


Japan International Cooperation Agency (JICA)
The Office of Planning and Statistics
The Republic of Palau

**THE STUDY
FOR PROMOTION OF
ECONOMIC DEVELOPMENT
IN THE REPUBLIC OF PALAU**

**FINAL REPORT
VOLUME-3
SECTOR REPORT**

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OCTOBER 2000

Pacific Consultants International

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1. APPRAISAL OF ECONOMIC PERFORMANCE

A recent country study undertaken by the IMF states as follows. "Palau faces many development constraints common among Pacific island economies, including a narrow resource base, geographical isolation, a small domestic market, a lack of infrastructure and skilled labor, and vulnerability to external and natural shocks."¹ The validity of this statement is no doubt.

The ROP is quite young in historical terms, having acquired political self-determination from United States Trust Territory rule in January 1980 when the Constitution was instituted, and independence when the Republic was proclaimed on November 1, 1994. Hence, it is not surprised that many features of general society, governance, economic performance, decision making, etc. are characterized by dichotomies, such as the stress between "post-colonial trauma and pro-active nation building", "tradition and the need for modernization", "subsistence economy versus monetary economy", and "old traditional style versus modernized style", the latter being demanded by any country, which wants to pursue a process of development under the external conditions of globalization.

The objectives of the Study is to assist the GOP in its nation-building efforts (1) by providing an impartial and objective diagnosis of the "state of the nation's economy", and (2) by providing a catalogue of measures to put the right fundamentals into place. Hence, the formal structure of both, analysis and reporting centers around one fundamental question: What needs to be done to re-institute, establish and maintain long-term macroeconomic viability and sustainability of the ROP?

1.1 National Policy Objectives and Hierarchy

Palau's Constitution, which came into force on January 1st, 1980 and which states the essential rules, under which the ROP should be governed, regulates some fundamental policy principles of outstanding relevance in the context of this Study. These principles, which must be kept in mind when discussing national (and state) government policy objectives and which form important elements of Palau's overall enabling environment, are² as follows:

Article IV, Section 6 ("Fundamental Rights") states that "No person shall be imprisoned for debt." This provision, tailored after the American Constitution, as noble as it is in its intentions, creates difficulties, in view of the fact that the ROP has many foreign laborers and no corporate bankruptcy law. At corporate management level, it may create difficulties to persecute, in case of fraud or other illegal behavior.

Article VI ("Responsibilities of the National Government") says that the national government is to provide especially, "free or subsidized health care" and "public education for citizens who shall be free and compulsory". This provision has an obvious direct impact on the national budget. The health care system for Palauans guarantees currently a subsidy for health care cost of between 95 to 30 percent, depending on the income level and family size. The self-cost component for Palauans in health care cost recovery is, therefore, between 5 to 70 percent of the treatment cost. The majority of Palauans pay around 30 percent of the actual cost. In other words, around 70 percent of health care treatment cost has to be funded from regular budget sources. Non-Palauans, and therefore the huge

¹ IMF Staff Country Report No.99/147 p 3.

² Listed in the text in the order, in which they appear in the Constitution.

foreign labor force, should in theory pay the full price or 100 percent of their health care cost. However, in reality many foreign workers do not have a health insurance resulting in unpaid bills after health care treatment. The total of such bills add to the budget burden. The ROP is now considering new health care legislation to address some of the underlying problems. In any event, it will be next to impossible to either increase the self-cost component considerably (thereby reducing the inherent health care system subsidies and, therefore, the burden on the budget) or introduce wholly private health care systems without changing the Constitution. This is even more so the case for education. Hence, it will be difficult to realize any savings and/or reductions in the budget items relevant for health care and education.

Article IX and Article XI regulate the powers of national and State governments to impose taxes, fees and levies. However, it is important to understand that State Governments cannot duplicate any taxes, levies and or fees already imposed on national level. Any taxes, levies and fees passed by State level legislatures are reviewed by the Attorney General's office and rejected, if they meet duplication criteria. This mechanism has severe consequences for State Governments to raise, independent from the national level Government, any revenues, and it has important practical implications. For example, if the road sections within State boundaries of the new Babeldaob Road are transferred in terms of O&M responsibility to State Governments, as has been hinted to the Study Team, State Governments would still depend on the allocation of national level budget resources for proper levels of O&M resources.

Article XIII, Section 8 ("General Provisions") states that only citizens of Palau and corporations wholly owned by citizens of Palau may acquire title to land or waters of the ROP. This principle creates very practical problems at two levels. First, foreign owned or dominated corporations cannot own and, therefore, collateralize land. Secondly, there are uncertainties how the GOP can arrange for extraterritoriality for embassies and other entities with diplomatic status, such as the UN and other regional organizations.

Article XIII, Section 9, states that no taxes shall be imposed on land. As will be demonstrated later in this Study, there is an urgent need to raise the revenue side of the national budget. This constitutional restraint limits the government's scope of levying new and additional taxes, as and when the need arises.

Article XIII, Section 11, states that Congress shall designate a place in Babeldaob to be the permanent capital of the ROP not later than ten years after the effective date of the Constitution. Hence, the question of the new capital in Melekeok State is for the national Government not an issue of "need", but one of constitutional requirements.

To be eager for more "self-reliant" development is the single most important policy objective pursued by the GOP.

1.2 Institutional Matters

It is beyond the scope of this Study to discuss each and every aspect, legal aspects, etc. Hence, the following narrative will highlight some selected essentials in the following areas:

- The overall legal and regulatory frameworks;
- The national planning process;
- Good governance; and

- Roles of public and private sector.

1.2.1 The Overall Legal and Regulatory Frameworks

Palau's Constitution, which may have been prepared with an eye on the American Constitution, but certainly also with a view to balance the "traditionally rooted power structure" with the requirements of a modern & democratic state³, cements and regulates many aspects, which can easily appear as rather obstacles than advantages to a modern state, which in turn is based on a monetary economy. One example will suffice to make the point. It is not immediately self-evident, why a nation of some 14,750 Palauan residents (estimated for 1999/2000 and excluding the over 5,000 foreign workers) needs 16 States, with the majority of such States having much less than 1,000 registered inhabitants and a real population size living there, which is actually even much smaller. The inherent public burden (in term of budget) to pay for the operations of the needed government machinery and personnel stands in no relation to any conceivable economic basis and or benefit. However, it appears that there is insufficient political will at present to address such fundamental issues in the political arena.

The ROP is as regards the overall legal framework still, according to the office of the Attorney General, in the process of putting the right "structures in place". "Palau National Code (PNC)" laws have replaced most Trust Territory laws, rules and regulations and they are, therefore, not applied anymore. The following important laws are at present considered by the legislature:

An insurance and health code

This is of obvious importance not only for Palau's overall business climate, but also to address the many problems related to the huge foreign labor force and the burden it creates on the public budget

Immigration and labor codes

The same general observation as above applies. Issues relevant in this context are controversial, since the huge numbers of non-Palauan workers are viewed, on the one hand, with skepticism, while they are, on the other hand, needed to maintain growth in certain sectors of the economy. The ROP has a minimum wage law (\$2.50 per hour) covering Palauan citizens. There are discussions now to extend this law to cover non-Palauan workers. Given the composition of the foreign workforce and the ROP's competitive edge in the region, such a move may have profound implications for foreign direct investment (FDI) attraction and the economy's overall competitiveness

A new tax code

An overhaul of the tax structure and its rates is overdue and needed, in order to broaden the Government's revenue-base and increase overall revenues. However, in addition to the constitutional limitations (as indicated above) imposed on such new law, it appears to be somewhat unclear up to now, what the overall net cash-benefit to the treasury of the new tax will be. There is also resistance in the business community, which is petitioning Congress through concerted efforts of the Chamber of Commerce and Industry to ensure that no net overall tax increase legislation is made for a period of five years. As is the case with so many other issues, it is difficult to perceive over the long-term how the ROP can have it both ways, so to speak:

Banking law

This is undoubtedly a must for a modern economy. Discussion focuses on how to

³ Please see the Article V, Sections 1 and 2 dealing with "Traditional Rights".

integrate proper banking supervisory legislation with the idea of establishing the ROP as an international financial center.

Bankruptcy laws

Should also be passed on an urgent basis, in order to introduce more clarity and transparency in the economic sphere.

1.2.2 The National Planning Process

The analysis contained in the Economic Memorandum attached as an Appendix to this Study has demonstrated clearly the fundamental dangers inherent in managing the country and economy on an "ad-hoc" and "as & when needed" basis. It is quite clear that there is not only a pressing need to monitor key performance parameter of the economy⁴, but also to have short-to medium term numerical targets for major internal parameter, such as the budget, public investments, external ODA resources, the balance of payments situation, and so on. The "Asian Crisis" should have taught meanwhile the lesson that much bigger and more complicated economies can get into serious trouble, if complacency in this area is allowed to settle in. The ROP has received at her independence in 1994 a well-prepared and comprehensive development plan, which was financed by the United States and implemented through UNDP. No adequate answers were provided, why this plan has been ignored for all practical purposes over all these years.

1.2.3 Good Governance

It is not surprising that in a small community, such as Palau, with its cross-relationships in terms of family and clan, that there are many people wearing many hats. However, in the medium- to long-term there should be a clear separation between "politics" and "business". A first step in the right direction is the "Ethics Code", which is presently under consideration. It is utterly detrimental to attracting more FDI, if and when a foreign businessperson has to discuss his/her business proposal with members of an entity scrutinizing his/her proposal, while such members have, at the same time, business interest in the same or a similar line-of-business.

1.2.4 Roles of Public and Private Sector

The ROP is by many standards a young nation with a past post-independence record of only some five years. It is self-evident from the data and other relevant documentation that the GOP has tried since independence to pursue a government-led growth strategy. However, while past performance may be impressive in comparison with other small island nations in the South Pacific, the past five years have also revealed the limitation to such an approach, in particular when one of the major policy objectives of the authorities is an increasing level of economic self-reliance. The following issues, which will be addressed, more in detail in the main economic summary report, need to be highlighted:

As is the case for nations big or small, a proper "overall enabling environment" in favor of the private sector, to use the terminology of the World Bank⁴, has to be (or has to be put) in place, which harvests the energy and creativity of people, a country's most important assets

The government's role in the medium- to long-term should be that of a prudent policy maker and regulator, and not necessarily that of a player in the economic sphere

⁴ This effort is supported by UNDP "Public Sector Support" projects.

Among of the key-functions of government in the economic sphere is to maintain prudent long-term sustainable internal and external balances. This would imply avoiding, but not be limited to avoiding unsustainable budget and balance-of-payments deficits. It would also imply that there is prudent and adequate planning machinery in place ensuring priorities and predictability

Last, but not least, there is an urgent need to put a minimum economic base/critical mass into place. It is very doubtful, how any economy can be, without such a base, more self-reliant in this era of "globalization".

Fundamental constraints for making more profound statements about the actual role of the public and private sector in Palau's economy are:

There is limited basic data on ownership patterns and so on, including informal and/or indirect government influence and interference.

The utilities are a perfect example for the problems underlying the latter aspect. Board members of the utilities, for example, are appointed directly, and Managing Directors of the utilities are obviously bound by Board decisions. On the other hand, it is apparent from the legal frameworks for the utilities that they are perceived as government-independent units, sometimes even referred to as "private" entities.

However, some of them are exempted from corporate tax payments (which would contradict that they are "private") and utilities rates are determined more on social than corporate performance grounds. In fact, it appears from interviews carried out with all utilities, that operating revenues of the utilities are insufficient to cover debt-services (for example PNCC), depreciation and/or needed future net-investments.

It is clear from the above that the GOP has presently no clear policy on an increasing role of the private sector in Palau's development process. Palau's "Chamber of Commerce and Industry" is, to some extent, involved in Palau's policy deliberation process. For example, the Chamber was member of the Banking Commission and the Chamber is informed by the FIB through copies of the relevant documents of FIAC decisions.

Hence, it must suffice in the context here to highlight that the Chamber has a clear business plan, which not only states the Chamber's mission, but also the current Committee structure, its goals and detailed activities. The individual Committees and attached goals are:

Tourism Committee

The year 2000 goal is to "Promote quality tourism while protecting the environment maximizing use of the indigenous labor force."

Utilities Committee

The year 2000 goal is to "Provide support to ensure reliable electrical power generation and distribution capable of meeting future needs and demands."

Labor and Immigration Committee

The year 2000 goal is to "Review current legislation on Foreign Labor and immigration and propose improvement."

Commercial Port Committee

The year 2000 goal is to "Identify and secure a location for a container yard to allow for increased volume at the commercial port."

Airport Committee

The year 2000 goal is to "Repair the existing terminal building to ensure that it is safe and in its best condition and promote the construction of a new terminal building as

soon as possible.”

Land Matters Committee

The year 2000 goal is to “Facilitate the determination of land ownership and the return of public land to rightful owners; provide zoning laws and building codes and the enforcement thereof.”

Foreign Investment Committee

The year 2000 goal is to “Improve foreign investment laws and regulations that encourage foreign investment and adequately protect investors and their investment.”

Asian Business Affairs Committee

The year 2000 goal is to “Improve relations with Asian markets and increase commercial and business opportunities with those markets.”

Committee on Banking Commission

The year 2000 goal is “To establish a Banking Commission to inform and regulate banks and financial institutions in Palau, to establish uniform industry standards & practices.”

Agriculture Committee

The year 2000 goal is “To promote local agriculture, consumption of local produce, export of local produce and investments in agriculture and horticulture.”

Fisheries Committee

The year 2000 goal is “To promote fishing industry.”

Strategic Committee

The year 2000 goals are to “ (1) The Chamber request OEK to pass legislation to impose moratorium on tax increase up to year 2000. (2) Push for an enactment of legislation to ensure that no net overall tax increase legislation is made for a period of 5 years. (3) Support privatization of some of the government services. Push for less government, and greater productivity from the government employees”.

