Outline of Phase VI Proposal

Background

The special July 2, 2021 SC meeting that focused on developing the priorities for Phase VI planning benefited richly from the outputs of the five stakeholder-led Virtual Working Groups that considered the efforts and results of the existing PFTAC programs during Phase V and identified future priorities. These outputs have provided invaluable stakeholder guidance and preferences as input to an IMF interdepartmental working group that met throughout September and October to develop the IMF strategy for the sixth phase of PFTAC operations and financing due to begin on May 1, 2023 following a full-year extension of Phase V.

A Program Document (PD) is being developed to fully articulate the proposed Phase VI model, including detailed budget and high-level program workplans and logical frameworks over a five year cycle between May 2023 and April 2028. As the internal IMF processes and approval of the strategy have only recently concluded, drafting of the PD is insufficiently advanced, so this note aims to summarize the key elements expected to be documented in the PD to facilitate discussions at the December 2, 2021 SC meeting. Feedback from those discussions will be taken into consideration in finalizing the first complete draft of the PD by late January 2022. This will be shared with SC members for further comment and feedback on a lapse of time basis, with a goal to distribute the finalized PD by early April, at least six weeks ahead of the 2022 SC meeting scheduled for late-May when initial donor indications and pledges will be sought. Ultimately, sufficient pledges from current and prospective donors, as well as renewed Letters of Understanding of member country commitments will be in place before the end of 2022 to guarantee a seamless transition between phase five and six on May 1, 2023.

The PFTAC Model

PFTAC provides Capacity Development (CD) support to 16 countries[1] in the Pacific region (including seven fragile states*). The Pacific is characterized by mostly small and micro-states, widely dispersed, often with narrow economic bases and growth opportunities, challenging capacity constraints, and increasing threats from climate change and natural disasters. PFTAC—the IMF's oldest regional CD center—is a mid-size RTAC with an average of seven long-term experts (LTX) during Phase V.

[1] Federated States of Micronesia (FSM)*, Fiji, Kiribati*, Republic of Marshall Islands (RMI)*, Nauru, Palau, Papua New Guinea (PNG)*, Samoa, Solomon Islands*, Timor-Leste*, Tonga, Tuvalu*, Vanuatu, and the New Zealand Realm jurisdictions of Cook Islands, Niue and Tokelau

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The Macroeconomic Context

The impact of COVID-19 in the Pacific has been severe, even though only a few countries experienced local outbreaks. Those with large tourism sectors have seen particularly large GDP contractions, unemployment, expanded fiscal deficits, and increased public debt. For others, drops in commodity exports, fishing revenues, and remittances have eroded income, fiscal, and external positions.

The economic and financial scars of the crisis are a concern. As the pandemic recedes, some Pacific Island Countries (PICs) will have to address legacies of the crisis – public debt, diminished buffers, corporate insolvencies, rising non-performing loans (NPLs), and contingent liabilities related to State Owned Enterprises (SOE).

Public debt rose sharply for some PICs between 2019 and 2021. Sharp contractions in GDP, combined with increased fiscal deficits, have boosted debt-to-GDP ratios, especially in tourism-dependent economies like Palau (+54 percent) and Fiji (+34 percent). Debt management capacity is generally underdeveloped in the region, and the majority of PICs are assessed as high-risk cases.

Natural disasters and climate risk are key issues for PICs. As with other small states, the economic and social damage from natural disasters and climate change are disproportionately large. With the size and frequency of such events on the rise, there will be continued need for investment in climate resilience and adaptation – more difficult now given the damage to fiscal buffers resulting from the pandemic.

The decline in correspondent banking relationships (CBRs) continues to be an issue for PICs. Concern over mostly Anti-Money Laundering (AML) penalties and pandemic-related pressure on profitability have led multinational banks to review the cost effectiveness of their CBRs with countries with weaker AML/CFT systems. The loss of CBRs in the Pacific is potentially disruptive to remittance inflows and much needed liquidity.

Recovery from COVID-19 may be slow and divergent. Longstanding challenges of geographic isolation, exposure to natural disasters and climate change, low capacity, and undiversified economic bases imply the recovery will take time – longer than other regions. Commodity exporters will recover with global demand, but tourism-economies will likely lag given prolonged border closures, vaccination challenges, and uncertainty about post-pandemic tourism.

PFTAC support is more essential than ever. Many of the post-pandemic challenges are at the heart of PFTAC's CD agenda, as well as reforms supported under existing and new PFTAC programs (like Debt Management). The topics and emphasis of delivery have already pivoted to the most pressing issues. Characteristics of the Pacific such as smallness, remoteness, low growth, narrow economic bases, and under resourced institutions is reflected in severe capacity constraints that are particularly manifested in the fragile states that constitute 7 of the 16 PFTAC country membership.

