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INTERNATIONAL DEVELOPMENT ASSOCIATION

SUPPLEMENTAL FINANCING DOCUMENT

FOR A PROPOSED SUPPLEMENTAL FINANCING

IN THE AMOUNT OF SDR 2.2 MILLION
(US$ 3.0 MILLION EQUIVALENT)

FROM THE
CRISIS RESPONSE WINDOW OF THE
INTERNATIONAL DEVELOPMENT ASSOCIATION

TO

TUVALU

FOR

THE SECOND DEVELOPMENT POLICY OPERATION

August 17, 2015

MACROECONOMICS AND FISCAL MANAGEMENT GLOBAL PRACTICE
EAST ASIA AND PACIFIC REGION

TUVALU GOVERNMENT FISCAL YEAR
January, 1 – December, 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of July 31, 2015)
Currency Unit - Australian Dollar (AUD)
(US$1.00 = AUD 1.3782)

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
AUD	Australian Dollar
CAS	Country Assistance Strategy
CIF	Consolidated Investment Fund
CPI	Consumer Price Index
CRW	Crisis Response Window
DPs	Development Partners
DPO	Development Policy Operation
DSA	Debt Sustainability Analysis
FTF	Falekaupule Trust Fund
GDP	Gross Domestic Product
GFC	Global Financial Crisis
GOT	Government of Tuvalu
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IMF	International Monetary Fund
MFED	Ministry of Finance and Economic Development
NDC	National Disaster Committee
OAG	Office of Auditor General
OIs	Outer Islands
PFM	Public Financial Management
PRM	Policy Reform Matrix
PWD	Public Works Department
RDA	Rapid Damage Assessment
SDR	Special Drawing Rights
TMTI	Tuvalu Maritime Training Institute
TMTS	Tuvalu Medical Treatment Scheme
TTF	Tuvalu Trust Fund
UN	United Nations
US$/USD	United States Dollar

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TUVALU

SUPPLEMENTAL DEVELOPMENT POLICY OPERATION

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SUPPLEMENTAL FINANCING AND PROGRAM SUMMARY

TUVALU

SUPPLEMENTAL DEVELOPMENT POLICY OPERATION

Recipient	Tuvalu
Implementing Agency	Ministry of Finance and Economic Development (MFED)
Financing Data	International Development Association (IDA) Grant from the Crisis Response Window (CRW)
Amount	Special Drawing Rights (SDR) 2.2 million, United States Dollar (USD) 3.0 million equivalent
Terms	Standard IDA Grant terms
Operation ID	P156169

I. BACKGROUND

1. **Tuvalu, comprised of nine Polynesian islands and atolls, is one of the smallest states in the world.** The Gross Domestic Product (GDP) of Tuvalu was estimated at AUD 41.7 million in 2014. Tuvalu has a land area of only 26km square and its population is estimated at 11,000. Tuvalu is one of the smallest and newest members of the World Bank Group, having joined the World Bank only in 2010. Tuvalu is not currently a member of the International Finance Corporation.

2. **Since the global financial and economic crises, the Government of Tuvalu (GoT) has progressed on substantive reforms while gradually rebuilding its fiscal buffers.** Tuvalu's economy is highly vulnerable to challenges stemming from its very small size and geographic isolation, and relies heavily on grants and buffer assets to absorb shocks. Tuvalu's buffer assets in the Consolidated Investment Fund (CIF) supported the GoT in weathering the recent global financial crisis (GFC)[1]. Over the past 3 years, the GoT has gradually rebuilt the CIF back to its sustainable level through a mixture of expenditure restraint, higher revenues and additional budget support from donors including two budget support operations from the World Bank. In parallel, the GoT has progressed on a number if reforms, including improving public financial management (PFM) and social service delivery.

3. **A tropical cyclone of a rare magnitude hit Tuvalu in March 2015, leading to significant displacement and loss of productive assets and infrastructure.** Although Tuvalu is highly vulnerable to climate and weather events such as king-tides, major cyclones are rare in Tuvalu, with the last recorded major cyclone hitting Tuvalu in 1997. Prior to the formation of Tropical Cyclone Pam (TC Pam), flooding from king tides (which peaked at 3.4 meters) caused considerable damage across Tuvalu. Between March 10 and 11, 2015, tidal surges, swamping and high winds associated with TC Pam swept across the low-lying islands of Tuvalu, with the Outer Islands (OIs) most affected. Buildings and coastal protection that were weakened during the extreme weather continued failing post cyclone. A state of emergency was subsequently declared on March 14, 2015. The disaster is estimated to have affected 40 percent of the population and the Rapid Damage Assessment (RDA) estimated damages of around AUD 14.0 million (33.6 percent of 2014 GDP). The infrastructure and housing sectors sustained damages of AUD 11.1 million. Damage and losses to the productive sector (through impacts on crops, livestock and fishing), amounted to AUD 2.9 million.

4. **The GoT, with the support of the donor community, has taken a series of steps in response to the disaster, but will need additional financing for the recovery efforts.** In the immediate aftermath of TC Pam and despite logistical challenges, protein rich food, fuel,

[1] For more details on the Tuvalu Trust Fund (TTF) and the CIF, see Annex 2.

generators, medical supplies, kitchen kits and shelter kits were provided by the GoT and humanitarian agencies. Subsequent support provided to the affected communities included construction materials, medicines, and tools to assist with the clean-up of storm debris. The GoT has endorsed the Recovery and Vulnerability Reduction Plan (taking into account the RDA outcomes), which estimates reconstruction costs at AUD 23.8 million in the short to medium term[2]. The GoT has also re-oriented some of the 2015 development budget towards recovery and reconstruction, although this is only expected to meet a portion of recovery related financing needs. Despite the significant fiscal cost, the GoT has begun to contract vendors (working together with the Kaupules – traditional island councils) in order to avoid delaying reconstruction works and ensure continued access to services by those most in need. Development Partners (DPs) are also rallying behind the GoT in providing additional resources to aid the recovery efforts with pledged support to sectors including agriculture, social services and infrastructure.

5. **The proposed USD 3.0 million supplemental financing from the CRW supports the GoT in post TC Pam recovery.** On May 18, 2015, the Board received a document regarding the planned USD 3.0 million IDA CRW support to Tuvalu for TC Pam recovery. TC Pam recovery and reconstruction creates an unanticipated financing need. However, Tuvalu is already at a high risk of debt distress and has no access to international capital markets, limiting the sources of funding available. After considering pledged grants from other DPs, the financing gap remains substantial (annual deficits averaging around 9.3 percent of GDP are expected over the next couple of years from a surplus counterfactual situation). Supplemental financing to the Second DPO remains the most appropriate instrument for providing timely support to the GoT in TC Pam recovery. The existing small IDA portfolio is already fully programmed, constraining options for reorientation of existing investment projects. In addition, the Second DPO was only approved by the Board in March 2015, therefore, a freestanding DPO may overload the reform agenda in a capacity constrained environment at a time when the GoT is focused on post cyclone recovery. Finally, this operation will ensure that the reforms supported under the Second DPO remain on track and are implemented without the risk of delay due to competing capacity or budgetary priorities arising from post disaster recovery. Overall, the proposed supplemental financing is consistent with the provisions of OP8.60.

