INTERNATIONAL MONETARY FUND

WEST BANK AND GAZA

REPORT TO THE AD HOC LIAISON COMMITTEE[1]

September 12, 2014

KEY ISSUES

Context: With the hostilities in Gaza, the political and security environment has deteriorated markedly over the past months. There have been several attempts to forge a ceasefire between Israel and Hamas, brokered by Egypt, most recently on August 26, when an open-ended ceasefire went into effect. Nevertheless, prospects for a broader settlement of the Israeli-Palestinian conflict remain highly uncertain.

Outlook and risks: The economic outlook has deteriorated substantially, especially for Gaza, which has suffered a devastating loss of life and property. While the conflict is focused on Gaza, disruption to economic activity has also occurred in the West Bank. The outlook depends critically on whether the ceasefire agreement holds, what its eventual terms are, and the speed and size of the international community's response to Gaza's reconstruction and humanitarian needs.

Key policy recommendations: The economic impact of the Gaza conflict is difficult to estimate at this stage, but the extent of the destruction and limited resources of the West Bank and Gaza (WBG) make international mobilization of aid crucial. The experience after the 2008/09 conflict indicates that without a lifting or at least easing of the blockade of Gaza, especially allowing the entry of construction materials, rebuilding efforts are likely to be unsuccessful. At the same time, it is vital that the Palestinian Authority, together with international partners, devise a robust fiscal mechanism to effectively deploy financial aid. This would help strengthen donor confidence that new resources will be effectively and transparently managed. Finally, the WBG's underlying fiscal strains have multiplied after the conflict, and with spending pressures bound to rise in the context of uncertain donor support, it is important that the Palestinian Authority maintains fiscal discipline.

[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.

Approved By
Juha Kähkönen and Ranil Salgado

Discussions were held in East Jerusalem and Ramallah during June 24–July 3, 2014, and the report was updated with subsequent developments. The staff team comprised Christoph Duenwald (head), Anja Baum, Rafik Selim, and Anna Unigovskaya (all MCD), and was assisted by Hania Qassis (Resident Representative Office) and Samim Cilem (Resident Advisor). The mission met Prime Minister Hamdallah, Deputy Prime Minister Mustafa, Finance Minister Bishara, Palestine Monetary Authority Governor Al Wazir, other senior officials, private sector representatives, and donors. The mission prepared a concluding statement and issued a statement to the media. Jonah Rosenthal, Cecilia Pineda, and Vanessa Panaligan (all MCD) contributed to producing this report.

CONTENTS

TABLES

ANNEXES

CONTEXT

1. **Mounting tensions earlier this year culminated in a lengthy armed conflict between Israel and Hamas in July and August.** Against the background of deteriorating Israeli-Palestinian relations following President Abbas' announcement of a reconciliation agreement between the two Palestinian factions Fatah and Hamas, the cycle of violence following the killing of three Israeli teenagers in the West Bank ignited a serious military confrontation between Israel and Hamas. The resulting loss of life and property has been devastating, but the recent open-ended ceasefire agreement brings optimism that a lasting truce can be negotiated. During the ceasefire negotiations, Israel has demanded the disarmament of Hamas while Hamas has demanded a lifting of the blockade.[2]

2. **Even if a lasting truce is achieved, political uncertainties abound.** Much will depend on the eventual terms of ceasefire agreement, and whether this eventually sets in motion a broader peace process which would bring substantial economic benefits to the WBG economy. Prospects for a lasting reconciliation between Fatah and Hamas are also uncertain. A looming issue is the implementation of the Fatah-Hamas unity agreement reached in late April, including governance arrangements for Gaza and the timeline for national elections. At this point, the consensus government sworn in on June 2, 2014 remains in place, although it continues to govern predominantly in the West Bank.

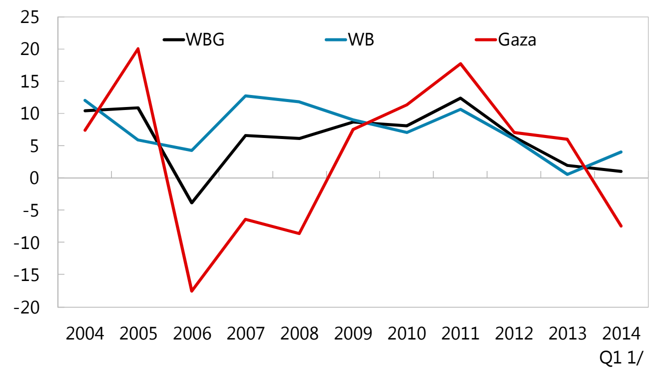
3. **While the IMF mission on which this report is based occurred before the conflict in Gaza erupted, the conclusions and policy recommendations remain broadly valid.** During the June/July discussions, staff emphasized the need for measures to contain the financing gap and for a contingency plan in case some of the fiscal risks materialize. After the mission had concluded its work, the tensions that were already palpable erupted into a military conflict, which has raised the WBG's public spending requirements for years to come owing to the need to rebuild Gaza. While staff's earlier policy advice remains generally appropriate, the dramatic shift in the economic landscape requires a modified emphasis in staff's policy recommendations. This report also offers revised macroeconomic projections for the WBG economy incorporating the impact of the conflict, but these are based on very limited information and may therefore have to be revised at a later stage.

[2] In this report, "blockade" refers to the restrictions placed on the movement of goods and people between Gaza on the one hand and Egypt and Israel on the other, whether by land or by sea. The nature of these restrictions has varied over time.

THE ECONOMY PRIOR TO THE CONFLICT

4. **Even before the Israel-Hamas conflict, the economy was slowing, particularly in Gaza** (Figure 1)**.** Growth decelerated from 6.3 percent in 2012 to 1.9 percent in 2013 (from 6.0 to 0.5 percent in the West Bank and from 7.0 to 6.0 percent in Gaza), reflecting political uncertainty, continued fiscal problems of the PA, and the effects of the tunnel closure between Egypt and Gaza that had a strong impact on construction activity and employment. Growth continued to decline in the first quarter of 2014, turning negative in Gaza, and stabilizing in the West Bank, supported by exports, which continued to grow at a 5 percent annual rate.[3] The situation in Gaza was particularly dire, with a humanitarian crisis slowly unfolding even before the Israel-Hamas conflict (Box 1). GDP data for the second quarter of 2014 are not yet available, but the Palestine Monetary Authority's (PMA) business sentiment indicator pointed to a continued decline in business confidence.[4] In addition, Israeli search operations for the missing teenagers (later found killed) in the West Bank, which focused on the main industrial center of Hebron, are likely to have disrupted economic activity in the second quarter.

Real GDP Growth, 2004–14
(In percent)



Sources: Palestinian Central Bureau of Statistics; and IMF staff estimates.
1/ Seasonally adjusted quarterly growth rate.

5. **Unemployment had surged to new heights, while inflation was stable.** In Gaza, the unemployment rate jumped to 45 percent in the second quarter of 2014 driven by a large loss of jobs in the construction sector, while declining to 16 percent in the West Bank reflecting seasonal factors. Youth unemployment in the West Bank and Gaza reached 39 percent, 63 percent in Gaza alone, adding to the risks of social instability.[5] Inflation remained subdued, helped by a further strengthening of the NIS exchange rate vis-à-vis the U.S. dollar. Inflation in Gaza remained below inflation in the West Bank prior to the conflict.

[3] The Palestinian Central Bureau of Statistics (PCBS) has revised its national accounts estimates for 2000–14 based on IMF TA recommendations. The preliminary GDP series used in this report was shared with staff at end-August. The complete revised data-set is expected to be available soon.

[4] This indicator, which is based on monthly surveys of managers of industrial firms in the WBG covering their current and expected levels of production, sales, and employment, has been compiled by the PMA since November 2012.

[5] Labor force participation was 46.4 percent in the West Bank and 44.7 percent in Gaza in Q2 2014, with a large gender gap. The participation rate of males reached 71.7 percent compared with 19.4 percent for females.

Box 1. Gaza Before the 2014 Conflict—Heading Toward a Humanitarian Crisis

Political conflicts and the blockade of Gaza have been major obstacles to economic activity, reconstruction and development throughout the last decade. Political conflicts, the tightening of the Israeli blockade in 2007 and the Gaza war at the end of 2008 left Gaza in a dire economic and humanitarian condition, with real GDP falling by 30 percent between 2006 and 2008. The blockade severely restricted the import of necessary construction materials, as well as economic activity of other sectors such as agriculture and tourism. Consequently, economic recovery was weak: absolute real GDP reached 2005 levels only by 2012, real GDP per capita remained below the 2005 levels even by 2014, and unemployment never fell below 25 percent. The blockade also led to heavy economic dependence on unofficial imports via tunnels to Egypt.

The tunnel closure in 2013 led to a collapse in growth and a financial crisis of the Hamas government, resulting in unsustainable unemployment levels and rising poverty. Estimates suggest that prior to their closure, imports of construction materials that entered Gaza via the tunnels were more than three times higher than the imports via official crossings with Israel.[1] Moreover, tunnel trade was an important source of revenue for the Hamas government and Gaza municipalities. Following the tunnel closure, construction collapsed, fuel became scarce, and unemployment skyrocketed to 45 percent before the onset of the current conflict, with youth unemployment at 63 percent. Hamas was confronted with a payment crisis, leaving 40,000 Hamas employees with a reduced or no salary since the beginning of 2014. In addition, already in 2012 a total of 1.1 out of 1.7 million people living in Gaza received food assistance,[2] and more than 70 percent of Gaza's population relied on services of a financially burdened UNRWA; this situation undoubtedly became worse with rapidly growing unemployment rates.

Gaza's Socio-Economic Development: 2005–13

	2005	2013
Social development		
Population	1,304,388	1,701,437
Growth rate	3.3	3.5
Registered refugees 1/	961,645	1,240,082
In percent of population	73.7	72.9
Poverty rate 2/	33.7	38.8
Deep poverty rate	19.9	21.1
Education 3/		
Literacy rate	93.3	96.4
Female (in percent)	89.7	94.5
Economic development		
GDP growth	20.1	6.0
GDP per capita (2005=100)	100	86.4
Inflation (eop)	2.7	-1.2
Unemployment rate 4/	28.2	38.5
Youth unemployment	37.9	65.6
Trade 5/		
Exports (in thousands of USD)	39,938	4,683
Imports (in thousands of USD)	643,142	391,766

Source: Palestinian Central Bureau of Statistics.
1/ Source: UNRWA, as of January 2014 and March 2005.
2/ Available for 2009 instead of 2005 and for 2011 instead of 2013.
3/ Available for 2012 instead of 2013.
4/ Based on fourth quarter.
5/ Available for 2004 instead of 2005 and for 2012 instead of 2013.

The economic and poverty situation was exacerbated by an insufficient and deteriorating water and electricity infrastructure, leading toward a humanitarian crisis. While the water and electricity supply never regained 2005 levels, the majority of the existing infrastructure relied mostly on fuel from the tunnel trade. Consequently, after the tunnel closures, power outages increased and Gaza's sole power plant reported production stoppages of up to 16 hours per day. Access to water of acceptable quality was becoming a critical problem. Over-abstraction from the aquifer has led to increasing seawater intrusion, and daily power cuts limited the ability for wastewater treatment plants, which further reduced water quality. A further decline in the quality and quantity of the water aquifer will result in its collapse within the next few years. This pre-war situation was unsustainable, and a further deterioration as a result of the current war will lead to a humanitarian crisis, absent a quick and generous international response.

[1] See OCHA Humanitarian Bulletin, Monthly Report, June 2013.

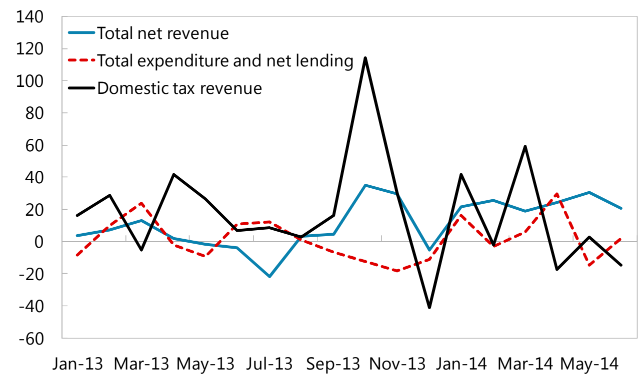
[2] See World Food Program Gaza Watch, WFP Palestine, 18 July 2013.

