IMF Country Report No. 19/43

REPUBLIC OF PALAU

February 2019

2018 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF PALAU

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2018 Article IV consultation with Palau, the following documents have been released and are included in this package:

- **Press Release** summarizing the views of the Executive Board as expressed during its February 1, 2019 consideration of the staff report that concluded the Article IV consultation with the Republic of Palau
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 1, 2019, following discussions that ended on November 7, 2018, 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 January 15, 2019.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for the Republic of Palau

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February 5, 2019

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Washington, D.C. 20431 USA

IMF Executive Board Concludes 2018 Article IV Consultation with the Republic of Palau

On February 1, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Palau.[1]

Palau's economic activity slowed significantly in FY2016 and FY2017. GDP contracted by 3.7 percent in FY2017, due to tourist arrivals dropping sharply by 17 percent. Construction activities also remained subdued because of lower capital grants and a delay in the construction of a new luxury hotel. Inflation turned positive at 0.9 percent in FY2017 as fuel and food prices rose. The current account deficit increased substantially to 17.9 percent of GDP in FY2017, due to the downturn in tourism. The fiscal position improved over the past years owing to concerted efforts at fiscal consolidation. The overall fiscal surplus (including grants and capital) rose to 4.8 percent of GDP in FY2017, with capital expenditure compressed at a low level due to low capital grant receipts. Public debt remains moderate and sustainable.

Growth is projected to recover moderately to 0.4 percent in FY2018 and increase to 2 percent in FY2019 with a recovery in construction activities and tourism. Inflation is projected to rise by 2.8 percent in FY2018, as commodity prices increase. The current account deficit is projected to come down to around 13 percent of GDP with a recovery of the tourism sector and the completion of major infrastructure projects. The fiscal position is projected to improve in the near-term as the overall fiscal balance is boosted temporarily after the disbursement of the Compact capital grants. Risks to the economic outlook are tilted to the downside. Economic downturn due to lower than expected tourism arrivals would worsen the fiscal position and the external sector. A shortfall of non-Compact capital grants would lead to lower infrastructure investment and lower economic growth. Palau remains vulnerable to natural disasters and climate change as in other Pacific Island economies. Other risks include weaker than expected global growth, including in the U.S. and China and a sharp tightening of global financial conditions and further US dollar appreciation. These risks could adversely affect the economy

[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.

through lower tourism receipts.

Executive Board Assessment[2]

Executive Directors agreed with the thrust of the staff appraisal. They welcomed signs of a gradual recovery of economic activity in tourism and construction. However, Directors noted that Palau continues to face medium-term challenges arising from the expiration of the Compact grants in FY2024, revenue volatility stemming from limited economic diversification, and vulnerabilities to climate change and natural disasters. They emphasized that continued sound macroeconomic policies will be important to ensure long-term fiscal sustainability, safeguard financial stability, reduce vulnerabilities to external shocks, and promote sustainable and resilient growth.

Directors welcomed the authorities' plan to develop a medium-term fiscal framework to accommodate high revenue volatility and to manage fiscal risks. They noted that the framework should employ a net worth approach, which provides the desired path for the current fiscal balance consistent with medium-term fiscal objectives. Directors recommended the need for additional fiscal adjustment over the medium term to ensure sustained increases in public investment for resilient growth. They underscored that adjustment should rely on a revenue-enhancing tax reform, complemented by a strengthening of public financial management, including in public investment. Directors welcomed the authorities' plan to implement a comprehensive tax reform, including the introduction of the VAT. They also encouraged continued efforts to lower subsidies to state-owned enterprises.

Directors welcomed the efforts to implement a comprehensive tourism strategy to support sustainable and resilient economic growth. They noted that greater geographical diversification of source countries could enhance the resilience of the sector and the economy. Directors also encouraged the authorities to improve the investment climate and foster the development of the private sector by adopting a streamlined foreign investment regime and addressing infrastructure bottlenecks. They encouraged the authorities to tackle the brain drain from youth emigration.

Directors noted that the banking system remains sound but lends too little domestically. They advised the authorities to relax the interest rate ceiling for commercial loans to better reflect riskiness and help small companies prepare business plans and financial statements. Directors welcomed the plans to broaden financial supervision to nonbank financial institutions to preserve financial stability. They recommended a cautious approach to cryptocurrencies, given the associated financial risks. In this regard, Directors encouraged steps to address the deficiencies in the AML/CFT framework.

[2] 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 summing up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Palau: Selected Economic Indicators 1/

Nominal GDP for FY2017: US$290 million
Population (2015): 17,661
GDP per capita for FY2015: US$17,139
Quota: SDR 3.1 million

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
						Est.	Proj.	
Real sector								
Nominal GDP (million US$)	225.3	245.7	293.1	304.0	289.8	296.5	309.5	323.6
Real GDP growth (percent change)	-1.7	3.0	10.4	0.5	-3.7	0.4	2.0	2.5
GDP deflator (percent change)	6.8	5.8	8.1	3.2	-1.0	1.9	2.4	2.0
Consumer prices (percent change; period average)	3.4	4.1	0.9	-1.0	0.9	2.8	2.4	2.0
Tourist arrivals (number of visitors)	110,823	125,674	168,764	146,629	122,050	115,964	118,283	121,240
Expenditure per Tourist Arrival (US$)	1,006	1,016	875	937	1,003	1,074	1,152	1,236
Public finance				(In percent of GDP)				
Central government								
Revenue	40.8	43.4	39.2	41.0	39.8	40.0	49.3	41.2
Taxes and other revenue	22.2	24.2	24.3	24.8	26.6	28.0	28.1	28.1
Grants	18.6	19.2	14.9	16.2	13.1	12.0	21.2	13.0
Expenditure	40.1	39.8	34.3	37.5	34.9	35.8	40.5	39.3
Expense	35.8	35.3	29.7	32.0	32.0	34.0	33.9	33.8
of which: grants to other government units	5.0	4.8	5.1	5.8	5.0	6.9	6.9	6.8
Net acquisition of nonfinancial assets	4.3	4.5	4.6	5.5	2.9	1.8	6.6	5.5
Current fiscal balance (excluding grants) 2/	-13.5	-11.1	-5.4	-7.2	-5.4	-6.0	-5.8	-5.7
Current fiscal balance (including current grants) 3/	-0.3	2.5	4.7	2.7	5.6	4.6	5.5	3.4
Net lending (+)/borrowing (–)	0.7	3.6	4.9	3.5	4.8	4.3	8.8	1.8
				(In millions of U.S. dollars)				
Compact Trust Fund (CTF) balance	189.6	199.2	183.9	196.8	219.8	226.5	293.9	294.8
Government cash and deposits 4/	6.2	9.6	23.4	28.6	32.7	49.9	83.6	93.2
In percent of GDP	2.8	3.9	8.0	9.4	11.3	16.8	27.0	28.8
Monetary sector								
Credit to private sector (in percent of GDP)	12.4	12.0	9.8	9.8	11.9	12.0	12.2	..
Credit to private sector (percent change)	8.9	5.9	-2.5	3.6	15.4	2.9	6.6	..
Balance of payments 3/								
Trade balance	-129.9	-155.1	-138.3	-136.3	-143.7	-147.9	-156.2	-158.7
Exports (f.o.b.)	11.8	12.5	11.6	11.3	9.8	11.1	12.6	12.7
Imports (f.o.b.)	141.7	167.6	149.9	147.6	153.5	159.0	168.8	171.4
Tourism receipts	105.7	121.3	138.9	129.6	115.8	114.2	124.4	137.7
Current account balance								
Including grants	-25.5	-33.9	-19.2	-31.9	-51.9	-51.4	-49.7	-51.2
Excluding grants	-67.6	-79.0	-59.9	-74.1	-94.0	-93.7	-95.0	-89.8
International Investment Position	216.5	243.2	267.3	311.3	339.7	346.6	424.4	413.8
Assets	424.9	467.1	510.1	579.5	618.6	651.0	760.5	780.4
Liabilities	208.4	223.9	242.7	268.1	278.8	304.3	336.1	366.6
Of which: External debt	65.0	70.6	64.4	80.0	85.9	91.3	101.1	107.6
				(In percent of GDP)				
Current account balance								
Including grants	-11.3	-13.8	-6.5	-10.5	-17.9	-17.3	-16.0	-15.8
Excluding grants	-30.0	-32.1	-20.4	-24.4	-32.4	-31.6	-30.7	-27.8
International Investment Position	96.1	99.0	91.2	102.4	117.2	116.9	137.1	127.9
Of which: External debt	28.9	28.7	22.0	26.3	29.6	30.8	32.7	33.2

Sources: Palau authorities; and Fund staff estimates and projections.
1/ Fiscal year ending September 30.
2/ Defined as tax and other revenue less expense.
3/ Includes withdrawls from CTF and Funding for US Federal Programs (Post Office and Meteorological Service)
4/ Includes unspent external loans.

INTERNATIONAL MONETARY FUND

REPUBLIC OF PALAU

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

January 15, 2019

KEY ISSUES

Outlook and risks. Palau, a small state in the Pacific, is heavily dependent on tourism and grants. Economic activity slowed down significantly due to lower tourism over the past two years. Growth is expected to pick up with a rebound in construction activities and tourism from FY2018 through 2020. The overall fiscal balance remained in surplus primarily owing to low capital expenditure and expected to improve further with the disbursement of the recently-ratified Compact grants. The outlook is generally favorable although subject to downside risks.

The discussions focused on:

Ensuring long term fiscal sustainability

- Develop a medium-term fiscal framework and strategy that can accommodate high revenue volatility and risks from the expiration of the Compact grants in FY2024.
- Implement a revenue-enhancing tax reform, including the introduction of the VAT and cuts in current spending to create room for higher public investment and fiscal buffers.
- Contain quasi-fiscal risks from public enterprises through strengthening public financial management.

Making potential growth more resilient and sustainable

- Implement a high-end tourism strategy to promote sustainable eco-tourism and lower volatility in the sector.
- Develop the infrastructure planning needed to support the rapidly growing tourism industry and enhance resilience to natural disasters and climate change.

Preserving financial stability and facilitating credit extension.

- Strengthen and broaden financial regulation and supervision. Adopt a cautious approach to cryptocurrencies and ensure that adequate AML/CFT measures are in place to mitigate the financial integrity risks.
- Facilitate credit extension by easing the interest rate ceiling on commercial loans and helping small and medium-sized enterprises to prepare business plans.

Approved By
Thomas Helbling (APD) and Yan Sun (SPR)

Discussions took place in Koror during October 25–November 7, 2018. The mission team comprised Ms. Kinoshita (Head, APD), Mr. Lee (APD), and Mr. Sullivan (APD). Mr. Amor (OED) also participated in the discussions. Ms. Ibrahim (APD) provided editorial assistance. The team met with Minister of Finance Sadang, other senior government officials, and representatives of the Congress, private sector, and donor community. A press release at the end of the mission was published on November 7, 2018.

CONTENTS

CONTEXT

1. **Palau is a small-island economy in the Pacific that relies heavily on tourism and foreign grants.** The country is exposed to natural disasters and climate change, although to a lesser extent than other Pacific Island countries (Appendix I). The political system is based on the U.S. model, with four-year presidential terms. The next election will be in 2020. President Remengesau Jr. was re-elected in November 2016. He is known for his environmental initiatives, including the creation of the world's largest marine sanctuary in 2015. Palau's legal tender is the U.S. dollar and its fiscal year ends in September.

2. **The ratification of the Compact Agreement with the United States after a long delay will temporarily boost near-term grant revenue.** Palau became independent in 1994 after having been under U.S. administration. As part of a 50-year Compact of Free Association, the United States provided US$580 million in financial aid to Palau during 1994–2009 for infrastructure investment, budget support, and the establishment of a Compact Trust Fund (CTF). The latter, with an initial endowment of US$70 million, was to provide Palau with annual revenue of US$15 million in FY2010–44. However, the CTF funds proved insufficient and a new Compact Review Agreement (CRA) extending financial assistance for another 15 years was signed in 2010. After a long delay, the agreement was ratified by the U.S. Congress in late 2017. The total assistance under the new agreement amounts to US$229 million, with over US$120 million to be disbursed in FY2019.

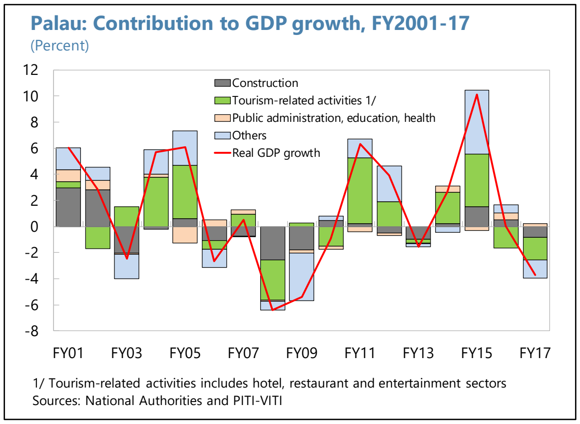
3. **Palau's economic policies in FY2016–17 were partly in line with past IMF advice (Appendix II).** Fiscal consolidation kept the overall fiscal balance in surplus, but at the cost of reduced capital spending. A tax reform bill was sent to the Congress in FY2018, which is pending. Basic infrastructure and internet connectivity were upgraded through AsDB-financed projects to support the growing tourism sector. Efforts to expand financial supervision to the National Development Bank of Palau and other non-bank financial institutions are also underway.

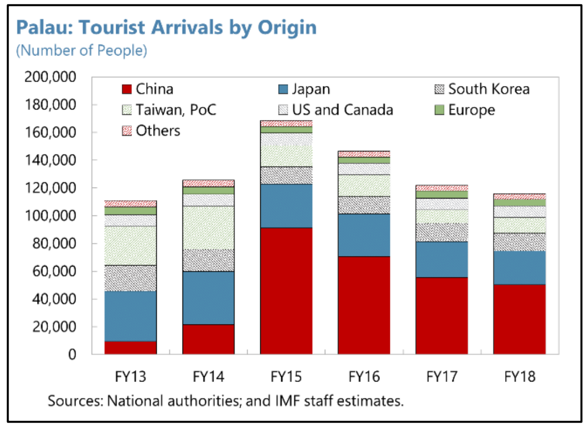
RECENT DEVELOPMENTS, OUTLOOK AND RISKS

4. **Economic activity slowed significantly in FY2016 and 2017.** GDP contracted by 3.7 percent in FY2017, due to tourist arrivals dropping sharply by 17 percent. The latter primarily reflects limits on the number of charter flight arrivals imposed in FY2016 after a tourism surge strained infrastructure in the previous year. Construction activity also remained subdued because of lower capital grants and a delay in the construction of a new luxury hotel.

5. **Growth is expected to pick up.** The rebound is driven by a recovery in construction activities related to a new luxury hotel and infrastructure projects financed by the recent disbursement of the Compact grant. In addition, a recent launch of faster internet services via fiber-optic cables is expected to have a positive impact on growth in the medium run. It is projected to be moderate with growth at 0.4 percent in FY2018, and then strengthen in FY2019, with growth at 2.0 percent in FY2019, as tourism activity is expected to start rebounding. In FY2020, growth should increase further to 2.5 percent, as the new hotel starts operating. Afterwards, growth will gradually moderate to 2 percent, as the one-off effect of the increased hotel capacity dissipates. Inflation

turned positive at 0.9 percent in FY2017 as fuel and food prices rose. The latter have risen further in FY2018, and inflation should increase further to about 2.8 percent in FY2018.





6. **The current account deficit increased temporarily with the downturn in tourism.** In FY2017, the deficit widened by about 7 percentage points to 17.9 percent of GDP. Over the medium-term, the current account deficit is projected to narrow to around 13 percent of GDP with the expected recovery of the tourism sector and the completion of major infrastructure projects. These deficits would continue to be financed with capital grants and FDI inflows (Appendix III).

7. **Banks continue to lend little domestically, investing most of their assets abroad.** In FY2017, the loan to deposit ratio remained low at 12.2 percent and credit to the private sector stood at 11.9 percent of GDP, despite domestic credit increasing by 15.4 percent.

8. **Risks to economic growth are tilted to the downside (Appendix IV).** The rebound in tourism activity could turn out to be weaker than expected, possibly due to tourist arrivals remaining low or because of delays in implementing a high-end tourism policy strategy (see below). A shortfall of non-Compact capital grants would lead to lower infrastructure investment and lower economic growth. Palau is also exposed to natural disasters like other Pacific Island economies, which, if such an event were to materialize, would lead to output losses and damage to infrastructure and other capital. Other risks include weaker than expected global growth, including in the U.S. and China and a sharp tightening of global financial conditions and further U.S. dollar appreciation, which would adversely affect the economy through lower tourism receipts. Given the lack of monetary and exchange rate policy instruments, Palau would need to rely on fiscal and structural policies should these risks materialize.

Authorities' Views

9. **The authorities agreed with staff's assessment of the economic outlook and risks.** They noted efforts to implement its high-value and environmentally sustainable tourism strategy and to continue efforts in upgrading infrastructure to increase resilience to natural disasters and climate change. They laid out this vision in the 'Palau Responsible Tourism Policy Framework', which includes greater collaboration and coordination among various agencies by establishing the National Tourism Board. They expected that improved internet connectivity from fiber-optic cables project would contribute to higher productivity and growth.

KEY POLICY ISSUES

The main economic policy priorities for Palau are to develop a medium-term fiscal framework and strategy to help manage fiscal risks and the expiration of the Compact grants, to raise public investment, to protect social spending, to make growth more resilient and sustainable through other reforms, and to preserve financial stability and integrity.

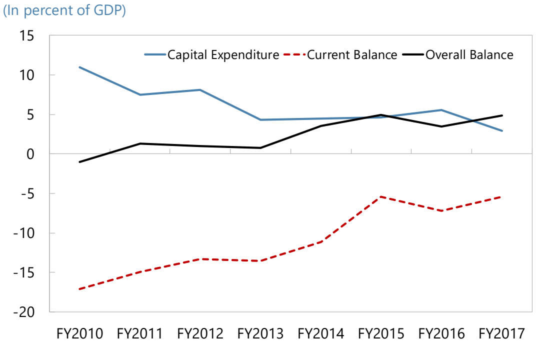
A. Ensuring Fiscal Sustainability

10. Palau has continued to receive substantial U.S. financial assistance despite the delay in the ratification of the new Compact Agreement. Before the ratification, Palau received current grants of US$13.1 million and withdrew US$5 million from the CTF annually in 2010–17. Following ratification in late 2017, the remaining funds under the new agreement are to be disbursed in a lump sum fashion, with US$65 million to be added to the CTF[1], US$34 million for capital improvement projects and US$25 million for current assistance in FY2018–19.

11. The fiscal position improved over the past few years, with the overall fiscal surplus reaching 4.8 percent of GDP in FY2017 (Text chart). Concerted efforts of multi-year fiscal consolidation resulted in improved overall and current fiscal balances. The overall fiscal balance (including grants and capital expenditure) has been in surplus since 2011. In 2017, it remained in surplus despite an economic downturn as capital expenditure was compressed at 2.9 percent of GDP, compared to 5.5 percent of GDP in FY2016. This is mainly due to lower capital grant receipts. On the other hand, domestic revenue rose by about 2 percent of GDP.

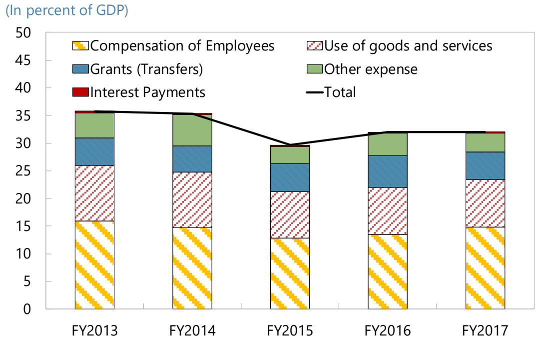
Development of Federal Government Expenditure

Palau: Fiscal Balance and Capital Expenditure, 2010-2017
(In percent of GDP)



Sources: PITI-VITI, Republic of Palau and IMF Staff Calculations

Palau: Composition of Current Expenditure
(In percent of GDP)



Sources: PITI-VITI and IMF Staff Calculations

12. The fiscal position is projected to improve further with the disbursement of the Compact grants. The overall fiscal balance is projected to increase to 8.8 percent of GDP in FY2019 with the lump sum Compact grants payment. On the revenue side, capital grants from the U.S. Compact are estimated to rise by 9.2 percent of GDP in FY2019. Capital investment financed by

[1] The CTF is now expected to maintain its nominal balance indefinitely, with the assumption of the same average nominal rate of return as before, as the additional contribution boosted the existing fund balance. Given the higher balance, the expected investment return will now be high enough to cover the withdrawal of US$15 million a year.

grants is projected to rise to 5 to 6 percent of GDP during 2019–21 before declining to 3.8 percent of GDP over the medium-term. Tax revenue is projected to increase by 2 percent of GDP from 2018 owing to higher receipts from the Pristine Paradise Environmental Fee (PPEF).[2] Current expenditure should rise by 2 percent of GDP because of higher transfers to state governments, the Civil Service Pension Fund (CSPF) and other entities as receipts from the PPEF are earmarked for redistribution. Current expenditure excluding the PPEF redistribution is projected to remain stable at around 32 percent of GDP in FY2018–19.

13. Over the medium-term, the overall fiscal balance is projected to remain at about 3 percent of GDP in FY2024 in the baseline scenario. Capital spending of around 4 percent of GDP in FY2022–24 is assumed to be financed by capital grants. Current grants, now at US$13 million per year, will decline to zero by FY2020. However, this decline will be largely offset by an increase in the permitted annual CTF withdrawals from the current US$5 million to US$15 million over the same period. The CTF balance is projected at about 80 percent of GDP by the end of FY2024.

