RECENT EXPERIENCE AND PROSPECTS OF THE ECONOMY OF THE WEST BANK AND GAZA[1]

STAFF REPORT PREPARED FOR THE MEETING OF THE AD HOC LIAISON COMMITTEE

New York, September 18, 2011

---

[1] This report was prepared by Oussama Kanaan (Chief of Mission), Udo Kock (Resident Representative), and Mariusz Sumlinski. Staff reports on the West Bank and Gaza are published on the IMF website (www.imf.org/wbg).

Contents Page

Appendix

Appendix Figures

I. EXECUTIVE SUMMARY

The economy of the West Bank and Gaza (WBG) is facing increased risks, with a significant slowdown of growth in the West Bank. The West Bank's strong performance from 2008 to 2010 has been enabled by sound economic management and reforms supported by donor aid, and the easing of Israeli internal barriers. However, the West Bank's real GDP growth declined from 8 percent in 2010 to 4 percent in the first half of 2011, with an unemployment rate unchanged at about 16 percent since mid-2010. The slowdown is due to continued fiscal retrenchment, declining aid (especially from regional donors) and a consequent liquidity crisis, as well as slower easing of Israeli restrictions over the past year. Gaza's output continued to recover from a highly repressed level following the easing of some import controls in mid-2010, with real GDP estimated to have risen by 28 percent in the first half of 2011 and unemployment declining to 28 percent from 37 percent last year. Gaza's recovery is also bound to wane without easing import controls on private investment inputs.

Persistent shortfalls in donor aid during 2011 have led to a liquidity crisis. Aid disbursements thus far in 2011 have been far below the expected amounts ($0.4 billion disbursed as of end-August compared to $0.7 billion envisaged for that period). The impact of the aid shortfalls has been compounded by the appreciation of the shekel, and lower-than-expected budgetary revenue. This has led to the accumulation of substantial domestic payment arrears, including on wages for the first time since 2007, and borrowing up to the commercial banks' limits.

It is important for the Palestinian Authority (PA) to implement a contingency plan that caps expenditure commitments below budgeted amounts. This is especially important given the likelihood of continued shortfalls in the remainder of the year, and the fact that there is little scope for further borrowing from banks beyond short-term bridge loans. The plan should include strict cost-saving measures and prioritization of expenditures, with a hiring freeze and postponement of lower-priority projects. While expenditure arrears cannot be fully prevented, these can be minimized through the effective use of the computerized accounting system, tightened commitment controls, and enhanced cash management, as well as by stepping up efforts to raise domestic tax collection. Development and community projects should only be implemented if there are matching donor funds.

In parallel with its adjustment to the liquidity shortage, the PA should persevere with structural reforms to lower aid dependence. To further raise public sector efficiency, phase out reliance on aid for the recurrent budget, and sustain private sector confidence, it is essential for the PA to step up key reforms. In particular, it should further strengthen the social safety net to better target assistance; complete the transfer of electricity distribution from municipalities to commercial companies to reduce electricity subsidies; and implement comprehensive pension and civil service reforms.

As the bulk of budgetary revenue is collected by the Government of Israel (GoI) on behalf of the PA, the two parties should promptly implement practical steps to enhance its collection and minimize leakages. Key steps that should be implemented in the remainder of 2011 include: (i) allowing the PA to settle electricity bills directly with the Israeli provider, as opposed to through deductions from clearance revenue; and (ii) assessing potential clearance revenue owed to the PA on the basis of the comprehensive data compiled by the GoI on trade between Israel and the WBG.

As stated in April 2011, IMF staff considers that the PA is now able to conduct the sound economic policies expected of a future well-functioning Palestinian state, given its solid track record in reforms and institution-building in the public finance and financial areas. This institutional capacity puts the PA in good stead to tackle its current liquidity difficulties and press ahead with further structural reforms. However, the recent aid shortfalls are posing serious risks to the PA's state-building capacity, especially given its still high aid dependence. Staff urges the authorities to continue the implementation of strong macroeconomic policies and a tight expenditure stance, including a hiring freeze in the remainder of 2011.

- The strengthened public finance management system allows the PA to control expenditures, apply rigorous budget preparation and execution practices, and establish fiscal transparency and accountability in line with international standards. These capacities, along with an overall tight expenditure stance, have contributed to a rise in the quality of spending and a sharp reduction in aid required for recurrent spending, from $1.8 billion in 2008 to $1.1 billion in 2010.

- The PMA's institutional reforms allow it to fulfill core functions of a central bank. These functions include the application of a rigorous banking supervision and regulatory framework, providing a strong credit and payment infrastructure, and monitoring and enforcing compliance with a governance code and an anti-money laundering law.

- The quality, transparency and timeliness of the data produced today by the Palestinian Central Bureau of Statistics, Ministry of Finance, and the PMA compare favorably with those of IMF member countries that maintain high data management and dissemination standards.

Economic growth will decline and unemployment rise unless the GoI steps up the removal of restrictions on economic activity in the WBG. Some initial measures were taken since February 2011 as part of the agreement between the Quartet Representative and the GoI. To ensure sustained and broad-based growth, it is important to implement these measures as scheduled and build on them by phasing out remaining restrictions on economic activity, in particular the restrictions on WBG's external trade, on internal movement in the West Bank, and on access to about 60 percent of its territory ("Area C").

It is essential that adequate aid to support the PA's reforms be pledged as soon as possible and disbursed in a timely manner. For 2011, there is an urgent need to secure donor assistance to cover the recurrent financing requirements of $1.1 billion. About $0.4 billion was disbursed by donors from January to end-August, and another $0.3 billion has been indicated by donors for September to December. Assuming that the indicated amount is disbursed, and that $0.1 billion is borrowed from domestic banks, the financing gap for 2011 is projected at $0.3 billion.

II. Recent Economic Developments

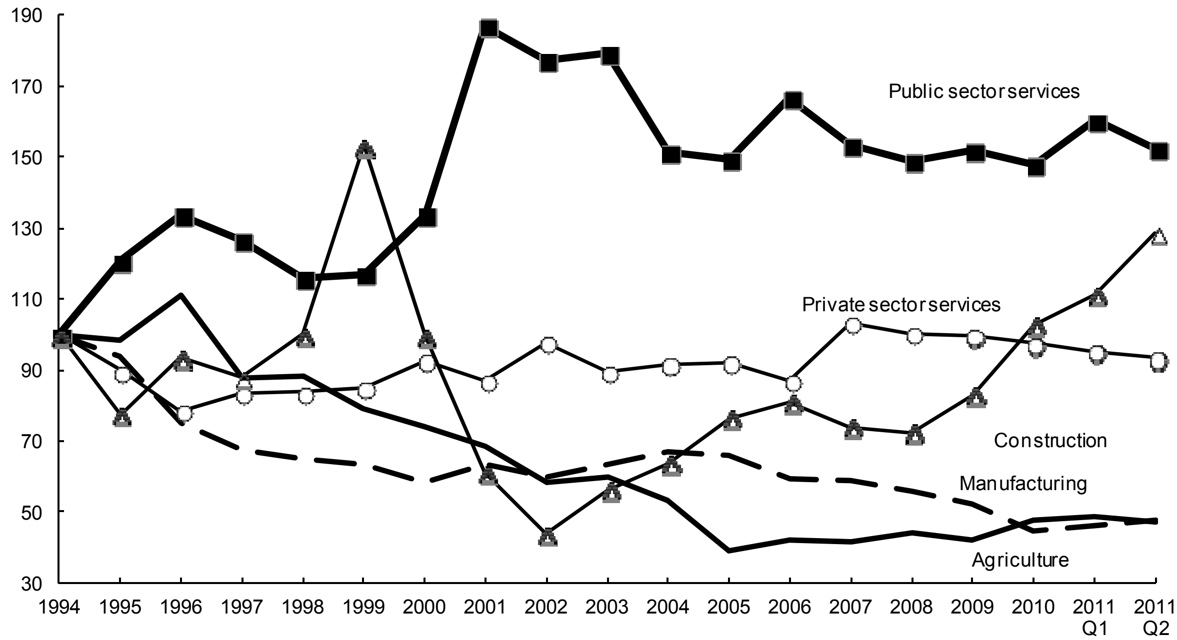
1. **Economic growth slowed in the West Bank but rose in Gaza in the first half of 2011.** Gaza's strong economic recovery is mostly a catch up from a very low base since the easing of the blockade in mid-2010. Despite Gaza's real GDP growth of 15 percent in 2010, which has risen further to 28 percent in the first half of 2011, its output level is lower today than in 2005 and the unemployment rate remains high at 28 percent. The West Bank's strong performance since 2008 has been enabled by sound economic management and reforms supported by donor aid, and the easing of Israeli internal barriers. However, the West Bank's real GDP growth declined from 8 percent in 2010 to 4 percent in the first half of 2011, with the unemployment rate remaining at the mid-2010 level of 16 percent. The slowdown is due to continued fiscal retrenchment, declining donor aid (especially from regional donors), and a consequent liquidity crisis, as well as slower easing of Israeli restrictions over the past year.[2] The WBG's year-on-year inflation rate remained at about 3 percent in 2010 and 2011, reflecting lower inflation in Israel and the easing of Gaza's import restrictions.

2. **The West Bank and Gaza (WBG)'s external trade continues to be constrained by restrictions on movement and access.** Exports of goods and services from the WBG to Israel declined by 7 percent in real terms in the year to March 2011. This decline follows a 25 percent contraction in exports over 2008–10 following the construction of the separation barrier as well as the slowdown in Israel's growth. Imports from Israel declined by a cumulative 7 percent in real terms during 2008–10, followed by a contraction of 4 percent in the year to March 2011. The import contraction has been less pronounced than that of exports due to the much tighter Israeli restrictions in the West Bank on exports than on imports. Since 1994, when trade between the WBG and Israel was largely unhindered, sectoral shares of the two core sectors producing tradable goods, manufacturing and agriculture, have shrunk substantially from 33 percent in 1994 to 16 percent in 2010 (Figure 1). In contrast, the sectors producing services and non-tradables, notably public and private services, and the construction sector, have fared better. This indicates that the WBG's pattern of production continues to be distorted and reflects persisting restrictions on external trade rather than the WBG's comparative advantage. This distortion has been accentuated by the small size of the domestic market and the absence of a local seaport and airport. Overall, the cumulative impact on economic growth of the restrictions since 1994 has been substantial (see Section B in the Appendix).

---

[2] According to the UN Office for the Coordination of Humanitarian Affairs (OCHA), the number of obstacles to movement within the West Bank declined from 626 at end-2009 to 505 obstacles at end-March 2010, but remained at about that level as of mid-2011. In addition, in 2010–11 the GoI, with support from USAID, expanded the capacity of several crossing points between the West Bank and Israel to facilitate the flow of merchandise trade. The GoI has also been working toward facilitating the passage from the West Bank to Israel of dairy and meat products, which have hitherto been tightly controlled.

Figure 1. Shares in GDP of Sectoral Output Relative to 1994
(Index; 1994=100)



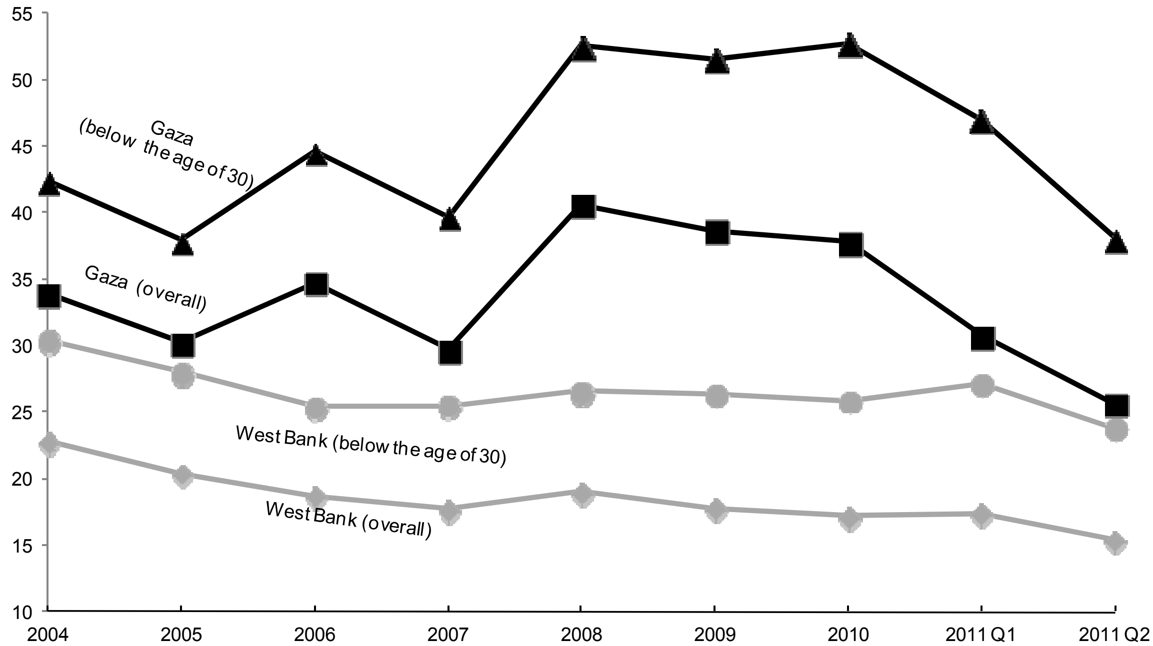
Source: Palestinian Central Bureau of Statistics; and IMF staff estimates.

Note: In 1994, the shares as percent of GDP were as follows: 9 for public sector services, 46 for private sector services, 9 for construction, 20 for manufacturing, and 13 for agriculture.

3. **The unemployment rate has declined very slowly in the West Bank, and remains high in Gaza, especially among the young (below the age of 30)**. In the West Bank, unemployment declined sluggishly from 19 percent in 2008 to 16 percent in the first half of 2011. Similarly, youth unemployment in the West Bank remains high at about 26 percent in the first half of 2011, about the same level as the same period last year (Figure 2). In Gaza, unemployment remains very high, although it declined in the first half of 2011, reflecting the marked recovery, from 37 percent to 28 percent, and from 51 percent to 43 percent for the young. The pick-up in internationally-supervised projects following the easing of restrictions on their imports in mid-2010 contributed to a decline in Gaza's unemployment. While the number of workers allowed into Israel from the West Bank has been rising, the ban on workers from Gaza remains in effect.[3]

[3] An important factor contributing to high unemployment stems from persisting restrictions on the number of Palestinian workers allowed into Israel. While the number of West Bank workers allowed into Israel has been rising, from an average of 48,479 in 2001–06 to 84,000 in the first quarter of 2011, as a share of the labor force it has increased only slightly to 12 percent in the first half of 2011 from the 2001–06 average of 10 percent. In contrast, in 2000 the share of the West Bank labor force employed in Israel was 19 percent. While 13 percent of Gaza's labor force was employed in Israel in 1999, since 2001 the number has been negligible.

