INTERNATIONAL MONETARY FUND

WEST BANK AND GAZA

REPORT TO THE AD HOC LIAISON COMMITTEE[1]

August 26, 2016

KEY ISSUES

Context: The Israeli-Palestinian peace process remains stalled and it is unclear whether renewed international peace efforts will gain momentum. With domestic political reconciliation deadlocked, the outlook for parliamentary elections is uncertain amid strained security conditions. Reconstruction in Gaza appears to have gathered pace since late 2015, although the humanitarian situation there remains severe.

Outlook and risks: Political and security uncertainties weigh heavily on the prospects for growth. Under these conditions and with sustained moderate policy reforms by the Palestinian Authority, real GDP growth in the West Bank and Gaza will likely reach 3.3 percent in 2016 (2.7 percent in the West Bank, and 5.5 percent in Gaza) and around 3½ percent in the medium term—insufficient to reduce unemployment and boost per capita incomes. This outlook is subject to significant risks: (i) escalating violence; (ii) further declines in donor support; (iii) the inability to effectively contain spending; and (iv) threats to correspondent bank relations. While assertive policy actions are needed to mitigate risks, a more fundamental improvement in the outlook requires a political breakthrough.

Key policy recommendations: The priority in 2016 should be to alleviate pressures associated with the nearly $500 million projected financing gap, and mitigate the risk of an even larger gap. The Palestinian Authority should focus on resisting pressures on the wage bill, intensifying revenue enforcement efforts, and considering possible contingency plans. To ensure fiscal and economic sustainability in the medium term, the authorities need to maintain a gradual and balanced approach to fiscal consolidation, underpinned with fiscal structural reforms. Improving economic cooperation with Israel remains important. Reversing the decline in donor aid will be crucial to avoid too rapid budget compression and create space for growth-friendly investment. Efforts to maintain financial stability and develop a longer-term policy vision can help create conditions for private sector-led growth.

[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 and Bob Traa

Discussions were held in East Jerusalem and Ramallah during July 13–25, 2016, and the report was updated with subsequent developments. The staff team comprised Karen Ongley (head), Priscilla Toffano, Anna Unigovskaya (all MCD), Mariusz Sumlinski (FIN), Ragnar Gudmundsson (IMF Resident Representative), and Hania Qassis (IMF Resident Representative Office). The mission met Finance Minister Bishara, Palestine Monetary Authority Governor Shawwa, other senior officials, donors and private sector representatives. The mission prepared a concluding statement and issued a press release. Ramsey Andrawis, Greg Basile, Cecilia Pineda, and Vanessa Panaligan also contributed to producing this report.

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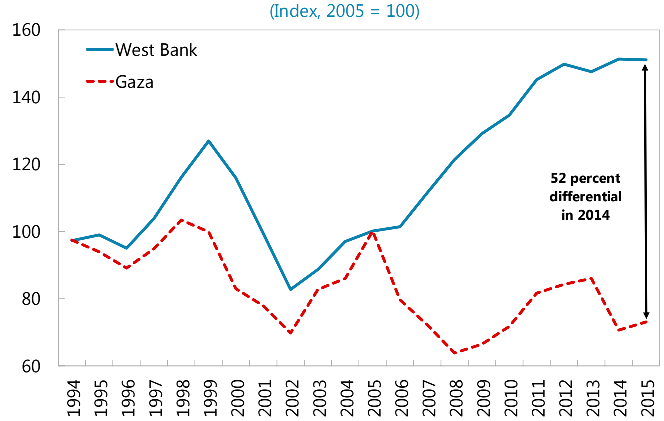
ANNEXES

CONTEXT

1. **The Israeli-Palestinian peace process remains stalled and security is strained.** Security coordination between the Palestinian Authority (PA) and Government of Israel (GoI) prevented the episodic violence since October 2015 from escalating into a deeper conflict. However, sporadic attacks continue to fuel a tense environment. There has also been good technical cooperation on economic issues and, earlier this year, Israel increased the number of permits for Palestinians working in Israel. Yet, the situation remains volatile, with entry permits periodically being revoked following security incidents. Moreover, Israeli restrictions and continued settlement expansion impede economic activity and exacerbate social hardships.

2. **The domestic political climate is uncertain and social pressures are building**. The outlook for new parliamentary elections is unclear, with little prospect for Hamas-Fatah reconciliation. However, Fatah and Hamas both plan to participate in municipal elections scheduled for October 2016. In Gaza, Hamas continues to act as the de facto government, hampering reconstruction efforts. The growing gulf between per capita incomes in Gaza and the West Bank offers some sense of the mounting humanitarian costs in Gaza. More broadly, rising social tensions were evident earlier this year with public sector strikes seeking higher wages and private sector employees protesting the proposed new social security law.

Evolution of GDP per Capita
(Index, 2005 = 100)



Sources: IMF World Economic Outlook and IMF staff calculations.

3. **Amid growing concerns for the two-state solution, key international partners are looking for alternatives to revive the peace process.** The French-sponsored meeting of foreign ministers in Paris in June 2016 called for the resumption of meaningful negotiations, with the hope of hosting a high-level conference later this year. The July 2016 report of envoys of the Middle East Quartet warns of eroding constituencies for peace on both sides, pointing (among others) to the risks posed by violence and settlement expansion. It calls on the PA and GoI to comply with basic commitments under existing agreements, advocates the cessation of settlement activities, and encourages the transfer of powers and responsibilities in Area C. However, prospects for peace through direct negotiations appear dim, with no recent signs of progress.

RECENT DEVELOPMENTS

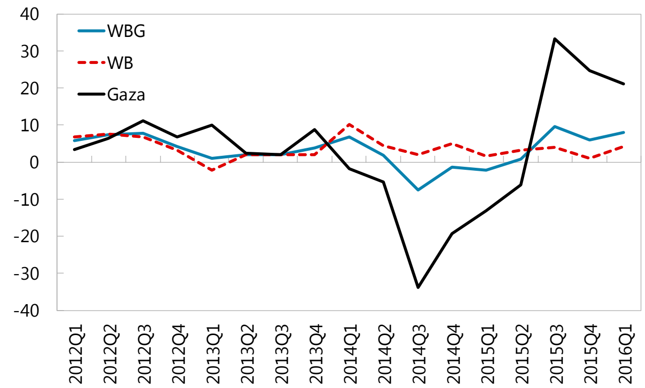
4. **The path of economic growth reveals two different, but difficult situations**—stagnant in the West Bank and volatile in Gaza.

- In the West Bank, real GDP growth slowed from 5.3 percent in 2014 to 2.5 percent in 2015 (with declining donor support and fiscal retrenchment), before picking up to 4.2 percent in Q1 2016, driven by private consumption and services.

- In Gaza, growth rebounded to 6.8 percent in 2015 following the 2014 war, and accelerated to 21 percent in 2016 Q1, as donor-funded reconstruction picked up.

Real GDP Growth, 2012-2016

(In y-o-y percent change)



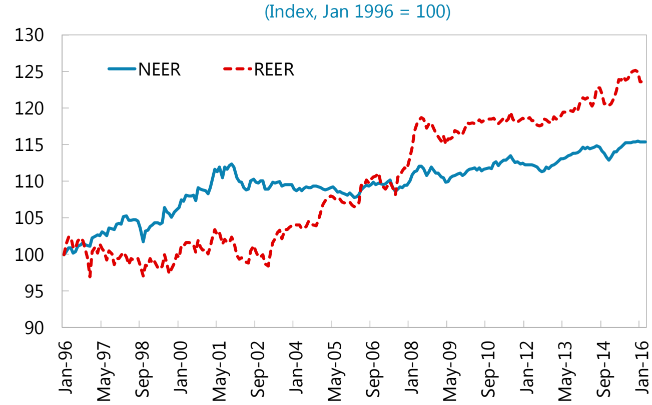
Sources: Palestinian Central Bureau of Statistics; and IMF staff estimates.

5. **Unemployment remains stubbornly high, especially among young people.** Overall unemployment reached 26.9 percent at end-June, up by about 2 percentages point compared to a year ago. Conditions are especially difficult in Gaza, where unemployment exceeds 40 percent and close to two-thirds of young people are without a job. With the dearth of job opportunities, too many people are disengaged from the labor market and labor force participation stood at just 45.7 percent in June.

6. **Inflation remains subdued**, edging above zero in July, reflecting low food and global commodity prices, and deflation in Israel. The real effective exchange rate appreciated by 1.1 percent in the year to March 2016, continuing the upward trend of the past decade and adding to the various non-price factors that weigh on competitiveness. Staff estimates suggest that, although unit labor costs declined in Gaza, they have increased by around 6 percent in the West Bank (the larger segment of the labor market) since 2015 Q1.

Effective Exchange Rate

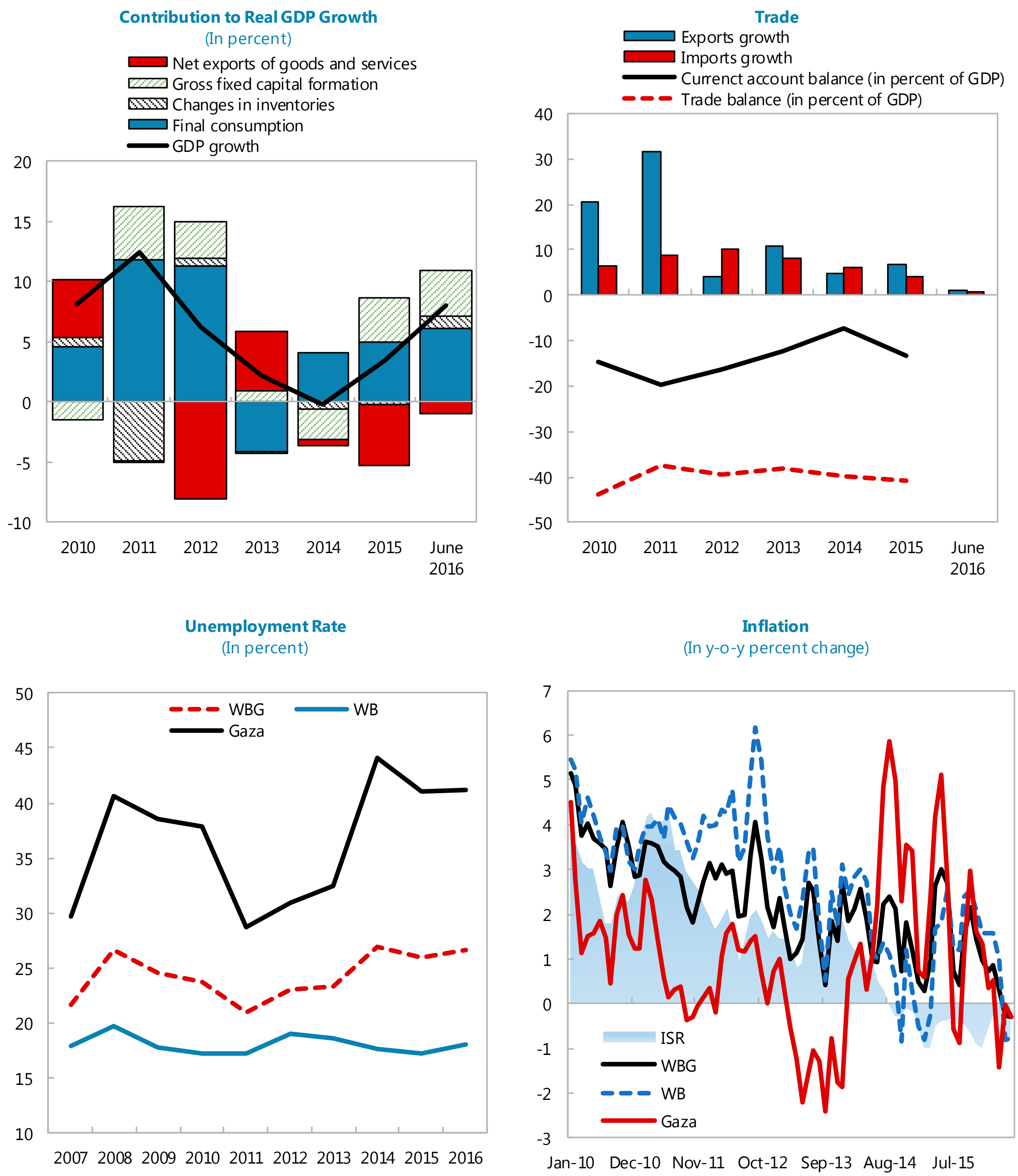
(Index, Jan 1996 = 100)



Note: An increase indicates appreciation.

Sources: Haver Analytics, Information Notice System; and IMF staff calculations.

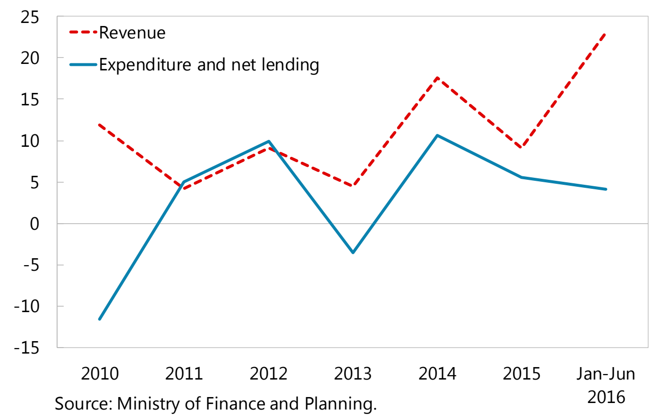
Figure 1. West Bank and Gaza: Recent Economic Developments 2010–16



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

7. Fiscal pressures eased in the first half of 2016, with stronger revenues reflecting seasonal and one-off factors. Robust, frontloaded domestic revenues were driven by higher customs and VAT receipts, and ongoing revenue administration efforts, whereas income tax revenue declined following amendments to the Income Tax Law in 2015.[2] The constructive PA-GoI dialogue helped to boost revenues, with a one-off net transfer of about NIS 500 million towards settling clearance revenues (CR)[3] and border crossing fees in March-May, and the early transfer of June CR by Israel. Spending pressures remain, however, as unbudgeted wage increases for teachers and engineers saw the wage bill increase by 4 percent, and costs from unpredictable domestic health referrals increased spending on goods and services. On balance, the PA reduced the deficit (commitment basis) to about NIS 1.7 billion in the first half of 2016, down from NIS 2.7 billion during the same period in 2015.

Revenue and Expenditure Growth
(In y-o-y percent change)



Source: Ministry of Finance and Planning.

8. Nonetheless, financing was extremely tight, hampering efforts to reduce arrears. Total budget support through June fell short of covering the deficit by about NIS 500 million as donors continued to face competing demands and low oil prices, and some disbursements were delayed. However, the PA continued repaying old arrears to the private sector and refrained from borrowing from banks. As a result, the PA accumulated net liabilities in excess of NIS 600 million to the private sector and municipalities. While this added to the debt stock, the authorities also reported other revisions to their debt data reflecting efforts to reconcile the stock of arrears, including revising down liabilities to the pension fund by around 3 percentage points of GDP based on a PricewaterhouseCoopers audit. On balance, total debt of the PA, including arrears, stood at 35 percent of GDP at end-June.

9. In March, the Ministry of Finance and Planning (MoFP) began issuing promissory notes to cover arrears to private suppliers. With an average daily issuance of about NIS 4 million, the stock of six-month notes reached about NIS 390 million by end-July. Notes were issued based on the seniority of private suppliers' claims and the size of arrears (claims in excess of NIS 250,000 were eligible). In parallel, the PA began building deposits at banks as reserves to cover the redemption of notes falling due later this year.

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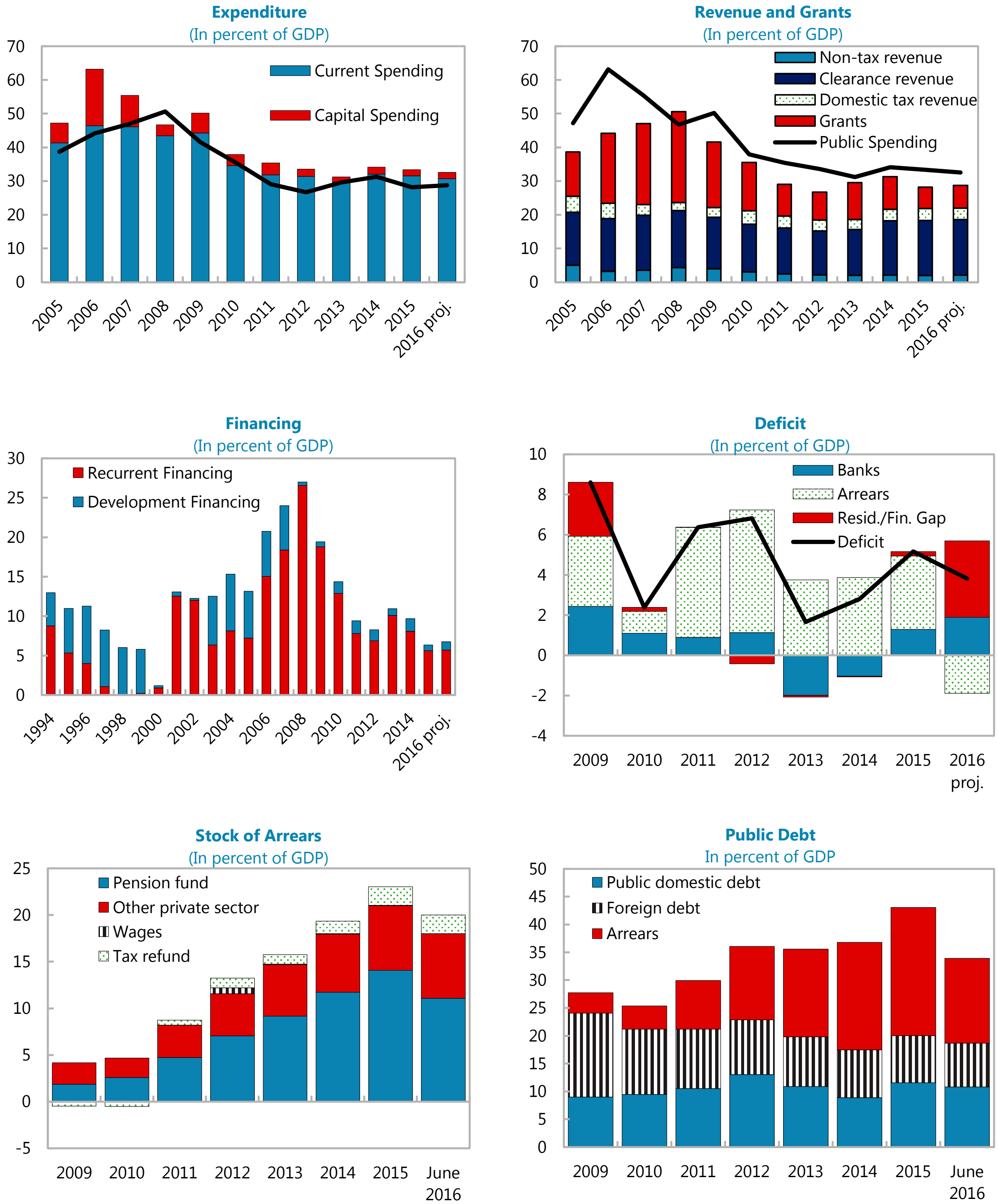
[2] The PA grants an 8 percent discount for VAT and income tax prepaid early in the year.

