INTERNATIONAL MONETARY FUND

IMF Country Report No. 23/430

REPUBLIC OF PALAU

December 2023

2023 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR 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 2023 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 December 1, 2023 consideration of the staff report that concluded the Article IV consultation with Palau.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on December 1, 2023, following discussions that ended on September 12, 2023, with the officials of Palau on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on [date on page 1 of final report circulated].
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Statement** updating information on recent developments.
- A **Statement by the Executive Director** for Palau.

Selected Issues

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

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International Monetary Fund
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PRESS RELEASE

PR23/467

IMF Executive Board Concludes 2023 Article IV Consultation with Palau

FOR IMMEDIATE RELEASE

Washington, DC – **December 21, 2023:** On December 1, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Palau.

Palau has emerged from the pandemic with significant output loss, high external debt, and inflation. After contracting by 2.0 percent in FY2022, economic activity is estimated to have stalled, growing by 0.8 percent in FY2023. Declining construction activity due to delays in the implementation of new infrastructure projects, is estimated to have offset a modest increase in tourism. Since fully lifting border restrictions in July 2022, the recovery in the tourism sector has been slow, reflecting lack of flights, tighter travel restrictions in Palau's source markets in East Asia, and the appreciation of the US dollar. After expanding to support the economy during the pandemic, fiscal policy has been significantly tightened towards its pre-pandemic balanced position.

Inflation has increased to historical highs—13 percent during FY2022 and FY2023—on the back of higher import prices for food and fuel due to Russia's war in Ukraine and global supply chain disruptions, the introduction of the Palau Goods and Services Tax (PGST), and one-off utility tariff adjustments. Inflation is projected to moderate to 5.9 percent in FY2024, as the impact of one-off price increases subsides.

While still subject to approval in the U.S. Congress, the renewal of the COFA Agreement (CRA-23) on May 22, 2023, under better financial terms, improves Palau's macroeconomic prospects. A gradual rebound in tourism and construction activity are expected to support the recovery, with growth projected at 12.4 percent in FY2024. Uncertainty around the outlook is elevated, reflecting the timing of approval of the CRA-23, strength of tourism recovery, international commodity price volatility, and natural disasters, with risks tilted to the downside.

Executive Board Assessment[2]

Executive Directors welcomed the improving economic outlook following significant scaring from the pandemic and commended the authorities for their decisive fiscal reform efforts over the past two years. Recognizing that the uncertainty around the outlook is elevated, Directors

[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.

encouraged the authorities to maintain their prudent policies and reform momentum to secure a sustainable economic recovery while addressing long-term growth bottlenecks and preparing for climate shocks. Directors emphasized the importance of continued engagement with development partners and the Fund, including in the area of technical assistance.

Directors welcomed the signing of a Compact Review Agreement (CRA) with the United States, under better financial terms, which would significantly enhance fiscal resources and present an opportunity to pay down debt while boosting priority social, infrastructure, and climate adaptation spending. Noting the high uncertainties, including on the timing of US Congress approval of the CRA, they welcomed the authorities' commitment to prudent fiscal and debt policies, supported by the Fiscal Responsibility Act and Debt Management Act, and the recent comprehensive tax reforms to enhance revenue mobilization. They encouraged further improvements in the efficiency of public spending, including more targeted social spending.

Directors underscored the importance of maintaining the reform momentum notably in the areas of civil service pensions, public sector employment, and wage bill management. They welcomed the authorities' plans to improve public financial management and encouraged the authorities to seek IMF capacity building in these areas.

Directors recommended enhancing financial sector resilience by further monitoring asset quality as pandemic support measures expire and strengthening financial sector supervision in the National Development Bank. Improving the payment system, and addressing structural impediments, including by establishing a credit bureau, would also be important.

Noting the benefits to financial inclusion, Directors called for a cautious approach to Fintech initiatives. They underscored the need to first close existing gaps in the regulatory and governance frameworks, and strengthen the country's AML/CFT framework, before exposing the financial system to new risks.

Directors underscored the importance of reforms to enhance the value added of tourism and encourage private and foreign direct investments. Integrating climate change adaptation and mitigation in the development policy is paramount given the criticality of climate risks for Palau.

It is expected that the next Article IV Consultation with Palau will be held on the 24-month cycle.

Table 1. Palau: Selected Economic Indicators

Nominal GDP for FY2022: US$246 million
Population (2022): 17,674
GDP per capita for FY2022: US$13,941
Quota: SDR 4.9 million

	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27
		Est.	Proj.				
Real sector							
Nominal GDP (million US$)	232.6	246.4	268.3	313.5	357.5	377.0	392.4
Real GDP growth (percent change)	-13.4	-2.0	0.8	12.4	11.9	3.5	2.0
GDP deflator (percent change)	4.2	8.1	8.0	4.0	1.9	1.9	2.0
Consumer prices (percent change; period average)	-0.5	13.2	13.0	5.9	2.2	2.2	2.3
Tourist arrivals (number of visitors)	3,412	9,247	35,052	70,509	91,681	106,686	110,954
Expenditure per Tourist Arrival (US$)	1,261	1,765	1,194	1,241	1,265	1,289	1,315
Public finance	(In percent of GDP, unless otherwise specified)						
Central government							
Revenue	57.6	57.7	48.9	51.7	48.2	47.5	47.0
Taxes and other revenue	24.0	22.7	26.8	26.9	25.8	25.7	25.6
Grants	33.6	35.0	22.1	24.9	22.4	21.8	21.4
Expenditure	65.3	61.0	48.6	49.8	47.6	47.2	46.7
Expense	56.9	52.5	44.1	41.3	40.0	39.9	39.8
of which: grants to other government units	10.1	6.9	7.1	7.9	7.2	7.2	7.0
Net acquisition of nonfinancial assets	8.4	8.4	4.4	8.5	7.6	7.4	6.9
Current fiscal balance (excluding grants) 2/	-32.9	-29.8	-17.3	-14.4	-14.2	-14.1	-14.2
Primary fiscal balance (including grants)	-7.3	-2.7	1.9	3.7	2.2	1.9	1.8
Net lending (+)/borrowing (–)	-7.6	-3.2	0.3	2.0	0.6	0.3	0.3
Compact debt service grants 3/				3.2	2.8	2.7	2.5
General government debt	70.7	68.4	66.2	53.8	45.4	41.7	37.4
Compact Trust Fund (CTF) balance	317.7	246.6	266.6	331.6	396.6	412.5	428.7
Financial sector							
Credit to private sector (in percent of GDP)	26.3	25.5	…	…	…	…	…
Credit to private sector (percent change)	2.8	2.4	…	…	…	…	…
Balance of payments 4/	(In millions of U.S. dollars)						
Trade balance	-127.1	-157.2	-149.0	-171.7	-191.4	-201.1	-206.3
Exports (f.o.b.)	1.1	2.1	3.1	5.6	6.0	6.4	6.4
Imports (f.o.b.)	128.1	159.3	152.1	177.3	197.4	207.5	212.7
Tourism receipts	4.1	15.4	37.5	78.8	104.6	124.3	132.1
Current account balance							
Including grants	-100.6	-134.9	-109.2	-82.1	-75.1	-60.2	-56.9
Excluding grants	-159.8	-201.4	-168.6	-155.1	-150.1	-137.3	-136.0
International Investment Position	-172.0	-373.1	-418.4	-373.6	-366.3	-399.7	-423.7
Assets	811.7	687.5	703.5	802.7	857.5	875.4	899.7
Liabilities	983.7	1,060.6	1,121.9	1,176.2	1,223.8	1,275.1	1,323.4
Of which: External debt	164.4	168.5	177.6	168.8	162.5	157.2	146.8
Current account balance	(In percent of GDP)						
Including grants	-43.3	-54.7	-40.7	-26.2	-21.0	-16.0	-14.5
Excluding grants	-68.7	-81.7	-62.8	-49.5	-42.0	-36.4	-34.7
International Investment Position	-74.0	-151.4	-155.9	-119.2	-102.5	-106.0	-108.0
Of which: External debt	70.7	68.4	66.2	53.8	45.4	41.7	37.4

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

INTERNATIONAL MONETARY FUND

REPUBLIC OF PALAU

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION

November 13, 2023

KEY ISSUES

Context. Palau has emerged from the pandemic with significant output loss, elevated public debt and historically high inflation. Adverse demographic trends, high dependence on tourism and external support, and vulnerability to climate change risks raise vulnerabilities. The authorities successfully enacted a fiscal responsibility framework and modernized the tax system. A new Compact Review Agreement (CRA-23), with better financial terms, is awaiting approval by US Congress.

Outlook and risks. Baseline projections assume the approval of Compact Agreement in FY2024. A gradual rebound in tourism is expected to support the recovery. Uncertainty around the outlook is elevated, reflecting the timing of approval of the CRA-23, strength of tourism recovery, international commodity price volatility, and natural disasters, with risks tilted to the downside.

Policies. Policies should focus on maintaining the reform momentum to secure a robust and sustainable economic recovery while addressing long-term growth bottlenecks. The CRA-23 presents an opportunity to pay down debt and rebuild fiscal buffers, while at the same time expanding spending in priority areas, including education, health, social security, infrastructure, and adaptation to climate change.

- **Fiscal policy** should remain prudent over the near-term in view of the uncertain economic recovery and higher debt and create fiscal space over the medium-term. The CRA-23 will help, but uncertainty around its timing requires contingency planning and continued fiscal prudence. Reform priorities include revenue administration, pension system, and public financial management.
- **Financial sector policies** should focus on improving financial sector supervision to preserve financial stability while addressing payment system challenges. The authorities' Fintech initiatives pose important financial integrity risks, and should be developed carefully, after closing the gaps in legal and governance frameworks.
- **Structural policies** should aim to diversify the economy and the tourism sector, enable private sector investment, and attract FDI, including by streamlining processes, improving the regulatory framework, and land-use planning. Climate change policies need to be integrated into development planning, with significant adaptation costs projected over the medium-term.

Approved By
Abdoul Wane (APD) and Bergljot B. Barkbu (SPR)

Discussions took place in Ngerulmud and Koror during August 30-September 12, 2023. The mission comprised Elif Arbatli-Saxegaard (head), Ricardo P. Davico, Irina Yakadina (all APD) and Csaba Feher (FAD). Robert Nicholl and Rhoda Karl (OED), Paul G. Seeds and John McAlister (all PFTAC), Jeanne Verrier (MCM), Kristina Miggiani (LEG), Emanuele Massetti, Danielle Minnett, Gemma Preston (all FAD) joined some of the meetings. Emanuele Massetti, Danielle Minnett, Gemma Preston (all FAD) gave a presentation on addressing climate change in Palau, policy options and strategies. Connor Kinsella, Saraf Nawar and Patricia Tanseco (all APD) contributed to the preparation of this report.

CONTENTS

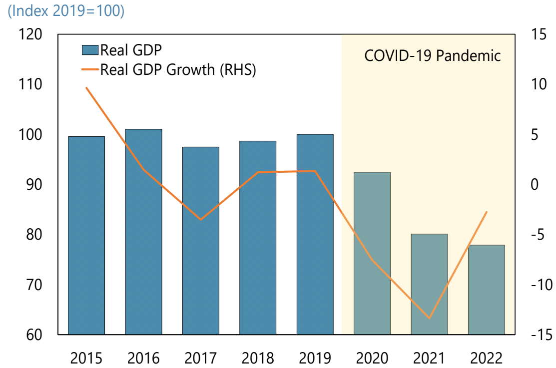
ANNEXES

CONTEXT AND POST-PANDEMIC LANDSCAPE

1. **The Republic of Palau is heavily dependent on tourism and external support, and vulnerable to climate change risks**. The country's small size limits scope for diversification, with tourism constituting about 40 percent of GDP and 25 percent of employment pre-pandemic. Island's dispersion and geographical isolation make Palau vulnerable to external shocks. Palau is heavily dependent on grants, primarily under a Compact of Free Association Agreement with the United States. While still subject to approval in the U.S. Congress, the signing of the new Compact Review Agreement (CRA-23) on May 22, 2023, under better financial terms, improves macroeconomic prospects (Annex I).

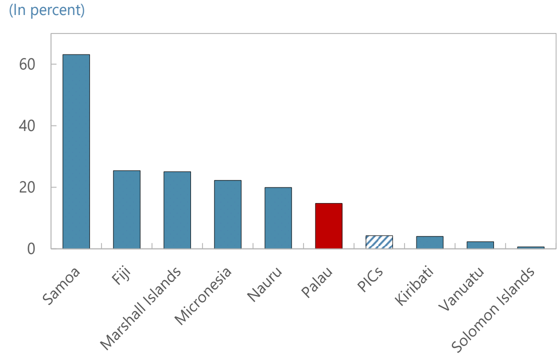
2. **The Palauan economy has emerged from the pandemic with significant scarring, elevated debt, and historically high inflation**. COVID-related isolation resulted in the loss of a fifth of the pre-pandemic level of GDP, and a spike in public debt—general government debt[1] surged to 70.7 percent of GDP in FY2020-FY2021[2] from about 30 percent of GDP before the pandemic. At the same time, inflation spiked to historical highs in FY2022 on the back of high food and fuel import prices. Rising cost of living and a protracted economic slump increased outward migration, adding to Palau's adverse demographic pressures—declining population and increasing dependency rates (Figure 1).[3]

Real GDP relative to Pre-pandemic Levels
(Index 2019=100)



Sources: Graduate School USA; and IMF staff estimates.

Migration Rates in the PICs, 2020
(In percent)



Source: United Nations

3. **Despite a challenging economic landscape, the authorities implemented important reforms since the pandemic**. The Fiscal Responsibility and Debt Management Act (FRDMA) was signed into law in 2021, and a major tax reform introducing a value-added tax, the Palau Goods and

[1] Palau's public debt is 100 percent external and mostly concessional (from ADB); public sector debt includes the subnational levels and SOEs.

[2] Fiscal year ends at the end of September.

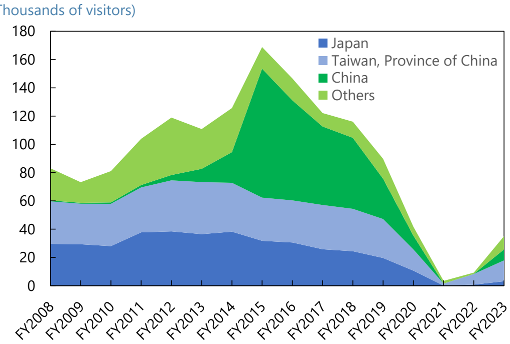
[3] The COFA allows Palauan citizens by birth to move to and work in the US without visa. There is anecdotal evidence of increased outward migration since the pandemic. Palau's elderly dependency ratio—ratio of elderly population (above 64) to working-age population (between 15-64)—has increased from 8 percent in 2005 to 13 percent in 2020 and is projected to increase to 19 percent by 2030 (United Nations Population Projections).

Service Tax (PGST), was adopted in 2021 and came into effect in January 2023 (Annex II). Macroeconomic policies implemented in recent years have been mostly in line with past Fund advice, but further reforms are needed to address looming pension system challenges (Table 6). Presidential and parliamentary elections are forthcoming in early November 2024 and mark an opportunity to accelerate reforms.

RECENT DEVELOPMENTS

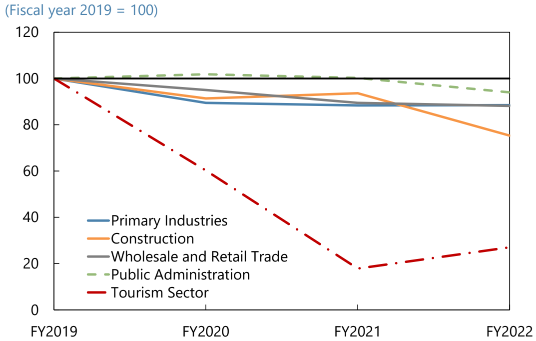
4. The post-pandemic economic recovery has been slow, reflecting a delayed upturn in tourism, fiscal consolidation, high inflation, and idiosyncratic supply shocks (Figure 2). After contracting by 2.0 percent in FY2022, economic activity is estimated to have stalled in FY2023 (+0.8 percent) because of continued declines in construction activity (due to winding down of big infrastructure projects and delays in the implementation of new projects), offsetting a modest pick-up in tourism. Since fully lifting border restrictions in July 2022, the recovery in the tourism sector has been impacted by lack of flights, tighter travel restrictions in Palau's source markets in East Asia, and the appreciation of the US dollar (Figure 3). Flights have been gradually resuming and arrivals are showing an uptick (to about 35 thousand in FY2023), though still well below pre-pandemic levels. On the expenditure side, government consumption and investment are estimated to have contributed negatively via a tighter fiscal stance and delays in large construction projects. Private consumption was subdued, reflecting high food and fuel prices, and the expiration of pandemic support measures.[4]

A "Rocky" Path in Tourism Arrivals
(Thousands of visitors)



Source: Palau Visitors Authority.

Economic Recovery by Industry
(Fiscal year 2019 = 100)



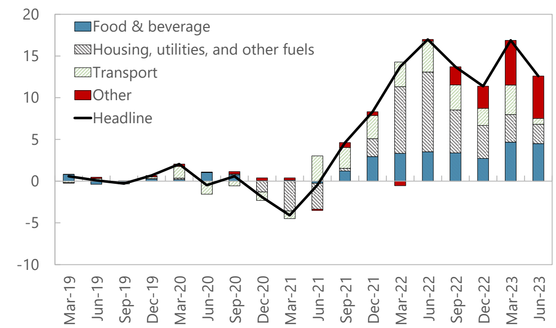
Source: Graduate School USA.

5. Inflation spiked to historical highs, driven by higher food and fuel import prices, one-off utility tariff adjustments, and the introduction of the Palau Goods and Services Tax (PGST). Palau's inflation rate hit a regional high of 13.2 percent (y/y) in FY2022 and is projected to remain elevated at 13 percent in FY2023. The large increase in inflation came on the back of a triple

[4] The Coronavirus One Stop Shop Relief Act (CROSS Act) comprised of a new unemployment benefits scheme, job creation scheme for public works, temporary subsidies for utility bills, and a lending scheme for the private sector, estimated at US$20 million. See 2021 IMF Article IV Report for a detailed discussion of the pandemic-related support measures. The CROSS Act expired in the third quarter of 2022 and while the CARES Act formally ended in March 2022, benefits were delivered retroactively to numerous eligible beneficiaries whose claims were initially rejected.

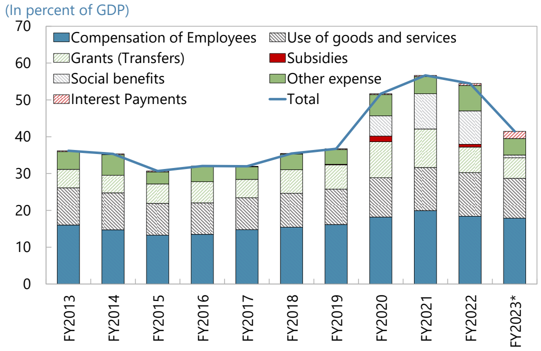
shock: a surge in import prices of food and fuel due to Russia's war in Ukraine and global supply chain disruptions, the introduction of the PGST in January 2023 and a sizable one-off utility tariff adjustment for households in May 2023. The introduction of the PGST was associated with a higher-than-expected pass-through to inflation pushing the CPI to surge by 17 percent (y/y) in 2023Q1.

Contribution to Headline Inflation
(In percentage points)



Source: Palau Office of Planning and Statistics, MOF.

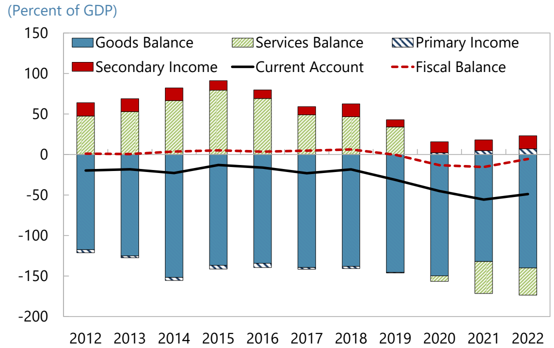
Composition of Current Expenditure, FY2013-23
(In percent of GDP)



Sources: Graduate School USA; and IMF staff calculations.

6. **After expanding to support the economy during the pandemic, fiscal policy has been significantly tightened towards its pre-pandemic balanced position (Figure 5)**. After peaking at 13.1 percent in FY2020, the fiscal deficit has declined to 3.2 percent in FY2022, largely reflecting the expiration of pandemic support measures. The fiscal deficit is projected to turn into a small surplus, (0.3 percent of GDP) already in FY2023, on the back of higher tax revenues—due in part to the early gains from the tax reform, with PGST alone yielding some 6.5 percent of GDP already in the first year of implementation. Expenditure is estimated to have declined significantly (by 17.5 percentage points of GDP), primarily driven by a 15.4 percentage points of GDP decline in project grants including related to the expiration of the support from the US CARES Act.[5] While total expenditure declined, the wage bill increased by about 1.5 percentage points of GDP, reflecting an across-the-board increase of 75 cents in the public sector hourly wage—a 20 and 7 percent increase relative to the minimum wage and the average public sector salary, respectively. The authorities also introduced several measures to mitigate the impact of the introduction of PGST and higher energy prices (e.g., tax refunds for low-income workers, utility subsidies) on households.

Current Account and Fiscal Balance
(Percent of GDP)



Source: Graduate School USA.

[5] Palau was eligible for the US Federal funds under Coronavirus Aid, Relief, and Economic Security (CARES) Act during FY2020-FY2022.

7. Palau's external position is assessed to be substantially weaker than implied by fundamentals and desirable policies in FY2022 (Annex III). The current account deficit peaked at about 55 percent of GDP in FY2022, amid a collapse in tourism and widening fiscal deficits, and is estimated to have declined to about 41 percent of GDP in FY2023. The REER has appreciated by 13 percent in 2022, driven by US dollar strength and Palau's relatively high inflation (Figure 4). Risks of external financing distress are low considering Palau's access to long-term concessional loans and grants.

8. Private sector credit growth remained steady during the pandemic, reflecting the expansion of lending by the National Development Bank of Palau (NDBP). Total credit to the private sector grew at an average rate of 3 percent between FY2019 and FY2022, reflecting the expansion of credit by NDBP, by 9 and 16 percent in FY2020 and FY2021 respectively. NDBP's expanded lending was facilitated by a concessional lending scheme[6] and an increase in housing loans under the Housing Development Loan Program.[7] As a result, NDBP now accounts for about half of overall credit, up from 10 percent pre-pandemic. Commercial bank credit, on the other hand, contracted by 8 percent in FY2021, and registered a modest 4 percent expansion in FY2022.

OUTLOOK AND RISKS

9. The economic outlook remains challenging, despite anticipated support from the CRA-23 and positive tourism trends. The baseline projections assume that the new CRA-23 will take effect in late FY2024. While the additional fiscal grants are expected to support growth and external balance, their timing and the speed of tourism recovery remain uncertain, as is the impact of high inflation on household spending.

- **Growth**. Output is expected to accelerate to 12.4 percent in FY2024, albeit from a low base. Recent positive trends in tourism, including higher tourist arrivals and additional actual and planned flights from source tourism markets (e.g., Korea, Hong Kong, SAR, Macao, SAR, and Singapore), and the construction of two new hotels starting next year, are expected to support the recovery. Visitor arrivals are projected to double to about 70 thousand. Construction activity is expected to accelerate, as material and labor bottlenecks are resolved. Major infrastructure projects are planned to break ground in FY2024, including upgrades to the communications and electricity infrastructure.

- **Inflation**. Inflation is projected to moderate to 5.9 percent in FY2024, as the PGST-related base effects (which explain about 60 percent of FY2023 inflation) will subside, supported by a projected decline in global commodity prices. Over the medium term, inflation is projected to

[6] Palau responded to the pandemic with a comprehensive policy package. One of the provisions of the Coronavirus One Stop Shop Relief Act (CROSS Act), was an US$1.5 million lending program targeting the tourism sector, which was administered by the NDBP.

[7] This is a program to help create affordable housing for citizens and is facilitated by a concessional US$15 million loan from the Mega International Commercial Bank.

return to a 2.0-2.5 percent range. Inflationary pressures and risks remain sizeable due to potential second-round effects of tariffs and public sector wage hikes.

- **External sector**. The current account deficit is projected to narrow in FY2024 to 26.2 percent of GDP and continue to decline over the medium term, supported by higher grants under the new CRA-23, the recovery in tourism and subsiding commodity prices.

- **Fiscal position**. The FY2024 budget, recently passed by the Palau National Congress (OEK), has conservative tax revenue projections, and envisions a broadly flat expenditure envelope (excluding expenditures financed through non-Compact grants), while accommodating an additional 7 percent increase in the public sector hourly wage. Along with the full year impact of the tax reform, the recovery in economic activity is projected to raise tax revenues, and higher budgetary grants under CRA-23 is expected to provide a further boost, while expenditure is projected to remain contained. As a result, the fiscal surplus is projected to increase to 2.0 percent of GDP, up from 0.3 percent of GDP projected for FY2023.

10. Uncertainty around the outlook is elevated and risks remain tilted to the downside (Annex IV). Delays in US Congress approval of the new CRA-23 constitute the key near-term risk. The projected recovery in the tourism sector could fail to materialize fully and extreme climate events, including potential droughts related to El Niño can have an adverse impact on growth and push up inflation. Global risks are tilted to the downside and involve an abrupt global slowdown and commodity price volatility. For the longer term, Palau's small size and geographical isolation will continue to make it vulnerable to external shocks and limit scope for diversification. Further, higher outward migration due to lackluster growth could exacerbate Palau's adverse demographic trends.

