INTERNATIONAL MONETARY FUND

WEST BANK AND GAZA

REPORT TO THE AD HOC LIAISON COMMITTEE[1]

September 18, 2015

KEY ISSUES

Context: The Israeli-Palestinian peace process remains stalled, and prospects for a resumption of talks have receded, owing to continued Israeli settlement activities and Palestinian steps toward international recognition. Recent sporadic acts of violence in the West Bank highlight the fragility of the security situation. On the domestic political front, the difficult reconciliation process between the main Palestinian factions remains stalled and political uncertainty is on the rise. The reconstruction of Gaza is progressing but remains hampered by administrative delays and Israeli restrictions on the import of construction materials, as well as slow donor aid disbursement.

Outlook and risks: The economic outlook for the remainder of 2015 is highly uncertain, with numerous risks calling for a cautious policy stance. Assuming the political status quo with no change in restrictions and/or security conditions, real GDP growth for the West Bank and Gaza (WBG) economy is projected at 2.9 percent, implying stagnant per capita incomes after a drop last year. Main risks to the outlook include an escalation of political tensions and violence, fiscal slippages, and shortfalls in donor aid. Risks could be mitigated—and medium-term prospects enhanced—through progress on the peace front, an easing of Israeli restrictions, scaled-up donor aid, and improved economic collaboration at a technical level between the Palestinian Authority (PA) and the Government of Israel (GoI), including by seeking clarity on the level of the PA's outstanding electricity sector debts.

Key policy recommendations: Continued policy discipline is required to address fiscal pressures and a projected large financing gap in 2015. Measures should focus on limiting the wage bill increase, introducing new government administrative fees, implementing the envisaged withholding tax on dividends, and further reducing fuel subsidies. In addition, the PA needs to redouble efforts to mobilize donor aid, including by demonstrating a commitment to structural reforms. Over the medium term, the PA's focus should shift to a more viable financing model based on further fiscal consolidation and a re-orientation of government outlays toward productivity—enhancing investment in human capital and infrastructure.

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

Approved By
Juha Kähkönen and Steven Barnett

Discussions were held in East Jerusalem and Ramallah during June 10–18, 2015, and the report was updated with subsequent developments. The staff team comprised Christoph Duenwald (head), Jonah Rosenthal, Priscilla Toffano, Anna Unigovskaya (all MCD), Ragnar Gudmundsson (IMF Resident Representative), and Hania Qassis (IMF Resident Representative Office). The mission met Prime Minister Hamdallah, 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 press release. Neil Hickey, Cecilia Pineda, and Vanessa Panaligan contributed to producing this report.

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ANNEXES

CONTEXT

1. The Israeli-Palestinian peace process remains stalled amid a fragile security situation. Since the breakdown of peace talks in April 2014, Israeli-Palestinian relations have been deteriorating, and prospects for a resumption of peace talks have further receded. In this environment, the PA has taken further steps towards international recognition by joining the International Criminal Court (ICC) in April 2015 and Israel continues to expand settlements in the West Bank. Sporadic small-scale launches of rockets from Gaza into Israel and acts of violence in the West Bank in recent months are reminders of the fragility of both the Israel-Hamas truce following the 2014 war and of the security situation in the West Bank.

2. On the domestic political front, the reconciliation between the main Palestinian factions—Hamas and Fatah—has stalled and political uncertainty is on the rise. Hamas remains unwilling to relinquish its security presence near the border crossings and to transfer power to the PA in Gaza. The PA's decision not to pay the salaries of around 40,000 civil servants hired by Hamas since 2007 to administer Gaza constitutes another challenge. The rift between the two sides was further deepened with Hamas's objection to the PA's appointment of four new ministers in the consensus government in July 2015. Meanwhile, Hamas continues to operate a shadow government in Gaza, impeding efforts at reconstruction.

3. Against this background, the reconstruction of Gaza—led by the Gaza Reconstruction Mechanism (GRM)[2]—is progressing but remains hampered by restraints on the import of construction materials. The World Bank estimates that 35 percent of the $3.5 billion pledged for Gaza in Cairo in September 2014 had been disbursed as of August 2015.[3] While repairs of some 90,000 partially damaged dwellings have been completed, reconstruction of about 16,000 destroyed homes, along with the rehabilitation of infrastructure, has only just begun. In the meantime, Hamas has reportedly resumed taxation of imports, including construction materials entering Gaza, and the blockade of Gaza remains largely in place.[4] Overall, the humanitarian situation in Gaza remains deplorable, as highlighted in a recent UNCTAD report.[5]

[2] The GRM is a temporary agreement between the PA and the GoI brokered by the United Nations in September 2014 to enable construction and reconstruction work in Gaza following the war.

[3] See http://www.worldbank.org/en/programs/rebuilding-gaza-donor-pledges.

[4] In this report, "blockade" refers to the restrictions placed on the movement of goods and people between Gaza and Israel, and the closure of the Rafah crossing by Egypt.

[5] See http://unctad.org/en/pages/newsdetails.aspx?OriginalVersionID=1068.

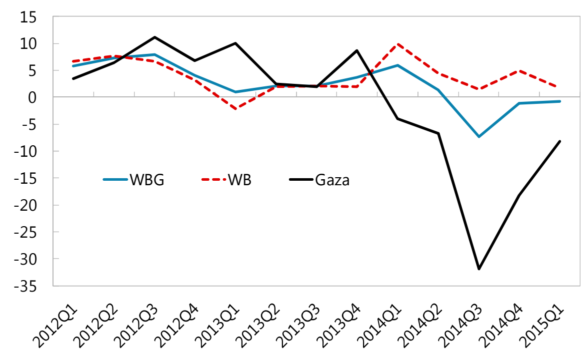
RECENT ECONOMIC DEVELOPMENTS

4. **Economic activity is weak.** Overall growth in the WBG declined further from -0.4 percent in 2014 to -0.8 percent in the first quarter of 2015, reflecting a slowdown in the West Bank.

- In the West Bank, a four-month suspension in clearance revenue (CR) transfers by Israel triggered a slowdown in growth from 5 percent year-over-year in the fourth quarter of 2014 to 1.8 percent in the first quarter of 2015.[6] Growth in Q1 was supported by consumption (public and private) financed by bank credit and increased employment of Palestinians in Israel. Short-term bank credit to the government and public sector employees allowed consumption smoothing during the period of fiscal strains. At the same time, unemployment declined from 17.4 percent at end-2014 to 15.4 percent in 2015:Q2, supported by an increase in employment of Palestinians in Israel and settlements.

Real GDP Growth, 2012–15

(In y-o-y percent change)



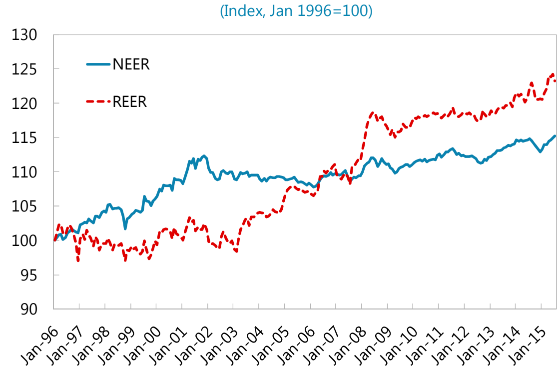
Sources: Palestinian Central Bureau of Statistics; and IMF staff estimates.

- In Gaza, reconstruction efforts started to produce a slow economic recovery in the first quarter of 2015, although real GDP still remained 8 percent below the level of the first quarter of 2014. Unemployment decreased modestly from 42.8 percent at end-2014 to 41.5 percent in 2015:Q2, with youth unemployment at close to 60 percent.

5. **Inflation is contained, while the real exchange rate is appreciating.** After briefly accelerating around the time of Ramadan, inflation slowed to 0.4 percent year-over-year in August, reflecting deflation in Israel and falling global commodity prices. Prices in the West Bank increased by 1.2 percent, while declining by 0.9 percent in Gaza. With inflation in the WBG generally higher compared with its trading partners, staff estimates that the real effective exchange rate increased by 0.9 percent over the 12-month period to July.

Effective Exchange Rate, 1996–2015

(Index, Jan 1996=100)



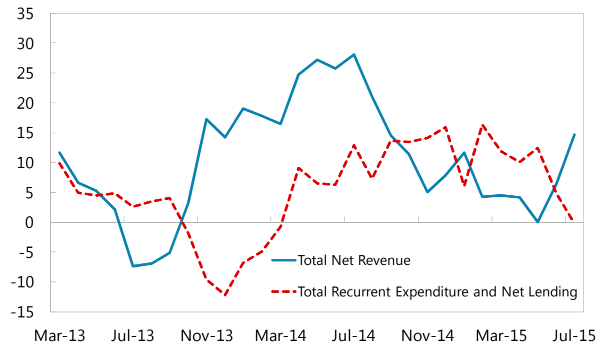
Sources: Haver; INS; and IMF staff estimates.

[6] Note that PCBS data for 2015:Q1 remain preliminary and may be revised at a later stage.

6. Following a reduction in the overall deficit in 2014, fiscal pressures, as reflected in the accumulation of arrears, have increased in 2015. In early 2015, the authorities managed a fiscal crisis brought on by the Israeli suspension of CR by rationing wage spending and temporarily expanding bank financing, while accumulating arrears.[7] Even after CR resumed in April, economic conditions remained difficult and a significant fiscal deficit was recorded in the first seven months of 2015. CR grew by 6.1 percent year-over-year, supported by improved customs administration and exchange of information with Israeli tax authorities. Domestic tax and nontax revenue increased by 2.5 percent, supported by efforts to expand the tax base and to strengthen tax administration.[8] Meanwhile, recurrent expenditure increased by 4.6 percent, driven largely by net lending (payments by the PA to Israel for electricity, water, and sanitation services, which are deducted from CR), which increased by about 25 percent owing to an extraordinary deduction linked to old debts, while donor support declined by about 6 percent compared to the same period in 2014. The expanding deficit was financed by arrears, which increased on a net basis by about $350 million since the beginning of the year after accounting for repayment of earlier arrears,[9] while the stock of debt to banks was reduced. Debt to the Israeli Electricity Corporation (IEC), some of which is in dispute, stood at NIS 1.6 billion in August.

Revenue and Expenditure Growth, 2013–15

(In y–o–y percent change, rolling 4-month period)



Source: Ministry of Finance.

7. Financial sector indicators are strong, but high exposure to the PA and its employees remains a major risk to stability. Nonperforming loans (NPLs) remain below 3 percent of total loans, and liquidity and capital ratios are high by international standards. However, loans to the PA and its employees comprised 41 percent of domestic bank credit at end-June. Credit to the private sector continued to grow robustly at 18 percent year-over-year in the second quarter of 2015, supported by an increase in private deposits, and directed mainly toward construction, real estate, and personal consumption. Recent stress tests by the PMA demonstrate the resilience of the banking system to a range of shocks.

[7] While CR was suspended, the authorities temporary paid only 60 percent of wages, accumulating wage arrears, and expanded short-term borrowing from domestic banks. Once Israel resumed clearance transfers in April, the arrears were cleared and loans were repaid.

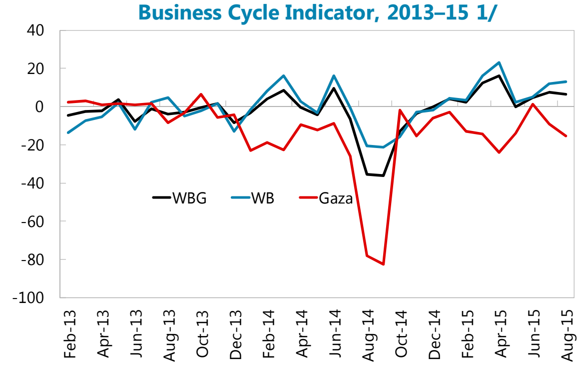
[8] For example, the number of registered taxpayers during January-July increased by 5,465 to reach 172,896. The full year target for 2015 is to increase the number of taxpayers by 12,000.

[9] This contrasts with the budget projection of $314 million of net arrears reduction during 2015.