[3] Clearance revenues are revenues (mainly in the form of indirect taxes) collected by Israel on behalf, and later transferred to, the PA.

Figure 2. West Bank and Gaza: Fiscal Sector Indicators, 1994–2016



Source: Ministry of Finance and Planning.

10. While the financial sector is generally healthy, pressures are growing.

- Nonperforming loans (NPLs) remain low and stable (2 percent of total loans as of March 2016), and capital and liquidity ratios are comfortable by international standards.
- However, robust growth of credit to the private sector (about 23 percent year-on-year through March 2016), outstripped deposit growth of 12 percent over the same period. Anecdotal evidence also points to strong nonbank lending—currently outside the regulatory perimeter—to the construction sector and public employees.
- Credit also remains concentrated in real estate, construction, and trade finance. For the first time, credit for consumption—21.7 percent of total credit at end-March—breached the PMA's concentration limit.[4]
- Credit to the PA and its employees remains the banks' largest exposure, at 41.3 percent of domestic bank credit in March 2016 compared to 42.5 percent in December. Also, by end-June, banks accumulated about NIS 180 million (48 percent) of the newly issued promissory notes.
- Commerzbank has begun limiting its correspondent services to Palestinian banks as part of its regional de-risking strategy, although given its small presence this does not appear to have had a significant impact. Citing AML/CFT concerns, Israeli banks continue to warn of, but have yet to act on, plans to terminate correspondent services with Palestinian banks.

OUTLOOK AND RISKS

11. Economic and political uncertainties weigh heavily on prospects for growth. Staff's baseline scenario assumes sustained moderate policy reforms by the PA, but a largely unchanged political and security landscape. On that basis, growth is projected to reach 3.3 percent in 2016—comprising 2.7 percent in the West Bank and 5.5 percent in Gaza—and average 3½ percent over the medium term. This would result in stagnant per capita incomes and rising unemployment as job creation would not keep pace with the expanding working age population. While assertive policy actions are still needed to mitigate risks and keep donors engaged, a more fundamental improvement in the outlook depends on a political breakthrough.

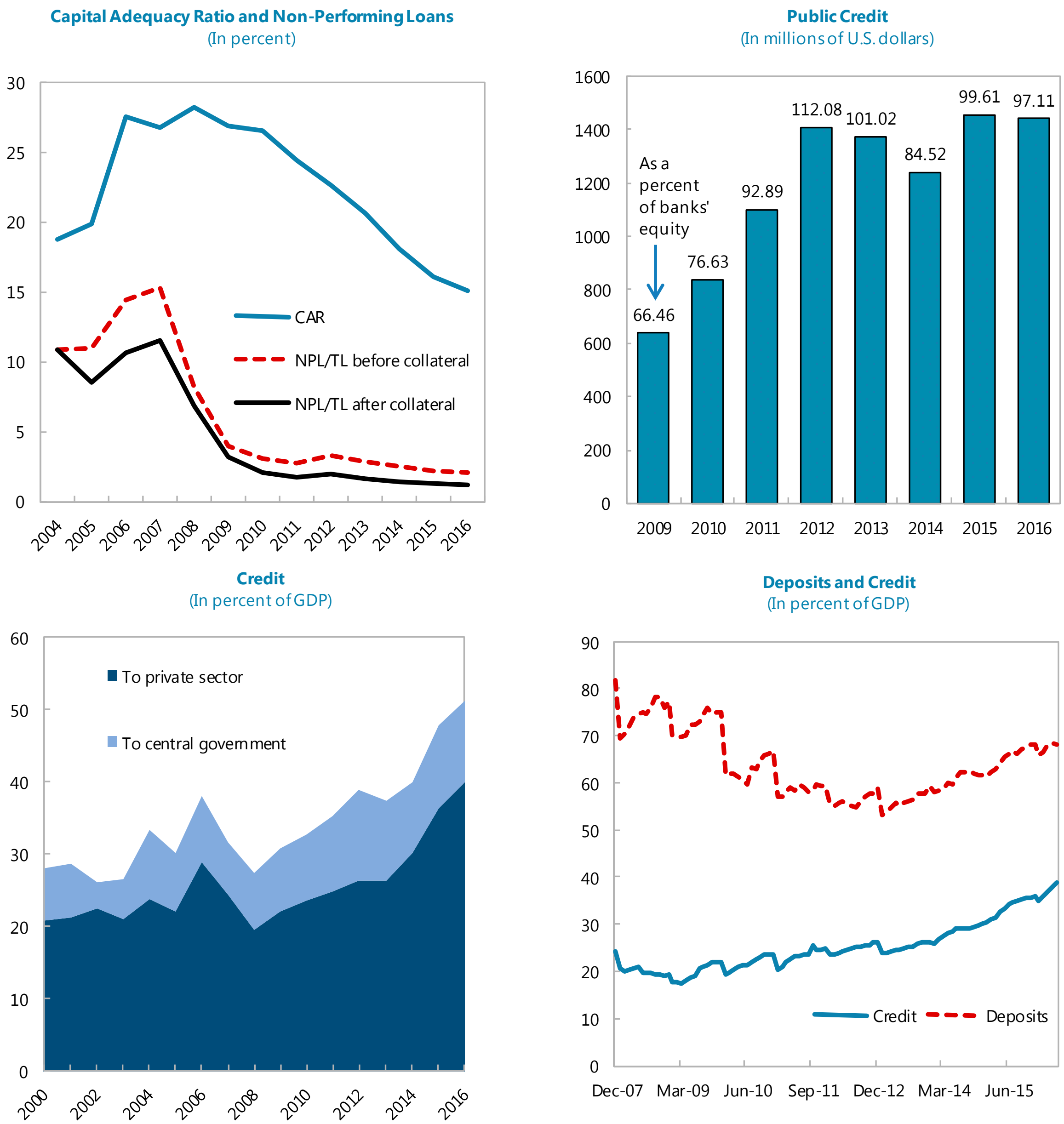
12. With key risks becoming more pronounced, economic and fiscal management could prove even more challenging in the period ahead (Annex I). The likelihood of an even steeper decline in donors' budget support could compromise the already fragile fiscal situation, adding pressures for deeper spending cuts or additional arrears. This could exacerbate social tensions, compounding the risk of escalating violence or difficulties in containing spending, resulting in a vicious cycle of political and fiscal risks. However, fiscal risks emanating from litigation in U.S. courts

[4] The concentration limit for any sector is set at 20 percent of total credit (PMA Regulation No. 5/2008, Article (1/6/5)).

(continued)

(*Sokolow vs. Palestine Liberation Organization*) have receded until the PA's appeal is decided.[5] Ongoing threats to Israeli-Palestinian correspondent banking relations, if realized, could undermine the payment system, increase cash-based transactions, weaken trade, and erode the tax base.

Figure 3. West Bank and Gaza: Financial Sector Data, 2000–16



Sources: Palestinian Monetary Authority; and IMF staff estimates.

[5] In October 2015, the judge in the Sokolow case stayed the execution of a $655 million verdict and ordered the PA to post a bond of $10 million, with additional monthly payments of $1 million pending conclusion of the PA's appeal. Although the timing is uncertain, the case will likely be decided sometime this year.

POLICY DISCUSSIONS

13. The authorities' efforts to develop a longer-term policy vision can be instrumental in managing these uncertainties and supporting economic development. Staff welcomed work toward finalizing the National Policy Agenda (NPA) for 2017–22, noting that it can provide a strong basis for enhanced donor engagement. The authorities advised that Cabinet approved in June the NPA policy priorities, anchored around three pillars: path to independence, government reform, and sustainable development. Line ministries are developing sector strategies, with a view to completing the NPA by year-end. Staff emphasized the need to integrate sector strategies within the 2017 budget to ensure policy actions are prioritized and realistic, and for clear indicators to monitor progress. Two core elements of the NPA provided a useful frame of reference for discussions with the authorities: (i) promoting effective government and fiscal sustainability; and (ii) reforms to strengthen the financial sector and business environment to support private sector growth.

A. Securing Fiscal Sustainability

Fiscal Policies in 2016

14. Staff and the authorities agreed that, despite the strong first half, budgetary management will prove more difficult for the remainder of 2016. Staff supported the authorities' intention to achieve a fiscal outcome broadly in line with the budget. With domestic revenue heavily frontloaded during the year, due largely to seasonal and one-off factors, the pace of revenue growth will ease in the second half of the year. Still, revenue (net of tax refunds) is projected to grow by a comfortable 11 percent. Expenditure is projected to increase by 3.5 percent (exceeding the budget), with recent pressures expected to continue—unbudgeted wage increases, and higher spending on goods and services (health referrals) and electricity (net lending). On this basis, staff projects a recurrent deficit of 8 percent of GDP this year, 1.8 percentage points of GDP lower than in 2015. The authorities acknowledged that, even with projected donor support at a level similar to 2015, the financing gap would approach $500 million (about 3½ percent of GDP).

15. Yet, the budget outturn is subject to significant risks. Staff noted that if delayed donor funding did not materialize, disbursements in the first half of the year implied an annualized decline of 25 percent (following the one-third drop in 2015), which would push the financing gap above $600 million. The authorities expressed serious concerns about falling donor aid, noting the potential economic and social costs of a more drastic fiscal adjustment.

16. Discussions focused on ways to contain the financing gap and mitigate risks. Staff and the authorities recognized that action by the PA, while vital, could only partly close the financing gap, and additional donor support would be needed to avoid further arrears.

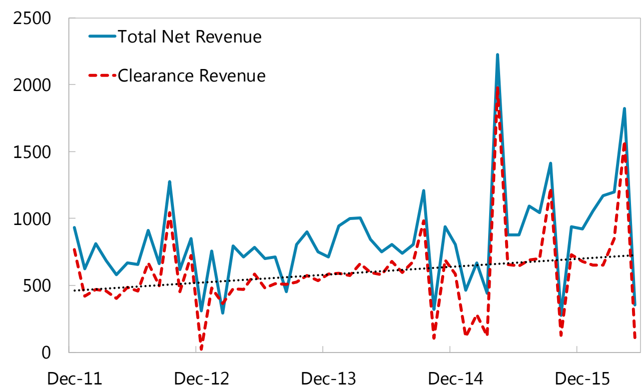
- Staff emphasized the need to resist additional spending pressures, particularly unbudgeted wage increases. In this regard, staff supports the authorities' decision to refrain from paying the cost-of-living adjustment above the mandatory 1.25 percent annual increase. The authorities also pointed to the unpredictable cost of health referrals, explaining these would be difficult to address this year and require further action over the medium term. Given the risk of steeper declines in donor aid, they are exploring possible contingency plans. Staff suggested focusing on limiting nonpriority spending to help protect social transfers to the poorest.

- The authorities and staff agreed on the importance of continuing efforts to enhance tax administration, focusing on stronger enforcement, better information sharing between tax directorates, and resisting new request for tax exemptions. However, the authorities pointed to the difficulties posed by understaffing in the Large Taxpayer Unit (LTU). Staff noted that still favorable global fuel prices also provide an opportunity to further reduce the fuel tax refund (fuel subsidies), however the authorities pointed to difficulties in removing fuel tax exemptions for Gaza (power plant). While increasing government fees remain an option, the authorities thought it unlikely to be implemented this year.

- The authorities highlighted the scope to further reduce revenue shortfalls through deepening their dialogue with the GoI.[6] Staff welcomed plans to intensify discussions, particularly given the volatility of CR transfers, which complicates fiscal management. As part of these broader efforts, the authorities highlighted ongoing discussions to resolve disputed claims in the electricity sector and transfer to the PA partial control over electricity distribution, which could also help lower monthly deductions from, and improve the predictability of, CR. Staff encouraged the authorities to pursue an agreement with the GoI on a transparent and equitable basis.

Volatility of Revenue

(In millions of NIS)



Source: Ministry of Finance and Planning.

17. **With fiscal risks mounting, staff supported the authorities' caution in managing the new promissory note program.** While the improved cash position enabled the MoFP to issue promissory notes to repay arrears to private suppliers and relieve their liquidity constraints, the authorities intend to handle prudently the issuance and redemption of promissory notes. In addition to scaling back planned issuances as the fiscal position tightens, the authorities stressed their commitment to maintaining the cash reserves for redeeming maturing promissory notes. Staff agreed that honoring maturing promissory notes is vital to the credibility of the program and helping preserve financial stability given the exposure of banks. Staff encouraged the authorities to transparently reflect the issuance and stock of notes in the fiscal accounts, and reiterated the need

[6] See Box 1 of IMF staff's April 2016 *Report to the AHLC*.

for a comprehensive arrears strategy, underpinned by an arrears stocktaking and prevention efforts (including enhanced public financial management (PFM)).

Fiscal Policies for 2017 and the Medium Term

18. The goal of gradual and growth-friendly fiscal adjustment over the medium term will require concerted action by the authorities, cooperation with Israel and donor engagement. Discussions focused on the trajectory of adjustment, with staff recommending an annual adjustment of the recurrent balance averaging 0.5 percentage points of GDP.[7] Assuming this and unchanged nominal donor support, the financing gap would narrow over the projection period, but not be eliminated. Staff and the authorities shared the concern about the viability of fiscal policy given the heightened risk to donor support. This would either force more rapid fiscal adjustment or lead to further arrears, which could undermine growth, impede the provision of government services, and threaten social cohesion. Although debt remains sustainable under the baseline (Annex II), the PA has limited capacity to close this gap through additional debt financing, both in terms of repayment capacity and the exposure of the banking system.

19. Staff urged the authorities to keep pursuing a broad-based approach to fiscal consolidation. The authorities highlighted their continuing efforts to enhance revenues. While staff supported these efforts, complementary steps to rebalance expenditures backed by PFM reforms could help improve the prospects for sustained adjustment that allows for growth-enhancing spending on infrastructure, health, and education.

- *Boosting revenue:* The authorities are considering several options, including taxing dividends and raising income tax for banks. They also noted that tax incentives for large taxpayers due to expire this year will not be renewed. Two new regional offices of the LTU will become operational later this year. Staff encourage the PA to continue their productive dialogue with the GoI, including through regular technical meetings. In addition to issues linked to implementing the Paris Protocol, lowering minimum threshold for taxing the income of Palestinian workers employed in Israel could yield significant revenue gains, while reducing labor market distortions.

- *Rebalancing spending:* To help guide the authorities' expenditure reform efforts, cross-country analysis by staff (Annex III) highlights the potential to improve the efficiency and structure of public spending. The findings align with the World Bank's recent Public Expenditure Review (PER) and point to areas where the authorities could: (i) reduce spending (addressing the oversized wage bill); (ii) improve the efficiency of spending (making spending on health referrals more predictable); and (iii) improve spending effectiveness (better targeting social assistance to the poor). Addressing some of these will require broad civil service and pension reforms. Although the authorities are not ready to commit to specific actions on wages or social

[7] At the time of discussions, the authorities were still developing the broad parameters for the 2017 budget.

(continued)

assistance, they are working with the World Bank on ways to manage spending on domestic health referrals.

- *Strengthening PFM:* Staff pointed to analysis demonstrating the role of structural fiscal reforms in securing more durable and growth-friendly fiscal adjustment.[8] The authorities highlighted that PFM reform is a priority under the NPA, with a new PFM strategy expected by year-end. Staff underscored that concrete progress could provide a stronger basis for donor engagement,[9] and suggested that outstanding items from the 2014–16 PFM strategy should inform priorities going forward (Box 1). For instance, enhanced budget preparation can improve the realism of the budget, particularly given the challenge of budgeting with persistent financing gaps. In this context, staff welcomed efforts to strengthen the macro-fiscal unit at the MoFP and improve macro-fiscal forecasting, which can help anchor the NPA in a realistic budget framework. Stronger controls over budget execution can help reduce non-priority outlays, promote spending efficiency, and facilitate a shift toward more investment spending. PFM can therefore reinforce efforts to clear arrears, including by preventing new arrears, and improving the ability to monitor the consistency of stocks and flows (highlighted by recent arrears reconciliation efforts). Staff welcomed the authorities' intention to clear the backlog of financial statement audits by 2019, following the recent publication of the audit of the 2011 financial statements.

B. Building a Foundation for Sustainable Development

Structural Reforms and Economic Independence

20. Staff is mindful that progress on the peace process and domestic reconciliation is vital for sustained economic development. Our analysis shows that, absent the political uncertainty and restrictions of the past twenty years, real GDP per capita (PPP) would have been significantly higher in the West Bank and Gaza (WBG). While estimates vary based on the methodology used to estimate what trend growth might have been, all three estimates reveal a substantial economic loss with gaps ranging from a near 40 percent under conservative assumptions up to 130 percent (Box 2). Persistent gaps make a compelling case for renewed efforts to shape a sustainable political horizon to benefit all parties.