Proposed Phase VI Programs

CD priorities during Phase VI will reflect the policy needs of member countries. Several long-standing priorities have crystallized from the pandemic, including fiscal risks of rising debt and contingent liabilities (e.g., SOEs), macroeconomic and financial stability (e.g., lower budget revenues and increased vulnerabilities), and diminished growth prospects from natural disasters and climate change. Medium-term frameworks and strategies supported by CD will help ensure the institutional capacity and legal frameworks are implemented to address the fiscal, debt, balance of payments and growth challenges arising from the pandemic and other shocks, while continuing to strengthen resilience to disasters and climate change. PFTAC's Phase VI strategy aims to meet the rising and evolving CD needs that have intensified with the COVID-19 pandemic while enhancing the CD's impact, traction, and sustainability, as underscored by the external evaluation.

To respond to post-COVID-19 priorities, current PFTAC programs are proposed to continue in Phase VI, with targeted expansion responding to needs but within the delivery and absorptive constraints of the region. The Financial Sector Supervision (FSS), Revenue, Real Sector Statistics (RSS), and the current Macro programs would all continue into Phase VI, and the long-term expert (LTX) position for the Government Finance Statistics (GFS) program that was discontinued in August 2021 would be reinstated to additionally cover Public Sector Debt Statistics (PSDS).

With increasing demand for CD to strengthen Public Financial Management (PFM) systems to be responsive to climate change issues and for member countries to potentially qualify for access to climate change financing, further efforts under the PFM program are expected that would benefit from a third LTX devoted to climate issues if funding and budget prospects permit. An additional PFM resource focused on climate change would provide space for the other PFM advisors to respond more deeply to other PFM topics where country demand exists such as fiscal transparency and gender aspects of PFM. Finally, a second Macroeconomic advisor and program is proposed with backstopping by the Institute of Capacity Development (ICD) with a focus on macroeconomic frameworks, work that has begun in FY2022 with IMF financing.

In addition to an emphasis on climate change, opportunities to mainstream gender, digitalization, and other cross-cutting issues into PFTAC programs will be pursued in close coordination with CD Departments (CDD) and the Asia Pacific Department (APD). Collaboration in Phase V across programs will be expanded in Phase VI, particularly between the Debt Management, PFM, Statistics, and Macro programs. The successful joint events between PFTAC and CARTAC in 2018 and 2019 to bring together revenue administrators and PFM practitioners from Small Island Developing States (SIDS) in the Caribbean, Pacific, and elsewhere will also be continued and broadened in topic range. Also, the past strong collaboration with regional institutions and development partners will further leverage PFTAC resources and expertise with these partners' comparative advantages, particularly with training.

Greater emphasis and support to fragile states is anticipated, in absolute terms and to expand the Phase V average share of resources and delivery beyond 34

percent. There is unmet demand in several fragile states particularly the larger economies of **Papua New Guinea** and **Timor-Leste** in topics covered by PFTAC, although approaches must be customized to match the institutional and absorptive capacity of the authorities. Severe capacity limitations in a number of micro-states including fragile states, require innovative approaches to move from capacity supplementation to impactful and sustainable CD.

Phase VI Objectives

The proposed objectives for Phase VI are outlined below. These include a continuation of Phase V objectives building on or completing ongoing projects, in addition to emerging priorities particularly around climate change, public investment, debt management, and medium-term macroeconomic models, all within an overarching post-COVID recovery context. High-level log frames will be included in the Program Document (PD) for Phase VI.

Public Financial Management (PFM). Support under Phase VI will continue to be framed by the member country PFM needs. Support will be provided to strengthen budget credibility and transparency through credible medium-term fiscal and budgetary frameworks; effective fiscal oversight; building effective budget execution practices and controls; and strengthening local capacity in risk-based auditing practices. As well, improved fiscal reporting, including the adoption of IPSAS cash standards and timely audit of annual financial statements will continue to be supported. Other priorities include strengthening cash and debt management, improved asset management frameworks, and improved public investment using PIMA diagnostics. PFTAC will continue its support to sequencing and prioritizing PFM reforms, through coherent roadmaps reflecting the findings of the PEFA diagnostics, and work closely with partners in coordinating reforms and CD. PEFA assessment support will continue albeit at a more appropriate frequency.

Climate change will receive dedicated support to implement the PFM green framework, PIMA and PEFA Climate Change assessments, and CD activities to better understand the impact on PFM policies. Gender related PFM activities will be supported where opportunities and demand arise. Regional CD activities will continue to bring practitioners together to both learn and share experiences.

