

March 31, 2020
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/8-1

10:00 a.m., February 1, 2019

1. Republic of Palau—2018 Article IV Consultation

Documents: SM/19/7 and Correction 1; and Supplement 1

Staff: Kinoshita, APD; Sun, SPR

Length: 24 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors Alternate Executive Directors

	I. Mannathoko (AE)
	E. Ondo Bile (AF), Temporary
	C. Moreno (AG), Temporary
N. Ray (AP)	
	P. Fachada (BR)
	K. Lok (CC), Temporary
	A. Del Cid-Bonilla (CE), Temporary
	N. Feerick (CO), Temporary
	S. Benk (EC)
	A. Sode (FF), Temporary
S. Meyer (GR)	
	M. Siriwardana (IN)
	P. Di Lorenzo (IT), Temporary
	Y. Naruse (JA), Temporary
	S. Alavi (MD), Temporary
	F. Al-Kohlany (MI), Temporary
	J. Hanson (NE), Temporary
	J. Sigurgeirsson (NO)
	Z. Smirnova (RU), Temporary
	W. Al Hafedh (SA), Temporary
	K. Tan (ST)
	P. Trabinski (SZ)
	O. Haydon (UK), Temporary
	S. Vitvitsky (US), Temporary

G. Tsibouris, Acting Secretary
H. Malothra, Summing Up Officer
D. Jiang, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present

Asia and Pacific Department: O. Brekk, T. Helbling, D. Lee, S. Roger. Fiscal Affairs Department: Y. Kinoshita. Strategy, Policy, and Review Department: Y. Sun. Executive Director: G. Lopetegui (AG). Senior Advisors to Executive Directors: Z. Mohammed (BR), J. Shin (AP), A. Tivane (AE). Advisors to Executive Directors: S. David

(AP), M. Kikiolo (AP), G. Kim (AP), P. Mooney (CO), R. Pandit (ST), A. Park (AP), I. Skrivere (NO), A. Zaborovskiy (EC).

1. **REPUBLIC OF PALAU—2018 ARTICLE IV CONSULTATION**

Mr. Ray and Mr. Amor submitted the following statement:

Palau is a very small island state in the North Pacific with an exceptional marine environment. The government has set aside around 80 percent of the country's maritime territory – roughly the size of France – as a marine sanctuary. Tourism is the main industry. A spike in tourist numbers in 2015 put significant strain on public infrastructure and raised environmental concerns. In response, the authorities acted to reduce the number of arrivals to levels consistent with their goal of preserving the fragile environment and safeguarding Palau's reputation as a pristine tourist destination. They are also increasing infrastructure investment to support private sector development.

The decline in tourist arrivals meant the economy contracted by 3.7 percent in 2017. The Palauan authorities agree with staff that growth picked up in 2018 and will strengthen to 2 percent in 2019 and into the medium term. Growth will be supported by public infrastructure projects and the construction of already-approved luxury hotel investments. Palau also recently completed a fiber-optic connectivity project, bringing high-speed broadband to the country. This will create new opportunities for Palauans and aid the delivery of more efficient health and education services.

Palau is vulnerable to natural disasters and external shocks. In the absence of monetary and exchange rate policies, the authorities agree that risk mitigation is limited to fiscal and structural policies. They have been building fiscal buffers and have secured a \$15 million facility with the Asian Development Bank that provides a predictable, quick-disbursing source of financing for response, recovery, and reconstruction activities following a natural disaster. Palau is working to diversify its tourism source markets as well as the tourism products it offers, while promoting inclusive growth through tourism product development in rural communities.

Fiscal Sustainability

The Palauan authorities are grateful for continued financial assistance from the international community. In particular, the United States provides support through the Compact of Free Association and the recently-approved \$123 million in Compact grants will help finance much-needed infrastructure investments. Compact grants are due to expire in 2024 and the authorities are working on a medium-term strategy to ensure fiscal self-sufficiency. Palau has seen a fiscal surplus since 2011 – even in 2017 when the economy slowed.

The authorities have saved some of these surpluses in a General Fund Reserve, which currently stands at 5 percent of GDP in 2018. They plan to continue building this into a fully-fledged stabilization fund to help cushion against economic shocks that impact domestic revenues.

Fiscal surpluses have been aided by revenue mobilization measures, including an environmental fee levied on inbound passengers. With technical support from PFTAC, a comprehensive tax reform bill has been prepared and is currently under consideration by the Congress. This proposed Palau Goods and Services Tax (PGST) is a much more efficient tax system that will result in strong revenue growth over the long term.

Potential contingent liability risks from the Civil Service Pension Fund (CSPF) and the SOEs have been acknowledged. An actuarial study will guide the plans to support the CSPF's long-term sustainability. The authorities also want to make SOEs, particularly the Palau Public Utilities Corporation, self-sustaining. They intend to phase out subsidies when service quality is upgraded, and social protection measures have been developed to support the low-income village residents who are likely to be affected by subsidy removal.

Financial Sector Stability

The presence of three U.S. FDIC-insured banks is the back-bone of the banking system in Palau, holding 91 percent of loans and 99 percent of deposits in 2017. The government also owns the National Development Bank, which is taking a more active role in providing credit to smaller borrowers in Palau. Banks are well-capitalized and liquid, with a low proportion of non-performing loans. With regards to supervision, the Financial Institutions Commission continues to enhance its capabilities through technical assistance and training from the IMF and US-FDIC and is broadening supervision and regulation to non-bank institutions. The Financial Intelligence Unit is making efforts to improve the AML/CFT regime.

While several cryptocurrency investors have approached Palau, the authorities recognize the risks and uncertainties around cryptocurrencies and do not plan to entertain any proposals. The authorities have asked the IMF and other international institutions to be proactive in their outreach and to raise awareness of the potential risks and benefits of blockchain technology more generally.

Growth and Private Sector Development

Development in Palau will continue to be guided by the Palau Responsible Tourism Policy Framework, which aims to make Palau a high-value tourism destination, targeting high-spending visitors over quantity. This will help safeguard Palau's unique natural assets and ensure a sustainable and resilient income stream for decades to come. The authorities have engaged with a Japanese company in a PPP to renovate, expand and manage Palau's international airport. Renewable Energy Investment plans will also help reduce energy costs for businesses and consumers, and assist Palau to meet its Paris Agreement pledge of increasing the share of renewable power to 45 percent by 2025. The authorities and development partners are ensuring that all new infrastructure projects are resilient to natural disasters and climate change.

Palau continues to experience "brain drain". In response, the President has submitted a bill to the Senate which would gradually raise the minimum wage from \$3.50 to \$8.50 per hour over the next 10 years. While staff recommends against this policy, the authorities are convinced that it is necessary to attract and retain Palauans and enhance labor force productivity given the more attractive minimum wage levels in neighboring islands.

The Palauan authorities thank the mission Chief and her team for the productive engagement and quality policy discussions, and thank the IMF for the continued support through provision of technical assistance and policy advice.

Mr. Fachada and Ms. Mohammed submitted the following statement:

We thank staff for the well-structured report and Mr. Ray and Mr. Amor for their insightful statement. The Palauan authorities are commended for preserving macroeconomic and financial stability, with an overall fiscal surplus, a sound banking system, and moderate and sustained public debt level, despite the recent slowdown in economic activity due to lower tourism. Nevertheless, Palau continues to face structural challenges related to low population, geographical remoteness, vulnerability to natural disasters and climate change, and heavy reliance on volatile tourism revenues and foreign grants.

Strengthening the fiscal framework is important. We welcome the adoption of a medium-term fiscal framework by the authorities, considering Palau's reliance on declining external financing, volatile tourism revenues,

and exposure to natural disasters. Whilst we note that the comprehensive tax reform would boost Palau's revenues once enacted by Congress, expenditure-reducing measures can further strengthen the fiscal position. Against this backdrop, the authorities' actions to reduce inefficient spending on state-owned enterprises and address contingent liability risks are warranted. We welcome their continued efforts to strengthen the public investment management framework while balancing project debt sustainability and limiting undue risks from PPPs. The authorities plan to continue building the General Fund Reserve (GFR) to safeguard the economy against adverse shocks is a step in the right direction. We take note that the tax reform bill was sent to Congress for consideration in September 2018 and would like to get a sense of timing of its implementation. Staff views are welcome on the length of time this process may take.