OUTLOOK AND RISKS

8. The outlook for the remainder of 2015 is challenging and subject to considerable risks. Assuming the political status quo, with no change in restrictions and/or security conditions, growth in the West Bank is projected to slow to 1.8 percent in 2015 from 5 percent in 2014, reflecting the impact of increased uncertainty on private demand and reduced growth in Israel (Table 1). In Gaza, a rebound of 6½ percent is expected from a low base, assuming continued reconstruction activity, albeit constrained by administrative delays and limits on imports of construction materials. The Palestine Monetary Authority's (PMA) Business Cycle Indicator highlights the continued negative business sentiment in Gaza and a lack of momentum in the West Bank. Real GDP growth for the WBG economy is therefore projected at 2.9 percent, implying stagnant per capita GDP given the high rate of population growth. Inflation is projected to remain low, at less than 2 percent. Falling donor support and fiscal pressures will lead to a large financing gap, projected at $0.5 billion (or 3.7 percent of GDP). Absent new measures to reduce the fiscal deficit, the financing gap will likely be filled by domestic borrowing and arrears accumulation. The main risks to the outlook relate to heightened political and security tensions, a related lower than expected rebound in private investment, and fiscal slippages. The latter include the inability of the PA to withstand spending pressures, revenue shortfalls, and lower donor aid. Other risks relate to spillovers from developments in the global economy and the region, including due to financial linkages with neighboring countries (Box 2, Annex I). Previously reported risks (see IMF AHLC report from May 2015) related to the financial implications of litigation in U.S. courts have receded until the PA's appeal is decided in the *Sokolow vs. Palestine Liberation Organization* case.[10]

Business Cycle Indicator, 2013–15 1/

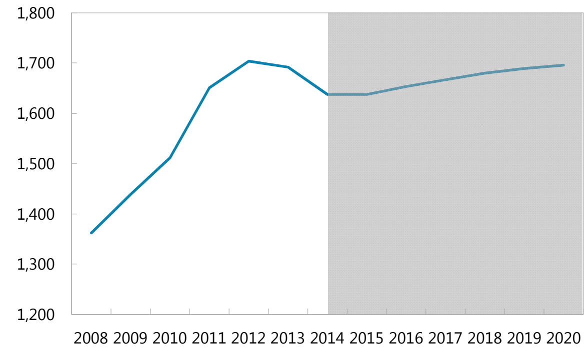


Source: Palestine Monetary Authority.
1/ Based on survey of managers of industrial firms in WBG. Values range between -100 and +100. Negative values denote pessimistic economic outlook.

[10] The judge in the Sokolow litigation recently ordered the PA to post a bond in the amount of $10 million following the PA's appeal of the earlier guilty verdict. The amount of the bond was much lower than many had expected.

9. In the medium term, absent a political breakthrough, growth will remain below what is needed to durably reduce unemployment and improve living standards. The high degree of political uncertainty implies a wide range of possible economic outcomes. In the baseline scenario, assuming the political status quo and unchanged Israeli restrictions, some decline in aid after the completion of Gaza reconstruction, and limited policy actions on the part of the PA, growth will hover around 3 percent, implying little if any growth in per capita incomes combined with a rise in unemployment. In Gaza, the reconstruction effort will continue in the medium term, supported by donors, but real GDP is not expected to reach its pre-war level until end-2017. In this scenario, the pace of fiscal consolidation will be insufficient to prevent arrears accumulation, including to the private sector, which in turn will hurt private demand and growth. A further deterioration in the political landscape or aid shortfalls would produce even worse economic outcomes. On the other hand, progress on the peace front and an easing of Israeli restrictions could dramatically improve economic outcomes. At the same time, even in the absence of a breakthrough on the peace front, improvements in Israeli-Palestinian economic cooperation at the technical level could prove beneficial.

Real GDP per Capita in WBG, 2008–20 (proj.)
(In 2004 U.S. dollars)



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

POLICY DISCUSSIONS

A. Fiscal Policy in 2015

10. Discussions focused on the 2015 budget, which was approved with a significant delay in late June due to the disruptions in clearance revenue transfers. The budget implies an expansion in the overall deficit from 12.4 to 18.4 percent of GDP, after factoring in a fourfold increase in development spending associated with Gaza reconstruction, and a reduction in the recurrent deficit from 10.4 percent in 2014 to 9.2 percent in 2015. Net revenue is projected to rise by 8.6 percent, reflecting plans to raise government fees in the second half of 2015 and higher dividends from the Palestinian Investment Fund. The projected increase in revenue also reflects efforts to expand the tax base and improve compliance, including with the help of the new income tax law introduced in April, which effectively lowers the income tax burden (Box 1). Recurrent expenditure is budgeted to rise by 3.6 percent, with the wage bill expanding by 3.8 percent on the basis of cost-of-living and legally mandated wage increases, combined with zero net hiring.[11] The budget foresees a sharp reduction in fuel subsidies ("fuel tax refund"), lower spending on goods and

[11] This assumes a 1.25 percent annual wage increase under the Civil Service Law, a 1.3 percent increase in the cost of living adjustment (on gross salary), a 5 percent increase in teachers' salaries accounting for 0.5 percent in the overall wage increase, and the allowance for promotions accounting for 0.7 percent of the wage increase.

services due to projected savings on the costs of health referrals,[12] and a 22-percent decline in net lending. The latter is based on efforts to improve payment discipline by municipalities and distribution companies, continue introducing prepaid meters to improve collections, and strictly implement a "deed of release"—a policy which prevents access to government services of citizens who are not current on their electricity bills.[13] With total donor support assumed at nearly $2 billion, the budget projects a financing gap of about $400 million, or about 3 percent of GDP. This is after assuming that about $300 million of arrears will be cleared using bank borrowing.

Budget 2015

	2013	2014		2015 Budget	
	NIS million	NIS million	% Change from 2013	NIS million	% Change from 2014
Net revenues	8,348	9,817	17.6	10,658	8.6
Recurrent expenditures and net lending	13,974	14,556	4.2	15,085	3.6
Wage expenditures	6,928	7,336	5.9	7,617	3.8
Nonwage expenditures	6,287	6,198	-1.4	6,668	7.6
Net lending	760	1,022	34.5	800	-21.7
Development expenditures	674	938	39.2	4,485	378.4
of which: Gaza reconstruction	--	--	--	3,080	--
Overall balance	-6,300	-5,676	-9.9	-8,912	57.0
Total financing	6,300	5,676	-9.9	8,912	57.0
External financing for recurrent expenditures	4,532	3,676	-18.9	3,120	-15.1
External financing for development expenditures	383	726	89.4	4,290	490.7
Domestic financing	746	1,311	75.7	1,502	14.5
Net domestic bank financing	-895	-469	--	1,170	--
Arrears (net)	1,680	1,762	4.9	-1,170	--
Residual/financing gap	-38	18	--	1,502	--

Sources: Ministry of Finance; and IMF staff calculations.

11. Staff noted that current policies and a significant reduction in budget support implied a larger financing gap compared with the budget. Staff project that, the recurrent deficit will decline by 0.5 percentage points to 9.9 percent of GDP, compared to a budget forecast of 9.2 percent, leading to a financing gap of $0.5 billion after accounting for development spending and projected donor financing.[14] Staff viewed the budget's projections for domestic revenue, tax refunds, and net lending as optimistic, pointing to the likely negative effect on revenue of the new income tax law implemented from May. Moreover, given the significant fiscal risks, the financing gap could be substantially larger. Staff cautioned that if the financing gap were filled with arrears accumulation or bank borrowing, debt would rise, posing a risk to debt sustainability (Annex III), while further accumulation of arrears to the private sector would undermine efforts to improve

[12] Health referrals refer to health services that are provided in Israel to Palestinians and that are deducted monthly from clearance revenue. Monthly deductions have been reduced from a peak of about NIS 36 million to about NIS 14 million at present.

[13] Efforts are underway to normalize financial relations between the PA and municipalities and to settle outstanding debts. The PA is committed to transfer to municipalities the share of transportation fees and property taxes which it collects on their behalf ("earmarked revenue collection"). In return, they expect timely payment of electricity bills.

[14] Relative to the May 2015 AHLC report, staff revised downwards its projections of aid for Gaza distributed via the budget since it appears that a large share of aid is provided outside of the budget.

revenue collection.[15] However, with the benefit of two months' additional fiscal data since the mission, some of staff's concerns, especially on domestic revenue, are to some extent being allayed, although risks remain tilted to the downside.

12. To close the financing gap and avoid arrears accumulation, staff recommended a combination of fiscal adjustment and additional donor aid. The proposed measures include: a 2 percent limit on the wage bill increase, close to projected inflation; the introduction of a 10 percent withholding tax on dividends, which had been considered before being shelved; a front-loaded increase in government fees; and the immediate elimination of fuel tax refund (untargeted fuel subsidy which should be replaced by targeted cash transfers). Mindful that those measures alone would be insufficient to fill in the gap, not least because less than half of the year would remain to implement them, staff advised that additional donor aid would be needed to avoid arrears accumulation. Staff also emphasized the importance of adhering to the prudential limit on government borrowing from banks.

Fiscal Measures

	2015		
Measure	NIS million	USD million	% GDP
Identified financing gap in 2015	1808	485	3.7
Total proposed measures	584	157	1.2
Increase in fees	200	54	0.4
Introduction of a 10-percent tax on dividends	100	27	0.2
Wage bill	134	36	0.3
Elimination of fuel tax subsidy	150	40	0.3
Other unidentified measures/new financing	1224	329	2.5

13. The authorities expressed concern about the political feasibility of the proposed measures, and defended the introduction of the new income tax law. They were supportive in principle of the proposed restraint on the wage bill, emphasizing efforts since 2013 to reverse the escalation in wages observed during the previous administration. They pointed to ongoing measures to reduce the number of new hires, eliminate ghost workers, and rationalize the cost structure through mergers, economies of scale and performance-based reviews. However, the authorities cited the difficult political situation and strong opposition from unions as constraining their actions. There was no appetite to introduce the tax on dividends at present, or to further reduce fuel subsidies beyond the target of NIS 25 million per month, as these help alleviate hardship in Gaza. On the other hand, the authorities indicated they would consider frontloading the increase in government fees. As regards the new income tax law, the authorities were more optimistic than staff about its net effect on revenue. They did not think that any losses would be incurred in 2015 as most of the income tax from large taxpayers had been prepaid in early 2015. They did not rule out the possibility of revenue losses in 2016 (estimating them at up to NIS 200 million), but believed enhanced tax compliance and measures on nontax revenue would offset them. They also noted a lack of progress in their discussions with Israel on the implementation of the Paris Protocol related to the proper assessment of transfers and fees owed to the PA by Israel, which in their view could significantly boost revenue.

[15] In this regard, the recently announced plan to proceed with clearance of $200 million of arrears to the private sector using bank borrowing is a positive step but will not in itself resolve the problem of arrears accumulation without additional fiscal measures to reduce the financing gap.

B. Fiscal Policy in the Medium Term

14. Staff reiterated that the existing financing model is not viable. In the medium term, growth-friendly fiscal consolidation, backed by more predictable aid, perhaps linked to deliverables, would improve economic outcomes, even in the presence of continued Israeli restrictions. Staff projects that, with a steady reduction in donor aid likely, fiscal consolidation of 4–5 percent of GDP is needed in the medium term to avoid arrears accumulation and improve the fiscal situation. Using international examples, staff outlined the lessons from successful fiscal consolidation efforts elsewhere, and outlined ways to make it more growth-friendly (Annex IV).

15. There are some encouraging signs that the PA, with the help of donors, is buying into this advice. Despite adverse circumstances, the authorities have managed to deliver lower deficits in the past few years, partly as a result of their successes in expanding the tax base, introducing a term limit for tax exemptions, and upgrading the system of health referrals by establishing the Health Information Management system with USAID assistance and the signing of MOUs with Israeli hospitals. Additionally, they pointed to ongoing efforts to stop electricity debt accumulation, including by instilling better control over municipalities' expenditure, consolidating transmission and purchasing systems, and eventually transferring responsibility for the management of utilities from local governments to commercial public corporations with assistance from the World Bank. The latter, however, would require infrastructure investments and become operational only in a few years. In the area of Public Financial Management (PFM), there has been some progress in improving reporting of intra-government transfers and recording of arrears. The authorities also requested technical assistance to improve fiscal analysis and forecasting capacity of the macro-fiscal unit at the MOF, which will be provided under a program financed by Belgium and supported by the Fund. Donors, such as the EU, are joining the World Bank in introducing results-based frameworks to their budget support disbursements.

16. At the same time, there is a large unfinished fiscal reform agenda. While the authorities agreed with the staff about the need to tackle pensions and civil service reform to ensure medium-term fiscal sustainability, they have not yet committed to specific actions in these areas. Lack of legal enforcement hinders tax administration reform. Public procurement reform has stalled, and the Public Procurement Council continues to face difficulties in exercising its role, despite receiving budgetary allocations in 2015. Despite progress in adopting a new accounting manual and better monitoring of arrears, many other PFM reforms remain to be implemented, as outlined in Box 1 of the IMF's May 2015 AHLC report. In particular, staff noted with concern that the 2011 audited financial statements have still not been approved, a delay that could set back the planned submission in 2015 of the audited financial statements for 2012 and 2013.

