



Republic of Palau

2012 ARTICLE IV CONSULTATION

Republic of Palau: 2012 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; 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 2012 Article IV consultation with the Republic of Palau, the following documents have been released and are included in this package:

- The staff report for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on January 25, 2012, with the officials of the Republic of Palau on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 24, 2012. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its March 12, 2012 discussion of the staff report that concluded the Article IV consultation.
- A statement by the Executive Director for the Republic of Palau.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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REPUBLIC OF PALAU

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

February 24, 2012

KEY ISSUES

Context. The economy has recovered strongly from the 2008–09 downturn, led by a rebound in tourist arrivals. An overarching challenge for Palau is to achieve self-sufficiency when the renewed Compact grants expire in FY2024.

Outlook and risks. Growth is expected to be favorable at 3 percent in FY2012 and average 2 percent over the medium term. But the outlook is clouded by an unsettled global environment and downside risks dominate. Highly dependent on tourism, imports of food and fuel, and foreign aid, Palau remains vulnerable to external headwinds and has limited policy space to counter these risks.

Fiscal sustainability. The authorities have made commendable efforts to reduce the current fiscal deficit (excluding grants) markedly during FY2010–11, but the deficit remains sizable. For FY2012, a reduction of 2 percent of GDP in the deficit is advisable, given the positive near-term outlook and the need to boost government cash reserves. Beyond FY2012, an average annual consolidation of 1½ percent of GDP through the rest of the decade is needed to achieve fiscal sustainability. This would require comprehensive tax reform and sizable reductions in wage bill and subsidies.

Public financial management. Staff supports the authorities' efforts to implement a medium-term budget framework in FY2013. There is also considerable scope to further strengthen budget execution and cash management.

Financial sector. The banking system remains sound and the Financial Institutions Commission (FIC) has made welcome progress in strengthening banking supervision. To safeguard stability, a priority is to bring non-bank financial institutions, including the National Development Bank, under the FIC's oversight.

Private sector development. A vibrant private sector is key to complementing the needed fiscal consolidation. Further efforts to promote private sector development are advisable.

Approved By
Patrizia Tumbarello
and **Claire Waysand**

Discussions took place in Koror with President Toribiong, Vice President and Minister of Finance Mariur, other senior government officials, members of Congress, private sector representatives, development partners, and the press during January 12-25, 2012. The mission team consists of Ms. Sun (head), Ms. Koh, Mr. Wu (all APD), and Mr. Gill (AsDB). Mr. Yang (Resident Representative for Pacific Island Countries) and Mr. Kaminaga (OED) also participated in the discussions.

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INTRODUCTION

1. **One of the smallest Pacific island countries, Palau depends on tourism and foreign aid for its livelihood** (Figure 1). Annual tourism receipts amount to about 50 percent of GDP. Grants, in particular under the Compact Agreement with the United States, averaged 25 percent of GDP during the last decade. However, renewed Compact grant assistance is set to end in FY2024.¹ Palau is on track to meet Millennium Development Goals (MDGs) by 2015. General elections are due in November 2012.
2. **An overarching challenge for Palau is to achieve self-sufficiency when the renewed Compact grants wind down.** Against this background, the 2012 Article IV

discussions focused on policies to achieve fiscal sustainability, improve public financial management, strengthen the financial sector, and promote private sector development.

3. **The authorities have been responsive to the Fund's advice.** During the past two fiscal years, they have tightened government spending and achieved fiscal adjustment in line with the Fund's recommendation. They have also made efforts to strengthen the budget process and improve the business climate. The Financial Institutions Commission (FIC) has continued to build up its supervisory capacity and strengthen bank oversight.

RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

A. Recent Developments

4. **The economy has recovered strongly from the 2008–09 downturn.** Real GDP growth is estimated to have reached about 6 percent in FY2011 (Table 1). This was driven by a 25 percent increase in tourist arrivals, surpassing pre-crisis levels (Box 1). Annual inflation increased from 1½ percent during 2009–10 to 3½ percent in 2011, due to a sharp rise in food and fuel prices during the first half of the year.
5. **The fiscal position has improved markedly, but the deficit remains sizable at 14 percent of GDP.** Thanks to spending restraint and economic recovery, the current fiscal deficit (excluding grants) declined cumulatively by 3½ percent of GDP during the past two fiscal years (Table 2 and Figure 2).

Nevertheless, government cash reserves stood at only US\$7 million (about one and a half months of government spending), while arrears amounted to about US\$15 million (7 percent of GDP) at end-FY2011.

6. **The rebound in tourist arrivals led to an improvement in the external position.** The current account deficit (excluding grants) declined to 11 percent of GDP in FY2011, despite a rise in imports from higher commodity prices (Table 3 and Figure 3). FDI flows have remained subdued. The Compact Trust Fund balance has stabilized at around US\$150 million, albeit still 15 percent below its pre-crisis peak.

B. Outlook and Risks

7. **The recovery will likely continue in the near term, supported by new scheduled flights and hotel construction.** The economy is projected to grow by 3 percent in FY2012 and average 2 percent over the next few years, with expansion in the tourism sector offsetting the expected fiscal consolidation (Table 4).

¹ The renewed agreement for FY2010–24 is pending U.S. Congressional approval.

Barring a spike in global commodity prices, inflation is expected to stay around 2 percent over the medium term.

8. Downside risks dominate and mainly stem from external factors. If a severe downturn spreads to Asia, the main tourist source region for Palau, the tourism sector could take a big hit (Box 1). This would have significant adverse effects on broader economic activity. An appreciation of the U.S. dollar amid heightened risk aversion could also reduce Palau's external competitiveness and further affect the tourism sector. Although the renewed Compact grants are unlikely to be affected, other aid flows may be delayed as donors face tighter finances. Given Palau's heavy dependence on imports, a sharp rise in food and fuel prices could depress domestic demand and weaken both the fiscal and external positions. Finally, while losses in Palau's overseas investments, notably the Compact

Trust Fund, would not have an immediate fiscal impact,² larger fiscal adjustments may be required over time to achieve sustainability. Given the sizable fiscal deficit and the absence of monetary and exchange rate policies, Palau has very limited policy space to counter these risks. In a downside scenario, Palau may need to seek concessional external assistance.

Authorities' Views

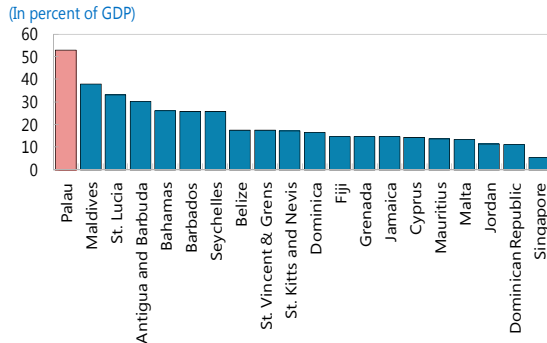
9. The authorities agreed with staff's assessment of the economic prospects and risks. They were particularly concerned about the impact of higher fuel prices on Palau's inflation and fiscal position. They concurred that Palau may have to seek concessional external assistance in the event of large negative shocks.

² Budget withdrawals from the Compact Trust Fund are specified under the Compact Agreement and have been US\$5 million annually. The Fund is invested in U.S. equities (65 percent) and bonds (35 percent).

Box 1. Palau's Tourism Sector

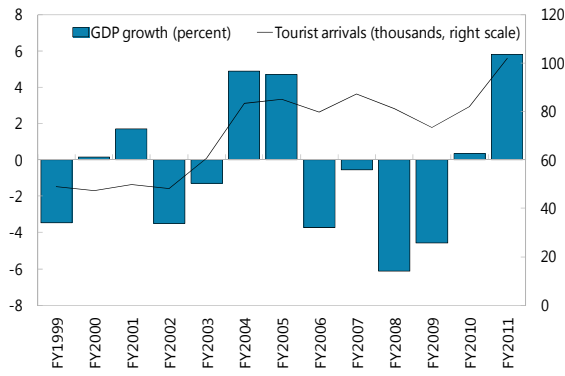
Tourism contributes considerably to the economy of Palau, one of the world's top diving destinations. Travel receipts amount to about 50 percent of GDP, more than twice the Pacific island average and among the highest in the world. Tourism is also a main source of growth in Palau, through employment generation and spillover to broader economic activity. A one percentage point increase in the growth rate of tourist arrivals is estimated to raise real GDP growth by 0.2 percentage points on average.

Travel Receipts for Tourism-Dependent States, Average 2001–2010
(In percent of GDP)



Source: IMF, International Financial Statistics.

Tourist Arrivals and GDP Growth

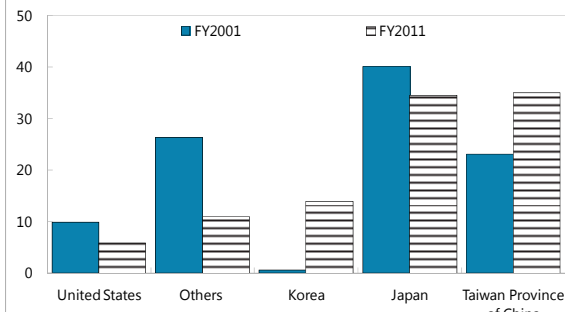


Source: Palauan authorities.

Visitors from Japan and Taiwan Province of China account for the bulk of tourist arrivals.

In contrast, other Pacific island economies, such as Fiji and Vanuatu are dominated by tourists from Australia and New Zealand. During the last decade, visitors from Korea and Taiwan Province of China to Palau have risen sharply, while tourists from Japan remain an important source. Tourists from other Asian markets such as China have also grown rapidly during the last two years, albeit from a very low base.

Tourists by Country of Residence
(In percent of total)



Source: Palauan authorities.

Global economic and financial conditions have profound implications on tourist arrivals and growth in Palau.

Palau's visitor arrivals were hit hard during the recent downturn, suffering a cumulative decline of about 20 percent over the period FY2008–09. Tourist arrivals have since rebounded—reflecting the global recovery, more scheduled flights, strengthened marketing, and the U.S. dollar's weakness relative to Asian currencies—and capacity constraints in the tourism sector are emerging. The literature on tourism suggests that tourist arrivals to small island countries are affected by economic developments in source countries, price considerations, external shocks, and supply factors, such as foreign direct investment and airlines services. Going forward, Palau's tourism sector could benefit from further efforts to improve the business climate and attract more investment. Preserving Palau's pristine environment will also go a long way toward ensuring sustainable development of the tourism sector.

POLICY DISCUSSIONS

A. Fiscal Policy

10. Palau needs sizable adjustment to achieve long-term fiscal sustainability.

When the renewed Compact grants expire in FY2024, government expense will need to be financed mainly by domestic revenue and withdrawals from the Compact Trust Fund. To prevent a sharp correction in spending or a depletion of the Compact Trust Fund, an average annual reduction in the current fiscal deficit (excluding grants) of 1½ percent of GDP through FY2019 is warranted (Appendix I). This would lead to a sustainable deficit of 3 percent of GDP and almost double government net worth (largely the Compact Trust Fund) to 90 percent of GDP, which will provide a sustainable source of financing going forward.

11. Staff analysis of the draft FY2012 budget under deliberation suggests no adjustment.³

The latest budget draft proposed to hike the hotel room tax from 10 to 12 percent (compared to the government's initial proposal of 15 percent) and raise the environment protection fee (i.e., green fee), with implementation set toward the end of the fiscal year. While the draft kept nominal current expenditure (i.e., expense) broadly unchanged from last year, a likely supplemental budget could raise annual expenditure growth to about 5 percent. If no additional revenue measures are enacted, staff projects the current deficit to remain unchanged. Financing the deficit could considerably reduce the government's cash reserves.

12. Staff recommended a reduction in the current deficit of 2 percent of GDP in FY2012 relative to FY2011.

³ The FY2012 conference budget draft was adopted by the Senate, but not the House of Delegates. An open-ended continuing resolution has been put in place.

necessary and feasible, given the positive near-term outlook and the need to boost government cash reserves. This would raise cash reserves or reduce arrears by about US\$1 million. Revenue windfalls should be saved. In a downside scenario, there is only limited room to lower the size of adjustment, given the large deficit and the need for fiscal sustainability.

- Ahead of concerted efforts on comprehensive tax reform (see below), staff supported the initial proposal to hike the hotel room tax from 10 to 15 percent, while allowing needed preparation time. Staff also encouraged quick implementation of the green fee increase. Additional measures should include raising water tariffs as scheduled and continuing to strengthen revenue administration (including upgrading the IT system), with assistance from the Pacific Financial Technical Assistance Centre (PFTAC). Altogether, these measures are estimated to lead to revenue gains of ½ percent of GDP relative to FY2011.
- Staff advised capping expense at FY2011 levels, resulting in a reduction of 1½ percent of GDP. The reduction would require prioritizing spending among all government arms and agencies on the national budget, given the needed transfer of US\$1.2 million to the Palau Public Utilities Corporation (PPUC) following a major fire. In light of a public wage bill out of line with peers, staff encouraged the authorities to reduce the number of temporary workers and continue to freeze hiring, enforce mandatory retirement, and allow only incremental salary increases.⁴ There is also scope to cut goods and services, particularly operational costs, and government transfers (excluding the one-off transfer to the PPUC), while protecting

⁴ Salary increments are legally required and average about 2 percent annually.

targeted social spending to low-income households.