Authorities' Views

11. The authorities agreed with the staff assessment of the macroeconomic outlook and risks. They expect the economy to be on a recovery path from FY2024, supported by a gradual resumption of tourism activities. The authorities remain cautious about the recovery, with tourism-related activities expected to remain below pre-pandemic levels through FY2026, pointing to several years of disappointing tourism arrivals. The authorities underscored that recent high inflation has been driven by a combination of different shocks, including the introduction of PGST, which has been associated with a higher-than-expected pass-through to prices. Inflation is expected to come down in FY2024, reflecting the dissipation of base effects, but the outlook is subject to high uncertainty reflecting the possibility of new commodity price shocks. Over the long-term, the authorities expect the implementation of a high-value tourism strategy, supported by prudently selected new opportunities in the international finance sector, to support growth. The authorities emphasized the importance of CRA-23 for Palau's macroeconomic prospects and expect it to come into effect in FY2024, though uncertainty remains regarding its timing.

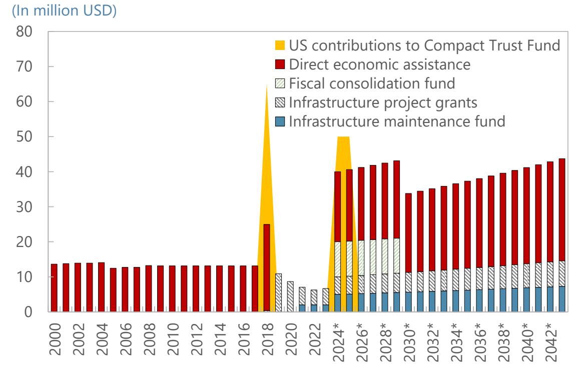
12. The authorities agreed with the external balance assessment, including the related uncertainty. They indicated that the COVID-19 pandemic continues to affect the assessment, given Palau's delayed recovery. They concurred that the current account deficit should narrow over the medium-term, with the recovery in tourism. At the same time, the fiscal position has improved significantly, supported by enhanced revenue mobilization, and is projected to improve further with higher grants under the CRA-23. The authorities agreed that structural reforms to diversify export related services, including in the tourism sector, should lower external risks and using Compact funding to build fiscal buffers over the medium-term should enhance Palau's external position.

POLICIES FOR THE POST-PANDEMIC RECOVERY

A. Fiscal Policy

13. The CRA-23 is projected to significantly enhance fiscal space. Under the draft legislation, Palau would receive additional US$899 million in grants over 20 years (FY2024-43), which includes 5-6 percent of GDP per year in budgetary grants (excluding infrastructure grants) and an additional 3 percent of GDP per year (for six years) as fiscal consolidation grants (Annex I). If approved in a timely manner, CRA-23 grants would help Palau reduce the pandemic debt build up, and increase cash buffers, while maintaining budgetary surpluses over the medium term. Based on the new Sovereign Risk and Debt Sustainability Framework (Annex V), Palau's debt is sustainable with high probability, and public debt is projected to decline to 33.7 percent of GDP by FY2028.

Transfers Under the Compact Agreement, FY2000-43
(In million USD)

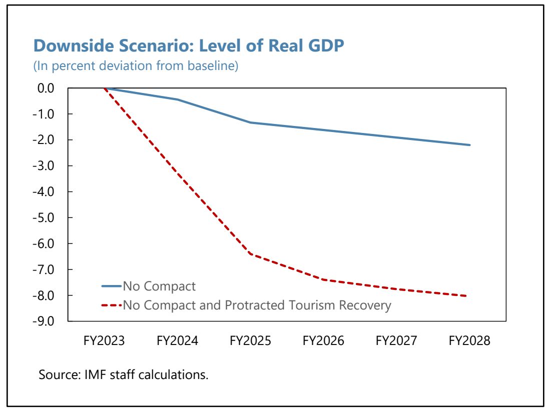


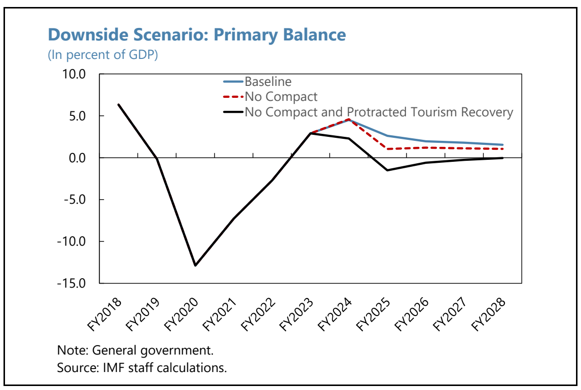
Sources: Graduate School USA; and IMF staff calculations.

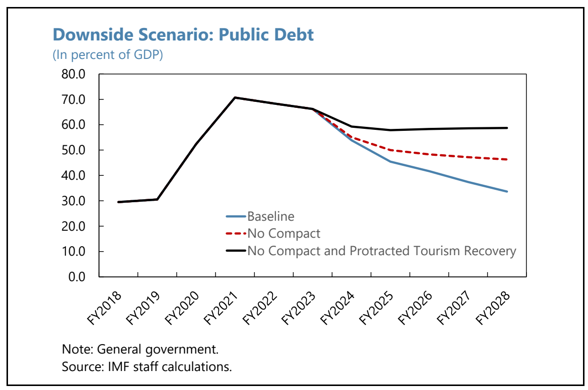
14. Uncertainty about the timing of the CRA-23 approval calls for a prudent fiscal approach in FY2024. Given the high uncertainty and lingering inflationary environment, a contractionary fiscal stance in FY2024 is appropriate, while further protecting the most vulnerable from cost-of-living shocks. If the Compact grant financing is temporarily delayed, the authorities have options to finance potential deficits in the interim, including additional Compact Trust Fund (CTF) withdrawals (of up to US$30 million) approved in the budget as a stopgap measure, a concessional US$25 million loan from ADB expected to be approved in 2024Q1, and using existing cash buffers, but a prolonged delay would require prioritizing measures to continue with fiscal consolidation over the medium-term. Under a risk scenario with no Compact disbursements over the medium-term and a weaker tourism recovery, debt sustainability risks would remain elevated (Box 1). Under such a scenario, a gradual fiscal consolidation over the medium- to long-term (of about 4 percentage points) underpinned by revenue mobilization and improvements in expenditure efficiency (see paragraph 15) can put debt firmly on a downward trajectory, create fiscal space for priority spending and safeguard the CTF.

Box 1. Downside Scenario

A downside scenario where the approval of the Compact agreement is delayed, and the tourism recovery is markedly weaker would result in elevated debt sustainability risks. Assuming a long delay in CRA-23 approval (beyond FY2028) would significantly lower grant revenues relative to the baseline. It is assumed that drawdowns (US$15 million per year) from the Compact Trust Fund would continue as in the baseline from FY2025 onwards while lower grants would lead to partial spending cuts[1], particularly on capital projects. Primary balance in FY2024 would not be impacted under the no-Compact scenario, reflecting the assumption of additional CTF withdrawals (stopgap measure). Overall, this scenario would imply lower primary surpluses, higher debt-to-GDP ratios (46.3 percent of GDP in FY2028 versus 33.7 percent under the baseline), and lower cash accumulation relative to the baseline.[2] A more severe scenario where tourism recovery is weaker than in the baseline (by 20-30 percent) in addition to no Compact agreement leads to significantly lower growth and primary balances over the medium term (by about 2 percent of GDP). Debt would stabilize at over 60 percent of GDP despite favorable interest rate-growth differentials.







[1] Capital projects are assumed be cut reflecting the shortfall in the Compact and US Federal Programs financing.

[2] The impact of a delay in Compact approval on debt is lower than the additional budget and debt consolidation grants as CTF withdrawal would be higher in FY2024, expenditure would be adjusted over the medium-term, containing the deterioration in primary balance and cash accumulation would be lower.

15. **A medium-term fiscal strategy that integrates concrete policies and projects to support Palau's development objectives while rebuilding fiscal buffers is necessary**. A prudent fiscal stance, in line with the Fiscal Responsibility Framework and consistent with staff's baseline projections, is appropriate, and should be supported by a full review of government saving vehicles and a new debt management strategy. Such a strategy should help set target contributions to the Cyclical Reserve Fund and Climate Resilience Fund and manage cash deposits and debt service after the Compact fiscal consolidation assistance expires. The fiscal strategy should also create fiscal space by enhancing expenditure efficiency and solidifying tax reforms.

- **Expenditure policy**. With higher financial resources afforded under the Compact Agreement, expenditure policy should focus on: (i) investments in infrastructure, health, and education to deliver the country's development goals and address long-term challenges like climate and demographic change; and (ii) improve expenditure efficiency by further streamlining subsidies and transfers. An assessment of the social assistance needs and programs is warranted and can be informed by the ongoing Household Consumption and Income Survey.

- **Revenue mobilization**. Bureau of Taxation has made progress with strengthening core tax administration functions, and effectively managed the transition to the new tax regime in 2023. Prioritizing revenue administration, including enhancing regulations, developing, and implementing a digital roadmap, and continued progress with capacity building, are critical to reap the benefits of recent reforms. Additional tax policy measures (e.g., implementation of a comprehensive income tax regime, and raising the carbon tax rate) could be considered in the medium-term once the recovery is entrenched and recent reforms are effectively implemented.

16. Palau needs swift public sector reforms to contain fiscal risks. The reforms need to focus on the pension system—in particular, the civil service scheme (Civil Service Pension Plan, CSPP)—and public sector employment and wage bill management. Efforts to reform the pension system and encourage the government to conclude the preparation of CSPP reform bill, which honors past pension rights, curtails the growth of unfunded liabilities, and reduces the budget's exposure to underwriting risks (Annex VI). It is also important to review public sector employment and compensation policies so that the public sector payroll better reflects the skill mix required by the government and addresses emigration challenges. The establishment of an Employment and Compensation Committee—in line with FAD technical advice—is recommended to review existing, and establish systematic hiring, promotion, and compensation policies.

17. While Palau's public financial management systems, by-and-large, reflect good practice, further improvements are needed. The FRBM Act (Annex VII) establishes a solid basis for good PFM practices, however, the recent PEFA found areas where additional measures are needed. A PFM Reform Roadmap, currently at an early stage of government review, will focus on: (i) improving the transparency of the budgeting, debt reporting, and public procurement process; (ii) completing prior years and current audit reports, and establishing an action plan for the timely audit of the Annual Financial Statement; (iii) establishing the legal and institutional framework for the effective oversight of state-owned enterprises; (iv) continuing the rollout of the Financial Management Information System; and, (v) improving PFM skills at state governments. Public financial management policies can also assist in climate change mitigation and adaptation efforts, by incorporating climate and natural disaster risks in the budget process.

Authorities' Views

18. The authorities emphasized that Palau's fiscal policy will be guided by the principles of fiscal responsibility enshrined in their Fiscal Responsibility and Debt Management Act. The authorities agreed that a tightening fiscal stance is appropriate in the near term, given the elevated macro-fiscal risks and high public debt, while protecting vulnerable households from cost-of-living shocks. The authorities welcomed staff's positive assessment of their reform initiatives, including the successful implementation of a major tax reform this year. Enhanced domestic revenues from the reform, together with the economic recovery, and higher grants under the CRA-23 are expected to generate large fiscal surpluses, which can be used to pay down debt and rebuild fiscal buffers, while at the same time expanding spending in priority areas. The authorities expect climate change related spending to increase considerably over time and have also emphasized important infrastructure gaps which will require additional financing over the medium-term. The Palau Development Plan, which is currently being drafted, can inform such priority areas and projects. Finally, authorities agreed that reforms to the Social Security System and Civil Service Pension Plan are important to ensure long-term sustainability and highlighted that significant progress has been made with drafting reform proposals.

19. The authorities are committed to pursuing reforms to further improve public financial management. They plan to finalize a PFM Roadmap, with IMF technical assistance, building upon a recently finalized PEFA assessment. The authorities are also committed to improving the management of fiscal risks, focusing on macro-fiscal risks, SOE sector risks and natural disasters, and to eliminate the backlog of financial audits of the government and public entities, caused by the pandemic-related logistical difficulties Other future initiatives include establishing internal audit and SOE oversight functions within the Ministry of Finance, broadening the publication of public finance documents and data, formulating a debt management policy, and strengthening PFM in state governments. The government is also actively discussing with advisors how PFM regulations may incorporate climate considerations. Finally, the authorities are committed to pursue public sector wage bill reform, with the objective to align the size and skill mix of the public sector payroll to the needs of the government, improve productivity, and attract and retain skilled labor.

B. Financial Sector Policies and Digital Initiatives

20. As the pandemic support measures expire, asset quality in the financial sector warrants close monitoring. Systemic risk is assessed to be moderate—reflecting the protracted recovery—and subject to significant uncertainty. Non-performing loans in the banking system have remained stable and low at around 0.6 percent in 2022. However, NDBP has significantly higher NPLs (estimated at around 13 percent), contributing to fiscal and financial systemic risks. In that context, the authorities are encouraged to upgrade NDBP's risk management and reporting and governance frameworks.

21. Efforts should focus on improving financial sector supervision. The supervisory capacity and resources of Palau's Financial Institutions Commission (FIC) should be enhanced, in line with its expanding mandate as laid out in its strategic plan (e.g., to regulate and supervise virtual assets/virtual asset service providers (VA/VASP)) and to mitigate risks from inadequate staffing. The US bank branches are systemically important and can be a source of international spillovers. Efforts are under way to enhance prudential regulations and returns issued by the FIC following the latest international standards. In addition, steps should be taken for NDBP to be supervised by the FIC (e.g., obtaining a bank license), given the significant role it plays in credit provision. Contingency plans and crisis preparedness in the event of natural disasters are also important.

22. Palau's financial system could play a stronger role in developing the private sector and improving the payment system. Structural impediments, including lack of collateral and record keeping practices, reduce opportunities for commercial banks to expand lending to the corporate sector. Establishment of a credit bureau—currently under consideration by the authorities—could reduce information asymmetries and help banks better manage credit risk. The payment landscape faces important challenges with high transaction fees and remains primarily cash- and check-based. The three US banks play a critical role in the payment system, and they constitute the sole correspondent banking relationships (CBRs).

23. The authorities should strengthen policies to mitigate potential financial integrity and other macro-financial risks related to their Fintech initiatives. The authorities are exploring two main Fintech initiatives as part of their economic diversification strategy and to offer cheaper and more convenient digital payment solutions.

- **Digital residency program (DRP)**. Rolled out in January 2022, DRP has registered about 10 thousand digital residents as of August 2023, and generated fiscal revenues of about US$1.4 million in FY2023. The Digital Residency Act's provision on legal name change, though currently not implemented, poses a serious risk that the DRP may be misused by persons wanting to conceal their identities. The authorities are encouraged to repeal this legal name change provision together with the implementation of enhanced risk mitigation measures aimed at ensuring transparency, oversight, and accountability. The authorities should ensure that the vetting of applicants is robust and includes sanctions and politically exposed persons (PEP) screening. Conducting a periodic review of applicants would also flag changes to the risk profile of DRP ID holders.

- **State-backed stablecoin**. The authorities are considering a US dollar-backed stablecoin, fully collateralized with safe assets held at a custodian bank, and recently launched a proof-of-concept. The stablecoin is intended to bring several benefits, including to make payments easier and more affordable, and increase financial inclusion. The main proposed use cases include low-fee person-to-business payments, person-to-person payments for local customs, remittances, and payments related to crypto tourism. Given the significant macro-financial, legal, financial integrity, regulatory, cybersecurity and reputational risks involved if the stablecoin is not developed and regulated well, the authorities' intention to move cautiously is appropriate. A full-fledged feasibility study and engagement with stakeholders are warranted to assess the benefits and risks of the stablecoin with respect to alternative options. The authorities should assess the ML/TF risks of stablecoin issuance and develop appropriate measures to effectively manage and mitigate these risks prior to launch.

24. Efforts to improve AML/CFT frameworks should continue, while taking a cautious approach to Fintech initiatives, which could pose important financial integrity risks. Gaps in the legal and AML/CFT frameworks, including those relating to prudential regulations, and Palau's Fintech initiatives, coupled with low institutional capacity contribute to significant risks, including potential loss of CBRs. The authorities should take a cautious approach to digital initiatives and first close existing gaps in the regulatory and governance frameworks, and strengthen the country's

AML/CFT framework, before exposing the financial system to new risks. At the same time, Palau is encouraged to continue to make progress on the 2018 Asia/Pacific Group on Money Laundering (APG) Mutual Evaluation Report (MER) recommendations, including by improving AML/CFT preventive measures, undertaking sectoral risk assessments, and implementing the VA/VASP requirements of FATF Recommendation 15 (e.g., putting in place AML/CFT regulations that specifically regulate VA/VASPs and finalizing the system for registering VASPs). Finally, strengthening risk-based AML/CFT supervision for financial institutions and designated non-financial business and professions (DNFBPs) such as real estate agents and lawyers, who represent high ML/TF risks, and strengthening the collection and publication of beneficial ownership information by companies remain important priorities.

Authorities' Views

25. The authorities shared staff views on the need to strengthen financial sector supervision. They noted that efforts are underway to enhance prudential regulations and to increase the resources of FIC, in line with its expanded mandate. They concurred with staff on the need to strengthen the financial system's role in developing the private sector, and plan to establish a consumer bureau, in line with staff recommendations. The authorities are also in the process of drafting a new payment system legislation outlining the legal framework for the establishment, regulation, and the oversight of a national payment system. Finally, the authorities agreed that taking steps to make NDBP supervised by FIC is a key priority, which will also help improve its financial management and noted that legislation allowing NDBP to take deposits has already been passed.

26. The authorities agreed on the need to move cautiously with their FinTech initiatives and recognized the associated financial integrity risks. The authorities emphasized that CDD checks for the DRP applicants are conducted by a KYC solution provider (SUMSUB), and the results are reported to the Digital Residency Office, which then conducts a second check against domestic criminal and migration lists. The authorities also noted that there are no plans for implementing the Digital Residency Act provision that allows for legal name change. The authorities agreed that it will be important to move cautiously with their stablecoin project and noted several steps that they expect to complete—including an analysis of the recent pilot, the implementation of additional pilots with a larger scope, securing a custodian bank, and a feasibility assessment—before a decision to launch the stablecoin is considered. The authorities agreed on the need to prioritize adopting legislation to regulate VA/VASPs, in line with FIC's strategic plan and expressed interest in technical assistance for ML/TF risk assessment related to VAs/VASPs. The authorities also noted that they are making some progress with enhancing risk-based supervision of DNFBPs and have submitted a TA request for help with their national risk assessment.

C. Structural Policies and Climate Change

27. Well-sequenced structural reforms are needed to diversify the economy and encourage private sector investment. The authorities are in the process of preparing a new

National Development Plan (NDP), which will identify actions and priorities in different sectors to achieve sustainable and inclusive growth. Effective implementation and enabling policies are critical to reap maximum benefits. Policies to enable private investment and attract FDI, including by streamlining processes, improving the regulatory framework and land-use planning, rule of law in the areas of property rights and contracts, and improving infrastructure are important. Given the limited scope to diversify exports, it is important to achieve diversification and higher value-added within the tourism sector. In this context, the authorities have made progress in diversifying the tourism offering, including expanding in-land tourism, cultural tourism, and small-scale manufacturing of handcrafts. However, further progress is needed to encourage greater entrepreneurship, diversify source tourism markets, increase linkages to the domestic sectors and enhance coordination and planning efforts within the government and the private sector (Annex VIII).

28. Investing in human capital development can help close skill gaps in the labor market, raise productivity and incomes, and arrest outward migration. Education policies should focus on teacher training and skills, upgrading school infrastructure, and vocational training. Investing in education and health can also help reduce outward migration, raise labor force participation (including of females), and incentivize Palauan citizens living abroad to return to Palau.[8]

29. Climate change is macro-critical given the significant adaptation costs and the impact of extreme weather events. Based on modelling estimates, Palau faces potential losses from sea-level rise of about 3 percent of GDP annually, on average, between 2020 and 2049, along an upward trend. It is estimated that cost-effective adaptation with a balanced mix of protection and planned retreat can reduce these losses to 1 percent of GDP per year (Box 2).[9] Adaptation strategies will need to consider rendering existing infrastructure more climate resilient (for example, roads) or retreating from coastal areas by transferring infrastructure (such as health care and education facilities) to better protected regions. Palau can also consider introducing a building code supporting more resilient construction standards—given the growing likelihood of catastrophic typhoons and tropical storms. Despite high average precipitation, periodic droughts represent important risks due to the limited catchment and retention capacity, and dilapidated infrastructure. To ensure stable supply of drinking water, major investments will be needed, potentially with external financial support.

30. Adaptation and mitigation will be most effective if integrated into the development planning. Cost-benefit analyses, including monetization of externalities will be useful for efficiently allocating resources across competing spending needs and the quantification of distributional

[8] Other policies (e.g., U.S. government allowing qualifying Palauan citizens to claim their U.S. Social Security and veteran benefits in Palau) are under consideration and could be highly beneficial.

[9] Palau 2023 Article IV Selected Issues Paper titled "Addressing Climate Change in Palau: Policy Options and Strategies" includes more detailed analysis on adaptation, mitigation and PFM policies related to climate change.

effects can be used to assess efficiency-equity trade-offs.[10] Removing barriers to efficient adaptation by the private sector will help unlock private investment. Palau's NDC targets[11] appear ambitious given the small share of its renewable energy production. There is room to improve the energy generation mix through carbon pricing and the ongoing reform of the PPUC, which may facilitate market entry of private renewable energy producers. This could also support external balance, reducing reliance on imported fuel. PPUC's targets of 10 percent and 25 percent of energy generation via solar farms by 2024 and 2025, respectively, are welcome and could be supported by ambitious upgrades in power generation and distribution. Completion of the recently published National Disaster Preparedness Baseline Assessment and the ongoing update of the Palau Climate Change Policy are welcome.

31. Appropriate public financial management policies can also assist in adaptation and mitigation efforts. Incorporating climate considerations in the budgeting process, integrating climate and natural disaster risks into fiscal risks assessments, and strengthening the assessment criteria for public investment planning and project appraisal to ensure adherence to resilient building codes and incorporating vulnerability to climate events, are important. These policies and broader PFM reforms can also help access climate risk financing from multilateral climate funds.[12]

Authorities' Views

32. The authorities noted that the pivot towards becoming a higher value tourism destination is underway. To promote longer stays, the authorities have contracted a consulting company to assist in developing a strategy to attract digital nomads and other longer stay visitors. Alongside these developments, the authorities are working with partners to upgrade the Port of Malakal, making it capable of accommodating larger vessels for both commercial and military use. Finally, to facilitate foreign investment the authorities highlighted a One-Stop-Shop concept for business license and permit applications that is near completion. This approach brings together relevant government agencies under one roof to streamline and expedite the review and regulatory process for foreign investment.

33. The authorities emphasized the importance of climate change adaptation and mitigation in their development policy. The authorities are updating their National Climate Change Policy and highlighted the importance of incorporating climate change into national planning, as well as developing KPIs and indicators to measure gaps. Amid growing threats of natural disasters and climate change, the authorities are committed to include climate change considerations in public investment management and planning, and to seek cost-effective and

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[10] The analysis in Box 2 is an example of how cost-benefit analysis can be applied to adaption to sea-level rise. Standard practices of cost-benefit analysis (CBA) must apply also to adaptation projects. For a discussion of challenges to CBA implementation in case of adaptation projects, see Bellon and Massetti (2022).

[11] Palau's Intended National Determined Contribution (INDC) aims to reduce energy sector emissions 22 percent below 2005 levels, increase renewable energy share to 45 percent and improve energy efficiency by 35 percent by 2025.

[12] Currently most climate-related financing to Palau is through bilateral sources of funding.

socially acceptable adaptation policies. There is also a plan to complete and issue a building code to promote more weather-resistant and climate-friendly technologies. The authorities noted that they are on track to implement their strategy of significantly increasing the economy's reliance on renewable (solar) energy and upgrading the power distribution infrastructure to improve reliability of supply. The authorities are also in the process of formulating Palau's second NDC, which will emphasize transportation and waste management. Finally, the authorities noted that energy costs are already relatively high in Palau given its remote location, and any adjustments to the carbon tax would depend on the level of current prices and local incomes.

D. Other Issues

34. Further improving statistics and building capacity. Palau's statistics are broadly adequate for surveillance, but further improvements in capacity and TA are needed to strengthen the quality and timeliness of macroeconomic data.[13] Priority areas include improving GDP deflators, broadening the coverage of fiscal data to the general government level, and the development of quarterly statistics for BOP, real, and fiscal sectors. Palau has also implemented the enhanced General Data Dissemination System (e-GDDS) in February 2022, with support from the IMF Statistics Department and the rebasing of GDP in FY22 was an important step. Efforts are underway to enhance the monitoring and analysis of data on climate change, and introduction of PGST offers an opportunity to collect comprehensive corporate data.

Authorities' Views

35. The authorities are committed to address data gaps with technical assistance from the Graduate School USA, the Fund, and ADB. Efforts are underway to improve data collection and compilation, and progress has been made recently with expanding the resources of the statistics office. The authorities are focusing on addressing gaps in the national accounts and improving GFS data, compiling quarterly estimates for GDP, and developing Producer Price Indexes, as well as Export & Import Price Indexes for key industries in Palau. The authorities are also keen to strengthen the capacity of state governments to facilitate timely production of financial statements. The ongoing Household Expenditure and Income Survey is expected to be finalized in early-2024, which will provide a critical update on demographics, and socio-economic indicators, as well as provide new weights for the CPI. The authorities also plan to develop new statistical indicators to provide insights on environmental and climate statistics and greater use of Geographical Information Systems (GIS) to assess vulnerabilities.