C. Financial Sector

17. The authorities and staff agreed that the financial sector is strong, but staff pointed to risks. These include high exposure of banks to the PA and its employees, as well as credit growth which outpaces growth of nominal GDP and is concentrated in a few sectors (Annex II). Additionally, staff noted risks stemming from currency mismatches in the banks' balance sheets and expressed concerns about whether the banking sector has sufficient capacity to manage the quickly rising volume of credit. The PMA responded that rapid credit growth reflected mostly financial deepening, emphasizing that supervisory standards are strict, loan-to-deposit ratios are low, and credit to the private sector is maintained within supervisory limits. At the same time, risks were being monitored closely, and work is continuing to further improve supervision and regulation, including with the help of technical assistance from the IMF, and to extend it to shadow banking. As discussed in the IMF's May 2015 AHLC report, the PMA has recently expanded its macro-prudential policy toolkit; is developing a bank resolution framework to include provisions for resolving foreign bank branches; and is providing inputs for the new central bank law with a view to ensuring stronger PMA independence. Additionally, beginning in 2015, banks started contributing to the deposit insurance fund (0.03 percent of eligible deposits per year), and work to expand the credit registry is ongoing.

18. The authorities welcomed two positive developments on outstanding issues involving cooperation with the Bank of Israel (BOI). First, they noted that an earlier cash surplus problem had eased without the need to expand the limit on cash conversion by the BOI, as cash shortages were observed in banks in early 2015.[16] Second, they welcomed Israel's decision to postpone by two years the implementation for Palestinians of the Locker Bill, which by limiting individual cash transactions in Israel to NIS 10,000 could negatively affect Israeli-Palestinian trade. The upgrade of the payment system started in May 2015 when the PMA introduced the National Switch to enable ATM connectivity between a number of large banks.

D. Structural Reforms

19. There remains scope to improve the business climate. Israeli restrictions, especially access to Area C and the near-total blockade of Gaza, remain major obstacles to an expansion of private sector activity.[17] However, there is significant scope for the PA to improve the business climate—to simplify procedures, improve legislation, and level the playing field for businesses. In particular, expeditious approval of the Secured Transactions Law, the Competition Law, and the New Companies Law would confer significant benefits. The World Bank is working with the authorities on the Secured Transactions Law, which is expected to boost private sector access to credit by formalizing the use of collateral. In general, the absence of a functioning legislature, vested interests in some cases, and the de facto jurisdictional divide between Gaza and the West Bank are, according to the authorities, among the obstacles preventing legislative initiatives from going forward. The World Bank and the Finnish Government are supporting land reform, where key challenges include gaps in the existing laws that require issuance of clear regulations and

[16] The PMA in the past expressed concerns about the limits set by the Bank of Israel on the amount of NIS cash transfers it accepts from Palestinian banks. These limits have been established at NIS 300 million per month in order to combat money laundering and financing of terrorism.

[17] The GoI emphasizes security concerns that restrict its ability to ease or lift restrictions in the WBG.

instructions; currently, only around 30 percent of land is registered, though progress has been made recently.

20. Staff emphasized that stronger economic collaboration between the PA and the GoI would be conducive to improved economic outcomes. The authorities and staff agreed on the importance of conducting meetings of the Joint Economic Committee that bring together the Palestinian and Israeli finance ministers to discuss and resolve outstanding issues linked to the implementation of the Paris Protocol. To stimulate a constructive dialogue between the two parties and enhance predictability of clearance revenue, staff emphasized the need to find a mutually acceptable solution concerning claims on outstanding electricity debts, building on ongoing discussions between the two finance ministries. In this regard, staff suggested an audit by a reputable international accounting firm leading to agreement on a repayment plan, an idea that resonated with the PA and donors.

STAFF APPRAISAL

21. A deadlocked peace process and stalled domestic political reconciliation characterize the difficult context in which the WBG economy operates. As a result, the economy operates well below its potential, resulting in declining, or at best stagnant, per capita incomes and persistently high unemployment. In Gaza, a humanitarian crisis continues to unfold, while sporadic violence in the West Bank is a reminder of the tenuous security situation and the risk of social unrest. In this environment, it is imperative that the PA maintains policy discipline and pursues economic reforms, and that donors raise the level of aid. On the part of Israel, easing restrictions and enhancing economic cooperation with the PA while ensuring consistent and predictable transfers of clearance revenue would contribute significantly to better economic outcomes in the WBG.

22. Economic activity in 2015 and the foreseeable future is insufficient to generate adequate job opportunities. The subdued pace of economic activity in the West Bank this year is the result of a slowdown in private demand linked to a drop in confidence following the suspension of clearance revenue transfers from January to April. The suspension also led to the accumulation of new arrears to the private sector. In Gaza, despite some encouraging signs that donor pledges are being disbursed, the pace of reconstruction still needs to gain momentum to strengthen growth and employment and improve the humanitarian situation. For 2015, staff projects a 1.8 percent rise in the West Bank's real GDP, while Gaza's economy should rebound by 6½ percent assuming continued construction activity. Beyond 2015, under the assumption of the political status quo, growth will remain modest and unemployment rates high. The main risks to the outlook are on the fiscal side and include higher-than-projected spending and revenue or donor aid shortfalls.

23. Fiscal policies combined with developments year-to-date imply a large financing gap in 2015. The continued net accumulation of arrears through the first seven months of 2015 is symptomatic of persistent fiscal pressures. The authorities are working to address these pressures. On the revenue side, they are contemplating a number of revenue-enhancing measures, including raising government administrative fees, broadening the tax base by increasing the number of registered taxpayers, carrying out risk-based audits, conducting voluntary disclosure and taxpayer awareness campaigns, and introducing a standardized reporting system for revenue collecting units. At the same time, amendments to the income tax law will likely result in revenue losses in the short term, even if they lead over time to additional revenue through greater compliance. On the expenditure side, while the authorities intend to adhere to a zero net hiring policy, the budget assumes a 3.8 percent increase in the wage bill, which is twice the projected inflation rate. In addition, a relatively large increase of 8 percent in nonwage spending (transfers and purchases of goods and services) is projected. Combined with a reduction in donor budget support relative to 2014, current fiscal policies imply a financing gap of nearly $500 million, or 3.7 percent of GDP, after factoring in an arrears repayment of roughly $300 million.

24. A combination of fiscal measures and additional donor support is needed to fill the projected financing gap. Fiscal measures, which are outlined below, can reduce the gap to some extent, but, absent scaled-up donor aid, the gap will likely be closed by recourse to harmful arrears and additional bank lending, which raises the PA's indebtedness and threatens fiscal sustainability. Staff recommends the following measures:

- Limit the increase in the wage bill to 2 percent or less in 2015, in line with inflation. In particular, there may be merit in eliminating the automatic annual salary increase of 1.25 percent as a first step.
- New government administrative fees should be introduced in full and without delay.
- The previously envisaged 10 percent withholding tax on dividends should be implemented in order to offset revenue losses from the new income tax law and to contribute to a more progressive tax regime.
- Fuel subsidies should be further reduced, building on the good progress already made.

25. In addition to containing the deficit, the PA needs to redouble efforts to mobilize donor aid. The large financing gap projected for 2015 cannot be closed through measures alone, and scaled up donor budget support for the PA is urgently needed. To strengthen its credibility vis-à-vis donors, strong policies on the part of the PA will be needed. Beyond 2015, the PA's focus needs to shift to a more viable financing model based on further fiscal consolidation and a reorientation of government outlays towards productivity-enhancing investment in human capital and infrastructure. For such efforts to succeed, continued and enhanced support from donors will be necessary, avoiding a substitution of aid away from the West Bank toward Gaza.

26. Efforts to consolidate the fiscal position should be accompanied by fiscal structural reforms. Despite some progress, further reforms in the PFM area are needed. Recent efforts to better account for the stock of arrears to the private sector, to track their accumulation in monthly fiscal reports, to assess contingent liabilities to the Pension Fund, and to reflect intra-governmental transfers in fiscal reports are welcome. However, staff noted with concern that the 2011 audited financial statements have still not been approved. In addition, implementation of the new procurement law remains dependent on the establishment of the High Council for Public Procurement, which should proceed expeditiously. Going forward, efforts should focus on increasing the transparency and quality of fiscal reporting, finalizing and implementing a new accounting manual, developing a medium-term expenditure framework with realistic macroeconomic and financing assumptions, and drafting an Organic Budget Law that will provide an overarching regulatory framework for all public finance related matters. In the revenue area, the most pressing issue is the inadequate tax policy enforcement legislation, which urgently needs to be updated.

27. Safeguarding financial stability remains a priority. While the system is sound and well capitalized, exposure to the PA and its employees and the rapid rate of growth in credit to the private sector call for close monitoring by the PMA, not least considering the weak operating environment. Some of the credit growth may be explained by the success of the PMA's financial inclusion efforts, but the concentration of lending in a narrow range of sectors, along with a high share of loans supporting consumption and increased lending by shadow banking entities, warrants close monitoring.

28. Given the uncertain prospects for a resumption of peace talks, economic collaboration at the technical level between the PA and the GoI takes on even greater importance. As demonstrated by the fiscal crisis during the first four months of the year, predictability of clearance revenue is critical to allow for normal budget execution and to preserve economic and social stability. Efforts to enhance predictability and preserve stability would be bolstered by the resumption of regular meetings of the Joint Economic Committee. In that context, one issue that urgently requires a mutually acceptable solution concerns the claims of both the GoI and the PA on outstanding electricity debts. An audit by a reputable international accounting firm leading to agreement on a repayment plan is one option that should be considered. More broadly, an easing of Israeli restrictions in the West Bank and a lifting of the blockade of Gaza remain the two most important steps for improving economic prospects.

Box 1. New Income Tax Law

In April, the PA enacted a new income tax law which introduced new income tax brackets as follows:

Old law		Amended law	
Income, NIS	Tax rate,%	Income, NIS	Tax rate,%
<30,000	exempt	<36,000	exempt
30,000-40,000	5	36,001-75,000	5
40,001-80,000	10	75,001-150,000	10
80,001-125,000	15	>150,000	15
>125,000	20		

The new law effectively lowers progressivity of the income tax and the marginal tax rate from 20 to 15 percent. Exceptions are given to monopolistic companies, particularly telecoms, for which the marginal tax rate of 20 percent remains unchanged. The effective tax rate for telecoms, however, is not expected to reach 20 percent on account of significant tax exemptions currently provided to telecoms.

Box 2. Economic Linkages Between the WBG and the Rest of the World (ROW)

The WBG is a small open economy with trade dominated by Israel. With the total value of exports plus imports at nearly 80 percent of GDP in 2014, the WBG is a fairly open economy, notwithstanding Israeli restrictions that raise transaction costs and hurt competitiveness of WBG products. Under the Oslo accords, a customs union was established between Israel and the WBG. The resulting tariff regime largely reflects Israel's preferences, which, together with geographic proximity and Israeli control of the WBG's border crossings, makes the economy of the WBG essentially a captive market for Israeli goods. In recent years, Israel accounted for more than 70 percent of all Palestinian imports and absorbed about 85 percent of Palestinian exports.[1] Other major trading partners include Arab countries and the EU. Exports are dominated by low value-added goods, such as construction materials, furniture, and foodstuffs. Major components of imports are energy, foodstuffs, and manufactured goods. As an oil importer, the WBG is also affected by movements in world oil prices. It is important to note that Israel's control of border crossings and ports makes it responsible for collecting foreign trade taxes on behalf of the PA.

The West Bank economy is supported by labor income from Israel. Israel issues work permits to Palestinians, the income from which supports consumption in the West Bank and reduces unemployment there. The number of work permits has varied over time, but has recently increased, prompted by growing Israeli demand for labor in the booming construction sector. As a result, labor income from Israel has increased to reach 10.2 percent of GDP in 2014, up from 6.5 percent in 2010; in 2014, Israel employed about 12 percent of workers from the West Bank. However, the employment is concentrated mainly in low-skilled sectors such as agriculture and construction, contributing little to the development of human capital, technology transfer, or long-term growth.

External transfers are an important source of budget and balance of payments financing. The WBG is a donor-dependent economy with annual external donor support to the PA accounting for about 10 percent of GDP over the past four years. Additional donor support is provided outside of the budget, which includes financing for the United Nations Relief and Works Agency (UNRWA) and, recently, Gaza reconstruction. At the same time, private transfers, mainly from the Palestinian diaspora, constitute about 10 percent of GDP. FDI inflows remain small, at only 1.4 percent of GDP on average over the past five years, reflecting weak business confidence and high country risk amid an uncertain political outlook.

Financial linkages of the WBG with the ROW are limited, apart from a heavy presence of Jordanian banks. The WBG uses the New Israeli Shekel as its currency, which ties monetary conditions to those in Israel. The banking system is dominated by branches of Jordanian banks. The largest Jordanian bank in the WBG, Arab Bank, holds almost one-third of total deposits, provides one-quarter of domestic credit, and accounts for almost 30 percent of total banking assets. Capital markets, on the other hand, are less developed and not well integrated internationally, with stock market capitalization at less than 25 percent of GDP, and no interbank or government bond markets.

