

**Republic of Palau: 2005 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic 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 2005 Article IV consultation with the Republic Palau, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 17, 2005, with the officials of the Republic of Palau on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 31, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 15, 2006 discussion of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for the Republic of Palau.

The document listed below have been or will be separately released.

Selected Issues Paper and Statistical Appendix

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

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INTERNATIONAL MONETARY FUND

REPUBLIC OF PALAU

**Staff Report for the 2005 Article IV Consultation**

Prepared by the Staff Representatives for the 2005 Consultation with the Republic of Palau

Approved by Masahiko Takeda and Anthony Boote

January 31, 2006

- This report is based on discussions held in Koror during November 2–17, 2005. The mission team comprised Ms. Abdelati (Head), Mr. Hussain (both APD), and Ms. Kinoshita (INS), and was assisted by Mr. Andrews (PFTAC) who visited Palau October 12–27, 2005. Ms. Amador (Senior Advisor to Executive Director) attended the meetings.
- In concluding the last consultation in February 2004, Executive Directors noted the economy's heavy reliance on grant-financed government activities and the downside risk stemming from the scheduled sharp decline in this assistance from the United States in 2009. They urged the authorities to reduce Palau's dependence on foreign assistance; achieve medium-term fiscal sustainability; and remove investment impediments to build the basis for sustained growth.
- The team met with President Remengesau, Minister of State Schnull, Minister of Commerce and Trade Besebes, Minister of Resources and Development Koshiba, Minister of Education Katosang, Health Minister Yano, other senior officials, donors, and representatives of banking, business and NGOs.
- Palau accepted the obligations of Article VIII, Sections, 2, 3, and 4 in December 1997 when it joined the Fund and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions.
- Serious statistical deficiencies hamper effective surveillance.
- Palau is on a 24-month consultation cycle.
- The authorities consent to publication of the PIN, Staff Report, and Selected Issues.

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## EXECUTIVE SUMMARY

### **Economic Developments and Challenges**

- Economic growth has picked up and inflation has remained low. Infrastructure building, financed by grants and direct investment, has supported construction and rising tourist and business arrivals. Fiscal performance has improved by curtailing current spending.
- The near term outlook remains upbeat, but longer term prospects are uncertain. Growth prospects depend on the magnitude of future grants and direction of economic policies. The authorities hope for extension of U.S. grants beyond 2009.
- The key challenges to sustained growth are achieving fiscal sustainability given the high reliance on grants; environmentally sustainable private sector development; and strengthening banking regulations and supervision.

### **Key Staff Recommendations**

- Further fiscal consolidation is necessary to prepare for the possible decline in U.S. grants. Even if U.S. grants are extended at similar levels beyond 2009, consolidation is desirable to enhance the country's resilience to external shocks and better prepare for self-reliance.
- To maintain recent fiscal gains, current spending must be contained in FY2006 below the level in the approved budget. Continuing the path toward fiscal sustainability requires further reductions in current spending together with comprehensive reforms to increase revenue collection over the long term.
- To eliminate impediments to private sector activity, investment regulations need to be more transparent, land registration and dispute resolution accelerated, pressures to raise the minimum wage resisted, and incentives to facilitate retention of trained Palauans introduced.
- To protect banking sector soundness, pending financial legislation and regulations need to be adopted, and the newly established supervisory agency and intelligence unit should be adequately staffed.

## I. TRANSFORMATION SINCE INDEPENDENCE

1. **Since independence, the Republic of Palau has endeavored to overcome the challenges it faces as a small island economy.** The country gained independence in 1994 following a decade of domestic turbulence and joined the Fund in 1997. In spite of per capita income of about \$6,500 and solid social indicators, Palau faces development constraints common among other Pacific island countries, including vulnerability to external shocks, a narrow production and export base, geographical isolation, and scarce labor (Table 1). There is no central bank and the U.S. dollar is the official currency.

	Fiji	Marshall Islands	Micronesia	Palau	Samoa	Solomon Islands	Tonga	Vanuatu
GDP per capita (current, US\$)	2,438	1,850	2,096	<b>6,480</b>	1,505	496	1,629	1,361
Population (thousands)	823	57	108	<b>21</b>	176	443	101	206
Land area (sq km)	18,270	181	702	<b>460</b>	2,830	27,990	720	12,190
Exports (fob, 2004, US\$ mn)	499	13	20	<b>6</b>	14	51	14	34
Principle exports (% total exports)	Garments (38%)	Fish (54%)	Fish (93%)	<b>Fish (100%)</b>	Fish (36%)	Timber (67%)	Squash (42%)	Coconut (33%)

2. **Judicious management of foreign aid has helped build a foundation for private sector growth.** Sizeable grants from the United States, Japan and Taiwan Province of China financed infrastructure to support tourism, albeit at the risk of damaging the fragile ecosystem. The public sector's share in economic activity has receded in line with the government's Management Action Plan of 2001, and political leadership has sought to foster a broad consensus for prudent economic management. However, achieving consensus for reforms has been challenging amidst the transition from a traditional tribal system to a modern democracy.

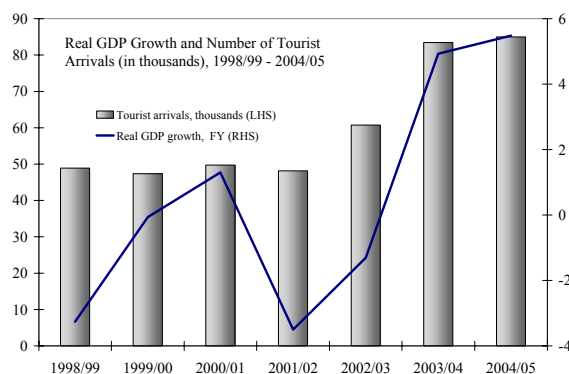
3. **Palau benefits from substantial U.S. assistance.** The Compact of Free Association provides \$600 million of grant assistance over 15 years from 1994 in exchange for the right to maintain U.S. military facilities, if needed, and allow passage of military transport through Palauan waters for 50 years. Grants aim to develop infrastructure and build a Compact Trust Fund (CTF) to enable Palau to replace grants through sustainable withdrawals from 1999–2044 (\$5 million per year from 1999–2009 and \$15 million inflation-adjusted annually from 2010). In recent years, budgetary grants from the United States have averaged about 18 percent of GDP, of which one third comes from federal grants outside of the Compact<sup>1</sup> (Table 2).

4. **The authorities hope for renewal of the Compact agreement beyond 2009.** Two neighboring former U.S. administrative territories, the Federated States of Micronesia (FSM) and the Republic of Marshall Islands (RMI), reached agreement with the U.S. government in 2003 to renew their Compacts for another 20 years.

<sup>1</sup> Palau competes for merit-based U.S. federal grant programs available to U.S. applicants.

## II. RECENT ECONOMIC DEVELOPMENTS

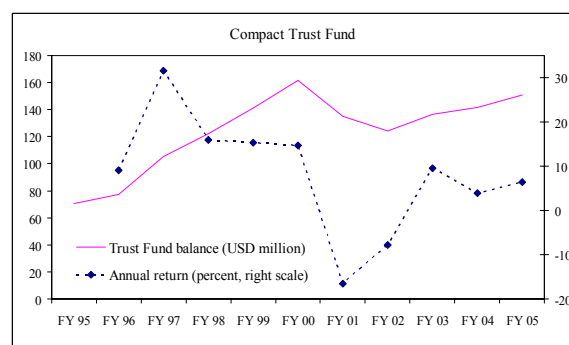
5. **After several years of slow growth, real GDP grew by 5 percent in FY2004 and FY2005<sup>2</sup>** (Figure 1). Growth has been driven by a steady increase in visitor arrivals with the start of new airline routes and hotels, and ongoing foreign-funded public projects that are increasingly undertaken by domestic firms. Inflation has been low in line with U.S. inflation.



6. **Fiscal performance continued to improve in FY2004 and FY2005.** The overall fiscal deficit (including grants) declined from 21 percent of GDP to under 5 percent of GDP in FY2003–05 compared to the previous three years, while the current budget balance improved by 8½ percent of GDP (Table 3) mainly due to sustained annual reductions in non-wage current expenditure. Revenue collection also strengthened, though to a lesser extent, on account of higher investment income, stronger economic activity, and the re-instatement of the excises on tobacco and alcohol in late 2003 and 2004, in line with earlier Fund recommendations.

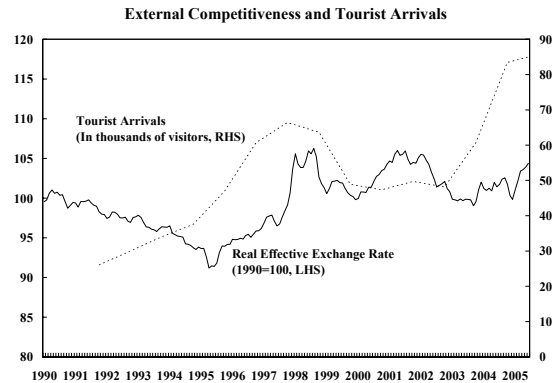
	Average 2000-02	Average 2003-05	Saving
Domestic revenue	25.8	26.3	0.5
Tax revenue	19.0	19.9	0.8
Nontax revenue	6.7	6.4	-0.3
Expenditure	67.4	59.5	7.9
Current	54.0	47.2	6.8
Wages and salaries	23.6	23.1	0.5
Goods and services	21.5	17.6	3.8
Subsidies and transfers	8.4	5.9	2.4
Other	0.6	0.6	0.0
Overall balance	-21.3	-4.4	16.9
Current balance	-29.3	-20.9	8.4

7. **The Compact Trust Fund has partially recovered.** Driven by declines in the U.S. equity market, its balance fell by 23 percent from a peak of \$162 million at end FY2000 to \$136 million (about 114 percent of GDP) at end-FY2003. Under a new investment strategy, the balance stood at \$153 million at end-2005 (106 percent of GDP, Table 4). Fund management conforms to legislative guidelines on reporting, internal and external audit, and withdrawal authorization. The government's useable non-Trust Fund assets remain below one month of import cover at end-FY2005 as surpluses have been used to finance infrastructure.



<sup>2</sup> Fiscal years run from October to September. National accounts are being revised, and these growth rates are based on preliminary estimates (See Annex V).

8. **Strong tourist receipts helped offset the impact of higher oil prices on the balance of payments** (Table 5). Palau's tourism arrivals had declined after the Asian crisis reflecting the lagged effect of a strong U.S. dollar vis-à-vis the currencies of competing Asian destinations. The current account swung into surplus in FY2003 and improved further in FY2005 owing to recovering tourism and fish exports (with the return of migratory varieties) and lower capital imports.



9. **Bank oversight remains inadequate but risks are mitigated by the dominant presence of viable foreign banks.** Information on banking activity is sketchy as bank reporting is incomplete and irregular. About 80 percent of deposits are held by branches of foreign banks that provide about two thirds in domestic credit and most deposits are insured under the FDIC. The local commercial banks account for less than one third of banking system assets in the form of smaller loans. However, interest rate spreads reach 15 percent, reflecting high transaction costs for micro lending and inability of foreign banks to accept land as collateral.

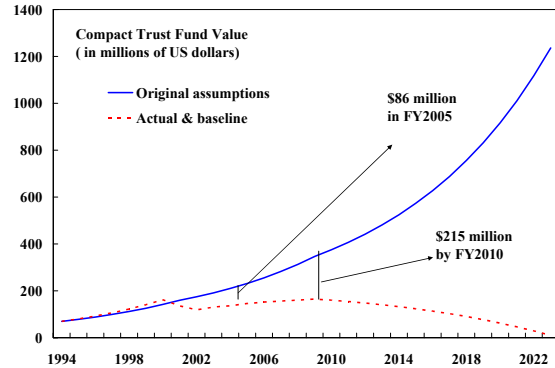
10. **Performance of the National Development Bank (NDBP) has markedly improved.** The Bank—following restructuring in 1999, new management in 2000 and 2003, and new funding from a Taiwan POC loan in 2004—resumed credit extension raising its loan portfolio to about 10 percent of GDP mainly to the housing sector. About 15 percent of its portfolio is non-performing, but loans are all collateralized, provisioning is being increased and collection strengthened, and it has maintained 6 percent profit-to-asset ratio in the last four years.

### III. ECONOMIC OUTLOOK

11. **The growth outlook for FY2006 and FY2007 remains upbeat.** Relocation of government offices in 2006 following completion of the Capitol complex will facilitate expansion of housing and businesses out of crowded Koror. Tourism will benefit from planned airport rehabilitation, new resorts, and expansion in scheduled flights. However, the current account deficit is expected to widen and inflation to rise due to higher fuel costs. Preliminary estimates suggest that a further 10 percent increase in oil prices can reduce the current account balance by 1 percent of GDP and lower growth by  $\frac{3}{4}$  percent of GDP. Downside risks also stem from possible capacity constraints in capital project implementation.



12. **Longer-term prospects are less certain.** The economy faces substantial downside risks from the possible sharp reduction in U.S. Compact grants and non-Compact U.S. federal program assistance, whose continued availability is unknown. While U.S. officials underscore that there is no obligation to provide another grant package, Palau officials expect Compact extension at levels consistent with current U.S. grants and replenishment of the CTF to originally envisioned levels. Initial discussions have begun in the context of bilateral economic consultations but a resolution is not expected soon.



13. **Since the terms of future U.S. grant assistance remains unknown at this stage, staff discussed illustrative scenarios for the medium and long term.** The scenarios are detailed in the background paper and outlined in Box 1.

- In the case where grants were not extended, two illustrative scenarios were discussed. In the first, the FY2009 CTF balance is drawn down until its depletion to ease the adjustment by allowing higher spending and growth (Scenario A). In the second, out of concern for intergenerational equity, fiscal policies are geared toward preserving the CTF’s real per capita value at the cost of lower spending and growth (Scenario B).
- If the Compact were renewed, the pace of adjustment could be extended over a much longer time period at higher levels of capital spending (and growth) without jeopardizing the CTF’s real per capita value. Alternatively, the authorities could aim for a higher CTF value that generates a sustainable income stream to fully replace grant assistance as originally envisioned (Scenario C). Such a target would insure against the risk of having to reduce capital spending as a share of rising GDP (Table 6).

