



Republic of Palau

## EconMAP Technical Note

March 31, 2020

# *Assessing the Impact of COVID-19 on the Palauan Economy*



Economic Monitoring and Analysis Program (EconMAP) Technical Notes are intended to provide concise and timely analysis of important issues for decision-makers in Palau. Technical notes utilize currently available data sets and macroeconomic tools developed in close collaboration with the Palau government. The EconMAP program is managed by the Graduate School USA's Pacific and Virgin Islands Training Initiatives (PITI-VITI) with funding support from the Department of the Interior's Office of Insular Affairs. Comments, questions or requests for further detail may be directed to [info@econmap.org](mailto:info@econmap.org).



# *Assessing the Impact of COVID-19 on the Palauan Economy*

## **Introduction**

The global emergence of the coronavirus disease (COVID-19) continues to have an extraordinary impact on tourism-reliant economies across the globe. The Republic of Palau is no exception. Heavily dependent on tourism, Palau attracted 90,000 foreign visitors in FY2019, as the sector contributed 20 percent to gross domestic product. 20 percent of all workers are employed in tourism-related activities. While Palau has been spared any confirmed cases of COVID-19, the economic consequences of this pandemic are already substantial.

Fortunately, the government of Palau entered the current fiscal year with a strong fiscal position based on a track record of fiscal responsibility and an overall fiscal policy that is designed to be resilient given the heavy reliance of the economy on the tourism sector. However, the COVID-19 impact will be larger than previous shocks; thus, a fiscal response will need to be designed and implemented on an urgent basis. The challenge will be to balance the need to provide some forms of counter-cyclical stimulus or compensation to affected

individuals and businesses while also limiting the negative fiscal impact of this cyclical shock. This Technical Note utilizes current statistical data and macroeconomic modeling to project the impact of COVID-19 and to outline a range of fiscal measures for government consideration. While the primary purpose of this document is to assist the government of Palau in developing its own fiscal response policies, dialogue with Palau's donor partners is also strongly recommended.

## ***Basic Assumptions Used in the Analysis<sup>1</sup>***

### **Tourism**

The first four months of the FY2020 fiscal year were favorable with visitor arrivals reaching 32,255 and growing by close to 30 percent compared with the previous year. Palau was on track to attract 116,000 visitors by the end of FY2020. Following the emergence of

<sup>1</sup> The assumptions made are as of 3/30/2020, and will be revised as further information comes to light.





COVID-19, tourism numbers dropped by half in February, and there is no doubt there will be a further significant reduction in March. Given the termination of all international flights (with the exception of a weekly United flight from Guam) it is assumed that, on average, Palau will receive just 400 business visitors each month. Thus, as Figure 1 indicates, for FY2020 a total of 44,075 visitors has been projected, which represents a 51 percent reduction from FY2019.

It has further been assumed that during all of FY2021 travel restrictions will remain in place and the overall number of visitors to Palau will remain negligible. Finally, it has been assumed that effective COVID-19 vaccines have been developed by the end September 2021, after which visitors begin to return to Palau, eager to travel after a long period of restriction. The projections assume visitor levels for FY2021 of just 4,800 a further 89 percent reduction from FY2020.

