INTERNATIONAL MONETARY FUND

WEST BANK AND GAZA

REPORT TO THE AD HOC LIAISON COMMITTEE[1]

September 6, 2018

KEY ISSUES

Deepening rifts between key stakeholders and surging violence in Gaza further imperil prospects for peace. Protests in Gaza ahead of, and turbulence since, the Nakba day and relocation of the United States' embassy to Jerusalem in mid-May, mark the most serious escalation since the 2014 war. Relations between the parties have hardened, amid a spate of new laws in Israel. The Palestinian Authority has expressed skepticism about the U.S. role as a neutral arbiter in the peace process. The domestic political situation remains tense and reunification plans have stalled.

The outlook is increasingly untenable. Longstanding constraints continue to act as a brake on growth, aggravated by large aid cuts and revenue losses. Gaza is suffering disproportionately, with its economy shrinking and unfolding humanitarian catastrophe. Overall GDP growth is projected to languish below 2 percent per year. The intended withholding of clearance revenues under new Israeli legislation will seriously undermine the already fragile fiscal situation. Large external imbalances will persist as restrictions impede development and add to vulnerabilities. Weaker growth and demographic pressures will substantially worsen unemployment, poverty, and per capita incomes.

The overriding challenge is to revive growth and alleviate poverty in the face of shrinking resources. More than ever this will depend on the Palestinian authorities, Israel, and donors coming together to ensure a comprehensive approach to reforms. The priority is to implement adjustment measures that help protect critical public service delivery, social spending and investment, and avoid a disorderly expenditure rollback disruptive to growth. Reforms to strengthen the fiscal framework and public institutions will help achieve this objective, promote public accountability, and reassure donors that resources will be well spent. Faster progress to systematically reduce "fiscal leakages"—based on fair and transparent discussions between the Israeli and Palestinian authorities—will be imperative. Stronger action to avert a build-up of financial sector risks and maintain correspondent banking relations will be essential to preserve financial stability and ensure banks can support economic activity. Finally, steps to shore up economic institutions, together with actions to ease restrictions on movement and access, will be crucial to stabilize Gaza and revitalize the overall economy's capacity to grow.

[1] The IMF provides technical services to the West Bank and Gaza, including policy advice in the macroeconomic, fiscal, and financial areas, as well as technical assistance, with a focus on tax administration, public expenditure management, banking supervision and regulation, and statistics. See www.imf.org/wbg for recent reports.

Approved By
Juha Kähkönen (MCD) and Nathan Porter (SPR)

Discussions were held in East Jerusalem and Ramallah during July 8–19, 2018, and the report was updated to reflect subsequent developments. The staff team comprised Karen Ongley (head), Marwa Al Nasaa, Maria Atamanchuk, and Jean van Houtte (all MCD), Robert Tchaidze (IMF Resident Representative), and Hania Qassis (IMF Resident Representative Office). The mission met Finance Minister Bishara, Palestine Monetary Authority Governor Shawwa, Minister of National Economy Odeh, other senior officials, donors, and private sector representatives. The mission prepared a concluding statement and issued a press release. Alexander de Keyserling and Cecilia Pineda also contributed to producing this report.

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POLITICAL CONTEXT

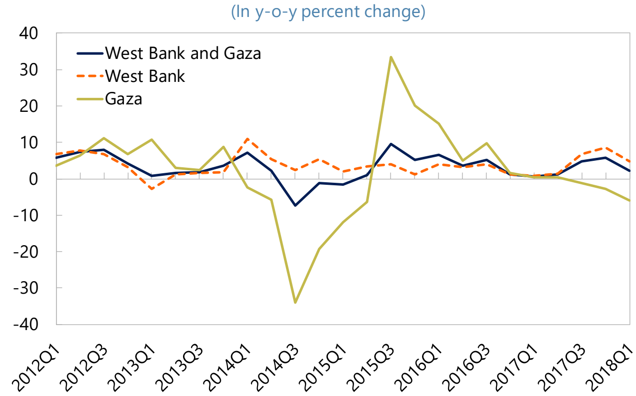
1. **Deepening divisions among key stakeholders and escalating violence in Gaza further imperil prospects for peace.** Protests in Gaza intensified in the run-up to events in mid-May—the Nakba day commemorating the 1948 exodus of the Palestinian population and the relocation of the United States' embassy to Jerusalem. The period witnessed the most serious escalation since the 2014 war, marred by sporadic rocket launches and incendiary kite attacks from Gaza, and military operations by Israel. A United Nations General Assembly resolution in June deplored the excessive and disproportionate use of force by Israel. Since protests began, more than 160 Gazans have died. Relations between the Palestinian Authority (PA) and Government of Israel (GoI) appear more fractured, with border closures and tougher restrictions, and a spate of legislation (e.g., withholding additional PA clearance revenues (CRs), denying Palestinians access to the Supreme Court). The PA remains skeptical of the anticipated U.S. peace plan and no longer views the U.S. as an honest broker. Meanwhile, a humanitarian catastrophe is unfolding in Gaza—electricity and clean water are in short supply, medical facilities are overwhelmed, and much of the population faces a significant loss of income.

2. **The domestic political situation remains tense.** Fatah-Hamas reconciliation is off-track and associated reunification plans, including contingency budgets and institutional mergers, have stalled. The PA continues to partially withhold payment of salaries and allowances to PA employees in Gaza. Intensified mediation efforts by the UN, Egypt, and others have yet to bear fruit. Hamas and smaller parties boycotted the May Palestinian National Council meeting (the first such meeting in 22 years), which elected a new Palestine Liberation Organization Executive Committee and re-elected President Abbas as chairman of the Committee.

RECENT ECONOMIC DEVELOPMENTS

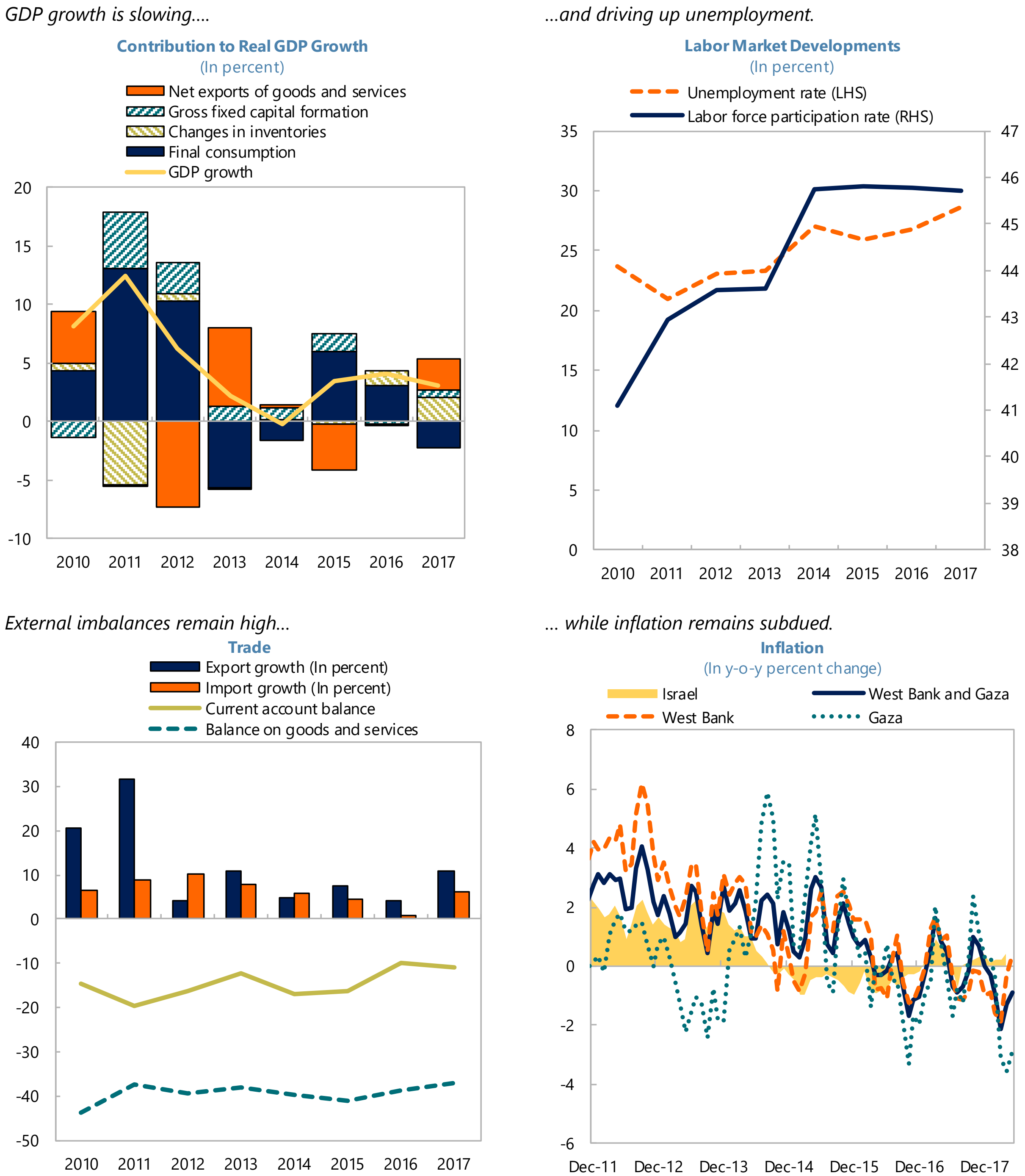
3. **Weak overall economic activity in WBG masks a much steeper decline in Gaza.** Real GDP growth across WBG slowed to 3.1 percent in 2017 and further to 2 percent in the first quarter of 2018, weighed down by declining activity in Gaza that reached -6 percent in 2018Q1. Reported real growth in the West Bank remained relatively buoyant at 8.4 percent in 2017Q4 and 4.8 percent in 2018Q1 YoY, supported by stronger activity in manufacturing, construction, and wholesale and retail trade. However, large unexplained residuals (including implied inventory accumulation) in recent quarters signal difficulties in fully accounting for growth in the West Bank.

Real GDP Growth
(In y-o-y percent change)



Source: Palestinian Central Bureau of Statistics.

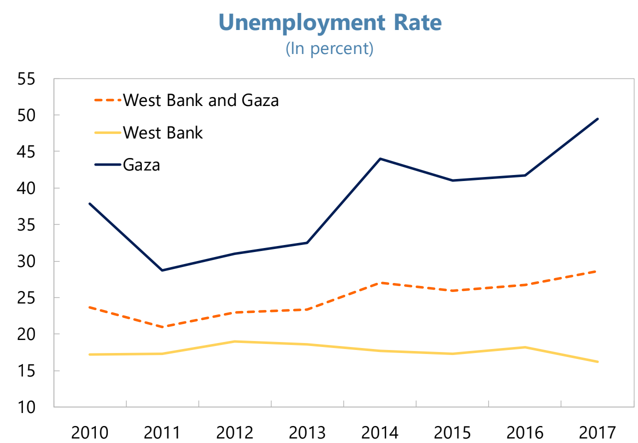
Figure 1. West Bank and Gaza: Recent Economic Developments, 2010–17



Sources: Palestinian Central Bureau of Statistics; and IMF staff estimates.

4. Inflation remained subdued in the first half of 2018, with the economy facing minor deflationary pressures as the price of some items declined (tobacco and alcoholic beverages). The continued appreciation of the shekel in 2017 and early 2018 also had a deflationary effect given the large share of imported goods.

5. Gaza continues to suffer disproportionately, with worsening unemployment and poverty. The unemployment rate in WBG has increased steadily in recent years, exceeding 32 percent in 2018Q2. While participation is low economy-wide, unemployment is much worse in Gaza, nearing 54 percent in 2018Q2 (compared to 19.1 percent in the West Bank) and with two-thirds of young people unemployed. The 2017 household survey (HHS) found that the poverty rate in Gaza increased since the 2011 HHS from 38.8 percent to 53 percent.[2] This worsened the overall poverty rate, despite an improvement in the West Bank. Moreover, people in Gaza suffer from much deeper poverty, with a "poverty gap"—the ratio between the average income of the poor and the poverty line—almost 6 times the level in the West Bank.



Source: Palestinian Central Bureau of Statistics.

6. Spending restraint averted a widening of the deficit in 2017 and first half of 2018.

- The authorities contained the overall fiscal deficit in 2017 to 8.1 percent of GDP (unchanged from 2016), as spending cuts offset a decline in revenues with the unwinding of one-off factors in 2016. In large part, lower spending reflected the retrenchment of PA personnel in Gaza and to a lesser extent in the West Bank, cuts to allowances for Gazan PA employees, and capping the electricity subsidy for Gaza.

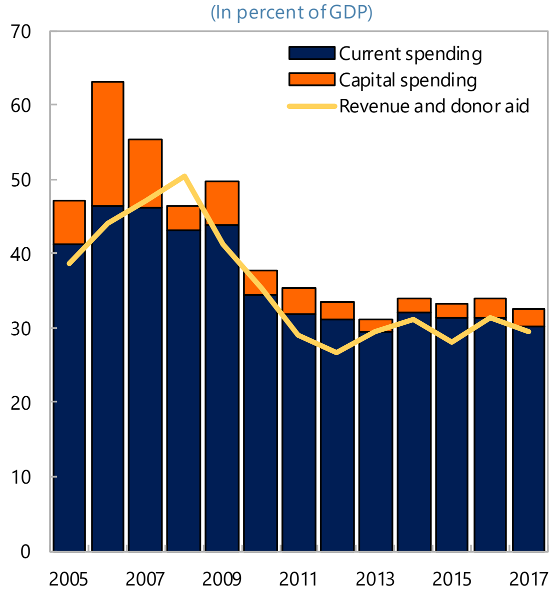
- This pattern continued in the first half of 2018, helping limit the overall fiscal deficit to almost 6 percent of GDP, slightly less than in 2017H1. The authorities reduced the wage bill by 17 percent YoY, through continued retrenchments and salary cuts in Gaza on top of previous cuts to allowances. Retrenchments triggered higher pension payments (up by more than 10 percent YoY), limiting the decline in total spending to 7 percent YoY. However, spending restraint helped to offset softening revenues. Marginally weaker revenues in 2018H1 reflected lower customs receipts (nearly -14 percent YoY) and CRs (-10 percent YoY), despite strong VAT and non-tax revenue (up nearly 22 percent YoY and 15 percent YoY, respectively).

[2] The Palestinian Central Bureau of Statistics defines the 2017 poverty line as NIS 2,470 for a household of five (2 adults and 3 children).

Figure 2. West Bank and Gaza: Fiscal Sector Indicators, 2005–17

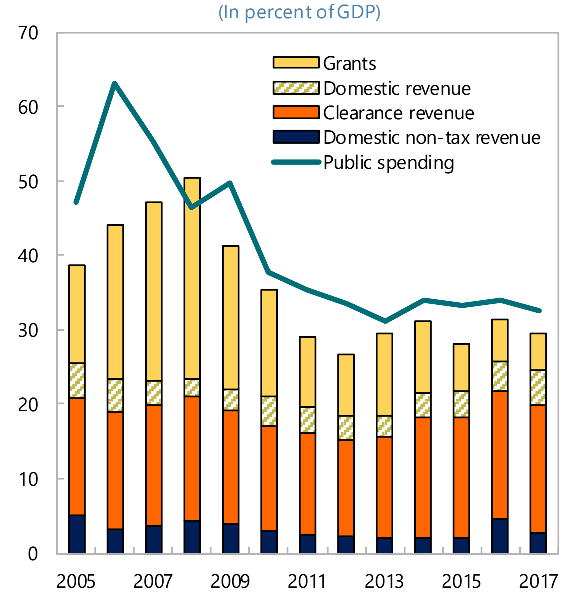
Expenditure restraint....

Expenditure
(In percent of GDP)



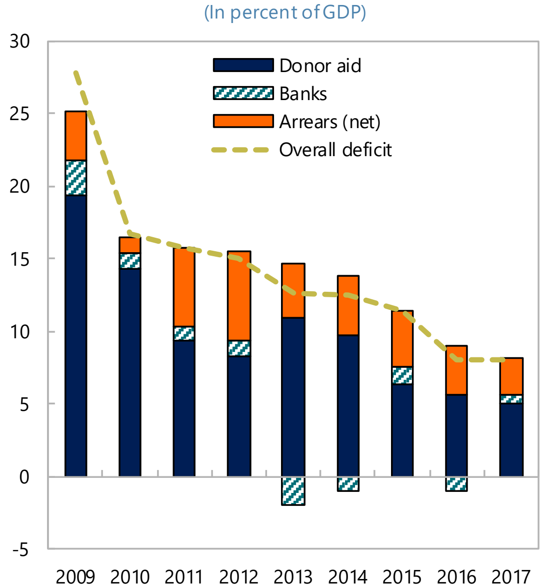
...has been offset by falling resources.

Revenue and Donor Aid
(In percent of GDP)



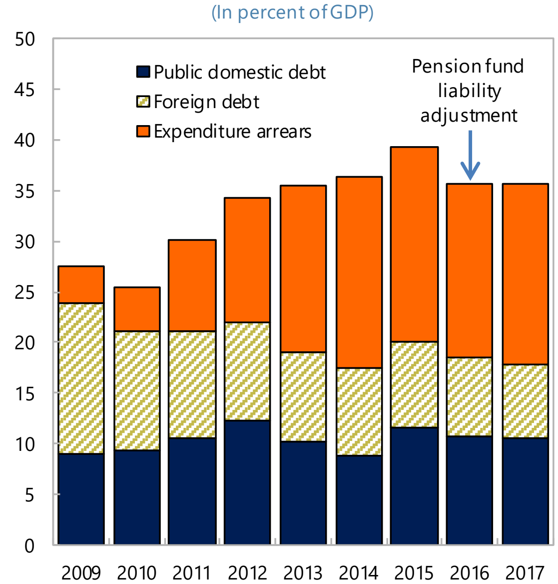
Financing is insufficient to prevent continued arrears...

Budget Financing
(In percent of GDP)



...which are keeping public debt high.

Public Debt
(In percent of GDP)



Sources: Ministry of Finance and Planning; and IMF staff estimates.

7. Nevertheless, shrinking financing saw the PA resort to arrears. The authorities refrained from additional bank financing, as net domestic bank financing turned mildly negative in the first half of 2018. At the same time, donor aid fell short of expectations in the absence of some key disbursements. With these pressures and continued efforts to clear existing arrears, the PA accumulated gross new arrears and the net arrears position deteriorated by 1.1 percentage points of GDP.

8. While the banking sector remains generally sound, the frail economy and fiscal position add to vulnerabilities. Banking sector profitability and liquidity remain comfortable, although have slightly declined over the past few years. Banks' overall exposure to the PA remains high, reflecting direct financing and indirectly via lending to PA employees and suppliers. With loan quality in Gaza weakening since the PA cut allowances for Gazan civil servants in March 2017, the Palestine Monetary Authority (PMA) helped steer a restructuring of affected loans in early 2018, representing about 5 percent of system-wide credit to the private sector. Credit concentration beyond exposure to the PA also remains an issue. Completing the PMA's requirement to replenish banks' capital buffers to a minimum of $75 million and progress toward implementing Basel III regulatory requirements are important steps to safeguard the banking system.

9. Israeli-Palestinian correspondent banking relations (CBRs) remain intact but strained due to diverging positions between the two authorities. The PA continues to prepare for a comprehensive evaluation of WBG's anti-money laundering and combatting the financing of terrorism (AML/CFT) regime, agreed with MENAFATF to commence in 2020. However, the Israeli authorities favor IMF involvement in the evaluation, ideally an IMF-led assessment, as a condition for actions to help maintain CBRs. The soon-to-be-completed National Risk Assessment (NRA), prepared with World Bank support, focuses on identifying key sector risks and recommendations to strengthen the regime ahead of the MENAFATF evaluation.

OUTLOOK AND RISKS

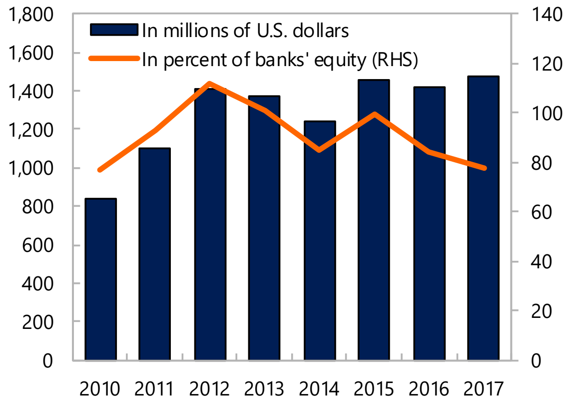
10. The economic outlook is precarious. The scarcity of productive capital, geographic fragmentation, and rigid external constraints show no signs of abating, and will continue to act as a brake on growth, aggravated by large aid cuts. The authorities emphasized that new Israeli legislation mandating the withholding of a substantial portion of CRs, commencing in 2019, will exacerbate the already serious fiscal financing strains.[3] Staff agreed, noting that the assumed forced accumulation of arrears will harm growth. On this basis, staff projects overall growth to languish at around 1½ percent in 2018–19, and only a fraction higher in subsequent years. The authorities have a slightly more optimistic view of the outlook, while they also acknowledge the high uncertainty.

[3] The new Israeli "Palestinian Prisoners Law" (promulgated on July 8, 2018) mandates withholding CRs of an amount equivalent to the GoI's estimate of PA payments to families of Palestinians imprisoned or killed for alleged terrorist offences under Israeli law.

