

Republic of Palau: 2003 Article IV Consultation—Staff Report; and Public Information Notice 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 2003 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 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **November 19, 2003**, 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 February 5, 2004.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its February 27, 2004 discussion** of the staff report that concluded the Article IV consultation.

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

Selected Issues and Statistical Appendix

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INTERNATIONAL MONETARY FUND

REPUBLIC OF PALAU

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for the
2003 Consultation with the Republic of Palau

Approved by Masahiko Takeda and Anthony Boote

February 5, 2004

- Discussions were held in Koror during November 6–19, 2003. The staff team comprising Messrs. Wang (Head, PDR), Bhundia, and Ms. Iakova (both APD). Mr. Leruth (PFTAC) overlapped with the mission during November 8–15. Mr. Francis (OED) participated in part of the discussions.
- The team met with President Remengesau, National Congress Speaker Gulibert, Finance Minister Sadang, other officials, and representatives of the private sector and donor community.
- The mission conducted outreach activities (seminars and roundtables) with parliamentarians and private sector representatives on fiscal consolidation, private sector development, and financial sector reform.
- Republic of Palau (Palau) is on a 24-month consultation cycle. The last Article IV consultation was concluded in January 2002.
- Palau has accepted the obligations of Article VIII, Section 2, 3, and 4, and maintains an exchange system free of restrictions on payments and transfers for current and capital international transactions.
- The principal author of this report is Mr. Wang.

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EXECUTIVE SUMMARY

- **The Republic of Palau is a small island economy, heavily dependent on tourism and external assistance.** Grant flows have been substantial, averaging over 30 percent of GDP in recent years but the large U.S. assistance will fall from 2009 under the present arrangements. Under the Compact agreement, large disbursements of grants have been made since mid-1990s to build basic infrastructure and create a Compact Trust Fund (CTF) to enable Palau to become self-sustainable.
- **Economic growth over the past few years has been modest,** reflecting the adverse impact of various external shocks which affected tourism, as well as the lack of progress in fiscal consolidation and reforms for private sector development. Palau has recorded large fiscal imbalances in recent years, despite some reductions in current non-wage expenditures, and the government's usable reserves have been exhausted. Palau's government expenditure, particularly the public sector wage bill, has remained one of the highest among Pacific island countries.
- **The FY2004 budget, as adopted by Congress, implies a fiscal deficit that will be substantially larger than available financing.** While the authorities agreed to take measures, including the implementation of their cost reduction plan to contain public sector personnel and operating costs, to close the financing gap and prevent the re-emergence of domestic arrears, much more remains to be done.
- **Over the medium term, the authorities recognized that substantial fiscal consolidation will have to be implemented for a smooth transition to the post-Compact future.** This will include seriously pursuing public sector reform to downsize the public sector and hence the wage bill, significantly reducing the need for withdrawals from the CTF, and generating fiscal surpluses to rebuild the government's usable reserves in the run-up to 2009. It is in the long-term interest of Palau to preserve the real per capita value of the CTF after 2009.
- **Strong private sector growth is also needed to reduce dependence on foreign assistance.** The government's structural reform agenda, as contained in its Management Action Plan, needs to be implemented to remove impediments to private sector development, particularly in the areas of privatization, foreign investment, land ownership, and banking.
- **Despite recent progress in anti-money laundering efforts, banking supervision and regulation remain lacking.** Additional actions are required to improve the regulatory framework and develop implementation capacity.

I. INTRODUCTION

1. **The Republic of Palau is a small island economy, heavily dependent on tourism and external assistance.** Although per capita GDP is relatively high (about \$6,000), with a population just under 20,000, Palau faces many development constraints common among other Pacific island countries, including a small domestic market, limited supply of skilled labor, inadequate infrastructure, geographical isolation, and vulnerability to external shocks. The government sector has remained large, accounting for over one-third of total employment in recent years. The U.S. dollar is legal tender and the official currency.

2. **Palau benefits from substantial U.S. assistance, but this may well fall from 2009.** After independence, Palau entered in 1994 into a free association with the United States under a 50-year Compact of Free Association (COFA), which provides 15 years of grant assistance. Large disbursements were made upfront to build basic infrastructure and to create a Compact Trust Fund (CTF) to enable Palau to become self-sustainable after cessation of Compact funding (Box 1). In recent years, grants from the United States have averaged about \$24 million or 20 percent of GDP per annum, financing primarily government operations. In addition, the United States has provided off-budget in-kind grants for a major road project. Palau has also received large in-kind (off budget) and cash grants from Japan and Taiwan Province of China for infrastructure projects.

3. **In concluding the last Article IV consultation, Executive Directors commended Palau's new administration for reinvigorating the reform process.** They welcomed the legislative initiatives aimed at public sector reform and removing impediments to economic growth but noted several challenges facing Palau including sluggish growth performance. In particular, they urged the authorities to undertake further fiscal consolidation, with the objective of achieving a balanced budget by FY2005 and to prepare for the scheduled end of current Compact funding provisions in FY2010. They encouraged the authorities to press ahead with structural reforms in order to build the basis for sustainable growth. The authorities broadly agreed with this reform agenda but implementation since 2001 has encountered difficulties including resistance in the legislative process. The government has proposed some reforms in key areas, which have not yet been adopted by Congress.

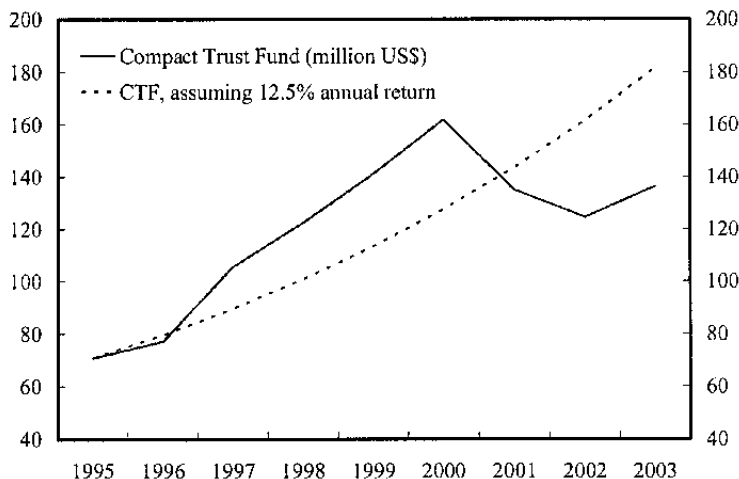
II. RECENT ECONOMIC DEVELOPMENTS

4. **Based on limited available data, real GDP is estimated to have grown by an average of 2 percent per year since 2000** (Table 1 and Figure 1). The modest economic growth over the past few years reflected the adverse impact of various external shocks which affected tourism, a major source of income for the country. There was solid growth in construction, including in foreign-funded public projects, but this had relatively little ripple effect on domestic output as virtually all materials were imported and construction workers, who are mostly foreigners, sent most salaries to their home countries. The combined contribution of agriculture and fishery to GDP continued to be small. Inflation has been low, with the CPI increasing by about 0.5 percent annually in the last two fiscal years.

Box 1. Republic of Palau: Compact Trust Fund, Non-Trust Fund Financial Assets, and Useable Reserves

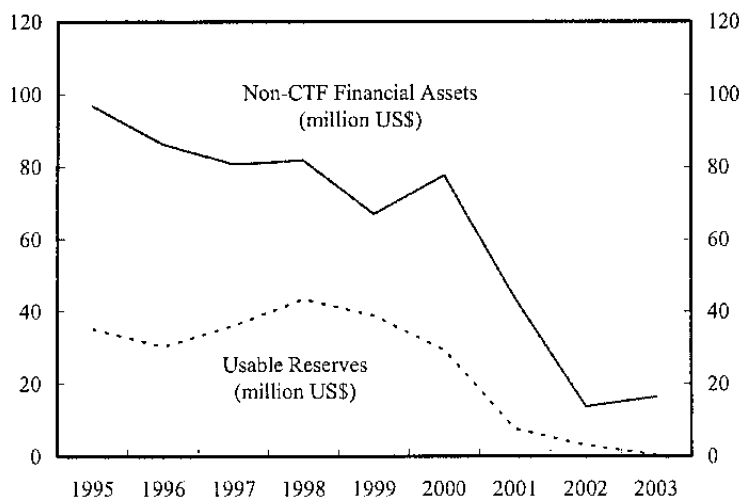
The Compact of Free Association (COFA) is a 50-year strategic treaty, under which the U.S. retains control of defense and security matters in Palau. In exchange, the U.S. has committed to provide Palau with pre-specified grants in the first fifteen years of the Compact. Total direct payments amount to some \$410 million over the period of 1994-2009.¹ In addition to Compact support, Palau is eligible for other U.S. assistance, based on direct proposals to grantor agencies, which has varied between \$7 million and \$11 million annually in recent years.

Under the COFA, Palau received lumpsum transfers of about \$70 million in mid-1990s to establish a Compact Trust Fund (CTF). The CTF is invested in U.S. equity and fixed income instruments, with the purpose of providing a steady source of income to replace the annual grants after their termination in 2009. Under the assumption, made in the early years of the COFA, of an average annual rate of return on investments of 12.5 percent, the CTF was expected to allow annual withdrawals of \$5 million between FY1998 and FY2009, and \$15 million between FY2010 and FY2043.² However, actual returns in recent years have been much lower. Palau has started making \$5 million annual withdrawals since FY2002.



The government's financial holdings also include non-Trust Fund assets. Donor support, including a large grant from the U.S. for discretionary capital expenditure disbursed in the initial years of the Compact, formed the basis of these funds, which have been used to finance capital projects and current expenditure.

The government's usable reserves are the balance of the non-Trust Fund assets excluding amounts earmarked for capital projects and other specific uses.



¹ Exclude in-kind grants (e.g., \$149 million for the Babeldaob ring road). See the *Selected Issues* paper for the disbursement schedule of annual grants.

² Under the COFA, any shortfall (excess) from the agreed annual distributions of the CTF resources through 2043 shall be covered by (accrue to) Palau, unless otherwise mutually agreed.

5. **The fiscal situation has improved somewhat over the past two years, but continues to be seriously in need of further strengthening.** Analysis of Palau's fiscal situation is complicated by a large amount of grants received and the time lags involved in their use. Primarily for this reason, the overall fiscal deficit swung from 21 percent of GDP in FY2001 to 28 percent of GDP in FY2002, and to 2 percent of GDP in FY2003 (Table 2). The very large capital expenditures in FY2001–02 were financed almost entirely by external assistance disbursed earlier, through the drawdown of the government's non-trust fund financial assets. These assets, after reaching low levels, increased slightly in FY2003 (Table 3). The underlying trend of the fiscal situation can be better captured by looking at the fiscal deficit excluding capital grants and spending (i.e., the balance between domestic revenue plus current grants and current expenditure). This deficit declined from about 10 percent of GDP in FY2001 to 7 percent of GDP in FY2002 and 5 percent of GDP in FY2003, owing mainly to reductions in non-wage current expenditures. While this adjustment was an improvement, it was inadequate to prevent the virtual depletion of the government's usable reserves (as defined in Box 1). To finance the deficits, the government also made withdrawals from the CTF of \$5 million each year in FY2002–03, and accumulated domestic arrears of \$3.1 million in FY2003.

