IMF Country Report No. 21/263

REPUBLIC OF PALAU

December 2021

2021 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 2021 Article IV consultation with Palau, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its November 29, 2021 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 November 29, 2021, following discussions that ended on October 7,2021, 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 November 8, 2021.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for the Republic of Palau.

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

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Washington, D.C.

PRESS RELEASE

PR21/368

IMF Executive Board Concludes 2021 Article IV Consultation with Palau

FOR IMMEDIATE RELEASE

Washington, DC – **December 9, 2021:** On November 29, 2021, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Palau.

Palau entered the pandemic with some fiscal buffers, including a moderate public debt. While strict health measures and preemptive border closure have helped prevent local community spreads of COVID-19 to date, they have severely impacted the tourism-dependent economy. Real GDP contracted by 9.7 percent in FY2020 and is estimated to have further declined by 17.1 percent in FY2021. In contrast to the tourism sector, construction activities were resilient, reflecting progress on large infrastructure projects and strong housing construction. Inflation edged up, driven by a rise in food and energy prices, and the current account widened significantly on the back of a sharp decline in tourism receipts.

The authorities adopted a comprehensive policy response with measures that appropriately aimed at strengthening healthcare and mitigating the economic and social hardship of the pandemic. Despite job losses in the tourism sector, employment support prevented a notable deterioration of overall labor market conditions. The economic fallout of the pandemic and the cost of the fiscal response have led to large fiscal deficits and a rapid increase in public debt. With about 90 percent of the total population fully vaccinated, Palau has started to gradually reopen its borders with some safety measures.

The economic outlook remains challenging. Real GDP is projected rebound by 9.4 percent in FY2022 alongside a gradual recovery in tourist arrivals, which are expected to remain below pre-pandemic levels through FY2023. Inflation is expected to pick up on the back of elevated international fuel prices. The large fiscal and current account deficits are projected to narrow as tourism activities recover. The outlook is subject to high uncertainty, and risks are titled to the downside, including from a protracted pandemic, a domestic outbreak, and natural disasters. Palau's graduation from the OECD's list of countries eligible for official development assistance could lead to lower concessional financing, in particular grants.

Executive Board Assessment[2]

Executive Directors welcomed the authorities' comprehensive policy response to the pandemic which helped limit its health and economic impacts. They noted that an economic recovery is underway, supported by a high vaccination rate and a gradual resumption of tourism. However, the outlook remains clouded by elevated uncertainty and risks. While

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

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

support to the economy should remain until the recovery is broadly entrenched, prudent policies are needed over the medium-term to support macroeconomic stability and promote sustainable, greener and inclusive growth.

Directors welcomed the extension of measures to provide targeted fiscal support to still affected households and firms. They agreed that fiscal policy should continue to be the first line of defense in case downside risks materialize.

Directors noted that fiscal risks over the medium-term have increased substantially and underscored the need for fiscal adjustment to rebuild fiscal resilience and preserve debt sustainability. They welcomed the approval of the comprehensive tax reform, which will contribute to fiscal adjustment while improving the efficiency of the tax system. Directors also concurred that additional revenue mobilization and expenditure rationalization efforts are needed to help accommodate higher climate spending, improve the external position, and provide buffers against potentially lower grants and concessional financing.

Directors agreed that financial sector reforms should be accelerated to support financial deepening. They highlighted the need to enhance SMEs' capacity to absorb credit and address the structural determinants of low credit creation. Risk-based supervision should be strengthened, including for non-bank financial institutions, and improving the AML/CFT framework should remain a high priority.

Directors underscored that steadfast implementation of structural reforms should continue to support sustained growth post-pandemic. They welcomed efforts to pursue greater diversification of source markets for tourism. Going forward, Directors saw merit in streamlining processes for foreign investment, improving the business environment, and enhancing human capital to encourage private investment within and outside the tourism sector.

Directors emphasized that strengthening resilience to climate change is essential for Palau's sustainable development. In this regard, they called for a timely implementation of Palau's climate change adaptation and mitigation strategy, including by tapping into climate risk financing, to enhance economic resilience.

Directors agreed that pursuing capacity building efforts will enhance macroeconomic management.

Table 1. Palau: Selected Economic Indicators, 2016/17-2025/26 1/

Nominal GDP for FY2020:	US$258 million
Population (2019):	17,457
GDP per capita for FY2020:	US$14,784
Quota:	SDR 3.1 million

	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
					Est.			Proj.		
Real sector										
Nominal GDP (million US$)	285.3	284.7	274.2	257.7	216.2	242.7	294.9	305.5	316.7	327.7
Real GDP growth (percent change)	-3.3	-0.1	-1.9	-9.7	-17.1	9.4	18.3	2.9	2.9	2.7
GDP deflator (percent change)	-1.1	-0.1	-1.8	4.1	1.2	2.5	2.8	0.7	0.7	0.8
Consumer prices (percent change; period average)	0.9	2.0	0.6	0.7	1.2	3.0	2.8	0.7	0.7	0.8
Tourist arrivals (number of visitors)	122,10	115,99	89,726	41,674	3,167	24,708	85,710	89,996	94,496	99,220
Expenditure per Tourist Arrival (US$)	976	984	1,061	1,257	1,273	1,312	1,361	1,384	1,408	1,432
Public finance					(In percent of GDP)					
Central government										
Revenue	40.3	44.5	44.5	47.4	46.3	41.2	38.0	39.0	38.6	38.9
Taxes and other revenue	27.2	27.2	27.8	24.0	22.1	20.3	22.9	24.3	24.8	25.4
Grants	13.1	17.3	16.7	23.4	24.2	21.0	15.1	14.7	13.8	13.6
Expenditure	35.5	38.2	44.1	58.3	65.8	53.9	41.1	39.4	38.4	37.1
Expense	32.5	35.9	39.6	52.3	61.3	48.9	36.7	35.3	34.1	32.3
of which: grants to other government units	5.1	6.5	11.1	14.1	18.3	12.7	7.4	6.6	6.1	6.0
Net acquisition of nonfinancial assets	3.0	2.3	4.5	6.1	4.5	5.0	4.4	4.2	4.3	4.8
Current fiscal balance (excluding grants) 2/	-5.3	-8.8	-11.8	-28.3	-39.2	-28.6	-13.8	-11.0	-9.2	-6.9
Current fiscal balance (including current grants) 3/	5.6	6.6	-1.0	-11.8	-20.1	-12.1	-2.6	0.0	1.6	3.7
Net lending (+)/borrowing (–)	4.8	6.3	0.4	-10.9	-19.5	-12.6	-3.2	-0.5	0.2	1.9
General government debt	34.4	37.0	38.6	62.1	85.7	90.3	74.0	71.1	66.7	62.1
					(In millions of U.S. dollars)					
Compact Trust Fund (CTF) balance	219.5	297.5	281.9	275.6	330.3	333.7	337.3	341.1	345.1	349.4
Government cash and deposits 4/	43.2	42.9	31.0	60.7	27.8	32.2	22.9	21.5	22.3	28.4
In percent of GDP	15.1	15.1	11.3	23.6	12.9	13.3	7.8	7.0	7.0	8.7
Monetary sector										
Credit to private sector (in percent of GDP)	12.1	12.3	11.6	11.8	..	..	..	..	..	..
Credit to private sector (percent change)	15.4	1.9	-9.3	-4.8	..	..	..	..	..	..
Balance of payments 3/										
Trade balance	-138.9	-136.5	-142.9	-147.8	-117.0	-128.1	-150.9	-145.5	-153.9	-160.4
Exports (f.o.b.)	14.6	15.5	13.4	6.1	8.7	10.1	13.9	14.1	14.3	14.6
Imports (f.o.b.)	153.5	151.9	156.4	153.8	125.7	138.2	164.8	159.6	168.3	175.0
Tourism receipts	113.0	104.8	91.9	50.9	3.9	31.3	112.8	120.5	128.8	137.6
Current account balance										
Including grants	-55.3	-44.4	-85.3	-124.4	-120.8	-109.6	-68.7	-61.8	-63.0	-61.3
Excluding grants	-93.4	-94.3	-120.6	-154.9	-152.8	-136.3	-99.0	-92.5	-94.4	-93.5
International Investment Position	-136.1	-105.0	-176.8	-256.3	-364.2	-438.5	-470.3	-494.4	-520.5	-544.4
Assets	629.0	715.2	688.9	736.9	721.7	734.6	763.5	801.4	836.1	874.6
Liabilities	765.1	820.2	865.7	993.2	1,085.9	1,173.0	1,233.7	1,295.8	1,356.5	1,419.0
Of which: External debt	85.9	91.8	91.4	150.1	183.4	217.9	214.8	210.8	203.2	194.8
					(In percent of GDP)					
Current account balance										
Including grants	-19.4	-15.6	-31.1	-48.3	-55.9	-45.2	-23.3	-20.2	-19.9	-18.7
Excluding grants	-32.7	-33.1	-44.0	-60.1	-70.7	-56.2	-33.6	-30.3	-29.8	-28.5
International Investment Position	-47.7	-36.9	-64.5	-99.4	-168.4	-180.7	-159.5	-161.8	-164.3	-166.1
Of which: External debt	30.1	32.2	33.3	58.2	84.8	89.8	72.8	69.0	64.2	59.4

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 withdrawals 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 2021 ARTICLE IV CONSULTATION

November 8, 2021

KEY ISSUES

Context. The COVID-19 pandemic and related containment measures have severely impacted the economy. Border closure and the suspension of commercial flights curtailed tourist arrivals. Real GDP contracted by 9.7 percent in FY2020, notwithstanding policy support. The economic contraction is estimated to have deepened in FY2021, and a gradual recovery is expected in FY2022 as tourism activities resume. While Palau's public debt remains sustainable, the economic fallout of the pandemic and the cost of the fiscal response have led to a sharp deterioration of the fiscal position and a rapid increase in public debt. The high share of concessional loans from multilateral creditors in Palau's external debt is an important risk mitigating factor. Palau is vulnerable to climate change and natural disasters.

Policies. Economic policies should focus on supporting the recovery, rebuilding fiscal resilience, and supporting sustainable growth post pandemic. The main policy recommendations include:

- In the near-term, extend policy support until the recovery is firmly entrenched, while improving the efficiency of COVID-related spending.

- In the medium-term, rebuild fiscal resilience through a gradual fiscal consolidation once the recovery is firmly underway and reform the public sector to contain rising fiscal risks. In addition to lowering public debt, fiscal consolidation would help improve the external position, accommodate higher spending to address climate change, and provide some buffers against potentially lower grants and concessional financing due to Palau's graduation from the OECD's list of countries eligible for official development assistance.

- Accelerate structural and financial sector reforms to help lift medium-term growth and promote a more resilient economy post pandemic, including through investment in climate resilient infrastructure and diversification within and outside the tourism sector.

Approved By
Thomas F. Helbling (APD) and Stefania Fabrizio (SPR)

Mission meetings were held virtually during September 22–October 7, 2021. The mission team comprised: Tidiane Kinda (Head), Ricardo P. Davico, Takuma Hisanaga, and Seohyun Lee (all APD). Leni Hunter (Regional Resident Representative), David A. Kloeden (PFTAC), and Luisa Malcherek (LEG) participated in some meetings. Talavai Iona (OED) and Rommel F. Rabanal (AsDB) joined the mission. Thomas F. Helbling (APD) and Chang Huh (Executive Director) attended the concluding meeting. The team met with Minister of Finance Udui, Minister of Human Resources, Culture, Tourism and Development Tmetuchl, Minister of Public Infrastructure and Industries Obichang, senior officials of the national and state governments and state-owned entities, the financial sector community, development partners, and private sector representatives. Kristine Laluces (APD) assisted in the preparation of this report.

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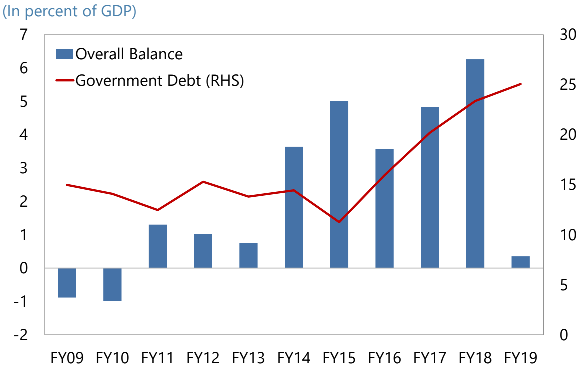
CONTEXT AND PRE-COVID-19 LANDSCAPE

1. Palau is a small state in the Pacific that relies heavily on tourism and foreign grants. Tourism-related sectors represented more than a third of GDP in FY2019. Since independence in 1994, Palau has benefited from grants under a Compact of Free Association with the United States for infrastructure investment, budget support, and to establish a Compact Trust Fund (CTF). President Surangel S. Whipps, Jr. was elected in November 2020 as the 10th President of the Republic of Palau. Palau's legal tender is the U.S. dollar and its fiscal year ends in September.

2. Palau entered the COVID-19 pandemic on a relatively strong footing. A track record of fiscal prudence led to sustained fiscal surpluses and the accumulation of government deposits. In end-FY2019, central government deposits reached 11 percent of GDP and public debt was moderate at about 39 percent of GDP. In addition, the banking system had ample liquidity, low non-performing loan ratios, and stable returns on assets.

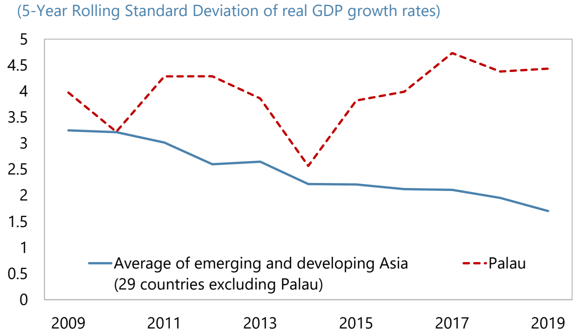
3. Palau was also facing important challenges. Reliance on tourism had led to volatile growth. The steady decline in tourist arrivals from FY2016 had dampened growth momentum and deteriorated the external balance. In FY2019, real GDP contracted by 1.9 percent, and the current account (CA) deficit doubled to 31 percent of GDP. Palau is vulnerable to economic and natural shocks, reflecting the country's small size, geographical isolation, and exposure to climate change risks. Rising sea levels and more intense typhoons are causing frequent inundations, damaging infrastructure, and crippling economic activities (Appendix I).

Palau: Fiscal Balance and Public Debt
(In percent of GDP)



Sources: Palau authorities; and IMF staff estimates.

Palau: Growth Volatility
(5-Year Rolling Standard Deviation of real GDP growth rates)

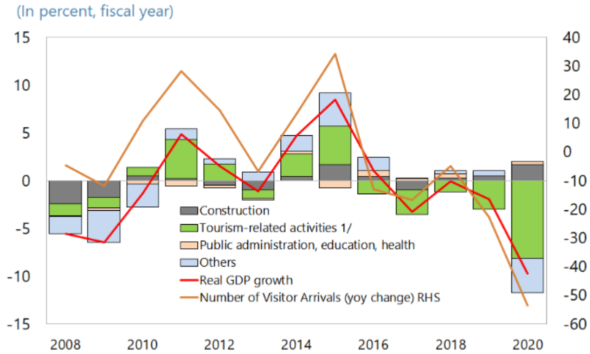


Reference: IMF (2019) Palau: Article IV Consultation—Staff Report, IMF Country Report 19/43, Appendix VIII.
Sources: World Economic Outlook, October 2021; and IMF staff estimates.

RECENT DEVELOPMENTS: A SEVERE IMPACT OF THE PANDEMIC CUSHIONED BY POLICY SUPPORT

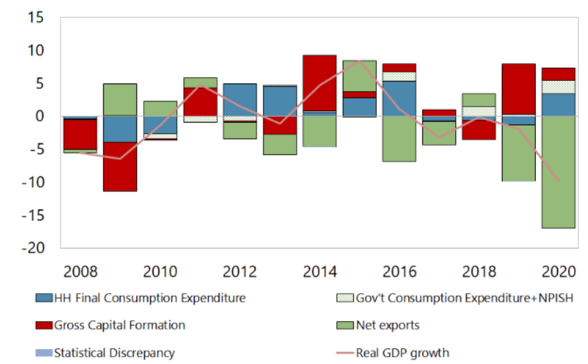
4. The pandemic severely impacted the economy. While Palau recorded its first cases of COVID-19 infections only in mid-August 2021, the authorities adopted and maintained strict and preemptive measures from the beginning of the pandemic (Appendix II). Border closure and the suspension of commercial flights curtailed tourist arrivals and put a severe strain on the economy.[1] Real GDP contracted by 9.7 percent (year-on-year) in FY2020, the lowest rate since FY2001, notwithstanding policy support (Figure 1 and Table 1). In contrast to tourism-related activities, the construction sector was resilient, reflecting progress on large infrastructure projects such as the airport extension and robust housing construction. On the demand side, the sharp drop in net exports was offset by investment and government consumption. Private consumption held up, reflecting support measures to households. Inflation edged up slightly, driven by a rise in food prices. Employment support prevented a notable deterioration of overall labor market conditions, though tourism-related sectors still suffered job losses.

Palau: Tourist Arrivals and GDP Growth by Contribution
(In percent, fiscal year)



1/ Tourism-related activities includes transport, hotel, restaurant and entertainment sectors.
Sources: Palau authorities; and the Graduate School USA.

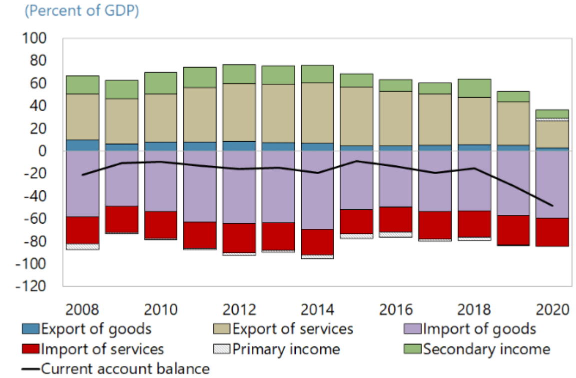
Palau: Real GDP Growth by Contribution
(In percent, expenditure approach, fiscal year)



Sources: Palau authorities; and the Graduate School USA

5. The current account deficit widened in FY2020. Driven by a sharp decline in tourism receipts, the CA deficit rose to 48 percent of GDP in FY2020 (Figure 2-3 and Table 2). Imports declined only marginally, as lower fuel imports were offset by higher import of foods and medical products. A rise in concessional loans from development partners, notably the Asian Development Bank (AsDB), helped finance the CA deficit.

Palau: Current Account Decomposition
(Percent of GDP)



Sources: Palau authorities; and Graduate School USA.

6. A comprehensive policy response helped cushion the impact of the pandemic. The authorities adopted measures that appropriately aimed at strengthening healthcare and mitigating the economic and social hardship of the pandemic. In addition to setting up domestic testing capability and quarantine facilities, the authorities have implemented a stimulus package of $20 million (7.8 percent of GDP) under the Coronavirus One Stop Shop Relief Act (CROSS Act), mostly financed through concessional financing

[1] Tourist arrivals dropped by 53 percent in FY2020, as the pandemic-induced decline was partially offset by robust tourist inflows between October 2019 and January 2020 (26 percent increase year-on-year).

from the AsDB. The package comprised a new unemployment benefit scheme, temporary subsidies for utility bills, a new temporary job creation scheme for public works, and a lending scheme for the private sector (Appendix III). In addition, citizens of Palau received unemployment benefits under the U.S. Coronavirus Aid, Relief, and Economic Security Act (CARES Act), with up to $19 million (7.4 percent of GDP) available.

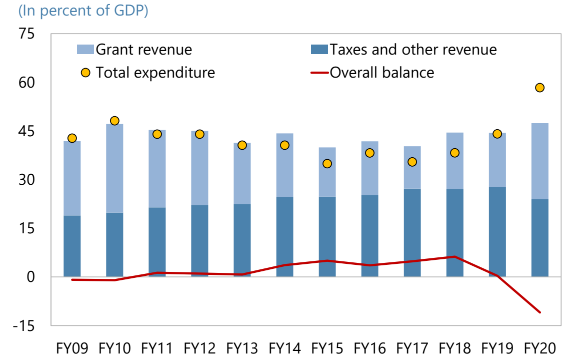
Palau: Policy Measures in Response to the COVID-19

List of Measures	Estimated size (in percent of GDP)
Public Health Measures	0.4
The CROSS Act	7.8
Unemployment benefits	2.7
Temporary jobs program	1.7
Private sector lending program	3.1
Lifeline subsidies for utility services	0.3
The US CARES Act	Up to 7.4
Pandemic Unemployment Assistance	
Federal Pandemic Unemployment Compensation	

Sources: Data provided by the Ministry of Finance; and IMF staff estimates.
Notes: Numbers may not sum up due to rounding.

7. **The economic downturn and support measures led to a large fiscal deficit**. Government non-grant revenues declined by 3.8 percentage points of GDP in FY2020, reflecting lower growth. The rollout of the support measures and their implementation have been gradual. By end-FY2020, about 26 percent of the budgeted resources under the CROSS Act (2 percent of GDP) and around 71 percent of support under the U.S. CARES ACT (5 percent of GDP) were disbursed.[2] In addition, non-crisis related spending, notably social benefits payments, subsidies to SOEs, and transfers to the Civil Service Pension Fund and the Social Security Fund increased by about 6 percent of GDP.[3] As support under the CARES Act was covered by corresponding grants, the fiscal deficit widened from a surplus of 0.4 percent of GDP in FY2019 to a deficit of 10.9 percent of GDP in FY2020 (Figure 4 and Table 3).[4]

Palau: Fiscal balance
(In percent of GDP)



Sources: Palau authorities; and IMF staff estimates.

8. **The banking system is sound overall and private sector credit growth has softened** (Table 4 and 5). Commercial banks have ample liquidity. While the ratio of non-performing loans to total loans increased from the pre-crisis average of 0.7 percent, it was contained at 1.7 percent in 2021Q1, reflecting extensive policy support, debt service moratoria and deferrals, and interest-only payments. From a low level, bank lending further declined by 4.8 percent in FY2020 (year-on-year), reflecting increased risk aversion and lower loan demand.

9. **Palau's external position was substantially weaker than implied by fundamentals and desirable policies in FY2020**. While results from the External Sustainability model indicate a CA gap

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[2] Estimates suggest that about half of the budgeted resources under the CROSS Act and around 94 percent of support under the U.S. CARES ACT were disbursed by end-FY2021.

[3] Expenditure-to-GDP ratio has also risen during pandemic due to a sharp decline in the denominator.

[4] Concessional financing from the AsDB helped finance most of non-crisis related spending as part of public sector reform programs.

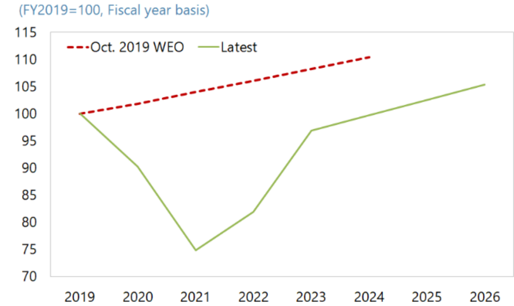
of -19.7 percent of GDP, the large uncertainty around the point estimate suggest that the CA gap is likely to be in the range of -5 to -20 percent in FY2020 (Appendix IV). Palau's CA deficit is expected to narrow in the medium term as tourism activities resume, but it would remain elevated. Structural reforms to diversify the economy and fiscal adjustment (see below) would further improve Palau's external balance and help resolve the CA gap. Risks of external financing distress are low considering banks' large foreign assets and provided that Palau continues to have access to long-term concessional loans and grants. The government's U.S. dollar deposits, the equivalent of foreign reserves in a dollarized economy, are appropriate at 5 months of government spending.[5]

10. **Economic policies have mostly been in line with past Fund advice**. A concerted multi-year fiscal consolidation resulted in improved fiscal balances before the pandemic. After many years of discussions, the authorities approved the comprehensive tax reform in September 2021. In addition to potential revenue gains, the tax reform will improve the efficiency of the tax system and better support growth. Upgrades of basic infrastructure and internet connectivity have supported the tourism sector. Despite the urgent needs, reforms to address imbalances in the public pension system and the public utility company have been lagging.

OUTLOOK: A DIFFICULT AND UNCERTAIN RECOVERY

11. **The economic outlook is challenging**. Real GDP is estimated to have contracted further by 17.1 percent (year-on-year) in FY2021, on the back of an estimated 92 percent drop in tourist arrivals. With about 90 percent of the total population fully vaccinated, Palau has started to gradually reopen its borders with some safety measures, and the travel bubble with Taiwan Province of China resumed in August 2021. Looking ahead, the recovery in tourist arrivals that started at the end of FY2021 on the back of the gradual reopening is expected to continue at a slow and modest pace until tourist arrivals reach the pre-pandemic level of FY2019 in FY2024. Under this scenario, real GDP is projected to rebound by 9.4 percent in FY2022 and 18.3 percent in FY2023. Over the medium-term, reflecting economic scarring including in the tourism sector, output is expected to remain on a lower trajectory. Inflation is expected to pick up from 1.2 percent in FY2021 to 3 percent in FY2022, on the back of elevated international commodity prices. Inflation is projected to subside over the medium-term, though the planned introduction of the Palau Goods and Services Tax (PGST) in FY2023 is expected to exert a one-off upward pressure on prices.

Palau: Pre/post-pandemic comparison of real GDP projections
(FY2019=100, Fiscal year basis)



Source: IMF Staff projections.

12. **Uncertainty around the outlook remains high and risks are tilted to the downside** (Appendix V). The main risk is a protracted COVID-19 pandemic and a domestic outbreak, which

[5] Disbursements of large external loans in FY2020, particularly by the AsDB, boosted government's deposits, reflecting in part the lag between disbursements and spending.

could impact full border reopening, depress tourist arrival, and prolong subpar economic growth. A protracted subpar economic growth could extend the weakened fiscal position, put debt sustainability at risk, and lead to a deterioration of banks' asset quality, particularly once support measures expire. Palau's graduation from the OECD's list of countries eligible for official development assistance could lead to lower concessional financing, in particular grants, though major donors do not currently condition their assistance on the OECD's list[6]. Other risks include higher-than-expected inflation and more frequent and severe natural disasters. On the upside, with the high vaccination rate in Palau, a rapid distribution of effective vaccines globally could expedite the resumption of tourism. While the ratification of a new Compact Agreement with the U.S., currently under negotiation, could boost grant revenues in the medium term, uncertainty remains regarding the timing and terms. Uncertainties related to external grants could also translate into the current account.

Authorities' Views

13. The authorities broadly agreed with the staff assessment of the outlook and risks. They expect the economy to be on a recovery path from FY2022, supported by a gradual resumption of tourism activities. Despite the expected recovery, the tourism-related activities are expected to remain below pre-pandemic levels through FY2023, highlighting the severe impact of the pandemic on the sector. The momentum in construction activities, which has provided some impetus to growth during FY2020-21, is expected to be sustained in the near-term, driven by foreign-financed projects such as the airport extension. The authorities noted that a strong resurgence of the virus globally or local transmissions in Palau could necessitate a significant tightening of containment measures and a delay in the increase of international flights to Palau, which could derail the recovery. They acknowledged that uncertainty remains regarding the timing and terms of a new Compact Agreement with the U.S.

