March 2002
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Republic of Palau: 2001 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2001 Article IV consultation with the Republic of Palau, the following documents have been released and are included in this package:

- the staff report for the 2001 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **September 20, 2001,** with the officials of Palau on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on November 30, 2001.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **January 4, 2002** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its January 4, 2002 discussion** of the staff report that concluded the Article IV consultation.

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

Recent Economic Developments

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

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INTERNATIONAL MONETARY FUND

REPUBLIC OF PALAU

Staff Report for the 2001 Article IV Consultation

Prepared by the Staff Representatives for the 2001 Consultation
with the Republic of Palau

Approved by R. Anthony Elson and Michael Hadjimichael

November 30, 2001

- **The last Article IV consultation was concluded in November 1999.** Executive Directors underscored the need for fiscal consolidation and structural reforms to expand the productive base of the economy and to prepare for the scheduled reduction in foreign grants.
- **Discussions for the 2001 Article IV consultation were held in Koror during September 7–20, 2001.** The staff team comprising Ms. Abdelati (head), Mr. Khatri, and Ms. Kim (all APD), worked closely with Ms. Olaso, the PFTAC Banking Regulation and Supervision Advisor, whose visit overlapped with the mission. The team met with President Remengesau, Vice President Pierrantozi, Minister of Administration Saddang, Minister of Trade and Commerce Besebes, other senior government officials, UNDP advisors, other donors, and private sector representatives.
- **Economic activity is weak and fiscal performance has deteriorated in FY2001.** Real GDP growth is estimated at around 1 percent in the past two years, with a slump in tourism only partially offset by the continuation of several large infrastructure projects. The overall fiscal deficit widened to 15 percent of GDP, financed primarily, as in earlier years, by a drawdown of assets from U.S. Compact grant receipts.
- **The FY2002 Budget (recently approved) targets a substantial consolidation, with the overall deficit falling to 7½ percent of GDP.** Passage of the tax package presently before Congress would reduce the deficit to below the target of 5 percent of GDP recommended by staff and limit asset drawdown.
- **The resumption of previously stalled structural reforms is a welcome step that would help revive growth.** The administration that took office in January 2001 has embarked on a wide range of initiatives aimed at public sector reform and removing impediments to growth. Particularly noteworthy are a new investment law currently under debate in Congress and proposals to streamline government. Financial sector legislation was recently passed, but implementation is yet to begin and some areas of the new legislation need to be strengthened.
- Palau accepted the obligations of Article VIII, Sections 2, 3, and 4 in December 1997.
- The principal author of this report is Ms. Abdelati.

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I. BACKGROUND

1. **The Republic of Palau has depended on external assistance for decades.** Japan used the islands as a military base from 1914 and developed basic infrastructure. In 1947, the islands became a strategic Trust of the United Nations, administered by the U.S. In 1981, Palau established a constitutional government and commenced discussions with the U.S. on an association agreement that was concluded in 1994, ten years after similar agreements with the Federated States of Micronesia and Marshall Islands. The Compact of Free Association provides grants totaling nearly $600 million over 15 years in exchange for U.S. defense control (Box 1).

2. **Compact grants were front-loaded in the first two years, intended to provide investment income and to finance budgetary spending until domestic revenue-raising capacity is strengthened.** Nearly three fourths of the cash grants were received during the first seven years of the fifteen-year agreement. The upfront cash grants for current operations and capital projects have been largely spent, enabling budget deficits averaging 9 percent of GDP (after grants) during the past six years, without domestic or foreign borrowing.[1] In addition, in-kind Compact grants were provided, in the form of various federal services and direct financing of a road project. A Compact Trust Fund (CTF) of $70 million, established to generate an income stream in the long run, has almost doubled in nominal terms despite sizeable losses in FY2001.[2] Over the past six years, non-Compact grants (from the U.S., Japan, and Taiwan Province of China) have averaged 11 percent of GDP annually.

Summary of Compact Grants
($ million, unless otherwise indicated)

	Total Compact Allocation	Amounts Received from 1994/95-2000/01	Unspent Balance of Grants Received	Grants Expected from 2001/02-2008/09
Total Compact grants	595	371	159	224
I. Total cash receipts	411	304	...	106
(percent of total allocation)		(74%)		(25%)
Of which:				
Compact Trust Fund (CTF)	70	70	135	...
Non-Trust Fund grants (NTF)	341	234	24	106
Current Operations	244	154	0	90
Capital Projects	97	81	24	16
II. Total in-kind grant aid	185	67	...	118
In-kind road project	149	54	...	95
In-kind federal services	36	13	...	23
Memo:				
Annual average of Non-Trust Fund cash grants				
(as percent of GDP)	(16%)	(26%)	...	(10%)
(per capita, in $ '000)	1195	1763	...	699

3. **Although per capita GDP is high ($6,180) in comparison with other Pacific Island countries, primarily because of very large U.S. grants, the economy faces several challenges common to other small island economies.** The main challenges include a narrow productive base, a shortage of skilled labor, a small domestic market, inadequate

[1] The overall government deficit (before grants) has averaged 35 percent of GDP, financed from current-year grants as well as by drawing down unspent balances.

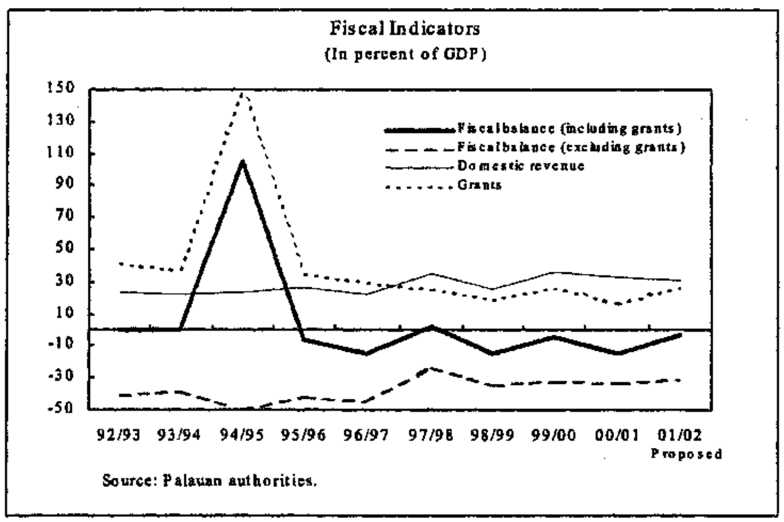
[2] Trust Fund resources can only be invested in U.S. securities and bonds, and are distributed among five funds that are managed by two U.S.-based institutions. The investment strategy is periodically reviewed by a U.S. investment advisor and a Board of Trustees.

infrastructure, and vulnerability to external shocks and natural disasters. The service sector constitutes a large proportion of GDP, with total grant aid exceeding one fourth of GDP annually, supporting the government sector. Tourism and fishing are the main private sector activities. A large share of the active workforce (36 percent) is engaged in the public sector, accounting for almost 50 percent of all wages paid in 1999. This partly reflects the demands of the communal system and the requirements of staffing a modern bureaucracy (Box 2).

4. **As with other small Pacific Islands, significant financial resources are needed to address geophysical challenges.** About 80 percent of the land area is on Babeldaob Island that is virtually inaccessible, but is expected to develop rapidly after the completion of two off-budget capital projects—the Japan-funded Koror-Babeldaob Bridge (in 2002) and a U.S.-funded Babeldaob Island ring road (in 2004). The 250 islands and their marine environment are fragile and could be destroyed by irresponsible development. The islands are home to a large variety of birds and unique vegetation, which are threatened by soil erosion and pollution from construction. The surrounding waters contain a diverse marine life and coral reefs, which are vulnerable to storms and climate change that could jeopardize income from tourism and fishing. Environmental protection has required significant budgetary resources to develop local agencies and expertise.

II. Recent Developments and Prospects[3]

5. **Economic activity has been weak in the last two years and inflation is low** (Figure 1 and Table 1). Following a 5½ percent decline in FY1999, real GDP is estimated to have expanded by only 1 percent annually in FY2000 and FY2001 (years ending September). Tourist activity—the main source of income—has not recovered since the Asian crisis, and its impact on overall growth has only been partially offset by project-related construction. Price inflation remains modest (2½ percent in FY2001) and slightly lower than in the U.S. Public and private sector wages have remained stable since 1996.



[3] Macroeconomic analysis for Palau is hampered by significant deficiencies in statistics. In particular, balance of payments and fiscal accounts contain large errors and omissions due to insufficient reporting and missing items.

6. **In spite of fiscal consolidation efforts, the overall fiscal deficit (including grants) increased to 15 percent of GDP in FY2001 from 4 percent of GDP in the previous year (Table 2).** This larger deficit stems mainly from a sharp decline in the income from U.S. invested assets through lower dividends and realized losses (6½ percent of GDP), and lower external grants (10 percent of GDP). Current expenditures declined by 9 percent of GDP, reflecting fiscal consolidation efforts after the November 2000 election. Capital spending increased slightly to accommodate reconstruction following damage from Storm Utor. Improvements in administration yielded nearly 3 percent of GDP in tax and nontax revenue as a number of measures were introduced ahead of the passage of the tax reform act.

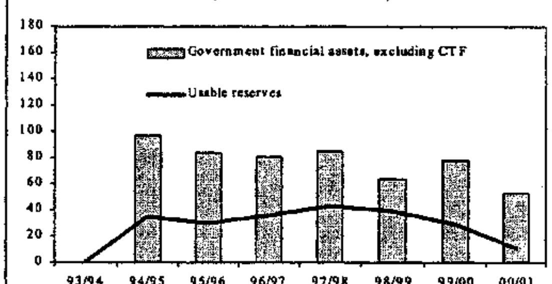
Reasons for Widening Deficit in FY2001
(In percent of GDP)

	Change from FY00	Reasons for Change: External Factors	Reasons for Change: Policy Improvements	Reasons for Change: Other 1/
Tax revenue	1.7		1.7	
Nontax revenue	-5.2			
Of which : Investment income	-6.4	-6.4		
Of which : Fees & charges	1.1		1.1	
Current grants	-0.7	-0.7		
Capital grants	-9.1	-9.1		
Current expenditure	-9.4		-9.4	
Capital expenditure	0.8		0.8	
Errors and Omissions	-6.4			-6.4
Overall balance	-11.2	-16.2	11.4	-6.4
Overall balance, excluding grants	-1.4			

1/ Represents amounts to be reimbursed (from reimbursable grants) and changes in accounts payable/receivable.

7. **Government asset balances have been declining, reflecting drawdowns to finance operational deficits as well as recent investment losses.** The fiscal deficits have been financed mainly by withdrawals from government financial assets excluding the CTF (non-Trust Fund Assets or NTFA).[4] Since a large part of the NTFA balance, which now stands at only $44 million, is associated with specific capital projects, freely usable official assets are estimated at $8 million (less than one month of imports). The market value of the CTF, which had grown at an average annual rate of over 13 percent during the period FY1995–FY2000 (to $162 million), declined by 17 percent in FY2001 (to $135 million), as about 60 percent of the Fund's assets are invested in U.S. stocks.

Government Assets (NTFA) and Usable Reserves
(In millions of U.S. dollars)

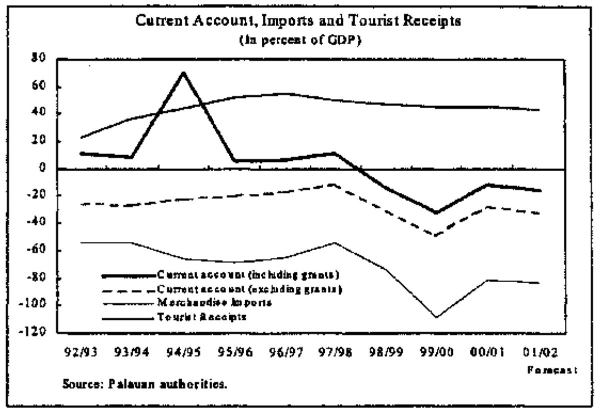


Source: Palauan authorities.

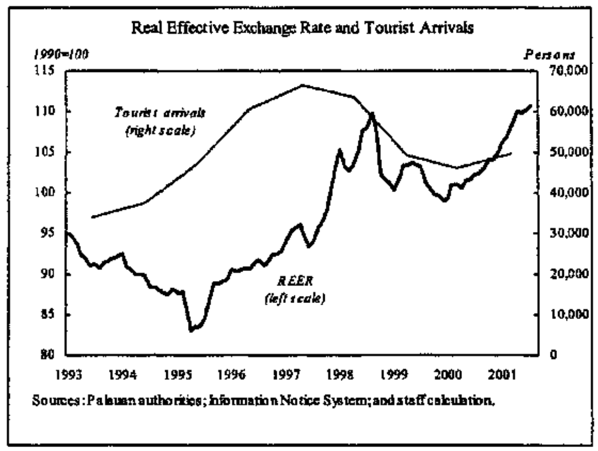
8. **The external current account deficit has widened in recent years** as project-related capital goods imports have increased and tourist receipts have fallen (Table 3). The worsening external position suggests that Palau's competitiveness continues to deteriorate.

[4] NTFA is the total of government asset balances, including the unspent balances of current and capital grants, and Local Fund balances, and excluding the Trust Funds.

The real effective exchange rate (REER) has appreciated by 25 percent since 1995.[5] Tourism competitiveness began to decline after the Asian crisis reflecting the lagged effect of a strong U.S. dollar and large real depreciations in the currencies of competing Asian destinations. Moreover, airfares are high as they are determined by a single carrier servicing Palau, and hotels have been reluctant, until recently, to adjust their prices in the face of weaker demand.



9. **The capital account was boosted in FY2000 by a grant and loan from Taiwan Province of China,** both to finance infrastructure; however, an expected grant in FY2001 did not materialize. External debt, which is all long term, remains low at 16 percent of GDP. Outstanding debt had been repaid by 2000, before contracting a $20 million concessional loan to finance the new Capital building. Foreign investment is impeded by current regulations and by unclear land use rights (See Box 2).



10. **Banking operations continue to be characterized by large outflows of deposits to U.S. banks.** There is no central bank or regulatory body. Five pieces of financial legislation have been introduced in June 2001, in advance of Palau's review by the Financial Action Task Force (Box 3). In approving the Financial Institutions Act (FIA), Congress diluted the provisions for banking regulation and supervision. Nevertheless, the law establishes a Financial Institutions Commission (FIC) to oversee banking regulation and supervision of the 20 registered banks.

11. **A large number of bills and legislative amendments have been proposed to Congress in the past 10 months to revive the previously stalled fiscal retrenchment and structural reforms.** In addition to financial sector legislation, these include a foreign investment act, budget reform act, statistical act, and constitutional amendments related to streamlining the executive and legislative branches.

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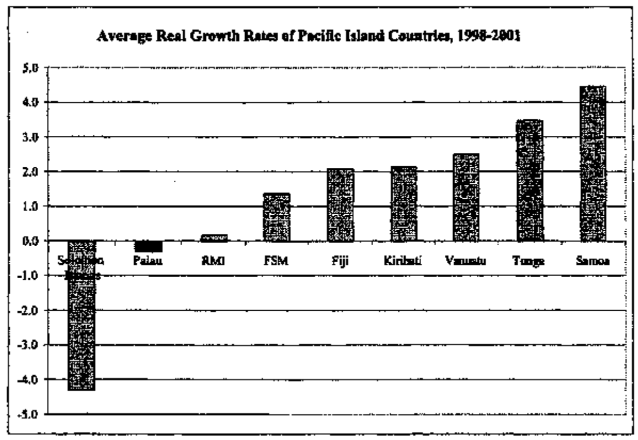
[5] Palau uses the U.S. dollar as its domestic currency. REER calculations are based on the Palau CPI which has been available since June 2000, the U.S. CPI for previous periods, and the CPI of Palau's four main trading partners: the U.S., Japan, Taiwan Province of China, and Singapore.

12. **Near-term growth prospects are uncertain.** Real GDP growth is projected to be around 3 percent at best in FY2002. The current account deficit is expected to widen somewhat to around 15 percent of GDP as lower investment income is offset by a slight improvement in tourism receipts. Tourism is expected to grow by 3 percent, somewhat less than forecast before the events of September 11. Since mid-September, there have been no indications of a slowdown in planned private sector investment or construction activity.

