February 19, 2002
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 02/1

10:00 a.m., January 4, 2002

Contents

Executive Board Attendance

S. Sugisaki, Acting Chair

Executive Directors	Alternate Executive Directors
S.M. Al-Turki	A.S. Alosaimi
	D. Ondo Mañe
	N. O'Murchú
	P.H. Whitehall, Temporary
M.J. Callaghan	D.C. Guinigundo
R.F. Cippà	W. Szczuka
	R. von Kleist
	H. Vittas
D.I. Djojosobroto	
	R.A. Jayatissa
	J. Prader
Ó. Ísleifsson	B. Andersen
O.-P. Lehmussaari	M.L. Nikitin, Temporary
	M. Lundsager
	A. Baukol, Temporary
P. Duquesne	
A. Mirakhor	
	A. Lushin
	F. Varela
	S.P. Collins
M. Portugal	
	T. Belay, Temporary
A.S. Shaalan	
Wei Benhua	Jin Qi
J. de Beaufort Wijnholds	Y.G. Yakusha
	M. Abbing, Temporary
	H. Toyama
A.G. Zoccali	R. Maino, Temporary

A.S. Linde, Acting Secretary
M.R. Schrader, Assistant

Also Present
Asia and Pacific Department: W.S. Tseng, Deputy Director; W. Abdelati, C. Browne, J. Carter, Y. Khatri, J.Y. Kim, A. Tweedie. European II Department: J. Odling-Smee, Director. Policy Development and Review Department: M. Hadjimichael. Secretary's Department: K.S. Friedman, M.J. Miller, P. Ramlogan, C.L. Sevy, C.M. Watson. Office of the Managing Director: R.S. Teja. Advisors to Executive Directors: M.P. Bhatta, S. Boitreaud, A. Fidjestøl, J. Gallardo, O.E. Garner, D.H. Kranen, S. Kropas, Liu F., J. Mafararikwa, M.F. Melhem, M. Yanase, F. Zurbrügg. Assistants to Executive Directors: A.S. Al Azzaz, A.A. Al-Nassar, A. Alber, N.J. Davidson, M. Di Maio, P.A. Dohlman, R. Gauba, T. Hadded, C. Harzer, B. Kelmanson, T. Komatsuzaki, T. Koranchelian, I. Kupča, Y. Lissovolik, D. Lombardi, T.P. Nguema-Affane, K.S. Oo, J. Sigurgeirsson, J. Sipko, D. Taylor, Tong Y., S. Urinbaev, Wei X.

1. EXECUTIVE DIRECTORS

Length: 5 minutes

The Acting Chair (Mr. Sugisaki) welcomed Mr. Isleifsson as Executive Director and Mr. Andersen as Alternate Executive Director for Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway, and Sweden.

2. REPUBLIC OF PALAU—2001 ARTICLE IV CONSULTATION

Documents: Staff Report for the 2001 Article IV Consultation (SM/01/358, 12/3/01); Recent Economic Developments (SM/01/359, 12/3/01; and Cor. 1, 12/6/01)

Staff: Abdelati, APD; Hadjimichael, PDR

Length: 1 hour

The staff representative from the Asian and Pacific Department (Ms. Abdelati) submitted the following statement:

> The following information on recent economic and policy developments, which does not change the thrust of the staff appraisal in SM/01/358, has become available since the staff report was issued.
>
> The two tax reform bills submitted by the President to the OEK (Palau's national congress) in October 2001, consisting of tax administrative reform and import tax reform, have been assigned to committees in both houses. The two bills were expected to be approved before the end of 2001 but the process has been delayed. Hearings on these two bills are expected to commence later this month when the OEK resumes its regular session. Every month of delay is estimated to reduce expected tax collections by one-third of a percentage point of GDP.
>
> There have also been delays in establishing the Financial Institutions Commission (FIC). Although the president submitted the list of nominees in October 2001, and the OEK has met to review it, their decision has not yet been issued. In the meantime, members of an Interim Financial Regulation Committee are drafting some preliminary regulations and reviewing the re-licensing applications of existing banks with assistance from the Pacific Financial Technical Assistance Centre (PFTAC). The cutoff date for the filing of applications for existing banks was December 17, 2001. Based on the reviews completed to date, two "shell banks," which were not in operation but had advertised themselves to have been authorized by Palau, have been effectively closed.

The number of tourist arrivals declined by about 25 percent in the October-November period compared to the same period of the last fiscal year. This decline was larger than projected in the staff report and is mostly due to fewer arrivals from Japan as the number of charter flights were temporarily reduced. However, there has been a pick up in charter flights from Japan since December and the staff's FY2002 projection of 3 percent growth in tourist activity could be achieved if tourist arrivals increase by an average 8 percent over last year for the remaining months of the fiscal year. This would depend on the continued frequency of both charter and regular flights to Palau and the pace of recovery of tourism in Asia.

Mr. Callaghan submitted the following statement:

Palau faces major challenges. Its size, scale, dispersion and distance from markets have proved to be a barrier to faster economic development. More recently, the crucial tourism sector was adversely impacted by the aftermath of the events of September 11, a reminder of Palau's vulnerability to external developments. To give some perspective of Palau's size, its GDP is five times smaller than that of the Fund's operational budget. The authorities recognize that one of the major challenges facing the economy is the decline and subsequent end of grants from the United States. Towards this end, the new administration has adopted a reform program which focuses on: public sector reform, including a salary and hiring freeze; revenue mobilization; investment promotion; human capital development; financial sector development; and environmental protection.

The path towards fiscal sustainability is never smooth nor easy. It will take time for the private sector to become the main source of employment growth within the economy. Given Palau's size and location, it is unrealistic to expect that a drastic reduction in the size of the public sector will see all the resources released immediately absorbed within the private sector. However, it is clear that priority must be given to creating the environment for greater entrepreneurship and the development of Palauan-based businesses. The authorities have taken a number of major steps towards reform and are committed to re-igniting private sector growth.

