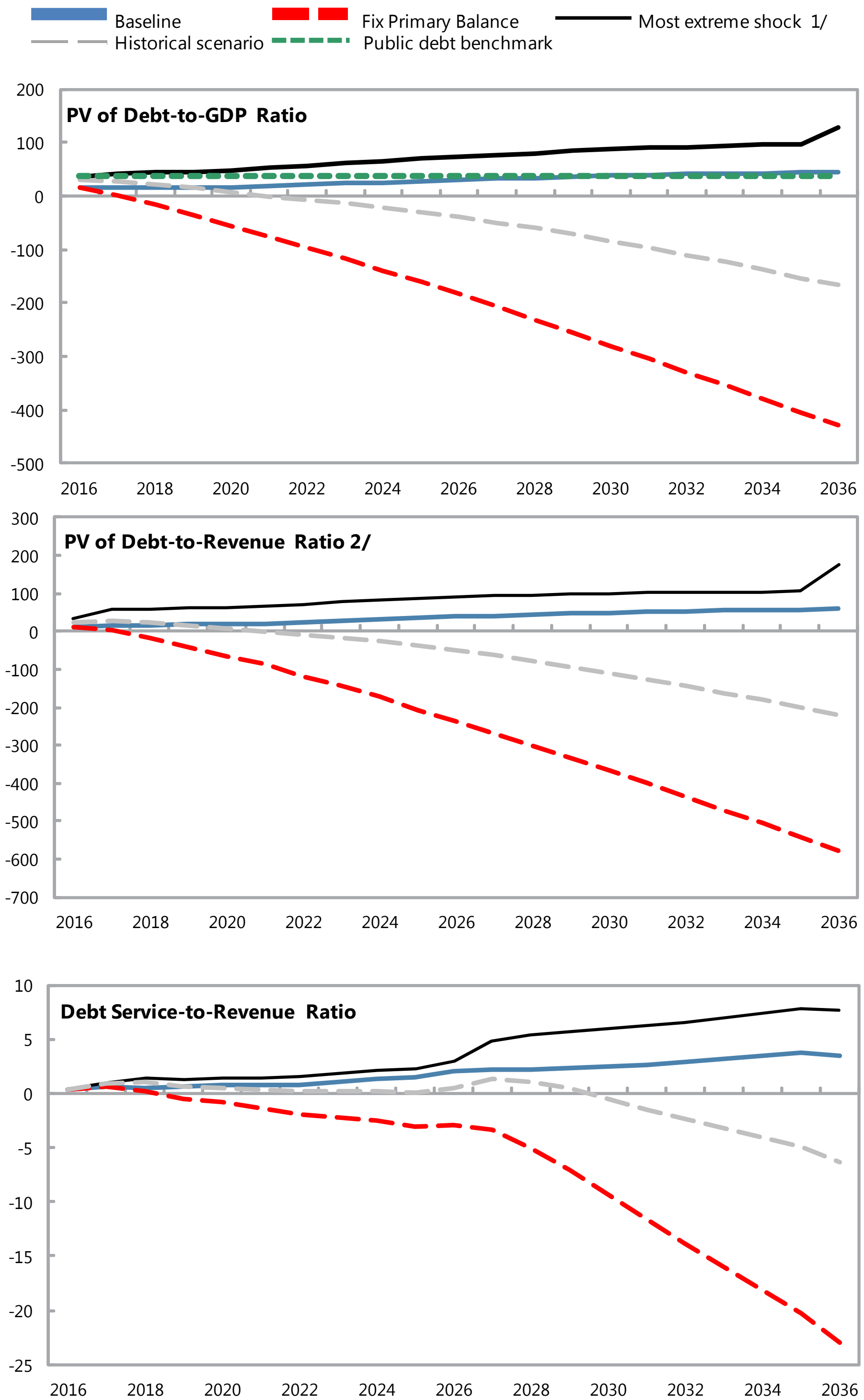
Figure 1. Kiribati: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2016–36 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2026. In figure b. it corresponds to a Terms shock; in c. to a Terms shock; in d. to a Terms shock; in e. to a Non-debt flows shock and in figure f. to a One-time depreciation shock.

