INTERNATIONAL MONETARY FUND

IMF Country Report No. 26/22

REPUBLIC OF PALAU

January 2026

2025 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF PALAU

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2025 Article IV consultation with Palau, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its January 26, 2026, consideration of the staff report that concluded the Article IV consultation with Palau.
- **The Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on January 26, 2026, following discussions that ended on November 20, 2025, with the officials of Palau on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 13, 2026.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staff of the IMF.
- A **Statement by the Executive Director** for the Republic of Palau.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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International Monetary Fund
Washington, D.C.

IMF Executive Board Concludes 2025 Article IV Consultation with Republic of Palau

FOR IMMEDIATE RELEASE

- *Palau's economic recovery is underway with an improving fiscal balance, declining debt, and well-contained inflation, though debt is still high. The growth outlook remains robust despite exposure to global uncertainty and extreme weather events.*
- *Policy priorities include further reducing debt, while improving tax administration following the successful tax reform, and managing fiscal risks, particularly through the swift implementation of pension reforms. Enhanced financial oversight, vigilant management of risks arising from digital initiatives, and tailored reforms to address challenges in financial intermediation and the payment system are important for supporting financial stability and development.*
- *Achieving high and sustained growth will require continued efforts to diversify the economy, strengthen capacity building, promote resilience-enhancing investments, attract skilled labor, and foster foreign investment that benefits the domestic economy.*

Washington, DC – January 30, 2026: On January 26, 2026, the Executive Board of the International Monetary Fund (IMF) completed the Article IV Consultation for the Republic of Palau.[1] The authorities have consented to the publication of the Staff Report prepared for this consultation.[2]

Palau's economy has rebounded strongly following a delayed post-pandemic recovery, underpinned by rising tourism arrivals and robust construction activity, as well as improved confidence and fiscal space. Building on a 12 percent post-pandemic growth rebound in FY2024, growth is estimated to have remained solid at 6.7 percent in FY2025, supported by favorable developments in tourism and construction. Inflation declined to 0.2 percent in FY2025, reflecting lower commodity prices and reduced domestic utility costs.

The outlook remains robust, supported by tourism and construction. Growth is projected at 4.1 percent in FY2026, with real GDP expected to surpass its pre-pandemic level. Inflation is anticipated to rise moderately in the near term due to higher global food prices, before moderating to around 2 percent over the medium term.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] *Option 1:* Under the IMF's Articles of Agreement, publication of documents that pertain to member countries is voluntary and requires the member consent. The staff report will be shortly published on the www.imf.org/[country] page.

Uncertainty remains high, with risks tilted to the downside. Spillovers from geopolitical tensions and global policy uncertainty could delay Palau's full tourism recovery, increase commodity price volatility, disrupt foreign investments, and affect donor support. Domestically, Palau could face potential risks arising from emerging digital initiatives and remains vulnerable to climate-related shocks.

Executive Board Assessment[3]

Executive Directors welcomed the ongoing economic recovery and the renewed Compact Review Agreement (CRA-23) with the United States, which has significantly enhanced fiscal resources and supported debt reduction. Directors encouraged the authorities to maintain prudent policies and sustain reform momentum to secure a durable economic recovery while addressing long-term growth bottlenecks and prepare for climate shocks.

Directors commended the authorities for their commitment to prudent fiscal policies and decisive reform efforts, including the continuing work to modernize the tax system, building on the successful implementation of tax reform in 2023. They encouraged the timely finalization and effective implementation of fiscal and debt strategies, with priority given to further debt reduction, improving the efficiency of public spending, advancing resilience-enhancing investments, and strengthening revenue mobilization through improving tax administration. Directors also underscored the importance of strengthening fiscal risk management, particularly through the swift implementation of pension reforms and measures to enhance SOE oversight and governance.

Directors recommended enhancing financial sector resilience by strengthening financial supervision and regulation—particularly by bolstering the capacity of the Financial Institutions Commission, enhancing supervision of the National Development Bank of Palau, and updating the legal and regulatory framework to reflect the system's growing complexity. To improve financial intermediation, they encouraged the authorities to prioritize reforms that address structural impediments.

Directors agreed that efforts to improve payment efficiency should be guided by a comprehensive domestic payment strategy tailored to the country's economic size and resources. They welcomed the authorities' commitment to a cautious approach to implementation of a tokenized dollar and their openness to exploring other suitable payment options. In this context, Directors emphasized the importance of first conducting a comprehensive cost-benefit analysis and full-fledged feasibility study while putting in place risk mitigating safeguards. They also stressed the need to close regulatory and governance gaps and strengthen the AML/CFT framework to safeguard the financial sector from macroeconomic, fiscal, and financial risks potentially arising from digital financial initiatives.

Directors welcomed the authorities' commitment to upgrade the value-added of the tourism sector and encouraged them to prioritize foreign direct investments that benefit the domestic economy. They agreed that integrating climate adaptation policies in the development strategy is paramount given the criticality of climate risks for Palau. Further improvement of statistics also remains crucial to support surveillance.

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[3] At the conclusion of the discussion, the Managing Director, as Chair of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.IMF.org/external/np/sec/misc/qualifiers.htm.

Building on the momentum achieved thus far, Directors called for continued carefully sequenced Fund support for capacity development.

Table 1. Palau: Selected Economic Indicators 1/

Nominal GDP for FY2024: US$322 million
Population (2024): 17,591
GDP per capita for FY2024: US$18,277
Quota: SDR 4.9 million

	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28	2028/29	2029/30
		Est.			Proj.			
Real sector								
Nominal GDP (million US$)	276.2	321.5	346.6	370.5	390.3	410.1	428.3	447.9
Real GDP growth (percent change)	1.2	12.0	6.7	4.1	2.7	2.6	2.2	2.2
GDP deflator (percent change)	10.2	3.9	1.0	2.7	2.6	2.4	2.2	2.3
Consumer prices (percent change; period average)	12.4	3.6	0.2	2.8	2.7	2.5	2.3	2.2
Tourist arrivals (number of visitors)	35,052	52,661	66,823	83,529	91,047	96,509	102,300	108,438
Expenditure per Tourist Arrival (US$)	1,616	1,606	1,554	1,569	1,609	1,648	1,684	1,723
				(In percent of GDP)				
Public finance								
Central government								
Revenue	48.1	53.8	53.7	53.1	52.6	52.3	52.0	51.4
Taxes and other revenue	27.0	26.3	28.8	27.3	27.3	27.3	27.4	27.4
Grants	21.2	27.5	24.9	25.8	25.3	24.9	24.7	24.0
Expenditure	50.4	52.6	51.9	51.6	51.5	51.3	51.3	51.2
Expense	45.4	45.3	45.4	45.3	45.3	45.2	45.2	45.1
of which: grants to other government units	6.1	7.0	7.6	7.6	7.6	7.6	7.6	7.6
Net acquisition of nonfinancial assets	5.0	7.2	6.5	6.3	6.2	6.1	6.1	6.0
Current fiscal balance (excluding grants) 2/	-18.4	-19.0	-16.6	-18.0	-18.0	-17.8	-17.8	-17.8
Primary fiscal balance (including grants) 3/	-0.8	2.3	2.9	2.9	2.6	2.4	2.2	1.7
Net lending (+)/borrowing (–)	-2.3	1.2	1.7	1.5	1.2	1.0	0.8	0.2
General government debt	77.9	63.3	56.1	50.2	46.0	42.7	40.0	38.0
				(In millions of U.S. dollars)				
Compact Trust Fund (CTF) balance	270.0	372.3	434.9	445.5	456.3	467.3	478.5	490.0
Financial sector								
Credit to private sector (in percent of GDP)	24.8	21.4	…	…	…	…	…	…
Credit to private sector (percent change)	9.2	0.6	…	…	…	…	…	…
Balance of payments 4/								
Trade balance	-161.4	-162.1	-180.6	-200.0	-211.1	-221.7	-230.5	-239.6
Exports (f.o.b.)	2.8	4.6	4.7	5.2	5.3	5.5	5.5	5.5
Imports (f.o.b.)	164.2	166.7	185.3	205.2	216.4	227.2	236.0	245.1
Tourism receipts	52.8	76.4	97.2	122.7	137.4	149.4	162.1	176.0
Current account balance								
Including grants	-105.4	-65.1	-61.7	-53.1	-51.2	-51.5	-49.0	-45.5
Excluding grants	-158.2	-146.1	-135.5	-134.4	-135.6	-139.0	-139.4	-139.2
International Investment Position	-397.8	-319.7	-289.3	-304.9	-331.2	-359.9	-390.9	-417.1
Assets	685.7	923.7	901.3	932.9	958.4	986.9	1,016.4	1,056.2
Liabilities	1,083.5	1,243.5	1,190.6	1,237.8	1,289.6	1,346.8	1,407.3	1,473.2
Of which: External debt	215.1	203.5	194.5	186.1	179.4	175.0	171.3	170.0
				(In percent of GDP)				
Current account balance								
Including grants	-38.2	-20.2	-17.8	-14.3	-13.1	-12.6	-11.4	-10.2
Excluding grants	-57.3	-45.4	-39.1	-36.3	-34.7	-33.9	-32.5	-31.1
International Investment Position	-144.1	-99.5	-83.5	-82.3	-84.9	-87.8	-91.3	-93.1
Of which: External debt	77.9	63.3	56.1	50.2	46.0	42.7	40.0	38.0

Sources: Graduate School USA; and Fund staff estimates and projections.
1/ Fiscal year ending September 30.
2/ Defined as tax and other revenue less expense.
3/ This reflects Compact grants under CRA-23 for debt service and are treated below the line the IMF's presentation.
4/ Includes withdrawals from CTF and funding for US Federal Programs (Post Office and Meteorological Service).

INTERNATIONAL MONETARY FUND

REPUBLIC OF PALAU

STAFF REPORT FOR THE 2025 ARTICLE IV CONSULTATION

January 13, 2026

KEY ISSUES

Context. Recovery is underway with improving fiscal balance, declining debt, and well-contained inflation, though FY2024 real GDP remained below pre-pandemic levels and the debt level is still high. The 2023 Compact Review Agreement (CRA-23) and a successful tax reform have provided Palau with additional fiscal space to navigate long-term challenges, including adverse demographic shifts and climate vulnerability.

Outlook and Risks. Recovery is expected to remain robust, supported by continued recovery in tourism and construction. However, the economy remains vulnerable to global uncertainty given its reliance on tourism, imports and external grants, with risks of delayed tourism recovery, increased commodity price volatility, and disrupted external financing tilted on the downside.

Policies should focus on securing sustainable recovery and long-term resilience, while preserving sufficient fiscal buffers and safeguarding financial stability.

Fiscal policy should remain prudent to facilitate debt reduction. The medium-term fiscal strategy should focus on reducing debt, promoting resilience-enhancing investments, improving spending efficiency, and broadening revenue mobilization efforts, in line with Palau's development and fiscal sustainability goals. Accelerating pension reform, strengthening SOE oversight and regulation, and enhancing public financial management remain crucial to managing fiscal risks.

Financial sector policies should prioritize strengthening financial supervision and regulation, while addressing financial intermediation and payment system challenges with policy options tailored to Palau's economic size and resources. Macro, fiscal, and financial integrity risks associated with the authorities' fintech initiatives, such as the tokenized dollar, should be carefully managed, supported by a stronger regulatory and legal framework.

Structural policies should aim to diversify the economy, upgrade the tourism sector, attract FDI, and retain skilled workers. Holistic reform planning and coordinated implementation efforts are key to success. Climate-related policies can be better integrated into development planning and public financial management processes.

Approved By
Harald Finger (APD) and Anna Ivanova (SPR)

Mission Dates: November 6-20, 2025

The mission team comprised Yuanyan Sophia Zhang (Mission Chief), Ricardo P. Davico, Irina Yakadina (all APD) and Kavita Ram (Fiji Office). Neil Saker (RRO, Fiji), John McAlister (PFTAC), and Meang Ngiraingas (OED) also joined the mission. To-Nhu Dao, Irene Velasquez, and Mariam Souleyman (all APD) contributed to the preparation of the staff reports and supported the mission.

CONTENTS

ANNEXES

CONTEXT

1. **Republic of Palau continues to face important structural challenges.** Palau is a high-income microstate renowned for its world-class marine conservation area. However, as one of the smallest Pacific Island Countries (PICs), it continues to face outward migration, geographic isolation and dispersion, constraining its potential for economic diversification. Given Palau's geography and heavy reliance on tourism, imports, and grants, the country remains highly vulnerable to external and climate shocks.

2. **The CRA-23 and a successful tax reform significantly improved the fiscal outlook.** The CRA-23 provided substantial grant assistance and contributions to the Compact Trust Fund (CTF), totaling nearly 900 million USD (over 300 percent of GDP) for FY2024-43, higher than the FY1999-2024 arrangements. The 2023 tax reform, which introduced the Palau Goods and Service Tax (PGST), significantly expanded domestic revenue mobilization (Annex I).

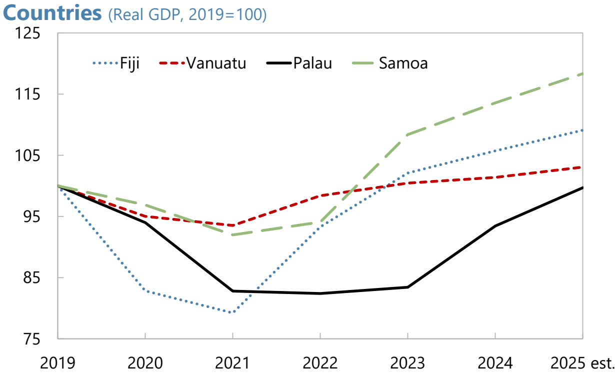
3. **Palau's policies were broadly in line with the past IMF advice, though some essential reforms should be accelerated (Annex VI).** The high-value tourism strategy is starting to bear fruit. Debt is on a downward path. However, pension reforms, for the Civil Service Pension Plan (CSPP) and Social Security Administration (SSA) pension scheme, remain pending. Labor shortages, especially of high-skilled workers in the public sector, are hindering the government's capacity to accelerate essential reforms and implement Capacity Development (CD) recommendations (¶24).

4. **The authorities strive to modernize the financial system through ambitious digital initiatives.** The government-backed tokenized dollar (TD), first introduced as a pilot in FY2022, is now included in a draft Digital Payment Service Bill (DPSB) recently submitted to the Congress (¶17). A pilot platform of the blockchain-based Palau Savings Bond (PSB) was showcased in FY2024, while operational details of the PSB, including terms and institutional arrangements, are being prepared before its full launch (¶18).

RECENT DEVELOPMENTS

5. **Following a delayed recovery post-pandemic, Palau's economy experienced a significant rebound in FY2024.** After the pandemic, Palau's economic recovery has been slower than in other tourism-driven PICs due to delayed resumption of flights from key markets and a strong US dollar. Economic momentum picked up in FY2024, with a 12 percent growth rebound, driven by increased tourism arrivals and construction activity, supported by confidence boost and improved fiscal space following the CRA-23. Minimum wage increases

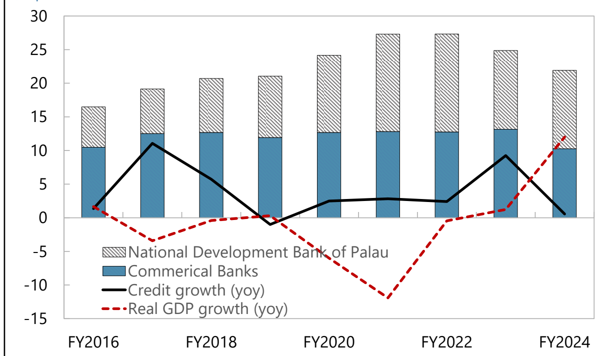
Economic Recovery in Tourism-Based Pacific Island Countries (Real GDP, 2019=100)



Sources: National authorities; and IMF staff estimates.

in FY2024 helped consumption recovery. Credit growth remained subdued in FY2024, reflecting increased provisioning and the write-off of NPLs, particularly by the National Development Bank of Palau (NDBP), limiting credit role in supporting growth. The credit-to-GDP ratio stood at 21 percent, well below regional averages. Latest statistics on tourism arrivals and construction activity suggest robust growth in FY2025, estimated at 6.7 percent. Inflation returned to single digits in FY2024 from its peak of 12.4 percent in FY2023 and declined further to 0.2 percent in FY2025 on the back of lower commodity prices and domestic utility costs.

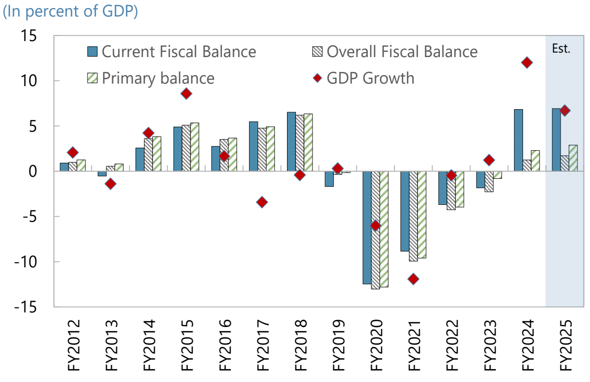
Credit and Economic Growth
(In percent of GDP)



Source: Graduate School USA.

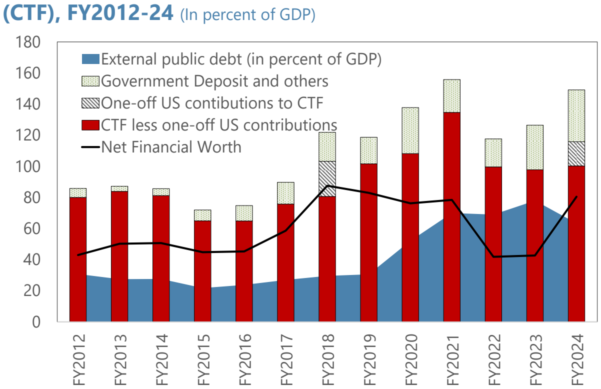
6. The fiscal position improved, backed by increased grants, buoyant domestic revenue, and spending restraint. Before the pandemic, Palau maintained a track record of fiscal surpluses, low debt, and positive net financial worth.[1] During the pandemic, fiscal policy loosened for essential support, with sizable borrowing from the ADB, pushing debt to nearly 80 percent of GDP. After the pandemic, economic recovery, increased CRA-23 grants, the successful tax reform, and restrained current spending helped turn fiscal deficits into surpluses. In FY2024, the primary balance rose to 2.3 percent of GDP, debt declined to 63 percent of GDP from its pandemic peak of 78 percent, while net financial worth improved to around 80 percent of GDP (¶12). Fiscal improvement continued in FY2025, with the primary surplus increasing to 2.9 percent of GDP, reflecting a strong revenue outturn and restrained spending, further reducing debt to 56 percent of GDP.

Fiscal Balances and GDP Growth, FY2012-25
(In percent of GDP)



Source: IMF staff calculations.

Stock of External Public Debt and Compact Trust Fund (CTF), FY2012-24 (In percent of GDP)

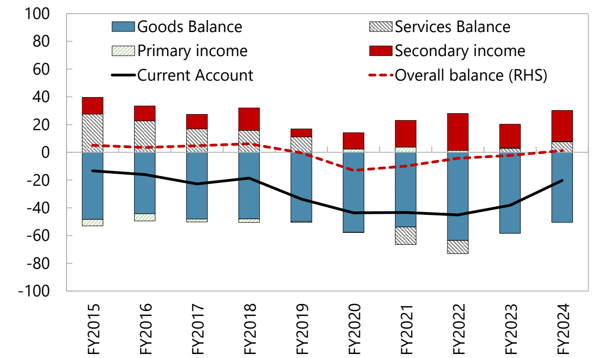


Source: IMF staff calculations.

[1] Net financial worth is calculated as the assets in deposit and Compact trust fund net of external debt and account payable.

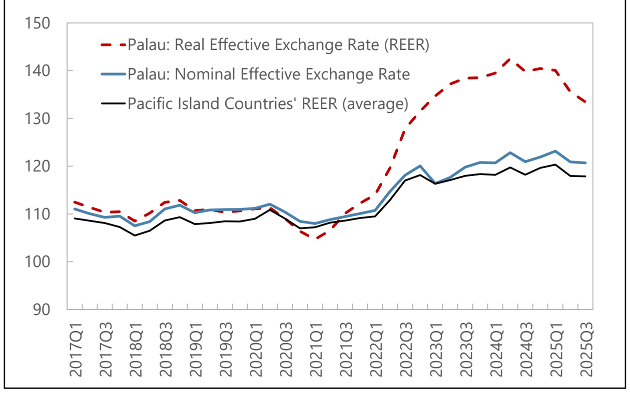
7. Despite improvement, Palau's external position is assessed to be substantially weaker than implied by fundamentals and desired policies (Annex V). The current account deficit narrowed from the peak at 49 percent of GDP in FY2022 to 20 percent in FY2024, reflecting the tourism recovery and higher external grants which offset increased import demand. Despite the recent decline, the current account gap remained at -7.5 percent. Further fiscal adjustment, structural reforms to diversify the domestic economy, and the ongoing efforts to promote high-value tourism would help narrow the saving-investment gap and facilitate external rebalancing. Financial inflows have remained robust, supported by foreign direct investment (FDI) in high-end hotel projects and additional US contributions to the CTF. During FY2021-24, the REER appreciated by 29.7 percent and the NEER by 11.5 percent, but both have since depreciated by 5 percent and 1 percent in FY2025, respectively, due to a weaker US dollar.

Current Account and Fiscal Balance
(In percent of GDP)



Sources: Palau authorities; and IMF staff calculations.

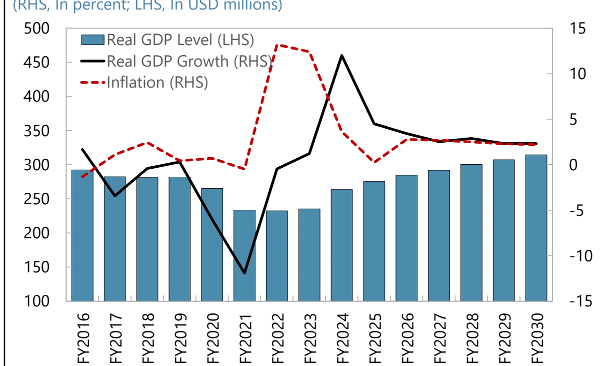
Real Effective Exchange Rates
(Index 2010=100)



OUTLOOK AND RISKS

8. The near-term outlook remains robust despite heightened global uncertainty. Continued recovery in tourism—supported by additional flights and expanding tourism exports to Australia and Japan—together with ongoing hotel construction and infrastructure projects, is expected to underpin growth in the near term. Public sector wage increases in FY2026 (¶10) are expected to raise real disposable income and boost consumption. While growth is to remain robust, it is projected to moderate to 4.1 percent in FY2026, accounting for spillovers from global economic policy uncertainty and normalization from the post-pandemic rebound. Real GDP is projected to surpass its pre-pandemic level in FY2026. After declining in FY2025, inflation is expected to edge up in the near term due to higher global food prices, before subsiding to around 2 percent over the medium term.

Baseline Projections
(RHS, In percent; LHS, In USD millions)



Sources: Graduate School USA; and IMF staff calculations.

9. Uncertainty remains elevated, with risks tilted to the downside (Annex VII). Spillovers from geopolitical tensions and global policy uncertainty present key near-term risks, which could delay Palau's full tourism recovery, disrupt foreign investments, and affect donor support (Annex IV). Given dependence on imports, especially food and energy, Palau is highly vulnerable to commodity price volatility including the impact on inflation. Domestically, Palau could face potential macro, fiscal and financial integrity risks stemming from emerging digital initiatives (¶17) and remains prone to climate-related shocks. If external financial conditions significantly tightened, there could be adverse spillovers, especially if the specific banks operating in Palau are directly impacted, which could lead to disruptions in the payment system and potential cash shortages, given the dominance of US bank branches and lack of a domestic payment system, and other financial stability concerns. In the long run, continued emigration of skilled labor may further constrain public sector capacity and limit the private sector's growth potential. In the event of downside shocks, policy responses should prioritize targeted and time-bound support to vulnerable groups, alongside prudential policies to safeguard financial stability, while allowing for broader support as warranted by nature and scale of the shocks. In the meantime, credible plans to strengthen policy buffers and address structural challenges (¶20-22) remain critical to enhancing resilience against future shocks.

