



Republic
of Palau



June 2019

ECONOMIC BRIEF

**PALAU
FY 2018**





1. Recent Economic Performance

Economic Performance

In FY2014 and FY2015 the tourism economy boomed, and GDP recorded a growth of 4.4 and 10.1 percent, respectively. In FY2016 the economy continued to grow by 0.8 percent despite a large drop-off in tourism as the forward momentum in the economy supported for growth from strong household demand in an election year. In FY2017 the economy contracted by a large 3.5 percent reflecting a drop in visitors from 146,629 to 122,050, a 17 percent reduction. In FY2018 the economy grew by 1.7 percent despite the continuing fall in visitors to 115,964. The outlook for the current year, FY2019, looks set to be a further large contraction as visitor numbers decline to less than 90,000.

In the tourism boom years, when the economy was clearly on the upswing, tourism was clearly the main driver of growth; However, capital investment was also a positive force. On the downside, not only did tourism demand negatively impact GDP but capital investment also failed to support growth of the economy. In FY2016 both household and public expenditures were positive forces in an election year that turned around what otherwise would have been a negative result. In the last two years all elements of demand were negative except for public expenditures which supported the economy in FY2018

Population and Income Levels

The population of Palau consists of Palauans and a large number of foreign workers, mostly Filipinos. Since 1986, the Palauan component of the population has grown by 0.2 percent, after allowing for external migration, reaching 12,890 in FY2015. The number of foreign residents has grown from 1,550 to 4,771 over the same period, reflecting the increased need for tourism-industry workers. GDP per capita has risen by 1.1 percent per annum since FY2000. Gross national income

attained a level of \$17,072 in FY2017, placing Palau in the World Bank's high-income group by exceeding their \$12,005 threshold.

Employment and Wages

The labor market in Palau is close to full employment, and Palauan employment has risen by 0.4 percent annually since FY2000. Nominal wages in the public and private sectors in Palau have grown by 2.3 and 2.6 percent, respectively, since FY2000 with public sector wages being 79 percent above those in the private sector. Real wages have declined marginally in the public sector, -0.1 percent per annum but grown by an average of 0.1 percent per annum in the private sector. Citizen wages are 52 percent above non-citizen wages with a majority of Palauan workers in the public sector and a majority of non-Palauans in the private sector.

In January 2017, the president submitted a bill to the OEK to raise the minimum wage from the current level of \$3.50 an hour by \$0.50 effective October 1, 2017, and to raise it by a further \$0.50 annually until reaching \$8.50 ten years hence. Since the introduction of the bill there has been no further action; however, if passed by the OEK the law would apply to all wage earners, Palauan and foreign. Currently the minimum wage in Guam is \$8.50, and the intent in the law is to attract Palauans working in the US to return to Palau. However, the new wage policy would likely have a significant negative impact on the cost of doing business in Palau.

Inflation

At the start of FY2015 the world economy entered a period of rapidly falling fuel prices, resulting in moderation in inflation in Palau to 2.2 percent for the year. In FY2016 these trends continued, but food prices were also declining resulting in negative inflation of 1.3 percent. However, these trends reversed in FY2017 with both food and fuel prices returning to positive territory, and the CPI recorded 0.9 percent for the year. FY2018 was a more normal year and the CPI rose by 2.0 percent with both fuel and food prices rising by over 4 percent. Overall the trends during the last 4 years, with prices rising on average less than 1 percent per annum, have helped moderate the cost of living.



2. Sector Issues

Tourism Developments

The rapid growth in tourism has presented special challenges to Palau. In FY2015, annual visitor arrivals grew by 34 percent and recorded a level of 168,767 visitors, an increase of 88,000 visitors above the FY2010 level. In FY2016, the number dropped back to 146,643, and again fell back to 122,050 in FY2017 and 115,964 in FY2018. Based on the first 7 months of data it is likely visitor numbers will drop back further to less than 90,000 in FY2019. The original increase in visitors was made possible by the large amount of excess capacity the nation had in tourist plant; occupancy rates increased from 38 percent in FY2010 to 61 percent in FY2015. The majority of the increase originated in middle-to lower-grade establishments with an associated large increase in package-tour visitors predominantly from China.

The large increase in visitors and improvement in occupancy rates encouraged additional construction in hotel plant. Coupled with the drop in arrivals through FY2018, the additional largely unoccupied plant led to a reduction in occupancy rates to 39 percent in FY2018. While the reverse in arrivals has been strongly associated with a contraction in the Chinese segment of the market, there have also been significant reductions in the more traditional, higher spending tourists.

The rapid increase in visitors had a significant impact on government revenues, but the marginal gain from low-spending visitors was less than the average. As a result, the impact on the economy on the upswing was less than the visitor numbers would infer, and on the downswing the impact of the loss was dampened. The fiscal surplus rose significantly as tourism boomed but was largely sustained through FY2018 despite the reduction in arrivals and falling occupancy rates. Even with the large drop forecast for FY2019 the fiscal position appears to have avoided running into deficit. The impact of the volatility of tourism on government revenues appears to have been less adverse than was anticipated: a favorable result.

Tourism Policy

Palau has adopted a policy to attract high-value tourists but has limited resources to implement the policy. As a result, tourist developments have been virtually unconstrained, and in an unregulated market, the economy has been subject to volatility and large swings in visitors. In 2015 Palau requested support from the ADB to assist with rationalization of the industry. The report endorsed the high-value concept and indicated the need for a comprehensive tourism strategy or master plan. This was further developed under a grant from the US Department of the Interior; however, that effort was limited to producing a Responsible Tourism Policy Framework. While the framework outlined important broad principles, it fell far short of a comprehensive strategy with specified and implementable actions. The need for a tourism strategy or master plan thus remains unfulfilled. Until a comprehensive approach can be developed, Palau will have limited options to mitigate the vagaries of market forces and to improve the likelihood of achieving its high-value tourism policy objectives.

Fisheries Policy and Marine Sanctuary

In October 2015 Palau passed the Palau National Marine Sanctuary bill which will preserve 80 percent of Palau's exclusive economic zone (EEZ) of 500,000 square kilometers as a protected area free from commercial fishing and exploitation. The reform will be executed gradually but the PMNS will be fully effective in January 1, 2020. Once implemented, the PMNS will be one of the largest protected ocean areas in the world.

Palau is currently a member of the Parties to Nauru Agreement, and thereby Palau benefits from the sale of vessel days to commercial fishing operators. While Palau's allocation of fishing days, or Party Allowable Effort, of about 600 days is small compared with other PNA members, fishing royalties have grown significantly in recent years and brought in \$8.5 million in revenues in FY2018. While Palau hopes to maintain the benefits of the PNA through sale of days to other members, other partners have argued that it is inconsistent with a fish conservation policy when it encourages an increase in fishing in other waters. Palau hopes that if it does, indeed, suffer a loss of fishing days, that the appeal as a conservation area will motivate demand for high value tourism to make up the short fall. However, to attract environmentally conscious visitors, Palau will need to control the mass package tour market that has dominated in recent years. In the interim, and



perhaps beyond, Palau also hopes it gains support from environmentally focused donors to offset any loss to its direct revenue base.