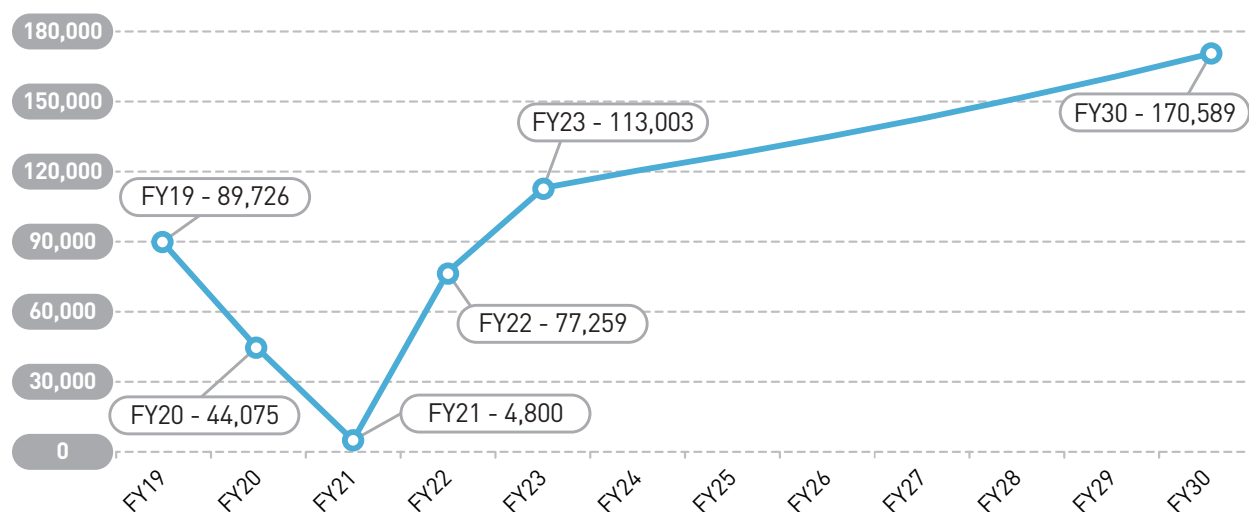
## Construction

Construction has traditionally had a large impact on the economy and the assumptions about major projects have a significant impact on the outcome. It is assumed that major projects will continue as planned, including the

*The impact of COVID-19 is estimated to be a reduction in GDP of 9.5 percent in FY2020 and 12.8 percent in FY2021.*

airport Public-Private Partnership (\$28 million phased over 2 years), the Japan International Cooperation Agency (JICA) funded relocation of the waste landfill (\$16 million phased over 2 years), Compact Koror road repavement (\$6-\$7 million), remaining elements of the Koror-Airai Sanitation Project (KASP), One-Stop shop in Koror (\$8 million), Oceans conference gym (\$8.6 million), Anguar dock, and Compact road rehabilitation to name the major projects. The projected higher level of grant-funded project expenditures is fortuitous as this will provide an anti-cyclical stimulus at a time when the cyclical negative impact on Palau's economy and the attendant fiscal deficit caused by COVID-19 are being realized.

**Figure 1 - Projected Tourism Arrivals**





## Public Sector

No change in the current levels of government operations or in public expenditures or programs has been assumed. Should the government be required to embark on an adjustment program, changes in the revenue and expenditure projections would be required.

*1,000 Palauans and 2,100 foreign workers are likely to lose their jobs.*

## Economic and Fiscal Impact

### Economic Impact

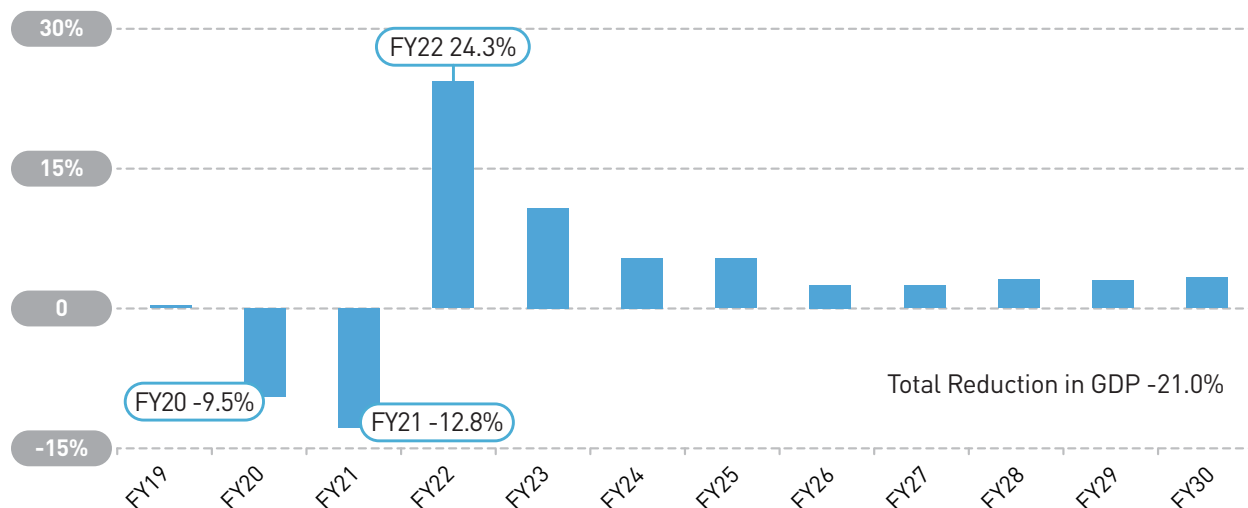
The economic impact of COVID-19 on the Palau economy is shown in Figure 2. In FY2020 real GDP is projected to fall by 9.5 percent. This decline would be even more severe without the projected contribution of the construction sector—with a positive impact of 2.0 percent of GDP. Without the impact of increased construction activity on the Palau economy, real GDP would be projected to fall by over 11.5 percent. In FY2021 there is a further projected reduction of real GDP by over 12.8 percent. The drop is larger in FY2021 due to the virtual disappearance of visitors for the whole fiscal year and the absence of further stimulus from construction. After FY2021 the projections assume a steady return to normalcy with a