Figure 3. West Bank and Gaza: Financial Sector Developments, 2004–17

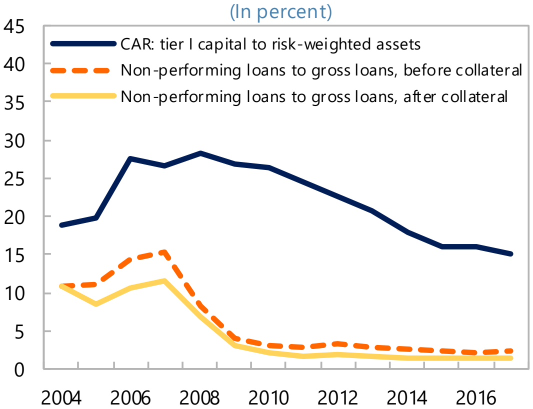
Banks' exposure to the PA remains high, but stable…

Public Credit



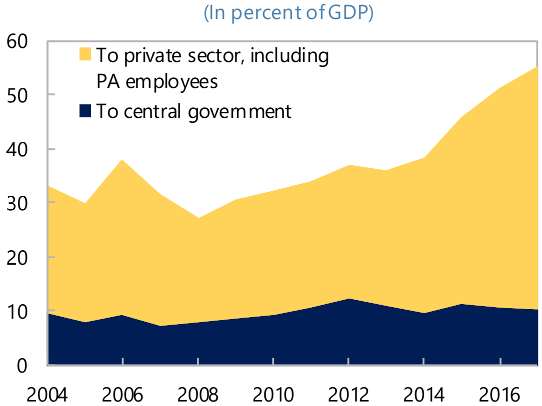
…while the decline in capital adequacy has slowed…

Capital Adequacy Ratio and Nonperforming Loans
(In percent)



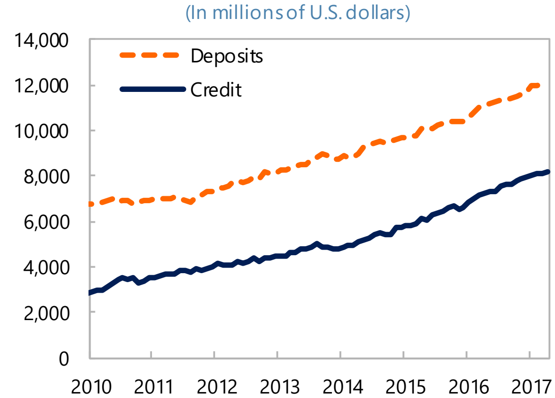
…despite credit to the private sector still growing rapidly…

Credit
(In percent of GDP)



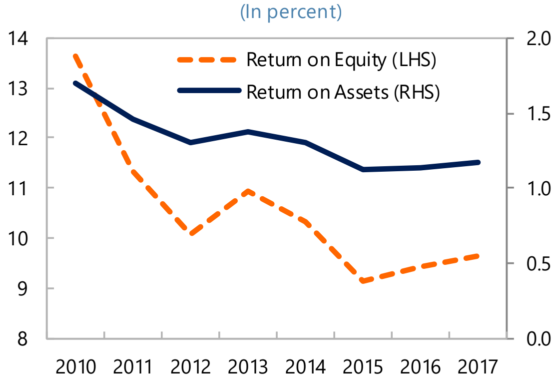
…financed by steady growth in deposits…

Deposits and Credit
(In millions of U.S. dollars)



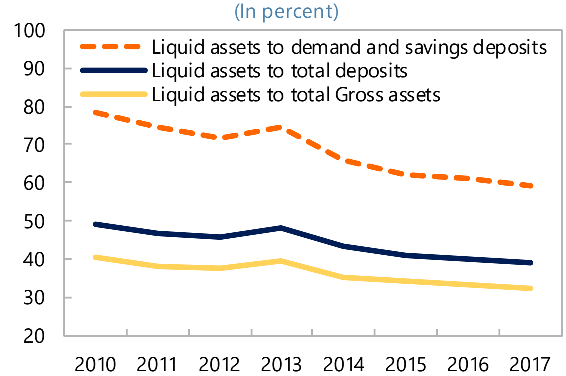
…while both profitability…

Profitability
(In percent)



…and liquidity have declined.

Liquidity
(In percent)



Source: Palestine Monetary Authority.

11. The increasingly untenable situation in Gaza is stifling the overall economy. The West Bank is projected to muddle through, growing by a lackluster 2.2 percent per year over the medium term. Yet, prospects for Gaza are even more fragile and uncertain. With large donor aid cuts prolonging the liquidity crunch, PA spending cuts, and tighter restrictions following recent unrest, Gaza's economy will likely contract further this year and next (-4 percent and -1.5 percent, respectively). Without a lasting change in circumstances, Gaza is unlikely to return to positive growth over the medium term. Population growth is expected to outstrip real growth (most severely in Gaza), substantially worsening unemployment, poverty, and per capita incomes.

12. Notwithstanding this sobering outlook, serious risks threaten the economy's longer run viability (Annex I). The longer the unhealthy income and employment dynamic persists, the greater the risks. Deteriorating socioeconomic conditions increase the possibility of large-scale unrest. The considerable loss of CRs exacerbates this risk due to the potentially adverse impact on public service delivery, PA salaries, and arrears accumulation. Additional inflammatory geopolitical developments, continued PA disengagement from Gaza, or larger-than-projected cuts in CRs cannot be ruled out. Further declines in donor support or disruptions to CBRs remain persistent risks. Unrest in and around Gaza may presage a deeper conflict that would intensify risks to the broader Palestinian economy. On the positive side, revived reunification efforts could help alleviate economic hardships and improve the outlook.

KEY POLICY THEMES

Old and new pressures—economic, social, and political—threaten to push the Palestinian economy into a downward spiral. The planned withholding of CRs puts the fiscal situation on the brink of unsustainability. Targeted measures and projects can be instrumental in stabilizing Gaza and averting a deeper collapse. However, putting both Gaza and the West Bank on a higher and more durable growth path that can improve the well-being of all Palestinians will require the PA, Israel, and donors to come together for a comprehensive approach to reforms and strengthening institutions. Policy discussions focused on measures the PA can independently adopt to address budgetary strains, preserve financial stability and alleviate constraints on growth. However, more than ever success depends on the complementary role Israel and donors can play, including alleviating longstanding external constraints on growth.

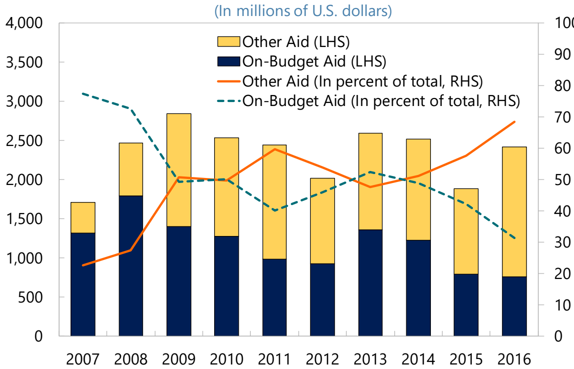
A. Policymaking in Fragility and Uncertainty

13. Arresting Gaza's decline will be vital to mitigate risks to the broader Palestinian economy. Staff shared their analysis of the widening performance gap between Gaza and the West Bank (Annex III). Stunted economic development left Gaza more vulnerable to recent shocks and undercut its future growth potential, with economic and social instability posing costs for the entire Palestinian economy. Priority humanitarian needs have crowded out donor support for the functioning of state institutions (Box 1), underscoring the challenge of finding sufficient resources to both meet essential humanitarian interventions and rebuild a functioning Gazan economy. The authorities acknowledged the potential for spillovers from Gaza, particularly via the banking sector, if further risks materialize (Box 2). Reducing insecurity and renewed political dialogue (namely, resuming reconciliation efforts) will be essential to stabilize Gaza's economy, lessen potential spillovers, and provide a basis for more effective economic policies. Progress on this front would help unlock donor support, particularly for scalable infrastructure projects in key sectors (water and energy).

Box 1. Trends in Donor Aid

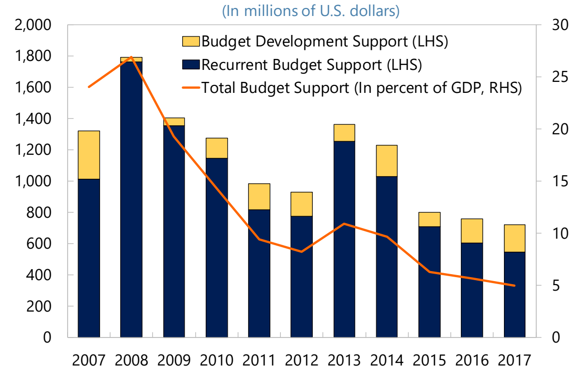
West Bank and Gaza has long been a large recipient of official donor aid. While overall donor support has remained at broadly similar levels over the past decade, it is increasingly being directed towards uses outside the budget. The corresponding decline in budget support, in both nominal terms and as a percent of GDP…

Donor Aid
(In millions of U.S. dollars)



Sources: Ministry of Finance and Planning; OECD; and IMF staff estimates.

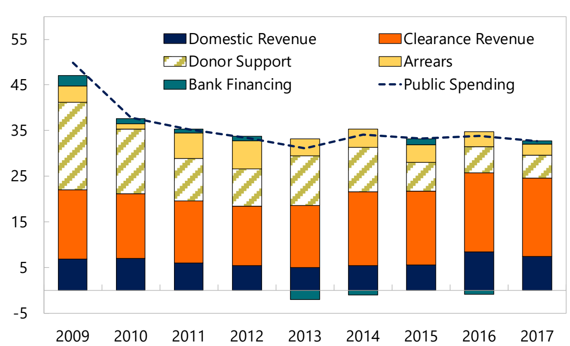
Donor Budget Support
(In millions of U.S. dollars)



Source: Ministry of Finance and Planning.

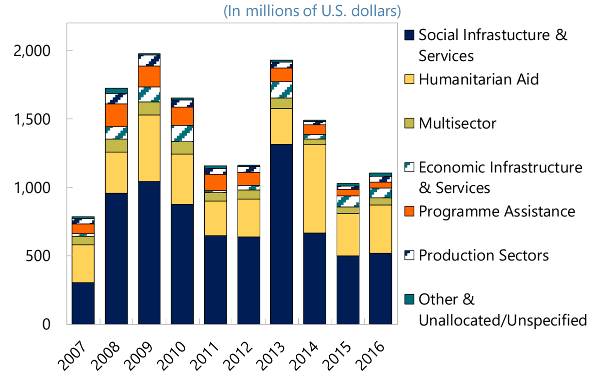
…has outpaced the authorities' efforts to reduce the budget deficit, necessitating the continued accumulation of arrears. At the same time, the distribution of aid from Development Assistance Committee donors, while not a complete picture, suggests that a large share of donor support to West Bank and Gaza goes toward humanitarian purposes—around one quarter on average since 2007. At a fundamental human level, these needs must take priority. Yet, the protracted nature of the crisis has meant fewer funds have been available to support investments in sustained growth and development (e.g. for economic infrastructure and services), which risks creating a vicious cycle of humanitarian needs.

Revenue and Donor Aid
(In percent of GDP)



Sources: Ministry of Finance and Planning; and IMF staff estimates.

DAC Bilateral ODA Commitments, by Purpose
(In millions of U.S. dollars)



Source: OECD.

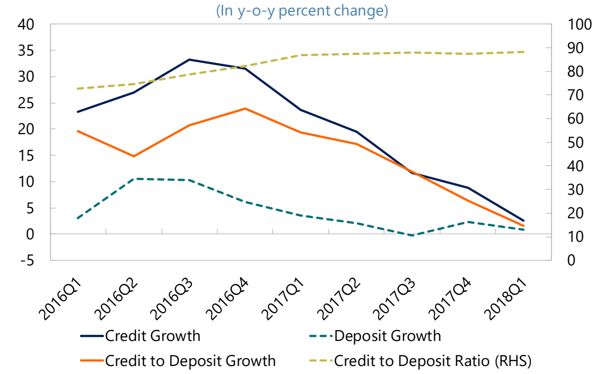
Prepared by Alexander de Keyserling.

Box 2. Economic Hardship in Gaza and Potential Spillovers to the West Bank

A decade of economic and political isolation has taken a toll on Gaza. In addition to the immense hardship and human suffering, the increasingly fragile economy[1] was particularly vulnerable to the recent drop in donor support and spending cuts by the PA. Although Gaza's isolation has eroded its commercial and trade ties with the West Bank, a further deepening of the economic hardships in Gaza could be transmitted to the West Bank economy through the still active banking sector connections.

The liquidity crunch in Gaza has seen a steady slowdown in deposit and credit growth. As economic conditions have become more difficult, households have increasingly relied on their personal savings to finance consumption. The resulting slowdown in deposit growth put upward pressure on the loan-to-deposit ratio, constraining banks' ability to soundly extend credit. Cuts to PA allowances starting in March 2017 exacerbated the situation, undermining the ability of PA employees to service their loans. With the weakening of borrowers' creditworthiness, banks are becoming increasingly cautious in extending new credit in Gaza. Cuts to PA wages from March 2018 could further reduce credit and deposit growth.

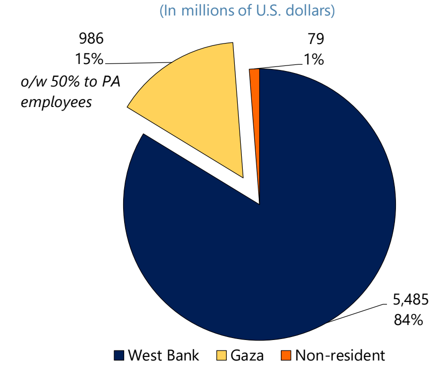
Gaza: Credit and Deposits
(In y-o-y percent change)



Sources: Palestine Monetary Authority; and IMF staff estimates.

The composition of credit in Gaza magnified banks' vulnerability. As of end-2017, around half of the nearly US$1 billion in credit extended by banks in Gaza was to PA employees. Cuts to PA employee allowances and associated risks to loan quality prompted banks to restructure US$350 million in loans, extending maturities from 5–7 years to 15–20 years. Although restructured loans account for only about 5 percent of system-wide credit to the private sector, restructuring could exert downward pressure on banks' profitability and increase the risk of maturity mismatches. With recent cuts in the UNRWA wage bill, credit to UNRWA employees (approximately US$70 million) carries similar risks.[2]

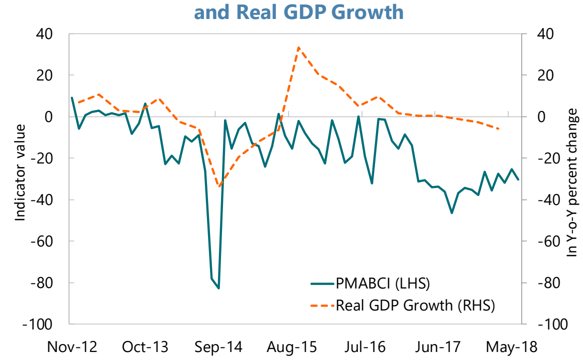
Credit to the Private Sector
(In millions of U.S. dollars)



Sources: Palestine Monetary Authority; and IMF staff estimates.

These banking sector developments might add to pessimism about production and employment prospects in Gaza. The PMA business cycle indicator[3] has been persistently weak in Gaza since early 2017, in keeping with the escalating fiscal and donor funding pressures as well as other adverse political and economic conditions. With more than 40 percent of credit in Gaza intended to finance consumption, banks' increasing reluctance to lend aggravates risks of decline in activity. The decline in demand for goods and services appears to be spilling over to retail and SME sectors, constraining their working capital and affecting their profitability, further undermining real sector growth.

Gaza: PMA Business Cycle Indicator and Real GDP Growth



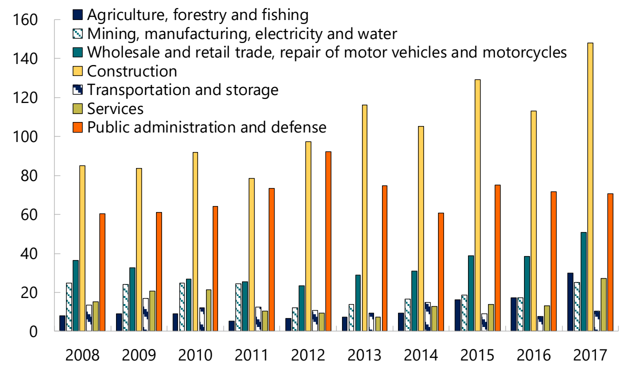
Sources: Palestine Monetary Authority; Palestinian Central Bureau of Statistics.

Box 2. Economic Hardship in Gaza and Potential Spillovers to the West Bank (concluded)

The West Bank is not immune to pressures in Gaza, particularly given the still active financial connections. The banking sector remains the main transmission channel of spillovers from Gaza into the West Bank, due to domestic banks' substantial exposure to both regions. With increasing fiscal pressures, and the banking sector's extensive exposure to the PA and PA employees, credit risks are on the rise, further depressing banks' appetite for lending. Anecdotal evidence points to an increase in risk aversion towards extending new credit and a potential pullback by banks in the West Bank. Sectors such as construction, wholesale and retail, appear to be highly dependent on credit. Slower credit growth could reduce output growth through these sectors.

Stock of Credit

(In percent of sector output)

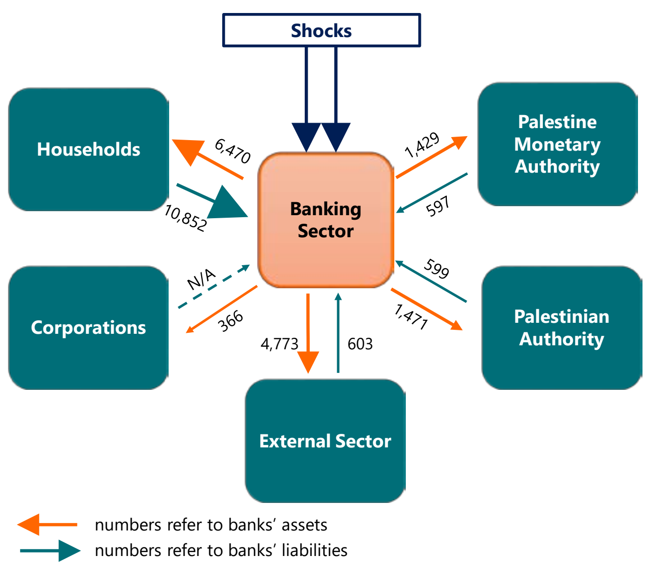


Sources: Palestine Monetary Authority; and IMF staff estimates.

Given the maturing role of the banking system in the WBG economy, spillovers from Gaza could have broader implications for the fiscal and real sectors going forward. The size of the Palestinian banking sector exceeds 100 percent of GDP and a partial balance sheet analysis reveals banks' strong linkages with the PA, private sector, and key segments of the Palestinian economy. Should risks to the banking sector materialize, including increasing NPLs and challenges with funding liabilities, it will negatively affect banks' asset quality and profitability, making banks more conservative with lending, and possibly seeking additional capitalization and financing. This could add to fiscal pressures and jeopardize the banking sector's ability to effectively support economic activity across both Gaza and the West Bank.

Banks' Intersectoral Links in the Palestinian Economy, End-2017

(In millions of U.S. dollars)



Source: Palestine Monetary Authority.

Prepared by Marwa Al Nasaa and Maria Atamanchuk.

[1] See Annex III, *West Bank and the Gaza Strip—Growing Apart*.

[2] In 2018, UNRWA voluntary contributions fell by $300 million. In July, UNRWA announced measures to address loss of funding, including non-renewal of 113 posts on emergency funding and conversion of 584 staff to part-time positions.

[3] The PMA's monthly PMABCI scores economic performance on a scale of -100 (weak) to 100 (strong).

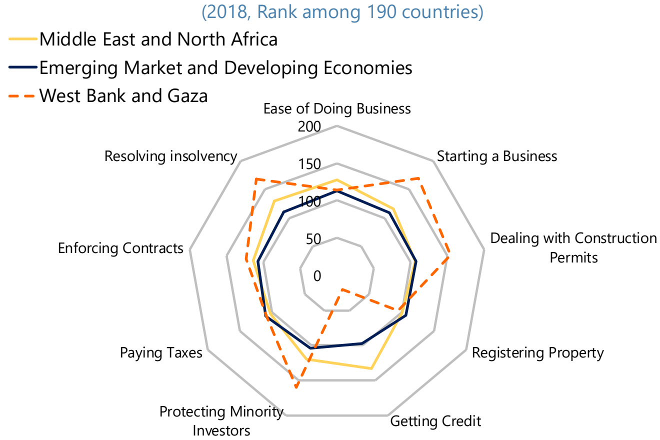
14. WBG's large and persistent external imbalances require a coordinated policy response. Staff presented its assessment of the external sector (Annex IV), with different methodologies pointing to an external position that is weaker than warranted by fundamentals and desirable policy settings. The persistently high current account deficit reflects lack of access to productive resources, and widespread obstacles to the efficient production and movement of goods. The sustained nominal and real effective appreciation compounds this situation, adding to the non-price factors that dominate competitiveness concerns. The magnitude of imbalances underscores the need to alleviate both internal and longstanding external constraints. While the Palestinian authorities can and should act to address internal constraints, many policy levers are wholly or partly in the hands of Israel as specified in the Oslo-related agreements (see Annex Table IV.3). The authorities noted that, in practice, how these agreements are implemented also impacts the efficacy of policies.