Figure 2. Unemployment in Gaza and in the West Bank
(In percent of labor force)



Source: Palestinian Central Bureau of Statistics.

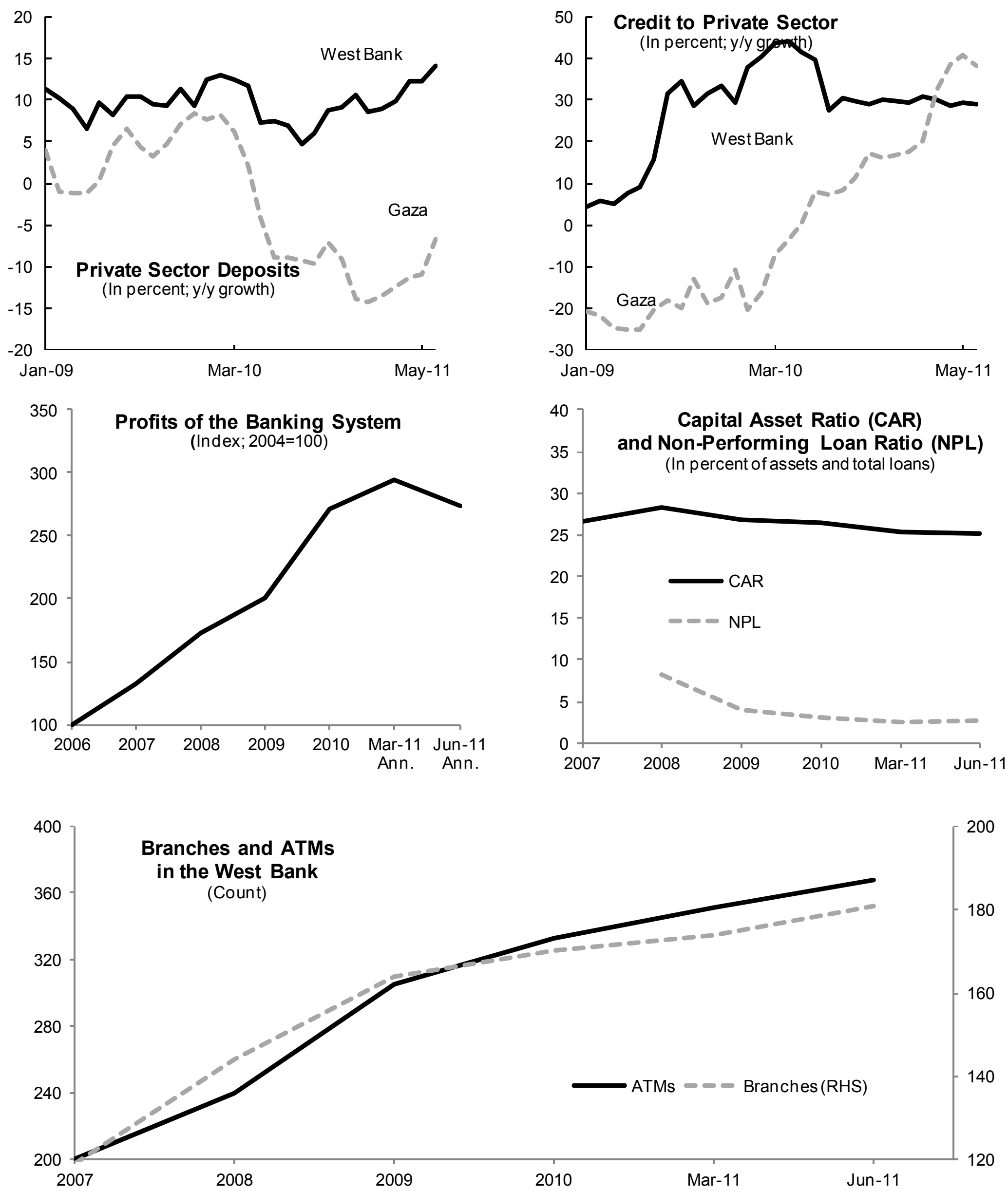
4. **The decline in year-on-year inflation during the first half of 2011 was driven by the easing of Gaza's blockade.** The WBG's CPI inflation rate (in NIS) was 3.1 percent in June 2011, compared to 3.6 percent in mid-2010. Inflation was significantly lower in Gaza (0.1 percent) than in the West Bank (4.4 percent), reflecting the relaxation of the blockade on imports of consumer goods and foodstuffs, as well as food's higher weight in Gaza's consumption basket compared to the West Bank. The impact of the rise in the West Bank's inflation, reflecting rising world food and fuel prices, has been tempered by its decline in Gaza following the easing of Gaza's import restrictions. While Gaza's inflation had risen sharply above that of the West Bank during the blockade, it has been on a declining trend since 2009 following the end of the Gaza war.

5. **The commercial banking system continues to perform well, with very limited exposure to global markets and conservative practices in private sector lending (Figure 3).** The share of non-performing loans in total loans continued its downward trend, from 4 percent at end-2009 to just below 3 percent at end-June, 2011. The banking sector continues to have adequate liquidity and is well capitalized.[4] In the West Bank, private deposits in U.S. dollar terms rose 14 percent in the year to June 2011, reflecting private income growth. In Gaza, private deposits in U.S. dollar terms declined by 7 percent, as cash was withdrawn to satisfy pent up demand for consumer goods following the relaxation of

[4] The ratio of the banking system's capital to risk-weighted assets is estimated at 25 percent at end-June 2011.

import controls. Gaza banks' prospects have improved due to the easing of restrictions by the Government of Israel (GoI) on the entry of consumer goods and bank-notes. While the restrictions on the entry of Jordanian dinars and U.S. dollars are still formally in place, their impact has been limited since mid-2010 with the inflows of these currencies through crossings at which controls have been eased, as well as the facilitation by the GoI of their entry for the purpose of payments by international organizations.

Figure 3. Banking Sector Indicators



Source: PMA; and IMF staff calculations.

6. **The Palestine Monetary Authority (PMA) continued to implement institutional reforms during 2010–11 (Box 1).** The rise in private bank credit in the WBG in the year to June 2011 stems from significant improvements in financial market infrastructure since 2009, including the establishment of a credit registry which allows a better assessment of borrowers' creditworthiness. Credit to the private sector in the West Bank rose by 29 percent, without excessive concentration in any particular sector, although exposure to the PA is high.[5] The improved conditions in Gaza led to a rise in private credit by 38 percent at end-June 2011. The rise in domestic credit opportunities has contributed to the steady decline in the share of bank deposits placed abroad from 56 percent at end-2008, to 51 percent in 2009 and 42 percent at end-June 2011. Given this decline and the improved domestic credit conditions, the PMA will be reviewing in the fall of 2011 the necessity of retaining the ceiling of 55 percent for the share of deposits placed abroad.[6]

7. **The PMA has been working with commercial banks to conduct stress tests in accordance with Basel II principles, taking into account the rising economic and political uncertainties.** Key variables in these tests include the rising credit exposure of banks to the PA and government employees, as well as to businesses supplying goods and services to the PA. These tests are especially important in view of the rise in government debt to banks to about $1.1 billion by mid-2011, equal to the banks' total equity. Another important purpose of the tests is to assess the risks of the recent rapid rise in credit to the private sector to the quality of loan portfolios. The share of non-performing loans to total loans is low and declining (from 8.2 percent in 2008 to 2.7 percent in mid-2011), and the rise in credit was aided by an enhanced capacity of banks to assess creditworthiness through the recently established credit registry. In addition, the PMA has introduced some precautionary measures, including higher capital and counter-cyclical reserve requirements. The tests will help identify additional measures to address bank weaknesses that might be warranted. The PMA has already conducted its own preliminary stress tests for the banking system and for individual banks. In view of the tests' results, the PMA has in mid-2011 discussed with several banks remedial actions, such as reducing their credit exposure to certain types of borrowers or sectors, and raising paid-in capital. The next step is for banks to fine-tune these preliminary results by applying their own stress tests, using appropriate scenarios and sensitivity analysis. The PMA intends to issue regulations by end-September 2011 that specify methodologies and procedures for those tests in line with Basel II principles. The results of the stress tests are expected to be submitted to the PMA by end-November 2011.

---

[5] Sectoral credit allocation has been stable since 2009. In particular, bank credit to the real estate and construction sector has remained unchanged at about 10 percent of total credit.

[6] Prior to 2008, banks were required to satisfy a floor of 40 percent for the ratio of domestic loans to deposits. In December 2008, that floor was eliminated and replaced with a ceiling of 55 percent for the share deposits placed abroad.

Box 1. Reforms by the Palestine Monetary Authority

Following steady institutional reforms since 2007, the Palestine Monetary Authority (PMA) is ready to carry out the functions of a central bank. These reforms, implemented with IMF technical assistance, have resulted in a rigorous regulation and on-site and off-site based supervision of all banks in the West Bank and Gaza (WBG). The PMA uses a broad range of prudential instruments, including reserves ratios, capital requirements, liquidity ratios, limits on credit concentration, outside placements, and currency exposure.

In 2010–11 the PMA has strengthened the supervision and regulatory framework and advanced toward the implementation of Basel II standards. In January 2010, a unit was established in the Supervision Department to implement the Fair Lending Regulations and conduct financial literacy campaigns. In May 2010, the PMA issued Basel II compliant regulations governing the disclosure of information by financial institutions. It also prepared regulations, for approval by end-2011, for licensing and supervision of Specialized Lending and Financial Companies, including microfinance institutions. In August 2010, the PMA adopted regulations governing mergers and acquisitions in line with best practices. These regulations have already been applied to bank mergers. The PMA has also applied Basel standards and procedures when liquidating two banks in 2010. To further strengthen the banking system's capital base, the PMA introduced two measures in December 2010: (i) an increase in the minimum capital requirement to $50 million (from $35 million); and (ii) new "counter-cyclical" reserve requirements according to which banks should add 15 percent of their net (after tax) income to their Tier I capital as an additional "bad times" buffer. In May 2011, the PMA established a Consumer Awareness and Market Discipline department to closely monitor developments in the mortgage and housing markets. In March and June 2011, the PMA conducted stress tests of individual banks and the banking system as a whole to assess the robustness of the banks and the system to plausible shocks. Full implementation of Basel II standards is expected by mid-2013.

The PMA established a modern payment infrastructure including bounced–checks tracking, credit scoring, and electronic payment systems. The bounced–check tracking, in operation since 2009, has contributed to the decline in bounced checks by an estimated 25 percent. The credit scoring system, which was integrated into the credit registry in July 2010, is considered by banks to have been an important contributor to the rise in the WBG's bank credit to the private sector. A bank deposit insurance scheme, developed with World Bank assistance, is expected to be ready in early 2012. The PMA installed the electronic payment system in November 2010. It includes a Real Time Gross Settlement system (RTGS) and a Clearance House. The payment system raised bank payments' efficiency and reduced liquidity risk.

The PMA and the Bank of Israel (BoI) have continued to facilitate cooperation between Palestinian and Israeli commercial banks. In 2009, large shekel cash surpluses had accumulated at Palestinian banks due to Israeli banks' refusal to accept cash deposits on concerns about legal implications. That problem was addressed in July 2010 through a special arrangement whereby the excess shekel cash is regularly deposited at Israeli banks' accounts with the BoI. The PMA and the BoI are currently working on devising practical ways to ensure the timely and regular transfer into Gaza of cash amounts adequate to cover fully commercial banks' needs, without pre-set limits on the amount of U.S. dollars or Jordanian Dinars. The close cooperation has already allowed the transfer into Gaza, since July 2010, of cash amounts beyond the usual limit of NIS 50 million per month.

A new Banking Law to strengthen the financial sector's legal framework was enacted in November 2010. A new central bank law, which guarantees the independence of the PMA, is expected to be submitted to the President for approval by end-2011. An Anti-Money Laundering (AML) law has been in force in line with international standards since October 2007, with technical assistance from the IMF and USAID. Since 2008, the PNA has been monitoring banks' compliance with a Basel committee compliant corporate governance code. The PMA is preparing its Monetary Operations Department for open market operations and the issuance of government securities and PMA Certificates of Deposits, including Sukuk certificates, with technical assistance from the Fund.

III. Fiscal Developments in 2011–12

A. Fiscal Developments in 2011

8. **While the PA has pursued a tight fiscal stance in the first half of 2011, persistent shortfalls in donor funding for both recurrent spending and development projects resulted in arrears accumulation, including on wages, and borrowing from commercial banks.**

- Tax revenue was lower than budgeted due to several factors, especially lower-than-expected economic growth. Clearance revenues were also adversely affected in early 2011. First, since February 2011, there was an 8 percent reduction in excise and purchase taxes on petroleum products in Israel. Second, there was a wide substitution of petroleum products imported into Gaza from Israel with cheaper products from Egypt. In addition, the unbudgeted partial repayment of license fees to the Palestinian Telecommunications Group, following the cancellation of a license agreement, has lowered non-tax revenue. Transfers of dividend payments from the Palestine Investment Fund (PIF) were also lower than budgeted.[7]

Table A. Clearance Revenues

	2009			2010			2011
	Jan.-Jun.	Jul.-Dec.	Year	Jan.-Jun.	Jul.-Dec.	Year	Jan.-Jun.
	(In millions of shekels)						
Total clearance revenue	2,029	2,343	4,372	2,307	2,486	4,793	2,443
West Bank	1,878	2,141	4,020	2,137	2,298	4,436	2,318
Gaza (estimates)	150	202	352	169	188	357	125

Source: Ministry of Finance.

- The wage bill for the first half of 2011 was about 3 percent higher than the budget pro-rated amount (or by about NIS100 million) reflecting primarily retroactive salary payments to employees appointed in late 2010. The increase in wage rates was as budgeted, consisting of: (i) an adjustment of 3.5 percent to compensate for 2010 inflation; and (ii) the 1.25 percent automatic yearly increase. The number of public sector employees rose on a net basis by about 1,700, consisting of 750 in education, 570 in security, 19 in health, and 359 in other sectors.