3. The External Sector

External Debt

Palau's external debt, at 32 percent of GDP, is low by regional standards. Debt service of 7 percent of national government domestic revenues has remained well within the capacity of the national government to service and does not present any threat of debt stress. However, large on-going ADB loans, the Koror-Airai Sanitation Project Phase I (\$28 million), the submarine-cable project for providing access to the internet backbone (\$25 million), a possible KASP Phase II (\$25 million), and two new loans including the forthcoming RoC housing loan (\$15 million) and possible 2nd backup fiber optic cable loan (\$25 million) suggest that Palau's debt profile should be monitored carefully for long-term sustainability.

All of the on-going and new loans are the liability of the national government but have been on-lent to the respective bodies. KASP I and possible KASP II will be serviced by the Palau Utilities Corporation, the existing submarine cable and possible backup cable will be serviced by the new Belau Submarine Cable Company, and the RoC loan will be on-lent and serviced by the National Development Bank of Palau. While the original cable project is already paying for itself there is strong justification for the 2nd fiber. However, there remains a risk that subsidies may be required in the case of the PPUC (especially if KASP II proceeds) depending on the pricing policy adopted, although PPUC is mandated to operate on a full cost-recovery basis. The new housing loan which includes funds for land subdivision in Babeldaob and loans to households may also require ongoing subsidies.

The debt-to-GDP ratio is projected to rise in FY2019 to 35 percent of GDP (excluding KASP II, which is now in deferred status) once KASP I and the original submarine cable loans are fully drawn down. If the new loans are

also fully utilized, then the debt to GDP ratio is likely to rise above 40 percent of GDP by FY2020. While much of the debt service will be covered by tariffs and fees, the increased liability that may be placed on the national government needs to be monitored. While the historically low external debt profile has provided Palau with significant space for future borrowing, this may well be approaching a desirable limit.



4. Fiscal Performance and Policy

The Fiscal Outlook

Palau has generally maintained a prudent fiscal policy. Between FY2005 and FY2013, it has recorded a fiscal balance in the range of -2.1 to +1.5 percent of GDP. With the onset of the economic recession in FY2008 and FY2009, the fiscal balance turned negative. However, since the recovery in FY2011, the government has recorded surpluses in each year. As the economy boomed in FY2014 a large surplus of 3.6 percent was recorded, with an even-larger surplus of 4.8 and 4.3 percent in FY2015 and FY2016, respectively. While the economy went into recession in FY2017, fiscal discipline was maintained, and a further surplus of 4.5 percent was attained. This fell to 2.5 percent in FY2018 with the continued economic weakness. By period end, government deposits had risen to \$43 million, up from a level of \$34 million five years earlier. Given the recent weakness in the economy this has been a favorable development.

Fiscal Responsibility and Fiscal Strategy

Under a recent technical assistance project supported by the ADB, a fiscal strategy was outlined for Palau. It was proposed that government consider enacting a fiscal responsibility framework in law. The principles of fiscal responsibility would commit Palau to manage fiscal risks prudently by applying five principles:

- Manage debt prudently;
- Manage the tax regime to best fit the structure of the economy and to allow for predictability over time;
- Manage capital expenditures to achieve rising national net worth over time;
- Manage reserves and insurance coverage to offset cyclical volatility, natural disasters and the impact of climate change; and
- Keep recurrent expenditures within available revenues over time.

Fiscal Challenges

Looking forward, despite the recent weaknesses, growth prospects and the fiscal outlook appear favorable. However, there remain significant potential fiscal shocks on the horizon:

- The collapsing reserve fund status of the Civil Service Pension Fund;
- The need to service the Koror-Airai Sanitation Project and other social loan repayments (requiring a potential substantial subsidy to the PPUC and NDBP); and
- The need to convert the current COFA Trust Fund from a sinking fund with a fixed nominal drawdown into a perpetual fund capable of supporting a reliable real distribution in perpetuity.

These elements are also identified in the fiscal strategy as requiring special focus.

Tax Reform

In 2013 tax reform efforts were initiated, with the main element being the introduction of the VAT. However, the proposal failed to gain sufficient votes in the OEK for passage into law. The VAT, now referred to as the Palau Goods and Service Tax, is ideally suited to Palau because a large part of the tax base falls on tourist expenditures. In FY2018 the tax base including household and tourist expenditures amounted to 99 percent of GDP, with tourist expenditures accounting for 40 percent. The introduction of The PGST has clear benefits in that a large part of the incidence of the tax falls on noncitizens. The tax-reform proposal also included introducing a net-profits tax. At present, business incomes, including those of tourist operators, are not taxed. After the failure of the 2013 tax reform initiative the proposal went on the back burner for several years. At the start of 2018 it once again came

under active consideration, and updated versions of the tax reform bills were prepared with IMF support. However, the renewed interest by mid-2019 appears to have stalled, perhaps influenced by national elections looming in November 2020.



5. Public Financial Management

Public Expenditure and Financial Accountability

In March 2013, Palau invited the Pacific Financial Technical Assistance Center (PFTAC) to assist the nation in the preparation of a Public Expenditure and Financial Accountability (PEFA) self-assessment. The PEFA is a framework for the assessment of public financial management (PFM) developed by the World Bank and a group of international donors. It has been implemented in many countries and provides an objective yardstick by which countries can assess and improve their PFM performance. The next stage in the PEFA process is for Palau to undergo a formal external assessment: this is planned for 2019. With the external assessment complete, Palau will be eligible to request that PFTAC assist in the preparation of a road map to improve their PEFA score. The PEFA provides a desirable and objectively verifiable method to assess reform effort over time. Palau has been making slow progress but may very well make more rapid progress once a fully specified road map is adopted.

Financial Management Information Systems

The FMIS in Palau is nearing the end of its effective life as the responsible software company is no longer operational. A replacement system is actively being pursued, and resources from the Compact Review Agreement have been allocated for this purpose. While it is self-evident that the replacement system must

have adequate capacity to support accounting and audit requirements, the system update also provides a valuable opportunity to upgrade reporting of fiscal statistics and support for budgeting and performance management including output delivery.

Public Sector Payroll

Recent trends in government payroll indicate a slight increase in equivalent person-years of 0.2 percent per annum between FY2005 and FY2018. Hourly rates of pay (including benefits) have risen from a level of \$8.92 per hour to \$12.74 an average annual growth rate of 2.8 percent; however, once the cost of living as measured by the CPI is factored in, real government wages have fallen by an average annual rate of 0.4 percent since FY2005. The total cost of government's payroll has risen by an annual average rate of 2.9 percent, but payroll costs have remained largely unchanged as a share of total expenditures. In relation to GDP, government payroll has fallen from 20 percent in FY2000 to 15 percent in FY2018. In effect government policy has been to stabilize payroll costs as a share of public expenditures, but to reduce the overall size of government relative to the economy over time: a welcome and favorable outcome.