III. Report on the Policy Discussions

13. **The discussions focused on: (i) the FY2002 Budget; (ii) the steps needed to achieve fiscal sustainability and maintain adequate reserves (in the form of freely usable government assets); and (iii) structural reforms to foster growth.** In the face of declining external grants, Palau needs to act promptly to reduce its fiscal imbalances on a sustained basis and achieve surpluses in the second half of the decade. Palau's growth performance since the Asian crisis is one of the lowest among Pacific Island economies, underscoring the need to continue with infrastructure development while accelerating the implementation of the government's structural reform agenda aimed at boosting domestic and foreign investment.[6]



14. **To frame its discussions, the team prepared with the authorities medium-term scenarios.** The team noted that future returns on U.S. stocks and bonds are likely to be much smaller than in 1995-2000. Thus, the income from the CTF alone could not be relied on to replace lost Compact grants from FY2010 onwards on a sustainable basis. Early withdrawals would further weaken the CTF's financial position.

A. The FY2002 Budget

15. **At the time of the mission, Congress was debating the FY2002 Budget that targeted an overall fiscal deficit of 6½ percent of GDP.**[7] The budget focused primarily on

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[6] The Management Action Plan (MAP) prepared in March 2001 outlines the administration's reform priorities with specific time-bound plans, targets, monitoring mechanisms, and six-monthly reports. It aims to accelerate implementation of previously stalled structural reforms.

[7] As explained in the background paper, the Budget is presented to Congress in a format that excludes most grant-financed capital spending. On this basis, the administration proposed a

(continued)

cutting current expenditure (by about 5 percent of GDP)—by reducing transfers to enterprises and goods and services—while increasing capital expenditure (by 3 percent of GDP). Additional grants were expected from Taiwan Province of China for capital projects and storm-related reconstruction. However, this budget was based on an optimistic projection for GDP growth and did not include specific revenue measures. The authorities explained that some further tax administration improvements were being implemented and that the tax reform legislation was expected to be approved by the end of FY2002.

16. **The mission recommended that the overall fiscal deficit (including grants) for FY2002 be brought down to below 5 percent of GDP.** Events since the U.S. terrorist attack suggested that nominal GDP growth would be modest, and thus revenue shortfalls would emerge. The team advised against delaying tax reforms until the end of FY2002 and urged the authorities to move ahead with reforms to reduce exemptions, broaden the tax base, introduce excise taxes, rationalize the import tax regime, and simplify the income tax regime. If such measures could not be introduced in a timely manner, further expenditure cuts would be needed. The mission stressed that continuation of a wage and hiring freeze and the initiation of streamlining measures were necessary to contain personnel expenses as proposed in the budget. Moreover, additional measures were needed in order to fund an Emergency Contingency Reserve Fund (ECRF), as approved by Congress, without dipping into freely usable reserve assets.[8] The authorities broadly agreed with the mission's recommendations, and indicated their intention to propose additional measures to Congress early in the year if revenue targets appeared at risk.

17. **However, after the mission's departure, Congress approved a FY2002 Budget that would effectively yield a deficit of around 7½ percent of GDP.** This budget reduced current expenditure by more than ½ percent of GDP, but also reduced import duties on alcohol (1 percent of GDP) and did not take into account the expected decline in domestic revenues stemming from the economic slowdown (1 percent of GDP).[9]

18. **The government then indicated it wanted a lower deficit than Congress had approved and to that end submitted a tax reform package on October 31, that is expected to be approved by Congress and become effective in January 2002.** In consultation with the staff, the authorities developed a tax package that could yield 4 percent of GDP on an annual basis. The package would include (i) reducing the 4 import duty bands

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balanced budget for FY2002, implying a drawdown of 6½ percent of GDP in the balance of unspent capital grants.

[8] Five percent of domestic revenue would be set aside annually for the ECRF, and would supplement usable reserves.

[9] The budget also took into account an increase in expected grants (1¼ percent of GDP) and lower expected investment income (1 percent of GDP).

(0–150 percent range) to a flat 5 percent rate; (ii) limiting import duty exemptions; (iii) calculating import duties on the CIF, instead of FOB, value of imports; and (iv) introducing excise taxes on tobacco, alcohol, fuel, boats, and vehicles. In addition, by reversing the earlier reduction of duties on alcohol, revenue would increase by about 1 percent of GDP. The overall fiscal deficit for FY2002 would be reduced to 3½ percent of GDP, if the package is approved in full and implemented by January 2002.

B. Fiscal Sustainability and Related Structural Reforms

19. **The team emphasized the need to develop a medium-term fiscal consolidation plan consistent with the scheduled phasing out of grants**, in accordance with the present Compact and realistic assumptions on future CTF returns and to take into account the need to build an adequate level of reserves.

20. **Accordingly, fiscal policy should target a containment of current expenditure to less than the total of domestic revenue and current Compact grants, since the majority of capital expenditure is grant-financed.** In spite of the decline in current expenditure from 61 percent to 52 percent of GDP in FY2001, and a further planned decline to 46 percent of GDP in FY2002, it remains excessively high compared to similar countries (Box 4). Recent expenditure cuts should be reinforced through accelerated public sector reforms in order to make room for much needed human and physical capital improvements. Current expenditure should be targeted to decline by 5 percent of GDP by FY2005, while capital expenditure remains above 12 percent of GDP. At the same time, domestic revenue should be further increased by 5 percent of GDP following implementation of the next stage of tax reform—including the introduction of a simplified income tax and a sales tax—which the authorities intend to present to Congress in FY2003. Undertaking these reforms in the next three years would allow small fiscal surpluses to emerge from FY2005 onward, and to reach a level by FY2009 that could compensate for the reduction in grant aid. The authorities confirmed their intention to contain current spending below domestic revenue and annual Compact grants while raising revenue as a percent of GDP by the end of the Compact period, although they were constrained by often-conflicting demands by Congress that could prevent them from achieving these goals.

21. **The mission endorsed the public sector reform initiatives aimed at streamlining government operations and improving service delivery**. In particular, staff welcomed measures taken in January 2001 to introduce a hiring freeze, and reactivate the National Planning Committee to oversee governmental reorganization. Since January, the President had also submitted a proposed constitutional amendment that would reduce the legislative branch from two houses to a single house. Revised public service system regulations were drafted in October 2001 that include provisions for staff re-training, transfer, and redundancy payments, as well as strengthening performance evaluation and standardizing benefits. A separate law is being drafted to adjust compensation schemes during 2002 with the aim of improving merit-based incentives. The authorities described a number of additional initiatives, including the passage by Congress in July 2001 of a law initiating a "performance management system" that aims to eliminate duplication of services and ensure productive use

of public funds. Legislation is also being prepared to reduce governmental operations by out-sourcing services and privatizing some maintenance and operational functions. Finally, the authorities are undertaking a study to further improve the efficiency of education and health care expenditures, including reforms aimed at moving to a self-financed health system (Box 5).

22. **The mission also emphasized the need for greater fiscal transparency and monitoring.** Staff pointed to the need to strengthen fiscal accounting and monitoring by developing in-house capacity to publish consolidated fiscal accounts; requiring state governments to fully report their fiscal operations; and eliminating extra-budgetary funds. Although extensive reporting is undertaken by an external auditing firm to conform to U.S. reporting requirements, fiscal reporting is inadequate for policy assessment and formulation. Government finance data reveal large "errors and omissions" that reflect amounts that are reimbursable from grants and changes in accounts payable/receivable that result from advances or partial payments to suppliers. The mission stressed the need to identify and correct these discrepancies and to secure additional technical assistance and training if needed. The authorities affirmed their intention to continue their ongoing investigation of these issues in consultation with the staff.

23. **The mission urged that measures be taken to reverse the recent increase in unfunded liabilities of the Social Security Fund (SSF) and the Civil Service Pension Fund (CSPF).** A change in the retirement qualification (from age 60 to 30 years of service without reduced benefits) in July 1999 increased the unfunded liabilities of CSPF from \$15 million to \$24 million. In addition, an increase in benefits related to a cost of living adjustment in 2000 required a lump-sum transfer to the CSPF of \$7.3 million, of which only \$1.5 million was transferred in FY2001. The authorities indicated that annual lease income from one of the two internet concessions (each yielding \$1.3 million) that were recently awarded to private companies will be earmarked for the CSPF. The government has proposed to Congress alternative funding plans for CSPF contemplating budget contributions, earmarked income, increased payroll contributions, and benefit reductions. While the SSF is self-financing by law, recent changes to benefits have increased its unfunded liability from \$15 million to \$20 million without providing for additional funding. In this connection, the mission welcomed the proposed legislation to reverse a part of this increase in benefits. However, while both funds will be able to continue to meet their current obligations for many years from current surpluses, the mission noted that the authorities need to devise plans to eliminate the unfunded liabilities of the two funds, which underscores the importance of reducing the size of the civil service and revising the contribution and benefit schemes.

C. Other Structural Reforms

24. **In view of Palau's sluggish growth performance, the mission stressed the need to proceed more vigorously with the government's structural reform agenda.** In particular, the team stressed the need for adequate financial sector regulation and supervision to promote efficient intermediation of financial savings and the elimination of impediments to private and foreign investment.

Financial sector reforms

25. **The mission welcomed the passage in June 2001 of legislature aimed at combating money laundering.** The FATF has since reviewed this legislation and deemed it adequate to keep Palau off the list of noncooperative countries. Moreover, the authorities had earlier forced the closure of one bank that was involved in unauthorized offshore operations. However, banking regulation and supervision remain virtually nonexistent, although there is no evidence of systemic banking problems and NPL ratios are very low (Box 6).

26. **The mission also welcomed the recently passed Financial Institutions Act (FIA), which paves the way for establishing the Financial Institutions Commission (FIC) to oversee banking regulation and supervision.** However, in order to ensure adequate oversight, the mission pressed for amendments in the following five areas: (i) removing potential sources of conflict of interest; (ii) clarifying the definition of regulatory capital and raising the capital adequacy requirement to international norms; (iii) requiring adequate record-keeping, reporting, and external certified auditing of all banks, not only foreign banks; (iv) clarifying the FIC's mandate to request additional reports and conduct on-site inspections, and completing an initial evaluation of all existing banks against the new regulations; and (v) re-instating the provision that limited the type of activities undertaken by a licensed financial institution to its level of paid-up capital. The authorities indicated their willingness to amend the legislation and/or address these issues through FIC regulations before the end of 2001. They also welcomed the prospective technical assistance from PFTAC in achieving this objective.

Removing impediments to investment

27. **The mission stressed the need to remove impediments to private investment,** including through amendment of the foreign investment law, which is expected in fiscal year 2002, and acceleration of dispute resolution by the Land Courts, which is now underway through increased budgetary allocations to the courts. The authorities recognized that foreign investment was constrained by a cumbersome review process and restrictions on foreign participation in various activities. In addition, as discussed in the background paper, the spread of Palauan-owned "fronts" for foreign investors has reduced transparency and negatively influenced investor incentives. The authorities noted that a new foreign investment law was currently under Committee review in the Congress and that legislation was being prepared that would permit longer leases for foreign investors and broader land rights to joint ventures. The authorities were keen to resolve these investment constraints in view of the growth prospects of Babeldaob Island, and related foreign financing needs, following the completion of the Compact Road.

28. **In view of the recent deterioration in competitiveness, the mission recommended that labor laws be revised.** A minimum wage of $2.50 per hour for Palauans was introduced in 2000, while a head tax of $500 is levied on employers for each foreign worker. Average wages for all foreign workers are about 50 percent of those of Palauans, but wages of unskilled foreign labor are as low as $0.35 per hour plus lodging. The minimum wage

legislation, in combination with the taxation of foreign labor, was intended to reduce the reliance on public sector employment by increasing private sector wages, especially for unskilled labor. However, it appears to have effectively worsened employment opportunities for Palauans, pushed up wages for foreign labor, and contributed to deteriorating competitiveness. The authorities stated that they planned to prepare a modern labor code with a view to encouraging greater private sector opportunities for Palauans.

29. **A Tourism Promotion Task Force has been formed to investigate ways to boost Palau's tourism earnings,** especially through reducing the relatively high cost of air transport.[10] Accordingly, officials have sought discussions with investors interested in setting up an airline that would link Palau with some of its neighbors thereby lowering noncharter airfares through increased competition and improving connections to Europe. Some other proposals under consideration involve diversification into new activities, e.g., golf courses, sports fishing, and retirement communities.

30. **The authorities fully recognize the need to preserve Palau's fragile environment and to protect against soil erosion and have embarked on a wide range of environmental initiatives.** Tourism prospects are closely tied to the success of efforts to preserve Palau's prime diving sites, while limiting construction-related pollution. Key institutions have been formed to monitor and analyze environmental data, regulate infrastructure development, and promote preservation policies. A major part of the government's effort is geared toward adequate safeguards ahead of the expected urbanization of Babeldaob Island. The authorities stated that a number of legislative items are being prepared to address environmental issues.

Tariff Rates in Pacific Island

Country	Simple Average Tariff Rate (Percent)	Effective Tariff Rate (Percent) 1/	IMF's Trade Restrictiveness Index 2/
Republic of Palau 3/	**<8**	**6.3**	**1**
Republic of Marshall Islands	11	7.1	5
Federated States of Micronesia	...	1.5	4
Fiji	12.4	9.7	5
Papua New Guinea	8.8	8.5	1
Kiribati	18.7	20.5	3
Samoa	12	9.6	5
Solomon Islands	22.7	11.5	4
Tonga	15	34.3	...
Vanuatu	...	22.8	4
Average (excl. Palau)	**14.4**	**14.0**	**3.9**

Sources: IMF Exchange Arrangements and Exchange Restrictions, 2000; and IMF Country Reports. The reported rates are for the latest available year.

1/ Calculated as the amount of import duties or trade taxes relative to total imports.

2/ Ranging from least restrictive (1) to most restrictive (10). The index has not yet been computed for Palau. The staff's estimate is indicated in the table, based on low tariffs and the absence of quantitative restrictions.

3/ There is no available estimate of the average tariff and many tariffs are specific rather than ad valorem. This is a rough staff estimate.

Trade liberalization

31. **Palau's trade regime is relatively open and the proposed tax reforms noted earlier constitute a**

[10] In addition to the single airline carrier servicing Palau, there are some chartered flights from Taiwan Province of China and Japan. However, these involve packaged tours that include food and accommodations at hotels owned by the overseas tour operators and generate little revenue for local businesses.

further improvement. Most imports are subject to a 3 percent tariff rate (See Tax Summary, Recent Economic Developments, Table 15); vehicles are subject to a rate of 5 percent, in addition to specific quantity-based import levies. Some luxury items are subject to a 25 percent rate. Alcohol and cigarettes are also subject to specific levies. Exceptions apply to medicine, food, and boats for personal use, as well as grant-financed imports and goods for government use. There are no export restrictions and only fish exports are taxed. The proposed tax reform noted earlier would introduce a uniform 5 percent tariff rate and remove exemptions for food, medicine, and boats for personal use. Palau would continue to have one of the lowest tariff rates among the Pacific Islands economies.

D. Medium-Term Growth Scenarios

32. **The team emphasized that improving growth prospects would require an acceleration in the pace of structural reforms,** and prepared with the authorities two illustrative medium-term scenarios covering the period through 2009/10 (See Annex V). The reform scenario assumes approval by Congress in the coming months of the tax package, investment law, and expenditure management reforms. It also assumes continued implementation of the government's strategy—as described in the MAP—which outlines sectoral priorities for infrastructure development, as well as further plans to improve the provision of public services and streamline government operations.

33. **Implementation of these reforms would facilitate a rise in annual real GDP growth** to 6 percent by the end of the decade, with tourism boosted by improvements in competitiveness spearheading private sector growth. Freely usable official reserves would increase to over three months of imports. Beyond 2009, the fiscal and external deficits resulting from the cessation of Compact grants could be filled by sustainable withdrawals from the CTF. In the less optimistic scenario which assumes no structural reforms, real growth would be constrained to 2 percent annually during this decade, and continued large fiscal deficits would make it impossible to compensate for the sizeable reduction in grants without substantially eroding official reserves and requiring Palau to undergo a difficult adjustment process. The authorities confirmed that Palau is keen to avoid the sharp output contractions that some other islands had experienced following the declines in grants upon which they had become reliant, as needed adjustments had been postponed.

34. **Nevertheless, the authorities shared the staff's view that even if they pursued the reforms underlying the reform scenario, there would be significant risks to the medium-term outlook associated with implementation capacity and external vulnerability.** While the government's long-term Master Development Plan issued in 1996 confirms the need to achieve fiscal and external sustainability and to do what is required, key measures have not so far been adopted on schedule. Both technical assistance requirements and political developments contributed in the past to delaying passage of legislation. Although several key reforms had been recently introduced, there remains a large agenda of pending legislative reforms. Moreover, the vulnerability of tourism to a number of factors—changes in the fragile marine environment, commercial fishing, pollution from increased

levels of construction and manufacturing, and the global economic downturn—underscores the possible adverse effect on growth prospects if timely corrective action is not taken.