Palau's new administration, which came to power in early 2001, has taken decisive steps to reinvigorate the reform process, restart economic growth, and provide for a smooth medium-term transition to the end of the current Compact funding arrangements with the United States. The key policy actions taken by the new administration in its first year include: fiscal consolidation in 2001 based on expenditure reduction of 9 percent and significant improvements in the administration and collection of taxes; the passage of the Budget Reform Act during 2001 – aimed at improving the effectiveness and efficiency of government operations through the use of performance-based budgeting; a freeze on public sector wages and hiring, with the aim of reducing the role of the public sector in the economy; the introduction of legislation to broaden the tax base, remove tax distortions and improve tax administration; the establishment of a reserve fund to restore the government's reserve assets to provide a cushion in the event of external shocks; the introduction of legislation to encourage non-resident investment by ensuring that the rules governing investment are simple, transparent, and evenly applied; and the passage of a comprehensive banking sector legislation, which provides for the registration and supervision of the banking sector.

These actions comprise a promising beginning to re-igniting private sector growth and assisting the transition to lower levels of external assistance in the medium-term. The Management Action Plan sets out the authorities' detailed structural reform plans, a timetable for reform, and a process for reporting on progress.

Despite strong expenditure reduction of around 9 percent, the 1999/2000 budget deficit was larger than expected as a result of lower external grants and lower returns on U.S. investments. This highlights the economy's dependency on foreign capital inflows and external developments.

Partly in response to the staff's recommendation for the 2002 budget, the authorities brought forward the introduction of the first stage of the tax reform package. When the legislation is passed, the changes will increase revenue by up to 4 percent of GDP and limit the budget deficit to around 3 ½ percent. In addition, the 2002 budget makes provision for 5 percent of domestic revenue to be set aside to rebuild reserves over time and reduce Palau's vulnerability to shocks.

Over the medium-term, the authorities intend to contain expenditure to below domestic revenue and annual Compact funding. Initiatives to help reduce expenditure over the medium-term include: streamlining of representative government and government structures, revised public sector regulations to provide greater labor flexibility, and a hiring freeze. Consideration is also being given to increased private financing of health care and greater use of the private sector to provide support services to the public sector.

Further tax reform is planned to raise domestic revenue and create room for increased government investment to raise human capacity, develop infrastructure to support private sector development, and protect Palau's fragile environment.

The authorities have two strategies for dealing with the unfounded liabilities of Social Security and Civil Service Pension Fund. Firstly, legislation has been proposed which will partially reverse the increase in benefits provided for by the previous administration. Secondly, the administration has presented options to Congress for the financing of the remaining liabilities.

The authorities have also renewed their efforts to address barriers to investment through: substantial infrastructure investment; developing simple, clear and non-discriminatory rules for non-resident investors, which are currently being debated in Congress; preparing legislation to allow for longer and more certain land leases; restructuring the National Development Bank's balance sheet, which has allowed it to restart lending, including facilitating lending by foreign banks which are unable to accept land as collateral; and providing for additional resources to speed the resolution of land title disputes.

During 2001, legislation was passed providing for comprehensive banking registration, regulation, and supervision. Upwards of 80 percent of deposits are with FDIC insured banks and most measures of banking soundness are at comfortable levels. However, the authorities are committed to fully implementing the legislation to ensure their financial sector remains sound. Steps will be taken to further strengthen the framework through regulation or legislation in order to address some of the issues raised by the staff. However, implementing the legislation will be a challenge, given the scarcity of human capacity in this area and the limited size of the financial sector.

The new management of the National Development Bank has restructured its balance sheet, improving the servicing of loans and fully provisioning for bad loans. This allowed the bank to resume lending operations. More regular reporting to the government has been initiated to prevent a recurrence of problems with the bank's operations.

Palau will continue to implement the FATF forty recommendations on combating money laundering.

The authorities' ambitious reform program will help revitalize the economy. However, the adjustment task is very large. The Fund's medium-term growth scenarios assume that the implementation of the reform program will boost private sector growth and result in annual real GDP growth of 6 percent by the end of the decade. However, as we have seen with the events of September 11, developments overseas can have a major impact on tourism, which is a vital sector of the economy. Furthermore, as a very small economy, there are always important capacity issues which need to be overcome. While priority must be given to creating the environment for private sector investment and business development, it will take time for the private sector to become the main source of employment in Palau.

Lastly, the authorities would like to express their gratitude to the staff for their contribution to the policy debate in Palau. Palau would also like to thank the Fund and the Pacific Financial Technical Assistance Centre for helping develop the framework for financial supervision and regulation.

Mr. Mirakhor submitted the following statement:

We thank the staff for the paper and Mr. Callaghan for his insightful statement. The authorities deserve commendation for their commitment to adjustment and reform manifested in the first year of the new administration by a number of important structural policy actions as well as a credible beginning toward fiscal consolidation. Nevertheless, economic activity in Palau remained weak in FY 2000/01, while the external current account and the fiscal deficit widened further. Inflation, however, remained low. To improve economic performance there is a need for fundamental changes in the structure of the economy aimed at fully harnessing the potential sources of growth. Mr. Callaghan is quite correct to suggest that the needed changes will require time and enhancement of the country's administrative capacity. Meanwhile, since Palau will continue to rely on tourism for quite some time, it will have to attract foreign investment into that sector. Reducing its vulnerability to external shocks would require diversifying the production base over the medium-term through improved competitiveness and active promotion of private sector development.