13. Beyond FY2012, Palau needs to embark on comprehensive revenue and expenditure reforms. These reforms are essential for resolving long-standing fiscal imbalances and achieving the needed adjustment of 7½ percent of GDP over the next 5 years.

- At only 14½ percent of GDP, Palau's tax revenue is among the lowest in the Pacific. Staff advised the authorities to continue improving revenue administration, eliminate import duty exemptions, and move to cost, insurance, and freight (CIF) evaluation for imports. These measures could be implemented relatively quickly and yield gains of 2–3 percent of GDP.
- Comprehensive tax reform is long overdue. The current inefficient system needs to be overhauled, replacing the gross revenue tax with a corporate income tax and moving from taxing imports to consumption, by introducing for example a value-added tax (VAT) of 10–15 percent. These measures could potentially raise revenue by 1–2 percent of GDP over the medium term. Consideration should be given to initiating efforts soon to build a national consensus on tax reform.

Fiscal Reforms for FY2013-17
(In percent of GDP)

| Measures | Impact |
|---|-----------|
| Revenue gain | 4 |
| Strengthening administration, removing exemptions and adopting CIF evaluation | 2-3 |
| Adopting corporate income and consumption taxes | 1-2 |
| Expenditure reduction | 3 |
| Civil service reform | 2-3 |
| Commercializing water and sewage services | ½ |
| Total adjustments 1/ | 7½ |

Source: Fund staff estimates.

1/ The increase in the hotel room tax and green fee in FY2012 is estimated to raise additional revenue of ½ percent of GDP in FY2013 due to a full-year effect.

- More than half of Palau's domestic budget (including only the Compact budget assistance) is spent on wages and salaries, which is unsustainable as the Compact assistance winds down. Palau's public wage bill also exceeds the average of non-Compact Pacific island countries by about 4 percent of GDP. Anecdotal evidence suggests that the average public sector wage is higher than that of workers with similar skills in the private sector. With assistance from development partners, civil service reform in a phased manner is needed to improve the efficiency and effectiveness of public services while reducing the wage bill. However, this process will need to be carefully planned and managed to minimize adverse social impact. With assistance from the Asian Development Bank (AsDB), commercializing water and sewage services as planned and outsourcing certain government functions are also vital for achieving a sustained reduction in expenditure.

14. Staff welcomed the government's efforts to clear arrears in a transparent and prioritized manner. At end-FY2011, the bulk of government arrears (defined as accounts payable) were payments owed to other public entities, with arrears to private businesses at about US\$2 million (1 percent of GDP). Staff welcomed the settlement of US\$3.2 million arrears to the PPUC in early 2012 and supported the plan to use part of the AsDB loan to pay down arrears.⁵ Discussions have also been underway on how to use arrears clearance grants under the renewed Compact agreement. Staff stressed that improving the budget process is critical in preventing new arrears.

15. Weak budget planning and execution as well as the lack of fiscal space are at the root of long-standing arrears. The government has made revenue projections

⁵ The loan of US\$16 million is for commercializing water and sewage services. Budget support amounts to US\$6 million. Disbursement of US\$9.8 million was received in early 2012.

more realistic in budget proposals, but the projections are sometimes inflated during deliberation. Moreover, final approved budgets often do not take into account all obligations, such as grant co-payments and arrears clearance. Budget execution is based on appropriations rather than cash availability, resulting in the drawdown of cash reserves and/or the accumulation of arrears. The use of supplemental budgets to increase spending has also weakened budget credibility. Palau's structural fiscal issue (low tax revenue and high wage bill) and the lack of consensus on how to resolve it place additional pressure on the budget process.

16. A medium-term budget framework (MTBF) and better cash management would help the budget process. Staff welcomed the authorities' efforts to implement an MTBF in FY2013, with assistance from the AsDB. The MTBF would entail a more comprehensive and realistic approach consistent with a sound fiscal policy strategy, thereby enhancing budget credibility. To prioritize spending, the MTBF would need to involve all government arms and agencies on the national budget. Staff also emphasized the importance of cash planning and spending controls. A priority is to make budget execution contingent on cash availability. Establishment of a cash management committee could also help ensure transparent cash allocations based on spending priorities.

17. Staff welcomed ongoing efforts to reform government-owned utilities. With assistance from the AsDB, progress has been made in commercializing water and sewage services. Water tariffs should continue to be raised as scheduled so as to achieve cost recovery by FY2016. Electricity tariffs have been charged at below cost recovery levels, reducing incentives for energy conservation and contributing to maintenance shortfalls and the PPUC's financial challenges. Staff encouraged timely implementation of the new tariff structure, which will reduce subsidies to middle to high-income

households and increase tariffs to cost recovery levels.⁶ Doing so could also lower Palau's reliance on fuel imports and reduce external vulnerability.

18. Palau's Civil Service Pension Fund (CSPF) and Social Security Fund face large unfunded liabilities, last estimated at about US\$130 million (60 percent of GDP).

In particular, the CSPF has been running negative cash flows since 2000 and is expected to deplete its reserves within ten years. To put both plans back on a viable path, staff advised the authorities to seek technical assistance and adopt measures early on, including increasing employee contributions, raising the social security entitlement age, adjusting the benefit structure, and moving to a defined-contribution scheme.

19. An effective fiscal and legal framework centered on a petroleum fund is essential for managing potential oil and gas revenue. With assistance from the World Bank, the National Petroleum Revenue Management and Sharing Act and the Petroleum Act were recently passed. Given the large uncertainty associated with the timing and size of petroleum revenue, staff supported the authorities' decision that it is too early to factor in such revenue when deriving fiscal adjustment needs.

Authorities' Views

20. The authorities reiterated their commitment to achieving fiscal sustainability. They noted that it was important to get all stakeholders on board a comprehensive tax reform, which could take time. The authorities also acknowledged the

⁶ Inflationary and social impacts are expected to be limited, as the bulk of adjustment comes from a reduction in the threshold for subsidized household tariffs. Electricity tariffs for businesses and low-income households will increase only slightly, while water and sewer tariffs for low-income households are not expected to have much impact on their monthly expenditure.

need for public sector rationalization, but underscored its political difficulty.

21. The authorities pointed to improvements in the budget process in recent years. Revenue projections have become more realistic. The authorities were keen to implement a medium-term budget framework in FY2013. They noted that the substantial arrears built up over the last decade would require some years to clear. Incoming cash is used to pay down arrears to ensure continued service delivery, keeping cash reserves thin while generating new

arrears. In their view, the US\$10 million Compact assistance earmarked for arrears clearance is key to improving the budget process.

22. The authorities were mindful of the need to ensure the sustainability of the pension funds. They have been seriously considering converting the CSPF from a defined-benefit to a defined-contribution scheme. An actuarial study of the CSPF will be conducted soon, which will help them make an informed decision, including whether additional measures are warranted.

B. Financial Sector

23. The overall banking system remains sound. Banks are liquid and profitable, but provide limited credit to the private sector. The presence of FDIC-insured U.S. banks helps mitigate risks to the financial sector. Three U.S. bank branches hold about 90 percent of total assets and 95 percent of total deposits, and have a non-performing loan ratio of less than 1 percent. Palau's domestic banks are relatively weak, with an average non-performing loan ratio of 40 percent. This largely reflects their operational weaknesses and business models of a small deposit base and more risky lending. Nevertheless, domestic banks maintain adequate provisions and do not pose a systemic risk to overall financial stability due to their small size (about 3 percent of total bank assets).⁷

24. Staff commended the FIC's proactive approach to bank regulation and supervision. The well-funded FIC has strengthened its capacity to conduct on-site examinations. It also implemented a new

off-site monitoring program and submitted Palau's first annual banking report to Congress in 2010. Staff supported the FIC's efforts to further strengthen capacity, particularly regarding the supervision of problem banks and conducting in-depth analysis. Domestic banks need to continue strengthening lending policies and writing off bad loans. As an independent and well-functioning FIC is crucial to sound supervision, the remaining vacancy on the FIC Board should be filled quickly with a qualified candidate.

25. Oversight of non-bank financial institutions needs to be strengthened. A priority is for the FIC to have the mandate to supervise the government-owned National Development Bank. Although the bank does not take deposits, its lending activities have implications for overall financial stability. It is the only residential mortgage lender and the largest commercial lender in Palau, with assets amounting to ¼ of total banking sector assets. Although currently small, potential fiscal risks could also arise from the bank's loan guarantees. Regarding other non-banks such as finance companies, while anecdotal evidence suggests that these institutions are small, the lack of information and inadequate supervision do not allow proper assessment of their potential risks. Staff advised that these non-banks also be brought under the oversight of the FIC, the only institution in

⁷ One domestic bank voluntarily ceased deposit-taking activity and transitioned into a finance company in late 2011. Due to limited business activity, the only uninsured foreign bank branch also notified the FIC of its decision to cease operations in Palau in 2012. Both banks are monitored and inspected by the FIC throughout the closure process. The number of banks in Palau will be reduced to 5, including 3 FDIC-insured U.S. bank branches and 2 domestic banks.

Palau with the ability to conduct financial supervision. The FIC will need to be equipped with adequate resources should its mandate be expanded to non-banks.

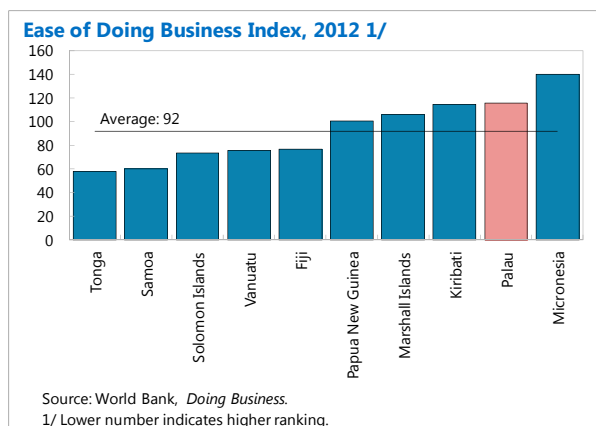
26. **Staff welcomed continued efforts in anti-money laundering and combating the financing of terrorism (AML/CFT).** An amendment to the AML legislation has been sent to the Office of President and takes on many of the recommendations contained in the 2008 AML/CFT assessment report. The Financial Intelligence Unit has also continued to build up its ability to conduct examinations. Staff encouraged the authorities to continue their efforts to align the AML/CFT regime with the 2008 recommendations and to ensure its effective implementation.

C. Private Sector Development

28. **Blessed with natural beauty and located close to fast-growing Asian markets, Palau has great potential to further develop a vibrant private sector.** Palau lags behind many of its peers in the World Bank's ease of doing business indicators. According to the AsDB, key obstacles include a restrictive FDI regime, foreign labor regulations that distort hiring practices, complex and opaque licensing arrangements, the lack of secured access to land, as well as inadequate access to bank credit. Foreign companies face minimum investment requirements and are subject to restrictions on the type of business activities. They are also required to pay higher foreign worker fee than domestic companies and to employ a minimum share of Palauan employees while domestic businesses are not. These distortions create incentives for front businesses (foreign companies with a Palauan as a front). Foreign workers have a lower minimum wage than Palauans, likely contributing to higher unemployment among Palauans. Regarding land, obtaining leases can be a long and burdensome process for foreign investors and titles can be contested. Finally, due to high credit risks and limited domestic investment opportunities, banks

Authorities' Views

27. **The authorities saw merits in bringing non-bank financial institutions under the FIC's oversight.** They would like to study the cost and benefit before making a final decision. With continued capacity building and adequate resources, the FIC expected to be able to fulfill a mandate expanded to non-banks. There was some concern in Congress that too strict regulation and supervision may put local financial institutions at a disadvantage. The authorities agreed that an effective FIC is essential for sound supervision and would fill the remaining FIC Board vacancy soon.



place most of their assets abroad and provide limited credit to the private sector.

29. **Staff discussed a range of measures to promote private sector-led growth in the face of needed fiscal adjustment.** The type of business activities could be managed through licensing arrangements rather than the source of capital (foreign or domestic). On labor regulations, consideration needs to be given to unifying the minimum wage for foreign and domestic labor, applying the same foreign worker fee for foreign and domestic employers, and controlling foreign worker inflows through the foreign worker fee instead of quotas. Staff advised the authorities to establish a one-stop

arrangement for state and national investment licensing requirements. There is also a need to make land leases precedent over a change in title to provide greater legal security for investors. Staff welcomed the authorities' efforts to strengthen the legal framework for movable collateral and encouraged timely passage of the secured transaction legislation, which will help improve access to bank credit.

Authorities' Views

30. **The authorities also viewed private sector development as a key complement to fiscal consolidation.** They agreed in

D. External Stability

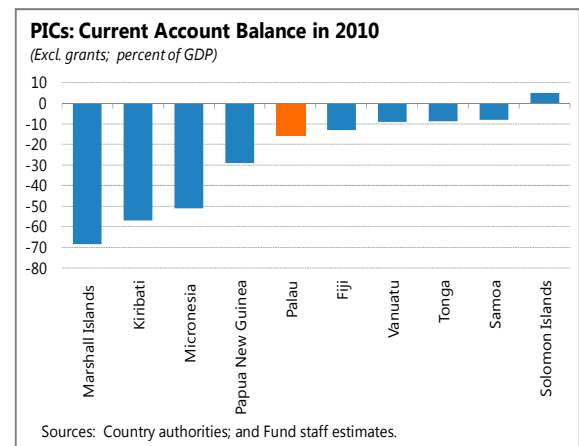
31. **Using the U.S. dollar as Palau's legal tender remains appropriate.** Palau is a small economy that maintains close financial and trade linkages with the United States. Moreover, Palau has very limited capacity to conduct its own monetary and exchange rate policy. The U.S. dollar has provided an important nominal anchor.

