MACROECONOMIC ASSESSMENT SUMMARY

1. **Economic growth has seen a sharp decline since FY2015.** From 10.1% in FY2015, real gross domestic product (GDP) growth in Palau is estimated to have declined to –3.7% in FY2017 due to a tourism slump. Tourist arrivals fell by 22.8% in FY2017, compounding a 13.1% decline in FY2016. This largely reflected the closure of Jellyfish Lake, a major tourist attraction, due to drought conditions during 2016–2018, as well as the appreciation of the US dollar, the local currency. A 26.8% fall in the number of tourists from the People's Republic of China (PRC), accounted for much of the decline—as the PRC cancelled Palau's status as an approved tourist destination, and several scheduled and chartered flights from the PRC were discontinued. Arrivals from traditional markets also fell due to the drought and the currency appreciation—with tourist arrivals into Palau from Japan down 22.4% and Taipei,China down 43.2% in FY2017. Slow implementation of projects funded by development partners contributed to the downturn.

2. **Growth is projected to recover gradually.** Palau is likely to return to modest annual growth of around 1% by FY2019, supported by the commencement of private investment in new hotels and of public infrastructure projects funded by development partners. Recovery in tourist arrivals will be slow and uneven, even as drought conditions ease and tourism infrastructure improves. This is largely due to the PRC's restrictions on advertisements for group tours to destinations not formally approved by the government, and the termination of flights from Tokyo.

3. **Inflationary pressures have increased, but remain modest.** Palau saw inflation return to 0.9% in FY2017, up from deflation of 1.3% in FY2016. This was driven by higher fuel prices and their spillover effects on consumer goods such as clothing and processed food, most of which have to be shipped from abroad. Inflation is projected to rise slightly to 1.5% in FY2018 before leveling off in FY2019, reflecting international food and fuel price trends.

4. **Palau remains critically dependent on grants.** The fiscal balance has yielded an overall surplus every year since FY2011 (averaging 2.8% of GDP between FY2011–FY2017) (table). However, the economy is dependent on grants from the United States (US) under the Compact of Free Association, which is a political, strategic and economic treaty between the Republic of Palau and the US. Palau currently receives funding from the US for national development projects.[1] Reflecting the importance of grants, the fiscal deficit excluding grants averages 15.7% during FY2011–FY2017. Palau's economic base is narrow, and domestic revenues are insufficient to cover current expenditures.

5. **Palau has made consistent efforts to raise own revenues.** Revenue-enhancing reforms have been undertaken to finance environmental protection programs, including in Protected Area Networks.[2] For instance, the green fee imposed on tourists with the departure tax, was raised in FY2012. Tobacco tax rates were also increased in FY2015. Domestic revenues rose from 21.4% of GDP in FY2011 to 26.4% in FY2017. Revenues are expected to rise to 28.1% in FY2018 with the green fee and departure tax replaced with Pristine Paradise Environmental Fee. Royalties from fishing also contributed to the rise in non-tax revenues from FY2014 onwards.

[1] The US contributed about $630 million dollars (over a 15-year period ending in 2009), and currently continues to provide annual grants under the Compact. Compact grants are expected to expire in FY2024.

[2] The Protected Areas Network (PAN) is an initiative of state governments in Palau, whereby traditional leaders, and individuals have independently designated protected areas within their boundaries that have environmental or ecological significance. The national government of Palau supports the states' efforts to protect their lands and waters and encourages sustainable development of state lands. All sites that join the PAN are eligible to apply for designated PAN funds, which will be used by each PAN site to manage its own resources in accordance with system wide goals and objectives for conservation and sustainable development.

6. **Current expenditures have seen a marginal decline.** The government has attempted to maintain a prudent economic stance. Although current expenditures grew in US dollar terms, it fell as a ratio of GDP from 36.3% in FY2011 to 34.2% in FY2017, as expenditure composition tilted towards preserving infrastructure investment to support the growing tourism industry and enhance resilience to natural disasters and climate change. Wages and salaries as a share of GDP have also declined slightly, but remain above that in average Pacific island economies.

Table: Fiscal Framework, FY2011–FY2018

(% of GDP unless otherwise indicated. All data by fiscal year.)

Item	2011	2012	2013	2014	2015	2016	2017p	2018f
Total revenue and grants	45.2	44.3	40.8	43.4	39.2	41.2	40.7	42.6
Total revenue	21.4	21.8	22.2	24.2	24.3	24.9	26.4	28.1
of which: tax revenue	18.0	18.2	18.4	19.3	19.4	19.7	19.5	20.4
Grants	23.8	22.4	18.6	19.2	14.9	16.3	14.3	14.4
Total expenditures	43.9	43.3	40.1	39.8	34.3	37.7	36.2	37.6
Current expenditure	36.3	35.2	35.8	35.4	29.7	32.1	34.2	35.2
of which: wages and salaries	17.8	16.2	15.9	14.7	12.8	13.5	14.1	13.6
Overall balance (including grants)	1.3	1.0	0.7	3.6	4.9	3.5	4.5	5.0
in $ million	2.5	2.2	1.7	8.8	14.4	10.7	13.0	15.1
Overall balance (excluding grants)	(22.5)	(21.4)	(17.9)	(15.6)	(10.0)	(12.7)	(9.8)	(9.5)
in $ million	(43.4)	(46.0)	(40.3)	(38.3)	(29.3)	(38.6)	(28.7)	(28.9)
Public external debt	32.4	32.2	28.8	26.7	22.0	26.4	34.2	34.7
GDP ($ million, current prices)	193.2	214.6	225.3	245.6	293.1	302.7	291.5	304.7