While acknowledging the commendably strong expenditure reduction thus far, continued fiscal consolidation will be critical not only for macroeconomic stability but also for improving the general performance of the economy. Adjustments will be needed to achieve fiscal sustainability over the medium-term. In this context, the staff is correct to suggest the need to develop a medium-term plan consistent with the scheduled declining grants and returns from the Compact Trust Fund (CTF) as well as build a cushion of reserves.

We welcome the planned civil service restructuring, including downsizing and streamlining of government administration. This should, however, be complemented with improved fiscal monitoring, accounting, and reporting as well as elimination of extra-budgetary funds. In this context, we welcome the authorities' efforts to eliminate the unfunded liabilities of the Social Security Fund and the Civil Service Pension. Clearly, the implementation of the agenda of adjustment and reform will cause economic hardships and dislocations at least over the short run. In this regard, one wonders if sufficiently strong social safety net is in place to assist the most vulnerable. The staff or Mr. Callaghan may wish to comment.

On the revenue side, while noting the reasonably high tax effort, reliance on grants is equally high. The proposed tax package before Congress, geared to streamlining the import tax regime and broadening the base as well as introducing excise taxes and reducing tax exemptions, is a welcome step. Further tax reform should focus on creating a more efficient and equitable tax regime, including by simplifying income tax and introducing a sales tax. Although Palau's external debt remains at tolerable levels, its current account deficits, sustained by receipts from tourism and foreign grants, remain unsustainably high. The continuing decline in external competitiveness and diminishing reserves is a source of concern.

Raising Palau's rate of economic growth will require far-reaching structural reforms to attract and maintain a high level of foreign investment. While the authorities' renewed efforts to address the problem of impediment to investment are welcome, there is a need for changes in the foreign investment law and strengthening the judicial system. Labor laws should also be reviewed with a view toward introducing more flexible hiring, firing, and minimum wage regulations.

Improved financial intermediation is also vital to promoting investment and growth. Although financial sector vulnerabilities remain low, a credible supervisory system will need to be instituted to ensure an efficient and robust financial system capable of maintaining public confidence. We welcome the Financial Institutions Act (FIA), which is to pave the way for establishing the Financial Institutions Commission (FIC) to oversee banking regulation and supervision. The amendments suggested by staff to strengthen oversight deserve due consideration. We also welcome the passage of legislation to combat money laundering, which should enhance Palau's international credibility and improve investor confidence.

As the medium-term scenarios clearly depict, the economic profile of Palau will remain fragile unless the necessary reforms are implemented. Clearly, the reform and adjustment agenda poses a daunting challenge to the authorities. While we are concerned with the limited capacity as well as with the question of social safety net, the 'reform scenario' has the potential to accelerate the growth rate of the economy and raise living standards. Vigorous efforts to crowd in the private sector will be needed in tandem with the implementation of structural reforms and retrenchment of the public sector.

We are encouraged by the authorities' appreciation of the challenges that lie ahead for Palau and by their strategies for addressing them, as elaborated by Mr. Callaghan. We wish them every success in revitalizing the economy of Palau.

Ms. Nikitin made the following statement:

I would like to thank the staff for an interesting set of papers and Mr. Callaghan for his helpful statement. Palau's economic growth performance has been weak in the past two years and its disappointing growth figure is one of the lowest growth rates among similar economies. However, the new government seems to have made good progress towards restarting reforms during the past year, which is also evident from Mr. Callaghan's statement.

The staff seems to suggest that the main source of growth in Palau will be tourism. I would appreciate the staff's comments on whether they believe that the growth rate in the medium-term scenario can be sustained by tourism alone. Along with tourism, fishing has been the other main private sector activity. However, the contribution of fisheries to Palau's GDP declined during the 1990s. It would also be interesting to hear the staff's view on the fishing industry's prospects in the near future.

I agree with the staff that there is a need to undertake fiscal adjustments in order to decrease Palau's dependence on grants from the United States. In this regard, it is unfortunate that the congress has not yet approved the first stage of the tax reform package. As noted in the staff report, continuing the tax reform is crucial in achieving fiscal sustainability. The public sector is very large and there exists an unnecessarily complicated administrative structure, which is difficult to justify on a purely economic basis. Therefore, the administration's intention to consolidate the government is clearly a step in the right direction. However, as Mr. Callaghan also notes in his statement, the private sector's ability to absorb resources from the public sector is likely to be limited. Thus, I fully support the authorities' position to give priority to reforms that will enable private sector growth.

With these remarks, I wish the authorities every success.

Mr. Baukol made the following statement:

As highlighted in Mr. Callaghan's statement, the authorities are focused on the goals of fiscal consolidation and pro-growth structural reforms. We agree with the authorities and the Fund staff that such fiscal and structural reforms are critical to ensure long-term fiscal and external viability and growth, free of excessive dependence on external grants. The authorities' recent progress in these areas, particularly the focus on reducing the size of government, tax reform, and financial sector oversight is a good base to transition away from reliance on the funding arrangement with the United States.

Fiscal consolidation is clearly needed given the undesirably large size of the public sector. At the same time, the contractionary effects of fiscal consolidation, in the context of slow growth and significant real exchange rate appreciation over the past five years, need to be offset by measures to enhance growth of the private sector. On these issues, we associate ourselves with the comments of Mr. Mirakhor regarding the need for improved fiscal monitoring and on removing impediments to investment, including more flexibility in labor laws. We also agree with the authorities that a growth strategy should include further development of tourism. Maintaining an attractive tourist destination in the long-run requires maintenance of a healthy ecosystem. Though positive steps have been taken in this regard, we are concerned about damage from coral dredging, poor fishing practices, and solid waste disposal.

We are concerned that the current package of fiscal and structural reforms may be overly ambitious, without clear priorities. The authorities have a laudable, though long, list of fiscal and structural reforms, as well as a new 'Emergency Contingency Reserve Fund.' We encourage the authorities not to spread their effort too thin; for example, the administrative capacity and financial resources needed to set up and manage the reserve fund may be better used on other priorities.

