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WEST BANK AND GAZA

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

THE MEDIUM-TERM VIABILITY OF THE WEST BANK AND GAZA'S FISCAL FINANCING MODEL[1]

Over the past two years, the Palestinian Authority (PA) has operated fiscal policy on a model of large deficits financed mostly by donors. However, the donor aid has not been sufficient to fully cover financing gaps, prompting the authorities to resort to arrears financing and lending from the banking system. In addition, given heightened financial stress, day-to-day cash management has overtaken longer-term policy making and planning. The main conclusion of this chapter is that this situation is not sustainable, and that it implies risks to both macroeconomic and social stability. We suggest a set of policy options aimed at bringing revenues and spending closer into line with available financing.

A. Introduction

1.   The PA's financing model is showing signs of stress, and its medium-term viability is in question. The PA has long relied on donor aid to finance high deficits. However, during the last two years as aid declined, both in dollar terms and in terms of GDP, while deficits remained broadly unchanged, a large financing gap emerged. To fill the gap, the PA had to resort to running up arrears and scaling up domestic bank financing. By end-2012, arrears had reached $1.5 billion, or 14.5 percent of GDP, increasing by over US$1 billion in just two years.[2] Roughly half of the arrears are to the Pension Fund—they create unfunded future fiscal liabilities—and the rest are arrears for goods and services and tax refunds to private sector and Israeli utilities.[3] Meanwhile, lending from banks had reached $1.4 billion at end-2012 (112 percent of equity), and began to threaten financial stability, as banks exceeded prudential indicative target for lending to the government.[4] In the last two years, public debt, including arrears, increased by about 10 percentage points of GDP, reaching 38 percent, only two percentage points below the 40-percent threshold prescribed by the Law on Public Debt.[5]

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[1] Prepared by Anna Unigovskaya.

[2] This is an estimate, derived by adding up annual flows. It does not account for arrears that might be settled against tax obligations, and may not be fully comprehensive.

[3] According to Israeli accounts, electricity arrears, including by municipalities and the PA, stood at about NIS 900 millions in June.

[4] A prudential indicative target for banks' lending to the PA is for loans not to exceed 100 percent of banks' equity. The ratio has since declined to slightly below 100 percent.

[5] The threshold is stipulated in the law on public debt.

2.   The main objective of this chapter is to examine the medium-term sustainability of the PA's financing model in a baseline status quo scenario. Fiscal sustainability has two dimensions. *The first dimension* relates to a deficit that is financeable without resorting to arrears, or imposing undue hardships on the population by haphazardly cutting spending. Government arrears to the private sector are destabilizing for the economy, as they undermine financial discipline and increase the cost of credit, thereby hurting growth. They also exacerbate government financing problems by worsening tax arrears. In the extreme, the chain of arrears could permeate all economic sectors leading to large-scale barter trade and economic paralysis. Across-the-board or random spending cuts, on the other hand, undermine provision of basic government services, and could lead to a loss of social cohesion. *The second dimension* implies running a deficit that is consistent with medium-term debt sustainability. On both accounts, the situation in the WBG is worrisome if the current fiscal financing framework is maintained. This chapter focuses primarily on the financing dimension of debt sustainability; Annex I of the staff report analyses debt sustainability.

3.   A sharp improvement in the political context would alter the picture significantly. The analysis conservatively assumes the status quo. If instead there were a breakthrough in peace negotiations and a consequent lifting of Israeli restrictions, the West Bank and Gaza's (WBG) economic prospects, including the fiscal picture, would strengthen in fundamental ways.

B. Fiscal Sustainability Analysis and Results

4.   The analysis of fiscal sustainability of the WBG compares projected annual financing requirements of the PA and financing sources. Annual financing requirement is a sum of overall budget deficit, funds required to roll over debt that matures in the course of the year, and non regularized arrears outstanding at the beginning of the year. Available financing consists of grants for budget support and development, domestic bank financing to roll over debt, new domestic bank financing in line with the assumption that domestic bank financing is capped at 100 percent of banks' equity, and arrears roll over. The external private financing option is not available, as the WBG does not have financial market access because of its aid dependency and high degree of political uncertainty.[6]

5.   We maintain the conservative assumption of the status quo. This implies that peace prospects remain uncertain, Israeli restrictions remain in place and continue to stifle growth, and external demand remains subdued in line with the IMF World Economic Outlook projections. More specifically, it is assumed that:

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[6] Sale of government-owned assets is normally considered a financing source. The Palestine Investment Fund is the largest government-owned fund with investments in the West Bank and Gaza and abroad, and assets amounting to about $0.8 billion at end-2012. However, liquidity of these assets is unknown, and therefore the Fund is not included in this analysis.

- Growth in the medium term will slow down from 5.9 percent in 2012 to 3 percent in 2016 to reflect continued political uncertainly, fiscal retrenchment (necessitated by the dearth of financing), and weak private and external demand.

- The exchange rate will remain stable and inflation will stay low at 2.8 percent, in line with the policy of the Bank of Israel, which is the issuer of the NIS, the currency of the WBG.

- Overall deficits excluding grants are projected to decline from 16.5 percent of GDP in 2012 to 11.2 percent of GDP in 2016. A slow pace of fiscal consolidation (of about 1.3 percent per year) is driven by the current expenditure compression. Revenue is projected to remain broadly flat in terms of GDP to reflect slow progress with revenue mobilization.

- Donor aid is assumed to increase to about 12 percent of GDP in 2013 from 9 percent in 2012 (partly reflecting delayed disbursements from 2012), but then decline modestly to 8.6 percent of GDP in 2016 as donors face their own fiscal constraints and competing priorities.

- Beyond donor grants, financing will be limited to borrowing from domestic banks at prevailing interest rates, which are about 4 percent above the inflation rate.[7] It is assumed that all existing debt (including arrears) will be rolled over and that the new borrowing will increase by 8 percent per year in line with an assumed expansion of the banking sector's capacity. This will ensure that government debt-to-equity ratio remains within the prudential indicative norm, i.e. less than 100 percent.

Key Assumptions					
	2012	2013	2014	2015	2016
		Proj.	Proj.	Proj.	Proj.
Real GDP (% growth)	5.9	4.5	4.0	3.5	3.0
Inflation (% change)	2.8	2.5	2.7	2.8	2.8
Revenue (% of GDP)	20.2	18.9	19.1	19.1	19.2
Expenditure (% of GDP)	36.7	33.8	32.4	31.3	30.4
Deficit (overall; % of GDP)	-16.5	-14.9	-13.3	-12.2	-11.2
Donor overall support (% of GDP)	9.1	11.7	9.7	9.1	8.6
Credit to government ($, billion)	1.4	1.5	1.6	1.8	1.9

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[7] Note that monetization of deficits and boosting fiscal revenues via money creation (seigniorage) are not feasible in the WBG, as it does not have own currency.

6.   The results demonstrate that the current financing model is not sustainable (Figure 1). Under the baseline assumptions, the fiscal financing gap widens over the projection period to about $1.5 billion, or 10 percent of GDP by 2016. Sensitivity analysis indicates that the gap could be substantially higher if certain risks materialize. For illustrative purposes, we analyze the impact of two shocks: a decline in aid, and failure of the expenditure effort. A halving of aid, brought on, for instance, by donor fatigue, would almost triple the size of the financing gap by 2016. Moreover, given that aid has been unpredictable in the past, shortfalls in aid relative to budget targets would also cause fiscal difficulties, as experienced in 2012. Similarly, if even the modest expenditure compression assumed in the baseline fails to materialize, due to for instance non-containment of the wage bill or of electricity costs, the fiscal financing gap would double by 2016.

7.   The economic impact of a non-financeable deficit could be severe. Events in late 2012 and early 2013 provide an indication of what can happen when the PA has to resort to distortionary forms of finance and why such a financing model is not viable over the medium term. In the adverse scenarios outlined above, the PA would be forced into borrowing from the banking sector or running up further arrears. Alternatively, or in combination with the above, the PA could compress expenditures in a haphazard way. Either way, this would result in an adverse impact on the economy, and, with a negative feedback loop, on the public finances.

8.   Debt sustainability analysis also points to major risks. Under the baseline scenario, public debt, including arrears, remains sustainable, albeit an elevated level close to a 40-percent official threshold. However, under the two above-mentioned shocks, the debt quickly becomes unsustainable jumping by more than 10-percentage points of GDP in 2016 in the case of the aid shock.

C. Policy Recommendations

9.   Restoring fiscal viability would require a new financing model for the PA. A breakthrough in the peace process and related lifting of Israeli restrictions would relieve financing constraints. However, even in the absence of such a game changing improvement in the WBG's circumstances, there are a number of policies the PA could pursue on its own, with the support of donors. These policies relate to fiscal deficit containment, improving the composition of spending, and lifting constraints on growth that are under the control of the PA.[8] Moreover, to be credible, these policy adjustments should take place in the context of a medium-term fiscal framework, which could be embedded in the upcoming National Development Plan 2014–16. Specifically:

- **Deficits should be lowered**. This means making the level of PA expenditures more consistent with revenue generation and available financing, but also expanding revenues:

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[8] See the chapter on growth in this volume.

- *On expenditure*, a cross-country comparison shows that current spending and the wage bill are high relative to peers (Figure 2). Most importantly, the wage bill needs to be reduced over time in order to make room for spending that raises the productive potential of the Palestinian economy, especially capital spending. Such a reduction in spending on wages should be undertaken in the context of a comprehensive reform of the civil service. Use of transfers to vulnerable segments of the population will partially compensate for cuts elsewhere. Other medium-term reform priorities relate to health care and pensions, both areas where spending is on an unsustainable track. At the same time, the delivery of public services needs to be improved (which would also strengthen tax compliance), and continued public financial management reforms would help raise the efficiency of public spending.

- *On revenue, a* cross-country comparison of the WBG with other MENA oil importers suggests that the revenues in WBG have not reached their potential (Figure 2). The focus of reforms should be on broadening the tax base and improving compliance. With respect to domestic taxes, the recent IMF technical assistance recommended to review tax holidays and exemptions and to optimize the investment promotion law to ensure that it targets only new investments. The revenue forgone because of exemptions is estimated to amount up to 1½ percent of GDP.

10.   Efforts to boost growth would be essential to support fiscal sustainability. For instance, doubling of growth to 7–8 percent sustained over several years would slash the financing gap by half. To support growth, the PA must ensure sufficient pro-growth spending within available fiscal envelop, as outlined above. At less than 3 percent of GDP, capital spending, is extremely low compared to other MENA oil importers, and insufficient to support the vast infrastructure needs of the WBG. Additionally, a range of structural reforms to improve the business climate, support financial intermediation, and strengthen public institutions can go a long way to stimulate private domestic and foreign investment (see the other chapters on growth and credit determinants in this volume).

11.   Such fiscal adjustment will not be easy to undertake. For a transitional period, it will be important that donors step up their aid to the WBG and make it more predictable to support these difficult reforms.[9] While it will be important for the WBG to reduce aid dependency over time, the shift to a new financing model will require such transitional support.[10] For its part, the PA can generate goodwill among donors by implementing robust fiscal policies in a coherent medium-term framework. Indeed, international experience from other aid dependent economies suggests that strong fiscal adjustment can help generate political support among donors for more aid. Donors are

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[9] It is estimated, for example, that aid volatility reduces the effectiveness of aid by 15 to 20 percent. See Kharas (2008).

[10] International success stories of countries, e.g. Botswana, Korea and Taiwan, demonstrate that aid dependence could only be reduced gradually, over 15-25 year horizon to allow countries to put infrastructure and higher tax revenues and savings in place.
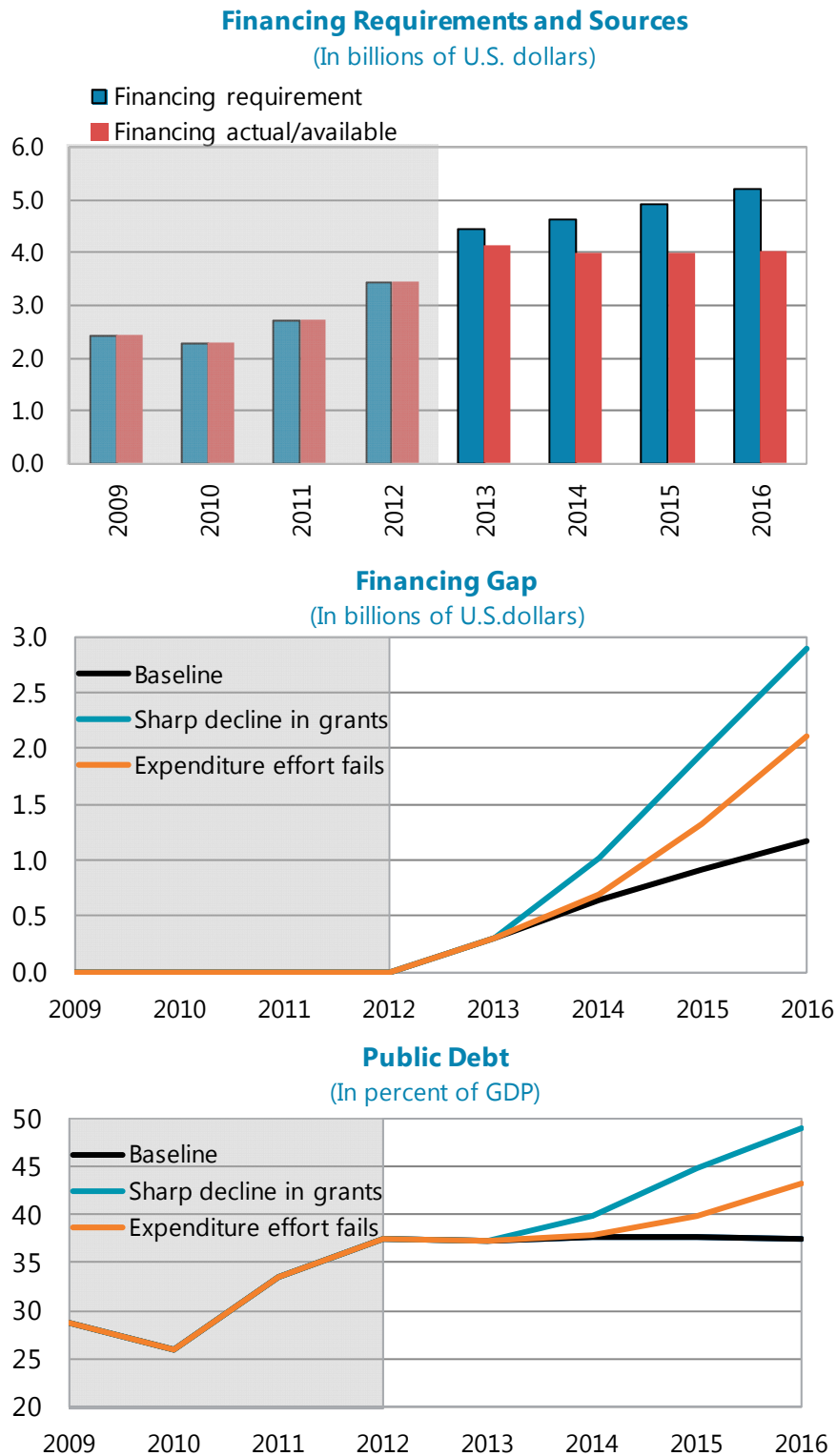
aware of pitfalls of aid dependency, which manifests in weakened incentives to mobilize revenue, especially from powerful groups, such as wealthier citizens and foreign investors, or undertake unpopular expenditure reforms. With that in mind, countries adjust policies. International evidence suggests that countries that are able to make progress towards implementing sound policies are also receiving higher grants, especially for development.[11]