( ) = negative, f = forecast, FY = fiscal year, GDP = gross domestic product, p = preliminary.
Sources: Pacific Islands Training Initiative. 2018. Economic Reporting Palau. http://www.pitiviti.org/initiatives/economics/palau.php; Asian Development Bank estimates.

7. **The government has requested a $15 million loan from ADB's ordinary capital resources for the proposed disaster contingent financing.**[3] This is based on the likely fiscal impact of medium- to high-impact disasters, taking into account possible support from development partners for immediate response, early recovery, and reconstruction, and the need to maintain public external debt at a sustainable level. Analysis undertaken under the Pacific Catastrophe Risk Assessment and Financing Initiative indicates that Palau faces an average annual loss of $2.7 million from typhoons, earthquakes, and tsunamis, with probable maximum losses of $16.8 million from a 1-in-50-year event, $46.7 million from a 1-in-100-year event, and $146.0 million from a 1-in-250-year event.[4] However, this estimate excludes losses from droughts, which are considered high-risk events in Palau, and also from possible downturns in economic growth due to reduced tourism.[5] The government envisions the establishment of a $25 million disaster contingency fund to respond in times of emergency and an $11 million National Disaster Recovery Fund and Insurance Program, neither of which is in place.[6] While the government is discussing the purchase of insurance from the Pacific Catastrophe Risk Insurance Company, this is still under internal deliberation. The proposed program will help fill the overall gap in short-term financing needs following a disaster caused by a natural hazard.

[3] ADB's comparable disaster contingent financing loan to the Cook Islands in 2016 was $10 million from ordinary capital resources. The Cook Islands population is around 17,500 compared to 21,500 in Palau (in 2016). ADB. 2016. *Report and Recommendation of the President to the Board of Directors: Proposed Policy-Based Loan to the Cook Islands for the Disaster Resilience Program.* Manila. ADB.

[4] Pacific Catastrophe Risk Assessment and Financing Initiative. 2011. *Country Risk Profile: Palau*. http://pcrafi.spc.int/documents/46/download. Losses refer to the direct costs to repair or replace damaged assets plus the emergency costs that governments may sustain as a result of providing necessary relief and recovery efforts (e.g. debris removal, setting up shelters for those made homeless, or supplying medicine and food).

[5] The decline in GDP growth in FY2017 resulted in an absolute decline of $11.2 million from FY2016 GDP at current prices. Moreover, tourism receipts declined by $14.1 million between FY2016 and FY2017.

[6] Government of Palau. 2015. *Palau Climate Change Policy for Climate and Disaster Resilient Low Emissions Development 2015*. Koror.

8. **Palau's public debt external has gone up recently but remains sustainable over the medium term.** Public external debt is estimated to have risen to 34.2% of GDP in FY2017 from 32.4% in FY2011. Part of this increase is due to ADB financing for large water, sanitation, and information and communications technology projects.[7] If the proposed disaster contingent financing loan proceeds of $15 million were to be fully drawn down in FY2019 due to the occurrence of a qualifying disaster, public external debt would rise to almost 40%. The debt-to-GDP ratio is projected to decline subsequently and fall below 34% by FY2022, if the government pursues its planned tax reforms[8] and tourism continues to recover.[9] The contingent financing would also potentially preclude more expensive borrowing for post-disaster needs, which could have adverse effects on debt sustainability. However, debt remains highly sensitive to a further real GDP growth shocks such as those that Palau could experience if faced with multiple large natural disasters.

9. **The outlook for Palau is one of slow recovery, subject to risks.** Economic growth is expected to recover very gradually, as construction picks up but tourism activity remains uncertain. Inflation is projected to remain low as commodity prices stabilize. The fiscal position is projected to improve further on continued fiscal prudence and comprehensive tax reforms. Palau's positive outlook is subject to substantial risks due to its reliance on tourism, grants, and commodity imports. A slowdown in key trading partners, further US dollar appreciation, sluggish recovery in tourism, and disasters caused by natural hazards could hurt the economy.

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7 Development Coordination (accessible from the list of linked documents in Appendix 2).

8 The authorities plan to implement comprehensive tax reforms, including the introduction of value added tax and net income tax, which are estimated to raise revenue by 3%–4% of GDP by 2030.

9 Tourist arrivals have increased by 10% in the first nine months of FY2018.