MACROECONOMIC AND FISCAL FRAMEWORK FOR THE WEST BANK AND GAZA: FIFTH REVIEW OF PROGRESS[1]

STAFF REPORT FOR THE MEETING OF THE AD HOC LIAISON COMMITTEE

Madrid, April 13, 2010

[1] This report was prepared by a team composed of Oussama Kanaan (Chief of Mission), Javier Gomez, and Mariusz Sumlinski. The macroeconomic and fiscal framework set out in the Palestinian Reform and Development Plan (PRDP) was assessed by IMF staff in "Medium-Term Macroeconomic and Fiscal Framework for the West Bank and Gaza," issued on December 5, 2007. The report on the fourth review of progress in implementing the framework was issued on September 22, 2009. Staff reports on the West Bank and Gaza are published on the IMF website (www.imf.org/wbg).

Contents Page

Executive Summary 3

I. Recent Economic Developments 4

II. Fiscal Developments in 2009 9

III. Macroeconomic Outlook 12

IV. Assessment 17

Text Box
Reforms by the Palestine Monetary Authority 8

Text Figures
Shares in GDP of Sectoral Output Relative to 1994 6
Paths of Regional Real GDP Per Capita Relative to 1999 14

Text Table
Clearance Revenues 9
Fiscal Indicators for 2008–10 11
Comparison of Baseline and Pessimistic Scenarios 14

Figure
Macroeconomic and Fiscal Developments 19

Tables
1. Selected Economic Indicators, 2008–13 20
2a. Central Government Fiscal Operations, 2008–13 (in millions of U.S. dollars) 21
2b. Central Government Fiscal Operations, 2008–13 (in millions of shekels) 22

EXECUTIVE SUMMARY

Economic growth in 2009 picked up significantly in the West Bank, but conditions in Gaza remain difficult. The Palestinian Authority (PA) has continued to build a solid track record in institution-building and economic and security reforms, supported by generous aid. The Government of Israel (GoI) has relaxed some restrictions on movement and access in the West Bank during 2009. However, there has been no additional significant easing of the West Bank's restrictions so far in 2010, and economic activity in Gaza remains severely constrained by the persisting blockade. Real GDP growth in the West Bank and Gaza (WBG) is estimated at 6.8 percent for 2009, consisting of 8.5 percent growth in the West Bank and 1 percent in Gaza.

The PA's 2010 Budget builds on the progress made last year in institution-building and public finance reforms. In 2009, the war in Gaza has imposed a burden on the budget as it required substantial non-wage emergency spending. The 2009 recurrent deficit on a cash basis was in line with the budget target. However, non-wage expenditure commitments were above budgeted amounts, and there was a shortfall in donor aid relative to the budget's external financing requirements including Gaza's emergency spending, which led to the accumulation of non-wage arrears. The 2010 Budget envisages a tightening of the fiscal stance to reduce the recurrent deficit to $1.24 billion from $1.59 billion on a commitment basis in 2009. Toward that end, it is important to step up structural reforms, including implementation of a social safety net and electricity sector reform, and to enhance commitment controls and cash management to minimize further arrears accumulation and recourse to bank borrowing.

There is an urgent need to secure adequate donor assistance to finance the 2010 recurrent financing requirements. A front-loading of that assistance is especially important given the aid shortfalls during the first quarter of the year. External recurrent financing requirements for April to December 2010 are projected at about $1.1 billion, given the $174 million already disbursed in the first quarter of 2010. The $1.1 billion is in addition to about $0.7 billion needed for public investment in the Palestinian territories in 2010.

Concerted actions by the three parties (the PA, the GoI, and the donor community) are critical to sustain the economic recovery and reduce significant risks to the economic outlook. Perseverance by the PA in institution-building, reforms and good governance, supported by adequate and timely donor aid, is needed to achieve increased self-reliance and sustain private sector confidence. A breakthrough in the peace process and removal of restrictions on a wider scale are essential for a durable and regionally balanced growth in the Palestinian territories. This requires action on three fronts. First, lifting Gaza's blockade is essential to stem the continuing decline in Gazans' living standards. Second, removing impediments to private and public investment in the West Bank's Area C, which represents about 60 percent of its territory, is needed to tap the West Bank's full growth potential. Finally, lifting restrictions on the Palestinian territories' external trade, especially on exports to Israel, is key to a sustained rise in real GDP per capita and a balanced growth pattern.

I. Recent Economic Developments

1. **In 2009 the macroeconomic situation continued to improve in the West Bank, but in Gaza conditions remain difficult due to the blockade.** In the West Bank, three key factors contributed to continued strong growth performance. First, private sector confidence has been bolstered by the Palestinian Authority (PA)'s track record in institution-building and reforms in particular in the security, public finance, and governance areas. Second, these reforms have been supported by generous donor budgetary aid, equivalent to about 22 percent of GDP in 2009. Third, some restrictions on movement and access have been relaxed, especially on movement of goods and people between major urban centers in the West Bank. While in Gaza the entry of humanitarian goods has been facilitated, persistent restrictions on capital inputs, raw and building materials have impeded the post-war private sector recovery as well as the reconstruction efforts. Real GDP in the West Bank and Gaza (WBG) is estimated at 6.8 percent, consisting of an estimated 8.5 percent growth in the West Bank and 1 percent in Gaza.

2. **Remaining restrictions on movement and access still constrain internal economic activity and external trade, and distort the pattern of growth and its regional distribution**.[2]

- The persistence of internal restrictions on Palestinian investment in Area C, which represents 60 percent of the West Bank's territory, constrains the West Bank's growth performance.[3] In addition, obstacles on movement among various West Bank regions significantly raise transportation costs.[4]

---

[2] To place recent developments in perspective, it is important to recall that the WBG, from the onset of occupation in 1967 until the early 1990s, enjoyed mostly free and unhindered trade with Israel. During that period the WBG's exports of goods and services, which went mostly to Israel, expanded rapidly and by the 1980s represented over half of its GDP. This expansion reflected the much larger size of the Israeli economy (over twenty times as large), complementarities in resource endowments, as well as weak transport links with Egypt and Jordan, and the absence of a seaport or airport within the WBG. The increased restrictions on the movement of goods and people across the Israel/WBG borders since the mid-1990s, culminating in the blockade on Gaza and completion of the Separation Barrier, led to a decline in exports to less than 15 percent of GDP in recent years.

[3] For details of the restrictions on investment in Area C, see the report by the UN Office for the Coordination of Humanitarian Affairs (OCHA), "Restricting Space: The Planning Regime Applied by Israel in Area C of the West Bank", December 2009, as well as the Report on the Work of the Office of the Quartet Representative (June 30, 2009 to February 28, 2010).

[4] According to OCHA, while the Israeli authorities have substantially eased restrictions on movement and access in the West Bank during 2009, there are still 550 remaining obstacles in the West Bank as of end-2009, compared to 630 obstacles at end-September 2008. These obstacles significantly lengthen travel time for most Palestinians. For updates, see www.ochaopt.org.