12.   The development of a domestic securities market would expand the financing options of the PA. Domestic financing options are currently very limited, as government debt is not securitized and not held by the general public, so establishing a market for securitized government debt would help deepen the financial market, and over time, provide the PA with more flexible and modern financing options.[12]

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[11] See *Real Aid 3: Ending Aid Dependency* by Anna Thomas, et al., London: ActionAid, 2011.

[12] Financial deepening helps ease government financing constraints and improve overall macroeconomic stability. See, for instance, Dabla-Norris and Srivisal (2013).

**Figure 1. West Bank and Gaza: Medium-Term Public Financing Outlook**

Financing Requirements and Sources
(In billions of U.S. dollars)

■ Financing requirement
■ Financing actual/available

Financing Gap
(In billions of U.S.dollars)

— Baseline
— Sharp decline in grants
— Expenditure effort fails

Public Debt
(In percent of GDP)

— Baseline
— Sharp decline in grants
— Expenditure effort fails

Sources: Ministry of Finance; and IMF staff projections.

Figure 2. West Bank and Gaza: Comparisons of Selected Fiscal Indicators with MENA
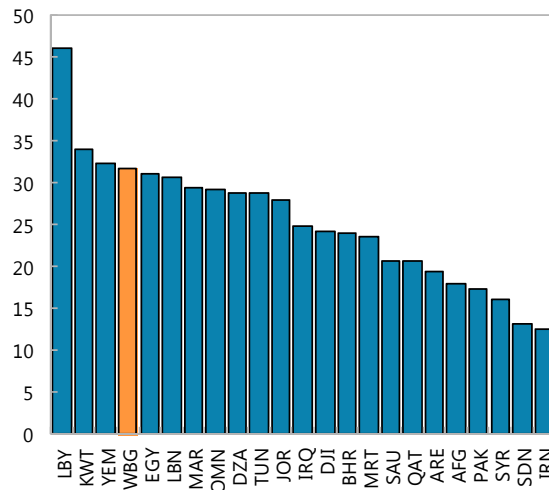
Non Grant Revenue 1/
(In percent of GDP)
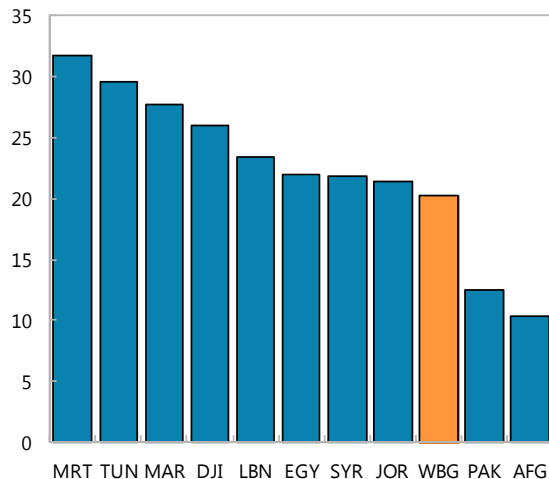
1/ Excluding Oil Exporters

Current Expenditure 1/
(In percent of GDP)

1/ Or latest available. General government data, except AFG, ALG, SAU and WBG, for which central government data were used.

Wages 1/
(In percent of GDP)

1/ Or latest available. General government data, except AFG, ALG, SAU and WBG, for which central government data were used.
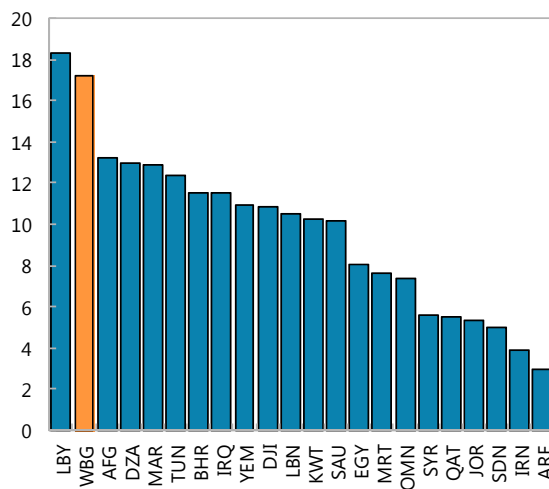
Capital Expenditure 1/ 2/
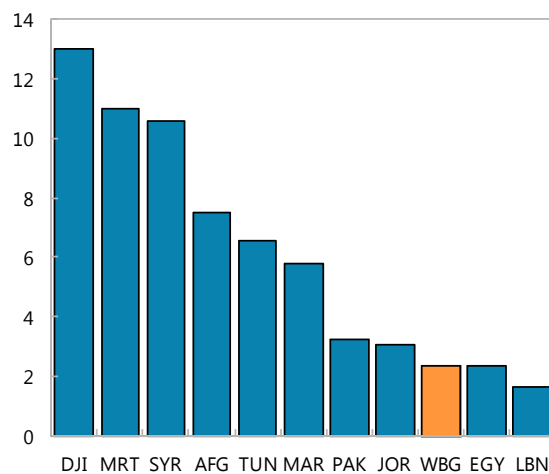(In percent of GDP)

1/ Or latest available. General government data, except AFG, ALG, SAU and WBG, for which central government data were used.
2/ Excluding Oil Exporters

Sources: World Economic Outlook; and Palestinian Authorities.

References

Dabla-Norris, Era, and Narapong Srivisal, 2013, *Revisiting the Link between Finance and Macroeconomic Volatility* (Washington: International Monetary Fund).

International Monetary Fund, *Staff Report for the Meeting of the Ad-Hoc Liaison Committee*, various editions: April 2011; March 2012; September 2012 (Washington).

Kharas, Homi J., 2008, *Measuring the Cost of Aid Volatility* (Washington: Wolfensohn Center for Development, Brookings Institution).

Anna Thomas, et al., 2011, *Real Aid 3: Ending Aid Dependency* London: ActionAid.

GROWTH IN THE PALESTINIAN ECONOMY[1]

This chapter looks at the recent growth performance of the Palestinian economy. Growth has been volatile and fueled by consumption, both public and private. Investment, on the other hand, has been weak, and the creation of new jobs has not been able to keep pace with the rising labor force. To a large extent, these patterns reflect the West Bank and Gaza's (WBG) political context and the restrictions imposed by Israel, which are the key obstacle to a more sustainable growth pattern. Nonetheless, this chapter examines whether domestic policies under the control of the Palestinian Authority (PA) can help to strengthen inclusive growth. The paper finds that scope for such policies exists, especially in the areas of business climate, access to credit, and international competitiveness.
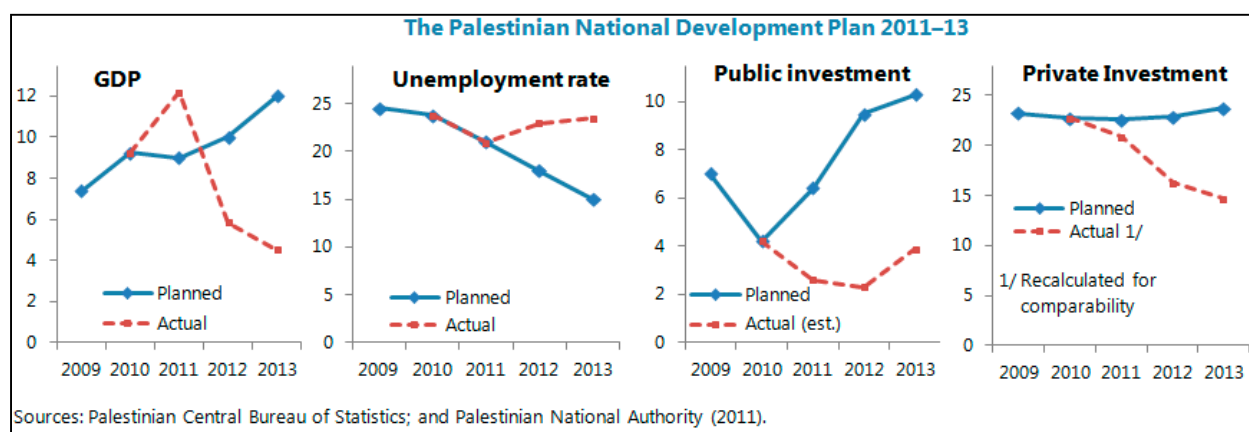
A. The Growth Narrative

1.   **Growth has been volatile, reflecting mostly political factors.** In the early years of the PA, following the 1993 Oslo agreement, growth reflected increased confidence and institution building as the PA assumed its administrative responsibilities. This trend was reversed between 2000 and 2002, during the Second Intifada and the subsequent tightening of Israeli restrictions. Growth rebounded thereafter, but real GDP per capita did not recover to the 1994 level until 2005. Hamas'

victory in the 2006 elections and its takeover of Gaza brought international sanctions and a tight blockade of Gaza, which led to another deep economic contraction. Growth resumed in 2007 in the West Bank when the international community supported the caretaker government with high levels of aid, but in Gaza growth only began to rebound in mid-2010, after some easing of the blockade and expansion of the "tunnel trade" with Egypt.

Growth in West Bank and Gaza
(In percent)

Source: Palestinian Central Bureau of Statistics.

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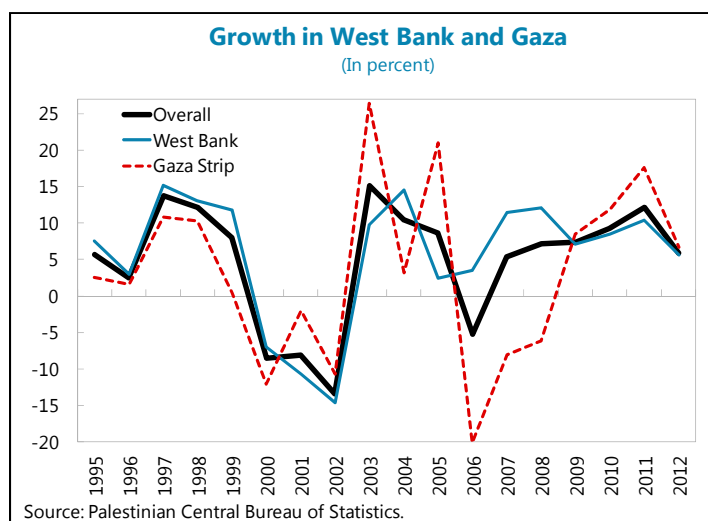
[1] Prepared by Marcin Sasin.

2.   Economic performance has deteriorated recently. The Palestinian National Development Plan 2011–13 set ambitious objectives which were not achieved. Growth, after peaking at 12 percent in 2011, decelerated to below 6 percent in 2012, compared with projections in excess of 10 percent. (Most of the decline was in the West Bank, as Gaza is still catching up after the sharp drop in output following the blockade.) Consequently, the downward trend in the unemployment rate has reversed, with more than 20 percent of the labor force out of work at end-June 2013, instead of the projected 15 percent. As discussed below, the reasons behind this deterioration are the long-standing economic and political uncertainty and uncertain aid flows. With the Israeli restrictions thwarting private-sector investment, the public sector remains the dominant force in the economy.

The Palestinian National Development Plan 2011–13

Sources: Palestinian Central Bureau of Statistics; and Palestinian National Authority (2011).