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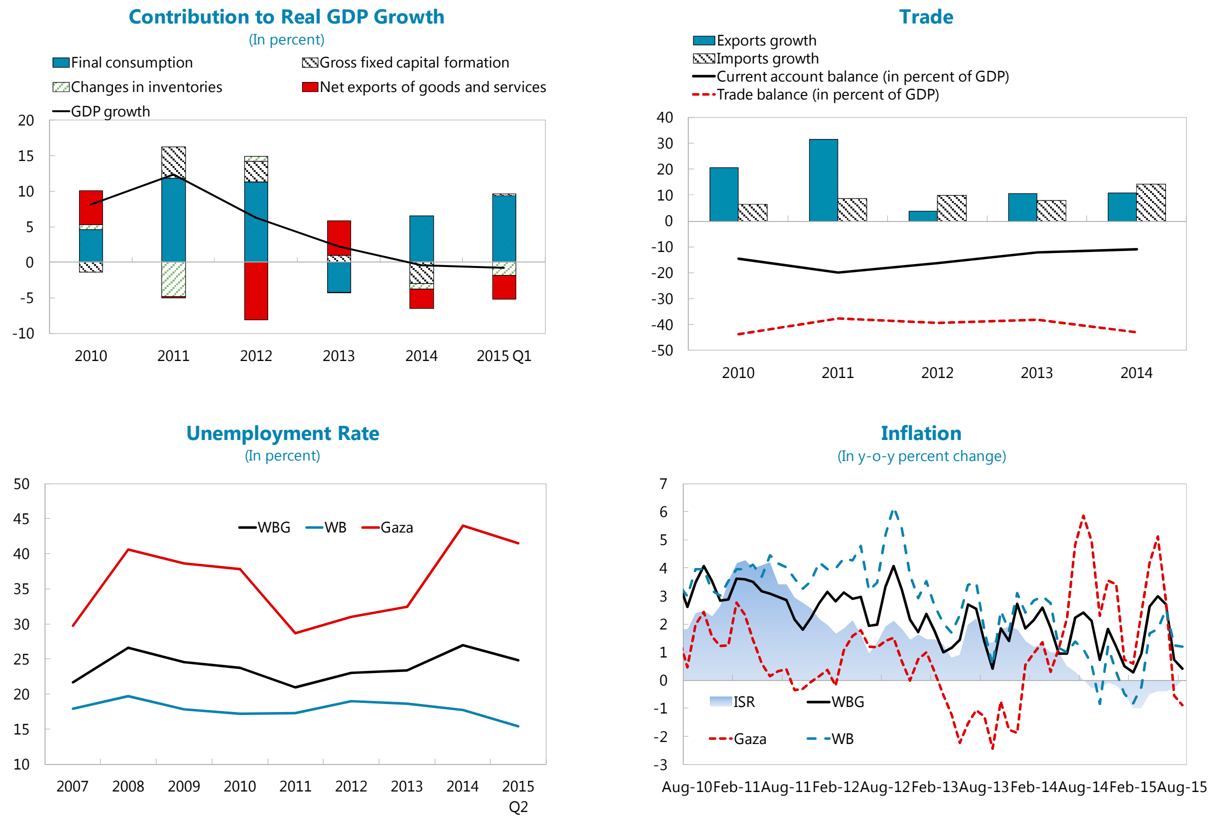
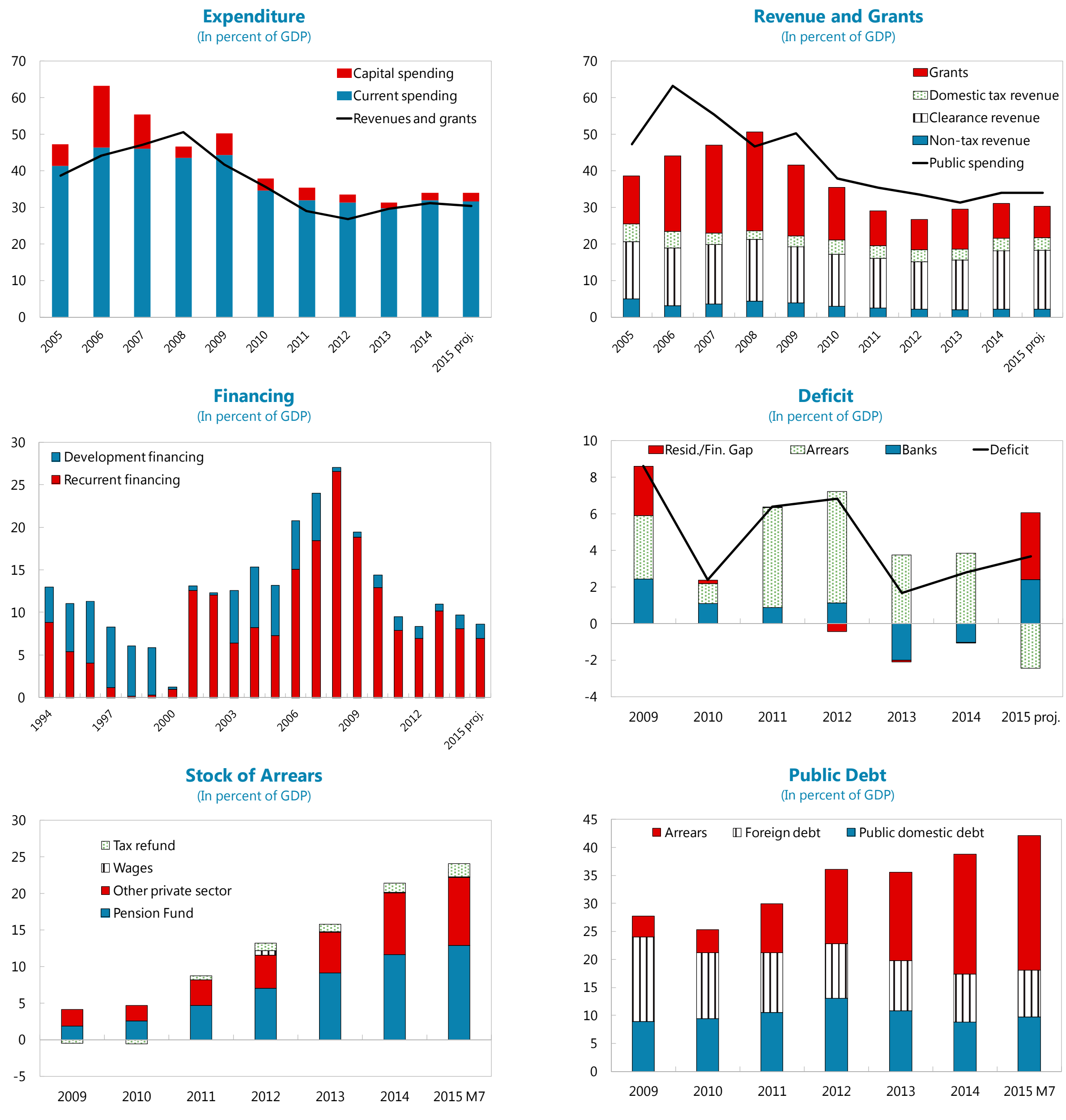
[1] These numbers, however, include some transit trade via Israel. Note that the figure for exports only reflects exports from the West Bank. Exports from Gaza to Israel resumed in 2015, but amount to only 6 percent of their pre-2007 levels, according to World Bank estimates.

Figure 1. West Bank and Gaza: Recent Economic Developments, 2007–15



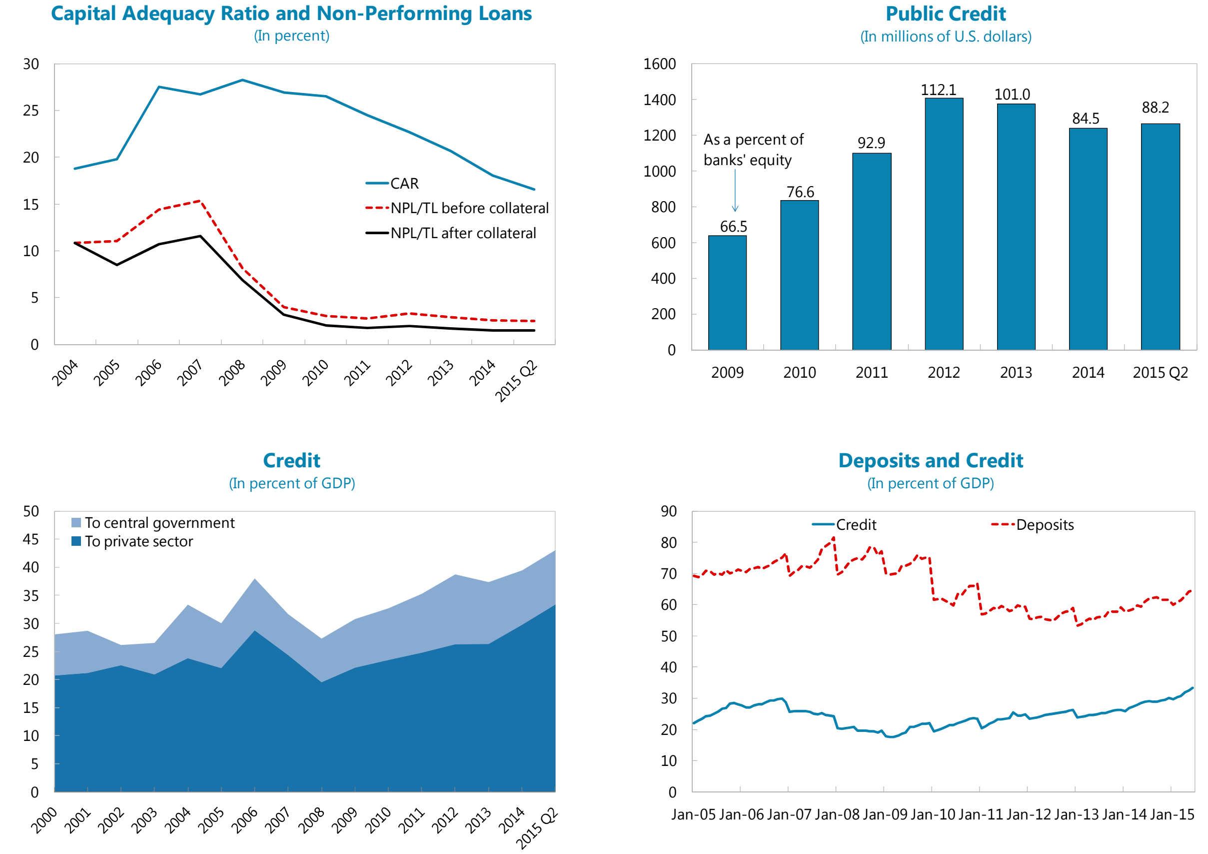
Sources: Palestinian authorities; and IMF staff calculations.

Figure 2. West Bank and Gaza: Fiscal Sector Indicators, 1994–2015



Sources: Palestinian authorities; and IMF staff calculations.

Figure 3. West Bank and Gaza: Financial Sector Indicators, 2000–15



Sources: Palestinian authorities; and IMF staff calculations.

Table 1. West Bank and Gaza: Selected Economic Indicators, 2012–20

(Population: 4.6 million; 2014 est.)
(Per capita GDP: $2,801; 2014)
(Poverty rate: 18 percent in the West Bank and 39 percent in Gaza Strip; 2011 est.)

