



# First Annual Report of the **Palau Economic Advisory Group**

*April 2023*

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EAG Chairman James Galbraith, Ph.D., with EAG members Peter Watson, Ph.D., Hon. Kaleb Udui, Jr., and Denise Konan, Ph.D., at the initial EAG meeting in Palau. (August 2022)

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## First Annual Report of the Palau Economic Advisory Group

### *Background*

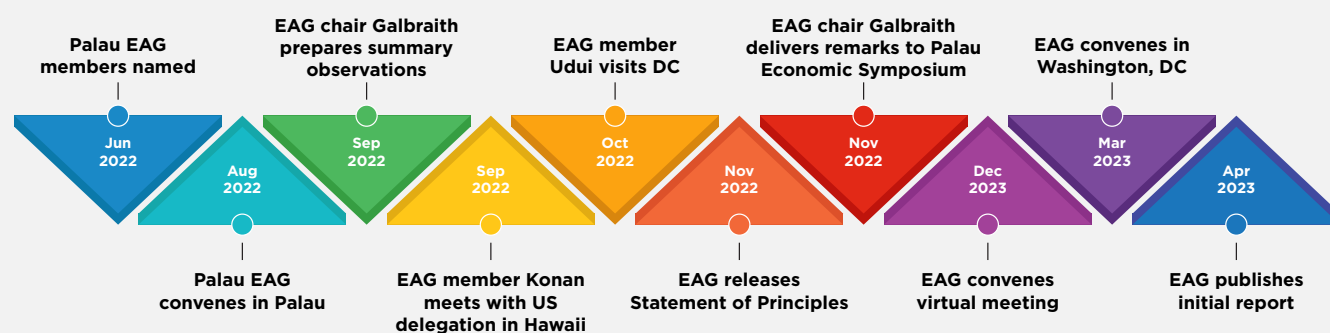
The Palau Economic Advisory Group (EAG) was formed during the spring and summer of 2022, pursuant to the terms of the 2010 Compact Review Agreement between the Republic of Palau and the United States. It consists of five members, two appointed by each government and a fifth nominated by Palau and selected by the United States. All members serve as volunteers. Secretariat assistance is provided by the Graduate School, USA, in Honolulu. Financial support for the operations of the EAG comes from the partner governments.

The five members are:

- Finance Minister Kaleb Udui (Palau)
- Professor Naoyuki Yoshino (Palau)
- Dr. Peter Watson (US)
- Professor Denise Konan (US)
- Professor James Galbraith (Palau/US)

The EAG is a long-term institution at the beginning of its mandate; its principal task is to help the government of Palau frame and execute a vision for successful and sustainable economic recovery, reconstruction, and development. This first annual Report summarizes EAG activities over the period from August 2022 through April 2023, and our initial observations on the principal problems and on the major tasks ahead. We introduce at **Appendix 1** our initial version of a Palau EAG Economic Indicators and Performance Dashboard with the expectation this tool will be updated and refined over time. Our principal recommendation at this stage, stated below, is that the Government of Palau advance the work of developing this vision, in preparation for the next mission of the EAG to Palau in August 2023.

### Timeline and Activities



## First Meeting

The EAG convened in Koror, Republic of Palau, on August 22, 2022, selecting Professor Galbraith to serve as Chair. There followed five days of meetings and site visits, including with President Whipps, the Cabinet and agency directors of the Palauan government, the US diplomatic representative, legislative leaders, and representatives of the donor community (including Japan, Taiwan, Australia, and the US). In addition, members of the EAG visited both Peleliu and Babeldaob. In Melekeok (Babeldaob) the EAG members were honored to meet with Paramount Chief REKLAI Ngirmang. **Appendix 2** provides details on these meetings and on the second set of meetings in Washington, DC in March 2023.

### Initial Summary Observations

Following the mission to Palau, on September 3, 2022, the Chair prepared and circulated this summary of observations:

- The immediate financial situation.** The financial situation of the economy and government of Palau is straightforward and dire: there is a collapse of tourism, absence of revenue, increase of debt and uncertain prospects for recovery. The collapse of tourism has two main elements: a decline following the Chinese visitor-driven boom which peaked roughly in 2015, and then the pandemic-induced lockdowns of 2020. Tourism has not since recovered for a complex of reasons, including quarantine requirements in the originating countries, the Chinese boycott, an absence of airline connections. Support provided through the CARES act and other pandemic relief programs from the United States are coming to an end. External debt has now risen to a high share of GDP, though on concessional terms, but still representing a burden hanging over future prospects. While it is tempting and reassuring to assume that tourism, incomes and revenues will soon begin to recover, there are few good reasons for confidence – the future is simply uncertain.

- **Infrastructure for future development.** The present state of Palau's infrastructure is poor. While power, water and roads are adequate, the port, schools, and hospital and some sewer projects are in bad shape and need of, broadly speaking, replacement. Law enforcement is underfunded. Koror has seen haphazard—and in many instances—low-quality foreign investment. Palau now has a strong fiber-optic bandwidth connection to the outside world, but the local wiring is obsolete. Existing infrastructure suffers from deficient maintenance and shortages of available, trained technical personnel to keep things running—this is true for example of the solar power and desalinization facilities on Peleliu. The airport needs a longer runway or full replacement. The country has plans to redevelop the big island and relocate much of the Palauan community there so that parts of Koror can be rebuilt to become an even more attractive visitor destination. A full reconstruction will be an expensive, long-term project requiring the development and commitment of appropriate planning, technical skills, and funds.
- **Institutional relations with the United States.** The United States has a strategic interest in a stable, prosperous, and sustainable Palau. This interest must be compatible with Palau's position as an independent, sovereign, and peaceful country, open to the world. The US government is not well-organized to manage its relationship with Palau, which is spread out over at least three departments (State, Interior, Defense) with divergent priorities, shifting personnel and—in some cases—short attention spans. Indicative results include long delays in the initial renewal of the Compact of Free Association (8 years) and in launching the EAG (12 years). The success of the relationship begs for the introduction of a more focused, stable US government institutional interlocutor able to partner with Palau to help meet the immediate problems and to sustain a partnership aimed at implementing a long-term vision.
- **Demographic and economic imbalances.** Palau faces an endemic problem of emigration and brain drain. Although (and in part, because) local educational resources are limited, a large share of the Palauan population goes abroad for post-secondary education. And because incomes are much higher in the United States, to which Palauans enjoy free access, a large share does not return, so that roughly half of the Palauan population now resides in the US. Meanwhile non-citizen workers from the Philippines, Bangladesh and elsewhere meet local labor demand, mostly in basic services and retail trades. The result is a significant lack of citizen workers with needed technical skills, such as plumbers, electricians, and maintenance staff for communications, power, water, and other essential functions. Apart from remittances (about which we know little) the economic potential of the expatriate community remains untapped, and the poor state of the infrastructure and weak health care services impede the development of a community of Palauan returnees or retirees, except for short visits. Improving local education is an important goal, but one intrinsically limited, in terms of sustained benefits to be captured within Palau, by the phenomenon of brain drain.
- **The future of tourism, in strategic and environmental context.** During the boom the major increase in tourists came from mainland China, largely on package-tour terms that provided relatively little per-visitor revenue to Palau, and which produced a significant amount of low-grade, ramshackle investment, now running to waste. Going forward, the challenge will be to establish Palau's reputation as a high-end, relatively high-cost, and limited tourist environment, consistent with environmental sustainability. An eventual renewed economic relationship with China, among other countries, must be consistent with that objective. The US military maintains a facility on Palau, which is welcome; a challenge is to keep the military presence below a threshold that would impair Palau's attractiveness as a tourist destination or endanger the environment. There is the possibility of multiple COFA-like arrangements, notably with Japan; these can be used to help provide the required capacities for sustainable development.
- **Financial management issues.** Palau should consider seeking non-profit status under US tax law for all public-purpose gifts and bequests from private parties—presently only the community college qualifies. There is some potential for a community reinvestment requirement, perhaps through the development bank (PNDB). There is some potential for financial arrangements that might bring some benefit to Palau and revenue to the government through “digital residencies” and similar schemes, although these pose reputation risks that should be mitigated carefully with financial regulators in partner countries. Reimbursement for medical costs under the VA, and also Medicare and Medicaid, might be arranged for qualified returnees.



- **Long-term Diversification Ideas.** Ultimately Palau needs an economy with a more diverse and stable basis than tourism alone. Possibilities include: (i) retirement communities for repatriated Palauans and others; (ii) residences for digital nomads, and enclaves for corporate headquarters and professional services; (iii) stations for oceanographic and marine-biological research stations; (iv) facilities for suitable educational partners, in such areas as public health, renewable energy, and business education; and (v) as a means of attracting investment, Palau could become a locus for visionary environmental management, with public relations benefits for participating private companies, which would in turn help to build the reputation of the country as a tourist destination.

## **Economic Indicators and Performance Dashboard**

In line with its mandate, the EAG will create a “Palau EAG Economic Indicators and Performance Dashboard,” to be maintained and updated at least annually by the Secretariat. The dashboard will provide a transparent framework for monitoring economic and fiscal indicators and a statistical basis for recommendations to the government of Palau, facilitating cooperation with the US and with other friendly nations, institutions, and donors. The EAG notes that in the period before its creation and before the adverse impact of the decline in tourism and the Covid pandemic, the fiscal and other policies of the government of Palau were responsible and prudent. However, the present situation reflects the consequences of profound changes in the economic environment, requiring a fresh path forward for sustainable development and improved economic conditions in Palau. **Appendix 1** provides a first iteration of the Dashboard.

## **Meeting in Hawaii with U.S. Delegation**

On September 21, 2022, Professor Konan held a meeting in Honolulu with a U.S. delegation on its way to Palau. The group discussed a wide range of relevant issues, including Palau’s debt, the question of raising the minimum wage, the size of Palau’s government in relation to the range of services it needs to provide, infrastructure requirements, potential incentives for the repatriation of Palauans living abroad, and the possible return of the Peace Corps to Palau. In discussing the plans of the EAG, Ambassador Yun urged that it prepare a report summarizing medium-term outlook and recommendations, including plans for the long-term continuity of the EAG, and that the EAG make plans to meet in Washington with members of Congress and representatives of the Departments of State, Interior, and other relevant agencies.

## **Palau Member Visit to Washington, DC**

From October 18-20, 2022, Minister Udui visited Washington, DC, and met with numerous cooperating parties, including the U.S. Development Finance Corporation (DFC), the U.S. Trade and Development Agency (TDA), and the Japan Bank for International Cooperation (JBIC). Dr. Watson and Professor Galbraith accompanied Minister Udui to each meeting during which the groundwork was laid for future cooperation and missions to Palau in the March 2023.