14. The authorities stressed the need to recognize Palau's vulnerability and fragility as a small state. Palau's graduation to high-income status has started to impact non-compact grants, disrupting ongoing projects and could impede the country's plans to meet its development needs and address challenges from climate change, rising oil prices, the ongoing pandemic, and other external shocks. The authorities noted that despite its high-income level, Palau remains fragile and highly vulnerable to exogenous and structural risks, including from climate change and natural disasters. Needed investments to address climate change are disproportionally large for Palau, reflecting the country's small population and economy. It is also important to note that the elevated costs arising from Palau's inherent constraints as a small island state erode purchasing power. The disbursement of population in the outlying states also lends to service delivery challenges that

[6] Palau is expected to graduate on January 1, 2022 from the Organization for Economic Cooperation and Development's (OECD) Development Assistance Committee (DAC) list of countries eligible for official development assistance. The graduation is based on Palau exceeding the World Bank's high-income threshold for three years. While the U.S., Japan and the AsDB, three major donors that account for about two-thirds of grants and all of concessional loans to Palau, do not operate on the DAC classification, support from other donors (notably Australia which accounts for close to 3 percent of total grants) could be delayed or reduced due to higher scrutiny and longer processes.

exacerbate inequalities in access to basic services and income-generating opportunities. Other sources of vulnerability for Palau include its remoteness, high dependence on volatile tourist arrivals, and a relatively high debt burden. The authorities emphasized that Palau's designation as a high-income country and the impending graduation from the OECD Development Assistance Committee bears serious implications on Palau's continued access to the grants and concessional financing needed to build resilience against exogenous and structural risks.

15. The authorities agreed with the external balance assessment, including the related uncertainty. They indicated that COVID-19 pandemic, a large shock, has further exacerbated the data-related uncertainty in Palau. They noted, however, that the rise in imports of pharmaceutical products during the pandemic is transitory and concurred that the current account deficit should narrow over the medium-term. They agreed with staff assessment that current and planned fiscal reforms, including the comprehensive tax reform and the rationalization of public expenditure, should support a gradual improvement of the fiscal position and help reduce the CA deficit.

POLICIES TO UNDERPIN A SUSTAINABLE RECOVERY

16. Considering the protracted economic slowdown and significant uncertainty, policy priorities should focus on securing a robust economic recovery and managing risks.

- Under the baseline, targeted fiscal and financial policies should be extended by accelerating execution of the CROSS Act, with support remaining in place until the recovery is firmly entrenched.
- Should downside risks materialize, targeted spending measures to reach affected entities should be the first line of defense, with due consideration to debt sustainability. The authorities should have contingency plans ready to provide adequate support to the most vulnerable, particularly through social assistance. As risks to debt sustainability are likely to increase under a downside scenario, a priority would be to rebuild fiscal resilience over the medium-term.

A. Near-Term Fiscal Policy Response to the Pandemic

17. Fiscal relief measures should be extended until the recovery is firmly entrenched. Considering that output remains significantly below pre-pandemic levels and substantial downside risks, accelerating the execution of the CROSS Act to extend targeted support to still affected households and firms, as envisaged in the FY2022 budget, is appropriate. After expanding to 19.5 percent of GDP in FY2021 on the back of the protracted downturn, fiscal support measures, and non-crisis spending for public sector reform, the fiscal deficit is projected to moderate to 12.6 percent of GDP in FY2022. While the reduction of the fiscal deficit in FY2022 could be in line with the recovering economy, the planned across-the-board 10 percent cut in spending other than support under the CROSS Act and transfers to state governments, education, and social security could fragilize the nascent momentum. A mitigating factor being that the majority of infrastructure projects is directly financed by capital grants.

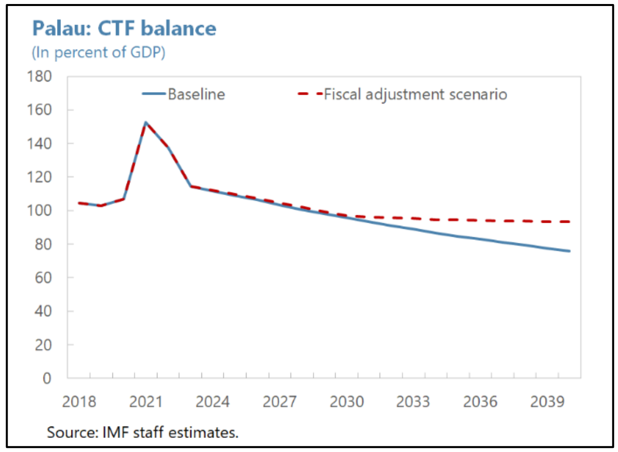
18. Enhancing governance safeguards will further improve the efficiency of COVID-related spending. As support measures were rapidly scaled-up, continued improvements to governance safeguards could further improve spending efficiency. The recent public expenditure review done in collaboration with the AsDB and covering outlays during FY2020 is a positive step. The planned update of the Corporations Act would enhance transparency in business ownership and create an electronic registry. Additional measures to further enhance governance safeguards and improve spending efficiency could include (i) a timely reporting and integration of COVID-related spending in the budget cycle; (ii) the conduct and publication of planned ex-post audits; and (iii) the publication of beneficial ownership information of awarded contracts. The use of available administrative data, for example tax return information, to support the selection of potential beneficiaries could help reduce processing times of applications and improve the execution rate of COVID-related spending. In addition, the targeting of support measures could be further improved, for instance by relying on indicators of corporate financial health such as the recovery in operating revenues or profits to focus on the most affected firms in the tourism sector. Lastly, constant communication between the government and the business community to capture changing needs and calibrate measures would also support a better targeting and take-up of available programs.

B. Rebuilding Fiscal Resilience over the Medium-Term

19. Palau is facing increasing fiscal risks. The negative effect of the pandemic on the economy and the cost of the fiscal response have opened an estimated cumulative fiscal financing need of about 51 percent of GDP in FY2020-22. Disbursed and planned AsDB financing at concessional terms of about US$100 million (42 percent of GDP) and bilateral donor financing of about US$20 million (8 percent of GDP) would cover most of these financing needs, which also helps to preserve government deposits at around 7-9 percent of GDP. While Palau's public debt remains sustainable, risks to debt sustainability have increased substantially. Public debt is projected to peak at 90 percent of GDP in FY2022 and gradually decline to 62 percent of GDP by FY2026, helped by favorable interest rate-growth differentials that reflect a large share of concessional financing (Appendix VI and VII). Under an alternative scenario, a delayed recovery, for instance due to a longer-lasting slowdown in tourism, would increase the likelihood of breaching debt sustainability benchmarks in the future. Considering increased fiscal risks, the authorities' plan to use the 2021 SDR allocation to enhance last-resort buffers is appropriate.

20. A gradual fiscal consolidation to lower public debt, reduce fiscal risks, and increase climate-related spending when the recovery is firmly underway is critical.

- Maintaining Palau's track record of fiscal prudence would require a timely unwinding of the emergency fiscal measures when the health crisis is over. In particular, the authorities should consider improving the targeting of relief measures and tapering unemployment benefits when the recovery is underway.



- In the medium term, a gradual fiscal adjustment of 1 percent of GDP per year over 5 years (FY2024-FY2028) will help achieve the authorities' objective of a balanced budget while safeguarding the CTF, strengthening long-term debt sustainability, accommodating higher spending to address climate change, and providing some buffers against potentially lower grants and concessional financing due to Palau's graduation from the OECD's list of countries eligible for official development assistance (Box 1).[7,8] The fiscal adjustment would also help improve Palau's external position.

21. The fiscal consolidation strategy should center on domestic revenue mobilization and expenditure rationalization:

- **Revenue mobilization**. Staff welcomes the recent approval of the comprehensive tax reform bill, expected to enter into force in January 2023. The reform includes the introduction of (i) a 10 percent PGST, (ii) a 12 percent business profits tax, and (iii) a redefined 4 percent land transaction proceeds fee (Appendix VIII). The tax reform could yield an estimated net revenue gain of about 1 percent of GDP and cover the first year the 5-year fiscal adjustment.[9] An effective implementation of the tax reform will rest on the elaboration and approval of corresponding regulations, with support from PFTAC, including to prevent abuse of PGST refunds. A modernization of the tax IT system is also critical for the implementation of the reform and would enhance revenue gains from tax administration. In addition to the tax reform, options to raise additional revenues to cover the remaining fiscal adjustment include (i) raising the carbon tax from 2 cents per gallon to above the initially proposed rate of 15 cents per gallon, which would support Palau's commitment to transition towards a greener economy; (ii) raising the business profits tax rate from 12 percent to at least 15 percent, which will align Palau's tax rate with the agreed global minimum corporate tax rate, and (iii) streamlining exemptions under the PGST.[10] In the long-term, Palau could consider a higher PGST rate if initial

[7] The CTF is expected to provide through drawdowns annual contributions of US$15 million to the budget starting in FY2019. These annual contributions aim to substitute most of grants provided under the Compact Agreement. Considering historical rates of return, increasing the annual withdrawal from the CTF above $15 million could endanger the fund's long-term sustainability and compromise its revenue generating capacity for future generations.

[8] The fiscal consolidation could be more ambitious and extended through FY2030 if needed, for instance to cover a larger than expected reduction in grants and concessional financing due to Palau's graduation from the OECD's list.

[9] The approved tax reform, already reflected in our baseline projections, could cover about a fifth (1 percent of GDP) of the required fiscal adjustment from FY2024, leaving 4 percent of GDP to be covered by additional measures starting in FY2025.

[10] The tax reform replaces the fuel import duty (5 cents per gallon) with a lower carbon tax (2 cents per gallon).

revenue mobilization and expenditure rationalization efforts (see below) fall short of covering the needed fiscal adjustment.

- **Expenditure rationalization**. Streamlining subsidies to the Palau Public Utilities Corporation (PPUC) and transfers to other public entities and state governments while enhancing their efficiency (see below) would also support the fiscal adjustment.[11] Strengthening public financial management (PFM), notably the public investment management framework, would help improve the efficiency of public investment. Conducting a formal Public Expenditure and Financial Accountability (PEFA) assessment would help define a broader strategy to improve PFM. The planned Fiscal Responsibility and Debt Management Act, under consideration in Congress, provides a fiscal framework that could support the medium-term fiscal adjustment and debt sustainability.[12] Future regulations to implement the Act should provide safeguards to further improve its effectiveness, including through well-defined escape clauses to reduce the procyclicality of fiscal policy, and a framework to better monitor and manage external debt.

Palau: Options of Measures to Support Fiscal Adjustment during FY2024-28

List of Measures	Estimated total saving (in percent of GDP)
Approved tax reform	**1.0**
Additional tax measures	**4.0**
Raise carbon tax gradually, up to 30 cents per gallon	1.5
Streamlining exemptions under the PGST	1.0
Improvements to tax administration with new IT system	1.0
Raise business profits tax rate, to at least 15 percent	0.5
Expenditure measures	**1.5**
Streamline subsidies to PPUC	1.0
Streamline subsidies and transfers to other public entities	0.5
Total measures	*6.5*

Note: The estimates assume a revenue gain of 0.2 percent of GDP per year due to improvements in tax administration. A potentially higher PGST rate in the long-term, if initial revenue mobilization and expenditure rationalization efforts fall short of covering the needed fiscal consolidation, is not included.
Source: IMF staff estimates.

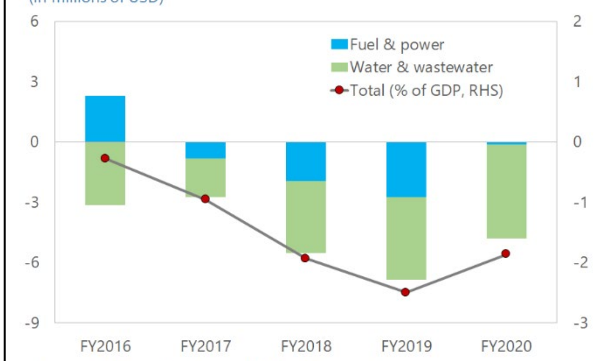
22. Swift public sector reform is critical to contain fiscal risks. Transfers to the Civil Service Pension Fund (CSPF), the PPUC, the Social Security Fund (SSF), and state governments have significantly increased in the past few years, reflecting these entities' increasingly difficult financial situations. Absent a reform or infusion of funds from the central government, rising payments of unfunded benefits to CSPF pensioners are requiring a drawdown of investments and will lead to a negative net position of the Fund in the near term. The authorities should accelerate ongoing discussions about far-reaching reforms, including an increase of retirement age, hikes in contribution rates for employers and employees, and a shift from a defined-benefit to a defined-contribution scheme. A swift implementation of a comprehensive set of reforms is critical for the sustainability of the CSPF. Considering the PPUC's operating losses, particularly for water and wastewater, building on support from the AsDB to accelerate reforms to adopt and maintain full cost recovery tariffs for both fuel and power, and water and wastewater is essential. A reform of the SSF, with support from the AsDB, to strengthen the Fund's governance and better align

[11] These reforms could generate annual savings of up to 1.5 percent of GDP.

[12] The Act aims to improve fiscal discipline, including through a guiding principle to manage operating expenditures within operating revenues, and a requirement to define total annual expenditure limits. To strengthen economic resilience, the Act aims to replace the current General Fund Reserve with two related funds, the Cyclical Reserve Fund to offset local revenue shortfalls, and the Climate Resilience Reserve Fund to finance declared emergencies and natural disasters. The Act also aims to promote sound debt management, including through a requirement for Congress approval on new loans that push public debt above 35 percent of GDP.

contributions with benefits is also important to secure the SSF's financial stability and contain fiscal risks. Enhancing state governments' fiscal management capacity would help them better align their expenditures with available resources, reducing the need for transfers from the central government.

Palau: PPUC Operating Profit/Loss by Function
(In millions of USD)



Sources: Palau authorities; and IMF staff estimates.

Authorities' Views

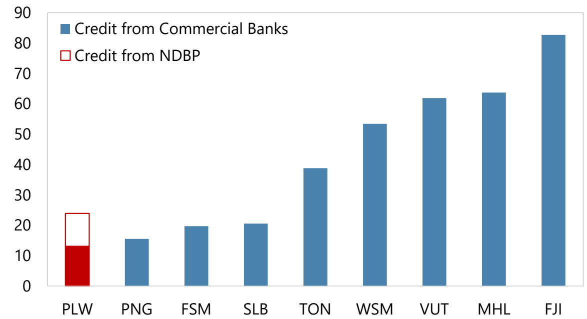
23. The authorities agreed with the staff team's near-term fiscal policy advice. The FY2022 budget includes provisions to extend the CROSS Act to provide targeted support to still affected households and firms. Efforts to improve the efficiency of COVID-related spending have included the recent public expenditure review done in collaboration with the AsDB and planned ex-post audits. The 10-percent cut in spending by government branches in the FY2022 budget aims at reducing extraneous spending while maintaining crucial public services. A supplementary monthly social security benefit of $100, financed by the central government, is expected in FY2022. The benefit aims to enhance the social safety net, cushion the prolonged adverse impact of the pandemic, and reflect higher cost of living.

24. The authorities concurred that fiscal risks had increased substantially, and reform-based fiscal adjustment was needed in the medium-term. They agreed that reforms to improve the efficiency and financial stability of the public pension system, the social security, and the public utilities company were critical to contain fiscal risks and preserve medium and long-term fiscal sustainability. They stressed that the comprehensive tax reform will help modernize the tax system and improve efficiency and fairness, while generating additional fiscal revenues. The transition from the Gross Revenue Tax to the Palau Goods and Services Tax, a VAT system, will encourage the entry of new and small businesses and promote foreign investment, particularly in high-value tourism. The authorities emphasized that the planned Fiscal Responsibility and Debt Management Act, under consideration in Congress, would cement Palau's track record of fiscal prudence. The key elements of the Act establish guiding principles for the budget process, PFM, debt management, and fiscal risk management, with a view to entrench sound fiscal policies in legislation and regulation.

C. Financial Sector Policies to Support Credit and Preserve Stability

25. Expanding access to credit could further support growth. Loan-to-GDP ratio was around 12 percent in FY2020, substantially lower than in other Pacific island countries. Bank lending is highly concentrated in small loans to individuals. Lending to businesses is constrained by structural issues, including a lack of reliable and accurate financial information for firms, small businesses' limited

Palau and Pacific Island Countries: Bank Credit to Private Sector
(In percent of GDP, 2020)



Sources: IFS; PITI-VITI; National Development Bank of Palau; and IMF staff estimates.

capacity to prepare projects, and the interest rate ceiling on commercial loans (Appendix IX).[13] Possible deterioration in banks' asset quality due to the pandemic could exert additional downward pressure on credit growth. To further support distressed but viable businesses and individuals affected by the pandemic, additional targeted and temporary measures implemented in collaboration with the government could include an extension of lending schemes and credit guarantee programs with emergency relief measures, in which banks bear part of the risk. In implementing these measures, it is important to avoid any relaxation of loan classifications and provisioning rules. Efforts to boost the structurally low credit creation include providing support to SMEs to prepare business plans and financial statements and strengthening the National Development Bank of Palau's (NDBP) lending capacity by effectively allowing it to take deposits through a license of the Financial Institutions Commission (FIC).

26. Efforts to improve AML/CFT should continue. The moratorium on crypto-asset and crypto-currency activities is adequate. Efforts to strengthen Know-Your-Customer practices, improve transparency of financial transaction reporting by enacting the Designated Non-Financial Businesses and Professions (DNFBPs) transaction reporting requirements of August 2021, and modernize the business registry and beneficial ownership disclosures by corporations are also welcome. In addition, the authorities could strengthen risk-based AML/CFT supervision for financial institutions and designate AML/CFT supervisors for non-bank financial institutions and DNFBPs such as real estate agents and lawyers, who represent high ML/TF risks.

Authorities' Views

27. The authorities agreed that Palau's banking system remained sound and that credit provision needed to increase. Palau's banking sector has maintained relatively strong capital and liquidity buffers throughout the crisis. While the balance sheets of some corporates in tourism-related activities have suffered from the crisis, policy measures have boosted household income and led to a reduction in household debt, increasing overall banks' liquidity. The recent decline in commercial loans interest rates illustrates that the interest rate ceiling on commercial loans is not a key obstacle to credit growth. However, structural factors, including SMEs' limited capacity to prepare business plans and well-structured projects are key impediments to credit growth. The authorities anticipate that the introduction of the PGST will support credit creation by enhancing companies' financial reporting practices. Additionally, the NDBP is expected to play an increasing role in the economy through varying financing support.

[13] Global inflationary pressures suggest that the recent reduction in lending rates is unlikely to be sustained.

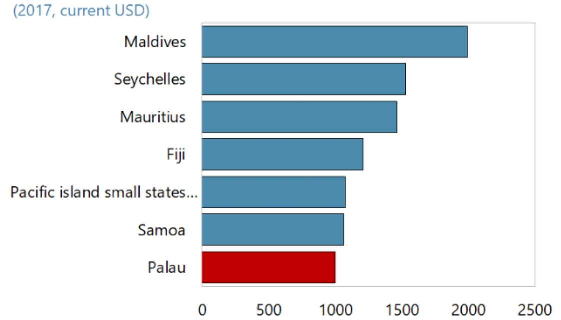
28. The authorities are pursuing efforts to broaden financial supervision and improve AML/CFT. They noted that the moratorium on crypto assets and crypto currency activities would remain in place until these activities can be adequately regulated and indicated their interest in developing a targeted legislative framework for virtual assets and virtual asset service providers with the support of IMF TA. They also pointed to recent efforts to improve risk-based AML/CFT supervision and to address AML/CFT shortcomings, including strengthening Know-Your-Customer practices and improving the transparency of financial transaction reporting by enacting the DNFBP transaction reporting requirements.

BEYOND THE PANDEMIC: A MORE RESILIENT AND GREENER ECONOMY

A. Strengthening Economic Structure and Addressing Climate Change

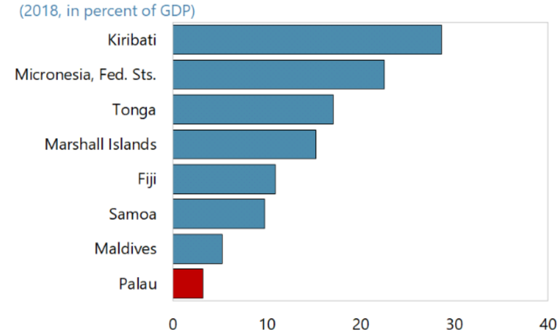
29. The pandemic provides an opportunity for Palau to revisit its growth model (Appendix X). Considering a possible long-lasting reduction in tourism activities, the authorities could consider reform options within and outside the tourism sector to support medium-term growth. Palau should continue to pursue greater diversification of source markets and move toward high-value and eco-tourism, which would enrich tourists' experience, increase revenue per tourist, reduce health risks, and contain the environmental impact. A comprehensive policy package, including streamlining processes for foreign investment, improving the regulatory framework and land-use planning, upgrading climate-resilient infrastructure, and enhancing human capital would have many benefits. These include creating quality jobs that could curb emigration, mitigating climate-related risks to growth, enhancing external sustainability, encouraging private investment within and outside tourism, and better integrating sectors. For instance, the eco-tourism strategy would benefit from a domestic agri-food supply chain with higher production and processing of agricultural and fishery products, which would also boost Palau's relatively low share of value-added from the agricultural and manufacturing sectors.

Palau and Pacific Island Countries: Tourism Receipts per Visitor
(2017, current USD)



Note: The data of tourism receipts in 2017 is the latest for Palau in WDI.
Sources: World Development Indicators, The World Bank; and IMF staff estimates.

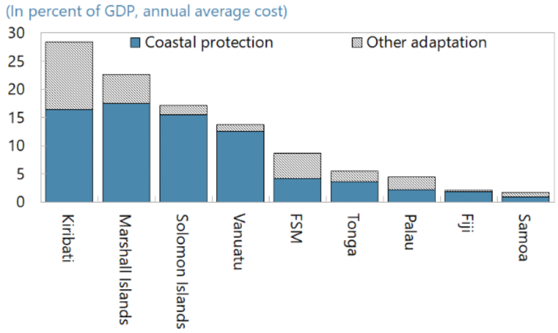
Palau and Pacific Island Countries: Agriculture, Forestry, and Fishing, Value Added
(2018, in percent of GDP)



Source: World Development Indicators, The World Bank.

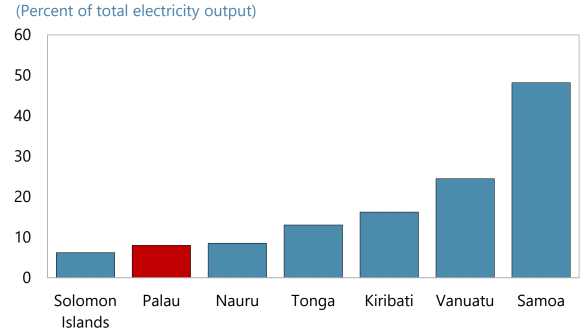
30. Strengthening resilience to climate change is also critical for Palau's sustainable development. (Appendix I). Palau is set to face substantial costs for coastal protection and other climate adaptation needs, estimated at a minimum of 4 percent of GDP per year[14]. The relatively small share of renewable energy production in Palau suggests that there is room to improve the energy generation mix. Stronger cyclones could inflict disproportionate damages to Palau's small economy, highlighting the importance of tapping into climate risk financing.[15] The planned reform of the PPUC would improve its financial sustainability and facilitate the entry of private renewable energy producers. Palau would also benefit from strengthening the synergy between its climate change objectives and its growth strategy. For instance, investment to enhance infrastructure resilience through coastal protection would minimize the impact of rising sea level on low-lying arable lands.

Palau and Pacific Island Countries: Costs of Coastal Protection and Infrastructure Adaptation
(In percent of GDP, annual average cost)



Sources: World Bank (2016) "Climate and Disaster Resilience" Pacific Possible Background Report No. 6; and IMF staff estimates.

Palau and Pacific Island Countries: Renewable Electricity Output for 2018
(Percent of total electricity output)



Sources: U.S. Energy Information Administration (EIA); International Renewable Energy Agency Renewable Energy Statistics 2020; and Palau 2019 State of the Environment Report.

Authorities' Views

31. The authorities are committed to enhance economic resilience and address fragility emanating from climate change. They noted the new administration's broad-based efforts in implementing a high-value tourism strategy, including developing suitable accommodations, and converting Palau's historical sites into new tourist attractions. The modernization and update of Palau's Corporations Law and the adoption of an International Arbitration Law reflect the country's efforts to promote the private sector and strengthen growth prospects. The authorities agreed that economic diversification should be pursued to further support growth, including through the development of a domestic agri-food value chain and value-added industries, the promotion of fintech, and the diversification of the tourism industry by including eco-tourism. The authorities stressed the growing threats of natural disasters and climate change and underscored the urgent

[14] In 2015, the authorities estimated Palau's climate change-related cost at $500 million (about 194 percent of 2020 GDP). This includes the needed relocation of the major hospital due to rising sea levels. See Appendix I for details.

[15] More broadly, it is critical for Palau to maintain access to concessional climate financing, which is likely, as these resources pay particular attention to countries' vulnerability to climate change. For example, the Green Climate Fund (GCF) provides grants and concessional loans to Non-Annex 1 countries which includes Palau. Non-Annex 1 countries under the United Nations Framework Convention on Climate Change are mostly developing countries, some of which are recognized as being especially vulnerable to the adverse impacts of climate change.

need for infrastructure investments to tackle Palau's fragility to climate change, with the most imminent project being the relocation of the national hospital. They underscored the importance of continued access to concessional financing and grants, highlighting that financing constraints have prevented a swift implementation of Palau's climate change adaptation and mitigation strategy.

B. Other Issues

32. **Improving statistics**. Palau's statistics are broadly adequate for surveillance thanks to technical assistance from PFTAC and the Graduate School USA. The development of quarterly statistics for BOP, real, and fiscal sectors would support economic monitoring and policy calibration. For the real sector, there is scope to improve data collection to address gaps in administrative data sources. Broadening the coverage of fiscal data to the general government level and improving the quality of public sector debt statistics is important. In this context, strengthening the capacity of state governments and other units of the general government to provide timely and adequate financial statements will support the compilation of fiscal data at the general government level. In addition, expanding the coverage of monetary statistics to include the NDBP and other financial corporations would support surveillance. Palau is expected to implement the enhanced General Data Dissemination System (e-GDDS) in early 2022, with support from the IMF Statistics Department.

Authorities' Views

33. **The authorities appreciated technical assistance support from the Fund, particularly PFTAC, and the Graduate School USA**. They pointed to the small size of the statistics office as a challenge and expressed strong interest in continued support to develop regulations that will support the implementation of the new tax reform. They indicated that support in the compilation of comprehensive fiscal accounts would enhance data quality, whereas implementation of e-GDDS will improve data accessibility. In addition, further support is necessary to improve the capacity of the recently created Financial and Economic Intelligence Services (FEIS), which is responsible for monitoring and reporting Palau's economic and fiscal situation, and formulating appropriate fiscal, financial, and macroeconomic policies. Palau has done well in leveraging administrative data for the compilation of the balance of payments and national accounts. The authorities view the introduction of the PGST as an opportunity to collect comprehensive corporate data and address gaps in their source data.

STAFF APPRAISAL

34. **The authorities' comprehensive economic policy response has cushioned the impact of the COVID-19 pandemic.** The pandemic and related containment measures have severely strained the tourism-dependent economy. The fiscal and financial policy response has helped to protect lives and livelihoods and preserve macro-financial stability during a major downturn. Palau's external position was substantially weaker than implied by fundamentals and desirable policies in 2020.

35. The economy is poised for economic recovery on the back of a high vaccination rate, but the near-term outlook remains challenging. With about 90 percent of the total population fully vaccinated, Palau has started to reopen its borders. Following two years of severe contraction, economic activity is projected to gradually rebound in FY2022, alongside tourism activities. The economic outlook is subject to elevated uncertainty and risks are tilted to the downside, including from the pandemic, higher inflation, a shortfall of non-Compact grants, and natural disasters.

36. Fiscal risks have increased substantially. Public debt has surged, reflecting the negative impact of the pandemic on the economy and the cost of the fiscal response. While risks to debt sustainability have increased substantially, Palau's public debt remains sustainable, helped by the large share of concessional financing, particularly from the AsDB, in overall budget financing.

