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Kiribati: 2009 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Kiribati

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2009 Article IV consultation with Kiribati, the following documents have been released and are included in this package:

- The staff report for the 2009 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 4, 2009, with the officials of Kiribati on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 16, 2009. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its May 1, 200,9 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for Kiribati.

The document listed below has been or will be separately released.

Selected Issues and Statistical Appendix.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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KIRIBATI

Staff Report for the 2009 Article IV Consultation

Prepared by the Staff Representatives for the
2009 Consultation with Kiribati

Approved by Kenneth Kang and Dominique Desruelle

April 16, 2009

- **Staff team**. Messrs. Khatri (Head), Tokuoka (both APD), and Steinberg (OAP). Mr. Moveni (OED) joined the mission.
- **Mission meetings**. The mission met with President Tong, Minister of Finance and Economic Planning Teewe, senior parliamentarians, heads of public enterprises, other senior officials, private sector representatives, and donors.
- **Exchange rate**. Kiribati has accepted the obligations of Article VIII, Sections 2, 3, and 4 and maintains an exchange system free of restrictions on payments and transfers for current international transactions. The currency of Kiribati is the Australian dollar.
- **Context of past surveillance**. The last Article IV consultation was concluded on April 27, 2007. Directors focused on the need for fiscal consolidation and preserving the Revenue Equalization Reserve Fund (RERF) by controlling the public sector wage bill and subsidies to public enterprises, and through structural measures, such as adoption of a medium-term budget framework and improved revenue administration. Directors welcomed the new Private Sector Development strategy and urged the authorities to move ahead with reform to improve the investment climate. The authorities have made some progress with fiscal consolidation and revenue administration, but capacity constraints have limited the pace of structural reforms overall.
- **Statistical Issues**. Kiribati subscribed to the General Data Dissemination System (GDDS) in 2004, but the quality of data remains weak and its availability subject to long lags. GDP and BOP series have been recently revised with Pacific Financial Technical Assistance Centre (PFTAC) assistance. The authorities have requested additional assistance with BOP statistics and GFS compilation.
- **Outreach:** At the end of the mission, the team made a presentation on the *Global Financial Crisis and its Impact on Kiribati* (attended by officials and the general public), issued a press release, and provided a briefing to key donors.

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EXECUTIVE SUMMARY

Background and Outlook

- Growth picked up in 2008 to 3½ percent, mainly reflecting growth in agricultural and public sector activity. Inflation reached 19 percent by end-2008, with the lagged pass through of global food prices. The fiscal deficit declined to 13.3 percent of GDP in 2008 (from 16 percent in 2007), reflecting higher fishing license fees (in A$ terms) and some expenditure constraint.
- The main impact of the global financial crisis and slowdown has thus far been through global asset price declines and the depreciation of the Australian dollar (A$). By end-2008, government and pension fund assets declined by around one-third (in U.S. dollars); and inflation remained at around 19 percent in part because of the A$ depreciation. Growth is projected to slow to around 1½ percent this year with the risks to the downside stemming from lower customs and fishing license revenues and smaller remittance flows.
- Growth has been trending downwards, but forceful reforms could enhance substantially medium-term prospects. In addition to recent improvements in revenue administration, a number of pivotal reforms are planned—notably reform of public enterprises—the implementation of which could raise the medium-term outlook.

Policy discussions focused on options for cushioning the impact of global shocks; and on the need for fiscal consolidation, public sector reforms, and private sector development:

- In the near term, in the absence of monetary policy options, the authorities agreed that fiscal policy could help mitigate the impacts of the global shocks through expediting and bringing forward grant funded projects; and through well targeted social spending if necessary.
- Over the medium term, fiscal sustainability requires halving the fiscal deficit and Revenue Equalization Reserve Fund (RERF) drawdowns. Staff estimates suggest reducing deficits to around 6–7 percent of GDP would stabilize the real per capita value of the RERF. Expenditure and revenue measures combined with structural reforms could deliver the needed adjustment in the medium term. A well-defined rule for RERF drawdowns and a medium term budget strategy could help smooth expenditure and safeguard the RERF. The authorities agreed with the need to contain RERF drawdowns, but noted some drawdowns were necessary to maintain government services.
- The mission and authorities broadly agreed on the reform priorities for improving public sector performance and developing the private sector. Public sector reforms in parallel with reforms to boost private sector opportunities would create fiscal space for much needed social spending, and would offer the best chances for success. While there has been some progress with reforms, progress has been constrained by limited capacity.

I. INTRODUCTION

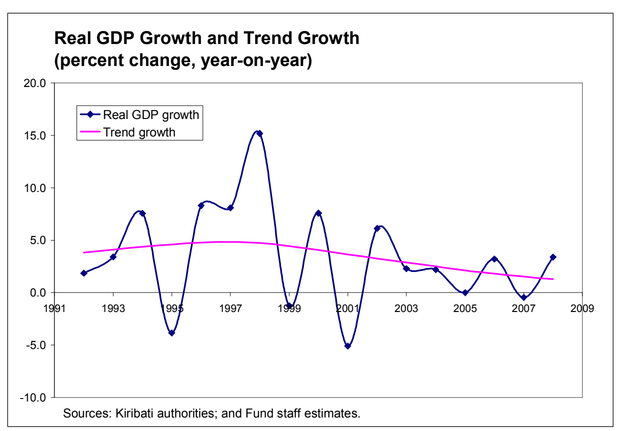
1. **The geography of Kiribati poses significant challenges, but also offers substantial opportunities**. Kiribati has a population of around 100,000, nearly half of which live densely concentrated in Tarawa and the remainder widely dispersed on low lying atolls in around 3½ million square kilometers of the equatorial Pacific Ocean. Like other Pacific island nations, Kiribati is far from major markets and has a shallow economic base. Production and exports are limited to copra, seaweed, and fish and much of the population (particularly on outer islands) lives a subsistence lifestyle. The public sector dominates the economy and external grants amount to around 60 percent of GDP (Figure 1). Kiribati is also one of the most vulnerable countries in the world to sea level rise. However, the geography also provides key sources of sustainable revenue. Fishing license fees, remittances from Kiribati seamen, and revenues from the trust fund (derived from phosphate up to 1979) already provide substantial revenue sources.

2. **This year's Article IV consultation focused on the impacts of the global financial crisis and slowdown and appropriate policy responses; and revisited longer-term challenges to economic sustainability**. The main impacts have, so far, been through the decline in public sector financial assets and the depreciation of the Australian dollars (A$); and have been contained by the limited role of exports, tourism, and FDI in Kiribati. In the absence of monetary policy, fiscal measures could help address adverse impacts and risks from the global crisis. In the medium term, there is a need for reducing the large public payroll and public enterprise subsidies, revenue enhancement, and medium-term budgeting; and the related need for public sector reform and private sector development. On top of progress with revenue administration, a number of pivotal reforms are planned—notably for reviewing and restructuring of public enterprises (PEs)—implementation of which would transform the medium-term outlook.

II. ECONOMIC BACKGROUND AND OUTLOOK

A. Recent Developments

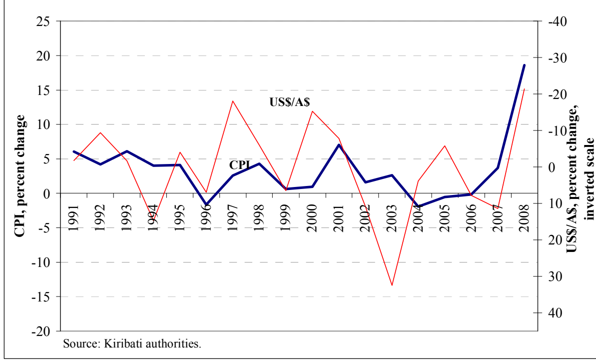
3. **Economic activity has picked up since the last Article IV consultation, but inflation has risen sharply since mid-2008:**



- **Real GDP growth in 2008 picked up to 3½ percent** (following a mild contraction in 2007), largely reflecting growth in agricultural and public sector activity.[1] However, growth has declined from an average of around 5 percent during the 1990s to around 2 percent during 2000–08, and unemployment has remained around 30 percent.

- **Inflation increased to around 19 percent by end-2008,** reflecting higher food prices.[2] Administered fuel prices mean that the public sector absorbed the impact of escalating global fuel prices through mid-2008. Depreciation of the A$ has in part offset the subsequent decline in international food and fuel prices.[3]

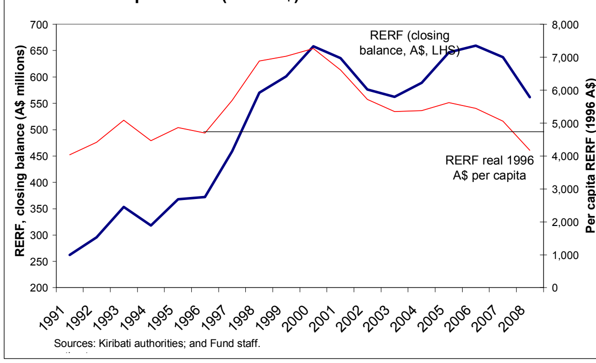
Inflation and Exchange Rate Changes, 1991–2008 (end period, year-on-year)



4. **The fiscal deficit declined from 16 percent of GDP in 2007 to 13.3 percent of GDP in 2008**. This improvement mainly reflected higher revenue from fishing license fees (in A$ terms), but also some expenditure constraint, with overall recurrent spending held broadly at 56½ percent of GDP. However, copra subsidies in 2008 were larger than expected given production was expected to decline last year with aging trees.

5. **Large fiscal deficits have necessitated large RERF drawdowns (A$25 million in 2008) as the RERF is the main source of deficit financing**. With the large drawdowns in recent years, and the global decline in asset values, the RERF has dropped to around A$4,200 in real per capita (1996 A$) terms, which is more than 40 percent below its peak in 2000 and below the previously cited informal target of the per capita level in 1996 (Box 1).

RERF Closing Balance (A$ millions) and Real Per Capita Level (1996 A$)



[1] In August 2008, PFTAC assisted the National Statistical Office (NSO) in revising Kiribati's national accounts and BOP data (and provided follow-up TA in February 2009 on the national accounts). The new indicative national accounts data (which suggest GDP levels are 50 percent higher than the official series) reflect the inclusion of household and informal sector activities, and methodological improvements.

[2] Inflation generally reflects import prices (with a lag related to contracts and shipments) and exchange rates.

[3] In early March 2009, Cabinet approved declines in retail petroleum prices to reflect lower world prices. While retail prices for petrol and kerosene are controlled, only kerosene was set below the import price.

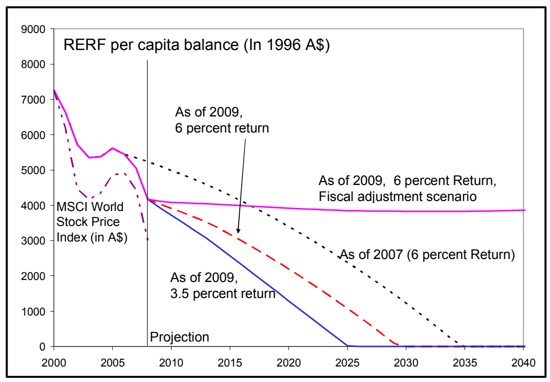
Box 1. Revenue Equalization Reserve Fund

Kiribati's Revenue Equalization Reserve Fund (RERF) has been an important source of income for Kiribati. The fund was established in 1956 and capitalized using phosphate mining royalties. Under a conservative policy, the fund's asset grew steadily until 1979 when phosphate deposits were exhausted. In subsequent years, this conservative approach continued, but there has been an increase in drawdowns from the RERF since 2001. The fund has been taking a relatively conservative investment strategy (30 percent equity; 70 percent bonds).

RERF Assets, Selected Years

	1956	1979	1987-1991	1992-1996	1997-2001	2002-2007	2008
RERF Balance (A$ mn, eop)	0.6	68.0	262.0	371.8	635.9	637.4	561.6
Per capita RERF Balance (1996 A$, eop)	179.0	3393.8	4032.3	4703.4	6615.3	5051.8	4173.0
Average Drawdown (percent of GDP)	…	…	…	…	-3.0	-14.5	-15.7
Average Return (percent per year)	…	…	11.5	9.5	12.7	3.9	-7.7

The RERF has been significantly affected by the global financial crisis. In 2008, the capital loss in A$ terms was over 10 percent and drawdowns (for financing budget deficits) mean the per capita RERF balance dropped by around 20 percent in 2008 to around A$ 4,200 (in 1996 A$).



Going forward, the outlook for the fund has worsened. If past trends persist, even under a relatively optimistic assumption of 6 percent *nominal* returns, the fund is projected to be depleted in 2030—five years earlier than the projection as of 2007 Article IV consultation. **To maintain the per capita value of RERF (in 1996 A$), a substantial fiscal effort is required.** Non-stochastic simulations indicate that with 6 percent returns, fiscal deficits need to be reduced to around 6 percent of GDP, implying an adjustment of around 6 percent of GDP from the expected deficit this year.

The asset mix of the fund is not a primary reason for the decline of the fund (the fund still averaged a 4.5 percent return during 2004–08). In addition to a reduction in fiscal drawdowns, there is a need for a well-defined target or rule combined with a medium-term budgeting framework. Successful experiences of natural resource funds (for example in Norway) indicate that formulating a medium-term plan is effective in allowing expenditure smoothing. If reforms can reduce fiscal uncertainty, then a more return oriented portfolio mix might be appropriate. Continued efforts to improve governance particularly through better disclosure, such as regular reports, would also be welcome.