Figure 2. Kiribati: Indicators of Public Debt Under Alternative Scenarios, 2016–36 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2026.

2/ Revenues are defined inclusive of grants.

Table 1. Kiribati: Public Sector Debt Sustainability Framework, Baseline Scenario, 2013–36

(In percent of GDP, unless otherwise indicated)

	Actual			Average 5/	Standard Deviation 5/	Estimate	Projections								
	2013	2014	2015			2016	2017	2018	2019	2020	2021	2016-21 Average	2026	2036	2022-36 Average
Public sector debt 1/	14.2	17.7	30.1			31.0	30.4	30.2	30.4	30.2	34.5		56.2	80.2	
of which: foreign-currency denominated	9.6	13.4	27.6			31.0	30.4	30.2	30.4	30.2	34.5		56.2	80.2	
Change in public sector debt	3.4	3.5	12.3			1.0	-0.6	-0.3	0.2	-0.2	4.3		3.8	1.5	
Identified debt-creating flows	14.3	-46.5	-30.7			10.3	-6.3	-1.1	2.9	3.1	2.9		2.7	1.4	
Primary deficit	-10.9	-42.9	-56.1	-2.5	26.3	-27.0	1.3	7.1	13.5	13.8	14.7	3.9	17.5	24.6	20.1
Revenue and grants	96.2	137.1	160.0			124.8	94.0	93.5	89.6	89.2	88.8		77.5	74.3	
of which: grants	31.8	51.2	43.6			61.8	35.8	36.2	32.7	32.7	32.7		22.4	22.4	
Primary (noninterest) expenditure	85.3	94.2	104.0			97.7	95.3	100.6	103.1	103.0	103.5		95.0	98.9	
Automatic debt dynamics	1.0	0.5	2.0			-2.0	-1.0	-0.9	-0.6	-0.3	-0.4		-0.8	-1.5	
Contribution from interest rate/growth differential	-0.2	-0.1	-0.1			-1.1	-1.0	-0.9	-0.7	-0.6	-0.6		-1.2	-2.0	
of which: contribution from average real interest rate	0.4	0.2	0.5			-0.3	-0.3	-0.3	-0.3	-0.1	-0.1		-0.4	-0.7	
of which: contribution from real GDP growth	-0.6	-0.3	-0.6			-0.9	-0.8	-0.6	-0.4	-0.5	-0.5		-0.9	-1.3	
Contribution from real exchange rate depreciation	1.2	0.6	2.1			-0.9	0.0	0.0	0.1	0.3	0.2		...	...	
Other identified debt-creating flows	24.3	-4.1	23.5			39.4	-6.6	-7.3	-10.0	-10.4	-11.3		-14.0	-21.6	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (RERF)	24.3	-4.1	23.5			39.4	-6.6	-7.3	-10.0	-10.4	-11.3		-14.0	-21.6	
Residual, including asset changes	-10.9	50.0	43.0			-9.4	5.7	0.8	-2.7	-3.2	1.3		1.1	0.1	
Other Sustainability Indicators															
PV of public sector debt	...	9.3	15.5			15.6	15.7	16.0	16.5	16.7	18.7		30.0	44.3	
of which: foreign-currency denominated	...	5.0	13.1			15.6	15.7	16.0	16.5	16.7	18.7		30.0	44.3	
of which: external	...	5.0	13.1			15.6	15.7	16.0	16.5	16.7	18.7		30.0	44.3	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	-10.0	-42.2	-55.1			-26.5	1.8	7.6	14.0	14.4	15.3		19.1	27.2	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	6.8	9.7			12.5	16.7	17.1	18.4	18.8	21.1		38.7	59.6	
PV of public sector debt-to-revenue ratio (in percent)	...	10.8	13.3			24.7	27.0	27.9	29.0	29.6	33.4		54.4	85.3	
of which: external 3/	...	5.8	11.2			24.7	27.0	27.9	29.0	29.6	33.4		54.4	85.3	
Debt service-to-revenue and grants ratio (in percent) 4/	1.0	0.6	0.6			0.4	0.6	0.5	0.6	0.7	0.7		2.1	3.5	
Debt service-to-revenue ratio (in percent) 4/	1.4	0.9	0.8			0.8	0.9	0.9	0.9	1.1	1.2		2.9	5.0	
Primary deficit that stabilizes the debt-to-GDP ratio	-14.4	-46.5	-68.4			-28.0	1.9	7.4	13.3	13.9	10.4		13.7	23.1	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	5.8	2.4	3.5	1.5	2.8	3.1	2.5	2.0	1.5	1.7	1.7	2.1	1.7	1.7	1.7
Average nominal interest rate on forex debt (in percent)	1.0	0.9	1.2	1.0	0.4	1.1	1.0	1.0	1.0	1.5	1.5	1.2	1.2	1.0	1.1
Average real interest rate on domestic debt (in percent)	13.7	6.8	13.6	8.1	4.4	...	...	...	...	...	...	...	...	...	...
Real exchange rate depreciation (in percent, + indicates depreciation	17.1	6.6	16.0	0.7	15.1	...	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	0.9	4.0	-0.2	2.4	2.8	1.5	2.0	2.0	1.3	1.4	1.2	1.6	1.1	1.3	1.1
Growth of real primary spending (deflated by GDP deflator, in percer	-2.1	13.1	14.2	4.5	8.0	-3.1	-0.1	7.7	4.1	1.6	2.2	2.0	2.3	0.5	1.4
Grant element of new external borrowing (in percent)	...	...	41.8	...	...	41.2	41.4	41.8	42.1	42.0	56.4	44.2	52.6	47.7	...

