INTERNATIONAL MONETARY FUND ASSESSMENT LETTER

Republic of Palau—Assessment Letter for the Asian Development Bank

June 11, 2020

I. Recent Developments, Outlook, and Risks

Recent Developments

Despite a slowing economy, Palau entered 2020 with a sound fiscal position. Real GDP growth contracted from 5.8 percent in FY2018 to -1.8 percent in FY2019, mainly due to a drop in tourist arrivals, notwithstanding strong infrastructure investment financed by grants under the Compact Review Agreement with the United States.[1] Inflation eased to 0.6 percent and current account widened to 27 percent of GDP in FY2019, reflecting weak tourism receipts. Despite volatile tourism revenue in recent years, a track record of fiscal prudence has led to sustained fiscal surpluses and accumulation of government deposits. In end-FY2019, central government deposits reached about 8.5 percent of GDP, public debt was moderate, and the banking system had ample liquidity, low non-performing loans ratios, and stable returns on assets.

The COVID-19 pandemic and associated travel disruptions are putting significant strain on the economy. While there have been no confirmed cases of COVID-19 in Palau as of June 5, 2020, the authorities have adopted early prevention and containment measures. These included travel bans on visitors from hard-hit countries, health screening at entry points, school closures, and restrictions on public events. Travel restrictions have also expanded worldwide and in key source markets for Palau, such as China, Japan, and Korea, as the virus spreads globally, hitting hard international tourism. Since late March, Palau has ceased all international commercial flights, effectively shutting down the domestic tourism industry. After three months of robust growth through January 2020, supported by efforts to diversify source markets, tourist arrivals to Palau dropped to zero in April 2020.

Outlook and Risks

The economic outlook has deteriorated significantly with the drag from the COVID-19 pandemic. Travel restrictions and weakened consumer confidence are expected to weigh heavily on tourist arrivals, which are expected to remain near a standstill through end-2020, before starting to recover slowly. Arrivals are expected to reach pre-COVID levels in 2023. Reflecting Palau's heavy reliance on tourism, real GDP is projected to contract sharply, by 11.4 percent in FY2020 and 7.4 percent in FY2021. Inflation is expected to remain subdued, as downward price pressures from the contracting economy more than offset upward price pressures from supply disruptions. The current account deficit is projected to widen further and reach 35 percent of GDP in FY2021, driven by a sharp decline in tourism receipts, notwithstanding some offset from lower oil prices and reduced tourism-related imports. The economy is expected to rebound in 2022, in tandem with a recovery in tourism from the COVID-19 shock. Growth is projected to reach 10.3 percent in FY2022 and 11.9 percent in FY2023, mostly due to base effects, and the current account deficit is expected to narrow gradually.

Downside risks are large. The uncertainty around the near-term outlook is greater than usual. The main risk is a prolonged COVID-19 global outbreak and possible domestic infections, which could extend the shortfall of tourist arrivals and tourism-related activities, further weighing on the economy. Under such a scenario, growth would be lower in FY2020-21 and the recovery would be delayed. Other risks include broader uncertainties around the depth of the global economic downturn and the speed of recovery, a shortfall of non-Compact capital grants, and natural disasters. A deterioration in financial institutions' asset quality could also weaken credit flows, further constraining investment and productivity. While upside risks are limited, a potential "travel bubble" between Palau and some partner countries could provide some cushion to the decline in tourism receipts.

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[1] Fiscal year ending September 30.

II. POLICY FRAMEWORK AND SETTINGS

In the absence of monetary and exchange rate policy instruments, Palau relies on fiscal, financial, and structural policies to address economic challenges.