6. **The fiscal position was already under pressure before the armed conflict.** Despite strong revenues, arrears of the PA continued to increase through June, reflecting higher-than-budgeted spending and back-loaded donor support.

- Total *revenues* grew 23 percent year-on-year, owing mainly to strong clearance revenues and advanced domestic VAT filings by a number of large companies.[6] Clearance revenues were bolstered by increased official imports of fuel into Gaza after the closure of the tunnels to Egypt and stepped-up tax administration efforts to combat under-invoicing.

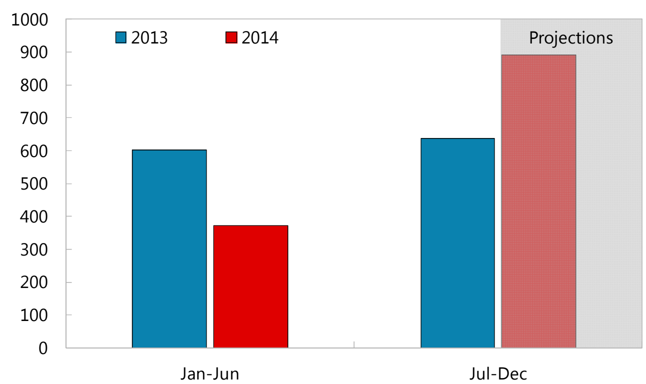
- Recurrent *expenditure* increased during this period by about 6 percent year-on-year, exceeding the 4-percent growth rate assumed under the budget.[7] Net lending (expenditure that represents the PA's payments for electricity, water, and sewage to Israel, which is incurred by means of deductions from clearance revenue) reached almost 85 percent of annual budget allocation by end-June and was responsible for excessive growth in expenditure, whereas wage and nonwage spending remained contained. The postponement of the cost-of-living adjustment and certain allowances, in addition to a reform of the transportation allowance and cancelation of the supervision allowance in Gaza, allowed containment of the wage bill, despite some increase in employment.

Revenue and Expenditure
(Y–o–y growth, in percent)



Source: Ministry of Finance.

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



Sources: Ministry of Finance; and IMF staff projections based on donors' pledges.

- At the same time, *donor support* in the first half of 2014 was low. As a result *arrears*, including to private suppliers, increased since the beginning of 2014 by more than NIS1 billion, or 2.5 percent of GDP, pushing public debt over the threshold of 40 percent of GDP prescribed by the Law on Public Debt (Figure 2). Additionally, the PA's direct

[6] The Ministry of Finance introduced an 8 percent tax discount on pre-paid VAT in 2014.

[7] Staff made an adjustment to the authorities' estimate of nonwage spending, taking into account that at least $100 million of arrears were cleared, and were erroneously booked under committed expenses on goods and services.

and contingent liabilities to the Israel Electricity Company (IEC), some of which are in dispute, have gone up, reaching NIS1.5 billion at end-May.[8]

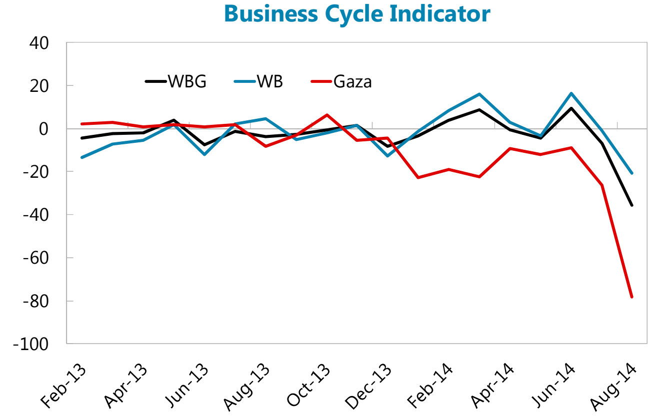
7. **Notwithstanding the economic slowdown and political uncertainty, as of end-June the banking sector remained healthy, although exposure to the PA and to consumer and real estate sectors was high** (Figure 3). The banking system remained liquid and profitable, with NPL ratios low at 2.6 percent and Tier I capital to risk-weighted assets at 18 percent in the second quarter of 2014. Credit growth to the private sector has been picking up through June this year, reaching 19.7 percent year-on-year. Banks continued to expand into the retail market, increasing their exposure to consumer, real estate and construction loans, which combined reached almost 50 percent of the banks' total private sector loan portfolio at end-June. Moreover, with a large share of consumer loans allocated to the PA employees, combined with banks' loans to the PA, total exposure of banks to the PA remained high, constituting 43 percent of the banks' loan portfolios. Reflecting high credit risk, lending-deposit interest rate spreads remained high at more than 10 percent for the NIS and 6 percent for the USD.[9]

ECONOMIC OUTLOOK AND RISKS

In this section, staff presents a set of revised macroeconomic projections taking into account the economic impact of the conflict. It should be stressed that, given the uncertainties, the estimates in this section should be considered highly tentative.

8. **Staff has revised GDP projections downward to reflect the economic impact of the conflict.**[10] From the production side of GDP, it is likely that most sectors in Gaza will have experienced significant losses, including agriculture, manufacturing, construction, and services (Box 2). On the expenditure side, consumption and investment likely have been hit hard. Staff's preliminary estimates project a decline of Gaza's GDP by about 20 percent in the first three quarters of 2014, compared to the same period last year. For the West Bank, economic disruptions have been less, but the decline in household and business confidence might have led to lower consumption and investment. Indeed, the PMA's business sentiment indicator shows a dramatic decline in August, in both Gaza and the West Bank. In addition, exports will be affected by softening

Business Cycle Indicator



Source: Palestinian Central Bureau of Statistics.

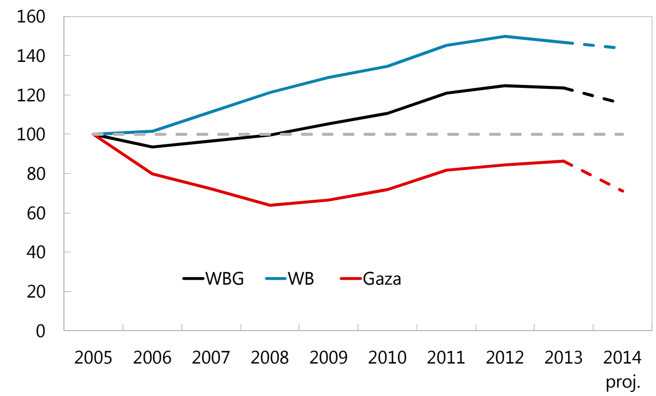
[8] Debt to IEC increased further to NIS1.7 billion at end-August.

[9] NIS lending rates are about 12 percent, and deposit rates 1.4 percent. USD lending rates are above 7 percent, and the USD deposit rates 0.75 percent on average. The spread on the Jordanian dinar is 7 percent.

[10] The previous report was published on June 30, 2014, and can be found on www.imf.org/wbg. In the June report, staff projected growth in the WBG to reach 2 percent in 2014, 1.6 percent in the West Bank and 3 percent in Gaza.

growth in Israel, the main export destination for the West Bank. Expecting a mild recovery in the fourth quarter of 2014 in both Gaza and the West Bank, staff projects that real GDP for the WBG will decline by between 3.5 and 4 percent for the year as a whole, with an output loss of 15 percent in Gaza and continuing stagnation in the West Bank. For 2015, staff projects a rebound in Gaza—on the assumption of increased aid to finance the reconstruction of Gaza—and a modest pickup in the West Bank for a combined growth rate of about 4.5 percent. With the projected decline in output, real per capita GDP in Gaza would fall to only 70 percent of its 2005 level and by 18 percent from 2013. Real GDP per capita in the West Bank would decline by 2 percent. Inflation in the WBG in 2014 is projected at 2.8 percent, up from 2.2 percent in the June 2014 report driven mainly by higher prices in Gaza and a depreciation of the shekel since mid-July. The WBG unemployment rate is expected to jump to 30 percent by end-2014. A sharp rise in Gaza's unemployment in the third quarter is likely, potentially followed by a modest decline in the fourth quarter as reconstruction begins.

Real GDP Per Capita, 2005–14
(2005=100)



Source: Palestinian Central Bureau of Statistics.

9. **The full extent of the conflict's fiscal impact is unknown at present.** Despite the weaker growth outlook, revenue is likely to be somewhat higher than previously projected on account of stronger-than-expected clearance revenue, which increased by 31 percent year-on-year in the first seven months of 2014. On the spending side, the authorities will have trouble containing net lending, which is running at well above budget targets, and spending on goods and services, which partly reflects arrears repayment (the exact amounts are unknown because of poor accounting for arrears), will likely exceed budgeted amounts.[11] Our expenditure projections do not yet account for the spending needed for Gaza reconstruction since the costs are unknown at this stage.[12,13] Taken together, this would result in an overall deficit of 16½ percent of GDP, up from 13¼ percent in the June 2014 report, reflecting in large part the downward revision in nominal GDP. Assuming that overall donor financing will reach $1.5 billion (of which $100 million is earmarked to arrears clearance, and $200 million for development), in line with updated donor pledges, and some increase in domestic borrowing, the resulting financing gap will amount to about $350 million.

[11] An inter-government committee has been set up to address the electricity non-payments, and a decision has been made to impose penalties on distributors who do not pay the bills to the IEC. These are encouraging measures, but their effectiveness is yet to be seen.

[12] Aside from minor war related aid transfers in July and August, no new spending on Gaza was made following the formation of the unity government in early June.

[13] The PA is preparing the Report on the Initial Damage Assessment ahead of a donors' conference on rebuilding Gaza tentatively scheduled for October 12, 2014 in Egypt.

Box 2. Gauging the Economic Impact of the Conflict in Gaza

The July-August military conflict reduced economic activity in all economic sectors in the third quarter of 2014, but the impact varies substantially depending on pre-war conditions, economic restrictions, and infrastructure losses during the conflict. We estimate the total third quarter loss at 45 percent compared to the previous quarter, reducing GDP by about 20 percent during the first three quarters of 2014 compared to the first three quarters of 2013. The following provides an evaluation of the main economic sectors.

- **Agriculture**: During the conflict an enlarged security buffer zone around the border made most of Gaza's arable land inaccessible, and fishing was banned completely, causing an estimated yearly loss of more than 9 percent in August alone. In addition, most of the 17,000 acres of Gaza's farmland has been ruined by tanks, shelling and air strikes, and much of its agricultural infrastructure, including greenhouses, irrigation systems, animal farms, fodder stocks and fishing boats was lost (Source: UNFAO). Staff expects a reduction of agricultural output of 80 percent during the conflict, and of 30 percent in the first three quarters of 2014.
- **Manufacturing, electricity and water**: Around 420 factories were destroyed or severely damaged during the conflict (source: Palestinian Federation of Industries), further increasing the number of unemployed people. The destruction of Gaza's sole power plant and much of the water and sewage infrastructure will further and lastingly reduce the sector's output. Staff expects a reduction of manufacturing output of 20 percent in the first three quarters of 2014, which includes a 50 percent loss in electricity supply and a 30 percent reduction in water and sewage activity since the onset of the conflict.
- **Construction**: Construction activity collapsed after the closure of the tunnels in 2013 by Egypt, and its share of GDP shrank from 18.5 percent in 2013Q2 to only 6 percent in 2014Q1. During the conflict construction activity came to a complete halt. Therefore, staff expects a reduction in construction activity of 75 percent in the first three quarters of 2014.
- **Wholesale and retail trade and services**: Next to the destruction of service infrastructure, shops and equipment, retail and service activity is expected to be severely limited in 2014Q3 because of inactivity, difficulties to withdraw money from banks, and reduced imports from Israel. Staff expects a reduction in activity of 50 percent during the conflict, lowering the sector's output by 15 percent in the first three quarters of 2014.
- **VAT on imports**: VAT collection increased steadily since the closure of the tunnels due to larger official imports, up to 6 percent of total Gaza GDP in 2014 Q1. During the conflict, however, import activity was severely limited, reducing the third quarter VAT by 50 percent. Given large increases in the first half of the year, total year to date VAT is expected to have more than doubled in comparison to the same period in 2013.