## **EAG Statement of Principles Released**

Following the completion of Minister Udui’s mission, the EAG ***drafted a statement of principles***, included by reference in this Report. A key opening paragraph is quoted here in full:

*“Palau at independence chose a Compact of Free Association with the United States, now up for renegotiation and renewal. It is axiomatic that such an agreement must be freely chosen and terminable by both parties. To be freely chosen, it must meet on mutually agreed terms the needs and requirements of both parties. The United States has primarily a strategic interest in the Indo-Pacific region, that it remains free and open and that it not become a region of military conflict. Peace and openness also are essential to Palau. But Palau’s needs and requirements are primarily in the economic and social sphere,*

*specifically in budget support, sustainable finance, the quest for long term economic development. That requires as its foundation a just, flexible, workable relationship between the Palauan people and the United States, recognizing that the lives of the two societies are now deeply intertwined. The two interests are asymmetric but balanced; the vast security powers of the U.S. find equivalence in economic prosperity for Palau. The Compact must recognize that the mutual goals of the two countries are to be achieved over an indefinite future. There is no natural end-point for either one."*

[This Statement of Principles was released on November 17, 2023, and posted to [www.palaeag.org](http://www.palaeag.org).]

### **Palau Economic Symposium Virtual Meeting**

On November 17, 2022, the Chair of the EAG gave brief opening remarks, remotely, to the annual economic symposium held at Koror. On this date as well the statement of principles was released to the public, after having been shared with parties in both governments.

### **EAG Virtual Check-in Meeting**

On December 15, 2022, the EAG held a meeting by Zoom. Subjects under review included the following:

- That the EAG statement of principles was received warmly by key interlocutors in both Palau and the United States.
- That negotiations for renewal of the COFA were on track and should be concluded relatively soon; these negotiations should include provision for long-term continuity in the mandate of the EAG.
- That missions to Palau by the DFC, TDA and JBIC were in preparation, with emphasis on key infrastructure projects, notably in transportation.
- That Minister Udui and Professor Konan had visited the University of Hawaii to discuss joint projects, including a potential joint degree/remote study program with Palau Community College and possible collaboration with the East-West Center.
- The Secretariat provided a briefing on the current status and outlook for the Palauan economy (see **Appendix 3**).

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## **Second Meeting**

The EAG met in person in Washington DC from March 12-16, 2023, and engaged with interlocutors across the spectrum of the U.S. government, including the legislative branch, to discuss next steps in a long-term program of constructive reform and mutual support between Palau and the United States. Two meetings were held at the State Department with Ambassador Yun, and a further meeting with Assistant Secretary Lambert and his team. One meeting was held at the Department of Interior with Assistant Secretary Cantor and her team. Three meetings were held with planning and funding agencies: DFC, TDA, and JBIC. Five meetings were held on Capitol Hill, with Representative Amata Coleman Radewagen, House Foreign Affairs, Senate Energy and Natural Resources, House Appropriations, and House Natural Resources. The mission also included lunch and dinner meetings. [see **Appendix 2** for more details on these meetings]

In general, the EAG noted strong bipartisan support for renewal of the Compact of Free Association, for the broad objectives of Palau's development strategy, and for the mission of the EAG. We were pleased by progress toward final agreement on terms of the COFA renewal and on certain specific investment initiatives, both of which will be necessary to provide Palau with the foundations of a successful economic path forward. At the same time, we were warned of the need to continue educating policymakers on these issues, in the context of an extraordinarily difficult U.S. budget climate.



In addition, the EAG received support in Washington for its work on an ongoing and indefinite basis (to be specified in the 2023 Compact Review Agreement), with an annual cycle of two in-person meetings, one of which will be in Palau in August and the other in March at locations chosen to be appropriate and useful. The EAG plans to meet next in Honolulu in August 2023, to make contact with members of the Palauan expatriate community, and to proceed then to Palau for further study and consultations. A tentative plan is being developed for a meeting in March 2024 in Tokyo.

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## Recommendation

Pending the completion of the Compact Review Agreement and the renewal of the Compact of Free Association, the Economic Advisory Group recommends that the Government of Palau develop and refine its vision for the implementation of the Compact and its plans and priorities for the years immediately ahead. Such a vision should take account the aspirations of Palauan civil society, the advice of donor and lending agencies, and the technical capacities existing on and accessible to Palau. It should recognize that the management of such a vision is a complex undertaking, that resources are ultimately limited, that proper sequencing is integral to success, but also that the moment of Compact renewal, under present conditions, represents a unique and transient opportunity. The Economic Advisory Group will hope and expect to have detailed discussions on these matters with its Palauan counterparts on the occasion of its forthcoming mission to Palau in August 2023.

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## Conclusion

The Palau Economic Advisory Group has begun operations under conditions that are both challenging and, in certain respects, favorable. The challenges stem from the need to frame and execute wide-ranging improvements in the physical, administrative and social conditions in Palau, and to facilitate a better integration between Palauans resident in the islands and those now living in the United States. The EAG plans to continue to study these issues, to obtain a better understanding of the needs and desires of the Palauan people, to continue to work closely with the United States and other partners, and to assist with technical matters in which we may be able to bring our competences to bear.

In this first year and in our first Annual Report the EAG has seen remarkable progress toward the completion of the renewal of the Compact of Free Association between Palau and the United States, and toward the development of key projects to meet the needs of Palau in several important areas, including health, transportation, and communications. We recommend, as above, that Palau work to integrate this progress into a coherent and practical vision for the path forward. In future years we expect to make specific recommendations, including, as appropriate, on (i) economic, financial and management policies (and reforms when needed); (ii) opportunities for Palau to work with U.S. agencies and programs; (iii) opportunities with friendly donor nations and finance institutions; and (iv) appropriate policy frameworks and sector development strategies in Palau. The larger goals include a broadening of Palau's economic base, a dampening of the effects of external shocks, and, ultimately, a more sustainable development path and improved livelihoods for the Palauan people in Palau.

The EAG waits anxiously for the successful completion of Compact renewal negotiations and will study the outlook and make specific recommendations for next steps once that framework is in place.

Respectfully submitted.

*Palau Economic Advisory Group*

April 28, 2023

## Appendix 1:

### Palau EAG Economic Indicators and Performance Dashboard

#### Background

Pursuant to the Compact Review Agreement (CRA) signed on 03 September 2010, the United States government (USG) and the Republic of Palau government (ROP) agreed, among other matters,

*“to establish an Advisory Group on Economic Reform and the ROP committed to undertaking economic, legislative, financial and management reforms with due consideration given to the reforms described in the International Monetary Fund’s (IMF) Country Report No. 08/162, Republic of Palau: Selected Issues and Statistical Appendix, (May 2008), and the Asian Development Bank’s (ADB) Strategy and Program Assessment, Palau: Policies for Sustainable Growth, A Private Sector Assessment (July 2007) and any other similar subsequent and future reports and recommendations issued by the IMF, the ADB, and other credible institutions, organizations or professional firms.”*

The CRA came into full force on 19 September 2018. The Economic Advisory Group (EAG) was formulated and had its initial meeting in Palau from 22-26 August 2022. A second virtual meeting was convened on 15 December 2022 (US date). As stated in the CRA,

*“the purpose of the Advisory Group is to contribute to the long-term economic sustainability of Palau by recommending economic, financial, and management reforms.” The responsibility of the EAG is further elaborated stating that the EAG “shall recommend economic, financial and management reforms and the schedule on which the reforms should be implemented.”*

The CRA further requires that the EAG,

*“shall report annually not less than thirty (30) days prior to the annual bilateral economic consultations to be held on or about June 1 every year on the Government of Palau’s progress in implementing reforms recommended by the Advisory Group or other reforms taken by the Government of Palau. The two governments are committed to these annual economic consultations being meaningful, substantive and comprehensive.”*

#### Mandated Timing for First Annual Report is Achievable with Proposed Meeting Cycle

The Chairman and members of the EAG consider the requirement for an initial report to be binding; indeed, the First Annual Report will be complete more than 30 days in advance of a notional June 1, 2023, annual bilateral meeting. The proposed “meeting cycle” is discussed in further detail and with an infographic in Appendix 2. This report will include initial findings, (very) preliminary recommendations and proposed next steps in the front matter of the report and will include this appendix 1, introducing a dashboard approach to monitor key indicators of the Palau’s fiscal and economic performance.

This dashboard approach is proposed to be maintained as background tracking and possibly to be expanded as economic, social, fiscal, financial, and management performance is observed by the EAG over the coming years. ROP leadership and officials have been exceedingly helpful in enabling the gathering of key data over the specified time periods and it is expected that continued cooperation will be necessary to inform the recommendation-making process that the EAG will undertake as it achieves increasing levels of understanding of the opportunities and challenges facing the Republic of Palau.

#### The Palau EAG Economic Indicators and Performance Dashboard

The EAG proposes an initial Dashboard in four parts. Data presently available are presented in charts below; other data will be sought and presented as it becomes possible to do so:

**1. Government Employment**

- a. National government number of employees
- b. National government employees as % of total employees
- c. National government wage bill, nominal and real (\$ millions)
- d. National government wage bill as % of GDP

**2. Fiscal Performance**

- a. Tax revenues as % of GDP
- b. Expenditures as % of GDP
- c. Fiscal balance as % of GDP
- d. Unreserved general fund cash balance (\$ millions)
- e. External debt as % of GDP

**3. Financial/Banking Performance**

- a. Total depository bank deposits as % of GDP
- b. Total depository bank loans as % of deposits

**4. Economic Performance**

- a. Real GDP (2015 prices, \$ millions)
- b. Real GDP per capita (2015 prices)
- c. Economic transformation—traded goods as % of GDP
- d. [to be determined: social sector performance indicators]

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## Initial Assessment of Palau's Economy, Pre-COVID

Each of the fourteen (14) charts includes a brief commentary on the trends indicated for Palau over the noted period. 3-year averages over four (4) time periods are utilized to smooth some of the volatility suffered by Palau in almost all economic, fiscal, and financial matters.

Data for each of the charts should be available through FY21 and/or FY2022 by late June 2023.

It should be noted that the dire outcome of a failure to secure additional funding through the CRA negotiations did not occur; however, an 8-year delay in funding the CRA was virtually tantamount to a zero-funding availability outcome for Palau's access to operational budget support and equated to an 8-year delay in capital funding support. Palau therefore faces a severe deficit and needs in infrastructure renewal, modernization and upgrading. In future it will be the policy of the EAG to include contemporary assessments of Palau's opportunities and challenges in our performance monitoring and in our making of recommendations and timelines associated with our policy recommendations.

