

EXECUTIVE SUMMARY

The economy is very narrowly based, with tourism, subsistence agriculture and public administration the main sectors of economic activity. There are few jobs in the formal economy. The government employs about a quarter of the workforce and accounts for around a fifth of GDP. There is very little industry. The economy is very heavily dependent upon foreign assistance from the US

Geography and Demographics

Palau is a country that consists of about 300 islands of which 9 are inhabited. It is located in the North Pacific Ocean, southeast of the Philippines and is slightly larger than two and a half times Washington DC. The climate is tropical. There are 2 seasons; a dry season lasting from December to April and a rainy season from May to December (the bulk of the rainfall occurs between July and October). The annual average temperature is 82°F. The population is just 20,879 and the population density is 45.5 per sq. km. Only two countries; Tuvalu and Nauru have fewer people. On 7 October 2006, the government moved the capital from Koror to Ngerulmud. Both settlements are located on the island of Babeldaob. The population of Ngerulmud is only 391. It has the smallest population of any capital in the world. The largest city, the commercial capital and the main port is Koror where about 64% of the population lives. Arable land accounts for 2.2% of the country, 83.4% of the population lives in urban areas, 88.3% of the country is covered by forests, there are 1,519 km of coastline and 4.3% of the land area is devoted to permanent crops. The median age is 32.4, the birth rate is 10.7 per 1,000 live births, the death rate is 7.8 per 1,000 people, the fertility rate is 1.73 children per female, 22.2% of the population is under 15, 32.8% is 25-44 and 6.3% is 65 and older. The average annual population growth rate between 2004 and 2008 was 0.47%. The time zone is nine hours ahead of Greenwich meantime. Palauan and English are the official languages. Palauan is the most spoken language. According to the 2000 census, it was spoken by 64.7% of the population. English was spoken by 9.4% of the population.



After three decades as part of the UN Trust Territory of the Pacific under US Administration, Palau opted for independence in 1978 rather than join the Federated States of Micronesia. A Compact of Free Association with the US was approved in 1986, but not ratified until 1993. It entered into force on October 1, 1994 when independence was declared.

SECTION SUMMARY AND TREND

Political Environment - Government & Civil Liberties	Trend
Free and fair elections are held on a regular basis. Freedoms of expression, the press, assembly, association, movement, religion and academic freedom are respected. The judiciary is independent.	Positive
Economic Overview	Trend
Infrastructure There is small road network that is in good condition. The airport is small and there are only a few flights to international destinations. There is no railway. The water system is plagued by high water losses which are estimated at 50%. Subsidies for the operations of the public water supply system are a major burden on the budget.	Stable
Energy Sector There are no indigenous sources of oil, natural gas, hydropower or coal. The electrification rate is 97%. The electrical generating system has been poorly maintained because of lack of funds.	Negative
External Accounts Palau has a large trade deficit because it has to import all of its oil and capital goods and much of its food need. In addition, a paltry level of exports is also a contributing factor for the large trade deficit. In FY08/09, merchandise exports were equivalent to just 5.6% of GDP.	Negative
External Debt The external debt is manageable.	Stable
Agriculture Sector Agriculture is largely subsistence in nature. Productivity is low because of the small size of plots, poor soil conditions, a lack of access to credit, limited irrigation and low levels of mechanization. Slightly more than 80% of the food requirement is imported.	Negative
Informal Economy There is limited information on the informal economy.	N/A
Business Environment	Trend
Openness to Foreign Investment Many sectors of the economy are reserved for nationals. There are no limitations or restrictions on the repatriation of profits and dividends.	Stable
Financial Sector There are 8 commercial banks of which 4 are US owned and insured by the FDIC. Locally owned banks account for about 25-30% of the assets of the banking system. The largest bank is the Bank of Hawaii. Bank regulators estimated that there were about \$80-\$85 mn in bank loans outstanding in early 2007 of which 20% were to the central government and about 70% to government and public utilities.	Stable
Corruption Corruption is a major problem. Several major political figures were convicted of corruption in 2009.	Negative
Human Capital	Trend
The infant mortality rate is 12.8 per 1,000 live births, the probability of dying between birth and the age of 1 is 13 per 1,000 live births, there are 363 mainline telephone lines and 602 cellular subscribers per 1,000 people, the prevalence of tuberculosis is 110 per 100,000 people, the per capita income in 2009 was \$9,550 (World Bank estimate) and the life expectancy is 71.5 years.	Stable