32. **The economy has maintained external competitiveness and stability.** Palau's real effective exchange rate is in line with long-term average. During the last decade, tourist arrivals to Palau grew by 7 percent per year, compared to an average of 2½ percent in other Pacific island countries. Furthermore, the renewed Compact assistance is expected to continue providing a relatively stable source of funding over the medium term, while fiscal adjustments will improve the current account balance (excluding grants). A decline in grants could also improve the balance to some extent by reducing imports.

33. **Continued fiscal consolidation is crucial for sustaining external stability.** Risks to external stability are limited in the near term, given Palau's external debt of about 35 percent of GDP and large financial assets. Over the longer term, insufficient fiscal adjustment in the context of

principle with many of staff's recommendations and pointed to recent progress in making Palau more business friendly, including regulatory improvement to the FDI regime and simplification of the approval process by individual government agencies. The authorities noted the difficulty in building a national consensus on land and labor reforms. They underscored the importance of preserving Palau's cultural and social identity while attracting foreign investment and labor. The government supported the secured transaction legislation and anticipated its passage through Congress soon.

declining grants could lead to an eventual depletion of the Compact Trust Fund and/or an unsustainable buildup in external debt. In addition, high export concentration in tourism and reliance on imports of food and fuel render Palau vulnerable to external shocks.



Authorities' Views

34. **The authorities shared staff's assessment.** They noted that Palau's external competitiveness cannot be taken for granted, as Palau faces strong competition from other tourism-based economies in the Pacific. They were mindful of the importance of fiscal prudence in maintaining external stability.

E. Statistics

35. **There is an urgent need to improve the coverage, timeliness and quality of statistics.** Palau's statistical capacity has deteriorated in recent years due to severe understaffing and inadequate capacity building. Data need to be used with caution and have serious shortcomings that hamper surveillance and policy formulation. Staff welcomed the authorities' commitment to producing quality and timely statistics as well as the work program laid out in a draft Statistics Master Plan for 2012-17. The Office of Planning and Statistics (OPS) should be adequately staffed and funded. Capacity

building should also be strengthened, particularly in the areas of economics statistics and macroeconomic analysis and framework.

Authorities' Views

36. **The authorities reiterated their commitment to improving statistics.** They were hopeful that, with the recent return of two capable staff members to the OPS, essential statistics can be produced more timely and with better quality. They indicated that continued technical assistance from development partners and PFTAC is key to capacity building.

STAFF APPRAISAL

37. **The outlook remains positive, but downside risks dominate.** The economy has emerged strongly from the 2008-09 downturn, led by record tourist arrivals. Expansion in the tourism sector is expected to continue supporting the economy. Nevertheless, in the context of a slowing global economy, Palau faces strong external headwinds due to its heavy reliance on tourism, imports of food and fuel, and foreign aid. Policy space to counter these risks is limited.

38. **Palau's current economic upturn presents an opportunity to rebuild fiscal buffers.** The authorities' efforts to reduce the current fiscal deficit markedly in recent years are commendable. A further reduction of 2 percent of GDP in FY2012 is advisable, given the positive near-term outlook and the need to boost cash reserves. In a downside scenario, there is only limited room to reduce the size of adjustment.

39. **Achieving fiscal sustainability calls for comprehensive reforms.** An average annual reduction in the current fiscal deficit of 1½ percent of GDP through FY2019 is needed. The adjustment would require an overhaul of the current inefficient tax system, replacing the gross revenue tax with a corporate income tax

and moving from the import tax to a consumption tax, as well as sizable reductions in wage bill and subsidies. Measures to address the large unfunded liabilities of the CSPF and the Social Security Fund are also needed.

40. **The authorities' efforts to improve the budget process and clear arrears are welcome.** Implementing a medium-term budget framework in FY2013 would make the budget more comprehensive and improve its credibility. Execution needs to be contingent on cash availability and a cash management committee could be established to help ensure transparent allocation of cash resources.

41. **Oversight of non-bank financial institutions needs to be enhanced.** The banking system remains sound. The FIC has made commendable progress in strengthening banking regulation and supervision. To safeguard financial stability, non-bank financial institutions, including the National Development Bank, should be brought under the FIC's oversight. The FIC will need to be equipped with adequate resources should its mandate be expanded.

42. **By unlocking higher growth, private sector development serves as a key complement to the needed fiscal consolidation.** Further efforts to create a level playing field for domestic and foreign investors and to make land leases more secure are advisable. Staff encourages the authorities to establish a one-stop arrangement for investment licensing and adopt the Secured Transaction Act. Consideration also needs to be given to labor reforms that help improve employment opportunities and skills development for Palauans.

43. **The U.S. dollar remains the appropriate legal tender for Palau.** The economy has maintained external competitiveness, but is vulnerable to shocks.

Continued fiscal consolidation is key to sustaining external stability.

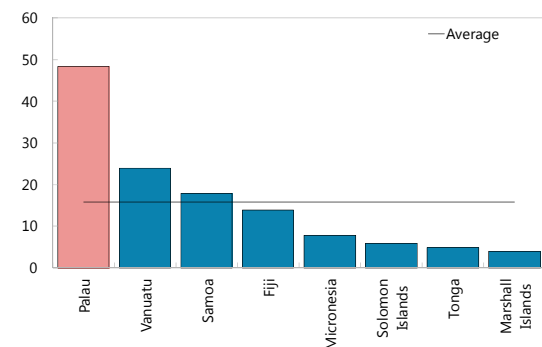
44. **Data shortcomings hamper surveillance and policy formulation.** The deterioration in Palau's statistical capacity needs to be addressed quickly. The authorities' commitment to improving statistics is welcome.

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

Figure 1. Palau: Recent Developments

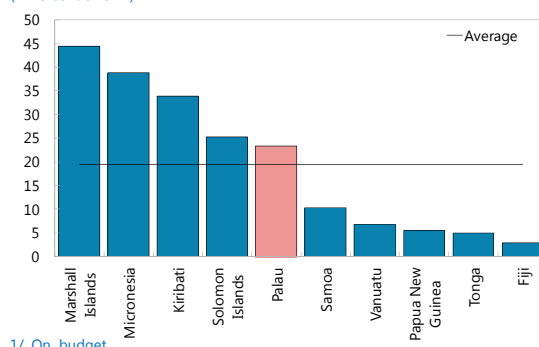
Palau's economy is dependent on tourism...

Tourism Receipts, 2000-2010 average
(In Percent of GDP)



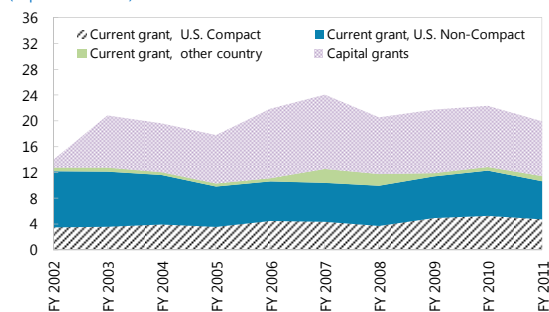
... and foreign aid.

Foreign Aid, 2010 1/
(In Percent of GDP)



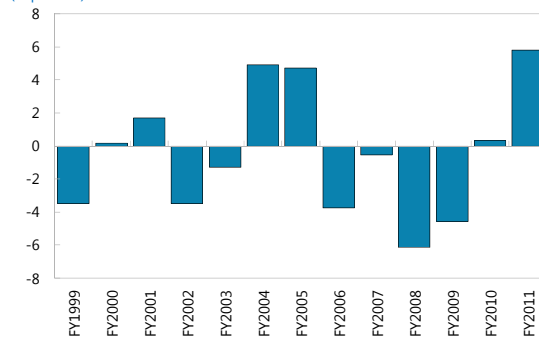
Foreign aid has declined somewhat in recent years...

Foreign Aid 1/
(In percent of GDP)



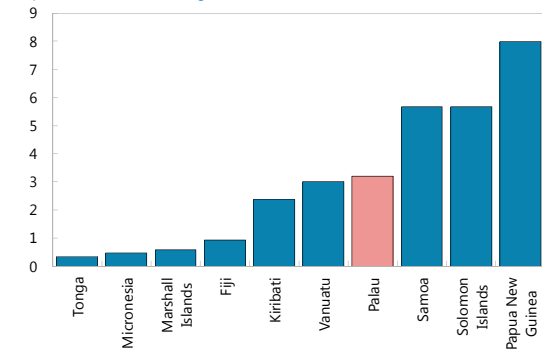
...but real growth picked up strongly in FY2011 due to tourism.

Palau: Real GDP Growth
(In percent)



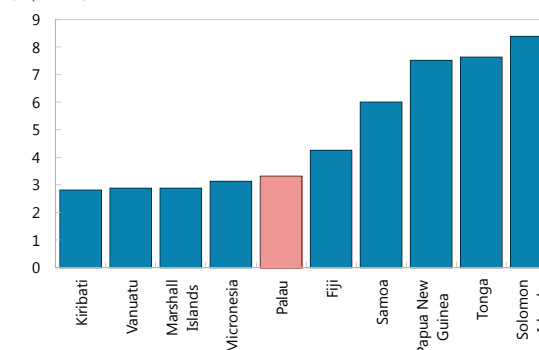
Palau's recent growth performance ranks in the middle range of Pacific island countries.

Real GDP Growth
(In percent, 2010-2011 average)



Inflation has been relatively low due to official dollarization.

Pacific Islands: Inflation, 2000-2010 average
(In percent)



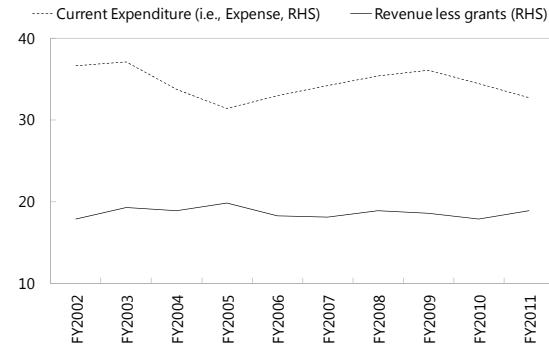
Sources: Country authorities; and Fund staff estimates.

Figure 2. Palau: Fiscal Sector Developments

Thanks to expenditure restraint...

Fiscal Effort

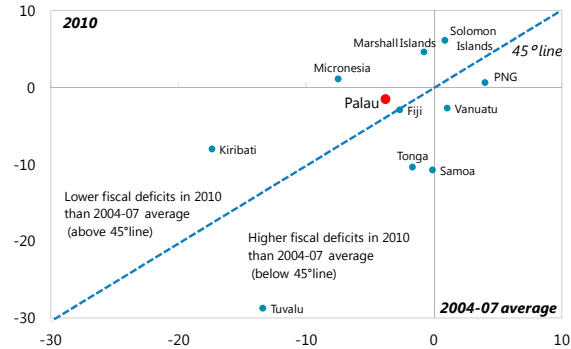
(In percent of GDP)



... the fiscal balance has improved.

Fiscal balance in 2010 vs. 2004-07 average

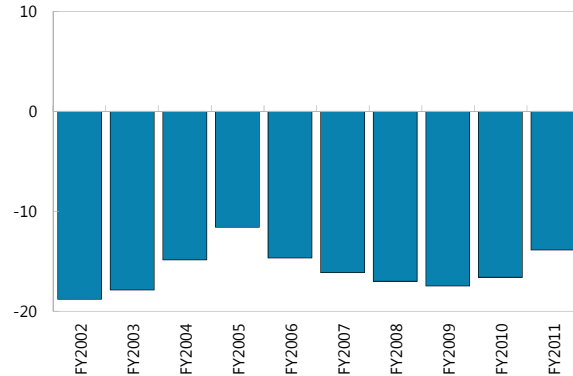
(In Percent of GDP)



But the deficit remains sizable...

Current Balance

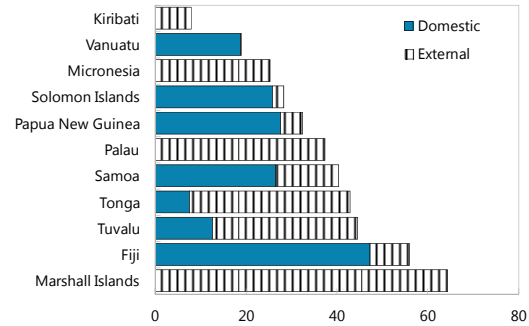
(Excluding grants, in percent of GDP)



...and public debt is in the middle range of Pacific islands.

Public Debt, 2010

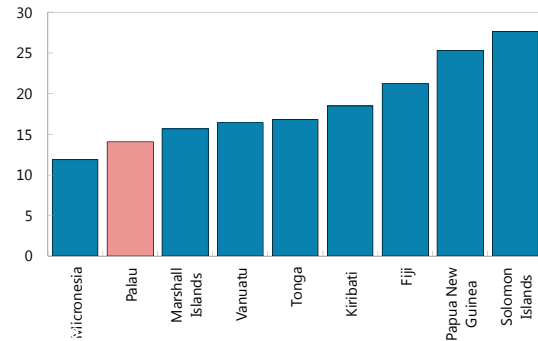
(In percent of GDP)



There is considerable scope to raise tax revenue...