#### IV. POLICY DISCUSSIONS

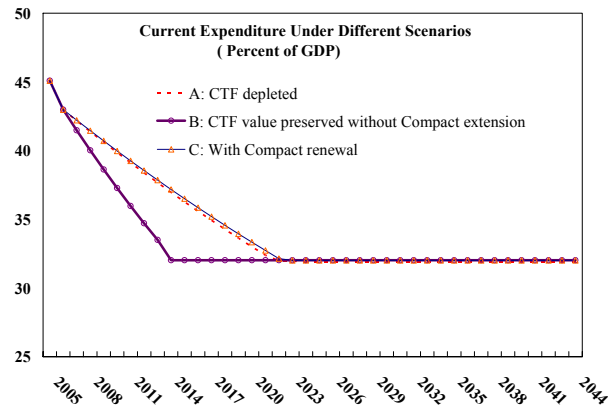
14. **Discussions focused on** (i) fiscal adjustment to permit a smooth transition to the post-Compact assistance future; (ii) reforms to promote private sector development and growth; and (iii) adequate regulation and oversight of the financial sector. In addition, the team discussed competitiveness concerns and trade policies.

##### A. Fiscal Policy and Sustainability

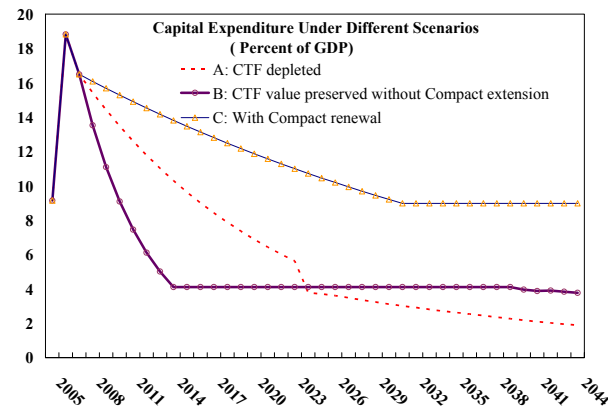
15. **The overarching macroeconomic challenge is the need to prepare for the eventual elimination of grant assistance.** Presently, current grants cover about one third of current spending needs, and if eliminated a sizeable fiscal contraction would be required.

### Box 1. Long-Run Fiscal Adjustment Scenarios

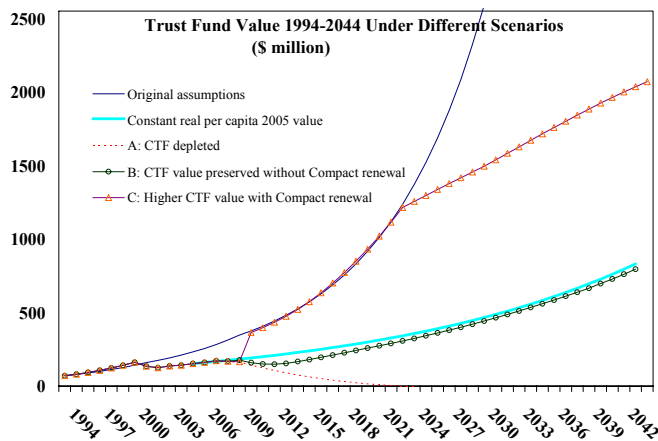
**The speed and extent of fiscal adjustment depends on the magnitude of future grants, chosen objectives, and assumed parameters.** Without prejudice to the outcome of negotiations, it is assumed that if the Compact is renewed, it would provide an average 18 percent of GDP in total budgetary support for 15 years plus an average 4 percent of GDP in Trust Fund contributions for 15 years (or the equivalent of \$210 million upfront replenishment of the CTF in FY2010). This would be less than the new RMI and FSM Compacts which provide about 40 percent of their GDP annually over 20 years. Other assumptions are detailed in the background paper. The scenarios imply varying speeds of adjustment for current expenditure and different levels of capital spending, depending on the future magnitude of grants and the chosen CTF target.



**Without Compact renewal, U.S. grants decline to under 2 percent of GDP in FY2010, and Palau becomes ineligible for federal agency programs.** Limiting the expenditure adjustment to say  $\frac{3}{4}$  percent of GDP per year would entail depleting the Trust Fund by FY2022, at which time large expenditure cuts will be needed. On the other hand, to preserve the CTF in real per capita terms, expenditure would need to decline by  $1\frac{1}{2}$  percent of GDP per year between FY2005 to FY2014 at which time CTF returns could sustain lower fiscal deficits. However, the magnitude and speed of expenditure compression under this scenario could have a severe effect on household incomes and public services. An economic slump would be likely in the medium term.



**On the other hand, Compact renewal would allow more gradual fiscal contraction.** If U.S. grants are extended at similar levels until FY2023, a more gradual phasing of the required expenditure retrenchment would be feasible. At the same time, the real per capita value of the CTF could be enhanced to a level which, consistent with the original objectives of the CTF, would generate annual income to replace for foreign aid after 2023. Higher public investment could allow real growth averaging 3-4 percent of GDP.



Spending on health and education, accounting for nearly 30 percent of total spending, is among the highest in Pacific islands. Although this has contributed to good social indicators for the Palau population (Table 7), it is not sustainable in the long term and has created a culture of dependence on free public services that the country cannot afford indefinitely.

16. **The authorities' paramount goal is to achieve financial independence by strengthening domestic revenue to cover current spending and build an adequate reserve fund to cope with external vulnerabilities.** Staff noted that the goal of covering current spending by domestic revenue generation remains far-off, requiring, for example, current spending to decline by as much as one quarter (about 12 percent of GDP) and tax revenue to increase by one fifth (about 5 percent of GDP) in the long run. The authorities concurred with these targets, but viewed them as impossible to achieve within a short period of time. Staff agreed that an adjustment of this magnitude would cause less social strain if it were spread over 10–15 years, although the required speed of adjustment depends on assumptions on future grants.

### FY2006 budget

17. **Staff cautioned that the targets of the FY2006 budget approved by Congress in October 2005 reverse recent consolidation efforts.** The authorities concurred with staff that it would be more appropriate to target an overall deficit of ½ percent of GDP rather than 4¾ percent of GDP. Staff urged that spending on goods and services be lower than budgeted by about 2 percent of GDP in line with recent step reductions, and Ministry of Finance officials intend to take additional measures to contain this category of spending. They expect the ongoing hiring freeze to allow the wage bill to be compressed while accommodating the new civil service salary structure and addressing staffing shortages in banking supervision, if these cannot be filled through reassignment. Staff welcomed the planned phased repayment of spending arrears to suppliers that amount to 1 percent of GDP over three years.

	FY05 Est.	FY06 Budget	FY06 Mission	Additional Savings Mission 1/
Current revenue	26.2	24.5	26.7	2.2
Tax revenue	21.0	19.2	21.4	2.2
Nontax revenue 2/	5.1	5.3	5.3	0.0
Capital revenue	1.4	...	...	
Current grants	15.3	15.7	15.7	0.0
Capital grants	10.8	18.8	18.8	0.0
Total expenditure	54.2	63.8	61.7	2.0
Current expenditure	45.1	45.0	42.9	2.0
Wages and salaries	22.4	21.0	21.2	-0.2
Goods and services	16.2	17.1	15.2	1.9
Interest payments	0.5	0.5	0.5	0.0
Transfers to enterprises	1.1	1.1	1.1	0.0
State block grants	3.2	3.1	3.1	0.0
Other transfers	1.7	1.5	1.5	0.0
Repayment of arrears	...	0.4	0.4	0.0
Capital expenditure	9.1	18.8	18.8	0.0
Current balance	-18.9	-20.4	-16.2	4.3
Overall balance (incl. grants)	-3.9	-4.7	-0.4	4.3

1 /Mission proposal compared to FY06 budget.  
2/ Includes local trust funds.

18. **Revenue is expected to outperform the budget projection, exceeding last year's outcome by ½ percent of GDP.** With unchanged tax collection effort, revenue would be maintained at 21 percent of GDP, and an additional ½ percent of GDP would come from recent measures (change in the import duty base from f.o.b. to c.i.f. and new airport fees).

## Medium-term fiscal reforms

### 19. Staff advised that reforming the tax system could help raise domestic revenue collection closer to the long-term target of 32 percent of GDP.

Although Palau's tax collections at around 20 percent of GDP are similar to the average for other island economies (Figure 2), the current system is inequitable and inefficient. Tax reform, consistent with TA provided by LEG and PFTAC, would aim to modernize the system by replacing the narrow-based wages and salaries taxes with a personal income and corporate income tax; as well as replacing the cascading gross receipts tax by a consumption tax such as the Value Added Tax, that exempts exports and refunds VAT collected on inputs.<sup>3</sup>

	Income Tax	Tax on Goods and Services	Trade Taxes	Other Tax	Total Tax Revenue	R a n k	Total Domestic Revenue
FSM							
FY2002	3.6	5.1	3.2	0.4	12.3		20.9
FY2004	3.2	4.8	2.9	0.2	11.1	1	19.0
Vanuatu							
FY2002	0.2	10.2	7.0	0.2	17.6		19.6
FY2004	0.3	11.2	7.2	0.0	18.7	2	20.6
Fiji							
FY2002	7.0	5.2	6.7	0.0	18.9		23.6
FY2004	6.3	6.6	6.1	0.0	19.0	3	22.1
Palau							
FY2002	4.9	6.1	4.5	2.7	18.3		23.8
FY2004	5.0	5.8	6.0	3.2	20.0	4	26.8
RMI							
FY2002	9.2	3.3	5.7	1.0	19.2		26.3
FY2004	9.9	3.7	5.8	1.6	21.0	5	31.3
Samoa							
FY2002	4.5	12.4	3.9	0.5	21.3		23.2
FY2004	4.4	14.0	3.6	0.6	22.6	6	25.3
Tonga							
FY2002	4.9	3.1	15.2	0.1	23.3		29.2
FY2004	4.1	3.0	14.4	0.1	21.7	7	26.2
Kiribati							
FY2002	8.1	0.0	17.2	0.1	25.4		56.0
FY2004	10.3	0.0	15.1	0.1	25.5	8	83.3
Mean							
FY2002	5.3	5.7	7.9	0.6	19.5		27.8
FY2004	5.4	6.1	7.6	0.7	20.0		31.8

20. **The authorities intend to postpone modernizing the tax system for 2-3 years.** To avoid overstressing the government's capacity, they wish to first strengthen collection efforts, eliminate exemptions on import duties, and adjust the reference price for the hotel room tax, the latter to allow the tourism sector to contribute more fully to domestic revenue generation. Staff agreed with these measures which together could yield up to 1 percent of GDP in FY2007. Since comprehensive reform is to be postponed, staff advised accelerating administrative measures, including introducing a full assessment system, a single taxpayer identification number, strengthened monitoring, and audit and penalty systems to improve the compliance rate.

21. **Nevertheless, the bulk of the adjustment will have to fall on expenditure reforms.** The pace at which current spending must be reduced and the amount of capital spending cuts will depend on the future level of grants and the government's long-term CTF objective. As suggested in the analysis in Box 1, the total expenditure adjustment needed over the long run is in excess of 20 percent of GDP (and as much as 30 percent of GDP without Compact renewal) spread over 10 to 25 years, of which capital spending cuts account for 10-15 percent of GDP. However, capital expenditure is expected to gradually decline as its funding sources dwindle, with somewhat limited short-term macroeconomic impact as the bulk is spent on foreign goods and services.

22. **Adjusting current expenditure requires specific measures to cut the wage bill and spending on goods and services.** Palau's high government wage bill will need to be reduced. The authorities believe this will decline over time in the context of the hiring freeze and as the government withdraws from public services that can be undertaken by the private

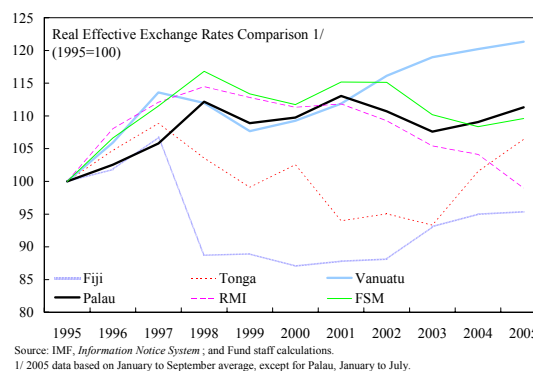
<sup>3</sup> See background paper on the fiscal reform agenda.

sector. The government's cost reduction plan has so far identified measures that could yield savings of 2-3 percent of GDP in the next 2-3 years from outsourcing: water and sewer, school and hospital meals, security and janitorial services, road repair to allow reduction in the staffing of public works, and management of the airport facilities to defray their dependence on budgetary outlays. In addition, they plan to introduce user fees for sports facilities and medical care. Further cuts will be needed over the long run to achieve the remaining savings of about 8 percent of GDP.

23. **Public debt is low at 13 percent of GDP.** Palau incurred a first loan (17 percent of GDP) on concessional terms in 2000 to finance construction of the new Capitol complex. Another \$15 million loan was contracted in 2004 for airport rehabilitation, but only \$1.5 million (1 percent of GDP) has been drawn due to the subsequent availability of U.S. grant financing. The authorities intend to avoid contracting of new loans, and to build a cushion of usable reserves, possibly from unspent CTF withdrawals or any revenue over-performance, to cope with vulnerability to shocks.