STAFF APPRAISAL

36. Palau is gradually recovering from the pandemic, thanks to higher tourist arrivals but is facing important challenges. The pandemic reduced GDP by over 20 percent and led to a significant increase in public debt. Inflation reached historically high levels on the back of high food

[13] See Statistical Issues Table in the Informational Annex for a more detailed discussion.

and fuel import prices, PGST introduction and one-off utility tariff adjustments. Palau's external position was substantially weaker than implied by fundamentals and desirable policies in FY2022. While still subject to approval in the U.S. Congress, the signing of CRA-23, under better financial terms, improves macroeconomic prospects.

37. The economic outlook is subject to elevated uncertainty and risks are tilted to the downside, including from delays in US Congress approval of the new CRA-23, a weaker recovery in the tourism sector, commodity price volatility, and extreme climate events, such as potential droughts related to El Nino.

38. Fiscal policy, which supported the economy during the pandemic, has been tightened toward pre-pandemic levels. The fiscal balance (including grants) is projected to return to a surplus in FY2023 and improve further in FY2024. Given the high uncertainty and lingering inflationary environment, a contractionary fiscal stance in FY2024 is appropriate, while further protecting the most vulnerable from cost-of-living shocks. While there were measures to help vulnerable populations, the historical loss of purchasing power may be calling for a larger—and more targeted—-support for the most vulnerable.

39. The new CRA-23, once approved, is expected to significantly enhance fiscal space. The CRA-23 presents an opportunity to pay down debt and rebuild fiscal buffers, while at the same time expanding spending in priority areas, including education, health, social security, infrastructure, and adaptation to climate change. If approved in a timely manner, additional grants would help Palau reduce the pandemic debt build up while maintaining budgetary surpluses over the medium term.

40. A medium-term fiscal strategy that integrates concrete policies and projects to support Palau's development objectives while rebuilding fiscal buffers is necessary. A prudent fiscal stance over the medium term, in line with the Fiscal Responsibility Framework, is appropriate, and should be supported by a full review of government saving vehicles and a new debt management strategy. As investments in infrastructure, health, and education are essential, ensuring uninterrupted future revenue mobilization while improving expenditure efficiency will continue to be vital.

41. Further efforts are needed to contain fiscal risks and improve public financial management. Palau's implementation of important fiscal reforms, including a fiscal responsibility framework in 2021 and a comprehensive tax reform in 2023, is commendable and continuing the reform momentum remains critical. Reforms need to focus on the pension system—in particular, the civil service scheme —and public sector employment and wage bill management. For the latter, the ongoing review should focus on policies to address emigration challenges. Public financial management improvements are also required, focusing on transparency, audit reports, oversight of state-owned enterprises, and capacity building.

42. Financial sector asset quality needs monitoring as pandemic support measures expire. Private sector credit growth remained steady during the pandemic, largely due to lending by the NDBP but the potential increase of non-performing loans at NDBP warrants attention. Financial sector supervision should be enhanced, with a focus on FIC resources and international standards. The financial system can play a greater role in developing the private sector and improving the payment system. Addressing structural impediments, like collateral issues and record keeping, as well as the establishment of a credit bureau can help.

43. Fintech initiatives should be approached cautiously to mitigate financial integrity and other risks. Gaps in the legal and AML/CFT frameworks, including those relating to prudential regulations, and Palau's Fintech initiatives, coupled with low institutional capacity contribute to significant risks. The authorities should take a cautious approach to digital initiatives and first close existing gaps in the regulatory and governance frameworks, and strengthen the country's AML/CFT framework, before exposing the financial system to new risks.

44. Structural reforms and strategic planning can support economic diversification and encourage private sector investment. Efforts underway to streamline business processes and diversify and increase value-added within the tourism sector are welcome. Further efforts to improve the regulatory framework and land-use planning, rule of law in the areas of property rights and contracts, and improving infrastructure are important. Investing in education and health are critical to help close skill gaps in the labor market and raise productivity and incomes.

45. Climate change policies must be integrated into development planning while public financial management policies should support climate change efforts. Adaptation strategies will need to consider rendering existing infrastructure more climate resilient or retreating from coastal areas by transferring infrastructure (such as health care and education facilities) to better protected regions. Cost-benefit analyses will be useful for efficiently allocating resources across competing spending needs.

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

Box 2. Climate Change Impacts and Adaptation Policies in Palau

Climate change presents pronounced risks on Palau, including through sea-level rise, ocean acidification, and an increase in the frequency and intensity of extreme rainfall events. According to estimates by the Australian Bureau of Meteorology and CSIRO, by 2030, sea-level in Palau could increase by an additional 8 to 18 cm relative to its average 1986–2005 level and if emissions follow present trends (SSP2- 4.5), by 2070, sea-level could increase by 23 to 48 cm above its 1986–2005 level. Coastal flooding constitutes a key impact, since some of the key infrastructure—namely the national port, fuel distribution facility, national hospital, and causeways—are susceptible to inundation from sea level rise and storm surge. In addition, many communities, especially in low-lying atoll islands, are located at or near coastal areas, and according to estimates by Pacific Disaster Center, about 30 percent of Palau's population would be impacted by sea level rise and storm surge. Available data is not suitable to provide a robust assessment of historical trends in neither the frequency nor the strength of tropical cyclones (typhoons) and droughts that occasionally hit the country, but previous events were associated with large economic costs.

Recent Climate-related Events Affecting Palau

Event	Year	Estimated Impact (millions of USD)
Typhoon Bopha	2012	15-20
Typoom Haiyan	2013	9.7
Drought from El Nino	2016-17	3.2
Tropical Cycline Surigae	2021	4.8

Source: Pacific Disaster Center

The Coastal Impact and Adaptation Model'(CIAM)[1] is used to estimate the cost of sea-level rise in Palau under alternative adaptation strategies. Three scenarios are considered under the baseline assumption that global emissions will follow present trends (text charts): (i) no planned adaptation; (ii) full protection; and (iii) efficient adaptation. The cost of sea-level rise in the no-adaptation scenario is estimated to be as high as 4 percent of GDP in 2040 annually, with inundation-related loss of land, relocation, and storm damages contributing most. The alternative hypothetical scenario in which all the coastline is protected would require an investment of approximately 2 percent of annual GDP in 2040 and an upfront investment of up to 5 percent of annual GDP during the present decade. Efficient adaptation, on the other hand, involves costs approximately equal to 1 percent of GDP, annually, throughout the century.[2] While the model provides a useful framework to systematically think about costs and benefits of alternative adaptation options to sea-level rise, its estimates are subject to significant uncertainty, including related to modelling assumptions and projected trajectory of sea-level rise, which is important to consider in policy assessments.

Notwithstanding the significant uncertainty in estimates, sea-level rise costs can be greatly contained with careful planning, and a balanced mix of protection and planned retreat. Investment in seawalls and similar expensive infrastructure should be assessed case-by-case using high-resolution analysis. Based on the CIAM model estimates for Palau and in many other country cases, planned retreat is found to minimize losses without large capital investment. While this strategy requires accepting residual damages with distributional effects, these should be thoroughly assessed, as it also preserves fiscal space to pursue other development goals. Cost-benefit analysis can help in this task by providing a standard framework to estimate social costs and benefits.

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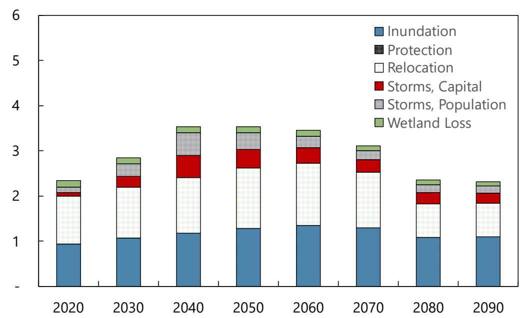
[1] CIAM is a global optimization model for cost-benefit analysis of adaptation, using projections of local sea-level rise, and information on different coastal segments to estimate the areas that will be inundated and the amount of capital and population at risk. It also accounts for storms which cause period inundations on top of sea-level rise. The reference dataset on which we build scenarios of temperature increase are from CMIP6. The Australian Bureau of Meteorology and CSIRO provide the most comprehensive and scientifically accurate assessment of climate trends for Palau. See Diaz (2016) and Selected Issues Paper "Addressing Climate Change in Palau: Policy Options and Strategies" for more details.

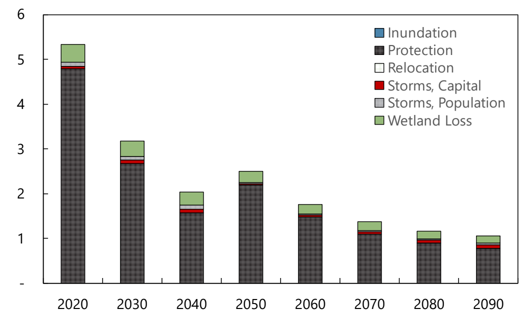
[2] The discontinuity in adaptation costs between 2040 and 2050 is due to the nature of the optimization problem, which considers adaptation up to 2050 and after as two distinct problems. For example, loss of land due to inundation is fixed during each adaptation period, but GDP grows, so that inundation loss as a percentage of GDP declines. When a new retreat perimeter is established in 2050, inundation losses increase and then decline following the growing dynamic in GDP. Protection is similarly chosen for a limited time horizon and costs are distributed equally over time. As sea-level rise increases over the century, one can observe a jump in optimal protection investment. Also in this case, the underlying growing dynamic of GDP explains the decline over time of protection costs as a percentage of GDP.

Box 2. Climate Change Impacts and Adaptation Policies in Palau (concluded)

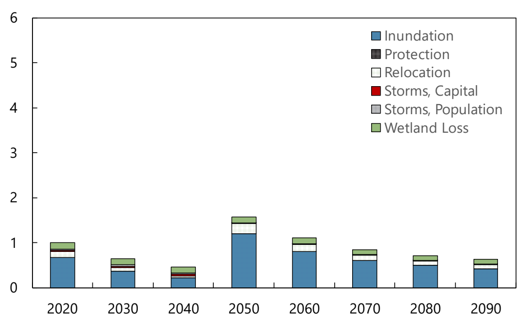
No Planned Adaption



Full Protection



Efficient Adaption



Policy Responses Under Various Scenarios:

No Planned Adaptation. Reaction to sea-level rise is by relocating. No protective structures are built, and capital losses are large.

Full Protection. Protective structures are built, sufficient to render the relocation of people or assets unnecessary.

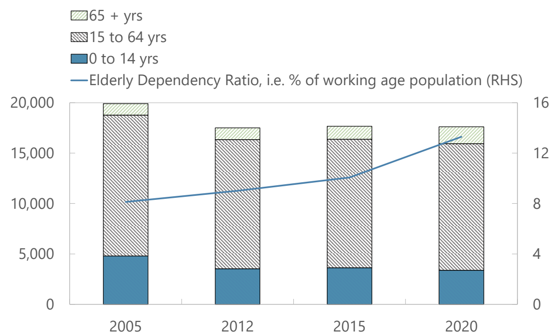
Efficient Adaptation. A mix of protection and retreat is implemented. The composition of measures is based on cost-benefit analyses and electing the strategy with the largest net present value.

Other impacts of climate change are harder to quantify and could be sizable. Additional outlays may be necessary to accommodate rising temperatures, and intensifying rainfall but the cost implications of these climate phenomena are difficult to estimate with the available models. The risk of coral bleaching, acidity of sea water, and sea-water temperature will intensify with potential negative effects on biodiversity, fisheries, and tourism. For example, events like the strong 1998 and 2016 El Niño that contributed to massive coral bleaching and decline of sea life in near shore areas become more likely with increasing temperatures.

Figure 1. Palau: Demographics

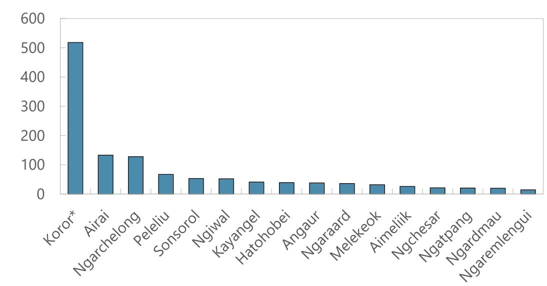
Palau's population has declined over the past decades and elderly dependency ratio has increased.

Population by Age Group



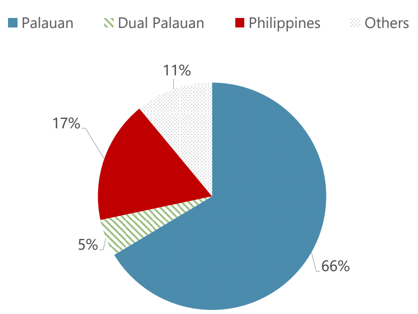
Palau's population is concentrated mainly in Koror, with the rest of the country not densely populated.

Population Density by State
(Per Sq. Mi.)



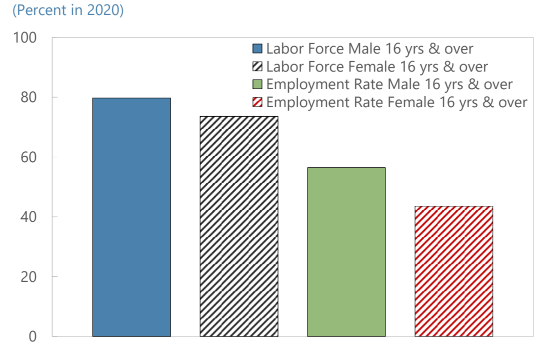
Palau's population is composed of a large share of non-Palauan workers, mainly from Asia.

Composition of Population by Citizenship



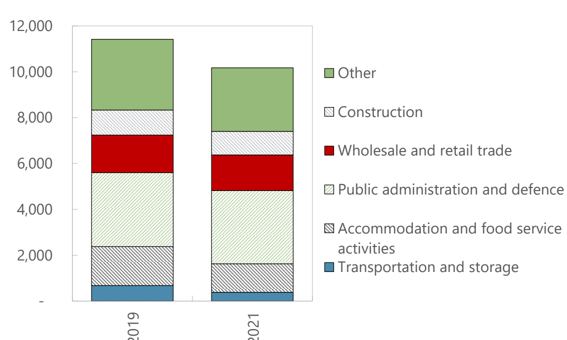
Labor force participation and employment ratios of females are slightly lower than males.

Labor Force Participation and Employment Ratio by Sex
(Percent in 2020)



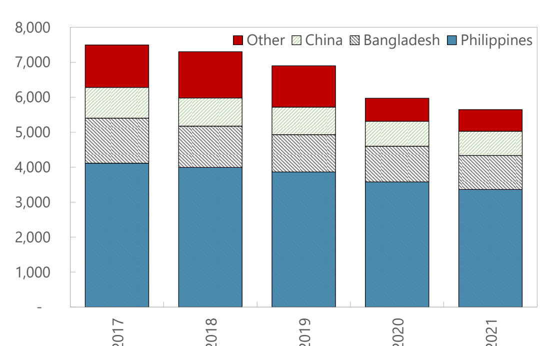
Employment declined during the pandemic, mainly reflecting the tourism-related sectors.

Composition of Employment by Sector



Foreign workers experienced the largest drop in employment.

Foreign Workers by Nationality



Sources: Censuses of Population & Housing, Republic of Palau; and Bureau of Immigration and Foreign Labor, Ministry of Justice, Republic of Palau.

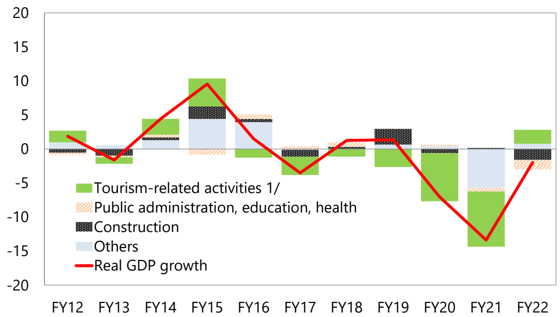
Figure 2. Palau: Real Sector Developments

The COVID-19 pandemic severely contracted Palau's tourism industry….

…despite fully reopening in July 2022 a recovery in tourism arrivals has been impacted by travel restrictions in source markets.

Contribution to GDP Growth, FY2012-22

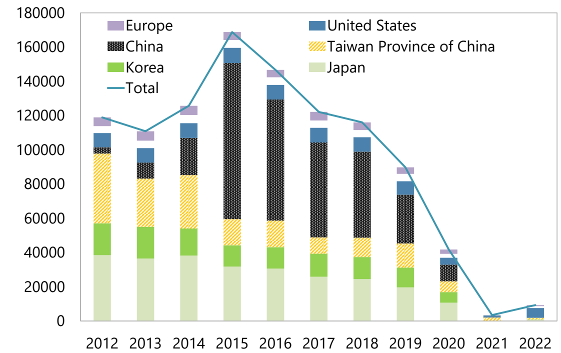
(In percent)



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

Tourist Arrivals

(Number of visitors by economy of origin)

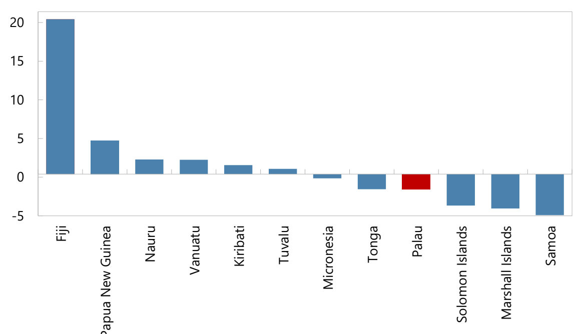


Recovery in Palau has been slower compared to other PICs…

… and inflation has surged to reginal highs driven by high import prices.

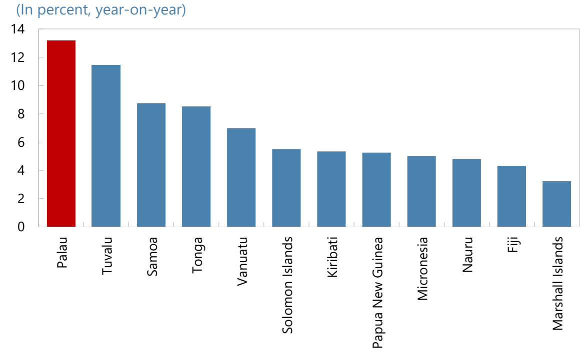
GDP Growth Among the Pacific Island Countries, 2022

(In percent, year-on-year)



Inflation Among the Pacific Island Countries, 2022

(In percent, year-on-year)



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

Credit to the private sector remained stable driven by higher lending from the National Development Bank.

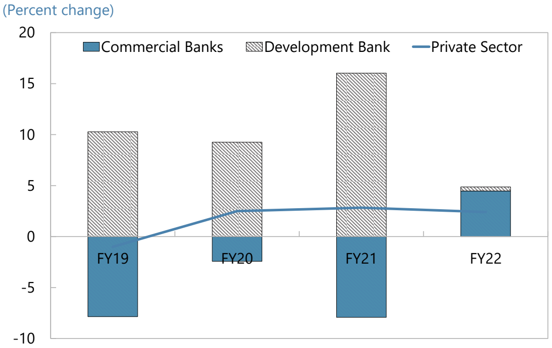
Employment

(Number of people employed in thousands)

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

Credit Growth

(Percent change)

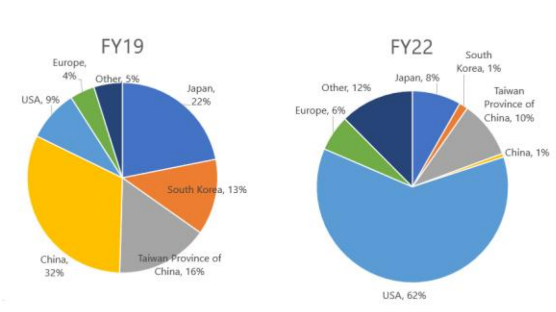


Sources: Palau authoritiesGraduate School USA; IMF World Economic Outlook; and IMF staff estimates.

Figure 3. Palau: Tourism Sector Developments

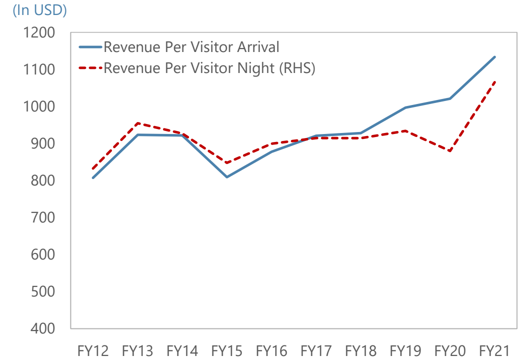
Despite fully reopening, travel restrictions from source economies in East Asia have dampened the recovery….

Change in Source Market Composition



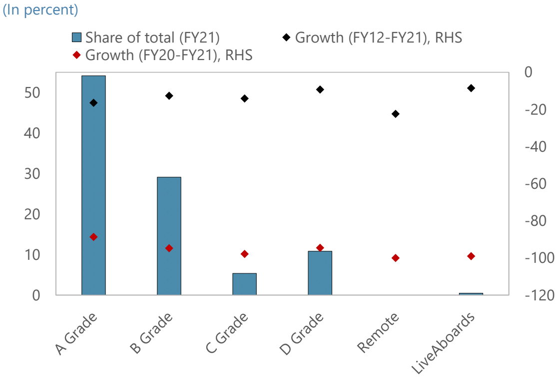
Revenue per tourist arrival is on an upward trend.

Revenue per Tourist Arrival/Night
(In USD)



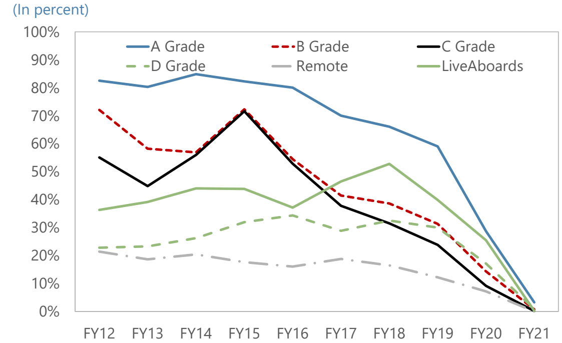
Visitor nights declined substantially for all hotel grades in FY2021.

Visitor Nights by Hotel Grade
(In percent)



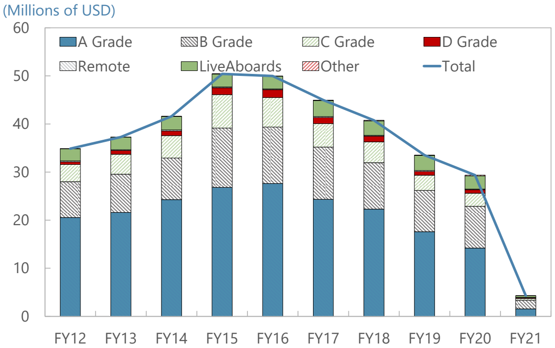
Excess capacity exists in all hotel categories…

Hotel Occupancy Rates by Hotel Grade
(In percent)



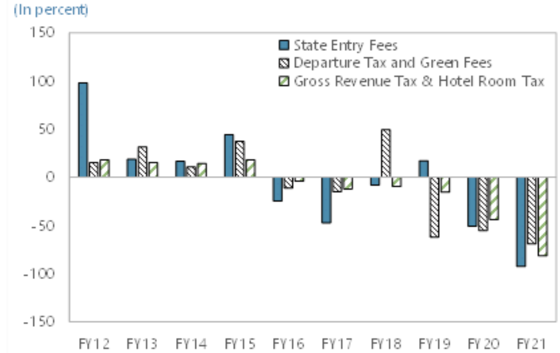
Hotel gross revenues collapsed across all categories.

Hotel Revenues by Grade
(Millions of USD)



Decline in arrivals led to lower tourism revenues in recent years.

Growth in Public Sector Revenue
(In percent)



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

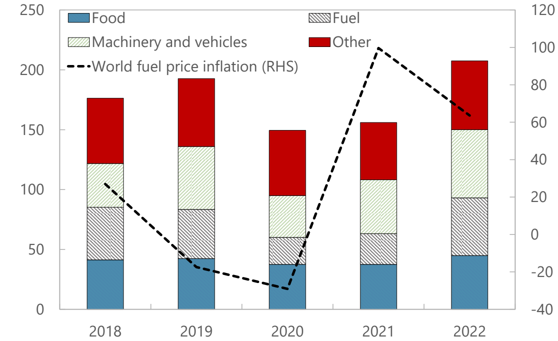
Figure 4. Palau: External Sector Developments

After successive declines since FY2016, associated with lower tourist arrivals, exports plummeted in FY2020-21 due to the pandemic.

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

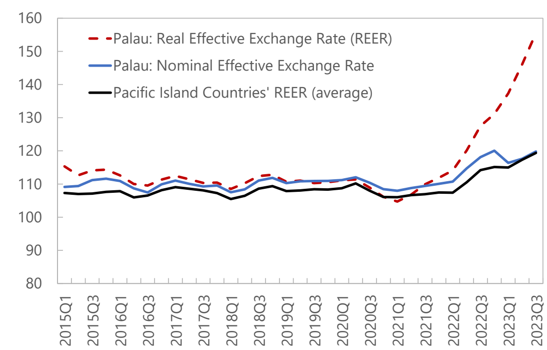
While imports fell during the pandemic, reflecting lower economic activity, imports picked up more recently due to higher commodity prices, primarily on fuel...