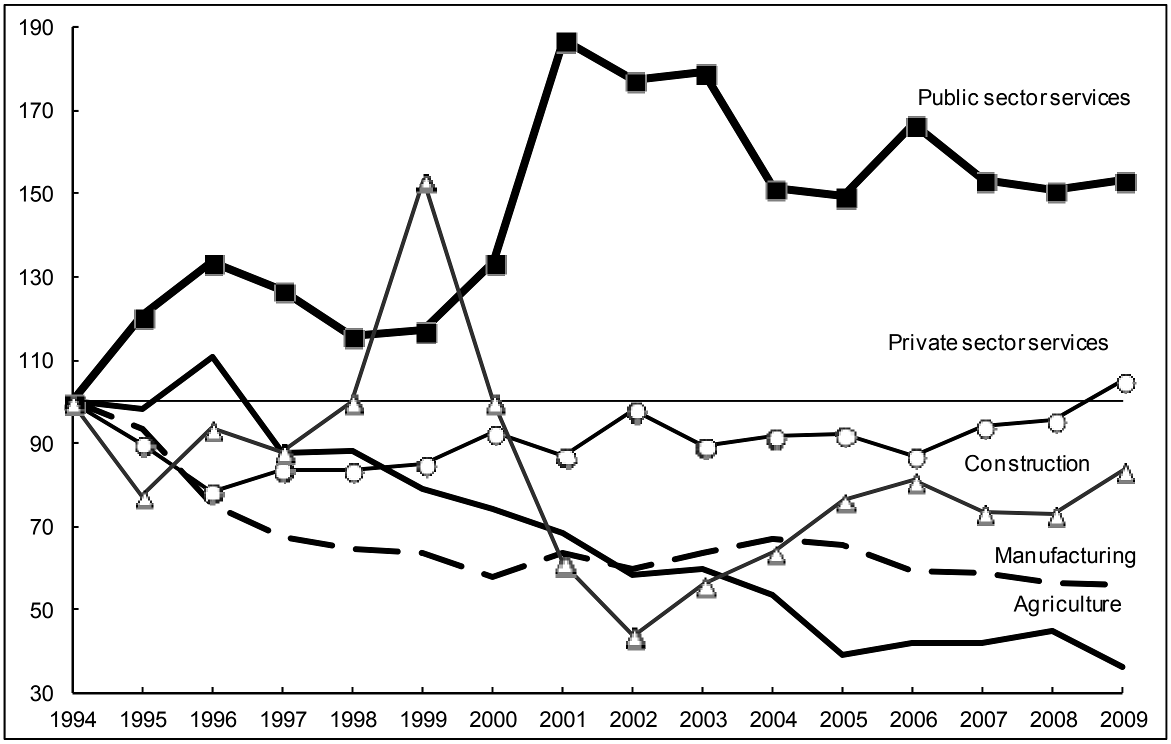
- The WBG's exports to Israel have been constrained in recent years by Gaza's blockade as well as the steady tightening of the Separation Barrier between the West Bank and Israel.[5] In Gaza, tight restrictions remain on the entry of building materials and supplies for donor-financed projects, including electricity and water supply projects. The Separation Barrier has had a particularly adverse impact on East Jerusalem, whose economy has traditionally relied heavily on its trade links and client base in the West Bank.[6]

- The trade restrictions have adversely affected the private sector in general and in particular the sectors producing tradable goods. The graph below depicts the evolution of the sectoral shares in GDP relative to their level in 1994. A major shift in the production structure has taken place since 1994, as the combined share of agriculture and manufacturing declined from one third of GDP in 1994 to about one fifth of GDP over the past five years. At the same time, the share of public services rose markedly. The share of private sector services, which are mostly traded within the WBG and are less vulnerable to the border restrictions, has fallen by much less than the shares of agriculture and manufacturing. Overall, there has been a shift in the pattern of private sector production reflecting the degree of restrictions rather than the WBG's comparative advantage in external trade. In 2009, while private sector services and construction surged, the share of manufacturing was unchanged, and that of agriculture declined.

[5]Exports of goods and non-factor services from the WBG to Israel are estimated by the Israel Central Bureau of Statistics to have declined in 2009 by 23 percent in dollar terms and 16 percent in shekel terms. Exports to Israel alone are estimated at about three fourths of the WBG's total exports.

[6] For details on the physical obstacles and non-trade barriers to the access of goods from the West Bank to Israel see the World Bank's report "An Analysis of the Economic Restrictions Confronting the West Bank and Gaza," published on www.worldbank.org. For a description of non-physical restrictions see "Movement of Goods from the West Bank to East Jerusalem and Israel", January 2010, by the Palestine Trade Center (PALTEL) published on www.paltrade.org.

West Bank and Gaza: Shares in GDP of Sectoral Output Relative to 1994
(Index; 1994=100)



Sources: Palestinian Central Bureau of Statistics; and IMF staff estimates.
Note: In 1994, the shares as a percent of GDP were as follows: 9 for public sector services, 46 for private sector services, 9 for construction, 20 for manufacturing, and 13 for agriculture.

3. **The 2009 unemployment rate in the WBG is still high at 25 percent, with only a modest decline in the West Bank**. While there was no significant decline in the West Bank's unemployment rate in the first half of the year compared to the same period in 2008, it declined from about 20 percent to 18 percent in the second half of 2009, reflecting the pickup in growth during the year. The lag between unemployment decline and output growth will likely diminish as the private sector gains confidence in the sustainability of the improved economic and trade conditions. In Gaza the unemployment rate remained virtually unchanged at about 39 percent, reflecting the still suppressed economic activity. While there has recently been some easing on an ad hoc basis for pre-approved batches of commercial goods and building materials, there are few indications for private investors of better near-term prospects for Gaza.

4. **Inflation declined significantly in 2009, despite some rebound in the second half of the year.** The twelve-month CPI inflation rate, after falling from 12 percent in mid-2008 to 2 percent in mid-2009, rose to 4 percent by end-2009, and further to 5 percent by February 2010. The CPI fluctuations during 2009 reflected largely changes in world petroleum and food prices. The variation in inflation during the year was much larger in the WBG than in Israel, given food's higher weight in the former's consumption basket. The

depreciation of the shekel vis-à-vis the dollar by an average of about ten percent in 2009, despite a partial reversal later in the year, reinforced the favorable impact of the fall in inflation on real incomes, given the importance of dollar-denominated sources of income including donor aid and remittances.

5. **Domestic banks have not been significantly affected by the global crisis and private sector deposits and credit continued to grow in the West Bank, but not in Gaza.** Overall, banks in the WBG have had very limited exposure to global markets, and applied conservative lending practices domestically. The non-performing loans (NPLs) and watch list loans[7] fell as a share of total bank loans from 11 percent at end-2008 to 3.6 percent at end-2009. In the West Bank, private sector deposits and credit rose by 5 and 23 percent (respectively) in real terms in the year to December 2009, reflecting the improved economic conditions and better investment climate. The rise in credit also reflected the increased supply of loanable funds as the Palestine Monetary Authority (PMA) lowered the limit on bank deposits placed abroad from 65 percent to 55 percent of total deposits. In contrast, in Gaza deposits remained broadly stagnant over the same period, while private credit contracted by about 17 percent, reflecting the limited recovery in economic activity and weak private investment. The PMA has made good progress in institutional reforms with intensive Fund technical assistance (Box 1).

6. **Limits on the inflow of cash in shekels into Gaza have eased, but other restrictions remain.** An agreement between the Israeli authorities and the PA in 2009 has allowed monthly shipments of shekels into Gaza, but not Jordanian dinars and U.S. dollars. The removal of the remaining restrictions is important to ensure sound exchange risk management by banks and settlement of non-shekel transactions and salaries. Another problem faced by the PMA and banks has been the accumulation in 2009 of large shekel cash surpluses in Palestinian banks due to Israeli banks' refusal to accept their cash deposits on concerns about possible legal implications. This is lowering Palestinian banks' interest income and raising their insurance costs. The cash surplus lessened temporarily in 2009 when Israeli banks accepted, on an ad hoc basis, deposits of limited amounts of shekels.

