

Republic of Palau: 2010 Article IV Consultation—Staff Report; a Public Information Notice; and a Statement by the Executive Director of the Republic of Palau on the Executive Board Discussion.

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 2010 Article IV consultation with the Republic of Palau, the following documents have been released and are included in this package:

- The staff report for the 2010 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on February 23, 2010, 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 April 12, 2010. 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 April 28, 2010 discussion of the staff report that concluded the Article IV consultation.
- A statement by the Executive Director for the Republic of Palau.

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

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REPUBLIC OF PALAU

Staff Report for the 2010 Article IV Consultation

Prepared by the Staff Representatives for the 2010 Consultation
with the Republic of Palau

Approved by Kenneth Kang and Aasim Husain

April 12, 2010

Discussions were held in Koror and the capital city, February 11–23, 2010. The mission comprised Mr. Lueth (head), Mr. Tokuoka (both APD), Mr. Gill (AsDB), Ms. Alonso, and Ms. Berarpour (both WB) and was joined by Mr. Lee and Ms. Tira (OED). The team met with President Toribiong, Vice President and Minister of Finance Mariur, other senior officials, members of Congress, and representatives of the banking, business and donor community.

Past surveillance: In concluding the last consultation in April 2008, Executive Directors encouraged the authorities to build a strong consensus for ambitious fiscal consolidation and to improve the business environment. They also called for adequate resources to ensure reliable and timely economic statistics.

Exchange regime: Palau accepted the obligations of Article VIII, Sections 2, 3, and 4 in December 1997, and maintains an exchange system free of restrictions on payments and transfers for current and capital transactions. The U.S. dollar is the legal tender.

Statistical issues: The quality of economic reporting remains weak and constrains effective policy evaluation.

Technical assistance: Since 2005, the Pacific Financial Technical Assistance Centre (PFTAC) has provided assistance in national accounts, bank supervision, tax administration and policy reform, and public financial management. A Monetary and Capital Markets Department (MCM) expert assists with bank examinations and supervision.

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EXECUTIVE SUMMARY

Background: Palau's economy has been hit by several external and domestic shocks, which led to a record contraction among Pacific island countries. The global financial crisis followed on the heels of a massive terms-of-trade shock, leading to a sharp curtailment of foreign direct investment (FDI) and private credit. Tourism—the island's main export—tumbled following an airline bankruptcy, and construction activity fell as major infrastructure projects reached completion. Over the near term, high oil prices and the decline in infrastructure spending weigh on the growth outlook.

Key policy challenges: The single most important issue in Palau remains fiscal policy, including its effect on medium-term growth as fiscal consolidation proceeds. Although the United States (U.S.) has extended Compact grant assistance for another 15 years, the current deficit would still need to shrink by 1½ percent of GDP per year over the next 10 years, to avoid a sharp drop in spending when Compact grants end. The budget for FY2010 falls short of this target. Weaknesses in the budget process have also led to the accumulation of sizeable arrears and the drawdown of the government's cash position. To sustain the economy in the face of the required fiscal adjustment, Palau needs to identify new sources of growth and revenue. In this context, the new administration is pursuing a liberalization of the FDI regime as well as oil and gas exploration.

Staff recommendations: For FY2010, staff has called for the adoption of all revenue measures currently before Congress (½ percent of GDP) and a reduction in spending by 1 percent of GDP, particularly on goods and services. Staff welcomed recent steps to improve budget preparation, but still recommended—as a contingency—basing budget execution strictly on cash availability. To achieve fiscal sustainability over the medium term, staff reiterated earlier recommendations for comprehensive tax and civil service reform. Staff supported recent efforts to generate new sources of growth and revenue, particularly, efforts to liberalize the FDI regime. However, staff also pointed to the challenges of managing oil revenues and cautioned against establishing corporate and ship registries. Staff observed a further deterioration in data quality and availability owing to understaffing.

Authorities' views: The government warned that Congress might reject some of the proposed revenue measures for FY2010 and felt that spending cuts would be politically difficult. The authorities remarked that cash-based budget execution is challenging as long as incoming cash was needed to clear outstanding arrears and ensure service delivery. In their view, some front-loading of U.S. Compact grants or debt financing were key for clearing arrears and regularizing budget execution. The authorities concurred with the need for fiscal consolidation over the medium term and are exploring ways to expand the tax base, including to foreigners. In this context, the authorities were unconvinced that corporate and ship registries would undermine anti-money laundering efforts, pointing to other Pacific islands as examples.

I. BACKGROUND

1. **Although blessed with natural beauty and a favorable geographic location, the young island nation still remains highly dependent on foreign assistance.** Situated just 800 km east of the Philippines and among the top diving destinations in the world, tourism is a main driver of the economy—both in the form of exports and inward FDI. The other drivers are foreign grants, which currently amount to some 20 percent of GDP and finance about half of government spending. With a population of 20,000, a third of which are foreign workers, and a per capita income of \$10,500, Palau is one of the smallest and wealthiest Pacific island countries.

2. **Self-sufficiency remains a high priority for the new administration, which came into office in January 2009.** Successive governments have called for reduced reliance on grants, with the medium-term goal of funding current fiscal spending out of domestic revenues. Palau is also building up a trust fund to sustain current spending when grant assistance expires (Box 1). While U.S. Compact grant assistance has been secured for another 15 years, the new administration is looking for innovative ways to spur growth and generate additional revenues—most prominently through the liberalization of the FDI regime and the offshore exploration of oil and gas.

II. ECONOMIC DEVELOPMENTS AND OUTLOOK

3. **The global financial crisis, compounded by some Palau-specific shocks, has taken a heavy toll on the island nation** (Figure 1). The economy contracted by close to 5 percent in FY2008 and, based on very preliminary indicators, 2 percent in FY2009.¹ This is the largest cumulative contraction among Pacific island countries over this period.

- FDI contracted as many foreign firms lost access to financing. Uncertainty about Palau's FDI regime and the outcome of the Compact negotiations with the U.S. may have further dampened foreign investment.
- Tourism, accounting for almost half of GDP—the highest among Pacific island countries—fell by a cumulative 17 percent over the last two years (in volume terms).
- Foreign capital grants and public investment contracted as major infrastructure projects, like the construction of the Compact road and its feeder roads, were completed.

¹ The fiscal year (FY) ends on September 30. Staff uses GDP estimates prepared by the Office of Planning and Statistics in collaboration with PFTAC.

Box 1. Palau: The Compact of Free Association

The Compact of Free Association (the “Compact”) is a 50-year strategic treaty, under which the U.S. retains control of defense and security matters in Palau. In exchange, the U.S. committed to set up a trust fund and provide Palau with pre-specified grants in the first fifteen years of the Compact. The Compact entered into force on October 1, 1994, as Palau became a sovereign nation.

U.S. Compact assistance amounted to about 20 percent of Palau’s GDP on average over FY1995–FY2009. Of this, 13 percent of GDP came in the form of budget support and 7 percent of GDP was for federal services—roads, weather, postal, and aviation. In addition, the U.S. provided \$70 million in seed money for the Compact trust fund (about 50 percent of FY1997 GDP). The U.S. also provided non-Compact assistance over FY1995–FY2009, averaging some 10½ percent of GDP per year.

The performance of the trust fund fell short of expectations. The purpose of the fund was to provide a steady stream of income that would replace Compact grants after 2009. In addition, Palau was allowed annual withdrawals from the fund amounting to \$5 million during FY2000–FY2009, and \$15 million, thereafter (actual withdrawals started only in FY2002). The fund returned 7½ percent per year through FY2009. This is above the benchmark, but falls short of the 12½ percent anticipated during the Compact negotiations. By end-FY2009, the Compact trust fund had accumulated \$140 million, compared to \$260 million expected at the outset.

The Compact mandates that the U.S. and Palau governments formally review the terms of the Compact on the 15th, 30th, and 40th anniversaries of the Compact and mutually agree to any alterations. The first 15 years formally ended on September 30, 2009. After initial delays, the two countries reached agreement on grant assistance for the next 15 years. Under the agreement, which still needs to pass the U.S. Congress, the U.S. would continue assistance at about current levels, including \$13–14 million annual budget support and a total of \$28 million for infrastructure maintenance. Some of the budget support may be front-loaded, so that Palau can clear its government arrears, and annual withdrawals from the trust fund would again be restricted to \$5 million.

4. **Inflation has come down since late-2008, but prices are on the rise again.** In September 2008, inflation reached 16.8 percent year-on-year on the back of high oil prices, severely cutting into disposable incomes and consumption. Inflation came down to 1.7 percent by mid-2009 (the latest data available), or broadly in line with other Pacific islands, but anecdotal evidence points to renewed price pressures.
5. **Monetary conditions have tightened in the wake of the global downturn.** Foreign bank branches, which account for about 95 percent of banking sector assets, are flush with liquidity as evidenced by a liquidity ratio of 77 percent (liquid assets to deposits and short-term liabilities). However, foreign bank branches have tightened credit standards, reflecting

a reassessment of risks at headquarters and Palau-specific concerns about household debt. As a result, private credit contracted by 20 percent in FY2009.

6. **Palau's external position deteriorated as oil prices spiked and overseas investments sustained major valuation losses** (Figure 2). In FY2008, the current account (including grants) deteriorated by about 10 percentage points of GDP to -18 percent of GDP. While it has recovered somewhat since then, external debt continued to increase and reached a record 38 percent of GDP in FY2009. Palau's power company played a large part in the recent buildup of external debt, all of which is on nonconcessional terms. Palau's external assets, namely pension funds and the Compact trust fund lost about 15 percent of their value since the financial crisis. Taken together, Palau's international investment position (foreign assets minus foreign liabilities) fell from 4 percent of GDP in FY2007 to -33 percent of GDP in FY2009.

7. **Fiscal policy continues to be too loose and the liquidity situation is becoming serious** (Figure 3). Domestic revenue fell and current spending rose over FY2008–FY2009, leading to a further deterioration in the current balance (domestic revenue minus current expenditure) of about 0.8 percent of GDP to -17 percent of GDP in FY2009. The current balance has been worsening since FY2005, despite the medium-term policy goal of a zero current balance. In addition, revenues and grants have not been sufficient to finance expenditures, as evidenced by a steady drawdown of government deposits to \$5 million at end-FY2009 (from over \$10 million in FY2007). While the latter has been a long-standing issue, government liquidity is becoming a concern as government deposits are approaching zero (and allowable withdrawals from the Compact trust fund are capped at \$5 million).

Outlook and risks

8. **The short-term outlook remains clouded, with growth projected to turn only slightly positive in FY2010.** Tourist arrivals and FDI should pick up in FY2010 along with the recovery in global growth and financial conditions. However, little stimulus is expected from public infrastructure projects and oil prices are projected to rise by 35 percent between FY2009 and FY2010. The latter would shave off some \$10 million or 5 percent of GDP, of disposable incomes and sustain inflation at around 6 percent. Downside risks include higher than expected oil prices, fewer grants as donor countries struggle with tighter finances, and a double dip in global growth, which would affect tourism. High household indebtedness poses a further downside risk to growth. On the upside, an expansion of flight schedules could lead to an increase in tourism.

III. POLICY DISCUSSIONS

A. Fiscal Policy

Near term

9. **The authorities have made important fiscal efforts in the FY2010 initial budget, but the supplementary budget will further undermine the government's cash position.**

The initial budget featured a 10 percent expenditure cut across-the-board relative to the FY2009 budget. However, a supplemental budget of \$4.9 million is likely to pass Congress and would lead to an increase in current spending over the FY2009 outturn. This would still reduce the current deficit by $\frac{1}{4}$ percentage point of GDP to $16\frac{1}{2}$ percent in FY2010, but would further worsen the government's cash position by about \$2 million relative to end-FY2009 (without additional revenue measures). Staff also notes that tax revenue projections in the budget may be on an optimistic side.