Economic Outlook	Trend
<p>Palau's economy has performed poorly in recent years and there is little reason to believe it will be able to register significant rates of growth in the near-term and thus break its great dependence on US economic assistance. The government is eager to encourage foreign investment but there are few reasons to invest in the country. There are no natural resources other than fish (mainly tuna), the population is miniscule, there is a very modest manufacturing sector, the total land area is very small and the banking system is shallow.</p>	<p>Negative</p>

I. Political Environment

Index	Rank	Score
Freedom House Index 2010	Status: Free	Political Rights: 1.0/7.0 Civil Rights: 1.0/7.0
Bertelsmann Transformation Index 2010	N/A	N/A
Fund for Peace - Failed State Index 2010	N/A	N/A
World Bank Gov Indicator 2009, Political Stability	90.4 Percentile	1.18

1. Government

The chief of state and the head of the government is President Johnson Toribiong. He has held the office since January 15, 2009. The president and the vice president are elected on separate tickets by popular vote to a four-year term. Suffrage is 18. The president is eligible for a second term. The last election was conducted in November 4, 2008 and the next one will be held in November 2012. In the 2008 balloting, President Toribiong garnered 51% of the vote. The voting was judged to be free and fair.

There is a bicameral National Congress that consists of the Senate and the House of Delegates. The Senate has 9 members who are elected by popular vote to a four year term. The House of Delegates has 16 members who are also elected by popular vote to a four year term. The Legislative elections coincide with the presidential vote. There are no political parties. All the members of the National Congress are independents.

2. Civil Liberties

Freedom House has designated Palau as "free" and has assigned it a rating of 1 out of 7 for political rights and 1 out of 7 for civil rights. The lower the rating the higher the degree of political and civil liberties. Palau is not ranked in the Bertelsmann Transformation Index and the Fund for Peace Failed State Index. It is ranked at the 90.4 Percentile in the World Bank's Political Stability Governance Indicator.

Freedoms of speech and the press are respected. There are several print publications, five privately owned radio stations, one privately owned television station and access to cable television. There are no restrictions on use of the internet. The government does not monitor e-mail correspondences or chatrooms and does not block websites. Freedom House ranks Palau 11 of 196 in its Freedom of the Press survey for 2010 and characterizes the press as "free."

Freedom of religion, movement, assembly, association and academic freedom are respected. NGOs are allowed to operate without government interference. Workers can form and join trade unions. As much of the economy consists of subsistence farming or family owned businesses there are no active unions. The law does not recognize the right to strike or to bargain collectively.

There is an independent judiciary. The police force has 300 members. There is no army. The law prohibits arbitrary arrest and detention and torture and the police observe these prohibitions. Police corruption is not a major problem. The law requires a warrant be issued by the Office of the Attorney General and signed by a judge before a person can be arrested. Detainees are notified promptly of the charges against them and are able to have access to a lawyer. If a detainee cannot afford a lawyer, one is provided for him at state expense. There is a functioning bail system. There are no jury trials. All decisions are made by the presiding judge. A 2008 amendment to the constitution did provide for jury trials but the amendment has yet to be implemented because of lack of funding. Defendants enjoy a presumption of innocence, have the right to appeal a decision and question witnesses, can present evidence on their own behalf, and have access to government-held evidence against them.

II. Economic Overview

The economy is very narrowly based, with tourism, subsistence agriculture and Public Administration the main sectors of economic activity. There are few jobs in the formal economy. The government employs about a quarter of the workforce and accounts for around a fifth of GDP. There is very little industry.

On October 1, 1994, the Compact of Free Association between the United States and Palau came into effect. Under its terms, Palau became an independent country with full sovereignty to conduct its own foreign affairs. However responsibility for defense remained with the US. Citizens of Palau have the right to enter, reside, study, and work indefinitely in the United States without a visa. The Compact provides grants to Palau to support the economy. The financial provisions of the Compact ended in September 2009. The US offered a final assistance package of \$156 mn following the end of its last payment in September 2009 for the period covering FY2010-FY2024 (fiscal year starts October 1). The government however indicated that the amount was inadequate and in late January 2010, the US and Palau reached an agreement on a \$250 mn package. It included \$2 mn a year for infrastructure maintenance and \$13.5 mn a year of direct financial assistance. The agreement though has been stalled by Palau's contention that the US is trying to "micromanage" its economic policy and as of the summer, it had yet to be implemented.

A June 12, 2008 US Government Accounting Office (GAO) report entitled "US Assistance to Palau, Accountability Over Assistance Provided and Palau Prospects for Economic Self Sufficiency" estimated that total US assistance to Palau between FY95 (FY begins on October 1) and FY09 was \$853 mn of which \$411 mn was budgetary assistance. According to the Compact, the funds received by Palau can only be used for current account operations and maintenance, energy self-sufficiency, maritime zone surveillance and enforcement and funding a trust fund that will be drawn upon when the compact funding ends. The Compact required the US to build a road system, which was to be completed by October 1, 2000. However, because of delays, it was not finished until October 1, 2007.