3.   Since 2004, growth in the WBG has been driven by consumption, nontradable services and labor inputs.

- *Growth has been driven by private and public consumption, fuelled by aid, and directed towards nontradable services.* Public consumption, though only a quarter of GDP in 2004, provided almost half of economic growth. The overall public-sector share in value added grew from 25 percent in 2007 to more than 30 percent in 2012. The service sector has been the main driver, contributing more than half of economic growth, and expanding to account for two-thirds of the economy in 2012. Although there is nothing wrong, in principle, with a service-based economy, it is not optimal in its current form in the WBG because the services produced—such as health, education or small-scale private services—are not tradable. As a result the capacity of the economy to pay for imports is weakening and the economy needs to be supported by external flows.

- *A growth accounting exercise suggests that growth has been driven mostly by labor inputs*, which accounted for more than half of the overall growth, followed by total factor productivity, accounting for about a quarter of the growth (about 1½ percentage points annually). The contribution of capital has been only about 10 percent—that is only about 0.6 percentage points

per year out of the total average annual growth of 6 percent over the same period, compared with an average of about 1.3 percentage points for the capital contribution seen across all countries over the past decade.[2] Private investment has stagnated in recent years at about 15 percent of GDP and declined further to 13 percent of GDP in 2012. At the same time, as fiscal space has been squeezed by recurrent expenditures, public investment has virtually collapsed from an average of about 9 percent of GDP in 2006–09 to less than 4 percent of GDP afterwards—a level likely insufficient to replace the depreciating stock. Furthermore investment has been directed largely to residential construction, rather than machinery, equipment or productive business infrastructure. Consequently, capacity in the tradable sectors has not developed—the shares of agriculture and manufacturing in value added fell from 13 and 20 percent, respectively, in 1994 to 8 and 16 percent in 2004 and further to 6 and 13 percent in 2012.

Sectors and Drivers of Growth in West Bank and Gaza

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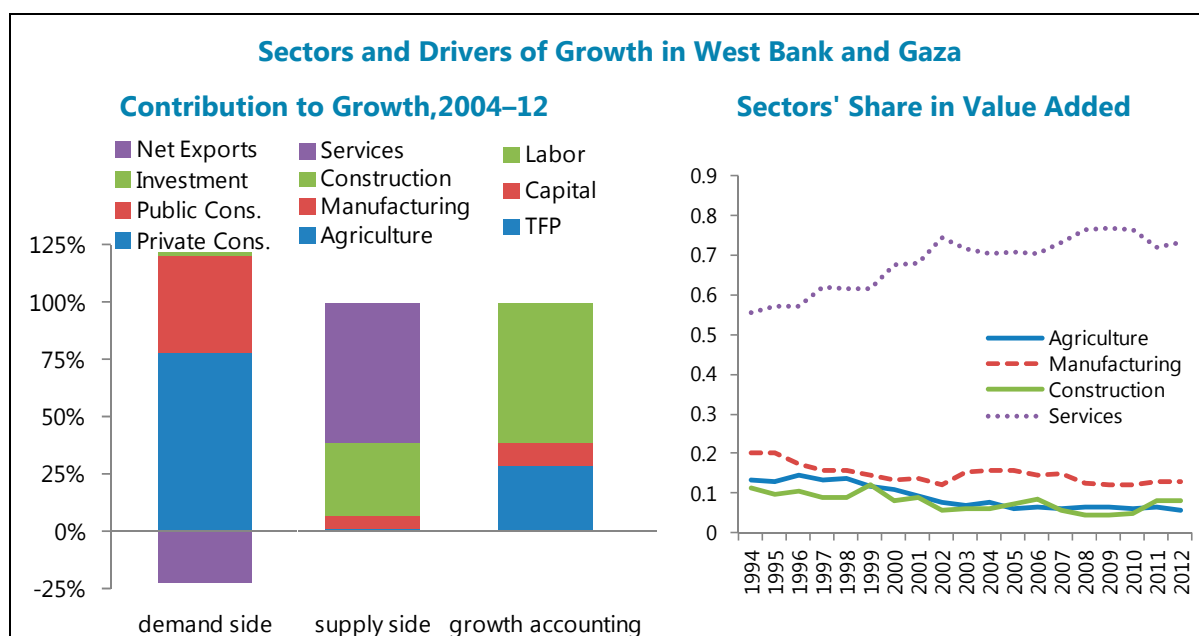
[2] Growth accounting takes a standard Cobb-Douglas production function $Y=A \cdot K^{\alpha} \cdot L^{(1-\alpha)}$ that combines factor inputs—capital K and labor L—and total factor productivity A to produce output Y, to decompose growth as $\Delta Y/Y = \Delta A/A + \alpha \cdot \Delta K/K + (1-\alpha) \cdot \Delta L/L$, that is into contributions from growth of productivity, capital and labor respectively. Consistent with the literature, it is assumed that $\alpha=1/3$. Furthermore, for the estimation of the capital stock, it is assumed that the depreciation rate is 5 percent, while the initial (1994) stock of capital is given by the average capital-output ratio for the whole period (1994–2002), for which data are available.

4.   The Israeli restrictions on movement and access and the uncertain political and security environment are the main factors behind the WBG's public sector led growth. Bureaucratic and physical impediments to private-sector activity include an economic blockade of Gaza; tight restrictions on economic development in Area C (which comprises about 60 percent of the WBG's territory and has significant economic potential); a fragmentation of the WBG into disconnected areas, which constricts the market and limits economies of scale; an extensive system of checkpoints and closures that hamper Palestinian firms from reliably supplying clients; restricted access to resources, such as water or land resulting in scarcity and high costs; lack of control over the WBG's external trade through control of borders as well as restrictions on imports and exports, including intermediate and investment goods.[3] The broad and permanent relaxation of these restrictions that would be associated with progress in the peace process would have by far the biggest positive impact of any conceivable measure on restoring private-sector investment and growth, and improving the fiscal outlook.[4]

5.   The Palestinian economy has grown less competitive and more aid dependent. Merchandise exports are only 7 percent of GDP,[5] and comprise mostly labor-intensive and natural resource intensive goods with little value added, such as building stone, garments, footwear, or furniture. This composition has not changed much from the past, when the Palestinian economy was supplying the Israeli market with labor-intensive goods, taking advantage of a relatively protective customs union. Since then, Israel transitioned to a high-value economy and removed protections for imports of low-value-added goods, while the Palestinian economy, limited by the restrictions and facing difficulties to invest and increase productivity, fell behind with a high cost structure that rendered it uncompetitive in the international market place.[6] Despite stagnant export sectors, imports continued to grow, supported by donor aid, which was increasing steadily until it peaked at more than 30 percent of GDP in 2008.

6.   The situation is becoming difficult to sustain. By 2011, aid had fallen sharply from its peak levels, but fiscal policy has been slow to adjust to tighter financing constraints. The government is resorting to domestic bank borrowing and extraordinary means of financing via arrears and the private sector is running down foreign assets to pay for imports. With productivity too low to support the high wages in the low-value-added sectors, there is a risk of falling real

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[3] It is not clear to what extent these restrictions reflect institutionalized bureaucratic inertia. Israel has been making some efforts to limit the negative economic impact of the restrictions, such as extending the hours of border check-points, installing merchandise scanners to speed up inspections, replacing some roadblocks with road gates, or allowing donors to upgrade secondary roads to underpass the main roads inaccessible to Palestinians. Notwithstanding the value of these changes, there is a risk of institutionalizing an inefficient and costly system.

[4] Various estimates suggest that had the WBG been free of restrictions and afforded similar growth conditions as other countries, potential GDP could have been higher by between 56 and 88 percent. See IMF (2011) and PA (2011) for more analysis of the costs of the restrictions.

[5] Data exclude East Jerusalem; see World Bank (2013) for more discussion on the WBG's competitiveness.

[6] For example, in agriculture, productivity measured by output per worker halved over 1994–2012.

wages or higher unemployment resulting in social hardship and a risk of unrest.[7] To avoid this outcome, the WBG economy will need to expand and raise productivity in the tradable sector through investment.

B. Growth Diagnostics

7.   Although restrictions and political uncertainty are the most binding constraints the PA can take measures to foster a better environment for private-sector investment. The currently binding restrictions on movement and access may be masking other deficiencies in the investment climate. Were the restrictions to be lifted tomorrow, the growth spurt might be short-lived as these other factors would become the binding impediments. In order to identify priority measures, the following section discusses, in a structured way, using a framework of Growth Diagnostics, the various factors potentially affecting incentives to invest.[8]

8.   The Growth Diagnostics framework offers a way to systematically look into factors affecting incentives to invest. From the perspective of an investor, incentives to invest depend on a comparison between how much it costs to finance an investment ("cost of finance") and the private returns to this investment, which in turn depend on the general returns to economic activity in the economy ("social returns") and the extent to which an investor can capture these returns ("appropriability"). Within each of these broad areas there are various potential constraints to private investment. This section discusses these constraints in the context of the Palestinian economy.
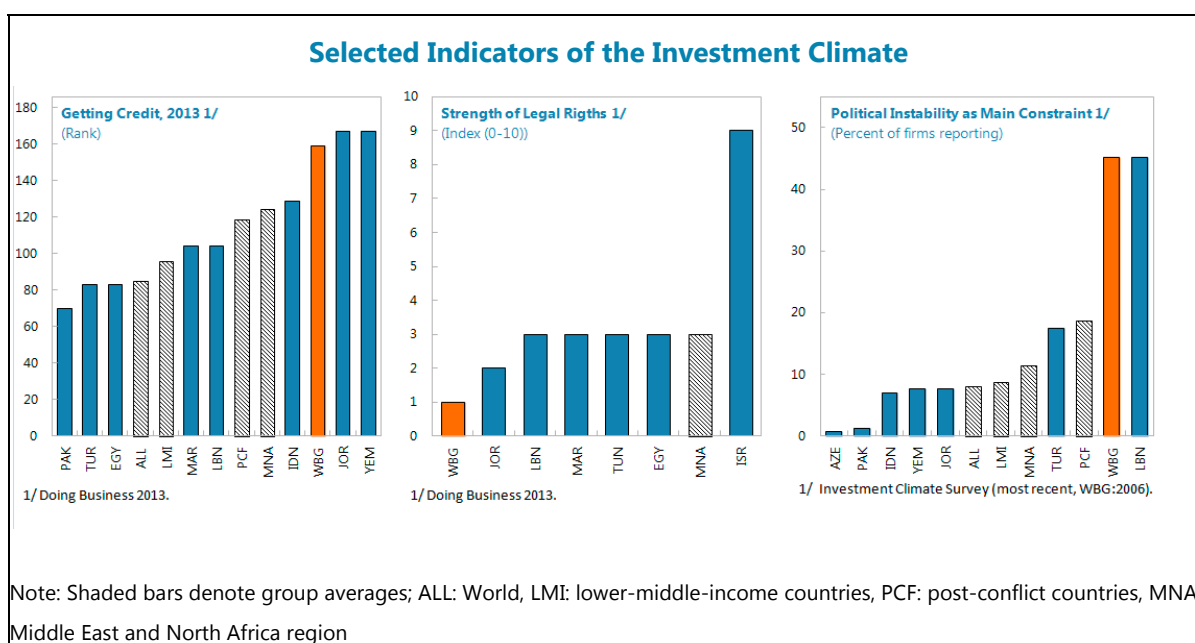
Growth Diagnostics Decision Tree
Possible constraints to (causes of) low private investment

High costs of finance
    Low savings
    Poor intermediation

Low returns to economic activity
  Low social returns
    Human capital
    Infrastructure
    Geography
    Political and other risks
  Low appropriability
    Market failures (eg., information externalities)
    Institutional failures
      Macro risks (financial, monetary, fiscal instability)
      Micro risks (institutional and business environment)

Source: Hausmann, Rodrick and Velasco (various years).

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[7] Even though real wages in the past decade have fallen by between 10 and 30 percent (depending on the skill level), wages are still high by international standards: for example, the World Bank (2012) finds that office workers' entry-level wages in the WBG are nearly 25 percent higher than in Turkey and 75 percent higher than in India.

[8] The approach has been developed by economists Hausmann, Rodrik and Velasco (2005).

Is high cost of finance a constraint?

9.   While availability and cost of finance may not be the most important constraint to investment for now, the lending environment needs to be improved.[9] With capital-assets ratio over 20 percent, non-performing loans (NPLs) ratio below 5 percent, ample liquidity, high profitability, and tight supervision, the Palestinian banking sector is healthy by most criteria. After a surge in 2008–10, credit to the private sector remains at about 28 percent of GDP—low by international standards, but only slightly below the regional benchmark. Consumer and residential mortgage credits are the largest and fastest growing components, however, while investment credit is falling. Even leaving aside the general lack of profitable investment opportunities in the economy constricted by restrictions, banks find it too risky to make unsecured, cash-based loans to the predominantly micro- and small enterprises, which have little experience in dealing with formal financial institutions and are unable to produce audited/certified financial statements. Weak creditor legal rights, as documented in the World Bank's Doing Business studies, because of deficiencies in legislation and its implementation, further impede credit. As a result, banks' lending relies on collateral, while the majority of enterprises finance their investments from retained earnings. As credit growth has recently fallen to about 10 percent, efforts to promote lending to the domestic economy should be strengthened.

Selected Indicators of the Investment Climate

Note: Shaded bars denote group averages; ALL: World, LMI: lower-middle-income countries, PCF: post-conflict countries, MNA: Middle East and North Africa region

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[9] See the last chapter in this volume on determinants of credit in the WBG for a more in-depth discussion on credit and the banking sector, including on measures needed to improve the lending environment.

Are returns to economic activity generally too low?

10.   One set of potential constraints is related to the overall level of returns in the economy, which may be too low to warrant an investment. These constraints include the availability and quality of labor/human capital, adequacy of infrastructure as well as geographic, political, and other factors. In the case of the WBG they are often effects of the Israeli restrictions.