The financial sector in Palau remains sound, despite continued low domestic credit. Although we share staff's view that greater domestic credit would support private sector activity, we acknowledge the authorities position that structural factors may influence the low bank lending. We agree with staff on their assessment of risks arising from the introduction of cryptocurrencies and the need to implement the Financial Action Task Force (FATF) recommendations. Cryptocurrencies pose significant financial integrity risks that requires enhanced supervision and regulations, particularly related to AML/CFT.

Palau's high-end tourism strategy provides for sustainable growth and environment protection. The authorities view in making Palau a high-value tourism destination by targeting high-spending visitors over quantity is welcome. This would not only provide sustainable income streams and preserve Palau's unique natural assets but ensure intergenerational equity. We also commend the authorities for their renewable energy investment plans aimed at increasing the share of renewable power to 45 percent by 2020.

Mr. Benk and Mr. Zaborovskiy submitted the following statement:

We thank staff for their insightful report and Messrs. Ray and Amor for the informative buff statement. As many Pacific microstates, Palau faces significant challenges, mostly stemming from climate change, a narrow production base, infrastructural bottlenecks, and cyclical tourism revenues. We broadly agree with the thrust of the staff's appraisal and policy recommendations and would like to add the following comments.

A growth-friendly gradual fiscal consolidation based on a sound fiscal framework is the prerequisite to ensure long-term budget and debt sustainability. We welcome the authorities' cautious fiscal policy stance which is broadly in line with staff's recommendations. However, progress in advancing fiscal structural reforms since the previous Article IV consultations has been uneven. We note that the authorities are more positive about the new fiscal reform bill to be approved by the Congress. Can staff comment on how the authorities' strategy compares to staff's reform scenario.

Further progress on the financial sector reform is needed to facilitate credit expansion and private sector development. Many of staff's recommendations on financial sector development at the time of the 2016 Article IV consultation remain relevant and should be pursued. Broadening supervision and regulation to non-bank institutions as mentioned in the buff statement is a welcome step. We encourage the authorities to address the existing AML/CFT deficiencies especially in view of possible future cryptocurrency operations.

Investors- and business-friendly structural reforms are critical to broaden the production base of the economy. We support staff's recommendations regarding structural policies and call on the authorities to move forward with supporting private sector development, improving the business environment and attracting FDI, including fiscally responsible Public Private Partnerships. Concerning the policies to prevent the brain drain from youth emigration, we would like staff to comment on the alternatives to the envisaged minimum wage hike that can bear fruits in the near term.

With these remarks we wish the authorities every success in their policy endeavors.

Mr. Sigurgeirsson and Ms. Skrivere submitted the following statement:

We thank staff for the report and Mr. Ray and Mr. Amor for their informative BUFF statement. We broadly share staff's appraisal and would like to offer the following points on fiscal policy, the tourism sector, and financial stability for emphasis.

We agree with staff's recommendations on efforts towards shifting to a medium-term fiscal framework and strategy. We commend the authorities for their efforts in maintaining overall budget surpluses that have led to a decline in net debt. However, as grant support is due to expire in the coming years, it is appropriate for Palau to shift towards developing a medium-term fiscal

framework and strategy. Such a strategy should combine a comprehensive tax reform to raise revenue, a reduction of inefficient current spending, and a strengthening of public financial management, in particular related to PPPs.

Through the promotion of sustainable eco-tourism, the authorities are rightly focusing on the high-end tourism strategy, preserving the environment, and enhancing resilience to natural disasters and climate change. Chinese and Taiwanese tourists made up half of all arrivals last year; however, according to staff's analysis they seem to be the most price-sensitive visitor group, on average spending less on accommodation than other nationalities. Therefore, greater efforts to diversify tourism source countries appears warranted. Like staff, we remain skeptical of an increase in the minimum wage as the right policy tool to limit emigration and retain workers for the tourism sector. An increasing number of skilled workers are migrating to the US, and the proposed minimum wage increase appears unlikely to substantially affect their decision to move away from Palau. Moreover, structural reforms and enhanced education and training, as proposed by staff, would also provide synergies for the tourism industry.

Financial stability and integrity need to be preserved, and emerging risks have to be carefully monitored. We encourage the authorities to swiftly address the AML/CFT deficiencies identified in the recent mutual evaluation report. Given the high risks, we support the authorities' decision not to respond to the cryptocurrency investors' proposals. We agree that the Fund and other international organizations could play a more active role in raising awareness of the potential risks and benefits, as well as evaluating the appropriate regulatory response to crypto assets.

Mr. De Lannoy submitted the following statement:

We would like to thank staff for the informative set of reports, and Messrs. Ray and Amor for their helpful buff statement. We largely share staff's assessment and policy recommendations.

We encourage the authorities to continue their efforts with implementing structural policies to make Palau's economy more resilient to economic shocks. Economic growth slowed down and consequently contracted in the last two years due to a lack of diversity and high dependence on tourism, which makes the country sensitive to external shocks.

We also encourage the authorities to enhance their efforts to diversify the economy within, as well as outside the tourism industry. Between 2012

and 2016, the tourism sector continued to increase its share in total exports, making Palau the most tourism-concentrated country among small states. We broadly agree with staff's assessment that Palau has limited options for inter-industry export diversification due to the country's small size. Still, measures to improve the business climate and facilitate private sector investments are highly recommended. We agree with staff's policy recommendation to increase efforts with facilitating domestic credit provision to the private sector by relaxing the interest rate ceiling for corporate loans to better reflect cost and riskiness, along with helping small and medium-sized enterprises prepare business plans and financial statements.

Despite the fact that the occurrence of natural disasters is relatively low in Palau compared to other small-island states, improving country resilience to natural disasters and climate change should be the top priority. We recommend the authorities to follow up on staff's policy proposal to implement contingent plans and to strengthen the infrastructure, including coastal protection and planning. Furthermore, we ask staff whether Palau's financial buffers and the US\$ 15 million facility with the Asian Development Bank could adequately mitigate financial risks following a natural disaster?

We support staff's recommendation to strengthen the fiscal framework over the medium-term and encourage the authorities to continue with a comprehensive tax and expenditure reform to achieve fiscal self-sufficiency. Palau relies heavily on Compact grants. Expiration of these grants in 2024 will result in a deterioration of the fiscal position that needs to be addressed. This fiscal adjustment requires improved tax collection and a shift in the public expenditure composition to investments in the country's infrastructure to facilitate the growing tourism industry as well as increase the country's resilience to natural disasters. We support staff's appraisal that fiscal adjustment needs to focus on the reform of public entities, fiscal institutions and of the Civil Service Pension Fund in order to eliminate unfunded liabilities.

Mr. Villar and Mrs. Del Cid-Bonilla submitted the following statement:

We thank staff for the comprehensive report and Mr. Ray and Mr. Armor for their useful buff statement. As other small-island countries, Palau has a little-diversified economy, and is highly vulnerable to climate change and other shocks. We commend the authorities for the ongoing process of fiscal consolidation and structural reforms. Even though Palau's economic outlook is positive, risks are tilted to the downside and important challenges

remain for growth to be more resilient and sustainable. We broadly share the thrust of the staff appraisal and will limit our comment on a few topics.

Moving to a medium-term fiscal framework and strategy to ensure long-term fiscal sustainability. Setting the current fiscal balance to ensure government's intertemporal budget constraint is a desirable approach to face volatile domestic revenues, the expiration of the Compact Agreement in 2024 and the decrease in non-compact grant resources. We commend the authorities for the comprehensive tax reform sent to Congress. Given non-approval by Congress of a previous fiscal reform, how does staff assess the possibilities for approval this time?