37. Considering the challenging near-term outlook, pandemic relief measures should be extended until the recovery is firmly entrenched. Accelerating the execution of the CROSS Act to provide targeted support to still affected households and firms, as envisaged in the FY2022 budget, is appropriate. Should downside risks materialize, targeted spending measures should be the first line of defense, with due consideration to debt sustainability.

38. A fiscal adjustment is needed to rebuild fiscal resilience in the medium-term. The adjustment should rely on both revenue mobilization and expenditure rationalization. Staff assesses that a fiscal adjustment of 1 percent of GDP per year over 5 years will help lower public debt ratios, preserve the CTF, accommodate higher spending to address climate change, provide some buffers against potentially lower grants and concessional financing, and improve the external position.

39. Staff welcomes the approval of the comprehensive tax reform. With potential revenue gains estimated at about 1 percent of GDP, the tax reform will contribute to the fiscal adjustment while improving the efficiency of the tax system and supporting growth. Options to raise additional revenue to support the fiscal adjustment include raising the carbon tax in line with Palau's commitments to address climate change, increasing the business profit tax rate to at least the 15 percent agreed minimum global corporate tax rate, and streamlining PGST exemptions.

40. Swift public sector reform to rationalize subsidies and transfers to public entities should also contribute to the fiscal adjustment. A rapid implementation of a comprehensive set of reforms, including an increase of retirement age and hikes in contribution rates, is critical for the near-term sustainability of the CSPF. Building on support from the AsDB, the authorities should accelerate the PPUC's reform to adopt and maintain full cost recovery tariffs. Strengthening the SSF's governance and enhancing state governments' fiscal management capacity would help better align these entities' expenditures with available resources.

41. Financial sector reforms should be accelerated to support credit growth and improve AML/CFT. To support the recovery, temporary measures such as credit guarantees, and debt moratoria should be extended and targeted to viable and still impacted firms. The NDBP should be placed under the supervision of the FIC to effectively allow the bank to take deposits, thereby strengthening its lending capacity. Enhancing SMEs capacity to prepare business plans and relaxing the interest rate ceiling on commercial loans could help boost the structurally low credit creation. Risk-based supervision should be strengthened, including by designating specific AML/CFT supervisors for non-bank financial institutions and DNFBPs.

42. Steadfast implementation of priority reforms should continue to support sustained growth post-pandemic. Palau should continue to pursue greater diversification of source markets and move toward high-value and eco-tourism. Streamlining processes for foreign investment, improving the regulatory framework and land-use planning, and enhancing human capital would encourage private investment within and outside tourism, better integrate tourism with other sectors of the economy, and create quality job opportunities.

43. Strengthening resilience to climate change is essential for Palau's sustainable development. A timely implementation of Palau's climate change adaptation and mitigation strategy, including by tapping into climate risk financing, is critical to enhance economic resilience against rising threats from climate change that could pose disproportionately large damages to Palau's small economy.

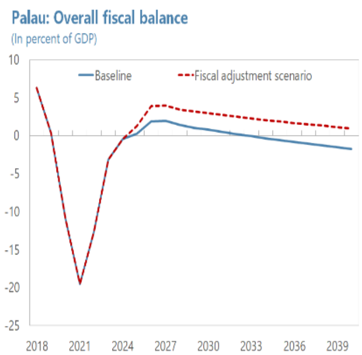
44. Pursuing capacity building efforts will enhance macroeconomic management. With technical assistance support from the Fund and PFTAC, the authorities should develop regulations that will support a timely implementation of the approved tax reform and improve data quality to support surveillance, particularly in the fiscal, external, and financial sectors.

45. It is recommended that the next Article IV consultation be held on the current 24-month cycle.

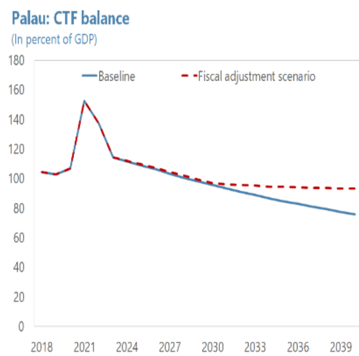
Box. 1. Palau: Medium-Term Fiscal Adjustment Scenario

This box describes a baseline and an illustrative fiscal adjustment scenario.

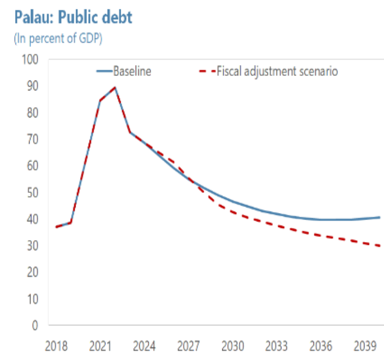
- **Baseline scenario.** The fiscal balance is projected to reach a surplus of 0.2 percent of GDP in FY2025, before declining to a deficit in FY2033. Public debt to GDP is expected to fall from a peak of 90 percent to 41 percent in FY2040, reflecting a favorable interest rate-growth differential. The CTF's balance is expected to erode to 76 percent of GDP by FY2040 with drawdowns of US$15 million annually.
- **Fiscal adjustment scenario.** This scenario aims at achieving the authorities' objective of a balanced budget while safeguarding the CTF for future generations, increasing spending to address climate change, and providing some buffers against potentially lower grants and concessional financing due to Palau's graduation from the OECD's list of countries eligible for official development assistance. In addition to the revenue gain from the tax reform in FY2024, the government pursues a fiscal adjustment of 1 percent of GDP per year over the 4 consecutive years (FY2025-FY2028).[1] The fiscal adjustment is achieved through higher domestic revenue mobilization and expenditure rationalization. Savings from the last two years of the fiscal adjustment (2 percent of GDP) are expected to cover half of the estimated spending needs to address climate change.[2] The adjustment leads to marginal dampening effects on growth in the near term. Under the scenario, the government would use parts of its primary surplus to repay existing debt from FY2030 and reduce drawdowns from the CTF by about half to US$8 million from FY2031. This would help stabilize the CTF balance at 93 percent of GDP and public debt would decline to 30 percent of GDP by FY2040.



Source: IMF staff estimates.



Source: IMF staff estimates.



Source: IMF staff estimates.

1/ The fiscal adjustment for 4 years (4 percent of GDP) will complement the net gains from the tax reform (1 percent of GDP) in FY2024 for a total fiscal adjustment of 5 percent of GDP over 5 years (FY2024-FY2028). The fiscal adjustment could be more ambitious and extended through FY2030 if needed, for instance if the graduation from the OECD's list leads to a larger than expected reduction in grants and concessional financing.

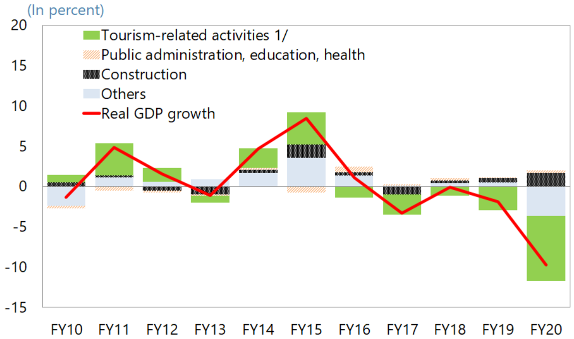
2/ The baseline incorporates part of ongoing and planned climate adaption and resilience projects (at least 1 percent of GDP).

Figure 1. Palau: Real Sector Developments

The COVID-19 pandemic severely impacted the economy in FY20…

Contribution to GDP Growth, FY2010-20

(In percent)

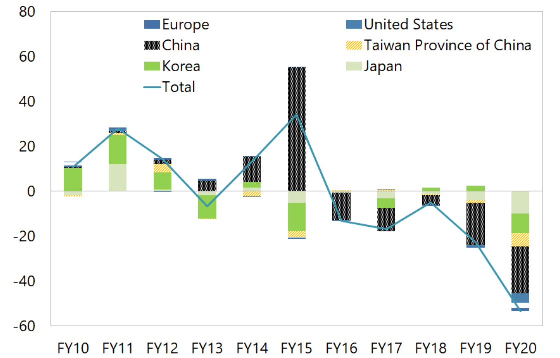


1/ Includes wholesale trade, transport, storage, repair of motor vehicles, and hotel and food services.

…due to the border closure that resulted in a collapse of inbound tourists.

Contribution to Tourism Growth

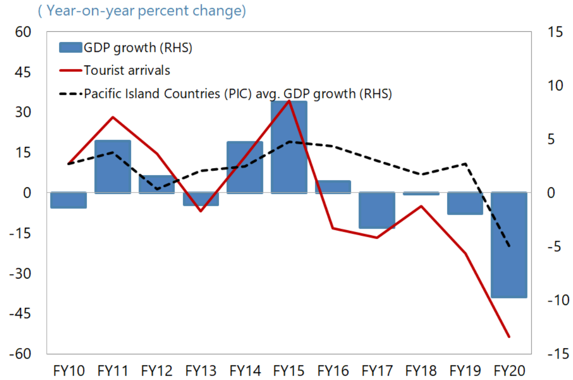
(Growth of tourist arrivals by country of origin, in percent)



Volatility in tourism has led to high growth volatility, even relative to peers in the Pacific.

Real GDP and Tourist Arrivals

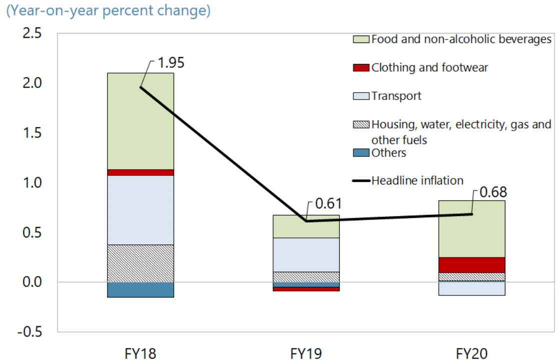
(Year-on-year percent change)



Inflation has been modest in FY2020, as the rise in food prices has been partially offset by lower transport costs.

Inflation

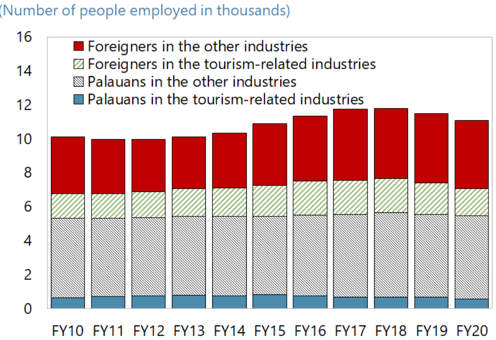
(Year-on-year percent change)



Foreign workers have been more impacted by the drop in employment due to the pandemic.

Palau: Employment

(Number of people employed in thousands)

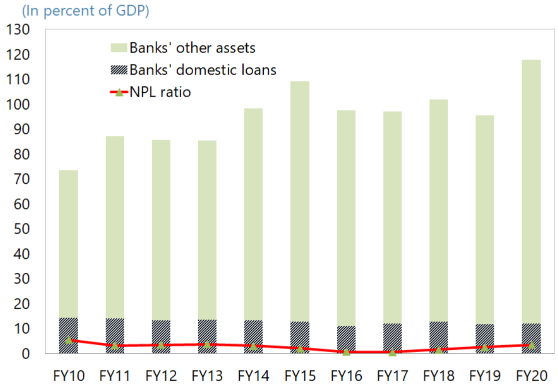


Note: Tourism-related industries includes transport, hotel, restaurant and entertainment.

Bank credit to the domestic private sector remains low despite sizeable asset positions.

Banks Assets

(In percent of GDP)

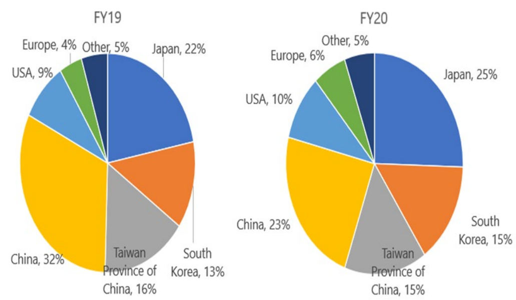


Sources: Palau authorities; the Graduate School USA; and IMF staff estimates.

Figure 2. Palau: Tourism Sector Developments

Most of tourist arrivals continue to depend on a handful of countries.

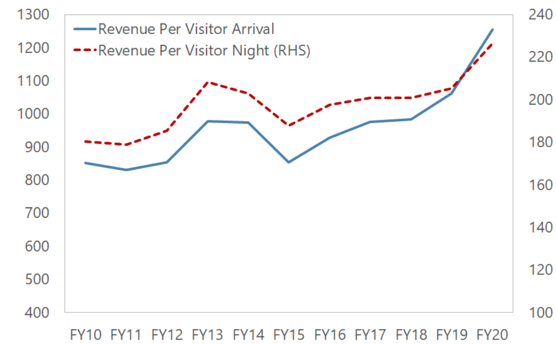
Change in Source Market Composition



The decline in revenue per tourist observed during the FY2015 tourism boom has gradually reversed.

Revenue per Tourist Arrival/Night

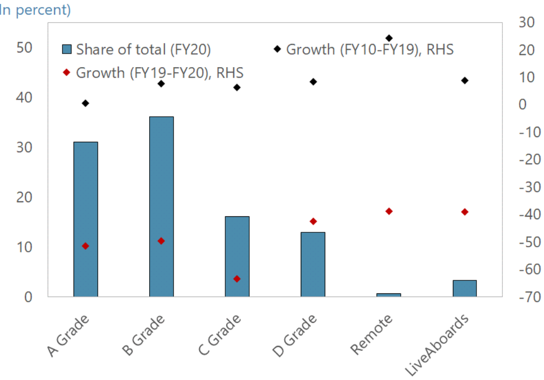
(In USD)



Visitor nights declined substantially for all hotel grades in FY2020.

Visitor Nights by Hotel Grade

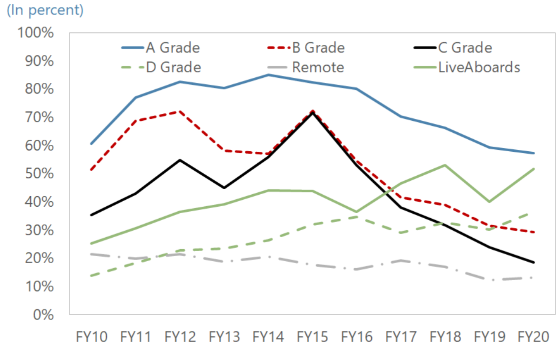
(In percent)



Occupancy rates of Grade A through C hotels were on a declining trend even before the pandemic.

Hotel Occupancy Rates by Hotel Grade

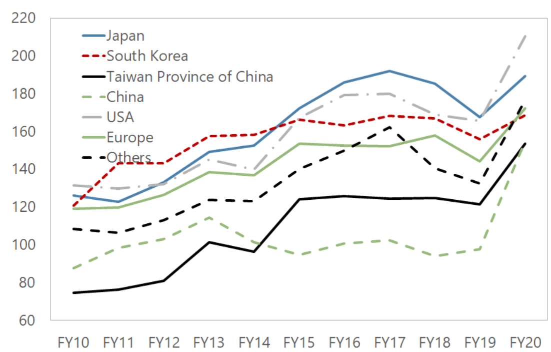
(In percent)



Average nightly spending on hotel rooms varies across source countries for tourists.

Average Room Price by Tourist Origin

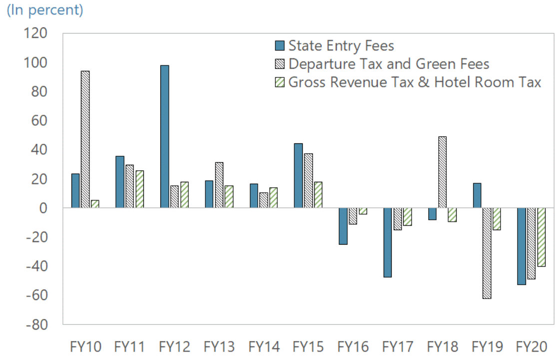
(In USD)



Decline in arrivals led to lower tourism revenues, except in FY2018 when the Pristine Paradise fee was introduced.

Growth in Public Sector Revenue

(In percent)



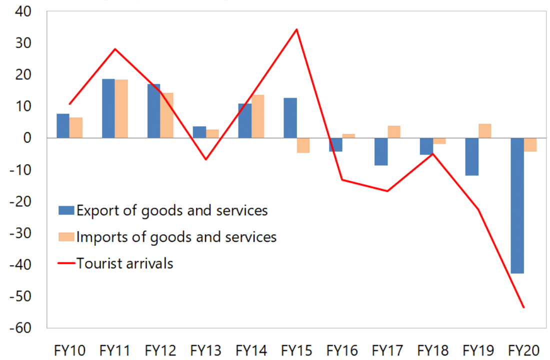
Sources: Palau authorities; and IMF staff estimates.

Figure 3. Palau: External Sector Developments

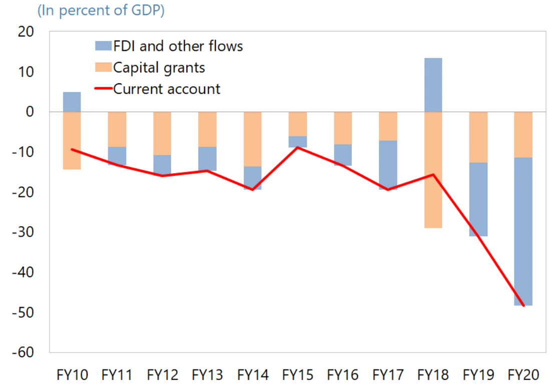
After successive declines since FY16 associated with lower arrivals, exports plummeted in FY20 due to the pandemic.

..., leading to a further widening of the current account deficit.

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



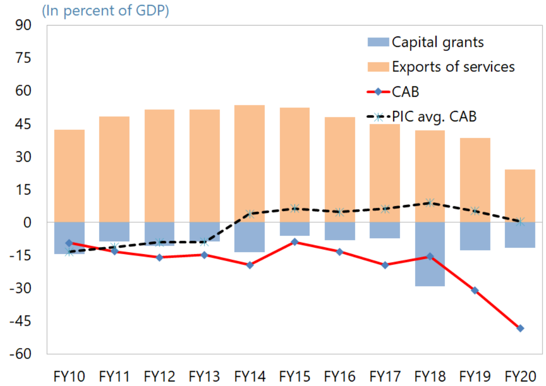
Current Account
(In percent of GDP)



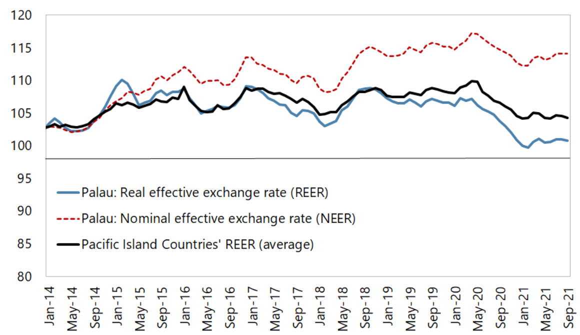
Palau's current account deficit has been larger than peers' average, and the gap is widening.

Palau's real exchange rate depreciated in the second half of 2020, along with other pacific island countries.

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



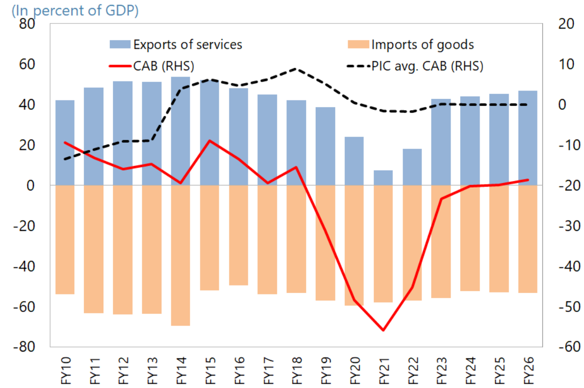
Real Effective Exchange Rate
(Index number, 2010=100)



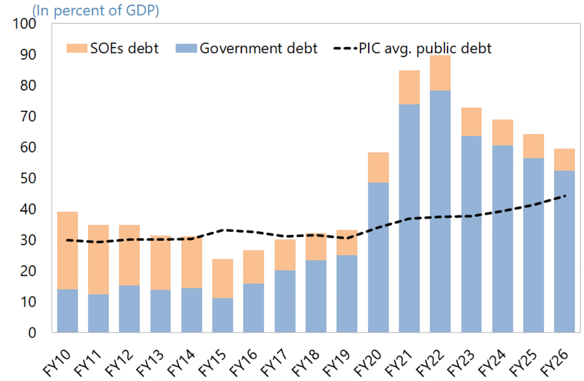
The current account deficit is expected to narrow from FY22 onwards as tourism activities resume.

External debt will increase sharply during FY20-22, mainly driven by disbursements of AsDB loans.

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



Public External Debt
(In percent of GDP)

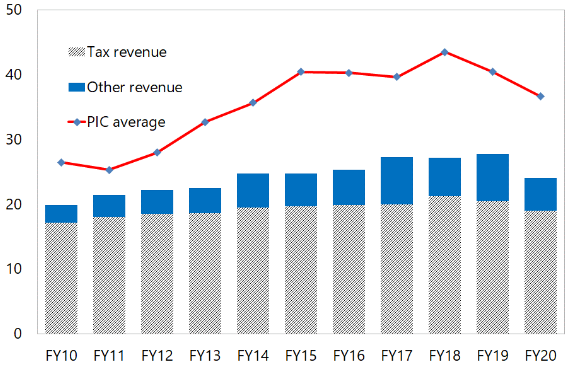


Sources: Palau authorities; IMF Statistics Department; and IMF staff estimates.

Figure 4. Palau: Fiscal Sector Developments

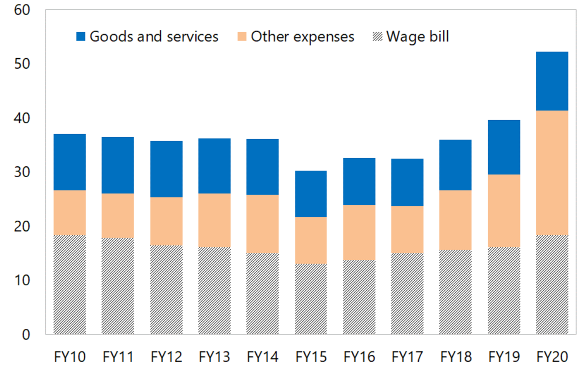
Both tax revenue and other revenue declined, reflecting the economic contraction and drop in tourism-related fees.

Domestic Revenue
(In percent of GDP)



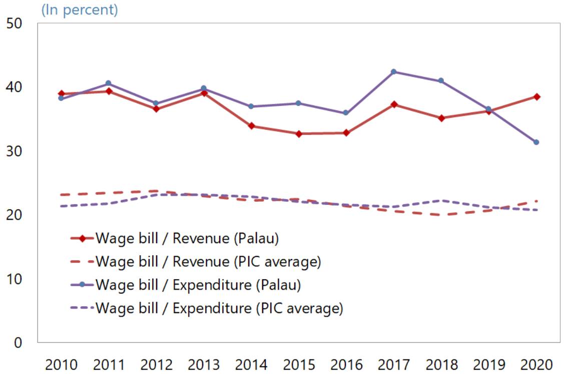
Current spending soared, mainly driven by higher subsidies, social benefits, and transfers.

Current Spending
(In percent of GDP)



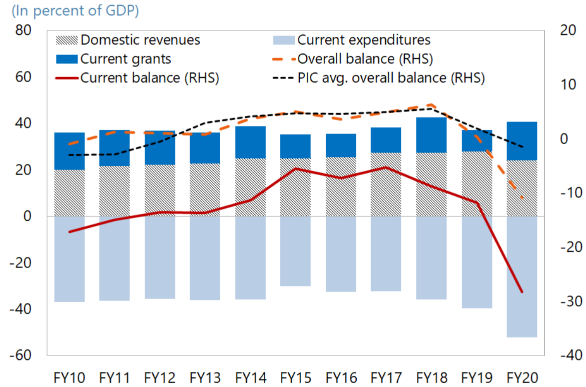
Palau's wage bill is larger than the average of peers in the pacific.

Wage Bill
(In percent)



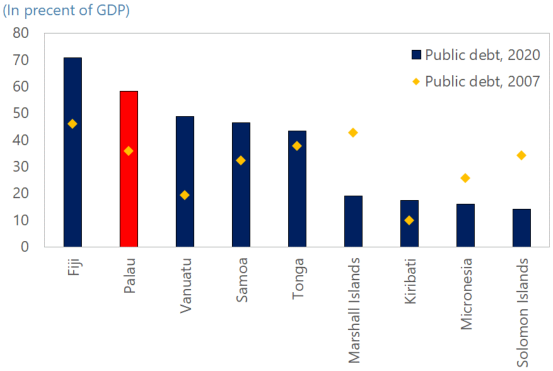
Palau's fiscal balance widened more than that of peers in the Pacific, reflecting its heavy reliance on tourism.

Fiscal Balance
(In percent of GDP)



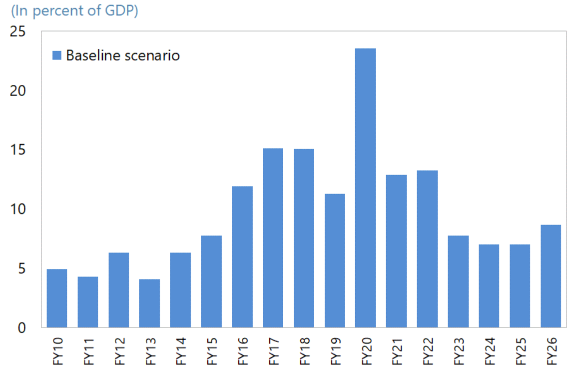
Palau's public debt remains high by regional standard.

Public debt
(In percent of GDP)



Government deposit is expected to decline in the medium term, reflecting future financing needs.

Government Currency and Deposits
(In percent of GDP)



Sources: Palau authorities; and IMF staff estimates.