- *Human capital and the labor market are not constraints to growth, but the education system should be improved to better match the requirements of a modernizing economy.* Education indicators in the WBG compare favorably with other countries. Enrollment rates are high, and English as well as computer literacy is satisfactory. Also, business environment surveys consistently find that labor regulations are not seen as particularly burdensome. On the other hand, employers report that, despite high unemployment, it is difficult to find qualified candidates with the right skills. As in other countries in the region, where wages in the public sector are high, students, hoping to get a government job, acquire skills that are not needed by the modern economy and neglect core competencies of communication, analysis, problem-solving, and work ethics. Reforms in this area take time to produce tangible results.

- *While infrastructure is available, its high costs impact competitiveness, and the underinvestment of the past years is starting to affect reliability.* Access to electricity is adequate and roads are generally good; nevertheless, there is plenty of anecdotal evidence that infrastructure represents a bottleneck for business, in part because of high costs, which are often related to Israeli restrictions. Lack of control of resources in Area C is particularly problematic, as it has resulted in scarcity of serviced land and water.

- *Geographic disadvantages are related to the restrictions.* Borders and access to ports are not under the WBG's control, while its economic territory is fragmented by restrictions and reduced to numerous disconnected areas that thwart economies of scale and enterprise growth.

- *The uncertainty created by the volatile political environment is perceived as a major constraint.* Without a sufficiently long time horizon of stability and predictability investors are likely to be wary of putting up significant capital, particularly in manufacturing or agriculture.

Can investors take advantage of the opportunities and capture returns?

11.   When profitable opportunities exist, investors need to be able to benefit from them. Important factors in this respect are information and know-how, limited externalities in the economy, a stable macroeconomic environment and a favorable institutional and business environment, including low corruption, a level playing field for firms, good legislation, and business-friendly administration. The relevant factors are discussed below.

12.   Many Palestinian enterprises lack the capacity to operate in a competitive international environment. Most enterprises are small (fewer than five employees), family-operated firms that supply isolated local markets. Enterprises that trade internationally have

typically been conducting business through Israeli middlemen, and have little independent interaction with foreign businesses. There is little foreign investment that would transfer know-how. To succeed, Palestinian enterprises need to develop their own connections, promote Palestinian products branding, learn to identify and enter new markets, implement quality standards and licenses, and build and upgrade their know-how.

13. **Risks to macroeconomic stability have increased due to a growing public sector footprint.** These risks are associated with:

- *Heightened vulnerability to aid, revenue, or expenditure shocks, increasing the risk of a disorderly fiscal adjustment and arrears accumulation.* Haphazard spending cuts could undermine the provision of basic government services while arrears undermine financial discipline (see the first chapter in this volume on fiscal sustainability) and hurt enterprises directly by increasing uncertainty and the costs of doing business.

- *High exposure of banks to the PA as a result of its borrowing to finance large deficits, adding significant risks to the financial sector.* In case the PA defaults on its credits, the currently underfunded deposit insurance may not be able to fully cover the lost deposits (see the last chapter in this volume on determinants of credit).

- *Potential crowding out of the private sector* from key markets, including the financial market and the labor market.

- *Producing expectations of higher taxation in the future* that would be needed to repay the mounting debt, including contingent pension liabilities.

14. **The WBG is lagging behind its peers in business environment indicators.** It ranks 135th out of 185 countries in the ease of doing business, and 179th on the "starting a business" criterion. This is unfortunate, because in order to overcome other disadvantages of its investment environment the WBG should distinctly surpass its neighbors. In that respect it is worth noting that:

- *The quality of Palestinian public institutions has improved markedly since the creation of the PA.* The PA is now able to independently conduct economic policies. A 2006 Investment Climate Assessment survey revealed that public officials rarely demanded bribes. Since then, the perception of prevalence of corruption has further improved.

- *However, the playing field for businesses could be improved.* The Palestinian business universe appears to consist of two tiers: well-connected large formal enterprises with good access to policymakers and international contacts and the related business opportunities versus the remainder of small firms. There is a need to build up a competition framework and regulatory bodies which serve to prevent the emergence of private monopolies or oligopolies.

- *The legal framework is not business-friendly.* Much of the economic legislation is inadequate for a modern economy and needs to be updated, clarified, and harmonized; burdensome procedures need to be simplified and costs reduced. A closer inspection of the most

problematic indicators in the Doing Business survey reveals that problems generally relate to high costs, incomplete and inconsistent legislation, and numerous and burdensome procedures needed to start or operate a business. Although many costs are related to Israeli restrictions, others are under the control of the PA and can be reduced. The Palestinian legal framework for economic activity is an incomplete, complex and often inconsistent patchwork of laws from different periods and legal traditions. The same applies to secondary regulations.[10] Examples of missing or outdated laws include: the company law, the movable assets law, the competition law, the financial leasing law, the insolvency regime, and the land law.[11]

Doing Business in West Bank and Gaza

1/ Doing Business, 2013
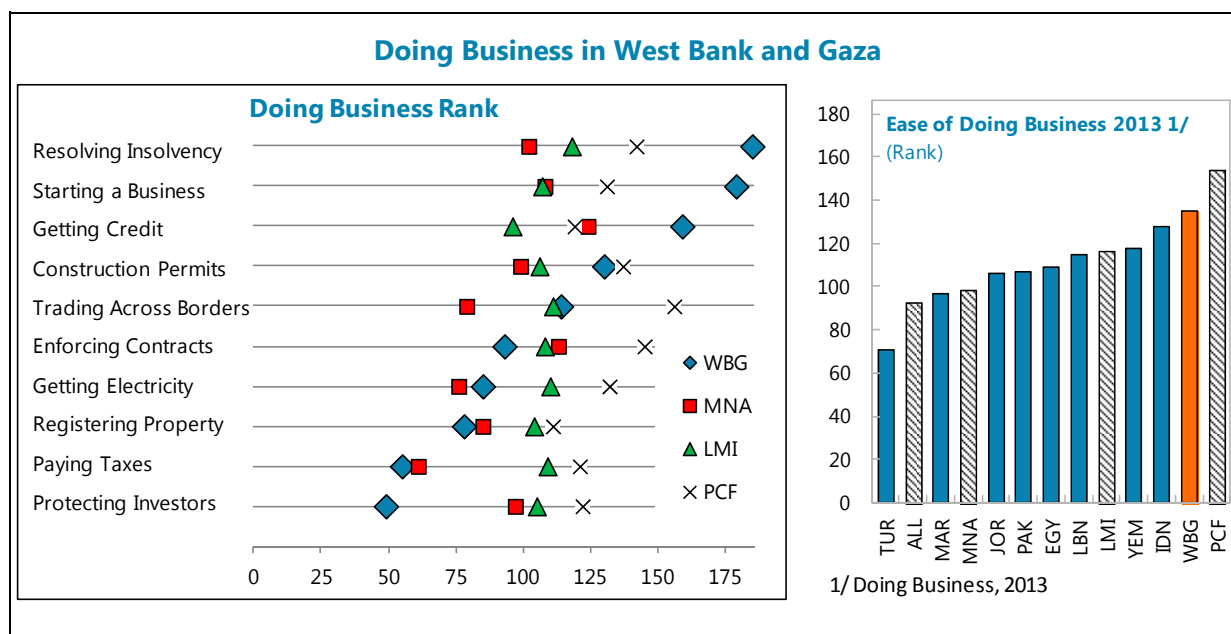
C. Policy Recommendations

15.   The growth potential of the Palestinian economy can be improved by:

- *Taking measures to ensure sustainable public finances and improve the composition of public spending*. This would safeguard macroeconomic stability (inter alia, by reducing risks in the financial system stemming from its high exposure to the PA), open space for development spending, lend credibility to investors' expectations of a friendly, low-tax, low-cost-of-finance environment in the future and, last but not least, stop the arrears, which has become extremely

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[10] Many regulations mandated by and cited in laws have never been enacted.

[11] Some of these laws are in draft form, awaiting presidential signature; however, the absence of a functioning legislature hampers a proper consultative process, and as a result, delays the signing of draft legislation into law.
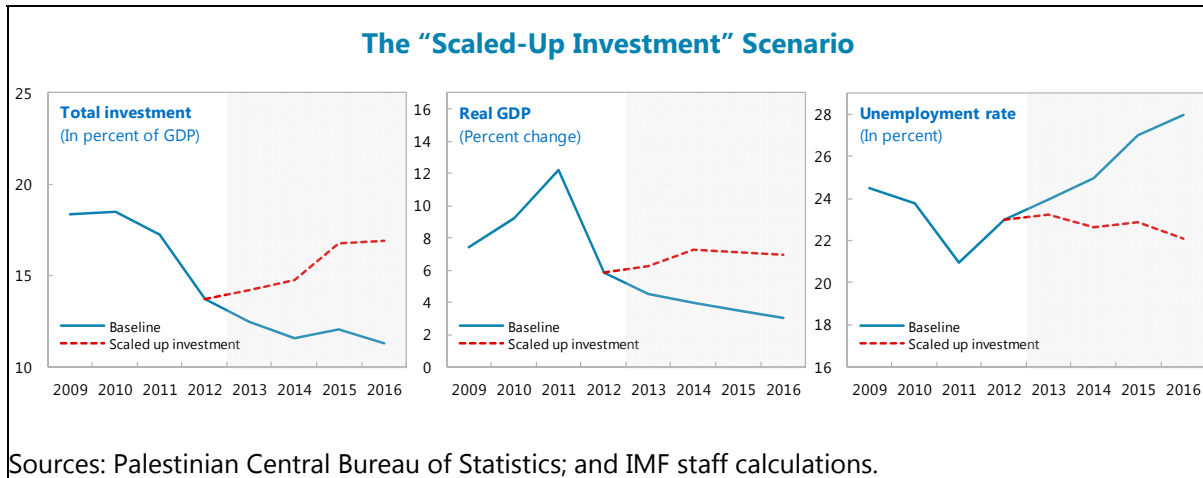
detrimental to the private sector. Fiscal consolidation is urgently needed but should be gradual and, growth-friendly, and mindful of the social environment.

- *Improving the business environment.* Costs should be reduced where possible, burdensome procedures simplified, and the incomplete, inconsistent and complex economic legislation updated, clarified, and harmonized. The PA could start with a review of laws to ensure their business-friendliness, consistency, and fairness. Such a review could be undertaken with the involvement of the business community.

- *Continuing efforts to improve access to credit, in particular for small- and medium-sized enterprises (SMEs).* Actions could include improving the availability and usefulness of collateral and strengthening creditors rights (by, inter alia, enacting the movable assets law, as well as improving the judicial aspects, including speeding up court procedures, training judges or promoting out-of court enforcement), encouraging better financial reporting (that would enable cash-flow lending), developing leasing, further exploring loan-guarantee funds that reduce the risk of lending to SMEs, and strengthening the institutional environment to attract non-bank financial institutions.

- *Promoting business competitiveness* via collection of market intelligence, facilitation of business contacts, promotion of the Palestinian brand, implementation of internationally recognized standards, and development of other business-supporting services and institutions.

D.   How Would the Economy Evolve in Case of Limited Reforms?

16.   An illustrative "scaled-up investment" scenario suggests that policy actions along the lines discussed in the previous section, supported by a limited relaxation of restrictions and continued aid flows, could increase growth by about three percentage points over the next three years. If successful, these policy actions should help bring investment to levels seen in the past (about 16 percent of GDP) and should result in growth—based on employment elasticities estimated in the next chapter in this volume on growth and employment—that is sufficient to reverse the increase in the unemployment rate expected under the status-quo ("baseline") scenario.[12]

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[12] See the IMF *Staff Report presented at the meeting of the Ad Hoc Liaison Committee, New York, September 2013* for details on the baseline projections.

The "Scaled-Up Investment" Scenario

Total investment
(In percent of GDP)

— Baseline
- - - Scaled up investment

Real GDP
(Percent change)

— Baseline
- - - Scaled up investment

Unemployment rate
(In percent)

— Baseline
- - - Scaled up investment

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

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THE LINK BETWEEN GROWTH, EMPLOYMENT, AND UNEMPLOYMENT IN THE WEST BANK AND IN GAZA[1]

Our analysis shows that removing Israeli restrictions would be crucial to creating a more flexible labor market needed for employment-intensive growth. Palestinian Authority can contribute by reforming the civil service to create a level playing field for the private sector. We find that even with an optimistic growth outlook and taking into account the possible effect of relaxation of Israeli restrictions and regulatory reforms (including reforms of the civil service), unemployment rates in the West Bank and in Gaza would remain high at about 16–17 percent in 2016, although the dispersion of unemployment would lessen. Provided that reforms and the removal of Israeli restrictions endure, and provided that the political outlook improves, the unemployment rate could continue to decline to single digits over the longer term.