Submarine Cable Company (BSCC). The provision of airport operations remains, however, a government department, as is the Post Office, and the port is owned by Koror State but operated by a private company under a 25-year concession. The operation and upgrade of the airport terminal will be contracted to a public private partnership (PPP) through JICA and a private Japanese corporation.

There is no legal framework to support the commercial operations of the sector, and unsurprisingly the sector performs poorly¹. Board members are political appointees and may lack experience in the functions of the SOE. SOEs are not required to operate on a commercial basis (except notionally for water) and prices are set at "affordable" rather than commercial rates. There is no monitoring mechanism of the sector and corporate planning is weak. As a result, maintenance is often insufficient and excessively deferred, resulting in disruption of services and, ultimately, in higher capital costs.

In 2014 the President issued an SOE policy with a primary objective that SOEs should operate as successful businesses and recover all their costs, including the costs of capital. A set of policy principles were outlined to support the primary objective: specification of community service obligations (CSOs), appointment of qualified directors excluding political appointees, preparation of annual performance targets, and performance monitoring and benchmarking, to name a few. The policy statement was well specified and would have greater effect if enacted into law.



6. State Owned Enterprise Reform

The SOE Sector

The SOE sector in Palau is not large in number of entities, in comparison to other Micronesian economies. There are four major SOEs of which one has been newly created: the Palau National Communications Corporation (PNCC), the Palau Public Utilities Corporation (PPUC), the National Development Bank of Palau, and the new addition, the Belau

Reforms in the Water and Sanitation Sector

Under the ADB Water Sector Improvement Program (WISP) provision of water and wastewater functions, formerly provided through a government department, were merged with the PPUC. A key element under the WISP was the provision of services at full cost recovery, and significant price increases have been achieved. A recent ADB review has studied the operations of PPUC including power and proposed a new tariff structure. A second ADB supported program in the sector, the Koror-Airai Sanitation Project (KASP \$28 million), entails substantial upgrading of infrastructure with the possibility of a second phase to complete the task (\$25 million). The KASP projects will result in significant increase in tariffs—in line with improved services—if

1 Private Sector Assessment (PSA) of Palau: Policies for Sustainable Growth Revisited: A Private Sector Assessment for Palau, the Pacific Private Sector Initiative, Sydney, Australia, 2017.

full cost recovery is to be achieved. Current projections (based on the tariff study) suggest tariff increases of 34 and 28 percent, respectively for the two phases accumulating to a total of 63 percent. In the absence of a firm commitment to raise tariffs, which have already risen significantly, the sanitation projects pose a significant risk to fiscal stability.

ICT Reforms

Reforms in the Telecom sector have progressed positively with the creation of the Palau Submarine Cable Company, an SOE created to manage a new fiber optic link to the internet backbone and funded through a loan from the ADB. Palau has partnered with the SEA-US cable project linking Indonesia, the Philippines, Palau and Yap to Guam, Honolulu and the US mainland. Laying of the cable was commissioned at the end of 2017 and is now complete. ICT services had been very poor in Palau with some of the highest prices in the Pacific region resulting in a "repressed" market, i.e. where demand is kept artificially low due to high pricing.

The implementation of the new fiber has resulted in considerable improvement in the quality of internet access and prices have fallen significantly. With currently over 3,800 fixed line and digital tv subscribers, and about 3,000 residential internet users, the market is nearing saturation. The major challenge for PNCC going forward will be to penetrate the remainder of the consumer market, introduce new products and tariffs in the business segment and for tourists while reducing cost.

The second phase of ICT reform was the passage into law at the end of 2017 of a Telecom reform bill, supported by the World Bank. The new law enables competition in the marketplace and removes the monopoly and protected position held by the existing provider, the Palau National Communications Corporation. The law also creates a new regulatory bureau in the Ministry of Infrastructure, Industries and Commerce, which will regulate the sector and issue licenses to potential new entrants, although there is a moratorium on new entrants for a period of two years.

A major concern for the PUC has been the legacy loan incurred to finance the old copper and satellite-based telecom infrastructure. The remaining debt and high finance cost have disadvantaged the PPUC to engage in a deregulated competitive marketplace. The government is currently under negotiation with the ADB to refinance the RUS loan with expectations for sector reform. A further issue under debate has been the possibility to build a second fiber connection to

enable Palau to guarantee continuous, disruption-free internet service. The financing costs appear comparable with that currently being paid for expensive satellite bandwidth, although that cost is likely to fall for any subsequent contract renewal. While there appears to be a strong business case for the 2nd fiber, it needs careful evaluation with realistic prices for ongoing satellite-based service-continuity protection.



7. The Financial Sector

Banking

The deposit base in the Palau banking system (\$283 million in FY2017) has grown very rapidly in the tourism boom period FY2011-FY2016 reflecting the booming economy, foreign direct investment, and land lease purchases. However, lending performance to the private sector has been weak and represents only 13 percent of the deposit base, probably the lowest in the region. The resulting surplus liquidity, now over \$254 million, is invested offshore in low yielding assets. The low rate of domestic lending reflects the perceived high risk of lending in Palau and a persistent perception of a "lack of bankable projects." Overall, the inability of businesses to prepare credible business plans and financial statements, lack of collateral, the limited ability to use land as security, and inadequate provisions to secure transactions have inhibited development of the financial sector. With limited opportunities, foreign commercial banks, coming under FDIC insurance and banking regulation, have preferred to invest their assets offshore in less risky and more secure markets.

Social Security Sustainability

The accrued liability of the Social Security system at the time of the last actuarial report in 2015 was \$268 million. The value of the assets of the fund was \$91 million indicating an unfunded liability of \$177 and a funded ratio of 34 percent. Despite the relatively low ratio

compared with other social security funds in the region, the system is in a favorable position looking forward.

In recent years the Social Security system has undergone a series of reforms and adjustments to increase benefits and to maintain sustainability. In 2013 taxable earnings were raised from \$5,000 to \$8,000 effective October 2017. The retirement age of 60 was raised to 62 as of October 2015 and will be raised to 63 from October 2020. Other significant financial changes include an increase in the basic benefit from \$98 per quarter to \$148. As part of the FY2017 budget an additional benefit of \$50 per month was awarded to beneficiaries and the government transferred \$2 million to support the payment. At the start of 2018 the 6 percent contribution rate for both employees and employers was raised to 7 percent to pay for the increase and the cap on taxable wages was removed. While these changes significantly improved the sustainability of the fund, a further monthly benefit of \$50 was awarded in 2018 coupled with a \$2 million transfer to cover the additional cost, a cost that will be required annually in the FY2019 budget and thereafter. Our projections indicate that the Social Security system is now on a sustainable basis, but that a careful actuarial assessment is required using Palau demographic and "experience" data to replace the current use of US life tables.

Civil Service Pension Fund

The Civil Service Pension Fund (CSPF) presents a significant risk to government. With an accrued net pension liability currently close on \$260 million, fund assets are a mere 10 percent of liabilities. Without reforms the CSPF is projected to collapse before 2030 and require \$7 million in annual support thereafter. Overtime the deficit is projected to rise as benefits are projected to exceed contributions.