6. **Palau's fiscal deficits in the last several years were the highest among island economies in the region, despite significant flows of external grants.** Tax revenue relative to GDP, at about 20 percent,¹ was not low by regional and international standards (Figure 2). However, Palau's government expenditure, averaging over 60 percent of GDP, was higher than most neighboring countries. In particular, Palau's public sector wage bill, at about 25 percent of GDP in the last two years, has remained one of the highest among the island countries in the region. Indeed, the government's wage bill was larger than total domestic (tax and nontax) revenue in the last two fiscal years.

7. **The external current account deficit deteriorated in FY2002 owing largely to the decline in tourist receipts in the aftermath of September 11, but improved somewhat in the following year** (Table 4). Tourist receipts started to rebound in the second half of FY2003, helped by the depreciation of the real effective exchange rate (REER). Palau's tourism competitiveness was adversely affected by the large appreciation of the U.S. dollar vis-à-vis the Japanese yen in 2000–early 2002.² As a result, the REER remains significantly above the levels before the Asian crisis (Figure 3), although it would have declined further since November 2003 with the weakening of the U.S. dollar. Limited air flights and high airfares also make Palau's tourism less competitive. However, efforts have been made

¹ Congress reduced the excise duties for alcohol and tobacco products in late 2001 (the impact was about 1–2 percent of GDP) and restored them in late FY2003.

² The share of visitors from Japan fell from 47 percent to about 40 percent of total tourist arrivals in the last two years.

recently to introduce competition in air flights and diversify the tourist base.³ Palau's exports went up in FY2001–02 due to the operations of three foreign-funded garment processing firms, but then fell sharply as these firms were closed for their own operational reasons. Imports fell in FY2003 reflecting lower grant-financed capital expenditure. The overall deficit since FY2001 has been financed by a drawdown in government financial assets.

8. **Driven by declines in the U.S. equity market and withdrawals, the balance of the government's CTF fell by 16 percent**, from a peak of \$162 million at end-FY2000 to \$136 million (equivalent to 110 percent of GDP) at end-FY2003. Pending a further drawdown to finance the budget deficit in FY2004, the CTF balance has since increased somewhat, in line with the upswing in the U.S. stock market. Official usable reserves declined from \$7.6 million (about one month of import cover) at end-FY2001 to \$0.4 million by end-FY2003.

III. POLICY DISCUSSIONS

9. **In the near term growth will be sustained, but medium-term prospects are clouded by fiscal uncertainties.** The recovery of tourism, facilitated by faster growth in East Asia, and the continuing large donor-funded infrastructure projects should support growth. Over the medium term, the big construction projects will likely wind down. More critically, the economy faces a large downside risk stemming from the possible sharp reduction in grant assistance from the United States after 2009, which would adversely affect government expenditure, domestic consumption, and economic activity.

10. **Against this background, the discussions centered on three key topics:** (i) fiscal adjustment in the transition to the scheduled end of Compact assistance six years from now; (ii) structural reforms to promote private sector development and economic growth; and (iii) measures to ensure adequate regulation and oversight of the financial sector. As several reform initiatives launched by the government have stalled in the legislative process, discussions were also held with parliamentarians. These initiatives include the comprehensive tax legislation, foreign investment law, and statistics law (submitted to the National Congress in 2001), and the amendments and regulations to enable banking supervision and implementation of the anti-money laundering legislation (proposed in 2003).

A. Fiscal Policy

11. **The FY2004 budget, as adopted by the National Congress (OEK) in October 2003, implies an overall fiscal deficit of about 12 percent of GDP**, taking into account the need for domestic arrears clearance and more prudently projected revenue. As in FY2003, the OEK overrode the government's expenditure reduction proposals and added unfunded discretionary capital expenditure for local governments of 2 percent of GDP. The mission pointed out that the deficit between current receipts (domestic revenue and current grants) and current expenditure would amount to 6 percent of GDP. This, in addition to unfunded capital expenditure, would exceed available financing by a wide margin, defined as the

³ See the *Selected Issues* paper, Chapter II by Ashok Bhundia.

allowable drawdown from the CTF less scheduled amortization of external debt (about 3 percent of GDP) plus resources available from usable reserves. The mission stated that, with usable reserves virtually depleted, the tight cash constraint will force adjustment, necessitating substantial expenditure cuts.

12. The authorities noted the difficulties to reduce expenditure prior to the presidential and parliamentary elections in November 2004 but nevertheless agreed to take measures to contain the deficit.

In this regard, they indicated their intention to implement the cost reduction plan proposed to the OEK in late 2002, including a continued hiring freeze, elimination of non-essential positions by attrition, a moratorium on travel authorizations on local revenue funded accounts, and containing other operating costs.

These measures, strongly supported by the mission, could help reduce current expenditure by about 2 percent of GDP, mostly through containing purchases of goods and services to below the levels in the last two years. The authorities informed the mission that capital expenditures unfunded by external assistance would be cut and that they were seeking grants to cover the additional discretionary capital expenditure.

To close the financing gap, the mission recommended the strengthening of tax administration and the change of import valuation for tax purposes from f.o.b. to c.i.f. basis. The authorities agreed to post the import valuation change publicly in January 2004 but noted this measure could be implemented only after posting without objection by the legislature. To ensure no new arrears are accumulated, the mission recommended the preparation of a contingency plan to prioritize expenditures, identify possible areas to cut, and strengthen controls of expenditure commitments. The authorities noted that expenditure could be contained by using the President's legal authority to limit spending authorization to available resources.

13. Beyond FY2004, the authorities recognized that substantial fiscal consolidation would be needed for a smooth transition to the post-Compact future. They agreed that the double digit losses of the CTF in FY2001–02 have necessitated a reassessment of the assumptions on the rate of return and drawdown of the CTF. The mission argued that assuming an annual average rate of return on investment of 6 percent, as in the recent COFA agreement between the United States and the Republic of Marshall Islands, and annual withdrawal of \$5 million before 2009 and \$15 million thereafter, the CTF would be exhausted by 2023, long before 2043 as anticipated in Palau's COFA agreement with the United States (Box 2). In addition, the Civil Service Pension Fund and Social Security Fund are under-funded by \$45 million (about 35 percent of GDP) in net present value (NPV) terms, further strengthening the case for early fiscal consolidation.

Republic of Palau: FY 2004 Budget (In percent of GDP)	
Overall deficit	12.4
<i>Of which</i> : Current deficit	5.7
Capital deficit	4.3
Arrears clearance	2.4
Financing	
CTF drawdown	3.9
Scheduled amortization	-0.9
Use of non-CTF assets	4.6
Financing gap	4.8

Republic of Palau: FY2004 Measures (In percent of GDP)	
Financing gap	4.8
Grants/capital exp. cuts	2.0
Current expenditure cuts	2.0
Import valuation	0.5
Tax Administration	0.3

14. **In view of the high uncertainty regarding aid flows after 2009, a reasonable strategy, although ambitious, might be to minimize the drawdown before 2009, thereby preserving the value of the CTF as much as possible.** This strategy would require reducing current expenditure sharply toward, and then beyond, the level of domestic revenue plus current grants through 2009.⁴ The authorities, while commenting that fiscal retrenchment, particularly on the size of the public sector, was politically difficult and would take time, stated that they would strive to achieve a balanced budget in the run-up to 2009 by containing the cost of government.

15. **On measures to achieve medium-term fiscal goals, the mission reiterated the critical importance of consolidating the wage bill in the context of public sector reform.** The mission's projections indicated that, in part because of the expected step down of Compact grants from 2005, current expenditure would have to be reduced, or domestic revenue would have to be boosted, by as much as 8 percent of GDP to significantly reduce the need for withdrawals from the CTF in FY2005–06. Additional adjustment would be required in the following years to move the balance into surplus so as to rebuild usable reserves. Although some revenue gain could be expected from a tax reform (see ¶ 16), a sizable expenditure adjustment would be necessary. With non-wage current expenditures already being curtailed since FY2001, downsizing of the civil service and hence the government's wage bill will have to be undertaken to achieve further fiscal consolidation. The mission also advised that the authorities keep capital expenditure within the envelope of available external concessional assistance.

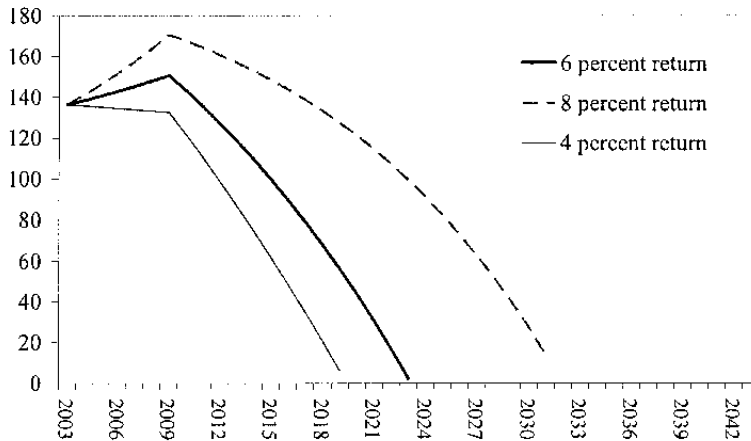
16. **On the revenue side, the authorities agreed that a comprehensive tax reform is needed to support fiscal consolidation and promote private sector development.** They noted that a tax reform package, submitted to the OEK in 2001, would remove import duty exemptions and increase tax revenue. Further reform to broaden the tax base and shift taxation from production to consumption, with a simplified income tax and a value-added tax replacing the existing tax on gross business revenue, would help remove an impediment to startup businesses, which have to pay the gross revenue tax even when not making profits. In this connection, the mission pointed out that various recent tax proposals (e.g., "reinvestment" act, gambling act), if enacted, would introduce multiple taxes on business

⁴ A path of accelerated fiscal consolidation is shown in Table 5. Relatively large drawdown of the CTF could be made in the first few years immediately after 2009 to support adjustment to the scheduled large decline in Compact grants.