A. Introduction

1.   The labor market in the West Bank and Gaza (WBG) is characterized by persistently high unemployment, with low employment growth as the main culprit. The unemployment rate in the WBG has fluctuated between 20 percent and 24 percent since 1995, except for a peak of 31 percent during the Intifada in 2002 and a few years with lower unemployment in the 1990s. Although demographic factors certainly played a role, the main reason is low employment growth. Fertility rates have declined in the past two decades, but remain high. Labor force participation, especially among women, is low despite a modest upward trend. With slightly higher participation rates offsetting the effect of lower population growth, the average growth of the labor force (the 'demand' for jobs)

| Stylized Facts About the Palestinian Labor Market						
	2012			Average 1995-2012		
	WBG	West Bank	Gaza	WBG	West Bank	Gaza
Population (x1,000, mid year)	4,293	2,649	1,644	3,388	2,133	1,255
Share of population aged <16 (percent)	40.4	38.4	43.7	44.6	42.7	47.7
Fertility rate 1/	4.4	4.0	5.2	4.9	4.4	5.7
Unemployment rate	23.0	19.0	31.0	22.2	18.2	30.7
Youth unemployment rate (aged 15-29)	35.2	35.2	47.5	29.8	25.0	39.7
Participation rate	0.44	0.46	0.40	0.41	0.43	0.37
Female participation rate	0.17	0.19	0.15	0.13	0.16	0.09
Total employed (x1,000)	858	602	256	601	433	168
Share of total employed (percent)						
Public sector	23	16	39	21	15	36
Private sector	68	70	61	66	69	61
Israel and settlements 2/	10	14	0	13	16	14
Memo item						
Real GDP growth	5.9	5.6	6.6	4.9	5.7	3.4

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

1/ 2010 instead of 2012 and average is based on PCBS surveys for 1997, 2004, 2006, 2007, and 2010.
2/ 1997-2000. As a result totals do not add up to 100.

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[1] Prepared by Udo Kock with research assistance from Hania Qassis.

has not shown a clear trend up or down and has averaged 4.8 percent since 1994. Total employment (the 'supply' of jobs) on average grew at roughly the same rate and as a result no progress has been made in the past two decades in reducing unemployment.

Real GDP Growth in West Bank Versus Gaza, 1994–2012	Unemployment in West Bank Versus Gaza, 1994–2012

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

Sources: Palestinian Central Bureau of Statistics; and IMF staff calculations.
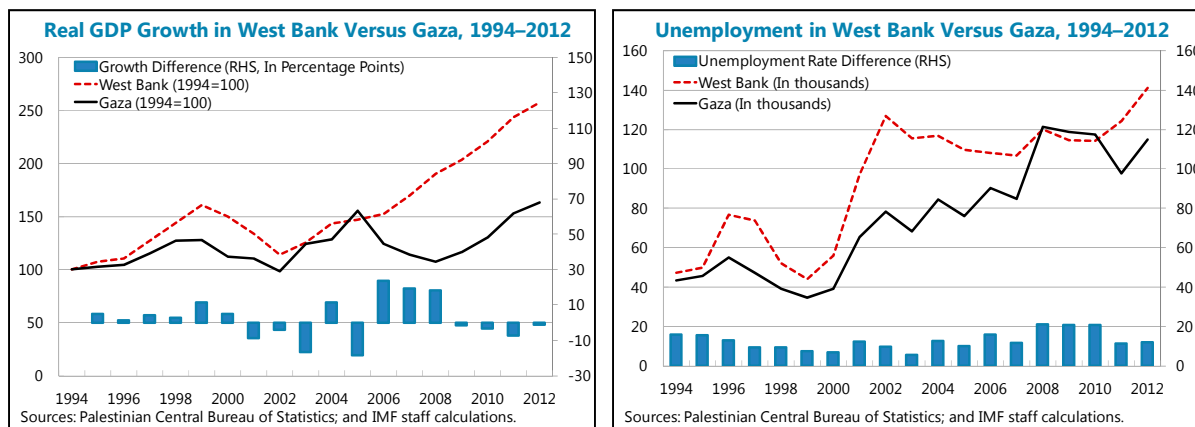
2.   Widely different growth and unemployment trajectories in the West Bank and in Gaza, as well as other distinct characteristics of the Palestinian labor market, call for a disaggregated analysis of the growth-employment nexus. Since 1994, the absolute average annual difference in real GDP growth was 9.1 percentage points in favor of the West Bank. Excluding 2003–08, when the Intifada and military conflict in Gaza resulted in large growth differences, still leaves an average annual growth gap of 4.6 percentage points. After the military conflict in 2006 and the virtual closure of Gaza, a large gap in output opened up between the two territories; unemployment was much higher in Gaza than in the West Bank (about 36½ percent versus 19½ percent on average since 2003). Differences in youth unemployment (aged 15–29) are similar: 28.7 percent in the West Bank versus a staggering 47.5 percent in Gaza at end-2012. The differences in economic structure and growth trajectories suggest that employment elasticities are very different in the two territories. The large share of public-sector employment and employment in Israel and settlements (in Gaza only until the outbreak of the Intifada in 2001) also renders aggregated employment elasticities—which measure the impact of changes in output on total employment—less useful.[2] A disaggregated analysis of employment elasticities in the West Bank and Gaza is also motivated by recent studies

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[2] There is evidence that across countries public-sector employment crowds out private sector employment, with the effect potentially stronger in the Middle East and North Africa (see A. Behar and J. Mok, 2013, *Does Public-Sector Employment Fully Crowd Out Private-Sector Employment?* IMF Working Paper 13/146). Behar and Mok point to three possible channels through which crowding out could occur, of which the labor market channel and the education channel seem most relevant for the West Bank and Gaza (the third channel is the product market channel where private-sector employment is crowded out through higher interest rates, higher taxes, and competition from state-owned enterprises). The labor market channel includes the negative effect on private employment of higher public-sector wages and more job security. The education channel includes the negative effect of individuals seeking qualifications appropriate for entering the public sector rather than the skills required by the private sector.

that show widely different employment elasticities across countries, sectors, and demographic groups.[3]

B. Employment Elasticities and Unemployment Scenarios

3.   Statistical analysis confirms that employment elasticities differ substantially between the West Bank and Gaza. We estimate several sets of equations in log specification for 12 different combinations of territory and employment. First, we estimate a set of dynamic equations. The estimated elasticities are significant for private-sector employment, but lose significance for the West Bank when public-sector employment or employment in Israel and settlements is included. The long-run private-sector employment elasticity in the West Bank and Gaza is close to unity, meaning that a one percent increase in real GDP growth, over time, generates a close to one percent increase in private sector employment.[4] This is relatively high compared to similar countries. By including a time trend we check the robustness of our estimates and find that the estimated coefficient for persistence is no longer significant while estimated long-run elasticities are much lower. Apparently there are factors other than GDP that potentially affect employment, such as policy changes in labor or product markets or, in the case of the West Bank and Gaza, changes in Israeli restrictions. A second set of estimated equations does not take into account employment persistence and includes a time trend. The estimated long-run employment elasticity for the West Bank and Gaza is 0.52, which is slightly higher than other MENA oil importers and similar to Jordan.[5] The employment elasticities for Gaza, however, are much larger than for the West Bank, meaning that economic growth there is more labor intensive.

Long-Run Employment Elasticities, by Type of Employment and Territory, 1995–2012			
	West Bank and Gaza	West Bank	Gaza
Dynamic equation			
Total employed	0.958**	0.788	1.563***
excl. Israel and settlements	1.110**	0.849	2.383***
Private sector (incl. Israel and settlements)	0.876	0.772	0.932**
excl. Israel and settlements	1.012**	0.810*	1.344**
Long-run equation with time trend			
Private sector excl. Israel and settlements	0.5209***	0.4436***	0.762***

Note: *, **, *** denote significance at 10 percent, 5 percent, and 1 percent respectively.

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[3] See E. Crivelli, D. Furceri, and J. Toujas-Bernaté, 2012, *Can Policies Affect Employment Intensity of Growth? A Cross-Country Analysis*, IMF Working Paper 12/218, and S. Kapsos, 2005, *The Employment Intensity of Growth: Trends and Macroeconomic Determinants*, ILO Employment Strategy Papers No. 12.

[4] Crivelli et al. (2012) find employment elasticities for lower-middle-income countries from 0.10–0.24 and in MENA oil importers from 0.09–0.39.

[5] Crivelli et al. (2012) find employment elasticities for lower-middle-income countries from 0.10–0.24 and in MENA oil importers from 0.09–0.39.

4.   Scenario analysis is used to demonstrate the impact of varying assumptions about GDP growth and employment elasticities. Three scenarios illustrate how the interaction of growth and private-sector employment, combined with employment projections for other categories, determines the evolution of unemployment over the medium term. Private-sector employment growth is determined by real GDP growth and the one year-ahead estimated private-sector employment elasticity for the relevant territory, while assumptions are made for labor force participation, public-sector employment and employment in Israel. Under any scenario unemployment would remain very high. In the baseline scenario unemployment would rise to about 28 percent in 2016, while in the pessimistic scenario it would reach 33 percent. Even under optimistic assumptions for growth and employment opportunities in Israel, more than one in five workers would be unemployed in 2016. Only in the optimistic scenario would the unemployment rates in the West Bank and Gaza converge rapidly (to about 21–23 percent in 2016), while in the baseline and pessimistic scenarios the unemployment rate in Gaza would remain 8–10 percentage points higher than in the West Bank.

Growth and Unemployment Scenarios for West Bank and Gaza, 2012–16 1/					
	2012	2013	2014	2015	2016
Baseline scenario					
Real GDP growth	5.9	4.5	4.0	3.5	3.0
Total employment (million)	858	883	907	928	948
Unemployment rate	23.0	24.1	25.4	26.8	28.3
Optimistic scenario					
Real GDP growth	5.9	6.3	6.9	7.4	7.5
Total employment (million)	858	894	935	981	1,037
Unemployment rate	23.0	23.2	23.0	22.6	21.5
Pessimistic scenario					
Real GDP growth	5.9	2.9	2.4	1.5	1.5
Total employment (million)	858	870	877	881	884
Unemployment rate	23.0	25.3	27.8	30.5	33.2
Memo item					
Labor force (million)	1,114	1,163	1,215	1,268	1,322

Source: Palestinian Central Bureau of Statistics; International Labor Organization (ILO) (labor force participation); and IMF staff calculations.

1/ The estimated one-year ahead employment elasticities in
   these scenarios are 0.53 for the West Bank and 0.94 for Gaza.
2/ Political and economic status quo; gradual slowdown of growth; no
   relaxation of restrictions; PA maintains hiring freeze adopted in 2012.
3/ Higher growth; fewer restrictions; more employment opportunities in
   Israel; opening up of Gaza; donor aid gradually shifted from budget
   support to investment; gradual decline in PA employment.
4/ Slowdown in growth; tighter restrictions and fewer job opportunities
   in Israel; Gaza remains closed; donor aid and PA employment unchanged.

5.   Relaxation of Israeli restrictions and implementation of labor market and product market reforms could increase the pace of unemployment reduction. More flexible labor and product markets are associated with higher employment elasticities and hence appropriate institutional reforms could result in higher job growth, for a given rate of output growth.[6] In the West Bank and Gaza labor market and product market flexibility is also low because of Israeli restrictions on movement and access of goods and persons and removing these restrictions—for example, those on the movements of persons and goods internally in the West Bank, and

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[6] Crivelli et al. (2012) find that the following factors are positively correlated with employment elasticities: labor market flexibility, product market flexibility, macroeconomic stability (as measures by low volatility of output and prices), the relative size of the service sector, and the share of urban population. The size of government and trade openness are found to be negatively correlated with employment elasticity, among others.

between the West Bank, Gaza, and East Jerusalem, and restrictions on access to land (Area C and East Jerusalem) and natural resources (mainly water)—can therefore lead to higher employment elasticity. Labor market reforms under the direct influence of the government could include reforming the civil service to reduce the disparity in incentives with the private sector, in terms of benefits and salaries. Domestic reforms that are under the control of the government would also contribute to more flexible product and labor markets, which are associated with higher employment elasticity.

6.   **We present medium-term unemployment projections with and without reforms, where reforms combine the effect of changes in Palestinian regulations and relaxation of Israeli restrictions (Figure 1).** The reform scenarios assume an increase by half in private sector employment elasticity while other assumptions are as before. Under baseline growth assumptions the envisaged impact of reforms on private-sector employment elasticity would not be enough to reduce unemployment, which would reach 26 percent in 2016, compared to 28 percent without reforms. Regulatory reform and relaxation of restrictions, however, also have a direct positive effect on growth; they would compound the positive impact on employment from higher employment elasticity. The combined effect of reforms and a more optimistic growth outlook could reduce unemployment in both the West Bank and in Gaza to about 16–17 percent in 2016; without reform the optimistic growth outlook would barely lead to a reduction in unemployment. The higher private-sector employment elasticity and the opening up of employment opportunities in Israel would lead to a much faster unemployment reduction in Gaza than in the West Bank.

C.   Conclusions and Recommendations

7.   **Absent sweeping changes in policies and restrictions, reducing the unemployment rate in the West Bank and Gaza to single digits requires unrealistically high growth rates.** Reducing unemployment to 8 percent in 2016 would require creating roughly 430,000 new private-sector jobs. With prevailing private-sector employment elasticities this would require annual real GDP growth rates of 23 percent in the West Bank and 21 percent Gaza. A more realistic target of absorbing new labor market entrants into the private sector would still require annual real GDP growth of 10–11 percent through 2016, which would imply an unemployment rate of 19.5 percent. Still, such high growth rates are difficult to realize and sustain, even in the absence of restrictions. During 1968–87, when borders with Israel were more open with fewer internal restrictions, annual average real GDP growth in the West Bank and Gaza was 7 percent.[7]

8.   **While reducing the unemployment rate to single digits may not be realistic in the near future, lowering unemployment is possible under the right conditions.** The biggest impact would come from a broad-based relaxation of Israeli restrictions, which would boost growth and reduce rigidities in labor and products markets that hold back job creation.

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[7] See Israeli Central Bureau of Statistics, 1996, Publication No. 1012.