Staff's Recommendations

14. Staff recommended the move toward a medium-term fiscal framework and strategy, given coming challenges and risks. The current fiscal policy approach is based on the legal requirement to maintain a balanced or surplus cash flow for various parts of the budget. While this fiscal policy strategy has resulted in overall budget surpluses and a decline in net debt, the move to a medium-term fiscal framework and strategy would help Palau to address future challenges. These include the expiration of the Compact grants, revenue risks related to tax revenue and Trust Fund return volatility, downside risks to future grants because of the country's high-income status, and risks from contingent liabilities from the quasi-fiscal sector. As in previous Article IV consultations, staff recommended a medium-term framework based on a net worth approach. This approach provides a broad goal of stabilizing the government's net worth in the long run. The change in net worth value due to a declining real value of the CTF guides the size of necessary fiscal adjustment over the medium-term, yielding the desired path for the current fiscal balance defined as domestic revenue minus current expenditure. The current fiscal balance is the policy variable that is set to ensure the government's intertemporal budget constraint, in which the net present value of future expenditure streams equals the net present value of future revenue streams plus the governments' financial net wealth.[3] The long-run net worth level is also consistent with the policy objectives of medium-term fiscal sustainability and the need to maintain appropriate buffers and capital investment, allowing the authorities to accommodate revenue volatility and exceptional expenditure related to natural disasters.

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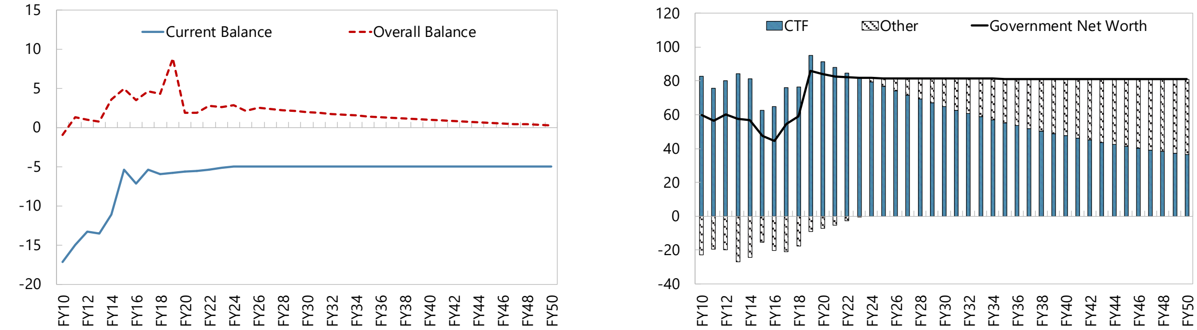
[2] Beginning January 1, 2018, Palau increased its airport departure tax from $50 to $100. The departure tax was renamed the Pristine Paradise Environmental Fee (PPEF).

[3] See International Monetary Fund (2008*), Republic of Palau: Selected Issues Papers*, Chapter 1.

Long-term Fiscal Sustainability in Staff's Baseline Scenario

Palau: Overall and Current Balance
(In percent of GDP, baseline fiscal projections)

Palau: Government Net Worth - Baseline Capital Spending
(In percent of GDP, baseline fiscal projections and sustainable level of capital exp.)

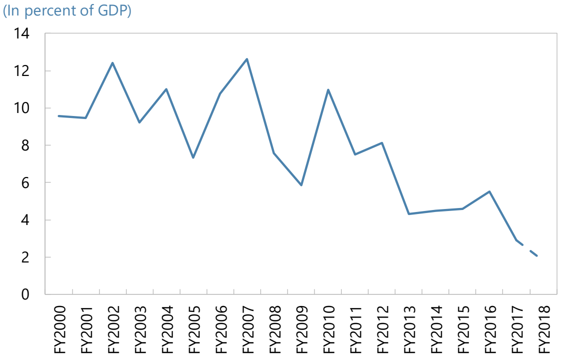


Sources: PITI-VITI and IMF Staff Estimates.

Sources: PITI-VITI and IMF Staff Estimates.

15. As illustrated in staff's reform scenario, additional medium-term fiscal adjustments would compensate for the expected loss of grant revenue and allow for higher public investment and fiscal buffers (Appendix V). In the baseline scenario, the current fiscal deficit in FY2018 is projected to widen to 6.0 percent of GDP in FY2018 and then gradually narrow to 5.0 percent in the medium-term. The CRA will provide a one-time boost to capital expenditure in FY2019–21, but capital spending would fall to 3.8 percent of GDP thereafter. Given the infrastructure gap to be closed for resilient and sustained long-run growth, capital investment has been too low in the past 5 years and needs to be higher than the 3.8 percent of GDP expected in the baseline. Thus, staff argued for fiscal adjustments of 4.7 percent of GDP to create room for higher public investment. Under staff's reform scenario, capital spending can be sustained at 7.5 percent of GDP from FY2023, raising GDP growth to 3 percent in the medium-term and achieving a higher government net worth than in the baseline.

Palau: Central Government Investment
(In percent of GDP)



Sources: PITI-VITI, Republic of Palau and IMF Stafrf Calculations

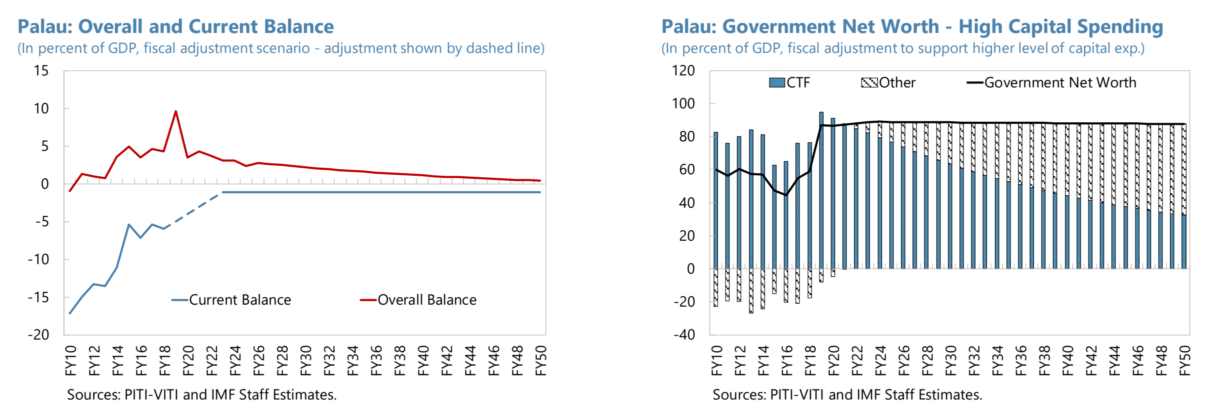
Palau: Reform Scenario with Tax Reform, FY2019–23
(percent of GDP)

	Current Fiscal Balance under reform scenario	Required Adj. under reform scenario	Revenue increase *Inc. VAT at about 12.5% 1/2/*	Expenditure cut *Inc. PPUC subsidy cut*
FY2018 Est.	-6.0			
FY2019	-5.8	0.1	0.0	0.1
FY2020	-5.4	0.4	0.1	0.3
FY2021	-4.0	1.4	1.1	0.3
FY2022	-2.6	1.4	1.1	0.3
FY2023	-1.2	1.4	1.1	0.3
Total Needed Adj.		**4.7**	**3.4**	**1.4**

1/ Assuming that the tax reform is implemented in October 2020.
2/ The tax reform with VAT is estimated to increase revenue by 3 percent of GDP by 2023 and revenue increase expected under the baseline is 0.4 percent of GDP

16. The medium-term fiscal adjustment should rely on tax and structural expenditure reforms. The comprehensive tax reform bill currently under consideration by the Congress would not only enhance the efficiency and fairness of the tax system but would also provide for an opportunity to raise revenue without undue distortions. The proposed comprehensive tax reform strategy includes: (i) introduction of a Value-Added taxes (VAT), in place of the gross revenue tax (GRT), (ii) introduction of net profits tax, (iii) reform/reduce the wages and salary tax rates for low income earners, and (iv) repeal of the GRT, general import tax, and hotel and vessel cabin tax (Appendix VI).[4] The increase in tax revenue from the reform could contribute about two-thirds of the required adjustment if the VAT tax rate is set at about 12.5 percent (see text table).[5] Without the tax reform, fiscal adjustment would need to rely more on expenditure cuts, which would be more difficult to implement and would be associated with relatively lower economic growth.

Long-term Fiscal Sustainability in Staff's Reform Scenario



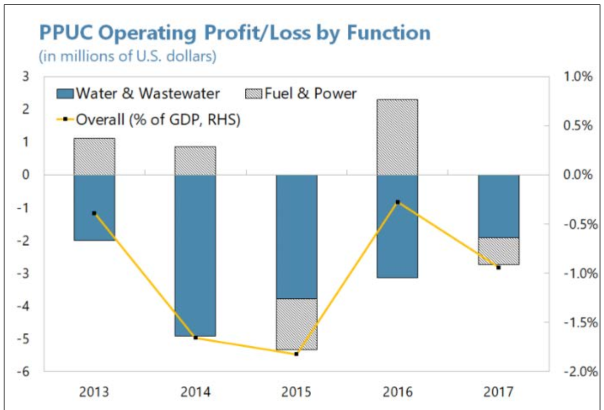
17. Reducing inefficient current spending and continuing to strengthen public financial management (PFM) should be a second pillar of the fiscal adjustment strategy. Eliminating subsidies to the Palau Public Utilities Corporation (PPUC) over the next 5 years would yield a cumulative saving of 1 percent of GDP. To mitigate the adverse impact of subsidy elimination, additional measures that strengthen the budget discipline and financial management at the public enterprises would be required. Furthermore, better PFM would also improve efficiency in public investment in the future as the authorities consider possible further joint ventures on infrastructure projects between public enterprises and private investors. Given the recent AsDB project loans and the public private partnership (PPP) in the airport expansion project, the authorities should continue to strengthen the public investment management framework while ensuring project debt sustainability and limiting undue risks of contingent liabilities from PPPs. In this respect, a formal Public Expenditure and Financial Accountability (PEFA) assessment would help update and identify

[4] The tax reform bill has benefited from extensive IMF/PFTAC technical assistance.

[5] In the baseline scenario, tax revenue is assumed to increase by about 0.1 percent of GDP each year due to the introduction of a new financial management system and the one-stop shop for tax payments and transfers. An additional expenditure adjustment of 0.4 percent over the next five years is assumed in the baseline from improved PFM.

the areas that need to be addressed on the PFM roadmap.[6] Staff analysis shows that public debt remains sustainable under the baseline (Appendix VII).

18. Palau should continue to reform the Civil Service Pension Fund (CSPF) and the Palau Public Utilities Corporation (PPUC) to contain quasi-fiscal risks.[7] While part of the revenue from the increased departure tax (PPEF) has been allocated to the CSPF starting in 2018, the fund's liabilities are expected to exceed its assets in the medium term in the absence of additional pension reform. The government also provided subsidies of about 1 percent of GDP last year to the PPUC. The PPUC is expected to increase tariffs to operate on a full-cost recovery basis, as stipulated under the terms of an AsDB project loan. To limit exposure to rising fuel prices, the authorities have also been considering a long-term plan to introduce solar energy sources.[8]



Sources: Financial Statements of PPUC (2013-17), U.S. Graduate School, IMF Staff Calculations.

Authorities' Views

19. The authorities agreed with the need to develop a medium-term fiscal framework. They noted the ongoing efforts to strengthen PFM and to adopt a medium-term fiscal strategy (MTFS) in the context of the medium-term development strategy first introduced in FY2000. The MTFS would include multi-year budgeting and planning as well as the development of a new performance reporting framework for expenditure. They also concurred with the need to raise additional revenue in the medium-term, given the expiration of the direct economic assistance under the Compact agreement. As Palau needs more capital investment to build resilience and to raise potential growth, they planned to continue to finance capital investment via bilateral grants from key developmental partners and available financing facilities such as the Green Climate Fund for climate change. Despite these plans, the authorities agreed with staff's reform scenario in which they can create further fiscal space for needed public investment in the near term. Over the medium-term, the authorities also planned to shift toward PPPs as a vehicle for financing capital projects. In this respect, they have started to use PPPs in the expansion of the national airport and the provision of solar power to the PPUC.

20. The authorities noted that the tax reform bill was sent to the Congress in September 2018, awaiting enactment into law. A tax bill was last considered in FY2014 but was not approved by the Congress. With more preparation and outreach, the authorities saw a better chance for the new bill to be approved. The comprehensive tax reform was focused on the introduction of the

[6] The self-assessment of the PEFA was conducted in 2013 with the assistance of the PFTAC.

[7] The PPUC is a state-owned firm that provides electricity, water and sewer services. 12.5 percent of the PPEF is earmarked for the CSPF.

[8] The President announced his plan to reach the target of 45 percent energy supply coming from renewable energy by 2020. Palau recently signed an agreement with a French contractor to build a solar panel grid.

'Palau Goods and Service Tax (PGST)' replacing the GRT and the increase in the net income tax rate for financial institutions and all PGST-registered businesses. The authorities also acknowledged the existence of unfunded liabilities in the CSPF and noted that an actuarial study to examine reforms to entitlements and contributions was under way. They stressed that this would form the basis of a reform plan to ensure the long-term sustainability of the CSPF, together with the new funds allocated from the PPEF. The authorities also want to make PPUC self-sufficient by raising water tariffs and reducing costs. However, they noted that the service quality needed to be improved in line with planned upgrades to the water system before tariffs could be raised.

21. The authorities also saw the merit of a fiscal buffer fund to support counter-cyclical fiscal policy. In FY2014, the government established a small buffer fund, or the General Fund Reserve (GFR) to set aside part of their budget surplus.[9] The GFR stands at about 5 percent of GDP in FY2018. The authorities would like to increase further to above 10 percent of GDP to make it a full-fledged buffer fund.[10] In addition, the authorities have a long-term aspiration to convert the CTF into a permanent fund. The recent injection of U.S. compact grants boosted the CTF balance but will only maintain a nominal value of the CTF. Additional funds would be needed to avoid a declining real value of the CTF, should it be converted into a permanent fund.

B. Making Potential Growth More Resilient and Sustainable

22. Palau can strengthen its growth potential by implementing a comprehensive tourism strategy in addition to addressing infrastructure gaps.[11] Palau's economic growth rate has been volatile because of its strong reliance on tourism. With its small population and land area, there is limited scope to diversify the economy. Nevertheless, structural policies to enhance the potential in tourism could strengthen future growth opportunities while also reducing sectoral and thus macroeconomic volatility. The focus should be on greater diversification of the source markets and moving toward high-end tourism, building on the pristine environment (Appendix VIII). Staff supported the authorities' continuing efforts to adopt a broad reform strategy in this domain, which includes efforts to strengthen the environment and upgrade resilience to natural disasters and climate change.

23. The brain drain from youth emigration is a constraint on growth but addressing the problem primarily through increasing the minimum wage could be counterproductive. Palau's total population, including migrants, had declined by 11 percent since 2005 mainly because of youth emigration. As a result, Palau relies heavily on foreign labor mainly from the Philippines (about

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[9] The GFR is to provide funds in the case of national emergency including natural disasters. The authorities drew from the GFR following severe droughts in 2016 (Republic of Palau Public Law No. 9-59. 2016. *Extreme Drought Emergency Funding Act*) (Appendix I).

[10] The authorities' intention to increase the fiscal buffer above 10 percent of GDP was taken into account in the baseline scenario, though the GFR is not treated separately from the government deposits.

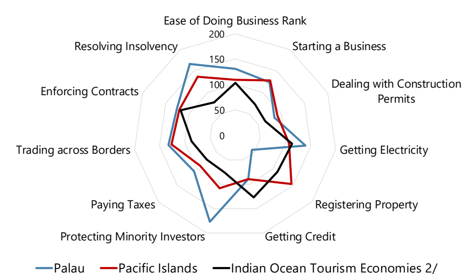
[11] The high-end tourism strategy is focused on shifting away from targeting a higher volume of arrivals to one focused on increasing revenue per arrival while keeping the growth of tourist arrivals in check. Other policy measures include tax breaks for prospective five-star hotels, increasing the capacity of the foreign investment board and the marketing budget of the Palau Visitors Authority to promote high-end, environmentally conscious brand Palau ('Pristine Paradise Palau').

twenty-seven percent of the population). Being concerned about the shrinking domestic population, the President has submitted a bill to the Congress that would increase the minimum wage to Guam levels over the next 10 years. However, increasing minimum wages could be counterproductive in retaining domestic labor force, as emigration may be concentrated in the higher-skilled labor segment with limited employment opportunities in Palau, and a general wage increase could lead to higher unemployment and a loss of competitiveness. Alternative approaches could be more effective in retaining young workers, including the implementation of structural reforms to improve entrepreneurial opportunities and the provisions of healthcare and primary schooling as well as vocational training in the tourism-related industry (Appendix X).

24. Building resilience to climate change and natural disasters is critical to Palau's development strategy (Appendix I). The authorities are continuing to internalize the risks to growth and the costs for ex-post response associated with natural disasters and climate change by building fiscal buffers and securing contingent financial assistance.[12] Over the medium-term, ensuring greater assistance from multilateral climate change schemes can help to cope with its substantial adaptation cost to prepare for natural disasters and climate change. Staff encouraged the authorities to continue to make a progress in climate resilience projects to strengthen early disaster warning system, improve coastal protection and planning, and promote renewable energy.

25. Improving the investment climate helps attract more foreign investment and foster the development of the private sector. Adopting a new foreign investment regime with less restrictions and requirements and creating a one-stop shop for potential investors remain a priority, given increasing reliance on FDI as a source of external financing and the prominence of tourism as the main recipient sector of FDI in Palau. Addressing infrastructure bottlenecks would also help attract more FDI. Improving the regulatory framework and land-use planning would also complement these efforts to increase FDI and to facilitate infrastructure development. The World Bank's Doing Business Indicators show that there is room for Palau to improve its business climate, relative to peers.[13] Palau lags its Pacific Island peers especially in getting electricity, protecting minority investors, and resolving insolvency (Text chart).

Ease of Doing Business Indicators, 2017
(Ranking out of 190 countries)[1/]



1/ Lower number indicates more favorable business climate.
2/ Indian Ocean Tourism Economies include Mauritius, Seychelles, Maldives and Sri Lanka.
Source: The World Bank Ease of Doing Business Indicators.

Authorities' Views

26. The authorities concurred with the need to promote private sector development. They emphasized that the recent Responsible Tourism Act and the increased authority of the Foreign Investment Board were designed to achieve these goals. They shared staff assessment on the growth

[12] Palau secured the contingent financial assistance from the AsDB in 2018, which will be available over the next three years.

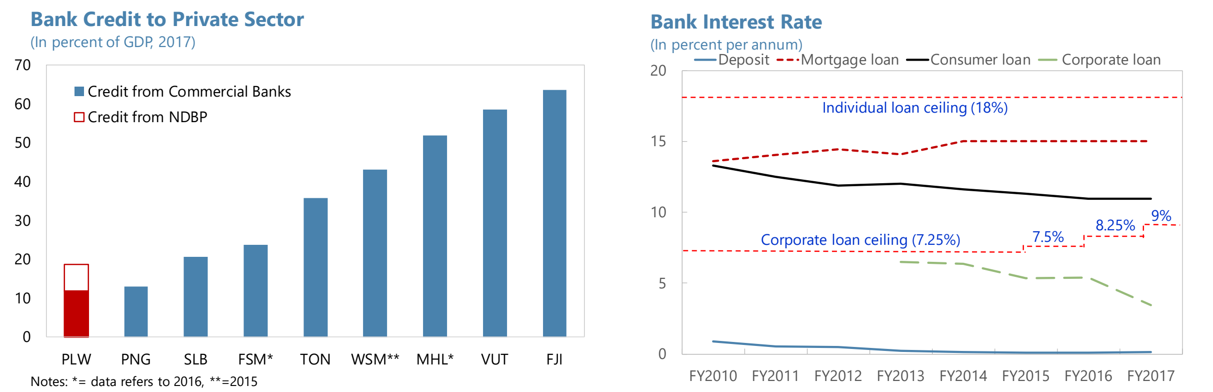
[13] Survey-based indicators reflecting investors' perceptions in the business environment. These indicators should be interpreted with caution due to a limited number of respondents, a limited geographical coverage, and standardized assumption on business constraints and information availability.

constraints associated with brain drains. The authorities were more optimistic about the potential for higher minimum wage to retain potential emigrants and attract Palauans abroad to return home. The authorities considered higher unemployment and/or a loss of competitiveness to be less likely outcomes of higher minimum wages than staff.

C. Preserving Financial Stability and Facilitating Credit Extension

27. The banking system remains sound, but credit creation has been low. Commercial banks in Palau have ample liquidity, a low non-performing loans ratio, and stable returns on assets. But the banking system remains small, with private credit amounting to only 12 percent of GDP, which is substantially lower than in other Pacific island countries. Banks have invested their excess liquidity in the U.S. Foreign banks continue to lend little domestically despite the rapid rise in deposits. Interest rate ceilings imposed may have played a role in restricting banks' lending to the corporate sector (Appendix IX). Under the usury law, the interest rate on lending to individuals is capped at 18 percent per annum while the interest rate on lending to corporations is capped at "the prime rate on corporate loans at large U.S. Money Center Banks+4 percentage points"—which stands at 9 percent as of August 2018. Other impediments to credit extension include the small market size, the lack of secured lending for real estate, and small business' limited capacity. Staff recommended (i) relaxing interest rate ceiling for corporate loans; and (ii) facilitating the process of strengthening the National Development Bank of Palau (NDBP)'s lending capacity by becoming a deposit-taking institution.[14]

Financial Sector Developments



Notes: *= data refers to 2016, **=2015
Sources: IFS, PITI-VITI, National Development Bank of Palau and IMF staff calculations.

Sources: PITI-VITI and Country authorities.