Box 2. Republic of Palau: Long-Term Scenarios for the Compact Trust Fund

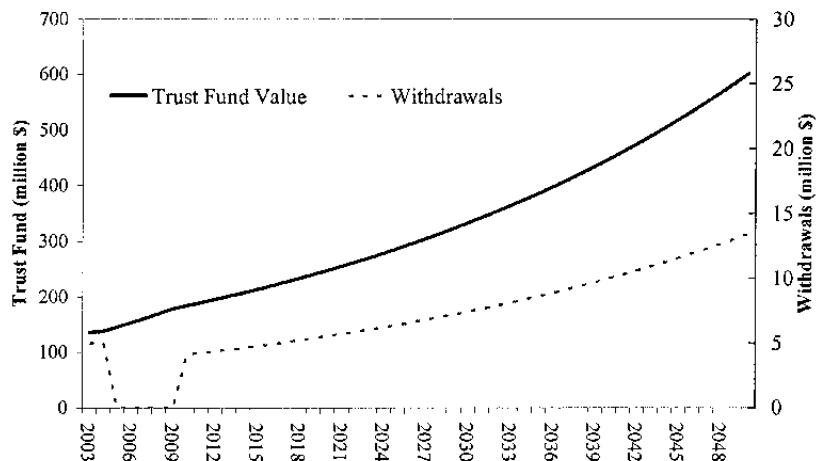
The mission discussed various scenarios to illustrate the need and scope for fiscal consolidation over the medium term. The balance of the CTF under different return assumptions is shown on the chart. The baseline scenario assumes 6 percent annual rate of return on the CTF, as in the recent COFA agreement between the U.S. and the Republic of Marshall Islands. Assuming annual withdrawals of \$5 million before 2009, and \$15 million thereafter, the CTF will be exhausted as early as 2023. The projections are sensitive to the assumed rate of return and to the amount and timing of withdrawals—limiting withdrawals in the near term would increase the resources available over the long term.¹

Compact Trust Fund Under a Fixed Withdrawal Schedule (\$5 million annually through 2009, \$15 million after 2009)



A policy of maintaining the value of the CTF and annual withdrawals constant in real per capita terms would be consistent with intergenerational equity. For illustrative purpose, the chart on the right depicts a possible withdrawal schedule and the corresponding value of the CTF under such a policy. It is assumed that annual Compact grants will decline from about \$16 million in FY2005–FY2009 to \$2 million thereafter and that no withdrawals are made between FY2006 and FY2009—a strategy that would ensure more funds are available to replace the Compact grants after 2009. Kiribati and Tuvalu are examples of countries in the Pacific that have successfully implemented a policy of maintaining constant real per capita values of their government funds.

Compact Trust Fund, Constant Real Per Capita Value After 2009



Assumes 6% investment return, 3% population growth + inflation, 0.7% investment fees.

¹ See Chapter I by Dora Iakova in the accompanying *Selected Issues* paper for more details.

income, undermining government revenue.⁵ Aspects of the “reinvestment” act may create loopholes in the management of public resources. The comprehensive tax reform therefore should be introduced in lieu of these proposals. The authorities noted that tax reform would require adequate support in the legislature, which may be difficult to mobilize prior to the elections. The President vetoed the gambling act recently.

17. **The mission encouraged the authorities to maintain the development financing strategy that does not rely on debt financing.** Palau incurred external debt of \$20 million (17 percent of GDP) on concessional terms in 2000 to finance construction of the new national capital. The government is negotiating another concessional loan of \$15 million for airport runway pavement improvement and possibly more borrowing for other development projects. The mission stated that additional borrowing will further increase debt-service obligations at the time when Compact grants decline and urged the authorities to refrain from any borrowing on commercial terms and to be prudent even when borrowing is on concessional terms. In this regard, the authorities agreed with the mission’s recommendation to develop debt management capacity, including on contingent liabilities arising from government guarantees, to ensure that the government’s debt-service obligations remain consistent with its repayment capacity.

18. **The authorities concurred with the mission’s recommendation to rebuild usable reserves.** Such reserves are needed in view of Palau’s vulnerability to shocks, the need for timely debt servicing, and cash management for donor-supported projects which are implemented on a reimbursement basis (Table 6). Given Palau’s very tight budget constraint, this strategy will have to be pursued gradually.

B. Structural Reforms

19. **The authorities shared the view of the mission that fiscal consolidation would need to be accompanied by strong private sector growth to achieve economic self-reliance.** The government’s economic development strategy emphasizes building economic institutions, developing basic infrastructure and the sectors that have the potential to support sustainable growth, particularly tourism and related services with expanded domestic participation, and consistent with preserving the environment. To implement this strategy, the government has adopted a Management Action Plan (MAP) which sets forth a comprehensive work schedule for the central government’s reform efforts through January 2005, with specific timetables for periodic assessment and to ensure monitoring by the public.

⁵ The “reinvestment” act proposes a new corporate income tax regime to attract foreign companies to establish themselves in Palau for tax purposes. Under the proposed regime, 80 percent of tax paid will be managed by a private entity, and can be invested back into the company. The gambling act introduces gambling in some parts of Palau with a tax on the difference between gross gambling receipts and payments to gambling winners.

20. **The government's structural reform agenda, summarized in the MAP, includes important public sector reforms,** aimed at downsizing the civil service, streamlining government operations, and improving service delivery. The MAP envisages privatization of certain public sector activities such as security and janitorial services, maintenance services, hospital revenue collection, road repair, and possibly airport operations. The MAP also includes measures to increase the efficiency and lower the cost of key public enterprises. The mission emphasized that given the dominant role of the public sector in Palau, these reforms should be implemented as rapidly as possible to facilitate private sector development. The authorities reiterated their intention to pursue these reforms and noted that expanding the employment opportunities in the private sector would help absorb surplus labor released from public sector reform.

21. **To attract foreign investment, the authorities agreed that the Foreign Investment Law needs to be amended to increase transparency and simplify the approval process.** The existing law mandates cumbersome review procedures, bans foreign investment in certain service sectors (e.g., retail and taxi services), and requires foreign investors to hire a minimum of 20 percent of Palauan citizens if their investment is below \$0.5 million. The authorities maintained that the service sector restrictions are often ineffective in reality and the minimum employment requirement aims to enable Palauans to benefit from opportunities created by foreign investment. The government intends to work with the OEK to enact the necessary legal changes, aiming at a one-stop process for the approval of foreign investment. Similarly, they are pushing for the adoption of the Uniform Commercial Code, which has also been submitted to the OEK and will facilitate private, including foreign, investment.

22. **The mission also discussed other possible steps to remove impediments to private sector-led growth.** Under Palau's traditional communal land tenure system, land title is held by the head of an extended family and subject to non-market allocation rules. This, together with shortcomings in the demarcation and registration of plots, have given rise to disputes over access to land. While there is no easy way to shorten the lengthy process of settling land ownership disputes, the authorities agreed that development in land survey and titling would help clarify land ownership. Establishing a land-lease system with little restrictions for foreign investors and a Public Land Bank for prospective investors would facilitate foreign investment as foreigners cannot legally own land. The high cost of obtaining domestic bank financing for startup business needs to be addressed through increased competition and strengthened regulatory oversight (see Section C).

23. **The authorities stated that they would continue to maintain an open trade and exchange system.** Staff estimates suggest that, with little changes in the trade regime since 2001 and most imports subject to a 3 percent tariff rate, Palau continues to rank 1 (least restrictive) in the Fund's Trade Restrictiveness Index. Palau's exchange system is free of restrictions on international current and capital transactions, which has served the country well.

C. Financial Sector Supervision and Regulation

24. **Palau has a large banking sector relative to its population.** The financial sector comprises 10 licensed commercial banks, one development bank, and several insurance companies, and credit unions. The largest three U.S.-based FDIC insured banks accounted for about 80 percent of deposits and 60 percent of net loans.⁶ Three other banks are branches of Asian banks. The remaining four are locally chartered, of which two are insolvent. Bank lending is limited, focusing on small consumer loans secured by deductions from salaries. The spreads between the deposit and lending interest rates are large. Funds tend to flow out of the country as foreign banks pool deposits at their headquarters for investment elsewhere.

25. **The mission welcomed the recent steps to enforce banking supervision and regulation,** building on the passage of the Financial Institutions Act (FIA), the Money Laundering and Proceeds of Crime Act, and the Mutual Assistance in Criminal Matters Act (AML acts) in 2001 and supported by technical assistance from the Fund and PFTAC. Recently, the Financial Institutions Commission (FIC) revoked the license of a foreign bank that is no longer registered in its home country. Licenses of the two insolvent domestic banks were suspended and these banks have agreed under the FIC's Consent Judgment to recapitalization by their owners within a fixed time frame. To implement the AML legislation, the Financial Intelligent Unit (FIU) was also set up in July 2003. Under the auspices of the FIU Chairman, a working group, comprising senior officials from relevant agencies, has been convened to facilitate information exchange on suspicious transactions. However, much remains to be done. In particular, the FIC and FIU still lack the necessary authority, funding, staff, and governance structure to perform their basic functions.

26. **The mission made clear that the FIA and AML acts need to be amended to enable effective implementation by the FIC and FIU.** Priority should also be given to building implementation capacity of these agencies including recruitment and training of bank examiners. While the AML acts need to be amended to meet international standards, the revisions of the FIA should give the FIC authority to issue regulations, conduct on-site inspections, and initiate prompt corrective measures, and require proper auditing and disclosure by banks. It should also limit the number of bankers that may serve as members of the FIC. The mission supported the amendments to the FIA and AML acts proposed by the government and the relevant regulations to achieve these objectives, and proposed that the recent legislation initiated in the OEK to weaken the FIA be rejected. The President recently vetoed the latter, which had twice been approved by the OEK, and agreed to push for early adoption of the government's FIA amendments.

27. **The mission suggested that operations of the National Development Bank (NDB) be carefully assessed and monitored.** Following restructuring by a new management team

⁶ See *Chapter II of the Selected Issues* paper.

and injection of capital by the government, the NDB has expanded its loan portfolio and resumed loan guarantee for lending by foreign banks. The authorities had indicated their intention to provide additional funding from the government's external borrowing to the NDB, which would compete with commercial banks in construction and commercial lending and may invest, through possible equity participation, in a Palauan airline venture. The mission pointed out that NDB should not be used as a vehicle for providing budgetary subsidy and advised the authorities to prudently manage the NDB's operating risks by reducing its involvement in commercial lending and risky investments. The mission also advised to bring the NDB under the purview of the FIC if it is allowed to accept deposits as proposed previously in the OEK.

D. Statistics and Technical Assistance Issues

28. **Palau has made some progress toward participation in the GDDS but serious deficiencies in economic statistics remain.** The authorities have committed to use the GDDS as the framework to develop and improve the statistical system and prepared draft metadata in November 2002. Despite these efforts, reporting of balance of payments and real sector data remains incomplete; monetary survey data is still not being collected; and since late 2002, the compilation of the GDP has been interrupted. The share of entities filing economic statistics has rapidly declined in recent years. The mission strongly urged adoption of the Statistics Law proposed to the OEK in 2001, which would provide the legal basis for enforcing data reporting and collection.

29. **The mission, in close cooperation with the PFTAC, assessed Palau's technical assistance needs.** As a result, the PFTAC statistics advisor visited Koror in early December to help address the problems in the compilation of national accounts statistics. PFTAC also proposed technical assistance in other areas including custom automation and tax reform. Assuming progress in the legislative process to amend the FIA, further technical assistance from the Fund is also expected to support financial sector reform in 2004.