Pacific Islands: Tax Revenue, 2010

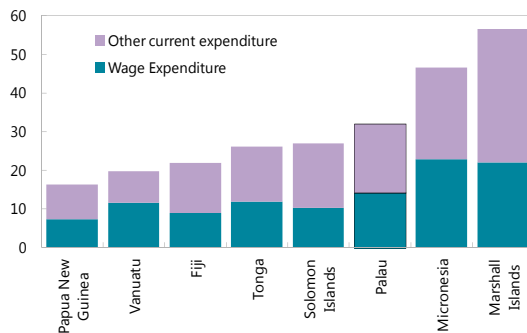
(In percent of GDP)



...and cut expenditure.

Pacific Islands: Current Expenditure, 2010

(In percent of GDP)



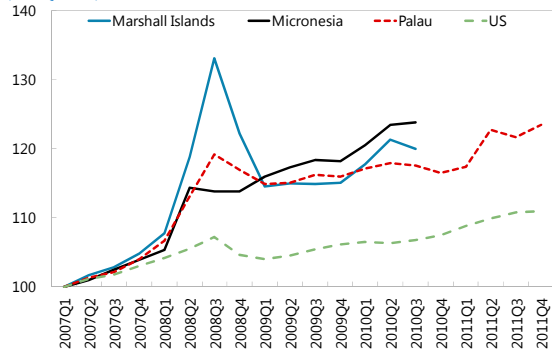
Sources: Country authorities; and Fund staff estimates.
1/ On fiscal year basis for Palau, Marshall Islands, Micronesia, and Tonga.

Figure 3. Palau: External Sector Developments

Although inflation picked up in the first half of 2011...

Consumer Price Index

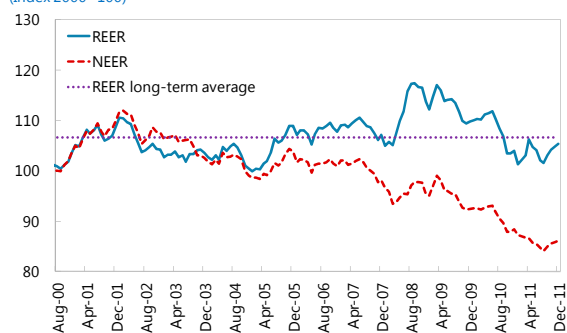
(2007Q1=100)



... the real effective exchange rate is broadly consistent with long-term average.

Effective Exchange Rates

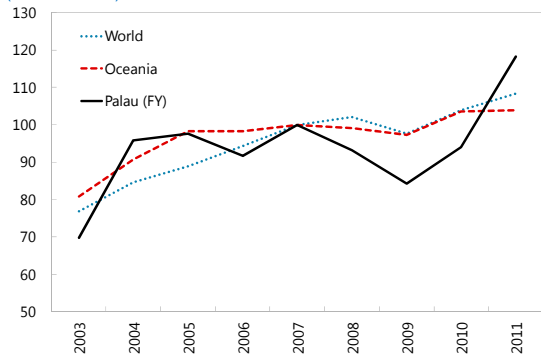
(Index 2000=100)



Tourist arrivals have recovered strongly since 2010...

International Tourism Arrival

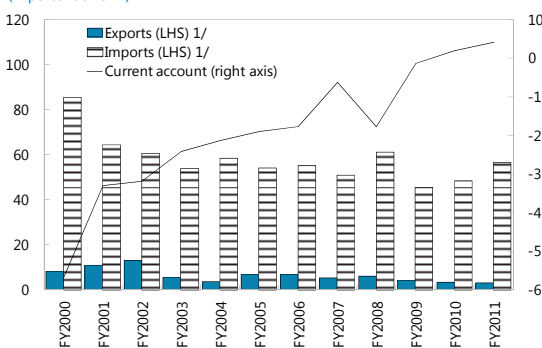
(Index 2007=100)



...contributing to an improvement of the current account.

Current Account Balance

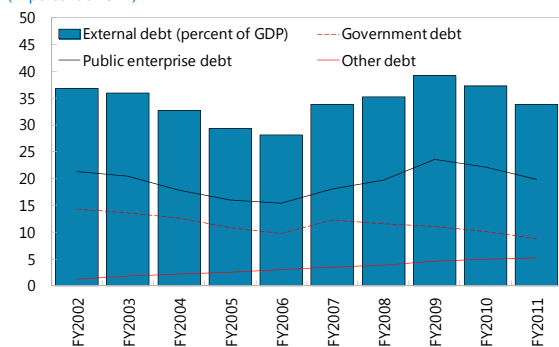
(In percent of GDP)



External debt has been relatively stable ...

External Debt

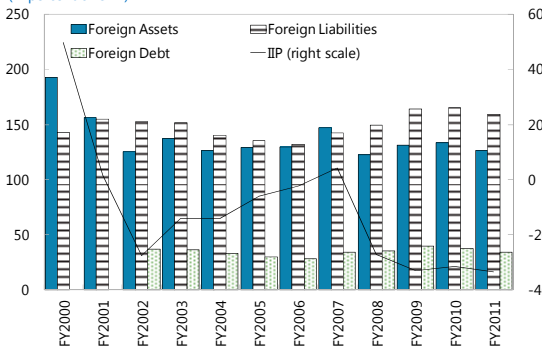
(In percent of GDP)



...so has Palau's net international position.

External position

(In percent of GDP)



Sources: Palauan authorities; World Tourism Organization; and Fund staff estimates.

Table 1. Palau: Selected Economic Indicators, 2006/07–2011/12^{1/}

| | |
|-------------------------|-------------------|
| Nominal GDP for FY2011: | US\$220.7 million |
| Population (2011): | 20,956 |
| GDP per capita: | US\$10,532 |
| Quota: | SDR 3 million |

| | 2006/07 | 2007/08 | 2008/09 | 2009/10 | 2010/11 | 2011/12 |
|--|-------------------------------|---------|---------|---------|---------|----------|
| | | | | | Est. | Proj. 2/ |
| Real sector | | | | | | |
| Real GDP growth (percent change) 3/ | -0.5 | -6.1 | -4.6 | 0.3 | 5.8 | 3.0 |
| GDP deflator (percent change) | 1.8 | 7.6 | 0.2 | 1.6 | 0.2 | 2.0 |
| Consumer prices (percent change; period average) | 3.0 | 11.9 | 1.4 | 1.5 | 3.4 | 2.0 |
| Tourist arrivals | 87,142 | 81,123 | 73,365 | 81,934 | 103,080 | 106,379 |
| Public finance | | | | | | |
| | (In percent of GDP) | | | | | |
| Central government | | | | | | |
| Revenue | 42.2 | 39.5 | 40.4 | 43.0 | 37.1 | 38.1 |
| Taxes and other revenue | 18.1 | 18.9 | 18.6 | 17.9 | 18.9 | 19.3 |
| Grants | 24.1 | 20.6 | 21.7 | 25.2 | 18.3 | 18.9 |
| Expenditure | 46.1 | 43.2 | 46.5 | 44.5 | 40.6 | 39.2 |
| Expense | 34.2 | 35.4 | 36.1 | 34.4 | 32.7 | 31.2 |
| Net acquisition of nonfinancial assets | 11.9 | 7.8 | 10.4 | 10.1 | 7.9 | 8.1 |
| Current balance (excluding grants) 4/ | -16.1 | -16.4 | -17.4 | -16.6 | -13.9 | -11.9 |
| Net lending (+)/borrowing (-) | -3.9 | -3.7 | -6.1 | -1.4 | -3.5 | -1.1 |
| | (In millions of U.S. dollars) | | | | | |
| Compact Trust Fund (CTF) balance 5/ | 176.2 | 146.8 | 144.0 | 150.5 | 147.4 | 148.8 |
| Interest income and capital gains/losses | 25.4 | -23.3 | 3.2 | 12.5 | 2.9 | 7.4 |
| Investment fees and withdrawals | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 |
| Government cash and cash equivalents 6/ | 11.5 | 8.3 | 4.1 | 4.8 | 7.0 | 14.8 |
| Balance of payments | | | | | | |
| Trade balance | -96.3 | -117.6 | -84.6 | -93.3 | -117.5 | -117.5 |
| Exports (f.o.b.) | 11.3 | 12.7 | 8.3 | 7.2 | 6.8 | 7.1 |
| Imports (f.o.b.) | 107.6 | 130.3 | 93.0 | 100.6 | 124.3 | 124.5 |
| Tourism receipts | 113.1 | 116.7 | 112.8 | 123.5 | 159.3 | 164.4 |
| Current account balance | | | | | | |
| Including grants | -13.2 | -37.9 | -2.9 | 4.1 | 9.0 | 13.5 |
| Excluding grants | -50.2 | -73.2 | -37.4 | -31.7 | -24.0 | -21.2 |
| International Investment Position | | | | | | |
| Assets | 310.3 | 261.3 | 267.6 | 277.8 | 278.3 | 285.8 |
| Liabilities | 301.5 | 319.4 | 335.2 | 343.6 | 352.1 | 369.1 |
| <i>Of which:</i> External debt | 71.5 | 75.3 | 80.2 | 77.7 | 74.8 | 80.1 |
| | (In percent of GDP) | | | | | |
| Current account balance | | | | | | |
| Including grants | -6.3 | -17.7 | -1.4 | 2.0 | 4.1 | 5.8 |
| Excluding grants | -23.8 | -34.3 | -18.3 | -15.2 | -10.9 | -9.1 |
| International Investment Position | | | | | | |
| <i>Of which:</i> External debt | 4.2 | -27.2 | -33.1 | -31.6 | -33.4 | -35.9 |
| | 33.8 | 35.2 | 39.3 | 37.3 | 33.9 | 34.6 |

Sources: Palauan authorities; and Fund staff estimates and projections.

1/ Fiscal year ending September 30.

2/ Staff proposals.

3/ PFTAC estimates.

4/ Defined as Revenue less Grants and Expense.

5/ As of end-year.

6/ As of end-year. Includes loan disbursements of \$9.8 million from AsDB in FY2012.

Table 2. Palau: Statement of Government Operations, FY2007–12 1/

| | 2006/07 | 2007/08 | 2008/09 | 2009/10 | 2010/11 | 2011/12 | |
|---|---------|---------|---------|---------|---------|-------------------------|----------|
| | | | | | Est. | Staff Est. Budget 2/ | Proj. 3/ |
| (In thousands of U.S. dollars) | | | | | | | |
| Revenue | 89,197 | 84,365 | 82,482 | 89,604 | 81,915 | 86,982 | 88,458 |
| Taxes | 29,764 | 32,106 | 29,679 | 29,261 | 31,991 | 33,610 | 33,877 |
| Taxes on income, profits and capital gains | 16,484 | 18,073 | 17,234 | 16,240 | 17,868 | ... | 18,832 |
| Taxes on international trade and transactions | 6,598 | 7,003 | 6,202 | 6,328 | 6,553 | ... | 6,905 |
| Other taxes | 6,681 | 7,030 | 6,243 | 6,693 | 7,570 | ... | 8,140 |
| Grants | 50,858 | 43,906 | 44,387 | 52,444 | 40,288 | 43,758 | 43,758 |
| Current | 26,546 | 25,152 | 24,319 | 26,759 | 25,272 | 25,050 | 25,050 |
| U.S. Compact | 12,717 | 13,233 | 13,148 | 14,537 | 13,000 | 12,750 | 12,750 |
| U.S. non-Compact | 9,256 | 8,009 | 10,094 | 11,007 | 10,503 | 10,500 | 10,500 |
| Other country | 4,573 | 3,911 | 1,078 | 1,214 | 1,769 | 1,800 | 1,800 |
| Capital | 24,312 | 18,753 | 20,068 | 25,685 | 15,016 | 18,708 | 18,708 |
| Other revenue | 8,575 | 8,353 | 8,416 | 7,899 | 9,635 | 9,614 | 10,823 |
| Nontax revenue | 6,481 | 7,044 | 6,711 | 5,271 | 6,178 | 5,860 | 6,670 |
| Local trust funds | 2,094 | 1,309 | 1,705 | 2,628 | 3,457 | 3,754 | 4,154 |
| Expenditure | 97,546 | 92,295 | 94,981 | 92,596 | 89,705 | 94,356 | 90,958 |
| Expense | 72,369 | 75,572 | 73,666 | 71,672 | 72,242 | 75,648 | 72,250 |
| <i>Of which: Compensation of employees</i> | 34,306 | 35,440 | 31,718 | 33,200 | 34,956 | ... | 34,556 |
| <i>Of which: Use of goods and services</i> | 28,166 | 28,865 | 31,458 | 26,647 | 26,138 | ... | 25,480 |
| Net acquisition of nonfinancial assets | 25,177 | 16,723 | 21,315 | 20,924 | 17,463 | 18,708 | 18,708 |
| Current balance (excluding grants) 4/ | -34,030 | -35,113 | -35,571 | -34,512 | -30,616 | -32,424 | -27,550 |
| Net lending (+)/borrowing (-) 5/ | -8,350 | -7,930 | -12,499 | -2,992 | -7,790 | -7,374 | -2,500 |
| Net acquisition of financial assets 6/ | -6,941 | -8,151 | -6,900 | -4,264 | -3,294 | -2,374 | 2,500 |
| Net incurrence of liabilities | 5,357 | -1,600 | -923 | -1,125 | 1,703 | 5,000 | 5,000 |
| Net financing | -8,350 | -7,930 | -12,499 | -2,992 | -7,790 | -7,374 | -2,500 |
| Statistical discrepancy | 3,948 | -1,380 | -6,521 | 147 | -2,793 | 0 | 0 |
| (In percent of GDP) | | | | | | | |
| Revenue | 42.2 | 39.5 | 40.4 | 43.0 | 37.1 | 37.5 | 38.1 |
| Taxes | 14.1 | 15.0 | 14.5 | 14.1 | 14.5 | 14.5 | 14.6 |
| Grants | 24.1 | 20.6 | 21.7 | 25.2 | 18.3 | 18.9 | 18.9 |
| Other revenue | 4.1 | 3.9 | 4.1 | 3.8 | 4.4 | 4.1 | 4.7 |
| Expenditure | 46.1 | 43.2 | 46.5 | 44.5 | 40.6 | 40.7 | 39.2 |
| Expense | 34.2 | 35.4 | 36.1 | 34.4 | 32.7 | 32.6 | 31.2 |
| Net acquisition of nonfinancial assets | 11.9 | 7.8 | 10.4 | 10.1 | 7.9 | 8.1 | 8.1 |
| Current balance (excluding grants) | -16.1 | -16.4 | -17.4 | -16.6 | -13.9 | -14.0 | -11.9 |
| Net lending (+)/borrowing (-) | -3.9 | -3.7 | -6.1 | -1.4 | -3.5 | -3.2 | -1.1 |
| Memorandum Item: | | | | | | | |
| Nominal GDP (thousand US\$) | 211,428 | 213,636 | 204,319 | 208,162 | 220,706 | 231,874 | 231,874 |

Sources: Palauan authorities; and Fund staff estimates and projections.

