

INTERNATIONAL MONETARY FUND ASSESSMENT LETTER

Republic of Palau—Assessment Letter for the Asian Development Bank July 18, 2018

1. **Economic activity slowed significantly in FY2016 and 2017 more than envisaged in the last Staff Report but is expected to pick up moderately in FY2018.** GDP contracted by 3.7 percent in FY2017 on the back of a sharp decline in exports due to a downturn in the tourism sector since FY2016 and a delay in construction of a new luxury hotel. As construction activities related to hotel and infrastructure projects resume, growth is expected to pick up this year. It is projected to strengthen gradually over the new few years, driven by foreign direct investment (FDI) inflows in the hotel-related sectors and large ADB loans to upgrade ICT and sanitation infrastructure. Tourism is also expected to recover.¹ The stronger medium-term growth is predicated on structural reforms and infrastructure improvements to raise growth, while risks of low growth remain in the near term if anticipated recovery in tourism is slower than expected.

2. **The external position is expected to improve slightly in FY2018 and 2019 on the back of a recovery in the tourism sector.** The current account deficit (including grants) widened to 17.8 percent of GDP in FY2017 due to lower export receipts in services and is projected to improve by 0.5 percent of GDP to 17.3 percent in FY2019. External debt is projected to increase from by 24 percent of GDP to 34 percent of GDP with new borrowings from the ADB for large infrastructure projects on water, sanitation, and ICT projects as well as for social projects in FY2017. Debt is expected to stabilize at around 35 percent over the medium-term. Palau has taken steps to improve public investment management, including the PEFA self-assessment, to gain from scaling up on public investment.

3. **Credit conditions have eased slightly in FY2017.** Loans to the private sector increased by 15.4 percent, compared to 3.6 percent in FY2016. Banks continue to lend little domestically despite the rise in domestic deposits as they invest most of their assets abroad. The key impediments for commercial lending include the lack of borrowers' ability to prepare business plans and maintain financial statements in addition to risk aversion from foreign U.S. banks.

4. **The fiscal position has improved in recent years but medium-term fiscal sustainability remains an issue.** Multi-year concerted efforts of fiscal consolidation lowered the budget deficit (current balance, excluding grants) to 7.9 percent of GDP in FY2017, down from 17 percent of GDP in FY2010. The narrowing reflects a steady rise in domestic revenue and expenditure restraints. The overall fiscal balance (including grants and capital expenditure) has been in surplus since FY2011 and the reliance on grants as a source of revenue also lessened significantly over the past few years, to 14 percent of GDP in FY2017

¹ Tourist arrivals had increased by 10 percent in the first nine months of this fiscal year.

compared to 27 percent of GDP in FY2010. The current balance in FY2017 worsened due to lower revenue from tourism downturn but the overall balance had improved by 1 percent of GDP reaching 4.5 percent of GDP. However, ensuring medium-term fiscal sustainability remains important with rising needs in infrastructure spending. The government's net worth stood at 65 percent of GDP. In FY2018-19, capital expenditure is expected to resume as they start infrastructure projects, leading to a slight worsening of the overall balance. Government deposits had increased to almost 19 percent of GDP in FY2017. On grants, the United States Congress ratified the 2010 Compact Agreement with Palau in end-2017.²

5. **Tax reform to ensure medium-term fiscal sustainability is a policy priority.** In the medium-term, increasing spending pressures in infrastructure development coupled with the expiration of the Compact grants in FY2024 could risk fiscal sustainability. Palau's graduation to high-income status in 2017 would also limit access to concessional financing going forward. Staff recommend and support the authorities' plan to implement the comprehensive tax reform including the introduction of VAT and the net income tax. The comprehensive tax reform is estimated to raise revenue by 3-4 percent of GDP by 2030 over the next ten years.

6. **Risks to the outlook are tilted to the downside.** Being reliant on tourism, grants, and commodity imports, Palau is heavily influenced by external factors. External risks include weaker-than-expected growth in markets for tourism which could arise from shocks to the international economy. These could have a direct impact on Palau's tourism sector via a fall in tourism demand. On the domestic front, lack of progress in tax reform would put medium-term fiscal sustainability at risk. Failure to implement a tourism strategy and to diversify the economy could reduce growth in the medium-term.