1.3 GDP Growth and Structural Composition

There is a general lack of reliable macro-data on the ROP, which creates difficulties for the republic in its membership with international organizations, such as the IMF. This problem is currently addressed by a UNDP project⁵, which is to establish reliable GDP and other related macro-economic data. The data generated by the UNDP project are widely used, including by the IMF, and they are also copied widely. This section draws almost exclusively on the same data.

The ROP's nominal GDP has grown from around \$76.9 million in 1990 to an estimated \$129.3 million in 1998⁶, indicating a compound growth rate over the eight-year period of 6.71 percent in nominal terms. Nominal GDP growth performance has been distinctly different when comparing Trust Territory (up to October 1994) with ROP times. Palau's economy was hit by a severe recession in the years 1992 and 1993, when nominal GDP contracted by -1.68 percent in 1992 and by a staggering -7.93 percent in 1993 with the absolute size of the economy falling below its 1990 level⁷. The pre-independence GDP growth rate for the period 1990 to 1994 is recorded as 2.43 percent, likely to indicate not only a decline in nominal, but also real per-capita income (Table 1.3.1 refers).

⁵ UNDP “Public Sector Development Project”.

⁶ On a calendar year basis.

⁷ The reasons for this serious recession are unclear and need to be clarified.

Table 1.3.1 Nominal GDP Growth Performance 1990 to 1999

Year	Nominal GDP (million \$)	Annual Average Growth Rate (%)	Compound Growth Rates over the Period (%)		
			Base		Base
1990	76.889	Base	Base		Base
1991	83.860	9.07	↓		
1992	82.450	-1.68	↓		
1993	75.909	-7.93	↓		
1994	84.631	11.49	2.43	Base	
1995	105.211	24.32		↓	
1996	124.264	18.11		↓	
1997	131.137	5.53		↓	↓
1998	129.250	-1.44		11.17	6.71
1999	129.250*	0.00			

Source: JICA Study Team

Note: * Figure in 1999 is estimated by the IMF.

The immediate post-independence years 1994, 1995 and 1996 were characterized by a substantial jump in nominal GDP reflected in considerable double-digit nominal growth. That growth was fueled by a huge cash injection into the economy (\$263.1 million, equivalent to 311 percent of Palau's 1994 GDP size) negotiated under the COMPACT and related direct United States payments. Such growth was carried by initial success stories in tourist arrivals, increasing from some 40,500 in 1993 to 69,230 in 1996 driving in turn growth in the hotels & restaurants sub-sectors, and trade and transport sub-sectors, the growth of which was driven by the United States direct grants and payments and the imports that they caused. However, as is reflected clearly in the annual GDP growth rates, nominal growth after 1996 has not only been declining sharply, but the ROP's economy has slipped again into a recession in 1998 and it is estimated to have been stagnant in 1999.

The structure of Palau's economy was in the past heavily dependent on the tertiary sector, which accounted already in 1990 for about 59 percent of GDP. The dependence of the economy on the tertiary sector, that is private and public sector services, has increased subsequently and notably as of the recession years 1992 and 1993 accounting for 81 percent in 1994 and an estimated 85 percent in 1998 (Table 1.3.2 refers).

Table 1.3.2 Structure of GDP

	(Unit: percent)		
	1990	1994	1998 (estimation)
Primary Sector	25.94	8.64	4.55
Secondary Sector	15.48	7.87	8.09
Tertiary Sector	58.59	81.04	85.38
Less bank charges	N/A	1.19	0.95
Plus import duties	N/A	3.64	2.93
GDP	100.00	100.00	100.00

Notes: The high share of the primary sector in 1990 is most likely wrong, due to statistical. There is an overvaluation of the fishery sub-sector, which was corrected in the statistics as of 1993.

Source: JICA Study Team

The relevance and weight of both the primary and secondary sectors have declined over the years. The share of the secondary sector, which is in terms of size Palau's second important economic sector, declined from about 15 percent of GDP in 1980 to slightly below 8 percent in 1994 and around 8 percent in 1998. The primary sector has played and continues to play a relatively minor role in Palau's economy. The share of the primary sector in nominal GDP has been halved over the period 1993 to 1998, which is from around 11 percent in 1993 to some 5 percent in 1998.

1.3.1 GDP Growth, Engines of Growth & Per Capita Income

The above described structural features and changes therein need to be filtered through growth-matrix analyses, in order to answer the following simple questions:

- Which sector/sub-sectors carried past nominal GDP growth and to what extent?
- What impact on GDP nominal growth has sub-sector growth and changes therein?

Economic sub-sectors can subsequently be ranked, under given factor endowment conditions, in order of importance for achieving overall GDP growth.

As mentioned already above, the overall economic nominal growth performance of Palau's economy over the period 1990 to 1998 has been recorded at a compound growth rate of 6.71 percent.

Table 1.3.3 Nominal and Estimated Real GDP Growth

	Unit	1990	1991	1992	1993	1994	1995	1996	1997	1998 (estimation)
Nominal GDP	\$ thousand	76,889	83,860	82,450	75,909	84,631	105,211	124,264	131,137	129,250
Real GDP (3% of deflator)	\$ thousand	76,889	81,417	80,049	73,698	82,166	102,147	120,645	127,317	125,485
Real GDP (5% of deflator)	\$ thousand	76,889	79,867	78,524	72,294	80,601	100,201	118,347	124,892	123,095
Total number of residents*	Persons	15,122	15,521	15,931	16,352	16,783	17,225	17,985	18,459	18,947
Nominal Per Capita Income	\$	5,085	5,403	5,175	4,642	5,043	6,108	6,909	7,104	6,822
Real Per Capita Income (3%)	\$	5,085	5,246	5,025	4,507	4,896	5,930	6,708	6,897	6,623
Real Per Capita Income (5%)	\$	5,085	5,146	4,929	4,421	4,803	5,817	6,580	6,766	6,497

Source: JICA Study Team

Notes: * Include the considerable amount of non-Palauan temporary workers. Growth has been estimated at 2.64 percent per year though this is likely to be overestimated.

However, the nominal growth may be misleading, since it doesn't take inflation into account. Official inflation data are not available yet. Notwithstanding this fact, if one assumes a dollar based inflation rate of say between 3 percent and 5 percent annually, the following major trend features for the Palauan economy over the eight-years period 1990 to 1998 are summarized as follows:

The overall growth performance of the economy has been and continues to be in bad shape. As observed above, the nominal GDP growth rate over the eight years period 1990 to 1998 has been recorded at 6.71 percent. Nominal GDP growth over the period 1990 to 1994 was 2.45 percent, and 11.19 percent in the post independence period 1994 to 1998. The economy has slipped into another recession in 1998 with a negative nominal GDP growth rate of -1.39 percent.

This picture changes, if GDP values are deflated by either a 3 or 5 percent inflation rate. In such event, deflated GDP would have grown by a compound growth rate over the period 1990 to 1998 of 6.31 percent (with a inflation of 3%) and a 6.06 percent for the case of 5% of inflation.

Actual contraction of the economy in the recession periods 1992/93 and 1998 would have been considerable with about -1.4 percent (1993 at a inflation of 3%), -2.03 percent (1993 at a inflation of 5%), and -1.44 percent (1998 at a inflation of 3% against 1997), and -1.44 percent (1998 for a inflation of 5% against 1997).

The impact on the statistical per capita income (meaning here per capita income of total number of residents, including the huge foreign labor force) would have been significant. In case of a 3 percent inflation rate adjusted economy, per capita income would have increased by 3.36 percent over the period, and in case of a 5 percent inflation rate adjusted economy per capita income would actually have

grown by 3.11 percent on average over the period.

Whatever the numbers have been remains to be determined on basis of exact econometrical data. It is, however, clear that Palau's economy has been in two severe recessions in 1992/93 and 1998/99, that is in four out of the nine years analytical period. This alone would hint at severe structural problems within Palau's economy.

Notwithstanding the rudimentary nature of macro-economic data, they can be employed to establish a sense for past engines of growth (in the positive and negative sense). A growth-analysis matrix approach is employed toward that end. The results of this analytical technique, which are summarized in Table 1.3.4, reveal the following analytical pattern:

The tertiary sector, which was 77 percent of nominal GDP on average over the period 1990 to 1998, accounted for around 8 percent of nominal growth. The transport & communications sub-sector had a weighted growth rate of 2.64 percent the single most important past engine of growth. This sub-sector alone accounted for 33 percent of tertiary sector growth, or 39 percent of nominal GDP growth.

The second most important sub-sector was public administration, which accounted with a weighted growth rate of 1.76 percent for 22 percent of tertiary sector growth and 26 percent of nominal GDP growth.

The third and fourth most important sub-sectors have been the "wholesale and retail trade" and "hotels & restaurants" sub-sectors, which accounted for 1.01 and 0.97 percent growth, equivalent to around 13 and 12 percent, respectively, of tertiary sector growth, or around 15 and 14 percent, respectively, of nominal GDP growth.

All other sub-sectors of the economy have played in the past either a marginal or a negative role in sector and/ GDP nominal growth performance.

Table 1.3.4 Results of Growth-matrix Analysis

(Unit: percent)

Parameter	Average Sector Share 1990-1998	Adjusted & Weighted Growth Rate 1990-1998
Agriculture	2.42	0.04
Fisheries	8.62	-1.35
PRIMARY SECTOR	11.04	-1.31
Mining & quarrying	0.26	-0.04
Manufacturing	0.79	0.06
Electricity, gas & water	0.93	-0.50
Construction	7.89	0.14
SECONDARY SECTOR	9.87	-0.35
Trade	17.51	1.02
Hotels & restaurants	10.41	0.97
Transport & communications	12.18	2.64
Finance & insurance	4.24	0.40
Real estate & business services	4.93	0.53
Public administration	22.32	1.76
Other services	5.73	0.79
TERTIARY SECTOR	77.32	8.12
Less: Imputed bank charges *	0.87	0.00
Plus: Import duties *	2.65	0.25
Gross Domestic Product	100.00	6.71

Source: JICA Study Team

Notes: * excluding the years 1990 and 1991 due to data unavailability.

These four listed sub-sectors combined accounted on trend average for about 62 percent of Palau's economy and 95 percent of nominal growth performance. The key features are summarized as follows:

The transport & communications sub-sector alone accounted for around 39 percent of the compound nominal growth of economy over the period 1990 to 1998

Public administration added on average 26 percent to compound nominal GDP growth. Both sector combined carried 66 percent of GDP growth, and

The "wholesale and retail trade" and "hotels and restaurants" sub-sectors carried each around 15 percent of GDP growth.

Table 1.3.5 Ranking of Sub-sectors

	Average Sector Share 1990-1998	Accumulated Sector Share 1990-1998	Weighted Growth Rate 1990-1998	Accumulated Growth Rate 1990-1998
Rank 1: Transport & communications	12.18	12.18	2.64	2.64
Rank 2: Public administration	22.32	34.49	1.76	4.41
Rank 3: Wholesale and Retail Trade	17.51	52.01	1.02	5.42
Rank 4: Hotels & restaurants	10.41	62.41	0.97	6.39

Source: JICA Study Team

Notes: Negative growth sub-sectors are not taken into account here.

The above pattern suggests strongly not only the overall structural weakness of GDP growth, but also that past and future nominal GDP growth performance will depend crucially on the growth performance of the above sub-sectors, in particular "transport & communications" and "public administration". One example may suffice to illustrate such strong dependency and structural weakness. Let us assume, for example, that "transport & communications" sub-sector growth in a given period is zero. Such event will have a direct and strong negative impact on overall GDP growth reducing it under given factor endowment conditions by some 2.64 percent points. In order to maintain past nominal GDP trend growth of 6.71 percent, this loss of 2.64 percent out of the 6.71 percent would have to be compensated for from stronger growth of other sub-sectors of the economy, or GDP growth would be reduced to 4.07 percent.

The only immediate candidates for such compensation are the sub-sectors ranked 2 to 4 in the above table. If, say the "public administration" sub-sector were to compensate, it would have to grow at factor 1.5 its past 1990 to 1998 trend growth rate of 9.27 percent, or 13.9 percent. Such an event is highly unlikely and also undesirable.

1.3.2 The Primary Sector: Growth & Structural Composition

The absolute output value of the primary sector has been falling steadily since 1993 recording a negative compound growth rate of -5.36 percent over the period 1993 to 1998 (Table 1.3.6 refers).

Table 1.3.6 Growth and Structural Composition of the Primary Sector

Parameter	Unit	1993	1994	1995	1996	1997	1998 (estimation)
Total Output value	\$ thousand	8,082	7,313	6,544	5,775	5,970	6,135
Agriculture	%	28.1	32.1	37.0	43.2	41.0	43.2
Fishery	%	71.9	67.9	63.0	56.8	59.0	56.8
Primary Sector							
Annual growth rate	%	Base	-9.51	-10.52	-11.75	3.38	2.76
Compound growth	%	Base					-5.36
Agriculture							
Annual growth rate	%	Base	3.21	3.15	3.02	-1.72	8.16
Compound growth	%	Base					3.12
Fisheries							
Annual growth rate	%	Base	-14.49	-16.97	-20.42	7.25	-0.99
Compound growth	%	Base					-9.71

Source: JICA Study Team

The contraction of the primary sector output measured in nominal terms has actually accelerated from -9.51 percent in 1994 to -10.52 and -11.75 percent in 1995 and 1996, respectively. Primary sector output growth has seen some modest recovery with 3.38 and 2.76 percent in 1997 and 1998, respectively. This somewhat drastic reduction has been caused by steep contraction in fishery sub-sector output, reflected in a negative compound growth rate of -9.71 percent over the period 1994 to 1998, and steep contractions in 1994 (-14.49 percent), 1995 (-16.97 percent), and 1996 (-20.42 percent). The agricultural sub-sector is small in absolute size, but it reached a compound growth rate of 3.12 percent over the period 1993 to 1998. The dramatic reduction in fishery sub-sector output is reflected in its diminishing weight in the primary sector. The fishery sub-sector has dominated in 1993 primary sector output with its share of about 72 percent. This share has fallen since to around 57 percent in 1998.