Imports of Goods
(In millions of USD)



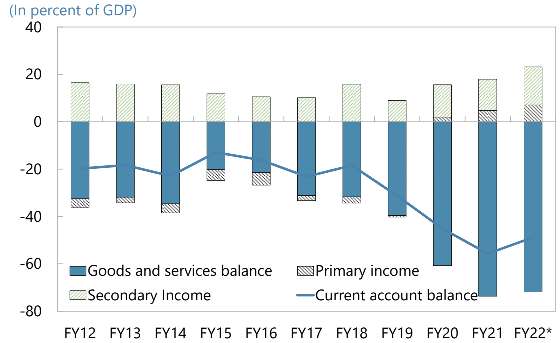
...at the same time, Palau's real exchange rate appreciated significantly, higher than in other pacific island countries...

Real Effective Exchange Rates
(Index 2010=100)



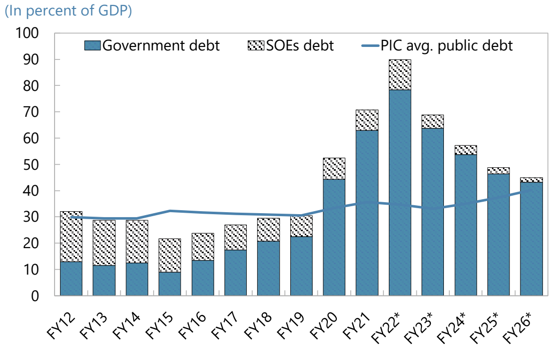
... all contributing to the widening of the current account deficit.

Current Account
(In percent of GDP)



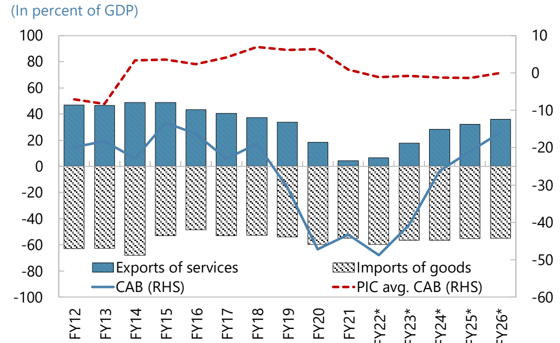
External debt increased sharply during FY2020-22, mainly driven by borrowing from ADB but is projected to decline thanks to the recovery and the fiscal consolidation grants.

Public External Debt
(In percent of GDP)



The current account deficit is expected to rapidly improve from FY2022 onwards as tourism activities resume.

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

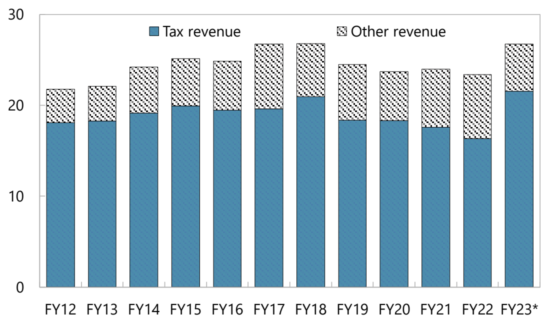


Sources: Palau authorities; Graduate School USA; IMF Statistics Department; and IMF staff estimates.

Figure 5. Palau: Fiscal Sector Developments

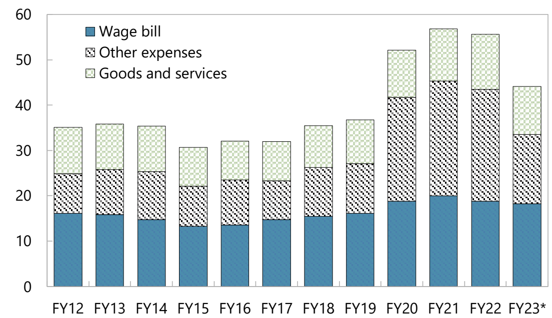
Domestic tax and other revenue are recovering from a prolonged economic contraction and a deep loss of tourism-related revenues...

Domestic Revenue
(In percent of GDP)



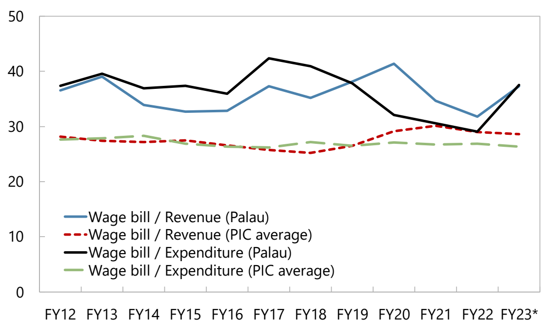
...while the current spending (expense) soared, mainly driven by one-off subsidies, social benefits, and transfers.

Current Spending
(In percent of GDP)



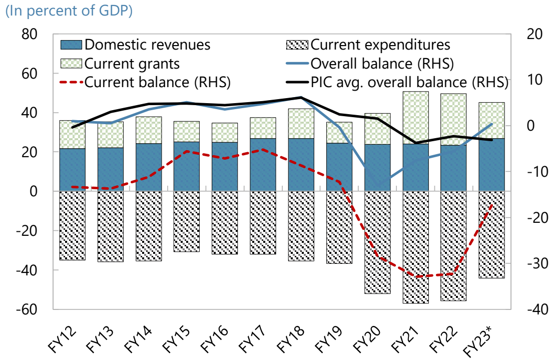
Palau has the largest public sector in the Pacific; and recent public sector wage raises have pushed up its share in overall expenditures.

Wage Bill
(In percent)



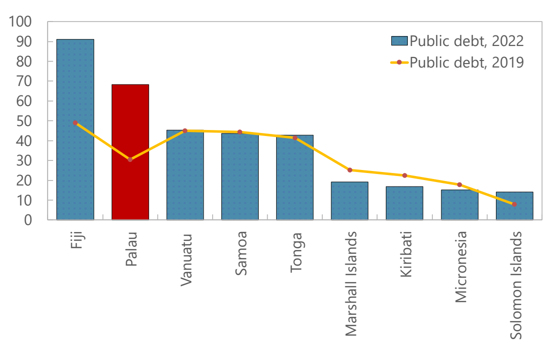
Palau's fiscal balance widened more than that of peers in the Pacific, reflecting its heavy reliance on tourism and a large pandemic support to the private sector.

Fiscal Balance
(In percent of GDP)



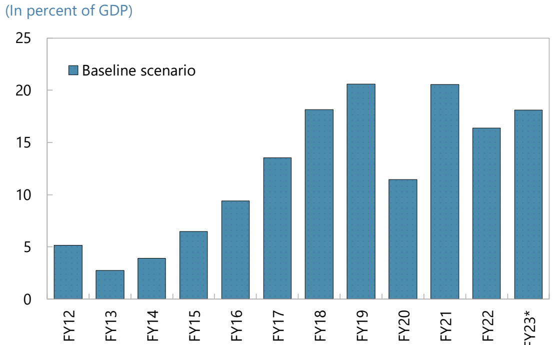
The pandemic resulted in the second highest jump in public debt relative to the region.

Public debt
(In precent of GDP)



Government deposits are accumulating as the pandemic-related financing needs diminish.

Government Currency and Deposits
(In percent of GDP)



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

Table 1. Palau: Selected Economic Indicators, 2017/18–2027/28 1/

Nominal GDP for FY2022: US$246 million
Population (2022): 17,674
GDP per capita for FY2022: US$13,941
Quota: SDR 4.9 million

	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28
					Est.			Proj.			
Real sector											
Nominal GDP (million US$)	288.6	282.0	257.6	232.6	246.4	268.3	313.5	357.5	377.0	392.4	406.2
Real GDP growth (percent change)	1.3	1.4	-7.0	-13.4	-2.0	0.8	12.4	11.9	3.5	2.0	1.5
GDP deflator (percent change)	-1.7	-3.6	-1.7	4.2	8.1	8.0	4.0	1.9	1.9	2.0	2.0
Consumer prices (percent change; period average)	2.4	0.4	0.7	-0.5	13.2	13.0	5.9	2.2	2.2	2.3	2.3
Tourist arrivals (number of visitors)	115,997	89,726	41,753	3,412	9,247	35,052	70,509	91,681	106,686	110,954	115,392
Expenditure per Tourist Arrival (US$)	909	971	1,009	1,261	1,765	1,194	1,241	1,265	1,289	1,315	1,341
Public finance				(In percent of GDP)							
Central government											
Revenue	43.9	42.4	45.4	57.6	57.7	48.9	51.7	48.2	47.5	47.0	46.7
Taxes and other revenue	26.8	24.5	23.7	24.0	22.7	26.8	26.9	25.8	25.7	25.6	25.6
Grants	17.1	17.8	21.7	33.6	35.0	22.1	24.9	22.4	21.8	21.4	21.2
Expenditure	37.7	42.7	58.5	65.3	61.0	48.6	49.8	47.6	47.2	46.7	46.5
Expense	35.4	36.7	52.1	56.9	52.5	44.1	41.3	40.0	39.9	39.8	39.7
of which: grants to other government units	6.0	6.2	9.7	10.1	6.9	7.1	7.9	7.2	7.2	7.0	6.9
Net acquisition of nonfinancial assets	2.3	6.0	6.4	8.4	8.4	4.4	8.5	7.6	7.4	6.9	6.8
Current fiscal balance (excluding grants) 2/	-8.6	-12.2	-28.4	-32.9	-29.8	-17.3	-14.4	-14.2	-14.1	-14.2	-14.1
Primary fiscal balance (including grants)	6.3	-0.2	-12.9	-7.3	-2.7	1.9	3.7	2.2	1.9	1.8	1.6
Net lending (+)/borrowing (–)	6.2	-0.4	-13.1	-7.6	-3.2	0.3	2.0	0.6	0.3	0.3	0.2
Compact debt service grants 3/							3.2	2.8	2.7	2.5	2.5
General government debt	29.5	30.5	52.4	70.7	68.4	66.2	53.8	45.4	41.7	37.4	33.7
				(In millions of U.S. dollars)							
Compact Trust Fund (CTF) balance	297.5	286.4	280.0	317.7	246.6	266.6	331.6	396.6	412.5	428.7	445.2
Financial sector											
Credit to private sector (in percent of GDP)	20.3	20.6	23.1	26.3	25.5	…	…	…	…	…	…
Credit to private sector (percent change)	5.7	-1.0	2.5	2.8	2.4	…	…	…	…	…	…
Balance of payments 4/											
Trade balance	-138.2	-140.9	-149.7	-127.1	-157.2	-149.0	-171.7	-191.4	-201.1	-206.3	-211.2
Exports (f.o.b.)	13.8	10.9	4.3	1.1	2.1	3.1	5.6	6.0	6.4	6.4	6.5
Imports (f.o.b.)	151.9	151.8	154.1	128.1	159.3	152.1	177.3	197.4	207.5	212.7	217.7
Tourism receipts	95.7	83.4	39.2	4.1	15.4	37.5	78.8	104.6	124.3	132.1	140.4
Current account balance											
Including grants	-54.8	-86.8	-121.5	-100.6	-134.9	-109.2	-82.1	-75.1	-60.2	-56.9	-53.0
Excluding grants	-104.7	-122.8	-158.8	-159.8	-201.4	-168.6	-155.1	-150.1	-137.3	-136.0	-133.9
International Investment Position	-62.3	-134.3	-170.6	-172.0	-373.1	-418.4	-373.6	-366.3	-399.7	-423.7	-443.9
Assets	715.2	688.9	745.6	811.7	687.5	703.5	802.7	857.5	875.4	899.7	930.4
Liabilities	777.5	823.1	916.2	983.7	1,060.6	1,121.9	1,176.2	1,223.8	1,275.1	1,323.4	1,374.4
Of which: External debt	85.1	86.0	134.9	164.4	168.5	177.6	168.8	162.5	157.2	146.8	136.7
				(In percent of GDP)							
Current account balance											
Including grants	-19.0	-30.8	-47.2	-43.3	-54.7	-40.7	-26.2	-21.0	-16.0	-14.5	-13.0
Excluding grants	-36.3	-43.5	-61.7	-68.7	-81.7	-62.8	-49.5	-42.0	-36.4	-34.7	-33.0
International Investment Position	-21.6	-47.6	-66.2	-74.0	-151.4	-155.9	-119.2	-102.5	-106.0	-108.0	-109.3
Of which: External debt	29.5	30.5	52.4	70.7	68.4	66.2	53.8	45.4	41.7	37.4	33.7

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

1/ Fiscal year ending September 30.

2/ Defined as tax and other revenue less expense.

3/ This reflects Compact grants under CRA-23 for debt service and are treated below the line the IMF's presentation.

4/ Includes withdrawls from CTF and funding for US Federal Programs (Post Office and Meteorological Service)

Table 2. Palau: Balance of Payments, 2017/18–2027/28 1/

	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28
				Est.				Proj.			
	(In millions of U.S. dollars, unless otherwise indicated)										
Current account balance	-54.8	-86.8	-121.5	-100.6	-134.9	-109.2	-82.1	-75.1	-60.2	-56.9	-53.0
Goods and services balance	-93.3	-110.1	-157.3	-160.8	-196.7	-169.4	-158.0	-154.8	-143.8	-143.0	-141.4
Goods balance	-138.2	-140.9	-149.7	-127.1	-157.2	-149.0	-171.7	-191.4	-201.1	-206.3	-211.2
Exports of goods f.o.b.	13.8	10.9	4.3	1.1	2.1	3.1	5.6	6.0	6.4	6.4	6.5
Imports of goods f.o.b.	151.9	151.8	154.1	128.1	159.3	152.1	177.3	197.4	207.5	212.7	217.7
Services balance	44.9	30.8	-7.5	-33.7	-39.5	-20.4	13.8	36.6	57.3	63.3	69.8
Exports of services	107.8	95.3	47.2	9.7	22.1	47.7	88.7	115.0	135.3	143.8	152.6
Travel	95.7	83.4	39.2	4.1	15.4	37.5	78.8	104.6	124.3	132.1	140.4
Imports of services	62.9	64.5	54.7	43.5	61.6	68.1	74.9	78.4	78.0	80.5	82.8
Primary income balance	-7.6	-2.1	5.9	9.7	3.0	5.7	3.7	2.9	3.1	3.0	2.8
Inflows	22.4	23.8	20.5	21.7	23.9	27.3	27.8	28.3	29.8	30.6	31.5
Outflows	30.0	25.9	14.6	12.0	20.8	21.6	24.1	25.4	26.7	27.7	28.7
Secondary income balance	46.1	25.5	29.8	50.5	58.8	54.5	72.1	76.8	80.6	83.1	85.5
Inflows	69.1	48.0	50.6	67.0	75.8	72.9	91.2	96.3	100.4	103.3	106.2
Of which: Grants on budget	49.9	36.0	37.3	59.2	66.5	59.4	73.0	75.0	77.1	79.1	80.9
Outflows	23.0	22.5	20.7	16.5	17.0	18.4	19.1	19.5	19.9	20.3	20.7
Capital account balance 2/	82.6	34.9	26.8	20.7	21.8	14.6	67.0	69.4	20.5	21.3	22.1
Net lending/borrowing (Current+Capital)	27.8	-51.9	-94.7	-80.0	-113.0	-94.7	-15.1	-5.7	-39.7	-35.6	-30.9
Financial account balance	10.3	-74.9	-48.1	-67.6	-103.7	-94.7	-15.1	-5.7	-39.7	-35.6	-30.9
Direct investment (net lending(+)=assets-liabilities)	-50.3	-44.7	-43.1	-31.0	-72.8	-53.7	-62.7	-53.6	-56.6	-58.9	-60.9
Portfolio investment (net lending(+)=assets-liabilities)	67.2	-13.9	-8.2	-3.4	-12.1	-14.4	30.7	30.6	-14.4	-14.5	-14.5
Other investment (net lending(+)=assets-liabilities)	-6.6	-16.3	3.2	-33.2	-18.8	-26.6	16.9	17.4	31.2	37.8	44.5
Assets (net acquisition)	0.9	-15.8	52.0	-4.2	-15.2	13.0	41.6	-2.2	10.4	17.0	23.7
Liabilities (net incurrence)	7.6	0.5	48.8	29.0	3.6	39.6	24.7	-19.6	-20.8	-20.8	-20.8
Of which: Public sector loans	7.2	0.9	48.8	29.0	3.6	39.6	24.7	-19.6	-20.8	-20.8	-20.8
Errors and omissions	-17.5	-23.0	46.6	12.3	9.4	0.0	0.0	0.0	0.0	0.0	0.0
Current account											
Including official grants	-54.8	-86.8	-121.5	-100.6	-134.9	-109.2	-82.1	-75.1	-60.2	-56.9	-53.0
Excluding official grants	-104.7	-122.8	-158.8	-159.8	-201.4	-168.6	-155.1	-150.1	-137.3	-136.0	-133.9
Memorandum items:	(In percent of GDP, unless otherwise indicated)										
Nominal GDP (million US$)	288.6	282.0	257.6	232.6	246.4	268.3	313.5	357.5	377.0	392.4	406.2
Current account											
Including official grants	-19.0	-30.8	-47.2	-43.3	-54.7	-40.7	-26.2	-21.0	-16.0	-14.5	-13.0
Excluding official grants	-36.3	-43.5	-61.7	-68.7	-81.7	-62.8	-49.5	-42.0	-36.4	-34.7	-33.0
External debt	29.5	30.5	52.4	70.7	68.4	66.2	53.8	45.4	41.7	37.4	33.7
International Investment Position	-21.6	-47.6	-66.2	-74.0	-151.4	-155.9	-119.2	-102.5	-106.0	-108.0	-109.3
Assets	247.8	244.3	289.5	349.0	279.0	262.3	256.0	239.9	232.2	229.3	229.1
Compact Trust Fund	103.1	101.6	108.7	139.0	101.9	99.4	105.8	110.9	109.4	109.2	109.6
Social Security Funds	50.1	51.3	59.9	73.8	55.6	48.4	39.0	32.0	28.1	24.7	21.5
Other	94.7	91.4	120.8	136.2	121.5	114.5	111.2	96.9	94.7	95.3	97.9
Liabilities	269.4	291.9	355.7	422.9	430.5	418.2	375.2	342.4	338.2	337.3	338.3
FDI	230.7	252.0	292.5	337.3	348.0	339.6	310.6	287.4	287.5	291.2	296.3
Government debt	20.8	22.5	44.3	62.9	62.0	61.2	50.3	43.0	40.0	36.3	33.1
Public enterprise debt	8.7	8.0	8.1	7.8	6.4	5.0	3.5	2.4	1.7	1.1	0.5
Other liabilities, incl. banks	9.2	9.5	10.8	15.0	14.1	12.4	10.8	9.5	9.0	8.6	8.4
Errors and Omissions	-6.1	-8.2	18.1	5.3	3.8	0.0	0.0	0.0	0.0	0.0	0.0

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

1/ Fiscal year ending September 30.

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

Table 3. Palau: National Government Operations 2017/18–2027/28 1/

	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28
					Est.			Proj.			
National Government Operations	(In millions of U.S. dollars)										
Revenue	126.7	119.4	117.0	134.0	142.3	131.2	162.2	172.2	179.2	184.5	189.8
Taxes	60.5	51.8	47.3	41.0	39.4	57.8	68.1	74.1	78.0	80.6	83.4
Taxes on income, profits and capital gains	11.0	10.9	10.4	10.2	9.0	13.3	15.1	16.3	17.2	17.9	18.6
Taxes on goods and services	21.4	21.5	15.4	14.5	13.8	27.1	33.3	36.7	38.7	40.0	41.5
Taxes on international trade and transactions	15.7	13.5	16.7	15.0	14.4	12.8	12.3	12.7	13.1	13.4	13.7
Other taxes	12.4	5.9	4.7	1.3	2.2	4.5	7.4	8.4	9.1	9.3	9.6
Grants 3/	49.4	50.3	55.9	78.2	86.3	59.4	78.0	80.0	82.1	84.1	85.9
Current	43.7	29.7	40.9	61.8	68.6	49.2	54.0	55.4	56.9	58.2	59.4
U.S. Compact	24.6	0.0	0.0	0.0	0.0	0.0	20.0	20.4	20.8	21.2	21.6
Drawdown from Compact Trust Fund	5.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0
U.S. non-Compact	9.5	9.6	20.8	40.9	40.5	37.8	14.0	14.3	15.1	15.7	16.2
Other country	4.6	5.1	5.1	5.9	13.1	11.4	5.0	5.7	6.0	6.3	6.5
Capital	5.6	20.6	15.0	16.4	17.6	10.2	24.0	24.6	25.3	25.9	26.6
Other revenue	16.9	17.3	13.9	14.8	16.6	14.1	16.0	18.1	19.0	19.8	20.5
Expenditure	108.9	120.4	150.8	151.8	150.2	130.3	156.0	170.0	178.1	183.3	188.9
Expense	102.3	103.6	134.3	132.3	129.5	118.3	129.4	142.9	150.4	156.0	161.1
Of which: Compensation of employees	44.6	45.5	48.4	46.4	45.3	48.9	53.1	55.2	58.2	60.6	62.7
Of which: Use of goods and services	26.6	27.1	26.8	26.8	29.3	28.5	32.3	38.7	41.2	42.9	44.4
Of which: Interest payments	0.4	0.6	0.6	0.8	1.3	4.1	5.4	5.7	5.9	5.7	5.6
Net acquisition of nonfinancial assets	6.6	16.9	16.5	19.5	20.8	11.9	26.6	27.2	27.7	27.3	27.8
Domestic Current balance (excluding grants) 2/	-24.9	-34.5	-73.1	-76.5	-73.5	-46.5	-45.3	-50.7	-53.3	-55.6	-57.2
Current Balance (including current grants) 3/	18.8	-4.8	-32.3	-14.7	-4.8	2.7	8.7	4.7	3.6	2.6	2.1
Primary Balance (including grants)	18.3	-0.4	-33.2	-16.9	-6.7	5.0	11.6	7.8	7.0	7.0	6.5
Net lending (+)/borrowing (–) 4/	17.8	-1.0	-33.7	-17.8	-8.0	0.9	6.2	2.2	1.1	1.2	0.9
Compact consolidation assistance	...	...	...	...	...	...	10.0	10.0	10.0	10.0	10.0
	(In percent of GDP)										
Revenue	43.9	42.4	45.4	57.6	57.7	48.9	51.7	48.2	47.5	47.0	46.7
Taxes	20.9	18.4	18.4	17.6	16.0	21.5	21.7	20.7	20.7	20.6	20.5
Grants	17.1	17.8	21.7	33.6	35.0	22.1	24.9	22.4	21.8	21.4	21.2
Other revenue	5.8	6.1	5.4	6.4	6.7	5.2	5.1	5.0	5.0	5.0	5.0
Expenditure	37.7	42.7	58.5	65.3	61.0	48.6	49.8	47.6	47.2	46.7	46.5
Expense	35.4	36.7	52.1	56.9	52.5	44.1	41.3	40.0	39.9	39.8	39.7
Net acquisition of nonfinancial assets	2.3	6.0	6.4	8.4	8.4	4.4	8.5	7.6	7.4	6.9	6.8
Current balance (excluding grants) 2/	-8.6	-12.2	-28.4	-32.9	-29.8	-17.3	-14.4	-14.2	-14.1	-14.2	-14.1
Current Balance (including current grants) 3/	6.5	-1.7	-12.5	-6.3	-2.0	1.0	2.8	1.3	0.9	0.7	0.5
Primary Balance (including grants)	6.3	-0.2	-12.9	-7.3	-2.7	1.9	3.7	2.2	1.9	1.8	1.6
Net lending (+)/borrowing (–) 4/	6.2	-0.4	-13.1	-7.6	-3.2	0.3	2.0	0.6	0.3	0.3	0.2
Compact consolidation assistance	...	...	...	...	...	...	3.2	2.8	2.7	2.5	2.5
National Government Balance Sheet	(In percent of GDP)										
Assets	18.2	20.6	11.5	20.5	25.7	18.1	17.1	17.8	19.5	21.3	23.0
Cash and deposits	18.2	20.6	11.5	20.5	25.7	18.1	17.1	17.8	19.5	21.3	23.0
Liabilities	25.6	27.7	50.8	69.1	67.3	66.1	54.6	46.7	43.5	39.7	36.4
Domestic accounts payable	4.9	5.3	6.5	6.2	5.4	4.9	4.2	3.7	3.5	3.4	3.3
External debt	20.8	22.5	44.3	62.9	62.0	61.2	50.3	43.0	40.0	36.3	33.1
Net Financial Assets 5/	-7.4	-7.1	-39.3	-48.5	-41.7	-48.0	-37.5	-28.9	-24.0	-18.4	-13.4
Memorandum Item:											
Nominal GDP (million US$)	288.6	282.0	257.6	232.6	246.4	268.3	313.5	357.5	377.0	392.4	406.2
Compact Trust Fund (in percent of GDP)	103.1	101.6	108.7	136.6	100.1	99.4	105.8	110.9	109.4	109.2	109.6

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

1/ Fiscal year ending September 30.

2/ Defined as Revenue less Grants and Expense.

3/ Includes withdrawals from CTF and Funding for US Federal Programs (Post Office and Meteorological

4/ Defined as Revenue less Expenditure.

5/ The government net worth excludes the Compact Trust Fund, which is governed by the Compact of Free Association.

