



REPUBLIC OF PALAU

2016 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF PALAU

October 2016

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 2016 Article IV consultation with Palau, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its September 9, 2016 consideration of the staff report that concluded the Article IV consultation with the Republic of Palau.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on September 9, 2016 following discussions that ended on May 31, 2016, 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 August 24, 2016.
- An **Informational Annex** prepared by the IMF.

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October 19, 2016

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IMF Executive Board Concludes 2016 Article IV Consultation with the Republic of Palau

The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with the Republic of Palau on September 9, 2016.

Palau's economy has performed well in recent years. The economy grew strongly in FY2015 (ending September 30, 2015) at 9.4 percent, with tourist arrivals and construction activity expanding by 35 percent. However, the rapid rise in tourism activity strained infrastructure and was tilted towards low budget tourists, which led the authorities to limit the number of charter flights in FY2016. Inflation declined to 2.2 percent in FY2015 in line with falling commodity prices, and the external position improved due to lower commodity prices and higher tourism receipts. The fiscal position strengthened because of spending restraint and strong revenue growth, with the current fiscal deficit (current expenditure less domestic revenue) falling from 11 percent of GDP in FY2014 to 5.5 percent in FY2015. Public debt remains moderate and sustainable.

The outlook for Palau is also favorable. Economic growth is expected to slow temporarily to zero in FY2016 as tourist arrivals decline, but to rebound to 5 percent in FY2017 as tourism activity recovers with the entry of new hotels and construction picks up. Inflation is projected to remain low at 2 percent as commodity prices stabilize. The current account deficit is expected to rise due to larger infrastructure related imports, and the fiscal position is projected to improve further on continued spending restraint. Palau's positive outlook is subject to substantial risks due to its reliance on tourism, grants, and commodity imports. A slowdown in key trading partners, further U.S. dollar appreciation, and natural disasters could hurt tourism activity. Higher commodity prices could make food and fuel imports costlier. Failure to implement a strategy for sustainable tourism development could reduce growth in the medium term. Palau will have to rely on fiscal and structural policies should risks materialize.

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.

Executive Board Assessment²

The Executive Directors welcomed Palau's robust economic growth and improved fiscal and external positions, underpinned by a strong tourism industry and significant expansion in construction activity. Directors noted that, while the outlook is favorable, the economy is subject to downside risks arising from the exposure to natural disasters and climate change, and from its heavy reliance on tourism and grants. They emphasized the importance of continued sound macroeconomic policies and structural reforms to ensure fiscal sustainability, preserve financial stability, and boost potential growth.

Directors welcomed the measures taken to strengthen the fiscal position. They underscored, however, that additional efforts will be needed over the medium term to ensure fiscal self-sufficiency when the Compact grants expire. Fiscal adjustment should build on the progress made on revenue and expenditure measures, including by replacing the gross revenue tax with a value added tax, and by reorienting infrastructure investment to support the tourism industry and enhance the resilience to natural disasters and climate change. Directors highlighted the importance of strengthening the fiscal framework by targeting a public sector net worth position as the fiscal anchor, while using the current fiscal balance as an operational target. In addition, they emphasized that improving public financial management and strengthening the civil service pension system would help contain fiscal risks and ensure debt sustainability.

Directors noted that the banking system remains sound and well supervised and welcomed the steps being taken to preserve financial stability and facilitate domestic credit expansion. Directors encouraged continued efforts to relax the ceiling on credit rates and to broaden the Financial Institutions Commission oversight to include non-bank financial institutions.

Directors emphasized that economic diversification and improving the business climate are key to reducing Palau's vulnerabilities and boosting potential growth. Priority should be given to developing a comprehensive strategy to ensure sustainable tourism development, supported by adequate infrastructure investment. Directors also encouraged the authorities to improve the regulatory environment and to strengthen the coordination among the national and state governments.

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

Palau: Selected Economic Indicators, 2009/10–2016/17 1/

Nominal GDP for FY2015: US\$287 million
 Population (2015): 17,885
 GDP per capita for FY2015: US\$16,070
 Quota: SDR 3.1 million

	2013/14	2014/15 Est.	2015/16	2016/17	2017/18 Proj. 2/	2018/19	2019/20	2019/21
Real sector								
Nominal GDP (million US\$) 3/	250.9	287.4	296.0	318.6	341.2	362.0	380.3	395.7
Real GDP growth (percent change)	4.2	9.4	0.0	5.0	5.0	4.0	3.0	2.0
GDP deflator (percent change)	5.2	4.7	3.0	2.5	2.0	2.0	2.0	2.0
Consumer prices (percent change; period average)	4.0	2.2	2.0	2.0	2.0	2.0	2.0	2.0
Tourist arrivals (number of visitors)	125,674	168,767	148,515	158,911	166,857	173,531	178,737	184,099
Public finance 3/ (In percent of GDP)								
Central government								
Revenue	43.3	40.6	39.6	41.8	40.8	40.3	39.8	39.4
Taxes and other revenue	24.4	25.4	24.8	25.5	26.1	26.0	25.9	25.8
Grants	18.9	15.3	14.8	16.3	14.8	14.3	13.9	13.6
Expenditure	39.8	35.6	41.6	42.7	39.6	36.7	36.5	36.0
Expense	35.4	30.9	30.3	30.2	30.1	30.0	29.9	29.9
Net acquisition of nonfinancial	4.4	4.7	11.3	12.5	9.5	6.7	6.5	6.1
Current fiscal balance (excluding grants) 4/	-11.0	-5.5	-5.5	-4.7	-4.0	-4.0	-4.0	-4.0
Net lending (+)/borrowing (-)	3.5	5.0	-2.0	-0.9	1.2	3.5	3.3	3.4
(In millions of U.S. dollars)								
Compact Trust Fund (CTF) balance	199.2	183.9	188.9	194.2	201.8	208.9	215.9	222.8
Government cash and deposits 5/	9.6	23.4	30.6	39.1	44.7	52.8	63.0	72.8
In percent of GDP	3.8	8.1	10.4	12.3	13.1	14.6	16.6	18.4
Balance of payments 3/								
Trade balance	-158.2	-142.4	-148.4	-164.8	-176.1	-177.0	-180.8	-184.6
Exports (f.o.b.)	19.1	14.5	11.9	14.6	16.1	17.7	18.7	19.6
Imports (f.o.b.)	177.3	156.8	160.3	179.4	192.2	194.7	199.5	204.2
Tourism receipts	129.3	150.4	139.0	153.2	163.2	172.3	180.1	188.3
Current account balance								
Including grants	-29.5	-1.5	-15.6	-22.4	-28.3	-22.8	-21.1	-19.3
Excluding grants	-74.4	-42.3	-56.1	-62.2	-66.3	-60.6	-58.3	-55.8
International Investment Position								
Assets	245.4	272.1	272.1	280.3	295.2	318.4	345.4	372.9
Liabilities	467.1	511.0	539.4	569.7	599.8	632.2	667.1	702.0
Of which: External debt	221.7	239.0	267.3	289.3	304.6	313.8	321.7	329.1
Of which: External debt	70.6	64.2	77.4	90.0	92.6	88.9	83.7	77.9
(In percent of GDP)								
Current account balance								
Including grants	-11.8	-0.5	-5.3	-7.0	-8.3	-6.3	-5.6	-4.9
Excluding grants	-29.7	-14.7	-19.0	-19.5	-19.4	-16.7	-15.3	-14.1
International Investment Position								
Of which: External debt	97.8	94.7	91.9	88.0	86.5	88.0	90.8	94.3
Of which: External debt	28.1	22.4	26.1	28.2	27.1	24.6	22.0	19.7

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

1/ Fiscal year ending September 30.

2/ Staff projections.

3/ Incorporates the authorities' revised estimates of GDP and balance of payments, and the audited government financial statements.

4/ Defined as tax and other revenue less expense.

5/ Includes unspent external loans.



REPUBLIC OF PALAU

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION

August 24, 2016

KEY ISSUES

Context. Palau is a middle-income micro state in the Pacific (*population: 18,000*) that relies heavily on tourism and grants, and is exposed to natural disasters. The economy grew strongly at 9.4 percent in FY2015 led by robust tourism and construction activity, but the surge in tourist arrivals strained infrastructure and was tilted to low budget tourism. The fiscal position has improved, but further efforts are needed to ensure long-term fiscal sustainability. The outlook is favorable although subject to significant downside risks. The discussions focused on:

Ensuring long term fiscal sustainability

- Further fiscal adjustment is needed to ensure self-sufficiency when the Compact grants expire in FY2024. This should include both revenue and expenditure measures, with the composition of expenditure tilted towards preserving infrastructure investment.
- The fiscal framework should be boosted by targeting a public sector net worth position as the fiscal anchor and using the current fiscal balance as an operational target.
- Public financial management should be strengthened to limit fiscal risks. Some public entities need to be reformed to limit their losses and reduce government subsidies.

Increasing potential growth and resilience

- Protecting the environment and positioning Palau as a high-end tourism destination requires adopting a broad strategy for sustainable tourism development, and limiting hotel developments until infrastructure has been upgraded.
- Appropriate infrastructure planning is needed to support the rapidly growing tourism industry and enhance resilience to natural disasters and climate change.

Preserving financial stability and facilitating credit extension.

- Banks remain sound and well supervised, but financial supervision should be extended to other financial institutions. Staff welcomes the authorities' plan to expand financial supervision to the National Development Bank of Palau.
- Banks continue to lend little domestically. Easing the interest rate ceiling on commercial loans and helping small and medium size enterprises to prepare business plans would help domestic financial intermediation.

Approved By
Patrizia Tumbarello
(APD) and Bob Traa
(SPR)

Discussions took place in Koror during May 18–31, 2016. The mission team comprised Mr. Guajardo (Head, APD), Ms. Raga (APD), Ms. Sian (SEC), and Mr. Usui (Asian Development Bank). Mr. Cafrine (OED) also participated in the discussions. Ms. Kanyabutembo and Ms. Liu (both APD) provided excellent research and administrative assistance. The team met with President Remengesau Jr., Minister of Finance Sadang, other senior government officials, and representatives of Congress, private sector, and donor community. A press release at the end of the mission was published on May 31, 2016.

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CONTEXT

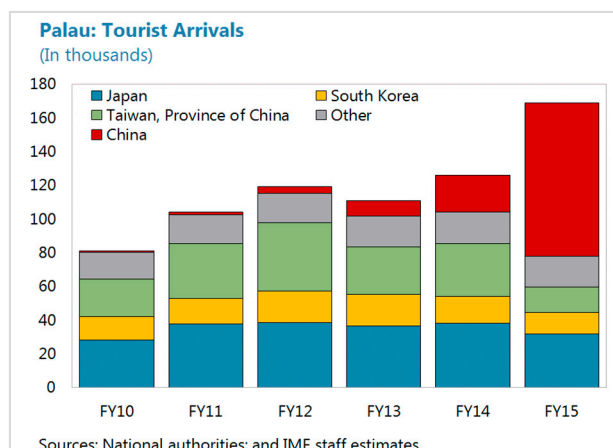
1. Palau is a middle-income micro state in the Pacific that relies heavily on tourism and grants, and is exposed to natural disasters and climate change. The country was hit by a severe drought early this year associated with El Niño weather conditions, which led the authorities to ration water consumption and declare state of emergency in March and April (Appendix I). Palau's political system is based on the U.S. model, the presidential term is four-year, and the next elections are in November 2016. President Remengesau Jr. is well regarded for his environmental initiatives such as the world's first shark sanctuary created in 2009 and the world's largest marine sanctuary created in 2015 (Appendix II). Palau's legal tender is the U.S. dollar and its fiscal year ends in September.

2. Palau became independent in 1994 after being under U.S. administration. As part of a 50-year Compact of Free Association, the United States provided US\$580 million in financial aid to Palau during 1994–2009 for infrastructure investment, budget support, and the establishment of a Compact Trust Fund (CTF). The CTF, with an initial investment of US\$70 million, was to provide Palau with US\$5 million in FY1999–09 and US\$15 million in FY2010–44. But the CTF funds proved insufficient and a new agreement extending financial assistance for another 15 years was signed in 2010. The new assistance included US\$30 million for the CTF, US\$122 million in current grants, and US\$67 million for infrastructure. However, the agreement has not been ratified by the U.S. Congress, although Palau continues to receive current grants and CTF withdrawals. The projections below assume that the agreement is ratified in FY2017, with the funds evenly disbursed during FY2018–24. Palau would face a drop in government revenue after FY2024 when the Compact grants expire, but it would continue to receive US\$15 million in CTF withdrawals until the CTF is exhausted.

3. Palau's economic policies in FY2014–15 were broadly in line with past IMF advice (Appendix III). The fiscal position has improved thanks to spending restraint, and a tax reform bill was sent to Congress in FY2014, which is pending approval. Basic infrastructure and internet connectivity are being upgraded through ongoing projects. Efforts to expand financial supervision to the National Development Bank of Palau and other non-bank financial institutions are also underway.

CURRENT DEVELOPMENTS, OUTLOOK AND RISKS

4. Growth. The economy grew strongly in FY2015 at 9.4 percent, significantly faster than other Pacific island countries, with tourist arrivals and construction activity expanding by 35 percent. But the boom in tourism strained infrastructure (water, sanitation, and waste disposal), was tilted to low budget tourists, led to a rise in low quality hotels, and put the environment at risk (Appendix IV). As a result, the authorities have limited the number of charter flights and tourist arrivals have slowed in FY2016. Construction was buoyant in FY2015 due to the development of infrastructure and new hotels.



The recent drought had a limited impact on growth due to its short duration and the small size of the agricultural sector. Growth is projected at zero in FY2016 due to lower tourist arrivals and a modest impact from the drought, but to rise to 5 percent in FY2017 as tourism recovers with the entry of new hotels and construction picks up. In the medium term, growth would gradually moderate to 2 percent as hotel developments are restricted until infrastructure has been upgraded.

5. Inflation and credit. In line with global trends, inflation fell to 2.2 percent in FY2015 as food and fuel prices declined and it is expected at 2 percent in FY2016–17 as commodity prices stabilize. Banks continue to lend little domestically despite the rapid rise in deposits, investing most of their assets abroad. Domestic loans fell by 2.5 percent in FY2015, with the loan-to-deposit ratio declining to 13 percent. The ceiling on lending rates for commercial loans and the lack of business plans and financial statements for small and medium size enterprises (SMEs) are likely at the root of this issue.

6. External Stability. The external position has improved. The current account deficit shrank from 12 percent of GDP in FY2014 to 0.5 percent in FY2015, mostly due to a fall in fuel imports by 10 percent of GDP, but lower food imports and higher tourism receipts also helped. Capital grants and FDI inflows exceeded the current account deficit by a wide margin. The current account deficit is expected to rise to 7 percent of GDP in FY2016–18 due to higher imports relating to fiber optic cable and sanitation projects financed with AsDB loans; and it is projected to stabilize at 5.5 percent of GDP in the medium term due to higher commodity prices and infrastructure related imports financed with Compact grants. These deficits would remain fully financed with capital grants and FDI inflows.

7. Risks. Palau's positive outlook is subject to substantial downside risks due to its high reliance on tourism, grants, and commodity imports (Appendix V). U.S. dollar appreciation, a slowdown in key trading partners, and natural disasters could hurt tourism. Higher commodity prices could make food and fuel imports costlier. Further delays in ratifying the Compact agreement with the United States could complicate financing of fiscal and external balances. A continued strong influx of low budget tourists and further increase in low quality hotels could position Palau as a mass tourism destination and thus hurt the environment. Failure to implement a tourism strategy and diversify the economy could reduce growth in the medium term. Given the lack of monetary and exchange rate policies, Palau's policy tools would be limited to fiscal and structural policies should risks materialize.

Authorities' views

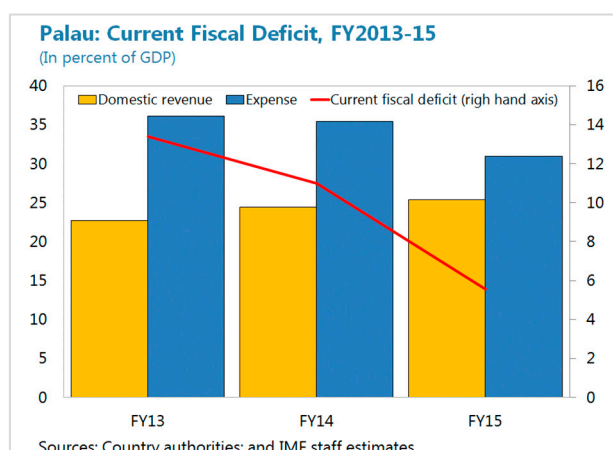
8. The authorities agreed with staff's assessment of the economic outlook and risks. They noted that their objective is to achieve a level of growth that is sustainable and consistent with their goals of maintaining a pristine environment and positioning Palau as a high-end tourism destination. In this regard, the surge in tourist arrivals in FY2015 was excessive as it strained infrastructure, was tilted towards package tour low budget tourists, and led to an increase in low quality hotels. These trends go against their goals, and justified the introduction of limits on charter flights and restrictions in hotel developments until infrastructure has been upgraded. The authorities also noted that although the increase in the airport departure tax from US\$50 to US\$100 per tourist from April 1, 2017 seeks to replace lost revenue from fishing licenses due to the creation of the marine sanctuary, it may also help discourage tourist arrivals, particularly for low budget tourists. However, they expect the impact of this measure on tourist arrivals to be limited.

KEY POLICY ISSUES

9. Sustainable Development Goals (SDGs). The authorities seek to achieve a number of SDGs to make development economically, socially, and environmentally sustainable. The SDGs prioritized by the authorities are: (i) Promoting sustained, inclusive and sustainable economic growth (SDG #8); (ii) Building resilient infrastructure (#9); (iii) Combating climate change and its impacts (#13); and (iv) Conserving the ocean and marine resources for sustainable development (#14). The key policy priorities in this regard are ensuring fiscal sustainability, raising potential growth and enhancing resilience, and preserving financial stability and facilitating credit extension.

A. Ensuring Fiscal Sustainability

10. Developments. Palau's fiscal position has improved noticeably. The current fiscal deficit (expense less domestic revenue) fell from 11 percent of GDP in FY2014 to 5.5 percent in FY2015. Tax revenue rose by 1 percent of GDP due to higher receipts from the airport departure tax as tourist arrivals soared, while expense declined by 4.5 percent of GDP due to spending restraint. The overall balance rose only by 1.5 percent of GDP due to a drop in grants. The CTF reached 64 percent of GDP in FY2015, while government deposits rose to 8.1 percent of GDP, domestic accounts payable fell to 5.4 percent of GDP, and government external debt declined to 10.4 percent of GDP.