1/ Fiscal year ending September 30.

2/ Based on the conference budget draft. Includes transfer and arrears clearance to PPUC, as well as a possible supplemental budget of \$4 million.

3/ Staff proposals.

4/ Defined as Revenue less Grants and Expense.

5/ Defined as Revenue less Expenditure.

6/ Includes annual withdrawals of \$5 million from the Compact Trust Fund.

Table 3. Palau: Balance of Payments, 2006/07-2011/12 1/

(In millions of U.S. dollars, unless otherwise indicated)

| | 2006/07 | 2007/08 | 2008/09 | 2009/10 | 2010/11 | 2011/12 |
|--|---------|---------|---------|---------|---------|---------|
| | | | | Est. | Proj. | |
| Trade balance | -96.3 | -117.6 | -84.6 | -93.3 | -117.5 | -117.5 |
| Exports, f.o.b. | 11.3 | 12.7 | 8.3 | 7.2 | 6.8 | 7.1 |
| Imports, f.o.b. | 107.6 | 130.3 | 93.0 | 100.6 | 124.3 | 124.5 |
| Services account | 88.0 | 85.4 | 88.4 | 99.4 | 133.1 | 138.4 |
| Receipts | 119.4 | 122.5 | 117.8 | 128.5 | 164.1 | 169.4 |
| <i>Of which:</i> Travel | 113.1 | 116.7 | 112.8 | 123.5 | 159.3 | 164.4 |
| Payments | 31.3 | 37.2 | 29.4 | 29.1 | 31.0 | 31.0 |
| Net income | -28.4 | -28.5 | -29.6 | -27.1 | -32.2 | -32.3 |
| Receipts | 11.1 | 11.8 | 11.0 | 11.0 | 10.6 | 10.8 |
| Payments | 39.5 | 40.4 | 40.7 | 38.1 | 42.8 | 43.1 |
| <i>Of which:</i> Dividends | 34.4 | 34.3 | 37.3 | 37.6 | 39.1 | 40.3 |
| Net transfers | 23.4 | 22.9 | 22.9 | 25.2 | 25.5 | 24.9 |
| Private | -13.2 | -12.1 | -11.2 | -10.3 | -7.1 | -9.4 |
| Official | 36.6 | 35.0 | 34.1 | 35.5 | 32.7 | 34.4 |
| Current account | | | | | | |
| Including official grants | -13.2 | -37.9 | -2.9 | 4.1 | 9.0 | 13.5 |
| Excluding official grants | -50.2 | -73.2 | -37.4 | -31.7 | -24.0 | -21.2 |
| Capital and financial account | 58.9 | 41.2 | 22.6 | 37.4 | 24.3 | -10.3 |
| Capital account | 26.1 | 20.3 | 12.5 | 27.9 | 15.0 | 18.7 |
| Financial account | 32.9 | 20.9 | 10.1 | 9.5 | 9.2 | -29.0 |
| Portfolio investment, net | -0.2 | 3.9 | 0.1 | 1.4 | 1.2 | -48.2 |
| Foreign direct investment, net | 13.2 | 14.1 | 10.9 | 11.0 | 11.3 | 11.6 |
| Other investment, net | 19.8 | 2.9 | -0.9 | -2.9 | -3.3 | 7.6 |
| Errors and omissions | 45.7 | 3.4 | 19.6 | 41.4 | 33.2 | 0.0 |
| Memorandum Items: | | | | | | |
| Nominal GDP | 211.4 | 213.6 | 204.3 | 208.2 | 220.7 | 231.9 |
| Current account (percent of GDP) | | | | | | |
| Including official grants | -6.3 | -17.7 | -1.4 | 2.0 | 4.1 | 5.8 |
| Excluding official grants | -23.8 | -34.3 | -18.3 | -15.2 | -10.9 | -9.1 |
| Capital and financial account (percent of GDP) | 27.9 | 19.3 | 11.0 | 17.9 | 11.0 | -4.4 |
| External debt (percent of GDP) | 33.8 | 35.2 | 39.3 | 37.3 | 33.9 | 34.6 |
| External debt (percent of exports of goods and services) | 60.1 | 52.7 | 79.2 | 72.1 | 57.0 | 58.0 |
| External debt service (percent of exports of goods and services) | ... | 49.3 | 69.9 | 62.4 | 48.3 | 52.5 |
| International Investment Position (percent of GDP) | 4.2 | -27.2 | -33.1 | -31.6 | -33.4 | -35.9 |
| Assets | 146.8 | 122.3 | 131.0 | 133.5 | 126.1 | 123.3 |
| Liabilities | 142.6 | 149.5 | 164.1 | 165.1 | 159.5 | 159.2 |
| FDI | 108.8 | 114.3 | 124.8 | 127.8 | 125.6 | 124.6 |
| Government debt | 12.2 | 11.6 | 11.1 | 10.1 | 8.8 | 11.9 |
| Public enterprise debt | 18.1 | 19.7 | 23.6 | 22.2 | 19.9 | 17.9 |
| Other debt | 3.5 | 3.9 | 4.6 | 5.0 | 5.2 | 4.7 |

Sources: Palau authorities; PFTAC estimates; and Fund staff estimates and projections.

1/ Fiscal year ending September 30.

Table 4. Palau: Medium-term Projections, 2009/10-2016/17 1/
(In percent of GDP, unless otherwise indicated)

| | 2009/10 | 2010/11 | 2011/12 | 2012/13 | 2013/14 | 2014/15 | 2015/16 | 2016/17 |
|--|---------|---------|---------|---------|---------|----------|---------|---------|
| | Est. | | | | | Proj. 2/ | | |
| Real sector | | | | | | | | |
| Real GDP growth (percent change) | 0.3 | 5.8 | 3.0 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 |
| Consumer prices (percent change; PA) | 1.5 | 3.4 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 |
| Public finance | | | | | | | | |
| Taxes and other revenue | 17.9 | 18.9 | 19.3 | 20.1 | 21.0 | 21.8 | 22.8 | 23.8 |
| Grants | 25.2 | 18.3 | 18.9 | 20.4 | 17.9 | 17.2 | 16.6 | 15.9 |
| Expense | 34.4 | 32.7 | 31.2 | 30.5 | 29.9 | 29.2 | 28.7 | 28.2 |
| Net acquisition of nonfinancial assets 3/ | 10.1 | 7.9 | 8.1 | 10.2 | 8.5 | 8.5 | 9.0 | 9.0 |
| Current balance (excluding grants) 4/ | -16.6 | -13.9 | -11.9 | -10.4 | -8.9 | -7.4 | -5.9 | -4.4 |
| Net lending (+)/borrowing (-) 5/ | -1.4 | -3.5 | -1.1 | -0.2 | 0.5 | 1.3 | 1.7 | 2.5 |
| Balance of payments | | | | | | | | |
| Current account balance (excluding grants) | -15.2 | -10.9 | -9.1 | -7.7 | -6.5 | -5.1 | -4.0 | -2.8 |
| Current account balance (including grants) | 2.0 | 4.1 | 5.8 | 6.4 | 6.8 | 7.2 | 7.2 | 7.5 |

Sources: Palauan authorities; and Fund staff estimates and projections.

1/ Fiscal Year ending September 30.

2/ Staff proposals.

3/ Assumes on-lending of \$6 million to the Palau Water & Sewer Corporation (PWSC) in FY2013.

4/ Defined as Revenue less Grants and Expense.

5/ Defined as Revenue less Expenditure.

APPENDIX I: PALAU—LONG-TERM FISCAL SUSTAINABILITY

This appendix assesses Palau's long-term fiscal sustainability, updating the estimates from the 2010 Article IV consultation. The results suggest that annual fiscal consolidation of 1½ percent of GDP on average through FY2019 is needed to achieve sustainability over the long run.

A. Framework and Assumptions

Fiscal sustainability is defined in a way where government fiscal operations satisfy the intertemporal budget constraint. This is expressed in the following equation:

$$W + G + R = C + K,$$

where the government's net worth (W) and the net present values of grants (G) and domestic revenue (R) are balanced against the net present values of current spending (C) and capital spending (K). The current balance (R-C) is set as the policy variable to satisfy the above equation, consistent with the authorities' policy goals.¹

Long-term macroeconomic and fiscal assumptions are in line with historical data.

The nominal rate of return on the Compact Trust Fund (6 percent) serves as the discount factor to calculate net present values (NPV).

- Macroeconomic assumptions:
 - Real GDP growth rate: 2 percent
 - Inflation: 2 percent
 - Real rate of return on the Compact Trust Fund: 4 percent
- Fiscal assumptions:
 - U.S. Compact current grants: US\$160 million over FY2010-24.
 - Other U.S. grants: 6 percent of GDP
 - Other country grants: 4 percent of GDP
 - Capital spending: 9 percent of GDP

A key exogenous variable is the government's initial net worth (W). The net worth comprises the outstanding Compact Trust Fund and government cash deposits, less the government's arrears and external debt. As of end-FY2011, government net worth was estimated at 54 percent of GDP, with the Compact Trust

¹ Details of this framework can be found in the Selected Issues Paper for the 2008 Article IV consultation (IMF Country Report No. 08/162). Domestic revenue refers to revenue less grants; current spending to expense; and capital spending to the net acquisition of non-financial assets.

Fund, deposits, external debt and arrears at 67, 3, 9 and 7 percent of GDP, respectively.

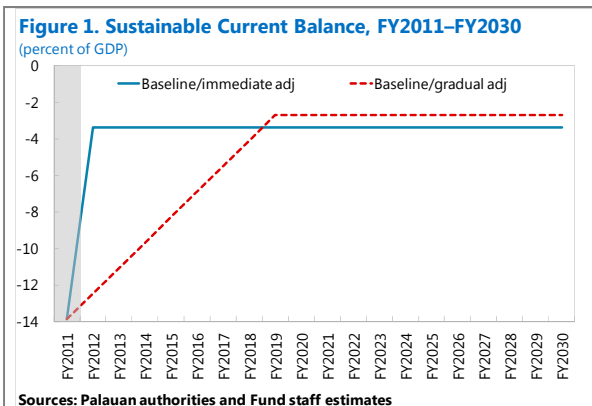
B. Findings

Baseline Scenario

Two cases are considered in the baseline scenario:

Immediate adjustment. Assuming that the necessary fiscal adjustment is carried out entirely in the following fiscal year, the current balance will need to fall sharply from -14 percent of GDP in FY2011 to -3½ percent in FY2012. This calls for a deficit reduction of 10½ percentage points in a single year, highlighting the challenge to achieving fiscal sustainability. The government's net worth would eventually reach 120 percent of GDP, twice as high as the current level.

Gradual adjustment. The 2010 Article IV consultation examined a ten-year period over FY2010-19 to gradually implement fiscal adjustments. Taking into account the fiscal consolidation already realized in FY2010-11, an adjustment of 1.4 percent of GDP per year is needed over the remaining eight years to ensure fiscal sustainability. This is similar to the findings of the 2010 Article IV consultation, as the impact of the lower growth assumption is offset by the lower real rate of return. The total adjustment is 11 percent of GDP during FY2012-19, slightly larger than an immediate



adjustment (10½ percent of GDP in one year). Government net worth would rise to 90 percent of GDP over time.

Sensitivity Analysis. The above results are fairly robust to different parameter assumptions. The tables below illustrate the required adjustments per year under the

gradual adjustment assumption with various combinations of parameter values. Variations in real growth, inflation and the real rate of return have a relatively minor impact on the needed adjustment. Lower valuations of the government’s initial net worth increase the needed annual fiscal consolidation.

