## Better investment climate would help Palau achieve sustained growth

After several years of slow or negative growth, economic activity has picked up in the Republic of Palau, while inflation has remained low, according to the IMF's latest economic review. Real GDP, driven by higher visitor arrivals and externally funded government projects, grew by 5 percent in FY2004 and 5½ percent in FY2005. Palau, a small island economy in the Pacific, relies heavily on tourism and on external assistance from its 50-year Compact of Free Association with the United States and grants from Japan and Taiwan Province of China to finance budget expenditure and infrastructure projects.

Better economic management has encouraged private sector activity. Fiscal performance was improved by capping nonwage current expenditure while strengthening revenue collections, allowing public debt to remain low. Although investment impediments remain, Palau ranks high on several indicators of the cost of doing business, and local private firms are undertaking a growing share of foreign-financed projects.

| **Palau** | 2002/03 | 2003/04 | Prel. 2004/05 | Proj. 2005/06 |
|---|---|---|---|---|
| | | (percent change) | | |
| Real GDP growth | –1.3 | 4.9 | 5.5 | 5.7 |
| Consumer prices (period average) | –0.6 | 5.8 | 2.7 | 3.0 |
| | | (million dollars) | | |
| Compact Trust Fund balance | 136.3 | 141.6 | 152.5 | 155.8 |
| Tourism receipts | 75.6 | 96.9 | 97.2 | 97.5 |
| | | (percent of GDP) | | |
| External public debt[1] | 15.9 | 14.0 | 13.2 | 11.3 |
| Current account balance (including grants) | 7.9 | 9.6 | 10.6 | 2.5 |

[1]Does not include public enterprise debt, which is not guaranteed by the government.
Data: Palauan authorities and IMF staff estimates and projections.

Near-term economic prospects are upbeat, with tourism and infrastructure projects playing major roles. In the longer term, however, Palau's prospects are more uncertain and will depend on the direction of economic policies and whether U.S. Compact assistance is renewed beyond 2009.

IMF Executive Directors welcomed Palau's improved economic performance. They commended the authorities for managing foreign aid judiciously and for reducing public sector spending, while noting that further efforts are needed to meet the long-run goal of covering current spending from domestic revenue generation.

Noting that Palau has a large banking sector relative to its size, the Directors stressed the importance of passing pending financial regulations and enhancing the capacity and resources of the new supervisory agency.

To establish a sound foundation for sustained growth, the Directors underscored the need to improve the investment climate and labor and land policies. They were encouraged by the ongoing domestic debate over reducing foreign investment restrictions and welcomed progress made on land titling and leasing, but warned against raising the minimum wage so as to safeguard job opportunities for Palauans. ■

## Lithuania should focus on medium-term fiscal pressures

Lithuania's GDP grew by 7.5 percent in 2005, with declining unemployment, high capacity utilization, and buoyant asset prices, according to the IMF's recent economic review. But rising inflation has exceeded the Maastricht inflation reference rate, delaying euro adoption. The economy has continued to be stimulated by fiscal and European Union (EU) expenditures.

The IMF Executive Board welcomed Lithuania's economic performance, attributing it to strong macroeconomic policies, wide-ranging structural reforms, and EU integration. But, the Directors cautioned, imbalances are emerging. Rapid growth of consumption and of investment in property and construction have contributed to inflation and new financial vulnerabilities. Over the longer term, challenges are likely to arise from international tax competition, demand for public goods, emigration, and pressures on international competitiveness.

Lithuania has a sizable current account deficit but low external indebtedness, and the risks from accumulating external short-term debt will need close monitoring. Rapid credit growth has supported households' increasing appetite for mortgages and corporate demands in nontradables sectors. The Directors saw no need to slow the pace of credit growth directly, but encouraged the authorities to conduct forward-looking supervision, cool the property market, and encourage the disclosure of bank fees, among other measures.

| **Lithuania** | 2003 | 2004 | 2005 | Proj. 2006 |
|---|---|---|---|---|
| | | (percent) | | |
| Real GDP growth | 10.5 | 7.0 | 7.5 | 6.8 |
| Consumer price inflation (12 months to end-year) | –1.3 | 2.8 | 3.0 | 3.5 |
| Unemployment rate (end-year) | 12.4 | 11.3 | 8.3 | 4.2 |
| | | (percent of GDP) | | |
| Current account balance | –6.9 | –7.7 | –7.0 | –7.5 |
| External general government debt | 13.8 | 13.7 | 13.2 | 12.8 |

Data: Lithuanian authorities and IMF staff projections.

On the export side, growth has been sound but faces capacity constraints in the oil-refining industry and increased international competition in labor-intensive goods.

According to the Directors, a year's delay in Lithuania's adoption of the euro is unlikely to concern financial markets: the currency board, fiscal policy, and trade and financial integration with Europe can be expected to stay on course. But they stressed that a more ambitious fiscal goal would help contain rising prices and suggested reducing the projected 2006 budget deficit. Expressing concern that the planned personal income tax cuts would weaken the revenue base from 2008 onward, the Directors called for measures to address medium-term fiscal pressures stemming from population aging and public sector wage increases. ■