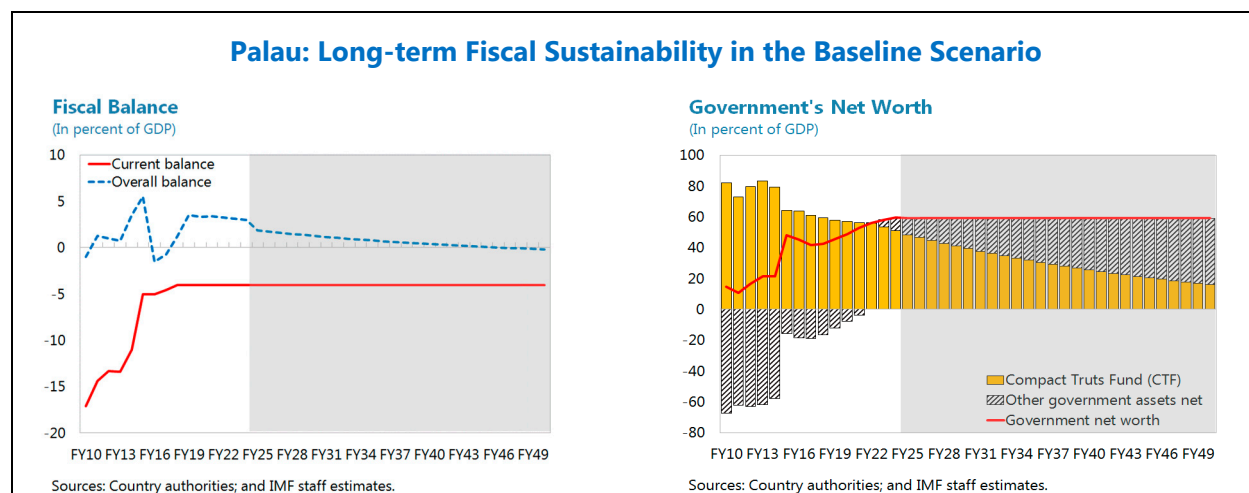


11. Medium-term outlook. Fiscal adjustment is set to continue due to sustained spending restraint, with the current fiscal deficit falling from 5.5 percent of GDP in FY2015 to 4 percent in FY2018. The current deficit would stay at 5.5 percent of GDP in FY2016 as the fall in tourism related revenue is offset by spending restraint. From FY2017, domestic revenue would remain stable as percent of GDP but for the rise in the airport departure tax from US\$50 to US\$100 per tourist from April 1, 2017. This measure would raise 2.4 percent of GDP in revenue, half of which is reserved for the Civil Service Pension Fund (CSPF) and is not reflected in the government accounts.¹ Government revenue would rise by 1.2 percent of GDP (0.6 percent in FY2017 and FY2018), but expense would also rise by the same amount as the extra revenue is reserved for the state governments and marine sanctuary, with no impact on the current fiscal balance. Spending restraint is expected to continue, with the current fiscal balance falling by 0.7 percent of GDP in FY2017 and FY2018. Public investment would be limited to that financed with capital grants and AsDB loans, with the overall fiscal balance

¹ This extra revenue is estimated to reduce the CSPF's unfunded liabilities from 39 percent of GDP in 2015 prior to the reform to 8 percent after the reform. More generally, the fact that this large improvement in the fiscal position is not reflected in the fiscal accounts highlights the need to expand the perimeter in the fiscal statistics to include the state governments, the CSPF, the Social Security Fund, and the state owned enterprises.

temporarily moving into deficit due to higher capital spending funded with AsDB loans, but returning into surplus afterwards due to the lower current fiscal deficits and higher Compact grants.

12. Long-term outlook. The current fiscal deficit is expected to remain at 4 percent of GDP from FY2018 onwards. Capital spending in FY2019-24 would continue to be set by capital grants and AsDB loans, with the overall fiscal balance staying in surplus as the current grants exceed the current fiscal deficit. As part of the FY2018-24 windfall is saved, the government's net worth—defined as the CTF plus government deposits, less domestic accounts payable, government external debt, and CSPF's unfunded liabilities—would rise from 48 percent of GDP in FY2015 to 59 percent in FY2024. The CTF would fall to 51 percent of GDP in FY2014 due to the larger withdrawals allowed under the renewed Compact agreement, while other government assets net would increase to 8.5 percent of GDP. Staff analysis suggests that the current fiscal deficit can be sustained at 4 percent of GDP post FY2024, provided that public investment is capped at 5.6 percent of GDP (Appendix VI). The overall fiscal balance falls after FY2024 as the Compact grants expire, but the government net worth stabilizes at 59 percent of GDP as the rise in other government assets net offsets the decline in the CTF.

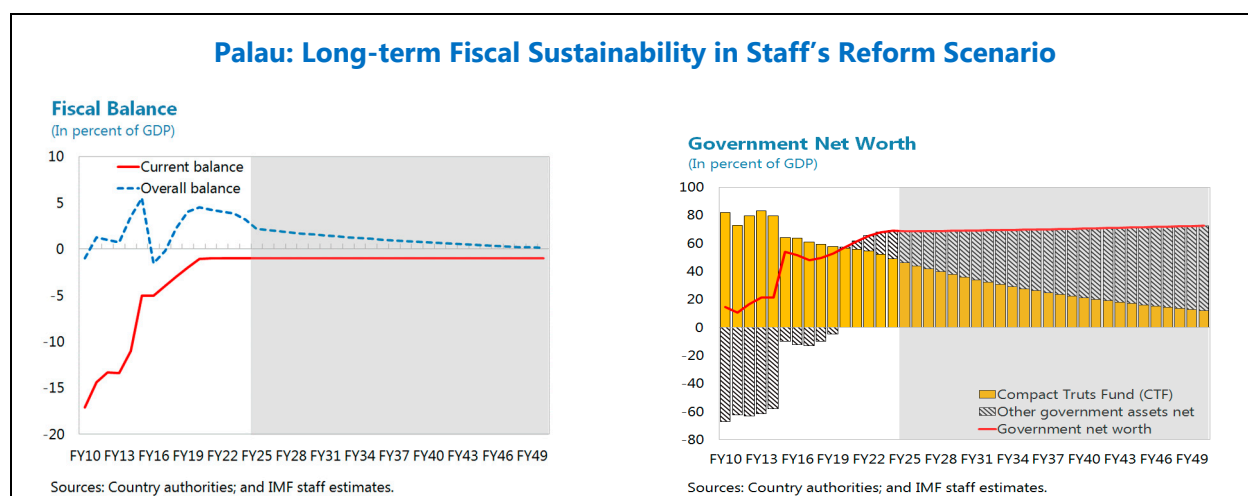


Staff's Reform Scenario

13. Strengthening the fiscal framework. Staff recommends targeting a net worth position of the public sector as the fiscal anchor, and using the current fiscal balance as the operational target. Targeting a net worth level would ensure fiscal self-sufficiency when the Compact grants expire in FY2024 by building sufficient government non-CTF assets to offset the decline in the CTF balance, thus keeping ample buffers. Using the current fiscal balance as the operational target would not only help achieve the desired government net worth position, but also reach a desired level of capital spending by restricting the level of current expenditure relative to domestic revenue.

14. Ensuring long-term fiscal sustainability. Staff recommends further fiscal adjustment in the medium term and to shift the composition of public expenditure towards investment to support the growing tourism industry and enhance resilience to natural disasters and climate change. In the baseline scenario, public investment is only 6.2 percent of GDP in FY2019–24 and 5.6 percent of GDP after FY2024—lower than Palau's historical average (8.3 percent of GDP) and below that of other

Pacific islands (11 percent of GDP). Moreover, Palau needs buffers because: (i) tax revenue is volatile given its reliance on taxes on tourism; (ii) the country is exposed to natural disasters and climate change; (iii) there are contingent liabilities in the CSPF and other public entities; and (iv) the CTF and other government assets are subject to market risk. Staff recommends targeting at government net worth position of 70 percent of GDP after FY2024, 11 percentage points more than in the baseline scenario. Staff also recommends cutting the current fiscal deficit to 1 percent of GDP by FY2020, which would not only help achieve the government's net worth target, but also increase public investment to 8.3 percent of GDP from FY2019. Real GDP growth would fall in FY2017–18 due to the fiscal adjustment, but it would increase in FY2019–21 as the gains from higher public investment more than offset the negative impact from fiscal consolidation. After FY2020, growth would increase by about 1 percentage point in line with the rise in public investment.



15. Attaining a balanced fiscal adjustment. Further fiscal adjustment should rely on revenue and expenditure measures. Staff supports a reform that replaces the gross revenue tax (GRT) with a single rate value added tax (VAT) with no exemptions, and raises the net income tax on financial institutions and all VAT-registered businesses. Staff also recommends strengthening tax compliance and using a bidding mechanism to manage charter flights instead of quantitative limits. Expenditures should be contained by prioritizing spending and gradually eliminating subsidies. Staff recommends splitting the fiscal adjustment equally between revenue and expenditure measures. The VAT and net income tax reforms could yield 1.5 percent of GDP in additional revenue by FY2020, while the wage bill could be reduced by 1 percent of GDP and government subsidies by 0.5 percent of GDP.

16. Strengthening public financial management (PFM). Robust PFM is key to contain fiscal risks and support fiscal adjustment. Staff advises sound public debt management and project administration to secure debt sustainability. Staff analysis shows that public debt remains sustainable despite the recent AsDB loans by US\$52 million to finance the upgrade of the Koror-Arai waste management system and the submarine fiber optic cable (Appendix VII). However, public debt remains highly sensitive to a real GDP growth shock such as those that Palau could experience if faced with large natural disasters. Staff also recommends prioritizing infrastructure that supports

tourism growth and resilience to natural disasters and climate change, adopting a medium-term budget framework, improving budget execution and planning, and strengthening cash management.

17. Reforming public entities. Some public entities need to be reformed. The Civil Service Pension Fund (CSPF) is estimated to have unfunded liabilities by 8.3 percent of GDP even after considering the extra revenue from the increase in the airport departure tax. Staff recommends reducing benefits and raising contributions to ensure its long-term sustainability. The Palau Public Utility Corporation (PPUC) relies on government subsidies for its provision of water services. Staff advises raising tariffs and lowering operational costs to ensure full cost recovery of its operations, while providing adequate protection to the most vulnerable. The other two state owned enterprises, the Palau National Communications Corporation and the Belau Submarine Cable Corporation, have been able to cover their costs with their own revenue, without requiring government support.

Authorities' views

18. The authorities welcomed staff's recommendation to strengthen the fiscal framework and analysis of long-term fiscal sustainability. They noted that the recommendation of further fiscal adjustment in the medium term is well aligned with their own goal of self-financing expense with domestic revenue (zero current fiscal balance) by FY2024. They also welcomed staff advice of replacing the GRT with a VAT and rising the net income tax for financial institutions and all VAT-registered businesses. They noted that a bill replacing the GRT with a VAT was sent to Congress in FY2014, but has not yet been approved. They also stressed ongoing efforts to strengthen PFM and the medium term budget framework. The authorities also acknowledged the existence of unfunded liabilities in the CSPF, and noted that a bill shifting the CSPF from a defined-benefit to a defined-contribution system was sent to Congress in FY2014, but has also not yet been approved. They stressed that this reform would ensure the long-term sustainability of the CSPF, with the new funds from the increase in the airport departure tax used to pay for the benefits during the transition. The authorities also want to make PPUC self-sufficient by rising tariffs and reducing costs. However, they noted that service quality needs to be improved in line with planned upgrades to the water system before tariffs can be raised.

B. Raising Potential Growth and Enhancing Resilience

19. Context. Palau faces several structural constraints common to small island states: a narrow economic base, remote location, small population, inadequate infrastructure, weak business climate, and exposure to natural disasters and climate change. The projects in the pipeline funded by AsDB loans and grants are aimed at lessening some of the infrastructure bottlenecks. The 2016 World Bank's Doing Business Report points to a number of weaknesses in Palau's business climate, such as resolving insolvency, trading across borders, enforcing contracts, paying taxes, getting electricity, and access to credit.



20. Achieving sustainable tourism development. Tourism remains Palau’s main growth engine, but the lack of a tourism policy and weak regulation have led to excessive growth of the low budget segment. To align tourism development with the authorities’ long-term goal of positioning Palau as a high-end tourism destination, staff recommends implementing a comprehensive tourism strategy that clearly outlines land zoning rules, protects the environment, regulates service quality, has adequate infrastructure planning, and improves the skills of the labor force. Several initiatives in this direction have been tried in the past, but lack of political will, limited resources, and coordination problems have limited their implementation (Appendix VIII). New tourism developments in Koror should be avoided until infrastructure has been upgraded, but developments outside Koror and green tourism could continue. The regulatory environment also needs to be strengthened to enhance scrutiny and enforcement of regulations. Better coordination among the national and state governments is necessary to ensure effective implementation of the authorities’ long-term vision.

21. Diversifying the economy. Economic diversification would help reducing volatility and broadening the sources of growth. To lower tourism volatility, the mission recommends promoting tourism from new destinations, including growing Asian markets. Developing domestic business activities that can supply the tourism industry such as agriculture and aquaculture, and tourism activities that would increase tourist spending, would also help diversify the sources of growth.

22. Improving the business environment. A strong business environment would help private investment growth. Palau foreign investment approvals are decided by a Foreign Investment Board, which operates in a case by case basis. Staff recommends adopting a new foreign investment regime to simplify investment approval and open all business to foreign investment through joint ventures provided that proper regulations are in place. Staff also supports the role of the Economic Advisory Group—which includes representatives of the government, Congress, and the private sector—in coordinating the dialog between the private and public sectors to improve policy formulation and planning, including on measures to improve Palau’s business environment.

23. Enhancing infrastructure. Infrastructure bottlenecks are limiting tourism growth. The recent surge in tourism strained water supply, sanitation, and waste disposal, while poor internet quality has been the main dissatisfaction of Palau’s visitors in tourist exit surveys. These bottlenecks will ease as the projects funded with AsDB loans and capital grants are completed, but appropriate infrastructure planning as part of a broader tourism strategy is needed. New infrastructure should also seek to increase resilience to natural disasters and climate change, which is a significant risk as the recent drought showed. Priorities include limiting developments in areas at risk of tropical storms and rising sea levels, and improving the water system. Staff welcomes the authorities’ plans to upgrade the water pipeline system in Koror and to broaden the sources of water to make it more stable.

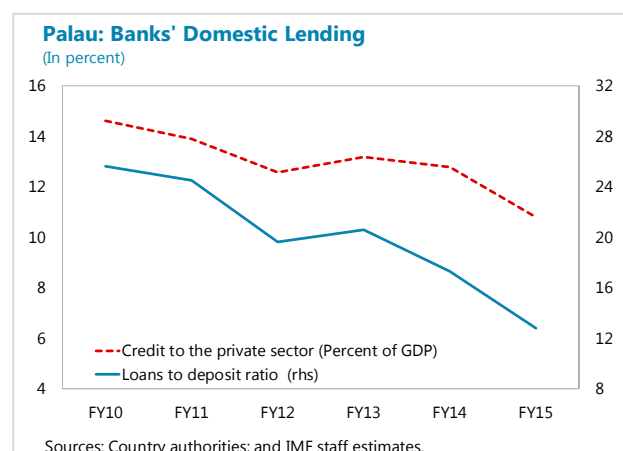
Authorities’ views

24. The authorities concurred with staff on the need to implement a comprehensive tourism strategy consistent with the long-term view of making Palau a high-end tourism destination and keeping a pristine environment. They noted that the bureau of tourism is preparing a plan along these lines, which should be finalized in the coming months. They also agreed that new hotel developments in Koror should be avoided until infrastructure has been upgraded, although they are open to high-end hotel developments that build their own treatment plants. The authorities agreed with staff on the need to prioritize infrastructure that helps tourism growth and resilience to natural

disasters and climate change. On the latter, they highlighted a new project financed with grants from Japan to upgrade the water pipeline system in Koror, which should reduce leakages and make water distribution more efficient. In addition, they are evaluating different alternatives to broaden the sources of water to avoid shortages such as the one experienced during the recent drought.

C. Preserving Financial Stability and Facilitating Credit Extension

25. Context. Palau's banks remain sound, with nonperforming loans at 2.1 percent, liquid assets at 90 percent, and return on assets at 1.4 percent. The presence of three foreign owned U.S. FDIC-insured banks that hold 93 percent of the loans and 99 percent of the deposits helps mitigate risks. But banks continue to lend little domestically despite the rapid rise in deposits, with domestic loans falling as percent of deposits and as percent of GDP. The legislation allowing the National Development Bank of Palau (NDBP) to take deposits was passed in Congress and once licensed, the NDBP will be regulated by the Financial



Institutions Commission (FIC) and will be subject to the same regulations of commercial banks. The loss of correspondent banking relationships has not been an issue in Palau as the three foreign owned U.S. FDIC insured banks do all the international transactions in the country. Anti-money laundering investigations have also improved with the enhanced role of the Financial Intelligence Unit (FIU).

26. Preserving financial stability. Keeping a sound financial sector is key to mitigate risks. The FIC has improved bank examinations, data collection, and reporting; while the FIU has enhanced anti-money laundering investigations. Staff recommends broadening the FIC's supervision to all non-bank financial institutions, including credit unions, and encourages the legislators to approve the Credit Union Act that put all credit unions under FIC supervision. Staff also welcomes the authorities plan to put the NDBP under FIC supervision, subject to the same regulations of commercial banks, while allowing it to take deposits and expand its lending activities. The authorities are also encouraged to continue improving the AML/CFT regime in line with the FATF standard.

27. Facilitating credit extension. To mobilize domestic credit, staff advises relaxing the interest rate ceiling for commercial loans to better reflect riskiness, and helping SMEs prepare business plans and financial statements. The NDBP can also help fill the financing gap for SMEs, especially in the agriculture sector. The NDBP lending activities have been constrained by the availability of financing from international financial institutions, and limited to the areas for which these funds are targeted, including agriculture, aquaculture, and housing. Once the NDBP is licensed to take deposits, it will be able to expand its lending activities to other areas of the economy.

28. Improving statistics. Palau's statistics are broadly adequate for surveillance thanks to technical assistance from IMF PFTAC and the Graduate School USA. Staff recommends improving tourism statistics and strengthening the statistics office to continue improving data quality.

Authorities' views

29. The authorities agreed with staff's assessment that Palau's banks remain sound. They noted that deposits have increased rapidly, which should help banks keep high profit levels. They also acknowledged that banks continue to lend little domestically, investing most of their assets abroad. They noted that the number of individuals loans has increased significantly, but the total loan stock has fallen because of the repayment of some large commercial loans. The authorities also observed that commercial lending has not picked up partly because foreign investors do not require domestic financing for their investment projects, but instead bring their own funds. The authorities are not convinced that the limit on lending rates to commercial loans is a key constraint to domestic credit growth. They believe that the lack of business plans and financial statements for SMEs is a more important factor. The authorities expect that the NDBP will help closing the financing gap for SMEs once it starts taking deposits and expanding its lending activities. However, it may take a few years for the NDBP to satisfy all the FIC's requirements to be licensed as a deposit taker. The authorities welcomed staff's advice to broaden FIC supervision to all financial institutions and appreciated staff's support to get the Credit Union Act passed in Congress.