Expanding employment opportunities in Israel, including for workers from Gaza, would also contribute significantly. The Palestinian Authority can also contribute by removing impediments to private-sector growth, as discussed in the chapter on Growth in the Palestinian Economy in this paper. Reforming the civil service to create a more level playing field with the private sector would be a significant step forward. Taking into account that generous public-sector wages and benefits and high public-sector employment could crowd out private-sector employment, the Palestinian Authority could, as a first concrete step, undertake a review of the Civil Service Law of 1998 (amended in 2005) with a view to bringing its provisions more in line with private-sector conditions. Provided that reforms remain in place and no new restrictions are introduced, and that the political outlook improves, the unemployment rate could continue to decline beyond the four-year horizon suggested in this paper and reach single digits over the longer term.

Figure 1. The Evolution of Unemployment in the West Bank and Gaza Under Different Assumptions for Growth and Changes in Regulations and Restrictions
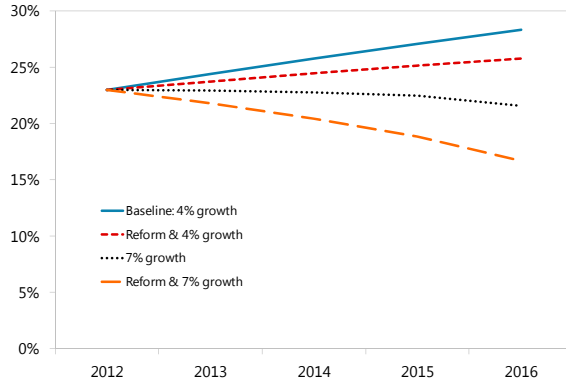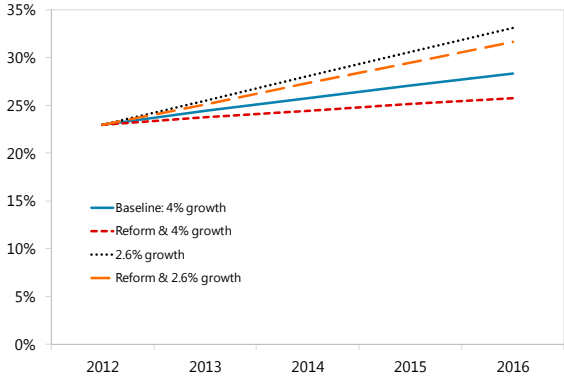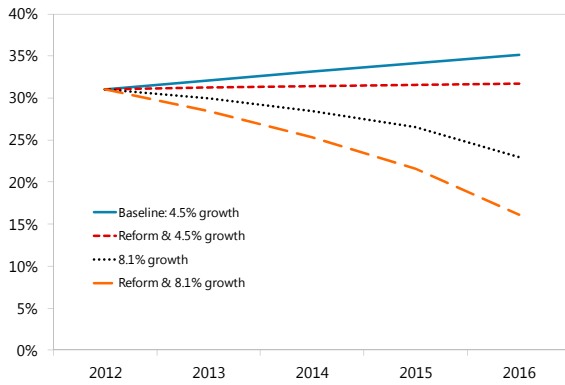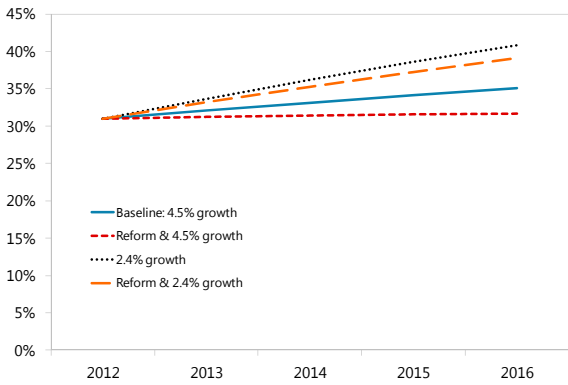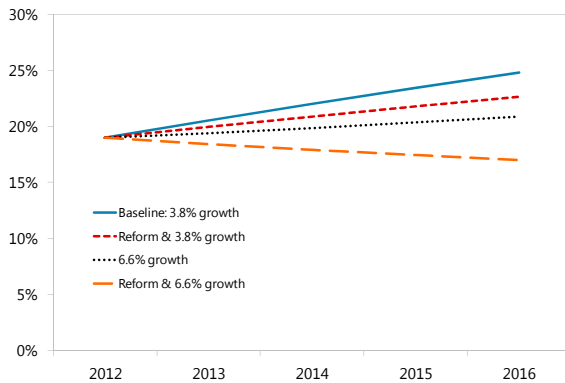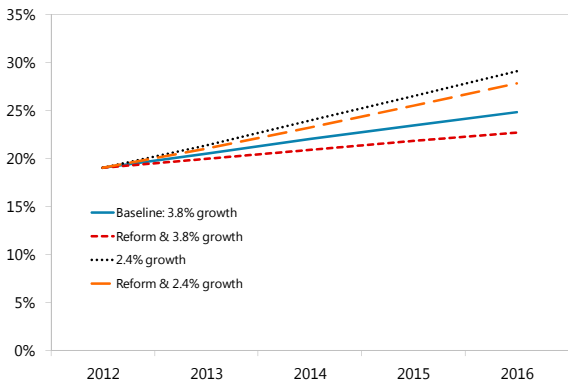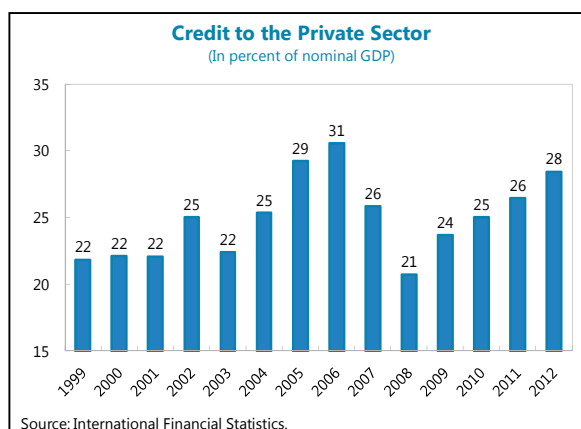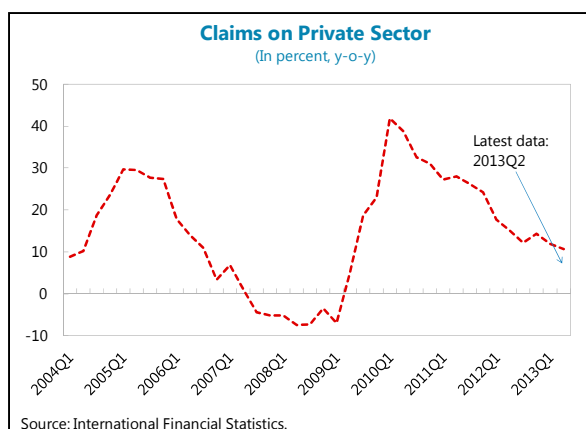

Source: IMF staff calculations.

DETERMINANTS OF PRIVATE-SECTOR CREDIT GROWTH IN THE WEST BANK AND GAZA[1]

This chapter analyzes whether the recent slowdown in credit growth is demand- or supply-driven. Although we find some tentative evidence that lending to the Palestinian Authority (PA), a supply factor, might decrease credit to the private sector, the recent slowdown in credit growth seems to be largely in line with cyclical economic fundamentals. At the same time, there are structural constraints to further financial deepening that manifest themselves in the low level of credit to GDP, its short-term time horizon, and strong bias towards consumption. Therefore, reforms that would help alleviate those constraints would be welcome.

A.   Introduction

1.   Growth of credit to the private sector in the West Bank and Gaza (WBG) has been declining recently, following a period of ups and downs. Credit growth was strong between 2004 and 2006 with the credit to GDP ratio peaking at 31 percent; negative in 2007 and 2008 with credit to GDP declining to 21 percent; and booming again after the end of the Gaza-Israeli conflict at end-2008 and early 2009 with the introduction of the credit registry. Since 2010 growth of credit to the private sector has been declining, reaching 12 percent in the first quarter of 2013, and 10.6 percent in June 2013.

Claims on Private Sector
(In percent, y-o-y)

Latest data: 2013Q2

Source: International Financial Statistics.

Credit to the Private Sector
(In percent of nominal GDP)

Source: International Financial Statistics.

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2.   This chapter analyzes the determinants of the recent decline in credit growth, and draws policy implications. It addresses the questions whether the recent decline in credit growth reflects a convergence towards a more sustainable expansion after a period of economic and political stability and structural improvement following the introduction of the credit registry in 2008, or do economic policies keep credit growth below potential. In this context, does the increasing credit to the PA crowd out credit to the private sector and contribute to the decline in credit growth? Are there structural factors constraining private-sector credit growth?

B.   Composition and Evolution of Credit Aggregates

3.   The recent decline in credit growth was mainly occurring in the West Bank. Credit growth shows strongly diverging trends in the West Bank and Gaza reflecting political circumstances. For example, in 2009–11 private-sector credit grew 31.9 percent in the West Bank, but only 17.4 percent in Gaza, where the economic and political situation was less favorable. However, in the year to June 2013, credit to the private sector grew by 21.5 percent in Gaza, while after years of strong growth it slowed to 8.7 percent in the West Bank. In June 2013 total bank credit in the West Bank and Gaza amounted to $4,258 million, or 28 percent of GDP. Slightly more than two-thirds of total credit was allocated to the private sector and the rest was allocated to the public sector. About 84 percent of credit to the private sector and almost all credit to the public sector was extended in the West Bank.

4.   In the last expansion, credit to the private sector was mainly driven by real estate and construction, and consumer credit. These sectors increased their share from 14.4 percent in 2008 to 21.3 percent in 2012 and from 7.6 percent to 21.0 percent, respectively (see table below). The share of credit to business and consumer services fell from 26.3 percent in 2008 to 10.2 percent in 2012, as credit to this sector declined by 5 percent annually. The share of trade financing—another business-oriented sector—declined from 24.4 percent to 20.2 percent, but grew in absolute terms by, on average, 15 percent per year since 2008. The strongest-growing sectors experienced the least accumulation of nonperforming loans (NPLs). The share of NPLs was particularly low for consumer credit, car finance, and real estate and construction credits, but high for trade finance, suggesting that the allocation of credit is driven by profitability and risk considerations.

5.   The slowdown was most pronounced in sectors other than consumer lending. During 2012 growth of credit to the private sector slowed by more than 15 percentage points to 10 percent in the second quarter of 2013. Credit growth declined most strongly in real estate and construction, trade finance, and mining and manufacturing, while consumer credit expanded by 68 percent. The general picture that emerges shows credit for investment or business purposes declining or growing below average and credit for consumption booming and becoming the main driver of credit growth. The real estate sector seems to be experiencing a soft-landing after years of extraordinary growth that might have lead to overheating in some regions.

West Bank and Gaza: Development and Composition of Credit to the Private Sector					
	Share in 2008 (In Percent)	Share in 2012 (In Percent)	Share 2012 vs. 2008 (In Percentage Points)	Growth 2008 to 2012 In Percent P.A.)	Annual Growth 2011 to 2012 (In Percent)	Q2 2013 (In Percent Y-O-Y)
Total Private Sector	100.0	100.0	0.0	21	13	10
Real estate and constructions	14.4	21.3	6.9	33	45	13
Land development	2.8	1.2	-1.7	-3	-22	103
Mining and manufacturing	7.9	9.0	1.0	24	-19	-34
Local and foreign trade finance	24.4	20.2	-4.1	15	13	-4
Agricultural and food processing	2.3	1.4	-1.0	5	-2	3
Tourism, hotels, restaurants	2.8	2.1	-0.7	12	9	9
Transportation	1.6	0.8	-0.8	3	-5	7
Business and consumer services	26.3	10.2	-16.1	-5	-28	-11
Securities purchasing and carrying	2.0	2.3	0.3	24	-4	-3
Cars & vehicles finance	3.6	4.1	0.6	25	6	12
Consumptions	7.6	21.0	13.5	56	75	68
Others in private sector	4.3	6.4	2.1	33	-10	-20
Source: Palestine Monetary Authority.						

6.   The direct share of the public sector in total credit increased from 28 percent in 2008 to 31 percent in 2012, potentially crowding out private sector credit.[2] Increased lending to the PA, apart from having a direct effect on private credit, could have provoked more risk-averse behavior of banks because of their increasing exposure to the PA, affecting private credit indirectly as well. Credit growth to the PA—averaging 35.6 percent between 2009 and 2011—exceeded growth of nominal GDP, and contributed to the accumulation of public debt, raising the risk to debt sustainability.[3] Furthermore, bank credit was mainly used to finance current expenditure, rather than investments to support private-sector growth.[4] As can be seen in the graph below, credit to the PA fluctuates with the general payment arrears, especially since fall 2012, indicating that the PA relies on bank credit for liquidity purposes in times of financial stress and not for long term investment expenditure. This also indicates that banks face elevated credit risks from their lending to the private sector as private suppliers to the PA are not paid in time.