15. In this regard, external actions will be vital to enable sustained economic development. Improved economic prospects ultimately depend on reviving the peace process and a path toward a two-state solution. Even so, Israel can take steps to help improve WBG's productive capacity and external competitiveness, namely allowing economic activity in Area C, and easing restrictions (including the "dual use" list) to facilitate internal movement and access to international markets. Staff discussed the limited progress toward starting industrial zones, and operationalizing scanners and streamlining administrative procedures at the border. Given lack of access to financial markets and internal resource constraints, staff urged donors to continue to fulfill their pivotal role in WBG's development, including helping the authorities fill critical infrastructure gaps in Gaza, and promoting well-functioning public institutions (Box 3).

16. Notwithstanding limits on the policy toolkit, staff urged the authorities to take actions to alleviate internal constraints. WBG's 26 place jump to 114th on the World Bank's 2018 Ease of Doing Business index showcases what is possible. The authorities agreed, pointing to the newly adopted Secured Transactions Law and collateral registry that facilitate SMEs' access to finance as accounting for the improvement in "getting credit" in 2018. Staff noted that the other sub-indices provide a guide to areas where there is most scope for improvement. The authorities emphasized that the Companies Law and drafts of the Debt Settlement Law, Competition Law, and Consumer Protection Law recently submitted to Cabinet will help with starting a business, resolving insolvency, and protecting minority investors. The authorities are also working with the World Bank to improve the efficiency of construction permitting. However, the Ramallah-only coverage of the Doing Business indicators suggests that reform

Ease of Doing Business

(2018, Rank among 190 countries)



Sources: World Bank Doing Business (2018); and IMF staff calculations.

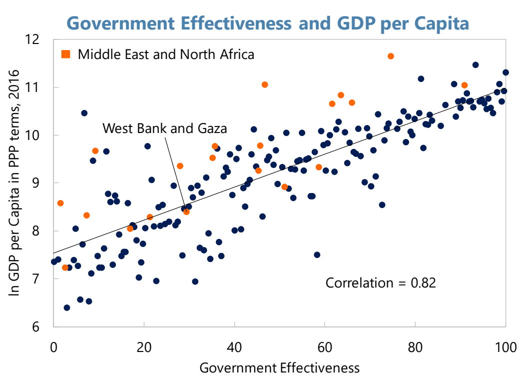
Box 3. Strong Institutions Matter for Growth

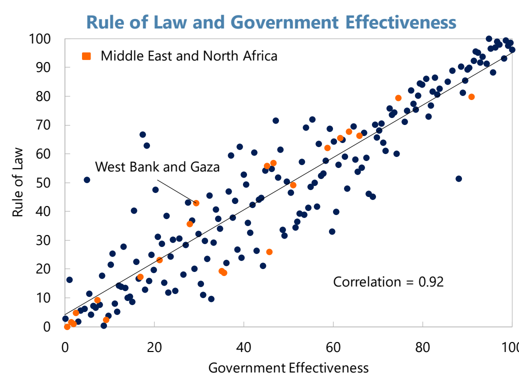
In the years since Oslo, the international community has supported efforts to build the institutional foundation for a future Palestinian state—for good reason. Research confirms that strong public institutions are critical to sustaining growth and improving living standards. Today, safeguarding and advancing that goal remains more important than ever. Robust public institutions will be crucial to successfully navigate the acute near-term fiscal and financial risks, and to complement donors' targeted interventions by ensuring the PA can continue to make effective investments in the sustained growth of the Palestinian economy.

Research emphasizes the importance of public institutions for economic development. Discussions of institutional strength often consider issues, such as property rights, political accountability, and governance (IMF, 2003). In this regard, institutions are among the key factors that are important for sustainable and inclusive growth (Mlachila et al., 2014; Rodrik et al., 2004). Similarly, Acemoglu et al. (2005) find that "differences in economic institutions are the fundamental cause of differences in economic development." While it is difficult to quantify the impact of changes in institutional quality on income and growth for a particular country, research suggests the effect is substantial (IMF, 2003; Góes, 2015).

Countries starting at lower levels of economic and institutional development can also benefit from "catch-up" effects. The prospect of convergence means that improving institutions can have the strongest impact in developing countries (IMF, 2003) or fragile states. This emphasizes merits of these countries putting institutional strengthening at the forefront of their efforts to promote growth and reduce poverty.

Strengthening public institutions can play a pivotal role in revitalizing WBG's stagnant economy. WBG continues to lag behind many countries in key governance indicators, including the rule of law and government effectiveness. To the extent countries with better government effectiveness tend to have higher GDP per capita (figures), continuing to strengthen these aspects of WBG's institutional foundation would help improve its economic prospects.





Sources: Worldwide Governance Indicators; and IMF staff calculations.

The international community can continue to play a key role in strengthening WBG's institutions. In the near term, reversing the decline in donor budget support can help limit arrears and avoid disruptions in public service delivery. Looking ahead, the goal is not to support open-ended spending commitments, but to support and incentivize institutional reforms that can improve the conduct of macroeconomic policies that will help promote sustained improvements in living standards.

Prepared by Maria Atamanchuk.

Sources: Dani Rodrik, Arvind Subramanian, Francesco Trebbi, 2004, Institutions Rule: The Primacy of Institutions Over Geography and Integration in Economic Development, *Journal of Economic Growth*, pp. 131–65; Daron Acemoglu, Simon Johnson, James A. Robinson, 2005, Institutions as a Fundamental Cause of Long-Run Growth, *Handbook of Economic Growth* (pp. 386–472); Carlos Góes, 2015, Institutions and Growth: a GMM/IV Panel VAR Approach, *IMF Working Paper 15/174*; IMF, 2003, Growth and Institutions, *World Economic Outlook*, pp. 95–128; and Montfort Mlachila, René Tapsoba, Sampawende J. A. Tapsoba, 2014, A Quality of Growth Index for Developing Countries: A Proposal, *IMF Working Paper 14/172*.

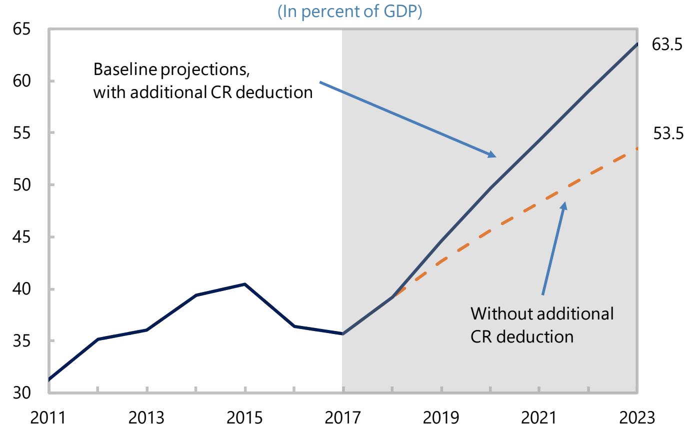
efforts should be mindful of the broader constraints, including the external factors noted above (e.g., the inability to register property in Area C). Going forward, the authorities should focus on strengthening the regulatory apparatus to enforce contracts, register property, and support effective infrastructure investments. Staff underlined the importance of a commercially viable electricity agreement with Israel, and investments in water supply and sewage treatment. With ongoing uncertainty and geopolitical strains, the authorities should prioritize institutional reforms to anchor effective fiscal and financial sector policies, and provide greater assurance of public sector accountability.

B. Securing Fiscal Sustainability

17. Staff welcomed the authorities' efforts to keep the budget on track, while noting the likely large financing gap for the whole year. The authorities pointed to difficult steps they have taken to contain spending, including retrenchments, while acknowledging the corresponding increase in pension liabilities. Staff projects the 2018 overall budget deficit to be largely unchanged at 8.3 percent of GDP. However, lower-than-budgeted donor budget support—possibly 10 percent lower than in 2017—will widen the financing gap to some 4 percent of GDP this year. Should the authorities make further efforts to contain the wage bill, these could ease pressures on the financing gap. On the other hand, large aid cuts impacting donor-funded quasi-fiscal activities could create contingent fiscal risks.

18. External factors will drive a substantial worsening of the fiscal outlook in 2019 and beyond. Based on GoI indications of the amount of CRs likely to be withheld, staff estimates a revenue loss of some 2 percentage points of GDP. The authorities expressed concern, noting this would vastly outweigh their plans for continued expenditure restraint and gains from revenue measures coming onstream. Other things equal, staff project the overall deficit to widen sharply to above 10 percent of GDP in 2019 and beyond. Given trends in donor support, annual financing gaps could average around 6½ percent of GDP over the medium term (up from around 3½ percent forecast in the March 2018 AHLC report). Under these conditions, the additional accumulation of arrears would push debt above 63 percent of GDP in 2023, of which 10 percentage points of GDP reflects the impact of the withholding of additional CRs (Annex II).[4]

Public Debt
(In percent of GDP)



Sources: Palestinian authorities; and IMF staff calculations and projections.

[4] Even without CRs being withheld, weaker growth and low donor aid would see debt exceed 50 percent of GDP.

19. A comprehensive approach to reform will be critical to secure fiscal sustainability. Moving to the debt-stabilizing balance implies an unrealistically fast adjustment that, even in better circumstances, could cripple growth. Mindful of this, staff advocated adjustment of 0.5 percentage points of GDP per year beyond the projected deficit, based on a mix of revenue and spending measures, and underpinned by deeper structural reforms. The authorities thought the pace of adjustment ambitious, but acknowledged their limited options.

20. Staff underlined that successful reform will require progress on three tracks:

- introducing a strategic, medium-term adjustment framework, backed by reforms to strengthen the fiscal framework to facilitate adjustment, promote public accountability, and reassure donors that scarce resources will be well spent;

- faster progress with the GoI toward reducing 'fiscal leakages', where clearly understood mechanisms for transparent information exchange are put in place and adhered to; and

- an actively engaged donor community that helps bridge the large financing gap (particularly given Gaza's critical needs) and supports well-functioning public institutions.

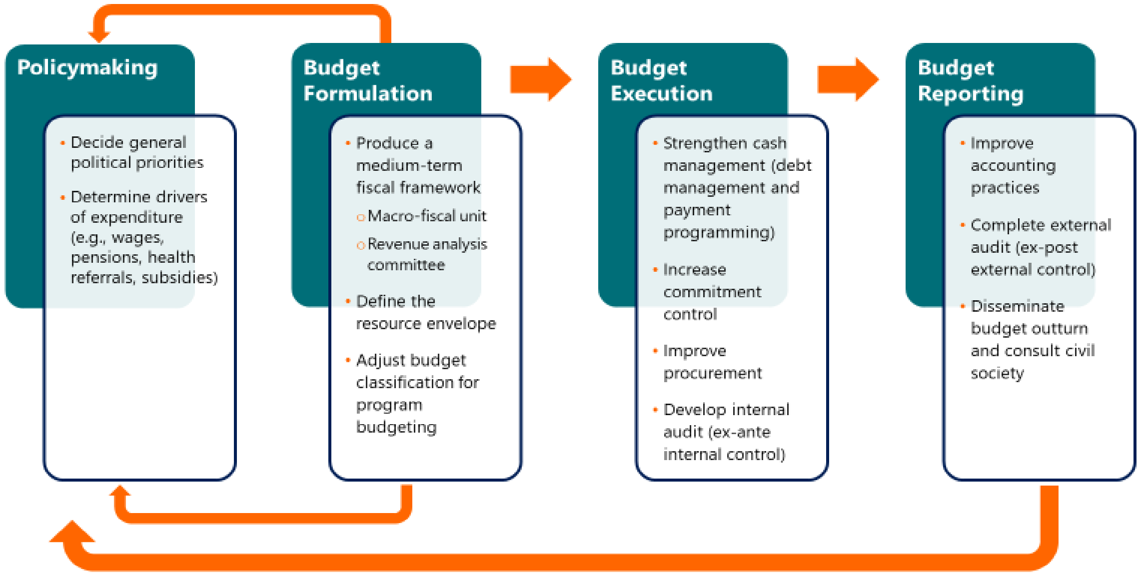
21. Staff pressed the authorities to adopt a broad-based strategy to contain and rebalance public spending over the medium term.

- The authorities plan to press forward with efforts to contain the wage bill, including considering further retrenchments or reevaluating wage increases. Comprehensive health insurance reform, including to control the cost of health referrals to Israel, is another priority. Staff urged the authorities to allow the fuel price to fluctuate with international prices. Given the large share of social spending (i.e., the cash transfer program to poor households), staff highlighted the potential gains—savings and effectiveness—from better targeting.

- Staff emphasized that more systematic reform of the key drivers of non-discretionary spending—i.e., civil service, public pension scheme, and health care system—will be essential to achieve a more productive spending mix. Staff noted the large share of pension liabilities in total debt, and the large portion of the projected debt increase predicated on future pension liabilities, especially given recent and prospective retrenchments.

- Faster implementation of the authorities' public financial management (PFM) strategy will help enhance control over expenditures and support fiscal adjustment. Staff encouraged the authorities to prioritize key outstanding issues, including commitment controls, the commitment versus accrual accounting treatment of expenditure data, payment programming, debt management, and arrears recording and clearing (Figure 4).

Figure 4. Priority Public Financial Management Reforms



22. **Staff also encouraged the authorities to advance planned revenue reforms.** The authorities intend to implement in 2019 the corporate income and dividend withholding tax measures put forward with the 2018 budget. They are also working toward adopting new licensing fees for petrol stations and winding down fuel subsidies. Collectively these measures could reduce the financing gap by around 1 percentage point of GDP. Given the extent of pressures, staff suggested the authorities explore other reforms, including updating real estate valuations, increasing administrative fees toward cost-recovery levels (and eliminating the nuisance fees), simplifying the tax system for SMEs, and reducing exemptions (especially inefficient investment incentives envisaged as an emergency measure in the 2018 budget).

Revenue Measures Considered by the PA

Measures	NIS million	In percent of GDP
Total	**630**	**1.2**
Increase in fees	200	0.4
Return to 20 percent income tax rate	200	0.4
Introduce a 10 percent dividend withholding tax	100	0.2
Eliminate fuel tax subsidy	130	0.2

Source: IMF staff estimates.

23. **Faster progress toward reducing 'fiscal leakages' will be crucial to offset the expected loss of CRs.** Work should go beyond securing one-off payments and ensure systematic change. Given the weight of CRs in WBG's revenues, staff suggested prioritizing measures with the largest potential revenue gain (e.g., introducing an electronic VAT interface and reducing the 3 percent administrative handling fee). New Israeli legislation on withholding CRs and lack of transparency or certainty about the amounts to be withheld runs counter to

Potential Annual Gain from the Largest Fiscal Leakages

Measures	NIS million	In percent of GDP
Total Annual Gain	**625**	**1.2**
Introduce one-stop shop VAT filing at the border	365	0.7
Transfer handling fee (per percentage point of assessed value)	190	0.4
Collect taxes from Area C	70	0.1

Sources: World Bank; DfID; and IMF staff estimates.

advancing the dialogue on fiscal leakages. Failure to advance these efforts increases the chance of further arrears accumulation and/or disorderly expenditure cuts that would harm growth.

C. Preserving Financial Stability

24. Staff recommended that the PMA sharpen regulatory oversight, given the worsening economic situation and associated financial sector risks.

- Last year, the PMA granted an emergency waiver on provisioning following the cuts to PA employees' allowances in Gaza, which saw a decline in provisions in percent of nonperforming loans (NPLs). The authorities pointed to the recent capital increase as helping to compensate for the effects of the waiver and safeguard the banking system. Staff underscored the importance of restoring full provisioning, given that cuts to PA allowances are unlikely to be reversed. Banks' large exposure to the PA and the deteriorating situation in Gaza increase the prospect of delinquent loans. With growing budgetary pressures, it will be important that the Ministry of Finance and Planning (MoFP) and PMA continue to observe the informal agreement limiting banks' credit to the PA at 100 percent of total capital.

- Staff encouraged the PMA to scrutinize risks more closely, making full use of its macro- and micro-prudential toolkits, and continuing more frequent on-site visits. The PMA should also leverage recent Fund TA on stress testing to better assess bank-by-bank risks. While the restructuring of affected private loans in Gaza earlier this year avoided an uptick in NPLs, it will have negative implications for profitability and balance sheet mismatches. Staff continued to encourage comprehensive monitoring of credit concentration risks arising from the banking sector's direct and indirect exposures to the PA, including promissory notes.

- The upcoming Financial System Stability Review (FSSR) will help identify financial sector vulnerabilities and priorities for future technical assistance (TA) to help enhance the PMA's institutional capabilities and ability to manage vulnerabilities.

25. Staff emphasized that establishing a permanent mechanism to replace CBRs via Israeli commercial banks will be crucial to preserve financial and economic stability. Staff welcomed the authorities' candid review of the AML/CFT regime under the NRA. The authorities emphasized the need to promote effective implementation of the banking sector regulatory and legal framework, and address gaps in legal frameworks in other sectors. With the NRA nearing completion, staff encouraged the authorities to articulate a clear forward-looking action plan around which they can redouble efforts to strengthen the AML/CFT regime. The IMF stands ready to support reforms via continued TA,[5] including focused on specific FATF recommendations. The IMF remains open to leading WBG's AML/CFT evaluation or participating as an external reviewer of a MENAFATF-led evaluation. Staff strongly encouraged direct dialogue between the Israeli and Palestinian authorities to find mutually agreeable modalities to move forward.

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[5] See Box 3 of IMF staff's August 2017 *Report to the AHLC*.

26. These challenges underscore the importance of preserving the PMA's institutional strength. The authorities highlighted work underway, supported by a private consulting firm, to develop a new PMA strategy as a successor to the 2006 Strategic Transformation Plan, originally prepared with IMF TA. To continue effectively managing system-wide risks, staff underlined the need for a robust governance framework that enshrines the core principles of central bank independence and executive accountability in the new central bank law in line with Fund advice.

STAFF APPRAISAL

27. Actions counter to the spirit of achieving a two-state solution and the increasingly turbulent security situation weigh heavily on the Palestinian economy. In this environment, development prospects are limited. Medium-term growth below 2 percent of GDP falls well short of generating enough jobs and higher incomes to improve livelihoods and reduce poverty for all Palestinians. Moreover, political risk deters private investment and necessitates aid be redirected toward essential humanitarian activities, inhibiting efforts to rebuild WBG's depleted capital stock. This sets the economy on a sub-optimal development course, with the share of high value-added and capital-intensive sectors declining.

28. Gaza's economic and humanitarian crisis is set to worsen without improved political relations, both Israeli-Palestinian and domestic. Gaza's descent into an unprecedented humanitarian crisis is accelerating, with all-time high poverty levels adding to the risk of deeper unrest. Without effective dialogue between all parties leading to greater political certainty, a relaxation of border constraints, and new investments in basic utilities, it will not be possible to reverse the prevailing destructive dynamic.

29. The PA's limited scope for policy action has been further reduced by interrelated political and financial tensions. The PA is constrained in addressing external structural issues that can only be solved through cooperation with Israel. Domestic political tensions also hamper effective policy implementation. Moreover, the PA's fiscal policy is largely a function of the availability of cash—and increasingly so, despite the PA's adjustment efforts. The growing financing shortfall severely limits the PA's ability to undertake large multi-year investments. Under these circumstances, the PA's best unilateral efforts will not be sufficient to put the Palestinian economy on the much-needed higher growth path. Moreover, even if growth can be revived in the near term, sustained support for robust public institutions will be essential to maintain improvements in growth and living standards.

30. Lasting improvements in economic prospects depend on stronger and more constructive engagement by the PA, Israel, and donors.

- The PA's efforts should focus on narrowing the fiscal deficit, with more targeted spending and continued revenue-raising efforts that includes a broadening of the tax base. Concerted reforms to strengthen fiscal frameworks and improve PFM would help facilitate adjustment, promote public sector accountability, and reassure donors that scarce resources will be well spent. It also has some scope to improve the business environment, thus allowing for privately generated income to take the place of social spending to some extent. Resuming reconciliation efforts could also help unlock donor support.

- Reaching a prompt and systemic agreement between the PA and GoI on the fiscal files, will be essential to avert a budgetary collapse. Israel can also help alleviate WBG's predicament by preventing further territorial fragmentation, and improving conditions for movement and access within and to/from WBG.

- Increased donor financing of the budget could act to consolidate the institutions of the Palestinian administration, particularly if linked to progress on reforms and supplemented with technical expertise in specific areas.

31. The PMA needs to sharpen its oversight to contain vulnerabilities in the financial system. Going forward, emerging risks should be scrutinized closely, with effective use of the full range of PMA policies. Credit concentration risks arising from the banking sector's exposures to the PA warrant close attention in view of escalating budgetary pressures. It will be also important to ensure banks' full provisioning given the deteriorating situation in Gaza and risks of rising delinquent loans. Continued efforts to strengthen WBG's AML/CFT regime and understandings on the modalities for a mutual evaluation will be vital to secure a longer-term solution to preserve Israeli-Palestinian CBRs. A Central Bank law that institutes checks and balances with clear executive mandates will help preserve the PMA's independence and institutional strength, ensuring it is well positioned to combat mounting risks.

Table 1. West Bank and Gaza: Selected Economic Indicators, 2016–23

(Per capita GDP: $2,926; 2017)

(Poverty rate: 14 percent in the West Bank and 53 percent in Gaza Strip; 2017 est.)