In this regard, could the staff comment on the authorities' Management Action Plan (MAP) prepared in March 2001 to help set a medium-term fiscal and structural strategy? What progress has been made under this plan?

Finally, we commend Palau for its recent efforts to strengthen anti-money laundering and terrorist financing laws as part of its bank regulation and supervision efforts. We encourage the authorities to continue these efforts and implement UN Security Resolution 1373 as soon as possible. We also encourage the authorities to work with the congress to implement the staff's recommendations regarding banking supervision.

Mr. Abbing made the following statement:

I would like to thank the staff for providing us with comprehensive material on what is a very small country. The Palauan authorities seem very serious about securing long-term sustainable growth, both by implementing structural reforms (albeit at a slow pace) and by setting up trust funds to generate future cash flows. These forward-looking policies deserve our full support.

Obviously, the major question is how Palau is going to be able to sustain growth when existing grants phase out. What options for growth are open for this pacific country? As noted by the staff, tourism seems to be the most likely answer. Under the optimistic reform scenario, strong structural and fiscal reform will facilitate a more dynamic private sector and (partly as a result) tourism will more than double this decade. Under this scenario, fiscal and external sustainability might be possible. Under the other 'no reform' scenario, even though tourism is still projected to increase by more than fifty percent, Palau will remain dependent on foreign grants due to a lack of fiscal consolidation. Especially when considering the September 11 events, I sincerely doubt whether the projections for tourism under either scenario are very realistic. Should we expect total tourism to the Pacific to increase strongly, or is Palau expected to lure tourist from nearby Pacific countries? Furthermore, I noted that the number of people employed in the tourism industry increased by no less than eighty percent in the 1995-2000 period, whereas real earnings actually declined. I am not sure what lies behind these data. Perhaps I am not fair in considering this time interval, as it encompasses the Asian crisis. It could also mean, however, that there is considerable slack in the tourist industry and in that case I would find it difficult to see tourism as the engine for growth in the medium-term.

Based on my more pessimistic outlook, strong and timely structural reforms seem all the more necessary to secure longer-term growth. In my view, the removal of impediments to private (and foreign) investment should top the authorities' list of priorities. Naturally, fiscal consolidation is also crucial and I welcome the ongoing efforts in this area. Reform in the financial sector could help as well. I noted the staff's recommendation to improve the regulatory and supervisory framework by 'establishing a strong commission that is capable of ensure effective implementation' of new legislation in this area. In principle, I would be all in favor of such a recommendation. However, I noted that the whole Palauan 'Finance, Insurance and Real Estate' sector employs no more than 116 people. And this includes bank tellers, money changers and estate agents. I therefore doubt whether it would be very realistic to set up a new supervisory commission, especially as the Government is trying so hard to reduce the public sector. In addition, as noted in the staff paper, eighty percent of deposits are entrusted to branches of U.S. banks that fall under U.S. supervision and the financial sector does not seem to give rise to serious problems. Perhaps instead of our somewhat 'standard' recommendation to set up 'strong supervision' the authorities could look into more creative solutions. Palau could for instance consider requesting 'outside supervision', which might be given in the form of technical assistance by member countries in the region.

Mr. Maino made the following statement:

I join previous speakers in commending the staff for their concise and instructive report on the Republic of Palau. At the center of the challenges faced by the economy lies the need to undertake a sizable fiscal adjustment to adapt the economy to the progressive cessation of U.S. Compact grants by 2005 when the unspent balance of capital grants is expected to be depleted. The passage of legislation aimed at combating money laundering and the Financial Institutions Act constitute a positive contribution to transparency and to improving the climate for investment. We encourage the authorities to further strengthen these efforts by amending the legislation on the lines suggested by the staff and to take advantage of this window of opportunity to consolidate the gains already made and help stop the large outflows of deposits to U.S. banks, keeping in mind the importance of strengthening the financial sector to intermediate savings and providing credit for viable projects. In this context, allow me to make a few brief remarks.

We are heartened by the major steps already taken by the authorities to re-ignite private sector growth, as detailed in Mr. Callaghan's helpful statement. This, together with the tax package being reviewed by Congress, should help consolidate the tax collection through a broadening of the tax base, lower tax distortions and improved tax administration. However, it seems to be also important, in the light of the present unfavorable scenario, to devote special efforts to accelerating public and civil sector reforms. Palau seems to be a clear example of one of the most over-governed countries in the world and, therefore suggesting the desirability of streamlining government and legislature bodies, not only to achieve higher public sector efficiency but, most importantly, to remove impediments to private sector development and entrepreneurship.

We note the agreement in Mr. Callaghan's statement with the staff's analysis and policy recommendations to develop tourism. We would like to ask the staff how it sees the prospects for further economic diversification of the narrow productive base in Palau, in addition to areas such as fisheries and tourism.

While recognizing the efforts made by the authorities concerning the reform agenda, exceptional exogenous factors following the events of September 11, will continue to adversely affect the economy in the upcoming year. A collective approach to trade issues is, therefore, needed. As almost all islands in the Pacific area rely heavily on tariffs as revenue sources, the Regional Trade Agreement entailing significant changes in domestic policies would be welfare enhancing. In this respect, the Pacific Islands Forum could serve as a basis to consolidate preferential access to the EU market. We would welcome clarification from the staff regarding the status of these negotiations and their possible contribution to further economic diversification and improved growth prospects.

In conclusion, despite past setbacks, the authorities significant efforts to revive the fiscal retrenchment and their renewed commitment to structural reform provide an auspicious opportunity to lay the conditions for fiscal sustainability and growth. We wish the authorities every success in this endeavor.

Mr. Whitehall made the following statement:

We thank staff for the report and the authorities for their helpful statement.