[7] The ratio of non-performing loans to total loans fell in the same period from 6.9 percent to 3.1 percent. Watch-list loans are defined as loans in arrears on interest or principal for 30 to 90 days. Non-performing loans are those in arrears for over 90 days.

Box 1. Reforms by the Palestine Monetary Authority

The Palestine Monetary Authority (PMA) has continued institutional reforms, supported by IMF technical assistance. The PMA's principal goal is to support a healthy banking system through rigorous supervision and prudential regulations in line with international practice. These regulations are enforced on all Gaza and West Bank banks through regular on-site and off-site supervision. The PMA applies a broad range of instruments, including through required reserves ratios, minimum capital requirements, minimum liquidity ratios, and limits on credit concentration and currency exposure. Since 2008 it has been monitoring banks' compliance with a corporate governance code in line with Basel II standards. The PMA's medium-term objective is to become a full-fledged central bank, and over the past year it has made progress in several areas:

- The PMA has further strengthened **the supervision and regulatory framework.** It has advanced along its roadmap aimed at a full implementation of Basel II standards by end-2011. Regulations governing the disclosure of information by financial institutions according to those standards have been prepared and are scheduled to be implemented by end-April 2010. The PMA has been implementing, since March 2009, "Fair Lending" regulations to standardize and improve the quality information on banks' credit policies and conditions available to borrowers and guarantors. In January 2010, a unit was created to review and enforce the Fair Lending regulations, as well as educate borrowers about their rights and in general raise the public's "financial awareness and literacy".
- The operation of the online-based **credit registry** is being further enhanced through the addition of a modern credit scoring system for banks and microfinance institutions (whose assets represent about 1 percent of total financial system assets). The credit scoring system is scheduled to become fully operational by mid-April 2010. In addition, an electronic check-tracking system to report bounced checks has been implemented since December 2009, contributing to a substantial decline in bounced checks since early 2010.
- The PMA is completing the installation of an **electronic payment system**, including a Real Gross Time Settlement System (RGTS) and an Automated Clearance House, which will raise bank payments' efficiency and help reduce liquidity risk. The system will be tested starting in May 2010, is expected to become fully operational by end-2010.
- A new Banking Law to strengthen the financial sector's **legal framework** has been approved by the Cabinet in March 2010, and is expected to be enacted following its signing by the President in April 2010. A new Central Bank Law is currently being reviewed by the Cabinet.

II. Fiscal Developments in 2009

7. **The recurrent fiscal deficit on a cash basis for 2009 is estimated at 22 percent of GDP, slightly below the budget target.** However, the deficit on a commitment basis was higher than budgeted due to non-wage expenditure arrears accumulation.

- Budgetary revenue, excluding one-off items such as dividend payments and license fees,[8] were broadly in line with the budget, with lower-than-expected clearance revenues offset in part by better domestic tax collection and lower tax refund payments:

  a. Domestic tax revenue rose from 4.5 percent of GDP in 2008 to 4.9 percent in 2009, mainly because of an increase in domestic tax revenue by 37 percent in the second half of the year, compared to the same period in 2008, due to improved tax enforcement and compliance.

  b. Total clearance revenues declined slightly in 2009 as a share of GDP from 18.4 percent to 18.0 percent. Clearance revenue performance in Gaza has been especially weak due to repressed economic activity and imports, while in the West Bank performance has picked up significantly in the second half of 2009.[9]

West Bank and Gaza: Clearance Revenues

	2008			2009		
	Jan.–June	July–Dec.	Year	Jan.–June	July–Dec.	Year
	(In millions of shekels)					
Total clearance revenue	1,865	2,053	3,918	2,029	2,343	4,372
West Bank	1,679	1,835	3,514	1,878	2,141	4,020
Gaza	186	218	404	150	202	352

Source: Ministry of Finance.

---

[8] One-off items were lower than budgeted due to postponement in the transfer of dividends by the Palestine Investment Fund. The latter was only partly offset by higher-than-budgeted license fees from Jawal and Zein telecommunications companies.

[9] While the West Bank's clearance revenues, in shekel terms, increased by 14 percent in 2009, they declined by 13 percent in Gaza.

- The 2009 wage bill on a commitment basis was about 4 percent higher than budgeted, taking into account the compensation to employees for interest incurred on loans taken during the non-payment of wages in 2006–07. The number of public sector employees, after declining by 1,443 in 2008, rose by 4,789 employees during 2009, implying a cumulative increase during 2008–09 by 3,346 (of which 595 employees in the health sector and 1,288 in the education sector). This compares to the PRDP's target ceiling of 3,000 new employees per year during 2008–10.

- Non-wage expenditures on a commitment basis were higher than budgeted (by $59 million). Non-wage expenditures, including emergency spending for Gaza, on a cash basis were lower than budgeted (by $148 million). The net increase by about $207 million in non-wage arrears stemmed from both an over-commitment of non-wage spending relative to the budget as well a shortfall in donor aid in relation to the budget's external requirements, including emergency spending for Gaza, by about $100 million.

- Net lending (including payments by the central government for utility bills owed by municipalities) was in line with the prorated budget projection. Measures to raise utility collection rates have continued to be implemented, including better monitoring and incentives for payment of bills by municipalities, as well as installation of prepaid meters.

- Donor aid in 2009 to the recurrent budget is estimated at about $1.35 billion compared to the budget's external financing requirements of $1.45 billion. In addition, there were delays in disbursing the aid, about two-thirds of which were paid in the second half of 2009. The shortfall, along with higher-than-budgeted expenditure commitments, led the PA to borrow about $180 million from domestic banks.

- Development spending in 2009 is estimated at about $400 million, well below the $1.1 billion envisaged in the budget (including $0.6 billion for Gaza reconstruction projects).

Fiscal Indicators for 2008–10
(In millions of U.S. dollars, unless otherwise indicated)

	2008	Budget 2009	Est. 2009	Proj. 2010
Total net revenues	1,568	1,630	1,598	1,927
Gross domestic revenues	562	625	585	707
Tax revenues	273	273	301	377
Gross clearance revenues	1,122	1,123	1,103	1,320
Tax refunds	116	118	91	100
Total recurrent expenditures (commitment basis):	2,886	3,080	3,190	3,164
Wage expenditures	1,453	1,410	1,467	1,550
Non-wage expenditures	985	1,290	1,349	1,364
Net lending	447	380	374	250
Total recurrent expenditures (cash basis)	3,273	3,080	2,920	3,164
Of which: non-wage expenditures (cash basis)	1,055	1,290	1,142	1,364
Recurrent balance (commitment basis)	-1,317	-1,450	-1,592	-1,237
Recurrent balance (cash basis)	-1,690	-1,450	-1,371	-1,237
Development projects	215	1,103	400	667
Overall balance (cash basis, including capital expenditures)	-1,905	-2,553	-1,771	-1,904
Financing	1,905	2,553	1,771	1,904
External support for recurrent and capital expenditures	1,979	2,553	1,755	1,909
External support for recurrent expenditures	1,764	1,450	1,355	1,242
External support for capital expenditures	215	1,103	400	667
Domestic financing	-29	---	176	---
Net external debt	-4	---	-4	-5
Memorandum items:				
GDP	6,108	6,318	6,117	6,940
Domestic tax revenue (in percent of GDP)	4.5	4.3	4.9	5.4
Clearence revenue (in percent of GDP)	18.4	17.8	18.0	19.0
Wage expenditures (commitment basis), in percent of GDP	23.8	22.3	24.0	22.3
Net lending (including subsidies; in percent of GDP)	7.3	6.0	6.1	3.6
External financing for recurrent budget (US$ billion)	1.76	1.45	1.35	1.24
Recurrent balance (commitment basis), in percent of GDP	-21.6	-23.0	-26.0	-17.8
Recurrent balance (cash basis), in percent of GDP	-27.7	-23.0	-22.4	-17.8
Net expenditure arrears accumulation (US$ billion)	-0.39	---	0.27	---
Of which: non-wage arrears	-0.07	---	0.21	---
Net expenditure arrears accumulation (in percent of GDP)	-6.3	---	4.4	---

Sources: Ministry of Finance; and IMF staff estimates.

