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REPUBLIC OF NAURU

November 2023

2023 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR REPUBLIC OF NAURU

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2023 Article IV consultation with Republic of Nauru, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its November 17, 2023 consideration of the staff report that concluded the Article IV consultation with Republic of Nauru.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on November 17, 2023, following discussions that ended on September 14, 2023, with the officials of Republic of Nauru on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 2, 2023.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Statement** updating information on recent developments.
- A **Statement by the Executive Director** for Republic of Nauru.

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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PRESS RELEASE

PR23/410

IMF Executive Board Concludes 2023 Article IV Consultation with Nauru

FOR IMMEDIATE RELEASE

Washington, DC – **November 28, 2023:** The Executive Board of the International Monetary Fund (IMF) concluded the 2023 Article IV consultation[1] with Republic of Nauru.

Growth moderated recently due to a scale down of the Regional Processing Center (RPC). Real GDP growth is estimated at 0.6 percent in FY2023, reflecting weaker demand and service-related trade. Inflation rose amid external shocks and escalating transportation costs, reaching 6.3 percent in FY2023. The fiscal surplus declined due to a reduction in RPC-related activities but remained sizable. The fiscal balance excluding the government's contribution to the Nauru Trust Fund (NTF) was at 8.3 percent of GDP in FY2023, with debt assessed to be sustainable under current policies. The external position is assessed to be moderately weaker than the level implied by fundamentals and desirable policies in FY2022.

Growth and inflation are expected to moderate over the medium term. Given the importance of the RPC in generating fiscal revenues and employment, its planned scale down is expected to adversely affect economic activity and fiscal and external positions over the medium term. However, diversification opportunities from the climate-resilient port and the construction of the fiber-optic cable are expected to provide some offset. Inflation is expected to slow as a result of lower global inflation and a tightening of monetary policy in Australia. The fiscal surplus is expected to decline this year and narrow significantly over the medium term.

Risks to the economic outlook are tilted to the downside. Deepening geo-economic fragmentation and an abrupt global slowdown could affect Nauru's trading partners and donors. Higher commodity prices could put upward pressure on inflation and fiscal spending. Continued pressure on financial services could disrupt national and international payments, affecting essential economic activities. Delayed fiscal and structural reforms could lead to an overdependence on volatile sources of revenues, jeopardizing fiscal sustainability. Uncertainties related to activities of the RPC pose risks to the medium-term economic and fiscal outlook. Similar to other pacific island countries (PICs), Nauru remains vulnerable to extreme climate events. Upside risks include an unexpected extension of RPC activities and increased demand for fishing licenses.

Executive Board Assessment[2]

Executive Directors noted that growth is expected to moderate over the medium term and risks are tilted to the downside. Against this background, Directors underscored the

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[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.

[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.

importance of structural and fiscal reforms, supported by capacity development, to promote diversification, sustainable growth, and climate resilience, particularly in the context of the planned scale-down of the Regional Processing Centre.

Directors concurred that fiscal policy should be anchored by fiscal discipline, revenue mobilization, and expenditure prioritization. They stressed that maintaining sufficient fiscal surplus to meet the target value of the Nauru Trust Fund will be key to supporting long-term growth and resilience. Directors agreed that tax reforms anchored in strong policy commitment and public support are needed to generate more sustainable sources of revenue. They emphasized that expenditure policies should prioritize spending that promotes growth, resilience, and inclusion.

Directors encouraged the authorities to further strengthen the AML/CFT framework, in line with recommendations from the FATF and the ongoing APG Mutual Evaluation. Noting the planned exit from the country of the only institution providing financial services and access to cross-border payments, they underscored the importance of close cooperation with foreign counterparts to facilitate the participation of new regional financial services providers in Nauru. Directors agreed that both market and non-market solutions are needed to improve access to formal financial services and emphasized the importance of addressing infrastructure gaps that constrain the use of digital payments.

Directors concurred that structural reforms to improve human capital, climate resilience, diversification, and governance are essential for Nauru’s long-term growth. They emphasized that education spending should prioritize improving participation and outcomes. Directors agreed that a detailed costing of priority projects would be critical for allowing a more strategic pursuit of climate finance. They noted that the completion of the new climate-resilient port and the undersea cable are expected to bring new sources of growth and employment opportunities.

Directors agreed that data shortcomings remain prevalent and continued efforts to enhance statistics, with adequate support from development partners, are needed.

Table 1. Nauru: Selected Economic Indicators, FY2021-25 1/

Nominal GDP (AU$ million, FY2023)	154.0	Human capital index (scale 0-1, 2020)	0.51
Per capita GDP (AU$, FY2023)	12,040	Infant mortality rate (per 1000 live births, 2021)	23.2
Population (FY2023)	12787	Poverty rate at $6.85 a day (2017 PPP, 2012)	61.7

	FY2021	FY2022	FY2023	FY2024	FY2025
			Est.	Proj.	
Real sector					
Real GDP growth (percent change)	7.2	2.8	0.6	1.4	1.2
Consumer price index (period average, percent change)	1.1	3.6	6.3	5.3	4.1
Population (thousand)	12.3	12.5	12.8	13.0	13.3
Structure of the economy					
Agriculture	3.2	3.2	3.2	3.3	3.6
Manufacturing	14.3	15.6	16.6	15.0	14.7
Services	74.6	71.4	72.1	74.0	74.0
Government finance (in percent of GDP)					
Total revenue and grants	137.4	158.3	135.3	128.9	95.6
Revenue	103.9	138.5	119.5	100.0	77.3
Grants 2/	33.6	19.8	15.9	28.9	18.3
Total expenditure	93.0	133.5	116.2	115.2	88.8
Net lending (+) / borrowing (-)	44.5	24.8	19.1	13.6	6.8
Excluding Trust Fund contribution	30.2	12.6	8.3	6.0	1.2
Stock of government deposits 3/	32.2	46.2	49.4	47.6	43.5
Stock of Trust Fund	81.3	111.5	122.4	131.0	144.2
Balance of payments					
Current account balance	8.9	-1.1	7.9	13.0	-2.5
(In percent of GDP)	3.8	-0.5	3.4	5.2	-0.9
Capital account balance	85.1	53.6	38.1	69.2	44.8
Financial accounts balance and other flows	111.8	60.7	46.0	82.2	42.3
Government debt indicators					
External debt 4/	9.3	25.8	26.2	38.7	35.1
(In percent of GDP)	3.9	12.2	11.5	15.6	13.5
Domestic debt 5/	39.0	21.1	19.9	18.9	17.9
(In percent of GDP)	16.6	10.0	8.7	7.6	6.9
External debt service 6/	0.8	0.8	5.7	6.4	6.8
(In percent of exports of goods and services)	1.1	0.7	5.6	6.6	6.3
Exchange rates					
Australian dollar per U.S. dollar (period average)	1.34	1.38	1.48	…	…
Nominal GDP (in millions of Australian dollars)	235.5	212.0	228.6	248.6	259.8
Nominal GNI (in millions of Australian dollars)	353.8	346.5	389.4	449.7	410.4
Nominal GDP per capita (in US dollars)	14,303	12,269	12,040	…	…

Sources: Nauru authorities and IMF staff estimates and projections.

1/ Nauru uses the Australian dollar as the legal tender, and the fiscal year ends in June. The revised growth statistics is scheduled to be published in January 2024.

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

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

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

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

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

INTERNATIONAL MONETARY FUND

REPUBLIC OF NAURU

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION

November 2, 2023

KEY ISSUES

Context. Nauru faces structural challenges due to its small size and remoteness, and is highly dependent on imports. The narrow revenue base comprises fishing license fees, residual phosphate processing, and revenue from the Regional Processing Center (RPC). Nauru is vulnerable to the negative effects of climate change, as the population inhabit in a narrow coastal area. The health and economic impact of the pandemic has been limited in Nauru, thanks to successful vaccination and containment strategies.

Outlook and risks: Growth is expected to moderate over the medium term due to the planned scale-down of the RPC. Risks to the outlook are tilted to the downside, stemming from continued pressure on financial services, delayed fiscal and structural reforms, and the uncertain future of the RPC. Nauru remains vulnerable to external shocks such as a rise in commodity prices, a sharp global slowdown, and climate change.

Main Policy Recommendations:

- **Fiscal** policy should continue to be anchored by the government's commitment to fiscal discipline. Revenue mobilization is warranted to generate more sustainable sources of revenue to offset the revenue losses from the scale-down of the RPC. Expenditure policies should prioritize spending that promotes growth, resilience, and inclusion, such as improving the efficiency of health and education spending and more targeted and progressive subsidies.

- **Financial sector** policy should continue to strengthen the AML/CFT framework and to improve Nauru's access to formal financial services. Implementing the recommended actions from the 2023 APG Mutual Evaluation could further improve the AML/CFT framework. Close cooperation with foreign counterparts to facilitate the participation of financial services providers in Nauru is crucial. Infrastructure gaps that constrain the use of digital payments would also need to be properly addressed.

- **Structural** policies should improve human capital, climate resilience, diversification, and governance. Education spending should prioritize improving enrollment and attendance rates. A detail costing of priority projects would be critical in allowing a more strategic pursuit of climate finance. Increasing diversification through the new climate-resilient port and digitalization, and addressing remaining corruption vulnerabilities could support Nauru's long-term growth.

Approved By
Nada Choueiri (APD) and Fabian Bornhorst (SPR)

Discussions took place in Nauru during September 1-14, 2023. The mission team comprised TengTeng Xu (head), Yue Zhou and Seruwaia Cagilaba (all APD), and Dannah Al-Jarbou (SEC). Chris Becker (OED) joined the mission. Neil Saker (Resident Representative, Fiji) and Samuel Wills (World Bank) participated in some meetings. Richard Berkhout, Heena Gupta (both LEG) and Jennifer Elliott (MCM) attended some of the technical meetings virtually. The mission met with Minister of Finance Martin Hunt, other senior government officials, representatives from the private sector, state-owned enterprises, development partners, and representatives of AUSTRAC and the Australian High Commission to Nauru. Shikha Rao, Connor Kinsella, To-Nhu Dao, Ricardo Pinto Davido, and Vyshnavi Thumbala Saikrishnan (all APD) contributed to the preparation of this report.

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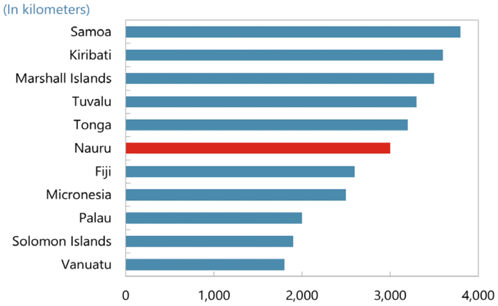
CONTEXT

1. Nauru faces structural challenges due to its small size and remoteness. Nauru is located in the south Pacific Ocean with approximately 21 square kilometers of land and a population of 12,000. Its geographical isolation and small size make Nauru dependent on imports and vulnerable to external shocks. A narrow and volatile revenue base comprises fishing license fees, residual phosphate processing revenue, and revenue from the Regional Processing Center (RPC)[1], which is being scaled down. Phosphate mining has resulted in widespread land degradation, forcing the population to inhabit in a narrow coastal area, thereby increasing their vulnerability to climate change.

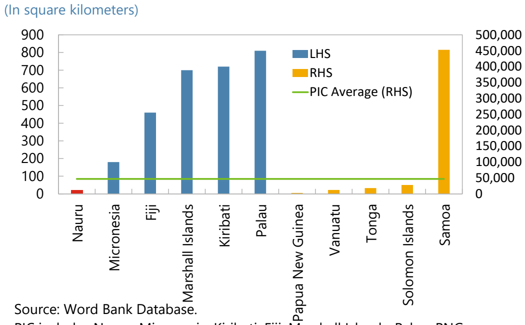
Nauru: Structural Challenges to Growth

Distance to the Nearest Continent
(In kilometers)



Sources: Google Earth and IMF staff estimates.

Total Land Area
(In square kilometers)



Source: Word Bank Database.
PIC includes Nauru, Micronesia, Kiribati, Fiji, Marshall Islands, Palau, PNG, Vanuatu, Tonga, Solomon Islands, and Samoa.

2. The health and economic impact of the pandemic has been limited, thanks to successful vaccination and containment strategies. Decisive containment measures, including border closure, quarantine protocols, the expansion of care capacity, and sizable fiscal support, have saved lives and sustained economic growth at the pre-pandemic level (Figure 1).

RECENT DEVELOPMENTS

3. Growth moderated recently due to a scale down of RPC activities. The economy expanded by 2.8 percent in fiscal year[2] (FY) 2022 as strong phosphate production and sizable fiscal support to households and State Owned Enterprises (SOEs)[3] partially offset a weaker transportation sector hit by COVID-related restrictions and rising fuel prices. Real GDP growth is estimated at 0.6 percent in FY2023 as the RPC continued to scale down, leading to weaker demand and service-related trade. Nauru's GDP series were rebased to reflect the latest industrial structure (Box 1).

[1] Australia established a regional processing center in Nauru (in September 2012) for the purpose of processing asylum seekers' international protection claims.

[2] FY2022 runs from July 2021 to June 2022.

[3] Fiscal support to households included expenditure on quarantine facilities, vaccines, protective personal equipments, and stimulus payments to government employees. For SOEs, cash support to Nauru Airlines and Nauru Shipping Lines ensured reliable transportation of food and fuel.

Box 1. Rebasing of Nauru's Gross Domestic Product[1]

Nauru's real GDP series has been rebased in 2021, with the support of IMF capacity development. The base year used for real GDP compilation has been updated to FY2013, using the results of the 2012/13 Household Income and Expenditure Survey (HIES). The HIES represents an important source for economic statistics as it provides information about the informal economy and is used to estimate the consumption structure of households needed to compile a Consumer Price Index (CPI). Prior to this rebasing, Nauru's GDP was based on constant 2006/07 prices, meaning that weights for deriving price-adjusted GDP were based on a decade old industrial structure. The FY2013 rebasing was achieved with the technical support of the Pacific Financial Technical Assistance Center (PFTAC), which has also been regularly assisting the Nauru Bureau of Statistics in compiling annual GDP series, including for FY2019 and FY2020 (the first two years compiled under the FY2013 base). The rebased GDP series was published in the April 2023 release of the IMF's *World Economic Outlook* database.

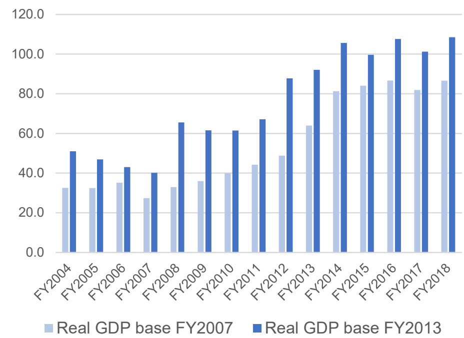
The improved data sources and extrapolation methods have led to a higher real GDP under the new base (Figure 1). The HIES 2012/13 was met with a much higher response rate (74 percent, against 54 percent in the HIES 2006/07), making it more representative – it ultimately covered close to 30 percent of Nauruan households, an effective sample size for the purpose of the survey. The design of the survey was also improved and extrapolation indicators were enhanced with the support of PFTAC. Following these methodological improvements, Figure 1 shows that real GDP is on average 40 percent higher under the FY2013 base than under the FY2007 base over the FY2004–2018 period. The rebasing and re-benchmarking of Nauru's national accounts also led to a slight downward revision of nominal GDP of a few percentage points (-1 percent on average), by applying revised price weights to volume's data.

The sectoral composition of real GDP has been affected by the rebasing, due to changes in the industrial structure reflected in the new HIES (Figure 2). While the weight of the primary sector in FY2018 was unchanged under the new FY2013 base, the weight of the secondary sector increased, driven by an expansion of manufacturing (secondary phosphate production) and construction sectors. At the same time, the size of the tertiary sector, most notably finance, business and public services, declined.

A future rebasing will be needed to take advantage of the forthcoming HIES. It is a good practice to carry out a new household survey every five years or so, as the basis to update the compilation and extrapolation of real GDP. A new HIES was initially planned for FY2022 but postponed to FY2024/2025. To maintain the meaningfulness and the representativeness of real sector statistics, another rebasing should be carried out soon afterwards, with PFTAC's technical support. Until then, the Nauru Bureau of Statistics plans to begin publishing its own series of biannual National Accounts Bulletins in January 2024. The launch publication will reflect data sources that have become available since the FY2023 rebasing; most importantly data from Treasury's financial management system.

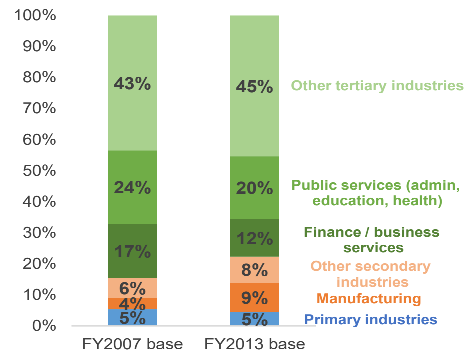
Box 1. Rebasing of Nauru's Gross Domestic Product (concluded)

Real GDP: Historical Series (In million AUD)



Source: PFTAC TA reports and IMF staff estimates.

Real GDP: Sectoral Composition
(FY2018; in percent)



[1] Prepared by Fabien Gonguet (APD).

4. Inflation rose amid external shocks and escalating transportation costs. Nauru's inflation is largely driven by external developments due to its heavy reliance on imports of essential products and the use of the Australian dollar as legal tender.[4] Average inflation increased to 3.6 percent in FY2022, driven by higher international food and fuel prices. While food and fuel costs receded in FY2023, persistent inflation in Nauru's trading partners and the reduction of transportation subsidies pushed inflation higher to 6.3 percent.

5. The fiscal surplus declined but remained sizable. Tax revenue declined as a reduction in RPC-related activities led to lower import duty and non-resident tax withholding.[5] On non-tax revenue, however, Nauru received higher-than-expected RPC revenues in FY2023 due to an extension of RPC operations at limited capacity, while fishing license fees moderated slightly (Figure 2). The fiscal balance excluding the government's contribution to the Nauru Trust Fund (NTF) was at 8.3 percent of GDP in FY2023.

6. Nauru's external position was moderately weaker than the level implied by fundamentals and desirable policies in FY2022 (Annex I). Rising imports, driven by high transportation costs, led to a current account balance (CAB) of -0.5 percent of GDP in FY2022. The reserve coverage is equivalent to 3.5 months of import in FY2022, above the reserve adequacy ratio of 2.8 months, but it is expected to decline over the medium term. Improving government spending

[4] However, the correlation of inflation between Nauru and Australia was only 0.25 from 2001Q2 to 2021Q4.

[5] Non-resident tax witholdings are mainly attributed to expatriate workers at the RPC.

efficiency, mobilizing domestic revenue, and continued compliance with fiscal discipline[6] are warranted to improve the external position.

7. Staff has been informed that Bendigo Bank Agency has decided to withdraw its operations from Nauru. The exit is not public information and is planned for a date to be confirmed. The exit would lead to a complete loss of banking services in Nauru and disrupt national and international payments, thereby limiting access to essential imports. The authorities, with the active support of the Australian government, are approaching other banks in Australia and the Pacific region to identify a replacement, and a contingency plan to address liquidity needs of Nauruan depositors is under discussion. Staff has worked with the authorities to provide advice on AML/CFT issues to improve its system, mitigate risks, and perceived jurisdictional risk perceptions, and on financial sector contingency planning to prevent a disorderly exit and is supporting the authorities' efforts for continued provision of financial services through engagement with the Australian government.

OUTLOOK AND RISKS

8. Growth is expected to moderate over the medium term. Growth is projected at 1.4 percent in FY2024, as an increase in wholesale and retail trade financed by RPC revenues offsets lower growth in transportation from a delay in the completion of the port. Notwithstanding higher RPC revenues this year, the planned scale-down of the RPC over the next few years is expected to adversely affect economic activity over the medium term, given the RPC's importance in generating fiscal revenue and employment (Box 2). Nevertheless, diversification opportunities from the climate resilient port (¶26), the fiber-optic cable, and the Alternative Pathways Program to retrain and reskill displaced RPC workers are expected to provide some offset. Inflation is expected to slow to 5.3 percent in FY2024, consistent with lower global inflation and a tightening of monetary policy in Australia. The CAB is expected to temporarily improve in FY2024 due to inflows associated with the RPC before worsening over the medium term as RPC revenues decline.

9. The fiscal surplus is expected to decline this year and narrow significantly over the medium term. The fiscal surplus excluding the government's contributions to the NTF is projected to moderate to 6 percent of GDP in FY2024, as RPC revenues partially offset a decline in other revenues. Current expenditure is projected to fall slightly with the withdrawal of Covid-related fiscal support but total expenditure is expected to pick up. The weaker-than-warranted fiscal balance poses a significant challenge to ensuring medium-term fiscal sustainability and building fiscal buffers against a sharp decline in RPC revenues. Over the medium term, the fiscal balance is expected to deteriorate significantly due to the scale-down of the RPC.

[6] The three fiscal responsibility ratios are: (i) the fiscal balance must be non-negative; (ii) personnel costs must be less than 30 percent of current expenditures; and (iii) the fiscal cash buffer must be equal to at least two months of non-RPC expenditure. The Memorandum of Understanding of the NTF require a contribution of 10 to 12 percent of domestic revenue when revenue is greater than AUD 100 million.

10. Nauru's debt is assessed to be sustainable under current policies (Annex II). Debt is estimated at 20.2 percent of GDP in FY2023.[7] The resolution of Nauru's external debt to Firebird (a global fund manager) in 2021 and sustained fiscal surplus in past years significantly reduced Nauru's debt vulnerability. However, the dependence on volatile non-tax revenues and donor grants underscores the importance of maintaining fiscal discipline to maintain debt sustainability.

Box 2. The Scale Down of the RPC and the Potential Impact[1]

The RPC, an important source of fiscal revenue and a major employer in the Nauruan economy, is expected to be phased out in coming years. The RPC entered the "Enduring Capability" phase in July 2023. While the Australian government will provide hosting fees and reimburse its operational costs to maintain physical presence of the RPC for potential future use, the prospects for RPC revenues beyond FY2026 remain unclear. Furthermore, the RPC employed more than 15 percent of the labor force in the past ten years, and these jobs would be at risk with the scale down.

The uncertainty over the RPC poses risks to Nauru's medium-term economic outlook, weighing on both revenue and employment.

- **Non-tax revenue**. RPC revenues, composed of hosting fees, reimbursable costs, service fees, and DJBC operation costs, is AUD 160 million in FY2024, and will decrease to AUD 100 million and AUD 95 million in FY2025 and FY2026, respectively. The baseline assumes that RPC revenues will decline further after FY2026.

- **Tax Revenue**. Business profit taxes from RPC activities and non-resident withholding taxes from expatriate workers will shrink by more than 80 percent in FY2024 and stabilize at a lower level. Business profit taxes apply to companies and individuals conducting large businesses and are mainly derived from RPC-related activities. Non-resident tax witholdings are mainly attributed to expatriate workers at the RPC.

- **Employment**. The scale-down of the RPC is expected to affect 800 workers (20 percent of working age population). The Nauruan authorities announced an Alternative Pathways Program to retrain and reskill displaced workers with the support of the Australian government, including reemployment opportunities in Nauru and through international labor mobility schemes.

[1] Prepared by Yue Zhou (APD).

11. Risks to the outlook are tilted to the downside (Annex III). Deepening geo-economic fragmentation and an abrupt global slowdown could affect Nauru's trading partners and donors. Higher commodity prices could put upward pressure on inflation and fiscal spending. Continued pressure on financial services could disrupt national and international payments, affecting essential economic activities. Delayed fiscal and structural reforms could lead to an overdependence on volatile sources of revenues, jeopardizing fiscal sustainability. Uncertainties related to activities of the RPC pose risks to the medium-term economic and fiscal outlook. Similar to other pacific island

[7] One third of Nauru's debt was domestic (related to the liquidation of the Bank of Nauru) and the rest was external.

countries (PICs), Nauru remains vulnerable to extreme climate events. Upside risks include an unexpected extension of RPC activities and increased demand for fishing licenses.