10. **Staff recommended cutting the FY2010 current balance by $1\frac{1}{2}$ percentage points of GDP to $-15\frac{1}{2}$ percent of GDP, in line with the needed medium-term adjustment (see below).²**

On the revenue side, this would require the passage of measures submitted with the supplemental budget, including the elimination of food import duty exemptions and a hike of the wage and salary tax for top earners (yielding $\frac{1}{2}$ percent of GDP net of some fee declines). In addition, the adjustment would require spending cuts of 1 percent of GDP, including for goods and services, which rose by $1\frac{1}{4}$ percent of GDP in FY2009. Specifically, outlays for utility bills, miscellaneous office supplies, and cars and buses—all part of the supplemental budget—could be considered for spending cuts, while protecting social-related expenditures. The proposed adjustment would lead to the accumulation of \$1 million in cash, which could be used to rebuild an appropriate liquidity buffer (ideally 2 months of government spending or about \$10 million) and/or reduce the \$11 million stock of government arrears.³ The authorities hoped that the revenue measures would pass Congress, given a high share of nondiscretionary spending items, particularly wages. They also pointed out that the government had reduced the number of schools on the largest island from 10 to 4, as part of their expenditure consolidation.

11. **Tackling weaknesses in the budget process is key to achieving fiscal sustainability and avoiding a further build-up in government arrears.** In the past, the approved budget tended to be too optimistic, as Congress over-estimated revenues, grant co-

² These numbers are based on GDP estimates prepared by the Office of Planning and Statistics in collaboration with PFTAC and have not yet been adopted as official estimates. If current official GDP numbers were used, the needed annual adjustment would increase to 2 percentage points of GDP.

³ The government arrears consist largely of payment arrears to domestic suppliers. The stock of arrears has been relatively stable at around \$11 million since 2004.

payments were not always factored in, and previously grant-financed employees ended up on the government's payroll. Budget execution then proceeded on the basis of an unrealistic budget, rather than cash availability, leading to a drawdown in cash reserves or the accumulation of government arrears. The authorities pointed to significant improvements in revenue projections under the current administration, as evidenced by a mere 1 percent revenue shortfall in the first quarter of FY2010. They also noted that the President has issued an executive order to create a foreign grant clearing house, which would help keep track of implicit government obligations previously not reflected in the budget.

12. **Staff supported the current administration's efforts to fix the budget process.** As a backup to the above measures, staff recommended to base quarterly budget allocations to line ministries on the most accurate projections of resource availability for the quarter. Moreover, the creation of a cash management committee, where line ministry and Ministry of Finance officials meet on a monthly basis, would ensure a transparent allocation of scarce cash resources. Finally staff noted that unless the budget process is fixed, the government should abstain from foreign borrowing. While sympathetic to the idea of making budget execution contingent on cash availability, the authorities pointed to the inherited stock of arrears as a major obstacle. To ensure continued service delivery, incoming cash is used to pay down arrears, leading to the reemergence of arrears at year-end. Hence, the clearance of arrears, possibly through debt financing, was key in the authorities' view.

Medium to long term

13. **Despite the renewal of U.S. Compact grants assistance, fiscal policy remains unsustainable, implying a sharp drop in spending once Compact grant assistance ends.** Staff estimates that, to ensure fiscal sustainability over the medium-term, the current balance would need to improve by 1½ percentage points of GDP per year over the next 10 years (see Appendix).

14. **Comprehensive reforms are needed to sustain fiscal consolidation over the medium term.** On the revenue side, staff reiterated earlier FAD recommendations to eliminate import duty exemptions, move to cost, insurance and freight (CIF) evaluation, and eventually replace the distortionary gross revenue tax with a corporate income tax. The first two measures could produce savings of 2 percent of GDP between FY2010–FY2015. On the expenditure side, the reduction in the FY2009 wage bill is welcome, but further cuts are recommended, given that Palau's wage bill exceeds the Pacific island average by at least 1 percentage point of GDP. Other spending would also need to be reduced. In particular, curtailing subsidies on water and sewage services (1 percent of GDP) by improving efficiency of these operations would be key to achieve the recommended adjustment in current spending of 5½ percent of GDP between FY2010–FY2015. The authorities acknowledged the need for fiscal consolidation, particularly through raising tax revenue. Given strong Congressional resistance to higher taxes, the government is exploring ways to expand the tax base, including to foreigners.

15. **A discovery of oil and gas reserves (Box 2) could substantially change Palau’s economic fortunes, but fiscal policy should continue to be guided by conservative assumptions.** Under the World Bank’s middle-case scenario for oil and gas reserves, the required fiscal adjustment would decline to ½ percentage point of GDP per year over ten years from 1½ percentage points under current circumstances. However, fiscal policy should be guided by the latter number until actual production is firmly on track. There are significant risks that extractible reserves turn out lower or that extraction is delayed. Also, maintaining macroeconomic stability and fiscal sustainability in the face of volatile and exhaustible oil and gas revenues will be a daunting task, given weaknesses in the annual budget process and the absence of a medium-term fiscal framework. The authorities agreed that it was too early to factor in potential oil revenues when deriving medium-term adjustment needs. At the same time, they felt it was crucial to have a strong fiscal and legal framework in place once exploration starts and appreciated technical assistance (TA) by the World Bank in this area.

Box 2. Palau: A Framework for Managing Oil and Gas Revenues

Palau is making new efforts towards oil and gas exploration (hence forth only “oil”). The President has recently signed a contract with a Houston based company, which gives the latter the rights to explore oil for 10 years, provided drilling starts before May 2010. Estimates obtained by the World Bank show a wide range of possible oil reserves, with the revenue from such reserves (in net present value) varying between ¾ of GDP to 8 times GDP, and a base case of 2¼ times GDP. For the oil wealth to be translated into a broad-based and sustainable increase in living standards, an effective fiscal framework for managing oil revenues is key.

A medium-term fiscal framework, supported by an oil fund, would ensure sustainability and stability of public spending in the face of exhaustible and volatile oil revenues. Fiscal policy guidelines or rules could be considered to impose some discipline on policymakers. The more successful fiscal guidelines or rules (Norway, Chile, Botswana) relate to the entire budget, instead of merely oil revenues, and are appropriately flexible. The oil fund would be a government account to which oil revenues (above the line in the budget) are credited and from which debits can be made to finance the budget (below the line). Oil fund assets should be invested abroad to isolate the economy from oil price volatility.

National governments are in a better position to manage exhaustible and volatile oil revenues than local governments. This is likely to remain a contentious issue, as the constitution gives local governments the ownership of, and right to tax natural resources, if not exclusively. With the spatial concentration of oil reserves, the assignment to local governments would lead to great welfare disparities across regions. A fiscal policy that is consistent with fiscal sustainability and macro stability also requires overview over various revenue sources (taxes, grants, trust fund, oil) and access to a trust fund, both of which is impossible in a decentralized setting. The distribution of revenues to local governments should be governed by a formula-based intergovernmental transfer system that takes into account environmental damages and infrastructure needs in oil drilling localities.

B. Financial Sector

16. **Palau's financial sector has weathered the global financial crisis relatively well.** Three of the four foreign bank branches, or about 95 percent of deposits, are Federal Deposit Insurance Corporation (FDIC) insured and non-performing loans in all foreign bank branches amount to less than 1 percent. Bank of Hawaii, which accounts for about 65 percent of banking system assets, remains a sound U.S. bank. There are three local banks with significant financial and operating weaknesses and nonperforming loans ranging from 12 to 50 percent. However, the banks account for little over 1 percent of banking system deposits.

17. **Staff welcomed the continued improvements in financial sector oversight and regulation.** Staffing and funding of the Financial Institutions Commission is appropriate, according to the Executive Commissioner, and the introduction of bank charges in FY2009, as opposed to budget funding, has further boosted supervisory independence. After an initial delay, banks started to report comprehensive financial data in the third quarter of 2009, which has been fed into a database for offsite supervision.

18. **Efforts against anti-money laundering and in combating the financing of terrorism (AML/CFT) are laudable and proposals to establish a corporate or ship registry in Palau should be resisted.** The AMF/CFT legal framework was upgraded with the help of the Pacific Anti-Money Laundering Program and three Congressmen have agreed to sponsor the legislation. The creation of two staff positions at the Financial Intelligence Unit (FIU), which has been moved to the Attorney General's office, is welcome. However, according to donors, the investigation and prosecution of money laundering and related offences will likely remain constrained in the absence of a financial crimes police unit, which is difficult to staff and the lack of relevant AML/CFT expertise of prosecutors. Given Palau's limited policing capacity, staff cautioned against the establishment of a corporate or ship registry. The authorities felt capacity constraints could be overcome and pointed to other Pacific island countries, such as Marshall Islands, that were raising revenue through corporate and ship registries.

C. External Sector

19. **It is appropriate for Palau to use the U.S. dollar as its legal tender.** Given Palau's size and administrative capacity the costs of maintaining a central bank and managing its own currency seem prohibitive. Moreover, close to half of Palau's imports and 80 percent of its grants come from the United States.

20. **Despite an elevated real effective exchange rate, Palau seems to have maintained its external competitiveness.** Despite inflation coming off its 2008 peak, the real effective exchange rate remains 6 percent above its long-term average. However, the current account (excluding grants) continues to improve from -45 percent of GDP in FY2002 to an estimated -25 percent of GDP in FY2009. The sharp drop in tourist numbers was due to the bankruptcy of a Taiwanese airline, since non-Taiwanese tourist numbers continued to increase

throughout the global downturn, albeit at a slower pace. The authorities agreed that Palau had outperformed its main rivals with tourist numbers falling by 20 percent in Guam and Saipan in the wake of the global financial crisis. In the authorities' view, the resilience of Palau's main export can be explained by the island's unique setting and sea life and the fact that it caters to high-end tourists that are not particularly price- and income-sensitive.

21. **Going forward, the current account is projected to improve, but Palau's external position remains vulnerable.** The current account should improve in line with fiscal consolidation, but the external position remains vulnerable to terms-of-trade shocks and valuation losses on Palau's overseas investments. The narrow export base—90 percent of exports are in tourism—is also a source of vulnerability. Staff pointed to the need to contain the debt of public utilities and to allow for greater pass-through of global oil prices to raise profitability. The authorities agreed that there was scope to increase the power company's profitability and noted that management had been changed recently to this end. Various efforts were under way to extend the export base beyond tourism, including oil and gas exploration and the formation of a tuna cartel.

Table. Palau: Medium-term Projections, 2007/08-2014/15 1/
(In percent of GDP, unless otherwise noted)

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
	Est.		Projection					
Real sector								
Real GDP growth (percent change)	-4.9	-2.1	1.0	2.0	3.0	3.0	3.0	3.0
Consumer prices (percent change; PA)	10.0	6.1	6.0	4.0	3.0	2.0	2.0	2.0
Public finance								
Domestic revenue	18.5	17.8	18.3	18.7	19.0	19.4	19.8	20.2
Current expenditure	35.3	34.7	33.7	32.5	31.4	30.3	29.1	28.0
Current balance (excluding grants) 2/	-16.8	-16.9	-15.4	-13.9	-12.4	-10.9	-9.4	-7.9
Overall balance (including grants) 3/	-3.1	-2.9	-1.2	-2.7	-2.5	-2.2	-1.9	-1.6
Balance of payments								
Current account balance (excluding grants)	-34.4	-24.8	-23.7	-21.6	-20.1	-18.5	-17.0	-15.5
Current account balance (including grants)	-17.9	-13.7	-9.6	-8.8	-8.1	-7.3	-6.5	-5.8

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

1/ Fiscal Year ending September 30.

2/ Defined as domestic revenue minus current expenditure.

3/ Including errors and omissions.

D. Structural Reforms

22. **The liberalization of Palau's FDI regime should give a welcome boost to private sector growth as fiscal consolidation proceeds.** There are several bills before the legislature, all of which intend to replace the case-by-case vetting of foreign investors under the existing regime by a rules based approach that is much less arbitrary and cumbersome. Lower minimum investment requirements and open-ended investment certificates are also important improvements over the current legislation. However, the list of business activities

that remain reserved for companies with Palauan strategic partners continues to limit job creation and knowledge transfer and keeps in place incentives for front businesses (foreign companies with a Palauan as front). The same is true for provisions largely left unchanged in the new bills that require foreign companies to pay higher foreign worker fees and wages than local companies.