8. **The PA has continued to strengthen the Public Finance Management System**, which has helped prioritize and raise the quality of public expenditures. The implementation of measures since mid-2007 to increase transparency and accountability has greatly facilitated the disbursement of donor aid directly to the PA budget.[10] Expenditure management was further enhanced in 2009:

[10] For details on the reform of the public finance management system since 2007, see the IMF reports on reviews of progress on www.imf.org/wbg.

- The new computerized accounting system has been rolled out from the Ministry of Finance (MoF) to line ministries, and effectively implemented since August 2009. The system has given line ministries increased ownership of financial management and improved the quality of budget execution.
- The MoF, with technical assistance from the United Kingdom's Department for International Development (DFID), has completed the FY 2008 financial statements in December 2009 and submitted them for review to the Supreme Audit and Administrative Control Bureau (SAAC). The SAAC's review of the statements is expected to be completed by end-June 2010.
- To enhance the operation of the MoF's Central Treasury Account (CTA), the process of opening "zero balance" accounts for line ministries was completed in August 2009. Bank accounts outside the CTA, except for a few special donor accounts, have been closed.
- A new web-based budget information system was completed in July 2009. The system enhanced communication between the MoF and line ministries during preparation of the 2010 budget, in particular by facilitating the compilation of budget submissions and the preparation of the final budget documents. The Chart of Accounts and budget classifications are being revised in line with GFS 2001, with a view to introducing them in the 2011 budget.

III. MACROECONOMIC OUTLOOK

9. **The macroeconomic framework assumes that the PA, the GoI and the donor community would take concerted actions to support the Palestinian economy**. In particular, it assumes, first, a steady removal of remaining obstacles on movement and access in the West Bank, including Palestinians' access to Area C, as well as the lifting of Gaza's trade restrictions especially on the entry of capital goods and raw materials. Second, the PA would continue with a prudent fiscal policy underpinned by institution-building measures, structural reforms, and sound public expenditure management, in line with the Thirteenth Government's vision toward statehood. Third, donors would continue to provide adequate and predictable financial assistance for the recurrent budget and public investment.

10. **Under the baseline scenario based on the above assumptions, real GDP growth would continue at about 7 percent in 2010, and rise gradually to 10 percent by 2012–13.** With population growing at about 3 percent per year, real income per capita would rise by about six percent per year over 2010–13, while the unemployment rate would decline from 25 percent in 2009 to 15 percent by 2013. Reflecting a prudent fiscal policy and acceleration of structural reforms, the recurrent budget deficit would fall as a share of GDP from 22 percent in 2009 to 6 percent by 2013, which would give room for a substantial rise in donor-financed public investment. The expansion of the private sector, in particular in export-oriented activities, would lay the foundations for longer-run growth.

11. **Under a "pessimistic" scenario real GDP growth slows down to 5 percent in 2010 and remains at around 4 percent over the medium term.** This results in real per capita GDP stagnating around its current level in the West Bank, and a continued decline in Gaza. The scenario assumes no progress in the peace process and only ad hoc and limited further easing of restrictions in the West Bank and of Gaza's blockade. Exports and investment opportunities would remain constrained, inhibiting private sector recovery. As indicated by past experience, restrictions on the movement of project personnel, raw materials, machinery and equipment tend to considerably slow the implementation of public investment and reconstruction projects, most of which are financed by donors. External aid for public investment would thus be substantially lower than in the baseline scenario. Budgetary revenue would also be lower, while social transfers and emergency spending would be higher, thus reducing the pace of fiscal consolidation.

12. **In the baseline scenario, the path of Gaza's real GDP per capita will begin to converge toward that of the West Bank over the medium term, while in the pessimistic scenario the divergence will continue.** The graph below depicts the paths of real GDP per capita of the West Bank and of Gaza in relation to their 1999 levels, just before the onset of the second Intifada and sharp intensification of restrictions on movement and access. From 2000 to 2002, the two paths were broadly aligned. From 2003 to 2005, real GDP per capita recovered in response to the limited relaxation of restrictions, especially in Gaza. In 2006, with the onset of the blockade, Gaza's real GDP per capita started on a downward trend. In contrast, the West Bank's real GDP per capita has grown steadily since 2007 with the advent of Prime Minister Fayyad's government, reflecting the influence of factors discussed in Section I above. The West Bank's real GDP per capita recovered to its 1999 level in 2009, and under the baseline scenario by 2013 is projected at about 26 percent above that level. However, in the pessimistic scenario it would be at only 10 percent above it. For Gaza, in the baseline scenario, GDP per capita by 2013 would be about 30 percent below its 1999 level, and about 50 percent below it in the pessimistic scenario.[11]

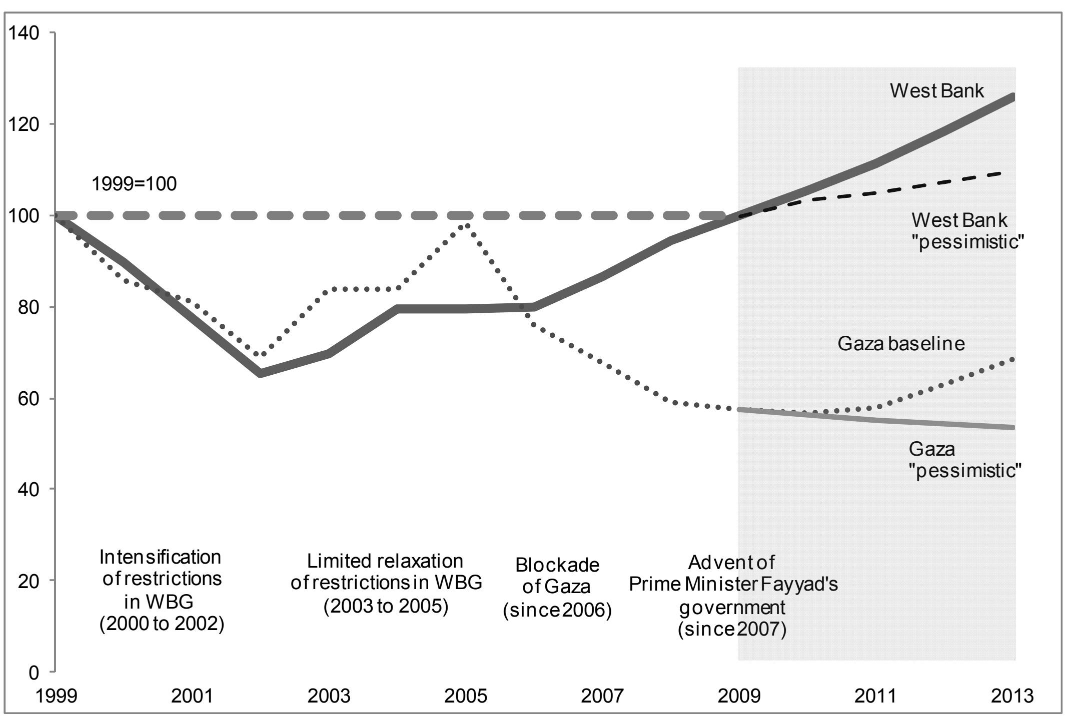
[11] The outlook for real GDP per capita in the pessimistic scenario is especially worrisome given the high incidence of poverty in the WBG, in particular in Gaza. According to a 2007 household survey for Gaza, about 80 percent of households in Gaza lived below the poverty line in 2007, compared to 45 percent in the West Bank. The poverty line for a six-person household in the household survey was set at NIS 2,363 in monthly expenditures per household. See the report by UNRWA, "Prolonged Crisis in the Occupied Palestinian Territory: Socio Economic Developments in 2007," July 2008, published on http://www.unrwa.org