Authorities' Views

10. The authorities broadly agreed with staff's assessment of the outlook and risks. While their expected recovery path broadly aligns with staff projections, the authorities anticipate higher near-term growth and medium-term potential supported by the expansion of tourism sources and economic diversification, including the development of financial services. With respect to risks, they highlighted geopolitical tensions and national security concerns, particularly those associated with illicit activities and cyber-attacks, as key near-term risks, while outward migration of skilled labor and materialization of climate shocks remain structural vulnerabilities for Palau. The authorities also underscored their ongoing efforts to build policy buffers, including the accumulation of savings and debt reduction, as well as initiatives to enhance climate resilience through targeted investments, e.g. new hospital project (¶12), to mitigate the impact of external shocks.

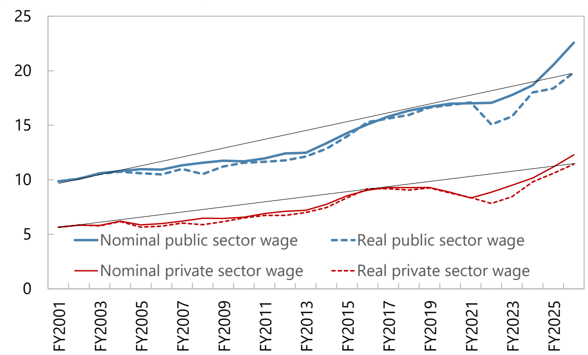
POLICY DISCUSSIONS

Palau should focus on preserving fiscal buffers while leveraging its expanded fiscal space to enhance resilience against growth and extreme weather events. This entails reducing debt towards the debt anchor, prioritizing resilience-enhancing investments, and accelerating pension reform, while strengthening public financial management to manage fiscal risks. Financial policies should focus on enhancing supervision and regulation to safeguard financial stability, while addressing financial intermediation and payment system challenges through policy options tailored to Palau's size and resources. Risks associated with the digital and fintech initiatives should be carefully managed by strengthening the legal, supervisory and regulatory frameworks.

A. Ensuring Fiscal Sustainability and Enhancing Resilience

11. Near-term fiscal policy continues to remain prudent, supporting ongoing debt reduction efforts. The FY2026 budget was passed on December 5, 2025, after two months of delay, during which spending was limited to up to 25 percent of the FY2025 budget envelope. Despite higher debt service costs and costs of living pressures, current spending under the FY2026 budget is tightly restrained. A 10-percent increase in public sector wages and disability pensions is offset by reductions in untargeted consumer electricity subsidies, transfers to state governments, and additional one-off spending cuts. The broadly neutral fiscal stance—with a steady primary surplus of 2.9 percent of GDP in both FY2025 and FY2026— is appropriate given the continued economic recovery. Increases in wages and disability pensions are broadly justifiable to compensate for accumulated costs of living increases. However, future wage adjustments should be restrained—as real wages have returned to their pre-pandemic trend after falling sharply during the inflation surge of FY2023—and more targeted, to reduce wage compression. (Annex III). Capital spending, which is off-budget and earmarked to external grants, is projected to remain broadly stable in the near term.

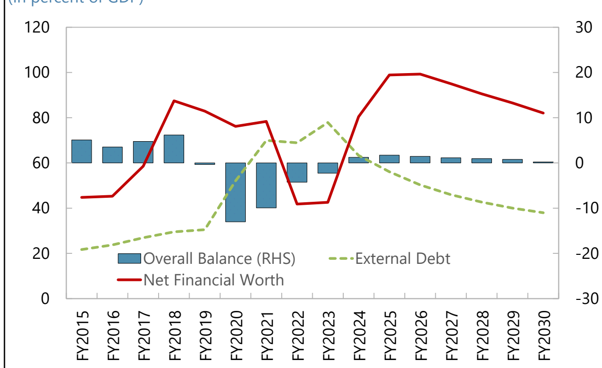
Public and Private Sector Salary
(In thousands of U.S. dollars)



Sources: Palau authorities; Graduate School USA; and IMF staff calculations.

12. Effective implementation of a medium-term fiscal strategy that facilitates debt reduction towards the debt anchor and promotes resilience-enhancing investments is essential. Maintaining fiscal surpluses while preserving buffers, as projected in the baseline, is critical to strengthening resilience against natural disasters, growth volatility, potential reduction in grant receipts, and contingent liabilities arising from pensions and state-owned enterprises (SOEs). The authorities are finalizing the FY2026-29 fiscal strategy. While the current draft broadly aligns with Palau's development and fiscal sustainability objectives, it would benefit from addressing the following areas:

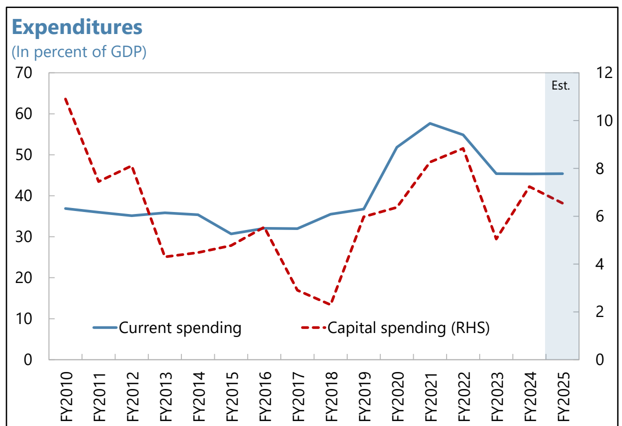
Medium-Term Fiscal Outlook
(In percent of GDP)



Source: IMF staff calculations.

- ***Developing a debt reduction strategy and strengthening compliance with savings rules:*** Palau's Fiscal Responsibility and Debt Management Act (FRDMA), together with an associated debt management policy, sets a debt anchor at 30 percent of GDP. While some fiscal rules already exist, such as capping operational expenses by operational revenue, they are not directly linked to the debt anchor. This warrants a thorough review of the existing rules, including their consistency with each other and with the debt anchor. The medium-term fiscal strategy should set out a concrete debt reduction strategy, aligned with medium-term spending priorities, to guide debt reduction towards the debt anchor. Specifically, the strategy should define a clear trajectory for reducing the debt stock and establish clear rules governing new borrowing and anticipated principal repayments. Staff recommends (i) limiting new borrowings, including on-lending to SOEs, to high-priority investment projects with transparent and concessional lending terms in domestic currency (US dollars) and (ii) prepaying high and variable interest rate loans to alleviate the debt servicing burden. To strengthen compliance with the debt anchor going forward, Palau should consider designing simple operational fiscal rules aligned with its debt anchor, with IFI technical assistance. Further capacity development in debt sustainability analysis and debt management and reforms to strengthen PFM will be essential for effective implementation. In the meantime, compliance with the rules governing withdrawals from the reserve funds should be reinforced.[2]

- ***Improving expenditure efficiency and promoting resilience-enhancing investment:*** It is essential to complete the pending spending audits and improve spending efficiency by further streamlining and better targeting subsidies and transfers. The authorities' ongoing efforts to invest in infrastructure, health, and education are welcome. To achieve the authorities' capital investment target of 10 percent of GDP, holistic planning and coordination across government agencies will be essential. In this context, the authorities should update Palau's National Development Plan (NDP), expiring in FY2026, as well as the corresponding annual infrastructure investment plans, to lay out priorities and concrete implementation and financing plans on resilience-enhancing investment (Annex II). The authorities should continue to mobilize low-cost financing for the much-needed investment projects, prioritizing domestic savings and expanded donor support. The proposed comprehensive spending review in the draft fiscal strategy is welcome. An assessment of the social assistance needs and programs would be warranted and can be informed by the recent Household Consumption and Income Survey.



Source: IMF staff calculations.

- ***Expanding revenue mobilization efforts:*** To reap the full benefits from the successful tax reform, the immediate priorities are to further enhance revenue administration, focusing on strengthening governance and the legal framework, modernizing IT systems, and building revenue administration capacity while preventing policy changes that could erode the tax base. The ongoing efforts to update the Tax Administration Act and upgrade the Tax Information System are welcome steps. Over the longer run, the authorities could consider developing a plan to phase in further reforms to broaden the tax base and improve redistribution (e.g.

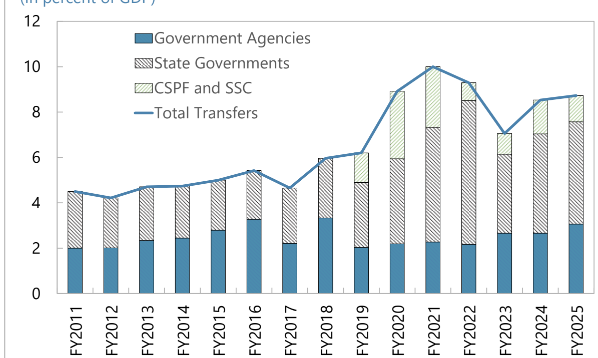
[2] Include Cyclical Reserve Fund and Climate Resilience Fund.

implementation of a comprehensive income tax regime), accounting for the country's institutional capacity (Annex I).

13. To contain fiscal risks, swift preparation and implementation of pension reform remains critical. Palau's pension system faces challenges from underfunding and demographic pressures from an aging population and emigration, particularly for the CSPP but also the SSA pension schemes. Swift implementation of a comprehensive set of pension reforms is crucial to curtail growing unfunded liabilities and ensure long-term fiscal stability. Ongoing reform efforts, including the commitment to update the actuarial analysis and approve a bill on the CSPP pension reform, are welcome. However, a thorough cost-benefit analysis of the available reform options – including on retirement age, contribution rates, choice of defined-benefit or defined-contribution scheme – and their associated implementation implications, are critical and should continue to leverage technical support from the IFIs.

14. Reforms of SOEs, underpinned by strengthened oversight and regulation, are critical to ensuring their financial soundness and reducing fiscal risks. Managing the financial position of the SOEs remains a key challenge, including both the Palau Public Utility Company (PPUC) and the Belau Submarine Cable Corporation (BSCC). While progress has been made such as PPUC's recent adoption of utility tariffs at cost recovery levels – these measures have contributed to an inflation spike in FY2023 and prompted substantial increases in untargeted government subsidies to offset household utility charges, creating continued fiscal burden. To better manage fiscal obligations and risks, household subsidies should be better targeted, and the PPUC tariff-setting mechanism should be improved to incorporate cost control and broaden the consumer base, with fully transparent tariff calculations.[3] More broadly, enhancing public sector oversight and regulatory capacity while creating proper consumer protection mechanisms will be essential to ensure effective monitoring and scrutiny of SOEs, including their financial situation, debt servicing capacity as well as pricing and investment decisions.

Total Budget Transfers to Public Sector
(In percent of GDP)



Sources: Palau authorities; and IMF staff calculations.

15. Further improvements to Palau's public financial management, as recommended in the PFM reform roadmap, should continue. With PFTAC's assistance, the PFM reform roadmap identified a few priority reform areas, including (i) improving the transparency of budget and debt reporting processes; (ii) completing overdue and pending audits and ensuring timely audits of current and future financial statements; (iii) establishing the legal and institutional framework to ensure effective oversight of SOEs; (iv) incorporating climate adaptation policies into the budget

[3] Given the current legal requirement, the water and sewer tariffs are currently charged only on households in the Koror and Airai states, about a third of total Palau households.

process; and (v) strengthening fiscal management capacity of state governments to help them better manage their resources and reduce reliance on the national budget. Reforms should be properly sequenced based on priorities and institutional capacity.

Authorities' Views

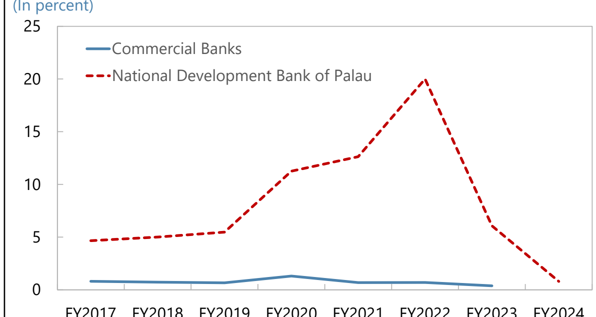
16. The authorities broadly agreed with staff's recommendations on the fiscal strategy. They stressed their commitment to developing a debt reduction strategy and would welcome IMF TA on operational fiscal rules and PFM reforms to build a path toward compliance with the 30 percent debt anchor. They saw an ongoing need to borrow for development purposes, including in affordable housing –which is key to attracting young skilled workers to return – but would prioritize low-interest borrowing for high-value projects and focus on accelerating the repayment of high and variable interest loans. The MoF concurred with staff's recommendations on preventing the erosion of the tax base and welcomed continued technical assistance to further strengthen tax administration. The authorities saw the recent wage increases as necessary to compensate for the rise in cost of living. They stressed their commitment to implement IMF TA recommendations to reduce wage compression. However, they noted that the Employment and Compensation Commission responsible for wage policies has yet to become operational.

17. The authorities agreed to prioritize pension reforms and make progress on other public sector reforms to better manage fiscal risks. They noted that pension reforms for the CSPF and SSA are at the forefront of their near-term policy priorities, as external financing support would depend on the approval of the respective pension reform laws by Congress. The authorities would welcome technical support from IFIs, including IMF TA, and agreed to conduct thorough cost and benefit analysis on reform options. The authorities agreed with the principle of making subsidies more targeted and acknowledged the need for a stronger regulatory framework to improve SOEs' operating and investment efficiency. State governments voiced their intention to increase revenue-generating capacity and strengthen PFM to reduce reliance on the central government.

B. Deepening Financial Market and Safeguarding Stability

18. The financial system appears broadly stable, despite pockets of vulnerability that warrant enhanced supervision and regulation. Commercial banks in Palau remain resilient, maintaining ample liquidity, solid capital buffers, low non-performing loans (NPL), and stable returns. However, during the pandemic, NDBP's loan book expanded significantly and its NPL ratio rose to 20 percent. Since FY2023, NDBP has increased provisioning and written off a sizable amount of NPLs, which fell to 0.8 percent in FY2024. Due to its critical role in credit provision and potential fiscal and systemic risks, NDBP needs enhanced

Nonperforming Loans to Total Loans
(In percent)

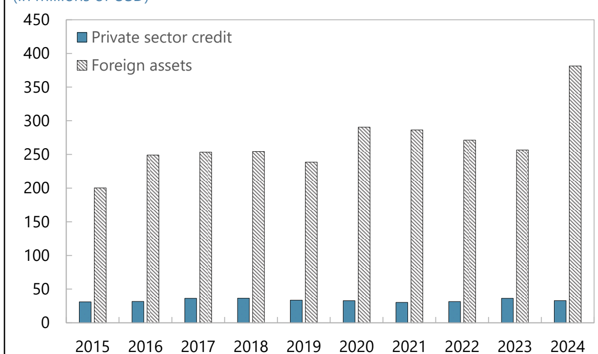


Sources: Palau Financial Institutions Commission; Palau Office of the Public Auditor; and IMF staff estimates.

supervision, risk management, and reporting. Staff recommends formal supervision and regulation of NDBP by Palau's Financial Institutions Commission (FIC), whose capacity needs to be significantly strengthened in line with its broader mandate.[4] The US branches remain systemically important; therefore, continued efforts to strengthen prudential regulations, contingency planning, and crisis preparedness are warranted. This includes updating the Financial Institutions Act (FIA), with potential Fund's technical assistance.

19. Addressing the structural challenges within Palau's banking system is essential to improve financial intermediation. The commercial banking system, dominated by US branches, transfers 92 percent of assets overseas instead of lending domestically. High lending standards, limited access to credit risk information, challenges in using land as collateral, lending rate ceilings on commercial loans, and inconsistent business record-keeping practices among SMEs constrain lending by foreign branches (SIP). NDBP partially fills the lending gap but faces funding limits.[5] The authorities are taking welcome steps to address these challenges, including establishing a credit registry with assistance from the ADB, revisiting the interest rate ceiling on commercial loans to allow greater flexibility for lenders to price risk, and making tax information available to improve credit assessments on SMEs. Clarification of legal uncertainties for foreign banks regarding land titles and foreclosure procedures could also be considered.[6] In contrast, policies aimed at enforcing domestic lending by foreign branches, such as the recently submitted Community Reinvestment Act, are unlikely to be effective, may risk credit misallocation, and could lead to the exit of foreign banks. Other efforts to increase funding for NDBP, including the proposed Palau Savings Bond (¶20) and foreign borrowing (¶12), would require scrutiny given associated fiscal risks.

Commercial Bank Assets
(In millions of USD)



Source: Graduate School USA.

20. The planned PSB, while intended to mobilize and retain domestic savings, should be carefully developed, with risks properly ringfenced. The government's aim is for the PSB to provide citizens additional options to save and invest, and to retain and mobilize household savings for the domestic economy. The pilot platform of the PSB, operated by blockchain-based technology, was first introduced in FY2024. The authorities are working on finalizing the prospectus, setting out the terms and institutional arrangements. Before the full launch, the authorities need to carefully assess the financial viability of PSB including the revenue generating capacity, operating costs, and potential fiscal risks. The coupon rate and maturity structure of the PSB should justify demand and

[4] FIC has an expanding mandate as laid out in its strategic plan (e.g., to regulate and supervise virtual assets/virtual asset service providers (VA/VASP)).

[5] Not deposit taking and only relies on long-term borrowing and loan repayments for funding.

[6] Including continuing work on the land registry and building the necessary prerequisites for land title insurance.

address potential maturity mismatch and fiscal risk concerns as raised funds are expected to finance infrastructure, housing, and SME projects through the NDBP. In this regard, strengthening risk management and supervision of the NDBP, updating debt management policy, and clarifying the mechanism of fund transfers between MoF and NDBP are critical (SIP). In the meantime, the supervisory, regulatory and legal frameworks need to be fully developed.

21. Efforts to improve payment efficiency should be guided by a comprehensive strategy tailored to Palau's economic size and resources. Palau's payment system relies on an external payment network and heavy use of cash, while facing relatively high transaction costs.[7] The authorities have been striving to modernize the payment system, starting with a pilot TD in FY2022 followed by its inclusion in the draft DPSB Bill (¶4). Without robust safeguards, the TD initiative could entail significant macro-financial, fiscal, legal, financial integrity, regulatory, cybersecurity, and reputational risks (see the accompanying Selected Issues Paper). The operational costs and the required work to build the necessary safeguards are disproportionally high in relation to Palau's resources, including the need to address gaps in the legal, prudential and regulatory framework, clarify reserves management and redemption guarantees, develop cybersecurity and data privacy protections, and ensure strong governance and supervisory oversight. Implementation of the TD should await until a comprehensive cost-benefit analysis and full-fledged feasibility study have been conducted, and risk mitigating safeguards are in place. Alternative payment options, possibly including adoption of exiting mobile money technology, should be considered, as they may be more commensurate with Palau's economic size and resources. Staff recommend starting by developing a tailored domestic payment strategy, with technical support from IFIs, to guide broader payment reforms.[8]

22. The authorities should strengthen the safeguards of the Digital Residency Program (DRP) to mitigate potential financial integrity risks.[9] The Digital Residency Act's provision on legal name changes, not yet implemented, poses financial integrity risks. Staff recommend repealing this provision, while enhancing risk mitigation measures to ensure transparency, oversight, and accountability. Robust vetting of applicants, including sanctions and politically exposed persons screening, remains key. Periodic reviews of applicants will help identify any changes in the risk profiles of DRP ID holders.

23. The AML/CFT framework requires further enhancements and a cautious approach to digital initiatives. Given gaps in the legal, prudential, AML/CFT frameworks, and low institutional capacity, Palau's digital initiatives, especially the tokenized dollar and digital residency program, may pose significant risks notably to the integrity of the financial system, which could lead to potential loss of Corresponding Banking Relationship (CBRs). Palau's work on a national assessment of money

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[7] Primarily on cross-border wire transfers.

[8] With technical assistance from IFIs, including the WB FSAP Development Module.

[9] Launched in February 2022, Palau's Digital Residency Program offers global citizens the chance to establish a digital identity, providing services like mail forwarding, a virtual phone number, e-Corporations registry, digital notary, access to services such as crypto trading and KYC-compliant digital finance, and extended stays.

laundering and terrorist financing (ML/TF) risks is a welcome step; developing a national AML/CFT strategy in line with the findings of that assessment would further enhance the risk management efforts. The authorities should also address the AML/CFT deficiencies identified in Palau's 2018 mutual evaluation by improving preventive measures and implementing FATF Recommendation 15. This includes conducting a comprehensive assessment of ML/TF risks posed by Virtual Assets/Virtual Asset Service Providers (VA/VASPs), as well as establishing a robust framework for AML/CFT supervision of VASPs. To mitigate non-resident ML/TF risks, Palau's Foreign Investment Board should strengthen its internal AML/CFT measures. Finally, strengthening risk-based AML/CFT supervision for financial institutions and designated non-financial business and professions and improving the collection and publication of beneficial ownership information by companies remain priorities.

Authorities' Views

24. The authorities broadly concurred with staff on the need to strengthen bank supervision and enhance financial intermediation, while acknowledging significant operational challenges. The FIC has requested technical assistance to update Palau's legal framework – specifically the Financial Institutional Act – to better align financial regulation with its broader mandate. Although the authorities agreed with staff on the importance of improving bank supervision and regulation, they noted the limited capacity of the current supervisory authority and the efforts underway to strengthen it. The authorities highlighted their ongoing efforts to address structural challenges on financial intermediation, including the establishment of a credit bureau and the review of lending rate caps. The authorities do not consider the use of land as collateral to be a constraint on lending by foreign branches. They see merit in considering alternative options such as enforcing lending floors on foreign branches (for example, the Community Reinvestment Act) and increasing funding to NDBP, including through the Palau Savings Bond and additional foreign borrowing.

25. The authorities have decided to take a cautious approach to the TD initiative and explore alternative payment options tailored to Palau. While maintaining a strong commitment to improving payment efficiency and developing financial services through digital and fintech initiatives, the authorities recognized the importance of proceeding prudently. They acknowledged the cost and risks associated with the TD and the need to address gaps in the legal, supervisory, and regulatory frameworks, in line with staff recommendations. The authorities conveyed openness to consider alternative payment solutions, such as mobile money, and welcomed technical assistance from IFIs to support the development of a domestic payment strategy and further refinement of the payment service bill.

C. Promoting Economic Resilience and Sustainable Growth

26. Palau's economic resilience and growth potential hinges on effective implementation of its development agenda. The comprehensive National Development Plan for FY2023-26 sets out the key priorities and action plans to diversify the economy and promote sustainable and inclusive growth. Some progress has been achieved, including expansion of cultural tourism and development of small-scale manufacturing of handcrafts. The eco-tourism strategy, formulated in FY2025, further identified detailed plans to promote high-value tourism and diversify tourism markets. Nevertheless, additional efforts are needed to foster entrepreneurship, address infrastructure gaps, and attract foreign direct investment – particularly those generating positive spillovers to the domestic private sector – while strengthening the rule of law, land use planning, and the regulatory framework. An update of the National Development Plan could help by taking stock and guiding next steps. Successful implementation will require close coordination efforts across government agencies and with the private sector.

27. Addressing the ongoing challenge of loss of skilled labor requires effective labor market policies, supported by structural reforms. Palau's total population, including migrants, has declined by about 10 percent since 2005, resulting in labor shortages, particularly among high-skilled workers. Previous efforts to address these challenges, such as across-the-board minimum wage increases, have not been successful at retaining high-skilled labor. Incorporating variation in productivity into wage-setting, alongside continued efforts to reduce wage compression, could lead to better-targeted approaches. These measures, supported by targeted labor market policies and structural reforms, are essential to address persistent labor shortages and support sustainable growth (Annex III).

28. Integrating climate adaptation policies into the country's development strategy remains essential. While Palau internalizes climate risks by maintaining fiscal buffers and periodically updating adaptation policies, these policies need to be more systematically integrated into development planning, PFM, and the budget process to ensure more efficient resource allocation.[10] Strengthening supervisory capacity, integrating climate-related risks into financial oversight, and enhancing data systems will help bolster financial sector resilience.

Authorities' Views

29. The authorities broadly agreed with staff on the structural reform priorities. They underscored ongoing efforts to strengthen infrastructure, with particular emphasis on adapting to climate vulnerabilities. The authorities expressed their commitment to further infrastructure improvements, primarily financed through donor support or concessional borrowing rather than drawing on savings or the CTF. In terms of reform priorities, the authorities highlighted their intention to update the National Development Plan, which is set to expire next year. For effective implementation, they agreed with staff's recommendation to enhance coordination across government agencies. Regarding economic diversification, the authorities expressed interest in developing financial services in addition to upgrading the tourism sector. They identified loss of skilled labor as a regional challenge, which they believed can be mitigated by raising wages and increasing the availability of affordable housing. The authorities reaffirmed their commitment to advancing recommended structural reforms.

[10] Recent Green PFM TA provided recommendations to help integrate climate measures into the PFM.