23. **According to the Asian Development Bank (AsDB), land and labor issues remain key to private sector development and important progress has been made.** Staff welcomed a 2008 referendum that approved the extension of land lease agreements for foreigners from 49 to 99 years (together with the introduction of resident visa). On land, next steps should include the introduction of land use and zoning laws to prevent unsightly and unsafe uses of land and the development of standardized lease agreements to reduce negotiation time and legal uncertainty. On labor, the president introduced a 6,000 quota for foreign workers to limit adverse socio-economic impacts on Palau's small population. The authorities agreed that adjusting the foreign labor fee was a more efficient tool to steer immigration, but explained that volatile Palauan emigration required a more flexible and exact tool. They also concurred that unifying the minimum wage for immigrant and Palauan workers would help reduce Palauan unemployment, but cited interest groups that favored cheap foreign labor.

E. Statistical Issues

24. **Staff encouraged the authorities to revise Palau's official GDP numbers.** The Office of Planning and Statistics has improved the GDP compilation methodology in close cooperation with the PFTAC. This yielded GDP numbers—used throughout the staff report—which corroborate earlier work by a consultant from the United Nations Development Program and are 30–40 percent higher than official estimates. Real growth rates also differ from those officially reported. The authorities explained that they need to carefully examine the numbers before adopting them.

25. **Increasing staff levels at the Bureau of Budget and Planning is an urgent priority.** The capacity to compile economic and government statistics is deteriorating owing to the loss of personnel with institutional memory and severe understaffing. Essential statistics, for example on price levels, have not been compiled since mid-2009 and without regular PFTAC missions national accounts and balance of payments statistics could not be sustained. The lack of staff and data, if not addressed, would impede national policy formulation. Recognizing the problem, the authorities have started recruiting new staff into the Bureau of Budget and Planning.

IV. STAFF APPRAISAL

26. **The global financial crisis, compounded by some Palau specific shocks, has taken a heavy toll on the Palauan economy.** Since the last Article IV consultation in 2008, the economy contracted by a cumulative 7 percent. FDI fell as foreign firms lost access to

financing, credit contracted as global banks tightened credit standards, and Palau's external position tumbled as foreign investments sustained heavy valuation losses. Tourism was little affected by the crisis, but took a hit in the wake of an airline bankruptcy, and foreign grants contracted as major infrastructure projects were completed.

27. **Near-term growth prospects remain clouded with growth projected to turn only slightly positive in 2010.** While tourism and FDI should improve with the recovery in global growth and financial conditions, higher oil prices and the lack of major investment projects weigh on the outlook. Downside risks include lower grant financing as donor governments struggle with tighter finances and higher than expected oil prices. On the upside, tourism could get a boost from an expansion of flight schedules.

28. **New revenue measures and expenditure restraint are needed, not least to protect the government's cash position.** Since the last Article IV consultation, the current balance deteriorated further and the FY2010 supplemental budget implies insufficient adjustment effort. Staff support the adoption of all revenue measures currently before Congress and additional expenditure restraint of about 1 percent of GDP. The resulting adjustment of about 1½ percent of GDP would not only be an important step towards Palau's goal of self-reliance, but also protect the government's cash position.

29. **Staff commends the new administration for its determination to fix the budget process as a precondition for fiscal discipline.** The administration is also in the process of establishing a grant clearing house, which would keep track of implicit government obligations previously not reflected in the budget. In addition, staff recommends basing budget execution strictly on cash availability and letting a cash management committee help assign scarce cash to line ministries.

30. **Despite an extension of U.S. Compact grants assistance for another 15 years, fiscal policy remains unsustainable.** To avoid a sharp drop in spending when U.S. Compact grants end, Palau needs to reduce its current deficit by 1½ percent of GDP per year over the next 10 years. This would require comprehensive tax reform; including the elimination of generous import duty exemptions and the move to CIF evaluation of imports, as well as civil service reform, given Palau's high wage bill. The discovery of oil and gas could reduce the required adjustment effort, provided strong fiscal and legal frameworks are in place. Government efforts in this regard, which are supported by the World Bank, are welcome.

31. **Staff welcomes the continued improvements in financial sector oversight, but the planned set-up of a corporate or ship registry could pose new challenges.** With 95 percent of deposits FDIC insured, the financial system poses little systemic risk. Shortcomings in the anti-money laundering framework identified by the Financial Action Task Force are being addressed, but plans to launch a corporate or ship registry could set back recent efforts.

32. **Palau maintained its external competitiveness, but its external position remains vulnerable to terms of trade shocks and valuation losses on overseas investments.** The real effective exchange rate remains above its long-term average, but the current account continues to improve and tourist numbers have held up comparatively well. Going forward, the current account should continue to improve along with fiscal consolidation, barring commodity price shocks and major dislocations in financial markets. Palau's exchange rate arrangement—the country uses the U.S. dollar as legal tender—remains appropriate given its size and limited administrative capacity.

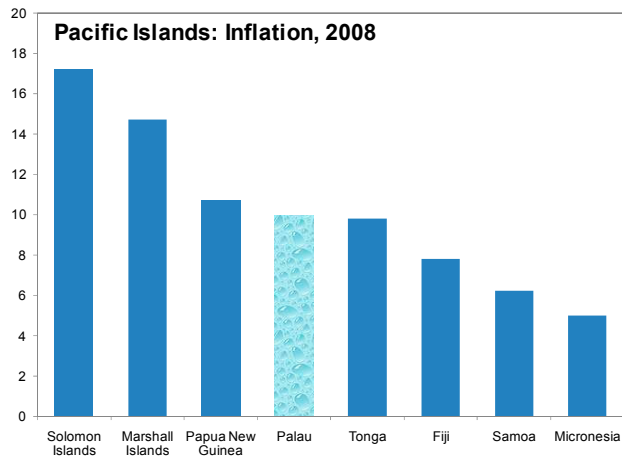
33. **Efforts to liberalize the FDI regime and improve land and labor regulation should give a welcome boost to the private sector growth as fiscal consolidation proceeds.** The FDI bills currently before Congress, if adopted, would mark an important improvement, in that they replace the discretionary vetting of foreign investors by a rules-based approach. The adoption of the 99-year lease and the introduction of resident visa are also welcome developments. Remaining obstacles to FDI and greater employment opportunities for Palauans are higher foreign labor fees for foreign employers and higher minimum wages for Palauan employees compared to their foreign counterparts.

34. **The provision of high-quality data remains essential for national policy formulation and surveillance.** Severe understaffing and the loss of personnel with institutional memory led to a deterioration in data quality and availability, which needs to be addressed urgently. Staff also recommends officially adopting the GDP numbers compiled jointly by the Office and Planning and Statistics and PFTAC. They are compiled using internationally best practice and extend beyond the official estimates, which end in FY2007.

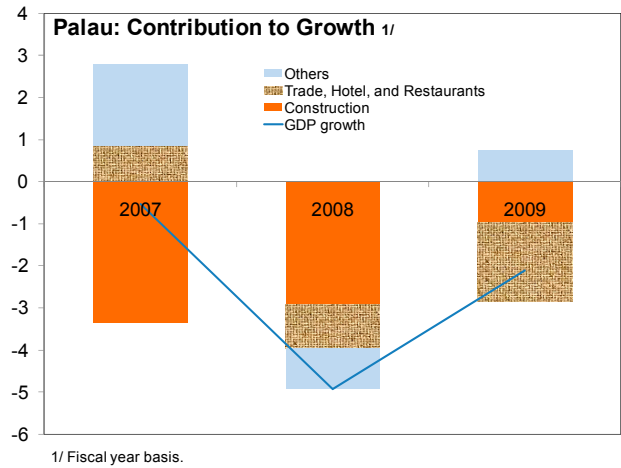
35. **It is recommended that the next Article IV consultation take place on a 24-month cycle.**

Figure 1. Palau: Oil Price Shock and Global Crisis

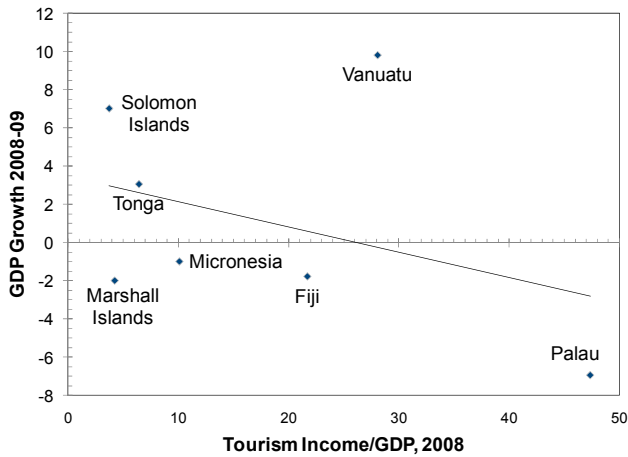
Sharp price increases in the wake of the 2008 global commodity boom,...



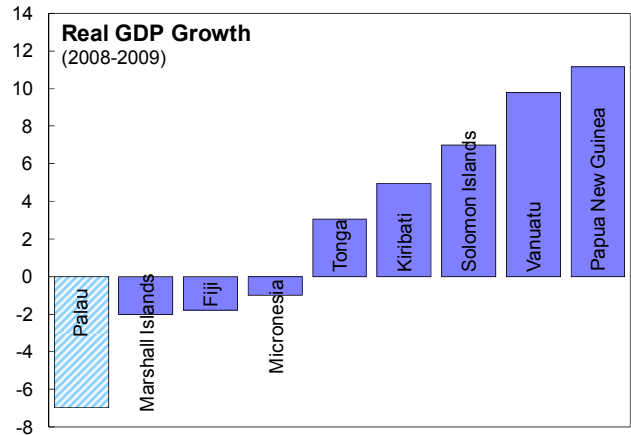
...the fall in construction activity following the completion of the Compact road, and...



...the fall in tourist numbers...



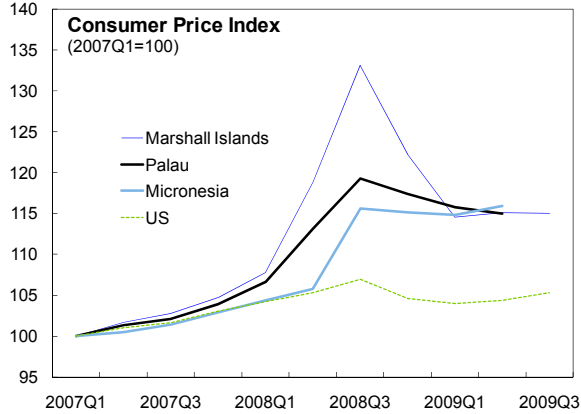
...lead to a major economic contraction.



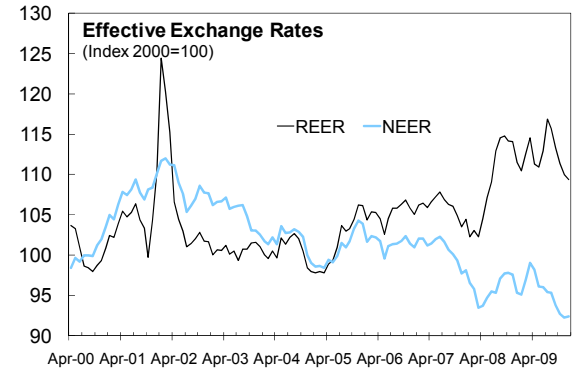
Sources: Palauan authorities; and IMF staff estimates and projections.