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[2] The indirect exposure to the PA adds to the concentrated credit exposure to the PA. Bank loans to PA employees amounted to close to 17 percent of credit this spring, implying that for some banks more than half of the loan book depends on the ability of the PA to meet its obligations. As loan service payments are directly deducted from wages, loans to PA employees are not serviced if the PA cannot pay its wages, as was the case last November and December.
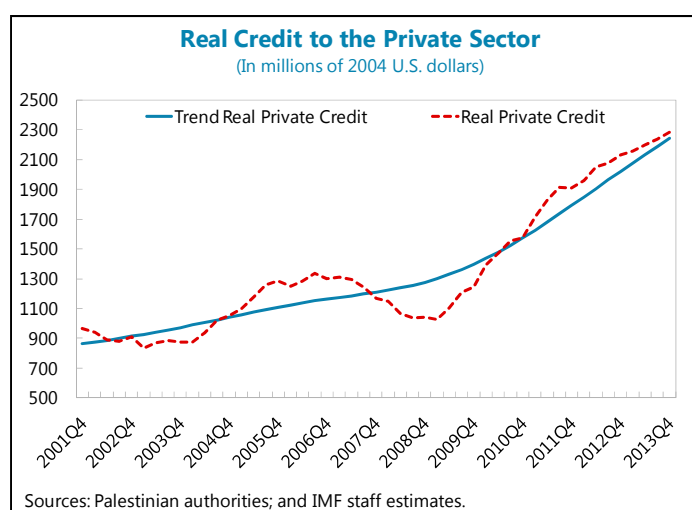
[3] See Annex I on debt sustainability in the IMF staff report.

[4] See the chapter on fiscal sustainability in this volume.

7.   The high volatility of credit to the PA makes banks' liquidity management more difficult. Credit to the PA has fluctuated in step with the government's payment arrears, particularly since the fall of 2012, suggesting that the PA relied on bank credit for liquidity purposes in times of financial stress. The standard deviation of monthly changes of credit balances to the public sector is more than four times higher than to the private sector, and might affect banks' ability to allocate more credit for private long-term investment.

Total Arrears of the PA and Public Credit

Absolute monthly change in Total Arrears (In NIS millions)

Absolute monthly change in Total Public Credit (In NIS millions) (RHS)

Source: Palestinian authorities.
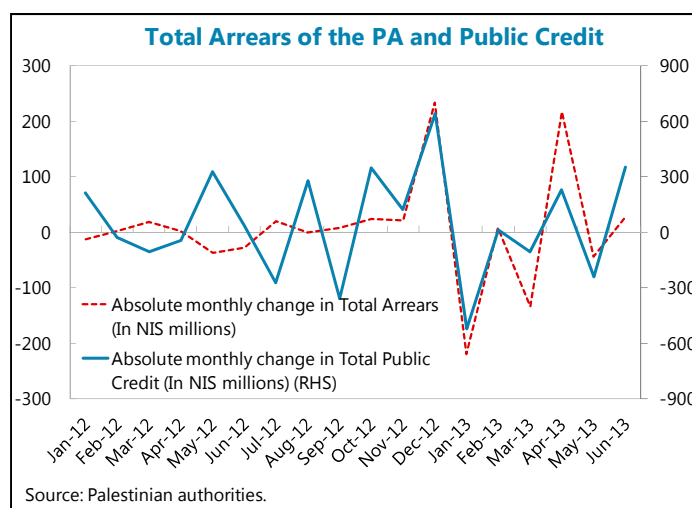
8.   Application of a standard smoothing technique does not indicate that the recent decline in credit growth is out of line with trend growth. The comparison with the trend, obtained using a Hodrick-Prescott filter for the quarterly credit levels shows that real credit to the private sector grew below the trend in 2007–08 and above the trend in 2009–11. It recently converged to the trend. The following sections analyze factors that contributed to the fluctuations around the trend.

Real Credit to the Private Sector
(In millions of 2004 U.S. dollars)

Trend Real Private Credit   Real Private Credit

Sources: Palestinian authorities; and IMF staff estimates.

C.   Analyzing Demand and Supply Effects of Credit to the Private Sector

9.   This section identifies the demand and supply factors that lead to strong volatility of credit growth and its recent decline. First, we determine demand and supply relationships by simple OLS regressions to identify the individual drivers of credit. Second, we use a disequilibrium model to account for the possibility that potential credit demand and supply might differ from each other such that credit rationing occurs. The scarcity of longer time series for a broader set of variables limits the empirical analysis; however, for the period between Q1 2002 and Q1 2013 quarterly data are available for the most important variables that potentially affect demand and supply of credit.

percent of assets by April 2009, and to 55 percent of assets by September 2009. This led to a significant jump in lending to the private sector shortly before the deadlines. We expect a negative coefficient, as higher NFA should reduce lending to the private sector.

- *Loanable funds.* Banks' ability to increase lending supply also depends on their deposit growth. To construct a variable for loanable funds we deduct reserve requirements from total deposits and expect a positive coefficient.

- *Crowding-out. L*ending to the PA might crowd-out lending to the private sector such that we expect a negative coefficient.

D.   Discussion of the Econometric Results

12.   Credit demand was found to depend on economic activity and lending rates. All other variables have the expected sign and show significant coefficients at least at the 10 percent level. To accommodate data irregularities we use dummies for Q1 2003 and Q2 2008. However, the significance and sign of the economic variables do not depend on the inclusion of the dummy variables.

- Credit demand depends positively on contemporaneous economic activity as approximated by real GDP in the West Bank and Gaza. We also tested whether credit demand depends on the economic activity in Israel and Jordan as trade financing makes up around 20 percent in credit (see table above). However, no additional relationship between credit in WBG and real GDP in Israel and Jordan could be found, which leads to the conclusion that GDP captures the effects of external trade to a sufficient degree.

- Credit demand depends negatively on loan interest rates. Loans in West Bank and Gaza are extended in U.S. dollars (USD), New Israeli shekels (NIS), and Jordanian dinar (JOD). Using all three interest rates leads to insignificant coefficients due to multicollinearity of the variables. Including interest rates individually or as an unweighted average leads to significant results except for the case of NIS. The best results are obtained for U.S. dollar loan rates, in line with priors; U.S. dollar loans make up a share between 54 and 72 percent of total loans in the sample period.

Credit Demand Equation			
Dependent variable: Real credit to the private sector			
Sample: Q1 2002 to Q1 2013			
Variable	Coefficient	Std. Error	Probability
C	0.30	0.05	0.00
Real GDP	0.25	0.08	0.00
USD loans interest rate	-0.04	0.01	0.00
Dummy Q2 2008	-0.10	0.03	0.00
Dummy Q2 2003	-0.11	0.03	0.00
Adjusted R2	0.60	Durbin-Watson	1.75

13.   Credit supply mainly depends on real GDP and foreign deposit rates. Again we add dummy variables due to data irregularities for Q1 2003 and Q2 2008. However, the sign and significance of the GDP and interest variables do not depend on the inclusion of the dummies. Adding NFA and loanable funds do improve the regression fit, while lending to the PA exceeds the 10 percent significance limit slightly. All other variables are significant at least at the 10 percent level and have the expected signs.

- Real GDP increases credit supply, indicating that a solid growth environment is an important determinant for lending as it reduces the risk of nonperforming loans.

- Deposit rates in Jordan decrease credit supply, as expected; the opportunity cost of providing credit to the private-sector increases.

- NFA reduces credit to the private sector as expected. The alternative use of a dummy for Q2 and Q3 2009, when the regulation limiting NFA became effective, also showed significant results but was dropped later as the use of NFA is preferred.

- Loanable funds increase the ability of banks to lend to the private sector.

- Loans to the PA decrease lending to the private sector. The coefficient has the right sign but falls short of the 10 percent significance level. Significance levels decrease for shorter time periods indicating that crowding out—while it seems to be prevalent to some degree— cannot be proven clearly in West Bank and Gaza.

Credit Supply Equation

Dependent variable: Real credit to the private sector
Sample: Q1 2002 to Q1 2013

Variable	Coefficient	Std. Error	Probability
C	0.09	0.02	0.00
Real GDP	0.26	0.09	0.00
Jordanian deposit rate	-0.02	0.00	0.00
Dummy Q2 2008	-0.09	0.03	0.01
Dummy Q1 2003			
Loans to PA	-0.06	0.04	0.11
NFA	-0.23	0.12	0.06
Loanable funds	0.50	0.18	0.01
Adjusted R2	0.55	Durbin-Watson	1.59

14.   In a second stage of the empirical analysis, we account for the possibility that demand and supply on the credit market might not clear. This could happen in cases when lenders and borrowers have asymmetric information, interest rates are sticky, i.e., they do not adjust freely and completely, and credit subsidies or credit rationing is present (Stiglitz and Weiss, 1981). As a result the observed credit volume would be the minimum of credit demand and supply:

$$C_t = min(C_t^d, C_t^s)$$

15.   We amend the approach used by Kyobe et al. (2012) and Poghosyan (2010) who among others apply a disequilibrium model that tries to attribute the observed development of credit aggregates to demand and supply factors by using variables that affect either supply or demand but not both. In addition to their approach, we account for the correlation between the residuals of demand and supply functions. The model is solved by a maximum likelihood function using the iterative procedure by Berndt, Hall, Hall and Hausman (1974).[6]

$$LL = \sum_{t=1} \log \left[f^d(C_t) F^s(C_t)(1 - F^s(C_t)) + f^s(C_t) F^d(C_t)(1 - F^d(C_t)) \right]$$

16.   The regression results show that credit to the private sector can be explained by a combination of demand and supply factors.[7] For identification reasons, not all variables that were taken for the OLS estimates can be used when simultaneously estimating demand and supply—which is for example why real GDP is not used for the supply side in addition to its use for the demand side. Results for the demand side are similar to OLS regressions stressing the importance of real GDP and interest rates besides the dummy for data irregularity in Q2 2008. On the supply side, loans to the PA are again not found to be significant. Instead higher net foreign assets of commercial banks reduce their propensity to provide loans to the domestic private sector. As shown in the chart below, credit demand and supply match the development of actual credit closely for most of the time, which does not indicate that credit rationing is a significant problem. Deviations between demand and supply, however, could be observed in 2008 and 2009, when

Maximum Likelihood Estimation of Disequilibrium Model			
Dependent variable: Real credit to the private sector			
Sample: Q1 2002 to Q1 2013			
Variable	Coefficient	Std. Error	Probability
Credit Demand			
Real GDP	0.65	0.40	0.10
USD loans interest rate	0.09	0.04	0.02
Dummy Q2 2008	-0.19	0.05	0.00
Credit Supply			
Jordanian deposit rate	0.01	0.03	0.77
Loans to PA	0.03	0.13	0.79
NFA	-0.86	0.40	0.03
Log likelihood	44.5	Akaike	-1.66
Avg. log likelihood	1.0	Schwarz	-1.3
Estimates use the BHHH iterative procedure			

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[6] See Kyobe et al. (2012) and Poghosyan (2010) for a detailed description.

[7] We estimate the variables in log levels corrected for a non-linear deterministic trend. Variables are also de-meaned which is why no intercepts appear.

lower credit demand seems to have driven credit developments. For end-2012 and early 2013 both credit demand and supply declined, suggesting that the recent decline of credit growth reflects the underlying economic fundamentals notably lower GDP and higher interest rates.

Demand, Supply and Actual Credit to the Private Sector
(In logs)

Source: IMF staff estimates.
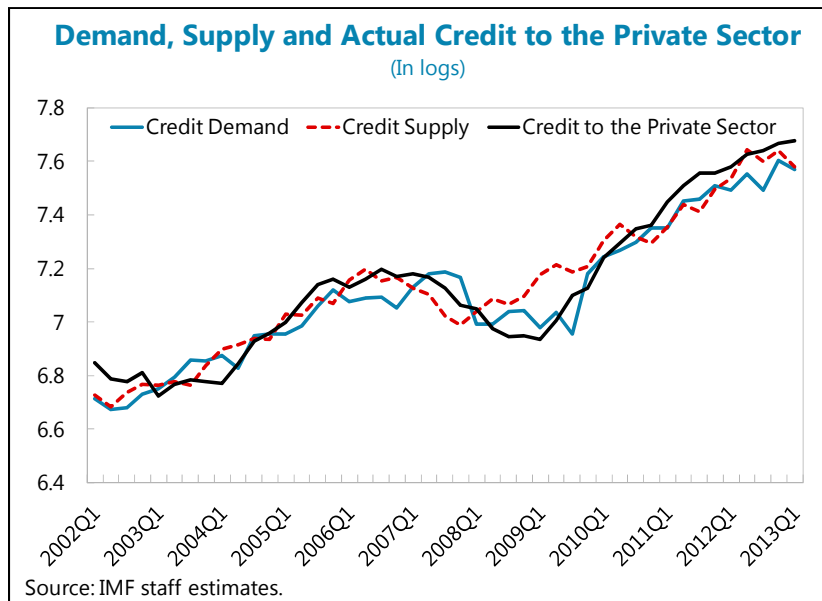
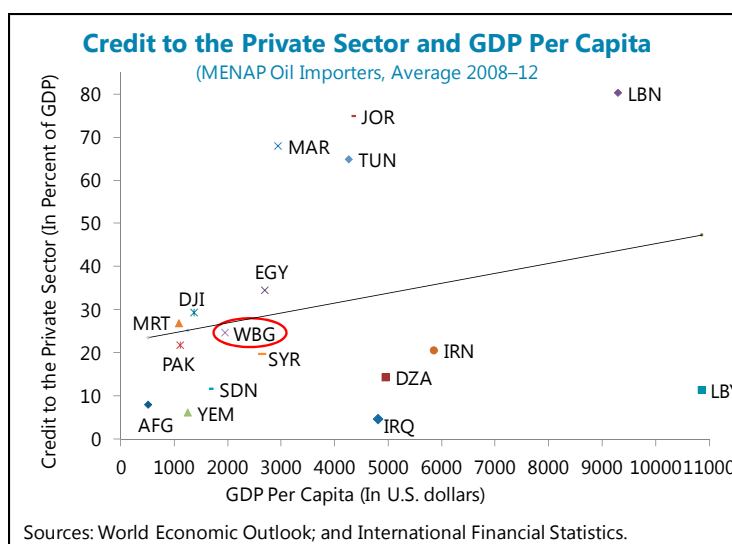## E. Regional Comparisons of the Level of Credit to the Private Sector

17. **Credit to the private sector might have been in line with cyclical economic fundamentals in the WBG lately, but at 28 percent of GDP it remains significantly below the MENA average.[8]** This could be sub-optimal in the sense that stronger trend growth of credit to the private sector could ultimately increase investment, employment and GDP growth. Therefore, the reasons for the low level of credit to GDP are explored below.