6. **Most PEs continued to operate with losses, although audited results are generally not available**. The poor performance of PEs likely reflects their pricing policies, bloated staffing, and the limited transparency and accountability. During 2008, in addition to on-budget transfers to PEs totaling A$1.8 million, there were continued increases in government guaranteed loans from Bank of Kiribati (BOK) to cover PE losses (the largest government guarantees are for the oil, shipping, and telecom PEs; while the Public Utilities

Board accounts for around ½ of the direct subsidy on budget). Such contingent liabilities have increased to around A$40 million (compared to around A$20 last year).

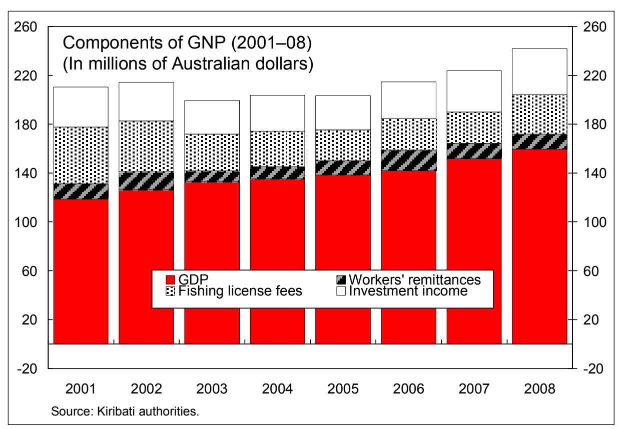
B. Outlook and Risks

7. **Against the backdrop of the global financial crisis and slowdown, near-term growth prospects have deteriorated and vulnerabilities increased**:

- ***In our baseline scenario, growth and inflation are expected to moderate in 2009***. With the sharp depreciation of the A$, inflation is expected to remain high until the second half of this year, but then to fall to around 3 percent by end-year. With inflation having eroded real income and wealth, and continued government expenditure constraint, growth is expected to be around 1.5 percent this year. The current account is expected to widen (to 3 percent of GDP) with lower investment income and grants offsetting the narrowing trade balance.

- ***The fiscal balance is expected to improve further, but is subject to significant risk***. With improvements in revenue administration and higher foreign currency denominated external revenues in A$ terms, the fiscal deficit is expected to narrow further this year. Customs revenues may also be weaker than expected—there is already some evidence of lower imports so far this year—as imports decline with real incomes and the weaker A$. There are also fiscal risks stemming from PE losses and growing loan guarantees; higher than budgeted copra subsidies; and lower fishing license revenues.

- ***External risks have also increased***. Income from external sources remains critical—investment income, and fishing license fees, and remittances account for around one-third of GNP—and could be adversely affected going forward (Box 2). Another risk is a further sharp depreciation of the A$, which could exacerbate inflation pressure and reduce the real purchasing power of the RERF.



8. **A positive medium-term outlook for Kiribati could be best secured through forceful reform implementation.** Without sustained reforms, growth is expected to fall below the 2 percent population growth in the medium term, suggesting deteriorating average living standards (Table 4). Sustained growth in per capita income could feasibly be achieved by public sector reforms and the expansion of private sector activity as a driver of growth. President Anote Tong, in his December 2007 policy statement, highlighted the need for

strengthening revenue collection, spending discipline, improving management of the RERF, reviewing the role of PEs, and improving the investment climate; and stated that "the private sector offers the best prospects for economic growth." Thus the priorities are well understood, but capacity constraints have been a key obstacle to implementation. Medium-term risks to the outlook include a continued period of low investment returns on government assets and risks associated with climate change.

Box 2. Impact of the Global Financial Turmoil and Slowdown on Kiribati

The impacts of the global financial crisis and slowdown have been contained by the small role of tourism, exports and FDI in the Kiribati economy. The main impacts have thus far been through the sharp declines in government assets and the exchange rate:

- **The RERF and the KPF declined by respectively 12 percent and 20 percent during 2008** (or 31 percent and 37 percent in U.S. dollar terms). The decline in government assets may constrain government expenditure and thus feed through to growth; and brings forward the expected RERF depletion date under current drawdown rates (Box 1).
- **The REER and the A$ depreciated by over 15 percent and 26 percent respectively during 2008 Q4**. High world prices for rice last year fed through into domestic inflation (cushioned somewhat by price subsidies), but the global food price declines have not yet been reflected in lower domestic prices, in part because of the depreciation of the A$.

Exports and tourism growth prospects will be curbed. With exports, at around 5 percent of GDP and minimal tourism, the direct impact of the global slowdown on these is unlikely to be substantial. However, growth prospects (particularly for tourism) will be affected in the near term. On the plus side the sharp depreciation increases the competitiveness of Kiribati in relation to other Pacific Islands.

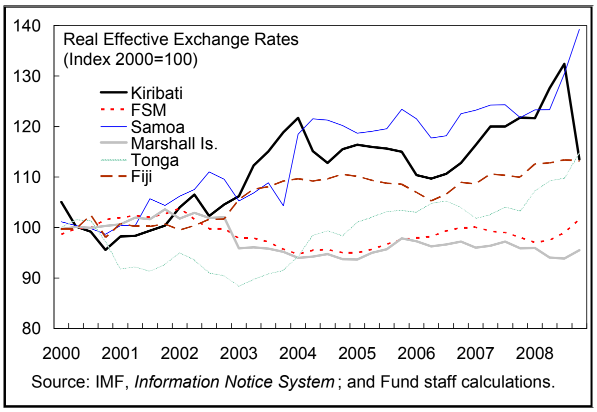
Other channels are uncertain:

- **Investment income could worsen,** depending on external developments.
- **Remittances may decline,** at least in foreign currency terms, going forward as there seems to have been a decline in demand for seafarers (the Marine Training Center intake was halved this year and Fisheries Training Center had no intake this year). However, to the extent that seamen are paid in foreign currency, there will be some upside in terms of A$ remittances.
- **Official aid flows could come under pressure**. Although donors did not foresee such declines, this could be a danger if donor economies continue to face difficulties.
- **Fishing license fees could fall,** if demand and/or the international tuna price decline; but these are mostly negotiated in U.S. dollars so there could still be a gain in A$ terms.

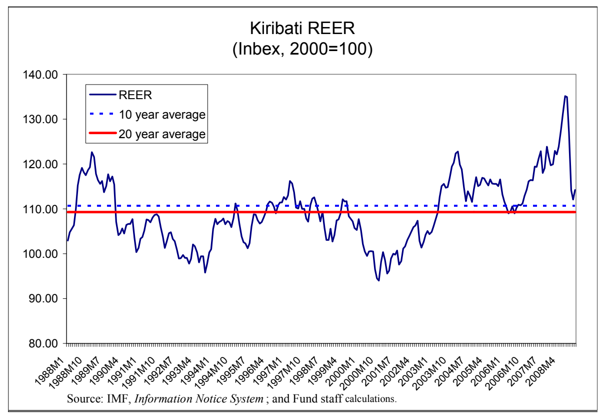
C. External Stability, Exchange Rate, and Competitiveness

9. **Kiribati's use of the Australian dollar is appropriate** given close financial and trade linkages to Australia and the limited administrative capacity to conduct independent monetary and exchange rate policies.[4]

10. **The real effective exchange rate is approximately in line with its long run level**. Taking the 10 and 20 year averages for the REER as indicative of the PPP-equivalent equilibrium level, the REER in December was still respectively 3 percent and 4½ percent above the long-run averages. This reflects the long period of A$ appreciation, being only partially reversed by the depreciation in the last quarter of 2008.



Source: IMF, *Information Notice System*; and Fund staff calculations.



Source: IMF, *Information Notice System*; and Fund staff calculations.

11. **Over the medium term, the external situation and current account deficit are broadly in line with macroeconomic fundamentals.** Staff and the authorities agreed that the medium-term external situation seems sustainable. Weak exports (which are basically flat in nominal terms) are explained more by structural factors—remoteness from major markets, widely dispersed and small size of the islands, poor soil, and overall limited business and export opportunities—than exchange rate competitiveness. In the medium term, external stability is not at significant risk given external debt is small (at around 11 percent of GDP and highly concessional), and external assets are still around 3½ times GDP. In the longer run, if large fiscal deficits continued, these would eventually deplete the RERF and undermine external sustainability.

III. Policies To Promote Sustainable Growth

12. **The mission supported the government's objective of enhancing economic growth for sustainable development and welcomed recent progress with reforms**. There is clearly political will at the highest level to move forward with reforms. In addition to recent revenue administration reforms, the government is planning to review and begin reform of PEs this year. The mission welcomed these pivotal undertakings and urged the

[4] In 2005, 37 percent of imports were from Australia and these accounted for 58 percent of import duties.

authorities to forge ahead with their reform agenda in the window available. Public sector reforms in parallel with reforms to boost private sector opportunities would create fiscal space for much needed social spending, and would offer the best chances for success. Experience from other Pacific Islands demonstrates the potentially large and timely benefits from a bold and comprehensive reform strategy (Box 3).

A. Fiscal Policy and RERF Drawdowns

13. **In the near term, in the absence of monetary policy options, the mission and the authorities agreed that fiscal policy can help mitigate the impacts of the global shocks**. Deficit neutral options include: expediting project implementation; bringing forward projects in the pipeline (which donors appeared to favor); and ensuring that any funds remaining undisbursed due to administrative delays and implementation issues are released by the authorities taking the appropriate steps. If additional measures are needed to cushion the impacts on the most vulnerable, well targeted social spending would be better than general subsidies.[5]

14. **Over the medium term, fiscal sustainability will require reducing deficits further and containing off-budget and contingent liabilities.** Staff estimates suggest that preserving the real per capita value of the RERF will require reducing drawdowns to around 6–7 percent of GDP. The decline in the deficit last year and the planned consolidation this year are important steps towards fiscal sustainability. Reducing the deficit to less than half the 2008 level will require additional revenue and expenditure measures. Off-budget and contingent liabilities also need to be carefully tracked and contained. Government guaranteed PE loans from the BOK have increased sharply. Such loan guarantees and subsidies implicit in intra-PE transactions—for example, between Kiribati Oil and the Public Utilities Board—are non-transparent and mask the true extent of the fiscal deterioration.[6]

15. **In addition, a fiscal buffer would be advisable in the context of longer-term fiscal risks associated with climate change.** Climate change will adversely affect Kiribati in the near future—with the impact intensifying over time. The main impact will come from rising sea levels, more frequent and severe storms, and erratic rainfall. While the fiscal costs are uncertain, they are likely to be substantial relative to GDP. An important first step is to recognize the fiscal risks involved and to start building a fiscal buffer—with the assistance of international donors—and to consider the implications for expenditure programs (See Annex III for a description of the World Bank's Kiribati Adaptation Program).

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[5] The copra subsidies seem to be poorly targeted, favoring the Copra Mill substantially more than copra producers. The impact of high import prices of rice was offset somewhat in 2008 by subsidies (used to reduce the margins above import prices, and some rice was also received in-kind and mainly distributed in schools), funded by Taiwan Province of China. The subsidy was focused on the key staple of low-income families (rice), and provides an example of how donors could step in to ease the impacts of external shocks.

[6] Public sector loans and overdrafts with BOK are also extremely expensive, with interest rates of 12 percent.

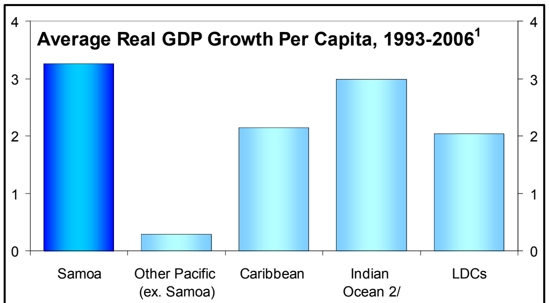
Box 3. Pacific Island Reform Successes

Samoa's Experience with Comprehensive Reforms.

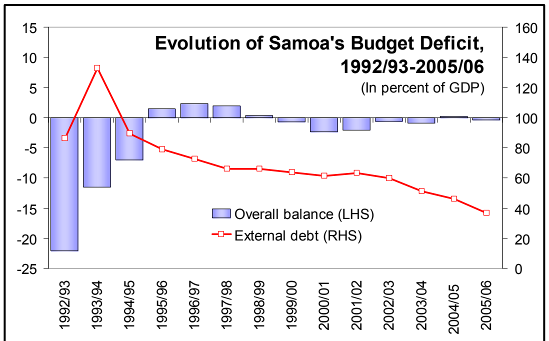
Samoa has achieved a major economic transformation since the early 1990s. Real per capita GDP increased faster than elsewhere in the Pacific or in other small island regions. The transformation owes to a broad-based reform program since the early 1990s, and facilitated by political stability:

- Tax reforms, notably the introduction of value-added tax (VAT) in 1994, and civil service reform brought a sizable reduction in public debt.
- Structural reforms to foster competition and develop the private sector were undertaken: external tariffs were lowered and PEs were privatized.
- Interest rates were liberalized, and credit ceilings were eliminated.

Samoa has benefited from the rapid growth of remittances and tourism, from a large and growing population of Samoans in Australia, New Zealand and the United States; which has also helped kick-start the broader tourism industry.



Sources: IMF, World Economic Outlook database; and staff calculations.
[1] Simple averages.
[2] Mauritius, Seychelles and Maldives.



Source: Samoan authorities; and staff calculations.