Figure 2. Palau: External Sector Developments

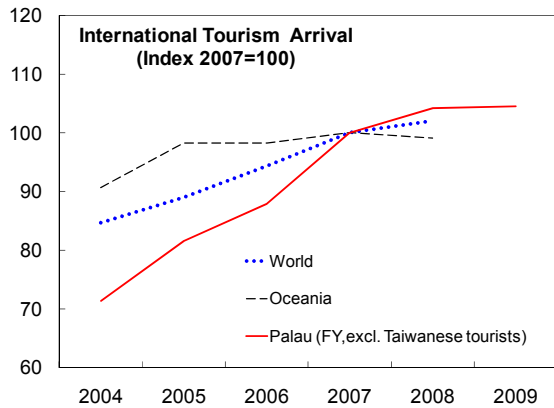
While the decline in inflation was in line with other Pacific islands...



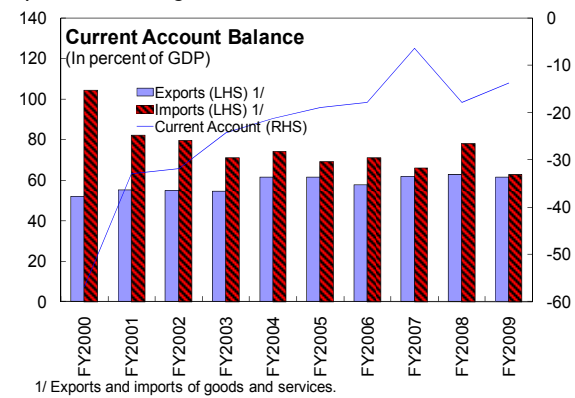
...the real effective exchange rate remains above its long-term average.



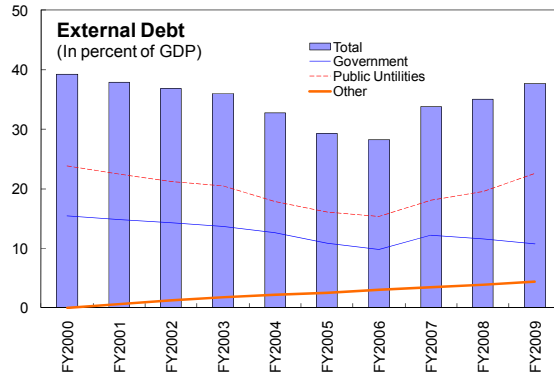
External competitiveness was maintained, as evidenced by relatively strong tourism exports.



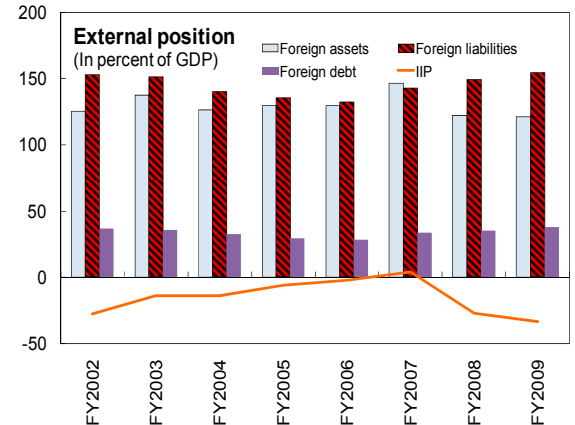
The current account deteriorated on account of higher oil imports in FY2008 and has resumed its upward trend again.



However, the external position remains vulnerable to terms of trade shocks, as evidenced by rising external debt...



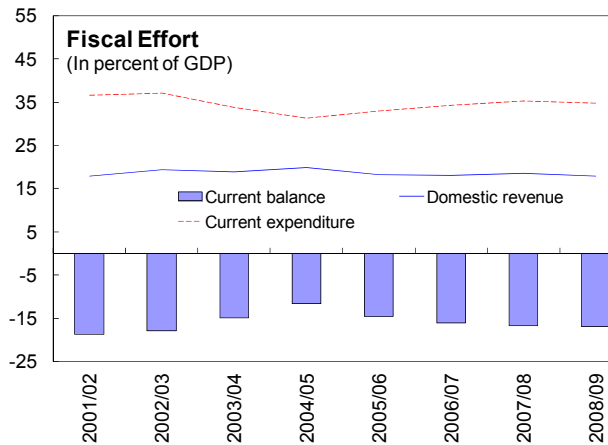
...and drops in the value of Palau's overseas investments.



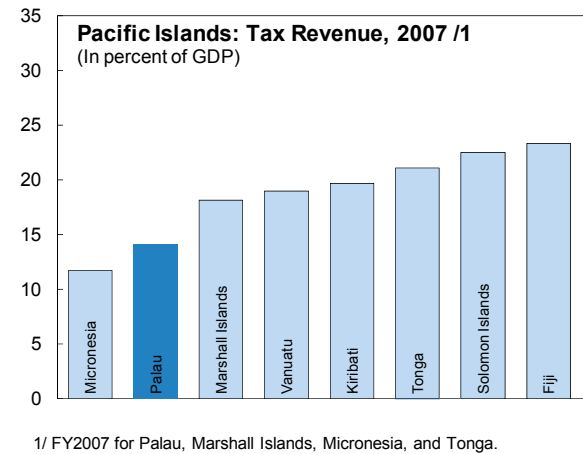
Source: Palauan authorities; PFTAC estimates; and IMF staff estimates and projections.

Figure 3. Palau: Fiscal Sector Developments

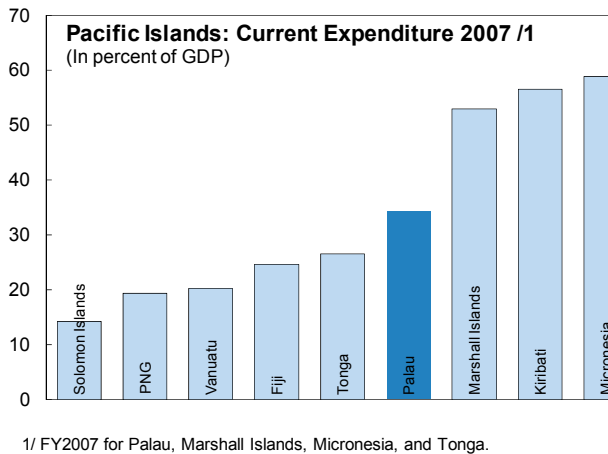
The fiscal effort has been steadily declining over recent years.



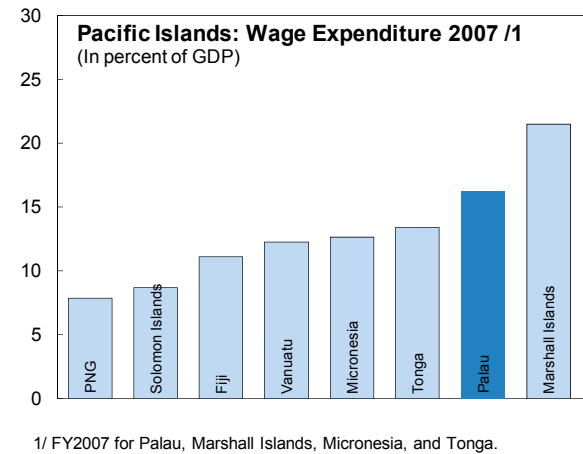
In terms of tax effort, Palau ranks next to last among Pacific island countries.



But, also in terms of current expenditures...



...and the wage bill, Palau could exercise greater restraint.



Sources: Palauan authorities; and IMF staff estimates.

Table 1. Palau: Selected Economic Indicators, 2004/05–2009/10^{1/}

	2004/05	2005/06	2006/07	2007/08	2008/09 Est.	2009/10 Proj.
Real sector						
Real GDP growth (percent change)						
Official estimates	5.5	3.0	2.5
PFTAC estimates 2/	4.7	-3.7	-0.5	-4.9	-2.1	1.0
GDP deflator (percent change) 3/	4.0	8.3	1.8	6.5	1.1	2.0
Consumer prices (percent change; period average)	3.2	4.8	3.0	10.0	6.1	6.0
Business and Tourist arrivals	85,004	79,823	87,142	81,123	73,365	78,055
Public finance						
	(In percent of official GDP)					
Central government						
Revenue	37.6	39.4	42.2	38.9	38.3	41.2
Domestic revenue	19.8	18.3	18.1	18.5	17.8	18.3
Grants	17.8	21.1	24.1	20.4	20.5	22.9
Expenditures	38.2	43.8	46.1	43.1	44.8	42.4
Current	31.4	32.9	34.2	35.3	34.7	33.7
Capital	6.8	10.9	11.9	7.8	10.1	8.7
Current balance (excluding grants) 4/	-11.6	-14.7	-16.1	-16.8	-16.9	-15.4
Overall balance (excluding grants) 5/	-19.3	-22.0	-29.9	-23.4	-23.4	-24.1
Overall balance (including grants) 5/	-1.5	-0.9	-5.8	-3.1	-2.9	-1.2
	(In millions of U.S. dollars; unless otherwise indicated)					
Compact Trust Fund (CTF) balance 6/	152.5	157.0	176.4	147.8	142.0	...
Interest income and capital gains/losses	16.8	10.4	25.4	-22.6	0.2	...
Investment fees and withdrawals	5.9	5.9	6.0	6.0	6.0	6.0
Government non-CTF financial assets	9.8	11.8	9.9	11.5	8.3	5.0
Balance of payments						
Trade balance	-94.1	-101.0	-96.3	-118.5	-91.7	-101.1
Exports (f.o.b.)	14.0	14.2	11.3	11.8	11.8	12.3
Imports (f.o.b.)	108.1	115.3	107.6	130.3	103.5	113.4
Tourism receipts	102.0	99.4	113.1	116.7	113.0	123.9
Current account balance						
Including grants	-37.9	-37.2	-13.6	-38.4	-29.1	-20.9
Excluding grants	-58.6	-70.7	-50.6	-73.7	-52.5	-51.9
International Investment Position	-12.0	-4.7	8.8	-57.9	-70.8	-65.9
Assets	259.0	270.9	310.3	261.3	256.2	262.5
Liabilities	271.0	275.6	301.5	319.2	327.0	328.4
Of which: external debt	58.8	58.9	71.5	75.1	79.8	78.2
	(In percent of GDP)					
Current account balance						
Including grants	-18.9	-17.8	-6.4	-17.9	-13.7	-9.6
Excluding grants	-29.3	-33.8	-23.9	-34.4	-24.8	-23.7
International Investment Position	-6.0	-2.3	4.1	-27.0	-33.4	-30.2
Of which: external debt	29.3	28.2	33.8	35.1	37.7	35.8

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

1/ Fiscal Year ending September 30.

2/ Fund staff projection for 2009/10.

3/ PFTAC and staff estimates.

4/ Defined as domestic revenue minus current expenditure.

5/ Including errors and omissions.

6/ As of end-year.