[7] The 2011 budget is converted to U.S. dollars at NIS 3.7 per $1, while outcomes are converted at NIS 3.5 per $1, the actual exchange rate for the first half of 2011. The PA needs an additional $6 for every $100 committed to cover losses due to NIS appreciation during 2011.

- Non-wage recurrent expenditures on a commitment basis were lower than budgeted by NIS 454 million, largely on account of the compression of social transfers (Table B). The application of the computerized accounting system, which now links the Ministry of Finance (MoF) with all line ministries, facilitated the compression of some expenditures taking into account the priorities set in the budget.

Table B. Non-Wage Expenditure in 2010–11

	Total	Operational expenditure	Transfers	Minor capital expenditure
		(Commitment basis; in millions of NIS)		
2010				
Budget	**3,484**	1,030	2,244	209
Outturn	**4,578**	1,841	2,629	107
2011 Jan-Jun				
Pro-rated Budget	**2,522**	932	1,545	45
Outturn	**2,068**	966	1,071	31

Source: Ministry of Finance.

- Net lending (mostly payments by the central government for utility bills owed by municipalities) continued its declining trend, from NIS 539 million in the first half of 2010, to NIS 307 in the same period in 2011. That decline reflects increased payments by the Gaza Electricity Distribution Company (GEDC) for fuel used by the Gaza Electricity Generating Company (GEGC) to produce electricity. Net lending is expected to continue to decline in the second half of 2011 to just below the budget target of NIS 592 million for 2011, as electricity distribution is envisaged to be transferred from the Tulkarm and Anabta municipalities to a private company, the Northern Electricity Distribution Company (NEDCO).

- Donor aid to finance the recurrent budget in January to June 2011 was significantly lower than envisaged in the 2011 budget. Only about $300 million was disbursed compared to $483 million that the budget anticipated. In addition, development aid was only $43 million—well below $180 million committed for development projects. Of $131 million cash expenditures on development projects $88 million was covered by the treasury, while the remaining $49 million (equivalent to about NIS 174 million) accumulated as arrears. Development spending is projected at

$400 million for 2011 based on matching–funds for public investment projects indicated by donors.

9. **Despite the compression of spending commitments to below budgeted levels, the shortfalls in aid, and the use of recurrent aid for development projects, have led to substantial arrears accumulation on recurrent spending and borrowing from domestic banks.** Available revenue was far from sufficient to cover even the compressed expenditure commitments, contributing to the accumulation of NIS 1030 million (or about $294 million) in arrears including to the pension fund, private sector suppliers, and development projects (Table C). The liquidity difficulties also led to an increase in net domestic financing during January-June by about $102 million, yielding a stock of debt to banks of about $1.1 billion as of end-June 2011. The liquidity problems became so severe that by early July 2011 the PA could not make its wage payments for the month of June, paying only about half of employees' salaries (the other half was paid in late August).[8] Liquidity management was also hampered by the delay in the transfer of clearance revenue by the GoI to the PA's budget in May 2011 (Box 2).

10. **The strengthening of the Public Financial Management System (PFM) has enabled the PA to manage the severe liquidity difficulties (Box 3).** The PFM improvements since mid-2007 have raised the quality and helped prioritize public expenditures, and enhanced transparency and accountability. In particular, expenditure management was markedly enhanced since 2010 through the integration of the Commitment Control System (CCS) into the Financial Management Information System (FMIS). The CCS automatically prevents expenditure commitments by line ministries that exceed amounts under "purchase orders" authorized by the MoF's General Accountant. The enhancement of the PFM has enabled the MoF to prioritize expenditure commitments and contain as much as possible arrears accumulation in essential areas such as transfers targeted through the social safety net.

[8] In addition, about $68 million, or NIS 240 million, in arrears accumulated since July on loan principal obligations to commercial banks, although the interest payments due have been paid in full. An understanding was reached between the MoF and commercial banks to reschedule the outstanding principal, if it remains unpaid, through the extension of additional banks loans in December 2011.

Table C. Composition of Net Arrears Accumulation 2010–11

	2009	2010	2011 Jan-June
(In millions of NIS)			
Contributions to the pension fund:			
of which: employee's share 1/	171	185	142
government's share	355	172	156
Nonwage expenditures 2/	460	92	337
Net lending	77	-103	---
Development projects 3/	118	88	174
Tax refund	-140	-39	222
Total	**1040**	**394**	**1030**

Source: Ministry of Finance.
1/ Item classified under "wage expenditures".
2/ Including to private sector suppliers.
3/ Item classified under "development projects".

Box 2. Recent Developments in Clearance Revenues

Clearance revenues are a major source of budgetary revenue for the PA. Their share in total PA revenue rose from about 60 percent in the mid-1990’s to 70 percent in 2010. They are collected by Israel on behalf of the PA, and transferred monthly. The PA budget is highly vulnerable to delays in the transfer of clearance revenues. This was made clear in May 2011 when the Government of Israel delayed the transfer of about NIS 352 million (about $100 million) in clearance revenues following the signing of the reconciliation agreement between Fatah and Hamas. The suspension worsened the liquidity shortage faced by the PA and delayed the payment of salaries to public sector employees. In addition, as a result of the nonpayment of salaries, some WBG commercial banks experienced payment delinquencies on loans owed by PA employees.

Given the already precarious liquidity situation due to aid shortfalls, and the fact that there is little scope for a further increase in the PA’s domestic debt, a suspension of clearance revenue would severely disrupt PA operations and prevent the payment of public sector wages. In the past, donors have compensated for the clearance revenue loss by disbursing additional aid. However, donors are experiencing their own financial difficulties, as they face competing demands for aid from other countries, as well as domestic pressures for budget cuts. Also, as noted above, today clearance revenue represents a larger share of total PA revenue. These factors make it all the more important that clearance revenue be transferred to the PA’s budget on a timely basis to prevent a severe crisis.

History of Suspension of Transfer of Clearance Revenue by Israel

Suspension period	Reason for suspension	Amounts withheld (In U.S. dollar millions)	Compensating donor mechanisms
Aug-Sep 1997	Intensification of hostilities	78	Short-term credit facility from the EU.
Dec 2000-Dec 2002	Second Intifada	500	Special Cash Facility from the EU, loans from the Islamic Development Bank, and the Emergency Services Support Project financed by IDA and European donors administered by the World Bank.
Mar 2006-Jul 2007	Hamas' electoral victory and formation of government.	1,100	Temporary International Mechanism funded allowances for civil servants and expenditures for basic services outside of budget.

Source: IMF staff reports various issues.

Box 3. Reforms in Public Financial Management

Since the advent of Prime Minister Fayyad's government in mid-2007, the PA has made wide-ranging reforms to its Public Financial Management (PFM) system. Today, the PFM system would be ready to support the functions of a state, and is a prime model to follow for developing countries in need of PFM reforms. The reforms have allowed the PA to tightly control expenditures, apply rigorous budget preparation and execution practices, and establish fiscal transparency and accountability in line with international standards. They also enabled a sharp reduction in the PA's reliance on donor aid for recurrent spending.

In mid-2007, the PA was faced with a PFM system that had been severely degraded by sanctions and mismanagement. The Ministry of Finance (MoF) had to tackle a number of exceptional challenges, including aid inflows that bypassed it, fragmented banking arrangements, weak budget procedures, and lack of fiscal reporting. The government took prompt steps to establish a Central Treasury Account which centralized all revenue, expenditure, and recurrent aid inflows under the MoF's control. By early 2008 all budget procedures were restored, expenditure controls and cash management strengthened, and fiscal accounts developed in line with best practice. These measures allowed the preparation of an emergency budget in 2008–09 that was the basis for generous donor support in 2008–09.

Major strides in PFM reforms have been taken by the PA since 2008, enabling an improvement in the quality of budgetary expenditures and their prioritization, as well as reduced arrears accumulation:

- In 2008, a Financial Management Information System (FMIS) was developed to link the MoF to line ministries. The FMIS, rolled out to all line ministries in 2009, increased the ministries' ownership of financial management and enhanced the quality of budget execution. At the same time a new web-based budget information system was developed and implemented by mid-2009. The new system enhanced communication between the ministries during annual budget preparations, in particular by facilitating the compilation of budget submissions and preparation of final budget documents. Since mid-2010, the FMIS has allowed the preparation of budgets based on ministries' program objectives, taking into account date information on budget execution, helped ensure that those line ministries' requests for budget allotments are in line with the overall budget ceiling set by the MoF. In parallel, a new chart of accounts and budget classification consistent with GFSM 2001 were integrated into the FMIS.
- To make public finances transparent and encourage feedback by civil society, in 2008 the MoF started publishing on its website monthly data on expenditures, revenue, external aid, and public debt. The data are published fifteen days after the end of each month, along with quarterly reports on budget execution. A macro-fiscal unit was established at the MoF in November 2010 to prepare fiscal assessments and projections based on a medium-term macroeconomic framework.
- To stem expenditure arrears accumulation, the MoF integrated in 2010 the Commitment Control System (CCS) into the FMIS. The CCS caps expenditure commitments by line ministries at "purchase orders" levels authorized by the MoF's General Accountant. Prior to implementation of the CCS, line ministries tended to make commitments at budgeted levels not accounting for cash availability. Since early 2011, the MoF has been working to enforce the matching of commitments with cash availability to minimize arrears accumulation. The CCS has also been strengthened in 2011 to ensure that purchase orders are determined by monthly cash plans that take into account delays in donor aid.
- In 2009, the MoF established procedures to enable regular external audits of its annual financial statements, in line with best international practice. The 2008 financial statements were audited in 2010 by the Supreme Audit and Administrative Control Bureau (SAACB) with assistance from Deloitte and Touche. The 2009 financial statements were completed and submitted to the SAACB, which is expected to finalize its audit report in September 2011. The MoF is currently finalizing its 2010 financial statements and plans to submit them to the SAACB by October 2011.

11. **Unless adequate aid is disbursed the PA will not be able to pay wages**. The limit on bank borrowing has already been reached and private suppliers are increasingly unwilling to accept deferred payments. From January to end-August 2011, about $0.4 billion has been disbursed, and another $0.3 billion was indicated by donors for the remainder of 2011, yielding total financing already disbursed or indicated of $0.7 billion. Net domestic bank financing for 2011 is projected at $0.1 billion, and it is assumed that arrears accumulated in the first half of 2011 will be repaid in the remainder of the year. Given the projected recurrent deficit of $1.1 billion (on a cash basis), this yields a financing gap of about $0.3 billion.

Table D. Fiscal Indicators for 2010–12 in millions of U.S. dollars

(In millions of U.S. dollars, unless otherwise indicated)

	2010	2011				2012
		Jan-Jun Estimate	Jul-Dec Proj.	Jan-Dec Proj.	Budget	
Total net revenues	1,927	1,010	1,096	2,106	2,149	2,363
Gross domestic revenues	745	389	354	743	812	834
Tax revenues	474	259	240	499	512	556
Nontax revenues	270	131	114	244	300	277
Gross clearance revenues	1,259	698	776	1,474	1,442	1,651
Tax refunds	76	77	34	111	105	122
Total recurrent expenditures (commitment basis):	3,076	1,611	1,671	3,282	3,232	3,327
Wage expenditures	1,613	932	954	1,887	1,709	1,967
Non-wage expenditures	1,227	591	644	1,235	1,363	1,260
Net lending	236	88	72	160	160	100
Total recurrent expenditures (cash basis)	2,956	1,430	1,852	3,282	---	3,377
of which: non-wage expenditures (cash basis)	1,156	450	644	1,094	---	1,310
Recurrent balance (commitment basis)	-1,149	-601	-574	-1,176	-1,084	-964
Recurrent balance (cash basis)	-1,083	-303	-815	-1,118	-967	-1,014
Development projects (commitment basis)	299	180	220	400	500	600
Development projects (cash basis)	275	131	269	400	---	600
Overall balance (cash basis, including development expenditures)	-1,358	-434	-1,084	-1,518	-1,467	-1,614
Financing	1,358	434	1,084	1,518	1,467	1,614
External support for recurrent and development expenditures	1,277	335	782	1,117	1,467	1,614
External support for recurrent expenditures disbursed or indicated	1,146	292	425	717	967	1,014
External support for development expenditures	130	43	357	400	500	600
Domestic financing	84	108	-40	68	---	---
Financing gap	---	---	---	333	---	---
Memorandum items:						
GDP	8,124	9,686	9,686	9,686	8,386	10,608
Domestic tax revenue (percent of GDP)	5.8	2.7	2.5	5.2	6.1	5.2
Clearence revenue (percent of GDP)	15.5	7.2	8.0	15.2	17.2	15.6
Wage expenditures (commitment basis), percent of GDP	19.9	9.6	9.9	19.5	20.4	18.5
Net lending (including subsidies; percent of GDP)	2.9	0.9	0.7	1.7	1.9	0.9
External financing for recurrent budget (US$ billion)	1.15	0.29	0.43	0.72	0.97	1.01
Recurrent balance (commitment basis), percent of GDP	-14.1	-6.2	-5.9	-12.1	-12.9	-9.1
Recurrent balance (cash basis), percent of GDP	-13.3	-3.1	-8.4	-11.5	-11.5	-9.6
Net expenditure arrears accumulation (US$ billion)	0.09	0.18	-0.18	0.00	---	-0.05
of which: non-wage arrears	0.07	0.14	-0.14	0.00	---	-0.05
Net expenditure arrears accumulation (percent of GDP)	1.1	1.9	-1.9	0.0	---	-0.5
Total interest payments (US$ million)	45	23	23	45	---	45
Domestic payments	36	21	21	41	---	41
External payments	10	2	2	4	---	4

Sources: Ministry of Finance; and IMF staff estimates.