The government can withdraw \$5 mn a year from the compact trust fund (withdrawals started in FY2002) up until FY2010 when it can increase the withdrawals to \$15 mn. The IMF Article IV Consultation Report that was released in May 2010 indicated that "The performance of the trust fund fell short of expectations. The purpose of the fund was to provide a steady stream of income that would replace the Compact grants after 2009. The fund returned 7½ percent per year through FY2009. This...falls short of the 12 ½ percent anticipated during the Compact negotiations. By end FY2009, the Compact Trust Fund had accumulated \$140 mn, compared to \$260 mn expected at the outset." The GAO report indicated that "To decrease its long-term reliance on trust fund financing, Palau will require fiscal reforms aimed at closing the gap between revenues and expenditures. Specifically, experts suggest that Palau increase its tax income by addressing the problem of weak tax administration and reduce its expenditures by lowering the public sector wage bill." The IMF Article IV Consultation Report warned that "Although the United States has extended Compact grant assistance for another 15 years, the current budget deficit would still need to shrink by 1 ½ percent of GDP per year over the next 10 years to avoid a sharp drop in spending when the Compact grants ends."

The GAO has urged the government to promote private sector growth and identified tourism and aquaculture as two of the most promising sectors for development that could boost economic growth and employment. However the GAO noted a host of factors that have impeded the development of the private sector including "stringent requirements" on foreign investment, a banking system that inadequately finances investment, a land ownership system that "prevents the effective use of land for development", a

lack of skilled labor, a history of delays in payments to vendors by the government and an “outdated commercial legal system” that lacks bankruptcy and consumer privacy protection laws.

The economy performed poorly in FY 2009. The Pacific Financial Technical Assistance Center (PFTAC) estimated it dropped by 2.1%, undermined by a decline in tourist arrivals and a reduction in public sector infrastructure outlays. This was the fourth consecutive FY decline and it brought the cumulative drop over this period to 10.8%. The PFTAC was established in Fiji in 1993 to provide technical advice to 15 Pacific island countries. It is operated by the IMF in consultation with the governments of the 15 countries and the donors of the countries that support them. The PFTAC is forecasting only a modest 1% increase in the present FY on expectations of a recovery in the tourist sector.

Retail and wholesale trade was the largest sector of the economy in FY07, accounting for 21.1% of the total followed by public administration at 19.9%, construction was responsible for 15.5% and hotels and restaurants had a 9.9% share. Manufacturing was just 0.5%, agriculture was 1.3% and fishing had a 2.2% share. Public Administration and compulsory social security employed 25.9% of the work force in the fourth quarter of 2008, wholesale and retail trade, repair of motor vehicles, motorcycles and personal and household goods had a 16.9% share, hotels and restaurants accounted for 13.9% and construction was responsible for 8.4%. Agriculture, hunting, forestry and fishing were 2.5% and manufacturing was 2.2%. The unemployment rate in 2005 was 3.5% for the urban population and 7.0% for the rural population.

Foreign workers account for about 54% of total employment. Around 60% of the foreign workers are from the Philippines, 15% are from China and 10% are from Bangladesh. About 90% of foreign nationals work in the private sector and the remainder are professional and technical experts who work for the government or one of its agencies. In October 2009, the government set a limit of 6,000 foreign workers. According to the law imposing the limit, “resident workers shall be given preference in employment in any industry or occupation for which such workers are qualified and available. Nonresident workers shall be employed only to supplement the labor force of available and qualified resident workers.” At the time the law was approved, non resident workers accounted for more than 25% of the population.

The economy descended at an annual average rate of 1.3% between FY2005 and FY2009 (according to PFTAC data). This compares to annual increases for calendar years 2005-2009 of 0.9% for Kiribati, 4.4% for the Philippines and 5.6% for the Solomon Islands. According to the World Bank, the per capita income in 2009 was \$9,550. This placed Palau 58 of 185 nations and territories that the World Bank compiles per capita data for.

Consumer prices rose at an average annual rate of 6.1% in FY08/09 (IMF estimate). This was down from 10.0% in the previous FY. The IMF is forecasting an advance of 6.0% in the present FY. The average annual inflation rate between FY05 and FY09 was 5.4%.

The main crops and agricultural products are coconuts, cassava and sweet potatoes. Fish and forests are the major natural resource. Tourism, handicrafts, construction and garments are the main industries.