10. **The risks to the near-term outlook are substantial.** If the current ceasefire failed to hold and the conflict resumed, the damage to the economy would increase. A truce without an easing of the Gaza blockade or a tepid response of donors to the financing need for infrastructure rebuilding and humanitarian assistance will postpone rebuilding and hence a recovery of economic activity. Other risks relate to potential inward spillovers from developments in the global economy and neighboring countries (Annex I).

11. **While a temporary boost to output might be expected next year from the rebuilding of Gaza, medium-term prospects remain bleak without a fundamental change of the political status quo.** The baseline scenario assumes that post-conflict reconstruction, supported by donors and private transfers, provides an economic boost to Gaza in 2015, after a sharp fall in output in 2014. The West Bank's economy is also likely to see a small rebound in 2015 after tepid growth in 2014. Beyond 2015, however, the baseline projection for the WBG is for a return to subpar growth of around 3 percent per year, implying rising unemployment and stagnant per capita incomes. This medium-term outlook is heavily dependent on how the political situation evolves, and the extent to which the Israeli restrictions in the West Bank and the blockade of Gaza persist.[14] The baseline scenario assumes that the political status quo remains in place and that peace negotiations are suspended with no immediate prospects of resumption, and hence no significant easing of Israeli restrictions. This scenario is unlikely to be sustainable over the medium term due to the potentially destabilizing effect of the unresolved conflict with Israel and economic stagnation with rising unemployment. On the other hand, as discussed in detail in the previous IMF report, a breakthrough in the conflict would yield a substantial peace dividend, benefitting both the Israeli and Palestinian economies.

POLICY ISSUES

A. Fiscal Policy

12. **Even before the conflict, staff cautioned that the PA faced a difficult fiscal situation in 2014.** On the revenue side, staff welcomed the authorities' efforts to implement revenue administration measures to increase the tax base and improve compliance in the context of the revenue strategy. Indeed, to some extent these efforts were reflected in the strong revenue performance in the first half of 2014. On the expenditure side, the authorities had contained wage spending in the first six months of the year, albeit in part because the payment of the cost-of-living adjustment was postponed to the end of the year. On the other hand, staff noted that recurrent expenditure had been gaining strength mostly on account of a strong increase in net lending. And with back-loaded donor support, arrears had continued to accumulate as little progress was made on strengthening commitment controls. All in all, staff noted that a significant financing gap in 2014 was likely, raising the specter of further arrears accumulation and posing risks to debt sustainability. An updated DSA shows that public debt in the baseline scenario remains sustainable in the medium term, but at a higher level than in the September 2013 DSA, and highly sensitive to a range of shocks (Annex II).

13. **Staff therefore stressed the need for fiscal discipline.** Staff emphasized the need for measures to reduce the financing gap, including: containing the overall increase in the wage bill to 3 percent rather than 5 percent in the budget; accelerating the reduction of poorly targeted fuel subsidies, while expanding the targeted cash transfer mechanism to support the poor; containing net

[14] The Government of Israel emphasizes security concerns that restrict its ability to ease or lift restrictions in the WBG.

lending by addressing the entrenched culture of non-payment in the electricity sector, relying on the World Bank's advice; and continuing efforts to increase revenue by raising tax compliance and reforming tax administration. Staff acknowledged that, with the year half over, it was not feasible to close the financing gap with fiscal measures alone and that additional external or domestic financing would be required to fill the gap. Recourse to further arrears accumulation to the private sector should be avoided as this undermines economic activity and tax collection efforts. In addition, staff cautioned that fiscal risks were on the rise and, if they materialized, would raise the financing gap further. The risks relate to increased Israeli deductions from clearance revenues, especially those related to the rising electricity debt with Israel, new spending pressures related to Gaza and the possible integration of the West Bank and Gaza administrations, and a shortfall in donor aid, much of which is yet to be disbursed. To counter these risks, staff recommended that a contingency plan be prepared. Such a plan would consist of additional expenditure cuts to avoid further arrears accumulation, and could include a wage freeze as a temporary measure and a complete freeze on nonessential spending.

14. **The authorities welcomed staff's recommendations, but there was little evidence of any traction.** While committed to prudent fiscal policies and wanting to avoid a further increase in arrears to the private sector, they were not willing to commit to specific measures to rein in spending. Instead, the authorities expressed frustration about the lack of control over a large part of their revenue base, citing unpredictable deductions by Israel from clearance revenue transfers as complicating fiscal management and planning. They also expressed concern about a perceived reduction in donor support.

15. **The conflict has made an already strained fiscal situation even more difficult for the PA to manage, and stepped up donor assistance will be critical.** The sharp decline in economic activity in Gaza will reduce revenue, but the bigger impact will be on the expenditure side. While the extent of the additional spending needs to alleviate human suffering and to repair physical damage in Gaza is not yet known, it is clear that the PA will not be able to absorb spending increases given its limited resources. Therefore, substantial additional donor assistance will be needed in 2014–15 and beyond to fund the reconstruction of Gaza. Given ongoing spending needs in the West Bank, it is important that the donor support is additional to, rather than a replacement of, the regular financial assistance the international community has been extending to the WBG for several years.

16. **For its part, the PA needs to maintain fiscal discipline and press ahead with fiscal reforms.** While some new donor cash assistance is expected in the aftermath of the conflict, it is unlikely to increase the spending envelope for the approved 2014 budget because much of the assistance may occur outside the PA's budget or, if through the budget, could be earmarked for Gaza. As a result, it is even more important now for the PA to take measures to reduce the financing gap. Moreover, given the dire fiscal position, it is now time to begin implementing the contingency measures discussed above. At the same time, public financial management (PFM) urgently needs to be enhanced for the government to strengthen its case for more aid and for additional aid to be used effectively. While progress has been achieved in cash management, arrears management needs to be improved, and reporting and recording of arrears must be made more reliable. This will be critical to sustain donors' confidence that their aid is used well. Given significant infrastructure needs, which are

exacerbated in the aftermath of the Gaza conflict, the PA's capacity to manage public investment must be increased for efficient identification, selection and appraisal of projects, and for reliable projections of their capital and recurrent costs.

17. **Beyond the next few years, the fiscal reform agenda remains largely unchanged, although the Gaza conflict has raised its urgency.** At a broad level, the current financing model that relies on donor aid to finance current spending is not viable. A transition to a model that would involve reduced recurrent deficits over time—helped by implementation of the revenue strategy—and a gradual shift in the composition of spending away from consumption toward growth-enhancing development spending is needed. Such a shift would have to be supported for some time by sustained and more predictable donor financing in combination with easing of Israeli restrictions. At a more specific level, the key areas for reform in the fiscal area over the medium term are not new:

- *Enhancing revenue*. The revenue strategy launched in early 2014 needs to be moved forward with a stronger focus on the Large Taxpayers Unit (LTU), which remains significantly understaffed, on functional reorganization, and on rolling back of tax incentives.[15] In this regard, the new amendments to the Investment Promotion Law are positive measures, as is the new 10 percent dividend tax slated to be implemented in 2015. The tax base should be expanded to Gaza if the unification between the Gaza and West Bank administrations proceeds.[16] Tax policies and tax legislation must be harmonized between Gaza and the West Bank to recover domestic tax revenue in Gaza that has not been collected by the PA since 2007 when the Hamas-led government took over the administration of Gaza.

- *Rationalizing expenditure*. On the expenditure side, comprehensive pension and civil service reforms are needed. A pension reform, along the lines agreed with the World Bank in 2010, would help contain growing pension costs and would require raising the retirement age and eliminating lump-sum payments at retirement. A civil service reform would help reduce the wage bill and raise public sector efficiency. To this end, the General Personnel Council (GPC) has started developing job classifications and descriptions for line ministries. The importance of progress in this area is also underscored by the prospect of unification of the Gaza-West Bank administrations and the need to ensure the creation of an efficient unified public sector from the start. In addition, spending on healthcare must be rationalized. The practice of granting free referrals for treatment abroad could be subject to abuse, and monitoring is needed to control the costs.

- *Reforming the electricity sector*. The government must address the longstanding problem of accumulation of contingent liabilities to Israel for electricity. Electricity debt payments are deducted by Israel on a monthly basis in an ad hoc manner from clearance revenues, and the PA records these in the budget as spending on net lending. The energy issue is complex and involves theft, technical losses, and poor payment discipline at all levels, including end-consumers, energy

[15] The latest initiative to put a term-limit on tax incentives is still not enacted.

[16] Given the size of Gaza's economy, it should contribute about a quarter of fiscal revenues.

distributors and municipalities. However, it needs to be addressed, because non-payment undermines fiscal discipline and contributes to unstable energy supply, thereby hurting the WBG's growth performance.

B. Rebuilding Gaza

18. **Economic growth in Gaza is expected to rebound quickly, but achieving a sustainable recovery will be a major challenge**. If the current ceasefire holds, a small but immediate economic recovery is likely, based on a quick revival of retail trade, the service sector, and small scale industry surrounding reconstruction activities. It is expected that international cash assistance to households that lost their homes and income sources will be substantial, further supporting this trend. However, one of the lessons of the post-2008/9 conflict experience is that a cash-based recovery is likely to be unsustainable (Box 3). Reconstruction activity will need to target small- and medium-sized enterprises, manufacturing, and agriculture, in order to reduce unemployment and build a sustainable economic foundation. In addition, crucial for any lasting recovery is the reconstruction of Gaza's electricity, building, and water and sewage infrastructure, which requires large scale external investment to regain even its pre-war state. Based on past experience, larger scale investment is likely to reach Gaza with a delay, and consequently unemployment is likely to remain high well into 2015.

19. **A sustainable recovery will depend on robust international support and coordination, as well as an easing of the blockade.** Similar to the aftermath of the 2008/09 conflict, international mobilization for Gaza's reconstruction is expected to begin shortly after the end of the conflict, based on a damage and needs assessment and a recovery and reconstruction plan for Gaza. The potentially large pledges will require strong coordination between the PA, international donors and support organizations in Gaza. Otherwise, there is a high risk that only a fraction of the pledges will materialize. Moreover, public and private sector capacity constraints risk dampening the near-term economic impact of large aid pledges. Crucially, reconstruction activity and the effective use of international aid are contingent on easing the blockade of Gaza, which heavily restricts the import of necessary construction material. Without a change in the border regime, a lasting recovery cannot be achieved.

C. Financial Sector Issues

20. **The PMA has been adroitly implementing its crisis preparedness plans in the face of deteriorating security conditions.** The recent episodes of bank closures in Gaza in response to armed threats from Hamas employees, who demanded to be paid salaries by the PA, have highlighted the risks that pertain to the banking system in the WBG. To address these risks, the PMA has been advancing its crisis preparedness, including in the areas of business continuity, scenario planning, risk mitigation, and disaster recovery. Recently, banks' risk reserves have been raised, and in the anticipation of potential banking disruptions, ATMs have been filled and their network expanded. Additionally, the PMA has been expanding mobile banking and the use of universal credit cards. These actions helped banks to service clients in Gaza even during the conflict.