IV. STAFF APPRAISAL

30. **Palau has continued to record large fiscal imbalances in recent years and the country's usable reserves have been exhausted.** The reduction of the imbalances between current receipts and current expenditures through compression of non-wage current expenditure since FY2001, while a welcome development, was inadequate. Also, the reduction is not sustainable in the absence of downsizing the civil service and hence the bloated wage bill. The accumulation of domestic arrears is a further cause for concern. External shocks during the period have complicated the authorities' adjustment efforts, but the lack of progress in fiscal consolidation, particularly in reducing the wage bill, and in reforms for private sector development is disappointing.

31. **The FY2004 budget, as adopted recently, implies a deficit that will again be substantially larger than available financing.** Much stronger efforts are needed to bring expenditure in line with budget constraints. In this regard, the government's cost reduction plan, especially measures to contain the public sector's personnel and operating costs, is crucial and should be implemented immediately and firmly. Equally important, the authorities should prioritize and tighten control of expenditure commitments in order to clear the domestic payment arrears and prevent their re-emergence. Without such decisive actions, it is not clear how the financing gap can be filled.

32. **Over the medium term, the overarching policy challenge is to prepare for the adjustment to the scheduled sharp reduction in grant assistance from the United States after 2009.** While the CTF is intended to provide a cushion for this, enhanced fiscal consolidation is vital for ultimate self-sufficiency. The authorities should seize the window of opportunity between now and 2009 by seriously pursuing public sector reform, significantly reducing the need for withdrawals from the CTF, and generating fiscal surpluses to rebuild usable reserves in the run-up to 2009. It is in the long-term interest of Palau to preserve the real per capita value of the CTF.

33. **In addition to adjustment on the expenditure side, a comprehensive revenue reform is needed** to rationalize the tax structure, support private sector development, and provide a robust source of funding for the government over the medium term. Further delays in introducing reforms will necessitate stronger spending cuts to obtain the fiscal adjustment goals. The authorities should continue to resist tax proposals that may create loopholes in the tax system and undermine government revenue.

34. **As a recipient of large external grants, the authorities should eschew borrowing on commercial terms and be prudent even when borrowing is on concessional terms** in order not to undermine the country's medium-term fiscal sustainability. In this regard, it is important to develop the authorities' debt management capacity.

35. **Palau's growth prospects and future living standards of its population depend on the development of a robust private sector.** This is a challenging goal in view of the severe constraints including a small domestic market. However, it is imperative to achieve this goal, and structural reforms will be essential in this regard. The government's structural reform agenda, as outlined in its economic development strategy and MAP, is commendable, emphasizing the areas of foreign investment, land ownership, tax, and banking. However, timely implementation will be key to realizing the benefits of the plan.

36. **Despite the passage of the Financial Institutions Act and the AML legislation in 2001 and recent progress in enforcement, banking supervision and regulation remain lacking.** As a result, the risk of bank failure and money laundering cannot be underestimated. Additional actions are needed promptly to improve the regulatory framework, to develop the implementation capacity, and to increase compliance by financial institutions. In this regard,

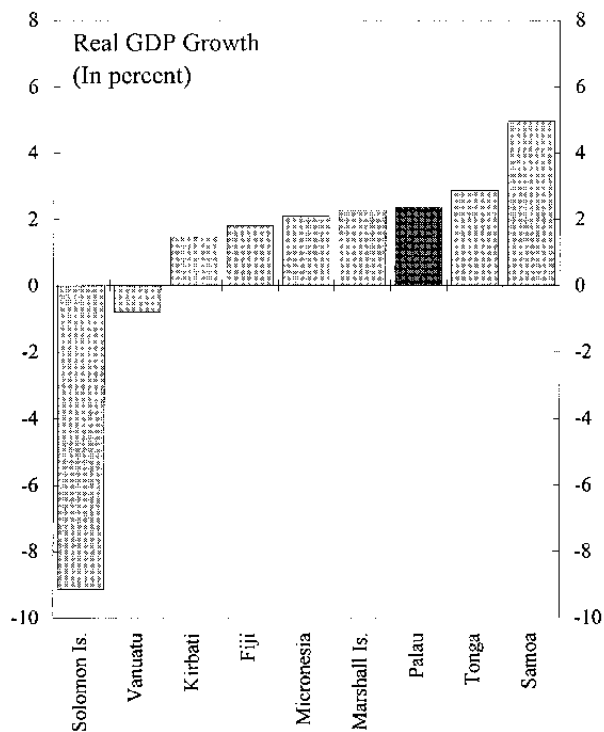
the amendments to the FIA and AML acts and the relevant regulations necessary for effective banking regulation should be enacted as soon as possible.

37. **Palau has made progress toward participation in the GDDS but the lack of legal framework continues to impede statistical work.** Significant statistical deficiencies have continued to hamper timely economic analysis and effective surveillance. The staff strongly urges the adoption of the Statistics Law as soon as possible. Training and retaining of local professional staff should be given priority.

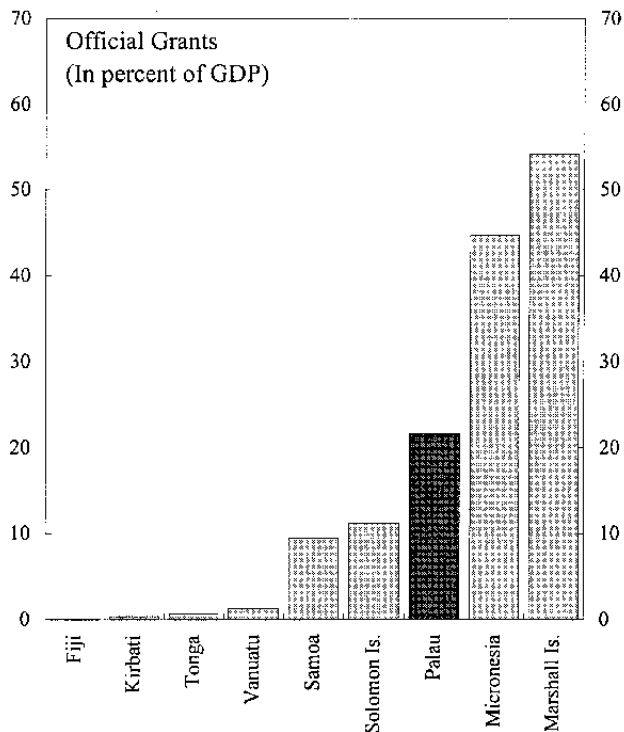
38. **The staff recommends that Palau remain on the 24-month consultation cycle.**

Figure 1. Republic of Palau: Recent Economic Developments in Regional Perspective
(2000-2002 average) 1/

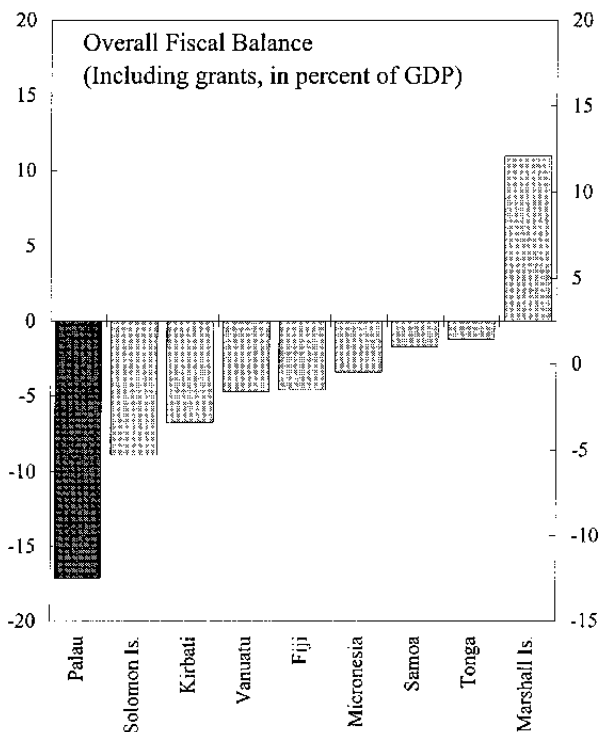
Economic recovery since the Asian crisis has been modest...



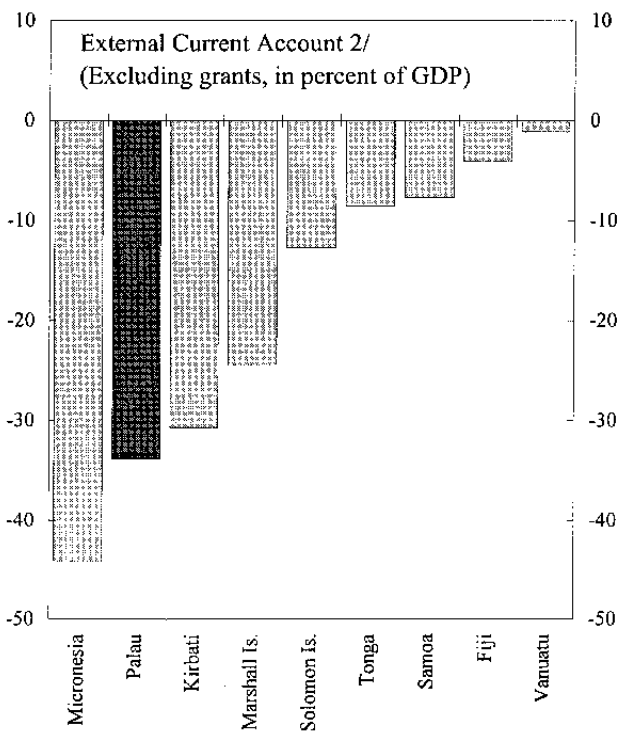
...despite significant flows of external grants...



...fiscal deficit has been among the highest in the region...



...external current account deficit has also remained very large.