28. The Financial Institutions Commission (FIC) continues its efforts to broaden financial regulation and supervision to non-bank institutions and to improve the anti-money laundering and combating the financing of terrorism (AML/CFT) regime. With the support of TA by IMF/PFTAC and the U.S. FDIC, the FIC has made good progress in conducting bank examinations, strengthening data collection and reporting, and publishing quarterly data. The FIC has prepared legislation to bring credit unions under the supervision of the FIC, which is currently under

[14] Legislation to permit the NDBP to take deposits has been passed and now it has been under regulatory inspections for being granted for a license by the FIC. The NDBP lending is expected to fill part of the financing gap for SMEs once it starts taking deposits.

consideration by the Congress. The authorities plan to address the AML/CFT deficiencies identified in Asia/Pacific Group on Money Laundering (APG)'s recent evaluation of Palau's compliance with the Financial Action Task Force (FATF) standard.[15] The authorities have recently been approached by foreign private investors who would like to operate cryptocurrencies but there is still much uncertainty around these developments. In the absence of related legislation, the FIC has not yet granted a bank license to cryptocurrency operators. Cryptocurrencies pose significant financial integrity risks that call for strong AML/CFT measures to mitigate them. The use of cryptocurrencies also raises consumer protection and cybersecurity risks. In light of this, staff encouraged the authorities to fully implement the FATF recommendations (including the revised Recommendation 15 regarding new technologies) and urged the authorities to take a cautious approach to any additional cryptocurrency-related plans, as these could also put Palau's banking relationships with foreign banks under pressure.

Authorities' Views

29. The authorities agreed with staff's assessment that Palau's banking system remains sound and that credit needs to rise. They noted that the introduction of a new secure online transactions registry had only a limited impact on FDIC banks' lending, as the take-up rate had been low. They also noted that there are structural factors behind low bank lending, including SMEs' limited capacity in preparing business plans and financial statements. The authorities were not convinced that the interest rate ceiling on commercial loans is a key obstacle to credit growth. They also agreed that the NDBP could play a role in extending domestic credit as they take deposits but it would need to strengthen its financial positions and satisfy regulatory requirements first.

30. The authorities recognized the importance of broadening financial supervision and addressing remaining AML/CFT issues. They expected that financial supervision will cover credit unions once the submitted legislation bill was passed. They also pointed to their efforts to address AML/CFT shortcomings. As money laundering risks in Palau were related to foreign-originated financial flows, they noted that more cooperation and exchange of information with foreign jurisdictions were needed. The authorities also urged the IMF to be proactive in assisting small states with regulations for cryptocurrency and blockchain technology.

D. External Sector Assessment

31. The external sector position is assessed to be moderately weaker than underlying fundamentals and desirable policy settings and continued fiscal consolidation is needed to narrow the current account gap. Palau's external position is assessed to be moderately weaker than underlying policy settings as the current account deficit widened due to a decline in tourism receipts (Appendix III). However, there is significant uncertainty in the assessment because of the substantial recent revisions to BOP data. In addition, the anticipated reduction of U.S. Compact

[15] Palau underwent an assessment by the Asia/Pacific Group on Money Laundering against the 2012 FATF AML/CFT standard on the basis of the 2013 assessment methodology and the report was published in September 2018. The findings identified several deficiencies, potentially placing Palau under closer scrutiny of the FATF.

grants will lead to a large structural change in external financing in FY2025. While the current account deficit increased substantially to 17.9 percent of GDP in FY2017 due to the downturn in tourism, the deficit is projected to come down to around 13 percent of GDP over the medium-term. The deficit would continue to be financed mostly with capital grants and FDI inflows. Continued fiscal consolidation will help in maintaining external stability. The government's U.S. dollar deposits, the equivalent of foreign reserves in a dollarized economy, remain appropriate at 3.8 months of government spending.

Authorities' Views

32. The authorities agreed with staff's external sector assessment. They noted that fiscal consolidation, recovery in construction related to hotel and public infrastructure projects and tourism recovery would help reduce the current account deficit. They also acknowledged the ongoing technical assistance on BOP statistics, which could lead to some downward revision in the size of current account deficits in the historical data.

E. Other Issues

33. Improving statistics. Palau's statistics are broadly adequate for surveillance thanks to technical assistance from IMF PFTAC and the Graduate School USA. Staff advised further improvements to BOP statistics. In addition, the inclusion of statistics on non-bank financial institutions in monetary statistics could help in the surveillance of financial activities.

STAFF APPRAISAL

34. Palau's economic growth is expected to recover over the medium term. The growth acceleration will be led by the rebound in tourism and construction activities financed by the recent disbursement of the Compact grant for capital projects. The outlook is generally positive, with growth increasing to 2.5 percent in FY2020 on the back of a further rebound in tourism and continuing construction activity. Inflation is expected to remain low with stable commodity prices and low U.S. inflation, while the current account deficit would decline as fiscal consolidation continues. The external sector position is moderately weaker than underlying fundamentals. Continued fiscal consolidation is needed to narrow the current account gap.

35. The economic outlook is subject to downside risks. Slower economic growth due to lower than expected tourist arrivals from failure to implement a tourism strategy could adversely affect the economy via worsening of the fiscal position and the external sector. Palau remains vulnerable to natural disasters like other Pacific Island countries. Other risks include weaker global growth and sharp tightening of global financial conditions accompanied by further U.S. dollar appreciation that would weigh on the external sector.

36. Developing a medium-term fiscal framework would help in accommodating high revenue volatility and managing fiscal risks. The framework should use the net worth approach, which provides the desired path for the current fiscal balance, consistent with medium-term fiscal policy objectives. This framework would support fiscal sustainability when the Compact grants expire in FY2024, allow for sustained increases in public investment and help in managing buffers for future contingencies.

37. A revenue-enhancing tax reform would create room for higher capital investment and strengthen fiscal buffers while ensuring fiscal sustainability. The authorities have made progress in improving Palau's fiscal position. As grant receipts decline with the expiration of the Compact grant, however, further fiscal adjustment is needed to offset revenue decline over the medium term. The adjustment should rely on higher revenue from a comprehensive tax reform, including the introduction of a VAT and lower subsidies to SOEs, which would require reforming the CSPF and restructuring the PPUC. Higher revenue from the tax reform can also provide fiscal space needed for higher public investment, contributing to higher potential growth.

38. The fiscal adjustment should be complemented by strengthening public financial management. Such strengthening would help in developing and maintaining infrastructure assets efficiently while maintaining fiscal discipline and reducing potential fiscal risks from investment projects.

39. A comprehensive high-end tourism strategy would support sustainable and resilient economic growth. Tourism will remain Palau's main growth engine, given the limited scope for economic diversification. Nevertheless, greater geographical diversification of source countries could mitigate the economy's vulnerability to shocks. The authorities' comprehensive tourism strategy is appropriately broad and should be implemented expeditiously.

40. Youth emigration is a constraint on growth but increasing the minimum wage could be a counterproductive approach to retaining the young. The planned increase in the minimum wage to the level of Guam could lead to higher unemployment and encourage foreign labor inflows, rather than reducing emigration. An alternative approach based on structural reforms to improve entrepreneurial opportunities, strengthen healthcare provision, and enhance primary schooling and vocational training in the tourism industry would be more effective.

41. Improving the investment climate is important and fostering the development of the private sector. Palau would benefit from adopting a simple and streamlined foreign investment regime and creating a one-stop shop for potential investors. Addressing infrastructure bottlenecks and improving the regulatory framework can complement these efforts to attract more FDI.

42. Preserving financial stability and integrity and facilitating credit extension would further support private sector development. Palau's banks remain sound but lend too little domestically. In this regard, relaxing the interest rate ceiling for commercial loans can be helpful as well as helping SMEs prepare business plans and financial statements. The authorities' plans to extend FIC's supervision to the credit unions and to address the AML/CFT deficiencies should be implemented in a timely manner. A cautious approach to cryptocurrencies is warranted, given the various financial risks associated with their operation especially financial integrity risk, particularly in the absence of AML/CFT measures for virtual assets.

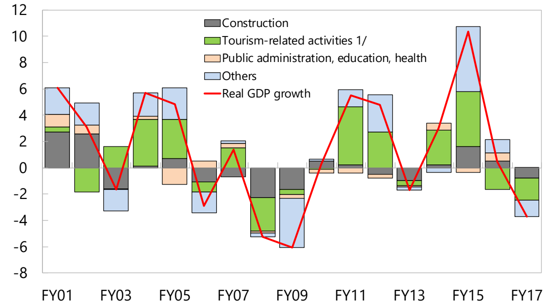
43. It is recommended that the next Article IV consultation take place on a 24-month cycle.

Figure 1. Palau: Real Sector Developments

The tourism boom of FY15 has been followed by a downturn…

Contribution to GDP growth, FY2001-17

(Percent)

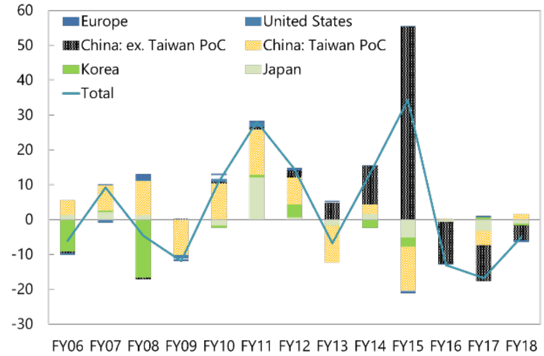


1/ Tourism-related activities includes hotel, restaurant and entertainment sectors.
Sources: National Authorities and PITI-VITI

…due to lower tourist arrivals, partly because of policy decisions to constrain visitor numbers.

Contribution to Tourism Growth

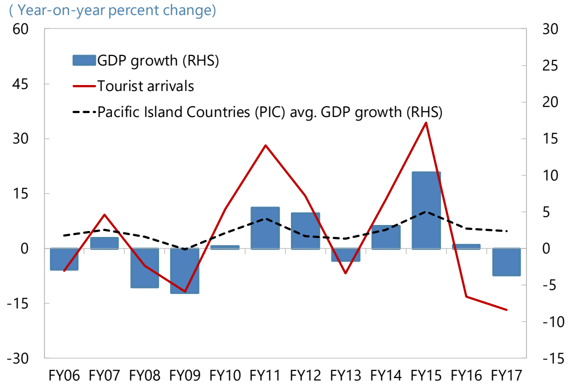
(Growth of tourist arrivals by country of origin, in percent)



Volatility in Palau's tourism sector has typically been reflected in economic outcomes…

Real GDP and Tourist Arrivals

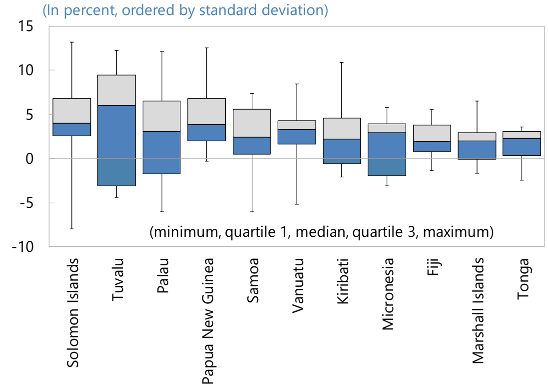
(Year-on-year percent change)



…and as a result, Palau has experienced high growth volatility, even relative to peers in the Pacific.

Volatility of GDP Growth, 2001-2017

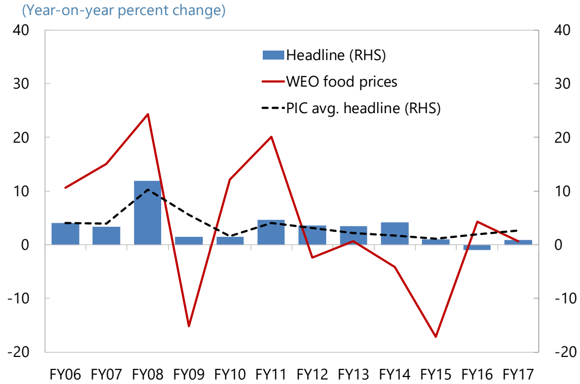
(In percent, ordered by standard deviation)



Inflation has become positive on the back of rising food prices.

Inflation

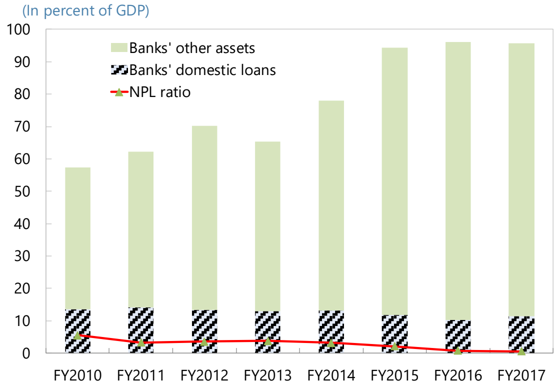
(Year-on-year percent change)



Domestic credit markets remain highly underdeveloped, with banks lending little despite sizable asset positions.

Banks Assets

(In percent of GDP)

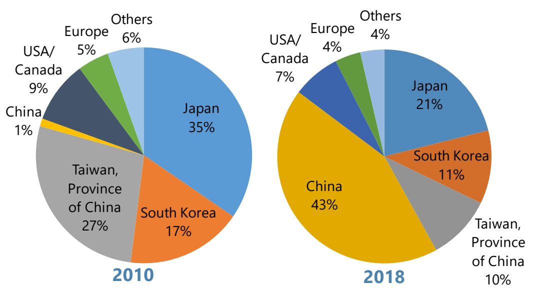


Sources: Country authorities; and Fund Staff Estimates.

Figure 2. Palau: Tourism Sector Developments

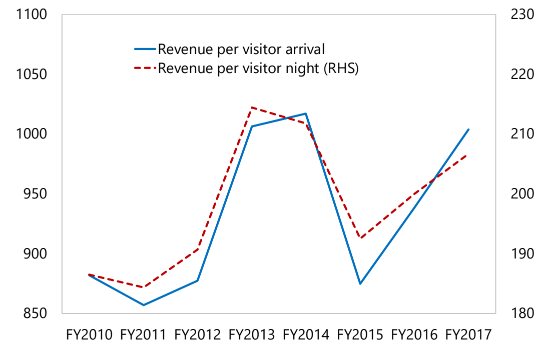
Chinese tourism has rapidly increased in Palau and now constitutes the largest share of tourist arrivals.

Change in Source Market Composition
(In percent)



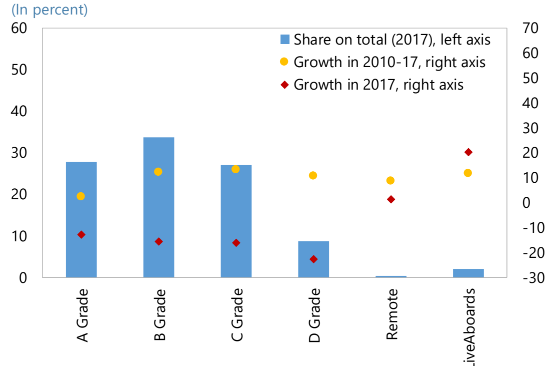
The decline in revenue per tourist observed during the FY15 boom has gradually reversed.

Revenue per Tourist Arrival/Night
(In US$)



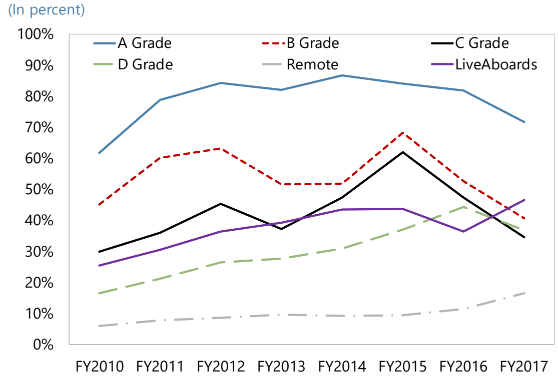
Arrivals growth has been spread across hotel grades, with 'second tier' hotels growing most…

Visitor Nights by Hotel Grade
(In percent)



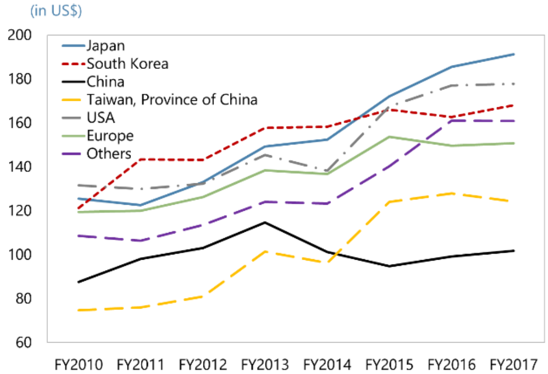
Occupancy rates in high-end hotels have remained stable, with other hotel types showing more volatility.

Hotel Occupancy Rates by Hotel Grade
(In percent)



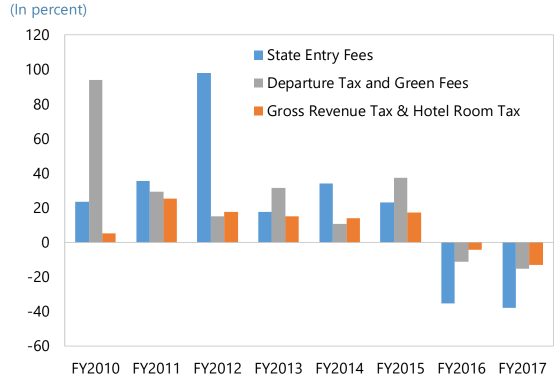
Average nightly spending on hotel rooms varies across tourists of different origin, with tourists from China and Taiwan, Province of China typically spending less on accommodation per night.

Average Room Price by Tourist Origin
(in US$)



The recent downturn has reduced tourism related taxes at both the federal and state-level.

Growth in Public Sector Revenue
(In percent)



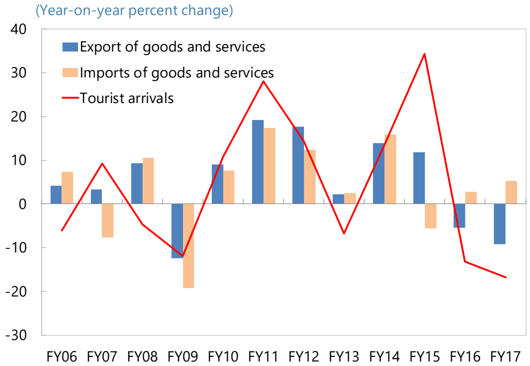
Sources: Country authorities; and Fund Staff Estimates.

Figure 3. Palau: External Sector Developments

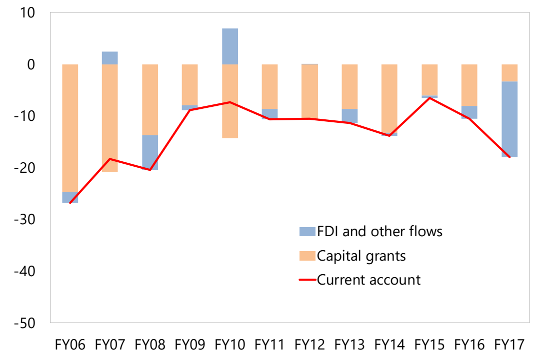
Exports started to decline in FY16 with a decline in tourist arrivals while imports maintained weak growth due to recent lower demand and contained fuel and food prices…

…a weak export growth led to a widening of current account deficit since FY16.

Exports and Imports of Goods and Services
(Year-on-year percent change)



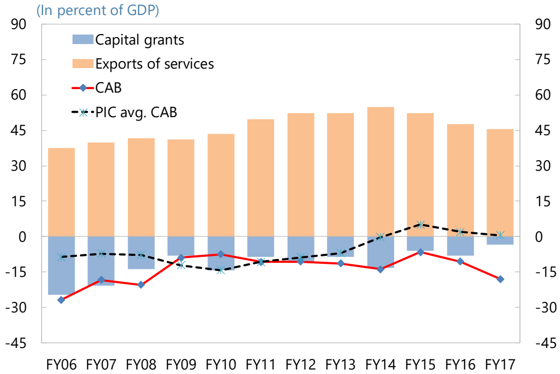
Current Account
(In percent of GDP)



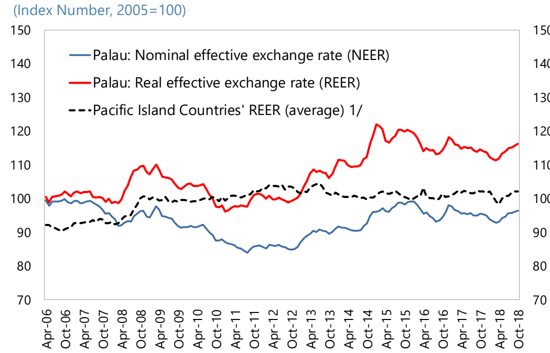
The current account deficit has been larger than other PICs and the gap is widening due to a decline in service exports and capital grants….

The real exchange rate has shown a mild depreciation since 2016.

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



Effective Exchange Rates
(Index Number, 2005=100)

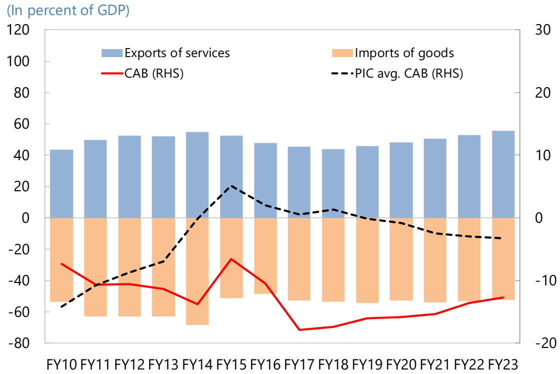


1/ Excludes resource-based countries

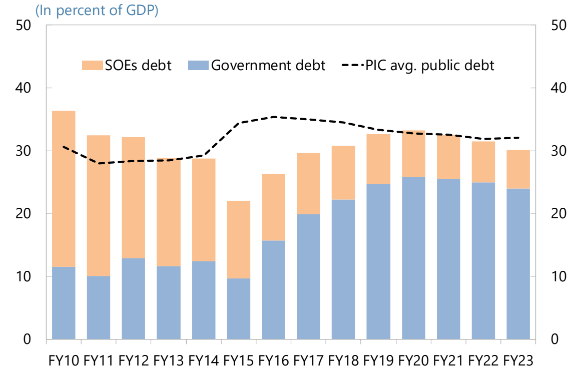
The current account deficit is expected to remain high through FY18 before it starts to come down gradually.

External debt has increased sharply during FY16-17, mainly due to disbursements of AsDB loans.