Table E. Fiscal Indicators for 2010–12 in millions of NIS
(In millions of NIS, unless otherwise indicated)

	2010	2011				2012
		Jan-Jun Estimate	Jul-Dec Proj.	Jan-Dec Proj.	Budget	
Total net revenues	7,188	3,534	3,837	7,372	7,951	8,270
Gross domestic revenues	2,778	1,362	1,239	2,602	3,004	2,918
Tax revenues	1,769	906	841	1,747	1,894	1,948
Nontax revenues	1,009	457	398	855	1,110	971
Gross clearance revenues	4,695	2,442	2,716	5,158	5,335	5,778
Tax refunds	285	270	118	388	388	427
Total recurrent expenditures (commitment basis):	11,473	5,639	5,847	11,486	11,960	11,643
Wage expenditures	6,017	3,263	3,341	6,604	6,325	6,885
Non-wage expenditures	4,575	2,068	2,254	4,322	5,043	4,408
Net lending	880	307	253	560	592	350
Total recurrent expenditures (cash basis)	11,127	5,004	6,482	11,486	---	11,818
of which: non-wage expenditures (cash basis)	4,312	1,575	2,747	4,322	---	4,583
Recurrent balance (commitment basis)	-4,284	-2,105	-2,010	-4,115	-4,009	-3,373
Recurrent balance (cash basis)	-4,039	-1,062	-2,853	-3,915	-3,579	-3,548
Development projects (commitment basis)	1,114	631	769	1,400	1,850	2,100
Development projects (cash basis)	1,026	457	943	1,400	---	2,100
Overall balance (cash basis, including development expenditures)	-5,065	-1,519	-3,796	-5,315	-5,429	-5,648
Financing	5,065	1,519	3,796	5,315	5,429	5,648
External support for recurrent and development expenditures	4,763	1,173	2,737	3,910	5,429	5,648
External support for recurrent expenditures disbursed or indicated	4,276	1,022	1,488	2,510	3,579	3,548
External support for development expenditures	487	151	1,249	1,400	1,850	2,100
Domestic financing	312	377	-139	238	---	---
Financing gap	---	---	---	1,166	---	---
Memorandum items:						
GDP	30,303	33,902	33,902	33,902	31,028	37,129
Domestic tax revenue (percent of GDP)	5.8	2.7	2.5	5.2	6.1	5.2
Clearence revenue (percent of GDP)	15.5	7.2	8.0	15.2	17.2	15.6
Wage expenditures (commitment basis), percent of GDP	19.9	9.6	9.9	19.5	20.4	18.5
Net lending (including subsidies; percent of GDP)	2.9	0.9	0.7	1.7	1.9	0.9
External financing for recurrent budget (NIS billion)	4.28	1.02	1.49	2.51	3.58	3.55
Recurrent balance (commitment basis), percent of GDP	-14.1	-6.2	-5.9	-12.1	-12.9	-9.1
Recurrent balance (cash basis), percent of GDP	-13.3	-3.1	-8.4	-11.5	-11.5	-9.6
Net expenditure arrears accumulation (NIS billion)	0.35	0.64	-0.64	0.00	---	-0.05
of which: non-wage arrears	0.26	0.49	-0.49	0.00	---	-0.05
Net expenditure arrears accumulation (percent of GDP)	1.1	1.9	-1.9	0.0	---	-0.1
Total interest payments (NIS million)	169	79	79	158	---	158
Domestic payments	132	72	72	145	---	145
External payments	37	7	7	13	---	13

Sources: Ministry of Finance; and IMF staff estimates.

B. Fiscal Outlook for 2012

12. **The preparation of the 2012 budget is underway, with a view to sending the budget circulars to line ministries by end-September 2011.** Preliminary work has started on setting targets for the budget's broad line items. These will be fine-tuned to take into account any revisions to the macroeconomic outlook:

- The increase in the wage bill will be limited to: (i) an adjustment of a maximum of 2.0 percent in wage rates to partly compensate for 2011 inflation (projected at 4 percent); (ii) the 1.25 percent automatic yearly increase; and (iii) an increase in net employment of 3,000 employees.

- Recurrent nonwage expenditures will decline by about 1 percent of GDP. Continued strengthening of the PFM system will allow the elimination of lower priority operational spending, while tighter commitment controls and cash management will help prevent arrears accumulation.

- Net lending is projected to decline by about 1 percent of GDP, reflecting continued commercialization of electricity distribution and measures to improve the incentives to municipalities and households to pay electricity bills.

- The revenue-to-GDP ratio is conservatively projected to increase by 0.6 percent of GDP in 2012, given the uncertainty regarding the impact of the tax administration measures and of improved cooperation with Israel's MoF to reduce clearance revenue leakages.

- The budget envisages no net domestic bank borrowing except for short-term loans. About $50 million in net arrears repayment is envisaged. Any higher-than-budgeted revenue or donor aid will be used to repay domestic payment arrears.

- The recurrent budget deficit on a commitment basis is projected to decline from about 12.1 percent of GDP in 2011 to 9.1 percent in 2012, a substantial fiscal adjustment. External financing needs for recurrent expenditure is projected at about $1 billion in 2012.

13. **To complement the enhanced PFM system, the PA has been implementing a comprehensive reform of tax administration with technical assistance from the Fund, DFID, and USAID.** The authorities are implementing an action plan for 2011–13, developed with assistance from the Fund, aimed at expanding the tax base and improving compliance, including the establishment of a unified revenue administration with a Large Tax Payers Unit and the computerization of taxpayers' records to reduce tax evasion. Since early 2011, the staff of the income tax department has been receiving training on the effective application of the recently developed manual on income tax operating procedures. One important step taken in 2011 has been the expansion of property tax collection to 37 municipalities (out of

107 municipalities in the West Bank) at end-June, with the aim of covering 52 municipalities by end-2011.

14. **The staff of the Palestinian and Israeli Ministries of Finance (MoF) reached understandings in principle on several measures aimed at strengthening collection and minimizing leakages of clearance revenue. These understandings need a prompt approval at the Israeli ministerial level to be put into practice.** The key understandings reached as of end-August 2011 are:

- Discontinue the current practice of settling unpaid electricity bills (owed by the Gaza Electricity Distribution Company and by Palestinian municipalities to the Israeli Electricity Company) through automatic deductions by the Israeli MoF from clearance revenue owed to the PA. Instead, to raise efficiency and transparency, the Israeli electricity company should send electricity bills to the Palestinian MoF which will be responsible for their settlement.

- The assessment of clearance revenue owed to the PA should be made on the basis of the data compiled by the GoI on trade between Israel and the WBG. Both sides should have equal access to data collected through shared electronic interfaces.

- It is important that PA officials be present at border crossings to enable close monitoring of imports into the West Bank and improve the collection of invoices for VAT and other taxes and fees.

- Several practices of revenue sharing should be reviewed to ensure that they are in line with the Paris Protocol. In particular, exit fees levied by Israel on Palestinian passengers crossing the Allenby Bridge should be equally shared between the two sides.

15. **The PA is considering a small issue of Treasury Bills in 2011 by securitizing the PA's debt to the PMA.** This would be a first step toward the gradual development of a Treasury Bills market which would help develop the money and interbank markets and provide a collateral in the new Real Time Gross Settlement system. The PA is also considering the issuance of Sukuk debt certificates, with PA real estate as collateral. These options could eventually lower the cost of funding for the PA. The authorities recognize that current conditions are not appropriate for a full scale issuance program, given the current severe liquidity problems and the need for further progress toward fiscal sustainability. They see initial issues of Treasury Bills or debt certificates as a demonstration of their institutional readiness to do so. The PMA has been receiving technical assistance from the Fund on debt management and money market development, including staff training, to ensure the implementation of best international practice.

IV. Medium-Term Outlook and Structural Reforms

16. **The PA's core economic objective is to ensure rising living standards for the Palestinian population and a steady reduction in unemployment.** Achieving this goal will require a strong pick up of economic growth in the West Bank after the slowdown in early 2011, and a sustained recovery in Gaza. All three parties (PA, the GoI, and donors) will need to pro-actively push the peace process forward and take measures to support the WBG's economic development. In particular, a substantial easing of trade and other restrictions, including on foreign direct investment, is required. This is essential to offset the impact on private sector activity and investment of the PA's fiscal retrenchment[9] and declining donor aid including for development projects. The PA should continue a prudent fiscal policy and structural reforms to reduce the recurrent budget deficit. Donors need to make up for the 2011 shortfalls incurred thus far, and henceforth disburse aid on time to cover the narrowing budget deficit as well as public investment and reconstruction needs.

17. **To sustain Gaza's strong recovery, and prevent the further slowdown of growth in the West Bank, it is essential to substantially ease restrictions on movement and access:**

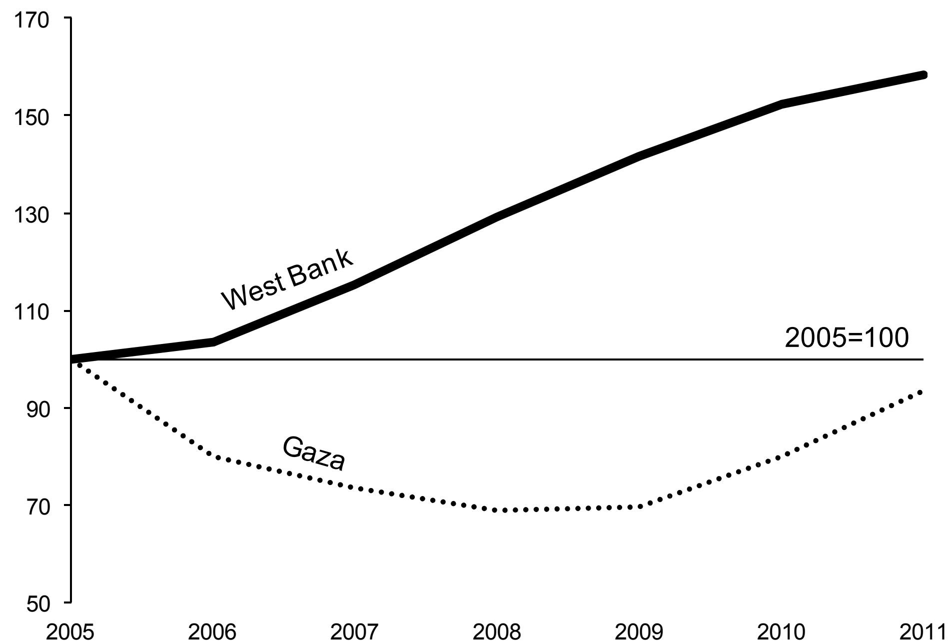
- While Gaza's growth in 2010 may appear impressive, much of it represents a "catch up" of real GDP following its contraction by a cumulative 30 percent during 2006–09 due to the trade restrictions. Even after its surge in 2010–11, Gaza's real GDP is projected to be 6 percent below its 2005 level by end-2011 (see Figure 4; and Section A in the Appendix). Given Gaza's separation from the West Bank, sustaining Gaza's recovery will require lifting of the ban on exports to Israel, its trade with the West Bank, and imports of inputs for private investments.

- In the West Bank, the removal since 2009 of a large number of roadblocks and other barriers to internal movement, as well as the expansion of capacity at crossing points with Israel, have provided a limited impetus to growth. To sustain the growth momentum, it is essential to continue lifting restrictions on movement and remove other core constraints on private sector expansion. First, the removal of restrictions on exports and "dual use" imports—which were tightened with the construction of the separation barrier in 2009–11—would allow the West Bank to benefit from trade complementarities with the much larger Israeli market and from its traditionally strong ties with East Jerusalem. Second, the removal of restrictions on investment in

[9] The fiscal retrenchment in recent years is reflected in the reduction of the cyclically adjusted primary deficit from about 30 percent of GDP in 2007 to 16 percent in 2010. This sharp reduction brings to the fore the diminishing role of discretionary public spending as a source of economic growth, and a greater role for the private sector.

"Area C", which represents 60 percent of the West Bank, would allow the West Bank's agricultural potential, in particular in the Jordan Valley, to be fully tapped.[10]

Figure 4. Paths of Regional Real GDP Relative to 2005
(Index; 2005=100)



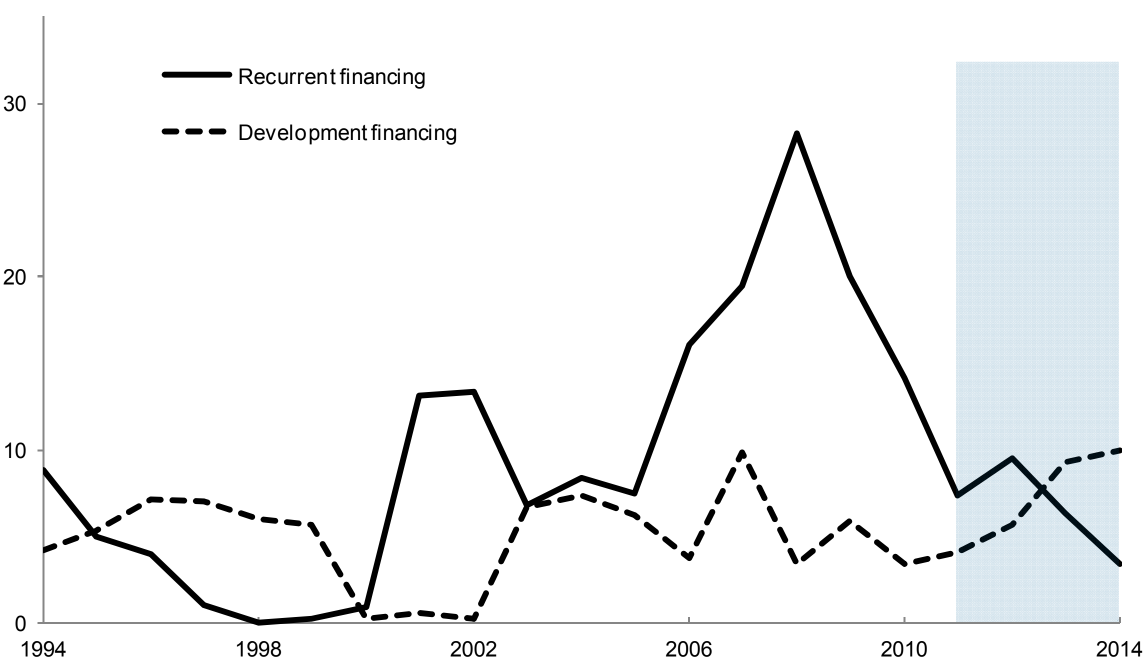
18. **The macroeconomic framework underpinning the Palestinian National Development Plan (PNDP) for 2011–13 has been revised in view of the slowdown in growth in the West Bank and a more uncertain medium-term economic outlook.** The WBG real GDP growth for 2011 has been revised from 9 percent to 7 percent due to rising political uncertainties, lower-than-envisaged donor aid to finance recurrent and development spending, and the hitherto limited easing of restrictions on movement and access. Nevertheless, the medium-term baseline scenario assumes that progress on these fronts starting in 2012 will enable the expansion of private sector activity and external trade. In particular, it assumes that the easing of trade and other restrictions, including on foreign direct investment, will outweigh the impact of the PA's fiscal retrenchment on private sector activity and investment. In Gaza, the further easing of the blockade will allow: (i) steadily

[10] For details of the restrictions on investment in "Area C", see the report by OCHA, "Restricting Space: The Planning Regime Applied by Israel in "Area C" of the West Bank," December 2009, published on www.ochaopt.org. For details on the physical obstacles and non-trade barriers to the access of goods from the West Bank to Israel see the World Bank's report "An Analysis of the Economic Restrictions Confronting the West Bank and Gaza," published on www.worldbank.org.

rising imports of investment inputs required by the private sector; and (ii) a gradual increase in trade with the West Bank and in exports. In the West Bank, lifting of remaining internal restrictions will be complemented by a phasing out of obstacles on external trade, in particular on exports to Israel and East Jerusalem, as well as on access to "Area C". The PA will implement a prudent fiscal policy and structural reforms to enable a sustained reduction in the recurrent budget deficit. Donors will disburse aid on time to cover the narrowing budget deficit as well as public investment and reconstruction needs.