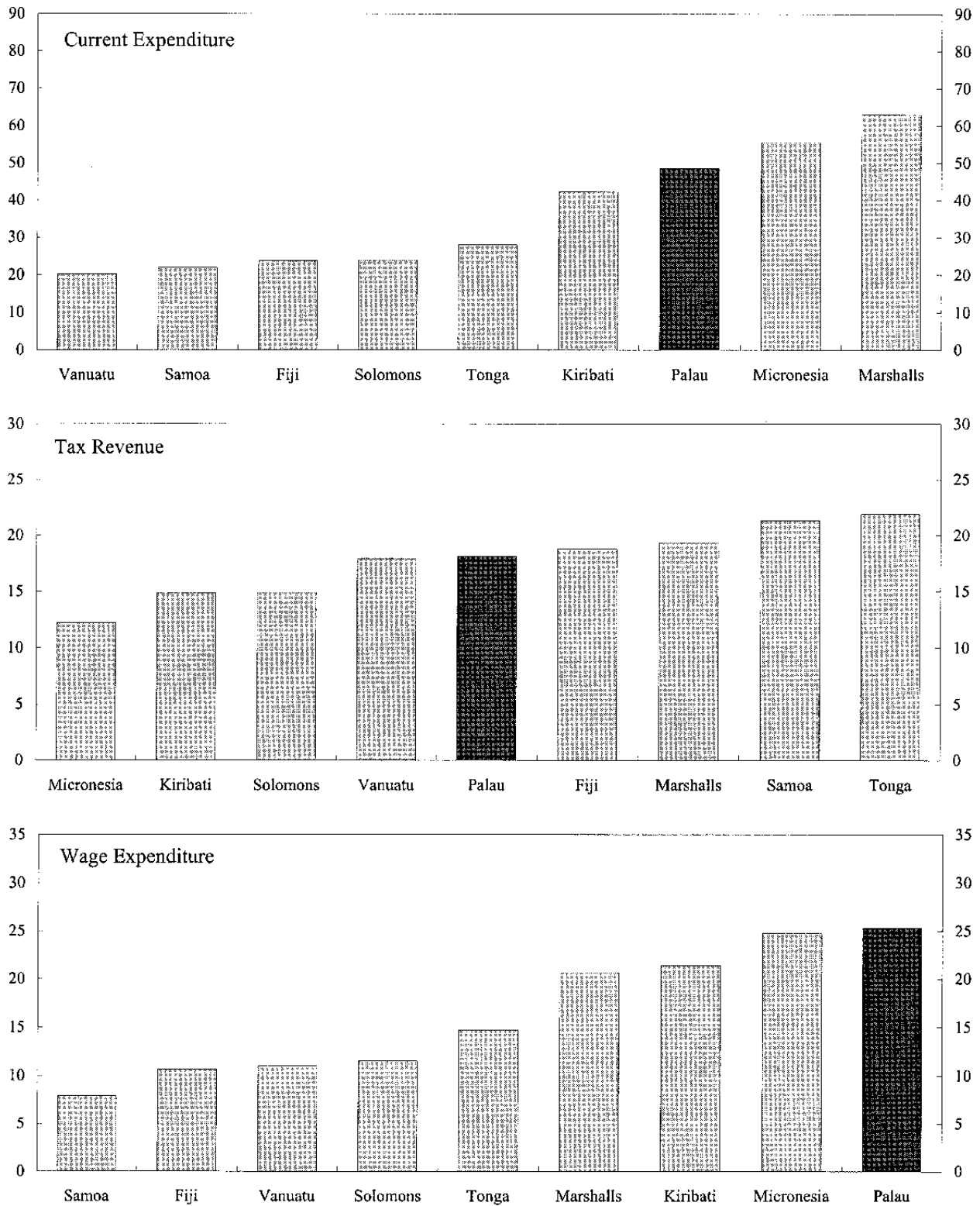


Source: National authorities and Fund staff estimates.

1/ Palau averages are for the period 2000/01-2002/03.

2/ Tonga and Solomon Islands averages are for the period 2000-2001.

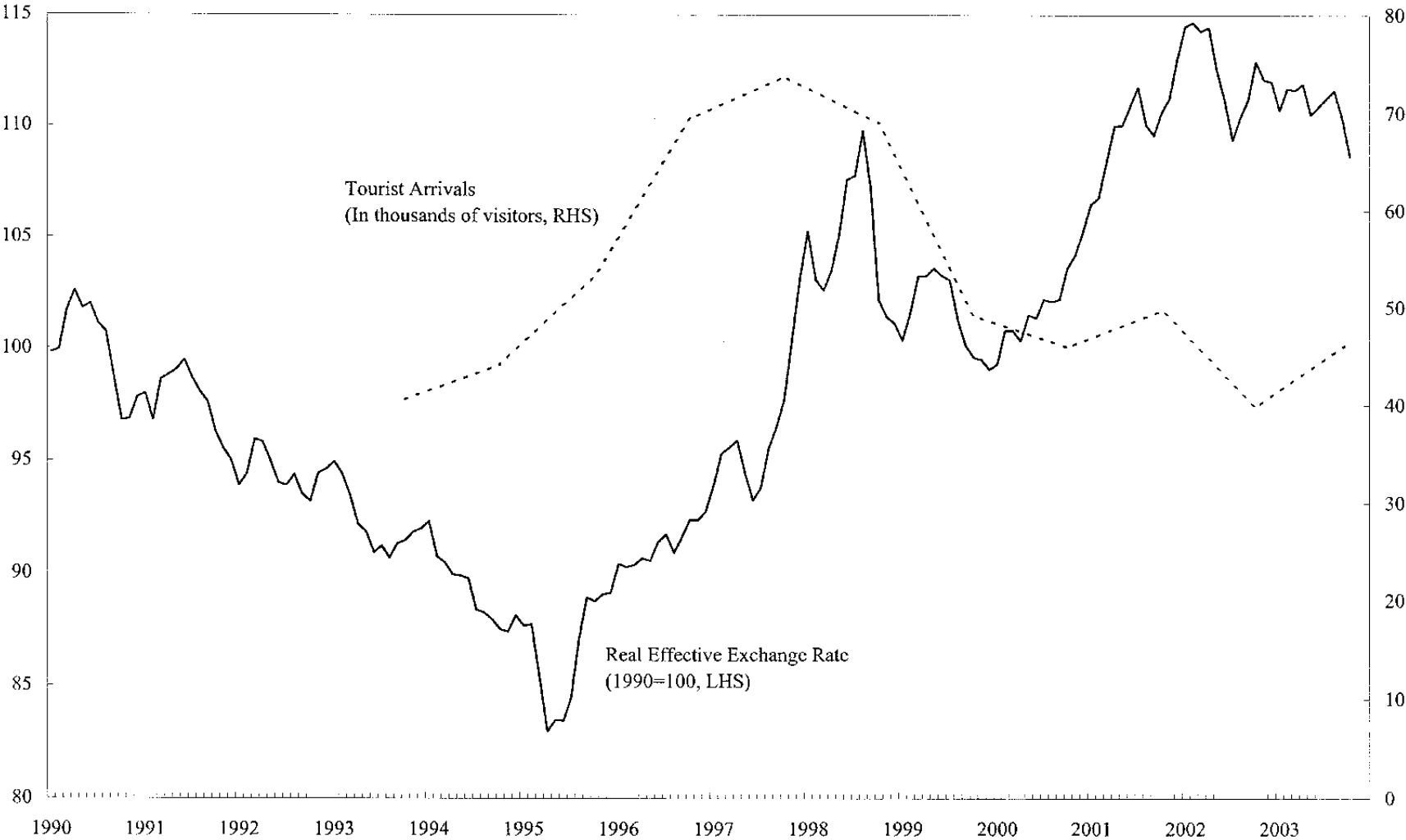
Figure 2. Republic of Palau: Indicators from a Pacific Island Perspective, 2002 1/



Source: National authorities and Fund staff estimates.

1/ The numbers for Kirabati are in percent of GNP.

Figure 3. Republic of Palau: Real Effective Exchange Rate and Tourist Arrivals



Source: Palauan authorities and Fund staff estimates.

Table 1. Republic of Palau: Selected Economic and Financial Indicators, 1998/99–2003/04

Nominal GDP (2003): US\$123.9 million 1/
 Population (2000): 19,129
 GDP per capita (2000): 6,179

	1998/99	1999/00	2000/01	2001/02 Est.	2002/03 Est.	2003/04 Proj.
Real sector						
Real GDP growth (percent change)	-5.4	0.3	4.5	1.1	1.5	2.0
Consumer prices (percent change, end-of-period) 2/	2.2	3.0	-1.3	0.4	0.3	0.5
Business and Tourist arrivals	49,170	45,932	49,731	39,833	46,615	50,000
(In millions of U.S. dollars)						
Public finance						
Central government						
Revenue	47.8	61.1	53.2	51.2	65.4	71.6
Domestic revenue	25.8	29.1	31.8	28.8	29.8	33.5
Grants	22.0	32.1	21.4	22.4	35.5	38.1
Expenditures	72.1	84.6	79.9	80.1	72.6	84.2
Current	64.1	72.1	64.6	59.1	58.6	62.5
Capital	8.0	12.5	15.4	21.0	14.0	21.7
Current fiscal balance 3/	-17.7	-21.7	-11.4	-8.9	-6.5	-7.2
Overall fiscal balance						
Including grants	-20.6	-18.1	-25.1	-34.2	-2.9	-15.7
Excluding grants	-42.6	-50.2	-46.5	-56.6	-38.4	-53.8
Compact Trust Fund (CTF) balance	141.1	161.8	135.0	124.5	136.6	...
Interest income and capital gains/losses	19.6	21.5	-25.8	-9.7	14.5	...
Investment fees and withdrawals	0.8	0.8	1.0	5.8	7.8	...
Government non-CTF financial assets	67.0	77.7	43.7	13.7	16.4	...
Usable reserves 4/	38.9	29.4	7.6	3.1	0.4	...
In percent of govt. expenditure	61.0	40.9	12.2	5.6	0.7	...
In months of imports	3.5	2.8	0.9	0.4	0.1	...
Balance of payments						
Trade balance	-127.3	-115.6	-81.1	-80.4	-81.8	-96.5
Exports (f.o.b.)	7.3	11.5	18.7	20.3	11.9	12.3
Imports (f.o.b.)	-134.6	-127.1	-99.8	-100.7	-93.7	-108.8
Tourism receipts	54.1	53.2	58.5	47.4	57.9	62.2
Current account balance						
Including grants	-62.4	-35.5	-7.3	-17.1	-5.3	-22.6
Excluding grants	-83.0	-67.0	-28.7	-38.5	-27.6	-45.5
Overall balance	-24.7	0.4	-25.1	-34.2	-3.4	-16.5
External public debt 5/	1.4	20.0	20.0	20.0	19.4	18.3
Debt service ratio 6/	6.6	2.2	0.9	1.0	1.8	3.0
(In percent of GDP)						
Current fiscal balance 3/	-15.4	-18.7	-9.5	-7.3	-5.2	-5.7
Overall fiscal balance						
Including grants	-18.0	-15.6	-20.9	-28.1	-2.3	-12.4
Excluding grants	-37.2	-43.2	-38.8	-46.5	-30.9	-42.4
External current account						
Including grants	-54.5	-30.6	-6.1	-14.0	-4.3	-17.8
Excluding grants	-72.5	-57.6	-23.9	-31.6	-22.3	-35.8
External public debt 5/	1.3	17.2	16.7	16.4	15.7	14.4

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

1/ Based on limited available data. The fiscal year is from October to September. For example, FY2002 is from October 2001 to September 2002.

2/ U.S. CPI is used for 1995 to 2000. Palau has compiled its own CPI since June 2000.

3/ Defined as domestic revenue plus current grants minus current expenditures.