II. THE IMPACT OF TROPICAL CYCLONE PAM

6. **Over several days in mid-March 2015, TC Pam tore through the Pacific, leaving behind a path of destruction.** Storm surges (estimated at 3-5 meters), swamping, and high winds associated with TC Pam, swept across the low-lying islands of Tuvalu on March 10, 2015. On March 13, TC Pam made landfall in Vanuatu. TC Pam was an extremely destructive Category 5

[2] The reconstruction and resilience plan incorporates costs associated with building back to more resilient standards, while the RDA assumes the assets are built back to previous standards. For example, the early engineering concept design report for the rebuilding of seawalls estimates unit costs ranging between AUD 2,000 – 13,500 per meter depending on the type of seawall built.

cyclone with estimated wind speeds of 250 kilometers per hour and wind gusts peaking at around 320 kilometers per hour. In Tuvalu, the most affected areas were the northern islands of Nanumaga and Nanumea, and the central islands of Nui and Vaitupu, where housing, infrastructure, food crops, livestock, and water and sanitation infrastructure was significantly damaged or destroyed.

7. **Although the Pacific Islands region is prone to natural hazards, Tuvalu is situated in a relatively quiet seismic area and rarely experiences severe tropical cyclones.** Tuvalu is located south of the equator at the northern extremity of an area known for the frequent occurrence of tropical cyclones with heavy wind, rains and storm surges typically experienced between the months of October and May. Tuvalu was last affected by damaging cyclones in 1972 and 1997. Tuvalu is also situated in a relatively quiet seismic area, but is surrounded by the Pacific 'ring of fire', which aligns with the boundaries of the tectonic plates. No significant earthquakes have been observed in recent history. Catastrophic risk modelling indicates that Tuvalu is expected to incur, on average, USD 0.2 million per year in losses due to tropical cyclones, earthquakes and tsunamis, equivalent to about 0.5 percent of the GDP[3]. In the next 50 years, Tuvalu has a 50 percent chance of experiencing a loss exceeding USD 4 million and casualties greater than 15 people, and a 10 percent chance of experiencing a loss exceeding USD 9 million and casualties greater than 50 people. With estimated damages of AUD 14.0 million (around USD 11 million equivalent), this makes TC Pam a relatively rare event in Tuvalu.

8. **Tuvalu saw an estimated 4,000 people, or 40 percent of the population, affected by TC Pam.** TC Pam affected communities and individuals in a number of ways. The cyclone harmed the livelihoods of households, limiting their ability to generate income and access services. It also damaged or destroyed homes and community infrastructure. In some communities, in addition to the temporary disruption to social service delivery, cases of diarrhea and post-traumatic stress disorder were reported. Particular distress was caused by the flooding of graveyards on Nanumea and Nui. Low-income individuals and those depending on subsistence livelihoods are suffering in the post-disaster period due to reduced incomes and food sources, especially in the OIs. The impact on subsistence farming, in which women feature prominently, means that the ability of women to generate income to provide food, nutrition, and basic needs for their families has significantly decreased.

9. **TC Pam resulted in significant damage to infrastructure.** Coastal infrastructure was heavily damaged by the storm surges and wave action resulting from TC Pam. Heavy flooding on the worst affected islands (some with much of the land under 600-900mm of water) caused further damage, particularly to the electrical systems. There was also damage to infrastructure and housing due to strong winds. The RDA estimates suggest that coastal protection has been heavily damaged on several islands, which represents around half of the estimated damage and losses. Legacy

[3] Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI) profile –Tuvalu Risk Profile -September 2011 by the World Bank, Asian Development Bank (ADB), GFDRR, and SPC. PCRAFI modeled losses are calculated based on asset replacement cost.

problems from the high tides are continuing, with buildings and coastal protection that were weakened during the extreme weather now failing.

10. **TC Pam impacted agriculture on seven out of the nine islands, which – given the importance of subsistence agriculture in Tuvalu – has significantly affected rural food security.** There were reported damages to physical infrastructure (e.g. livestock enclosures, plant nurseries, boat ramps) and equipment (e.g. fishing boats). Additionally, strong winds and storm surges resulted in damage to coconut and banana trees, uprooting of crops (e.g. breadfruit), and saltwater inundation of many swamp taro pits and home vegetable gardens. Replanting these crops and purchasing sufficient substitute goods to ensure food security until the next harvest will impose costs to households. Livestock also incurred substantial losses on some islands – many chickens and pigs were lost during the cyclone. On some islands, damage to fishing boats has led to additional costs for households in terms of foregone income from commercial fishing, or additional costs to purchase fish on the market for household consumption.

11. **The RDA estimated total damage and losses amounting to AUD 14.0 million.** The RDA was completed with input from the joint GoT-United Nations (UN) Development Programme rapid assessment teams and the UN Office for the Coordination of Humanitarian Affairs, among others. The total cost of damage and losses is estimated at AUD 14.0 million, equivalent to 33.6 percent of Tuvalu's 2014 GDP. Most of the damage and losses were sustained in the infrastructure sectors (67 percent) followed by the agricultural sector (20 percent) and housing (13 percent). Associated losses in production (mainly agriculture) were estimated at AUD 1.9 million (around 14 percent of total disaster effects). Given limited private sector activities in the OIs, and the quick resumption of service provision particularly in health and education, the resulting losses from other sectors are assumed to be negligible. While the damage to assets occurred at the time of the cyclone, the associated changes to economic flows will persist beyond 2015.

Table 1. Summary of Rapid Damage Assessment (AUD '000)

Sector	Damages	Losses	Total (AUD)	Percentage of Total
Agriculture	942	1,914	2,856	20.4%
Infrastructure	9,293	0	9,293	66.5%
Community and government	2,112	0	2,112	15.1%
Coastal Protection	7,180	0	7,180	51.4%
Housing	1,823	0	1,823	13.0%
Total	**12,058**	**1,914**	**13,972**	**100.0%**

Source: Rapid Damage Assessment

12. **The effects of TC Pam were most heavily felt by those living on the OIs, where poverty is more concentrated.** The capital Funafuti and the second most populous island (Vaitupu) were not severely affected by TC Pam. Estimates suggest that 4,000 people (around 40 percent of the population) were affected and many households in the OIs were displaced as a result of the cyclone. In addition, productive sector losses and the damage to infrastructure are concentrated in

the OIs. The reduced productive capacity and the damage to inshore channels (which limits the ability for boats to bring in goods) are likely to increase inflationary pressures. Given the OIs' vulnerability to price shocks, this may worsen the poverty situation in the short term. The damage to infrastructure such as hospitals and seawalls in turn impact on OI service delivery and resilience to shocks. These have been identified as factors underlying poverty trends, particularly for the OIs. On the other hand, planned investment and reconstruction for the OIs is likely to improve employment prospects in the medium term.

III. THE GOVERNMENT'S RESPONSE

13. **In the immediate aftermath of TC Pam, then caretaker government led a coordinated response effort across all sectors supported by humanitarian and bilateral partners.** The GoT declared a state of national emergency on March 14, 2015 in view of the significant impact on lives and property and the large displacement caused by TC Pam. The Tuvaluan Red Cross dispatched shelter kits to affected OIs. Subsequently, the GoT deployed a team from the Public Works Department (PWD) to construct temporary shelters and to help in the clean-up of flood debris. The GoT also distributed protein rich tinned foods and rice stocks as well as relief items including water purification tablets and medical supplies. DPs including Australia, New Zealand, and the UN Children's Fund provided additional resources including boats to transport goods to the OIs, technical experts to assess impact and needs and medical and sanitation supplies. The National Disaster Committee (NDC) and the TC Pam foreign relations sub-committee (of the NDC) coordinated the immediate response effort and external assistance.