19. **In the baseline scenario, under the above assumptions and policy expectations, the expansion of private sector activity and external trade would sustain real GDP growth at 7 percent in 2012 and raise it further to 10 percent in 2013–14, with a fall in unemployment from 21 percent in 2011 to 15 percent by 2013.** The recurrent deficit would decline to 6 percent of GDP in 2013, with a shift in the composition of spending from wages and subsidies to public investment. This in turn would allow a shift in the composition of donor aid from recurrent budget financing to development projects, gradually moving back to the situation which prevailed in the mid-1990s when the bulk of the budgetary aid financed development expenditures (Figure 5).

Figure 5. Composition of Donor Aid
(Percent of GDP)



Source: Ministry of Finance.

20. **In an alternative "low-growth" scenario, the peace process will remain stalled, and Israeli restrictions would not ease significantly, inhibiting trade and private investment, and impeding the implementation of development projects.** Real GDP growth would remain at about 4 percent over the medium term and the unemployment rate would remain at about 20 percent. Budgetary revenue would be lower, while emergency spending and arrears accumulation would be higher, thus slowing the pace of fiscal adjustment, with the recurrent deficit at 11 percent of GDP by 2013 (Table F).
The low-growth scenario implies stagnant living standards, given the yearly population growth rate of about 3–4 percent.

Table F. Comparison of Baseline and Low-Growth Scenarios

	2010	2011	2012	2013	2014	2012	2013	2014
		Baseline Scenario				Low Growth Scenario		
Output and Investment								
Real GDP (percentage change)	9.3	7.0	7.0	10.0	10.0	4.0	3.8	3.6
West Bank	7.6	4.0	5.0	8.0	8.0	3.4	3.4	3.1
Gaza	15.2	17.0	12.0	15.0	15.0	5.6	5.0	5.0
Real GDP per capita (percentage change)	6.2	3.9	4.0	6.9	6.4	1.0	0.8	0.6
West Bank	4.8	1.3	2.7	5.5	4.8	0.7	0.7	0.5
Gaza	11.6	13.0	8.2	10.9	10.7	2.0	1.5	1.5
Gross capital formation (in percent of GDP)	16.5	16.9	19.0	25.8	29.9	15.5	17.5	16.2
Of which: public investment (in percent of GDP)	3.5	4.3	5.8	9.5	10.1	3.0	5.1	5.7
				(In percent of GDP)				
Public finances 1/								
Revenues	23.7	21.7	22.3	23.3	24.0	21.3	21.4	21.5
Recurrent expenditures and net lending	37.9	33.9	31.4	29.2	27.0	32.9	32.4	32.5
Recurrent balance (before external support)	-14.1	-12.1	-9.1	-5.9	-3.0	-11.5	-11.0	-11.0
Recurrent balance, on a cash basis (before external support)	-13.3	-11.5	-9.6	-6.3	-3.4	-9.9	-8.2	-8.0
Expenditure arrears accumulation	1.1	0.0	-0.5	-0.4	-0.4	1.6	2.8	3.0
Capital expenditures	3.4	4.1	5.7	9.3	10.0	2.9	5.0	5.5
(In millions of U.S. dollars)	275	400	600	1,095	1,295	300	548	648
External recurrent budgetary support	14.1	7.4	9.6	6.3	3.4	9.7	6.7	3.7
(In billions of U.S. dollars)	1.1	0.7	1.0	0.7	0.4	1.0	0.7	0.4
Total external support, including capital expenditures	15.7	11.5	15.2	15.6	13.3	12.6	11.7	9.2
(In billions of U.S. dollars)	1.3	1.1	1.6	1.8	1.7	1.3	1.3	1.1
Financing gap (in billions of U.S. dollars)	…	0.3	…	…	…	…	…	…
				(In percent of GDP)				
External sector								
Exports of goods and nonfactor services	14.3	17.0	22.1	24.4	27.0	17.8	19.0	19.0
Import of goods and nonfactor services	62.5	63.5	69.5	75.0	78.4	63.2	68.8	68.2
Current account balance (excluding official transfers)	-31.6	-24.2	-25.5	-28.9	-30.0	-23.7	-28.5	-28.2
Current account balance (including official transfers)	-15.9	-12.6	-10.2	-13.3	-16.6	-11.1	-16.8	-18.9
Memorandum items:								
Unemployment rate (average in percent of labor force)	24	21	18	15	13	20	20	20

Sources: Palestinian authorities and IMF staff estimates.
1/ Commitment basis, unless otherwise stated.

21. **While the assumptions regarding the budgetary revenue and donor aid outlook are appropriately conservative, it is important for the PA to prepare for "downside" as well as "upside" risks:**

- To prepare for lower-than-envisaged revenue or aid, it is important for the PA to continue the implementation of austerity measures to contain the accumulation of domestic payment arrears and bank borrowing, although it will be difficult to fully prevent them if the revenue and aid shortfalls persist given the need to meet essential expenditures. These measures would include strict prioritization of expenditures, a hiring freeze, postponement of non-essential projects, and a freeze in public sector wages.

- On the upside, budgetary revenue could be higher than envisaged in the baseline scenario, in particular if political breakthroughs allow the operation in 2012–13 of the Gaza Marine offshore gas field, or a quick pickup in collection of domestic tax revenues from Gaza. Given the high level of domestic debt, it is important to ensure that higher-than-expected revenue or aid is used for the repayment of domestic payment arrears and bank loans, as opposed to accommodating new spending commitments.

22. **To help ensure steady progress toward fiscal sustainability it is essential to step up the implementation of the key structural reforms as set out in the PNDP for 2011–13:**

- **Streamline and better target social assistance.** In 2010, several cash assistance programs in the West Bank have been merged into one central program with a single payment modality. The eligibility for the assistance under the program is verified through on-site visits and a proxy means test to identify households below the poverty line. The Ministry of Social Affairs will be regularly updating the database of targeted households to ensure that only those below the poverty line receive assistance. In a first phase, about 47,000 households in the West Bank, and 15,000 households in Gaza, are expected to undergo verification by end-2011 to determine which households could "graduate" from the assistance program. Another key social safety net measure has been the implementation since July 1, 2011 of the "lifeline electricity tariff", for households in the social safety net, for which a "lifeline" amount of household electricity consumption is billed only at cost.[11] This measure is especially important given the increase in tariffs as electricity distribution is commercialized.

[11] The Palestinian Electricity Regulatory Commission has developed a methodology for setting a unified tariff structure for the West Bank's distribution companies. This structure includes a lifeline tariff for poor households at which the first 100 kWh of electricity is priced at cost of supply (which is below existing tariff rates).

- **Phase out electricity subsidies (imposed on the MoF due to non-payment by municipalities of their electricity bills) by completing the transfer of electricity distribution from municipalities to commercial companies.** Two important steps were taken since 2010: (i) in early 2010, the transfer of electricity distribution from the municipality of Nablus to the Northern Electricity Distribution Company (NEDCO); and (ii) the installation as of mid-2011 of about 150,000 pre-paid meters in the West Bank to improve bills payment, with an additional 214,000 meters slated to be installed by end-2012. An action plan was prepared in 2010 to complete the transfer of distribution from the remaining local governments in the northern West Bank region to NEDCO by end-2012. The transfer of distribution in the remainder of the West Bank to other private electricity companies is expected to be completed by end-2011. Progress in electricity sector reform has helped reduce electricity subsidies from 6 to 3 percent of GDP in 2009–10, with a further decline to less than 2 percent of GDP projected for 2011, and less than 1 percent projected by 2013.

- **Reform the public pension system.** The comprehensive public pension reform action plan was adopted in July 2010. In May 2011 the authorities reached agreement with the World Bank on legislative amendments (including to the Public Pension law) needed to implement parametric changes to the pension system. The authorities submitted the amendments to the Council of Ministers. The reforms planned for the remainder of 2011 include indexing pensions to the CPI, raising the retirement age from 60 to 62, and ensuring that pensions are paid only to those who have reached the minimum age and served the minimum number of years specified in the pension law. The remaining steps for 2012 include the elimination of lump sum payments at retirement.[12] Prompt implementation of these reforms is important to ensure that the target of restoring the system's viability by end-2012 is achieved.

- **Initiate civil service reform aimed at a steady decline in the wage bill and greater public sector efficiency**. The authorities have hitherto relied on controls on wage rates and new employment to contain the growth of the wage bill. While this approach has yielded substantial budgetary savings, it will need to be complemented by additional measures to ensure long-run sustainability and increased efficiency in the delivery of public sector services. It is important to step up the preparation of a

[12] The staff of the IMF and World Bank have jointly produced preliminary estimates of the impact of the different components of pension reform on the "implicit pension debt" defined as the present value of the pension system's projected liabilities to current and future pensioners. Assuming constant government real wages, the elimination of the early retirement option (for both the civil service and security schemes) yields an implicit pension debt of about 30 percent of GDP, compared to about 60 percent of GDP in the no-reform scenario. The increase in the retirement age yields an implicit pension debt of about one third of GDP, compared to about 70 percent in the no-reform scenario. Under the assumption of declining government real wages, pension debt declines by even greater amounts.

plan for a comprehensive civil service reform, in collaboration with the World Bank, to ensure that it is submitted to the Cabinet by end-2011 as envisaged in the PNDP. In the meantime, a comprehensive review of employees' qualifications and performance should be undertaken to pave the way for a new incentive structure with a wider salary scale. The review should include a careful assessment of personnel needs in key sectors, including health and education, to fine-tune the current annual ceiling of 3,000 new public sector employees.[13] Work has started in mid-2011 on drafting job descriptions and position structures with a view to completion by end-2011.

- **While restrictions on movement and access are the main constraint on private sector development, the pickup in private investment envisaged by the PNDP will also require the strengthening of the legal and regulatory framework to improve the investment climate for businesses.** The PA has been collaborating closely with the World Bank in the preparation of laws to ensure that incentives and regulations facing private investors are in line with best international practice. The Ministry of National Economy has taken steps in 2011 to reduce red tape faced by new small- and medium-sized businesses, including streamlining of registration procedures. A new Procurement Law has been signed by the President, which will improve efficiency, accountability and transparency in the acquisition of goods and services by the government. Several other laws have been approved by the Cabinet.[14] Prompt implementation of these laws is important to support the WBG's economic development. It is also important to establish an independent regulator for the telecommunication sector as required by the 2009 telecommunications law. The independent regulator is essential to ensure a level-playing field in the telecommunications sector.

V. Appraisal

23. **In 2011 the Palestinian economy has entered the most difficult phase since the launching of the PA's reform program at the Paris Conference in 2007.** Serious challenges to the PA have emerged simultaneously on several fronts, with a liquidity crisis following persistent donor aid shortfalls; a weakening impetus to economic growth from the lack of significant easing of Israeli restrictions on movement and access in 2011, as well as

---

[13] At the request of the MoF, DFID has funded a study to assess the efficiency of the PA and UNRWA in providing services for health and education in the WBG. Recommendations on appropriate levels of recruitment for the two sectors are expected to be published later this year.

[14] These laws include the New Companies Law, that removes the bureaucratic red tape faced by new companies; and the New Industry Law, both of which ensure a fair treatment of private companies independently of the sector of operation; and the Movable Assets Law which facilitates access to bank finance by enabling the use of movable assets as collateral.

from fiscal retrenchment; and an increasingly uncertain domestic and regional political environment:

- The PA has established a solid track record since 2007 of sound economic and fiscal management including restraint on the public sector wage bill, reduced utility subsidies, prioritized expenditures, transparent government finances, and enhanced tax administration. The PA has been implementing a budget for 2011 set to continue along the path of orderly fiscal adjustment and reforms, underpinned by a tight expenditure stance. However, aid disbursements thus far in 2011 have been far below the expected amounts ($0.4 billion disbursed as of end-August compared to $0.7 billion envisaged). The impact of the aid shortfalls has been compounded by shortfalls in budgetary revenue and the depreciation of the U.S. dollar which has reduced the shekel equivalent of dollar-denominated aid. This has led to the accumulation of substantial domestic payment arrears, including on wages for the first time since 2007, and borrowing up to the commercial banks' limits.

- The removal by the GoI in 2009–10 of many of the West Bank's internal obstacles to movement has contributed to the recovery of economic activity. Similarly, in Gaza, the relaxation of some import controls in mid-2010—on consumer goods and investment inputs to internationally-supervised projects—has started a recovery of Gaza's output, albeit from a highly repressed level following a tight blockade. However, core restrictions on the expansion of private sector activity and investment remain, including access to the West Bank's "Area C", export restrictions, and import controls on private investment inputs in Gaza.

- The WBG's economic growth outlook, and prospects for a significant reduction in unemployment, have been dimmed by the persistence of restrictions as well as inadequate and unpredictable aid for essential recurrent public spending and development projects. The adverse impact of these factors on the WBG's investor incentives is bound to be compounded by the increased risk of social turmoil, especially in the absence of a breakthrough in the peace process.

24. **Given the likelihood of continued shortfalls for the remainder of the year, and the fact that there is little scope for further borrowing from banks, it is essential that the PA caps expenditure commitments below budgeted levels.** This will require strict cost-saving measures and prioritization of expenditures, including a hiring freeze and postponement of lower-priority projects, to meet the shortfalls in aid. While domestic payment arrears cannot be fully prevented due to the existence of essential expenditures, these can be minimized through the effective use of the computerized accounting system to tighten commitment controls and enhance cash management, as well as by stepping up efforts to raise domestic tax collection. The implementation of development and community projects should, as much as possible, be aligned with conservative projections for external project aid to minimize arrears accumulation and to rechannel budgetary resources away

from essential recurrent spending. It is particularly important to avoid further increases in public sector wage rates in 2011, and to prevent further increases in 2012 beyond the maximum 2 percent raise to partly compensate for 2011 inflation.