Vanuatu's Recent Success

Economic growth in Vanuatu has picked up since 2003, helped by: a booming tourism sector and foreign direct investment, particularly in real estate by Australians. Introduction of VAT combined with improved compliance and expenditure controls have improved the fiscal position. Some other factors behind Vanuatu's success include:

- **Progresses in transportation and communication sector—** Port Vila is now connected with Australia, New Zealand, and Fiji by several airlines, helped by its proximity to Australia and New Zealand, and the government's relaxation of restrictions and opening up to foreign carriers.
- **Sound monetary and financial policy**—the basket peg has helped contain inflationary pressures and the banking sector follows international prudential standards.
- **Political stability—**government changed every year during 1995–2003, but political stability under the former coalition government, which managed to stay in office for four years boosted confidence in the economy and enabled the government to pursue structural and fiscal reforms.

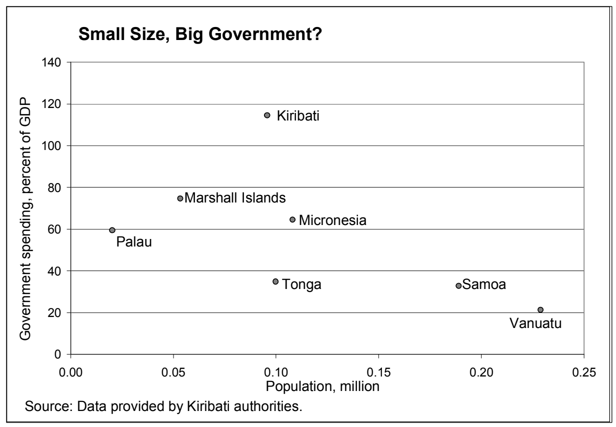
These experiences highlight the potential benefits Kiribati can reap from fiscal consolidation measures and leveraging its political stability to pursue deep structural reforms. Transportation links, supported by appropriate policy, are clearly key to developing tourism for a remote island nation.

16. **The mission's recommendations (similar to the previous consultations) included**:

- ***Improve tax revenues***. Next steps with tax administration could be improving compliance of large taxpayers by strengthening administration and adoption of a more effective penalty system; merging tax and customs offices; and establishing single taxpayer identification numbers. The mission recommended adoption of a broad-based consumption tax and introduction of excises. As tariffs and customs revenues decline under regional trade agreements (RTAs), gradual most-favored-nation (MFN) reduction of tariffs together with adoption of a consumption tax and excises would minimize trade diversion and could more than offset lost customs revenues.

- ***Increase and make more stable fishing license fees:*** options include (sub-regional) collective agreements, use of auctions, improved governance and transparency in the contracting process, and hedging of foreign currency risk.[7]

- ***Expenditure measures.*** Government spending is large (around 115 percent of GDP) and the public sector accounts for two-thirds of formal sector employment. Medium-term expenditure adjustment will require *reductions in the wage bill,* through controlling numbers;[8] and *improving performance of PEs and reducing subsidies* (discussed below).



17. **The authorities are well aware of the need for fiscal consolidation and for containing RERF drawdowns and have taken measures to do so.** The authorities' priority for tax administration reform is adoption this year of "PAYE Final"—which involves tax deductions from wages and simplification of the tax structure, such that much fewer assessments are required—which will free-up resources to focus on compliance, particularly of large taxpayers, through audits. They plan to consider the next steps with tax administration after progress with these priorities. The authorities reiterated plans to introduce a broad-based consumption tax, but capacity constraints have hindered progress, and they indicated the need for further preparation and technical assistance. They agreed that excises could compensate for the revenue losses from RTAs (which may be at least 15 percent of current customs revenue). The authorities noted recent efforts to extend the

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[7] Potential gains are difficult to estimate—we use a conservative assumption of $22 million a year from fishing licenses (around the 2008 level) over the medium term.

[8] Civil service reform should be done in conjunction with reforms to increase private sector opportunities (discussed below) and appropriate social protections.

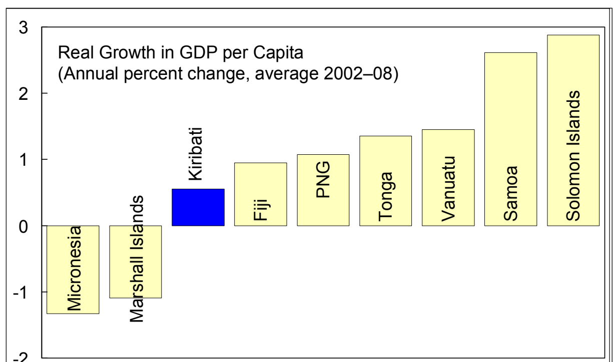
tenor of fishing licenses and the possibility of collective regional agreements or regional joint ventures. On the expenditure side, the authorities reported freezing civil service numbers in recent years, and constraining increases in the wage bill to at most the rate of inflation (increases were substantially below inflation in 2008); but noted the difficulty of reducing numbers given large scale unemployment.

18. **The mission suggested a well defined target or rule for the RERF combined with a move to a medium-term budget framework would allow expenditure smoothing** (in the context of volatility in revenues) while safeguarding the RERF. A target of retaining the RERF's real per capita value (at or near the current level) in the medium term seems appropriate from the perspective of inter-generational equity. Longer-term external stability considerations (and the need for a fiscal buffer to cushion the impact of climate change) would favor a more conservative policy. More immediately, given the high costs of overdrafts with BOK, improved cash planning and commitment control are needed.

19. **The authorities felt it was important to stabilize the RERF balance over the medium term.** They noted that RERF drawdowns were necessary to maintain government services as expanding the revenue base will take time. The authorities would like to build capacity to analyze the RERF management and performance for themselves, but remain committed to a relatively large share of less-risky assets. The authorities recognize the importance of a medium-term budgetary framework (MTBF) and indeed plan to move to a MTBF with the support of the ADB and others, over the next five years.

B. Strategy to Enhance the Role of the Private Sector

20. **The mission and authorities agreed that development of the private sector is key to boosting sustainable growth.** Kiribati's draft Private Sector Development Strategy (PSDS) appropriately addresses the key priority areas.[9] The mission supported the overall strategy and recommended that the authorities move forward with a monitorable implementation plan, including timelines and accountability for deliverables. The authorities' focus on developing



Sources: IMF, *World Economic Outlook*; and Kiribati authorities.

[9] The draft PSDP (scheduled to be finalized this year) focuses on creating an enabling environment through: promoting business culture; improving access to land; restricting the scope of public enterprises and promoting fair competition; improving licensing and infrastructure services; improving access to capital; and creating a conducive investment climate.

Kiribati's vast marine resources and tourism is appropriate and Kiritimati Island will be important in this regard.[10]

21. **In addition, the mission suggested sustained growth in per capita income could be achieved by**:

- *Improving the performance of PEs*. The mission recommended limiting PE operations to areas where private sector operations are not viable. Putting the PEs on a sound financial footing will require adjusting prices, increasing efficiency, and improving financial management (such as reducing reliance on costly overdrafts and loans). Enhanced monitoring (such as through annual disclosure of audited financial statements), increased accountability, and reduced implicit and cross-subsidies are key to improving performance of PEs.

- *Improving the investment climate*. In addition to crowding out by PEs, constraints on private sector growth include the cumbersome permitting and registration processes, price controls, and restrictions on activities open to foreigners (ADB), (Figure 4).

- *Improving land titling and registration and associated financial intermediation*. Progress has been made on Kiritimati island—progress elsewhere will be difficult, but is important.

The authorities regarded private sector development as a priority and reported tangible progress and concrete plans in key areas:

- *Reviewing and restructuring PEs*. Recognizing their fiscal burden and constraint on private sector development, the authorities reported plans (awaiting parliamentary approval) to review and restructure PEs. The plan suggests 15 (out of 24) public enterprises should "exit" (which could involve privatization or liquidation). The authorities acknowledged the need to improve monitoring and accountability of PEs, especially through regular disclosure of audited financial accounts. ADB and AusAid are providing technical assistance on exit and reform of PEs respectively.

- *Introducing competition*. The authorities expressed concern about private sector monopolies (particularly in the context of PE reform) and have targeted improved competition. So far, a new airline has been allowed to directly compete with Air Kiribati; Digicell is expected to enter the cellular communications market; and increased financial sector competition is targeted (discussed below).

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[10] Kiritimati Island is relatively large, and has much potential for eco-tourism and fishing; and the land is government owned, thus limiting land tenure issues.

- *Development of tourism*. The authorities stressed tourism as an immediate and viable way of increasing growth, but recognized Kiribati's remoteness and the challenge of ensuring regular flights.

C. Financial Sector Issues

22. **Financial intermediation in Kiribati is limited, as is financial sector competition**. The BOK (the only commercial bank, 25 percent government owned and 75 percent owned by ANZ), and the Kiribati Provident Fund (KPF) invest most of their resources abroad, although lending to central government and PEs by BOK has increased significantly. The Development Bank of Kiribati (DBK) makes loans to small businesses, but poor risk management has led to high non-performing loans. With only one bank and one insurance company, competition is limited and BOK customers have regularly complained about high fees and interest charges resulting from its monopoly position.[11]

23. **The mission agreed with the authorities on the need for greater competition, but cautioned that an appropriate regulatory and supervisory framework should be in place**. In the insurance sector, the Kiribati Insurance Act was changed in December to allow entry into the insurance industry. The government is also considering the commercialization of the DBK as a means to introduce competition for deposits and loans from BOK. Still DBK's large portfolio of non-performing loans (thought to be around one-third of total loans) is a concern, and further expansion of its activity should be limited until an appropriate regulatory and supervisory framework is in place—particularly with regard to risk management.[12] The draft financial sector legislation, prepared with the assistance of PFTAC, seems to have been shelved and there has been little focus on financial supervision.

24. **KPF's historical dividend policy and the recent sharp decline in foreign asset prices have resulted in its financial position deteriorating to the point where liabilities exceed assets**.[13] The mission recommended limiting dividends until capital returns to prudent levels (an independent actuarial study suggested that KPF should carry 25 percent of total capital in reserves). In the medium term, KPF should review its investment strategy and dividend policy, based on international best practice.

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[11] Around 20 percent of BOK's loans are consumer loans, with the rest relating to government and PEs. BOK's parent (ANZ) issued new guidelines governing credit allocation which have resulted in loan tenures declining, but these have not yet resulted in a contraction of credit.

[12] Government financial corporations generally fail to comply with statutory accounting and reporting requirements on a timely basis; and there is a lack of adequate and effective internal control and risk management systems.

[13] KPF changed its investment policy in 2008 to a 60–40 split between risky assets and fixed income assets, from 50–50 previously. At end-2008, member funds (A$100 million) exceed the asset balance (A$77 million).

IV. Staff Appraisal

25. **Kiribati's geography poses major challenges, but also offers growth opportunities**. Kiribati's marine and natural resources—through fishing and tourism—can boost sustainable growth.

26. **In the absence of other policy options, fiscal policy could be used to counter the impacts of the global slowdown**. Deficit neutral options, such as expediting or bringing forward project implementation, could be supplemented, if necessary, by well targeted social expenditure to ease the impacts on the most vulnerable.

27. **Over the medium term, fiscal sustainability will require halving deficits and RERF drawdowns.** Fiscal consolidation will require a strategy that phases expenditure reductions with tax policy and administration measures. On the expenditure side, the focus should be on controlling civil service salaries (through numbers), and reducing PE subsidies and loan guarantees. On the revenue side, the priorities are to further strengthen revenue administration, adopt a broad-based consumption tax, introduce excises, and improve fishing license revenues. A well-defined rule for RERF drawdowns (such as maintaining the real per capita level of the RERF), in conjunction with a medium-term budget framework would help smooth expenditure and safeguard the RERF. Most immediately, improved cash management is needed.

28. **Public sector reforms in parallel with reforms to boost private sector opportunities, would offer the best chances for success.** In addition to civil service reforms, reviewing and restructuring PEs (including through exits), and improving their performance (through improving financial management, monitoring and accountability) would support growth, private sector development, and help create fiscal space for much needed social expenditure; and greater private sector opportunities would support public sector reforms. Key in this regard is improving the investment climate and land titling; introducing competition; and development of marine resources and tourism.