At a high level, we can see that the then-prevailing IMF modeling exercise predicted a need to improve the fiscal position by some 0.9 percent annually for the period from FY2009 – FY2021 even with Compact renewal in place. [see the IMF paper referenced in the CRA, pp7-10]. In fact, Palau, despite a delayed compact renewal, achieved an improvement in its overall fiscal balance from a deficit of 3.6% at the end



Palau EAG members with U.S. Special Presidential Envoy for Compact Negotiations, Joseph Yun. (March 2023)

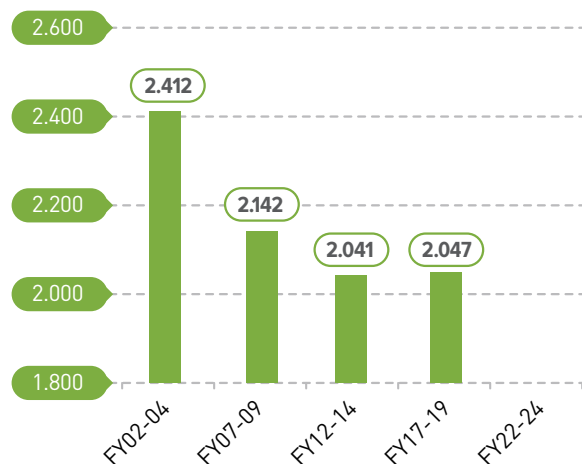
of FY2009 to a surplus of 6.2% in FY18—an adjustment averaging 1.1% annually. This was greatly aided by the strong growth of tourism during this period. FY19 resulted in a small deficit (0.4% of GDP) as a result of active retribution by the government of PRC drastically reducing tourism arrivals. Palau then suffered a near-total stoppage of tourism during the pandemic, and therefore of revenue-earning activities.

The key takeaway is that Palau did manage its fiscal situation responsibly and outperformed the stark modeling projections for austerity shared by the IMF in 2008. Notably, Palau achieved progress on revenues—achieving an increase of 6.5% of GDP from FY2009 through FY2018. This too was reversed by the slump in tourism. Going forward, the EAG hopes to work with its partners to overcome the infrastructure deficit and help lay the foundation for a more diversified, higher-income and sustainable economy for Palau, permitting the resumption of progress toward fiscal health and economic growth.

The Palau EAG Fiscal and Economic Performance Dashboard follows.

## Government Employment

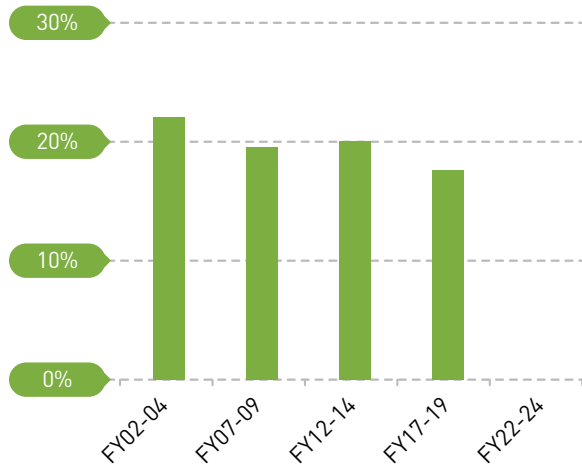
### 1.a. Nat'l Gov't Employees



A common critique by observers of the Palauan economy during the initial Compact period was that the government workforce was “too big” and absorbed “too many” resources. Whether this was (or perhaps is even true to this date), the size of the government has been reduced to the point where in health, education and financial management vacancies remain unfilled and service levels clearly suffer.

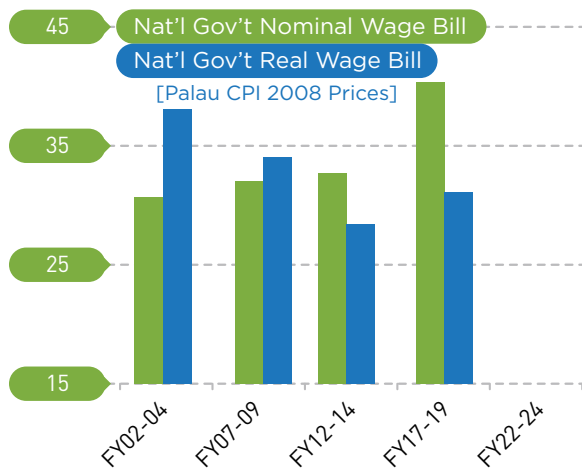
The 15% decline in total national government employees (from 2,412 in FY02-04 to 2,047 in FY17-19) represents the results of persistent and prudent efforts by Palau’s leadership to rely more on the private sector in its economic growth strategy. It is expected that the next period (FY22-24) will show a small further decline in the size of the national government.

## 1.b. Nat'l Gov't Employees [as % of Total Employees]



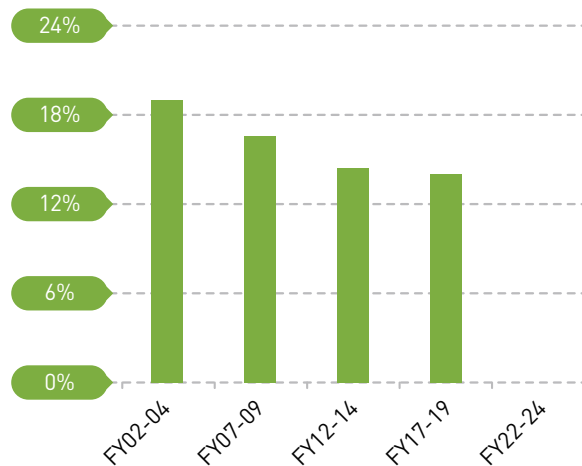
Palau experienced a 20% decline in the share of national government employees as a share of total employees (from 22.1% in FY02-04 to 17.6% in FY17-19). This is consistent with a strengthening private sector and is expected to continue as a trend—absent the immediate impacts of the COVID-19 pandemic.

## 1.c. Nominal &amp; Real National Government Wage Bill (\$millions)



The 18% decline in the total real wage bill of the national government (from \$38.1 million in FY02-04 to \$31.1 million in FY17-19) also demonstrates a persistent and prudent approach to fiscal management and to reduce the prior imbalance between government wages and private sector wages (in part). The EAG members will closely monitor this metric as minimum wage policy has been applied to government workers (about a 12.5% nominal increase in the face of high inflation) in FY2023 and appears to be legislated to increase by a slightly smaller percentage in FY24. This policy represents an attempt to make wages more attractive, especially as senior Palauan workers age and the stated policy of consecutive administrations is to bring more Palauan workers and their families back home.

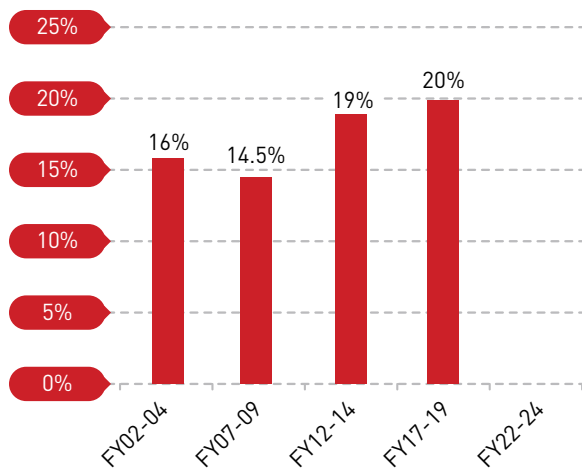
## 1.d. Nat'l Gov't Wage Bill as % GDP



The 26% decline in the national government wage bill as a share of GDP (from 19% in FY02-04 to 14% in FY17-19) is the expected result of declining real wages at a time when the economy was growing at a modest rate. Of note is the fact that the IMF analysis referred to in the CRA mandate for the EAG assumed this metric would remain stable and the fiscal deficit then present and threatening to deteriorate would, indeed, have created a dire need for the sharp adjustments prescribed by the IMF. Palau, instead, chose an incremental path to fiscal adjustment over the long-term and exceeded the total adjustment that had been called for, albeit with the help of the “stop-gap” funding that was in place from FY2010-17 until the FY2018 effectivity of the 2010 Compact renewal.

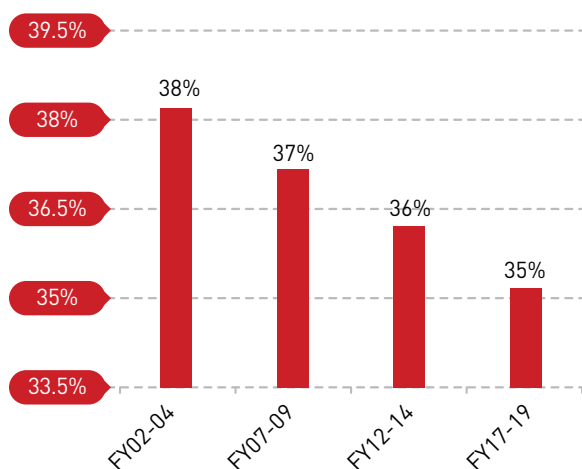
## Fiscal Performance

### 2.a. Tax Revenues as % GDP



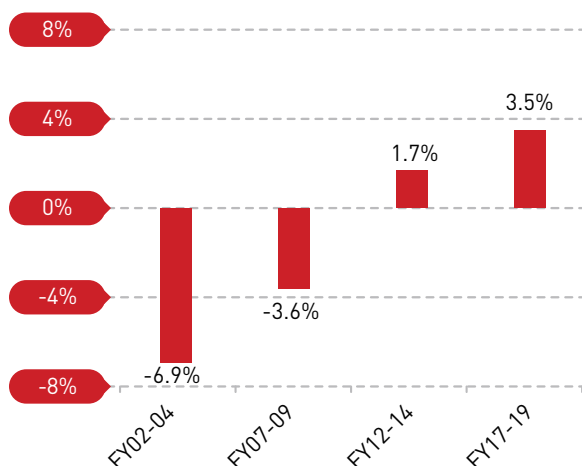
The 25% increase in taxes as a share of GDP (from 16% in FY02-04 to 20% in FY17-19) is the result of incremental tax policy changes to the long-standing Trust Territory-vintage tax system in Palau. Ultimately, Palau has adopted a tax policy consistent with the advice of the IMF and other observers as far back as 2002. This was an important achievement of Palau's fiscal policy, but it came with increased tax distortions and with diminishing returns in terms of tax collections in proportion to GDP growth. The EAG will be closely monitoring the macro- and micro-impacts of the comprehensive tax reform passed in FY2022 and implemented as of January 1, 2023. It is likely tax effort will rise again when the impacts of the COVID-19 pandemic are well and truly in the past.