> The economy faces many challenges: small size, remoteness, imminent erosion of external financial support, sluggish growth, weak external current account, and significant capacity limitations.
>
> The administration appears committed to undertaking necessary reform measures and should be commended for a 9 percent expenditure reduction facilitated by a wage and hiring freeze and legislative reform to facilitate fiscal and financial reform.
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> We emphasize the importance of following through on structural reform initiatives, particularly in the public sector.
>
> We support the comments of Mr. Mirakhor on the need for structural reforms to attract investment. It is of vital importance to strengthen the private sector and improve prospects for tourism investment through infrastructure and other developments.
>
> Competitiveness problems for tourism owing to high airfares and an appreciating currency (25 percent) need to be addressed.
>
> We encourage the authorities to persevere in their efforts to reform their economy.

The staff representative from the Asia and Pacific Department (Ms. Abdelati) explained that, on Mr. Mirakhor's question about the sufficiency of the social safety net, Palau had a relatively high per capita income (more than $ 6,000 per year), with ample opportunities for employment in the private sector. Palau had been dependent on foreign labor over the last few years, and there had been a large influx of workers into the private sector. Specifically, the existing social safety net was limited to some form of disability assistance and widowers' assistance provided through the social security fund. However, the staff was not advising an extension of the current system, as there were strong extended family structures in place that served a similar purpose as a social safety net. It was hoped that, with higher economic growth, there would also be more private sector opportunities.

Mr. Mirakhor recalled that Mr. Callaghan had noted in his statement that it would take time for the labor released from the public sector to be absorbed into the private sector. This raised issues relating to the appropriateness of the existing social safety net. However, the staff had suggested that there were ample employment opportunities in the private sector, which seemed to be contrary to Mr. Callaghan's suggestion. If it took time before private sector jobs were generated, then some form of social safety net would be required to accommodate those released from the retrenchment of the public sector.

The staff representative from the Asia and Pacific Department (Ms. Abdelati) responded that the current opportunities in the private sector were at a much lower wage than in the public sector, so Palauans were reluctant to leave the public sector, as the average wage in the public sector was about $11,000 a year and the average wage in the private sector was perhaps about $5,000. In practical terms, moving to the private sector meant that, instead of one person working and supporting a whole family, two family members might have to work in the private sector at lower wages. While that constituted possibly a short-term hardship for families, it would not warrant a formal social safety net.

On Ms. Nikitin's question about whether there would be sufficient scope for tourism alone to sustain economic growth in Palau, there were several areas currently under consideration that could support growth, the staff representative stated. Some of those activities were tourist related, but some were geared toward the domestic population. For example, three golf courses were currently being built, and eco-tourism projects and hiking trails were being considered. In addition, there was some discussion of how to diversify into new areas, and the bridge to the main island would expand development opportunities. Tourism in Palau was limited and contained few hotels, which meant there was considerable scope to expand tourism and the related hospitality and service industry. Recent studies, including a JAICA report and a regional study by the World Bank, had revealed that tourism could at least triple without significant impact on the environment, and that was the basis for the staff's projections.

As regards the growth potential of the fishing industry, based on the limited available information, fishing appeared to be very limited in Palau and was considerably less than in similar neighboring islands, the staff representative continued. Part of the reason was the limited fishing zone area, but there was also an international issue, as the fishing took place offshore and was not brought into Palau. In addition, the waters surrounding Palau were considered a nursing ground and the fish were too small to exploit. Also, environmental factors like tropical storms had a large impact on the amount of potential fishing. All those factors indicated no significant scope for improvement in that area. However, a new surveillance system had been introduced by the authorities in order to improve the fishing rights and the fishing fees collected from boats in the area. The authorities also considered expanding sports fishing as an activity, but there was only limited scope for expansion in that.

On Mr. Baukol's question about progress implementing the March 2001 Management Action Plan (MAP), the plan attempted to outline the objectives in every sector of the economy and how reform implementation could be monitored, the staff representative explained. It also listed the goals for the first six months of the administration. The MAP was to be reviewed every six months, and the first review took place in September 2001. A report with the results of that first review had been provided to the staff during the mission in November 2001. Many of the authorities' goals were not achieved at all or on time. However, in nearly every area, reforms were initiated and some progress was. The authorities' thought it preferable to have such a blueprint to guide the administration in the reform process and to keep building on it. In that sense, the MAP was a vehicle to guide the reform process, monitor progress, and identify, with the help of committees, reform priorities.

Mr. Baukol asked whether the Management Action Plan included a timetable with outcome-based goals or whether it was more based on legislative goals. To what extent had the World Bank or Asian Development Bank been involved in assisting the authorities in devising and monitoring the MAP?

The staff representative from the Asia and Pacific Department (Ms. Abdelati) responded that the prescribed actions were of a legislative nature, but also included actions that should be taken by the administration. The authorities had introduced in 2000 a performance management system, which identified their goals and objectives in certain areas. For example, in education, the plan prescribed by what percentage the authorities wanted to increase student capacity, the number of schools, and the number of certified teachers. Those objectives could be monitored, and the outcomes were part of the newly introduced performance management system, which tied expenditures with expected outcomes.

With respect to assistance, the staff was not aware of any the authorities had received in preparing the Management Action Plan, the staff representative continued. The World Bank was not currently involved in Palau. Although the Bank had produced an island report that had covered Palau through the Bank's Pacific assistance center, no Bank mission had visited Palau. Palau was not yet a member of the Asian Development Bank, but the authorities were currently working on their membership.

Mr. Abbing asked, on the Financial Institutions Commission, whether it was realistic to set up a regulatory commission, as the staff report noted that only a small number of people were employed in the banking sector. On tourism, was there an explanation that the number of people employed in the tourism industry had increased by 80 percent whereas real earnings in that sector had actually decreased?