Fiscal Policy

In response to the COVID-19 pandemic, the government has initiated actions that appropriately support the health sector and hard-hit individuals and businesses. Reflecting revenue shortfall from weaker economic activity, notably tourism, and expected fiscal measures, the fiscal balance is projected to deteriorate from a moderate surplus of 0.3 percent of GDP in FY2019 to a deficit of -6.4 percent of GDP in FY2020 and -12.3 percent of GDP in FY2021. The government has addressed urgent needs in the health sector by setting up domestic testing capability and quarantine facilities. It has also announced measures totaling $20 million (8 percent of GDP) to mitigate economic and social hardship through targeted support to affected businesses and individuals. These include a new unemployment benefit scheme, temporary subsidies for utility bills, a new temporary job creation scheme for public works, and a lending scheme for the private sector. Considering the severity of the shock, the loosening of the fiscal stance is necessary and an early implementation of expected support measures would help contain the economic fallout from the pandemic.

Palau will need to rebuild its fiscal buffers over the medium-term. The negative effect of the COVID-19 pandemic on the real economy and the cost of the fiscal response to cushion its impact have opened cumulative fiscal and BOP financing gaps of about 24 and 31 percent of GDP in FY2020-22, respectively. Financing these gaps with a drawdown of government deposits and borrowing at market rates would expose the economy to the risk of disorderly BOP and fiscal adjustment in the future (due to higher gross financing needs and depletion of reserves) and crowding out of private sector credit. However, the planned ADB financing at concessional terms of US$45 million in total (about 18 percent of GDP) would help cover most of FY2020-22 financing needs and go a long way to mitigating these risks. Preserving Palau's track record of fiscal prudence would require a timely unwinding of the emergency fiscal measures when the health crisis is over. Over the medium term, additional fiscal revenue mobilization and further rationalization of current spending will be needed to rebuild government deposits, accommodate potential revenue loss from the expiration of the Compact grants in FY2024, and finance permanently higher spending in infrastructure and health to make growth more resilient. Priority measures include introducing a value-added tax (VAT) and reducing subsidies to SOEs through reforms.

Debt Sustainability

Preliminary analysis suggests that Palau's public debt will surge in the near term but remain sustainable. The public debt-to-GDP ratio is expected to rise sharply in the near term due to the fallout of the COVID-19 pandemic. Under the baseline scenario, public debt is projected to peak at 61 percent of GDP in FY2021, from 38 percent in FY2019, mainly driven by the economic contraction, expected policies in response to the COVID-19 pandemic, and associated widening in fiscal deficits. Although high by historical standards, the debt-to-GDP burden is projected to decline gradually to 42 percent by FY2025 as the economy recovers. Gross financing needs are projected to peak at close to 15 percent of GDP in FY2021, before declining gradually to 3 percent of GDP by FY2025. The large share of public debt provided by development partners and associated favorable terms are important risk mitigating factors.

Relative to the 2018 debt sustainability analysis, the preliminary analysis suggests that the likelihood of breaching thresholds in the event of risks has increased markedly. A growth shock scenario assumes a larger contraction in FY2021 and a slower recovery in FY2022, consistent with a protracted fallout of the COVID-19 pandemic. Under this scenario, the public-debt-to-GDP ratio would rise rapidly to 82 percent of GDP in FY2022 and remain close to the 70 percent of GDP threshold through FY2025. Under a constant primary balance shock, which assumes that the looser fiscal stance observed in FY2020 is maintained through the projection horizon, the debt-to-GDP ratio would increase steadily and reach 75 percent of GDP in FY2025, putting debt sustainability severely at risk. A constant primary balance will also lead to a substantial increase in gross financing needs, which would reach 18 percent of GDP during FY2024-25. Other relevant risks to debt sustainability include natural disasters and a materialization of contingent liabilities to SOEs. Considering Palau's susceptibility to shocks and the impact of these shocks on debt sustainability, continued fiscal prudence in the near term and rebuilding fiscal buffers over the medium term should be a key priority. In that context, enhancing domestic revenue mobilization and further rationalizing current expenditure would help to better secure debt sustainability.