CAPACITY DEVELOPMENT AND DATA ISSUES

30. Building on the momentum achieved thus far, continued Fund support for capacity development will be carefully sequenced to facilitate the implementation of priority reforms. The Fund's technical assistance (TA) has played an important role in facilitating essential reforms, notably the successful implementation of the tax reform and the establishment of the Employment and Compensation Committee. Continued reform efforts to strengthen PFM, AML/CFT framework, and revenue administration will benefit from the ongoing TA. To further strengthen the authorities' capacity to manage financial and fiscal risks, including those arising from the fintech and digital initiatives (Annex XI), additional technical assistance in the areas of prudential regulations, debt sustainability analysis, debt management, pension reform, and the development of a domestic payment strategy would be helpful (Annex XI). Importantly, TA needs to be carefully sequenced to reflect reform priorities and institutional capacity.

31. Further improvement of statistics remains crucial to support surveillance. While Palau's statistics are broadly adequate for surveillance, further improvements in data coverage and timeliness are warranted. Key priorities include improving GDP deflators, broadening the coverage of fiscal and BOP data, developing quarterly statistics for the balance of payments and real sectors, and ensuring timely reporting and audit of banks' financial statements (Annex IX).

Authorities' Views

32. The authorities concurred with staff's assessment of data gaps and capacity development priorities. They reiterated their commitment to addressing data gaps with support from the Graduate School USA and IMF technical assistance. To facilitate essential reforms, the authorities also agreed on the importance of prioritizing capacity development to strengthen tax administration, facilitate debt reduction, enhance financial supervision and regulation, implement pension reform, and develop a tailored national payment strategy.

STAFF APPRAISAL

33. Palau's economy experienced a strong rebound and is projected to maintain robust growth, while inflation remains broadly contained. Flight resumption from key tourism markets, increased construction activity, improved fiscal space from CRA-23, and wage increases boosted demand and economic activity, contributing to a strong rebound in FY2024 and robust growth in FY2025. The economy is expected to carry on the growth momentum in the near term with support from additional flights, diversifying tourism markets, and construction projects. After declining to the low single digits in FY2025, inflation is projected to remain broadly contained despite the upside pressure from wage increases, which will be partially offset by lower food prices.

34. Palau's external position has improved but remains substantially weaker than implied by fundamentals and desired policies. The current account deficit has narrowed, reflecting a recovery in tourism activity, which was supported by weaker dollar and real exchange rate depreciation. The tight fiscal stance in FY2024 also contributed to narrowing the saving-investment gap. Nonetheless, the FY2024 current account deficit is estimated to be about -7.5 percent of GDP larger than the level implied by economic fundamentals and desired policies. Further resumption of tourism activity and the authorities' efforts to pivot towards high-value tourism, structural reforms to diversify the domestic economy, and fiscal adjustment would help improve Palau's external balance.

35. Risks remain tilted to the downside, underscoring the importance of robust contingency planning. Heightened global economic and policy uncertainty risk clouds the outlook, potentially delaying the recovery, disrupting import prices, and adversely affecting foreign direct investment and donor financing. In addition, spillovers from tighter global financial conditions—transmitted through the systemically important foreign bank branches—could result in payment system disruptions. Furthermore, premature implementation of digital and fintech initiatives, without adequate safeguards, could expose the economy to macroeconomic, fiscal, and financial integrity risks. In this context, the authorities should prioritize contingency planning to protect the vulnerable groups and preserve economic and financial stability should these risks materialize.

36. The medium-term fiscal strategy should prioritize reducing debt, improving spending efficiency, and expanding revenue mobilization efforts. Developing a comprehensive debt reduction strategy aligned with the existing debt anchor, setting out a clear debt path and rules for new borrowings and principal repayment, would be critical to guide the debt reduction efforts. To enhance compliance with the FRDMA, the authorities should continue to strengthen institutional capacity and public financial management while considering appropriate fiscal rules. Compliance with the rules on reserve funds would further support the preservation of fiscal buffers. The authorities should continue to promote resilience-enhancing investments consistent with development objectives, focusing on updating the National Development Plan (NDP) and corresponding annual infrastructure investment plans, improving coordination across implementation agencies, and mobilizing financing, preferably from donors or existing savings. Revenue mobilization efforts should continue, with near-term priority on strengthening revenue administration.

37. Swift implementation of pension and SOE reforms is important to better manage fiscal risks. Effective implementation of reforms of the CSPP and SSA pension plans should be guided by thorough cost- benefit analysis of the available reform options. SOE reforms remain critical to improve their financial situation and reduce fiscal risks. For PPUC, the tariff-setting mechanism needs to be improved and made fully transparent, supported by better-targeted household subsidies to protect the most vulnerable. Enhanced oversight and regulation of SOEs are critical to help better guide their investments and improve SOEs' cost efficiency. Reforms to strengthen PFM should continue, including for state governments.

38. Enhanced financial sector supervision is essential to safeguard financial stability and mitigate systemic risks. While the financial sector remains broadly sound, significant gaps persist in financial supervisory oversight and regulation. Staff recommend strengthening supervision of NDBP, given its systemic role in credit provision, including formal supervision by the FIC, whose capacity needs to be significantly strengthened in line with its broader mandate. Macro and financial integrity risks stemming from the digital and fintech initiatives should be carefully managed with a stronger legal, supervisory and regulatory framework.

39. Improving financial intermediation requires concerted efforts to address multi-faceted structural challenges. Private sector credit continues to be constrained by collateral constraints, limited access to credit information, and lending rate caps. Ongoing reforms to establish a credit registry, revisit interest rate caps and enable the use of tax information for credit risk assessments are welcome steps to incentivize domestic lending. The authorities could also continue the work to help clarify the legal uncertainties for foreign banks regarding land titles and foreclosure procedures. While the planned PSB intends to mobilize domestic savings, it needs to be carefully developed with thorough cost and benefit analysis and strong safeguards. Over the medium term, greater economic diversification, enhanced financial literacy, and improvements in the business environment will also facilitate stronger credit growth.

40. Efforts to improve payment efficiency should be guided by a comprehensive domestic payment strategy tailored to the country's economic size and resources. The TD, if pursued, could entail significant risks — including macro-financial, legal, regulatory, and financial integrity concerns— without robust safeguards. A thorough cost-benefit analysis and feasibility study, along with reforms to strengthen legal, supervisory and regulatory framework are essential before launching the TD. Alternative payment options, such as mobile money, may be more suitable, with efforts grounded in a tailored domestic payment strategy to guide broader payment reforms.

41. Well-sequenced and coordinated implementation of structural reforms helps enhance economic resilience and promote sustainable growth. Ongoing efforts to diversify and increase value-added within the tourism sector, including the recently developed eco-tourism strategy, are welcome. Further efforts to address infrastructure gaps, promote FDI, and facilitate financial intermediation remain critical. One priority is to update the National Development Plan for the next four years, followed by effective implementation facilitated by close coordination across government agencies. Effective labor market policies and structural reforms will be critical to mitigate challenges related to loss of skilled labor and raise productivity. Climate policies can be better integrated into development planning and public financial management to support climate adaptation efforts.

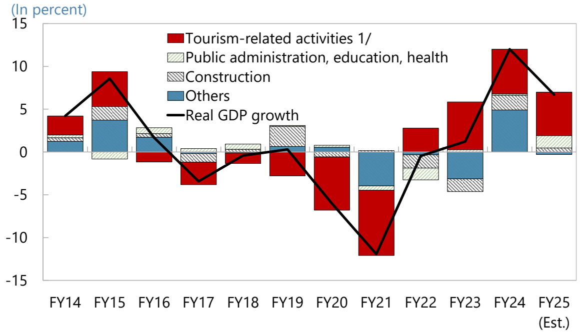
42. Further data improvement and capacity development are important to support sound policies and essential reforms. While broadly adequate for surveillance, Palau's statistics need further improvement, including the coverage of fiscal and BOP data. Essential reforms on PFM, revenue administration, and debt management require continued CD support, particularly to update the legal framework for financial institutions, develop a domestic payment strategy, produce a thorough cost-benefit analysis on pension reforms, and improve fiscal framework.

43. It is recommended that the next Article IV consultation take place on a 24-month cycle.

Figure 1. Palau: Real Sector Developments

Palau's economy began to recover in 2023, supported by resuming tourism and construction activity.

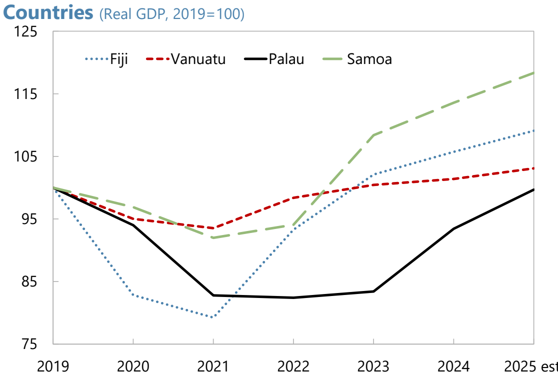
Contribution to GDP Growth
(In percent)



1/ Includes wholesale trade, transport, storage, repair of motor vehicles, and hotel and food services.

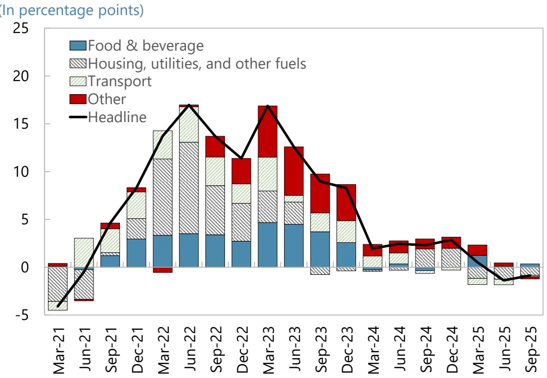
... although its recovery has been slower than that of peers.

Economic Recovery in Tourism-Based Pacific Island Countries (Real GDP, 2019=100)



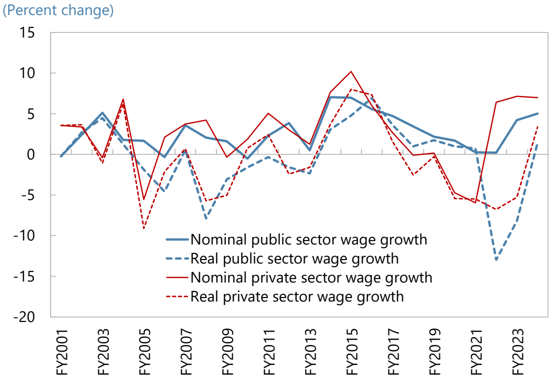
Inflation has remained contained since the peak in 2023.

Contribution to Headline Inflation
(In percentage points)



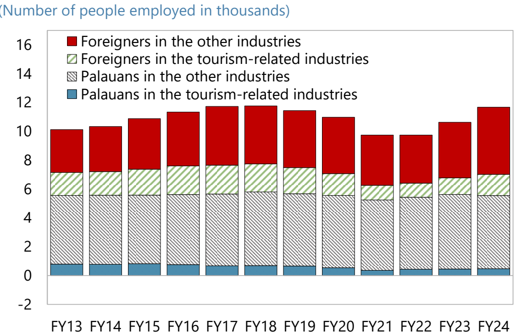
... which supported recent real wage growth.

Public and Private Sector Salary Growth
(Percent change)



Foreign workers returned after the Pandemic, supporting the recovery of employment.

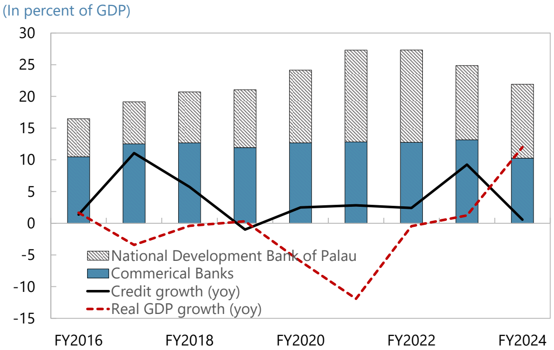
Employment
(Number of people employed in thousands)



Note: Tourism-related industries includes transport, hotel, restaurant and entertainment.

Despite the growth recovery, credit declined.

Credit and Economic Growth
(In percent of GDP)



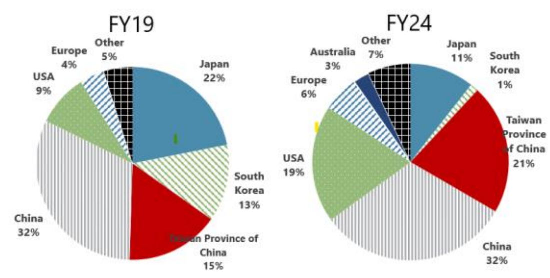
Source: Graduate School USA.

Sources: Palau authorities; the Graduate School USA; IMF's *World Economic Outlook* database; and IMF staff estimates.

Figure 2. Palau: Tourism Sector Developments

Most visitors to Palau are from East Asia, although there has been some diversification into other markets…

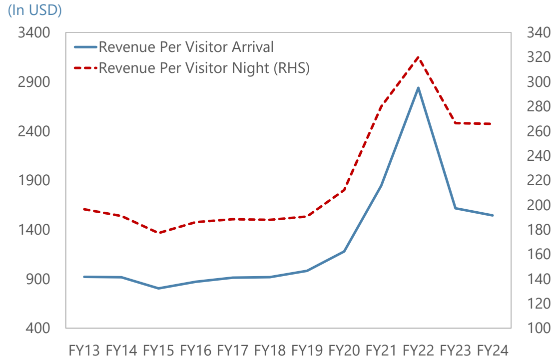
Change in Source Market Composition



Source: Palau Visitors Authority.

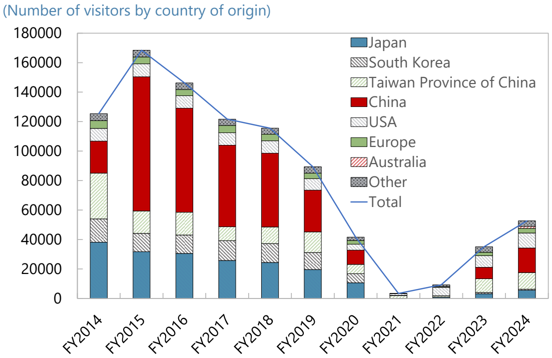
…with higher revenue per tourist arrival/night compared to pre-pandemic.

Revenue per Tourist Arrival/Night
(In USD)



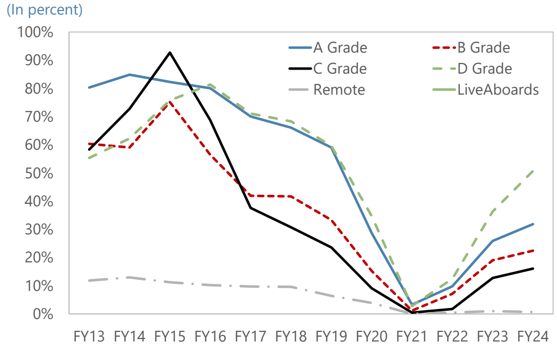
Visitors from China contributed to most to the recent growth in tourism.

Tourist Arrivals
(Number of visitors by country of origin)



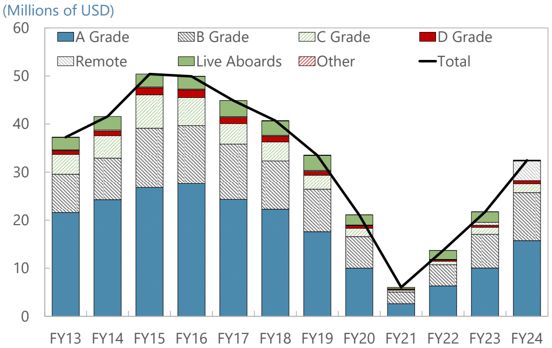
Hotel occupancy rates remain well below pre-pandemic levels, with A-Grade hotels most impacted.

Hotel Occupancy Rates by Hotel Grade
(In percent)



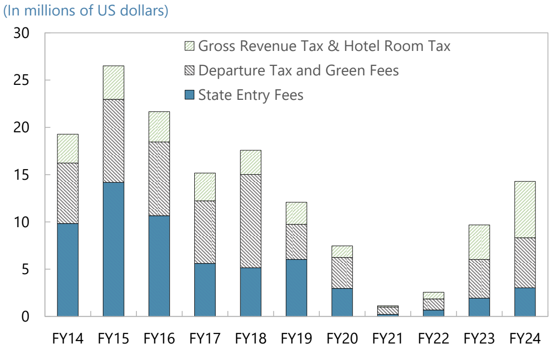
Hotel revenues are rebounding in all categories after the pandemic downturn.

Hotel Revenues by Grade
(Millions of USD)



After steep declines, the recovery of tourism arrivals generated significant tax revenues in FY2024.

Tourism Tax Revenue
(In millions of US dollars)

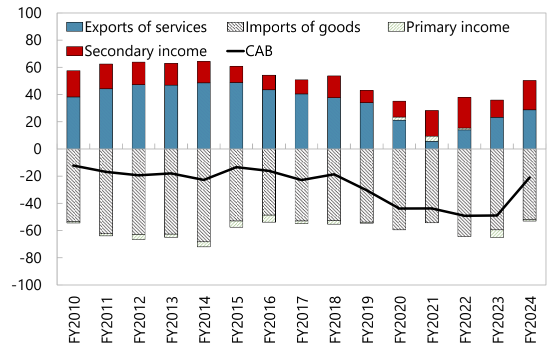


Sources: Palau authorities; and IMF staff estimates.

Figure 3. Palau: External Sector Developments

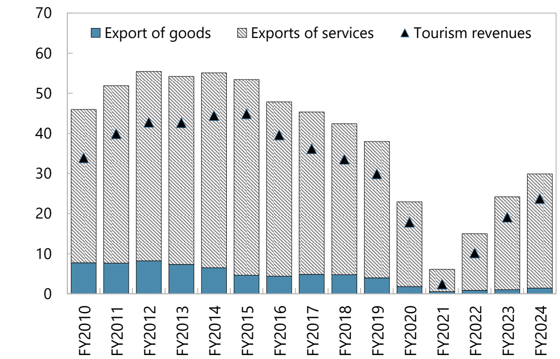
A recovery in tourism and compact-related grants helped restore the current account deficit to near pre-pandemic levels....

Current Account Balance (CAB)
(In percent of GDP)



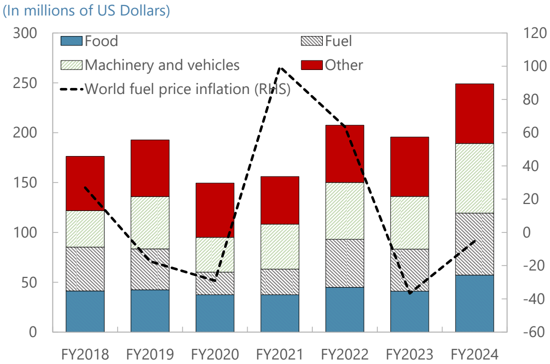
...with tourism revenues on a growth path, supported by higher arrivals and revenues per tourist.

Exports of Goods and Services
(In percent of GDP)



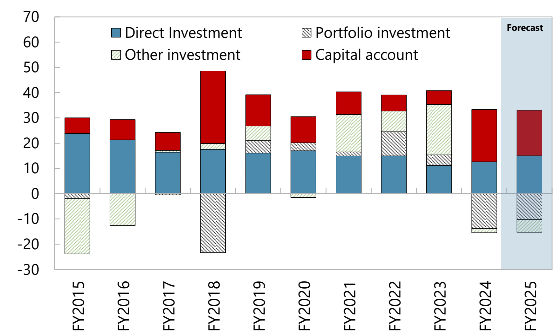
Imports are increasing alongside higher tourism levels and economic growth.

Imports of Goods
(In millions of US Dollars)



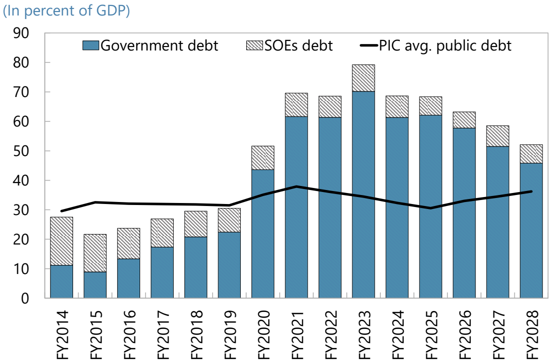
FDI in tourism is robust, while US CTF contributions are strengthening capital and financial accounts in 2024-25.

Capital Account and Financial Account Components
(In percent of GDP)



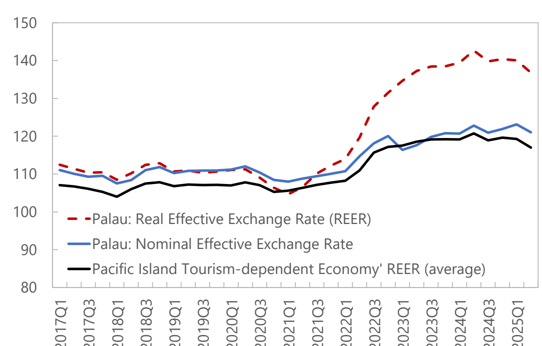
External debt increased sharply during FY20-22 but is forecasted to decline over the medium term.

Public External Debt
(In percent of GDP)



Palau's real exchange rate appreciated more than other Pacific Islands but has depreciated recently due to low domestic inflation and a weaker dollar.

Real Effective Exchange Rates
(Index 2010=100)

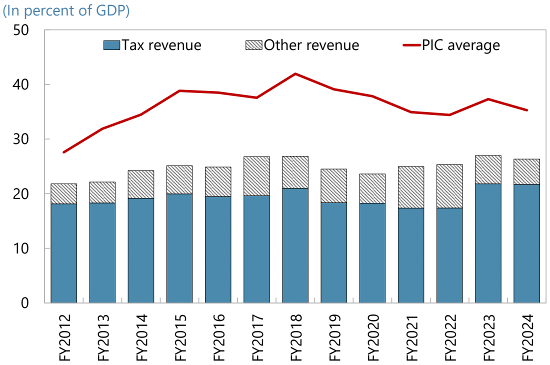


Sources: Palau authorities; IMF Statistics Department; and IMF staff estimates.

Figure 4. Palau: Fiscal Sector Developments

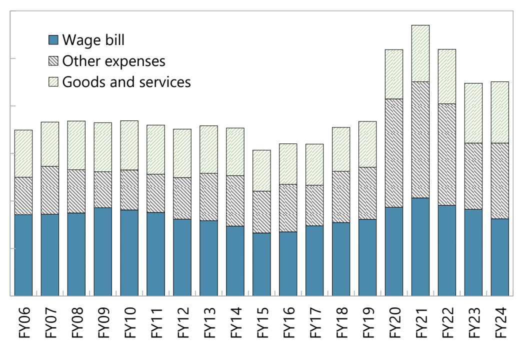
Palau tax reform proved revenue-enhancing from the get-go.

Domestic Revenue
(In percent of GDP)



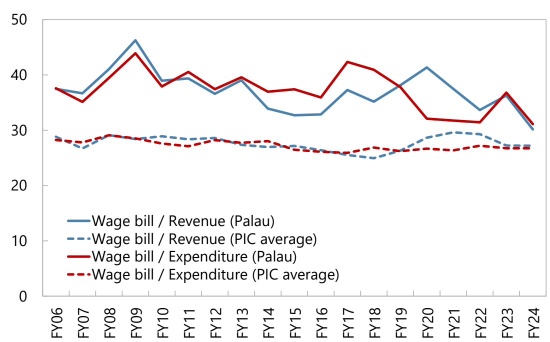
Current spending is declining, but food and fuel prices continue to exert pressures on wages and utility subsidies.

Current Spending
(In percent of GDP)



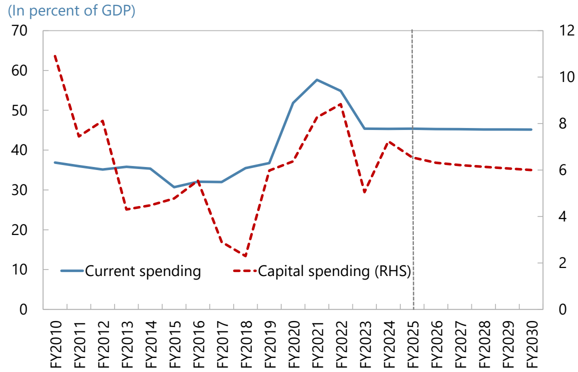
Palau's wage bill is larger than the average of Pacific Island Countries (PICs) reflecting its larger public sector.