Table 1. Palau: Selected Economic Indicators, 2016/17–2025/26 1/

Nominal GDP for FY2020: US$258 million
Population (2019): 17,457
GDP per capita for FY2020: US$14,784
Quota: SDR 3.1 million

	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
					Est.			Proj.		
Real sector										
Nominal GDP (million US$)	285.3	284.7	274.2	257.7	216.2	242.7	294.9	305.5	316.7	327.7
Real GDP growth (percent change)	-3.3	-0.1	-1.9	-9.7	-17.1	9.4	18.3	2.9	2.9	2.7
GDP deflator (percent change)	-1.1	-0.1	-1.8	4.1	1.2	2.5	2.8	0.7	0.7	0.8
Consumer prices (percent change; period average)	0.9	2.0	0.6	0.7	1.2	3.0	2.8	0.7	0.7	0.8
Tourist arrivals (number of visitors)	122,103	115,997	89,726	41,674	3,167	24,708	85,710	89,996	94,496	99,220
Expenditure per Tourist Arrival (US$)	976	984	1,061	1,257	1,273	1,312	1,361	1,384	1,408	1,432
Public finance					(In percent of GDP)					
Central government										
Revenue	40.3	44.5	44.5	47.4	46.3	41.2	38.0	39.0	38.6	38.9
Taxes and other revenue	27.2	27.2	27.8	24.0	22.1	20.3	22.9	24.3	24.8	25.4
Grants	13.1	17.3	16.7	23.4	24.2	21.0	15.1	14.7	13.8	13.6
Expenditure	35.5	38.2	44.1	58.3	65.8	53.9	41.1	39.4	38.4	37.1
Expense	32.5	35.9	39.6	52.3	61.3	48.9	36.7	35.3	34.1	32.3
of which: grants to other government units	5.1	6.5	11.1	14.1	18.3	12.7	7.4	6.6	6.1	6.0
Net acquisition of nonfinancial assets	3.0	2.3	4.5	6.1	4.5	5.0	4.4	4.2	4.3	4.8
Current fiscal balance (excluding grants) 2/	-5.3	-8.8	-11.8	-28.3	-39.2	-28.6	-13.8	-11.0	-9.2	-6.9
Current fiscal balance (including current grants) 3/	5.6	6.6	-1.0	-11.8	-20.1	-12.1	-2.6	0.0	1.6	3.7
Net lending (+)/borrowing (–)	4.8	6.3	0.4	-10.9	-19.5	-12.6	-3.2	-0.5	0.2	1.9
General government debt	34.4	37.0	38.6	62.1	85.7	90.3	74.0	71.1	66.7	62.1
					(In millions of U.S. dollars)					
Compact Trust Fund (CTF) balance	219.5	297.5	281.9	275.6	330.3	333.7	337.3	341.1	345.1	349.4
Government cash and deposits 4/	43.2	42.9	31.0	60.7	27.8	32.2	22.9	21.5	22.3	28.4
In percent of GDP	15.1	15.1	11.3	23.6	12.9	13.3	7.8	7.0	7.0	8.7
Monetary sector										
Credit to private sector (in percent of GDP)	12.1	12.3	11.6	11.8	..	..	..	..	..	..
Credit to private sector (percent change)	15.4	1.9	-9.3	-4.8	..	..	..	..	..	..
Balance of payments 3/										
Trade balance	-138.9	-136.5	-142.9	-147.8	-117.0	-128.1	-150.9	-145.5	-153.9	-160.4
Exports (f.o.b.)	14.6	15.5	13.4	6.1	8.7	10.1	13.9	14.1	14.3	14.6
Imports (f.o.b.)	153.5	151.9	156.4	153.8	125.7	138.2	164.8	159.6	168.3	175.0
Tourism receipts	113.0	104.8	91.9	50.9	3.9	31.3	112.8	120.5	128.8	137.6
Current account balance										
Including grants	-55.3	-44.4	-85.3	-124.4	-120.8	-109.6	-68.7	-61.8	-63.0	-61.3
Excluding grants	-93.4	-94.3	-120.6	-154.9	-152.8	-136.3	-99.0	-92.5	-94.4	-93.5
International Investment Position	-136.1	-105.0	-176.8	-256.3	-364.2	-438.5	-470.3	-494.4	-520.5	-544.4
Assets	629.0	715.2	688.9	736.9	721.7	734.6	763.5	801.4	836.1	874.6
Liabilities	765.1	820.2	865.7	993.2	1,085.9	1,173.0	1,233.7	1,295.8	1,356.5	1,419.0
Of which: External debt	85.9	91.8	91.4	150.1	183.4	217.9	214.8	210.8	203.2	194.8
					(In percent of GDP)					
Current account balance										
Including grants	-19.4	-15.6	-31.1	-48.3	-55.9	-45.2	-23.3	-20.2	-19.9	-18.7
Excluding grants	-32.7	-33.1	-44.0	-60.1	-70.7	-56.2	-33.6	-30.3	-29.8	-28.5
International Investment Position	-47.7	-36.9	-64.5	-99.4	-168.4	-180.7	-159.5	-161.8	-164.3	-166.1
Of which: External debt	30.1	32.2	33.3	58.2	84.8	89.8	72.8	69.0	64.2	59.4

Sources: Palau authorities; and IMF 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: Balance of Payments, 2016/17–2025/26 1/

	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
					Est.	Proj.				
	(In millions of U.S. dollars, unless otherwise indicated)									
Current account balance	-55.3	-44.4	-85.3	-124.4	-120.8	-109.6	-68.7	-61.8	-63.0	-61.3
Goods and services balance	-79.8	-83.1	-108.9	-150.1	-146.6	-131.4	-90.6	-79.0	-80.7	-79.6
Goods balance	-138.9	-136.5	-142.9	-147.8	-117.0	-128.1	-150.9	-145.5	-153.9	-160.4
Exports of goods f.o.b.	14.6	15.5	13.4	6.1	8.7	10.1	13.9	14.1	14.3	14.6
Imports of goods f.o.b.	153.5	151.9	156.4	153.8	125.7	138.2	164.8	159.6	168.3	175.0
Services balance	59.1	53.4	34.1	-2.4	-29.5	-3.2	60.3	66.4	73.2	80.9
Exports of services	128.1	119.6	105.6	62.1	15.7	43.9	126.1	134.5	143.5	153.3
Travel	113.0	104.8	91.9	50.9	3.9	31.3	112.8	120.5	128.8	137.6
Imports of services	69.0	66.2	71.6	64.4	45.3	47.1	65.8	68.1	70.3	72.4
Primary income balance	-5.1	-7.2	-0.9	5.7	6.1	6.7	0.8	-4.3	-4.8	-5.3
Inflows	23.0	22.5	26.4	18.2	23.0	24.8	26.0	27.1	28.2	29.3
Outflows	28.1	29.7	27.3	12.5	16.9	18.0	25.2	31.4	33.0	34.6
Secondary income balance	29.6	45.9	24.5	20.0	19.6	15.0	21.1	21.5	22.5	23.6
Inflows	52.2	69.2	47.5	40.2	40.1	36.0	42.7	43.3	44.4	45.6
Of which: Grants on budget	38.1	49.9	35.4	30.4	32.0	26.7	30.3	30.7	31.5	32.2
Outflows	22.7	23.3	22.9	20.2	20.5	21.0	21.6	21.7	21.9	22.0
Capital account balance	20.6	82.6	34.9	29.5	17.3	17.3	17.7	17.7	15.8	16.0
Net lending/borrowing (Current+Capital)	-34.8	38.2	-50.4	-94.9	-103.6	-92.3	-51.0	-44.1	-47.1	-45.3
Financial account balance	-44.8	13.6	-75.6	-84.6	-103.6	-92.3	-51.0	-44.1	-47.1	-45.3
Direct investment (net lending(+)=assets-liabilities)	-43.3	-47.6	-45.7	-72.9	-51.2	-52.4	-63.7	-66.0	-68.4	-70.8
Portfolio investment (net lending(+)=assets-liabilities)	1.4	67.2	-11.8	-10.1	42.0	-9.9	-10.3	-10.7	-10.9	-10.9
Other investment (net lending(+)=assets-liabilities)	-3.0	-6.0	-18.1	-1.7	-94.4	-29.9	23.1	32.6	32.2	36.4
Assets (net acquisition)	4.2	0.9	-15.8	52.0	-71.7	4.3	19.8	28.4	24.5	27.8
Liabilities (net incurrence)	7.2	6.9	2.3	53.6	22.7	34.2	-3.2	-4.2	-7.7	-8.5
Of which: Public sector loans	7.2	6.6	2.7	53.6	22.7	34.3	-3.2	-4.1	-7.6	-8.5
Errors and omissions	-10.0	-24.6	-25.2	10.3	0.0	0.0	0.0	0.0	0.0	0.0
Current account										
Including official grants	-55.3	-44.4	-85.3	-124.4	-120.8	-109.6	-68.7	-61.8	-63.0	-61.3
Excluding official grants	-93.4	-94.3	-120.6	-154.9	-152.8	-136.3	-99.0	-92.5	-94.4	-93.5
Memorandum items:	(In percent of GDP, unless otherwise indicated)									
Nominal GDP (million US$)	285.3	284.7	274.2	257.7	216.2	242.7	294.9	305.5	316.7	327.7
Current account										
Including official grants	-19.4	-15.6	-31.1	-48.3	-55.9	-45.2	-23.3	-20.2	-19.9	-18.7
Excluding official grants	-32.7	-33.1	-44.0	-60.1	-70.7	-56.2	-33.6	-30.3	-29.8	-28.5
External debt	30.1	32.2	33.3	58.2	84.8	89.8	72.8	69.0	64.2	59.4
International Investment Position	-47.7	-36.9	-64.5	-99.4	-168.4	-180.7	-159.5	-161.8	-164.3	-166.1
Assets	220.4	251.2	251.3	286.0	333.7	302.7	258.9	262.3	264.0	266.9
Compact Trust Fund	76.9	104.5	104.5	108.7	152.8	137.5	114.4	111.6	109.0	106.6
Social Security Funds	48.3	50.8	52.8	59.9	73.6	67.7	57.5	57.3	57.2	57.2
Other	95.3	96.0	94.0	117.4	107.4	97.5	87.0	93.3	97.8	103.0
Liabilities	268.1	288.1	315.8	385.4	502.2	483.4	418.3	424.1	428.3	433.0
FDI	232.2	249.4	275.7	321.6	406.9	384.2	337.7	347.6	356.9	366.6
Government debt	20.2	23.4	25.1	48.6	73.9	78.4	63.7	60.5	56.4	52.5
Public enterprise debt	9.9	8.9	8.3	9.7	10.9	11.4	9.1	8.5	7.7	7.0
Other liabilities, banks	5.8	6.4	6.7	5.6	10.4	9.4	7.8	7.5	7.2	7.0
Errors and Omissions	-3.5	-8.6	-9.2	4.0	0.0	0.0	0.0	0.0	0.0	0.0

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

1/ Fiscal year ending September 30.

Table 3. Palau: National Government Operations, 2016/17–2025/26 1/

	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
					Est.			Proj.		
National Government Operations					(In millions of U.S. dollars)					
Revenue	115.0	126.7	121.9	122.2	100.2	100.1	111.9	119.0	122.3	127.6
Taxes	56.9	60.5	56.0	48.8	31.7	34.8	48.2	52.4	56.0	59.7
Taxes on income, profits and capital gains	10.9	11.0	15.1	12.0	7.8	8.5	11.8	12.9	13.8	14.7
Taxes on goods and services	21.1	21.4	21.5	17.3	11.3	12.3	17.1	18.6	19.9	21.2
Taxes on international trade and transactions	16.0	15.7	13.5	15.7	10.2	11.2	15.5	16.8	18.0	19.2
Other taxes	8.9	12.4	5.9	3.8	2.5	2.7	3.8	4.1	4.4	4.7
Grants 3/	37.3	49.4	45.7	60.3	52.3	50.9	44.5	44.8	43.7	44.4
Current	31.0	43.7	25.1	42.5	35.4	29.9	33.2	33.5	34.2	34.9
U.S. Compact	13.1	24.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Drawdown from Compact Trust Fund	5.0	5.0	15.0	14.6	15.0	15.0	15.0	15.0	15.0	15.0
U.S. non-Compact	9.7	9.5	9.6	23.9	17.0	11.1	13.5	13.7	14.2	14.7
Other country	3.1	4.6	5.1	4.1	3.4	3.8	4.7	4.8	5.0	5.2
Capital	6.3	5.6	16.0	17.8	10.6	10.6	11.0	11.0	9.2	9.3
Of which : U.S. Compact	0.0	0.4	10.9	6.4	2.0	2.0	2.0	2.0	0.0	0.0
Other revenue	20.7	16.9	20.2	13.0	16.1	14.4	19.3	21.8	22.6	23.4
Expenditure	101.2	108.9	120.9	150.3	142.4	130.7	121.3	120.4	121.5	121.4
Expense	92.8	102.3	108.6	134.7	132.6	118.6	108.2	107.7	107.9	105.8
Of which: Compensation of employees	42.9	44.6	44.1	47.1	45.3	46.3	45.1	44.9	44.3	44.3
Of which: Use of goods and services	25.1	26.6	27.5	28.2	27.4	25.7	27.1	27.9	29.0	30.0
Net acquisition of nonfinancial assets	8.4	6.6	12.3	15.7	9.7	12.1	13.0	12.7	13.6	15.6
Domestic Current balance (excluding grants) 2/	-15.1	-24.9	-32.4	-72.8	-84.8	-69.4	-40.8	-33.5	-29.3	-22.7
Current Balance (including current grants) 3/	15.9	18.8	-7.3	-30.3	-43.4	-29.4	-7.6	0.0	4.9	12.2
Net lending (+)/borrowing (–) 4/	13.8	17.8	1.0	-28.2	-42.2	-30.6	-9.3	-1.4	0.8	6.1
					(In percent of GDP)					
Revenue	40.3	44.5	44.5	47.4	46.3	41.2	38.0	39.0	38.6	38.9
Taxes	19.9	21.2	20.4	18.9	14.7	14.3	16.3	17.1	17.7	18.2
Grants	13.1	17.3	16.7	23.4	24.2	21.0	15.1	14.7	13.8	13.6
Other revenue	7.3	5.9	7.4	5.1	7.5	5.9	6.5	7.1	7.1	7.1
Expenditure	35.5	38.2	44.1	58.3	65.8	53.9	41.1	39.4	38.4	37.1
Expense	32.5	35.9	39.6	52.3	61.3	48.9	36.7	35.3	34.1	32.3
Net acquisition of nonfinancial assets	3.0	2.3	4.5	6.1	4.5	5.0	4.4	4.2	4.3	4.8
Current balance (excluding grants) 2/	-5.3	-8.8	-11.8	-28.3	-39.2	-28.6	-13.8	-11.0	-9.2	-6.9
Current Balance (including current grants) 3/	5.6	6.6	-2.7	-11.8	-20.1	-12.1	-2.6	0.0	1.6	3.7
Net lending (+)/borrowing (–) 4/	4.8	6.3	0.4	-10.9	-19.5	-12.6	-3.2	-0.5	0.2	1.9
National Government Balance Sheet					(In percent of GDP)					
Assets	15.1	15.1	11.3	23.6	12.9	13.3	7.8	7.0	7.0	8.7
Cash and deposits	15.1	15.1	11.3	23.6	12.9	13.3	7.8	7.0	7.0	8.7
Liabilities	24.5	28.1	30.4	52.4	73.6	78.1	63.4	60.2	56.1	52.1
Domestic accounts payable	4.3	4.9	4.7	4.0	4.8	4.3	3.5	3.4	3.3	3.2
External debt	20.2	23.2	25.7	48.4	68.8	73.8	59.9	56.8	52.8	48.9
Net Financial Assets 5/	-9.3	-13.0	-19.1	-28.9	-60.8	-64.8	-55.7	-53.2	-49.1	-43.5
Memorandum Item:										
Nominal GDP (million US$)	285.3	284.7	274.2	257.7	216.2	242.7	294.9	305.5	316.7	327.7
Compact Trust Fund (in percent of GDP)	76.9	104.5	102.8	107.0	152.8	137.5	114.4	111.6	109.0	106.6

Sources: Palau authorities; and IMF 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 4. Palau: Assets and Liabilities of Deposit Money Banks, 2013/14–2019/20 1/

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
	(In millions of U.S. dollars)						
Assets	175.9	231.8	281.7	290.9	291.7	274.2	324.0
Notes and coins	3.1	2.3	2.2	2.2	1.8	2.6	4.5
Foreign assets	140.8	198.0	246.8	251.1	252.5	235.9	286.0
Claims	29.6	28.9	29.9	34.5	35.1	31.9	30.3
Private sector	32.1	31.0	31.8	36.3	36.5	33.7	32.8
Commercial	2.8	1.2	1.2	6.5	8.4	5.4	5.2
Consumer	29.2	29.8	30.6	29.8	28.1	28.2	27.6
Non-resident	0.0	0.0	0.1	0.1	0.0	0.0	0.0
less Reserve for Loan Losses	-2.5	-2.2	-2.0	-1.9	-1.4	-1.8	-2.5
Fixed Assets	1.4	1.4	1.5	1.6	2.0	3.5	1.8
Unclassified assets	0.9	1.3	1.3	1.5	0.3	0.3	1.4
Liabilities							
Deposits	171.2	225.8	275.3	283.8	283.3	263.8	316.3
Demand Deposits	73.3	91.9	114.2	102.1	95.3	106.7	131.7
Savings Deposits	84.6	120.9	146.6	165.9	159.5	125.4	150.9
Time and Certificate of Deposit	12.7	12.4	13.9	15.0	28.6	31.7	33.6
Deposits Due to Banks and Financial Institutions	0.6	0.5	0.7	0.8	0.0	0.0	0.0
Other Liabilities	0.1	0.8	0.1	0.3	0.3	2.1	1.8
Capital	4.6	5.2	6.2	6.8	8.1	8.3	5.9
Issued and Fully Paid Up Common Stock	4.0	4.0	4.1	4.1	4.1	4.1	4.0
Paid-in Premium	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Retained Profits (Losses) (Prior Years)	-1.3	-1.0	-0.9	-0.7	-0.5	-0.3	-0.7
Income (Loss) Year-to-date	1.8	2.2	3.1	3.3	4.4	4.4	2.6
Memorandum Item:							
Loan/deposit ratio (in percent)	17.3	12.8	10.9	12.2	12.4	12.1	9.6
Loans (in percent of GDP)	12.3	10.0	10.0	12.1	12.3	11.6	11.8
Loans (percent change)	5.9	-2.5	3.6	15.4	1.9	-9.3	-4.8
Deposits (percent change)	25.9	31.9	21.9	3.1	-0.2	-6.9	19.9
Consumer loans (in percent of private sector loans	91.2	96.2	96.3	82.2	76.9	83.9	84.1
Commercial loans (in percent of total loans)	8.8	3.8	3.7	17.8	23.1	16.1	15.9
Nominal GDP (million US$)	240.9	287.6	298.3	285.3	284.7	274.2	257.7

Sources: Palau authorities; and IMF staff estimates.

1/ Fiscal year ending September 30.

Table 5. Palau: Banks' Financial Soundness Indicators, 2016–2021Q1

	2016	2017	2018	2019	2020	2021Q1
Capital adequacy						
Regulatory capital to risk-weighted assets 1/	91.3	91.7	..	..	..	..
Regulatory Tier 1 capital to risk-weighted assets 1/	87.6	86.4	..	..	..	..
Asset quality						
Nonperforming loans to total gross loans	0.8	0.6	0.6	0.7	1.6	1.7
Provisions for loan losses to nonperforming loans	551.0	696.8	730.1	771.2	505.3	525.5
Earnings and profitability						
Return on assets	1.5	1.6	2.0	2.1	1.1	0.6
Interest margin to gross income	84.8	85.6	86.6	85.4	82.1	85.5
Noninterest expenses to gross income	37.9	35.1	32.3	32.3	41.0	33.7
Liquidity						
Liquid assets to total assets (liquid asset ratio)	87.4	86.0	86.2	85.0	88.2	88.4

Source: Financial Institutions Commission (FIC).
1/ Uninsured banks only.

Appendix I. Palau's Climate Change Challenges[1]

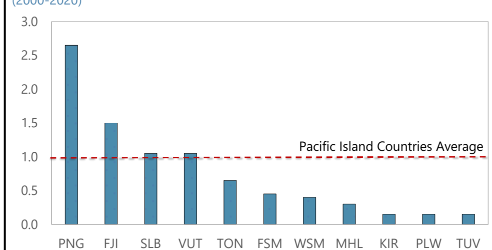
Palau is vulnerable to climate change. The authorities have laid out ambitious targets related to climate change, but limited financing has hindered timely implementation of adaptation projects, calling for diversification of financing sources. This appendix also highlights that Palau could reinvigorate its mitigation efforts by promoting renewable energy production to improve the energy mix, and by strengthening synergy between its climate change objectives and its tourism strategy.

A. Impact of Climate Change on Palau

1. **Climate change poses an existential threat to Palau.** Miles et al. (2020)[2] highlights several aspects of Palau's climate change risks. Climate change could increase the intensity of tropical cyclones. Sea water level and air temperature have been on the rise in Palau (panels in Figure 1), and these trends are expected to continue. According to the projections by the Australian Bureau of Meteorology and Commonwealth Scientific and Industrial Research Organization (2014), annual average air temperature in Palau will rise by 0.7-1.6 °F by 2030, and 1.3-2.5 °F by 2050 relative to the period between 1986 and 2005 under the medium-emissions scenario.

2. **Climate events impose social as well as economic costs on Palau**. Though frequency of natural disasters is not as high as in the other pacific island countries (right chart), cyclones with greater intensity could inflict devastating damage to Palau's infrastructure, raising importance of climate risk financing for Palau[3]. The gradual rise of sea level will erode low-lying coastal land that is critical for Palau's economic and agricultural activities. Higher air temperature could increase cases of heat stroke and lower labor productivity. Warmer seawater will expose the coral reef to excess heat, potentially undermining Palau's attractiveness as a prime worldwide diving and beach destination. The authorities estimate the negative economic impact from climate change to be in the range of 4 to 20 percent of GDP annually[4], including through adverse effects to agricultural and fish produce, and a decline in tourism revenue.

Palau and Pacific Island Countries: Average Number of Natural Disasters per Year
(2000-2020)



Source: EM-DAT, CRED / UCLouvain, Brussels, Belgium – www.emdat.be (D. Guha-Sapir)

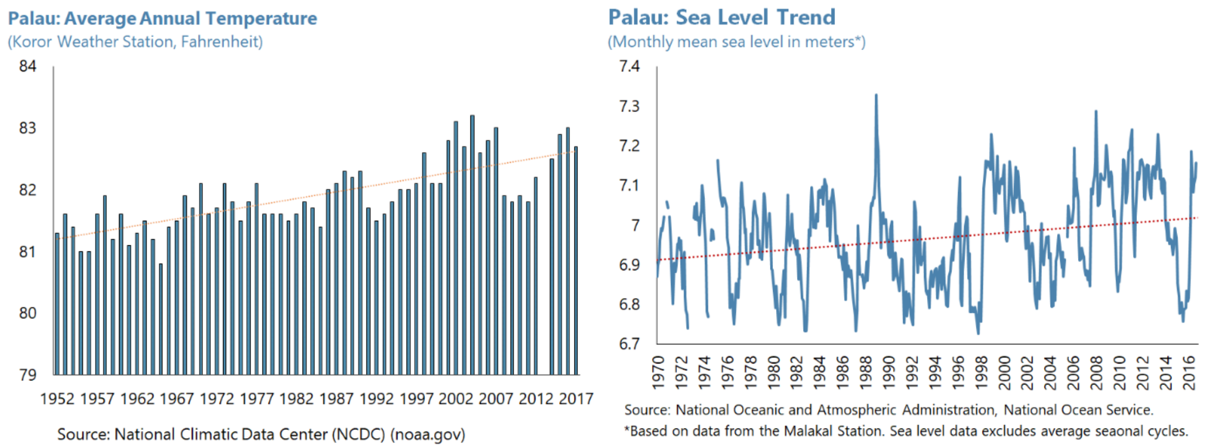
[1] Prepared by Takuma Hisanaga (APD) with research assistance of Ricardo Pinto Davico (APD).

[2] Miles, W., Z. Grecni, E. Matsutaro, P. Colin, V. Keener, Y. Golbuu, et al., 2020: Climate Change in Palau: Indicators and Considerations for Key Sectors. Report for the Pacific Islands Regional Climate Assessment. Honolulu, HI: East-West Center

[3] According to the Pacific Catastrophe Risk Assessment and Financing (PCRAFI, 2011), expected annual loss due to tropical cyclones and earthquakes for Palau is 2.7 million USD (about 1 percent of 2019 GDP). Over the next 50 years, Palau has a 50 percent chance of incurring losses exceeding 30 million USD (11 percent of 2019 GDP), and a 10 percent chance of experiencing catastrophic losses exceeding 247 million USD (88 percent of 2019 GDP).

[4] Palau Climate Change Policy, 2015.

Figure 1. Palau: Rising Temperature and Sea Level



B. Palau's Climate Change Policies and Implementation

3. **Palau's strategic approach to climate change is shaped by the authorities' three defining decisions made in the mid-2010s.** First, the government established its basic climate change strategy in "Palau Climate Change Policy" in 2015. The strategy centers around three objectives: (i) enhance adaptation and resilience, (ii) manage disasters and minimize disaster risk; and (iii) mitigate global climate change by working towards low emission development. Second, in 2016, Palau became one of the first states to ratify the UNFCCC (United Nations Framework Convention on Climate Change) Paris Agreement. In its "Intended Nationally Determined Contribution" submitted to the UNFCCC, Palau introduced three indicative targets: (i) reduce energy sector emissions by 22 percent relative to the 2005 levels by 2025, (ii) generate 45 percent of its energy from renewable sources by 2025, and (iii) increase energy efficiency by 35 percent by 2025. Third, in 2016, the government also aligned its tourism strategy with its climate change objectives in "the Palau Responsible Tourism Policy Framework" by prioritizing protection of the Palau's pristine environment and targeting niche markets as opposed to mass-tourism[5].

4. **The implementation of adaptation measures has been hampered by financing constraints.** The Five-year Climate Change Action Plan, which constitutes a part of Palau Climate Change Policy, has identified a list of priority adaptation projects. These include for instance the relocation of the national hospital[6] due to rising sea levels and the establishment of emergency shelters. The estimated total cost of the 5-year Climate Change Action Plan —for both the public and private sectors combined—was 500 million USD for the period FY2016-FY2020 (Figure 2, left chart). However, Palau's first Voluntary National Review of the SDGs ("Pathway to 2030" (2019)) stated that only 22.8 million USD was made available until 2018, suggesting that limited access to

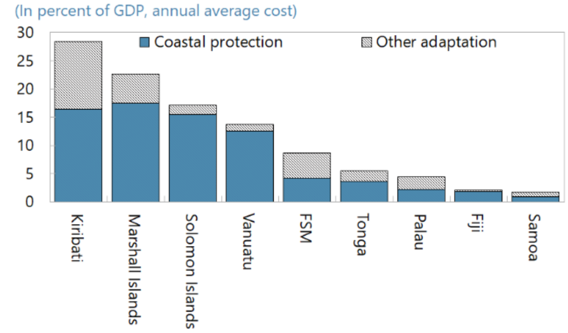
[5] Palau has already taken several initiatives to safeguard the environment while promoting the tourism industry. For example, in 2009, Palau created a shark sanctuary where commercial shark-fishing operations are prohibited. Palau also became the first nation to ban reef-damaging sunscreen products in January 2020.

[6] President signed an executive order in September 2021 to establish a committee to evaluate new locations.

funding for climate adaptation is a major impediment. The cost estimate is currently under revision by the new administration.

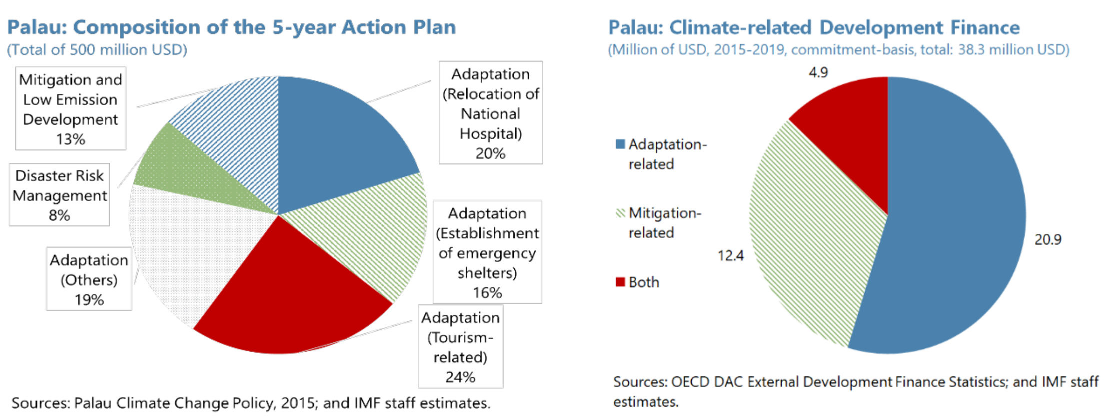
5. **Looking ahead, Palau faces substantial adaptation needs over the long-term.** The World Bank estimates additional costs for coastal protection and other adaptation projects during 2020's to be about 4 percent of GDP per year for Palau.[7] Meeting these long-term financing needs will remain a challenge. According to the OECD's External Development Finance Statistics, the amount of climate-related development finance between 2015 and 2019 for Palau was about 38 million USD, out of which the financing for adaptation was between 21 to 26 million USD (Figure 2, right panel)[8]. This is equivalent to 4 to 5 million USD per year (1.5 to 1.9 percent of 2019 GDP), covering about a half of the costs estimated by the World Bank. It will be important for the government to renew efforts in the next few years to secure financing for adaptation projects from diversified sources, both domestically and internationally. In this context, the grant from the Green Climate Fund in 2020, a first time for Palau is a welcome step[9]. The renewal of the Compact Agreement with the United States beyond 2024 could provide further boost to the climate change efforts.