West Bank and Gaza: Comparison of Baseline and Pessimistic Scenarios

		Baseline Scenario				Pessimistic Scenario			
	2009	2010	2011	2012	2013	2010	2011	2012	2013
Output and Investment									
Real GDP (percentage change)	6.8	7.0	8.0	10.0	10.0	5.0	4.0	4.3	4.4
Real GDP per capita (percentage change)	3.8	4.0	5.0	6.9	6.9	2.1	1.1	1.4	1.5
Gross capital formation (in percent of GDP)	30.7	34.7	35.2	35.5	37.3	27.9	27.1	26.6	26.4
Of which: public investment (in percent of GDP)	7.1	10.1	10.3	10.3	11.3	7.1	6.6	6.7	6.8
		(In percent of GDP)							
Public finances 1/									
Revenues	26.1	27.8	29.5	29.3	29.3	26.1	24.7	25.0	25.5
Recurrent expenditures and net lending	52.1	45.6	42.3	38.1	34.3	49.3	46.8	45.0	42.0
Recurrent balance (before external support)	-26.0	-17.8	-12.7	-8.9	-5.0	-23.2	-22.1	-20.0	-16.5
Recurrent balance, on a cash basis (before external support)	-22.4	-17.8	-13.4	-9.4	-5.5	-18.4	-14.1	-10.5	-6.5
Expenditure arrears accumulation	4.4	0.0	-0.6	-0.6	-0.5	4.8	8.0	9.5	10.0
Capital expenditures	6.5	9.6	9.8	9.8	10.9	6.6	6.0	6.2	6.4
(In millions of U.S. dollars)	400	667	762	873	1,095	450	450	500	550
External recurrent budgetary support (in billions of U.S. dollars)	1.4	1.2	1.0	0.8	0.6	1.2	1.0	0.8	0.6
Total external support, including capital expenditures	28.7	27.5	23.3	19.4	16.4	24.8	20.1	16.7	12.8
(In billions of U.S. dollars)	1.8	1.9	1.8	1.7	1.7	1.7	1.5	1.3	1.1
		(In percent of GDP)							
External sector									
Exports of goods and nonfactor services	12.7	15.8	17.0	20.1	21.9	11.7	12.4	12.8	13.7
Import of goods and nonfactor services	68.8	85.8	85.4	84.1	83.6	71.9	70.7	67.9	66.4
Current account balance (excluding official transfers)	-27.5	-37.9	-34.2	-30.1	-27.7	-28.7	-25.0	-21.3	-17.4
Current account balance (including official transfers)	1.2	-10.4	-10.9	-10.8	-11.3	-3.9	-4.9	-4.6	-4.6
Memorandum items:									
Unemployment rate (average in percent of labor force)	24.5	23.2	21.3	18.2	14.8	25.7	26.4	26.9	27.3

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

West Bank and Gaza: Paths of Regional Real GDP Per Capita Relative to 1999
(Index; 1999=100)



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

13. The structural reforms initiated in 2009 need to be stepped up to ensure steady progress toward fiscal sustainability and reduced reliance on recurrent budgetary aid in line with the baseline scenario:

- **A streamlining and better targeting of social transfers is needed.** The social safety net prepared in 2009 in cooperation with the World Bank should be promptly implemented. The improved targeting of social transfers would help protect the poor from the impact of price increases due to the commercialization of electricity distribution.

- **The transfer of electricity distribution from municipal control to commercial utility companies should be completed by end-2010.** This would ensure continued progress in bills' collection and help phase out utility subsidies.

- **It is important to prevent the accumulation of arrears to the pension fund and contain the rise in budgetary payments to retirees.** The plan to restore the viability of the public pension system should be finalized in 2010, including steps to roll back early retirement provisions and reduce replacement rates.

- **A comprehensive civil service reform is needed to enable a steady decline in the wage bill and to raise public sector efficiency**. It will become increasingly difficult to continue to reduce the wage bill by relying only on restraint of wage rates and employment growth. A civil service reform should be implemented to enable a steady reduction of the wage bill from its current level of 24 percent toward the range of 5–10 percent of GDP typically spent on the payroll in most developing and industrialized countries. While the reform could take several years to implement, one important objective would be to improve the incentive structure through a widening of salary distribution, following a comprehensive audit and review of employees' qualifications and performance.[12] This would be supported by a strategy to enable the steady absorption of newly retrenched public sector employees into the private sector, facilitated by a sustained economic recovery. Regarding immediate steps for 2010, it is important to undertake a review of personnel needs in key sectors, including health and education, with a view to determining an appropriate target ceiling for additional public sector recruitment in preparation for the forthcoming 2011–13 PRDP.[13]

---

[12]For civil service reform options, see the World Bank's "West Bank and Gaza—Public Expenditure Review, Volumes I and II," February 2007, published on www.worldbank.org.

[13] In particular, the current target of 3,000 new employees per year may not be suitable for 2011–13 given the changing needs of different sectors since 2007.

14. **The 2010 Draft Budget was submitted to the Cabinet in mid-March 2010, and is expected to be approved by the President in April.** The budget envisages enhanced revenue mobilization, a continued shift from recurrent spending toward public investment, more efficient targeting of social transfers, and measures to minimize arrears accumulation. The recurrent budget deficit on a cash basis would decline as a share of GDP from about 22 percent to 18 percent. Given the limited scope for domestic bank financing for 2010[14], that deficit, projected at $1.24 billion, would be financed entirely by donor aid. The budget has the following key features:

- **The wage bill is envisaged to decline by 1.7 percent of GDP**, reflecting: (i) a ceiling for a general wage rate increase of 4 percent, including a 2.75 percent increase to cushion the impact of the surge in inflation during 2008–09;[15] and (ii) a 2 percent increase in employment owing to a net addition of 3,000 workers, mainly in the health and education sectors.

- **Utility bill collection rates are expected to rise** due to continued enforcement of measures to improve compliance, installation of prepaid meters, and the transfer of electricity distribution in the West Bank from local governments to commercial utility companies. These measures would reduce utility subsidies by about two percentage points of GDP.

- **Public finance management reforms, designed with Fund technical assistance, will be stepped up** in particular to prevent the accumulation of new arrears in 2010, including: (i) the implementation of the procurement module for control commitments in the Computerized Accounting System, which will minimize delays in the registration of purchases of goods and services; (ii) improving the cash planning process to ensure that commitments are made in line with available and expected funds; and (iii) activating the cash management committee to align cash releases with budget priorities.