Authorities' Views

12. The authorities broadly concurred with staff's assessment on the economic outlook and risks. They acknowledged that the scale-down of the RPC would significantly affect growth, employment, fiscal and external positions, given the importance of the RPC in the Nauruan economy. While uncertainties related to the RPC pose substantial downside risks over the medium term, the authorities are optimistic that the climate-resilient port and the fiber-optic cable might provide some offset to support growth and create employment. The authorities are preparing a foreign direct investment bill to attract investment and to promote trade within the region, to boost potential growth. They considered that RPC-related risks outweigh risks of a global slowdown as Nauru is highly dependent on the RPC, while the exposure to the global economy is limited to a few trading partners. Furthermore, the authorities acknowledged the risks of further pressure on financial services, which could have significant macroeconomic impact.

POLICIES TO BUILD RESILIENCE AND ACHIEVE SUSTAINABLE GROWTH

Discussions focused on policies to build resilience and achieve sustainable growth. Staff recommended: (i) maintaining fiscal discipline, strenthening revenue mobilization, and improving expenditure efficiency; (ii) continuing to strengthen the AML/CFT framework and improving access to formal financial services; (iii) structural reforms to improve human capital and achieve Sustainable Development Goals (SDGs), strengthen climate resilience, increase diversification, and improve governance.

A. Fiscal Policies

13. Fiscal policy should continue to be anchored by the government's commitment to fiscal discipline. Nauru's fiscal framework includes three fiscal responsibility ratios and a supplemental requirement for the government to contribute to the NTF (Box 3). The authorities broadly complied with the fiscal responsibility ratios during the pandemic. Maintaining sufficient fiscal surplus to finance the government's contribution to the NTF will be key to achieving its target value of AUD 700 million by 2033.

14. Revenue mobilization is warranted to generate more sustainable sources of revenue. In the *short* term, the authorities should consider: (i) removing discretionary exemptions in import duties and ultimately replacing import duties with excise duties in a revenue neutral manner[8]; and (ii)

[8] Eliminating import duties is consistent with the PACER Plus Agreement, which is a free trade agreement that entered into force for some PICs in December 2020. New Zealand, Australia, Samoa, Tuvalu, Kiribati, Tonga, Solomon Islands, Niue, Vanuatu and Cook Islands are Parties to the Agreement. Nauru has signed but not ratified the PACER Plus. Once ratified, Nauru will have until 2042 to reduce most tariffs to zero. Nauru will liberalize tariffs on 93 percent of Australian exports. Most tariff reductions will take place before 2027.

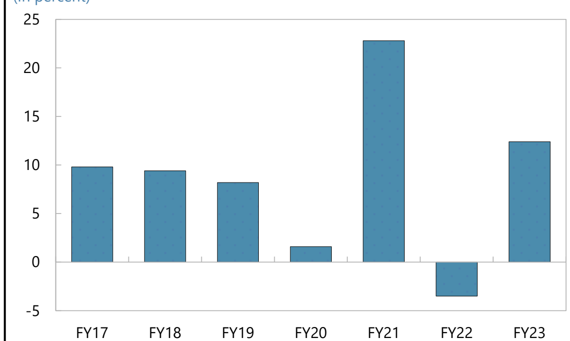
improving the progressivity of the personal income tax and reducing exemptions in the corporate income tax.[9] In the *medium* term, further revenue administration measures should be implemented, such as revenue risk management, audits, regular review of excise rates, and digitalizing tax administration. Over the *long* term, the authorities could consider introducing a value added tax—a good sustainable source of revenue (Annex IV). In addition, policy commitment and public support are key to the success of tax reforms.

Box 3. An Update on Nauru's Intergenerational Trust Fund[1]

The Intergenerational Trust Fund of Nauru (NTF) was established as a perpetual fund in 2015.[2] The primary objective of the NTF is to generate future revenues for the Government of Nauru (GoN) to invest in education, health, environment, and infrastructure after 2033. The NTF is expected to play a crucial role in supplementing volatile government revenues over the medium term, as revenues associated with phosphate mining and the Regional Processing Center (RPC) are projected to decline.

The multi-year return of the NTF remains on target. In FY2023, the nominal return of the NTF was 12.4 percent, with a real return of 5.4 percent (using Australia inflation rate). The overall real investment returns since April 2016 stood at 5.4 percent, above the performance objective of achieving a real return of 4.5 percent.[3]

Nominal Annual Returns on the Nauru Trust Fund
(In percent)



Source: Nauru Intergenerational Trust Fund Annual Reports.

The market value of the NTF continued to grow, thanks in part to contributions from the GoN and its development partners. The total market value of NTF's investment reached AUD 296.2 million at the end of FY2023, of which, about AUD 30.6 million can be attributed to cash contributions from the GoN and donors during the fiscal year. The GoN is required to contribute 10 to 12 percent of domestic revenue to the NTF when domestic revenue is greater than AUD 100 million under the Memorandum of Understanding (MOU) with donors. These contributions are crucial for the NTF to achieve its target of AUD 700 million by 2033.

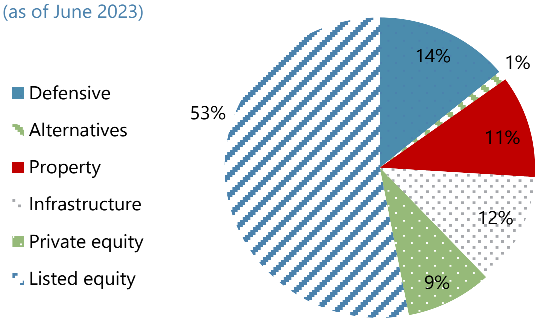
On asset allocation, the NTF has continued its diversification strategy into growth assets. The NTF has continued the transition to the 85/15 strategy[4] through the buildup of growth assets such as private equity, infrastructure, and private debt. By the end of FY2023, growth assets comprised more than 80 percent of NTF's investment portfolio, including 27.9 percent in international equity assets and 28.4 percent in Australian equity assets. Assets remained largely liquid with two thirds of investment in liquid assets.

Sound and effective governance are crucial for the future of the NTF. The MOU between contributing parties and the GON are core documents for the governance of the NTF and have been published. The NTF also submitted Financial Reports for FY2022 to improve the monitoring of its assets and performance by the public.

[9] Cross-country analysis shows that eliminating tax exemptions of custom duty, excise taxes, and corporate taxes could raise revenue by 4-6 percent of GDP in some PIC countries. Personal income taxes account for around 30 percent of total tax revenues in PIC countries in 2020 (Sy et al. 2022).

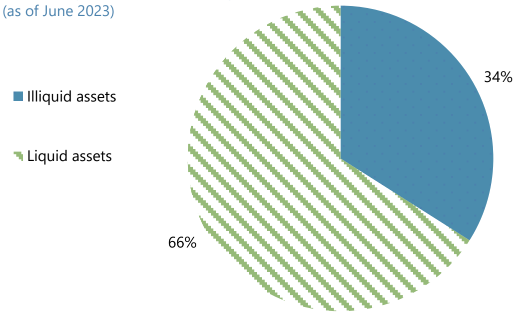
Box 3. An Update on Nauru's Intergenerational Trust Fund (concluded)

Asset Allocation of the Nauru Trust Fund
(as of June 2023)



Source. Nauru Intergenerational Trust Fund Annual Report, 2023

Liquidity of NTF Holdings
(as of June 2023)



Source. Nauru Intergenerational Trust Fund Annual Report, 2023.
Notes. Classification of assets by liquidity is done in the source. Illiquid assets represent holdings in infrastructure, direct property and private equity.

[1] Prepared by Yue Zhou (APD) and Dannah Al-Jarbou (SEC).
[2] A perpetual fund means that annual distributions are less than the annual estimated investment returns over the long run.
[3] See Annual Report of the Intergenerational Trust Fund (2021) and IMF Country Report No. 22/28.
[4] The 85/15 investment strategy refers to allocating 85 percent to growth assets and 15 percent to defensive assets.

15. Expenditure policies should prioritize spending that promotes growth, resilience, and inclusion. This requires improving the efficiency of current spending through enhanced public financial management (PFM) such as formalizing the fiscal responsibility ratios in a rules-based framework, improving health and education spending efficiency and improving the targeting and progressivity of subsidies. Specifically, the authorities are encouraged to formalize the fiscal responsibility ratios with a well-designed fiscal rule, with well-calibrated rule limits, and the provisions of well-designed escape clauses and correction mechanisms to manage large, unexpected shocks and breaches from rule limits. The authorities should conduct a careful review of SOE subsidies and grants to increase the efficiency of government spending, and adopt digital technologies to promote remote access to education and healthcare services abroad.

Authorities' Views

16. The authorities agreed with the importance of revenue mobilization and expenditure rationalization, but noted the challenges with raising taxes. They acknowledged that revenue and expenditure measures are required to offset the decline in RPC revenues. They identified non-essential spending items such as some payments for official business travel, subsidies to SOEs, and local donations as possible areas for expenditure reductions in their internal scenario analysis. On revenue mobilization measures, they analyzed options to lower the thresholds of personal income tax and to reduce or remove exemptions in corporate income tax, but emphasized that tax collection is a politically sensitive issue in Nauru. On revenue administration measures, a newly launched T.I.N[10] database and a proposed ADB-funded Small State IT Solution project[11] are expected to improve the efficiency of tax administration through digitalization. On fiscal responsibility ratios, the authorities noted that they worked well during the pandemic without being formalized. Finally, on PACER Plus, they considered that the fiscal cost of ratifying the agreement could outweigh its benefits, unless domestic tariff imposition completely offsets the potential revenue loss from eliminating import duties (which are one of just a few sources of revenue).

B. Financial Sector Policies

17. Nauru has limited financial services and cross-border payment facilities. Nauru has only one agency of an Australian bank, Bendigo Bank Agency, which provides financial services and access to cross-border payments indirectly via Bendigo Bank Australia. Cross-border payments remain limited[12] and costly largely due to the relatively small size of the financial sector, population, and economy. Currently, Nauru is unable to access correspondent banking transactions in US dollar, Euro, British Pound, and Fiji dollar through Bendigo Bank Australia. The lack of correspondent banking relations (CBRs) in major currencies makes foreign currency transactions more costly, limits Nauru's access to the international financial system, and may complicate some debt repayments and the receipt of donor aid and grants. Factors that have contributed to limited financial services in Nauru include changing business model of foreign banks, limited business opportunities for banks, and relatively high costs of banking operations. Perceived legacy issues continue to pose challenges in assessing correspondent banking services. A further restriction of financial services could have a significant economic and financial impact, limiting Nauru's access to essential imports and foreign inflows and affecting the domestic production of electricity and water due to its dependency on imported fuels.

18. Efforts to improve the AML/CFT legal framework are ongoing. Nauru passed the Beneficial Ownership Act in 2017, and subsequently passed a new Anti-Money Laundering and Targeted Financial Sanctions Act in June 2023, with support from the Asia Pacific Group on Money Laundering (APG). The APG's mutual evaluation for Nauru is ongoing, and the APG's report is scheduled for adoption in July 2024. Strengthening the AML/CFT system is important not only for enhancing access to CBRs but also for bolstering Nauru's overall financial integrity and resilience. Aligning with FATF recommendations can lead to better technical compliance ratings in the ongoing APG assessment, and thereby contribute to alleviating legacy compliance perceptions. Since the mutual evaluation will be published, this should also demonstrate the commitment of the authorities.The authorities indicated that they plan to update a national risk assessment (NRA). A

[10] The Taxpayer Identification Number (T.I.N) is a unique tax identification number assigned by the Nauru Revenue Office to individuals and businesses that are registered for tax purposes.

[11] The proposed ADB funded Small State IT Solution project will involve a review of the legal, regulatory, and institutional framework of Nauru's tax administration, and develop technical and policy advice and recommendations based on best international practices.

[12] Apart from Bendigo Bank Agency, cross-border payments services are also provided by an agent of Western Union in Nauru, with a current daily limit of AUD 7,500 for both businesses and households.

well-conducted NRA that is in line with FATF guidance can bolster understanding of ML/TF risks in Nauru, guide informed decisions, and strengthen the financial sector's integrity and resilience.

19. Staff supports ongoing measures to improve Nauru's access to formal financial services and recommends further actions (Annex V). The authorities are encouraged to implement the recommended actions that are expected from the mutual evaluation. Staff supports the provision of financial sector services by regional financial institutions that are effectively regulated and supervised by their home jurisdiction, backed by strong bilateral cooperation between the Nauruan authorities and their overseas counterparts.[13] The authorities are encouraged to consider both market and non-market solutions to improve Nauru's access to financial services, drawing on lessons from other PICs.[14] On market solutions, advancing structural reforms with better access to internet and land can help improve the business climate and general opportunities for banks to intermediate transactions. For non-market solutions, the public sector could play a more active role including providing carefully designed subsidies to facilitate CBRs. Digital financial innovations, if appropriately designed and managed, could provide a durable and safe solution to financial sector challenges, by providing greater access and financial inclusion. Infrastructure gaps that constrain the use of digital payments would also need to be properly addressed, for example, through the planned undersea fiber-optic cable project. At the regional level, more proactive discussions and concerted actions are needed to identify solutions to financial sector pressures in PICs.

Authorities' Views

20. The authorities reiterated their strong commitment and ongoing efforts to further strengthen the AML/CFT framework and improve access to formal financial services. They noted that the new Anti-Money Laundering and Targeted Financial Sanctions Act 2023 addressed gaps identified by the APG in 2018 and strengthened the independence of the NFIU. The authorities noted that the Act will progressively be implemented and enforced. In addition, further regulations have been and will be drafted to facilitate such implementation. They confirmed that NFIU will take a proactive role to work with all competent authorities. They viewed that the continued pressure on CBRs were largely driven by legacy issues. They emphasized the improvements in their AML/CFT framework over the past two decades. They reiterated the findings of the risk assessment conducted by Australian authorities that the ML/FT risk for remittances from Australia to PICs is low, and findings of New Zealand authorities that the overall ML/FT inherent risk for New Zealand-to-Pacific remittance corridor is medium, and for transactions under $1000 it is low. The authorities highlighted that they recognize the importance of the APG mutual evaluation in addressing CBR pressures, and are using regional platforms such as APG and AUSTRAC to raise their CBR concerns.

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[13] Nauru's new Anti-Money Laundering and Targeted Financial Sanctions Act 2023 has provisions enabling certain exemptions from Nauru's AML/CFT framework to foreign financial institutions under certain conditions, for example, where such an entity is adequately regulated and supervised for AML/CFT in another country, or where there is a low-risk of financial crime. Australia's FIU and AML/CFT regulatory and supervisory authority (AUSTRAC) and the Nauru Financial Intelligence Unit (NFIU) continue to cooperate with respect to the provision of financial services by Bendigo Bank Agency in Nauru.

[14] See, for example, Vanuatu IMF Country Report No. 23/115.

They emphasized their commitment to cooperating with foreign counterparts to facilitate the participation of financial services providers in Nauru, and to improve access to formal financial services.

C. Structural Reforms

Improve Human Capital to Help Achieve The SDGs

21. **Despite the authorities' significant efforts, challenges in raising school enrollment, attendance rates, and the teacher-to-student ratio remain.** With 60 percent of the population under 25, around 35 percent of the population in Nauru is of school age but the school enrollment rate and the teacher-to-student ratio are below world average. Furthermore, attendance rates in primary and secondary schools are low. To improve education outcomes, the authorities introduced initiatives to offer free school lunches, cash rewards for school attendance, teacher training on literacy and numeracy, and curriculum review. Nauru has also partnered with Australia to support its education sector through the Nauru Improved Education Initiative, the Nauru Health Support Program, and the Alternative Pathways Program.

22. **Nauru should improve the quality and efficiency of education expenditure to supplement its current efforts and help achieve the SDGs.** The amount of Nauru's education spending is estimated to be adequate, but the composition of the expenditure is geared toward capital and other recurrent spending (such as school rations and overseas scholarships) instead of teachers' salaries, compared with peers (Annex VI). To improve the teacher-to-student ratio and to raise the the enrollment and attendance rates, more resources should be allocated to teaching staff, through improved efficiency of existing capital and other recurrent expenditure. Hiring more teachers, investing in teachers' training and conducting a nationwide information campaign on the value of education could help raise school attendance, improve teaching quality, and achieve education SDGs. Furthermore, Nauru should continue to leverage the existing education programs with Australia to improve education outcomes.

Strengthen Climate Resilience

23. **Nauru has made further progress in climate adaptation and mitigation but long-term climate-related challenges remain**. Nauru is advancing its climate mitigation agenda through the development of solar farms. About 50 percent of electricity in Nauru will be generated by solar power by mid-2024, reducing its reliance on imported fuel. On adaptation, Nauru has been actively working with development partners to improve infrastructure and maritime connectivity through the construction of a new climate resilient port. The new port will provide a more reliable transportation link, increase trade and economic activity, and reduce Nauru's carbon footprint by 30 percent (Annex VII). However, long-term challenges remain as volatile weather patterns from global warming could affect the stock of tuna and rising sea levels could lead to coastal erosion.

24. **The authorities introduced initiatives to strengthen climate resilience through improved infrastructure to safeguard strategic assets**. The "Higher Ground Initiatives" program is

designed to fight climate change (specifically, the threat of rising sea levels) and environmental degradation, including rehabilitating households at risk from coastal erosion to higher elevation areas (Figure 3). The program is also envisaged to increase the energy efficiency of housing, public facilities, and agricultural production with priority focus on water, environment and food security.

25. Accelerating climate adaptation and mitigation could further enhance Nauru's resilience to climate change. Nauru has identified national adaptation priorities including at the sectoral level within its national adaptation plan RonAdapt, but needs a detailed costing of priority projects, which would allow a more strategic pursuit of climate finance. The costing should be integrated into the budget and medium-term framework, including provisions to support the new climate change unit.

Increase Diversification

26. Structural reforms to diversify the economy are crucial for Nauru's long-term development. The completion of the new port and related infrastructure could help bring new sources of growth and employment opportunities. For example, investing in refrigerated storage could develop domestic containerization (and potentially fish processing in due course) and generate additional government revenues. The new port could support the transit of container ships, potentially as a regional transportation hub. Increased participation in regional labor mobility schemes could help increase remittances, partly offsetting the employment losses from the RPC scale-down. Universal digital connectivity could improve labor force participation, enhance access to education and healthcare, strengthen social protection, and support Nauru's long-term growth potential (Annex VIII). A legal and regulatory framework that improves access to land is needed over time to attract private sector investment.

Improve Governance

27. Measures to address governance and corruption vulnerabilities are critical to achieving Nauru's medium-term growth and development objectives. Recent improvements to PFM, include a clearer fiscal strategy and better debt management, a formal debt management strategy, improved timeliness of in-year budget reports, further transparency of budget information, and better internal controls for non-salary expenditures. Building on this progress, the authorities should continue to strengthen fiscal governance (PFM controls), and the rule of law (protection of property and contractual rights). Addressing these governance weaknesses could improve efficiency in resource management, reduce vulnerabilities to corruption, and support growth.

28. The authorities should continue PFM reforms including for SOEs, following the IMF recommendations from the 2021 Article IV consultation (Annex IX):

- *Continue reforms to strengthen SOEs*: the capacity of SOEs to comply with the Public Enterprise Act and for the SOE monitoring unit to monitor compliance remain limited. The authorities should ensure that the SOE monitoring unit is well-staffed with the required technical expertise, and improve fiscal transparency and SOE auditing.

- *Improve procurement procedures in line with international standards*: Procurement processes, including the publication of procurement contracts and their awardees' beneficial ownership information remain non-public. The authorities' plan to review the procurement framework through ADB technical assistance.

- *Phase out the use of cash for taxation and other transactions*: Tax collections and business transactions are mostly digitized and tax administration will be fully digitized with the proposed ADB funded IT Small State Solution. The authorities should expedite plans to fully digitize tax administration to strengthen financial controls and reduce corruption risks.

29. The authorities should continue implementing the remaining key recommendations from the 2022 Public Expenditure and Financial Accountability Assessment (PEFA). These include: (i) improving the efficiency of public spending with a single supplementary budget linked to a mid-year review; (ii) enhancing the quality of the budget submission and the frequency of publishing budget-related information; (iii) enhancing public asset management; and (iv) improving internal and external audit. The authorities are encouraged to continue engaging PFTAC in technical assistance on revenue mobilization and PFM.

Authorities' Views

30. On structural reforms, the authorities broadly agreed with staff's recommendations to improve human capital, climate resilience, diversification, and governance.

- **Human capital:** they agreed that improving the efficiency of education spending should help improve enrollment and the teacher-to-student ratio. They also mentioned several structural barriers, including an undervaluation of education among parents, and relatively low salary for teachers compared with private sector and RPC-related occupations.

- **Climate resilience:** they confirmed that the completion of the ADB-financed solar farm is expected to significantly reduce reliance on imported fuel to generate electricity. They agreed that investing in battery storage could further strengthen the reliance on renewable energy, but noted the relatively high cost of batteries.

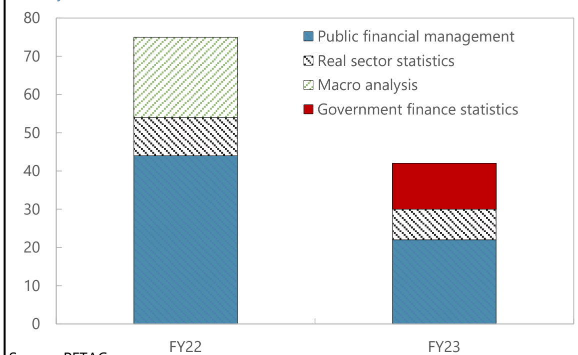
- **Diversification:** they agreed that the new port could bring diversification opportunities through domestic containerization and as a regional transportation hub. Nauru has signed an agreement with neighboring countries to support their freight transit. The participation in the Australia and New Zealand labor mobility schemes is expected to rise, after very low initial take-up, as workers affected by RPC scale-down are reskilled for opportunities in Australia, including in construction and age-related care.

- **Governance:** they agreed with the necessary steps to improve governance, including more frequent publication of budget related information, strengthened staffing capacity for internal and external audits, and improved procurement management framework. They broadly agreed that land reforms are needed to improve accessibility and to attract private sector investment over time.

D. Capacity Development

31. Continued efforts to enhance capacity in statistics are warranted. Capacity development (CD) in Nauru remains a challenge as the National Statistics Office and the Ministry of Finance Treasury Division are understaffed with limited capacity to collect and process data. Data shortcomings remain prevalent and prevent timely analysis of economic developments. IMF technical assistance plays a supplementary role for compiling government finance, real sector, and external sector statistics (Annex X). The resumption of in-person country visits has improved the quality of data provided by authorities. The Article IV mission coincided with a PFTAC technical assistance mission on real sector statistics to review and update Nauru's GDP. Resource constraints need to be addressed to develop a self-sustained compilation program for macroeconomic statistics. Authorities should establish domestic compilation of government finance statistics. The authorities are encouraged to leverage development partners' assistance to continue improving the quality and availability of statistics.

PFTAC Capacity Development in Nauru
(TA days)



Source: PFTAC.

Authorities' Views

32. The authorities appreciated the Fund's continued CD support and noted that progress in compiling macroeconomic statistics remains a priority. They appreciated the ongoing support from PFTAC and CDOT in compiling macroeconomic statistics and in PFM. The authorities expressed interest in receiving further technical assistance in the areas of tax audit compliance, procurement, fiscal and economic analysis, and fiscal risk assessment.

STAFF APPRAISAL

33. Growth and inflation are expected to moderate over the medium term. Given the importance of the RPC in generating fiscal revenues and employment, its planned scale-down is expected to adversely affect economic activity and fiscal and external positions over the medium term. However, diversification opportunities from the climate-resilient port and the construction of the fiber-optic cable are expected to provide some offset. Inflation is expected to slow as a result of lower global inflation and a tightening of monetary policy in Australia. The external position is assessed to be moderately weaker than the level implied by fundamentals and desirable policies. Risks to the economic outlook are tilted to the downside.

34. Fiscal policy should be anchored by fiscal discipline, revenue mobilization, and expenditure prioritization. Maintaining sufficient fiscal surplus to finance the government's contribution to the NTF will be key to achieving its target value and to supporting Nauru's long-term growth and resilience. Formalizing the fiscal responsibility ratios in a rules-based framework can further enhance the credibility of fiscal discipline. Revenue mobilization with policy commitment and public support is warranted to generate more sustainable sources of revenue and offset the revenue losses from the scale-down of the RPC. Expenditure policies should prioritize spending that promotes growth, resilience, and inclusion, such as improving the efficiency of health and education spending and improving the targeting and progressivity of subsidies.