Wage Bill
(In percent)



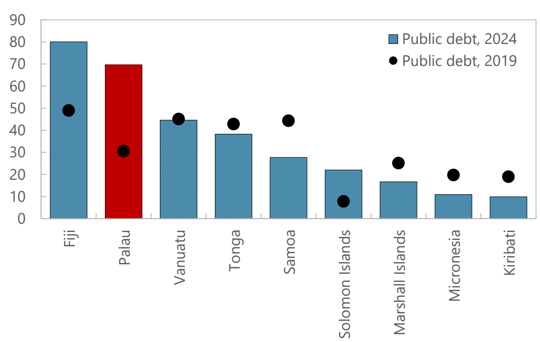
Capital spending has been lower than a decade ago.

Expenditures
(In percent of GDP)



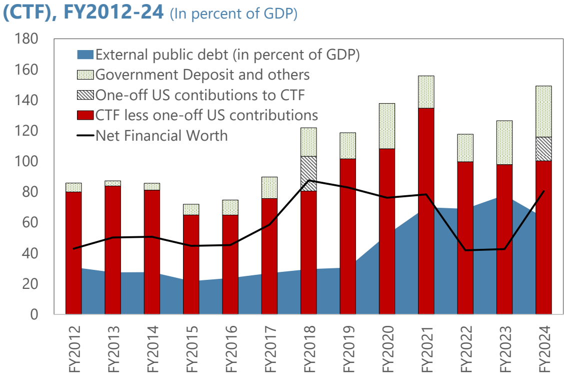
Palau's public debt surged during the pandemic and while on a declining path, remains high by regional comparison.

Public Debt
(In percent of GDP)



Savings buffers are being rebuilt after the pandemic.

Stock of External Public Debt and Compact Trust Fund (CTF), FY2012-24 (In percent of GDP)



Sources: Palau authorities; IMF Statistics Department; and IMF staff estimates.

Table 1. Palau: Selected Economic Indicators, FY2022/23–2029/30 1/

Nominal GDP for FY2024: US$322 million
Population (2024): 17,591
GDP per capita for FY2024: US$18,277
Quota: SDR 4.9 million

	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28	2028/29	2029/30
		Est.			Proj.			
Real sector								
Nominal GDP (million US$)	276.2	321.5	346.6	370.5	390.3	410.1	428.3	447.9
Real GDP growth (percent change)	1.2	12.0	6.7	4.1	2.7	2.6	2.2	2.2
GDP deflator (percent change)	10.2	3.9	1.0	2.7	2.6	2.4	2.2	2.3
Consumer prices (percent change; period average)	12.4	3.6	0.2	2.8	2.7	2.5	2.3	2.2
Tourist arrivals (number of visitors)	35,052	52,661	66,823	83,529	91,047	96,509	102,300	108,438
Expenditure per Tourist Arrival (US$)	1,616	1,606	1,554	1,569	1,609	1,648	1,684	1,723
Public finance		(In percent of GDP)						
Central government								
Revenue	48.1	53.8	53.7	53.1	52.6	52.3	52.0	51.4
Taxes and other revenue	27.0	26.3	28.8	27.3	27.3	27.3	27.4	27.4
Grants	21.2	27.5	24.9	25.8	25.3	24.9	24.7	24.0
Expenditure	50.4	52.6	51.9	51.6	51.5	51.3	51.3	51.2
Expense	45.4	45.3	45.4	45.3	45.3	45.2	45.2	45.1
of which: grants to other government units	6.1	7.0	7.6	7.6	7.6	7.6	7.6	7.6
Net acquisition of nonfinancial assets	5.0	7.2	6.5	6.3	6.2	6.1	6.1	6.0
Current fiscal balance (excluding grants) 2/	-18.4	-19.0	-16.6	-18.0	-18.0	-17.8	-17.8	-17.8
Primary fiscal balance (including grants) 3/	-0.8	2.3	2.9	2.9	2.6	2.4	2.2	1.7
Net lending (+)/borrowing (–)	-2.3	1.2	1.7	1.5	1.2	1.0	0.8	0.2
General government debt	77.9	63.3	56.1	50.2	46.0	42.7	40.0	38.0
		(In millions of U.S. dollars)						
Compact Trust Fund (CTF) balance	270.0	372.3	434.9	445.5	456.3	467.3	478.5	490.0
Financial sector								
Credit to private sector (in percent of GDP)	24.8	21.4	…	…	…	…	…	…
Credit to private sector (percent change)	9.2	0.6	…	…	…	…	…	…
Balance of payments 4/								
Trade balance	-161.4	-162.1	-180.6	-200.0	-211.1	-221.7	-230.5	-239.6
Exports (f.o.b.)	2.8	4.6	4.7	5.2	5.3	5.5	5.5	5.5
Imports (f.o.b.)	164.2	166.7	185.3	205.2	216.4	227.2	236.0	245.1
Tourism receipts	52.8	76.4	97.2	122.7	137.4	149.4	162.1	176.0
Current account balance								
Including grants	-105.4	-65.1	-61.7	-53.1	-51.2	-51.5	-49.0	-45.5
Excluding grants	-158.2	-146.1	-135.5	-134.4	-135.6	-139.0	-139.4	-139.2
International Investment Position	-397.8	-319.7	-289.3	-304.9	-331.2	-359.9	-390.9	-417.1
Assets	685.7	923.7	901.3	932.9	958.4	986.9	1,016.4	1,056.2
Liabilities	1,083.5	1,243.5	1,190.6	1,237.8	1,289.6	1,346.8	1,407.3	1,473.2
Of which: External debt	215.1	203.5	194.5	186.1	179.4	175.0	171.3	170.0
		(In percent of GDP)						
Current account balance								
Including grants	-38.2	-20.2	-17.8	-14.3	-13.1	-12.6	-11.4	-10.2
Excluding grants	-57.3	-45.4	-39.1	-36.3	-34.7	-33.9	-32.5	-31.1
International Investment Position	-144.1	-99.5	-83.5	-82.3	-84.9	-87.8	-91.3	-93.1
Of which: External debt	77.9	63.3	56.1	50.2	46.0	42.7	40.0	38.0

Sources: Graduate School USA; and Fund staff estimates and projections.
1/ Fiscal year ending September 30.
2/ Defined as tax and other revenue less expense.
3/ This reflects Compact grants under CRA-23 for debt service and are treated below the line the IMF's presentation.
4/ Includes withdrawls from CTF and funding for US Federal Programs (Post Office and Meteorological Service).

Table 2. Palau: Balance of Payments, FY2022/2023–2029/30 1/

	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28	2027/29	2029/30
		Est.			Proj.			
	(In millions of U.S. dollars, unless otherwise indicated)							
Current account balance	-105.4	-65.1	-61.7	-53.1	-51.2	-51.5	-49.0	-45.5
Goods and services balance	-153.8	-137.8	-134.4	-132.0	-130.4	-130.7	-128.0	-124.5
Goods balance	-161.4	-162.1	-180.6	-200.0	-211.1	-221.7	-230.5	-239.6
Exports of goods f.o.b.	2.8	4.6	4.7	5.2	5.3	5.5	5.5	5.5
Imports of goods f.o.b.	164.2	166.7	185.3	205.2	216.4	227.2	236.0	245.1
Services balance	7.6	24.3	46.2	68.0	80.6	91.0	102.5	115.1
Exports of services	64.0	91.6	113.8	140.8	157.1	170.8	185.5	201.4
Travel	52.8	76.4	97.2	122.7	137.4	149.4	162.1	176.0
Imports of services	56.4	67.2	67.6	72.8	76.5	79.8	83.0	86.3
Primary income balance	1.8	0.9	6.4	4.0	0.8	-2.3	-5.8	-9.4
Inflows	25.0	28.0	31.2	32.4	33.0	33.7	34.3	35.0
Outflows	23.2	27.1	24.7	28.4	32.2	36.0	40.1	44.4
Secondary income balance	46.6	71.8	66.3	74.9	78.4	81.5	84.8	88.4
Inflows	65.9	95.4	90.2	99.4	103.6	107.2	111.1	115.3
Of which: Grants on budget	52.9	81.0	73.8	81.3	84.4	87.5	90.5	93.7
Outflows	19.3	23.6	23.9	24.5	25.1	25.7	26.3	26.9
Capital account balance 2/	15.2	66.5	62.6	13.5	14.2	14.9	15.6	16.3
Net lending/borrowing (Current+Capital)	-90.2	1.4	0.9	-39.6	-37.0	-36.6	-33.4	-29.3
Financial account balance	-97.5	9.0	0.9	-39.6	-37.0	-36.6	-33.4	-29.3
Direct investment (net lending(+)=assets-liabilities)	-30.9	-40.6	-52.0	-55.6	-58.5	-61.5	-64.2	-67.2
Portfolio investment (net lending(+)=assets-liabilities)	-11.6	44.4	35.6	-12.3	-12.2	-12.2	-7.3	-7.0
Other investment (net lending(+)=assets-liabilities)	-55.0	5.2	17.4	28.3	33.8	37.1	38.2	45.0
Assets (net acquisition)	-14.7	124.9	-67.2	26.9	20.8	24.0	25.1	30.9
Liabilities (net incurrence)	40.4	119.7	-84.6	-1.4	-13.0	-13.0	-13.1	-14.1
Of which: Public sector loans	40.4	1.8	2.3	-1.4	-13.0	-13.0	-13.1	-14.1
Errors and omissions	-7.3	7.6	0.0	0.0	0.0	0.0	0.0	0.0
Current account								
Including official grants	-105.4	-65.1	-61.7	-53.1	-51.2	-51.5	-49.0	-45.5
Excluding official grants	-158.2	-146.1	-135.5	-134.4	-135.6	-139.0	-139.4	-139.2
Memorandum items:	(In percent of GDP, unless otherwise indicated)							
Nominal GDP (million US$)	276.2	321.5	346.6	370.5	390.3	410.1	428.3	447.9
Current account								
Including official grants	-38.2	-20.2	-17.8	-14.3	-13.1	-12.6	-11.4	-10.2
Excluding official grants	-57.3	-45.4	-39.1	-36.3	-34.7	-33.9	-32.5	-31.1
External debt	77.9	63.3	56.1	50.2	46.0	42.7	40.0	38.0
International Investment Position	-144.1	-99.5	-83.5	-82.3	-84.9	-87.8	-91.3	-93.1
Assets	248.3	287.3	260.0	251.8	245.5	240.7	237.3	235.8
Compact Trust Fund	99.6	115.8	125.5	120.3	116.9	114.0	111.7	109.4
Social Security Funds	45.5	41.1	36.5	32.6	29.3	26.3	23.6	22.0
Other	103.2	130.5	98.0	99.0	99.3	100.4	102.0	104.4
Liabilities	392.4	386.8	343.5	334.1	330.4	328.4	328.6	329.0
FDI	310.9	279.7	274.4	271.7	272.9	274.8	278.1	280.9
Government debt	68.8	56.0	49.9	44.8	38.9	36.4	34.4	33.1
Public enterprise debt	9.1	7.3	6.2	5.5	7.0	6.3	5.6	4.9
Other liabilities, incl. banks	5.0	40.8	13.0	12.1	11.5	11.0	10.5	10.1
Errors and Omissions	-2.7	2.4	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Graduate School USA; and IMF staff estimates and projections.

1/ Fiscal year ending September 30.

2/ Captial Account includes inflows into the Compact Trust Fund as part of the New Compact Agreement (CRA-23).

Table 3. Palau: National Government Operations, FY2022/2023–2029/30 1/

	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28	2028/29	2029/30
		Est.			Proj.			
National Government Operations				(In millions of U.S. dollars)				
Revenue	133.0	173.0	186.0	196.6	205.4	214.4	222.9	230.1
Taxes	60.2	69.7	79.9	85.6	90.1	94.6	98.7	103.1
Taxes on income, profits and capital gains	13.1	14.6	15.0	16.0	16.8	17.6	18.4	19.2
Taxes on goods and services	28.5	34.0	42.9	46.3	48.7	51.2	53.4	55.9
Taxes on international trade and transactions	13.1	13.9	13.6	14.5	15.3	16.1	16.8	17.5
Other taxes	5.6	7.2	8.4	8.9	9.3	9.7	10.1	10.5
Grants 3/	58.4	88.4	86.2	95.5	98.9	102.3	105.7	107.4
Current	45.7	83.1	81.6	86.2	89.3	92.4	95.5	96.9
U.S. Compact	0.0	20.0	20.4	20.8	21.2	21.6	22.1	22.5
Drawdown from Compact Trust Fund	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0
U.S. non-Compact	18.2	21.5	22.1	23.3	24.8	26.2	27.6	29.1
Other country	8.0	19.2	16.7	17.8	18.8	19.7	20.6	21.5
Capital	12.7	5.3	4.7	9.4	9.6	9.9	10.2	10.5
Other revenue	14.3	14.9	19.9	15.4	16.5	17.5	18.5	19.6
Expenditure	139.3	169.1	180.0	191.1	200.9	210.4	219.5	229.1
Expense	125.3	145.8	157.4	167.8	176.7	185.3	193.5	202.2
Of which: Compensation of employees	50.5	51.7	54.8	58.1	61.1	64.0	66.7	69.5
Of which: Use of goods and services	35.4	43.0	45.8	46.2	48.7	51.2	53.5	55.9
Of which: Interest payments	6.2	4.3	4.9	5.4	5.9	6.1	6.5	6.9
Net acquisition of nonfinancial assets	13.9	23.3	22.7	23.4	24.2	25.2	26.0	26.9
Domestic Current balance (excluding grants) 2/	-50.8	-61.1	-57.6	-57.6	-57.6	-57.6	-57.6	-57.6
Current Balance (including current grants) 3/	-5.1	21.9	24.0	28.6	31.7	34.8	37.9	39.3
Primary Balance (including grants)	-2.2	7.4	10.0	10.6	10.1	9.8	9.6	7.7
Net lending (+)/borrowing (–) 4/	-6.3	4.0	6.0	5.4	4.5	3.9	3.3	1.0
				(In percent of GDP)				
Revenue	48.1	53.8	53.7	53.1	52.6	52.3	52.0	51.4
Taxes	21.8	21.7	23.1	23.1	23.1	23.1	23.0	23.0
Grants	21.2	27.5	24.9	25.8	25.3	24.9	24.7	24.0
Other revenue	5.2	4.6	5.7	4.2	4.2	4.3	4.3	4.4
Expenditure	50.4	52.6	51.9	51.6	51.5	51.3	51.3	51.2
Expense	45.4	45.3	45.4	45.3	45.3	45.2	45.2	45.1
Net acquisition of nonfinancial assets	5.0	7.2	6.5	6.3	6.2	6.1	6.1	6.0
Current balance (excluding grants) 2/	-18.4	-19.0	-16.6	-15.5	-14.8	-14.0	-13.4	-12.9
Current Balance (including current grants) 3/	-1.8	6.8	6.9	7.7	8.1	8.5	8.9	8.8
Primary Balance (including grants)	-0.8	2.3	2.9	2.9	2.6	2.4	2.2	1.7
Net lending (+)/borrowing (–) 4/	-2.3	1.2	1.7	1.5	1.2	1.0	0.8	0.2
National Government Balance Sheet				(In percent of GDP)				
Assets	28.7	33.3	32.1	31.9	27.7	23.9	20.6	17.5
Cash and deposits	28.7	33.3	32.1	31.9	27.7	23.9	20.6	17.5
Liabilities	76.5	61.4	52.3	47.4	42.6	41.1	40.2	40.0
Domestic accounts payable	6.0	5.4	2.5	2.6	3.6	4.7	5.8	6.9
External debt (national government)	70.5	56.0	49.8	44.8	38.9	36.4	34.4	33.1
Net Financial Assets 5/	-47.8	-28.1	-20.3	-15.5	-14.9	-17.2	-19.6	-22.5
Memorandum Item:								
Nominal GDP (million US$)	276.2	321.5	346.6	370.5	390.3	410.1	428.3	447.9
Compact Trust Fund (in percent of GDP)	97.8	115.8	125.5	120.3	116.9	114.0	111.7	109.4

Sources: Graduate School USA; and Fund staff estimates and prc

1/ Fiscal year ending September 30.
2/ Defined as Revenue less Grants and Expense.
3/ Includes withdrawals from CTF and Funding for US Federal
4/ Defined as Revenue less Expenditure.
5/ The government net worth excludes the Compact Trust Fund, which is governed by the Compact of Free Association.

Table 4. Palau: Financial Corporations Survey, 2017/18–2023/24 1/

	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
	(In millions of U.S. dollars)						
Net foreign assets	243.0	228.8	282.3	276.7	260.7	246.8	373.0
Claims on nonresidents	254.3	238.6	290.7	286.6	271.4	256.7	381.6
Liabilities to nonresidents	11.3	9.8	8.4	9.9	10.7	9.9	8.6
Domestic claims	15.8	27.1	-1.2	4.7	17.4	23.5	6.2
Net claims on central government	-42.9	-31.0	-60.7	-56.5	-45.3	-45.1	-62.7
Claims on other sectors	58.7	58.1	59.6	61.3	62.7	68.5	68.9
of which:							
Private sector	58.7	58.1	59.6	61.3	62.7	68.5	68.9
Domestic Liabilities	258.8	255.9	281.1	281.5	278.1	270.3	379.2
Deposits	237.1	230.3	254.1	251.0	248.6	234.4	336.7
Demand deposits	90.3	99.4	115.4	120.5	123.3	115.5	199.6
Other deposits	146.9	130.9	138.7	130.4	125.3	119.0	137.2
Securities other than shares	2.5	2.5	1.4	1.5	1.4	1.4	1.1
Shares and other equity /2	26.4	27.9	31.0	36.1	35.5	39.1	41.8
Other liabilities 2/	-7.2	-4.8	-5.4	-7.1	-7.4	-4.6	-0.5
Memorandum Item:							
Commercial bank loans (in percent of GDP) 3/	12.7	11.9	12.7	12.8	12.8	13.2	10.3
Commercial bank loans (percent change) 3/	0.7	-7.9	-2.4	-7.9	4.5	15.1	-9.2
Commercial bank deposits (percent change) 3/	0.1	-6.9	19.9	-2.3	-4.4	-4.9	42.6
Nominal GDP (million US$)	288.2	282.0	259.0	235.9	247.5	276.2	321.5

Source: Graduate School USA.

1/ Fiscal year ending September 30. Includes the National Development Bank of Palau (NDBP).

2/ Staff estimates for 2023/24.

3/ Excludes the National Development Bank of Palau.

Table 5. Palau: Banks' Financial Soundness Indicators, 2018–2023 1/

	2018	2019	2020	2021	2022	2023
Average total assets (in thousands of USDs)	285,057	277,403	303,704	319,610	309,432	299,062
Capital adequacy 2/						
Tier 1 capital to assets	1.27	1.39	1.10	1.08	1.15	1.25
Tier 1 capital to risk-weighted assets	2.27	2.22	1.74	0.39	0.15	0.08
Asset quality						
Nonperforming loans to total loans	0.60	0.66	1.56	0.31	0.60	0.61
Provisions for loan losses to total loans	4.42	5.11	7.86	6.80	6.12	4.56
Earnings and profitability						
Return on assets	1.94	2.11	1.03	1.05	1.97	3.28
Interest margin to gross income	86.55	85.35	82.08	81.55	84.32	87.84
Noninterest expenses to gross income	32.30	32.33	41.00	48.45	40.27	26.19
Liquidity						
Core liquid assets to total assets	86.15	85.00	88.18	89.02	87.50	85.63
Deposits to total liabilities	98.42	97.60	97.61	97.78	97.61	97.48

Source: Financial Institutions Commission (FIC).

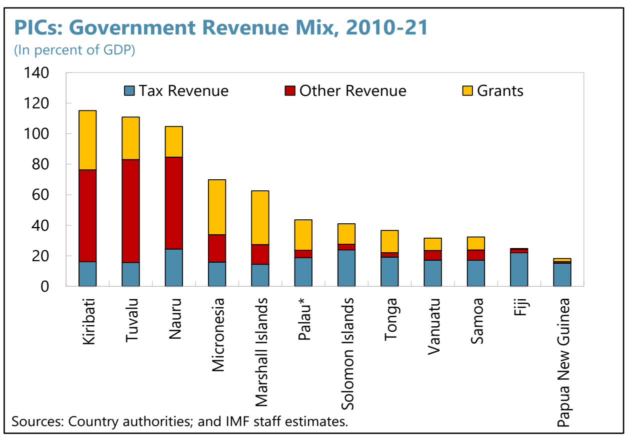
1/ Refers to banking institutions operating in Palau, excluding the National Development Bank of Palau (NDBP).

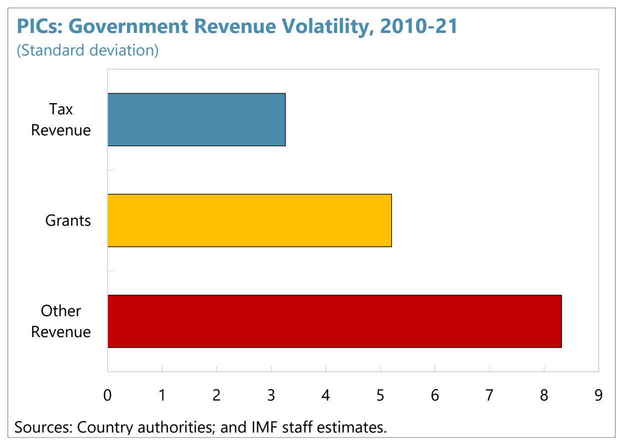
2/ According to the Financial Institutions Commission's prudential regulations and the Financial Institution Act, FDIC insured U.S. bank branches are not required to maintain capital or assigned capital in Palau.

Annex I. Tax Reform in Palau: A Key Milestone[1]

Palau's 2023 tax reform marked a significant step towards modernizing the tax system, setting an example for the region. The reform expanded the domestic tax base and improved redistribution. To align Palau's tax system with international best practices, further reforms should be appropriately phased in to strengthen administrative capacity, address loopholes, further broaden the tax base, and better align tax policies with sustainable development and equity objectives.

1. **The 2023 tax reform was a significant milestone in unlocking Palau's domestic tax potential.** Prior to the reform, Palau relied heavily on foreign grants and non-tax revenue for essential government spending. The tax base was narrow, primarily dependent on the gross revenue tax (GRT) and import duties, with compliance gaps due to administrative burdens and limited digital infrastructure. The 2023 reforms introduced the Palau Goods and Services Tax (PGST) and Business Profits Tax (BPT), eliminated import duties, lowered wage and salary taxes with refunds for those earning US$ 15,000 or less, reduced the occupancy tax, replaced import tariffs on select products with excises (including a carbon tax on liquid fossil fuels), and replaced the GRT with a business license fee for earnings of US$ 50,000 or less annually. [2]





2. **Revenue collection following the reform exceeded expectations.** The PGST, a broad-based consumption tax, replaced outdated revenue mechanisms and enhanced fiscal resilience by diversifying income sources, eliminating cascading effects and improving resource reallocation. The tax-to-GDP ratio increased from 18.1 percent before the reform to 21.6 in FY2023 and 22.8 percent in FY2024, surpassing expectations. However, the introduction of PGST contributed to inflation, which peaked at 13 percent in FY2023, posing challenges for public support in the early stage of the reform. Nonetheless, inflation proved to be temporary, falling to around 2 percent by end-2024. Compensation measures, such as WST tax credits and grants for informal workers, also helped partially offset inflationary impact and were well-received.[3]

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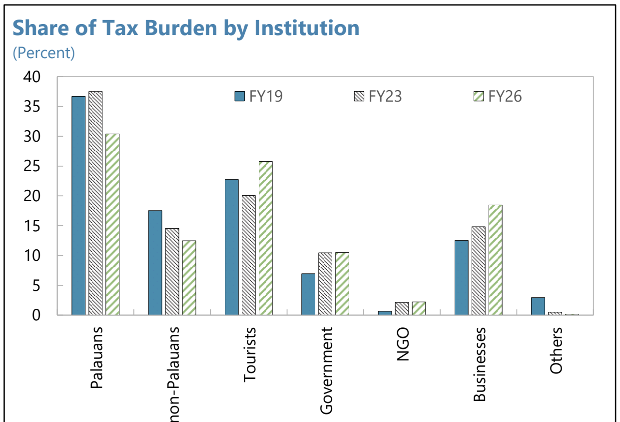
[1] Prepared by John McAlister, Revenue Administration Advisor (FAD, PFTAC), with inputs from Sebastian Beer and Vincent de Paul Kocou (FAD).

[2] The PGST is a single rate, multistage, value-added tax on consumption.