35. **The medium-term exercise served to illustrate the extent of fiscal adjustment, averaging 1 percentage point of GDP per annum over the next 8 years, needed to prepare for the expected decline in grant aid by about 6½ percent of GDP in FY2010.** Although the government's stated objective is to refrain from CTF withdrawals before FY2010, the scenarios showed that in the absence of fiscal reforms, existing reserves would be depleted by FY2008 and CTF withdrawals would be needed. In discussing future CTF returns, the team emphasized the need to assume more modest returns than those achieved in recent years, particularly in view of the substantial stock market losses in FY2001, and to avoid withdrawals before FY2010 and limit them thereafter (Annex VI). The authorities agreed with the desirability of limiting withdrawals beyond 2010 to a level aimed at maintaining the real per capita value of the CTF.[11]

IV. Technical Assistance and Data Issues

36. **Severe data shortcomings continue to hamper economic assessment and policy formulation.** Following the recommendations of the staff team during the 1999 Article IV consultation discussions, regular GDP compilation was undertaken, a CPI index was developed, and a new customs reporting system has improved trade statistics. The authorities agreed that the next priority is a statistics law to formalize the government's role in collecting and disseminating economic data to the public, which would also prepare Palau for participation in the GDSS. They also recognized that improvements would be needed in the balance of payments and government finance statistics.

37. **As in the case of other small island economies, Palau has a dearth of economic management expertise** and is dependent on foreign advice. Palau benefits from a considerable amount of PFTAC advice (see Annex II). In general, technical assistance has been effective and advice is implemented in a timely manner. The authorities are requesting additional PFTAC assistance in establishing effective banking supervision, designing financial disclosure guidelines, modifying bank taxation rules, and establishing a banking survey.

V. Staff Appraisal

38. **In spite of sizeable fiscal expansion, economic activity has been weak and prospects remain poor in the absence of structural reforms.** This outlook reflects the economy's high dependence on tourism and the poor performance of that sector since the Asian crisis. Recent grant-financed infrastructure projects have only partially offset some of

[11] With the assumption of average nominal returns of 6-8 percent during the period FY2002-FY2009, and no early withdrawals, an amount of $2-8 million could be drawn in FY2010, which could be gradually increased thereafter.

this weak demand. Cost competitiveness has declined due to the relative strength of the U.S. dollar. Private investment remains low reflecting rigidities in the land and labor markets, and cumbersome regulations on foreign investment.

39. **Palau needs to undertake large fiscal adjustments to prepare for the decline and subsequent cessation of U.S. Compact grants, without depleting government assets.** Although the authorities believe that some amount of grant assistance will continue to be forthcoming from other sources, it is prudent to assume that future support will be much less than is now available. Consequently, fiscal deficits on the scale of those incurred over recent years will not be financeable.

40. **In moving to fiscal sustainability, the authorities should target a marked reduction of the overall government deficit in FY2002 to below 5 percent of GDP, and a balanced budget by FY2005, when the unspent balance of capital grants is expected to be depleted.** However, in view of the recent budget passed by Congress that yields a deficit of 7½ percent of GDP, it is important that additional revenue and expenditure measures be approved to achieve the intended deficit target in FY2002 and beyond.

41. **To this end, the tax package currently under review in Congress should be implemented as soon as possible.** This package focuses appropriately on streamlining the import tax structure, introducing excise taxes, reducing exemptions, and broadening the import duty tax base. In FY2003, the authorities should move ahead with plans to shift to a more efficient and equitable tax structure by introducing a simplified income tax and a sales tax, as well as continuing to adjust fees on public services.

42. **Fundamental structural reforms are essential to achieve long-term fiscal sustainability while fostering growth and building reserve assets.** As such, the new administration's reform program is pointed in the right direction by focusing on revenue mobilization, public administrative reform, human capital development, financial sector development, investment promotion, and environmental protection. If these reforms are elaborated and initiated in the coming year, Palau would be much better prepared to absorb future external shocks and the prospective reduction in U.S. grant assistance. Given the low level of freely usable reserves, there is a need to build a buffer against adverse external shocks, while continuing to avoid withdrawals from the CTF. In developing future policy options, it is important to adopt more conservative assumptions on CTF's future returns. The establishment of an Emergency Contingency Reserve Fund is a welcome step and every effort should be made to commence its funding in FY2002.

43. **The planned curtailment of current government expenditures by advancing civil service reform should be continued.** The salary and hiring freeze should be enforced until the size of the civil service is reduced through attrition and existing posts are linked strictly to skill and performance requirements. It is important to proceed expeditiously with plans to reorganize the government by reducing the number of offices and removing some layers of government. In particular, there is merit in the administration's aim to consolidate state government activity into a more unified central administration and to establish a unicameral

legislature. At the same time, fiscal monitoring capacity must be strengthened by recruiting qualified staff, requiring state governments to report their fiscal operations, eliminating extra-budgetary funds, and developing in-house accounting, forecasting, and reporting capacity.

44. **The government should emphasize the intended shift in its role from being the main employer to one of supporting private sector investment and entrepreneurship.** Reform initiatives aimed at right-sizing government and improving service delivery are welcome. The new "performance management system," if successfully implemented, could eliminate duplication of services and ensure productive use of public funds, while out-sourcing or privatizing some maintenance and operations services.

45. **Palau's growth prospects will depend critically on its ability to develop tourism by attracting foreign investment and nurturing domestic entrepreneurship.** The government's structural reform agenda recognizes the need to remove impediments to Palau's growth and is broadly appropriate. Nevertheless, implementation has been slow in the last seven years suggesting that concerted efforts are needed to expedite the current initiatives to remove restrictions of foreign investment and delays in resolving land disputes, which have discouraged investment. Success in removing these impediments will require: (i) Congressional support for the initiatives outlined in the MAP; (ii) prioritization and sequencing of the broad range of initiatives; and (iii) timely elaboration of specific strategies, related legislation, and implementation procedures.

46. **While the recent passage of financial legislation is welcome, continued efforts are needed to establish a viable supervisory framework in Palau.** Although there are no signs of immediate systemic risk, it is essential that Palau develop a financial sector that is capable of intermediating savings and providing credit for viable projects. Weaknesses in the regulatory and supervisory framework must be addressed by amending the legislation and establishing a strong Commission that is capable of ensuring its effective implementation. Moreover, the financial disclosure of audited bank reports will lead to strengthened accounting and disclosure practices of businesses which would, in turn, encourage bank lending.

47. **Weaknesses in data continue to hamper the assessment of economic developments and policy formulation.** With the exception of recent improvements in trade data, other components of balance of payments statistics are weak and incomplete. Fiscal accounting is extensive, but improvements are needed in developing consolidated reports to guide policy formulation and in removing remaining discrepancies. Efforts are also needed to compile quarterly GDP indicators, a GDP deflator, and monetary statistics.

48. The next Article IV consultation with Palau is proposed to take place on the 24-month cycle.

Box 1. Republic of Palau: The Compact of Free Association

The Compact of Free Association (the "Compact") is a 50-year political, strategic, and economic treaty between the Republic of Palau and the United States. Under the Compact, Palau conducts its own domestic and foreign affairs, while the United States retains control of defense and security matters as well as exclusive strategic access to the land adjoining the Airai Airfield and a part of Malakai Harbor. Under the Compact, the United States is to pay the government of Palau **a specified sum of money in the first 15 years of the Compact**. The Compact took effect on October 1, 1994, as Palau became a sovereign nation in free association with the United States.

The Compact payments are not entirely economic aid. Rather, they are a combination of rent and aid, which amounts to nearly $600 million in total direct payments. About three quarters of the cash amounts have been disbursed in the first seven years. Under the Compact, citizens of Palau may enter the United States and establish residence as nonimmigrants, and accept employment. The terms of the Compact and its related agreements are subject to review by both parties at specified intervals during its 50-year life.

The main goal of the Compact funds is to establish an infrastructure that would enable Palau to become self-sustaining by the end of the 15-year period. Among the conditions of the Compact's approval by the U.S. Congress was the formal adoption by the Palauan government of **an economic development plan (EDP)**, which outlined particular goals and methods to achieve these goals. In addition, the government of Palau is required to report annually to both the President and Congress of the United States "on the implementation of the plans and on its use of the funds" made available under the Section 211 Grant (as detailed in Table 4). The Compact funds comprise the following elements:

- One portion, Section 211(f) amounting to $70 million, is set aside for a Trust Fund, which is to provide a stream of income over the long run.

- Another large element of grant assistance provides front-loaded grants in the first year of the Compact for current and capital improvements that are lowered in the second year and further reduced from the fifth year.

- Assistance is also provided in the form of an in-kind grant amounting to $149 million for the construction of the Compact Road on Babeldaob Island. This project is planned for completion by summer 2004.

- In addition to economic assistance, the United States has made available to Palau under the Compact services and programs of agencies such as (i) the Federal Deposit Insurance Corporation (FDIC), the Small Business Administration, the Economic Development Association, the Rural Electrification Administration, the Job Training and Training Act, Job Corps; (ii) postal services; and (iii) services relating to tourism and marine resource development of the Department of Commerce.

In addition to Compact support, Palau continues to be eligible for other U.S. assistance, based on direct proposals to grantor agencies, which have amounted to an additional $7 million annually in recent years.

Box 2. Republic of Palau: Tribal Influences and Land Rights

Like other Pacific Island economies, cultural factors permeate and influence economic and political processes. The traditional tribal system is intertwined with the demands of a modern government and has resulted in a large public service where resources are allocated in a manner in which collective decision-making remains an important element.

The large size of the public sector stems partly from the need for consensus-building and tribal representation. The system of government is modeled after the U.S. and comprises 16 states which have their own constitutions, legislature, and elected governor and are represented in the two houses in the National Congress—known in Palauan as Olbiil Era Kelulau (OEK). Although the tenets of modern democracy and the traditional tribal system have been skillfully blended, reconciling the differences between a communal and private enterprise system has been more challenging, as it has been throughout the Pacific. Tribal leaders continue to play a role in decision-making.

A major constraint on economic development has been the uncertainty over property rights, in particular title and rights to land. A communal land tenure system appears to raise transaction costs for undertaking commercial agriculture, tourism, mining, and other activities. Nonmarket allocation rules, along with shortcomings in the demarcation and registration of plots, give rise to disputes over access to land. Foreigners cannot legally own land, nor enter certain industries. Restrictions on the use of land as collateral also hinder credit growth. The constitution prohibits the taxation of land.

The concentration of land approvals in the hands of a relatively small number of influential Palauans also creates the potential for corruption and misuse of resources. Much of the land in Palau is owned by clans and can only be given or sold to a Palauan individual by the unanimous consent of clan members. At the same time, Japanese occupation during WWII and the subsequent redistribution of land created much confusion about land ownership. There are also difficulties in gaining access to land for public purposes, such as for the provision of telecommunication services.

Recognizing the consequences of such uncertainties, the government has taken steps to make the land market more predictable without changing the fundamental institutional construct which reserves freehold land for Palauans only. All lands have been required to be surveyed and registered with the Land Court by 2005. Less than 10 percent of land had been registered by the mid-1990s. However, the number of litigations has increased, slowing down the process and making it difficult to acquire land that is suitable for development. Even after titles are granted, there are still individual-to-clan disputes. Courts have recently increased their capacity to handle the litigation, but only 50 percent of cases have been resolved.

To facilitate foreign investment, Palau allowed in 1995 leasing of land for up to 50 years (with a further 59 years extension). Foreign concerns seeking long-term land access tend to take local partners, especially landowners, or obtain fixed-term leases on lands for which titles have been obtained and registered in the Land Court.

It will be important to continue making progress on:

- accelerating the process of land surveying and registration;
- clarifying procedures for government land acquisition for infrastructure and public use; and
- further strengthening the capacity of the Land Courts.

Box 3. Republic of Palau: Initiatives to Combat Money Laundering

Reports that offshore banks in Palau and other Pacific Island economies were involved in large-scale money laundering activities prompted in late-1999/early-2000 a few large international banks to place a ban on U.S.-dollar denominated transactions involving Palau, Nauru, and Vanuatu. In response, Palau established a National Banking Review Commission to investigate these allegations. Composed of representatives of the government and members of the business sector and chaired by the Attorney General, the Commission was given broad powers to determine the accuracy of reports by the international banks that had imposed the bans. The Commission issued a report declaring that there is no credible evidence that any financial institution in Palau had engaged in activities that would justify the accusations.

The U.S. Department of State has raised concerns over Palau's bank licensing procedures. The *Money Laundering and Financial Crimes Report, 2000* notes that a few shell banks had been established through a mechanism in which entities in Palau applied for certification of incorporation and business licenses in a local (in lieu of national) level jurisdiction. None of these were ever given foreign investment approval or any approval to do business in Palau. Nonetheless, a few of these were reported to have handled almost $2 billion in suspicious transactions with foreign financial entities.

Palau has sought assistance from the United States, the Pacific community, the U.N., and the IMF in its efforts to develop an anti-money laundering regime and has participated in international meetings and conferences on financial crime. Palau is also a signatory to the anti-money laundering initiatives of the Pacific Island Forum and has made significant advances to comply with the Honiara Declaration (which calls for the implementation of the FATF 40 Recommendations).

In June 2000, FATF listed some Pacific Island Forum members, but not Palau, as "noncooperative jurisdictions". These countries were regarded as having detrimental rules and practices, which obstruct international cooperation against money laundering and allow criminals to escape the effect of anti-money laundering measures. Palau was not reviewed at that time.

The FATF Plenary Meeting in June 2001 postponed a review of Palau's status regarding "noncooperative jurisdictions". The decision on Palau and three other countries was postponed until September as each of these countries had passed legislation in recent weeks that had not yet been incorporated into FATF's results. More time was needed to review this new legislation.

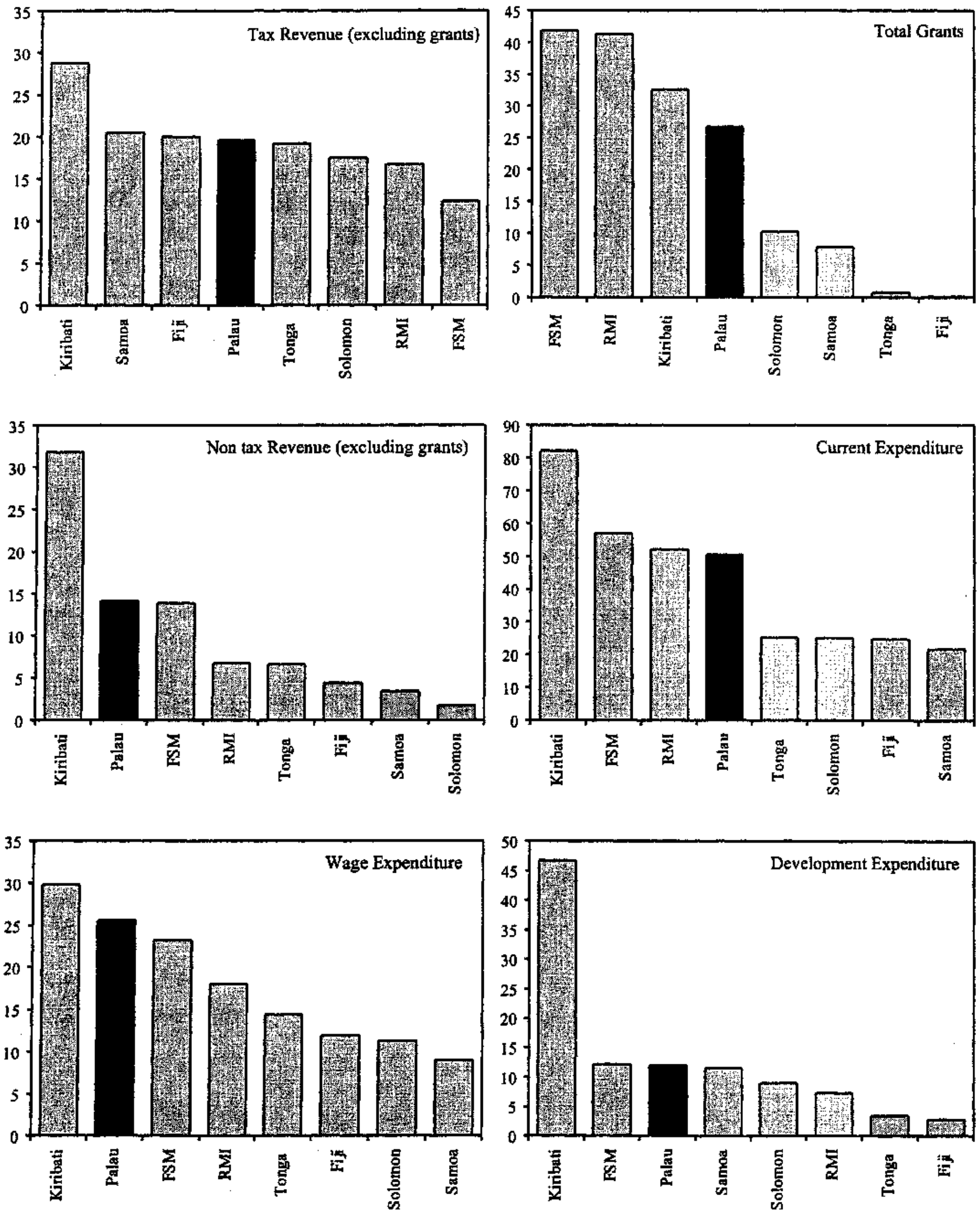
In September 2001, the FATF review was completed and, based on the legislation passed in June, Palau was not included on the list of con-compliant or non-cooperative countries. Since June, one bank's license was revoked. Also, the activities of several previously licensed financial institutions that do not meet the eligibility criteria under the new law, will be restricted. Palau intends to continue to implement the FATF 40 Recommendations.