14. **The newly formed government in April 2015, continued to prioritize post disaster recovery.** General elections were held on March 31, 2015. The Cabinet, which was formed on April 10, 2015, and technical specialists visited the OIs in the second half of April to better understand post disaster impacts and needs. This information together with the RDA formed the basis of the GoT's Recovery and Vulnerability Reduction Plan, which has subsequently been endorsed by the Parliament. The plan is broken into short, medium and long term activities, spread out across agriculture, environment, education, health, infrastructure and disaster risk management areas, with a focus on OIs. The plan estimates reconstruction costs at around AUD 23.8 million in the short to medium term (compared to RDA estimates of AUD 14.0 million) as the GoT plans to capitalize on opportunities to build better services and infrastructure than existed before the cyclone, which will help reduce the impact resulting from future climate events and disaster risks.

15. **The GoT has begun to implement the Recovery and Vulnerability Reduction Plan.** The NDC has been tasked to lead the coordination of the recovery and reconstruction efforts. The Ministry of Home Affairs and the PWD will be the key implementing agencies, with the MFED and the Prime Minister's Office respectively responsible for financing and oversight. Short term activities identified under the Recovery and Vulnerability Reduction Plan are being implemented.

Recognizing capacity constraints, the GoT has also been in discussion with external contractors already mobilized in country, for them to carry out in 2015 and 2016 some of the planned reconstruction activities in a cost effective and timely manner.

16. **However, TC Pam recovery creates an unexpected financing need, which is not expected to be fully met, after considering pledged grants from DPs.** Given the unexpected financing need arising from TC Pam recovery and the GoT's limited ability to borrow from alternative sources, high level dialogues with DPs were held seeking their support to the recovery efforts. After considering pledged grants from other DPs and the scope to reorient some of planned capital budget towards post disaster recovery, the financing gap remains substantial.

IV. THE WORLD BANK'S RESPONSE AND STRATEGY

17. **The Bank provided an immediate response in the aftermath of TC Pam.** A Bank mission was fielded in country immediately after the cyclone hit. The RDA was subsequently completed with significant input from the UN Development Programme assessment team, government assessments, and the UN Office for the Coordination of Humanitarian Affairs and the Bank. The RDA provided a baseline assessment of the economic impact of TC Pam, which informed both the GoT's reconstruction plan and DPs' support. The Minister of Finance & Economic Development communicated a request for World Bank support to Tuvalu's recovery efforts on April 8th, 2015.

18. **The Bank also provided technical and financial support to the GoT.** The Bank fielded additional missions in the first half of May, 2015 to provide technical assistance to the GoT on the best way forward vis-à-vis recovery and reconstruction. Coincidentally, the Second DPO was disbursed soon after TC Pam landed providing short term liquidity relief to the GoT in the aftermath of the disaster.

19. **The Bank is now working in a coordinated manner with other DPs to support the GoT in post TC Pam recovery and reconstruction.** The Bank has been engaged in dialogue with DPs including the UN agencies, bilateral partners, and the ADB in coordinating support to the GoT in its recovery and reconstruction efforts. Bilateral and multilateral partners have indicated in principle support for the recovery of the agriculture and fisheries sectors as well as mobilizing resources to support the reconstruction of infrastructure[4]. Other partners such as the European Commission and UN agencies will support the GoT in strengthening its disaster risk management capacities. Resources provided by the Bank will complement activities undertaken by other DPs in support of the GoT's priority recovery and reconstruction areas.

[4] The ADB has requested USD 3.0 million from their disaster response facility to support the GoT's recovery efforts.

20. **The proposed USD 3.0 million supplemental financing from the CRW supports the GoT in post TC Pam recovery.** On May 18, 2015, the Board received a document regarding the planned USD 3.0 million IDA CRW support to Tuvalu for TC Pam recovery. TC Pam recovery and reconstruction creates an unanticipated financing need. However, Tuvalu is already at a high risk of debt distress and has no access to international capital markets, limiting the sources of funding available. After considering pledged grants from other DPs, the financing gap remains substantial (annual deficits averaging around 9.3 percent of GDP are expected over the next couple of years from a surplus counterfactual situation). Supplemental financing to the Second DPO remains the most appropriate instrument for providing timely support to the GoT in TC Pam recovery. In addition, this operation will ensure that the reforms supported under the Second DPO remain on track and are implemented without the risk of delay due to competing capacity or budgetary priorities arising from post-disaster recovery.

V. THE SECOND DEVELOPMENT POLICY OPERATION AND AN UPDATE

21. **The Second DPO supports reforms to strengthen PFM and improve social services delivery.** Given the importance of the public sector to Tuvalu's economy, an effective system for PFM is critical. The first pillar of the program focuses on strengthening PFM with the specific development objectives of improved commitment control, enhanced oversight of fishing revenue, and streamlined reporting from local governments (Kaupules). The second pillar focuses on improved service delivery with the specific objectives of enhancing the management and efficiency of the essential, but costly, overseas medical treatment scheme and strengthening vocational training, including increasing access for women. These services are essential to building and maintaining human capital, a key asset for an undiversified small economy. Together, the supported reforms are designed to help Tuvalu improve its fiscal position both in terms of revenue and expenditure, while maintaining the quality of public services. Financing provided through these operations supports the maintenance of adequate buffer assets in the CIF to ensure Tuvalu's ability to absorb future shocks without impeding the level of service delivery.

A. ECONOMIC PERFORMANCE SINCE THE APPROVAL OF THE SECOND DPO

22. **Macroeconomic performance since the approval of the Second DPO has been strong, reflecting implementation of the reform program and higher than expected revenue.** The 2014 budget outturn was more positive than expected, and the surplus was added to the corpus of the TTF to enhance Tuvalu's fiscal sustainability. Tax collections were higher with company taxes collected equivalent to 5.6 percent of GDP compared to the original conservative forecast of 2.2 percent of GDP. This was explained by the continued strength of the domestic fishing joint ventures. Recurrent expenditure outturn came in close to the original projections while capital expenditure was underspent. Pre-grant deficit was narrower than originally projected at 21 percent of GDP or around the sustainable level (see Box 1). With a higher level of non-recurrent grants (as

defined in footnote 8, Table 2) received in 2014 compared to previous years, the GoT has contributed AUD 3.0 million from the surplus to the corpus of the TTF to ensure longer term fiscal sustainability. Return on the TTF was also higher than anticipated, resulting in AUD 8.7 million distribution to the CIF for 2015 (original projection of AUD 2.1 million) as per distribution rules.

Box 1. Fiscal Sustainability in Tuvalu

In the Tuvalu context, fiscal sustainability is measured by the ability of financial assets in the TTF and CIF to continuously finance post-grant deficits, including through periods of shock. Based on historical information (length of shock and average deficit), a sustainable level of assets in the CIF is numerically expressed as 16 percent of the maintained value of the TTF. This level could be sustained when the GoT achieves pre-grant deficits of around 21 percent of GDP going forward. With grants expected at around 16 percent of GDP, the remaining deficit (around 5 percent of GDP) could be sustainably financed by drawdowns from CIF assets, which is fully replenished by distributions from the TTF even at an assumed lower rate of return. For more details on the TTF and the CIF, see Annex 2.