D. External Sector Assessment

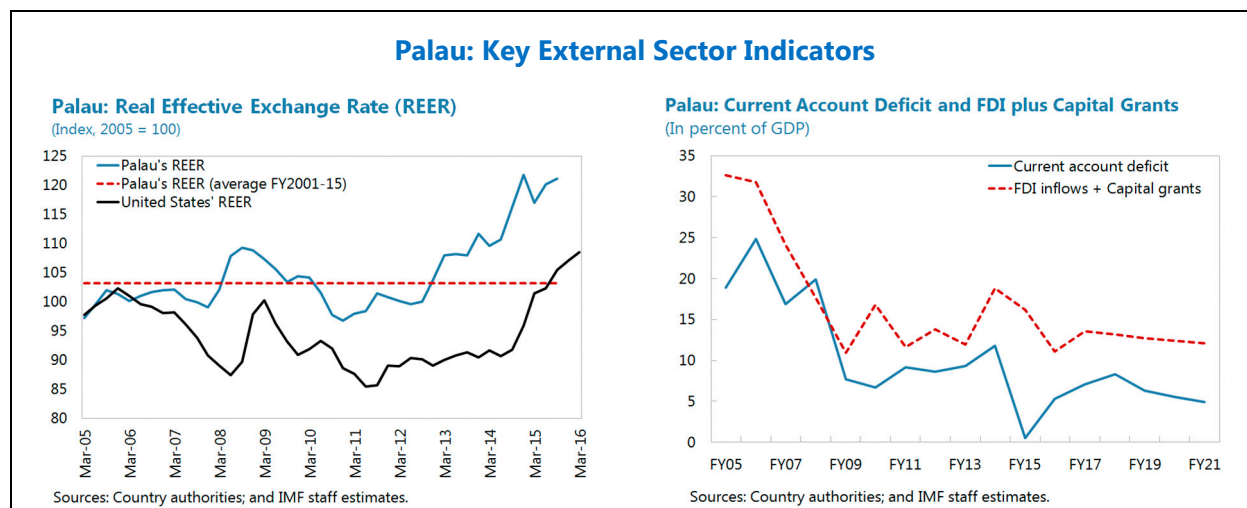
30. Palau's external sector is broadly in equilibrium. Although the real effective exchange rate appreciated by 22 percent between FY2011 and FY2015, in line with the strengthening of the U.S. dollar, the current account deficit has fallen reflecting lower commodity prices and strong tourism receipts. Looking ahead, the U.S. dollar is expected to strengthen further as the Fed rises policy rates and Palau's current account deficit is projected to increase somewhat due to higher commodity prices and infrastructure related imports. But these deficits would remain fully covered by FDI inflows and capital grants, suggesting that Palau's external sector is broadly in equilibrium.² However, heavy reliance on tourists from a few countries is a vulnerability, and weaknesses in infrastructure and investment climate could hinder development of tourism businesses. Therefore, strengthening fiscal consolidation and improving competitiveness by improving infrastructure and the business climate are essential for maintaining external stability going forward. The use of the U.S. dollar as Palau's legal tender remains appropriate as it provides an important nominal anchor.

31. Government deposits, as a measure of foreign reserves, remain appropriate covering 2.7 months of spending, including debt service. Fully dollarized economies may need liquidity buffers in U.S. dollars to support domestic financial institutions, to repay short-term external debt, and as a buffer for government financing.³ For Palau, the first two arguments are not very relevant. The liquid asset ratio in the banking sector is high at 90 percent, and Palau does not borrow short-term externally, with all of its external debt being long-term with international organizations. However, government revenue volatility is a risk. A useful rule of thumb for the minimum size of fiscal reserves is one month of spending. Palau's government deposits in FY2015 stood at 8.1 percent

² Data gaps impede a more robust external sector assessment for Palau, such those based on the IMF's External Balance Assessment (EBA) model or the IMF's EBA-Lite model.

³ See IMF Policy Paper, "Assessing Reserve Adequacy—Specific Proposal," April 2015.

of GDP or 2.7 months of government spending, well above the minimum requirement. Moreover, they are projected to increase to about 6 months of spending by FY2021.



Authorities' views

32. The authorities agreed with staff's external sector assessment, and noted that the current account deficits are expected to remain lower than in the past, with FDI inflows and capital grants fully covering them. Moreover, government deposits are projected to increase in line with fiscal consolidation, thus providing additional buffers.

STAFF APPRAISAL

33. Palau's economy has performed well in recent years and the outlook is favorable. Real GDP growth has been robust, inflation has been low and stable, and the external and fiscal positions have improved. The outlook is positive, with growth temporarily declining to zero in FY2016 due to lower tourist arrivals, but rebounding to 5 percent in FY2017–18 as tourism activity recovers and construction activity picks up. Inflation is expected to remain low due to stable commodity prices, while the current account deficit would rise due to larger infrastructure related imports. The fiscal position would improve further due to continued spending restraint.

34. This positive outlook is subject to large downside risks. Further U.S. dollar appreciation, a slowdown in key trading partners, and natural disasters could hurt tourism. Higher commodity prices would make food and fuel imports costlier. A continued strong tourist influx could position Palau as a mass tourism destination and hurt the environment. Given the lack of monetary and exchange rate policies, Palau would need to rely on fiscal and structural policies should risks materialize.

35. The fiscal framework should be strengthened by targeting the public sector net worth as a fiscal anchor and using the current fiscal balance as an operational target. This framework would not only help ensure fiscal self-sufficiency when the Compact grants expire in FY2024, but also increase public investment and keep ample buffers for future contingencies.

36. Further fiscal adjustment is needed to ensure fiscal sustainability. The authorities have made significant progress in improving Palau's fiscal position in recent years. However, further fiscal

adjustment is necessary over the medium term to ensure fiscal self-sufficiency when the compact grants expire in FY2024. This adjustment should rely on both revenue and expenditure measures, and the composition of government expenditure should be shifted towards infrastructure investment.

37. The fiscal adjustment should be complemented with reforms to fiscal institutions and public entities. Strengthening public financial management is key to support fiscal adjustment and maintain fiscal discipline. Sound public debt management and project administration would help secure debt sustainability and contain fiscal risks. Staff advises reforming the CSPF to eliminate its unfunded liabilities, and restructuring the PPUC to ensure full cost recovery of its operations and reduce the need for government subsidies.

38. Implementing a comprehensive tourism strategy is key to achieve sustainable tourism development. Tourism remains Palau's main growth engine, but the recent surge in tourist arrivals strained infrastructure and was tilted towards low budget tourists. This goes against the authorities' goal of positioning Palau as a high end tourism destination and is a threat to the environment. Staff welcomes the authorities' plans to implement a comprehensive tourism strategy that sets clear rules for sustainable tourism development. Staff also recommends avoiding new hotels developments until infrastructure has been upgraded, improving the regulatory environment, and strengthening the coordination among the national and state governments.

39. Diversifying the economy would help reducing volatility and broadening the sources of growth. Staff recommends promoting high end tourism from new destinations, including growing Asian markets, developing domestic business activities that can supply the tourism industry such as agriculture and aquaculture, and stimulating activities that would increase tourist spending.

40. Infrastructure development is needed to support the growing tourism industry and enhance resilience to natural disasters and climate change. Infrastructure bottlenecks are limiting tourism growth, highlighting the need for appropriate infrastructure planning as part of a broader tourism strategy. Infrastructure investment should also aim to increase resilience to natural disasters and climate change, including by limiting developments in areas at risk of tropical storms and rising sea levels, and improving the water system to avoid shortages in the future.

41. Improving the business climate would support private sector investment. Staff advises adopting a new foreign investment regime to simplify investment approval and open all business activities to foreign investment through joint ventures. Staff also supports the coordinating role of the Economic Advisory Group in the dialog between the private and public sectors to improve policy formulation and planning, including on measures to improve the business climate.

42. Preserving financial stability and increasing domestic credit would support private sector activity. Palau's banks remain sound, but continue to lend little domestically. Staff welcomes the authorities' plans to broaden the FIC's supervision to the credit unions, and advises relaxing the interest rate ceiling for commercial loans to better reflect riskiness, and helping SMEs prepare business plans and financial statements. Staff also welcomes the authorities' plan to put the NDBP under FIC supervision, subject to the same regulations of commercial banks, while allowing it to take deposits and expand its lending activities more broadly in the economy.

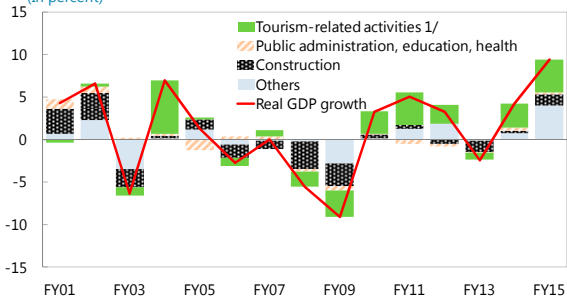
43. It is recommended that the next Article IV consultation take place on a 24-month cycle.

Figure 1. Palau: Real Sector Developments

The economy grew strongly in FY15 led by robust tourism and construction activity...

Palau: Contribution to GDP Growth

(In percent)



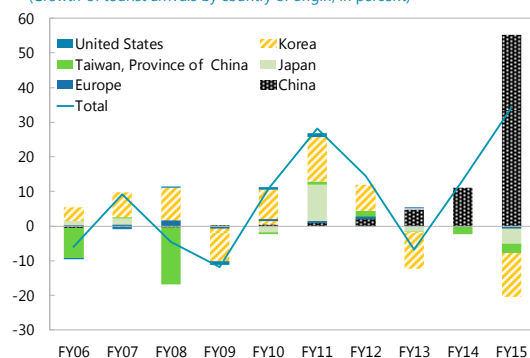
Sources: Palau authorities and staff calculations.

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

...tourism activity boomed due to the rapid rise in tourists from China. Tourists from other countries declined.

Contribution to Tourism Growth

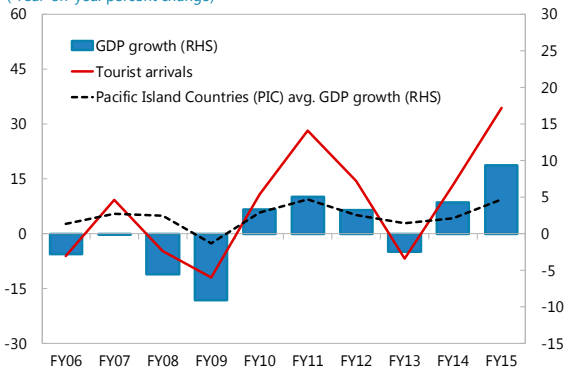
(Growth of tourist arrivals by country of origin, in percent)



Tourism activity has grown faster in Palau than in other Pacific islands, driving GDP growth...

Real GDP and Tourist Arrivals

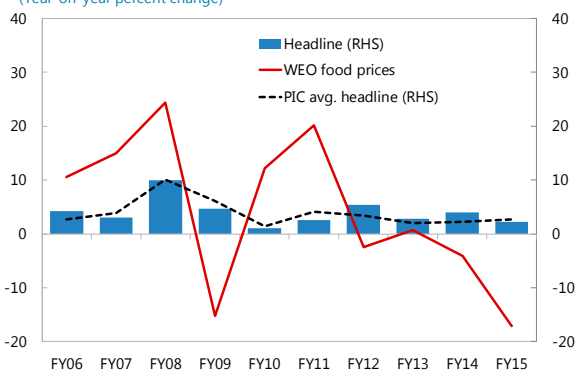
(Year-on-year percent change)



In line with global trends, inflation declined in FY15 due to lower global food and fuel prices.

Inflation

(Year-on-year percent change)

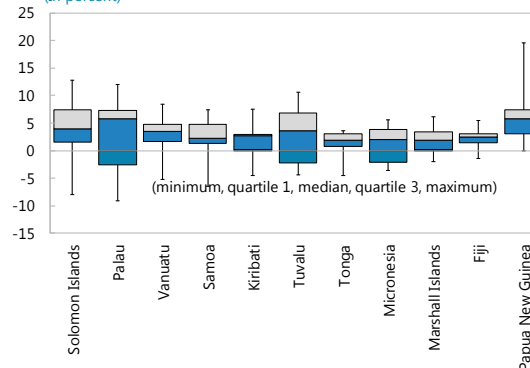


Sources: Country authorities; and Fund staff estimates and projections.

...but tourist arrivals are volatile, leading to a higher GDP growth volatility in Palau than in its peers.

Volatility of GDP Growth, 2001-2015

(In percent)



Banks continue to lend little domestically, investing most of their increased assets abroad.

Banks Assets

(In percent of GDP)

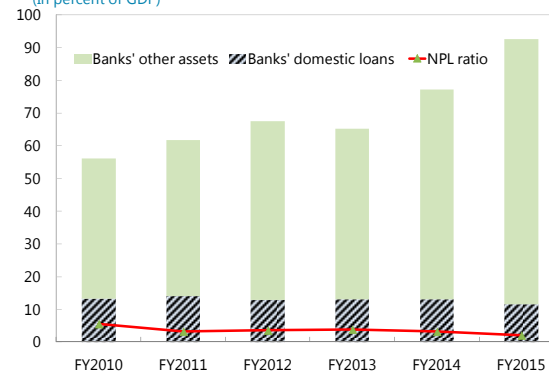
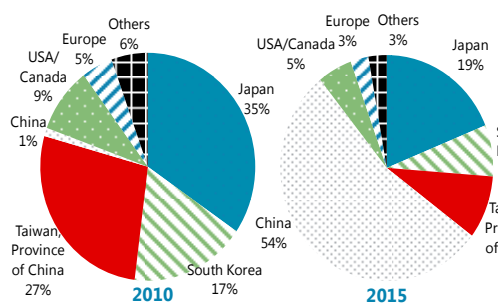


Figure 2. Palau: Tourism Sector Developments

The share of Chinese tourists on total tourist arrivals has increased significantly since 2010...

Palau: Change in Source Market Composition

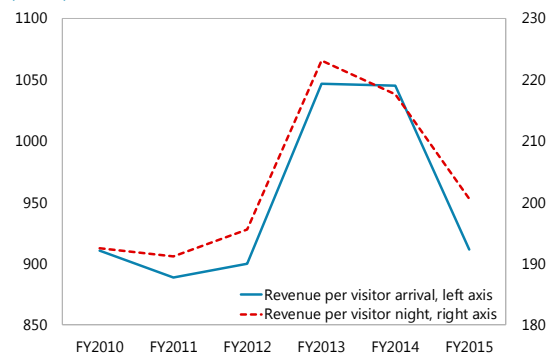
(In percent)



...but total revenue per tourist arrival slowed to US\$912 from US\$1,045 in 2013-14...

Palau: Revenue per Tourist Arrival/Night

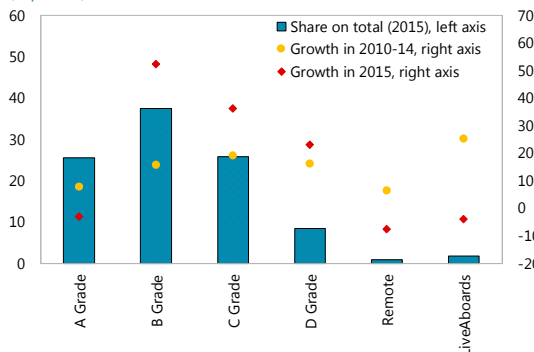
(In US\$)



...which is a reflection of the slower growth in visitor nights in high-end A Grade hotels...

Palau: Visitor Nights by Hotel Grade

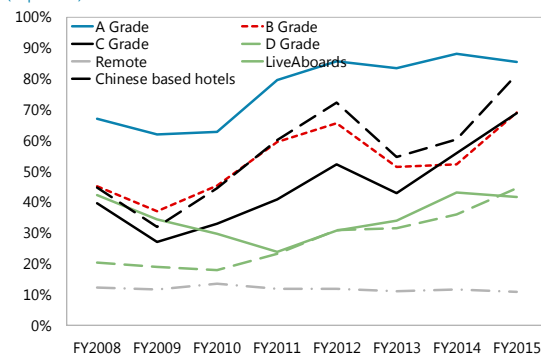
(In percent)



...amid a sharp increase in occupancy rates of lower-grade hotels...

Palau: Hotel Occupancy Rates by Hotel Grade

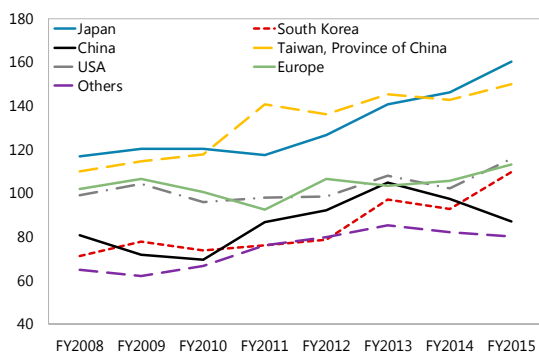
(In percent)



...with Chinese tourists spending less in accommodation than Japanese and Taiwanese tourists...

Palau: Average Room Price by Nationality

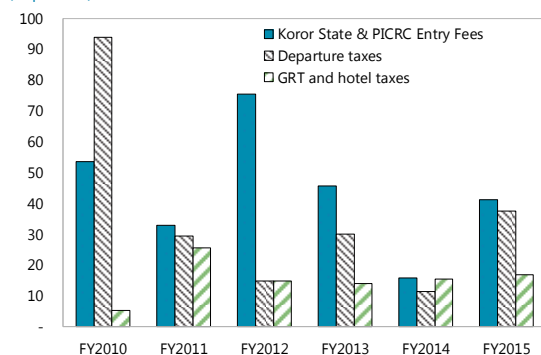
(in US\$)



...resulting in lower increases in gross revenue tax (GRT) and hotel tax collections than in the airport departure tax and entry fees to the main touristic attractions.

Palau: Growth in Public Sector Revenue

(In percent)

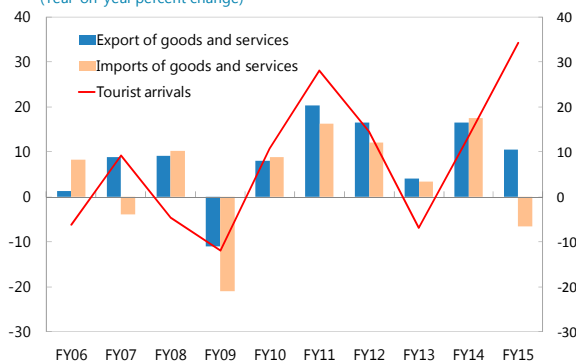


Sources: Graduate School USA, Pacific and Virgin Islands Training Initiatives; and IMF staff estimates.

Figure 3. Palau: External Sector Developments

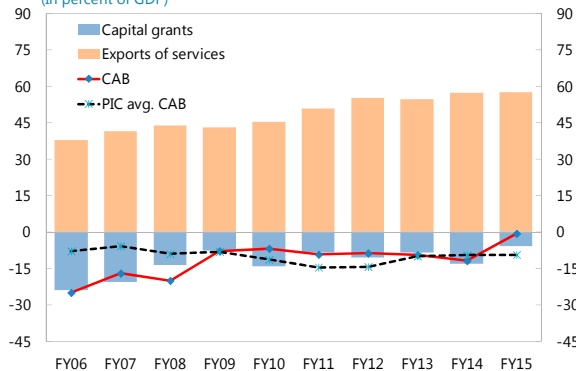
Palau's imports fell due to lower food and fuel prices despite the increase in tourist arrivals...