21. Nevertheless, staff and the authorities agreed with the importance of structural reforms to help improve the environment for private sector development. Staff welcomed the recently approved Moveable Asset Law and the now operational Asset Registry. The new Companies Law is on track to be passed by end-2016. However, the authorities stressed that Israeli restrictions, including lack of access to Area C, may limit progress. Staff acknowledged this, but noted the potential gains from reducing the cost and time of starting a business,[10] and improving land

[8] IMF policy paper, *Fiscal Policy and Long-term Growth*, June 2015.

[9] The audit of the 2011 financial statements released in May 2016 was qualified, revealing problems in accounting practices.

[10] World Bank, *Doing Business 2016: Measuring Regulatory Quality and Efficiency*, 2016.

registration (currently only 30-35 percent of land is registered in the West Bank). Some studies suggest that private equity (PE) could be a source of investment well suited to the circumstances in WBG. Therefore, building a deeper understanding of the obstacles to PE and its impact on growth can help guide future policies to improve the investment environment (Annex IV). The authorities also plan to keep working toward achieving WTO observer status, with a view to building capacity in trade administration, policy and the legal framework.

Box 1. Public Financial Management Reforms—An Update

Public financial management (PFM) has been an important element of the government's fiscal reform agenda. A PFM reform strategy for 2014-16 was developed in 2013 with the assistance of development partners, including DfID, the World Bank, EU, and IMF. Based on the 2013 PEFA results, the strategy sought to address weaknesses in budget preparation, execution, reporting, and audit. It included measures to:

- develop a legal framework for the budget (organic budget law);
- strengthen macro-fiscal forecasting and the medium-term expenditure framework;
- introduce cash management and commitment controls;
- improve accounting and reporting; and
- institute regular financial audits in line with the International Public Sector Accounting Standards.

However, progress has been uneven, and a large unfinished reform agenda remains. The main achievements relate to establishing a macro-fiscal unit (MFU) at the MoFP, efforts to improve the recording of arrears aging in the BISAN system, introducing cash planning and commitment recording at selected ministries, and completing and publishing an audit of the 2011 financial statements. Work recently began, with IMF-backed technical support, on strengthening macroeconomic forecasting and reporting at the MFU. The World Bank is assisting the MoFP with strengthening accounting and reporting, and commitment recording and controls. Implementation of commitment controls is expected to begin in 2017. However, action is still needed to: develop the legal framework for the budget; reform public procurement; address the still significant weaknesses in accounting and reporting; and audit the backlog of financial statements (2012–15).

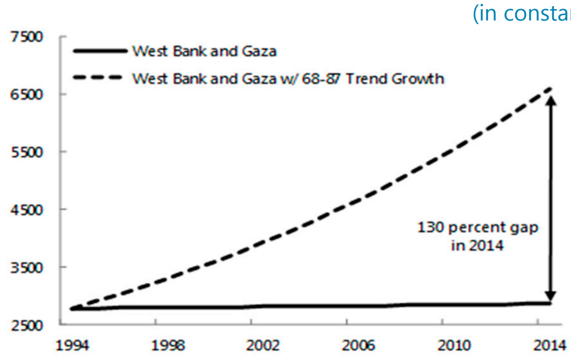
Looking ahead, PFM reform is a priority under the NPA. In this context, the PA is developing a new PFM reform agenda, which aims to set out a realistic timetable for tackling outstanding PFM issues. Effective implementation will require strong ownership and accountability, in particular by establishing clear lines of responsibility and decision-making at the MoFP (which efforts to restructure the MoFP should facilitate), and with continued support from development partners targeted at addressing low capacity (e.g., direct support via resident advisors).

Prepared by Anna Unigovskaya.

Box 2. West Bank and Gaza—Estimating the Growth Performance Gap, 1994–2014[1]

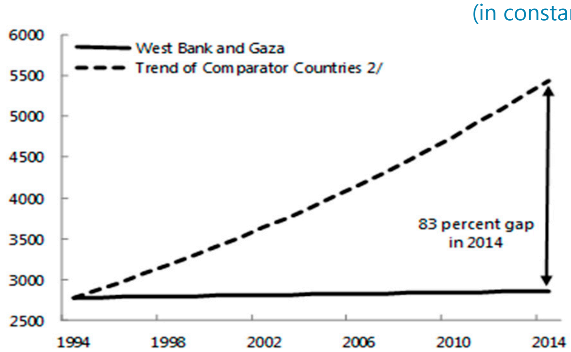
Political uncertainty and restrictions on movement and access are widely understood to impose costs on the Palestinian economy. Yet, it is extremely difficult to precisely calculate these costs, particularly given endogeneity, omitted variable, and measurement problems. Nonetheless, estimating several hypothetical growth paths—what per capita output might have been absent these constraints—offers some perspective on the range of potential economic losses. While the results point to different possible "growth performance gaps", all three methodologies—even the most conservative—indicate that output per capita would have been significantly higher than it is today.

Figure 2.1. Trend PPP Output Per Capita Compared to 1968–87 Trend WBG Growth
(in constant PPP dollars)



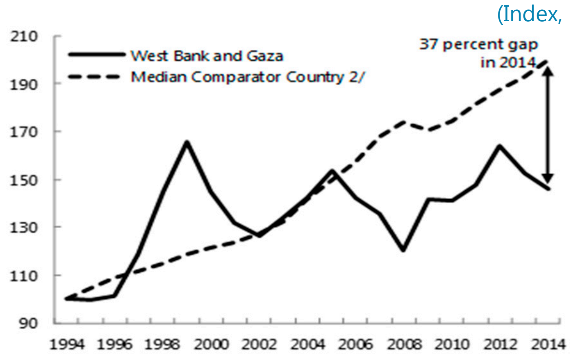
During 1994-2014, per capita output in the WBG grew at a trend rate of just over 0.1 percent. However, had WBG continued to grow at the higher trend it experienced during 1968–87 (4.4 percent)—
a period when borders with Israel were more open—**real PPP GDP per capita today would be 130 percent higher.**

Figure 2.2. Trend PPP Output Per Capita Compared to Comparator Countries' Trend Growth, 1994-2014
(in constant PPP dollars)



An alternative approach is to look trend growth for a group of countries[1] with real per capita GDP similar to that of WBG in 1994. Had WBG's growth performance during 1994–2014 been more in line with those comparator countries (3.4 percent), **WBG's real PPP GDP per capita today would be 83 percent higher.**

Figure 2.3. PPP Output Per Capita Compared to Comparator Countries' Median PPP Growth, 1994-2014
(Index, 1994 = 100)



A third approach focuses on annual median growth among the same group of comparator countries.[2] Had WBG grown each year during 1994–2014 by the median growth rate for the comparator group, **WBG's real PPP GDP per capita today would be 37 percent higher.**

Prepared by Greg Basile.
[1] This box updates analysis prepared in IMF staff's September 2011 *Report to the AHLC*.
[2]The comparator group includes countries whose real PPP GDP per capita was within +/-20 percent of WBG's in 1994: Angola, Armenia, Bhutan, Cabo Verde, Cameroon, People's Republic of China, Equatorial Guinea, Georgia, Côte d'Ivoire, Kiribati, Mauritania, Moldova, Mongolia, Nicaragua, Nigeria, Pakistan, and Uzbekistan.

Financial Sector Development and Stability

22. Staff and the authorities agreed that ensuring financial stability is a vital ingredient for longer-term financial development and inclusion. Building on earlier efforts, the authorities continue to enhance the regulatory framework. While staff's analysis does not point to a credit boom,[11] the rapid growth and concentration of private sector credit needs to be monitored closely, particularly where it is near the PMA's threshold. Given banks' largest exposure is to the PA and its employees, staff supports the PMA's intention to monitor these risks closely (Box 3). The growing indebtedness of public employees warrants close attention, as in many cases it extends beyond the banking system and thus circumvents the regulatory limit of 50 percent of monthly income. The PMA intends to bring nonbanks to the regulatory perimeter and connect them to the credit registry. They are also monitoring carefully banks' holdings of promissory notes (having imposed a $100 million limit on overall holdings), and plan to increase the risk weight of promissory notes as they implement Basel II later this year. The planned implementation of the National Strategy for Financial Inclusion starting in October 2016 will support financial sector diversification to include SMEs and improve access in rural sectors. Staff cautioned that efforts to promote financial inclusion should not come at the expense of supervisory standards.

23. Staff welcomed the authorities' efforts to prevent Israeli-Palestinian correspondent bank relations (CBRs) being severed, particularly given the broader global context and the high volume of transactions between the two economies. Terminating CBRs could have severe consequences given the central role of the shekel in the WBG and the economic ties with Israel via trade, employment, and remittances (Annex V). The primary concern is that a rise in cash transactions would erode the tax base, reverse financial inclusion, and potentially increase money laundering and terrorism financing risks—contrary to the efforts of both Israel and the PA. The PA is working vigorously to prevent that, with efforts centered on bringing WBG's AML/CFT regime in line with international standards. In late 2015, the WBG joined MENAFATF and approved a new AML/CFT law, adding CFT provisions. The law was recently further upgraded to: (i) delink the criminalization of terrorism from terrorist acts; (ii) improve the AML/CFT National Committee's procedures, including for analyzing suspicious transactions and activities; and (iii) define "material support" to terrorism. The authorities are now focused on ensuring proper implementation of the law, including with IMF technical support. The PMA plans to establish an AML/CFT department to work with the existing Financial Intelligence Unit to prepare for a comprehensive assessment of the AML/CFT regime. In this regard, staff encouraged the authorities to liaise with MENAFATF.

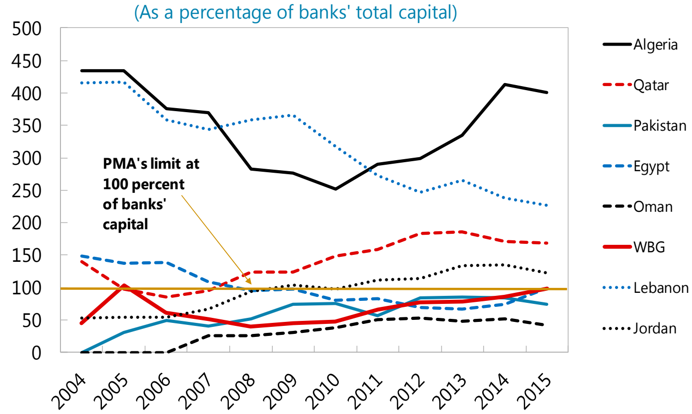
[11] IMF staff's September 2015 *Report to the AHLC*, Annex II, "Rapid Credit Growth in the West Bank and Gaza: How Much Should We Worry?".

Box 3. Banks' Exposure to the Public Sector

The banking system is an important source of financing for the budget. With the exception of donor budget support, the budget is financed mainly through domestic bank borrowing. Since 2012, bank credit (loans) to the PA has increased by almost 30 percent and accounted for 23 percent of total bank credit in the first quarter of 2016—the largest exposure to any sector.

The PMA monitors this exposure closely to guard against the risk of sovereign default. While single borrower and concentration limits do not apply to the government,[1] the PMA enforces a *gentlemen's agreement* limiting banks' credit to the PA to 100 percent of total capital, thus ensuring the full absorption of losses in the event of default. As of end-March 2016, credit to the PA stood at 97 percent of banks' capital. At first glance, this may seem overly cautious given that exposures in WBG compare relatively favorably among countries in the region (see figure), very few countries apply limits on exposures to the government, and that Basel rules are still benign on sovereign debt.[2]

Bank Credit to the Public Sector
(As a percentage of banks' total capital)



Sources: National data for WBG, Lebanon, and Jordan; and IMF Monetary and Financial Statistics for all other countries.

There are, however, good reasons for the PMA to adopt a more prudent stance, suggesting stringent ex-ante regulation may be the most effective tool to preserve financial stability.

- *Banks in WBG are exposed to the public sector via other channels.*
  - Loans to public employees accounted for 18 percent of total credit in the first quarter of 2016, with one-third of banks exposed to the PA or its employees for more than half of their portfolio.
  - Banks have begun to discount recently issued promissory notes to cover the PA's arrears to private creditors, with banks holding 48 percent of the stock of promissory notes as of end-June 2016.

  Collectively, these direct and indirect exposures to the public sector represent around 174 percent of banks' capital, which compares less favorably to other countries.

- *WBG's unique circumstances provides less scope to effectively manage risks if realized.* The narrow tax base and lack of access to international financial markets limit fiscal alternatives in times of crisis. There is no lender of last resort to provide liquidity or recapitalize banks, and no independent currency to help manage any adjustment. Banks' exposure is via relatively illiquid instruments, such as loans and promissory notes, rather than tradeable securities.

Prepared by Priscilla Toffano and Ramsey Andrawis.

[1] The single borrower's limit is 10 percent of bank's capital up to 25 percent with the consent of the PMA. According to the concentration limit no sector in the economy can receive more than 20 percent of total credit.

[2] For example, sovereign risk is specifically excluded from the new Basel Standard for Large Exposure, April 2014.

STAFF APPRAISAL

24. The Palestinian economy continues to face considerable headwinds, with security risks and fading hopes for peace weighing heavily on growth prospects. Although economic activity received a temporary boost in the first quarter of 2016, this largely reflects transitory factors including an uptick in Gaza reconstruction. With a breakthrough in the peace process unlikely, growth is projected to average 3½ percent in the medium term, which falls well short of generating enough jobs to make a meaningful dent in unemployment and an improvement in people's lives. By exacerbating social hardship—particularly in Gaza—this risks aggravating existing political and security uncertainties. With a decline in donor funding becoming more probable, this could test the viability of an already strained fiscal position, further compromising growth and welfare.

25. Despite a strong performance in the first half of 2016, fiscal management will prove increasingly difficult. Strong domestic revenues and a boost to CR helped drive down the deficit, despite emerging wage and health spending pressures. While the authorities managed to repay some old arrears, delays in donor aid tightened the financing situation and saw some new arrears accumulate. Yet, even with mounting spending pressures, front-loaded domestic revenues, and no predictable increase in CR, the authorities should still manage a strong fiscal adjustment this year (almost 2 percentage points). Even if delayed donor support materializes, there will still be a sizeable financing gap of almost $500 million, or 3½ percent of GDP. However, if donor support continues at its current rate, the financing gap could exceed $600 million.

26. This highlights the need to focus on lessening financing pressures and mitigating risks to the budget. The PA should focus on measures to restrain spending, particularly avoiding added pressures on the wage bill, as well as intensifying ongoing revenue enforcement and collection efforts. Given the risk of tighter fiscal financing, the intention to consider contingency plans is prudent. Also, effective and transparent management of the new promissory notes will be crucial to the credibility of the PA's arrears reduction efforts. The commitment to protect cash reserves to ensure maturing notes can be redeemed is particularly welcome. However, given financing constraints, a comprehensive domestic arrears reduction strategy is needed.

27. All parties—the PA, GoI, and donors—have a role to play in ensuring gradual and growth-friendly fiscal consolidation.

- The PA's adjustment efforts should continue to incorporate a balance of measures to mobilize domestic revenue and rationalize recurrent spending. The latter could be guided by IMF staff's cross-country public expenditure analysis and the World Bank's PER, with a view to: reducing oversized recurrent spending; expanding the targeting of transfers to help deliver more effective coverage for the poorest households without raising overall costs; and rebalancing spending over time toward more investment.

- The ongoing dialogue between the PA and GoI can be instrumental to further enhancing revenue and improving its predictability.

- Reversing the declining trend in donor aid will be crucial to avoid too rapid budget compression and free up resources for growth-friendly investment.

28. In this regard, the authorities' efforts to develop a longer-term policy vision are vital to achieving greater economic prosperity. The NPA, which is expected to be finalized by end of 2016, includes a welcome emphasis on achieving economic development through promoting effective government and fiscal sustainability, as well as reforms to improve the business environment for which financial stability is a key component. However, close integration with the budget to promote effective prioritization (starting with sector strategies consistent with the 2017 budget), and concrete indicators to monitor progress will be crucial to achieving the NPA objectives.

29. Strengthened PFM can promote more durable fiscal adjustment and provide a stronger basis for donor engagement. Plans to finalize a new PFM strategy—a priority under the NPA—provide an opportunity to revive the PA's PFM agenda. While progress is being made in some areas, such as commitment recording at selected ministries, the NPA provides an opportunity to tackle the key remaining reforms under the previous 2014–16 PFM strategy. A serious PFM reform effort could have significant payoffs in the WBG context, including better control over non-priority spending, greater spending efficiency, a better ability to monitor and prevent arrears, and stronger accounting practices. Moreover, work to strengthen the Macro-Fiscal Unit at the MoFP and improve macro-fiscal forecasting can help ensure the NPA is anchored in a realistic budget framework, which may help catalyze donor support.

30. Ensuring the continued stability of the financial system can help provide the foundation for sustained economic progress. Overall the banking system remains healthy, thanks to strong supervision by the PMA. In this regard, close and continuous monitoring can help manage risks related to banks' high exposure to the PA—including through recently issued promissory notes—as well as rapid growth of credit to the private sector. The rising indebtedness of public employees, including credit extended outside the formal banking system, would also benefit from close monitoring.

31. Risks concerning the potential withdrawal of Israeli correspondent banking relationships warrant added attention. The PMA is actively taking steps to mitigate these risks by implementing its strengthened AML/CFT framework, in close cooperation with the Financial Intelligence Unit and with technical assistance from the IMF. Plans to create an AML/CFT supervision unit within the PMA as well as a National Risk Assessment Committee, incorporating representatives of the judicial system, would reinforce these efforts. Taking steps to prepare a comprehensive assessment of WBG's AML/CFT regime, in coordination with the MENAFATF, will be instrumental in demonstrating compliance with international best practice.

Table 1. West Bank and Gaza: Selected Economic Indicators, 2013–21

(Population: 4.6 million; 2014 est.)
(Per capita GDP: $2,790; 2014)
(Poverty rate: 16 percent in the West Bank and 39 percent in Gaza Strip; 2014 est.)