Various remedies have been enacted and proposed. The mandatory retirement after 30 years of public service has been removed. The CSPF has proposed raising contributions from employers and employees from the current 6 percent to 10 percent each, but this seems an impossibly large increase. As part of the marine-sanctuary bill passed in 2015, the law provided for a further \$50 increase in the Pristine Paradise Environmental Fee, of which \$25 was to be devoted to the CSPF. The marine sanctuary act was subsequently revised and in order to maintain compliance with IATA rules, the \$25 reserved for the CSPF was reallocated to the Palau International Airport. However, the law also stated that monies that otherwise would have been appropriated for the PIA would be transferred to the

CSPF. An actuarial study and reform proposals have been called for, but the future of the CSPF remains highly uncertain.

As a general principal it would not be appropriate to use broad tax policy (although the PPEF is levied on non-citizens) to fund expenditures related to civil servants. More appropriate would be an increase in contributions or adjustment to benefits. However, the proposed rate increase is large and perhaps a combination of both might be more appropriate. Less desirable has been changes in law creating a 4 percent remittance tax on transfers to be earmarked for the fund. This tax is not applicable to commercial-bank transfers, acts as a tax on money-transfer agencies, and is effectively a distortionary tax on low-income foreign workers. In FY2018 the tax provided \$0.4 million to the fund and although the CSPS needs every penny it can get; the tax is inequitable, inefficient and, over time likely to be avoided through alternative transfer methods.



8. Private Sector Development

The World Bank's Doing Business Survey

The World Bank's ease-of-doing-business survey indicates that Palau ranks 133rd out of the 190 countries surveyed, in the bottom 1/3rd, and suggests there is considerable room for improvement. Palau fares better than the FSM and RMI, which are ranked 160th and 150th, respectively, but is substantially below most of the South Pacific nations. Overall, Palau's scores are generally weak, but ranks in the bottom 1/3rd in starting a business, getting electricity, protecting investors, trading across borders, and resolving bankruptcy.

Land Tenure

Land issues have long been identified as a significant constraint to private sector development in Pacific nations, and Palau is no exception. Land may only be

owned by Palauan citizens and is owned by individuals, clans, and the government. A particular issue arises that foreign-owned financial institutions cannot secure mortgages on land or land leases in the event of default since foreign institutions are not entitled to ownership. In effect the only institution that can issue mortgages against land or land leases is the National Development Bank of Palau. Lease terms can be issued up to 99 years, and limited duration is not a problem. The lack of effective land-use planning in Palau is a serious weakness. This is especially so in a tourism-based economy, where the major means to effective implementation of policy and attainment of the high-value tourism objective would be supported through efficient land-use planning.

The Regulatory Environment

Palau's regulatory environment is based on its constitution, customary law and common law as applied in the United States and has no Uniform Commercial Code (UCC) or equivalent. The PSA review indicates that the current Companies Act is not suited to modern commerce, and the company registry is functioning poorly. The law contains only guidelines, with important details delegated to the regulations. Palau has draft legislation for a new reformed Companies Bill, which creates a modern electronic framework, but this has yet to be considered by the OEK.

A large number of requirements, permits, and licenses are required for a business to be allowed to operate in Palau. Many of these problems will be reduced through centralizing the system into a "one stop shop" that has been recommended and adopted in many jurisdictions. The former finance buildings in Koror are being rebuilt for this purpose. Creation of the electronic corporate registry, and administrative merger of the different agencies currently granting approvals into one office would greatly simplify the process. Finally, Palau lacks a bankruptcy statute. The current system protects neither debtors nor creditors. The proof of debt is long and complicated, and legal practitioners are required. There are no systematic means by which debts can be discharged, and many individuals have no means of getting out of debt.

Foreign Direct Investment

Palau operates an old-style foreign-investment board approach to FDI regulation, which imposes a range of bureaucratic restrictions and requirements. The law has been recently amended to provide powers to the board to control "front" businesses: businesses owned

by Palauans but operated by noncitizens. The original law, with a wide range of onerous requirements, was weakly enforced and encouraged the creation of fronts. However, whether the new law, which remains highly prescriptive, will result in improved quality and quantity of foreign investment remains to be seen.



9. Compact Issues

Compact Renewal

Near the end of FY2010 Palau signed the Compact Review Agreement (CRA) with the US. Subsequently the agreement was submitted to the US Congress, where it remained, for eight years, awaiting approval. During this period Palau received funding at the nominal level prevailing in FY2009 through discretionary annual continuing appropriations. At the start of 2018, the U.S. Congress authorized and appropriated funds to finance the CRA, based on the total funds agreed to in the CRA less those expended on continuing appropriations during the intervening years. The funds, \$123.8 million, were provided as a lump sum to be allocated as determined by the original parties.

The terms originally specified in the CRA were for continuing current grant assistance, although at a declining level. Additional resources were provided to support the Compact Trust Fund, infrastructure maintenance and capital projects. By way of a mutual agreement between the U.S. and Palau, the remaining funds have been allocated, for the most part in the spirit of the schedule outlined in the original CRA. It is understood that an additional allocation was diverted from lower priority uses and provided to support the Compact Trust Fund to support Palau's long-term intent to establish a perpetual fund.

A new feature of the CRA was the creation of an advisory group comprising five members: two nominated by each country and one chosen by mutual agreement. The purpose of the advisory group is to contribute to the long-term economic sustainability



of Palau by recommending economic, financial and management reforms. Considering the success in Palau in generating improved information and statistical flows and also considering Palau's generally good performance in terms of fiscal accountability, the government may request that the advisory group's mission and intent be rolled into the bi-lateral annual consultations—also specified in the CRA.

The Palau Compact Trust Fund

An enlightened feature of the original Compact was the creation of a trust fund. The CTF was intended to provide \$5 million annually from FY1999 to FY2009 and then \$15 million annually for government operations through the Compact's 50th year in FY2044; this approach differs from the Trust Funds created later for the amended Compacts with the FSM and RMI. Those sister Freely Associated State Trust Funds were designed to provide a perpetual source of fully inflation-adjusted distributions. Moreover, original projections were based on the CTF achieving an unlikely annual return of 12.5 percent. As it turned out, the CTF achieved a 7.47 percent return through FY2009. This result was actually slightly better than the blended benchmark market rate of return of 7.32 percent over the same period; however, based on projections made at the end of FY2009 the CTF would have failed by FY2022, long before fulfilling the Compact objective of providing level funding through all 50 years (FY2044).

As a result of the required Compact Section 432 Review, an agreement was reached to renew the economic-assistance terms of the Compact, to reduce planned withdrawals and to deposit additional funds into the CTF over the period FY2010–FY2024. For the purposes of the Section 432 Review the forward projections for annual investment returns were made using a 5.5 percent growth rate. Using that rate of return, the \$293.3 million value of the fund at the end of FY2018, including a CRA deposit of \$62.5 million near the end of the fiscal year, current projections indicate that the CTF will achieve its original objective and persist well beyond FY2044. Still it should be noted this implies a continual decline in the real value of transfers over the remaining period of the Compact. Taking market volatility into account, there remains a 5 percent chance the CTF will fail prior to FY2044 and the value of the CTF corpus is declining in roughly 40 percent of cases through FY2044.