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



Public External Debt
(In percent of GDP)

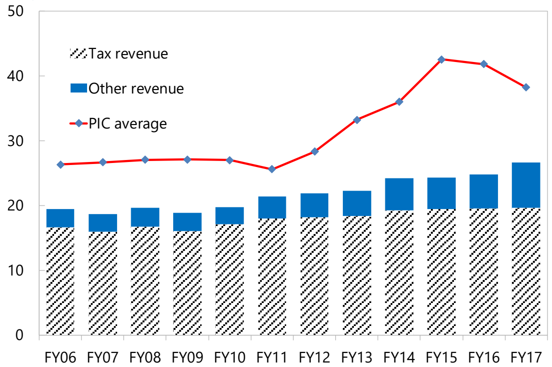


Sources: Country authorities; and Fund Staff Estimates.

Figure 4. Palau: Fiscal Sector Developments

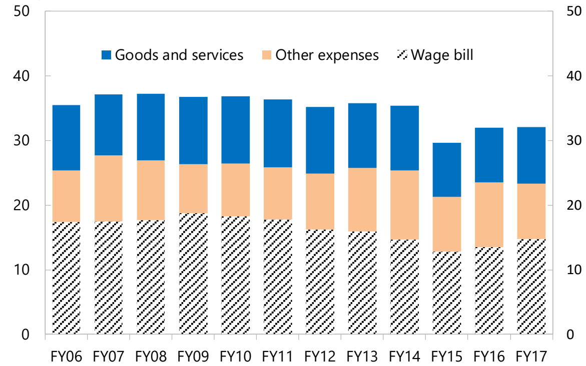
Domestic revenue has gradually improved due to ongoing improvements to revenue administration…

Domestic Revenue
(In percent of GDP)



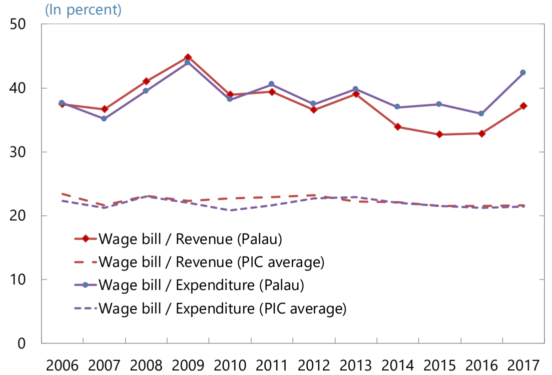
….while spending has begun to increase following the tourism boom of FY15.

Current Spending
(In percent of GDP)



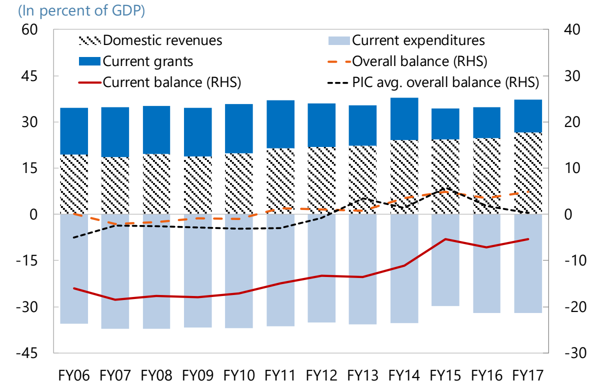
Palau continues to spend far more than its peers on wages, a reflection of its small size.

Wage Bill
(In percent)



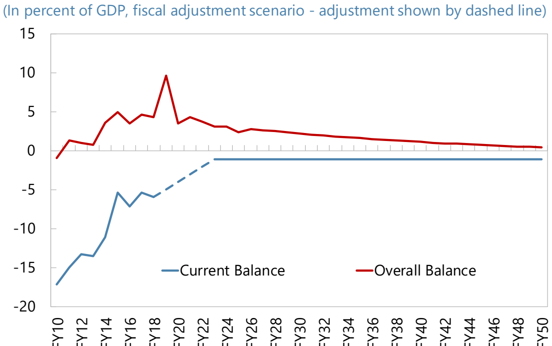
The current fiscal balance has deteriorated following the FY15 boom, while the overall balance has improved following reductions in capital expenditure.

Fiscal Balance
(In percent of GDP)



To restore investment and guarantee sustainability, a large fiscal investment is needed.

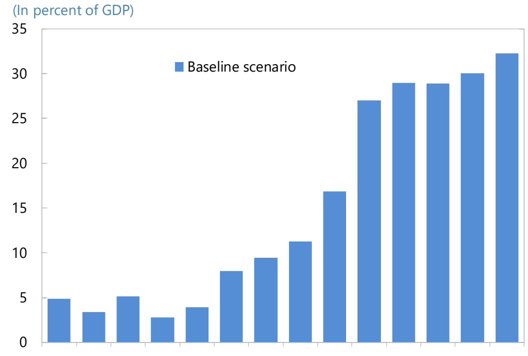
Overall and Current Balance
(In percent of GDP, fiscal adjustment scenario - adjustment shown by dashed line)



Sources: PITI-VITI and IMF Staff Estimates.

The large accumulation of government deposits is expected to continue at a reduced pace after FY19.

Government Currency and Deposits
(In percent of GDP)



Sources: Country authorities; and Fund Staff Estimates.

Table 1. Palau: Selected Economic Indicators 1/

Nominal GDP for FY2017: US$290 million
Population (2015): 17,661
GDP per capita for FY2015: US$17,139
Quota: SDR 3.1 million

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
						Est.	Proj.	
Real sector								
Nominal GDP (million US$)	225.3	245.7	293.1	304.0	289.8	296.5	309.5	323.6
Real GDP growth (percent change)	-1.7	3.0	10.4	0.5	-3.7	0.4	2.0	2.5
GDP deflator (percent change)	6.8	5.8	8.1	3.2	-1.0	1.9	2.4	2.0
Consumer prices (percent change; period average)	3.4	4.1	0.9	-1.0	0.9	2.8	2.4	2.0
Tourist arrivals (number of visitors)	110,823	125,674	168,764	146,629	122,050	115,964	118,283	121,240
Expenditure per Tourist Arrival (US$)	1,006	1,016	875	937	1,003	1,074	1,152	1,236
Public finance				(In percent of GDP)				
Central government								
Revenue	40.8	43.4	39.2	41.0	39.8	40.0	49.3	41.2
Taxes and other revenue	22.2	24.2	24.3	24.8	26.6	28.0	28.1	28.1
Grants	18.6	19.2	14.9	16.2	13.1	12.0	21.2	13.0
Expenditure	40.1	39.8	34.3	37.5	34.9	35.8	40.5	39.3
Expense	35.8	35.3	29.7	32.0	32.0	34.0	33.9	33.8
of which: grants to other government units	5.0	4.8	5.1	5.8	5.0	6.9	6.9	6.8
Net acquisition of nonfinancial assets	4.3	4.5	4.6	5.5	2.9	1.8	6.6	5.5
Current fiscal balance (excluding grants) 2/	-13.5	-11.1	-5.4	-7.2	-5.4	-6.0	-5.8	-5.7
Current fiscal balance (including current grants) 3/	-0.3	2.5	4.7	2.7	5.6	4.6	5.5	3.4
Net lending (+)/borrowing (–)	0.7	3.6	4.9	3.5	4.8	4.3	8.8	1.8
				(In millions of U.S. dollars)				
Compact Trust Fund (CTF) balance	189.6	199.2	183.9	196.8	219.8	226.5	293.9	294.8
Government cash and deposits 4/	6.2	9.6	23.4	28.6	32.7	49.9	83.6	93.2
In percent of GDP	2.8	3.9	8.0	9.4	11.3	16.8	27.0	28.8
Monetary sector								
Credit to private sector (in percent of GDP)	12.4	12.0	9.8	9.8	11.9	12.0	12.2	..
Credit to private sector (percent change)	8.9	5.9	-2.5	3.6	15.4	2.9	6.6	..
Balance of payments 3/								
Trade balance	-129.9	-155.1	-138.3	-136.3	-143.7	-147.9	-156.2	-158.7
Exports (f.o.b.)	11.8	12.5	11.6	11.3	9.8	11.1	12.6	12.7
Imports (f.o.b.)	141.7	167.6	149.9	147.6	153.5	159.0	168.8	171.4
Tourism receipts	105.7	121.3	138.9	129.6	115.8	114.2	124.4	137.7
Current account balance								
Including grants	-25.5	-33.9	-19.2	-31.9	-51.9	-51.4	-49.7	-51.2
Excluding grants	-67.6	-79.0	-59.9	-74.1	-94.0	-93.7	-95.0	-89.8
International Investment Position	216.5	243.2	267.3	311.3	339.7	346.6	424.4	413.8
Assets	424.9	467.1	510.1	579.5	618.6	651.0	760.5	780.4
Liabilities	208.4	223.9	242.7	268.1	278.8	304.3	336.1	366.6
Of which: External debt	65.0	70.6	64.4	80.0	85.9	91.3	101.1	107.6
				(In percent of GDP)				
Current account balance								
Including grants	-11.3	-13.8	-6.5	-10.5	-17.9	-17.3	-16.0	-15.8
Excluding grants	-30.0	-32.1	-20.4	-24.4	-32.4	-31.6	-30.7	-27.8
International Investment Position	96.1	99.0	91.2	102.4	117.2	116.9	137.1	127.9
Of which: External debt	28.9	28.7	22.0	26.3	29.6	30.8	32.7	33.2

Sources: Palau authorities; and Fund staff estimates and projections.
1/ Fiscal year ending September 30.
2/ Defined as tax and other revenue less expense.
3/ Includes withdrawls from CTF and Funding for US Federal Programs (Post Office and Meteorological Service)
4/ Includes unspent external loans.

Table 2. Palau: Medium-term Projections, 2015/16–2023/24 1/

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
			Est.		Proj.				
Baseline Scenario									
Real sector									
Real GDP growth (percent change)	0.5	-3.7	0.4	2.0	2.5	2.2	2.0	2.0	2.0
Consumer prices (percent change; period average)	-1.0	0.9	2.8	2.4	2.0	2.0	2.0	2.0	2.0
Public finance	(In percent of GDP, unless otherwise indicated)								
Central Government									
Taxes and other revenue	24.8	26.6	28.0	28.1	28.1	28.2	28.3	28.4	28.5
Grants	16.2	13.1	12.0	21.2	13.0	12.5	12.3	12.0	11.7
Expense	32.0	32.0	34.0	33.9	33.8	33.7	33.7	33.6	33.5
Net acquisition of nonfinancial assets	5.5	2.9	1.8	6.6	5.5	5.1	4.2	4.0	3.8
Current balance (excluding grants) 2/	-7.2	-5.4	-6.0	-5.8	-5.7	-5.5	-5.4	-5.2	-5.0
Current balance (including current grants) 3/	2.7	5.6	4.6	5.5	3.4	3.3	3.3	3.4	3.4
Primary balance	3.7	5.0	4.4	9.0	2.0	2.0	2.9	3.0	3.1
Net lending (+)/borrowing (–) 4/	3.5	4.8	4.3	8.8	1.8	1.9	2.7	2.8	2.9
Government Net Worth	42.1	53.3	59.6	87.8	85.4	83.5	83.4	83.5	83.3
Compact Trust Fund (CTF) balance	64.7	75.8	76.4	94.9	91.1	87.7	84.6	81.6	78.8
Domestic Arrears	5.7	4.2	2.8	1.4	1.2	1.0	0.8	0.6	0.6
Public external debt	26.3	29.6	30.8	32.7	33.2	32.5	31.5	30.1	28.6
Of which: Government external debt	15.7	19.9	22.3	24.7	25.8	25.5	24.9	23.9	22.9
Government cash and deposits	9.4	11.3	16.8	27.0	28.8	29.3	31.1	32.5	33.7
	(In percent of GDP, unless otherwise indicated)								
Balance of payments									
Current account balance (excluding grants)	-24.4	-32.4	-31.6	-30.7	-27.8	-26.8	-24.6	-23.2	-21.9
Current account balance (including grants)	-10.5	-17.9	-17.3	-16.0	-15.8	-15.4	-13.6	-12.7	-11.8
External debt	26.3	29.6	30.8	32.7	33.2	32.5	31.5	30.1	28.6
External debt (in percent of exports of goods and services)	51.3	60.6	64.4	65.6	64.0	59.6	55.2	50.5	46.1
External debt service (in percent of exports of goods and services)	5.4	5.9	5.8	5.8	6.0	5.8	5.6	5.6	5.5
Staff's Reform Scenario 5/	(In percent of GDP, unless otherwise indicated)								
Real and external sector									
Real GDP growth (percent change)	0.5	-3.7	0.4	2.0	2.5	2.2	2.8	3.0	3.0
Consumer prices (percent change; period average)	-1.0	0.9	2.8	2.4	2.0	3.0	2.2	2.0	2.0
Current account balance (including grants, percent of GDP)	-10.5	-17.9	-17.3	-16.0	-15.2	-15.0	-13.2	-12.2	-11.2
Public finance									
Central Government									
Taxes and other revenue	24.8	26.6	28.0	28.1	28.1	29.2	30.3	31.4	31.9
Grants	16.2	13.1	12.0	21.2	13.0	12.5	12.3	12.0	12.0
Expense	32.0	32.0	34.0	33.9	33.6	33.2	32.9	32.6	32.9
Net acquisition of nonfinancial assets	5.5	2.9	1.8	6.6	5.5	5.1	6.5	7.5	7.5
Current balance (excluding grants) 2/	-7.2	-5.4	-6.0	-5.8	-5.4	-4.0	-2.6	-1.2	-1.1
Change Relative to Baseline	0.0	0.0	0.0	0.0	0.2	1.5	2.8	4.0	4.0
Net lending (+)/borrowing (–) 4/	3.5	4.8	4.3	8.8	2.1	3.4	3.1	3.4	3.4
Change relative to Baseline (Additional Buffers)	0.0	0.0	0.0	0.0	0.2	1.5	0.4	0.5	0.5
Government Net Worth	42.1	53.3	59.6	87.8	85.6	85.2	85.6	86.2	86.6
Compact Trust Fund (CTF) balance	64.7	75.8	76.4	94.9	91.1	87.7	84.6	81.6	78.8
Domestic Arrears	5.7	4.2	2.8	1.4	1.2	1.0	0.8	0.6	0.6
Public external debt 6/	26.3	29.6	30.8	32.7	33.2	32.1	30.9	29.4	27.8
Government cash and deposits	9.4	11.3	16.8	27.0	28.9	30.6	32.8	34.6	36.2

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

1/ Fiscal Year ending September 30.
2/ Defined as tax and other revenue less expense.
3/ Includes withdrawls from CTF and Funding for US Federal Programs (Post Office and Meteorological Service)
4/ Defined as Revenue less Expenditure.
5/ Staff's reform scenario assumes that the current fiscal deficit is reduced by 1.1 percent of GDP each year during FY2019-24 to 1.9 percent of GDP in FY2025. This is achieved by raising taxes and cutting current expenditure, and the additional savings are used to gradually increase public investment, reaching 7.5 percent of GDP by FY2024 onwards. It is assumed that this improves medium term growth.
6/ For the purpose of this exercise we assume that Palau uses the additional fiscal space created by reform to fund capital investment directly.

Table 3. Palau: Balance of Payments, 2012/13–2019/20 1/

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
						Est.	Proj.	
	(In millions of U.S. dollars, unless otherwise indicated)							
Current account balance	-25.5	-33.9	-19.2	-31.9	-51.9	-51.4	-49.7	-51.2
Goods and services balance	-55.1	-66.4	-36.9	-51.4	-76.7	-79.3	-79.8	-72.1
Goods balance	-129.9	-155.1	-138.3	-136.3	-143.7	-147.9	-156.2	-158.7
Exports of goods f.o.b.	11.8	12.5	11.6	11.3	9.8	11.1	12.6	12.7
Imports of goods f.o.b.	141.7	167.6	149.9	147.6	153.5	159.0	168.8	171.4
Services balance	74.8	88.7	101.4	84.9	66.9	68.6	76.4	86.6
Exports of services	117.6	134.9	153.3	144.7	131.8	130.7	141.6	155.4
Travel	105.7	121.3	138.9	129.6	115.8	114.2	124.4	137.7
Imports of services	42.8	46.2	51.9	59.8	64.9	62.1	65.2	68.8
Primary income balance	-9.9	-9.5	-19.3	-15.9	-8.2	-9.1	-10.7	-12.9
Inflows	9.5	10.4	12.8	12.1	17.4	18.2	19.1	19.9
Outflows	19.4	19.9	32.1	27.9	25.6	27.3	29.8	32.7
Secondary income balance	39.6	42.0	37.0	35.3	33.1	36.9	40.8	33.7
Inflows	52.4	56.0	54.5	55.4	54.5	58.8	63.7	57.7
Of which: Grants on budget	42.1	45.0	40.8	42.2	42.1	42.3	45.3	38.6
Outflows	12.8	14.0	17.4	20.0	21.4	21.9	22.9	23.9
Capital account balance	19.5	32.6	17.6	24.4	9.8	9.3	100.7	17.9
Net lending/borrowing (Current+Capital)	-6.0	-1.3	-1.5	-7.5	-42.1	-42.1	51.0	-33.4
Financial account balance	1.6	5.4	38.2	19.5	-8.2	-42.1	51.0	-33.4
Direct investment (net lending(+)=assets-liabilities)	-6.5	-12.9	-31.0	-14.4	-8.6	-20.1	-22.0	-24.0
Portfolio investment (net lending(+)=assets-liabiliti	2.0	-9.9	6.6	0.6	2.0	1.2	1.2	1.1
Other investment (net lending(+)=assets-liabilities)	6.1	28.2	62.6	33.3	-1.7	-23.3	71.8	-10.5
Of which: Public sector loans	-4.1	5.6	-6.2	10.3	6.8	9.0	11.0	5.8
Errors and omissions	7.6	6.7	39.7	27.0	33.9	0.0	0.0	0.0
Current account								
Including official grants	-25.5	-33.9	-19.2	-31.9	-51.9	-51.4	-49.7	-51.2
Excluding official grants	-67.6	-79.0	-59.9	-74.1	-94.0	-93.7	-95.0	-89.8
Memorandum items:	(In percent of GDP, unless otherwise indicated)							
Nominal GDP (million US$)	225.3	245.7	293.1	304.0	289.8	296.5	309.5	323.6
Current account								
Including official grants	-11.3	-13.8	-6.5	-10.5	-17.9	-17.3	-16.0	-15.8
Excluding official grants	-30.0	-32.1	-20.4	-24.4	-32.4	-31.6	-30.7	-27.8
External debt	28.9	28.7	22.0	26.3	29.6	30.8	32.7	33.2
International Investment Position	96.1	99.0	91.2	102.4	117.2	116.9	137.1	127.9
Assets	188.6	190.1	174.0	190.6	213.4	219.5	245.7	241.1
Compact Trust Fund	84.2	81.1	62.7	64.7	75.7	76.4	94.9	91.1
Social Security Funds	52.2	47.6	40.6	41.6	47.5	47.7	47.0	46.3
Other	52.2	61.4	70.7	84.3	90.2	95.4	103.7	103.8
Liabilities	92.5	91.1	82.8	88.2	96.2	102.6	108.6	113.3
FDI	63.6	62.4	60.8	61.9	66.6	71.9	75.9	80.0
Government debt	11.6	12.4	9.6	15.7	19.9	22.3	24.7	25.8
Public enterprise debt	17.3	16.3	12.3	10.6	9.8	8.5	8.0	7.4
Other liabilities, banks	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Errors and Omissions	3.4	2.7	13.5	8.9	11.7	0.0	0.0	0.0

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

1/ Fiscal year ending September 30.