Sensitivity Analysis Under Gradual Adjustment
(In percent of GDP, unless otherwise indicated)

| | | Real GDP Growth (in percent) | | | | | | | Real GDP Growth (in percent) | | | | | |
|----------------------------------|---|------------------------------|-------------|------|------------------------|---|------|-------------|------------------------------|------------------------|----|------|-------------|------|
| | | 1 | 2 | 3 | | | | | 1 | 2 | 3 | | | |
| Real Rate of Return (in percent) | 2 | 1.51 | 1.59 | 1.61 | Inflation (in percent) | 1 | 1.2 | 1.29 | 1.4 | Govt Initial Net Worth | 0 | 1.50 | 1.53 | 1.57 |
| | 3 | 1.4 | 1.51 | 1.59 | | 2 | 1.29 | 1.40 | 1.51 | | 15 | 1.44 | 1.50 | 1.55 |
| | 4 | 1.29 | 1.40 | 1.51 | | 3 | 1.4 | 1.51 | 1.59 | | 35 | 1.37 | 1.45 | 1.53 |
| | 5 | 1.19 | 1.29 | 1.40 | | 4 | 1.5 | 1.59 | 1.61 | | 55 | 1.29 | 1.40 | 1.51 |

Source: Fund staff calculations

Scenario with Broad Coverage of Public Debt

The scope of public debt is broadened in this scenario to include public enterprise debt and maintenance backlog, estimated at US\$44 million and US\$80 million, respectively, at end-FY2011. As a result, government net worth falls to -2 percent of GDP.

Immediate adjustment. In FY2012, the current balance would need to improve to -2½ percent of GDP, from -14 percent in FY2011. The needed adjustment is slightly larger than in the baseline, reflecting lower initial net worth. The government’s net worth would rise to 70 percent of GDP over time.

Gradual adjustment. To achieve fiscal sustainability by FY2019, fiscal adjustment of 1½ percent of GDP per year through FY2019 is required. Cumulatively, the adjustment is 12½ percent of GDP over eight years, larger than an immediate adjustment.

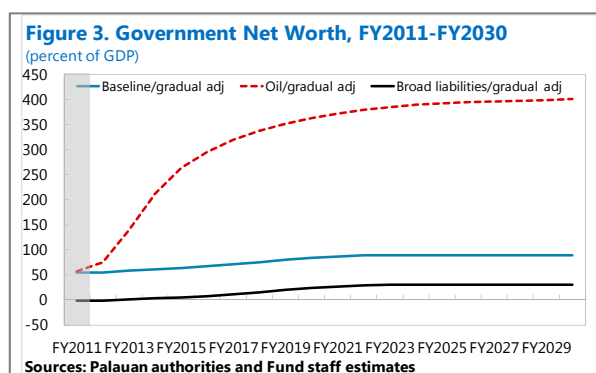
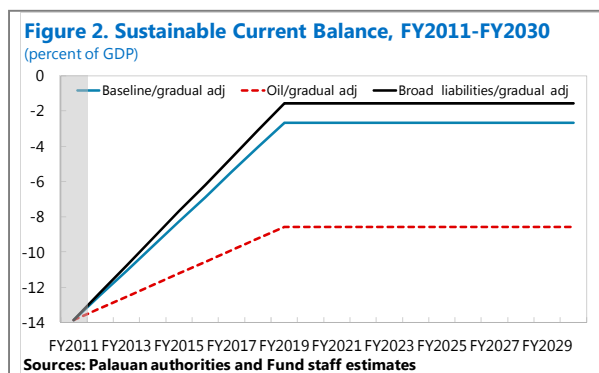
The government’s net worth would gradually rise to 30 percent of GDP.

Scenario with Oil-Related Revenue

This scenario incorporates potential oil-related revenue of US\$650 million in NPV terms, based on World Bank estimates. The revenue is assumed to come on stream in FY2013.

Immediate adjustment. Large fiscal adjustments are needed even with substantially more favorable revenue projections than the baseline scenario. In FY2012, the current (non-oil) balance would still need to improve by 5½ percentage points to -8½ percent of GDP, although the size of adjustment is much smaller. The government’s net worth climbs to 450 percent of GDP over the medium term.

Gradual adjustment. To achieve fiscal sustainability by FY2019, fiscal consolidation of ¾ percentage points of GDP per year is required. The government’s net worth would rise to 400 percent of GDP.





REPUBLIC OF PALAU

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

February 24, 2012

Prepared By **Asia and Pacific Department**
(In consultation with other Departments)

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ANNEX I. FUND RELATIONS

(As of February 10, 2012)

I. **Membership Status:** Joined December 16, 1997; Article VIII

II. General Resources Account:

| | SDR Million | Percent Quota |
|---------------------------|-------------|---------------|
| Quota | 3.10 | 100.00 |
| Fund holdings of currency | 3.10 | 100.00 |
| Reserve position in Fund | 0.00 | 0.03 |

III. SDR Department:

| | SDR Million | Percent Allocation |
|---------------------------|-------------|--------------------|
| Net cumulative allocation | 2.96 | 100.00 |
| Holdings | 2.96 | 100.00 |

IV. **Outstanding Purchases and Loans:** None.

V. **Financial Arrangements:** None.

VI. **Projected Obligations to Fund:** None.

VII. Exchange Rate Arrangements.

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.

VIII. Article IV Consultation:

The first Article IV consultation discussions took place during June 24–July 6, 1999 and the Article IV consultation procedure was completed on November 10, 1999. The last Article IV consultation discussions were held during February 2010. The Executive Board discussed the staff report and concluded the consultation on April 28, 2010. Palau is on a 24-month consultation cycle.

IX. Technical Assistant:

STA, MCM, LEG, and PFTAC have provided technical assistance on statistics, banking supervision, tax policy, and combating of financial crime and financial system abuse.

X. Resident Representative:

Mr. Yongzheng Yang has been the Resident Representative for Pacific Island Countries since September 2010. He is based in Suva, Fiji.

ANNEX II. RELATIONS WITH THE WORLD BANK GROUP

1. The Bank team led by Mr. Suri and the Fund team led by Ms. Sun maintain a close working relationship and have an ongoing dialog on a range of macroeconomic and structural issues.

2. The teams agreed that Palau's key macroeconomic challenges are to achieve long-term fiscal sustainability and to spur private sector development, in the absence of a higher level of grants. To meet these challenges, Palau needs to achieve significant fiscal adjustments over a prolonged period and facilitate private sector development.

3. Based on this shared assessment, the teams identified five macro-critical areas for structural reform:

- **Fiscal adjustments.** This comprises three elements:

(i) Revenue reform. Tax revenue stands at 14½ percent of GDP, one of the lowest in the Pacific. Measures to boost revenue include improving tax administration, eliminating import duty exemptions, and moving to cost, insurance and freight (CIF) evaluation for imports. Over the longer term and with adequate preparation, the current inefficient tax system needs to be overhauled, replacing the gross revenue tax with a corporate income tax and moving from the import tax to a consumption tax, such as a value-added tax (VAT).

(ii) Expenditure reform. More than half of Palau's domestic budget is spent on wages and salaries, which is unsustainable as Compact grants wind down. While Palau's wage bill is the lowest among Compact countries, it exceeds the non-Compact Pacific

island average by about 4 percent of GDP. Anecdotal evidence also suggests that the average public sector wage is higher than that of workers with similar skills in the private sector. In the absence of stepped-up grants, the public sector wage bill needs to be rationalized in a phased manner through adjustments in both the civil service size and average pay. However, this will need to be planned and managed carefully as reductions in the public sector could have large adverse knock-on impacts on the economy. Subsidies on certain government functions, such as water and sewage services, also remain a sizeable burden for the government.

(iii) Public financial management. Revenue projections sometimes are inflated during deliberation and final approved budgets are not comprehensive. Budget execution is based on appropriations rather than cash availability, resulting in the drawdown of cash reserves and/or accumulation of arrears. With assistance from the AsDB, the authorities have been working towards implementing a medium-term budget framework in FY2013, which will help improve the budget process. There is also a need to base budget execution on cash availability and establish a cash management committee, which could help ensure transparent allocations of cash resources.

- **Public utilities.** The Palau Public Utilities Corporation faces financial difficulties and maintenance suffers. Electricity tariffs should be increased towards cost-recovery levels, with mechanisms to protect the poor. With assistance from the AsDB, the authorities are

making progress in commercializing water and sewage services. A key challenge here will be to balance commercial viability with the need to ensure access to vulnerable groups.

- **Potential petroleum revenue.** A strong legal and fiscal framework to manage potentially volatile oil and gas revenue is essential. Adequate capacity to manage such revenue is also critical to translating petroleum wealth into a broad-based and sustainable increase in living standards.
- **Private sector development.** Key obstacles to private sector development include a restrictive FDI regime, foreign labor regulations that distort hiring practices, complex and opaque licensing arrangements, the lack of secured access to land, as well as inadequate access to bank credit. Measures to promote private sector development include continued liberalization of the FDI

regime, establishment of a one-stop arrangement for business licensing, timely passage of the secured transaction legislation, and improvement of land and labor regulations.

- **Statistics.** The capacity to compile macroeconomic statistics has deteriorated due to the loss of key personnel and severe understaffing. Strong statistical capacity is critical as serious shortcomings in data quality and availability impede policy formulation and surveillance.

4. The teams agreed on close cooperation going forward. The below table lists the teams' work programs during October 2011-January 2013. The Bank is currently in the process of assessing Palau's eligibility for World Bank resources. This process will have implications for the Bank's potential lending program and the relevant outcomes of discussions with the authorities will be shared with the Fund team.

Palau: Bank and Fund Planned Activities in Macro-critical Structural Reform Areas

October 2011-January 2013

| Title | Products | Provisional Timing of Missions | Expected Delivery Date |
|------------------------------|---|---|------------------------|
| 1. Bank Work Program | Discussions for broadband internet project | Very preliminary discussions initiated in November 2011 | To be confirmed |
| 2. Fund Work Program | PFTAC technical assistance on national account and balance of payments statistics | October-November 2011 | October-November 2011 |
| | PFTAC technical assistance on revenue administration | 2012 | 2012 |
| | PFTAC technical assistance on financial supervision | 2012 | 2012 |
| | 2012 Article IV consultation | January 2012 | March 2012 |
| | 2013 Staff Visit | Early 2013 | Early 2013 |
| 3. Joint Work Program | Mutual update on work program developments and information sharing | Semi-annual | Ongoing |

ANNEX III. RELATIONS WITH THE ASIAN DEVELOPMENT BANK

(PREPARED BASED ON INPUT FROM THE ASDB STAFF AS OF END-JANUARY 2012)

Palau joined the Asian Development Bank (AsDB) on December 29, 2003, as its sixty-third member. While admitted as a regional country, its country classification was to be determined. AsDB prepared a *Country Economic Report for Palau* and the *Development Status and Country Classification of the Republic of Palau* which served as the basis for a determination of Palau's development status. On December 16, 2005, Palau was re-classified as a Pacific developing member country. A more recent report prepared by AsDB in 2007, *Republic of Palau: Achieving Sustainable Development*, provided a more detailed overview of Palau's economy.

Palau and the AsDB entered into a new 5 year *Country Partnership Strategy (CPS) 2009–13*. The strategy aligns AsDB's program with that of Palau's Medium Term Development Strategy.

The Outcomes of the CPS are: (i) improve public sector effectiveness to achieve the medium-term fiscal strategy; (ii) facilitate private sector development; (iii) deliver safe water and sanitation services to Palauans; and (iv) manage the threat of Climate Change.

Bilateral and regional technical assistance grants scheduled during the strategy are in the attached tables.

Table A3.1: Indicative Assistance Pipeline for Lending Products, 2012–2014

| Project/Program Name | Sector | Targeting Classification | Primary Theme | Division | Year of PPTA | Cost (\$ million) | | | | | | Co-finance |
|--------------------------------|--|--------------------------|---------------|----------|--------------|-------------------|-------------|-------------|-------------|--------------|-------------|------------|
| | | | | | | ADB | | | | | Gov't | |
| | | | | | | Total | OCR | ADF | | Total | | |
| | | | | | | | | Loans | Grants | | | |
| 2012 Firm | | | | | | | | | | | | |
| Koror–Airai Sanitation Project | Water supply and other municipal infrastructure and services | GI | ENV | PAUS | 2009 | 12.00 | 9.92 | 1.98 | 0.00 | 11.90 | 0.10 | nil |
| Total | | | | | | 12.00 | 9.92 | 1.98 | 0.00 | 11.90 | 0.10 | |
| 2013 | | | | | | | | | | | | |
| None | | | | | | | | | | | | |
| 2014 | | | | | | | | | | | | |
| None | | | | | | | | | | | | |
| Total | | | | | | 12.00 | 9.92 | 1.98 | 0.00 | 11.90 | 0.10 | |

ADB = Asian Development Bank; ADF = Asian Development Fund; ENV = environmental sustainability; GI = general intervention; Gov't = government; OCR = ordinary capital resources; PAUS = Pacific Urban, Social Development, and Public Management Division; PPTA = project preparatory technical assistance.

Source: Asian Development Bank estimates.