23. **The GoT would have achieved a fiscal surplus, and continued on a sustainable fiscal path without the impact of TC Pam.** As consistent with the GoT's commitment to fiscal discipline, the 2015 recurrent deficit is expected to remain in-line with original projections. Also, as stated in the letter of development policy, there was no salary increase provided to public servants in 2015. Although spending on wages in the first half of 2015 was on track to original projections, this is expected to pick-up in the second half of the year as capital projects including TC Pam recovery and reconstruction activities pick up[5]. Capital expenditure is expected to increase substantially in 2015 reflecting planned increase in development spending and TC Pam recovery and reconstruction activities[6]. Planned increase in development spending would have been fully funded by higher TTF distributions. However, since TC Pam the GoT has indicated plans to reorient some of the planned development spending towards TC Pam recovery and reconstruction, including to build assets back to more resilient standards at higher cost.

24. **TC Pam is expected to have limited revenue impact, given the narrow domestic revenue base.** TC Pam is expected to have a very limited impact on indirect taxes in 2015: higher cyclone related import taxes may offset any impact from the dampened collection of consumption taxes. Corporate taxes, which are largely derived from fisheries activities, are not expected to be affected by TC Pam, but rise due to favourable external market conditions impacting on the profitability of the fishing joint ventures. Non-tax revenues derived largely from interest and dividends, offshore fishing activities and the lease of the dot.tv domain are not expected to be

[5] Given the expected increase in capital projects, including TC Pam recovery and reconstruction activities, the GoT has temporarily unfrozen positions in the PWD to enable the completion of these activities. However a significant number of these posts remain unfilled as at end-June. Separately, the GoT has taken initial steps to enhance public sector management including to: (i) outsource senior public servants; (ii) tighten the recruitment process; and (iii) undertake a functional review of the public sector. All new recruitment will adhere to the tightened recruitment process.

[6] Increase in development spending was among others to: finance the construction of primary schools in OIs (co-financed by Australia); refit the transport vessel which provides a critical transport link (both goods and people) to the OIs; and increase Kaupule projects. Given the lumpy nature of development projects and the small size of the economy, an AUD 2.0 million project will increase capital spending by around 4.7 percent of GDP.

affected by TC Pam, but increase due to the favourable renegotiation of the dot.tv contract in 2014 and favourable exchange rate for USD denominated revenues such as fishing license fees.

Figure 1. Unanticipated financing gap and sources of financing (AUD millions)

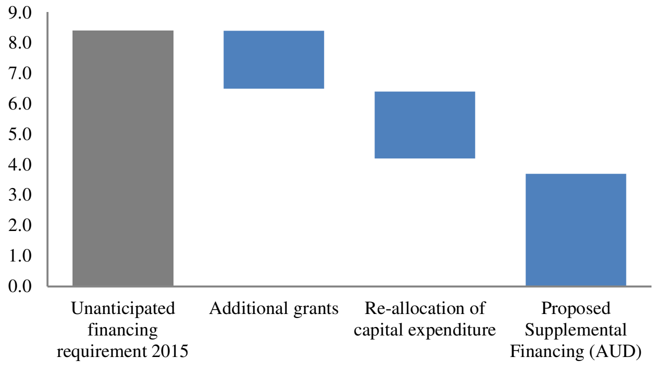
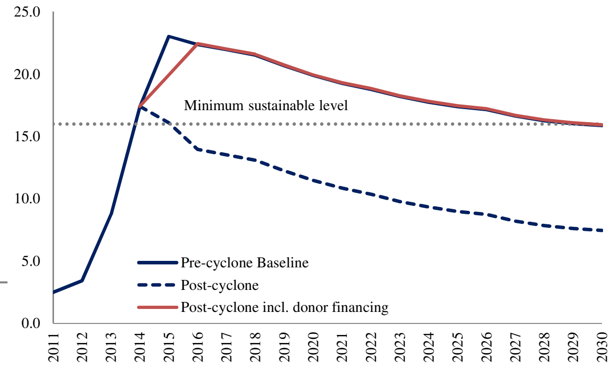


Figure 2. CIF as a share of TTF maintained value (in percentage)



Source: World Bank staff estimates

25. **TC Pam is however expected to result in additional expenditures which cannot be met by expected grants and TTF distributions.** TC Pam is expected to result in unexpected expenditures amounting to at least AUD 14.0 million (based on the RDA) or widen pre-grant deficit by an average of 15.0 percent of GDP over the next couple of years. The financing need cannot be fully met by expected grants and TTF distributions[7]. As a result, deficits averaging AUD 4.3 million are expected to arise over the next two years, before the budget normalizes and returns to a small surplus in 2017. Given the GoT's limited ability to borrow to finance this, additional grant support including the proposed supplemental financing will help meet this unexpected financing gap and ensure Tuvalu's longer term fiscal sustainability[8].

26. **Reconstruction efforts are expected to boost growth in the short term while elevating inflationary pressures.** Growth is expected to be boosted to around 3.1 percent in 2015, despite the negative impact of TC Pam. The significant negative impact from TC Pam, including losses to the agricultural sector are expected to be fully offset by the impact of the additional planned investment and the post-cyclone related reconstruction. Given the small size of the economy, reconstruction efforts can have a significant immediate positive impact on the economy. Inflation is similarly expected to pick-up to around 4.7 percent in 2015 reflecting growing government expenditure and a potential shortage of essential items due to cyclone related disruptions in transportation and in the domestic supply of agricultural products, which is partly offset by falling fuel prices.

[7] The projections take into account monies already spent on recovery activities and external contracts being entered into by the GoT to facilitate timely implementation of the recovery efforts. To build assets back to more resilient standards, the GoT is looking to reorient a portion of the planned capital budget towards recovery and reconstruction activities.

[8] IMF working paper (WP/15/125) concluded that, given Pacific island countries face severe challenges from natural disasters and climate change, building policy buffers is especially important to enhance their resilience before these events occur. Towards this end, continued external assistance and access to insurance schemes are also important.