Table 2. Palau: National Government Budgetary Operations, 2004/05–2009/10 1/

	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	
						Est. Budget 2/	Proj.
(In thousands of US\$)							
Total revenue and grants	75,352	82,239	89,360	83,267	81,266	88,988	90,003
Domestic revenue	39,695	38,173	38,339	39,618	37,835	39,035	40,050
Tax revenue	30,086	29,376	29,764	31,488	29,679	31,354	31,969
Nontax revenue	6,276	6,641	6,481	6,821	6,451	5,981	6,381
Local Trust Funds	1,333	2,157	2,094	1,309	1,705	1,700	1,700
Grants	35,657	44,066	51,021	43,650	43,431	49,953	49,953
Current grants	20,678	21,642	26,078	25,442	23,362	30,931	30,931
U.S. Compact	12,471	12,717	12,717	13,233	12,840	14,537	14,537
U.S. non-Compact	7,217	7,827	8,892	7,977	9,260	12,840	12,840
Other country	990	1,098	4,470	4,232	1,263	3,554	3,554
Capital grants	14,979	22,424	24,943	18,208	20,068	19,022	19,022
Total expenditure	76,466	91,506	97,546	92,295	94,981	94,313	92,613
Current expenditure	62,830	68,778	72,369	75,572	73,666	75,291	73,591
Of which:							
Wages and salaries	31,687	32,760	34,306	35,440	31,718	32,303	31,573
Other purchases of goods and services	21,433	25,959	28,166	28,865	31,458	34,142	33,371
Capital expenditure	13,636	22,728	25,177	16,723	21,315	19,022	19,022
Errors and Omissions, including Accounts Payable/Receivables	-1,896	7,402	-4,112	2,477	7,626	0	0
Current balance (excl. grants)	-23,135	-30,604	-34,030	-35,954	-35,831	-36,256	-33,541
Overall balance	-3,010	-1,865	-12,298	-6,551	-6,089	-5,325	-2,610
Financing	3,010	1,865	12,298	6,551	6,089	5,325	2,610
Net long-term borrowing	-1,643	-1,143	5,357	-1,600	-2,228	-1,600	-1,600
New borrowing	0	0	6,500	0	0	0	0
Principal repayments	1,643	1,143	1,143	1,600	2,228	1,600	1,600
Change in NTF assets 3/	-347	-1,992	1,941	3,151	3,317	1,925	-790
Withdrawals from Trust Fund	5,000	5,000	5,000	5,000	5,000	5,000	5,000
(In percent of GDP)							
Total revenue and grants	37.6	39.4	42.2	38.9	38.3	40.7	41.2
Domestic revenue	19.8	18.3	18.1	18.5	17.8	17.9	18.3
Grants	17.8	21.1	24.1	20.4	20.5	22.9	22.9
Total expenditure	38.2	43.8	46.1	43.1	44.8	43.2	42.4
Current expenditure	31.4	32.9	34.2	35.3	34.7	34.5	33.7
Of which:							
Wages and salaries	15.8	15.7	16.2	16.5	15.0	14.8	14.5
Goods and services	10.7	12.4	13.3	13.5	14.8	15.6	15.3
Capital expenditure	6.8	10.9	11.9	7.8	10.1	8.7	8.7
Errors and Omissions, including Accounts Payable/Receivables	-0.9	3.5	-1.9	1.2	3.6	0.0	0.0
Current balance (excl. grants)	-11.6	-14.7	-16.1	-16.8	-16.9	-16.6	-15.4
Overall balance	-1.5	-0.9	-5.8	-3.1	-2.9	-2.4	-1.2
Memorandum Item:							
GDP (tousand US\$)	200,300	208,900	211,600	214,300	212,000	218,402	218,402

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

1/ Fiscal year ending September 30.

2/ Includes expenditure measures in the proposed supplementary budget.

3/ Government general fund only.

Table 3. Palau: Balance of Payments, 2004/05-2009/10 1/

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

	2004/05	2005/06	2006/07	2007/08	2008/09 Est.	2009/10 Proj.
Trade balance	-94.1	-101.0	-96.3	-118.5	-91.7	-101.1
Exports, f.o.b.	14.0	14.2	11.3	11.8	11.8	12.3
Imports, f.o.b.	108.1	115.3	107.6	130.3	103.5	113.4
Services account	79.1	73.3	87.7	86.1	89.7	98.4
Receipts	109.0	105.9	119.3	122.6	118.6	130.2
<i>Of which:</i> Travel	102.0	99.4	113.1	116.7	113.0	123.9
Payments	30.0	32.6	31.6	36.5	29.0	31.7
Net income	-29.1	-28.4	-28.4	-28.7	-37.9	-36.5
Receipts	10.0	10.1	11.1	11.8	6.1	8.1
<i>Of which:</i> Compact Trust Fund	4.4	4.2	4.8	4.9	1.4	2.9
<i>Of which:</i> Pension Funds	2.4	2.8	3.6	4.1	3.1	3.1
Payments	39.1	38.5	39.5	40.5	44.0	44.6
<i>Of which:</i> Dividends	34.4	33.5	34.4	34.4	37.4	37.9
Net transfers	6.2	19.0	23.5	22.7	10.9	18.3
Private	-14.3	-13.8	-13.2	-12.3	-12.3	-12.3
Inflows	1.6	1.7	1.6	1.9	1.6	1.7
Outflows	15.8	15.5	14.8	14.2	13.9	14.0
Official	20.4	32.8	36.6	35.0	23.2	30.6
Inflows	20.7	33.5	37.0	35.3	23.4	30.9
Outflows	0.2	0.8	0.4	0.3	0.2	0.3
Current account (includes official grants)	-37.9	-37.2	-13.6	-38.4	-29.1	-20.9
Current account (excludes official grants)	-58.6	-70.7	-50.6	-73.7	-52.5	-51.9
Capital and financial account	34.8	27.3	49.0	41.7	34.3	20.9
Capital account	24.6	26.3	26.1	21.2	22.5	21.5
Financial account	10.3	1.0	22.9	20.5	11.8	-0.6
Portfolio investment, net	-1.6	-1.9	-2.0	3.3	5.1	1.3
Foreign direct investment, net	14.3	4.5	13.2	14.1	3.0	0.7
Other investment, net	-2.4	-1.7	11.6	3.0	3.7	-2.6
Errors and omissions	-3.1	-9.9	35.4	3.3	5.2	0.0
Memorandum items:						
Nominal GDP	200.3	208.9	211.6	214.3	212.0	218.4
Current account (percent of GDP)						
Including official grants	-18.9	-17.8	-6.4	-17.9	-13.7	-9.6
Excluding official grants	-29.3	-33.8	-23.9	-34.4	-24.8	-23.7
External debt (percent of GDP)	29.3	28.2	33.8	35.1	37.7	35.8
International Investment Position (percent of GDP)	-6.0	-2.3	4.1	-27.0	-33.4	-30.2
Assets	129.3	129.7	146.6	121.9	120.8	120.2
Liabilities	135.3	132.0	142.5	149.0	154.2	150.3
FDI	106.0	103.8	108.7	113.9	116.6	114.5
Government debt	10.8	9.8	12.2	11.6	10.7	9.6
Public enterprise debt	16.0	15.4	18.1	19.6	22.6	21.4
Other debt	2.5	3.0	3.5	3.9	4.4	4.7

Sources: PFTAC estimates; Fund staff estimates and projections.

1/ Fiscal year ending September 30.

APPENDIX I. PALAU: UPDATE ON FISCAL SUSTAINABILITY

Drawing on work done during the previous Article IV (in 2008), this appendix updates needed fiscal adjustments for the government to satisfy the intertemporal budget constraint. The following three scenarios are considered: i) a baseline scenario; ii) a scenario with a middle case of oil related revenues; and iii) a scenario with a broader coverage of public liabilities. The results confirm that current fiscal policy is unsustainable, highlighting that a significant fiscal adjustment is required even under the scenario with new oil-related revenues.

A. Framework, Assumptions, and Data

Framework

Closely following the selected issues paper (SIP) for the 2008 Palau Article IV consultation, this appendix judges fiscal sustainability by examining whether government fiscal operations satisfy the intertemporal budget constraint. Specifically, the following equation is adopted as a condition for fiscal sustainability.

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

where W is the government's net worth, and T , R , C , and K are the net present values (NPV) of grants, domestic revenues, current spending, and capital spending, respectively. The commonly assumed rate of return on the Compact Trust Fund works as the discount factor to calculate NPVs. Under this framework, and in correspondence with the authority's own policy goals, the current balance ($R-C$) is chosen as the policy variable. It is set to satisfy the above equation, assuming certain levels of grants and capital spending (see fiscal assumptions below).

Assumptions and data

Medium-term macroeconomic and fiscal assumptions are based on historical data.

- Macroeconomic assumption:⁴
 - Real GDP growth rate: 3 percent
 - Inflation: 2 percent⁵

⁴ These macroeconomic assumptions are the same as those in the SIP for the 2008 Palau Article IV consultation.

⁵ Over the medium term, inflation is projected to moderate to 2 percent in line with the historical average before the period of rising oil prices.

- Real rate of return on the Compact Trust Fund or, more accurately, net financial assets: 6 percent.
- Fiscal assumption:
 - U.S. Compact grants: US\$ 250 mil during FY2010–FY2024 (based on latest available information)
 - U.S. non Compact grants (on budget): about 7 percent of GDP
 - Grants from other countries (on budget): about 4 percent of GDP
 - Capital spending (on budget): 9½ percent of GDP.

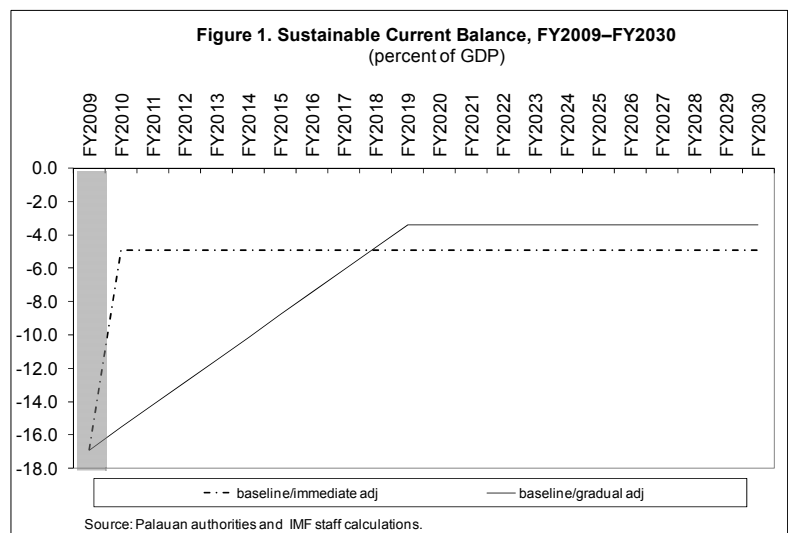
A key exogenous variable is the government’s net worth (W). The government’s net worth consists of the outstanding of Compact Trust Fund, government deposits, government external debt, and government expenditure arrears. As of end-FY2009, the government net worth stood at 55 percent of GDP, with the Compact Trust Fund, deposits, external debt, and arrears, representing 67, 3, 10, and 5 percent of GDP, respectively.

B. Findings

Baseline scenario

This scenario is run with assumptions specified above (only).

- *Immediate adjustment.* Assuming that the adjustment is made all at once in FY2010, the current deficit would need to improve to -5 percent of GDP from -17 percent of GDP in FY2009, confirming that current fiscal policy is unsustainable. Despite the upward revision to historical GDP data, the required adjustment in percent of GDP (12 points) is larger than the corresponding adjustment under the Compact renewal scenario considered in the 2008 SIP (10 points). This is mainly because the assumption about the U.S. Compact grants under the current scenario based on the updated information is less favorable than under the



Compact renewal scenario in the 2008 SIP. The government's net worth stabilizes at 120 percent of GDP—a level about twice as high as the current level.

- *Gradual adjustment.* Assuming that adjustments are made gradually through FY2019 starting in FY2010 (over ten years), the fiscal adjustment needed to achieve fiscal sustainability would be 1.35 percentage points of GDP per year. The cumulative size of adjustment between FY2010–FY2019 is 1½ percentage points larger than the immediate adjustment. The government's net worth broadly stays at the current level (in percent of GDP).
- *Sensitivity analyses.* The results are fairly robust to varying parameter assumptions. The tables below report the required adjustments per year under the gradual adjustment assumption with various combinations of parameter values. The results confirm that a lower rate of return requires a larger adjustment, but also show that reasonable variations in the parameter values have a relatively minor impact on the needed adjustment.

Sensitivity Analysis under Gradual Adjustment				
(Percentage Points of GDP)				
		Real GDP Growth		
		2	3	4
Real Rate of Return	5	1.34	1.41	1.47
	6	1.27	1.35	1.42
	7	1.21	1.29	1.36

		Real GDP Growth		
		2	3	4
Inflation	1	1.26	1.34	1.41
	2	1.27	1.35	1.42
	3	1.29	1.36	1.43

Scenario with a middle case of oil related revenues

The key additional assumption relative to the baseline is the inclusion of oil related revenues of US\$598 mil in NPV terms, from the World Bank's middle case estimate.