Indicative Assistance Pipeline for Nonlending Products and Services, 2012–2014

| Assistance Name | Sector | Division | Assistance Type | Sources of Funding | | | | Total (\$'000) |
|---|--|----------|-----------------|--------------------|-----------------|--------|-----------------|-----------------|
| | | | | ADB | | Others | | |
| | | | | Source | Amount (\$'000) | Source | Amount (\$'000) | |
| 2012 | | | | | | | | |
| Water Supply and Sanitation Utility Strengthening Project | Water supply and other municipal infrastructure and services | PAUS | CDTA | Trust Fund | 600.00 | | 0 | 600.00 |
| Improving Public Policy and Public Management Capability | Public sector management | PAUS | CDTA | TASF | 225.00 | | 0 | 225.00 |
| Total | | | | | 825.00 | | 0 | 825.00 |
| 2013 | | | | | | | | |
| Public Sector Reform Facility | Public sector management | PAUS | CDTA | TASF | 1,000.00 | | 0 | 1,000.00 |
| Total | | | | | 1,000.00 | | 0 | 1,000.00 |
| 2014 | | | | | | | | |
| None | | | | | | | | |
| Total | | | | | 1,825.00 | | 0 | 1,825.00 |

ADB = Asian Development Bank; CDTA = capacity development technical assistance; PAUS = Pacific Urban, Social Development, and Public Management Division; TASF = Technical Assistance Special Fund.

Source: Asian Development Bank estimates.

Indicative Assistance Pipeline for Regional Nonlending Products and Services Accessible by Palau, 2012–2014

| Assistance Name | Sector | Division | Assistance Type | Sources of Funding | | | | |
|--|--------|----------|-----------------|--------------------|-----------------|------------|-----------------|-----------------|
| | | | | ADB | | Others | | Total (\$'000) |
| | | | | Source | Amount (\$'000) | Source | Amount (\$'000) | |
| 2012 | | | | | | | | |
| Regional Harmonization of Policy Settings in the Pacific | MUL | PAOD | RDTA | TASF | 1,000.00 | | 0.00 | 1,000.00 |
| Strengthening the Capacity of Pacific DMCs to Respond to Climate Change, Phase 2 (supplementary) | MUL | PATE | CDTA | TASF | 500.00 | GEF | 1,000.00 | 1,500.00 |
| Pacific Regional ICT Connectivity Project Phase 3 (Palau and Federated States of Micronesia) | TCT | PAUS | PPTA | TASF | 800.00 | | 0.00 | 800.00 |
| Strengthening Public Financial Management in Pacific Developing Member Countries | PSM | PAUS | CDTA | | 0.00 | Trust Fund | 1,000.00 | 1,000.00 |
| Enhancing ADB's Engagement in Fragile and Conflict Affected Situations | MUL | PAUS | CDTA | | 0.00 | TBD | 800.00 | 800.00 |
| Total | | | | | 2,300.00 | | 2,800.00 | 5,100.00 |
| 2013 | | | | | | | | |
| Implementing the Pacific Regional Audit Initiative in Pacific Island Countries | PSM | PAUS | CDTA | TASF | 1,300.00 | | 0.00 | 1,300.00 |
| Public Policy Strengthening | PSM | PAUS | CDTA | TASF | 500.00 | | 0.00 | 500.00 |
| Total | | | | | 1,800.00 | | 0.00 | 1,800.00 |
| 2014 | | | | | | | | |
| Pacific Financial Technical Assistance Centre 2015–2016 | PSM | PAUS | CDTA | TASF | 700.00 | | 0.00 | 700.00 |
| Strengthening Regulatory Capacity for ICT Development in the Pacific (phase 2) | TCT | PAUS | CDTA | | 0.00 | Trust Fund | 800.00 | 800.00 |
| Building Capacity for Statistics in the Pacific Phase 2 | PSM | PAUS | CDTA | | 0.00 | Trust Fund | 1,000.00 | 1,000.00 |
| Total | | | | | 700.00 | | 1,800.00 | 2,500.00 |

ADB = Asian Development Bank; ADF = Asian Development Fund; CDTA = capacity development technical assistance; DMC = developing member country; GEF = Global Environment Facility, ICT = Information and Communication Technology; MUL = multisector; PAOD = Office the Director General, Pacific Department; PATE = Pacific Transport, Energy, and Natural Resources Division; PAUS = Pacific Urban, Social Development and Public Management Division; PPTA = project preparatory technical assistance; PSM = public sector management; RDTA = research and development technical assistance; TASF = Technical Assistance Special Fund; TBD = to be determined; TCT = transport and information and communication technology.

Source: Asian Development Bank estimates.

ANNEX IV. RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE (PFTAC)¹

Palau has been a heavy user of PFTAC technical assistance in recent years. In phase III (FY2009–11) there were 21 missions, spread across all sectors, with the largest concentration in public financial management (PFM), where the focus was on strengthening cash management and laying the groundwork for the development of medium-term budgeting. Other results achieved in phase III included revenue compliance strategies and strengthened bank supervision through the adoption of regulations, improved bank reporting and the establishment of an on-site supervision program. Methodologies for producing a broader range of national income and balance of payments statistics were also developed.

Strategy 2011–13

PFTAC's TA strategy is guided by the APD regional strategy note and is planned within the results framework for current PFTAC (Phase IV) FY2011–16 funding cycle.²

PFTAC TA aims to support the authorities sustain progress on fiscal consolidation and strengthen the financial sector. Priorities will be strengthening revenue administration and, in close coordination with AsDB, strengthening PFM. Continued strengthening of financial sector supervision will also be required.

In **public financial management**, the focus will be on continuing to support the AsDB

project on developing medium-term budgeting. PFTAC will also encourage Palau to undertake a PEFA assessment and look to support it in 2013, in line with the objectives of the regional PFM roadmap. Follow up support on accounting and cash management may also be required.

In **tax administration and policy**, follow up to recent TA on IT development and improved corporate strategy, business planning and compliance will be provided. Ultimately, the aim is to lay the foundation for a modernized tax policy and the introduction of VAT. Assistance in this area is not expected to commence until 2013. If resources are available, additional assistance may be available in the customs administration area, in line with recent informal discussions with the authorities.

In the **financial sector supervision** area, support in the off-site area will be in developing prudential returns that allow ultimate integration with the automated statistical system currently being developed by PFTAC and RBNZ for implementation in the South Pacific Central Banks. Capacity building in on-site supervision will also continue, likely in late-2012.

In **economic statistics**, PFTAC will be available to build capacity to produce National Accounts and Balance of Payments statistics under the methodologies developed in phase III and implemented with ongoing PFTAC support. However, with significant levels of Compact-related statistics support expected to begin in 2012, there may not be a demand for substantial PFTAC TA support.

In the **macroeconomic analysis and frameworks** area, little demand for direct TA is currently anticipated. Officials will though be encouraged to participate in financial programming and macro-fiscal issues planned for 2012.

¹ PFTAC is a regional technical assistance institution operated by the IMF with financial support of the AsDB, Australia, Japan, Korea and New Zealand. The Centre's aim is to build skills and institutional capacity for effective economic and financial management that can be sustained at the national and regional level. Member countries are Cook Islands, Federated States of Micronesia, Fiji, Kiribati, Marshall Islands, Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Tokelau, Tonga, Tuvalu, and Vanuatu. It is based in Suva, Fiji.

² The results framework and additional detail on recent activity can be found within the PFTAC Phase IV program document and FY2011 Annual Report, available at www.pftac.org.

ANNEX V. STATISTICAL ISSUES

As of January 25, 2012

| Assessment of Data Adequacy for Surveillance | |
|--|-------------------------|
| <p>General: Palau's statistics have serious shortcomings that hamper surveillance. Shortcomings include the coverage, timeliness, and quality of economic statistics in all sectors. Since 2009, the Office of Planning and Statistics (OPS) had just one statistician until a second returned from study leave in the summer of 2011. As a result, no macroeconomic statistics had been compiled before a PFTAC statistics mission in November 2011. Staff shortages have also prevented capacity building in recent years. The authorities' capacity to produce macroeconomic statistics will remain weak, unless understaffing and inadequate capacity building are addressed. In general, the quality of data is weak and the statistics, particularly national accounts estimates, need to be used with caution.</p> | |
| <p>National Accounts: With PFTAC assistance, production-based and expenditure-based GDP estimates through FY2011 were compiled in November 2011. Expenditure-based GDP estimates, however, have large discrepancies with production-based estimates. Estimates for the last three years (FY2009–11) suffer from significant weaknesses in source data availability and quality. These gaps need to be filled before the estimates can be finalized and adopted as official.</p> | |
| <p>Price statistics: From mid-2009 to mid-2011, the quarterly consumer price index was not compiled on a regular basis due to the lack of staff. The series was backdated in mid-2011. The data quality needs to be improved, particularly regarding the precise specification of priced items.</p> | |
| <p>Government finance statistics: Fiscal data are compiled as part of the annual budget process, but budget data provide an incomplete coverage of grants, with only "Compact" current grants included. Upon request, the authorities provide fiscal data using the GFSM 1986 format. Only one staff is able to prepare the data, and data quality and timeliness are a matter of concern. The most recent audited accounts available are for FY2009.</p> | |
| <p>Monetary and financial statistics: Since Q3 2009, banks have submitted quarterly financial statements, including balance sheets and profit and loss statements, to the Financial Institutions Commission (FIC). The submissions enabled the FIC to prepare soundness indicators and publish Annual Banking Sector Reports since 2009.</p> | |
| <p>Balance of payments: Preliminary balance of payments estimates have been compiled through FY2011 with assistance from the PFTAC. However, there are substantial data gaps for FY2009–11 due to poor source data. International merchandise trade statistics have not been compiled for FY2010–11. Improvements to data on tourism's impact on the economy and a visitors' survey are needed. More BOP compilers are also needed. Final government accounts and quarterly social security data are missing from the latest estimations. Errors and omissions remain high.</p> | |
| II. Data Standards and Quality | |
| Does not participate in the General Data Dissemination System (GDDS). Palau has been invited to participate in a Japanese sponsored technical assistance project to GDDS participation. | No data ROSC available. |
| III. Reporting to STA (Optional) | |
| No data are currently reported to the Statistics Department for publication in <i>Government Finance Statistics Yearbook</i> , <i>Balance of Payments Statistics Yearbook</i> , or <i>International Financial Statistics</i> . | |

Palau: Table of Common Indicators Required for Surveillance
As of January 25, 2012

| | Date of Latest Observation (For all Dates in Table, Please use Format mm/dd/yy) | Date Received | Frequency of Data ⁷ | Frequency of Reporting ⁷ | Frequency of Publication ⁷ |
|---|---|---------------|--------------------------------|-------------------------------------|---------------------------------------|
| Exchange Rates (U.S. dollar is official currency) | NA | NA | NA | NA | NA |
| International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹ | NA | NA | NA | NA | NA |
| Reserve/Base Money | NA | NA | NA | NA | NA |
| Broad Money | NA | NA | NA | NA | NA |
| Central Bank Balance Sheet | NA | NA | NA | NA | NA |
| Consolidated Balance Sheet of the Banking System | NA | NA | NA | NA | NA |
| Interest Rates ² | NA | NA | NA | NA | NA |
| Consumer Price Index | 12/30/11 | 01/06/12 | Q | I | I |
| Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴ | 09/30/11 | 01/13/12 | A | I | I |
| Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government | 09/30/11 | 01/13/12 | A | I | I |
| Stocks of Central Government and Central Government-Guaranteed Debt ⁵ | 09/30/11 | 01/13/12 | A | I | NA |
| External Current Account Balance | 09/30/11 | 11/07/11 | A | I | I |
| Exports and Imports of Goods and Services | 09/30/11 | 11/07/11 | A | I | NA |
| GDP/GNP | 09/30/11 | 11/07/11 | A | I | I |
| Gross External Debt | 09/30/11 | 01/13/12 | A | I | NA |
| International Investment Position ⁶ | 09/30/11 | 01/13/12 | A | I | NA |

1 Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency, but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency, but settled by other means.

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 Includes external gross financial asset and liability positions vis-à-vis nonresidents.

7 Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 12/24
FOR IMMEDIATE RELEASE
March 14, 2012

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2012 Article IV Consultation with Palau

On March 12, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the 2012 Article IV consultation with the Republic of Palau.¹

Background

Palau depends on tourism and foreign aid for its livelihood. Annual tourism receipts amount to about 50 percent of GDP, while grants, in particular under the Compact Agreement with the United States, averaged 25 percent of GDP during the last decade. An overarching challenge for Palau is to achieve self-sufficiency when the renewed Compact grants wind down in FY2024.

The economy has recovered strongly from the 2008–09 downturn. Real GDP growth is estimated to have reached about 6 percent in FY2011, on the back of a 25 percent surge in tourist arrivals. Annual inflation increased from 1½ percent during 2009–10 to 3½ percent in 2011, due to a sharp rise in food and fuel prices during the first half of the year.

The fiscal position has improved markedly but the deficit remains sizable. Thanks to spending restraint and economic recovery, the current fiscal deficit (excluding grants) declined cumulatively by 3½ percent of GDP during the past two fiscal years. But the deficit remained high at 14 percent of GDP. At end-FY2011, government cash reserves stood at

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. At the conclusion of the discussion, the Managing Director, as Chairman 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>

only US\$7 million (about one and a half months of government spending), while arrears amounted to about US\$15 million (7 percent of GDP).

The external position has improved alongside the rebound in tourist arrivals. The current account deficit (excluding grants) declined to 11 percent of GDP in FY2011, despite a rise in imports from higher commodity prices. The Compact Trust Fund balance has stabilized at around US\$150 million, albeit still 15 percent below pre-crisis peaks.