Financial Policies

While the banking system is sound overall, the weakening outlook calls for close monitoring to prevent a deterioration of banks' balance sheets. Commercial banks have ample liquidity, low non-performing loan ratios, and stable returns on assets, but the economy's dependence on the contracting tourism sector is a source of risk. Direct exposure of banks to the tourism sector is limited, with small-sized consumer loans representing 84 percent of total bank loans. However, a sharp slowdown of the tourism sector, which accounts for more than a quarter of total employment, could adversely impact the performance of consumer loans. Palau's cautious approach to maintain the moratorium on crypto-asset and crypto-currency activities, introduced in March 2019, until these activities can be adequately regulated is appropriate. The banking system remains small, with private credit at about 11 percent of GDP, which is substantially lower than in other Pacific island countries.

Providing financial relief to affected corporates and households and supporting credit creation will help limit excessive economic disruption and facilitate a rapid recovery. The National Development Bank of Palau announced plans to provide financial reliefs, including interest only payments, term extension, loan consolidation, and temporary payment deferral. Some private banks have introduced payment deferral and forbearance programs for three months. To further support all affected businesses and individuals, additional targeted and temporary measures implemented in collaboration with the government could include (i) lending schemes and credit guarantee programs with emergency relief measures; and (ii) an extension of payment deferrals, debt service moratorium, and repayment holidays. In implementing these measures, it is important to avoid blanket relaxations of loan classifications and provisioning rules. Relaxing the interest rate ceiling for commercial loans and providing support to SMEs in preparing business plans and financial statements could help boost credit creation.

Macrostructural Issues

Comprehensive structural reforms are needed to secure a solid recovery, strengthen potential growth, and support long-term fiscal sustainability. Where possible, structural reforms should be part of the recovery packages. For instance, advancing climate resilient infrastructure projects, improving coastal protection, and promoting renewable energy would help better internalize risks from natural disasters and climate change while supporting the recovery. Other long-standing and medium-term priorities include adopting a new foreign investment regime with less restrictions and improving land-use planning to attract FDI. Reforming the Civil Service Pension Fund and the Palau Public Utilities Corporation would help contain quasi-fiscal risks and support long-term fiscal sustainability.

IMF Relations

Palau is on a 24-month Article IV consultation cycle. The 2018 Article IV consultation was concluded by the IMF's Executive Board on February 1, 2019. The Fund provides technical assistance and training from headquarters and PFTAC.

Table 1. Palau: Selected Economic Indicators, 2013–2023[1]

Nominal GDP for FY2019: US$280 million
Population (2019): 17,457
GDP per capita for FY2019: US$16,039
Quota: SDR 3.1 million