Table 4. Palau: National Government Operations, 2012/13–2019/2020 1/

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
						Est.	Proj.	
National Government Operations	(In millions of U.S. dollars)							
Revenue	92.0	106.6	114.9	124.7	115.3	118.7	152.5	133.3
Taxes	41.4	47.4	57.0	59.5	56.9	63.7	66.7	69.9
Taxes on income, profits and capital gains	7.4	8.2	9.1	10.0	10.9	12.2	12.8	13.4
Taxes on goods and services	17.4	19.7	22.6	24.1	22.2	22.7	23.7	24.8
Taxes on international trade and transactions	9.6	11.6	14.4	15.2	14.9	15.2	15.9	16.6
Other taxes	7.1	8.0	10.8	10.3	8.9	13.6	14.3	15.1
Grants 3/	41.9	47.1	43.7	49.3	38.1	35.6	65.6	42.2
Current	29.7	33.6	29.6	30.1	31.0	31.3	35.1	29.3
U.S. Compact	13.1	13.1	13.1	13.1	13.1	13.1	11.4	0.0
Drawdown from Compact Trust Fund	5.0	5.0	5.0	4.7	5.0	5.0	10.0	15.0
U.S. non-Compact	9.7	9.9	10.2	10.0	9.7	9.9	10.3	10.8
Other country	1.9	5.5	1.2	2.2	3.1	3.2	3.4	3.5
Capital	12.2	13.5	14.1	19.2	6.3	4.3	30.5	12.9
Of which : U.S. Compact	...	0.0	0.0	0.0	0.0	1.0	22.0	3.0
Other revenue	8.6	12.1	14.2	15.9	20.3	19.4	20.2	21.1
Expenditure	90.3	97.8	100.4	114.0	101.2	106.1	125.4	127.3
Expense	80.6	86.8	87.0	97.2	92.8	100.8	104.9	109.4
Of which: Compensation of employees	35.9	36.1	37.6	41.0	42.9	43.8	45.8	47.9
Of which: Use of goods and services	22.6	24.6	24.4	25.9	25.1	25.7	26.8	28.0
Net acquisition of nonfinancial assets	9.7	11.0	13.5	16.8	8.4	5.3	20.5	17.9
Domestic Current balance (excluding grants) 2/	-30.5	-27.4	-15.8	-21.8	-15.6	-17.7	-18.0	-18.3
Current Balance (including current grants) 3/	-0.8	6.2	13.8	8.3	16.1	13.6	17.2	11.0
Net lending (+)/borrowing (–) 4/	1.7	8.8	14.4	10.7	14.0	12.6	27.2	6.0
	(In percent of GDP)							
Revenue	40.8	43.4	39.2	41.0	39.8	40.0	49.3	41.2
Taxes	18.4	19.3	19.4	19.6	19.6	21.5	21.5	21.6
Grants	18.6	19.2	14.9	16.2	13.1	12.0	21.2	13.0
Other revenue	3.8	4.9	4.8	5.2	7.0	6.5	6.5	6.5
Expenditure	40.1	39.8	34.3	37.5	34.9	35.8	40.5	39.3
Expense	35.8	35.3	29.7	32.0	32.0	34.0	33.9	33.8
Net acquisition of nonfinancial assets	4.3	4.5	4.6	5.5	2.9	1.8	6.6	5.5
Current balance (excluding grants) 2/	-13.5	-11.1	-5.4	-7.2	-5.4	-6.0	-5.8	-5.7
Current Balance (including current grants) 3/	-0.3	2.5	4.7	2.7	5.6	4.6	5.5	3.4
Net lending (+)/borrowing (–) 4/	0.7	3.6	4.9	3.5	4.8	4.3	8.8	1.8
National Government Balance Sheet	(In percent of GDP)							
Assets	2.8	3.9	8.0	9.4	11.3	16.8	27.0	28.8
Cash and deposits	2.8	3.9	8.0	9.4	11.3	16.8	27.0	28.8
Liabilities	21.2	19.8	14.9	21.4	24.1	25.1	26.1	27.1
Domestic accounts payable	9.6	7.4	5.3	5.7	4.2	2.8	1.4	1.2
External debt	11.6	12.4	9.6	15.7	19.9	22.3	24.7	25.8
Net Financial Assets 5/	-18.4	-15.9	-6.9	-12.0	-12.8	-8.2	0.9	1.7
Memorandum Item:								
Nominal GDP (million US$)	225.3	245.7	293.1	304.0	289.8	296.5	309.5	323.6
Compact Trust Fund (in percent of GDP)	84.2	81.1	62.7	64.7	75.8	76.4	94.9	91.1

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

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

Table 5. Palau: Assets and Liabilities of Deposit Money Banks, 2010/2011–2016/17 1/

	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
			(In millions of U.S. dollars)				
Assets	113.6	135.7	140.4	175.9	231.8	281.7	290.9
Notes and coins	1.7	2.5	3.8	3.1	2.3	2.2	2.2
Foreign assets	82.8	105.3	106.2	140.8	198.0	246.8	251.1
Claims	25.8	25.7	27.9	29.6	28.9	29.9	34.5
Private sector	27.9	27.1	30.1	32.1	31.0	31.8	36.3
Commercial	7.8	2.9	2.7	2.8	1.2	1.2	6.5
Consumer	20.1	24.2	27.4	29.2	29.8	30.6	29.8
Non-resident	0.2	0.3	0.2	0.0	0.0	0.1	0.1
less Reserve for Loan Losses	-2.3	-1.7	-2.3	-2.5	-2.2	-2.0	-1.9
Fixed Assets	1.8	1.7	1.5	1.4	1.4	1.5	1.6
Unclassified assets	1.5	0.5	0.9	0.9	1.3	1.3	1.5
Liabilities							
Deposits	105.4	130.9	136.0	171.2	225.8	275.3	283.8
Demand Deposits	37.7	55.6	63.9	73.3	91.9	114.2	102.1
Savings Deposits	52.7	61.6	58.9	84.6	120.9	146.6	165.9
Time and Certificate of Deposit	15.0	13.6	12.7	12.7	12.4	13.9	15.0
Deposits Due to Banks and Financial Institutions	1.8	0.3	0.5	0.6	0.5	0.7	0.8
Other Liabilities	0.3	0.3	0.3	0.1	0.8	0.1	0.3
Capital	6.2	4.3	4.1	4.6	5.2	6.2	6.8
Issued and Fully Paid Up Common Stock	6.0	3.3	4.0	4.0	4.0	4.1	4.1
Paid-in Premium	0.0	0.7	0.0	0.0	0.0	0.0	0.0
Retained Profits (Losses) (Prior Years)	-1.1	-1.6	-1.4	-1.3	-1.0	-0.9	-0.7
Income (Loss) Year-to-date	1.3	2.0	1.5	1.8	2.2	3.1	3.3
Memorandum Item:							
Loan/deposit ratio (in percent)	24.5	19.6	20.6	17.3	12.8	10.9	12.2
Loans (in percent of GDP)	13.3	12.0	12.4	12.0	9.8	9.8	11.9
Loans (percent change)	4.7	-0.5	8.9	5.9	-2.5	3.6	15.4
Deposits (percent change)	9.5	24.1	3.9	25.9	31.9	21.9	3.1
Consumer loans (in percent of private sector loans)	71.9	89.4	91.1	91.2	96.2	96.3	82.2
Commercial loans (in percent of total loans)	28.1	10.6	8.9	8.8	3.8	3.7	17.8
Nominal GDP (million US$)	193.2	214.6	225.3	245.7	293.1	304.0	289.8

Sources: Palau authorities; and IMF staff estimates.

1/ Fiscal year ending September 30.

Table 6. Palau: Banks' Financial Soundness Indicators, 2014–2018

	2014	2015	2016	2017	2018Q1	2018Q2	2018Q3
Capital adequacy							
Regulatory capital to risk-weighted assets 1/	103.1	90.6	91.3	91.7	..	..	..
Regulatory Tier 1 capital to risk-weighted assets 1/	94.2	87.1	87.6	86.4	..	..	..
Asset quality							
Nonperforming loans to total gross loans	3.2	2.1	0.8	0.6	0.7	0.7	0.7
Provisions for loan losses to nonperforming loans	240.7	266.8	551.0	696.8	640.1	583.5	535.1
Earnings and profitability							
Return on assets	1.4	1.4	1.5	1.6	1.9	1.9	2.0
Interest margin to gross income	83.4	84.2	84.8	85.6	86.8	86.7	86.7
Noninterest expenses to gross income	41.6	39.5	37.9	35.1	32.3	33.0	32.4
Liquidity							
Liquid assets to total assets (liquid asset ratio)	81.4	85.8	87.4	86.0	86.5	86.0	86.1

Source: Financial Institutions Commission (FIC).

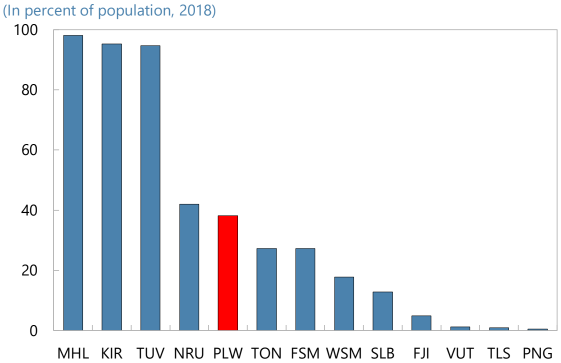
1/ Unensured banks only.

Appendix I. Enhancing Resilience to Climate Change

1. **Building resilience to natural disasters and climate change is critical for Palau.** Climate change is likely to have an adverse impact on Palau given that about 40 percent of its land area consists of low elevation atolls and that the expected sea-level rise is estimated to be 0.38–0.72 meters during 2010–50 and 0.84-1.62 meters by 2100 (AsDB, 2013).[1] The expected cost of climate change in Palau would be substantial, given Palau's high dependence on tourism and fisheries.[2] According to AsDB (2013), the cost of climate change in the Pacific region as a whole is estimated to be 2.2-3.5 percent of annual GDP by 2050 and it is likely to be particularly significant in the sector, such as agriculture, fisheries, tourism, environment protection and health.

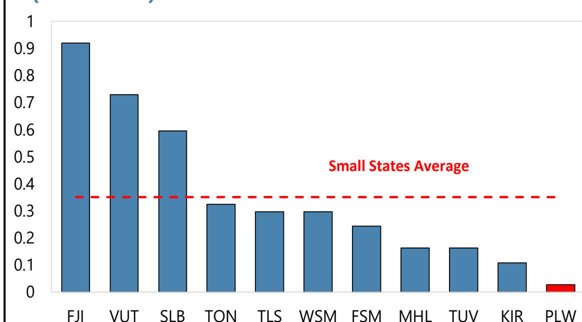
2. **The probability of occurrence of natural disasters is lower in Palau than its PIC peers.** The Emergency Events Database (EM-DAT) indicates that Palau had been hit by natural disasters only once since 1980.[3] Based on the EM-DAT database, Lee, Zhang and Nguyen (2018) suggest that Palau is not necessary for the adjustment in the medium-term baseline projection against the expected impact of severe natural disasters given its low likelihood of a severe natural disaster.[4]

Population Living in Low Elevated Coastal Zones
(In percent of population, 2018)



Source: United Nations - Committee for Development Policy, *2018 triennial review*.

Average Number of Natural Disasters per Year (1980-2016)



Sources: EM-DAT Database; and IMF staff calculations.

3. **However, Palau could become more exposed to severe natural disasters because of climate change.** Analysis undertaken by the Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI) estimates that Palau is expected to face an average annual loss of US$2.7 million from disasters. For instance, severe drought associated with El Niño weather conditions led to water

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[1] "The Economics of Climate Change in the Pacific" (AsDB, 2013).

[2] Also, the Intergovernmental Panel on Climate Change (2014) suggested that the costs of sea level rise impacts in the Pacific would be highest for Micronesia, Palau, RMI, and Nauru.

[3] The database is available at: http://www.emdat.be/. Disasters included in EM-DAT satisfy one of the following criteria: (i) 10 or more people killed; (ii) 100 or more people affected; (iii) a declaration of a state of emergency; and (iv) a call for international assistance. Note that some natural disasters which satisfy the above criteria may not be included as the database rely on the available information from UN agencies, non-government organizations, insurance companies, research institutes, and press agencies.

[4] "The Economic Impact of Natural Disasters in Pacific Island Countries: Adaptation and Preparedness", (Lee, Zhang and Nguyen, 2018), IMF Working Paper, 18/108.

shortages across Palau. The government's estimated financing needs were US$3.2 million (1.1 percent of GDP), mainly for water acquisition and distribution.

4. The authorities have made efforts in enhancing resilience to climate change. Their adaptation strategy and action plan are embedded in the "Palau Climate Change Policy: For Climate and Disaster Resilient Low Emissions Development" which aims to (i) enhance adaptation and resilience, (ii) manage disasters and minimize disaster risk; and (iii) mitigate global climate change by working towards low emission development. The cost of the 5-year action plan (FY2016–20) is estimated to be around US$500 million. The authorities will finance the implementation from various sources including multilateral and bilateral donors, and the national budget. In 2018, Palau secured a policy-based contingent financial assistance for natural disasters from AsDB up to US$15 million over the next three years. This loan is likely to cover the potential financing needs for the government to respond to disasters over the next three years.[5,6] Over the near-term, internalizing the risks to growth and the costs for ex-post response associated with natural disasters and climate change is important by building domestic fiscal buffers, and by securing external buffers.

5. Staff supported and encouraged the authorities' continuing efforts to proceed with climate resilience projects to strengthen the early disaster warning system, improve coastal protection and planning, and promote renewable energy. Over the medium-term, given the substantial adaptation cost to prepare for natural disasters and climate change, increasing the financial assistance from multilateral climate change schemes should be a priority.

[5] The potential financing needs for the government to respond to disasters can be mostly secured by this program for the time being, given that the expected financing needs for next three years would be about US$8.1 million (i.e., PCRAFI's estimate on average annual loss from natural disasters US$2.7 million × 3 years).

[6] The General Fund Reserve (GFR) also can be used for emergency funding for severe natural disasters. For instance, US$1.65 million emergency funding for severe drought was drawn from the GFR in 2016 (Republic of Palau Public Law No. 9-59. 2016. *Extreme Drought Emergency Funding Act*).

Appendix II. Staff Policy Advice, 2016 Article IV Consultation

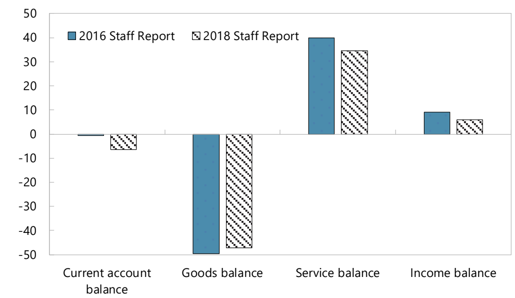
Staff Advice	Policy Actions Taken
Fiscal Policy	
Continue with a fiscal adjustment over the medium term to prepare for the expiration of the Compact grants in FY2024, with the composition of expenditure tilted towards infrastructure investment.	The current fiscal deficit widened in FY2016 due to weak tourism arrivals and low growth but subsequently returned to 5.4 percent of GDP, the same level as in FY15, owing to higher non-tax revenue. However, capital expenditure was lowered, while the overall fiscal balance remained in surplus. A tax reform bill was sent to the Congress in FY2018 to enact the GST, pending for approval.
Improve public financial management (PFM) to contain fiscal risks and support fiscal adjustment.	The authorities continue to improve the timeliness of data collection and audits. They plan to replace the existing system with a new Financial Information Management System for better accounting, recording, and management. PEFA is now planned for FY2019. Public debt remains sustainable.
Reforming public entities Civil Service Pension Fund (CSPF) and Palau Public Utilities Corporation (PPUC)) to limit their losses and reduce subsidies.	After the increase of the departure tax (PPEF - Pristine Paradise Environmental Fee) in January 2018, 12.5 percent of the tax revenue was transferred to the CSPF to improve Fund's sustainability. But more reform measures including raising contributions and retirement age are needed to sustain the fund. For the PPUC, the tariff rate was increased in 2016 and subsequent tariff increases necessary for full cost recovery were postponed.
Financial Market Policy	
Expand the coverage of the FIC's financial regulation and supervision to the National Development Bank of Palau and other non-bank financial institutions.	The authorities are making progress towards broader coverage of financial regulation and supervision. Legislation to permit the NDBP to take deposits has been passed and now it has been under regulatory inspections for being granted for a license by the FIC. The FIC has also prepared legislation to bring credit unions under the supervision of the FIC, which is currently under consideration by the Congress.
Structural Policies	
Implement a comprehensive strategy for sustainable high-end tourism development with appropriate infrastructure planning. Diversify the economy and broaden the sources of promoting high-end tourism from new destinations, including growing Asian markets.	Palau has been promoting sustainable high-end tourism, away from low-budget tourism. In April 2018, Palau passed the Pristine Paradise Act that outlines foreign investment strategy that encourages high-end investment in the tourism sector.
Infrastructure bottlenecks should be addressed to support the growing tourism sector and to enhance resilience to natural disasters and climate change.	A large-scale submarine internet cable project was completed in FY2018, which improved internet services. The sanitation project to improve water supply is ongoing. The authorities have secured contingent financial assistance for natural disasters from the AsDB.
Improve the business climate including the introduction of a new foreign investment regime.	Palau has simplified the investment regime by clarifying and greatly enhanced the powers of the Foreign Investment Board. However, regulatory approvals from multiple agencies remains a prerequisite for investment, and new avenues for applying through the state governments have been added.
Data and Statistics	
Improve tourism statistics and strengthen the statistics office to continue improving data quality.	Palau continues to develop its statistical capacity with assistance from PFTAC on GFS and National Accounts. The Graduate School USA also provides extensive statistical support and training.

Appendix III. External Sector Assessment

The external position is assessed to be moderately weaker than underlying fundamentals and desirable policy settings. However, there is significant uncertainty in the assessment after recent substantial revisions to BOP data. Continued fiscal consolidation and efforts to fill the infrastructure gap will help narrow the current account gap. The expiration of the U.S. Compact in FY2024 will lead to a large structural change in external financing.

1. Data revision. BOP data revision and GDP rebasing in FY2017 led to substantial increases in the historical current account deficit compared to the last Staff Report. Data revisions in the current account were the most dramatic for FY2015 (the base year for the projection in the previous Staff Report). The current account deteriorated markedly in FY2015 from -0.5 percent of GDP to -6.5 percent of GDP. Most of this adjustment is explained by the service balance and income balance with the increase in the deficit 5.4 and 3.0 percentage point in percent of GDP, respectively. The goods balance improved somewhat, but not sufficiently to offset the widening in the service and income deficits. This data revision and deterioration in FY2016-17 current account due to a downturn in tourism have led to a substantial increase in the medium-term current account deficit.

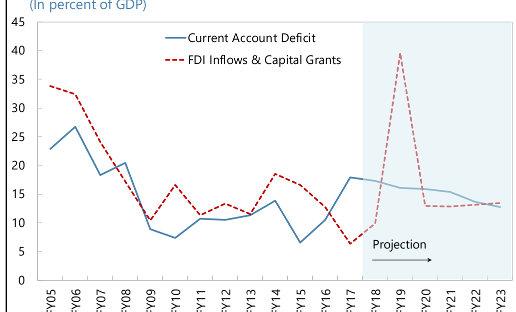
FY2015 Current Account Revision
(In percent of GDP)



Sources: Country authorities; and IMF staff estimates.

2. Current account. The current account deficit increased substantially to 17.9 percent of GDP in FY2017 due to the downturn in tourism and the recent data revisions. Over the medium-term, the current account deficit is projected to narrow to around 13 percent of GDP with a recovery of the tourism sector and completion of major infrastructure projects. The deficits would continue to be financed mostly with capital grants and FDI inflows.

Current Account Deficit and FDI plus Capital Grants
(In percent of GDP)



Sources: Country authorities; and IMF staff estimates.

3. External balance assessment. The external position is assessed to be moderately weaker than underlying fundamentals and desirable policy settings. However, the assessment is complicated and subject to a large margin of error, given data limitations, the vulnerabilities of a small island economy in general, and the anticipated large structural change in external financing from the expiration of U.S. Compact in FY2024.

- **The External Sustainability approach** yields a current account norm of -10.5~-12.1 percent of GDP and the current account gap is around -0.6~-2.2 percent based on the scenario on the benchmark levels on net foreign assets (NFA)—implying the assessment on external position would be moderately weaker than fundamentals. However, the assessment is subject to significant uncertainty linked to substantial data revisions**.**

External Sustainability Approach

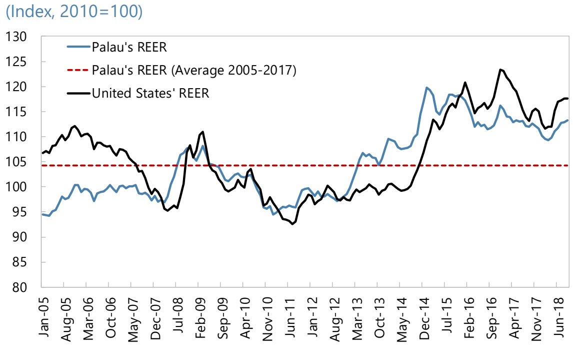
		CA norm (% of GDP)	Underlying CA (% of GDP)	CA gap	REER gap
Stabilizing NFA at	41.1 % of GDP	-10.5	-12.7	-2.2	5.1
Reaching NFA at	20.0 % of GDP in 2036	-12.1	-12.7	-0.6	1.5

Notes: Underlying CA uses projected medium-term (FY2023) current account. NFA data are taken from an updated version of the External Wealth of Nations Database based on the methodolgy by Lane and Milesi-Ferretti (2007).

- **The Current Account and REER approaches** are less applicable due to data limitations that result in large margins of statistical variation around the estimates. These backward-looking approaches cannot take into account the structural break in FY2025 arising from the expiration of the U.S. Compact grant.

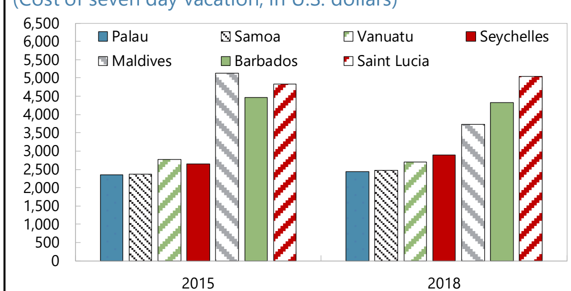
4. Competitiveness. The real effective exchange rate (REER) has shown a mild depreciation since 2016 in line with the valuation of the U.S. dollar, boosting Palau's competitiveness somewhat. While tourism costs in the Pacific islands are low relative to Caribbean beach destinations and Maldives, prices in Palau are broadly similar to other Pacific destinations (e.g., Samoa and Vanuatu). Palau's high-end tourism strategy with maintaining its competitiveness may contribute to reducing current account deficit by raising tourism revenue. However, Palau's external competitiveness is hampered by domestic labor shortage, especially skilled labor. Under the U.S. Compact Agreement, people from Palau can work in the U.S. without a separate permit, resulting in an increasing number of skilled workers migrating to the U.S. motivated by higher wages, better health care and education systems, although this negative impact is partly offset by higher remittances to Palau. Given significant infrastructure gaps, the capital projects recently completed or in the pipeline supported by AsDB could potentially raise the country's competitiveness by improving infrastructure capacity.

Real Effective Exchange Rate
(Index, 2010=100)



Sources: Country authorities; and IMF staff estimates.

Palau and Selected Comparators: Tourism Competitiveness
(Cost of seven day vacation, in U.S. dollars)



Note: The Week at the Beach Index uses hotel price data from Tripadvisor and crowdsourced data on meal and drink prices to compute a representative cost for a seven day vacation. For details on the methodology see LaFramboise et. al. (2014)
Sources: Tripadvisor, Numbeo, World Cab Fares and IMF Staff Estimates.

5. Reserves. Government U.S. dollar deposits effectively serve as reserves, and as the main instrument to absorb short-term liquidity shocks, given that the country has no central bank and uses U.S. dollar as its official currency. Fully dollarized economies should have liquidity buffers in U.S. dollars to support domestic financial institutions, to repay short-term external debt, and as a buffer for government financing. For Palau, the third argument is most relevant as government revenue is highly volatile, while the first two are not much relevant as the liquid asset ratio in the banking sector is high at 86 percent, and the country does not borrow short-term externally, with all its external debt being long-term with international organizations. Central government deposits were 11.3 percent of GDP in FY2017, which corresponds to 3.8 months of government spending and 1.8 months of imports. The level is well above the minimum requirement considering that a rule of thumb minimum size of fiscal reserves is one month of government spending.[1]

[1] "Assessing Reserve Adequacy—Specific Proposals" (2015), IMF Policy Paper.