35. Financial sector policy should continue to strengthen the AML/CFT framework in line with FATF recommendations and improve Nauru's access to formal financial services. Implementing the recommended actions from the APG Mutual Evaluation could further improve Nauru's AML/CFT framework. Close cooperation with foreign counterparts to facilitate the participation of regional financial services providers in Nauru is crucial for financial inclusion and access to formal financial services. Both market and non-market solutions are needed to improve access, by advancing structural reforms to improve the business climate and opportunities, and by considering carefully designed subsidies to provide CBRs, if needed. Carefully designed and managed digital financial innovations could help address financial sector challenges and improve financial inclusion. Infrastructure gaps that constrain the use of digital payments would also need to be properly addressed.

36. Structural reforms to improve human capital, climate resilience, diversification, and governance are essential for Nauru's long term growth. Education spending should prioritize improving enrollment and attendance rates and increasing the teacher-to-student ratio. Efforts to accelerate climate adaptation and mitigation are important to ensure Nauru's resilience to climate change. A detailed costing of priority projects would be critical in allowing a more strategic pursuit of climate finance. The completion of the new climate-resilient port and the undersea cable are expected to bring new sources of growth and employment opportunities. Addressing remaining governance risks in PFM controls and the protection of property and contractual rights is needed to reduce corruption vulnerabilities and support growth.

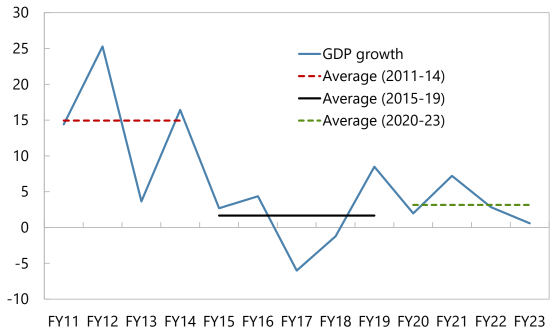
37. Data shortcomings remain prevalent, and continued efforts to enhance statistics are needed. Nauru's statistical capacity remains weak, and data shortcomings prevent timely analysis and hamper surveillance. Further efforts to address resource constraints and to leverage development partners' assistance are crucial to improve the quality and the availability of statistics.

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

Figure 1. Recent Developments

Growth moderated recently…

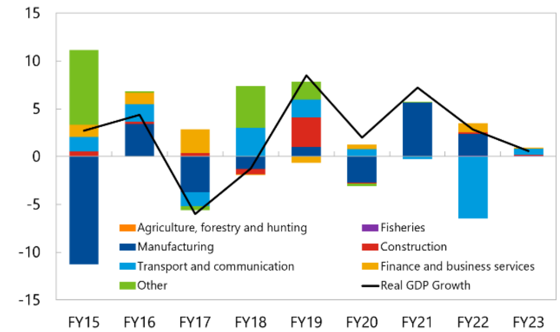
Real GDP Growth
(In percent)



Source: IMF staff calculations.

…amid the scale down of the RPC.

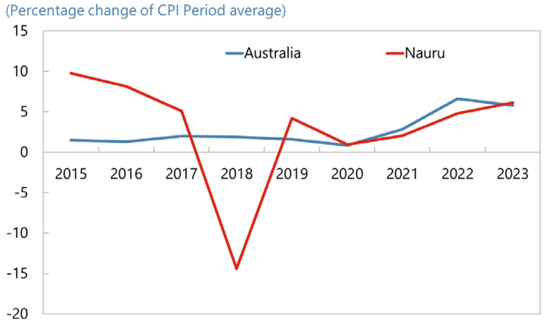
Real GDP Growth Contribution
(In percent)



Sources: Nauru authorities; and IMF staff calculations.

Inflation rose reflecting external factors.

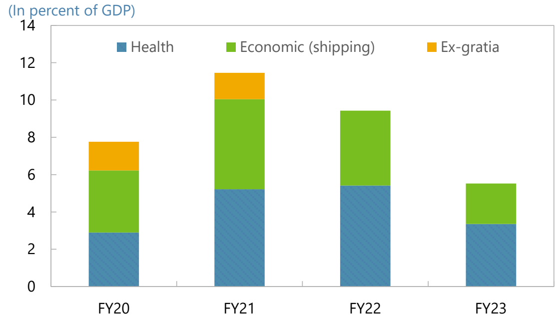
Inflation
(Percentage change of CPI Period average)



Source: IMF World Economic Outlook.

Covid-related expenditure has gradually come down.

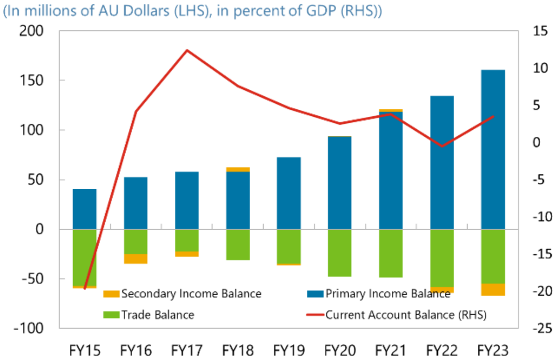
COVID-Related Expenditures 1/
(In percent of GDP)



Sources: Nauru authorities, and IMF staff estimates.
1/Economic (shipping) and ex-gratia supports refer to subsidies to Nauru Airlines and cash transfers for general purposes, respectively.

The CA balance recorded a small deficit in FY2022 and returned to positive territory in FY2023.

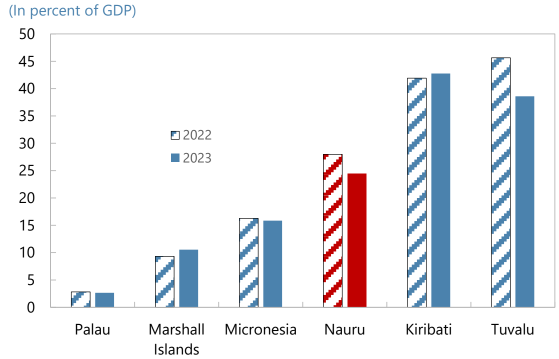
Current Account Balance
(In millions of AU Dollars (LHS), in percent of GDP (RHS))



Sources: Nauru authorities; and IMF staff calculations.

Fishing license fees remained an important source of revenues.

PICs: Fishing License Revenues
(In percent of GDP)

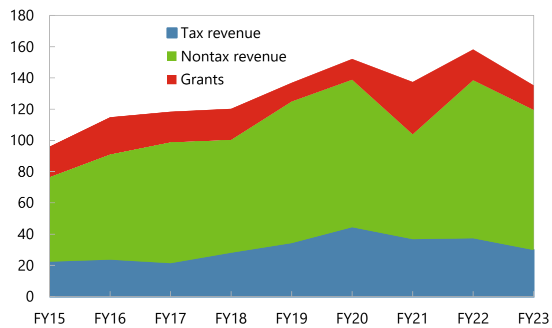


Source: IMF staff estimates.

Figure 2. Recent Fiscal Developments

Total revenues started to moderate in FY2023 as the RPC entered the enduring capabitlity stage…

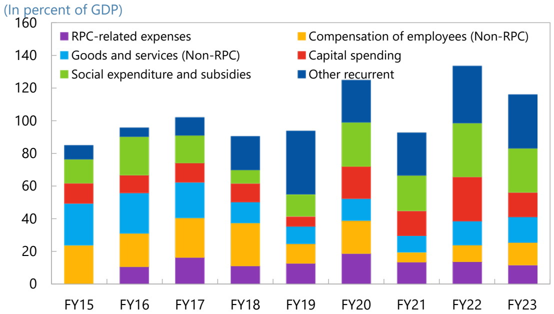
Revenue
(In percent of GDP)



Sources: Nauru authorities; and IMF staff calculations.

…constraining capital expenditure.

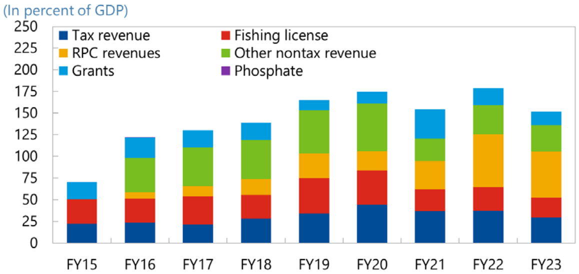
Fiscal Expenditure
(In percent of GDP)



Sources: Nauru authorities; and IMF staff calculations.

An extension of RPC operations at limited capacity in FY2023 avoided a sharp decline of revenues…

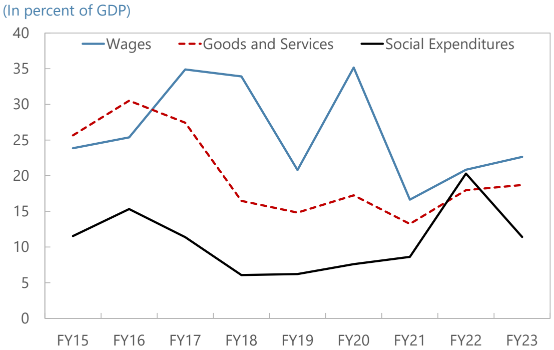
Fiscal Revenue
(In percent of GDP)



Sources: Nauru authorities; and IMF staff calculations.
Note: RPC revenues include hosting fees, reimbursable costs, service fees, and DJBC operations. In FY2023, RPC revenues increased despite a scale down of RPC activities, with a positive net impact on total revenues. From FY2025, RPC revenues are expected to decrease by 25.7 percent of GDP.

…sustaining current spending in wages and goods and services.

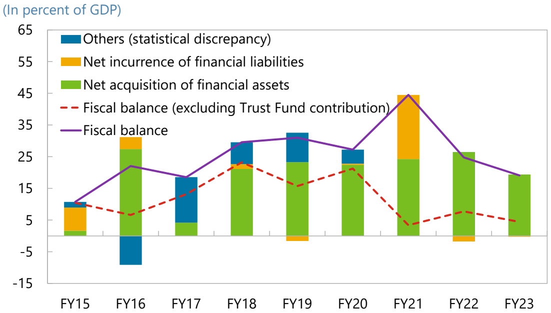
De-composition of Fiscal Expenditures
(In percent of GDP)



Source: Nauru authorities.

The overall balance remained positive but narrowed in recent years…

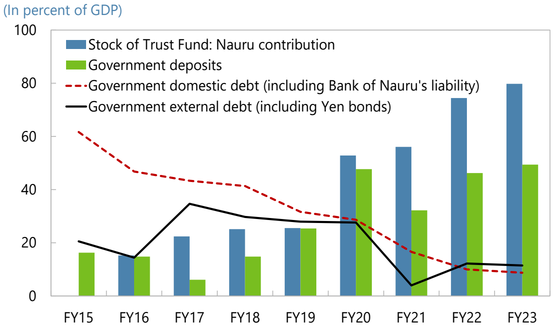
Fiscal Balance Excluding Trust Fund Contribution
(In percent of GDP)



Sources: Nauru authorities; and IMF staff calculations.

…while the government continued to build savings including in the NTF.

Government Deposits and Debt
(In percent of GDP)

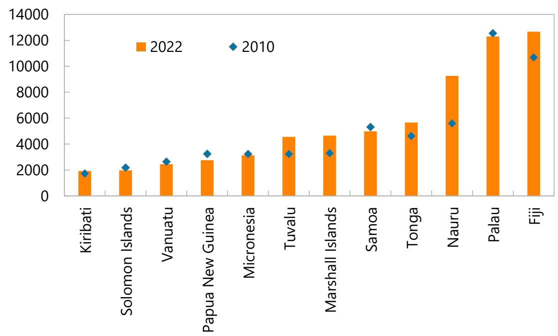


Sources: Nauru authorities; and IMF staff calculations.

Figure 3. Constraints to Raising Growth Potential

Nauru has one of the highest real GDP per capita among Pacific island countries…

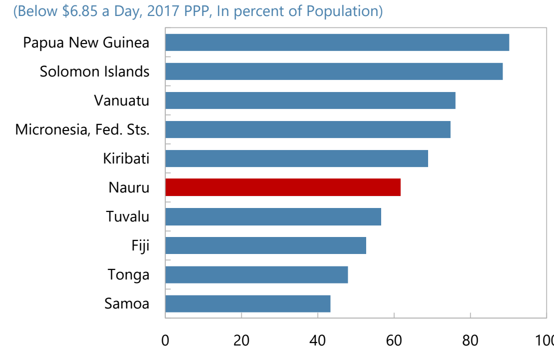
Pacific Islands Countries: GDP per Capita
(Purchasing power parity; international dollars)



Source: IMF, World Economic Outlook.

…but the poverty rate remains high.

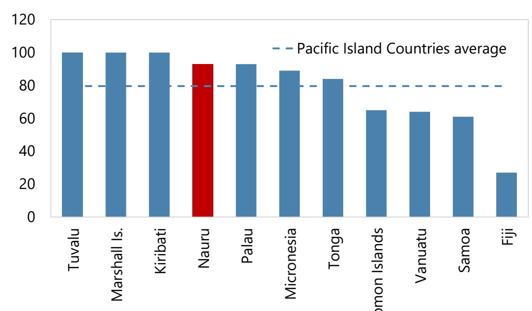
Poverty Headcount Ratio
(Below $6.85 a Day, 2017 PPP, In percent of Population)



Source: World Bank's *World Development Indicators*.

Close to 100 percent of the population live within 1km of a coast.

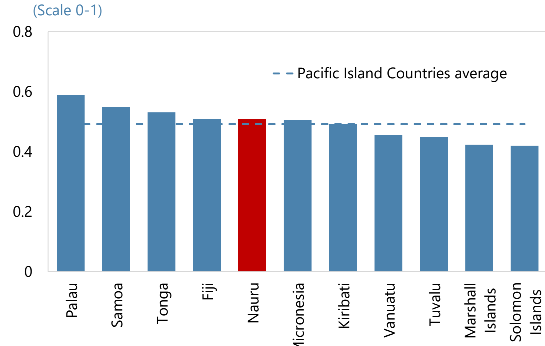
Population Living Within 1km of a Coast
(In percent of total population)



Note: Population as per most recent census
Sources: Andrew et al. (2019), IMF staff estimates

Nauru's human capital index is at around the average of pacific island countries.

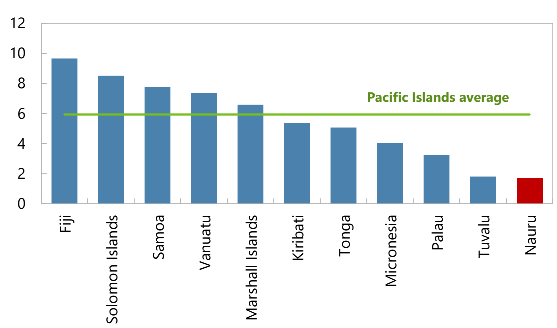
Human Capital Index, 2020
(Scale 0-1)



Source: World Bank.

Nauru faces high transportation costs, which limits its export potential.

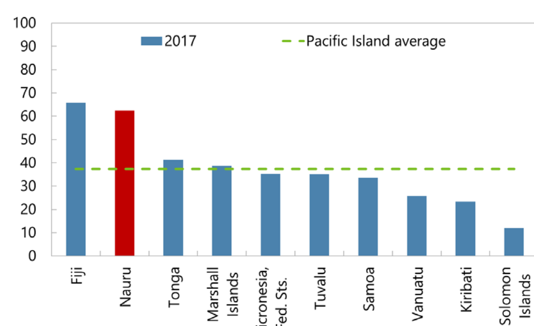
Liner Shipping Connectivity Index



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

Better internet connectivity can help Nauru achieve further digitalization.

Individuals Using the Internet
(In percent of population)



Source: World Bank, World Development Indicators.

Table 1. Nauru: Selected Economic Indicators, FY2021-25 1/

Nominal GDP (AU$ million, FY2023)	154.0	Human capital index (scale 0-1, 2020)	0.51
Per capita GDP (AU$, FY2023)	12,040	Infant mortality rate (per 1000 live births, 2021)	23.2
Population (FY2023)	12787	Poverty rate at $6.85 a day (2017 PPP, 2012)	61.7

	FY2021	FY2022	FY2023	FY2024	FY2025
			Est.	Proj.	
Real sector					
Real GDP growth (percent change)	7.2	2.8	0.6	1.4	1.2
Consumer price index (period average, percent change)	1.1	3.6	6.3	5.3	4.1
Population (thousand)	12.3	12.5	12.8	13.0	13.3
Structure of the economy					
Agriculture	3.2	3.2	3.2	3.3	3.6
Manufacturing	14.3	15.6	16.6	15.0	14.7
Services	74.6	71.4	72.1	74.0	74.0
Government finance (in percent of GDP)					
Total revenue and grants	137.4	158.3	135.3	128.9	95.6
Revenue	103.9	138.5	119.5	100.0	77.3
Grants 2/	33.6	19.8	15.9	28.9	18.3
Total expenditure	93.0	133.5	116.2	115.2	88.8
Net lending (+) / borrowing (-)	44.5	24.8	19.1	13.6	6.8
Excluding Trust Fund contribution	30.2	12.6	8.3	6.0	1.2
Stock of government deposits 3/	32.2	46.2	49.4	47.6	43.5
Stock of Trust Fund	81.3	111.5	122.4	131.0	144.2
Balance of payments					
Current account balance	8.9	-1.1	7.9	13.0	-2.5
(In percent of GDP)	3.8	-0.5	3.4	5.2	-0.9
Capital account balance	85.1	53.6	38.1	69.2	44.8
Financial accounts balance and other flows	111.8	60.7	46.0	82.2	42.3
Government debt indicators					
External debt 4/	9.3	25.8	26.2	38.7	35.1
(In percent of GDP)	3.9	12.2	11.5	15.6	13.5
Domestic debt 5/	39.0	21.1	19.9	18.9	17.9
(In percent of GDP)	16.6	10.0	8.7	7.6	6.9
External debt service 6/	0.8	0.8	5.7	6.4	6.8
(In percent of exports of goods and services)	1.1	0.7	5.6	6.6	6.3
Exchange rates					
Australian dollar per U.S. dollar (period average)	1.34	1.38	1.48	…	…
Nominal GDP (in millions of Australian dollars)	235.5	212.0	228.6	248.6	259.8
Nominal GNI (in millions of Australian dollars)	353.8	346.5	389.4	449.7	410.4
Nominal GDP per capita (in US dollars)	14,303	12,269	12,040	…	…

Sources: Nauru authorities and IMF staff estimates and projections.

1/ Nauru uses the Australian dollar as the legal tender, and the fiscal year ends in June.
The revised growth statistics is scheduled to be published in January 2024.

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

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

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

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

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

Table 2. Nauru: Medium-Term Baseline Scenario, FY2021-28 1/

	FY2021	FY2022	FY2023	FY2024	FY2025	FY2026	FY2027	FY2028
			Est.			Proj.		
Real sector								
Real GDP growth (percent change)	7.2	2.8	0.6	1.4	1.2	1.2	1.1	1.0
Consumer price index (period average, percent change)	1.1	3.6	6.3	5.3	4.1	3.2	2.5	2.0
				(In percent of GDP)				
Government finance 2/								
Total revenue and grants	137.4	158.3	135.3	128.9	95.6	83.5	79.3	78.7
Total expenditure	93.0	133.5	116.2	115.2	88.8	79.9	76.6	76.5
Current expenditure	77.8	106.6	101.3	90.2	74.3	73.9	70.6	70.5
Net acquisition of non-financial assets	15.2	27.0	15.0	25.0	14.5	6.0	6.0	6.0
Net lending (+) / borrowing (-)	44.5	24.8	19.1	13.6	6.8	3.6	2.7	2.2
Excluding trust fund contribution	30.2	12.6	8.3	6.0	1.2	-1.7	-2.4	-2.8
Stock of government deposits	32.2	46.2	49.4	47.6	43.5	36.8	47.7	26.0
of which: Cash buffer requirement	25.1	32.8	34.1	33.3	28.4	30.0	29.7	30.8
Stock of Trust Fund	81.3	111.5	122.4	131.0	144.2	155.0	168.0	181.2
		(In millions of Australian dollars, unless otherwise indicated)						
Balance of payments								
Current account balance	8.9	-1.1	7.9	13.0	-2.5	-3.9	-4.9	-6.2
(In percent of GDP)	3.8	-0.5	3.4	5.2	-0.9	-1.4	-1.8	-2.2
Capital account balance	85.1	53.6	38.1	69.2	44.8	22.6	22.4	22.2
Financial accounts balance and other flows	111.8	60.7	46.0	82.2	42.3	18.7	17.5	15.9
Government debt indicators								
External debt 3/	9.3	25.8	26.2	38.7	35.1	31.4	26.4	22.7
(In percent of GDP)	3.9	12.2	11.5	15.6	13.5	11.6	9.4	7.9
Domestic debt 4/	39.0	21.1	19.9	18.9	17.9	16.9	15.9	14.9
(In percent of GDP)	16.6	10.0	8.7	7.6	6.9	6.2	5.7	5.2
External debt service	0.8	0.8	5.7	6.4	6.8	6.6	6.5	6.3
Exchange rates								
Australian dollar per U.S. dollar (period average)	1.34	1.38	1.48	…	…	…	…	…
Nominal GDP (in millions of Australian dollars)	235.5	212.0	228.6	248.6	259.8	271.7	279.6	287.4

Sources: Nauru authorities and IMF staff estimates and projections.

1/ Nauru uses the Australian dollar as the legal tender, and the fiscal year ends in June.
2/ Fiscal year runs from July 1 to June 30.
3/ Including the defaulted Yen bonds (until 2021 when the debt was settled), and use of Special Drawing Rights (SDR).
4/ Including government liability related to Bank of Nauru's liquidation.

Table 3. Nauru: Balance of Payments, FY2022-28 1/

	FY2022	FY2023	FY2024	FY2025	FY2026	FY2027	FY2028
		Est.			Proj.		
	(In millions of Australian dollars)						
Current account balance	-1.1	7.9	13.0	-2.5	-3.9	-4.9	-6.2
Goods (f.o.b.)	-84.9	-88.0	-118.6	-87.7	-85.0	-77.4	-80.3
Credit	62.3	48.0	40.6	47.5	52.3	53.1	53.8
Debit	147.2	136.0	159.1	135.3	137.3	130.4	134.1
Services balance	-38.9	-38.1	-40.7	-34.8	-36.5	-38.0	-39.5
Credit	53.8	52.9	56.6	59.3	62.2	64.8	67.3
Debit	92.7	90.9	97.3	94.1	98.7	102.8	106.9
Primary income balance	134.5	160.8	201.1	150.6	150.0	144.6	149.3
Credit	148.2	171.3	213.6	159.3	158.5	153.1	157.7
Debit	13.7	10.5	12.5	8.7	8.6	8.5	8.4
Secondary income balance	-11.9	-26.8	-28.7	-30.5	-32.4	-34.1	-35.7
Credit	21.9	14.3	15.3	15.6	15.9	16.3	16.6
Debit	33.8	41.1	44.0	46.1	48.3	50.4	52.3
Capital account balance	53.6	38.1	69.2	44.8	22.6	22.4	22.2
Credit	53.6	38.1	69.2	44.8	22.6	22.4	22.2
Debit	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account balance	60.7	46.0	82.2	42.3	18.7	17.5	15.9
Assets	86.4	71.4	100.3	27.3	1.7	-2.8	-3.9
Liabilities	25.7	25.4	18.1	-15.1	-17.0	-20.3	-19.8
Memorandum items:							
Nominal GDP	212.0	228.6	248.6	259.8	271.7	279.6	287.4
Current account balance (in percent of GDP)	-0.5	3.4	5.2	-0.9	-1.4	-1.8	-2.2
Stock of external government assets	315.9	371.2	435.2	469.1	497.5	525.7	555.2
Reserves	70.3	84.5	102.2	87.0	68.6	47.7	26.0
Trust Fund	236.4	279.9	325.8	374.6	420.9	469.8	520.6
Others, including donor funds	9.2	6.7	7.2	7.6	7.9	8.3	8.6
Change in external government assets	40.8	55.3	64.0	33.9	28.4	28.2	29.5
External debt 2/	31.5	31.9	44.5	40.8	37.1	26.4	22.7
Medium-and long-term loans	21.7	22.0	34.5	30.9	27.2	23.5	19.8
Yen bond	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Short term government debt and arrears	2.9	2.9	2.9	2.9	2.9	2.9	2.9
SDR allocations	7.0	7.1	7.1	7.1	7.1	7.1	7.1
SDR allocations net of SDR holdings	1.3	1.4	1.4	1.4	1.4	1.4	
External debt service	0.8	4.1	4.8	5.2	5.0	4.5	4.4
Principal	0.7	2.3	3.7	3.7	3.7	3.7	3.7
Interest	0.1	1.7	1.1	1.5	1.3	0.8	0.7
International Investment Position	502.5	548.5	630.7	673.0	691.7	709.2	725.1
Assets	641.4	712.8	813.1	840.3	842.0	839.2	835.3
Liabilities	138.9	164.3	182.3	167.3	150.3	130.0	110.2

Sources: Nauru authorities and IMF staff estimates and projections.

