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The Development Status and Country Classification of Palau

1. Attached for the consideration of the Board is a paper on the above subject.
2. This Paper should be read with *Palau: Country Economic Report*, circulated to the Board on 17 October 2005 (DOC.IN.271-05).
3. In the absence of any request for discussion and in the absence of a sufficient number of abstentions or objections (which should be communicated to The Secretary by the close of business on 7 November 2005), the recommendation in paragraphs 29 and 30 of the Paper will be deemed to have been approved, to be so recorded in the minutes of a subsequent meeting of the Board. Any notified abstentions or objections will also be recorded in the minutes.

For Inquiries: K. Sakai, Strategy and Policy Department
(Ext. 6550)
C. W. MacCormac, Strategy and Policy Department
(Ext. 6554)

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ASIAN DEVELOPMENT BANK

**THE DEVELOPMENT STATUS
AND COUNTRY CLASSIFICATION
OF THE
REPUBLIC OF PALAU**

October 2005

CURRENCY EQUIVALENTS

Currency Unit – US dollar (\$)

ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
DMC	–	developing member country
GDP	–	gross domestic product
GNI	–	gross national income
GNP	–	gross national product
IBRD	–	International Bank for Reconstruction and Development
IDA	–	International Development Association
IMF	–	International Monetary Fund
LDC	–	least developed country
OCR	–	ordinary capital resources
TA	–	technical assistance
UN	–	United Nations

NOTES

The fiscal year (FY) of the Government ends on 30 September.

In this report, “\$” refers to US dollars.

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I. INTRODUCTION

1. The Republic of Palau (Palau) became a member of Asian Development Bank (ADB) in December 2003.¹ While admitted as a regional country, its development status was left undetermined and a country classification under ADB's graduation policy² was not undertaken. The Government of Palau requested at the 2005 ADB Annual Meeting that the development status and country classification of Palau should be determined. Considering that more than 3 years have passed since the Board considered Palau's membership, and taking into consideration recent developments of the country's economic conditions, it is considered appropriate that ADB undertakes a review of its policy towards Palau. This paper takes into account the findings of the *Country Economic Report* on Palau which is being circulated to the Board separately,³ and sets forth considerations relevant to determining the development status of Palau and its country classification, and makes recommendations in this regard.

II. CONSIDERATIONS RELEVANT TO THE DEVELOPMENT STATUS AND COUNTRY CLASSIFICATION

2. Development status of a regional member is a significant issue, because eligibility for ADB assistance is linked to the determination by the Board of Governors that a country is a developing member country of ADB. Article 2(ii) of the Agreement Establishing The Asian Development Bank (the Charter) empowers ADB to "utilize the resources at its disposal for financing development of the developing member countries in the region..., and having special regard to the needs of the smaller or less developed member countries in the region" (emphasis added). Article 8 of the Charter states that "[t]he resources and facilities of the Bank shall be used exclusively to implement the purpose and functions set forth respectively in Articles 1 and 2 of this Agreement." Moreover, Article 14(ii) provides that ADB, when selecting suitable projects, "shall always to be guided by the provisions of sub-paragraph (ii) of Article 2 of this Agreement." Thus, a determination on the development status of Palau is directly relevant to Palau eligibility to receive financing in the form of loans, guarantees, or equity investments, including investments in the private sector.

3. Paragraph 4 of Article 28 of the Charter provides that "the Board of Governors may, by a vote of two-thirds of the total number of Governors, representing not less than three-fourths of the total voting power of the members, from time to time determine which countries or members of the Bank are to be regarded as developed or developing countries or members, taking into account appropriate economic considerations." Subject to the determination by the Board of Governors that a member country shall be regarded as a developing member country (DMC), the Board of Directors may then determine the country classification of that DMC in accordance with the criteria set forth in ADB's 1998 graduation policy.

4. The Charter indicates that "appropriate economic considerations" are to be taken into account when determining the development status of member countries, although no specific guidelines have been laid down in this regard. A 1995 report noted that "in determining development status, there appears to have been an implicit link between the member country's per capita gross national product (GNP) and its classification as a developed or a developing

¹ ADB. 2002. *Membership of the Republic of Palau*. Manila.

² ADB. 1998. *A Graduation Policy for the Bank's Developing Member Countries*. Manila.

³ ADB. 2005. *Country Economic Report, the Republic of Palau*. Manila

country.”⁴ That report also noted that a high per capita GNP may not be sufficient to determine whether a member requires ADB assistance, as other factors, such as narrow economic base, should also be taken into consideration. In 1998, ADB approved its graduation policy which may further provide a relevant reference for consideration in determining development status.