Box 3. A Look Back at the Gaza War 2008/09 and Its Aftermath (Operation Cast Lead)

The first of the three recent Israeli-Palestinian military conflicts, Operation Cast Lead caused severe loss of life and property in Gaza.[1] The 23-day conflict that began at end-December 2008 left more than 1400 Palestinians killed and caused significant damages to buildings, farmland, and public infrastructure, including water and electricity. Unemployment surged from 32 percent in 2007 to 41.5 percent in the first quarter of 2009, and the overall cost of rebuilding Gaza was estimated at close to $5 billion.[2]

International resource mobilization began immediately after the hostilities ended, but actual donor disbursements fell short of pledges, as the blockade hampered project implementation. Based on the damage and needs assessment prepared jointly by the UN, NGOs, and the PA, the early recovery estimate for Gaza was $1.3 billion. Donors pledged a multiple of this amount at the March 2009 donors' conference in Sharm el-Sheikh, with pledges from Arab donors exceeding those of traditional donors. However, one year later, only a fraction of the pledges ($330 million) had materialized, as the realization of donor aid was severely limited by the restrictions on the import of construction materials by Israel. Consequently, most of the aid came in form of cash assistance to the poor, short-term employment schemes and emergency input-driven support to backyard farming (UN provided food assistance). In mid-2009, the PA adopted a supplementary recurrent budget of $0.3 billion for emergency expenditure, which was two-thirds financed by external budget support, and the remainder by further bank borrowing.

Although the reconstruction effort was hampered by the blockade, the economy rebounded due to the proliferation of tunnel trade activity. Restrictions on import of construction materials under the Israeli blockade severely impeded major reconstruction efforts. As a result, more than one year after the conflict, three quarters of the damage to buildings and infrastructure remained unrepaired. Unemployment surged, as manufacturing was deprived of inputs, and export markets declined. However, growing tunnel trade between Egypt and Gaza, financed by unofficial and private sources, helped the recovery. During 2009–11, Gaza's economy grew on average by 12 percent. By 2010, more than 70 percent of damaged homes had been repaired and more than 50 percent of the damaged and destroyed industrial establishments had been reconstructed and resumed operations, albeit in many cases at reduced capacity.[3]

However, the recovery was not sustainable. The recovery was consumption-driven, aided by cash assistance. The blockade hindered exports and investment, including in critical infrastructure such as electricity and water, limiting industrial development and job creation. In addition, the dependence on the informal tunnel trade exposed the economy to a risk which materialized in the fall of 2013, when the tunnels were shut down.

---

[1] The 2012 seven-day long conflict caused 163 casualties and substantially less economic damage than the 2014 or 2008/09 conflicts, and is therefore not used as a comparison here.

[2] Based on UNDP Report: *One Year After, Gaza—Early Recovery and Reconstruction Needs Assessment*, Jerusalem, May 2010.

[3] Unorthodox construction techniques, such as recycling of crushed rubble and compressed earth block technology, were used to circumvent import restrictions imposed under the blockade.

21. **In the aftermath of the conflict, a high level of supervisory vigilance is needed.** Experience elsewhere has shown that a sharp deterioration in economic conditions usually increases nonperforming loans. With the drop in economic activity in Gaza, and to some extent in the West Bank, the quality of loan portfolios is likely to weaken, which will be reflected in the financial soundness indicators only with a lag.[17] During the mission, staff also discussed two recurring issues:

- *The exposure of the banking system to the PA*. The PMA argued that direct bank exposure to the PA is manageable and that the WBG banking system indicators have been sound during extended periods of high exposure to the PA. Staff cautioned about relying too much on banking indicators to assess banking stability, noting that (i) the low NPLs could mask the practice of ever-greening of loans, and (ii) that the high CARs could be partly the result of a zero-risk-weighting of the loans to the PA and send a misleading signal given the precarious fiscal position of the PA.

- *Banks' high exposure to the housing market*. Most of the housing loans are at interest rates that are linked to the LIBOR, increasing the risk of a sharp increase in NPLs in case of higher global interest rates, for instance, under USA monetary tapering. Enhanced monitoring of the housing market is also called for in light of the existing plans to introduce mortgage-backed securities by the Palestinian Mortgage Housing Corporation. Although the exposure to the housing market is high, data on house prices and rents are not available, and the PMA's current stress testing framework does not account for real estate market developments. To address the issue of inadequate monitoring, the PMA and the PCBS have recently agreed to work on developing a house price index, and the PMA plans to introduce from end-2014 new stress tests to account for the risks in the housing market.

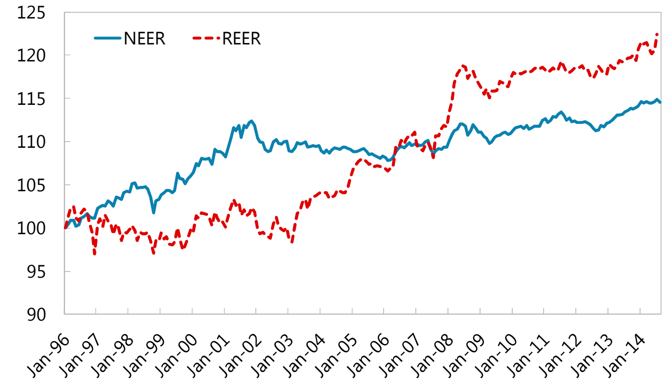
22. **The PMA expressed concerns about the limits set by the Bank of Israel on the amount of NIS cash transfers it accepts from Palestinian banks.** Israel's restrictions have been a longstanding issue arising out of money-laundering and financing of terrorism concerns. Current agreed limits on monthly cash shipments are set at NIS300 million, which are insufficient as the WBG is a largely cash-based economy, leading to persistent excessive cash accumulation in the Palestinian banks. Limits on cash shipments have been relaxed for the months of July and August, with shipments of NIS600 million each. However, the outstanding stock of cash in banks now exceeds NIS800 million, incurring losses to the banks, hurting financial intermediation, and contributing to high lending rates. The Bank of Israel believes that over time the greater use of non-cash payments in both Israel and the WBG will help to alleviate the excess cash problem.

[17] After the 2008/09 conflict, however, the banking sector proved to be resilient. A one-month spike in banks' excess reserves at the PMA and a slight reduction in credit growth were observed, but NPLs remained low and deposits stayed stable.

D. Structural Issues

23. **Structural policies to improve the investment climate and strengthen competitiveness remain an important component of the authorities' reform agenda regardless of political developments.** As was highlighted in the past IMF and World Bank reports, political uncertainty and Israeli restrictions seriously impact the investment climate in the WBG.[18] In addition, price based indicators of competitiveness, such as the real effective exchange rate, imply that the WBG has lost competitiveness over time (text chart). Staff has argued that there is scope for independent policy action to improve the business climate. Although some progress has been made in this area, particularly in access to finance with the adoption of the Leasing Law, much remains to be done.[19] This includes enacting the New Companies Law, the New Industry Law, the Debt Resolution Law and the Law on Secured Transactions, and activating the Movable Collateral Registry. Additionally, progress is urgently needed on land registration, which is among key factors hindering private investments in the WBG according to the World Bank.[20] Harmonization of the business regulations in the WBG is another challenge that will need to be tackled in the context of unification. The authorities agree with the staff on the structural reform agenda, but point out that the absence of a functioning legislature hinders policy action.

Effective Exchange Rate
(Index, Jan 1996=100)



Sources: Haver; INS; and IMF staff calculations.

STAFF APPRAISAL

24. **The West Bank and Gaza's economic situation was difficult even before the Israel-Hamas military conflict in July-August.** Against the background of continued Israeli restrictions and rising political uncertainty, the WBG economy has been on a slowing trend since 2012, causing real per capita incomes to decline and unemployment to rise. Going forward, increased political uncertainty translates into greater macro-fiscal risks, and prudent policies by the PA as well as continued donor support are therefore needed more than ever. Despite the understandable focus on short-term economic management, it is important for the PA not to lose sight of the structural reform agenda aimed at boosting the economy's performance over the medium term.

[18] For example, it takes on average 23 days for businesses in the West Bank to export and 38 days to import, compared to just 10 days for businesses in Israel. See *West Bank and Gaza Investment Climate Assessment: Fragmentation and Uncertainty,* World Bank, 2014.

[19] See June 2014 IMF Report on Macroeconomic Developments and Outlook.

[20] See *West Bank and Gaza Investment Climate Assessment, op cit.*

25. **The conflict represents a major economic shock for the Palestinian economy**. The economic outlook has deteriorated sharply compared to the IMF's previous report, especially for Gaza, which has suffered a devastating loss of life and property, the impact of which is only beginning to be assessed. Given a sharp output loss in the third quarter, Gaza's real GDP is estimated to have declined by about 20 percent in the first three quarters of 2014, compared to the same period in 2013. For the year as a whole, we project that real GDP in Gaza will decline by 15 percent, and by 3¾ percent in the WBG, although these projections may need to be revised once more information becomes available. Going forward, the speed of economic recovery will depend on whether the current ceasefire agreement translates into a longer-lasting truce with an easing of the blockade of Gaza, and on the extent to which the international community is able to mobilize aid for Gaza. Of course, as discussed in past reports, the economic dividend from a broader Israeli-Palestinian peace agreement would be substantial.

26. **The cost of rebuilding Gaza goes well beyond the PA's resources and generous donor support will be critical**. The full fiscal impact of the conflict is not yet known, but there is little doubt that the PA faces large expenditure needs related to the reconstruction of Gaza. The PA and international agencies will need to make a realistic assessment of these needs in the coming weeks and months. It will be important for the PA, with the support of its international partners, to prepare a recovery and reconstruction plan along the lines of what was presented at the 2009 Gaza Conference in Egypt. It is clear that there is no room in the PA's budget to accommodate the new spending needs, and that stepped up donor financial assistance will be critical. The WBG remains structurally reliant on donor assistance, even in the absence of the costs related to Gaza rebuilding, and it is important for donors to treat the Gaza-related assistance as an addition to the aid envelope and not a substitution.

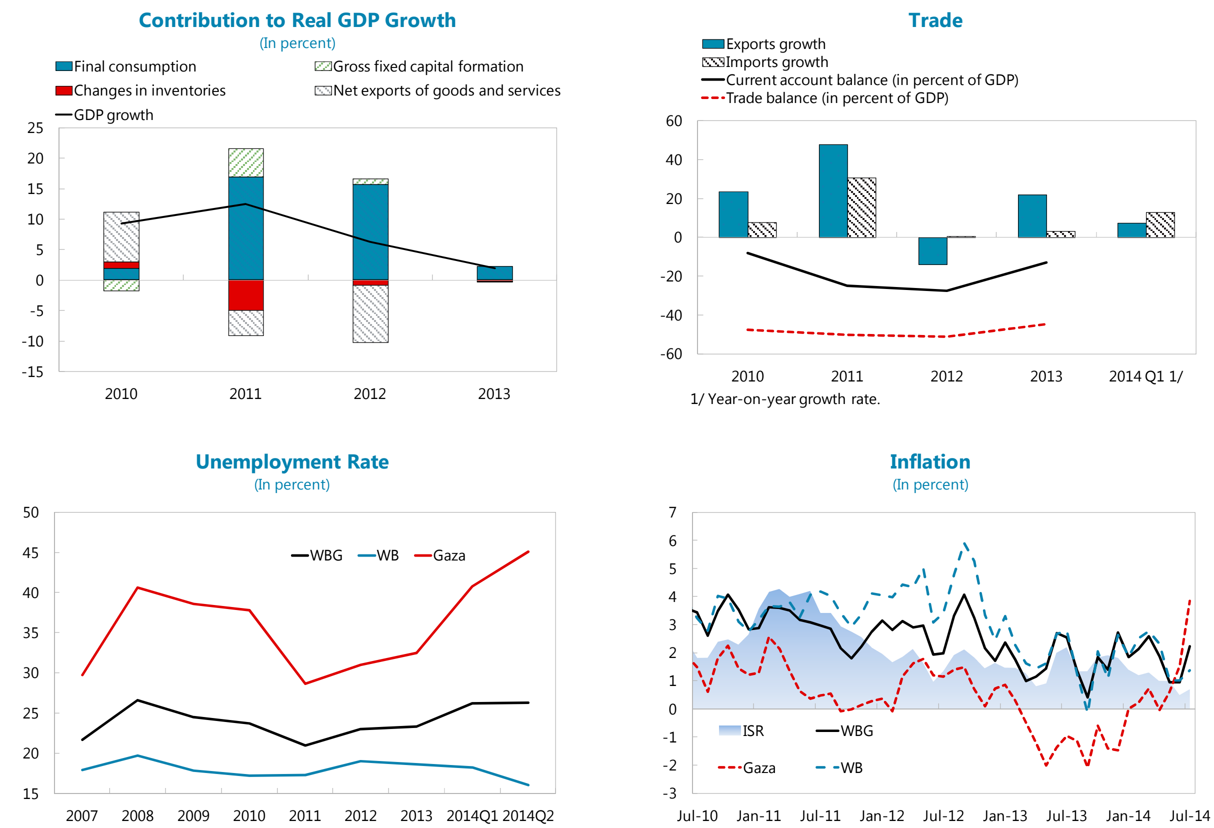
27. **Against this background, the PA needs to maintain fiscal discipline and, together with its international partners, urgently develop a robust fiscal mechanism to harness effectively donor aid in Gaza**. Fiscal risks, which were already substantial before the conflict, have risen substantially. There are certainly grounds for higher spending related to Gaza reconstruction, but this needs to be tied to the availability of financing. In the meantime, the PA should contain current spending, especially in light of other fiscal risks, including the additional potential spending commitments—for instance, on salaries for public sector workers in Gaza—associated with integrating the West Bank and Gaza administrations. At the same time, the PA's welcome efforts to increase revenues should continue, to increase the resources available for meeting the rising spending needs. The PA also needs to urgently improve public financial management, including budgeting and accounting, to strengthen donors' confidence that aid is used effectively and transparently. To that end, the authorities may wish to seek scaled-up technical assistance from development partners and the IMF. Raising the capacity to manage public investments will need to be high on the PA's agenda in light of the coming repairs to Gaza's infrastructure.

