

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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