- **The implementation of development projects will be stepped up in 2010**, given the increased focus on community-based projects that are less vulnerable to restrictions on movement and access, and assuming an easing of restrictions on the entry of inputs for Gaza's development projects. Public investment would rise

[14] The stock of public debt to commercial banks is estimated at about $750 million as of end-February 2010.

[15] The 4 percent increase in the average wage rate consists of the 1.25 percent automatic annual wage increase, and 2.75 percent adjustment to partially compensate for the decline in public sector real wage rates since 2007. While the PRDP envisaged an average yearly inflation rate of 3 percent for 2008–10, the currently projected average inflation rate for that period is 5 percent per year. The average public real wage rate has declined by a cumulative 9 percent during the two years 2008–09. Given the envisaged 1 percent increase in the average real wage rate for 2010, it is projected to decline by a cumulative 8 percent during 2008–10.

from about $400 million in 2009 to a total of $670 million in 2010, about $350 million of which will consist of community-based projects.

- **The revenue-to-GDP ratio is projected to recover** toward historical levels as a result of the continued recovery in private sector activity as well as a steady strengthening of tax administration.[16]

15. **Out of the $1.24 billion required to finance the recurrent deficit in 2010, only about $174 million has been disbursed by donors in the first quarter of 2010**, resulting in a shortfall of about $45 million per month. Preliminary data for January and February indicate that while revenues and expenditures have been broadly in line with the 2010 budget, the aid shortfall resulted in additional nonwage arrears of about $24 million and additional borrowing from domestic commercial banks by about $44 million during January–February 2010. Prompt disbursement of aid for 2010 is critical to prevent a further rise in domestic debt and interest payment obligations, which would further increase the budget's future external financing requirements.

IV. Assessment

16. **IMF staff considers that institution-building and public finance reforms undertaken so far by the PA are in line with the Palestinian Reform and Development Plan (PRDP) and the vision toward statehood set out in "Program of the Thirteenth Government" for 2010–11.** The PA should persevere with these reforms to reinforce the private sector's confidence and reduce its reliance on donor recurrent budgetary aid. It is particularly important, as envisaged in the 2010 budget, to continue to improve the quality and efficiency of public spending while shifting its composition toward growth enhancing public investment. Toward that end, key structural measures need to be accelerated in 2010, including the implementation of a social safety net to better target assistance to the poor, electricity sector reform to further reduce utility subsidies, and steps toward comprehensive pension and civil service reforms. It is also important for the PA to continue to widen its responsibility for the management of public investment in collaboration with donors, including community-based projects.

17. **Concerted actions by the three parties (the PA, the GoI, and donors) are essential to sustain the economic recovery and reduce significant risks to the economic outlook:**

[16] The implementation of revenue administration measures will be done with technical assistance from the IMF and USAID. An IMF technical assistance mission set out an action plan for the second half of 2010 and the medium-term, which includes the establishment of a large taxpayer multi-revenue unit, a strategy to improve taxpayer compliance, and adoption of modern information technology. Progress in revenue administration is expected to be supported by regular IMF peripatetic missions starting in mid-2010.

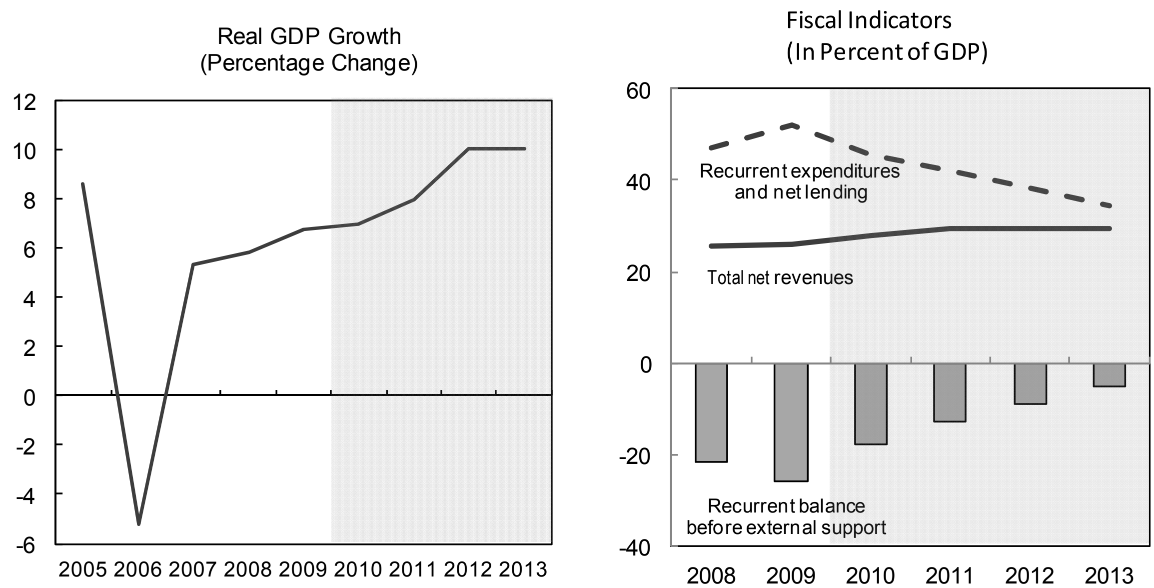
- To maintain the growth momentum in the West Bank, lifting remaining restrictions on movement and access is essential, including those on external trade, especially on exports to Israel, as well as on economic activity and investment in Area C.

- The impact of the war in Gaza and persistent blockade has worsened the humanitarian situation and severely restrained growth. A removal of restrictions on the entry of raw materials and capital goods is essential to enable reconstruction and a recovery of Gazans' living standards. It is also important to lift remaining controls on entry of non-shekel cash into Gaza, and reestablish correspondent relationships between Palestinian and Israeli banks.

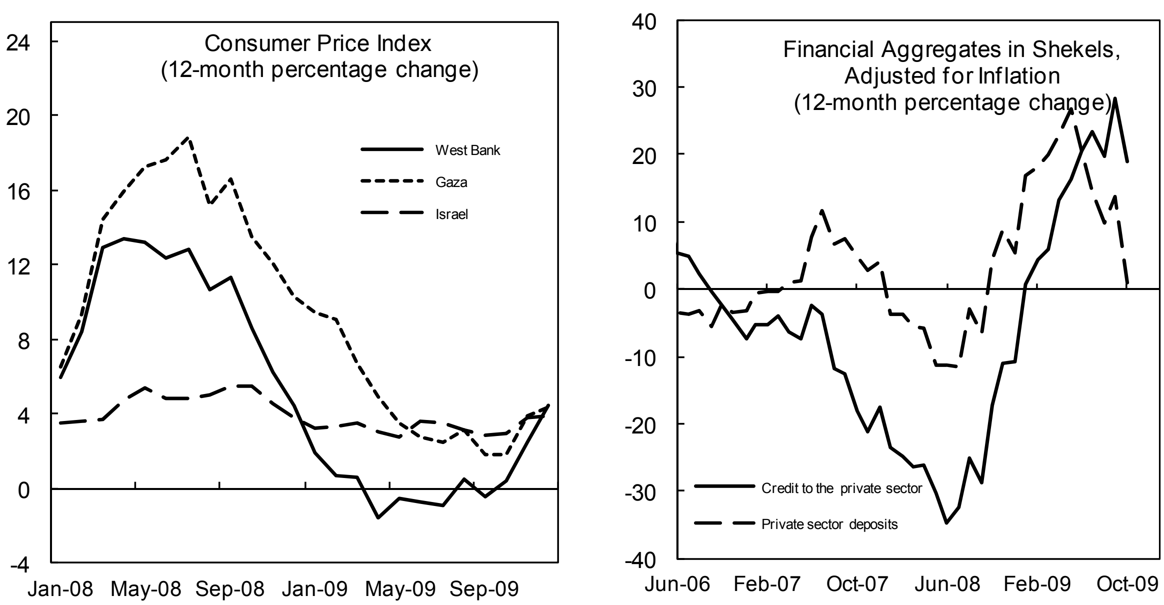
- Given the difficult liquidity situation and its potential adverse impact on private sector and bank confidence, it is important for the PA to maintain a fiscal stance in line with the 2010 budget and for donors to ensure timely and predictable aid disbursements. It is important to prevent a repeat of the 2009 situation when expenditure commitments exceeded available cash, leading to significant arrears accumulation and domestic bank borrowing. Toward that end, the PA should continue to enhance commitment controls and cash management as well as strengthen tax administration. It is also important for the PA to make full use of the new computerized accounting system and undertake a careful prioritization of its planned expenditures with a view to postponing lower priority spending commitments in case of aid shortfalls until the disbursement of adequate aid. This could involve delaying recruitment of new public sector employees, or postponing lower priority investment projects. Donors, for their part, should front-load as much as possible of the $1.1 billion in required recurrent budget financing for April to December 2010, especially in view of the aid shortfalls in the first quarter of the year.