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

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

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

Table 2. Republic of Palau: National Government Budgetary Operations, 1998/99-2003/04

	1998/99	1999/00	2000/01	2001/02	2002/03 Preliminary	2003/04 Budget 1/	2003/04 Staff Proj. 2/
(In millions of U.S. dollars)							
Total revenue and grants	47.8	61.1	53.2	51.2	65.4	74.6	71.6
Domestic revenue	25.8	29.1	31.8	28.8	29.8	36.4	33.5
Tax revenue	18.9	22.9	24.1	22.0	23.0	29.6	26.7
Salaries and wages	5.2	5.5	6.0	5.9	6.5	6.7	6.7
Import tax	5.0	6.4	6.8	5.5	5.3	9.2	7.8
Gross revenue tax	5.6	6.2	6.9	7.4	7.4	7.7	7.6
Other	3.2	4.8	4.5	3.3	3.9	6.0	4.6
Nontax revenue 3/	4.5	4.3	5.8	4.5	5.3	5.3	5.3
Local trust funds	2.4	1.9	1.9	2.2	1.5	1.5	1.5
Grants	22.0	32.1	21.4	22.4	35.5	38.1	38.1
Current grants	20.6	21.3	21.4	21.4	22.3	21.8	21.8
U.S. Compact	13.6	13.6	13.8	13.9	13.9	14.1	14.1
U.S. non-Compact	6.4	6.8	7.0	6.5	7.7	7.0	7.0
Other country	0.6	0.8	0.6	1.0	0.7	0.8	0.8
Capital grants	1.4	10.8	0.0	1.0	13.3	16.3	16.3
U.S. non-Compact	1.4	0.6	0.0	1.0	1.5	3.1	3.1
Other country	-	10.2	-	-	11.8	13.2	13.2
Total expenditure	72.1	84.6	79.9	80.1	72.6	84.2	84.2
Current expenditure	64.1	72.1	64.6	59.1	58.6	62.5	62.5
Wages and salaries	28.4	29.3	30.0	30.8	30.1	30.6	30.6
Other purchases of goods and services	27.3	30.4	27.0	23.4	23.9	26.7	26.7
Interest payments and investment fees	0.4	0.3	0.9	0.8	0.8	1.1	1.1
Subsidies and transfers	8.1	12.1	6.7	4.1	3.8	4.1	4.1
Public enterprises	1.3	3.1	2.8	1.7	1.7	1.7	1.7
Other	6.7	8.9	3.9	2.5	2.2	2.4	2.4
Capital expenditure	8.0	12.5	15.4	21.0	14.0	21.7	21.7
Balance ex. capital grants & expenditure	-17.6	-21.7	-11.4	-8.9	-6.5	-4.3	-7.2
Errors and omissions, Accounts payable/receivable 4/	3.6	5.3	1.7	-5.3	4.4	0.0	-3.1
Overall balance	-20.6	-18.1	-25.1	-34.2	-2.9	-9.7	-15.7
Financing	20.6	18.1	25.1	34.2	2.9	9.7	15.7
Net long-term borrowing	-4.1	18.6	-	-	-0.6	-1.1	-1.1
New borrowing	-	20.0	-	-	-	-	-
Principal repayments	4.1	1.4	-	-	0.6	1.1	1.1
Change in NTF assets 5/	24.7	-0.4	25.1	29.2	-1.6	5.8	11.8
Withdrawals from Compact Trust Fund	-	-	-	5.0	5.0	5.0	5.0
(In percent of GDP)							
Total revenue and grants	41.8	52.6	44.3	42.1	52.7	58.7	56.4
Domestic revenue	22.6	25.0	26.5	23.6	24.1	28.7	26.4
Tax revenue	16.5	19.7	20.1	18.1	18.6	23.3	21.0
Nontax revenue	4.0	3.7	4.8	3.7	4.3	4.2	4.2
Grants	19.2	27.6	17.8	18.4	28.7	30.0	30.0
Total expenditure	63.0	72.8	66.7	65.8	58.6	66.3	66.3
Current expenditure	56.0	62.0	53.8	48.6	47.3	49.2	49.2
Wages and salaries	24.8	25.2	25.0	25.3	24.3	24.1	24.1
Capital expenditure	7.0	10.7	12.8	17.3	11.3	17.1	17.1
Balance ex. capital grants and expenditure	(15.4)	(18.7)	(9.5)	(7.3)	(5.2)	(3.3)	(5.7)
Overall balance	(18.0)	(15.6)	(20.9)	(28.1)	(2.3)	(7.6)	(12.4)
Memorandum item: (in millions of U.S. dollars)							
GDP (fiscal year)	114.4	116.3	119.9	121.7	123.9	127.0	127.0

Source: Ministry of Finance.

1/ Budget as approved by the National Congress.

2/ Taking into account arrears clearance, debt service, and more prudently projected revenue. See table 5 for projections of accelerated fiscal consolidation.

3/ Nontax revenue comes mainly from different fees and charges.

4/ The staff projection for 2003/04 includes 3.1 million accounts payable to cover arrears that have been accumulated in 2002/03.

5/ Change in non-trust fund assets excluding capital gains/losses. A minus sign is an increase in assets.

Table 3. Republic of Palau: Financial Holdings of the Central Government, 1998/99–2002/03

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

	1998/99	1999/00	2000/01	2001/02	2002/03 Prel.
Total non trust fund assets	67.0	77.7	43.7	13.7	16.4
Deposits with foreign banks 1/	64.6	45.3	39.8	10.8	10.9
Deposits with domestic banks 2/	2.4	32.4	3.9	2.9	5.5
Fiduciary funds 3/	141.1	161.8	135.0	124.5	136.3
Total financial holdings	208.1	239.5	178.7	138.2	152.7

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

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

2/ Deposits with local banks.

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

Table 4. Republic of Palau: Balance of Payments, 1998/99–2003/04
(In millions of U.S. dollars)

	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04
				Est.	Est.	Proj. 1/
Trade balance	-127.3	-115.6	-81.1	-80.4	-81.8	-96.5
Exports, f.o.b.	7.3	11.5	18.7	20.3	11.9	12.3
Imports, f.o.b.	-134.6	-127.1	-99.8	-100.7	-93.7	-108.8
Services account	43.8	38.5	47.0	35.2	49.2	46.9
Receipts	54.1	53.2	58.5	47.4	57.9	62.2
Travel	54.1	53.2	58.5	47.4	57.9	62.2
Payments	-10.3	-14.7	-11.6	-12.1	-8.7	-15.2
Freight and insurance 2/	-8.4	-12.7	-9.6	-9.8	-6.6	-13.1
Travel	-1.9	-2.0	-1.9	-2.3	-2.1	-2.2
Income	4.8	5.5	5.3	4.7	3.9	3.2
Investment income	4.8	5.5	6.0	5.5	4.6	4.3
Interest payment	0.0	0.0	-0.7	-0.7	-0.7	-1.1
Current transfers	16.3	36.1	21.4	23.4	23.4	23.8
Private	-5.7	3.3	-1.4	0.3	-1.3	-1.7
Inflows	1.5	11.1	5.7	7.2	5.7	5.9
Outflows	-7.2	-7.9	-7.1	-6.9	-7.1	-7.6
Official	22.0	32.9	22.9	23.1	24.7	25.5
Business licenses and fees	1.9	1.9	2.1	2.3	3.0	3.1
Grants	20.6	31.5	21.4	21.4	22.3	22.9
Other 3/	-0.6	-0.6	-0.6	-0.6	-0.5	-0.5
Current account (includes official grants)	-62.4	-35.5	-7.3	-17.1	-5.3	-22.6
Current account (excludes official grants)	-83.0	-67.0	-28.7	-38.5	-27.6	-45.5
Capital and financial account	64.6	40.5	23.7	15.8	23.2	26.0
Public sector	63.6	38.5	22.7	13.8	22.2	25.0
Capital grants 4/	67.6	20.0	22.7	13.8	22.8	26.2
Loan disbursements	0.0	20.0	0.0	0.0	0.0	0.0
Loan repayments	-4.1	-1.4	0.0	0.0	-0.6	-1.1
Private sector	1.0	2.0	1.0	2.0	1.0	1.0
Foreign direct investment	1.0	2.0	1.0	2.0	1.0	1.0
Errors and omissions 5/	-26.9	-4.6	-41.5	-32.9	-21.3	-20.0
Overall balance 6/	-24.7	0.4	-25.1	-34.2	-3.4	-16.5
Memorandum items:						
Current account/GDP (in percent)						
Including official grants	-54.5	-30.6	-5.6	-14.0	-4.3	-17.8
Excluding official grants	-72.6	-57.6	-23.4	-31.6	-22.3	-35.8
Service receipts/GDP (in percent)	47.3	45.8	48.8	38.9	46.8	48.9
REER (percent change)	-6.5	2.8	8.0	2.9	-1.8	...
Public debt/GDP (percent) 7/	1.2	17.2	16.7	16.4	15.7	14.4
Debt service ratio 8/	6.6	2.2	0.9	1.0	1.8	3.0

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

1/ Before adjustment measures.

2/ Based on data collected by Customs from 2000/01, and assume 10 percent of fob imports for previous years.

3/ Contribution to international and regional organizations.

4/ Includes in-kind capital grants.

5/ Large error and omission in 1998/99 reflect underreporting of imports prior to April 1999 when new customs system was implemented. There are no reliable estimates of net private capital flows since no banking system data is collected on a systematic basis.

6/ Reflects the changes in the financial holdings of the Government.

7/ Does not include a loan to the PNCC in 1994 (with no government guarantee).

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

Table 5. Republic of Palau: Medium-Term Scenarios, 2002/03–2009/10

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Unchanged Policies								
(In percent of GDP)								
Real GDP growth	1.5	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Total government revenue	52.7	56.4	43.9	43.6	43.4	43.2	43.0	34.1
<i>Of which</i> : Current grants 1/	18.0	17.2	15.1	14.5	14.0	13.6	13.2	4.4
Capital grants 2/	10.7	12.8	4.0	4.0	4.0	4.0	4.0	4.0
Total government expenditure	58.6	66.3	53.6	53.1	45.3	45.1	44.8	42.5
Fiscal balance 3/	-2.3	-12.4	-9.7	-9.4	-2.0	-1.9	-1.8	-8.4
Primary balance 3/	-1.9	-11.7	-8.8	-8.5	-1.1	-1.1	-1.1	-7.7
External debt	14.8	29.2	26.6	24.2	21.8	19.6	17.5	15.4
Debt service	0.9	1.4	2.5	2.4	2.2	2.1	2.0	1.9
(In millions of U.S. dollars)								
CTF balance 4/	136.3	138.4	140.6	142.9	145.4	147.9	150.6	143.2
Withdrawals from the CTF	5.0	5.0	5.0	5.0	5.0	5.0	5.0	15.0
Usable reserves	0.4	5.0	5.0	0.5	0.5	0.5	0.5	0.5
New borrowing 5/	--	20.0	...	...	...	...	...	...
Accelerated Fiscal Consolidation								
(In percent of GDP)								
Real GDP growth	1.5	2.0	1.0	1.5	2.1	2.5	3.0	3.5
Total government revenue	52.7	57.4	44.5	44.5	44.5	44.1	44.0	35.2
<i>Of which</i> : Current grants 1/	18.0	17.2	15.2	14.6	14.1	13.6	13.2	4.4
Capital grants 2/	10.7	12.8	4.0	4.0	4.0	4.0	4.0	4.0
Total government expenditure	58.6	62.3	46.5	43.5	43.0	42.1	41.5	41.3
Fiscal balance 3/	-2.3	-7.3	-2.0	1.0	1.5	2.0	2.5	-6.1
Primary balance 3/	-1.9	-6.9	-1.6	1.4	1.9	2.3	2.8	-5.8
External debt	14.8	13.4	12.3	11.1	10.0	8.8	7.7	6.7
Debt service	0.9	1.3	1.2	1.2	1.1	1.0	1.0	0.9
(In millions of U.S. dollars)								
CTF balance 4/	136.3	138.4	140.6	145.9	153.7	161.8	170.4	163.6
Withdrawals from the CTF	5.0	5.0	5.0	2.0	--	--	--	15.0
Usable reserves	0.4	0.4	1.6	3.7	4.6	6.4	9.0	13.5
New borrowing	--	--	...	...	...	...	...	...