Post Compact Review Period Uncertainties

The term of the CRA will expire at the end of FY2024 and further funding thereafter will be provided from distributions from the Compact Trust Fund. However, there is some uncertainty over the continuation of many of the federal programs and services Palau currently benefits from that are provided through annual Congressional appropriations. The range of major programs in the Compact includes: Postal Services, FDIC, NOAA, Pell grants, FAA, education, health programs, etc., which are subject to periodic Congressional authorization and annual appropriations. While the shortfall in distributions after FY2024 from the creation of a perpetual Compact Trust Fund is estimated to be \$5.8 million, the range of possible loss of Federal programs may, in the worst case, add a further \$16 million or more to the size of potential fiscal adjustment. In the remaining years of the amended Compact through FY2024, clarity is required on the status of these programs so that Palau can effectively plan for the post-FY2024 Compact period.



10. Economic Outlook

Improvement in outlook expected in the near-term

The period of weak economic performance experienced since the tourism boom is expected to continue in FY2019 as visitor arrivals are expected to decline by 25 percent to less than 90,000 and GDP is projected to drop significantly. However, economic growth is projected to resume during the next 5 years as the tourism industry recovers and occupancy rates return to normal. With occupancy rates returning to 50 percent, the average attained during FY2012–FY2016 period, visitor numbers would reach 165,000 in FY2024, but still below the peak level attained in FY2015.

A variety of construction projects are also planned for this period including the \$30 million airport renewal

PPP, the \$15 million Japanese funded landfill relocation project, \$20 million CRA infrastructure projects, and completion of the KASP I sewer and wastewater project. A variety of smaller projects are also anticipated including a new conference center, Angaur dock and visitor sites. Reflecting the assumptions that: (i) the private sector is able to obtain positive returns on the recent investments, (ii) the number of flights expands with new services as carriers have proposed, and (iii) the projected surge in infrastructure projects, growth is projected to average 4.5 percent through the end of the CRA period. No doubt there will be annual variation characteristic of a small economy like Palau, but prospects looks favorable.

inflation and incomes is less favorable as per capita real incomes fall by an estimated 5 percent to pay for the additional resource allocation to fund the reforms. However, the financial position of the nation is considerably improved: the CTF becomes perpetual, the CSPS is stabilized, the nation's infrastructure is improved, and fiscal policy has been protected against cyclical volatility. The nation would have implemented an economical efficient tax regime. Overall, the impact of adoption of the fiscal strategy on public sector financial wealth is estimated to improve significantly by over 25 percent. The tradeoff is the classical one between resource mobilization in the near term to support enhanced economic growth versus policies that will provide greater benefit to future generations.

Reforms needed to consolidate the fiscal challenges

A reform scenario based on the fiscal responsibility framework and related fiscal strategy is developed² to redress the long-run fiscal risks under the of the current policy environment:

- **Tax reform.** Palau implements a comprehensive tax-reform strategy in FY2021.
- **Perpetual COFA Trust Fund.** Drawdowns from the CTF are reduced in FY2021 and thereafter maintained at the real rate of FY2021 allowing for a stable and secure level of funding on a perpetual basis.
- **Civil Service Pensions Fund reform.** Government allocates additional transfers from the PPEF to the CSPF together with an increase in employer and employee contributions.
- **SOE reform:** Government adopts the KASP I project requirement of full cost recovery and further implements KASP II with a Community Service Obligation (CSO) to address impact on vulnerable households.
- **Infrastructure Development.** Commitment is made to maintain national government infrastructure spending as a fixed proportion to GDP.
- **General Fund Reserve.** The GFR is restructured to maintain the reserve at a specified ratio to domestic revenue.

The impact of the reforms on the real economy, GDP and employment, is projected to be minor with little variation between the "baseline", that is before reform, and the reform scenario. However, the impact on



11. Other Issues

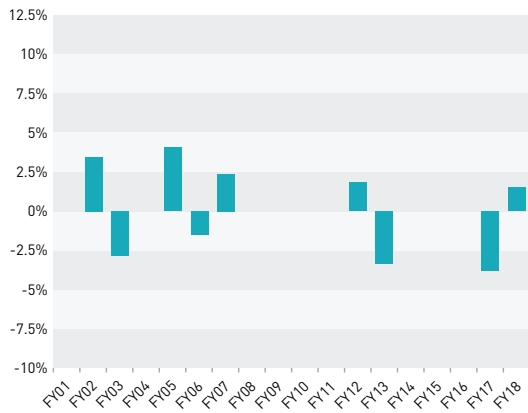
Statistical Issues

Statistical availability in Palau can now be accorded a high score. After a period of weak and deteriorating availability of macroeconomic data, Palau now has a comprehensive range of economic statistics through which to monitor economic performance: GDP by production and expenditure in current and constant prices, employment, wages, consumer prices, banking, balance of payments and GFS statistics. An initial set of economic statistics is available by the end of March and final estimates are available after completion of the annual audits at the end of June. Current weaknesses exist in the lack of a comprehensive business survey to estimate private sector value added, and provision of producer prices to estimate the constant price series. Efforts to integrate the statistical system through data base management to improve integrity and consistency are largely complete. Quarterly GDP estimates—a priority of international institutions—are also under consideration. Staffing levels have improved considerably, and progress is being made with capacity building.

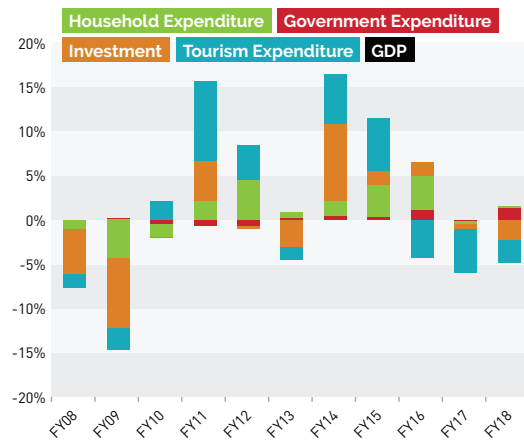
² See Palau Economic Review FY2018, forthcoming.