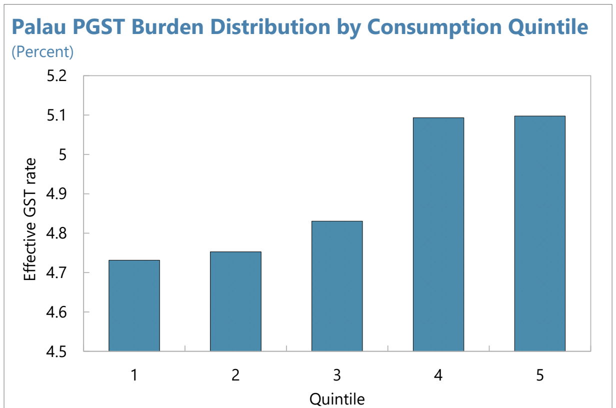
[3] Compensation mechanisms outside of the direct PGST design to lower the effective taxation burden on low-income households may merit some redesign considerations to improve cost-effectiveness and targeting.

3. The reform contains some income redistribution measures, but more is needed. The tax burden appears to be redistributed across sectors, shifting from households to the government and business sectors. To further alleviate the PGST burden on lower-income groups, measures such as direct cash transfers, GST discount cards, refunds for GST-inclusive purchases, or income tax relief (like itemized GST deductions or tax credits) may be warranted.

4. Several factors contributed to the success of the tax reform. Years of meticulous preparation, in close collaboration with international partners, ensured that the reform is well designed and effectively implemented. Development partners provided technical assistance, facilitated community outreach, and supported financial literacy programs to ensure a transparent and straightforward implementation process. Additionally, compliance with the newly introduced PSGT was high from the outset, although there is still room for improvement. Palau leads the region in tax reform efforts and is currently providing peer-to-peer assistance to the Marshall Islands, supporting their endeavors toward modernizing the tax system.



Sources: Palau authorities; and IMF staff calculations.



Sources: Household Income and Expenditure Survey (HES) 2023; and IMF staff calculations.

5. To align Palau's tax system with international best practices, ongoing reform efforts are essential. Strengthening revenue administration should be the priority to fully realize the potential tax revenue gains.

- **Tax administration.** To fully benefit from the tax reform, Palau could prioritize enhancing administrative efficiency and closing loopholes. Key priorities include investing in staff capacity, modernizing IT systems, implementing risk-based audits, and strengthening governance.

- **To ensure sustained progress, the authorities could consider developing a medium-term tax reform strategy.** This plan should outline priorities and timelines for expanding BPT coverage, redesigning compensation mechanisms for low-income households, enhancing digital infrastructure and audit capabilities, and reviewing PGST parameters. A structured roadmap will help align reforms with capacity and resource availability, ensuring effective implementation over time.

Annex II. Fiscal Strategy: Model-Based Saving-Investment Analysis[1]

Palau is vulnerable to tourism-related macroeconomic shocks and climate-related disasters. Managing its expanded fiscal space strategically, from the renewed US Compact agreement and tax reform, is crucial for building resilience and ensuring sustainable growth. Using the IMF's Debt-Investment-Growth-Natural Disaster (DIGNAD) model, this analysis evaluates alternative fiscal strategies, finding that prioritizing resilience-enhancing public investment outperforms strategies focused on current spending. Frontloading infrastructure investments can help reduce future borrowing costs and mitigate shock impacts.

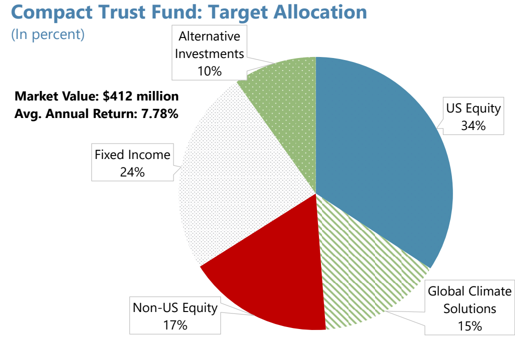
1. Palau combines high debt and savings amid significant spending needs. The pandemic severely impacted its fiscal position, pushing public debt to over 80% of GDP in FY2023 from 30% pre-FY2019. The recent US Compact Review Agreement (CRA-23) secured nearly US$ 900 million in grants for FY2024-43, boosting fiscal space alongside revenue from recent tax reforms. Debt is projected to decline due to medium-term fiscal surpluses and fiscal consolidation grants under CRA-23, though it remains above pre-pandemic levels. Savings are sizable, attributed to cash deposits and a growing CTF.

2. To enhance resilience, Palau's medium-term fiscal strategy needs to address the large infrastructure gap while balancing saving and investment decisions. As a small Pacific Island Country (PIC), Palau is vulnerable to natural disasters and global macroeconomic shocks. Enhancing infrastructure capacity can help diversify the economy and mitigate these shocks but requires increases capital spending. One example of large projects is the pressing need to relocate the main public hospital from a low-lying area prone to flooding. Such public investments are yet to be incorporated into the fiscal strategy and the budgetary process. Meanwhile, growth volatility, high debt levels, and large current spending needs require a prudent savings buffer. Balancing saving and investment trade-offs is critical to support Palau's resilience and growth objectives.

Box 1. Compact Trust Fund

The US-funded Palau CTF was established in 1999 and originally set up to provide annuities through FY2043 and beyond. After several top-ups and other saving vehicles, CTF stood at approximately 116 percent of GDP at the end of FY2024, mostly invested in financial instruments and bank deposits. The CTF creates an additional trade-off to best hedge against a potentially large natural disaster shock: accumulating more savings versus investing in resilient public infrastructure.

Compact Trust Fund: Target Allocation
(In percent)



Source: Republic of Palau COFA Trust Fund, Comparative Analysis Report as of December 2024.

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[1] Prepared by Irina Yakadina (APD).

3. **We use a model-based approach to highlight key saving-investment tradeoffs for Palau's medium-term fiscal strategy.** We adapt the DIGNAD model to Palau's economy to analyze these tradeoffs under various shock scenarios. We examine the impact of high, medium, and low severity shocks, including natural disasters and macroeconomic shocks, on growth, fiscal balances, and public debt. The model is recalibrated for each shock type, comparing tighter and looser fiscal policies.

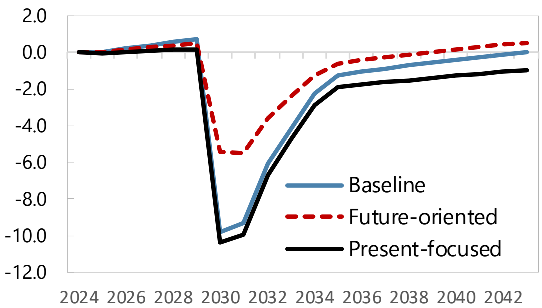
Preserve Fiscal Buffers Through High Quality and Disaster-Resilient Infrastructure Investments

4. **We study fiscal policy trade-offs between infrastructure investments and current spending in the face of a potential large shock.** We evaluate three different strategies under a once-in-100-years storm—historically sized at a 9 percent of GDP loss—projected to hit five years into the projection period. The first scenario—the baseline—allocates the enhanced Compact capital grants (1.5 percent of GDP) to standard infrastructure investment. The second scenario—dubbed Future-oriented—uses the same grants to build shock-resilient infrastructure, which is nearly twice as expensive as the standard one, as it requires imported technology. Resilient infrastructure provides enhanced protection against shocks (that the cash buffers do not offer) and boosts GDP growth more than the standard one. Finally, the third scenario—Present-focused—substitutes investment with additional current spending in the form of consumer transfers and tax cuts (halving the VAT rate), relying on consumption-driven growth.

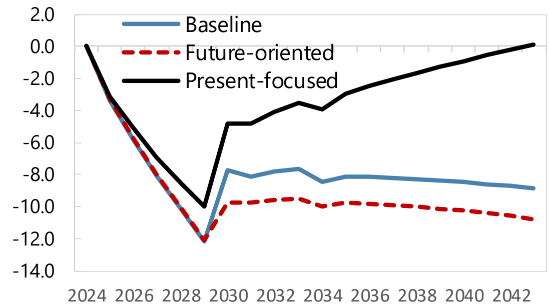
5. **Results show that prioritizing infrastructure investment is more effective than relaxing revenue mobilization efforts and increasing current spending.** The present-focused scenario results in higher primary deficits and a slightly higher concessional debt. Prioritizing consumption over investment leads to lower long-term growth without high-quality infrastructure to support recovery. While cutting taxes boosts private consumption and investment, any potential shock could cause a significant output fall with lasting consequences. This, combined with the need for non-concessional borrowing for recovery, could lead to unsustainable long-term debt dynamics. The difference between the least and most sustainable policies is explained by higher primary surpluses in the latter, averaging about 2 percent of GDP.

Annex II. Figure 1. Palau: DIGNAD Simulation Results for Baseline, Future-Oriented and Present-Focused Scenarios

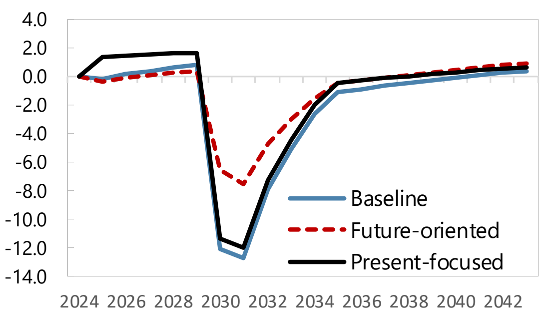
GDP Growth
(In percent, deviation from steady state)



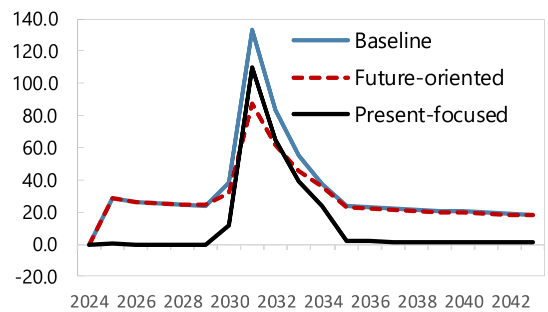
Public Debt
(In percent of GDP, deviation from 2024)



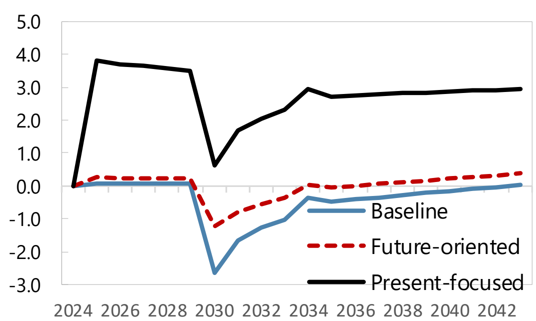
Private Investment Growth
(In percent, deviation from steady state)



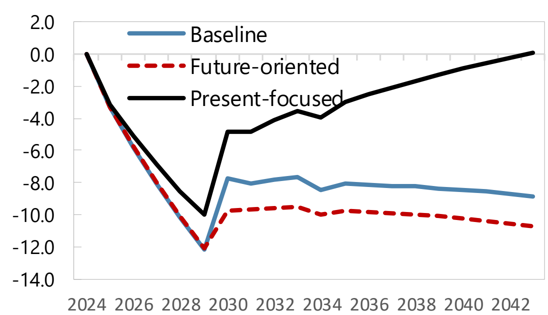
Public Inverstment Growth
(In percent, deviation from steady state)



Private Consumption Growth
(In percent, deviation from steady state)



Trust Fund
(In percent of GDP, deviation from 2024)



Sources: IMF DIGNAD model simulation results; and IMF staff estimates.

Frontload Investment Projects to Gain Earlier Benefits and Reduce Costs

6. As a separate exercise, we compare two public investment scenarios to highlight the trade-off between immediate and delayed implementation. We analyze timelines for relocating and rebuilding the main hospital in a less populated state, estimated to cost 30 percent of GDP over three years. Assuming a mild flood shock (3 percent of GDP) renders the hospital unusable, we scale down the model's assumptions from economy-wide to local impacts, such as developing surrounding areas with new infrastructure. Unlike previous capital spending, this project is expected to be financed by Palau's savings and concessional loans, not funded by traditional donors like the U.S. and Japan. We compare two timelines: Immediate (before the shock) and Delayed (post-shock rebuilding).

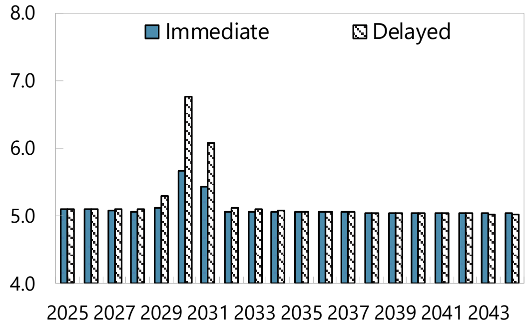
7. Results suggest that the Immediate strategy dominates the Delayed one, despite the non-trivial costs of rebuilding the hospital and larger fiscal space in later years. Medium-term benefits of immediate action include mitigating over two-thirds of the flood impact on GDP, thus stimulating GDP growth and reducing government expenditures on reconstruction following the shock (Figure 3). There is also a cost-saving aspect of acting earlier: it allows for full use of domestic savings and concessional financing, while post-disaster reconstruction crowds out cheap financing and complicate building with quality (expensive, imported) materials.

Prioritize Frontloading High Quality, Resilience-Enhancing Investment, While Preserving Fiscal Buffers and Ensuring Debt Sustainability

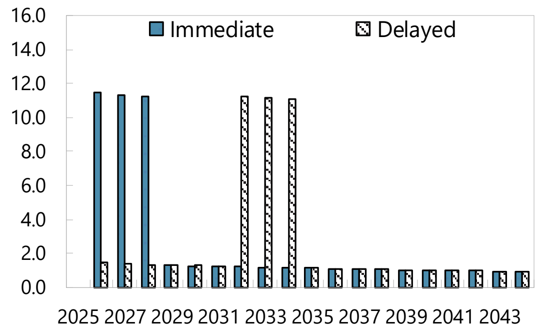
8. In summary, maintaining sound fiscal policies and thoughtfully balancing saving and investment are essential for strengthening Palau's resilience, fostering growth, and ensuring long-term sustainability. Palau is highly vulnerable to natural disasters and climate-related risks, and its economic growth is tightly linked to global tourism trends. To address these challenges, the Palauan authorities should keep building fiscal buffers, reduce debt towards pre-pandemic levels, and avoid using expanded fiscal space primarily for current spending. Fiscal strategy should focus on prioritizing high-quality, timely investments that deliver lasting benefits and help reduce the potential costs from natural disasters. By frontloading resilient infrastructure projects, Palau can gain earlier advantages and better manage risks. Integrating risk assessment and management into medium-term fiscal planning would allow for more effective resource allocation, align fiscal policy with development goals, and support sustainable growth for the nation.

Annex II. Figure 2. Palau: DIGNAD Simulation Results for the Immediate and Delayed Scenarios

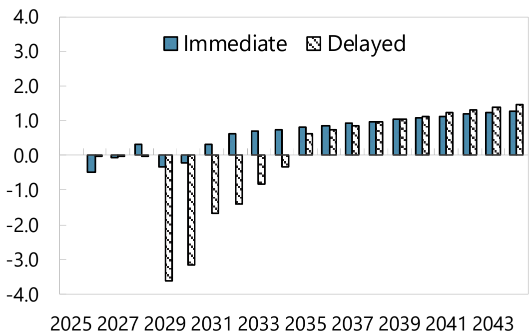
Standard Public Infrastructure Investment
(In percent of GDP)



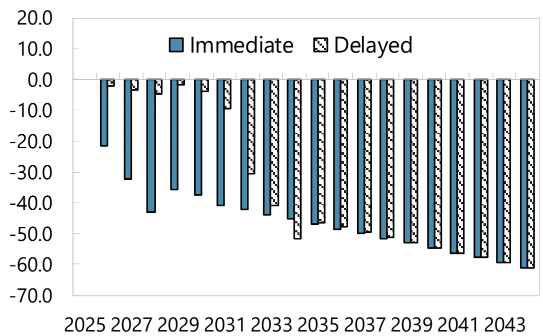
Adaptation Public Infrastructure Investment
(In percent of GDP)



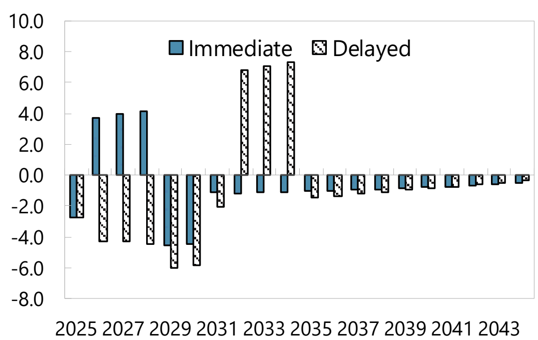
GDP Growth
(In percent, deviation from steady state)



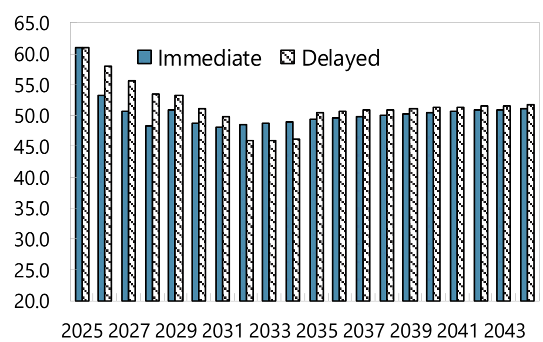
Trust Fund
(In percent of GDP, deviation from 2024 level)



Primary Deficit
(In percent of GDP)



Concessional Public Debt
(In percent of GDP)



Sources: IMF DIGNAD model simulation results; and IMF staff estimates.

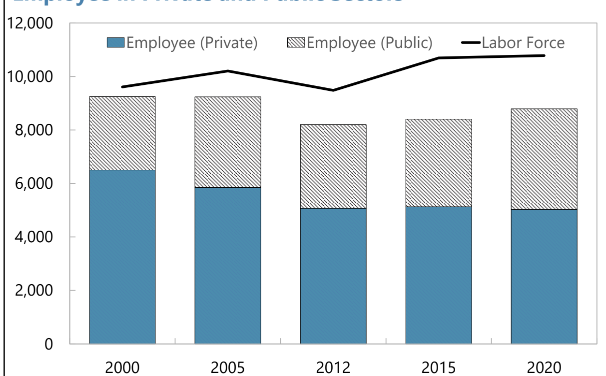
Annex III. Addressing Labor Shortages in the Public Sector[1]

Palau faces critical challenges in recruiting and retaining qualified public sector staff, especially in health and education. These shortages are largely due to high emigration rates driven by structural factors and a compressed public wage structure. Universal public wage increases are not the most effective policy to address these challenges and may unnecessarily increase the fiscal burden. Instead, targeted employment policies and structural reforms should be prioritized to reduce wage compression and create an economically friendly environment for emigrants to return.

1. **Palau faces challenges in attracting and retaining qualified staff in the public sector due to high emigration.** As one of the smallest countries in the world, Palau has substantial staffing needs, with the public sector employing nearly a quarter of the working-age population. However, considerable emigration and net retirements have led to labor shortages, particularly in high-skilled occupations such as teachers, managers, accountants, doctors, and business and financial experts.

2. **Emigration can be attributed to several key factors.** Population has decreased by 11.5 percent since 2005 largely due to emigration to Guam and other U.S. territories. While wage differentials may have partially incentivized this trend, education opportunities, healthcare, and the relative diversity of economic opportunities in the U.S. also make emigration attractive under the Compact of Free Association Agreement.[2]

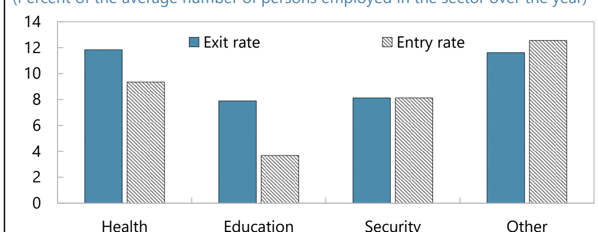
Employee in Private and Public Sectors



Sources: UNDESA; GSUSA; and IMF staff calculations.

Departures and Recruitments in Government

(Percent of the average number of persons employed in the sector over the year)



Sources: IMF staff calculations based on FY2022 payroll data.

Note: The figure shows the departure (respectively, entry) rate in national government employment. The departure (respectively, entry) rate in FY2022 is measured as the ratio between the number of people employed in a sector and who were marked as Inactive (respectively, who were hired) in the payroll date between October 1, 2021 and September 30, 2022 and the average number of employees in the sector during the period. By convention and construction of data, people who worked in two different sectors throughout the year are linked to the latest sector.

3. **Across-the-board wage increase is not the most effective policy to retain skilled workers.** Since FY 2014, the government has implemented universal wage increases across the pay grades. To compensate for the double-digit inflation in 2023, the government implemented two consecutive hourly pay increases of US$ 0.75 each for FY 2023 and 2024. For instance, the highest pay was 10 times the lowest pay in FY2006; and the ratio declined to 6-to-1 in FY2024. This practice

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[1] Prepared by Thévenot, Céline (FAD)

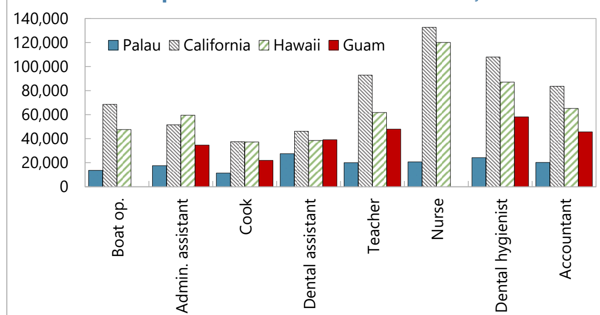
This note builds on several Technical Assistance Reports delivered to Palau between 2023 and 2025, in particular [Republic of Palau: Technical Assistance Report-Managing Government Employment and Compensation in: Technical Assistance Reports Volume 2024 Issue 027 (2024)] from S. Walker, C. Bloch, C. Thévenot and C. Bender.

[2] Allows Palauan nationals to travel, live, work or study in the U.S. without a visa or work permit

has contributed to pay compression making Palau's pay scale among the most compressed in the world, potentially worsening skilled staff shortages in the public sector.

4. Public sector wage and employment policies should be well-targeted and ensure consistency with broader fiscal strategy and spending priorities. Wage adjustments should be carefully tailored to sectors facing severe staff shortages, rather than applied uniformly. The government should also consider reclassifying specific positions to higher grades, awarding targeted pay supplements or allowances, and applying differential pay increases. These tools are most effective when data-driven, based on evidence of recruitment difficulties, vacancy rates, or turnover patterns. If strategically used, they would allow the government to respond flexibly to market pressures and labor shortages without unnecessarily increasing the overall wage bill. Most importantly, compensation expenditure must remain sustainable and consistent with the overall spending priorities. Moreover, wage policies should be integrated into the budget process and aligned with the fiscal strategy, with active involvement of the Employment Compensation Commission (ECC).[3]

Median Compensation for Selected Positions in Palau and Main Competitor Labor Markets (U.S dollars/year)



Sources: IMF staff calculations based on data from US Bureau of Labor Statistics and Palauan authorities. Wages in Palau refer to government employees. Wages for California, Hawaii, and Guam refer to both public and private sectors.

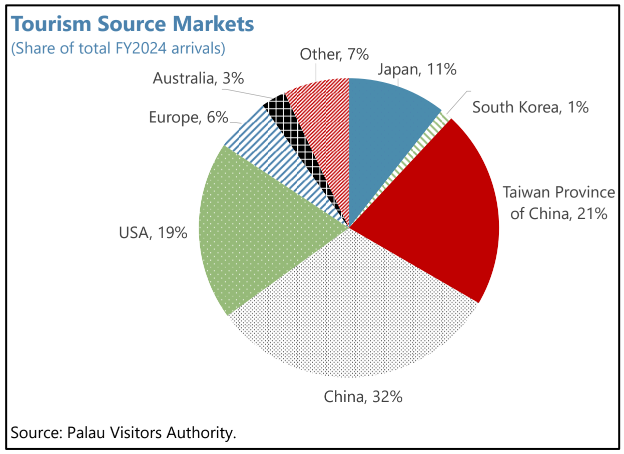
5. Structural policies can be more effective in curtailing emigration. These include strengthening social services by investing in education (including upgrading school infrastructure and vocational training), improving healthcare and social safety nets (including pension reforms), and providing more affordable housing options. Additionally, expanding the pool of skilled workers in the public sector by encouraging the recruitment of foreign workers can help. Improving data collection on emigration, potentially through surveying outbound air passengers, can also provide a clearer understanding of what motivates migration decisions. Such reforms should be carefully designed and tailored for the country's capacity and resources.

[3] The ECC was established to formulate a medium-term strategy for securing adequate staffing for public services taking into consideration compensation policies and fiscal sustainability.