Table 2. Tuvalu: Government Budget, 2009-17 1/

	2009	2010	2011	2012	2013	2014 Est.	2014 Original	2015 Proj.	2015 Original	2016 Proj.	2016 Original	2017 Proj.	2017 Original
Real sector	(Percent change, unless otherwise indicated)												
Real GDP growth	-1.7	-2.7	8.5	0.2	1.3	2.2	2.2	3.1	2.5	3.8	2.5	1.8	1.9
Consumer prices (period average)	-0.1	-1.9	0.5	1.4	2.0	3.3	3.3	4.7	3.1	3.5	3.0	3.0	2.9
Balance of payments	(In millions of Australian dollars, unless otherwise indicated)												
Current account balance 2/	-1.2	-4.1	-13.9	9.8	10.4	11.0	11.0	-14.2	-5.1	-12.2	-8.3	-5.3	-5.9
(In percent of GDP)	-3.3	-11.9	-36.5	25.3	26.1	26.4	26.4	-31.8	-11.3	-25.4	-17.3	-10.6	-11.8
Gross official reserves 3/	29.9	26.6	24.1	27.5	36.7	48.7	48.7	41.9	43.9	36.0	38.0	35.9	35.9
(In months of imports of goods and services)	7.7	6.1	6.6	6.5	7.8	7.0	8.0	6.9	7.7	6.6	6.9	7.1	7.1
Debt indicators	(In millions of Australian dollars, unless otherwise indicated)												
Gross public debt (incl. guarantees)	22.0	19.3	17.3	16.6	16.3	23.7	23.7	21.3	21.3	18.9	18.9	15.9	15.9
(In percent of GDP)	63.2	55.6	45.3	43.0	41.1	56.9	56.9	47.6	47.6	39.6	39.6	32.0	32.0
Government finances	(In percent of GDP, unless otherwise indicated)												
Revenue	58.9	55.5	47.8	56.6	83.1	73.4	69.6	75.8	72.9	71.3	70.2	68.4	68.9
Taxes	14.7	16.5	16.9	15.0	19.0	17.8	14.4	17.7	15.8	16.7	15.0	16.0	14.5
Direct 4/	6.6	9.1	9.9	8.3	11.2	10.6	7.3	9.2	7.3	8.9	7.3	8.8	7.2
Indirect	8.1	7.4	7.0	6.7	7.7	7.1	7.1	8.5	8.5	7.7	7.8	7.1	7.2
Nontax revenue	44.2	39.1	30.9	41.5	64.1	55.6	55.2	58.1	57.1	54.6	55.1	52.4	54.4
Of which: Fishing license fees	26.3	20.6	14.9	21.8	45.5	31.7	31.9	34.0	34.7	32.2	33.6	31.1	32.4
Recurrent expenditure	80.9	75.5	65.9	68.7	73.5	85.6	85.3	86.6	84.3	82.3	82.2	79.7	80.7
Wages and salaries	32.5	33.8	31.3	31.9	32.2	35.6	35.6	36.4	34.2	34.1	33.1	32.7	32.9
Purchase of goods and services 5/	21.9	23.2	19.8	20.1	21.2	27.6	27.3	22.6	21.9	22.2	22.0	22.1	22.0
Purchase of fuel in lieu of Japan fuel grant	…	…	…	…	…	…	…	2.5	2.5	1.3	1.3	0.0	0.0
Subsidies and transfers 6/	23.5	15.0	11.7	16.3	19.9	22.1	22.1	21.4	21.8	21.2	22.1	21.5	22.3
Potential PE restructuring and related costs	…	…	…	…	…	…	…	3.2	3.3	3.1	3.2	3.0	3.1
Interest payments	0.7	0.8	0.8	0.3	0.3	0.3	0.3	0.5	0.5	0.4	0.5	0.4	0.5
Other expense	2.3	2.7	2.3	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Recurrent / structural balance	**-22.0**	**-20.0**	**-18.1**	**-12.2**	**9.6**	**-12.1**	**-15.7**	**-10.7**	**-11.4**	**-11.0**	**-12.0**	**-11.4**	**-11.8**
Net acquisition of nonfinancial assets (capital) 7/	21.8	20.2	12.0	6.3	7.6	9.1	11.0	18.8	9.8	9.2	9.4	8.6	9.0
TC Pam recovery and reconstruction costs	…	…	…	…	…	…	…	18.5	…	11.6	…	…	…
Balance before grants	**-43.8**	**-40.2**	**-30.1**	**-18.4**	**2.0**	**-21.3**	**-26.8**	**-48.1**	**-21.2**	**-31.7**	**-21.4**	**-20.0**	**-20.8**
Grants 8/	29.9	16.4	21.2	27.7	24.6	48.3	50.9	39.7	20.8	21.5	20.7	19.8	20.9
Recurrent	22.6	15.8	16.4	12.4	16.5	16.8	21.3	12.4	12.7	11.7	11.8	11.4	11.9
Non-recurrent	7.3	0.6	4.8	15.3	8.1	16.3	14.4	7.8	3.4	5.4	4.4	4.0	4.4
TTF distributions to CIF	…	…	…	…	…	15.2	15.2	19.5	4.7	4.4	4.6	4.3	4.5
Overall balance (net lending / borrowing) 9/	**-13.9**	**-23.8**	**-8.9**	**9.3**	**26.5**	**27.0**	**24.2**	**-8.4**	**-0.4**	**-10.2**	**-0.7**	**-0.2**	**0.0**
(in millions of Australian dollars)	-4.8	-8.3	-3.4	3.6	10.5	11.3	10.1	-3.7	-0.2	-4.9	-0.3	-0.1	0.0
Memorandum Items (in millions of Australian dollars)													
Tuvalu Trust Fund (TTF) balance	95.5	108.0	118.7	130.6	140.6	144.1	144.1	150.7	147.7	154.5	151.4	158.3	155.2
(In percent of GDP)	274.8	311.2	311.4	339.1	339.4	345.6	345.6	337.0	337.3	323.4	330.0	317.8	324.9
Consolidated Investment Fund (CIF) balance	15.3	7.2	3.2	4.5	14.6	24.7	24.3	20.9	24.1	16.0	23.8	15.9	23.8
(In percent of GDP)	44.1	20.8	8.3	11.6	36.9	59.1	58.2	46.8	55.1	33.6	51.9	32.0	49.9
Nominal GDP	34.7	34.7	38.1	38.5	39.7	41.7	41.7	44.7	43.8	47.8	45.9	49.8	47.8

Sources: Tuvalu authorities and IMF and World Bank staff estimates.
1/ Tuvalu uses the Australian dollar as its currency. It has no central bank operations.
2/ The current account deficit widens from 2015 due to large grant financed infrastructure projects such as the World Bank Aviation Project and increased imports associated with reconstruction activities. These are expected to be partly financed through increased capital transfers.
3/ Defined as sum of foreign assets of the National Bank of Tuvalu, the Consolidated Investment Fund, and SDR holdings.
4/ Fisheries joint venture companies are among the largest tax payers in Tuvalu.
5/ Includes payment of arrears in 2014 and deferred maintenance fund from 2015 onwards, contributing to maintenance needs of the planned investment projects and avoid future arrears
6/ Includes medical treatment scheme and scholarships, as well as Community Service Obligations (CSO).
7/ Includes capital expenditure and in-kind and technical assistance largely for OIs. Reconstruction expenditure does not assume build back better, which could cost an additional AUD 6.0 million in the medium term, based on the Government's reconstruction and resiliance plan.
8/ Includes recurrent grant from Taiwan, China; non-recurrent grants from World Bank (DPO II) and known pledged support from other donors in response to TC Pam. Does not include the proposed supplemtal operation or pledged in-kind/capital grants in response to TC Pam.
9/ Given the limited financing channel, this is indicative of the net asset accumulation (+ve) / drawdown (-ve) requirements from the CIF.

27. **In the medium term, growth and inflation are expected to normalize as the impact from TC Pam subsides.** In 2016 growth is expected to remain elevated at around 3.8 percent as post-cyclone recovery activities continue. In 2017, as reconstruction activities wind down, growth is expected to moderate to around 1.8 percent. Inflation is similarly expected to moderate to around 3.0 percent in the medium term as the effects of one-off factors wear off.

28. **The external sector is expected to remain strong.** Despite the planned increase in capital projects and the impact from TC Pam, the balance of payments is expected to remain strong.