The trend in the fisheries sub-sector requires explanation, in particular after the independence year 1994 when the ROP started to claim a 200 miles Exclusive Economic Zone (EEZ). Given the fish-rich resources of the ROP one would expect somewhat that the commercial fishery sub-sector plays a more important role in the structure of the GDP's income side.

1.3.3 The Secondary Sector: Growth & Structural Composition

Secondary sector output was in 1992 still at a nominal level of some \$10.4 million, contracting in 1993 as a result of the economy's recession to a level of \$6.6 million, equivalent to a reduction in output value of some -36 percent. Since then, the output value of the secondary sector has remained in the period 1996 to 1998 at a similar level of some \$10.4 to 10.7 million. This is roughly equivalent in nominal terms to the 1992 output level, implying a perhaps quite considerable reduction in real terms. The overall compound growth performance of the secondary sector over the period 1992 to 1998 (including the recession years of 1992 and 1993) has been with 0.59 percent minute. The economy's recession is reflected in the sharp drop in 1993 of construction sub-sector output, which caused an annual negative secondary sector growth rate of about -36 percent. Annual secondary sector growth picked up again in 1995 (a growth rate of about 41 percent against the preceding year), which has since then slowed down considerably to the one percent range in 1997 and 1998.

Secondary sector output has carried in the past and continues to be overwhelmingly carried by construction sector output, which accounted in 1992 for about 81 and in 1998 for some 93 percent of secondary sector output, thereby determining the potential

growth performance of the secondary sector (Table 1.3.7 refers).

Table 1.3.7 Growth and Structural Composition of the Secondary Sector

	Unit	1992	1993	1994	1995	1996	1997	1998 (estimation)
Total Output value	\$ thousand	10,369	6,605	6,661	9,419	10,498	10,610	10,740
Mining & quarry	%	5.09	8.89	6.67	3.20	1.51	1.30	1.35
Manufacture	%	5.71	8.48	11.11	9.78	10.50	9.12	9.46
Utilities	%	8.25	13.97	9.13	3.12	-0.19	-4.73	-3.98
Construction	%	80.95	68.66	73.10	83.90	88.19	94.31	93.17
Secondary Sector								
Annual growth rate	%	Base	-36.30	0.85	41.41	11.46	1.07	1.23
Compound growth	%	Base						0.59
Mining & Quarrying								
Annual growth rate	%	Base	1.78	-24.36	-32.21	-47.51	-12.66	5.07
Compound growth	%	Base						-19.38
Manufacturing								
Annual growth rate	%	Base	-5.41	32.14	24.46	19.65	-12.16	4.96
Compound growth	%	Base						9.42
Utilities								
Annual growth rate	%	Base	7.95	-34.13	-51.64	-99.66	N/A	N/A
Compound growth *	%	Base						-81.51
Construction								
Annual growth rate	%	Base	-45.97	7.36	62.31	17.15	8.08	0.00
Compound growth	%	Base						2.97

Source: JICA Study Team

Notes: * only for the period 1992 to 1996, after that output value is negative.
N/A means not available.

The mining & quarrying sub-sector, the share of which in secondary sector output has been falling continuously from around 5 percent in 1992 (the share peaked in 1993 with roughly 9 percent of secondary sector output) to 1.5 percent. The share of the mining & quarrying sub-sector has remained in the one percent order of magnitude over the period 1996 to 1998. The mining & quarrying sub-sector comprises bauxite and phosphate mining as well as quarrying for general construction purposes. Total output value has been falling consistently from about \$0.5 million in 1992 to around \$0.15 million in 1998, which is reflected in double digit negative growth rates from 1994 to 1997. The compound growth rate over the period 1992 to 1998 is estimated at -19.38 percent.

The manufacturing sub-sector, the output value of which has been growing from around \$0.6 million in 1992 to some \$1.0 million in 1998, plays likewise a minute role in both GDP and the economy's secondary sector. Though the base is very small, the overall compound growth rate over the period 1992 to 1998 has been with 9.42 percent well above nominal GDP and secondary sector growth. However, the manufacturing sector's output value has been stagnating at around \$1.0 million over the years 1996 to 1998.

The performance of the utilities sub-sector comprising water and electricity, is somewhat unusual in that it has produced increasing negative output values in 1996, 1997 and 1998. The output value of this public services providing sub-sector has declined by a compound negative growth rate of a stunning -82 percent, indicating strong and persistent difficulties within this sub-sector.

Construction, which is as mentioned above by far the most important sub-sector within the economy's secondary sector, has performed with a compound growth rate of 2.97 percent also modestly over the period 1992 to 1998. After having been affected severely by the recession (a negative growth rate of around -46 percent in 1993),

construction sector growth jumped to around 62 percent in 1995 and is, since then, slowing down considerably (around 17 percent in 1997 and 8 percent in 1998).

Notwithstanding this poor performance, construction accounts for around 93 percent of secondary sector output (1998).

1.3.4 The Tertiary Sector: Growth & Structural Composition

It is no exaggeration to state that the economy of the ROP is the economy's tertiary or services sector. The absolute size of this sector's output has grown from around \$45 million in 1990 to about \$109 million in 1998 (see a table in Appendix 2), equivalent to a compound growth rate over the period of 11.71 percent, well above overall nominal GDP growth. The tertiary sector's output expanded rapidly in the immediate post-independence years, when output grew by about 15 percent in 1994, around 27 percent in 1995, and 21 percent in 1996. Output growth since then has fallen drastically to around 7 percent in 1997, and it is estimated that output contracted actually in 1998 by around -2.5 percent.

The absolute size of four sub-sectors determine the absolute size of output of the tertiary sector, namely:

- Public administration;
- Trade;
- Transportation & communication; and
- Hotels & restaurants.

The four sectors together accounted in 1990 for about 80 percent of tertiary sector output, and still around 77 percent in 1998. The trade sub-sector's compound growth rate over the period is recorded with 6.80 percent roughly in line with overall nominal expansion of GDP.

This sub-sector, which accounted for about 27 percent of tertiary sector output in 1990 and some 20 percent in 1998, has expanded rapidly in 1995 (about 38 percent growth) and 1996 (about 21 percent growth) and is since then contracting by about -8 percent in 1997 and some -10 percent points in 1998.

The wholesale and retail trade sub-sector has been, not surprisingly because of Palau's extremely limited production base, consistently the second most important tertiary sector in Palau's economy after the "public administration" sub-sector.

Output of the "hotels & restaurants" sub-sector has seen steady expansion, growing over the period under consideration well above nominal GDP growth at a compound growth rate of 10.92 percent.

Table 1.3.8 Growth and Structural Composition of the Tertiary Sector

	Unit	1990	1991	1992	1993	1994	1995	1996	1997	1998 (estimation)
Total Output value	\$ thousand	45,047	48,914	55,713	59,544	68,586	86,784	105,134	111,965	109,215
Wholesale and Retail Trade	%	26.67	28.21	25.15	23.59	21.51	23.49	23.36	20.18	18.62
Hotels & restaurant	%	13.89	13.92	9.78	10.78	10.40	15.68	15.70	14.72	13.12
Transportation & communication	%	7.48	6.94	16.72	16.76	15.27	16.63	16.51	17.73	18.91
Finance & insurance	%	6.91	6.49	4.31	3.43	4.73	5.12	5.37	5.87	6.62
Real estate & banking services	%	7.35	7.64	5.80	6.12	6.00	5.29	4.81	6.96	7.85
Public administration	%	31.55	30.72	33.10	34.33	33.52	26.74	25.59	26.19	26.44
Other services	%	6.14	6.09	5.13	4.99	8.57	7.05	8.66	8.35	8.44
Tertiary Sector										
Annual growth rate	%	Base	8.58	13.90	6.88	15.19	26.53	21.14	6.50	-2.46
Compound growth	%	Base								11.71
Wholesale and Retail Trade										
Annual growth rate	%	Base	14.85	1.57	0.21	5.03	38.21	20.46	-7.99	-10.00
Compound growth	%	Base								6.80
Hotel & restaurants										
Annual growth rate	%	Base	8.77	-19.92	17.74	11.12	90.83	21.26	-0.17	-15.00
Compound growth	%	Base								10.92
Transport & communication										
Annual growth rate	%	Base	0.77	174.15	7.16	4.97	37.73	20.28	14.41	4.00
Compound growth	%	Base								25.43
Finance & Insurance										
Annual growth rate	%	Base	2.02	-24.28	-14.98	58.76	37.01	27.01	16.40	10.01
Compound growth	%	Base								11.11
Real Estate & Banking Services										
Annual growth rate	%	Base	12.74	-13.44	12.77	12.95	11.44	10.29	53.94	10.01
Compound growth	%	Base								12.62
Public administration										
Annual growth rate	%	Base	5.71	22.73	10.86	12.46	0.93	15.95	8.98	-1.50
Compound growth	%	Base								9.27
Other services										
Annual growth rate	%	Base	7.63	-4.00	3.88	97.81	4.15	48.78	2.75	-1.50
Compound growth	%	Base								16.23

Source: JICA Study Team

The absolute size, which was recorded at about \$6 million in 1990, has reached an estimated \$14 million in 1998. The output peaks have been in 1996 and 1997 when output was recorded at around \$16.5 million. Output growth of this sub-sector jumped immediately after independence in 1995 by about 91 percent. However, growth has slowed down, and output has actually contracted in 1998 by around -15 percent.

The importance of the "transport & communications" sub-sector has grown consistently within the tertiary sector structure. Its share in tertiary sector output was a mere 7.5 percent in 1990 reaching almost an estimated 19 percent by the year 1998. The sub-sector's compound growth rate over the period 1990 to 1998 was, though from a small base of about \$3.4 million, with around 25 percent the highest among all tertiary sub-sectors. The absolute size of this sub-sector was in 1998 with \$18.9 million the second largest after that of "public administration". However, as is the case with other sub-sectors, nominal growth performance has slowed down consistently and considerably after 1995, when growth peaked at about 38 percent. Still, the "transport & communications" sub-sector is one of the economy's few sub-sectors, which still achieved positive growth of about 4 percent from 1997 to 1998.

The share of the "finance & insurance" sub-sector in tertiary sector output has and remains the smallest sub-sector. Its share was with around 6.9 percent the highest in 1990 and falling to its lowest point of about 3.4 percent in 1993. The share has increased again to an estimated 6.6 percent in 1998. However, this sub-sector's output has grown in absolute terms at a compound growth rate of 11.11 percent over the period. In fact, with the two recession years of 1992 and 1993, output value has increased from roughly \$3.1 million in 1990 to about \$7.2 million in 1998 reflecting increased business activities.

The share of the "real estate & business services" sub-sector is relatively minor having accounted for roughly 7.4 percent in 1990 and, after falling clearly below that level thereafter, climbing again to around 7.9 percent in 1998. However, as is the case for finance & insurance, the absolute size of this sub-sector's output has grown consistently by a compound growth rate over the period of 12.6 percent. The output size, which was around \$3.3 million in 1990, reached a level of \$8.6 million in 1998. The sub-sector was affected by the recession in only 1992, when output value contracted by about -13 percent.

The "public administration" sub-sector has been the largest sub-sector in terms of size at least for the period 1990 to 1998. It measured in 1990 around \$14.2 million and increased to an estimated absolute size of \$28.9 million in 1998 implying a compound growth rate over the period of 9.27 percent.

In other words, output expansion in public administration has exceeded that of the total economy on annual average by roughly 38 percent over the whole period. It appears from the available data that:

The authorities in Palau responded in 1992, the first year of the 1992 to 1993 recession period, to the crisis by increasing considerably public sector employment. Output, which is in this sub-sector overwhelmingly labor force and not capital or technology driven, increased by about 23 percent, while GDP contracted by about -1.7 percent.

This trend is even more distinct for 1993. Public sector output increased against 1992 by roughly 11 percent, while the overall economy contracted by roughly -8 percent.

This trend of continuous expansion of "public administration" output continues up to 1997 when output value peaked at \$29.3 million, equivalent to 22 percent of the total economy and/or 4.9 times the size of the primary sector, and/or 2.8 times the size of the economy's secondary sector.

The "other services" sub-sector has expanded steadily and consistently over the whole period. Output measured some \$2.8 million in 1990 increasing to an estimated \$9.2 million in 1998, equivalent to a compound growth rate in nominal terms of 16.23 percent, some 9.52 percent point above the overall growth performance of the economy. In fact, output growth jumped in 1994, the year of independence, by a staggering 98 percent as against 1993.

1.4 Employment and Productivity

The collection of data on employment by sub-sectors by GOP is limited only in census years. JICA Study Team used "Palau Travel & Tourism - An Economic Perspective" prepared for Palau Visitor Authority.

The data indicate that actual employment, including Palauan and non-Palauan labor, has increased from 5,599 people in 1990 to some 8,399 persons in 1999. This would

be equivalent to a compound growth rate over the period 1990 to 1999 of 4.61 percent, indicating an elasticity factor between nominal GDP and employment growth of 1.46.

Employment growth over the period under consideration, according to these data, has been highest in the combined "agriculture, fishery and mining" sub-sectors. Employment, or the number of jobs, was recorded at 446 in 1990 and 784 in 1999, which would imply a compound growth rate of 6.47 percent. It appears that employment increased even during the recession years 1993 and 1998. No explanation is available for this highly unusual phenomenon.