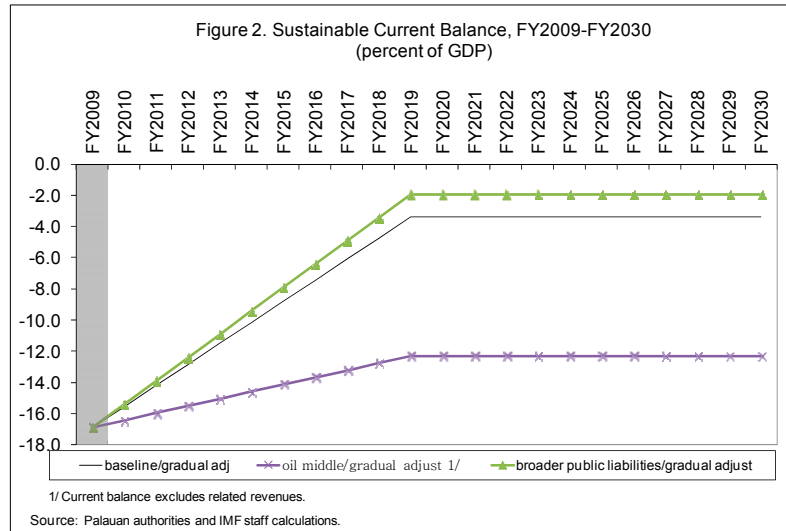
- *Immediate adjustment.* In FY2010, the current (non-oil) deficit would still need to improve to -13 percent of GDP (from -17 percent of GDP in FY2009), although the size of adjustment is much smaller than that in the baseline. This result highlights that current fiscal policy is unsustainable even with substantially more favorable revenue projections than in the baseline. The government's net worth climbs to 400 percent of GDP over the medium term.
- *Gradual adjustment.* To achieve fiscal sustainability by FY2019, the fiscal adjustment of 0.5 percentage points of GDP per year would be enough. The government's net

worth rises to 380 percent of GDP, moderately lower than that under the immediate adjustment case.

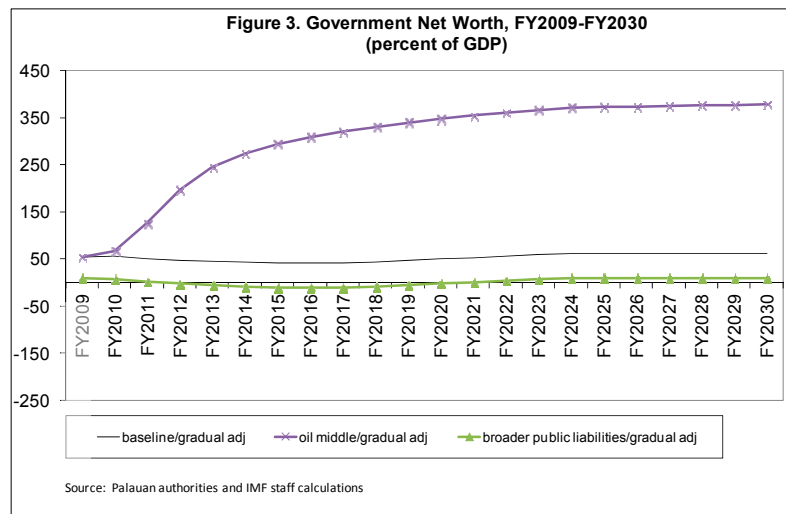
Scenario with a broader coverage of public debt

The following additional assumptions are included relative to the baseline. US\$46 mil of public enterprise debt and US\$50 mil of maintenance backlog are subtracted from the government’s net worth. As a result, the net worth would be only 10 percent of GDP as of end-FY2009.

- Immediate adjustment.* In FY2010, the current deficit would need to improve to -3½ percent of GDP (from -17 percent of GDP in FY2009). The needed adjustment is somewhat larger than that in the baseline, reflecting the lower net worth at the starting period. The government’s net worth gradually rises to 70 percent of GDP from around 10 percent of GDP in FY2009.



- Gradual adjustment.* To achieve fiscal sustainability by FY2019, the fiscal adjustment of 1.5 percentage points of GDP per year would be required. The government’s net worth converges towards 10 percent of GDP over time, following an initial decline owing to large current deficits.



INTERNATIONAL MONETARY FUND

REPUBLIC OF PALAU

Staff Report for the 2010 Article IV Consultation—Informational Annex

Prepared by the Asia and Pacific Department

April 12, 2010

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ANNEX I. PALAU: FUND RELATIONS
(As of March 11, 2010)

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

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

III. SDR Department:	SDR Million	%Allocation
Net Cumulative Allocation	2.96	100.0
Holdings	2.96	100.0

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 February–March 2008. The Executive Board discussed the staff report, Country Report No. 08/161 and concluded the consultation on April 30, 2008. 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, June 2006
	Tax reform and strengthening tax administration	November 2007, September 2008

	Public expenditure management	January 2007, February 2007
	Fiscal management	March 2007
	Budget process and formulation	January 2007, March 2008
	Cash planning	February 2009, July 2009, November 2009
LEG	Preparation of a new tax code	October 1998
	Banking legislation (together with MFD)	April 2002
	Anti-money laundering legislation	February 2004
	Joint AML/CFT assessment	March 2008
MFD/ MCM/ PFTAC	Establishment of bank supervision functions	October 2000
	Banking law and regulations	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
	Bank supervision: issues related to failure of Pacific Savings Bank	May 2006, November 2006
	Financial sector supervision	April 2007
	Banking supervision advisor to aid with on-site examination	October 2007–November 2007
	Banking supervision advisor to aid in drafting new banking regulations	January 2008
	Banking supervision advisor to aid in preparation of new prudential reporting requirements for banks	January 2009

Baking supervision advisor to aid in preparation of off-site monitoring system and on-site examination August 2009

STA/
PFTAC National accounts statistics development and estimation December 2003, April 2004, October 2005, June 2006, May 2007, September 2008, October 2009

Balance of payments statistics development June 2009

XI. Resident Representative: None.

ANNEX II. PALAU: RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE (PFTAC)¹

The Centre's assistance since 2000 has included 35 advisory missions, the participation of officials in seminars (32) and secondments mostly in the tax administration area (10).

Public Financial Management

Palau did not request explicit technical assistance (TA) in this area from 2003 to 2006, but joined the newly-organized Pacific Financial Managers' Association (PIFMA) in 2006 and hosted the Third PIFMA meeting at Koror in March 2008. PFTAC provided assistance in revenue estimation and in developing the Financial Instructions (FIs) in 2007. This was followed by training on the newly developed FIs in early 2008. Assistance was also provided in November 2009 on setting up a cash planning system in all line ministries. Discussions are underway now to assist the government in taking forward the medium-term budgeting project being discussed with the Asian Development Bank (AsDB).

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. In mid-2006, a tax administration mission visited Palau to review the organizational structure of the Division of Revenue and Taxation, and its operations. In 2007, a tax reform and administration mission visited Palau. In respect of short-term revenue shortfalls, arising from the 2008 budget, advice was given on improving the effectiveness of the tax administration in tackling the high levels of non compliance, policy advice on 19 different short-term revenue raising options and longer-term reform. In September 2008, the Minister of Finance requested the mission focusing on improving domestic revenues. In November 2008, a risk management compliance plan was developed and staff were to understand the concepts and processes to implement the plan. A follow-up mission is planned for 2010.

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). Subsequently, assistance was provided primarily

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

through the use of peripatetic advisors, although three missions were undertaken during 2006 and 2007 by the PFTAC advisor to provide guidance and recommendations on receivership matters relating to the failure of Pacific Savings Bank. As a result of recommendations by the peripatetic advisors, and likely in response to the recent failure of Pacific Savings Bank, needed amendments to the Financial Institutions Act were approved in February 2008. During 2008 and 2009, the PFTAC advisor was involved in three missions to Palau. These missions involved providing assistance in finalizing regulations for implementing the revised banking law (which have subsequently been issued), drafting and implementing comprehensive prudential reporting requirements for banks and providing training and assistance in the conduct of an on-site bank examination. Additional missions are planned by the PFTAC advisor to provide assistance and training in off-site monitoring and to further the capacity of the staff in bank supervision and on-site bank examination skills.

Economic and Financial Statistics

PFTAC has provided significant statistics technical assistance to the Office of Planning and Statistics (OPS) in Palau since 2003, partly due to the high turnover of statistics staff. Several missions have been undertaken and PFTAC has sponsored statistical staff for secondments and to attend regional training courses. The PFTAC statistics advisor undertook missions to Koror in December 2003 and in April 2004 to assist the authorities in documenting and improving the system of national accounts statistics (NAS) and with finalization of the GDDS metadata.

In October 2005, the PFTAC statistics advisor assisted the authorities in revising NAS for 2001–05. Follow-up national accounts missions were undertaken as follow: June 2006 to provide further NAS training for OPS staff; May 2007 to help finalize GDP estimates up to 2006; September 2008 to update NAS to 2007 and to produce experimental estimates of national income and disposable income; and October 2009 to implement further improvements in the NAS methodology, as well as to update the estimates to 2008. New saving and net lending/borrowing estimates were also produced during that mission. Counterparts were involved in the NAS development work and updating of estimates, and were provided on-the-job and seminar-based training during each NAS mission. One NAS statistician participated in a PFTAC half-funded secondment on data editing at Statistics New Zealand in April 2007, while another NAS statistician participated in the NAS Training Seminar conducted by PFTAC in Nadi in July 2009.

The PFTAC statistics advisor also provided assistance to OPS counterparts in improving data sources and compilation methods for balance of payments (BOP) statistics during his September 2008 and October 2009 missions. In addition, the BOP compiler participated in a one-month PFTAC funded secondment on BOP statistics at Statistics New Zealand in May 2009 and a short-term expert mission to assist with improving BOP statistics was undertaken in June 2009. A follow-up BOP mission is planned for later in 2010.

ANNEX III. PALAU: RELATIONS WITH THE WORLD BANK GROUP²

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

The Pacific Regional Strategy directs the Bank's work in Palau. It focuses on creating an environment conducive to generating sustainable economic growth and employment, while recognizing that small populations and the marked remoteness of the Pacific island countries pose significant development challenges to the region. The country strategy includes technical assistance to the government to prepare primary and secondary legislation for petroleum exploration, development, and production activities, following on from earlier work to aid Palau in developing its oil and gas sector policy. The World Bank is also providing assistance in designing Palau's revenue and distribution policy with the aim of supporting the development of the relevant regulatory instruments. To this end, the Bank prepared a report on the macroeconomic implications and related policy options and tools for the management of petroleum revenues to facilitate consensus building across levels of government.

As part of a broader effort to deepen engagement with Palau and other World Bank Group members in the North Pacific, the World Bank has recently assigned a Senior Economist based in Washington, D.C. to work with the government and outline a substantive program of technical assistance. Under this initiative, the World Bank has begun to develop a broad development agenda in the North Pacific, including in the areas of growth and development strategies, institutional strengthening, expenditure policy, and public finance management. The World Bank has also been asked to support the development of the National Development Plan alongside the AsDB.

The *Doing Business 2010*, is the seventh in a series of annual reports investigating the regulations that enhance business activity and those that constrain it. Doing Business ranks Palau based on 10 indicators of business regulation that record the time and cost to meet government requirements in starting and operating a business, trading across borders, paying taxes, and closing a business. Palau was ranked 97 overall out of the 183 economies surveyed for the 2010 report, which covered the period from June 2008 through May 2009.

Palau is an International Bank for Reconstruction and Development (IBRD)-eligible country.

² Prepared by World Bank staff (as of February 2010).

ANNEX IV. PALAU: RELATIONS WITH THE ASIAN DEVELOPMENT BANK³

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

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

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

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

³Prepared by AsDB staff (as of March 2010).