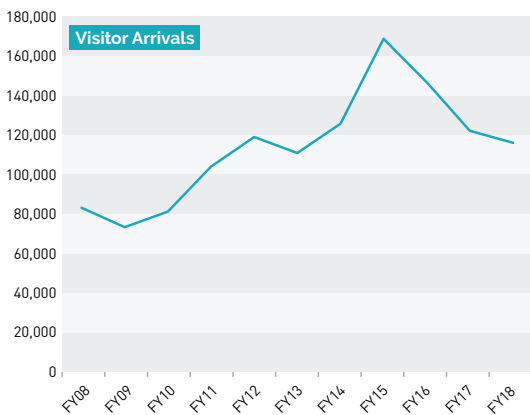
Palau experienced strong growth in FY14 and FY15 with booming tourism industry, but **GDP Growth** faltered in FY16, declined strongly in FY17 and remained weak in FY18



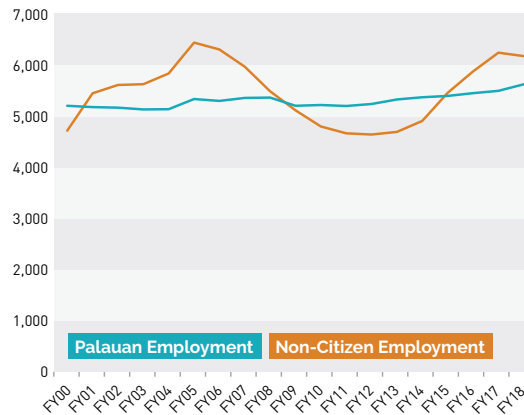
Tourism and investment **Main Drivers** of economic Growth.



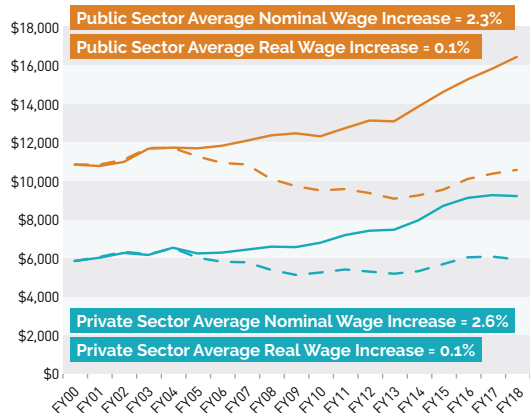
Strong growth in **Visitor Arrivals** through FY15, but large downturn in FY16 through FY18.



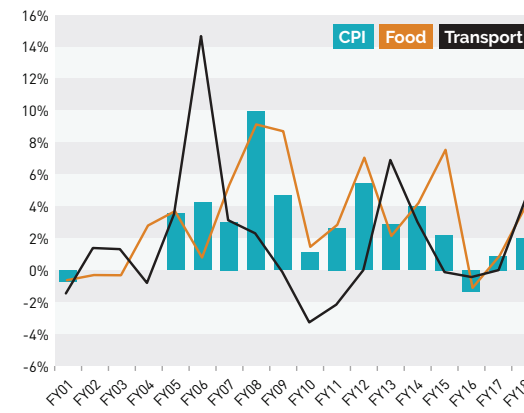
Labor market operates at **full employment** for Palauans with non-citizen employment adjusting to demand.



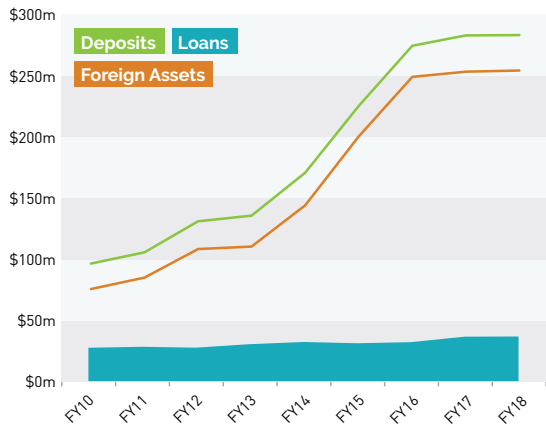
Real Wages improve since the tourism boom and low inflation public/private sector wage differential remains large.



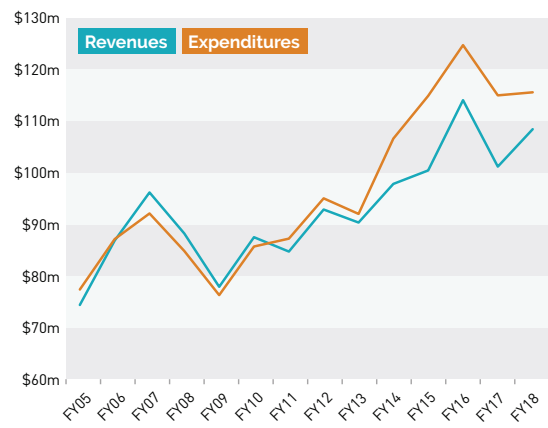
Inflation remains modest averaging 0.9 percent during the last 4 years.



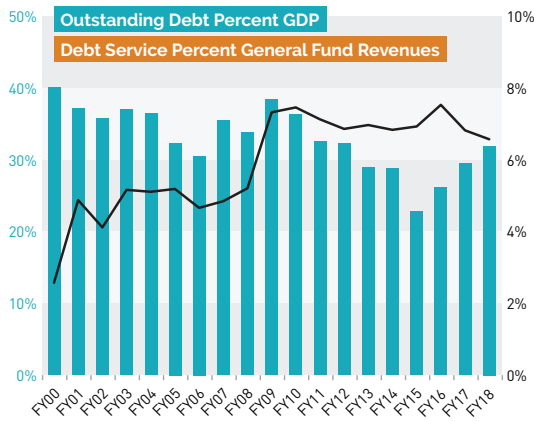
Commercial bank lending remains very weak; funds invested offshore; deposit growth has stabilized since FY17.



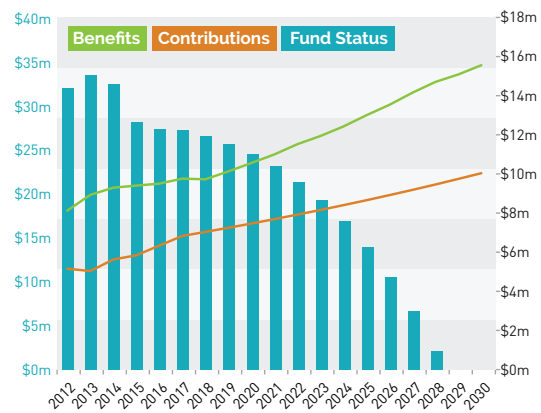
Palau generates large fiscal surpluses as tourism industry booms, and maintained in the last few years despite drop off in the economy.



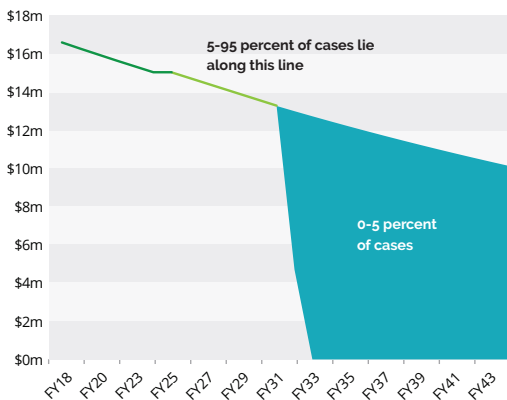
External Debt low as % of GDP but is rising.