5. According to ADB’s 1998 graduation policy, the criteria for graduation from regular ADB assistance are (i) per capita GNP; (ii) availability of commercial capital flows on reasonable terms; and (iii) for key economic and social institutions, attainment of a certain level of development. The graduation policy adopted the International Bank for Reconstruction and Development (IBRD) per capita GNP benchmark of \$5,445 at 1997 prices as the level that would trigger the graduation process.⁵ In assessing the availability of commercial capital flows, a thorough country-specific evaluation is undertaken to determine whether prevailing policy, incentive structures, and institutions encourage the use of capital to support investment, and whether export growth will provide the basis for sustained creditworthiness. Key considerations in this evaluation include macroeconomic stability, exchange rate policy, the extent of trade and investment liberalization, privatization, tax reform, financial sector liberalization, and corporate governance. Assessment of the level of development of key economic and social institutions is necessarily country specific and takes into account (i) the quality of processes for macroeconomic management, (ii) the regulatory and supervisory framework of the financial sector, (iii) the efficiency and flexibility of labor markets, and (iv) the legal system.

6. Furthermore, country classification, including determining the eligibility of developing member countries (DMCs) to borrow from the Asian Development Fund (ADF), is based on two criteria: per capita GNP and debt repayment capacity. Regarding per capita GNP, the 1998 graduation policy adopted the World Bank’s per capita GNP estimates based on the Atlas method and the operational cutoff of the International Development Association (IDA) for eligibility. IDA’s current per capita gross national income (GNI, formerly GNP) operational cutoff is \$965 in 2004 US dollars.⁶ A multidimensional evaluation procedure, combining quantitative and qualitative assessments, was used to measure the debt repayment capacity of DMCs. The quantitative component uses four indicators: debt sustainability, private capital inflows, gross domestic saving rate, and size of the economy. The qualitative assessment uses five indicators: categorization as a heavily indebted poor country (HIPC) by the World Bank and the International Monetary Fund (IMF), volatility of export growth, main external financing source, degree of access to IDA funds, and whether sovereign borrowing by the country is rated by Moody’s, or Standard & Poor’s. DMCs are classified into four categories: (i) ADF only (Group A), (ii) ADF with limited amounts of OCR (Group B1), (iii) OCR with limited amounts of ADF (Group B2), and (iv) OCR only (Group C). The approach is captured in a decision matrix in Table 1 below.

7. The system of country classification has an additional impact on operations with regard to cost-sharing limits and domestic preferences. The cost-sharing limits for the borrowing DMCs for project financing by ADB are follows: 80% for Group A, 75% for Group B1, 70% for Group B2, and 65% for Group C.⁷ The government contribution to technical assistance (TA) should be

⁴ ADB. 1995. *The Development Status and Country Classification of the Republic of Nauru*. Manila.

⁵ The current IBRD benchmark is set at per capita gross national income (GNI, formerly GNP) \$5,685 in 2004 US dollars.

⁶ The World Bank in 2001 adopted the terminology of gross national income (GNI), in place of GNP.

⁷ ADB. 2002. *Review of Cost-Sharing Limits for Project Financing as an Element of ADB’s 1998 Graduation Policy*. Manila. The Board on 25 August 2005 approved the paper “Cost sharing and eligibility of expenditures for ADB financing: A new approach.” Cost-sharing under this new policy framework upon effective will supersede the existing policy on cost-sharing limits.

at least 15% of the total TA costs for Group A, 20% for Groups B1 and B2, and 30% for Group C. Such contribution will be subject to the limit of total TA costs minus foreign exchange costs and costs of domestic consultants.

Table 1: Decision Matrix of Classification

Debt Repayment Capacity	Per Capita GNP Cutoff			
	Below per Capita GNP Cutoff		Above per Capita GNP Cutoff	
	LDC ^a	Other	LDC ^a	Other
Weak	ADF only (Group A)	ADF only (Group A)	ADF only (Group A)	ADF with limited OCR (Group B1)
Limited	ADF with limited OCR (Group B1)	ADF with limited OCR (Group B1)	ADF with limited OCR (Group B1)	OCR with limited ADF (Group B2)
Adequate	OCR with limited ADF (Group B2)	OCR with limited ADF (Group B2)	OCR with limited ADF (Group B2)	OCR only (Group C)

ADF = Asian Development Fund, GNP = gross national product, LDC = least developed country, OCR = ordinary capital resources

^a To be classified as an LDC on the basis of the United Nations' classification of low-income and less developed countries, a country must fall below thresholds established for income, economic diversification, and social development.