Table 1.4.1 Estimated Employment by Sub-sectors

Sub-sectors	1990	1993	1994	1995	1996	1997	1998	1999
Figures (persons)								
Agriculture, Fishing & Mining	446	543	673	724	738	753	768	784
Construction & Manufacturing	954	1,027	1,125	1,165	1,188	1,212	1,236	1,261
Transport, Communications, Utilities	477	532	605	435	444	453	462	471
Trade, Restaurants & Hotels	800	909	1,053	1,448	1,477	1,506	1,537	1,567
Finance, Insurance & Real Estate	119	181	263	122	124	127	129	132
Services	687	824	1,008	1,573	1,604	1,637	1,669	1,703
Public Administration	2,116	2,181	2,268	2,292	2,338	2,385	2,432	2,481
TOTAL	5,599	6,197	6,995	7,759	7,913	8,073	8,233	8,399
Share (percent)								
Agriculture, Fishing & Mining	7.97	8.76	9.62	9.33	9.33	9.33	9.33	9.33
Construction & Manufacturing	17.04	16.57	16.08	15.01	15.01	15.01	15.01	15.01
Transport, Communications, Utilities	8.52	8.58	8.65	5.61	5.61	5.61	5.61	5.61
Trade, Restaurants & Hotels	14.29	14.67	15.05	18.66	18.67	18.65	18.67	18.66
Finance, Insurance & Real Estate	2.13	2.92	3.76	1.57	1.57	1.57	1.57	1.57
Services	12.27	13.30	14.41	20.27	20.27	20.28	20.27	20.28
Public Administration	37.79	35.19	32.42	29.54	29.55	29.54	29.54	29.54
TOTAL	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: Palau Travel & Tourism - An Economic Perspective.

Note: The numbers as of 1995 are somewhat surprising, since shares in total are almost identical.

Total employment generated by the combined "construction and manufacturing" sub-sectors increased from 954 jobs in 1990 to about 1,261 jobs in 1999, reflecting a compound growth rate over the period of 3.15 percent. In this case, too, employment increased during the economy's recession years.

Employment in the combined "transport, communications & utilities" sub-sectors decreased over the period by about -0.14 percent, that is from 477 jobs in 1990 to 471 jobs in 1999. Employment in the combined "wholesale and retail trade, restaurants & hotels" sub-sectors increased considerable from some 800 jobs in 1990 to 1,567 in 1999. This would be equivalent to a compound growth rate of 7.76 percent over the period. Employment for the combined "finance, insurance & real estate" sub-sectors, which is in absolute terms the smallest employment base in the economy, increased only modestly by a compound growth rate of 1.16 percent.

This growth rate implies a change in absolute number of jobs from 119 in 1990 to some 132 in 1999. The "services" sub-sector has actually generated quite a number of new additional jobs according to the data available. Employment grew from 687 people in 1990 to about 1,703 in 1999, implying a compound growth rate of 10.61 percent, the highest growth among all sub-sectors of the economy. The "public administration" sub-sector, which accounts for the highest share in employment, has also increased the number of jobs from 2,116 in 1990 to 2,481 in 1999. Such employment development would imply a compound growth rate of 1.78 percent over the period.

The numbers on employment shares across economic sub-sectors are somewhat illogical, since most shares appear to have remained almost identical and/or stable over

the years from 1995 to 1999. It may, therefore, suffice here to just look at changes between the census years 1990 and 1995. It appears that "public administration" is the economy's largest employer having accounted for around 38 percent of total employment in 1990 and 30 percent in 1999. The fall in share is due to the employment increase in other sub-sectors, since absolute employment has risen in public administration from some 2,116 employees in 1990 to 2,481 in 1999. The second and third most important sub-sectors for employment has been "Other services", which accounted for around 12 percent of total employment in 1990 and around 20 percent in 1995, followed by the "trade, restaurants & hotels" sub-sectors, which accounted in 1990 for around 14 percent and in 1995 for some 19 percent of total employment. "Construction and manufacturing" combined absorbed some 17 percent of employment in 1990 with its share falling to around 15 percent in 1995.

Although there have to be serious doubts about the completeness and accuracy of the above employment data, it may be useful to use them tentatively for a rough indication of output per employee parameter and changes therein for the census years 1990, 1995 and the period 1990 to 1998 in Table 1.5.2.

Labor productivity measured in term of output value per employee has been poor by many standards. Labor productivity in the overall economy decreased by a compound growth rate of -0.73 percent over the period 1990 to 1995 and increased over the subsequent years 1995 to 1998 by a compound growth rate of 4.97 percent. However, over the whole period 1990 to 1998 compound labor productivity growth was a modest 1.37 percent, while the labor force itself increased at a compound growth rate of 4.94 percent.

This performance phenomenon alone hints also at serious performance problems within the Palauan economy in the form of actually decreasing labor productivity, or, in other words, a steadily increasing labor force producing less and less output. The performance of 1990-95, 1995-98 and 1990-98 is summarized in Table 1.6.3. Major trends of the table are summarized as follows:

The transport, communications and utilities' sub-sectors combined showed the strongest positive trend with actual employment falling by -0.40 percent, while output per employee increased by a compound growth rate of 16.34 over the same period.

Other positive trend sub-sectors were "finance, insurance & real estate", in which employment increased by 1.01 percent, while output per employee increased over the same period by 10.78 percent. Also, public administration performed well with employment increasing by 1.76 percent, while output per employee increased by 7.38 percent.

All other sub-sectors showed poor to almost catastrophic labor productivity performance. Employment in the "other services" sub-sector increased by 11.73 percent while output per employee increased only by 4.02 percent. "Trade, Restaurants & Hotels" though important in overall size, performed poorly. Employment in the sub-sector increased by 8.50 percent, while output per employee declined by a compound growth rate of -0.16 percent over the period 1990 to 1998.

"Construction & manufacturing" has been likewise a poor performer. Total employment increased by 3.29 percent, while output per employee declined by a compound growth rate of -0.81 percent over the reference period.

The worst performer in terms of labor productivity developments over the past decade or so was beyond doubt the "agriculture, fishing & mining" sub-sectors.

According to official data, employment in these sub-sectors increases by 7.03 percent, while output per employee declined by a staggering -19.13 percent.

Table 1.4.2 Output per Employee

Sub-sectors	1990	1995	1998	Average 1990 to 98
Output value (\$ thousand)				
Agriculture, Fishing & Mining	19,943	6,845	6,280	11,214
Construction & Manufacturing	9,080	8,824	11,022	8,619
Transport, Communication & Utilities	6,220	14,723	20,222	13,013
Trade, Restaurant, & Hotels	18,272	33,998	34,671	27,721
Finance, Insurance and & Real Estate	6,425	9,035	15,802	9,104
Services	2,767	6,119	9,214	5,693
Public Administration	14,212	23,203	28,879	22,157
TOTAL	76,919	102,747	126,090	97,521
Employment (persons)				
Agriculture, Fishing & Mining	446	724	768	679
Construction & Manufacturing	954	1,165	1,236	1,146
Transport, Communication & Utilities	477	435	462	485
Trade, Restaurant, & Hotels	800	1,448	1,537	1,287
Finance, Insurance and & Real Estate	119	122	129	150
Services	687	1,573	1,669	1,338
Public Administration	2,116	2,292	2,432	2,312
TOTAL	5,599	7,759	8,233	7,397
Output Value/Employee (\$)				
Agriculture, Fishing & Mining	44,715	9,454	8,177	16,515
Construction & Manufacturing	9,518	7,574	8,917	7,521
Transport, Communication & Utilities	13,040	33,846	43,771	26,831
Trade, Restaurant, & Hotels	22,840	23,479	22,558	21,539
Finance, Insurance and & Real Estate	53,992	74,057	122,496	60,693
Services	4,028	3,890	5,521	4,255
Public Administration	6,716	10,123	11,875	9,583
TOTAL	13,738	13,242	15,315	13,184
Rate of Changes/Growth (percent)				
Agriculture, Fishing & Mining	-	-26.71	-4.72	-19.13
Construction & Manufacturing	-	-4.47	5.59	-0.81
Transport, Communication & Utilities	-	21.02	8.95	16.34
Trade, Restaurant, & Hotels	-	0.55	-1.33	-0.16
Finance, Insurance and & Real Estate	-	6.52	18.26	10.78
Services	-	-0.69	12.38	4.02
Public Administration	-	8.55	5.46	7.38
TOTAL	-	-0.73	4.97	1.37

Source: JICA Study Team

Table 1.4.3 Labor Productivity by Sub-sector

Sub-sectors	Rate of Change in Actual Employment			Rate of Changes in Output per Employee		
	1990 to 95	1995 to 98	1990 to 98	1990 to 95	1995 to 98	1990 to 98
Agriculture, Fishing & Mining	10.17	1.99	7.03	-26.71	-4.72	-19.13
Construction & Manufacturing	4.08	1.99	3.29	-4.47	5.59	-0.81
Transport, Communications & Utilities	-1.83	2.03	-0.40	21.02	8.95	16.34
Trade, Restaurant & Hotels	12.60	2.01	8.50	0.55	-1.33	-0.16
Finance, Insurance & Real Estate	0.50	1.88	1.01	6.52	18.26	10.78
Services	18.02	1.99	11.73	-0.69	12.38	4.02
Public Administration	1.61	2.00	1.76	8.55	5.46	7.38
TOTAL	6.74	2.00	4.94	-0.73	4.97	1.37

Source: JICA Study Team

1.5 Wages and Value of Output

The growth of gross wages and salaries in comparison with output and productivity growth is among the significant indicators on how increasing wealth in the economy is distributed, for example between wages and gross profits, and whether productivity increases, which form the basic justification for gross wage and salary increases, stay ahead of such wage & salary increases. An in-depth analysis of these features is unfortunately not possible, due to data and time limitations⁸. However, what can be done is to summarize the general trend between developments in output and gross wages and salaries. It has to be kept in mind in this context that nominal and not real values are used in the comparison and that conclusions are, therefore, indicative only.

The following major trends, as summarized in Table 1.5.1, can be observed over the period 1990 to 1998.

Table 1.5.1 Gross Wages & Value of Output

Unit	Annual Average Gross Wages							Value of Output						
	\$				Percent			\$ thousand				Percent		
Economic Sub-sector	1990	1994	1998	90-98	1990/94	1994/98	1990-98	1990	1994	1998	1990-98	1990/94	1994/98	1990-98
Agriculture	4,777	3,335	3,136	3,177	-8.59	-1.53	-5.12	2,296	2,346	2,650	2,404	0.54	3.09	1.81
Fishing	3,562	5,460	4,983	4,869	11.27	-2.26	4.29	17,647	4,967	3,485	8,554	-27.16	-8.48	-18.35
PRIMARY SECTOR	4,170	4,398	4,060	4,023	1.34	-1.98	-0.33	19,943	7,313	6,135	10,958	-22.18	-4.30	-13.70
Mining & quarrying	0	0	0	0	N/A	N/A	N/A	N/A	444	145	329	N/A	-24.40	N/A
Manufacturing	4,248	4,827	5,483	4,071	3.25	3.24	3.24	528	740	1,016	784	8.81	8.25	8.53
Utilities	6,353	6,679	9,126	6,610	1.26	8.12	4.63	2,849	608	-427	921	-32.03	-28.21	-10.04
Construction	4,076	4,131	4,976	4,591	0.34	4.76	2.53	8,522	4,869	10,006	7,834	-13.06	19.73	2.03
SECONDARY SECTOR	4,892	5,212	6,528	5,091	1.60	5.79	3.67	11,899	6,661	10,740	9,795	-13.50	12.69	-1.27
Wholesale and retail trade	4,684	4,884	5,535	5,226	1.04	3.18	2.11	12,014	14,751	20,337	17,389	5.26	8.36	6.80
Hotels & restaurants	4,180	5,327	5,335	4,896	6.25	0.04	3.10	6,258	7,132	14,334	10,332	3.32	19.07	10.97
Transport (excluding communications)	8,060	7,363	7,711	7,624	-2.24	-1.10	-0.55	3,371	10,476	20,649	12,092	32.77	18.49	25.43
Finance & insurance	8,368	11,500	12,667	10,609	8.27	2.45	5.32	3,112	3,245	7,231	4,209	1.05	22.18	11.11
Public administration	7,678	9,681	11,185	9,669	5.97	3.68	4.82	14,212	22,989	28,879	22,157	12.78	5.87	9.27
Other services (including real estate)	5,077	5,248	6,306	5,324	0.83	4.70	2.75	6,080	9,993	17,785	10,589	13.23	15.50	14.36
TERTIARY SECTOR	6,341	7,334	8,123	7,225	3.70	2.59	3.14	45,047	68,586	109,215	76,767	11.08	12.33	11.71
TOTAL ECONOMY	5,134	5,648	6,237	5,446	2.41	2.51	2.46	76,889	84,631	129,250	99,289	2.43	11.17	6.71

Source: JICA Study Team

Note: Total economy equals GDP figures.

As recorded earlier, nominal GDP growth over the whole period 1990 to 1998 has been 6.71 percent. The available data suggest that national average gross salary and wage levels over the same period rose by some 2.46 percent, indicating a positive gap of 4.25 percent. This would imply that the economy has expanded slightly in real terms, while real salaries & wages have declined, if one assumes an average annual inflation rate of say between 3 to 4 percent.