Revenue Policy and Administration. The considerably expanded Phase V program will continue to provide support to member countries on tax policy, tax legislation, and tax administration to meet country demands for revenue mobilization and to recover from COVID-19 and meet future challenges such as climate change. Assistance will aim at: (a) getting tax administration foundations like accurate taxpayer registers right; (b) designing and implementing Medium Term Revenue Strategies; (c) supporting tax administration efforts for sufficient staff to fulfill their mandate: (d) ensuring robust and fair revenue systems to overcome the pandemic impact, maximize revenue collections, and counter trade revenue losses due to PACER Plus; (e) dealing with challenges presented by international tax issues; (f) providing stronger IT support and dealing with digitization; (g) improving risk management and data analysis; (h) continuing improvements to core tax functions; (i) further improving organizational structures;

(j) assisting with emerging areas such as extractive industries and more attention to small and medium enterprises; (k) continuing with PITAA/PFTAC training workshops; (l) cooperating and collaborating with other development partner programs; (m) developing the capacity (and possibly the regulatory framework) to participate more fully in Exchange of Information protocols; and (n) being responsive to specific country needs with due consideration of the demand on the time of executives and other staff.

Real Sector Statistics (RSS). The availability of quality macroeconomic statistics is key to effective policy decisions. Building on initiatives to improve the accuracy, periodicity, and timeliness of key data, the RSS work program would focus on: (i) implementing Quarterly National Accounts (QNA) programs in additional countries (**Tonga**, the **Solomon Islands**, and **Vanuatu**), (ii) enhancing compilation programs in price statistics, including to better measure services; and (iii) supporting the maintenance of RSS compilation programs to mitigate risks of slippages, including by providing continuous training and supporting source data improvements. Further, the scope for developing climate indicators of physical risk will be examined as these become more critical in assessing the impact of climate-driven shocks and to support policy responses in fragile states.

Work in National Accounts and price statistics will continue to reflect the limited absorptive capacity of several national statistical offices, with priorities and modes of delivery evidencing a clearer distinction between microstates (many also fragile) requiring capacity supplementation and those that have the potential to leverage CD to improve their compilation systems. In the case of capacity supplementation, more intensified engagements to ensure regular data availability will be facilitated by greater STX use —with the LTX providing essential links to Fund surveillance needs; and also focusing on those microstates that have the resources to sustain improvements. The RSS program will also seek opportunities to take a regional approach to capacity supplementation, including the use of common tools, methods, and where possible data sources.

Government Finance Statistics (GFS). Given the strong demand in the region for GFS and PSDS, STA will reestablish a GFS LTX in the region. The new LTX will support PIC efforts to improve the coverage and timeliness of fiscal and debt statistics to facilitate informed policy analysis and decisions. To address the rising concerns about debt sustainability among Pacific Islands, the new GFS LTX will pay particular attention to debt sustainability and debt issues – improving sectoral and instrument coverage of debt data – and closely coordinate with the Japan-financed debt management advisor.

Macroeconomic Planning & Forecasting. The main objective for the Macroeconomic Program during Phase VI is to ensure that all member countries are able to advance their macro-fiscal capacity as well as to respond to broader macroeconomic modelling and analysis requirements. This macro-fiscal capacity progression will need to be tailored to individual country circumstances, with some countries requiring support for the construction of basic forward estimates and an appropriate economic outlook, and others for the application of more advanced techniques and modelling approaches.

Macroeconomic Frameworks. The ongoing pandemic and associated economic shocks to PICs, many also fragile, have accentuated the need to bolster macroeconomic frameworks, forecasting, and analytical capabilities. The main role of the prospective ICD-backstopped Macroeconomic Frameworks advisor will be to assist PICs to develop capacity in macroeconomic forecasting and policy analysis to support policy decision making and communications at central banks and relevant government agencies, in close coordination with the existing APD-backstopped Macroeconomic advisor. Emphasis will be to assist country officials in strengthening their macroeconomic forecasting and analytical capacity; supporting the development of analytical tools to improve macroeconomic and macro-fiscal forecasting ability, credibility, and policy analysis; and helping identify and mitigate macroeconomic risks. Depending on country needs and capacity, the macroeconomic-frameworks TA projects may range from building Excel-based, sectoral-relationship frameworks with supporting economic projection equations, to building semi-structural gap models or even DSGE models of national economies. Near-term forecasting/ nowcasting and/or debt dynamics tools will also be included in these macroeconomic frameworks.