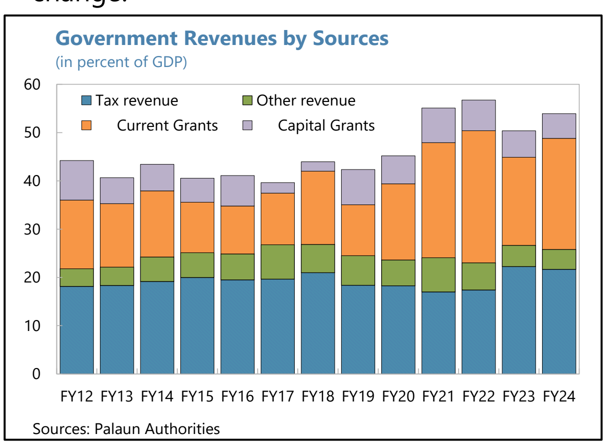
Annex IV. Palau Amid Heightened Global Trade and Policy Uncertainty

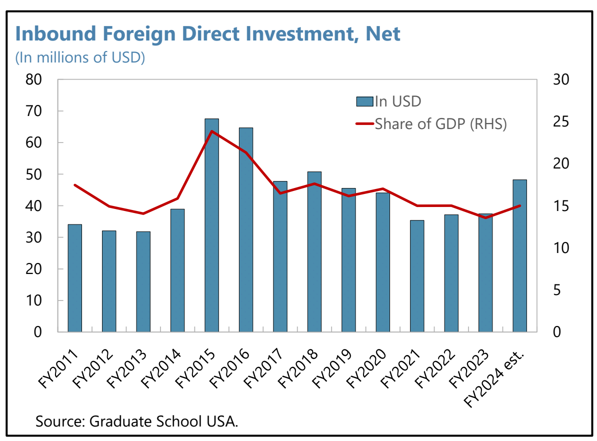
Palau is one of the few countries that avoided the tariffs from the U.S. Nonetheless, as a tourism dependent microstate that relies heavily on external grants, Palau can be vulnerable to the risks of a significant global slowdown, escalating geopolitical tensions, and a protracted policy uncertainty, which would impact the Palauan economy through lower tourism demand and capital inflows. A 1 ppt slowdown of global growth could shave 0.5-1.2 ppt growth in Palau, narrow fiscal surplus by 1.1-1.6 percent of GDP, and slow the debt reduction by around 0.5 percent of GDP each year, with the impact primarily transmitted through the following channels.

- **Tourism channel:** Tourism-related activity accounts for close to 40 percent of GDP, one of the highest among Pacific Island Countries (PICs). An important share of domestic fiscal revenue comes from tourism-related activities. As the Palau's main tourist source countries in Asia have been significantly impacted by higher tariffs; further escalation of trade tension could negatively impact their growth and demand for tourism travel to Palau.



- **Uncertainty, FDIs, and capital grants:** Global uncertainty and growth shocks could weigh on investment sentiments and curtail FDIs (around 20 percent of GDP), the primary funding source for the tourism-related construction activity. Furthermore, while most current grants are guaranteed under the CRA-23, other aids such as capital grants, coming mostly from Asia, as well as grants from the U.S. Federal programs could be curtailed if foreign nations' policies change.[1]





[1] Palau's government spending relies primarily on grants (over 50 percent) from foreign countries led by the U.S., which provided budget financing through the Compact Agreement and the U.S. Federal programs. Other countries (mostly from Asia) also provide sizeable current and capital grants.

Annex V. External Sector Assessment

Overall Assessment: *The external position of Palau in FY2024 was substantially weaker than the level implied by fundamentals and desirable policies. The external sector account remains in deficit due to Palau's high dependence on imports for food and fuel. In addition, the real effective exchange rate remained overvalued compared to other Pacific Islands, as the U.S. dollar strengthened against major currencies and relatively high domestic inflation followed the introduction of the PGST.*

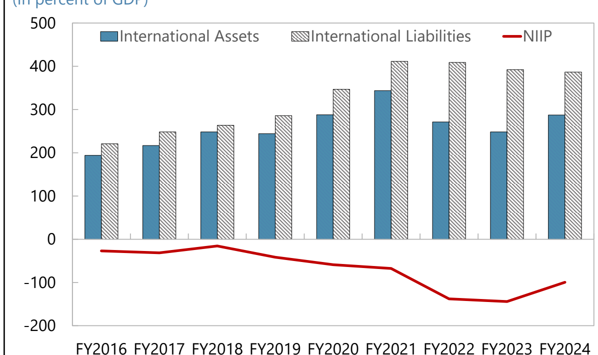
Potential Policy Responses: *Fiscal consolidation, including strengthening the medium-term fiscal framework, further resumption of tourism activity as well as the authorities' efforts to pivot towards high-value tourism, and structural reforms to diversify the domestic economy and reduce import reliance would support a narrowing of the current account deficit. Structural reforms to enhance financial intermediation, while reducing financial integrity risks in the AML/CFT framework, and a cautious approach in the digital finance initiatives, would lower risks to capital inflows and the loss of correspondent banking relationships.*

Foreign Assets and Liabilities: Position and Trajectory

Background. Following a sharp deterioration in FY2022 and FY2023, Palau's Net international Investment Position (NIIP) improved significantly, to -99 percent of GDP in FY2024 from -144 percent the previous year. The improvement in NIIP was driven by a high GDP growth and U.S. contributions to the CTF. IIP liabilities are dominated by direct investment, which accounts for about 70 percent of the total, followed by external debt at about 20 percent. External debt is long-term and largely concessional, mostly from the ADB. IIP assets mainly consist of CTF balances and foreign assets of U.S. bank branches. Government deposits are held in domestic branches of U.S. banks, thus are not treated as IIP assets.

Assessment. Under the current policies, the NIIP is projected to gradually deteriorate over the medium term, as current account deficits continue to weigh on the external balance, remaining well above pre-pandemic averages of around -60 percent of GDP. The pandemic increase in external debt mostly reflects concessional, long-term loans, limiting external sustainability risks. FDI investment is expected to remain strong in the medium term, outpacing the projected reductions in the external debt.

Net International Investment Position
(In percent of GDP)



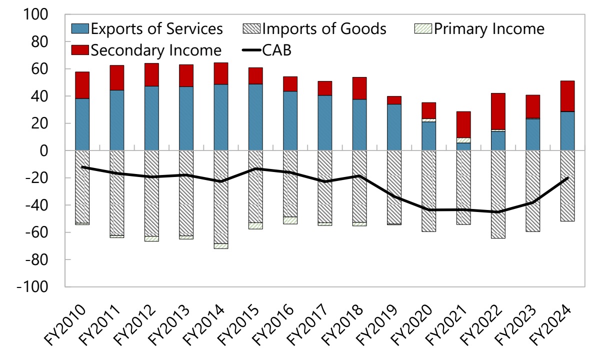
Source: Graduate School USA.

FY2024 Est. (% GDP)	NIIP: (-) 99	Gross Assets: 287	Debt Assets: n.a.	Gross Liab.: 387	Debt Liab.: 63

Current Account

Background. The current account deficit improved significantly in FY2024 to 20 percent of GDP, from the pandemic highs of about 45 percent of GDP in FY2022. The improvements in the current account balance were driven by the continued recovery in tourism and higher grants from the renewal of the U.S. Compact Agreement. The trade balance in FY2024 was -43 percent of GDP, consistent with historical averages. Palau's high dependence of imports and relatively low exports of goods drives the consistently high trade deficits.

Current Account Balance (CAB)
(In percent of GDP)



Sources: Graduate School USA; and IMF staff calculations.

Assessment. The External Sustainability (ES) approach is more suitable than other methods for Palau, given its island economy, unusual external financing structure, the high negative NIIP, and data limitations.[1] Palau's large and negative NIIP exposes it high levels of external risks, despite the relatively large share of FDI in total liabilities. Thus, instead of assuming a stabilization of the NIIP at its current level, staff calculated the REER and CA adjustment needed to reduce the NIIP to a lower benchmark of -75 percent of GDP by 2030. This benchmark is slightly higher than Palau's pre-pandemic NIIP levels and informed by Palau's high vulnerability to external shocks. The ES model estimates the CA gap at -7.5 in FY2024. Hence, staff assesses the external position to be substantially weaker than implied by fundamentals and desirable policies. Palau's CA deficit is expected to modestly improve in the medium term as tourism arrivals continue to increase. Structural reforms to foster economic diversification, coupled with investments in renewable energy to reduce dependence on fuel imports, alongside prudent fiscal consolidation, would strengthen Palau's external position and help narrow the current account deficit.

Palau: Model Estimates for External Sustainability Approach
(In percent of GDP)

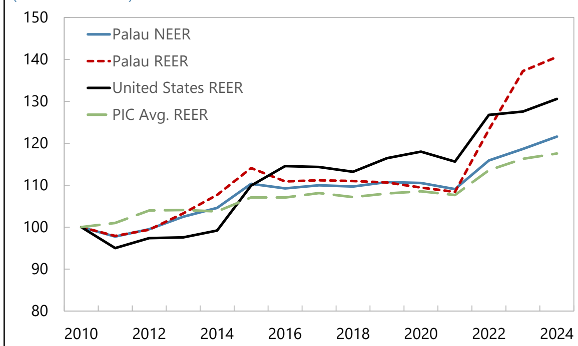
REER gap model estimates (in percent)	CA gap by model estimates
20.6	-7.5

[1] The Current Account and REER approaches are less applicable for Palau due to data limitations, including incomplete demographic information.

Real Exchange Rate

Background. The United States dollar serves as both legal tender and the official currency in Palau[2], which does not have a central bank. Consequently, Palau's real effective exchange rate (REER) historically tracks the U.S. dollar. From 2021 to 2024, the REER appreciated by 29.7 percent while the nominal effective exchange rate (NEER) increased by 11.5 percent. However, recent months have seen a depreciation in both rates, driven by a weakening U.S. dollar and a low domestic inflation. Given that tourism costs in Palau are broadly similar to other Pacific destinations (e.g., Samoa and Vanuatu), exchange rate developments may be a factor impacting its competitiveness as a tourist destination.

Nominal and Real Effective Exchange Rates
(Index 2010=100)



Source: IMF's Effective Exchange Rate Database.

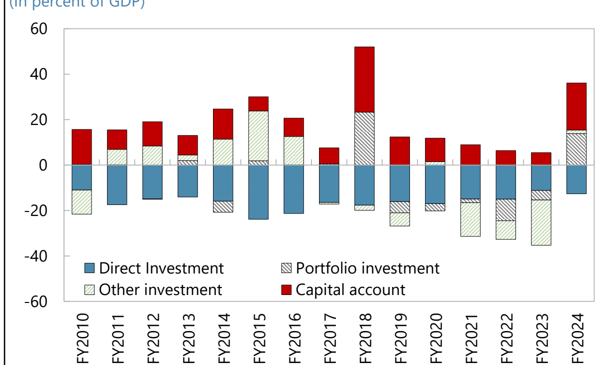
Assessment. The ES model indicates that the REER in FY2024 was overvalued by 20.6 percent. This assessment comes with the same caveats as the CA assessment.

Capital and Financial Accounts: Flows and Policy Measures

Background. The capital account is mainly composed of government grants and U.S. contributions to the Compact Trust Fund (CTF). The capital account inflows in FY2024 amounted to around 20 percent of GDP including two US$ 50 million U.S. contributions under the new Compact Agreement. The financial account improved to a 3 percent of GDP surplus in FY2024 from peak pandemic deficits of 35 percent. The decline in the financial account deficit was driven by CTF contributions. FDI, primarily in the tourism sector, averaged about 15 percent of GDP.

Assessment. The financing structure of the external position is largely stable. Inflows are dominated by FDI, with additional support from CTF contributions and concessional loans. Outflows consist of commercial bank transfers and debt amortization. In the medium term, Palau would benefit from a more diversified FDI inflows to support activities outside of the tourism sector and further economic development.

Capital Account and Financial Account Components
(In percent of GDP)



Sources: Graduate School USA; and IMF staff calculations.

[2] As per the Article V of the US Public Law 99-658 (11.14, 1986), "The currency of the United States is the official circulating legal tender of Palau."

FX Intervention and Reserves Level

Background. The foreign reserve assets of Palau consist of Special Drawing Rights (SDR) holdings and the reserve tranche position in the Fund. Palau does not have a central bank or a Ministry of Finance unit that performs monetary authority functions. Using this narrow definition, Palau's international reserves amounted to US$10 million in FY2024. Government deposits, which are held in U.S. bank branches in Palau, are not considered international reserves because they represent claims on residents and therefore do not meet the criteria for international reserve assets. However, applying a broader definition that includes government deposits—since they can be used for short-term liquidity needs—Palau's gross international reserves totaled US$ 117 million at the end of FY2024, up by US$ 89.5 million compared to FY2023. The increase in reserves reflects higher government deposits following Palau's improved fiscal position after the renewal of the Compact Agreement.

Assessment. Palau's international reserves in FY2024, including government deposits in resident banks, stood at 5.5 months of imports, well above the typical adequacy benchmark of 3 months of current imports. Additionally, the government is allowed to withdraw US$ 15 million annually from the Compact Trust Fund and can access further withdrawals, including from the Climate Fund, in extraordinary circumstances, subject to an emergency declaration by the President of Palau and with the agreement of signatory governments.

Annex VI. Past Fund Policy Advice

2023 Article IV Consultation Recommendations	Actions Taken
Fiscal policy	
Develop a medium-term fiscal strategy that integrates concrete policies and projects to support Palau's development objectives while rebuilding fiscal buffers is necessary.	The draft FY2026-29 fiscal strategy, currently under review, is broadly consistent with development objectives and the fiscal responsibility framework.
Conduct a full review of government saving vehicles and a new debt management strategy.	The draft FY2026-29 fiscal strategy suggested a new debt reduction strategy and a plan to review targeted contributions to the Cyclical Reserve Fund and the Climate Resilience Fund.
Expenditure policy should focus on investments in infrastructure, health, and education, and improving expenditure efficiency by further streamlining subsidies and transfers.	The authorities have been prioritizing growth-enhancing and inclusive social spending. Transfers to subnational governments have been streamlined but remain elevated while utility tariff subsidies to households continue across the board.
Prioritize improving revenue administration and continuing progress with capacity building.	The tax reform was implemented successfully in January 2023. As for the next steps, the authorities are prioritizing and have budgeted adopting a new tax administration IT system and digitalizing tax payments.
Improve PFM to contain fiscal risks	The PFM Road Map is under development. The authorities produced FY2025 and FY2026 Palau's Citizen's Budgets as important steps to improve the budgetary transparency and the budget formulation process.
Financial Sector Policy	
Address structural impediments that limit financial intermediation, including record keeping practices. Strengthen regulatory and governance frameworks to mitigate potential financial integrity and other macro-financial risks related to their Fintech initiatives.	The implementation of tax reform in 2023 has been instrumental in helping SMEs improve their financial reporting. The authorities conducted a national assessment of its money laundering and terrorist financing risks (NRA)
Structural Policies	
Well-sequenced structural reforms are critical to enable private investment, attract FDI, and diversify the economy,	Palau published the FY2025 eco-tourism strategy outlining policies to promote sustainable high-value tourism moving away from low-budget tourism.
Improve public financial management to assist climate adaptation efforts.	Palau received an IMF TA on the green PFM, which provided recommendations on how to incorporate climate adaptation measures into the budget process.

Annex VII. Risk Assessment Matrix

Likelihood	Risks[1]	Expected Impact	Main Policy Recommendation
	External Risks		
High	**Escalating Trade Measures and Prolonged Uncertainty**. Rising trade barriers and prolonged policy uncertainty could reduce trade, investment, and growth. Inflationary pressures may emerge, especially in countries imposing tariffs.	High ST, MT	• Continue the efforts to diversify source markets of tourism. • Provide temporary and targeted support to vulnerable households. • Accelerate structural reforms to enhance economic resilience and preserve policy space
High	**Commodity Price Volatility.** Shifts in supply and demand—driven by geopolitical tensions and conflicts, OPEC+ actions, or the green transition—may fuel commodity price swings, intensifying external and fiscal pressures, social unrest, and macroeconomic instability.	Medium ST, MT	• Provide temporary and targeted transfers to support vulnerable households. • Allow the gradual pass-through of international prices. • Accelerate transition to renewable energy adoption and increase
	Domestic Risks		
Medium	**Labor Shortage**. Continuing emigration would exacerbate the labor shortage of high-skilled workers and further constrain the capacity of the public sector, resulting in permanent loss of growth potential.	High ST, MT	• Review wage and employment policies, prioritizing the reduction of wage compression. • Accelerate structural reforms to improve business environment and other incentives to retain high-skilled workers.
Medium	**Financial sector weakness and spillovers.** Given the systemic role played by US banks operating as branches in Palau, there could be adverse spillovers from a tightening in financial conditions, especially if the specific banks operating in Palau are directly impacted, which could lead to disruptions in the payment system and potential cash shortages, given the dominance of US bank branches and lack of a domestic payment system, and other financial stability concerns.	Medium ST, MT	• Accelerate efforts to enhance financial supervision. • Guide banks to adequately recognize losses, accumulate provisioning, and maintain liquidity and capital buffers. Implement capital injection if needed. • Enhance crisis preparedness and contingency plans, including through coordination with US bank regulators such as the FDIC.
High	**Financial integrity and reputational risks related to digital initiatives and cyberthreats.** Digital initiatives that are already underway can expose Palau to significant financial integrity and reputational risks, in the absence of effective regulation and supervision, including due to limited domestic capacity. Digital initiatives also increase risks from cyberattacks and can cause financial instability and reputational risks.	Medium ST, MT	• Carefully assess and manage financial integrity and reputational risks. • Take a gradual approach and strengthen regulatory and supervisory capacity before rolling out initiatives. • Strengthen AML/CFT framework, including through continued collaboration with international bodies.
Low to Medium	**Extreme climate events and climate change**. Probability of occurrence of natural disasters is low in Palau, though the country remains exposed to occasional droughts, and tropical cyclones. Rising sea levels pose a macro-critical risk, and climate change is expected to also lead to coral bleaching and other negative effects on biodiversity.	High to Medium MT	• Maintain reserve buffers and accelerate climate adaptation policies, including building climate resilient infrastructure, and implementing coastal protection and planning. • Provide temporary and targeted transfers to support vulnerable households.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path. The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Annex VIII. Debt Sustainability Analysis

Annex VIII. Figure 1. Palau: Risk of Sovereign Stress

Horizon	Mechanical signal	Final assessment	Comments
Overall	...	Moderate	The overall risk of sovereign stress is moderate, reflecting moderate medium- and long-term risks. Medium-term risks are assessed as moderate despite the low mecahnical signal as large investement needs may require new project borrowing, whcih, without reducing the existing stock of debt presents risks, to debt reduction. Risks over the long-term are assessed as moderate, reflecting large spending needs to build resilient infrastructure and support the existing pension plans.
Near term 1/			
Medium term	Low	Moderate	Medium-term risks are assessed as moderate despite a low mechanical signal due to high volatility of GDP (wide fan chart) that could undermine the projected debt reduction. In addition, large resilient infrastructure investment needs may require new project borrowing beyond what is considered in the baseline, slowing debt reduction and increasing vulnerability decreasing the space to absorb shocks, as shown by the natural disasters stress test. Gross financing needs signals low risk based on projected primary surpluses and the Compact fiscal consolidation grant that expires in FY2029.
Fanchart	Moderate	...	
GFN	Low	...	
Stress test	Nat. Diast.	...	
Long term	...	Moderate	The projected costs associated with pension obligations and the investment needs to build resilient infrastructure are sizable and subject to significant uncertainty.
Sustainability assessment 2/	Not required for surveillance countries	Not required for surveillance countries	
Debt stabilization in the baseline			Yes

DSA Summary Assessment

Commentary: Palau's debt sustainability is supported by the economic recovery since 2024, a new Compact agreement with the United States, and a successful domestic revenue mobilization via tax reform. The resulting fiscal space will ensure that debt declines at a solid pace while cash buffers are built up. Debt reduction needs to continue to ensure sufficient fiscal space in a globally volatile environment. In addition, reforms to tackle pension liabilities remain critical to secure long-term fiscal sustainability.

Source: Fund staff.

Note: The risk of sovereign stress is a broader concept than debt sustainability. Unsustainable debt can only be resolved through exceptional measures (such as debt restructuring). In contrast, a sovereign can face stress without its debt necessarily being unsustainable, and there can be various measures—that do not involve a debt restructuring—to remedy such a situation, such as fiscal adjustment and new financing.

1/ The near-term assessment is not applicable in cases where there is a disbursing IMF arrangement. In surveillance-only cases or in cases with precautionary IMF arrangements, the near-term assessment is performed but not published.

2/ A debt sustainability assessment is optional for surveillance-only cases and mandatory in cases where there is a Fund arrangement. The mechanical signal of the debt sustainability assessment is deleted before publication. In surveillance-only cases or cases with IMF arrangements with normal access, the qualifier indicating probability of sustainable debt ("with high probability" or "but not with high probability") is deleted before publication.

Annex VIII. Figure 2. Palau: Debt Coverage and Disclosures

	CG	GG	NFPS	CPS	Other	Comments
1. Debt coverage in the DSA: 1/	CG	GG	NFPS	CPS	Other	
1a. If central government, are non-central government entities insignificant?					n.a.	

2. Subsectors included in the chosen coverage in (1) above:

Sector		Subsectors captured in the baseline	Inclusion	Comments
CPS / NFPS / GG: expected / CG	1	Budgetary central government	Yes	
CPS / NFPS / GG: expected / CG	2	Extra budgetary funds (EBFs)	No	Not applicable
CPS / NFPS / GG: expected / CG	3	Social security funds (SSFs)	Yes	No SSF debt
CPS / NFPS / GG: expected	4	State governments	Yes	
CPS / NFPS / GG: expected	5	Local governments	Yes	No LG debt
CPS / NFPS	6	Public nonfinancial corporations	Yes	
CPS	7	Central bank	No	No Central Bank
CPS	8	Other public financial corporations	Yes	

3. Instrument coverage:	Currency & deposits	Loans	Debt securities	Oth acct. payable 2/	IPSGSs 3/

4. Accounting principles:	Basis of recording		Valuation of debt stock		
	Non-cash basis 4/	Cash basis	Nominal value 5/	Face value 6/	Market value 7/

5. Debt consolidation across sectors:	Consolidated	Non-consolidated

Color code: chosen coverage; Missing from recommended coverage; Not applicable

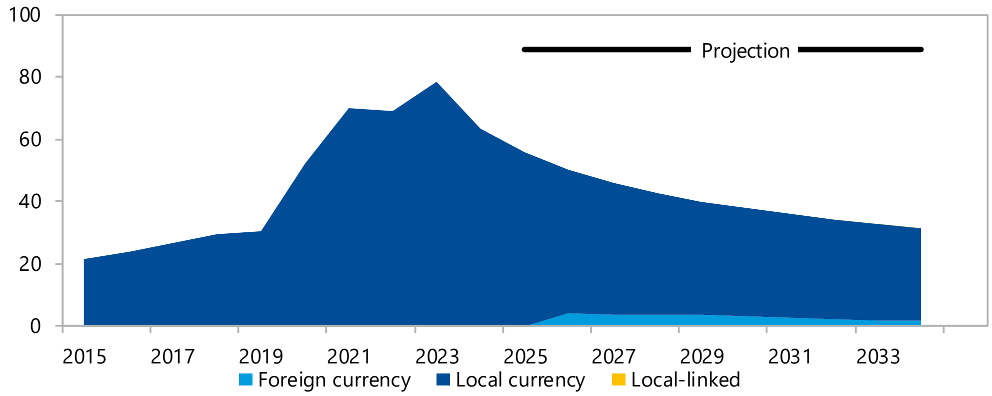
Reporting on Intra-Government Debt Holdings

Sector		Issuer \ Holder	Budget. central govt	Extra-budget. funds	Social security funds	State govt.	Local govt.	Nonfin. pub. corp.	Central bank	Oth. pub. fin corp	Total
CPS / NFPS / GG: expected / CG	1	Budget. central govt									0
CPS / NFPS / GG: expected / CG	2	Extra-budget. funds									0
CPS / NFPS / GG: expected / CG	3	Social security funds									0
CPS / NFPS / GG: expected	4	State govt.									0
CPS / NFPS / GG: expected	5	Local govt.									0
CPS / NFPS	6	Nonfin pub. corp.									0
CPS	7	Central bank									0
CPS	8	Oth. pub. fin. corp									0
		Total	0	0	0	0	0	0	0	0	0

1/ CG=Central government; GG=General government; NFPS=Nonfinancial public sector; PS=Public sector.
2/ Stock of arrears could be used as a proxy in the absence of accrual data on other accounts payable.
3/ Insurance, Pension, and Standardized Guarantee Schemes, typically including government employee pension liabilities.
4/ Includes accrual recording, commitment basis, due for payment, etc.
5/ Nominal value at any moment in time is the amount the debtor owes to the creditor. It reflects the value of the instrument at creation and subsequent economic flows (such as transactions, exchange rate, and other valuation changes other than market price changes, and other volume changes).
6/ The face value of a debt instrument is the undiscounted amount of principal to be paid at (or before) maturity.
7/ Market value of debt instruments is the value as if they were acquired in market transactions on the balance sheet reporting date (reference date). Only traded debt securities have observed market values.