The staff representative from the Asia and Pacific Department (Ms. Abdelati) explained that the Financial Institutions Commission would consist of five people who did not need to be employed on a full-time basis. The commission was receiving considerable assistance, and most of the initial work would consist of reviewing bank licenses and producing forms for banks to start reporting and requiring them to produce audited reports. There had been a discussion about whether the authorities should pool their resources with other islands and have a regional supervisory body, or have some other country conduct the supervision for them. However, while that was viewed as possibly beneficial in the short-term to speed up supervision, the authorities believed that over the longer-term, it was to their benefit to develop local capacity for banking supervision and regulation, which would be facilitated by technical assistance and training.

On tourism, the total number of tourists was around 55,000 a year, the staff representative said. A change of one or two thousand from one country to another, like a shift from American to Japanese or Japanese to Taiwanese tourists, would change the amount of spending, because the per-tourist spending differed substantially depending on the origin of the tourists. In Palau, there had been a shift to more Taiwanese and fewer Japanese tourists, which meant that tourist spending had fallen, although the number of tourists had not declined as much. As for the number of people employed, many entered Palau to assist in the building of new resorts and hotels. Most of the foreign labor was less costly and was displacing some of the more costly Palauans, once the minimum wage was instituted.

On the status of the discussions with the European Union, the authorities were expecting that the EU would participate in the PFTAC and were looking forward to receiving assistance through the PFTAC, the staff representative advised.

The Acting Chair (Mr. Sugisaki) noted that any assistance from the EU in the Fund's technical assistance center in the Pacific island region would be welcome. In fact, some of the current donors had expressed their wish to reduce the level of assistance or withdraw altogether, so any new additional assistance from other sources would be most welcome.

Mr. Callaghan made the following concluding statement:

> We have begun 2002 with the Article IV report for the smallest member of the Fund. To put it in perspective, Palau consists of just over 19,000 people, and the land area is just over twice the size of the District of Columbia, and as we noted in our statement, its GDP is five times smaller than the Fund's operational budget. It is a positive sign that we have started 2002 looking at the smallest member because I represent the four smallest members in the Fund, and I have a particular focus on the interests of the small members. If the time spent on the Fund's surveillance was proportional to the size of the economy, countries like Palau would not receive much attention at all. But the reality is that Article IV processes for economies like Palau can make a much more significant contribution to policy development than it can for many of the larger economies, and this Article IV process is no different.
>
> The comments that have been made today about Palau and the comments in Mr. Mirakhor's statement are very pertinent, and they will be reported in full, and I am grateful for those contributions. As with other small economies, these comments will be analyzed by the authorities far more thoroughly than the views that may be expressed about larger members of the Fund.
>
> Palau certainly faces many challenges, and Mr. Mirakhor summed it up very well in his statement where he says ultimately it is facing a fundamental change in the structure of the economy. But Palau is a small, confident, politically stable democracy, and its influence in the region is well above its relative size. The comment has been made that it is one of the classic examples of an over-governed country. Certainly, it has 19,000 people, it has a central government, it has 16 states, all with elected governors, it is perhaps the epitome of democracy. That may not be efficient, but it is also part of having to bring together a traditional clan-based leadership structure and trying to amalgamate that in a modern system of government. So, you get some of these outcomes, which may not be the most efficient in terms of a

type of government and a type of administrative structure, but it is part of the reality of bringing together an island community to a system of government. As I say, it is a very politically stable government and it is quite a vibrant democracy.

The staff report and the RED paper are very good and they have highlighted the many challenges facing Palau. One of them that has come up in the comments today is the fact that it is very small, it has a very narrow resource base, there is considerable geographic dispersion around the islands, and it is a long way from major population centers. It is very hard to overcome these challenges, and they have imposed certain problems in terms of capacity constraints that have already been raised, and it means that Palau will rely very much on the advice and assistance from other parts of the world. But one of the most pressing challenges it has to confront is the decline of the grants from the United States, and they have largely underwritten the economy since it gained independence in the early 1990s.

As has already been noted, the economy is very vulnerable. It is vulnerable to the vagaries of the weather, it is vulnerable to typhoons, it has had the impact of the El Nino effect, but its main vital aspect of the economy, tourism, is very vulnerable to developments elsewhere in the world. It suffered badly from the Asian economic crisis and the decline in tourists coming from Asia, and it has been badly affected by the events of September 11th. So while people have focused on the fact that the main source of growth is likely to be tourism, Palau will remain very vulnerable, and that is a fact of life.

The other aspect that is worth pointing out in terms of its vulnerability is that Palau does have a trust account and has been building up its trust account in preparation for the decline in grants from the United States. This means it remains very vulnerable to what happens in financial developments in the rest of the world. The interest income from its trust account was just under $7 million in 1999-2000, and last year it was down to $3 million. It is a very substantial fall in interest income because of what happened in the rest of the world, mainly what happened in the United States' financial markets, and the total value of that trust account fell from just over $160 million down to just above $130 million. You need to keep that in perspective in terms of the size of the shock that this small economy has had to adjust for. But the important thing is that the current administration is very aware of what has to be done and what is required to implement a reform program to achieve fiscal sustainability, to improve its investment climate, and to re-ignite private sector growth. Those changes will not occur overnight and there is a capacity problem. Importantly, Palau is benefiting very much from the Fund and its collaboration with the Fund, and the technical assistance it has received.

Some of the important things noted in the staff's supplementary statement is that in response to the staff's recommendations for the 2002 budget, the authorities have brought forward the tax reform package and the bills are now before Congress, and similarly the staff highlighted the importance of removing the impediments for foreign investment, and towards that end new foreign investment laws have been brought to Parliament. So I would just highlight again the impact that these consultations can have in these small economies.