Sources: Country authorities; and staff estimates and projections.

1/ [Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.]

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 2. Kiribati: Sensitivity Analysis for Key Indicators of Public Debt, 2016–36

	2016	2017	2018	2019	2020	2021	2026	2036
PV of Debt-to-GDP Ratio								
Baseline	16	16	16	17	17	19	30	44
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	29	27	22	15	7	0	-39	-167
A2. Primary balance is unchanged from 2016	16	1	-16	-36	-57	-77	-183	-429
A3. Permanently lower GDP growth 1/	16	16	17	19	20	23	44	93
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2017-2018	18	21	24	27	30	34	60	98
B2. Primary balance is at historical average minus one standard deviations in 2017-2018	42	53	53	54	55	57	71	79
B3. Combination of B1-B2 using one half standard deviation shocks	36	42	43	46	48	52	74	100
B4. One-time 30 percent real depreciation in 2017	20	20	20	20	21	21	27	36
B5. 10 percent of GDP increase in other debt-creating flows in 2017	2	7	12	18	24	31	68	129
PV of Debt-to-Revenue Ratio 2/								
Baseline	12	17	17	18	19	21	39	60
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	23	29	24	16	7	0	-50	-220
A2. Primary balance is unchanged from 2016	12	1	-17	-40	-64	-87	-237	-578
A3. Permanently lower GDP growth 1/	13	17	18	21	22	26	56	120
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2017-2018	14	22	25	29	32	37	75	129
B2. Primary balance is at historical average minus one standard deviations in 2017-2018	34	57	57	60	62	65	92	107
B3. Combination of B1-B2 using one half standard deviation shocks	28	43	45	50	53	57	94	132
B4. One-time 30 percent real depreciation in 2017	16	21	21	23	23	24	35	48
B5. 10 percent of GDP increase in other debt-creating flows in 2017	1	7	12	20	27	35	87	174
Debt Service-to-Revenue Ratio 2/								
Baseline	0	1	1	1	1	1	2	4
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	0	1	1	1	1	0	0	-6
A2. Primary balance is unchanged from 2016	0	1	0	0	-1	-1	-3	-23
A3. Permanently lower GDP growth 1/	0	1	1	1	1	1	2	6
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2017-2018	0	1	1	1	1	1	3	7
B2. Primary balance is at historical average minus one standard deviations in 2017-2018	0	1	2	2	1	1	3	7
B3. Combination of B1-B2 using one half standard deviation shocks	0	1	1	1	1	1	3	8
B4. One-time 30 percent real depreciation in 2017	0	1	1	1	1	1	3	5
B5. 10 percent of GDP increase in other debt-creating flows in 2017	0	1	1	1	1	1	1	-2