Table 4. Palau: Financial Corporations Survey, 2015/16–2021/22 1/

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
	(In millions of U.S. dollars)						
Net foreign assets	235.7	241.0	243.0	228.8	282.3	276.7	259.7
Claims on nonresidents	249.2	253.4	254.3	238.6	290.7	286.6	271.4
Liabilities to nonresidents	13.5	12.4	11.3	9.8	8.4	9.9	11.7
Domestic claims	14.4	12.3	15.8	27.1	-1.2	4.7	17.4
Net claims on central government	-35.6	-43.2	-42.9	-31.0	-60.7	-56.5	-45.3
Claims on other sectors	50.0	55.5	58.7	58.1	59.6	61.3	62.7
of which:							
Private sector	50.0	55.5	58.7	58.1	59.6	61.3	62.7
Domestic Liabilities	250.1	253.4	258.8	255.9	281.1	281.5	277.1
Deposits	231.3	232.7	237.1	230.3	254.1	251.0	248.6
Demand deposits	101.0	92.3	90.3	99.4	115.4	120.5	123.3
Other deposits	130.3	140.4	146.9	130.9	138.7	130.4	125.3
Securities other than shares	2.6	2.7	2.5	2.5	1.4	1.5	1.4
Shares and other equity	24.1	24.6	26.4	27.9	31.0	36.1	36.7
Other liabilities	-7.9	-6.5	-7.2	-4.8	-5.4	-7.1	-9.7
Memorandum Item:							
Commercial bank loans (in percent of GDP) 2/	10.5	12.5	12.7	11.9	12.7	13.0	12.8
Commercial bank loans (percent change) 2/	2.9	14.1	0.4	-7.9	-2.4	-7.9	4.5
Commercial bank deposits (percent change) /2	21.9	3.0	0.1	-6.9	19.9	-2.3	-4.4
Nominal GDP (million US$)	303.4	290.1	288.6	282.0	257.6	232.6	246.4

Source: Graduate School USA.

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

2/ Excludes the National Development Bank of Palau.

Table 5. Palau: Banks' Financial Soundness Indicators, 2017–2022 1/

	2017	2018	2019	2020	2021	2022
Capital adequacy						
Tier 1 capital to assets	1.25	1.27	1.39	1.10	1.08	1.15
Tier 1 capital to risk-weighted assets	2.19	2.27	2.22	1.74	0.39	0.15
Asset quality						
Nonperforming loans to total loans	0.61	0.60	0.66	1.56	0.31	0.60
Provisions for loan losses to total loans	3.82	4.42	5.11	7.86	6.80	6.12
Earnings and profitability						
Return on assets	1.55	1.94	2.11	1.03	1.05	1.54
Interest margin to gross income	85.55	86.55	85.35	82.08	81.55	84.32
Noninterest expenses to gross income	35.05	32.30	32.33	41.00	48.45	40.27
Liquidity						
Liquid assets to total assets (liquid asset ratio)	85.95	86.15	85.00	88.18	89.02	87.50

Source: Financial Institutions Commission (FIC).

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

Table 6. Implementation of Main Recommendations of the 2021 Article IV Consultation

Policies	2021 Article IV Consultation Recommendations	Actions Taken
Fiscal Policy	Fiscal relief measures should be extended until the recovery is firmly entrenched. The authorities should consider improving the targeting of relief measures and tapering unemployment benefits when the recovery is underway. Across-the-board cuts in spending (other than certain priority areas) could fragilize economic momentum.	Spending under the CROSS Act was accelerated during FY2022. While spending on certain priority areas increased (e.g., social transfers), other expenditures were curtailed.
	Enhancing governance safeguards can further improve spending efficiency. Additional measures 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 authorities published detailed information on COVID-related spending in their 2022 Fiscal Update. Support measures expired in FY2022. The authorities are making progress with ex-post audits, and plan to publish all reports as soon as possible.
	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.	The tax reform was implemented successfully in January 2023. The authorities are also prioritizing adopting a new IT system and digitalization in the next phase of their tax administration reforms.
	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 provides a fiscal framework that could support the medium-term fiscal adjustment and debt sustainability.	The authorities conducted an agile PEFA assessment and are in the process of outlining a PFM roadmap. The Fiscal Responsibility and Debt Management Act was passed in November 2021.
	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.	The PFM Roadmap will support the effective implementation of the Fiscal Responsibility Framework.
	A swift implementation of a comprehensive set of reforms is critical for the sustainability of the CSPF and SSF.	Some reform proposals are under discussion for CSPF, and a new legislation is submitted to OEK for SSF.
Financial Sector Policies	To further support distressed but viable businesses and individuals affected by the pandemic, additional targeted and temporary measures 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.	The support measures adopted during the pandemic have been phased out.
	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	The implementation of tax reform in 2023 is expected to help improve financial reporting among SMEs. There is also interest in having NDBP take deposits,

Table 6. Implementation of Main Recommendations of the 2021 Article IV Consultation (concluded)

	effectively allowing it to take deposits through a license of the Financial Institutions Commission (FIC). The moratorium on crypto-asset and crypto-currency activities is adequate. 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.	though the process of obtaining a bank license can be involved. The moratorium applies to financial institutions regulated by FIC and has limited coverage. The authorities have the intention to adopt regulations to bring VA/VASPs under FIC regulation. The authorities are committed to improving the AML/CFT framework and are working towards enhancing the capacity of FIC/FIU, including through technical assistance.
Structural Policies	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. Tap into climate risk financing. The planned reform of the PPUC would improve its financial sustainability and facilitate the entry of private renewable energy producers.	The authorities are working on finalizing their National Development Plan which can help identify priorities and reforms. Palau is keen to tap into more climate risk financing. A new ADB loan includes financing for climate change adaptation policies. The new COFA agreement also allows for grants to be used to address climate change risks. The authorities have initiated reform of PPUC. In 2021, an independent regulatory process was adopted to assist in establishing cost recovery tariffs and gradually eliminating tariff caps. There were also governance and management reforms aiming to improve profitability.

Annex I. A New Compact of Free Association Agreement[1]

Palau's 2023 Compact Review Agreement (CRA) with the US for the next 20 years marks an important milestone in the economic history of Palau that has emerged from the global pandemic with significant scarring and a sharp increase in public debt relative to its Pacific Islands peers. The draft legislation for the new CRA, signed by Palau and the US on May 2023, is currently with the US Congress for approval. The proposed economic package is estimated to total US$889 million dollars, or 367 percent of FY2022 GDP. In addition, Palau will continue to be eligible for US Federal programs and services.

1. The proposed Compact Revue Agreement (CRA) for FY2024–43 boosts financial support, including debt relief. Under the proposed CCRA, Palau will receive US$889 million from the US over the course of 20 years, or about 38-44 million per annum (16 percent of FY2023 projected GDP) in financial support (including budget support, contributions to the Compact Trust Fund, support for debt payment). The renewed compact will deliver about 30 million in the first year (FY2024) (excluding the Compact Trust Fund withdrawals), which compares with about US$17 million projected to get in for the same year, the last one under the current CRA.

Compact Agreement for FY24-43

	Horizon	Annual Disbursement in 2024 (millions of US$)	Total (2024-2043) (millions of US$)
Budget Grants	2024-2043	20	486.0
Infrastructure Grants	2024-2043	10	243.0
Debt Relief	2024-2029	10	60.0
Contribution to CTF	2024-2025	50	100.0
Total Financing		**90**	**888.9**
Allowed annual withdrawal from CTF	2024-2043	Capped at 15 million during 2024-26 but can be increased to up to 4 percent of the three-year moving average of the CTF value beyond 2026	

2. The 2023 CRA has the following five components, of which the first three are similar to the current CRA agreement, while the last two respond to the post-pandemic financing needs:

- The 2023 CRA establishes an increase in annual grants from US$15 million previously to US$20 million in FY2024 (an additional 2.1 percent of GDP over FY2023), indexed to increase by 2 percent a year. These can be used exclusively for education, health, climate adaptation, justice, public safety, and CRA-related audits which is a new rule introduced in this CRA. Spending in these areas is already more than US$20 million and therefore the earmarking of budget grants is not expected to pose a constraint on its use.

- The 2023 CRA offers US$5 million (also indexed at 2 percent per year) in infrastructure grants, on project-by-project basis. Those can only be used for projects identified in Palau's National Infrastructure Investment Plan 2021-30 (published in September 2021) or a similar plan if updated going forward. This plan will be annually monitored and evaluated as a component of the annual budget process.

[1] Prepared by Irina Yakadina (APD).

- The 2023 CRA makes it mandatory for Palau to budget at least US$1 million a year for infrastructure maintenance and in return offers to contribute US$5 million a year through FY2033, indexed at 2 percent, to the Infrastructure Maintenance Fund for the US-government financed projects.

- The 2023 CRA establishes a Fiscal Consolidation Fund with annual US contributions of US$10 million in FY2024-29, exclusively used to discharge government debts owed to ADB (prior to April 1, 2023) and possibly Taiwan, Province of China, subject to special approval.

- Palau's Compact Trust Fund (CTF) will receive US$100 million over FY2024-25. CTF withdrawals will be capped at the annual US$15 million during FY2024-26 (as at present) but can be increased to up to 4 percent of the three-year moving average of the CTF value thereafter. The use of funds is limited to same as under the first bullet. Additional withdrawals, including for emergencies, can be negotiated in the future.

3. In addition to the financial support, the new CRA could extend Palau's eligibility for federal services and programs (normally available to US state and local governments) and introduce eligibility for new ones. These could include FEMA disaster relief and extending FDIC coverage to Palauan banks, both of which are under consideration and will be negotiated separately from the CRA.

4. The new Compact agreement will also introduce fiscal procedures, which will be a new feature of Palau's CRA. The fiscal procedures are related to the development of an annual implementation plan, grant administration, preparation of annual financial reports and contracts and procurement.

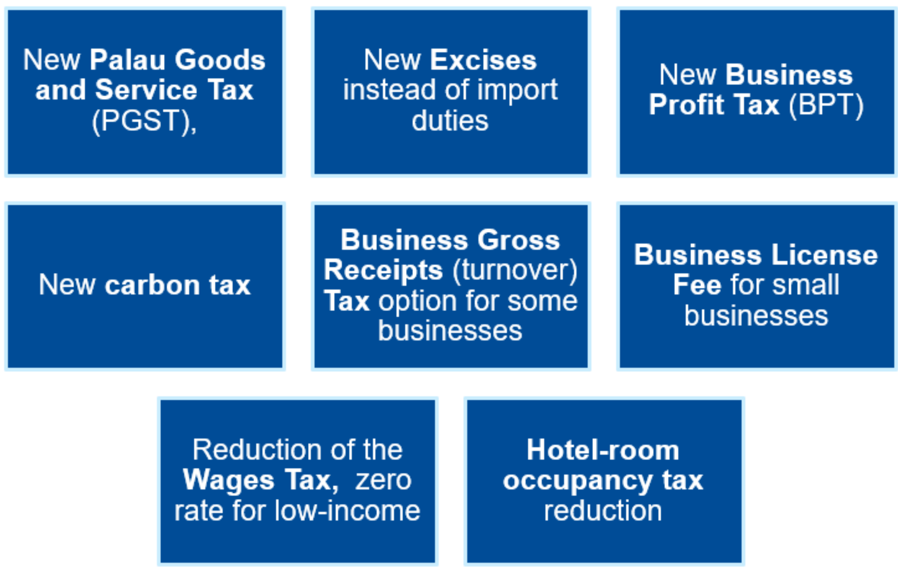
5. Risks to the timeliness of the new Compact approval remain elevated. While the new CRA stands to boost Palau's fiscal space considerably, risks of delayed approval by the US Congress remain elevated. The baseline scenario assumes approval of the draft legislation and its enactment sometime in FY2024. Previous Compact approval proved to be a very lengthy process. After the original Compact (US$580 million for FY1994-2009) ended, the approval of the 2010 CRA by the US Congress took until FY2018 and had to be increased for the total of US$229 million for FY2019-24.

6. During the years awaiting the US final approval, Palau was able to draw US$5 million a year from the original CTF and continued to benefit from some US Federal programs. In the absence of budgetary assistance grants, Palau's response to negative shocks during that period entailed a significant spike in external borrowing, primarily from ADB.

Annex II. Palau's Tax Reform[1]

1. **Palau implemented a major reform to modernize its tax system**. The legislation for the reform, Republic of Palau Public Law (RPPL) No. 11-11, passed in September 2021, and the implementation started in January of 2023. The legislative passage of a value-added tax—the Palau Goods and Services Tax—and subsequent implementation at the start of 2023 marked a milestone in Palau's history.

Key Tax Reform Elements



2. **The reform comprises the following key components**:

- Introducing the Palau Goods and Services Tax (PGST) at single rate of 10 percent;
- Introducing Business Profits Tax (BPT) for PGST-registered businesses, at 12 percent (same as the top marginal wage tax rate), initially to be collected at 2 percent of gross receipts during the first year of implementation;
- Revising the wage tax rates to offset some of PGST regressivity by reducing the rate for (annual) incomes falling between US$8,000 – US$40,000 to 10 percent, and issuing a PGST tax refund to Palau citizens with incomes below US$15,000 at the end of each calendar year;
- Converting specific import taxes into excises, applicable to both imports and domestic products;

[1] Prepared by Irina Yakadina (APD).

- Abolishing the general import duty (3 percent rate) and the turnover tax—Business Gross Receipts Tax (BGRT)—for PGST-registered taxpayers;

- Continuing to apply BGRT to any non-PGST registered person (individual or entity) with an annual gross income more than US$50,000, at 4 percent of the person's gross revenue (turnover), or a business license fee for businesses with an annual gross income less than US$50,000; and

- Introducing a carbon tax.

3. The tax reform was thoroughly prepared by the Palau Bureau of Revenue and Taxation (BRT) in close collaboration with key stakeholders. Support was provided by numerous donors including ADB in-country experts, the Australian Tax Office (ATO) and PFTAC advisers. International community assistance with significant external communication capability support and subject matter expertise helped with a swift reform implementation and allowed the BRT to launch the reform within a very tight timeframe. The reform is expected to remain unmodified although minor changes in law will need to be enacted to improve administration and efficiency.

4. Tax reform led to favorable revenue performance in FY23, with significant overperformance in PGST relative to the FY2023 Budget projections. Revenue effort exceeded design stage projections and led to a favorable improvement in the fiscal outturn for FY2023 despite the weak economic recovery. The two new major taxes are expected to yield an additional (relative to budget) 6.5 percent of GDP for PRGT and 1.2 percent of GDP for profits tax already in FY2023, for which the reform was applicable to only the three last quarters.

5. Part of the PGST's earlier-than-expected success can be attributed to a surprise inflation. Prior to PGST introduction, analysts had estimated the tax reform to be revenue neutral. However, by the end of 2022 inflation had reached historical highs due to the global spikes in food and fuel prices. PGST introduction led to a higher than expected pass-through to prices, despite wide-reaching BRT communication efforts to explain the offsetting part of the reform (such as scrapping import duties of 3 percent and GRT of 4 percent as well as lowering wage taxes and hotel occupancy taxes).

Annex III. External Sector Assessment[1]

Overall Assessment*: The external position of Palau in FY2022 is substantially weaker than the level implied by fundamentals and desirable policies. Since reopening in July 2022 after the COVID-19 pandemic lockdown, a slow recovery in tourism arrivals, high commodity prices for imported goods, and deteriorating terms of trade have put a significant strain on Palau's external position. In addition, the real effective exchange rate (REER) remained overvalued with the U.S. dollar strengthening against major currencies impacting Palau's competitiveness. Given this backdrop, the current account (CA) deficit increased in FY2022 to 55 percent of GDP. Over the medium-term, a recovery in tourist arrivals and fiscal consolidation would support a narrowing of the current account deficit. This assessment is, however, subject to unusually high uncertainty given the difficulties in predicting key factors shaping the external position (e.g., tourism recovery, renewal of the Compact Agreement with the United States), limited data, data weaknesses, and frequent large data revisions.*

Potential Policy Responses*: Fiscal consolidation including through enhancing revenue mobilization would help lower the current account deficit, while structural reforms to diversify export related services, including in the tourism sector, should lower external risks. Structural reforms in the financial sector and reducing the risks associated with financial integrity by strengthening the AML/CFT framework, including revisiting initiatives in digital finance, would lower risks to capital inflows and the loss of correspondent banking relationships (CBRs). Once signed, the renewal of the Compact of Free Association with the United States would provide a significant and reliable increase in financial support, further strengthening Palau's external position.*

Foreign Assets and Liabilities: Position and Trajectory

Background. The *deficit* in the net international investment position (NIIP), averaging roughly 35 percent of GDP in FY2015-19, spiked to 151 percent of GDP in FY2022. The decrease in the NIIP is largely attributed to a decline in the Compact Trust Fund (valuation losses and a drawdown) on the asset side, combined with an additional debt disbursement from the Asian Development Bank increasing liabilities. The IIP assets consist of portfolio investments of the Compact Trust Fund and public pension funds, which account for 60 percent of gross assets. On the liability side, FDI accounts for a roughly 80 percent of gross liabilities with the remainder consisting mostly of government loans.

Assessment. The expected recovery in the tourism sector will improve the current account balance. The NIIP deficit is expected to steadily decline over time close to pre-pandemic levels of about 40 percent of GDP. Additional capital contributions by the United States to the Compact Trust Fund, fiscal consolidation, and a repayment of part of the pandemic related debt (mostly from the ADB) will drive the improvement in NIIP.

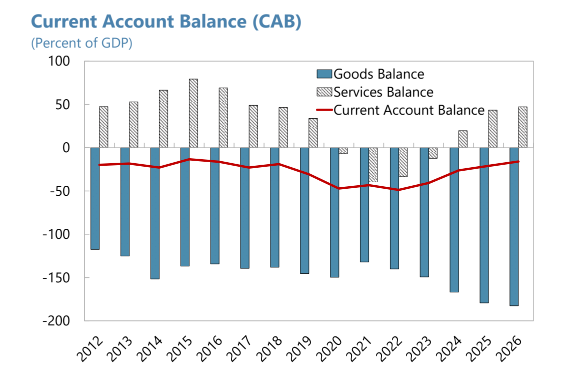
2022 (% GDP)	NIIP: -151	Gross Assets: 279	Debt Assets: n.a.	Gross Liab.: -430	Debt Liab.: 70

Current Account

Background. The current account deficit in Palau widened significantly in FY2022 to about 55 percent of GDP, compared with pre-pandemic averages of 20 percent of GDP in FY2015-19. The trade deficit deteriorated significantly due a collapse in the tourism sector beginning in FY2021 and the slow recovery in FY2022, coupled with high commodity prices driving food and fuel imports. Beginning in FY2023, current account deficits are expected to steadily narrow to pre-pandemic levels in the medium-term, spurred by an expected recovery in the tourism sector and improvements in the secondary account (compact and budget grants).

[1] Prepared by Ricardo Pinto Davico (APD).

Assessment. The ES approach is 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.[1] While Palau has a CA gap of -11.3 according to the ES model[2], uncertainty around the assessment remains particularly high. There are difficulties in predicting the key factors that are expected to drive the external position (such as the timing of the tourism recovery, commodity price disruptions, and renewal of the Compact Agreement with the United States), limited data, and frequent large data revisions. In this context, the staff view that the CA gap is likely to be in the range of 0 to -20 percent of GDP in FY2022. Thus, staff assess that Palau's external position to be substantially weaker than the level implied by fundamentals and desirable policies. Palau's CA deficit is expected to narrow in the medium term as tourism activities resume. Structural reforms to diversify the economy and fiscal adjustment would further improve Palau's external balance and help resolve the CA gap.



Model Estimates for 2022 based on the External Sustainability Approach (in percent of GDP)

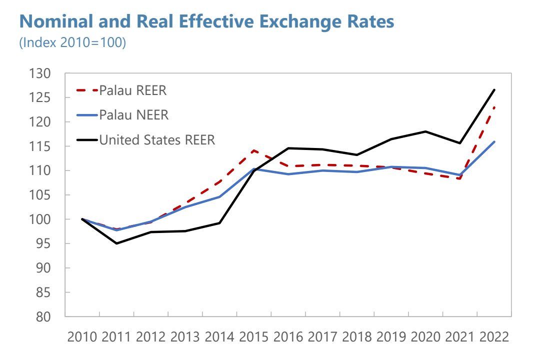
REER gap model estimates (in percent)	CA gap by model estimates	Staff view on possible range of CA gap
30.6	-11.3	0~-20

Real Exchange Rate

Exchange rate regime. The exchange rate arrangement is an exchange arrangement with no separate legal tender. The currency of Palau is the US dollar, which circulates freely.

Background. Thus, Palau's real effective exchange rate (REER) broadly follows the U.S. dollar. During 2022, the REER of Palau appreciated by 14 percent, driven by the strength of the USD. Given that tourism costs in Palau are broadly similar to other Pacific destinations (e.g., Samoa and Vanuatu) exchange rate developments may be a factor impacting its competitiveness as a tourist destination.

Assessment. The REER gap in FY2022 was 30.6 percent from the ES model. The decline in the current account balance coincides with a period of REER appreciation. To reduce external imbalances, the authorities should implement structural polices to support diversification of exports of goods and services. Reduce reliance on imported fuel by pursuing renewable energy.



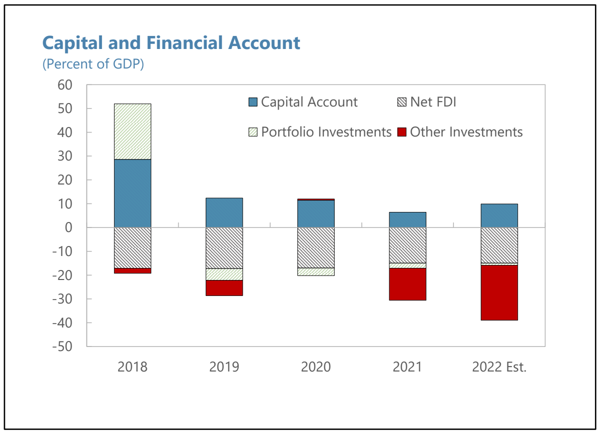
Source: IMF's Information Notice System Database.

[1] The Current Account and REER approaches are less applicable for Palau due to data limitations.
[2] The ES model calculates the level of current account needed to stabilize the NIIP at the level of 2022 (-151 percent of GDP).

Capital and Financial Accounts: Flows and Policy Measures

Background. The capital account inflows consist of contributions to the Compact Trust Fund and capital grants from the US and other countries. In FY2022, capital inflows are estimated to remain flat at 9 percent of GDP from FY2021. The financial account recorded a net outflow in FY2020-FY2022, mainly driven by direct investment and government foreign borrowing (recorded under other investments).

Assessment. Risks of external financing distress are low considering banks' large foreign assets, additional Compact funding and provided that Palau continues to have access to long-term concessional loans and grants.



FX Intervention and Reserves Level

Background. Palau is a fully dollarized economy and does not have its own currency, nor a central bank or a unit in the Ministry of Finance that performs monetary authority functions. There are no restrictions on international payments or transfers. The foreign reserve assets of Palau consist of SDR holdings and the reserve tranche position in the Fund. Government deposits with resident banks are accessible as a liquidity buffer and to meet external obligations. However, based on the *Balance of Payments and International Investment Position Manual* (*BPM6*) these deposits are not considered reserve assets for balance of payment purposes, given they are claims on residents and thus do not meet the standard for reserves.

Assessment. As a fully dollarized economy, with no central monetary authority, assessment of reserve adequacy reflects government and financial institutions' liquidity buffers to meet potential shocks. Government's US dollar deposits in domestic banks in FY2022 was US$63.2 million (26 percent of GDP, five months of government spending and five months of imports). These levels provide an appropriate fiscal buffer of over one month and over three months of imports benchmarks.[3] The need for a liquidity buffer to repay short-term external debt is limited for Palau due to the country's access to long-term concessional financing from the ADB and other bilateral creditors. The government can also withdraw from its Compact Trust Fund (with prior consultation with the US) if faced with large shocks. Financial system is dominated by US bank branches which hold large external assets and have high liquidity ratios. Considering Palau's specific characteristics and existing fiscal buffers, its reserve position is assessed to be broadly adequate.

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

Annex IV. Risk Assessment Matrix (RAM)[1]

Likelihood	Risks	Expected Impact	Main Policy Recommendation
	External Risks		
Medium	**Abrupt global slowdown or recession.** Global and idiosyncratic risk factors combine to cause a synchronized sharp growth downturn, with recessions in some countries, adverse spillovers through trade and financial channels, and market fragmentation causing sudden stops in EMDEs. A global slowdown would further delay Palau's economic recovery and pose further strain on its public finances.	High **ST, MT**	• Diversify source markets of tourism. • Provide temporary and targeted transfers to support the vulnerable households.
High	**Commodity price volatility.** A succession of supply disruptions (e.g., due to conflicts, uncertainty, and export restrictions) and demand fluctuations causes recurrent commodity price volatility, external and fiscal pressures in EMDEs, contagion effects, and social and economic instability. Palau's dependence on imports makes it highly exposed to commodity price shocks.	Medium **ST, MT**	• Provide temporary and targeted transfers to support vulnerable households. • Allow the gradual pass-through of international prices. • Accelerate transition to renewable energy adoption and increase domestic food production.
	Internal Risks		
Medium	**Delays in US Congress approval of the new Compact agreement.** Lower grant assistance and uncertainty about future financial assistance would deteriorate fiscal position in the near-term and lead to curtailed spending, including on infrastructure, resulting in lower growth and higher public debt. The impact would depend on the nature and extent of the delay.	Medium **to** High **ST**	• Secure alternative financing sources and interim arrangements to avoid a large fiscal contraction, and to maintain spending on priority areas. Accelerate efforts to enhance revenue mobilization, and fiscal reforms to secure debt sustainability over the medium to long term.
Medium	**Permanent decline in tourism**. Even after borders fully reopened in July 2022, tourism arrivals have remained far below pre-pandemic levels. A gradual recovery is underway but precautionary measures and cautious attitudes could linger in key source markets in East Asia.	High **ST, MT**	• 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. • Diversify source markets for tourism beyond East Asia.
Medium	**Financial sector weakness and spillovers.** Banks' asset quality could deteriorate as support measures are withdrawn and if the recovery in tourism stalls. The National Development Bank of Palau (NDBP), which has expanded its lending during the pandemic, to support small businesses and the tourism sector may be more vulnerable. Given the systemic role played by US banks operating as branches in Palau, there could be adverse spillovers from a further tightening in financial conditions, especially if the specific banks operating in Palau are directly impacted. At the very extreme, if one or some of these banks fail, there could be severe consequences, including through (i) loss of CBR relationships; (ii) disruptions in the payment system and potential cash shortages, given the dominance of US bank branches and lack of a domestic payment system; and (iii) financial sector panic and uncertainty.	Medium **ST, MT**	• Accelerate efforts to enhance financial supervision, including through strengthening the monitoring of banks' asset quality, including in NDBP. • Guide banks to adequately recognize losses, accumulate provisioning, and maintain liquidity and capital buffers. Implement capital injection if necessary. • Enhance crisis preparedness and contingency plans, including through coordination with US bank regulators such as the FDIC.
High	**Financial integrity and reputational risks related to digital initiatives and cyberthreats.** Digital initiatives that are already underway including the Digital Residency Program and the sovereign stablecoin project can expose Palau to significant financial integrity and reputational risks, in the absence of effective regulation and supervision, including due to limited domestic capacity. Digital initiatives also increase risks from cyberattacks and can cause financial instability and reputational risks.	Medium **ST, MT**	• Guide decisions related to digital initiatives based on an assessment of possible financial integrity and reputational risks. • Take a gradual approach and strengthen regulatory and supervisory capacity before rolling out initiatives. • Strengthen AML/CFT framework, including through continued collaboration with international bodies.
Low **to** Medium	**Extreme climate events and climate change**. Probability of occurrence of natural disasters is low in Palau, though the country remains exposed to occasional droughts, and tropical cyclones. Rising sea levels pose a macro-critical risk, and climate change is expected to also lead to coral bleaching and other negative effects on biodiversity.	High **to** Medium **MT**	• Contingency plans should include maintaining reserve buffers and accelerating climate adaptation policies, including building climate resilient infrastructure, and implementing coastal protection and planning. • Provide temporary and targeted transfers to support vulnerable households. • Enhance emergency response and preparedness against climate events, including in the financial sector.