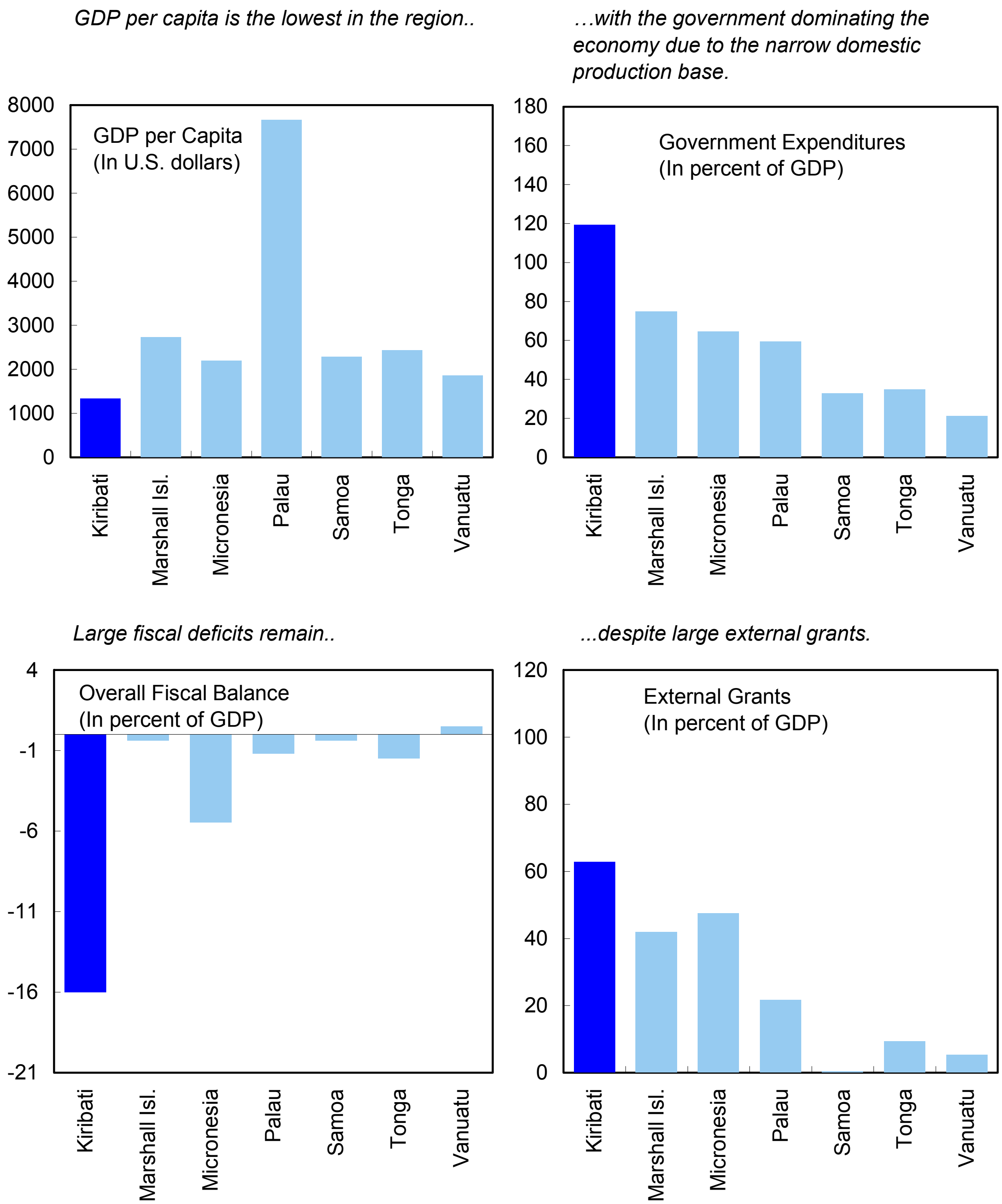
29. **The financial system requires greater competition, but also an appropriate regulatory and supervisory framework**. Given DPKs large NPLs, expansion of its activities should be preceded by an appropriate risk management framework. KPFs investment strategy and dividend policy should be reviewed, and dividends limited until KPF's capital position is strengthened.

30. **The use of the A$ remains appropriate**, given the extensive financial and trade ties with Australia.

31. **Recent data improvements will support improved policy making**. However, there is much scope to further strengthen data compilation and dissemination.

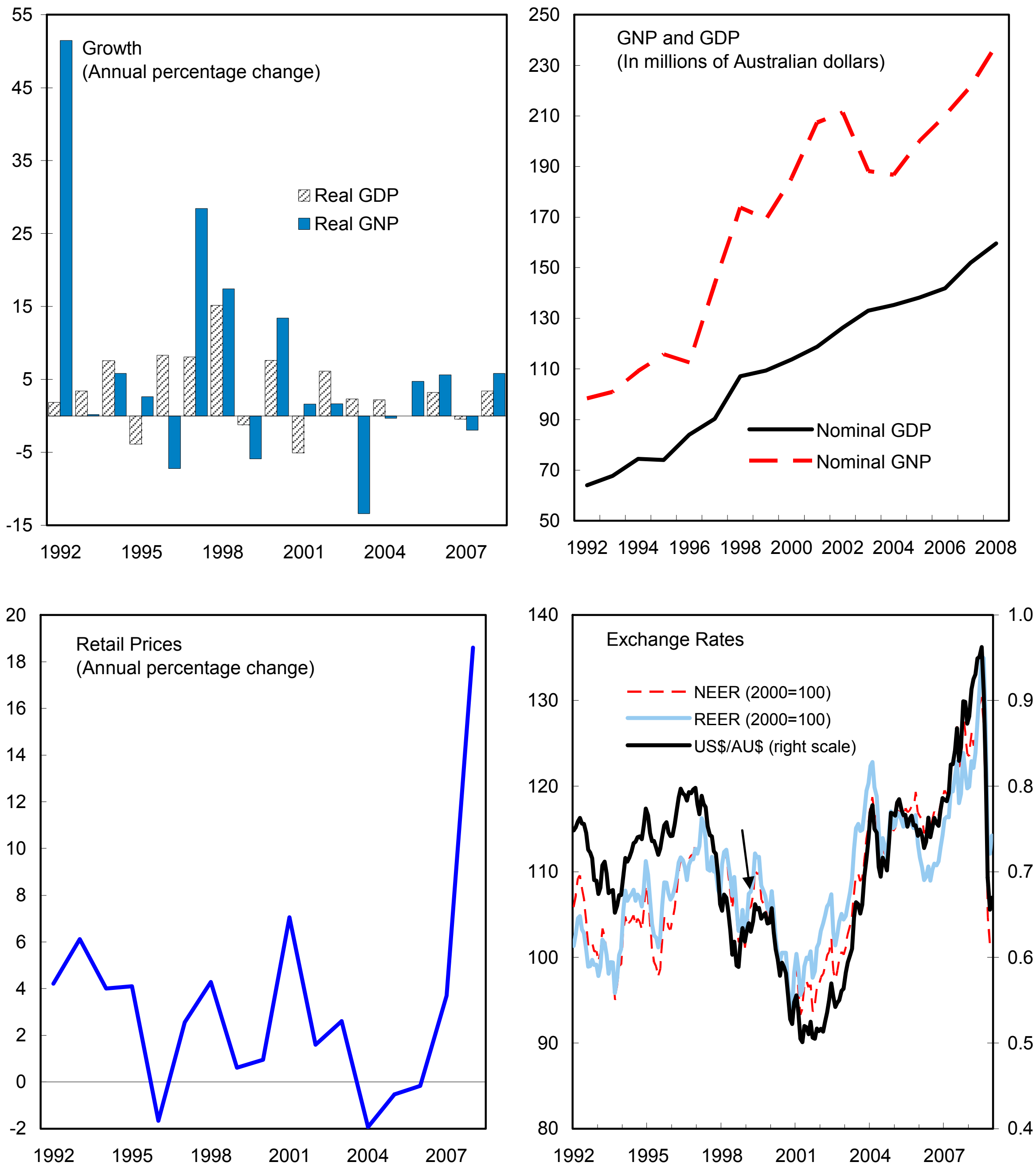
32. **It is recommended that the next Article IV consultation take place on a 24-month cycle**. The authorities would welcome a more regular dialogue including in the form of an interim staff visit early next year.

Figure 1. Kiribati: Comparative Chart with Other Pacific Island Countries
(Latest available year 1/)



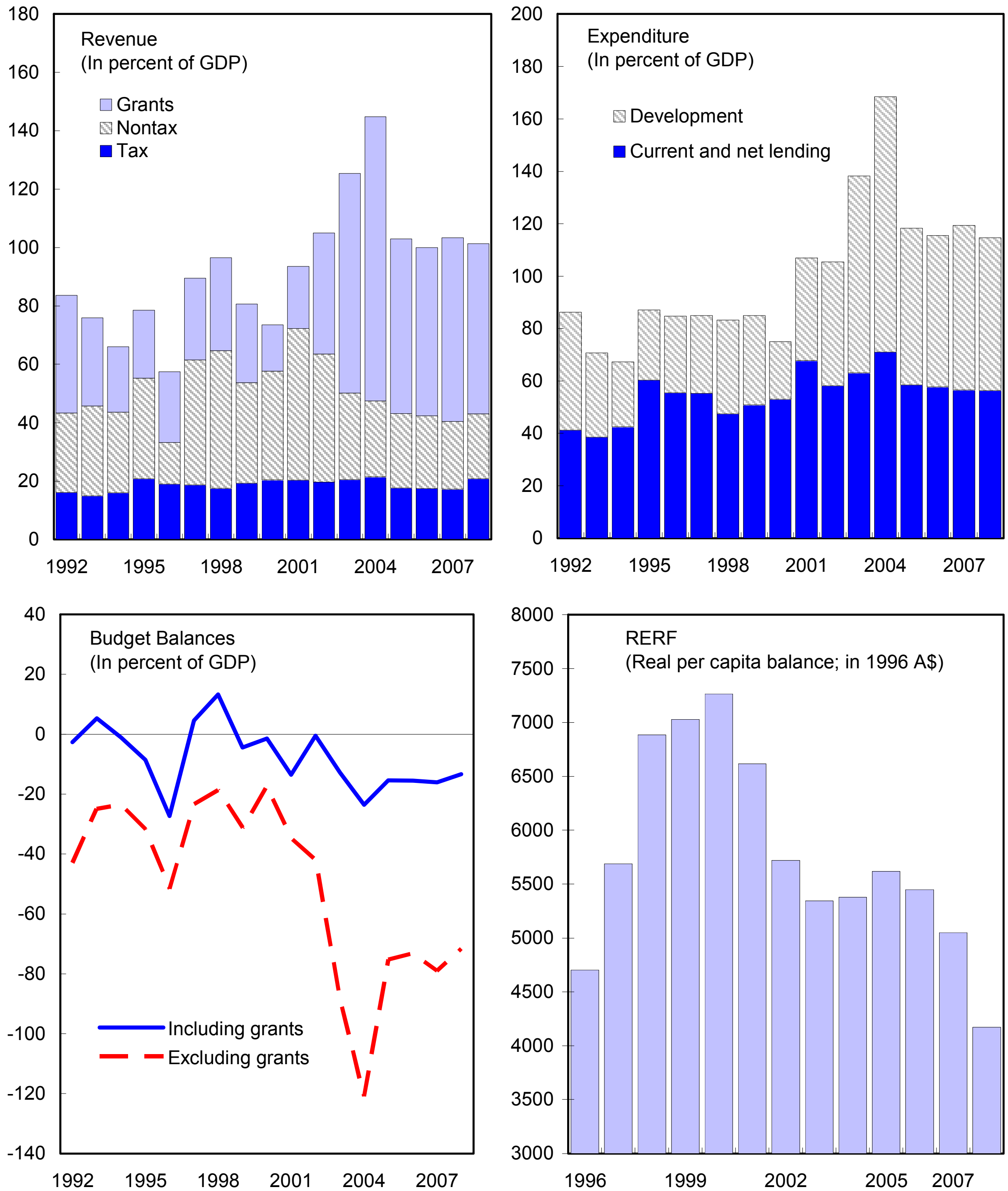
1/ For Kiribati, data is as of 2007.
Source: Data provided by the authorities.

Figure 2. Kiribati: Output, Prices, and Exchange Rates, 1992–2008



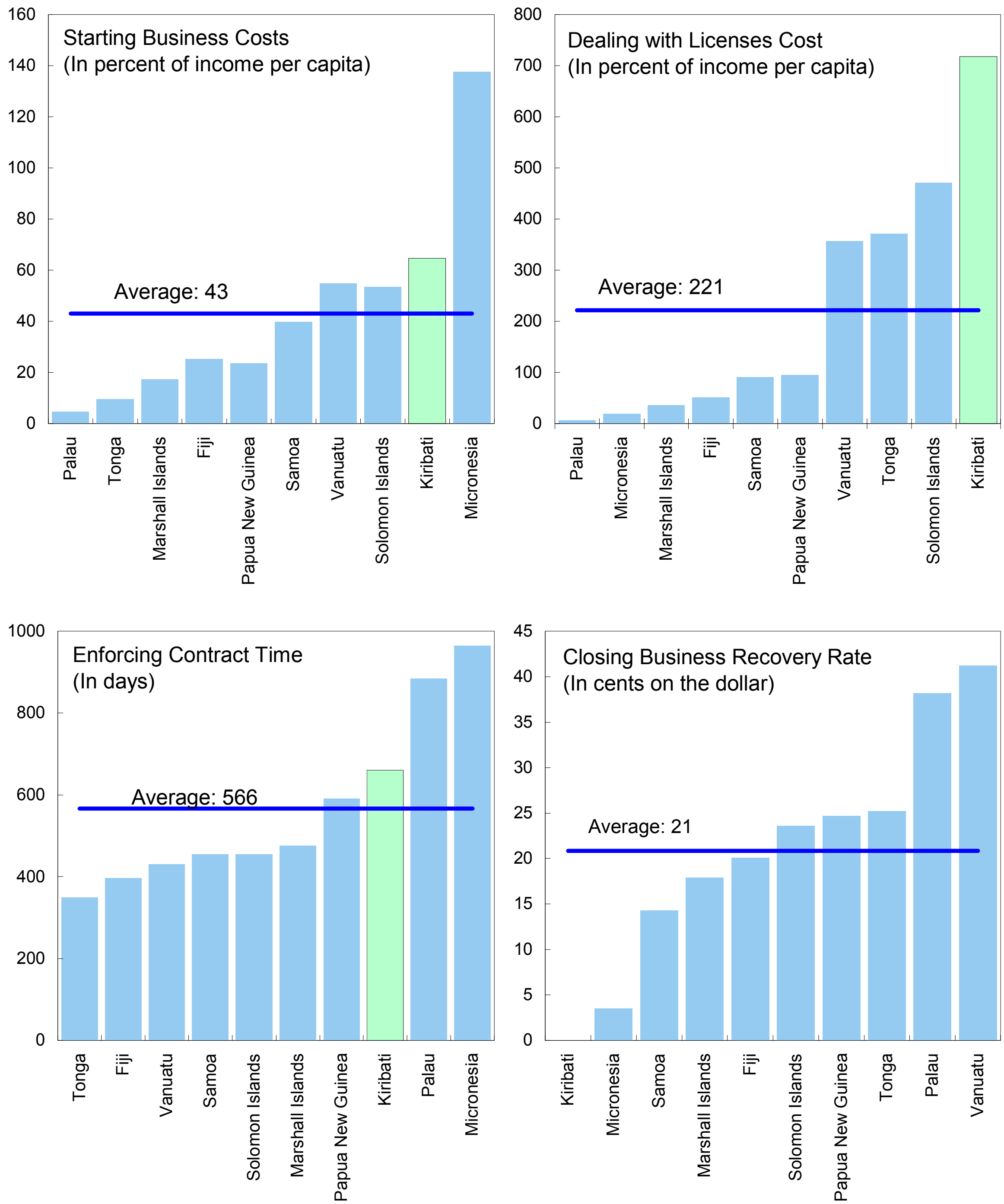
Sources: Data provided by the Kiribati authorities; and Fund staff estimates.