Sources: Country authorities; and staff estimates and projections.
1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.
2/ Revenues are defined inclusive of grants.

Table 3. Kiribati: External Debt Sustainability Framework, Baseline Scenario, 2013–36

(In percent of GDP, unless otherwise indicated)

	Actual			Historical 6/ Average	Standard 6/ Deviation	Projections									
	2013	2014	2015			2016	2017	2018	2019	2020	2021	2016-2021 Average	2026	2036	2022-2036 Average
External debt (nominal) 1/	**9.6**	**13.4**	**27.6**			**31.0**	**30.4**	**30.2**	**30.4**	**30.2**	**34.5**		**56.2**	**80.2**	
of which: public and publicly guaranteed (PPG)	9.6	13.4	27.6			31.0	30.4	30.2	30.4	30.2	34.5		56.2	80.2	
Change in external debt	2.3	3.8	14.2			3.4	-0.6	-0.3	0.2	-0.2	4.3		3.8	1.5	
Identified net debt-creating flows	-7.7	-23.8	-45.2			6.6	2.0	1.2	-0.3	-1.9	-2.5		-7.7	-0.4	
Non-interest current account deficit	**-8.3**	**-24.1**	**-45.1**	**5.1**	**13.6**	**6.9**	**2.2**	**1.3**	**-0.4**	**-2.1**	**-2.6**		**-7.7**	**-0.5**	-5.3
Deficit in balance of goods and services	35.4	14.1	-13.0			43.9	31.1	30.7	29.7	28.7	27.5		18.3	21.4	
Exports	57.6	77.1	109.6			57.1	52.9	52.2	52.1	51.8	51.6		50.5	47.4	
Imports	93.0	91.3	96.7			101.0	84.0	83.0	81.7	80.5	79.2		68.8	68.8	
Net current transfers (negative = inflow)	-21.5	-17.7	-17.4	-21.2	3.7	-23.9	-13.9	-13.7	-13.6	-13.5	-13.3		-9.6	-9.6	-9.9
of which: official	-19.4	-15.8	-15.8			-22.4	-12.6	-12.6	-12.6	-12.6	-12.6		-8.6	-8.6	
Other current account flows (negative = net inflow)	-22.2	-20.5	-14.7			-13.1	-15.0	-15.7	-16.5	-17.3	-16.8		-16.4	-12.2	
Net FDI (negative = inflow)	**0.6**	**0.2**	**0.2**	**0.0**	**2.1**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**		**0.3**	**0.6**	0.4
Endogenous debt dynamics 2/	**0.1**	**0.2**	**-0.4**			**-0.5**	**-0.4**	**-0.3**	**-0.1**	**-0.1**	**0.0**		**-0.3**	**-0.5**	
Contribution from nominal interest rate	0.1	0.1	0.2			0.3	0.3	0.3	0.3	0.4	0.5		0.6	0.8	
Contribution from real GDP growth	-0.4	-0.2	-0.5			-0.8	-0.7	-0.6	-0.4	-0.5	-0.5		-0.9	-1.3	
Contribution from price and exchange rate changes	0.4	0.3	...			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	**9.9**	**27.6**	**59.4**			**-3.1**	**-2.6**	**-1.5**	**0.5**	**1.8**	**6.7**		**11.5**	**1.9**	
of which: exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	5.0	13.1			15.6	15.7	16.0	16.5	16.7	18.7		30.0	44.3	
In percent of exports	...	6.5	11.9			27.2	29.6	30.6	31.7	32.3	36.3		59.4	93.4	
PV of PPG external debt	**...**	**5.0**	**13.1**			**15.6**	**15.7**	**16.0**	**16.5**	**16.7**	**18.7**		**30.0**	**44.3**	
In percent of exports	**...**	**6.5**	**11.9**			**27.2**	**29.6**	**30.6**	**31.7**	**32.3**	**36.3**		**59.4**	**93.4**	
In percent of government revenues	**...**	**5.8**	**11.2**			**24.7**	**27.0**	**27.9**	**29.0**	**29.6**	**33.4**		**54.4**	**85.3**	
Debt service-to-exports ratio (in percent)	**0.8**	**0.4**	**0.4**			**0.9**	**1.0**	**1.0**	**1.0**	**1.2**	**1.3**		**3.2**	**5.5**	