	2012	2013	Prel. 2014	Projections 2015	2016	2017	2018	2019	2020
Output and prices				(Annual percentage change)					
Real GDP (2004 market prices)	6.3	2.2	-0.4	2.9	3.9	3.7	3.7	3.4	3.2
West Bank	6.0	1.0	5.1	1.8	3.0	2.8	2.7	2.6	2.6
Gaza	7.0	5.6	-15.2	6.5	6.5	6.5	6.5	5.8	5.0
CPI inflation rate (end-of-period)	1.7	2.7	1.2	1.6	2.5	2.5	2.5	2.5	2.4
CPI inflation rate (period average)	2.8	1.7	1.7	1.6	2.6	2.5	2.5	2.5	2.4
Investment and saving				(In percent of GDP)					
Gross capital formation, *of which:*	21.2	21.8	18.6	21.8	21.1	21.5	18.9	19.2	19.2
Public	3.5	3.3	3.6	4.0	6.1	6.1	3.5	3.5	3.5
Private	17.7	18.5	15.0	17.7	15.0	15.4	15.5	15.7	15.8
Gross national savings, *of which:*	5.0	9.5	7.8	10.7	9.1	9.1	8.7	8.7	7.9
Public	-6.0	-1.0	-2.3	-3.0	-2.5	-2.0	-1.6	-0.9	-0.5
Private	11.0	10.6	10.1	13.7	11.6	11.1	10.4	9.6	8.4
Saving-investment balance	-16.2	-12.3	-10.9	-11.1	-12.0	-12.4	-10.2	-10.5	-11.3
Public finances 1/				(In percent of GDP)					
Revenues	18.4	18.6	21.5	21.7	22.0	22.3	22.5	22.7	23.0
Recurrent expenditures and net lending	31.4	29.7	31.9	31.7	31.2	30.9	30.4	30.2	29.8
Wage expenditures	15.7	15.4	16.1	15.8	15.5	15.3	15.0	14.8	14.6
Nonwage expenditures	13.2	12.6	13.6	13.8	13.8	13.7	13.7	13.7	13.7
Net lending	2.5	1.7	2.2	2.1	2.0	1.8	1.7	1.6	1.5
Recurrent balance (commitment, before external support)	-12.9	-11.1	-10.4	-9.9	-9.2	-8.6	-8.0	-7.4	-6.9
Recurrent balance (cash, before external support)	-7.1	-7.5	-5.1	-12.4	-10.3	-9.7	-9.0	-8.5	-7.9
Development expenditures	2.2	1.5	2.1	2.3	4.6	4.5	1.5	1.5	1.5
(In millions of U.S. dollars)	243	187	262	300	604	610	217	210	217
Overall balance (commitment, before external support)	-15.1	-12.6	-12.4	-12.2	-13.8	-13.0	-9.5	-9.0	-8.4
Total external support, including for development expenditures	8.3	11.0	9.7	8.6	10.8	10.5	7.4	7.5	7.3
(In millions of U.S. dollars)	930	1,361	1,230	1,114	1,431	1,435	1,039	1,016	1,022
External support for recurrent expenditure (in millions of U.S. dollars)	774	1,255	1,027	894	894	894	894	894	894
In percent of GDP	6.9	10.1	8.1	6.9	6.7	6.6	6.3	6.6	6.4
Financing gap (in millions of U.S. dollars) 2/	...	...	...	485	452	428	391	301	261
In percent of GDP	...	...	...	3.7	3.4	3.1	2.8	2.2	1.9
Monetary sector 3/				(Annual percentage change)					
Credit to the private sector	14.3	11.0	16.0	15.0	15.0	13.0	12.0	12.0	12.0
Private sector deposits	6.8	10.7	9.9	7.4	6.9	6.4	5.9	5.4	4.9
External sector				(In percent of GDP)					
Current account balance (excluding official transfers)	-23.1	-22.4	-18.9	-18.0	-18.7	-19.0	-16.6	-17.0	-17.7
Current account balance (including official transfers)	-16.2	-12.3	-10.9	-11.1	-12.0	-12.4	-10.2	-10.5	-11.3
Exports of goods and nonfactor services	16.7	16.7	18.0	18.2	17.8	17.7	17.7	17.8	17.7
Import of goods and nonfactor services	56.1	54.8	61.1	60.3	59.9	59.7	56.8	57.8	57.8
Net factor income	7.6	8.6	10.8	10.8	10.6	10.5	10.4	10.4	10.3
Net current transfers	15.6	17.3	21.3	20.3	19.6	19.0	18.4	19.1	18.5
Private transfers	8.7	7.1	13.2	13.4	12.8	12.5	12.1	12.5	12.1
Official transfers	6.9	10.1	8.1	6.9	6.7	6.6	6.3	6.6	6.4
Memorandum items:									
Nominal GDP (in millions of U.S. dollars)	11,235	12,419	12,744	12,974	13,260	13,636	14,101	13,606	14,061
Per capita nominal GDP (U.S. dollars)	2,617	2,809	2,801	2,771	2,753	2,753	2,768	2,597	2,610
Unemployment rate	23	23	27	27	28	29	29	30	30
Al Quds stock market index (annual percentage change) 4/	0.1	13.4	-7.1	-4.2	...	...	...	...	...

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.
4/ For 2015, percent change since end-2014.

Table 2. West Bank and Gaza: Central Government Fiscal Operations, 2012–18

				Budget	Projections			
	2012	2013	2014	2015	2015	2016	2017	2018
	(In millions of shekels, unless otherwise stated)							
Net revenues	7,989	8,348	9,817	10,658	10,508	11,270	12,098	12,974
Gross domestic revenues	2,806	3,078	3,114	3,290	3,290	3,475	3,715	3,973
Tax revenues	1,852	2,157	2,149	2,220	2,220	2,192	2,354	2,526
Nontax revenues (accrued)	954	921	966	1,070	1,070	1,284	1,361	1,447
Of which: arrears	59	...	...	...	...	...	...	...
Clearance revenues (accrued)	5,617	6,103	7,331	7,768	7,768	8,274	8,794	9,341
Of which: arrears	-479	14	13	...	...	...	...	...
Less tax refunds 1/	434	834	628	400	550	480	410	340
Of which: arrears	239	27	147	...	...	...	...	...
Recurrent expenditures and net lending (commitment)	13,593	13,336	14,556	15,085	15,307	15,987	16,747	17,572
Of which: arrears	1,863	1,601	2,281	-1,170	-1,170	-579	-597	-614
Wage expenditures (commitment)	6,812	6,928	7,336	7,617	7,617	7,937	8,290	8,658
Of which : arrears	816	380	570	...	...	...	...	...
Nonwage expenditures (commitment)	5,709	5,648	6,198	6,668	6,668	7,050	7,457	7,914
Of which: arrears	1,046	1,221	1,712	-1,170	-1,170	-579	-597	-614
Net lending	1,072	760	1,022	800	1,022	1,000	1,000	1,000
Development expenditures (commitment)	937	674	938	4,485	1,118	2,334	2,429	890
Of which: on Gaza reconstruction	...	...	25	3,080	373	1,545	1,592	...
Of which: arrears	124	66	351	...	...	...	...	...
Recurrent balance (commitment, excl. development expenditure)	-5,604	-4,988	-4,739	-4,427	-4,799	-4,718	-4,649	-4,598
Overall balance (commitment)	-6,541	-5,662	-5,676	-8,912	-5,916	-7,052	-7,078	-5,488
Total financing	6,541	5,662	5,676	8,912	5,916	7,052	7,078	5,488
Net domestic bank financing	490	-895	-469	1,170	1,170	425	425	425
External debt repayment			-38		-41	-67	-164	-178
External financing for recurrent expenditures	2,986	4,532	3,676	3,120	3,330	3,452	3,558	3,659
External financing for development expenditures	601	383	726	4,290	820	2,074	2,153	596
Other domestic financing	---	---	---	---	---	---	---	---
Arrears accumulation (net)	2,646	1,680	1,762	-1,170	-1,170	-579	-597	-614
Of which: repayment			-1,004	-1,170	-1,170	-579	-597	-614
Residual/financing gap 2/	-182	-38	18	1,502	1,808	1,747	1,702	1,600
	(In millions of U.S. dollars, unless otherwise stated)							
Net revenues	2,072	2,312	2,744	2,861	2,821	2,918	3,039	3,169
Gross domestic revenues	728	853	870	883	883	900	933	970
Tax revenues	480	597	601	596	596	567	591	617
Nontax revenues (accrued)	248	255	270	287	287	332	342	354
Of which: arrears	15	...	...	...	...	...	...	...
Clearance revenues (accrued)	1,457	1,690	2,049	2,085	2,085	2,143	2,209	2,281
Of which: arrears	-124	4	4	...	...	...	...	...
Less tax refunds	113	231	176	107	148	124	103	83
Of which: arrears	62	7	41	...	...	...	...	...
Recurrent expenditures and net lending (commitment)	3,525	3,693	4,068	4,049	4,109	4,140	4,207	4,292
Of which: arrears	483	443	638	-314	-314	-150	-150	-150
Wage expenditures (commitment)	1,767	1,919	2,050	2,045	2,045	2,055	2,083	2,115
Of which: arrears	212	105	159	...	...	...	...	...
Nonwage expenditures (commitment)	1,481	1,564	1,732	1,790	1,790	1,825	1,873	1,933
Of which: arrears	271	338	478	-314	-314	-150	-150	-150
Net lending (commitment)	278	210	286	215	274	259	251	244
Development expenditures (commitment)	243	187	262	1,204	300	604	610	217
Of which: on Gaza reconstruction	...	...	25	800	100	400	400	...
Of which: arrears	32	18	98	...	...	...	...	...
Recurrent balance (commitment, excl. development expenditure)	-1,453	-1,381	-1,324	-1,188	-1,288	-1,222	-1,168	-1,123
Overall balance (commitment)	-1,696	-1,568	-1,586	-2,392	-1,588	-1,826	-1,778	-1,340
Total financing	1,696	1,568	1,586	2,392	1,588	1,826	1,778	1,340
Net domestic bank financing	127	-248	-131	314	314	110	107	104
External debt repayment			-10	---	-11	-17	-41	-44
External financing for recurrent expenditures	774	1,255	1,027	838	894	894	894	894
External financing for development expenditures	156	106	203	1,152	220	537	541	146
Arrears (net)	686	465	493	-314	-314	-150	-150	-150
Of which: repayment			-281					
Residual/Financing gap 2/	-47	-11	5	403	485	452	428	391
Memorandum items:				(In percent of GDP, unless otherwise stated)				
Revenues	18.4	18.6	21.5	22.1	21.7	22.0	22.3	22.5
Recurrent expenditures and net lending	31.4	29.7	31.9	31.2	31.7	31.2	30.9	30.4
Wage expenditures	15.7	15.4	16.1	15.8	15.8	15.5	15.3	15.0
Nonwage expenditures	13.2	12.6	13.6	13.8	13.8	13.8	13.7	13.7
Net lending	2.5	1.7	2.2	1.7	2.1	2.0	1.8	1.7
Recurrent balance (commitment) before external support	-12.9	-11.1	-10.4	-9.2	-9.9	-9.2	-8.6	-8.0
External financing for recurrent expenditures	6.9	10.1	8.1	6.5	6.9	6.7	6.6	6.3
Development expenditures (cash)	1.9	1.4	1.3	9.3	2.3	4.6	4.5	1.5
Overall balance (commitment)	-15.1	-12.6	-12.4	-18.4	-12.2	-13.8	-13.0	-9.5
Overall balance (cash)	-9.0	-8.9	-6.4	-20.9	-14.7	-14.9	-14.1	-10.6
Residual/financing gap	-0.4	-0.1	0.0	3.1	3.7	3.4	3.1	2.8
Nominal exchange rate (NIS per U.S. dollar)	3.86	3.61	3.58	...	...	...	...	...
Nominal GDP (in millions of shekels)	43,322	44,843	45,596	48,328	48,328	51,210	54,281	57,732

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, 2012–18 (GFSM 2001)

	2012	2013	2014	Projections 2015	2016	2017	2018
	(In millions of shekels)						
Revenue	11,576	13,263	14,220	14,657	16,795	17,809	17,229
Taxes	7,035	7,426	8,852	9,438	9,986	10,738	11,526
Domestic taxes	1,852	2,157	2,149	2,220	2,192	2,354	2,526
Clearance taxes	5,617	6,103	7,331	7,768	8,274	8,794	9,341
Tax refund	-434	-834	-628	-550	-480	-410	-340
Grants	3,587	4,915	4,402	4,149	5,526	5,711	4,256
External budget support	2,986	4,532	3,676	3,330	3,452	3,558	3,659
External development support	601	383	726	820	2,074	2,153	596
Other revenue	954	921	966	1,070	1,284	1,361	1,447
Of which: dividends	120	116	121	134	161	171	182
Expenditures	14,530	14,009	15,494	16,424	18,321	19,176	18,462
Expense	13,593	13,336	14,556	15,307	15,987	16,747	17,572
Compensation of employees 1/	6,812	6,928	7,336	7,617	7,937	8,290	8,658
Use of goods and services	2,112	1,816	2,333	2,225	2,358	2,499	2,658
Grants 2/	1,072	760	1,022	1,022	1,000	1,000	1,000
Other expense 3/	3,597	3,832	3,864	4,442	4,692	4,958	5,256
Net acquisition of nonfinancial assets	937	674	938	1,118	2,334	2,429	890
Gross operating balance	-2,017	-73	-336	-650	808	1,062	-342
Net lending / borrowing (overall balance)	-2,954	-746	-1,274	-1,767	-1,526	-1,367	-1,232
Net financial transactions	-2,954	-746	-1,274	-1,767	-1,526	-1,367	-1,232
Net acquisition of financial assets	...	...	...	...	...	...	...
Domestic							
Currency and deposits	...	...	...	...	...	...	...
Net incurrence of liabilities	3,136	785	1,256	-41	-221	-336	-368
Domestic	3,136	785	1,293	0	-154	-172	-189
Loans	490	-895	-469	1,170	425	425	425
Net domestic bank financing	490	-895	-469	1,170	425	425	425
Other accounts payable	2,646	1,680	1,762	-1,170	-579	-597	-614
Arrears (recurrent)	2,043	1,628	1,424	-1,170	-579	-597	-614
Arrears (capital)	124	66	351	...	...	...	...
Arrears (clearance)	-479	14	13	...	...	...	...
Foreign	...	...	-38	-41	-67	-164	-178
Loans	...	...	-38	-41	-67	-164	-178
Statistical discrepancy/financing gap	-182	-38	18	1,808	1,747	1,702	1,600
Memorandum items:							
Gross operating balance excl. grants (commitment)	-5,604	-4,988	-4,739	-4,799	-4,718	-4,649	-4,598
Gross operating balance excl. grants (cash)	-3,082	-3,374	-3,328	-5,969	-5,297	-5,246	-5,212
Overall balance (NLB) excl. grants (commitment)	-6,541	-5,662	-5,676	-5,916	-7,052	-7,078	-5,488
Overall balance (NLB) excl. grants (cash)	-3,894	-3,982	-3,914	-7,086	-7,631	-7,675	-6,102
Revenue (percent of GDP)	26.7	29.6	31.2	30.3	32.8	32.8	29.8
Expenditure (percent of GDP)	33.5	31.2	34.0	34.0	35.8	35.3	32.0
Expense (percent of GDP)	31.4	29.7	31.9	31.7	31.2	30.9	30.4
Wage expenditure (percent of GDP)	15.7	15.4	16.1	15.8	15.5	15.3	15.0
Nonwage expenditures (percent of GDP)	4.9	4.1	5.1	4.6	4.6	4.6	4.6
GOB (commitment) excluding grants (percent of GDP)	-12.9	-11.1	-10.4	-9.9	-9.2	-8.6	-8.0
GOB (cash) excluding grants (percent of GDP)	-7.1	-7.5	-7.3	-12.4	-10.3	-9.7	-9.0
External support (recurrent)	6.9	10.1	8.1	6.9	6.7	6.6	6.3
in millions of NIS	2,986	4,532	3,676	3,330	3,452	3,558	3,659
NLB (commitment) excluding grants (percent of GDP)	-15.1	-12.6	-12.4	-12.2	-13.8	-13.0	-9.5
NLB (cash) excluding grants (percent of GDP)	-9.0	-8.9	-8.6	-14.7	-14.9	-14.1	-10.6
Total external support (in millions of shekels)	3,587	4,915	4,402	4,149	5,526	5,711	4,256
Nominal GDP (in millions of shekels)	43,322	44,843	45,596	48,328	51,210	54,281	57,732
Exchange rate	3.9	3.6	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, 2011–15
(In percent)