Figure 3. Kiribati: Central Government Budget, 1992–2008



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

Figure 4. Kiribati: Indicators of Investment Climate



Source: Data provided by the authorities.

Table 1. Kiribati: Selected Economic Indicators, 2004–09

Nominal GDP (2008):	US$136.6 million
Population (2008):	97,552
GDP per capita (2008):	US$1,400
Quota:	SDR 5.6 million

	2004	2005	2006	2007	2008	2009 Proj.
Growth						
Real GDP (percent change)	2.2	0.0	3.2	-0.5	3.4	1.5
Consumer prices (percent change, end-of-period)	-1.9	-0.5	-0.2	3.7	18.6	2.8
Central government finance (percent of GDP)						
Revenue and grants	144.9	103.0	100.0	103.4	101.3	96.7
Total domestic revenue	47.5	43.1	42.3	40.4	43.0	40.9
Grants	97.4	59.9	57.7	62.9	58.3	55.9
Expenditure and net lending	168.5	118.3	115.5	119.4	114.6	108.9
Current	71.1	58.4	57.8	56.5	56.3	53.0
Of which: wages and salaries	27.7	27.1	29.3	27.3	27.1	26.3
Development	97.4	59.9	57.7	62.9	58.3	55.9
Overall balance	-23.6	-15.3	-15.5	-16.0	-13.3	-12.2
Financing	23.6	15.3	15.5	16.0	13.3	12.2
Revenue Equalization and Reserve Fund (RERF)	19.0	10.8	23.6	29.6	15.7	12.2
Other	4.6	4.5	-8.1	-13.6	-2.3	0.0
RERF						
Closing Balance (in millions of U.S. dollars)	459	475	522	562	389	391
Closing Balance (in millions of $A)	589	647	660	637	562	577
Per Capita Value (in 1996 $A)	5,379	5,618	5,447	5,052	4,173	4,059
Commercial banks (in millions of U.S. dollars)						
Foreign assets	44.1	17.1	20.8	30.3	36.5	…
Private sector claims	13.2	33.3	30.7	35.4	37.0	…
Total deposits	54.1	42.7	44.2	65.7	73.6	…
Balance of payments (in millions of U.S. dollars)						
Current account including official transfers	-11.0	-20.2	-3.1	-1.3	-1.3	-3.5
(In percent of GDP)	-11.1	-19.1	-2.9	-1.0	-0.9	-3.1
Current account excluding official transfers	-108.1	-83.5	-64.8	-81.5	-80.9	-67.0
(In percent of GDP)	-108.4	-79.0	-60.6	-64.0	-59.2	-59.0
External debt (in millions of U.S. dollars)	13.0	11.3	13.1	12.9	10.1	9.9
(In percent of GDP)	12.3	11.2	11.7	9.6	9.1	8.8
External debt service (in millions of U.S. dollars)	0.7	1.2	0.4	2.2	1.7	1.6
(In percent of exports of goods and services)	5.2	7.6	2.9	15.4	12.3	11.4
Exchange rate (A/US period average) 1/	1.4	1.3	1.3	1.2	1.2	…
Real effective exchange rate (period average) 2/	116.3	115.7	110.9	119.5	123.8	…
Memorandum items						
Nominal GDP (in millions of Australian dollars)	135.3	138.3	142.0	152.0	159.7	166.6

Sources: Data provided by the Kiribati authorities; and Fund staff estimates and projections.
1/ The Australian dollar is the domestic currency.
2/ Year 1990=100.

Table 2. Kiribati: Summary of Central Government Operations, 2004–09

	2004	2005	2006	2007	2008	2009	
						Budget	Proj.
	(In millions of Australian dollars)						
Total revenue and grants	196.0	142.4	141.9	157.2	161.7	155.2	161.1
Revenue	64.3	59.6	60.0	61.5	68.6	62.1	68.1
Tax revenue	29.0	28.3	28.6	29.9	29.7	31.5	29.3
Nontax revenue	35.3	31.3	31.4	31.6	38.9	30.6	38.8
Of which: Fishing license fees	28.9	25.0	25.8	25.4	32.2	24.0	32.2
External grants	131.7	82.8	81.9	95.7	93.1	93.1	93.1
Total expenditure and net lending	227.9	163.6	163.9	181.5	183.0	181.4	181.4
Current expenditure	96.2	80.8	82.0	85.8	89.9	88.4	88.4
Of which : Personnel costs	37.5	37.5	41.5	41.5	43.3	43.8	43.8
Subsidies to public enterprises 1/	14.2	6.3	4.6	7.2	9.0	7.3	7.3
Other current expenditure	44.5	37.0	35.9	37.1	37.6	37.3	37.3
Development expenditure	131.7	82.8	81.9	95.7	93.1	93.1	93.1
Net lending	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-31.9	-21.2	-22.0	-24.4	-21.3	-26.3	-20.3
Financing	31.9	21.2	22.0	24.4	21.3	26.3	20.3
Revenue Equalization and Reserve Fund	25.7	15.0	33.5	45.0	25.0	26.3	20.3
Consolidated Fund	3.9	10.6	-8.7	-20.5	-3.7	0.0	0.0
Development Fund	-16.1	0.4	6.5	4.3	0.0	0.0	0.0
STABEX Fund	0.3	0.0	0.0	0.0	0.0	0.0	0.0
External loans (net)	1.0	0.0	0.0	0.0	0.0	0.0	0.0
Other sources	17.2	-4.8	-9.3	-4.4	0.0	0.0	0.0
	(In percent of GDP)						
Total revenue and grants	144.9	103.0	100.0	103.4	101.3	93.1	96.7
Revenue	47.5	43.1	42.3	40.4	43.0	37.3	40.9
Tax revenue	21.4	20.5	20.2	19.7	18.6	18.9	17.6
Nontax revenue	26.1	22.6	22.1	20.8	24.4	18.4	23.3
Of which : Fishing license fees	21.4	18.0	18.2	16.7	20.2	14.4	19.3
External grants	97.4	59.9	57.7	62.9	58.3	55.9	55.9
Total expenditure and net lending	168.5	118.3	115.5	119.4	114.6	108.9	108.9
Current expenditure	71.1	58.4	57.8	56.5	56.3	53.0	53.0
Of which: Wages and salaries	27.7	27.1	29.3	27.3	27.1	26.3	26.3
Subsidies to public enterprises 1/	10.5	4.5	3.2	4.8	5.6	4.4	4.4
Other current expenditure	32.9	26.8	25.3	24.4	23.6	22.4	22.4
Development expenditure	97.4	59.9	57.7	62.9	58.3	55.9	55.9
Net lending	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-23.6	-15.3	-15.5	-16.0	-13.3	-15.8	-12.2
Financing	23.6	15.3	15.5	16.0	13.3	15.8	12.2
RERF	19.0	10.8	23.6	29.6	15.7	15.8	12.2
Consolidated Fund	2.8	7.7	-6.2	-13.5	-2.3	0.0	0.0
Development Fund	-11.9	0.3	4.6	2.8	0.0	0.0	0.0
STABEX Fund	0.2	0.0	0.0	0.0	0.0	0.0	0.0
External loans (net)	0.8	0.0	0.0	0.0	0.0	0.0	0.0
Other sources	12.7	-3.5	-6.5	-2.9	0.0	0.0	0.0
Memorandum items							
RERF balance (in milllions of Australian dollars;end of period)	589.1	646.8	659.6	637.3	561.6	571.0	576.9
RERF*:* Accrued income	21.6	21.0	22.4	30.0	34.2	20.0	20.0
Valuation changes	32.6	53.6	25.4	-5.5	-83.5	16.8	16.8
Government drawings	25.7	15.0	33.5	45.0	25.0	26.3	20.3
Development balance (in percent of GDP)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current balance (in percent of GDP, exclud. grants)	-23.6	-15.3	-15.5	-16.0	-13.3	-15.8	-12.2
Nominal GDP at market prices	135.3	138.3	142.0	152.0	159.7	166.6	166.6

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

1/ Includes subsidies to copra production.

Table 3. Kiribati: Balance of Payments, 2004–09

(In millions of U.S. dollars)

	2004	2005	2006	2007	2008	2009
Current account balance	-11.0	-20.2	-3.1	-1.3	-1.3	-3.5
Trade balance	-57.8	-73.6	-60.3	-66.5	-71.6	-56.0
Exports, f.o.b.	3.1	5.3	3.2	3.9	4.8	4.0
Imports, f.o.b.	60.9	78.9	63.6	70.3	76.4	60.1
Balance on services	-22.4	-33.0	-23.5	-33.0	-31.0	-24.6
Credit	9.1	11.5	8.4	9.5	12.1	10.5
Debit	31.5	44.5	32.0	42.5	43.0	35.1
Balance on factor income 1/	37.9	47.1	51.3	58.3	61.9	46.0
Credit	48.4	49.0	53.8	62.4	65.1	48.7
Fishing license fees	21.3	19.1	19.4	21.3	22.3	22.0
Investment income	21.6	21.4	22.6	28.5	32.4	16.2
Remittances	7.4	9.3	12.7	10.4	10.4	10.4
Debit	10.5	1.9	2.5	4.2	3.2	2.7
Balance on current transfers	31.3	39.4	29.5	39.9	39.4	31.1
Credit	35.8	45.7	37.4	49.9	49.5	39.5
Of which: Government	35.3	45.1	36.8	49.2	48.8	39.0
Debit	4.5	6.4	7.9	10.1	10.1	8.4
Of which: Government	2.2	4.1	5.6	7.3	7.2	6.0
Financial and capital account balance	35.0	-2.5	3.2	0.6	7.1	4.2
Government	62.5	17.2	24.9	31.0	30.7	24.5
Capital transfers	61.8	18.2	24.9	31.0	30.7	24.5
Loans (net)	0.8	-0.9	0.0	0.0	0.0	0.0
Direct investment	0.5	0.6	0.6	0.3	0.3	0.2
Financial institutions	-28.0	-20.3	-22.3	-30.7	-23.9	-20.6
Errors and omissions	-19.7	17.5	-7.9	0.2	5.2	0.0
Overall balance	4.3	-5.2	-7.9	-0.4	11.1	0.7
Change in external assets (increase -) 2/	-4.3	5.2	7.9	0.4	-11.1	-0.7
Revenue Equalization Reserve Fund	4.5	-3.2	9.5	14.1	-6.7	1.0
Government funds 3/	-8.8	8.4	-1.7	-13.6	-4.4	-1.7
Memorandum items:						
Balance on goods and services (percent of GDP)	-80.5	-100.9	-78.4	-78.0	-75.1	-70.9
Current account balance (percent of GDP)	-11.1	-19.1	-2.9	-1.0	-0.9	-3.1
Current account balance excluding official grants	-108.1	-83.5	-64.8	-81.5	-80.9	-67.0
(In percent of GDP)	-108.4	-79.0	-60.6	-64.0	-59.2	-59.0
Official external assets	474.3	481.0	530.6	585.9	411.5	414.2
(In years of imports)	5.1	3.9	5.6	5.2	3.4	4.4
Foreign reserve assets	25.1	15.6	18.5	35.0	31.0	32.0
(In months of imports of goods and services)	3.1	1.6	2.2	3.5	3.8	4.1
Other assets	449.2	465.5	512.1	550.9	380.5	382.1
External debt 4/	13.0	11.3	13.1	12.9	10.1	9.9
(In percent of GDP)	12.3	11.2	11.7	9.6	9.1	8.8
External debt service 5/	0.7	1.2	0.4	2.2	1.7	1.6
(In percent of exports of goods and services)	5.2	7.6	2.9	15.4	12.3	11.4

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

1/ Includes fishing license fees, which would be shown as current transfers under conventional international guidelines.
2/ Excludes valuation changes.
3/ Comprises the Consolidated Fund, Development Fund, and STABEX Fund.
4/ External debt at end–2002 is adjusted by $A 3.2 million reflecting forgiven debt.
5/ An increase in the debt service in 2007 reflects maturity of certain external borrowing including from Japan.