Indicative Assistance Pipeline for Lending Products and Services, 2009–2010

Item	Targeting Classification	Cost (\$ million)							
		Total	ADB					Gov't.	Cofinancing
			OCR	ADF		Total			
				Loans	Grants				
Year Tentative Loans									
2009									
	Babeldaob Water Supply Project	16.16	14.20	1.80		16.00	0.16		
	Total	16.16	14.20	1.80		16.00	0.16		
2010									
		–	–	–	–	–	–	–	

ADB = Asian Development Bank, ADF = Asian Development Fund, EIB = European Investment Bank, ENV = Environmental Sustainability, Gov't = Government, ISD = Inclusive Sustainable Development, OCR = ordinary capital resources, PAHQ = Pacific Operations Division, WFPF = Water Financing Partnership Facility.

Source: Asian Development Bank estimates.

Indicative Assistance Pipeline for Nonlending Products and Services, 2009–2011

Sector Assistance Name	Responsible Division	Sources of Funding				Total (\$'000)
		ADB		Others		
		Source	Amount (\$'000)	Source	Amount (\$'000)	
2007						
Public Sector Management						
Facility for Economic and Infrastructure Management	PAHQ	JSF	1000		–	1000
Water Supply and Other Municipal Infrastructure and Services						
Preparing the Babeldaob Water Supply	PAHQ	JSF	600		–	600
2008						
Public Sector Management						
Development of a Sustainable Health Financing Scheme	PAHQ	JSF	400		–	400
2009						
Public Sector Management						
Implementing a Medium Term Budget Framework	PAHQ	TASF	500		–	500
2010						
Water Supply and Other Municipal Infrastructure and Services						
Preparing the Sanitation Sector Development Project	PAHQ	JSF	700		–	700
Water Supply and Other Municipal Infrastructure and Services						
Water Supply and Sanitation Utility Strengthening Project	PAHQ	TBC	500		–	500
2011						
Public Sector Management						
Public Sector Reform Facility	PAHQ	TASF	1,000		–	1,000
Total			4,700		–	4,700

ADB = Asian Development Bank, C = Cluster, CDTA = capacity development technical assistance, CEF = Clean Energy Fund, JSF = Japan Special Fund, PAHQ = Pacific Operations Division, PPTA = project preparatory technical assistance, R = Regional, TASF = Technical Assistance Special Fund, TBC = to be confirmed.

Regional Assistance Accessible by Palau (2009)⁴

Sector Assistance Name	Sources of Funding				Total (\$'000)
	ADB		Others		
	Source	Amount (\$'000)	Source	Amount (\$'000)	
2009					
Education					
Skilling the Pacific Implementation	TASF	600		–	600
Energy					
Promoting Access to Renewable Energy in the Pacific	–	–	CEF	3,000	3,000
Multisector					
Establishment of the Pacific Infrastructure Advisory Centre	–	–	AusAID	1,800	1,800
Supporting ADB's Engagement in Fragile Situations	TASF	750		–	750
Strengthening the Capacity of Pacific DMCs to Respond to Climate Change	TASF & CCF	3,500		–	3,500
Public Sector Management					
Pacific Economic Management	TASF	3,000		–	3,000
Private Sector Development Initiative, Phase II	JSF & TASF	4,500	AusAID	6,500	11,000
Transport and Communication					
Pacific Regional ICT Development	–	–	GoK	500	500
Total		12,350		11,800	24,150

AsDB = Asian Development Bank, AusAID = Australian Agency for International Development, C = Cluster, CDTA = capacity development technical assistance, CEF = Clean Energy Fund, GoK = Government of Korea, ICT = Information and Communication Technology, JSF = Japan Special Fund, PAHQ = Pacific Operations Division, PATA = policy advisory technical assistance, PLCO = Pacific Liaison and Coordination Office, PPTA = project preparatory technical assistance, R = Regional, TASF = Technical Assistance Special Fund.

⁴ The figures in this table are the total value of the assistance not the value of assistance to Palau.

ANNEX V. PALAU—STATISTICAL ISSUES
As of March 11, 2010

I. Assessment of Data Adequacy for Surveillance	
General: Data currently available have some shortcomings, but are broadly adequate for surveillance. Recently, historical data in a few areas have shown significant improvements. However, the authorities' capacity to compile statistics on national accounts, prices, government finance, and balance of payments is deteriorating due to the substantial reduction in the number of staff in the Bureau of Budget and Planning. Going forward, the lack of staff, if not addressed, would impede effective surveillance. The authorities have started recruitment of new staff.	
National Accounts: With PFTAC's assistance, production-based GDP estimates through FY2009 have been significantly improved. Expenditure-based GDP data have been estimated at the same time. These estimates are about 30–40 percent higher in levels than the authorities' official figures, as under-estimation has been corrected across sectors. The authorities have not yet adopted the new estimates as their official GDP numbers. Despite the improvements in historical data, the authorities' capacity to produce consistent estimates of the national accounts will likely remain weak, unless the under-staffing problem is resolved.	
Price statistics: A consumer price index has been compiled since 2000 on a quarterly basis, but reported irregularly. The index has not been compiled since mid-2009.	
Government finance statistics: General government fiscal data are compiled as part of the annual budgetary process. The authorities provide fiscal data to the Fund in a standard Fund-format usable for analysis, but data quality and timeliness is deteriorating due to the loss of institutional memory and under-staffing.	
Monetary statistics: Monetary statistics have significantly improved. Previously, balance sheet data were not regularly provided by banks to the authorities because they were not legally required to do so, and hence the banks only filed quarterly tax forms to the Ministry of Finance. Since Q3 2009, banks have been required to submit detailed financial statements every quarter, including balance sheets and profit and loss statements, to the Financial Institutions Commission.	
Balance of payments: Together with national accounts statistics, balance of payments estimates have been upgraded through FY2008 with the help of PFTAC. The authorities' compilation capacity is weak, and will likely remain so without additional staff.	
II. Data Standards and Quality	
Does not participant in the General Data Dissemination System (GDDS).	No data ROSC available.
III. Reporting to STA (Optional)	
No data are currently reported to Statistics Department for publication in the <i>Government Finance Statistics Yearbook</i> , the <i>Balance of Payments Statistics Yearbook</i> , or the <i>International Financial Statistics</i> .	

Palau: Table of Common Indicators Required for Surveillance
As of March 11, 2010

	Date of latest observation (For all dates in table, please use format mm/dd/yy)	Date received	Frequency of Data ⁷	Frequency of Reporting ⁷	Frequency of Publication ⁷	Memo Items: ⁸	
						Data Quality – Methodological soundness ⁹	Data Quality – Accuracy and reliability ¹⁰
Exchange Rates (U.S. dollar is official currency)	NA	NA	NA	NA	NA		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	NA	NA	NA	NA	NA		
Reserve/Base Money	NA	NA	NA	NA	NA		
Broad Money	NA	NA	NA	NA	NA		
Central Bank Balance Sheet	NA	NA	NA	NA	NA		
Consolidated Balance Sheet of the Banking System	NA	NA	NA	NA	NA		
Interest Rates ²	NA	NA	NA	NA	NA		
Consumer Price Index	06/30/09	07/31/09	Q	I	I		
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	09/30/09	02/19/10	A	I	I		
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	09/30/09	02/19/10	A	I	I		
Stocks of Central Government and Central Government-Guaranteed Debt	09/30/09	02/19/10	A	I	NA		
External Current Account Balance	09/30/08	10/30/10	A	I	I		
Exports and Imports of Goods and Services	09/30/08	10/30/10	A	I	NA		
GDP/GNP	09/30/09	11/06/09	A	I	I		
Gross External Debt	09/30/09	02/19/10	A	I	NA		
International Investment Position ⁶	09/30/09	02/19/10	A	I	NA		

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

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

³ Foreign, domestic bank, and domestic nonbank financing.

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

⁵ Including currency and maturity composition.

⁶ Includes external gross financial asset and liability positions vis-à-vis nonresidents.

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

⁸ These columns should only be included for countries for which Data ROSC (or a Substantive Update) has been published.

⁹ Reflects the assessment provided in the data ROSC or the Substantive Update (published on ..., and based on the findings of the mission that took place during...) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).

¹⁰ Same as footnote 9, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 10/60
FOR IMMEDIATE RELEASE
May 14, 2010

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

IMF Executive Board Concludes 2010 Article IV Consultation with Palau

On April 28, 2010, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Republic of Palau.¹

Background

The global financial crisis, compounded by some Palau-specific shocks, has taken a heavy toll on the island nation. Foreign direct investment (FDI) contracted as many foreign firms lost access to financing. Tourism accounting for almost half of GDP fell by a cumulative 17 percent over the last two years owing in large parts to the bankruptcy of a Taiwanese airline. And, foreign capital grants and public investment contracted as major infrastructure projects, like the construction of the Compact road and its feeder roads, were completed.

Monetary conditions have tightened in the wake of the global downturn. Foreign bank branches, which account for about 95 percent of banking sector assets, are flush with liquidity. However, foreign bank branches have tightened credit standards, reflecting a reassessment of risks at headquarters and Palau-specific concerns about household debt. As a result, private credit contracted by 20 percent in FY2009 (October-September).

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

Palau's external position deteriorated as oil prices spiked and overseas investments sustained major valuation losses. In FY2008, the current account (including grants) deteriorated by about 10 percentage points of GDP to -18 percent of GDP. While it has recovered somewhat since then, external debt continued to increase and reached a record 38 percent of GDP in FY2009. Palau's external assets, namely pension funds and the Compact trust fund lost about 15 percent of their value since the financial crisis. Taken together, Palau's international investment position (foreign assets minus foreign liabilities) fell from 4 percent of GDP in FY2007 to -33 percent of GDP in FY2009.

Fiscal policy continues to be loose and the liquidity situation is becoming serious. Domestic revenue fell and current spending rose over FY2008–FY2009, leading to a further deterioration in the current balance (domestic revenue minus current expenditure). The current balance has been worsening since FY2005, despite the medium-term policy goal of a zero current balance. In addition, revenues and grants have not been sufficient to finance expenditures, as evidenced by a steady drawdown of government deposits.

The short-term outlook remains clouded, with growth projected to turn only slightly positive in FY2010. Tourist arrivals and FDI should pick up in FY2010 along with the recovery in global growth and financial conditions. However, little stimulus is expected from public infrastructure projects and oil prices are projected to rise by 35 percent between FY2009 and FY2010. Downside risks include higher than expected oil prices, fewer grants as donor countries struggle with tighter finances, and a double dip in global growth, which would affect tourism. On the upside, an expansion of flight schedules could lead to an increase in tourism.

Executive Board Assessment

Executive Directors noted that, in the wake of the global crisis, the Palauan economy had been hit by sizable domestic and external shocks, which contributed to a large contraction. Directors commended the authorities for steering Palau through these turbulent times. While near-term prospects have improved, many challenges remain however to be tackled to consolidate the recovery and sustain growth.

Directors observed that ensuring a sustainable fiscal position remains the most important challenge confronting Palau. They welcomed recent steps to strengthen fiscal policy such as the tax measures currently before Congress, and encouraged further efforts to protect the government's cash position and advance toward the authorities' goal of self sufficiency.

Directors underscored that gradual fiscal adjustment will be necessary over the medium term to prevent a sharp correction once U.S. Compact grant assistance ends in 2024. This would be achieved through the passage of all the revenue measures currently before Congress and

additional spending restraint. They welcomed recent efforts to improve the budget process as a precondition for fiscal discipline. Looking forward, the adjustment would require a comprehensive tax reform as well as civil service reform. Directors recommended a conservative approach to possible future oil and gas revenues in the formulation of fiscal policy. They welcomed the authorities' work on strengthening the fiscal and legal frameworks for managing such revenues, and encouraged them to continue drawing on technical assistance from the World Bank.

Directors welcomed the authorities' efforts to streamline the FDI regime, including the FDI bills currently before Congress, to generate new sources of revenues and growth as fiscal consolidation proceeds. They noted that higher labor fees for foreign investors and lower minimum wages for foreign workers continue to impede FDI and employment generation for Palauans.

Directors supported the continued use of the U.S. dollar as legal tender, given Palau's small size and administrative capacity. They observed that Palau has maintained its external competitiveness, but remains vulnerable to terms of trade shocks. Greater pass-through of global oil prices to contain debt accumulation in public utilities would therefore be desirable. Directors welcomed continued improvements in financial sector oversight, but urged caution in proceeding with the plans to launch a corporate and ship registry, which could pose new challenges in fighting money laundering given Palau's current oversight capacity.