7. **IMF Relations.** Palau is a surveillance country on a 24-month Article IV cycle. The latest Article IV mission took place on May 2016, and the Executive Board concluded the consultation on September 9, 2016. The next Article IV mission is currently scheduled in October 2018. Palau continues to benefit from a comprehensive IMF technical assistance from the Pacific Technical Assistance Center (PFTAC) in several areas, including on tax reform, banking supervision and AML/CFT.

² The ratification should lead to the disbursement of slightly over 100 million USD of unpaid funds. The disbursement is currently under review from both parties.

Table 1. Palau: Selected Economic Indicators 2013–2019 1/

Nominal GDP for FY2016:	US\$303 million					
Population (2015):	17,661					
GDP per capita for FY2015:	US\$16,853					
Quota:	SDR 3.1 million					
	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
				Est.	Proj. 2/	
Real sector						
Nominal GDP (million US\$) 3/	245.6	293.1	302.7	291.5	302.7	321.1
Real GDP growth (percent change)	2.7	10.1	0.0	-3.7	0.8	3.5
GDP deflator (percent change)	6.2	8.4	3.3	0.0	3.0	2.5
Consumer prices (percent change; period average)	4.1	0.9	-1.0	0.9	3.0	2.5
Tourist arrivals (number of visitors)	125,674	168,764	146,629	122,050	128,153	130,716
Public finance 3/						
	(In percent of GDP)					
Central government						
Revenue	43.4	39.2	41.2	40.7	41.2	41.7
Taxes and other revenue	24.2	24.3	24.9	26.4	27.4	28.0
Grants	19.2	14.9	16.3	14.3	13.8	13.7
Expenditure	39.8	34.3	37.7	36.2	38.3	39.8
Expense	35.4	29.7	32.1	34.2	34.7	35.3
Net acquisition of nonfinancial assets	4.5	4.6	5.6	2.0	3.6	4.5
Current fiscal balance (excluding grants) 4/	-11.1	-5.4	-7.2	-7.9	-7.3	-7.3
Net lending (+)/borrowing (-)	3.6	4.9	3.5	4.5	2.9	1.9
	(In millions of U.S. dollars)					
Compact Trust Fund (CTF) balance	199.2	183.9	196.8	219.8	227.0	235.5
Government cash and deposits 5/	9.6	23.4	28.6	54.6	57.9	63.7
In percent of GDP	3.9	8.0	9.5	18.7	19.1	19.8
Balance of payments 3/						
Trade balance	-158.5	-141.6	-140.0	-143.2	-153.9	-154.6
Exports (f.o.b.)	18.8	15.4	18.7	15.2	18.1	19.3
Imports (f.o.b.)	177.3	157.0	158.7	158.4	171.9	173.9
Tourism receipts	121.3	138.9	129.8	115.7	125.6	136.3
Current account balance						
Including grants	-37.2	-22.3	-34.9	-51.9	-52.9	-55.5
Excluding grants	-45.0	-40.8	-42.2	-42.2	-45.5	-38.7
International Investment Position	243.2	267.3	311.4	325.2	332.3	341.2
Assets	467.1	510.1	579.5	618.0	642.3	670.6
Liabilities	223.9	242.7	268.1	292.9	310.0	329.4
Of which: External debt	70.6	64.4	79.9	99.8	105.0	112.3
	(In percent of GDP)					
Current account balance						
Including grants	-15.1	-7.6	-11.5	-17.8	-17.5	-17.3
Excluding grants	-33.5	-21.5	-25.5	-32.3	-32.5	-29.3
International Investment Position	99.0	91.2	102.9	111.5	109.8	106.3
Of which: External debt	28.8	22.0	26.4	34.2	34.7	35.0

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

1/ Fiscal year ending September 30.

2/ Staff projections.

3/ Incorporates the authorities' revised estimates of GDP and balance of payments

4/ Defined as tax and other revenue less expense.

5/ Includes unspent external loans.