The economy is likely to continue expanding, with growth projected at 3 percent in FY2012 and 2 percent over the medium term. Downside risks dominate. A severe downturn in Asia, the main tourist source region for Palau, could significantly affect the tourism sector, with large adverse knock-on effects on the economy. Although the renewed Compact grants are unlikely to be affected, other aid flows may be delayed as donors face tighter finances. A sharp rise in food and fuel prices could also depress domestic demand and weaken the fiscal and external positions, given Palau's heavy dependence on imports. The sizable fiscal deficit and the absence of monetary and exchange rate policies suggest that Palau has limited policy space to counter these risks.

Executive Board Assessment

Executive Directors welcomed Palau's strong economic recovery and positive near-term outlook. Directors observed, however, that risks are tilted to the downside and that Palau remains vulnerable to external headwinds. The key challenge is to build the domestic consensus for reforms that will achieve a sustainable fiscal position and strengthen growth prospects as Compact grants wind down.

Directors commended the recent improvement in the fiscal balance. They encouraged the authorities to take advantage of the current economic upturn to further advance fiscal consolidation and boost government cash reserves. Directors underscored that fiscal sustainability calls for gradual and substantial adjustment over the medium term, requiring comprehensive tax reform and sizable reductions in the public wage bill and subsidies. They also stressed the need to address the large unfunded liabilities of the Civil Service Pension Fund and the Social Security.

Directors welcomed recent efforts to strengthen the budget process and clear arrears. They supported the implementation of a medium-term budget framework in FY2013 to improve budget planning and enhance credibility. Directors welcomed ongoing efforts to reform government-owned utilities.

Directors noted that the banking system remains sound, and welcomed continued progress in strengthening bank oversight. To safeguard financial stability, they encouraged enhancement in the regulation and supervision of non-bank financial institutions, including the National Development Bank of Palau.

Directors welcomed recent progress in improving the business climate. They encouraged further efforts to promote private sector development, including creating a level playing field for domestic and foreign investors.

Directors welcomed the authorities' commitment to improving the quality and timeliness of data. They encouraged adequate staffing and capacity building of the Office of Planning and Statistics.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The [staff report](#) (use the free [Adobe Acrobat Reader](#) to view this pdf file) for the 2012 Article IV Consultation with Palau is also available.

Palau: Selected Economic Indicators FY2006/07–2011/12 1/

| | |
|-------------------------|-------------------|
| Nominal GDP for FY2011: | US\$220.7 million |
| Population (2011): | 20,956 |
| GDP per capita: | US\$10,532 |
| Quota: | SDR 3 million |

| | 2006/07 | 2007/08 | 2008/09 | 2009/10 | 2010/11 | 2011/12 |
|--|---------|---------|-------------------------------|---------|---------|----------|
| | | | | Est. | | Proj. 2/ |
| Real sector | | | | | | |
| Real GDP growth (percent change) 3/ | -0.5 | -6.1 | -4.6 | 0.3 | 5.8 | 3.0 |
| GDP deflator (percent change) | 1.8 | 7.6 | 0.2 | 1.6 | 0.2 | 2.0 |
| Consumer prices (percent change; period average) | 3.0 | 11.9 | 1.4 | 1.5 | 3.4 | 2.0 |
| Tourist arrivals | 87,142 | 81,123 | 73,365 | 81,934 | 103,080 | 106,379 |
| | | | (In percent of GDP) | | | |
| Public finance | | | | | | |
| Central government | | | | | | |
| Revenue | 42.2 | 39.5 | 40.4 | 43.0 | 37.1 | 38.1 |
| Taxes and other revenue | 18.1 | 18.9 | 18.6 | 17.9 | 18.9 | 19.3 |
| Grants | 24.1 | 20.6 | 21.7 | 25.2 | 18.3 | 18.9 |
| Expenditure | 46.1 | 43.2 | 46.5 | 44.5 | 40.6 | 39.2 |
| Expense | 34.2 | 35.4 | 36.1 | 34.4 | 32.7 | 31.2 |
| Net acquisition of nonfinancial assets | 11.9 | 7.8 | 10.4 | 10.1 | 7.9 | 8.1 |
| Current balance (excluding grants) 4/ | -16.1 | -16.4 | -17.4 | -16.6 | -13.9 | -11.9 |
| Net lending (+)/borrowing (-) | -3.9 | -3.7 | -6.1 | -1.4 | -3.5 | -1.1 |
| | | | (In millions of U.S. dollars) | | | |
| Compact Trust Fund (CTF) balance 5/ | 176.2 | 146.8 | 144.0 | 150.5 | 147.4 | 148.8 |
| Interest income and capital gains/losses | 25.4 | -23.3 | 3.2 | 12.5 | 2.9 | 7.4 |
| Investment fees and withdrawals | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 |
| Government cash and cash equivalents 6/ | 11.5 | 8.3 | 4.1 | 4.8 | 7.0 | 14.8 |
| Balance of payments | | | | | | |
| Trade balance | -96.3 | -117.6 | -84.6 | -93.3 | -117.5 | -117.5 |
| Exports (f.o.b.) | 11.3 | 12.7 | 8.3 | 7.2 | 6.8 | 7.1 |
| Imports (f.o.b.) | 107.6 | 130.3 | 93.0 | 100.6 | 124.3 | 124.5 |
| Tourism receipts | 113.1 | 116.7 | 112.8 | 123.5 | 159.3 | 164.4 |
| Current account balance | | | | | | |
| Including grants | -13.2 | -37.9 | -2.9 | 4.1 | 9.0 | 13.5 |
| Excluding grants | -50.2 | -73.2 | -37.4 | -31.7 | -24.0 | -21.2 |
| International Investment Position | | | | | | |
| Assets | 310.3 | 261.3 | 267.6 | 277.8 | 278.3 | 285.8 |
| Liabilities | 301.5 | 319.4 | 335.2 | 343.6 | 352.1 | 369.1 |
| Of which: External debt | 71.5 | 75.3 | 80.2 | 77.7 | 74.8 | 80.1 |
| | | | (In percent of GDP) | | | |
| Current account balance | | | | | | |
| Including grants | -6.3 | -17.7 | -1.4 | 2.0 | 4.1 | 5.8 |
| Excluding grants | -23.8 | -34.3 | -18.3 | -15.2 | -10.9 | -9.1 |
| International Investment Position | | | | | | |
| Of which: External debt | 33.8 | 35.2 | 39.3 | 37.3 | 33.9 | 34.6 |

Sources: Palauan authorities; and Fund staff estimates and projections.

1/ Fiscal year ending September 30.

2/ Staff proposals.

3/ PFTAC estimates.

4/ Defined as Revenue less Grants and Expense.

5/ As of end-year.

6/ As of end-year. Includes loan disbursements of \$9.8 million from AsDB in FY2012.

**Statement by Christopher Legg, Executive Director for the Republic of Palau, and
Mack Kaminaga, Advisor to the Executive Director
March 12, 2012**

The authorities in the Republic of Palau would like to place on record their appreciation to the Fund staff for their constructive engagement which has led to an effective and productive 2012 Article IV Consultation. They found the discussions on various aspects of the Palau's economy and the evolving outlook open-minded and useful. They concurred with the views expressed in the report as it correctly identifies the economic challenges and the way forward to address the challenges.

Economic Development and outlook

The economy has recovered strongly from the global crisis in 2008 and 2009, supported by an increase in tourist arrivals of 25 percent in FY 2011. As a result, real GDP growth is estimated to have reached 6 percent in FY 2011. The economy is expected to grow by 3 percent in 2012 and 2 percent over the next few years after that, driven by expansion in the tourism sector. The sharp rise in food and fuel prices has contributed to the acceleration in inflation to 3½ percent during the first half of this year.

Given the favorable increase in the number of tourists coming to Palau, the authorities have focused on development initiatives that would positively improve the tourism sector. New hotels are being constructed in order to accommodate increased tourist volumes. The authorities have also negotiated an increase in the number of scheduled flights to Palau in response to the demand. Tourism-related activities have also been increased and improved as well.

The authorities have also embarked on other developmental activities which include commercializing water and sewage services with the aim to achieve full cost recovery by 2016. The energy sector will also implement a new tariff structure that will reduce subsidies to middle- to high-income households and increase tariffs to full cost recovery level. The authorities will soon implement an increase in the 'green fee' (tied to visitor departure tax) as another initiative that would strengthen the fiscal position (see below). The upgrading of information technology systems is also part of the reform agenda.

While the outlook is positive for 2012 and favorable in the next few years thereafter, there are growing risks to the forecasts. Risks remain weighted to the downside if a severe downturn spreads to Asia, (the main tourist source for Palau). A sharp rise in food and fuel prices would also have a negative impact on the economy, since Palau heavily depends on imports. Furthermore, Palau's requirement for ongoing fiscal austerity and the absence of monetary and exchange rate policies (the economy is dollarized), limit policy space to counter the risks.

In their efforts to strengthen economic development the authorities intend to develop a vibrant private sector. They have taken steps to create a business environment that would allow businesses, both foreign and domestic, to operate successfully through their regulatory

improvement to the FDI regime and simplification of their regulations on both land-use and the labor market.

The authorities understand the importance of attracting foreign investment and labor, as well as creating a favorable business environment given the importance of the private sector in economic development. The ADB has identified some of obstacles for ‘doing business’ in Palau and through the steps mentioned above, hope to address these hindrances. They are of the view that private sector development is a key complement to the planned fiscal consolidation. They are also conscious of the need for a dynamic and competitive private sector to help spur self-sustaining long-term growth and continue to work on improving the business climate.

Fiscal Sustainability

As a result of five years of negative or near-zero GDP growth due to the downturn in tourism, the authorities face a considerable number of challenges on the fiscal front. Sizable adjustment is required in order to achieve long-term fiscal sustainability. Staff estimate that an average annual reduction in the current fiscal deficit (excluding grants) of 1½ percent of GDP through FY 2019 is warranted. In total a fiscal adjustment amounting to around 7½ percent of GDP (over the next 5 years) will be required. The authorities recognize the task that lies ahead but also try to balance the adjustment with the need for political support of the required reforms. These challenges are compounded by the expiration of Compact grants in FY2024 which have averaged 25 percent of GDP over the past decade.

Given the burden of adjustment, the authorities would need to embark on comprehensive revenue and expenditure reforms, which are essential to resolve long-standing fiscal imbalances. Another factor contributing to fiscal imbalances is that more than half of Palau’s domestic budget is spent on wages and salaries, which will become unsustainable as Compact assistance winds down.

The current economic recovery has allowed an opportunity for the authorities to begin the consolidation of the fiscal position. Immediate steps have been taken to strengthen revenue collection. They have continued to embark on several measures to implement structural, as well as revenue and expenditure reforms.

Structural reform involves energy sector reform and the current commercialization of water and sewage services. The authorities are in agreement with the staff that by implementing higher energy tariffs they will be able to achieve greater cost recovery. This could also lower Palau’s reliance on fuel imports and reduce external vulnerability. By 2016 water tariffs should also achieve the level of full cost recovery.

The revenue that would be generated from the ‘green fee’ initiative, as well as possible cuts in wages and subsidies, would also strengthen the fiscal position.

The authorities noted that comprehensive tax reform will strengthen their effort to re-build the fiscal position. However, they realize that the current tax system is inefficient and would

need to be reformed. Given the importance of tax reform, the authorities have taken steps to propose an increase in the hotel room tax.

They further intend to improve tax administration, eliminate import duty exemptions, and move to cost, insurance, and freight evaluation for imports. Included with the tax reform as a measure of strengthening the fiscal position, the authorities also intend to replace the gross revenue tax with a corporate income tax and will consider moving from taxing imports to a value-added tax (VAT) as recommended by the Fund staff.

The authorities have taken steps to implement a medium-term budget framework (MTBF) given that this would entail a structured, comprehensive, and realistic approach that is consistent with a sound fiscal policy strategy. An added benefit from this approach would be enhancing budget credibility and governance. With the MTBF in place, the authorities hope to exert better control over budget execution (which is based upon cash availability, cash planning, and spending).

Financial Sector

The banking system remains profitable and well capitalized. The authorities are committed to ensure that the banking system is stable and safe for depositors. They have implemented prudential measures through the establishment of the Financial Institutional Commission (FIC). The FIC is mandated for the purposes of monitoring banking activities in accordance with the banking regulations. The FIC has been proactive in its mandate and has recently implemented its new off-site monitoring program.

The FIC continues to serve in its supervisory role and to safeguard the banking activities. While the FIC does not have the mandate to supervise the National Development Bank of Palau or other finance companies, the authorities intend to legally give this mandate to the FIC given that potential fiscal risks could arise without proper and independent supervision.

The authorities are committed to continue in their effort against money laundering and in combating the financing of terrorism (AML/CFT). They have established the Financial Intelligence Unit within the government with the mandate to oversee any criminal activities within the financial sector. Legislation has been introduced to further support and strengthen this work. The Financial Intelligence Unit has also strengthened its capacity to conduct AML/CFT examinations.

The presence of FDIC-insured US banks in Palau also provides a stabilizing influence on the financial system and helps mitigate risks.

Reform Agenda

The authorities have also initiated steps to reform government-owned utilities in order to reduce subsidies and improve services and revenue. The IT system is on schedule to be modernized as part of the reform agenda. The authorities are committed to continue with their ongoing reform program, including the restructuring of the public and private sectors.