			Projections					
	2016	2017	2018	2019	2020	2021	2022	2023
Output and prices			(Annual percentage change)					
Real GDP (2004 market prices)	4.1	3.1	1.4	1.4	1.7	1.7	1.7	1.7
West Bank	3.0	4.3	3.0	2.2	2.2	2.2	2.2	2.2
Gaza	7.7	-0.3	-4.0	-1.5	0.0	0.0	0.0	0.0
CPI inflation rate (end-of-period)	-1.0	0.0	1.0	1.7	2.2	2.2	2.2	2.2
CPI inflation rate (period average)	-0.2	0.2	0.8	1.5	2.0	2.2	2.2	2.2
Investment and saving			(In percent of GDP)					
Gross capital formation, *of which:*	21.2	21.0	20.6	20.4	20.2	20.1	20.0	20.0
Public	5.2	4.5	4.2	4.2	4.1	4.0	4.0	3.9
Private	16.0	16.5	16.4	16.3	16.2	16.1	16.1	16.1
Gross national savings, *of which:*	11.1	10.1	7.8	7.0	6.7	6.2	5.9	5.4
Public	-1.1	-1.8	-2.5	-5.0	-5.0	-5.0	-5.1	-5.1
Private	12.2	11.9	10.3	12.0	11.7	11.2	10.9	10.4
Saving-investment balance	-10.1	-10.9	-12.7	-13.4	-13.5	-13.8	-14.2	-14.6
Public finances 1/			(In percent of GDP)					
Revenues	25.8	24.6	23.7	21.6	21.6	21.6	21.7	21.8
Recurrent expenditures and net lending	31.4	30.1	29.4	29.4	29.3	29.3	29.2	29.3
Wage expenditures	15.2	14.6	13.0	13.1	13.2	13.2	13.3	13.5
Nonwage expenditures	14.1	13.7	14.4	14.4	14.4	14.4	14.4	14.4
Net lending	2.0	1.8	2.0	1.9	1.8	1.6	1.5	1.4
Recurrent balance (commitment, before external support)	-5.6	-5.5	-5.8	-7.8	-7.7	-7.6	-7.6	-7.5
Recurrent balance (cash, before external support)	-1.1	-1.2	-6.4	-8.5	-8.3	-8.2	-8.1	-8.0
Development expenditures	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
(In millions of U.S. dollars)	335	367	381	391	408	426	445	464
Overall balance (commitment, before external support)	-8.1	-8.1	-8.3	-10.4	-10.3	-10.2	-10.1	-10.0
Total external support, including for development expenditures	5.7	5.0	4.5	4.1	4.0	3.9	3.8	3.7
(In millions of U.S. dollars)	760	722	674	636	646	656	667	678
External support for recurrent expenditure (in millions of U.S. dollars)	603	546	490	440	440	440	440	440
Financing gap (in millions of U.S. dollars)	…	…	620	1,008	1,053	1,102	1,153	1,200
In percent of GDP	…	…	4.1	6.5	6.5	6.5	6.6	6.6
Monetary sector 2/			(Annual percentage change)					
Credit to the private sector	20.0	15.0	12.0	8.0	6.0	6.0	6.0	6.0
Private sector deposits	7.8	9.5	5.1	4.0	4.4	4.1	4.1	4.1
External sector			(In percent of GDP)					
Current account balance (excluding official transfers)	-14.6	-14.7	-16.0	-16.3	-16.3	-16.4	-16.7	-17.0
Current account balance (including official transfers)	-10.1	-10.9	-12.7	-13.4	-13.5	-13.8	-14.2	-14.6
Exports of goods and nonfactor services	18.2	18.6	17.8	18.2	17.2	17.1	17.0	16.9
Import of goods and nonfactor services	56.7	55.6	55.8	56.1	54.5	53.9	53.4	53.0
Net factor income	11.8	10.7	10.5	10.1	9.6	9.1	8.7	8.2
Net current transfers	16.7	15.5	14.8	14.4	14.1	13.8	13.6	13.4
Private transfers	12.2	11.7	11.5	11.6	11.4	11.2	11.1	11.0
Official transfers	4.5	3.8	3.3	2.9	2.7	2.6	2.5	2.4
Memorandum items:								
Nominal GDP (in millions of U.S. dollars)	13,397	14,498	15,039	15,428	16,127	16,844	17,587	18,325
Per capita nominal GDP (U.S. dollars)	2,781	2,926	2,951	2,943	2,991	3,037	3,083	3,123
Unemployment rate	25	29	31	32	34	37	39	39
Al Quds stock market index (annual percentage change)	-0.5	12.0	…	…	…	…	…	…

Sources: Palestinian authorities; World Bank; and IMF staff estimates and projections.

1/ Commitment basis.

2/ End-of-period; in U.S. dollar terms.

Table 2a. West Bank and Gaza: Central Government Fiscal Operations, 2016–21

	2016	2017	2018	2019	2020	2021
			Projections			
	(In millions of U.S. dollars, unless stated otherwise)					
Net revenues	3,457	3,567	3,558	3,330	3,484	3,642
Gross domestic revenues	1,224	1,154	1,198	1,243	1,307	1,375
Tax revenues	623	764	794	828	873	922
Nontax revenues	601	390	405	415	434	453
Clearance revenues 1/	2,325	2,486	2,432	2,148	2,234	2,326
Tax refunds 2/	-92	-73	-72	-61	-57	-59
Total expenditures (commitment basis)	4,537	4,737	4,807	4,931	5,138	5,356
Recurrent expenditures and net lending	4,202	4,370	4,426	4,540	4,730	4,929
Wage expenditures	2,041	2,120	1,957	2,026	2,123	2,228
Nonwage expenditures	1,893	1,983	2,169	2,224	2,324	2,427
Operational expenditure	740	771	801	820	857	895
G&S	663	695	687	704	736	769
Interest	77	76	114	116	121	126
Transfers	1,139	1,193	1,348	1,383	1,445	1,510
Transfers	944	989	1,116	1,145	1,196	1,250
Social	195	204	212	217	227	237
Minor capital expenditure	14	19	20	21	22	23
Net lending	268	267	300	290	282	274
Development expenditures	335	367	381	391	408	426
Recurrent balance (excl. development expenditure)	-745	-803	-868	-1,210	-1,246	-1,287
Overall balance (commitment basis)	-1,080	-1,170	-1,249	-1,601	-1,654	-1,714
Total financing						
Domestic financing (net)	-108	140	100	100	100	100
External financing (net - incl. grants)	742	679	629	593	601	612
Amortization	-18	-43	-45	-44	-45	-45
Disbursements	760	722	674	636	646	656
Budget support	603	546	490	440	440	440
Development expenditure support	157	175	184	196	206	216
Net arrears accumulation	442	352	-100	-100	-100	-100
New arrears	758	767	0	0	0	0
Repayment of arrears	-316	-415	-100	-100	-100	-100
Residual/financing gap	5	0	620	1,008	1,053	1,102
Memorandum items:	(In percent of GDP, unless stated otherwise)					
Revenues	25.8	24.6	23.7	21.6	21.6	21.6
Recurrent expenditures and net lending	31.4	30.1	29.4	29.4	29.3	29.3
Wage expenditures	15.2	14.6	13.0	13.1	13.2	13.2
Nonwage expenditures	14.1	13.7	14.4	14.4	14.4	14.4
Net lending	2.0	1.8	2.0	1.9	1.8	1.6
Recurrent balance (commitment) before external support	-5.6	-5.5	-5.8	-7.8	-7.7	-7.6
External financing for recurrent expenditures	4.5	3.8	3.3	2.9	2.7	2.6
Development expenditures (commitment)	2.5	2.5	2.5	2.5	2.5	2.5
Overall balance (commitment)	-8.1	-8.1	-8.3	-10.4	-10.3	-10.2
Residual/financing gap	0.0	0.0	4.1	6.5	6.5	6.5
Nominal exchange rate (NIS per U.S. dollar)	3.84	3.60	…	…	…	…
Nominal GDP (in millions of shekels)	51,452	52,187	52,568	54,205	56,531	58,960

Sources: Ministry of Finance and Planning; and IMF staff projections.

1/ Revenue collected by Israel on behalf of, and transferred to, the Palestinian Authority.

2/ Includes fuel subsidies.

Table 2b. West Bank and Gaza: Central Government Fiscal Operations, 2016–21

	2016	2017	Projections 2018	2019	2020	2021
	(In millions of shekels, unless otherwise stated)					
Net revenues	13,276	12,841	12,438	11,699	12,213	12,749
Gross domestic revenues	4,701	4,155	4,189	4,366	4,581	4,813
Tax revenues	2,392	2,751	2,775	2,908	3,061	3,228
Nontax revenues	2,309	1,404	1,414	1,458	1,520	1,585
Clearance revenues 1/	8,930	8,947	8,500	7,548	7,832	8,142
Tax refunds 2/	-355	-261	-250	-215	-200	-206
Total expenditures (commitment basis)	17,423	17,051	16,803	17,324	18,012	18,747
Recurrent expenditures and net lending	16,137	15,730	15,472	15,951	16,581	17,254
Wage expenditures	7,837	7,631	6,840	7,118	7,443	7,798
Nonwage expenditures	7,270	7,139	7,582	7,814	8,148	8,496
Operational expenditure	2,843	2,776	2,800	2,882	3,004	3,132
G&S	2,547	2,502	2,400	2,475	2,581	2,692
Interest	296	274	400	407	423	440
Transfers	4,375	4,294	4,711	4,858	5,067	5,284
Transfers	3,627	3,559	3,900	4,021	4,194	4,374
Social	748	735	740	763	796	830
Minor capital expenditure	52	68	71	74	77	80
Net lending	1,029	960	1,050	1,020	990	960
Development expenditures	1,287	1,321	1,331	1,372	1,431	1,493
Recurrent balance (excl. development expenditure)	-2,861	-2,889	-3,034	-4,253	-4,368	-4,505
Overall balance (commitment basis)	-4,148	-4,211	-4,365	-5,625	-5,799	-5,998
Total financing	4,148	4,211	4,365	5,625	5,799	5,998
Domestic financing (net)	-415	504	350	351	351	350
Net domestic bank financing	-415	504	350	351	351	350
Other domestic financing	---	---	---	---	---	---
External financing (net - incl. grants)	2,848	2,442	2,198	2,083	2,108	2,141
Amortization	-71	-155	-157	-153	-157	-157
Disbursements	2,919	2,597	2,355	2,236	2,265	2,298
Budget support	2,318	1,965	1,713	1,546	1,542	1,540
Development expenditure support	602	632	642	690	723	758
Net arrears	1,697	1,266	-350	-351	-351	-350
Accumulation of arrears	2,911	2,761	---	---	---	---
Repayment of arrears	-1,215	-1,495	-350	-351	-351	-350
Residual/financing gap	18	-2	2,166	3,542	3,691	3,857
Memorandum items:						
Accumulation of arrears	2,911	2,761	---	---	---	---
Encashment shortfalls	58	-19	---	---	---	---
Nontax revenue	---	---	---	---	---	---
Clearance revenue	58	-19	---	---	---	---
Payment shortfalls	2,811	2,669	---	---	---	---
Tax refund arrears	-17	70	---	---	---	---
Expenditure arrears	2,828	2,600	---	---	---	---
Wage arrears	505	568	---	---	---	---
Non-wage expenditure arrears	1,860	1,631	---	---	---	---
Net lending arrears	---	---	---	---	---	---
Development expenditure arrears	463	400	---	---	---	---
Errors and omissions	158	73	---	---	---	---

Sources: Ministry of Finance and Planning; and IMF staff projections.

1/ Revenue collected by Israel on behlaf of, and transferred to, the Palestinian Authority.

2/ Includes fuel subsidies.

Table 3. West Bank and Gaza: Central Government Fiscal Operations (GFSM 2001), 2016–21

	2016	2017	2018	2019	2020	2021
			Projections			
	(In millions of shekels)					
Revenue	16,195	15,438	14,793	13,934	14,478	15,047
Taxes	10,967	11,436	11,024	10,241	10,692	11,164
Domestic taxes	2,392	2,751	2,775	2,908	3,061	3,228
Clearance taxes	8,930	8,947	8,500	7,548	7,832	8,142
Tax refund	-355	-261	-250	-215	-200	-206
Grants	2,919	2,597	2,355	2,236	2,265	2,298
External budget support	2,318	1,965	1,713	1,546	1,542	1,540
External development support	602	632	642	690	723	758
Other revenue	2,309	1,404	1,414	1,458	1,520	1,585
Of which: dividends	290	176	178	183	191	199
Expenditures	17,423	17,051	16,803	17,324	18,012	18,747
Expense	16,137	15,730	15,472	15,951	16,581	17,254
Compensation of employees 1/	7,837	7,631	6,840	7,118	7,443	7,798
Use of goods and services	2,547	2,502	2,400	2,475	2,581	2,692
Grants 2/	1,029	960	1,050	1,020	990	960
Other expense 3/	4,723	4,637	5,182	5,339	5,567	5,804
Net acquisition of nonfinancial assets	1,287	1,321	1,331	1,372	1,431	1,493
Gross operating balance	58	-292	-679	-2,017	-2,103	-2,207
Net lending / borrowing (overall balance)	-1,229	-1,614	-2,010	-3,389	-3,534	-3,700
Net financial transactions	-1,140	-1,468	-570	-1,949	-2,093	-3,698
Net acquisition of financial assets	…	…	…	…	…	…
Net incurrence of liabilities	1,122	1,470	-1,597	-1,593	-1,597	-157
Domestic	1,193	1,624	-1,440	-1,440	-1,440	0
Loans	-486	307	350	351	351	350
Net domestic bank financing	-486	307	350	351	351	350
Other accounts payable	1,679	1,317	-1,790	-1,791	-1,791	-350
Foreign	-71	-155	-157	-153	-157	-157
Loans	-71	-155	-157	-153	-157	-157
Statistical discrepancy/financing gap	18	-2	2,166	3,542	3,691	3,857
Memorandum items:						
Gross operating balance excl. grants (commitment)	-2,861	-2,889	-3,034	-4,253	-4,368	-4,505
Gross operating balance excl. grants (cash)	-1,803	-2,097	-4,823	-6,044	-6,159	-4,855
Overall balance (NLB) excl. grants (commitment)	-4,148	-4,211	-4,365	-5,625	-5,799	-5,998
Overall balance (NLB) excl. grants (cash)	-2,627	-3,018	-6,154	-7,416	-7,590	-6,348
Revenue (percent of GDP)	31.5	29.6	28.1	25.7	25.6	25.5
Expenditure (percent of GDP)	33.9	32.7	32.0	32.0	31.9	31.8
Expense (percent of GDP)	31.4	30.1	29.4	29.4	29.3	29.3
Wage expenditure (percent of GDP)	15.2	14.6	13.0	13.1	13.2	13.2
Nonwage expenditures (percent of GDP)	5.0	4.8	4.6	4.6	4.6	4.6
GOB (commitment) excluding grants (percent of GDP)	-5.6	-5.5	-5.8	-7.8	-7.7	-7.6
GOB (cash) excluding grants (percent of GDP)	-3.5	-4.0	-9.2	-11.2	-10.9	-8.2
External support (recurrent)	4.5	3.8	3.3	2.9	2.7	2.6
in millions of NIS	2,318	1,965	1,713	1,546	1,542	1,540
NLB (commitment) excluding grants (percent of GDP)	-8.1	-8.1	-8.3	-10.4	-10.3	-10.2
NLB (cash) excluding grants (percent of GDP)	-5.1	-5.8	-11.7	-13.7	-13.4	-10.8
Total external support (in millions of shekels)	2,919	2,597	2,355	2,236	2,265	2,298
Nominal GDP (in millions of shekels)	51,452	52,187	52,568	54,205	56,531	58,960
Exchange rate	3.8	3.6	…	…	…	…

Sources: Ministry of Finance and Planning; and IMF staff projections.

1/ Wage expenditures.

2/ Grants to local governments related to purchase of water and electricity.

3/ Includes transfers (social benefits) and minor capital.

Table 4. West Bank and Gaza: Financial Soundness Indicators, 2011–18

(In percent)

	Dec-11	Dec-12	Dec-13	Dec-14	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Capital adequacy (for all banks)														
Tier I capital to risk-weighted assets	22.9	22.2	21.5	20.0	18.1	17.0	16.4	17.1	17.2	16.3	16.2	16.2	15.5	15.0
Regulatory capital to risk-weighted assets	21.1	20.3	20.0	18.9	18.0	17.4	16.7	17.4	18.0	17.1	16.8	16.9	16.6	16.0
Capital adequacy (for local banks)														
Tier I capital to risk-weighted assets	24.5	22.7	20.7	18.0	16.1	15.1	14.2	15.7	16.0	14.9	15.3	14.9	14.9	14.8
Regulatory capital to risk-weighted assets	20.3	18.8	17.8	16.3	15.4	15.2	14.1	15.6	16.5	15.4	15.5	15.2	16.1	15.6
Asset quality 1/														
Nonperforming loans (percent of total loans)	2.7	3.1	2.9	2.5	2.1	2.0	2.0	2.2	2.2	2.2	2.4	2.4	2.3	2.3
Nonperforming loans net of provisions to capital	3.8	4.9	4.7	4.0	3.4	3.3	3.1	3.7	3.7	4.3	5.0	5.0	5.2	4.9
Coverage ratio (provisions as percent of nonperforming loans)	60.9	60.1	59.1	61.4	67.3	68.8	70.4	66.4	65.8	63.7	60.2	62.0	58.4	60.7
Earnings and profitability														
Return on assets (ROA)	1.9	1.8	1.9	1.7	1.5	1.7	1.6	1.5	1.5	1.4	1.6	1.6	1.5	1.5
Return on equity (ROE) 2/	17.0	16.2	18.7	17.1	15.0	17.4	16.9	16.0	15.6	15.2	16.6	16.4	16.1	15.7
Interest income to gross income	71.7	72.4	74.0	72.4	72.2	70.4	70.9	71.9	71.4	70.2	69.2	70.6	70.9	69.5
Non-interest expenses to gross income	57.2	55.4	54.8	60.1	63.0	61.3	61.7	61.9	62.6	63.5	61.8	61.3	62.0	62.8
Personnel cost to non-interest expenses	55.5	53.8	53.9	51.5	51.3	52.0	52.0	51.3	50.4	52.7	54.2	52.5	53.0	55.7
Liquidity														
Liquid assets to total assets	38.2	37.5	39.5	35.4	34.2	33.9	33.1	32.7	33.0	34.0	31.4	30.8	32.3	30.0
Liquid assets to demand and savings deposits	74.4	71.6	74.7	65.9	62.3	61.8	61.7	61.7	61.2	65.2	59.0	57.5	59.3	55.7
Liquid assets to total deposits	46.9	45.8	48.1	43.2	41.0	40.6	39.9	39.7	39.9	41.0	37.8	37.2	39.1	36.4

Source: Palestine Monetary Authority.

1/ Nonperforming loans includes loans more than 90 day overdue.

2/ Return on equity (ROE) is a ratio of income before extraordinary items and taxes to average Tier 1 capital.

Annex I. Risk Assessment Matrix[1]

Nature/Sources of Risk	Relative Likelihood	Expected Impact If Realized	Policies to Mitigate Risks
		DOMESTIC RISKS	
Escalating unrest due to discontent with the lack of opportunities or prospects for peace	***High***	***High*** A deeper conflict in Gaza or widespread unrest could disrupt economic and financial transactions or the provision of public services, and endanger the stability of banks, with possible spillovers to the West Bank. This would undermine growth and intensify the humanitarian crisis in Gaza and. Any tightening of Israeli restrictions or increased uncertainty about donor aid would compound the situation.	Sound macroeconomic management and economic reforms could help instill confidence and alleviate economic strains at the margin. However, economic policies can do little in the near term to directly mitigate geo-political pressures.
Declining and/or volatile donor support due to shifts in donor sentiment, fiscal strains in donor countries, or competing demands	***High***	***High*** Larger-than-anticipated declines in donor support could worsen the already large financing gaps, necessitating additional arrears or deeper spending cuts (including in Gaza). This could compromise public service delivery, increase banking sector vulnerabilities, and harm economic growth and social cohesion.	Instill confidence through strong policies that could, over time, support growth, promote fiscal sustainability and reduce dependence on donor support, including: gradual fiscal adjustment; improving the composition of budget spending; strengthening budget institutions; and ensuring financial sector resilience.
Increased uncertainty around the level and consistency of Clearance Revenues (CRs) due to new Israeli legislation	***High***	***Medium/High*** A larger-than-anticipated decline in CRs transfers payments could worsen the already large financing gaps, leading to additional arrears or deeper spending cuts. Uncertain or inconsistent CR transfers would complicate budget management. These efforts would compromise public service delivery, banking sector stability, economic growth and social cohesion.	Absent a legislative reversal in Israel, it will be essential to accelerate efforts—based on fair and transparent discussions—to reduce fiscal leakages and partially offset the loss of CR resources withheld.
Reduced financial services by Israeli correspondent banks	***High***	***Medium/High*** Loss of Israeli-Palestinian correspondent bank relations would lead to trade and financial transactions being canceled or shifted into cash/informality. This could undermine WBG's payment system, harming financial stability and growth.	(1) Effectively implement "Anti-Money Laundering and Terrorism Financing" law and related regulations. (2) Continue to enhance legal and regulatory frameworks, build implementation capacity.
Increased economic fragmentation due to diverging Gazan and West Bank economies and/or settlement expansion	***High***	***Medium/High*** Further erosion of geographic control or increased restrictions would shrink access to the economy's resources and stifle investment, with impeding negative effects on growth and the economic viability of a Palestinian state.	Sound macroeconomic management and domestic reforms could help instill confidence. Yet, economic policies can do little in the near term to directly mitigate geo-political pressures.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Nature/Sources of Risk	Relative Likelihood	Expected Impact If Realized	Policies to Mitigate Risks
		GLOBAL RISKS	
Intensified risks from fragmentation/ security dislocation in parts of the Middle East	***High***	***High*** Any direct spillover of regional instability would exacerbate security and economic uncertainties in WBG. Unrest in the region could divert donor aid away from WBG and/or affect Israel's stance toward security and restrictions.	Sound macroeconomic management, proactive reforms and engaging partners could help instill confidence. Economic policies can do little to mitigate external geo-political risks.