The primary sector has been a very poor performer over the reference period. The nominal value of the primary sector's gross output contracted by -13.7 percent, while nominal salaries & wages declined only by -0.3 percent. The relatively slower decline in wages & salaries indicates that overall profitability and, therefore, the primary sector's capability to invest from retained profits/earnings must have declined quite significantly. It is interesting to note that developments within the agricultural sub-sector indicate increasing potential profitability, with nominal wages & salaries declining by -5.1 percent, while nominal output grew at around 1.8 percent. Potential profitability in the fishery sub-sector, on the contrary, must have

⁸ For example, detailed accurate employment data by economic sub-sector have not been made available. Hence, a comparison between productivity and wages & salary increases could not be undertaken.

taken a serious decline with nominal output declining by about -18.4 percent, while nominal salaries & wages actually grew by about 4.3 percent

The secondary sector was another quite poor performer losing overall potential profitability with nominal output declining over the reference period by -1.3 percent, while nominal salaries & wages grew by 3.7 percent. Only in manufacturing has nominal output growth performed well above nominal salaries & wages growth. The utilities and construction sub-sectors have been quite poor performers in terms of potential profitability. The worst performer has been the utilities sub-sector with drastic decreases in the nominal value of output, while nominal salaries & wages grew at 4.6 percent, clearly above the level of national nominal salaries and wages increase

Not surprisingly, and confirming earlier presented results of the econometric analysis, the tertiary sector has been an overall good performer in terms of increasing potential profitability. The nominal value of output grew by about 11.7 percent over the reference period, while nominal salaries & wage increases stayed with 3.1 percent slightly above the average for the whole economy. In all sub-sectors of the tertiary sector nominal output growth has outpaced nominal salaries & wages growth, indicating increasing potential profitability in economic performance. Increases in the potential profitability in the transport sub-sector (excluding communications) have been outstanding throughout the whole economy. Nominal output growth was around 25.4 percent, while nominal salaries and wages declined actually by about -0.6 percent. The second best performer has been the other services sub-sector followed by hotels and restaurants. These economic activities seem to be quite profitable from an overall perspective.

1.6 Balance of Payments

Palau's trade balance is characterized by a persistent and high trade deficit (Table 1.7.1 refers). Export, import and trade balance performance over the seven fiscal years) 1992/93 to 1998/99 displayed the following major trends:

The export performance of Palau's economy has been in constant decline. The total value of exports accounted for about \$17.7 million in 1992/93, this value has since dropped to an estimated \$11 million, or 62 percent of its 1992/93 level in 1998/99. The share of exports as percent of GDP has subsequently declined considerably from about 23 to 8 percent. Such performance is equivalent to a negative growth performance of -7.66 percent over the period.

The absolute value of imports has increased from \$42 million in 1992/93 to \$63 million in 1998/99, equivalent to a compound growth rate of 6.98 percent. The value of imports peaked in 1995/96 and 1996/97 at a level of \$72 million. It has since decreased to a level of \$63 million. This would imply that imports in terms of percent of GDP have fallen slightly from around 54 percent in 1992/93 to some 46 percent in 1998/99. It has to be noted that these f.o.b. values are underestimated, since freight & insurance would have to be added.

Given the high import demand of the economy and its poor export performance, the trade balance or resource gap has been growing from around 32 percent of GDP in 1992/93 to its peak of some 48 percent of GDP in 1995/96, declining again to some 38 percent of GDP in 1998/99.

Table 1.6.1 Export & Import Performance 1992/93 to 1998/99

Year	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99 (estimation)
GDP	77,544	82,450	100,066	119,501	129,419	129,722	136,208
Exports f.o.b.	17,739	12,582	13,868	13,907	11,814	11,095	10,994
Imports f.o.b.	-42,209	-44,240	-60,438	-72,424	-72,894	-63,222	-63,258
Trade balance	-24,470	-31,658	-46,570	-58,517	-61,080	-52,127	-52,264
In percent of GDP							
Exports f.o.b.	22.88	15.26	13.86	11.64	9.13	8.55	8.07
Imports f.o.b.	-54.43	-53.66	-60.40	-60.61	-56.32	-48.74	-46.44
Trade balance	-31.56	-38.40	-46.54	-48.97	-47.20	-40.18	-38.37

Source: IMF Country Report

Notes: GDP growth in 1998/99 has been assumed at 5 percent.

Table 1.6.2 Structure of Imports

Parameter	1994	1995	1996	1997	Average 1994 to 97
	(Unit: \$ thousand, persons)				
Gross Domestic Product	84,631	105,211	124,264	131,137	111,311
Population Size *	16,728	17,225	17,680	18,146	17,445
Total Import Value	48,582	62,719	79,636	69,289	65,057
Of which	(Unit: percent)				
Food & live animals	14	15	12	16	14
Beverages & tobacco	8	8	7	9	8
Crude materials, in edible except fuel	[0]	[0]	[0]	[0]	[0]
Mineral fuels lubricant & rel. minerals	41	24	26	12	25
Animal & vegetable oils, fats & waxes	[0]	[0]	[0]	[0]	[0]
Chemicals & related products	2	4	2	4	3
Manufactured goods	7	8	6	8	7
Machinery & transport equipment	12	21	30	25	23
Misc. Manufactured Articles	15	20	16	25	19
Commodities & Transaction	1	[0]	[0]	[0]	[0]
	(\$ thousand)				
Import per capita	2,904	3,641	4,504	3,818	3,729
Food, beverage & tobacco	639	837	856	955	820
Mineral fuels, lubricant	1,191	874	1,171	458	932
Chemicals & rel. minerals	58	146	90	153	112
Manufactured Goods	203	291	270	305	261
Machinery & transportation	349	765	1,351	955	858
Misc. Manufactured Articles	436	728	721	955	709
All other	29	0	45	38	37

Source: IMF country report

Notes: * meaning total number of residents. This number has been estimated using the growth rate recorded between the census years 1990 and 1995, i.e. 2.64 percent.

[0] means the value is very small.

The extremely high levels of consumption, which cannot be supported by Palau's minuscule production base, warrant a closer look at the structure and sources of imports. Not surprisingly, "machinery & transport equipment" together with "mineral fuels, lubricants & related minerals" account on average for 47 percent of total imports, exceeding 50 percent in 1996 (Table 1.6.2 refers).

Food, beverages and tobacco accounted on average over the four years period for another 22 percent of the total value of imports, and miscellaneous manufactured products accounted on average for another 19 percent of total import value.

The fragile and dangerous interrelationship between the domestic consumption pattern and import levels is illustrated by analyzing the pattern in terms of per capita income and per capita import demand. The average per capita income over the period 1994 to

1997 was \$6,381. A staggering 58 percent, equivalent to \$3,729, of per capita income was spent to feed the import bill. On average, some \$820 or about 22 percent, of that total were spent for importing food, beverages and tobacco, and another \$709 was spent for importing and consuming miscellaneous manufactured products.

The bulk of the balance went on average for paying the import bill for machinery & transport equipment (\$858, or 23 percent of the total) and, subsequently the import of mineral fuels, lubricants (accounting for \$932 per year on average or 25 percent of the total) and so on needed to support the country's large vehicle fleet, but also electricity generation⁹.

Table 1.6.3 Balance of Payment Performance

Parameter	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99 (estimate)
(Unit: \$ thousand)							
GDP (nominal)	77,544	82,450	100,066	119,501	129,419	129,722	136,208
Travel receipts	17,698	29,429	40,554	54,213	61,220	58,003	53,476
Investment income	3,202	-177	10,458	10,159	17,857	6,619	7,590
Private outflows	-5,562	-6,542	-5,698	-6,391	-7,466	-7,190	-7,194
Fishing rights	855	931	1,001	1,000	867	800	825
Grants	27,592	27,845	84,643	31,060	29,598	28,435	21,969
Current account (Including official grants)	8,243	8,219	68,345	12,646	21,661	17,167	7,963
Current account (Excluding official grants)	-19,349	-19,626	-16,298	-18,414	-7,937	-11,268	-14,006
Errors & Omissions	-12,273	-21,270	-29,165	-29,838	-24,917	-11,017	-25,352
Overall balance	-238	-380	96,309	-12,218	-3,085	4,096	-19,310
(Unit: percent)							
Imports (f.o.b.)	-54.43	-53.66	-60.40	-60.61	-56.32	-48.74	-46.44
Trade balance	-31.56	-38.40	-46.54	-48.97	-47.20	-40.18	-38.37
Travel receipts	22.82	35.69	40.53	45.37	47.30	44.71	39.26
Investment income	4.13	-0.21	10.45	8.50	13.80	5.10	5.57
Private inflows	-7.17	-7.93	-5.69	-5.35	-5.77	-5.54	-5.28
Fishing rights	1.10	1.13	1.00	0.84	0.67	0.62	0.61
Grants	35.58	33.77	84.59	25.99	22.87	21.92	16.13
Current account (Including official grants)	10.63	9.97	68.30	10.58	16.74	13.23	5.85
Current account (Excluding official grants)	-24.95	-23.80	-16.29	-15.41	-6.13	-8.69	-10.28
Errors & Omissions	-15.83	-25.80	-29.15	-24.97	-19.25	-8.49	-18.61
Overall balance	-0.31	-0.46	96.25	-10.22	-2.38	3.16	-14.18

Source: JICA Study Team

The three most important countries of origin for Palau's imports are the United States, Guam and Japan. Together they accounted for 61 percent of imports in 1996 and 71 percent in 1997.

The large trade deficit, which accounted for an estimated 38 percent of GDP in 1998/99, was largely offset by estimated receipts from tourism (Table 1.6.3 refers).

As is the case for the other key features indicated above, balance of payments characteristics hint strongly at the overall critical fragility of Palau's economy. The following critical relationships illustrate that status:

Trade balance and travel receipts

The huge and persistent trade deficits, at time almost reaching 50 percent of nominal GDP (in 1995/96) "need", so to speak, travel receipts, which inject cash into the

⁹ It has to be determined still, how much of that part of the import bill is needed to support electricity generation, which is based on diesel power stations.

economy needed to counterbalance the huge trade bill, to say it simply. Only in 's 1996/97, 1997/98 and 1998/99 appear those receipts to have exceeded the trade deficit. Such over-dependence on travel/tourism receipts is dangerous in view of (1) the volatility in the tourism market; and (2) Palau's non-preparedness to absorb without any difficulties large number of tourists.

Investment income

Investment income in the first three years after independence has been sizable, ranging from around 10 to 14 percent of GDP. However, such income has fallen off in 's 97/98 and 98/99 to around 5 to 6 percent of GDP.

Private outflows

The size of private outflows reflects perhaps the sizable foreign labor force, which transfers back home part of their salaries and wages. In other words, any increase or decrease in the size of the foreign labor force will have a direct and immediate effect on that BOP position.

Official transfers-fishing rights

They have, for the period under consideration, never been sizable and their contribution, measured in terms of percent of GDP, appears to be declining from around one percent of GDP in 1992/03 to 0.6 percent in 1998/99.

Grants

ROP's dependence on grants is no news. What is interesting, however, are two features, namely (1) they have stayed at very similar levels of between \$27 to 29 million with the exception of the independence year 1994/95, when the level of grants reached a staggering 85 percent of GDP and 1998/99 when they were down to a level of \$22 million. (2) In terms of trend the relevance of grant has decreased from around 36 percent of GDP in 1992/93 to some 16 percent in 1998/99.

Given such circumstances, it is not surprising that the current account can be kept in the positive only through the inclusion of official grants. Without that, the current account would have shown red number numbers over all FY's, ranging from around 25 percent of GDP in Trust Territory times to some 10 percent of GDP in 1998/99. Needless to point out here, that this declining level is only so, because of the considerable growth achieved in selected years from travel receipts.

Errors & omissions

They are extraordinarily high (18 percent of GDP in 1998/99) and some explanations by the authorities are warranted in this context.

Overall balance

Having said all the above, Palau's overall balance has been in the red for all except two years. The negative overall balance accounted in 1998/99 for a sizable -14 percent of GDP. Such negative performance has an automatic and direct impact on the financial holdings of the GOP (excluding Compact Agreement Section 211 (f), Trust Fund).

1.7 Governmental Budget

There is a general perception that the ROP's public sector is oversized (in comparison to the private sector and the overall size of the economy) and the ROP budget cannot be sustained over the medium- to long-term, due to the narrow economic tax and revenue base and, therefore, its heavy dependence on external savings. In fact, the revenue to expenditure gap (grants being accounted for as regular budget items) requiring financing was negative only in 1995/96 and 1998/99 (estimated) reaching -7.69 percent and an estimated -11.19 percent of nominal GDP, respectively. This picture changes dramatically, if the grant element is taken out of gap calculations (Table 1.7.1 refers).

It must be stated that not only is the ROP on the total revenue side heavily dependent on external assistance, but also that a significant part of such resources have gone and continue to go into recurrent expenditures for national average wages & salaries fueling in turn consumption, and that not enough resources are allocated for any productive purposes, such as maintenance and net-additions to the economic and social-infrastructure.

The major characteristics and trends in GOP budgetary operations are summarized as:

Dependency level on grants and COMPACT funds

Total government revenues have almost always been overwhelmingly dependent on externally funded grants. The dependency ratio of revenues to pure grants has slightly decreased from around 64 percent in 1992/93 to an estimated 43 percent in 1998/99. However, if investment income from all sources is also taken into account, the dependency ratio has with around 50 to 60 percent remained in the same order of magnitude as in Trust Territory times.

Other revenue features

The above is further illustrated by the fact the domestic revenues alone have remained relatively inelastic to the overall expansion of the economy. Taking the 's as computation basis, nominal GDP has grown by a compound rate of 9.87 percent over the six-years period (8.01 percent since 1994/95) while tax revenues have grown by only 8.75 percent (8.70 percent since 1994/95). In fact the overall share of domestic revenues has remained in the same order of magnitude (with the exception of 1996/97 and 1997/98) at around 23 to 24 percent. Pure tax revenues have since independence remained below Trust Territory time levels at around 13 to 14 percent.

Tax Structure and Rates

Tax buoyancy is too low in the ROP and the expansion of total tax revenues lacks behind expansion of the overall economy. Such expansion has likely been carried growth in import tax revenues and "other" tax revenues (Table 1.7.3 refers). The authorities do recognize the need to increase overall tax revenues and a tax reform package is under consideration.