1/ The fiscal year ends in June.

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

Table 4. Nauru: Central Government Operations, FY2021-28 1/

	FY2021	FY2022	FY2023	FY2024	FY2025	FY2026	FY2027	FY2028
			Est.			Proj.		
	(In millions of Australian dollars)							
Total revenue and grants	323.6	335.6	309.4	320.4	248.4	226.9	221.6	226.2
Revenue	244.6	293.6	273.1	248.5	200.9	201.2	195.7	200.1
Tax revenue	86.4	79.1	68.0	28.7	29.9	31.3	32.2	33.1
Nontax revenue	158.3	214.6	205.1	219.9	171.0	169.9	163.5	167.0
Of which: Fishing license fees	59.8	58.2	51.3	54.5	58.1	61.9	64.9	68.0
RPC revenues	76.8	128.6	122.2	160.0	100.5	95.0	85.2	85.2
Other nontax	15.9	22.7	26.6	4.1	11.2	11.7	12.0	12.4
Grants 2/	79.0	41.9	36.3	71.9	47.4	25.7	25.9	26.1
Budget support (current)	21.3	10.3	8.6	13.9	14.2	14.5	14.7	15.0
Development fund (capital)	20.1	31.7	27.7	58.0	33.3	11.2	11.2	11.1
Of which: Trust fund contribution by donors	8.0	7.1	4.8	4.8	4.8	4.8	4.8	4.8
Expenditure	218.9	283.1	265.7	286.5	230.7	217.1	214.2	219.9
Expenses	183.2	226.0	231.5	224.4	193.1	200.8	197.4	202.7
Of which : Non-RPC expenses	150.9	196.8	204.7	199.7	170.3	179.8	178.0	184.8
Compensation of employees	39.2	44.2	51.8	53.4	55.8	58.4	60.1	61.8
Goods and services	31.2	38.1	42.7	36.2	30.8	31.2	29.7	30.5
Social expenditure	20.3	43.0	26.1	24.3	25.4	26.6	27.4	28.1
Subsidies and donations	30.8	26.6	35.6	39.3	19.7	20.5	19.5	20.0
Interest payment	0.2	0.0	0.1	0.1	1.0	0.9	0.8	0.7
Other	61.6	74.0	75.2	71.0	60.4	63.1	59.9	61.6
Net acquisition of non-financial assets	35.7	57.1	34.2	62.1	37.6	16.4	16.8	17.3
Donor financed	11.4	21.3	19.6	48.9	23.8	1.9	1.9	2.0
Government capital expenditure	24.3	35.8	14.6	13.2	13.8	14.5	14.9	15.3
Net lending (+) / borrowing (-)	104.7	52.5	43.7	33.9	17.7	9.8	7.5	6.3
Excluding Nauru trust fund contribution	71.0	26.7	19.0	14.8	3.2	-4.7	-6.6	-8.1
Net financing	104.7	52.5	43.7	33.9	17.7	9.8	7.5	6.3
Net acquisition of financial assets	57.1	56.1	44.3	46.4	14.0	6.1	3.8	2.6
Changes in government deposit 3/	15.4	22.2	14.9	5.5	-5.3	-13.2	-15.1	-16.6
Fiscal cash buffer transfer	0.0	1.0	0.0	17.1	0.0	0.0	0.0	0.0
Trust fund: Nauru contribution	33.7	25.8	24.6	19.1	14.5	14.5	14.1	14.4
Trust fund: Donor contribution	8.0	7.1	4.8	4.8	4.8	4.8	4.8	4.8
Net incurrence of financial liabilities	-47.7	3.7	0.6	12.5	-3.7	-3.7	-3.7	-3.7
External 2/	-42.2	15.8	0.6	12.5	-3.7	-3.7	-3.7	-3.7
Domestic	-5.4	-12.1	0.0	0.0	0.0	0.0	0.0	0.0
Statistical discrepancy	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
	(In percent of GDP)							
Total revenue and grants	137.4	158.3	135.3	128.9	95.6	83.5	79.3	78.7
Revenue	103.9	138.5	119.5	100.0	77.3	74.1	70.0	69.6
Tax revenue	36.7	37.3	29.7	11.5	11.5	11.5	11.5	11.5
Nontax revenue	67.2	101.2	89.7	88.4	65.8	62.5	58.5	58.1
Of which: Fishing license fees	25.4	27.5	22.4	21.9	22.4	22.8	23.2	23.7
RPC revenues 4/	32.6	60.7	53.4	64.4	38.7	35.0	30.5	29.6
Grants	33.6	19.8	15.9	28.9	18.3	9.5	9.3	9.1
Expenditure	93.0	133.5	116.2	115.2	88.8	79.9	76.6	76.5
Expenses	77.8	106.6	101.3	90.2	74.3	73.9	70.6	70.5
Of which : Non-RPC expenses	64.1	92.8	89.5	80.3	65.6	66.2	63.7	64.3
Net acquisition of non-financial assets	15.2	27.0	15.0	25.0	14.5	6.0	6.0	6.0
Net lending (+) / borrowing (-)	44.5	24.8	19.1	13.6	6.8	3.6	2.7	2.2
Excluding trust fund contribution	30.2	12.6	8.3	6.0	1.2	-1.7	-2.4	-2.8
Net acquisition of financial assets	24.2	26.4	19.4	18.7	5.4	2.2	1.4	0.9
Net incurrence of financial liabilities	-20.2	1.7	0.3	5.0	-1.4	-1.4	-1.3	-1.3
Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:								
Nominal GDP (in millions of Australian dollars)	235.5	212.0	228.6	248.6	259.8	271.7	279.6	287.4
Stock of government deposit (includes cash buffer) 3/	75.8	98.0	112.9	118.4	113.1	100.0	84.9	68.3
In percent of GDP	32.2	46.2	49.4	47.6	43.5	36.8	30.4	23.8
In months of non-RPC current spending 6/	6.0	6.0	6.6	7.1	8.0	6.0	5.2	4.0
Required cash buffer in Australian dollars	25.1	32.8	34.1	33.3	28.4	30.0	29.7	30.8
Required cash buffer in months of non-RPC spending	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Stock of Trust Fund	191.5	236.4	279.9	325.8	374.6	420.9	469.8	520.6
In percent of GDP	81.3	111.5	122.4	131.0	144.2	155.0	168.0	181.2
Use of Special Drawing Rights (SDRs) 5/	1.3	1.3	1.4	1.4	1.4	1.4	1.4	0.0
Stock of government debt (percent of GDP) 6/	20.5	22.2	20.2	23.2	20.4	17.8	15.1	13.1
Stock of government external debt	9.3	25.8	26.2	38.7	35.1	31.4	26.4	22.7
External debt (in percent of GDP)	3.9	12.2	11.5	15.6	13.5	11.6	9.4	7.9
Stock of government domestic debt	39.0	21.1	19.9	18.9	17.9	16.9	15.9	14.9
Domestic debt (in percent of GDP)	16.6	10.0	8.7	7.6	6.9	6.2	5.7	5.2

Sources: Nauru authorities and IMF staff estimates and projections.

1/ The fiscal year ends in June.

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

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

4/ Including RPC hosting fees, reimbursable costs, service fees, and DJBC operations.

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

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

Annex I. External Sector Assessment[1]

***Overall Assessment**: Nauru's external position was moderately weaker than the level implied by fundamentals and desirable policies in FY2022. This reflects an expansion of the government's current spending and a subsequent narrowing of the current account (CA) balance. Reserves remain adequate in FY2022, but are expected to decline over the medium term. The assessment is subject to substantial uncertainty due to data limitations and about revenues from the Regional Processing Center (RPC) beyond FY2026.[1]*

***Potential Policy Responses**: The weakening external position is partly driven by an increase in the government's current spending, indicating the need to improve government spending efficiency and to mobilize domestic revenue. Compliance with fiscal discipline and rebuilding FX reserve buffers will help ensure fiscal and external sustainability. Structural reforms to enhance human capital and to diversify the economy would boost long-term productivity and competitiveness.*

Foreign Assets and Liabilities: Position and Trajectory

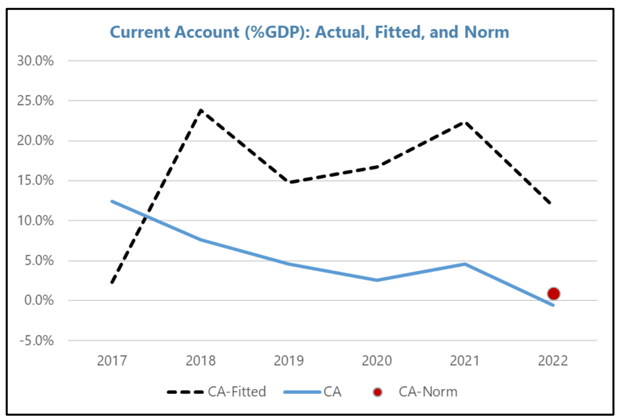
Background. The Net International Investment Position (NIIP) of Nauru was AUD 502.5 million, equivalent to 237.1 percent of GDP in FY2022. The NIIP has been growing strongly in the past five years driven by the expansion of the Nauru Trust Fund (NTF).

Assessment. At a net creditor position, the NIIP is expected to stabilize at around 240-250 percent of GDP over the medium term, with NTF inflows offset by a decline in the CA balance and in RPC-related capital inflows. Risks to the NIIP path include a loss in NTF investments, insufficient NTF contributions, and widening CA deficits.

FY2022 (% GDP)	NIIP: 237.1	Gross Assets: 302.5	Debt Assets: N/A	Gross Liab.: 65.5	Debt Liab.: 63.3

Current Account

Background. The CA recorded a deficit of 0.5 percent of GDP in FY2022, with a sizable deficit in goods and services trade partly offset by a surplus in primary income (RPC revenues). Rising fuel prices led to a deterioration in the terms of trade and higher trade deficit in transportation services. The CA balance temporarily turned positive at 3.4 percent of GDP in FY2023 due to a windfall increase in RPC revenues. The expansion of the government's current spending reduced domestic savings. Over the medium term, staff projects that a decline in RPC revenues and a heavy reliance on imports will lead to sustained CA deficits. The magnitudes and diverging signs of trade and primary income balance suggest that the overall CA may be less reliable as an indicator of competitiveness than its components.



Assessment. The external sector assessment uses the revised EBA-lite 3.0 CA model, as it relies on more up-to-date data (FY2022) compared with the REER model (FY2020). The CA model indicates a cyclically adjusted CA balance of -0.5 percent of GDP, lower than the estimated CA norm of 0.9 percent of GDP, pointing to a negative CA gap of -1.4 percent of GDP. The external position is assessed to be moderately weaker than the level implied by fundamentals in FY2022.

[1] There are substantial data gaps in conducting the EBA-lite exercise for Nauru. For example, indicators on the prime saver share, the life expectancy at age 45, the private-credit-to-GDP ratio, the change in the private-credit-to-GDP ratio, and the share of overseas population are not available for Nauru. Instead, we use the indicators in other pacific island countries (Fiji or the Solomon Islands) as a proxy. These variables contribute -0.5 percent of GDP to the cyclically adjusted CA. The baseline assumes RPC revenues will continue to decline further after FY2026.

[1] Prepared by Yue Zhou (APD).

However, the relative policy gap is estimated at around 11.3 percent, mainly reflecting the large fiscal surplus from a windfall increase in RPC revenues. As the RPC enters the "Enduring Capability" status in July, with its revenues scheduled to decline from FY2025, the fiscal surplus is expected to narrow over the medium term, leading to a weaker external position. Policies should aim to improve government spending efficiency, mobilize revenue, and strengthen human capital to boost long-term productivity and competitiveness.

Nauru: EBA-lite Model Results, 2022

	CA model 1/	**REER model** 1/
	(in percent of GDP)	
CA-Actual	**-0.5**	
Cyclical contributions (from model) (-)	0.0	
COVID-19 adjustors (-) 2/	0.0	
Additional temporary/statistical factors (-)	0.0	
Natural disasters and conflicts (-)	-0.1	
Adjusted CA	**-0.5**	
CA Norm (from model) 3/	**0.9**	
Adjustments to the norm (-)	0.0	
Adjusted CA Norm	**0.9**	
CA Gap	**-1.4**	**1.9**
o/w Relative policy gap	11.3	
Elasticity	-0.5	
REER Gap (in percent)	**2.9**	**-4.0**

1/ Based on the EBA-lite 3.0 methodology

2/ No additional cyclical adjustment is applied to the model estimates.

3/ Cyclically adjusted, including multilateral consistency adjustments.

Real Exchange Rate

Background. The REER appreciated by 1.7 percent in FY2022 and is now 2.8 percent below the historical average (June 2023). The REER is largely determined by Nauru's inflation relative to Australia, a major trading partner, with the Australian dollar being the legal tender in Nauru. Movements in the REER have little impact on competitiveness because trade is predominantly in Australian dollars. The main components of the CA (phosphate exports, fishing license fees, RPC revenues, grants, essential imports) are inelastic to the REER, and the model predicts limited relevance of the REER in closing the CA gap. From the saving-investment perspective, reducing the government's current spending and implementing structural reforms to boost exports would help increase domestic savings and improve the external imbalance.

Assessment. The EBA-lite CA model indicates that a REER gap of 2.9 percent. Higher domestic inflation relative to its major trading partners may weaken the REER in FY2024. In the absence of additional revenue or external financing, the projected moderation of the fiscal surplus would imply lower domestic savings, which could lead to a higher CA deficit and a larger REER gap over the medium term.

Capital and Financial Accounts: Flows and Policy Measures
Background. The capital account registered a surplus of AUD 53.6 million (25.3 percent of GDP) in FY2022, underpinned by development grants and donor contributions to the NTF, although donor supports decreased from the peak in FY2021. The surplus in the financial account is supported by a rise in the government's deposit of fiscal surplus. However, the delayed disbursement of the EXIM loans, which was scheduled for FY2021, narrowed the surplus in FY2022. Portfolio investment outflows mainly reflects the government's contributions to the NTF. **Assessment**. Capital inflows have been volatile due to the uncertainty related to donor support. Sustained CA deficit in the medium term requires continued financing from donors and/or sufficient reserves. Continued fiscal prudence, donor grant support, and structural reforms to boost exports and attract FDI inflows are warranted to ensure sustained growth of external assets and foreign reserves. At the same time, effective risk management of the NTF during market volatility is critical to protect the value of external assets.
FX Intervention and Reserves Level
Background. Nauru has been building up foreign reserves in the past ten years. Foreign reserves increased to 33.2 percent of GDP in FY2023, or equivalent to 4.6 months of imports, mainly due to a windfall increase in RPC revenues. The market value of the NTF continued to grow in FY2023, thanks to government and donor contributions. **Assessment**. Staff assesses that the use of the Australian dollar as legal tender remains appropriate given Nauru's strong trade and financial linkage with Australia and Nauru's small size. In the absence of a central bank, the Australian dollar provides a nominal anchor. The Assessing Reserve Adequacy (ARA) matrix for small state credit-constrained economies with fixed exchange rates is used to assess Nauru's reserve adequacy. Based on this matrix, the adequate level of foreign reserves amounts to 2.8 months of imports given that the main function of foreign reserves in a dollarized economy is to prevent a liquidity crisis. The reserve coverage ratio appears to be sufficient in FY2022 at 3.5 months of imports. The reserve coverage ratio increased to 4.6 months of imports in FY2023 due to a windfall increase of RPC revenues. Over the medium term, foreign reserves are expected to decline to less than three months of imports by FY2028 as RPC revenues decline and fiscal surplus narrows. Compliance with fiscal discipline and rebuilding FX reserve buffers are crucial to maintain foreign reserves adequacy.

Annex II. Sovereign Risk and Debt Sustainability Analysis[1]

1. Nauru is at a low overall risk of sovereign stress. The sizable fiscal surplus, robust non-tax revenue performance, and the resolution of the external debt have contributed to a significant reduction in public debt. Over the medium term, public debt is projected to decline to 15.2 percent of GDP, supported by a narrowing but positive primary balance. Nevertheless, Nauru remains vulnerable to large macroeconomic shocks, including shocks to the current account (CA). Mitigating factors include fiscal surplus from continued donor support, a long maturity of public debt, and the grant elements of external debt. The realism assessment is subject to uncertainties as historical macroeconomic and debt profile data before 2009 is unavailable.

2. Background. The primary surplus remained sizable, exceeding 20 percent of GDP in FY2022, mainly due to increased donor supports (RPC revenues) and robust fishing license fees during the pandemic. Public debt has reduced significantly after the resolution of Nauru's external debt to Firebird in 2021 and large fiscal surplus. The external debt is composed of EXIM bank loans (AUD 24.1 million), which is financed by grants, and informal debt of membership fees[2] (AUD 2.9 million) in FY2022. Domestic debt consists entirely of the liability that the government undertook as a guarantor of the Bank of Nauru, which went into liquidation in 2016. That said, the delayed construction of the climate-resilient port could generate contingent liability of unknown amount as the government is liable for the additional spending exceeding the amount of donor grants.

3. Baseline. Staff's baseline scenario is based on the revised FY2023 and FY2024 budget and the scheduled scale down of the RPC from July 2023. The primary deficit is expected to narrow but remain positive at around 2 percent of GDP over the medium term, driven by a reduction in RPC revenues, a permanent decline in RPC-related tax revenues, and continued compliance with fiscal discipline. Growth is projected to pick up in FY2024 but moderate over the medium term. These factors contribute to a decreasing trend in public debt from 21.2 percent of GDP in FY2023 to 15.2 percent in FY2028. Contingent liability related to the climate-resilient port is excluded in the baseline.

4. Realism. The realism assessment is subject to uncertainties as historical macroeconomic and debt profile data before 2009 is unavailable, due to data limitations. The three-year adjustment in cyclically adjusted primary balance appears to be an outlier compared to historical and international experience, as it mainly reflects one-off factors such as the windfall increases in RPC revenues. While Nauru does not have potential GDP estimates due to data limitation, real GDP growth appears to converge towards the 10-year average, albeit at a lower level.

5. Risks and mitigating factors. Nauru's downward public debt dynamics remain vulnerable to macroeconomic shocks, especially those related to the deterioration of the CA. In the stress test scenarios, the external debt could rise to 60 percent of GDP in FY2028 in response to shocks to the

[1] Prepared by Yue Zhou (APD).

[2] The EXIM loans were used to purchase two new aircrafts for Air Nauru. Membership fees include those owed to international organizations (e.g., International Postal Union).

CA, which has been volatile historically since phosphate production receded in 2000s. Growth shocks and real exchange rate shocks have a moderate impact on the debt trajectory. Mitigating factors include fiscal surplus from continued donor support, a long maturity of the public debt, and the grant elements of external debt.

Figure 1. Nauru: Risk of Sovereign Stress

Horizon	Mechanical signal	Final assessment	Comments
Overall	…	Moderate	The overall risk of sovereign stress is moderate, reflecting a relatively low level of vulnerability in the near-term and moderate levels of vulnerability in the medium-, and long-term horizons.
Near term 1/			
Medium term	Low	Moderate	Medium-term risks are assessed as moderate. While rollover risks remain low, Nauru remains susceptible to macroeconomic shocks.
Fanchart	Moderate	…	
GFN	Low	…	
Stress test	…	…	
Long term	…	Moderate	Long-term risks are moderate as aging-related expenditures on health and social security feed into debt dynamics.
Sustainability assessment 2/	Not required for surveillance countries	Not required for surveillance countries	
Debt stabilization in the baseline			Yes

DSA summary assessment

Commentary: Nauru is at a low overall risk of sovereign stress. This assessment underpinned by continued and decreasing RPC hosting fees payment by Australia and sound fiscal policies in compliance with fiscal disciplines. Near term risks are low while medium and long term risks are moderate. However, as illustrated in by the large width of the debt fan chart, Nauru remains vulnerable to large macroeconomic shocks, including those related to contingent liabilities, commodity prices, and natural disasters. In addition, historical macroeconomic and debt profile data before 2009 is not available, undermining the depth of analysis.

Source: Fund staff.

Note: The risk of sovereign stress is a broader concept than debt sustainability. Unsustainable debt can only be resolved through exceptional measures (such as debt restructuring). In contrast, a sovereign can face stress without its debt necessarily being unsustainable, and there can be various measures—that do not involve a debt restructuring—to remedy such a situation, such as fiscal adjustment and new financing.

1/ The near-term assessment is not applicable in cases where there is a disbursing IMF arrangement. In surveillance-only cases or in cases with precautionary IMF arrangements, the near-term assessment is performed but not published.

2/ A debt sustainability assessment is optional for surveillance-only cases and mandatory in cases where there is a Fund arrangement. The mechanical signal of the debt sustainability assessment is deleted before publication. In surveillance-only cases or cases with IMF arrangements with normal access, the qualifier indicating probability of sustainable debt ("with high probability" or "but not with high probability") is deleted before publication.

Figure 2. Nauru: Debt Coverage and Disclosures

						Comments
1. Debt coverage in the DSA: 1/	CG	GG	NFPS	CPS	Other	
1a. If central government, are non-central government entities insignificant?					n.a.	
2. Subsectors included in the chosen coverage in (1) above:						

Sector		Subsectors captured in the baseline	Inclusion	Comments
CPS / NFPS / GG: expected / CG	1	Budgetary central government	Yes	
CPS / NFPS / GG: expected / CG	2	Extra budgetary funds (EBFs)	No	Not applicable
CPS / NFPS / GG: expected / CG	3	Social security funds (SSFs)	No	No information
CPS / NFPS / GG: expected	4	State governments	Yes	
CPS / NFPS / GG: expected	5	Local governments	No	No local government
CPS / NFPS	6	Public nonfinancial corporations	No	
CPS	7	Central bank	No	
CPS	8	Other public financial corporations	No	

3. Instrument coverage:	Currency & deposits	Loans	Debt securities	Oth acct. payable 2/	IPSGSs 3/

4. Accounting principles:	Basis of recording		Valuation of debt stock		
	Non-cash basis 4/	Cash basis	Nominal value 5/	Face value 6/	Market value 7/

5. Debt consolidation across sectors:	Consolidated	Non-consolidated

Color code: chosen coverage; Missing from recommended coverage; Not applicable

Reporting on intra-government debt holdings

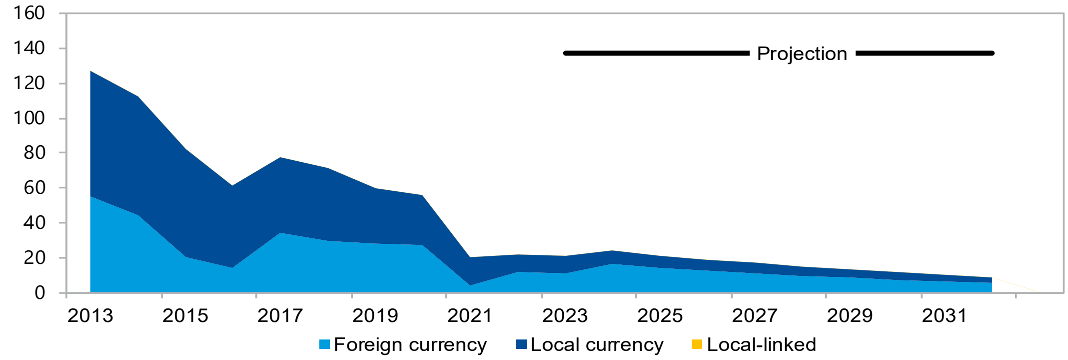
Sector		Issuer \ Holder	Budget. central govt	Extra-budget. funds	Social security funds	State govt.	Local govt.	Nonfin. pub. corp.	Central bank	Oth. pub. fin corp	Total
CPS / NFPS / GG: expected / CG	1	Budget. central govt									0
CPS / NFPS / GG: expected / CG	2	Extra-budget. funds									0
CPS / NFPS / GG: expected / CG	3	Social security funds									0
CPS / NFPS / GG: expected	4	State govt.									0
CPS / NFPS / GG: expected	5	Local govt.									0
CPS / NFPS	6	Nonfin pub. corp.									0
CPS	7	Central bank									0
CPS	8	Oth. pub. fin. corp									0
		Total	0	0	0	0	0	0	0	0	0

1/ CG=Central government; GG=General government; NFPS=Nonfinancial public sector; PS=Public sector.
2/ Stock of arrears could be used as a proxy in the absence of accrual data on other accounts payable.
3/ Insurance, Pension, and Standardized Guarantee Schemes, typically including government employee pension liabilities.
4/ Includes accrual recording, commitment basis, due for payment, etc.
5/ Nominal value at any moment in time is the amount the debtor owes to the creditor. It reflects the value of the instrument at creation and subsequent economic flows (such as transactions, exchange rate, and other valuation changes other than market price changes, and other volume changes).
6/ The face value of a debt instrument is the undiscounted amount of principal to be paid at (or before) maturity.
7/ Market value of debt instruments is the value as if they were acquired in market transactions on the balance sheet reporting date (reference date). Only traded debt securities have observed market values.