Annex II. Debt Sustainability Analysis[1]

This debt sustainability analysis (DSA)[2] suggests that financing gaps will increase due in large part to lower clearance revenues (CR), and will thus continue to add to the stock of public debt throughout the forecast period. A scenario illustrating the path of public debt without new additional CR deductions, points to a lower but nonetheless significant rate of debt accumulation. In either case, debt sustainability remains questionable, particularly given the debt trajectory's vulnerability to weaker growth and lower donor aid—both of which are significant risks.

Structure of Public Debt

1. **At end-2017, gross public debt[3] was estimated to be 36.6 percent of GDP[4].** While this debt level is relatively low, it poses a significant challenge given institutional and policy constraints in West Bank and Gaza. The end-2017 estimate is similar to the debt stock at end-2016, as new domestic arrears accumulation was offset by a reduction in external debt. The composition of public debt is increasingly skewed toward shorter maturity domestic debt and decreasing external debt.

- Domestic debt (including arrears and CR advances) represented 80.6 percent of total debt at the end of 2017. Arrears to the pension fund, PA civil servants in Gaza whose allowances were withheld since March 2017, and suppliers (including promissory notes) increased by 1.3 percentage point of GDP, and accounted for 50.3 percent of total debt. Formal debt to the financial sector remained stable, as banks maintained their exposure to the PA.[5]

- External debt represented 19.7 percent of total debt. It decreased by 0.7 percentage points of GDP during 2017, largely reflecting the Arab Fund for Economic and Social Development waiving repayment of a $41.9 million loan. It is mostly at long maturities and on concessional terms (with an effective interest rate of close to zero).

West Bank and Gaza: Total Debt Liabilities of the PA

(In percent of GDP in NIS)

		Estimates	
	2015	2016 [1]	2017 [1]
Gross debt liabilities	40.5	36.5	36.6
Domestic debt	30.9	27.9	28.7
Loans and overdrafts	11.6	10.7	10.4
Arrears	19.3	17.1	18.4
External debt	9.6	8.6	7.9
Memorandum item:			
Domestic debt (excl. pension arrears)	15.7	15.8	n/a
Gross debt liabilities (percent of GDP in US$)	40.4	36.4	35.6

Sources: Ministry of Finance and Planning; and IMF staff estimates.

[1] Figures are estimates due to insufficient official data.

[1] Prepared by Jean van Houtte and Alexander de Keyserling.

[2] This DSA uses the 2017 Market Access Countries DSA template developed by the IMF; it is based on estimated and actual end-2017 domestic and external debt stock data, and estimated and actual 2017 debt flow data.

[3] Debt coverage includes accounts payable and pension liabilities in line with the IMF's *Public Sector Debt Statistics: Guide for Compilers and Users* (2013).

[4] Gross public debt in US dollars as a percentage of GDP in US dollars in slightly less (35.6 percent of GDP). This reflects the significant appreciation of the new Israeli shekel, and the standard practice of converting GDP at the year-average exchange rate while debt stock is converted at the year-end exchange rate.

[5] Non-arrears debt is projected to carry an interest rate of 6 percent. Arrears are projected to carry a zero interest rate.

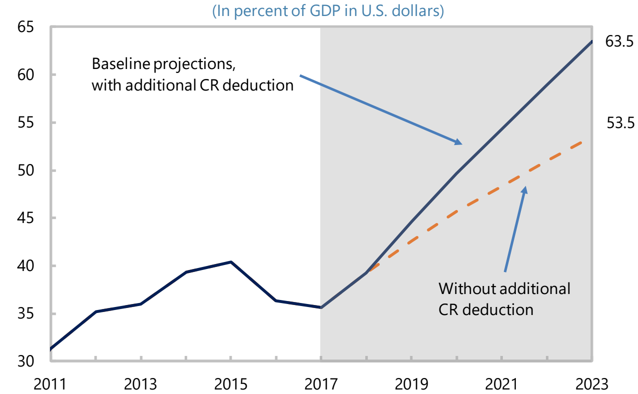
Macroeconomic Developments and Projections

2. **The macroeconomic outlook has deteriorated further**. Under the baseline scenario, real growth is projected at 1½ percent in 2018–19 and almost 1¾ percent over the medium term, while inflation remains close to 2 percent annually. The already large fiscal deficit is projected to jump from 8.3 percent of GDP in 2018 to 10.3 percent in 2019 due to expected CR deductions of around 2 percentage points of GDP. Thereafter, the deficit decreases by only half a percentage point of GDP over the medium term. With this and donor budget support projected to dip to US$440 million from 2019 onwards, the financing gap hovers continuously around 6½ percent of GDP.

Debt Sustainability

3. **The large anticipated fiscal shock triggered by the withholding of CRs causes gross public debt to grow rapidly.** Under the baseline scenario, gross public debt is projected to exceed 63 percent of GDP by the end of 2023—an increase of almost 18 percentage points of GDP over 5 years. This is significantly higher than the 47.8 percent of GDP projected in March 2018, due to the lower GDP growth outlook and the large increase in the financing gap. The latter reflects lower budget support over the projection period and the projected fall in CRs.

Public Debt
(In percent of GDP in U.S. dollars)



Sources: Palestinian authorities; and IMF staff calculations and projections.

4. **If, however, Israel does not withhold CRs, this would substantially limit the rate of debt accumulation.** A scenario without large CR deductions starting in 2019, but unchanged donor budget support and growth, would result in smaller financing gaps (4.5 percent of GDP per year) and significantly lower debt accumulation—reaching 53 percent of GDP by 2023 or 10 percentage points of GDP less than the baseline.

5. **An adverse growth shock poses the greatest risk to sustainability.** A growth shock that illustrates the materialization of key risks would push the level of public debt to almost 72 percent of GDP by 2023, effectively doubling the accumulation of public debt in 5 years. A combined macro-fiscal shock, that adds a temporary fiscal deterioration to the growth shock, results in a public debt level of more than 77 percent of GDP by 2023. West Bank and Gaza's policy constraints and relatively limited ability to manage shocks only heighten the risks of unexpected challenges.

6. **Increased financing pressures from the adverse political and economic circumstances raise questions about the sustainability of the debt burden despite meaningful fiscal efforts.** Without stable CRs (or material progress toward reducing fiscal leakages) and sufficient external resources from donors, a significant share of financing needs will continue to be met through the accumulation of arrears. Moreover, their short maturity creates an additional and significant refinancing challenge that could lead to higher debt if their clearance with formal debt instruments is associated with a non-zero interest rate.

Figure II.1. West Bank and Gaza: Public Sector Debt Sustainability Analysis —Baseline Scenario

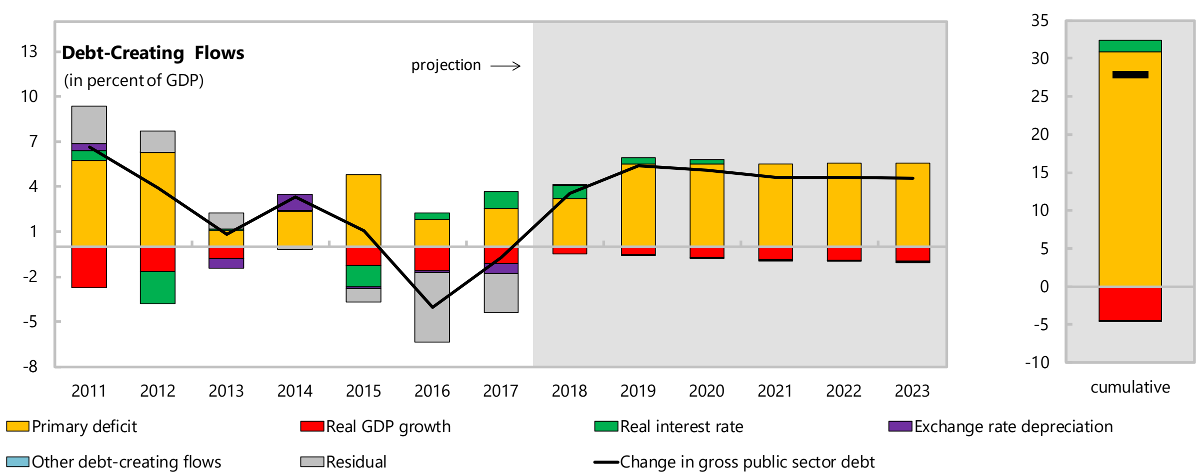
(In percent of GDP (Shekel); unless otherwise indicated)

Debt, Economic and Market Indicators [1]

	Actual			Projections					
	2010-2015 [2]	2016	2017	2018	2019	2020	2021	2022	2023
Nominal gross public debt	29.2	36.4	35.6	39.2	44.6	49.7	54.3	58.9	63.5
Public gross financing needs		29.0	28.2	32.3	37.2	42.6	47.6	52.5	57.3
Real GDP growth (in percent)	6.0	4.1	3.1	1.4	1.4	1.7	1.7	1.7	1.7
GDP deflator (in percent)	3.4	0.3	-1.6	-0.7	1.7	2.5	2.5	2.3	2.2
Nominal NIS GDP growth (in percent)	9.6	4.5	1.4	0.7	3.1	4.3	4.3	4.0	3.9
Effective interest rate (in percent) [3]	1.9	1.5	1.5	1.7	2.8	3.3	2.4	2.3	2.2

Contribution to Changes in Public Debt

	Actual			Projections							
	2010-2015	2016	2017	2018	2019	2020	2021	2022	2023	cumulative	debt-stabilizing
Change in gross public sector debt	1.5	-4.1	-0.7	3.6	5.4	5.1	4.6	4.6	4.6	27.9	primary
Identified debt-creating flows	-0.6	0.6	1.9	3.6	5.4	5.1	4.6	4.7	4.6	27.9	balance [8]
Primary deficit	1.6	1.8	2.5	3.2	5.5	5.5	5.5	5.6	5.6	30.9	-1.0
Primary (noninterest) revenue and grants	35.4	31.5	29.6	28.1	25.7	25.6	25.5	25.5	25.5	156.0	
Primary (noninterest) expenditure	33.6	33.3	32.1	31.4	31.2	31.1	31.0	31.0	31.1	186.8	
Automatic debt dynamics [4]	-2.2	-1.3	-0.6	0.3	-0.1	-0.4	-0.9	-0.9	-1.0	-3.0	
Interest rate/growth differential [5]	-2.2	-1.1	0.0	0.3	-0.1	-0.4	-0.9	-0.9	-1.0	-3.0	
Of which: real interest rate	-0.7	0.4	1.2	0.8	0.4	0.3	-0.1	0.0	0.0	1.5	
Of which: real GDP growth	-1.5	-1.6	-1.1	-0.5	-0.5	-0.7	-0.8	-0.9	-1.0	-4.4	
Exchange rate depreciation [6]	0.0	-0.1	-0.7	...	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [7]	2.9	-4.6	-2.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	



Source: IMF staff calculations.

1/ Public sector is defined as central government.

2/ Based on available data.

3/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

4/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

5/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

6/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

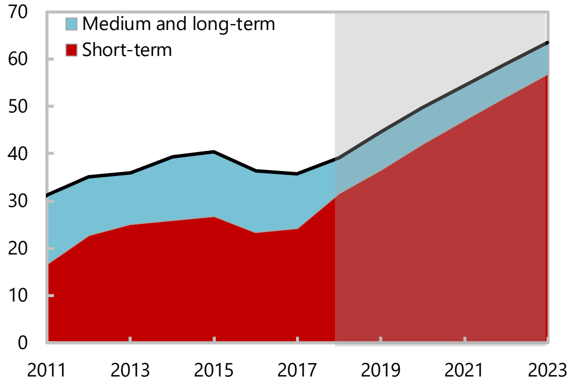
7/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

8/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

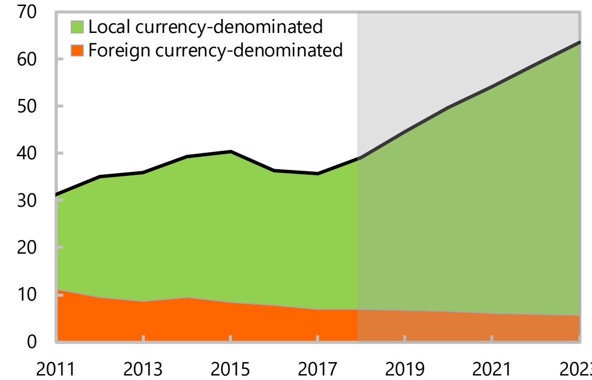
Figure II.2. West Bank and Gaza: Public Debt Sustainability Analysis —Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



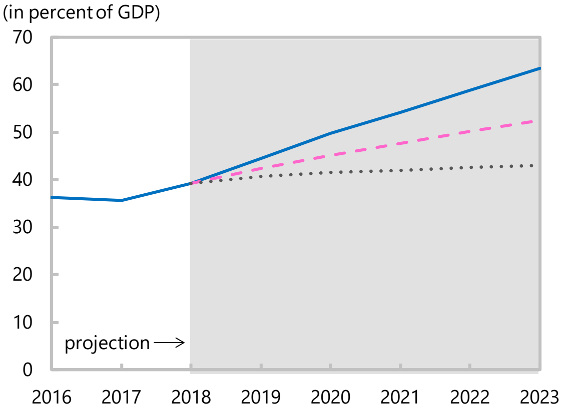
By Currency
(in percent of GDP)



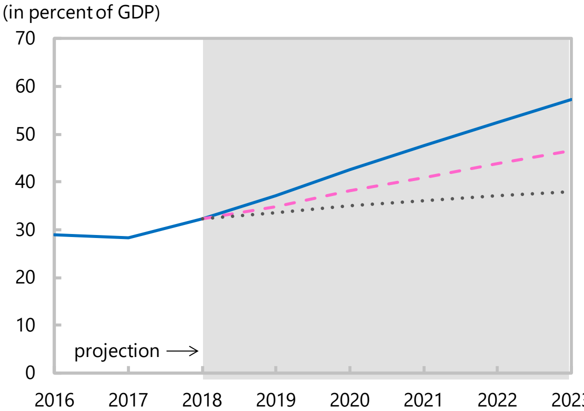
Alternative Scenarios

Baseline Historical Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

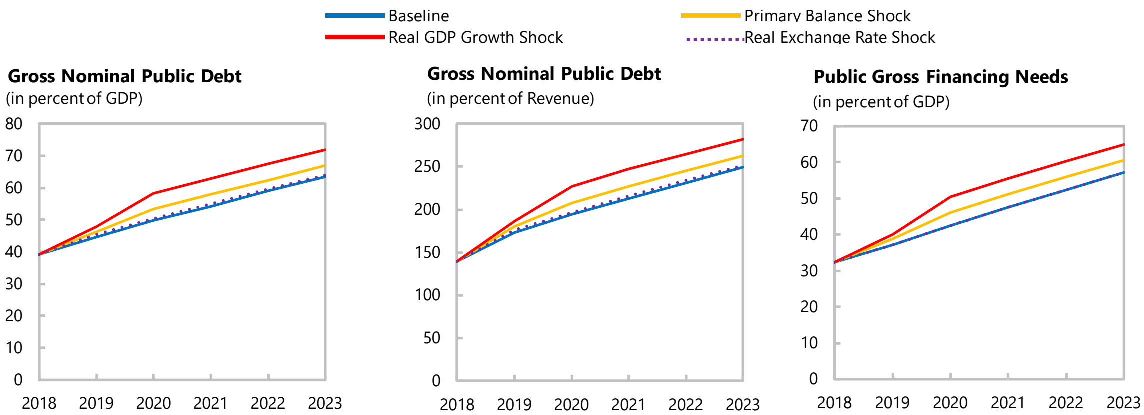
Baseline Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	1.4	1.4	1.7	1.7	1.7	1.7
GDP deflator	-0.7	1.7	2.5	2.5	2.3	2.2
Primary Balance	-3.2	-5.5	-5.5	-5.5	-5.6	-5.6
Effective interest rate	1.7	2.8	3.3	2.4	2.3	2.2
Constant Primary Balance Scenario						
Real GDP growth	1.4	1.4	1.7	1.7	1.7	1.7
GDP deflator	-0.7	1.7	2.5	2.5	2.3	2.2
Primary Balance	-3.2	-3.2	-3.2	-3.2	-3.2	-3.2
Effective interest rate	1.7	2.8	3.4	2.6	2.5	2.4

Historical Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	1.4	5.4	5.4	5.4	5.4	5.4
GDP deflator	-0.7	1.7	2.5	2.5	2.3	2.2
Primary Balance	-3.2	-3.1	-3.1	-3.1	-3.1	-3.1
Effective interest rate	1.7	2.8	2.1	1.3	1.2	1.0

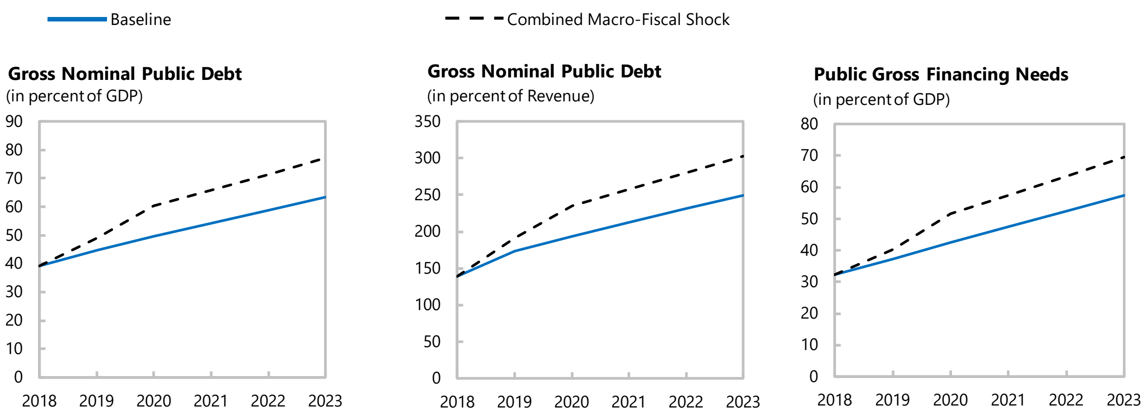
Sources: Palestinian authorities; and IMF staff calculations.

Figure II.3. West Bank and Gaza: Public Debt Sustainability Analysis—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

Primary Balance Shock	2018	2019	2020	2021	2022	2023
Real GDP growth	1.4	1.4	1.7	1.7	1.7	1.7
GDP deflator	-0.7	1.7	2.5	2.5	2.3	2.2
Primary balance	-3.2	-7.2	-7.2	-5.5	-5.6	-5.6
Effective interest rate	1.7	2.8	3.6	2.7	2.2	2.1
Combined Shock						
Real GDP growth	1.4	-2.3	-1.9	1.7	1.7	1.7
GDP deflator	-0.7	0.8	1.6	2.5	2.3	2.2
Primary balance	-3.2	-7.2	-8.5	-5.5	-5.6	-5.6
Effective interest rate	1.7	2.8	5.1	4.3	4.3	4.2

Real GDP Growth Shock	2018	2019	2020	2021	2022	2023
Real GDP growth	1.4	-2.3	-1.9	1.7	1.7	1.7
GDP deflator	-0.7	0.8	1.6	2.5	2.3	2.2
Primary balance	-3.2	-7.0	-8.5	-5.5	-5.6	-5.6
Effective interest rate	1.7	2.8	3.5	2.9	2.2	2.1
Real Exchange Rate Shock						
Real GDP growth	1.4	1.4	1.7	1.7	1.7	1.7
GDP deflator	-0.7	2.1	2.5	2.5	2.3	2.2
Primary balance	-3.2	-5.5	-5.5	-5.5	-5.6	-5.6
Effective interest rate	1.7	2.8	3.2	2.4	2.3	2.1

Source: IMF staff calculations.

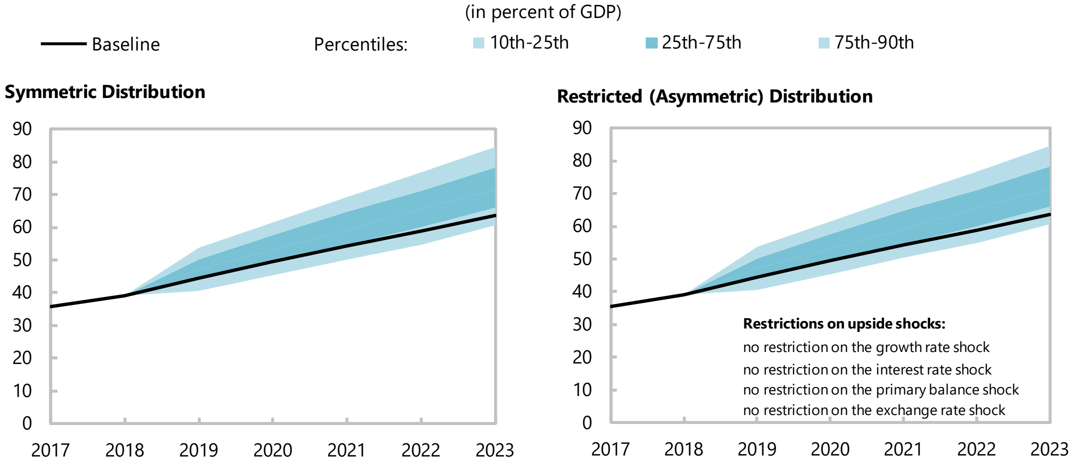
Figure II.4. West Bank and Gaza: Public Debt Sustainability Analysis—Risk Assessment

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

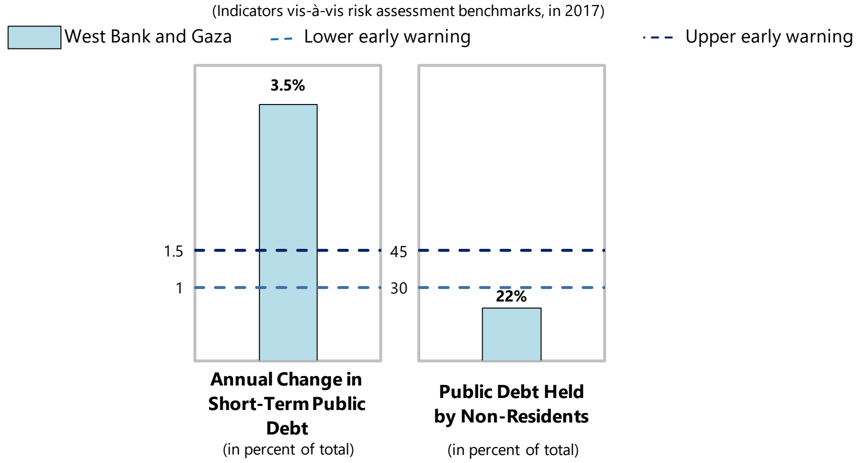
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2017)



Source: IMF staff calculations.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.