Palau and Pacific Island Countries: Costs of Coastal Protection and Infrastructure Adaptation
(In percent of GDP, annual average cost)



Sources: World Bank (2016) "Climate and Disaster Resilience" Pacific Possible Background Report No. 6; and IMF staff estimates.

Figure 2. Palau: Costs and Financing for Climate Change



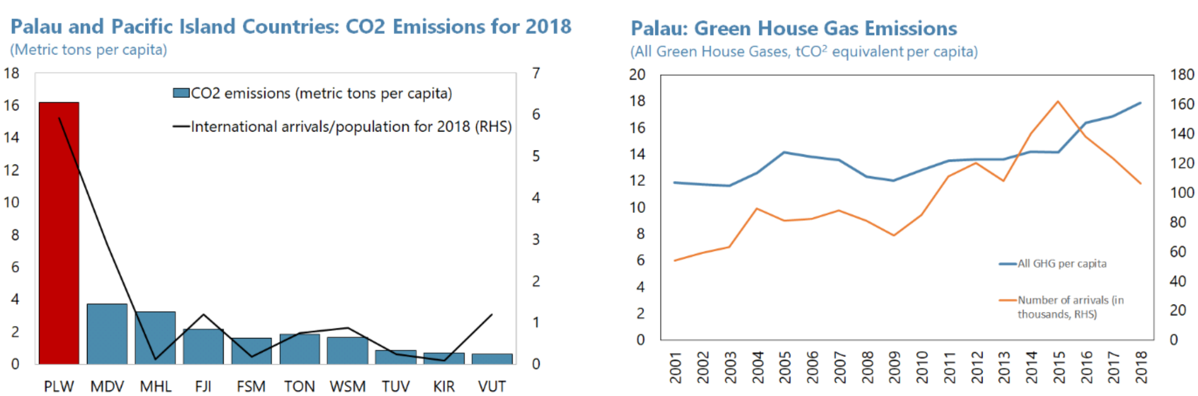
[7] This estimate by the World Bank is different from the estimate of the Palau's 5-year action plan. The former looks at long-term adaptation costs in pacific island countries based on a model, while the latter is the total cost of the authorities' priority projects scheduled for FY2016 and 2020 (a bottom-up approach).

[8] The amount is 26 million USD if the projects that cover both adaptation and mitigation are counted as adaptation, and 21 million USD if such projects are excluded.

[9] This grant is a part of the multi-country project to enhance climate information and knowledge services for resilience.

6. Palau has room to improve its energy generation mix, which would add to mitigation efforts. Though total emission from Palau is negligeable on a global scale, CO_2 emissions per capita for Palau is high compared to other pacific island and small countries, likely reflecting large inflows of visitors who contribute to emissions but are not included in the denominator: population (Figure 3, left panel). Reflecting a development of economic activities, greenhouse gas emissions per capita have been on the rise in Palau despite a continuous decline in inbound visitors (Figure 3, right panel). Palau has room for a greener, lower-emission energy production mix. For example, considering the small share of renewable energy production in Palau's (8 percent), the authorities could strengthen efforts to increase renewable energy, notably solar energy. With support from the Asian Development Bank (AsDB), the authorities plan to provide affordable financing to low-income and female households for promoting energy-efficient housing and roof-top solar electricity generation. The authorities have also secured a policy-based loan from the AsDB in 2020 to improve the financial viability of the PPUC, which could facilitate the entry of private renewable energy producers.

Figure 3. Palau: Climate Change Mitigation for Palau



Source: World Development Indicators, The World Bank

Sources: Climate Watch Historical GHG Emissions, 2021; United Nations, World Population Prospects, 2019; and World Development Indicators, The World Bank.

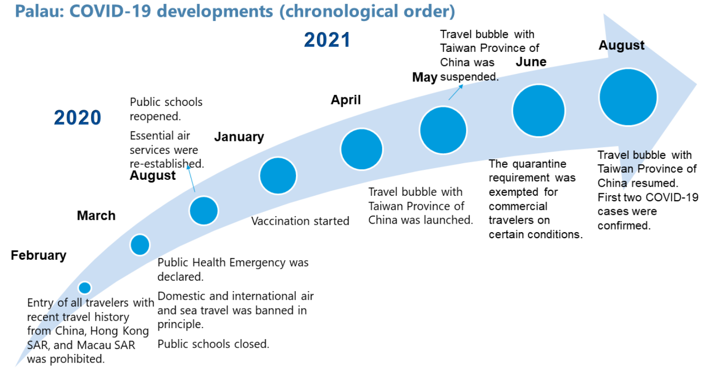
Appendix II. Covid-19 Developments

Strict and preemptive measures have helped Palau remain free of COVID-19 infections until August 2021. A cautious approach towards reopening has started, supported by a high vaccination rate.

1. **A travel ban on arrivals from the most affected countries and other preemptive measures were introduced in 2020**. In March 2020, a public health emergency was issued to fast-track procurement of medical supplies, domestic and international air and sea travel were banned with a few exceptions (e.g. repatriation), public schools closed, and public events were restricted. These early and stringent measures helped prevent domestic infections.

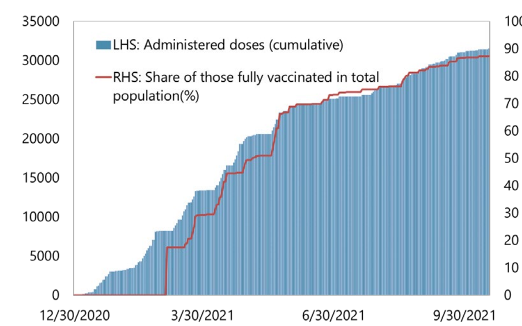
2. **The government took a cautious approach towards reopening**. The authorities first set up domestic COVID-19 testing capability and quarantine facilities before starting to cautiously loosen restrictions. In August 2020, public schools reopened with safety measures and the government reestablished essential air services, allowing a minimum number of flights for emergencies, repatriation, medical referral, and worker recruitment. After several months of preparation, a travel bubble with Taiwan Province of China, was launched on April 1, 2021. However, the bubble was suspended on May 19, 2021 due to a rise of COVID-19 infections in Taiwan Province of China and resumed in mid-August. Effective June 18, 2021, the quarantine requirement was exempted for commercial airline travelers, on a condition that they present a proof of vaccination and either a negative COVID-19 PCR test result or proof of recovery from COVID-19. As of October 2021, Palau maintains a regular weekly flight service with Guam. On August 21, Palauan health authorities announced that two visitors were tested positive, confirming the nation's first active COVID-19 cases. As of October 17th, eight cases have been confirmed.

Palau: COVID-19 developments (chronological order)



3. **Palau's vaccination program has proceeded at a fast pace**. Palau was included in the U.S. COVID-19 vaccine distribution program (*Operation Warp Speed*) as one of the freely associated states. Its nationwide vaccination program started on January 3, 2021 and the U.S. provided further support to the roll-out of vaccines by dispatching a group of health experts in April 2021. Palau has become one of the countries with the largest COVID-19 vaccine coverage. As of October 17, 2021, 15,643 persons (87 percent of the population) are fully vaccinated.

Palau: COVID-19 Vaccination



Source: United States Centers for Disease Control and Prevention.

Appendix III. Policy Responses to the Covid-19 Pandemic

Palau has responded to the pandemic with a comprehensive policy package. In addition to a $20 million (7.8 percent of GDP) package under the Coronavirus One Stop Shop Relief Act (CROSS Act), citizens of Palau received unemployment benefits under the U.S. Coronavirus Aid, Relief, and Economic Security Act (CARES Act) with up to $19 million or 7.4 percent of GDP available.

1. Package under the CROSS Act.

- **Unemployment benefits** (US$6.9 million): Both Palauan and foreign nationals could receive unemployment benefit of US$100 (i) per week for the unemployed, (ii) per fortnight if monthly earnings are lower by 50 percent, (iii) per month if monthly earnings are lower by more than 25 percent (but less than 50 percent). About 10,824 beneficiaries received this program by end-FY2020, including 80 percent of foreign workers.[1] The average benefit per worker under this program is $219 per month.

- **New temporary job creation scheme** (US$4.3 million): Those unemployed because of the pandemic were eligible for work in the new temporary jobs program at the minimum wage of US$3.5 per hour. Nonresidents, particularly in the tourism sector, benefitted from this program, coupled with a transfer of their employment visas. The program has provided support to 1,294 individuals by end-FY2020.

- **Lending scheme for the private sector** (US$8 million): Administered through the National Development Bank of Palau (NDBP), the loans under this program have 10-year terms, no payment obligations during the first two years, an annual interest rate of 2 percent starting from the third year, and principal repayments from the fourth year. These loans were designed to cover fixed costs or to finance improvement of tourism facilities.[2] About US$1.5 million was disbursed from the allocated envelope by end-FY2020.

- **Temporary subsidies for utility bills** (US$0.8 million): This program provides funding to cover electricity, water, and sewer bills for low-income households. The subsidy covers 150 kilowatt hours of electricity and 5,000 gallons of water supply per household.

[1] Palauan who were also eligible for the unemployment benefits under the U.S. CARES Act, which provides larger benefits than under the CROSS Act, transferred to the CARES Act.

[2] 2/ In Addition to administering the US$8 million targeted lending program, the NDBP has provided financial reliefs, including interest only payments, term extension, loan consolidation, and temporary payment deferrals. Some private banks introduced payment deferrals and forbearance programs.

2. Benefits under the CARES Act.

- **Pandemic Unemployment Assistance** (PUA): From February 2, through December 31, 2020, the program provided US$397 per week for up to 39 weeks to individuals, including self-employed, who lost their jobs due to pandemic.

- **Federal Pandemic Unemployment Compensation** (FPUC): Individuals who receive the PUA were also eligible to receive an additional US$600 supplemental payment under the FPUC, payable only for weeks of unemployment beginning on or after April 1, through July 31, 2020.

Summary of Policy Responses to the Covid-19 Pandemic

	Amount in US$ Million	in percent of GDP	**Financing sources**	**Utilization 1/** in US$ Million (in percent)
Health related responses	**0.9**	**0.4**	**Budget**	**-**
Additional fund appropriated to the Hospital Trust Fund for prevention and preperation for COVID-19	0.9	0.4		-
The CROSS Act	**20.0**	**7.8**	**Budget**	**5.1 (25.5)**
Unemployment benefits; $100 (i) per week for the unemployed; (ii) per fortnight if monthly earnings reduced by 50%; (iii) per month if monthly earnings reduced by more than 25%	6.9	2.7		2.3 (33.3)
Temporary jobs program: at minimum wage of $3.50 per hour	4.3	1.7		1.3 (29.8)
Private sector lending program: loans to affected industries through the National Development Bank of Palau	8.0	3.1		1.5 (18.8)
Lifeline subsidies for utility services: electricity, water, and sewer for low income households	0.8	0.3		-
The US CARES Act	**up to 19**	**7.4**	**Foreign grants**	**13.5 (70.8)**
The Pandemic Unemployment Assistant (PUA) program: $397 per week up to 39 weeks	-	-		-
The Federal Pandemic Unemployment Compensation (FPUC) program: $600 per week, April-July 2020.	-	-		-

1/ As of end FY2020.

Appendix IV. External Sector Assessment[1]

Based on preliminary data and EBA-lite model results, Palau's external position is assessed to be substantially weaker than implied by fundamentals and desirable policies. The COVID-19 pandemic and associated travel disruptions have put significant strain on Palau's external position, with the current account deficit widening significantly. Over the medium-term, the current account deficit is expected to narrow toward the pre-COVID level as the pandemic fades and tourism activities resume. While the availability of large concessional loans and banks' large foreign assets are mitigating factors to external financing risks, the authorities should reinvigorate structural reform efforts and pursue a well-designed fiscal adjustment plan to improve the current account balance. Palau's external assessment is subject to large uncertainty around any point estimate, reflecting difficulties in predicting key factors shaping the external position in the future (e.g., tourism revival, renewal of the Compact Agreement with the United States), limited data, and frequent large data revisions.

1. External position. Being a small island nation with little natural resources, Palau's external position is vulnerable. Without fossil fuel resources and limited availability of arable land, Palau relies heavily on imports for food, fuel, and industrial products. Palau's exports come almost entirely from inbound tourism. However, export revenues from tourism are not large enough to make up for imports in most years, leading to chronic current account deficits. The primary income balance is broadly balanced, while secondary income balance is positive thanks to grant receipts, partially offsetting the negative trade balance. Even before the pandemic, tourist arrival was on a downward trend. As a result, the current account deficit widened from 16 percent of GDP in FY2018 to 31 percent of GDP in FY2019. In FY2020, the current account deficit further widened to 48 percent of GDP as tourism-related service exports effectively evaporated after April 2020. Palau has a negative NIIP (net international investment position)[2], which declined further to about -99 percent of GDP in FY2020. Over the medium-term, the current account deficit is expected to narrow toward the pre-COVID average level as the pandemic fades, tourism activities resume, and fiscal positions improve, though significant uncertainty remains around this outlook.

2. External balance assessment (EBA). The External Sustainability (ES) approach is considered to be more informative than other approaches in the case of Palau, considering its island economy features and unusual external financing structure, the widely negative NIIP and data limitations.[3] While Palau has a CA gap of -19.7 percent according to the ES model[4], difficulties in predicting key factors that are expected to drive the external position (for instance tourism revival, the response of import to lower tourism, and the renewal of the Compact Agreement with the United States), limited data, and frequent large data revisions imply a large uncertainty around any point estimate. In this context, staff view that the CA gap is likely to be in the range of -5 to -20 percent in FY2020,

[1] Prepared by Takuma Hisanaga (APD) with research assistance of Ricardo Pinto Davico (APD).

[2] In 2019, there was a major historical revision in IIP data as the authorities improved estimation methodology of FDI. As FDI (liability) was revised upwards, the IIP net position has become negative.

[3] The Current Account and REER approaches are less applicable for Palau due to data limitations.

[4] The ES model calculates the level of current account needed to stabilize the NIIP at the level of 2020 (-99% of GDP).

accounting for the large uncertainty and particularly a possible sharper reduction in import in response to a long-lasting reduced tourism inflow. As such, staff assesses Palau's external position in FY2020 to be substantially weaker than the level implied by fundamentals and desirable policies, while noting a possible revision of FY2020 data.

Palau: Model Estimates and staff view for 2020 based on the External Sustainability Approach (in percent of GDP)

REER gap by model estimates (in percent)	CA gap by model estimates	Staff view of possible range of CA gap
48.6	-19.7	-5~-20

3. Imminent risks of external financing distress, however, are still low, given the structure of external financing. This assumes continuous access to long-term, concessional loans from the multilateral organizations and the availability of grant financing from the U.S. Large foreign assets in the banking sector (about 111 percent of GDP in 2020) are also a mitigating factor to external financing risks. However, protracted external imbalances could pose a financing challenge over the medium term. As the level of the CA deficit pre-COVID was already elevated, additional efforts remain needed to further reduce it. Reinvigorated structural reforms, including (i) increasing renewable energy production to cut fuel imports, and (ii) developing domestic agri-food supply chain to reduce food imports, could help improve the current account balance. An ambitious fiscal adjustment strategy (for instance 1 percent of GDP per year for 5 years) could also help improve the external position while providing room to increase public investments in climate-resilient infrastructure.

4. Exchange rate and competitiveness. Palau has no central bank and uses U.S. dollar as its legal tender. Therefore, Palau's real effective exchange rate (REER) broadly follows that of the U.S. Dollar. Given that tourism costs in Palau are broadly similar to other Pacific destinations (e.g., Samoa and Vanuatu), exchange rate developments could be a factor that tourists take into account when deciding on their destinations. The real effective exchange rate moderately depreciated in the second half of 2020, in line with movement of U.S. dollar.

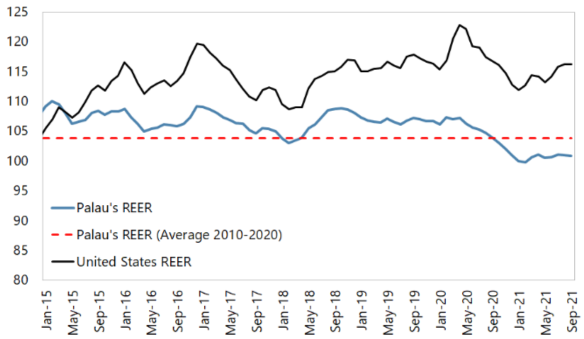
5. Reserves. The government's U.S. dollar deposits effectively serve as reserves and as the main instrument to absorb short-term liquidity shocks. Thanks to a series of AsDB loans that more than offset a revenue shortfall and the stimulus expenditures in FY2020, the government deposits increased in FY2020 to 23.6 percent of GDP, covering more than 3 months of imports. The current level of government deposits is also adequate as a fiscal buffer, corresponding to 5 months of government spending which is higher than the standard yardstick of one month of government spending used for an appropriate fiscal buffer[5]. The need for a liquidity buffer to repay short-term

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

external debt is limited for Palau, thanks to the country's access to long-term concessional financing from the bilateral or multilateral official creditors.

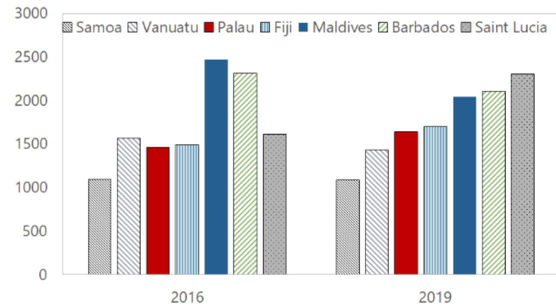
Figure 1. Palau: Real Effective Exchange Rate and Competitiveness

Real Effective Exchange Rate
(Index number, 2010=100)



Source: IMF Statistics Department.

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



Note: Week at the Beach Index compiles the average cost of a basket of the basic items typically consumed on a 7-day-visit to a beach destination.
Sources: TripAdvisor; WorldCabFares; Numbeo; and IMF staff estimates.

Appendix V. Risk Assessment Matrix[1]

	Sources of Risks (Horizon)	Relative Likelihood (high, medium or low)	Expected Impacts if Realized (high, medium or low)	Recommended Policy Responses
Domestic	***1. 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 outputs losses. Damages to infrastructure lead to lower growth.	Contingent plans should include maintaining reserve buffers and expanding contingent financing plans with development partners. Strengthen infrastructure including coastal protection and planning.
	2. Uncontrolled Covid-19 local outbreak (short term)	**Low** While likelihood is low given the successful vaccination campaign in Palau, there is a risk that vaccine-resistant variants could cause a local outbreak.	**High** Limited healthcare capacity could require costly containment measures and prolong border closure.	Secure financing sources or draw down government deposits to prop up healthcare capacity and provide support to firms/households.
	3. Graduation from the OECD's DAC list	**High** Palau is expected to graduate in 2022 from the OECD's DAC list of countries eligible for official development assistance.	**Medium** Availability of concessional financing, particularly grants could tighten over the medium-term.	Fiscal adjustment could provide buffer against potential shortfall of concessional financing, particularly grants.
	4. Delay in extending the Compact agreement (medium term)	**Low** The Compact Agreement with the United States is scheduled to expire in 2024. The two authorities are negotiating to extend the agreement.	**High** If delayed, 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.
	5. Growing NPL (medium term)	**Medium** Banks' asset quality could deteriorate with a spike in NPL ratios, especially for lending to the tourism sector, once the support measures expire.	**Medium** Banks could deleverage to rebuild capital buffers, leading to a tightening of credit conditions.	Strengthen monitoring of bank's asset quality and implement capital injection if necessary.
External	**6. Resurgence of the Covid-19 pandemic** (short term)	**Medium** A resurgence of the infections in the source markets for the Palau's tourism industry possibly due to vaccine-resistant variants could delay border-reopening for Palau.	**High** Prolonged COVID-19 impact could render many tourism-related businesses unviable.	Diversify source countries of tourists. Undertake counter-cyclical fiscal policy to mitigate adverse economic impact on the economy.
	7. Rising commodity prices (short term)	**Medium** Global commodity prices could increase more than expected amid post-pandemic pent-up demand and supply disruptions.	**Medium** Higher imported inflation in Palau could suppress domestic consumption and derail the recovery.	Support the vulnerable households. Accelerate renewable energy adoption and increase domestic food production.
	8. Permanent decline in global tourism (medium term)	**Medium/High** Even after borders fully reopen, precautionary measures and cautious attitudes could linger, weighing on tourism globally for a long time.	**Medium/High** Persistent behavioral changes will suppress tourist inflows to Palau. Productivity in the tourism sector declines due to additional costs, including health and cleaning protocols, and contactless measures for accommodation and food services.	Pursue low-volume, high-value tourism strategy, with focus on eco-tourism. Promote economic diversification through comprehensive policies to improve the investment climate, enhance investment in human capital, and upgrade climate-resilient infrastructure.

[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 VI. Debt Sustainability Analysis[1]

While Palau's public debt remains sustainable, a sharp deterioration of the fiscal position due to the pandemic has significantly increased debt sustainability risks. Under the baseline scenario, the public debt-to-GDP ratio is projected to more than double in the near term and peak at 90 percent of GDP in FY2022, from the pre-pandemic level of 39 percent of GDP. Although high by historical standards, the debt-to-GDP burden is projected to decline gradually to about 62 percent by FY2026, helped by favorable interest rate-growth differentials that reflect a large share of concessional financing. The likelihood of breaching sustainability benchmarks has increased substantially under alternative scenarios (GDP growth shock or constant primary balance shock). Considering Palau's susceptibility to shocks, including high growth volatility and natural disasters, rebuilding fiscal buffers over the medium term once the post-pandemic recovery is fully entrenched should be a priority.

1. **The public debt-to-GDP ratio increased from 38.6 percent of GDP in FY2019 to 62.1 percent in FY2020 with the disbursement of new loans.**[2] Disbursements in FY2020 include the ADB loans for (i) the Pacific Disaster Resilience Program (US$15 million); (ii) the COVID-19 Pandemic Relief Option (CPRO, US$20 million); (iii) Palau Public Utilities Corporation (PPUC) Reform Program (US$5 million), and the Mega International Commercial Bank's loan for the Housing Development and Loan Program (US$15 million).

2. **Debt profile.** Public debt in the analysis includes the central government's external debt (58.0 percent of GDP in FY2020), the government's domestic accounts payable or domestic arrears (4.0 percent of GDP in FY2020), and the SOEs' debt (9.7 percent of GDP in FY2020), which is fully guaranteed by the government and is a contingent liability. Most of Palau's external debt is from bilateral or multilateral official creditors for specific projects, and as such there is no one-to-one linkage between the fiscal balance and debt issuance.[3]

3. **Baseline macro-fiscal assumptions.** The macroeconomic and policy assumptions follow the team's baseline projections. Following a 9.7 percent drop in FY2020, real GDP is projected to further contract by 17.1 percent in FY2021, before rebounding by 9.4 percent and 18.3 percent in FY2022 and FY2023. The fiscal position is expected to deteriorate significantly in the near-term, reflecting pandemic-related decline in revenues and a sharp increase in discretionary expenditure to support the economy. From 10.9 percent of GDP in FY2020, the fiscal deficit is projected to widen to 19.5 percent of GDP in FY2021 and moderate to 12.6 percent of GDP in FY2022. The fiscal position is projected to improve in the medium-term as the economy recovers, turning to a surplus in FY2025.

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[1] Prepared by Seohyun Lee (APD).

[2] 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.

[3] The debt sustainability analysis presented in this appendix provides the broadest possible coverage of public sector debt based on available data while existing data only allows for the monitoring of fiscal accounts (revenue and expenditure) at the central government level.

4. Under the baseline scenario, the public debt-to-GDP ratio is projected to peak at 90 percent of GDP in FY2022, before declining gradually to around 62 percent of GDP by FY2026. Favorable interest rate-growth differentials, which reflect a large share of concessional financing and associated low interest rates are a critical aspect of the quick reversal of the public debt-to-GDP ratio. In addition to the widened fiscal deficit, the sharp increase in the public debt-to-GDP ratio will be driven by the AsDB's loan disbursements for (i) a policy-based operation for the Recovery through Improved Systems and Expenditure Support (RISES) program (US$55 million) and (ii) additional disbursements for the PPUC Reform Program (US$5 million) during FY2021-22.

5. Financing needs. Under the baseline scenario, Palau's gross financing needs (defined as the sum of the fiscal deficit and maturing debt) are projected to reach 21.7 percent of GDP in FY2021. As the economy recovers, the government is expected to be able to use projected budget surpluses to fully pay for the scheduled debt services from FY2026.

6. Realism of baseline assumptions.

- Past assumptions about real growth and the GDP deflator have been relatively optimistic while assumptions about the primary balance have been pessimistic.
- Under the baseline scenario, the projected 3-year adjustment in the cyclically adjusted primary balance (CAPB) is in a percentile rank of 57 percent compared to the historical experience for market access countries. The CAPB 3-year average level is in a percentile rank of 70 percent.

7. The fan charts illustrate the possible evolution of the public debt ratio over the medium term, under symmetric and asymmetric distributions of risks based on historical outturns. Under a symmetric distribution, there is around a 50 percent probability that debt will remain below 62 percent of GDP over the medium term. If restrictions are imposed—i.e., an asymmetric scenario where it is assumed that there are no positive shocks to the primary balance—there is a probability of around 25 percent that the debt path will remain below 62 percent of GDP over the projection horizon.

8. Stress tests and risks. Alternative scenarios such as a growth shock scenario and a constant primary balance scenario suggest that the likelihood of breaching sustainability benchmarks has increased substantially.[4]

- **Macro-fiscal stress tests**. Under a GDP growth shock scenario that assumes a slower recovery pace from FY2022, the public debt-to-GDP ratio would rise substantially to nearly 100 percent of GDP in FY2022 and remain above the 70 percent of GDP benchmark through FY2026. Under a constant primary balance shock, which assumes that the considerably looser fiscal stance projected in FY2021 is maintained through the projection horizon, the debt-to-GDP ratio would

[4] Based on the historical data, Palau is less exposed to natural disasters compared to other PICs and the expected annual loss from natural disasters is estimated to be around 1 percent of GDP (Appendix I). Under these assumptions, the impact of natural disaster shocks on Palau's debt profile would be minimal compared to other alternative scenarios.

increase steadily and reach 146 percent in FY2026, putting debt sustainability severely at risk. A constant primary balance would also lead to a substantial increase in gross financing needs, reaching 62 percent of GDP in FY2026, well above the 15 percent of GDP benchmark.

- **Contingent liabilities to SOEs shock**. The potential increase in government expenditure from several sources, particularly from the contingent liabilities to SOEs, would be another source of risk for debt sustainability. This shock assumes that the government is obliged to absorb all SOE's guarantees over 5 years with negative feedback effects on interest rates. The debt-to-GDP ratio would rise to 83 percent of GDP in the medium term, breaching the DSA benchmark.

- **Heat map**. By debt level and gross financing needs, all alternative scenarios would breach the DSA benchmarks. By debt profile, the share of debt held by foreigners is high at 93 percent of GDP, though the preeminence of concessional financing from multilateral creditors is a mitigating factor.