Commentary: The coverage in the SRDSA is for the central government. Fiscal year in Nauru starts in July.

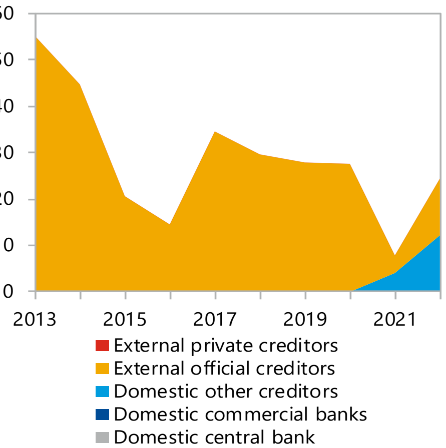
Figure 3. Nauru: Public Debt Structure Indicators

Debt by Currency (Percent of GDP)



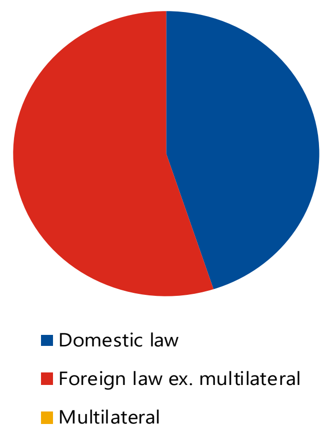
Note: The perimeter shown is general government.

Public Debt by Holder (Percent of GDP)



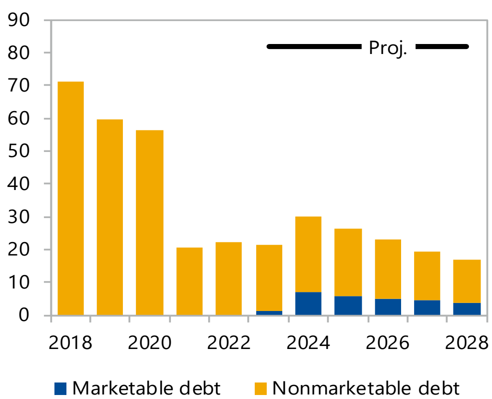
Note: The perimeter shown is general government.

Public Debt by Governing Law, 2022 (Percent)



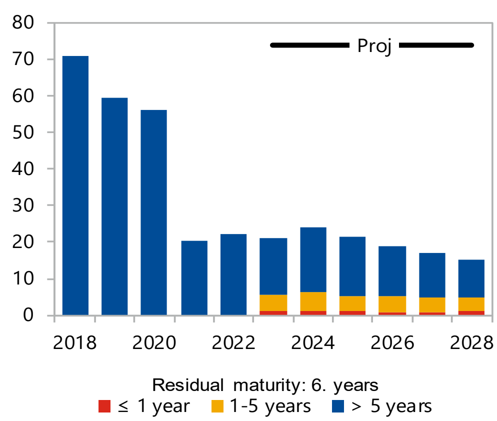
Note: The perimeter shown is general government.

Debt by Instruments (Percent of GDP)



Note: The perimeter shown is general government.

Public Debt by Maturity (Percent of GDP)



Note: The perimeter shown is general government.

Commentary: Nauru's public debt are mainly nonmarketable, foreign-currency denominated official debt, with maturities above 5 years. Domestic debt consists entirely of the liaiblity that the government undertook as the guarantor of the Bank of Nauru, which went into liquidation in 2016.

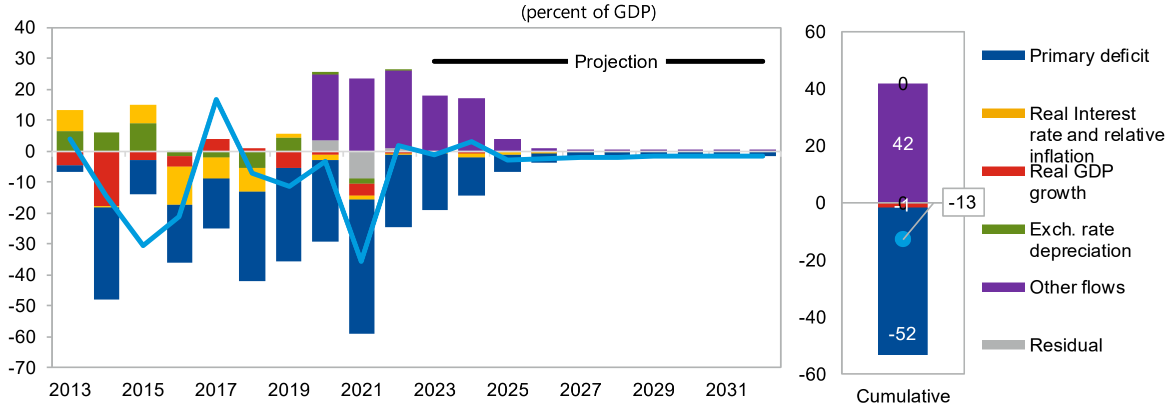
Figure 4. Nauru: Baseline Scenario

(percent of GDP unless indicated otherwise)

	Actual	Medium-term projection						Extended projection			
	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Public debt	22.2	21.2	24.2	21.4	19.0	17.0	15.2	13.7	12.2	10.7	9.2
Change in public debt	1.6	-0.9	3.0	-2.7	-2.4	-2.0	-1.8	-1.5	-1.5	-1.5	-1.5
Contribution of identified flows	0.6	-1.0	3.4	-2.8	-2.2	-2.0	-1.9	-1.6	-1.6	-1.6	-1.6
Primary deficit	-23.4	-18.0	-12.5	-5.9	-2.8	-2.0	-1.7	-1.7	-1.7	-1.7	-1.7
Noninterest revenues	156.9	133.8	127.4	94.3	82.4	78.3	78.0	78.0	78.0	78.0	78.0
Noninterest expenditures	133.5	115.8	115.0	88.4	79.6	76.3	76.3	76.3	76.3	76.3	76.3
Automatic debt dynamics	-1.0	-0.9	-1.4	-1.0	-0.6	-0.4	-0.4	-0.1	-0.1	0.0	0.0
Real interest rate and relative inflation	-0.7	-0.7	-1.1	-0.7	-0.3	-0.2	-0.2	-0.1	-0.1	0.0	0.0
Real interest rate	-0.6	-0.7	-1.8	-1.6	-0.5	-0.3	-0.2	0.1	0.1	0.1	0.1
Relative inflation	-0.1	-0.1	0.7	0.9	0.2	0.1	0.0	-0.2	-0.2	-0.1	-0.1
Real growth rate	-0.6	-0.1	-0.3	-0.3	-0.2	-0.2	-0.2	0.0	0.0	0.0	0.0
Real exchange rate	0.3	...	...	...	...	...	...	...	...	...	...
Other identified flows	25.1	17.9	17.2	4.1	1.1	0.4	0.2	0.2	0.2	0.2	0.2
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(minus) Interest Revenues	-1.4	-1.5	-1.4	-1.3	-1.1	-0.9	-0.7	-0.7	-0.7	-0.7	-0.7
Other transactions	26.4	19.4	18.7	5.4	2.2	1.4	0.9	0.9	0.9	0.9	0.9
Contribution of residual	1.0	0.1	-0.4	0.0	-0.2	0.0	0.0	0.1	0.1	0.1	0.0
Gross financing needs	-18.8	-18.3	-12.8	-5.3	-2.2	-1.3	-0.8	-0.9	-1.0	-0.9	-0.9
of which: debt service	6.0	1.3	1.1	1.9	1.7	1.7	1.6	1.6	1.4	1.6	1.5
Local currency	5.7	0.5	0.4	0.6	0.4	0.4	0.4	0.4	0.3	0.4	0.4
Foreign currency	0.3	0.7	0.7	1.3	1.3	1.2	1.2	1.1	1.2	1.1	1.1
Memo:											
Real GDP growth (percent)	2.8	0.6	1.4	1.2	1.2	1.1	1.0	0.0	0.0	0.0	0.0
Inflation (GDP deflator; percent)	2.8	3.1	9.6	7.9	3.4	2.6	2.2	0.0	0.0	0.0	0.0
Nominal GDP growth (percent)	-10.0	7.8	8.8	4.5	4.6	2.9	2.8	0.0	0.0	0.0	0.0
Effective interest rate (percent)	0.0	0.0	0.0	0.9	0.9	0.9	0.9	0.8	0.8	0.8	0.8

Contribution to Change in Public Debt

(percent of GDP)



Staff commentary: Public debt will rise a bit in FY23 but then stablize, reflecting expectations of continued repayment of debt, narrowing but positive primary deficits, and stable economic conditions. Public debt-to-GDP ratio slightly differs from Table 1 and Table 2 due to exchange rate valuation effect: DSA adjusts external debt with exchange rate movement while the other Tables do not.

Figure 5. Nauru: Realism of Baseline Assumptions

Forecast Track Record 1/	**t+1**	**t+3**	**t+5**
Public debt to GDP			
Primary deficit			
r - g			
Exchange rate depreciaton			
SFA			
	real-time	**t+3**	**t+5**
Historical Output Gap Revisions 2/			

Comparator group:

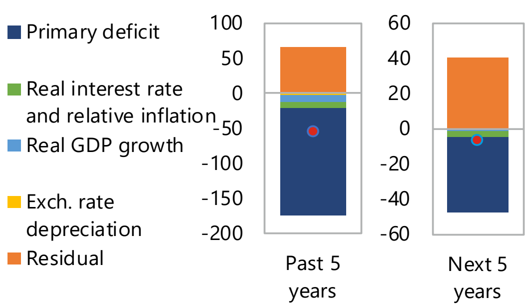
Emerging Markets, Non-Commodity Exporter, Surveillance

Color code:

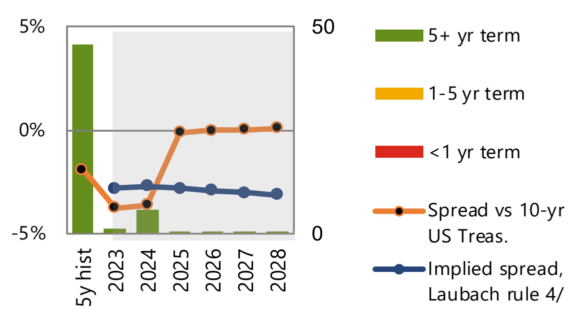
Optimistic
- > 75th percentile
- 50-75th percentile

Pessimistic
- 25-50th percentile
- < 25th percentile

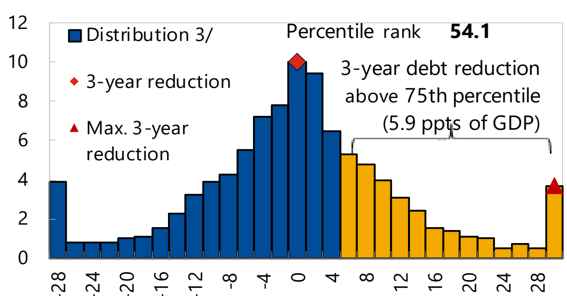
Public Debt Creating Flows
(Percent of GDP)



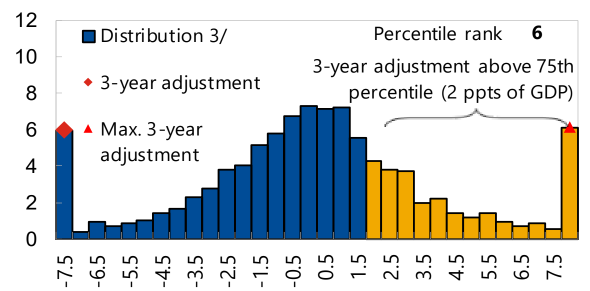
Bond Issuances (bars, debt issuances (RHS, %GDP); lines, avg marginal interest rates (LHS, percent))



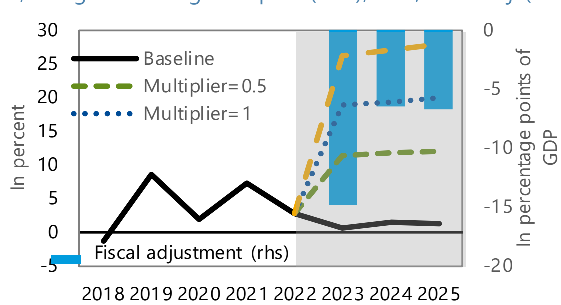
3-Year Debt Reduction
(Percent of GDP)



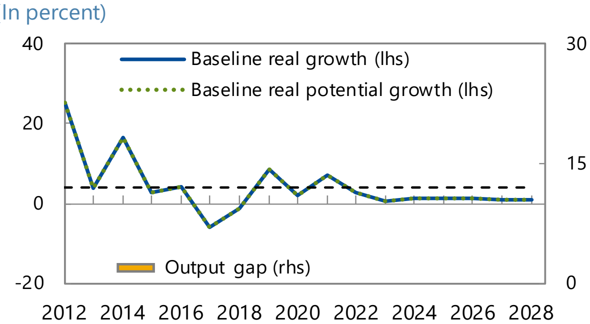
3-Year Adjustment in Cyclically-Adjusted Primary Balance
(percent of GDP)



Fiscal Adjustment and Possible Growth Paths
(Lines, real growth using multiplier (LHS); bars, fiscal adj. (RHS)



Real GDP Growth
(In percent)



Commentary: The recovery from COVID-19 will impart complicated effects on the growth path. Realism analysis raises some concerns about the revenues and its proceedings are mainly contributed to the Nauru Trust Fund. The large primary balance adjustment in the next three years reflects an expected scale down of RPC and subsequent RPC revenues.

Figure 5. Nauru: Realism of Baseline Assumptions (concluded)

REER Gap (+ overvaluation)
(Percent)

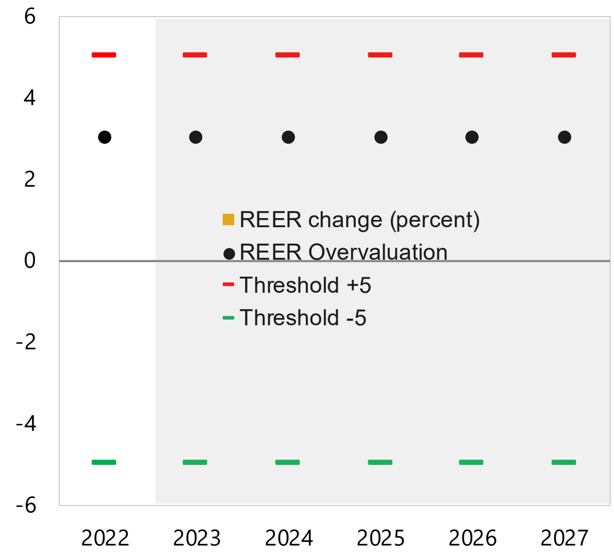
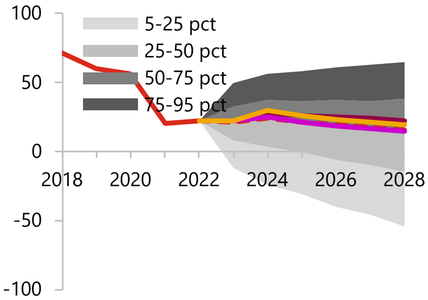


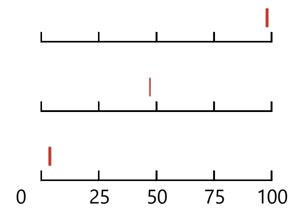
Figure 6. Nauru: Medium-Term Risk Assessment

Final Fanchart (Pct of GDP)

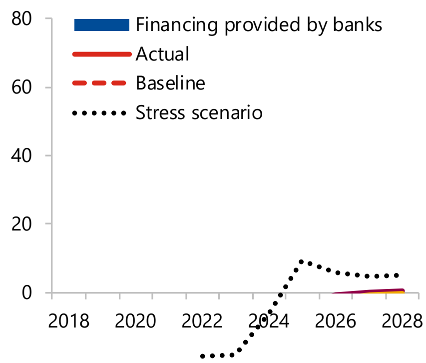


Debt Fanchart Module

	Value	Contrib [1/]	Percentile in peer group [2/]
Fanchart width *(percent of GDP)*	119.4	1.7	
Probability of debt non-stabilizaiton *(percent)*	16.5	0.1	
Terminal debt-to-GDP x institutions index	7.8	0.2	
Debt fanchart index (DFI)		2.0	
Risk signal: [3/]		Moderate	

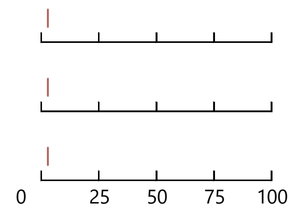


Gross Financing Needs (Pct of GDP)



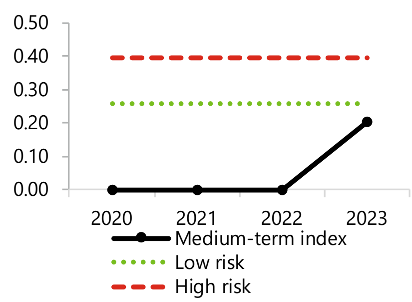
Gross Financing Needs (GFN) Module

	Value	Contrib	
Average baseline GFN *(percent of GDP)*	-6.8	-2.3	
Banks' claims on the ger govt *(pct bank assets)*	0.0	0.0	
Chg. In banks' claims in stress *(pct banks' assets)*	0.0	0.0	
GFN Financeability Index (GFI)		-2.3	
Risk signal: [4/]		Low	



Banking crisis Commodity prices Exchange rate Contingent liab. Natural disaster

Medium-term Index (Index number)



Medium-term Risk Analysis

	Value	Norm. Value	Weight	Contribution
Debt fanchart index	2.04	0.45	0.50	0.23
GFN finaceability index	-2.31	-0.04	0.50	-0.02
Medium-term index		0.2		
Risk signal: 5/		Low		
Final assessment:		Moderate		

Prob. of missed crisis, 2023-2028, if stress not predicted: 9.1 pct.

Prob. of false alarms, 2023-2028, if stress predicted: 52.3 pct.

Commentary: The Debt Fan Module points moderate risk in the medium term due to vulnerability to external shocks as indicated by the large width of the chart. The GFN Financeability Module is not performed as Nauru does not have a domestic banking sector that possesses government debt. Staff assess that liquidity risk is limited as Nauru uses Australian dollars as legal tender and foreign reserves appears to be adequate. Hence, the overall medium-term risk assessment is solely based on the solvency indicator.

Source: IMF staff estimates and projections.

1/ See Annex IV of IMF, 2022, Staff Guidance Note on the Sovereign Risk and Debt Sustainability Framework for details on index calculation.

2/ The comparison group is emerging markets, non-commodity exporter, surveillance.

3/ The signal is low risk if the DFI is below 1.13; high risk if the DFI is above 2.08; and otherwise, it is moderate risk.

4/ The signal is low risk if the GFI is below 7.6; high risk if the DFI is above 17.9; and otherwise, it is moderate risk.

5/ The signal is low risk if the GFI is below 0.26; high risk if the DFI is above 0.40; and otherwise, it is moderate risk.

Annex III. Risk Assessment Matrix

Likelihood	Risks	Expected Impact	Main Policy Recommendation
External Risks			
Medium	**Abrupt global slowdown or recession.** Global and idiosyncratic risk factors combine to cause a synchronized sharp growth downturn, with adverse spillovers through trade and financial channels, and markets fragmentation.	Medium Abrupt global slowdown could affect Nauru's trading partners and donors, leading to weaker economic activities, reduced remittances, and lower grants.	Maintain prudent fiscal policy and build fiscal buffers through revenue mobilization to generate more sustainable sources of revenue. Targeted subsidies to protect the most vulnerable.
High	**Commodity Price Volatility.** A succession of supply disruptions and demand fluctuations causes recurrent commodity price volatility, external and fiscal pressures, and social and economic instability.	High A sharp increase in commodity prices will transmit to domestic inflation and possibly social instability. High import costs could worsen the external position and affect fiscal balance through rising cost of imported goods.	Secure steady food and fuel delivery through future contracts. Targeted subsidies to protect the most vulnerable and accelerate shift to renewable sources of energy, such as solar power.
High	**Deepening Geo-Economic Fragmentation.** Broader and deeper conflicts and weakened international cooperation lead to a more rapid reconfiguration of trade and FDI, supply disruptions, technological and payments systems fragmentation, rising input costs, etc.	High Further increase in food and commodity prices would push up inflation and affect fiscal and external sustainability through larger deficits.	Build fiscal buffers through revenue mobilization to generate more sustainable sources of revenue. Targeted subsidies to protect the most vulnerable.
Medium	**Extreme Climate Events.** Extreme climate events cause damage to infrastructure, and loss of human lives and livelihoods, amplifying supply chain disruptions and inflationary pressures, causing water and food shortages, and reducing growth.	High Nauru is extremely vulnerable to climate-related shocks given its small size, remoteness, and the concentration of its population and buildings in coastal areas.	Improve disaster preparedness by seeking cost-effective insurance, establishing contingency financing from bilateral partners, and investing in climate-resilient infrastructure.
Internal Risks			
High	**Uncertainties related to the scale-down of the Regional Process Center (RPC) over the medium-term.** Uncertainty about RPC revenues after FY2026.	High Given the importance of RPC-related activities in the economy, a sharper-than-expected reduction in RPC-related revenue over the medium-term would worsen the fiscal position and weaken growth. A significant scale-down would lead to mass job losses, undermine macro stability, and risk social discontent.	Accelerate plans for the upskilling, reallocation, and retraining of RPC workers. Maintain prudent fiscal policy and build fiscal buffers through revenue mobilization to generate more sustainable sources of revenue. Mobilize donor support if needed.
High	**Continued pressure on correspondent banking relationships (CBRs) and on financial services.** Connectivity to the global payments system remains fragile. The lack of a CBR for USD transactions imposes high transaction costs. Continued decline of financial services by international banks in the region could create additional pressures and risks.	High A loss of CBR could exclude Nauru from the global banking and payment system and hinder financial inclusion. Continued pressure on CBRs and financial sector services could disrupt disrupt payments, affecting essential financial services and economic activities.	Cooperating with foreign counterparts to facilitate the participation of financial services providers in Nauru is crucial. Contingency planning for potential losses of CBRs and risks to financial services. Continue to strengthen the AML/CFT framework by implementing the recommended actions from the APG Mutual Evaluation. Close infrastructure gaps that constrain the use of digital payments.
Medium	**Delayed fiscal and structural reforms.** Nauru relies heavily on volatile non-tax revenues (i.e., RPC revenues and fishing license fees), which pose significant fiscal risks.	Medium Delayed fiscal and structural reforms could lead to overdependence on volatile sources of revenues, jeopardizing fiscal sustainability and dampen long-term growth potential.	Maintain prudent fiscal policy and build fiscal buffers through revenue mobilization to generate more sustainable sources of revenue. Work with development partners to prioritize the reform agenda and monitor reform progress.
Medium	**Social discontent.** Supply shocks, high inflation, RPC-related job losses, a decline in real wage, and worsen inequality could trigger social discontent, slow growth, and undermine policy credibility.	Medium As a small state, social cohesion is relatively high and the incidence of social discontent turning into social unrest is limited.	Secure steady food and fuel delivery through future contracts. Targeted subsidies to protect the most vulnerable. Accelerate plans for the upskilling, reallocation, and retraining of RPC workers.