A 1999 law set the minimum wage at \$2.50 per hour. Foreign workers however are not included under the minimum wage law. Unskilled foreign workers receive \$1.50 to \$2.00 an hour. Many foreign workers also receive basic accommodations and food free or at nominal cost. There is no legislation setting a limit on the maximum hours worked. There have been reports of mistreatment of foreign workers especially for domestic help, farmers, waitress, beautician and construction workers.

There is no minimum age set for employment. Child labor is not a problem in the formal economy. It does though exist in the informal economy. No foreign worker under 21 can be employed. This regulation is effectively enforced.

Palau is a party to the South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA), which came into force in 1981. It is an agreement between Australia, New Zealand and the South Pacific Forum (SPF) that allows duty free access to products from SPF countries to Australia and New Zealand. The members of the SBF are Australia, the Cook Islands, the Federated States of

Micronesia, Fiji, Kiribati, the Marshall Islands, Nauru, New Zealand, Niue, Palau, Papua New Guinea, Samoa, the Solomon Islands, Tonga, Tuvalu and Vanuatu.

1. Infrastructure

A major extension of the road network, including an 85km two lane highway around Babeldaob was scheduled for completion in 2005 as part of the Compact agreement. However, a series of landslides delayed the project and it was not completed until August 2007. The initial cost estimate was \$100 mn but it ended up costing twice as much. In January 2008 sub-surface drainage pipes were installed in some sections of the highway by the Army Corps of Engineers to prevent water seeping under the surface. The US Department of State Travel Advisory noted that "Construction of the main road connecting the airport with downtown Koror has been completed...the newly constructed roadway, known as the Compact Road that loops around the large island of Babeldaob is in excellent condition. Secondary roads connecting villages to the Compact Road vary in quality from good to rough. The national speed limit is 25 miles per hour."

There are 3 airports of which 1 is paved. Roman Tmetuchl International Airport is the main airport. It is located 6km from Koror. The airport covers 480 acres, is at an elevation of 176 feet and has a 7,200 feet runway. The airport is the main hub for Belau Air, the privately owned domestic carrier. It operates a Cessna that has a capacity of 5 passengers. Continental Micronesia, which is a wholly owned subsidiary of Continental Airlines, has flights to Guam, Manila and Yap. Asiana Airlines, China Airlines and Japan Airlines have charter flights to Seoul, Taipei, Osaka and Tokyo. The flight time between Palau and Manila is 2 hours and 18 minutes.

There is no railway.

The main port is at Koror. There is one main commercial dock that services merchant and fishing vessels and a small tanker port that is used to receive fuel. There are smaller docks throughout the islands that are used for inter-island passenger service, private vessels and small cargo vessels. Malakal Commercial port, which is the main commercial and fishing dock, is privately owned. The tanker port is owned by the government and smaller ports are owned and operated by private companies or municipal governments. Malakal port has 3 berths, 2 of which are used for merchant ships and the third is for fishing vessels. The average depth of the port is 9 meters. It can accommodate 2 cargo ships at a time. Most of the cargo traffic is containerized. Much of the cargo that arrives is transshipped from Guam, including petroleum products. The port receives occasional visits from international cruise ships.

Palau relies heavily on watersheds for its water. The Koror/Airai treatment plant extracts 4.5 million gallons a day from the Ngerimel Dam and Ngerikiil River (which supplies 80% of the water). The water system is plagued by high water losses which are estimated are 50% and inadequate tariff rates. Subsidies for the operations of the public water supply system are a major burden on the budget. At the end of June, the government indicated that it would seek a \$16 mn loan from the Asian Development Bank (ADB) to boost the efficiency of the water and sanitation systems. The loan will enable the government to meter water usage in most of the country. Pollution of ground water caused by poorly maintained septic tanks, landfills and saltwater intrusion is a problem. Coastal waters are polluted by oil from outboard motors and ships.

Tourists are advised not to drink tap water unless it has been boiled, filtered or chemically disinfected and not to use ice cubes.

2. Energy Sector

Palau has no indigenous sources of coal, natural gas, oil and hydropower. There is no oil refinery and as a result all refined petroleum products including gasoline, jet fuel, kerosene and diesel must be imported. The Palau Public Utilities Corporation (PPUC) is a semi-autonomous government agency that is responsible for generating electricity, maintaining the electrical grid system and transmitting and distributing power. The total installed electricity capacity is 35 MW. There are 5 power plants all of which are fueled by imported diesel. The electrification rate is 97%. The electrical generating system has been

poorly maintained because of lack of funds. As a result of the unreliability of the electric supply in Koror many businesses have installed their own generators.