9. Considering Palau's susceptibility to shocks and the impact of these shocks on debt sustainability, continued fiscal prudence in the near term and rebuilding fiscal buffers over the medium term should be a priority. In that context, enhancing domestic revenue mobilization and further rationalizing current expenditure would help to better secure debt sustainability. Given Palau's exposure to climate change risks, the country should continue to tap into concessional climate-related financing to enhance resilience and face potential future climate shocks.

Figure 1. Palau: Public Sector Debt Sustainability Analysis – Baseline Scenario

(In percent of GDP unless otherwise indicated)

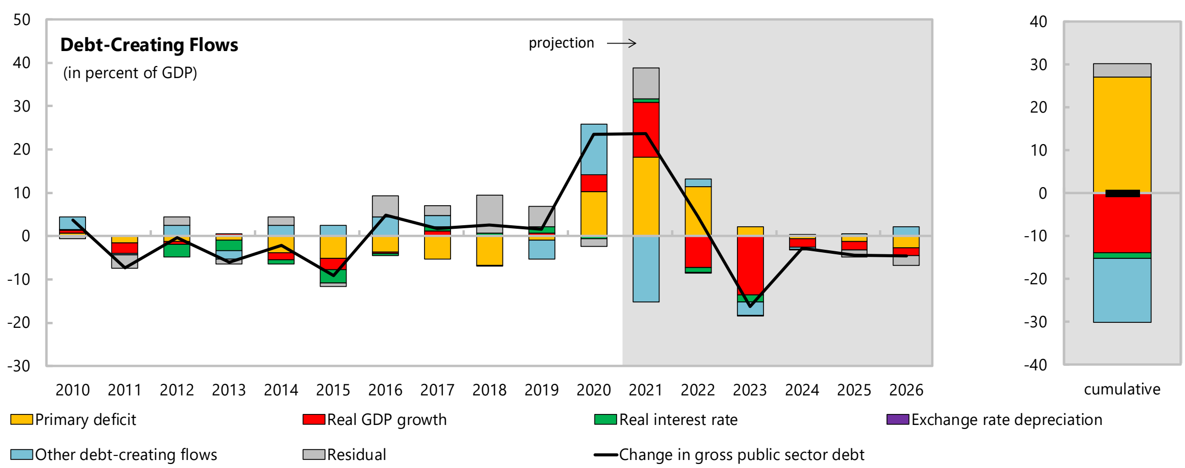
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2010-2018 [2/]	2019	2020	2021	2022	2023	2024	2025	2026
Nominal gross public debt	39.0	38.6	62.1	85.7	90.3	74.0	71.1	66.7	62.1
Of which: guarantees	15.9	8.3	9.7	10.9	9.7	8.0	7.7	7.5	7.2
Public gross financing needs	-2.0	1.2	12.7	21.7	16.1	7.4	4.3	3.3	2.0
Real GDP growth (in percent)	1.6	-1.9	-9.7	-17.1	9.4	18.3	2.9	2.9	2.7
Inflation (GDP deflator, in percent)	3.5	-1.8	4.1	1.2	2.5	2.8	0.7	0.7	0.8
Nominal GDP growth (in percent)	5.3	-3.7	-6.0	-16.1	12.2	21.5	3.6	3.7	3.5
Effective interest rate (in percent) [4/]	1.3	1.8	2.4	2.0	1.2	1.1	1.1	1.1	1.1

As of June 30, 2021		
Sovereign Spreads		
EMBIG (bp) 3/		n.a.
5Y CDS (bp)		n.a.
Ratings	Foreign	Local
Moody's	n.a.	n.a.
S&Ps	n.a.	n.a.
Fitch	n.a.	n.a.

Contribution to Changes in Public Debt

	Actual			Projections							
	2010-2018	2019	2020	2021	2022	2023	2024	2025	2026	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-1.3	1.6	23.5	23.6	4.6	-16.3	-2.9	-4.4	-4.6	0.0	
Identified debt-creating flows	-2.9	-3.1	25.2	16.4	4.7	-16.2	-2.8	-2.7	-2.4	-3.0	
Primary deficit	-3.1	-0.9	10.2	18.3	11.3	2.1	-0.5	-1.2	-2.8	27.2	0.3
Primary (noninterest) revenue and grants	43.3	44.5	47.3	46.3	41.2	38.0	39.0	38.6	38.9	242.0	
Primary (noninterest) expenditure	40.2	43.6	57.6	64.6	52.6	40.1	38.4	37.4	36.1	269.2	
Automatic debt dynamics [5/]	-1.4	2.1	3.4	13.4	-8.4	-15.2	-1.8	-1.7	-1.5	-15.2	
Interest rate/growth differential [6/]	-1.4	2.1	3.4	13.4	-8.4	-15.2	-1.8	-1.7	-1.5	-15.2	
Of which: real interest rate	-0.8	1.4	-0.6	0.7	-1.2	-1.6	0.3	0.3	0.2	-1.3	
Of which: real GDP growth	-0.6	0.7	4.0	12.7	-7.2	-13.6	-2.1	-2.0	-1.7	-13.9	
Exchange rate depreciation [7/]	0.0	0.0	0.0	...	...	...	...	...	...	...	
Other identified debt-creating flows	1.7	-4.4	11.5	-15.2	1.8	-3.2	-0.5	0.2	1.9	-14.9	
Change in government domestic currency and deposits (negative)	1.7	-4.4	11.5	-15.2	1.8	-3.2	-0.5	0.2	1.9	-14.9	
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 loans)	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/]	1.5	4.8	-1.8	7.2	-0.1	-0.1	-0.1	-1.7	-2.2	3.0	



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.

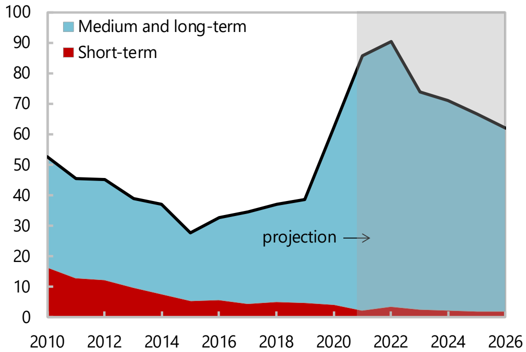
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 2. Palau: Public Debt Sustainability Analysis – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

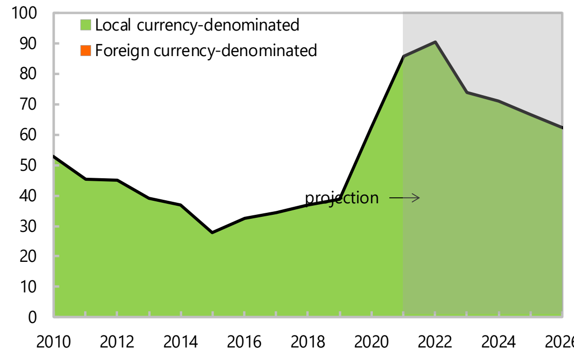
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

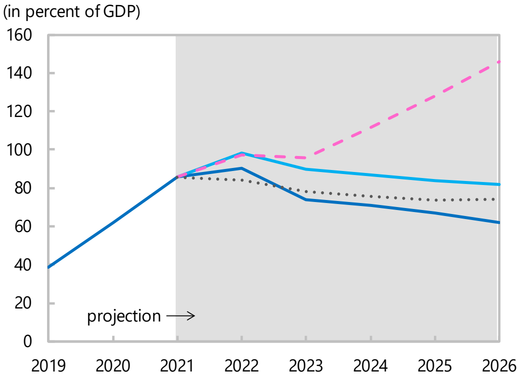


Alternative Scenarios

Baseline
Real GDP Growth Shock
Historical
Constant Primary Balance

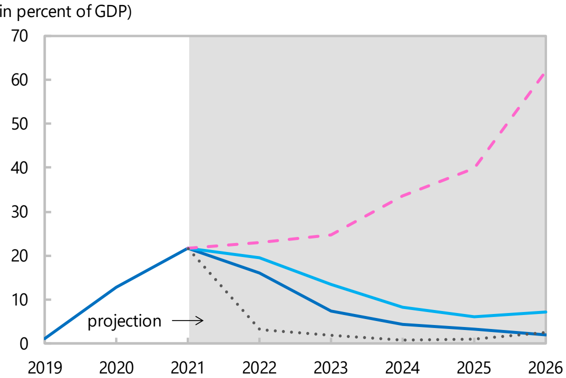
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

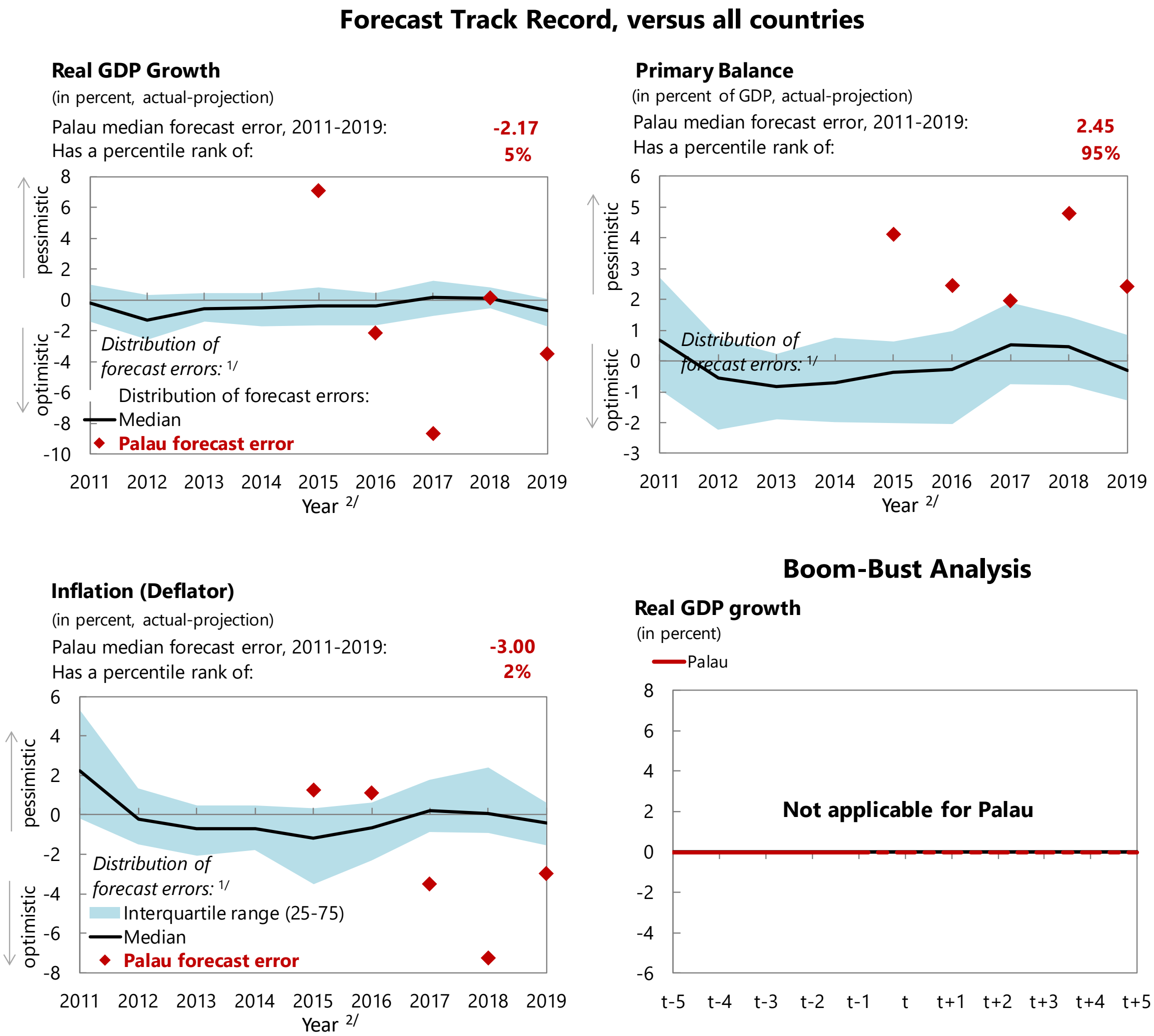
(in percent)

Baseline Scenario	2021	2022	2023	2024	2025	2026
Real GDP growth	-17.1	9.4	18.3	2.9	2.9	2.7
Inflation	1.2	2.5	2.8	0.7	0.7	0.8
Primary Balance	-18.3	-11.3	-2.1	0.5	1.2	2.8
Effective interest rate	2.0	1.2	1.1	1.1	1.1	1.1
Constant Primary Balance Scenario						
Real GDP growth	-17.1	9.4	18.3	2.9	2.9	2.7
Inflation	1.2	2.5	2.8	0.7	0.7	0.8
Primary Balance	-18.3	-18.3	-18.3	-18.3	-18.3	-18.3
Effective interest rate	2.0	1.2	1.2	1.4	1.7	2.0

Historical Scenario	2021	2022	2023	2024	2025	2026
Real GDP growth	-17.1	0.4	0.4	0.4	0.4	0.4
Inflation	1.2	2.5	2.8	0.7	0.7	0.8
Primary Balance	-18.3	1.9	1.9	1.9	1.9	1.9
Effective interest rate	2.0	1.2	1.0	0.9	0.9	0.9
Real GDP Growth Shock						
Real GDP growth	-17.1	4.4	13.2	2.9	2.9	2.7
Inflation	1.2	1.3	1.5	0.7	0.7	0.8
Primary Balance	-18.3	-14.6	-7.0	0.5	1.2	2.8
Effective interest rate	2.0	1.2	1.3	1.5	1.4	1.5

Source: IMF staff.

Figure 3. Palau: Public Debt Sustainability Analysis – Realism Baseline Assumptions



Source : IMF staff.

1/ Plotted distribution includes all countries, percentile rank refers to all countries

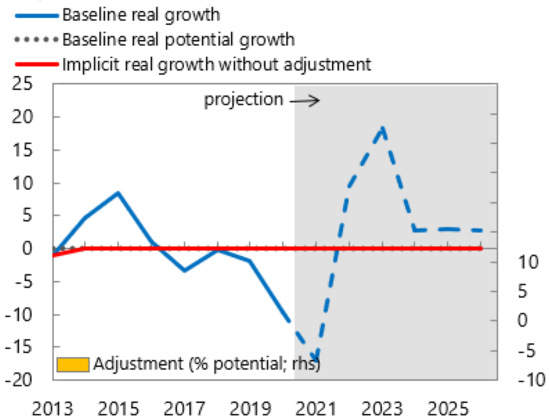
2/ Projections made in the spring WEO vintage of the preceding year

Figure 3. Palau: Public Debt Sustainability Analysis – Realism Baseline Assumptions (concluded)

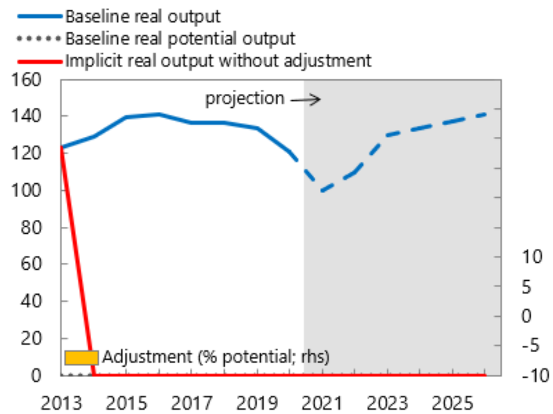
Growth and Level of Output in Absence of Fiscal Adjustment

Assumed multiplier of 1, persistence of 0.6

Real GDP Growth
(in percent)

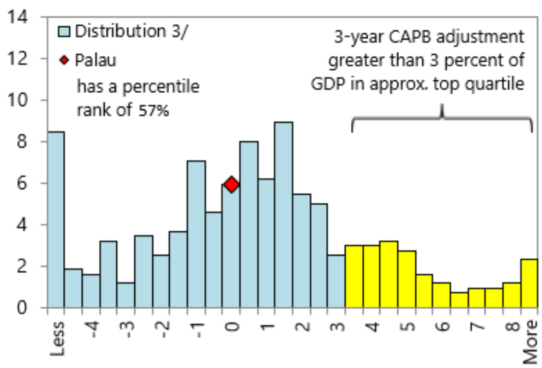


Real Output Level
(Baseline real output in 2021=100)

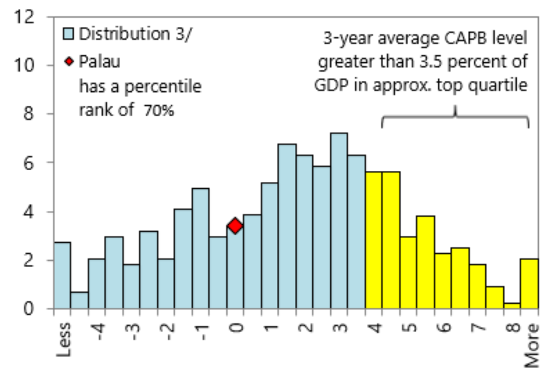


Assessing the Realism of Projected Fiscal Adjustment

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



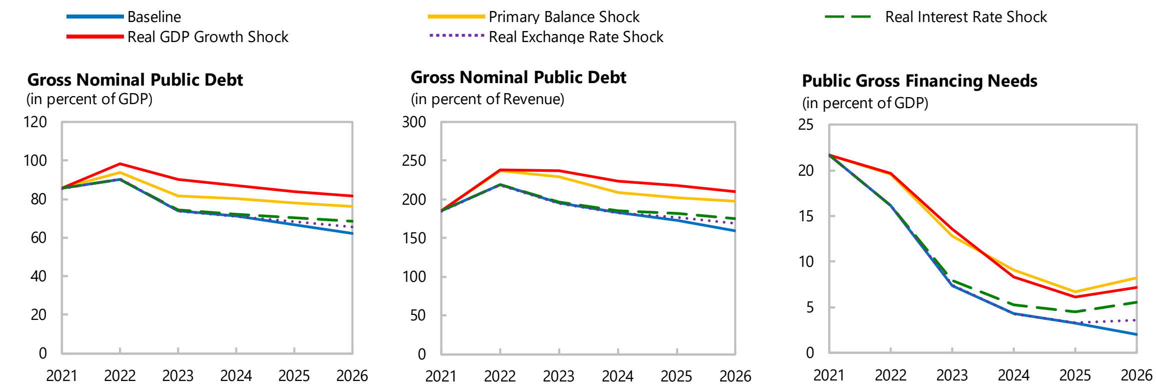
3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



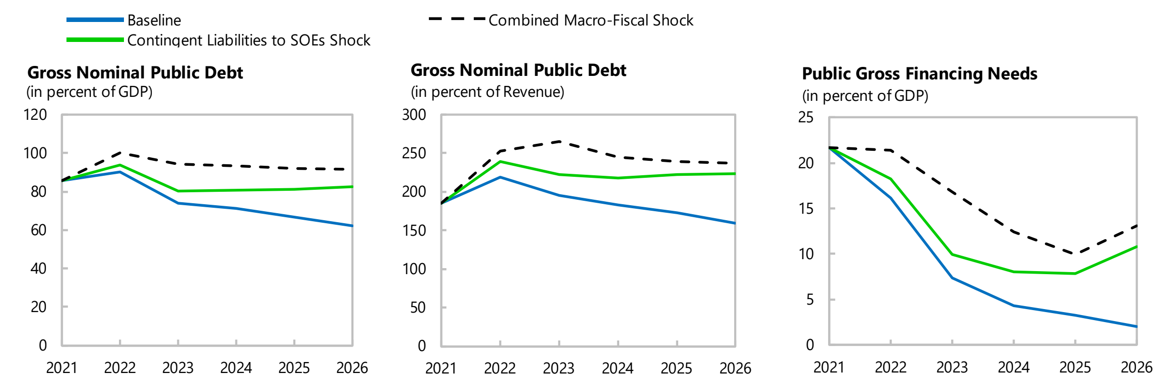
Source : IMF staff.
3/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 4. Palau: Public Debt Sustainability Analysis – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

	2021	2022	2023	2024	2025	2026
Primary Balance Shock						
Real GDP growth	-17.1	9.4	18.3	2.9	2.9	2.7
Inflation	1.2	2.5	2.8	0.7	0.7	0.8
Primary balance	-18.3	-14.8	-6.7	-0.8	0.9	2.0
Effective interest rate	2.0	1.2	1.4	1.6	1.5	1.6
Real Interest Rate Shock						
Real GDP growth	-17.1	9.4	18.3	2.9	2.9	2.7
Inflation	1.2	2.5	2.8	0.7	0.7	0.8
Primary balance	-18.3	-11.3	-2.1	0.5	1.2	2.8
Effective interest rate	2.0	1.2	2.0	2.1	2.2	2.4
Combined Shock						
Real GDP growth	-17.1	4.4	13.2	2.9	2.9	2.7
Inflation	1.2	1.3	1.5	0.7	0.7	0.8
Primary balance	-18.3	-16.3	-9.3	-0.8	0.9	2.0
Effective interest rate	2.0	1.2	2.1	2.6	2.8	3.0
Contingent Liabilities to SOEs Shock						
Real GDP growth	-17.1	7.4	16.3	0.9	0.9	0.7
Inflation	1.2	2.5	2.8	0.7	0.7	0.8
Primary balance	-18.3	-13.3	-4.1	-1.5	-0.8	0.8
Effective interest rate	2.0	1.2	1.2	1.2	1.3	1.4

	2021	2022	2023	2024	2025	2026
Real GDP Growth Shock						
Real GDP growth	-17.1	4.4	13.2	2.9	2.9	2.7
Inflation	1.2	1.3	1.5	0.7	0.7	0.8
Primary balance	-18.3	-14.6	-7.0	0.5	1.2	2.8
Effective interest rate	2.0	1.2	1.3	1.5	1.4	1.5
Real Exchange Rate Shock						
Real GDP growth	-17.1	9.4	18.3	2.9	2.9	2.7
Inflation	1.2	2.5	2.8	0.7	0.7	0.8
Primary balance	-18.3	-11.3	-2.1	0.5	1.2	2.8
Effective interest rate	2.0	1.2	1.1	1.1	1.1	1.2

Source: IMF staff.

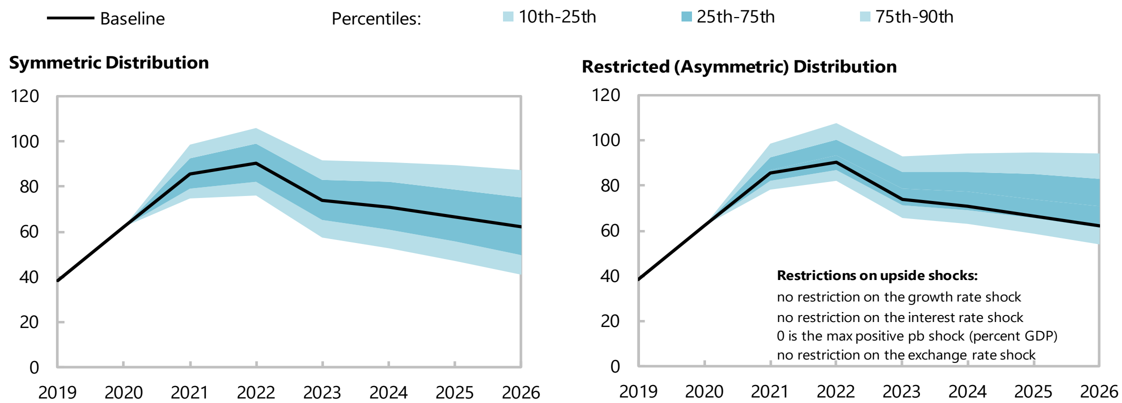
Figure 5. Palau: Public Debt Sustainability Analysis Risk Assessment

Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

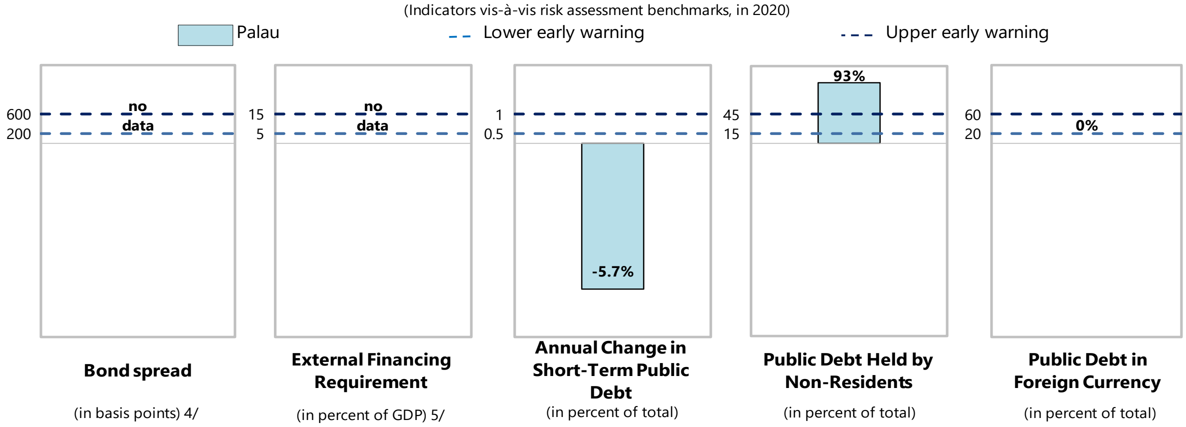
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2020)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 01-Apr-21 through 30-Jun-21.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

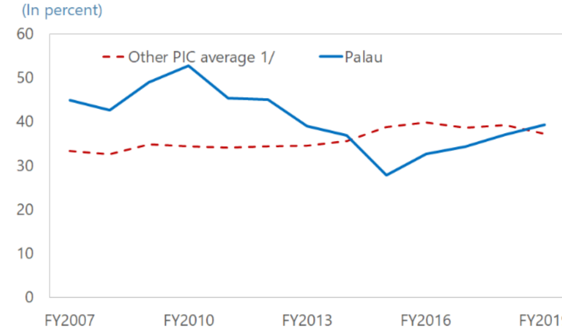
Appendix VII. The COVID-19 Pandemic and Public Debt[1]

Palau's public debt was on a downward trend before the COVID-19 pandemic, helped by sustained fiscal prudence. An increasingly large share of public debt was held by multilateral creditors. The pandemic has led to a rapid and significant increase of public debt and debt servicing cost. While the large of multilateral creditors and associated concessional terms are an important risk mitigating factor, the high uncertainty around the path of the recovery, rising spending needs to address climate change, and limited debt management capacity call for prudence. This includes rebuilding fiscal buffers in the medium-term when the economic recovery from the pandemic is fully entrenched.

A. Evolution of Public Debt prior to the COVID-19 Crisis

1. **Palau's public debt was on a downward trajectory during the past decade before the COVID-19 pandemic**. A track record of fiscal prudence and associated fiscal surpluses have led to a gradual decline in Palau's public debt to GDP ratio. From 49 percent of GDP in 2009, Palau's debt to GDP ratio declined to about 28 percent of GDP in FY2015, before hedging up slightly to 39 percent of GDP in 2019. From a cross-country perspective, Palau's debt to GDP ratio during the period 2007-2019 (40 percent of GDP) was however slightly higher than the average level in other Pacific Islands countries (36 percent of GDP).

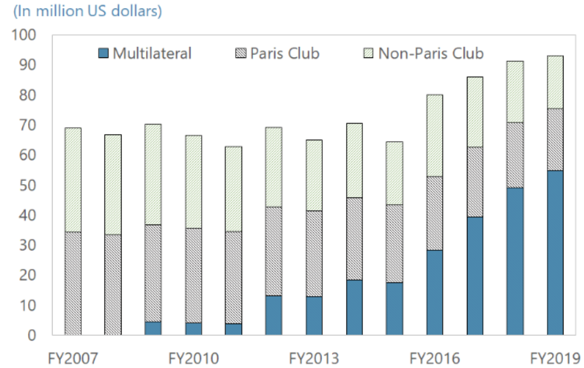
Palau: Public Debt to GDP Ratio
(In percent)



Sources: Palau authorities; and IMF staff estimates.
1/ Countries include Fiji, Kiribati, Marshall Islands, Micronesia, PNG, Samoa, Solomon Islands, Tonga, Tuvalu and Vanuatu.