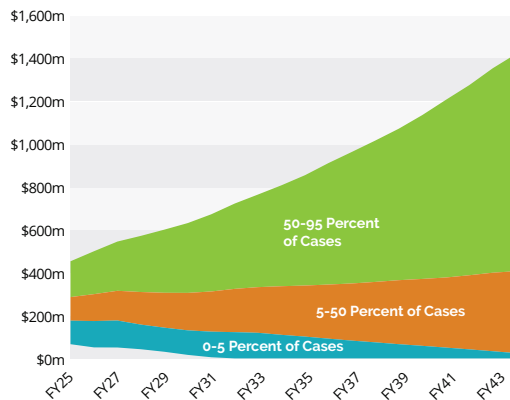
Palau Civil Service Pension Fund projected to collapse in FY28 when fund converts to pay-as-you-go scheme.



Following COFA rules, Compact Trust Fund distributions decline in real terms and have a five percent chance of failure through FY2044.



Following COFA rules, the Compact Trust Fund corpus declines in real terms in roughly forty percent of cases through FY2044.



Palau summary economic indicators, FY2010-FY2018

	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18
Per Capita Income measures									
GDP current prices, \$ million	185,923	196,665	212,097	220,723	241,336	281,472	297,142	282,158	277,787
Population	18,288	17,946	17,611	17,400	17,359	17,661	17,884	17,901	17,536
GDP per capita \$	10,166	10,958	12,043	12,686	13,902	15,937	16,615	15,762	15,841
GNI per capita \$	11,026	11,867	13,074	13,801	14,960	17,194	18,058	16,805	17,072
GNDI per capita \$	12,942	13,809	15,068	15,852	17,144	19,068	19,824	18,424	19,557
National accounts									
GDP, at constant FY2015 prices, \$ million	230.8	246.1	250.6	242.2	255.6	281.5	283.1	272.3	276.4
GDP, % growth	0.3%	6.6%	1.8%	-3.3%	5.5%	10.1%	0.6%	-3.8%	1.5%
Prices (annual percent change)									
Consumer price index	1.1%	2.6%	5.4%	2.8%	4.0%	2.2%	-1.3%	0.9%	2.0%
Employment and Wages									
Number of employees	10,095	9,939	9,953	10,096	10,357	10,938	11,416	11,832	11,896
% change	-2.9%	-1.5%	0.1%	1.4%	2.6%	5.6%	4.4%	3.6%	0.5%
Private sector	5,238	5,243	5,402	5,579	5,766	6,184	6,631	6,896	6,961
% change	-5.3%	0.1%	3.0%	3.3%	3.4%	7.2%	7.2%	4.0%	0.9%
Public sector	3,756	3,665	3,622	3,675	3,739	3,743	3,843	3,954	3,985
% change	0.7%	-2.4%	-1.2%	1.5%	1.8%	0.1%	2.7%	2.9%	0.8%
Other	1,100	1,031	929	842	852	1,012	943	981	950
Palau citizens	5,260	5,241	5,280	5,369	5,412	5,440	5,492	5,539	5,669
Foreign workers	4,834	4,699	4,674	4,727	4,945	5,499	5,924	6,293	6,227
Average annual wage	8,494	8,870	9,189	9,265	9,961	10,334	10,858	11,125	11,356
% change	1.7%	4.4%	3.6%	0.8%	7.5%	3.7%	5.1%	2.5%	2.1%
Private sector	6,815	7,209	7,443	7,495	7,986	8,722	9,143	9,280	9,226
% change	3.4%	5.8%	3.2%	0.7%	6.6%	9.2%	4.8%	1.5%	-0.6%
Public sector	12,317	12,736	13,135	13,089	14,277	14,621	15,274	15,827	16,441
% change	-1.2%	3.4%	3.1%	-0.4%	9.1%	2.4%	4.5%	3.6%	3.9%
Palau citizens	10,685	11,026	11,274	11,183	12,015	12,428	13,123	13,714	13,826
Foreign workers	6,110	6,465	6,834	7,086	7,712	8,262	8,757	8,847	9,107
Average annual real wage (less inflation)	10,044	10,219	10,041	9,844	10,180	10,334	11,003	11,175	11,188
% change	0.6%	1.7%	-1.7%	-2.0%	3.4%	1.5%	6.5%	1.6%	0.1%
Government Finance Statistics, (\$ million)									
Revenue	85.7	87.2	95.0	92.0	106.6	114.9	124.7	115.0	127.0
Tax revenue	31.2	34.7	39.0	41.4	47.0	56.6	59.1	56.9	60.6
Grants	49.6	46.0	48.2	41.9	47.1	43.7	49.3	37.3	49.8
Other revenue	4.8	6.6	7.9	8.6	12.5	14.6	16.3	20.7	16.5
Expense	-67.4	-70.2	-75.4	-80.6	-86.8	-87.0	-97.2	-92.8	-103.7
Compensation of employees	-33.4	-34.3	-34.8	-35.9	-36.1	-37.6	-41.0	-42.9	-43.4
Use of goods and services	-19.0	-20.2	-21.9	-22.6	-24.6	-24.4	-25.9	-25.1	-26.9
Other expense	-15.0	-15.7	-18.7	-22.1	-26.1	-24.9	-30.4	-24.8	-33.4
Net Worth and its Changes	-18.3	-17.0	-19.6	-11.4	-19.8	-27.9	-27.5	-22.2	-26.2
Nonfinancial assets	-20.1	-14.5	-17.4	-9.7	-11.0	-13.5	-16.8	-8.4	-4.7
Financial assets	-7.1	3.8	-10.1	6.1	-9.7	-9.4	-27.8	-18.4	-32.0
Financial liabilities	8.9	-6.3	8.0	-7.8	0.9	-5.0	17.2	4.6	10.5
Overall fiscal balance	-1.8	2.5	2.2	1.7	8.8	14.4	10.7	13.8	18.5
(In percent of GDP)									
Revenue	46.1%	44.4%	44.8%	41.7%	44.2%	40.8%	42.0%	40.7%	45.7%
Taxes	16.8%	17.6%	18.4%	18.8%	19.5%	20.1%	19.9%	20.2%	21.8%
Domestic revenues	26.7%	23.4%	22.7%	19.0%	19.5%	15.5%	16.6%	13.2%	17.9%
Grants	2.6%	3.3%	3.7%	3.9%	5.2%	5.2%	5.5%	7.3%	5.9%
Expense	-36.3%	-35.7%	-35.6%	-36.5%	-36.0%	-30.9%	-32.7%	-32.9%	-37.3%
Compensation of employees	-18.0%	-17.5%	-16.4%	-16.3%	-15.0%	-13.4%	-13.8%	-15.2%	-15.6%
Use of goods and services	-10.2%	-10.3%	-10.3%	-10.2%	-10.2%	-8.7%	-8.7%	-8.9%	-9.7%
Non Financial Assets	-10.8%	-7.4%	-8.2%	-4.4%	-4.6%	-4.8%	-5.7%	-3.0%	-1.7%
Overall fiscal balance	-1.0%	1.3%	1.0%	0.8%	3.6%	5.1%	3.6%	4.9%	6.7%