large growth rate in FY2022 as the economy recovers from a deep decline.

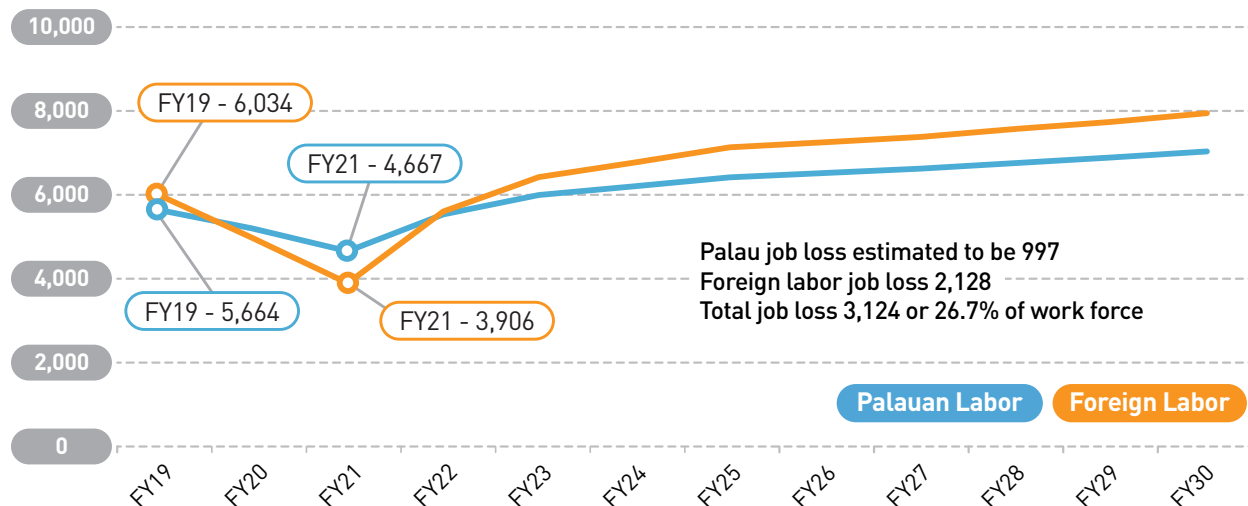
### Employment Impact

The impact on employment is shown in Figure 3 and is indicated for both Palauan and foreign workers. The implied loss of jobs for Palauans over the two fiscal periods is close 1,000 or 18 percent of the total number of Palauans employed. For foreign workers job loss is much larger with a reduction in employment of 2,100 jobs or 35 percent of foreigners employed. The impact on jobs results in a large level of unemployment. Typically, unemployment is not an issue for foreign workers as they leave the country with cessation of employment; however, such immediate and unplanned departures of released foreign workers may

**Figure 2 - Annual Palau Real GDP Growth (% change)**



**Figure 3 - Employment of Palauan and Foreign Workers**



be constrained by travel restrictions and minimal flight availability. The projected level of unemployment among Palauan workers exceeds anything Palau has previously experienced. The loss in jobs is estimated through the ratio of jobs to output in the different sectors of the Palau economy. As Palauans are largely concentrated in the public sector, job loss is mitigated. For foreign labor the impact is greater as they provide the majority of workers in the tourism sector. It is also necessary to point out that these projections are averages for the remainder of fiscal year FY2020, and all of FY2021.