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



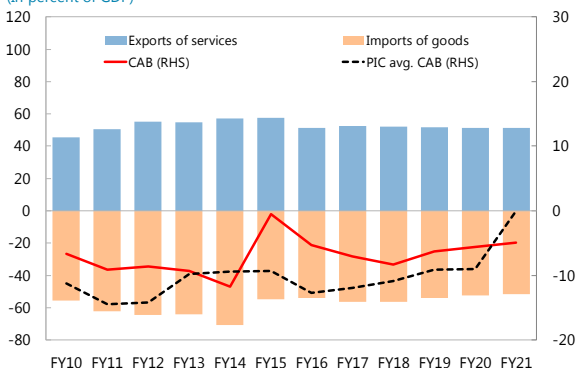
Palau's current account deficit is now lower than in other Pacific islands, partly due to growing service exports...

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



Palau's current account balance is expected to worsen in FY16-18 due to infrastructure related imports financed with AsDB loans...

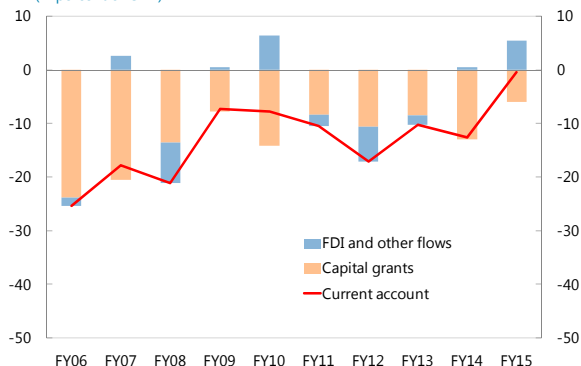
Current Account Balance (CAB) (In percent of GDP)



Sources: Country authorities; and Fund staff estimates and projections.

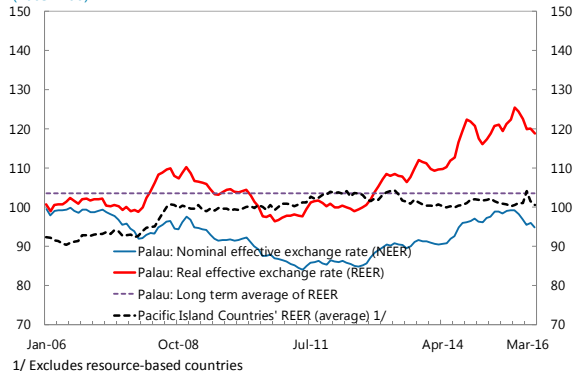
...the fall in food and fuel prices also led to a sharp reduction in the current account deficit.

Current Account (In percent of GDP)



...despite the increase in Palau's real exchange rate by over 20 percent in the last two years.

Effective Exchange Rates (2005=100)



...these loans would temporarily increase public external debt, but debt would remain lower than in other Pacific island countries.

Public External Debt (In percent of GDP)

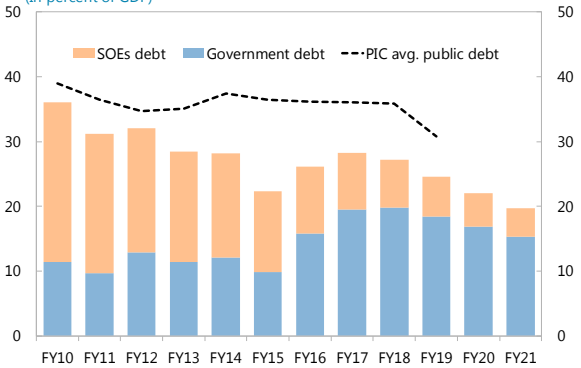
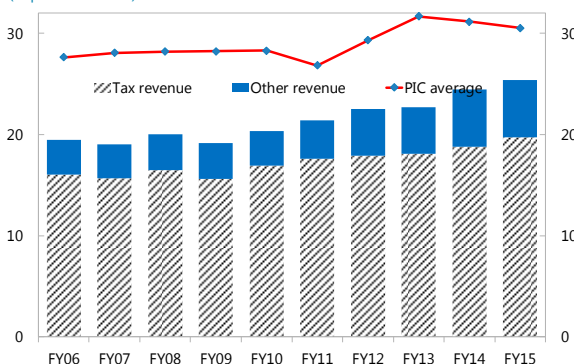


Figure 4. Palau: Fiscal Sector Developments

Palau's domestic revenues have been increasing rapidly in recent years supported by the buoyant economy...

Domestic Revenue

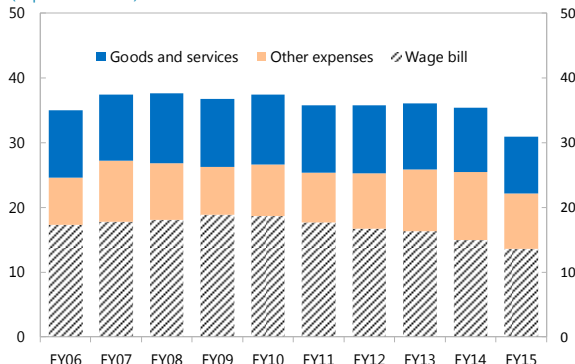
(In percent of GDP)



...and expense has been declining, especially the wage bill, in the backdrop of expenditure restraint...

Current Spending

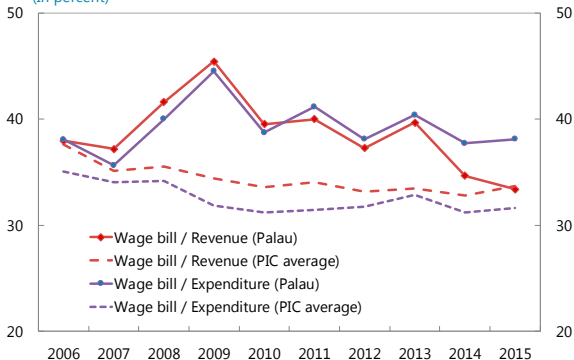
(In percent of GDP)



...but Palau's wage bill remains above that of other Pacific islands, especially as a ratio to overall expenditure.

Wage Bill

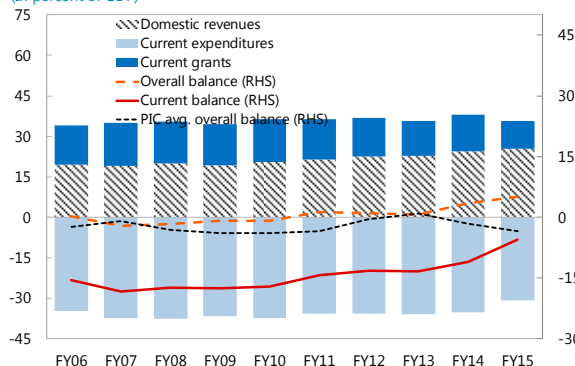
(In percent)



The current and overall fiscal balances have increased, particularly in FY2015.

Fiscal Balance

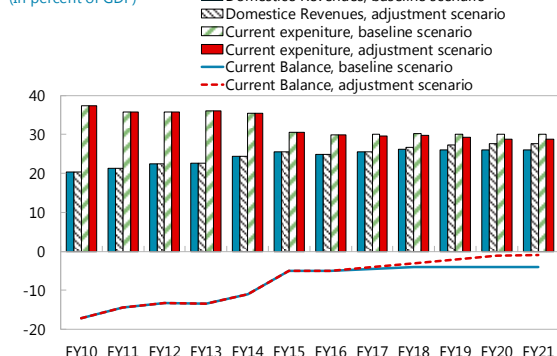
(In percent of GDP)



Fiscal consolidation is expected to continue in Palau, although at a slower pace...

Medium Term Fiscal Framework

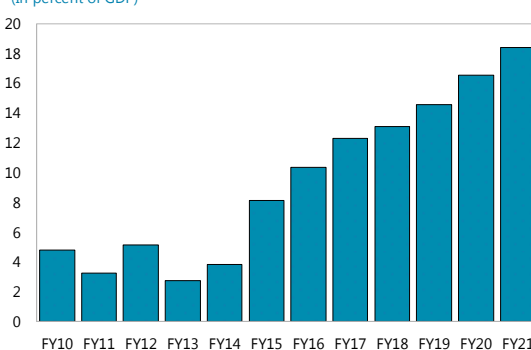
(In percent of GDP)



...and the government is expected to keep increasing its deposits to fund expenditure after FY2024.

Baseline Scenario: Government Currency and Deposits

(In percent of GDP)



Sources: Country authorities; and Fund staff estimates.

Table 1. Palau: Selected Economic Indicators, 2013/14–2020/21 1/

Nominal GDP for FY2015:	US\$287 million
Population (2015):	17,885
GDP per capita for FY2015:	US\$16,070
Quota:	SDR 3.1 million

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
		Est.			Proj. 2/			
Real sector								
Nominal GDP (million US\$) 3/	250.9	287.4	296.0	318.6	341.2	362.0	380.3	395.7
Real GDP growth (percent change)	4.2	9.4	0.0	5.0	5.0	4.0	3.0	2.0
GDP deflator (percent change)	5.2	4.7	3.0	2.5	2.0	2.0	2.0	2.0
Consumer prices (percent change; period average)	4.0	2.2	2.0	2.0	2.0	2.0	2.0	2.0
Tourist arrivals (number of visitors)	125,674	168,767	148,515	158,911	166,857	173,531	178,737	184,099
Public finance 3/								
					(In percent of GDP)			
Central government								
Revenue	43.3	40.6	39.6	41.8	40.8	40.3	39.8	39.4
Taxes and other revenue	24.4	25.4	24.8	25.5	26.1	26.0	25.9	25.8
Grants	18.9	15.3	14.8	16.3	14.8	14.3	13.9	13.6
Expenditure	39.8	35.6	41.6	42.7	39.6	36.7	36.5	36.0
Expense	35.4	30.9	30.3	30.2	30.1	30.0	29.9	29.9
Net acquisition of nonfinancial assets	4.4	4.7	11.3	12.5	9.5	6.7	6.5	6.1
Current fiscal balance (excluding grants) 4/	-11.0	-5.5	-5.5	-4.7	-4.0	-4.0	-4.0	-4.0
Net lending (+)/borrowing (-)	3.5	5.0	-2.0	-0.9	1.2	3.5	3.3	3.4
					(In millions of U.S. dollars)			
Compact Trust Fund (CTF) balance	199.2	183.9	188.9	194.2	201.8	208.9	215.9	222.8
Government cash and deposits 5/	9.6	23.4	30.6	39.1	44.7	52.8	63.0	72.8
In percent of GDP	3.8	8.1	10.4	12.3	13.1	14.6	16.6	18.4
Balance of payments 3/								
Trade balance	-158.2	-142.4	-148.4	-164.8	-176.1	-177.0	-180.8	-184.6
Exports (f.o.b.)	19.1	14.5	11.9	14.6	16.1	17.7	18.7	19.6
Imports (f.o.b.)	177.3	156.8	160.3	179.4	192.2	194.7	199.5	204.2
Tourism receipts	129.3	150.4	139.0	153.2	163.2	172.3	180.1	188.3
Current account balance								
Including grants	-29.5	-1.5	-15.6	-22.4	-28.3	-22.8	-21.1	-19.3
Excluding grants	-74.4	-42.3	-56.1	-62.2	-66.3	-60.6	-58.3	-55.8
International Investment Position								
Assets	245.4	272.1	272.1	280.3	295.2	318.4	345.4	372.9
Liabilities	467.1	511.0	539.4	569.7	599.8	632.2	667.1	702.0
Of which: External debt	221.7	239.0	267.3	289.3	304.6	313.8	321.7	329.1
Of which: External debt	70.6	64.2	77.4	90.0	92.6	88.9	83.7	77.9
					(In percent of GDP)			
Current account balance								
Including grants	-11.8	-0.5	-5.3	-7.0	-8.3	-6.3	-5.6	-4.9
Excluding grants	-29.7	-14.7	-19.0	-19.5	-19.4	-16.7	-15.3	-14.1
International Investment Position								
Of which: External debt	97.8	94.7	91.9	88.0	86.5	88.0	90.8	94.3
Of which: External debt	28.1	22.4	26.1	28.2	27.1	24.6	22.0	19.7

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

1/ Fiscal year ending September 30.

2/ Staff projections.

3/ Incorporates the authorities' revised estimates of GDP and balance of payments, and the audited government financial statements.

4/ Defined as tax and other revenue less expense.

5/ Includes unspent external loans.

Table 2. Palau: Medium-term Outlook, Baseline and Reform Scenarios, 2013/14–2020/21 1/

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
		Est.				Proj. 2/		
Baseline Scenario								
Real sector								
Real GDP growth (percent change)	4.2	9.4	0.0	5.0	5.0	4.0	3.0	2.0
Consumer prices (percent change; period average)	4.0	2.2	2.0	2.0	2.0	2.0	2.0	2.0
Public finance								
	(In percent of GDP, unless otherwise indicated)							
Central Government								
Taxes and other revenue	24.4	25.4	24.8	25.5	26.1	26.0	25.9	25.8
Grants	18.9	15.3	14.8	16.3	14.8	14.3	13.9	13.6
Expense	35.4	30.9	30.3	30.2	30.1	30.0	29.9	29.9
Net acquisition of nonfinancial assets 3/	4.4	4.7	11.3	12.5	9.5	6.7	6.5	6.1
Current balance (excluding grants) 4/	-11.0	-5.5	-5.5	-4.7	-4.0	-4.0	-4.0	-4.0
Primary balance	3.7	5.3	-1.9	-0.8	1.4	3.7	3.5	3.5
Net lending (+)/borrowing (-) 5/	3.5	5.0	-2.0	-0.9	1.2	3.5	3.3	3.4
Public external debt	26.7	22.0	26.1	28.2	27.1	24.6	22.0	19.7
Of which: Government external debt	12.3	10.4	15.8	19.5	19.8	18.4	16.9	15.3
Public domestic account payables	7.3	5.4	3.9	2.4	1.1	0.0	0.0	0.0
Government cash and deposits	3.8	8.1	10.4	12.3	13.1	14.6	16.6	18.4
Balance of payments								
Current account balance (excluding grants)	-29.7	-14.7	-19.0	-19.5	-19.4	-16.7	-15.3	-14.1
Current account balance (including grants)	-11.8	-0.5	-5.3	-7.0	-8.3	-6.3	-5.6	-4.9
External debt	26.7	22.0	26.1	28.2	27.1	24.6	22.0	19.7
External debt (in percent of exports of goods and services)	41.2	35.2	47.1	49.5	47.8	43.4	39.1	34.9
External debt service (in percent of exports of goods and services)	4.1	3.9	4.2	3.8	5.3	3.7	4.0	3.7
Staff's Reform Scenario 6/								
Public finance								
	(In percent of GDP, unless otherwise indicated)							
Central Government								
Taxes and other revenue	24.4	25.4	24.8	25.5	26.6	27.2	27.6	27.5
Grants	18.9	15.3	14.8	16.3	14.8	14.3	13.9	13.6
Expense	35.4	30.9	30.3	29.9	29.9	29.4	28.6	28.6
Net acquisition of nonfinancial assets 3/	4.4	4.7	11.3	12.5	9.5	8.3	8.3	8.3
Current balance (excluding grants) 4/	-11.0	-5.5	-5.5	-4.4	-3.3	-2.2	-1.0	-1.0
Net lending (+)/borrowing (-) 5/	3.5	5.0	-2.0	-0.6	1.9	3.8	4.6	4.2
Public external debt	26.7	22.0	26.1	28.3	27.2	24.6	22.0	19.5
Government cash and deposits	3.8	8.1	10.4	12.6	13.8	16.4	19.6	21.4
Real and external sector								
Real GDP growth (percent change)	4.2	9.4	0.0	4.8	4.8	4.2	3.3	2.8
Current account balance (including grants, percent of GDP)	-11.8	-0.5	-5.3	-6.9	-7.9	-6.0	-5.6	-4.6

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

1/ Fiscal Year ending September 30.

2/ Staff projections.

3/ Includes capital spending financed by loans from the Asian Development Bank (ADB) since 2011/12.

4/ Defined as Revenue less Grants and Expense.

5/ Defined as Revenue less Expenditure.

6/ Staff's reform scenario assumes that the current fiscal deficit is reduced by 1.1 percent of GDP each year during FY2017–20 to 1 percent of GDP in FY2020. This is achieved by raising taxes and cutting current expenditure, and the additional savings are used to increase public investment to 8.3 percent of GDP from FY2019 onwards. The extra fiscal adjustment reduces growth in the initial years, but leads to higher growth by about 1 percentage point in the medium-term due to the

Table 3. Palau: Balance of Payments, 2013/14–2020/21 1/

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
		Est.				Proj. 2/		
(In millions of U.S. dollars, unless otherwise indicated)								
Current account balance	-29.5	-1.5	-15.6	-22.4	-28.3	-22.8	-21.1	-19.3
Goods and services balance	-59.2	-27.5	-42.4	-48.8	-52.9	-47.4	-45.6	-43.8
Goods balance	-158.2	-142.4	-148.4	-164.8	-176.1	-177.0	-180.8	-184.6
Exports of goods f.o.b.	19.1	14.5	11.9	14.6	16.1	17.7	18.7	19.6
Imports of goods f.o.b.	177.3	156.8	160.3	179.4	192.2	194.7	199.5	204.2
Services balance	99.0	114.9	106.0	116.0	123.2	129.6	135.1	140.8
Exports of services	143.3	165.1	152.4	167.1	177.7	187.1	195.2	203.7
Travel	129.3	150.4	139.0	153.2	163.2	172.3	180.1	188.3
Imports of services	44.3	50.2	46.4	51.1	54.5	57.5	60.1	62.8
Primary income balance	-11.6	-11.1	-12.0	-12.8	-13.9	-14.8	-15.7	-16.6
Inflows	10.4	13.2	13.5	14.1	14.7	15.4	16.0	16.7
Outflows	22.0	24.3	25.6	26.9	28.6	30.2	31.7	33.2
Secondary income balance	41.2	37.1	38.8	39.2	38.4	39.4	40.2	41.1
Inflows	56.0	54.4	56.6	58.3	59.0	61.2	63.1	64.9
Of which: Grants on budget	44.9	40.8	40.5	39.8	38.0	37.8	37.2	36.5
Outflows	14.8	17.3	17.8	19.2	20.5	21.8	22.9	23.8
Capital account balance	32.6	17.2	18.1	34.2	32.7	33.7	34.5	35.2
Net lending/borrowing (Current+Capital)	3.1	15.7	2.5	11.8	4.4	10.8	13.4	15.9
Financial account balance	3.7	38.4	2.5	11.8	4.4	10.8	13.4	15.9
Direct investment (net lending(+)=assets-liabilities)	-14.6	-29.3	-14.8	-9.0	-12.2	-12.4	-12.6	-12.8
Portfolio investment (net lending(+)=assets-liabilities)	-9.9	4.9	1.5	1.4	1.5	1.4	1.1	1.3
Other investment (net lending(+)=assets-liabilities)	28.2	62.8	15.8	19.5	15.1	21.9	24.9	27.4
Of which: Public sector loans	5.6	-6.4	14.5	13.4	2.2	-3.5	-5.1	-6.4
Errors and omissions	0.6	22.7	0.0	0.0	0.0	0.0	0.0	0.0
Current account								
Including official grants	-29.5	-1.5	-15.6	-22.4	-28.3	-22.8	-21.1	-19.3
Excluding official grants	-74.4	-42.3	-56.1	-62.2	-66.3	-60.6	-58.3	-55.8
(In percent of GDP, unless otherwise indicated)								
Memorandum items:								
Nominal GDP (million US\$)	250.9	287.4	296.0	318.6	341.2	362.0	380.3	395.7
Current account								
Including official grants	-11.8	-0.5	-5.3	-7.0	-8.3	-6.3	-5.6	-4.9
Excluding official grants	-29.7	-14.7	-19.0	-19.5	-19.4	-16.7	-15.3	-14.1
External debt	28.1	22.4	26.1	28.2	27.1	24.6	22.0	19.7
International Investment Position	97.8	94.7	91.9	88.0	86.5	87.9	90.8	94.2
Assets	186.2	177.8	182.2	178.8	175.8	174.7	175.4	177.4
Compact Trust Fund	79.4	64.0	63.8	61.0	59.2	57.7	56.8	56.3
Social Security Funds	46.6	41.3	42.2	41.2	40.5	40.2	40.3	40.8
Other	60.2	72.5	76.2	76.6	76.1	76.7	78.3	80.3
Liabilities	88.4	83.1	90.3	90.8	89.3	86.7	84.6	83.2
FDI	60.2	60.8	64.2	62.6	62.1	62.1	62.6	63.5
Government debt	12.1	9.8	15.8	19.5	19.8	18.4	16.9	15.3
Public enterprise debt	16.0	12.5	10.3	8.8	7.4	6.2	5.1	4.4
Other liabilities, banks	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Palau authorities; PFTAC estimates; and Fund staff estimates and projections.