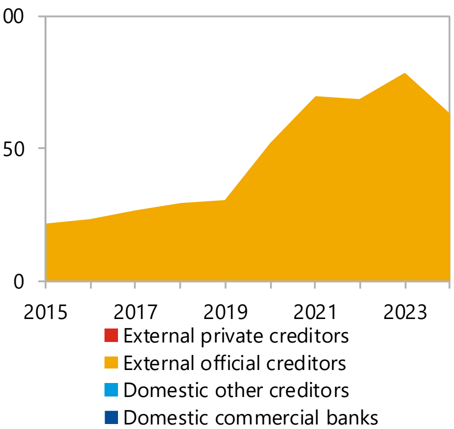
Commentary: The SRDSA coverage is general government debt consistent with GFS 2014.

Annex VIII. Figure 3. Palau: Public Debt Structure Indicators



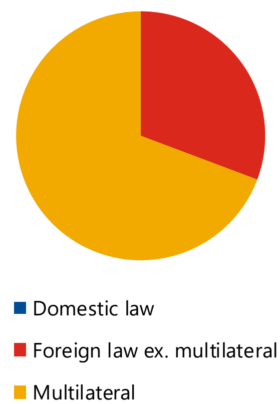
Note: The perimeter shown is consolidated public sector.

Public Debt by Holder (Percent of GDP)



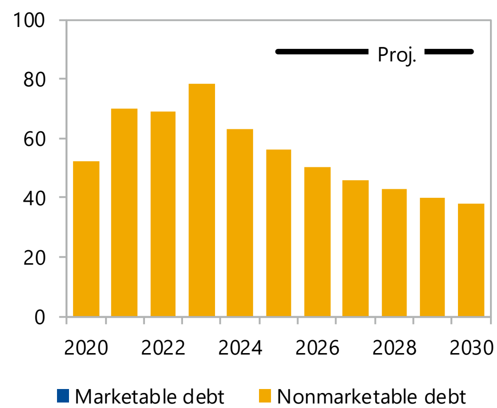
Note: The perimeter shown is general government.

Public Debt by Governing Law, 2024 (percent)



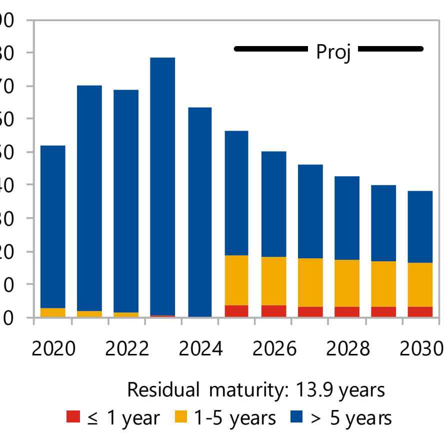
Note: The perimeter shown is general government.

Debt by Instruments (Percent of GDP)



Note: The perimeter shown is general government.

Public Debt by Maturity (Percent of GDP)



Note: The perimeter shown is general government.

Commentary: Palau's debt portfolio is prudent and consists of only external, highly concessional, multilateral (mostly ADB) long-term debt denominated in domestic currency (U.S. dollars).

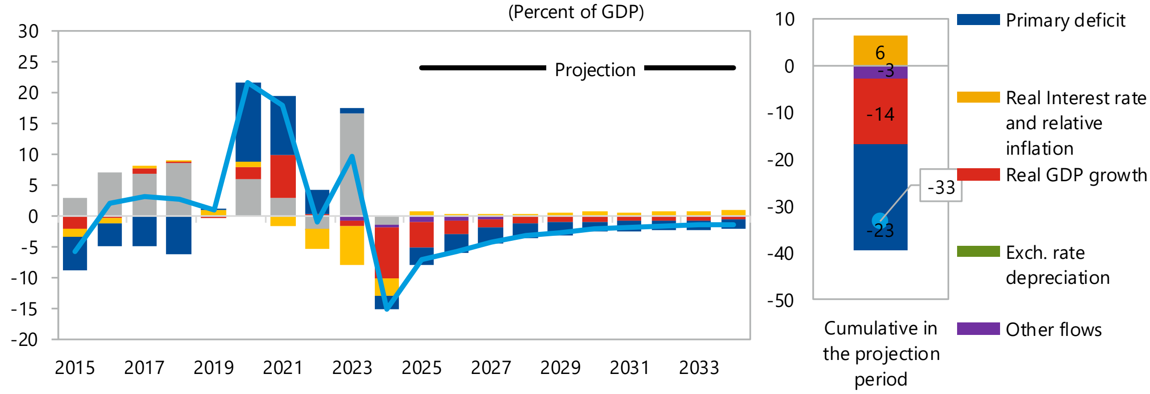
Annex VIII. Figure 4. Palau: Baseline Scenario

(Percent of GDP unless indicated otherwise)

	Actual	Medium-term projection						Extended projection			
	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034
Public debt	63.3	56.1	50.2	46.0	42.7	40.0	38.0	36.0	34.3	32.7	31.3
Change in public debt	-15.2	-7.2	-5.9	-4.3	-3.3	-2.7	-2.0	-1.9	-1.7	-1.6	-1.4
Contribution of identified flows	-13.6	-7.2	-5.9	-4.3	-3.3	-2.7	-2.0	-1.9	-1.7	-1.5	-1.4
Primary deficit	-2.3	-2.9	-2.9	-2.6	-2.4	-2.2	-1.7	-1.7	-1.6	-1.6	-1.5
Noninterest revenues	53.5	53.4	53.0	52.6	52.2	52.0	51.3	51.4	51.4	51.4	51.4
Noninterest expenditures	51.3	50.5	50.1	50.0	49.8	49.7	49.6	49.7	49.7	49.8	49.9
Automatic debt dynamics	-11.1	-3.2	-2.2	-1.1	-0.8	-0.4	-0.2	-0.2	-0.1	0.0	0.1
Real interest rate and relative inflation	-2.7	0.8	0.1	0.2	0.4	0.6	0.6	0.6	0.7	0.8	0.8
Real interest rate	-2.7	0.8	0.1	0.2	0.3	0.5	0.6	0.6	0.7	0.7	0.8
Relative inflation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real growth rate	-8.4	-4.0	-2.2	-1.3	-1.2	-0.9	-0.9	-0.8	-0.8	-0.7	-0.7
Real exchange rate	0.0	…	…	…	…	…	…	…	…	…	…
Other identified flows	-0.3	-1.1	-0.9	-0.6	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(minus) Interest Revenues	-0.3	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0
Other transactions	0.0	-0.9	-0.8	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Contribution of residual	-1.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross financing needs	0.3	0.9	1.9	2.0	1.0	0.6	1.1	1.0	0.4	0.2	0.2
of which: debt service	2.9	4.0	4.8	4.7	3.5	2.9	2.9	2.7	2.1	1.8	1.7
Local currency	2.9	4.0	4.8	4.6	3.4	2.8	2.5	2.3	1.7	1.5	1.4
Foreign currency	0.0	0.0	0.0	0.1	0.1	0.1	0.4	0.3	0.3	0.3	0.3
Memo:											
Real GDP growth (percent)	12.0	6.7	4.1	2.7	2.6	2.2	2.2	2.1	2.1	2.1	2.1
Inflation (GDP deflator; percent)	3.9	1.0	2.7	2.6	2.4	2.2	2.3	2.3	2.3	2.3	2.3
Nominal GDP growth (percent)	16.4	7.8	6.9	5.3	5.1	4.4	4.6	4.5	4.5	4.5	4.5
Effective interest rate (percent)	0.0	2.4	2.8	3.0	3.2	3.5	3.9	3.9	4.2	4.6	4.9

Contribution to Change in Public Debt

(Percent of GDP)



Commentary: Public debt will continue declining due to strong economic fundamentals and fiscal consolidation grants FY2024-29. Large past residuals reflect Palau's borrowing for investment projects while accumulating cash savings.

Annex VIII. Figure 5. Palau: Realism of Baseline Assumptions

Forecast Track Record 1/	t+1	t+3	t+5
Public debt to GDP			
Primary deficit			
r - g			
Exchange rate depreciaton			
SFA			

	real-time	t+3	t+5
Historical Output Gap Revisions 2/			

Comparator Group:

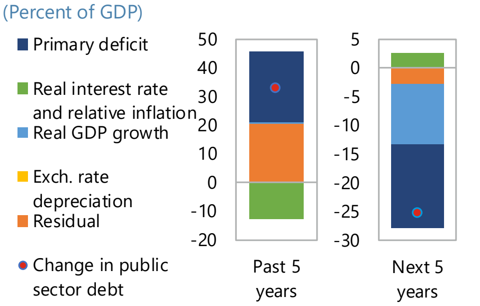
Emerging Markets, Non-Commodity Exporter, Surveillance

Color Code:

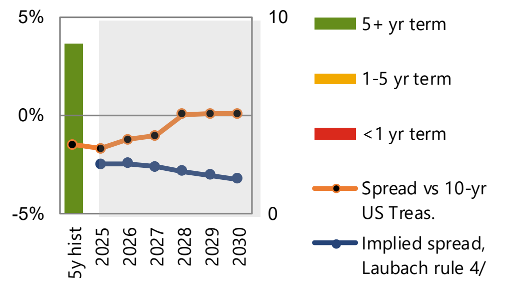
Optimistic
- > 75th percentile
- 50-75th percentile

Pessimistic
- 25-50th percentile
- < 25th percentile

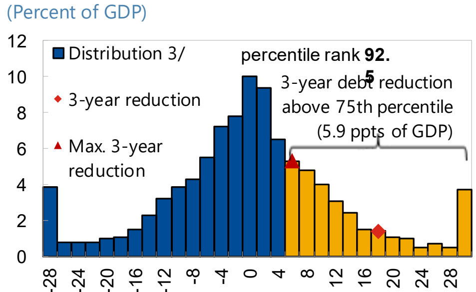
Public Debt Creating Flows
(Percent of GDP)



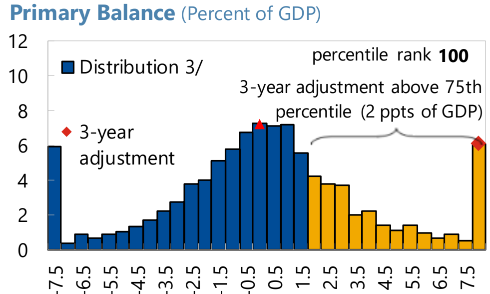
Bond Issuances
(Bars, debt issuances (RHS, %GDP); lines, avg marginal interest rates (LHS, percent))



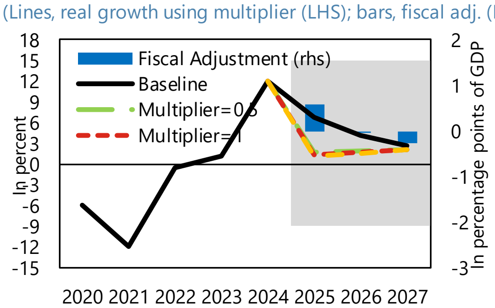
3-Year Debt Reduction
(Percent of GDP)



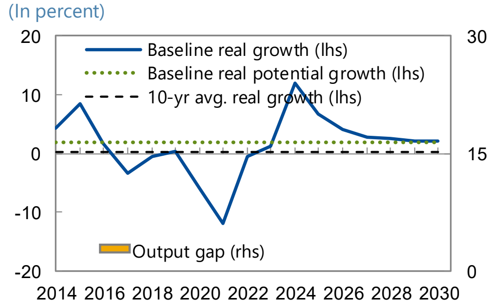
3-Year Adjustment in Cyclically-Adjusted Primary Balance
(Percent of GDP)



Fiscal Adjustment and Possible Growth Paths
(Lines, real growth using multiplier (LHS); bars, fiscal adj. (RHS))



Real GDP Growth
(In percent)



Commentary: The ongoing economic recovery coupled with fiscal surpluses, in line with Palau's fiscal strategy, as well as large savings will help undo the pandemic debt surge. Palau is projected to maintain primary surpluses and use savings to finance GFN in FY2025-29 in compliance with the Compact fiscal consolidation grant terms.

Source : IMF Staff.

1/ Projections made in the October and April WEO vintage. Program status not used in creating comparator group due to lack of data.

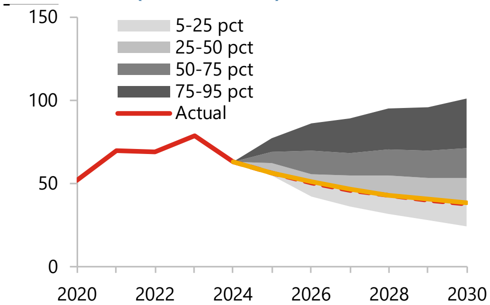
2/ N/A for Palau. Calculated as the percentile rank of the country's output gap revisions (defined as the difference between real time/period ahead estimates

3/ Data cover annual obervations from 1990 to 2019 for MAC advanced and emerging economies. Percent of sample on vertical axis.

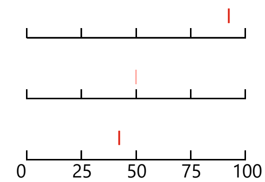
4/ The Laubach (2009) rule is a linear rule assuming bond spreads increase by about 4 bps in response to a 1 ppt increase in the projected debt-to-GDP ratio.

Annex VIII. Figure 6. Palau: Medium-Term Risk Assessment

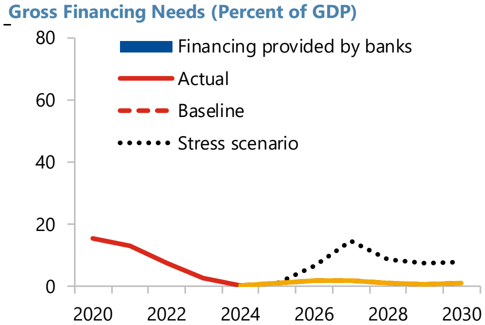
Final Fanchart (Percent of GDP)



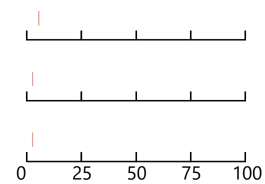
	Value	Contrib 1/	Percentile in peer group 2/
Debt fanchart module			
Fanchart width *(percent of GDP)*	76.9	1.1	
Probability of debt non-stabilizaiton *(percent)*	19.2	0.2	
Terminal debt-to-GDP x institutions index	26.0	0.6	
Debt fanchart index (DFI)		1.8	
Risk signal: 3/		**Moderate**	



Gross Financing Needs (Percent of GDP)



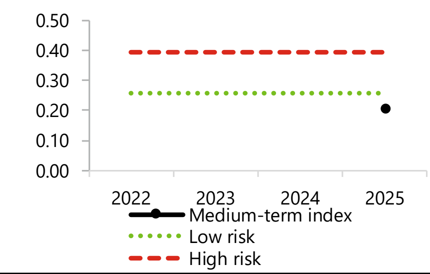
	Value	Contrib 1/	Percentile in peer group 2/
Gross financing needs (GFN) module			
Average baseline GFN *(percent of GDP)*	1.2	0.4	
Initial Banks' claims on the gen. govt *(pct bank assets)*	0.0	0.0	
Chg. In banks' claims in stress *(pct banks' assets)*	0.0	0.0	
GFN financeability index (GFI)		0.4	
Risk signal: 4/		**Low**	



Triggered stress tests (stress tests not activated in gray)

Banking crisis | Commodity prices | Exchange rate | Contingent liab. | Natural disaster

Medium-Term Index (Index Number)



Medium-term risk analysis

	Value	(normalized)	Weight	Contribution
Debt fanchart index	1.8	0.4	0.5	0.2
GFN finaceability index	0.4	0.0	0.5	0.0
Medium-term index		0.2		
Risk signal: 5/		**Low**		
Final assessment:		**Moderate**		

Prob. of missed crisis, 2025-2030, if stress not predicted: 9.1 pct.
Prob. of false alarms, 2025-2030, if stress predicted: 52.3 pct.

Commentary: Palau's medium-term risk is assessed as moderate despite the low mechanical signa as large resilient infrastructure investment needs may require new project borrowing slowing debt reduction and increasing vulnerability to shocks.

Source: IMF staff estimates and projections.

1/ See Annex IV of IMF, 2022, Staff Guidance Note on the Sovereign Risk and Debt Sustainability Framework for details on index calculation.
2/ The comparison group is emerging markets, non-commodity exporter, surveillance.
3/ The signal is low risk if the DFI is below 1.13; high risk if the DFI is above 2.08; and otherwise, it is moderate risk.
4/ The signal is low risk if the GFI is below 7.6; high risk if the DFI is above 17.9; and otherwise, it is moderate risk.
5/ The signal is low risk if the GFI is below 0.26; high risk if the DFI is above 0.40; and otherwise, it is moderate risk.

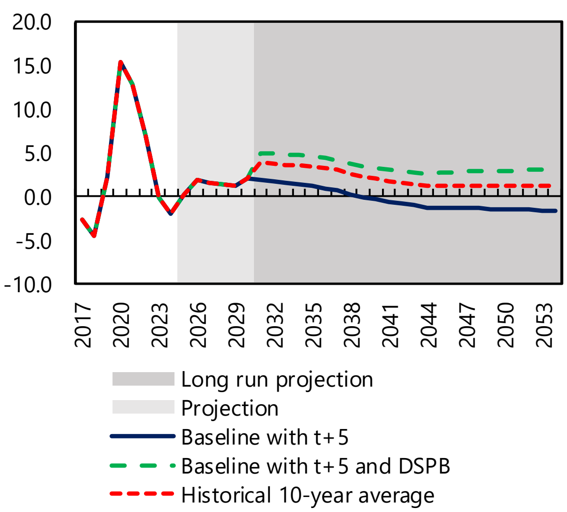
Annex VIII. Figure 7. Palau: Triggered Modules

Large amortizations	**Pensions**	**Climate change: Adaptation**	Natural Resources
	Health	Climate change: Mitigation	

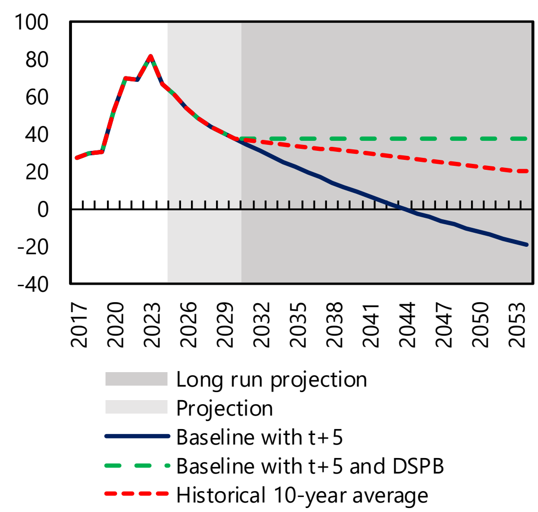
Palau: Long-Term Risk Assessment: Large Amortization

Projection	Variable	Risk Indication
Medium-term extrapolation	GFN-to-GDP ratio	
	Amortization-to-GDP ratio	
	Amortization	
Medium-term extrapolation with debt stabilizing primary balance	GFN-to-GDP ratio	
	Amortization-to-GDP ratio	
	Amortization	
Historical average assumptions	GFN-to-GDP ratio	
	Amortization-to-GDP ratio	
	Amortization	
Overall Risk Indication		

GFN-to-GDP Ratio



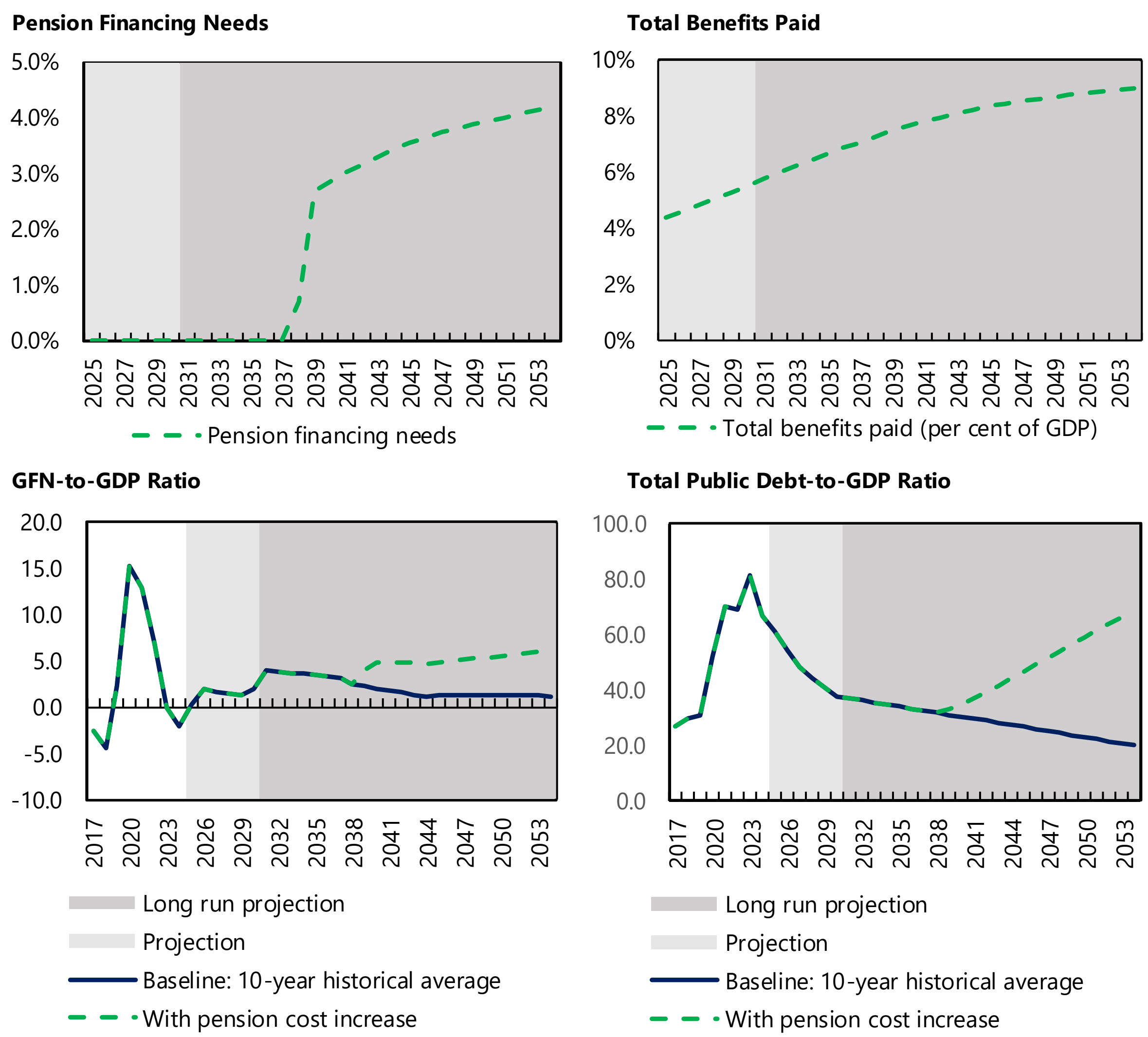
Total Public Debt-to-GDP Ratio



Commentary: Palau debt amortization needs are projected to rise as of FY2026. The historical scenario data covers the unprecedented output loss of pre-pandemic GDP due to 3 years of pandemic-related isolation.