PPG debt service-to-exports ratio (in percent)	**0.8**	**0.4**	**0.4**			**0.9**	**1.0**	**1.0**	**1.0**	**1.2**	**1.3**		**3.2**	**5.5**	
PPG debt service-to-revenue ratio (in percent)	**0.7**	**0.3**	**0.3**			**0.8**	**0.9**	**0.9**	**0.9**	**1.1**	**1.2**		**2.9**	**5.0**	
Total gross financing need (Millions of U.S. dollars)	-13.7	-44.0	-71.3			12.6	5.1	3.7	0.6	-2.3	-3.5		-13.2	8.3	
Non-interest current account deficit that stabilizes debt ratio	-10.6	-27.9	-59.3			3.4	2.8	1.5	-0.6	-1.9	-6.9		-11.5	-2.0	
Key macroeconomic assumptions															
Real GDP growth (in percent)	5.8	2.4	3.5	1.5	2.8	3.1	2.5	2.0	1.5	1.7	1.7	2.1	1.7	1.7	1.7
GDP deflator in US dollar terms (change in percent)	-5.7	-3.1	-16.8	2.8	11.9	0.2	3.4	1.9	1.3	1.4	0.7	1.5	1.1	1.3	1.1
Effective interest rate (percent) 5/	1.0	0.9	1.2	1.0	0.4	1.1	1.0	1.0	1.0	1.5	1.5	1.2	1.2	1.0	1.1
Growth of exports of G&S (US dollar terms, in percent)	27.5	32.8	22.4	19.0	19.5	-46.2	-1.8	2.5	2.5	2.6	2.0	-6.4	2.3	2.3	2.3
Growth of imports of G&S (US dollar terms, in percent)	-0.2	-2.6	-8.8	3.1	13.8	7.9	-11.8	2.6	1.3	1.5	0.7	0.4	2.8	3.0	1.9
Grant element of new public sector borrowing (in percent)	...	...	41.8	...	...	41.2	41.4	41.8	42.1	42.0	56.4	44.2	52.6	47.7	52.1
Government revenues (excluding grants, in percent of GDP)	64.5	86.0	116.4			63.0	58.1	57.2	56.9	56.5	56.1		55.1	51.9	54.1
Aid flows (in Millions of US dollars) 7/	59.6	95.4	90.1			112.1	64.5	68.1	63.8	64.8	75.4		64.9	83.6	
of which: Grants	59.6	95.4	69.9			102.3	62.9	66.1	61.4	63.3	64.9		50.8	67.6	
of which: Concessional loans	0.0	0.0	20.1			9.8	1.6	2.0	2.4	1.5	10.5		14.1	16.0	
Grant-equivalent financing (in percent of GDP) 8/	...	...	48.8			64.2	36.2	36.7	33.3	33.1	35.7		25.7	25.1	26.1
Grant-equivalent financing (in percent of external financing) 8/	...	...	87.0			94.8	98.5	98.3	97.8	98.6	93.9		89.7	89.5	90.2
Memorandum items:															
Nominal GDP (Millions of US dollars)	187.7	186.3	160.4			165.7	175.6	182.5	187.7	193.5	198.2		226.9	301.9	
Nominal dollar GDP growth	-0.2	-0.7	-13.9			3.3	6.0	3.9	2.9	3.1	2.4	3.6	2.8	3.0	2.8
PV of PPG external debt (in Millions of US dollars)		8.5	20.2			26.1	27.5	29.1	31.0	32.2	37.1		68.0	133.6	
(PVt-PVt-1)/GDPt-1 (in percent)			6.3			3.7	0.8	0.9	1.0	0.6	2.5	1.6	2.8	2.6	2.7
Gross workers' remittances (Millions of US dollars)	12.1	11.3	11.4			10.0	10.6	11.0	11.3	11.7	12.0		14.3	19.1	
PV of PPG external debt (in percent of GDP + remittances)	...	4.7	12.2			14.7	14.8	15.1	15.6	15.8	17.7		28.2	41.6	
PV of PPG external debt (in percent of exports + remittances)	...	6.0	11.2			24.6	26.6	27.4	28.4	28.9	32.5		52.8	82.4	
Debt service of PPG external debt (in percent of exports + remittance	...	0.3	0.3			0.8	0.9	0.9	0.9	1.1	1.1		2.8	4.9	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Assumes that PV of private sector debt is equivalent to its face value.

