

**Joint Annual Report**

**2003**

**European Commission/**

**Republic of PALAU**

## **1.. Executive Summary**

Article 5, Annex IV of the Cotonou Agreement requires that the National Authorising Officer and Head of Delegation shall annually undertake an operational review of the indicative programme and, within 30 days of completion of review, draw up and submit a report to the Development Finance Committee.

This joint annual report for 2003 fulfils this reporting requirement.

The Country Strategy Paper and National Indicative Programme (NIP) for the Republic of Palau were signed in Koror on 6<sup>th</sup> September 2003.

The NIP provides for an indicative financial allocation of € 2 m for the "A" Envelope, and € 0.6 m for the "B" envelope. The focal area of EC-Palau cooperation is the energy sector, to which 85% of the A envelope (€ 1.7m) is to be allocated ; a further programme (€ 0.3m), also in the field of renewable energy, is to be implemented by Non-State actors.

The preparation of project proposals to be financed under the Cotonou Agreement began in 2003 and the status of proposals in the focal and non-focal sectors by end 2003 was as follows :

In the latter half of 2003, a draft Financing Proposal of the proposed focal sector programme on Energy (covering 5 of the new PACP countries, including Palau) was developed, in concert with beneficiary countries and with the Forum Secretariat (which is to manage the project). The Financing Proposal was expected to be reviewed by the EDF Committee in the second half of 2004, and implementation expected to begin in early 2005.

A Draft Financing Proposal for a programme to be implemented by non-state actors - which by agreement with the Government of Palau also focuses on renewable energy - was in preparation at the end of 2003, with the expectation of approval and implementation by end-2004.

## **2. The Republic of Palau's National Policy Agenda**

### **2.1 National Objectives**

In 1996, a National Master Plan was developed establishing the framework and policies for the pursuit of sustained economic and social development over a 25-year period. The main long-term development objectives of the Master Plan are summarised as follows:

(i) a substantial shift in economic activity from the public sector to the private sector aimed at increasing productivity and efficiency of the resource use; (ii) strengthening of government institutions to improve co-ordination of the decision making processes while, at the same time, reducing the relative size of government; and (iii) identification of financing strategies, including tax reform, to offset the decline in US assistance over time.

Within the framework of the Master Plan, a five-year National Development Strategy was adopted with the emphasis on infrastructure development and other capital investment.

The Government's vision, goals, macroeconomic framework and related development strategies are set out in the National Master Plan, the key elements of which are:

**Vision:**

*To substantially enhance the quality of life of Palauans and future generations of Palauans.*

**Goals:**

- increase real economic growth per capita on a sustained basis;
- share the benefits of economic growth on an equitable basis, in ways that reward enterprise, risk taking and hard work, and allow foreign workers and investors a genuine stake in development;
- enrich and enhance confidence in the Palauan culture, raise national consciousness, and protect the natural environment.

**Macroeconomic Framework and Development Strategies / Key Macroeconomic Policy**

*To establish a stable, predictable and internationally competitive macroeconomic environment for private investment; financing of government expenditures; and sustained economic growth.*

Development strategies focus on the following areas: fiscal management, the labour market, foreign investment, taxation and charges, and the financial sector.

### **3. ANALYSIS OF THE POLITICAL, ECONOMIC AND SOCIAL SITUATION**

#### **3.1. Political situation**

Palau is a constitutional government, in free association with the USA, and a market-based democracy modelled after the U.S., although the traditional communal system remains strong. It has a tripartite form of government comprising an executive, legislative and judicial branch.

Though a fundamentally politically stable and peaceful country, 2003 was a troubled year in many ways for Palau, with its tourist industry rocked by the SARS crisis and incidents of political tension and unrest, including a riot by more than 200 mainland Chinese garment factory workers, left stranded in Palau by their unscrupulous employer for several months without pay or return tickets.

##### **3.1.1. Democratic participation**

Palau has a modern democratic form of government. Although traditional values remain strong, it is not the case that high office is held only by traditional leaders. Opportunities therefore exist for the general populace to participate in governance and the decision-making process.

### **3.1. 2. Human Rights**

Palau has a good record in terms of human rights. All the essential freedoms of speech, expression, association etc. are enshrined in the constitution.

### **3.2. Economic and social situation**

The Republic of Palau is an island nation located in the North Pacific Ocean south-east of the Philippines. The total land area is 458 km<sup>2</sup>. The country comprises over 200 islands of which Babeldaob (272 km<sup>2</sup>) the largest. Only nine of Palau's islands are inhabited. The Exclusive Economic Zone is 600,900 km<sup>2</sup>.