### 2.b. Expenditures as % GDP



The 8% decline in expenditures as a share of GDP (from 38% in FY02-04 to 35% in FY17-19) is actually an important part of Palau's fiscal adjustment over the long-term. Again, the IMF macro-modeling used for the report and recommendations called out in the CRA mandate for the EAG implied expenditures remaining steady as a share of GDP, resulting in extensive borrowing in the absence of substantial fiscal compression. This outcome was avoided and Palau's government expenditures may need to reverse trend, albeit with a focus of any increase on capital investments. The EAG expects to monitor this metric closely in the post-COVID period.

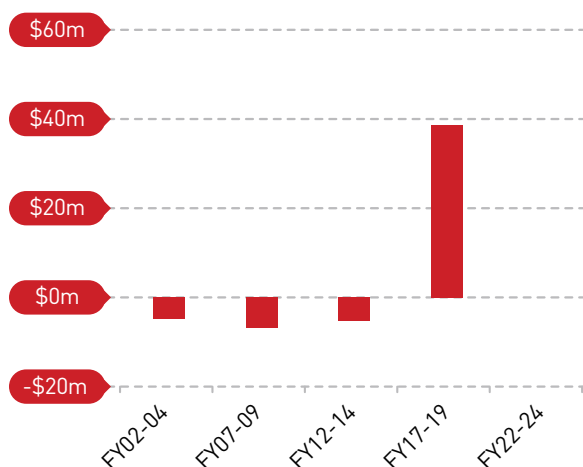
### 2.c. Fiscal Balance as % GDP



The fiscal adjustment of 10.4% of GDP (from -6.9% in FY02-04 to +3.5% in FY17-19) is, perhaps, the most impressive metric within the monitoring dashboard. This is a greater magnitude of adjustment than the IMF had called for and it is proof of an improved and prudent fiscal stance over an extended period. Alas, the impact of the COVID-19 pandemic has been devastating and Palau is in dire need of a "reset" of its economic strategy. The EAG will, over time, make recommendations to execute a more sustainable approach to tourism recovery/growth coupled with restoration of Palau's infrastructure stock and, perhaps with the greatest difficulty and uncertainty, a needed diversification of Palau's economic base.

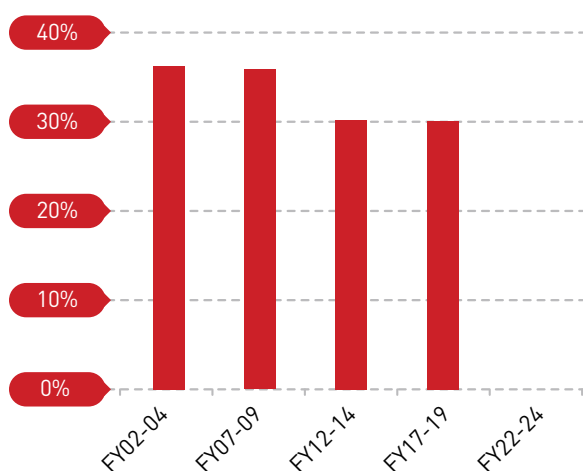


## 2.d. Unreserved general fund cash balance (\$millions)



The \$43.4 million increase in Palau's available fund balance (from -\$4.8 million in FY02-04 to +\$38.6 million in FY17-19) is indicative of a major turnaround in its core management of government finances and an achievement, albeit temporary and in the end not fully sufficient, of its long-stated goal to have an adequate "rainy day" fund. In the end, the impact of the COVID-19 pandemic was far greater in magnitude and in time than prior economic shocks that have periodically set back the Palauan economy. The EAG will closely monitor this metric as any return to persistent government deficits would be debilitating with respect to private sector growth.

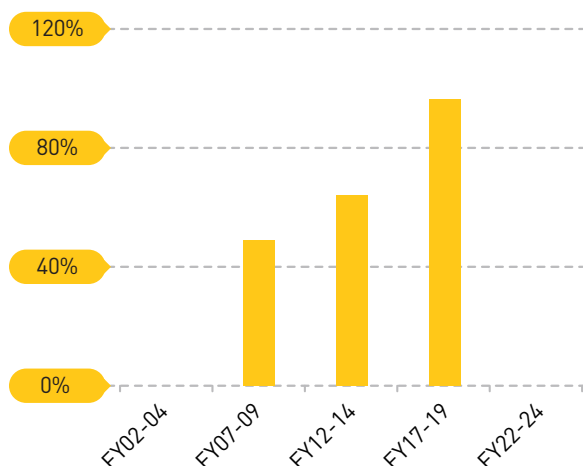
## 2.e. External Debt as % GDP



The 17% decline in Palau's external debt as a share of GDP (from 36.3% in FY02-04 to 30.1% in FY17-19) was an impressive accomplishment. Given Palau's income status, there was room to expand the debt ratio to address important infrastructure bottlenecks to economic growth (especially in water/sanitation, information and communication technology, transport, and power). Unfortunately, the impacts of the COVID-19 pandemic led to an increase in borrowing on the reasonable assumption that the crisis was a cyclical shock. With 20:20 vision it appears that the fiscal shock, due to the level of borrowing and the time delay in economic recovery will leave a small structural deficit for Palau to manage. The EAG will closely monitor Palau's external debt stance which may be assisted materially if the current understanding of the "2023 Compact Review Agreement" comes into effect timely.

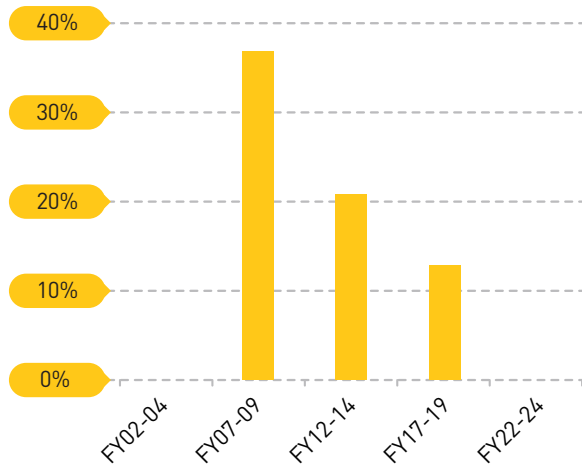
## Financial/Banking Performance

### 3.a. Total depository bank deposits [as % GDP]



The near-doubling of banking deposits (from 49% in FY02-04 to 96% in FY17-19) highlights the relatively high and growing penetration of banking in the Palauan economy. The banking sector received minimal attention from the IMF and other observers at the time of the referenced report. The EAG has a stated objective of trying to find ways for Palau's economy to increase the mobilization of domestic resources. This would preferably be through means that maintained the relatively high and growing level of deposits as a share of GDP while also increasing total lending, especially for commercial lending. Alternatively, the government or a public sector entity may be called upon to intermediate. In any case the EAG will closely monitor banking and domestic finance as the economy faces the need for substantial investment.

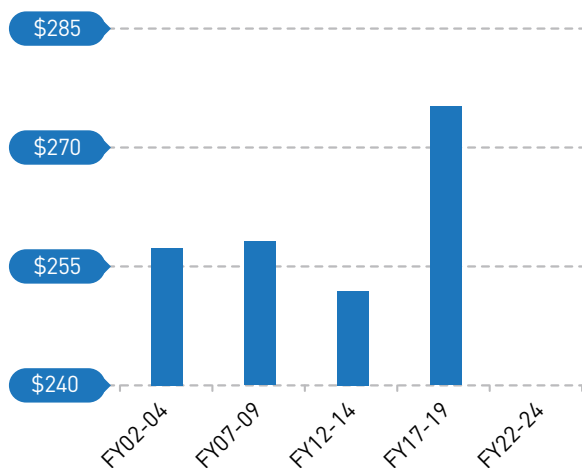
### 3.b. Total depository bank loans [as % Deposits]



The 65% decline in bank loans as a share of total deposits (from 37% in FY02-04 to 13% in FY17-19) results from a small decline in loans at the time of a near-doubling of deposits. As noted above, the EAG will closely monitor this metric. If creative means to mobilize bank lending are unsuccessful, then other means to mobilize ample domestic resources to meet the economy's need for infrastructure, improved tourism plant, and diversified production will be considered for recommendation.

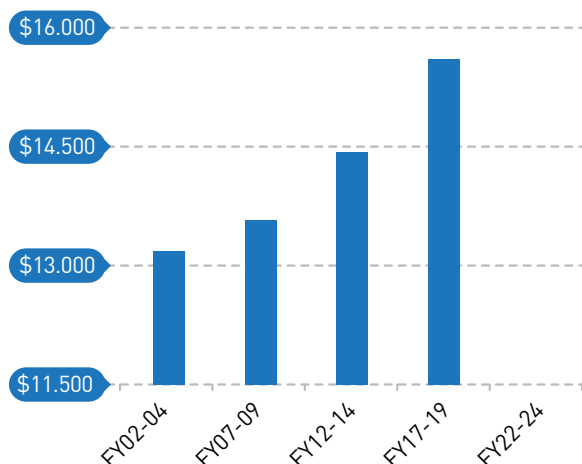
## Economic Performance

### 4.a. Real GDP (2015 prices)

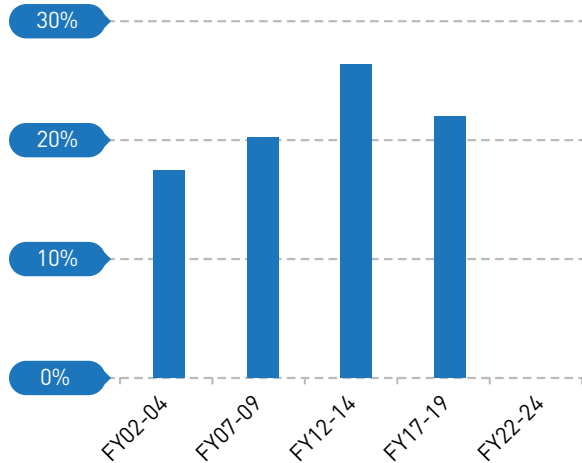


The 7% increase in real GDP (from \$257 million in FY02-04 to \$275 million in FY17-19) is a disappointing result over a 15-year period. Nearly one-third of the years over the period resulted in negative real economic growth. The fact is the economy suffers from external shocks that are well beyond Palau's control. The COVID-19 pandemic effect on the economy post FY19 is a decline of a further 25% increasing the need for a sustainable recovery that does not simply retrace the path to boom-bust economic outcomes. The EAG will closely monitor Palau's economic and fiscal management with an eye toward finding ways to reduce Palau's reliance on a narrow and volatile economic base. This is, indeed, the crux of the problem and the challenge the EAG will partner with Palau to try to overcome.