Table 4. Kiribati: Medium-Term Projections, 2007–14

	2007	2008	2009	2010	2011	2012	2013	2014
Baseline scenario								
Real sector								
Real GDP (percentage change)	-0.5	3.4	1.5	1.1	1.1	1.1	1.1	1.1
Inflation (end of period)	3.7	18.6	2.8	2.8	2.8	2.8	2.8	2.8
Nominal GDP at market prices (in millions of Australian dollars)	152.0	159.7	166.6	173.1	180.0	187.0	194.4	202.0
Population (in thousands)	95.7	97.6	99.4	101.4	103.0	104.6	106.3	108.0
Government finance								
Total revenue and grants (in percent of GDP)	103.4	101.3	96.7	93.8	90.9	88.2	85.7	83.3
Revenue	40.4	43.0	40.9	40.0	39.2	38.4	37.8	37.2
External grants	62.9	58.3	55.9	53.7	51.7	49.8	47.9	46.1
Total expenditure and net lending (in percent of GDP)	119.4	114.6	108.9	106.8	104.8	102.8	100.9	99.1
Current expenditure	56.5	56.3	53.0	53.0	53.0	53.0	53.0	53.0
Of which: Wages and salaries	27.3	27.1	26.3	26.3	26.3	26.3	26.3	26.3
Development expenditure	62.9	58.3	55.9	53.7	51.7	49.8	47.9	46.1
Overall balance (in percent of GDP)	-16.0	-13.3	-12.2	-13.0	-13.8	-14.6	-15.2	-15.9
RERF balance (end of period; in millions of Australian dollars) 1/	637.3	561.6	576.9	587.6	596.4	603.4	609.5	614.5
In per capita, real	5,052	4,173	4,059	3,938	3,826	3,705	3,582	3,457
Balance of payments (in millions of U.S. dollars)								
Trade balance	-66.5	-71.6	-56.0	-57.1	-58.5	-60.0	-61.6	-63.2
Balance on services	-33.0	-31.0	-24.6	-24.0	-23.4	-22.8	-22.1	-21.8
Balance on factor income	58.3	61.9	46.0	43.5	43.3	43.1	42.9	42.7
Balance on current transfers	39.9	39.4	31.1	30.3	29.5	28.9	28.2	27.5
Current account	-1.3	-1.3	-3.5	-7.3	-9.0	-10.8	-12.5	-14.7
(In percent of GDP)	-1.0	-0.9	-3.1	-6.3	-7.6	-8.8	-10.0	-11.4
Current account balance excluding official grants	-81.5	-80.9	-67.0	-69.8	-70.6	-71.7	-72.8	-74.4
(In percent of GDP)	-64.0	-59.2	-59.0	-60.0	-59.3	-58.5	-57.8	-57.4
Overall balance	-0.4	11.1	0.7	-2.7	-3.8	-5.1	-6.2	-6.8
(In percent of GDP)	-0.3	8.1	0.6	-2.3	-3.2	-4.2	-4.9	-5.2
External debt (in millions of US$; end of period)								
External debt	12.9	10.1	9.9	9.7	9.6	9.5	9.4	9.3
(In percent of GDP)	9.6	9.1	8.8	8.4	8.1	7.8	7.5	7.2
External debt service	2.2	1.7	1.6	1.6	1.6	1.6	1.6	1.6
(In percent of exports of goods and services)	15.4	12.3	11.4	10.5	9.7	9.0	8.3	7.8
Adjustment Scenario								
Real sector								
Real GDP (percentage change)	-0.5	3.4	1.5	2.3	3.1	3.1	3.1	3.1
Inflation (end of period)	3.7	18.6	2.8	3.3	2.8	2.8	2.8	2.8
Nominal GDP at market prices (in millions of Australian dollars)	152.0	159.7	166.6	175.1	185.4	196.4	208.0	220.2
Government finance								
Total revenue and grants (in percent of GDP)	103.4	101.3	96.7	95.1	92.6	89.8	87.3	84.9
Revenue	40.4	43.0	40.9	41.9	42.4	42.4	42.5	42.7
External grants	62.9	58.3	55.9	53.1	50.2	47.4	44.8	42.3
Total expenditure and net lending (in percent of GDP)	119.4	114.6	108.9	105.2	101.2	97.4	93.8	90.3
Current expenditure	56.5	56.3	53.0	52.0	51.0	50.0	49.0	48.0
Of which: Wages and salaries	27.3	27.1	26.3	25.3	24.3	23.3	22.3	21.3
Development expenditure	62.9	58.3	55.9	53.1	50.2	47.4	44.8	42.3
Overall balance (in percent of GDP)	-16.0	-13.3	-12.2	-10.1	-8.6	-7.6	-6.5	-5.4
RERF balance (end of period; in millions of Australian dollars) 1/	637.3	561.6	573.8	589.0	606.8	626.7	650.2	677.8
In per capita, real	5,052	4,173	4,059	3,947	3,893	3,848	3,821	3,813
Balance of payments								
Trade balance	-66.5	-71.6	-62.8	-64.9	-67.4	-70.2	-73.2	-76.4
Balance on services	-33.0	-31.0	-24.6	-24.2	-24.1	-23.9	-23.7	-23.5
Balance on factor income	58.3	61.9	44.2	44.2	44.3	44.6	44.9	45.3
Balance on current transfers	39.9	39.4	31.1	30.1	29.2	28.4	27.5	26.6
Current account	-1.3	-1.3	-12.1	-15.0	-18.5	-22.3	-26.3	-30.5
(In percent of GDP)	-1.0	-0.9	-10.6	-12.7	-15.1	-17.3	-19.5	-21.6
Current account balance excluding official grants	-81.5	-80.9	-75.6	-77.3	-79.6	-82.2	-84.9	-87.6
(In percent of GDP)	-64.0	-59.2	-66.5	-65.7	-64.8	-63.9	-63.0	-62.1
Overall balance	-0.4	11.1	-1.5	0.5	2.0	3.2	5.3	7.6
(In percent of GDP)	-0.3	8.1	-1.3	0.4	1.7	2.5	3.9	5.4
External debt (in millions of US$; end of period)								
External debt	12.9	10.1	9.9	9.7	9.6	9.5	9.4	9.3
(In percent of GDP)	9.6	9.1	8.8	8.3	7.9	7.4	7.0	6.6
External debt service	2.2	1.7	1.6	1.6	1.6	1.6	1.6	1.6
(In percent of exports of goods and services)	15.4	12.3	11.4	10.5	9.7	9.0	8.3	7.7

Sources: Data provided by the Kiribati authorities; and Fund staff estimates and projections.
1/ Projections assume an annual nominal portfolio rate of return of 6 percent.

Table 5. Kiribati: Social Indicators

	Kiribati	Same Region/Income Group	
		East Asia and Pacific	Lower-middle Income
Population			
Total population (millions)	0.10	1,914	3,437
Growth rate (percent annual)	1.6	0.8	1.0
Urban population (percent of population)	43.8	43.3	41.7
Total fertility rate (births per woman)	3.6	2.0	2.3
GNI per capita (in U.S. dollars)	1,170	2,180	1,887
Current public expenditure			
Health (in percent of GDP)	11.7	1.8	2.0
Education (in percent of GDP)	17.8	2.7	4.7
Gross primary enrollment			
(In percent of school age population)	113	114	111
Male	112	115	113
Female	114	114	110
Immunization rate (percent 12-23 months)			
Measles	61	89	77
Diphtheria/Pertussis/Tetanus (DPT)	86	89	75
Life expectancy at birth (years)			
Total	63	71	69
Male	60	69	67
Female	66	73	70
Mortality			
Infant (per thousand live births)	47	24	41
Under 5 (per thousand live births)	64	29	54

Sources: World Bank, *World Development Indicators 2008* .

APPENDIX. KIRIBATI: MEDIUM-TERM PROJECTIONS

This appendix describes key assumptions in the medium-term projections and summarizes the results of the two scenarios.

Baseline policy scenario

Policy assumptions. In the absence of deep structural reforms, medium-term real GDP growth declines to 1.1 percent. Current expenditure is assumed to increase in line with GDP growth. Tax revenues also increase at this pace, and the losses of custom revenue due to the regional trade arrangements are partly offset by administrative reform.

Outcome. The fiscal deficit (in percent of GDP) would increase gradually, as revenue in percent of GDP declines while current expenditure (in percent of GDP) is flat. The RERF would decline to A$ 3,500 in real per capita terms (1996 A$) in 2014 from A$4,200 in 2008, as drawdowns to finance the fiscal deficits are large.

Adjustment scenario

Policy assumptions. In the adjustment scenario, fiscal and structural reforms (including PEs reform and revenue reform) are fully implemented. The medium-term real GDP growth is 3.1 percent, 2 percentage points higher than that in the baseline scenario. Continued fiscal reforms help to increase the tax and customs revenue to GDP ratio by 1 percentage point annually in the medium term (with phasing in of a consumption tax and excises starting in 2010); and reduce the current expenditure to GDP ratio by 1 percentage point annually.[1] (Development expenditure financed by external grants stays at the 2008 *level* in the medium-term in both scenarios).

Outcome. In this scenario, GDP would be higher by around 20 percent in FY2014 than in the baseline scenario. Fiscal reform would contribute to a continuous reduction in the fiscal deficit (the deficit would be reduced to around 5.5 percent of GDP in 2014). With substantially smaller fiscal deficits, the RERF balance would stop declining in real per capita terms (1996 A$) in the medium term.

[1] This reduction still allows current expenditure to grow in nominal terms at around 3.5 percent annually.

INTERNATIONAL MONETARY FUND

KIRIBATI

Staff Report for the 2009 Article IV Consultation—Informational Annex

Prepared by Asia and Pacific Department
(In consultation with other departments)

April 16, 2009

Contents Page

ANNEX I. KIRIBATI: FUND RELATIONS
(As of February 28, 2009)

I. **Membership Status**: Joined June 3, 1986; Article VIII

II. **General Resources Account**

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

III. **SDR Department**

SDR Department	SDR Million	Percent of Allocation
Holdings	0.01	N/A

IV. **Outstanding Purchases and Loans**: None.

V. **Financial Arrangements**: None.

VI. **Projected Obligations to the Fund**: None.

VII. **Implementation of HIPC Initiative**: Not Applicable

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

IX. **Exchange Rate Arrangement**: The Australian dollar is legal tender and the domestic currency of Kiribati. Kiribati issues a small amount of coins.

X. **Article IV Consultation:** The 2007 Article IV consultation discussions with Kiribati were held in Tarawa during February 20–March 1, 2007. Kiribati is on a 24–month consultation cycle.

XI. **Technical Assistance (TA), 1995–2009:**
STA, LEG, and PFTAC have provided TA on statistics, tax administration and policy, budget management, banking supervision, and combating of financial crime and financial system abuse.

XII. **Resident Representative**: None.

ANNEX II. KIRIBATI: RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE[1]

(As of March 2009)

The Centre's assistance to Kiribati since 1998 has included 27 advisory missions. Kiribati also sent 11 officials to regional seminars and workshops. PFTAC organized three attachments.

Tax administration and policy

PFTAC recommended reforms in 2003 which included: a value-added tax (VAT); presumptive tax; and a single ad valorem tax on imports from non Pacific countries; simplified personal income tax (PIT); single rate of corporate income tax (CIT). A steering committee was established to manage the introduction of the reforms

The domestic revenue issues require to be addressed with some urgency. Compliance levels are low and the impact of trade liberalization (PICTA and PACER) is expected to reduce trade revenues by up to 15 percent on which Kiribati is highly dependant.

Although agreed to in principle little progress has been made to introduce the reforms. However in February 2009, the cabinet approved the introduction of legislation to treat income tax deductions from salary and wages (PAYE) as a final tax. There is some confidence in Kiribati that the legislation will be passed through the Parliament. It is hoped that the more substantial changes to reform the tax base will follow.

PFTAC has indicated that it stands ready to assist the authorities implement the reform once the cabinet has made a firm commitment to proceed. Meanwhile, AusAid is funding a customs automation project and PFTAC has indicated a willingness to assist a broader customs modernization project upon request.

Public financial management

AusAid maintains a long-term TA program aimed at improving public sector financial and economic management. A joint PFTAC mission with Asian Development Bank (AsDB) on public financial management reform was undertaken in August 2006. Following this mission, a multi-donor mission of AusAID, PFTAC, and AsDB visited Kiribati from

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

12–15 December 2006. NZAID was represented by AusAID on the mission. Discussions were held with the objective of implementing the recommendations made by the earlier two missions. Two areas, implementation of a multi-year budget framework and a cash planning and commitment control system, identified by the PFTAC August 2006 mission, were agreed to by the government for immediate implementation. A draft ToR for setting up a multi-year budget framework has been sent to the government for its comments and approval is awaited. Also awaited are the governments request to initiate work on cash planning and commitment control.

Financial sector regulation and supervision

In August 2003, the PFTAC advisor and an IMF legal expert visited Kiribati to conduct consultations with industry and government officials on a Financial Institutions Bill that had been drafted in July 2002. No major concerns arose from the discussions. Proposed responses to comments raised in the meeting, together with appropriately amended draft legislation, were forwarded to the authorities in December 2003 for action. In 2005, the advisor was invited to attend a government and industry workshop to discuss aspects of the Financial Institutions Bill. The mission did not precede however, the advisor provided authorities with papers, which highlighted the need for such legislation. To date there has been no further progress on the draft Financial Institutions Bill or the previously drafted Anti-money laundering legislation. The PFTAC advisor makes periodic contact with the Ministry of Finance regarding the status of the draft legislation.