28. **It is important that other economic policy areas are not forgotten as the focus on short-term crisis management sharpens in the aftermath of the conflict.** The impact of the conflict on the real sector may well weaken the quality of banks' loan portfolios, so enhanced PMA monitoring of the banking system is important. Beyond that, longstanding issues such as improving the business

climate, pension and civil service reforms, and strengthening the electricity sector, which is draining the budget, should not be forgotten. Indeed, the conflict makes some of these reforms even more pressing.

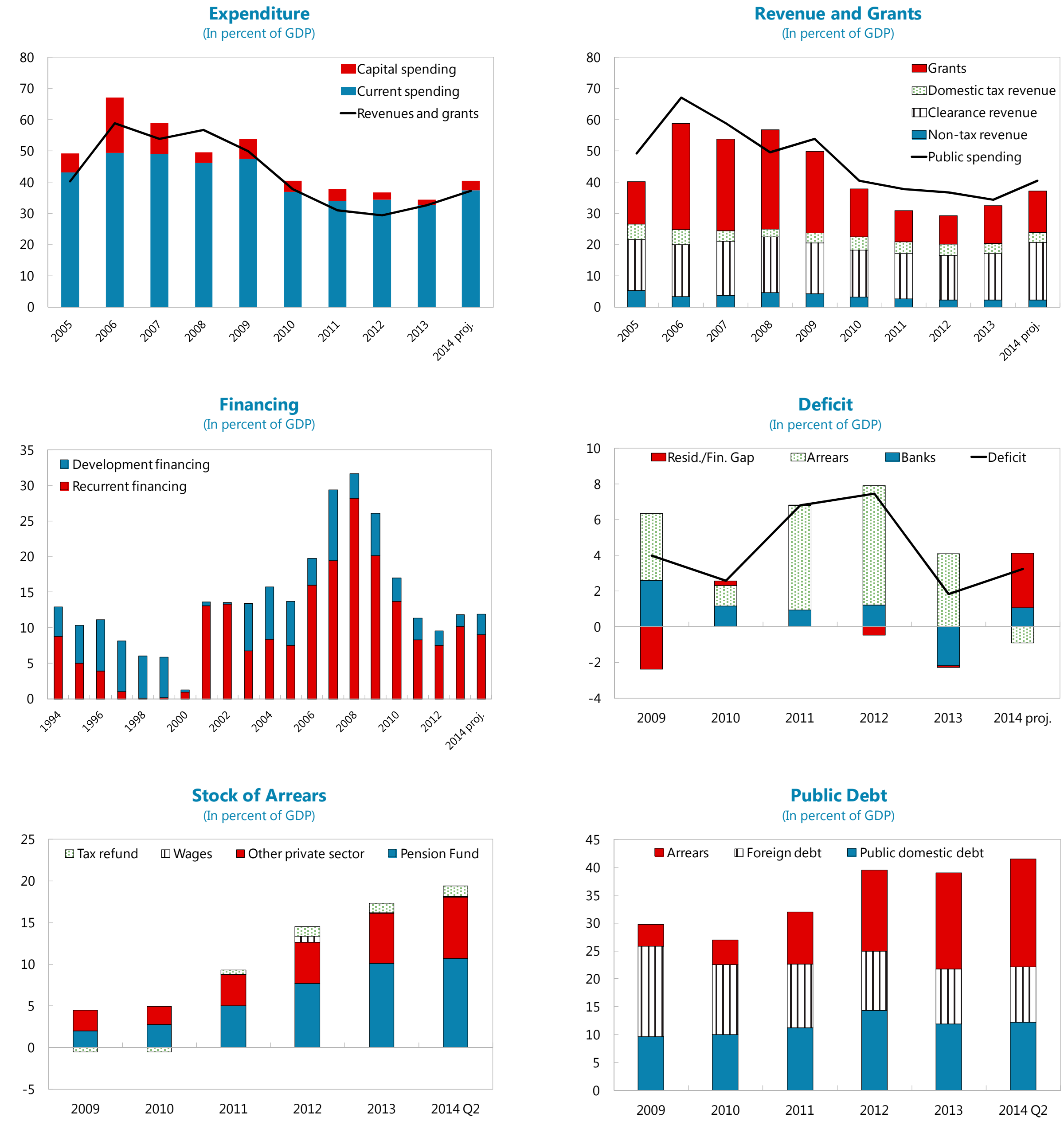
29. **A strong and sustainable recovery in Gaza will depend on an easing of the blockade and large-scale donor support.** The post-2008/09 conflict experience suggests that the following factors are central in producing a robust recovery: first, a lifting or at least an easing of the blockade of Gaza is needed so that construction materials can be imported into Gaza; second, in order to harness effectively the potentially large donor pledges, strong coordination between the PA, international donors, and support organizations in Gaza will be required; and third, generous financial support from the international community is needed in light of the large scale physical destruction in Gaza. It will be important that robust verification and monitoring procedures be put in place to ensure that financial assistance is used for intended purposes. From a broader perspective, it is important to reiterate the need to shift to a viable financing model, to replace the current unsustainable one, focused on a pro-growth re-composition of spending toward development, supported by more predictable donor financing and an easing of Israeli restrictions in the West Bank.

Figure 1. West Bank and Gaza: Recent Economic Developments, 2007–14



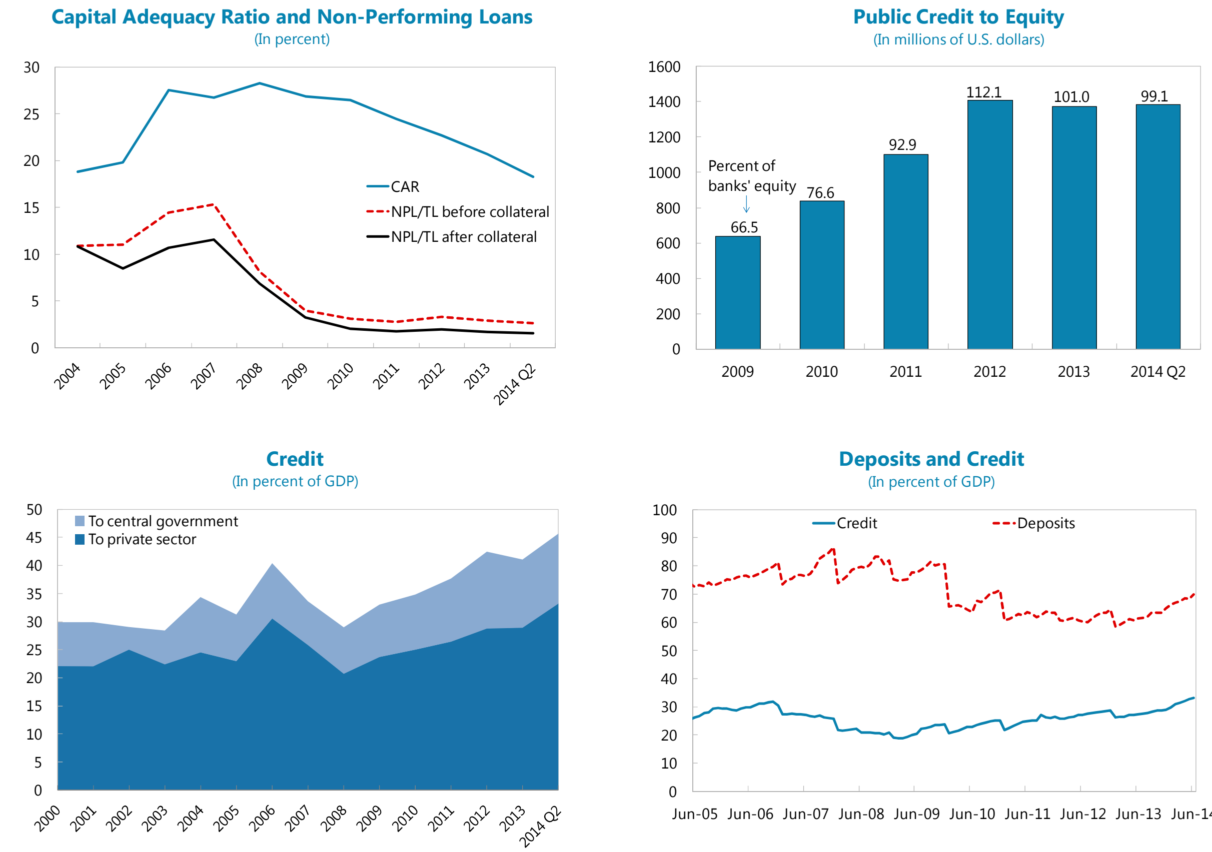
Sources: Palestinian Central Bureau of Statistics; and IMF staff estimates.

Figure 2. West Bank and Gaza: Fiscal Sector Indicators, 1994–2014



Sources: Ministry of Finance; and IMF staff estimates.

Figure 3. West Bank and Gaza: Financial Sector Indicators, 2000–14



Sources: Palestine Monetary Authority; and IMF staff estimates.

Table 1. West Bank and Gaza: Selected Economic Indicators, 2011–19

(Population: 4.4 million; 2012 est.)
(Per capita GDP: $2,557; 2013)
(Poverty rate: 18 percent in the West Bank and 39 percent in Gaza Strip; 2011 est.)