1/ Fiscal year ending September 30.

2/ Staff projections.

Table 4. Palau: National Government Operations and Balance Sheet, 2013/14–2020/21 1/

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
		Est			Proj. 2/			
(In millions of U.S. dollars)								
National Government Operations								
Revenue	108.6	116.8	117.2	133.1	139.4	145.8	151.3	155.9
Taxes	47.2	56.6	56.5	63.0	69.5	73.3	76.8	79.7
Taxes on income, profits and capital gains	8.2	9.1	9.4	10.1	10.9	11.5	12.1	12.6
Taxes on goods and services	19.6	22.5	23.1	25.2	27.0	28.6	30.1	31.3
Taxes on international trade and transactions	11.6	14.4	14.9	16.0	17.1	18.2	19.1	19.9
Other taxes	7.9	10.6	9.1	11.7	14.5	15.0	15.5	15.9
Grants 3/	47.3	43.8	43.8	52.0	50.4	51.8	52.9	53.6
Current	33.8	29.8	29.8	29.8	28.7	29.2	29.4	29.4
U.S. Compact	13.1	13.1	13.1	13.1	7.3	6.0	5.0	4.0
Drawdown from Compact Trust Fund	5.0	5.0	5.0	5.0	9.0	10.0	10.5	11.0
U.S. non-Compact	10.1	10.4	10.4	10.4	11.1	11.8	12.4	12.9
Other country	5.5	1.2	1.2	1.2	1.3	1.4	1.5	1.5
Capital	13.5	14.1	14.1	22.2	21.7	22.7	23.5	24.2
Of which : U.S. Compact	0.0	0.0	0.0	0.0	6.0	6.0	6.0	6.0
Other revenue	14.1	16.4	16.9	18.2	19.4	20.6	21.7	22.5
Expenditure	99.8	102.4	123.3	136.0	135.2	133.0	138.7	142.4
Expense	88.8	88.9	89.8	96.3	102.8	108.6	113.8	118.2
Of which: Compensation of employees	37.6	39.0	40.0	42.0	45.0	47.7	50.1	52.1
Of which: Use of goods and services	24.9	25.4	25.8	27.4	29.5	31.3	32.9	34.2
Net acquisition of nonfinancial assets 3/	11.0	13.5	33.5	39.8	32.4	24.4	24.9	24.2
Current balance (excluding grants) 4/	-27.5	-15.9	-16.4	-15.1	-13.8	-14.6	-15.4	-16.0
Net lending (+)/borrowing (-) 5/	8.8	14.4	-6.0	-2.9	4.1	12.8	12.6	13.4
(In percent of GDP)								
Revenue	43.3	40.6	39.6	41.8	40.8	40.3	39.8	39.4
Taxes	18.8	19.7	19.1	19.8	20.4	20.3	20.2	20.1
Grants	18.9	15.3	14.8	16.3	14.8	14.3	13.9	13.6
Other revenue	5.6	5.7	5.7	5.7	5.7	5.7	5.7	5.7
Expenditure	39.8	35.6	41.6	42.7	39.6	36.7	36.5	36.0
Expense	35.4	30.9	30.3	30.2	30.1	30.0	29.9	29.9
Net acquisition of nonfinancial assets	4.4	4.7	11.3	12.5	9.5	6.7	6.5	6.1
Current balance (excluding grants)	-11.0	-5.5	-5.5	-4.7	-4.0	-4.0	-4.0	-4.0
Net lending (+)/borrowing (-)	3.5	5.0	-2.0	-0.9	1.2	3.5	3.3	3.4
(In percent of GDP)								
National Government Balance Sheet								
Assets	3.8	8.1	10.4	12.3	13.1	14.6	16.6	18.4
Cash and deposits	3.8	8.1	10.4	12.3	13.1	14.6	16.6	18.4
Liabilities	27.8	24.0	28.0	30.2	29.1	26.6	25.1	23.6
Domestic accounts payable	7.3	5.4	3.9	2.4	1.1	0.0	0.0	0.0
External debt	12.3	10.4	15.8	19.5	19.8	18.4	16.9	15.3
Civil Service Pension Fund's unfunded liabilities	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3
Net worth (assets - liabilities) 6/	-24.0	-15.8	-17.7	-17.9	-16.0	-12.1	-8.6	-5.2
Memorandum Item:								
Nominal GDP (million US\$)	250.9	287.4	296.0	318.6	341.2	362.0	380.3	395.7
Compact Trust Fund (in percent of GDP)	79.4	64.0	63.8	61.0	59.2	57.7	56.8	56.3

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

1/ Fiscal year ending September 30.

2/ Staff projections.

3/ Includes capital spending financed by loans from the Asian Development Bank.

4/ Defined as Revenue less Grants and Expense.

5/ Defined as Revenue less Expenditure.

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

Table 5. Palau: Deposit Money Banks Balance Sheet, 2009/10–2014/15 1/

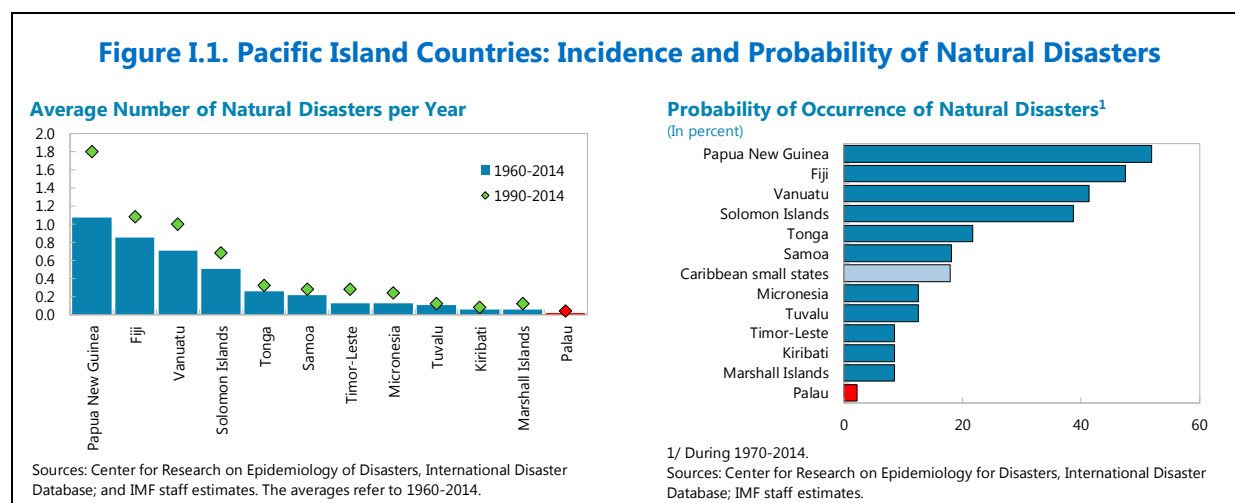
	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15 Est.
Assets	104.7	113.6	135.7	140.4	175.9	231.8
Notes and coins	1.6	1.7	2.5	3.8	3.1	2.3
Foreign assets	73.4	82.8	105.3	106.2	140.8	198.0
Claims	24.6	25.8	25.7	27.9	29.6	28.9
Private sector	26.9	27.9	27.1	30.1	32.1	31.0
Commercial	4.0	7.8	2.9	2.7	2.8	1.2
Consumer	22.9	20.1	24.2	27.4	29.2	29.8
Non-resident	0.4	0.2	0.3	0.2	0.0	0.0
less Reserve for Loan Losses	-2.7	-2.3	-1.7	-2.3	-2.5	-2.2
Fixed Assets	2.0	1.8	1.7	1.5	1.4	1.4
Unclassified assets	3.1	1.5	0.5	0.9	0.9	1.3
Liabilities						
Deposits	96.3	105.4	130.9	136.0	171.2	225.8
Demand Deposits	31.6	37.7	55.6	63.9	73.3	91.9
Savings Deposits	47.3	52.7	61.6	58.9	84.6	120.9
Time and Certificate of Deposit	17.3	15.0	13.6	12.7	12.7	12.4
Deposits Due to Banks and Financial Institutions	2.1	1.8	0.3	0.5	0.6	0.5
Other Liabilities	0.2	0.3	0.3	0.3	0.1	0.8
Capital	6.1	6.2	4.3	4.1	4.6	5.2
Issued and Fully Paid Up Common Stock	5.7	6.0	3.3	4.0	4.0	4.0
Paid-in Premium	0.0	0.0	0.7	0.0	0.0	0.0
Retained Profits (Losses) (Prior Years)	-1.2	-1.1	-1.6	-1.4	-1.3	-1.0
Income (Loss) Year-to-date	1.6	1.3	2.0	1.5	1.8	2.2
Memorandum Item:						
Loan/deposit ratio (in percent)	25.6	24.5	19.6	20.6	17.3	12.8
Loans (in percent of GDP)	13.4	12.8	11.9	12.2	11.8	10.0
Loans (percent change)		4.7	-0.5	8.9	5.9	-2.5
Deposits (percent change)		9.5	24.1	3.9	25.9	31.9
Consumer loans (in percent of private sector loans)	85.2	71.9	89.4	91.1	91.2	96.2
Commercial loans (in percent of total loans)	14.8	28.1	10.6	8.9	8.8	3.8
Nominal GDP (million US\$)	184.3	201.2	215.8	228.5	250.9	287.4

Sources: Palau authorities; and IMF staff estimates.

1/ Fiscal year ending September 30.

Appendix I. Risks of Natural Disasters

The Pacific island countries are among the most exposed to natural disasters in the world. Their location and small size make them vulnerable to earthquakes and tsunamis, and weather-related disasters such as cyclones, droughts, and floods (IMF 2015). But Palau has been less affected than other Pacific island countries in the past. Figure 1.1 shows that among 12 Pacific island countries, Palau had the lowest average number of natural disasters per year during 1960–2014, and the lowest probability of occurrence of natural disasters calculated over 1970–2014. Still, the Pacific Catastrophe Risk Assessment and Financing Initiative estimates a 50 percent chance that Palau could experience large losses (US\$30 million or 10 percent of GDP) due to natural disasters in the next 50 years.



This year, Palau was hit by one of the strongest droughts in its history due to El Niño weather conditions. A report from the National Oceanic and Atmospheric Agency in March 21, 2016 placed Palau in extreme drought level 3 of 4, with the cumulative rainfall in the previous four months at the lowest level since 1951. The two main sources of water had been declining since late 2015, and the Ngerimel Dam, which provides 80 percent of water consumption in normal times, was shut down in April. As a result, the government restricted water consumption to three hours a day since March 29. This restriction was lifted in May 9 when the weather conditions normalized.

The recent drought showed the need for fiscal buffers and investment to make infrastructure more resilient to natural disasters and climate change. The government's plan for this emergency included importing drinking water and water test kits, improving water distribution in some areas, buying medications in case of disease outbreaks, and promoting public awareness. The cost was estimated at US\$3 million (1 percent of GDP). Going forward, Palau will need to broaden its sources of water, especially because of unpredictable weather conditions due to climate change and the rapid growth in water demand due to the expanding tourism industry. Alternative options include developing underground water sources, enhancing water storage facilities, and using desalination plants for sea water. Palau's government deposits, currently at 8.1 percent of GDP, are insufficient to finance the response to potentially large natural disasters with losses close to 10 percent of GDP as estimated by the Pacific Catastrophe Risk Assessment and Financing Initiative.

Appendix II. National Marine Sanctuary

Background. Palau has been preserving its natural resources for many years, and is an active player in initiatives to preserve marine life among Micronesian states and the United Nations. Palau took another milestone in October 2015 when it passed the Palau National Marine Sanctuary (PMNS) Act, which will preserve 80 percent of Palau's exclusive economic zone (EEZ) of 500,000 square kilometers as a no-take area that is protected from all exploitation. The reform will be executed gradually and the PMNS will be fully effective in January 1, 2020. Once implemented, the PMNS will be one of the largest protected ocean areas in the world.

Benefits and Costs. Studies find that that ocean protection is a more sustainable use Palau's marine resources. Cheung and others (2010) project that Palau may lose 25 percent of its fish catch by 2050 due to climate change, making conservation vital. The PMNS will lower fishing rights revenue, but this will be offset by giving all revenue from fishing agreements and a part of the environmental impact fee (US\$12.5 per tourist) to the state governments. Sala and others (2013) find that the value of well-enforced marine reserves in adjacent fishing and tourism exceeds the pre-reserve value. Looking at sharks alone, Vianna and others (2010) estimate that a reef shark has a life-time value of US\$1.9 million through dive tourism, compared to US\$10,800 if it were fished. Tourist appreciation of Palau's protected marine life is also clear in tourist expenditure patterns, where diving is the third largest expense item.

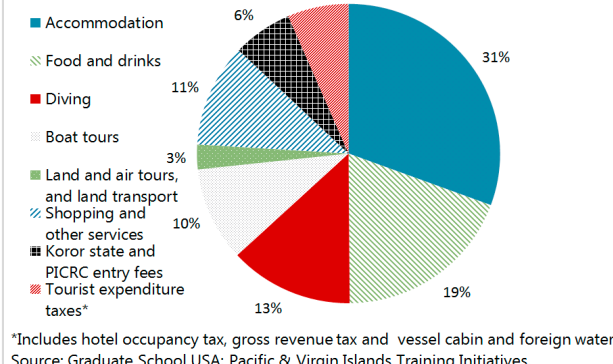
Surveillance and funding. Palau's Ministry of Natural Resources, Environment and Tourism (MNRET) manages the PMNS, oversees foreign fishing agreements, issues fishing permits, monitors fish stocks and harvests within the DFZ, and coordinates enforcement. The Fisheries Protection Trust Fund (FPTF) was established under the National Treasury to fund surveillance, enforcement and related trainings. All fines, forfeiture proceeds, and part of the environmental impact fee (US\$10 per tourist) are remitted to the FPTF. The government is also exploring a potential of debt-for-nature swap that would allow Palau to divert loan payments to activities that support the PMNS. Regional partners also fund Palau's surveillance. Going forward, Palau released a 2016–2021 monitoring, control and surveillance (MCS) plan that will aid in fighting illegal activities and fishing violations in Palau's EEZ. The MCS plan also aims to improve Palau's search and rescue, pollution detection, weather forecasting, and resilience to climate change.

Palau: Conservation Milestones

Year	Regulation/Initiatives
1956	Ngerukewid Islands ("70 Islands") Wildlife Preserve is created.
1994	Palau becomes an independent nation.
1994	Passage of the Marine Protection Act, which includes a moratorium on fishing for bumphead parrotfish.
1998	Regulations protecting sea turtles are put in place.
2003	Protected Areas Network establishes a framework for protected areas across Palau to get access to technical assistance, monitoring, Palau commits to the Micronesia Challenge, a commitment of Micronesian states to conserve 30 percent of the marine environment and 20 percent of the terrestrial environment by 2020.
2006	Ban on bottom trawling is enacted.
2009	Palau establishes the world's first shark sanctuary.
2010	Palau declares marine mammal sanctuary.
2012	Rock Islands Southern Lagoon becomes UNESCO World Heritage
2013	Dugong Protection Act is signed into law.
2014	President Tommy Remengesau Jr. announces his commitment to the Palau National Marine Sanctuary at the United Nations.
2015	Palau National Marine Sanctuary Act is signed into law.