			Est.	Projections					
	2013	2014	2015	2016	2017	2018	2019	2020	2021
Output and prices				(Annual percentage change)					
Real GDP (2004 market prices)	2.2	-0.2	3.5	3.3	3.5	3.5	3.5	3.5	3.5
West Bank	1.0	5.3	2.5	2.7	3.0	3.0	3.0	3.0	3.0
Gaza	5.6	-15.1	6.8	5.5	5.0	5.0	5.0	5.0	5.0
CPI inflation rate (end-of-period)	2.7	1.2	1.0	1.1	1.5	2.1	2.1	2.1	2.1
CPI inflation rate (period average)	1.7	1.7	1.4	1.3	1.3	1.9	2.1	2.1	2.1
Investment and saving				(In percent of GDP)					
Gross capital formation, *of which:*	21.8	19.0	21.2	21.2	20.5	20.5	20.6	20.6	20.5
Public	3.3	3.6	4.7	4.9	4.0	4.0	4.0	4.0	4.0
Private	18.5	15.4	16.5	16.4	16.5	16.5	16.6	16.6	16.5
Gross national savings, *of which:*	9.5	11.6	7.7	7.8	9.1	9.6	9.9	8.9	9.1
Public	-1.0	-2.3	-4.0	-2.6	-2.4	-2.0	-1.6	-1.2	-0.7
Private	10.6	14.0	11.7	10.4	11.6	11.6	11.4	10.1	9.9
Saving-investment balance	-12.3	-7.4	-13.5	-13.5	-11.4	-10.9	-10.7	-11.7	-11.4
Public finances 1/				(In percent of GDP)					
Revenues	18.6	21.6	21.7	22.7	22.6	22.8	23.1	23.3	23.5
Recurrent expenditures and net lending	29.7	32.0	31.4	30.6	30.1	29.7	29.3	28.8	28.4
Wage expenditures	15.4	16.1	15.1	14.9	14.6	14.4	14.2	13.9	13.7
Nonwage expenditures	12.6	13.6	13.9	13.7	13.6	13.6	13.6	13.6	13.5
Net lending	1.7	2.3	2.4	2.0	1.9	1.7	1.5	1.3	1.2
Recurrent balance (commitment, before external support)	-11.1	-10.4	-9.6	-7.9	-7.5	-6.8	-6.2	-5.5	-4.9
Recurrent balance (cash, before external support)	-7.5	-5.1	-4.6	-9.8	-8.6	-7.8	-7.1	-6.4	-5.8
Development expenditures	1.5	2.1	1.8	1.7	1.7	1.7	1.7	1.7	1.7
(In millions of U.S. dollars)	187	262	230	236	247	259	272	286	299
Overall balance (commitment, before external support)	-12.6	-12.5	-11.4	-9.6	-9.3	-8.6	-7.9	-7.3	-6.7
Total external support, including for development expenditures	11.0	9.7	6.3	6.2	6.2	6.0	5.6	5.4	5.2
(In millions of U.S. dollars)	1,361	1,230	799	836	883	891	879	889	898
External support for recurrent expenditure (in millions of U.S. dollars)	1,255	1,027	709	718	718	718	718	718	718
In percent of GDP	10.1	8.1	5.6	5.3	5.1	4.8	4.6	4.4	4.2
Financing gap (in millions of U.S. dollars) 2/	...	...	...	482	483	438	411	364	307
In percent of GDP	...	...	...	3.6	3.4	3.0	2.6	2.2	1.8
Monetary sector 3/				(Annual percentage change)					
Credit to the private sector	11.0	17.3	20.0	15.0	13.0	12.0	12.0	12.0	12.0
Private sector deposits	10.7	7.2	7.3	6.8	6.3	5.8	5.8	5.8	5.8
External sector				(In percent of GDP)					
Current account balance (excluding official transfers)	-22.4	-15.5	-19.1	-18.8	-16.4	-15.7	-15.3	-16.0	-15.6
Current account balance (including official transfers)	-12.3	-7.4	-13.5	-13.5	-11.4	-10.9	-10.7	-11.7	-11.4
Exports of goods and nonfactor services	16.7	17.1	18.3	16.9	17.0	17.1	17.1	16.9	16.7
Import of goods and nonfactor services	54.8	56.8	59.2	56.3	54.1	53.5	53.1	53.3	52.7
Net factor income	8.6	10.9	10.9	10.7	10.8	10.7	10.7	10.6	10.6
Net current transfers	17.3	21.4	16.4	15.3	15.0	14.8	14.5	14.2	14.0
Private transfers	7.1	13.3	10.8	10.0	10.0	10.0	10.0	10.0	9.9
Official transfers	10.1	8.1	5.6	5.3	5.1	4.8	4.6	4.4	4.2
Memorandum items:									
Nominal GDP (in millions of U.S. dollars)	12,419	12,697	12,681	13,526	14,136	14,824	15,578	16,405	17,135
Per capita nominal GDP (U.S. dollars)	2,809	2,790	2,708	2,808	2,854	2,910	2,973	3,045	3,094
Unemployment rate	23	27	26	28	29	29	30	30	30
Al Quds stock market index (annual percentage change)	13.4	-7.1	6.0	...	...	...	...	...	...

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

1/ Commitment basis.
2/ Financing gaps in the medium term are expected to be filled by grants that are yet to be identified.
3/ End-of-period; in U.S. dollar terms.

Table 2. West Bank and Gaza: Central Government Fiscal Operations, 2013–19

	2013	2014	2015	Projections 2016	2017	2018	2019
	(In millions of shekels, unless otherwise stated)						
Net revenues	8,348	9,817	10,712	11,856	12,307	13,092	13,952
Gross domestic revenues	3,078	3,114	3,323	3,466	3,632	3,863	4,117
Tax revenues	2,157	2,149	2,354	2,357	2,509	2,684	2,877
Nontax revenues	921	966	969	1,108	1,124	1,179	1,240
Clearance revenues (accrued)	6,103	7,331	7,988	8,747	8,960	9,446	9,981
Of which: arrears	14	13	35	...	...	...	...
Less tax refunds 1/	834	628	599	356	286	216	146
Of which: arrears	27	147	335	...	...	...	...
Recurrent expenditures and net lending (commitment)	13,336	14,556	15,453	15,991	16,401	17,005	17,673
Of which: arrears	1,601	2,281	2,194	-975	-578	-580	-582
Wage expenditures (commitment)	6,928	7,336	7,439	7,781	7,956	8,240	8,555
Of which : arrears	380	570	603	...	...	...	...
Nonwage expenditures (commitment)	5,648	6,198	6,844	7,150	7,435	7,804	8,208
Of which: arrears	1,221	1,712	1,592	-975	-578	-580	-582
Net lending	760	1,022	1,169	1,061	1,011	961	911
Development expenditures (commitment)	674	938	893	913	951	1,000	1,054
Of which: on Gaza reconstruction	...	89	132	---	---	...	...
Of which: arrears	66	351	206	...	...	...	...
Recurrent balance (commitment, excl. development expenditure)	-4,988	-4,739	-4,741	-4,135	-4,095	-3,912	-3,722
Overall balance (commitment)	-5,662	-5,676	-5,635	-5,048	-5,046	-4,913	-4,776
Total financing	5,662	5,676	5,635	5,048	5,046	4,913	4,776
Net domestic bank financing	-895	-469	677	975	425	425	425
External debt repayment		-38	-43	-51	-70	-72	-72
External financing for recurrent expenditures	4,532	3,676	2,757	2,778	2,769	2,776	2,784
External financing for development expenditures	383	726	347	457	637	670	626
Arrears accumulation (net)	1,680	1,762	1,876	-975	-578	-580	-582
Of which: repayment		-1,004	-917	-975	-578	-580	-582
Residual/financing gap 2/	-38	18	20	1,865	1,863	1,693	1,594
	(In millions of U.S. dollars, unless otherwise stated)						
Net revenues	2,312	2,744	2,756	3,064	3,192	3,386	3,599
Gross domestic revenues	853	870	855	896	942	999	1,062
Tax revenues	597	601	606	609	651	694	742
Nontax revenues	255	270	249	286	291	305	320
Clearance revenues (accrued)	1,690	2,049	2,055	2,260	2,324	2,443	2,574
Less tax refunds	231	176	154	92	74	56	38
Recurrent expenditures and net lending (commitment)	3,693	4,068	3,976	4,133	4,253	4,398	4,558
Wage expenditures (commitment)	1,919	2,050	1,914	2,011	2,063	2,131	2,206
Nonwage expenditures (commitment)	1,564	1,732	1,761	1,848	1,928	2,018	2,117
Net lending (commitment)	210	286	301	274	262	248	235
Development expenditures (commitment)	187	262	230	236	247	259	272
Recurrent balance (commitment, excl. development expenditure)	-1,381	-1,324	-1,220	-1,069	-1,062	-1,012	-960
Overall balance (commitment)	-1,568	-1,586	-1,450	-1,305	-1,309	-1,270	-1,232
Total financing	1,568	1,586	1,450	1,305	1,309	1,270	1,232
Net domestic bank financing	-248	-131	174	252	110	110	110
External debt repayment		-10	-11	-13	-18	-19	-19
External financing for recurrent expenditures	1,255	1,027	709	718	718	718	718
External financing for development expenditures	106	203	89	118	165	173	161
Arrears (net)	465	493	483	-252	-150	-150	-150
Of which: repayment		-281	-236	-252	-150	-150	-150
Residual/Financing gap 2/	-11	5	5	482	483	438	411
Memorandum items:	(In percent of GDP, unless otherwise stated)						
Revenues	18.6	21.6	21.7	22.7	22.6	22.8	23.1
Recurrent expenditures and net lending	29.7	32.0	31.4	30.6	30.1	29.7	29.3
Wage expenditures	15.4	16.1	15.1	14.9	14.6	14.4	14.2
Nonwage expenditures	12.6	13.6	13.9	13.7	13.6	13.6	13.6
Net lending	1.7	2.3	2.4	2.0	1.9	1.7	1.5
Recurrent balance (commitment) before external support	-11.1	-10.4	-9.6	-7.9	-7.5	-6.8	-6.2
External financing for recurrent expenditures	10.1	8.1	5.6	5.3	5.1	4.8	4.6
Development expenditures (cash)	1.4	1.3	1.4	1.7	1.7	1.7	1.7
Overall balance (commitment)	-12.6	-12.5	-11.4	-9.6	-9.3	-8.6	-7.9
Overall balance (cash)	-8.9	-6.4	-6.0	-11.5	-10.3	-9.6	-8.9
Residual/financing gap	-0.1	0.0	0.0	3.6	3.4	3.0	2.6
Nominal exchange rate (NIS per U.S. dollar)	3.61	3.58	3.89	...	...	...	...
Nominal GDP (in millions of shekels)	44,843	45,429	49,290	52,338	54,510	57,321	60,397

Sources: Ministry of Finance; and IMF staff projections.
1/ Includes fuel subsidies.
2/ Financing gaps in the medium term are expected to be filled by grants that are yet to be identified.

Table 3. West Bank and Gaza: Central Government Fiscal Operations, 2013–19 (GFSM 2001)

			Prel.	Projections			
	2013	2014	2015	2016	2017	2018	2019
	(In millions of shekels)						
Revenue	13,263	14,220	13,816	15,091	15,713	16,539	17,362
Taxes	7,426	8,852	9,743	10,748	11,183	11,913	12,712
Domestic taxes	2,157	2,149	2,354	2,357	2,509	2,684	2,877
Clearance taxes	6,103	7,331	7,988	8,747	8,960	9,446	9,981
Tax refund	-834	-628	-599	-356	-286	-216	-146
Grants	4,915	4,402	3,105	3,235	3,406	3,446	3,410
External budget support	4,532	3,676	2,757	2,778	2,769	2,776	2,784
External development support	383	726	347	457	637	670	626
Other revenue	921	966	969	1,108	1,124	1,179	1,240
Of which: dividends	116	121	122	139	141	148	156
Expenditures	14,009	15,494	16,346	16,905	17,352	18,005	18,727
Expense	13,336	14,556	15,453	15,991	16,401	17,005	17,673
Compensation of employees 1/	6,928	7,336	7,439	7,781	7,956	8,240	8,555
Use of goods and services	1,816	2,333	2,530	2,530	2,635	2,771	2,920
Grants 2/	760	1,022	1,169	1,061	1,011	961	911
Other expense 3/	3,832	3,864	4,314	4,619	4,800	5,033	5,288
Net acquisition of nonfinancial assets	674	938	893	913	951	1,000	1,054
Gross operating balance	-73	-336	-1,637	-900	-689	-466	-312
Net lending / borrowing (overall balance)	-746	-1,274	-2,530	-1,814	-1,640	-1,466	-1,366
Net financial transactions	-746	-1,274	-2,394	-1,814	-1,640	-1,466	-1,366
Net acquisition of financial assets	…	…	…	…	…	…	…
Domestic							
Currency and deposits	…	…	…	…	…	…	…
Net incurrence of liabilities	785	1,256	2,375	-51	-223	-227	-229
Domestic	785	1,293	2,418	0	-153	-155	-157
Loans	-895	-469	634	975	425	425	425
Net domestic bank financing	-895	-469	634	975	425	425	425
Other accounts payable	1,680	1,762	1,783	-975	-578	-580	-582
Arrears (recurrent)	1,628	1,424	1,612	-975	-578	-580	-582
Arrears (capital)	66	351	206	…	…	…	…
Arrears (clearance)	14	13	35	…	…	…	…
Foreign	…	-38	-43	-51	-70	-72	-72
Loans	…	-38	-43	-51	-70	-72	-72
Statistical discrepancy/financing gap	-38	18	20	1,865	1,863	1,693	1,594
Memorandum items:							
Gross operating balance excl. grants (commitment)	-4,988	-4,739	-4,741	-4,135	-4,095	-3,912	-3,722
Gross operating balance excl. grants (cash)	-3,374	-3,328	-3,164	-5,110	-4,673	-4,492	-4,303
Overall balance (NLB) excl. grants (commitment)	-5,662	-5,676	-5,635	-5,048	-5,046	-4,913	-4,776
Overall balance (NLB) excl. grants (cash)	-3,982	-3,914	-3,851	-6,023	-5,624	-5,493	-5,357
Revenue (percent of GDP)	29.6	31.3	28.0	28.8	28.8	28.9	28.7
Expenditure (percent of GDP)	31.2	34.1	33.2	32.3	31.8	31.4	31.0
Expense (percent of GDP)	29.7	32.0	31.4	30.6	30.1	29.7	29.3
Wage expenditure (percent of GDP)	15.4	16.1	15.1	14.9	14.6	14.4	14.2
Nonwage expenditures (percent of GDP)	4.1	5.1	5.1	4.8	4.8	4.8	4.8
GOB (commitment) excluding grants (percent of GDP)	-11.1	-10.4	-9.6	-7.9	-7.5	-6.8	-6.2
GOB (cash) excluding grants (percent of GDP)	-7.5	-7.3	-6.4	-9.8	-8.6	-7.8	-7.1
External support (recurrent)	10.1	8.1	5.6	5.3	5.1	4.8	4.6
in millions of NIS	4,532	3,676	2,757	2,778	2,769	2,776	2,784
NLB (commitment) excluding grants (percent of GDP)	-12.6	-12.5	-11.4	-9.6	-9.3	-8.6	-7.9
NLB (cash) excluding grants (percent of GDP)	-8.9	-8.6	-7.8	-11.5	-10.3	-9.6	-8.9
Total external support (in millions of shekels)	4,915	4,402	3,105	3,235	3,406	3,446	3,410
Nominal GDP (in millions of shekels)	44,843	45,429	49,290	52,338	54,510	57,321	60,397
Exchange rate	3.6	3.6	3.9	…	…	…	…

Sources: Ministry of Finance; 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, 2011–16
(In percent)

	Dec-11	Dec-12	Dec-13	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16
Capital adequacy (for all banks)									
Tier I capital to risk-weighted assets	22.9	22.2	21.5	20.0	18.8	18.2	17.9	18.1	17.0
Regulatory capital to risk-weighted assets	21.1	20.3	20.0	18.9	17.8	17.2	17.8	18.0	17.4
Capital adequacy (for local banks)									
Tier I capital to risk-weighted assets	24.5	22.7	20.7	18.0	17.4	16.9	16.2	16.1	15.1
Regulatory capital to risk-weighted assets	20.3	18.8	17.8	16.3	15.7	15.3	15.4	15.4	15.2
Asset quality 1/									
Nonperforming loans (percent of total loans)	2.7	3.1	2.9	2.5	2.7	2.5	2.5	2.1	2.0
Nonperforming loans net of provisions to capital	3.8	4.9	4.7	4.0	4.9	4.2	4.2	3.4	3.3
Coverage ratio (provisions as percent of nonperforming loans)	60.9	60.1	59.1	61.4	58.6	63.3	63.6	67.3	68.8
Earnings and profitability									
Return on assets (ROA)	1.9	1.8	1.9	1.7	1.6	1.6	1.6	1.5	1.7
Return on equity (ROE) 2/	17.0	16.2	18.7	17.1	15.7	15.5	15.7	15.0	17.4
Interest income to gross income	71.7	72.4	74.0	72.4	71.5	70.6	71.7	72.2	70.4
Non-interest expenses to gross income	57.2	55.4	54.8	60.1	60.2	61.0	62.0	63.0	61.3
Personnel cost to non-interest expenses	55.5	53.8	53.9	51.5	53.0	52.8	51.8	51.3	52.0
Liquidity									
Liquid assets to total assets	38.2	37.5	39.5	35.4	34.1	33.4	35.9	34.2	33.9
Liquid assets to demand and savings deposits	74.4	71.6	74.7	65.9	62.9	60.0	65.3	62.3	61.8
Liquid assets to total deposits	46.9	45.8	48.1	43.2	41.8	40.0	42.9	41.0	40.6

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. West Bank and Gaza—Risk Assessment Matrix[1]
Potential Deviations from the Baseline

Nature/Sources of Risk	Relative Likelihood	Expected Impact If Realized	Policies to Mitigate Risks
Reduced support due to donor "fatigue," competing demands on donor resources, and falling oil prices for Arab donors.	***High***	***High*** A larger than expected decline in donor budget support—particularly if sustained if donors reconsider their long-term support for the PA—could jeopardize fiscal sustainability. Widening financing gaps would make fiscal management more difficult, leading to additional arrears or deeper spending cuts that could be detrimental to economic growth and social cohesion.	(1) Instill confidence through strong domestic policies, anchored in gradual medium-term fiscal adjustment and reforms to strengthen government institutions. (2) Implement pro-growth policies, including the composition of budget spending and ensuring resilience of the financial sector, could over time reduce aid dependency and support fiscal sustainability.
Reduced financial services by global/ regional banks ("de-risking")	***High***	***High*** Restrictions on cash transfers to Israel by WBG banks already pose a liquidity risk. Severing correspondent banking relationships—especially Israeli-Palestinian bank relations—could jeopardize financial stability and the functioning of the WBG payment system, by pushing more transactions into cash (informality).	(1) Effectively implement the new "Anti Money Laundering and Terrorism Financing" law and related regulations to promote confidence. (2) Seek technical support to build implementation capacity, and an independent assessment of the WBG AML/CFT regime (possibly by the MENA Financial Action Task Force).
Heightened risk of fragmentation/security dislocation in part of the Middle East	***High***	***Medium/High*** Social and political unrest in the region could divert donor aid away from the WBG and associated fiscal pressures. Any direct spillover of regional instability and dislocation would exacerbate security and economic uncertainty in WBG.	Economic policies can do little to mitigate particular risks. At best, maintaining strong domestic policies could instill confidence.
Resumption of hostilities between Hamas and Israel in Gaza; escalation of violence in the West Bank	***Medium/ High***	***High*** Resumption of the conflict in Gaza would further erode the humanitarian and economic situation. Increased unrest in the West Bank could undermine growth and lead to tightening Israeli restrictions. Donors may further scale back support.	In the short run, economic policies can do little to mitigate particular risks. At best, maintaining strong domestic policies could instill some confidence.