Annex IV. Nauru Revenue Mobilization[1]

Nauru faces significant spending needs related to achieving sustainable development goals (SDGs) and adapting to rising sea levels. Revenues from the Regional Processing Center (RPC) are expected to fall over the medium term as the RPC enters the "enduring capability" stage. Tax reforms and policy commitments will be key to meeting the country's financing needs in a sustainable manner. These measures include: (i) removing discretionary exemptions in import duties and ultimately replacing import duties with excise duties; and (ii) improving the progressivity of the personal income tax and reducing exemptions in the corporate income tax in the short term. In the medium term, the authorities should implement further revenue administration measures, such as revenue risk management, audits, and regular review of excise rates. Over the long term, the authorities could consider introducing a value added tax—a good sustainable source of revenue.

A. Motivation

1. Similar to other Pacific Island Countries (PICs), Nauru faces significant spending needs related to achieving the SDGs and adapting to rising sea levels. Nauru has demonstrated its commitment to achieving the SDGs through the review of its National Sustainable Development Strategy (NSDS). However, only 26 percent of the NSDS milestones have been implemented, due to a lack of funding and capacity, weak coordination, land issues, and unclear goals (UN Voluntary National Review for Nauru, 2019). In addition, Nauru is vulnerable to the impact of climate change, including rising sea levels, changes in rainfall patterns, and higher ocean temperature and acidification, given its relatively low capacity to cope with disasters.[2]

2. The revenue performance has been strong but is expected to decline over the medium term. Despite the COVID shock, revenue has increased from 102.6 percent of GDP in 2018 to 141.2 percent in 2022, driven by a rise in RPC revenues. However, as the RPC transitioned into the "Enduring Capability"[3] state in July 2023, RPC-related revenues are expected to decline over the medium term, putting revenues on a downward trajectory. In addition, Nauru relies heavily on volatile non-tax revenue (RPC and fishing license fees) and grants[4], which brings considerable uncertainties to fiscal performance.

3. Higher tax revenue would need to be an essential pillar of financing SDGs and climate-related spending, with policy commitment being a key to tax policy reform (Sy et al., 2022). The sizable spending needs to meet SDGs and achieve climate resilience require decisive tax and

[1] Prepared by Yue Zhou (APD).

[2] See IMF climate change dashboard Climate Change Indicators Dashboard (imf.org)

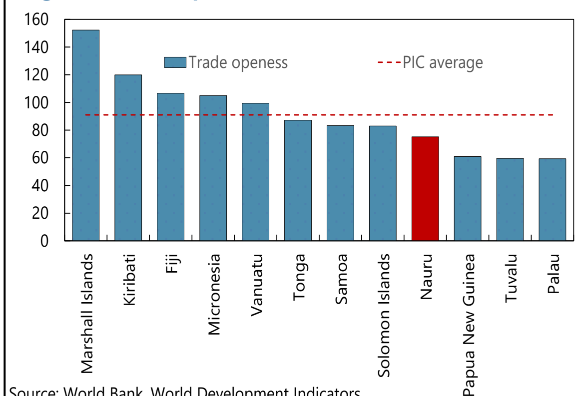
[3] The RPC was established by Australia in September 2012 to process asylum seekers' international protection claims. The "Enduring Capability" phase is intended to maintain RPC services at a contingent ready state, capable to be reactivated to host new arrivals.

[4] Non-tax revenue and grants account for more than 60 percent of total government revenue in FY2022.

revenue administration reforms to raise revenue. However, raising tax revenue requires policy commitment and public support. A well-designed communication strategy and stakeholder consultation emphasizing the benefits of reforms will be key to increasing awareness and building consensus.

4. Nauru has the potential to collect additional revenue by enhancing institutional quality (Sy et al., 2022). International experience shows that the most important determinants of tax capacity include GDP per capita, trade openness, the share of agriculture in GDP, control of corruption, and government effectiveness. For Nauru, a rise in government effectiveness, and trade openness (relative to the PIC average) could play an important role in reaching its revenue potential (Figure 1). Similar to other PICs, Nauru faces challenges in raising tax revenues (Sy et al., 2022). The major obstacles include: (i) an over-reliance on fishing revenue and grants; (ii) a lack of reform momentum; (iii) policy and legislative constraints; (iv) insufficient information and communication technology (ICT); and (v) understaffed and underfunded tax administration. Moreover, the technical capacity of staff in the Nauru Revenue Office could be further strengthened to improve the quality of tax administration.

Figure 1. Trade Openness (2019)



Source: World Bank, World Development Indicators.
Note: Trade openness is measured as total export plus imports divided by GDP.

B. Reform Options: Tax Policy Measures and Institutional Reforms

Short Term Measures

5. Nauru could consider replacing import duties with excise duties on a limited range of goods. Import duties contain discretionary exemptions granted by regulation according to the Custom Act, with most exemptions granted by Cabinet decisions. This gives rise to concerns about a lack of transparency, a potential for abuse, and inequality. Exemptions also lead to forgone revenue, which could be significant.[5] In addition, Nauru has signed but has not ratified the Pacific Agreement on Closer Economic Relations Plus (PACER Plus), under which some PICs are required to abolish import duties and investigate alternate sources of revenue to offset these losses. While PACER Plus will not have a significant revenue impact for at least 10 years, due to the generous schedule of tariff reductions negotiated by Nauru, the authorities could move sooner to eliminate the distortionary import duties and replace them with excise duties.

[5] In 2020, the Pacific Financial Technical Assistance Center (PFTAC) provided technical assistance to the Nauruan authorities on a Tax Policy Reform Strategy to help formulate a tax system that provides sustained revenues while improving equity. Some of tax policy advice in this Annex is drawn from that report.

6. Improving the progressivity of the Personal Income Tax (PIT) and closing loopholes in the Corporate Income Tax (CIT) for multilateral companies can help recover the foregone revenue.

- *The Employment and Service Act (2019) sets a flat PIT rate of 20 percent for resident individuals with monthly earnings above 8400 AUD (RPC-related employees are taxed at 30 percent).* However, the current tax base is very narrow due to the excessively high tax-free thresholds. Redesigning the PIT schedule with a lower threshold and a progressive tax rate would increase tax revenue and have a beneficial redistributive effect, while reducing administrative burdens.
- *On CIT, the continued use of tax exemptions to incentivize investment could erode the tax base* and encourage other investors to seek exemptions, reducing confidence, and leading to lower economic growth potential. Therefore, a comprehensive review to take stock of the existing tax exemptions should be conducted to help eliminate unnecessary exemptions and limit forgone revenue on existing taxes.

Medium Term Measures

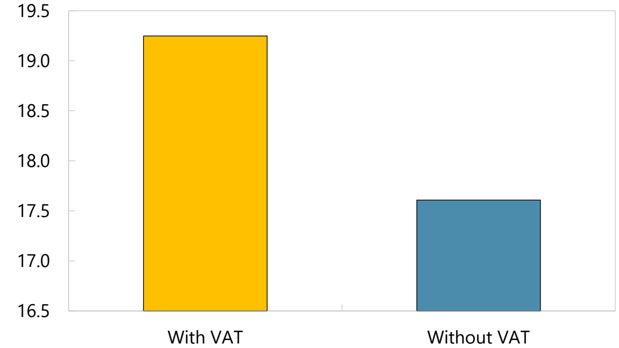
7. Further revenue administration measures are warranted to achieve revenue mobilization. International experience suggests that revenue administration measures accompanied tax policy measures in 90 percent of successful revenue mobilization episodes, regardless of the country's income level or tax revenue level. The most common measures include audits and verification programs to reduce incidences of tax evasion and corruptive practices. Streamlining tax payment processes by focusing on large taxpayers also help manage payment obligations. These measures are of particular interest to PICs as government effectiveness seems to have the largest impact on revenue potential (Sy et al., 2022). In addition, the authorities could explore regional opportunities for trainings in tax administration, risk management, and audits to improve the capacity of staff involved in tax administration.

8. Investment in digitalization, including ICT support, e-tax, e-commerce, could facilitate tax administration and increase revenue. Digitalization supports all aspects of revenue administration, including registration, filing, monitoring, and compliance management. Digital technology has been increasingly used in revenue administration to address the information gaps that hinder revenue mobilization. Nevertheless, the benefits vary by tax types and the type of digital technologies. The authorities would need to improve digital infrastructure and provide technical training to staff as the success of digitalization in revenue administration depends largely on the availability of stable digital connectivity and qualified revenue administrative staff. The planned undersea fiber-optic cable project could help improve access to high-speed, reliable, and affordable internet services and create economic opportunities.

Long Term Measures

9. Nauru could consider introducing VAT together with eliminating the distortionary trade taxes. The VAT is considered less distortionary than trade tax as the crediting mechanism under a VAT prevents tax cascading and it applies to both domestic and imported goods, if well designed and administered (Casperson and Metcalf, 1994; Hoseini and Briand, 2020; Pomeranz, 2015). International experience shows that the introduction of VAT (and rate increase), eliminating exemptions, and a focus on large taxpayers can help collect significant tax revenues in a sustainable manner (Figure 2). Such tax policy measures could deliver significant gains but might take longer time to implement in Nauru due to capacity constraints and the sensitivity of tax collection. For example, introducing VAT at the international average tax rate (of 16 percent) and C-efficiency[6] (of 65 percent) could raise tax revenue by up to 10.4 percent of GDP in Nauru.[7]

Figure 2. Tax Revenues with VAT System in PICs



Note: The average tax-to-GDP ratio of countries without VAT system is much lower once large (three-off) CIT payments from 2017 to 2019 in Micronesia are factored out. Micronesia does not have a VAT.

Sources: IMF (2022); and IMF staff calculations.

[6] The VAT C-efficiency is measured by the actual VAT revenue as a share of GDP divided by VAT rate, an indicator of the efficiency of the VAT system.

[7] Potential VAT revenue is calculated as Nauru's GDP multiplied by the average VAT rate and the average C-efficiency.

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Annex V. Financial Sector Development[1]

Nauru has limited financial services and cross-border payment facilities. This annex provides an overview of Nauru's financial sector, developments in correspondent banking relationships (CBRs), and improvements to the AML/CFT framework. It examines the potential impact of financial sector and CBR pressure on the economy and proposes policy options to improve Nauru's access to formal financial services.

Financial Sector Development

1. **Nauru has made notable progress in rectifying its AML/CFT regulatory framework.** Nauru has had a long history of pressures on the financial sector, including a loss of CBRs and financial services, dating back to early 2000s. The CBR pressures were largely associated with legacy issues related to its offshore financial center, and the liquidation of Bank of Nauru (BoN), culminating in the temporary designation of Nauru by the Financial Action Task Force (FATF), as a non-cooperative territory in 2000. Nauru passed a Counter Terrorism and Transnational Organised Crime Act in 2004 and an anti-money laundering and terrorism financing law in 2008. In 2003, Nauru was removed from the OECD's List of Uncooperative Tax Havens.[2] In 2005, Nauru came off FATF's Non-Cooperative Countries and Territories (NCCT) list.[3] In 2008, the U.S. Department of Treasury withdrew its earlier notice and finding of Nauru as a jurisdiction of primary money laundering concern.[4] Measures were taken for the closure of the offshore banking sector and the BoN, and efforts were made to deregister overseas companies. Nauru was essentially de-banked between 2004 and 2014 and operated as a cash economy for more than a decade.[5] In 2015, the government re-established the provision of banking services in Nauru through an agency agreement with Bendigo and Adelaide Bank Limited of Australia (Bendigo Bank Australia).[6] In 2019, the Global Forum on Transparency and Exchange of Information for Tax Purposes (the Global Forum) rated Nauru as largely compliant.

2. **The financial sector in Nauru remains underdeveloped, with limited access to financial services**. Like other microstates in the Pacific, Nauru does not have its own currency or central bank and uses the Australian dollar as the legal tender. Nauru also lacks any domestic formal financial institutions. The only financial institution in Nauru, Bendigo Bank Agency, is an agency of an Australian financial institution, and is subject to Australian financial supervision and AML/CFT

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[1] Prepared by Dannah Al-Jarbou (SEC) and Seruwaia Cagilaba (APD).

[2] See [Nauru is Removed from OECD List of Uncooperative Tax Havens - OECD]

[3] See [FATF Annual Report 2005-2006]

[4] See https://www.fincen.gov/sites/default/files/shared/Section311_WithdrawalNauru.pdf

[5] De-banking refers a complete loss of financial services.

[6] The Agency opened in Nauru in June 2015, pursuant to an agency agreement between Nauru's Ministry of Finance and Bendigo and Adelaide Bank Limited of Australia. https://naurufinance.info/bendigo-agency/

regulations and supervision (AUSTRAC). AUSTRAC is also the Financial Intelligence Unit (FIU) to which Bendigo files Suspicious Transaction Reports (STRs). Under the agency agreement, Bendigo Bank Agency can provide Nauru's residents access to basic financial services, including savings and term deposits, ATM access, and electronic payments through internet banking and international debit cards. However, the agency bank does not offer loans or asset management products in Nauru (IMF, 2017). An agent of Western Union, an international money transfer operator (not a deposit-taking bank) was also established in Nauru in 2008 and was registered through letters of exchange with the Ministry of Justice that administers the Business License Act. Western Union in Nauru is supervised by New Zealand's AML/CFT supervision authority, NZFIU. Connectivity to the global and regional financial sector is limited partly due to Nauru's small size, economy, population, and its remoteness.

CBR-Related Developments

3. **Connectivity to the global payment system remains fragile given the limited financial services and cross-border payment facilities**. Western Union in Nauru, while providing global money transfer services, can only facilitate small scale transactions up to a limit of AUD 50,000 per day (for total nation-wide transactions).[7] Bendigo Bank Agency in Nauru does not have direct CBRs but accesses CBR services indirectly via Bendigo Bank Australia. Bendigo Bank Australia is supervised by Australian authorities. Bendigo Bank Agency does not have access to CBRs for foreign currency transactions in US dollars,[8] British Pounds, Euros, or Fiji dollars through Bendigo Bank Australia.

4. **The decline in foreign banking interest and CBRs in Pacific Island Countries (PICs) reflects multiple factors, including limited business opportunities and relatively high costs of performing banking operations**.[9] International banks have continued to refine their methodologies for allocating capital to the most profitable business lines and to re-orient their business model to focus on core business over the past decades. Low growth, small size, and structural issues such as land ownership limit growth and business opportunities in PICs. Furthermore, an unfavorable ML/TF risk perception, driven for example by low ratings in AML/CFT assessments, can have a negative impact on the risk appetite of foreign banks in the context of CBRs, or may increase the cost of compliance in PICs due to ML/TF risk perceptions. In the context of remittances, a 2021 report by AUSTRAC assessed the overall ML/TF risk for remittances sent through remittance providers from Australia to PICs as low (AUSTRAC, 2021). In June 2023, AUSTRAC has issued guidance for financial institutions to ensure a balance between risk

[7] This daily limit for total transactions is set by negotiation with Western Union's regional management and can be increased. A limit of AUD 7,500 per day applies to both businesses and individuals.

[8] Subsequent to the FATF designation in 2000, on December 20, 2002, the US Department of the Treasury designated Nauru as a jurisdiction of primary money laundering concern. This resulted in the imposition of special measures, including the prohibition on U.S. financial institutions from maintaining correspondent accounts for Nauru financial institutions. On April 18, 2008, this finding was withdrawn. See FinCEN Advisory – FIN-2008-A005 | FinCEN.gov .

[9] Some examples of loss in CBRs in the Pacific: Tuvalu, the country's largest bank lost its long-term CBR with an Australian bank; Marshall Islands' only domestic commercial bank was informed it would lose its CBR with a U.S.-based bank by the end of 2016 citing concerns about the cost of complying with new U.S. regulations.

management and financial inclusion, in the context of the decline of financial services in certain contexts within Australia (AUSTRAC, 2023).

5. Ongoing improvements in the AML/CFT framework may help Nauru improve its jurisdictional risk perceptions and attract financial service providers, as needed. Nauru has an updated AML/CFT legal framework, which has undergone significant improvements over the years. The recent Anti-Money Laundering and Targeted Financial Sanctions Act 2023 was enacted to address many of the shortcomings in the AML/CFT legal framework. The new law also entails provisions for simplified and enhanced due diligence, that would support proportionate risk-based compliance measures by the domestic financial sector. The law also facilitates participation of potential financial services providers, for example by enabling certain foreign financial institutions to provide Nauruans access to financial services, without the additional burden of AML/CFT supervision and oversight in Nauru, if this is conducted by the home country of the financial institutions.

The Impact of Financial Sector and CBR Pressures

6. A lack of full banking services in Nauru remains a constraint to future economic development. Prior to the entry of Bendigo Bank Agency, the economy was cash based with no payment systems, and was reliant on formal and informal remitters.[10] However, to some extent businesses and individuals were able to hold non-resident bank accounts abroad (for example, in Australia) and conducted financial transactions via Internet banking (APG, 2012). During the absence of formal banking services from 2004-2014, both formal and informal remitters provided cash to the government and state-owned enterprises for payroll in exchange for electronic deposits to their accounts in Australia. However, these remitters operated on a small scale and did not provide accounts or take deposits. The informal remitters enabled Nauruans living in Australia to remit funds to Nauru (APG, 2012). In addition, when Nauru was without a bank, the Government used BoN facilities for storing cash to pay salaries, which were paid over the counter on presentation of a paycheck (ADB, 2007). The continued lack of full banking services to date limits private sector development opportunities in Nauru as firms are unable to access credit both locally with the Bendigo Bank Agency as well as in Australia. Banking services remain limited in Nauru due to a range of factors, including changing business model of foreign banks, limited business opportunities for banks, and relatively high costs of banking operations. Perceived legacy issues continue to pose challenges in assessing correspondent banking services.

7. The lack of correspondent banking services in major currencies make foreign exchange (FX) transfers costly and limits access to the international financial system. Currently, Nauru incurs losses in incoming FX transactions for fishing license fee revenues as payments are to be made by licensees in US dollars, a major currency in which Nauru has no CBRs. US dollar denominated trade is estimated to have accounted for around 13 percent of total imports in FY2022.

[10] In 2012, in addition to Western Union there were three small scale informal remitters that provided remittances services in addition to their main line of business (general stores). Businesses that are established for the sole purpose of money transfer services would be subject to normal business registration under the Business Licenses Act and/or Corporations Act (if incorporating). The only formal remittance provider was the agent of Western Union which was licensed under the Business Licenses Act.

Essential imports such as fuel are settled in US dollars, adding another layer of FX transaction costs. The lack of US dollar correspondent banking services could complicate some debt repayments A further restriction of CBRs and financial services could affect Nauru's financial inclusion and access, complicates the receipt of donor aid and grants, and limit economic growth, investments, and diversification (IMF, 2021). Further pressure on financial services would disrupt national and international payments and cross-border flows, trade, and remittances, risking exclusion from international payment networks.

8. **Further restriction of financial services can have a significant economic and financial impact**. Foreign banks have played an important role in developing the banking systems in PICs, bringing in technology infrastructure such as staffing, operational knowledge and capacity, and capital. The return of banking services to Nauru helped promote financial inclusion. Within 18 months of the opening of Bendigo Bank Agency in Nauru, the number of accounts had reached to 7,600 (IMF, 2017), with the latest number at 14,100 in 2023. Through Bendigo Bank Agency, Nauru-based customers have access to the regional and global financial payment system and can undertake cross border payments (including digitally) that are essential for businesses and individuals and for the government to undertake treasury operations (except in the currencies that are not facilitated for Nauru-based customer accounts, as set out above). A further restriction of formal financial services would have widespread implications for the wider Nauruan economy, particularly given its high dependence on imports and foreign inflows from RPC-related revenues, fishing licensing fees, and official development assistance. Moreover, the production of electricity and water is also dependent on imported fuel that are paid in US dollars. Reduced access to international flows and formal financial services would further marginalize the PIC economies, accentuating their economic and financial vulnerability.

Policy Recommendations

9. **A multi-pronged approach with both market and non-market solutions is necessary**. On market solutions, advancing structural reforms is needed to improve the business climate and help generate opportunities for banks to intermediate transactions. This includes improving access to the internet, as the cost of mobile internet plans in Nauru is among the highest in the region. A new undersea communication cable project, East Micronesia Cable, is expected to improve the quality and cost of internet services. The project is in partnership with Australia, Japan, and the United States to support Nauru along with two other Pacific Islands to improve internet connectivity, provide funding and implementation support to build the needed infrastructure[11]. The authorities will also need to address structural issues such as land ownership, to attract private sector investment. For non-market solutions, the public sector could play a more active role given the

[11] The project is a six-party collaboration between Australia (through the Australian Infrastructure Financing Facility for the Pacific), Japan and the United States, Kiribati, Federal States of Micronesia (FSM) and Nauru. The value of this project is estimated at USD$95 million and is 100 percent grant funded. The new submarine cable will connect the three Pacific nations with the existing HANTRU-1 cable at FSM, providing internet connectivity through a submarine cable. For details, see the Australian Infrastructure Financing Facility for the Pacific (AIFFP), "East Micronesia Cable", available at https://www.aiffp.gov.au/investments/investment-list/east-micronesia-cable

public good nature of banking services in PICs, for example, by considering carefully designed subsidies to facilitate CBRs (see IMF, 2023).

10. Digital financial innovations, if appropriately designed and managed, could provide a durable and safe resolution to financial sector challenges, by providing greater access and financial inclusion. Digitization and innovation are a necessary pillar that must be tailored to each country's circumstances. Given Nauru's strong mobile phone presence (about 90 percent of the population has access), digital solutions that enable fiat transactions may alleviate concerns related to limited access to financial services, for example, through mobile money and online banking enabled by improvements in digital technology. This could potentially go hand in hand with attracting foreign commercial banks that provide financial services digitally to Nauruan citizens. The implementation of the required AML/CFT measures is essential prior to the commencement of such services, in line with the FATF recommendations, including those related to the use of new technologies and to money transfer services. Remote online banking services (by regional financial institutions that are effectively regulated and supervised by their home jurisdiction, supported by strong bilateral cooperation mechanisms between the Nauruan authorities and their overseas counterparts) could also be provided.

11. More proactive discussions and concerted actions are needed at the regional level to identify solutions to financial sector pressures in the PICs. Given that such pressures are affecting many PICs, there is a need for enhanced regional efforts and engagement with advanced economies in the region to proactively identify possible regional solutions. The authorities could also use regional platforms including the APG for raising any AML/CFT related issues that constrain the provision of financial or CBR services, whether in Nauru or the broader PICs context, or in relation to requirements of foreign banks. Further donor support could help enable authorities to tailor regional solutions to country specific context.

12. Going forward, the authorities are encouraged to continue improving Nauru's access to formal financial services. Strengthening the business environment to reduce costs of doing business and improve business opportunities for banks needs to be prioritized. Strengthening the AML/CFT system is important not only for enhancing access to CBRs but also for bolstering Nauru's overall financial integrity and resilience. Aligning the legal framework with the FATF recommendations can lead to better technical compliance ratings in the ongoing APG assessment, and thereby contribute to alleviating legacy compliance perceptions. Infrastructure gaps that constrain the use of digital payments would also need to be properly addressed. The planned undersea cable project could help improve access to affordable internet services and digital payments.

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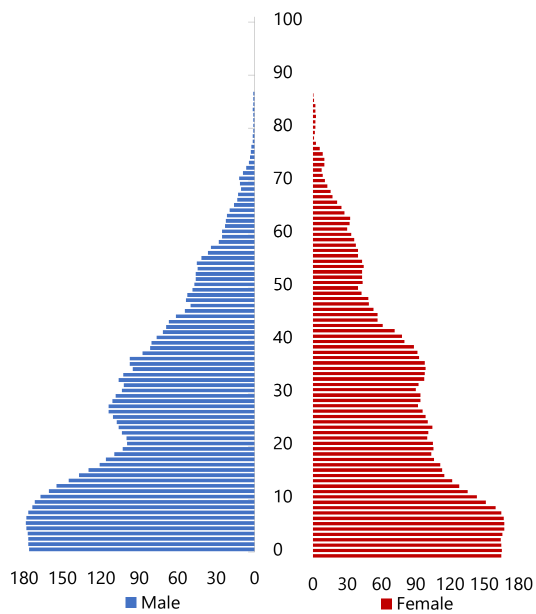
Annex VI. Education Spending and Sustainable Development Goals (SDGs)[1]

Nauru has a large share of school-age population. While the current level of education spending is estimated to be adequate, the school enrollment and attendance rates and the teacher-to-student ratio appear to be low. Preliminary analysis suggests that improving the efficiency of spending on education is needed to reach the outcomes of high-performance peers. Education spending should prioritize improving enrollment and attendance rates and increasing the teacher-to-student ratio.

1. Nauru has a large share of school-age population. In Nauru, 35 percent of the population is at school age (Figure 1), nearly twice as high as the average for peer countries. Given the significant share of youth, the working-age population in Nauru will increase to 61.4 percent in 2033 from the current 58.8 according to UN projections.