### 4.b. Real GDP/capita (2015 prices)



The 18% increase in real GDP per capita (from \$13,186 in FY02-04 to \$15,611) represents a disappointingly modest growth in the economy (the numerator) and a disturbing decline in the population (the denominator). While much of that decline was from the reduction in foreign workers, the lack of a modestly growing Palauan population indicates the challenge to the Palau leadership that has led them to focus on bringing Palauans home. This metric, too, will show a large impact post-COVID-19 pandemic. The EAG notes that, prior to the anticipated onset of renewed terms under the 2023 Compact Review Agreement, Palau will have suffered a two-decade long period of zero net gains in income per capita.

**4.c. Economic Transformation [Traded Goods as % GDP]**

The 52% increase in the share of traded goods in the Palau economy (from 17.4% in FY02-04 to 26.4% in FY12-14) was followed by a 17% reversal (decline) through the FY17-19 period. So, the Palauan economy has experienced a measure of “economic transformation” in which its capacity to produce tradeable goods has expanded, but this has been driven by the tourism sector and was in the downturn with the collapse of the China tourism boom—even before the impact of the COVID-19 pandemic. The EAG will monitor this relatively slow-moving metric as a measure of Palau’s private sector and outward-oriented economic strategy is implemented.



Members of the Palau Economic Advisory Group with Palau President Hon. Surangel Whipps, Jr., and U.S. Chargé d'affaires, Andrew McLean. (August 2022)

## Palau EAG Monitoring Dashboard Data

1 Government Employment						
		FY02-04	FY07-09	FY12-14	FY17-19	FY22-24
a	Nat'l Gov't Employees	2,412	2,142	2,041	2,047	
b	"Nat'l Gov't Employees [as % of Total Employees]"	22,1%	19,6%	20,1%	17,6%	
c	Nat'l Gov't Nominal Wage Bill	30,7	32,0	32,7	40,4	
c	"Nat'l Gov't Real Wage Bill [Palau CPI 2008 Prices]"	38,1	34,0	28,5	31,1	
d	Nat'l Gov't Wage Bill as % GDP	19,0%	16,6%	14,4%	14,1%	
2 Fiscal Performance						
		FY02-04	FY07-09	FY12-14	FY17-19	FY22-24
a	Tax Revenues as % GDP	16%	14,5%	19%	20%	
b	Expenditures as % GDP	38%	37%	36%	35%	
c	Fiscal Balance as % GDP	-6,9%	-3,6%	1,7%	3,5%	
d	"Unreserved general fund cash balance (\$millions)"	\$(4,8)	\$(6,8)	\$(5,3)	\$38,6	
e	External Debt as % GDP	36,3%	35,9%	30,2%	30,1%	
3 Financial/Banking Performance						
	(Bank deposits)		94,316	145,65	276,705	
		FY02-04	FY07-09	FY12-14	FY17-19	FY22-24
a	"Total depository bank deposits [as % GDP]"		49%	64%	96%	
b	"Total depository bank loans [as % Deposits]"		36,8%	20,7%	12,8%	
4 Economic Performance						
		FY02-04	FY07-09	FY12-14	FY17-19	FY22-24
a	Real GDP (2015 prices)	\$257,3	\$258,1	\$251,9	\$275,1	
b	Real GDP/capita (2015 prices)	\$13.186	\$13.582	\$14.428	\$15.611	
c	"Economic Transformation [Traded Goods as % GDP]"	17,4%	20,2%	26,4%	22,0%	
>	Nominal GDP	161,042	192,941	227,116	287,157	
>	CPI deflator (2008q2=100)	80,5	94,0	114,9	130,0	

## Appendix 2: Meeting Briefs for Year One (2022/2023) of the Palau EAG

### Initial Meeting in Palau

The Palau EAG held their initial meeting in Koror, Palau from **August 22-26, 2022**. All five EAG members joined the initial meeting, which included:

- Welcoming discussions with the President of Palau and United States Chargé d’Affaires;
- An internal organizing meeting of the EAG at which the members designated a Chair (Galbraith) and a Deputy Chair (Konan)
- A comprehensive “Listen and Learn” session which included an “Economic Overview—Retrospective FY1995-2021” and an opportunity for each Palau ministry and several public enterprises to present their current challenges, opportunities, policy priorities, and initiatives to the EAG;
- A meeting with Palau’s diplomatic corps and multi-lateral development partners;
- A land and sea tour highlighting health, education, and infrastructure needs, featuring a visit with High Chief REKLAI in Melekeok;
- A boat trip to the State of Peleliu and meeting with Governor and Representative; and
- A de-briefing/close-out session with Palau’s executive and legislative leadership.

Following their initial visit to Palau, the EAG issued a ***General Statement of Objectives, Principles, and Preliminary Programs***, available online at <https://pubs.pitiviti.org/eag-principles>. It was subsequently noted that this was, indeed, a preliminary document and not to be confused with the annual report that will be provided to the United States and Palau governments and shared publicly in Spring 2023 (in advance of an anticipated Palau-US bilateral economic consultation notionally scheduled for June of each year.)

### Virtual Check-in Meeting

The Palau EAG held a virtual “check-in” meeting on **December 15, 2022**. All five EAG members joined the meeting, which included updates on the following:

- Compact negotiations status and expected timeline;
- DC-based efforts with potential partner agencies (TDA, DFC, and JBIC all targeted toward promoting private investment and infrastructure development);
- University of Hawaii-based efforts (training, research, and articulation agreement with Palau Community College);
- Japan-based efforts (focus on infrastructure, finance mobilization, fiscal stabilization, and environmental sustainability); and
- Palau-based efforts (training needs, policy initiatives and overall Economic & Fiscal Update).

The EAG also discussed their plans: (i) for the second in-person meeting (subsequently held in Washington, DC, in April 2023); (ii) for the First Annual Report; and (iii) for the likely meeting cycle for future years

## ***Second Meeting in Washington, Dc***

The Palau EAG held their second meeting in Washington, DC from **March 13-16, 2023**. During the week, EAG members:

- Met with executive branch officials, including:
  - » at the State Department with the Special Presidential Envoy for Compact Negotiations and his team responsible for ongoing Compact renewal negotiations with all three Freely Associated States;
  - » at the State Department with the Deputy Assistant Secretary of State Lambert from the Bureau of East Asian and Pacific Affairs and other lead officials with an interest in Palau and Indo-Pacific development and security matters, including the Bureau of Economic and Business Affairs;
  - » at the Department of the Interior with the Assistant Secretary for Insular and International Affairs and other officials with lead responsibility for implementation of the Compact of Free Association with all three Freely Associated States;
- Met with potential Palau partner agencies, including:
  - » the US Trade and Development Agency (TDA);
  - » the US Development Finance Corporation (DFC); and
  - » the Japan Bank for International Cooperation (JBIC);
- Met with legislative branch officials, including:
  - » at the Rayburn Building with staff of the House Foreign Affairs Indo-Pacific Subcommittee;
  - » at the Rayburn Building with Hon. Representative Aumua Amata Coleman Radewagen, and members of her staff; her roles include Vice-Chair House Foreign Affairs Subcommittee on the Indo-Pacific, House Natural Resources Subcommittee on Indian and Insular Affairs, and Co-Chair of the Pacific Islands Caucus;
  - » at the Dirksen Building with staff of the Senate Energy and Natural Resources Committee;
  - » in the Capitol with staff of the House Appropriations Subcommittee on State and Foreign Operations;
  - » in the Longworth Building with staff of the House Natural Resources Subcommittee on Indian and Insular Affairs.
- Led a debriefing close-out session at the State Department with the Special Presidential Envoy for Compact Negotiations and his team.
- Completed internal discussions to enable the finalization of the first annual report of the Palau EAG for submission in April 2023 to the government of Palau and the government of the United States.

Such a submission date follows the 2010 Compact Review Agreement mandate that “the Advisory Group shall report annually not less than thirty (30) days prior to the annual bilateral economic consultations to be held on or about June 1 every year...”

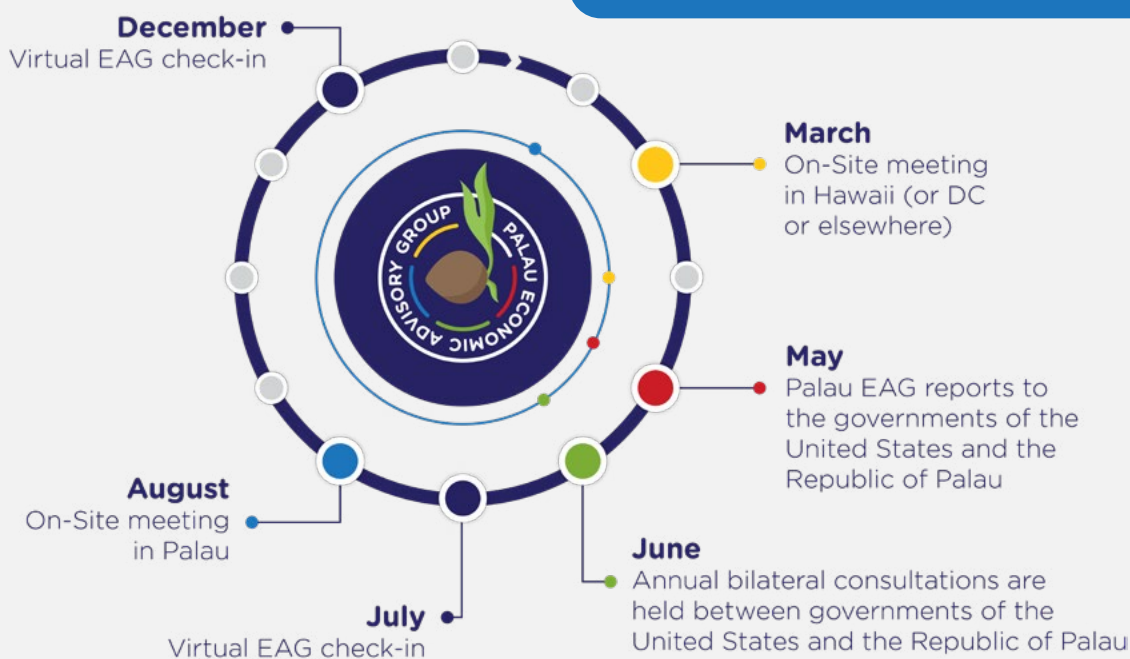
## ***Planned EAG Meeting Cycle in Future Years***

In future years, the EAG plans to follow a similar—albeit still flexible—annual cycle of meetings that should work well to accommodate the academic year constraints on several EAG members while also ensuring conformance with the above-mentioned 2010 CRA mandate for annual reporting to the government of Palau and the government of the United States. The infographic shown below depicts the planned cycle of two in-person meetings to be held in Palau each late Summer (August) and each Spring (April). The second meeting will be in Honolulu, Hawaii, unless the members designate an alternative site. Just as in the first year the meeting was held in Washington, DC, the second meeting may be held in Tokyo, Japan.