### B. Exchange Rate Regime and Trade Policies

24. **The exchange rate regime remains appropriate given Palau's small size and predominance of U.S. grants and trade flows.** The tourism industry appears to be competitive. Palau compares well to other tourism-dependent island economies in terms of visitor arrivals, expenditure, and infrastructure.<sup>4</sup> The country scores high marks in several categories of the World Bank's *Doing Business* survey (Figure 3) and private sector wages are kept low owing to the abundance of expatriate workers accepting lower wages than the stipulated minimum wage for Palauans.



25. **Palau is expected to maintain its open trade system.** The tariff structure has five nonzero bands, most imports are subject to a 3 percent rate, and the unweighted average rate is below 3 percent. About 30 percent of trade taxes are collected from cigarette and alcohol duties that are subject to additional specific taxes. A harmonized system nomenclature and on-line document filing

Tourism Indicators in Small-Island Economies  
(1993–2003 average)

	Tourism share of GDP (%) 1/	Tourist arrivals per thousand population 2/	Rooms per thousand population	Tourist expenditure per capita (US\$)	Tourist expenditure per room (US\$ '000)	Main markets 3/
<b>Caribbean</b>						
Bahamas	35	5.0	45	4,853	107	US
Barbados	28	1.8	22	2,454	111	UK, US
Dominica	18	0.9	10	577	56	French W.I., US
Jamaica	20	0.5	7	444	62	US
<b>Pacific Islands</b>						
Fiji	22	0.4	7	322	48	Australia, New Zealand
Palau	45	2.9	39	3,300	85	Taiwan POC, Japan
Marshall Island	3	0.1	5	56	11	US, Japan
Micronesia	7	0.1	4	127	33	US, Japan
Tonga	6	0.3	7	105	16	Australia, New Zealand
Vanuatu	27	0.2	25	260	10	Australia, New Zealand
<b>Africa</b>						
Maldives	53	1.3	24	947	40	Italy, UK
Mauritius	18	0.5	6	424	67	France, UK
Seychelles	34	1.5	28	1,517	54	France, UK

Source: World Tourism Organization, *Compendium of Tourism Statistics*, and Fund staff estimates.

1/ Share of travel receipts in GDP, average of 1999–2003.

2/ Population is measured in mid-year 2002.

3/ Main markets between 1999–2003.

<sup>4</sup> See background paper on tourism.

were introduced as part of customs modernization to further facilitate trade. Licensing is limited to requirements for agricultural quarantine and health concerns. To preserve the low-tariff regime, staff advised against raising the general tariff rate from 3 percent to 5 percent as a proposed revenue generating measure, but saw merit in removing duty exemptions.

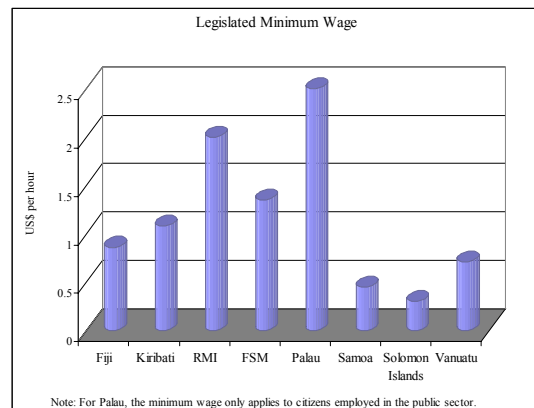
### **C. Private Sector Development and Economic Diversification**

26. **Opportunities for private sector growth could be further exploited.** Outside tourism, potential areas of growth include agriculture, fish processing, handicrafts, and some services currently provided by the public sector. The tourism development plan encourages investors to shift toward higher-end tourism with higher domestic value-added. However, key impediments include non-transparent investment regulations that benefit the better-connected individuals, shortage of Palau skilled labor, limited access to land, and further infrastructure needs.

27. **In spite of the recent increase, foreign direct investment (FDI) has not realized its full potential.** FDI reached 13 percent of GDP in FY2005, far above the regional average, on account of some large hotel and airline projects. However, foreign businesses complain of the inability to own land or use it as collateral, restrictions on sectors in which foreigners are allowed to participate, the stipulation that 20 percent of employees be Palauan citizens for investments below \$0.5 million, and an annual \$500 permit fee for hiring expatriates that Palauan employers do not have to pay. The mission noted that these restrictions have promoted the proliferation of arrangements (called “fronts”), whereby foreign investors operate under a Palau silent partner, that reduce tax compliance and subject both Palauan and foreign partners to fraud and liability risks. One proposal under consideration is to equalize the \$500 annual permit fee between foreign investors and Palauan employers to reduce the incentive for fronts and encourage employment of Palauan labor. This and other issues are under debate in the business community and within Congress and a consensus will need to be reached on the benefits of removing impediments to foreign investment.

28. **Limited access to land has been a key constraint for domestic and foreign investment.** About 40 percent of plots remain unregistered, and restricted access to land hampers development of agriculture and credit-financed investment. The authorities intend to speed up titling and registration, and have introduced a process of quiet title to register lots as state land after an undisputed 45-day announcement, allowing its lease for private use. A bill that passed Senate hearings in December 2005 proposes extension of land leases to foreigners from 50 to 99 years.

29. **Skilled labor shortages are exacerbated by the tendency of Palauans to seek employment in the United States,** making it more difficult for foreign investors to hire the required percentage of Palauan workers. Foreign workers make up nearly one half of the labor force, mostly in unskilled jobs that are unattractive to Palauans. Staff argued against the proposal to increase the minimum wage, already the highest among Pacific islands, as an ineffective measure for encouraging the return of Palauans working abroad. Indeed, it could further encourage substitution of Palauan unskilled workers by foreign labor that is not subject to the minimum wage legislation and has a much lower reservation wage. However, staff saw potential merit in requiring recipients of state-sponsored scholarships for study abroad who do not return to repay study costs.



#### D. Financial Sector Soundness

30. **Palau has a large banking sector relative to its population but lacks adequate regulation and supervisory oversight.** The financial sector consists of eight commercial banks, one development bank, and several other financial institutions.<sup>5</sup> Pending passage of regulations, the quality of the loan portfolio is not known nor the possible impact of any banking sector problems on public finances. However, all banks reported improved profitability in the last two years and progress in loan recovery following a rise in delinquent loans after the economic slump in 2001. Progress has been disappointing since the passage in 2001 of a watered-down version of the Financial Institutions Act (FIA) and establishment of a governing Board for the supervisory Financial Institutions Commission (FIC). In the same year, the Money Laundering and Proceeds of Crime Act (MLPCA) and the Mutual Assistance in Criminal Matters Act were passed. However, Palau was assessed in 2002 under the Fund's Offshore Financial Center (OFC) assessment program as non-compliant on 16 out of 25 Basel core principles, and the situation remains unchanged. Fund TA missions in 2004 advised that unless the proposed FIA amendment is adopted without further modification, neither prudential nor AML/CFT supervision will be feasible in Palau. They also saw a need for strengthening the still pending amendment to the MLPCA to comply with key aspects of the FATF 40+9 Recommendations.

31. **The FIC lacks the resources and sufficient authority to carry out its supervisory responsibilities.** Four years after establishment, it has received only one out of five recommended professional staff and a fraction of the planned budget due to concern by some legislators that the proposed FIA amendment could grant FIC's staff and Board excessive power that could be misused for political objectives. Absent adoption of the amendment, the

<sup>5</sup> See background paper on the financial sector.

FIC lacks clear authority to introduce regulations, investigate, or enforce compliance through on-site inspection. Nevertheless, its officials reported that they had advised remedial action when needed and successfully decommissioned some banks in spite of law suits questioning their authority under current legislation. Staff stressed the need for passage of the FIA amendment which would allow the FIC to issue financial regulations along the lines recommended by MFD and LEG. Moreover, the FIC and the Financial Intelligence Unit must have the necessary budget, staffing, training, and governance structure to fulfill their duties.

32. **As in previous discussions, the authorities agreed with staff recommendations but pointed to legislative bottlenecks.** They intend to strengthen efforts to engender support for passage of needed legislation and regulations and to provide FIC with adequate resources. After the mission, the Senate held a first hearing on financial legislation in early December and FIC has initiated a recruitment search of additional staff. MFD and LEG stand ready to provide further capacity-building technical assistance once bank examiners have been recruited.

33. **The National Development Bank needs to further strengthen its loan recovery efforts.** Bank management explained that most bad loans initially arose from the weak economy in 2001 and they had since proceeded more cautiously in expanding their new loans. Staff welcomed the success of recent external audits to reinforce collection and encouraged continued efforts in conjunction with capacity building assistance.

#### E. Statistical Issues

34. **Serious deficiencies remain in most areas of economic statistics with the notable exception of public finance** (Annex V). Some collected statistics cannot be compiled or disseminated due to shortage of trained staff and high staff turnover. Recognizing capacity constraints, staff commended the authorities' efforts to improve national account and balance of payments statistics, and welcomed the intention to seek training for new staff. Staff and the authorities concurred that the Office of Planning and Statistics would benefit from additional technical assistance to build capacity, especially to maintain the national accounts system. In the longer term, as customs and banking data become more readily available, they would benefit from help in refining the balance of payments. The authorities stressed that they welcomed further hands-on help at regular intervals. Once they are more adequately staffed, they would be able to devote some resources to the GDSS project.

#### V. STAFF APPRAISAL

35. **Judicious management of foreign aid and political stability have helped build a foundation for economic growth.** Growth has picked up after several years of stagnation and inflation remains subdued. Foreign grants have supported infrastructure development that has encouraged tourist and business visitors since 2003 and provided opportunities for local companies. Fiscal performance has improved, with a narrowing of the large current



fiscal deficit by 8½ percentage points of GDP in the last three years compared to the previous three years.

36. **However, longer-term prospects depend on the future level of grants and direction of policies.** Palau remains highly dependent on grant assistance to provide public services and pay the relatively large civil service wage bill, and vulnerable to external shocks and risks of over-exploiting its ecosystem. Shortages of skilled staff, restrictions on land ownership, and cumbersome and non-transparent investment procedures, impede private sector activity.

37. **Possible renewal of Compact grants would allow the adjustment to be phased over a longer period of time, but it would not obviate the need for adjustment.** Postponing fiscal adjustment efforts and structural reforms until after a decision is made on future grants would make it harder for the country to adjust and achieve economic self-reliance. Given the uncertainty, targeting a pace of adjustment consistent with a lower level of future grants reduces the risk of future fiscal and social strains.

38. **The government's stated long-term objective of covering current spending from domestic revenue generation is therefore appropriate.** While currently comparable to similar countries in the region, the tax base could be broadened by eliminating exemptions and addressing non-compliance. But over the medium term, the best option is a comprehensive overhaul of the tax system centered around a VAT or consumption tax that eliminates cascades in the gross receipts tax, and more efficient corporate and personal income taxes that would capture those currently outside the tax net.

39. **The bulk of fiscal adjustment will nevertheless need to come from expenditure containment.** For 2006, current spending should be curtailed below the proposed budget. In the medium term, current spending has to be steadily reduced from 45 percent of GDP to around 32 percent of GDP by downsizing the public sector. This can be achieved by continuing the hiring freeze, capping the nominal rate of increase in non-wage current spending, raising user fees for medical and other public services, and outsourcing and privatizing some services.

40. **Use of the U.S. dollar as domestic currency provides welcome monetary stability.** Over one half of grants and imports come from the United States and the real effective exchange rate has been relatively stable. Tourism appears relatively competitive and they plan to target more high-end visitors that are less price sensitive.

41. **It is Palau's best interest to maintain its open trade system.** This can be achieved by removing duty exemptions, followed by introducing a consumption tax in the context of comprehensive tax reform, instead of raising tariff rates. The recent introduction of the harmonized system of tariff classification and computerized customs filing system will further facilitate trade.

42. **Removing investment impediments would help establish the basis for sustained growth.** Foreign investors seek local partners to circumvent foreign investment restrictions

on sectors of activity, owning land, minimum domestic labor requirements, and the higher cost for foreign labor permits. Staff welcome proposals before Congress that aim to reduce investment restrictions, and the quiet title process that has facilitated registration and leasing of state land. A consensus will need to be reached on the benefits of further removing impediments to foreign investment in Palau, while safeguarding the interests of the local community.