There is currently no law in Palau permitting offshore banking. The Offshore Banking Act was suspended in 1982.

Box 4. Republic of Palau: Comparison of Fiscal Indicators Among Pacific Island Countries

Palau's domestic revenue is supplemented by substantial U.S. grant receipts. Combined tax and nontax revenue (excluding grants) are the second highest among the island economies in relation to GDP. Nontax revenue collections are only second to that of Kiribati which receives large sums from fishing rights. Although Palau receives substantial grants of around 25 percent of GDP, these are lower than grants received by the Federated States of Micronesia (FSM), Marshall Islands (RMI), and Kiribati.

Palau has a relatively high ratio of wage expenditure to GDP although current expenditures as a percent of GDP are in line with other island states. The government is the largest employer, accounting for about 30 percent of total employment. In 1999, public sector wages accounted for about 50 percent of all wages paid.



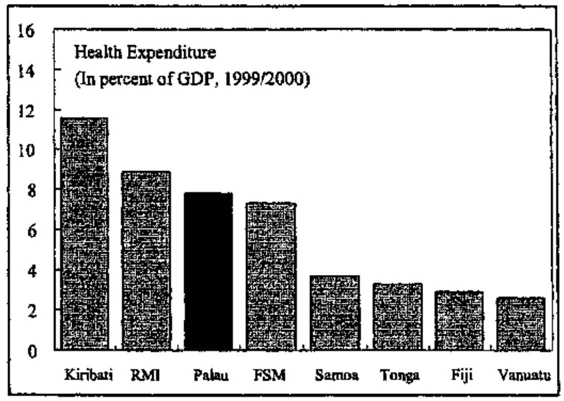
Source: PIC database for 1999. All indicators are in percent of GDP.

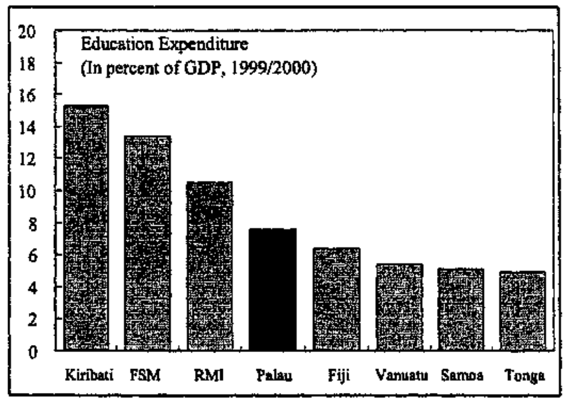
Box 5. Republic of Palau: Social Services

Expenditures on health and education in Palau are in line with the average expenditures in other island economies. Education, health, and medical services are provided by the government in Palau. Outlays for these services account for 16 percent of GDP, compared with a range of 8 percent and 27 percent of GDP for other island economies.

A number of initiatives are aimed at improving cost-efficiency of public health and education services. Despite declining government transfers in recent years, the main hospital was able to provide increased medical services to patients by imposing health service fees at about 25 percent of medical cost. The demand for increased medical services was largely due to an increase in the number of foreign workers in Palau. However, much scope remains for improving the quality of education services, as about 38 percent of teachers are high school graduates who do not hold college/university degrees. Some savings can be achieved by limiting the school lunch program which currently extends to private schools.

Palau faces a shortage of skilled labor which is one of its main developmental constraints. A community college was established in 1993. The Ministry of Education records show that enrollment grew by 7 percent for elementary schools and 13 percent for secondary schools in 1998–99. The total student enrollment was 4,150 in 2000. Palau is facing a shortage of local teachers, and the student-teacher ratio increased to its highest level in 1998–99. A teacher's certification bill is awaiting Parliamentary approval. The introduction of local certification standards will increase the number and quality of teachers.





Human Development Indicators in Pacific Island Countries

Country	Human Develop-ment Index (HDI) 1/	Percentage of People not Expected to Reach 40 Years	Percentage of Illiterate Adults	Percentage of Popula-tion without Access to Safe Water	Percentage of Under-weight Children (5 Years or Older)	Human Poverty Index 2/
Palau	**0.861**	**7.3**	**8.6**	**14.0**	**8.0**	**10.8**
Micronesia	0.569	10.5	28.7	56.0	15.0	26.7
Fiji	0.667	7.4	7.1	23.0	7.9	8.5
Kiribati	0.515	16.3	7.8	20.0	12.9	12.6
Marshall Islands	0.563	13.2	25.6	23.5	17.0	19.5
Tonga	0.647	10.3	1.0	10.0	17.0	8.6
Samoa	0.590	13.7	4.3	63.0	21.0	49.1
Solomon Islands	0.371	8.4	69.7	5.0	2.0	5.9
Vanuatu	0.425	12.2	66.5	13.0	23.0	46.6

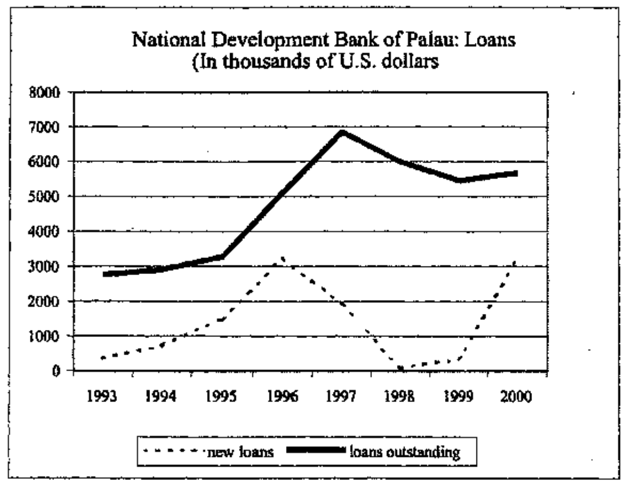
Source: Pacific Regional Strategy, The World Bank (2000).
1/ The Human Development Index (1 being the highest ranking) is derived from combining the average life expectancy at birth, adult literacy, gross school enrollments, and adjusted GDP per capita.
2/ The Human Poverty Index is derived from combining the life expectancy, literacy, and standard of living indices.

Box 6. Republic of Palau: Banking System

Palau has a large banking sector relative to its population. The financial sector consists of around 20 registered banks (not all of which are active), including three U.S.-based banks, a development bank, and a number of small credit unions. The branches of U.S.-based banks are insured by the FDIC and follow U.S. regulations. Local banks are not yet subject to formal regulation. As Palau uses the U.S. dollar, and given its strong links with the U.S. banking system, deposit rates in Palau tend to mirror those of the U.S. However, lending rates vary from 5-18 percent for smaller loans, and commercial loans are extended at the U.S. prime rate plus 1-4 percent.

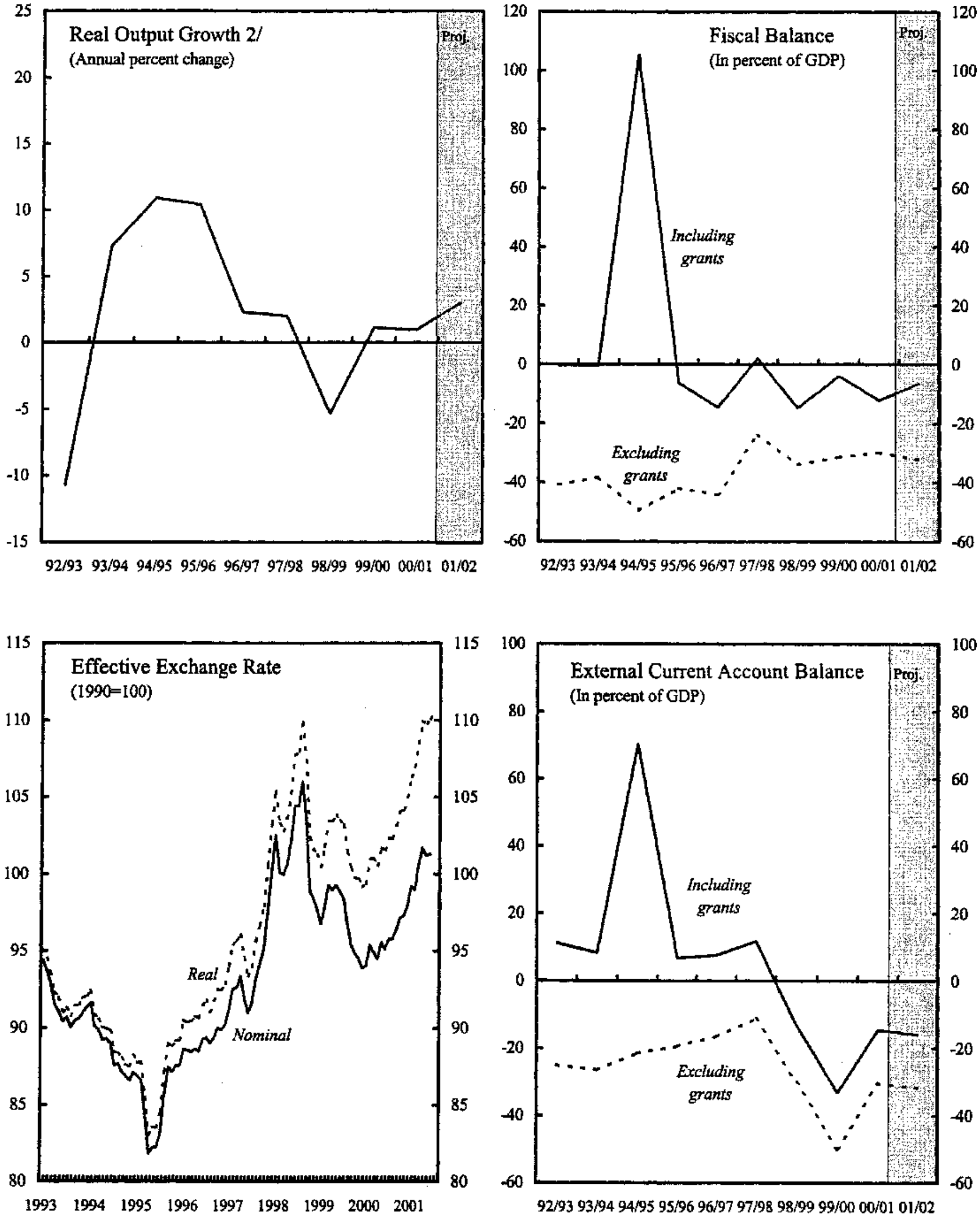
Commercial banks lending is limited and funds have tended to flow out of the country. Foreign commercial banks have tended to pool deposits at their headquarters for investment elsewhere, as indicated by the substantial excess of deposits over loans. Lending has tended to focus on smaller consumer loans (well secured by deductions from salaries paid into bank accounts) rather than business loans. Commercial loans are viewed as more risky and the difficulties in using land as collateral has presented a problem for foreign-owned banks.

The National Development Bank of Palau (NDBP) eased this constraint by guaranteeing 90 percent of commercial loans for a fee (the NDBP can also assume the title of land in the case of default). The NDBP's provision of loan guarantees and lending was constrained in 1998/99 by the deterioration in its balance sheet (related to poor-quality directed lending). New management was brought in to focus on loan recovery and improve monitoring and loan risk assessments. In 1999, the NDBP made news loans of only $350,000, which increased in 2000 to around $3.2 million with the recovery of its financial position and a government transfer.



Bank regulation and supervision in Palau is being developed following the enactment of the new Financial Institutions Act (FIA), which was approved in June 2001. While there is some concern that the final form of the legislation has resulted in the general weakening of supervision powers over financial institutions, the authorities have indicated their intention to strengthen the law through amendments and regulations. The FIA represents a step forward as several previous attempts to have banking legislation enacted have failed. The FIA will be implemented by the Financial Institutions Commission (FIC), to be overseen by five Board members who will develop regulatory guidelines and monitor banks' compliance. Selection of the five Board members has been difficult, due to the lack of qualified individuals who are not current Bank officials. There is also a concern over the lack of appropriate funding for the FIC. Once the Board members and staff are selected, the FIC is expected to review the accounts, operations, and staffing of each of the licensed banks to determine their compliance with the new regulations as presented in the FIA. They will also begin to collect banking data that can form the basis for a banking survey.

Figure 1. Republic of Palau: Selected Economic Indicators, 1993-2002 1/



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

1/ Preliminary estimates for 2000/01.
2/ Inflation data are not available for Palau. Nominal GDP is deflated by inflation in the United States.

Table 1. Republic of Palau: Selected Economic and Financial Indicators, 1993/94–2001/02 1/

Nominal GDP (2000): US$118.2 million
Population (2000): 19,129
GDP per capita (1999): US$6,179

	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	Est. 2000/01	Proj. 2001/02
	(In millions of U.S. dollars, unless otherwise specified)								
Real sector									
Nominal GDP 2/	83.5	95.2	108.2	113.2	117.3	113.5	118.2	122.5	129.9
(percent change)	10.1	14.0	13.6	4.6	3.6	-3.3	4.2	3.6	6.1
GDP deflator 3/	2.6	2.8	2.9	2.3	1.6	2.2	3.0	2.6	3.0
Real GDP (percent change)	7.3	10.9	10.4	2.3	2.0	-5.4	1.1	1.0	3.0
Nominal GDP (FY)	81.6	92.3	105.0	112.0	116.3	114.4	117.0	121.4	128.0
Business and tourist arrivals	37,578	47,023	60,719	66,441	63,656	49,170	45,932	49,731	51,223
Tourist spending	29.4	40.6	54.2	61.2	58.0	54.1	53.2	54.3	54.8
Public finance									
Central government									
Revenues	49.6	165.1	66.5	58.0	71.3	51.0	75.0	61.6	70.0
Domestic	18.8	22.1	29.1	24.9	41.3	29.0	42.9	40.2	35.4
Grants	30.9	143.0	37.5	33.2	30.0	22.0	32.1	21.4	34.6
Expenditures	50.4	65.3	75.1	76.5	64.6	71.7	84.5	77.2	79.7
Current	47.4	56.7	58.1	58.3	54.8	63.7	71.8	63.1	59.4
Capital	3.0	8.5	17.0	18.3	9.9	8.0	12.7	14.1	20.3
Overall fiscal balance (including grants)	-0.4	97.3	-6.6	-16.3	2.4	-16.8	-4.7	-18.5	-9.7
(In percentage of GDP)	-0.5	105.4	-6.3	-14.5	2.1	-14.7	-4.0	-15.2	-7.5
Overall fiscal balance (excluding grants)	-31.2	-45.7	-44.1	-49.5	-27.5	-38.8	-36.7	-39.9	-44.3
(In percentage of GDP)	-38.3	-49.6	-42.0	-44.2	-23.7	-33.9	-31.4	-32.9	-34.6
Compact Trust Fund (CTF) balance 4/	0	70.8	77.2	105.5	122.4	141.1	161.8	135.0	...
Revenues	...	71.0	7.0	28.9	17.6	19.6	21.5	-25.8	...
Expenditures	...	0.3	0.6	0.5	0.8	0.8	0.8	1.0	...
Government assets (non-Trust Fund assets) 5/	0.5	97.5	84.1	81.0	85.1	67.0	77.7	44.0	...
Balance of capital grants 6/	...	61.6	55.9	44.7	38.4	33.8	53.8	41.9	34.4
Balance of current grants 6/	...	38.2	35.3	31.1	44.1	28.0	18.5	14.7	14.0
Balance of usable reserves (excl.CTF) 5/	...	35.1	30.3	36.1	43.4	38.9	29.4	7.6	7.2
Balance of payments									
Trade balance	-31.7	-46.6	-58.5	-61.1	-52.1	-70.3	-115.6	-80.8	-85.1
Exports (f.o.b.)	12.6	13.9	13.9	11.8	11.1	13.6	11.5	18.3	21.9
Imports (f.o.b.)	-44.2	-60.4	-72.4	-72.9	-63.2	-83.9	-127.1	-99.1	-107.0
Current account balance (including grants)	2.8	60.7	1.4	4.2	9.7	-14.3	-42.7	-15.7	-18.9
(In percentage of GDP)	3.4	65.8	1.3	3.7	8.4	-12.5	-36.5	-12.9	-14.8
Current account balance (excluding grants)	-25.6	-23.9	-24.8	-21.9	-16.7	-33.0	-62.0	-34.8	-39.3
(In percentage of GDP)	-31.3	-25.9	-23.6	-19.6	-14.4	-28.8	-52.9	-28.7	-30.7
Overall balance	-0.8	92.8	-9.6	-16.6	-1.2	-20.9	13.9	-18.5	-6.2
External debt	20.0	15.5	12.5	9.1	5.5	1.4	20.0	20.0	20.0
External debt service	...	4.5	3.0	3.4	3.6	4.1	1.4	0.7	0.7

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

1/ Fiscal year beginning October 1.
2/ On a calendar year basis. The column 1995/96 refers to 1996, and so forth.
3/ U.S. CPI is used as GDP deflator for 1995 to 1999. Palau began compiling CPI from June 2000, therefore, the GDP deflator for year 2000 is the average of U.S. deflator and Palau CPI. For 2001, Palau CPI is used as deflator.
4/ Covers operations of the Trust Fund from 1994/95.
5/ Usable reserves estimated as government assets (total reserves) plus annual drawable amounts from the CTF less the balance of (project-related) capital grants.
6/ Staff estimate of the unused balance of grant receipts. Capital and current balance do not add to total because of valuation losses in 2001.

Table 2. Republic of Palau: National Government Budgetary Operations, 1994/95-2001/02

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01 Estimated	2001/02 Budget. As Passed 1/	2001/02 Budget. Proposed 2/
					(In thousands of U.S. dollars)				
Total revenue and grants	165,086	66,538	58,036	71,306	51,017	74,984	61,493	70,058	75,233
Domestic revenue	22,069	29,087	24,864	41,325	29,024	42,922	40,186	35,422	40,597
Tax revenue	13,351	15,637	16,829	19,037	18,925	22,879	25,762	25,195	30,370
Salaries and wages	3,822	4,096	4,620	4,720	5,152	5,480	6,315	6,827	6,827
Import tax	3,136	3,298	3,850	4,410	4,973	6,433	6,473	6,138	10,338
Gross revenue tax	4,774	6,068	6,260	6,260	5,615	6,184	7,145	6,617	6,617
Other	1,619	2,175	2,099	3,647	3,185	4,782	5,829	5,613	6,588
Nontax revenue	8,719	13,450	8,036	22,288	10,099	20,042	14,424	10,227	10,227
Fishing rights income	230	210	130	120	137	39	76	134	134
Interest income	56	79	68	81	69	253	1,875	879	879
Fees and charges	1,247	1,195	1,158	1,440	2,950	2,113	2,573	2,984	2,984
Other	1,043	1,713	2,088	15,288	1,361	1,876	1,383	1,410	1,410
Local trust funds	1,082	1,574	1,786	2,696	2,377	1,856	1,806	1,120	1,120
Investment income	5,061	8,679	2,806	2,663	3,205	13,906	6,711	3,700	3,700
Grants	143,017	37,452	33,172	29,981	21,993	32,062	21,307	34,636	34,636
Current grants	72,843	26,161	26,098	26,435	18,624	19,298	19,128	20,342	20,342
U.S. Compact	62,107	18,623	18,856	19,220	11,570	11,640	11,701	11,827	11,827
U.S. non-Compact	10,431	7,239	7,012	6,626	6,420	6,829	6,748	7,302	7,302
Other country	305	299	230	589	634	829	679	1,213	1,213
Capital grants	70,174	11,291	7,074	3,546	3,369	12,764	2,179	14,294	14,294
U.S. Compact	64,360	4,900	3,500	2,000	2,000	2,000	2,000	2,000	2,000
U.S. non-Compact	5,814	6,391	3,574	1,546	1,369	569	179	3,894	3,894
Other country	0	0	0	0	0	10,195	0	8,400	8,400
Total expenditure	65,251	75,148	76,542	64,617	71,678	84,493	77,202	79,691	79,691
Current expenditure	56,722	58,145	58,252	54,761	63,689	71,767	63,080	59,417	59,417
Wages and salaries	23,203	25,820	27,777	27,355	28,381	29,275	29,863	30,358	30,358
Purchases of goods and services	23,627	19,896	25,298	22,982	27,256	30,414	25,360	24,327	24,327
Interest payments	83	0	0	0	0	0	700	700	700
Subsidies and other current transfers	9,809	12,429	5,177	4,424	8,052	12,078	7,157	4,032	4,032
Public enterprises	5,543	7,889	3,037	1,964	1,337	3,149	3,287	1,662	1,662
Other	4,266	4,540	2,140	2,460	6,715	8,929	3,870	2,370	2,370
Capital expenditure	8,529	17,003	18,290	9,856	7,989	12,726	14,122	20,274	20,274
Errors and omissions 3/	-2,560	1,993	2,220	-4,252	3,875	4,843	-2,770	0	0
Overall balance	97,276	-6,616	-16,285	2,437	-16,786	-4,667	-18,479	-9,633	-4,458
Financing	-97,276	6,616	16,285	-2,437	16,786	4,667	18,479	9,633	4,458
Net long-term borrowing	-4,500	-3,000	-3,400	-3,600	-4,067	18,566	0	0	0
New borrowing	0	0	0	0	0	20,000	0	0	0
Principal repayments	4,500	3,000	3,400	3,600	4,067	1,434	0	0	0
Privatization receipts	0	0	3,052	0	0	0	0	0	
Contingency Reserve Fund	0	0	0	0	0	0	0	0	-1,696
Other 4/	-92,776	9,616	16,633	1,163	20,853	-13,899	18,479	9,633	6,154
					(As a percent of fiscal year GDP)				
Total revenue and grants	178.8	63.4	51.8	61.3	44.6	64.1	50.7	54.6	58.7
Domestic revenue	23.9	27.7	22.2	35.5	25.4	36.7	33.1	27.6	31.7
Tax revenue	14.5	14.9	15.0	16.4	16.5	19.6	21.2	19.7	23.7
Nontax revenue	9.4	12.8	7.2	19.2	8.8	17.1	11.9	8.0	8.0
Of which : Investment income	5.5	8.3	2.5	2.3	2.8	11.9	5.5	2.9	2.9
Grants	154.9	35.7	29.6	25.8	19.2	27.4	17.6	27.0	27.0
Current grants	78.9	24.9	23.3	22.7	16.3	16.5	15.8	15.9	15.9
Capital grants	76.0	10.8	6.3	3.0	2.9	10.9	1.8	11.1	11.1
Total expenditure	70.7	71.6	68.4	55.6	62.6	72.2	63.6	62.2	62.2
Current expenditure	61.4	55.4	52.0	47.1	55.7	61.3	52.0	46.3	46.3
Capital expenditure	9.2	16.2	16.3	8.5	7.0	10.9	11.6	15.8	15.8
Overall balance	105.4	-6.3	-14.5	2.1	-14.7	-4.0	-15.2	-7.5	-3.5
Overall balance, excluding grants	-49.6	-42.0	-44.2	-23.7	-33.9	-31.4	-32.8	-34.5	-30.5
Memorandum items:									
Direct financed projects not included above									
Compact road project 5/	...	...	...	...	5,000	20,000	28,571	28,571	28,571
Koror-Babeldaob Bridge 5/	...	...	...	...	...	9,269	12,359	3,090	3,090
New Airport Project 5/	...	...	...	...	...	...	...	2,333	2,333

Sources: Reports on the Audit of Financial Statements; and data provided by the Palauan authorities. Fiscal year runs from October to September.

1/ At the time the budget was passed, Congress also, separately, reduced "sin taxes", reducing revenue by $1.2 million.

2/ Includes reduction in GRT relating to the impact of the events of September 11 and changes to import tax regime and introducing excise duties.

3/ Represents monies to be reimbursed (from reimbursable grants), changes in accounts payable/receivable, and other unidentified items.

4/ This is the change in government assets (NTFA).

5/ Estimates of annual disbursements out of total project cost of $125 million for the road; $24.7 million for the bridge and $14 million for the airport.

Table 3. Republic of Palau: Balance of Payments, 1994/95–2000/01

(In thousands of U.S. dollars)

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	Est. 2000/01	Proj. 2001/02
Trade balance	-46,569	-58,517	-61,082	-52,127	-70,278	-115,619	-80,837	-85,111
Exports, f.o.b.	13,868	13,907	11,812	11,094	13,574	11,508	18,267	21,921
Imports, f.o.b. 1/	-60,438	-72,424	-72,894	-63,222	-83,852	-127,127	-99,104	-107,032
Services account	23,958	34,447	41,203	40,292	35,443	25,794	32,756	31,627
Receipts	40,554	54,213	61,220	58,003	54,144	53,240	54,307	54,850
Travel	40,554	54,213	61,220	58,003	54,144	53,240	54,307	54,850
Payments	-16,596	-19,766	-20,016	-17,711	-18,701	-27,445	-21,551	-23,223
Freight and insurance	-15,109	-18,106	-18,223	-15,805	-16,770	-25,425	-19,821	-21,406
Travel	-1,487	-1,660	-1,793	-1,906	-1,931	-2,020	-1,730	-1,817
Income	2,832	3,788	3,872	271	6,215	23,236	14,028	17,774
Investment income 2/	10,458	10,522	9,410	5,608	12,204	27,782	21,575	26,830
Income and interest payment 3/	-7,626	-6,734	-5,538	-5,337	-5,989	-4,546	-7,547	-9,056
Current transfers	80,499	21,659	20,180	21,306	14,288	23,926	18,368	16,799
Private	-4,818	-5,408	-6,404	-6,062	-5,680	3,272	-1,899	-2,472
Inflows	880	983	1,062	1,129	1,500	11,135	5,686	5,971
Outflows	-5,698	-6,391	-7,466	-7,190	-7,180	-7,862	-7,585	-8,443
Official	85,317	27,067	26,584	27,368	19,968	20,654	20,267	21,509
Business licenses and fees	1,001	1,000	867	1,724	1,915	1,933	1,728	1,763
Grants	84,643	26,161	26,098	26,435	18,624	19,298	19,128	20,346
Other 4/	-327	-95	-381	-791	-571	-577	-589	-600
Current account (includes official grants)	60,720	1,377	4,173	9,742	-14,332	-42,663	-15,685	-18,912
Current account (excludes official grants)	-23,923	-24,784	-21,925	-16,693	-32,956	-61,961	-34,813	-39,258
Capital and financial account	65,674	10,291	5,674	14,146	7,003	51,484	6,144	14,193
Public sector	65,674	8,291	3,674	-54	6,003	49,484	5,144	14,294
Capital grants 5/	70,174	11,291	7,074	3,546	3,369	12,764	2,179	14,294
In-kind capital grants	...	...	...	...	6,701	18,154	2,965	...
Gross borrowing	...	...	...	...	...	20,000	...	...
Loan repayments	-4,500	-3,000	-3,400	-3,600	-4,067	-1,434	0	...
Private sector	...	2,000	2,000	14,200	1,000	2,000	1,000	...
Foreign direct investment 6/	...	2,000	2,000	1,000	1,000	2,000	1,000	...
Other private inflows	...	...	...	13,200	...	...	...	...
Current plus capital account	126,394	11,667	9,847	23,888	-7,329	8,821	-9,541	-4,719
Error and omissions 7/	-33,618	-21,284	-26,481	-25,051	-13,524	5,078	-8,938	-1,435
Overall balance 8/	92,776	-9,616	-16,633	-1,163	-20,853	13,899	-18,479	-6,154
Memorandum items:								
Imports/GDP (in percent)	-65.5	-69.0	-65.1	-54.4	-73.3	-108.6	-81.6	-83.6
Import duties/GDP	3.4	3.1	3.4	3.8	4.3	5.5	5.3	5.7
Current account/GDP (in percent)								
Including official grants	70.2	6.7	7.6	8.4	-12.5	-36.5	-12.9	-14.8
Excluding official grants	-25.9	-23.6	-19.6	-14.4	-28.8	-52.9	-28.7	-30.7
Service receipts/GDP (in percent)	43.9	51.7	54.7	49.9	47.3	45.5	44.7	42.8
REER appreciation (12 month basis)	1.1	3.1	5.4	11.1	-6.5	2.8	8.0	...
Usable reserves in months of imports	19.2	14.3	13.3	15.5	9.7	7.4	5.3	...
External debt/reserve ratio	0.2	0.1	0.1	0.1	0.3	0.3	0.5	...

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

1/ Includes direct financed aid project imports and other tax-exempt imports.

2/ Includes realized investment gains and losses.

3/ Includes estimated profit repatriation by foreign fish and garment exporters until 2000/01, and interest payment.

4/ Contribution to international and regional organizations.

5/ Includes $13 million in 1997/98 for K-B bridge settlement and excludes grants-in-kind.

6/ Staff estimates on investments in new hotels/resorts.

7/ Large error and omission in 1994/95-1998/99 reflect underreporting of imports prior to April 1999 when new customs system was implemented. In addition, net private current inflows are underestimated as inflows are only reported by one bank in Palau.

8/ Usable reserves calculated as NTFA (government assets excluding Compact Trust Fund) minus amounts related to capital projects.

Table 4. Republic of Palau: Selected Social Indicators, 1995 and 2000

	1,995	2,000
GDP per capita (U.S. dollars)	5,527	6,179
Area (sq. miles)		
Land	188	188
Sea	237,850	237,850
Demographic indicators (2000)		
Total population	17,225	19,129
Population growth (percent per annum)		
1986-90	2.4	...
1990-95	2.6	...
2000	...	2.1
Crude birth rate (per 1,000)	13.4	14.5
Crude death rate (per 1,000)	7.0	6.5
Infant mortality (per 1,000)	20.0	10.8
Labor force	8,368	9,845
Employed	7,780	9,621
Agriculture, fisheries, and mining	724	215
Construction	1,089	1,112
Manufacturing	78	345
Transport, storage, communication, and other public utilities	436	765
Wholesale, retail, restaurants, and hotels	1,455	2,619
Finance, insurance, and real estate	124	116
Other business, personal, community, and social services	1,120	1,246
Public administration	2,879	3,203
Unemployed	588	224
Age structure (in percent)		
0-14	28	24
15-64	66	71
65 and over	6	5
Public health and education		
Education		
Percent graduating		
Primary	97	97
Secondary	65	78
College	12	10
Student/teacher ratio (1998 and 2000)	11	11
Health		
Number of encounters at dispensary	115	48

Sources: *1995 and 2000 Census of Population and Housing from the Office of Planning & Statistics;* and Social Security Office.

Republic of Palau: Fund Relations

(As of November 30, 2001)

I. Membership Status: Joined: 12/16/1997; Article XIV

II. General Resources Account:

	SDR Million	%Quota
Quota	**3.10**	**100.0**
Fund Holdings of Currency	3.10	100.0
Reserve position in Fund	0.00	0.0

III. SDR Department: None

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements: None

VI. Projected Obligations to Fund: None

VII. Exchange Arrangement:

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

VIII. Article IV Consultation:

The first Article IV consultation discussions took place during June 24–July 6, 1999 and the Article IV consultation procedure was completed on November 10, 1999. Palau is on a 24-month consultation cycle.

IX. Current Financial Arrangement: None

X. Technical Assistance:

Technical assistance for the period June 1996–September 2001 is reported in the following table.

XI. Resident Representative: None

Republic of Palau: IMF Technical Assistance, June 1996–September 2001[1]

Topic	Purpose	Date
Fiscal Affairs Department		
Public financial management	Provided assistance on the preparation of longer-term fiscal forecasts.	June 1996
	Assisted Ministry of Administration with their performance budgeting project.	July 1998
Tax policy and administration	Analysis of the Master Plan for the future direction of tax policy and preparation of recommendations to be used by a Tax Reform Committee.	January 1998
	Assisting the Tax Reform Committee in preparing the future tax policy for Palau.	March 1998
	Assisting the Tax Reform Committee to examine newly drafted tax law and preparing final report for presentation to the President and the National Congress.	June 1998
	Assisted with preparation of the new tax code and with implementation of tax and customs administration.	October 1998–March 1999
Legal Department		
Tax policy	Assisted with drafting the new tax code.[2]	June 1998 and September–November 1998
Monetary and Exchange Affairs Department		
Banking legislation	Assisted in establishing bank supervision functions.	October 2000
	Assisted, with support from PFTAC, in drafting banking law and regulation.	January 2001

[1] Palau has also been receiving technical assistance from the PFTAC for developing economic and financial statistics (see Annex II).
[2] The Legal Department is providing ongoing assistance during the implementation stage (which is expected to begin shortly).

Republic of Palau: Support from the Pacific Financial Technical Assistance Centre[1]

The Centre's assistance since Palau joined the Fund has included 16 advisory missions, with the main focus on the design of a comprehensive tax reform package and the establishment of a financial institutions act that would meet international standards.

Public Financial Management

Advice from the Centre has concentrated on the strengthening of budget processes through improved monitoring of government expenditure and its financial position during the year, implementation of performance budgeting, and the preparation of medium-term budget projections as a basis for fiscal management.

Tax Administration and Policy

Beginning in 1998, the Centre assisted the authorities with the design and advancement of a comprehensive tax reform package through the stages of planning, public debate, and congressional hearings. In parallel, plans were prepared for a strengthening of the Revenue and Customs Bureau. Following an inactive period around the Presidential election in 2000, the reform effort has resumed. Legal assistance from the Fund is being organized, and the Centre will help with implementation and administration.

Financial Sector Regulation and Supervision

The absence of a regulatory system and supervisory capacity despite a sizable number of licensed onshore and offshore banks and deposit-taking institutions presented a systemic and reputational risk for Palau. In response, assistance from the Centre focused on the establishment of a comprehensive Financial Institutions Act and the definition of principle features needed to meet international standards. Subsequently, an IMF legal expert assisted in drafting the required legislation. PFTAC's Banking Advisor is currently assisting with the establishment of a supervisory framework.

Economic and Financial Statistics

In 2000, the Centre conducted an assessment of data needs, institutional structures, and operational procedures for an effective production and dissemination of a core set of economic and financial statistics. Following the mission's advice, the authorities are using the GDDS as an organizing framework. Areas that will require priority assistance include: the establishment of a Statistics Act to legitimize and organize data collection and dissemination, as well as the compilation of banking survey data, quarterly GDP indicators and a GDP deflator, and improved external sector data collection.

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[1] The Pacific Financial Technical Assistance Centre (PFTAC) in Suva, Fiji is a multi-donor technical assistance institution, financed by IMF, UNDP, ADB, AusAID, and NZODA, with the IMF as Executing Agency. The Centre's aim is to build skills and institutional capacity for effective economic and financial management that can be sustained at the national level. Member countries are: Cook Islands, Federated States of Micronesia, Fiji, Kiribati, Marshall Islands, Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Tokelau, Tonga, Tuvalu, and Vanuatu.

Republic of Palau: Relations with the World Bank Group

Total commitments: None

IFC investments: None

The Republic of Palau joined the World Bank Group on December 16, 1997.

In recent years, the Bank Group has provided nonlending services to Palau in a number of areas.

- In the health sector, the Bank has provided technical assistance involving the review of a draft health care plan and legislation.

- In March 1999, the Bank Group's Foreign Investment Advisory Service (FIAS) carried out a diagnostic review of the investment environment and, since then, has undertaken two separate reviews of new draft foreign investment legislation.

- The Bank also provided assistance on the Y2K problem, and on the management of coastal areas.

- In the latter part of 1998 and early-1999, South Pacific Project Facility (SPPF), a small- and medium-enterprise (SME) development initiative of the International Finance Corporation provided advisory services to the National Development Bank of Palau. More recently, work has commenced on a number of SME projects in the tourism sector.

- Formal input is being provided for a Sustainable Tourism policy.

The Bank's fourth biennial Regional Economic Report for its Pacific Island member countries, including Palau, was issued in November 2000. This report, *'Cities, Seas and Storms: Managing Change in Pacific Island Economies,'* aims to help the people and governments of the pacific islands deal proactively with some of the major challenges and opportunities confronting them at the beginning of the twenty-first century. It focuses particularly on the three areas: the growth of towns, the management of ocean resources, and the impact of, and adaptation to, climate change.

Republic of Palau: Statistical Issues

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

A. Real Sector

Since 1984, GDP estimates by economic activity at current prices have been compiled by different organizations, including the UNDP, the United Nations Economic and Social Commissions for Asia and the Pacific, and under a joint project by the University of Oregon and the U.S. Department of Interior. With assistance from a UNDP consultant, the Office of Planning and Statistics has produced revised GDP estimates for 1996–99 by compiling sectoral data using wage data from social security and profit data from the corporate tax returns. GDP data for 2000 are based on a preliminary compilation and the 2001 estimate is based on interviews with local businesses and on tourist arrival information. There are plans to develop quarterly GDP estimates. Quarterly price statistics have been collected since June 2000 that will be used in the future to produce a CPI series and develop a GDP deflator.

B. Government Finance

Extensive government data are compiled at the national level as part of annual budgetary process, and the authorities have been providing these fiscal data to the Fund on a regular basis. Weaknesses in this data involve mainly the transformation of the data into GFS format and some areas of misclassification. Problems arise from the proliferation of special earmarked funds. Moreover, although external auditors and investment managers provide detailed accounts, these reports are not effectively used to provide public information or regular reports for policy-makers. State Governments have not provided budgetary accounts for the past three years. The reporting of annual, quarterly, and monthly data for the *GFS* and *IFS*, respectively, is highly recommended.

C. Monetary Accounts

Balance sheet data are not currently provided by banks to the authorities, hence there is no official banking or monetary survey reported. At present, the banks only file corporate tax forms to the Ministry of Administration. The authorities had agreed to take steps to have banks report their balance sheet by end-1999, but this has not been done. The mission assisted in initiating a summary of operations of the major banks using the corporate tax forms. Improved reporting is expected with the formation of the Financial Institutions Commission.

D. Balance of Payments

Balance of payments data are very weak. Only import data are reported in a systematic way through the new customs system. All other items are rough estimates based on incomplete information. The estimates are based on fiscal data (for official transactions), tourism data (for service receipts), and social security data (for worker remittances). No information is collected on foreign investment activities and the lack of commercial banking data hampers estimation of other capital flows.

Republic of Palau: Core Statistical Indicators
(As of October 15, 2001)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP	External Debt
Data of latest observation	N/A	July 2001	N/A	N/A	N/A	6/01	06/01	6/01	09/01	FY2001 (prel.)	2000 (prel.)	2001 (prel.)
Date received	N/A	9/99	N/A	N/A	N/A	9/01	09/01	09/01	10/01	10/01	09/01	09/01
Frequency of data 1/	N/A	M	N/A	N/A	N/A	M	Q	M	A	A	A	A
Frequency of reporting 2/	N/A	V	N/A	N/A	N/A	V	V	E	V	V	V	A
Source of data 3/	N/A	A,O	N/A	N/A	N/A	A	A	A,O,P	A,O	A,O	A,O	A
Mode of reporting 4/	N/A	E	N/A	N/A	N/A	V	V	V,E	V	V	V	V
Confidentiality 5/	N/A	A	N/A	N/A	N/A	U	U	U	U	U	U	U
Frequency of publication 6/	D/A	V	N/A	N/A	N/A	V	V	V	V	V	V	A

1/ A - annually; M- monthly, Q – quarterly, D - daily.
2/ D - daily; V - staff visits.
3/ P - publicly released information; A - direct reporting by the authorities; O - staff estimates.
4/ E - electronic data transfer; V - staff visits.
5/ U - unrestricted use; A - for staff use only; B - embargoed for a specified period and thereafter for unrestricted use.
6/ A - annually; D - daily; V - staff visits.

Republic of Palau: Illustrative Medium-Term Scenarios, 2001/02–2009/10

The authorities' medium-term strategy aims to establish institutions and policies in Palau that will promote economic sustainability. The strategy as described in the Management Action Plan (MAP) issued in March 2001, focuses on developing the private sector, minimizing government intervention, providing physical infrastructure, and developing human capital. Reforms of the public sector and the financial sector, together with efforts to improve the environment for foreign investors, will—if implemented fully and in a timely manner—move Palau towards sustainability in the post-Compact period. Reform implementation has picked up since the November 2000 election, but most initiatives require Congress approval. Delays would endanger the effectiveness of the reforms in boosting growth and achieving a sustainable fiscal and external position by 2009.

Two alternative medium-term scenarios were discussed with the authorities. The **Reform Scenario** assumes that the government adheres to the priorities identified in its MAP, pursuing the fiscal and structural reforms necessary to achieve long-term sustainability. Under this scenario, deficits through 2004/05 would be limited to capital spending financed by unspent balances of capital grants and budgetary surpluses would be achieved in the second half of the decade. Structural reforms foster growth in the private sector, tourism, and investment. The **No Reform Scenario** assumes that the reforms necessary to attain sustainability are delayed and only partially adopted. In both scenarios, growth and imports are expected to reflect the large infrastructure projects scheduled for the next two or three years. The slowdown in growth in the region and globally following the events of September 11 are expected to affect tourism in 2001/02. Both scenarios do not take into account climatic or other external shocks. Both scenarios assume that the government refrains from using the Compact Trust Funds before 2008/09. The main differences between the two scenarios are highlighted in Figure V.1.

A. **The Reform Scenario** (Table V.1)

Real GDP growth rates gradually approaching 6 percent by the end of the decade are based on accelerated implementation of structural reforms. Vigorous pursuit of the fiscal and structural reforms outlined in the MAP can be expected to spur a more dynamic private sector led by tourism, as well as foreign and domestic investment as the environment for such investment improves. The removal of impediments to foreign investment and progress with land registration, together with improved reporting of corporate information, will support domestic uses for private savings currently held outside of Palau. Inflation is expected to remain in line with Palau's major trading partners at around 3 percent.

Fiscal sustainability

The government's medium-term objective—to maintain expenditure growth below revenue growth—is appropriate. If the first tax package becomes effective in January 2002, tax gains could amount to 3 percent of GDP in 2001/02 and the fiscal deficit would be limited to around 3½ percent of GDP. In the following year, however, the fiscal deficit would widen as grant aid would decline back to normal levels from the expected sharp increase in 2001/02. The deficit could be eliminated by 2004/05 as domestic revenues increase with the introduction of the second stage of tax reforms (income tax and VAT/sales tax). Capital expenditure would stay relatively high, in line with the objective of developing infrastructure to support private sector development. Initially, current expenditure is expected to decline in nominal terms following the implementation of output budgeting, a hiring freeze, and outsourcing of government services, and other planned civil service reforms. Government expenditure would then begin to grow, but at a slower rate than nominal GDP.

The fiscal consolidation will allow for preservation of the CTF, while also raising tax revenue collection to replace grants, and slowly building usable reserves. The scenario shows that the Contingency Reserve Fund would accumulate to around $20 million by 2008/09. Non-Compact grants are expected to continue beyond 2009, but total grants would decline sharply to less than half of their previous level following cessation of Compact grants. In 2009/10, the fiscal position would switch to a deficit that could be financed by CTF withdrawals without eroding the value of the Fund in real terms, if no withdrawals have been made before then.

External sustainability

Reflecting the fiscal consolidation, the overall balance of payments moves into surplus towards the end of the period. It is assumed that a concerted effort is made to promote exports (assisted by Palau's joining the ACP countries in getting favorable access to EU markets). Reforms to foreign investment legislation and labor laws would improve competitiveness. Imports are assumed to grow more rapidly during the period 2002-2004, while a number of large infrastructure projects are underway, but then grow at a slower pace than nominal GDP after 2005—on the assumption that the private sector develops some domestic capacity for import substitution. The current account balance declines somewhat, as the trade deficit is partly off-set by receipts from growing tourism.

B. **The No Reform Scenario** (Table V.2)

This scenarios assumes that the critical structural reforms continue to be postponed and the government falls further behind on its timetable for reform. The slower fiscal consolidation would mean that insufficient spending on infrastructure is undertaken and real GDP growth would thus remain low (reaching a maximum rate of 2 percent).

Fiscal sustainability

Under this alternative scenario, there is insufficient effort to reduce dependence on grants, and once they cease, a large sudden adjustment would be needed. Government expenditure is assumed to grow in line with GDP. Current expenditure declines, but not sufficiently to allow capital expenditure to increase relative to GDP. Domestic revenue would not increase in FY2002 in the absence of approval of the tax package, but revenues would gradually recover to the growth rate of nominal GDP. The overall government deficit in this scenario worsens in the second half of the period, resulting in a gap in 2009/10 that could not be met on a sustainable basis from CTF withdrawals.

External sustainability

The drawdown of reserve assets through capital outflows under this scenario implies that external sustainability cannot be achieved. The trade balance remains large under this scenario, and inflows from foreign investment would be lower. With the large overall balance of payments deficit, government reserve assets would be completely depleted by 2007/08.

Table V.1. Republic of Palau: Government's Reform Scenario [1]

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01 Estimated	2001/02 8/	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Real sector																
Real GDP growth (CY, percent) 2/	10.9	10.4	2.3	2.0	-5.4	1.1	1.0	3.0	3.9	4.1	4.5	5.2	5.3	5.5	5.5	6.1
Visitor arrivals per year 2/	47,023	69,330	73,719	68,928	56,466	56,502	55,595	57,263	60,699	64,948	70,793	77,164	84,881	93,369	102,705	111,949
(percentage change)	6.7	47.4	6.3	-6.5	-18.1	0.1	-1.6	3.0	6.0	7.0	9.0	9.0	10.0	10.0	10.0	9.0
Public finance (percent of GDP)																
Revenue and grants	178.8	63.4	51.8	61.3	44.6	64.1	50.8	58.8	53.0	53.8	53.5	53.0	52.3	51.6	51.0	45.1
Domestic	23.9	27.7	22.2	35.5	25.4	36.7	33.1	31.7	33.1	35.0	37.0	38.1	38.5	38.9	39.3	39.8
Grants	154.9	35.7	29.6	25.8	19.2	27.4	17.7	27.1	20.0	18.7	16.5	14.9	13.8	12.7	11.7	5.3
Expenditures	70.7	71.6	68.4	55.6	62.6	72.2	63.6	62.2	59.3	56.9	53.6	51.8	50.0	48.2	46.5	45.0
Current	61.4	55.4	52.0	47.1	55.7	61.3	52.0	46.4	45.3	43.4	41.2	39.3	37.5	36.2	34.5	34.0
Capital	9.2	16.2	16.3	8.5	7.0	10.9	11.6	15.8	14.0	13.5	12.4	12.5	12.5	12.0	12.0	11.0
Overall fiscal balance (including grants)	105.4	-6.3	-14.5	2.1	-14.7	-4.0	-15.2	-3.5	-6.3	-3.1	-0.1	1.3	2.3	3.4	4.5	0.1
Overall fiscal balance (excluding grants)	-49.6	-42.0	-44.2	-23.7	-33.9	-31.4	-32.9	-30.5	-26.2	-21.9	-16.6	-13.6	-11.4	-9.3	-7.2	-5.2
Balance of payments (US$ mn.)																
Exports (f.o.b.)	13.9	13.9	11.8	11.1	13.6	11.5	18.3	21.9	23.1	24.6	26.3	28.0	29.9	31.9	34.0	35.7
Imports (f.o.b.)	-60.4	-72.4	-72.9	-63.2	-83.9	-127.1	-99.1	-107.0	-114.6	-119.4	-116.6	-114.7	-124.4	-135.2	-147.0	-160.7
Balance of trade (US$ mn.)	-46.6	-58.5	-61.1	-52.1	-70.3	-115.6	-80.8	-85.1	-91.5	-94.8	-90.4	-86.7	-94.5	-103.3	-112.9	-124.9
(As percentage of GDP)	-50.4	-55.8	-54.6	-44.8	-61.4	-98.8	-66.6	-66.5	-65.8	-63.6	-56.3	-49.8	-50.1	-50.4	-50.7	-51.3
Current account balance (US$ mn.)																
Including grants 6/	60.7	1.4	4.2	9.7	-14.3	-42.7	-15.7	-18.9	-12.4	-9.6	-3.1	3.5	3.4	3.5	3.8	-0.7
(As percentage of GDP)	65.8	1.3	3.7	8.4	-12.5	-36.5	-12.9	-14.8	-8.9	-6.5	-1.9	2.0	1.8	1.7	1.7	-0.3
Excluding grants	-82.3	-36.1	-29.0	-20.2	-36.3	-74.7	-37.1	-53.5	-39.6	-37.1	-29.1	-21.9	-22.0	-22.0	-21.8	-13.3
(As percentage of GDP)	-89.2	-34.4	-25.9	-17.4	-31.7	-63.9	-30.6	-41.8	-28.5	-24.9	-18.1	-12.6	-11.7	-10.7	-9.8	-5.5
Overall balance	92.8	-9.6	-16.6	-1.2	-20.9	13.9	-18.5	-6.4	-8.6	-5.7	-1.3	1.0	3.2	5.7	8.7	-0.9
Government assets (NTFA, US$ mn.) 3/	96.8	86.3	80.8	81.8	67.6	77.9	43.7	35.7	25.3	17.5	14.1	12.7	13.2	15.9	21.4	16.9
Contingency Reserve Fund (US$ mn.) 4/	0	0	0	0	0	0	0	1.7	3.5	5.6	7.7	10.2	12.9	15.8	19.0	22.6
Balance of capital grants/loans (US$ mn.)	62	56	45	38	34	54	42	36	24	12	0	0	0	0	0	0
Compact Trust Fund Balance (US$ mn.) 5/	70.8	77.2	105.5	122.4	141.1	161.8	135.0	145.8	157.5	170.1	183.7	198.4	214.3	231.4	249.9	261.3
Of which: Amount drawable from CTF 6/	0.0	0.0	0.0	0.0	5.0	5.3	5.5	5.8	6.1	6.4	6.7	7.0	7.4	7.8	8.1	8.0
Usable reserves 7/	35.1	30.3	36.1	43.4	38.9	29.4	7.4	7.3	10.7	17.6	28.8	29.9	33.4	39.5	48.6	47.5
External debt (US$ mn.)	15.5	12.5	9.1	5.5	1.4	20.0	20.0	20.0	20.0	20.0	18.9	17.7	16.6	15.4	14.3	13.1
External debt service (US$ mn.)	4.5	3.0	3.4	3.6	4.1	1.4	0.7	0.7	0.7	2.2	2.2	2.1	2.0	2.0	1.9	1.9
Principal payments	...	...	...	...	4.1	1.4	0.0	0.0	0.0	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Interest payments	...	...	...	...	0.0	0.0	0.7	0.7	0.7	1.1	1.0	1.0	0.9	0.8	0.8	0.7
Nominal GDP(FY) (US$ mn.)	92.3	105.0	112.0	116.3	114.4	117.0	121.4	128.0	136.7	146.6	157.7	170.5	185.0	200.9	218.4	238.4

Sources: Palau Statistical Yearbook; Palauan authorities; and staff estimates.

1/ Fiscal year beginning October 1.
2/ In calendar years to 1996/97 for visitor arrivals.
3/ Excludes the Compact Trust Fund and Contingency Reserve Fund.
4/ The Contingency Reserve Fund is 5 percent of unrestricted local revenues; unrestricted local revenue is taken as 75 percent of domestic revenue.
5/ The CTF balance is assumed to grow by 8 percent annually, with no withdrawals until FY2010. Withdrawal from FY2010 onwards are assumed to be such that net balance of the CTF grows by 2 percent each year.
6/ The CTF Agreement allows for withdrawals of $5 million a year from 1998/99, with an inflation adjustment of 5 percent each year.
7/ Usable reserves are defined as government assets (NTFA) plus the Contingency Reserve Fund less the balance relating to capital grants.
8/ This incorporates adoption of the full tax package presented to Congress on October 30.

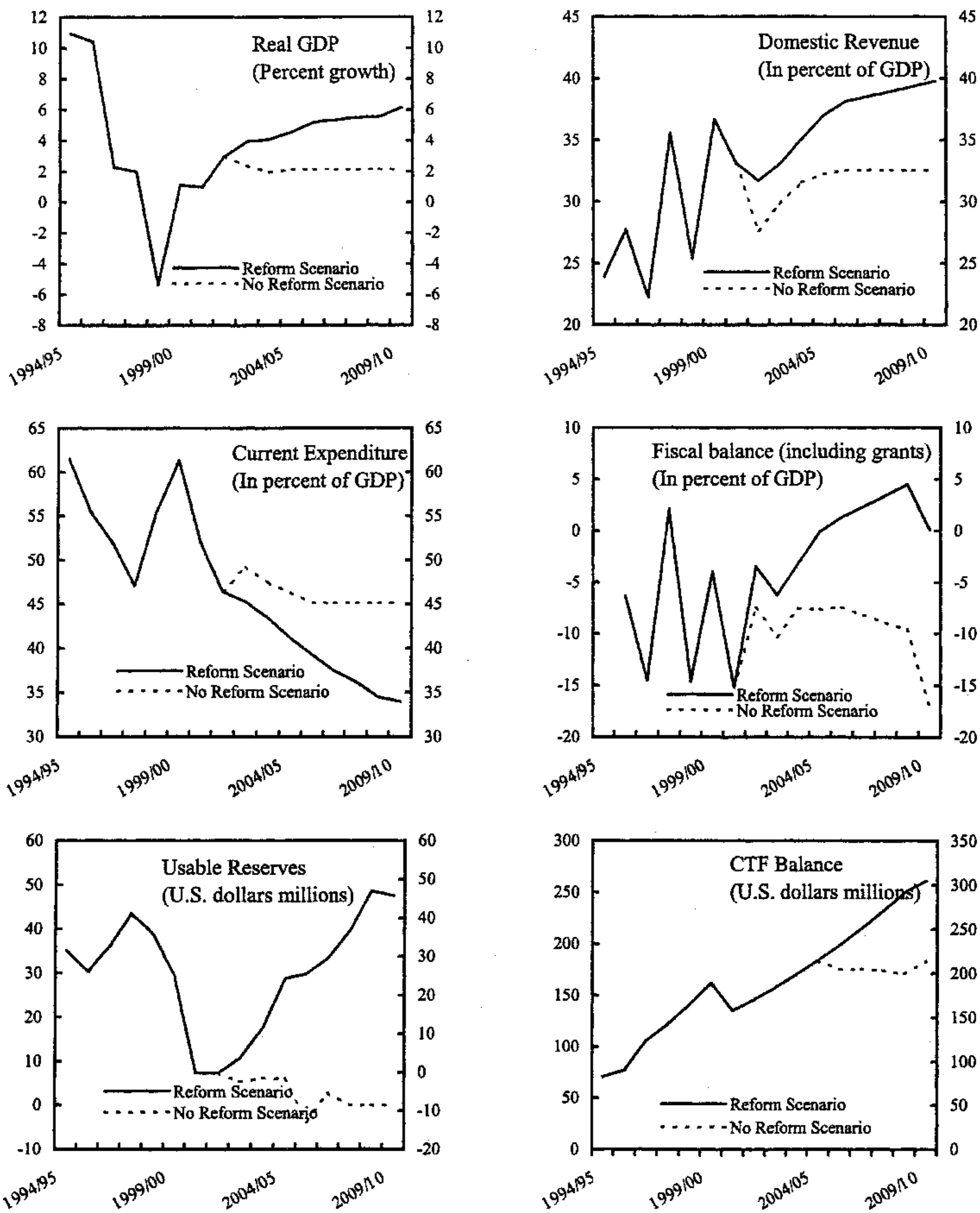
Table V.2. Republic of Palau: No Reform Scenario[1]

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01 Estimated	2001/02 8/	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Real sector																
Real GDP growth (percent) 2/	10.9	10.4	2.3	2.0	-5.4	1.1	1.0	3.0	2.4	1.9	2.1	2.1	2.1	2.1	2.1	2.1
Visitor arrivals per year 2/	53,229	69,330	73,719	68,928	56,466	56,502	55,595	57,263	59,553	61,340	64,407	68,271	72,368	76,710	81,312	86,191
(percentage change)	20.8	30.2	6.3	-6.5	-18.1	0.1	-1.6	3.0	4.0	3.0	5.0	6.0	6.0	6.0	6.0	6.0
Public finance (percent of GDP)																
Revenue and grants	178.8	63.4	51.8	61.3	44.6	64.1	50.8	54.7	50.0	50.9	49.6	48.7	47.9	47.2	46.5	39.1
Domestic	23.9	27.7	22.2	35.5	25.4	36.7	33.1	27.6	29.8	31.6	32.2	32.5	32.5	32.5	32.5	32.5
Grants	154.9	35.7	29.6	25.8	19.2	27.4	17.7	27.1	20.2	19.3	17.4	16.2	15.4	14.7	14.0	6.5
Expenditures	70.7	71.6	68.4	55.6	62.6	72.2	63.6	62.2	60.3	58.4	57.3	56.1	56.1	56.1	56.1	56.1
Current	61.4	55.4	52.0	47.1	55.7	61.3	52.0	46.4	49.3	47.4	46.3	45.1	45.1	45.1	45.1	45.1
Capital	9.2	16.2	16.3	8.5	7.0	10.9	11.6	15.8	11.0	11.0	11.0	11.0	11.0	11.0	11.0	11.0
Overall fiscal balance (including grants)	105.4	-6.3	-14.5	2.1	-14.7	-4.0	-15.2	-7.5	-10.3	-7.5	-7.6	-7.4	-8.2	-8.9	-9.6	-17.0
Overall fiscal balance (excluding grants)	-49.6	-42.0	-44.2	-23.7	-33.9	-31.4	-32.9	-34.6	-30.5	-26.9	-25.1	-23.6	-23.6	-23.6	-23.6	-23.6
Balance of payments (US$ mn.)																
Exports (f.o.b.)	13.9	13.9	11.8	11.1	13.6	11.5	18.3	21.9	22.4	23.2	24.0	24.9	25.8	26.7	27.7	28.7
Imports (f.o.b.)	-60.4	-72.4	-72.9	-63.2	-83.9	-127.1	-99.1	-107.0	-112.9	-118.5	-124.7	-131.1	-138.0	-145.1	-152.7	-160.6
Balance of trade (US$ mn.)	-46.6	-58.5	-61.1	-52.1	-70.3	-115.6	-80.8	-85.1	-90.5	-95.3	-100.6	-106.2	-112.2	-118.4	-125.0	-132.0
(As percentage of GDP)	-50.4	-55.8	-54.6	-44.8	-61.4	-98.8	-66.6	-66.5	-66.1	-66.3	-66.5	-66.8	-67.0	-67.2	-67.5	-67.7
Current account balance (US$ mn.)																
Including grants	60.7	1.4	4.2	9.7	-14.3	-42.7	-15.7	-18.9	-13.6	-17.1	-22.5	-49.1	-52.5	-56.1	-59.8	-75.8
(As percentage of GDP)	65.8	1.3	3.7	8.4	-12.5	-36.5	-12.9	-14.8	-10.0	-11.9	-14.9	-30.9	-31.4	-31.9	-32.3	-38.9
Excluding grants	-82.3	-36.1	-29.0	-20.2	-36.3	-74.7	-37.1	-53.5	-40.9	-44.5	-48.5	-74.5	-78.0	-81.6	-85.4	-88.4
(As percentage of GDP)	-89.2	-34.4	-25.9	-17.4	-31.7	-63.9	-30.6	-41.8	-29.9	-30.9	-32.1	-46.8	-46.6	-46.3	-46.1	-45.4
Overall balance	92.8	-9.6	-16.6	-1.2	-20.9	13.9	-18.5	-6.4	-13.9	-11.9	-12.6	-12.8	-14.7	-16.7	-18.7	-34.0
Government assets (NTFA, US$ mn.) 3/	96.8	86.3	80.8	81.8	67.6	77.9	43.7	35.7	20.2	6.5	-7.9	0.0	0.0	0.0	0.0	0.0
Contingency Reserve Fund (US$ mn.) 4/	0	0	0	0	0	0	0	1.7	3.3	5.1	6.9	8.8	2.7	0.0	0.0	0.0
Balance of capital grants/loans (US$ mn.)	62	56	45	38	34	54	42	36	24	12	0	0	0	0	0	0
Compact Trust Fund Balance (US$ mn.) 5/	70.8	77.2	105.5	122.4	141.1	161.8	135.0	145.8	157.5	170.1	183.7	175.2	175.6	174.1	170.5	184.1
Of which: Amount drawable from CTF 6/	0.0	0.0	0.0	0.0	5.0	5.3	5.5	5.8	6.1	6.4	6.7	7.0	7.4	7.8	8.1	...
Usable reserves 7/	35.1	30.3	36.1	43.4	38.9	29.4	7.4	7.3	5.3	6.1	6.0	-3.7	2.7	0.0	0.0	0.0
External debt (US$ mn.)	15.5	12.5	9.1	5.5	1.4	20.0	20.0	20.0	20.0	20.0	18.9	17.7	16.6	15.4	14.3	13.1
External debt service (US$ mn.)	4.5	3.0	3.4	3.6	4.1	1.4	0.7	0.7	0.7	2.2	2.2	2.1	2.0	2.0	1.9	1.9
Principle payments	...	...	...	...	4.1	1.4	0.0	0.0	0.0	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Interest payments	...	...	...	...	0.0	0.0	0.7	0.7	0.7	1.1	1.0	1.0	0.9	0.8	0.8	0.7
Nominal GDP(FY) (US$ mn.)	92.3	105.0	112.0	116.3	114.4	117.0	121.4	128.0	135.2	142.1	149.4	157.2	165.3	173.9	183.0	192.5

Sources: Palau Statistical Yearbook; Palauan authorities; and staff estimates.

1/ Fiscal year beginning October 1.
2/ In calendar years to 1996/97 for visitor arrivals.
3/ Excludes the Compact Trust Fund and Contingency Reserve Fund.
4/ The Contingency Reserve Fund is 5 percent of unrestricted local revenues; unrestricted local revenue is taken as 75 percent of domestic revenue.
5/ The analysis assumes the CTF balance grows by 8 percent annually, with no withdrawals until FY2010. Withdrawal from FY2010 onwards are assumed to be such that net balance of the CTF grows by 2 percent each year.
6/ The CTF Agreement allows for withdrawals of $5 million a year from 1998/99, with an inflation adjustment of 5 percent each year.
7/ Usable reserves are defined as government assets (NTFA) plus the Contingency Reserve Fund less the balance relating to capital grants.
8/ This scenario assumes that the tax package before Congress is not approved this year.

Figure V.1. Republic of Palau: Medium-Term Macroeconomic Scenarios, 1994/95-2009/10



Source: Palauan Authorities; and staff estimates.

Republic of Palau: Compact Trust Fund—Analysis of Future Possible Income

Although the rate of return on the investment of Compact Trust Fund (CTF) resources has so far exceeded expectations, lower returns should be expected in the future. Average returns for the period 1994/95 to 1999/00 were 13¼ percent, but the average dropped to 11½ percent following negative returns of 17 percent in 2000/01. When the CTF was established, the average return envisaged was 12½ percent, and at that time, it was assumed that the value of the Fund could be preserved even with annual withdrawals of $5 million from 1998/99 to 2008/09, and $15 million thereafter.[1] These assumptions appear to have been overly optimistic and unachievable. Staff analysis indicates that, even with returns of 12 percent annually, broadly in line with the historical average, withdrawals of this magnitude would erode the value of the Fund. Moreover, the experience of the past 7 years should be considered exceptional and much lower average returns are to be expected in the future. Staff prepares alternative assumptions for evaluating the future income potential from the Fund, based on returns of 6-8 percent annually. Staff also suggested that the authorities aim to limit future withdrawals beyond 2008/09 so as to target 2 percent annual real increase over the long term.

To illustrate the sensitivity of the future value of the CTF and of maximum possible withdrawals to various assumed rates of return, staff discussed a number of different scenarios with the authorities. The table below summarizes the analysis from three different assumptions on rates of return under three different strategies. Under Scenario 1, no withdrawals are made until the end of the Compact Period; thereafter, $15 million is drawn annually. In Scenario 2, $5 million is drawn from 2002 and then $15 million is drawn annually from 2010. In Scenario 3, the maximum withdrawal is made each year in an amount that allows the Fund to increase in real terms by 2 percent. The scenarios assume 3 percent future annual inflation.

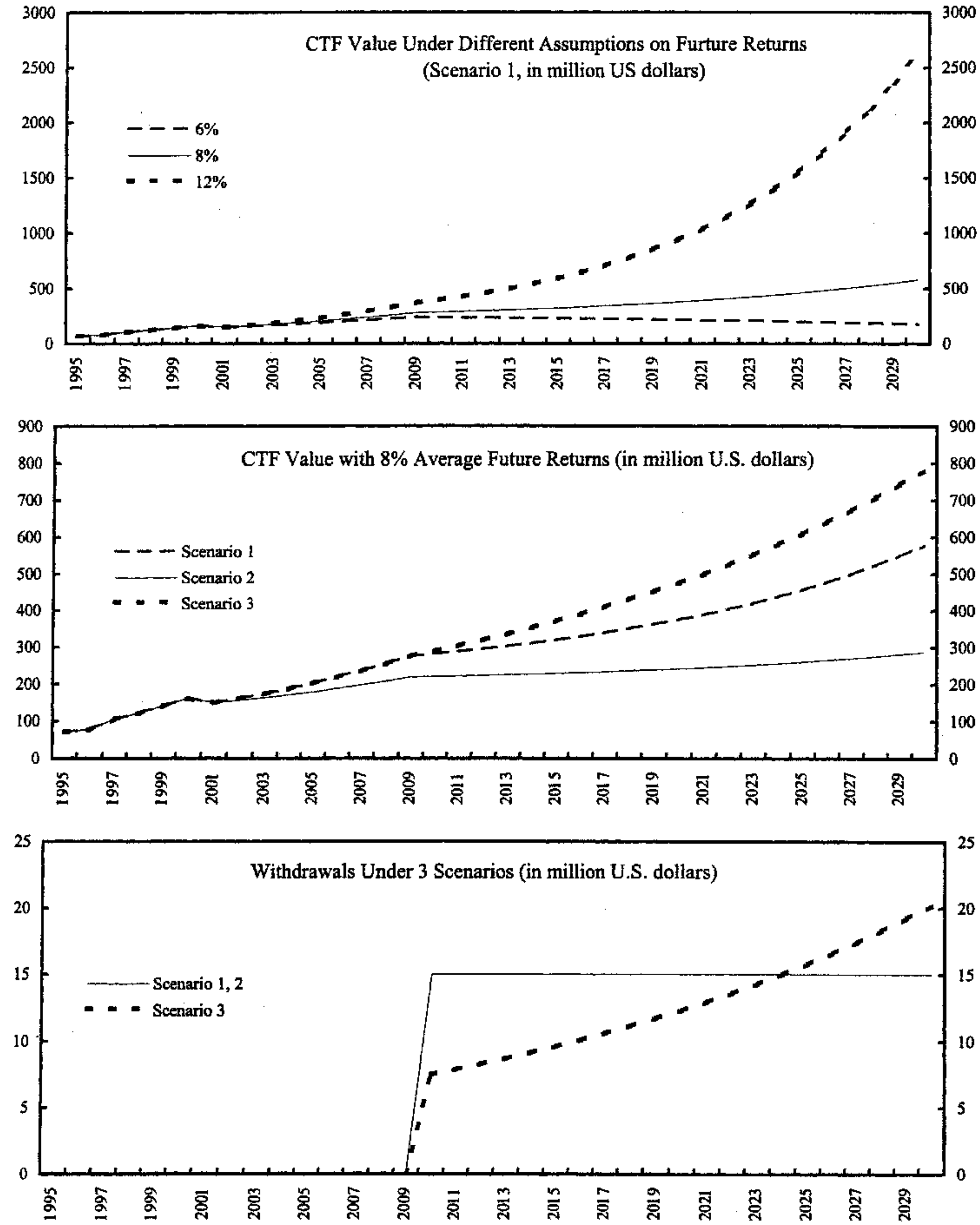
Summary of Analysis of Future Returns from Investing CTF Under Different Assumptions

	Withdrawal Assumption ($ mn)			Value of Trust Fund in 2010 ($ mn)		
	Pre-2009	2009/10	2019/20	6% Return	8% Return	12% Return
Scenario 1	Nil	15	15	212	254	358
Scenario 2	5	15	15	157	192	281
Scenario 3*	Nil	2/7/21	3/11/34	226	262	351

* Maximum withdrawal subject to allowing Fund to increase in real terms by 2 percent, depending on the rate of return of 6/8/12 percent. At a 6 percent average return, a maximum withdrawal of $2 million in 2009/10 would assure a 2 percent increase in the real value of the CTF value.

[1] In the original Compact Agreement, the maximum permissible withdrawal allowed—starting in 1998/99—was $5 million, adjusted for inflation (the CTF agreement assumes an inflation rate of 5 percent per annum).

Figure VI.1. Republic of Palau: Compact Trust Fund, 1995-2030



Source: Palau Authorities; and staff estimates.

Statement by the IMF Staff Representative
January 4, 2002

The following information on recent economic and policy developments, which does not change the thrust of the staff appraisal in SM/01/358, has become available since the staff report was issued.

1. The two tax reform bills submitted by the President to the OEK (Palau's national congress) in October, consisting of tax administrative reform and import tax reform, have been assigned to committees in both houses. The two bills were expected to be approved before the end of 2001 but the process has been delayed. Hearings on these two bills are expected to commence later this month when the OEK resumes its regular session. Every month of delay is estimated to reduce expected tax collections by one-third of a percentage point of GDP.

2. There have also been delays in establishing the Financial Institutions Commission (FIC). Although the President submitted the list of nominees in October, and the OEK has met to review it, their decision has not yet been issued. In the meantime, members of an Interim Financial Regulation Committee are drafting some preliminary regulations and reviewing the re-licensing applications of existing banks with assistance from the Pacific Financial Technical Assistance Centre (PFTAC). The cutoff date for the filing of applications for existing banks was December 17, 2001. Based on the reviews completed to date, two "shell banks," which were not in operation but had advertised themselves to have been authorized by Palau, have been effectively closed.

3. The number of tourist arrivals declined by about 25 percent in the October–November period compared to the same period of the last fiscal year. This decline was larger than projected in the staff report and is mostly due to fewer arrivals from Japan as the number of charter flights were temporarily reduced. However, there has been a pick up in charter flights from Japan since December and the staff's FY2002 projection of 3 percent growth in tourist activity could be achieved if tourist arrivals increase by an average 8 percent over last year for the remaining months of the fiscal year. This would depend on the continued frequency of both charter and regular flights to Palau and the pace of recovery of tourism in Asia.

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IMF Concludes 2001 Article IV Consultation with the Republic of Palau

On January 4, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Palau.[1]

Background

The Republic of Palau has had one of the lowest growth rates among Pacific Islands in spite of sizeable grants. The Compact of Free Association provided front-loaded grants totaling nearly $600 million over the fifteen-year period to 2009. Of this amount, a Trust Fund of $70 million was set aside that stood at $135 million at end-September 2001. In addition to Compact grants, other grants from the U.S., Japan, and Taiwan Province of China, have enabled the funding of budget deficits averaging 9 percent of GDP (after grants) during the past six years, without domestic or foreign borrowing. External debt (all of which is long term) remains low at 15 percent of GDP.

Palau faces a number of development challenges. Substantial improvements in human and physical infrastructure are needed to sustain higher growth rates. About 80 percent of the land area is on Babeldaob island which is virtually inaccessible now, but it is expected to develop rapidly after the completion of a Japan-funded bridge in 2002 and a U.S.-funded island access road in 2004. Recent labor shortages have increased reliance on foreign labor. The public sector is large and accounts for 36 percent of total employment. Foreign investment is impeded by current regulations and by unclear land use rights. Environmental factors—storms, climate

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

change, and soil erosion from urban development—could destroy natural resources without adequate preventive measures that require budgetary resources.

Economic activity has been weak in the last two years and inflation is low. Following a 5 percent decline in FY1999, real GDP growth is estimated to have been only 1 percent annually in FY2000 and FY2001 (years ending September). Tourist activity has not recovered since the Asian crisis, and its impact on growth has been only partially offset by project-related construction.

The overall fiscal deficit (including grants) increased to 15 percent of GDP in FY2001 from 4 percent of GDP in the previous year. This larger deficit stems mainly from external factors, namely a sharp decline in investment income from lower dividends and realized losses, and lower grants. Current expenditures declined by 9 percent of GDP, reflecting fiscal consolidation efforts, and improvements in tax administration yielded nearly 3 percent of GDP. These savings allowed capital spending to increase slightly to accommodate reconstruction following damage from Storm Utor.

Asset balances have been declining as a result of drawdowns to finance fiscal deficits, as well as recent investment losses. Although there have been no withdrawals from the Compact Trust Fund to date, its market value declined by 17 percent in FY2001 after registering average returns of 13 percent in the previous six years (about 60 percent is invested in U.S. stocks).

The external current account deficit has widened in recent years as project-related capital goods imports have increased and tourist receipts have fallen. The capital account was boosted in FY2000 by a grant and loan from Taiwan Province of China, both to finance infrastructure; however, an expected grant in FY2001 did not materialize. The worsening external position suggests that Palau's competitiveness continues to deteriorate. The real effective exchange rate has appreciated by 25 percent since 1995. Tourism competitiveness began to decline after the Asian crisis reflecting large real depreciations in the currencies of competing Asian destinations. Airfares are high and are set by a single carrier servicing Palau. Discussions with two potential airline investors aimed at reducing air transport costs are likely to be delayed due to recent events.

The administration that took office in January 2001 has embarked on a wide range of initiatives aimed at removing impediments to growth. Passage of financial legislation in June contributed to the Financial Action Task Force (FATF) decision not to place Palau on the list of noncooperative jurisdictions with respect to money laundering. The new Financial Institutions Act paves the way for establishing a Financial Institutions Commission to oversee banking regulation and supervision of the 12 licensed banks. A budget reform law introduced "performance management system" to improve public sector efficiency. A new investment law is currently under debate in Congress, as is a tax reform act, a statistical act, and constitutional amendments related to streamlining the executive and legislative branch.

The near-term outlook is uncertain. Real GDP growth is projected to be around 3 percent in FY2002. The overall fiscal deficit is expected to narrow significantly reflecting an increase in grants and in domestic revenue if current tax reform proposals are approved by the Palau Congress. The external current account deficit is expected to widen somewhat to around

17 percent of GDP as lower investment income is offset by a slight improvement in tourism receipts. Tourism is expected to grow by 3 percent, somewhat less than forecast prior to the events of September 11. However, these prospects are subject to considerable down side risks because of the global economic slowdown.

Executive Board Assessment

Executive Directors commended Palau's new administration for reinvigorating the reform process and welcomed the recent legislative initiatives aimed at public sector reform and removing impediments to economic growth. At the same time, they pointed to several challenges facing Palau: the sluggish growth performance, which remained lower than other Pacific Island countries; the need to diversify the production base to reduce vulnerability to external shocks through improved competitiveness and active promotion of private sector development; the end of the current Compact funding provisions in FY 2010, and the draw-down of the government's asset balances. Directors agreed that the main tasks ahead are to remove investment impediments in order to build the basis for sustained growth, to reduce Palau's dependence on foreign assistance, and to achieve medium-term fiscal sustainability.

Directors considered that the large overall fiscal deficit in 2001 is not sustainable, given that nearly three-fourths of the cash component of Compact grants (excluding the Trust Fund) has been spent. They welcomed the recent efforts to address this problem–including the strengthening of tax administration, restraint on public sector wages, and a hiring freeze during FY2001. Nevertheless, they urged further fiscal consolidation, especially since foreign assistance is likely to be smaller in future years and there is a need to maintain an adequate reserve buffer to protect against future external shocks.

Directors urged the authorities to develop a medium-term fiscal consolidation plan consistent with the scheduled end of current Compact funding provisions, based on realistic assumptions about future Compact Trust Fund returns, and aiming to achieve a balanced budget by FY2005. Directors recommended that domestic revenue be raised to a level that would offset the expected reduction in grants in FY2010 and avoid depletion of the real value of the Trust Fund. To achieve this objective, previously delayed tax reforms would need to be implemented without further delay.

As a first step, for FY2002, Directors urged that the tax package presented to Congress in October 2001 be implemented as soon as possible in order to achieve the targeted reduction in the overall fiscal deficit. It will also be essential to prepare the next phase of tax reform, including income and sales tax reform, for presentation to Congress during the coming year. In view of Palau's relatively high public sector wage bill compared with neighboring countries, Directors emphasized the need to continue with the hiring freeze and to proceed with the recommendations of the National Planning Committee on governmental reorganization, while ensuring that a sufficiently strong social safety net is in place to assist the most vulnerable segments of the population. Directors also expressed concerns over the recent increase in unfunded liabilities of the Social Security Fund and the Civil Service Pension Fund, and urged that the contribution and benefit schemes be revised.

Directors supported the structural reform agenda set out by government in its *Management Action Plan (MAP)* of March 2001. Noting that failure to deal effectively with structural impediments in the past had prevented a widening of the economy's productive base, Directors urged consistent implementation of the policies in the MAP.

Directors stressed the need to shift the government's role from being the main employer to one of promoting adequate physical and human capital development. Directors were encouraged by ongoing reorganization efforts, including plans to reduce the size of the civil service, the better linking of existing posts to skill and performance requirements, and the removal of some layers of government while outsourcing services and privatizing some maintenance and operational functions.

Directors stressed the importance of fostering an environment conducive to private investment. In this regard, they welcomed the recent presentation to Parliament of the new foreign investment law and hoped for its speedy adoption. Directors considered it important to reduce the rigidities in land and labor markets that have constrained the growth of tourism and private investment more generally. Therefore, they urged continued efforts to accelerate dispute resolution by the Land Courts. Directors expressed concern over the impact of the recent minimum wage legislation on competitiveness, and encouraged the authorities to review other regulations on employment.

Directors welcomed the passage in June 2001 of legislation aimed at combating money laundering and establishing a framework for banking regulation and supervision. In this connection, they urged prompt establishment of the Financial Institutions Commission (FIC) that will develop regulations and oversee the implementation of the new legislation. They also called for further strengthening of the regulatory and supervisory framework to address some of its weaker elements, including through the drafting of the FIC regulations, amending the newly passed Financial Institutions Act, if necessary, and by requiring financial disclosure of audited accounts by all licensed banks.

Directors welcomed the steps that have been taken to improve data reporting and quality, and encouraged Palau to participate in the Fund's General Data Dissemination System. However, they noted that significant statistical deficiencies remained, particularly in balance of payments, national accounts, and monetary statistics, that continue to impede effective surveillance and policy formulation. They therefore urged the authorities to continue their efforts to improve data collection and dissemination and to improve reporting to the Fund.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2001 Article IV Consultation with Palau is also available.

Republic of Palau: Selected Economic and Financial Indicators, 1996/97–2000/01 1/

	1996/97	1997/98	1998/99	1999/00	Est. 2000/01
Real sector					
Nominal GDP 2/	113.2	117.3	113.5	118.2	122.5
GDP deflator 3/	2.3	1.6	2.2	3.0	2.6
Real GDP (percent change)	2.3	2.0	-5.4	1.1	1.0
Business and Tourist arrivals	66,441	63,656	49,170	45,932	49,731
Public finance					
Domestic revenue	24.9	41.3	29.0	42.9	40.2
Grants	33.2	30.0	22.0	32.1	21.4
Expenditures	76.5	64.6	71.7	84.5	77.2
Current	58.3	54.8	63.7	71.8	63.1
Capital	18.3	9.9	8.0	12.7	14.1
Overall fiscal balance (including grants)	-16.3	2.4	-16.8	-4.7	-18.5
(In percentage of GDP)	-14.5	2.1	-14.7	-4.0	-15.2
Compact Trust Fund (CTF) balance	105.5	122.4	141.1	161.8	135.0
Government Assets (non-Trust Fund assets)	81.0	85.1	67.0	77.7	44.0
Balance of payments					
Exports (f.o.b.)	11.8	11.1	13.6	11.5	18.3
Imports (f.o.b.)	-72.9	-63.2	-83.9	-127.1	-99.1
Current account balance (including grants)	4.2	9.7	-14.3	-42.7	-15.7
(In percentage of GDP)	3.7	8.4	-12.5	-36.5	-12.9
Overall balance	-16.6	-1.2	-20.9	13.9	-18.5
External debt	9.1	5.5	1.4	20.0	20.0

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

1/ Fiscal year beginning October 1.

2/ On a calendar year basis. The column 1996/97 refers to 1997, and so forth.

3/ Based on US CPI and Palau CPI from 2000.