5/ Current-year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

7/ Defined as grants, concessional loans, and debt relief.

Table 4. Kiribati: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2016–36

(In percent)

	Projections							
	2016	2017	2018	2019	2020	2021	**2026**	2036
PV of debt-to GDP ratio								
Baseline	16	16	16	17	17	19	**30**	44
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2016-2036 1/	14	16	17	20	23	28	**66**	97
A2. New public sector loans on less favorable terms in 2016-2036 2/	17	17	18	19	19	23	**43**	76
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	16	17	17	18	18	20	**32**	48
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	-8	-29	-29	-29	-29	-28	**-18**	19
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	17	18	18	19	19	21	**34**	51
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	20	19	19	20	20	22	**34**	46
B5. Combination of B1-B4 using one-half standard deviation shocks	-11	-47	-47	-47	-48	-47	**-37**	11
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	23	22	23	24	24	27	**43**	63
PV of debt-to-exports ratio								
Baseline	27	30	31	32	32	36	**59**	93
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2016-2036 1/	25	29	33	38	45	55	**130**	204
A2. New public sector loans on less favorable terms in 2016-2036 2/	30	33	34	36	37	44	**86**	161
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	28	30	31	32	32	36	**59**	93
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	-8	-31	-31	-31	-32	-30	**-20**	22
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	28	30	31	32	32	36	**59**	93
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	35	36	37	38	39	43	**66**	97
B5. Combination of B1-B4 using one-half standard deviation shocks	-9	-38	-38	-39	-39	-38	**-32**	10
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	28	30	31	32	32	36	**59**	93
PV of debt-to-revenue ratio								
Baseline	25	27	28	29	30	33	**54**	85
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2016-2036 1/	22	27	30	35	41	51	**119**	186
A2. New public sector loans on less favorable terms in 2016-2036 2/	27	30	31	33	34	41	**79**	146
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	26	29	30	32	32	36	**59**	92
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	-13	-50	-50	-50	-51	-49	**-33**	36
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	26	31	32	33	34	38	**62**	98
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	32	33	34	35	36	40	**61**	89
B5. Combination of B1-B4 using one-half standard deviation shocks	-17	-82	-83	-83	-85	-83	**-68**	22
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	36	38	40	42	42	48	**78**	122

Table 4. Kiribati: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2016–36 (concluded)

(In percent)