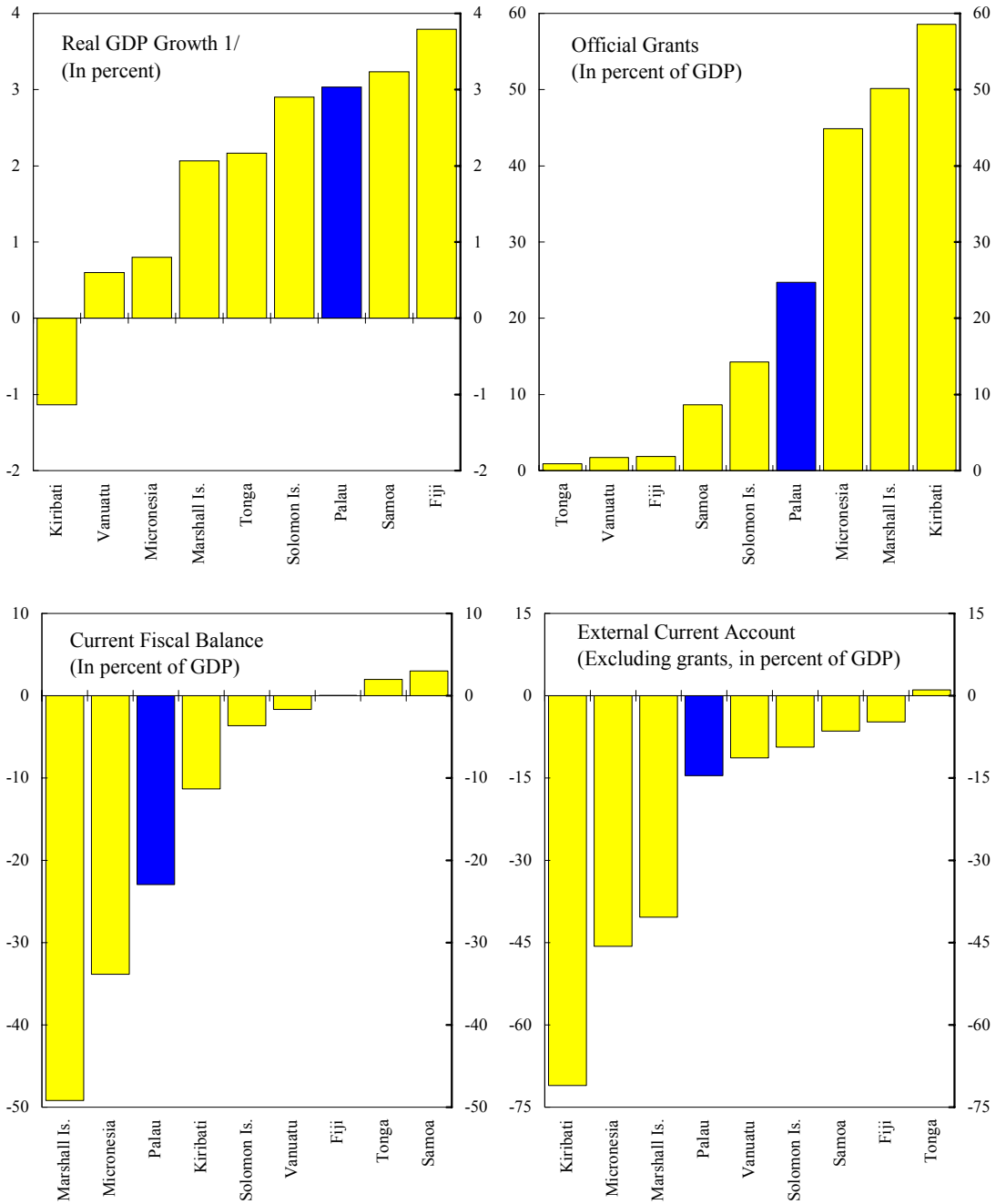
43. **Palau is becoming increasingly dependent on foreign labor.** Raising the minimum wage for Palauans would be counter-productive given easy access to employment opportunities in the United States at much higher wages, combined with a much lower reservation wage for unskilled Asian labor. Requiring recipients of state-sponsored scholarships for study abroad who do not return to repay study costs may increase incentives of Palauans to return.

44. **In spite of initial progress, the relatively large banking sector lacks adequate regulation and supervisory oversight.** The Financial Institutions Act (FIA) adopted in 2001 provides for establishment of a Financial Institutions Commission but did not provide it sufficient authority to undertake oversight. Urgent adoption of the amendment to the FIA, and adequate resources including two bank examiners, would allow the Commission to issue regulations, and to exercise supervisory functions. Amending the Money Laundering and Proceed of Crimes Act would help address money laundering concerns. Both the FIC and Financial Intelligence Unit must have the necessary authority, budget, and governance structure to fulfill their duties. Ongoing efforts to strengthen the National Development Bank should be continued.

45. **While data provision for surveillance purposes is still adequate overall,** staff's analysis was affected by serious shortcomings in the areas of banking and national accounts. Further efforts are needed to improve data collection, compilation methodology, and dissemination.

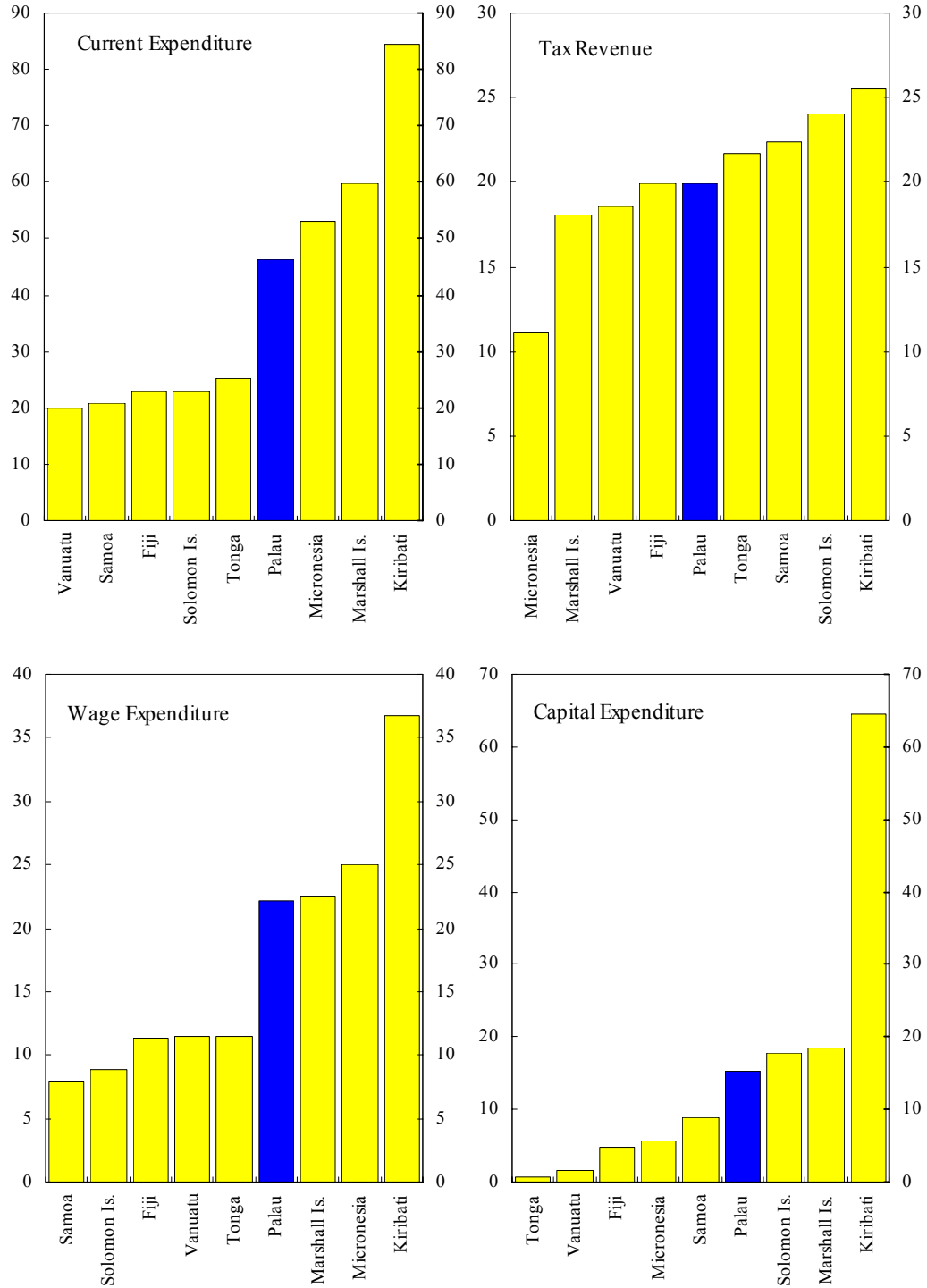
46. **It is proposed that the next Article IV consultation be conducted on the 24-month consultation cycle.**

Figure 1. Republic of Palau: Recent Economic Developments in a Regional Perspective (2002–2004 average)



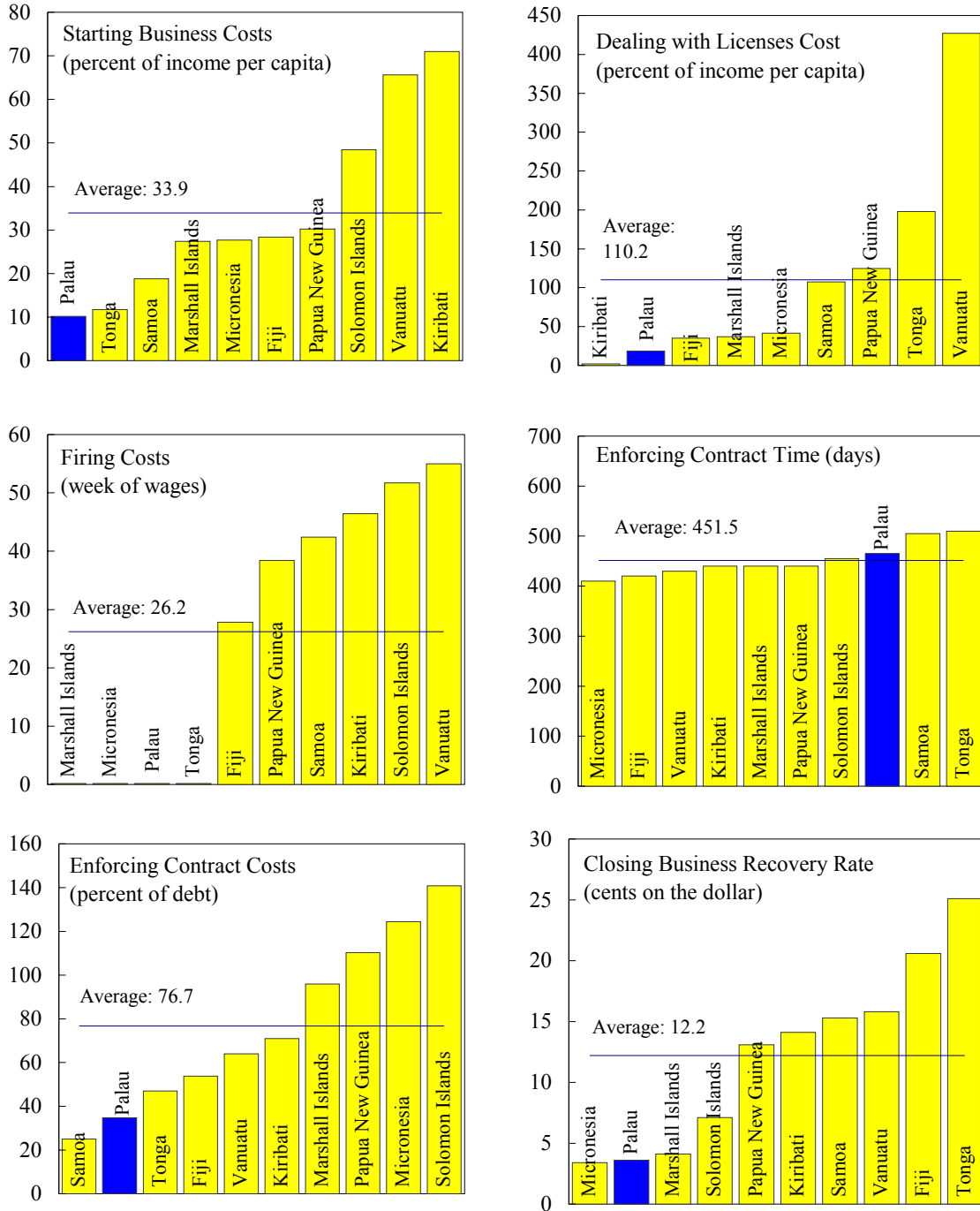
Sources: National authorities; and Fund staff estimates.  
 1/ Figure for Palau GDP is based on 2003–2005 data.

Figure 2. Republic of Palau: Fiscal Indicators from a Pacific Island Perspective  
(2004, in percent of GDP)



Sources: National authorities; and Fund staff estimates.

Figure 3. Republic of Palau: Indicators of Investment Climate, 2005



Source: World Bank, *Cost of Doing Business*, 2005.

Table 1. Republic of Palau: Selected Economic Indicators, 2000/01–2005/06

Nominal GDP (2004): US\$133.6 million  
 Population (2004): 20,610  
 GDP per capita (2004): 6,480

	2000/01	2001/02	2002/03	2003/04	2004/05 Prel.	2005/06 Proj.
<b>Real sector</b>						
Real GDP growth (percent change)	1.3	-3.5	-1.3	4.9	5.5	5.7
GDP deflator (percent change) 1/	3.0	1.4	2.3	2.3	2.8	3.0
Consumer prices (percent change; period average)	0.8	-1.2	-0.6	5.8	2.7	3.0
Business and Tourist arrivals	49,731	48,157	60,734	83,452	85,004	...
<b>Public finance</b>						
	(In percent of GDP)					
Central government						
Revenue	43.1	42.4	54.0	54.3	53.6	61.3
Domestic revenue	25.7	23.8	26.0	26.8	27.6	26.7
Grants	17.3	18.6	28.1	27.6	26.0	34.5
Expenditures	64.6	66.3	62.6	61.7	54.2	61.7
Current	52.2	48.9	50.0	46.4	45.1	42.9
Capital	12.4	17.4	12.6	15.3	9.1	18.8
Current balance 2/	-26.4	-25.1	-24.0	-19.7	-18.9	-16.2
Overall balance (excluding grants)	-37.7	-46.9	-30.4	-34.5	-30.0	-35.0
Overall balance (including grants) 3/	-20.3	-28.3	-2.4	-6.9	-3.9	-0.4
	(In millions of U.S. dollars; unless otherwise indicated)					
Compact Trust Fund (CTF) balance						
Revenue	135.0	124.5	136.3	141.6	152.5	155.8
Interest income and capital gains/losses	-25.8	-4.7	19.5	11.3	16.8	...
Investment fees and withdrawals	1.0	5.8	7.7	6.0	5.9	...
Government non-CTF financial assets						
Usable reserves 4/	43.7	13.7	16.4	9.5	12.6	15.9
(In months of imports)	3.9	2.9	5.5	2.2	2.0	5.1
	0.5	0.4	0.7	0.2	0.2	0.5
<b>Balance of payments</b>						
Trade balance	-83.3	-76.4	-79.8	-101.4	-91.8	-101.9
Exports (f.o.b.)	16.6	20.3	8.4	5.9	13.4	13.5
Imports (f.o.b.)	-99.9	-96.7	-88.2	-107.3	-105.2	-115.5
Tourism receipts	58.5	57.4	75.6	96.9	97.2	97.5
Current account balance						
Including grants	-9.4	-11.0	9.6	12.6	15.1	3.9
Excluding grants	-29.8	-31.5	-11.4	-10.8	-6.6	-20.4
Overall balance	-25.1	-34.2	-3.4	-10.2	-5.2	-1.8
External public debt 5/	20.0	20.0	19.4	18.3	18.7	17.5
Debt service ratio 6/	1.2	1.2	1.7	1.9	1.8	1.9
	(In percent of GDP)					
Current account balance						
Including grants	-7.6	-9.1	7.9	9.6	10.6	2.5
Excluding grants	-24.1	-26.1	-9.3	-8.3	-4.6	-13.2
External public debt 5/	16.2	16.6	15.9	14.0	13.2	11.3

Sources: Data provided by the Palauan authorities; and Fund staff estimates.