25. **In parallel with preparations to address liquidity crises in response to exceptional shortfalls in donor aid, as discussed above, it is essential for the PA to continue to build on its track record of reforms and sound public finance management.** To raise economic efficiency and fully eliminate longer-term reliance on recurrent aid, it is important to step up key structural reforms:

- Clearance revenue represents two thirds of the PA's total budgetary revenue. Given the PA's pressing financing needs, it is important that the agreements reached between the technical teams at the Palestinian and Israeli ministries of finance be promptly approved at the Israeli ministerial level and implemented to enhance the collection of clearance revenue and minimize leakages. Practical steps that could be implemented starting in the fall of 2011 include: (i) creating a mechanism to allow the PA to settle directly unpaid electricity bills, instead of relying on the system of "automatic deductions" from clearance revenue by Israel's MoF; and (ii) assessing potential clearance revenue owed to the PA on the basis of comprehensive data compiled by the GoI on trade between Israel and the WBG. With regard to domestic taxes, it is important to step up implementation of the action plan for 2011–13, developed with assistance from the Fund, to expand the tax base and improve compliance, in particular the establishment of a unified revenue administration and the computerization of taxpayers' records to reduce tax evasion.

- Given that social transfers represent over one fourth of total nonwage expenditures, the development of a comprehensive social safety net in collaboration with the World Bank and the EU has been an important step to ensure that assistance reaches the truly vulnerable groups. In the remainder of 2011, it is important to apply effectively the database of poor households as a basis for all social payments, to exclude from the system recipients that are no longer eligible, and to better target social assistance and electricity subsidies.

- Electricity subsidies, reflected in the "net lending" component of the budget, have declined substantially due to improved incentives for municipalities and households to pay their electricity bills. To ensure that these subsidies are fully phased out over the medium term, it is essential to abide by the PNDP's timetable for the commercialization of electricity distribution in the West Bank. The "lifeline" electricity tariff, which bills electricity at supply cost, has been in effect since July 2011 and should be effectively applied to eligible households.

- Implementing the action plan to reform of the pension system will restore its viability and prevent large longer-run costs to the budget. This requires bold measures to be incorporated in the 2012 budget, including indexing the pensions to the CPI and raising the retirement age.

- A comprehensive civil service reform is essential to sustain the reduction in the wage bill. While the share of the wage bill in GDP has declined in recent years due to limits on increases in wage rates and new employment, at 20 percent it is still significantly higher than the 10–15 percent that is typical of countries at a similar stage of development. It will become increasingly difficult to reduce the wage bill by relying on a "blanket" restraint on wage rates and new employment.

- The results of the stress tests conducted by commercial banks will be key inputs to the PMA's action-plan to reduce banks' vulnerabilities—in particular to the risks of a possible downturn in economic activity and increased exposure to the public sector. It is important that remedial actions that are warranted by the tests' result—including raising certain banks' paid in capital and reducing their exposure to specific sectors—be taken in line with the schedule set by the PMA for 2011–12. Prompt implementation of remedial measures is especially important given the recent substantial rise in bank credit to the PA and to the private sector. Fund staff welcomes the PMA's upcoming review of the necessity of retaining the ceiling on the share of bank deposits placed abroad. It is important to replace that ceiling with prudential norms in order to efficiently regulate diversification of banks' portfolios between domestic credit and outside placements.

26. **To stem the risks of a major slowdown of economic growth and a deepening liquidity crisis, concerted actions are needed by the PA, the GoI, and donors**:

- As stated in the April 2011 staff report, the IMF staff considers that the PA is now able to conduct the sound economic policies expected of a future well-functioning Palestinian state, given its solid track record in reforms and institution-building in the public finance and financial areas.[15] However, the recent aid shortfalls are posing serious risks to the PA's state-building capacity, especially given its still high aid dependence. However, the recent aid shortfalls are posing serious risks to the PA's state-building capacity, especially given its still high aid dependence. Staff urges the authorities to continue the implementation of strong macroeconomic policies and a tight expenditure stance, including a hiring freeze in the remainder of 2011. In the context of shortfalls in donor aid, it is essential for the PA to fully deploy its institutional capacity to prudently manage the current liquidity crisis and step up the implementation of structural measures as set out above.

---

[15] See the IMF Staff Report for the Meeting of the Ad Hoc Liaison Committee in Brussels, April 13, 2011, published on www.imf.org/wbg.

- To maintain the growth momentum, rebalance the composition of output, and accelerate the state-building process, it is essential for the GoI to phase out all economic restrictions as soon as possible. In Gaza, where living standards still lag far behind those in the West Bank, a lasting recovery in private sector investment and employment will require a removal of the ban on exports and private sector imports of investment inputs. Fully tapping the West Bank's potential and sustaining its growth will require a broad-based removal of barriers on exports to Israel, of imports of machinery and equipment, as well as allowing Palestinian economic activity in "Area C".

- The shortfalls and delays in disbursements have imposed a significant cost on the PA in terms of interest payments and additional premia required by private suppliers of goods and services. They also risk, even with prioritization efforts by the PA, to curtail much needed social or other essential spending. Sustained donor aid during 2008–10 supported the successful implementation of the Palestinian Reform and Development Plan for 2008–10, presented at the Paris Donors' Conference in December 2007, and was essential to sustain orderly reforms and fiscal adjustment. The latter in turn enabled the PA to reduce the aid needed to finance the recurrent budget deficit, from $1.8 billion in 2008 to $1.1 billion in 2010. In the same vein, timely and adequate aid in support of the PNDP for 2011–13 will allow sustained reforms and adjustment which in turn will enable early self-reliance by the PA for its recurrent spending, with donor aid increasingly focused on growth-enhancing development projects.

Table 1. Selected Economic Indicators, 2008–14

(Population: 4 million; 2010 est.)
(Per capita GDP: $2,007; 2010)
(Poverty rate: 18 percent in the West Bank and 38 percent in Gaza Strip; 2010 est.)

	2008	2009	2010	Projections 2011	2012	2013	2014
Output and prices			(Annual percentage change)				
Real GDP (2004 market prices)	7.1	7.4	9.3	7.0	7.0	10.0	10.0
West Bank	12.0	9.5	7.6	4.0	5.0	8.0	8.0
Gaza	-6.1	0.7	15.2	17.0	12.0	15.0	15.0
CPI inflation rate (end-of-period)	7.0	4.3	2.8	3.8	2.7	2.3	2.5
CPI inflation rate (period average)	9.9	2.8	3.7	4.0	3.1	2.3	2.4
Investment and saving			(In percent of GDP)				
Gross capital formation, *of which:*	19.3	18.9	16.5	16.9	19.0	25.8	29.9
Public	4.1	6.1	3.5	4.3	5.8	9.5	10.1
Private	15.2	12.8	12.9	12.7	13.2	16.3	19.9
Gross national savings, *of which:*	30.2	7.5	0.6	4.3	8.8	12.5	13.3
Public	3.9	9.4	4.0	0.1	5.7	9.3	10.0
Private	26.3	-2.0	-3.5	4.2	3.1	3.2	3.3
Saving-investment balance	10.9	-11.4	-15.9	-12.6	-10.2	-13.3	-16.6
Public finances 1/			(In percent of GDP)				
Revenues	25.1	23.6	23.7	21.7	22.3	23.3	24.0
Recurrent expenditures and net lending	46.2	47.2	37.9	33.9	31.4	29.2	27.0
Wage expenditures	23.3	21.7	19.9	19.5	18.5	17.6	16.7
Nonwage expenditures	15.8	19.9	15.1	12.7	11.9	10.9	10.0
Net lending	7.2	5.5	2.9	1.7	0.9	0.7	0.3
Recurrent balance (commitment, before external support)	-21.1	-23.5	-14.1	-12.1	-9.1	-5.9	-3.0
Recurrent balance, cash (before external support)	-27.1	-20.3	-13.3	-11.5	-9.6	-6.3	-3.4
Development expenditures	3.4	5.9	3.4	4.1	5.7	9.3	10.0
(In millions of U.S. dollars)	215	400	275	400	600	1,095	1,295
Overall balance (before external support)	-24.5	-29.5	-17.5	-16.3	-14.7	-15.2	-13.0
External recurrent budgetary support (in billions of U.S. dollars)	1.8	1.4	1.1	0.7	1.0	0.7	0.4
Total external support, including for development expenditures	31.7	25.9	15.7	11.5	15.2	15.6	13.3
(In billions of U.S. dollars)	2.0	1.8	1.3	1.1	1.6	1.8	1.7
Financing gap (in billions of U.S. dollars)	…	…	…	0.3	…	…	…
Monetary sector 2/			(Annual percentage change)				
Credit to the private sector	-3.4	22.9	31.2	32.2	21.5	23.8	23.6
Private sector deposits	14.0	5.7	9.9	19.2	14.0	16.8	16.6
External sector			(In percent of GDP)				
Exports of goods and nonfactor services	15.4	13.6	14.3	17.0	22.1	24.4	27.0
Import of goods and nonfactor services	65.4	64.5	62.5	63.5	69.5	75.0	78.4
Net factor income	10.2	8.1	7.4	6.9	6.7	6.4	6.1
Net current transfers	50.8	31.4	24.9	26.9	30.5	31.0	28.7
Official transfers	31.7	25.9	15.7	11.5	15.2	15.6	13.3
Current account balance (excluding official transfers)	-20.7	-37.3	-31.6	-24.2	-25.5	-28.9	-30.0
Current account balance (including official transfers)	10.9	-11.4	-15.9	-12.6	-10.2	-13.3	-16.6
Memorandum items:							
Nominal GDP (in millions of U.S. dollars)	6,247	6,764	8,124	9,686	10,608	11,751	13,001
Per capita nominal GDP (U.S. dollars)	1,633	1,719	2,007	2,323	2,471	2,658	2,857
Unemployment rate (average in percent of labor force)	27	25	24	21	18	15	13
Al Quds stock market index (annual percentage change)	-16.2	11.6	-0.7	…	…	…	…

Sources: Palestinian authorities; and IMF staff estimates.

1/ Commitment basis.

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

Table 2. Central Government Budget, 2008–14 in millions of U.S. dollars

	2008	2009	2010	2011			Projections		
				Budget	Jan-Jun	Proj.	2012	2013	2014
	(In millions of U.S. dollars, unless otherwise stated)								
Total net revenues	**1,568**	**1,597**	**1,927**	**2,149**	**1,010**	**2,106**	**2,363**	**2,738**	**3,117**
Gross domestic revenues	562	585	745	812	389	743	834	1,028	1,207
Tax revenues	273	301	474	512	259	499	556	628	707
Nontax revenues (accrued)	289	284	270	300	131	244	277	400	500
Nontax revenues (cash)	289	284	270	300	113	229	277	400	500
Clearance revenues (accrued)	1,122	1,103	1,259	1,442	698	1,474	1,651	1,845	2,060
Clearance revenues (cash)	1,137	1,090	1,242	1,558	769	1,547	1,651	1,845	2,060
Clearance revenues (net arrears)	-15	13	16	-116	-71	-73	---	---	---
Tax refunds	116	91	76	105	77	111	122	135	149
Total recurrent expenditures and net lending (commitment)	**2,886**	**3,190**	**3,076**	**3,232**	**1,611**	**3,282**	**3,327**	**3,430**	**3,506**
Wage expenditures (commitment)	1,453	1,467	1,613	1,709	932	1,887	1,967	2,065	2,169
Wage expenditures (cash)	1,771	1,423	1,564	---	892	1,887	1,967	2,065	2,169
Wage expenditures (net arrears)	-317	44	50	---	41	---	---	---	---
Nonwage expenditures (commitment)	985	1,349	1,227	1,363	591	1,235	1,260	1,285	1,298
Nonwage expenditures (cash)	1,055	1,142	1,156	---	450	1,235	1,310	1,335	1,348
Nonwage expenditures (net arrears)	-70	207	71	---	141	---	-50	-50	-50
Net lending (commitment)	447	374	236	160	88	160	100	80	40
Net lending (cash)	447	355	263	---	88	160	100	80	40
Net lending (net arrears)	---	20	-28	---	----	---	---	---	---
Recurrent balance (commitment, before external support)	**-1,317**	**-1,592**	**-1,149**	**-1,084**	**-601**	**-1,176**	**-964**	**-693**	**-389**
subtract: nontax revenue arrears	---	---	---	---	18	16	---	---	---
add: expenditure arrears (net)	-387	270	93	---	181	---	-50	-50	-50
subtract: net clearance due (+) or repaid (-)	-15	13	16	-116	-71	-73	---	---	---
add: arrears on tax refunds	---	-36	-11	---	63	---	---	---	---
Recurrent balance (cash, before external support)	**-1,690**	**-1,371**	**-1,083**	**-967**	**-303**	**-1,118**	**-1,014**	**-743**	**-439**
Development expenditures (commitment)	**215**	**430**	**299**	**500**	**180**	**400**	**600**	**1,095**	**1,295**
Development expenditures (cash)	**215**	**400**	**275**	**---**	**131**	**400**	**600**	**1,095**	**1,295**
Development expenditures (arrears)	**---**	**30**	**23**	**---**	**50**	**---**	**---**	**---**	**---**
Overall balance (cash, including development expenditures)	**-1,905**	**-1,771**	**-1,358**	**-1,467**	**-434**	**-1,518**	**-1,614**	**-1,838**	**-1,734**
Total financing	**1,905**	**1,771**	**1,358**	**1,467**	**434**	**1,518**	**1,614**	**1,838**	**1,734**
Net domestic bank financing	-29	176	84	---	108	68	---	---	---
Other domestic financing	---	---	---	---	---	---	---	---	---
External financing for recurrent expenditures	1,764	1,355	1,146	967	292	717	1,014	743	439
External financing for development expenditures	215	400	130	500	43	400	600	1,095	1,295
Net external debt	-4	-4	---	---	---	---	---	---	---
Financing gap	---	---	---	---	---	333	---	---	---
Memorandum items:	(In percent of GDP; unless otherwise stated)								
Revenues	25.1	23.6	23.7	25.6	10.4	21.7	22.3	23.3	24.0
Recurrent expenditures and net lending	46.2	47.2	37.9	38.5	16.6	33.9	31.4	29.2	27.0
Wage expenditures	23.3	21.7	19.9	20.4	9.6	19.5	18.5	17.6	16.7
Nonwage expenditures	15.8	19.9	15.1	16.3	6.1	12.7	11.9	10.9	10.0
Net lending	7.2	5.5	2.9	1.9	0.9	1.7	0.9	0.7	0.3
Recurrent balance (commitment) before external support:	-21.1	-23.5	-14.1	-12.9	-6.2	-12.1	-9.1	-5.9	-3.0
Recurrent balance (cash) before external support	-27.1	-20.3	-13.3	-11.5	-3.1	-11.5	-9.6	-6.3	-3.4
External support (recurrent)	28.2	20.0	14.1	11.5	3.0	7.4	9.6	6.3	3.4
in millions of U.S. dollars	1,764	1,355	1,146	967	292	717	1,014	743	439
Development expenditures (cash)	3.4	5.9	3.4	6.0	1.3	4.1	5.7	9.3	10.0
Overall balance (cash)	-30.5	-26.2	-16.7	-17.5	-4.5	-15.7	-15.2	-15.6	-13.3
Total external support (in millions of U.S. dollars)	1,979	1,755	1,277	1,467	335	1,117	1,614	1,838	1,734
Nominal exchange rate (average; NIS per US dollar)	3.6	3.9	3.7	3.7	3.5	3.5	...	...	...
Nominal GDP (in millions of U.S. dollars)	6,247	6,764	8,124	8,386	9,686	9,686	10,608	11,751	13,001

Sources: Ministry of Finance; and IMF staff estimates.