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

Annex V. Debt Sustainability Analysis[1]

Figure 1. Palau: Risk of Sovereign Stress

Horizon	Mechanical signal	Final assessment	Comments
Overall	...	Moderate	The overall risk of sovereign stress is moderate. Medium-term risks are low thanks to significant financial support through a new Compact Agreement with the United States. At the same time a potential delay in Compact funding constitutes a key risk. Risks over the long-term are assessed to be moderate, reflecting large spending needs due to climate change and pensions. If Compact were approved, overall risk assessment would have been low.
Near term 1/			
Medium term	Low	Low	Medium-term risks are assessed as low consistent with a low mechanical signal. The fanchart signals moderate risk mainly due to the width of the fanchart, while gross financing needs signals low risk.
Fanchart	Moderate	...	
GFN	Low	...	
Stress test	Nat. Diast.	...	
Long term	...	Moderate	The projected costs associated with pension obligations and climate change adaptation are sizable and subject to significant uncertainty. On the other hand, Compact funding will significantly enhance fiscal space to respond to long-term spending needs and in particular climate change.
Sustainability assessment 2/			Debt declines over the medium-term in the baseline and under risk scenarios, thanks to a large extent the new Compact agreement. At the same time, Palau will continue to operate under its Fiscal Responsibility and Debt Management Act that will help maintain fiscal surpluses.
Debt stabilization in the baseline			Yes

DSA Summary Assessment

Commentary: Palau's debt sustainability is supported by a new Compact agreement with the United States, which involve significantly higher budget and infrastructure grants and debt consolidation grants. Most indicators have started to normalize as the recovery is under way after the COVID-related economic contraction. The Compact debt consolidation grants during FY2024-2029 will ensure that debt declines at a solid pace and cash buffers are built up. Medium-term liquidity risks will be offset by the increase in grants under the signed Compact. Debt reduction will help free up fiscal space, but reforms to tackle pension liabilities remain critical to secure long-term fiscal sustainability.

Source: Fund staff.

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

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

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

[1] Prepared by Irina Yakadina (APD).

Figure 2. Palau: Debt Coverage and Disclosures

						Comments
1. Debt coverage in the DSA: 1/	CG	GG	NFPS	CPS	Other	
1a. If central government, are non-central government entities insignificant?					n.a.	
2. Subsectors included in the chosen coverage in (1) above:						

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

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

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

5. Debt consolidation across sectors:	Consolidated	Non-consolidated

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

Reporting on Intra-Government Debt Holdings

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

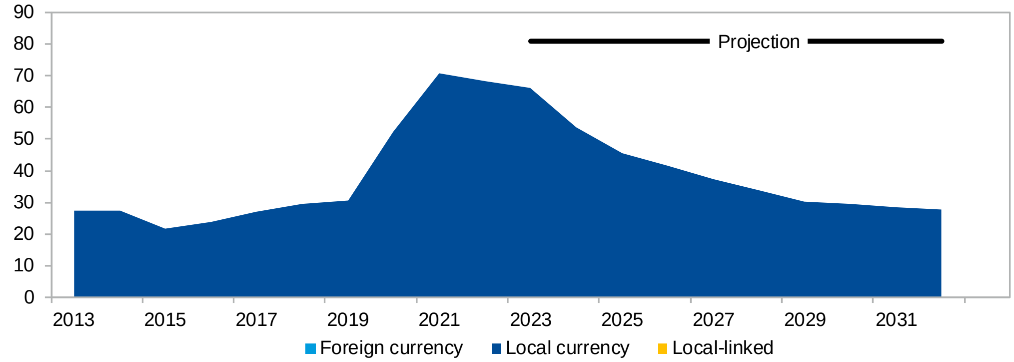
1/ CG=Central government; GG=General government; NFPS=Nonfinancial public sector; PS=Public sector.
2/ Stock of arrears could be used as a proxy in the absence of accrual data on other accounts payable.
3/ Insurance, Pension, and Standardized Guarantee Schemes, typically including government employee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

Commentary: Coverage is general government debt consistent with GFS 2014.

Figure 3. Palau: Public Debt Structure Indicators

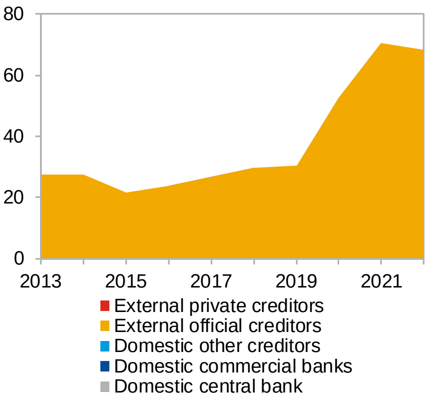
Debt by currency (percent of GDP)

Debt by Currency (Percent of GDP)



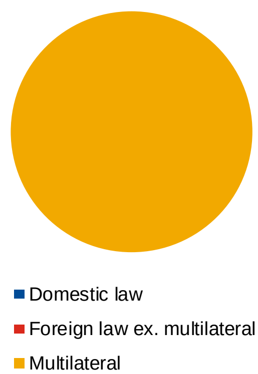
Note: The perimeter shown is consolidated public sector.

Public Debt by Holder (Percent of GDP)



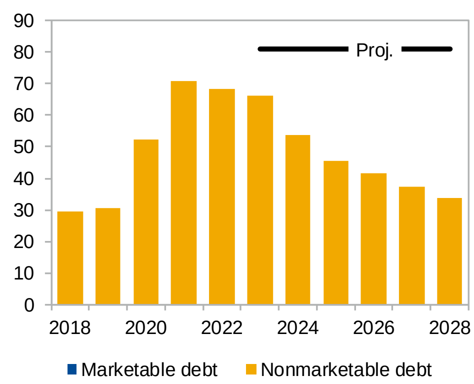
Note: The perimeter shown is general government.

Public Debt by Governing Law, 2022 (Percent)



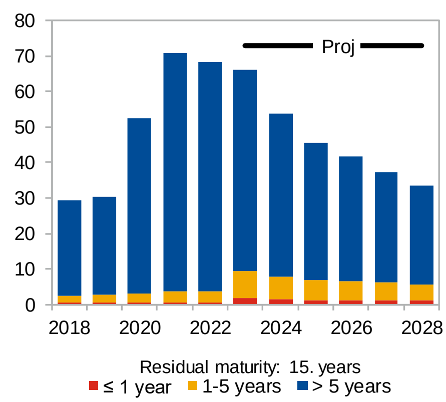
Note: The perimeter shown is general government.

Debt by Instruments (Percent of GDP)



Note: The perimeter shown is general government.

Public Debt by Maturity (Percent of GDP)



Note: The perimeter shown is general government.

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

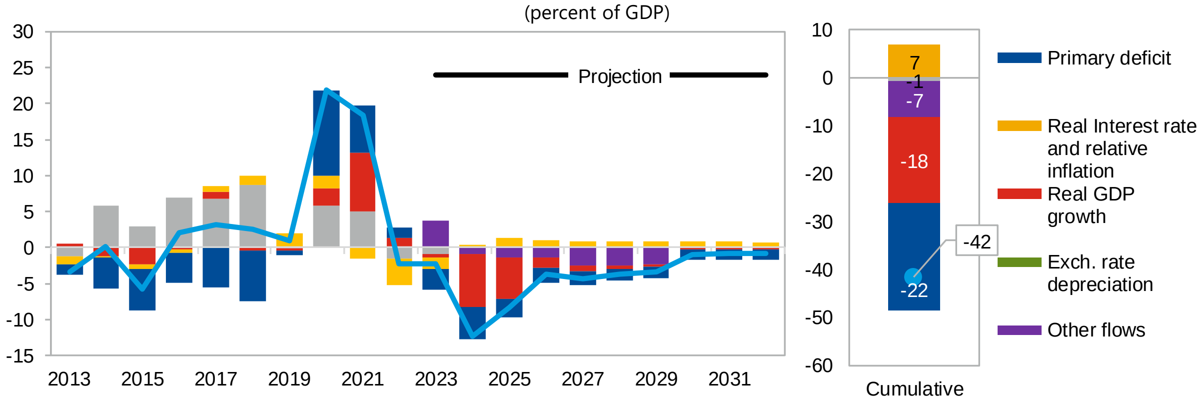
Figure 4. Palau: Baseline Scenario

(percent of GDP unless indicated otherwise)

	Actual	Medium-Term Projection						Extended Projection			
	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Public debt	68.4	66.2	53.8	45.4	41.7	37.4	33.7	30.3	29.4	28.5	27.6
Change in public debt	-2.3	-2.2	-12.3	-8.4	-3.8	-4.3	-3.7	-3.4	-0.9	-0.9	-0.9
Contribution of identified flows	-0.7	-1.4	-12.3	-8.4	-3.8	-4.3	-3.7	-3.4	-0.9	-0.9	-0.9
Primary deficit	1.5	-2.9	-4.5	-2.6	-2.0	-1.8	-1.5	-1.5	-1.5	-1.4	-1.4
Noninterest revenues	57.7	48.9	51.7	48.2	47.5	47.0	46.7	45.4	44.0	42.8	41.5
Noninterest expenditures	59.2	46.0	47.2	45.6	45.6	45.2	45.2	43.9	42.6	41.4	40.1
Automatic debt dynamics	-2.2	-2.2	-6.9	-4.4	-0.5	0.1	0.3	0.5	0.5	0.5	0.5
Real interest rate and relative inflatioı	-3.6	-1.6	0.4	1.3	1.1	0.9	0.8	0.8	0.8	0.8	0.8
Real interest rate	-3.6	-1.6	0.4	1.3	1.1	0.9	0.8	0.8	0.8	0.8	0.8
Relative inflation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real growth rate	1.4	-0.5	-7.3	-5.7	-1.5	-0.8	-0.6	-0.3	-0.3	-0.3	-0.3
Real exchange rate	0.0	...	...	...	...	...	...	...	...	...	...
Other identified flows	0.0	3.7	-1.0	-1.4	-1.3	-2.5	-2.5	-2.4	0.0	0.0	0.0
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(minus) Interest Revenues	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other transactions	0.0	3.7	-1.0	-1.4	-1.3	-2.5	-2.5	-2.4	0.0	0.0	0.0
Contribution of residual	-1.6	-0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross financing needs	6.3	4.3	-0.2	1.0	1.2	1.0	0.3	0.5	0.8	0.6	0.3
of which: debt service	4.8	7.2	4.3	3.6	3.2	2.8	1.8	2.0	2.3	2.0	1.6
Local currency	4.8	7.2	4.3	3.6	3.2	2.8	1.8	2.0	2.3	2.0	1.6
Foreign currency	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memo:											
Real GDP growth (percent)	-2.0	0.8	12.4	11.9	3.5	2.0	1.5	1.0	1.0	1.0	1.0
Inflation (GDP deflator; percent)	8.1	8.0	4.0	1.9	1.9	2.0	2.0	2.0	2.0	2.0	2.0
Nominal GDP growth (percent)	5.9	8.9	16.9	14.0	5.5	4.1	3.5	3.0	3.0	3.0	3.0
Effective interest rate (percent)	2.7	5.4	4.7	4.7	4.4	4.2	4.2	4.5	4.9	4.8	4.8

Contribution to Change in Public Debt

(percent of GDP)



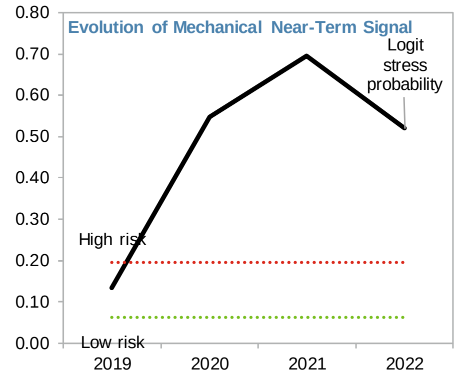
Commentary: Public debt will be declining due to fiscal consolidation grants FY2024-29, improving primary balances and growth recovery.

Figure 5. Palau: Near-Term Risk Analysis

Year of data	2019	2020	2021	2022
To predict stress in [t+1, t+2]	*2020-21*	*2021-22*	*2022-23*	*2023-24*
Logit stress probability (LSP)	0.133	0.547	0.694	0.520
Change in LSP	0.032	0.414	0.148	-0.174
due to:				
Institutional quality	-0.001	-0.007	0.010	0.000
Stress history	0.000	0.109	0.122	-0.025
Cyclical position	0.040	0.082	0.083	0.109
Debt burden & buffers	-0.008	0.249	-0.067	-0.260
Global conditions	0.000	0.000	0.000	0.000

Prob. of missed crisis, 2023-2024 (if stress not predicted): 86.3 pct.

Prob. of false alarm, 2023-2024 (if stress predicted): 1.3 pct.



Commentary: Palau's risk of near-term stress is moderate reflecting the reversal of one-off expenditures, and the ongoing economic recovery. High mechanical signal reflects the COVID-related sovereign stress due to a large output loss coupled with one-off fiscal support to the economy financed by ADB loans.

Figure 6. Palau: Realism of Baseline Assumptions

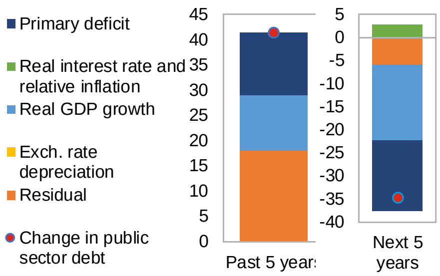
Forecast Track Record 1/	t+1	t+3	t+5
Public debt to GDP			
Primary deficit			
r - g			
Exchange rate depreciaton			
SFA			

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

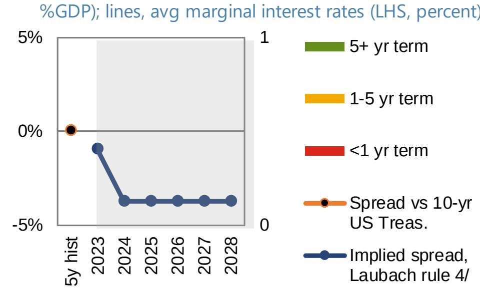
Comparator Group:
Emerging Markets, Non-Commodity Exporter, Surveillance

Color Code:
Optimistic: > 75th percentile; 50-75th percentile
Pessimistic: 25-50th percentile; < 25th percentile

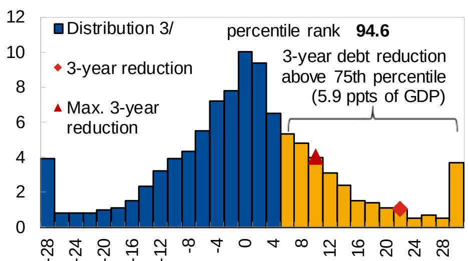
Public Debt Creating Flows
(Percent of GDP)



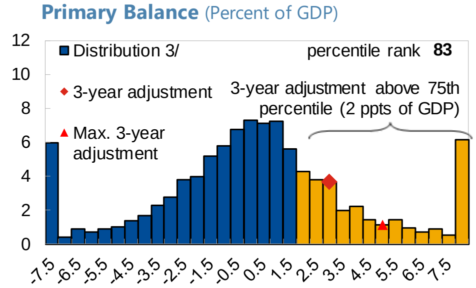
Bond Issuances (Bars, debt issuances (RHS, %GDP); lines, avg marginal interest rates (LHS, percent))



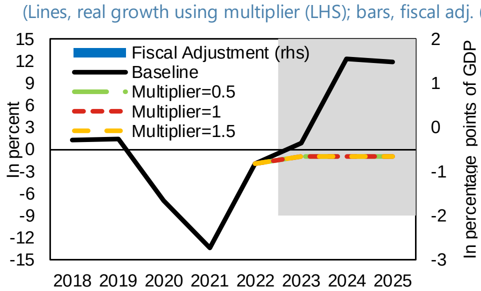
3-Year Debt Reduction
(Percent of GDP)



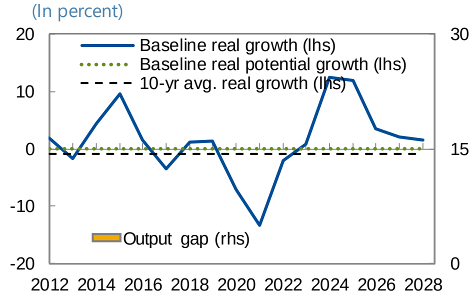
3-Year Adjustment in Cyclically-Adjusted Primary Balance (Percent of GDP)



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



Real GDP Growth
(In percent)



Commentary: Under the new Compact agreement with the US, the projected recovery coupled with debt relief will undo the pandemic debt accumulation. Excluding debt relief, realism analysis does not point to major concerns. Palau issues no bonds. As cyclically-adjusted primary balances estimates are not available, primary balances are used instead.

Source : IMF Staff.

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

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

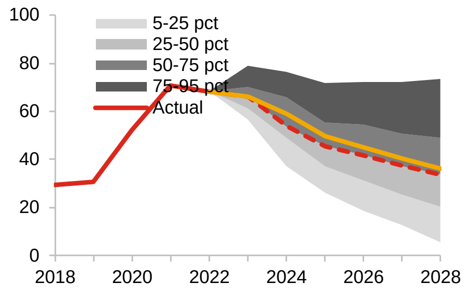
3/ Data cover annual observations from 1990 to 2019 for MAC advanced and emerging economies. Percent of sample on vertical axis.

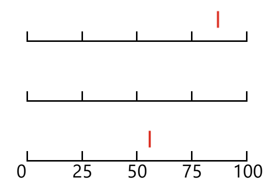
4/ The Laubach (2009) rule is a linear rule assuming bond spreads increase by about 4 bps in response to a 1 ppt increase in the projected debt-to-GDP ratio.

Figure 7. Palau: Medium-Term Risk Assessment

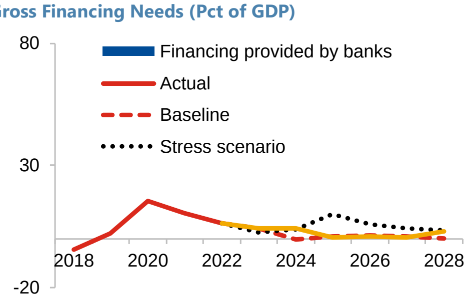
	Value	Contrib [1/]	Percentile in peer group [2/]
Debt fanchart module			
Fanchart width *(percent of GDP)*	67.8	1.0	
Probability of debt non-stabilizaiton *(percent)*	28.7	0.2	
Terminal debt-to-GDP x institutions index	33.5	0.7	
Debt fanchart index (DFI)		2.0	
Risk signal: [3/]		Moderate	
Gross financing needs (GFN) module			
Average baseline GFN *(percent of GDP)*	1.3	0.4	
Initial Banks' claims on the gen. govt *(pct bank assets)*	0.0	0.0	
Chg. In banks' claims in stress *(pct banks' assets)*	0.0	0.0	
GFN financeability index (GFI)		0.4	
Risk signal: [4/]		Low	

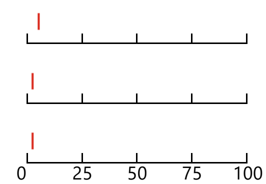
Final Fanchart (Pct of GDP)





Gross Financing Needs (Pct of GDP)

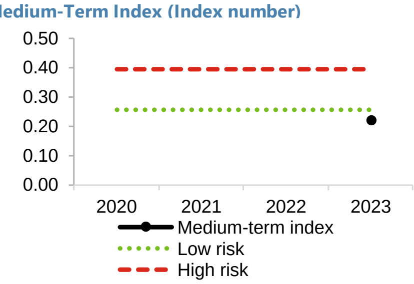




Triggered stress tests (stress tests not activated in gray)

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

Medium-Term Index (Index number)



Medium-term risk analysis

	Value	Value (normalized)	Weight	Contribution
Debt fanchart index	2.0	0.4	0.5	0.2
GFN finaceability index	0.4	0.0	0.5	0.0
Medium-term index		0.2		
Risk signal: 5/		Low		
Final assessment:		Low		

Prob. of missed crisis, 2023-2028, if stress not predicted: 9.1 pct.
Prob. of false alarms, 2023-2028, if stress predicted: 48.9 pct.

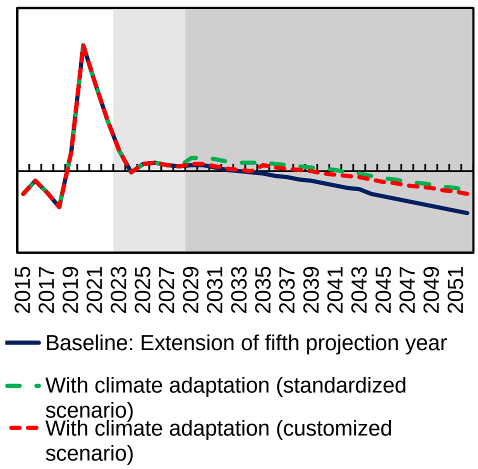
Commentary: Palau's risk of sovereign stress in the medium term is low. The width of fanchart triggers a moderate mechanical signal but reflects a very large output loss relative to peers during COVID-related border closures. Financing risks are assesed as low under the baseline scenario.

Source: IMF staff estimates and projections.

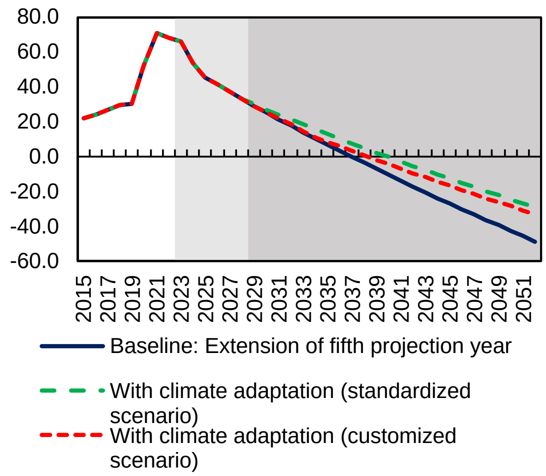
1/ See Annex IV of IMF, 2022, Staff Guidance Note on the Sovereign Risk and Debt Sustainability Framework for details on index calculation.
2/ The comparison group is emerging markets, non-commodity exporter, surveillance.
3/ The signal is low risk if the DFI is below 1.13; high risk if the DFI is above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

Figure 8. Palau: Climate Change: Adaptation

GFN-to-GDP Ratio



Total Public Debt-to-GDP Ratio



Commentary: Long-term climate adaptation needs are compatible with stable or declining debt and GFN ratios. Most of the required financing is projected to come in the form of external grants under the new Compact Agreement with the US.

Annex VI. Reforming the Pension System in Palau[1]

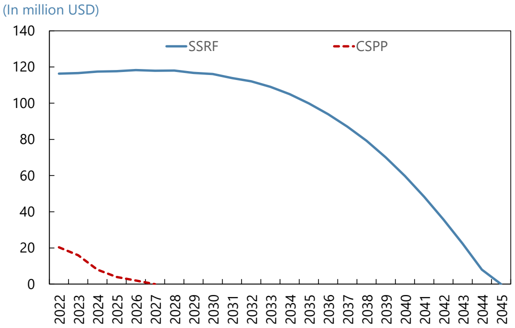
Palau's two publicly underwritten pension schemes are running out of their reserves, implying substantially higher annual budget subsidies (pay-as-you-go financing) in the future. The government has initiated a reform process to address this fiscal risk. The proposed reforms—both conceptually and in terms of their regulatory details—will bring the schemes' rules closer to best practice, improve their financial sustainability and may, depending on how outstanding details are finalized, contribute to benefit adequacy and distributional equity.