Directors noted that high-quality data are essential for policy formulation and surveillance. They looked forward to the adoption of the GDP numbers compiled with the help of the Pacific Financial Technical Assistance Center and to the increase in staffing levels at the Bureau of Budget and Planning.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The [staff report](#) (use the free [Adobe Acrobat Reader](#) to view this pdf file) for the 2010 Article IV Consultation with Palau is also available.

Palau: Selected Economic Indicators, 2004/05–2009/10 1/

	2004/05	2005/06	2006/07	2007/08	2008/09 Est.	2009/10 Proj.
Real sector						
Real GDP growth (percent change)						
Official estimates	5.5	3.0	2.5
PFTAC estimates 2/	4.7	-3.7	-0.5	-4.9	-2.1	1.0
GDP deflator (percent change) 3/	4.0	8.3	1.8	6.5	1.1	2.0
Consumer prices (percent change; period ave.)	3.2	4.8	3.0	10.0	6.1	6.0
Business and Tourist arrivals	85,004	79,823	87,142	81,123	73,365	78,055
Public finance						
	(In percent of official GDP)					
Central government						
Revenue	37.6	39.4	42.2	38.9	38.3	41.2
Domestic revenue	19.8	18.3	18.1	18.5	17.8	18.3
Grants	17.8	21.1	24.1	20.4	20.5	22.9
Expenditures	38.2	43.8	46.1	43.1	44.8	42.4
Current	31.4	32.9	34.2	35.3	34.7	33.7
Capital	6.8	10.9	11.9	7.8	10.1	8.7
Current balance (excluding grants) 4/	-11.6	-14.7	-16.1	-16.8	-16.9	-15.4
Overall balance (excluding grants) 5/	-19.3	-22.0	-29.9	-23.4	-23.4	-24.1
Overall balance (including grants) 5/	-1.5	-0.9	-5.8	-3.1	-2.9	-1.2
	(In millions of U.S. dollars; unless otherwise indicated)					
Compact Trust Fund (CTF) balance 6/	152.5	157.0	176.4	147.8	142.0	...
Interest income and capital gains/losses	16.8	10.4	25.4	-22.6	0.2	...
Interest fees and withdrawals	5.9	5.9	6.0	6.0	6.0	6.0
Government non-CTF financial assets	9.8	11.8	9.9	11.5	8.3	5.0
Balance of payments						
Trade balance	-94.1	-101.0	-96.3	-118.5	-91.7	-101.1
Exports (f.o.b.)	14.0	14.2	11.3	11.8	11.8	12.3
Imports (f.o.b.)	108.1	115.3	107.6	130.3	103.5	113.4
Tourism receipts	102.0	99.4	113.1	116.7	113.0	123.9
Current account balance						
Including grants	-37.9	-37.2	-13.6	-38.4	-29.1	-20.9
Excluding grants	-58.6	-70.7	-50.6	-73.7	-52.5	-51.9
International Investment Position	-12.0	-4.7	8.8	-57.9	-70.8	-65.9
Assets	259.0	270.9	310.3	261.3	256.2	262.5
Liabilities	271.0	275.6	301.5	319.2	327.0	328.4
Of which: external debt	58.8	58.9	71.5	75.1	79.8	78.2
	(In percent of GDP)					
Current account balance						
Including grants	-18.9	-17.8	-6.4	-17.9	-13.7	-9.6
Excluding grants	-29.3	-33.8	-23.9	-34.4	-24.8	-23.7
International Investment Position	-6.0	-2.3	4.1	-27.0	-33.4	-30.2
Of which: external debt	29.3	28.2	33.8	35.1	37.7	35.8

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

1/ Fiscal Year ending September 30.

2/ IMF staff projection for 2009/10.

3/ PFTAC and staff estimates.

4/ Defined as domestic revenue minus current expenditure.

5/ Including errors and omissions.

6/ As of end-year.

**Statement by Hi-Su Lee, Executive Director and Teea Tira, Advisor to the
Executive Director**

April 28, 2010

Background

Our Palauan authorities thank the staff for their frank assessment of the developments in the economy and the constructive exchange of views during the Article IV consultation. The dialogue was greatly enhanced by the joint presence of the World Bank and ADB.

A decline in domestic activity following on the heels of the global crisis hit Palau's economy hard, resulting in a cumulative economic contraction of 7 percent since 2008. A drop in foreign direct investment (FDI), completion of major infrastructure projects such as the compact road and a fall in tourism all contributed to the decline in economic growth. Sustainable growth in the medium and long-term will hinge on prudent fiscal policy, liberalization of the FDI regime as well as oil and gas exploration.

Compact Fund Agreement

The authorities appreciate the continued support from the international community, in particular from the U.S. Since the last Article IV consultation, negotiation of the compact grant funding has been the authorities' topmost priority and they look forward to the finalization of the negotiation in the upcoming weeks. Conclusion of a favorable compact fund agreement will give them breathing space to concentrate further on the necessary fiscal adjustments.

Fiscal Policy

The current administration came into power in January 2009 facing a very weak economy, uncertainty surrounding compact grant funding, and major losses in the compact trust fund (CTF). It was a significant turning point for the authorities, strengthening their determination to avoid repetition of the situation they faced in FY 2008/2009 of contemplating too large an adjustment within a very short-time period. The authorities maintain the long standing desire, shared by most Palauans, to lessen their dependency on external assistance notably the compact grant fund and to pursue their underlying objective of self-sufficiency.

The authorities see merit in staff recommendation of a gradual fiscal adjustment, though they feel that the key issue in this context is the timing and implementation of the adjustment. As such, the authorities believe that a clear and credible medium-term strategy would be beneficial and are open to further technical assistance in this area.

Short-term measures

In the short-term, the authorities do not agree that an immediate reduction of 1 percent of GDP in expenditure is warranted, given the current weak economic environment. However, the authorities do see scope for a more measured mix of revenue and expenditure adjustments measures, weighted towards increasing tax revenues. As such, the authorities have submitted for Congressional approval measures to eliminate food import duty exemptions and a hike of the wage and salary tax for top earners. These measures are politically difficult, especially at a time when most Palauans are feeling the effects of higher commodity prices. Though inflation has been contained compared with previous years, the price of essential goods remains high compared to prior the global economic crisis. As a step towards reducing expenditure, the authorities have started with reducing the number of schools seeing the rationale to streamline government provided education services.

Medium to Long-term measures

In recognition that an adjustment will need to occur to close the gap between projected expenditure and revenue, the authorities will continue to explore ways and means of increasing revenue and containing expenditure. On the revenue side, they are working towards further expanding the tax base through refinement of the existing FDI regime and increasing tax measures on visitors/foreigners. Part of the tax measures have already been implemented through increasing departure tax on visitors and further consideration of environment-related taxes. In respect of the oil and gas exploration, the authorities concur with staff that, while it is too early to rely on potential oil revenues when deriving medium-term adjustment needs, these will need to be taken into consideration as the project progresses.

On the expenditure side, the authorities consider proper reallocation of resources across the public sector as a means of exercising greater restraint on current expenditure as well as addressing the issue of under-staffing in key areas. The authorities see value in expenditure rationalization as a means of reducing and enhancing further the quality of government expenditure. However, their limited capacity in respect of the required skills needed to carry out such an exercise without necessarily disrupting government key services is a constraining factor. They are open to assistance in this area.

Budget and Liquidity Issue

The authorities acknowledge that the liquidity issue is of critical importance in light of the fact that stocks of arrears brought forward from previous years are competing for the same pool of financing resources as government operations. Such arrears are due to domestic suppliers and are currently being settled from domestic revenue collected within the current period. The authorities have made efforts to ensure that the level of arrears remains stable, and agree with staff that it highlights the importance of further enhancing budget management processes. The authorities would like to clear the arrears through either:

- possibly frontloading of the compact grant or,

- restructuring the arrears – though this is relatively difficult given the arrears are from domestic suppliers who require immediate repayment in order to maintain their business activities or,
- securing external assistance in the form of a loan to clear the arrears and allow for a more long-term and structured repayment schedule. The authorities are contemplating ADB assistance in this respect.

In all three options, the authorities will require a credible plan of action that supports domestic economic activity whilst at the same time preventing further accumulation of arrears. In this context the authorities view further enhancement of the budget management processes as critical with the potential assistance from the ADB to include revenue and spending plans that ensure sufficient room to make repayments on the restructured debt.

Structural Policy and Growth

Efforts have been made by the authorities in addressing the long standing issue of land tenure, an impediment to private sector growth common across most of the Pacific islands. A 2008 referendum approved the extension of land lease agreements for foreign investors to 99 years from the previous 49 along with the introduction of resident visa aimed at increasing certainty to foreign investment.

There is still a lot of work to be done in improving the business environment not just for foreign investors but also for the local investors. In respect of FDI, the legislature is expected to review several bills, all of which intend to streamline the existing regime replacing it with a rules based approach that is much less arbitrary and cumbersome. The authorities agree that further refinement of the FDI regime will be necessary and will take into consideration staff recommendation. Clarification of land issues such as ownership, zoning laws and land use will also need to progress along with labor and immigration issues.

In working on improving the business environment, the authorities see value in strengthening select productive sectors such as agriculture, tourism and fishing.

The tourism industry remains a lynchpin of economic growth but was impacted to a certain extent by the global economic crisis with various developments funded by foreign investors put on hold and tourism numbers declining. The authorities feel that, as the global economy picks up, such projects would resume as well as expansion of flight services and market sources will assist in boosting this sector. Nevertheless, the authorities will continue to market Palau towards a specific niche market particularly high-end tourism as a means of maintaining the balance between increasing growth in this sector and preserving their pristine environment.

Development of the fishing and agricultural sector form part of the authorities' long-term objectives. In respect of the fishing sector, they aim to build on the outcomes of the regional collaboration, Parties to the Nauru Agreement (PNA), on managing the regional fish-stock as a means to capture a higher share of fishing profits. In respect of the

agriculture sector, the authorities see value in cultivating and putting to good use idle land. They have noted what is happening in neighboring countries where local produce are substituting imported items and would like to explore further such options.

Exploration of Oil and Gas

The authorities concur with staff that a fiscal and legal framework is key to ensuring maximum returns to the nation as a whole from the potential oil and gas revenues. As such the authorities have a taskforce in place overseeing the oil and gas project. Membership is drawn from relevant stakeholders including the government (chair), the legislature and private sector. With relatively broad representation, the authorities feel that the proposed fiscal and legal framework will gain wide support and express appreciation for the technical assistance (TA) by the World Bank in this area.

Data and Staffing

The authorities acknowledge the need to strengthen the statistics, budget and planning office and advised that they are currently consulting with an overseas firm that will provide long-term TA for the statistics office. They see merit for a locally based consultant set up at key offices such as Statistics to not only build up the quality of the existing data but to also build up staff capacity so that in future years there is a readily available domestic pool of the required skills. They also request that they be given more time to review the GDP numbers before formally adopting them.

Anti-money Laundering

The AML/CFT legal framework was upgraded with the help of the Pacific Anti-Money Laundering Program. In addition, further resources have been put into the Financial Intelligence Unit with a strategic move to the Attorney General's office as a means of maximizing use of limited resources. The authorities note staff concern but do not agree that setting up a ship and corporate registry would undermine the efforts underway on strengthening the anti-money laundering framework. They are currently reviewing what other countries within the region have accomplished in this respect and will build on their experiences in setting up a proper framework for a ship and corporate registry. They consider that revenue earned from such a venture can be utilized to build the required capacity and add to their efforts to strengthen oversight in all sectors.

Conclusion

Our Palauan authorities appreciate the recent Article IV consultation and interim staff visits. Bearing in mind the challenges that they face, they remain committed to undertaking the required policy and reform efforts necessary for long-term sustainable growth. They also intend to work closely with the Fund through its technical assistance programs.