	Projections							
	2016	2017	2018	2019	2020	2021	**2026**	2036
Debt service-to-exports ratio								
Baseline	1	1	1	1	1	1	3	6
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2016-2036 1/	1	1	1	1	1	1	3	10
A2. New public sector loans on less favorable terms in 2016-2036 2/	1	1	1	1	1	1	3	9
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	1	1	1	1	1	1	3	6
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	0	0	0	0	0	0	-1	0
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	1	1	1	1	1	1	3	6
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	1	1	1	1	1	1	4	6
B5. Combination of B1-B4 using one-half standard deviation shocks	0	0	-1	-1	0	0	-1	-1
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	1	1	1	1	1	1	3	6
Debt service-to-revenue ratio								
Baseline	1	1	1	1	1	1	3	5
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2016-2036 1/	1	1	1	1	1	1	3	9
A2. New public sector loans on less favorable terms in 2016-2036 2/	1	1	1	1	1	1	3	8
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	1	1	1	1	1	1	3	5
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	1	0	-1	-1	0	0	-1	-1
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	1	1	1	1	1	1	3	6
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	1	1	1	1	1	1	4	5
B5. Combination of B1-B4 using one-half standard deviation shocks	1	0	-1	-1	-1	-1	-2	-3
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	1	1	1	1	2	2	4	7
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	47	45	43	41	39	37	29	17

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Statement by Barry Sterland, Executive Director for Kiribati
and Chris Stewart, Advisor
September 7, 2016

We thank the staff for their report, the high quality of engagement – both in terms of the thoughtful analysis as well as the open attitude of the team in their dialogue with our authorities. We welcome the past and continuing assistance of the IMF, other international financial institutions and Kiribati's development partners. The new Government largely agrees with the staff's analysis and would like to highlight a number of points.

Context

Kiribati consists of 33 small islands spread over a vast area of the Pacific Ocean; there is about 4,500km between the eastern and western zones. High transaction costs between the outer islands and South Tarawa, due to isolation and infrastructure needs, affect development. Growth to a large extent depends on the fortunes of the fishing industry. Half the population is located in and around the capital, South Tarawa. The vast majority of Kiribati is only a few metres above sea level, and having a relatively limited supply of fresh drinking water, the country is highly vulnerable to climate change as well as both El Niño and La Niña events. In facing these challenges, Kiribati has a good record of stable democracy and orderly transitions between governments, social cohesion, good relations with donors and prudent economic management. Building on recent reforms, the new Government is also committed to taking a prudent approach to economic management.

Economic Outlook

The authorities agree with staff that the underlying drivers of economic growth are moderating and risks are generally to the downside. At the same time, upside risks are present, including growth flowing from continued construction activity at the airport, water and sanitation projects, and an upgrade to the causeway running between the two most heavily populated islands. The authorities agree that inflation is expected to remain low.

Fiscal Policy

The authorities welcome the IMF's analysis of the fiscal position, and will carefully consider the IMF's advice in putting together the medium-term fiscal framework. The new Government intends to maintain a balanced budget over the medium term. It will consider carefully the recommendations to target structural balances, so fluctuations are treated symmetrically. Some flexibility in the framework is appropriate in order to respond to large variations in fishing license revenue. The Government also intends to carefully manage Kiribati's balance sheet. It intends only to draw on the Revenue Equalization Reserve Fund (RERF) as a last resort and not for recurrent spending.

The Government has recently announced a number of fiscal measures that will both improve social inclusion as well as reduce costs in the longer-term. In particular, early evidence suggests that people are migrating back to the outer islands in response to the increase in copra prices; this is helping to reduce both economic and social issues in South Tarawa. The Government has also recently committed to reviewing some expenditures, including SOEs and public financial management, and is considering civil service reforms including outsourcing. The Government has also provided a modest increase in spending on education and health to address critical social needs. Furthermore, the 2016 Budget Speech noted that the Government will seek to increase maintenance spending in the coming years to a level proportionate with the needs of the nation so as to reduce long-run repair costs. It should be noted that last year's increase in public sector wage costs was driven by a one-off change in the mechanism by which home leave payments were provided.

The Government is undertaking a number of actions to improve revenues. Most importantly, the authorities are working to improve compliance with the new VAT system. In particular, the newly established Taxpayer Services Division will work on improving the collection rate as well as the timeliness of collections. The Government recognizes the revenue implications of exempting SOEs from the VAT. At the same time, these exemptions are important in keeping costs down for outer islanders (especially as the exemptions primarily relate to household necessities). The Government is considering introducing new measures to widen the tax base.