Source: Pew Charitable Trusts (2016)

Palau: Share of Tourism Expenditure by Market Segment (in percent, average 2010–2015)

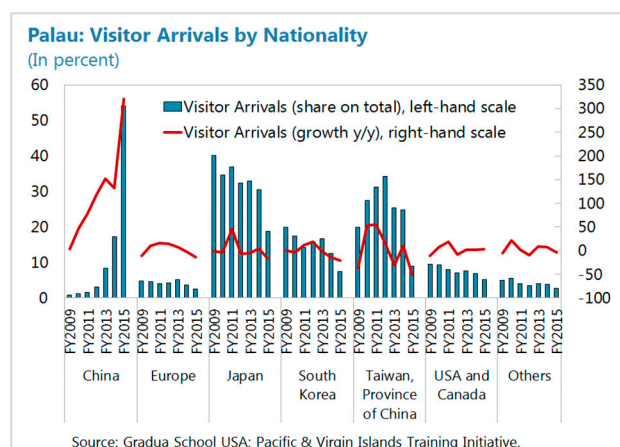


Appendix III. Staff Policy Advice, 2014 Article IV Consultation

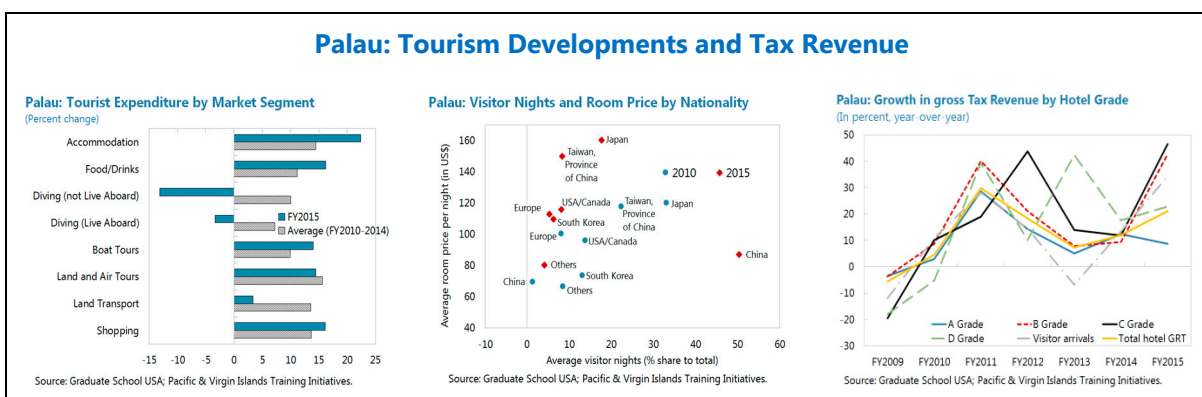
Staff Advice	Policy Actions
Fiscal Policy	
Replenish the fiscal buffers by containing current spending and saving any additional revenue gains.	The authorities contained current spending growth in FY2014–15, with expense decreasing from 36 percent of GDP in FY 2013 to 31 percent in FY2015. In addition, 2 percent of GDP on extra revenue were also saved. As a result, the current fiscal deficit declined by 8 percent of GDP between FY2013 and FY2015.
Strengthen fiscal consolidation over the medium term through comprehensive tax reform and expenditure reform to achieve fiscal self-sufficiency when the Compact grants expire in FY 2024.	The authorities sent a tax reform bill to Congress in 2014, but it is still pending approval. They have achieved a significant reduction in current spending in recent years. However, further fiscal adjustment is need to ensure fiscal self-sufficiency.
Improve public financial management to strengthen the budget framework and ensure debt sustainability.	The authorities have made progress in improving public financial management, including by improving the timeliness of their data collection and audits. Public debt remains sustainable.
Continue reforming public entities to contain fiscal risks and reduce government subsidies.	The Palau Public Utility Corporation relies on government support, but the authorities plan to reform it to make it sustainable. The unfunded liabilities of the Civil Service Pension Fund were sharply reduced with the additional revenue earmarked from the recently legislated increase in the airport departure tax.
Financial Market Policy	
Broaden financial regulation and supervision to include the National Development Bank of Palau (NDBP) and other non-bank financial institutions.	The legislation allowing the NDBP to take deposits was passed in Congress and once licensed, the NDBP will be regulated by the Financial Institutions Commission (FIC) and will be subject to the same regulations of commercial banks. The draft Credit Union Act that put all credit unions under FIC supervision was submitted to Congress in FY2014, but it has not yet been approved.
Structural Policies	
Diversify the sources of growth, including within and outside the tourism industry.	There has been limited progress on economic diversification. Tourism remains the main growth engine, and the composition of tourist arrivals have become more concentrated in a few countries.
Expand basic infrastructure such water and sanitation system to promote development of new hotels and raise tourism growth.	The authorities secured two loans from the AsDB to upgrade the Koror-Arai waste management system and to connect to a submarine fiber optic cable. In addition, Palau Japanese government will provide a grant to upgrade the water pipelines in Koror. These projects, when completed, will ease some of the infrastructure bottlenecks.
Adopt a new foreign investment regime to simplify investment approval and open all business activities to foreign investment through joint ventures.	Foreign investment approvals continue to be decided by a Foreign Investment Board that operates in a case by case basis. Limits to foreign ownership in key areas remain.

Appendix IV. Tourism Developments

Tourist arrivals surged by 34 percent in FY2015, with the bulk coming from China. Chinese tourists accounted for 54 percent of total arrivals, followed by Japanese (19 percent) and Taiwanese (9 percent). This contrasts with profile in 2009-14, when Chinese tourists accounted for 5 percent, while Japanese and Taiwanese accounted for 35 and 27 percent. High concentration of tourists from one country poses a risk the tourism industry, with potentially disruptive consequences for Palau if outward Chinese tourism flows were to decline.










The change in profile of tourist arrivals has altered expenditure patterns and visitor activities. The surge in tourists in 2015 led to a sharp rise in total visitor spending on accommodations, but receipts from the gross revenue and hotel taxes have not risen as fast, reflecting a shift to low-cost hotels (Figure 2). Occupancy rates of Chinese-based hotels rose from 44 percent in 2010 to 81 percent in 2015, with Chinese tourists spending US\$87 on average per room, less than Japanese and Taiwanese tourists who spend US\$160 and US\$150 respectively. Spending on boat tours also rose, while diving expenditures declined. Boat tours, which cater to a bigger number of tourists per trip, tend to have a higher impact to the environment and lower gains per tourist compared with diving activities. More generally, tourism revenue per arrival declined to US\$3,987 in 2015 from US\$4,749 in 2014.



Recent tourism developments highlight the need for Palau to act on its national tourism strategy before the pristine environment and the quality of tourist experience deteriorate. The limits on charter flights and the legislated rise in the airport departure tax are concrete policies undertaken to address the growing capacity constraints in the tourism sector. However, a comprehensive tourism strategy is needed to ensure the sustainability of Palau's main growth engine.

Appendix V. Risk Assessment Matrix 1/

Risk		Relative Likelihood	Impact if Realized	Potential Impact	Staff Advice on Policy Response
External risks	Tighter global financial conditions lead to U.S. dollar appreciation 	M	M	Reduced tourist arrivals and growth; lower fiscal and external balances.	Structural reforms to boost non-price competitiveness of the tourist sector.
	Persistently lower energy prices 	L	M	Higher current account balances and lower domestic energy prices, stronger growth	Use the low energy price environment to increase utility tariffs and lower government subsidies.
	Weaker than expected global growth, including in China and other Asian economies. 	M	L	Somewhat lower tourist arrivals. China's demand for travel is expected to remain strong.	Diversify tourism to other countries, including by expanding regular flights connectivity.
Domestic risks	Natural disasters and climate change 	M	M	Growth slows due to lower tourism activity, weaker agricultural production and damaged infrastructure.	Build buffers for fast post-disaster response. Make infrastructure more resilient to natural disasters and climate change.
	Faster progress on fiscal consolidation 	M	H	The fiscal balance rises faster due to continued strong growth and expenditure restraint.	Additional fiscal savings should be saved to ensure fiscal sustainability beyond FY2024.
	Further delays in ratifying the 2010 Renewed Compact Agreement with the United States 	L	H	Reduced infrastructure investment and CTF recapitalization. Growth would be lower in the medium-term.	Increase taxes and cut expense further to self-finance public investment and secure long-term fiscal sustainability.
	No implementation of a tourism strategy and no economic diversification. 	M	M	Economic volatility raises; growth and tourism receipts slow in the medium term.	Adopt a comprehensive high-end tourism strategy and promote agriculture and aquaculture.
<p>^{1/} The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.</p>					

Appendix VI. Long-Term Fiscal Sustainability Analysis

Palau can sustain a current fiscal deficit at 4 percent of GDP after FY2024 if public investment is set at a low 5.6 percent of GDP. Staff recommends reducing the current fiscal deficit to 1 percent of GDP from FY2020 to increase public investment to 8.3 percent of GDP, while keeping ample buffers.

The analytical framework is based on the government's intertemporal budget constraint. This framework requires that the government's net worth plus the net present value (NPV) of future revenue equals the NPV of future expenditure as follows:

$$W + G + R = C + K$$

where the government's net worth (W), and NPVs of grants (G) and domestic revenue (R) are balanced against the NPVs of fiscal expense (C) and capital spending (K).

The current deficit (C-R) and capital spending are endogenous, while the government's net worth and grants are exogenous. The government's net worth is inherited and is equal to the Compact Trust Fund (CTF) plus government's deposits, less domestic accounts payable, government's external debt, and unfunded liabilities of the Civil Service Pension Fund (CSPF). Grants are determined by the donors and the Compact agreement. In contrast, capital spending and the current deficit are chosen by the policymakers to satisfy the government's intertemporal budget constraint. In the baseline scenario, capital spending is chosen after FY2024 for a given current deficit. In the reform scenario, the current deficit is chosen to achieve a desired level of capital spending.

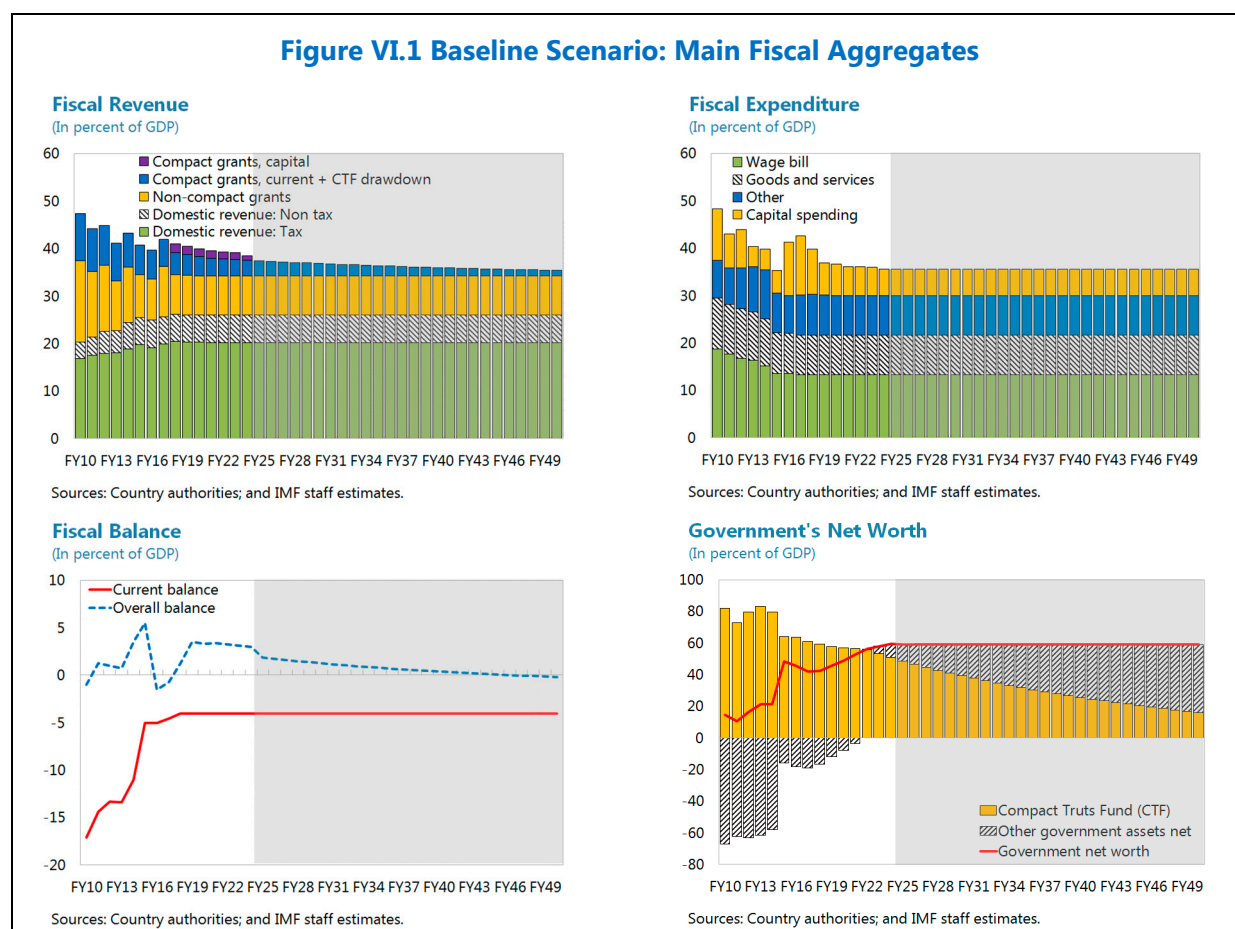
The government's net worth in FY2015 was 48 percent of GDP, with the CTF balance at 64 percent of GDP, government deposits at 8.1 percent of GDP, domestic accounts payable at 5.4 percent of GDP, government external debt at 10.4 percent of GDP, and unfunded liabilities in the CSPF at 8.3 percent of GDP. The following assumptions were used in the baseline scenario:

- Nominal GDP growth is 3 percent in FY2016, 7.6 percent in FY2017, 7.1 percent in FY2018, 6.1 percent in FY2019, 5.1 percent in FY2020, and 4 percent thereafter.
- The CTF nominal rate of return is 6.5 percent, slightly higher than the 5.8 percent obtained during FY2000–15, but lower than the 7.3 percent attained during FY2009–15.
- U.S. Compact grants total US\$124 million in FY2018–24 (total direct assistance of US\$229 million minus advances of US\$105 million received during FY2010–17).
- The CTF withdrawals are US\$5 million in FY2016–17, increasing gradually after to US\$13 million in FY2023, and US\$15 million from FY2024 onwards. The CTF is exhausted in FY2082.
- Other U.S. grants total US\$184 million in FY2016–24 and 5.4 percent of GDP thereafter, while other country grants total US\$ 104 million in FY2016–24 and 2.8 percent of GDP thereafter.

Baseline Scenario

Capital spending in FY2016–24 is set by the existing AsDB loans and capital grants (compact and other), averaging 11 percent of GDP in FY2016–18 and 6 percent in FY2019–24. After FY2024, capital spending is set to satisfy the government's intertemporal budget constraint while keeping the current fiscal deficit at 4 percent of GDP from FY2018 onwards. The results show that the current deficit can be sustained at this level if public investment is capped at 5.6 percent of GDP after FY2024

(Figure 3.1). The government's net worth stabilizes at 59 percent of GDP after FY2024 as the increase in other non-CTF government assets net offsets the fall in the CTF. Current and capital spending are financed with domestic revenue, investment income, CTF withdrawals, and non-compact grants.



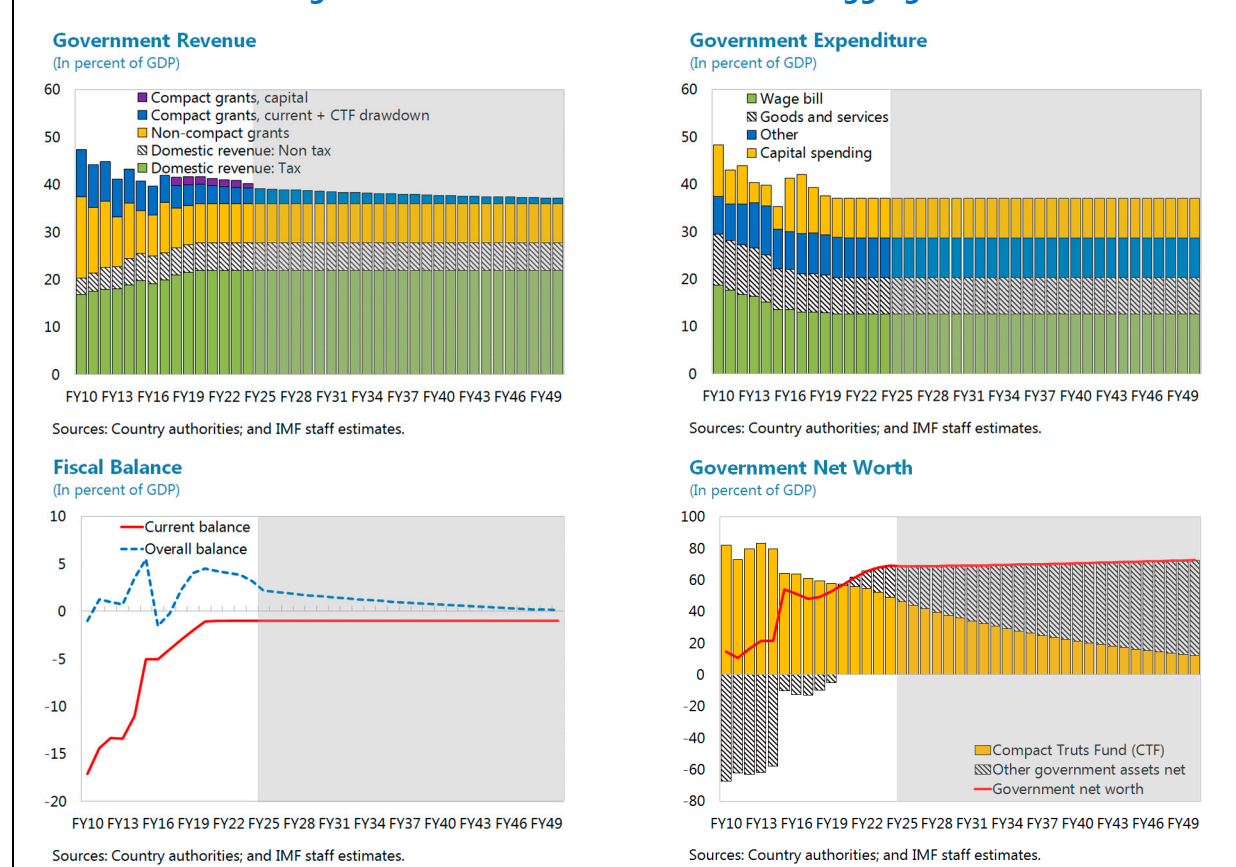
Palau needs more infrastructure investment to support its rapidly growing tourism industry and to enhance its resilience to natural disasters and climate change. A public investment rate of 5.6 percent of GDP is lower than Palau's historical average (8.3 percent of GDP) and that of other Pacific island countries (11 percent of GDP). Palau also needs buffers as: (i) tax revenue is volatile given its reliance on taxes on tourism; (ii) the country is exposed to natural disasters and climate change; (iii) there are contingent liabilities in the CSPF and other public entities; and (iv) the CTF and other government assets are subject to market risk. For example, the CTF lost 5 percent of its value (3.5 percent of GDP) in FY2015 due to global financial volatility. Thus, staff recommends further cuts to the current fiscal deficit to allow for higher public investment and higher buffers as discussed below.

Reform Scenario

Staff recommends targeting a government net worth of 70 percent of GDP after FY2024 as the fiscal anchor, and cutting the current fiscal deficit to 1 percent of GDP from FY2020 as the operational target. In the reform scenario, capital spending in FY2016-18 is kept the same as in the baseline (11 percent of GDP in average), but it is increased to 8.3 percent of GDP from FY2019. The increase in capital spending makes it equal to its FY2000-15 average, and is motivated by the need to sustain

tourism growth and make infrastructure more resilient to natural disasters and climate change. As a result, real GDP growth increases by 1 percentage point after from FY2020. The current fiscal deficit is chosen to ensure enough funding for the increased level of capital spending. The results show that cutting the current fiscal deficit by 1.1 percent of GDP each year in FY2017-20 to 1 percent from FY2020 onwards would allow raising public investment to 8.3 percent of GDP from FY2019, while achieving the government net worth target of 70 percent of GDP after 2024, thus keeping ample buffers (Figure 3.2). As in the baseline scenario, government current and capital spending would be financed with tax revenue, investment income, CTF withdrawals, and non-compact grants.