Lower and upper risk-assessment benchmarks are: 400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

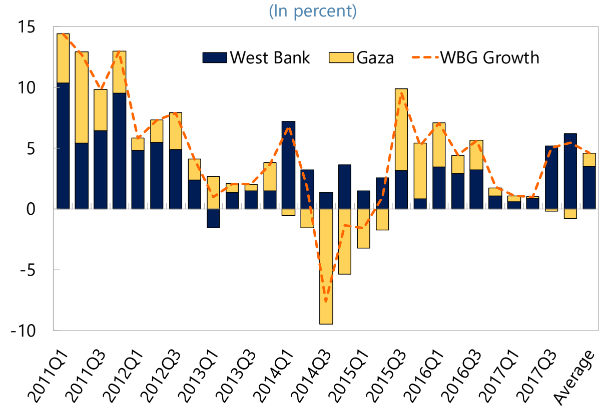
Annex III. West Bank and the Gaza Strip—Growing Apart[1]

Years of isolation and recurring conflict have left the Gazan economy lagging far behind the West Bank. Its volatile performance has stunted economic development and undercut the economy's ability to provide for the livelihood of Gaza's residents. This is evident in the structure of the economy, its labor market and social indicators, as well as Gaza's dependence on government and donors. This steady erosion of economic buffers has left the economy more susceptible to macroeconomic and geopolitical risks.[2] The current circumstances—the strained political relationship between the two enclaves, increasing uncertainty around aid flows, and emerging vulnerabilities in the Palestinian financial sector—are a major constraint on Gaza's ability to grow, with negative implications for the overall health of the Palestinian economy.

1. **The Gaza and West Bank economies have followed very different patterns—increasingly so over the past decade**. Real GDP growth in Gaza has been significantly lower on average (3.1 percent against 5.5 percent) and more volatile (standard deviation of 11.1 percent against 7.8), reflecting the state of perpetual unrest and conflict (Figure III.1). This was particularly evident with the collapse and rebound of Gaza's contribution to growth around the 2014 war (text figure). Consequently, the level of real GDP in Gaza has fallen behind that of the West Bank: while the latter more than tripled since 1995, it has not even doubled in Gaza. The share of Gaza in the Palestinian economy has fallen from more than 35 percent in the 1990s to less than 25 percent today. This has also had a measureable effect on people's livelihoods. Today, real GDP per capita in Gaza is less than half of that in the West Bank.

Contributions to Growth

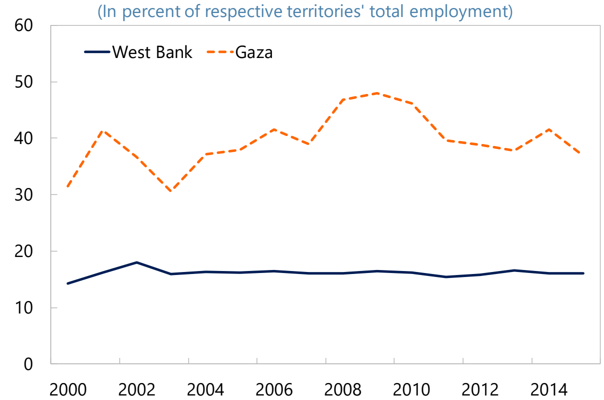
(In percent)



Source: Palestinian Central Bureau of Statistics.

Public Sector Employment Share

(In percent of respective territories' total employment)



Source: Palestinian Central Bureau of Statistics.

2. **The structure of Gaza's economy is also different** (Figure III.1). While private consumption plays a key role in driving output in both enclaves, Gaza is almost twice as reliant on public consumption (41 percent of GDP against 22 in the West Bank). The economy's dependence on the public sector is also evident in the larger share of the

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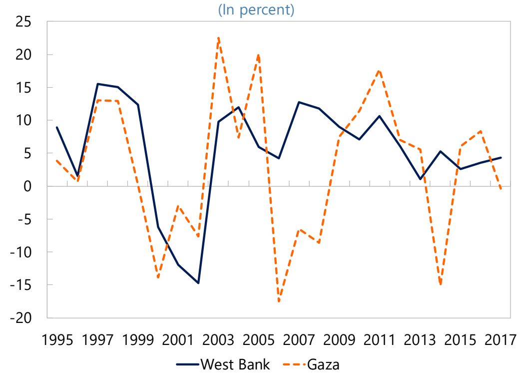
[1] Prepared by Hania Qassis and Robert Tchaidze.

[2] See also Box 1 on "The Risk of Eroding Economic and Political Buffers", [March 2018 *Report to the AHLC*].

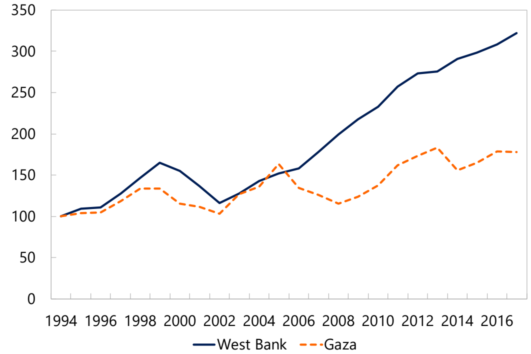
Figure III.1. West Bank and Gaza: GDP and Its Components

More volatile growth, particularly since the 2000s, saw Gaza's GDP fall well behind that of the West Bank.

Real Growth
(In percent)

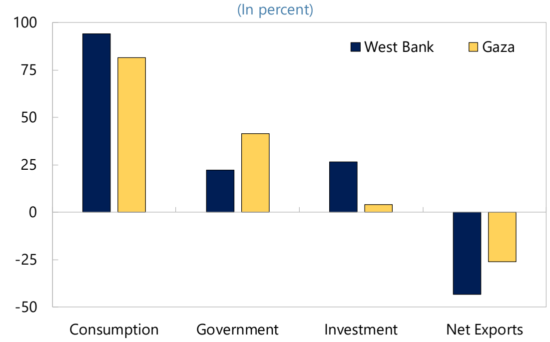


Real GDP Index
(1994 = 100)

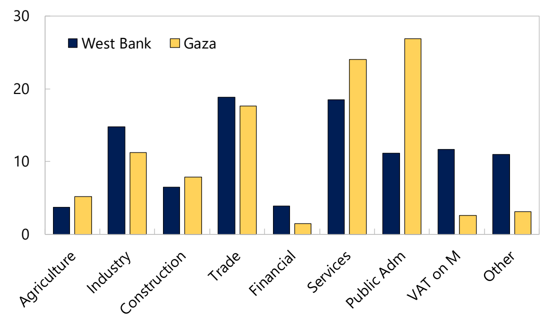


While private consumption is a key driver of growth in both regions, Gaza is significantly more dependent on the government (whether looking at the demand- or supply-side components of GDP), and investment is almost non-existent.

GDP by Demand Components, 2011Q1-2017Q4 Average
(In percent)

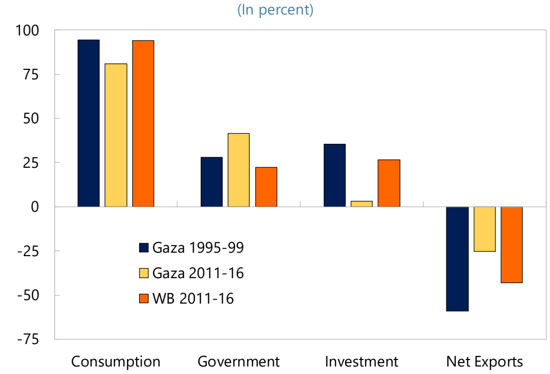


GDP by Supply Components, 2011Q1-2017Q4 Average
(In percent)

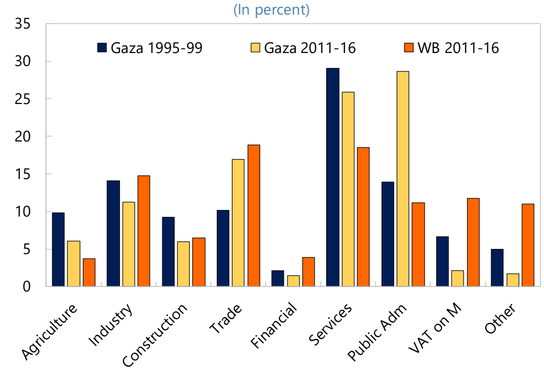


Yet, the structure of Gaza's economy in the late 1990s was very similar to what the structure of the West Bank is today, both from the demand and supply perspectives.

Gaza GDP by Demand Components
(In percent)



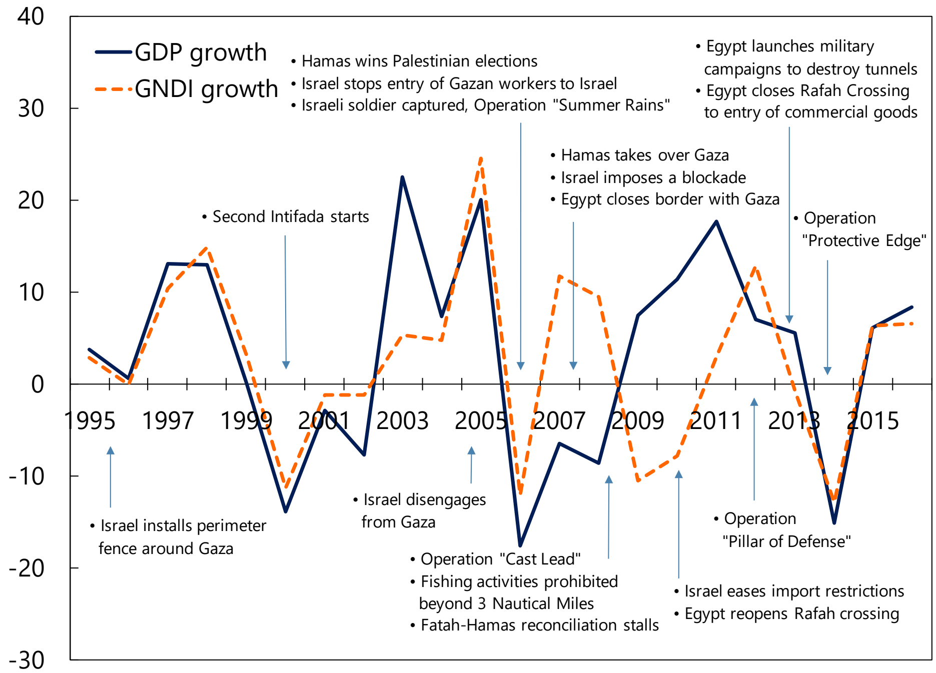
Gaza GDP by Supply Components
(In percent)



Sources: Palestinian Central Bureau of Statistics; and IMF staff calculations.

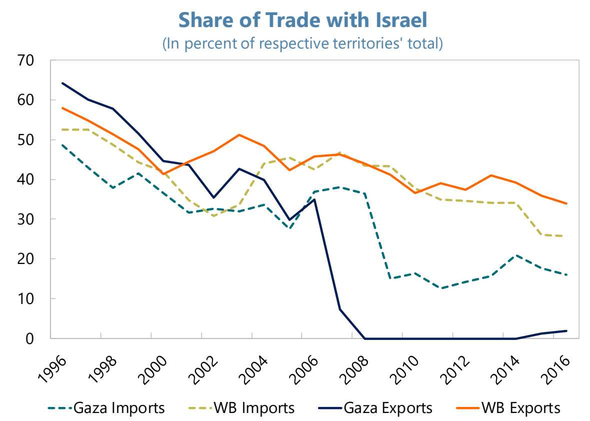
public sector services on the supply side (and employment), relative to the West Bank. Also, investment is virtually absent in Gaza at just 4 percent of GDP compared to 26 percent of West Bank GDP. Out of this, investment into productive capital (i.e., non-buildings) has averaged just 0.5 percent of GDP against 6 percent in the West Bank. Finally, net imports in Gaza are much lower than in the West Bank (26 versus 43 percent of GDP). However, these differences are a relatively recent phenomenon. In the late 1990s, the structure of Gaza's GDP was quite similar to that of the West Bank. The divergence reflects the increasingly unfavorable conditions in which the Gaza economy has operated over the past decade: recurring conflict, restrictions on the movement of goods and labor, an inhospitable investment environment, and declining capacity to spend (Figure III.2).

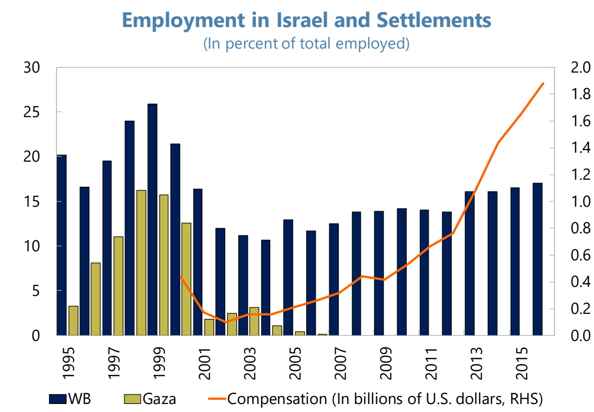
Figure III.2. Gaza: Political and Economic Events, 1995–2016
(In percent)



Sources: Palestinian Central Bureau of Statistics; United Nations Office for the Coordination of Humanitarian Affairs.

3. **Gaza's economic deterioration is also associated with a significant decline in economic relations with Israel.** In the late 1990s, Israel was the destination for more than 60 percent of Gaza's exports. Today that share is effectively zero. Similarly, before the second intifada, almost 16 percent of Gaza's employed population was working in Israel. Today that number is zero. Meanwhile, the West Bank continues to develop economic ties with Israel. Today more than 30 percent of the West Bank's exports head to Israel, and some 17 percent of employed residents of the West Bank labor force work in Israel, with their earnings having increased from US$0.8 billion in 2012 to US$1.9 billion in 2016.





Sources: Palestinian Central Bureau of Statistics; and IMF staff calculations.

4. One observes a similar picture in the banking sector, with financial development in the West Bank outpacing Gaza. Recurrent conflicts and tighter restrictions have hindered the ability of Gazans to have the same access to banking services as in the West Bank. The number of bank branches and ATMs are starkly different in the two regions. In the West Bank, there are 36 branches and 72 ATMs per 100,000 adults; in Gaza there are only 11 branches and 16 ATMs per 100,000 adults (Table 1).[3] The limits on financial intermediation, together with the inherent volatility of the Gazan economy, have undercut the ability of Gaza's economy to generate growth and income. This has been particularly disruptive to deposit growth. With Gazans forced to draw down their savings to sustain consumption, the deposit-to-GDP ratio dropped over the past decade (namely savings and time deposits) (Figure III.3).

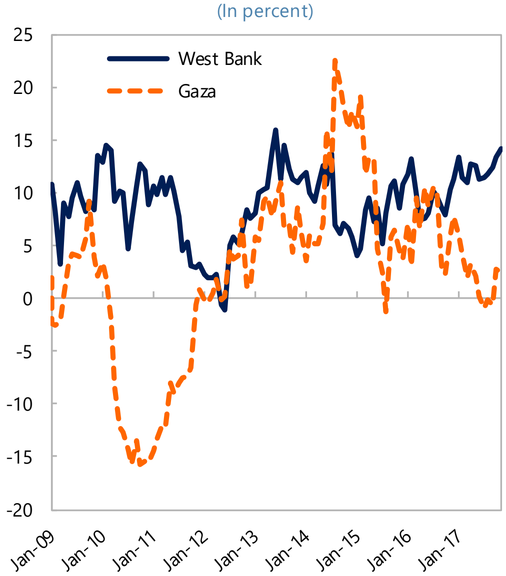
5. In these circumstances, the continued reliance on credit in Gaza poses risks to the banking system (Figure III.4). Following the 2014 war, private credit growth in Gaza accelerated, outpacing both credit growth in the West Bank and deposit growth in Gaza. Consequently, the loan-to-deposit ratio in Gaza increased sharply, nearing 90 percent (compared to around 65 percent in the West Bank). While rapid credit growth by itself need not be a source of concern, the composition of credit alongside the economy's dependence on the public sector and donor aid suggests that banks' operations in Gaza may become a source of financial vulnerability. Around half of Gaza's credit portfolio is extended to PA employees, and the dollar amount of loans to UNRWA employees (and those guaranteed by UNRWA employees) are double that of the West Bank. Moreover, with more than 40 percent of Gaza's credit portfolio intended to finance consumption, financial vulnerabilities can easily spillover into the broader Gazan economy. In this regard, the rapid increase in bounced checks and NPLs, especially in Gaza, is a worrying sign.

[3] According to the 2017 Census; number of adults aged 18 years and above.

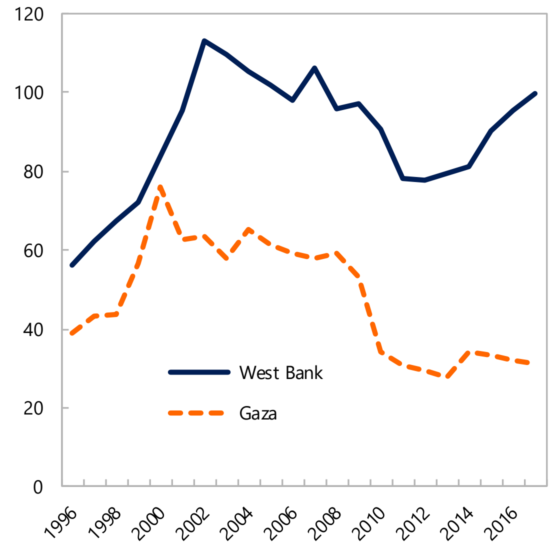
Figure III.3. West Bank and Gaza: Financial Inclusion and Savings

Gaza's deposit growth has been volatile and declining, reflecting lower financial inclusion and limited income of residents.

Total Deposit Growth
(In percent)

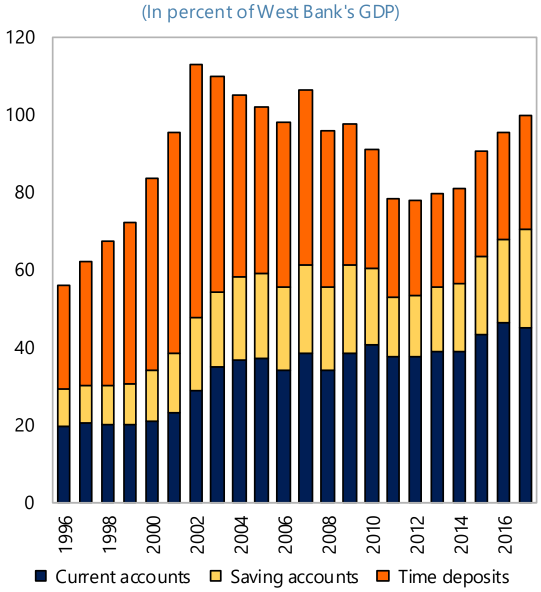


Total Deposits
(In percent of respective territories' GDP)

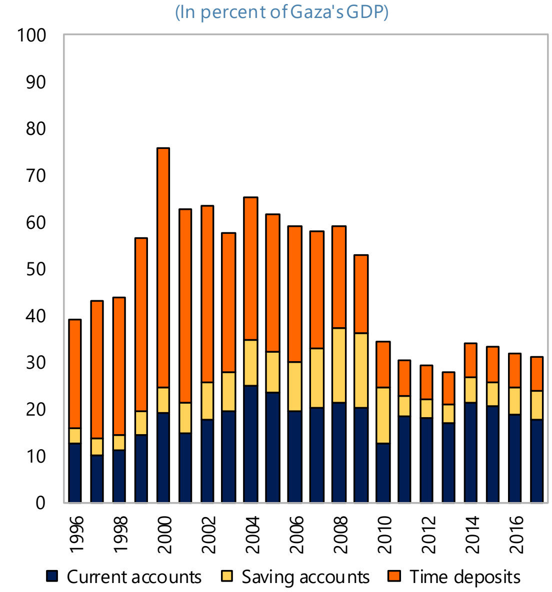


The decline was most felt with savings and time deposits in Gaza, a likely reflection of the run-down of deposits to consume or the severely constrained ability of individuals to save.