Appendix IV. Risk Assessment Matrix (RAM) 1/

	Sources of Risks (Horizon)	Relative Likelihood (high, medium or low)	Expected Impacts if Realized (high, medium or low)	Recommended Policy Responses
Domestic	**1. Lower tourist arrivals** (short and medium term)	**Medium/High** Tourist arrivals have historically been volatile. Lower tourist arrivals could reflect many factors, including delays in implementing the high-end tourism strategy, changes in preferences in tourism markets, a loss of competitiveness relative to competing locations or heightened diplomatic tensions with major tourist source markets.	**High** Lower tourist arrivals would lower economic growth, worsen the fiscal position and also impact the external sector adversely, as tourism receipts accounts for over 80% of export revenues.	Draw from the buffer reserve fund to compensate for revenue shortfall while rationalizing current expenditure. Accelerate tourism-related structural reforms to strengthen and diversify the sector, notably implementation of the newly formulated high-end tourism strategy. (Appendix VIII).
	2. Natural disasters and climate change (short and medium term)	**Low/Medium** While the probability of occurrence of natural disasters is low in Palau, the country remains exposed to occasional droughts and adverse effects of climate change from rising sea levels.	**High** Volatile weather conditions caused by global warming can lead to loss of outputs due to lower tourist arrivals. Damages to infrastructure lead to lower potential growth.	Contingent plans should include maintaining reserve buffers and expanding contingent financing plans with development partners (Appendix I). Strengthen infrastructure including coastal protection and planning. In the event of occurrence of natural disasters, contingent funding should be drawn to rebuild infrastructure and to provide social safety nets to the affected.
	3. Shortfall of non-Compact capital grant receipts (medium term)	**Medium** Given Palau's graduation to high-income status, future grant flows are subject to downside risks.	**High** Infrastructure investment will be curtailed and/or delayed due to lack of financing, leading to lower growth.	Secure alternative financing sources to continue to build and maintain infrastructure, while ensuring debt sustainability.
External	**4. Weaker-than-expected global growth in the US and China** (medium term)	**Medium** *China:* Disorderly deleveraging, adversely affecting near-term growth (Low). Insufficient progress in deleveraging and rebalancing reduce medium-term growth (medium). *U.S.*: More binding capacity constraints increase the risks of a sharper-than-expected slowdown (medium).	**High** Lower tourism receipts from the main source markets, as well as lower FDI and financial inflows from the U.S. and China.	Diversify tourism to other source countries. Undertake counter-cyclical fiscal policy by increasing infrastructure spending to mitigate adverse economic impact on the economy.
	5. Sharp tightening of global financial conditions (short term)	**High** Faster increases of the US interest rate leading to stronger U.S. dollar.	**Medium/High** An appreciation of the U.S. dollar would worsen Palau's external position due to a loss of competitiveness in the tourism sector.	Continue with structural reforms to implement high-end tourism strategy by boosting non-price competitiveness to retain tourist arrivals.

1/ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities.

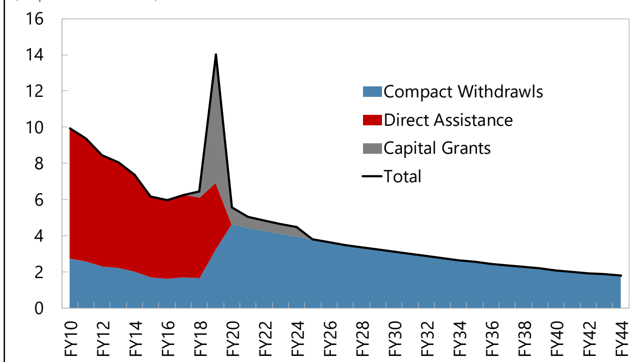
Appendix V. Medium Term to Long Term Fiscal Sustainability

Given Palau's reliance on declining and potentially volatile external financing, we discuss the benefits of moving to medium-term fiscal considerations through stabilizing the government net worth. Without a change in fiscal stance, Palau would need to maintain public investment at a low 3.8 percent of GDP to sustain a current fiscal deficit at 5.0 percent of GDP after FY2024. This is unlikely to be sufficient for the country's development goals. Staff recommended reducing the current fiscal deficit to 1.2 percent of GDP by FY2023 to create the space for increasing public investment to 7.5 percent of GDP. [1]

1. The financial provisions of the Compact of Free Association, provide direct assistance up to the year FY24 as well as endowing a trust fund for medium-term fiscal sustainability. The maximum permitted withdrawals from the Compact Trust Fund are fixed at US$15 million, meaning their real value erodes over time (Text Chart). Adjustments to prepare for the expiration of the Compact Agreement should be achieved before FY24 to avoid a disorderly and costly forced adjustment. In addition, there has been an ongoing trend of falling non-Compact grant revenue, generating further fiscal pressures in the medium term. Non-Compact grants have fallen from 17.2 percent of GDP in FY10 to 8.1 percent of GDP in FY17.

Estimate Revenues from Compact Agreement

(In percent of GDP)



Note: Nominal GDP assumed to grow at 4% after FY24.
Sources: PITI-VITI, Republic of Palau and IMF Staff Estimates.

2. With declining grant financing, Palau will need alternative sources of financing infrastructure investment. Palau had relied mostly on capital grants to develop infrastructure in the past. However, as Palau graduated to high-income status in 2016, future grant flows are expected to decline. In FY2017, capital expenditure fell to a low of just 2.9 percent of GDP and is expected to fall further to 1.8 percent in FY2018.

3. The current fiscal approach is broadly characterized by running a balanced budget (after external financing) in order to manage cash flow. While this has benefits of simplicity and reduced immediate fiscal risks, it also reduces the ability to appropriately respond to structural changes, such as those outlined above. It can also limit the ability to build fiscal buffers which are important in economies marked by low diversification and vulnerable to natural disasters and climate change (Appendix I). Staff recommended a medium-term framework based on the net worth approach as in the previous Article IV consultations. This approach provides a broad goal of stabilizing the government' net worth and the desired path of the fiscal balance that is consistent with the aim to maintain the government's net worth while preserving the appropriate level of capital

[1] The historical average of capital spending ratio is about 7.5 percent for FY2000–17.

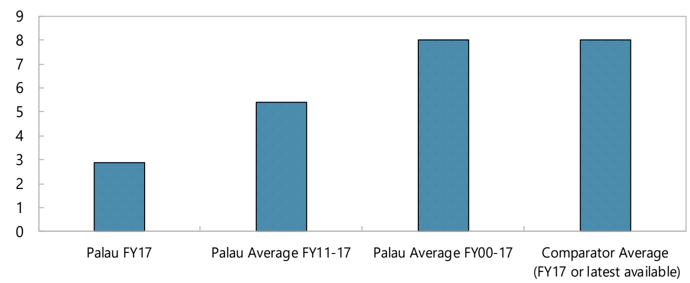
investment.[2] Given the assumption on the expected nominal rate of return on the CTF, the government's net worth will decline over the medium term. To offset this expected decline, the government needs to generate overall fiscal surpluses. With declining grant receipts, the overall fiscal balance is expected to worsen and capital investment should be kept low in the absence of fiscal adjustments. On the other hand, Palau still needs to build infrastructure to enhance resilience and to support the growing tourism sector and lower capital investment is not desirable.

4. Based on the net worth approach, we consider two scenarios, baseline and reform. Under the baseline, the government's net worth cannot be sustained without compressing capital investment. Next we outline a reform scenario in which revenue generation and expenditure cuts allow for higher capital spending over the medium-term, while maintaining the net worth.

Baseline Scenario

Under staff's baseline fiscal assumptions, the long run level of capital spending should be set at 3.8 percent of GDP, to avoid compromising fiscal sustainability. While this is higher than 2 percent of GDP in FY2017, it would represent a level significantly below the country's historical average, the average of comparator countries and below the long-run level of grant financing (7.3 percent). In the baseline scenario, the government's net worth stabilizes at 83.5 percent of GDP, as the decline in the value of the CTF is offset by rising government assets generated through high overall fiscal balances.[3]

Capital Expenditure in Palau and Tourism-Dependent Small States
(In percent of GDP)



Note: Comparator Countries are Tourism-Dependent Small Sates in the Pacific and Indian Oceans. Specifically Fiji, Maldives, Mauritius, Samoa, Seychelles, Sri Lanka, Tonga and Vanuatu.

Reform Scenario

Given the country's need for infrastructure modernization in support of high-value tourism, as well the need to build buffers due to volatile revenue flows and the risks associated with climate change, a level of capital spending of 3.8 percent of GDP is unlikely to be sufficient to achieve Palau's development goals while also mitigating risks.

In the reform scenario, capital spending returns to a level in line with historical trend of 7.5 percent of GDP by FY2024. This requires an adjustment of 4.7 percent of GDP to reach a fiscal balance of -1.2

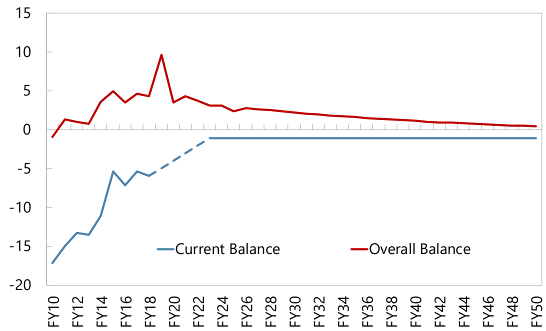
[2] The net worth approach does not provide the target for the optimal level of government's financial wealth, but rather the change in net worth value due to a declining real value of the CTF guides the size of necessary fiscal adjustment over the medium-term. The government's net worth is estimated to reach 88 percent of GDP in FY2019.

[3] We impose the assumption of a sustainable level of capital spending from FY2024. As a result, there is a decline in government net worth during the period FY2019-24 as overall balances do not fully offset the declining value of the CTF.

percent.[4] It is envisaged 4 percent of this adjustment would come through new policy measures, tax reform and expenditure cuts, with the rest coming from improvements to financial management. Staff estimates that the tax reform would raise additional revenue of 2.4 – 4.0 percent of GDP by FY2024, depending on the VAT rates (Appendix VI). This could be accompanied by expenditure reduction by phasing out subsidies to the Palau Public Utility Company (PPUC), in line with the terms stipulated in the AsDB project loan (the Koror-Airai Sanitation Project). Greater fiscal space would provide room to raise infrastructure investment by about 3 percent of GDP and allow for higher fiscal buffers. Under this scenario, the government's net worth would stabilize at 86.2 percent of GDP in the medium term.[5]

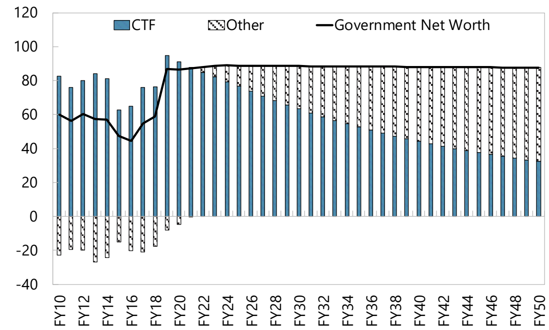
Palau: Long-term Fiscal Sustainability in Staff's Reform Scenario

Overall and Current Balance
(In percent of GDP, fiscal adjustment scenario - adjustment shown by dashed line)



Sources: PITI-VITI and IMF Staff Estimates.

Government Net Worth - High Capital Spending
(In percent of GDP, fiscal adjustment to support higher level of capital exp.)



Sources: PITI-VITI and IMF Staff Estimates.

Fiscal Risks

Palau also faces significant fiscal risks. The SOE sector holds large external debt equivalent to about 10 percent of GDP, part of which could become contingent liabilities for the central government. In addition, the Civil Service Pension Fund (CSPF) is unsustainable and, in the event of a collapse of the fund, the pension liabilities would like to be borne by the government.

The most immediate risks are unfunded liabilities of the CSPF and the AsDB loan made to the PPUC, guaranteed by the central government. Were these risks to materialize, they would entail a fiscal cost of roughly two percent of GDP over the medium term, increasing the required adjustment to obtain sustainability commensurately.

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[4] Since the last analysis (IMF 2016) the initial current fiscal balance has deteriorated from -5.4 percent of GDP to - 6.0 percent, increasing the size of the required adjustment.

[5] Due to the fiscal adjustment preceding the additional investment expenditure, the overall balance is somewhat higher between FY2019–23. Cumulatively, this raises an additional 3.3% of GDP, which it is assumed stored as additional deposits, therefore raising net worth relative to baseline (Table 2).

Appendix VI. Tax Reform

Over the medium term, Palau needs to mobilize revenue by introducing a modern and efficient tax system to compensate for the impact of reduced grant receipts and fishing revenue. The main pillar of the tax reform should be the introduction of the VAT and the net profit tax, replacing the existing import duties and gross revenue tax.[1]

1. **The tax reform is a policy priority, with the anticipated expiration of the Compact grants in FY2024.** As in other Compact states, Palau currently has no Value-Added tax (VAT). The existing gross revenue tax and import duties are distortionary and inefficient and discourage private sector investment and business start-ups. The comprehensive tax reform with the introduction of the VAT could not only enhance efficiency and fairness of the current tax system but also provide an opportunity to raise revenue without undue creating distortions or adverse economic consequences.

2. **The comprehensive tax reform bill is under consideration in the Congress.** This reform includes several components including the introduction of the VAT (or, Palau Goods and Services Tax, 'PGST'), expansion of the Net Income Tax (NIT) and reforms to other fees and existing taxes. Much of the burden of the tax reform proposal is intended to fall on tourists, as opposed to the resident population as tourists account for as about seven times as the number of residents. The reform bill includes measures to counter the impact from a one-off increase in prices.

3. **The tax reform is estimated to increase tax revenue by 2.4–4 percent of GDP by FY2024.** The extent of revenue increase depends on the VAT tax rate chosen. The range of 10–15 percent under consideration for Palau is consistent with rates in the region (Text Table). However, the offsetting measures for low-income earners are needed for the potential one-off increase in prices at the time of the VAT introduction. With this being taken into account, a rate below 10 percent would fail to raise sufficient revenue to offset the adverse impact.[2]

4. **The VAT rate above 12.5 percent is also consistent with the fiscal adjustment required for the medium-term sustainability.** In the medium-term reform scenario, staff argued for fiscal adjustments of 4.7 percent of GDP (Appendix V). The required improvement in fiscal balance above the baseline scenario is 4 percent of GDP over the medium term. With one percent coming from subsidy cuts to PPUC, the remaining 3 percent of GDP can be raised from the tax reform. This leads us to suggest 12.5 percent of the VAT rate in the reform scenario.

5. **Evidence of the negative impact of the VAT on the tourism sector from other tourism-dependent Pacific islands—the Cook Islands and Fiji—has been limited.** Country examples show that the VAT could raise higher tax revenue without affecting the number of tourist arrivals significantly. Tourist arrivals are found to be insensitive to changes in the price level of the destination country. Both Cook Islands and Fiji showed little sign of a negative impact on the wider tourism sector following the implementation of the VAT.

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[1] This note benefitted from TA work on Palau's tax reform done by Iris Claus and Peter Mullins (IMF PFTAC).

[2] The impact on revenue was examined under the VAT rate at 10, 12.5 and 15 percent, respectively.

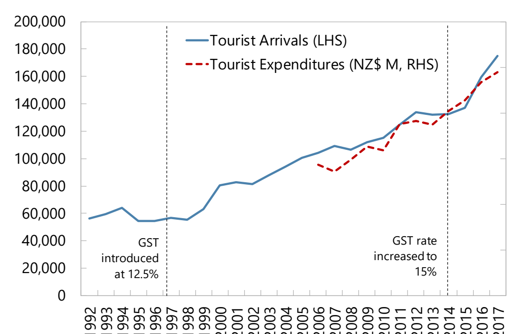
VAT in Pacific Island Countries, 2018

Country	VAT Rate (in percent) 1/	VAT Threshold Local Currency	VAT Threshold US$ 2/	Year of Introduction
Cook Islands	15 (12.5)	NZ$40,000	$28,360	1997
Fiji	9 (15, 12.5, 10)	F$100,000	$49,042	1992
Kiribati	12.5	A$100,000	$78,073	2014
Niue	12.5	NZ$75,000	$53,174	2009
PNG	10	K250,000	$77,711	1999
Samoa	15 (10)	SAT$130,000	$51,802	1994
Tonga	15	TOP100,000	$45,663	2005
Tuvalu	7	$A100,000	$78,073	2009
Vanuatu	15 (12.5)	VT4,000,000	$36,593	1998

Source: Tax administration of relevant country
1/ Original VAT rates are in brackets.
2/ Exchange rate at January 1, 2018.

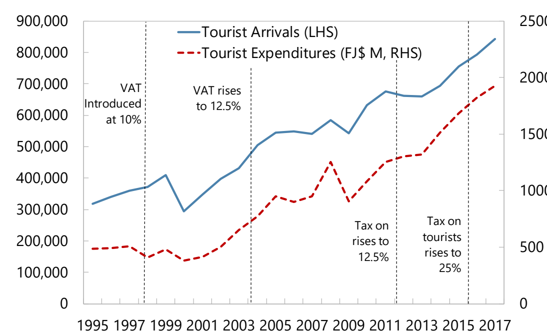
Cook Islands and Fiji: Impact of VAT Introduction on Tourism Outcomes

Cook Islands: Visitor Arrivals and Tourism Earnings



Sources: Ministry of Finance and Management, WDI.

Fiji: Tourist Arrivals and Expenditures



Sources: Reserve Bank of Fiji and World Development Indicators.

6. **Other elements in the proposed reform include the reforms in the net income tax and wages and salary tax, which would enhance efficiency and equity of the existing tax system.** The NIT can be expanded to taxpayers above the VAT threshold.[3] The current GRT rate is 4 percent. With the proposed 10 percent, the corporate income tax rate still remains competitive in Palau, compared to the average of 25.7 percent in the PICs. Wages and salary taxes can be reduced for low-income earners. This should compensate low-income earners for the potential price increases due to the VAT. An additional tax tier could be added to make the tax system more progressive.

7. **There are numerous ancillary benefits to a modernized tax system.** A modern VAT system would encourage more detailed account keeping for medium and large enterprises. This would have benefits for the financial sector, as the lack of detailed financial records is frequently cited as an underlying cause for the low private sector credit extended by the banking system. In

[3] The VAT registration threshold is proposed to set for businesses with annual gross revenue of US$100,000.

addition, the dual-entry nature of GST record keeping (i.e. by supplier and purchaser along the supply chain) is expected to increase broader tax and regulatory compliance while reducing the potential for so-called 'front businesses', which have frequently been cited as an issue in Palau.[4]

[4] In the Palauan context, the term 'front-business' refers to businesses that are formally owned by Palauans but in fact are controlled and run by foreign nationals. This is typically done to avoid restrictions on business activities reserved for Palauans.

Appendix VII. Debt Sustainability Analysis

Palau's public debt is expected to remain sustainable despite the AsDB loans of about US$53 million which started to be disbursed in FY2016. Under the baseline scenario, the public debt-to-GDP ratio is projected to decline to 25.6 percent of GDP by FY2023, mainly driven by the scheduled debt repayment for major project loans starting from FY2018. GDP growth shocks and associated fiscal costs arising from high volatility in the tourism sector or natural disasters are the major risks to debt sustainability.

1. **The public debt-to-GDP ratio started to increase starting from FY2016 and it is projected to continue to increase through FY2018, before declining gradually afterwards, due to the disbursements from the recent AsDB loans.**[1] The disbursements of AsDB loans for the Koror-Airai sanitization and submarine-cable projects started in FY2016 and are planned to be completed by FY2019. Public debt in the analysis includes the central government's external debt (19.9 percent of GDP in FY2017), the government's domestic accounts payable or domestic arrears (4.2 percent of GDP in FY2017), and the SOEs' debt (9.8 percent of GDP in FY2017), which is fully guaranteed by the government and is a contingent liability.

2. **An important element in the analysis is that Palau does not have access to private foreign capital markets.** All of Palau's external debt is from international organizations for specific projects, and thus there is no direct linkage between the fiscal balance and debt issuance in the private debt market. The baseline scenario assumes that the central government and SOEs do not take new external loans during FY2018–23, and thus the debt stock declines in line with the amortization of past loans. The path of public debt could be less favorable if the government or the SOEs take new debts (e.g., Koror-Airai sanitization project-phase II, US$ 25million) in the coming years.

3. **Under the baseline scenario, the public debt-to-GDP ratio is projected to decline to 25.6 percent of GDP by FY2023 from 34.5 percent in FY2018.** The decline of the public debt-to-GDP ratio will be driven by the scheduled debt repayment for major project loans during this period. As the primary surpluses and gains from the growth-interest rate differential in FY2020–23 are larger than those required to pay for the scheduled debt service, the government uses the surplus to fully repay its domestic arrears and to build government deposits.

4. **The alternative scenarios such as the constant primary balance scenario highlight Palau's stable fiscal position in that these scenarios do not lead to large deviations from public debt and gross financing needs under the baseline scenario.** However, the GDP growth shock scenario and the historical scenario highlight the sensitiveness of the public debt-to-GDP ratio and financing needs to a growth shock. The GDP growth shock scenario of a decline in real GDP growth by 5.2 percentage points (corresponding to one standard deviation of GDP growth during past 10 years) during FY2019–20 would lead the public debt-to-GDP ratio to jump to 46.4 percent of GDP in FY2020 and remains around 40 percent by FY2023.

[1] Public debt in the DSA is larger than that in Table 4 because it covers both central government and SOEs which hold a large share of public debt in recent years.

5. This result highlights that GDP growth shocks and associated fiscal costs—which may result from the high volatility of the tourism sector and large natural disasters—are the major risks to the public-sector debt sustainability.[2] Also, the potential increase in government expenditure from several sources (the contingent liability shock) would be another source of risk for debt sustainability.[3]

[2] Lee et al. (2018) shows that extreme natural disasters may have significant impacts on GDP growth and fiscal balance in Pacific island countries with varying degrees: 0.4~5.6 percentage point decline in GDP growth and 0.9~4.1 percentage point decline in fiscal balance-to-GDP ratio (IMF Working Paper, 18/108).