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
								Proj.		
Real sector										
Nominal GDP (million US$)	243.7	278.8	296.7	287.6	285.3	280.4	250.9	234.7	261.5	297.0
Real GDP growth (percent change)	6.0	5.0	-0.4	-2.0	5.8	-1.8	-11.4	-7.4	10.3	11.9
GDP deflator (percent change)	2.6	8.9	6.9	-1.1	-6.2	0.1	1.0	1.0	1.0	1.5
Consumer prices (percent change; period average)	4.0	2.2	-1.3	0.9	2.0	0.6	0.0	0.0	1.0	1.5
Tourist arrivals (number of visitors)	125,674	168,770	146,650	122,103	115,997	89,726	41,614	22,047	62,117	95,110
Expenditure per Tourist Arrival (US$)	1,023	881	945	1,011	1,019	1,139	1,197	1,119	1,145	1,178
Public finance					(In percent of GDP)					
Central government										
Revenue	43.8	41.2	42.0	40.0	44.4	43.5	42.9	40.3	39.6	39.5
Taxes and other revenue	24.4	25.5	25.4	27.0	27.1	27.2	24.1	21.7	23.1	24.7
Grants	19.3	15.7	16.6	13.0	17.3	16.3	18.8	18.6	16.5	14.8
Expenditure	40.2	36.0	38.4	35.2	38.2	43.1	49.3	52.6	44.4	39.3
Expense	35.6	31.2	32.8	32.3	35.9	38.7	46.6	50.1	40.6	35.2
of which: grants to other government units	4.8	5.4	5.9	5.0	6.5	10.8	13.3	13.4	9.2	7.3
Net acquisition of nonfinancial assets	4.5	4.8	5.7	2.9	2.3	4.4	2.7	2.5	3.9	4.1
Current fiscal balance (excluding grants) 2/	-11.2	-5.7	-7.3	-5.3	-8.7	-11.6	-22.4	-28.4	-17.5	-10.5
Current fiscal balance (including current grants) 3/	2.6	5.0	2.8	5.5	6.6	2.5	-6.8	-13.0	-4.3	0.8
Net lending (+)/borrowing (–)	3.6	5.2	3.6	4.8	6.2	0.3	-6.4	-12.3	-4.9	0.2
General government debt	36.5	28.6	32.8	34.1	36.9	38.1	56.7	61.0	55.9	47.9
					(In millions of U.S. dollars)					
Compact Trust Fund (CTF) balance	199.2	183.9	196.8	219.5	297.5	281.9	282.2	282.5	282.8	283.2
Government cash and deposits 4/	11.5	19.2	27.5	37.9	38.7	23.7	10.7	9.7	9.6	9.6
In percent of GDP	4.7	6.9	9.3	13.2	13.5	8.5	4.3	4.1	3.7	3.2
Monetary sector										
Credit to private sector (in percent of GDP)	12.1	10.3	10.1	12.0	12.3	11.4	-	-	-	-
Credit to private sector (percent change)	5.9	-2.5	3.6	15.4	1.9	-9.3	-	-	-	-
Balance of payments 3/										
Trade balance	-151.7	-136.8	-134.3	-139.5	-138.2	-145.0	-119.0	-109.3	-128.5	-147.0
Exports (f.o.b.)	15.9	13.1	13.3	14.1	13.8	11.2	8.4	7.5	9.6	12.4
Imports (f.o.b.)	167.6	149.9	147.6	153.5	151.9	156.3	127.4	116.9	138.1	159.4
Tourism receipts	122.7	140.5	131.3	117.3	108.8	96.3	46.8	23.1	66.7	105.2
Current account balance										
Including grants	-43.3	-23.8	-39.9	-53.8	-43.3	-74.6	-81.8	-82.5	-84.5	-89.5
Excluding grants	-83.8	-60.2	-77.3	-91.9	-93.2	-109.4	-112.6	-109.2	-112.6	-119.6
International Investment Position	-71.3	-76.1	-63.4	-68.7	-18.1	-83.2	-172.2	-240.7	-309.1	-379.8
Assets	471.3	514.3	584.3	624.8	711.0	680.6	662.3	619.8	589.0	557.4
Liabilities	542.6	590.4	647.7	693.5	729.1	763.8	834.5	860.6	898.0	937.2
Of which: External debt	70.6	64.4	75.8	81.7	87.7	87.1	137.3	138.2	142.7	139.7
					(In percent of GDP)					
Current account balance										
Including grants	-17.8	-8.5	-13.4	-18.7	-15.2	-26.6	-32.6	-35.2	-32.3	-30.2
Excluding grants	-34.4	-21.6	-26.0	-32.0	-32.6	-39.0	-44.9	-46.5	-43.1	-40.3
International Investment Position	-29.3	-27.3	-21.4	-23.9	-6.3	-29.7	-68.6	-102.6	-118.2	-127.9
Of which: External debt	29.0	23.1	25.5	28.4	30.7	31.1	54.7	58.9	54.6	47.0

Sources: Palau authorities; and Fund staff estimates and projections.
1/ Fiscal year ending September 30.
2/ Defined as tax and other revenue less expense.
3/ Includes withdrawls from CTF and Funding for US Federal Programs (Post Office and Meteorological Service)
4/ Includes unspent external loans.