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November 23, 2021

**Statement by Ms. Kashima and Mr. Watanabe on Republic of Palau
(Preliminary)
Executive Board Meeting
November 29, 2021**

We thank staff for the informative report, and Mr. Huh and Mr. Iona for their insightful buff statement. The COVID-19 pandemic has severely hit the tourism-dependent Palauan economy, leading to a prolonged contractions of economic activities. The authorities' comprehensive policy responses backed by financial supports from international partners has helped avoid further deterioration. However, there are high uncertainties to the economic outlook due to the unclear path of the pandemic, volatile tourism recovery, substantial government debt, and natural disaster shocks. **As we broadly concur with the thrust of the staff's appraisal and policy advice, we would like to offer the following comments for emphasis.**

Fiscal Policy

While fiscal relief measures need to be extended until the recovery is firmly entrenched, Palau should rebuild fiscal buffers and strengthen fiscal sustainability over the medium-term. COVID-19 related measures have led to a substantial surge of Palau's debt sustainability risk, with the public debt-to-GDP ratio reaching 90% in 2022. Strengthening domestic revenue mobilization and public financial management (PFM) is critical, more so given Palau's recent graduation from the OECD's development assistant countries list. In this regard, we welcome the approval of the comprehensive tax reform, which is expected to increase revenue by about 1 percent of GDP. We encourage the authorities to further consider revenue mobilization measures and expenditure rationalization. *Are there any capacity constraint concerns or other impediments for the smooth implementation of the comprehensive tax reform and further reforms?* Securing climate financing is also an urgent issue in light of Palau's high vulnerability to natural disasters.

Financial and Monetary Policy

Access to credit should be strengthened. We note the low loan-to-GDP ratio, and the structural constraints for lending to businesses, such as lack of reliable financial information for firms and the interest ceiling on commercial loans. We encourage the authorities to consider measures to expand access to credit, while ensuring appropriate credit risk management among banks. *Can staff comment on the supervisory capacity of the FIC in overseeing the operations and risk management of foreign banks? Appendix IX provides that the NDBP is not formally licensed and supervised by the FIC; what is the regulatory and supervisory framework for the NDBP?* Improving the AML/CFT framework and strengthening risk-based supervision is also necessary. Further, inflation developments should be properly monitored, in light of the upcoming introduction of the Palau Goods and Services Tax in 2023. Developments in global commodity prices and supply-side pressures could also have potentially large impacts on small island states such as Palau.

Structural Reforms and Capacity Developments

Steadfast implementation of structural reforms is essential to achieve Palau's sustainable growth for the post-pandemic era. Considering the country's heavy reliance on tourism, its small-scale private business sector, and its vulnerability to climate change, it is imperative for Palau to diversify its economy and attract foreign investment. As noted by staff, this will require developing business-related regulatory frameworks, enhancing human capital, and investing in climate-friendly infrastructures. We very much appreciate the appendices on these topics. *Can staff further elaborate on the authorities' work plans in these areas, including receiving technical support from development partners?*

Lastly, we would like to emphasize the importance of supporting the authorities' efforts through the Fund's CD that is well-integrated with the policy recommendation under the Article IV consultation. We would appreciate if a more detailed capacity development strategy could be included in the staff report of the next Article IV consultation. This would be helpful for the authorities and the board to clearly understand the linkage between CD delivery and policy recommendation. It would also contribute to further enhancing collaboration with other development partners.