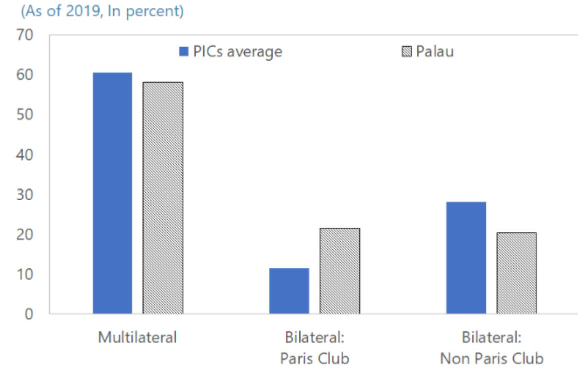
2. **Multilateral creditors had provided an increasing share of public debt**. Before the Global Financial Crisis, Palau was solely reliant on bilateral creditors, from the Paris Club and non-Paris Club. Loans from multilateral creditors started to increase in 2009. As of 2019, about 60 percent of Palau's

Palau: Debt Decomposition by Creditors
(In million US dollars)



Sources: Palau authorities; and IMF staff estimates.

Palau: Debt Decomposition by Creditors
(As of 2019, In percent)



Sources: Palau authorities; and IMF staff estimates.

[1] Prepared by Seohyun Lee (APD).

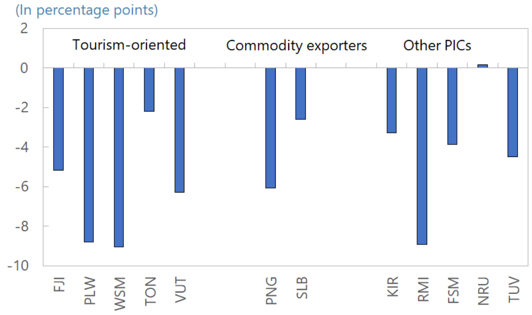
external debt comes from multilateral creditors, broadly in line with the average in PICs, and is mostly from the Asian Development Bank (AsDB) and for infrastructure projects.

B. The Impact of the COVID-19 Crisis

3. **The COVID-19 pandemic has led to a rapid and sizeable increase of public debt, mostly financed by multilateral creditors**. With one of the largest economic contractions and fiscal deficit widening among PICs, Palau's public debt to GDP ratio has been revised upwards substantially—by an average of 52 percentage points of GDP during 2020-22 compared to pre-pandemic projections. Loans provided by multilateral creditors, mainly the AsDB, have accelerated and are expected to reach 80 percent of total external debt in FY2025, from 59 percent of total debt in FY2019.[2]

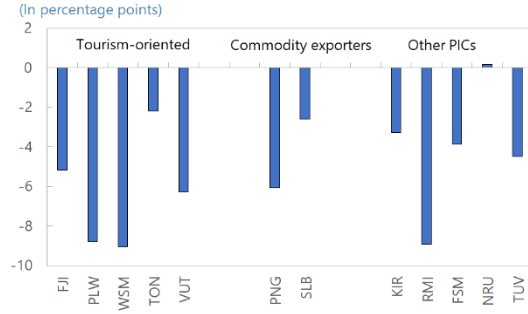
Palau: Macroeconomic Impact of COVID-19 Crisis (1)

Palau: Changes in Real GDP Growth, 2020-21 Average vs. 2019
(In percentage points)



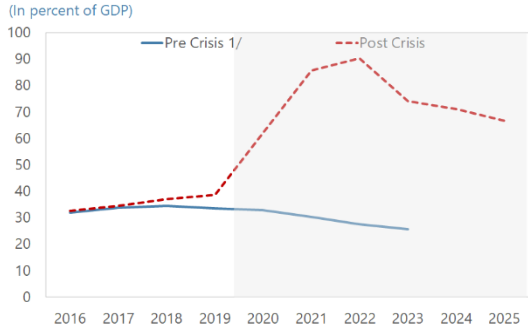
Sources: World Economic Outlook; and IMF staff estimates.

Palau: Changes in Real GDP Growth, 2020-21 Average vs. 2019
(In percentage points)



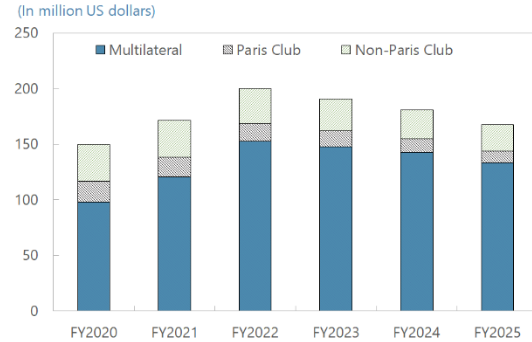
Sources: World Economic Outlook; and IMF staff estimates.

Palau: Public Debt to GDP Ratio
(In percent of GDP)



Source: IMF staff estimates.
1/ Pre COVID-19 Crisis projections are based on the 2018 AIV Staff Report.

Palau: Debt Decomposition by Creditors, Post COVID-19
(In million US dollars)

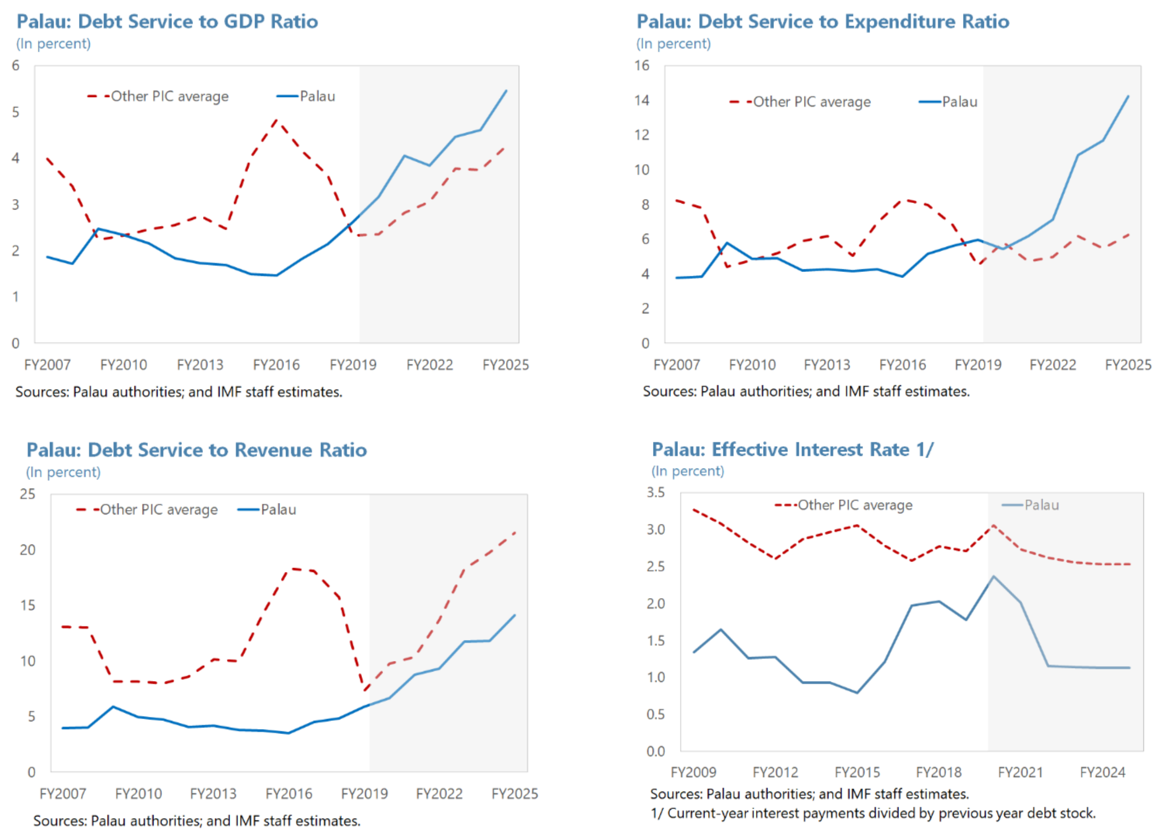


Sources: Palau authorities; and IMF staff estimates.

[2] ADB loans of US$100 million during FY2020-22 include (i) the Pacific Disaster Resilience Program (US$15 million); (ii) the COVID-19 Pandemic Relief Option (US$20 million); (iii) support to the PPUC's reform (US$10 million); and the Recovery through Improved Systems and Expenditure Support (US$55 million). These loans are provided on a concessional basis with interest rates ranging between 1.5 percent and 2 percent, and a grace period of 3 to 5 years.

4. The cost of servicing Palau's public debt has increased markedly with the COVID-19 shock. While Palau's debt service to GDP ratio was below the average of PICs before the pandemic, it is projected to spike in the coming years and exceed PICs' average. A similar dynamic is expected when the debt service ratio is defined as a share of expenditure.[3] The effective interest rate rose from 1.3 percent in 2009 to 1.8 percent in 2019. With the pandemic shock, it is projected to reach 2.3 percent in 2020 but stabilize at 1.1 percent afterwards, below the average for PICs.

Palau: Macroeconomic Impact of COVID-19 Crisis (2)



5. The overhang of public debt from the pandemic may take time to resolve. Given the uncertainty around the growth outlook, combined with pressing investment needs to address climate change, the unprecedented level of public debt may persist even after the pandemic recedes. Important risk mitigating factors that may facilitate debt reduction include (i) the large share of concessional loans provided by development partners and (ii) Palau's track record of fiscal prudence that would support implementation of the needed medium-term fiscal consolidation. In

[3] Palau's debt service to revenue is also expected to rise sharply in the post-COVID era but remains slightly below the average level in PICs. This is because an extremely high debt service to revenue ratio for PNG (over 100 percent) during 2020-25 pushes up the overall average for PICs.

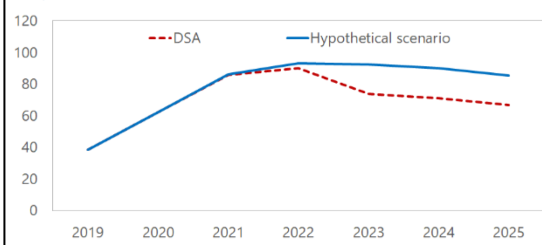
addition to raising revenues through a tax reform, improving spending efficiency, and reducing fiscal risks would be key.

C. Debt Carrying Capacity

6. Palau retains some debt carrying capacity because of a favorable interest rate-growth differential. In the long run, contained real interest rates and robust trend growth allow countries to carry higher debt. For Palau, although the average growth rate is low (1.8 percent during 2010-19), it exceeds the average real interest rate (-1.0 percent), implying that modest primary deficits could be sustained without a surge in debt. For instance, a hypothetical scenario of a longer lasting fiscal shock, that is a lower primary balance by 1 percentage points of GDP compared to the path in the DSA baseline while GDP growth and real interest rate remain at their historical average level, illustrates that debt to GDP ratio would trend downward in the medium-term even with more adverse fiscal assumptions.

Palau: Public Debt to GDP Ratio 1/

(In percent of GDP)



Source: IMF staff estimates.

1/ In a hypothetical scenario, growth rate (1.8 percent) and real interest rate (-1.0 percent) are assumed to be historical averages during 2010-2019. Average primary deficit for 2021-25 is assumed to be larger than the DSA baseline by 1 ppt, assuming that the COVID-19 impacts last longer.

7. However, vulnerability to climate change, low diversification, and limited institutional capacity are additional constraints for Palau's debt carrying capacity. Palau is vulnerable to various from climate-related risks and need to invest to strengthen its resilience, with substantial climate adaptation costs (see Appendix I) further constraining debt carrying capacity. In addition, a narrow production and export base and a high reliance on tourism can adversely affect debt carrying capacity by reducing potential growth and increasing growth volatility. Due to its small size and population, limited institutional capacity for effective debt management in Palau is another constraint. Palau has neither a separate debt management unit nor a national debt management strategy. Debt data compiled by the Office of Planning and Statistics (OPS) includes external debt of the central government, National Development Bank of Palau and other public nonfinancial corporations and external debt guaranteed by the central government. Expanding the scope of the compilation to the general government would help better capture and monitor the full extent of debt obligations and its dynamic and help reduce risk of disruption of debt service obligations.

Appendix VIII. Tax Reforms

A comprehensive tax reform has been a key policy priority for Palau in recent years. The tax reform bill, approved on September 29, 2021, is expected to enter into force on January 1, 2023.

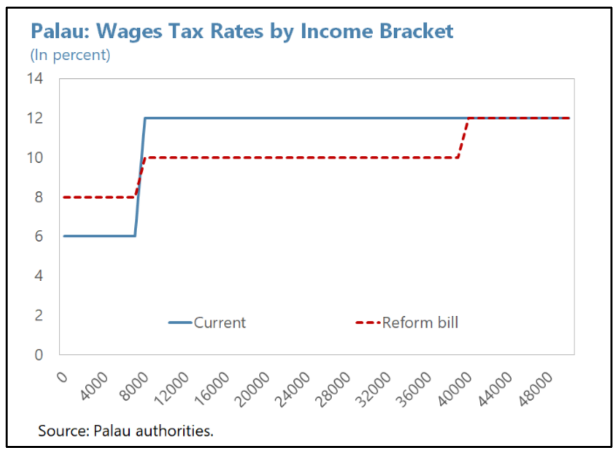
1. The main components of the tax reform package include:

- **The Palau Goods and Services Tax (PGST)—a value added tax**. The new PGST will have a rate of 10 percent on goods and services, excluding financial services.

- **The Business Profits Tax (BPT)**. From the 4 percent profits tax for only financial services, the expanded BPT will be applied to the PGST-registered businesses and financial institutions at the rate of 12 percent.

- **Gross Revenue Tax (GRT)**. The current GRT of 4 percent will apply to businesses with a turnover exceeding $50,000 unless they opt in for the BPT. Smaller businesses with a turnover below $50,000 will be only subject to a $100 per annum business license fee.

- **Adjustments to wages and salaries tax rates.** The marginal tax rate is reduced from 12 percent to 10 percent for incomes between $8,000 and $40,000 and tax refunds will be provided for Palauan citizens with annual income below $15,000. The marginal tax rate for the lowest income bracket below $8,000 is raised from 6 percent to 8 percent.



- **Social assistance to the vulnerable.** Those who are in informal sector with revenue below $15,000 are to receive a social assistance payment of 4 percent of total revenue, up to a maximum of $600. Similarly, Palauan receiving Social Security benefits or payments from the Civil Service Pension Fund, or both, whose total income is less than $15,000, are entitled to receive a social assistance payment of 4 percent, up to $600 yearly.

- **The conversion of the import duty into an excise tax.** "Sin" goods, for example, alcoholic beverages, cigarettes, and tobacco products, are subject to excise duty at the rate similar to the import duty.

- **Carbon Tax.** The existing fuel tax (5c per gallon) is turned into a carbon tax at rate of 2c per gallon.

- **Taxes on hotel rooms and vessel cabins:** Tax rate is changed from $12 or 12 percent to $10 or 10 percent whichever is higher.

- **Land transaction proceeds fee** to be imposed at the rate of 4 percent on the proceeds of leases or land transfers, rather than the total value of land transactions under the existing land transfer tax. The fee is not applied to leases made by the Palau Public Land Authority or public land authorities to Palauan.

2. The tax reform is expected to boost revenue collection and improve efficiency, while preserving fairness. The reform is expected to increase tax revenue by around 1 percent of GDP per year net of compensations, and refunds under the PGST are expected to support investments. While the value added tax and excise duties are likely to pass along to consumers via higher prices, wages tax rate adjustments combined with tax refunds and social assistance are included in the tax reform to compensate low-income and vulnerable households under the new tax system.

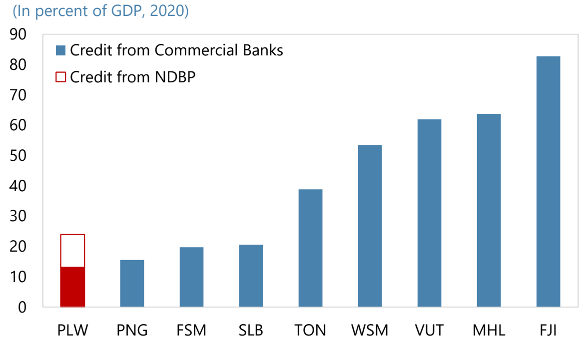
Appendix IX. Financial Sector Reforms[1]

Palau's financial intermediation by commercial banks remains constrained due to its unique market structure with a large share of foreign-owned banks and other long-standing structural impediments. While the National Development Bank of Palau (NDBP) plays a key role in providing credit to niche markets, its role can be further strengthened by enhancing its supervisory and regulatory frameworks. Continued efforts to improve credit market can help create for sustained economic growth.

1. **Access to private sector credit is limited in Palau compared to other Pacific Island Countries (PICs).** Commercial banks in Palau consist of three foreign-owned U.S. FDIC-insured banks and two non-FDIC-insured banks, all of which are regulated by the Palau Financial Institutions Commission (FIC). The U.S. FDIC-insured banks hold 99 percent of the total deposits in the banking sector and 90 percent of the total loans as of December 2018. With access to the U.S. capital markets, the U.S. bank branches invest their excess liquidity offshore rather than lending to local businesses. Net foreign assets amount to nine times as much as credit to domestic private sector in FY2020. The National Development Bank of Palau (NDBP) also take part in domestic lending without taking deposits and is not currently under the FIC regulatory framework.[2] With dollarization and the unique structure of banking sector in Palau, bank credit-to-GDP ratio is substantially lower than other PICs even including loans from the NDBP.

Palau and Pacific Island Countries: Bank Credit to Private Sector

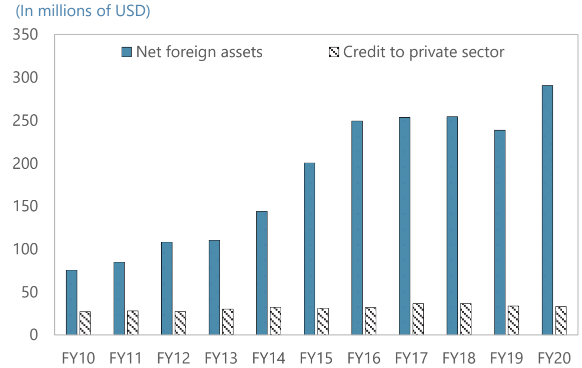
(In percent of GDP, 2020)



Sources: IFS; PITI-VITI; National Development Bank of Palau; and IMF staff estimates.

Palau: Commercial Bank Assets

(In millions of USD)



Source: PITI-VITI.

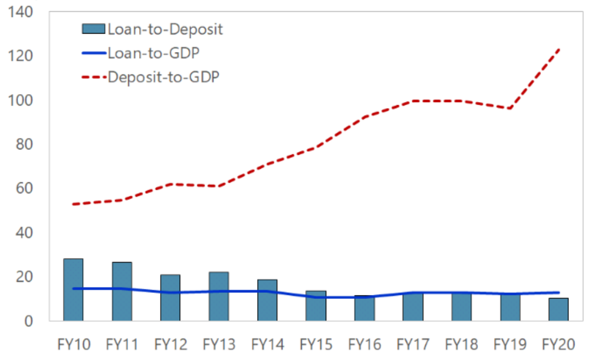
2. **Commercial bank lending is too small to support Palau's growth.** Loan-to-GDP ratio in FY2020 was around 12 percent, much lower than the deposit-to-GDP ratio of over 120 percent. Commercial bank lending to private sector decreased by 2.4 percent in FY2020 (y/y) and recent data from the FIC shows that lending has further shrunk in 2021q1 by 8.3 percent compared to the end of FY2020. Loans to businesses amounted to 16 percent of total loans in FY2020, a 3.4 percent drop due to the pandemic, despite low lending rates. Loans to households also declined by 2.2 percent in FY2020, compared to the pre-pandemic level in FY2019, to 84 percent of total commercial bank

[1] Prepared by Seohyun Lee (APD)

[2] Although the legislation allowing the NDBP to take deposits was passed in Congress in 2014, the NDBP is not currently formally licensed and supervised by the FIC.

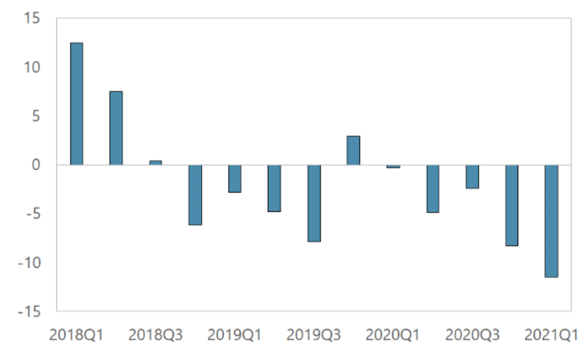
loans to the private sector. Financial intermediation for the domestic economic is limited as bank lending is highly concentrated in small-sized loans to individuals.[3]

Palau: Bank Loan and Deposit Ratio
(In percent)



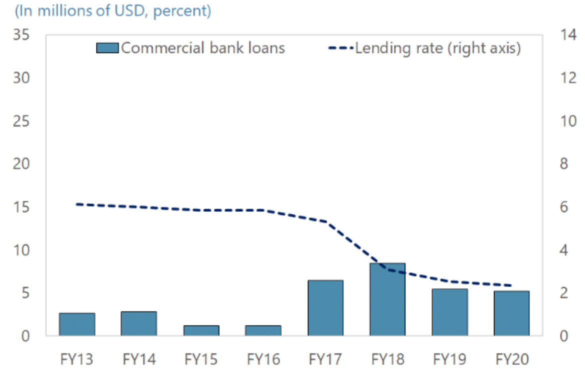
Sources: PITI-VITI; and IMF staff estimates.

Palau: Commercial Banks' Credit to Private Sector Growth
(In percent, year-on-year)



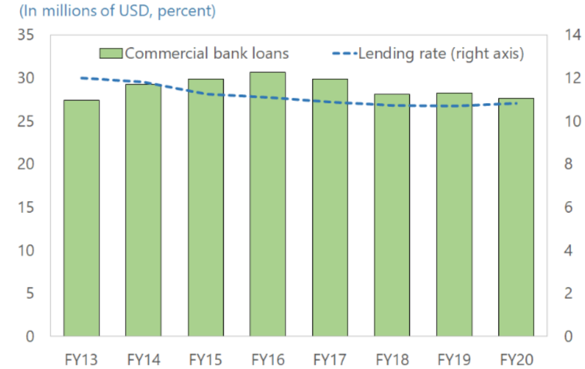
Sources: Palau Financial Institutions Commission; and IMF staff estimates.

Palau: Credit to Private Non-financial Corporations
(In millions of USD, percent)



Source: PITI-VITI.

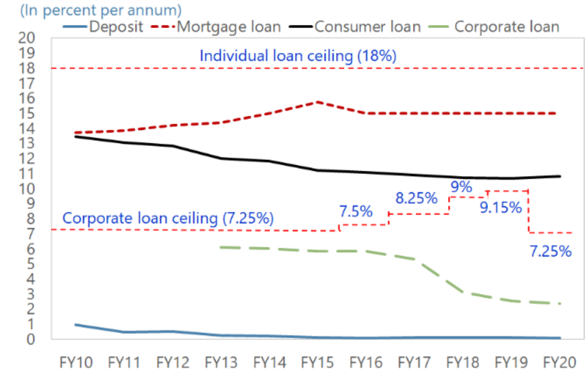
Palau: Credit to Individuals
(In millions of USD, percent)



Source: PITI-VITI.

3. **Commercial banks are restrained from lending to domestic businesses due to several structural issues, including interest rate ceiling, lack of reliable and accurate financial information for firms, and land ownership structure**. Under the usury law, the interest rate on lending to business is capped at the prime rate on corporate loans plus 4 percentage points—which stands at 7.25 percent as of since May 2020. Lending rates for corporations in the US including Guam where the legal and institutional structures are more developed are much higher than the lending rate ceiling, making them more attractive investment options for the foreign banks operating in Palau. In addition, the interest rate on individual loans—capped at 18 percent by the law—stand at

Palau: Bank Interest Rate
(In percent per annum)



Sources: PITI-VITI; and Palau authorities.

3 The size of individual loans at the end of FY2020 is 23.8 thousand USD per borrower.

10.8 percent in FY2020 and has led banks to focus more on consumer loans. Information asymmetry due to the lack of reliable financial data for corporations is another structural issue. Limited capacity for small firms to implement appropriate accounting practices makes it difficult for banks to assess the creditworthiness of these firms. Also, the ability to use fixed property as collateral is limited since only residents can take title to land and repossession by foreign banks is complicated in the event of default.

4. **The NDBP plays a key role in providing credit to niche markets—small businesses loans and mortgage loans.** The NDBP is exempted from the lending rate ceiling and is the only financial institution allowed to directly take land as collateral. Compared to other state-owned development banks in Pacific islands, the NDBP's share in domestic credit is around 35 percent, the highest among its peers. Its lending operations are managed at the direction of government, which includes agriculture and aquaculture financing, renewable energy programs, small business loans, guaranteed loans, microfinance and housing loans. Loans are provided at fixed interest rates, including 6 percent for microfinance (up to $15,000) and agriculture loans; 8 percent for small businesses, first time home buyers and fishing loans; and 10 percent for other housing and business loans. More than half of the NDBP's portfolio consists of housing loans (55 percent) while commercial loans other than primary industry—agriculture and fishing—amount to 37 percent. The NDBP maintain high level of capital adequacy ratio and the proportion of non-performing loans to total portfolio is around 4 percent as end-2017[4], the lowest among the other development banks in Pacific islands.

5. **While the operations of the NDBP fill an otherwise unmet funding need in the private sector, its role can be further strengthened by addressing some weaknesses**. The NDBP is neither licensed as a financial institution nor subject to the supervision of the financial sector regulator. Without the purview of any designated supervisory authority, government-directed lending and guarantee programs may dampen the efficient allocation of financial resources and eventually increase fiscal risks.[5] Expanding the coverage of the FIC's regulation and supervision to the NDBP is essential for securing the soundness and stability of financial system and managing fiscal risks. The NDBP's capacity to expand its loans is constrained by limited funding sources.[6] Licensing and implementing regulations for the NDBP would enable it to take deposits as stable funding sources, improving its lending capacity, and facilitating financial intermediation for the private sector. The NDBP needs to improve its operating efficiency by reducing delays in processing loan applications (ADB, 2017) and build capacity to comply with regulatory requirements and manage potential risks.

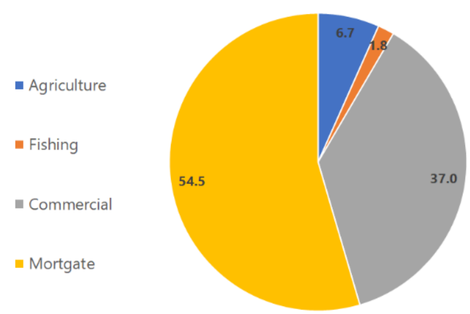
[4] The NPL ratio as of September 2020 stood at 4.7 percent.

[5] As of September 2019, concentrations of credit risk result from significant customers represents 15 percent of total borrowings (Financial Statements and Independent Auditors' Report, Years ended September 30, 2019 and 2018).

[6] NDPB's major funding sources are retained earnings and loans from the European Investment Bank, the government, the Mega International Commercial Banks and the Republic of Palau Social Security Retirement Fund.