Figure 1. West Bank and Gaza: Macroeconomic and Fiscal Developments

Sustained recovery and fiscal adjustment are envisaged over the medium term, provided reforms and the easing of trade restrictions continue.



Inflation has declined in 2009, while real private sector bank credit and deposits have picked up.



Sources: Ministry of Finance, Palestinian Central Bureau of Statistics, and IMF staff estimates.

Table 1. West Bank and Gaza: Selected Economic Indicators, 2008–13

(Population: 3.8 million; 2008 est.)
(Per capita GDP: $1,597; 2008 est.)
(Poverty rate: 57 percent, of which 46 percent in the West Bank and 79 percent in Gaza Strip; 2007 est.)

		Est.	Projections			
	2008	2009	2010	2011	2012	2013
Output and prices			(Annual percentage change)			
Real GDP (2004 market prices)	5.9	6.8	7.0	8.0	10.0	10.0
CPI inflation rate (end-of-period)	7.0	4.3	3.0	3.0	3.0	3.0
CPI inflation rate (period average)	9.9	2.8	3.0	3.0	3.0	3.0
Investment and saving			(In percent of GDP)			
Gross capital formation, *Of which:*	26.9	30.7	34.7	35.2	35.5	37.3
Public	4.1	7.1	10.1	10.3	10.3	11.3
Private	22.8	23.7	24.6	24.9	25.2	26.0
Gross national savings, *Of which:*	35.7	32.0	24.4	24.3	24.7	26.0
Public	10.8	2.7	9.7	10.5	10.5	11.4
Private	24.8	29.3	14.7	13.7	14.2	14.6
Saving-investment balance	8.7	1.2	-10.4	-10.9	-10.8	-11.3
Public finances 1/			(In percent of GDP)			
Revenues	25.7	26.1	27.8	29.5	29.3	29.3
Recurrent expenditures and net lending	47.2	52.1	45.6	42.3	38.1	34.3
Wage expenditures	23.8	24.0	22.3	20.7	18.9	17.3
Nonwage expenditures	16.1	22.1	19.7	18.2	16.7	15.2
Net lending	7.3	6.1	3.6	3.4	2.5	1.8
Recurrent balance (commitment, before external support)	-21.6	-26.0	-17.8	-12.7	-8.9	-5.0
Recurrent balance, cash (before external support)	-27.7	-22.4	-17.8	-13.4	-9.4	-5.5
Capital expenditures	3.5	6.5	9.6	9.8	9.8	10.9
(In millions of U.S. dollars)	215	400	667	762	873	1,095
Overall balance (before external support)	-25.1	-29.0	-27.4	-22.5	-18.7	-15.8
External recurrent budgetary support (in billions of U.S. dollars)	1.76	1.35	1.24	1.05	0.84	0.56
Total external support, including for capital expenditures	32.4	28.7	27.5	23.3	19.4	16.4
(In billions of U.S. dollars)	1.98	1.75	1.91	1.81	1.72	1.66
Monetary sector 2/			(Annual percentage change)			
Credit to the private sector	-3.4	22.9	28.1	25.0	26.0	26.8
Private sector deposits	14.0	5.7	15.4	16.5	18.5	19.8
External sector			(In percent of GDP)			
Exports of goods and nonfactor services	14.4	12.7	15.8	17.0	20.1	21.9
Import of goods and nonfactor services	67.2	68.8	85.8	85.4	84.1	83.6
Net factor income	9.8	9.4	12.6	12.6	11.8	11.2
Net current transfers	51.7	47.9	47.0	45.0	41.3	39.2
Official transfers	32.4	28.7	27.5	23.3	19.4	16.4
Current account balance (excluding official transfers)	-23.6	-27.5	-37.9	-34.2	-30.1	-27.7
Current account balance (including official transfers)	8.7	1.2	-10.4	-10.9	-10.8	-11.3
Memorandum items:						
Nominal GDP (in millions of U.S. dollars)	6,108	6,117	6,940	7,774	8,862	10,085
Per capita nominal GDP (U.S. dollars)	1,597	1,554	1,714	1,866	2,067	2,286
Unemployment rate (average in percent of labor force)	25.9	24.5	23.2	21.3	18.2	14.8
Al Quds stock market index (annual percentage change)	-16.2	11.6	…	…	…	

Sources: Palestinian authorities; and IMF staff estimates.

1/ Commitment basis.