West Bank: Deposits by Type
(In percent of West Bank's GDP)



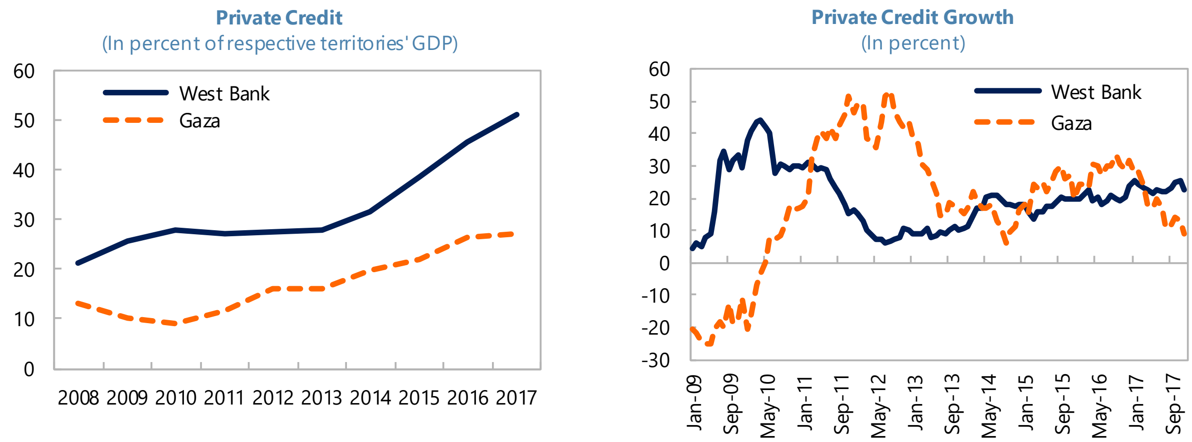
Gaza: Deposits by Type
(In percent of Gaza's GDP)



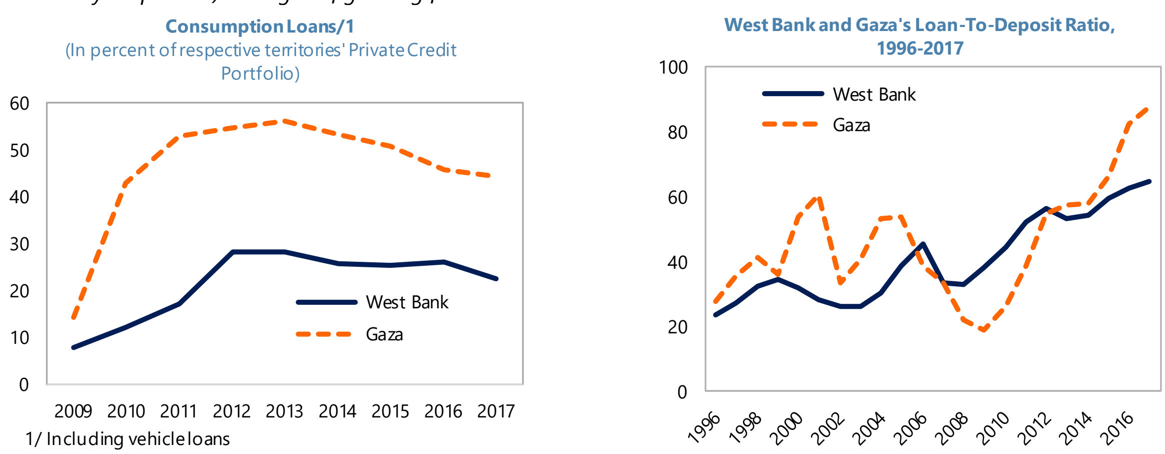
Sources: Palestine Monetary Authority; Palestinian Central Bureau of Statistics; and IMF staff calculations.

Figure III.4. West Bank and Gaza: Credit Expansion and Growing Financial Risks

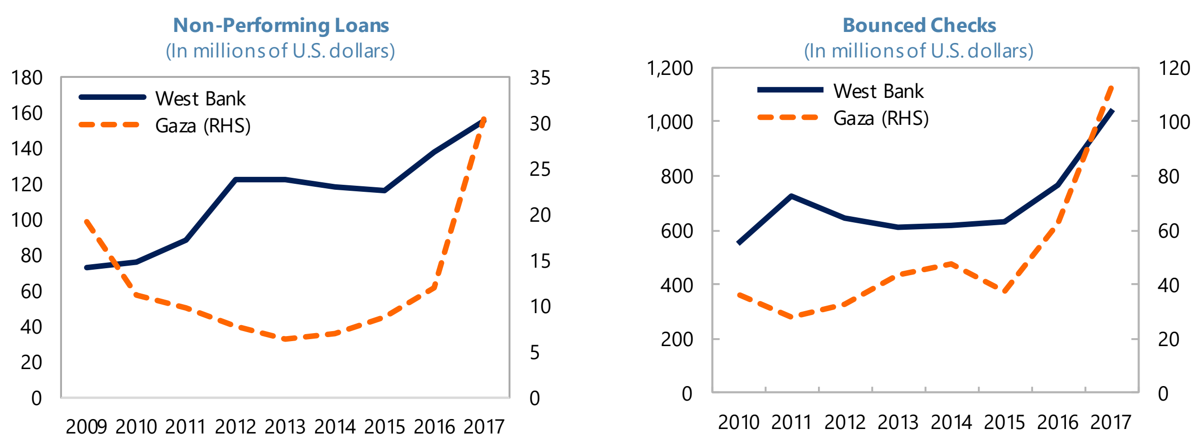
While the level of total private credit in Gaza has been consistently lower than in the West Bank, its growth rate has been more volatile and for quite some time has outpaced that of the West Bank.



Gaza's higher concentration of credit towards consumption loans and the more rapid escalation of its loan-to-deposit ratio (now nearly 90 percent) are signs of growing financial vulnerabilities.



These vulnerabilities in Gaza are evidenced by the sharp increases in non-performing loans and bounced checks.



Source: Palestine Monetary Authority.

6. Overall, Gaza's economic potential is far from being fully realized (Figure III.5). Labor participation rates are low (although not dissimilar to those in the West Bank), but unemployment rates are much higher. Gaza's capital stock has been largely destroyed after years of conflict and instability, and there are serious obstacles to rebuilding it.[4] Gaza's economy is underbanked, with little capacity to improve the situation in the near term, and there is less appetite to start new businesses than in the West Bank. With this potential not being realized, there is a widening income gap between the West Bank and Gaza that has important social and geopolitical implications.

7. In particular, growth rates in Gaza could have been three times higher, had the utilization of production inputs been similar to that of the West Bank. The so-called Solow accounting exercise allows to estimate contributions of various inputs—employment growth, capital accumulation, and productivity changes—to the overall real GDP growth.

- While the level of employment in Gaza has been growing on average by 4.5 percent a year in 2007–16 against 2.2 in the West Bank, the productivity growth was just 1 percent against 2.7 in the West Bank, and the capital stock (adjusted for conflict) has been declining by 2.6 percent a year against an increase of 1.8 percent a year in the West Bank.
- Together these observations explain an average annual growth rate of 2.8 percent in Gaza against that of 6.7 percent in the West Bank with the capital erosion being the biggest drag on the economy, and the weak productivity growth being an additional brake on the economy.
- Had the capital stock accumulation and productivity growth rates been similar to those in the West Bank, output growth in Gaza could have reached 9 percent. That would have been without taking into account much higher unemployment rates in Gaza that imply a potential for even faster growth rates in the level of employment and, correspondingly, in the level of output.

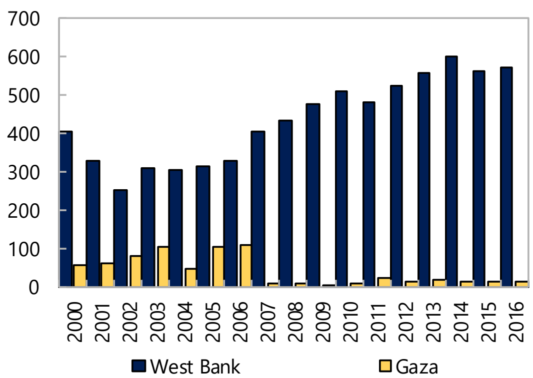
8. These observations show that the humanitarian crisis facing Gaza has been years in the making and will require a substantial change in conditions to turn the situation around. The constraints imposed on the economy for political and security reasons have changed its structure, held back its development, and substantially undermined its potential. In turn, this environment has cost people their livelihoods—both the loss of income and loss of opportunity—and risks feeding into social unrest and radicalizing population. Young people have been hit especially hard, as the vast majority is unemployed and sees little, if any, prospects for their future. This points not only to the magnitude of the policy challenge, but to a necessity of a political breakthrough to overcome Gaza's structural constraints and reverse the decline.

[4] See Annex III on "The Cost of Conflict and Political Uncertainty for the Economy's Capacity to Grow" in the IMF's August 2017 *Report to the AHLC*.

Figure III.5. Gaza: Unrealized Potential

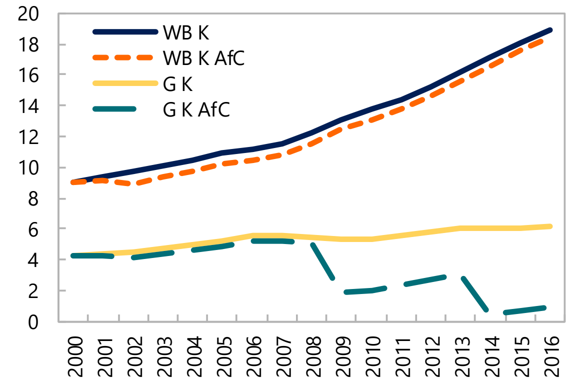
Investment in productive capital (non-buildings) in Gaza is well below that of the West Bank.

Investment in Productive Capital
(In millions of U.S. dollars)



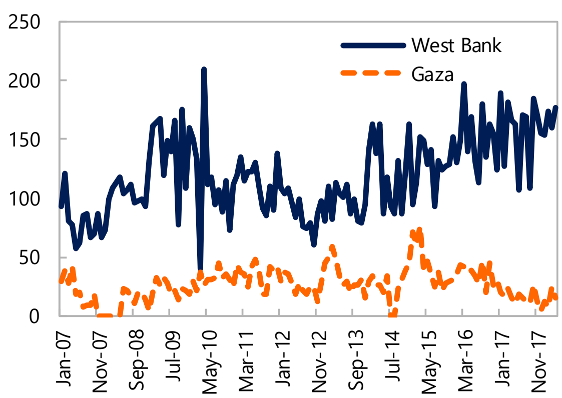
Hence, the stock of capital, especially when accounting for conflict-related destruction, is virtually non-existent.

West Bank and Gaza's Capital Stock
(In billions of 2004 U.S. dollars)



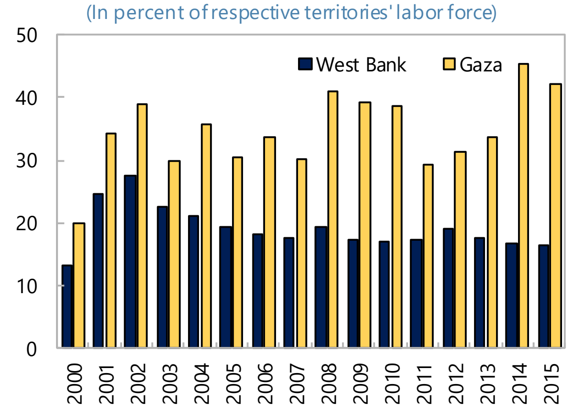
Appetite for new business remains significantly lower in Gaza than in the West Bank…

Number of Company Registrations



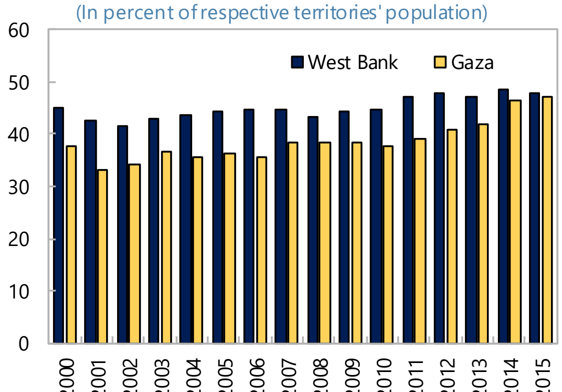
… with much higher unemployment rates in Gaza; especially over the past decade.

Unemployment Rate
(In percent of respective territories' labor force)



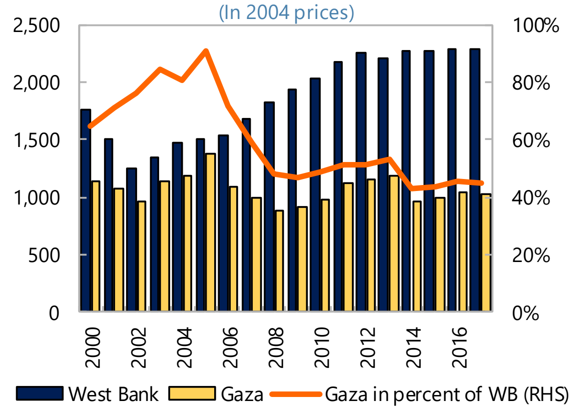
… despite low—and broadly similar—labor participation rates in both Gaza and the West Bank.

Labor Force Participation
(In percent of respective territories' population)



A sizeable gap in real GDP per capita between the two territories emerges.

Real GDP Per Capita
(In 2004 prices)



Sources: Palestinian Central Bureau of Statistics; and IMF staff calculations.

Table III.1. Main Socio-Economic Indicators for West Bank and Gaza, 2017

	West Bank	Gaza
Population, thousands	2,882	1,899
Of which (0-17) years	42%	47%
Of which (18-29) years	22%	23%
Of which 60 years and over	5%	4%
Registered Refugees, thousands 1/	810	1,300
Population Density (Persons per Km^2)	509	5,203
Population Projection by 2030, thousands 2/	3,969	3,081
Population Projection by 2050, thousands 2/	5,690	5,017
Number of households	594,429	334,710
Average household size	4.8	5.6
Mean number of children born	4.3	4.5
Youth (19–24 years) unemployment rate	25.5	57.9
Share of illiterate population	2%	2%
Completed Associate Diploma and Above	13%	14%
Percentage of individuals who use improved drinking water	95.1	11.4
Average Monthly Expenditure per Capita (in USD) 3/	310	128.5
Average Monthly Consumption per Capita (in USD) 3/	312	134.0
Poverty percentage	14%	53%
Deep Poverty 4/	6%	34%
Percentage of individuals that earned an income less than the deep poverty line	15%	54%
GINI Index	32%	34%
Total number of ATMs	560	84
Total number of bank branches	279	58

Sources: Palestinian Central Bureau of Statistics; and Palestine Monetary Authority.

1/ United Nations Relief and Works Agency, as of 31st of Dec 2016 for West Bank and as of October 31, 2016 for Gaza.

2/ United Nations Population Fund; projections using high variant.

3/ The poverty line and deep poverty line for reference household (two adults and three children) stood at NIS 2,470 (USD 671) and NIS 1,974 (USD 536) respectively.

4/ Exchange rates used were the same as the ones cited in PCBS Palestine Living Standard report for 2017; 3.68 USD/NIS and 5.19 JOD/NIS.

Annex IV. External Sector Assessment[1]

Staff analysis using standard IMF methodology confirms that the West Bank and Gaza (WBG) faces large and persistent external imbalances. These imbalances both evidence the underlying restrictions impeding WBG's development and add to the vulnerabilities facing the WBG economy. The Current Account (CA) Balance and Real Effective Exchange Rate (REER) approaches using External Balance Assessment-Lite (EBA-Lite) methodology indicate that WBG's external position in 2017 was weaker than suggested by the fundamentals and desirable policy settings. This finding, despite some data limitations, is consistent with the significant restrictions on WBG's external market access. The recent deterioration of the security situation and impact on the Palestinian economy point to a further weakening of WBG's external position. Given WBG's unique geopolitical circumstances, the authorities cannot avail themselves of the whole macroeconomic policy toolkit, and serious fiscal strains further limit their room for policy maneuver. Thus, significantly improving WBG's external position would also require actions to relax external constraints.

Background

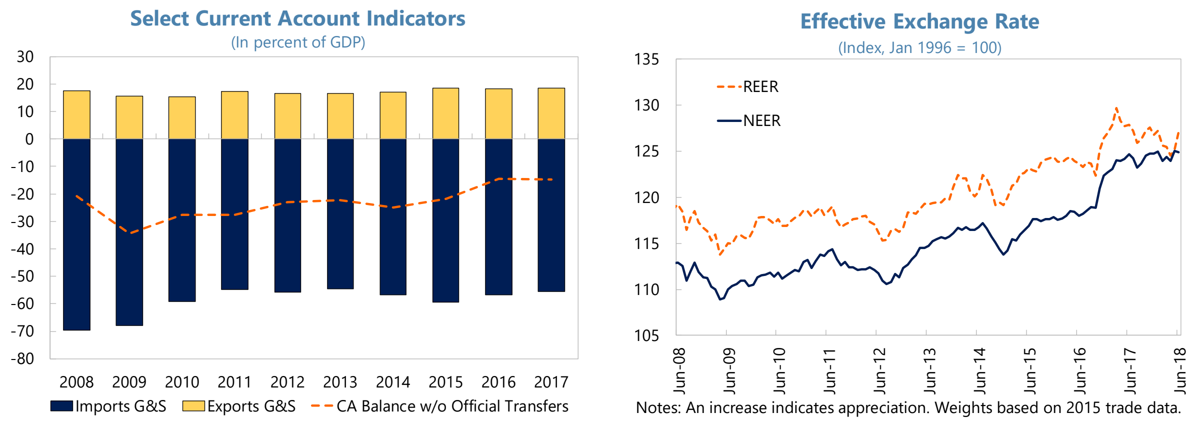
1. **WBG's large external current account deficit is expected to remain high over the medium term** (Figure IV.1.) The CA deficit (excluding official transfers) has averaged more than 20 percent of GDP over the past decade, driven by a profound imbalance in merchandise trade. Reasons for this high trade deficit include: (i) significant export market access constraints: (ii) import restrictions from the "dual use list" of restricted products affecting the production process; (iii) a deterioration of the capital base that underpins production processes, especially in Gaza; (iv) crippling restrictions on access to land and water for agriculture, and fishing grounds; and (v) the steady real appreciation of the main currency in use in WBG, the Israeli shekel. High net income inflows mitigate the impact of the trade balance on the CA, but the prevailing low private savings and public dissaving nonetheless underpin WBG's dependence on aid and small investments from abroad.[2]

2. **Prospects for lasting improvements in the CA position are weak**, since conditions underpinning past imbalances are set to continue and will likely be compounded by new adverse developments. Despite a better than average outturn in 2016–2017 due to higher income from day workers in Israel and somewhat higher reconstruction in Gaza even without "reunification", staff expects the CA deficit will average around 16.5 percent of GDP over the medium term. This reflects, among others, ongoing restrictions, slowing construction employment opportunities in Israel, and a domestic economy hobbled by the withholding of a large part of clearance revenue. Staff's baseline macroeconomic framework also assumes donor support at the current low level, which is inadequate to meaningfully address fiscal risks.

[1] Prepared by Jean van Houtte (MCD), with Mohammed Saleh (SPR).

[2] The BOP suffers from significant data weaknesses, and its improvement is a priority for the PCBS; an IMF TA mission visited Ramallah in July 2018 to help address them.

Figure IV.1. West Bank and Gaza: Select External Sector Indicators



Sources: Palestinian Central Bureau of Statistics; and IMF staff estimates.

Notes: An increase indicates appreciation. Weights based on 2015 trade data.
Sources: Haver Analytics, Information Notice System; and IMF staff calculations.

Methodology

3. **The EBA-lite methodology includes three approaches: current account model, real exchange rate model, and external sustainability approach**. Based on available data, staff used the first two approaches for this ESA.[3] The current account (CA Balance) and real exchange rate (REER) models are based on two panel regressions of the current account and the real exchange rate, respectively, on policy variables and variables that are not directly within the authorities' control, such as population growth. The regressions provide estimated current account and exchange rate "norms," which are values consistent with fundamentals and desirable policies. External gaps are assessed by the difference between the cyclically-adjusted actual current account and real exchange rate and their corresponding norms.

Assessing External Competitiveness

4. **Both the CA Balance approach and REER approach suggest that WBG's external position is weaker than warranted by fundamentals and desirable policy settings.** The implied overvaluation of the shekel under both approaches is strongest with the CA Balance approach.

- Under the CA Balance approach, the gap between the actual current account deficit and the norm derived from fundamentals is relatively high for 2017, and is within the range of -5.3 percent plus or minus the standard deviation for the CA Balance approach regression. Moreover, the CA balance's projected deterioration beyond 2017's unusually favorable outcome will increase that gap further. The CA deficit is set to increase as public and private savings levels fall. The contribution of policy variables (the "overall policy gap") is negligible (0.1 percent of GDP). This means that the overall policy challenge facing the WBG authorities is no greater than that of the rest of the world. The fiscal policy gap (-0.3 percentage point of GDP) reflects a rate of adjustment of 0.5 percentage points of GDP per year for 5 years. However, it is offset by an

[3] Staff did not pursue the External Sustainability approach due to gaps in Net International Investment Position data.

equivalent relative overperformance in WBG's other policies (the "residual policy gap"). The substantial negative unexplained residual gap of -5.4 percentage points (i.e., the difference between the CA gap and the overall policy gap) likely captures underlying structural policy gaps and impediments.

- The REER approach for 2017 also points to a significant overvaluation of the shekel, albeit somewhat milder than the CAB approach. It is within the range of 9 percent plus or minus the standard deviation for the REER approach regression. Importantly, in the absence of WBG having an actual policy rate, the analysis assumes a relatively high notional policy rate of 6 percent (compared with less than 1 percent for Israel). If WBG's notional policy rate were lower, the REER approach would show a higher overvaluation (a policy rate decrease of 1 percent causes a 0.2 percentage point increase in overvaluation).