	Dec-11	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15
Capital adequacy (for all banks)												
Tier I capital to risk-weighted assets	22.9	22.2	21.5	21.2	21.0	21.5	21.1	20.1	20.0	20.0	18.8	18.0
Regulatory capital to risk-weighted assets	21.1	20.3	19.8	19.5	19.3	20.0	19.6	18.9	18.9	18.9	17.8	17.1
Capital adequacy (for local banks)												
Tier I capital to risk-weighted assets	24.5	22.7	21.2	20.9	20.5	20.7	20.4	18.3	18.3	18.0	17.4	16.6
Regulatory capital to risk-weighted assets	20.3	18.8	17.7	17.7	17.3	17.8	17.5	16.2	16.5	16.3	15.7	15.1
Asset quality 1/												
Nonperforming loans (percent of total loans)	2.7	3.1	3.2	3.1	2.9	2.9	2.8	2.6	2.7	2.5	2.7	2.5
Nonperforming loans net of provisions to capital	3.8	4.9	4.7	5.1	4.8	4.7	4.8	4.4	4.3	4.0	4.9	4.2
Coverage ratio (provisions as percent of nonperforming loans)	60.9	60.1	61.6	59.3	60.5	59.1	58.9	61.2	61.7	61.4	58.6	63.4
Earnings and profitability												
Return on assets (ROA)	1.9	1.8	2.0	2.0	2.0	1.9	1.9	1.8	1.7	1.7	1.6	1.6
Return on equity (ROE) 2/	17.0	16.2	19.1	18.5	18.8	18.7	18.6	17.8	17.2	17.1	15.7	15.6
Interest income to gross income	71.7	72.4	74.0	75.0	74.6	74.0	74.5	74.1	73.9	72.4	71.5	70.8
Non-interest expenses to gross income	57.2	55.4	52.8	53.5	54.1	54.8	55.0	58.2	59.9	60.1	60.2	61.0
Personnel cost to non-interest expenses	55.5	53.8	57.4	56.9	55.1	53.9	56.3	53.7	52.5	51.5	53.0	52.9
Liquidity												
Liquid assets to total assets	38.2	37.5	36.3	36.8	37.5	39.5	38.0	37.0	36.9	35.4	34.1	32.8
Liquid assets to demand and savings deposits	74.4	71.6	69.1	69.4	71.1	74.7	72.0	71.1	68.3	65.9	62.9	60.0
Liquid assets to total deposits	46.9	45.8	44.6	45.0	45.8	48.1	46.5	45.7	45.1	43.2	41.8	40.0

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

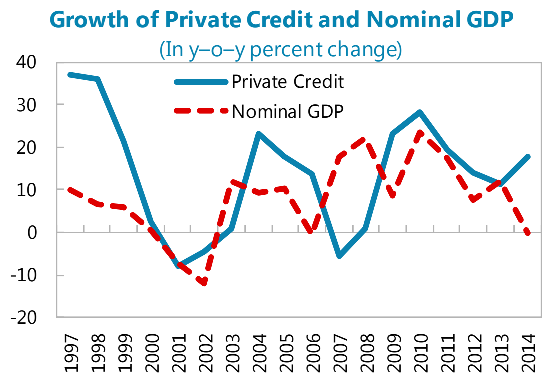
Nature/Sources of Main Threats	Likelihood of Realization in the Next Three Years	Expected Impact on Economy If Risk is Realized	Policy Recommendations to Mitigate Risks
Structurally weak growth in key advanced and emerging economies	***High/low/Short to Medium Term***	***Low*** A further slowdown in 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.	***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. 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	***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.

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
Donor "fatigue" and reduced support from Arab donors due to falling oil prices	***Medium/Medium Term***	***High*** Budget support from Arab donors could decline due to a reduction in oil producers' income following the sharp decline in oil prices. The suspension of peace talks, if sustained, could lead other donors to reconsider their long-term commitment to supporting the PA, which could threaten fiscal sustainability. Budget support could also decline due to diversion of commitments to Gaza reconstruction.	(1) Instill confidence through strong domestic policies, anchored in medium-term fiscal adjustment; (2) Reduce aid dependency and support fiscal sustainability via pro-growth policies; and (3) Continue reforms to improve government institutions.
Risks to energy prices, with increased volatility due to uncertainty about the persistence of the oil supply shock and the underlying drivers of the price decline	***Medium/Short Term***	***Low/Medium*** Increase in energy prices if passed to consumers will lead to lower demand and growth. Maintenance of subsidies, on the other hand, will further weaken already fragile fiscal position.	Phase out fuel subsidies and allow pass-through of energy prices to consumers, while strengthen targeted social transfers to support the poor.
Heightened risk of fragmentation/state failure/security dislocation in the Middle East	***Medium/Medium 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.

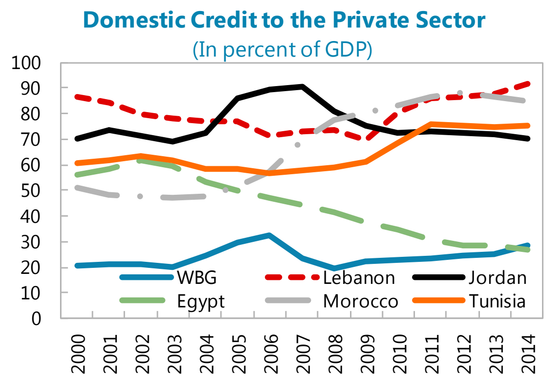
[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate 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. Rapid Credit Growth in the West Bank and Gaza (WBG): How Much Should We Worry?

In recent years, the WBG has experienced high private sector credit growth, despite slowing economic activity. Bank credit to the private sector has risen annually by an average of 20 percent since 2009, almost double the rate of nominal GDP growth over the same period. Following 16 percent growth in 2014, credit has continued to expand at 18 percent year-over-year in the second quarter of 2015.



Sources: National authorities; and IMF staff calculations.



Source: IMF Staff Calculations.

Part of this growth reflects catching up, but rapid credit expansion is often accompanied by a buildup of macro-financial risks. The WBG's credit expansion started from a low base, even by regional standards; while its 2014 credit-to-GDP ratio of 31 percent was slightly higher than that of Egypt, it was more than 50 percent lower than those in Jordan, Lebanon, and Morocco, and below the average level of countries in the MENA region. Hence, high private credit growth could reflect a catching-up process and the financial deepening associated with financial inclusion (Annex Box 1). On the other hand, it could indicate the emergence of a credit boom linked to looser lending standards, excessive leverage, and asset price bubbles, with attendant risks for macro-financial stability (Gourinchas and Obstfeld, 2012).

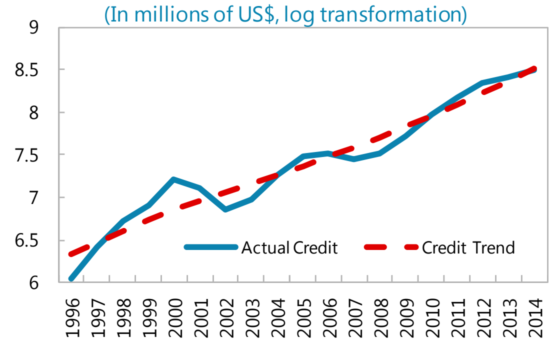
Statistical analysis of data on private credit, however, is inconclusive on the extent to which rapid credit growth has increased risks.

- **Analysis of credit gaps does not point to existence of a boom.** Credit booms are generally defined as extraordinary deviations ("gaps") in the actual credit from a long-term trend or from an ad hoc threshold.[1] Borio and Lowe (2004) first documented the properties of the credit gap as a useful early warning indicator for banking crises. In this case, the analysis of the actual

[1]As a cautionary note, the short length and high volatility of the historical data for the WBG make it difficult to identify a conclusive credit trend.

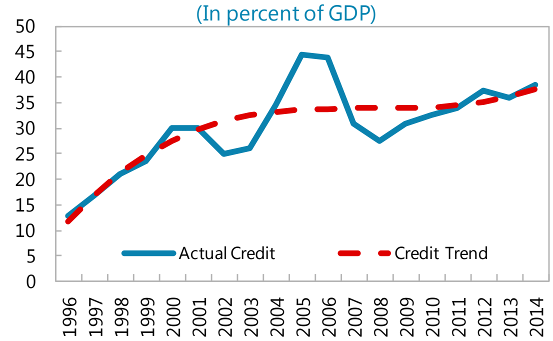
credit—and its trending pattern—does not point to a problem because both the credit level and the credit-to-GDP ratio in WBG are consistent with their trends.[2]

Growth of Credit Relative to Trend
(In millions of US$, log transformation)



Sources: National authorities; and IMF staff calculations.

Credit Relative to Cubic Trend
(In percent of GDP)



Sources: National authorities; and IMF staff calculations.

- **The WBG does not significantly display the patterns of rapid credit expansion and contraction seen in a typical credit boom (see Dell'Ariccia and others, 2012).** As a middle-income economy with an under-developed financial system, the WBG has seen high growth in the credit-to-GDP ratio by absolute standards, but this growth could not be assessed as exceptionally strong or abrupt.[3]

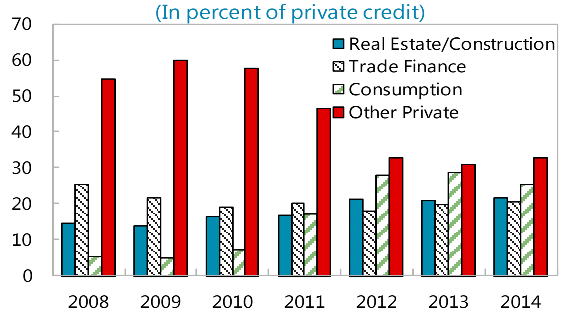
Nevertheless, economic analysis of private credit points to risks that need to be monitored. Lack of statistical evidence does not preclude the possibility of a credit boom, as statistical analysis is known to miss credit booms associated with financial crises (Mitra and others, 2011). In addition, even in the absence of a credit boom, there are risks that need to be monitored. These include high and increasing concentrations of credit, and possibly the insufficient capacity of bank supervisors to monitor a rapidly expanding loan portfolio.

[2] Two measures of credit (credit level and credit-to-GDP ratio) and two types of trends (the HP filter of log credit with a smoothing parameter set equal to 100 and the backward-looking rolling cubic trend, which incorporates two inflection points to allow for financial deepening and reversal) have been considered in this analysis.

[3] In a recent paper, Dell'Ariccia and others (2012) analyze 175 credit booms in a sample of 170 countries over the period 1960–2010 and find that: (i) most booms happen in middle-income countries and under-developed financial systems; (ii) the median credit-to-GDP ratio at the start of a boom is 19 percent; and (iii) the median boom lasts three years, with the credit-to-GDP ratio growing at about 13 percent per year, or about five times its median growth in non-boom years.