Nature/Sources of Risk	Relative Likelihood	Expected Impact If Realized	Policies to Mitigate Risks
Structurally weak growth in key advanced and emerging economies	***High/ Medium***	***Medium*** The WBG is sensitive to a slowdown in Israel, including as a result of developments in Europe for example. Further restraint in donor countries could affect availability of aid for the PA. This could further weaken growth, increase unemployment, and worsen the fiscal position.	(1) Instill confidence through strong domestic policies, anchored in medium-term fiscal adjustment. (2) Improve competitiveness of the economy via scaled-up investment in infrastructure, and education to support human capital development.
Persistently lower energy prices	***Low***	***Low*** Failure to capitalize on lower global fuel prices by maintaining fuel subsidies could further weaken an already fragile fiscal position.	Phase out fuel subsidies while strengthening targeted social transfers to support the poor.

[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.

Annex II. Public Debt Developments and Sustainability[1]

This annex updates debt developments since IMF staff's April 2016 report to the Ad-Hoc Liaison Committee. Reflecting ongoing reconciliation efforts, the authorities revised downwards the stock of arrears, which implies a reduction in the overall estimate of the debt stock. Nevertheless, the debt sustainability analysis suggests that, under the baseline scenario, debt will continue on an upward trajectory for several years before stabilizing. Moreover, under a variety of shocks, debt will rise sharply, pointing to serious debt sustainability concerns, particularly given constraints on the PA's repayment capacity and heightened risks to donor aid.

Structure of Public Debt

Domestic liabilities—including domestic debt (mainly to banks) and other accounts payable—represent the largest share (about 75 percent) of total debt.[2] Of this, the overdraft and majority of bank loans are short term obligations, with the interest on overdrafts averaging about 7 percent and interest costs for loans ranging from 3 to 6 percent. Among other domestic accounts payable (arrears), liabilities to the pension fund represent the largest share of overall debt (32 percent), and accounts payable to the private sector and municipalities currently stand at around 10 percent of total debt. However, these arrears are currently subject to a reconciliation exercise (see below).

Most of external debt—about 25 percent of total debt—is to multilateral and official bilateral creditors on concessional terms. The average effective interest rate on external debt in 2015 was less that 0.5 percent. New external debt disbursements expected from the European Investment Bank (EIB) (EUR 10 million for electricity sector) and Italy (EUR 61 million for micro-finance) are also on highly concessional terms (20 years grace period, 30 years maturity, with zero interest in case of Italy, and about 3 percent interest for EIB).

Debt Developments and Arrears Reconciliation

Fiscal developments since the end of 2015 have had limited impact on the debt stock due to improved revenue, with a one-off large clearance transfer and an advance from Israel, as well as stronger domestic revenues. On this basis, the PA accelerated repayment of arrears to the private sector and debt to banks remained broadly unchanged. However, delays in some disbursements resulted in significantly lower donor budget support in the first half of 2016, and the PA accumulated new arrears. This accumulation mainly affected the private sector, municipalities and ministries.

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[1] Prepared by Anna Unigovskaya.

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

(continued)

At the same time, the authorities reported other revisions to their debt data, reflecting ongoing efforts to reconcile the stock of arrears.[3] In particular, the authorities made a large one off revision of outstanding liabilities to the pension fund from about $1.9 billion to $1.5 billion as of June 2016 on the basis of an audit by PricewaterhouseCoopers.[4] In the absence of this revision, staff estimates that the overall debt stock would have remained broadly stable in nominal terms, and would have declined as a share of GDP from 40 percent at end-2015 to 38 percent in June. However, after the revision of pension fund liabilities, the total public debt stock stood to 35 percent of GDP at end June (Table 1). Moreover, several other items—in particular, the arrears/liabilities with municipalities and the Palestinian Investment Fund—are under negotiation as part of the reconciliation exercise. The process involves netting out claims and a further downward revision of liabilities is expected once the agreements are finalized.

Debt Sustainability

Notwithstanding the downward revisions to the debt stock, debt dynamics warrant continued fiscal caution. The main macroeconomic assumptions remain broadly unchanged, with average growth of 3.5 percent in the medium term and fiscal consolidation of 0.8 percentage points of GDP per year. Donor aid (for budget support and development) is projected to be maintained in nominal (US$) terms at the current level, equivalent to 6.5 percent of GDP on average. The resulting financing gaps (2.8 percent of GDP on average), as in the past, are assumed to be financed by a combination of domestic bank loans and arrears on unchanged effective terms (about 3.5 percent interest).

Although the DSA suggests that debt remains sustainable, public debt under the baseline is projected to stabilize only after rising to 40 percent of GDP in 2019 from 37 percent in 2016. However, debt remains susceptible to a variety of shocks. In particular, both the shock to growth and the primary balance—both key macroeconomic risks—see debt reaching or exceeding 50 percent of GDP. The heightened risk of further declines in donor aid, in conjunction with limited fiscal financing alternatives in times of crisis (see Box 3), pose additional risks to debt sustainability.

[3] This is in keeping with the need to enhance some aspects of fiscal data, including reconciling the stocks and flow of arrears, and to develop and accurate record of public debt data on a gross and net basis (see Annex VII).

[4] Some details of the scope of the audit and the coverage of the revision (e.g., the coverage of pension liabilities for both civilian and military personnel) require further clarification.

Table II.1. West Bank and Gaza: Total Debt Liabilities of the PA

(In millions of U.S. dollars)

	2012	2013	2014	2015	June 2016 (prel.)	
					In mln. $	% of
Gross debt liabilities	4,041	4,638	4,550	5,117	4,679	100
In percent of GDP	36	37	36	40	35	…
Domestic debt 1/	1,385	1,268	1,128	1,467	1,457	31
Bank loans	719	661	631	799	785	17
Overdraft	480	366	303	433	436	9
Petroleum Authority loans	178	225	181	221	222	5
Other public institutions loans	8	15	13	13	14	0
Other domestic accounts payable, incl. arrears, and debt securities 2/	1,409	2,101	2,190	2,450	2,060	44
Pension fund 3/	1,058	1,465	1,619	1,923	1,508	32
Private suppliers, municipalities and ministries 4/	269	555	473	428	460	10
o/w promissory notes to private suppliers	…	…	…	…	91	
Palestinian Investment Fund (PIF) 5/	79	79	95	96	89	2
PMA	3	3	3	3	3	0
External debt, incl. clearance advances	1,247	1,269	1,231	1,201	1,162	25
Arab Financial Institutions	629	630	621	618	618	13
Al Aqsa Fund	522	524	517	518	517	11
Arab Fund for Economic & Social Development	57	58	57	56	56	1
Islamic Development Bank	50	48	47	44	45	1
International and Regional Institutions	339	343	348	337	335	7
World Bank	290	284	277	269	266	6
European Investment Bank	26	36	48	45	46	1
IFAD	3	3	3	2	2	0
OPEC	19	20	20	20	20	0
Bilateral loans	130	136	120	101	103	2
Spain	92	96	84	76	77	2
Italy	33	35	31	20	20	0
China	5	5	5	5	5	0
Clearance advances from Israel (from 2012)	150	160	142	144	106	2
Memo: Debt of Palestinian entities to Israeli Electricity Company 6/		375	463	438	440	…
Gross debt liabilities, excl. Pension Fund	2,983	3,173	2,931	3,194	3,171	…
In percent of GDP	27	26	23	25	23	…

Source: Ministry of Finance and Planning.

1/ As reported by the MOFP in monthly reports (http://www.pmof.ps/en/41).

2/ Included in line with recommendations from "Public Sector Debt Statistics: Guide for Compilers and Users", IMF, 2013.

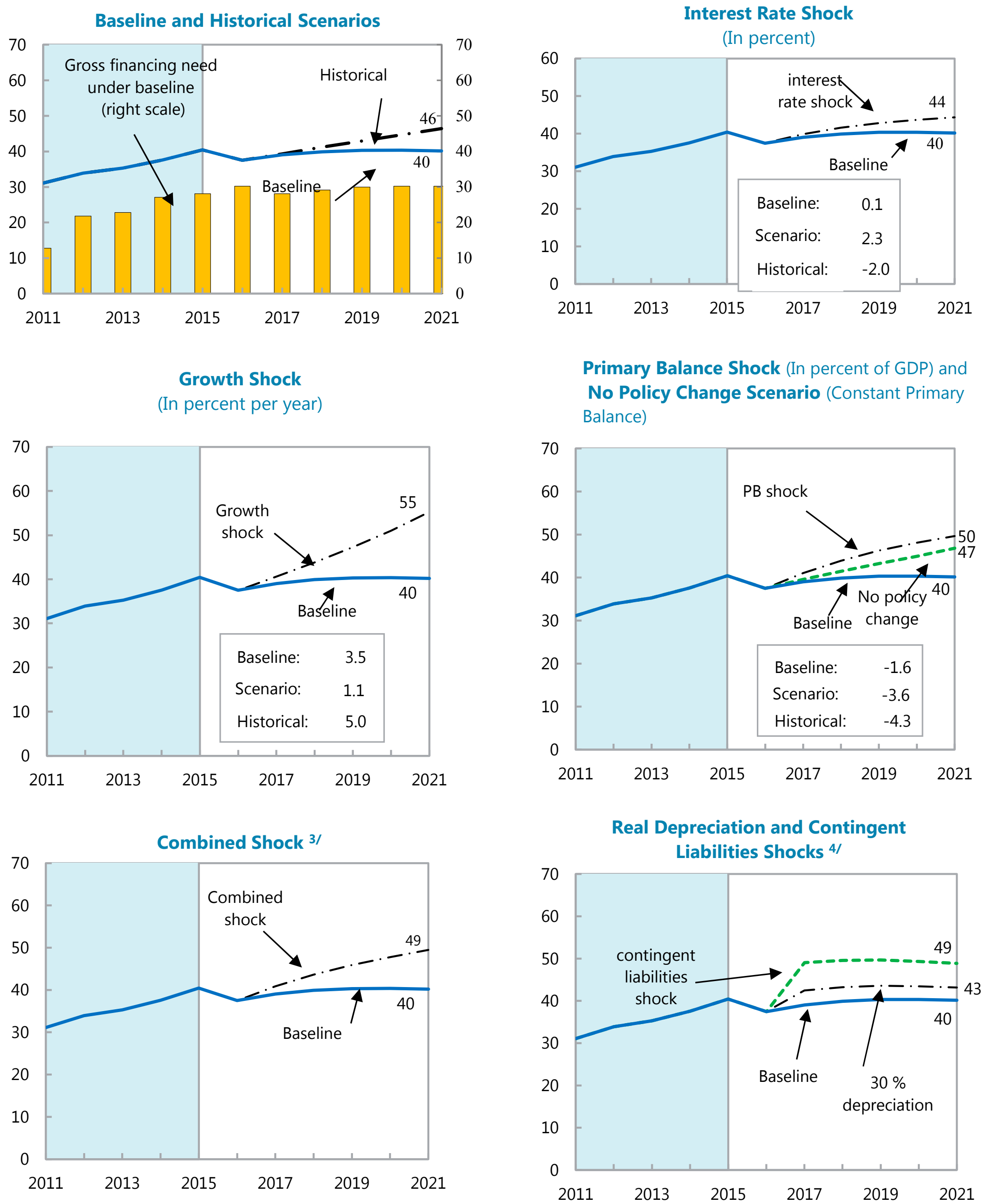
3/ Preliminary June 2016 data reflect revised information on outstanding stock of liabilities following PriceWaterhouseCoopers audit of the pension fund. The MOFP has yet to advise of the impact on historic data for 2012-15.

4/ Includes debt to municipalities, which is under negotiation, with the MOFP seeking audit and reconciliation.

5/ The MOFP is currently negotiating a settlement to offset debt against PIF dividends to the budget.

6/ Of total debt, about $90 million is debt of the PA.

Figure II.1. West Bank and Gaza: Public Debt Sustainability: Bound Tests [1/2/]
(Public debt in percent of GDP)



Sources: Palestinian authorities; and IMF staff estimates and projections.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table II.2. West Bank and Gaza: Public Sector Debt

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Debt-stabilizing primary balance 9/
1 **Baseline: Public sector debt 1/**	31.1	33.9	35.3	37.6	40.4	**37.5**	**39.0**	**39.9**	**40.3**	**40.3**	**40.2**	**-1.4**
Of which: foreign-currency denominated	11.4	9.5	8.6	9.3	8.4	7.9	7.6	7.3	6.9	6.5	6.2	
2 Change in public sector debt	11.0	2.8	1.4	2.3	2.9	-3.0	1.5	0.9	0.4	0.0	-0.2	
3 Identified debt-creating flows (4+7+12)	3.7	3.3	-0.1	2.3	2.9	1.1	1.5	0.6	0.2	-0.3	-0.7	
4 Primary deficit	6.0	6.3	1.5	2.6	4.6	3.0	2.5	1.9	1.6	1.2	0.8	
5 Revenue and grants	29.0	26.7	29.6	31.3	28.0	28.8	28.8	28.9	28.7	28.7	28.7	
6 Primary (noninterest) expenditure	35.1	33.0	31.0	33.9	32.7	31.8	31.3	30.8	30.3	29.9	29.5	
7 Automatic debt dynamics 2/	-2.3	-3.0	-1.5	-0.3	-1.7	-1.9	-0.9	-1.3	-1.4	-1.5	-1.5	
8 Contribution from interest rate/growth differential 3/	-1.9	-3.8	-0.9	-0.2	-2.4	-1.9	-0.9	-1.3	-1.4	-1.5	-1.5	
9 Of which: contribution from real interest rate	0.4	-2.1	-0.2	-0.3	-1.2	-0.6	0.3	0.0	-0.1	-0.2	-0.1	
10 Of which: contribution from real GDP growth	-2.2	-1.7	-0.7	0.1	-1.2	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3	
11 Contribution from exchange rate depreciation 4/	-0.4	0.8	-0.6	-0.1	0.8	...	...	...	...	...	...	
12 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	0.0	
13 Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) 5/	7.3	-0.5	1.5	0.0	-0.1	-4.1	0.0	0.2	0.2	0.3	0.5	
Public sector debt-to-revenue ratio 1/	107.1	126.9	119.3	120.0	144.3	130.0	135.4	138.3	140.3	140.5	139.8	
Gross financing need 6/	12.8	21.9	22.8	27.1	28.1	30.2	28.1	29.1	30.0	30.3	30.2	
in billions of U.S. dollars	1.3	2.5	2.8	3.4	3.6	4.1	4.0	4.3	4.7	5.0	5.2	
Scenario with key variables at their historical averages 7/						**37.5**	**39.3**	**41.2**	**42.9**	**44.6**	**46.4**	**-3.0**
Scenario with no policy change (constant primary balance) in 2016-2021						**37.5**	**39.6**	**41.5**	**43.2**	**44.9**	**46.8**	**-1.6**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	12.4	6.3	2.2	-0.2	3.5	3.3	3.5	3.5	3.5	3.5	3.5	
Average nominal interest rate on public debt (in percent) 8/	2.0	2.0	0.6	0.6	1.5	1.3	1.5	1.7	1.7	1.7	1.7	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.0	-7.2	-0.6	-0.9	-3.4	-1.5	0.9	0.1	-0.1	-0.3	-0.2	
Nominal appreciation (increase in US dollar value of local currency, in percent)	4.5	-7.2	6.8	0.9	-7.9	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	0.0	9.2	1.3	1.5	4.9	2.7	0.6	1.6	1.8	2.0	2.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	5.0	0.1	-3.9	9.0	-0.3	0.7	1.7	1.8	2.0	2.1	2.1	
Primary deficit	6.0	6.3	1.5	2.6	4.6	3.0	2.5	1.9	1.6	1.2	0.8	

Sources: Palestinian authorities; and IMF staff estimates and projections

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = 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).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ 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.