Table 3. Central Government Budget, 2008–14 in millions of shekels

	2008	2009	2010	2011			Projections		
				Budget	Jan-Jun	Proj.	2012	2013	2014
				(In millions of shekels, unless otherwise stated)					
Total net revenues	**5,627**	**6,282**	**7,188**	**7,951**	**3,534**	**7,372**	**8,270**	**9,582**	**10,911**
Gross domestic revenues	2,017	2,301	2,778	3,004	1,362	2,602	2,918	3,596	4,224
Tax revenues	979	1,185	1,769	1,894	906	1,747	1,948	2,196	2,474
Nontax revenues (accrued)	1,038	1,115	1,009	1,110	457	855	971	1,400	1,750
Nontax revenues (cash)	1,038	1,115	1,009	---	395	800	971	1,400	1,750
Clearance revenues (accrued)	4,027	4,338	4,695	5,335	2,442	5,158	5,778	6,458	7,210
Clearance revenues (cash)	4,080	4,286	4,634	5,764	2,690	5,413	5,778	6,458	7,210
Clearance revenues (net arrears)	-52	52	61	-429	-248	-255	---	---	---
Tax refunds	417	357	285	388	270	388	427	473	523
Total recurrent expenditures and net lending (commitment)	**10,354**	**12,543**	**11,473**	**11,960**	**5,639**	**11,486**	**11,643**	**12,006**	**12,272**
Wage expenditures (commitment)	5,215	5,768	6,017	6,325	3,263	6,604	6,885	7,229	7,590
Wage expenditures (cash)	6,354	5,596	5,832	---	3,121	6,604	6,885	7,229	7,590
Wage expenditures (net arrears)	-1,139	171	185	---	142	0	---	---	---
Nonwage expenditures (commitment)	3,535	5,304	4,575	5,043	2,068	4,322	4,408	4,497	4,542
Nonwage expenditures (cash)	3,785	4,490	4,312	---	1,575	4,322	4,583	4,672	4,717
Nonwage expenditures (net arrears)	-250	815	263	---	493	---	-175	-175	-175
Net lending (commitment)	1,604	1,471	880	592	307	560	350	280	140
Net lending (cash)	1,604	1,395	983	---	307	560	350	280	140
Net lending (net arrears)	---	77	-103	---	----	---	---	---	---
Recurrent balance (commitment, before external support)	**-4,727**	**-6,261**	**-4,284**	**-4,009**	**-2,105**	**-4,115**	**-3,373**	**-2,424**	**-1,361**
subtract: nontax revenue arrears	---	---	---	---	62	55	---	---	---
add: expenditure arrears (net)	-1,389	1,063	345	---	635	---	-175	-175	-175
subtract: net clearance due (+) or repaid (-)	-52	52	61	-429	-248	-255	---	---	---
add: arrears on tax refunds	---	-140	-39	---	222	---	---	---	---
Recurrent balance (cash, before external support)	**-6,063**	**-5,391**	**-4,039**	**-3,580**	**-1,062**	**-3,915**	**-3,548**	**-2,599**	**-1,536**
Development expenditures (commitment)	**771**	**1,691**	**1,114**	**1,850**	**631**	**1,400**	**2,100**	**3,833**	**4,533**
Development expenditures (cash)	**771**	**1,573**	**1,026**	**---**	**457**	**1,400**	**2,100**	**3,833**	**4,533**
Development expenditures (arrears)	**---**	**118**	**88**	**---**	**174**	**---**	**---**	**---**	**---**
Overall balance (cash, including development expenditures)	**-6,835**	**-6,964**	**-5,065**	**-3,580**	**-1,519**	**-5,315**	**-5,648**	**-6,431**	**-6,069**
Total financing	**6,835**	**6,964**	**5,065**	**3,580**	**1,519**	**5,315**	**5,648**	**6,431**	**6,069**
Net domestic bank financing	-106	691	312	---	377	238	---	---	---
Other domestic financing	---	---	---	---	---	---	---	---	---
External financing for recurrent expenditures	6,328	5,328	4,276	3,579	1,022	2,510	3,548	2,599	1,536
External financing for development expenditures	771	1,573	487	1,850	151	1,400	2,100	3,833	4,533
Net external debt	-16	-16	---	---	---	---	---	---	---
Financing gap	---	---	---	---	---	1,166	---	---	---
Memorandum items:				(In percent of GDP; unless otherwise stated)					
Revenues	25.1	23.6	23.7	25.6	10.4	21.7	22.3	23.3	24.0
Recurrent expenditures and net lending	46.2	47.2	37.9	38.5	16.6	33.9	31.4	29.2	27.0
Wage expenditures	23.3	21.7	19.9	20.4	9.6	19.5	18.5	17.6	16.7
Nonwage expenditures	15.8	19.9	15.1	16.3	6.1	12.7	11.9	10.9	10.0
Net lending	7.2	5.5	2.9	1.9	0.9	1.7	0.9	0.7	0.3
Recurrent balance (commitment) before external support:	-21.1	-23.5	-14.1	-12.9	-6.2	-12.1	-9.1	-5.9	-3.0
Recurrent balance (cash) before external support	-27.1	-20.3	-13.3	-11.5	-3.1	-11.5	-9.6	-6.3	-3.4
External support (recurrent)	28.2	20.0	14.1	11.5	3.0	7.4	9.6	6.3	3.4
in millions of U.S. dollars	1,764	1,355	1,146	967	292	717	1,014	743	439
Development expenditures (cash)	3.4	5.9	3.4	6.0	1.3	4.1	5.7	9.3	10.0
Overall balance (cash)	-30.5	-26.2	-16.7	-11.5	-4.5	-15.7	-15.2	-15.6	-13.3
Total external support (in millions of shekels)	7,099	6,901	4,763	5,429	1,173	3,910	5,648	6,431	6,069
Nominal exchange rate (NIS per US dollar)	3.6	3.9	3.7	3.7	3.5	3.5	...	...	...
Nominal GDP (in millions of shekels)	22,415	26,597	30,303	31,028	33,902	33,902	37,129	41,128	45,504

Sources: Ministry of Finance; and IMF staff estimates.

APPENDIX[16]

[16] This appendix includes analyses undertaken by the IMF team for the West Bank and Gaza during 2011, including those published in the April 2011 staff report by O. Kanaan, J. Gomez, U. Kock, and M. Sumlinski on the website www.imf.org/wbg. The website includes IMF staff reports and analyses published since 2007.

A. The Development Paths of the West Bank and Gaza Since 1994

The regional paths of real GDP per capita and unemployment in the WBG have been severely affected by the conflict and Israeli restrictions; they have diverged since 2006 with the tightening of controls on Gaza. Convergence will depend on the phasing out of the restrictions and reintegration of the two territories' economies.

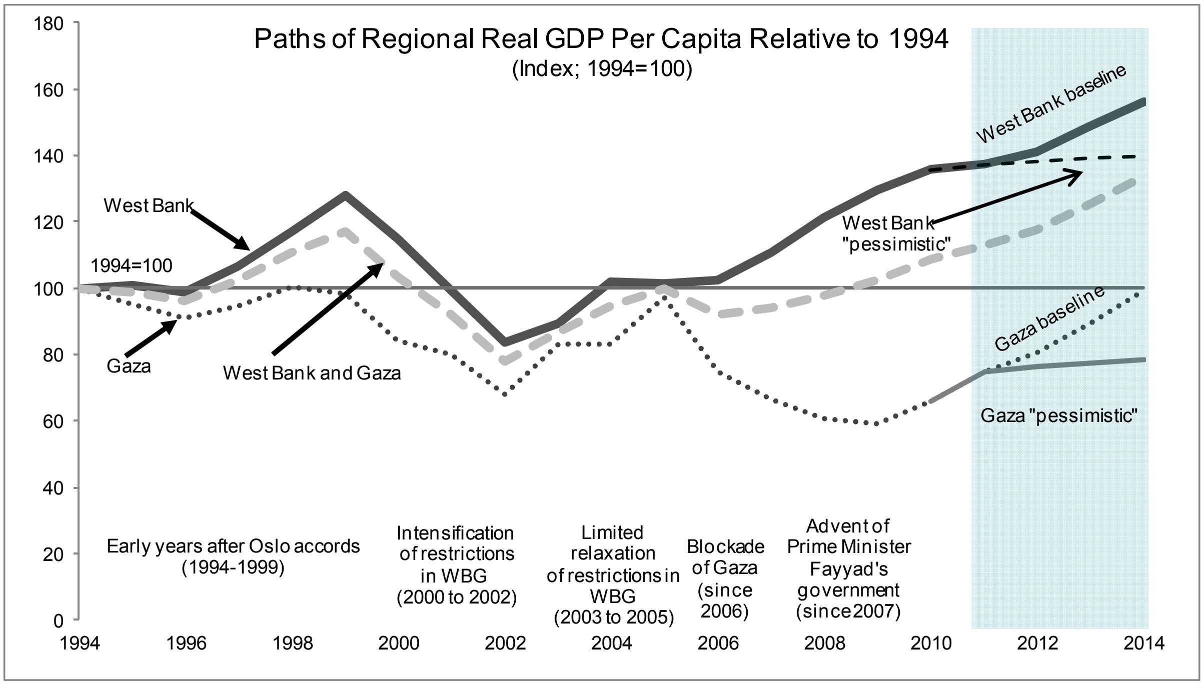
1. **The WBG's real GDP per capita has fluctuated widely since 1994.** From 1994 to 1999, the rising GDP per capita trend reflected the increased private sector confidence and institution-building as the PA took over key administrative responsibilities from the GoI. From 2000 to 2002, real per capita GDP declined sharply with the unfolding of the second Intifada and sharp intensification of trade restrictions.

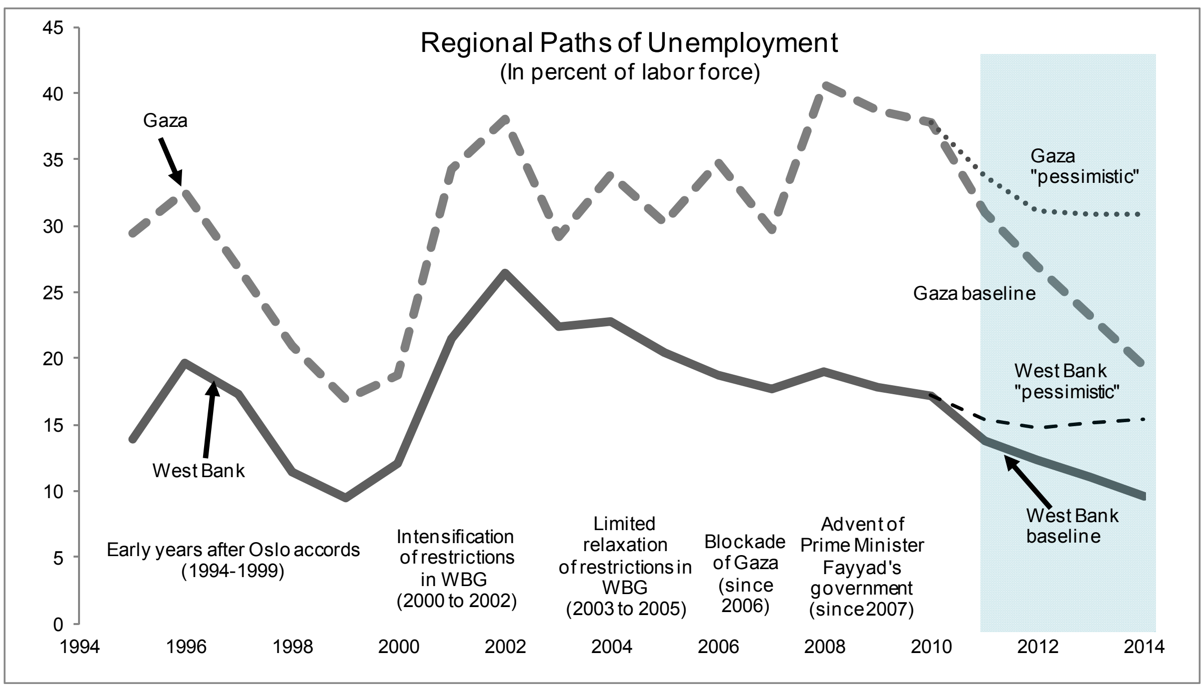
2. **From 2003 to 2005, real GDP per capita recovered to the 1994 level, in response to the limited relaxation of restrictions.** It then declined again reflecting the onset of Gaza's blockade, before recovering in 2007 following the advent of Prime Minister Fayyad's government. By 2009, the WBG's real GDP per capita recovered to its 1994 level.