Table IV.1. Summary Results of EBA-Lite Panel Regressions

CA Approach		
Current Account - Actual		-13.8%
CA - Cyclically Adjusted	(a)	-14.1%
Current Account Norm		-8.6%
CA Norm - Cyclically Adjusted	(b)	-8.8%
Current Account Gap	**(c = a - b)**	**-5.3%**
o/w Overall policy gap	(d = e + f)	0.1%
Fiscal policy gap	(e)	-0.3%
Residual policy gap	(f)	0.4%
Elasticity to REER		-0.24
Implied REER Gap		22.2%
REER Approach		
REER Gap		**9.1%**

Sources: Palestinian Central Bureau of Statistics; and IMF staff calculations.

Table IV.2. ESA Classification of the Overall Assessments

CA gap	REER gap (based on elasticity at -0.2)	Description in overall assessment
≥ 4%	≤ -20%	... substantially stronger...
[2%, 4%]	[-20%, -10%]	... stronger ...
[1%, 2%]	[-10%, -5%]	... moderately stronger ...
[-1%, 1%]	[-5%, 5%]	The **external position** is **broadly consistent** with fundamentals and desirable policy settings.
[-2%, -1%]	[5%, 10%]	... moderately weaker ...
[-4%, -2%]	[10%, 20%]	... weaker ...
≤ -4%	≥ 20%	... substantially weaker ...

5. **While analytical results under both approaches are broadly consistent with each other, data limitations warrant prudence.** WBG suffers from relatively short data spans and missing data for some variables. In the case of missing country data, alternative data sources were used, as per

well-established methodology for other countries, except for two variables for which no alternative data could be found. Averages of regional comparators were substituted in both cases. However, these last two variables, which are relevant only for the CA Balance approach, have only a limited effect on the regression[4] and do not substantively affect the finding that WBG's external position is weaker than suggested by the fundamentals.

6. Given the dominant effect of external restrictions, examining qualitative- or survey-based indicators provides a more fulsome assessment of WBG's competitiveness. While some indicators are lagging, others showcase the potential of the WBG economy.

- WBG is ranked 114th of 190 countries on the World Bank's 2018 Doing Business report, up 26 places from the previous year. Although this put WBG close to the average for the Middle East and North Africa, there are two important caveats:
  - One, the Ramallah-only coverage of the Doing Business indicators for WBG is biased toward a favorable outcome. While a single city or region approach is not unique, it is more problematic in this case as it does not capture well the significant constraints across the entire Palestinian economy, and especially in Gaza.
  - Two, the ease of "getting credit" was a key driver in WBG's 26 place improvement, which reflected the benefits likely to stem from passage of the Secured Transactions Law and from setting up a new collateral registry in 2017. However, rapid credit growth is also a watch point for the financial sector, particularly amid heightened pressures on banks in Gaza (see Box 1). Moreover, stark regional differences in access to credit—again, especially in Gaza (see Annex III)—give staff some pause in interpreting these results.
- According to the ILO, more than 100,000 Palestinian day laborers in Israel (more than 12 percent of Palestinians employed in the West Bank) earn wages that are more than twice what they are in WBG.[5] This speaks to the dearth of opportunities in the West Bank, where only half the working age population has a job. While average wages in the West Bank are around 40 percent of what they are in Israel, the labor productivity of workers in Israel is around twice that of workers in the West Bank, thus making the alleviation of structural impediments to productivity in WBG one of the key avenues to improving competitiveness.

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[4] In the case of the variable tracking the quality of institutions (the ICRG index), a 10 percent increase in the index causes the relative overvaluation to decrease by 0.2 percentage points. In the case of the variable tracking the openness of the capital account (an index from 0 to 1 reflecting the Chinn-Ito index), a 10 percent increase in the index causes the relative overvaluation to decrease also by 0.2 percentage points. The combined effect of these two stresses is cumulative.

[5] Israeli figures—including permitted and unpermitted workers, plus workers in settlements—puts the total figure of Palestinians working in the Israeli economy closer to 150,000 or 17 percent of the West Bank's labor force.

- The Worldwide Governance Indicators[6] also show mixed results. As of 2016, issues such as "control of corruption" and "rule of law" remain problematic, with scores for WBG of -0.15 and -0.31 respectively, although both scores are marginally better than the respective Emerging Markets and Developing Economies averages of -0.3 and -0.5.

7. Overall, staff assesses WBG's external position to be weaker than warranted by fundamentals. Taking into account all the above factors and the significant degree of uncertainty, staff assesses the CA gap to be -2 to -6 percent of GDP and the REER to be overvalued by 5–25 percent.

Issues and Policy Options

8. Significant structural constraints and policy limitations prevent WBG from reaping the benefits of non-negligible competitive advantages, such as low wages, a young and well-educated workforce, relatively easy access to banking, and geographic proximity to large markets. While the WBG authorities control some policy levers, many are either wholly or partly in the hands of Israel as explicitly set out in the documentation associated with the post-Oslo process (Table IV.3). The efficacy of policies is also impacted by administrative or other actions impacting how these agreements are implemented in practice. Moreover, those policies where there is more latitude are at risk of being overburdened given the limits on other policies.

- *Monetary policy is not a policy option for WBG authorities.* Monetary policy by the Bank of Israel is understandably geared to addressing the needs of an Israeli economy, for which the shekel does not appear overvalued,[7] but that is structurally different from the Palestinian economy.

- *Fiscal policy is a policy area where WBG authorities have significant control, but limited scope*. While controlling the large fiscal deficit would help the external position, the demands on fiscal policy—in terms of minimizing the harm to growth and addressing potential emergency needs in Gaza—call for a gradual and limited fiscal adjustment. Moreover, lack of progress on reducing 'fiscal leakages' from CRs (see paragraph 21 of main text) and the prospective CR withholding by Israel substantially constrain the PA's options for fiscal adjustment. More active Israeli support towards the resolution of "fiscal files" could improve PA revenue significantly and sustainably.

- *The WBG authorities have leeway to improve external competitiveness by furthering structural reforms.* These reforms include basic infrastructure improvements in terms of quality and price, certain improvements in the business environment, and other structural reforms highlighted elsewhere in this report. However, Israel retains formal control over key structural policy levers. Issues about access for goods and services to external markets are largely within the hands of Israel. Electricity and water provision are also in large part a function of Israeli engagement.

[6] World Governance Indicators score governance performance on a -2.5 (weak) to 2.5 (strong) scale.

[7] *Israel: 2018 Article IV Consultation*, IMF Country Report No. 18/111.

Table IV.3. West Bank and Gaza—Key Limits on the Economic Policy Toolkit Under the Oslo Process Agreements

MONETARY AND FINANCIAL POLICIES

A Palestinian currency (or alternative currency arrangements) can only be introduced by agreement with Israel[3]

Minimum liquidity requirements on NIS deposits, which are also tied to changes in corresponding requirements in Israel[3]

Limits on converting NIS held by PMA into FX and vice versa[3]

FISCAL POLICY

Israel administers so-called "clearance revenues", collecting some WBG taxes—mostly indirect taxes representing around two-thirds of PA revenues—and subsequently transferring these to the PA[1]

Israel deducts a 3 percent handling fee on import taxes and other indirect taxes collected for the PA[1]

WBG VAT rates are tied to (i.e., not more than 2 percentage points below) Israeli VAT rates[1]

TRADE & STRUCTURAL POLICIES

Israel administers WBG's border transactions[1,2,3]

Limits on imported and exported goods (according to the so-called A1, A2, and B lists)[1]

West Bank is divided into Areas A, B and C:[3]

- In Area A, the PA has full responsibility for internal security and public order, and civil affairs;
- In Area B (around 25% of the WB), the PA has full responsibility for civil affairs, and Israel has over-riding security authority; and
- In Area C (around 60% of the WB), Israel retains full responsibility for security and public order and civil affairs.

Committee for co-operation[2] to jointly consider economic issues in WBG related to:

- Water development;
- Electricity production and distribution;
- Energy, including oil and gas in Gaza;
- Finance;
- Transport and communications;
- Trade and trade promotion;
- Labor relations and social welfare issues.

Sources:
[1] The Paris Protocol or Protocol on Economic Relations Between the Government of Israel and the PLO.
[2] The Oslo I Accord or Declaration of Principles on Interim Self-Government Arrangements.
[3] The Oslo II Accord or Interim Agreement on the West Bank and the Gaza Strip.

Annex V. Technical Assistance by the IMF to the Palestinian Authority, 2013–18

The IMF has provided technical assistance (TA) focused in the areas of public financial management, revenue administration, banking supervision, and national accounts. The priorities over the medium term remain on public financial management, tax policy and revenue administration, and banking supervision and stability. There is a need to periodically review and help enhance the authorities' statistical capacity, especially in GFSM 2001, the external sector, and national accounts (expenditures side). It is expected that the IMF's Fiscal Affairs Department (FAD) and Monetary and Capital Markets Department (MCM) will continue to provide TA, dependent on the authorities' commitment and progress, supported by Middle East Regional Technical Assistance Center (METAC).

Mission Date	Mission	Date of TA Report
Fiscal Sector: Since 2007, components of a modern public financial management system have been put in place and steadily upgraded. Progress to date in PFM was made in drafting legal frameworks for the budget process and the organization of the Ministry of Finance and Planning; adopting cash management standards and establishing a cash management unit; establishing an independent external audit agency; and establishing a macro-fiscal forecast unit. A new Public Financial Management Strategy 2017–22 has been adopted to chart a path towards new legislative and regulatory frameworks; review commitment controls and cash controls; cash planning; improve the management of debt, cash and arrears; and strengthen compliance with GFSM 2001 standards. Since 2010, the TA efforts aimed at modernizing the tax administration. The work program, derived from FAD's assessment of tax policy, will strengthen the administration of income tax and VAT for the large and medium taxpayer segments and reduce tax incentives and exemptions. Recent notable progress includes creating a single Taxpayer Identification Number and operationalizing the Large Taxpayer Unit.		
Jan. 22–31, 2013	Public Financial Management Progress Review	Jan. 2013
Jun. 25–Jul. 8, 2013	Supplementary Technical Review: Investment Tax Incentives and Tax Expenditure Costs	Jul. 2013
Nov. 24–Dec. 5, 2013	Strengthening LTO Operations	Dec. 2013
Jan. 8–21, 2014	Public Financial Management Reform Agenda 2014–16	Mar. 2014
Nov. 9–20, 2014	Strengthening Large Taxpayer Unit	Nov. 2014
Nov. 23–Dec. 1, 2014	Public Financial Management Progress Review	Dec 2014
Mar. 8–19, 2015	Compliance Modeling in LTU and Tax Departments	Mar. 2015
Aug. 16–27, 2015	Revenue Management System	Aug. 2015
Aug. 23–28, 2015	Work Program for Macro-Fiscal Advisor	n.a.
Oct. 13–25, 2015	Improving Taxation of SMEs: Design and Compliance Issues	Dec. 2015
Jan. 10–21, 2016	Preparation of Files for Prosecution	Jan. 2016
May 15–26, 2016	Supporting Effective Risk Management in the General Directorate of Customs Excise and VAT	May 2016
June 12–24, 2016	Budget Preparation and Macro-Fiscal Forecasting	June 2016
July 10–22, 2016	Budget Preparation and Macro-Fiscal Forecasting	Aug. 2016

July 31–Aug. 18, 2016	Training on Investigative Technique and Preparation of Customs for Prosecution	Aug. 2016
April 3–13, 2017	Budget Preparation and Macro-Fiscal Forecasting	May 2017
April 30–May 11, 2017	Customs Risk Management	April/May 2017
August 28–31, 2017	Operationalization of the PFM reform strategy	Sept. 2017
Sept. 4–13, 2017	Budget Preparation and Macro-Fiscal Forecasting	Oct 2017
Sept. 6–17, 2017	Strengthening Large Taxpayers Unit (LTU)	Sept. 2017
Nov. 27–Dec. 7, 2017	Budget Preparation and Macro-Fiscal Forecasting	Dec. 2017
Aug. 12–23, 2018	Budget Preparation and Macro-Fiscal Forecasting	n.a.
Monetary and Financial Systems: TA in this area has supported the Palestine Monetary Authority (PMA) to become a competent monetary authority, with an emphasis on developing and strengthening its capacity to supervise and regulate banks, as well as steps needed to introduce government securities, operate a high-quality reserves management system, and prepare for eventual introduction of an independent currency for the Palestinian economy when conditions are right. The PMA established a credit registry, instituted periodic stress testing of banks, introduced a deposit insurance scheme, and prepared plans for contingency crises management. The authorities have stepped up efforts to strengthen the Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) framework, with the support of IMF TA.		
Jan. 13–17, 2013	Reserve Management Policy and Investment Guidelines	Jan. 2013
Mar. 31–Apr. 11, 2013	Follow up on Risk-Based Supervision Manual	May 2013
Jun. 30–Jul. 10, 2013	Follow up on Risk-Based Supervision	July 2013
Nov. 3–14, 2013	Implementing Risk-Based Supervision*	Nov. 2013
Nov. 16–26, 2013	Credit Registry	Nov. 2013
May 25–29, 2014	Follow up on Risk-Based Supervision Manual	June 2014
Oct. 26–Nov. 6, 2014	Follow up on Risk-Based Supervision Manual	n.a.
Jan. 18–29, 2015	Follow up on Risk-Based Supervision Manual	n.a.
Mar. 8–19, 2015	Review of the Crises Preparedness and Management Framework*	May 2015
April 5–16, 2015	Implementing Risk-Based Supervision*	April 2015
April 13–17, 2015	Risk Assessment and Stress Testing*	May 2015
Feb 14–25, 2016	Follow up on Risk-Based Supervision Manual	n.a.
April 3–14, 2016	Implementing Risk-Based Supervision	April 2016
Mid 2016–Ongoing	Desk-based review of the AML/CFT framework	n.a.
Sept. 25–Oct. 6 ,2016	Implementing Risk-Based Supervision	n.a.
May 14–25, 2017	Workshop to develop the CFT legal frameworks of Jordan, Iraq, and West Bank and Gaza (in Amman, Jordan)	n.a.

Sept. 24–Oct. 3, 2017	Enhancing International Financial Reporting Standard 9 Implementation	March 2018
Feb. 25–March 8, 2018	Implementation of International Financial Reporting Standards	March 2018
July 1–5, 2018	Implementation of International Financial Reporting Standards	n.a.
Aug. 26–30, 2018	Financial Sector Stability Review Scoping mission	n.a.
Statistics: TA on statistical issues has focused on implementing and aligning existing statistical compilation and dissemination systems with international statistical standards across three major datasets for economic policy analysis—government finance statistics (GFS), national accounts (NA), and external sector statistics (ESS). These efforts enabled WBG to become a subscriber to the IMF's Special Data Dissemination Standard (SDDS) in April 2012. Further work is needed in improving data consistency in ESS, strengthening the methodology for quarterly GDP data, developing an inter-institutional strategic plan for GFSM2001 implementation, and developing a set of high-frequency indicators to detect economic trends and risks.		
Jan. 27–31, 2013	Balance of Payments Statistics – IIP	n.a.
May 18–29, 2014	National Accounts	June 2014
May 21–June 3, 2014	Monetary and Financial Statistics	June 2014
Dec. 7–18, 2014	Price Index	Dec. 2014
Feb. 1–12, 2015	External Sector Statistics	April 2015
Feb. 22–26, 2015	National Accounts	Mar. 2015
April 17–24, 2016	National Accounts	August 2016
Aug. 28–Sept. 1, 2016	National Accounts	Mar. 2017
Oct. 2–6, 2016	Producer Price Index	Dec. 2016
May 7–11, 2017	National Accounts	n.a.
Dec 17–21, 2017	National Accounts	Dec. 2017
March 11–15, 2018	National Accounts	July 2018
June 24–28, 2018	National Accounts	n.a.
July 28–Aug. 2, 2018	External Sector Statistics	n.a.
n.a. – not applicable. * Reports classified as confidential or strictly confidential.		

Annex VI. Statistical Issues[1]

(As of August 15, 2018)

I. Assessment of Data Adequacy

While data provision in the West Bank and Gaza (WBG) has some shortcomings, it is broadly adequate for economic analysis and policymaking. Statistics on government finance and the external sector are priority areas for improvement—for the former, the comprehensive and timely reporting of liabilities is an important issue; for the latter, the main issues involve inconsistencies between BOP and IIP data.

National Accounts: The Palestinian Central Bureau of Statistics (PCBS) compiles and disseminates annual and quarterly GDP estimates. Annual estimates of changes in inventories, although based on source data, lack credibility. Quarterly GDP estimates are mainly based on volume indicators, including an index of industrial production, and quarterly labor force statistics. Quarterly GDP by production, available since 2000, is calculated only at constant prices, while the expenditure components, available since 2011, are calculated at current and constant prices. Proper quarterly indicators for several components of GDP by expenditure are lacking and changes in inventories are derived as residual. PCBS has rebased the annual and quarterly GDP from 2004 to 2015, but the estimates require improvements. Revisions are expected in the near term with the availability of new source data (including the 2016/17 Palestinian Expenditure and Consumption Survey (PECS) and the 2017 establishment census), the adoption of improved compilation methods (including chain-linked volume measures) and the calculation of quarterly GDP by production at current prices. In improving annual and quarterly national accounts PCBS is supported by IMF technical assistance.

Price Statistics: The PCBS has compiled and disseminated a consumer price index (CPI) for WBG since January 1996. In January 2014, the weights and index reference period were updated to 2010 using expenditure weights compiled from the 2010 PECS. The PCBS plans to publish a rebased CPI during 2018 based on the 2016/2017 PECS, following completion of the field work undertaken with support from the World Bank. There is a need to improve CPI compilation methods, mainly in relation to regularly updating the weights, fully implementing the Jevons formula at the lower level, treatment of season items, insurance weights, quality adjustments, and the inclusion of housing rent expenditures.

The PCBS has disseminated a producer price index (PPI) since 1997. Current weights are based on data collected in 2013. An updated PPI was released in January 2016 with the base period as December 2015. Weights are updated every 5 years.

Government Finance Statistics: Data compiled by the Ministry of Finance and Planning's (MoFP) Financial Reporting Department are broadly aligned with the recommendations of the GFSM 2001/2014. The general government sector is comprised of the budgetary central government, the social security fund, and some local government units. The latest annual data reported to the IMF Statistics Department (STA), with reference to 2015, excluded the social security subsector. The reported data also lack information on stock positions in financial assets and liabilities. Attention is needed to reconcile the stocks and flows of arrears, to develop an accurate record of gross and net public debt, and to produce real-time detailed debt statements. Quarterly and monthly series are disseminated by the authorities (http://www.pmof.ps/en/web/guest/43). The provision of institutional, transaction, and balance sheet information needs to be enhanced to fully meet the reporting requirements outlined in *Government Finance Statistics to Strengthen Fiscal Analysis* (February 2010) and the related Board decision on the use of the GFS analytical framework for fiscal analysis.

[1] Prepared by the IMF's Statistics Department, with inputs from the Middle East and Central Asia Department.

Monetary and Financial Statistics: The Palestine Monetary Authority (PMA) compiles and reports to STA monthly monetary data for the central bank, other depository corporations (ODCs), and other financial corporations (OFCs) using the standardized report forms (SRFs). The SRFs data for OFCs are on a quarterly basis and include insurance companies only. In general, monetary data for WBG based on the SRFs are in broad conformity with the recommendations of the *Monetary and Financial Statistics Compilation Guide* (*MFSMCG*), except that the source data for ODCs do not provide complete breakdowns by counterpart sector. Therefore, claims on public nonfinancial corporations include some claims on OFCs and extra-budgetary central government units, claims on the private sector include some claims on OFCs, and deposits included in broad money also include some deposits of extra-budgetary central government units. These departures from the *MFSMCG* are well noted in the metadata (country notes).
Financial Soundness Indicators (FSIs): Following assistance from STA, the PMA reports quarterly FSIs to the Fund, which are published on the IMF's FSI website. These FSIs comprise 11 core FSIs, 6 encouraged FSIs for deposit takers (with some delay), 2 encouraged FSI for other financial corporations (OFCs), 3 encouraged FSIs for non-financial corporations (NFCs), and 2 encouraged FSIs for real estate markets.
External Sector Statistics (ESS): WBG reports quarterly balance of payments (BOP) and international investment position (IIP) in the format of the sixth edition of the *Balance of Payments and International Investment Position Manual* (*BPM6*). There are some inconsistencies between the IIP and BOP due to gaps in coverage, misclassifications in both datasets, and inconsistencies in the methodologies employed by the two agencies (PMA and PCBS) for recording related activities. The July 2018 BOP statistics mission suggested revisions to improve the consistency of ESS, including (i) adding the stock of currency in circulation to currency and deposits (assets); (ii) revising non-financial sector stock data in the IIP and CPIS to ensure consistent recording; and (iii) including accumulated reinvested earnings in the IIP. Revised data are expected to be sent to IMF as well. WBG also provides monthly International Reserves and Foreign Currency Liquidity data to STA (as prescribed by the SDDS), participates in the Coordinated Direct Investment Survey (CDIS) with annual data for the period 2010–16, and in the Coordinated Portfolio Investment Survey (CPIS) with semiannual data from December 2017. However, CPIS data are currently not fully consistent with the IIP. The revised estimates would ensure consistency of these statistics.

II. Data Standards and Quality	
West Bank and Gaza has been an SDDS subscriber since April 2012.	No data ROSC has taken place in West Bank and Gaza.