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To: Members of the Executive Board

From: The Acting Secretary

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Questions:	Mr. Nyberg, APD (ext. 35919)

***The authorities have not consented to the publication of this assessment by the World Bank.**

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Tuvalu—Assessment Letter for the Asian Development Bank
August 12, 2015

Tuvalu was severely impacted by Cyclone Pam in March 2015. The cyclone is estimated to have affected 40 percent of the population and caused damages of A$14 million, or around 33 percent of GDP, mainly to outer island infrastructure such as sea walls, but also agriculture and housing.[1] In the immediate crisis response, the authorities have prioritized food security, recovery and reconstruction spending, with assistance of development partners.

The gradual build up of fiscal buffers allowed a rapid government response. Prior to Cyclone Pam, the authorities had gradually built up fiscal buffers. The fiscal position continued to improve in 2014 and accumulated fiscal buffers in the Consolidated Investment Fund (CIF) amounted to around 60 percent of GDP at end-2014, allowing for a rapid initial government response to the disaster. In view of the substantial costs of recovery and reconstruction, the government has also re-oriented a portion of the 2015 capital budget to meet financing needs and the government has sought support from development partners.

Despite the impact of Cyclone Pam, the near-term macroeconomic outlook remains generally stable. While the cyclone damaged some productive capacity of the economy, particularly in the agricultural sector, reconstruction activities may provide a short-term economic boost in 2015 and 2016. Considering the small size of the economy and the development partner support under consideration, there is scope for a modest positive growth impact, with projected growth in the range of 3–4 percent in 2015–16, as contractors previously engaged in donor-financed projects can be rapidly redeployed for reconstruction. In the near-term, there may be some upward pressure on inflation owing to supply constraints but over the longer term, inflation is expected to remain in the range of 2–3 percent. Although fiscal revenues are not projected to be significantly affected by the impact of Cyclone Pam, the budget deficit is expected to widen substantially in 2015–16 to a projected 8–9 percent of GDP (not including potential additional development partner recovery support) as a result of recovery spending. The reconstruction spending is expected to be largely completed by 2016, financed by development partner grants but also drawing on accumulated buffers. The cost of reconstruction is still uncertain (e.g. depending on the quality of rebuilding), but it is likely that balances in the CIF will drop to around 11 percent of the maintained value of the Tuvalu Trust Fund by end-2016 (below the prudent level of 16 percent) in the baseline scenario without development partner support. The balance of

[1] The World Bank, *Tuvalu Disaster and Loss Assessment* (May 2015); Government of Tuvalu, *Tropical Cyclone Pam Recovery: Vulnerability Reduction Plan* (May 2015).

payments position is expected to continue to be supported by donor inflows, fishing revenues, internet licensing fees and returns on the Tuvalu Trust Fund.

Fiscal risks remain high. With its low-lying and isolated islands, Tuvalu will continue to be vulnerable to natural disasters like Cyclone Pam and this highlights the importance of disaster risk management, including maintaining substantial fiscal buffers to lower risks to debt sustainability. The 2014 IMF/World Bank debt sustainability analysis concluded that Tuvalu is at high risk of debt distress. The access to grants remains essential as the unprecedented impact of Cyclone Pam now heightens risks to fiscal sustainability and buffers in the CIF are drawn down to meet reconstruction needs. The revenue base is narrow with dependence on volatile foreign assistance and fishing license fees. Moreover, the returns of the Tuvalu Trust Fund are subject to significant uncertainty, which affects the resources available to the authorities. The fiscal position also needs to provide for substantial contingent liabilities stemming from vulnerabilities in state-owned enterprises and exposure to natural disasters. To improve fiscal sustainability, a focus on recurrent expenditure restraint, including public service wages, and a well-anchored medium-term fiscal framework is needed to maintain buffers.

To enhance medium-term growth prospects and strengthen resilience, continued progress on the structural reform agenda remains critical. Key policy recommendations include**:**

- *Strengthening public financial management.* The authorities have made important progress in this area, including improved budget documentation and greater commitment controls. To address volatility in fishing license revenues, the 2015 Budget introduced an income averaging mechanism where fishing revenue above average will be held in the CIF. Despite progress under the reform plan, there remains scope to enhance the cost-effectiveness of spending and limit the growth in recurrent spending to enhance fiscal sustainability. The civil service wage bill has increased from around 32 percent of GDP in 2013 to an estimated 36 percent in 2014. Over the medium-term, a wage setting mechanism is necessary to ensure that public sector wage increases are in line with productivity gains in the economy.

- *Strengthening the financial sector.* In the unsupervised state-owned dual-bank system, asset quality remains poor as a large share of the loan portfolio is nonperforming. The authorities have requested technical assistance from PFTAC to set up a regulatory framework under the Banking Commission Act. The situation in both banks appears to have improved recently, but government resource constraints have held back progress on establishing a more formal oversight of the banking sector.

- *State enterprise reform.* Non-bank public enterprises have made large losses in recent years, reflecting weak governance. To improve the performance of public enterprises, a comprehensive reform package for the sector should be implemented with the priority on a clear definition of their social responsibilities, which, together with strengthened accounting and auditing practices, would enhance transparency and accountability.

The authorities are cognizant of the challenges and remain committed to the reform agenda. Elections held in March 2015 resulted in broad policy continuity. A Policy Reform Matrix (PRM), formulated in consultation with development partners, has been adopted to enhance governance, social development, facilitate private sector growth, and safeguard macroeconomic stability. Under the third phase of the PRM (August 2014–December 2015), the public enterprise reform plan has been approved by cabinet, setting out the strategies to improve the commercial and financial viability of public enterprises. Other policy priorities under the third phase include strengthened fiscal sustainability through regulating the use of long-term fiscal buffers and improved public sector management policies. Continued progress on the structural reform agenda remains essential to raise the medium term growth potential and reduce risks to fiscal sustainability.

The Staff Report for the 2014 Article IV consultation for Tuvalu was discussed by the Executive Board in August 2014.[2] Tuvalu is on the 24-month cycle and the next Article IV consultation is planned for the first half of 2016.

[2] See IMF Country Report No. 14/253.