3. **The dynamics of overall real GDP per capita reflects a wide divergence in output paths between the West Bank and Gaza** (see Figure 1). The West Bank's real GDP per capita has grown steadily since 2007, and is projected to be about 50 percent above its 1994 level by 2013. In contrast, Gaza's real GDP per capita has been on a downward trend since 2006, with its recovery starting only in 2010 with the easing of the blockade. In the baseline scenario, Gaza's real GDP per capita will be at 10 percent below its 1994 level by 2013, while in the low-growth scenario it will be about 23 percent below the 1994 level.

4. **The early years since 1994 witnessed a steady fall in the West Bank's and in Gaza's unemployment rates to 10 percent and 17 percent**. However, since the second Intifada, Gaza's rate has, until recently, remained exceptionally high at an average of about 34 percent, while the West Bank's rate has been on a broadly declining trend. This divergence reflects the tighter restrictions in Gaza on external trade and on the employment of workers in Israel, the higher sensitivity of its output to such restrictions given its small domestic market, higher uncertainty faced by the private sector due to more frequent hostilities, as well as the degradation of public institutions and infrastructure since 2006. In the baseline scenario, the West Bank's unemployment rate is projected to decline to 11 percent by 2013, while that in Gaza would decline to 23 percent. In the low-growth scenario, unemployment rates would remain high, at 15 percent in the West Bank and 31 percent in Gaza by 2013.

Figure 1. Regional Real GDP Per Capita and Unemployment





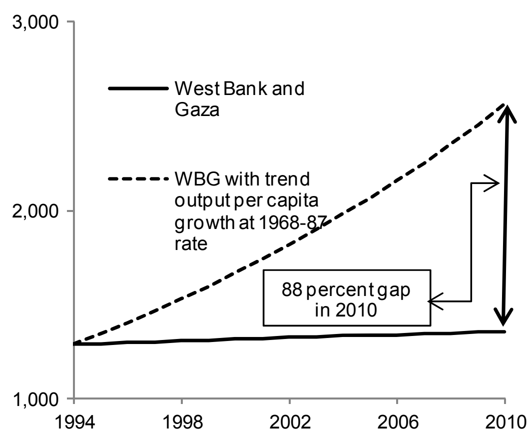
Sources: Palestinian Central Bureau of Statistics; and IMF staff estimates and projections.

B. Economic Growth Since 1994

The low trend output growth and wide fluctuations experienced by the WBG's economy since 1994 suggest that, had there been no restrictions since 1994, the WBG output per capita would have been significantly higher than it actually was. To estimate the extent of this "growth performance gap," the output path of the WBG was compared to hypothetical output paths for the WBG simulated using the neoclassical growth model, on the basis of: (i) the WBG's growth performance during 1968–87, when borders with Israel were more open; and (ii) the growth performance since 1994, of a group of countries with real GDP per capita comparable to that of the WBG in 1994. [17] *The results indicate sizable growth performance gaps and thus ample potential for high growth in case of continued easing of restrictions.*

1. The WBG's per capita output from 1968 to 1987, a period without conflict or restrictions, was decomposed into trend output per capita, and deviations from that trend. Trend output per capita grew at 4.4 percent per year during 1968–87, while it grew at -0.6 percent during 1994–2010. Had the WBG since 1994 had the same trend output growth as during 1968–87, real GDP per capita in 2010 would have been 88 percent higher than it actually was (Figure 2).

Figure 2. Trend Output Per Capita Gap Compared to 1968-87 WBG Growth
(In constant U.S. dollars)

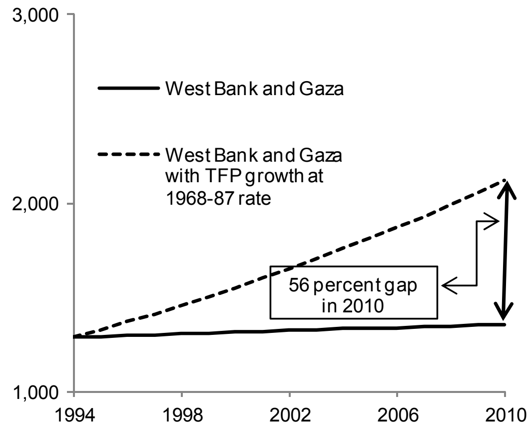


2. The standard growth accounting framework was applied to decompose the WBG's output into contributions from capital, labor, and Total Factor Productivity (TFP). The WBG's average TFP growth per year during 1968–87 is estimated at 1.8 percent, while

[17] The countries are: Angola, Armenia, Bhutan, Cameroon, Cape Verde, China, P.R.: Mainland, Côte d'Ivoire, Equatorial Guinea, Georgia, Guyana, Kiribati, Mauritania, Moldova, Mongolia, Nicaragua, Nigeria, Pakistan, Uzbekistan.

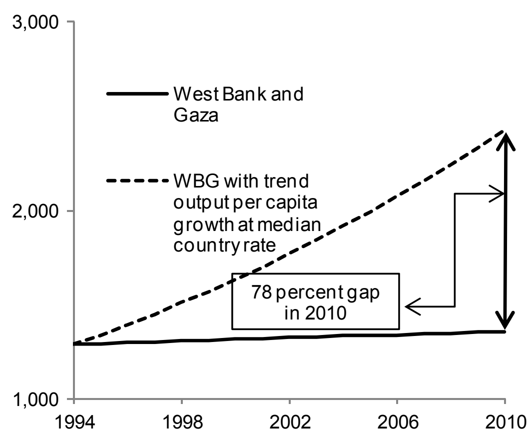
for 1994–2010 it is -0.5 percent. Had the WBG since 1994 had the same TFP growth as during 1968–87, real GDP per capita in 2010 would have been 56 percent higher than it actually was (Figure 3).

Figure 3. TFP Output Per Capita Gap Compared to 1968-87 WBG TFP
(In constant U.S. dollars)



3. Next, the WBG's performance was evaluated against other countries whose PPP-adjusted real GDP per capita was at about 20 percent above or below that of the WBG in 1994,. Among those countries ranked by the yearly growth of trend real GDP per capita since 1994 the WBG comes second lowest with growth of trend output per capita of −0.6 percent. The median trend growth rate was 4.0 percent. Had the WBG since 1994 had the trend output growth at the median rate, real GDP per capita in 2010 would have been 78 percent higher than it was (Figure 4).

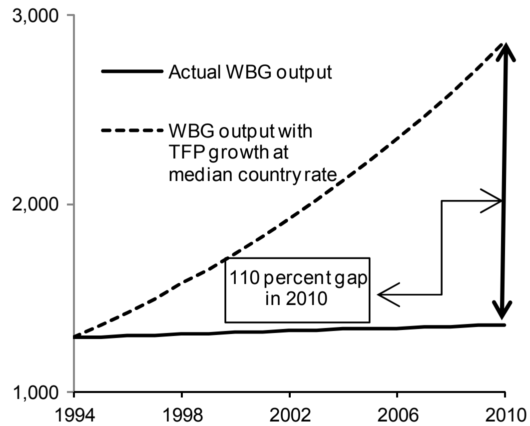
Figure 4. Trend Output Per Capita Gap Compared to Other Countries' Trend Growth
(In constant U.S. dollars)



4. The standard growth accounting framework was applied to decompose each country's output growth into contributions from capital, labor, and TFP. The WBG's average TFP growth per year since 1994, at -0.5 percent, was the second lowest in the group. The median TFP growth among the other countries was 3.0 percent per year. Had the WBG TFP grew since 1994 at the median TFP growth of 3.0 percent, the WBG's real GDP per capita in 2010 would have been 110 percent higher than it actually was (Figure 5).

Figure 5. Trend Output Per Capita Gap Compared to Other Countries' TFP

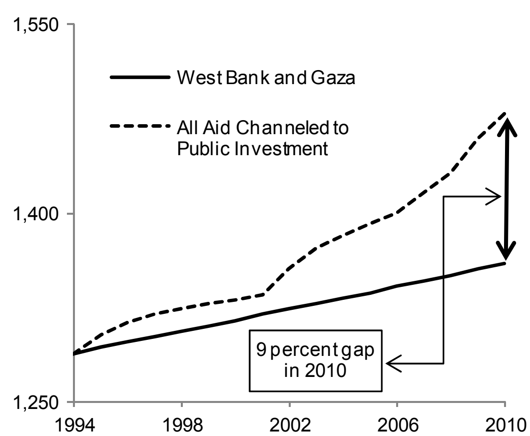
(In constant U.S. dollars)



5. The conflict and restrictions have raised external financing requirements for emergency and social spending. Given limited overall aid from donors, this has led to a diversion of aid from public investment to recurrent spending. Had all aid disbursed since 1994 been channeled to public investment, all else equal, real GDP per capita would have been 9 percent higher in 2010 than it actually was (Figure 6).

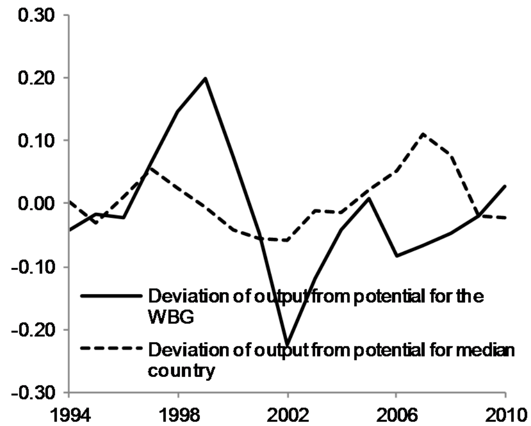
Figure 6. Trend Output per Capita Gap with All Aid Channeled to Public Investment

(In constant U.S. dollars)



6. Countries were next ranked by the volatility of their output as measured by the standard deviation of output from trend. The WBG has the second highest volatility in the group, with a standard deviation of 9.5 percent, compared to the median standard deviation of 4.7 percent (Figure 7).

Figure 7. Output Volatility
(In percent of potential output)



C. Economic Measures Agreed By the Quartet Representative and Israel

On February 4, 2011, the Quartet Representative and the GoI agreed on a package of measures to support the WBG's development. The package includes a series of initial, practical steps that need to be taken promptly. To expand Palestinian private sector activity and raise revenue to the PA in a sustainable manner, it is essential to build on those steps by lifting the remaining restrictions on movement and access.

1. Relaxing Gaza's export restrictions

Pre-agreement situation: Since the onset of the blockade in 2006, the GoI imposed a general ban on exports from Gaza. The GoI occasionally permitted the export of limited quantities of flowers and strawberries destined to EU markets.

Agreed measures and progress:

- *Starting on April 1, 2011*, the GoI will permit the export of textiles, furniture, and agricultural products from Gaza to international markets (but not to Israel or the West Bank). As of mid-March 2011, the GoI has permitted the export to EU markets of limited quantities of cherry tomatoes and sweet peppers, in addition to flowers and strawberries.

  Progress: Export of textile and furniture has been approved but has not yet commenced as Gaza exporters have traditionally relied on Israeli and West Bank markets and developing new international contacts has proven difficult. A transport mechanism to export tomatoes and potatoes to Jordan has been tested in July 2011 but so far nothing has been exported as a result of the high cost of transferring products through the Kerem Shalom crossing and seasonal price variations in Jordan.

- *By end-April 2011*, the GoI will decide on whether to allow PA-approved Gaza producers to transfer textiles and furniture to pre-approved West Bank purchasers.

  Progress: Measures not yet implemented as of end-August 2011.

- *Once a merchandise security scanner is installed*, *expected by mid-2011*, the GoI will increase the quantities, and potentially the range, of goods exported to all markets except Israel and the West Bank.

  Progress: Measures not yet implemented as of end-August 2011.

- *The GoI has agreed to consider, in due course, further relaxation of export restrictions.*

  Progress: Measures not yet implemented as of end-August 2011.

2. Relaxing Gaza’s import restrictions

Pre-agreement situation: From 2006 to mid-2010, the GoI allowed into Gaza mostly humanitarian goods and limited quantities of consumer goods on a “positive list”. Since mid-2010, it has applied a “negative” or “controlled goods” list, which in effect lifts restrictions on imports of consumer goods, as well as on inputs destined to pre-approved, internationally-supervised investment and construction projects. However, the policy has maintained import restrictions on a broad range of investment inputs for the private sector, including construction inputs, as well as machinery and equipment considered to have potential dual military/civilian use.

Agreed measures and progress:

- The GoI has agreed to discuss with the United Nations the implementation of a pilot arrangement, *to start on April 1, 2011*, to allow PA-approved Gaza businesses to import limited quantities of construction inputs.

  Progress: The pilot arrangement was approved in August 2011 and is expected to start in late-August, if the security situation permits. There has been no general relaxation of import restrictions on construction materials.

- *In progress since February 2011*: The GoI has agreed to pre-approve 20 new internationally supervised construction projects in Gaza including in the health, housing, infrastructure, and environmental areas. The funders of these projects are preparing to implement them in coordination with the GoI.

  Progress: New projects have been approved since February 2011 and this has contributed to the recent high growth rates in Gaza.

3. Enhancing energy supply to the West Bank and Gaza

Pre-agreement situation: Since 2006, Gaza has depended for its electricity mostly on an inefficient oil-based power station with obsolete equipment. Power outages have been frequent. Prior to September 2010, the plant was dependent on the provision of fuel purchased by the PA, but the subsidy was gradually phased out as payment of electricity bills by Gaza consumers improved.

Agreed measures and progress:

- *By June 2011*: The GoI agreed to conclude preliminary discussions with the PA on the development of the Gaza Marine offshore gas field. The development of this field will provide natural gas to both the Gaza Strip and the West Bank.

  Progress: none.

- The GoI has agreed to approve the upgrading of the existing power station and the construction of a second one following the submission of the PA plans. It has also agreed to the use of the gas from the Gaza Marine field (once developed) by the two plants, and to review requests to provide electricity to Gaza from Israeli sources.

Progress: The GoI has facilitated the entry of materials and staff to upgrade and maintain the existing power plant.

4. **Improving the collection of clearance revenue**

A key fiscal objective of the PA has been to raise clearance revenue toward its full potential through joint steps with the GoI, including through enhanced information-sharing and monitoring by PA officials of imports at crossing points/gateways. The GoI agreed to schedule regular meetings with the PA to identify and agree on measures to raise and streamline the transfer of revenue to the PA.

Progress: Meetings between officials from the Palestinian and Israeli Ministries of Finance began in March 2011 but were suspended in April following the signing of the Palestinian reconciliation agreement. Meetings resumed in July. See paragraph 14 in the main report for the key understandings reached, at a technical level, as of end-August 2011.