Imports associated with planned capital projects and TC Pam related activities are expected to be largely funded through rising income (including TTF distribution, property income, remittances) and capital grants. Given the high levels of accumulated reserves, the balance of payments is expected to remain strong (reserves adequate to finance around 7 months of imports of goods and services). The GoT has indicated no plans to borrow externally to finance fiscal or balance of payment deficits, instead preferring to drawdown its reserve assets where possible. Support from DPs is almost entirely in the form of grants. As such, debt indicators are not expected to change in the medium term. The 2014 Debt Sustainability Analysis noted that although Tuvalu is currently at a high risk of debt distress, a modest surplus in the long term, potentially achieved through planned reforms, could lower the risk of debt distress.

B. IMPLEMENTATION PROGRESS OF REFORMS SUPPORTED BY THE SECOND DPO

29. **The Second DPO supported reforms to strengthen PFM and social service delivery, which are having a positive impact, and the GoT remains committed to their implementation.** The Second DPO supported reforms to: (i) improve commitment control; (ii) enhance oversight of fishing revenue; (iii) streamline reporting of local governments (Kaupules); (iv) enhance the efficiency of the tertiary health sector; and (v) strengthen primary and secondary education (including vocational), with increased access for women. Six months on, these reforms are already beginning to produce some benefits with reduced arrears by the government, revenue tracking, Kaupule reporting, tighter management of patients participating in the Tuvalu Medical Treatment Scheme (TMTS) and the introduction of broader vocational training opportunities. The March 2015 elections returned 7 out of 8 caretaker Cabinet members. The election results ensures continuity in the government administration and continued commitment to the reform agenda.

30. **PFM reforms supported under the programmatic DPO series have resulted in the production of monthly budget-tracking reports and implementation of commitment control procedures.** Regular in-year reporting has helped to strengthen monitoring of budget implementation leading to fewer re-allocations stemming from weak monitoring and controls (this is evidenced by the reduction in variance in composition of expenditure outturn compared to original approved budget). The introduction and implementation of commitment control procedures is helping to control overspending by line ministries by ensuring expenditures are accounted for as they occur. The latest report generated by the Financial Management and Information System indicates an aggregate accounts payable of AUD 0.2 million (around 0.5 percent of GDP), substantially reduced from previous years. These reports also contain the breakdown of accounts payable by outstanding length. This will also help reduce the need for re-allocations and improve cash management. Taken together, these reforms have led to improvements in budget execution, as well as a reduction in arrears and are likely to improve effectiveness in the use of public resources.

31. **The implementation of a strengthened OI project management policy and reporting framework has unblocked fund flows and will improve the quality and development impact of OI expenditure.** The implementation of the outer island project management policy (supported under the First DPO) is expected to result in greater prioritization of the projects by Kaupules to satisfy each island's needs and encourage timely and on budget delivery of projects. The adoption of a streamlined, context appropriate, financial reporting framework is expected to strengthen OI governance through increased transparency and accountability. These reforms have already resulted in the unblocking of financial flows to the OIs (number of projects and development expenditure to OIs have increased by over 25 percent compared to 2012). These projects are important as they develop core infrastructure which enables service delivery and helps communities to invest in assets to support income generating activities such as communal farming and fishing especially impacting on the livelihoods of the poor. In addition, 7 out of 8 Kaupules have compiled 2014 accounts and monthly electronic reporting is being rolled out to all Kaupules. In the medium term, these reforms are also expected to improve the quality and the development impact of OI expenditure.

32. **Revenue management has also been strengthened, which in turn supports enhanced fiscal sustainability.** Reforms to strengthen fisheries revenue management (in conjunction with the broader set of reforms underway to strengthen the fisheries sector), and efforts to ensure the integrity of tax systems have improved revenue management. Given the significance of fisheries receipts, regular updating of all financial records in the fisheries management system and regular reconciliation of fishing revenues with Treasury records (which was not undertaken previously) has improved Tuvalu's oversight of fees received from fisheries. April reconciliation of treasury and fisheries records show deviation of only 20K. This, together with the strengthening of the integrity of the tax systems, will minimize any revenue leakage and improve revenue management. Taken together, these reforms are also expected to lead to improvements in in-year cash management through more accurate revenue estimation. In the medium term, these reforms are expected to minimize disruptions to service delivery as a result of revenue volatility and to support fiscal sustainability.

33. **Reforms to strengthen social service delivery have resulted in the broadening of vocational training opportunities.** The GoT has re-oriented budget allocations to primary and secondary education including vocational training, with expenditure for basic education increasing by at least 5 percent per annum since 2012. Beginning May 2015 a new purse-seiner training course is offered at the main vocational training facility, the Tuvalu Maritime Training Institute (TMTI), which will expand economic opportunities for the institute's graduates. The GoT has also opened the TMTI (previously a male only) to female participation and is looking to further broaden the suite of vocational training offered to benefit those previously excluded from the education system. Towards this end, the GoT is exploring service orientated vocational training and the first female graduate is expected in 2015. In the long term, improving employment opportunities for all will contribute to the goals of reducing poverty and promoting shared prosperity.

34. **Reforms to enhance the efficiency of the costly but essential TMTS have allowed greater resources to be devoted to primary and preventative care, benefitting the broader population including the poor.** The revised TMTS policy institutionalized: (i) a strengthened patient referral committee to oversee the patient selection process; (ii) a new referral system for complex treatments such as cardiac surgery to accredited high quality hospitals in India to reduce the cost and timeline for referrals; (iii) the requirement for patients to be affordably accommodated in government leased houses or private homes instead of hotels; (iv) patient responsibility clauses to encourage timely and successful completion of treatment. The revised TMTS policy continues to be implemented with the strengthened referral committee meeting regularly. A number of complex cardiac cases have been treated in India with good turnaround times and outcomes, and patients referred to Suva continue to be housed in government leased properties. Enhancing the efficiency of the overseas medical treatment scheme has enabled greater resources to be devoted to primary and preventative care. This will benefit the broader population and improve healthcare outcomes (including non-communicable diseases), reducing the need for specialized tertiary care in future.

35. **The GoT has also taken steps to address vulnerabilities in the public sector and the banking sector.** To reduce banking sector vulnerabilities, the GoT has included funding for the establishment of the Banking Commission in the 2015 budget. An International Monetary Fund (IMF) technical assistance was fielded in March 2015 with in-principle agreement to establish a Banking Commissioner function within the MFED. Towards this end, the IMF legal department is reviewing the Banking Commission Act. Once the Banking Commission is established, the IMF will schedule a series of short on-site examinations of the banks to ascertain their compliance with the Act and sound financial practices. On public sector vulnerabilities, the GoT is working with ADB to develop a public enterprise reform plan and to privatize the Vaiaku Lagi Hotel in 2015.