Figure 1. Population Pyramid in Nauru, 2023



Sources: Nauru Bureau of Statistics, World Population Prospects (2022 Revision), and IMF staff calculations.

2. Nauru's education spending is estimated to be broadly adequate, based on preliminary estimates by the IMF's Fiscal Affairs Department. Nauru spends around 7.7 percent of GDP on education, compared to a required amount of 8.1 percent based on a SDG costing exercise (see Table 1 and Appendix). The main observations are: (i) the student-per-teacher ratio is very high compared to high-performing peers; (ii) teacher wages are slightly below peer countries

[1] Prepared by Nick Carroll (FAD) and Yue Zhou (APD).

(1.2 percent of GDP per capita vs 1.5 percent in peer countries); (iii) capital and other recurrent spending (not related to teachers' salaries) is high (79.6 percent vs 40.8 percent); and (iv) the share of public spending in education is high.

Table 1. Nauru: Preliminary Estimates of Education Inputs and Spending of Benchmark Countries

	3-year Average GDP per Capita US$7000-US$20000			Nauru	
	All	Low Performance	High Performance	2020 (or latest)	2030
GDP per capita	12,347.6	12,113.5	12,998.0	10,323.3	10,241.4
Cost drivers and other factors					
Students per teacher ratio	14.3	15.1	12.2	36.0	12.2
Teacher wages (ratio to GDP per capita)	1.8	1.9	1.5	1.2	1.5
Capital and other recurrent spending (% total spending	44.1	45.3	40.8	79.6	40.8
Student age population (% total population)	27.3	27.8	25.8	45.7	47.0
Enrollment rate (preprimary to tertiary)	84.8	83.1	89.4	70.9	81.4
Private share (% of total spending)	21.3	23.3	16.0	10.1	16.0
Spending and outcomes					
Education spending (percent of GDP)	5.3	5.4	4.9	7.7	8.1
Public	4.2	4.2	4.1	6.9	6.8
Private	1.1	1.3	0.8	0.8	1.3
Spending per student (USD 2020)	2,816.3	2,842.0	2,755.9	2,442.1	2,171.4
SDG4 index	90.9	88.2	98.3		>97

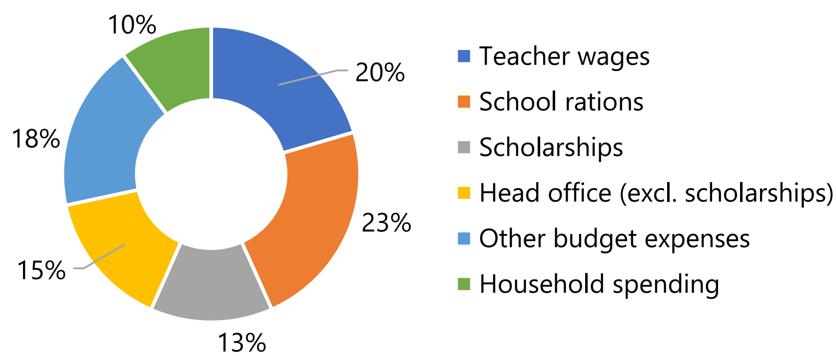
Source: IMF Staff estimates. These preliminary estimates were produced based on publicly available from the World Bank, the authorities, and other sources. They are preliminary estimates as they have not undergone the usual peer review validation and review for spending estimates, and therefore are subject to change. The Annex outlines the key data and assumptions that were used for the table.
Note: All countries with a GDP per capita between US$7000-US$20000 and an SDG 4 index equal to or greater than (below) 97 in 2021 are classified as high (low) performing peers.

3. **The challenge of lifting education participation in Nauru is significantly greater than the headline enrollment numbers suggest.** The major challenge facing Nauru's education system in terms of participation in education is around school attendance (i.e. enrolled students not attending school). Data provided by the authorities suggests an attendance rate of 39.8 percent compared to an enrollment rate of 70.9 percent. This suggests that there needs to be a doubling of the number of students attending school from current levels (to achieve an effective participation rate of 80 percent that is achieved by peer countries). If the student-to-teacher ratio is adjusted for the number of attending students (rather than student population), the current effective student-to-teacher ratio is 14.3, a level similar to peers.

4. **The main driver of high costs in Nauru's education system is capital and other recurrent spending, instead of teachers' salaries.** Compared to other countries, Nauru spends a large share of its education budget on items other than teachers' wages (Figure 2), including school rations (23 percent of the budget) and scholarships (13 percent of the budget). There are potentially rationales for spending on both overseas scholarships and food programs at school. However, if this

spending mix were to be maintained, Nauru would need to increase resources for teaching staff (particularly if attendance rates at school can be significantly raised), meaning that it would need to spend more than high performing peers. Alternatively it could look for savings in capital and other recurrent spending to cover some of the additional teaching costs.

Figure 2. Composition of Nauru Education Spending, 2021



Source: IMF staff calculations on 2023-24 budget data.

5. Education policies should prioritize lifting attendance and enrollment, increasing the number of teachers and improving the quality of teaching. Nauru should develop systems to reach every child and keep them in school, such as identifying and re-enrolling out-of-school (OOS) children through direct outreach and through engaging parents, families, and communities through mobile technologies or in-school events aimed at improving their involvement in children's education (see World Bank 2023). Doubling student numbers while improving the student-to-teacher ratio, would require additional teaching staff costing 1.6 percent of GDP (assuming that the teaching workforce would need to double in size). Policies should focus on allocating resources more efficiently from capital and other recurrent spending to hiring more teachers and improving teaching quality. Further revenue mobilization, prioritization of education spending, and improved efficiency of educational spending are warranted (Annex IV).

6. Nauru should continue to leverage the existing education programs with Australia to improve education outcomes. The Nauru Improved Education Initiative (up to AUD 5 million, FY18-22) aims to improve the number and quality of teaching staff; increase the enrollment and retention rates of students; and improve access to relevant high-quality tertiary, technical and vocational education services. In response to the scale down of the RPC, which is expected to affect around 800 workers (20 percent of working age population), the Nauruan authorities announced an Alternative Pathways Program to retrain and reskill displaced workers with the support of the Australian government, including reemployment opportunities in Nauru and through international labor mobility schemes. The Nauru-Australia development partnership program could be further strengthened through: (i) developing a comprehensive education and health sector strategy across ministries; (ii) enhancing donor support coordination to agree on broad areas of funding support; (iii) establishing an education and health working group to coordinate different stakeholders; and (iv) retaining quality teachers and healthcare staff in Nauru.

Appendix. Preliminary Estimates of Education Spending Needs[1]

The SDG costing estimate for education is expressed as the total additional spending needed to perform well in the education SDG (SDG 4), that is, the difference between the spending needed in 2030 and the spending level today. The estimated spending needs to achieve the SDG 4 reflect the projected demographics characteristics (e.g., student-age population) in Nauru by 2030 and the current levels of education spending in Nauru's high performing peers. These cost drivers include teachers' wages, the student-to-teacher ratio, the enrollment rate, and education spending other than the teacher wage bill as a share of total education spending. The total education expenditures (as a percent of GDP) needed in 2030, E^{2030} is expressed as an identity:

$$E^{2030} = \frac{w_{ref}}{STR_{ref}} e_{tar} \frac{SAP^{2030}}{100-E_{ref}^{oth}}$$

where

- w_{ref} is the reference, or benchmark, value of teachers' annual wages as a ratio to GDP per capita, applied to Nauru for 2030; the reference values emanate from the average values of Nauru's peers that perform well on the SDG 4 index;

- STR_{ref} is the reference value of the student-teacher ratio,

- e_{tar} signifies the target enrollment rate, i.e., the number of students as a percentage of the student-age population, based on 2 years of ECD/pre-primary and of tertiary level, and 4 years of primary and of secondary levels

- SAP^{2030} indicates Nauru's projected student-age population as a percent of total population, in 2030, and

- E_{ref}^{oth} pertains to the reference value of all education spending besides the teacher wage bill, expressed as a percent of total expenditures in education.

The approach of matching Nauru's 2030 cost drivers to today's level of the high performers is seen in the corresponding columns of Table 1. Table A.1 gives the data sources and the computation of demographic factors and cost drivers (latest estimates available are for 2020, 2021 or 2022).

The assumptions made here are based on available data sources and the assumptions required to ensure consistency in the SDG costing tool. There may be some variations from other existing sources and the sources and values are subject to change.

[1] All variables refer to total (i.e., public plus private) spending in this appendix unless otherwise indicated.

Table A I.1. Nauru: Computation and data sources for variables used in the education SDG costing estimation

Variable	Value	Computation	Data source
Population (*pop*)	12,787	Extracted from the source	WDI
Student age population, *SAP* (percent of total pop)	45.7	100 * population_aged_2_to_22 / *pop*	WDI
Total student population (pre-primary-tertiary)	5842	Population * % student age population	Derived
Enrollment rate	70.9	From authorities	Authorities
Enrolled students	4142	Total student population * enrollment rate	Derived
Attending students	2324	Attendance rate * total student population	Attendance rate provided by authorities
Student-teacher ratio	36	From authorities	Authorities
Number of teachers	162	Total student population / student-teacher ratio	Derived
Teachers wages	US$12,748	Adjusted for inflation and exchange rate	2020 budget speech
Total public spending (million A$)	12.55	2021 actual spending (Education)	2023-24 Budget
Share of non-food household spending on education (hh_edu)	1.4%	Extracted from source	Nauru hardship and poverty report
Private spending on education (million A$)	1.41	hh_edu *(household non-food spending / GDP) * GDP	Derived + WEO
Total spending (million A$)	13.96	Public spending + private spending	Derived
Exchange rate (US$ – AU$)	1.38	Period average (2022)	WEO
Total spending (million US$)	10.115	Total spending * exchange rate	Derived
Nominal GDP (million US$)	131,055	Extracted from the source and averaged for 2018-20	WEO
Nominal GDP per capita 2018-20 (US$)	10,323	nominal_GDP / *pop*	Derived
Real GDP per capita, 2030 (million US$)	10,241	Computed by the IMF team	IMF team
Total education spending, *E* (percent of GDP)	7.7	Total spending / nominal GDP	Derived
Other recurrent and capital spending (% total spending)	79.6	Teacher wage bill / total spending	Derived

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Annex VII. Improving Resilience to Climate Change[1]

Given Nauru's location and small size, it is vulnerable to climate risks, particularly through coastal erosion, storm surges, and rising ocean temperature impacting the stock of tuna. The authorities introduced initiatives to strengthen climate resilience through improved infrastructure to safeguard strategic assets. The "Higher Ground Initiatives" program is designed to fight climate change (specifically, the threat of rising sea levels) and environmental degradation, including rehabilitating households at risk from coastal erosion to higher elevation areas.

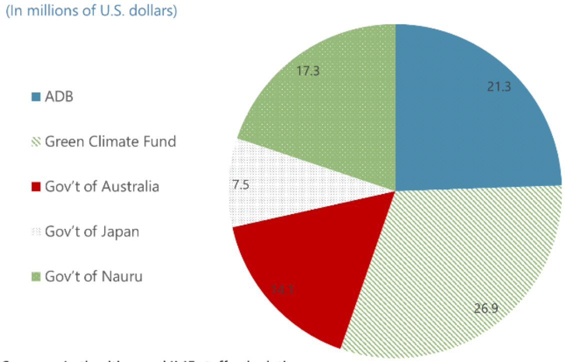
Furthermore, Nauru has been addressing climate risks through both mitigation and adaptation approaches and has made substantial progress on both fronts, through the ongoing construction of a climate resilient port and solar farms. About 50 percent of electricity in Nauru will be generated by solar power by Q2 2024. The climate resilient port will allow for more reliable transportation link, encourage increased trade and economic activity, and reduce Nauru's carbon footprint by 30 percent. This annex examines Nauru's progress with the climate resilient port and solar farms and their expected impact on the economy.

A. Sustainable and Climate-Resilient Connectivity Project

1. **Nauru is constructing a new climate resilient port to allow for a more reliable transportation link and encourage increased trade and economic activity**. Nauru's government is partnering with the Asian Development Bank (ADB), the Green Climate Fund (GCF), the Government of Australia and the Government of Japan to construct a new port that includes container storage and port security facilities to improve connectivity, replacing the century old port (NMPA - Nauru Maritime and Port Authority). Currently, Nauru is one of the least connected countries in the world (bottom 10) based on maritime connectivity (United Nations, 2022). The new port will significantly improve Nauru's port operations and improve the process of loading and unloading cargos from vessels by providing safer docking and anchoring options for ships.

2. **The climate resilient port is Nauru's largest climate project, co-financed by the international partners and the Government of Nauru**. The project's overall construction cost was initially budgeted for USD65.2 million (about 52 percent of GDP) at the time of approval in January 2018. ADB agreed to lead the project with co-financing from the GCF, Governments of Australia, Japan (all grant financing) and Nauru. The new port is located on land leased to the government through long term arrangements. The construction of the port project is currently facing some delays and cost overruns. The delays were partly due to

Project Financing
(In millions of U.S. dollars)



Sources: Authorities; and IMF staff calculations

[1] Prepared by Dannah Al-Jarbou (SEC).

strict Covid-19 guidelines related to personnel and temporary relocation costs[2] and staffing and skills constraints. The estimated completion date for the port was September 2023, however, further delays are expected. In May 2022, ADB approved a $15.0 million additional financing grant to cover project cost overruns (APD, Data Sheet 2022, and IMF, 2021).

3. Nauru's remoteness, size, and limited local capacity present challenges to project implementation. The project already encompassed technical difficulties related to building a deep-water port in a challenging marine environment. Furthermore, Nauru faces continued staffing and skills constraints to carry out the required construction and monitoring needed to deliver on the project effectively and efficiently. Given these challenges, the ADB has put innovative safeguards and called for strong and well-defined reassurances to ensure costs are controlled with strong project management to ensure successful completion[3] (ADB, innovation 2020).

4. Improved port infrastructure has the potential to benefit trade, the business environment, and economic activities through new growth opportunities. These benefits include further economic diversification, new commercial opportunities in domestic fisheries, and improved employment opportunities. Nauru's exclusive economic zone (EEZ) is one of the most favorable in the region for tuna purse seine fishing[4]. The completion of the new port and related infrastructure is expected to help Nauru capitalize more on its EEZ. Investing in refrigerated storage could help develop domestic fish containerization facilities (and fish processing in due course) in Nauru and help generate additional government revenues. The development of the new port could create local employment opportunities through the development of new industries and the expansion of fisheries through domestic fish containerization and processing facilities.

5. Nauru's Carbon footprint is expected to be reduced by 30 percent with the introduction of the new port (IMF, 2019). The new port will allow large vessels to berth directly at the port of Aiwo and shelter them from waves, improving overall safety and efficiency. This is expected to reduce the waiting time for docking and the accompanying fuel consumption compared to the current mooring system. Nauru is dependent on maritime and air cargo for essential food and fuel, which can be expensive and restrictive. By allowing ships to dock year-round (instead of weather dependent), the new port is expected to lower the cost of shipping and essential imports (including fresh food), improve the supply chain of goods, and provide Nauru with better access to international shipping and services (ADB, DD 2020).

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[2] The new port is located on land leased through long term arrangements to the government (ADB, innovation 2020), and some of the existing residents would need to be relocated for the construction of the port. The government prepared a resettlement plan complying with ADB safeguard policies.

[3] Safeguards included: (i) real-time remote drone-based monitoring system to track progress and identify gaps and risks; (ii) appoint an independent specialist firm to advise on the design review to enhance the credibility among the stakeholders and financiers; (iii) engage external probity support to audit procurement activity and ensure transparency and integrity; and (iv) add independent technical auditors to audit the performance of both the contractor and the supervision consultant.

[4] Tuna purse seine fishing is an efficient method that enables vessels to catch (with vertical nets) and freeze onboard large quantities of tuna.

B. Solar Power Development Project

6. Nauru is constructing a new solar farm, co-financed by the ADB and the Government of Nauru. This project, which is currently under construction was commissioned in 2021, will fund the delivery of reliable, affordable, and sustainable solar energy to meet the needs of the island nation. At the time of signing, the ADB's grant was valued at USD 22 million, with an expected completion date in 2024. The project is fully owned by Nauru Utility Company (NUC, the developer) and covers six hectares of land for the new solar farm (ADB, 2019).

7. Nauru's energy security was heavily reliant on imported diesel, with about 97 percent of total electricity coming from diesel generators in 2018. The reliance on imported fossil fuels delivered through Nauru's single port creates vulnerability to both fluctuations in international fuel prices and supply disruptions including from weather-related events. The dependence on fossil fuel for energy generation has increased the risk of power outages stemming from supply interruptions and volatile fuel prices (ADB, 2023). The heavy reliance on imported diesel fuel for power generation was also very expensive and not environmentally friendly.

8. Nauru's move to renewable sources of energy will further reduce its reliance on diesel and increase the share of electricity generated by solar power to about 50 percent by 2024. This project is the third solar farm initiative on the island. Currently, about 10 percent of electricity on the island is generated by solar power, through one 500-kilowatt (KW) solar plant funded by the United Arab Emirates, a 1 MW solar plant funded by New Zealand government and the EU and other existing solar panels on rooftops that connect to the grid. The new ADB solar farm project is expected to generate about 30-40 percent of electricity, bringing the total solar dependency to about 50 percent by 2024 (ADB, 2023). This project is expected to further reduce dependance on diesel, provide significant savings in production costs of electricity and reduce CO2 emissions. The latest solar farm project is also envisaged to improve the overall energy efficiency of the business environment and strengthen the institutional capacity of the NUC, by training staff in the new solar and storage systems (SolarQuarter, 2019). However, the current battery storage capacity remains limited and increasing the capacity would further reduce Nauru's dependence on imported fuel.

9. The solar project is expected to help accelerate progress in gender equality through the implementation of the gender action plan. The gender action plan within the solar farm project is designed to improve the employment and training outcomes of women with detailed targets, indicators, and defined responsibility of ownership. For workers on the solar power plant and the battery storage system, the plan explicitly includes hiring targets ranging from 10 to 20 percent women. This target has been exceeded, with the current composition of woman at about 33 percent as of end June 2023. The plan also aims to improve awareness to gender topics from equal pay, policies related to harassment, to improving facilities to better accommodate women in the workspace.[5]

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[5] See Asian Development Bank, Gender "Solar Power Development Project: Investment Facility Report - Pacific Renewable Energy Investment Facility - Gender Action Plan". Available at: http://www.adb.org/Documents/RRPs/?id=49450-009-2

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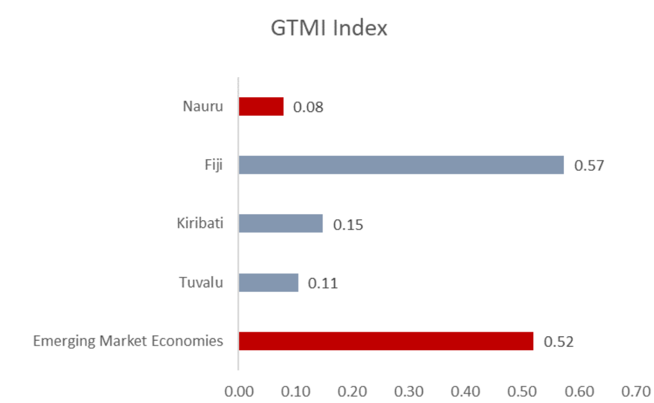
Annex VIII. The Digitalization Challenge in Nauru: Investment Needs and Possible Benefits[1]

The annex: (i) assesses the state of digitalization and the use of government technology in public finance (GovTech) in Nauru in comparison to its peers; (ii) estimates digital infrastructure investment needs to achieve universal broadband; (iii) identifies the determinants and social dividends of digital adoptionn; and (iv) assesses the tax revenue benefits related to GovTech.

1. Nauru envisages digitalization—from GovTech to private sector e-businesses and foreign investment—as one of the engines of growth over the medium term. The government has taken steps to ensure affordable internet access to all citizens. For example, the government has completed 50 percent of the domestic underground cable construction and has started geographical exploration for the construction of the fiber-optic cable connecting Nauru to the rest of the world. Nevertheless, internet access remains relatively expensive: a mobile contract including 2 GB of data at a minimum of 3G speed costs US$ 20.40 per month, equivalent to 1.5 percent of income, compared to 1.1 percent of income in Emerging Market economies.[2] While 84 percent of the population is connected to the internet—similar to Fiji with 88 percent and above Kiribati and Tuvalu with 54 percent and 72 percent, respectively— the internet speed is relatively slow.

2. Nauru lags its peers in the use of GovTech. The GovTech Maturity Index (GTMI, see Figure 1) traces the advances in supporting core government systems, enhancing service delivery, mainstreaming citizen engagement, and fostering GovTech enablers. In particular, Nauru has room for improvements in *Digital Citizen Engagement* (which measures aspects of public participation platforms, citizen feedback mechanisms, open data, and open government portals) and in *GovTech Enablers Index* (which captures strategy, institutions, laws, and regulations, as well as digital skills, and innovation policies and programs, to foster GovTech).

Figure 1. GovTech Maturity Index



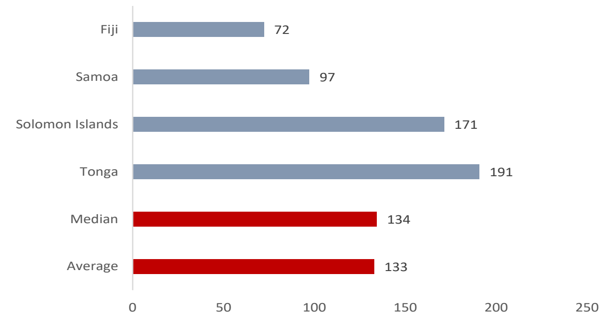
Source: World Bank, https://www.worldbank.org/en/programs/govtech/gtmi.

[1] Prepared by Mariano Moszoro (FAD) and Yue Zhou (APD).

[2] "Mobile communications and Internet in Nauru," https://www.worlddata.info/oceania/nauru/telecommunication.php.

3. IMF staff estimates that the investment needs in domestic digital infrastructure to achieve universal broadband in Nauru range from US$ 148 thousand to US$ 390 thousand (i.e., 0.1–0.3 percent of GDP). This amount is based on the cost of connecting a user in in peer Pacific Island Countries (Fiji, Samoa, Solomon Islands, and Tonga) according to Oughton, Amaglobeli, and Moszoro (2023), times the population still to be connected in Nauru (16 percent of 12,780 population).

Figure 2. Cost Per User in Pacific Island Countries



Source: Oughton, Amaglobeli, and Moszoro (2023).

4. More importantly, Nauru has started upgrading its backbone connection to bring high-speed, reliable, and affordable internet access. Nauru relies on satellites for most of its internet connections. Only around 8 percent of the population have their own fast internet connection. The penetration rate of 4G is around 30 percent and there is no modern 5G network.[4] The instalment of a fiber-optic cable to mainland Australia to connect Micronesia, Nauru, and Kiribati by December 2025 is expected to significantly increase internet speed from 1.5 gbps to 10 gbps. Total cost is estimated at $95 million[5] and will be funded by Australia, the US, and Japan.[6]

5. The government needs to address data affordability by encouraging market competition once the fiber-optic cable becomes operational. In general, a more concentrated telecom market, rather than a more competitive one, allows broadband service providers to exploit their market power and charge higher prices. Currently, Nauru relies on one single private company to provide data service, partly attributed to its small market size. Encouraging market competition, such as open bidding for data services provision, and improving the corporate governance framework would help reduce the costs of data services.

6. Attaining higher digital connectivity in Nauru can generate significant social dividends. The government is encouraged to develop a digital adoption plan to fully reap the benefit of digitalization.

[4] "Mobile communications and Internet in Nauru," https://www.worlddata.info/oceania/nauru/telecommunication.php.

[5] Nauru's FY23-24 Budget Speech, https://naurufinance.info/wp-content/uploads/2023/06/2023-24-BP1-Budget-Speech_Final.pdf, and "Pacific internet cable to curb China aims," *The Washington Post*, June 19, 2023. https://www.arkansasonline.com/news/2023/jun/19/pacific-internet-cable-to-curb-china-aims/. Arguably, one-third of this cost is attributable do Nauru.

[6] ABC/Reuters, "New undersea internet cable for Nauru, Kiribati and the Federated States of Micronesia will be funded by Australia, the US and Japan," 30 December 2021, https://runway.airforce.gov.au/resources/link-article/new-undersea-internet-cable-nauru-kiribati-and-federated-states-micronesia.