Figure VI.2 Reform Scenario: Main Fiscal Aggregates



Medium-term fiscal adjustment should rely on both revenue and spending measures. Staff supports a tax reform that replaces the gross revenue tax (GRT) with a single rate value added tax (VAT) with no exemptions, and raising the net income tax for financial institutions and all VAT-registered businesses. Staff also recommends cutting expense, especially government consumption and subsidies, which account for about half of total expense. In the reform scenario, broadly half of the medium-term fiscal adjustment is achieved through higher revenue, and the other half through cuts to government's consumption and subsidies.

Appendix VII. Public Sector Debt Sustainability Analysis

Palau's public debt remains sustainable despite the recent AsDB loans by US\$52 million to fund the upgrade of the Koror-Arai waste management system and the submarine fiber optic cable, which will be disbursed gradually during FY2014-20. Staff uses a broad definition of public debt in its analysis, including the central government's external debt (10.4 percent of GDP in FY2015), the government's domestic accounts payable or domestic arrears (5.4 percent of GDP in FY2015), and the SOEs' debt, which is fully guaranteed by the government and is a contingent liability (11.6 percent of GDP in FY2015). Staff's baseline scenario projects that the public debt will fall from 27.3 percent of GDP in FY2015 to below 20 percent in FY2021. Most of this decline is due to the large primary surpluses during FY2018-21 and the positive growth-interest rate differential.

One key element in the analysis is that Palau does not have access to private foreign capital markets. All of Palau's external debt is from international organizations for specific projects, and thus there is no direct link between the fiscal balance and debt issuance in the private debt market. The baseline scenario's public debt projections assume that the central government and SOEs do not take new foreign loans during FY2016-21, and thus the debt stock declines in line with the amortization of past loans. The path of public debt could be less favorable if the government or the SOEs take on new debt in the coming years. The central government's debt stock increases temporarily during FY2016-18 due to the disbursements from the recent AsDB loans, but it declines afterwards. As the primary balances and flows from the growth-interest rate differential in FY2016-21 are larger than those required to pay for the debt service, the government uses the surplus to fully repay its domestic arrears and to build government deposits. If the primary balances and flows from the growth-interest rate differential were insufficient to cover for the debt service, public debt could rise in the form of larger domestic arrears, as it happened during the global financial crisis.

The alternative scenarios highlight the recent improvements in Palau's fiscal position. The historical scenario, in which GDP growth, real interest rates, and primary balances are equal to their FY2006-15 averages, leads to higher public debt and gross financing needs than in staff's baseline scenario. The scenario with a constant primary deficit at the projected FY2016 level of 1.9 percent of GDP also leads to higher debt-to-GDP ratios and gross financing needs than in staff's baseline scenario. The alternative scenarios also highlight the sensitiveness of the public debt-to-GDP ratio to a growth shock. A decline in real GDP growth by 5.5 percentage points in FY2017-18 would increase the public debt-to-GDP ratio by 13 percent of GDP by FY2018, with the debt ratio declining by FY2021 to levels similar to that of FY2016. This result also highlights the sensitiveness of Palau's public debt to large natural disasters, which not only could cause a decline in growth of this magnitude, but also lead to larger government expenditure for relief and reconstruction.

Palau Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

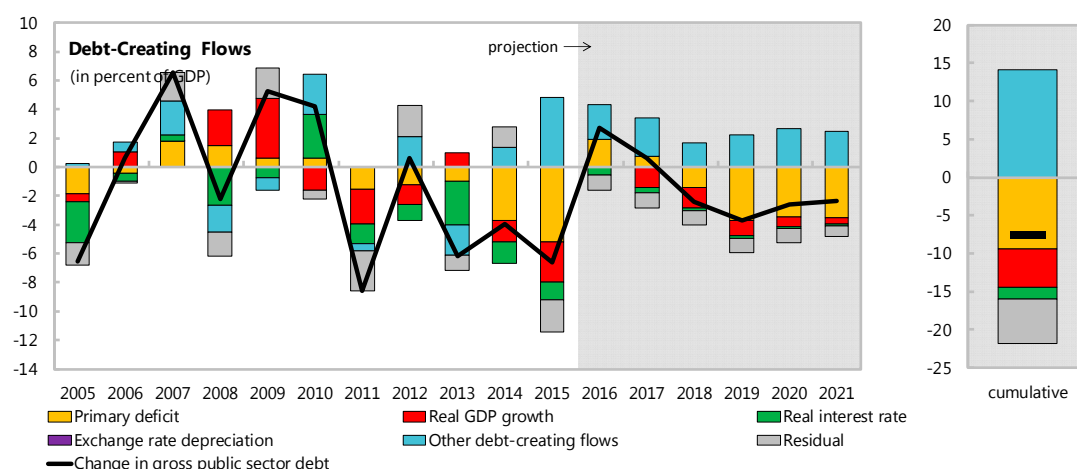
(In percent of GDP, unless otherwise indicated)

Debt, Economic and Market Indicators ^{1/}

	Actual			Projections							As of April 30, 2016		
	2005-2013 ^{2/}	2014	2015	2016	2017	2018	2019	2020	2021				
Nominal gross public debt	43.1	34.0	27.3	30.1	30.7	28.3	24.6	22.0	19.7	Sovereign Spreads EMBIG (bp) 3/ n.a. 5Y CDS (bp) n.a.			
Of which: guarantees	21.1	14.4	11.6	10.3	8.8	7.4	6.2	5.1	4.4				
Public gross financing needs	0.8	-2.7	-4.3	2.8	1.7	0.5	-2.7	-2.2	-2.4				
Real GDP growth (in percent)	-0.8	4.2	9.4	0.0	5.0	5.0	4.0	3.0	2.0	Ratings	Foreign	Local	
Inflation (GDP deflator, in percent)	4.0	5.3	4.7	3.0	2.5	2.0	2.0	2.0	2.0	Moody's	n.a.	n.a.	
Nominal GDP growth (in percent)	3.1	9.8	14.6	3.0	7.6	7.1	6.1	5.1	4.0	S&Ps	n.a.	n.a.	
Effective interest rate (in percent) ^{4/}	1.4	1.1	1.0	0.9	1.2	1.3	1.5	1.6	1.6	Fitch	n.a.	n.a.	

Contribution to Changes in Public Debt

	Actual			Projections							
	2005-2013	2014	2015	2016	2017	2018	2019	2020	2021	cumulative	
Change in gross public sector debt	-0.7	-3.9	-6.6	2.7	0.6	-2.4	-3.7	-2.6	-2.3	-7.7	debt-stabilizing
Identified debt-creating flows	-0.5	-5.4	-4.4	3.8	1.6	-1.4	-2.7	-1.6	-1.6	-1.9	primary
Primary deficit	-0.2	-3.7	-5.2	1.9	0.8	-1.4	-3.7	-3.5	-3.5	-9.4	balance ^{9/}
Primary (noninterest) revenue and grants	44.0	43.3	40.6	39.6	41.8	40.8	40.3	39.8	39.4	241.7	2.0
Primary (noninterest) expenditure	43.9	39.6	35.5	41.5	42.6	39.4	36.6	36.3	35.9	232.3	
Automatic debt dynamics ^{5/}	-0.7	-3.0	-4.0	-0.6	-1.8	-1.7	-1.2	-0.8	-0.5	-6.6	
Interest rate/growth differential ^{6/}	-0.7	-3.0	-4.0	-0.6	-1.8	-1.7	-1.2	-0.8	-0.5	-6.6	
Of which: real interest rate	-1.0	-1.5	-1.3	-0.6	-0.4	-0.2	-0.2	-0.1	-0.1	-1.5	
Of which: real GDP growth	0.3	-1.5	-2.8	0.0	-1.4	-1.4	-1.1	-0.7	-0.4	-5.0	
Exchange rate depreciation ^{7/}	0.0	0.0	0.0	
Other identified debt-creating flows	0.3	1.3	4.8	2.4	2.7	1.6	2.2	2.7	2.5	14.1	
Drawdown in Government Domestic	0.3	1.3	4.8	2.4	2.7	1.6	2.2	2.7	2.5	14.1	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt flows (incl. ESM and Euro)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes ^{8/}	-0.2	1.4	-2.2	-1.1	-1.0	-1.0	-1.0	-1.0	-0.7	-5.8	



Source: IMF staff.

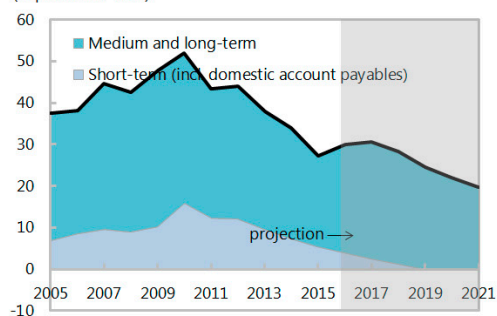
^{1/} Public sector is defined as central government and includes public guarantees, defined as SOE debt.^{2/} Based on available data.^{3/} Long-term bond spread over German bonds.^{4/} Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.^{5/} Derived as $[(r - \pi(1+g) - g + ae(1+r))/(1+g+\pi+g\pi)]$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).^{6/} The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as $-g$.^{7/} The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.^{8/} Includes changes in the stock of guarantees, asset changes, and interest revenues (if any). For projections, includes exchange rate changes during the projection period.^{9/} Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Palau Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

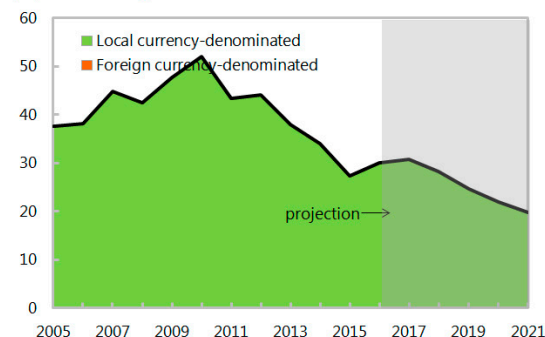
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)



Alternative Scenarios 1/

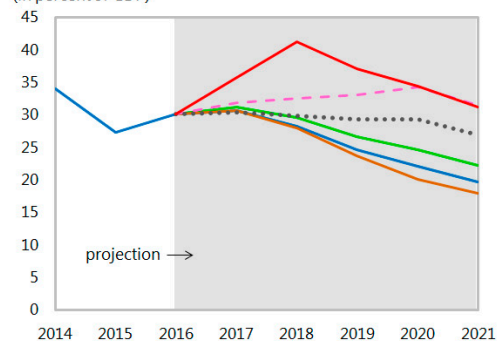
— Baseline
— Real GDP Growth Shock

..... Historical
— No Fiscal Adjustment Scenario

- - - Constant Primary Balance
— Adjustment Scenario

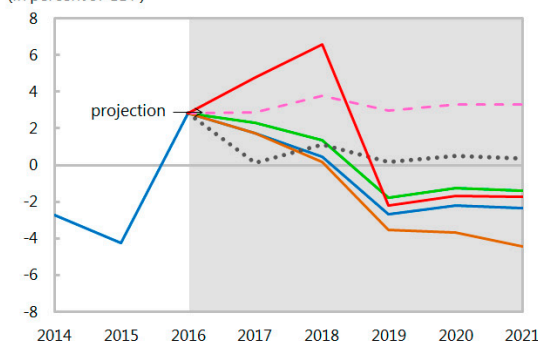
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	0.0	5.0	5.0	4.0	3.0	2.0
Inflation	3.0	2.5	2.0	2.0	2.0	2.0
Primary Balance	-1.9	-0.8	1.4	3.7	3.5	3.5
Effective interest rate	0.9	1.2	1.3	1.5	1.6	1.6
Constant Primary Balance Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	0.0	5.0	5.0	4.0	3.0	2.0
Inflation	3.0	2.5	2.0	2.0	2.0	2.0
Primary Balance	-1.9	-1.9	-1.9	-1.9	-1.9	-1.9
Effective interest rate	0.9	1.2	1.3	1.5	1.6	1.6
No Fiscal Adjustment Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	0.0	5.2	5.1	4.0	3.0	2.0
Inflation	3.0	2.5	2.0	2.0	2.0	2.0
Primary Balance	-1.9	-1.4	0.5	2.8	2.6	2.6
Effective interest rate	0.9	1.2	1.3	1.5	1.6	1.6
Historical Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	0.0	0.5	0.5	0.5	0.5	0.5
Inflation	3.0	2.5	2.0	2.0	2.0	2.0
Primary Balance	-1.9	0.9	0.9	0.9	0.9	0.9
Effective interest rate	0.9	1.2	1.1	1.0	0.9	0.9
Real GDP Growth Shock	2016	2017	2018	2019	2020	2021
Real GDP growth	0.0	-0.5	-0.5	4.0	3.0	2.0
Inflation	3.0	1.1	0.6	2.0	2.0	2.0
Primary Balance	-1.9	-3.8	-4.4	3.7	3.5	3.5
Effective interest rate	0.9	1.2	1.6	2.2	2.2	2.3
Adjustment Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	0.0	5.0	4.9	3.8	2.8	1.8
Inflation	3.0	2.5	2.0	2.0	2.0	2.0
Primary Balance	-1.9	-0.8	1.7	4.6	4.9	5.6
Effective interest rate	0.9	1.2	1.3	1.5	1.6	1.6

Source: IMF staff.

1/ The results under the **constant primary balance scenario** are unrealistic as the primary fiscal balance is in deficit in FY2016 due to disbursements of an AsDB loan for the fiber optic and water and sewage projects. A **no fiscal adjustment scenario** is included to show the potential debt trajectory under a scenario where expenditure restraint stops in FY2017, thus leaving expenditure almost flat in terms of GDP. The debt trajectory under the **adjustment scenario** incorporates both revenue and expenditure reforms as recommended by staff.

Appendix VIII. Tourism Strategy

Palau has developed several tourism strategies over the years, including those laid out in the Tourism Action Plan (2008), the Presidential Management Action Plan (2001), the Study for Promotion of Economic Development in the Republic of Palau (2000), Sustainable Tourism Policies and Action Plan (1997), the 2020 National Master Development Plan (1996), the National Environmental Management Strategies (NEMS) (1994), and the Economic Development Plan (1994). The most recent one formed part of the 2009-2014 Medium Term Development Strategy which set out key strategies and actions for economic, social, environmental and cultural goals over the five-year period. Under the plan, the tourism strategy is to position Palau as an island of choice for environmentally conscious visitors and realize higher returns from tourism. Some of the key actions identified under the strategy are:

- Clarify organizational roles, including those of the Palau Visitors Authority (PVA), the Chambers of Commerce, and the Belau Tourist Association.
- Align the government agenda with that of tourism agencies.
- Position Palau on the world tourism marketplace, through more targeted marketing as a high-end destination, by fostering ecotourism, and developing new attractions.
- Increase investment into quality accommodation and encourage product upgrades.
- Improve air access by making adjustments to bilateral air service agreements.
- Create partnerships for environmental management of key tourism resources.

The actions identified in the current strategy are not new nor different to those set out in previous strategies. The aim to distinguish Palau as a high end destination, promote sustainable tourism and improve management of natural and cultural resources have been regular features of the various strategies since 1994. However, progress on achieving these objectives has been slow. A range of factors explain the slow progress, but the authorities' failure to press ahead with implementation, allocate sufficient resources to advance reforms, and ensure policy consistency across government are important factors holding back progress. A lack of political will has also been cited as a factor, although confusion on the way forward has also been mentioned.

The separation of legislative powers among the states and the national government is another key obstacle to implementing the national strategy. While the national government controls the overall strategy on tourism and development, it is the state governments that control the implementation of certain policies within their states. This poses difficulties for the federal government to implement the overall national tourism strategy across all the states, particularly as not all states share the same vision of the national strategy.

The recent influx of tourist arrivals has posed further stress on the national strategy. Various agencies have noted that both the state and federal government have been in reacting to developments in tourism rather than proactively pursuing policies, for instance, the restrictions on charter flights and Koror State's moratorium on hotel development were implemented to limit development of package tourism. The authorities' concern has been that the rise in package-tourism is not consistent with the 'high-end destination' objective under the tourism strategy.

However, there is a lack of clarity among government and tourism agencies on the definition of 'high-end' tourism and the most effective policies to achieve that goal. Agencies are generally

confused whether ‘high-end’ implies higher spending per day or whether they would like target tourists from certain destinations. Furthermore, government and tourism agencies appear to be working against each other. For instance, while the PVA has been marketing Palau as a high-end destination, there have been several low-quality and budget hotel establishments under construction in Koror. While the authorities point to a number of loopholes in existing legislation, particularly on hotel development, purchases of land-leases, and regulations, there has been little in the way of addressing the weaknesses in the legislative and regulatory frameworks to ensure that developing trends in the tourism industry are consistent with the overall national strategy.

That said, there has been notable progress on some areas of the tourism strategy, in particular, to preserve Palau’s marine assets. In 2009 Palau established the world’s first shark sanctuary banning any form of commercial fishing of sharks. Later in October, 2015, Palau’s congress approved the Palau National Marine Sanctuary Act to establish one of the world’s largest protected areas of ocean, and protect Palau’s key tourism resources. This are welcome developments, although greater efforts are needed to make progress on the other areas of the national tourism strategy.



REPUBLIC OF PALAU

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

August 24, 2016

Prepared By

The Asia and Pacific Department
(In consultation with other Departments)

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FUND RELATIONS

(As of July 31, 2016)

Membership Status: Joined December 16, 1997; Article VIII

General Resources Account:

	SDR Million	Percent Quota
Quota	3.10	100.00
Fund holdings of currency	3.10	100.00
Reserve position in Fund	0.00	0.03

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	2.96	100.00
Holdings	2.99	101.07

Outstanding Purchases and Loans: None.

Financial Arrangements: None.

Projected Obligations to Fund: None.

Exchange Rate Arrangements.

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

Article IV Consultation:

Palau is on a 24-month consultation cycle. The last Article IV consultation discussions were held in February 2014. The Executive Board discussed the staff report and concluded the consultation on April 23, 2014.

Technical Assistance:

FAD, LEG, STA, and PFTAC have provided technical assistance on tax reforms, statistics, banking supervision, and Anti-Money Laundering and Combating the Financing of Terrorism.

Resident Representative:

Mr. Tubagus Feridhanusetyawan has been the Resident Representative for Pacific Island Countries since [September] 2014. He is based in Suva, Fiji.

IMF–WORLD BANK COLLABORATION

(August 2016)

The World Bank and IMF teams for the Republic of Palau led by Mr. Robert Utz (Lead Economist) and Mr. Guajardo (IMF Mission Chief for Palau) maintain a close working relationship and dialogue on macroeconomic and structural issues.

Palau's reliance on tourism, grants and commodity imports pose risks to the economy. In turn, Palau will need to rely on fiscal and structural policies to help mitigate potential risks such as a slowdown in key trading partners, further U.S. dollar appreciation, natural disasters, and higher commodity prices. Against this backdrop, the teams agreed that Palau's key macroeconomic challenge is to enhance resilience and lift potential growth in the medium term. Based on this shared assessment, the teams identified key areas of reforms as follows: (i) securing fiscal sustainability; (ii) raising potential growth and enhancing resilience; and (iii) ensuring financial stability and facilitating credit extension.