VI. RATIONALE FOR THE PROPOSED SUPPLEMENTAL FINANCING

36. **The proposed USD 3.0 million supplemental financing from the CRW supports the GoT in post TC Pam recovery.** On May 18, 2015, the Board received a document regarding the planned USD 3.0 million IDA CRW support for Tuvalu for TC Pam recovery. TC Pam recovery and reconstruction creates an unanticipated financing need. However, Tuvalu is already at a high risk of debt distress and has no access to international capital markets, limiting the sources of funding available. After considering pledged grants from other DPs, the financing gap remains substantial (annual deficits averaging around 9.3 percent of GDP are expected over the next couple of years from a surplus counterfactual situation). Supplemental financing to the Second DPO remains the most appropriate instrument for providing timely support to the GoT in TC Pam recovery. The existing small IDA portfolio is already fully programmed, constraining options for reorientation of existing investment projects. In addition, the Second DPO was only approved by

the Board in March 2015, therefore, a freestanding DPO may overload the reform agenda in a capacity constrained environment at a time when the GoT is focused on post-cyclone recovery. Finally, this operation will ensure that the reforms supported under the Second DPO remain on track and are implemented without the risk of delay due to competing capacity or budgetary priorities arising from post-disaster recovery. Overall, the proposed supplemental financing is consistent with the provisions of OP8.60.

VII. IMPLEMENTATION ARRANGEMENTS

A. TERMS OF THE SUPPLEMENTAL FINANCING

37. **The Recipient is Tuvalu and this supplemental financing is a single-tranche IDA grant for USD 3.0 million funded through the CRW.** The grant would be made available upon grant effectiveness, as all policy actions supported under the Second DPO have been met. No conditions, except for the standard requirement for a legal opinion will apply to this supplemental financing. There will be an overall requirement for the GoT to continue to maintain an appropriate macroeconomic policy framework as required under the Second DPO. The closing date for this Supplemental Operation is December 31, 2016.

B. FUNDS FLOW AND AUDITING REQUIREMENTS

38. **The fiduciary arrangements outlined in the Second DPO still apply.** An assessment of the PFM environment was outlined in the Second DPO, with subsequent improvements in the environment due to the progress in PFM reforms mentioned earlier in this document. The preliminary results from the 2015 PEFA also noted improvements, compared to the 2011 PEFA, in the quality of budget documentation (now published via web), financial instructions, monitoring of public enterprises and commitment control. Although challenges remain, the GoT is working with the IMF in constructing a new PFM reform roadmap on the basis of the 2015 PEFA results.

39. **As an IMF Safeguards Assessment is not available, a set of mitigation measures have been proposed.** Tuvalu does not have a central bank and uses the Australian Dollar as its currency. In addition, Tuvalu has not accessed IMF funds. There is no indication of major issues within the foreign exchange environment, given that Tuvalu uses the Australian Dollar. However, without a safeguards assessment, and limited previous experience in DPOs, a set of mitigation measures have been proposed below, including a separate Local Currency Deposit Account opened in the government's Consolidated Fund held at the National Bank of Tuvalu, together with an audit.

40. **The proposed supplemental financing will follow IDA's disbursement procedures for development policy grants.** Once the operation becomes effective, and at the request of the Recipient, the proceeds will be deposited by IDA into a deposit account in a separate government

account at the National Bank of Tuvalu. The National Bank's 2014 annual financial statements received an unqualified audit opinion, and it has previously been used for the designated account for the DPOs and the Pacific Aviation Investment Program in Tuvalu. As a due diligence measure, within 30 days of receipt the Recipient will provide a written confirmation to IDA when an equivalent amount is accounted for in the government's budget management system. Disbursements would not be linked to specific purchases. The proceeds of the operation would not be used to finance expenditures excluded under the Agreement. If, after being deposited in a government deposit account, the proceeds of the operation are used for ineligible expenditure as defined in the Financing Agreement, IDA will require the Recipient to refund the amount directly to IDA. Any such amounts refunded to IDA shall be cancelled.

41. **As an additional mitigation measure, the Bank will require an audit of the receipt of the disbursement in the deposit account and into the budget management system of the Recipient.** The financial audit report should be furnished to the Bank within 6 months from the last disbursement. In that event the Recipient would report i) the exact sum received into the deposit account and its supporting details; ii) that this account was only used for the purposes of the operation and that no other amounts were deposited into this account, including confirmation from corresponding bank(s) involved in the funds flow; and (iii) that an equivalent amount was accounted for in the Recipient's budget management system. This will enable IDA to review compliance with the Financing Agreement and achievement of the objectives of the operation.

C. ENVIRONMENTAL ISSUES

42. **This proposed supplemental financing is not likely to have any negative effects on Tuvalu's environment or natural resources.** The Environment Protection Act (2008) provides the overarching legislative framework for environmental protection and management in Tuvalu including environmental impact assessments for larger projects. However a framework for costing and compliance is not yet fully in place and capacity in the Department of Environment is thin, thus the capacity and resources to effectively undertake this role are limited. Tuvalu will continue to be heavily reliant on outside expertise provided by regional organizations such as the Secretariat of the Pacific Community's Regional Environment Program. The operation does not support specific policies or activities other than those underpinning the Second DPO to strengthen PFM and social services delivery. This operation is therefore not likely to have any negative effects on Tuvalu's environment or natural resources.

VIII. BENEFITS AND RISKS

43. **The proposed USD 3.0 million supplemental financing from the CRW supports the GoT in post TC Pam recovery.** Post TC Pam recovery and reconstruction creates an unexpected financing gap, after considering pledged grants from other DPs and Tuvalu's limited access to other sources of financing. With limited scope to reorient the existing IDA portfolio or establish a

separate operation, the proposed supplemental financing will provide in-time support to the GoT in its post-cyclone response efforts. The proposed operation will also ensure that the government's reform program, including those supported under the Second DPO, remains on track despite competing priorities.

Table 3. Systematic Operations Risk Rating

Risk Categories	**Rating (H, S, M or L)**
Political and governance	Moderate
Macroeconomic	Substantial
Sector strategies and policies	Substantial
Technical design of project or program	Substantial
Institutional capacity for implementation and sustainability	Substantial
Fiduciary	Substantial
Environment and social	Moderate
Stakeholders	Moderate
Other	Moderate
Overall	**Substantial**

44. **The risk assessment made for the Second DPO remains.** The proposed operation carries risks stemming from thin institutional capacity in the GoT, and an uncertain external and domestic environment. Firstly, thin capacity in the public sector presents a risk that could impede the implementation of the supported reforms and reconstruction activities. This is being mitigated by selectivity in the design of the program, clear communication on requirements of each policy action, and where gaps arise providing external technical support. Secondly, external and domestic risks stemming from financial market volatility, commodity price volatility, uncertain external aid environment and reconstruction cost variability could place a strain on Tuvalu's fiscal situation. These idiosyncratic risks could however counteract one-another and the Bank will continue to work with IMF staff to monitor macroeconomic risks and provide policy advice as needed. Financial sector risks for example are being addressed initially with policy advice from the IMF.

ANNEX 1: FUND RELATIONS NOTE

Tuvalu—Assessment Letter for the World 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 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.

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

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.