Annex VIII. Figure 8. Palau: Demographics: Pensions

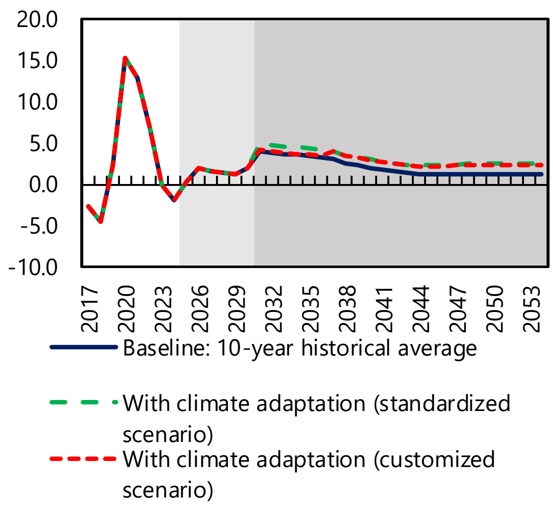
Permanent adjustment needed in the pension system to keep pension assets positive for:	30 years	50 years	Until 2100
(pp of GDP per year)	1.9%	2.7%	3.4%



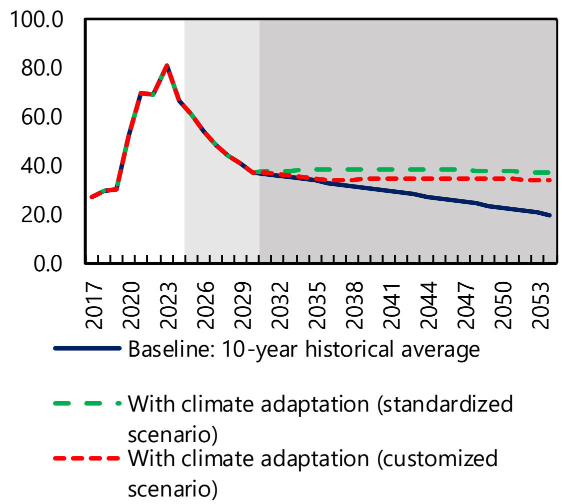
Commentary: Without the two pressing pension reforms (on civil service and social security pensions) that are under discussion, Palau would experience large financing needs that may undo the long run debt reduction.

Annex VIII. Figure 9. Palau: Climate Change: Adaptation

GFN-to-GDP Ratio



Total Public Debt-to-GDP Ratio



Commentary: Long-term climate adaptation needs projections are in line with standard parameter values and Palau-specific estimates.

Annex IX. Data Issues

Annex IX. Table 1. Palau: Data Adequacy Assessment for Surveillance

Data Adequacy Assessment Rating 1/							
B							
Questionnaire Results 2/							
Assessment	National Accounts	Prices	Government Finance Statistics	External Sector Statistics	Monetary and Financial Statistics	Inter-sectoral Consistency	Median Rating
	B	B	B	C	C	B	B
Detailed Questionnaire Results							
Data Quality Characteristics							
Coverage	B	B	B	B	B		
Granularity 3/	A		C	B	C		
			A		C		
Consistency			B	C		B	
Frequency and Timeliness	C	B	B	C	C		

Note: When the questionnaire does not include a question on a specific dimension of data quality for a sector, the corresponding cell is blank.
1/ The overall data adequacy assessment is based on staff's assessment of the adequacy of the country's data for conducting analysis and formulating policy advice, and takes into consideration country-specific characteristics.
2/ The overall questionnaire assessment and the assessments for individual sectors reported in the heatmap are based on a standardized questionnaire and scoring system (see IMF *Review of the Framework for Data Adequacy Assessment for Surveillance*, January 2024, Appendix I).
3/ The top cell for "Granularity" of Government Finance Statistics shows staff's assessment of the granularity of the reported government operations data, while the bottom cell shows that of public debt statistics. The top cell for "Granularity" of Monetary and Financial Statistics shows staff's assessment of the granularity of the reported Monetary and Financial Statistics data, while the bottom cell shows that of the Financial Soundness indicators.

A	The data provided to the Fund are adequate for surveillance.
B	The data provided to the Fund have some shortcomings but are broadly adequate for surveillance.
C	The data provided to the Fund have some shortcomings that somewhat hamper surveillance.
D	The data provided to the Fund have serious shortcomings that significantly hamper surveillance.

Rationale for staff assessment. As a small island country, Palau faces challenges due to limited capacity and staffing constraints in compiling and disseminating official statistics. Despite these limitations, the data provided to the Fund have some shortcomings but are broadly adequate for surveillance. Palau receives substantial technical assistance from PFTAC and the Graduate School USA, which supports by recompiling and disseminating several datasets used for surveillance. Annual data for GDP and Balance of Payments (BOP) are disseminated with a six-month lag, affecting the team's ability to conduct conjunctural analysis. Staff analysis of economic trends would benefit from quarterly data on GDP and BOP. Quarterly GFS data is provided upon request by the Graduate School USA. GFS data at the general government level is compiled, but dissemination is significantly delayed due to late audits. Additionally, the increased use of high-frequency indicators, market surveys, and more timely data dissemination practices would enhance the analysis. Regarding balance of payments statistics, the high errors and omissions in the BOP statistics complicate surveillance efforts. In addition, foreign direct investment estimates are inconsistent with counterpart data from the Fund's Coordinated Direct Investment Survey (CDIS) database. Analyzing financial sector developments is challenging due to staffing constraints at the Financial Institutions Commission (FIC), which affects the timeliness of their reports.

Changes since the last Article IV consultation. The authorities have released the results of the 2023 Household Income and Expenditure Survey (HIES). With PFTAC's support, the Consumer Price Index (CPI) basket is being reweighted.

Corrective actions and capacity development priorities. The authorities should strengthen institutional capacity at the Office of Planning by increasing both staff and non-staff resources. Reporting on State-Owned Enterprises' activities should be more detailed and granular. Capacity development efforts should prioritize supporting the compilation of quarterly GDP, improving GDP deflators, compiling GDP by expenditure breakdowns, and broadening fiscal data coverage. In the financial sector, key priorities include enhancing data timeliness, disseminating an Other Depository Corporations Survey, as well as incorporating the National Development Bank into to the reports.

Use of data and/or estimates in Article IV consultations in lieu of official statistics available to staff. None

Other data gaps. Additional information on environmental and climate risks, including greater use of Geographical Information Systems (GIS) to assess vulnerabilities were announced during the 2023 AIV Consultation. Comprehensive and more frequent surveys on migration and foreign laborers would enhance staff's analysis of the labor market and its impact on economic activity. Palau does not report to the IMF the Financial Access Survey and Financial Soundness Indicators.

Annex IX. Table 2. Palau: Data Standards Initiatives

Palau participates in the Enhanced General Data Dissemination System (e-GDDS) and publishes the data on its National Summary Data Page since February 2022. Palau disseminates only seven of the fifteen encouraged data categories.

Annex IX. Table 3. Palau: Table of Common Indicators Required for Surveillance

As of August 18, 2025

	Data Provision to the Fund				Publication under the Data Standards Initiatives through the National Summary Data Page			
	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Expected Frequency[6,7]	Palau[8]	Expected Timeliness[6,7]	Palau[8]
Exchange Rates	NA	NA	NA	NA	D	...	...	...
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	NA	NA	NA	NA	M	...	1M	...
Reserve/Base Money	NA	NA	NA	NA	M	...	2M	...
Broad Money	FY 2024	Jul-25	A	A	M	...	1Q	...
Central Bank Balance Sheet	NA	NA	NA	NA	M	...	2M	...
Consolidated Balance Sheet of the Banking System	FY 2024	Jul-25	A	A	M	...	1Q	...
Interest Rates[2]	FY 2024	Jul-25	A	A	M	...	...	...
Consumer Price Index	2025Q2	Jul-25	Q	Q	M	Q	2M	1M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	NA	NA	NA	NA	A	...	3Q	...
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	FY 2024	Jun-25	A	A	Q	A	1Q	7M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	NA	NA	NA	NA	Q	...	2Q	...
External Current Account Balance	FY 2024	Jul-25	A	A	Q	A	1Q	7M
Exports and Imports of Goods and Services	FY 2024	Jul-25	A	A	M	M	12W	2M
GDP/GNP	FY 2024	Jun-25	A	A	Q	A	1Q	7M
Gross External Debt	FY 2024	Jun-25	A	A	Q	A	2Q	7M
International Investment Position	FY 2023	Jun-24	A	A	A	A	3Q	7M

[1] Includes reserve assets pledged or otherwise encumbered, as well as net derivative positions.

[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Frequency and timeliness: ("D") daily; ("W") weekly or with a lag of no more than one week after the reference date; ("M") monthly or with lag of no more than one month after the reference date; ("Q") quarterly or with lag of no more than one quarter after the reference date; ("A") annual.; ("SA") semiannual; ("I") irregular; ("NA") not available or not applicable; and ("NLT") not later than.

[7] Encouraged frequency of data and timeliness of reporting under the e-GDDS and required frequency of data and timeliness of reporting under the SDDS and SDDS Plus. Any flexibility options or transition plans used under the SDDS or SDDS Plus are not reflected. For those countries that do not participate in the IMF Data Standards Initiatives, the required frequency and timeliness under the SDDS are shown for New Zealand, and the encouraged frequency and timeliness under the e-GDDS are shown for Eritrea, Nauru, South Sudan, and Turkmenistan.

[8] Based on the information from the Summary of Observance for SDDS and SDDS Plus participants, and the Summary of Dissemination Practices for e-GDDS participants, available from the IMF Dissemination Standards Bulletin Board (https://dsbb.imf.org/). For those countries that do not participate in the Data Standards Initiatives, as well as those that do have a National Data Summary Page, the entries are shown as "..."

Annex X. Country Engagement Box

1. The National Development Plan (NDP) sets out the key medium-term policy objectives for the Palauan economy in FY2023-26. The NDP focuses on diversifying the economy, attracting foreign investment, building human capital, and raising financial deepening to achieve sustainable and inclusive growth, while protecting Palau's natural resources and enhancing economic resilience to climate vulnerability and addressing its heavy reliance on grants and tourism. Other priorities include strengthening fiscal framework and institutional capacity, promoting economic digitalization, and modernizing the payment system.

2. Benefiting from close engagement with development partners (DPs), Palau has been making steady efforts to address its key economic challenges, despite uneven progress in some areas. Like other small island states, Palau's growth potential and economic resilience are constrained by limited human capital, large exposures to natural disasters, and global shocks. Palau also faces challenges to diversify and upgrade its growth engine, retain skilled workers, deepen domestic financial system, and reduce fiscal dependence on foreign aid. To address some of these challenges, the authorities have been making important progress, including implementing a tax reform to broaden the domestic revenue base, upgrading tourism services to attract high-value tourists, integrating climate change considerations into economic planning and fiscal strategies, establishing the Employment and Compensation Committee to develop policies in retaining high-skilled government employees, and striving to enhance financial inclusion through digital payment solutions. Nonetheless, capacity building continues to be constrained by shortage of human capital. The lack of effective financial intermediation of private credit remains a key impediment for growth.

3. Against this backdrop, the IMF prioritizes the engagement with Palau in close collaboration with other key development partners, accounting for the capacity constraints.

Objectives	Proposed strategies
Strengthening medium-term fiscal framework to ensure sustainability, enhancing resilience (including to climate shocks), and boosting potential growth.	Assess policy tradeoffs around different fiscal policy paths and saving-investment dynamics and inform medium-term fiscal anchor/fiscal rules to secure debt sustainability, enhance resilience to climate and other macroeconomic shocks. The DIGNAD model results were presented to the authorities during the Staff Visit and included hands-on training. PFM CD should focus on reforms that support effective operationalization of MTFF and potential fiscal rules, in line with the country's capacity to implement, while integrating a climate perspective. The recently completed Green PFM TA, with potential follow-ups, provides guidance on integrating climate considerations into the fiscal planning and budgetary process.
Enhancing capacity building.	Foster collaborative efforts with other development partners to identify gaps and multifaceted strategies. The HQ-based TA on the public wage bill and employment, advising the options to preserve government employees, is an important contribution. The IMF should continue to provide CDs in the macro-critical areas such as tax administration, debt management, pension reforms, etc.

Objectives	**Proposed strategies**
Reinforcing revenue mobilization efforts.	Continue to provide CD and TA support through PFTAC (further reforms to enhance tax administration) and HQ (recently completed tax diagnostic), regional capacity building workshops on tax expenditures—all funded by the Government of Japan.
Raising financial deepening and inclusion, modernize the payment system.	Closely monitor initiatives related to fintech, assess risks and macroeconomic impact, and keep open communication channels with the authorities. Continue to support the authorities in improving their AML/CFT policies. This Article IV also provides analysis and policy recommendations on financial deepening, and payment system reforms, in collaboration with the World Bank that is conducting an FSAP Development Module update on related topics.
Mitigating financial stability risks.	Continue to highlight potential risks related to the governance of the National Development Bank of Palau (NDBP), and the predominant role played by the two US bank branches in the Article IV consultation.

Annex XI. Capacity Development, 2023-25

Area	TA Provider	Timeline
Tax Policy and Administration		
Revenue administration	PFTAC (FAD)	January 2025
Tax policy diagnostic assessment	PFTAC (FAD)	November 2024
Revenue administration	PFTAC (FAD)	August 2023
Revenue administration	IMF (LEG)	January 2023
Expenditure Policy and Administration		
Expenditure policy	IMF (FAD)	May 2024
Expenditure policy, Wage bill	IMF (FAD)	November 2023
Financial Sector Stability		
AML/CFT	IMF (LEG)	March 2025
AML/CFT	IMF (LEG)	April 2024
Financial supervision and regulation	PFTAC (MCM)	June 2023
Public Financial Management		
Green public financial management	PFTAC (FAD)	March 2025
Debt management	PFTAC (MCM)	March 2024
Macroeconomic Programming and Analysis		
Economic and fiscal forecasting	IMF (APD)	March 2025
Economic Statistics		
Consumer Price Index	(IMF) STA	June 2025
National Accounts Statistics	(IMF) STA	January 2025
Producer Price Index	(IMF) STA	September 2024
Government Finance Statistics	(IMF) STA	January 2024
Producer Price Index	(IMF) STA	November 2023

INTERNATIONAL MONETARY FUND

REPUBLIC OF PALAU

January 13, 2026

STAFF REPORT FOR THE 2025 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By | Asia and Pacific Department (in collaboration with other departments)

CONTENTS

FUND RELATIONS

(As of November 30, 2025)

Membership Status: Joined: December 16, 1997; Article VIII

General Resources Account:	**SDR Million**	**Percent Quota**
Quota	4.9	100.00
Fund Holdings of Currency	4.45	90.82
Reserve Position in Fund	.45	9.20

SDR Department:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	7.65	100.00
Holdings	7.23	94.40

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Overdue Obligations and Projected Payments to Fund[1/]

(SDR Million; based on existing use of resources and present holdings of SDRs):

			Forthcoming		
	2025	**2026**	**2027**	**2028**	**2029**
Principal					
Charges/interest	0.01	0.01	0.01	0.01	0.01
Total	0.01	0.01	0.01	0.01	0.01

[1/] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Implementation of HIPC Initiative: Not Applicable

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

Implementation of Catastrophe Containment and Relief (CCR): Not Applicable

Exchange Arrangement: The de jure and de facto exchange rate arrangements are classified as no separate legal tender. The U.S. dollar is legal tender and the official currency. Palau maintains an exchange system that is free of restrictions on international payments and transfers for current and capital transactions.

Article IV Consultation: Palau is on a 24-month cycle. The 2023 Article IV Consultation discussions were held during August 30 – September 12, 2023. The staff report (IMF Country Report No. 2023/430) was considered by the Executive Board and the consultation concluded on December 1, 2023.

Capacity Development: Since the 2023 Article IV, IMF technical assistance has focused on tax policy, tax administration, tax law, bank supervision, debt management, public sector wage bill, and statistics (PPI, CPI, and government finance) has been provided mainly through PFTAC.

Resident Representative: The resident representative office in the Pacific Islands, including Palau, was opened in September 2010 in Suva, Fiji. Mr. Neil Saker is the current Resident Representative.

RELATIONS WITH OTHER INTERNATIONAL FINANCIAL INSTITUTIONS

Relations with other IFIs:

• World Bank Group:
https://www.worldbank.org/ext/en/region/eap/pacific-islands

• Asian Development Bank:
https://www.adb.org/countries/palau/main

• Pacific Financial Technical Assistance Center:
https://www.pftac.org/content/PFTAC/en1.html

Statement by Ms. Luu Nghi, Alternate Executive Director, and Ms. Meang Ngiraingas, Advisor to the Executive Director

January 26, 2026

Overview

The Republic of Palau expresses its appreciation to Ms. Zhang and her team for facilitating an open and constructive dialogue throughout the Article IV mission. The authorities appreciate the staff's comprehensive analysis and insights, which offer valuable guidance for ongoing policy discussions. The authorities broadly agree with staff's appraisal and value the Fund's continued support. They remain fully committed to implementing reforms that protect fiscal sustainability, reinforce financial stability, increase resilience to climate and external shocks, and foster sustainable and inclusive economic growth.

As a small island state located in the western Pacific, Palau is widely recognized as a pristine marine paradise and global leader in ocean conservation. The nation's economy is primarily supported by the Compact of Free Association Agreement (COFA) with the United States, alongside international tourism, foreign aid, and concessional financing.

Economic Outlook and Risks

Following the deep and prolonged disruptions from the COVID19 pandemic, Palau's economic recovery has strengthened considerably in recent years. The renewal of the Compact Review Agreement (CRA23) and successful implementation of the 2023 tax reform have significantly improved the fiscal outlook and provided much needed policy space at a crucial time. The CRA-23 provides substantial grant assistance and contributions to the Compact Trust Fund (CTF), amounting to nearly USD 900 million, which exceeds 300 percent of GDP from FY2024 to FY2043. The 2023 tax reform, which introduced the Palau Goods and Services Tax (PGST), significantly expanded domestic revenue mobilization and improved compliance.

Economic activity rebounded strongly with 12 percent growth in FY2024, led by a revival in tourism and construction activity, supported by restored flight capacity, continued progress on high-value tourism initiatives, and improved investor confidence. The authorities expect increased short-term growth and medium-term potential due to expanded tourism and economic diversification, including the development of financial services. Inflation has eased sharply from its FY2023 peak of 12.4 percent to 0.2 percent in FY2025, and remains contained, supported by lower commodity prices and the normalization of utility costs. The current account deficit narrowed from a peak of 49 percent of GDP in FY2022 to 20 percent in FY2024, reflecting the tourism recovery and higher external grants which offset increased import demand. The minimum wage increases in FY2024, with the most recent adjustment that took effect on October 2025, have contributed to a consumption recovery.

The authorities generally agree with staff that the outlook for the near future is positive, though some uncertainty remains. The authorities recognize that global tensions and national security concerns stemming from illicit activities, and cyber-attacks represent significant near-term risks. Additionally, given the country's reliance on imports and their ongoing efforts to diversify the economy, additional challenges may arise through commodity price fluctuations. The authorities acknowledge that skilled labor emigration continues to pose a challenge for both the public sector and the broader economy and that measures such as increasing wages and expanding access to affordable housing could be helpful mitigants.

Fiscal Policy

The authorities remain committed to prudent fiscal management to safeguard the gains achieved in recent years. The FY2026 national budget was approved on December 5, 2025, following a two-month delay, with spending still strictly restrained, despite higher debt service obligations and cost-of-living pressures. The authorities highlight ongoing efforts to strengthen policy buffers, including the accumulation of fiscal reserves and debt reduction, as well as targeted climate resilience investments, such as a new hospital relocation project.

Work is underway to finalize the FY2026–29 medium-term fiscal strategy, which will serve as a central framework for operationalizing the authorities' debt reduction efforts, public investment priorities, and revenue mobilization agenda. The authorities are committed to developing a debt reduction strategy with interest on receiving technical assistance for developing transparent operational fiscal rules to reinforce compliance with the 30 percent debt anchor defined under the Fiscal Responsibility and Debt Management Act (FRDMA). Capacity development in debt sustainability analysis and debt management, including reforms to strengthen PFM systems to support implementation that is based on priorities and institutional capacity, are also needed. The authorities also recognize the need to improve expenditure efficiency**.** Ongoing efforts focus on investing in infrastructure, health, and education, with an emphasis on securing affordable financing for essential projects by prioritizing domestic savings and increasing donor support. The authorities have proposed a comprehensive spending review in the draft fiscal strategy.

On revenue mobilization, the authorities remain committed to preserving the gains from the 2023 tax reform. The immediate priorities include further strengthening revenue administration by enhancing governance and the legal framework, modernizing IT systems, and building revenue administrative capacity, while safeguarding against policy changes that may undermine the tax base. The authorities remain dedicated to the ongoing efforts to update the Tax Administration Act and upgrade the Tax Information System.

Effective management of fiscal risks requires swift preparation and execution of pension reforms, alongside essential reforms of state-owned enterprises (SOEs). Palau's pension system continues to face challenges due to insufficient funding, an aging population and emigration. These challenges affect both the Civil Service Pension Plan (CSPP) and the Social Security Administration (SSA) pension schemes. The authorities express strong support for these continuing reform initiatives, which remain central to their immediate policy agenda. This includes their commitment to improving actuarial analysis and enacting legislation on CSPP pension reform. On SOEs, the authorities underscore the importance of enhancing oversight of SOEs, with a particular focus on reinforcing the regulatory framework and improving both operational and investment efficiency.

Financial Sector

The authorities welcome staff's assessment that Palau's financial system remains broadly stable. The authorities recognize vulnerabilities of the National Development Bank of Palau (NDBP) and support stronger financial oversight and risk management between NDBP and the Ministry of Finance. The authorities highlight that efforts are ongoing to bring NDBP under the formal oversight of the Financial Institutions Commission (FIC) to enhance governance and are taking steps to enhance the capacity of the FIC, particularly as its mandate expands to include virtual asset service providers. With TA support from the Fund, the FIC is working to update Palau's legal framework, specifically the Financial Institutional Act, to ensure that financial regulation is closely aligned with its overarching mandate. Additional initiatives are underway to address structural challenges in financial intermediation, such as establishing a centralized credit bureau with the support of the Asian Development Bank and reviewing lending rate caps. The authorities are also considering measures such as requiring foreign branches to reinvest a portion of their deposits locally under the proposed Community Reinvestment Act, increasing NDBP funding through the proposed Palau Savings Bond (PSB) to retain domestic savings, and additional foreign concessional financing. The PSB has not yet been launched as several operational, legal, and regulatory procedures must be completed before the instrument becomes active. The development costs associated with the PSB are expected to be funded through contributions from international donors.

The authorities maintain a strong commitment to improving payment efficiency and developing financial services through digital and fintech initiatives. The authorities appreciate staff's detailed analysis of the risks associated with the tokenized dollar (TD) and the Digital Residency Program (DRP), including the consideration of potential loss of Corresponding Banking Relationship (CBRs). The authorities acknowledge the importance of a cautious approach and are undertaking further due diligence, including feasibility studies and legal reviews. The authorities are exploring alternative payment solutions, such as mobile money, which may offer more practical and cost-effective benefits given Palau's size and capacity. The authorities are interested in technical assistance from the World Bank and the IMF, in developing a tailored domestic payment strategy.

Strengthening AML/CFT compliance remains a high priority. The authorities are in the process of finalizing the national risk assessment of its money laundering and terrorist financing risks with the support of the IMF, and are committed to implementing its recommendations, including strengthening supervision of financial institutions and designated nonfinancial businesses, and improving beneficial ownership transparency.

Structural Reforms

The authorities acknowledge that structural challenges continue to impede growth, particularly the persistent shortage of skilled labor. Palau's population declined by 11.5 percent since 2005, leading to labor shortages. Prior initiatives aimed at addressing these challenges, including universal wage increases, have not been effective. The authorities appreciate staff's analysis of wage compression and its effect on public sector recruitment and retention. The authorities are committed to exploring options for better targeted wage adjustments, improved grading of positions, and more flexible compensation mechanisms.

The authorities are committed to updating the National Development Plan (NDP) as a core instrument for guiding economic diversification, infrastructure priorities, strengthening human capital, and climate resilient development over the medium-term. The authorities welcome staff's recognition of progress in diversifying the tourism sector through high-value and ecotourism strategies. Palau released its FY2025 eco-tourism strategy, detailing plans to encourage sustainable, high-value tourism instead of low-budget travel and is aiming to attract investments that align with the country's natural and cultural assets.

Given Palau's high exposure to climate-related risks, the authorities place strong emphasis on climate resilient infrastructure, including planned investments in health and coastal protection. The authorities appreciate the technical advice provided under the Green PFM initiative and intend to further integrate climate risk assessments into budget planning, public investment appraisal, and fiscal risk management.

Capacity Support

The authorities acknowledge and appreciate the valuable technical assistance and policy guidance offered by the Fund, which has contributed significantly to key reforms, including the implementation of tax reform and the creation of the Employment and Compensation Committee. They further welcome continued reform efforts to strengthen PFM, AML/CFT framework, tax revenue administration, and the development of a domestic payment strategy. The authorities remain committed to addressing data gaps through ongoing improvements to economic and fiscal statistics, supported by the Graduate School USA and TA from the Fund, which are essential for informed and effective policymaking. The authorities look forward to deepening their collaboration with the Fund as they continue to address Palau's development needs and long-term challenges.