Financial Sector Supervision (FSS). Though the PICs have made significant strides, they are yet to catch up with the international regulatory standards and supervisory practices that have been significantly enhanced drawing on lessons from banking crisis episodes and rapid financial sector advances. International banking standards have expanded beyond capital to encompass liquidity and large exposure standards that are critical to ensuring survival of financial institutions under stress. Macro-prudential supervision has expanded regulatory capital to include various types of capital buffers that can be drawn down during periods of stress and includes identifying domestic systemically important financial institutions needing stronger supervision. Basel III standards on leverage and interest rate risk in the banking book further enhance the rigor of the regulatory framework. All standards for the measurement of risk weighted assets have also been comprehensively revised. While Basel international standards were developed for advanced/ larger economies, they provide scope for proportional implementation in smaller jurisdictions, with discretion for national circumstances and optional approaches for risk and capital measurement.

In this rapidly evolving world, COVID-19 shocks have interrupted reforms, with the distance to the target having increased in many developing countries. In this context, the Fund urges that reforms set in train are not halted, or worse, rolled back. Completion of current thematic projects launched by PFTAC will lay the necessary foundation for the PICs to take their financial sector regulation to the next level. PFTAC stands ready to assist the PICs in achieving this objective. The Steering Committee identified the following regional priorities: (1) monitoring of systemic risks; (2) preparation/review of supervision manuals; (3) NPL resolution; (4) financial stability reports; (5) supervisory stress testing of financial institutions; (6) bank resolution; (7) Basel III liquidity standards; (8) off-site supervision; (9) early intervention in weak banks; and (10) development of prudential and risk management standards for non-banking credit institutions. TA for specific countries will depend on individual country priorities, such that projects deemed 'High Priority' take first priority, and ongoing projects completed first before Phase VI. PFTAC will assist the PICs in adopting international standards with suitable simplifications based on proportionality, without compromising rigor.

Debt Management. Sustainable debt levels and good debt management in the region will be significant to the region's development given COVID-19 pandemic measures have brought many countries closer to debt distress. The new PFTAC public debt management program is focused on CD to support country efforts in managing sustainable debt levels. Countries should focus on building debt transparency with particular attention to debt statistics, strengthening legal frameworks and institutional arrangements to support strong debt management, and ensuring sustainable medium-term debt management strategies for effective management of cost and risk. These improvements would support the development of domestic debt markets for the much needed resource mobilization.

Resource Requirements

Proposed resources will expand from the Phase V average of seven LTX to at least nine resident advisors, preferably ten including a dedicated climate change LTX. This comprises: (1) four fiscal LTX, two each for PFM and Revenue and an aspirational third PFM advisor focused on climate change; (2) two Statistics, one each for RSS and GFS/PSDS; and (3) an LTX each for FSS, the APD-backstopped Macro program, and the proposed ICD-backstopped Macro program. These numbers are exclusive of the Debt Management program and LTX that is financed by the Government of Japan through end-FY24 and hopefully will be a strong candidate for a 3-year extension, but if further Japanese financing does not materialize, space and funding may need to be found within the PFTAC budget to absorb the program from the second year of Phase VI (i.e., FY25).

The recent independent evaluation of Phase V noted that PFTAC has been effective and efficient in using its resources and excellent overall value for money. Phase V programs and objectives were well aligned and supportive of the national priorities of member countries. While the evaluation period preceded the pandemic, the robust and trusted networks that PFTAC built over many years with its members proved very effective in pivoting to remote CD delivery and strengthened surveillance during COVID-19. Remotely delivered CD will be an important and complementary modality in Phase VI, but will not be a substitute for a return to in-country engagement, which is strongly favored by the member countries.

A fund-raising envelope of $US 40 million is targeted over five years (FY24 – FY28)[2] sufficient to finance the proposed nine preferably ten advisors and programs based on an average Phase V annual cost of approximately $US 6 million for seven advisors (i.e., $US 30 million over five years). COVID-induced changes may affect future costs from past averages given uncertainties about airline service resumption in a region that was already limited and expensive, likely offset by savings from continuation of virtual CD to supplement and expand upon in-person delivery. Continuing the arrangements introduced in Phase V, member countries are expected to contribute 10

[2] Phase V had a fund-raising target of $US 39.3 million for a 5 ½ year period. Contributions of at least $US38.1 million are on hand to finance the extended phase of 6 ½ years.

percent ($US4 million) under the currently agreed contribution formula with the balance from the current seven donors (ADB, Australia, Canada, EU, Korea, New Zealand, and United States) and other prospects like the United Kingdom.

At least a further $US 3 million IMF contribution is expected to finance the director, local staff, and other overheads as in Phase V at an average annual cost of at least $US600,000. However, the IMF board is currently considering various budget augmentation possibilities to expand IMF-wide support on various issues such as climate change, fragile states, gender, digitalization, and other topics, so the IMF contribution to PFTAC overheads that were otherwise covered from donor/member contributions may increase providing further space for CD delivery from the donor and member country fund-raising target.