### Fiscal Impact

The fiscal outturn is shown in Figure 4. In FY2020 a fiscal deficit<sup>2</sup> of \$18 million or 7 percent of GDP is projected. In FY2021 the gap widens and the deficit rises to \$22 million or 10 percent of GDP. While the impact is large it is mitigated by the structure of Palau's fiscal account. About half of revenues are non-tax revenues representing grants, drawdowns from the COFA trust fund, fishing fees, and other fees and charges. These are all assumed not to be impacted by COVID-19. The principal

<sup>2</sup> On a Government Finance Statistics basis

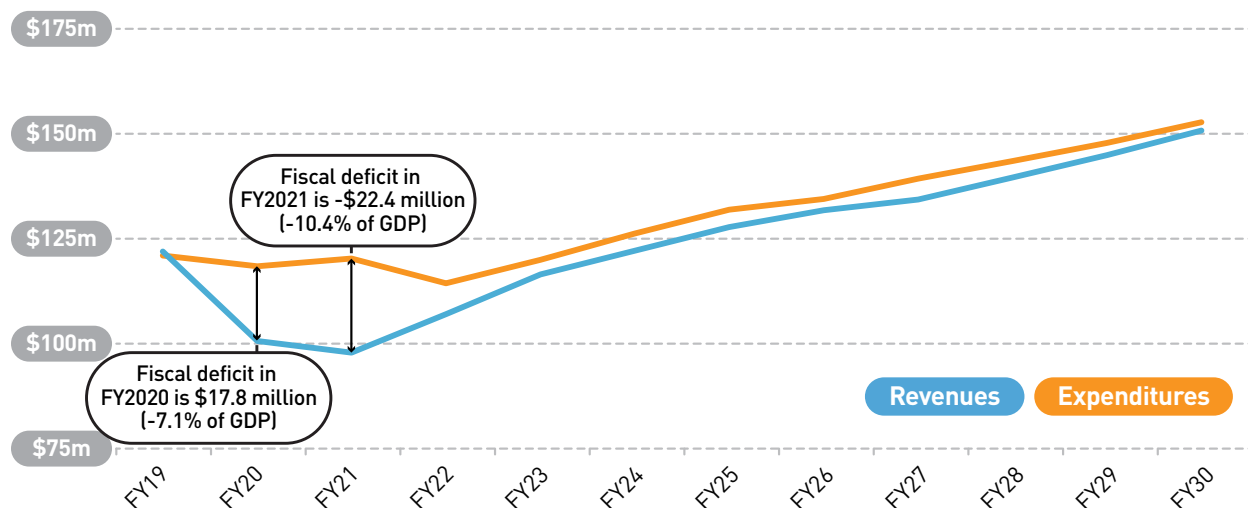
*The negative impact on the fiscal balance over the two years FY2020 and FY2021 is likely to reach \$40 million.*

components of the tax revenues are the payroll tax, Gross Revenues Tax, hotel room tax, PPEF, and import taxes. Total tax revenue falls by \$11 million in FY2020 and a further \$19 million in FY2021. On the expenditure side the figures reflect the FY2020 budget, which was a conservative and slightly contractionary budget. The conservative nature of the budget helps preserve the fiscal position but does not address the magnitude of the cyclical fiscal shock facing Palau. It is assumed—but not recommended—that the budgeted expenditures for FY2020 are maintained into FY2021.

### Financing

The combination of the two years of projected fiscal deficits indicates a total fiscal deficit of

**Figure 4 - Revenue and Expenditures (\$)**



about \$40 million and after debt repayment a financing need of about \$46 million<sup>3</sup>. The banking data indicates that at the end of FY2019 the government was holding about \$31 million in deposits, which the government of Palau has accumulated through previous fiscal surpluses during the tourism boom years. Much of these funds are part of the general fund reserve. However, the government would not be able to operate effectively on a zero cash basis and maybe close to \$20 million is available for emergency purposes. While these funds will provide a fiscal cushion to bridge the gap during the coming months, they will not be sufficient to weather the full impact of the COVID-19 downcycle.

### Collateral Issues Add to the Fiscal Challenge

While the national government budget will come under pressure there are also important parallel threats to Palau's national insurance schemes: Social Security and Civil Service Pension System. Recent projections indicate that due to the reduction in wages and payroll, the impact on Social Security will be a reduction of \$4 million or

22 percent of the FY2019 level of contributions through FY2021. In the case of the Civil Service Pension Plan, given the previous assumption of no changes in government payroll, the impact will be minimal. However, the CSPP operates with a growing structural deficit. Since both insurance systems have investments, the recent significant loss in value in financial markets makes drawdown of capital a costly solution to funding pension needs. Koror state will also face a crisis given the loss of entrance fees revenues for the Rock Islands and Jellyfish Lake. In FY2019 Koror state ran a \$10 million budget and achieved a \$1 million surplus. Without Rock Island revenues this will rapidly shift to a projected \$5 million deficit. Proportionately, the state will face a far greater loss of revenue—and thus needed adjustment—than the national government. As with the national government the state governments recorded a high level of bank deposits at \$26 million at the end of FY2019. It is understood Koror state may have a fiscal reserve of about \$10 million, but after allowance for other revenue losses from lease and rent revenues to ease the impact on the business sector, there is unlikely to be sufficient funds to avoid a significant adjustment.

