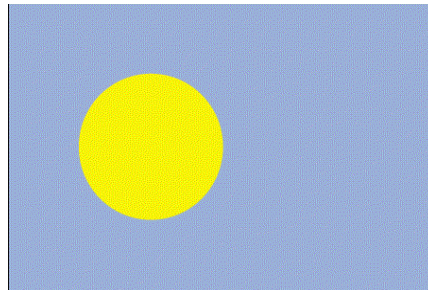


# COUNTRY REVIEW

## Palau



23 December 2010

**ANALYST: Dr. Manfred Stamer**

**EULER HERMES COUNTRY RISK GRADE: C**

Country Risk Grades are on a scale of AA, A, BB, B, C, D  
where AA is the lowest and D the highest risk.

## COUNTRY PROFILE

Capital city:	Koror
GDP:	USD 180 mn (2009e)
Population:	20,397 (2009)
GDP per capita:	USD 8,807 (2009e)
Currency:	US dollar (USD)
Form of state:	Constitutional government in free association with the US (since 1994)
Head of government:	President Johnson TORIBIONG (since January 2009)
Next elections:	Presidential and legislative: November 2012

Palau, a group of eight main islands and over 250 islets in the Pacific, gained independence from US-administered UN trusteeship in 1994. The Compact of Free Association (CFA) with the US entered into force, under which the US remains responsible for Palau's defence for 50 years and provided more than USD650mn assistance over the 15-year period to 2009. Financial aid under the CFA was extended in September 2010, providing further USD250mn for the next 15 years until 2024. Palau witnessed several instances of political violence in the 1980s, but has been calm in recent years.

The Palauan economy consists primarily of tourism (accounting for some 50% of GDP), subsistence agriculture and fishing. The government is the major employer of the work force (some 25%), relying heavily on financial assistance from the US. The roughly 20,000 inhabitants enjoy a relatively high per capita income of about USD8,800 p.a. The structure of the economy makes it vulnerable to external shocks. For example, tourist arrivals from Asian countries dropped significantly in the aftermath of the 1997-98 Asian crisis as well as the 2007-2009 global economic crisis. And although long-run prospects for tourism in the main Pacific island destinations are generally good, some countries could lose market share to Fiji, which has become the primary focus of low-cost airline operators. Concern is also growing about declining fish stocks in the area.

Information on Palau is sparse and economic data is inconsistent across different sources and often not up-to-date. Following average annual growth of 4.3% or so in 2005-07, real GDP contracted by 1% in 2008 and 3% in 2009 as tourism dropped sharply by a cumulative 17% in the two years. Growth is projected to recover modestly to 0.5% in 2010 and 2% in 2011. Inflation accelerated to 12% in 2008 as fuel prices soared but eased to 2.4% in 2009 and is forecast at 3-4% in 2010-2011. Fiscal policy has been generally expansive and large annual fiscal deficit of more than 20% of GDP have been largely financed through grants, but at times, also through unreasonable draw-downs in government financial assets (e.g. down to USD16mn in 2003 from USD78mn in 2000) and the accumulation of domestic arrears. In the past, budget planning has often been unrealistic and the track record of the government's fiscal policies is not good. Including grants, the annual fiscal deficit has been estimated at 4-6% of GDP in 2006-2008 and slightly lower in 2009-2010. More fiscal discipline is needed in the coming years as annual grants from the US are expected to be lower than in the past. The current account deficit (including grants) was unsustainably high at 21% of GDP in 2008 and 16% in 2009 and is unlikely to improve much in 2010-2011. External debt has risen from a low 15.2% of GDP in 2004 to a more worrisome 37.7% in 2009 (10.7% government debt on concessional terms, 22.6% public enterprise debt, 4.4% private sector debt). Transfer and convertibility risk is relatively low, though, thanks to the US dollar being legal tender.

The Structural Business Environment is adequate, but below average in our assessment overall and information is incomprehensive. The banking sector is dominated by foreign bank branches and has weathered the global financial crisis relatively well, but regulation and supervision can be further improved.

**Dr. Manfred Stamer**

**Hamburg: +49 (0)40 8834 3607**