Source: Asian Development Bank. 1998. *A Graduation Policy for the Bank's Developing Member Countries*. Manila.

III. ECONOMIC CONSIDERATIONS OF PALAU

8. The Republic of Palau is a small island economy, with a population of 19,200 (2000 census). The economy is heavily dependent on tourism and external assistance. Although per capita GNI was considered one of the highest in the Pacific, Palau faces many development constraints common to other Pacific island countries, including a small domestic market, limited supply of skilled labor, inadequate infrastructure, geographical isolation, and vulnerability to external shocks. The government sector accounts for over one third of total employment, and public expenditure for about 60% to 65% of gross domestic product (GDP).⁸ The economy consists primarily of tourism, retail, and subsistence agriculture and fishery. Tourism is the primary engine of economic growth, with the public sector and large construction funded by the US under a provision of the Compact.⁹ The production and export base of the economy is very narrow. The services sector, including public services, is estimated to account for 83% of GDP, while agriculture, forestry and fishing are estimated to account for only 4% of GDP. Local manufacturing activity is very small, accounting for about 1.4% of GDP. There is very high

⁸ It is noted that there remain serious deficiencies in economic statistics and problems with estimating the GDP.

⁹ As per the *Country Economic Report* on Palau, total payments provided for under the Compact from 1 October 1994 to 30 September 2009 are estimated at about \$600 million. In addition to Compact grants, Palau is eligible for assistance from other US programs. The total value of such grants over the first 15 years of the Compact is estimated at \$111 million. Source: ADB. 2005. *Country Economic Report, the Republic of Palau*. Manila.

dependency on imports, with the ratio of imports to GDP ranging from 75% to 115% in recent years. Although there is a large surplus on the services account owing to tourism, the very high trade deficit has led to current account deficits in most recent years.

9. The per capita GNI of Palau has been estimated at \$6,870 in 2004 US dollars according to the World Bank (Table 2). As noted in ADB's *Country Economic Report* on Palau (footnote 2), Palau's real GDP decreased by 2% in 2004, compared with a 0.3% increase in 2003 and a 4.3% decrease in 2002. As per the *Asian Development Outlook 2005*,¹⁰ Palau's GDP growth in the medium term is forecast to be about 2% and to occur in a low-inflation environment,¹¹ with a large trade deficit offset by inflows on the services, income, and transfers accounts.

10. Although its per capita GNI has remained above the graduation benchmark, the level of development of key economic and social institutions in Palau is not comparable to that of other graduates of ADB. There is notably a need to (i) improve the legal framework for banking supervision and regulation; (ii) create conditions for private sector-led growth with consistent implementation of structural reform agenda in particular in areas of privatization, foreign investment, land ownership, and banking, and (iii) deepen fiscal adjustment to reduce the public sector's personnel and operating costs and to cut capital outlays not funded by external assistance.¹² It is also noted that Palau has not been rated by the major commercial rating agencies. The Government had very limited commercial borrowing.

11. The *Asian Development Outlook 2005* noted that, over the medium to long term, the Government faces the twin economic challenges of managing fiscal adjustment to a decline in sector grants and encouraging broad-based private sector development in a small domestic economy. At present, there is an overdependence on aid and tourism and a consequent uncertainty about sustained growth prospects when there is scheduled sharp reduction in grant assistance from the United States after 2009, which would adversely affect government expenditure, domestic consumption, and economic activity.

12. It is noted that Palau is a member of the World Bank and is classified as an IBRD-only borrower. The World Bank noted that its approach in Palau is shaped by an awareness of three major factors. First, Palau has access to large-scale grant resources from other development partners (mainly Japan; Taipei, China; and the United States). Second, Palau has high per capita GDP relative to other Pacific countries. And third, Palau has the potential to achieve more robust economic growth outcomes given its growing tourism industry, but will need to undertake a strong reform program to achieve such outcomes, particularly to address its fiscal challenges and to enhance the private sector enabling environment.¹³

13. In summary, it is considered that Palau currently has a high per capita GNI, but its key economic and social institutions are not well developed, and the availability of commercial capital flows on reasonable terms appears to be limited. It is therefore considered appropriate for a determination to be made by the Board of Governors that Palau be regarded as a developing member country of the Asian Development Bank.

¹⁰ ADB. 2005. *Asian Development Outlook 2005*. Manila.

¹¹ Inflation based on a consumer price index in 2004 was 0.2% in the *Asian Development Outlook 2005*, while it was 5% in the *Country Economic Report* on Palau.