The authorities carefully consider potential climate change mitigation and adaption costs and are examining the feasibility of explicitly recognizing these costs in the budget. This information can already be obtained from the budget and identifying it more explicitly would help underline the need for assistance. Kiribati has also been at the forefront of efforts to highlight the need to address climate change on a global level. It will continue to seek assistance from the international community in adjusting to climate change.

SWF and Cash Reserves

The Revenue Equalization Reserve Fund (RERF), Kiribati's sovereign wealth fund, has significant financial assets and will be managed prudently for both current and future generations. Protecting the capital value of the RERF is a key priority of the Government and the authorities are developing a framework for achieving this. The Government will consider a rules-based withdrawal mechanism using the IMF's research as an input. Since the finalisation of the staff report, the Government has moved AUD$70 million into the RERF arising from strong recent returns from fishing. The authorities agree with staff's proposals to maintain a buffer of around 3 months of recurrent spending.

Structural Reforms

The authorities remain firmly committed to their reform efforts and welcome staff's acknowledgement of the progress made in recent years. This has made good use of the technical assistance provided by the Asian Development Bank and the World Bank since 2009. Beyond the significant reduction in the number of SOEs, there has been a marked change in the strategic direction of the remaining SOEs towards a more commercial focus. The Government is currently undertaking the second stage of these reforms. This has two main elements. First, major decisions affecting SOEs will now be joint decisions between the portfolio minister and the Minister of Finance, rather than just the portfolio minister. Second, a number of additional SOEs are in the process of being privatized. Each of these are at a separate stage but the direction of travel is clear. The new government looks forward to the negotiations with the corporatized SOEs on the appropriate size of any community service obligation (CSO) payments now that the budget is out of the way. In progressing this, it will be important for these entities to improve their competitiveness - especially given that many are now in monopoly positions.

The Government will carefully assess proposals to promote air transportation and shipping services. This will help ensure that any expansions are sustainable and the best use of resources when considered in a holistic manner. Given the complexity of such decisions, the authorities will also ensure that they seek a number of different perspectives, including expertise from international financial institutions and development partners.

The authorities agree on the need to address issues with the Development Bank of Kiribati (DBK) and the Kiribati Provident Fund (KPF) and note that this is under active consideration. Policy initiatives in these areas will aim to strengthen the resilience of these institutions while, at the same time, continuing to improve the population's access to finance. The latter is especially important as financial development in Kiribati significantly lags behind that in similar countries. Any expansion of the DBK into commercial banking will only be done after careful analysis. Likewise, the authorities intend to approach PFTAC for technical assistance on KPF investment policies and operations, noting that 'crediting rates' provided to KPF members have fallen over time and are subject to periodic review.

Private Sector Development

The authorities recognize that encouraging growth in the private sector is vital. To facilitate this, the Government finalized a Private Sector Development Strategy in 2015. This strategy focused on creating an enabling environment for the private sector as well as generating business opportunities for small-, micro-, and medium-enterprises. This, in turn, is supported through actions ranging from improving infrastructure and the availability of capital to updating business registration processes. These tasks remain important today and, as such, the authorities plan to review progress and update this strategy where gaps are found. On land registration, this is a long running challenge for both Kiribati and other Pacific countries given the customary land system.

Longer term, improved educational outcomes are a key plank of the new Government's plan to help private sector growth. The new strategic plan for the education sector – itself coming out of the recently released 2016-19 Development Plan – will allow students to better capitalize on employment opportunities both domestically and overseas, through improving both the quality of teaching and infrastructure. This has been developed with considerable input from Kiribati's development partners and intensive business community involvement to help ensure that students are best suited to workforce. Beyond this, the authorities are working with Australia and New Zealand to increase both temporary and permanent opportunities for i-Kiribati workers.