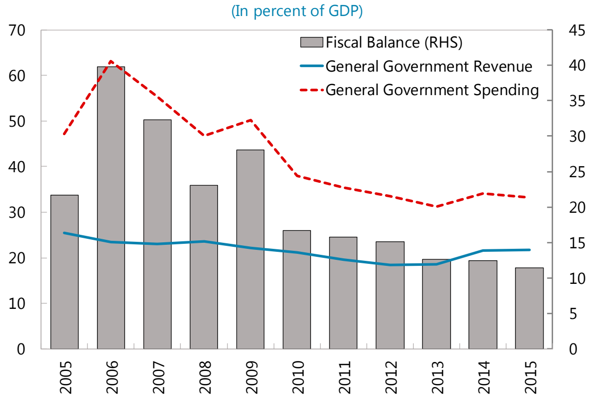
Annex III. Cross-Country Public Expenditure Diagnostic[1]

While overall government expenditures in the West Bank and Gaza (WBG) have declined significantly over the past decade, further expenditure cuts may be becoming more difficult to implement. However, a comparison of the level and composition of spending in WBG with a range of comparator countries suggests there is considerable scope to reduce some oversized recurrent expenditure items, rebalance spending toward development expenditures, and improve targeting of social assistance to the poor.

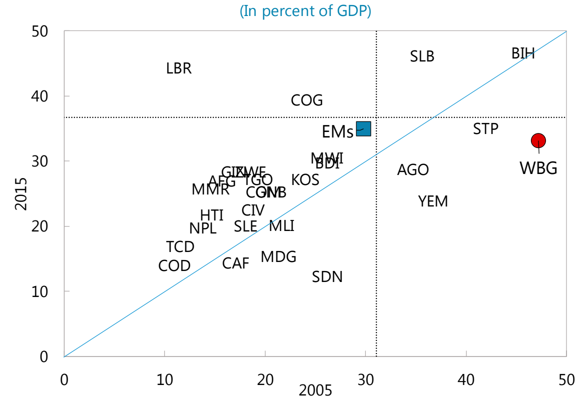
Government spending fell dramatically over the past decade….

Despite facing extraordinary political and development challenges, the Palestinian Authority (PA) has tackled head on the need to achieve a more sustainable fiscal position. A dramatic decline in general government spending lies at the heart of the PA's efforts to reduce the overall fiscal deficit from a peak of nearly 40 percent of GDP in 2006 to under 12 percent in 2015.[2] The West Bank and Gaza (WBG) is one of a few economies—including other fragile states[3] and emerging market economies (EMs)—that has sustained the adjustment in spending over the past decade (i.e., economies below the 45° line, see figure).

WBG: Budget Indicators, 2005-2015
(In percent of GDP)



Change in General Government Spending
(In percent of GDP)



Sources: Ministry of Financing and Planning, and IMF "FAD—Expenditure Assessment Tool, 2016".
Note: In the right panel, the dashed lines represent the average for fragile states; "EM" is the average for emerging market economies.

…but further reductions are proving more difficult…

In recent years, the pace of expenditure reduction has eased and more upward spending pressures have emerged, with general government spending stuck above 31 percent of GDP in 2015. Of course, the goal should not be to cut government spending at all cost. While a key objective is to

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[1] Prepared by Mariusz Sumlinski (FIN).

[2] The authorities' data, starting in 2009, are available at http://www.pmof.ps/en/web/guest/41.

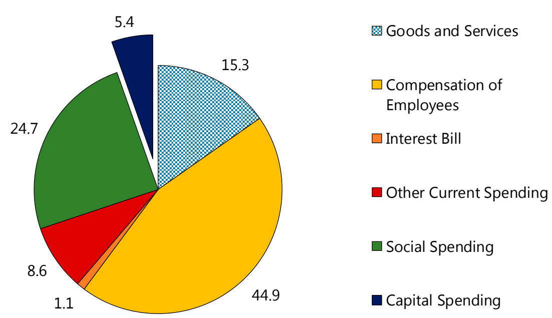
[3] The reference country group average data come from IMF staff's "FAD—Expenditure Assessment Tool, 2016". The West Bank and Gaza is compared with the emerging market economies (EMs) and fragile states (as defined and listed in *IMF Engagement with Countries in Post-Conflict and Fragile Situations—Stocktaking*, IMF, May 2015).

achieve a more sustainable level of overall spending, it is equally important to preserve or even create space for spending that invests in the productive capacity of the economy (i.e., capital spending) or to make more effective spending to protect the most vulnerable. Comparing WBG with other countries provides some insights into where there may be scope to contain some expenditures, rebalance others, and improve the efficiency or effectiveness of other spending.

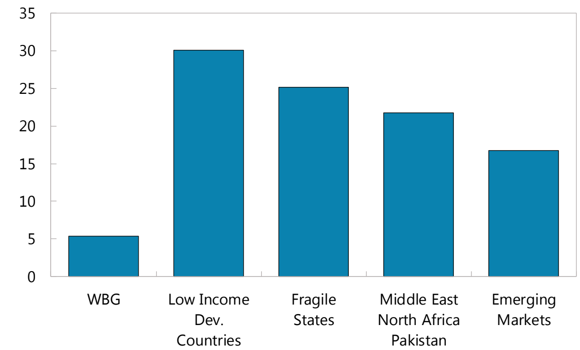
...and spending remains heavily skewed toward recurrent expenditures.

The overall decline in government spending has not yet achieved the desired rebalancing towards capital (development) spending. Capital expenditure represents a very small share of WBG's budget, accounting for only about 5 percent of total spending and less than 2 percent of GDP in 2015—much lower than among other country groups.

WBG: Spending by Economic Classification, 2015
(In percent of total spending)



Capital Spending, latest available
(In percent of total spending)

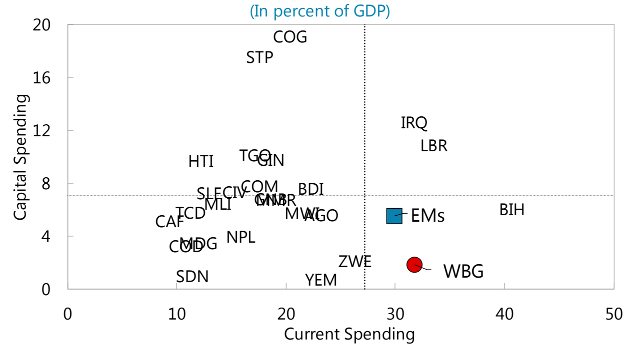


Sources: Ministry of Financing and Planning, and IMF "FAD—Expenditure Assessment Tool, 2016".

Moreover, the level of capital spending appears to have declined over the past decade. While development expenditure averaged about ten percent of total expenditure during 2005–15, it has declined steadily from about 12 percent in 2009 to about 5 percent in 2015 (although this may, in part, reflect declining donor support).

The WBG also continues to have one of the highest shares of current expenditure and one of the lowest shares of capital expenditure in total expenditures compared to EMs and particularly other fragile states.

Current and Capital Spending, latest available
(In percent of GDP)

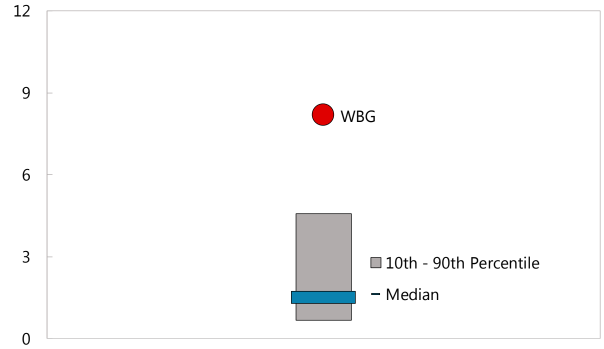


Sources: Ministry of Finance and Planning, and IMF "FAD - Expenditure Assessment Tool, 2016".
Note: Dashed line is the average for fragile states.

WBG' s security spending absorbs a large share of the budget…

Expenditures on public order and safety absorbed the largest share of total expenditure, averaging around 30 percent of total spending during 2009–15 and standing around 8.1 percent of GDP in 2015 (Annex Table 2). When compared with military expenditures in the world in 2015, West Bank and Gaza expenditures on public order and safety are a significant outlier, well above the 90th percentile.[4]

Military Expenditure for 172 Countries, 2015
(In percent of GDP)



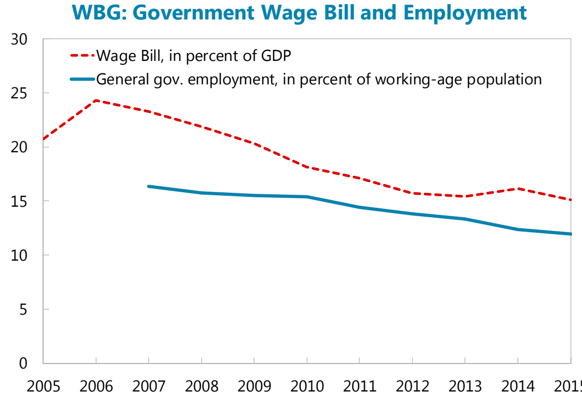
Sources: Stockholm International Peace Research Institute (SIPRI) 2015, Ministry of Finance and Planning, and IMF staff calculations.

…and the oversized wage bill is also well beyond country norms.

Expenditures on the wage bill—wages, salaries and allowances—have declined steadily as a percent of GDP over the past decade. However, as this fall broadly parallels the decline in total government spending, the wage bill has remained broadly stable as a share of total expenditures. In 2015, the wage bill represented about 45 percent of total expenditures, having hovered around 47 percent of total expenditures in 2009.

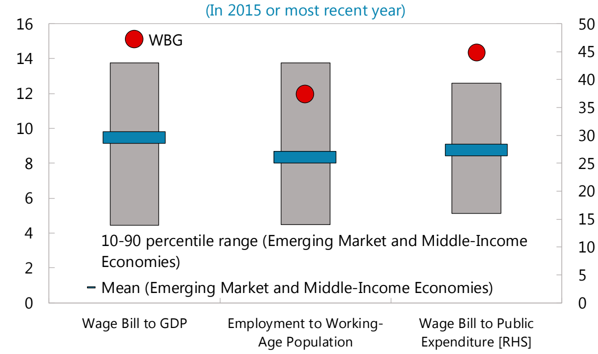
In this regard, WBG's wage bill—both as a share of expenditures and relative to GDP (around 15 percent in 2015)—compared unfavorably to other countries, above the 90th percentile for EMs and yielding similar results for other country comparators (e.g., low income and developing countries). At the same time, public sector employment in the WBG appears to be less out of line than the wage bill itself. This aligns with the findings of the World Bank's recent Public

WBG: Government Wage Bill and Employment



Source: Ministry of Finance and Planning.

Public Sector Wage Bill and Employment
(In 2015 or most recent year)



Sources: Ministry of Finance and Planning, and IMF "FAD - Expenditrue Assessment Tool, 2016".

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[4] SIPRI defines military expenditure to include current and capital expenditure on the armed forces, including peace keeping forces; defense ministries and other government agencies engaged in defense projects; paramilitary forces when judged to be trained, equipped and available for military operations; and military space activities. For data and additional information see http://milexdata.sipri.org. Public order and safety expenditures are used for WBG.

(continued)

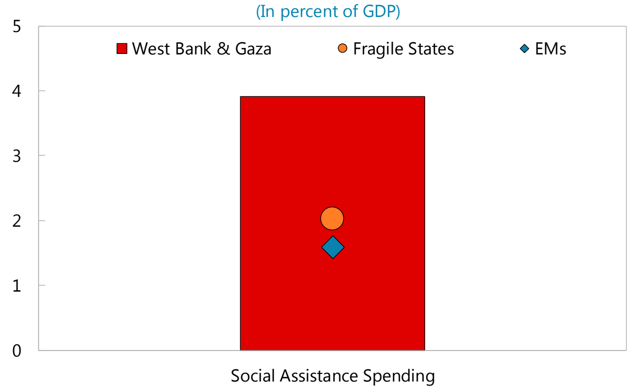
Expenditure Review (PER),[5] which prioritizes the need to address wages and allowances rather than an oversized civil service. Related to this, the PER also points to a relatively large public-private wage differential,[6] which can impinge on efforts to facilitate private sector led development and employment.

Overall social spending is strong, but could better target the poor…

WBG apportions a significant share of total expenditures—almost 25 percent in 2015—toward transfers[7] and social expenditures. Spending on social benefits accounted for nearly 60 percent of transfers or nearly 4 percent of GDP, above the average expenditure on social assistance for both EMs and fragile states.

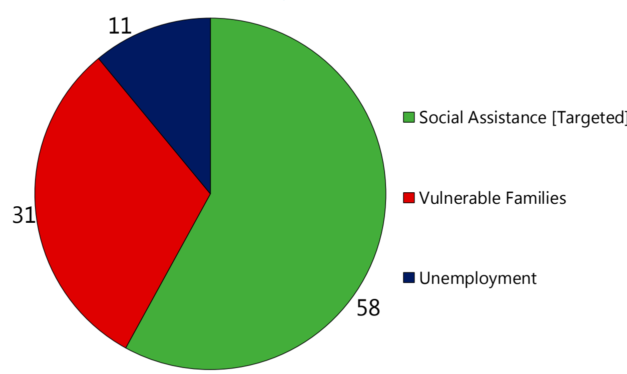
While this relatively high level of social assistance may reflect the need to support the poor and vulnerable given WBG's unique political and developmental challenges, a significant portion of spending could be better targeted. Currently, under 60 percent of social benefits is in the form of targeted assistance. Although this portion has been recognized as one of the most advanced cash assistance programs in the Middle East and North Africa region,[8] there is considerable scope to enhance targeting of the remaining share of social assistance spending. This could help more effectively support the poorest and most vulnerable, and efficiency gains could allow some savings that over time could be redirected toward capital spending.

Social Assistance Spending, latest available
(In percent of GDP)



Sources: Ministry of Finance and Planning, and IMF "FAD - Expenditure Assessment Tool, 2016".

WBG: Social Assistance Spending, 2015
(In percent of total)



Source: Ministry of Finance and Planning.

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[5] World Bank, "Public Expenditure Review of the Palestinian Authority", June 2016, Chapter 2.

[6] The differential is reported at 18 percent for the West Bank and 50 percent for Gaza for 2013. See World Bank, PER, June 2016.

[7] Social benefits constitute the biggest expenditure under "transfers", with other components including: civilian and military pensions, assistance for prisoners and detainees, payments to NGOs and civil society and universities, compensation for damages and emergency expenditures, local government support, other transfers, assistance to released prisoners, and educational subsidies and scholarships.

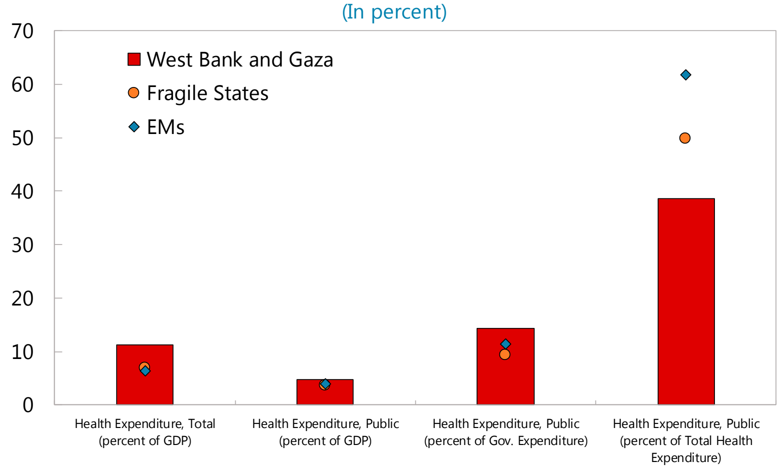
[8] West Bank and Gaza Fact Sheet, March 2015, World Bank.

...and addressing unpredictable health referral costs could help fiscal management.

In general, health expenditures (on average) do not seem out of line with country comparators. However, outlays on goods and services—reflecting an extensive system of medical referrals—represent a significant share of overall health spending. The system of referrals, either within WBG or to neighboring countries, was developed to compensate for lack of available treatments, medical equipment, medicine, and medical expertise. While it may have served some well, it is implemented with little control, as reflected in the large and volatile outlays on health-related goods and services.

Key Health Expenditure Indicators, latest available

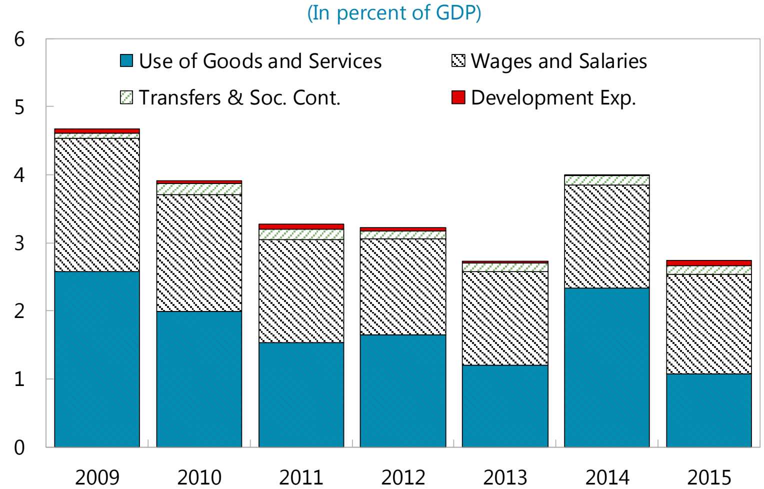
(In percent)



Sources: World Bank PER 2016, Ministry of Finance and Planning, and IMF "FAD - Expenditure Assessment Tool, 2016".

WBG: Expenditure on Health, by Economic Classification

(In percent of GDP)



Source: Ministry of Finance and Planning.