Economic and financial statistics

GDDS metadata was published on the IMF website in April 2004, following assistance with drafting by PFTAC. A brief mission was undertaken in August 2006 to assess TA needs. The BOP compiler benefited from training provided in a regional course in April 2005. The presence at the University of the South Pacific in Suva of a senior statistician was utilized to arrange an attachment with PFTAC in 2006 to help build practical knowledge in Kiribati's economic statistics compilation. The PFTAC Multisector Statistics Advisor (MSA) undertook a balance of payment (BOP) and national account (NA) statistics review mission in August 2008, and assisted the authorities in improving compilation methods and use of source data, as well as providing training. The MSA also provided assistance in revising and updating the BOP and NA estimates. A follow-up NA statistics mission by a short-term expert was undertaken in early February 2009 to continue developing NA statistics data sources and methods provide further training and to update the estimates. PFTAC is also sponsoring a one-month attachment for the BOP compiler with Statistics New Zealand in May 2009.

ANNEX III. KIRIBATI: RELATIONS WITH THE WORLD BANK GROUP[2]

(As of March 2009)

Kiribati became a World Bank Group member in 1986. Since that time the Bank's assistance consisted of a range of regional initiatives and the development of a major Global Environment Facility (GEF) program on adaptation to climate change (Kiribati Adaptation Program 2003–15). The Bank's assistance to Kiribati, guided by the government's own priorities articulated in the National Development Strategies 2004–07 and the Bank's broader Pacific Regional Engagement Framework 2006–09 focuses on helping the country to prepare for the effects of climate change and rising sea levels, which the government recognizes as having the potential to have major social and economic consequences. A revised Pacific Regional Engagement Framework, addressing Kiribati and eight other Pacific Island member countries is under preparation.

The World Bank has no ongoing International Association for Development (IDA) operations. Various trust funds support the development and implementation of the Kiribati Adaptation Program. Phase I of the Kiribati Adaptation Program started in 2003 and was completed in 2006. Phase II of the Program (KAP-II) was approved on 1 June, 2006, with a US$1.8 million GEF grant as well as co-financing by the government, AusAID, and NZAID. KAP-II aims to develop and demonstrate the systematic diagnosis of climate-related problems and the design of cost-effective adaptation measures, while continuing to integrate climate risk awareness and responsiveness into economic and operational planning. Lessons learned from KAP-II would be used to plan the long-term national response to climate change, and will be relevant to many other small island states around the world.

Following the release of the World Bank report "At Home and Away: Expanding Job Opportunities for Pacific Islanders through Labor Mobility" (August 2006), Kiribati participates in the two active temporary worker schemes in the region established by the governments of New Zealand in 2007 and Australia in February 2009. In response to the increase in global food prices, the World Bank is preparing a regional crisis response program using a US$6 million grant received from the Food Price Crisis Response Trust Fund. The program is expected to include a possible development policy operation in Kiribati, currently estimated at around US$2 million. A World Bank team undertook a mission to Kiribati in June 2008 to assess the impacts of the 2008 food and fuel crisis and a second mission will return in April 2009 to identify operational design options.

Kiribati is also expected to receive assistance under the proposed Pacific Regional Infrastructure Facility (PRIF), a multi-donor trust fund principally supported by the government of Australia. The Facility aims to support a broad range of infrastructure and TA

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[2]Prepared by World Bank staff.

activities throughout the Pacific. A World Bank mission involving each of the four PRIF development partners visited Kiribati in June 2008 to identify priorities for support including the provision of advisory services in the areas of telecommunications, public utilities, environmental management, and the management of state-owned enterprises, as well as possible investment needs.

Total loan commitments: None. A US$645,580 grant from the Japan Climate Change PHRD funds (administered by IDA) was signed on February 19, 2003, a US$99,100 Project Development Fund grant from GEF was signed on October 28, 2004, a US$1.4 million grant from AusAID was signed on June 27, 2006, a US$310,216 from NZAID was signed on September 4, 2006, and a US$1.8 million World Bank Trust Fund was signed on July 6, 2006—all for the preparation and implementation of the Kiribati Adaptation Program.

IFC investments: None.

ANNEX IV. KIRIBATI: RELATIONS WITH THE ASIAN DEVELOPMENT BANK[1]

(As of March 2009)

The Asian Development Bank has approved six project loans to Kiribati amounting to US$15.1 million, all from Special Fund resources. In addition, TA amounting to US$12.8 million has been provided for 36 projects. The latest AsDB loan to Kiribati was approved by AsDB in December 1998 for a Sanitation, Public Health, and Environment Improvement project. The AsDB most recently approved an $800,000 TA grant for Economic Management and Public Sector Reform in November 2008.

The strategy of the AsDB in Kiribati directly supports the government's Kiribati Development Strategy (NDS) 2008–11. Further, AsDB's approach is anchored in the mid-term review of the Pacific Strategy, which put a stronger emphasis on issues of supporting a conducive environment for private sector development, good governance, and capacity development. Rapid population growth and urban migration has left Kiribati with overcrowded urban areas, and its most pressing development challenges are social and environmental concerns, including the impacts of climate change, access to clean water and sanitation, and the spread of HIV/AIDS. AsDB supports the government's efforts to balance growth more evenly throughout the country through TA for the Integrated Land and Population Development Program on Kiritimati Island. AsDB also supports efforts to improve the government's financial management through TA for Economic Management and Public Sector Reform recognizing the sizeable constraint the poor performance of public enterprises is placing on government ability to fund needed goods and services.

AsDB Loan Approvals and Disbursements, 2003–2008
(In thousands of U.S. dollars)

	2003	2004	2005	2006	2007	2008
Loan disbursements[1]	2,424	2,494	1,564	152	…	…
Cumulative disbursements[1]	9,494	11,988	13,552	13,704	13,704	13,704
Cumulative net loan amount[2]	13,991	14,065	13,934	13,946	13,958	13,704
Undisbursed loan amount						
(including not yet effective)	4,550	2,077	382	242	254	…
Cumulative principal repayments[3]	512	587	669	789	909	1,051
Interest payments[3]	77	104	120	134	133	146

Source: Data provided by the AsDB.

[1] U.S. Dollar equivalent at time of loan negotiation.

[2] Converted at prevailing exchange rates at time of disbursement.

[3] Principal amount less cancellation.

[4] Converted at prevailing exchange rates at time of receipt of payment.

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[1] Prepared by Asian Development Bank staff.

ANNEX V. KIRIBATI—STATISTICAL ISSUES

As of March 31, 2009

I. Assessment of Data Adequacy for Surveillance	
General: Data provision has some shortcomings, but is broadly adequate for surveillance. Balance of payments is the most affected area.	
National Accounts: With PTFAC's assistance, GDP estimates have been significantly improved. During the last mission of February 2009, revised estimates up to 2007 and provisional estimates for 2008 were near completion. The estimates have been revised to include informal economic activities, based on the 2006 Household Income and Expenditure Survey. Also, the constant price estimates were rebased to 2006 prices. However, further capacity building would be needed to continue to improve the quality of GDP estimates. PFTAC has also recommended that the statistics authorities work more closely with other agencies (e.g., tax authorities, public enterprises). There are no expenditure-based GDP estimates. Also, unemployment indicators are not regularly available.	
Price statistics: The monthly retail price index (1996=100) is produced with a short lag (about a month), based on a survey in the capital (a national index is not available). There are no producer, wholesale, or trade price indices.	
Government finance statistics: Budget outcome is available with a lag of about a year. Currently, a provisional budget outcome for 2008 is available. There are misclassifications in the current statistics, which have been identified by PFTAC. Audited financial statements of public enterprises are not available.	
Monetary statistics: The balance sheets of all the financial institutions (Bank of Kiribati, Development Bank of Kiribati, Kiribati Provident Fund, and Kiribati Insurance Corporation) are available with lags, but the consolidated balance sheets of the financial sector is not available. Data on interest rates are reported with a long lag.	
Balance of payments: The quality of the data has been improved with recent PFTAC assistance. However, there still remain some shortcomings: i) external statistics are reported with a long delay (about a year or more), ii) there are large errors and omissions in some years, which appear to partly reflect the underestimation of private transfers, iii) and there are some inconsistencies between the balance of payments data and budget data. Given capacity constrains, the most recent balance of payments estimates are available for 2007. As in the case of GDP data, PFTAC has suggested the need for further statistical capacity building. In this regard, PFTAC plans to provide follow-up assistance this year (2009), together with Statistics New Zealand.	
II. Data Standards and Quality	
Participant in the General Data Dissemination System (GDDS) since 2004.	No data ROSC available.
III. Reporting to STA (Optional)	
No data are currently reported to STA for publication in the *Government Finance Statistics Yearbook,* the *Balance of Payments Statistics Yearbook* or in the *IFS.*	

KIRIBATI: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

As of March 24, 2009

	Date of latest observation (For all dates in table, please use format dd/mm/yy)	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items:[8]	
						Data Quality – Methodological soundness[9]	Data Quality – Accuracy and reliability[10]
Exchange Rates	17/03/09	17/03/09	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities1	31/12/08	26/02/09	M	A	NA		
Reserve/Base Money	NA	NA	NA	NA	NA		
Broad Money	NA	NA	NA	NA	NA		
Central Bank Balance Sheet	NA	NA	NA	NA	NA		
Consolidated Balance Sheet of the Banking System	NA	NA	NA	NA	NA		
Interest Rates[2]	31/12/06	01/03/07	A	A	I		
Consumer Price Index	28/02/08	04/03/09	M	Q	Q		
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	31/12/08	15/01/09	A	A	I		
Revenue, Expenditure, Balance and Composition of Financing3– Central Government	31/12/08	15/01/09	A	A	I		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	13/10/08	26/02/09	A	A	I		
External Current Account Balance	31/12/07	25/02/09	A	A	I		
Exports and Imports of Goods and Services	31/12/07	25/02/09	A	A	I		
GDP/GNP	31/12/08	25/02/09	A	A	I		
Gross External Debt	31/12/08	15/01/09	A	A	I		
International Investment Position[6]	31/12/07	26/02/08	A	A	I		

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[8] These columns should only be included for countries for which Data ROSC (or a Substantive Update) has been published.
[9] Reflects the assessment provided in the data ROSC or the Substantive Update (published on ..., and based on the findings of the mission that took place during...) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[10] Same as footnote 9, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

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IMF Executive Board Concludes 2009 Article IV Consultation with Kiribati

On May 1, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Kiribati.[1]

Background

Economic activity picked up in 2008 with growth reaching 3½ percent (following a mild contraction in 2007), largely reflecting growth in agricultural and public sector activity. External sources of income (investment income, fishing license fees, and remittances) have remained critical and account for around one-third of GNP. The Australian dollar (A$) is used as the domestic currency.

Inflation increased to around 19 percent by end-2008, largely reflecting higher food prices. Administered fuel prices mean that the public sector absorbed the impact of the run-up in global fuel prices through mid-2008. The sharp depreciation of the A$ during the last quarter of 2008 has in part offset the subsequent decline in international food and fuel prices.

The fiscal deficit declined from 16 percent of GDP in 2007 to 13.3 percent of GDP in 2008. This improvement mainly reflected higher revenue from fishing license fees (in A$ terms), but also some expenditure constraint. Large fiscal deficits have necessitated large drawdowns from Revenue Equalization Reserve Fund (RERF) (A$25 million in 2008) as the RERF is the main source of deficit financing. With the large drawdowns in recent years, and the global decline in

[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. 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.

asset values, the RERF has declined substantially in real per capita terms. Furthermore, most public enterprises (PEs) have continued to operate with losses, and there have been large increases in government guaranteed loans from Bank of Kiribati to PEs. On the positive side, there has been notable progress with improving revenue administration.

The current account deficit was broadly unchanged in 2008. The stock of external debt was around 9 percent of GDP at the end of 2008, with most borrowing on concessional terms from the Asian Development Bank. External debt service is around 11 percent of exports of goods and services.

Structural reforms are underway, although the pace has been limited by capacity constraints. Plans to review and restructure the large number of loss making PEs have been announced. Kiribati's draft Private Sector Development Strategy also addresses the key priority areas for creating an enabling environment for business. Developing Kiribati's vast marine resources and tourism are key, but Kiribati's remoteness and the difficulty of ensuring regular flights are major challenges.

Executive Board Assessment

Executive Directors welcomed the recent improvement in economic activity. They observed that, while Kiribati faces challenges from its remote location and vulnerability to climate change, strong policy performance would contribute to maintaining financial stability, and support Kiribati in taking advantage of its vast marine and natural resources, and growth opportunities in fishing and tourism, to sustain economic growth.

Directors considered that, in the absence of monetary policy options, fiscal policy could be used in the near term to counter the negative impacts of the global economic slowdown, including by bringing forward projects and through well-targeted social spending if necessary. They stressed, however, that over the medium-term deficits would need to be reduced in order to maintain fiscal sustainability. Directors welcomed the recent improvement in revenue administration. They indicated that, going forward, fiscal consolidation will depend on additional revenue and expenditure measures including the further strengthening of revenue administration, the introduction of consumption tax and excises, and enhanced fishing license revenues. On the expenditure side, priority should be given to controlling the public sector wage bill, and reducing subsidies and loan guarantees to public enterprises.

Directors noted the substantial decline in the Revenue Equalization Reserve Fund (RERF) due to large drawdowns and global asset prices declines, and agreed that a well-defined rule for drawdowns from the RERF and a medium-term budgetary framework could help smooth expenditure and safeguard the RERF. They also stressed the importance of improving public sector cash management given the high cost of bank overdrafts.

Directors welcomed the planned review and reform of PEs as critical to promoting private sector development, and to boosting the growth potential. The rationalization and reform of PEs by enhancing their financial management, transparency and monitoring would create fiscal space for much needed social spending and increase the scope for private sector activity. Improving the investment climate and land titling, enhancing competition, and developing further Kiribati's marine resources and tourism would also contribute to promoting private sector development.