<sup>3</sup> This excludes on-lent loan repayments due from the SOE sector



## ***Fiscal Policy and the Compelling Need for an Adjustment Program***

The above analysis is based on the EconMAP economic model. The projections indicate a need for a significant adjustment in the remainder of FY2020 and through FY2021. Palau thus needs to start preparing budget revisions and a set of policies to respond to the coming economic downturn. In any fiscal adjustment program, there are three areas of policy action: expenditure adjustments, revenue enhancements, and access to financing. The optimal balance between these policy actions and the nature of adjustments—temporary or permanent—depend on the assessed nature of the fiscal shock. Permanent adjustments with minimal use of financing are required in the case of structural deficits. Palau entered this period of COVID-19 impact with no structural deficit and substantial fiscal reserves. Given that Palau is clearly facing a cyclical shock<sup>4</sup> as a result of COVID-19 the government may consider a greater proportion of financing in an adopted adjustment program. Further, some or most of the adjustments to expenditures and revenues may be designed as temporary rather than permanent measures.

### **Revenue Measures**

Proposals have been made to reduce taxes—notably the GRT—to protect the business community. However, across-the-board reductions in GRT would have a significant negative impact on government revenues and would worsen the coming fiscal stress. More

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<sup>4</sup> The fiscal deficit facing Palau due to the COVID-19 pandemic actually qualifies as a specific sub-set of the classic definition of a cyclical shock. Cyclical shocks can be caused by a downturn in revenues caused by a recession or depression in economic activity as part of the “business cycle.” Cyclical shocks can also be “event-driven.” Palau is clearly facing an event-driven cyclical shock. The implication is that the crisis will remain as long as the causative event is unresolved. Historically, event-driven fiscal shocks are shorter in terms of time to full recovery, but each event differs.

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*Palau needs to start preparations for budget adjustments and discussions with partners to help finance the fiscal gap.*

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importantly, across-the-board reductions to the GRT would utterly fail to benefit businesses that lose all of their revenue base while providing a disproportionate benefit to less affected businesses. Given the size of the fiscal shock and the unprecedented impact on the labor force—and in particular on Palauan workers—the government will surely want to consider options for providing relief. Relief needs to be tightly targeted to effectively and efficiently provide compensatory support to the impacted sectors of the business community, possibly the tourism industry; to the small business sector; and to households affected by job losses. Transfer programs to provide an anti-cyclical stimulus would be preferable as opposed to using the tax regime to provide relief.

As noted above, construction activity has a significant impact on economic activity. Discussion with donor partners to accelerate infrastructure programs can play an important role in maintaining economic activity. Use of remaining funds under the Compact infrastructure grant, ICT projects to roll out fiber to businesses and residences, acceleration of the national government one stop-shop and administrative complex in Koror, and many other infrastructure projects would all assist in supporting the economy.

### **Expenditure Measures**

Palau may need to provide support to affected parties. Consideration should be given to



support (i) additional health needs, (ii) Palauan households affected by job losses, and (iii) businesses in affected sectors. At the same time policies to reduce or eliminate non-essential services should be considered. Government payroll is the largest component of expenditures and in FY2019 represented \$44 million or about 40 percent of the overall cost of running government. Reductions in payroll or reduced working hours could be considered as a form of burden sharing by the public sector to partially offset the fiscal deficit during the period of negative COVID-19 effects. Purchases of goods and services is the second largest element of expenditures and there is some scope for temporary adjustment there as well. Travel needs (\$3.7 million in FY2019) will be significantly reduced reflecting the travel bans now imposed by nearly all countries. Professional and contractual services (\$5.1 million) is another area of potential temporary adjustment.