In 2009, the government signed a contract with Palau Pacific Exploration (PPX) of Australia to explore for oil and natural gas in a 1 million acre concession in Palau's territorial waters. Anglo Securities of Houston, which PPX has hired to attract investors, has estimated that there could be as much as 1 billion barrels or more of oil. The oil is located under 130 feet of water at a depth of about 5,000 feet. The IMF Article IV Report that was released in May noted that "Palau is making new efforts towards oil and gas exploration...Estimates obtained by the World Bank show a wide variety of possible oil reserves, with the revenues from such reserves (in net present value) varying between ¼ GDP to 8 times GDP and a base case of 2 ¼ times GDP."

3. External Accounts

Palau has a large trade deficit because it has to import all of its oil and capital goods and much of its food need. In addition, a paltry level of exports is also a contributing factor for the large trade deficit. In FY08/09, merchandise exports were equivalent to just 5.6% of GDP. The IMF estimated the trade deficit dropped by 22.6% in FY08/09 to \$91.7 mn as imports declined by 20.6% and exports were unchanged. The deficit was equal 43.3% of GDP. For FY09/10, the IMF is forecasting a shortfall of \$101.1 mn. This would be equal to 46.3% of projected GDP. Fish is the main export while petroleum products and food are the main imports. The US, Japan, Singapore and Taiwan are the major trading partners.

Tourism is an important source of services income that helps to partially offset the large trade deficit and provides employment. Tourists are attracted to the scuba diving, snorkeling and coral reefs. The IMF estimated that tourist receipts in 08/09 were \$113 mn. This was down from \$116.7 mn in the previous fiscal year and was equal to 5.3% of GDP. There were 83,114 tourist arrivals in 2008 of which 36.5% were from Japan, 17.6% were from Taiwan and 17.2% were from Korea.

Foreign assistance and tourism help to contain the current account deficit. The IMF estimated the shortfall was \$29.1 mn in FY08/09. This was down from \$38.4 mn in the previous FY and was equal to 1.4% of GDP. For FY09/10, the IMF is forecasting a deficit of \$20.9 mn.

4. External Debt and Budget Balance

The external debt at the end of FY08/09 was \$79.92 mn. This was up from \$75.21 mn in the previous FY and was equal to 37.7% of GDP. Of the debt, 59.9% was owed by public companies and 28.4% by the government. In its Article IV Consultation report, the IMF noted that "external debt continued to increase and reached a record 38 percent of GDP in FY2009. Palau's power company played a large role in the recent buildup of external debt, all of which is on nonconcessional terms. Palau's external assets, namely pension funds and the Compact Trust Fund lost about 15 percent of their value since the financial crisis. Taken together, Palau's international investment position (foreign assets minus foreign liabilities) fell from 4 percent of GDP in FY2007 to -33 percent of GDP in FY2009."

The budget is very dependent upon grants which the IMF forecasts will account for 55.5% of total government revenue in the present FY and will be equal to 22.9% of projected GDP. Revenue for FY09/10 is forecasted to rise by 1.1% and spending is predicted to drop by 1.8%. With respect to spending, wages and salaries will account for 34.1% and capital expenditures 20.5%. The budget deficit is forecasted to decline to 1.2% of GDP from 2.4% of GDP in FY08/09. Excluding grants, the shortfall will be 15.4% of GDP. The IMF has urged the government to tighten its fiscal stance by slashing government spending on office supplies and cars. It welcomed the government's decision to increase the top tax for high wage and salary earners and recommended the government build up a cash buffer to reduce its \$11 mn stock of arrears to domestic suppliers. The IMF also recommended the government allocate more money to the Bureau of Budget and Planning which is so short staffed that its "capacity to compile economic and government statistics is deteriorating...Essential statistics, for example on price levels, have not been compiled since mid-2009 and without regular PFTAC mission national accounts and balance of payments statistics could not be sustained. The lack of staff and data, if not addressed, would impede national policy formulation."

5. Agriculture Sector

Agriculture is largely subsistence in nature. Productivity is low because of the small size of plots, poor soil conditions, a lack of access to credit, limited irrigation and low levels of mechanization. Slightly more than 80% of the food requirement is imported.

In April, the government began drafting a law to promote the domestic fishing industry. President Toribiong noted that the tuna industry could be a source of huge revenues for the government and a source of employment and therefore he was considering limiting fishing agreements with foreign companies. As part of the program to promote the fishing sector, the government may impose higher fish export taxes, higher access fees, greater restrictions on foreign fishing in Palau waters and create a tuna canning industry. Domestic income from the tuna sector is estimated to be less than \$1 mn a year. Much of this is derived from licenses granted to foreign fishing vessels of which Taiwanese and Japanese account for the majority.