Reducing current spending and continue strengthening PFM should be a pillar of the fiscal strategy. Staff recommends a formal PEFA assessment to update and identify areas that need to be addressed on the PFM roadmap. The authorities started to use PPPs in some large infrastructure projects and have indicated their intention to continue using this vehicle for other capital projects. Given the fiscal contingencies that can arise from PPPs, have the IMF or other development partners accompanied the authorities in this task so far? Is a formal PEFA being considered? Can staff also elaborate on the fiscal contingencies related to SOEs other than CSPF and PPUC?

Strengthening Palau's growth potential and making it more sustainable and resilient is critical. We welcome the authorities' continuous efforts to adopt a comprehensive tourism strategy, which include actions to strengthen the environment and upgrade resilience to natural disasters and climate change. We found staff analysis on labor market and minimum wages (MW) particularly useful and share the view that an increase in MW should be part of a broader approach to prevent youth emigration. One important element, however, is how Palau's MW currently compares with peer countries; Can staff add comments on this?

The interest rate ceiling on corporate loans could be one of the causes preventing more credit expansion. Relaxing this ceiling would provide greater incentives by better reflect costs and risks. Lack of secured lending for real state is another obstacle for credit expansion pointed by staff; however, we didn't find any specific recommendation to address this issue. Staff's comments are welcome.

With these remarks we wish the Palauan authorities success in their future endeavors.

Ms. Mannathoko and Mr. Abdullahi submitted the following statement:

We thank Messrs. Ray and Amor for their informative buff statement. It has helped us to better understand the challenges the Palau economy faces and how they are being addressed. We also thank staff for a well written report.

Palau faces similar climate change and diversification challenges to other small island states. The reliance on tourism, at about 45 percent of GDP and reflected in the sharp slowdown in 2016 and contraction in 2017, necessitates an effective tourism strategy that balances medium term growth with long-run sustainability. We therefore urge the authorities to prioritize the full implementation of the lower volume - higher value, high-end tourism strategy. We would value staff's elaboration on what is constraining progress in the diversification of tourism source countries. Going forward, the authorities need to prepare a strong fiscal and structural regime to deal with looming challenges including multiple and significant fiscal demands, as well as job creation needs for the young population. Considerations in these areas are discussed below.

Fiscal Risks and Sustainability

With US Compact grants set to expire in five years, we commend the authorities on the important progress made in revenue mobilization and a comprehensive tax reform bill. We also back the decision to develop a medium term fiscal framework that will support fiscal sustainability, smooth out revenue volatility and manage fiscal risks. Given the multiple fiscal demands on the horizon including climate change requirements, we agree on the importance of establishing a robust stabilization fund. However, with competing demands also looming, such as potential SOE and civil service pension obligations, properly defined access to the stabilization fund will be essential. Could staff comment on whether rules are in place defining requirements for future access to the fund?

Public sector efficiency will become increasingly important as fiscal needs expand, and in this regard, we applaud the authorities' ongoing efforts to strengthen public financial management (PFM) and encourage a formal public expenditure and financial accountability assessment that will help identify PFM priorities going forward.

Youth Migration and Wages

The long-term solution to the youth migration problem is job creation, and in this regard, priority should be given to improving the investment climate, including labor productivity; and private sector development, with a view to diversifying economic opportunities. With respect to the labor market, the authorities' intention to raise minimum wages has multiple implications, the net effect of which could be a different outcome from that intended; so we understand staff's concern. Could staff indicate whether quantitative labor market analysis is available beyond what is in Appendix X, to assess the skill levels and skill mix of youth migrants out of Palau, and the implications of a higher minimum wage? The authorities believe higher wages will boost productivity, but such outcomes may depend on the labor market context. Thus country-specific analysis may be needed to establish the true nature of the labor market and outward immigration and convince the authorities to reconsider the minimum wage measure.

Financial Sector Effectiveness

With private credit at just 12 percent of GDP, substantial improvement in financial intermediation is needed to support private sector growth and diversification into non-tourism activities. Currently, banks' investment of excess liquidity in the U.S. diverts domestic resources away from productive domestic use. We therefore encourage the central bank to re-assess its policy measures and focus on developing a framework that will enable and support intermediation.

In closing, we commend the Palauan authorities on the current economic recovery and wish them success going forward.

Ms. Pollard and Mr. Vitvitsky submitted the following statement:

We thank staff for the interesting Article IV report on Palau and Messrs. Ray and Amor for their helpful buff statement. Like other small island nations, Palau is heavily dependent on tourism though has inadequate infrastructure to support the growing industry and to build resilience to natural disasters. Palau also faces output, revenue, and external balance volatility. In this context, we support staff recommendations to develop a medium-term fiscal framework to account for revenue volatility and the future expiration of Compact grants. We also encourage the authorities to improve public financial management (PFM) and to take concrete steps to improve the investment

climate, which will help attract more FDI and foster the development of the private sector

We welcome progress by the Financial Institutions Commission (FIC) to improve its efforts to strengthen financial sector supervision and to enhance the AML/CFT framework. In this regard, we are pleased to see TA support from the IMF and the FDIC. We also encourage the authorities to address AML/CFT deficiencies to move towards compliance with the Financial Action Task Force (FATF) standards.

Regarding cryptocurrency investors approaching Palau, we are glad that the authorities recognize the risks and uncertainties around cryptocurrencies and do not plan to entertain any proposals, as articulated by Messrs. Ray and Amor's buff statement. It is critical that there be a fulsome and candid assessment of the potential economic, financial sector, and financial integrity risks surround the introduction of cryptocurrencies in Palau. The monetary and financial impacts of issuing a virtual currency as a legal tender are still unknown, and we urge the authorities to continue to exercise caution.

Mr. Gokarn and Mr. Siriwardana submitted the following statement:

We thank staff for their comprehensive report and Mr. Ray and Mr. Amor for their informative buff statement. Growth in Palau is expected to have recovered moderately in 2018 after the contraction in 2017 due to the drop in tourist arrivals. Inflation remains subdued. The continued fiscal surplus, which has been saved in a General Fund Reserve, has come at the cost of expense restraint in the recent past. The current account deficit has increased due to the decline in tourism receipts. As a Pacific microstate, Palau is faced with urgent infrastructure and environmental challenges due to its heavy reliance on the tourism as the back-bone of the economy, given its narrow economic base, which has also threatened the long-term sustainability of the economy. This has led to output, sectoral and macroeconomic volatility as well. The country's proneness to natural disasters also calls for adequate investments. The expiration of the Compact grants in 2024 will add to these challenges. Hence, strong efforts to improve fiscal management and implement structural reforms as well as to expand tourism-related infrastructure, supported by continued international assistance, are critical to sustain the long-term growth. We broadly concur with staff's appraisal and wish to make following remarks for emphasis.

Sustaining tourism while promoting and preserving Palau's pristine environment is a key challenge. We noted that the over-reliance on the environment could badly affect the ecosystem. Could staff comment on using the environment policy for economic benefits in Palau? The measures introduced in 2017 to reduce tourist arrivals has significantly dropped economic activity. We agree with the limitations in promoting diversification outside the tourism industry to build adequate economic buffers to reduce economic risks and vulnerabilities associated with tourism given the unique features in Palau. In this context, we would welcome staff's comments on the progress in moving towards high-end tourism to raise individual tourist spending by diversifying tourism markets and products. We would also like to know about the progress in implementing the 2017-21 Palau Responsible Tourism Policy Framework. We encourage the authorities to address infrastructure bottlenecks and improve the business climate to promote private investment.

Fiscal prudence is essential to build fiscal buffers and ensure Palau's long-term fiscal and debt sustainability. Cautious fiscal planning is imperative to face upcoming challenges and avoid sudden and ad-hoc policy changes post 2024. We agree with staff on a medium-term fiscal framework to incorporate multi-year planning and budgeting. We welcome authorities' medium-term plans to build fiscal buffers and the envisaged reforms to introduce a modern and efficient tax system to improve domestic revenue mobilization, which should be complemented by structural expenditure reforms to achieve fiscal self-sufficiency by the time Compact grants expire, to open up space for greater growth-enhancing capital spending in tourism and to enhance resilience to natural disasters. Further, we support staff's recommendations to improve public financial management and address fiscal risks. We noted authorities' plans to increase PPPs to finance capital projects. While this has merit given the pressing needs, we wonder whether Palau has adequate expertise and the necessary frameworks to expand PPPs. Staff's comments are welcome. We commend the authorities' commitment, indicated in buff Statement, to develop social protection measures to support low income village residents. We are encouraged by the staff's assessment that public debt remains sustainable but continued efforts are necessary to maintain this status.