Credit is concentrated in the West Bank and in three economic sectors. Eighty-four percent of private credit is extended in the West Bank and only 16 percent in Gaza. Credit is also concentrated in construction, trade, and, consumption. Loans to these three sectors account for almost 70 percent of domestic credit and 20 percent of GDP. The loan-to-deposit (LTD) ratio increased from 31 percent in 2008 to 55 percent in 2014 indicating that the rapid extension of loans did not always go hand in hand with the growth in deposits. At the same time, private credit has not exceeded 20 percent of total credit in any sector, an ad hoc concentration threshold set by the PMA as indicative of emerging vulnerabilities.[4]

Sectoral Distribution of Credit
(In percent of private credit)

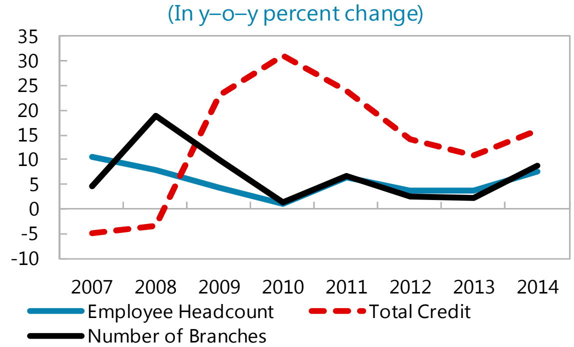


Sources: National authorities; and IMF staff calculations.

Of concern is the rise of consumption loans, which have increased dramatically since 2008 and now account for a quarter of domestic credit, or 7 percent of GDP. Many of them are extended to employees of the PA, thereby adding to the already-high direct exposure of the banking sector to the PA. The theoretical literature linking the financial sector to the real economy makes a distinction between the role of investment and consumption credit with some evidence that the former is associated with economic growth while the effect of the latter is more ambiguous (Beck and others, 2012). However, private investments in WBG increased from almost 16 percent in 2008 to 19 percent of GDP in 2014, seeming to exclude the crowding out of private investment by consumption (see Junius, 2013).

Worries arise about whether the banking sector has adequate capacity for managing the rising volume of credit. While total credit has more than doubled since 2009, banking sector growth has been unable to keep the same pace. In particular, the number of employees and bank branches has increased since 2007 by much less than bank credit. Although increased banking personnel productivity has been supported by the creation of the credit registry, understaffing in banks should be monitored to safeguard against a drop in credit quality.

Evolution of Banking Sector Capacity
(In y–o–y percent change)

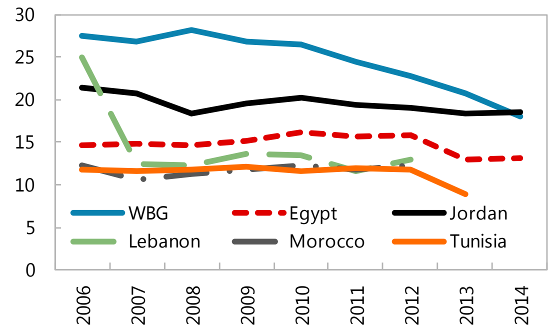


Sources: National authorities; and IMF staff calculations.

[4] PMA Regulation No. 5/2008 Article (1/6/5).

The PMA has been working to address the risks, but close monitoring needs to continue. The PMA has implemented a range of strong macroprudential policies, including countercyclical capital buffers, limits on real estate exposure, and monitoring of loan-to-value and loan-to-income ratios. Currently, the banking system is well capitalized by international standards, NPLs are below 3 percent, and liquidity is high. However, there has been a steady decline in capital adequacy. In addition, liquidity management by banks is constrained by the absence of a functioning interbank market, strained political relations with Israel, and a lack of access to capital markets. Furthermore, borrowers are reported to have currency mismatches between their loans and incomes, particularly in mortgages. Thus, even if recent private credit growth is a reflection of financial deepening rather than a boom, continuous vigilance is needed to monitor heightened risks in the context of a slowing economy.

Capital Adequacy Ratio

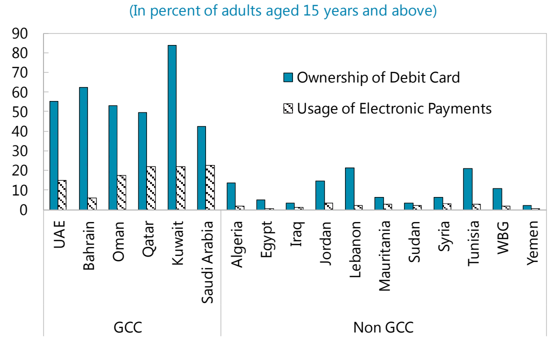


Source: Regional Economic Outlook.

Annex Box 1. Financial Inclusion in West Bank and Gaza[1]

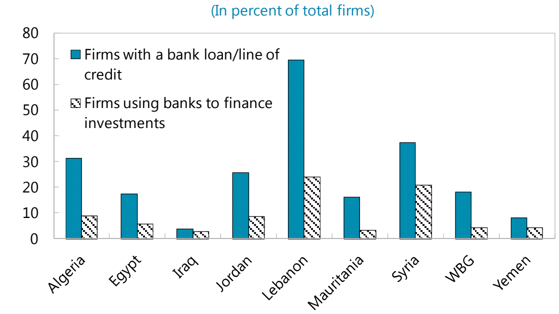
Financial inclusion is accelerating in the WBG, but there is a divergence between access to, and use of, bank credit. Financial inclusion is a process of increasing the efficiency, depth, breadth, and reach of financial systems, which is normally measured in terms of the number of individuals who own a bank account, have requested a loan in the past year, and make use of debit cards or electronic payments. The private credit-to-GDP ratio, a standard indicator of financial inclusion, has grown rapidly. Still, as of 2013, while 59 percent of adults had bank accounts, only 11 percent had credit accounts; based on a World Bank study, only 11 percent of adults had a debit card and a meager 2 percent made use of electronic payments.[1] The divergence between access to, and use of, bank credit could be attributed to religious reasons, according to the World Bank. Among firms, 18 percent had a line of credit and 4 percent used banks to finance investments, on par with Egypt, but below Lebanon and Jordan.

Financial Inclusion Indicators at the Individual Level
(In percent of adults aged 15 years and above)



Source: World Bank Financial Inclusion Report, 2014; and IMF staff calculations. All data from 2011 or most recent available.

Financial Inclusion Indicators on the Firm Level 1/
(In percent of total firms)



Source: World Bank Financial Inclusion Report, 2014 and IMF staff calculations.
1/ Based on surveys of more than 130,000 firms spanning 2005 and 2011, conducted by the World Banks' enterprise unit.

The PMA has taken important steps toward enhancing financial inclusion. During the past decade, the PMA has aimed to reduce the population per branch. This indicator decreased from 16,900 people per branch in 2013 to 16,000 in 2014. In 2008, it established a Credit Bureau (CB) and in 2010 launched a credit scoring system linked to the credit registry, thereby supporting the rise of bank credit to the private sector. Later, it expanded the CB to include a database for SMEs and a Bounced Checks System. The PMA has also encouraged the use of ATMs and e-banking services to lower the cost, and accelerate the execution of, transactions and reduce the use of cash. In 2013, the PMA launched the second phase of the International Banking Account System (IBAN) and, more recently, implemented the National Switch Payment System, vital for the development of retail ATM transactions. It also organized several banking awareness campaigns aimed at children and youth. In 2015, the PMA began formulating its first National Financial Inclusion Strategy.

Further progress, however, would require overcoming a number of challenges. Challenges include expanding banking services to the large informal sector, improving competition in the banking sector, and overcoming banks' discrimination against smaller customers. Improving competition can be achieved through adoption of innovative technologies, enhancing banks' business models so that they reach out to new clients, and strengthening the regulatory framework. To this end, the enactment of the Competition Law and the Secured Transaction Law and the utilization of the asset registry would enhance credit provision, particularly for SMEs, including by allowing collateralization of machines and equipment. This should be complemented by efforts to strengthen creditors' rights and speeding up the procedures for collateral enforcement.

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[1] Source: PMA and World Bank (2014).

[2] See World Bank (2014).

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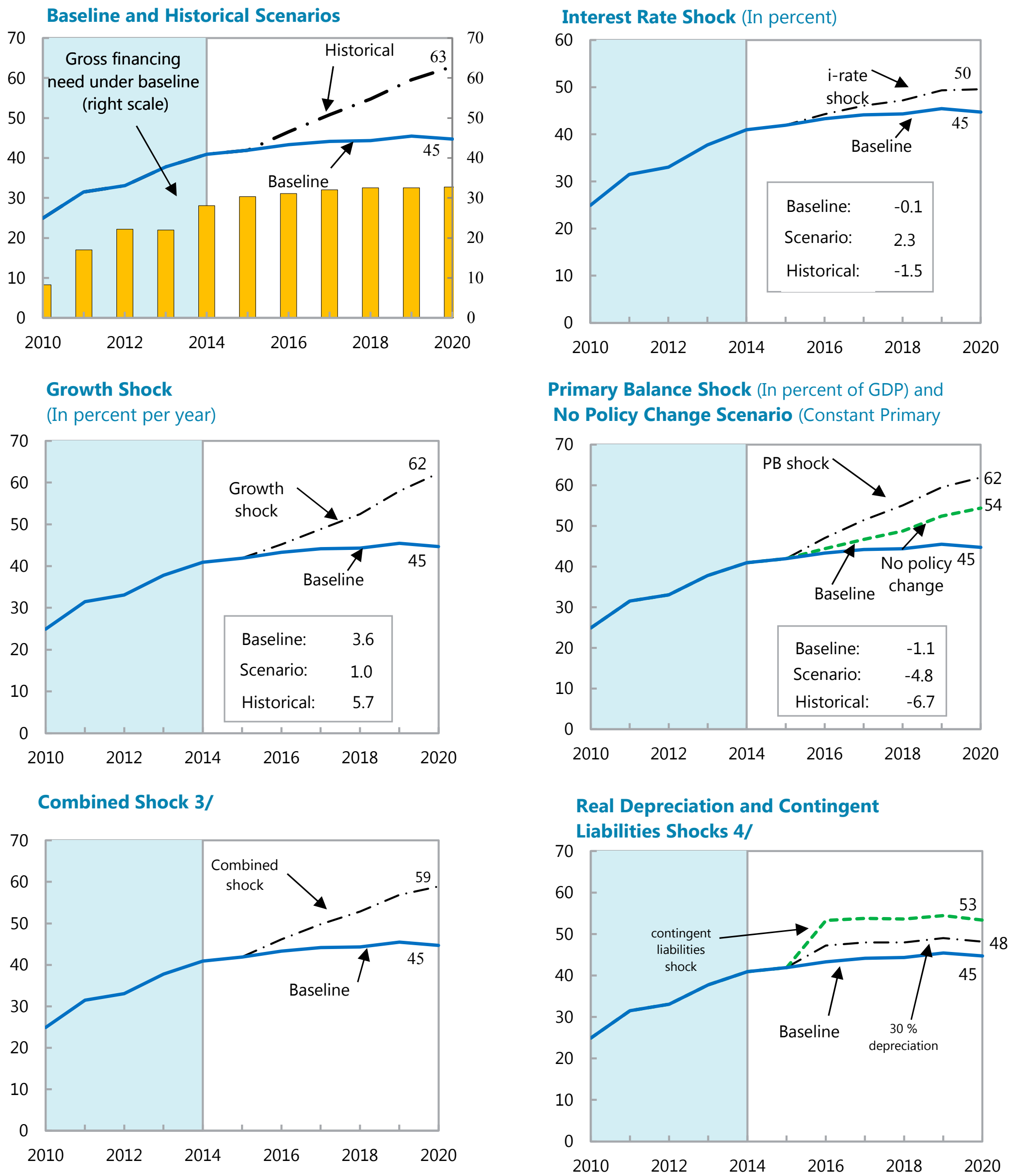
Annex III. Update of Debt Sustainability Analysis (DSA)

This DSA updates the DSA of May 2015. Since then staff assumed more sanguine view on the pace of fiscal consolidation in the medium-term to reflect continuing difficulties of the PA to contain current spending, including wages. A financing gap was raised from 1.6 percent of GDP on average over 2015–20 to about 3 percent, while macroeconomic projections of growth, prices and exchange rate changed only marginally.

The results of the DSA demonstrate that the risks to debt sustainability have increased. Public debt under the baseline scenario is on a rising path through 2019, stabilizing only at the end of the projected period.[1] At its peak, public debt is projected to reach 45 percent, up almost 5 percentage points of GDP from 2014. An interest rate shock could add 5 percentage points of GDP to the debt level at the end of the projected period, with public debt rising to 50 percent of GDP in 2020. The increase could be even more dramatic, with public debt rising to almost 60 percent of GDP or more and public debt becoming unsustainable, in case of shocks to growth, primary balance, or a combined shock. A one-time contingent liabilities shock equivalent to 10 percent of GDP (e.g., in case of non-payment to utilities) would elevate the level of debt immediately by about ten percentage points. A similar effect would occur with a fall in donor aid.