Mr. Mirakhor raised the question that the fundamental restructuring of the economy will not be painless. It will not be painless, for the reality is that the benefits of the restructuring take time to emerge, if you are removing the government sector as by far your main employer in the economy, and shifting the source of employment growth to the private sector. There are certain major impediments to this process, like a minimum wage that is inhibiting the employment of Palauans as opposed to foreign workers, but all these changes will take time, and they will not be painless.

On the question of the adequacy of the social safety net, one of the great advantages of the communal nature of island life is that it does provide an in-built safety net, but it also has the disadvantage in that it does run counter to the spirit of entrepreneurial enterprise. This is one of those unique and important cultural aspects which are throughout the Pacific Islands, namely, a very strong communal community-based structure.

To conclude, I would just re-emphasize again the importance that this Article IV process has made to Palau and on behalf of my authorities, I would very much like to thank the staff for all their efforts. It has been greatly appreciated.

Finally, we are still waiting for advice as to whether they will publish the report.

Mr. Mirakhor emphasized the equality of treatment for all Fund members' countries and each deserved the full attention of the staff, the management, and the Board, irrespective of size. He had never favored a 24-month consultation cycle for smaller countries. In that regard, Mr. Callaghan's considerations on the importance of Fund advice and Fund relations to such countries were very pertinent. In view of the fact that 2002-2003 would be a crucial period for Palau to develop a sustainable economic and financial policy, and the fact that the World Bank and the Asian Development Bank were not involved, a closer and more frequent contact between the Fund and the authorities might be warranted.

The Acting Chair (Mr. Sugisaki) noted that Mr. Mirakhor had frequently emphasized the principle of the equality of treatment among the membership, particularly on surveillance issues. The Fund's Asian and Pacific Department would monitor Palau's economic development closely, and if the need for closer contact arose, the Fund would provide direct assistance from its headquarters or PFTAC technical assistance center based in Fiji.

The Acting Chair made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended Palau's new administration for reinvigorating the reform process and welcomed the recent legislative initiatives aimed at public sector reform and removing impediments to economic growth. At the same time, they pointed to several challenges facing Palau: the sluggish growth performance, which remained lower than other Pacific Island countries; the need to diversify the production base to reduce vulnerability to external shocks through improved competitiveness and active promotion of private sector development; the end of the current Compact funding provisions in FY 2010, and the drawdown of the government's asset balances. Directors agreed that the main tasks ahead are to remove investment impediments in order to build the basis for sustained growth, to reduce Palau's dependence on foreign assistance, and to achieve medium-term fiscal sustainability.

Directors considered that the large overall fiscal deficit in 2001 is not sustainable, given that nearly three-fourths of the cash component of Compact grants (excluding the Trust Fund) has been spent. They welcomed the recent efforts to address this problem, including the strengthening of tax administration, restraint on public sector wages, and a hiring freeze during FY2001. Nevertheless, they urged further fiscal consolidation, especially since foreign assistance is likely to be smaller in future years and there is a need to maintain an adequate reserve buffer to protect against future external shocks.

Directors urged the authorities to develop a medium-term fiscal consolidation plan consistent with the scheduled end of current Compact funding provisions, based on realistic assumptions about future Compact Trust Fund returns, and aiming to achieve a balanced budget by FY2005. Directors recommended that domestic revenue be raised to a level that would offset the expected reduction in grants in FY2010 and avoid depletion of the real value of the Trust Fund. To achieve this objective, previously delayed tax reforms would need to be implemented without further delay.

As a first step, for FY2002, Directors urged that the tax package presented to Congress in October 2001 be implemented as soon as possible in order to achieve the targeted reduction in the overall fiscal deficit. It will also be essential to prepare the next phase of tax reform, including income and sales tax reform, for presentation to Congress during the coming year. In view of Palau's relatively high public sector wage bill compared with neighboring countries, Directors emphasized the need to continue with the hiring freeze and to proceed with the recommendations of the National Planning Committee on governmental reorganization, while ensuring that a sufficiently strong social safety net is in place to assist the most vulnerable segments of the population. Directors also expressed concerns over the recent increase in unfunded liabilities of the Social Security Fund (SSF) and the Civil Service Pension Fund (CSPF), and urged that the contribution and benefit schemes be revised.

Directors supported the structural reform agenda set out by government in its Management Action Plan (MAP) of March 2001. Noting that failure to deal effectively with structural impediments in the past had prevented a widening of the economy's productive base, Directors urged consistent implementation of the policies in the MAP.

Directors stressed the need to shift the government's role from being the main employer to one of promoting adequate physical and human capital development. Directors were encouraged by ongoing reorganization efforts, including plans to reduce the size of the civil service, the better linking of existing posts to skill and performance requirements, and the removal of some layers of government while outsourcing services and privatizing some maintenance and operational functions.

Directors stressed the importance of fostering an environment conducive to private investment. In this regard, they welcomed the recent presentation to Parliament of the new foreign investment law and hoped for its speedy adoption. Directors considered it important to reduce the rigidities in land and labor markets that have constrained the growth of tourism and private investment more generally. Therefore, they urged continued efforts to accelerate dispute resolution by the Land Courts. Directors expressed concern over the impact of the recent minimum wage legislation on competitiveness, and encouraged the authorities to review other regulations on employment.

Directors welcomed the passage in June 2001 of legislation aimed at combating money laundering and establishing a framework for banking regulation and supervision. In this connection, they urged prompt establishment of the Financial Institutions Commission that will develop regulations and oversee the implementation of the new legislation. They also called for further strengthening of the regulatory and supervisory framework to address some of its weaker elements, including through the drafting of the FIC regulations, amending the newly passed Financial Institutions Act, if necessary, and by requiring financial disclosure of audited accounts by all licensed banks.