Expenditure levels and growth

Expenditure levels have increased from around \$46.6 million to \$71.6 million over the period 1992/93 to 1998/99, equivalent to a compound nominal growth rate of 7.44 percent (Table 1.7.4 refers). With total revenues (including grants and investment income) growing by only 2.23 percent over the same period, expenditure growth has outpaced revenue growth by 5.21 percent on average. In other words, not only are expenditure outlays high in absolute terms, but the gap between increasing revenues and expenditures is widening in favor of expenditures.

Table 1.7.1 Key Features of Budget Performance

Parameter	Unit	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99 (projection)
Nominal GDP	\$ thousand	77,544	82,450	100,066	119,501	129,419	129,722	136,208
Domestic Revenues	%	23.24	22.76	23.14	23.86	30.21	33.44	23.70
Tax revenues	%	14.53	15.42	13.34	13.09	13.00	14.68	13.68
Non-tax revenues	%	8.71	7.34	9.80	10.77	17.21	18.77	10.01
Grants	%	40.47	37.43	142.92	31.34	25.63	23.11	17.71
COMPACT	%	N/A	N/A	126.38	19.68	17.27	16.36	10.10
Other	%	40.47	37.43	16.54	11.66	8.36	6.75	7.60
Total Revenues & Grants	%	63.72	60.18	166.07	55.20	55.84	56.56	41.41
Current expenditures	%	55.17	57.45	56.60	48.66	45.01	42.21	44.76
Wages & salaries	%	26.36	27.88	23.19	21.61	21.46	21.09	20.11
Purchase goods & services	%	28.35	26.63	23.61	16.65	19.55	17.72	18.72
Subsidies & cur. Tr.	%	0.46	2.94	9.80	10.40	4.00	3.40	5.93
Capital expenditures	%	4.89	3.65	8.52	14.23	14.13	7.60	7.84
OVERALL BALANCE	%	0.31	0.46	100.83	-7.71	0.25	5.93	-11.19
Revenue/Expenditure Gap	%	3.65	-0.93	100.94	-7.69	3.30	6.74	-11.19

Source: JICA Study Team computations.

Table 1.7.2 Revenue Dependency Ratios

Parameter	Unit	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99
GDP (nominal)	\$ thousand	77,544	82,450	100,066	119,501	129,419	129,722	136,208
A. Total revenue & grants	\$ thousand	49,408	49,619	166,176	65,960	72,270	73,366	56,398
Excluding								
1. Grants	\$ thousand	31,384	30,857	143,017	37,451	33,172	29,981	24,118
2. Compact Inv. Inc.	\$ thousand	0	0	6,206	8,180	17,107	4,804	6,590
3. Local Trust Fund	\$ thousand	441	479	1,082	1,574	1,786	2,696	2,600
B. Revenues without 1.	\$ thousand	18,024	18,762	23,159	28,509	39,098	43,385	32,280
C. Revenues without 1.+2.	\$ thousand	18,024	18,762	16,953	20,329	21,991	38,581	25,690
D. Revenues without 1.+2.+3.	\$ thousand	17,583	18,283	15,871	18,755	20,205	35,885	23,090
E. Revenue Dependency Ratio								
To grants	%	63.52	62.19	86.06	56.78	45.90	40.86	42.76
To grants & investment in come and local trust fund	%	64.41	63.15	90.45	71.57	72.04	51.09	59.06
F. Dependency factor as % of GDP								
To grants	%	40.47	37.43	142.92	31.34	25.63	23.11	17.71
To grants, investment income and local trust fund	%	41.04	38.01	150.21	39.50	40.23	28.89	24.45

Source: JICA Study Team

Table 1.7.3 Tax Revenue Structure and Changes

Parameter	Unit	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99 (Projection)
Nominal GDP	\$ thousand	77,544	82,450	100,066	119,501	129,419	129,722	136,208
Total tax revenues	\$ thousand	11,269	12,712	13,351	15,637	16,829	19,037	18,640
Of which:								
Salaries & Wages	\$ thousand	3,060	3,455	3,822	4,096	4,620	4,720	5,003
Import Tax	\$ thousand	2,707	3,258	3,136	3,298	3,850	4,410	4,586
Gross Revenue Tax	\$ thousand	4,194	4,753	4,774	6,068	6,260	6,260	5,884
Other	\$ thousand	1,308	1,246	1,619	2,175	2,099	3,647	3,167
Percent of total								
Salaries & Wages	%	27.15	27.18	28.63	26.19	27.45	24.79	26.84
Import Tax	%	24.02	25.63	23.49	21.09	22.88	23.17	24.60
Gross Revenue Tax	%	37.22	37.39	35.76	38.81	37.20	32.88	31.57
Other	%	11.61	9.80	12.13	13.91	12.47	19.16	16.99

Source: JICA Study Team

Table 1.7.4 Expenditures & Structural Changes

Parameter	Unit	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99 (Projection)
GDP (nominal)	\$ thousand	77,544	82,450	100,066	119,501	129,419	129,722	136,208
Total expenditures	\$ thousand	46,576	50,383	65,168	75,148	76,542	64,617	71,642
Current expenditures	\$ thousand	42,784	47,371	56,639	58,145	58,252	54,761	62,850
Salaries & Wages	\$ thousand	20,442	22,989	23,203	25,820	27,777	27,355	27,385
Goods & services	\$ thousand	21,985	21,958	23,627	19,896	25,298	22,982	27,385
Interest payments	\$ thousand	0	0	0	0	0	0	0
Subsidies/transfers	\$ thousand	357	2,424	9,809	12,429	5,177	4,424	8,080
Capital expenditures	\$ thousand	3,792	3,012	8,529	17,003	18,290	9,856	10,677
Percent of total								
Current expenditures	%	91.86	94.02	86.91	77.37	76.10	84.75	87.73
Salaries & Wages	%	43.89	45.63	35.60	34.36	36.29	42.33	38.22
Goods & services	%	47.20	43.58	36.26	26.48	33.05	35.57	38.22
Interest payments	%	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Subsidies/transfers	%	0.77	4.81	15.05	16.54	6.76	6.85	11.28
Capital expenditures	%	8.14	5.98	13.09	22.63	23.90	15.25	14.90
Percent of GDP								
Current expenditures		55.17	57.45	56.60	48.66	45.01	42.21	46.14
Salaries & Wages	%	26.36	27.88	23.19	21.61	21.46	21.09	20.11
Goods & services	%	28.35	26.63	23.61	16.65	19.55	17.72	20.11
Interest payments	%	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Subsidies/transfers	%	0.46	2.94	9.80	10.40	4.00	3.41	5.93
Capital expenditures	%	4.89	3.65	8.52	14.23	14.13	7.60	7.84

Source: JICA Study Team

General expenditure structure

Current expenditures have over the past dominated the expenditure structure of the government's budgets. The share of current expenditures in total budget expenditures was above the 90 percent mark in Trust Territory times (1992/93 and 1993/94 only), decreasing to around 87 percent (1994/95) and falling further to around 77 percent (two subsequent FY's). This share is on the rise again reaching around 85 percent in 1997/98 and 88 percent in FU 1998/99. Budget expenditures officially classified as "capital expenditures"¹⁰ have been for whatever reason relatively low in Trust Territory times (again only for 1992/93 and 1993/94) when its share in total expenditures was around 8 percent (1992/93) and 6 percent (1993/94). Capital expenditures increased significantly after independence reaching levels of around 23 to 24 percent in 's 1995/96 and 1996/97. This share has since then decreased again to around 15 percent.

Current expenditure structure

Current expenditures over the analytical seven years time frame have been almost split equally among salaries & wages and the purchase of goods & services, which accounted for similar shares in total current expenditures. Expansion of the absolute level for salaries & wages over the whole period has been with a compound growth rate of 4.99 percent faster than that for the purchase of goods & services (3.73 percent). Two outstanding features are that so far no interest payments have been necessitated and, secondly, subsidies & current transfers have increased sharply since 1994/95 (around 15 percent of total expenditures in s 1994/95 and 1995/96) and are in the rise again almost doubling in 1998/99 (as against the previous FY) to around 11 percent of total expenditures.

¹⁰ There is a need to clarify, whether the substantial current expenditure category "purchase of goods & services" may reflect partly capital expenditures.

Capital expenditure structure

There is, for the time being, not enough information on the breakdown of capital expenditures (purpose & outlays) so that it must suffice to state that capital expenditures in absolute terms have grown considerably as of 1994/95 reaching a peak level of \$18.3 million in 1996/97. Since then they have fluctuated considerably having been recorded at \$10.7 million in 1998/99.

1.8 Banking Sector and Financial Institutions

It is important in the context of analyzing and understanding the ROP's economy and the role the banking and financial institutions sectors plays therein, to start with a couple of truisms and general observations, namely:

- The ROP uses the U.S. dollar as legal tender;
- The ROP has no central bank and/or banking supervisory institution and no comprehensive supervisory legislation (though the filing of annual reports for operational banks if required);
- The ROP currently regulates by law maximum lending rates through a New York "prime lending rate plus surcharge" formula; and
- The primary function of an economy's banking and financial institution sector is to channel through lending operations national savings into investments yielding the best possible return.

It has been somewhat difficult, due to the absence of proper comprehensive legislation, to obtain a clear picture on the status and trends in Palau's banking and financial sector. It is quite clear, therefore, that the ROP is in no position whatsoever to apply a Keynesian approach in macro-management. Notwithstanding this fact, the JICA Study Team has made an attempt to gather some basic information through a primary survey among the major operational banking institutions and to draw, based on the interview and other related secondary data, a sketch of the position, trends and issues in this important sector of the economy.

Structure of Banking Sector

There are, as of end 1999, some 27 banking institutions chartered in the ROP, out of which 12 have been chartered in 1999 alone. The majority of these banking institutions fall or will have to fall under Palau's Foreign Investment law, requiring for their operations a Foreign Investment Approval Certificate. The following key structural features can be observed:

There are only two banking institutions, which enjoy a "perpetual" licensing status, namely the "Bank of Hawaii" and the "Bank of Guam"

There are five institutions, which are chartered outside the ROP, namely the "Bank of Guam" (incorporated in Guam), the "Bank of Hawaii" (incorporated in Hawaii), "Bank Pacific" (formerly Guam Savings & Loan, incorporated in Guam), "First Commercial Bank" (incorporated in Taiwan), and "First Federal Banking" (incorporated in Nauru)

There are only two government controlled banks, namely the "Melekeok Government Bank Corporation", which is a State-owned bank, and the "National Development Bank of Palau - NDBP", which should function as a development financing institution

Seven, out of the 27 banking institutions, account as of end 1999 for the bulk of the currently prevailing banking operations in the ROP, and

Only one institution, the "Palau Construction Bank", seems to be sector-wise

specialized in its operations.

Table 1.8.1 Rough Banking Sector Structure

Banking Institutions Incorporated before Independence	Banking Institutions Incorporated after Independence
Bank of Guam Bank of Hawaii Bank of Micronesia Corp. Melekeok Government Bank Corp. Pacific Savings Bank Palau Central Bank, Inc. Palau First National Bank, Inc. National Development Bank of Palau	Between 1994 and 1998: 7 institutions In 1999: 12 institutions
Total: 8 institutions	Total: 19 institutions

Source: JICA Study Team

Key Features of Seven Selected Banking Institutions

It appears from the interview survey carried out among the seven important institutions that:

The total value of assets in the period 1999/2000 of these seven institutions alone must have been in the order of magnitude of at least \$116 million¹¹, equivalent to some 90 percent of the ROP's 1999 GDP size.

The "Bank of Guam" and the "Bank of Hawaii" accounted for some U.S. dollar 86 million out of the above total, equivalent to about 74 percent of the seven institutions total assets, or 66 percent of the country's 1999 GDP size.

Most banks have only one branch in Koror. Only the "Pacific Savings Bank Ltd." has presently two Branches, namely in Koror and Peleliu. This Bank is in the process of opening another branch in Arai State for the purpose of handling and processing government paychecks.

It appears that the seven institutions have around 26,135 "customers" (covering both depository & lending operations), out of which roughly 64 percent are with the Bank of Guam and the Bank of Hawaii. The Pacific Savings Bank claims about 7,000 customers or 27 percent of the seven institutions total customer-base. If these numbers were correct, it would imply that the three banks combined account for 94 percent of the ROP's financial sector total domestic customer-base.

It appears that the structure of the customer-base is predominantly "private individuals". Only the Bank of Guam claims a different pattern. Their customer-base comprises about 50 percent "private individuals" and the remaining 50 percent comprise "business"; "institutional entities" and "government".

Main banking functions

The two most important banking functions quoted in the interviews were:

- To serve as depository banks (checking, savings and time deposit accounts), and
- Consumer lending.

Major features of lending operations

The most revealing features resulting from the banking institution interview survey were:

Palau was described as "a debtor society", in which borrowing is driven (as far as

¹¹ It has to be pointed out again that the numbers quoted here are based on answers provided in the interview survey, and not on audited accounts. Hence, such data have to be interpreted with caution.

private individuals, which constitute the vast majority of borrowers, are concerned) by two factors: (1) "Customs"; and (2) a "consumption pattern", which is tailored around the "American model" (as is quite apparent from the number and type of cars on Koror's streets and the prevailing white consumer goods).

There is significant spread between deposit and lending rates. Deposit rates (at May 1999 level), depending on the type of deposit, range from 0 to 3.95 percent, while lending rates range from between 12 to 18 percent with an implicit spread of 8 to 14 percent.

Customs has two functions in the monetarized system. First, it induces borrowing, sometimes to staggering amounts, in order to meet the social expectations associated with these traditional social rules. Secondly, it serves as a risk-lowering factor for lenders, since customs requires also that debts be honored (in case the borrower cannot repay, dies, and so on) through the extended family system.