The population of about 20,000 comprises Palauans (70%), Asians (28%), and Europeans (2%). The annual population growth rate of 2.1% reflects an influx of foreign workers and an outflow of Palauans to neighbouring countries and the USA. The bulk of the population (70%) resides on the main island of Koror, which is also the centre of government and formal employment. Further development of Koror is constrained by its small size. To ease overcrowding, Babeldaob, the largest island with one quarter of the population, is being developed as the new capital and centre of government. It is also the location of Palau's international airport. The development of Babeldaob as the capital of Palau is enshrined in the 1981 Constitution.

#### **3.2.1. Economic situation, structure and performance**

From 1947 until 1994, Palau was part of the UN Trust Territory of the Pacific Islands (together with the Marshall Islands and the Federated States of Micronesia), administered by the USA. In 1994, Palau signed a 30-year political, strategic and economic treaty with the USA, known as the Compact of Free Association, marking its accession to independence. Palau remained within the US monetary system and the currency of Palau is the US dollar. Under the Compact, Palau conducts its own domestic and foreign affairs (while the U.S. retains control of defence and security matters, and exclusive strategic access to Palau's waterways), and receives grants totalling more than \$500 million over a fifteen-year period to 2009. \$70 million has been set aside in a Trust Fund (which is now more than double the original deposit) for use after Compact grants cease in 2009.

As a small Pacific Island State, Palau faces many constraints to development that are similar to those of other Pacific Island economies. These include a narrow resource base, geographical isolation, a small domestic market, vulnerability to natural hazards and external shocks, as well as a lack of infrastructure and skilled labour. These factors, combined with a high dependence on external aid, have developed the government sector as one of the major factors of the economy.

The economy consists primarily of tourism, subsistence agriculture and fishing. The government is the major employer of the workforce, relying heavily on financial assistance from the U.S. Business and tourist arrivals numbered 50,000 in 2000/01. In 2000, the public sector accounted for about 22% of GDP, an increase of 3.5% over the 1990 figure. Government is currently the major provider of infrastructure, services and employment. Other services, including trade, hotels and restaurants, transport and communications account for about 51% of GDP, almost twice as much as in 1990, driven by a strong growth in trade and

tourism-related services. Financial services have also shown strong growth over the decade, from 8.4% of GDP in 1990 to more than 12% by 2000.

Economic growth in 2003 was very modest, however (1%), due partly to the effects of the SARS crisis on the country's biggest revenue earning sector, tourism. For a time the airport was closed to visitors from Taiwan – the second biggest tourism market – and the fear of travel generated in the main Japanese market by the SARS scare. (Visitor numbers in Palau are usually some 60,000 annually – three times the number of the country's population).

The main economic challenge facing Palau is to ensure the viability of its economy by reducing its considerable reliance on foreign assistance. The establishment of a Trust Fund. (see above) to be drawn on after the scheduled end of Compact funds in 2009 constitutes a step in that direction.

#### **Economic data**

GDP (2003)	: US \$122m
ODA and Official aid (2003)	: US \$ 34m
EU exports to Palau	: € 3m (principally machinery)
EU imports from Palau	: € 15,000 (principally plants, flowers, fish, pearls)
Main export commodities	: shellfish, tuna, copra, garments
Main industries	: tourism, craft items, garment making

#### **3.2.2. Social aspects**

Palau's GDP/per capita in 2003 was US \$6,280, one of the highest among the Pacific Island countries. Life expectancy at birth averages 69 years (64 for men, 74 for women), the infant mortality rate is low (15.7 deaths per 1,000 live births) and literacy is universal.

All Palauans have universal access to free education and health provision, a right which is enshrined in the Constitution. Palau has relatively high levels of education, sanitation, and public health services, which have been instrumental in bringing many communicable diseases under control. However, with changing lifestyles and dietary patterns, Palau is now experiencing higher rates of non-communicable diseases (cardiovascular and hypertension-linked diseases, obesity and cancer) that create new challenges for public health and curative services. A growing challenge is to design and implement effective health promotion and information campaigns with adequate financing mechanisms that focus on preventive rather than curative care to reduce the incidence of lifestyle diseases.

In recent years the quality of education has deteriorated as a result of the enactment of a mandatory 30-year service retirement law which led to the loss of experienced teachers and a shortage of qualified and experienced successors.

#### **3.2.3. Structure of the public sector and recent developments**

The public sector's contribution to GDP increased by 3.5% throughout the 1990s, and government remains the major employer of the workforce, with some 75% of employees funded by the state.