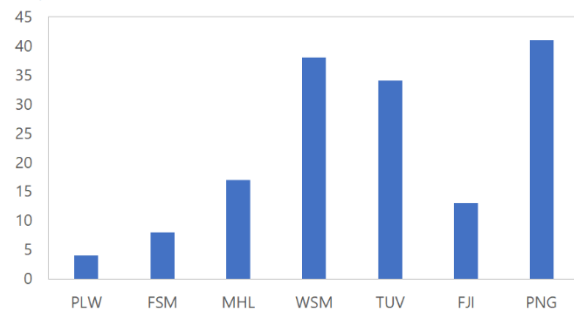
6. Continued efforts can further improve credit market structure and boost credit creation. In line with previous advice, key recommendations include relaxing the interest rate ceiling for corporate loans and strengthening the NDBP's lending capacity by expanding the coverage of the FIC's financial regulation. To address information asymmetry, financial reporting practices for SMEs should be improved through capacity building. Improving the FIC's regulatory and supervisory framework for commercial banks, the NDBP and other financial intermediaries, including credit unions and microlenders, can enhance access to credit.

Palau: NDBP Loan Portfolio
(As of 2019, in percent)



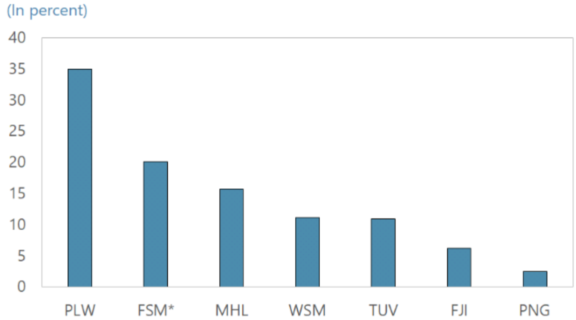
Sources: National Development Bank of Palau; and IMF staff calculations.

Palau and Pacific Island Countries: Development Banks' Non Performing Loans
(In percent)



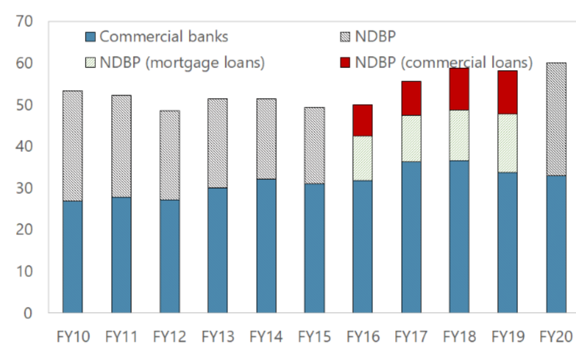
Source: ADB (2019).

Palau and Pacific Island Countries: Development Banks' Credit to Total Domestic Credit[1]
(In percent)



1/ As of 2017 except FSM (2016).
Source: Asia Development Bank (2019).

Palau: Credit to Private Sector by Financial Institution
(In millions of USD)



Sources: PITI-VITI; NDBP; and IMF staff estimates.

Appendix X. Rethinking Palau's Growth Model[1]

Considering the unprecedented and likely long-lasting negative impact of the pandemic on the tourism industry as well as rising threats from climate change, returning to the pre-pandemic growth model in the aftermath of the health crisis entails risks. Going forward, Palau's growth model could focus on two key pillars: (i) the tourism sector could be tailored to high-value tourism activities, with a focus on eco-tourism; and (ii)the pace of economic diversification could be accelerated. A comprehensive policy package should be prepared and implemented, including to improve the investment climate, enhance investment in human capital, and upgrade climate-resilient infrastructure.

A. Post-Pandemic Tourism Strategy

1. **Palau's growth model should be revisited.** Returning to the pre-pandemic economic model, which relies heavily on tourism entails risks, considering the expected long-lasting change in global tourism and risks emanating from climate change. A recent IMF study[2] points out a risk of long-term scarring for tourism dependent economies. It shows that under the benchmark scenario of a 10 percent decline in productivity in the tourism sector over the long-term[3], real GDP of the pacific island countries 10 years after the pandemic will remain approximately 10 percent below the pre-COVID-19 forecast. Climate change threatens the competitive advantage of Palau's tourism industry that hinges on its pristine but fragile eco-system. For example, the Jellyfish Lake, a popular tourist destination, was forced to close for about two years after experiencing a severe drought in 2016.

2. **A high-value tourism strategy could bring multiple benefits to Palau.** First, less focus on the volume of visitors will enable low-density tourism services and reduce health risks. A lower risk of infection could itself enhance Palau's attractiveness as a tourist destination in the post-pandemic world. Second, this strategy will lower Palau's high import leakages. A report by the Conservation Strategy Fund (2016)[4] corroborates this argument with its finding that 27 percent of high-end tourists spending remains within Palau's economy, compared to 18 percent for mass-market tourism. A smaller import leakage will support sustainable growth as it will enhance the resilience of Palau's economy to external shocks. Third, the impact of tourism on the environment will be mitigated, ensuring long-term sustainability of Palau's biodiversity, a key asset for the tourism

[1] Prepared by Takuma Hisanaga (APD).

[2] Goretti, Manuela and Leigh, Lamin, 2021, "Tourism in the Post-Pandemic World: Economic Challenges and Opportunities for Asia-Pacific and the Western Hemisphere" *IMF Departmental Paper,* No. 21/02.

[3] The study assumes that productivity in the tourism sector declines due to additional costs borne by tourism operators and firms, which include health and cleaning protocols, social distancing measures, and contactless measures for accommodation and food services.

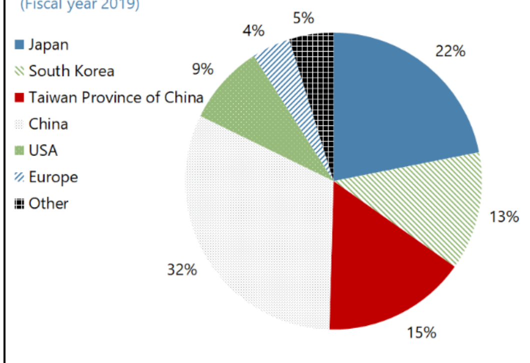
[4] Barr, Rhona, et al, 2016, "Sustainable tourism pathways for Palau: findings and recommendations from a cross-sectoral workshop," Discussion Paper No. 16, Conservation Strategy Fund.

sector. A manageable number of visitors will prevent over-stressing Palau's fragile eco-system while eco-tourism will lure more environment-conscious tourists.

3. **The shift of Palau's tourism policy in 2016 was a step in the right direction.** To protect Palau's pristine environment and its global branding, the Palauan authorities adopted "The Palau Responsible Tourism Policy Framework and Action Plan" in December 2016. The Framework attempts to steer the Palau's tourism sector towards niche tourism markets such as eco-tourism and it prioritizes value growth over volume growth.

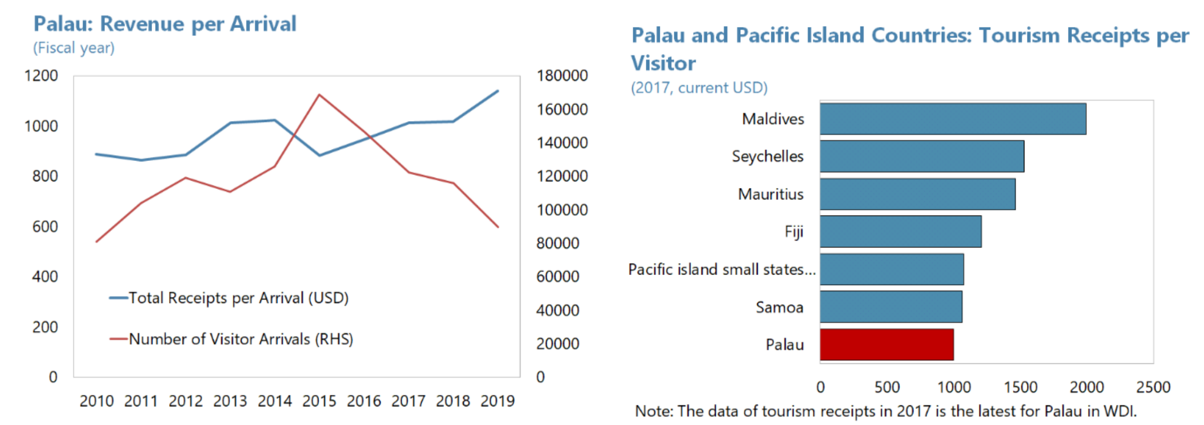
4. **While meaningful progress has been made, more could be done.** While tourism receipt per visitor in Palau is still to the average of pacific island small states, many other tourism-dependent countries have achieved higher receipt per visitor (Figure 2). This suggests that Palau has some room to increase revenue per tourist. Despite the authorities' recent efforts to diversify source markets, they remain concentrated on a few east-Asian countries, notably with China, Japan, South Korea, and Taiwan Province of China, accounting for about 83 percent of total tourist arrivals (text chart on the right). Shifting the composition of tourist arrivals towards Oceania, Europe, and the U.S. would reduce over-dependence on a specific region, smoothen seasonal fluctuation of demand, and help reduce volatility.

Palau: Source Market Composition for Visitor Arrivals
(Fiscal year 2019)



Sources: Palau authorities; and Graduate School USA.

Figure 2. Palau: Tourism Receipts



Source: Palau authorities.

Note: The data of tourism receipts in 2017 is the latest for Palau in WDI.
Sources: World Development Indicators, The World Bank; and IMF staff estimates.

5. **Palau should further promote eco-tourism.** Eco-tourism will not only increase attractiveness to high-value tourists, but also contribute to long-term sustainability of Palau's eco-diversity, a key asset to Palau's tourism sector. It is a welcome step that Palau Bureau of Tourism,

Sustainable Travel International, and Slow Food launched a project in August 2020 to mitigate the tourism sector's carbon footprint, in an effort to make Palau the world's first "Carbon Neutral Tourism Destination." Specific measures in this direction include training of local eco-guides and development of local food supply chain (discussed in the next section).

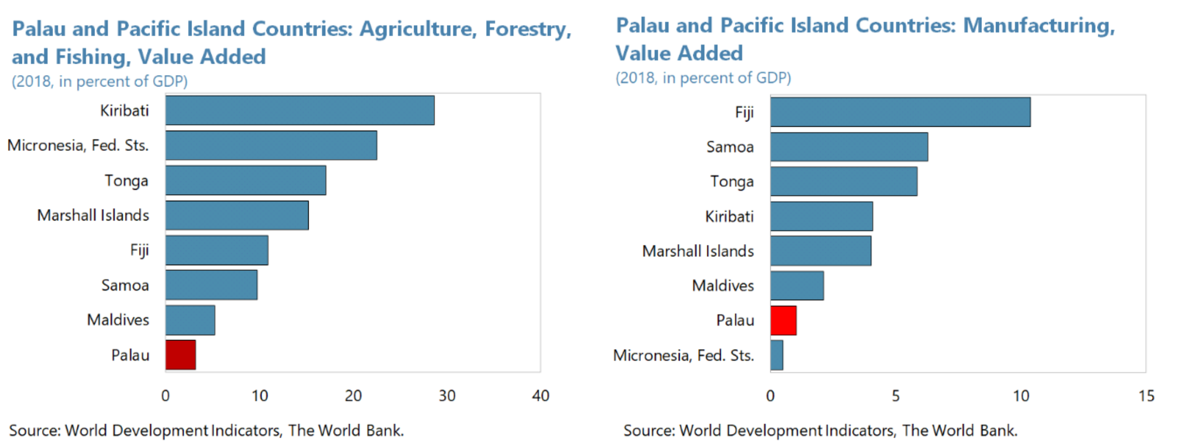
B. Potential Diversification Beyond Tourism

6. Palau could rebalance its economy towards non-tourism sectors. Though opportunities for economic diversification are generally limited for small island countries, Palau has some room to promote non-tourism activities, including by better linking them with the tourism sector.

7. Reviving its agricultural policy could reinforce Palau's eco-tourism strategy, while also contributing to Palau's food security. The eco-tourism strategy will benefit from an increase of domestic agricultural and fishery production, which will enable the provision of farm-to-table dining experience to tourists. Currently, the share of the agricultural industry in GDP—including the forestry and fishing sectors—is about 3 percent, lower than many other small island countries (left chart in Figure 3). The nation's agriculture strategy in 2015 set an objective that 50 percent of food consumption be produced locally by 2020. However, progress has been modest, with a combination of factors at play including saltwater intrusion into taro patches, high local production cost relative to imports, and diminished interests in agriculture among the youth. Overcoming these challenges will require policy initiatives such as investment in protection of low-lying arable land from seawater and vocational training to farmers.

8. Palau's manufacturing sector is underdeveloped. Palau has room to increase the share of its manufacturing value added in GDP. It is currently one percent of GDP, below the level in most small island countries (right chart in Figure 3). Enhancing the domestic manufacturing capability would provide alternative employment opportunities. Considering all constraints, small-scale productions of goods related to tourism or agriculture could be pursued. These include food or fish processing and manufacturing of gifts and souvenirs for tourists.

Figure 3. Palau: Non-Tourism Sectors



9. **A comprehensive reform package is needed to support economic diversification.** Such a package should be comprised of multi-pronged measures addressing the following three policy objectives:

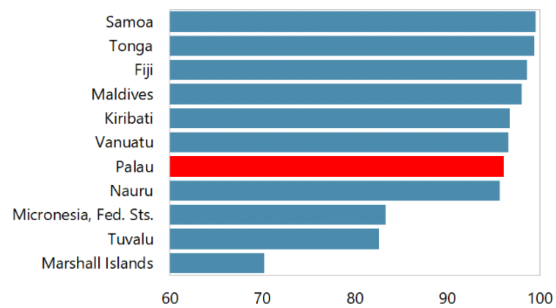
- **Improve the investment climate.** Compared to other pacific island countries, Palau lags behind in timeliness of business-related procedures such as getting electricity and contract enforcement, while performing better in terms of property registration and insolvency resolution. (text chart on the right).

Palau: Investment Climate
(100=Average of pacific island countries excluding Palau, 2019)

Note: Data for Palau is indexed to an arithmetic average of pacific island countries excluding Palau (Fiji, French Polynesia, Kiribati, Marshall Islands, Micronesia, Fed. Sts., Nauru, New Caledonia, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu).
Sources: World Development Indicators, The World Bank, IMF staff calculations

- **Invest in human capital.** While Palau performs well in primary education (text chart on the right), challenges remain in brain-drain (an issue that the educated youth often choose to work abroad) and an under-representation of Palauan women in STEM (Science, Technology, and Engineering) fields[5]. Renewed policy push to address these challenges—for example, expanding scholarship for those who seek jobs in Palau and women in STEM fields—would be desirable.

Palau and Pacific Island Countries: Net Enrollment Rate for Primary Education
(2020 or latest available year, percent)



Source: UNESCO Institute for Statistics.

- **Upgrade infrastructure.** Immense infrastructure needs exist in Palau, in order to achieve sustainable and diversified economic growth. Improvement of road network, aviation connectivity, and telecommunication could serve as foundation of diversified economic activities. On the other hand, there are still social infrastructure needs such as sewage and sanitation facilities. On climate-adaptation front, retrofitting and relocation of existing critical infrastructure, and protection of low-elevation areas—including through hard seawalls and eco-system-based adaptation[6]—are particularly important. Palau could consider financing these infrastructure needs from multiple sources: Infrastructure that serves primarily the tourism sector could be financed by tourism revenues to the extent possible. Climate-related projects could be financed by emerging "green" donors such as the Green Climate Fund.

[5] According to "Pathway to 2030" (Palau's Voluntary National Review on the SDGs published in 2019), while Palauan women have higher levels of education attainment than men—46 percent of women with post-high school education compared to 37 percent of men—, they are underrepresented in Science, Technology, and Engineering (STEM) fields. For example, of Palauan citizens educated in engineering or construction, only 6 percent are female.

[6] Miles et al. (2020) proposes revegetating coastal areas with mangroves to reduce flooding and erosion, with a view to protect coastal communities from storm surge and high winds.

INTERNATIONAL MONETARY FUND

REPUBLIC OF PALAU

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

November 8, 2021

Prepared By	The Asia and Pacific Department (In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of September 30, 2021)

Membership Status: Joined December 16, 1997; Article VIII

General Resources Account:

	SDR Million	Percent Quota
Quota	4.90	100.00
Fund holdings of currency	4.45	90.82
Reserve position in the Fund	0.45	9.20

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocations	7.65	100.00
Holdings	7.24	94.54

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Projected Payments to the Fund: None

Implementation of HIPC Initiative: Not applicable

Implementation of Multilateral Debt Relief Initiative: Not applicable

Implementation of Catastrophe Containment and Relief: Not applicable

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

Article IV Consultation: Palau is on a 24-month cycle. The 2018 Article IV Consultation discussions were held in Koror during October 25–November 7, 2018. The staff report (IMF Country Report No. 19/43) was considered by the Executive Board and the consultation concluded on February 1, 2019.

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 INTERNATIONAL FINANCIAL INSTITUTIONS

Relations with other IFIs:

• 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/countrieswp.html

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 fiscal and 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 2012-20 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: Since 2012, annual GDP estimates by production have been compiled and published, and the methodology has improved. Further areas of improvement include incorporating the recent business surveys and compiling GDP estimates by expenditure.
Price statistics: Data quality has improved, and the Consumer Price Index has been regularly published on a quarterly basis.
Government finance statistics: Annual fiscal data are compiled using GFS2014 classification and were published in the 2012-20 Palau Statistical Yearbook. Further improvements include broadening the coverage beyond the central government, improving the frequency and timeliness of reporting, and including the audited accounts. Annual GFS data have not been reported to STA.
Monetary and financial statistics: The depository corporations survey is unavailable since there is no central bank. TA on monetary and financial statistics could assist the authorities in developing the standardized report forms for the other depository corporations. For the Financial Access Survey (FAS), data was reported through 2017 for some key series and indicators including the two indicators (commercial bank branches per 100,000 adults and ATMs per 100,000 adults) adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (SDGs).
Financial Soundness Indicators: Banks have submitted quarterly financial statements, including balance sheets and profit and loss statements, to the Financial Institutions Commission (FIC) since 2009. The FIC publishes financial soundness indicators (FSIs) and balance sheet data on a quarterly basis on its website (https://www.ropfic.org/). 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: Annual data for the balance of payments and international investment position are reported according to *BPM6* and published in the 2012-20 Palau Statistical Yearbook. Large errors and omissions undermine the usefulness of these statistics for surveillance. A Tourist Expenditure Survey is expected to improve tourism-related data quality. The expected implementation of the comprehensive tax reform, including the Palau Goods and Services Tax, in January 2023 could help improve data quality.

II. Data Standards and Quality	
Palau began participating in the General Data Dissemination System in August 2013 and provides only metadata.	No data ROSC is available.

Palau: Table of Common Indicators Required for Surveillance
(As of October 2021)

	Date of latest Observation	Date Received	Frequency of Data[1]	Frequency of Reporting[1]	Frequency of Publication[1]
Exchange Rates (US dollar is the official currency)	N/A	N/A	N/A	N/A	N/A
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[2]	N/A	N/A	N/A	N/A	N/A
Reserve/Base Money[3]	N/A	N/A	N/A	N/A	N/A
Broad Money[3]	N/A	N/A	N/A	N/A	N/A
Central Bank Balance Sheet[3]	N/A	N/A	N/A	N/A	N/A
Consolidated Balance Sheet of the Banking System	3/2021	9/2020	Q	Q	Q
Interest Rates[4]	N/A	N/A	N/A	N/A	N/A
Consumer Price Index	6/2021	6/2021	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[5]—General Government	N/A	N/A	N/A	N/A	N/A
Revenue, Expenditure, Balance and Composition of Financing[5,6]—Central Government	9/2020	9/2021	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt	9/2020	9/2021	A	A	A
External Current Account Balance	9/2020	9/2021	A	A	A
Exports and Imports of Goods and Services	9/2020	9/2021	A	A	A
GDP/GNP	9/2020	9/2021	A	A	A
Gross External Debt	9/2020	9/2021	A	A	A
International Investment Position	9/2020	9/2021	A	A	A

[1] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I), and Not Available (N/A).

[2] The government's U.S. dollar deposits effectively serve as reserves.

[3] Palau has no central bank

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

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

[6] The central government is only the budgetary central government.

Statement by Chang Huh, Executive Director for Palau
and Talavai Iona, Advisor to the Executive Director
November 29, 2021

Our Palauan authorities appreciate the constructive and frank dialogue with staff during the 2021 Article IV consultations. They agree that the staff report provides a fair assessment of the macroeconomic challenges posed by COVID-19 and the policy response to date. The policy recommendations are well received by the authorities and will be taken into consideration as they develop their inclusive and sustainable growth recovery strategy.

The tropical archipelago of Palau is located in the western Pacific Ocean and is made up of 8 principal islands and about 445 uninhibited rock islands, with a combined land area of about 177 square miles. Palau's Rock Islands were granted the prestigious status of UNESCO World Heritage in 2012 and are a major tourist attraction.

Palau's economy is highly dependent on tourism. In FY2019, the sector contributed more than a third to GDP. The sudden stop to tourist arrivals at the onset of COVID-19 severely affected economic activities.

Palau is designated a high-income country and will graduate from OECD Development Assessment Committee's (DAC) list of countries eligible for development assistance in January 2022.

Despite its high-income per capita status, the inherent vulnerabilities and costs associated with a small, open, island state, are disproportionally high and they diminish the country's purchasing power. These costs are further exacerbated by the country's extreme exposure to climate change and natural disasters. Furthermore, logistical challenges in delivering services to the dispersed population in remote locations aggravate inequalities in access to basic services and economic opportunities.

COVID-19 Response and Recent Developments

Along with commercial flight cancellations, the authorities immediately strengthened the healthcare system by setting up domestic testing and quarantine facilities. Palau recorded its first COVID cases in August 2021 at the border but has remained a COVID-safe destination due to its strict and preemptive measures since the beginning of the pandemic. There has been no community transmission detected and no deaths recorded. With support from the US *Operation Warp Speed*, Palau's vaccination program has been very successful. As of October, this year, full vaccination coverage was approaching 100 percent of the eligible population. This impressive inoculation rate was enabled by a strong public campaign that was met with minimal vaccine hesitancy. The focus is now on the third booster dose.

To support affected businesses and households, the authorities rolled out the Coronavirus One Stop Shop Relief Act (CROSS Act) in the tune of $20 million. This was complemented by the US Coronavirus Aid, Relief, and Economic Security Act (CARES Act), amounting to $19 million, bringing the combined relief packages to 15.2 percent of GDP.

The sudden stop in tourist arrivals triggered the economic contraction as restaurants, hotel services, tour guides, and other related services, were immediately affected. Consequently, the current account deficit rose to 48 percent of GDP in FY2020, although it was partially offset by the ADB loan that financed the CROSS Act. The loss of tourism revenues, economic contraction and counter-cyclical fiscal measures led to a large deficit of 10.9 percent of GDP in FY2020. Without the concessional loan and grants, the bottom line could have been much worse.

Economic Outlook and Risks

The authorities expect a gradual economic recovery from FY2022, but output will remain below pre-pandemic levels through FY2023. Tourism activities will be the major determinant of the macroeconomic situation in the near future. While the world's COVID-19 inoculation rate is expected to rise, new variants and vaccine effectiveness continue to be the major risks that will dictate tourist arrivals. The authorities initiated a cautious opening of safe travel corridors with Guam and Taiwan that include stringent testing regime and proof of vaccination, with an aim to gradually include more tourism partnering countries.

Palau faces a host of other risks that could impede growth in the near to medium term. They include higher than expected inflation, extreme exposure to natural disaster and climate change, and the uncertain timing and terms of a new Compact Agreement with the US.

More concerning to the authorities is the country's graduation from OECD DAC list of countries eligible for grants and concessional loans. There is a high risk of knock-on effect of this graduation which could affect existing relationships with other development partners. The authorities are of the view that for a small island state with a population of about 18,000, the high-income categorization ignores the fixed public administration and social services costs, let alone efforts to facilitate a diversified and sustainable economy while building resilience against external shocks including climate change. Nominal income per capita is generally not an appropriate measure of wealth and purchasing power in microstates.

Fiscal Policy

The authorities are committed to fast tracking the roll out of targeted benefits under the CROSS Act, and to extend them until recovery is firmly entrenched. An additional $100 per month supplementary benefit is planned in light of the prolonged impact of the pandemic and increased cost of living. To address the widening deficit, a 10 percent across the board cut to recurrent expenditures in the FY2022 budget, save for crucial public services, was planned.

With the help of the ADB, the authorities engaged in a review of public expenditures which will enhance the efficiency and impact of COVID-19 related spending. They are also planning to carry out ex-post audits of spending and publish the results.

Over the medium term, the authorities recognize the increased likelihood of breaching debt sustainability benchmarks and are committed to a gradual fiscal adjustment as soon as conditions permit. On the revenue mobilization side, a Comprehensive Tax Reform Legislation was signed by the President last month, which will contribute about a fifth of the required adjustment from FY2024. On the expenditure side, the planned Fiscal Responsibility and Debt Management Act would lay the foundation for enhanced budget processes, debt management and fiscal risk management. Moreover, reforms to improve the efficiency and financial stability of the public pension system, the social security, and the public utilities company will be needed to preserve medium and long-term fiscal sustainability.

Financial Sector Policies

The authorities agree that increased credit provision to the private sector could support growth, especially given the low level of lending and the banks' strong capital and liquidity provisions during the pandemic. The introduction of the Palau Goods and Services Tax (PGST) will require businesses to prepare financial reports. Complying to this requirement will help address information asymmetry which has hindered lending to small and medium enterprises. Capacity building will also be needed in areas such as business plan preparation for bankable projects.

In recognition of the increased role of the National Development Bank of Palau's (NDBP) in the economy, there are plans to allow it to take deposits through a license of the Financial Institutions Commission (FIC). This will also support financial stability in general.

The authorities continue to make good progress on enhancing AML/CFT compliance. In particular, the moratorium on crypto assets and crypto currency activities will be maintained until adequate regulation are put in place. Technical support from the Fund in this area will be critical. Notable improvements were made to the Know-Your-Customer initiative and to the transparency of financial transaction reporting.

On Correspondent Banking Relationships (CBR) we remain very concerned that the Pacific region has been under severe pressure from de-risking (according to BIS, Swift data). Existing relationships have proven to be fickle and are sometimes terminated with only several months' notice. We therefore wish to express our appreciation and strong support for the ongoing work on this issue by Fund staff.

Climate Change

Climate change is adding new layers of economic and environmental challenges Palau is already facing. Higher temperatures and stronger typhoons are causing coastal flooding and destroy marine ecosystems which impose social and economic costs. Rebuilding after every natural disaster is becoming more and more expensive for the authorities. Hence, they are committed to building resilient infrastructure to address Palau's fragility to climate change.

The authorities emphasized the need to access climate finance (concessional loans and grants) to support their ambitious climate change adaptation and mitigation efforts. Notwithstanding the authorities' efforts to estimate the climate financing gap through the Palau Climate Change Policy, we encourage staff to assess how Palau could benefit from the Fund's climate technical assistance toolkits of CMAP and/or DRS.

Tourism

The pandemic risks leaving long-term scarring on Palau's tourism industry. The authorities are already considering a major adjustment to its tourism strategy, building on the 2016 Palau Responsible Tourism Policy Framework. A major feature of the policy is moving away from mass-tourism and focus on niche markets. In adjusting to COVID-19 social distancing requirements, the authorities aim to take advantage of opportunities offered by high-value and eco-tourism that promote culture while safeguarding its biodiversity. Furthermore, there is great potential benefits from including in the strategy a domestic agri-food supply chain and value-added industries, as well as the preservation of historical sites.

The authorities are also working to diversify source markets to include Oceania, Europe and the US.