Directors observed that greater competition together with an enhanced regulatory and supervisory framework would strengthen the financial sector. Given the large share of non-performing loans and its plan for expansion, the Development Bank of Kiribati should improve its risk management. In light of its weak capital position, the investment strategy and dividend policy of the Kiribati Provident Fund should be reviewed.

Directors welcomed the recent improvements in national accounts and balance of payments statistics, and looked forward to further improvement in data compilation and dissemination.

Kiribati: Selected Economic Indicators, 2004–09

	2004	2005	2006	2007	2008	2009 Proj.
Growth						
Real GDP (percent change)	2.2	0.0	3.2	-0.5	3.4	1.5
Consumer prices (percent change, end-of-period)	-1.9	-0.5	-0.2	3.7	18.6	2.8
Central government finance (percent of GDP)						
Revenue and grants	144.9	103.0	100.0	103.4	101.3	96.7
Total domestic revenue	47.5	43.1	42.3	40.4	43.0	40.9
Grants	97.4	59.9	57.7	62.9	58.3	55.9
Expenditure and net lending	168.5	118.3	115.5	119.4	114.6	108.9
Current	71.1	58.4	57.8	56.5	56.3	53.0
Of which: wages and salaries	27.7	27.1	29.3	27.3	27.1	26.3
Development	97.4	59.9	57.7	62.9	58.3	55.9
Overall balance	-23.6	-15.3	-15.5	-16.0	-13.3	-12.2
Financing	23.6	15.3	15.5	16.0	13.3	12.2
Revenue Equalization and Reserve Fund (RERF)	19.0	10.8	23.6	29.6	15.7	12.2
Other	4.6	4.5	-8.1	-13.6	-2.3	0.0
RERF						
Closing Balance (in millions of U.S. dollars)	459	475	522	562	389	391
Closing Balance (in millions of $A)	589	647	660	637	562	577
Per Capita Value (in 1996 $A)	5,379	5,618	5,447	5,052	4,173	4,059
Commercial banks (in millions of U.S. dollars)						
Foreign assets	44.1	17.1	20.8	30.3	36.5	…
Private sector claims	13.2	33.3	30.7	35.4	37.0	…
Total deposits	54.1	42.7	44.2	65.7	73.6	…
Balance of payments (in millions of U.S. dollars)						
Current account including official transfers	-11.0	-20.2	-3.1	-1.3	-1.3	-3.5
(In percent of GDP)	-11.1	-19.1	-2.9	-1.0	-0.9	-3.1
Current account excluding official transfers	-108.1	-83.5	-64.8	-81.5	-80.9	-67.0
(In percent of GDP)	-108.4	-79.0	-60.6	-64.0	-59.2	-59.0
External debt (in millions of U.S. dollars)	13.0	11.3	13.1	12.9	10.1	9.9
(In percent of GDP)	12.3	11.2	11.7	9.6	9.1	8.8
External debt service (in millions of U.S. dollars)	0.7	1.2	0.4	2.2	1.7	1.6
(In percent of exports of goods and services)	5.2	7.6	2.9	15.4	12.3	11.4
Exchange rate (A/US period average) 1/	1.4	1.3	1.3	1.2	1.2	…
Real effective exchange rate (period average) 2/	116.3	115.7	110.9	119.5	123.8	…
Memorandum items						
Nominal GDP (in millions of Australian dollars)	135.3	138.3	142.0	152.0	159.7	166.6

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

1/ The Australian dollar is the domestic currency.
2/ Year 1990=100.

Statement by Hi-Su Lee, Executive Director for Kiribati
and Raynold Moveni, Advisor
May 1, 2009

Introduction

Kiribati shares the common characteristics of most small island economies: small landmass, dispersion of the islands, and significant distance from international markets. These disadvantages make the cost of delivering government services expensive, hinder growth of domestic markets, and preclude economies of scale production. However, the Kiribati economy is also supported by several positive attributes. Firstly, Kiribati has a strong traditional culture which, to a large extent, has acted as a social safety net for I-Kiribati, and has also provided a stable socio-political environment over the years. Secondly, and despite still being a young nation, Kiribati is a vibrant democracy and follows good governance practices. Since the end of phosphate mining in 1979, successive governments have prudently managed proceeds from phosphate mining through the Reserve Equalization Reserve Fund (RERF), and have responsibly used income from fishing license fees to fund government services.

Our Kiribati authorities valued this year's Article IV consultation during a time when the global economy is under strain. The authorities also consider this Article IV to be a timely one because the discussion has provided invaluable input to the government's deliberations on policies critical to move Kiribati forward. Like other countries, Kiribati has been affected by the global turmoil and the staff report provides a detailed description of channels through which Kiribati continues to be affected.

Economic Developments and Outlook

Based on available data, Kiribati's economy is estimated to have grown by 3½ percent in 2008, reversing the mild contraction recorded in 2007. Strong agricultural activities, particularly copra production, and stronger-than-expected growth in public sector activities were the main driving forces behind this growth. Formal sector employment expanded by about 15 percent to around 50,000 in 2008. Domestic inflation remained subdued in the first half of 2008, while the banking sector remained profitable, liquid, and well-capitalized.

As a small island economy isolated from international markets, Kiribati has been affected by international developments with a lag. The pass-through of the international food price shock to domestic prices sent domestic inflation surging to 19 percent at end-2008 from just 3 percent at end-2007. As a result, consumer spending slowed considerably, prompting businesses to scale back operations and reducing government revenue collections. The downturn in foreign asset prices has also affected the value of RERF, which has been the authorities' principal source of budget deficit financing, and the balance sheet of Kiribati Provident Fund (KPF). Combined with the downturn in international trade and associated reduction in demand for Kiribati's primary exports (copra and fish), this confluence of factors is combining to reduce activity growth and constrain fiscal position.

The authorities expect real GDP growth to slow down in 2009 and the domestic inflation to return to its normal trend of 2-4 percent in the second-half of 2009. In addition, once customs and tax reforms are completed later this year, the authorities expect government revenues to increase and, with prudent expenditure administration, for the overall fiscal position to improve further this year. The authorities agree with staff that forceful implementation of reform beginning this year is the key to placing the economy on a sustainable medium-term growth path,

Fiscal Sector

As in previous years, the main fiscal objective of the government in 2008 was to maintain a budget that is affordable and consistent with the unofficial target of maintaining the real per capita value of the RERF at the 1996 level. Accordingly, recurrent expenditures were capped at 56½ percent of GDP, recruitments were frozen, development expenditures were confined to donor funding, and rigorous measures were introduced to strengthen revenue administration. Indeed, the authorities were broadly on track to achieve their 2008 fiscal target in the absence of the international food and fuel price shocks. To minimize the impact of rising prices on poor, the authorities introduced a price subsidy on rice. Notwithstanding these pressures, the overall fiscal deficit, as a ratio of GDP, declined from 16 percent in 2007 to 13 percent in 2008. This improvement largely reflects higher-than-expected revenue collections, particularly from fishing license fees, and better expenditure administration.

Because of Kiribati's enormous Exclusive Economic Zone (covering some 1.24 million square miles of the Pacific Ocean), fishing license fees are Kiribati's single most important source of government revenue. Compared to 2007, revenue collections from this source have increased by about 27 percent to A$32.2 million and contributed more than 41 percent of government revenues in 2008. Compared to other revenue sources, collections from Inland Revenues are small. This is consistent with the pace of private sector development and economic structure of Kiribati, where most people not employed in the public sector are engaged in subsistence farming and fishing. However, in the medium-term, the authorities are anticipating Inland Revenue collections to increase once the customs and tax administration reforms are completed later this year. Funded by AusAID and other multilateral institutions, the reforms are aimed at: (1) strengthening and modernizing the customs and tax administration framework; (2) improving the capacity of tax customs service to increase collections; and (3) facilitating the authorities planned move to PAYE final this year, whereby the tax bracket not subject to tax will be increased from A$1800 to A$4000 and the tax structure simplified. The authorities expect revenue loss of between A$1.2 million to A$2.1 million a year as a result of that increase but that this loss will be offset by tax gains as the planned move to PAYE final will free up resources to focus more on compliance through tax audits.

To increase government revenue collections in the medium to long-term, the authorities are committed to: (1) developing the private sector so that tax revenues can increase; (2) expanding the tax base through the adoption of a broad-based consumption tax; and (3) increasing revenue earning from, and improving the administration of, granting fishing licenses through close collaboration with Forum Fisheries Agency and other coastal states in the region. On the expenditure side, the authorities are committed to adhering to a cap on recurrent expenditures of 56 percent of GDP, confining development expenditures to donor funding, and following responsible expenditure management practices. In addition, with assistance from bilateral and multilateral development partners, the authorities plan to develop a long-term budgeting and a multi-year budgeting framework.

Revenue Equalization Reserve Fund

Drawdown from RERF has been the principal source of budget deficit financing. However, as staff has rightly point out, the global crisis has eroded the value of RERF and substantial fiscal adjustment is required to keep the per capita value of RERF constant at the 1996 level. Thus, in line with the need to maintain the capacity of RERF to sustain future budgets, the authorities will: (1) review existing guidelines relating to the protection of RERF capital value; (2) improve public and parliamentary understanding of RERF performance through enhanced transparency and; (3) consider introducing a legislative restructuring of RERF into a national reserve fund not accessible to government without parliamentary approval; and (4) with assistance from ADB, will move to a medium-term budgetary framework (MTBF) over the next five years and will incorporate RERF within that MTBF. The authorities expect these planned measures to protect RERF in the medium-term and, in that context, welcome staff's recommendation to reduce the drawdown of RERF through the reduction in fiscal deficit.

Financial Sector

Kiribati has a small financial sector comprising of one commercial bank (Bank of Kiribati (BOK)), a development bank (Development Bank of Kiribati (DBK)), a superannuation fund (Kiribati Provident Fund (KPF)), and an insurance company (Kiribati Insurance Limited (KIL)). Based on recent data, BOK is profitable, liquid, and well-capitalized. However, KPF is showing signs of financial stress as demonstrated by its negative capital position at end-2008, reflecting the downturn in foreign asset prices and a legislated dividend policy requiring KPF to declare a 7.5 percent dividend each financial year. In an attempt to boost its capital position, the KPF has, since 2007: (1) allowed additional voluntary contributions from its members; (2) taken on board voluntary contributions from seafarers, I-Kiribati, working abroad, and outer island copra workers; and (3) changed its investment strategy by investing 60 percent of its assets on growth assets. Recent information also suggests that DBK could also be in financial distress due to a large portfolio of non-performing loans.

Because the size of the financial sector is small, financial intermediation is very limited and financial sector competition is virtually non-existent. Thus, to encourage competition, the authorities in December 2008 have amended the Kiribati Insurance Act to allow entry into the insurance industry. Similarly, the authorities are also contemplating commercialization of the DBK. In these regards, the authorities agree with staff's recommendation on bringing into force robust financial sector legislation and strengthening the financial sector supervisory framework prior to commercializing the KDB.

Structural Issues and Medium-term Challenges

Because of its physical geography, Kiribati is exposed to many risks. The Staff Report provides a thorough description of these risks and recommendations on the way forward. The government has developed a "Kiribati Development Plan: 2008-2011". This plan takes as its starting point the desirability of the private sector becoming an engine of growth. This is particularly challenging in Kiribati's case due to shortages of skilled workers, weak infrastructure, and limited investment opportunities. Nonetheless, to provide an environment conducive to private sector growth, the Cabinet has approved a plan to reform all PEs. That approval will pave the way for the government to divorce itself from 15 out of 24 PE businesses that the government has assessed the private sector could run more efficiently on a commercial basis.

As part of the Development Plan, the authorities and their development partners have taken a number of initiatives to address skill shortages in Kiribati. Those initiatives include: (1) providing tertiary scholarships to I-Kiribati in priority fields; (2) establishing a Kiribati-Australia Nurses Initiative whereby I-Kiribati youths obtain Australian nursing qualifications and industry experience; (3) equipping Kiribati Teachers College with appropriate tools or resources to train and produce high-quality teachers; (4) improving quality of local curriculum and assessment, raising educational standards, providing high-quality curriculum resources for schools; and (5) strengthening the domestic maritime institution to train and produce high-quality seafarers. Progress has been achieved in these areas and that the authorities are hopeful of reaping the benefits of these initiatives in the coming years.

The authorities are also committed to a sustained increase in per capita growth through: (1) developing fully and commercializing the fisheries and marine resources either through a public-private partnership with reputable foreign investors or a close collaboration with coastal states in the region to obtain maximum sustainable EEZ access fees; (2) developing tourism in the Line and Phoenix island groups; (3) expanding production and export of fish, prawns, and solar salt from Kiritimati Island; (4) strengthening and diversifying the copra industry; (5) developing human resources for local and foreign labor markets; (6) encouraging private sector to invest in industries that Kiribati has comparative advantage in such as seaweed farming and pet fishing and; (7) providing supporting infrastructure; and (8) fostering good relationships with existing and potential bilateral and multilateral development partners. The road ahead will be challenging but with strong political will, and help from development partners, and multilateral institutions, the authorities are hopeful of addressing some of Kiribati's challenges and moving the economy forward.

Final Remark

Finally, our Kiribati authorities express their sincere gratitude to the Mission Chief and his team for the candid and productive exchange of views during the Article IV consultation in Tarawa, and for their frank assessment of the developments in the economy. They also welcome the well-written and succinct staff report, which provides a balanced account of the economy's performance.