The current EAG members also propose to have 1-2 virtual meetings to maintain momentum on initiatives and to keep themselves timely informed of developments within Palau and with respect to the overall US-Palau relationship in its many dimensions.



The annual cycle of meetings and reports for the Palau Economic Advisory Group



## Persons Met in Palau (August 2022)

### Palau Council of Chiefs

- High Chief **REKLAI Ngirmang** (Melekeok)

### Palau Executive Branch

- **H.E. Surangel Whipps, Jr**, President of the Republic of Palau
- **Hon. Uduch Sengebau Senior**, Vice-President of the Republic of Palau
- **Hon. Ngirai Tmetuchl**, Minister of Human Resources, Culture, Tourism, and Development
- **Hon. Dr. Dale Jenkins**, Minister of Education
- **Hon. Gaafar Ucherbelau**, Minister of Health and Human Services
- **Hon. Steven Victor**, Minister of Agriculture, Fisheries, and Environment
- **Hon Charles Obichang**, Minister of Public Infrastructure, Industries, and Commerce
- **Hon. Gustave Aitaro**, Minister of State

### Palau Legislative Branch

- **Hon. Hokkons Baules**, President of the Senate
- **Hon. Kerai Mariur**, Vice-President of the Senate
- **Hon. Secilil Eldebechel**, Floor Leader of the Senate

- **Hon. Rukebai Inabo**, Senator
- **Hon. TJ Imrur Remengesau**, Senator
- **Hon. Dr. Steve Kuartei**, Senator
- **Hon. Umiich Sengebau**, Senator
- **Hon. Mark Rudimch**, Senator
- **Hon. Andrew Tabelaul**, Senator
- **Hon. Mason Whipps**, Senator
- **Hon. Sabino Anastacio**, Speaker of the House of Delegates
- **Hon. Lucio Ngiraiwet**, Vice-Speaker of the House of Delegates
- **Hon. Gibson Kanai**, Floor Leader of the House of Delegates
- **Hon. Vicky Ngiratkakl-Kanai**, Delegate
- **Hon. Warren S. Umetaro**, Delegate
- **Hon. Sebastian R. Marino**, Delegate
- **Hon. Lee T. Otobed**, Delegate
- **Hon. Noah Kemesong**, Delegate
- **Hon. Timothy R. Sinsak**, Delegate
- **Hon. Frutoso “Toto” Tellei**, Delegate
- **Hon. Nace N. Soalablai**, Delegate
- **Hon. Mengkur W. Rechelulk**, Delegate
- **Hon. Yutaka Gibbons, Jr**, Delegate
- **Hon. Mario S. Gulibert**, Delegate
- **Hon. Swenny Ongidobel**, Delegate

### ***Palau Diplomatic Corps and Donor Representatives***

- **H.E. Akira Karasawa**, Ambassador of Japan to the Republic of Palau
- **H.E. Richelle Turner**, Australian Ambassador to the Republic of Palau
- **H.E. Jessica Chienyi LEE**, Ambassador of Taiwan to the Republic of Palau
- **Hon. Andrew McLean**, United States Chargé d’Affaires, US Embassy/Palau
- **Degi Young**, World Bank Resident Representative for the North Pacific
- **Alfonsa Koshiba**, Senior Country Officer, Asian Development Bank
- **Kay Schwendinger**, Head of Resident Coordinator Office (Micronesia)
- **Sharon Sakuma**, United Nations Country Coordination Specialist (Palau)
- **Masato Abe**, Economist, UN Palau Country Team
- **Matthew Broome**, Consulate General of New Zealand (online)

### ***Peleliu State Government***

- **Hon. Emais Roberts**, MD, FACS, Governor of Peleliu
- **Hon. Nace N. Soalablai**, Delegate Peleliu State



## **Persons Met in Washington, DC (April 2023)**

### ***Office for Compact Negotiations—U.S. Department of State***

- **Hon. Joseph Y. Yun**, Special Presidential Envoy for Compact Negotiations
- **Jane Bocklage**, Deputy for Compact Negotiations
- **Karen Stewart**, Former Ambassador to Marshall Islands, Belarus, and Laos
- **Christine Singh**, Staff for Compact Negotiations
- **Michael A Gonzalez**, Foreign Affairs Officer
- **Christine Singh**, Staff for Compact Negotiations

### ***Bureau of East Asian and Pacific Affairs—U.S. Department of State***

- **Hon. Mark Lambert**, Deputy Assistant Secretary
- **Jenny Morrell**, Pacific Regional Unit Chief
- **Taryn Laubenstein**, Environment, Science, Technology and Health Officer
- **Eric Salzman**, Economic and Commercial Officer
- **James Flowers**, Financial Economist

### ***Office of Insular and International Affairs—Department of the Interior***

- **Hon. Carmen Cantor**, Assistant Secretary for Insular and International Affairs (Interior)
- **Hon. Keone Nakoa**, Deputy Assistant Secretary for Insular and International Affairs (Interior)
- **John Brewer**, Director, Office of Insular Affairs (Interior)
- **Jeff Scott**, Counsel (Interior)

### ***Japan Bank for International Cooperation***

- **Hiroyuki Suzuki**, Chief Representative (JBIC Washington)
- **Hisashi Inoue**, Senior Representative (JBIC Washington D.C.)

### ***U.S. Trade and Development Agency***

- **Verinda Fike**, Regional Director, Indo-Pacific
- **Kevin Toohers**, Country Manager, Indo-Pacific Region
- **Brent Harrison**, Country Manager, Health Care and Smart Grid, Indo-Pacific
- **Brandon Megordon**, Indo-Pacific Manager
- **Alissa Lee** (Agrobusiness and Aviation)
- **Tanvi Madhusudaner** (Energy)

### ***U.S. International Development Finance Corporation***

- **James Polan**, Vice President, Office of Development Credit
- **Alison Germak**, Deputy Vice President, Office of Development Credit
- **Loren Rodwin**, Managing Director, Social Enterprise Finance Team, Office of Development Credit

### ***House Foreign Affairs Indo-Pacific Subcommittee***

- **Ann E. Kowalewski**, Professional Staff Member
- **Sebastian Wigley**, Legislative Assistant to Rep. Young Kim
- **Mark Akpaninyie**, Indo-Pacific Policy Analyst

### ***Congressional Office, U.S. House of Representatives, American Samoa***

- **Amata Coleman Radewagen**, Member of Congress
- **Richard P. Stanton**, Legislative Director
- **Daniel M. Black**, Legislative Assistant

### ***Senate Energy and Natural Resources***

- **Melanie Thornton**, Ph.D., Democratic Professional Staff Member
- **John Tanner**, Deputy Staff Director
- **David Gardner**, Legislative Assistant
- **Michael Espy**, Staff Assistant

### ***House Appropriations Subcommittee on State, Foreign Operations, and Related Programs***

- **Jamie McCormick**, Professional Staff Member (Majority)
- **Erin Kolodjeski**, Clerk/Professional Staff Member

### ***House Natural Resources Subcommittee on Indian and Insular Affairs***

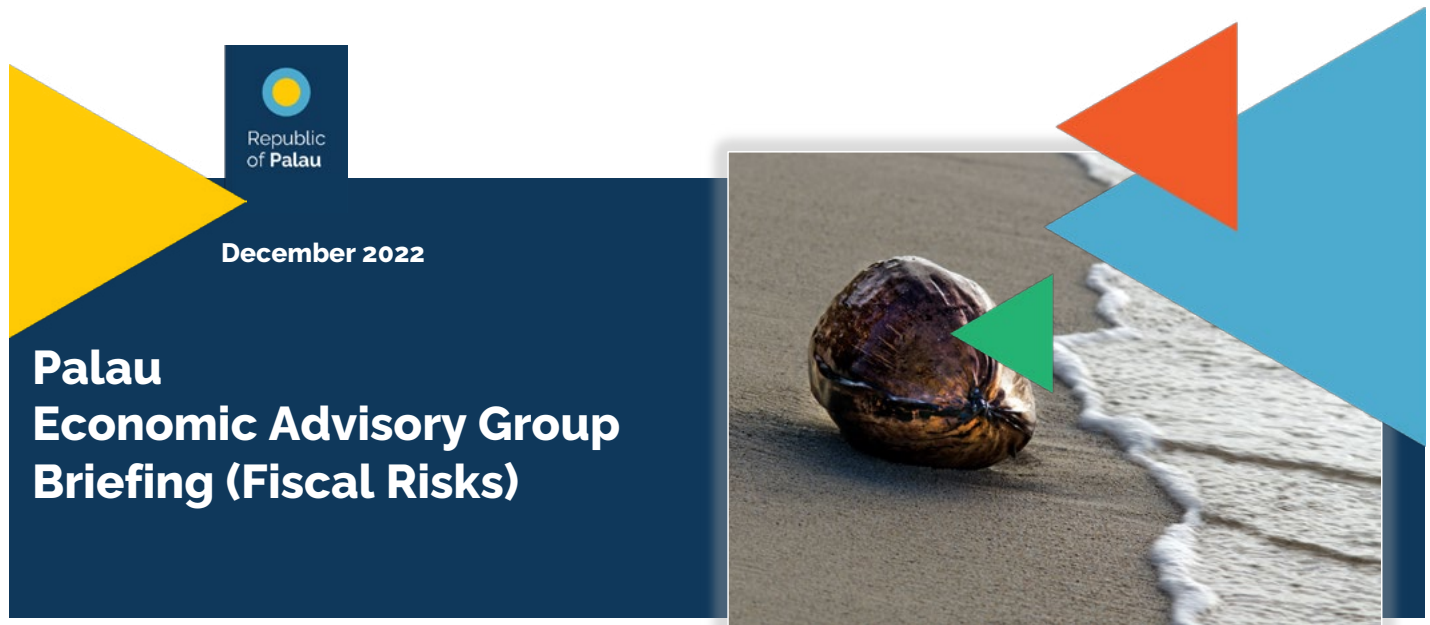
- **Ken Degenfelder**, Staff Director
- **Jocelyn Broman**, Professional Staff Member
- **Ransom Fox**, Clerk