			Est.	Projections					
	2011	2012	2013	2014	2015	2016	2017	2018	2019
Output and prices				(Annual percentage change)					
Real GDP (2004 market prices)	12.4	6.3	1.9	-3.7	4.4	4.0	3.5	3.0	3.0
West Bank	10.7	6.1	0.5	0.5	2.3	2.6	2.6	2.7	2.6
Gaza	17.7	7.0	6.0	-15.0	11.0	8.0	6.0	4.0	4.0
CPI inflation rate (end-of-period)	2.7	1.7	2.7	2.8	2.7	2.7	2.6	2.6	2.6
CPI inflation rate (period average)	2.9	2.8	1.7	2.6	2.8	2.7	2.7	2.6	2.6
Investment and saving				(In percent of GDP)					
Gross capital formation, *of which:*	17.3	13.7	12.4	13.8	15.9	15.8	15.8	14.4	14.7
Public	3.8	3.8	3.6	3.9	5.9	5.7	5.5	3.9	3.8
Private	13.5	9.9	8.8	9.9	10.0	10.1	10.4	10.5	10.9
Gross national savings, *of which:*	-6.4	-15.2	-5.6	-12.3	-15.5	-13.3	-12.6	-11.3	-11.3
Public	-4.7	-6.6	-1.1	-2.1	-3.1	-2.4	-1.7	-1.1	-0.5
Private	-1.6	-8.6	-4.5	-10.2	-12.4	-11.0	-10.9	-10.2	-10.8
Saving-investment balance	-23.6	-28.9	-18.0	-26.1	-31.4	-29.2	-28.4	-25.7	-26.0
Public finances 1/				(In percent of GDP)					
Revenues	20.9	20.2	20.5	24.0	23.9	23.8	23.8	23.8	23.9
Recurrent expenditures and net lending	34.0	34.4	32.7	37.5	35.4	33.9	32.8	31.7	30.8
Wage expenditures	18.2	17.2	17.0	18.4	17.7	17.0	16.4	15.8	15.3
Nonwage expenditures	14.3	14.4	13.8	16.4	15.9	15.4	15.0	14.7	14.4
Net lending	1.4	2.7	1.9	2.6	1.8	1.5	1.3	1.2	1.0
Recurrent balance (commitment, before external support)	-13.1	-14.2	-12.2	-13.5	-11.4	-10.1	-9.0	-7.9	-6.9
Recurrent balance (cash, before external support)	-8.0	-7.8	-8.3	-14.4	-12.3	-10.9	-9.7	-8.6	-7.6
Development expenditures	3.8	2.4	1.7	3.0	4.1	3.9	3.8	2.4	2.4
(In millions of U.S. dollars)	370	243	187	328	488	510	531	352	373
Overall balance (commitment, before external support)	-16.9	-16.5	-13.9	-16.5	-15.5	-14.1	-12.8	-10.3	-9.3
Total external support, including for development expenditures	10.1	9.1	12.0	13.2	9.9	9.3	8.9	8.4	7.9
(In millions of U.S. dollars)	984	930	1,362	1,467	1,193	1,208	1,222	1,236	1,227
External support for recurrent expenditure (in millions of U.S. dollars)	815	774	1,255	1,267	1,000	1,000	1,000	1,000	1,000
In percent of GDP	8.3	7.6	11.1	11.4	8.3	7.7	7.2	6.8	6.4
Financing gap (in millions of U.S. dollars) 2/	...	...	...	349	661	608	565	296	244
In percent of GDP	...	...	...	3.1	5.5	4.7	4.1	2.0	1.6
Monetary sector 3/				(Annual percentage change)					
Credit to the private sector	24.2	14.3	11.0	13.0	10.0	9.5	9.5	9.0	9.0
Private sector deposits	4.0	6.8	10.7	9.9	7.4	7.4	6.7	6.3	5.8
External sector				(In percent of GDP)					
Current account balance (excluding official transfers)	-32.0	-36.4	-29.1	-37.5	-39.7	-36.9	-35.7	-32.6	-32.4
Current account balance (including official transfers)	-23.6	-28.9	-18.0	-26.1	-31.4	-29.2	-28.4	-25.7	-26.0
Exports of goods and nonfactor services	15.4	16.3	18.6	19.0	19.3	19.2	19.2	18.9	19.0
Import of goods and nonfactor services	59.1	63.1	58.8	69.2	71.0	67.7	66.1	62.3	62.0
Net factor income	7.3	7.0	7.1	7.7	7.5	7.4	7.3	7.2	7.1
Net current transfers	12.7	10.9	15.0	16.4	12.8	11.9	11.2	10.5	9.9
Private transfers	4.4	3.3	3.9	5.0	4.4	4.2	3.9	3.7	3.5
Official transfers	8.3	7.6	11.1	11.4	8.3	7.7	7.2	6.8	6.4
Memorandum items:									
Nominal GDP (in millions of U.S. dollars)	9,775	10,255	11,302	11,090	12,018	12,920	13,794	14,671	15,540
Per capita nominal GDP (U.S. dollars)	2,345	2,389	2,557	2,437	2,567	2,682	2,784	2,880	2,966
Unemployment rate	21	23	25	30	29	30	31	32	32
Al Quds stock market index (annual percentage change)	-2.6	0.1	13.4	…	…	…	…	…	…

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

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

Table 2. West Bank and Gaza: Central Government Fiscal Operations, 2011–17

	2011	2012	2013		Budget	SR	Projections			
			Sep. Staff Report	Outcome	2014	2014	2014	2015	2016	2017
	(In millions of shekels, unless otherwise stated)									
Net revenues	7,321	7,989	8,085	8,348	9,311	9,216	9,446	10,139	10,809	11,509
Gross domestic revenues	2,642	2,806	3,047	3,078	3,326	3,231	2,884	3,102	3,262	3,430
Tax revenues	1,727	1,852	2,129	2,157	2,329	2,240	1,977	2,079	2,191	2,308
Nontax revenues (accrued)	915	954	918	921	997	991	907	1,023	1,072	1,122
Of which: arrears	130	59	...	...	...	...	...	...	...	...
Clearance revenues (accrued)	5,095	5,617	5,870	6,103	6,545	6,545	7,262	7,637	8,047	8,479
Of which: arrears	-235	-479	-147	14	...	...	...	...	...	...
Less tax refunds 1/	416	434	832	834	560	560	700	600	500	400
Of which: arrears	368	239	...	27	...	...	...	...	...	...
Recurrent expenditures and net lending (commitment)	11,897	13,593	13,431	13,336	13,915	14,175	14,768	14,991	15,410	15,845
Of which: arrears	1,300	1,863	-272	1,601	...	-356	-356	-353	-351	-351
Wage expenditures (commitment)	6,381	6,812	6,956	6,928	7,265	7,265	7,265	7,520	7,720	7,925
Of which : arrears	374	816	-272	380	...	...	...	...	...	...
Nonwage expenditures (commitment)	5,015	5,709	5,925	5,648	6,050	6,050	6,463	6,722	6,990	7,270
Of which: arrears	926	1,046	...	1,221	...	-356	-356	-353	-351	-351
Net lending	501	1,072	550	760	600	860	1,040	750	700	650
Development expenditures (commitment)	1,325	937	1,010	674	1,260	704	1,165	1,723	1,792	1,862
Of which: on Gaza reconstruction	...	...	...	...	...	...	...	706	703	701
Of which: arrears	270	124	...	66	...	...	...	...	...	...
Recurrent balance (commitment, excl. development expenditure)	-4,576	-5,604	-5,346	-4,988	-4,604	-4,959	-5,322	-4,853	-4,601	-4,335
Overall balance (committment)	-5,901	-6,541	-6,356	-5,662	-5,864	-5,663	-6,487	-6,576	-6,393	-6,198
Total financing	5,901	6,541	6,356	5,662	5,864	5,663	6,487	6,576	6,393	6,198
Net domestic bank financing	334	490	272	-895	...	425	425	425	425	425
External debt repayment						-37	-37	-39	-61	-144
External financing for recurrent expenditures	2,915	2,986	4,319	4,532	4,784	4,226	4,504	3,528	3,514	3,507
External financing for development expenditures	605	601	676	383	1,080	429	711	682	730	778
Arrears	2,043	2,646	-125	1,680	...	-356	-356	-353	-351	-351
Residual/financing gap 2/	4	-182	1,214	-38	...	976	1,240	2,333	2,137	1,983
	(In millions of U.S. dollars, unless otherwise stated)									
Net revenues	2,046	2,072	2,153	2,312	2,586	2,592	2,657	2,874	3,076	3,282
Gross domestic revenues	738	728	811	853	924	909	811	879	928	978
Tax revenues	483	480	567	598	647	630	556	589	623	658
Nontax revenues (accrued)	256	248	244	255	277	279	255	290	305	320
Of which: arrears	36	15	...	...	...	...	...	...	...	...
Clearance revenues (accrued)	1,424	1,457	1,563	1,691	1,818	1,841	2,043	2,165	2,290	2,418
Of which: arrears	-66	-124	-39	4	...	...	...	...	...	...
Less tax refunds	116	113	221	231	156	158	197	170	142	114
Of which: arrears	103	62	...	7	...	...	...	...	...	...
Recurrent expenditures and net lending (commitment)	3,325	3,525	3,576	3,694	3,865	3,987	4,154	4,250	4,386	4,518
Of which: arrears	363	483	-72	443	...	-100	-100	-100	-100	-100
Wage expenditures (commitment)	1,783	1,767	1,852	1,919	2,018	2,044	2,044	2,132	2,197	2,260
Of which: arrears	105	212	-72	105	...	...	...	...	...	...
Nonwage expenditures (commitment)	1,402	1,481	1,578	1,565	1,681	1,702	1,818	1,905	1,989	2,073
Of which: arrears	259	271	...	338	...	-100	-100	-100	-100	-100
Net lending (commitment)	140	278	146	210	167	242	293	213	199	185
Development expenditures (commitment)	370	243	269	187	350	198	328	488	510	531
Of which: on Gaza reconstruction	...	...	...	...	...	...	...	200	200	200
Of which: arrears	76	32	...	18	...	...	...	...	...	...
Recurrent balance (commitment, excl. development expenditure)	-1,279	-1,453	-1,424	-1,382	-1,279	-1,395	-1,497	-1,376	-1,309	-1,236
Overall balance (committment)	-1,649	-1,696	-1,692	-1,568	-1,629	-1,593	-1,825	-1,864	-1,820	-1,767
Total financing	1,649	1,696	1,692	1,568	1,629	1,593	1,825	1,864	1,820	1,767
Net domestic bank financing	93	127	72	-248	...	120	120	120	121	121
External debt repayment						-10	-10	-11	-17	-41
External financing for recurrent expenditures	815	774	1,150	1,255	1,329	1,189	1,267	1,000	1,000	1,000
External financing for development expenditures	169	156	180	106	300	121	200	193	208	222
Arrears	571	686	-33	465	...	-100	-100	-100	-100	-100
Residual/Financing gap 2/	1	-47	323	-11	...	274	349	661	608	565
Memorandum items:	(In percent of GDP, unless otherwise stated)									
Revenues	20.9	20.2	19.8	20.5	23.6	21.6	24.0	23.9	23.8	23.8
Recurrent expenditures and net lending	34.0	34.4	32.9	32.7	35.3	33.2	37.5	35.4	33.9	32.8
Wage expenditures	18.2	17.2	17.1	17.0	18.4	17.0	18.4	17.7	17.0	16.4
Nonwage expenditures	14.3	14.4	14.5	13.8	15.3	14.2	16.4	15.9	15.4	15.0
Net lending	1.4	2.7	1.3	1.9	1.5	2.0	2.6	1.8	1.5	1.3
Recurrent balance (commitment) before external support	-13.1	-14.2	-13.1	-12.2	-11.7	-11.6	-13.5	-11.4	-10.1	-9.0
External financing for recurrent expenditures	8.3	7.6	10.6	11.1	12.1	9.9	11.4	8.3	7.7	7.2
Development expenditures (cash)	3.0	2.1	2.5	1.5	3.2	1.6	3.0	4.1	3.9	3.8
Overall balance (commitment)	-16.9	-16.5	-15.6	-13.9	-14.9	-13.3	-16.5	-15.5	-14.1	-12.8
Overall balance (cash)	-11.0	-9.8	-15.9	-9.8	-14.9	-14.1	-17.4	-16.3	-14.9	-13.5
Residual/financing gap	0.0	-0.5	3.0	-0.1	0.0	2.3	3.1	5.5	4.7	4.1
Nominal exchange rate (NIS per U.S. dollar)	3.58	3.86	...	3.61	...	...	...	...	...	...
Nominal GDP (in millions of shekels)	34,977	39,541	40,800	40,800	39,426	42,674	39,426	42,392	45,399	48,374

Sources: Ministry of Finance; and IMF staff projections.

1/ Includes fuel subsidies.

2/ Financing gaps in the medium term are expected to be filled by grants that are yet to be identified.