Palau summary economic indicators, FY2010-FY2018 cont'd

	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18
Depository Corporations Survey (\$ million)									
Net foreign assets	75.4	84.7	108.1	110.2	143.9	200.3	249.1	253.3	254.2
Domestic claims	18.0	19.7	13.8	21.0	16.9	8.7	-3.8	-6.9	-6.4
Net claims on national government	-8.9	-8.2	-13.3	-9.1	-15.2	-22.3	-35.6	-43.2	-42.9
Claims on other sectors	26.9	27.9	27.1	30.1	32.0	31.0	31.8	36.3	36.5
Private non-financial corporations	4.0	7.8	2.9	2.7	2.8	1.2	1.2	6.5	8.4
Individuals	22.9	20.0	24.2	27.4	29.2	29.8	30.6	29.8	28.1
Broad money liabilities	84.8	95.0	115.5	124.8	153.8	201.4	236.4	237.1	237.9
Demand deposits	31.1	37.1	54.7	63.0	69.6	88.9	106.1	96.8	91.0
Other deposits	53.6	57.8	60.8	61.9	84.2	112.5	130.3	140.4	146.9
Capital and other accounts	8.7	7.3	6.3	4.9	5.3	6.0	8.8	9.6	11.2
Loans to deposit ratio, %	31.7%	29.4%	23.5%	24.1%	20.8%	15.4%	13.4%	15.3%	15.4%
Memo: item: National Development Bank of Palau lending	26.4	24.4	21.5	21.4	19.4	18.3	18.2	19.3	n.a.
Balance of Payments \$ million									
Trade balance	-18.0	-30.7	-32.4	-33.8	-38.5	-20.7	-15.5	-16.1	-23.4
Service balance	55.5	70.5	86.7	88.6	107.3	121.6	112.9	94.1	86.2
Primary Income balance	-1.2	-1.1	-1.5	-1.5	-1.2	-0.9	-1.1	-1.7	-1.7
Secondary Income balance	-42.6	-45.0	-55.4	-53.8	-54.7	-61.1	-66.0	-68.0	-64.8
Current Account, balance	-16.2	-24.5	-32.4	-31.7	-43.5	-24.4	-40.7	-54.8	-47.2
Capital Account, balance	26.1	16.8	22.9	19.5	32.6	17.6	24.4	10.3	74.7
Financial account balance	14.1	17.9	10.7	18.0	17.5	-7.0	24.0	38.7	-5.6
International Investment Position (IIP), \$ million									
Total stocks, net	-80.1	-111.1	-83.0	-77.7	-71.5	-76.3	-67.8	-68.0	-30.5
Direct investment, net	337.6	335.7	399.1	428.9	471.4	514.3	584.3	624.7	707.6
Portfolio investment, net	417.7	446.7	482.1	506.6	542.9	590.6	652.1	692.7	738.1
Other investment, net	253.2	274.4	291.5	308.5	327.3	362.1	391.7	426.8	465.2
memo: COFA Trust Fund	151.1	146.5	171.8	189.6	199.2	183.9	196.8	219.5	293.3
External Debt, \$ million									
Gross External Debt, total	66.5	62.7	69.1	65.0	70.6	64.4	79.3	85.3	91.2
National Government	21.1	19.5	27.7	26.1	30.4	28.2	47.8	57.6	66.0
Public Enterprises	45.4	43.2	41.4	38.9	40.2	36.2	31.5	27.7	25.2
Gross External debt as % of GDP	35.8%	31.9%	32.6%	29.5%	29.3%	22.9%	26.7%	30.2%	32.8%
Debt Service	6.4	6.2	6.5	6.4	7.3	8.0	9.4	7.8	8.3
Debt service as % of national government revenues	7.5%	7.1%	6.9%	7.0%	6.8%	6.9%	7.5%	6.8%	6.6%
Tourism									
Total Tourism receipts, \$ million	72.0	89.7	105.1	112.3	128.5	148.7	138.3	123.2	117.3
Tourist nights	383,487	482,973	547,050	520,029	603,658	766,997	687,958	592,667	568,104
Receipts per visitor, \$	888	864	884	1,013	1,023	881	944	1,009	1,011
Receipts per visitor night, \$	188	186	192	216	213	194	201	208	206
Direct value added per visitor night, \$ million	91.3	86.4	90.9	107.8	105.8	100.2	107.3	109.0	103.7
Average length of stay, nights	4.7	4.6	4.6	4.7	4.8	4.5	4.7	4.9	4.9
Tourism arrivals	81,101	103,903	118,928	110,823	125,674	168,764	146,629	122,050	115,964
Japan	28,046	37,759	38,428	36,474	38,200	31,786	30,585	25,829	24,437
South Korea	14,104	14,826	18,675	18,501	15,834	12,453	12,529	13,472	12,872
Taiwan	22,209	32,682	40,645	28,171	31,175	15,258	15,501	9,493	11,354
China	956	1,656	3,715	9,357	21,706	91,174	70,741	55,491	50,211
USA	7,560	8,439	8,308	8,432	8,630	8,850	8,479	8,480	8,394
Europe	3,819	4,297	5,092	5,507	5,390	4,653	4,293	5,005	4,486
Other	4,407	4,244	4,065	4,381	4,739	4,589	4,501	4,280	4,210
Hotel occupancy rate	37.2%	46.8%	52.4%	47.2%	51.9%	61.3%	52.7%	41.9%	39.0%
Number of Hotel rooms, yearly average	1,420	1,464	1,480	1,555	1,669	1,773	1,903	1,987	2,022
Tourism Direct Value Added, \$ million	35.0	41.7	49.7	56.1	63.9	76.9	73.9	64.6	58.9
% change									
Tourism receipts	7.5%	24.6%	17.2%	6.8%	14.5%	15.7%	-7.0%	-11.0%	-4.8%
Tourism arrivals	10.8%	28.1%	14.5%	-6.8%	13.4%	34.3%	-13.1%	-16.8%	-5.0%
Tourism nights	11.7%	25.9%	13.3%	-4.9%	16.1%	27.1%	-10.3%	-13.9%	-4.1%
Tourism receipts per visitor	-2.9%	-2.7%	2.4%	14.6%	1.0%	-13.9%	7.1%	7.0%	0.2%
Tourism receipts per visitor night	-3.7%	-1.0%	3.4%	12.3%	-1.4%	-9.0%	3.7%	3.4%	-0.7%

June 2019

ECONOMIC BRIEF

PALAU FY 2018

The Palau Economic Brief is produced annually to provide an independent assessment of the Republic of Palau's economic performance and policy environment, as well as independently verified economic statistics. The Palau Economic Brief summarizes the full Palau Economic Review, which is developed to assist the government of Palau and the U.S. Department of the Interior's Office of Insular Affairs to fulfill their respective reporting requirements under Palau's Compact of Free Association with the United States.

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Additional information on the EconMAP program, as well as a digital copy of this report, is available online at <http://www.econmap.org>