A. Introduction

1. Palau's public pension schemes are about to exhaust their reserves over a policy-relevant horizon. The general Social Security Retirement Fund or SSRF (administered by the Republic of Palau Social Security Administration, ROPPSA) is projected to exhaust its reserves by the mid-2040s, while the Civil Service Pension Plan (CSPP) will already run out of reserves by 2027-28. Absent reform, once their reserves are depleted, they will become pay-as-you-go financed with a continuous need for the government to augment the schemes' contribution revenues with budget transfers (deficit financing). The accrued-to-date liabilities of SSRF and CSPP were approximately US$550 million and US$220 million as of 2020, respectively, representing 250 and 101 percent of GDP. Of the total (gross) accrued liabilities, US$438 million and US$189 million were unfunded (net) liabilities.

SSRF and CSPP Reserves

(In million USD)



Sources: Callund Consulting Ltd, IMF staff estimates

2. The reform efforts of the government of Palau focus on ensuring that the growth of the two pension schemes' net liabilities is reversed or at least arrested, while the adequacy of pension benefits is maintained. These two objectives can only be reconciled if the schemes' revenues increase – and indeed, higher taxes earmarked for ROPSS and CSPP are an important part of the government pension reform strategy. The government's reform concepts, with the help of advisors, has already been finalized and translated into draft legislation submitted to legislature in case of SSRF, while details of CSPP's reform are still under discussion.

[1] Prepared by Csaba Feher (FAD).

B. The Current Pension System

Social Security Retirement Fund (SSRF)

3. **The Social Security Scheme is a contributory, defined benefit scheme where participation is mandatory for all workers, including the self-employed and public sector employees**. The scheme pays old age, disability, and survivor pensions in the form of full life annuities.[2] Contributions are levied at 14 percent, equally split between employers and employees, levied on actual full remuneration or presumed labor income (in case of the self-employed and various categories of entrepreneurs). Social security coverage is universal, and members tend to have long contribution histories. High coverage and contribution compliance is, to a great extent, driven by stable employment in the public sector, SOEs and public corporations. SSRF's active contributors numbered approximately 10.5 thousand in 2022, indicating near-universal coverage. Currently, the scheme has 12 thousand citizen contributors[3] and 38 thousand non-citizen contributors registered (i.e., people who have contributed at least once during their lifetime), of which 4.7 and 4.8 thousand citizen and non-citizen contributors respectively were active (i.e., having at least one salary record in the year). The scheme has 3.7 thousand beneficiaries.

4. **Old age pension eligibility conditions are generous based on an international comparison**. The normal retirement age is 60 and the minimum contribution history ensuring eligibility is 9.5 years. The replacement rate schedule is progressive: higher income brackets are replaced to a lesser extent. Cumulative lifetime earnings are calculated by adding nominal values without valorizing them in line with past wage dynamics. Benefits are not indexed but are subject to a contributory minimum of US$148 per month which is not indexed. To compensate recipients for the lack of regular indexation and the subsequent loss of benefits' real value, ad-hoc supplemental benefits have been universally added to pensions over the past 10 years. The three supplements (at US$50 per month each) awarded over the past 10 years effectively raised the minimum pension to US$298 per month.

5. **SSRF's funding ratio[4] on an accrued-to-date liability basis has been steadily declining, estimated at 20 percent as of 2020**. Benefit expenditures systematically exceed contribution revenues by approximately 30 percent, predicting the exhaustion of their reserves (currently at US$115 million, equal to approximately 50 percent of GDP) by 2044.[5] Once the reserves are

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[2] Lumpsum payments are available in certain cases of survivor pension eligibility.

[3] SSRF considers citizens of Palau, Micronesia, and the United States as domestic contributors.

[4] The funding ratio shows the ratio of available resources to obligations and can be measured along different concepts. The most restrictive definition measures reserves against accrued-to-date liabilities. This method is equivalent to estimating the liquidation value of a scheme, i.e., whether the present value of benefits to be paid to existing pensioners and the present value of benefit promises accrued to active members can be met existing reserves. The funding ratios quoted in the actuarial assessments and this annex are based on accrued-to-date liabilities and resources.

[5] Projections referenced in this annex rely on the reports of Callund UK Ltd., an independent actuarial and policy advisory firm retained by ADB to assist the government in formulating its pension reform strategy.

depleted, SSRF will become pay-as-you-go and will require additional resources to stay current on its benefit obligations. The additional resources may be generated by higher contribution rate or direct deficit financing by the treasury.

6. An unusual feature of the scheme's finances is that migrant workers' contributions usually don't lead to vested pension rights and benefit payment. While this may be perceived as an additional income tax levied on foreign workers which do not result in additional accrual of pension entitlements, this situation introduces additional uncertainties into the scheme's financial position: if the number of overseas workers declines (as it happened during the COVID-19 crisis), it can have a profound negative effect on SSRF contribution revenues.

Civil Service Pension Plan (CSPP)

7. CSPP is a contributory, occupational, defined benefit pension scheme for public sector employees. The scheme has 3300 active contributors and 1600 pensioners. Active CSPP members are also contributing to the general social security scheme (SSRF) and receive pensions from both schemes. Contributions are levied at 12 percent of gross wages, split equally between employees and the government (as employer).

8. Eligibility is conditioned on reaching 60 years of age and having contributed for at least five years. Benefits accrue at 2 percent per year, with the resulting replacement rate applied to the best three years' salary. Given that public sector age-earning profiles are typically upward sloping, CSPP can be characterized as a final salary scheme. Past earnings entering the pension formula are not valorized to historic wage dynamics and benefits are not indexed, either.

9. The high CSPP accrual rate of 2 percent per year - especially since it is applied to the best three years' average salary[6] results in high replacement rates. CSPP benefits, in combination with SSRF pensions, are over 70 percent of best (or final) salaries in the case of more than 90 percent of CSPP retirees. Close to 30 percent of retiring civil servants receive a combined pension which is over 125 percent of their best (final) average salaries.

10. CSPP contribution revenues cover approximately two-thirds of its expenditures, with the shortfall financed by drawing down its reserves. CSPP reserves are equal to approximately 14 percent of its accrued-to-date liabilities and are declining at a rate which implies total reserve depletion by 2028. After that year if benefits expenditures are limited to CSPP's contribution revenues, the depletion of the reserves will imply a benefit reduction of between 50 and 58 percent or a contribution rate increase from today's 12 percent to between 20 and 25 percent. Alternatively, the scheme would need to rely on significant annual budget transfers equal to roughly half of its benefit expenditures.

[6] Given civil service pay scale characteristics, "best three years" is practically equivalent to the last three years of employment, making CSPP a final salary scheme.

The Reform Proposals

11. Over the past two years, the government has initiated work on a set of reform proposals. The objectives of the reform are to: (i) improve the pension schemes' financial sustainability and to curtail the government's exposure to underwriting risks; (ii) improve SSRF's generosity and make its pension formula more progressive; (iii) bring SSRF regulations in line with good practice; and (iv) transform CSPP into a defined contribution scheme. In addition, the government is also considering the option of expanding the coverage of the reformed CSPP to the private sector, transforming the new, defined contribution scheme, into an additional component of universal, mandatory pension insurance. While the SSRF reform measures have already been submitted to legislature as the "Social Security Continuity Bill", the CSPP reform is still in its preparatory phase.

Social Security Retirement Fund (SSRF)

12. The normal retirement age is proposed to increase from today's 60 to 65 years for both men and women, starting immediately after the amendment's effectiveness. Early retirement will be available from no more than five years prior to the normal retirement age, with high, nonlinear early retirement penalties designed to exceed the actuarially neutral deduction and thereby discouraging early withdrawal from the labor market. Deferred retirement will be rewarded with nonlinear benefit increases but incomes earned after the normal retirement age won't be liable to contributions and, consequently, will not generate additional pension entitlements.

13. The SSRF Bill introduces systematic, rule-based indexing of pension benefits which is a major improvement compared to the previous practice of ad-hoc pension supplements. At the same time, the authorities may wish to consider indexing pensions to prices instead of wages (as is currently proposed by the bill). Price indexation is fiscally less costly and maintains benefits' real value.

14. The benefit formula is to undergo profound changes, too. The current structure of a relatively low minimum pension supplemented by a higher earnings-related component will be transformed into a more generous minimum pension complemented by earnings-related pensions calculated along lower replacement rates (Table 1). Furthermore, while the new minimum will be paid in full to everyone retiring with at least 38 quarters of contributions[7], the new earnings-related pension component will be pro-rated, reflecting the retiring workers' contribution histories relative to the full career defined as 140 quarters (35 years) of contributions.

[7] To increase in line with retirement age.

Table 1. Palau: Proposed Reform of the SSRF Benefit Formula

Current Benefit Formula		Revised Benefit Formula	
Income band (unrevalued cumulative earnings)	Replacement rate (percent)	Income band (revalued cumulative earnings)	Replacement rate (percent)
		Fixed (minimum, full-career) benefit	$4000 p.a.
-11,000	27.00	-250000.00	1.00
11,001-44,000	2.90	250,001-375,000	0.75
44,001-500,000	1.50	375,001-500,000	0.50
500,001-	0.75	500,001-	0.50

15. Past wages considered in the pension formula will be valorized to economy-wide wage dynamics (as opposed to adding past wages using nominal values), and benefits will be indexed annually to wages, too. A similar indexation policy will be applied to the US$4,000 per annum minimum pension and the brackets determining the replacement rate schedule.

16. In term of the transition, the bill will create a system which will temporarily—until 2027—calculate newly awarded pensions according to both the old and the new formula, paying the higher of the two. The recalculation is expected to happen regularly (during its five years of implementation) because while pensions based on the new formula may be lower, the automatic indexation may increase them above the pension calculated according to the old formula (in case that latter was higher at the time of retirement).[8]

17. In additional to adjustments to eligibility and benefit rules, the reform bill also seeks to increase the revenues of SSRF by increasing contribution rates from today's 14 percent to 18 percent. According to the authorities, the two measures that may prove difficult to ensure legislative approval are the retirement age and contribution rate increases.

18. The reform also introduces a new, basic pension benefit of 4,000 dollars per year, replacing the current minimum pension and pension supplements. Eligibility will be conditional on a full career (of 38 quarters of contribution history to increase gradually, in line with the proposed retirement age increase) with shorter working careers meriting a proportionally smaller basic pension. Workers with less than 38 quarters of contributions will be ineligible for the basic pension. The new benefit rules will introduce greater internal redistribution within the scheme and is also expected to lead to higher average pensions due to the systematic valorization of wages considered in the pension formula, the annual benefit indexation foreseen by the reform bill, and the 10 percent one-off increase of the minimum pension (from today's US$298 to US$333 per month.).

[8] The comparison is made using contemporaneous monthly benefit and is not based on prospective benefit levels or present values of pension wealth (total expected receipts).

Civil Service Pension Plan (CSPP)

19. The reform's most important feature is the closure of the current DB scheme to new accruals (contributions) and collect future contributions in individual pension accounts. Thus, the scheme is to transition from a defined benefit towards a defined contribution paradigm.[9] The government is committed to honoring accrued rights (i.e., pensions already in service and active workers' entitlements).

20. The applicability of the reforms would be differentiated across groups of employees, depending on their contribution histories and age. Pensions already in payment would remain unchanged. Employees with less than 10 years of contributions would see their employee contributions credited towards their DC individual accounts; workers with more than 10 but less than 20 years contribution history would have both their employee and employer contributions credited immediately to their DC accounts. Workers with more than 20 years of service but further than 5 years from retirement could opt for either receiving two pensions (one based on accruals up to the reform and anther one from the new DC scheme) or see their past contributions plus interest credited to their DC individual account. People closer than 5 years to retirement would not be impacted by the structural reform but would have their benefits subjected to a reduction (because of combined limit on benefits or as a straight deduction of between 0 and 20 percent).

21. Redirecting contributions to individual accounts will create a "transitional deficit" or "double-financing issue." Entitlements in the current DB scheme will need to be financed although new revenues will be locked away in DC accounts. Proposals to address this issue include increasing the recently introduced value-added tax (PGST) by 20 percent, from 10 to 12 percent and cutting in half the employer (government) contributions to the new DC account (from today's 6 to 3 percent). The issues that remain open are discussed below, in the assessment section.

22. Beyond the structural changes, the proposal would also introduce parametric adjustments to CSPP: increasing the retirement age to 65 (in line with the SSRF bill). Further changes - currently under consideration – include the reduction of the accrual rate and imposing a joint ceiling on publicly underwritten pension benefits paid to public employees (by SSRF and CSPP).

[9] The basic design of the CSPP reform – closing the current DB scheme to new contributions and replacing it with a new DC, individual account arrangement – is not the only reform option for stopping the growth of unfunded liabilities. A defined benefit scheme can be designed in a manner that keeps the schemes finances in actuarial balance going forward. While it is understood the government is committed to replacing the current DB scheme with a DC one, it should be noted that a reformed DB arrangement would avoid the double financing problem and may permit a more gradual shift away from today's generous scheme rules.

C. Assessment Of the Reform Proposals

Social Security Retirement Fund (SSRF)

23. **The proposed reforms will bring SSRF regulations in line with best practice**. It will reflect the government's social policy objective of greater redistribution within the system towards workers with lower earnings and shorter careers.

24. **On certain points, the bill submitted to legislature requires additional provisions to make it complete and to fully reflect the reform concept**.

- **Most importantly, the conditions of eligibility, benefit level, and other regulations pertaining to the basic pension are omitted from the bill and do not appear in other articles of legislation**. It is recommended that the bill be amended, and the missing provisions added.

- **It is also unclear how workers with contribution histories falling short of the minimum eligibility condition would be treated**. While it is understood that coverage is high, with almost every worker duly covered by SSRF contributions, regulatory completeness requires that all eventualities (such as short careers) are covered in a manner reflecting the government's social policy objectives and fiscal space.

- **Finally, the bill remains silent on the treatment of foreign contributors, who often fail to accrue the minimum qualifying contribution histories before leaving the country**. Since these individuals are not eligible for a compensation, their pension contributions function as a tax supporting SSRF's finances. While the financial consequences of compensation or some form of recognition of past contributions would have a straightforward (negative) impact on SSRF finances, equity considerations argue for (i) establishing international social security agreements with the home countries of foreign workers or; (ii) when home countries operate no pension schemes where returning workers would contribute, a compensation payable either in the form of past contributions or proportional pensions at the time of retirement.

25. **The proposed retirement age increase is fast: one year each year**. Although the new bill will allow early retirement (with penalties), the pace of the proposed increase may stand in the way of passing the bill into act. The government may wish to consider either a slower rate of increase (such as the more common six or three months per year), a deferred commencement of the increase or a combination of the two.

Civil Service Pension Plan (CSPP)

26. **The CSPP proposal translates the government's primary policy objectives – stopping the build-up of unfunded liabilities in CSPP, while continuing to offer public service employees generous, additional pensions - well into a reform concept**. It is important to note that while the proposal will put a stop to the accumulation of unfunded (net) DB pension liabilities

but will not reduce the funding gap in terms of accrued-to-date liabilities which will need to be financed by the government after the depletion of the DB reserves.

27. In CSPP, the parametric adjustments envisaged—retirement age increase and a ceiling on total retirement benefits underwritten by the state—could be augmented by further measures. The accrual rate (or marginal replacement rate earned by additional years of contribution) is 2 percent which is high in international comparison. Lowering the accrual rate – possibly to between 1.4 and 1.8 percent – could result in gradually cutting benefit expenditures by 10 to 30 percent.

28. In addition to reducing the accrual schedule, the calculation base should, also in line with international best practice, be expanded to cover members' full earning career, as opposed to today's practice of considering the three best years of the person's wage history. Depending on the typical age-earning profile of contributors, this could also reduce benefit expenditures and make benefits more equitable, relative to lifetime contribution performance. The above changes would need to be applied retroactively (to past entitlements) to make a tangible impact, since the reform concept foresees no new benefit accruals in the current DB scheme. The expansion of the calculation base would also necessitate valorizing past earning records. In this respect, best practice argues for valorizing past individual earnings with the economywide wage index.

29. The proposal should clarify the payout phase from CSPP. Social policy considerations would argue for mandating the purchase of annuities at retirement. Although there are currently no life insurers in Palau. Palau's use of the dollar and access to US financial markets would make addressing this issue less profound than in other countries.

Annex VII. Palau's Fiscal Responsibility Framework[1]

1. According to the principles of fiscal responsibility outlined in the Fiscal Responsibility and Debt Management Act (FRDMA) §105, the Palauan government is committed to responsible fiscal management. These principles encompass:

- Managing operating expenditures over the medium-term within operating revenues and in relation to the rate of growth of the economy.
- Managing net capital and financial assets, including the COFA Trust Fund, to achieve rising real national net worth over time.
- Managing debt prudently.
- Managing the revenue regime to best fit the structure of the economy, to provide for an equitable allocation of tax burdens, and to allow for predictability over time.
- Managing reserves and insurance coverage to offset cyclical volatility, the costs of natural disasters, and the impact of climate change.
- Managing the non-primary government public sector prudently, including ensuring State-Owned Enterprises (SOEs) and Public Financial Institutions (PIFs) are managed to deliver services on an effective and financially sustainable basis.
- Managing fiscal risks and contingent liabilities prudently.

Palau's Principles of Fiscal Responsibility

2. The Government may depart from the principles of responsibility provided the departure is temporary. Furthermore, the President needs to state the reason for the departure and indicate the timeline to return to adherence to the principles. Should any such circumstances arise which force departure from these principles during the fiscal year, they must be timely disclosed in accordance with the provisions of the FRDMA (FRDMA, Republic of Palau).

3. As required under law, the President is required to submit to the OEK at the start of each administration—or as circumstance dictate—a Fiscal Strategy that outlines Palau's fiscal goals and policies and that clearly demonstrates adherence to the principles of fiscal responsibility.

4. As required by the law, the authorities publish an Economic and Fiscal Update to discuss recent departures from the above principles of fiscal responsibility. The key reasons and the proposed offsetting measures highlighted in the Fiscal Update are as follows:

[1] Prepared by Irina Yakadina (APD).

- **Managing Operating Expenditures**: The Palauan authorities have temporarily departed from this principle due to the unforeseen impact of the COVID-19 pandemic, with increased spending to support affected businesses, households, and employees during the crisis, as revenue contracted. This departure was necessary for economic and social stability during an unprecedented period of pandemic isolation. As the recovery gains strength, Palau is gradually returning to adherence to this principle. The authorities aim at maintaining fiscal discipline by ensuring tax rate stability and predictability and controlling expenditures until the economic recovery is fully entrenched and the CRA-23 is approved by the US Congress.

- **Managing Net Capital and Financial Assets**: Palau's net public sector national wealth has declined significantly since the onset of the pandemic. Factors contributing to this decline include reduced investment and increased external debt to finance deficit spending during the pandemic. To reverse this trend, Palau is pursuing several measures, including infrastructure development, grants from the Compact of Free Association (CRA-23), Public-Private Partnerships (PPPs), bond issuances, and additional funding for the COFA Trust Fund. The successful implementation of tax reform and economic recovery is expected to generate surpluses for infrastructure investment and future development.

- **Managing Debt Prudently**: Palau has traditionally maintained cautious external debt policies, with debt-to-GDP ratios around 30 percent before the COVID-19 pandemic. However, the crisis led to a substantial increase in debt levels. To address this, the authorities intend to establish mechanisms for prudent debt management, including debt sustainability analysis (DSA), software for debt recording, and a debt management unit to review and assess risks of proposed borrowing and guarantees issuance. Palau is also considering paying down variable-interest-rate and short-duration loans using fiscal consolidation grants from CRA-23.

- **Managing the Revenue Regime**: Tax reform, particularly the introduction of the Palau Goods and Services Tax (PGST), has been a significant fiscal achievement. PGST, excise taxes, and other reforms have modernized Palau's tax system. Ongoing initiatives include evaluating the tax reform program, upgrading the Tax Information System, and implementing customs reforms.

- **Managing Reserves and Insurance Coverage**: Palau has replaced the General Fund Reserve with a Cyclical Reserve and a Climate Resilience Fund, addressing fiscal risks related to economic cycles, climate events, and natural disasters. Contributions to these funds are made from domestic revenues, and withdrawals are permitted under specific conditions. Palau is actively seeking technical assistance to determine appropriate reserve targets.

- **Managing State-Owned Enterprises (SOEs) and Public Financial Institutions (PFIs)**: SOEs and PFIs have presented fiscal challenges, but progress has been made in improving their financial stability. PPUC has implemented full cost recovery tariffs, reducing fiscal risk. Reforms for the Social Security System and Civil Service Pension Plan are underway to ensure long-term sustainability. Successful implementation of tax reform, CRA-23, and economic recovery will create fiscal opportunities to address these challenges.

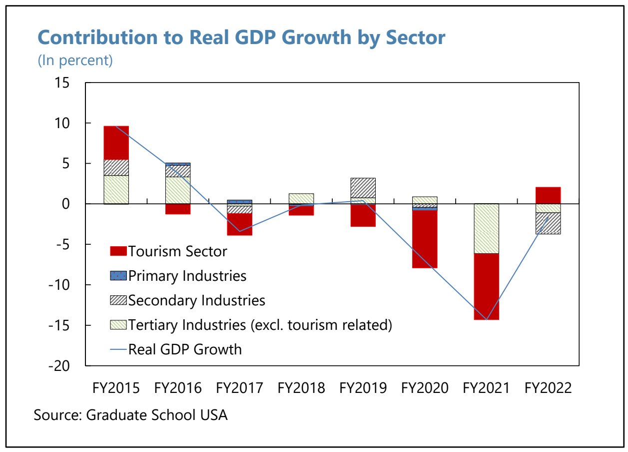
- **Managing Fiscal Risks and Contingent Liabilities**: Palau faces various fiscal risks, including economic volatility, financial sector crises, changing debt interest rates, demographic changes, natural disasters, government guarantees, litigation, public-private partnerships, environmental degradation, and local government deficits. The authorities plan to continue to monitor and manage these risks to ensure fiscal sustainability.

Annex VIII. Building Resilience and Sustainable Tourism in Palau[1]

Tourism is an important driver of economic activity in Palau. Prior to the pandemic, tourism activities contributed to about a third of GDP. Outside of the public sector, it is the principal sector of employment. As in other countries, the tourism sector in Palau was severely impacted by the pandemic, but the recovery has been slower than in other Pacific islands. This annex reviews the tourism sector landscape in Palau and assesses its post-pandemic recovery. It then proposes strategies, based on experiences in other countries, to transition to a high-value with low impact tourism model while building resilience in the tourism sector to climate change and reducing economic volatility—policy objectives outlined in Palau's 2025 National Development Plan. Enacting important structural changes to enhance planning and coordination, support the nascent sectors, and improve climate resiliency will build a stronger tourism sector for the future.

A. The Tourism Sector Landscape in Palau

1. **Tourism is an important driver of economic activity in Palau**. Tourism and related activities historically contributed to about a third of GDP. Tourism is the principal source of private sector jobs, accounting for 21 percent of private sector employment in FY2022, down from a pre-pandemic average of about 35 percent. Foreign labor makes up roughly 70 percent tourism workers.[2] If we consider tourism's contribution to related industries, the weight of the tourism sector in Palau was estimated historically at about 50 percent of GDP.[3]



2. **Visitor arrivals in Palau have averaged 115,000 visitors per year during the pre-pandemic period**. Most tourists originated from East Asia, including China (32 percent in FY2019), followed by Japan (22 percent) and Taiwan, Province of China (16 percent), and Korea (13 percent). While accounting for a bulk of visitor arrivals, visitors from mainland China were mostly part of package tours that generated lower revenues.

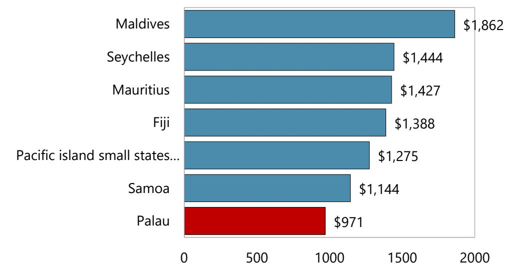
[1] Prepared by Ricardo Davico and Saraf Nawar (APD).

[2] Graduate School USA, EconMap (http://econmap.org).

[3] Palau Responsible Tourism Policy Framework, 2017-2021. December 2016.

3. Palau's revenue per tourist arrival in FY2019, a main metric of the value added by tourism, was among the lowest in the Pacific Island destinations. The revenue per tourist arrival measures the average spending per tourist during their visit. Palau's relatively low revenue is attributed to shorter stays by visitors, the high share of low value-added package tours from China, and fewer tourism products for visitors.

Pre-Pandemic Revenues Per Visitor Arrival
(2019, current USD)

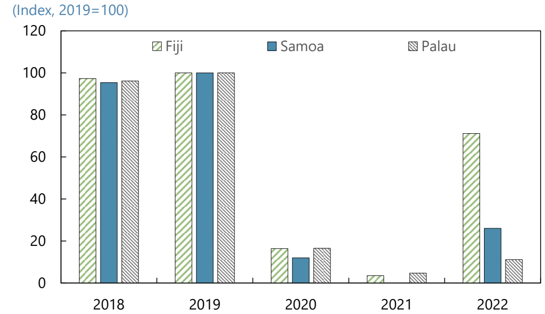


Sources: World Development Indicators, The World Bank; and IMF staff estimates.

B. Assessing the Post-Pandemic Tourism Recovery

4. The Palauan economy emerged from the pandemic with significant scarring and a tepid recovery. Palau's tourism sector is recovering at a pace far slower than other destinations in the South Pacific. In FY2022, Palau's tourism visitor numbers were 9 percent of pre-pandemic levels with 9,247 visitors. In contrast, Fiji's visitor arrivals reached 72 percent of the average 2018-19 levels. Samoa has recovered to 29 percent of pre-pandemic levels.