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

Table 2a. West Bank and Gaza: Central Government Fiscal Operations, 2008–13

	2008	Budget 2009	Est. 2009	Projections 2010	2011	2012	2013
	(In millions of U.S. dollars, unless otherwise stated)						
Total net revenues	**1,568**	**1,630**	**1,598**	**1,927**	**2,296**	**2,594**	**2,956**
Gross domestic revenues	562	625	585	707	914	1,031	1,188
Tax revenues	273	273	301	377	430	486	549
Nontax revenues	289	353	284	275	484	545	639
Clearance revenues (accrued)	1,122	1,123	1,103	1,320	1,505	1,701	1,923
Clearance revenues (cash)	1,137	0	1,090	1,320	1,505	1,701	1,923
Clearance revenues (net arrears)	-15	0	13	0	0	0	0
Tax refunds	116	118	91	100	123	138	155
Total recurrent expenditures and net lending (commitment)	**2,886**	**3,080**	**3,190**	**3,164**	**3,286**	**3,380**	**3,460**
Wage expenditures (commitment)	1,453	1,410	1,467	1,550	1,612	1,676	1,744
Wage expenditures (cash)	1,771	0	1,423	1,550	1,612	1,676	1,744
Wage expenditures (net arrears)	-317	0	43	0	0	0	0
Nonwage expenditures (commitment)	985	1,290	1,349	1,364	1,411	1,480	1,532
Nonwage expenditures (cash)	1,055	0	1,142	1,364	1,461	1,530	1,582
Nonwage expenditures (net arrears)	-70	0	207	0	-50	-50	-50
Net lending	447	380	374	250	263	224	184
Recurrent balance (commitment, before external support)	**-1,317**	**-1,450**	**-1,592**	**-1,237**	**-990**	**-786**	**-504**
add: expenditure arrears (net)	-387	0	270	0	-50	-50	-50
subtract: net clearance due (+) or repaid (-)	-15	0	13	0	0	0	0
add: arrears on tax refunds	0	0	-36	0	0	0	0
Recurrent balance (cash, before external support)	**-1,690**	**-1,450**	**-1,371**	**-1,237**	**-1,040**	**-836**	**-554**
Capital expenditures	**215**	**1,103**	**400**	**667**	**762**	**873**	**1,095**
Overall balance (cash, including capital expenditures)	**-1,905**	**-2,553**	**-1,771**	**-1,904**	**-1,802**	**-1,709**	**-1,648**
Total financing	**1,905**	**2,553**	**1,771**	**1,904**	**1,802**	**1,709**	**1,648**
Net domestic bank financing	-29	0	176	0	0	0	0
Other domestic financing	0	0	0	0	0	0	0
External financing for recurrent expenditures	1,764	1,450	1,355	1,242	1,046	843	562
External financing for capital expenditures	215	1,103	400	667	762	873	1,095
Net external debt	-4	0	-4	-5	-6	-7	-8
Residual	-40	0	-156	0	0	0	0
Memorandum items:	(In percent of GDP; unless otherwise stated)						
Revenues	25.7	25.8	26.1	27.8	29.5	29.3	29.3
Recurrent expenditures and net lending	47.2	48.7	52.1	45.6	42.3	38.1	34.3
Wage expenditures	23.8	22.3	24.0	22.3	20.7	18.9	17.3
Nonwage expenditures	16.1	20.4	22.1	19.7	18.2	16.7	15.2
Net lending	7.3	6.0	6.1	3.6	3.4	2.5	1.8
Recurrent balance (commitment) before external support:	-21.6	-23.0	-26.0	-17.8	-12.7	-8.9	-5.0
Recurrent balance (cash) before external support	-27.7	-23.0	-22.4	-17.8	-13.4	-9.4	-5.5
External support (recurrent)	28.2	23.0	22.1	17.9	13.5	9.5	5.6
in millions of U.S. dollars	1,764	1,450	1,354.9	1,242	1,046	843	562
Capital expenditures	3.5	17.5	6.5	9.6	9.8	9.8	10.9
Overall balance (cash)	-31.2	-40.4	-29.0	-27.4	-23.2	-19.3	-16.3
Total external support (in millions of U.S. dollars)	1,979	2,553	1,755	1,909	1,808	1,716	1,656
Nominal exchange rate (NIS per US dollar)	3.6	4.0	3.9	...	...	...	...
Nominal GDP (in millions of U.S. dollars)	6,108	6,318	6,117	6,940	7,774	8,862	10,085

Sources: Ministry of Finance; and IMF staff estimates.

Table 2b. West Bank and Gaza: Central Government Fiscal Operations, 2008–13

		Budget	Est.	Projections			
	2008	2009	2009	2010	2011	2012	2013
	(In millions of shekels, unless otherwise stated)						
Total net revenues	**5,627**	**6,520**	**6,282**	**7,323**	**8,725**	**9,857**	**11,234**
Gross domestic revenues	2,017	2,500	2,300	2,687	3,473	3,917	4,515
Tax revenues	979	1,090	1,185	1,433	1,634	1,846	2,087
Nontax revenues	1,038	1,410	1,115	1,045	1,840	2,071	2,428
Clearance revenues (accrued)	4,027	4,492	4,338	5,016	5,720	6,465	7,307
Clearance revenues (cash)	4,080	0	4,286	5,016	5,720	6,465	7,307
Clearance revenues (net arrears)	-52	0	52	0	0	0	0
Tax refunds	417	472	357	380	468	525	588
Total recurrent expenditures and net lending (commitment)	**10,354**	**12,320**	**12,543**	**12,023**	**12,488**	**12,845**	**13,147**
Wage expenditures (commitment)	5,215	5,640	5,768	5,890	6,126	6,371	6,625
Wage expenditures (cash)	6,354	0	5,596	5,890	6,126	6,371	6,625
Wage expenditures (net arrears)	-1,139	0	171	0	0	0	0
Nonwage expenditures (commitment)	3,535	5,160	5,304	5,183	5,362	5,624	5,822
Nonwage expenditures (cash)	3,785	0	4,490	5,183	5,552	5,814	6,012
Nonwage expenditures (net arrears)	-250	0	815	0	-190	-190	-190
Net lending	1,604	1,520	1,471	950	1,000	850	700
Recurrent balance (commitment, before external support)	**-4,727**	**-5,800**	**-6,261**	**-4,701**	**-3,763**	**-2,988**	**-1,913**
Add: expenditure arrears (net)	-1,389	0	1,063	0	-190	-190	-190
Subtract: net clearance due (+) or repaid (-)	-52	0	52	0	0	0	0
add: arrears on tax refunds	0	0	-141	0	0	0	0
Recurrent balance (cash, before external support)	**-6,063**	**-5,800**	**-5,391**	**-4,701**	**-3,953**	**-3,178**	**-2,103**
Capital expenditures	**771**	**4,412**	**1,573**	**2,535**	**2,894**	**3,316**	**4,159**
Overall balance (cash, including capital expenditures)	**-6,835**	**-10,212**	**-6,964**	**-7,235**	**-6,847**	**-6,493**	**-6,263**
Total financing	**6,832**	**10,212**	**6,964**	**7,235**	**6,847**	**6,493**	**6,263**
Net domestic bank financing	-106	0	691	0	0	0	0
Other domestic financing	0	0	0	0	0	0	0
External financing for recurrent expenditures	6,253	5,800	5,328	4,720	3,976	3,204	2,134
External financing for capital expenditures	771	4,412	1,573	0	0	0	0
Net external debt	-16	0	-16	-19	-23	-27	-30
Residual	-71	0	-612	0	0	0	1
Memorandum items:	(In percent of GDP; unless otherwise stated)						
Revenues	25.7	25.8	26.1	27.8	29.5	29.3	29.3
Recurrent expenditures and net lending	47.2	48.8	52.1	45.6	42.3	38.1	34.3
Wage expenditures	23.8	22.3	24.0	22.3	20.7	18.9	17.3
Nonwage expenditures	16.1	20.4	22.1	19.7	18.2	16.7	15.2
Net lending	7.3	6.0	6.1	3.6	3.4	2.5	1.8
Recurrent balance (commitment) before external support:	-21.6	-23.0	-26.0	-17.8	-12.7	-8.9	-5.0
Recurrent balance (cash) before external support	-27.7	-23.0	-22.4	-17.8	-13.4	-9.4	-5.5
External support (recurrent)	28.2	23.0	22.1	17.9	13.5	9.5	5.6
in millions of U.S. dollars	1,764	1,450	1,355	1,242	1,046	843	562
Capital expenditures	3.5	17.5	6.5	9.6	9.8	9.8	10.9
Overall balance (cash)	-31.2	-40.4	-29.0	-27.4	-23.2	-19.3	-16.3
Total external support (in millions of shekels)	6,954	20,424	6,901	11,974	10,846	9,724	8,427
Nominal exchange rate (NIS per US dollar)	3.6	4.0	3.9	...	...	...	...
Nominal GDP (in millions of shekels)	21,916	25,271	24,055	26,370	29,542	33,674	38,322

Sources: Ministry of Finance; and IMF staff estimates.