III. Business Environment

Index	Rank	Score
Economic Freedom of the World Index 2009	N/A	N/A
Heritage Foundation Economic Freedom Index 2010	N/A	N/A
World Economic Forum – Global Competitive Index 2009-2010	N/A	N/A
Milken Institute Capital Access Index 2009	N/A	N/A
UNCTAD – Inward Potential Performance Index 2005-2007	N/A	N/A
World Bank Ease of Doing Business 2010	97/183	N/A
World Bank Gov Indicator 2009, Regulatory Quality	23.2 Percentile	-0.73
World Bank Gov Indicators 2009, Rule of Law	70.3 Percentile	0.68
Transparency International Corruption Perception Index 2009	N/A	N/A

1. Summary of Indices

Palau is ranked 97 of 183 in the World Bank's 2010 ease of doing business survey. In the previous year survey, it was ranked 92. It is ranked 103rd for starting a business, 8th for employing workers, 183rd in getting credit, 8th in enforcing contracts, 18th in registering property, 172nd in protecting investors, 91st in paying taxes, 124th for trading across borders, 54th for dealing with construction permits and 59th in closing a business. With respect to the World Bank's governance indicators, it is ranked at the 23.2 percentile for regulatory quality and at the 70.3 percentile for rule of law.

Palau is not ranked in any of the major international competitiveness and economic indices.

2. Openness to Foreign Investment

All applications for foreign investment must be submitted to the Foreign Investment Board (FIB), which consists of 7 government appointed members. The FIB requires an investment to be more than \$500,000 and its workforce be composed of at least 20% nationals. It has the authority to request additional information to assess an investment including "extent of current availability" of the proposed investment, "benefit to the economy", the "financial capacity, experience and expertise of the investor", the "technical and economic viability of the proposed project," "the utilization of domestic resources", "impact on employment generation", export earning potential and import savings, the extent of transfer of managerial and technical skills and impact on the environment. The FIB makes a decision on an

application for investment within 90 days of submission. Following an approval, the FIB will set the duration, scope and conditions for the investment. All foreign investment must submit periodic reports to the FIB so it can determine compliance with the stipulations that have been established. Once approval is granted, investors need to obtain the necessary licenses from the Bureau of Revenue, Customs and Taxation and from the state government where the business will operate. No non-citizen can make an investment in an existing business wholly owned by a citizen without a foreign investment approval certificate. There is a non refundable \$500 investment application fee and a \$25 foreign investment quarterly report fee. Foreign investment is allowed in all sector of the economy except for wholesale and retail trade, land transportation including buses, taxis and car rentals, tour guides, fishing guides, diving guides, water transportation, handicrafts, gift shops, bakeries and bars. Foreigners cannot own land but they can lease it. In 2008, a referendum approved the extension of the lease period to 99 years from 49. Foreign investors can freely repatriate earnings and dividends.

3. Taxes

There is no corporate income tax. The social security contribution is 6% of salary. On July 22, the government passed several changes to the tax laws that will take effective with the start of FY 2010/2011. A scuba diving tax of \$5 a day was imposed, the departure tax was set at \$20 per person (previous it was \$10 for nationals and \$20 for foreigners) and the hotel room tax was set at 15% of the net room charge, up from 10%. The income tax for the first \$6,000 of income was left at 6% and for income over \$8,000 it remained at 12%. Earnings over \$25,000 however will be subjected to a tax rate of 14%, whereas previously, it was 12%. The legislature rejected a proposal to eliminate the duty exemption for imported food.

4. Financial Sector

There are 8 commercial banks of which 4 are US owned and insured by the FDIC. Locally owned banks account for about 25-30% of the assets of the banking system. The largest bank is the Bank of Hawaii. Bank regulators estimated that there were about \$80-\$85 mn in bank loans outstanding in early 2007 of which 20% were to the central government and about 70% to government and public utilities. The bulk of commercial lending to the private sector consists of consumer credit, secured by salary deductions. The government owned Development Bank of Palau was restructured in 1999 and in 2004 it received a capital infusion. It is now run on a commercial basis. The main business of the bank is mortgage lending. About 15% of its loan portfolio is non-performing.