### **3.3. External Environment**

#### **3.3.1. Balance of payments**

No information available.

#### **3.3.2. Merchandise Trade**

Palau has a permanent trade deficit, with the value of imports averaging some ten times that of exports. The fall in imports in 2003 reflected lower grant-financed capital expenditure.

### **3.4. Sustainability of Current Policies**

#### **3.4.1. Economic development**

Despite its relatively high GDP/capita rate (higher than many other Micronesian countries), Palau's economy remains highly dependent on external assistance. A Trust Fund has been established to assist Palau in its social and economic development when scheduled Compact funds end in 2009 which, if properly managed, will form a basis for the sustainability of current development policies. Tourism is a sector with greater development potential, but – as the events of 2003 have demonstrated – future over-reliance on tourism for government revenue could be a risky strategy.

#### **3.4.2. Unemployment**

Unlike many Pacific Island countries, unemployment is not an area of undue concern, with the present rate standing at only 2.3%.

#### **3.4.3. Gender issues**

Women in Palau have traditionally enjoyed a high social status and equality with their male counterparts. They enjoy full equality under the Constitution and have guaranteed access to a full range of health services and education. Younger women are now equalling or surpassing men in educational achievement and receive a greater share of post-secondary grants and loans. Women are also achieving high rank in the public service. Women select the male heads of clans.

#### **3.4.4. Environment**

Compared to many other Pacific Island countries, the environment in Palau is in relatively good condition, although the impact of tourism and climate change on the environment is growing. The success of the tourism industry is closely related to the country's unspoilt environment, specifically as regards the marine resources, and the utilisation of several dive sites is already considered beyond their absorption capacity. Further degradation of these resources will suppress the long-term development potential of the tourist industry. Effective

site management plans are therefore required to ensure that the integrity of the marine and land environments is maintained for future generations. (see also Environment Profile in Annex).

Waste management, however, is a serious concern. The rate at which solid waste and sewerage are generated exceeds the country's absorption capacity. With the current extensive development of public infrastructure on the island of Babeldaob, watershed protection and conservation is of the highest concern and may require restrictions to land use to protect fresh water resources.

#### **3.4.5. Governance : Sound Development Management**

Compact assistance is scheduled to last for another 5 years, but in order to advance the cause of economic self-reliance, it is vital that the authorities implement policies capitalising on the potential for economic growth. This is likely to involve a degree of privatising of areas at present in the public sector and, more generally, to continue to create an enabling environment for private sector development.

### **4. OVERVIEW OF ONGOING COOPERATION IN THE REGION**

The 9<sup>th</sup> EDF Regional Programme foresees an allocation of €29 million and includes three focal sectors "Economic Integration and Trade" (€9 million), "Human Resource Development" (€8 million) and "Fisheries" (€5 million) and €7 million for a non-focal sector, destined for the extension of a number of 8<sup>th</sup> EDF programmes to the 6 new ACP countries, including RMI. The Regional Programme was signed in 2002 by Commissioner Poul Nielson, during his first visit to the Pacific.

- "Regional Economic Integration Programme" (REIP) - €9.2 million

The programme aims to assist the region in strengthening its capacity to implement PICTA (the proposed free trade area among the Pacific island countries), negotiate trade agreements with developed partners (e. g. an Economic Partnership Agreement with the EU) ; to participate in multilateral trade negotiations (WTO) and to assist the private sector in addressing supply-side constraints.

The EDF approved the programme at its November 2003 meeting and at the end of the year the Financing Agreement (FA) had been finalised. The FA was scheduled to be officially signed by the RAO and by the Commissioner during the latter's visit to Fiji in February 2004.

- "Human Resources Development" (HRD) – PRIDE programme - €8 million

The objective of the programme is two-pronged: to assist Pacific island countries (PICs) in developing a sector-wide strategy for Education and subsequently to finance the implementation of some parts of that strategy. Most PICs have identified Education as a focal sector in their National Indicative Programmes, and a number of other donors are very active in the sector in all of them. Therefore, the parts of the strategies that have a more national character will be implemented with national funding (both governments' own resources and that of donors) and those that have the capacity to be shared by the region can be selected for funding by this programme. The programme is implemented by the Institute of Education of the University of the South Pacific (USP).

The Financing Proposal was finalised in 2003 and approved by the EDF Committee in September. Both the Financing Agreement and Contribution Agreement were signed in Suva in November 2003.