[3] The scenario considers the potential increase in government expenditure arising from the failure of repayment on the on-lent funds by the Palau Public Utilities Corporation (PPUC) and Palau National Communications Corporation (PNCC) as well as the potential government support to the Civil Service Pension Fund (CSPF)'s obligations (assumed as 2 percent of GDP per year in total). However, the potential liabilities from public-private partnership project (e.g., PPP for airport renovation and expansion) were not included due to lack of information to identify the size of contingent liabilities.

Figure 1. Palau: Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

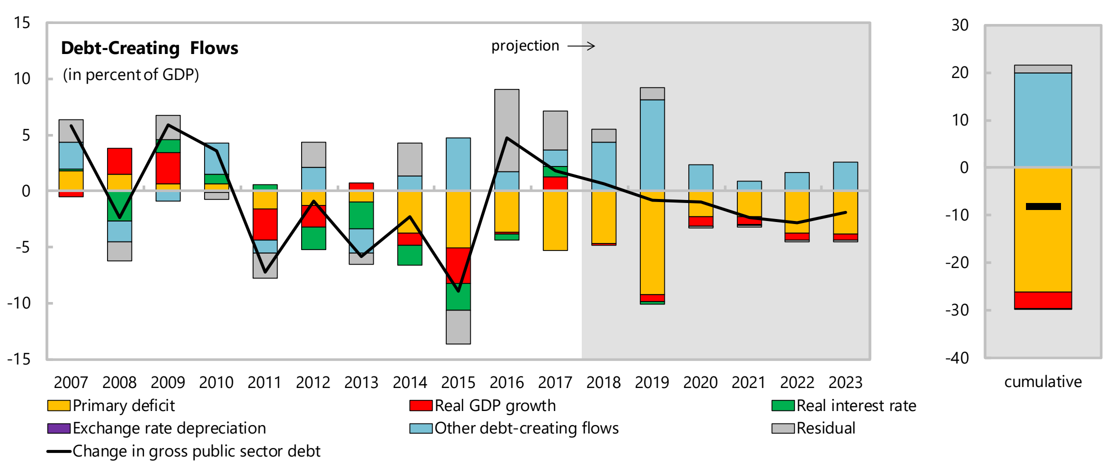
(In percent of GDP, unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections						As of September 06, 2018		
	2007-2015 [2/]	2016	2017	2018	2019	2020	2021	2022	2023			
Nominal gross public debt	42.3	32.0	33.8	34.5	33.6	32.7	30.3	27.5	25.6	Sovereign Spreads		
Of which: guarantees	20.2	10.6	9.8	8.5	8.2	7.8	7.5	7.2	6.9	EMBIG (bp) 3/		n.a.
Public gross financing needs	0.1	-2.8	-4.0	-3.9	-6.7	1.1	2.1	-0.1	-1.4	5Y CDS (bp)		n.a.
Real GDP growth (in percent)	1.4	0.5	-3.7	0.4	2.0	2.5	2.2	2.0	2.0	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	3.8	3.2	-1.0	1.9	2.3	2.0	2.0	2.0	2.0	Moody's	n.a.	n.a.
Nominal GDP growth (in percent)	5.3	3.7	-4.7	2.3	4.4	4.5	4.2	4.0	4.0	S&Ps	n.a.	n.a.
Effective interest rate (in percent) [4/]	1.2	1.2	2.0	2.0	1.8	1.9	1.9	2.1	2.2	Fitch	n.a.	n.a.

Contribution to Changes in Public Debt

	Actual			Projections							
	2007-2015	2016	2017	2018	2019	2020	2021	2022	2023	cumulative	debt-stabilizing
Change in gross public sector debt	-1.4	4.8	1.8	0.6	-0.8	-1.0	-2.3	-2.8	-1.9	-8.2	primary
Identified debt-creating flows	-1.5	-2.6	-1.7	-0.5	-1.9	-0.8	-2.2	-2.7	-1.8	-9.8	balance [9/]
Primary deficit	-0.9	-3.7	-5.3	-4.7	-9.2	-2.3	-2.3	-3.8	-3.8	-26.2	2.1
Primary (noninterest) revenue and grants	43.6	41.0	39.8	40.0	49.3	41.2	40.7	40.5	40.4	252.2	
Primary (noninterest) expenditure	42.7	37.3	34.5	35.3	40.0	38.9	38.4	36.8	36.6	226.0	
Automatic debt dynamics [5/]	-1.4	-0.7	2.2	-0.1	-0.8	-0.8	-0.7	-0.6	-0.5	-3.6	
Interest rate/growth differential [6/]	-1.4	-0.7	2.2	-0.1	-0.8	-0.8	-0.7	-0.6	-0.5	-3.6	
Of which: real interest rate	-1.0	-0.5	1.0	0.0	-0.2	0.0	0.0	0.0	0.1	-0.2	
Of which: real GDP growth	-0.4	-0.1	1.2	-0.1	-0.7	-0.8	-0.7	-0.6	-0.5	-3.4	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.8	1.7	1.4	4.3	8.2	2.4	0.9	1.7	2.5	19.9	
Change in government domestic currency a	0.8	1.7	1.4	4.3	8.2	2.4	0.9	1.7	2.5	19.9	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt flows (e.g., ESM and Euroarea lo	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	0.1	7.4	3.5	1.1	1.1	-0.1	-0.1	-0.1	-0.2	1.6	



Source: IMF staff.

1/ Public sector is defined as central government and includes public guarantees, defined as SOE Debt.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

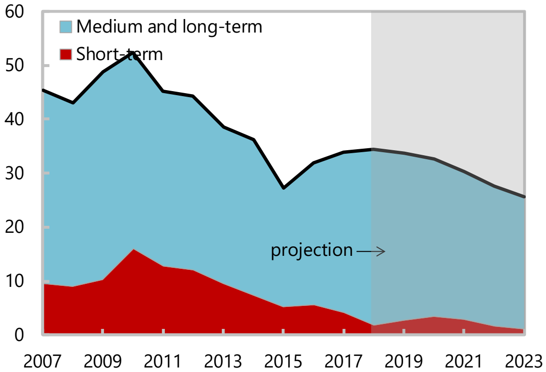
8/ Includes changes in the stock of guarantees, asset changes, and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

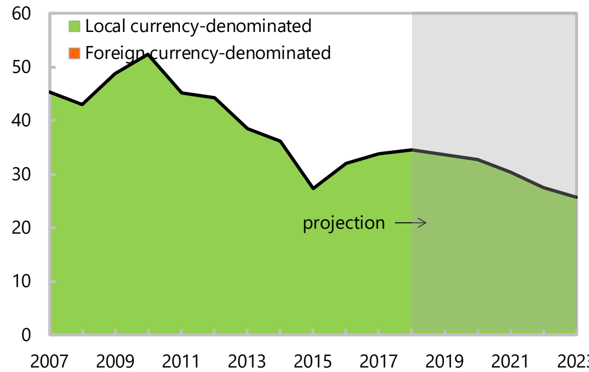
Figure 2. Palau: Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



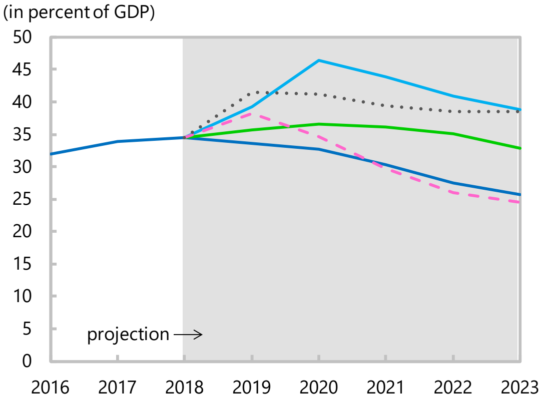
By Currency
(in percent of GDP)



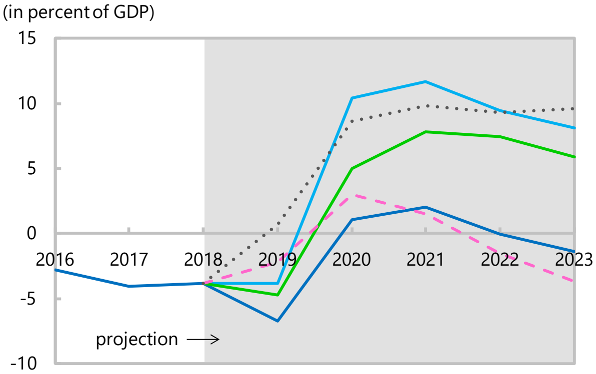
Alternative Scenarios

Baseline
Real GDP Growth Shock
Historical
Contingent Liabilities to SOEs Shock
Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

Baseline Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	0.4	2.0	2.5	2.2	2.0	2.0
Inflation	1.9	2.3	2.0	2.0	2.0	2.0
Primary Balance	4.7	9.2	2.3	2.3	3.8	3.8
Effective interest rate	2.0	1.8	1.9	1.9	2.1	2.2
Constant Primary Balance Scenario						
Real GDP growth	0.4	2.0	2.5	2.2	2.0	2.0
Inflation	1.9	2.3	2.0	2.0	2.0	2.0
Primary Balance	4.7	4.7	4.7	4.7	4.7	4.7
Effective interest rate	2.0	1.8	1.6	1.8	2.1	2.4
Contingent Liability shock						
Real GDP growth	0.4	2.0	2.5	2.2	2.0	2.0
Inflation	1.9	2.3	2.0	2.0	2.0	2.0
Primary Balance	4.7	7.2	2.3	2.3	3.8	3.8
Effective interest rate	2.0	1.8	1.8	1.7	1.6	1.6

Historical Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	0.4	0.8	0.8	0.8	0.8	0.8
Inflation	1.9	2.3	2.0	2.0	2.0	2.0
Primary Balance	4.7	1.9	1.9	1.9	1.9	1.9
Effective interest rate	2.0	1.8	0.9	0.8	0.9	0.8
Real GDP Growth Shock						
Real GDP growth	0.4	-3.2	-2.7	2.2	2.0	2.0
Inflation	1.9	1.0	0.7	2.0	2.0	2.0
Primary Balance	4.7	6.5	-3.1	2.3	3.8	3.8
Effective interest rate	2.0	1.8	1.8	1.9	1.5	1.6

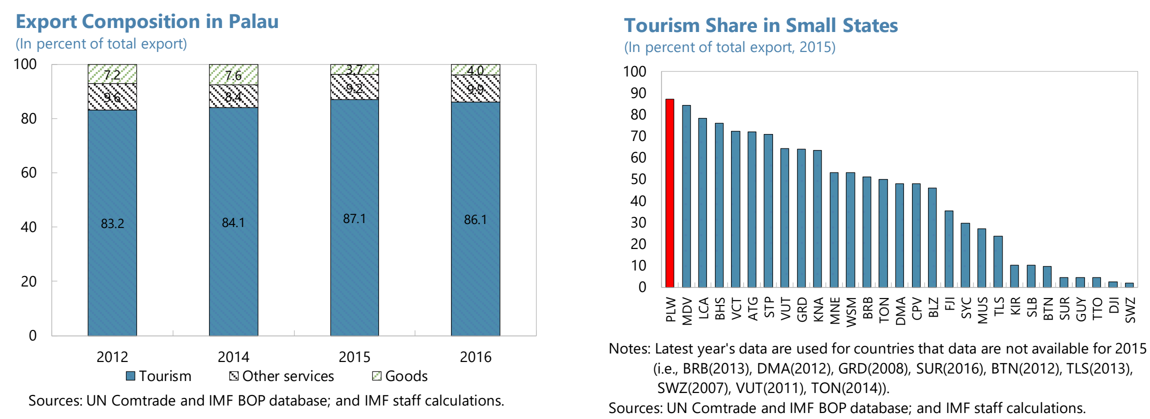
Source: IMF staff.

Appendix VIII. Tourism and Diversification

1. Export diversification could provide substantial economic benefits. Export diversification is an important driver of potential growth by reducing growth volatility in low-income developing countries (LIDCs) and small states (IMF, 2014; McIntyer et al., 2018).[1] The benefits would be particularly important for small states such as Palau, which are characterized by high levels of trade openness with highly concentrated exports to a narrow range of goods or services and are experiencing high volatility in growth.

2. Palau's tourism sector accounts for 86 percent of total export in 2016 and the share has increased by 3 percent from 83 percent in 2012. In 2016, other services (e.g., transportation and telecommunication) accounts for about 10 percent of total exports while the share of goods is only 4 percent of total exports. Palau is the most tourism-concentrated countries among small states.

Figure 1. Palau: Role of Tourism in Export Composition



3. The export concentration index is particularly high in Palau compared to its small states peer.[2] Palau's concentration index is almost twice as high as the average of other Pacific and Caribbean small states while it is higher than other tourism-concentrated small states (i.e., its tourism share is above 50 percent of total export). Moreover, staff finds some positive linkages between concentration index and growth volatility, implying that more concentrated (or less diversified) countries experience higher volatility in growth. Palau having the most concentrated export structure among small states also coincides with high GDP growth volatility.

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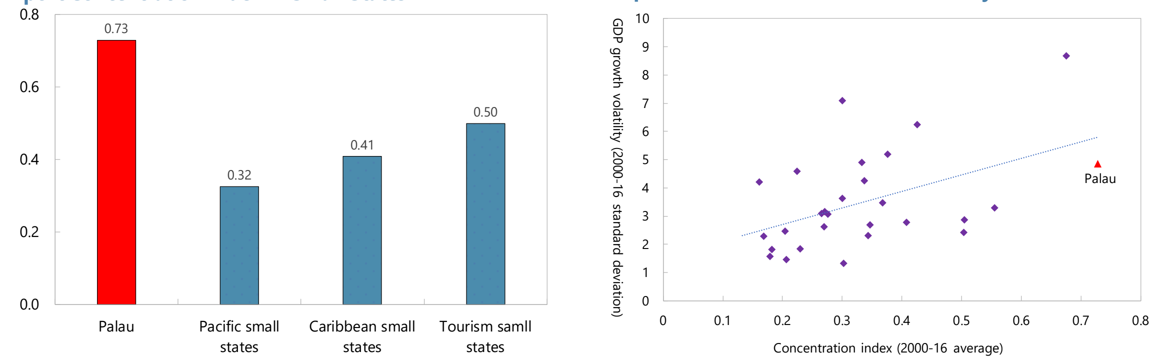
[1] "Sustaining Long-run Growth and Macroeconomic Stability in Low-income Countries: The Role of Structural Transformation and Diversification" (IMF, 2014); and "Economic Benefits of Economic Diversification in Small States" (McIntyre, Li, Wang, and Yun, 2018).

[2] The diversification measure is calculated by the Herfindahl index for country-level export flows in products at SITC1 digit level from the Comtrade database and 1-digit level service exports data from IMF BOP database. The Herfindahl index is calculated as the sum of squared market shares for each country and year. A larger value in concentration index means 'more concentration' or 'less diversification'.

Figure 2. Palau: Macroeconomic Consequences of Export Concentration

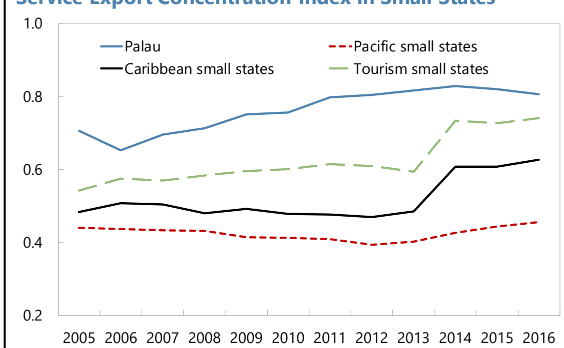
Export Concentration Index in Small States | **Export Concentration and GDP Volatility in Small States**



Sources: UN Comtrade and IMF BOP database; and IMF staff calculations.

Sources: UN Comtrade, IMF BOP and IMF WEO database; and IMF staff calculations.

Service Export Concentration Index in Small States



Sources: IMF BOP database; and IMF staff calculations.

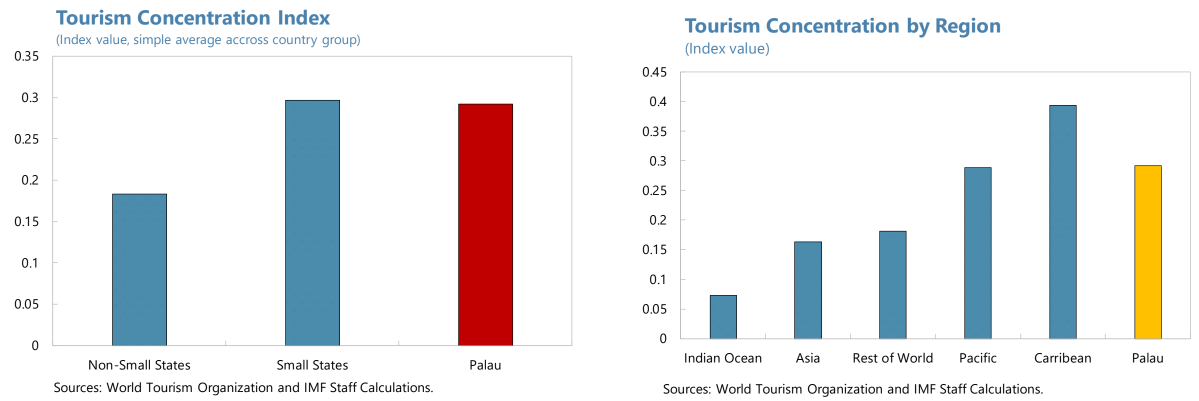
4. Palau's concentration index in service exports has seen a mild increase since 2006. An index for Palau has increased from 0.65 in 2006 to 0.81 in 2016, which is commonly observed in other small states, particularly salient in tourism-dominant countries including Palau and Caribbean small states.[3]

5. Though the opportunities for inter-industry export diversification may be limited due to its small size, Palau can alleviate its growth volatility by increasing diversification within the tourism industry. Tourism in Palau is heavily dependent on a handful of major source countries. We replicate the methodology above to create an index of how diversified tourist arrivals are across 194 economies by country of origin. [4] This analysis highlights that tourism in small states tends to be relatively undiversified (Figure 3), with a reliance on a small number of partners. For example, on average economies in the Caribbean receive 44 percent of their total arrivals from the United States and other tourism-reliant economies in the Pacific (Samoa, Fiji and Vanuatu) received 52 percent of their arrivals from Australia and New Zealand. This increases vulnerability to economic and trade shocks emanating from source countries. Palau's level of diversification is in line with those of other small states. However, given its stronger reliance on tourism (Figure 2), there is greater need to ensure a broader base of tourism demand.

[3] Steep increase of concentration index in 2014 for Caribbean small states is mainly due to significant BOP data revisions in several Caribbean countries.

[4] A Herfindahl index for tourism arrivals. The Herfindahl index is calculated as the sum of squared market shares (i.e. arrivals from a particular country divided by total arrivals) for each origin-destination pair and year.

Figure 3. Palau: International Comparison: Diversification within Tourism



6. **Palau has sought to achieve high-end tourism by targeting higher income segments, which are assumed to be less price sensitive.** Using cross-country data from World Trade Organization, we examine the effect of diversification on growth volatility for tourism-concentrated economies. Following the approach of Kpodar and Imam (2015), we relate tourism concentration indices to output volatility:

$$Vgrowth_{i,t} = \beta_0 + \beta_1 X_{i,t} + \beta_2 Z_{i,t} + u_i + \epsilon_{i,t}$$

where $Vgrowth_{i,t}$ denotes volatility of GDP growth, $X_{i,t}$ is a set of macro control variables (e.g., GDP per capita), $Z_{i,t}$ is a set of tourism concentration-related variables such as tourism share in exports, tourism concentration index, and revenue per arrival.[5] $Vgrowth_{i,t}$ is determined by the volatility of the cyclical component of growth, calculated as the deviation from trend growth, which is assumed to follow an AR(1) process:

$$\ln(Y_{i,t}) = \alpha_i + \beta \ln(Y_{i,t-1}) + y_{i,t} + \epsilon_{i,t}$$

We analyze a sample of 49 tourism-dependent economies, defined as economies where tourist receipts constitute over 20 percent of exports.

7. **We find that high concentration in tourism is a significant driver of growth volatility**. In Column 3 of the text table, we find that an increase by one percentage point increase in the concentration index leads to an increase of 4 percentage point in standard deviation of GDP. This impact is lessened, however, in a country with greater tourism dependence as seen in the negative interaction term.

8. **Our results show that countries with a higher average revenue per tourist arrival do not exhibit higher output volatility.** This indicates that targeting high-end tourism alone may not lead

[5] "Does a Regional Trade Agreement Lessen or Worsen Growth Volatility? An Empirical Investigation" (Kpodar and Imam, 2016).

to lower output volatility unless further geographical diversification is pursued, while targeting high revenue tourists is necessary for Palau to ensure tourism revenues while alleviating pressures on infrastructure (Column 4 of Text Table).

9. **Regression results find that Palau's high concentration in tourism indeed contributes to its high output volatility.** And moving towards high-end tourism alone would not reduce output volatility. Given the limited scope for further export diversification and heavy reliance on tourism, this highlights the need for Palau to further build fiscal buffers to counter-cyclicality caused by tourism dependence and to undertake structural reforms to enhance potential growth and increase resilience.