1/ Proxied by US CPI.

2/ Defined as domestic revenue minus current expenditure.

3/ Does not include errors and omissions.

4/ The government's non-Compact Trust Fund assets excluding amounts reserved for capital projects and other specific uses.

5/ Does not include public enterprise debt which is not guaranteed by the government.

6/ In percent of exports of goods and nonfactor services.

Table 2. Republic of Palau: U.S. Grants, 1994/95-2008/09  
(In thousands of U.S. dollars; end of the period)

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	Total	Average
<b>Under Compact</b>																	
Basic grants	21,227	18,623	18,856	19,220	11,570	11,712	11,785	11,928	11,928	12,071	10,471	10,717	10,850	10,917	10,985	202,860	13,524
Operations	14,948	12,781	12,781	12,781	7,781	7,851	7,781	7,781	7,781	7,781	6,781	6,781	6,781	6,781	6,781	133,952	8,930
Inflation adjustment 1/	6,279	5,842	6,075	6,439	3,789	3,861	4,004	4,147	4,147	4,290	3,690	3,936	4,069	4,136	4,204	68,908	4,594
Energy - Section 211(b)	28,000	-	-	-	-	-	-	-	-	-	-	-	-	-	-	28,000	1,867
Inflation adjustment	12,880	-	-	-	-	-	-	-	-	-	-	-	-	-	-	12,880	859
Trust fund - Section 211(f)	66,000	-	4,000	-	-	-	-	-	-	-	-	-	-	-	-	70,000	4,667
Capital improvements	36,000	-	-	-	-	-	-	-	-	-	-	-	-	-	-	36,000	2,400
Inflation adjustment	16,560	-	-	-	-	-	-	-	-	-	-	-	-	-	-	16,560	1,104
Military options	5,500	-	-	-	-	-	-	-	-	-	-	-	-	-	-	5,500	367
Special program assistance	6,300	4,900	3,500	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	38,700	2,580
<b>Total direct payments under Compact</b>	<b>192,467</b>	<b>23,523</b>	<b>26,356</b>	<b>21,220</b>	<b>13,570</b>	<b>13,712</b>	<b>13,785</b>	<b>13,928</b>	<b>13,928</b>	<b>14,071</b>	<b>12,471</b>	<b>12,717</b>	<b>12,850</b>	<b>12,917</b>	<b>12,985</b>	<b>410,500</b>	<b>27,367</b>
Total (excluding Trust Fund)	126,467	23,523	22,356	21,220	13,570	13,712	13,785	13,928	13,928	14,071	12,471	12,717	12,850	12,917	12,985	340,500	22,700
(as percent of GDP)	137.0	22.4	20.0	18.2	11.9	11.6	11.2	11.5	11.4	10.8	8.8	8.2	7.5	6.9	6.5	6.5	20.3
<b>Federal services (not in budget)</b>																	
Road system construction	53,000	-	96,000	-	-	-	-	-	-	-	-	-	-	-	-	-	9,933
Weather, postal, aviation services	1,340	1,490	1,640	1,790	1,940	2,090	2,240	2,390	2,540	2,690	2,840	2,990	3,140	3,290	3,440	35,850	2,390
Total federal services	54,340	1,490	97,640	1,790	1,940	2,090	2,240	2,390	2,540	2,690	2,840	2,990	3,140	3,290	3,440	184,850	12,323
<b>Total Compact aid</b>	<b>246,807</b>	<b>25,013</b>	<b>123,996</b>	<b>23,010</b>	<b>15,510</b>	<b>15,802</b>	<b>16,025</b>	<b>16,318</b>	<b>16,468</b>	<b>16,761</b>	<b>15,311</b>	<b>15,707</b>	<b>15,990</b>	<b>16,207</b>	<b>16,425</b>	<b>595,350</b>	<b>39,690</b>
(as percent of GDP)	267.4	23.8	110.8	19.8	13.6	13.4	13.0	13.5	13.5	12.8	10.8	10.2	9.4	8.7	8.2	8.2	36.6
<b>Other Non-Compact Assistance</b>																	
Applications to grantor agencies 2/	16,245	13,630	10,586	8,172	7,789	7,399	7,020	7,553	8,034	12,249	10,633	11,230	11,500	11,313	11,595	154,948	10,330
FAA grants	16,245	13,630	10,586	8,172	7,789	7,399	7,020	7,553	8,034	12,249	10,633	12,500	12,500	0	11,595	25,000	13,333
Total Non-Compact	17.6	13.0	9.5	7.0	6.8	6.3	5.7	6.3	6.6	9.4	7.5	15.4	14.1	6.0	5.8	179,948	11,997
(as percent of GDP)	17.6	13.0	9.5	7.0	6.8	6.3	5.7	6.3	6.6	9.4	7.5	15.4	14.1	6.0	5.8	179,948	11,997
<b>Total U.S. grants</b>	<b>263,052</b>	<b>38,643</b>	<b>134,582</b>	<b>31,182</b>	<b>23,299</b>	<b>23,201</b>	<b>23,045</b>	<b>23,871</b>	<b>24,502</b>	<b>29,010</b>	<b>25,944</b>	<b>39,437</b>	<b>39,990</b>	<b>27,520</b>	<b>28,021</b>	<b>775,298</b>	<b>51,687</b>
(as percent of GDP)	285.0	36.8	120.2	26.8	20.4	19.6	18.7	19.8	20.1	22.2	18.3	25.5	23.5	14.7	13.9	45.7	45.7
Total budgetary payments, excl. Trust Fund	142,712	37,153	32,942	29,392	21,359	21,111	20,805	21,481	21,962	26,320	23,104	36,447	36,850	24,230	24,581	520,448	34,697
(as percent of GDP)	154.6	35.4	29.4	25.3	18.7	17.9	16.9	17.8	18.0	20.1	16.3	23.6	21.6	12.9	12.2	29.4	29.4

Sources: Independent Auditor's Report on financial statements; and data provided by the Bureau of Program, Budget and Management, MOA.

1/ Estimates for FY 2005-2009.

2/ Grants received based on proposals submitted to grantor agencies. Projected amounts for last three years.

Table 3. Republic of Palau: National Government Budgetary Operations, 2001/02-2005/06

	2001/02	2002/03	2003/04		2004/05			2005/06	
			Budget	Prov.	Budget	Brief	Prelim.	Budget	Proj. 1/
	(in thousands of US dollars)								
Total revenue and grants	51,224	65,866	74,526	71,069	81,241	72,211	76,053	91,202	94,630
Domestic revenue	28,775	31,657	36,400	35,016	38,609	38,188	39,126	37,863	41,291
Tax revenue	22,042	22,706	29,600	26,131	28,534	28,677	29,838	29,647	33,075
Salaries and wages	5,901	6,326	6,700	6,508	6,739	7,036	6,978	7,064	7,595
Import tax	5,455	5,693	9,200	7,885	7,538	8,525	8,860	7,985	10,143
Gross revenue tax	7,380	7,120	7,700	7,536	8,900	8,517	9,072	9,045	9,874
Other	3,306	3,567	6,000	4,202	5,357	4,599	4,928	5,553	5,464
Nontax revenue	4,519	5,713	5,300	7,321	6,630	7,884	5,955	6,771	6,771
Fishing rights income	83	101	...	106	159	115	158	100	100
Interest income	257	315	...	2,097	100	2,267	127	75	75
Fees and charges	1,265	2,778	...	2,855	3,182	...	3,164	3,392	3,392
Licenses and fees	1,973	1,915	...	2,025	2,189	...	1,982	2,274	2,274
Other	941	604	...	238	1,000	...	524	930	930
Local Trust Funds	2,214	3,238	1,500	1,564	1,445	1,627	1,333	1,445	1,445
Capital revenue	...	...	...	...	2,000	...	2,000	...	...
Grants	22,449	34,209	38,126	36,053	42,632	34,023	36,927	53,339	53,339
Total expenditure	80,068	76,305	84,199	80,794	101,786	80,302	76,947	98,452	95,306
Current expenditure	59,030	60,960	62,499	60,767	66,188	63,608	63,972	69,432	66,286
Wages and salaries	29,056	30,118	30,600	28,965	31,280	33,779	31,808	32,462	32,762
Other purchases of goods and services	21,783	22,570	26,700	23,804	25,526	24,862	22,996	26,974	24,027
Interest payments	712	712	1,100	687	919	751	665	748	748
Investment fees	81	62	...	54	...	49	40	...	0
Subsidies and transfers	7,398	7,498	4,100	7,257	8,463	4,167	8,463	8,748	8,748
Public enterprises	1,662	1,669	...	1,549	1,587	...	1,587	1,652	1,652
State block grants	3,266	3,484	1,700	3,268	4,491	1,556	4,491	4,711	4,711
Other	2,470	2,345	2,400	2,440	2,385	2,611	2,385	2,385	2,385
Payment of arrears	...	...	...	...	...	...	...	500	500
Capital expenditure	21,038	15,345	21,700	20,027	35,598	16,694	12,975	29,020	29,020
Errors and omissions									
Accounts payable/receivables	-5,343	7,571	-27	659	0	0	-4,702	0	0
Current balance	-30,255	-29,303	-26,099	-25,751	-27,579	-25,420	-26,846	-31,569	-24,994
Overall balance (excluding grants)	-56,636	-37,077	-47,826	-45,119	-63,177	-42,114	-42,523	-60,589	-54,014
Overall balance (including grants)	-34,187	-2,868	-9,700	-9,066	-20,545	-8,091	-5,596	-7,250	-675
Financing	34,187	2,868	9,700	9,066	20,545	8,091	5,596	7,250	675
Net long-term borrowing	0	-571	-1,100	-1,143	-1,143	-1,142	357	-1,143	-1,143
New borrowing 2/	0	0	...	0	0	0	1,500	0	0
Principal repayments	0	571	1,100	1,143	1,143	1,142	1,143	1,143	1,143
Withdrawals from non-trust fund assets	29,187	-1,561	5,800	5,209	16,688	4,233	239	3,393	-3,182
Withdrawals from Trust Fund	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000
	(in percent of GDP)								
Total revenue and grants	42.4	54.0	58.7	54.3	58.6	52.1	53.6	59.1	61.3
Domestic revenue	23.8	26.0	28.7	26.8	27.9	27.6	27.6	24.5	26.7
Tax revenue	18.3	18.6	23.3	20.0	20.6	20.7	21.0	19.2	21.4
Nontax revenue	3.7	4.7	4.2	5.6	4.8	5.7	4.2	4.4	4.4
Local Trust Funds	1.8	2.7	1.2	1.2	1.0	1.2	0.9	0.9	0.9
Capital revenue	...	...	...	...	...	...	1.4	...	...
Grants	18.6	28.1	30.0	27.6	30.8	24.6	26.0	34.5	34.5
Current	17.0	17.2	17.2	17.9	15.8	14.4	15.3	15.7	15.7
Capital	1.6	10.9	12.8	9.7	14.9	10.2	10.8	18.8	18.8
Total expenditure	66.3	62.6	66.3	61.7	73.5	58.0	54.2	63.8	61.7
Current expenditure	48.9	50.0	49.2	46.4	47.8	45.9	45.1	45.0	42.9
Wages and salaries	24.1	24.7	24.1	22.1	22.6	24.4	22.4	21.0	21.2
Other purchases of good and serv.	18.0	18.5	21.0	18.2	18.4	17.9	16.2	17.5	15.6
Interest payments	0.6	0.6	0.9	0.5	0.7	0.5	0.5	0.5	0.5
Investment fees	0.1	0.1	0.0	0.0	...	0.0	0.0	0.0	0.0
Subsidies and transfers	6.1	6.2	3.2	5.5	6.1	3.0	6.0	5.7	5.7
Public enterprises	1.4	1.4	0.0	1.2	1.1	0.0	1.1	1.1	1.1
State block grants	2.7	2.9	1.3	2.5	3.2	1.1	3.2	3.1	3.1
Other	2.0	1.9	1.9	1.9	1.7	1.9	1.7	1.5	1.5
Capital expenditure	17.4	12.6	17.1	15.3	25.7	12.1	9.1	18.8	18.8
Current balance	-25.1	-24.0	-20.6	-19.7	-19.9	-18.4	-18.9	-20.4	-16.2
Overall balance (excluding grants)	-46.9	-30.4	-37.7	-34.5	-45.6	-30.4	-30.0	-39.2	-35.0
Overall balance (including grants)	-28.3	-2.4	-7.6	-6.9	-14.8	-5.8	-3.9	-4.7	-0.4
<b>Memorandum item:</b>									
GDP (fiscal year)	120,755	121,909	127,000	130,852	138,521	138,521	141,889	154,430	154,430

Sources: Audit Report, and DIALOG 134-P Financial Report, MOF.

1/ Staff proposal, with authorities' agreement.

2/ A new loan of \$15.5 million was contracted in 2003/04 but is only partially drawn.