1/ Based on the disbursement schedule as specified under the COFA agreement with the United States.
2/ Assumptions on disbursements beyond FY2004 are based on annual average in FY1999–FY2003. Excludes off-budget grants.
3/ The fiscal balance in FY2004 includes \$3.1 million arrears clearance.
4/ Annual average rate of return on investment is assumed to be 6 percent.
5/ Disbursement is assumed to take place toward end-FY2004. The loan is repayable in 22 years, with an interest rate of 2.75 percent and no grace period.

Table 6. Republic of Palau: External Vulnerability Indicators, 1998/99–2003/04

	1998/99	1999/00	2000/01	2001/02 Est.	2002/03 Est.	2003/04 Proj.
Exports (annual percent change)	-34.2	57.5	62.6	8.6	-41.2	3.0
Imports (annual percent change)	113.0	-5.6	-21.5	0.9	-6.9	16.0
Current account balance (in percent of GDP)						
Including grants	-62.4	-35.5	-7.3	-17.1	-5.3	-22.6
Excluding grants	-83.0	-67.0	-28.7	-38.5	-27.6	-45.5
Capital and financial account balance (in percent of GDP) 1/	64.6	40.5	23.7	15.8	23.2	26.0
Usable reserves (in millions of US dollars) 1/	38.9	29.4	7.6	3.1	0.4	...
In months of imports	3.5	2.8	0.9	0.4	0.1	...
Short-term external debt	--	--	--	--	--	--
External public debt (in percent of GDP) 2/	1.3	17.2	16.7	16.4	15.7	14.4
Debt-service ratio (in percent of goods and nonfactor services) 2/	6.6	2.2	0.9	1.0	1.8	3.0

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

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

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

Table 7. Republic of Palau: Selected Social Indicators, 1995 and 2000, and 2001/02 1/

	1995	2000	2001 Est.	2002 Est.
GDP per capita (U.S. dollars)	5,527	6,179	6,111	6,094
Area (sq. miles)				
Land	188	188	188	188
Sea	237,850	237,850	237,850	237,850
Demographic indicators (2000)				
Total population	17,225	19,129	19,626	19,976
Population growth (percent per annum)				
1986-90	2	...	...	...
1990-95	3	...	...	...
2000	...	2	...	...
Crude birth rate (per 1,000)	13	15	15	13
Crude death rate (per 1,000)	7	7	7	7
Infant mortality (per 1,000)	20	11	17	23
Labor force	8,368	9,845	...	...
Employed 2/	7,780	9,621	11,099	11,632
Agriculture, fisheries, and mining	724	215	183	287
Construction	1,089	1,112	1,815	2,285
Manufacturing	78	345	...	...
Transport, storage, communication, and other public utilities	436	765	607	573
Wholesale, retail, restaurants, and hotels	1,455	2,619	2,364	2,291
Finance, insurance, and real estate	124	116	126	150
Other business, personal, community, and social services	1,120	1,246	1,917	2,049
Public administration	2,879	3,203	4,087	3,997
Unemployed	588	224	...	...
Age structure (in percent)				
0-14	28	24	...	...
15-64	66	71	...	...
65 and over	6	5	...	...
Public health and education				
Education				
Percent graduating				
Primary	97	97	118	119
Secondary	65	78	99	82
College	12	10	11	12
Student/teacher ratio (1998 and 2000)	11	11	...	...
Health				
Number of encounters at dispensary	115	48	...	...

Sources: 1995 and 2000 Census of Population and Housing; Data provided by the Office of Planning and Statistics.

1/ Figures for 2001-2003 are estimates based on partial data.

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

REPUBLIC OF PALAU: FUND RELATIONS
(As of December 31, 2003)

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

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	0.0

III. SDR Department: None

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements: None

VI. Projected Obligations to Fund: None

VII. Exchange Arrangement:

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

VIII. Article IV Consultation:

The first Article IV consultation discussions took place during June 24–July 6, 1999 and the Article IV consultation procedure was completed on November 10, 1999. The last Article IV consultation discussions with the authorities were held in Koror during September 2001. The Executive Board discussed the staff report (SM/01/358) and concluded the consultation on January 4, 2002. Palau is on a 24-month consultation cycle.

IX. Current Financial Arrangement: None

X. Technical Assistance:

FAD	Preparation of a new tax code, tax and customs administration	October 1998–March 1999
LEG	Preparation of a new tax code	October 1998
	Banking legislation (together with MFD)	April 2002

MFD	Establishment of bank supervision functions	October 2000
	Banking law and regulations (supported by PFTAC)	January 2001
	Assessing compliance with international supervisory standards and effectiveness of anti-money laundering arrangements in the banking sector	April 2002
	Peripatetic advisor to the Financial Institutions Commission (six short-term visits to advise implementation of the Financial Institutions Act	February 2002- May 2003

XI. Resident Representative: None

**REPUBLIC OF PALAU:
SUPPORT FROM THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE¹**

The Centre's assistance since Palau joined the Fund in 1997 has included 19 advisory missions, the participation of officials in seminars (8) and secondments mostly in the tax administration area (8). The project coordinator joined the 2003 Article IV consultation discussions.

Public Financial Management

Discussions between the Minister of Finance and PFTAC started at the last FEMM were continued during the 2003 Article IV consultation discussions.

Tax Administration and Policy

In 1998, the Center helped design and advance a comprehensive tax reform package and strengthen the Revenue and Customs Bureau. In 2001, PFTAC collaborated with LEG to draft a Tax Administration Bill, with very little progress. 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".

Financial Sector Regulation and Supervision

Technical assistance was provided directly by IMF headquarters to draft a legislation for an effective banking supervision framework and PFTAC's advisor was involved in the process, up to the enactment of the Financial Institutions Act (FIA) in June 2001. Two follow-up missions were undertaken by PFTAC to assist with FIA's implementation, the organization of the Financial Institutions Commission (FIC), and the drafting of licensing guidelines. An MFD peripatetic advisor paid a number of visits in Palau. Implementation and enforcement are still pending.

Economic and Financial Statistics

In 2000 and 2002, PFTAC conducted comprehensive reviews and produced an agreed action plan to broaden the range of available statistics. Palau participated in the November 2002 workshop in Suva. The key sustainability requirement under the action plan was an expansion in the professional local staff, which has not been done. The post of Government Statistician has been vacant since late 2002. Two graduate level statisticians are in post at present. A PFTAC mission visited Koror in December 2003 to assist with training the new recruits in the national accounts system and with finalization of the GDDS metadata.

¹ The Pacific Financial Technical Assistance Centre (PFTAC) in Suva, Fiji is a regional technical assistance institution operated by the IMF with financial support of the Asian Development Bank, Australia, Japan 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 level. Member countries are: Cook Islands, Federated States of Micronesia, Fiji, Kiribati, Marshall Islands, Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Tokelau, Tonga, Tuvalu, and Vanuatu.

REPUBLIC OF PALAU: RELATIONS WITH THE WORLD BANK GROUP¹

Total commitments: None

IFC investments: None

The Republic of Palau joined the World Bank Group on December 16, 1997. Guided by its Pacific Regional Strategy papers of 2000 and 2002, the Bank Group has provided nonlending services to Palau in a number of areas:

- In 2003, the Bank has helped build local capacity in the area of economic valuation of natural resources.
- A mission was fielded in 2003 to assist the government with guidelines for the future development of Palau's petroleum sector, including appropriate legal, fiscal and regulatory frameworks, and mechanisms to assess the social and economic impact of exploration and production activity.
- In the health sector, the Bank has provided technical assistance involving the review of a draft health care plan and legislation.
- In March 1999, the Bank Group's Foreign Investment Advisory Service (FIAS) carried out a diagnostic review of the investment environment and, since then, has undertaken two separate reviews of new draft foreign investment legislation.
- In the latter part of 1998 and early-1999, South Pacific Project Facility (SPPF), a small- and medium-enterprise (SME) development initiative of the International Finance Corporation provided advisory services to the National Development Bank of Palau. More recently, work has commenced on a number of SME projects in the tourism sector.
- Assistance was provided to manage the Y2K problem.

The Bank's fifth biennial Regional Economic Report for its Pacific Island member countries, including Palau, was issued in September 2002. This report *Embarking on a Global Voyage: Trade Liberalization and Complementary Reforms in the Pacific* focuses on the efforts of Pacific Island Countries (PICs) to integrate more closely with the global economy. The report evaluates the strategy of PICs to enter into a regional trade agreement, and analyses the interaction of trade liberalization with complementary reforms in other sectors of the economy. The Regional Economic Report for 2000, *Cities, Seas and Storms: Managing Change in Pacific Island Economies*, focused on three areas: managing the growth of towns, the management of ocean resources, and the impact of, and adaptation to, climate change.

¹ Prepared by World Bank staff.

REPUBLIC OF PALAU: RELATIONS WITH THE ASIAN DEVELOPMENT BANK

The Republic of Palau joined the Asian Development Bank on December 29, 2003.

REPUBLIC OF PALAU: STATISTICAL ISSUES

The Office of Planning and Statistics is responsible for the compilation of national statistics. There are presently no official statistical publications at the aggregate level and data on national accounts, monetary developments, and the balance of payments are severely limited. Since the conclusion of the first Article IV consultation mission in July 1999, the authorities, however, have been providing to the Fund the available core economic data on a regular basis.

A. Real sector

Estimates of the national accounts have only been compiled on a sporadic basis since 1984, and have been interrupted since late 2002. GDP data by economic activity at current prices for 1984–85, 1990–91, and 1992–93 were compiled by a UNDP consultant, the United Nations Economic and Social Commission for Asia and the Pacific, and under a joint project by the University of Oregon and the U.S. Department of Interior, respectively. These GDP estimates are not comparable because of methodological differences in compilation. However, the 1992–93 GDP data were found to be the most adequate in coverage and quality; and a similar approach was followed, with some improvements, by an UNDP consultant to produce a comparable set of GDP estimates for 1996 and 1997. The 1992 and 1993 and 1996 and 1997 GDP data were then used as benchmarks by the staff to estimate GDP for 1994 and 1995 and 1998 in line with available sector indicators for these years. The authorities' capacity to produce consistent official estimates of the national accounts suffered a loss due to the departure of the head statistician in 2002. Efforts are being made to train new staff. A consumer price index has been compiled since June 2001 on a quarterly basis and has been used to compile a GDP deflator.