¹² IMF. 2004. *Republic of Palau: 2003 Article IV Consultation – Staff Report; and Public Information Notice on the Executive Board Discussion*. Washington, D.C.

¹³ The World Bank. 2005. *Pacific Regional Strategy*. Washington. Available: siteresources.worldbank.org.

14. Subject to a determination by the Board of Governors that Palau shall be regarded as a developing member country, an assessment is made in the following regarding the classification of Palau under ADB's graduation policy.

15. The 1998 graduation policy reviewed country classifications based on 1997 per capita GNP and an assessment of debt repayment capacity based generally on a specific set of data sources covering 1989–1996. For consistency, Palau's classification is examined below in terms of 2004 per capita GNI (formerly GNP), and debt repayment capacity, using generally the same data source and same methodology applied for the 1998 graduation policy paper. The latest available data from other specific sources have also been used. As in many other small island economies, there are serious deficiencies in economic statistics in Palau. Some indicators, such as gross domestic savings rates and private capital flows, could not be calculated.

A. Per Capita Gross National Product

16. By United Nations (UN) standards, Palau does not belong to the group of least developed countries (LDC).

17. The GNI (formerly GNP) per capita was estimated at \$6,870 in 2004 (in 2004 US dollars), which was significantly higher than the IDA operational cutoff of \$965 in 2004 US dollars.¹⁴ GNI per capita in dollar terms (nominal prices) using the Atlas methodology was high from 2001 to 2004 (Table 2). As per the *Asian Development Outlook 2005*, Palau's GDP growth in the medium term is forecast to be about 2% per annum. It is likely that Palau's per capita GNI will also be maintained at its current level in 2005–2007.

Table 2: Some Economic Indicators of Palau

Item	1999	2000	2001	2002	2003	2004
GDP growth (% in constant prices)	(4.6)	0.1	3.7	(4.3)	0.3	(2.0)
Consumer prices (% change, period average)	—	—	(0.6)	(0.3)	0.9	5.0
GNI (\$ billion, nominal prices) ^a	—	—	0.13 ^b	0.14 ^b	0.15	0.14
GNI per capita (\$, nominal prices) ^a	—	—	6,730	7,140	7,500	6,870

— = not available.

^a The World Bank estimates, using the Atlas methodology.

^b Asian Development Bank estimates.

Sources: ADB. 2005. *Country Economic Report, the Republic of Palau*. Manila; The World Bank. 2001-2005. *Operational Policies, OP3.10, Annex D*. Available: www.worldbank.org; The World Bank. 2004-2005. *Palau at a Glance*. Available: www.worldbank.org.

B. Debt Repayment Capacity

1. Quantitative Variables

18. **Debt Sustainability Ratio.** Based on limited data, debt sustainability ratios from 2001 to 2004 were calculated at -22.2%, -34.1%, -23.2%, and -37.0%, respectively. Based on these debt sustainability ratios, it indicates that Palau's debt repayment capacity is constrained.

19. **Size of the Economy.** The size of the Palau economy as measured by GNI, Atlas method, experienced minor changes in 2001–2004 (Table 2). Palau is one of the smallest

¹⁴ The World Bank. July 2005. *Operational Policies, OP3.10, Annex D*. Available: www.worldbank.org.

island economies in the Pacific. Its size of economy in terms of GNI is similar to that of Marshall Islands and Tonga, however is smaller than that of Fiji, Federated States of Micronesia, Samoa, Solomon Islands, and Vanuatu, but larger than that of Kiribati.¹⁵

2. Qualitative Variables

20. **Classification as Heavily Indebted Poor Country.** Palau is not classified as a heavily indebted poor country.

21. **Vulnerability to Fluctuations in Export Growth.** Palau's exports of goods and services increased by 5.4% in 2000 and 19.3% in 2001, but declined by 12.3% in 2002, then increased again by 3.1% in 2003 and further by 6.7% in 2004 (footnote 12). Export growth fluctuates largely due to Palau's narrow domestic production base and overdependence on tourism. Tourism receipts on average accounted for about 80% of total exports of goods and services in 1999–2004. Tourism receipts fluctuate and were down after the Asian financial crisis, the 11 September 2001 attacks in the United States, and the epidemic of severe acute respiratory syndrome (SARS) in Asia. Tourism receipts have recovered in 2003 and 2004. Export earnings of Palau are considered vulnerable to external events.