Credit to Private Sector
(In percent of GDP)

Source: Regional Economic Outlook.

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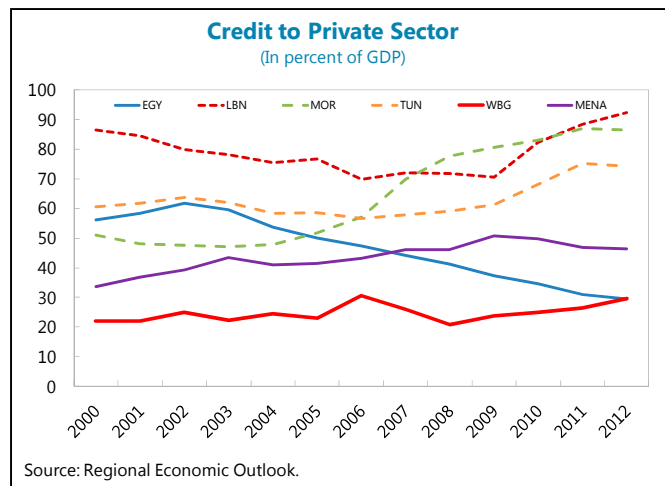
[8] See also Barajas et al. (2010) for an analysis of the slowdown of credit growth in other MENA countries.

18.   The cross-country comparison suggests that the level of financial deepening in the WBG is consistent with its level of development: The WBG has a relatively low credit to GDP ratio, but also a relatively low GDP per capita. Oftentimes economic development goes together with financial deepening. Therefore, it could be expected that a boost to GDP growth—as might be expected if Israeli restrictions are lifted—would contribute to further credit deepening, but also that financial deepening itself might boost GDP growth.

Credit to the Private Sector and GDP Per Capita
(MENAP Oil Importers, Average 2008–12

Sources: World Economic Outlook; and International Financial Statistics.

19.   The banking sector appears able to support further financial deeping, as it is much healthier than the MENA average. In the WBG, banks' Tier 1 capital to risk-weighted-assets stood at 22.7 percent at the end of 2012; NPLs remained at low levels of around 3.3 percent before and 2.0 percent after taking accepted collateral into consideration. Furthermore, provisions to NPLs amount to more than 90 percent and banks' profitability also remains strong despite high liquidity ratios. Financial soundness indicators (FSI) of the WBG compare very favorably to FSIs of other MENA countries, suggesting that the WBG could support a higher ratio of credit to GDP than is typical, on average, for its level of per capita GDP.

20.   The WBG's ranking for the ease of getting credit in the World Bank Doing Business indicators is very low. The WBG's ranking for getting credit stands at 159 out of 185 countries and is even lower than its overall rank of 135. Except Jordan, all MENA countries are ranked higher, while Israel is ranked 12th. The strength of legal rights appears to be the major impediment, which may partly be attributable to the Israeli restrictions; Palestinian law enforcement is not allowed to enter East Jerusalem and Area C, covering 61 percent of the WBG, and real estate and moveable assets there cannot be used as collateral for loans. Nonetheless, creditor rights could also be strengthened by domestic reforms. Banks, for example, would benefit from faster court procedures that currently may take five years and more for collateral enforcement. Other reforms could support out-of court enforcement, to allow a general description of collateral and a unified collateral registry.[9]

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[9] See the chapter on growth in this volume.
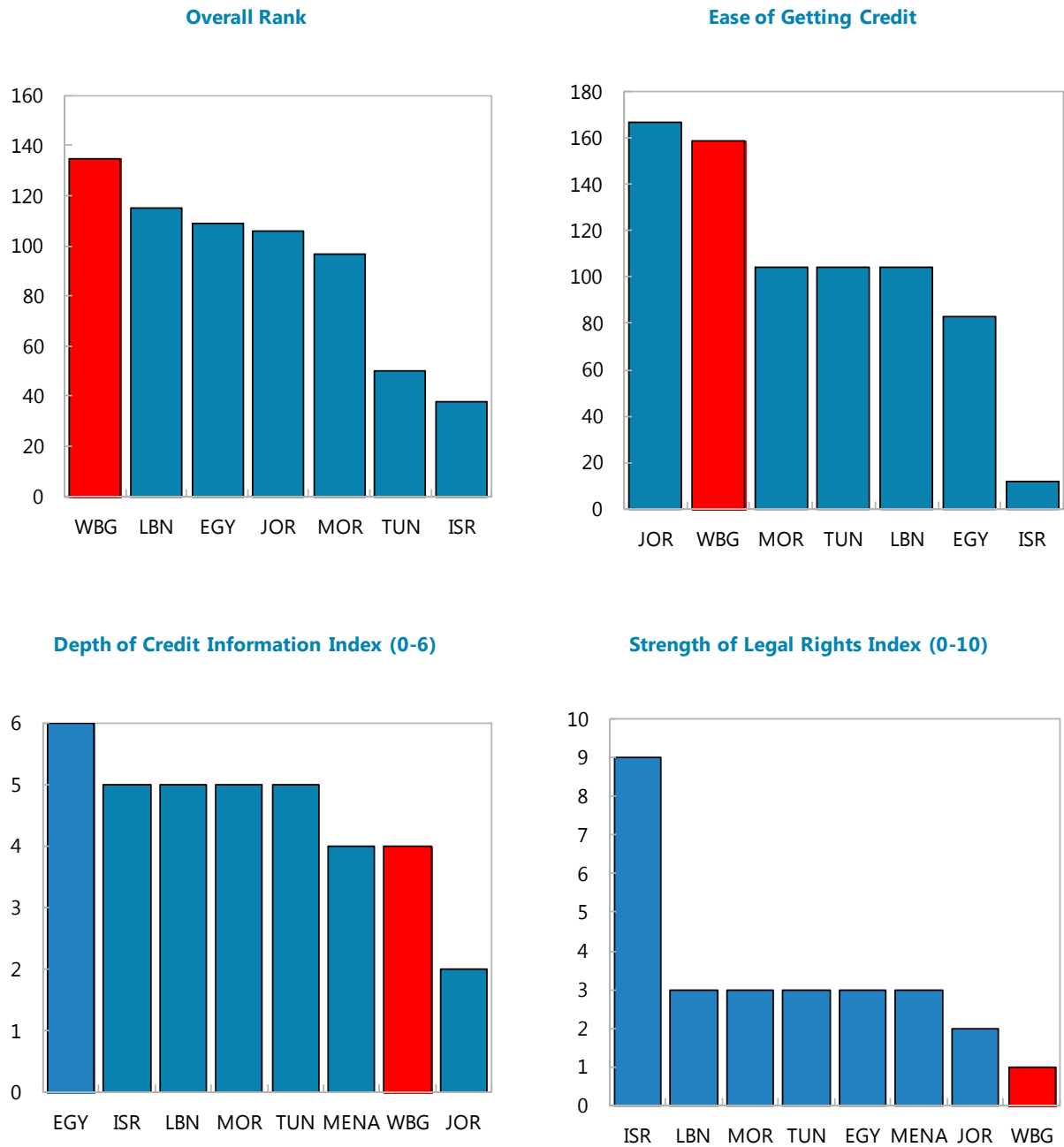
F.   Conclusion

21.   We found that the recent decline in private credit growth largely reflects its fundamental cyclical determinants like the slowdown in GDP growth and higher deposit rates in Jordan. The higher rates in Jordan increased the attractiveness of keeping foreign deposits at parent or sister institutions of commercial banks that often have a Jordanian origin, at the expense of lower lending to the private sector in the WBG. This also indicates that funds would be available for stronger credit growth to the private sector in the WBG. Evidence for a credit crunch or credit rationing on the side of banks could not be found. Hence, reforms that increase the attractiveness for banks to lend locally could improve financial deepening which in turn might boost economic growth and employment. While clear econometric evidence for crowding out could not be found, banks and banking supervision should monitor closely the increasing exposure of banks to the PA as well as its employees and suppliers as those loans make up more than 50 percent of lending in every third commercial bank and therefore constitute very concentrated credit risks. In this context, the PA should make very strong efforts to adopt a medium-term fiscal framework and to avoid payment arrears to its employees and suppliers.[10] Such arrears increase the credit risk of a larger number of bank clients, which might constrain a broader expansion of credit to the economy.

22.   The comparatively low ratio of credit to the private sector to GDP can be largely explained by the WBG's low level of per capita GDP; however, given the good health of the banking system, private credit to GDP has the potential to increase. Main structural impediments to credit growth include weak legal rights, especially creditor rights, inefficient and lengthy court procedures, and limited access to collateral. The implementation of the movable assets law would expand the availability of collateral, and contribute to the increase in credit supply. To enhance the growth potential of the economy, the PA should take measures to improve the overall business environment, and the ease of getting credit in particular. As the share of credit that is used for investment purposes has been declining sharply in the past several years and credit growth in several business-related segments has even been negative lately, reforms that result in higher credit to SMEs or for other productive purposes might be particularly helpful to stimulate economic growth. The recent strong growth of credit to consumers, however, should be watched carefully.
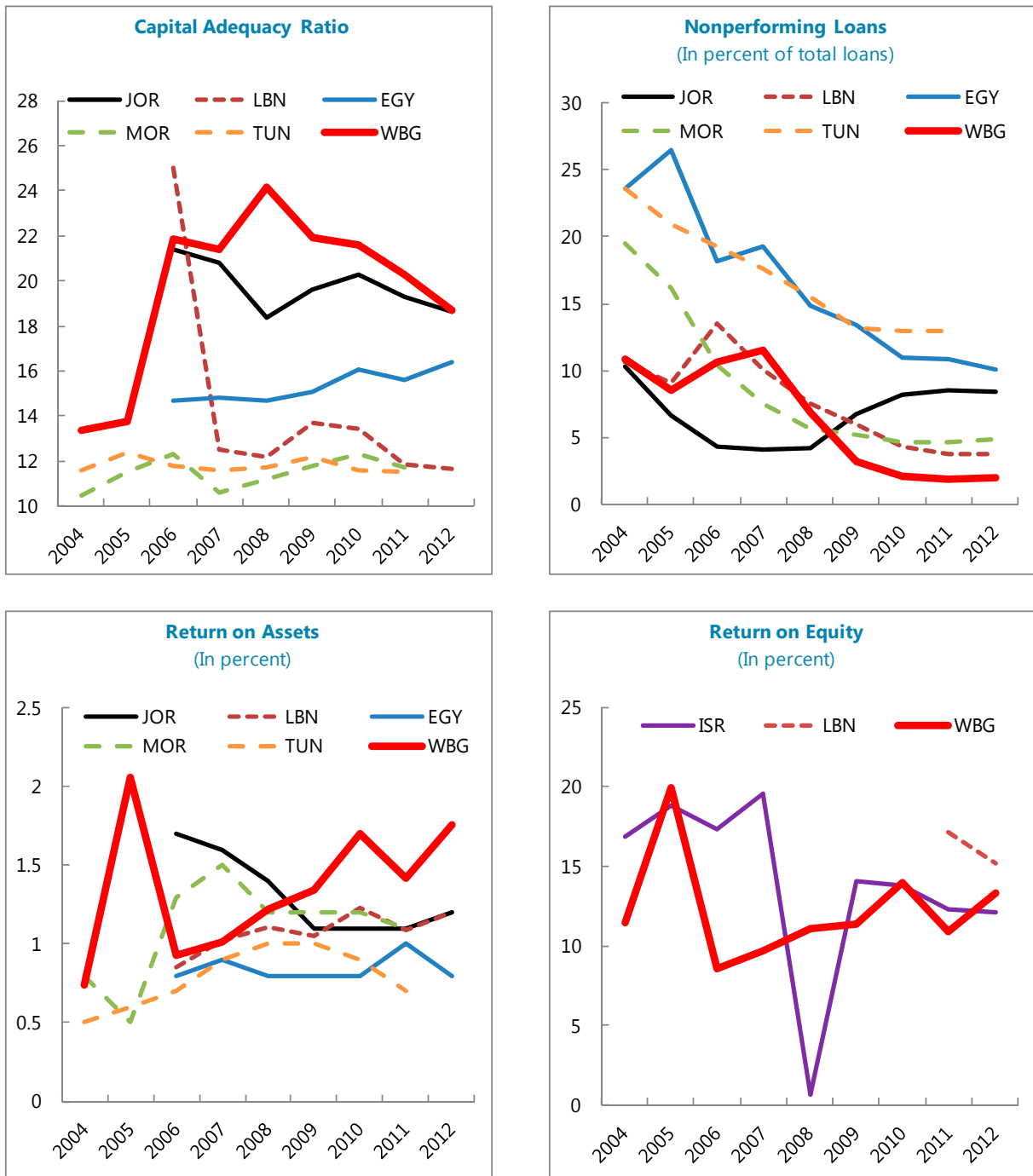
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[10] See the chapter on fiscal sustainability in this volume and the Staff Report.

Figure 1. West Bank and Gaza: Doing Business Indicators, 2013

Overall Rank

Ease of Getting Credit

Depth of Credit Information Index (0-6)

Strength of Legal Rights Index (0-10)

Source: World Bank Doing Business Indicators.

Figure 2. West Bank and Gaza: Financial Soundness Indicators, 2004–12

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