The banking system remains sound with adequate liquidity and low NPLs. We support staff's recommendation to relax the interest rate ceiling for corporate loans to facilitate domestic credit growth. We would welcome staff's comments on the "front businesses" in the context of their links with the financial system, the trends in domestic credit and regulatory framework

for corporates in Palau. We welcome the efforts to strengthen bank supervision and broaden the supervision to non-bank financial institutions. Further strengthening of the AML/CFT framework is also important to address associated risks. We positively note the authorities' cautious approach on cryptocurrencies given their potential risks and uncertainties.

We commend the authorities' efforts to enhance resilience to climate change and natural disasters. We noted staff's recommendation to internalize costs for the ex-post response associated with such events. Staff's comments are welcome on the efforts to build ex-ante resilience as well. In this context, we note that authorities and development partners will be ensuring that all new infrastructure projects are resilient to natural disasters and climate change, as indicated in the buff statement, which is encouraging.

With these remarks, we wish the authorities of Palau success in their future endeavors.

Mr. Trabinski and Ms. Wehrle submitted the following statement:

We agree with staff's overall assessment and recommendations for Palau. We welcome the authorities' strategy to focus on the high-end, environmentally sustainable tourism sector and to encourage investment in this area. As mentioned by Mr. Ray and Mr. Amor in their insightful buff, better internet connectivity through fiber-optic cables have the potential to improve the delivery of health and education services to Palauans. Better connectivity could also help the country promote location-independent jobs, in addition to the tourism sector. Notwithstanding these positive developments, we note that Palau faces high growth volatility relative to peers in the Pacific. We thus have the following points for emphasis:

Developing a medium-term fiscal framework and strategy should be a key priority. The authorities' current approach of avoiding deficits for different budgetary items, while seemingly conservative and effective in generating surpluses, does not enable them to factor in future challenges. These include the expiration of Compact grants, the potential decline in the real value of the Compact Trust Fund, revenue volatility, contingent liability risks, and potential natural disasters. We would thus see merit in introducing a longer-term net worth approach to determine the optimal level of current expenditure.

Improvements in public financial management would be helpful, given Palau's important infrastructure investment needs. We agree that Palau could

benefit from a PEFA assessment to find additional ways to increase public investment efficiency. Moreover, the authorities should reduce subsidies to the utilities company, as highlighted in the report.

We encourage the authorities to develop a comprehensive strategy to promote private sector development. Such a strategy could help attract strongly needed foreign investment and could help mitigate the brain drain. The report suggests that improving entrepreneurial opportunities would help retain high-skilled labor with limited employment opportunities in Palau. Promotion of private sector activity would go hand in hand with increasing the currently low level of domestic bank lending. The authorities highlight the SMEs' limited capacity in preparing business plans and financial statements as an important reason for the banks' reluctance to lend. A stronger private sector is key to greater resilience, especially as future grant flows are expected to decline due to Palau's high-income status.

Mr. Tan and Ms. Pandit submitted the following statement:

We thank staff for the well-presented report and Messrs. Ray and Amor for their informative buff statement. Given its heavy reliance on tourism and foreign assistance, the Palauan economy faces key challenges from significant revenue volatility as well as vulnerabilities from natural disasters and climate change. To foster long-term macroeconomic stability and resilient growth, it is imperative that the authorities seize the recent disbursement of the Compact grants as an opportunity to pursue and sustain reform efforts to strengthen and entrench key policy frameworks and forward-looking strategies in Palau. We concur with the broad thrust of the staff appraisal and would like to raise the following comments for emphasis.

Further strengthening in Palau's fiscal policy and strategy is warranted for long-term fiscal sustainability. We appreciate the establishment of the fiscal buffer fund and the authorities' plans to continue building up the fund to help cushion the economy against economic shocks. That said, we concur with staff that greater progress is needed to put in place a medium-term framework and strategy that would mitigate fiscal risks and lay the foundation to achieve more resilient and sustainable growth. As noted in the staff report, key efforts should focus on tax and structural expenditure reforms, as well as strengthening public financial management while limiting undue risks from PPP contingent liabilities. Staff noted that past Article IV consultations had previously recommended a medium-term framework based on a net worth approach. Could staff elaborate on the progress made to date and the likely impediments if any that may be holding the authorities back?

Putting in place a comprehensive tourism strategy is critical for sustainable growth and increasing the economy's resiliency to shocks. As Palau has limited scope to diversify its economy, we encourage the authorities to address infrastructure gaps as rightly noted by staff. Structural reforms are essential to both support a vibrant tourism sector as well as increase Palau's resilience against natural disasters and climate change. To this end, significant investments and advancement in the business climate would be necessary through having an investment friendly regulatory framework and smoothing the infrastructure bottleneck. With respect to the challenge of brain drain from youth emigration, we agree with staff's recommendations to improve entrepreneurial opportunities, strengthening healthcare provision, and enhancing vocational training and primary schooling.

Financial stability and accessible bank credit will support private sector investment and development. We take positive note of the authorities' efforts to strengthen the supervisory and regulatory framework through enhanced data compilation and reporting, and the commitment to address the AML/CFT deficiencies. While the banking system remains sound with sufficient liquidity and a low level of NPL, it is encouraging that the authorities are cognizant of staff's assessment that credit extension has to rise to support investment and achieve Palau's growth potential.

With these comments, we wish the authorities success in their endeavors.

Ms. Levonian, Ms. McKiernan and Mr. Feerick submitted the following statement:

We thank staff for their report and Messrs. Ray and Amor for their helpful buff statement. As with many island nation states, the significant challenges of a geographically dispersed population, narrow economic base and vulnerability to climate change underscore the necessity to build buffers and support potential growth. We note the broad coalescence of views between staff and the authorities and the solid traction of previous Fund advice outlined in Appendix II. We broadly agree with the thrust of the staff assessment and offer the following comments for emphasis.

Given the unique revenue profile and looming challenges and risks, we agree with staff's recommendation to move towards a medium-term fiscal framework and strategy. The short-term strategy, with legal requirements to balance certain parts of the budget, has worked well over recent years, which is reflected in a series of surpluses and the decline in net debt. Looking to the

longer term, as grants decline, a more strategic framework for fiscal planning is needed, and we note staff's suggestion towards a net-worth approach. This could usefully be complemented by a suite of public financial management reforms to generate fiscal space for priority expenditure areas.

While Palau is not as prone to sizeable weather-related shocks as others in the region, climate change remains macro-critical. The authorities' use of a precautionary funding line from the AsDB, to be drawn down in the event of a shock, represents novel liquidity management. Nevertheless, from a solvency perspective, there is also a clear need to build fiscal buffers. We note the authorities' efforts to upgrade infrastructure to increase resilience to natural disasters. Indeed, recent research undertaken by the Western Hemisphere Department has demonstrated the growth benefits from investing in ex-ante resilience.

The financial sector, albeit small, appears sound from a capital and liquidity perspective. The key issue, in order to retain correspondent banking relationships, will be to continue to enhance the AML/CFT framework, including to pro-actively introduce regulations around cryptocurrencies. More generally, given limited capacity, we agree with the authorities that the Fund should be proactive in assisting small states with regulations for cryptocurrency and blockchain technology.

The concentrated economic structure – with tourism accounting for 90 percent of exports - alongside geographic dispersion, pose challenges for potential growth. Recognizing the limited scope for economic diversification, staff's suggestions around diversifying the tourism sector are pragmatic. Appendix VIII of the staff report usefully outlines the potential benefits to economic stability from such diversification. Other recommendations around improving business environment, where Palau lags peers, also appear reasonable. From a structural perspective, migration is a key challenge facing Palau, with the total population having declined by 11 percent since 2005, mainly due to youth emigration. We note the disagreement between staff and the authorities on the impact of an increase in the minimum wage on migration. On balance, we would agree with staff on the alternative suite of structural reforms, which could deliver more returns without the competitiveness diminishing impact of increasing the minimum wage.