## Financing

As indicated above the existing level of deposits and general fund reserve provide some resources to fund the fiscal gap. However, scope for support from this source is limited and the government cannot operate effectively on a zero-balance account. Without recourse to deficit financing from the financial sector or a central bank, any government facing a cyclical deficit of the magnitude currently faced by Palau will need to consider funding from bilateral and international partners. While some grant assistance may be possible such as the ADB Asia Pacific Disaster Response Fund, other funding will need to be considered on a loan basis, such as the ADB Contingent Disaster Finance, which is likely to be approved by the Board to cover the COVID-19 crisis.

Additional financing through the ADB or other multilaterals would probably involve some accompanying revenue and expenditure measures, though such measures would likely be targeted to strengthen Palau's fiscal position and institutions on a longer-term

basis. The World Bank and the IMF could also be approached for lending activities directly responsive to the cyclical deficit challenge. Taiwan may be another valuable partner in this endeavor. Given the need to preserve economic and financial stability, a \$25 - \$30 million standby facility coupled with additional timely support from Palau's donor partners, could provide the comfort and counter-cyclical stimulus that Palau needs to be able to manage the projected resource gap and economic impact of COVID-19.

## Potential Components of a Fiscal Response

Working with Palau's donor partners the government may consider a fiscal response program that includes the following categories, among others:

- First and foremost, a health sector strengthening program to address the urgent needs of the COVID-19 pandemic and to improve Palau's ability to provide sustained, high quality health services to its population and to visitors. Depending on ultimate funding support from donor partners, consideration should be given to investments supporting the re-location of the hospital to higher ground.
- An unemployment relief program administered through the Social Security Administration that provides direct payments to Palauan workers and foreign workers in critical occupations that have lost their jobs in directly impacted sectors (indirectly affected sectors may be added later);
- Subject to financing availability, the government may coordinate an orderly repatriation program for suddenly displaced tourism and related sector foreign workers, keeping in mind the need to maintain a small cadre of reserve labor and to maintain positive relations with key sources of labor upon recovery of the economy.





- A business relief program that provides:
  - » Subject to financing availability: support to businesses in directly impacted sectors—with priority to small businesses, perhaps measured as (presumptive) loss of gross revenues—to be confirmed through subsequent BGRT filings; and
  - » Government guaranteed loans through the National Development Bank of Palau and/or commercial banks to businesses in directly impacted sectors to cover (i) fixed costs to maintain lease payments and physical plant and equipment through the tourism downturn; and, perhaps, to finance physical improvements that will allow construction and rehabilitation during the tourism downturn.
- A public sector expenditure control program that provides fiscal space to support relief programs and allows for “burden-sharing” to enable Palau to exit the current crisis in a position of relative strength. Elements of such a program might include the transfer of savings from a 72-hour bi-weekly pay period, travel restrictions, reductions in purchases of goods and services, and reductions in professional and contractual services—all on a temporary basis, perhaps through FY2021 or the period of the event-driven cyclical fiscal shock.
- Acceleration of public investment projects funded with donor grant or loan support, including necessary attention to minimizing bottlenecks to: project design, planning, engineering and labor needs.

The six outlined components of an overall Fiscal Response are provided in general form for consideration of the Palauan leadership. It is important that the depth and breadth of the eventual response needs to be sized and timed to reflect support from Palau’s donor partners and recognition that Palau needs to be extraordinarily wary of depleting its entire fiscal reserve at this time.

## Conclusion

The economic and fiscal impacts projected in this note are based on an economic model of the Palauan economy. The impacts, of course, are driven by the structure of the economy. While developments will take their course, it is felt the magnitude of the projected outcome given the assumptions relating to visitors to Palau are reasonable and of the right order of magnitude. These can be modified as more information comes to light. Importantly, the analysis indicates the compelling need to prepare a fiscal adjustment strategy to maintain stability and to open channels with Palau’s partners for potential financing sources.

## About EconMAP

The Economic Monitoring and Analysis Program (EconMAP) provides professional expertise to support statistical development and economic analysis in the three Freely Associated States (FAS) of the Republic of the Marshall Islands (RMI), the Federated States of Micronesia (FSM) and the Republic of Palau (ROP). Annual program outputs for each FAS include the development of economic statistics, the publication of Economic Reviews, and the delivery of economic presentations. Occasional topical reports and technical notes are also published occasionally.

The EconMAP program is supported by the Department of the Interior's Office of Insular Affairs, and managed by the Graduate School USA's Pacific & Virgin Islands Training Initiatives. Additional information is available online at <http://www.pitiviti.org>.



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