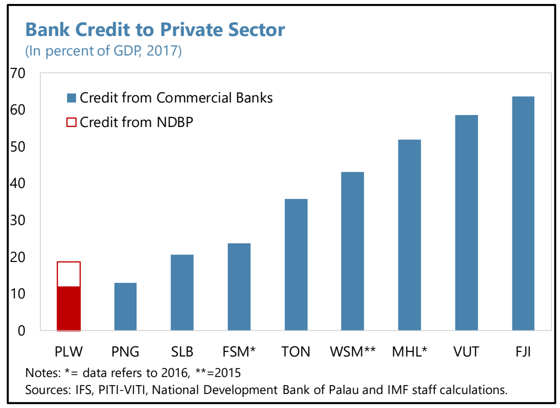
Output Volatility and Tourism

VARIABLES	(1) Baseline	(2) Robustness	(3) Tourism Concentration	(4) High End Tourism
Tourism Share of Exports	0.0318 ***	-0.03 ***	0.0626 ***	-0.02
	(0.0088)	(0.0065)	(0.0117)	(0.0200)
GDP per Capita (PPP Terms, 2011 Int. Dollars)	0.00 ***	(0.00067) ***	0.00005 ***	2.07 **
	(0.0000)	(0.000035)	(0.000012)	(0.810000)
Inflation Volatiliy		0.1380 ***		
		(0.045700)		
Trade Openness		0.0005		
		(0.003400)		
Pacific Dummy		1.0480 **		
		(0.526000)		
Tourism Arrivals Concentration Index			4.1380 **	
			(2.046000)	
Tourism Receipts Share * Concentration Index			-0.1260 ***	
			(0.043100)	
Revenue per arrival				-0.000057
				(0.000350)
Constant	1.30 ***	0.81	0.40	0.93
	(0.4390)	(0.5170)	(0.5370)	(0.6110)
Observations	185	167	176	137
R-squared	0.236	0.280	0.330	0.291
Number of Countries	49	49	47	40

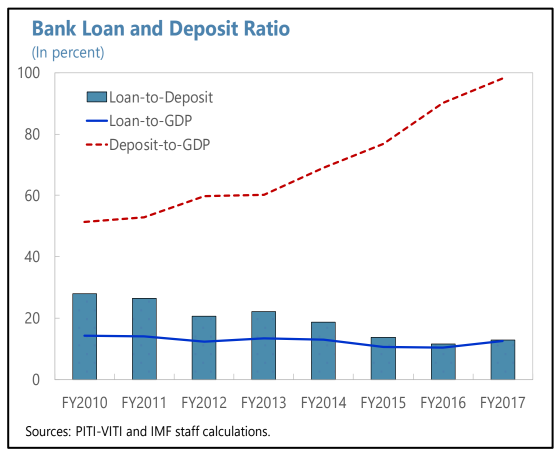
1/ Standard errors in parentheses: ***p,0.01, ** p<0.05, *p,0.1

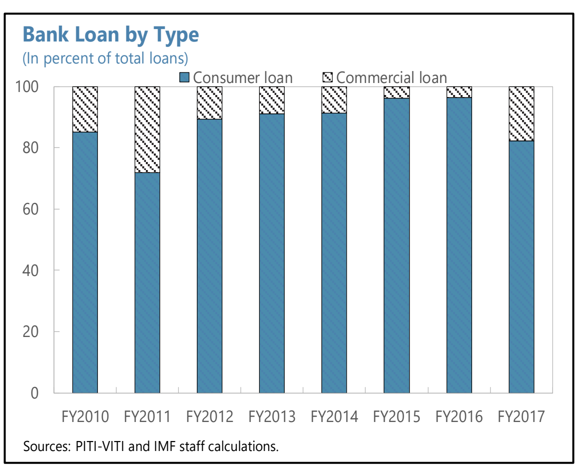
Appendix IX. Financial Sector Reforms

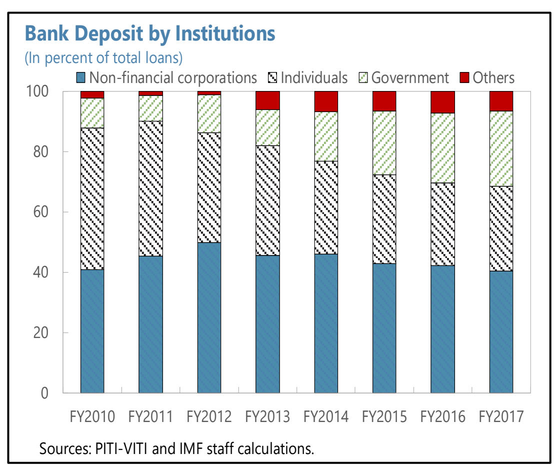
1. Credit provision to the private sector is limited in Palau. The banking system in Palau consists of three foreign-owned U.S. FDIC-insured banks (holding 91 percent of the loans and 99 percent of the deposits as of December 2017) and two non-FDIC-insured banks (operating savings accounts only), and the National Development Bank of Palau (NDBP) (taking part in domestic lending without taking deposits currently). Bank credit-to-GDP ratio is substantially lower than other Pacific island countries (PICs) and it is still much lower than most Pacific islands even including loans from the National Development Bank of Palau (NDBP). Although the legislation allowing the NDBP to take deposits was passed in Congress in December 2014, to obtain a license and take deposits, the NDBP is required to meet all regulatory requirements that commercial banks are subject to fulfill.



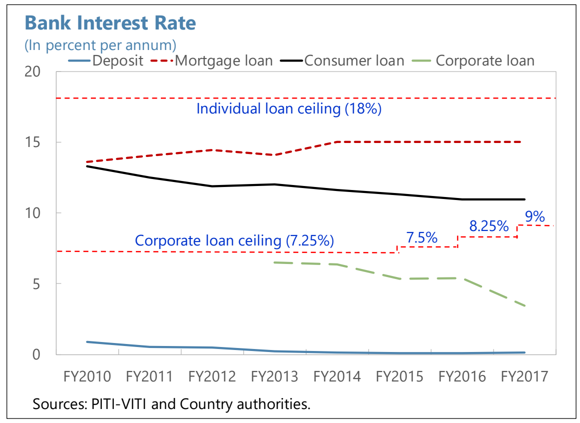
2. Foreign banks continue to lend little domestically despite the rapid rise in deposits. Bank loan has declined from 14.3 percent of GDP to 10.4 percent during FY2010–16 before rebounding to 12.5 percent in FY2017. Meanwhile, the deposit-to-GDP ratio has increased substantially from 51.3 percent to 98.1 percent during FY2010–17, leading to a steady decline in loan-to-deposit ratio. Commercial lending accounts for only 17.8 percent of total loans in FY2017 and which has shown a drastic decline during FY2010–16 before rebounding in FY2017, while consumer lending has maintained at least 80 percent of total loans except for FY2011. On bank deposit, deposits from non-financial corporations have accounted for 40–50 percent of total deposits during FY2010–17 while deposits from individuals have continuously declined by around 20 percentage points since FY2010 and government deposits have increased by similar amounts.







3. Interest rate ceilings imposed may have played a role in limiting banks' lending to the corporate sector. Under the usury law, the interest rate on lending to individuals is capped at 18 percent per annum while the interest rate on lending to corporations is capped at "the prime rate on corporate loans at large U.S. Money Center Banks+4 percentage points"—which stands at 9 percent as of August 2018. Interest rate ceilings do not appear as binding constraints for individual loans while those for corporate loans are expected to bind in that the interest rate for the U.S. small businesses loans—comparable to Palau corporate loans—ranged from 8 percent to 40 percent in October 2015. As a result, foreign-owned banks have chosen to invest their assets in less risky and more secured offshore markets (e.g., U.S. and Guam) rather than to lend in domestic markets. Also, the large spread between lending and deposit rates is found as in most Pacific island countries.[1]



4. Facilitating domestic credit provision is a key to private sector development. As identified by AsDB (2017), to mobilize domestic credit, the banking sector in Palau needs to deal with several structural impediments for banks to extend credit, including the lack of secured lending for real estate, and small business' limited capacity to prepare financial statements, and lending caps on the interest rate.[2] The authorities can facilitate domestic credit provision by relaxing the interest rate ceiling for corporate loans to better reflect cost and riskiness, along with helping small and medium-sized enterprises (SMEs) prepare business plans and financial statements. In the banking system, the NDBP's role can be strengthened by filling the financing gap for SMEs which can be facilitated with the NDBP's license for taking deposits by securing more stable funding sources. Furthermore, the NDBP needs to build capacity to meet the regulatory requirements and improve its system for loan approval and monitoring to safeguard the potential risks for depositors.

[1] Large interest rate spreads in PICs mainly result from high cost and high risk of credit potentially arising from small scale, vulnerability to shocks, and geographic dispersion in the region (IMF Working Paper, 15/96).

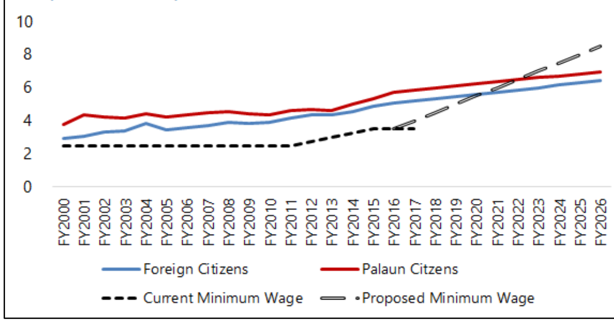
[2] "Private Sector Assessment for Palau: Policies for Sustainable Growth Revisited" (AsDB, 2017).

Appendix X. Labor Market and Minimum Wages

Palau is considering a minimum wage increase to the U.S. level over the next ten years. This is partially aimed to reduce youth emigration to Guam and other U.S. territories. However, increasing minimum wage could also lead to labor market distortions and a loss of competitiveness. Alternative approaches to stem outward migration are to implement structural reforms to increase job opportunities for the youth by further developing the private sector and to improve the provisions of healthcare and elementary schooling.

1. The proposed increase in the minimum rate is sizable for an extended period of time (Text Chart). The wage rate in Palau is US$3.50 an hour, which is set to increase to US$8.50 by 50 cents annually over the next ten years. While there is some disagreement on the impact of small increases to the minimum wage in the literature, large minimum wage increases can adversely affect Palau's competitiveness as it adds to the cost of doing business. It would also add significant fiscal costs for state governments, whose average wage is significantly below the proposed minimum.

Average Hourly Wages in Private Corporate Sector and Minimum Wage Proposal
(In U.S. dollars)



2. Migration is not driven purely by wage differentials but also by social and cultural factors (IMF 2015). In addition, factors such as educational opportunities, healthcare and the relative diversity of economic opportunities in the host country encourage the youth to migrate, contributing to high migration. Furthermore, migration is typically high where there is freedom of movement agreement between the source and host countries. This is true for several Pacific islands but is also seen in Eastern Europe, Central Asia and Nepal/Bhutan.

3. Setting wages above the equilibrium wage rate can generate unemployment, which could exacerbate outward migration. It has been argued this contributed to outward migration in Puerto Rico during the 20th century (Castillo-Freeman & Freeman, 1992), where emigration remained high despite a rapid increase in the minimum wage required to align with the mainland United States. It is also worth noting that, despite its higher minimum wage, Guam also experiences a high level of outward migration.

4. In addition, the increase in minimum wage is likely to have a limited impact on Palauan U.S. residents' migration patterns. The median civilian salary of Palauans living in the mainland United States is US$22,098.[1] This translates into an hourly wage of US$12.06 per hour, based on average U.S. working patterns. Even with the increase of the minimum wage in Palau to US$8.50,

[1] This estimate is based on the American Communities Survey (2010–15). Palauans are identified under the category number 533. As these data are reported on the basis of ethnicity rather than nationality this estimate may include second-generation Palauans-Americans.

Palauans living in the U.S. are still better off getting paid a higher wage in the U.S., with little incentive to return to Palau.

5. There are alternative approaches which can help increase the benefit from outward migration, without adding labor market distortions. These include:

- Ensuring there are limited barriers for migrants seeking to return to Palau (particularly regarding the taxation of repatriated earnings from abroad).
- Undertaking structural reforms to improve the ease of doing business, thereby creating greater entrepreneurial opportunities for potential emigrants and encouraging the diaspora to return and apply skills learnt abroad.
- Taking advantage of modern communications to build strong and active diaspora networks.
- Improving data collection on emigration, potentially through surveying outbound air passengers, to formulate a clearer understanding of what motivates migration decisions.

6. The minimum wage is not an effective tool for migration policy and should be set to balance goals of labor market efficiency and poverty reduction. There are potentially large costs for both the private and public sectors of rapidly increasing the minimum wage. There is also limited evidence that low wages are a driver of emigration or that the proposed increase would be sufficient to alter migration decisions.

INTERNATIONAL MONETARY FUND

REPUBLIC OF PALAU

January 15, 2019

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

Asia and Pacific Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of December 31, 2018)

Membership Status: Joined December 16, 1997; Article VIII

General Resources Account:

	SDR Million	Percent of Quota
Quota	3.10	100.00
Fund holdings of	3.10	100.00
Reserve position in the	0.00	0.03

SDR Department:

	SDR Million	Percent of Allocation
Net cumulative allocation	2.96	100.00
Holdings	2.99	101.08

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Projected Payments to Fund: None

Implementation of HIPC Initiative: Not applicable

Implementation of MDRI Assistance: Not applicable

Implementation of CCR: Not applicable

Exchange Rate Arrangements: The de jure and de facto exchange rate arrangement is an arrangement with no separate legal tender. The U.S. dollar is legal tender and the official currency. Palau has accepted the obligations of Article VIII, Sections 2, 3 and 4 and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions.

Last Article IV Consultation: Palau is on a 24-month cycle. The 2016 Article IV Consultation discussions were held in Koror during May 18–31, 2016. The staff report (IMF Country Report No. 16/328) was considered by the Executive Board and the consultation concluded on September 9, 2016.

Technical Assistance: Technical assistance on tax policy, tax law, bank supervision, and statistics (GDP and government finance) has been provided mainly through PFTAC.

Resident Representative: The resident representative office in the Pacific Islands was opened in September 2010 in Suva, Fiji. Ms. Leni Hunter is the current Resident Representative.

RELATIONS WITH OTHER IFIs

Relations with other International Financial Institutions:

- World Bank Group:
  http://projects.worldbank.org/search?lang=en&searchTerm=&countrycode_exact=PW
- Asian Development Bank:
  https://www.adb.org/countries/palau/main
- Pacific Financial Technical Assistance Center:
  https://www.pftac.org/content/PFTAC/en1/reports11.html#tab_5

STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance	
General: Data provision has some shortcomings but is broadly adequate for surveillance. In particular, external sector statistics need to be further improved, while the coverage of monetary statistics could be expanded. Reporting lags could be shortened. With the support of technical assistance from IMF/PFTAC and the Graduate School USA, the Office of Planning and Statistics (OPS) compiles and publishes macroeconomic data at an annual frequency. The *2012-17 Palau Statistical Yearbook* provide comprehensive data on macroeconomic indicators, population, employment, housing, education, health, investment, tourism, and other economic indicators has been published on Palau's website (https://www.palaugov.pw/executive-branch/ministries/finance/budgetandplanning/rop-statistical-yearbooks/). The OPS continues to rely heavily on external consultants and TA. Further improvements in capacity and additional TA are needed to strengthen the quality and timeliness of macroeconomic data.	
National Accounts: Annual GDP by production and income are compiled and published by Palau. The latest data available to date are for FY2017 and the base year has been recently updated to 2015. Further areas of improvement include more timely publication data and incorporating the improved data sources into GDP estimates.	
Price statistics: Data quality has improved, and the Consumer Price Index has been regularly published on a quarterly basis with a one to two quarter lag.	
Government finance statistics: Fiscal data are compiled using the GFSM 2014 classification and were published in the *2012-17 Palau Statistical Yearbook*. Further improvements include broadening the coverage beyond the budgetary central government, improving the frequency and timeliness of reporting, and including the audited accounts. Annual GFS data for the budgetary central government are reported to STA.	
Monetary and financial statistics: The monetary survey is unavailable since there is no central bank. Palau does not report monetary and financial statistics to IMF's Statistics Department (STA) using the standardized report forms (SRFs). TA on monetary and financial statistics could assist the authorities in developing the SRFs for the depository corporations and strengthening data reporting.	
Financial Soundness Indicators: Palau do not report to STA Financial Soundness Indicators (FSIs) that are in line with the *FSI Guide* for publication on the IMF's website. Banks have been submitting quarterly financial statements, including balance sheets and profit and loss statements, to the Financial Institutions Commission (FIC) since 2009. The FIC publishes FSIs and balance sheet data on a quarterly basis. However, the FSIs do not include data from the National Development Bank of Palau as it remains outside the FIC's supervision.	
External Sector Statistics: The balance of payments and international investment position are compiled annually following the *BPM6* and published in the *2012-17 Palau Statistical Yearbook*. However, there have been delays in reporting these data to STA. The Business Enterprise Survey and the Hotel Accommodation Survey and Tourist Expenditure Survey are expected to improve data quality, particularly tourism-related data. The financial accounts data need to improve as large errors and omissions undermine the usefulness of balance of payments data for surveillance. Palau participates in the coordinated direct and portfolio investment surveys of the IMF.	
II. Data Standards and Quality	
Palau began participating in the General Data Dissemination System in August 2013.	No data ROSC is available.

Palau: Table of Common Indicators Required for Surveillance
(As of December 2018)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates (US dollar is the official currency)	12/2018	1/2019	M	M	M
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	2018Q4	12/2018	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	NA	NA	NA	NA	NA
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	FY2017	9/2018	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[5]	FY2017	9/2018	A	A	A
External Current Account Balance	FY2017	9/2018	A	A	A
Exports and Imports of Goods and Services	FY2017	9/2018	A	A	A
GDP/GNP (GDP production)	FY2017	9/2018	A	A	A
Gross External Debt	FY2017	9/2018	A	A	A
International Investment Position[6]	FY2017	9/2018	A	A	A

1/ Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
2/ Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
3/ Foreign, domestic bank, and domestic nonbank financing.
4/ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments. The data for general government are not available due to lack of capacity.
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); and not available (NA).

Statement by Mr. Ray, Executive Director, and Mr. Amor, Advisor to the Executive Director on Republic of Palau
February 1, 2019

Palau is a very small island state in the North Pacific with an exceptional marine environment. The government has set aside around 80 percent of the country's maritime territory – roughly the size of France – as a marine sanctuary. Tourism is the main industry. A spike in tourist numbers in 2015 put significant strain on public infrastructure and raised environmental concerns. In response, the authorities acted to reduce the number of arrivals to levels consistent with their goal of preserving the fragile environment and safeguarding Palau's reputation as a pristine tourist destination. They are also increasing infrastructure investment to support private sector development.

The decline in tourist arrivals meant the economy contracted by 3.7 percent in 2017. The Palauan authorities agree with staff that growth picked up in 2018 and will strengthen to 2 percent in 2019 and into the medium term. Growth will be supported by public infrastructure projects and the construction of already-approved luxury hotel investments. Palau also recently completed a fiber-optic connectivity project, bringing high-speed broadband to the country. This will create new opportunities for Palauans and aid the delivery of more efficient health and education services.

Palau is vulnerable to natural disasters and external shocks. In the absence of monetary and exchange rate policies, the authorities agree that risk mitigation is limited to fiscal and structural policies. They have been building fiscal buffers and have secured a $15 million facility with the Asian Development Bank that provides a predictable, quick-disbursing source of financing for response, recovery, and reconstruction activities following a natural disaster. Palau is working to diversify its tourism source markets as well as the tourism products it offers, while promoting inclusive growth through tourism product development in rural communities.

Fiscal sustainability

The Palauan authorities are grateful for continued financial assistance from the international community. In particular, the United States provides support through the Compact of Free Association and the recently-approved $123 million in Compact grants will help finance much-needed infrastructure investments. Compact grants are due to expire in 2024 and the authorities are working on a medium-term strategy to ensure fiscal self-sufficiency. Palau has seen a fiscal surplus since 2011 – even in 2017 when the economy slowed. The authorities have saved some of these surpluses in a General Fund Reserve, which currently stands at 5 percent of GDP in 2018. They plan to continue building this into a fully-fledged stabilization fund to help cushion against economic shocks that impact domestic revenues.

Fiscal surpluses have been aided by revenue mobilization measures, including an environmental fee levied on inbound passengers. With technical support from PFTAC, a comprehensive tax reform bill has been prepared and is currently under consideration by the

Congress. This proposed Palau Goods and Services Tax (PGST) is a much more efficient tax system that will result in strong revenue growth over the long term.

Potential contingent liability risks from the Civil Service Pension Fund (CSPF) and the SOEs have been acknowledged. An actuarial study will guide the plans to support the CSPF's long-term sustainability. The authorities also want to make SOEs, particularly the Palau Public Utilities Corporation, self-sustaining. They intend to phase out subsidies when service quality is upgraded, and social protection measures have been developed to support the low-income village residents who are likely to be affected by subsidy removal.

Financial sector stability

The presence of three U.S. FDIC-insured banks is the back-bone of the banking system in Palau, holding 91 percent of loans and 99 percent of deposits in 2017. The government also owns the National Development Bank, which is taking a more active role in providing credit to smaller borrowers in Palau. Banks are well-capitalized and liquid, with a low proportion of non-performing loans. With regards to supervision, the Financial Institutions Commission continues to enhance its capabilities through technical assistance and training from the IMF and US-FDIC and is broadening supervision and regulation to non-bank institutions. The Financial Intelligence Unit is making efforts to improve the AML/CFT regime.

While several cryptocurrency investors have approached Palau, the authorities recognize the risks and uncertainties around cryptocurrencies and do not plan to entertain any proposals. The authorities have asked the IMF and other international institutions to be proactive in their outreach and to raise awareness of the potential risks and benefits of blockchain technology more generally.

Growth and private sector development

Development in Palau will continue to be guided by the Palau Responsible Tourism Policy Framework, which aims to make Palau a high-value tourism destination, targeting high-spending visitors over quantity. This will help safeguard Palau's unique natural assets and ensure a sustainable and resilient income stream for decades to come. The authorities have engaged with a Japanese company in a PPP to renovate, expand and manage Palau's international airport. Renewable Energy Investment plans will also help reduce energy costs for businesses and consumers, and assist Palau to meet its Paris Agreement pledge of increasing the share of renewable power to 45 percent by 2025. The authorities and development partners are ensuring that all new infrastructure projects are resilient to natural disasters and climate change.

Palau continues to experience "brain drain". In response, the President has submitted a bill to the Senate which would gradually raise the minimum wage from $3.50 to $8.50 per hour over the next 10 years. While staff recommends against this policy, the authorities are convinced that it is necessary to attract and retain Palauans and enhance labor force productivity given the more attractive minimum wage levels in neighboring islands.

The Palauan authorities thank the mission Chief and her team for the productive engagement and quality policy discussions, and thank the IMF for the continued support through provision of technical assistance and policy advice.