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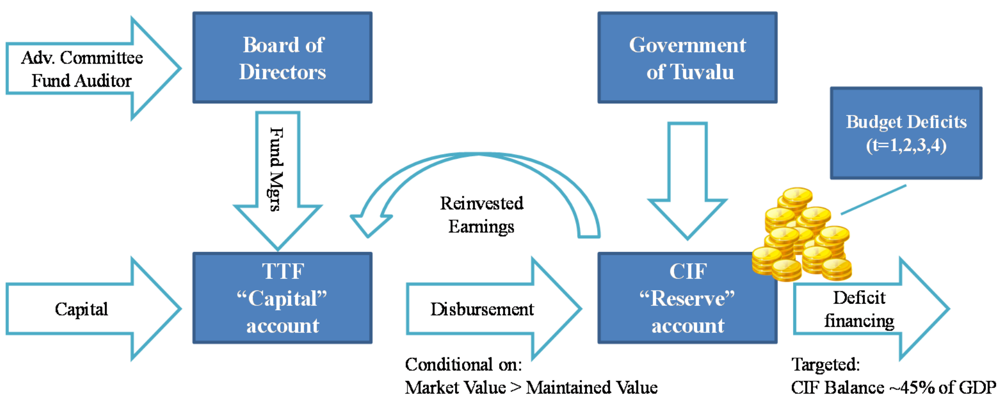
[2] See IMF Country Report No. 14/253.

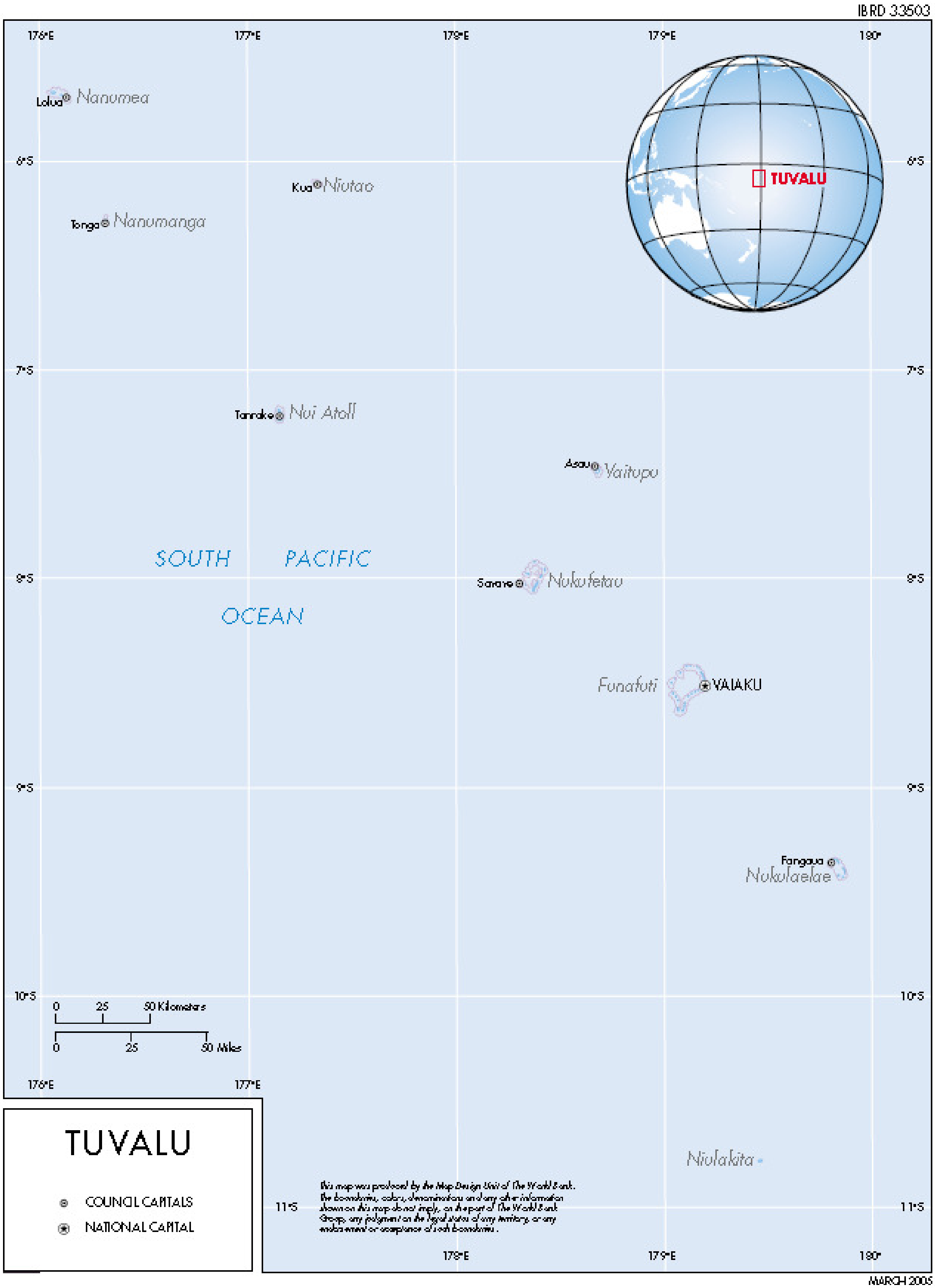
ANNEX 2: THE TUVALU TRUST FUND

As Tuvalu has very limited financing options other than grants to finance fiscal deficits, the TTF and CIF were established to contribute to Tuvalu's fiscal sustainability. The TTF was established in 1987 to provide an additional source of funding for recurrent expenditures and to set the country on a path towards greater financial autonomy. The TTF initially comprised of a single capital account commonly referred to as the TTF. The TTF was capitalized by donors (Australia, New Zealand, Japan, the Republic of Korea and the United Kingdom), and the GoT in 1988. The TTF is a capital preserving fund and its capital has grown over the years through reinvestment of its own earnings and contributions by the GoT during surplus periods. The TTF is not fully sovereign with development partners represented on its Board. The TTF's capital account aims to generate a real rate of return of 4.5 percent in excess of the Australian Consumer Price Index. An ancillary trust fund was established under full government control to facilitate predictability and regularity of transfers to the budget. In years when the market value of the TTF exceeds it's real maintained value (indexed to the Australian Consumer Price Index), the surplus is transferred to the CIF for use in the subsequent years. Transfers accumulate in the CIF until the GoT withdraws for budget financing. The CIF targets a minimum balance equivalent to 16 percent of the TTF's real maintained value (or around 45-50 percent of GDP), based on the assumption that a "dry-spell" up to four years could occur where no distribution would be made from the TTF. This was demonstrated in the aftermath of the GFC, when the buffer assets in the CIF providing financing to the government when no TTF distribution was made.



The ability of the TTF and CIF to contribute to Tuvalu's fiscal sustainability is contingent on global financial market conditions. Since the capital of the TTF is invested in international financial markets (approximately 60 percent in defensive and 40 percent in growth assets), annual investment returns have typically shown high levels of volatility. Negative shocks usually mean that no new distributions will be made to the CIF. In 10 out of the past 25 years, the TTF did not make distributions to the CIF (post 1987, 2000 and 2008 crises). The TTF, which suffered losses of around 20 percent during the GFC, achieved returns of around 10 percent in 2012 and 2013, recuperating some of the earlier losses and enabling in 2013 the first distribution to the CIF since 2009.

In parallel to the TTF, the local governments (Kaupules) together with donor partners capitalized the Falekaupule Trust Fund (FTF). The FTF aims to provide a sustainable source of funding for OIs' development. It's fully governed by the Kaupules, invested in parallel to the TTF and has the same distribution rules. The market value of the FTF is AUD 27.5 million (70 percent of GDP). Annual distribution in typically averaged around AUD 0.8 million (2 percent of GDP).



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Funafuti
VAIAKU
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TUVALU
COUNCIL CAPITALS
NATIONAL CAPITAL
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MARCH 2005