Directors welcomed steps to improve data reporting and quality, and encouraged Palau to participate in the Fund's General Data Dissemination System. However, they noted that significant statistical deficiencies remained, particularly in balance of payments, national accounts, and monetary statistics, that continue to impede effective surveillance and policy formulation. They therefore urged the authorities to continue their efforts to improve data collection and dissemination and to improve reporting to the Fund.

It is expected that the next Article IV consultation with the Republic of Palau will be held on a 24-month cycle.

3. EXECUTIVE DIRECTOR

Length: 30 minutes

The Acting Chair (Mr. Sugisaki) bade farewell to Mr. Lehmussaari, the Executive Director for Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway, and Sweden.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/01/130 (12/17/01) and EBM/02/1 (1/4/02).

4. ECUADOR—STAND-BY ARRANGEMENT—WAIVER OF PERFORMANCE CRITERION

1. Ecuador has requested a waiver for the nonobservance of the continuous performance criterion on the nonaccumulation of external payments arrears set forth in paragraph 3(d) of the Stand-By Arrangement for Ecuador (EBS/00/66, Sup. 2, 4/24/00).

2. The Fund waives the nonobservance of the performance criterion on the nonaccumulation of external payments arrears, including those that may arise in the ongoing debt reconciliation process, on the condition that the information provided by Ecuador on performance under this criterion, including the amounts subject to the ongoing debt reconciliation described in EBS/01/209 (12/21/01) is accurate.

Decision No. 12649-(02/1), adopted
December 28, 2001

5. HAITI, AND REPUBLIC OF PALAU—ARTICLE IV CONSULTATION—POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies," attached to Decision No. 5392-(77/63), adopted April 29, 1977, as amended, the Executive Board decides that the period for completing the next Article IV consultation with The Republic of Palau and Haiti shall be until the dates indicated in EBD/01/119 for such countries. (EBD/01/119, 12/19/01)

Decision No. 12650-(02/1), adopted
December 28, 2001

6. SOCALIST PEOPLE'S LIBYAN ARAB JAMAHIRIYA—DECISION CONCLUDING ARTICLE XIV CONSULTATION

1. The Fund takes this decision in concluding the 2001 Article XIV consultation with the Socalist People's Libyan Arab Jamahiriya.

2. The Socialist People's Libyan Arab Jamahiriya continues to maintain restrictions on the making of payments and transfers for current informational transactions in accordance with Article XIV, Section 2, as described in SM/01/51 (2/15/01). The Fund encourages the Socialist People's Libyan Jamahiriya to eliminate these restrictions as soon as circumstances permit. (EBD/01/119, 12/19/01)

Decision No. 12651-(02/1), adopted
December 28, 2001

7. TWELFTH GENERAL REVIEW OF QUOTAS—ESTABLISHMENT OF COMMITTEE OF THE WHOLE

In accordance with Rule D-3 of the Fund's Rules and Regulations, a Committee of the Whole for the Twelfth General Review of Quotas, with the Managing Director as Chairman, is hereby established. Committee action shall not be binding on the Executive Board. Minutes of the meetings shall be prepared and circulated for approval of Committee members. (EBD/01/118, 12/18/01)

Adopted December 27, 2001

8. EUROPEAN CENTRAL BANK—OBSERVER STATUS

The Executive Board has reviewed Decision No. 11875-(99/1), adopted December 21, 1998. The Decision shall be reviewed again before January 1, 2003. (EBD/01/120, 12/21/01)

Decision No. 12652-(02/1), adopted
December 28, 2001

9. STAFF RETIREMENT PLAN—SUPPORT PAYMENTS FOR CHILDREN, INCLUDING THOSE BORN OUT OF WEDLOCK—REVISION

Section 11.3 of the Staff Retirement Plan (SRP) shall be amended to treat all children the same when a court order provides for the payment of a part of a retiree's pension for child support, regardless of whether a child is born within a marriage or out of wedlock. (EBAP/01/140, 12/19/01)

Decision No. 12653-(02/1), adopted
December 27, 2001

10. DOMESTIC PARTNER BENEFITS—EXTENSION

That the range of benefits currently available to the domestic partners of eligible Fund staff be expanded to include appointment and repatriation benefits; emergency leave, emergency travel, and travel time; salary advances for education expenses of employees' domestic partners; travel under the points system; travel insurance and personal effects insurance; worker's compensation; education travel and allowance; and home leave travel and allowance.

That natural and legally adopted children of domestic partners be considered eligible for Fund benefits on the same basis as stepchildren of married Fund staff.

In the event that the domestic partner relationship is terminated, the children of the domestic partner would no longer be eligible for these benefits.
(EBAP/01/135, 12/11/01)

Adopted December 18, 2001
Effective February 4, 2002

11. CHANGE IN ELIGIBILITY FOR EXPATRIATE BENEFITS

The eligibility criteria for expatriate benefits are amended so that:

- Non-grandfathered staff who are presently employed by the Fund but who hold an RA visa and new recruits who hold RA visas will be eligible for full expatriate benefits for themselves and their eligible family members, provided they relinquish their RA visa and obtain a G-4 visa.
- This option will be limited to one change in a Fund career.
- Staff who exercise this option will be required to submit acceptable proof of the change of visa status.
- Eligibility for benefits will be counted from the date of issuance of the G-4 visa. (EBAP/01/135, 12/11/01).

Adopted December 18, 2001
Effective May 1, 2002

12. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 01/77, 01/79, 01/88, 01/92, 01/96, 01/99, and 01/104 are approved.

13. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by Assistants to Executive Directors as set forth in EBAM/01/149 (12/17/01), EBAM/01/150 (12/19/01), EBAM/01/152 (12/21/01), and EBAM/01/154 (12/27/01) is approved.

14. TRAVEL BY MANAGING DIRECTOR

Travel by The Managing Director as set forth in EBAP/01/142 (12/21/01) is approved.

APPROVAL: February 26, 2002

SHAILENDRA J. ANJARIA
Secretary