Mr. Sylla, Mr. Nguema-Affane and Mr. Ndong Ondo Bilee submitted the following statement:

We thank staff for the concise report, and Mr. Ray and Mr. Amor for their helpful buff statement.

We welcome the improved macroeconomic situation in Palau in 2018 supported by a recovery in tourism activity and capital spending. We commend the authorities for the implementation of prudent economic and financial policies. The economic outlook has improved subsequent to the U.S ratification of a new Compact Review Agreement in late 2017, with growth recovery expected to continue over the medium term. Nonetheless, we share staff assessment of risks to the outlook, notably those stemming from the country's vulnerability to natural disasters. We therefore urge the authorities to press ahead with policies aimed at addressing the daunting challenges facing Palau, including the infrastructure gap, natural disasters, and the expiration of the Compact's grants.

The authorities should proceed with their policy of fiscal surplus of the past few years. The current adjustment strategy has served the country well in building buffers. It should be further strengthened to ensure longer-term fiscal and debt sustainability against expected decline in external assistance and large capital spending needs. The ongoing efforts to enhance Public Finance Management (PFM) and adopt a multi-year Medium-term Fiscal Strategy (MTFS) will also help in this regard. We support the authorities' plan to continue building the General Fund Reserve into a fully-fledged stabilization fund to further increase buffers against shocks, as indicated in Mr. Ray and Mr. Amor's buff statement. The Congress' speedy approval of the comprehensive tax reform bill will be critical to enhance domestic revenue collection and increase fiscal space for priority infrastructure and climate change-related spending.

We welcome the continued soundness of the banking system. We note the agreement between the authorities and staff on the need to increase the low bank lending. However, there seems to be a disagreement on reform priority in this regard. Staff recommended relaxing the interest rate ceiling for corporate loans and enhancing the capacity of the National Development Bank of Palau (NDBP), whereas the authorities seem to consider addressing structural impediments, including the SMEs' limited capacity, as a top priority. Staff comments will be welcome. We see merit in actions being undertaken by the Financial Institution Commission (FIC) to broaden financial regulation and oversight to non-bank institutions and to improve the

AML/CFT framework in collaboration with development partners, including the IMF/PFTAC and the US FDIC. While we share staff recommendations on cryptocurrency, we encourage them to provide the authorities with appropriate TA in this area.

Structural reforms should be stepped up to increase growth potential and build the country's resilience to shocks. We encourage the authorities to swiftly finalize and implement their comprehensive and sustainable tourism strategy for promoting Palau as a high-end and environmentally conscious touristic destination. In addition, building on current low debt and robust surplus, the authorities should intensify actions to strengthen resilience to climate change and natural disasters, including internalizing risks to growth within a predictable framework, building more fiscal buffers, and securing contingent financing assistance such as the recent facility from AsDB. The authorities should also step-up efforts to ease doing business notably by improving access to electricity, protecting minority investors, and enhancing insolvency resolutions. Staff's recommendations to adopt a lesser restrictive investment regime and create a one-stop shop window for investment to bolster FDI inflows should also be considered.

Regarding youth emigration, which is a significant constraint to growth, we note the policy differences between the authorities (raising the minimum wage) and staff (entrepreneurship and education policies). Could both approaches be used at the same time for an effective and comprehensive response to this problem? We also wonder whether this emigration has any impact on remittances. Staff comments are welcomed.

Mr. Castets and Mr. Sode submitted the following statement:

We thank staff for the quality of their documents and Messrs. Ray and Amor for their insightful buff statement. Even if Palau economic performance has been slowing in FY 2016 and 2017, the country economic policies remain sound and economic prospects are rather favorable. However, Palau faces several structural challenges related notably to climate change and to its future access to concessional financing. While we broadly agree with staff analysis and recommendations, we would like to make the following comments for emphasis:

We commend the authorities for their strategy to develop a high-value and sustainable tourism sector. Such a strategy as the potential to increase potential growth as well as to provide jobs and entrepreneurial opportunities for the population. It is now crucial to focus on the implementation of such a

strategy and identify key institutional obstacles to its success. As highlighted by staff, this means efficiently addressing the infrastructure gap, streamlining the regulatory environment and improving the business climate. We also tend to agree with staff that promoting education will simultaneously benefit the tourism sector while limiting the brain drain of the young population. Regarding staff recommendation against a rise in the minimum wage, could staff elaborate on its argument, notably by providing metrics (comparing Palau minimum wage with peers) to measure the potential damage to employment and competitiveness.

We support staff recommendation to make progress in climate resilience projects notably to strengthen early disaster warning system, improve coastal protection and planning, and promote renewable energy. Regarding the budgetary framework, while we support staff call for a move toward a medium term fiscal framework, we wonder if and how staff recommend integrating the need for a fiscal buffer related to climate change and natural disaster risk.

We fully concur with staff on the need to create fiscal space through better domestic resources mobilization. It is essential to decrease the country reliance on external grants and to ensure the financing of its capital expenditure needs. In this regard, we commend the authorities for the comprehensive tax reform bill currently under consideration by Congress and we hope it will be adopted.

We encourage the authorities to address the AML/CFT deficiencies identified in Asia/Pacific Group on Money Laundering (APG)'s recent evaluation of Palau's compliance with the Financial Action Task Force (FATF) standard. Regarding the approach made by private investors on cryptocurrency, we are reassured by Messrs. Ray and Amor statement that their authorities do not intent to follow them. At this stage, we believe risks clearly outweigh potential benefits.

The Acting Chair (Mr. Zhang) noted that Palau was a small state in the Pacific with an exceptional marine environment that was particularly dependent on tourism and grants. It faced a number of challenges, particularly given the expiration of the Compact grants with the United States and declining grant inflows due to the recent changes in its income status by the World Bank. It would be crucial to build fiscal buffers to accommodate revenue volatility while investing in growth-enhancing infrastructure facilities. A more fundamental question was how to make growth more resilient and sustainable and make the medium-term fiscal framework more accommodative to ensure fiscal sustainability.

Mr. Meyer made the following statement:

We thank Mr. Ray and Mr. Amor for their buff statement and the staff for the insightful report. We have not issued a gray statement as we agree with the staff's appraisal, and I would therefore like to offer a few comments.

As a small island country operating mostly in the tourism sector, the focus on increasing potential growth while reducing volatility has our full support. Going forward, the key challenges would be boosting revenues in the context of decreasing grants in the medium term, increasing resilience to natural disasters, and advancing structural reforms.

We take positive note that the overall fiscal balance has been in surplus since 2011, and public debt levels are generally sound. We encourage the authorities to safeguard these past achievements. Higher capital expenditures financed by disbursements of the Compact grants will help address Palau's public infrastructure needs. In this regard, and to counter future revenue declines related to the expiration of the Compact grants, medium-term budgetary planning and raising tax revenues via a broader tax base could create additional room for growth-enhancing public investment and fiscal buffers. We welcome staff's technical assistance (TA) in this regard. We also welcome the answer that we received on the question about the tax reform bill. However, we read the staff's answer as indicating that there was relatively limited probability of achieving that tax reform, and we have some concerns in that regard.

As Palau is a small and remote country, opportunities to foster inter-industry diversification should be seized but are also limited. We welcome the staff's analysis on a promising intra-industry diversification strategy geared towards high-end tourism. Such a strategy could boost economic growth while preserving environmental sustainability. To this end, lifting restrictions on FDI and streamlining administrative requirements for foreign investors could further benefit the high-end tourism strategy. In addition, natural disasters pose a significant risk to Palau, so we therefore share the staff's view that the authorities should step up their efforts to enhance resilience to these disasters.

Lastly, like the staff, we strongly emphasize the risks associated with the use of cryptocurrencies unless strong policy frameworks are in place and progress has been made to meet regulatory standards on Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) issues.