Another important feature of the banking system, which needs to be understood clearly, is the fact that bank-lending rules & contracts allow banks to recall total loan repayment, if, in the subjective internal assessment of the lending institution, the borrower may face future problems in debt-service. In other, words, there are no objective criteria, which would determine when banks could take action to recall loans.

The following general observations are called for in this context:

Given the fact that the ROP economy is U.S. dollar-based (and, therefore, to some degree U.S. dollar inflation sensitive), lending rates, in particular real lending rates, are extremely high. Banking operations are, in view of the high spread between deposit and lending rates, obviously highly profitable from a potentials point of view

The above circumstances result in two quite serious consequences. First, commercial lending, which is at around 12 to 15 percent, is quite limited, since only few commercial projects can produce an IRR high enough (a minimum of 21 to 25 percent) to secure debt-service and a reasonable ROI and/or ROE for the investor. Second, foreign investors are highly unlikely to source part of their financing needs from Palau's financial market, due to the extravagant lending rates. As a consequence, foreign investors will have to come to Palau with there offshore financing in their "suitcase" so to speak, creating a need for offshore collateralization. This factor in combination with the fact that foreign investors cannot own land is an absolute and serious constraint to increasing FDI into the ROP. It is, therefore, not surprising, that commercial borrowing is quite limited to sub-sectors with high profitability, such as retailing.

Secondly, the even higher consumer lending rates can only be realized as long as (1) the allotment system remains in place, and (2) collateralized assets can be realized in case of default, and (3) the economy keeps expanding and does not slip into a prolonged recession.

Conclusions on structural weaknesses in the banking sector

These structural features are, from a macro-economic perspective, so overwhelmingly important, that the following conclusions with serious consequences for macro-management, must be drawn:

The banking sector appears to function mainly by drawing national savings into its system, which in turn are then invested off-shore and/or on-lend in form of highly expensive consumer lending. Such lending, in turn, impacts on the already extravagant import-bill of the ROP, in view of the spending pattern associated with such consumer lending.

Domestic savings are channeled only to a very limited extent into productive commercial investment into the ROP economy.

The allotment-based consumer lending will function only smoothly as long as the economy keeps performing/growing well, in other words, as long as there is no pressing need to scale down the workforce, in particular the large Palauan dominated government labor force; and as long as the collateralized assets can be realized quickly in case of loan-repayment default.

In other words, the system is structured and operating presently in a way that there is a pertinent danger for triggering a banking sector crisis, should an increasing number of salary & wage receivers, who are banking sector borrowers, be released from the employed workforce, in particular in the public sector.

There are no precise data on the structure of the current lending portfolio of the banking system, in particular the total outstanding amounts of consumer and working capital/investment loans, which are not performing. The interviewed banks were, for obvious reasons, reluctant to discuss this matter with the Study Team other than in very general terms. There is, however, circumstantial evidence from discussions with secondary sources, such as lawyers and companies engaged collecting debts, which are not serviced properly, that the non-service of debts seems to be a widespread phenomenon.

Other features of lending operations, collateral & non-performing loans

It appears from the survey results that only for the two major banks, the Bank of Guam and the Bank of Hawaii, were there a significant split between consumer lending and lending to business operations. The structure of lending operations of the Bank of Guam was claimed to be 75 percent for business lending, and the remainder of 25 percent for consumer lending. In the case of the Bank of Hawaii, lending operations between the two potential borrower groups was said to be roughly at par. All other banking institutions structure of lending operations was predominantly geared toward consumer lending, even that of the National Development Bank of Palau (NDBP), which seems to be an odd phenomenon. The features of the NDBP are interesting from many points of view. They are given, therefore, a separate section below.

The consumer lending of all interviewed institutions is collateralized at two levels:

- By real estate and other tangible assets of up to 120 percent of the borrowed amount; and
- Through the allotment system.

In case of investment lending, such lending is collateralized with tangible assets. Only the Bank of Hawaii uses a more modern, cash flow-based approach in investment lending.

The definition of a "non-performing loan" varies among institutions. One institution classified loans into this category, if they defaulted for a period exceeding 90 days, and two other institutions said that the default period should exceed 180 days. No overall indicative data could be obtained on the total number of loans falling into this category. Only one bank, which had at the time of the interview some 484 outstanding consumer loans, said that they had 65 cases of non-performing loans in their portfolio, equivalent to 13 percent of the number of all outstanding loans. However, no value was attached to that number of non-performing loans.

Perception of Palau's economic performance

Somewhat surprising were also the answers to the bank's perceptions of the Palauan economic performance prospects. Most banks viewed the construction and hotels &

restaurants sub-sectors as future engines of growth for the Palauan economy, but then had no loan exposures in these sub-sectors. Likewise, the interviewed institutions either avoided a clear answer and/or could not substantiate their perception of the short to medium-term GDP growth-perspective of the economy. Three institutions estimated it to be between 7.5 to 10 percent and two institutions quoted 5 to 7.5 percent. Only one bank said explicitly that GDP growth would be below 5 percent without ODA projects, and another institution said GDP growth would be over 10 percent.

The National Development Bank of Palau

The ROP has no central bank and/or banking supervisory institution, but it has a development bank, the NDBP. Surprisingly, the NDBP does not currently function as a typical development bank. The bank, which has some 8 employees, total assets in the amount of about \$7.2 million (as of beginning 2000) and which is led recently by a new dynamic President from Fiji, has been engaged in the past in some lending and guaranteeing commercial bank loans. The Bank, which is prohibited by law to accept deposits, has not extended any new loans over the past 18 months, due to a lack of capital. The function and past performance of the NDBP seems to be highly unusual from many perspectives.

The following issues need to be addressed on an urgent basis in this context:

There can be no doubt that the ROP needs a banking institution, which plays the role of a traditional development banking institution. Such an institution is not only needed to introduce more downward pressure on lending rates, but also to serve government development objectives in priority sectors of the economy as well as for SME and venture capital lending.

The relevant authorities should review, on an urgent basis, the need in the country for such an institution, since it is obvious that many of the development directions, such as for example in agriculture, cannot be viable at the lending rates of the commercial banking sector.

If such need has been established, the authorities should determine the role the existing NDBP is to play in the future development process of Palau. Obviously, if there were a need for such an institution, the NDBP would be the most logical candidate.

However, if the NDBP is to play this role in a serious manner, it has to be empowered to do so, which may entail various legal and statutory changes.

Conversely, if the NDBP cannot function in its originally intended role of a development bank, then there is actually no need for this institution at all.

1.9 Foreign Direct Investment

1.9.1 Current Situation of FIAC Issuance

Table 1.9.1 shows the issuance of Foreign Investment Approval Certificate (FIAC) from 1974 to 1999. In 1974 to 1983, average annual issuance is around one per year, and in 1984 to 1993, it is around four per year. It is increasing since the middle of 1990s resulting from economic development by the Compact Fund and infrastructure development projects such as the Compact Road. In 1999 the issuance increased rapidly to 26 in a year.

Out of the companies which success to have FIAC, about 65% are doing business activity in Palau according to the comparison of the list of FIAC companies with business directory of Palau.

Table 1.9.1 Issuance of FIAC

Year	1974 - 1983	1984 - 1993	1994	1995	1996	1997	1998	1999	Total
No. of Issuance	9	41	7	12	12	8	17	26	132

Source: Foreign Investment Board

Table 1.9.2 shows issuance of FIAC by business field in 1998 and 1999. Hotel and real estate occupies 30.2% in recent two years. Construction and rock quarry follows it by 18.6% and accounting, design and consultant ranked the third position. This seems to reflect the expectation of tourism development and infrastructure development in Palau.

Table 1.9.2 Issuance of FIAC by business field

Business Field	1998	1999	Total
Garment	0	2	2
Finance	1	3	4
Construction, Rock quarry	3	5	8
Restaurant	2	1	3
Hotel, Real Estate	7	6	13
Air Transport	0	1	1
Accounting, Design, Consultant	3	3	6
Health Service	0	2	2
Utility Service (Water, electricity)	0	2	2
Movie	0	1	1
Repair service of machine equipment	1	0	1
Total	17	26	43

Source: Foreign Investment Board

1.9.2 Laws & regulations for FDI

The fundamental law regulating FDI in the ROP is the "Foreign Investment Act 28 PNC Sections 101 et seq." The entity responsible for screening, approving and monitoring FDI is the "Foreign Investment Board -FIB" and the proceedings for all FDI related matters are regulated in "Regulations Implementing The Foreign Investment Act, 28 PNC Sections 101 et seq.". The FIB has five fundamental functions, namely (1) to review, evaluate, and approve applications; (2) to monitor and enforce compliance; (3) to monitor, including spot inspections; (4) to review the procedures and regulations; and (5) to submit an annual report to the President. The FIB has seven members, which are appointed by the President with the advice and consent of the Senate and the OEK.

The following business activities are reserved exclusively for citizens and business enterprises in which citizens have an ownership interest. They are not permitted to undertake by any business enterprise in which no citizen has an ownership interest:

- Wholesale or retail sale of goods;
- All land transportation, including bus services, taxi services, and car rentals;
- Handicraft and gift shops (exempted are the premises of hotels and the Palau International Airport);
- Bakeries;
- Bar services;
- Tour guides, fishing guides, diving guides, and any other form of water transportation services;
- Travel and tour agencies;
- Operations manufacturing products being produced by wholly Palauan-owned manufacturing enterprises;

- Equipment rentals for both land and water within the ROP, including equipment for purpose of tourism;
- Commercial fishing for other than highly migratory species; and
- Any such other businesses as the Board may determine.

Paragraph 106 of the law regulates that the minimum investment requirement is \$0.5 million. Likewise, no approval certificate shall be issued for foreign investment, in which less than 20 percent of the persons engaged are citizens of the ROP.

1.9.3 Problems & Constrains of FDI Environment

The Foreign Investment Advisory Services, a joint service of the International Finance Corporation and The World Bank conducted review of the environment of foreign investment. The report points out and recommends the followings:

If the Palauan government wishes to maximize the quality and quantity of foreign investment in Palau, it needs to replace the current regulatory approach with a registration process for foreign investors.

It is recommended that the Government protect as few sectors as possible and include only those sectors where there will be at least a reasonable level of competition from among citizen investors.

It is recommended that the Government apply the absolute minimum of conditions such as the current joint venture requirements and the deposit guarantees of foreign investors.

Foreign investment monitoring is currently ineffective and it is recommended that the Government establish a new monitoring system.

The present citizen employment policy is ineffective and discriminates against foreign investors. It is recommended that the Government either abandon the foreign worker fee or review the amount of the fee, and apply the minimum wage legislation evenly in the private sector.

To enhance the effectiveness of the policy for employing foreign workers, it is recommended that the Government designate work permits to specific positions in approved investments, issue the permits to the investment concerned, and award residence permits for foreign workers against work permits. And the Government assesses the individuals nominated to fill the work permit positions only on the standard immigration criteria not on qualifications, skills or experiences since there are matters for the employer.

As an inducement to foreign investors, it is recommended that the Government automatically award to all FIRC holders one or more work permits for key management positions and that they be valid for the duration of the FDI project.

To enhance the promotion of investment in Palau, it is recommended that the Government establish an investment promotion agency, develop an investment promotion strategy, and prepare an investment promotion brochure.

It is recommended that the Government give favorable consideration to the proposals for the reforming tax environment prepared by IMF. It is also strongly recommended that Palau continue a policy of no tax incentives for investors.

As further attraction of FDI, it is recommended that the Government consider membership of the International Center for the Settlement of Investment Disputes (ICSID) and the Multilateral Investment Guarantee Agency (MIGA).

The Government doesn't seem to carry out the recommendations described before. And more interviews from managers of FDI companies, they point out followings:

Criteria of FDI approval are not clear. It often occurs that applications of FDI, which are accepted business field, have not approved or delayed without clear reason.

In general Palauan Government assume an attitude of arrogant superiority for FDIs though most of developing countries manage to attract FDIs.

Not only the reform of FDI approval system, but also economic systems have to be improved. For example, some famous international bank deny to send money to Palau because Palauan government doesn't have laws and institutions for financial sector, and a possibility of the money laundering is available here. Potential FDI companies hesitate to invest in Palau in such situation.

Some regulations about non-citizen workers are big constrains for FDI companies. Annual payment of US\$500 per a non-resident worker a year is heavy burden for FDI companies, which is committing in the market system.

Land dispute in the all over the country is also a big constrain for FDI.

1.10 COMPACT and other ODA Resources

Negotiations between Palau and the United States have been marked by bitter internal disagreements and political struggles. Some of the controversy seems to linger on until today. However, the negotiated COMPACT agreement resulted in the ROP's independence in free association with the U.S. The following aspects of the COMPACT are of importance within the context of this Study: (1) the COMPACT's basic philosophy and time frame; (2) total resources made available, their purposes and mechanisms of disbursement and monitoring; and (3) impact on the ROP's resource use and economy.

The Compact of Free Association (in short COMPACT) is a 50-year strategic, political and economic treaty between the ROP and the United States, which went into effect on October 1, 1994. The ROP conducts under the COMPACT its own domestic and foreign affairs as any sovereign nation would, while the United States retains control of defense and security matters as well as exclusive strategic access to Palau's waterways and Koror and Arai land areas. The U.S. Congress approved the COMPACT in 1986 and finalized it in 1989 passing other related laws. Among the conditions of Congress for the COMPACT's approval was the formal adoption by the GOP of an economic development plan (EDP), which was to outline particular goals and how to achieve them, using COMPACT funds?