A July 2007 report by the ADB entitled "Palau: Policies for Sustainable Growth, A Private Sector Assessment," noted that "Bankers describe the culture of debt repayment as very weak. Borrowers often strenuously resist repayment of their loans and not infrequently bounce checks. Knowingly writing a check with insufficient funds is a criminal offense but lawyers could not recall a recent instance of prosecution...a substantial number of people have been sued for non-payment of debt...Interviews with bankers, regulators and businesses indicated that there are many deficiencies in the collateral framework that impact negatively on the ability to borrow and increase the risks of lending...Deficiencies exist in all phases of the process of collateralization...The result is that pledging collateral is expensive and the lenders insist on excess collateral to secure loans...Mortgages on fixed property are available....Typical mortgage loan terms are based on 75% of the assessed value of the property for a 15-20 year term loan...The regulatory framework for bank regulation is weak. Until comparatively recently there was no bank supervision. The Financial Institutions Act now provides for regulation, but does not assure adequate funding for the Office of the Supervision of Banks...There are grounds for concern regarding the liquidity of some banks, especially those that are owned locally. The IMF reports that local banks are not retaining sufficient capital to meet withdrawals. There are, in addition, numerous anecdotes regarding cash shortages. Several depositors recounted that they are often not able to withdraw cash at will if the amounts are over \$2,000."

In February 2008 amendments to the Financial Institutions Act (FIA) were signed into law. Among them were provisions for more effective bank supervision that require all banks to have an annual audit, and granting bank supervisors immunity in carrying out official acts.

The currency is the US dollar. There is no central bank.

5. Corruption and Transparency

Palau is not ranked in Transparency's International's corruption perception index. It has accepted the UN Convention Against Corruption.

Corruption is a major problem. In 2009, the speaker of the Koror state government was convicted of perjury and misconduct, the governor of Melekeok state was found guilty of using public funds for personal purposes, former president Remengesau was found guilty of misconduct, including the stealing of public funds for which he faces fines of up to \$1.2 mn, the former head of economic development was charged with unlawful fishing and employment of non-resident workers, and the ombudsman faced charges of forgery. To restrain corruption, new anti-money-laundering measures were introduced in 2007. Implementation of these new regulations though has not been effective because of lack of resources and inadequate record keeping. The Office of the Special Prosecutor and the Office of the Public Auditor are responsible for combating government corruption.

6. Standards Compliance Assessments

IMF Dissemination Standard	Subscription Status
Special Data Dissemination Standard	Not a subscriber
General Data Dissemination Standard	Not a subscriber

IMF Assessment	Standards Assessed	Dates	Compliance Level
Reports on Standards and Codes (ROSCs)	Anti-Money Laundering and Combating the Financing of Terrorism	Jan. 13, 2009	Low
Financial Sector Assessment Programs (FSAPs)	N/A		

The IMF has assessed Palau for Anti-Money Laundering and Combating the Financing of Terrorism. The report noted that money laundering is a criminal activity but the "freezing of terrorists assets...is not adequately addressed...the legislation shows deficiencies regarding measures of seizing of evidence and property and the freezing of capital and financing transactions related to financing terrorism."

IV. Human Capital

Index	Rank	Score
UNDP Human Development Index 2009	N/A	N/A

1. Social Indicators

Palau is not ranked in the 2009 UNDP HDI. The infant mortality rate is 12.8 per 1,000 live births, the probability of dying between birth and the age of 1 is 13 per 1,000 live births, 100% of births are attended to by a skilled health care professional, the under 5 mortality rate is 15 per 1,000 people, 97% of infants 12-23 months are fully immunized against measles, the maternal mortality rate is 170 per 100,000 live births, there are 51.3 birth defects per 1,000 live births, 92.0% of infants 12-23 months have been immunized against diphtheria, pertussis (whooping cough) and tetanus, 89% of the population have access to clean drinking water, 67% of the population have access to improved sanitation facilities, the probability of dying between the ages of 15 and 60 is 17.5%, the neonatal mortality rate is 7 per 1,000 live births, 9% of babies are born with low birth weight, the immunization rate of 1 year olds for hepatitis B is

92% and for polio, it is 94%, 27% of pregnant women suffer from anemia, and the life expectancy (2010 projections of the US Census Bureau) is 71.5 years (74.8 years for females and 68.4 years for males).

There are 478 prisoners per 100,000 people, pretrial detainees are 4.1% of the prison population, 8.6% of prisoners are women and 6.5% are foreigners.

2. Access to Technology

There are 363 mainline telephone lines and 602 cellular subscribers per 1,000 people. Internet use is 273 per 1,000 people. There are 591 radios per 1,000 people and there are 541.8 televisions per 1,000 people. In 2007, there were 5,530 motor vehicles of which 33% were cars, 14% were motorized 2-3 wheelers, 24% were minibuses and vans with a capacity of less than 20 and 29% were trucks.

3. Health Indicators

There are 600 nurses and midwives per 100,000 people, 160 physicians per 100,000 and 500 hospital beds per 100,000 people.