Mr. Feerick made the following statement:

We thank the staff for the report and Mr. Ray and Mr. Amor for the helpful buff statement. As a constituency that also comprises a number of small island states with similar challenges, we would like to emphasize two points.

Firstly, notwithstanding that Palau is not as exposed to climate change challenges as its peers, I believe it is clear from the report that climate change remains macrocritical. Interesting research from the Western Hemisphere Department (WHD) has shown that investing in ex ante resilience infrastructure, notwithstanding higher upfront cost, pays dividends over time through confidence and investment channels. The implications of this research are far reaching, and we are heartened to note the Palauan authorities' intentions in this regard.

Our second point relates to correspondent banking relationships (CBRs), which is not necessarily a big issue for Palau at the moment. However, it will be important to enhance the AML/CFT framework and its effectiveness. Moreover, given the uncertainty around cryptocurrencies and the limited capacity in Palau, we would like to echo the authorities' call for Fund support in this area. With that, I wish the authorities well.

Ms. Mannathoko made the following statement:

I have a follow-up question for the staff. We asked a question about what the authorities described as a stabilization fund. The staff indicated the General Fund Reserve (GFR). Our question was more about what rules or guidance are in place. But the context of our question was really, given the many different demands that are coming up, and even described in the report, there was the possibility of state-owned enterprise (SOE) and civil service obligations transfer becoming contingent liabilities in the future. Given the fact that five years down the road the U.S. Compact grants would have expired, we wonder if there will be more pressure to use those resources. Our question was whether the rules essentially define in advance what the fund can be used for.

The staff representative from the Asia and Pacific Department (Ms. Kinoshita), in response to questions and comments from Executive Directors, made the following statement: ¹

I thank the Chair and the Directors for constructive and useful comments. We have provided most of the answers in written form, but I want to highlight a few points.

A number of Directors asked where the authorities are in terms of the implementation of the policies. On the fiscal front, this refers to Mr. Meyer's question about the probability that the tax reform will happen. The staff and the authorities are in agreement to push forward with the tax reform in the context of the medium-term fiscal strategy. However, there seems to be some disagreement on whether the tax reform should be revenue enhancing or not. The disagreement is between the government, which is fully supporting revenue enhancement, and the parliament. But given this risk, if this will not be revenue enhancing, there will be some implications for how Palau can go ahead with the infrastructure investment.

In this context, if this will not be the first-best scenario, then the public-private partnerships (PPPs) may have to take a more prominent role. In this respect, as a second pillar suggestion for policy, there will be a need to strengthen public financial management (PFM) to enhance efficiency and build up the capacity to implement PPPs.

On the structural reform agenda, the main message is that Palau is a small island economy with very limited resources. Therefore, it has less room for diversification. The authorities' main goal is to achieve the high-end tourism while preserving the environment. This refers to the other question raised by Mr. Feerick about the need for investment. Solid infrastructure is important to make tourism sustainable.

With respect to ex ante policies for climate change, Palau is actually exposed to rising sea level issues. The authorities are trying to move all the hospitals and schools to a higher level, which takes longer. But they are trying to build a seawall to reduce the damage from rising sea levels. This is all in the context of the climate change policy, and they have a five-year action plan. Investing in productive infrastructure is the backbone of enhancing potential growth.

¹ Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

On the stabilization fund, we did talk about accessibility with a light brush. Basically, as it stands, they own about 5 percent of GDP in the GFR, and they have an intention to develop this into a full-fledged fiscal stabilization fund. However, the funds are only accessible in exceptional circumstances because the president has to declare a state of emergency, or in the case revenue falls short of more than 5 percent of the projected amount in the previous year. These are tight and less flexible rules.

The authorities also have cash reserves in the form of government deposits. Currently they amount to about 17 percent of GDP as of 2018. In principle, in the case of emergency, they can just withdraw this with no contingency plan. But to address more long-term issues about the high revenue volatility because of this narrow dependence on tourism, our recommendation will be to have a more comprehensive fiscal stabilization that goes beyond this GFR, or they could build on it to have such a facility.

Mr. Ray made the following concluding statement:

I thank Directors for their comments. I also wanted to thank the mission team for a very good report that accurately captures the challenges and opportunities that face Palau.

We are talking about one of the smallest members of the Fund, with a population of roughly 20,000. It is also highly isolated and has a very narrow economic base. Natural disasters are not that frequent. That is the geography, but that being said, were there to be one, it would be quite serious.

The authorities are committed to a development strategy that maximizes the benefits that it can get from its limited resource base. In particular, the authorities have focused on preserving what is an exceptional marine environment for future generations, and they have been prepared to take a hit to the economy for a few years in order to rebase the level of tourism and focus on this high-end strategy.

That being said, Directors are right to focus their gray statements on the need to develop a robust medium-term fiscal framework and strategy, particularly given the expiration of Compact grants in a few years. This is a reform priority for authorities, and they value the support that the staff gives to them. Indeed, when the mission was in country, there was a workshop on this issue. This is an area where my authorities would welcome further support from the Fund.

Other staff recommendations are largely in line with the authorities' reform agenda, and we discussed the goods and services tax already this morning. One of the things that staff pointed out in the written responses is that the timetable is ambitious given the administrative task of bringing in the tax.

The authorities recognize the need to address the infrastructure gap, streamline the business environment, and improve the business climate. That being said, in an economy like this, the private sector opportunities are quite limited. There is a large pipeline of FDI applications, and as Mr. Meyer said, trying to get through that in an efficient way would be helpful. One of the issues that my authorities face is the capacity to assess these applications and to do due diligence on the applicants.

A number of Directors had views on the minimum wage policy. My authorities agree with the staff that strengthening the quality of health care, enhancing education in primary schools can improve the immigration situation. The highest level of education that one can get in Palau is a two-year community college. Everybody else has to go overseas to advance their education, and getting them back is the hard part. However, my authorities remain of the view that given the wage rates in Guam, there is a need to lift the minimum wage gradually over a number of years to encourage young Palauans to either come back or stay in Palau.

I wanted to make a personal comment about Ms. Kinoshita. This is not her first stint on the Palau desk, and my authorities are delighted she has returned as mission chief, and they have asked me to make particular note of that this morning. I should also say that they have given approval for their report to be published after this morning's discussion, which is good.

I have a personal comment. This is a jewel in the Pacific. It is a beautiful place with authorities that have a long-term and careful view of how to use that beauty, and anything the Fund can do to help them is welcome.

The Acting Chair (Mr. Zhang) noted that the Republic of Palau is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed signs of a gradual recovery of economic activity in tourism and construction. However, Directors noted that Palau continues to face medium-term challenges arising from the expiration of the Compact grants in FY2024, revenue volatility stemming from limited economic diversification, and vulnerabilities to climate change and natural disasters. They emphasized that continued sound macroeconomic policies will be important to ensure long-term fiscal sustainability, safeguard financial stability, reduce vulnerabilities to external shocks, and promote sustainable and resilient growth.

Directors welcomed the authorities' plan to develop a medium-term fiscal framework to accommodate high revenue volatility and to manage fiscal risks. They noted that the framework should employ a net worth approach, which provides the desired path for the current fiscal balance consistent with medium-term fiscal objectives. Directors recommended the need for additional fiscal adjustment over the medium term to ensure sustained increases in public investment for resilient growth. They underscored that adjustment should rely on a revenue-enhancing tax reform, complemented by a strengthening of public financial management, including in public investment. Directors welcomed the authorities' plan to implement a comprehensive tax reform, including the introduction of the VAT. They also encouraged continued efforts to lower subsidies to state-owned enterprises.

Directors welcomed the efforts to implement a comprehensive tourism strategy to support sustainable and resilient economic growth. They noted that greater geographical diversification of source countries could enhance the resilience of the sector and the economy. Directors also encouraged the authorities to improve the investment climate and foster the development of the private sector by adopting a streamlined foreign investment regime and addressing infrastructure bottlenecks. They encouraged the authorities to tackle the brain drain from youth emigration.