A very positive development occurred during 2003: at the invitation of the Pacific Island Countries, led by Samoa, and with the consent of the Commission, NZAid agreed to provide funding for PRIDE, to the tune of NZD 5 million for three years, with the possibility of additional funding after that. This allowed USP to proceed with the recruitment of the project management team during the second half of 2003. At the end of the year all but one element of the team have been selected and all have either ACP or EU nationality. USP is also finalizing works in the PRIDE office building. The team will start working in February 2004.

Implementation of this programme went faster than expected: implementation had been forecast to start in early 2004, but at the end of 2003 almost all the team has already been selected and works in the office were almost completed.

- "Fisheries" - €5 million

Two programmes are being funded in this sector :

- a) Extension of PROCFISH to the 6 new ACPs - €1.997 million

The complementary Financing Proposal was approved in late 2003, and the Financing Agreement was to be signed in February 2004, during Commissioner Nielson's visit to Fiji, for immediate implementation (cf. 8<sup>th</sup> EDF, below, for further details on PROCFISH).

- b) DEV FISH, a programme to be managed by the Forum Fisheries Agency (FFA) in collaboration with the Secretariat of the Pacific Community (SPC) - € 3 million

The objective of the programme is to increase the benefits received by PICs from sustainable use of marine resources, by increasing the capacity of PICs to directly participate in the tuna fishing and processing industry, and reinforcing national and regional policies and strategies for the sector.

By end-2003, the Financing Proposal was being finalised by EC headquarters, with a view to a decision by mid-2004. Implementation should start immediately after.

- Non-focal sector - € 7 million

The non-focal sector is composed of extensions of existing programmes to the new 6 ACP countries, and support to the Palau Festival of Arts:

- a) All extensions refer to the participation of the 6 new ACP countries (Cook Islands, Federated States of Micronesia, Nauru, Niue, Palau and the Republic of the Marshall Islands), which cannot benefit from 8<sup>th</sup> EDF funding, in projects/programmes recently approved and financed under the 8<sup>th</sup> EDF. Three extension proposals were approved during 2003 and one other is being finalised, as per the table below.



PROJECT	EURO Millions	EDF SOURCE	STATUS
SPC/DSAP ext.	1.981	9th NF	Approved. FA signed by Com. Nielson in Feb 2004
SPC/PPP ext.	1.512	9th NF	Approved. FA signed by Com. Nielson in Feb 2004
SOPAC ext.	2.55	9th NF	Approved. FA signed during the first quarter of 2004
SPREP/PIEN ext.	0.56	9th NF	being finalised by HQ in view of a decision by mid-2004

b) The Palau Festival of Arts is a co-financing project with the Pacific OCT, consisting of € 330,000 from the 9<sup>th</sup> EDF RIP (including balances of previous EDFs, transferred into the 9<sup>th</sup>) and € 250,000 from the OCTs. The RIP part will finance the purchase of sound and light equipment, its installation and the training of Festival staff for its operation. The OCT part will finance accommodation, local transport and catering for the participants from the French Pacific territories. The Festival will take place in Palau in July 2004 and the organisation wanted to start tendering for the sound and light equipment in November 2003.

The Financing Proposal was presented to the Delegation in May 2003 and, after further processing, to AIDCO at the end of the same month. Changes in staff in EC headquarters and difficulties in coordinating funding from different sources resulted in serious delays to the programme. Approval was expected at the end of the first quarter of 2004.

#### 4.1 NIP Focal sectors

##### 4.1.1 9<sup>th</sup> EDF NIP Focal sector - Energy (€ 1.7m)

Following discussions between the EC and the Government of Palau on the implementation of the proposed focal sector programme, the Delegation proceeded with the drafting of a Financing Proposal for the interventions in the renewable energy sector. Agreement on the final Financing Proposal was sought from the five NAOs involved in December 2003, since the programme is to be implemented at a sub-regional level, together with FSM, Nauru, Niue and Marshall Islands. The Financing Proposal is expected to be presented to the EDF Committee in the second half of 2004, with a Financing Agreement signed soon thereafter.

#### 4.2. Other programmes

##### NSA Programme "Palau Renewable Energy Programme" (€ 0.3m)

Following discussions between the Delegation and Non-State representatives in Palau, a draft Financing Proposal aimed at enhancing and expanding community-based activities in the field of renewable energy was developed, to be submitted for approval in the first half of 2004. The project was expected to begin implementation in the latter half of 2004.