Table III.1. West Bank and Gaza: Spending and Functional Classifications[1/]

	2009	2010	2011	2012	2013	2014	2015
				Economic classification			
				(in NIS millions)			
Total expenditure (commitment)	**13,702**	**12,590**	**13,222**	**14,530**	**14,010**	**15,494**	**16,566**
Current spending	12,853	11,476	11,897	13,593	13,336	14,556	15,673
Wages and salaries	5,779	6,019	6,381	6,812	6,928	7,336	7,440
Use of goods and services	2,120	1,841	1,792	2,257	1,817	2,333	2,530
Transfers & social contributions	3,267	2,629	3,165	3,426	3,478	3,605	4,095
Minor capital	213	107	58	26	29	61	41
Interest					325	199	178
Net lending	1,474	880	501	1,072	760	1,022	1,169
Earmarked payments							220
Development	849	1,114	1,325	937	674	938	893
Expenditure arrears	*1,181*	*433*	*1,571*	*1,987*	*1,667*	*2,633*	*2,494*
				(in percent of GDP)			
Total expenditure (commitment)	**48.3**	**37.9**	**35.4**	**33.5**	**31.2**	**34.1**	**33.6**
Current spending	*45.3*	*34.6*	*31.9*	*31.4*	*29.7*	*32.0*	*31.8*
Wages and salaries	20.4	18.1	17.1	15.7	15.4	16.1	15.1
Use of goods and services	7.5	5.5	4.8	5.2	4.1	5.1	5.1
Transfers & social contributions	11.5	7.9	8.5	7.9	7.8	7.9	8.3
Minor capital & Earmarked payments	0.8	0.3	0.2	0.1	0.1	0.1	0.5
of which: Earmarked payments							0.4
Net lending & Interest	5.2	2.7	1.3	2.5	2.4	2.7	2.7
of which: Interest	0.0	0.0	0.0	0.0	0.7	0.4	0.4
Development	*3.0*	*3.4*	*3.5*	*2.2*	*1.5*	*2.1*	*1.8*
Expenditure arrears	*4.2*	*1.3*	*4.2*	*4.6*	*3.7*	*5.8*	*5.1*
				Functional Classification			
				(in NIS millions)			
Total expenditure	**11,504**	**11,470**	**12,058**	**12,870**	**12,655**	**13,998**	**13,751**
General public services	1,625	1,597	1,679	1,590	1,835	1,753	1,807
Public order & safety	3,636	3,762	3,751	4,500	3,795	4,033	4,013
Economic affairs	278	343	276	372	303	473	311
Environmental protection	11	11	12	12	12	13	13
Housing and community amenities	299	184	202	195	160	150	205
Health	1,329	1,306	1,227	1,402	1,228	1,829	1,353
Recreation, culture, and religion	342	322	343	327	316	363	368
Education	1,922	2,008	2,179	2,287	2,427	2,579	2,548
Social protection	2,063	1,938	2,389	2,185	2,579	2,805	3,133
				(in percent of GDP)			
Total expenditure	**40.6**	**34.5**	**32.3**	**29.7**	**28.2**	**30.8**	**27.9**
General public services	5.7	4.8	4.5	3.7	4.1	3.9	3.7
Public order & safety	12.8	11.3	10.0	10.4	8.5	8.9	8.1
Economic affairs	1.0	1.0	0.7	0.9	0.7	1.0	0.6
Environmental protection	0.04	0.03	0.03	0.03	0.03	0.03	0.03
Housing and community amenities	1.1	0.6	0.5	0.4	0.4	0.3	0.4
Health	4.7	3.9	3.3	3.2	2.7	4.0	2.7
Recreation, culture, and religion	1.2	1.0	0.9	0.8	0.7	0.8	0.7
Education	6.8	6.0	5.8	5.3	5.4	5.7	5.2
Social protection	7.3	5.8	6.4	5.0	5.8	6.2	6.4

Sources: Ministry of Finance and Planning, and IMF staff estimates.
Note: 2009-10 converted from USD to NIS at actual exchange rate.
1/ The difference between economic and functional classifications totals is owing to recording of use of goods and services and development expenditure for functional classification on cash basis and to transactions in process.

Annex IV. A Future Role for Private Equity in West Bank and Gaza?[1]

More investment is needed to improve prospects for economic growth. Constraints on activity in WBG have seen growth skewed heavily towards consumption, while investment grew on average by only around 1½ percent per year over the past fifteen years. In this context, a key policy goal is to make more room for investment spending in the budget. To help boost private investment private equity (PE) is receiving more attention as a potential source of financing. PE is an institutional investment in non-publically traded companies with high growth potential, via growth capital and venture capital (VC) funds.[2]

Studies suggest that PE has the potential to boost productivity and economic growth. For instance: PE could be up to nine times more effective in promoting innovation than conventional bank lending; the operating profitability of PE-backed buyouts was 4.5 percent higher than comparable non-buyout companies;[3] and increasing VC investments by 0.1 percent of GDP is associated with a 0.3 percent increase in real GDP growth in advanced economies, with a larger 1 percent increase for early-stage investments.[4]

Although still a nascent source of investment, PE could be well suited to the unique circumstances in WBG. Since 2011, three equity funds and one VC fund have been established, with total committed capital slightly in excess of US$200 million.[5] VC funding is prevalent in the information and communication technology sector, which could be a promising avenue for investment growth in WBG. Activities such as software development, creating Arabic website content, and business process outsourcing may: (i) benefit from WBG's relatively high educational standards and competitive unit labor costs within the region; and (ii) be less prone to the high transaction costs linked to restrictions on imports and exports of physical goods. By some estimates, the sector's contribution to GDP could experience an eight-fold increase to almost US$1 billion and generate over 18,000 jobs by 2030.[6]

Given this potential, building a deeper understanding of how PE can impact growth can guide actions to improve WBG's investment environment. Challenges in the business environment include intellectual property rights and, in particular, the need for an investment regime where foreign and minority interests are adequately protected. While incubators, accelerators and IT hubs

[1] Prepared by Ragnar Gudmundsson and Hania Qassis.

[2] EBRD Transition Report, *Trends and Value Creation in Private Equity*, 2015–16. Growth capital funds often acquire minority shares in relatively mature companies. Venture capital funds acquire minority stakes in young companies.

[3] *Exploring the Impact of Private Equity on Economic Growth in Europe*, Frontier Economics, May 2013.

[4] T. Meyer, *Venture Capital Adds Economic Spice*, Deutsche Bank Research, September 14, 2010.

[5] World Bank, *West Bank and Gaza—Investment Climate Assessment: Fragmentation and Uncertainty*, 2014.

[6] The Portland Trust, *Beyond Aid: A Palestinian Private Sector Initiative for Investment, Growth and Employment*, 2013.

(continued)

exist in WBG, the eco-system for startups is still nascent and the weak IT infrastructure remains a major obstacle. Another priority is better integrating the educational curriculum and R&D skills sought by ICT companies. The Palestinian diaspora can be an important source of PE, although until now much of this investment has gone into real estate rather than productivity-enhancing investments. A recent IMF study found that diasporas, by funding education, training, and healthcare can help raise long-term economic growth, on average, by 0.6 percent in emerging and developing home countries.[7]

[7] IMF, *Avoiding the New Mediocre: Raising Long-Term Growth in the Middle East and Central Asia*, 2016; and Pritha Mitra, *Addition by Subtraction: How Diasporas Can Boost Home-Country Growth*, IMF Blog, May 18, 2016.

Annex V. The Unique Nature and Importance of Israeli-Palestinian Correspondent Banking Relations[1]

The unique nature of Israeli-Palestinian correspondent banking relationships reflects the broader economic relationship as specified under the Paris Protocol and the highly integrated economies. The large volume of transactions settled via correspondent banking services represent a sizable share of economic activity in the West Bank and Gaza (WBG). The termination of correspondent services could have a significant economic impact, including by increasing the share of informal/cash transactions that are both harder to tax and harder to monitor against illegal transactions. To help guard against these risks, the Palestine Monetary Authority—as part of its broader efforts to promote a rigorous financial regulatory regime—has stepped efforts to bolster WBG's AML/CFT regime.

Nature of Israeli-Palestinian Correspondent Bank Relations

The domestic and "cross-border" aspects of financial institutions and economic transactions in the WBG are complex and often overlapping. The Oslo II Accord divided the West Bank into three administrative areas: Areas A and B, under the jurisdiction of the Palestinian Authority (PA); and Area C, over which Israel retains full control. This differs somewhat from the institutional structures underpinning the financial system. The WBG has an independent banking system (including Palestinian banks operating in Area C and Gaza) that is supervised by the Palestine Monetary Authority (PMA). However, the WBG uses as its main currency the new Israeli shekel, issued by the Bank of Israel (BoI).[2] The two economies are also highly integrated: 70 percent of Palestinian imports and 85 percent of exports are to and from Israel,[3] and 17 percent of the labor force in the West Bank works in Israel and settlements. This results in a high volume of shekel-denominated transactions each day within the same currency area, but between two different jurisdictions.

In principle, shekel payments between Palestinian and Israeli banks should be settled via clearing houses connected to each other. Article IV of the Paris Protocol (PP) specifies that:

- the clearing of money orders and transactions between banks operating in the WBG and banks operating in Israel will be done between the Israeli and Palestinian clearing houses on a same working day basis; and
- both sides will allow correspondent relations between each other's banks and the PMA will have the right to convert, at the BoI, excess shekels received from Palestinian banks into foreign currency.

[1] Prepared by Priscilla Toffano.

[2] As the WBG has no currency on its own, the PA's budget and price statistics are expressed in Israeli shekels.

[3] Data on Palestinian trade from/to Israel are taken from COMTRADE and include some transit trade via Israel.

While the PP establishes some limits for the conversion of shekels into foreign currency, it does not specify a limit on the amount of transactions to be cleared in shekels.

In practice, payments are settled via correspondent services. The WBG and Israel each have four clearing houses used to clear *domestic* payments.[4] However, for various reasons (including different legal, business and technological systems), none of these Israeli and Palestinian clearing houses are currently connected to each other. Consequently, payments are settled by private banks via correspondence services.

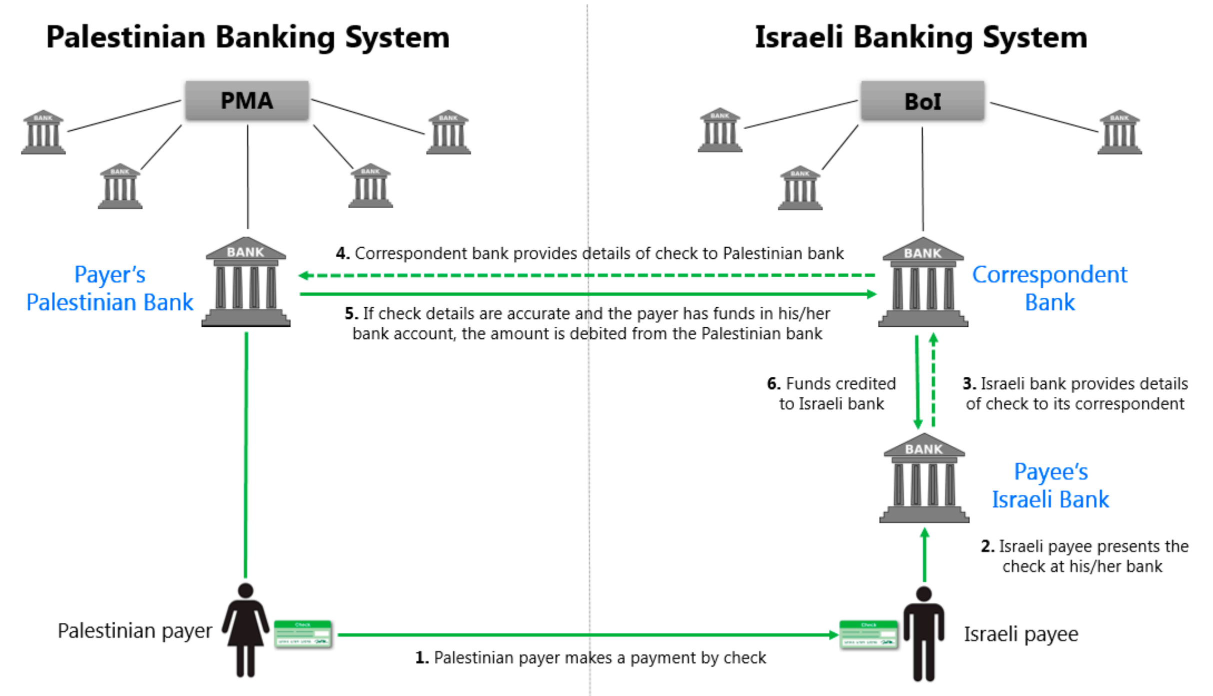
Consider, for instance, when a Palestinian makes a payment in Israel via a check (see Figure V.1). In this case, the Palestinian payer writes a check against his/her account in a Palestinian bank. Upon receipt of the check, the Israeli payee deposits it into his/her account at an Israeli bank. As the Palestinian and Israeli banks do not hold accounts with each other, they use the services of a correspondent bank to 'clear the check' (i.e., process the transaction). Specifically:

- the Israeli bank provides details of the check to its Israeli correspondent bank, which in turn transfers this information to the Palestinian payer's bank;
- if the information is accurate and the Palestinian payer has sufficient funds, the amount will be debited from his/her account at the Palestinian bank;
- the funds will then be transferred via the correspondent bank by crediting the Israeli bank's account at the correspondent bank; and
- finally, the Israeli bank now has access to these funds to credit the Israeli payee's account.[5]

[4] WBG and Israel each have four clearing houses: (i) the Check Clearing Houses (settling paper-based payments, mainly checks); (ii) the Automatic Clearing Houses (settling inter-bank movements not based on paper or cash, like salary payments, tax rebates, etc.); (iii) the Switch Clearing Houses (settling credit card payments); and (iv) the Real Time Gross Settlement Clearing Houses (settling transactions in real time, but without the possibility of cancellation).

[5] This annex focuses on the role of correspondent banks in settling Israeli/Palestinian transactions. In this context, the clearing houses in Israel have no direct transactions with Palestinian banks. However, two Israeli clearing houses—the Checks Clearing House (CCH) and the Real Time Gross Settlement Clearing House (RTGS)—play a role in finalizing the transaction among Israeli banks. In parallel with the exchange of check details between the payee's Israeli bank and the Israeli correspondent bank (step 3 in Figure V.1), details of the check are also sent to the CCH. Final settlement between the Israeli banks (step 6 in Figure V.1) occurs through the crediting and debiting of their accounts in the RTGS system.

Figure V.1. Settlement of Palestinian-Israeli Check Payment via Correspondent Bank



Threats to Sever Correspondent Relations

Despite recurring threats over the past decade, recent indications that Israeli banks will sever correspondent relations have become more acute. Israeli banks first indicated that they planned to sever ties with Palestinian banks in 2006, with these early threats focusing mainly on correspondent banking services with banks operating in Gaza.[6] The threats reportedly reflected growing concerns about potential liability in the event of legal proceedings related to claims of money laundering or terrorism financing. Three interrelated factors point to the need to take seriously the latest threats to sever Israeli-Palestinian correspondent relations.

- One is the broader global context, where banks increasingly see correspondent services as being too risky, too unprofitable or too complex.
- Two, the uncertainty of regulatory expectations and increasing fines for banks' failings in Anti-Money Laundering (AML) procedures covering correspondent banking.[7]

[6] In 2007, the Israeli Cabinet declared Gaza a hostile entity. In 2009, Israeli correspondent banks interrupted all services to banks operating in Gaza claiming that it was impossible to verify with certainty that the transactions were not benefitting Hamas.

[7] See C. Lowery and V. Ramachandran, "Unintended Consequences of Anti-Money Laundering Policies for Poor Countries", CDI Working Group Report, 2015.

- Three, the difficulty to monitor, and associated costs with processing, the high volume of transactions (often small in value) in the Israeli-Palestinian context may contribute to the reluctance of Israeli banks to handle transactions with banks in the West Bank.

Potential Economic Impact of Severing Correspondent Relationships

Transactions settled via correspondent services represent a large share of economic activity in the WBG. In 2015, around 300,000 checks were issued by Palestinians for Israeli beneficiaries and deposited in Israeli correspondent banks and 800,000 checks were issued by Israelis for Palestinian beneficiaries and deposited in Palestinian banks. These transactions were valued at NIS 8 billion and NIS 7 billion, respectively, which together are equivalent to around 30 percent of WBG's GPD. A similar system is used for outward and inward money transfers, which amounted to around NIS 8 billion and NIS 14 billion, respectively (or around 16 and 28 percent of WBG's GDP).[8]

The termination of correspondent services could have a significant economic impact, principally by driving more transactions into cash (see Figure V.2). In terms of the potential loss of activity, large commercial transactions between Israel and the West Bank are most at risk. If the parties involved are unable to access alternative correspondent services (i.e., via banks abroad), transaction may be cancelled, effectively reducing the volume of trade. On the other hand, the lack of correspondent services would drive medium- and small-sized transactions into cash, with a more prominent role for money changers. As trade is disrupted and becomes more informal, this could undermine efforts to broaden the tax base in WBG and negatively impact fiscal revenue. It could also impact the stability of the WBG financial system that the PMA has worked so hard to secure (see below). The problem of excess accumulation of liquidity, which is already a source of concern for Israel and detracting from the profitability of Palestinian banks, would worsen. More informality would also undermine the PMA's efforts to promote financial inclusion, reducing the proportion of the population using financial services. At the extreme, the nature of financial and commercial transactions in the West Bank could become similar to what has already occurred in Gaza, with no official means of payment other than cash, and vulnerable parts of the population finding it difficult to manage cash flows, build capital and savings, and mitigate economic shocks.[9]

While the economic costs may be less significant for Israel, driving transactions into cash would run counter to efforts to promote more secure, electronic transactions. Since imports from and exports to WBG represent only 2 and 6 percent, respectively, of total Israeli imports and exports, the economic cost of severing correspondent banking services would be much lower for Israel. This cost would mainly fall on Israeli trading companies (that absorb around half of the imports for WBG) and construction firms. The move to more informality could create added

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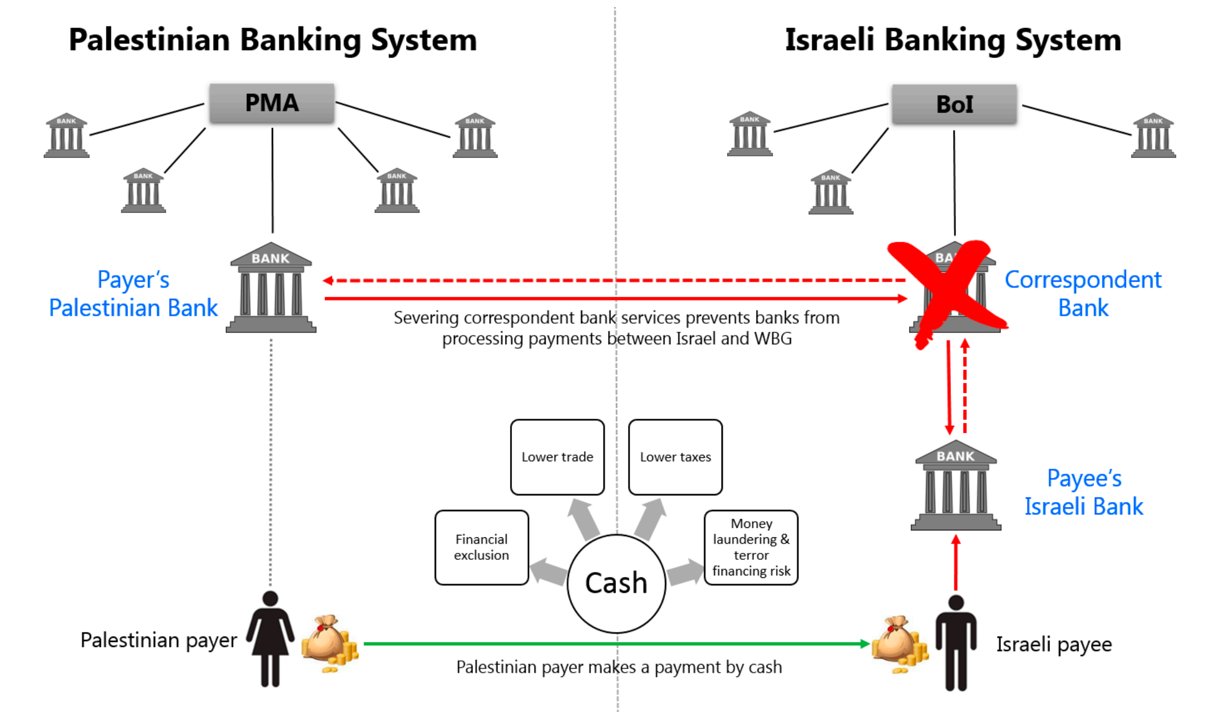
[8] Outward transfers are transfers issued by Palestinians to Israeli beneficiaries (e.g., payments of companies and government institutions settling their liabilities to Israel). Inward transfers are transfers issued by Israelis to Palestinian beneficiaries (e.g., remittances and clearance revenue collected by Israel on behalf of the PA).