Directors noted that the banking system remains sound but lends too little domestically. They advised the authorities to relax the interest rate ceiling for commercial loans to better reflect riskiness and help small companies prepare business plans and financial statements. Directors welcomed the plans to broaden financial supervision to nonbank financial institutions to preserve financial stability. They recommended a cautious approach to cryptocurrencies, given the associated financial risks. In this

regard, Directors encouraged steps to address the deficiencies in the AML/CFT framework.

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

APPROVAL: April 7, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Fiscal Policy

1. ***Reform scenario and authorities' strategy: Can staff comment on how the authorities' fiscal strategy compared to staff's reform scenario?***
 - The authorities' strategy is broadly in line with staff's reform scenario, partly reflecting significant technical assistance from IMF PFTAC. The authorities are seeking to implement a revenue-enhancing VAT. They are also committed to phasing out subsidies to the PPUC (as stipulated under the terms of an AsDB loan). In the reform scenario, staff recommend that the fiscal space from these reforms be used to finance infrastructure investment to offset the decline in capital grants. While the authorities broadly agree with this, they noted that they are also considering alternative sources of infrastructure financing such as PPPs.
2. ***PPPs/PFM: While increased PPPs has merit given the pressing needs, we wonder whether Palau has adequate expertise and the necessary framework to expand PPPs. Staff's comments are welcome. Given the fiscal contingencies that can arise from PPPs, have the IMF or other development partners accompanied the authorities in this task so far? Is a formal PEFA being considered? Can staff also elaborate on the fiscal contingencies related to SOEs other than CSPF and PPUC?***
 - Staff advise a cautious approach to expanding PPPs, given the authorities' lack of experience and the absence of a formal framework. The authorities have committed to two projects and are waiting for the outcome of these experiences before taking up further PPPs, which, in a staff view, is a prudent approach. The authorities have received some technical advice on PPPs from the World Bank but would benefit from further support. Staff recommended a formal PEFA, which would identify the areas of PPP-related TA needs. A PEFA has been scheduled but postponed several times in recent years.
 - Contingent liabilities from PPUC and CSPF are the most immediate concern. The other three SOEs – the National Development Bank (NDBP), National Communications Corporation (PNCC) and Submarine Cable Company (BSCC) – are profitable and financially sound.

3. ***Tax reform bill: Staff views are welcome on the length of time for the approval of the tax reform bill currently under consideration in Congress. How do staff assess the possibilities for approval this time?***

- The tax bill will be introduced in the April 2019 parliamentary session. The authorities envisage the tax coming in to effect in January 2020. In staff's view, this plan is ambitious, given the technical and administrative preparations necessary before introducing the VAT. In the reform scenario, staff envisages January 2021 as the implementation date.
- The authorities are committed to the tax reform and have recently appointed a senior official to oversee the process. IMF PFTAC has engaged in outreach with parliamentarians on the proposed tax reform to help secure political support for the tax reform. However, the window for parliamentary approval is narrow, given that elections will be held in late-2020, which could be an obstacle to reform.

4. ***Stabilization Fund: Could staff comment on whether rules are in place defining requirements for future access to the stabilization fund?***

- Palau currently has access to two funds, the Compact Trust Fund (CTF) and the newly established General Fund Reserve (GFR). For the CTF, the authorities can withdraw up to \$15 million annually; larger withdrawals are subject to the approval of the U.S. authorities before FY2044. For the GFR, the authorities can withdraw the necessary amount if revenues fall below 5 percent of the projected revenue of the previous year or if the President declares a state of emergency (e.g., in the event of natural disasters).

5. ***Medium-term fiscal strategy: Staff noted that past Article IV consultations had previously recommended a medium-term framework based on a net worth approach. Could staff elaborate on the progress made to date and the likely impediments if any that may be holding the authorities back? Regarding the budgetary framework, while we support staff call for a move toward a medium term fiscal framework, we wonder if and how staff recommend integrating the need for a fiscal buffer related to climate change and natural disaster risk.***

- The authorities have made efforts towards developing a medium-term fiscal framework, including multi-year budgeting and planning as well as in developing a new performance reporting framework for expenditure. They recently upgraded the financial management information systems to improve the budgeting and planning process. However, they remain constrained by a lack of resources and established work practices. A PEFA self-assessment and subsequent PFM roadmap could help in

prioritizing the steps needed in the development of a medium-term framework given the constraints.

- As regards fiscal buffers in staff recommendations, they include the buffers including those related to climate change and natural disaster. However, we do not model the costs of climate change in estimating required fiscal buffers. Given that the World Bank PCRAFI's estimate of an average annual cost of natural disaster is \$2.7 million (about 1 percent of GDP each year), the current buffers are comfortably above the estimated cost. By increasing infrastructure spending to build resilience infrastructure, the long-term cost related to climate change can be reduced.

Financial Sector

6. *Lack of secured lending for real estate is another obstacle for credit expansion. However, we did not find any specific recommendation to address this issue. Staff's comments are welcome.*
 - As foreigners cannot own land in Palau, foreign-owned banks—which account for 91 percent of total loans—cannot use real estate as a collateral for mortgage lending. Given political sensitivity and complexity of legal issues related to land ownership, staff did not make specific policy recommendations in this regard. However, the National Development Bank of Palau (NDBP) can provide mortgage loans and staff's recommendation on strengthening of NDBP's lending capacity would help increase mortgage lending and thus increase domestic credits.
7. *We would welcome staff's comments on the front businesses in the context of their links with the financial system, the trends in domestic credit and regulatory framework for corporates in Palau.*
 - Front businesses in Palau are referred to businesses that are formally owned by Palauans but are operated by non-Palauans. They are typically used to avoid restrictions on non-Palauans to conduct business activities. However, staff do not have much sense on the role of front business in the Palau financial system due to lack of data. It is possible that 'front businesses' operated by foreigners are less likely to borrow domestically, understating domestic credit.
8. *Staff recommended relaxing the interest rate ceiling for corporate loans and enhancing the capacity of the National Development Bank of Palau (NDBP), whereas the authorities seem to consider addressing structural impediments, including the SMEs' limited capacity, as a top priority. Staff comments will be welcome.*

- Staff and the authorities share the view that both enhancing NDBP's lending capacity and raising SMEs borrowing capacity are important to resolve the low credit creation in the private sector. While the authorities argue that relaxing the interest rate ceiling for corporate loans may not fully resolve the problem of low credit growth, they agree that it would help in promoting credit growth in the corporate sector, given that the ceiling is set substantially below rates for individual loans and small business loans in the United States.

Growth and Structural Issues

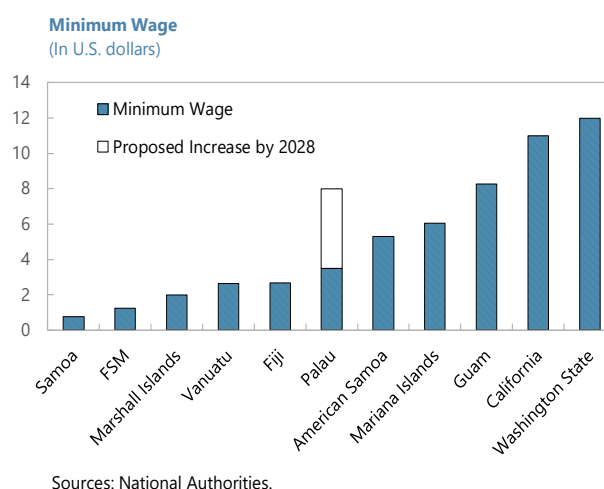
Minimum Wage and Youth Migration

9. *Policies to alleviate youth emigration: We would like staff to comment on the alternatives to the envisaged minimum wage hike that can bear fruits in the near term. Could both approaches (raising the minimum wages and entrepreneurship and education policies) be used at the same time for an effective and comprehensive response to this problem? We also wonder whether this emigration has any impact on remittances. Staff comments are welcome. Could staff indicate whether quantitative labor market analysis is available beyond what is in Appendix X, to assess the skill levels and skill mix of youth migrants out of Palau, and the implications of a higher minimum wage? The authorities believe higher wages will boost productivity, but such outcomes may depend on the labor market context. Thus, country specific-analysis may be needed to establish the true nature of the labor market and outward immigration and convince the authorities to reconsider the minimum wage measure.*
- In staff's view, a large increase in the minimum wage is not the most effective policy to address outward migration, given the possibility of negative side effects such as a loss of competitiveness. The lack of employment opportunities may well be another driver for youth emigration, and staff recommend long-term structural reforms to boost the private sector development and to improve entrepreneurial opportunities. In the near-term, staff recommends increasing health and education provisions to create a more attractive environment for the youth. In addition, staff highlights the role for "taking advantage of modern communications to build strong and active diaspora networks" (SDN/16/07 "Emigration and Its Economic Impact on Eastern Europe"). As in Ireland and Poland, Palau could also develop programs to maintain ties with diaspora abroad and could therefore advertise business and investment opportunities to emigrants.
 - Quantitative analysis of the labor market in Palau is limited due to the lack of reliable labor market statistics (e.g. the unemployment rate is only available every five years). As a result, a more detailed quantitative study has not been possible. Data collection

on emigration and labor market could help formulate a clearer policy recommendation with better understanding of the drivers and composition of emigrants, which would also enable staff to do more quantitative analysis.