The COMPACT is, in essence, a mix of aid and rent. The main goal of the COMPACT is to put infrastructure in place that would enable the ROP to become a self-sustaining economy by the end of a 15-years period 1994 to 2009. There are, in principle, two types of funds, restricted ones, i.e. they can only be used for a particular purpose, and unrestricted funds, the use of which can be decided freely. COMPACT funds are designated for three general uses:

- Funding government recurrent expenditures to maintain a certain level of public service while the economy moves toward more reliance on market forces and the private sector;
- Building of basic infrastructure, such as roads, energy, transport, communication and water facilities so that the ROP can become eventually a self-supporting economy; and

- Establishment of a trust fund in the form of a long-term investment portfolio of initially \$70 million (provision 211(f)) that would yield enough cash reserve over the 15-years period to replace the budgetary aid provided by the United States during the 15-years period.

The COMPACT requires (1) the GOP to submit annual reports detailing expenses by use and type of funds, and (2) calls for annual economic consultations between the ROP and the United States.

There is quite some confusion in some official documents, economic reports and the press about how much funds have been used already, how much are still available for future use, and how long will such funds last. It is useful and necessary, since these questions are of essence to budgetary aspects of this Study, to clarify essential points:

It has been the practice of the U.S. in the past to disburse to ROP's treasury funds directly, once a project/expenditure item has gone through the established review and approval procedures. Hence, as a consequence, funds for a particular purpose may have been transferred to the ROP say in 1996, while actual expenditures and disbursements in the ROP occurred only say 2 years later. This time lapse has created additional investment earnings, while the funds stayed in the financial system either onshore and/or offshore. It is, therefore, essential to judge fund flows from three perspectives, (1) appropriated by the United States and transferred to the ROP treasury; (2) appropriated by the ROP for its intended purpose; and (3) actual expenditure incurred by the ROP.

This practice is discontinued since the Compact road. All expenditures for the Compact road are paid for directly to the contractor by the US treasury. In other words, the funds do not circulate through the ROP's economic and financial system and cannot generate additional investment income for the treasury.

That leaves the GOP with little leverage, since the only source to cover any fiscal (and for that matter BOP gaps) deficits are (1) yields from the 211(f) trust fund, on the use of which there is a \$5 million p.a. ceiling between 1998/99 and 2008/09; and (2) yields from other funds already received from the United States, but expenditures not yet having materialized.

Table 1.10.1 and Table 1.10.2 summarize the picture of funds availability according to the various sources made available to the JICA Study Team.

Table 1.11.1 would suggest a total fund availability to the ROP of about \$412.26 million for the period 1994/95 to 2008/09, excluding yields from the 211(f) trust fund and yields from appropriated and transferred, but not yet used funds. If the 211(f) trust fund were taken out of this amount (for the reasons see further below), which total resources earmarked under the COMPACT would be \$342.26 million.

Assuming further that all earmarked funds up to 1999/2000 have been appropriated by the ROP (but as regards 1999/2000 not yet all disbursed to cover actual expenditures) this would imply an overall available balance as of the current of \$51.40 million. However, other official and public documents seem to indicate different levels of not yet appropriated funds as summarized in Table 1.10.2.

Table 1.10.1 Schedule of Compact Fund

Items	Actual appropriations										Scheduled										TOTAL
	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09						
COFA Non-Trust Fund																					
COFA Section 211(a) Current Account	12.00	12.00	12.00	12.00	7.00	7.00	7.00	7.00	7.00	7.00	6.00	6.00	6.00	6.00	6.00						
COFA Section 211(c) Communications	1.65	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15						
COFA Section 211(d) Health, Education, Maritime Surveillance	0.63	0.63	0.63	0.63	0.63	0.63	0.63	0.63	0.63	0.63	0.63	0.63	0.63	0.63	0.63						
COFA Section 211(e) Maritime Zone	0.67																				
COFA Section 215 Inflation Adjustment	6.28	5.84	6.08	6.44	3.79	3.93	4.08	4.22	4.36	4.50	4.00	4.12	4.24	4.37	4.49						
SUB-TOTAL	21.23	18.62	18.86	19.22	11.57	11.71	11.86	12.00	12.14	12.28	10.78	10.90	11.02	11.15	11.27						
COFA Section 211(b) Energy Production	26.00																				
COFA Section 211(b) Energy Production	2.00																				
COFA Section 215 Inflation Adjustment	12.89																				
SUB-TOTAL	40.89	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00						
COFA Section 212(b) Capital Account	36.00																				
COFA Section 215 Inflation Adjustment	16.56																				
SUB-TOTAL	52.56	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00						
COFA Section 213 Impact Fund	5.50																				
SUB-TOTAL	5.50	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00						
COFA Section 221(b)(1) Special Block Grant	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00						
COFA Section 221(b)(2) Education Special Grant	4.30	2.90	1.50																		
SUB-TOTAL	6.30	4.90	3.50	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00						
TOTAL NON-TRUST FUND	126.48	23.52	22.36	21.22	13.57	13.71	13.86	14.00	14.14	14.28	12.78	12.90	13.02	13.15	13.27						
COFA Trust Fund	66.00																				
GRAND TOTAL TRUST FUND	192.48	23.52	26.36	21.22	13.57	13.71	13.86	14.00	14.14	14.28	12.78	12.90	13.02	13.15	13.27						

Source: State of the Republic Address May 3, 2000 by Office of the President

Table 1.10.2 Diverging Data on Funds Availability as of 2000/01
(Unit: \$ million)

Data Source	Total Funds Available as of 2000/01
Scheduled Disbursement of Compact Fund (Table 1.10.1)	51.40
Budget Office	65.80
Union Address, May 2000	
211 (f) Trust Fund	164.50
Inappropriate by April 30	27.30
Office of Planning & Statistics	144.55

Source: JICA Study Team

Note: * Excludes 211 (f). Comprising \$121.30 not yet received as of December 1999 and \$23.22 received, but not yet appropriated.

It could not yet be determined with certainty which number is correct and it is assumed that the \$27.3 million mentioned in the May 2000 "State Of The Republic Address" refers to funds already received under the COMPACT, but not yet appropriated and spent by the ROP.

Table 1.10.3 shows amounts of ODA (Official Development Assistance) by major Development Assistance Committee (DAC) members of OECD and International Organizations. It shows the United States and Japan are major player of aids to ROP. Aids by other countries are limited in grants of small equipment, training program and scholarship program. Besides DAC major countries, Republic of Korea and Israel granted scholarship program training program, and dispatch some specialists.

Table 1.10.3 ODA by DAC Major Countries and International Organizations

Year	(Unit: \$ million)							Total
	1 st	2 nd	3 rd	4 th	5 th	6 th	7 th	
95	US (132.0)	Japan (9.5)	Australia (0.2)	UNTA (0.1)	-	-	-	141.8
96	US (58.0)	Japan (4.0)	Australia (0.2)	New Zealand (0.1)	UNTA (0.1)	-	-	62.4
97	US (24.0)	Japan (13.8)	UNDP (0.7)	Australia (0.3)	UNTA (0.1)	UNFPA (0.1)	New Zealand (0.0)	38.9

Source: Annual Report on Japan's ODA 1998

Note: Net expenditure value

The Government of Palau is going to borrow \$20 million from the International Commercial Bank of China in Taiwan in order to implement the phase 2 of Capital Relocation Project in Melekeok. The phase 2 project aims to construct buildings for the executive, legislative and judicial branches.

According to the information made available to the Study Team, there are - with the exception of the COMPACT with the United States - no other formal bilateral arrangements, such as trade agreements, currently in force.

Table 1.10.4 shows a summary overview on the type and amounts involved, indicating that the ROP has received since 1994 some \$55 million (excluding the pending airport project) in assistance in the fields of fisheries, power generation and distribution and transport. To this the \$5.0 million for the maritime surveillance patrol boat from Australia have to be added.

Table 1.10.4 Assistance to the ROP from Japan and Australia 1994 to Present

(Unit: \$ million)				
Country	Purpose	1994 to 1999	2000 and after	Total
Japan	Fisheries Facility & Equipment in Peleliu, Koror, and Ngeremlengui	2.60		2.60
Japan	Fisheries Facility & Equipment in Ngaraard, Ngardmau and Kayangel	2.00		2.00
Japan	Power Distribution in Koror, Ngchesar, Melekeok, Ibobang, Ngaremlengui	12.12		12.12
Japan	Power Distribution IV	0.03		0.03
Japan	Palau International Coral Reef Center		7.02	7.02
Japan	Peleliu Channel Dredging	3.02		3.02
Japan	New KB Bridge		28.00	28.00
	Sub-total	19.77	35.02	54.79
Australia	New Patrol Boat, Equipment and Training	5.00		5.00
	Total	24.77	35.02	59.79

Source: Capital Improvement Project (CIP) Office

Note: The list does not include new terminal building of Palau International Airport, which is estimated at around \$25.8 million

Apart from ODA, GOP is going to borrow \$20 million from the International Commercial Bank of China in Taiwan in order to implement the phase 2 of Capital Relocation Project in Melekeok. The phase 2 project aims to construct buildings for the executive, legislative and judicial branches.

The ROP is member in the IMF, the World Bank group, UNDP and other specialized agencies of the UN-system. Needless to say that such membership has outstanding importance, since it provides the ROP with a window not only to international impartial expertise, but also potential assistance. In fact, UNDP sponsors currently two important projects in the ROP, namely

- TTP/97/002- Informal Employment and Sustainable Livelihood; and
- TTP/97/001- Public Sector Development Project.

Informal Employment and Sustainable Livelihoods Project began in 1997, and continues until now. The project aims to facilitate private sector development, primary production and family self-reliance by strengthening the informal sector of the Palauan economy. The project collected information and data about informal economy until now, and will concentrate in subsistent agriculture development until now.

The public sector development project is of somewhat crucial importance, since it is to produce, macroeconomic data on the ROP, which form an essential element in Article 4 negotiations with the IMF. The project aims to increase the efficiency and effectiveness of the civil service by addressing weakness in the central servicing functions of national planning, financial and organizational management. It also aims to strengthen aid coordination, improve data collection and statistical analysis for development planning, and introduce vigorous analysis in planning. Although all ministries would be involved in the project when the project starts in 1997, actual cooperation is limited.

Foreign Investment Advisory Service, a joint service of the International Financial Corporation (IFC) and The World Bank conducted a review of the environment for foreign investment in Palau in accordance with a request from the Vice President, the Minister of State and the Minister of Commerce and Trade. It issued the report describing the present investment policy environment, primary focusing on the

Government's policies and procedures. The report also recommends a number of areas that should be a priority for attention by the Government if it wishes to enhance the attractiveness of the environment it offers for foreign direct investment.

IMF conducted a recent economic developments study based on the Article IV consultation and issued a country report in 1999.

Palau is not member country of Asian Development Bank (ADB), though it warns the weakness of economy in the Pacific Islands, and conducted some economic reform projects there. According to the interview to the responsible personnel in the Bureau of Foreign Affairs, Palau don't wish to enter the ADB member because GDP per capita of Palau is enough high not to be aided by other member countries, but to aid other countries.

Though disbursement and tender procedures differ between the three donors referenced above, the fact remains that the ROP has benefited directly or indirectly since independence in 1994 from assistance in the amount of about \$472 million for recurrent expenditures and the establishment of social and economic infrastructure.

This is equivalent to assistance of roughly \$31,993 per Palauan residing in Palau in 1999, or \$2,133 on an annual average over the 1994 to 2009 15-years period (at 1999 Palauan population size of an estimated 14,753, i.e. excluding non-Palauan residents). The annual average of \$2,133, in turn, is roughly equivalent to 34 percent of the economy's average wages & salaries in 1998.

1.11 External Relations and Contractual Obligations

The ROP is only five years old as an independent sovereign nation, but she has already a wide range of bilateral and multilateral relationships and the ROP is signatory to a number of important international conventions and agreements.

Bilateral relations

The ROP has formalized relations with the United States, Japan, Italy, the Philippines, Taiwan, and Thailand. The ROP has Embassies in the United States (Washington D.C.) and Japan (Tokyo). The following Embassies are in the ROP:

- United States of America; Charge d'Affair level representation (the U.S. Ambassador in Manila, Philippines, covers the ROP);
- Japan; Charge d'affairs level representation;
- Italy; Ambassador level representation;
- Philippines; Ambassador level representation; and
- Taiwan; Ambassador level representation (decided, but not yet physically established).

According to the information made available to the Study Team, there are - with the exception of the COMPACT with the United States - no other formal bilateral arrangements, such as trade agreements, currently in force.

International organizations

The ROP is member in the IMF, the World Bank group, UNDP and other specialized agencies of the UN system. Needless to say that such membership has outstanding importance, since it provides the ROP with a window not only to international impartial expertise, but also potential assistance.

Palau is not member country of Asian Development Bank (ADB), though it warns the weakness of economy in the Pacific Islands, and conducted some economic reform projects there. According to the interview to the responsible personnel in the Bureau

of Foreign Affairs, Palau don't wish to enter the ADB member because GDP per capita of Palau is enough high not to be aided by other member countries, but to aid other countries.

Signatory party

The ROP is, likewise, signatory party to many important international agreements and conventions.

Brief assessment

The following observations are not only obvious, but also called for:

Long-term bilateral relations should be dictated by long-term national interests and needs and there should be a reasonable balance between the cost to the country for such relations and the benefits derived from them. There is a need in the ROP to adopt a more systematic and cost-benefit oriented approach. Areas of national interest are obviously the fisheries sub-sector; trade relations; general HRD oriented arrangements (education, science & technology); and general ODA arrangements.

The cost to the country (direct and indirect impact on the public budget) of her bilateral, multilateral and other obligations could not be determined exactly. However, the GOP should make such an assessment with a view to prioritize desired relationships and attaching a benefit label to them.

Last, but not least, there is a dire need to assess, from an impartial and objective point of view the country's need for ODA assistance in its different form. There is likewise a dire need to establish a systematic and credible internal ODA policy formulation and implementation mechanism. If this is not done properly, it is perfectly possible that ODA assistance, at least to the extent that it builds up physical infrastructure assets, turns in the medium to long-term into an unsustainable burden for the ROP.