22. **Main External Financing Source.** Private financing, including foreign direct investment and portfolio investment, accounted for a small portion of Palau's total external financing in 1999–2004, on average about 5% of total capital inflows (footnote 12). Palau's main external source of financing is official sources.

23. **Rating for Sovereign Borrowing.** Palau has not been rated by Moody's, Standard & Poor's, or Fitch. Palau is classified as "not rated".

24. **Degree of IDA Access.** The World Bank classified Palau as an IBRD-only borrower. Palau is not eligible to borrow IDA concessional resources.

3. Findings on Debt Repayment Capacity

25. Palau has high per capita GNI which is due to large transfers from foreign grants, especially the Compact fund. However, the economy faces a large downside risk stemming from the scheduled sharp reduction of grants from the United States after 2009, which would adversely affect government expenditure, domestic consumption, and economic activity.

26. The IMF Staff Report noted that "as a recipient of large external grants, the authorities should eschew borrowing on commercial terms and be prudent even when borrowing is on concessional terms in order not to undermine the country's medium-term fiscal sustainability" (footnote 12).

27. Taking into consideration the proceeding points, including the quantitative and qualitative variables (paras. 16–24), Palau's debt repayment capacity is considered to be "limited".

¹⁵The World Bank. 2005. *Global Development Finance Online*. Available: www.worldbank.org. Cook Islands, Nauru, and Tuvalu are not members of the World Bank. GNI data using Atlas method are not available for these three countries.

C. Joint Application of the Two Criteria

28. The 1998 graduation policy paper stated that the decision matrix (Table 1) provides the foundation for classifying and graduating DMCs. Thus, Palau is classified as Group B2 (OCR with limited amount of ADF). However, considering that Palau currently has a high per capita GNI and receives considerable transfers of foreign grants, especially the Compact fund which will be provided at least until 2009, it is not envisaged that Palau will have access to ADF resources during the ADF IX period (2005–2008).

IV. RECOMMENDATIONS

29. It is recommended that the Board of Directors agree to adopt the draft Report to the Board of Governors (Appendix 1) and submit this Report, together with the draft Resolution (Appendix 2), to the Board of Governors under the Special Procedure provided under Section 3 of the By-Laws, with a request for a vote by telex, facsimile or email within thirty days of the date of transmittal.

30. Subject to approval of the draft Resolution (Appendix 2) by the Board of Governors and determination by the Board of Governors that Palau shall be regarded as a developing member country of ADB, it is recommended that the Board of Directors approve the classification of the Republic of Palau as a Group B2 country, for the purpose of access to ordinary capital resources and eligibility for financing from ADB's Asian Development Fund, and with regard to cost-sharing limits on ADB financing of project costs, norms for sharing of TA costs,¹⁶ and the domestic preference scheme for procurement of goods and civil works, as prescribed under the graduation policy framework. However, considering that Palau currently has a high per capita GNI and receives considerable transfers of foreign grants, especially the Compact fund which will be provided at least until 2009, it is not envisaged that Palau will have access to ADF resources during the ADF IX period (2005–2008).

¹⁶The Board on 25 August 2005 approved the paper "Cost sharing and eligibility of expenditures for ADB financing: A new approach." Cost-sharing under this new policy framework upon effective will supersede the existing policy on cost-sharing limits.

DEVELOPMENT STATUS OF PALAU

(Draft) Report of the Board of Directors

1. The Board of Directors has considered the case for conferring the status of a developing country on the Republic of Palau, a regional member of the Asian Development Bank (ADB).
2. The Board of Directors recommends that the Board of Governors determine, pursuant to paragraph 4 of Article 28 of the Agreement Establishing the Asian Development Bank, that the Republic of Palau shall be regarded as a developing member country of ADB.
3. The Board of Directors considers that a decision on this matter should be taken as soon as possible and that the Special Procedure in Section 3 of the By-Laws of ADB should be invoked for this purpose. Accordingly, the Board of Directors has authorized the President to transmit to each Governor the text of the draft Resolution together with this Report, with a request for a vote by telex, facsimile or email within thirty days of the date of transmittal.

(Draft) Resolution No. _____

DEVELOPMENT STATUS OF THE REPUBLIC OF PALAU

WHEREAS:

The Republic of Palau was admitted as a regional member country of the Asian Development Bank on 29 December 2003;

It is appropriate to determine the development status of the Republic of Palau pursuant to paragraph 4 of Article 28 of the Agreement Establishing the Asian Development Bank.

NOW THEREFORE the Board of Governors hereby RESOLVES:

That the Republic of Palau shall be regarded as a developing member country of the Asian Development Bank.