Recovery in Visitor Arrivals is Stronger in Other Pacific Destinations...
(Index, 2019=100)



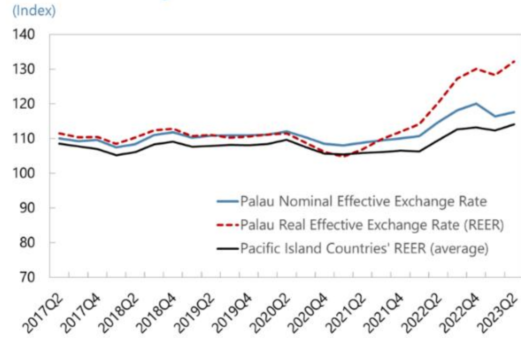
Sources: Central Statistical Offices of Fiji, Samoa, and Palau.

5. Three key factors are driving Palau's slower recovering in tourism.

a. Dependence on select source markets in East Asia (i.e., China, Taiwan, Province of China, and Japan). Outbound tourism from these countries has been slower to recover when compared to Australia and New Zealand visitors, which are the source markets for Fiji and Samoa.

b. International flights into Palau have been slow to resume and uncertainty remains on their resumption to pre-pandemic levels. According to the authorities, airlines are prioritizing larger markets and facing labor constraints, including for pilots. As of September 2023, international flight volume to Palau is at about two-thirds of pre-pandemic levels with 10 incoming flights per week.

Effective Exchange Rates
(Index)



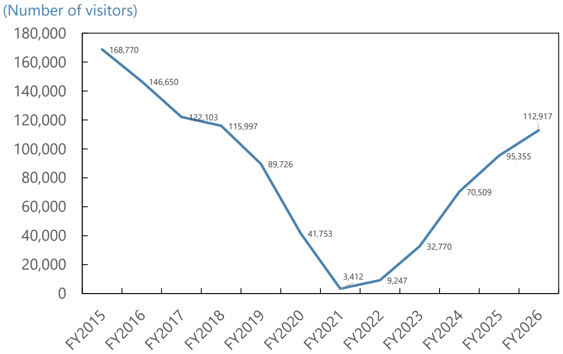
Source: IMF Information Notice System.

c. The appreciation of the U.S. Dollar impacted Palau's cost competitiveness compared with other tourism destinations in the South Pacific. Palau's Real Effective

Exchange Rate (REER) appreciated by 14 percent in 2022. The impact has been mostly felt with the Japanese visitor arrivals, which have yet to resume in significant numbers. The REER for Japan has depreciated by 22 percent over the past two years.

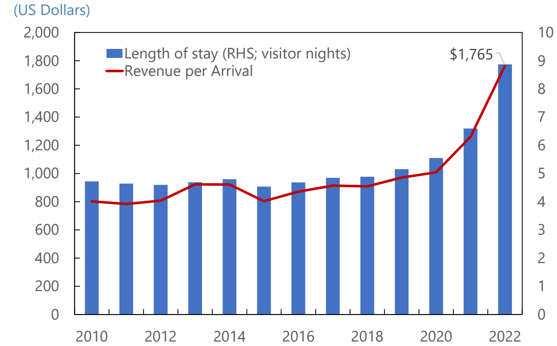
6. Despite a challenging environment, early indicators point to gradual rebound in the tourism sector. In FY2023, visitor arrivals are projected to increase to over 30 thousand from a low base of nine thousand the previous year. In the medium-term, IMF staff estimates are for visitor arrivals to approach pre-pandemic levels by FY2026. The source markets for visitors thus far in FY2023 show a shift to higher spending US and Taiwan, Province of China, visitors and longer length of stays from an average of five to over eight days in FY2022. In combination, these factors have contributed to a near doubling of the revenue per visitor arrival in FY2023 to an all-time high of US$1,765. Palau's high revenue per tourist arrival in FY2022 are projected to be temporary without additional reforms in the tourism sector. Temporary factors, such as a high proportion of long-staying US miliary visitors are driving much of this increase. To sustain a higher revenue per arrival level, additional deepening needs to take place.

Tourism Arrivals
(Number of visitors)



Source: Graduate School USA; and IMF staff estimates.

Revenue Per Tourist Arrival
(US Dollars)



Source: Graduate School USA.

C. Transitioning Toward High Value, Low Impact Tourism

7. The authorities' Responsible Tourism Policy Framework 2017-2021, published in December 2016, outlines a strategy to transition Palau into a high-value tourism destination, with a focus on low impact and sustainability. The policy framework is currently being updated, though no major changes are expected. The strategy aims to develop Palau as a niche tourism market, with higher revenues per visitor, and an expanded tourism offering, with lower impact on the environment and maintaining Palau as a pristine destination.

8. The authorities have made inroads in efforts to pivot into a high-value tourism destination. Many of their initiatives are still in infancy but are integral to expand the tourism offering and target the high-value segment. The initiatives can be categorized into three key areas:(i) expanding cultural and eco-tourism; (ii) developing new high-end offerings and for digital nomads; and (iii) expanding flights and facilitating foreign investment.

- To develop cultural tourism, authorities are actively identifying and restoring cultural sites while collaborating with local villages and tour operators to craft enriching cultural tourism experiences. These endeavors not only facilitate the creation of new tourism connections but also lend support to local food production and create incentives for the local arts and handicrafts. Concurrently, to foster eco-tourism, authorities are extending hiking trail networks and investing in camping and glamping opportunities for visitors. Collectively, these initiatives contribute to the growth of inland tourism in Palau.

- Palau is actively developing its high-end tourism offerings, with two new luxury hotel projects in the pipeline: the Four Seasons Hotel, featuring 40 water-front units set to open in FY2025-26 (US$40 million investment), and the IHG group's 150-unit luxury resort slated for FY2024 (US$35 million investment). Alongside these developments, the authorities are working with the US Military to upgrade the Port of Malakal, making it capable of accommodating larger vessels for both commercial and military use. In addition, initiatives are underway to improve the hydrographical mapping and update the navigational charts, as well as proposals for the improvement of aids to maritime navigation. These combined efforts are aimed at attracting the luxury yacht segment, bolstering Palau's high-end tourism sector.

- To promote longer stays, the Ministry of Human Resources, Culture, Tourism & Development has contracted a consulting company to perform an assessment and assist in developing a strategy to attract digital nomads and other longer stay visitors.

- The authorities are taking concerted action to enhance the country's international connectivity and promote foreign investment. They are actively collaborating with external partners, including tour operators, foreign embassies, and airlines, to expand international flights into Palau. Although a new weekly flight connection from Brisbane, via Port Moresby, has been established with strong support from the Australian government, challenges such as low flight load factors and labor shortages, notably among pilots, persist in expanding additional connections. Furthermore, the Palau International Airport's capacity limitations for larger aircraft add to these challenges. Simultaneously, to encourage foreign investment, particularly in the tourism sector, the authorities are set to open a One-Stop-Shop concept for business license and permit applications. This innovative approach brings together relevant government agencies under one roof to streamline and expedite the review process, facilitating the regulatory process for foreign investment in Palau.

D. Enhancing Resilience in The Tourism Sector

9. **Palau is promoting sustainable tourism practices to safeguard its natural beauty and ecological integrity**. This involves multifaceted efforts, including educating tourists about responsible behavior, reducing single-use plastics through awareness campaigns, and implementing stringent waste management programs.

10. **To protect its marine biodiversity and maintain the allure of its underwater wonders, Palau established the Palau National Marine Sanctuary, covering a vast 80% of**

Palau's exclusive economic zone. Complemented by rigorous enforcement against illegal fishing and activities detrimental to the marine ecosystem, these measures aim to ensure the health and resilience of Palau's underwater treasures.

11. Palau has established eco-certification programs for tourism businesses, including dive operators, providing tourists with confidence in choosing environmentally responsible operators for their activities. For instance, leading resorts (e.g., the Palau Pacific Resort) demonstrated a commitment to sustainability by implementing solar energy systems and wastewater treatment facilities, significantly reducing their environmental impact. These eco-conscious measures aligned with Palau's broader efforts to promote sustainable tourism and reduce its carbon footprint, making it easier for tourists to enjoy eco-friendly experiences while contributing to the preservation of the environment.

12. The intricate relationship between tourism's role in Palau's economy and its susceptibility to climate change, requires bolstering climate resilience and sustainability. Periodic droughts, the sustainable management of water, sewage, and electricity resources, as well as the threats posed by sea-level rise and the impact of high winds from climate events, all present significant challenges to the tourism sector and the broader economy. To proactively address these risks, authorities have implemented a series of climate risk mitigation measures:

- Palau's national development program has established specific renewable energy targets: 20 percent by 2020 and 45 percent by 2025. These targets aim to reduce Palau's reliance on imported fuels, primarily diesel, for electricity generation. In collaboration with the Palau Public Utility Company, the Japanese government is providing financial support for a US$17.5 million project spanning two years. This project focuses on upgrading Palau's electricity grid infrastructure, enabling the implementation of net metering to absorb into the grid excess electricity generated by rooftop solar panels.

- Palau's water system faces constraints due to limited storage capacity in the current reservoirs and an aging network. Current conservation efforts mainly involve issuing consumer notices during periods of low reservoir levels. In a bid to promote conservation, the Palau National Development Bank (PNDB) has mandated the installation of rainwater containment systems and solar panels as prerequisites when financing new home constructions.

- The authorities have established the National Emergency Management Office (NEMO) as the principal coordinating agency for comprehensive disaster management. NEMO's mandate extends beyond coordination, encompassing essential facets such as education, capacity building, and rigorous planning and evaluation. Presently, NEMO is actively engaged in enhancing disaster preparedness and augmenting its capacity for climate risk analysis, a process that currently relies on external weather centers situated in Guam.

- Within the Ministry of Finance, the Palau Automated Land and Resource Information System Office (POLARIS) utilizes LIDAR technology to measure elevation and gather sea-level data.

This data is then integrated into a Geographical Information System (GIS), alongside recently completed census data. This integrated approach allows for effective risk assessments, identifying vulnerable homes and providing valuable information for emergency responders.

Box 1. Lessons from Curacao, Iceland, and Costa Rica

Curacao diversified its tourism source markets by: (i) refocusing the tourism demand structure toward the North American market without replacing the established Dutch and Venezuelan markets; (ii) increasing airlift from North America to 20 additional flights per week; (iii) simultaneously increasing the quality of tourism experiences through human capital development; (iv) allocating additional finances for marketing efforts and tourism product development for the new demand structure; and (v) revamping attractive heritage sites to attract North American tourists.

Iceland implemented a Tourism Roadmap that supports the sustainable development of tourism with focus on seven key elements: (i) Coordination among stakeholders; (ii) Providing a positive visitor experience; (iii) Reliable data; (iv) Nature conservation; (v) Labor skills and quality; (vi) Increased sector profitability; and (vii) Better distribution of tourists across the country. A key policy priority in Iceland's tourism strategy is the implementation of a Tourism Balance Axis, a tool to measure the carrying capacity of tourism, via its impact on social welfare, on public services, and the environment.

Costa Rica's Certificate for Sustainable Tourism (CST) program plays a crucial role in identifying eco-friendly tour operators and accommodations in the country. This certification program evaluates and recognizes businesses in the tourism industry that demonstrate a commitment to sustainable practices, environmental conservation, and responsible tourism. CST assesses various criteria, including waste management, energy efficiency, community involvement, and cultural preservation, to ensure that certified establishments minimize their environmental impact and contribute positively to local communities. Travelers seeking eco-conscious experiences in Costa Rica can rely on the CST program as a trustworthy guide to make environmentally responsible choices while exploring the country's stunning natural beauty.

E. Policy Recommendations

13. To enhance the shift towards high-value, low-impact tourism, the authorities are encouraged to build upon their current achievements by enhancing coordination and planning efforts within the government and with the private sector. While the Responsible Tourism Policy Framework offers a comprehensive vision for the future of Palau's tourism sector, there remains a lack of specificity regarding the means to achieve the stated objectives, and securing the commitment of all stakeholders may be uncertain. This highlights the crucial necessity for a centralized government agency dedicated to planning and coordination. Such an agency would facilitate more efficient interagency collaboration, establish performance metrics, and enable the prioritization and sequencing of projects, ultimately ensuring the successful realization of these goals. Additional measure could include:

- **Enhance human capital with focused vocational training for Palauan nationals**, by creating job training and apprenticeship programs that target skilled labor categories that are in high demand. Higher paid vocational jobs in construction and the hospitality sector are largely performed by foreign workers. Apprenticeship and vocational programs for Palauan nationals should focus on improving skills in the labor force and increase opportunities in the private sector, which may slow demographic pressures from youth migration.

- **Establish requirements for customer service training of workers in the tourism economy**. Successful implementation of a high-value tourism strategy is dependent on the quality of visitor the experiences. Positive perceptions of Palau as a destination are gained between the interaction of service workers and tourists. Guidelines for service workers, combined with regular visitor perception surveys, are intended to benchmark current perceptions, and build Palau's value as a destination.

- **Improve access to financing for micro and small enterprises**. The Palau National Development Bank currently provides micro-loans to individuals and businesses, but pricing does not reflect portfolio risk. Establishment of a credit bureau—currently under consideration by the authorities—could reduce information asymmetries and help banks better manage credit risk.

- **Target new tourism source markets by collaborating with airlines and travel agencies, investing in infrastructure, and promoting sustainability practices**. Creating diverse tourism products and simplifying visa and entry procedures can enhance the appeal to a wider range of travelers. Additionally, Palau should closely monitor marketing performance and adapt strategies as needed to ensure a successful expansion of its tourism source markets.

INTERNATIONAL MONETARY FUND

REPUBLIC OF PALAU

November 13, 2023

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

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

CONTENTS

FUND RELATIONS

(As of September 30, 2023)

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	7.23	94.50

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 has accepted the obligations under Article VIII, Section 2(a), 3, and 4 of the IMF's Articles of Agreement, and maintains an exchange system that is free of multiple currency practices and of restrictions on the making of payments and transfers for current international transactions.

Article IV Consultation: Palau is on a 24-month cycle. The 2021 Article IV Consultation discussions were held virtually during September 22 – October 7, 2021. The staff report (IMF Country Report No. 2021/263) was considered by the Executive Board and the consultation concluded on November 29, 2021.

Technical Assistance: Technical assistance on tax policy, tax law, tax administration, bank supervision, public sector wage bill, 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. Mr. Neil Saker 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

(As of October 2023)

I. Assessment of Data Adequacy for Surveillance
General: Data provision has some shortcomings but is broadly adequate for surveillance. The introduction in 2023 of the Palau Goods and Services Tax (PGST) expanded the availability of administrative data that could improve the compilation of national accounts and balance of payments statistics. The coverage of fiscal and monetary statistics could be expanded and reporting lags could be shortened. With the support of technical assistance (TA) from IMF/PFTAC and the Graduate School USA, the Office of Planning and Statistics (OPS) compiles and publishes macroeconomic data on a monthly, quarterly, and annual frequency. The 2012-22 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. The authorities identified as their statistical priorities addressing data gaps in the production side GDP along with quarterly estimates, compiling Producer Price Indexes, developing statistics on the impacts of climate change (including on water resources and electricity demand) as well as quarterly fiscal statistics for the central government.
National accounts: Since 2012, annual GDP estimates by production have been compiled and published, and the methodology has improved. The last PFTAC mission conducted in November 2022 helped to improve the quality of GDP chain volume series in 2019 reference year by production and expenditure. PFTAC is coordinating with the Graduate School USA which collected input data and published national accounts to improve the quality of GDP data and prepare metadata Further areas of improvement include disseminating quarterly GDP estimates compiling GDP estimates using the expenditure approach and improving GDP deflators.
Price statistics: The Consumer Price Index is regularly published on a quarterly basis, with a timeliness of about three months after the reference quarter. The existing weights are based on the results from the Household Income and Expenditure Survey (HIES) 2014 The weights are expected to be updated once the HIES 2022-23 is finalized in early-2024. The authorities plan on developing a Producer Price Indexes (PPIs) and Export & Import Indexes (XMPIs) for specific target industries that are significant for the economy in Palau.
Government finance statistics: Annual fiscal data for the budgetary central government (BCG) are compiled using *GFSM 2014* classification and were published in the 2012-22 Palau Statistical Yearbook. Further improvements include broadening the coverage beyond the BCG, improving the frequency and timeliness of reporting. Palau started to compile general government data up to 2019 for the annual GFS database. External debt statistics disseminated by the OPS could be further improved by expanding the sectoral breakdown to include public enterprises and by improving timeliness.
Monetary and financial statistics: The Graduate School USA publishes annual data on depository corporations survey, which covers the commercial banks only, as well as a financial corporations survey that includes the Palau National Development Bank (PNDB). OPS publishes a consolidated balance sheet of the commercial banks. For the Financial Access Survey (FAS), data is available through 2022Q4 on the FIC website (https://ropfic.org/) 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). The latest FAS data reported to STA refers to 2017.
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 2012-22 Palau Statistical Yearbook and the National Summary Data Page (NSDP). Large errors and omissions undermine the usefulness of these statistics for surveillance. Further areas of development include disseminating quarterly balance of payments and international investment position data and improving the timeliness of data dissemination.
II. Data Standards and Quality
On February 18, 2022, Palau fully implemented the IMF's Enhanced General Data Dissemination System (e-GDDS), an important data transparency initiative, by launching its National Summary Data Page (NSDP). The NSDP is a national "data portal" that serves as a one-stop dissemination vehicle for publishing essential macroeconomic data aligned with the data categories in the Table of Common Indicators Required for Surveillance. Palau currently disseminates 7 of the 13 encouraged categories on its NSDP.

Palau: Table of Common Indicators Required for Surveillance
(As of October 2023)

	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	9/2023	10/2023	A	A	A
Interest Rates[4]	9/2023	10/2023	A	A	A
Consumer Price Index	2023Q2	10/2023	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	FY2022	9/2023	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt	FY2022	9/2023	A	A	A
External Current Account Balance	FY2022	9/2023	A	A	A
Exports and Imports of Goods and Services	06/23	10/2023	M	M	M
GDP/GNP	FY2022	9/2023	A	A	A
Gross External Debt	2022Q4	4/2023	Q	Q	Q
International Investment Position	FY2022	7/2023	A	A	A

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

[2] Foreign reserve assets consist of SDR holdings and the reserve tranche position in the Fund.

[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. Fiscal year ending September 30.

Statement by Robert Bruce Nicholl, Executive Director Palau and Rhoda Karl, Senior Advisor to the Executive Director

Executive Board meeting December 1, 2023

Overview

The Palauan authorities expressed their gratitude to Ms. Elif Arbatli Saxegaard and her team for the candid and constructive dialogue during the Article IV Consultation. They are in broad agreement with the staff assessment. The policy recommendations are appropriate, and the authorities are actively considering them as part of their budget and policy making processes.

Palau is a small Western Pacific state, made up of 8 principal islands and about 445 uninhabited rock islands, with a combined land area of about 177 square miles. It relies heavily on the Compact of Free Association Agreement (COFA) with the US, international tourism, and foreign grants. Delivering services to the dispersed population in remote locations is costly and logistically challenging. Palau is also highly vulnerable to the effects of climate change.

The recent shocks arising from the pandemic (mainly border closures) were severe, and Palau is now emerging with significant scarring, elevated debt, and historically high inflation; higher emigration (in large part, a result of the free flow of Palauan's to the US under the COFA) is also impacting the economy. However, amidst these challenges, in 2021 the authorities implemented critical reforms by strengthening fiscal framework through the Fiscal Responsibility Act (FRA) and Debt Management Act (DMA), and the implementation of major tax reforms in 2023 (the center piece being a goods and services tax). The COFA renewal (CRA-23), which awaits US congressional approval, has improved financial terms that will support Palau's macroeconomic prospects, but the authorities are also mindful of the uncertainties. Until final approval of the CRA-23, Palau will engage in an annual process of incremental funding release (Continuing Resolutions), which creates uncertainty around the timing of financial flows and adds to its administrative burden.

Economic Outlook and Risks

The Palauan authorities agree with the staff assessment of the economic outlook; real GDP has contracted significantly since 2020 and the expected strong recovery in 2023 has been dampened by delays in construction material shipments and labor shortages (again in part the result of COFA related emigration). The authorities are expecting a sustained recovery from 2024 as tourism related exports recover to their pre-pandemic level and the large construction projects is commenced. Palau's external position was substantially weaker than implied by fundamentals and desirable policies, reflecting slower-than-expected recovery in tourist arrivals, high commodity prices for imported goods, and deteriorating terms of trade.

The authorities are grappling with double digit inflation, which is driven by higher food and fuel prices, the base effect of the introduction of the Palau Goods and Services Tax (PGST), and utility tariff adjustments for households as temporary subsidies are gradually reduced. An appreciable reduction in the inflation rate is expected next year as the base effect of the PGST fades and other price pressures moderate.

The improved outlook is subject to significant downside risks: first, if there is further delay in importing large project construction materials; second, if there is further delay in recruiting labor for construction; third, if there is an acceleration of emigration; and fourth, the onset of climate related disasters and related effects (such as sea temperature warming that will impact coral reefs and associated marine life), particularly arising from the El Niño period ahead.

Fiscal Policy

The Palauan authorities have a strong track record of prudent fiscal management and are committed to maintaining this practice to set debt on a downward trend, in accordance with, and to be guided by, the FRA and DMA. They agree with staff that there is a need for continued fiscal consolidation in the near-term, given the elevated debt and macro-fiscal risks. The fiscal support measures put in place during the pandemic were withdrawn by the end of the 2021/22 fiscal year and this policy impact on the budget position was reinforced by higher-than-expected revenue for 2022/23. Continued fiscal consolidation supported by higher revenue mobilization efforts and the CRA-23 grant is expected to return the budget to a surplus position from 2023/24, thereby setting debt on a downward trajectory, while rebuilding fiscal buffers.

Palau's enhanced domestic resource mobilization efforts in implementing the PGST and the business profit tax will be supported by development of a digital administrative system to improve tax management and collection efficiency. The authorities are grateful for the support PFTAC has provided this and are committed to continuing this partnership.

On expenditure, the authorities will continue to protect vulnerable households from increased cost-of-living pressures. Strengthening public financial management through targeted household support is an important component of enhancing efficiency to support fiscal consolidation. This will facilitate efforts to expand investment in education, health, social security, infrastructure, and adaptation to climate change. Based on the recent Public Expenditure and Financial Accountability assessment, the authorities are developing a roadmap of reforms for implementation. The authorities have flagged a need for capacity development and the Fund's targeted support will be highly valued. Furthermore, the civil service pension plans that is currently being progressed will aim to reduce the risks of growth in unfunded liabilities and ensure long-term sustainability.

The high cost of the fiscal response to the pandemic has led to a rapid increase in public debt. However, the high share of external concessional loans from multilateral creditors is a mitigating cost factor. Funds consistently released under the CRA-23 and increased tax revenue are forecasted to appreciably reduce debt. Palau's debt is assessed to be sustainable with high probability and projected to decline over the medium term. The authorities are aware of the uncertainty around the timing of the CRA-23 grants and are working on possible options in the interim. They also recognize that a more prolonged delay would require prioritizing fiscal measures to maintain debt sustainability.

Financial Sector

Close monitoring and supervision of the financial sector is essential to minimize systemic financial and fiscal risks, considering the slow economic recovery and the National Development Bank of Palau's (NDBP's) high exposure to Non-Performing Loans. Given the NDBP's important lending role, the authorities are considering steps to enable it to function more like a commercial bank. This could enable NDBP to take deposits and be regulated by Palau's Financial Institutions Commission (FIC). They are also working to sufficiently resource the FIC to enable the effective delivery of its mandate.

The authorities acknowledge the need to encourage an inclusive financial system and to strengthen its role to develop the private sector to support growth. Efforts are underway to address structural impediments to credit provisioning. While the authorities are planning to establish a consumer bureau and introduce new payment system legislation, the recently implemented PGST requires businesses to prepare financial reports. Complying with this requirement will help address information asymmetry, which has hindered lending to small and medium enterprises.

The authorities recognize the potential for financial integrity, macro-financial, regulatory and cybersecurity risks, and are cautiously progressing their FinTech initiatives. The review of a recent pilot stable coin project will determine its merits and feasibility. While the authorities will continue to strengthen the AML/CFT risk-based supervision framework, they need capacity support from the Fund to help with the ML/TF and national risk assessments.

Structural Reforms

The authorities recognize the importance of diversification to support sustainable growth and building economic resilience. They will identify priority measures in different sectors in the new National Development Plan (NDP). Consistent with Palau's Responsible Tourism Policy Framework, efforts are pivoting toward adding higher value to the tourism sector and further developing a niche market. For this reason, maintaining the viability of the coral reef network is an important factor to preserve its appeal to the global diving community. The authorities are also seeking ways to attract digital nomads and longer stay visitors, enhancing cultural and eco-tourism, upgrading their port to accommodate larger vessels, and reducing red tape to encourage foreign investment in the industry.

Palau's vulnerability to climate change is also reflected by periodic droughts that affect water supply, a rising sea-level, and storms. The authorities have increased efforts within their constrained resources to progress mitigation and adaptation programs. Strong progress has been made in disaster management and preparedness, as well as in the renewable energy space, including building capacity for climate risk analysis. The authorities are committed to building climate resilient infrastructure and will need support to access climate finance (concessional loans and grants).

Capacity Support

The authorities rely heavily on the capacity support provided by the Fund, including through PFTAC and other development partners, then enabling Palau to deliver on macro-critical reforms. They also highly value the policy recommendations from the Article IV consultations. With significant capacity constraints and multiple challenges ahead, the authorities see value in continued close engagement with the Fund to ensure traction and continuity in the implementation of essential reforms. However, this engagement is complicated by the 24-month Article IV frequency.