- Raising internet adoption from the current 80 percent to full 100 percent would lead to a 4.3 percentage point upswing in **labor force participation**.[7] This impact is more pronounced for women (5.8 percentage points) compared to men (2.4 percentage points). There's also evidence indicating that internet usage diminishes the time spent on unpaid labor by women (Kumar, Amaglobeli, and Moszoro 2023).

- Utilizing digital tools in **education** can produce noteworthy educational dividends. The Nauru Education Connectivity Project, launched in 2019, aims to install Wi-Fi networks in all schools and provide laptops and tablets for students and teachers.[8] Empirical findings underscore that digital integration can substantially enhance educational outcomes (Kumar, Amaglobeli, and Moszoro 2023). Equipping students with digital devices and internet access stands to benefit a broader spectrum of learners aiming to access education in Australia and New Zealand.

- Increased digitalization and connectivity can positively impact the accessibility and the delivery of **healthcare** services through various avenues (Wang and Bloch 2023). Information gathered from electronic health records can contribute to diagnostics, disease monitoring, health security, and furnish valuable evidence for policymaking (including resource allocation). The health spending is around 8 percent of total expenditure. However, a significant portion of healthcare expenditure in Nauru is channeled towards sending individuals to Australia for basic treatments. Telemedicine—which was banned in February 2019—[9] holds the potential to alleviate pressure on healthcare services. Additionally, digital tools for disease surveillance can pinpoint outbreaks and monitor disease spread, while novel digital platforms can streamline international pooled procurement efforts to improve drug accessibility.

- Digitalization can contribute to strengthening the **social safety net (SSN)** by enhancing identification accuracy, eligibility verification, and delivery mechanisms. Nauru's SSN relies heavily on the support of the extended family, which limits the productivity and mobility of workers—particularly for women.[10] Improved coverage of SSN can be attained through targeted approaches employing socioeconomic data to curtail losses resulting from identification and verification challenges. Digital payment systems can yield fiscal savings; a transition from physical cash disbursements to financial transfers can alleviate the responsibilities of frontline service providers concerning cash management (Bird and Hanedar 2023).

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[7] The estimates are derived from a difference-in-difference regression of labor force participation on internet use at country level after controlling for GDP per capita and other country characteristics. For detailed methodology, see Kumar, Amaglobeli, and Moszoro (2023).

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[10] Republic of Nauru, 2021 Article Iv Consultation—Press Release; Staff Report; Informational Annex; And Statement by the Executive Director for Nauru.

7. Leveraging GovTech has the potential to streamline revenue collection and enhance spending efficiency. Total revenue is 115 percent of GDP in 2024, but it is expected to decline to 80 percent of GDP over the medium term due to planed RPC scale-down. GovTech solutions in revenue administration could help alleviate this revenue loss. Transitioning to comprehensive e-filing procedures could increase tax revenue by up to 3 percent of GDP (Amaglobeli and others), while implementing electronic fiscal devices (EFDs) and e-invoicing can contribute to advancing revenue mobilization by 0.6 percent and 0.8 percent of GDP, respectively (Nose 2023). At the same time, the introduction of a public management information system can improve expenditure transparency by systematically documenting capital projects and enhancing the oversight of capital budgets across the project lifecycle.

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Annex IX. Authorities' Response to Fund Policy Advice

Fund Recommendation	Policy Actions
Fiscal Policy	
Extend vaccinations to the younger eligible population and calibrate fiscal support for food and fuel security to the state of the pandemic. Authorities should calibrate containment measures to the state of the pandemic while scaling up preparedness, including enhancing medical facilities to meet both long-term needs and a possible public health emergency.	The adult population is fully vaccinated. Covid vaccinations has been extended to the younger eligible population aged 4-11 year olds and 12-18 year olds, of which 86 percent and 92 percent are fully vaccinated. The authorities have removed all Covid containment measures and reduced Covid-related spending in FY24 budget, including capital expenditures due to one-off provisions made in FY23 relating to COVID. For future preparedness, the authorities have implemented the Public Health Bill 2023, invested in ongoing staff training and upgraded medical facilities to provide the care and prevention services. In the FY24 budget, AUD 6.6M was allocated as Community Service Obligations (CSOs) to key SOEs to help keep food, fuel, and electricity affordable for the public.
Expeditiously formulate a plan to absorb or upskill current RPC workers.	The authorities have put in place an Alternative Pathways Program, which is funded by Australia to upskill those affected by the RPC scale down and to facilitate re-employment within Nauru or in Australian labor mobility programs. To date, about 400 people have lost their jobs due to the RPC scale down and are currently undergoing training under the Alternative Pathways program.
Tax Reforms	
Formulate a medium-term revenue strategy to generate more reliable forms of revenue, including by widening the tax base, raising excise taxes on goods tied to poor lifestyle habits, and introducing a consumption tax.	The authorities are reviewing their medium-term revenue strategy. They are considering some of the recommendations from the 2020 PFTAC TA related to widening the tax base for employment and services tax (EST) and small business tax (SBT) and raising the tax rate for SBT.
Governance and PFM Reforms	
Ensure that the SOE monitoring unit is adequately resourced, phase out subsidies to weak-performing SOEs and enhance procurement processes in line with international standards. On PFM, formalize the fiscal responsibility ratios in a rules-based framework with mechanisms to manage deviations from those rules; phase out cash transactions; and formulate a new debt management strategy.	The SOE monitoring unit still needs to be adequately resourced to improve accountability. The compliance of SOEs with the Public Enterprise Act could be further strengthened. The authorities viewed that the accuracy and the reliability of some SOE financial reports could be further improved. The authorities have phased out subsidies to some nonperforming SOEs in the FY23 and FY24 Budgets. A new debt management strategy was formulated and finalized in 2022. There are plans to review the current procurement framework and fully digitize the current tax administration. Further effort to limit supplementary budgets is needed, which were issued in FY23.
Financial Sector Reforms	
Continue efforts to align the AML/CFT framework with the revised 2012 FATF recommendations, accelerate implementation of legislated improvements to the AML/CFT framework, and measures to mitigate identified risks.	Authorities implemented the Anti Money Laundering and Targeted Financial Sanctions Act 2023 in June, with support from the Asia Pacific Group on Money Laundering (APG), which addresses gaps identified in 2018. There are plans to finalize the 2023 National Risk Assessment and address the remaining AML/CFT gaps ahead of the APG Mutual Evaluation in October 2023.

Structural Reforms	
Fund Recommendation	**Policy Actions**
To develop new sources of growth, measures to lower structural barriers should be taken in the short-term. Addressing governance weaknesses would enhance long-term growth potential. Improving the quality of education and health in accordance with the SDG goals will need targeted investment.	Plans are underway for an undersea cable financed by Australia, Japan, and the United States to enhance digital connectivity. More effort is needed to close infrastructure gaps, including in waste management and dwelling quality. Steps have been taken to improve education quality in the FY24 budget, including training and capacity development for teachers, improving school facilities and rations. According to FY24 budget, the Government of Nauru (GON) will invest over AUD 20M in the health sector and related services to improve and strengthen local hospital capacity.
Climate Policies	
Mitigating the effects of climate change can help the transformation required to raise potential growth and achieve fiscal self-reliance.	In terms of climate mitigation measures, the climate-resilient port is further delayed and expected to be operational by end FY24, and a solar farms project, co-financed by the ADB, is expected to be completed in FY24. GON has implemented the Higher Ground Initiative, which is a long-term climate adaptation initiative focused on relocating those affected by rising sea levels. In the FY24 budget, AUD 1.8M has been allocated to further develop the site on Land Portion 230, and AUD 3.0M was allocated towards Phase 2 of the Higher Grounds Initiative.

INTERNATIONAL MONETARY FUND

REPUBLIC OF NAURU

November 2, 2023,

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

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

CONTENTS

FUND RELATIONS

(As of September 30, 2023)

Membership Status: Joined April 12, 2016; Article VIII

General Resources Account:

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

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocations	3.55	100.00
Holdings	2.86	80.75

Outstanding Purchases and Loans: None

Financial Arrangements: None

Projected Payments to Fund
(SDR Million based on existing use of resources and present holdings of SDR):

	Forthcoming				
	2023	**2024**	**2025**	**2026**	**2027**
Principal					
Charges/Interest	**0.010**	**0.030**	**0.030**	**0.030**	**0.030**
Total	**0.010**	**0.030**	**0.030**	**0.030**	**0.030**

Exchange Rate Arrangement

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

Technical Assistance

Nauru has received technical assistance (TA) from the Pacific Financial Technical Assistance Centre's (PFTAC) and from the Capacity Development Office in Thailand (CDOT) in recent years. In FY2023, TA provided by PFTAC included developing a PFM roadmap, a review of the Public Expenditure and Financial Accountability, a review of tax administration and core tax functions, updating the GDP estimates, and the compilation of the Government Finance Statistics (GFS). In FY2024, PFTAC TA has offered additional support for the compilation of 2020-2021 GDP estimates and a review of tax administration and core tax functions. TA on external sector statistics delivered by CDOT is setting up a compilation program for the balance of payments and IIP statistics including addressing institutional issues.

Resident Representative

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

Technical Assistance Activities:

IMF Capacity Development		
Provided by:	**Topic:**	**Period:**
PFTAC	Statistics - National Accounts	July 2018
CDOT	Statistics - External Sector Statistics	October 2018
PFTAC	PFM – Transition to IPSAS Cash Reporting	February 2019
PFTAC	Revenue – Review of tax administration reforms	April 2019
PFTAC	Statistics - National Accounts – Building independent compilation capacity	May 2019
PFTAC	Revenue – Review organizational arrangements and core tax functions	September 2019
PFTAC	PFM – Financial Reporting on IPSAS Cash	November 2019
PFTAC	Government Finance Statistics	December 2019
PFTAC/FAD	Tax Policy Review	January 2020
PFTAC	Revenue – Organizational arrangements and core tax functions	March 2020
PFTAC	Macroeconomic Analysis Program	August-September 2020
PFTAC	Revenue – Revenue Administration Program	November 2020
CDOT	External Sector Statistics	November – December 2020
PFTAC	Government Finance Statistics	November – December 2020
PFTAC	Statistics – National Accounts	January 2021
PFTAC	Revenue – review administrative reforms	April 2021
PFTAC	Statistics – National Accounts	July 2021
PFTAC	Macroeconomic Program – Macro-fiscal model	August 2021
CDOT	External Sector Statistics	November – December 2021
PFTAC	PFM – Agile PEFA Assessment	March – May 2022
CDOT	Statistics - External Sector Statistics	October 2022

Provided by:	**Topic:**	**Period:**
PFTAC	Statistics – Updating National Accounts GDP	November 2022
PFTAC	Revenue – Enhance compliance improvement strategy and improve core tax functions	February 2023
PFTAC	PFM Roadmap	February – April 2023
PFTAC	Statistics - Government Finance Statistics	April 2023
PFTAC	Revenue - Risk management of tax collection and tax audit capability development	June 2023
PFTAC	Revenue – Enhance compliance improvement strategy and improve core tax functions	August 2023
PFTAC	Statistics – Updating National Accounts GDP	September 2023
PFTAC	Macroeconomic Program - Macro-fiscal model	November 2023

RELATIONS WITH OTHER INTERNATIONAL FINANCIAL INSTITUTIONS

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

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

STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance
General: Data provision has serious shortcomings that significantly hamper surveillance. Nauru became a member of the IMF in April 2016. During the membership preparation in 2014-15, the authorities compiled data with the support of PFTAC technical assistance (TA). Most macroeconomic data remain unpublished and are compiled during TA missions by PFTAC and CDOT. Despite one additional staff being recruited and assigned to the compilation of external sector statistics, the capacity of the National Bureau of Statistics (NBS) remains limited. Nauru has continued to rely on TA, capacity supplementation, and donor support in compiling data.
National Accounts (NA): Annual GDP estimates have improved with the support of PFTAC TA. In November 2022, TA was provided to update the real sector statistics. The mission assisted the NBS with the compilation of GDP estimates for 2020-2021 and recommended a Memorandum of Understanding with the National Revenue Office to access business tax records for further improving NA statistics. The NBS should increase the number of suitably skilled technical staff for compiling NA as currently only 1 staff is working part-time on NA.
Price Statistics: The NBS compiles the quarterly CPI with the reference year 2015. However, the latest PFTAC TA in 2019 found that the CPI data has some shortcomings related to the prices of imported motor vehicles. There are no producer, wholesale, or trade price indices.
Government Finance Statistics (GFS): Nauru reported budgetary central government GFS for the first time in 2018 with significant assistance from PFTAC. The authorities published quarterly central government GFS in 2018 and annual data in 2019, however no estimates were produced during the Covid-19 pandemic. The latest GFS TA mission in April 2023 extended the time series to 2022 and provided the authorities with streamlined tools to support the statistical compilation. However, the production process has not been internalized by the authorities, which continue to rely on capacity supplementation from PFTAC to compile and disseminate the GFS.
Monetary and Financial Statistics: There are no monetary and financial statistics available since the financial sector is still in early stage of development. Nauru uses the Australian dollar as legal tender and does not have a central bank. There was no financial institution in Nauru over the past decade until Bendigo Bank agency opened in Nauru in June 2015. The agency provides financial services (mainly deposits, but no loans and no foreign exchange transactions) on behalf of Bendigo and Adelaide Bank Limited of Australia. Nauru reported data to the Financial Access Survey (FAS) for the first time in 2023. Data series reported include the number of ATMs, the number of depositors and deposit accounts at commercial banks, the value of outstanding deposits at commercial banks, the number of debit cards, and the number of mobile and internet banking transactions for 2022.
External Sector Statistics (ESS): An absence of the ESS data hampers surveillance. There is only one staff in the NBS that is assigned and trained to compile ESS, therefore there is limited prospects of developing a self-sustained compilation program over the medium-term due to capacity constraints and unresolved institutional issues. In the absence of domestic data sources for important ESS components (including cross-border trade), there is a need to rely on partner countries' data. Apart from well-known limitations of relevant databases, the reliance on partner countries' data has drawbacks from confidentiality concerns due to the size of Nauru's economy. An October 2022 ESS TA mission assisted authorities in compiling balance of payments data for FY 2022 and advised on further developments of the ESS compilation program following the ESS project framework.

II. Data Standards and Quality	
At present, Nauru does not participate in any of the IMF's Data Standards Initiatives.	No data ROSC are available.

Table of Common Indicators Required for Surveillance
(As of October 2023)

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange rates[1]	10/25/2023	10/25/2023	D	NA	NA
International reserve assets and reserve liabilities of the monetary authorities[2]	09/30/2023	09/30/2023	NA	M	NA
Reserve/base money[3]	NA	NA	NA	NA	NA
Broad money[3]	NA	NA	NA	NA	NA
Central bank balance sheet[3]	NA	NA	NA	NA	NA
Consolidated balance sheet of the banking system	NA	NA	NA	NA	NA
Interest rates	NA	NA	NA	NA	NA
Consumer price index	03/2023	06/2023	Q	Q	Q
Revenue, expenditure, balance and composition of financing[4]—general government[5]	FY2023	NA	NA	NA	NA
Revenue, expenditure, balance and composition of financing[4]—central government	FY2023	06/2023	M	Q	NA
Stocks of central government and central government-guaranteed debt[5]	FY2023	06/2023	A	A	NA
External current account balance	FY2022*	11/2022	A	A	A
Exports and imports of goods and services	FY2022*	06/2023	A	A	A
GDP/GNP	FY2021*	08/2021	A	A	NA
Gross external debt	FY2022	10/2022	A	A	NA
International investment position[6]	FY2022*	11/2022	A	A	A

[1] Nauru uses the Australian dollar as its legal tender.

[2] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means. Data on reserve position in the Fund and SDR holdings are available on the IMF website https://www.imf.org/data/imf-finances. Other reserve assets include deposits channeled via Bendigo Bank Agency into Bendigo Bank Australia which are considered cross-border and liquid and unrestricted government financial assets in Bendigo Bank Agency in Nauru are legitimately attributed to international reserves. Data on other reserve assets is from government of Nauru cash monitor.

[3] Foreign, domestic bank, and domestic nonbank financing.

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

[5] Including currency and maturity composition.

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

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

* Compiled by experts during TA missions.

Statement by the IMF Staff Representative
November 17, 2023

This statement is to update the Executive Board on developments following the issuance of the Staff Report for the 2023 Article IV Consultation. These developments do not alter the thrust of the staff report or staff appraisal.

Bendigo Bank's planned exit from Nauru was made public on November 14, 2023, when the Government of Nauru and Bendigo & Adelaide Bank (the Bank) issued a joint statement notifying that Bendigo Bank Agency will exit Nauru by December 2024.

On the reason for the planned exit, the joint statement noted that "the Bank has identified the opportunity to reduce complexity and simplify its business by focusing on its Australian operations and exiting its only international presence". The statement highlights the 12 months' advance notice as "enabling an orderly transition to another provider of banking services".

On next steps, the joint statement mentioned that "the Australian Government and the Asian Development Bank (through the Private Sector Development initiative) will support the Government of Nauru as it explores alternative providers of banking services. Bendigo Bank will provide assistance and support to enable an orderly transition to a new provider."

Statement by Robert Bruce Nicholl, Executive Director for Republic of Nauru and Chris Becker, Advisor to the Executive Director
November 17, 2023

This was the first full in-person mission since the pandemic. The authorities attach significant value to engagement with the IMF and broadly concur with the staff assessment, including most policy recommendations. Being one of the most isolated, small, and vulnerable members of the Fund, Nauru faces difficult policy choices while constrained by very limited prospects for economic diversification.

The challenge of isolation and being small. Nauru is remotely located, around 2,000 miles north-east of Australia in the Pacific Ocean. The total land mass of just 8 square miles is around one-third of the size of Manhattan Island, with a population of around only 12,000 people. However, including the vast territorial waters, the exclusive economic zone is more than twice as large as New York State. Fishing-related activities and shipping are important to Nauru, but it's very small economy severely limits the ability to leverage benefits of the 'blue economy'. Many of the usual economic indicators, such as income per capita, are misleading in the case of microstates because they do not meaningfully reflect the high cost of living or the fixed costs of providing infrastructure and government services to a small population. Transport costs are extremely high, and almost all goods, materials, and services are imported. Even vegetables and other foods are difficult to cultivate in Nauru due to a lack of arable land.

Exposure to natural disasters and the effects of global warming represent a significant risk to the economic outlook. Several initiatives, like the new port facilities and solar farms, are underway to adapt to climate change, but predicted shifts in migration patterns for tuna stock are considered a downside risk, given they provide a major source of revenue from the sale of fishing licenses to foreign vessels.

Economic infrastructure, development, and diversification. The Regional Processing Centre (RPC) is the single largest source of economic activity, government revenue, and employment in the economy. However, activity is expected to scale down as the Centre is used less over time. The authorities are engaged in finding ways to accommodate this transition. Plans are underway to absorb some RPC workers into other sectors and to provide upskilling through training for others. Infrastructure projects are supporting growth, although we note that it is only possible to manage very few projects concurrently, given capacity constraints and domestic skills shortages. The biggest project currently underway is the new maritime port and container storage facility. This infrastructure development looks promising in its potential to generate significant local benefits and might pave the way for related industries, such as a hub for containerization and shipping services to the rest of the Pacific. A major challenge will be to limit costs since containers that arrive almost always return empty given the lack of exports. While work is progressing on the port, there have been Covid-related delays and cost overruns.

The solar farm projects are delivering benefits but are somewhat hindered by battery storage costs. Other infrastructure projects focus on upgrading and maintaining the ring road and tarmac on the airport landing strip. The move to renewable sources of energy achieves the dual purpose of moving away from generating electricity by burning expensive fossil fuels (such as diesel), while also meeting environmental targets.

Broadening the economic base is very difficult. Remittance revenues are negligible given limited participation in regional worker initiatives and there is little domestic application for farming skills. Given that much of the labor force is not work ready, few are able to participate in seafaring or fruit picking in Australia or New Zealand.

Nauru does not have a meaningful comparative advantage in tourism. Other Pacific islands like Fiji and New Caledonia are well-established tourist destinations, with associated infrastructure, including more frequent flights that are around five times cheaper than a flight to Nauru. Currently, the island is also not a particularly desirable holiday destination due to environmental degradation related to phosphate mining, an absence of hotels, waste management challenges, strong coastal currents that make swimming dangerous, and a lack of entertainment. Developing a niche tourism industry (game fishing, WWII sights) would be a long-term venture with possible merit, but this would divert scarce investment funds from higher priority areas such as health, education, infrastructure, or small-scale replacement of food imports.

Economic diversification is also hindered by the inability to tap into economies of scale. Both the absolute value of economic activity and the number of industries that can be sustained are limited on a small land mass with few inhabitants. The arrangements for land ownership are a major constraint. Land rights are often inherited in a manner that splits the property rights between many relatives, leading to minute fragmentation of land titles which is difficult to overcome when negotiating acquisition of larger tracts of land. The authorities acknowledge this as a problem that holds back many aspects of economic activity and development, but at the same time find it difficult to implement policies that contravene customary practices.

Financial sector and associated arrangements. Nauru uses the Australian dollar as its legal tender and does not have a central bank or commercial banks. In 2015 the government entered into an 'agency' arrangement with an Australian bank. The accounts and transactions of Nauruans are ultimately managed abroad by the parent bank and most of the associated financial infrastructure is not physically located in Nauru. Agency staff are accredited in Australia as financial service providers and must abide by requirements of the licensing regime in the parent jurisdiction. Australian regulators supervise all aspects of the operations of the agency based on Australian best practice.

In addition, the government is active in maintaining its AML legislation to current standards and engages with regional bodies such as the Asia-Pacific Group (APG) on Money Laundering. In its previous assessment, the group noted that Nauru faces low risks of money laundering and terrorist financing. The regulatory authorities in both Australia and New Zealand have characterized the overall risks in the Pacific to be low-medium. Nauru was removed from the OECD list of uncooperative tax havens almost 20 years ago and is now considered to be largely compliant, reflecting its commitment to transparency and information exchange. The authorities are frustrated by the inability of the international financial system to look beyond the financial mismanagement in the past.

As is the case with other agencies operated by the parent bank, the Nauru agency cannot have its own direct Correspondent Banking Relationships (CBR) that would allow it to conduct cross-border transactions in its own right. Fostering indirect CBRs, therefore, involves explaining the benefits and safeguards of the agency arrangement. However, it continues to be both expensive and difficult to conduct foreign exchange transactions in US dollars, euros, British pounds, and Fiji dollars. The lack of connectivity to the international payments system makes inbound investment almost impossible and curtails economic development. Even the receipt of donor aid and grants is complicated and expensive when not received in Australian dollars.

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

Fiscal position and indebtedness. The fiscal position has improved dramatically in recent years since the authorities were able to reach a substantially discounted settlement on legacy debt obligations. The debt sustainability analysis continues to assess debt as being sustainable.

The authorities note that support for the national airline, phosphate mining, and fuel subsidies bring indirect benefits in terms of food security, employment, and ongoing access to trade in goods and services. The Utilities Corporation provides electricity at a discount to ensure that low-income households remain included in accessibility to power. Similarly, the national carrier is the sole supplier of critical air travel services that connect Nauru to the rest of the world. Given that there is no lending to finance private sector commercial or household activity, there is considerable reliance on State-Owned Enterprises (SOE) either through the direct provision of goods and services, or through subsidies to support community services. The authorities are committed to further strengthening governance and public financial management, including ensuring that the SOE monitoring unit is sufficiently resourced to close gaps in accountability.

Education, and social safety net. Education outcomes in Nauru are held back by poor attendance and a cultural change is needed for teenagers to complete high school. The lack of work-readiness translates directly into a shortage of skills and well-educated workers. The government is actively engaged in deepening the pool of talented students who complete secondary schooling and those who seek tertiary education abroad. Creating domestic work opportunities is also important for retaining talent.

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

The population is at risk of non-communicable diseases and health care facilities are limited.
The social safety net is largely delivered through employment in subsidized industries and there are no unemployment benefits. As in other developing countries, Nauru relies heavily on the

support of the extended family, although this also limits the productivity and mobility of workers – particularly females.

Capacity development. The authorities welcome the capacity development and technical assistance from the Fund. Further progress in filling data gaps and compiling macroeconomic statistics remains a priority. The authorities appreciate technical assistance and capacity development delivered both regionally and via the headquarters of the IMF. The authorities look forward to further constructive engagement with the Fund, and value the assistance and policy advice that they have received to date.