Table 3. West Bank and Gaza: Central Government Fiscal Operations, 2011–17
(GFSM 2001)

	2011	2012	2013	Projections			
				2014	2015	2016	2017
	(GFSM 2001; in millions of shekels)						
Revenue	10,841	11,576	13,263	14,661	14,348	15,053	15,794
Taxes	6,406	7,035	7,426	8,539	9,116	9,738	10,387
Domestic taxes	1,727	1,852	2,157	1,977	2,079	2,191	2,308
Clearance taxes	5,095	5,617	6,103	7,262	7,637	8,047	8,479
Tax refund	-416	-434	-834	-700	-600	-500	-400
Grants	3,520	3,587	4,915	5,215	4,209	4,244	4,285
External budget support	2,915	2,986	4,532	4,504	3,528	3,514	3,507
External development support	605	601	383	711	682	730	778
Other revenue	915	954	921	907	1,023	1,072	1,122
Of which: dividends	160	120	116	114	129	135	141
Expenditures	13,222	14,530	14,009	15,933	16,714	17,203	17,707
Expense	11,897	13,593	13,336	14,768	14,991	15,410	15,845
Compensation of employees 1/	6,381	6,812	6,928	7,265	7,520	7,720	7,925
Use of goods and services	1,792	2,112	2,148	2,252	2,331	2,393	2,457
Grants 2/	501	1,072	760	1,040	750	700	650
Other expense 3/	3,223	3,597	3,500	4,211	4,390	4,597	4,813
Net acquisition of nonfinancial assets	1,325	937	674	1,165	1,723	1,792	1,862
Gross operating balance	-1,056	-2,017	-73	-107	-643	-357	-50
Net lending / borrowing (overall balance)	-2,381	-2,954	-746	-1,272	-2,366	-2,150	-1,913
Net financial transactions	-2,381	-2,954	-746	-1,272	-2,366	-2,150	-1,913
Net acquisition of financial assets	…	…	…	…	…	…	…
Domestic							
Currency and deposits	…	…	…	…	…	…	…
Net incurrence of liabilities	2,377	3,136	785	32	34	13	-70
Domestic	2,377	3,136	785	70	72	74	74
Loans	334	490	-895	425	425	425	425
Net domestic bank financing	334	490	-895	425	425	425	425
Other accounts payable	2,043	2,646	1,680	-356	-353	-351	-351
Arrears (recurrent)	1,538	2,043	1,628	-356	-353	-351	-351
Arrears (capital)	270	124	66	…	…	…	…
Arrears (clearance)	-235	-479	14	…	…	…	…
Foreign	…	…	…	-37	-39	-61	-144
Loans	…	…	…	-37	-39	-61	-144
Statistical discrepancy/financing gap	4	-182	-38	1,240	2,333	2,137	1,983
Memorandum items:							
Gross operating balance excl. grants (commitment)	-4,576	-5,604	-4,988	-5,322	-4,853	-4,601	-4,335
Gross operating balance excl. grants (cash)	-2,803	-3,082	-3,374	-5,677	-5,205	-4,952	-4,686
Overall balance (NLB) excl. grants (commitment)	-5,901	-6,541	-5,662	-6,487	-6,576	-6,393	-6,198
Overall balance (NLB) excl. grants (cash)	-3,858	-3,894	-3,982	-6,842	-6,928	-6,745	-6,548
Revenue (percent of GDP)	31.0	29.3	32.5	37.2	33.8	33.2	32.7
Expenditure (percent of GDP)	37.8	36.7	34.3	40.4	39.4	37.9	36.6
Expense (percent of GDP)	34.0	34.4	32.7	37.5	35.4	33.9	32.8
Wage expenditure (percent of GDP)	18.2	17.2	17.0	18.4	17.7	17.0	16.4
Nonwage expenditures (percent of GDP)	5.1	5.3	5.3	5.7	5.5	5.3	5.1
GOB (commitment) excluding grants (percent of GDP)	-13.1	-14.2	-12.2	-13.5	-11.4	-10.1	-9.0
GOB (cash) excluding grants (percent of GDP)	-8.0	-7.8	-8.3	-14.4	-12.3	-10.9	-9.7
External support (recurrent)	8.3	7.6	11.1	11.4	8.3	7.7	7.2
in millions of NIS	2,915	2,986	4,532	4,504	3,528	3,514	3,507
NLB (commitment) excluding grants (percent of GDP)	-16.9	-16.5	-13.9	-16.5	-15.5	-14.1	-12.8
NLB (cash) excluding grants (percent of GDP)	-11.0	-9.8	-9.8	-17.4	-16.3	-14.9	-13.5
Total external support (in millions of shekels)	3,520	3,587	4,915	5,215	4,209	4,244	4,285
Nominal GDP (in millions of shekels)	34,977	39,541	40,800	39,426	42,392	45,399	48,374
Exchange rate	3.6	3.9	3.6	…	…	…	…

Sources: Ministry of Finance; and IMF staff projections.

1/ Wage expenditures.

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

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

Table 4. West Bank and Gaza: Financial Soundness Indicators, 2010–14
(In percent)

	Dec-10	Dec-11	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14
Capital adequacy (for all banks)									
Tier I capital to risk-weighted assets	23.3	22.9	22.2	21.5	21.2	21.0	21.5	21.1	20.1
Regulatory capital to risk-weighted assets	21.4	21.1	20.3	19.8	19.5	19.3	20.0	19.6	18.9
Capital adequacy (for local banks)									
Tier I capital to risk-weighted assets	26.5	24.5	22.7	21.2	20.9	20.5	20.7	20.4	18.3
Regulatory capital to risk-weighted assets	21.6	20.3	18.8	17.7	17.7	17.3	17.8	17.5	16.2
Asset quality 1/									
Nonperforming loans (percent of total loans)	3.1	2.7	3.1	3.2	3.1	2.9	2.9	2.8	2.6
Nonperforming loans net of provisions to capital	2.9	3.8	4.9	4.7	5.1	4.8	4.7	4.8	4.4
Coverage ratio (provisions as percent of nonperforming loans)	70.4	60.9	60.1	61.6	59.3	60.5	59.1	58.9	61.2
Earnings and profitability									
Return on assets (ROA)	2.1	1.9	1.8	2.0	2.0	2.0	1.9	1.9	1.8
Return on equity (ROE) 2/	21.1	17.0	16.2	19.1	18.5	18.8	18.7	18.6	17.8
Interest income to gross income	59.4	71.7	72.4	74.0	75.0	74.6	74.0	74.5	74.1
Non-interest expenses to gross income	55.0	57.2	55.4	52.8	53.5	54.1	54.8	55.0	58.2
Personal cost to non-interest expenses	55.3	55.5	53.8	57.4	56.9	55.1	53.9	56.3	53.7
Liquidity									
Liquid assets to total assets	40.3	38.2	37.5	36.3	36.8	37.5	39.5	38.0	37.0
Liquid assets to demand and savings deposits	78.4	74.4	71.6	69.1	69.4	71.1	74.7	72.0	71.1
Liquid assets to total deposits	49.1	46.9	45.8	44.6	45.0	45.8	48.1	46.5	45.7

Source: Palestine Monetary Authority.

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

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

Annex I. Risk Assessment Matrix[1]
Potential Deviations from Baseline

Nature/Sources of Main Threats	Likelihood of Realization in the Next Three Years	Expected Impact on Economy if Risk is Realized	Policy Recommendations to Mitigate Risks
Heightened geopolitical risks in the Middle East, leading to a sharp rise in oil prices, with negative spillovers to the global economy	***High/Short term***	***High*** The WBG is highly dependent on energy imports. Social pressures for costly mitigating measures would increase, particularly if second-round effects become prominent, and worsen an already difficult fiscal outlook.	(1) Implement full pass-through to consumers including for electricity tariffs; (2) Follow up efforts to improve collection at the local level; and (3) Use the existing targeted cash transfer scheme to support the poor.
Protracted period of slower growth in advanced and emerging economies	***High/Short to medium term***	***Low*** A further slowdown in growth, higher unemployment, and worsening in the fiscal position. The WBG is sensitive to a slowdown in Israel. Austerity in donor countries could affect availability of aid for the PA.	(1) Instill confidence through strong domestic policies, anchored in medium-term fiscal adjustment; (2) Improve competitiveness of the economy via scaled-up investment in infrastructure, and education to support human capital development.
Pressures on the banking system mostly from a deteriorating domestic and regional environment, and potentially from the USA's monetary tapering	***Medium/Short to medium term***	***Medium*** The WBG banks are heavily exposed to the PA and its employees. There are no direct linkages to global financial markets, but the considerable presence of Jordanian banks could pose major challenges in case of a crisis in the home country, because of insufficient coordination in bank resolution across borders. In addition, most mortgage lending rates are linked to the LIBOR, and their rise as USA monetary tapering progresses could lead to higher NPLs. The restriction on cash transfers by WBG banks to Israel is another source of risk.	(1) Instill confidence through strong domestic policies, anchored in medium-term fiscal adjustment; (2) Further strengthen the banking supervisory framework, including cross-border supervision and cooperation with the Central Bank of Jordan; (3) Broaden data coverage of the real estate market; and (4) Develop an early warning model and a contingency plan.
Resumption of hostilities between Hamas and Israel; a surge in unrest in Gaza and the West Bank	***Medium to High/Short to medium term***	***Medium to High*** If the conflict resumes, the humanitarian and economic situation in Gaza would deteriorate further. Even if the truce holds, domestic unrest in the West Bank (e.g., due to a flare-up of violence in Gaza because of further deterioration of the humanitarian situation) could lead to a tightening of Israeli restrictions, and possible suspension of clearance revenue transfers. Some donors may withdraw support.	In the short run, economic policies can do little to mitigate these particular risks. At best, maintaining strong domestic policies could instill some element of confidence.

Donor "fatigue"	***Medium/Medium term***	***High*** The suspension of peace talks, if sustained, could lead some donors to reconsider their long-term commitment to supporting the PA, which could threaten fiscal sustainability.	(1) Instill confidence through strong domestic policies, anchored in medium-term fiscal adjustment; (2) Support fiscal sustainability via pro-growth policies; and (3) Continue reforms to improve government institutions.
Spillovers from social unrest in Egypt, Iraq, Jordan, Lebanon, and Syria	***Medium to High/Short term***	***High*** Social and political unrest in the nearby region could spill over to the WBG and potentially divert donor money away from the WBG.	Economic policies can do little to mitigate these particular risks. At best, maintaining strong domestic policies could instill some element of confidence.
[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.			

Annex II. West Bank and Gaza: Debt Sustainability Analysis—An Update

Public debt continued to increase in 2013 and the first half of 2014, reflecting growing arrears.[1] Since the end of 2012 public debt increased by $838 million, reaching $4.9 billion or 44 percent of projected 2014 GDP, and exceeding a 40 percent government-mandated threshold for public debt. During this period, arrears grew by $929 million, including by $237 million during the first six months of 2014, reaching $2.3 billion.[2] Arrears to the Pension Fund and private suppliers remained the primary financing source of the financing gap. They also were used to substitute for expensive domestic financing, which declined since end-2012 by $113 million, as authorities reduced bank overdrafts and loans.[3] Most of the accumulated arrears were to the Pension Fund—$590 million, but a significant amount $339 million was to the private suppliers.

Public Debt
(In millions of U.S. dollars)

	2012	2013	Jun. 2014	
				In Percent
Public debt, including arrears	4,041	4,638	4,879	100
Domestic debt	1,467	1,349	1,356	28
Of which: long term	337	298	346	7
Bank loans	719	661	606	12
Of which: long term	337	298	346	7
Overdraft	480	366	407	8
Petroleum Authority loans	178	225	222	5
Other public institutions loans	8	15	15	0
Palestinian Investment Fund	79	79	102	2
PMA	3	3	3	0
External debt	1,247	1,269	1,267	26
Arab Financial Institutions	629	630	628	13
Al Aqsa Fund	522	524	517	11
Arab Fund for Economic & Social Development	57	58	58	1
Islamic Development Bank	50	48	52	1
International and Regional Institutions	339	343	343	7
World Bank	290	284	280	6
European Investment Bank	26	36	40	1
IFAD	3	3	3	0
OPEC	19	20	20	0
Bilateral loans and advances	280	296	296	6
Spain	92	96	95	2
Italy	33	35	34	1
China	5	5	5	0
Israel 1/	150	160	161	3
Arrears 2/	1,327	2,019	2,256	46
Pension fund	1,058	1,465	1,648	34
Private supliers 3/	269	555	608	12
Memo: Debt Palestinian entities to Israeli Electricity Company		375	429	

Sources: Palestinian authorities; and IMF staff estimates.
1/ Includes clearance advances.
2/ Excluding arrears on debt service, and for electricity to Israel Electric Corporation.
3/ Estimated arrears, includes payables.