B. Government finance

Fiscal data are compiled at both the national and state level as part of their respective annual budgetary processes. The authorities have agreed to provide these fiscal data to APD on a regular basis in a standard Fund-format usable for analysis. Considerable technical assistance has been provided by PFTAC, a long-term FAD advisor, and LEG for preparation of a new tax code.

C. Monetary accounts

Audited balance sheet data are not regularly provided by banks to the authorities as they are not legally required to do so, and hence there is no official collection of a banking survey. At present, the banks only file quarterly tax forms to the Ministry of Finance.

D. Balance of payments

Balance of payments data are not compiled by the authorities. Estimates of the balance of payments have been prepared by the staff based on official data on imports, interest income, official grants, debt service, and the financial holdings of the government, and estimates of exports, services, and private transfers. Compilation of the balance of payments is further complicated by a lack of commercial banking data.

Core Statistical Indicators
(As of November 2003)

Country: **Republic of Palau:**

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP	External Debt
Data of latest observation	N/A	09/03	N/A	N/A	N/A	06/03	09/03	FY2003	FY2003	FY2003 (prel.)	FY2001 (prel.)	FY2003 (prel.)
Date received	N/A	11/03	N/A	N/A	N/A	11/03	11/03	11/03	11/03	11/03	11/03	11/03
Frequency of data 1/	N/A	M	N/A	N/A	N/A	M	Q	M	A	M	A	A
Frequency of reporting 2/	N/A	V	N/A	N/A	N/A	V	V	Q	V	M	V	A
Source of data 3/	N/A	A,O	N/A	N/A	N/A	A	A	A,O/P	A,O	A,O	A,O	P
Mode of reporting 4/	N/A	V	N/A	N/A	N/A	V	V	E	V	E	V, E	V
Confidentiality 5/	N/A	A	N/A	N/A	N/A	U	U	B	B	B	B	B
Frequency of publication 6/	D/A	V	N/A	N/A	N/A	V	V	V	V	V	V	A

1/ A - annually; D - daily; M- monthly.

2/ A - annually; D - daily; M- monthly; Q - quarterly; V - staff visits.

3/ A - direct reporting by the authorities; O - staff estimates; P - publicly released information.

4/ E - electronic data transfer; V - staff visits.

5/ A - for staff use only; B - embargoed for a specified period and thereafter for unrestricted use; U - unrestricted use.

6/ A - annually; D - daily; V - staff visits.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
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Public Information Notice (PIN) No. 04/14
FOR IMMEDIATE RELEASE
March 2, 2004

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

IMF Concludes 2003 Article IV Consultation with the Republic of Palau

On February 27, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Palau.¹

Background

The Republic of Palau is a small island economy, heavily dependent on tourism and external assistance. With a population just under 20,000, Palau faces many development constraints common among other Pacific Island economies including a small domestic market and vulnerability to external shocks. The public sector is large and accounts for over one-third of total employment.

The Compact of Free Association provided front-loaded grants from the United States over the fifteen-year period to 2009. Large disbursements have been made since mid-1990s to build infrastructure and create a Compact Trust Fund (CTF) to enable Palau to become self-sustainable. The CTF stood at US\$136 million at end-September 2003. In recent years, grants from the U.S. have averaged about US\$24 million or 20 percent of GDP per annum, financing primarily government operations. Palau has also received large in-kind (off budget) and cash grants from Japan and Taiwan Province of China for infrastructure projects. External debt (all of which is on concessional terms) remains low at 16 percent of GDP.

Economic growth has been modest in the last few years and inflation is low. Following a recovery of 4.5 percent in FY2001, real GDP growth is estimated to have been only 1 percent

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.

annually in FY2002-03 (years ending September), reflecting the adverse impact of various external shocks that affected tourism, a major source of income for the country. The effect of shocks on growth has been only partially offset by project-related construction.

Palau has recorded large fiscal imbalances in recent years. The overall fiscal deficit (including grants) swung from over 20 percent of GDP in FY2001-02 to 2 percent of GDP in FY2003, due primarily to the time lags involved in the receipt and use of project-related external assistance. Excluding capital grants and spending, the balance between domestic revenue plus current grants and current expenditure declined from about 10 percent of GDP in FY2001 to 5 percent of GDP in FY2003. However, this adjustment was inadequate to prevent the virtual depletion of the government's usable reserves. To finance the deficits, the government also made withdrawals from the CTF in the last two years and accumulated domestic arrears in FY2003.

The external current account deficit deteriorated in FY2002 owing largely to the decline in tourist receipts in the aftermath of September 11, but improved in the following year. Tourist receipts rebounded in the second half of FY2003, helped by the depreciation of the real effective exchange rate, which remains significantly above the levels before the Asian crisis. Palau's tourism competitiveness was adversely affected by the large appreciation of the U.S. dollar vis-à-vis the Japanese yen in 2000-early 2002. Limited air flights and high airfares also make Palau's tourism less competitive. However, efforts have been made recently to introduce competition in air flights and diversify the tourist base. Imports fell in FY2003 reflecting lower grant-financed capital expenditure. The overall deficit since FY2001 has been financed by a drawdown in government financial assets.

The authorities launched a wide range of reform initiatives since 2001 but several important ones have stalled in the legislative process. Passage of the Financial Institutions Act and anti-money laundering legislation paved the way for establishing banking supervision and regulation in Palau. While the banking regulatory framework still needs improvements for effective implementation, a tax reform package, a new foreign investment law, a statistics law, and proposals related to streamlining the executive and legislative branch have not yet been enacted.

In the near-term, growth will be sustained, but medium-term prospects are clouded by fiscal uncertainties. The recovery of tourism and continuing large donor-financed infrastructure projects should support growth. Over the medium term, the big construction projects will likely wind down. The economy faces a large downside risk stemming from the scheduled sharp decline in grant assistance from the United States after 2009, which would affect government expenditure, domestic consumption, and economic activity.

Executive Board Assessment

Executive Directors agreed with the thrust of the staff appraisal. They noted that Palau's economic growth performance over the past few years has been affected by various external shocks and vulnerabilities typical for a small economy. But they noted also the economy's heavy reliance on government activity, which, in turn, is driven to a significant extent by

external grants that are expected to decline from 2009. Against this background, Directors stressed that Palau needs to vigorously pursue a medium-term program of fiscal consolidation and private sector development, in order to achieve sustained economic growth and reduce the dependence on foreign assistance. They were encouraged that the authorities have a realistic and comprehensive policy agenda to achieve these objectives, and pressed for timely implementation of reforms.

Directors welcomed the improvement in Palau's fiscal situation in the last two years as a result of a reduction of non-wage current expenditure. Nevertheless, they suggested deeper fiscal adjustment to prepare for the scheduled sharp decline in grant assistance from the United States after 2009. Directors stressed that the immediate priority is to limit the budget deficit in fiscal year 2004 to available financing. Concrete measures to achieve this will include implementation of the government's cost reduction plan, especially the measures to reduce the public sector's personnel and operating costs and to cut capital outlays not funded by external assistance. Directors urged the authorities to prioritize and tighten control of expenditure commitments in order to clear domestic payment arrears and prevent their re-emergence.

For the medium term, Directors stressed the importance of prudent management of the Compact Trust Fund and the need to further strengthen the fiscal position in order to rebuild usable reserves in the run-up to 2009. In this regard, they underscored the critical importance of public sector reform to downsize the civil service and hence the wage bill. They urged the authorities to adopt the tax package proposed in 2001 to strengthen tax revenue, to embark on a comprehensive revenue reform to support fiscal consolidation, and to continue to resist tax proposals that may create loopholes in the tax system and undermine government revenue. Directors also cautioned that external borrowing, including on concessional terms, should be consistent with medium-term debt sustainability, and welcomed the authorities' intention to develop Palau's debt management capacity.

On private sector development, while recognizing the severe constraints facing Palau, Directors emphasized that every effort must be made to create the conditions for private sector-led growth, as it is vital for economic self-reliance and sustainable development and for absorbing displaced workers from the public sector. They supported the government's structural reform agenda set out in its economic development strategy and Management Action Plan, and urged timely and consistent implementation, particularly in the areas of privatization, foreign investment, land ownership, and banking.

Directors welcomed recent progress in enforcing the Financial Institutions Act and anti-money laundering legislation. They urged the authorities to adopt the amendments and regulations that are needed to further improve the legal framework for banking supervision and regulation that was adopted in 2001, and to strengthen implementation capacity. They advised the government to exercise caution in its involvement in commercial lending and risky investments.

Directors noted that with much remaining to be done in the area of structural reform, a strong public consensus in support of reform would need to be developed. They therefore welcomed

the Fund staff's outreach efforts to engage in dialogue with the members of Congress, and encouraged further endeavors in the future.

Directors encouraged the authorities to take steps to improve the compilation and reporting of economic statistics. In this regard, they commended the authorities for placing the Statistics Law before the Congress, and emphasized that efforts need to be made to train and retain local professional staff.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Republic of Palau: Selected Economic and Financial Indicators, 1999/00–2003/04

	1999/00	2000/01	2001/02	2002/03	2003/04
			Est.	Est.	Proj.
Real Sector					
Real GDP growth (percent change) 1/	0.3	4.5	1.1	1.5	2.0
Consumer prices (percent change, end-of-period) 2/	3.0	-1.3	0.4	0.3	0.5
Business and tourist arrivals	45,932	49,731	39,833	46,615	50,000
Public finance (in percent of GDP)					
Revenue	52.6	44.3	42.1	52.7	56.4
Domestic revenue	25.0	26.5	23.6	24.1	26.4
Grants	27.6	17.8	18.4	28.7	30.0
Expenditure	72.8	66.7	65.8	58.6	66.3
Current	62.0	53.8	48.6	47.3	49.2
Capital	10.7	12.8	17.3	11.3	17.1
Overall fiscal balance (including grants)	-15.6	-20.9	-28.1	-2.3	-12.4
Compact Trust Fund (CTF) balance (in millions of U.S. dollars)	161.8	135.0	124.5	136.6	...
Government non-CTF financial assets (in millions of U.S. dollars)	77.7	43.7	13.7	16.4	...
Usable reserves (in millions of dollars) 3/	29.4	7.6	3.1	0.4	...
Balance of payments (in millions of U.S. dollars)					
Exports (f.o.b.)	11.5	18.7	20.3	11.9	12.3
Imports (f.o.b.)	-127.1	-99.8	-100.7	-93.7	-108.8
Tourism receipts	53.2	58.5	47.4	57.9	62.2
Current account balance (including grants)	-35.5	-7.3	-17.1	-5.3	-22.6
(in percent of GDP)	-30.6	-5.6	-14.0	-4.3	-17.8
Overall balance	0.4	-25.1	-34.2	-3.4	-16.5
External public debt 4/	20.0	20.0	20.0	19.4	18.3
Debt service ratio 5/	2.2	0.9	1.0	1.8	3.0

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

1/ Based on limited available data.

2/ U.S. CPI is used for 1995 to 2000. Palau has compiled its own CPI since June 2000.

3/ The government's non-CTF assets excluding amounts reserved for capital projects and other specific uses.

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

5/ In percent of exports of goods nonfactor services.