The prevalence of tuberculosis is 110 per 100,000 people (in the US, it is 2.5 per 100,000 people), the tuberculosis death rate is 14.0 per 100,000 people and the TB treatment success rate averaged 85% between 2003 and 2006. The prevalence of diabetes is 9.1% of the population between 20 and 79 (the average for the Western Pacific is 5.0). According to the International Diabetes Federation, there are 12,103 people with diabetes between the ages of 20 and 79 and the number of deaths attributed to diabetes will be 17 in 2010. The prevalence of smoking for men 15 and older is 37.7% and for females 15 and older it is 9.3%. The per capita health expenditure in 2007 was \$873 and the total expenditures on health were 10.8% of GDP. The number of road accident fatalities in 2007 was 3.

The US Department of State Travel Advisory noted that "Health facilities are adequate for routine medical care but limited in availability and quality. Doctors, clinics, and one national hospital often expect immediate cash payment for health services."

4. Education Indicators

Education is universal, and compulsory from the age of 6 to 14. It is free until the age of 17. Primary school starts at 6 and lasts for 5 years and secondary school begins at 11 and lasts for 7 years. The completion rate for primary school is 97% and for secondary school, it is 78%. The teacher/pupil ratio in primary school is 13:1.

In 2005 the literacy rate was 95.2% for adults 25 and older.

There is a dearth of information on the major education indicators.

V. Economic Data, Outlook and Credit Rating

IMF Country Data Overview 2010 (Est.)						
GDP Growth	GDP:	GDP per capita:	CPI:	Current Account as % of GDP	Budget balance as % of GDP	FDI (UNCTAD 2009)
1.0% (PFTAC estimate)	\$218.402mn (FY09/10)	\$9,550 (World Bank data for 2009)	6.0% (FY09/10)	1.3%	-1.2% (FY09/10)	\$700,000 (IMF net FDI estimate for FY09/10)

1. Latest IMF Consultation

The May IMF Article IV Consultation Report noted that "The short-term outlook remains clouded, with growth projected to turn only slightly positive in FY2010. Tourist arrivals and FDI should pick up in FY2010 along with the recovery in global growth and financial conditions."

2. Economic Outlook

Palau's economy has performed poorly in recent years and there is little reason to believe that it will be able to register significant rates of growth in the near-term and thus break its great dependence on US economic assistance. The government is eager to encourage foreign investment but there are few reasons to invest in the country. There are no natural resources other than fish (mainly tuna), the population is miniscule, there is a very modest manufacturing sector, the combined land area is very small and the banking system is shallow. The only viable industry is tourism. In 2008, there were 83,114 tourist arrivals, which is about 300% more people than the total population. Palau however does not have the tourist infrastructure to accommodate a substantial increase in tourist arrivals.

The possibility of discovering oil and natural gas could totally alter the economic outlook by making Palau among the richest nations on a per capita basis in the world. It would also propel the current account into surplus and end the dependence on US economic assistance. But even if the oil estimates of PPX are valid, it will be many years before the oil begins to flow and have an economic impact. In the meantime, Palau will remain a poor country with an anemic economic growth potential.

3. Country Credit Ratings

Credit Rating	Standard & Poor's	Moody's	Fitch Ratings
(as of date of publication)	N/A	N/A	N/A

Palau has not been rated by any of the major credit rating agencies.

VI. Membership in international organizations

Financial Action Task Force (FATF)	Not a member
International Center for Settlements of Investment Disputes (ICSID)	Not a member
International Federation of Accountants (IFAC)	Not a member
Multinational Investment Guarantee Agency (MIGA)	Yes, a member
United Nations Convention Against Corruption	Accession on March 24, 2009
World Intellectual Property Organization (WIPO)	Not a member
World Trade Organization (WTO)	Not a member

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<http://www.standardandpoors.com/ratings/sovereigns/ratings-list/en/us/?sectorName=Governments&subSectorCode=39&subSectorName=Sovereigns>

Memberships

Financial Action Task Force

http://www.fatf-gafi.org/pages/0,3417,en_32250379_32236869_1_1_1_1_1,00.html

International Center for Settlements of investment Disputes

<http://icsid.worldbank.org/ICSID/FrontServlet?requestType=ICSIDDataRH&reqFrom=Main&actionVal=ViewContractingStates&range=A~B~C~D~E>

International Federation of Accountants

<http://web.ifac.org/about/member-bodies>

Multinational Investment Guarantee Agency

http://www.miga.org/quickref/index_sv.cfm?stid=1577

United Nations Convention Against Corruption

<http://www.unodc.org/unodc/en/treaties/CAC/signatories.html>

World Intellectual Property Organization

<http://www.wipo.int/members/en/>

World Trade Organization Members

http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm