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.