Palau EAG  
members visit  
the U.S. Capitol  
in Washington,  
DC. (March 2023)



## Appendix 3

### Palau Economic Advisory Group Briefing from GSUSA (December 2022)



1

## Outline

### Palau Faces Extraordinary/Simultaneous Headwinds

- Covid-19 Pandemic Recovery is Slow and Uncertain
- The US \$ is historically strong
- Compact Renewal post FY2024 is Uncertain (... but promising)

1. Modeling Background to Fiscal Risk Analysis
2. Recent & Projected Fiscal Performance
3. Social Security Administration Financial Risks
4. Civil Service Pension Plan Financial Risks
5. Public Enterprise Financial Risks

2

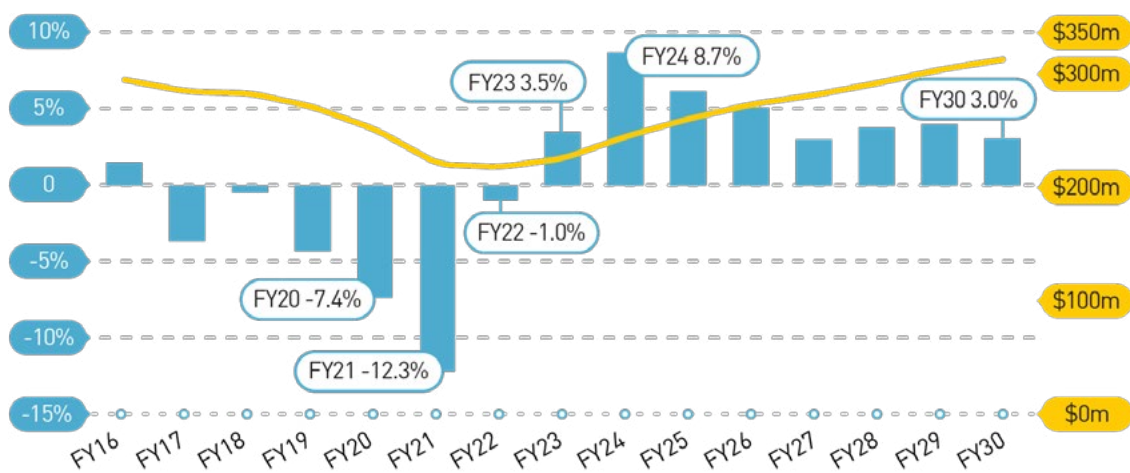


# 1. Modeling Background to Fiscal Risk Analysis



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## Modeling Background—GDP Projections



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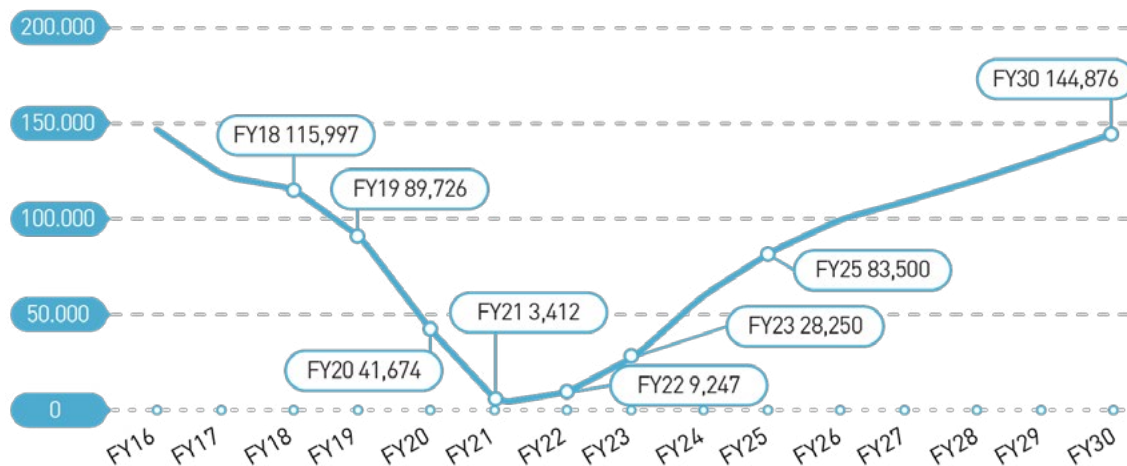
Palau EAG Meeting #2 (Virtual) – December 2022

Graduate School USA / [www.econmap.org](http://www.econmap.org)





## Modeling Background—Tourism Arrivals

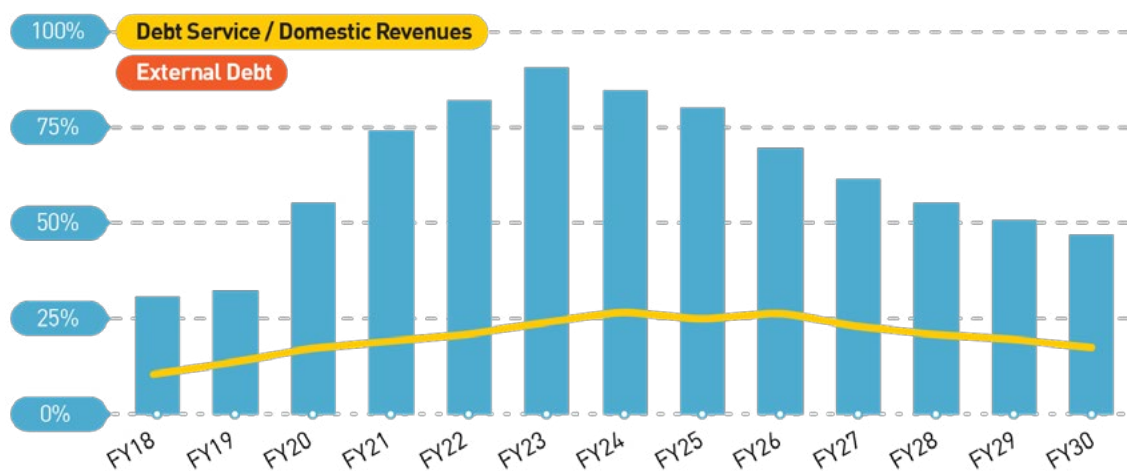


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## Modeling Background—External Debt



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## 2.

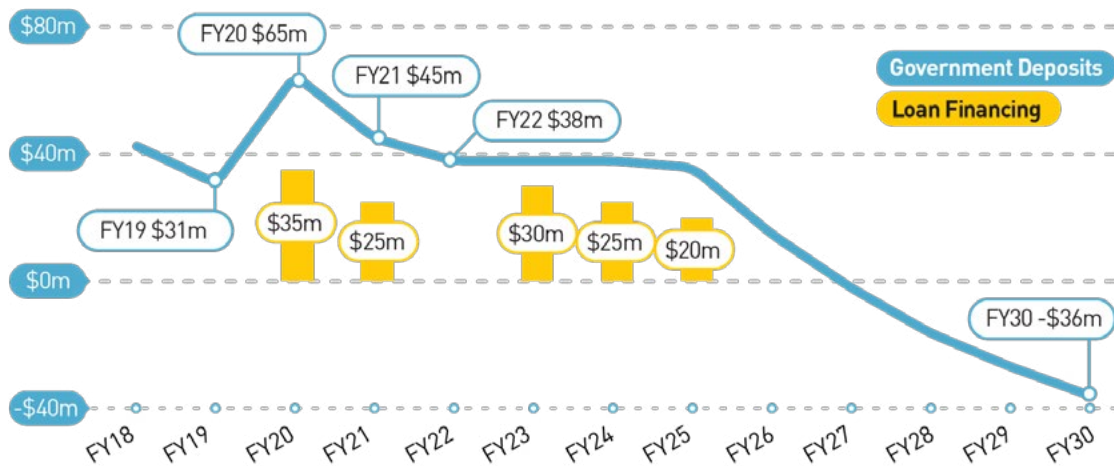
## Recent & Projected Macro-Fiscal Performance



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## Projected Fiscal Outturn

Baseline = Current Policies + Slow Tourism Recovery + \$45m Additional Loans (FY24 & FY25)



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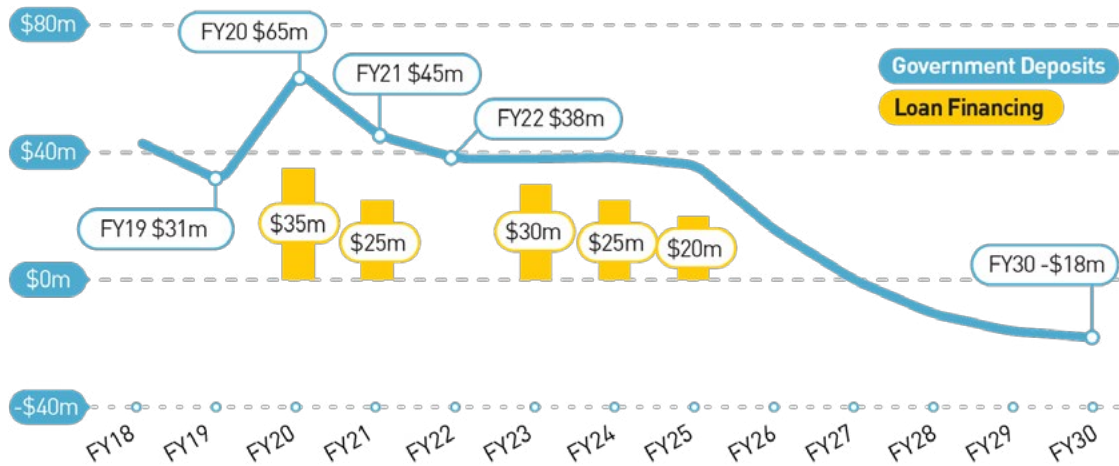
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## Projected Fiscal Outturn:

Baseline = Current Policies **FASTER Tourism Recovery** + \$45m Additional Loans



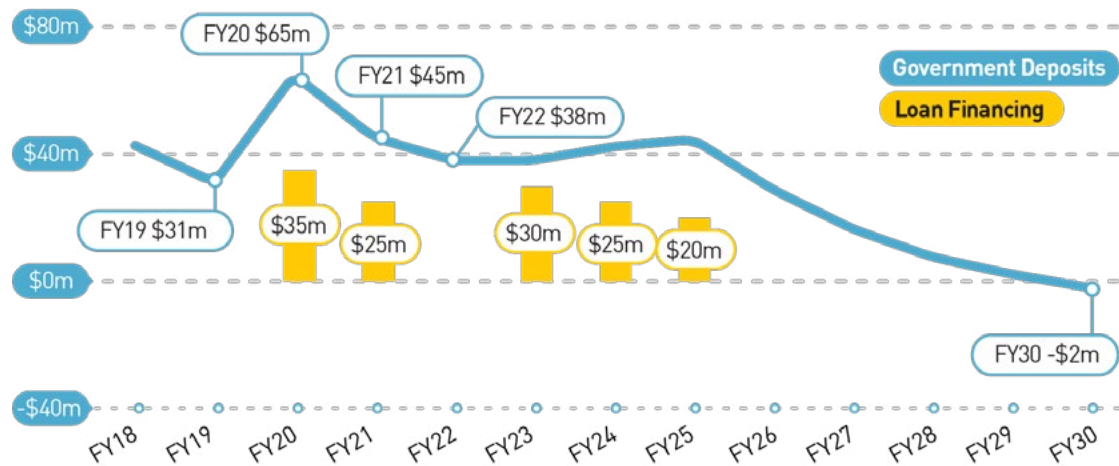
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## Projected Fiscal Outturn

Baseline = **Delay 2<sup>nd</sup> Pay** + Slow Tourism Recovery + \$45m Additional Loans



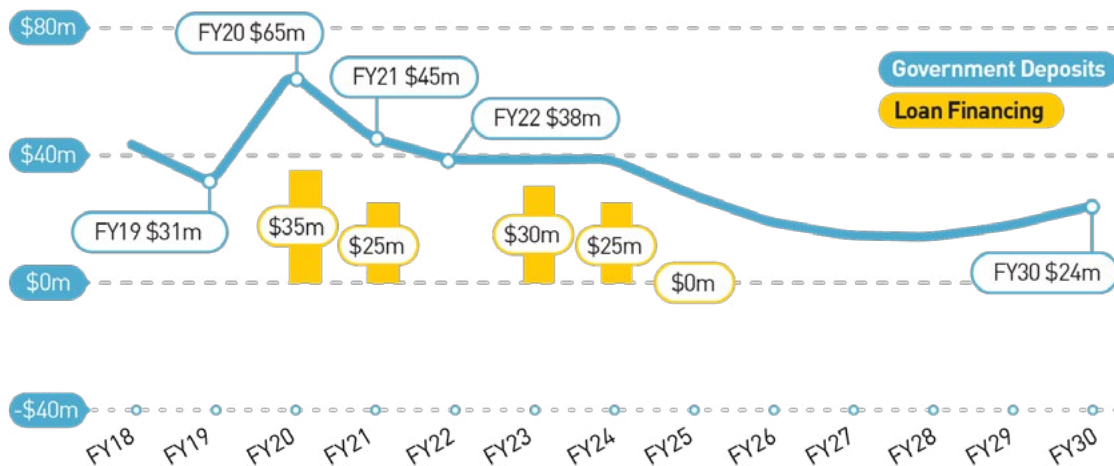
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## Projected Fiscal Outturn

Baseline = Current Policies + Slow Tourism Recov **\$25** **\$45m** Additional **Est FY25 Renewed**



\*Palau Country Focus: The Economic Impact of the End of Compact Grant Assistance, p.24-26, 2021 at <<https://pubs.pitiviti.org/palau-compact>>

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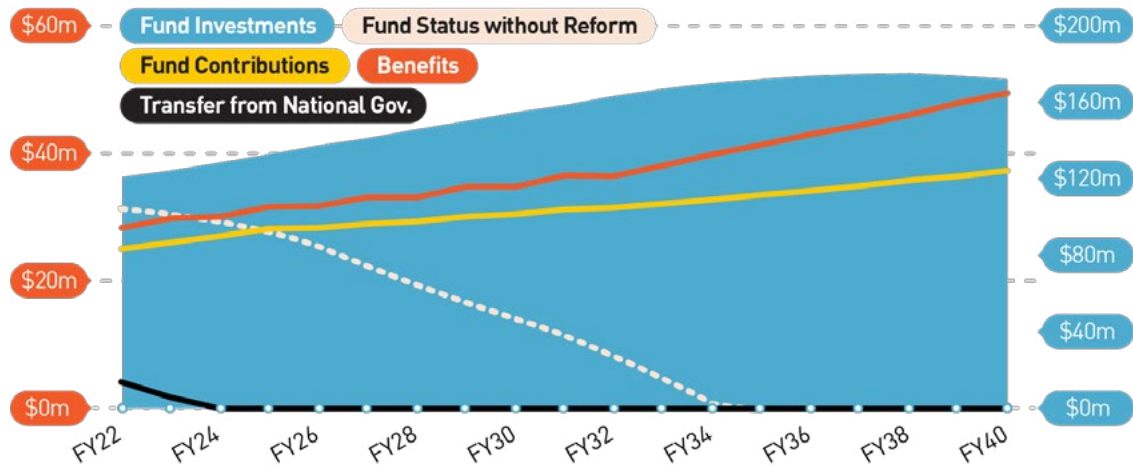


## 3. Social Security Administration



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# Social Security Administration



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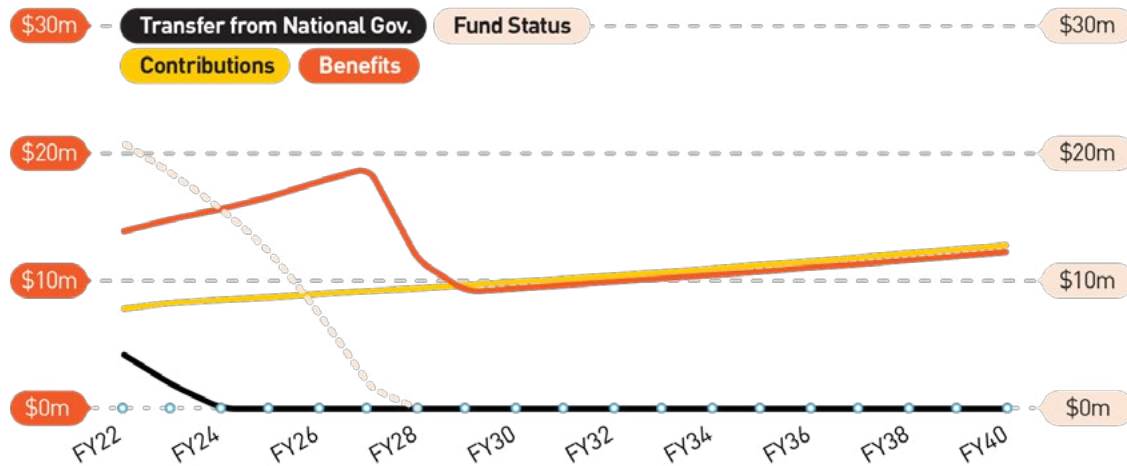
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## 4. Civil Service Pension Plan

## Civil Service Pension Plan



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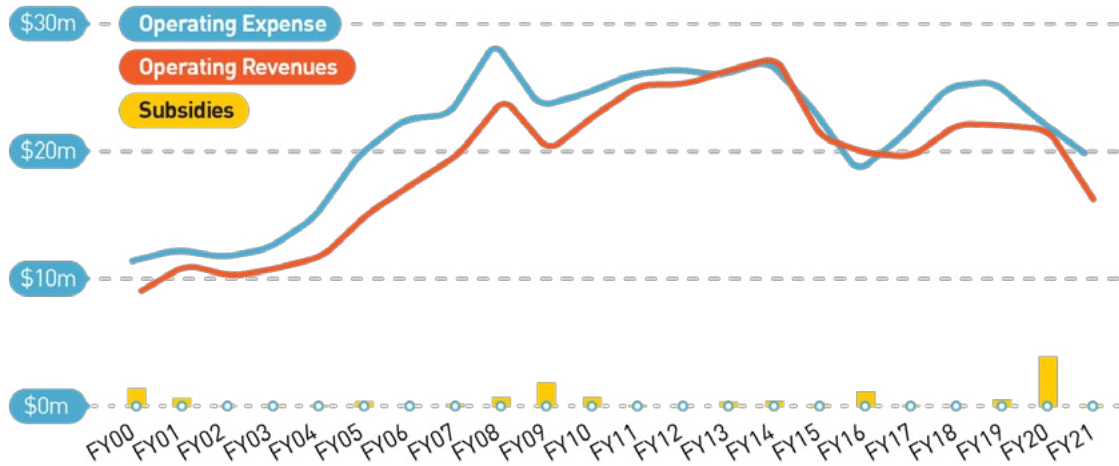
## 5. Public Enterprise Financial Risks



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## Palau Public Utility Corporation: Electricity

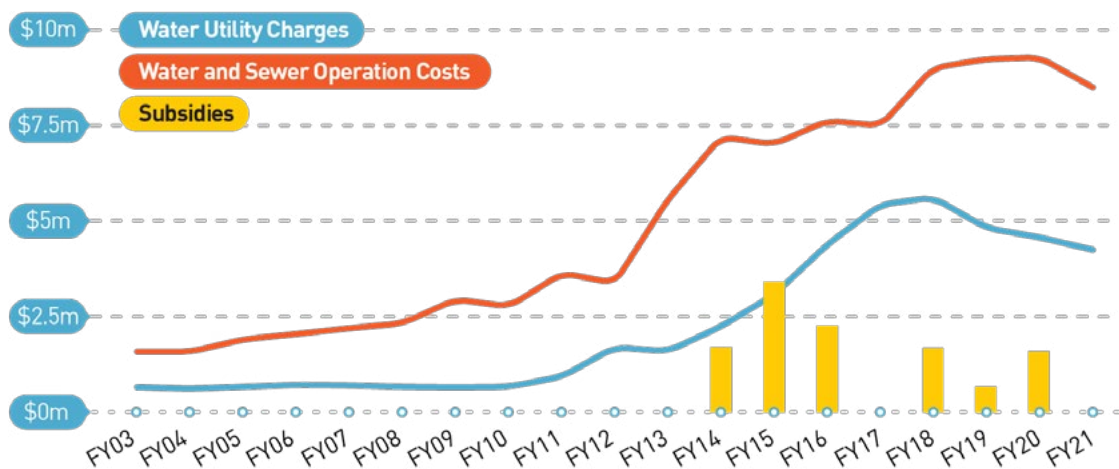


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## Palau Public Utility Corporation: Water & Sewer



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# QUESTIONS?

December 2022

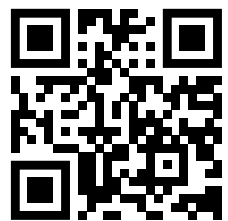
## Palau Economic Advisory Group Briefing (Fiscal Risks)



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 [palaueag.org](https://palaueag.org)