INTERNATIONAL MONETARY FUND

Staff Country Reports

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May 2008
IMF Country Report No. 08/161

Republic of Palau: 2008 Article IV Consultation—Staff Report; and Public Information Notice on the Executive Board Discussion for Republic of Palau

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2007 Article IV consultation with the Republic of Palau, the following documents have been released and are included in this package:

- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 4, 2008, with the officials of Republic of Palau on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 9, 2008. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its April 30, 2008 discussion of the staff report that concluded the Article IV consultation.

The document listed below has been or will be separately released.

Selected Issues Paper and Statistical Appendix

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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International Monetary Fund
Washington, D.C.

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REPUBLIC OF PALAU

Staff Report for the 2008 Article IV Consultation

Prepared by the Staff Representatives for the 2008 Consultation with the Republic of Palau

Approved by Steven Dunaway and Anthony Boote

April 9, 2008

Discussions: held in Koror and the capital city, February 21–March 4, 2008. The mission team comprised Ms. Baker (Head), Mr. Lueth (both APD), and Ms. Yang (FIN), with participation of Ms. Manalac (OED), and Mr. Nun (MCM expert). The team met with President Remengesau, Minister of Finance Sadang, Minister of Resources and Development Koshiba, other senior officials, and representatives of the legislature, banking, business and the donor community.

Past surveillance: in concluding the last consultation in February 2006, Executive Directors cautioned against postponing adjustment. They encouraged the authorities to step up efforts toward achieving sustainability, including through targeting an appropriate pace of fiscal consolidation over the medium term and strengthening the foundation for private sector led growth.

Exchange regime: Palau accepted the obligations of Article VIII, Sections 2, 3, and 4 in December 1997, and maintains an exchange system free of restrictions on the making of payments and transfers for current and capital transactions. The U.S. dollar is legal tender.

Statistical issues: economic reporting has deteriorated and constrains effective policy evaluation.

Technical assistance: since 2005, PFTAC has provided assistance in national accounts, bank supervision, tax administration and policy reform, and public financial management. An MCM expert assisted with bank examinations and supervision.

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EXECUTIVE SUMMARY

Background: performance has weakened somewhat since the last consultation. Growth has come down to near its historical average, inflation remains moderate, competitiveness has been preserved and the current account deficit has been stable. However, fiscal performance has been mixed, as revenue weakness has undermined expenditure restraint. The near-term outlook is favorable, with risks skewed to the downside. Palau is at a critical juncture, as term limits imply a sweeping change in leadership following the November elections and the scheduled cessation of Compact grants in 2009 weighs on public finances.

Main Issues: despite relatively high per capita income, self-reliance remains a distant goal. The authorities have long recognized that fiscal policy is not sustainable, but lack of consensus has stalled much of the reform agenda in this small, young nation. In addition, impediments to private sector investment remain. In order to achieve fiscal sustainability and foster long-term growth, structural reforms are required.

Staff's views: the most pressing need is to start on a path to fiscal sustainability. Even in a best-case scenario the required adjustment is formidable. Delays in adjustment not only imply a larger required consolidation down the road, but also increase the likelihood that the Compact Trust Fund will be depleted. Revenue measures should complement progress to date on the expenditure side. In this context, the measures contained in the supplemental budget are welcome. The current exchange rate regime—the U.S. dollar is legal tender—remains appropriate given Palau's small size and close ties to the United States. Looking ahead, establishing a foundation for private sector led growth is key to achieving self-reliance. Policies to encourage high value added tourism and export diversification would help sustain living standards while preserving Palau's pristine environment. Such policies need to be underpinned by a strong legal framework which facilitates contract enforcement and secures property rights. Data provision, while adequate for surveillance, has deteriorated and constrains policy assessment.

Authorities' views: there are hopeful signs that government sponsored reforms will be passed given the increasing recognition that the status quo is not sustainable. An adjustment of about 5 percentage points of GDP over the next 5 years is feasible, assuming that the revenue measures in the supplemental budget are approved. Some frontloading may be possible. They recognize the key role private sector investment can play in fostering growth and aiding information transfer. Progress is being made on the titling of land. However, while several proposals to change and even abolish the foreign investment law have been tabled, there is a lack of consensus on how to make the most of foreign investment and labor while protecting citizen opportunities. Preserving Palau's unique environment is also a top priority. They agree that quality data is required to underpin policy formulation and they continue to work toward producing consistent and reliable data.

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