To this end, the World Bank is currently supporting the government of Palau in undertaking reforms and investments aimed at improving access to Information and Communications Technology (ICT). A Technical Assistance Grant, signed in September 2013, provides advisory support and capacity building needed to support ICT sector reform and liberalization in Palau. Furthermore, under Phase II of the Pacific Regional Connectivity Program, an investment in telecommunications infrastructure is under preparation. This could entail support for a fiber-optic submarine cable in order to increase the availability and reduce the cost of international bandwidth and hence facilitate the rollout of faster-cheaper broadband Internet.

Palau: Bank and Fund Implemented and Planned Activities, 2015–16			
Title	Products	Provisional Timing of Missions	Expected Delivery Date
1. World Bank Work Program	ICT Technical Assistance to support Palau's ICT sector reform. This runs parallel to the Palau-Federated States of Micronesia connectivity project.	Twice a year	2016 – 2021
	Technical Assistance - Payment Systems.	As needed – possibly September 2016.	2017
2. IMF Work Program	IMF/PFTAC technical assistance on balance of payments statistic.	Ongoing	Several missions a year.
	Article IV consultation.	May 2016	September 2016
3. Joint Work Program	Mutual update on work program developments and information sharing.	Semi-annual	Ongoing

RELATIONS WITH THE ASIAN DEVELOPMENT BANK

(August 2016)

After joining the Asian Development Bank (AsDB) in December, 2003, as its sixty-third member country, Palau was classified as an AsDB developing member country in December 2005. AsDB has since approved 6 loans totaling US\$69.8 million and six technical assistance projects totaling US\$3.8 million. Cumulative disbursements to Palau for lending and grants financed by Ordinary Capital Resources (OCR), the Asian Development Fund (ADF), and other special funds amount to \$17.7 million.

Country Operations and Business Partnership (COBP) 2016-2018 attaches high priority to provide support to improve public sector effectiveness, facilitate private sector development, deliver safe water and sanitation services, and improve connectivity.

Regional connectivity is vital for Palau's development. In December 2015, AsDB approved lending of US\$25 million for the North Pacific Regional Connectivity Investment Project. The project will increase broadband access in Palau by supporting the development of a submarine fiber-optic cable system to link Palau to an internet cable hub in Guam.

Also in 2015, AsDB provided technical assistance to help the Government of the Republic of Palau generate policy options for tourism development.

AsDB assistance was also given to develop a medium-term budget framework that has enabled the government to plan more effectively, improve tools for fiscal management and deficit reduction, and better implement development plans. AsDB has built upon these initiatives by helping the government prepare its Medium-Term Development Strategy and provided support for Palau to conduct a household income and expenditure survey in 2014.

To improve access to business credit, AsDB has provided technical assistance for new secured transaction legislation. The government has launched a secured transaction registry, making it possible for banks to provide loans with greater security, and at reduced risk.

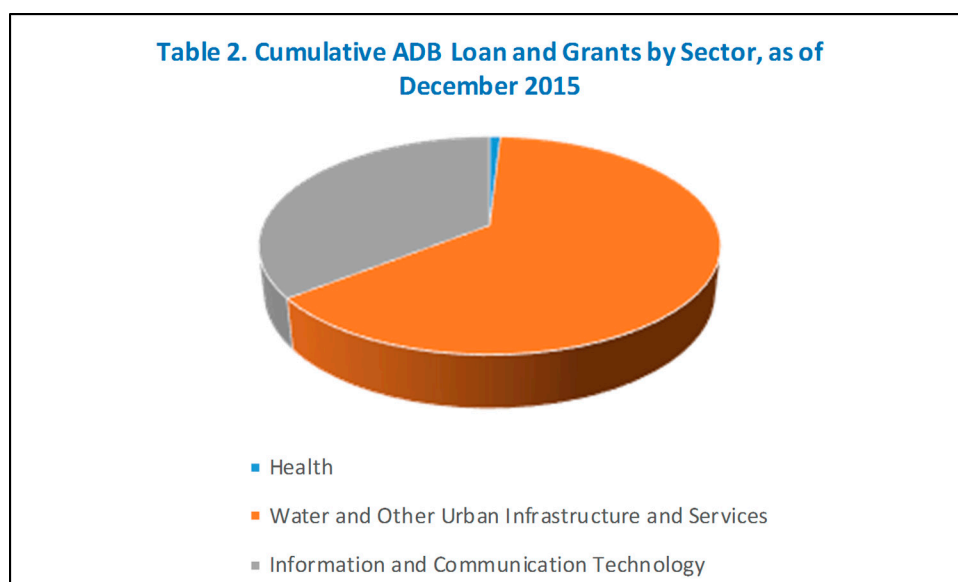
AsDB has also supported improvements to governance in Palau's state-owned enterprises (SOEs), facilitate business growth by improving business registration systems, and develop an SOE policy that will eventually include relevant legislative measures.

AsDB support for sustainable health care financing was extended in 2013, with AsDB assistance covering the cost accounting of all health services in Palau. Also in 2013, AsDB released the second tranche of a program loan for a series of technical and infrastructure projects. These projects support Palau's economic growth by improving public health, environmental protection, and basic water and sewerage services. AsDB approved a project to upgrade the sewerage network in Koror and Arai, which will directly benefit about 70 percent of the population, while helping to cater to the growing tourism market.

No lending pipeline for Palau is proposed in the COBP, 2016–2018 as the government will focus on project implementation. There is a proposed allocation of US\$500,000 for technical assistance.

Table 1. Loan, Grant, and Technical Assistance Approvals 1/ (In US\$ Millions)					
	2012	2013	2014	2015	2003-2015
Projects					
Sovereign					
Loans	-	28.8	-	25.0	69.8
Grants	-	0.2	-	-	0.2
Nonsovereign	-		-	-	-
Loans					
Equity Investments					
Guarantees					
Subtotal	-	29.0	-	25.0	70.0
Technical Assistance					
Sovereign	-	-	-	0.5	3.8
Nonsovereign					
Subtotal	-	-	-	0.5	3.8
Cofinancing including Trust Funds					
Sovereign	-	-	-	-	-
JFPR - Grants					
JFPR - TA					
Others		-			-
Nonsovereign					
Subtotal	-	-	-	-	-
TOTAL	-	29.0	-	25.5	73.8

Source: Listing of Loans, TA, Grant and Equity Approvals (OSFMD website).
1/ Amounts are net of cancellations. Sovereign Loans and grants include those funded by OCR and ADF. Cofinancing includes funding for loans, grants and technical assistance from sources other than OCR, ADF and TASF.



RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE (PFTAC)¹

(August 2016)

Palau has been a heavy user of PFTAC technical assistance (TA) in recent years. In phase IV (FY2012–16) there were 24 missions, with the largest concentration in the Revenue Sector. Other results achieved in phase IV included revenue compliance strategies and strengthened bank supervision through the adoption of regulations, improved bank reporting, and the establishment of an on-site supervision program. Methodologies for producing a broader range of national income and balance of payments statistics were also developed.

Strategy 2014–16

PFTAC's TA strategy is guided by the APD regional strategy note and is planned within the results framework for the current PFTAC (Phase IV) FY2012–16 funding cycle.²

PFTAC TA aims to support the authorities sustain progress on fiscal consolidation and strengthen the financial sector. Priorities will be strengthening revenue administration and, in close coordination with AsDB, improving PFM. Continued strengthening of financial sector supervision will also be required. Macroeconomic statistics will continue to be developed mainly via annual sub-regional workshops.

In the **public financial management** area, the focus will be on continuing to support AsDB's project on developing medium-term budgeting. PFTAC in 2013 assisted Palau to undertake a PEFA Self-Assessment. Officials from Palau have regularly attended PFTAC's PFM workshops including most recently its workshops on Medium-term Expenditure Forecasting (November 2015) and Social Security Finance Reform (April 2017).

In the **tax policy and revenue** area anticipated reforms to the current tax system, including the implementation of a VAT, have not materialized due to the Senate Ways and Means Committee unable to secure a majority vote. However, PFTAC recommendations to strengthen revenue administration were accepted by the authorities and resulted in: (a) the development of a new strategic and business plan which highlights the most important objectives to be achieved over the next three years; and (b) Ministerial approval to implement a new function based organizational structure. Budget clearance to secure additional resourcing requirements is underway and new staff position descriptions being negotiated with the Bureau of Public Service System.

In the **financial sector supervision** area, prudential returns are now implemented, and Palau is in line for the integration of the Financial Sector Information System (FSIS) developed by the Reserve Bank of New Zealand to be performed in late 2014. In June 2016, the Commission hosted the annual meeting

¹ PFTAC 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. It is based in Suva, Fiji.

² The results framework and additional detail on recent activity can be found within the PFTAC Phase IV program document and FY2016 Annual Report, available at www.pftac.org.

of the Association of Financial Supervisors of Pacific Countries, for which PFTAC is the secretariat. Capacity building in risk based banking supervision will continue including workshops for management on how to manage in a risk based environment.

In **economic statistics**, PFTAC will continue to provide technical assistance for the development of GDP estimates by expenditure and will assist with capacity building in national accounts statistics (RBM code 4.1) to further embed independent production skills. IMF HQ will provide resources to produce better current and capital accounts of the balance of payments (RBM codes 4.6-4.8) and government finance statistics.

In the **macroeconomic analysis and frameworks** area, PFTAC will provide TA on developing the methodology used to forecast revenues focusing on planned tax reform measures. In addition, TA will also be provided to develop capacity to assess alternative fiscal consolidation options for preserving fiscal/debt sustainability when the Compact grants expire in FY2024.

STATISTICAL ISSUES

STATISTICAL ISSUES APPENDIX

(As of August 24, 2016)

Assessment of Data Adequacy for Surveillance

General: Palau's statistics have improved during the past years and are now broadly adequate for surveillance. With the support of technical assistance (TA) from IMF/PFTAC and the Graduate School USA, the Office of Planning and Statistics (OPS) compiles and publishes macroeconomic data at an annual frequency. The *2012-14 Palau Statistical Yearbooks* that provides comprehensive data on macroeconomic indicators, population, employment, housing, education, health, investment, tourism, and other economic indicators has been published on Palau's website (<http://palaugov.pw/executive-branch/ministries/finance/budgetandplanning/rop-statistical-yearbooks/>). Further areas for improvement include broadening the coverage and providing more frequent reporting, particularly of fiscal and external sector data. The OPS has recruited more staff but continues to rely heavily on external consultants and TA. Further improvements in capacity and additional TA are needed to strengthen the quality and timeliness of macroeconomic data.

National Accounts: Since 2012, GDP estimates by production have been compiled and published, and the methodology has improved. Further areas of improvement include incorporating the recent business surveys and compiling GDP estimates by expenditure.

Price Statistics: Data quality has improved and the Consumer Price Index has been regularly published on a quarterly basis on Palau's website (<http://palaugov.pw/executive-branch/ministries/finance/budgetandplanning/consumer-price-index-cpi/>).

Government Finance Statistics (GFS): Fiscal data are compiled using GFSM2001 classification and were published in the *2012-14 Palau Statistical Yearbooks*. Further improvements include broadening the coverage beyond the central government and improving the frequency and timeliness of reporting, including of the audited accounts. The authorities have recruited new staff to compile GFS data and to participate in regional training and remote TA from STA. Annual GFS data have not been reported to STA.

Monetary and Financial Statistics (MFS): The monetary survey is unavailable since there is no central bank. Moving ahead, an MFS TA could assist the authorities in developing the standardized report forms for the depository corporations and strengthening data reporting.

Financial sector surveillance: Banks have submitted quarterly financial statements, including balance sheets and profit and loss statements, to the Financial Institutions Commission (FIC) since 2009. The FIC publishes financial soundness indicators (FSIs) and balance sheet data on a quarterly basis (<http://www.ropfic.org/>). However, the FSIs do not include data from the National Development Bank of Palau as it remains outside the FIC's supervision.

External sector statistics: The balance of payments and international investment position are reported according to BPM6 and published in the *2012-14 Palau Statistical Yearbooks*. The Business Enterprise Survey and the Hotel Accommodation Survey and Tourist Expenditure Survey are expected to improve data quality, particularly tourism-related data. The financial accounts data have also improved, resulting in a reduction of errors and omissions.

Data Standards and Quality

Palau began participating in the General Data Dissemination System in August 2013, and comprehensive information on Palau's statistical production and dissemination practices are available on the IMF website.

No data ROSC available.

Palau: Table of Common Indicators Required for Surveillance
(As of August 24, 2016)

	Date of Latest Observation	Date Received	Frequency of Data ⁷	Frequency of Reporting ⁷	Frequency of Publication ⁷
Exchange Rates (U.S. dollar is the 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	06/30/16	7/31/16	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	NA	NA	NA	N/A	NA
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	09/30/15	5/18/16	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	09/30/15	5/18/16	A	A	A
External Current Account Balance	09/30/15	5/18/16	A	A	A
Exports and Imports of Goods and Services	09/30/15	5/18/16	A	A	A
GDP/GNP	09/30/15	5/18/16	A	A	A
Gross External Debt	09/30/15	5/18/16	A	A	A
International Investment Position ⁶	09/30/15	5/18/16	A	A	A

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).

**Statement by Barry Sterland, Executive Director of Palau, and Ronald Cafrine,
Advisor to the Executive Director of Palau
September 9, 2016**

Mr. Sterland and Mr. Cafrine submitted the following statement:

We thank the Fund and staff for the constructive discussions during the 2016 Article IV consultation and a very useful staff report. We largely agree with staff views expressed in the report, which effectively highlight the government reform efforts, as well as the remaining challenges to preserve macroeconomic stability and ensure long-term growth. The authorities remain highly appreciative of the valuable technical assistance provided by the Fund, including under PFTAC, and anticipate continued engagement and support.

Palau, is a small middle-income island state in the North Pacific, with a narrow production base and heavy reliance on tourism and grants. As such, the economy is both highly vulnerable to natural disasters as well as external economic shocks. To ensure macroeconomic stability, the government is determined to build adequate buffers against downside risks, address structural impediments to growth and maintain prudent macroeconomic policies. Given the inherent challenges faced by Palau, my authorities are very grateful for the continued assistance from the international community, in particular the United States which has been providing financial support through the Compact of Free Association.

Economic Development and Outlook

The economy expanded by close to 9½ percent in 2015, driven by a massive increase in tourist arrivals and a significant expansion in construction activity. This brought both positive and negative effects. While beneficial for short-run economic growth, the unexpectedly large increase in tourists, concentrated in Koror State, strained the limited infrastructure base of the island. This, in turn, raised concerns about long-run sustainability and, if unmonitored, Palau's reputation as a pristine tourist destination could be at risk from a degraded environment.

The authorities, in recognition of these pressures, announced a few measures to safeguard the tourism sector's long-run sustainability while still supporting economic activity. In the short-term, the authorities limited the number of charter flights, as well as imposing restrictions on new hotel developments in Koror State unless that development meets certain environment and infrastructure standards (including its own water, sewerage and electricity). Furthermore, to help relieve the pressure on Koror's infrastructure, while still supporting tourism and economic activity, tourism investments outside of Koror are exempt from these restrictions. Over the medium- and long-term, Koror's infrastructure will be better able to handle private sector development as the authorities are scaling up infrastructure investment. The authorities are committed to implementing a comprehensive tourism

strategy that both preserves the fragile environment and lays the basis for a soundly based long-term growth.

While the outlook remains positive, growth is expected to be flat in 2016 owing to the expected temporary decline in arrivals following these restrictions before accelerating in 2017 and 2018. Our authorities are confident that growth will quickly rebound as new hotels and infrastructure are brought on line together, achieving the authorities' objective of high long-term growth, and consistent with staff's economic growth forecasts. Likewise, the authorities agree that downside risks to the outlook predominate and recognize that risk mitigation measures are limited to fiscal and structural policies in the absence of monetary and exchange rate policies. As such, the authorities remain intent on building fiscal buffers (see below). They are also actively considering how to diversify the economy, especially given the current infrastructure bottlenecks as well as the longer-term risks associated with climate change.

Fiscal Sustainability

The authorities agree with staff on the necessity for additional medium-term fiscal adjustment to ensure fiscal self-sufficiency, especially after the US Compact grant ends in 2024. In 2015, commendable fiscal discipline brought expenditure savings of 4.5 percent of GDP, which helped lower the deficit significantly. At the same time, revenues increased by about 1 percent of GDP.

The authorities will continue to build fiscal space over the medium-term. This will involve careful decisions to ensure that the authorities reach both their goal of a zero current fiscal balance by 2024 and are able to continue to invest in public investment to support the tourism industry and enhance the country's resilience to natural disasters. To achieve this outcome, the authorities will build on existing progress with new revenue measures, including through increasing the existing airport departure tax in the short-term and, in the medium-term, more comprehensive tax reform that is projected to mobilize over 4 percent of GDP in additional revenue. This will be supported by the careful monitoring of investment projects to avoid fiscal slippage, and expenditure constraint (itself supported by improved implementation of Public Financial Management (PFM) principles).

Staff views with respect to potential contingent liability risks from the Civil Service Pension Fund (CSPF) and the SOEs were also acknowledged by the authorities. The authorities have taken steps to correct the large unfunded liabilities within the CSPF, with the Congress already considering legislation that will improve the sustainability of the system. The authorities are considering cost recovery strategies for SOEs and are committed to removing subsidies once service quality has been adequately upgraded. In the meantime, planned investment to improve water distribution are underway.

Banking and Financial Sector Stability

Palau's banking system remains strong and resilient, with banks well capitalized and liquid, with a low non-performing ratio of about 2 percent. The presence of three U.S. FDIC-insured banks is the back-bone of the banking system in Palau, holding 93 percent of the loans and 99 percent of the deposits. With regards to supervision, the Financial Institutions Commission (FIC) continues to enhance its capabilities through technical assistance and training from the Fund, while the Financial Intelligence Unit (FIU) has also improved its ability to undertake anti-money laundering investigations. The authorities are pleased that de-risking, which poses a real threat in other pacific island countries, has been assessed and reported by staff not to be a problem in Palau, owing to the three U.S. banks doing the majority of transactions. The authorities continue to undertake efforts to improve businesses' access to credit. This includes advisory services working with applicants to improve their business plans and financial statements, as well as the Development Bank taking a more active role in providing credit to smaller borrowers.

Growth and Private Sector Development

The authorities remain committed to improving the business environment to allow the private sector to play a larger role in economic activity. To this end, the authorities are focused on reducing impediments to setting up new businesses which will improve investor confidence and lift potential growth. In this area, the ADB and other development partners continue to provide useful assistance, assisting the Government's development agenda to improve infrastructure and reduce business costs. The government, and these development partners, are also ensuring that all new infrastructure projects undergo assessments of their resilience to natural disasters and climate change. However, the challenges faced by the authorities are structural in nature and common with other small states. This underlines the importance of continued assistance and taking a long run view on these reforms.

The recently established Economic Advisory Group (EAG) – comprising both public and private sector representatives – underlines the importance that the Government places on promoting private sector development. Whilst the focus for the short-term will be to ensure that the country continues to benefit through tourism growth that is environmentally sustainable, the EAG would be addressing pertinent policy and structural matters with the objective of attracting investment and boosting private sector development.