[9] See T. Durner and L. Shetret, "Understanding Bank De-Risking and Its Effects on Financial Inclusion", Global Center on Cooperative Security Research Report, November 2015.

incentives to under-report VAT receipts, with the potential for fiscal losses. However, the cost to financial security would be much higher. Increasing the share of cash transactions would decrease the ability to monitor illegal activities and transactions, contrary to the objectives of the international framework for anti-money laundering (AML) and combating the financing of terrorism (CFT).

Figure V.2. Potential Economic Impact of Severing Correspondent Bank Relations



Policy Actions to Manage the Risk

The Palestinian authorities have adopted a multi-pronged approach to address the threat to correspondent banking relations. Since 2008, the PMA has worked to promote a rigorous banking supervision environment and to expand its macroprudential toolkit so that banks could be well positioned to cope with shocks. In light of recent emerging strains in correspondent bank relations, the WBG has stepped efforts to bolster the AML/CFT elements of the WBG regulatory framework.[10]

- The Palestinian AML law was issued in 2007, with IMF technical support. The authorities added a CFT module to this law, with the new AML/CFT law approved in December 2015. This law, and the accompanying regulations, criminalizes terror financing, and establishes a committee to order the freezing of terrorist assets and issue a list of designated entities.
- In late 2015, the WBG became a member of MENAFATF, a Financial Action Task Force-style regional body for the MENA region. MENAFATF has indicated that a comprehensive assessment of WBG's AML/CFT framework may be five or more years away.

[10] In parallel, the GoI is treating this issue seriously and working to prevent a collapse of correspondent relations.

- The PMA is working in closely with the Financial Intelligence Unit to effectively implement the new law. They are also developing a strategy to help expedite a MENAFATF assessment.
- To help provide further reassurance, the Palestinian authorities are receiving IMF technical assistance that will review the new legislation and accompanying regulations, with a view to supporting effective implementation of the enhanced law.
- In June 2016, the PMA conducted a successful roadshow to reassure U.S. banks of the soundness of WBG's AML/CFT regime. In this context, the PMA commissioned an assessment of the AML/CFT regime by an internationally recognized firm to help demonstrate adherence to international best practice.
- Looking further ahead, the PMA's ongoing work to promote cashless transactions will also be crucial to minimize cash-related crimes (see box).

WBG can benefit from international initiatives to address the withdrawal of correspondent banking relationships, as well as international support tailored to its circumstances. As indicated in a recent staff discussion note, home authorities of global banks should communicate their regulatory expectations and affected countries should continue strengthening their regulatory and supervisory frameworks to meet relevant international standards, with the help of technical assistance where needed.[11] Clarifying these standards, including on AML/CFT, could help promote a baseline for regulatory expectations. Industry initiatives could be pursued to facilitate customer due diligence and help reduce compliance costs. Enhancing national efforts to comply with international standards (including with donor-funded TA) and facilitating cross border information sharing would allow banks to conduct effective due diligence on their counterparts.[12] However, in the event of a complete loss of correspondent relations, it will be important to maintain official channels of communication, particularly if there is a need to consider a more active role for public support or an alternative mechanism for clearing transactions in the specific WBG-Israel circumstances.

[11] M. Erbenova and others, "The Withdrawal of Correspondent Banking Relationships: A Case for Policy Action," IMF Staff Discussion Note SDN/16/06, June 2016.

[12] For instance, analysis by the Bank for International Settlements points to ways to strengthen information sharing mechanisms (e.g., using centralized databases to facilitate improved "know-your-customer") that could help reliably identify the parties to a transaction and lessen the costs of safety inspections. See Committee on Payments and Market Infrastructures, "Correspondent Banking," Bank for International Settlements Consultative Report, 2016.

Annex Box. Moving Toward a Cashless Economy[1]

In advanced and developing economies alike, the trend towards cashless financial transactions has gained momentum, explained in large part by technological innovation. In Sweden, for instance, the value of cash declined from about 10 percent of GDP in 1950 to less than 2 percent in 2015, and the absolute amount of cash in circulation decreased by close to 15 percent between 2007 and 2014.[2] In Kenya, the use of mobile phone-based money has grown from zero to more than 75 percent of the adult population in less than ten years, with the value of daily transactions approaching the equivalent of 4.5 percent of annualized GDP.[3]

The move towards a cashless economy offers a number of perceived benefits, including:

- Reduced banking costs;
- Promoting access to financial services for the unbanked and under-banked;
- Encouraging savings, access to credit, and investment;
- Contributing to higher government revenue through reduced tax evasion; and
- Minimizing cash-related crimes and facilitating AML/CFT efforts.

On the other hand, cashless transactions raise potential concerns such as the loss of anonymity, and vulnerability to cyber-crime and related cyber-security costs.

In the WBG, the PMA has implemented since 2010 a number of measures that aim to support the eventual shift towards a cashless economy. These include the launch of a Real Time Gross Settlement system linked to the clearing house in order to automate bank transfers; the creation of IBAN codes to facilitate cross-border transfers; and the launch in May 2015 of a National Switch Payment System to allow ATM connectivity which should cover all banks by end-2016. Other ongoing initiatives involve linking Points of Sale with the National Switch to encourage card transactions, the establishment of mobile phone payment services, and the creation of an electronic check clearing system to reduce processing times from four to one day.

While these steps should help lower transactions costs and promote development of the WBG financial sector, they are also consistent with Israel's planned *Locker Bill* that will limit cash transactions to NIS 10,000 and apply to WBG by end-2017. Thus, severing of Israeli-Palestinian correspondent banking relationships would run counter to these efforts by forcing economic agents to revert to cash-based transactions.

[1] Prepared by Ragnar Gudmundsson.

[2] *Decreasing Cash Usage and the Central Bank's Role: The Swedish Experience*, Erik Lenntorp, Sveriges Riksbank, January 2016.

[3] "Cashing In on the Digital Revolution," Njuguna Ndung'u, Armando Morales, Lydia Ndirangu, *Finance and Development*, June 2016.

Annex VI. West Bank and Gaza: Technical Assistance by the IMF to the Palestinian Authority, 2011–16[1]

The IMF has provided TA to the West Bank and Gaza (WBG) in the areas of public financial management (PFM), revenue administration, banking supervision, and national accounts. Technical support is also being provided to the recently established macro-fiscal unit within the Ministry of Finance and Planning (MoFP). Priorities for capacity building over the medium term focus on public financial management, revenue administration, and banking supervision. There is also a need for intermittent review and assistance to enhance the statistical capacity especially in GFSM 2001, external sector, and national accounts. It is expected that FAD and MCM, supported by METAC, will continue to provide TA, dependent on the authorities' commitment and progress.[1]		
Mission Date	**Mission**	**Date of TA Report**
Fiscal Sector: Since 2007, numerous reforms have been undertaken to put in place the components of a modern PFM system. Significant progress in PFM was made in drafting legal frameworks, adopting Single Treasury Account (STA), establishing debt management and cash planning units, modernization of budget classification and Chart of Accounts, developing a computerized financial management information system (FMIS), strengthening accounting and reporting, establishing internal audit departments in ministries as well as an independent external audit agency, and establishing a macro-fiscal unit at the MoFP. A medium-term PFM reform plan was agreed in 2011, with updated plan established for 2014–16. Currently, the key objective is to consolidate the institutionalization of progress already made. Further to consolidation, approval of legislative and regulatory frameworks, review of implementation of commitment control and STA, cash planning, arrears recording and formulation of strategies for minimizing arrears, and compliance with GFSM 2001 standards need to be addressed. Since 2010, TA efforts expanded into mobilizing revenue compliance by modernizing tax administration. A medium-term revenue work program, recommended by the FAD, aims to strengthen the administration of income tax and VAT for the large and medium taxpayer, and reform the income tax and reduce tax incentives and exemptions. So far, a computerized revenue management system has been launched, a tax procedures code was approved by the Cabinet but not enacted, and the LTU, under a newly appointed director, has begun more effective work. In the medium term, the FAD TA priorities will remain the improvement of public financial management and modernization of revenue administration.		
Mar. 19–30, 2011	Palestinian Authority Integrated Tax Administration System	Mar. 2011
Jul. 3–7, 2011	Self-Assessment Preparations and Progress with its Introduction in LTU	n.a.
Sep. 14–27, 2011	Tax Audits Procedures	Oct. 2011
Sep. 28–Oct. 30, 2011	Improving Compliance with Income Tax	Dec. 2011
Dec. 1–12, 2011	Public Financial Management Progress Review	Jan. 2012
Feb. 1–14, 2012	Tax Administration	n.a.
Apr. 15–22, 2012	Tax Revenues Clearance Procedures	May 2012

[1] Prepared by Hania Qassis.

Jun. 13–26, 2012	Improving Income Tax and Tax Incentives Proposed Tax Policy TTF	Jul. 2012
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	n.a.
July 31–Aug. 18, 2016	Training on Investigative Technique and Preparation of Customs for Prosecution	n.a.
Monetary and Financial Systems: TA efforts have focused on supporting the Palestine Monetary Authority (PMA) in becoming a competent monetary authority to operate a high-quality reserves management system, to supervise and regulate banks, to gain capacity in introducing government securities, and prepare for the eventual introduction of an independent currency for the Palestinian economy when conditions are right. The PMA has established a credit registry, instituted periodic stress testing of banks, introduced a deposit insurance scheme, and prepared plans for contingency crises management. The PMA has developed substantial capacity as a central bank toward the possibility of issuance of a national currency.		
Dec. 3–8, 2011	Support to the Palestine Monetary Authority Credit Registry	Dec. 2011
Dec. 8–15, 2011	Enhancing the Capacities of the Palestine Monetary Authority and Options for the Issuance of New Currency and the Monetary Policy Regime *	Mar. 2012

Jan. 15–26, 2012	Developing a Government Securities Market	n.a.
Feb. 5–9, 2012	Reserve Management Policy and Investment Guidelines *	Apr. 2012
Mar. 25–Apr. 3, 2012	Risk-Based Banking Supervision*	Apr. 2012
Oct. 9–18, 2012	Implementing Risk-Based Supervision	Oct. 2012
Oct. 31–Nov. 15, 2012	Strengthening the Frameworks for Contingency Crisis Management, Consolidated and Cross Border Supervision and Stress Testing	June 2013
Dec. 8–12, 2012	Developing the Government Securities Market	Dec. 2012
Jan. 13–17, 2013	Reserve Management Policy and Investment Guidelines	Jan. 2013
Mar. 31–Apr. 11, 2013	Follow up on Risk Based Supervision Manual	n.a.
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

Statistics: TA on statistical issues has focus on efforts to implement and align existing statistical compilation and dissemination systems with the latest international statistical standards across three major datasets—government finance statistics (GFS), national accounts (NA), and external sector statistics (ESS)—for economic policy analysis. These efforts culminated with the WBG becoming a subscriber to the IMF's Special Data Dissemination Standard (SDDS) in April 2012. Further work is needed to improve data consistency in ESS, develop an inter-institutional strategic plan for GFSM2001 implementation, and develop of a set of high-frequency indicators to detect economic trends and risks. In general, the transparency and timeliness of the data produced by the Palestinian Central Bureau of Statistics, MoFP, and the PMA compare favorably with countries that maintain good data management and dissemination standards.

Oct. 16–27, 2011	Report on the SDDS Assessment Mission	Oct. 2011
Nov. 27–Dec. 1, 2011	Balance of Payments Statistics – IIP	n.a.
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	n.a.
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	n.a.
Aug. 28–Sept. 1, 2016	National Accounts	n.a.

[1] METAC – Middle East Regional Technical Assistance Center.

n.a. – not applicable.

* Reports classified as confidential or strictly confidential.

Annex VII. West Bank and Gaza—Statistical Issues[1]

(As of July 25, 2016)

I. Assessment of Data Adequacy

While data provision in the West Bank and Gaza has some shortcomings, it is broadly adequate for economic analysis and policymaking. The most affected areas are the government finance statistics and the external sector statistics; for the latter needed improvements concern, in particular, inconsistencies between BOP and IIP data, and timeliness of data dissemination.

National Accounts: The Palestinian Central Bureau of Statistics (PCBS) compiles and disseminates annual and quarterly national accounts estimates. The annual estimates were recently rebased to 2010 and there is need to begin work for the next rebase. The authorities have committed to improving both source data and compilation methods. The quarterly GDP estimates need improvement. GDP by production are available only at constant prices (2004). Since 2011, the expenditure components have been calculated at the current and constant prices. The 2013 supply and use tables will be finalized in the near term, providing well organized source data at a more detailed level which can be used to further enhance national accounts estimates.

Price Statistics: The PCBS has compiled and disseminated a CPI for WBG since January 1996. The weights and index reference period was updated to 2010 from the January 2014 index using expenditure weights compiled from the Palestinian Expenditure and Consumption Survey (PECS) conducted in 2010. The PCBS plans to undertake the next PECS, with the support of the World Bank, starting in August 2016. It is expected to take around one year, with the results expected to be available by the end of 2017. A PPI has been disseminated since 1997. Current weights are based on data collected in 2013. An updated PPI was released in January 2016. There is need to improve CPI and PPI compilation methods.

Government Finance Statistics: The Ministry of Finance and Planning's (MoFP) Financial Reporting Department compiles data that are broadly aligned with the recommendations of the GFSM 2001. The general government sector is comprised of the budgetary central government, the social security fund and a variety of local government units. The latest annual data reported to STA, with reference to 2014, excluded the social security subsector, reducing the usefulness of the data for fiscal analysis. The reported data also lack information on stock positions in financial assets and liabilities. Particular attention is needed to reconcile the stocks and flows of arrears, and to develop an accurate record of public debt on a gross and net basis. The Audit Report on the 2011 consolidated financial statements, which was published in May 2016, also points to fiscal accounting weaknesses, including the need for more frequent bank reconciliations and establishing a quality control function in the MoFP's Accounting Department. Quarterly and monthly series are disseminated by the authorities (http://www.pmof.ps/en/web/guest/43). The authorities are encouraged to enhance the institutional, transactions, and balance sheet information provided so as to fully meet the reporting requirements outlined in SM/10/43 and the related Board decision on the use of the GFS analytical framework for fiscal analysis.

[1] Prepared by STA, with MCDWBG team inputs.

Monetary and Financial Statistics: The Palestinian Monetary Authority (PMA) compiles and reports to STA monthly monetary data for the central bank and other depository corporations (ODCs) using the standardized report forms (SRFs). The PMA also compiles SRF-based monetary data for other financial corporations (OFCs) on a quarterly basis, comprising insurance companies only. In general, monetary data for the West Bank and Gaza 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, i.e., no breakdown for OFCs and extra-budgetary central government units. For this reason, claims on public nonfinancial corporations include some claims on OFCs and extra-budgetary central government units, claims on 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 sector surveillance: Following assistance from STA, the PMA reports quarterly FSIs to the Fund, which are published on the IMF's FSI website. The reported FSIs comprise 12 core FSIs, 7 encouraged FSIs for deposit takers, 1 encouraged FSI for other financial corporations (OFCs), and 2 encouraged FSIs for non-financial corporations (NFCs).
External sector statistics: 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*), and monthly International Reserves and Foreign Currency Liquidity data to STA as prescribed by the SDDS. However, timeliness needs to be improved (as of May 2016, the latest IIP and BOP data submitted to STA correspond to Q1 2015 and the latest monthly International Reserves and Foreign Currency Liquidity data to December 2015). There are numerous inconsistencies between the IIP and BOP due to gaps in coverage, misclassifications in both datasets, and inconsistencies in the methodologies employed. The last METAC BOP statistics mission was conducted in February 2015. WBG participates in the Coordinated Direct Investment Survey (CDIS) with annual data for the period 2010–14.

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.