10. *How is Palau’s minimum wage compare with peer countries. Can staff add comments on this? Regarding staff recommendation against a rise in the minimum wage, could staff elaborate on its argument, notably by providing metrics (comparing Palau minimum wage with peers) to measure the potential damage to employment and competitiveness.*

- Palau’s minimum wages currently are the highest among the tourism-dependent small states (e.g., Samoa, Vanuatu, Fiji, the Maldives and Seychelles) but they are considerably lower than those in U.S. states and territories. It should be noted that Palauans can move to U.S. without a visa under the terms of the Compact Agreement.’



- Estimating the impact on employment and competitiveness is challenging given data limitations. However, the proposed minimum wage will overtake the projected average wage by staff, even under optimistic assumptions. This indicates the policy will add significantly to wage costs of both the private and public sectors. Staff argue that “the minimum wage is not an effective tool for migration policy and should be set to balance goals of labor market efficiency and poverty reduction.”. This does not preclude raising the minimum wage by smaller amounts, but raising it to the level of Guam is arbitrary and costly.

11. *Could both approaches (raising the mw and entrepreneurship and education policies) be used at the same time for an effective and comprehensive response to this problem? We also wonder whether this emigration has any impact on remittances. Staff comments are welcome.*

- An anecdotal evidence suggests that those emigrating from Palau are primarily the highly-skilled and that they likely leave to pursue tertiary education in the U.S. As such, they would not be minimum wage earners, raising doubt about whether this policy will succeed in reversing the emigration decision. Staff also noted that the size of the minimum wage increase is large, which could lead to unemployment or a large

inflow of immigrants. Evidence from the household income and expenditure survey (HIES) suggests that remittances to Palau are low, which aligns with anecdotal evidence that Palauans living abroad do not typically remit money.

Tourism Strategy

12. We would value staff's elaboration on what is constraining progress in the diversification of tourism source countries.

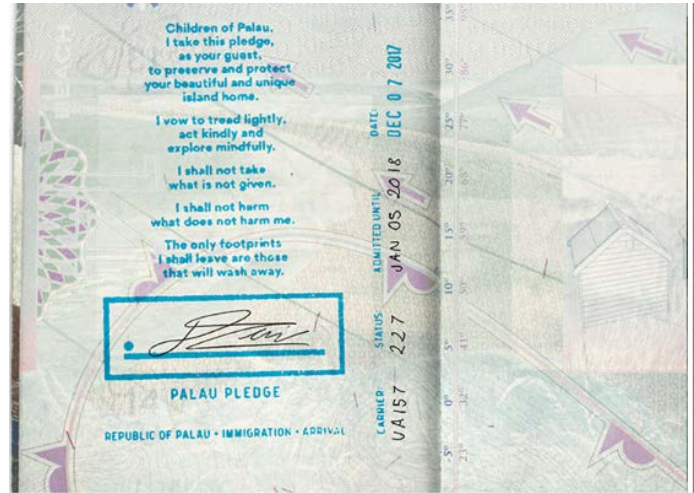
- Palau has made some progress towards diversification since 2015. Nevertheless, there are constraining factors. First, tourist arrivals from China, the largest source market currently, have been growing at 16 percent annually since 2010, faster than those from other major markets, thereby increasing market concentration. Second, there are diseconomies of scale that make catering to different markets challenging. This applies to marketing and to the airline industry, which has a preference for routes with extensive regular demand (as opposed to 1-2 flights a week).

13. We would welcome staff's comments on the progress in moving towards high-end tourism to raise individual tourist spending by diversifying tourism markets and products. We would also like to know the progress in implementing the 2017-21 Palau Responsible Tourism Policy Framework.

- Average expenditure per tourist arrival has risen steadily since the 2015 boom. The authorities have introduced policy measures aimed at further targeting the high-end market. These include an increase in the visitor fee from \$50 to \$100 to limit mass market tourism. In addition, the connection of the undersea fiber-optic cable has dramatically improved internet quality, addressing what had been the most frequently cited complaint on visitors' survey.
- The authorities have made progress in implementing several areas of the Palau Responsible Tourism Policy Framework.
 - Expanding the remit of the Foreign Investment Board to verify investment are in line with the high-end tourism strategy
 - Upgrading IT and sanitation infrastructure (under ADB project loans)
 - Providing visitors information to clarify acceptable behavior in Palau.
- However, other measures are still pending, including replacing the Gross Revenue Tax with the VAT, to increase the tax burden on tourists, and introducing certification and quality monitoring schemes for hotels and other tourism-related businesses.

14. *Could staff comment on using the environment policy for economic benefits in Palau?*

- While the recent experience (following the 2015) highlights potential tradeoffs between environmental sustainability and economic growth, staff support and commend the authorities' recognition of the longer term economic benefits associated with environmental conservation. The main tourism attraction is its marine environment and the major tourist activity is scuba diving.
- Palau has sought to leverage its environmental conservation to support its tourism industry under its 'Pristine Paradise Palau' branding effort. Initiatives such as the creation of the world's largest marine sanctuary, banning certain harmful sunscreens and the 'Palau Pledge' (an innovative passport stamp designed to encourage environmentally responsible behavior) have all been covered by several major media outlets internationally, generating significant free publicity. Moving forward, Palau is seeking to generate 55 percent of its power through renewable energy by 2025, gaining further global publicity, and attracting high-end, environmentally conscious tourists,



Climate Change

15. *Furthermore, we ask staff whether Palau's financial buffers and the US\$ 15 million facility with the AsDB could adequately mitigate financial risks following a natural disaster?*

- In the near term, the potential financing needs from natural disasters could be covered by AsDB's three-year financial facility, given that the expected financing needs for next three years would be about US\$8.1 million (i.e., PCRAFI's estimate of the average annual loss from natural disasters US\$2.7 million times three years). In addition, the General Fund Reserve (GFR) which currently stands at about 5 percent of GDP, could also be used for emergency funding. Nevertheless, over the medium-term, more flexibility would be helpful, given limitations to using the AsDB facility (3 years) and strict conditions for the use of the GFR. Building domestic fiscal buffers and securing external buffers with financial assistance from multilateral donors and climate change schemes should be a priority.

16. *We noted staff's recommendation to internalize costs for the ex-post response associated with such events. Staff's comments are welcome on the efforts to build ex-ante resilience as well.*
- The authorities have made efforts in enhancing the resilience to climate change and natural disasters, by both increasing the capacity for ex post response and building ex ante resilience. The authorities' "Palau Climate Change Policy: For Climate and Disaster Resilient Low Emissions Development" outlines their adaptation strategy and a 5-year action plan to: (i) enhance adaptation and resilience; (ii) manage disasters and minimize disaster risk; and (iii) mitigate global climate change. Progress in building ex ante resilience has been limited, however, and the authorities should proceed with several measures, including strengthening the early disaster warning system, improving coastal protection and planning, and promoting renewable energy.