## 5. Programming perspectives for the following years

9 <sup>th</sup> EDF NIP	2004	2005	2006	2007	2008
<b>Commitments (in € million)</b>					
Energy Programme (€ 1.7m)	1.7				
NSA programme (€ 0.3m)	0.3				
<b>Disbursements (in € million)</b>					
Energy Programme		0.4	0.7	0.4	0.3
NSA programme		0.075	0.125	0.075	
<b>Total (cumulative)</b>	<b>2.0</b>	<b>0.475</b>	<b>0.825</b>	<b>0.475</b>	<b>0.2</b>

## 6. 2003 Annual Operational Reviews – specific themes

6.1 The speeding up of the use of previous EDF resources  
(As a new ACP State, this is not applicable to Palau).

6.2 Setting indicators and targets for measuring poverty reduction, and results in focal sectors

6.2.1 Indicators for measuring poverty reduction

No information available.

6.2.2. Indicators for measuring results in focal sectors

Indicators to measure results of the focal sector programme would include the number of renewable energy initiatives running in the country and/or the share of energy consumption derived from renewable sources.

6.3. Dialogue in-country with the Office of the NAO and non-State actors

Dialogue in-country with the NAO has been necessarily relatively limited, given the great distance between the Delegation responsible for Palau (the Fiji-based Delegation) and the Palauan capital, Koror, some 6,000 kilometres and several flying days apart. The proposed opening of an EC Office in the neighbouring Federated States of Micronesia, scheduled to take place in 2004, should greatly facilitate EC-NAO in-country dialogue in future.

In general terms the present government has shown a welcome readiness to encourage funding for Non-Governmental organizations. The NIP includes a component for NSAs (15% of the A envelope), which has been allocated for community-based projects to be implemented by non-state actors. Good NSA contacts have been established by the Delegation with NSA representatives in Palau.

## 7. Conclusions

*(a one-page resume of the foregoing, to be written when the full text is completed and agreed)*

## **Republic of Palau : Country Environmental Profile**

### **Land**

The Republic of Palau, an archipelago of over 300 high and low islands, is the most western of the Caroline Islands group of the south-western Pacific. Palau's total land area is 188 square miles. The islands of Palau are diverse in geological origin and formation. Though many of Palau's food resources are found in the sea, food production from land will remain significant. Soils need to be managed properly and not be allowed to degrade as this will constitute a constraint not only to agriculture but also to marine resource management.

### **Water**

Palau has freshwater resources. The only sustained stream flow is found on the large volcanic island of Babeldaob. Other surface water resources exist in the form of fresh water lakes and ponds.

### **Climate and Forestry**

The climate is described as maritime tropical rainy. There is little seasonal variation in temperature.

### **Marine**

Palau is endowed with a high level of diversity and abundance of marine resources which historically have provided one of the most important food sources for the population. Many of the perceived opportunities for increasing economic self-sufficiency in the country focus on the utilization of resources which are directly or indirectly dependent upon the coastal marine habitat. As a relatively small island nation, Palau has a very limited amount of such habitat. It is therefore important that inputs to the coastal marine habitat be quantified and monitored. Some aspects of marine tenure and traditional conservation measures do remain valid in Palau. Chiefly decrees continue to be issued to ban harvesting from certain areas or of certain species.

### **Minerals**

Mineral resources, like lithosols, were found in Angaur and Peleliu and contained substantial reserves of phosphate which were mined during the German and Japanese Administrations. At present, only gravel, soils, sand and corals are mined or dredged.

### **Tourism**

Three major resource areas having potential for sustainable economic development are tourism, marine resources and agriculture forestry. Palau's economic future depend on these and without environment protection and proper conservation measures, Palau's natural resources will be depleted sooner than otherwise. Tourism is now being used to introduce people to and educate them about the unique marine and terrestrial ecosystems of the Palau archipelago. Studies show that, with proper forethought and planning, Palau can develop a tourist industry which is dependent on, but which also works to sustain, the beauty of the natural environment, and the cultural heritage and quality of life of the people of Palau.

**Waste Management**

The safe disposal of solid waste is likely to become a major problem if control measures are not established. The changes being experienced, including rapid growth in tourism and population, increased availability of imported consumer products and an increase in the number of industrial type activities, mean that the potential exists for serious problems to develop in the future.

**Environmental Management**

In recent years, there has been a growing realisation of the need to develop and implement environmental management strategies to guide the small island nations of the Pacific towards a development path which is more sustainable. In Palau, environmental management and sustainable development is supported by the fact that development prospects in the Republic are based largely on the development of natural resources – environmental tourism, forestry and marine resources. A general overall requirement for the management of marine resources is to address the problem of overlapping or indistinct jurisdictions and responsibilities. The costs and benefits of developments must be accurately weighed and the projected outcome of economic returns specifically evaluated.