Table 4. Republic of Palau: Financial Holdings of the Central Government, 1994/95-2004/05

(In thousands of U.S. dollars; end of period)

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	Provisional	
										2003/04	2004/05
Foreign assets 1/											
Deposits with foreign banks	96,173	83,953	76,086	64,241	64,628	45,313	39,785	10,805	10,874	7,324	7,541
<i>Change in FB assets</i>		(12,220)	(7,867)	(11,845)	387	(19,315)	(5,528)	(28,980)	69	(3,550)	217
Change due to:											
Deposits	60,230	23,938	22,410	21,221	13,652	13,714	37,313	16,006	13,928	14,071	12,533
Interest income	4,522	4,472	308	74	28	60	171	55	48	2,079	188
Investment Gains/Losses	4,084	3,281	13,679	4,772	9,857	10,247	(8,928)	(768)	1,094	(1,675)	261
Investment Fees	(450)	(552)	(477)	(419)	(393)	(350)	(185)	(81)	(62)	(54)	(40)
Withdrawals	(38,449)	(43,359)	(43,787)	(37,493)	(22,757)	(42,987)	(33,900)	(44,192)	(14,938)	(17,971)	(12,725)
<i>Total Change</i>	29,937	(12,220)	(7,867)	(11,845)	387	(19,316)	(5,529)	(28,980)	70	(3,550)	217
Grant deposited/withdrawn from Bank of Guam							23,328	(23,329)			
Domestic assets 2/											
Deposits with domestic banks	622	2,300	4,715	17,580	2,377	32,369	3,882	2,907	5,493	2,159	1,964
<i>Change in DB assets</i>		1,678	2,415	12,865	(15,203)	29,992	(28,487)	(975)	2,586	(3,334)	(195)
Fiduciary funds 3/	70,779	77,176	105,536	122,362	141,139	161,833	135,039	124,496	136,295	141,613	152,509
Total financial holdings	167,574	163,429	186,337	204,183	208,144	239,515	178,706	138,208	152,662	151,096	162,014

Sources: Data provided by the Office of the President and Ministry of Finance.

1/ Deposits with all foreign banks, including those in the United States.

2/ Deposits with local banks.

3/ Refer only to Compact Section 211(f) Trust Fund, excluding the Civil Service Pension Trust and Social Security Retirement Fund.

Table 5. Republic of Palau: Balance of Payments, 2000/01-2005/06

(In thousands of U.S. dollars)

	2000/01	2001/02	2002/03	2003/04	2004/05 Est.	2005/06 Proj.
Trade balance	-83,302	-76,367	-79,833	-101,398	-91,765	-101,936
Exports, f.o.b.	16,567	20,345	8,411	5,882	13,414	13,548
Imports, f.o.b.	-99,869	-96,712	-88,244	-107,280	-105,179	-115,485
Services account	47,889	46,005	68,239	87,698	86,539	85,902
Receipts	59,537	58,339	76,911	98,680	98,858	99,139
Travel	58,531	57,354	75,612	96,940	97,220	97,500
Other	1,006	986	1,300	1,739	1,638	1,638
Payments	-11,648	-12,334	-8,672	-10,982	-12,319	-13,237
Transportation	-10,682	-11,129	-7,697	-9,457	-10,790	-11,703
Passenger's Service	-1,032	-1,302	-1,095	-1,761	-1,766	-1,771
Freight and insurance	-9,650	-9,827	-6,602	-7,696	-9,024	-9,932
Travel	-966	-1,205	-975	-1,525	-1,529	-1,534
Income	5,985	5,450	4,458	6,019	4,169	1,406
Investment income	5,163	4,854	3,911	5,605	3,733	3,733
Income and interest payment	-700	-712	-704	-687	-665	-3,428
Current transfers	19,993	13,954	16,740	20,235	16,151	18,507
Private	-1,420	-7,250	-4,750	-4,154	-6,891	-7,220
Inflows	5,686	7,494	4,123	3,022	1,124	1,196
Outflows	-7,106	-14,743	-8,873	-7,177	-8,015	-8,416
Official	21,413	21,204	21,490	24,389	23,042	25,727
Business licenses and fees	1,380	1,148	1,062	1,077	1,634	1,650
Grants	20,334	20,561	20,966	23,383	21,650	24,319
Other	-301	-505	-538	-71	-242	-242
Current account (includes official grants)	-9,435	-10,957	9,604	12,554	15,094	3,878
Current account (excludes official grants)	-29,769	-31,518	-11,362	-10,829	-6,556	-20,441
Capital and financial account	14,036	10,848	18,996	25,043	34,359	47,671
Public Sector	1,064	1,888	12,672	11,527	15,634	27,877
Capital grants	1,064	1,888	13,243	12,670	15,277	29,020
Gross borrowing	0	0	0	0	1,500	0
Loan repayments	0	0	-571	-1,143	-1,143	-1,143
Private Sector	12,972	8,960	6,324	13,516	18,725	19,794
Foreign direct investment	12,972	8,960	6,324	13,516	18,725	19,794
Other private inflows 1/	-29,688	-34,078	-32,039	-47,806	-54,692	-53,368
Overall balance	-25,087	-34,187	-3,439	-10,209	-5,239	-1,818
Memorandum items:						
Current account/GDP (in percent)						
Including official grants	-7.6	-9.1	7.9	9.6	10.6	2.5
Excluding official grants	-24.1	-26.1	-9.3	-8.3	-4.6	-13.2
Service receipts/GDP	48.2	48.3	63.1	75.4	69.7	64.2

Sources: Data provided by the Ministry of Finance and Palau Visitors Authority, Banks; and Fund staff and Ministry of Finance estimates.

1/ Includes change in net foreign assets of commercial banks and errors and omissions.

Table 6. Medium-Term Scenarios  
(In percent of GDP, unless otherwise specified)

	2004	2005	2006	2007	2008	2009	2010	2024
	Actual	Prelim.	Projections					
<b>A. CTF Depleted</b>								
Real GDP growth (percent)	4.9	5.5	5.7	5.5	4.8	4.4	4.0	-2.0
Revenue and grants	54.3	53.6	61.4	58.5	49.6	48.5	37.3	35.9
Domestic revenue	26.8	27.6	26.8	27.3	27.8	28.3	28.8	32.0
Total grants (actual to 2006)	27.6	26.0	34.6	31.3	21.8	20.2	8.5	3.9
Current grants	17.9	15.3	15.8	14.8	12.8	12.2	2.2	2.0
Capital Grants	9.7	10.8	18.8	16.5	9.0	8.1	6.3	1.9
<i>of which: Total U.S. grants</i>	20.1	16.3	23.6	22.1	13.6	12.9	1.5	1.3
Expenditure (actual to 2004)	61.7	54.2	61.8	58.7	56.8	55.0	53.3	35.9
Current	46.4	45.1	43.0	42.2	41.4	40.6	39.8	31.9
Capital	15.3	9.1	18.8	16.5	15.4	14.4	13.5	4.0
Current balance	-19.7	-17.5	-16.2	-14.9	-13.6	-12.3	-11.1	0.1
Overall balance	-6.9	-0.6	-0.4	-0.1	-7.2	-6.5	-16.0	0.0
CTF Balance	142	153	161	169	166	163	142	0
<b>B: Preserve CTF RPCV without Compact Renewal</b>								
GDP Growth	4.9	5.5	5.7	4.5	3.0	2.0	1.0	0.5
Revenue and grants	54.3	53.6	61.4	58.5	49.6	48.5	37.3	35.9
Revenue (actual to 2004)	26.8	27.6	26.8	27.3	27.8	28.3	28.8	32.0
Total grants (actual to 2006)	27.6	26.0	34.6	31.3	21.8	20.2	8.5	3.9
Current grants	17.9	15.3	15.8	14.8	12.8	12.2	2.2	2.0
Capital Grants	9.7	10.8	18.8	16.5	9.0	8.1	6.3	1.9
<i>of which: Total U.S. grants</i>	20.1	16.3	23.6	22.1	13.6	12.9	1.5	1.3
Expenditure (actual to 2004)	61.7	54.2	61.8	58.0	53.5	49.7	46.4	36.1
Current	46.4	45.1	43.0	41.5	40.0	38.6	37.3	32.0
Capital	15.3	9.1	18.8	16.5	13.5	11.1	9.1	4.1
Current Balance	-19.7	-17.5	-16.2	-14.2	-12.3	-10.3	-8.5	0.0
Overall balance	-6.9	-3.9	-0.4	0.6	-4.0	-1.2	-9.1	-0.3
CTF Balance	142	153	160	171	170	176	159	324
<b>C: Increase CTF RPCV Under New Compact</b>								
GDP Growth	4.9	5.5	5.7	5.5	4.8	4.8	4.5	3.3
Revenue and grants	54.3	53.6	61.4	58.5	49.6	48.5	58.2	35.4
Revenue (actual to 2004)	26.8	27.6	26.8	27.3	27.8	28.3	28.8	32.0
Total grants (actual to 2006)	27.6	26.0	34.6	31.3	21.8	20.2	29.4	3.4
Current grants	17.9	15.3	15.8	14.8	12.9	12.2	23.1	1.5
Capital Grants	9.7	10.8	18.8	16.5	9.0	8.1	6.3	1.9
<i>of which: Total U.S. grants</i>								
Expenditure (actual to 2004)	61.7	54.2	61.8	58.7	56.9	55.3	53.7	40.9
Current	46.4	45.1	43.0	42.2	41.4	40.7	40.0	32.0
Capital	15.3	9.1	18.8	16.5	15.5	14.6	13.7	8.9
Current balance	-19.7	-17.5	-16.2	-14.9	-13.7	-12.4	-11.2	0.0
Overall balance	-7.4	-0.6	-0.4	-0.2	-7.3	-6.8	4.5	-5.4
CTF Balance	142	153	161	172	168	165	365	1256
Memorandum:								
CTF-constant real per capita value	142	153	160	168	175	183	191	357

Sources: Data provided by Palauan authorities; and Fund staff estimates and projections.

Table 7. Republic of Palau: Selected Social Indicators, 1995 and 2001–2005 1/

	1995	2001	2002	2003	2004	2005
GDP per capita (U.S. dollars)	5,529	6,352	5,980	6,045	6,480	6,925
Area (sq. miles)						
Land	188	188	188	188	188	188
Sea	237,850	237,850	237,850	237,850	237,850	237,850
Demographic indicators						
Total population	17,225	19,626	19,976	20,304	20,610	20,891
Population growth (percent per annum)						
1986–90	2.4	...	...	...	...	...
1990–95	2.6	...	...	...	...	...
1995–00	2.0	...	...	...	...	...
2001–05	1.8	...	...	...	...	...
Age-dependency ratio (dependents to working-age population)	51	...	...	...	...	...
Labor force	8,368	...	...	...	...	...
Employed 2/	7,780	11,099	11,632	13,248	...	...
Agriculture, fisheries, and mining	724	183	287	261	...	...
Construction	1,089	1,815	2,285	2,678	...	...
Manufacturing	78	...	...	...	...	...
Transport, storage, communication, and other public utilities	436	607	573	526	...	...
Wholesale, retail, restaurants, and hotels	1,455	2,364	2,291	2,639	...	...
Finance, insurance, and real estate	124	126	150	169	...	...
Other business, personal, community, and social services	1,120	1,917	2,049	2,595	...	...
Public administration	2,879	4,087	3,997	4,374	...	...
Unemployed	588	...	...	...	...	...
Age structure (in percent)						
0-14	28	...	...	...	...	...
15-64	66	...	...	...	...	...
65 and over	6	...	...	...	...	...
Public education						
Percent graduating						
Primary	97.0	118.0	119.0	...	...	...
Secondary	65.0	99.0	82.0	...	...	...
College student/teacher ratio	11.0	10.9	11.6	12.1	...	...
Health						
Crude birth rate (per 1,000)	13.4	15.3	13.0	13.7	14.0	13.0
Crude death rate (per 1,000)	7.0	7.0	6.7	6.7	7.0	7.0
Infant mortality (per 1,000)	20.0	16.7	23.2	16.7	16.0	16.0
Life expectancy at birth, female (years)	72.6	...	...	75.4	75.7	...
Life expectancy at birth, male (years)	65.7	...	...	67.5	67.8	...
Life expectancy at birth, total (years)	70.8	...	...	71.3	71.6	...
Hospital beds (per 1,000)	61.0	...	...	65.0	65.0	...

Sources: 1995 and 2000 Census of Population and Housing; Data provided by the Office of Planning and Statistics; Social Security Office and World Bank, World Development Indicators.

1/ Figures for 2001–2005 are estimates based on partial data.

2/ Composition of employment figures for 2001–2003 are based on figures from social security records.

Table 8. Republic of Palau: External Vulnerability Indicators, 2000/01–2004/05

	2000/01	2001/02	2002/03	2003/04	<u>2004/05</u> Prel.
Exports (annual percent change)	44.0	22.8	-58.7	-30.1	128.1
Imports (annual percent change)	-21.4	-3.2	-8.8	21.6	-2.0
Current account balance (in percent of GDP)					
Including grants	-7.6	-9.1	7.9	9.6	10.6
Excluding grants	-24.1	-26.1	-9.3	-8.3	-4.6
Capital and financial account balance (in percent of GDP)	11.4	9.0	15.6	19.1	24.2
Usable reserves (in millions of US dollars) 1/	3.9	2.9	5.5	2.2	2.0
In months of imports	0.5	0.4	0.7	0.2	0.2
Short-term external debt	--	--	--	--	--
External public debt (in percent of GDP) 2/	16.2	16.6	15.9	14.0	13.2
Debt-service ratio (in percent of goods and nonfactor services) 2/	1.2	1.2	1.7	1.9	1.8

Sources: Data provided by the Palauan authorities; and Fund staff estimates.

1/ The government's non-Trust Fund financial assets excluding amounts reserved for capital projects and other specific uses.

2/ Does not include public enterprise debt not guaranteed by the government.

**REPUBLIC OF PALAU: FUND RELATIONS**  
(As of December 31, 2005)

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

<b>II. General Resources Account:</b>	<b>SDR Million</b>	<b>%Quota</b>
Quota	3.10	100.0
Fund Holdings of Currency	3.10	100.0
Reserve position in Fund	0.00	0.03

**III. SDR Department:** None

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

**V. Financial Arrangements:** None

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

**VII. Exchange Arrangement:**

The U.S. dollar is legal tender and the official currency. Palau maintains an exchange system that is free of restrictions on international payments and transfers for current and capital transactions.

**VIII. Article IV Consultation:**

The first Article IV consultation discussions took place during June 24–July 6, 1999 and the Article IV consultation procedure was completed on November 10, 1999. The last Article IV consultation discussions were held during November 2003. The Executive Board discussed the staff report and concluded the consultation on February 27, 2004. Palau is on a 24-month consultation cycle.

**IX. Current Financial Arrangement:** None

**X. Technical Assistance:**

FAD/ PFTAC	Preparation of a new tax code, tax and customs administration	October 1998–March 1999
	Modernization of customs administration	February 2004
	Strengthening tax administration	July 2005

LEG	Preparation of a new tax code	October 1998
	Banking legislation (together with MFD)	April 2002
	Anti-money laundering legislation	February 2004
MFD	Establishment of bank supervision functions	October 2000
	Banking law and regulations (supported by PFTAC)	January 2001
	Assessing compliance with international supervisory standards and effectiveness of anti-money laundering arrangements in the banking sector	April 2002, August 2004
	Peripatetic advisor to the Financial Institutions Commission (seven short-term visits to advise on implementation of the Financial Institutions Act)	February 2002–March 2004
	Bank supervision advisor to review Financial Institutions Act	April 2005
PFTAC	National accounts estimation and GDDS	December 2003, April 2004, October 2005

**XI. Resident Representative:** None

**REPUBLIC OF PALAU:  
SUPPORT FROM THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE<sup>1</sup>**

The Centre's assistance since Palau joined the Fund in 1997 has included 25 advisory missions, the participation of officials in seminars (18) and secondments mostly in the tax administration area (10). A statistics advisor visited Palau ahead of the 2005 Article IV consultation.

**Public Financial Management**

No assistance in this area has been requested by the Palau authorities since 2003. Representatives from the Ministry of Finance have been invited by PFTAC to join the newly-organized Pacific Financial Managers' Association (PaFMA) in 2006.

**Tax Administration and Policy**

In response to a request received in July 2003, PFTAC reviewed and provided extensive comments on the draft "Registration Corporation Act" and the draft "Reinvestment Incentive Act". In early 2004, a customs administration mission visited Palau to design a strategy and an action plan to modernize the Customs Division. In mid-2005, a tax administration mission visited Palau to review the organizational structure of the Division of Revenue and Taxation, and its operations.

**Financial Sector Regulation and Supervision**

PFTAC's advisor was involved in two follow-up missions for implementing the Financial Institutions Act (passed in June 2001), as well as to organize the Financial Institutions Commission and the drafting of licensing guidelines. Subsequently, an MFD peripatetic advisor paid a number of visits to Palau. However, the implementation and enforcement are still pending.

**Economic and Financial Statistics**

The post of Government Statistician has been vacant since late 2002, and two graduate level statisticians are in post at present. A PFTAC mission visited Koror in December 2003 and in April 2004 to assist the authorities in documenting and improving the system of national accounts and with finalization of the GDDS metadata. Subsequently in October 2005, a PFTAC statistics advisor assisted the authorities in revising national accounts for 2001–05. Follow-up missions are expected in the near future.

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



## REPUBLIC OF PALAU: RELATIONS WITH THE WORLD BANK GROUP<sup>1</sup>

Total commitments:	None
IFC investments:	None
Recent reports:	Pacific Regional Strategy FY2006–2009, May 2005.  Embarking on a Global Voyage: Trade Liberalization and Complementary Reforms in the Pacific, September 2002.

Palau became a World Bank Group member in December 1997. Since then, the Bank has provided technical assistance in a number of areas, namely oil and gas and natural resource management, and in the health sector.

In early-1999, the South Pacific Project Facility, a small- and medium-enterprise development initiative of the International Finance Corporation provided advisory services to the National Development Bank of Palau, as well as to a number of SME projects in the tourism sector. A diagnostic review of the investment climate was conducted by the Bank Group's Foreign Investment Advisory Services in 1999, and has since undertaken two separate reviews of the new draft foreign investment legislation.

The Bank's fifth biennial Regional Economic Report for its Pacific Island member countries, including Palau, was issued in September 2002. The report focused on their efforts to integrate more closely with the global economy. It evaluated the strategy to enter into a regional trade agreement and analyzed the interaction of trade liberalization with complementary reforms in taxation and the public sector.

The new Pacific Regional Strategy, which covers Palau, will direct the Bank's work in the region from 2006 to 2009. It focuses on creating an environment conducive to generating sustainable economic growth and employment, while recognizing that small populations and marked remoteness of the Pacific island countries pose significant development challenges to the region. The Bank seeks to play a selective role in Palau, focusing on providing targeted policy advice and analytical support to leverage donor resources and build local capacity.

Palau is an IBRD-eligible country.

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<sup>1</sup>Prepared by World Bank staff (as of December 2005).

## REPUBLIC OF PALAU: RELATIONS WITH THE ASIAN DEVELOPMENT BANK<sup>1</sup>

Total Commitments: None

The Republic of Palau joined the Asian Development Bank on 29 December 2003, as its sixty-third member. While admitted as a regional country, its development status was left undetermined and its country classification was to be undertaken. AsDB prepared a *Country Economic Report for Palau* and the *Development Status and Country Classification of the Republic of Palau* which served as the basis for a determination of Palau's development status. On 16 December 2005, the Republic of Palau was re-classified as a Pacific developing member country.

In order to scope and plan the future programming, a pre-Country Programming Mission was undertaken in November 2005. Guided by new AsDB's Pacific strategy—*Priorities of the Poor: A Pacific Strategy for the Asian Development Bank (2005–2009)*, the AsDB suggested future missions, including a joint mission with the United States Department of the Interior, to conduct private sector assessment.

A country programming mission is envisaged in the second quarter of 2006.

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<sup>1</sup>Prepared by AsDB staff (as of January 2006).

## REPUBLIC OF PALAU: STATISTICAL ISSUES

While data provision for surveillance purposes is still adequate overall, staff's analysis was affected by serious shortcomings in the areas of banking and national accounts. These shortcomings stem mainly from capacity constraints. The Office of Planning and Statistics is responsible for the compilation of national statistics. There are presently no official statistical publications at the aggregate level and limited data are available on national accounts, monetary developments, and the balance of payments. However, since the conclusion of the first Article IV consultation mission in July 1999, the authorities have been providing to the Fund the available core economic data on a periodic basis. PFTAC advisors provided assistance during 2003–2005 in improving the national accounts statistics, and with compiling the GDDS metadata. The authorities have committed to adopting the GDDS and have appointed a country coordinator but much remains to be done in this area. The long awaited passage of the Statistics Law would further help formalize data collection and reporting.

### **A. Real sector**

Estimates of the national accounts have only been compiled on a sporadic basis since 1984, and have been interrupted since late 2002. GDP data by economic activity at current prices were compiled by a UNDP consultant, the United Nations Economic and Social Commission for Asia and the Pacific, and under a joint project by the University of Oregon and the U.S. Department of Interior. A UNDP consultant produced a comparable set of GDP estimates for 1992–1999 in line with available sector indicators for these years.

The authorities' capacity to produce consistent official estimates of the national accounts is very weak. GDP growth rates reported in the staff report are based on preliminary estimates from sector indicators. A PFTAC advisor who visited Palau in October 2005 discovered serious deficiencies in source data, and follow up visits will be needed to provide hands-on assistance. One previously trained official was re-hired following the mission and efforts are also being made to train new staff.

A consumer price index has been compiled since 2000 on a quarterly basis, but inconsistencies have appeared since the last quarter of 2003.

### **B. Government finance**

Fiscal data are compiled at both the national and state level as part of their respective annual budgetary processes. The authorities have provided these fiscal data to APD in a standard Fund-format usable for analysis.

**C. Monetary accounts**

Audited balance sheet data are not regularly provided by banks to the authorities as they are not legally required to do so, and hence there is no official collection of a banking survey. At present, the banks only file quarterly tax forms to the Ministry of Finance. Although most banks have been reporting to the Financial Institutions Commission since 2003, reports are often incomplete and the lack of standardized format and classification guidelines prevent aggregation and meaningful analysis. Lack of data prevents preparation of most financial soundness indicators.

**D. Balance of payments**

Balance of payments data compilation remains weak. Estimates of the balance of payments have been prepared by the staff based on data provided by the authorities on imports, interest income, official grants, debt service, financial holdings of the government, and rough estimates of exports, services, private transfers and foreign direct investment. Compilation of the balance of payments is further complicated by a lack of commercial banking data due both to the absence of a reporting system for international financial transactions of bank clients as well as the lack of legal reporting requirement for commercial banks.

**Republic of Palau: Table of Common Indicators Required for Surveillance**

(As of January 12, 2006)

	Date of latest observation	Date received	Frequency of Data <sup>6</sup>	Frequency of Reporting <sup>6</sup>	Frequency of publication <sup>6</sup>
Exchange Rates (US dollar is official currency)	NA	NA	NA	NA	NA
International Reserve Assets and Reserve Liabilities of the Monetary Authorities <sup>1</sup>	6/05	9/05	M	I	N/A
Reserve/Base Money	NA	NA	NA	NA	NA
Broad Money	NA	NA	NA	NA	NA
Central Bank Balance Sheet	NA	NA	NA	NA	NA
Consolidated Balance Sheet of the Banking System	NA	NA	NA	NA	NA
Interest Rates <sup>2</sup>	5/05	1/06	M	I	NA
Consumer Price Index	6/05	9/05	Q	I	NA
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> – General Government <sup>4</sup>	FY99 (State) FY05 (Funds)	1/06	M	I	NA
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> – Central Government	FY2005 (Prel)	11/05	M	I	NA
Stocks of Central Government and Central Government-Guaranteed Debt <sup>5</sup>	FY2005	11/05	M	I	NA
External Current Account Balance	FY2005 (Prel)	11/05	M	I	NA
Exports and Imports of Goods and Services	FY2005 (Prel)	11/05	M	I	NA
GDP/GNP	FY2005 (Prel)	11/05	A	I	NA
Gross External Debt	FY2005 (Prel)	11/05	M	I	NA

<sup>1</sup> Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

<sup>2</sup> Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

<sup>3</sup> Foreign, domestic bank, and domestic nonbank financing.

<sup>4</sup> The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

<sup>5</sup> Including currency and maturity composition.

<sup>6</sup> Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA)



INTERNATIONAL MONETARY FUND

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

On February 15, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Palau.<sup>1</sup>

### **Background**

The Republic of Palau is a small island economy that relies heavily on tourism and external assistance. Palau faces development constraints common among other Pacific island economies, including vulnerability to external shocks, a narrow production and export base, geographical isolation, and scarce labor.

Palau benefits from substantial U.S. assistance under the fifty-year Compact of Free Association. Under the agreement, direct payments from 1994 to 2009 aim to support economic self-reliance by financing current expenditure, developing infrastructure, and building the balance of the Compact Trust Fund (CTF) to provide a sustainable income stream from 2010 to 2043. In recent years, budgetary grants from the U.S. have averaged about 18 percent of GDP, of which one third comes from federal grants outside of the Compact. CTF returns have been lower than anticipated and the CTF balance stood at US\$153 million (106 percent of GDP) at end-2005. In addition to U.S. grants, Palau receives sizable grants from Japan and Taiwan Province of China to finance infrastructure projects.

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<sup>1</sup> Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

Economic growth has picked up in recent years while inflation has been low. After several years of slow growth, real GDP grew by 5 percent in FY2004 and FY2005, driven by a steady increase in visitor arrivals with the start of new airline routes and hotels, and externally funded government projects.

Palau's fiscal performance has continued to improve in FY2004 and FY2005. The overall fiscal deficit (including grants) declined from 21 percent of GDP to under 5 percent of GDP in FY2003-05 compared to the previous three years, while the current budget balance improved by 8½ percent of GDP, mainly due to the capping of the rate of increase of non-wage current expenditure. On the revenue side, revenue collections strengthened as a result of higher investment income, stronger economy, and the re-instatement of excises on tobacco and alcohol in 2003 and 2004. Fiscal consolidation has allowed Palau to avoid borrowing and public debt is low at 13 percent of GDP.

The balance of payments position has strengthened in recent years. The external current account swung into surplus in FY2003 and improved further in FY2005 on account of improved tourism and fish exports, and lower capital imports. Higher tourism receipts partially offset the impact of higher oil prices on the current account.

Banking sector reform has progressed slowly since it was initiated in 2001. Palau's large financial sector relative to its size consists of four foreign branches of commercial banks, four domestically chartered banks, five insurance companies, a number of credit unions, and some twelve remittance companies. Risks are mitigated by the dominant role of U.S.-based banks that hold the majority of deposits, and overall bank profitability is reported to have improved although banking statistics are lacking. Five financial laws were introduced in 2001 that allowed for establishment of the Financial Institutions Commission (FIC) to supervise banks and the Financial Intelligence Unit (FIU) to investigate suspicious transactions. However, existing legislation does not allow FIC to issue regulations and both FIC and FIU do not have adequate resources to fulfill their duties.

Private sector activity has contributed to recent growth. A larger share of foreign-financed projects are undertaken by local firms and tourism-related infrastructure has been improving, albeit from a low base. Palau ranks highly in several indicators of the cost of doing business. Although foreign direct investment reached an estimated 13 percent of GDP in FY2005, a number of investment impediments remain. Investment is restricted to specific activities, about half of available land lots do not yet have title and cannot be used to secure loans, non-transparent investment regulations benefit few citizens, and labor regulations raise costs in the context of shortage of skilled Palauan labor.

Economic prospects in the near term remain upbeat but are uncertain in the longer term. Tourism will continue to be a main source of near-term growth while ongoing externally financed large infrastructure projects will support construction and other services. However, longer-term prospects depend on the direction of government's economic policies and whether the U.S. Compact is renewed beyond 2009.

## **Executive Board Assessment**

Executive Directors welcomed the improved economic performance and disciplined policies over the past two years. They commended the authorities for the judicious management of foreign aid focused on infrastructure building and strengthening of human capital, and for the success in reducing public sector spending in line with the government's Management Action Plan of 2001.

Looking ahead, Directors noted that a renewal of U.S. Compact grants beyond 2009 was uncertain and cautioned against postponing fiscal adjustment and structural reforms until after a decision is made on future grants. In view of this uncertainty, they encouraged the authorities to target a pace of fiscal consolidation consistent with a gradual decline in future grants to reduce the risk of social strains from a sharp and sudden adjustment.

Directors endorsed the government's long-term objective of covering current spending from domestic revenue generation, but saw a need for greater expenditure containment to achieve this goal, particularly on goods and services. Over the medium term, downsizing the public sector, including through maintaining the hiring freeze and outsourcing services, would help reduce spending to a sustainable level. Directors also encouraged further strengthening of tax collection efforts and eliminating exemptions in the near term, and later considering a comprehensive overhaul of the tax system centered on a non-cascading consumption tax, and a more efficient and broader-based corporate and personal income tax.

Directors supported the continued use of the U.S. dollar as the domestic currency and the maintenance of an open trade regime. They agreed that the exchange rate regime provides an appropriate nominal anchor, and emphasized that a continuation of cautious fiscal and wage policies would help preserve external competitiveness in the context of an open trade regime.

Directors stressed the importance of adequately regulating and supervising Palau's relatively large financial system. They noted that the Financial Institutions Commission (FIC) lacks sufficient authority or resources to issue regulations and exercise effective supervisory oversight. They urged the authorities to pass the necessary amendments to the Financial Institutions Act and anti-money laundering legislation, and to ensure adequate authority, budget, and staffing of the FIC and the Financial Intelligence Unit. Directors also welcomed ongoing efforts to strengthen the National Development Bank of Palau.

Directors underscored the need to improve the investment climate and labor and land policies to establish a sound foundation for sustained growth. They welcomed progress made on land titling and leasing and were encouraged by the ongoing debate over reducing investment restrictions. Directors cautioned against raising the minimum wage in order to safeguard employment opportunities for Palauans.

Directors encouraged the authorities to improve the coverage, reliability, and timeliness of national accounts and banking statistics and supported the authorities' request for more technical assistance in these areas.



**Public Information Notices (PINs)** form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Republic of Palau: Selected Economic Indicators, 2000/01–2005/06 1/

	2000/01	2001/02	2002/03	2003/04	2004/05 Prel.	2005/06 Proj.
<b>Real sector</b>						
Real GDP growth (percent change)	1.3	-3.5	-1.3	4.9	5.5	5.7
Consumer prices (percent change; period average)	0.8	-1.2	-0.6	5.8	2.7	3.0
Business and Tourist arrivals	49,731	48,157	60,734	83,452	85,004	...
<b>Public finance (in percent of GDP)</b>						
Revenue	43.1	42.4	54.0	54.3	53.6	61.3
Domestic revenue	25.7	23.8	26.0	26.8	27.6	26.7
Grants	17.3	18.6	28.1	27.6	26.0	34.5
Expenditures	64.6	66.3	62.6	61.7	54.2	61.7
Current	52.2	48.9	50.0	46.4	45.1	42.9
Capital	12.4	17.4	12.6	15.3	9.1	18.8
Current balance 2/	-26.4	-25.1	-24.0	-19.7	-18.9	-16.2
Overall balance (including grants) 3/	-20.3	-28.3	-2.4	-6.9	-3.9	-0.4
Compact Trust Fund (CTF) balance (in millions of U.S. dollars)	135.0	124.5	136.3	141.6	152.5	155.8
Government non-CTF financial assets in millions of U.S. dollars)	43.7	13.7	16.4	9.5	12.6	15.9
Usable reserves 4/ (in millions of U.S. dollars)	3.9	2.9	5.5	2.2	2.0	5.1
(in months of imports)	0.5	0.4	0.7	0.2	0.2	0.5
<b>Balance of payments (in millions of U.S. dollars)</b>						
Exports (f.o.b.)	16.6	20.3	8.4	5.9	13.4	13.5
Imports (f.o.b.)	-99.9	-96.7	-88.2	-107.3	-105.2	-115.5
Tourism receipts	58.5	57.4	75.6	96.9	97.2	97.5
Current account balance (including grants) (in percent of GDP)	-9.4	-11.0	9.6	12.6	15.1	3.9
Current account balance (excluding grants) (in percent of GDP)	-29.8	-31.5	-11.4	-10.8	-6.6	-20.4
Overall balance	-25.1	-34.2	-3.4	-10.2	-5.2	-1.8
External public debt (in percent of GDP) 5/	16.2	16.6	15.9	14.0	13.2	11.3
Debt service ratio 6/	1.2	1.2	1.7	1.9	1.8	1.9

Sources: Data provided by the Palauan authorities; and Fund staff estimates.

1/ Fiscal year ends in September.

2/ Defined as domestic revenue minus current expenditure.

3/ Does not include errors and omissions.

4/ The government's non-Compact Trust Fund assets excluding amounts reserved for capital projects and other specific uses.

5/ Does not include public enterprise debt which is not guaranteed by the government.

6/ In percent of exports of goods and nonfactor services.

**Statement Jong Nam Oh, Executive Director for Republic of Palau  
and Cyd Amador, Senior Advisor to Executive Director  
February 15, 2006**

**Key Points**

- Disciplined policies and the progress in the implementation of reforms have contributed to the favorable economic performance. Fiscal soundness will help preserve macroeconomic stability and prepare the economy for potentially-substantial fiscal adjustments over the medium term.
- Robust and sustainable growth will require more meaningful advances in structural reforms. Going forward, the authorities are committed to a broad range of reform initiatives that will raise the economy's growth potential, including through the promotion of a more business-friendly environment and the strengthening of the financial system.

Our authorities thank the staff for the productive and collegial exchange of views during the Article IV mission and for the well-written report, which provides a concise and balanced account of the economy's performance. The report, together with the paper on selected issues, also give a fair summary of the many challenges Palau faces, and the policy advice they contain are well appreciated by the authorities. Engagement with the Fund has helped strengthen the macroeconomic framework, anchor policy formulation and implementation, and guide the reform process.

As an independent sovereign country, Palau has a young history. However, its culture and traditions date back centuries. This particular blend of democratic and local institutions is behind the country's vibrancy. Together with other characteristics typical to many small island states, this has influenced the reform path chosen by the authorities. The theme that resonates in the authorities' development agenda is sustainable economic growth, with the central challenge being one of carefully managing the balance between economic openness and growth, on the one hand, and preserving the country's environmental and cultural assets on the other hand.

Palau is nearing a crossroad, with the approach of 2009 when important decisions regarding the financial provisions of the Compact of Free Association with the United States will have to be made, and Palau's capacity to manage the fiscal adjustments required under conditions of reduced reliance on foreign assistance and public sector-led growth will be tested. Palau's transformation into a self-reliant economy is based on a roadmap that is aligned with the country's economic, social and institutional priorities and requirements. A central feature of this strategic blueprint, known as the Management Action Plan, is its recognition of the need to develop a dynamic private sector that could take over the reins of growth.

Economic transformation carries with it new challenges, many with important social implications. Given Palau's highly-regarded community structure, our authorities have exerted considerable efforts to consult extensively with stakeholders, including legislators and traditional chiefs, on the direction of economic reform. This consultative process is key to galvanizing popular support that will ensure lasting reforms. Consistent with their commitment to transparency, the authorities have consented to the publication of the staff report and related papers. They hope that this will bring key developmental issues to the public's attention, invite public debate and lead to a better understanding, as well as promote ownership, of the reform agenda. Our authorities are also well aware that achieving sustained growth is critical to ensuring that the political dynamics facilitate the reform effort.

**Our authorities are committed to preserving macroeconomic stability. Responsible fiscal stewardship will help prepare for potentially large fiscal adjustments.**

Economic growth has accelerated to over 5 percent in FY2005 on the strength of higher tourism receipts, foreign-funded public infrastructure projects and foreign investment. With a narrow production base, a small domestic market and its isolation from major economic centers, diversification away from public sector-led activities has been quite challenging. There has been of late steady private sector growth driven by tourism and allied activities such as domestic trade, and the small commercial fishing industry. Looking ahead, medium-term growth is expected to proceed at a solid pace on the back of the authorities' continued commitment to disciplined policies and meaningful reforms.

The fiscal performance has improved, with the fiscal deficit (including grants) averaging at under 5 percent in FY 2003-05. Fiscal discipline is key to macroeconomic stability and long-term fiscal sustainability. Palau uses the US dollar as the domestic currency and does not have an independent monetary policy; fiscal policy, therefore, is the main lever for macroeconomic policy. Fiscal prudence is also critical in preparing the economy for potentially-substantial fiscal adjustments that could arise from the Compact review.

Anchoring the authorities' resolve to fiscal conservatism is their long-term objective of meeting current spending through domestic revenue generation. In this regard, they have adopted measures to strengthen revenue performance and improve expenditure management. On the revenue front, steps have been taken to enhance tax administration, including through intensified audits and enhanced automation, and to expand the revenue base through tax policy reform, such as the reinstatement of excises on tobacco and alcohol and the change in the import duty base. On the expenditure front, efforts have been made to rationalize spending and tighten budgetary controls. Right-sizing the government, including through a hiring freeze, is integral to expenditure containment. Moreover, spending has been prioritized toward education and health, as well as infrastructure and maintenance. Related to the latter, the authorities have established the Public Sector Investment Program to coordinate efforts to upgrade the country's infrastructure, including by strengthening the planning, prioritization, monitoring and evaluation of investments, to support growth and diversification.

The authorities continue to explore innovative ways to contain the cost of public services and make the government more efficient. Other spending controls being considered include further rationalizing government operations (through organizational and personnel restructuring), outsourcing of services such as maintenance and construction, and improving accountability and productivity of expenditures through performance-based budgeting.

While firmly committed to spending restraint, the authorities are well aware that significant funding shortfalls could arise unless additional revenue is raised. Fundamental improvements in revenue-mobilizing capacity are needed. In this regard, they are considering initiatives to further strengthen revenue collection through stronger monitoring and audits, imposition of higher penalties, and continuing modernization of customs administration. Better coordination and management of overseas development assistance are also being pursued. Over the medium term, the authorities intend to consider further tax policy reforms to bolster revenue, establish simple and fair rules and equitable tax burdens, and modernize the tax system.

Consistent with the cautious fiscal stance, the authorities are committed to the settlement of arrears and the timely payment of government bills. The authorities, who in the past have adhered to the conservative position that loans will be taken only where a strong revenue source exists to make repayment, also intend to avoid undertaking new loans and to build up the level of usable reserves.

**Work continues on a wide range of structural reforms that will help reorient the economy toward private sector-led development.**

The authorities continue to push the reform agenda, with a view to boosting growth, raising productivity and competitiveness, promoting employment opportunities, and enhancing the economy's flexibility to handle unexpected shocks and downturns. The staff report gives a good summary of the structural measures that the authorities have implemented and identifies those areas where stronger action is needed. Progress on some structural reforms—especially those in the legislative queue—has been mixed, explained in part by the need to undertake extensive consultations to generate support for reforms. However, the Compact's looming review has provided fresh impetus to the need to decisively address the causal forces that impede strong, sustainable growth.

Recognizing that the active involvement of a dynamic and competitive private sector is critical in fortifying the foundations of the economy, the authorities continue to promote private sector development. A strong commitment to an open trade and exchange system is an important element of this strategy, as is stronger regional cooperation among Pacific Island countries in order to, among other things, strengthen local capacity, mitigate the effects of remoteness, and boost trade. The government also continues to work toward the adoption of a new commercial code that is simple and aligned with international best practices and that will establish consistent rules for private sector transactions. Some progress is also being made to address the sensitive issue of land access. The government is helping to draft a law that will enhance the collateralization of long-term leases to facilitate

the use of leased lands as collateral for bank loans. The government has also pushed for the completion of land titling by early 2008.

The authorities are well aware of the need to create a stable and competitive macroeconomic environment for domestic and foreign investment. Toward this end, the government has been working on a regulatory framework that will establish a simple, transparent and effective set of economic rules and provide appropriate incentives for foreign investment, which can help expand and diversify the economic base.

Work is ongoing to develop a long-term vision for tourism and related industries. Tourism products are being diversified, and efforts are being intensified to promote Palau in more markets. The authorities are considering ways to reorganize the tourism management structure within the government to clearly define responsibilities for regulation, marketing and enforcement.

Our authorities recognize the need for a well-functioning financial system. While there have been improvements in the supervisory and regulatory framework, they are mindful that gaps remain in supervision and regulatory oversight because of limited enforcement capabilities and regulatory powers. To promote the efficient intermediation of funds and management of risks as well as ensure the health of the banking system, the authorities continue to push for the passage of amendments to banking laws, and are working closely with legislators in this area.

Capacity building is high on the list of the government's priorities. The government is committed to enhancing human resource training and development, with emphasis on equipping Palauans with necessary skills and training that will help them become more involved in the economy and respond to new opportunities.

### **Concluding remarks**

Our authorities consider the current favorable economic conditions as providing a good opportunity to pursue reforms that will enhance the economy's competitiveness and productivity and render it more resilient to shocks. They are also keenly aware that there are challenges ahead, and they are committed to undertaking the sustained policy and reform efforts that are required to meet these challenges. Many of the reforms that the authorities are contemplating could run into capacity constraints. Our authorities put a premium on institutional and human capacity building, as well as on addressing shortcomings in the statistical database that have made economic assessment and informed policy formulation a challenge. They value the support of the Fund, and request for continued strong technical assistance in the Fund's areas of expertise.