Arrears comprise 46 percent of total debt. Arrears of the Pension Fund comprise 34 percent of debt at end-June 2014, constituting unfunded future fiscal liabilities, while arrears to the private sector, mostly for goods and services and tax refunds, comprise 12 percent of debt. *Domestic debt*, the second largest component of public debt comprising 28 percent of total debt, remains mostly short-term debt (75 percent) although the authorities recently managed to raise the maturity of domestic bank debt. Of total bank debt, arrears to banks are estimated at more than $90 million. Bank debt is normally extended at interest rates ranging from 4 percent on loans to 7–8 percent on overdrafts.[4] Overdrafts declined in 2013 but began creeping up again

[1] Public debt includes debt of the PA.

[2] Information on arrears reflects latest estimates by the Ministry of Finance and covers arrears to private suppliers and the Pension Fund. Arrears to private suppliers are overestimated to the extent that the available information does not allow to distinguish between payments due and payments past due.

[3] While providing savings in the short term, a policy of substituting bank debt with arrears to the private sector could undermine private sector liquidity and growth, and could endanger government revenue and fiscal position in the longer term.

[4] Most borrowing is in U.S. dollars and NIS, but there are loans from Jordanian banks in Jordanian dinars.

in 2014 as the authorities were facing increased financing pressures. The authorities have also resorted to borrowing from the Palestinian Investment Fund ($23 million during in 2014), and General Petroleum Corporation (about $40 million during 2013–14). *External debt*, comprising 26 percent of public debt and consisting of multilateral and bilateral concessional loans, increased marginally since 2012, mainly on account of disbursements by the European Investment Bank for construction of electricity stations. Arrears on external debt (principal and interest) reached about $71 million at end-June.

The assumptions for the current Debt Sustainability Analysis (DSA) have changed since the last DSA in September to reflect updated medium-term projections and a negative effect on the 2014 GDP (base year) of the war in Gaza.[5] They take into account:

- Slowing growth to 3 percent by 2019, averaging 3.7 percent over 2015–19 against 3.3 percent in the September 2013 DSA—a higher rate, but from a lower base to reflect a negative shock to real GDP in 2014 from the war in Gaza;
- Stable exchange rate and inflation, as determined by Israeli monetary policy (same assumption as in the September 2013 DSA); and
- A financing gap, averaging 2.9 percent of GDP in 2014–19—an upward revision from 2.7 percent in the previous DSA—to reflect declining aid, a slow pace of fiscal consolidation, and new spending needs associated with Gaza reconstruction. It is assumed that financing gaps are filled by a combination of arrears and domestic borrowing.

The results of the updated public DSA highlight increasing risks (Table A1 and Figure A1). The DSA shows that public debt in the baseline scenario remains sustainable in the medium term, but at a higher level than in the September DSA, and sensitive to shocks. Debt is projected to rise to 51.1 percent of GDP in 2017 before declining to 49 percent of GDP in 2019, staying above the threshold of 40 percent, prescribed by the Law on Public Debt, throughout the projected period. This result is sensitive to a range of shocks. Sensitivity analysis demonstrates that a shock equivalent to a one standard deviation to the interest rate will raise the debt to 55 percent of GDP by 2019. The shocks to growth, primary balance, or a combined shock will raise the debt level even more to 68, 61, and 61 percent of GDP by 2019, respectively. A one-time contingent liabilities shock equivalent to 10 percent of GDP (e.g., in the case of non-payments to utilities) will elevate the level of debt immediately by about ten percentage points. A similar effect will occur with a fall in donor aid.

[5] See Staff Report for September 2013 meeting of the AHLC.

Table A1. West Bank and Gaza: Public Sector Debt Sustainability Framework, 2009–19

(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	**Debt-stabilizing primary balance 9/**
1	**Baseline: Public sector debt 1/**	28.9	26.3	33.2	38.7	40.2	**45.2**	**47.9**	**49.8**	**51.1**	**50.3**	**49.3**	**-1.8**
	o/w foreign-currency denominated	15.5	11.9	12.2	10.4	9.4	9.8	9.1	8.5	8.0	7.5	7.1	
2	Change in public sector debt	2.5	-2.6	6.9	5.5	1.5	5.0	2.7	1.9	1.3	-0.8	-1.0	
3	Identified debt-creating flows (4+7+12)	1.4	-2.5	3.5	4.5	0.0	4.6	2.4	1.6	0.9	-1.1	-1.4	
4	Primary deficit	3.7	2.0	6.4	7.0	1.1	2.6	4.7	3.8	3.0	1.0	0.5	
5	Revenue and grants	49.9	37.8	31.0	29.3	32.5	37.2	33.8	33.2	32.7	32.2	31.8	
6	Primary (noninterest) expenditure	53.6	39.9	37.4	36.3	33.6	39.8	38.5	37.0	35.7	33.2	32.3	
7	Automatic debt dynamics 2/	-2.3	-4.5	-3.0	-2.6	-1.2	2.0	-2.2	-2.3	-2.1	-2.1	-1.9	
8	Contribution from interest rate/growth differential 3/	-3.7	-3.8	-2.5	-3.4	-0.5	2.0	-2.2	-2.3	-2.1	-2.1	-1.9	
9	Of which contribution from real interest rate	-2.1	-1.6	0.4	-1.6	0.2	0.5	-0.4	-0.5	-0.5	-0.6	-0.5	
10	Of which contribution from real GDP growth	-1.7	-2.3	-2.9	-1.9	-0.7	1.5	-1.8	-1.8	-1.6	-1.5	-1.4	
11	Contribution from exchange rate depreciation 4/	1.4	-0.7	-0.5	0.8	-0.6	...	...	...	...	...	...	
12	Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
13	Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
14	Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15	Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16	Residual, including asset changes (2-3) 5/	1.1	-0.1	3.4	1.0	1.5	0.3	0.3	0.3	0.4	0.3	0.3	
	Public sector debt-to-revenue ratio 1/	57.9	69.5	107.1	132.2	123.7	121.5	141.5	150.2	156.5	156.1	155.1	
	Gross financing need 6/	10.0	12.3	18.0	24.0	25.1	31.2	34.6	37.2	39.0	38.8	38.2	
	in billions of U.S. dollars	0.7	1.0	1.8	2.5	2.8	3.4	4.0	4.6	5.2	5.5	5.7	
	Scenario with key variables at their historical averages 7/						**45.2**	**46.7**	**48.1**	**49.6**	**50.8**	**51.9**	**-3.4**
	Scenario with no policy change (constant primary balance) in 2014-2019						**45.2**	**45.8**	**46.6**	**47.6**	**48.6**	**49.7**	**-1.9**
	Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
	Real GDP growth (in percent)	7.4	9.3	12.4	6.3	1.9	-3.7	4.4	4.0	3.5	3.0	3.0	
	Average nominal interest rate on public debt (in percent) 8/	1.3	2.2	1.6	1.5	1.8	1.5	2.2	2.0	2.0	1.9	1.9	
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-8.5	-5.7	1.8	-4.9	0.6	1.2	-0.8	-0.9	-1.0	-1.3	-0.9	
	Nominal appreciation (increase in US dollar value of local currency, in percent)	-8.8	5.2	4.5	-7.2	6.8	...	...	...	...	...	...	
	Inflation rate (GDP deflator, in percent)	9.8	7.9	-0.1	6.3	1.2	0.4	3.0	3.0	2.9	3.1	2.8	
	Growth of real primary spending (deflated by GDP deflator, in percent)	18.1	-18.7	5.5	3.2	-5.6	13.8	1.1	-0.1	-0.1	-4.2	0.2	
	Primary deficit	3.7	2.0	6.4	7.0	1.1	2.6	4.7	3.8	3.0	1.0	0.5	

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

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

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

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

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

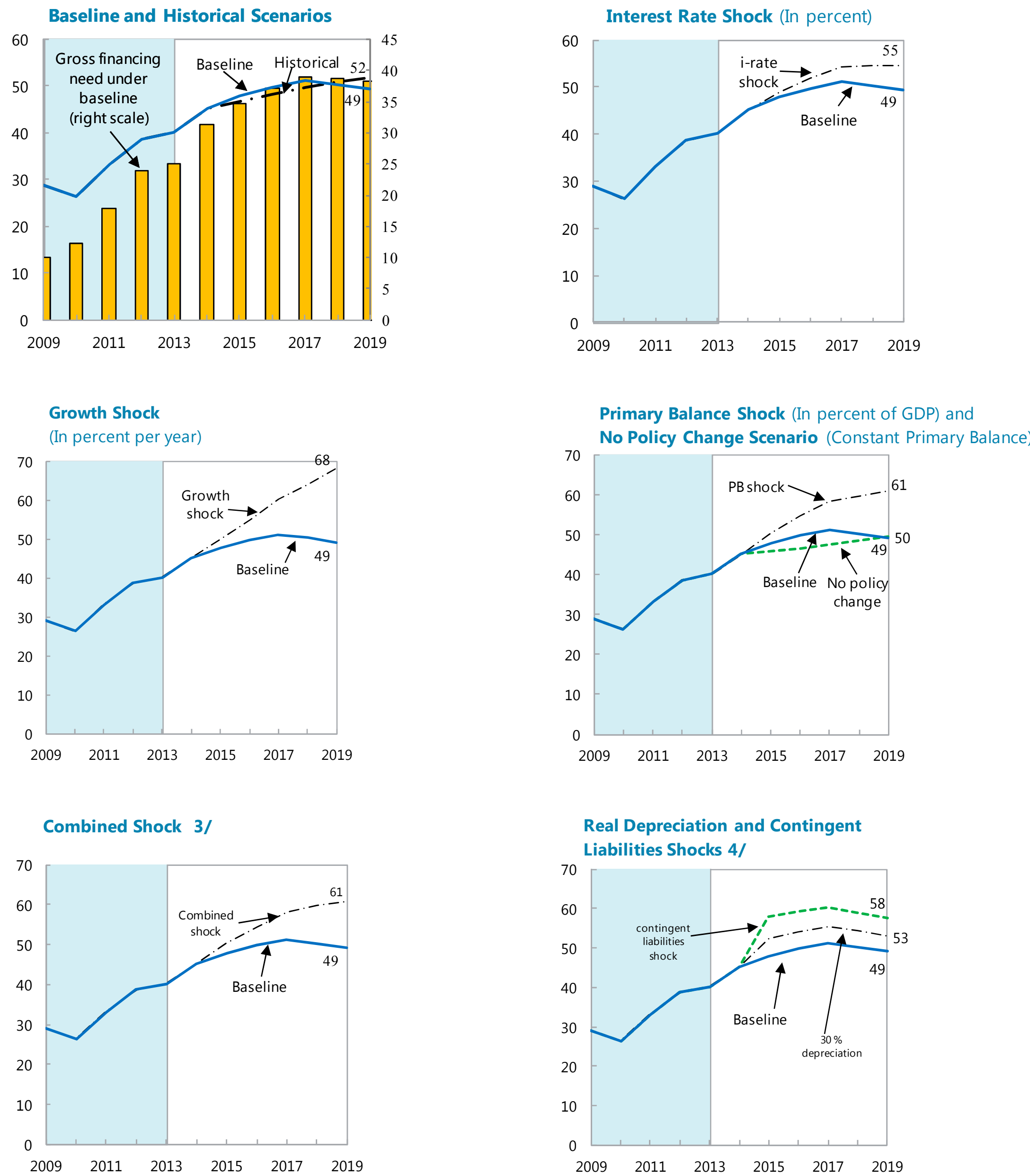
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

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

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

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

Figure A1. West Bank and Gaza: Public Debt Sustainability: Bound Tests 1/ 2/
(Public debt in percent of GDP)



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

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent ¼ standard deviation shocks applied to real interest rate, growth rate, and primary balance.

4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).