[1] Public debt refers to debt of the PA, including estimated arrears.

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 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table A1. West Bank and Gaza: Public Sector Debt Sustainability Framework, 2010–20

(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Debt-stabilizing primary balance 9/
1	**Baseline: Public sector debt 1/**	24.9	31.5	33.1	37.8	40.9	**41.9**	**43.3**	**44.1**	**44.3**	**45.5**	**44.7**	**-1.6**
	Of which: foreign-currency denominated	11.2	11.4	9.5	8.6	9.3	8.8	8.3	7.8	7.3	6.9	6.6	
2	Change in public sector debt	1.8	6.6	1.6	4.7	3.2	1.0	1.4	0.8	0.2	1.1	-0.8	
3	Identified debt-creating flows (4+7+12)	0.2	3.1	2.0	1.3	1.6	1.3	0.6	0.1	-0.5	-0.9	-1.4	
4	Primary deficit	2.0	5.7	6.4	1.5	2.2	3.2	2.1	1.6	1.2	0.5	0.2	
5	Revenue and grants	35.5	29.0	26.7	29.6	31.2	30.3	32.8	32.8	29.8	30.2	30.2	
6	Primary (noninterest) expenditure	37.5	34.8	33.2	31.0	33.4	33.5	34.9	34.4	31.1	30.7	30.4	
7	Automatic debt dynamics 2/	-1.8	-2.6	-4.4	-0.2	-0.6	-1.8	-1.5	-1.6	-1.7	-1.4	-1.6	
8	Contribution from interest rate/growth differential 3/	-3.0	-2.1	-4.0	-0.9	-0.1	-1.8	-1.5	-1.6	-1.7	-1.4	-1.6	
9	Of which: contribution from real interest rate	-1.4	0.6	-2.3	-0.2	-0.2	-0.7	0.0	-0.1	-0.2	0.0	-0.2	
10	Of which: contribution from real GDP growth	-1.6	-2.8	-1.7	-0.7	0.1	-1.1	-1.5	-1.5	-1.5	-1.4	-1.4	
11	Contribution from exchange rate depreciation 4/	1.2	-0.5	-0.4	0.7	-0.5	...	...	...	...	...	...	
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/	1.6	3.4	-0.5	3.5	1.5	-0.4	0.8	0.8	0.7	2.0	0.7	
	Public sector debt-to-revenue ratio 1/	70.2	108.4	123.7	127.7	131.3	138.3	132.0	134.5	148.6	150.5	148.0	
	Gross financing need 6/	8.3	17.0	22.2	22.0	28.1	30.3	31.1	32.1	32.6	32.6	32.7	
	in billions of U.S. dollars	0.7	1.7	2.7	2.6	3.5	4.1	4.4	4.8	5.2	5.5	5.8	
	Scenario with key variables at their historical averages 7/						**41.9**	**46.5**	**50.8**	**54.7**	**59.6**	**62.9**	**-4.2**
	Scenario with no policy change (constant primary balance) in 2015-2020						**41.9**	**44.4**	**46.7**	**48.7**	**52.3**	**54.4**	**-1.9**
	Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
	Real GDP growth (in percent)	8.1	12.4	6.3	2.2	-0.4	2.9	3.9	3.7	3.7	3.4	3.2	
	Average nominal interest rate on public debt (in percent) 8/	1.8	2.9	1.4	0.7	1.5	1.3	2.2	2.2	2.2	2.3	2.3	
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-6.5	2.8	-7.7	-0.6	-0.6	-1.7	0.2	-0.1	-0.4	0.2	-0.4	
	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)	8.3	0.0	9.2	1.3	2.1	3.0	2.0	2.2	2.6	2.1	2.7	
	Growth of real primary spending (deflated by GDP deflator, in percent)	-18.7	4.1	1.3	-4.3	7.3	3.1	8.3	2.3	-6.5	2.2	2.0	
	Primary deficit	2.0	5.7	6.4	1.5	2.2	3.2	2.1	1.6	1.2	0.5	0.2	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Annex IV. Global Fiscal Adjustment: Some Lessons for the West Bank and Gaza

In recent years, the IMF has recommended medium-term fiscal adjustment in the WBG to stem accumulation of arrears, reduce aid dependence, and ensure public debt sustainability. Staff estimates that the required adjustment amounts to at least 4 percent of GDP. While significant, an adjustment of this magnitude is not uncommon. This annex summarizes lessons for the WBG that could be drawn from fiscal adjustment in other regions.

Fiscal adjustment, especially when large, is never an easy choice for a government. Regardless of whether the adjustment is revenue- or expenditure-based, there are losers in society, as some are bound to pay higher taxes while others see government subsidies decline and free services diminish. Because of this, fiscal reforms are politically difficult, and often implemented in dire economic circumstances. Typically, these occur when the economy is overheating and inflation picks up or when debt sustainability is compromised because of excessive deficits or financing constraints. Despite the challenges, many economically diverse countries enjoyed success with large fiscal adjustments of more than 5 percentage points of GDP over a span of two years.[1]

In the WBG, significant fiscal consolidation is needed. Its fiscal sustainability is at risk, it relies on fickle donor aid, and it has no market access. Residual fiscal financing gaps have typically been financed by accumulation of arrears and borrowing from commercial banks. Staff projects that, assuming unchanged donor aid and unchanged policies, the WBG could face a financing gap of about 4 percent of GDP over the next several years. Moreover, there are significant downside risks that could increase the projected financing gap by about 2 percentage points of GDP, including from demographic factors such as age pensions, which are not fully accounted for.[2] In addition, public debt has significantly increased, arrears have been creeping up, and debt sustainability is at risk. Hence, a fiscal adjustment of 4 percent of GDP or more is needed to prevent the accumulation of new arrears and the further erosion of private sector confidence.

In the current political and economic environment, the WBG will likely be more successful at gradual, rather than front-loaded, adjustment. Some front-loading, however, would be beneficial to avoid reform fatigue, a common pitfall, and to forestall the accumulation of arrears to the private sector. International experience suggests that both gradual and upfront adjustments could be successful, and that political and demand conditions dictate the speed of adjustment. A newly elected government with a strong public mandate would more likely resort to front-loaded adjustment, since gradual adjustments are more difficult to sustain politically. For instance, in the majority of cases (eight out of 12 cases) of large fiscal adjustments studied by Tsibouris and others where the countries faced financing constraints and had new political leadership, adjustment programs were front-loaded. In the WBG, however, weak demand conditions in an economy

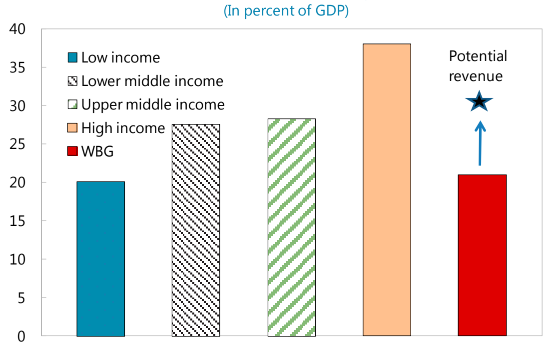
[1] See, for example, Tsibouris and others (2006) for case studies.

[2] The World Bank is currently conducting a study of the pension system in the WBG.

suffering from political uncertainty and Israeli restrictions, combined with lack of political unity, suggest a gradual approach to fiscal consolidation. To sustain the consolidation, however, given the significant share of aid in budget financing, continuous donor support will be required. Success will also critically depend on the support of Israel in providing steady transfers of clearance revenue and removing restrictions to allow more private sector activity.

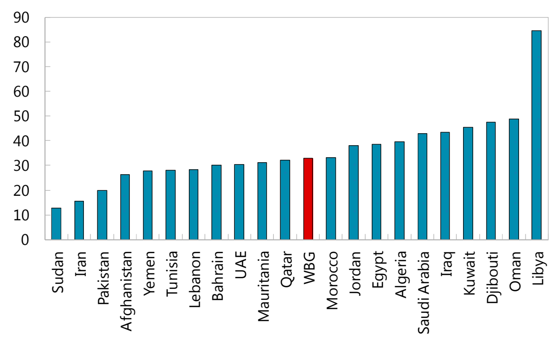
Increasing revenue will play an important role in the WBG's fiscal consolidation. The choice between revenue- and expenditure-based fiscal consolidation is typically country specific.[3] Expenditure-based consolidation is preferred in countries where the size of the public sector is excessive. This has been the case in many OECD economies. Revenue-based consolidations have been more prevalent in emerging and developing economies with low revenue-to-GDP ratios. Revenue measures are also easier to implement compared to expenditure measures, especially if they are perceived as improving fairness, and if taxpayers perceive an improvement in the quality of public services. The WBG has significant potential to raise revenue by expanding the tax base, improving compliance, and raising nontax revenue (see Report to the AHLC, May 2015), and to improve fairness by making the tax system less regressive.[4] Moreover, total expenditure in the WBG does not appear excessive compared to other countries in the Middle East and North Africa region.

Government Revenue Excluding Grants, 2013
(In percent of GDP)



Source: IMF staff estimates.

Public Expenditure, 2014
(In percent of GDP)



Source: IMF staff estimates.

At the same time, expenditure measures can be implemented more quickly, and are necessary to address short-run financing constraints. The WBG and other countries have demonstrated that revenue measures often require improvements in tax administration that take time to implement, while clamping down on tax exemptions draws resistance from vested interests. This stymies reform, prompting expenditure cuts—often to investment—to address immediate fiscal concerns. For instance, in all cases of large revenue-based fiscal consolidation studied by Tsibouris and others (Brazil 1999–2003, Cote d'Ivoire 1993–2000, Jamaica 1998–2001, Nigeria 1990–2000, Russia 1999–2002, Zambia 1989–94) some type of expenditure measures were implemented to support fiscal adjustment. In Brazil, in particular, the annual practice was to curtail

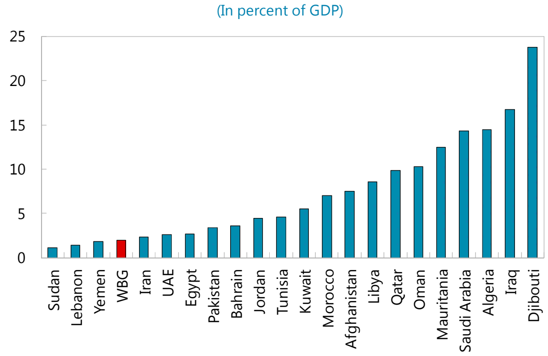
[3] The distinction between the two types of consolidations is made for expositional purposes; in practice, a combination of the two types of measures is used.

[4] See Jewell and others (2015) for a discussion of fair taxation in MENA.

expenditure during the first part of the year, until revenue performance was ascertained. It is important, however, to avoid across-the-board cuts in order to ensure continuous delivery of public services at acceptable levels and thereby ensure public support for reforms.

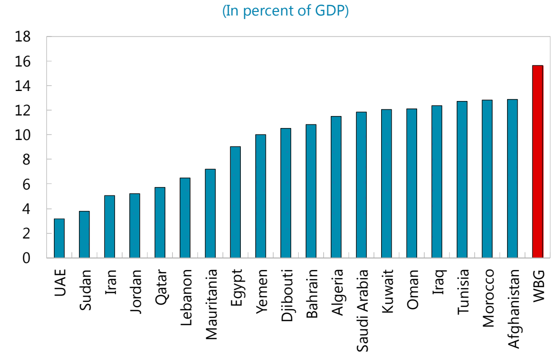
In the WBG, the expenditure effort should focus on rationalizing the wage bill and transfers while strengthening the social safety net. Expenditure measures that are undertaken should be growth-friendly.[5] Although in the short-run expenditure consolidation may lower aggregate demand and thereby negatively affect growth, in the longer term this effect dissipates if the contractionary impact of lower public spending is mitigated by an expansionary private sector response. This response is more pronounced when cuts affect wages and transfers, and productive public investment spending is preserved or even increased (if there is fiscal space).[6] Moreover, cutting wages and transfers delivers sustainable nonreversible adjustment, unlike some low-quality measures which have only a transitory effect.[7] For instance, in all cases of large fiscal consolidation in Tsibouris and others, a combination of measures to contain wages, untargeted subsidies, or excessive social transfers was applied. In some cases, public investment were also reduced or reoriented towards social sectors, such as health and education (Cote d'Ivoire and South Africa). In the WBG, the level of public investment spending is small, compared to other MENA countries, while expenditure on wages is the highest in the region.

Capital Expenditure, 2014
(In percent of GDP)



Source: IMF staff estimates.

Wage Expenditure, 2014
(In percent of GDP)



Source: IMF staff estimates.

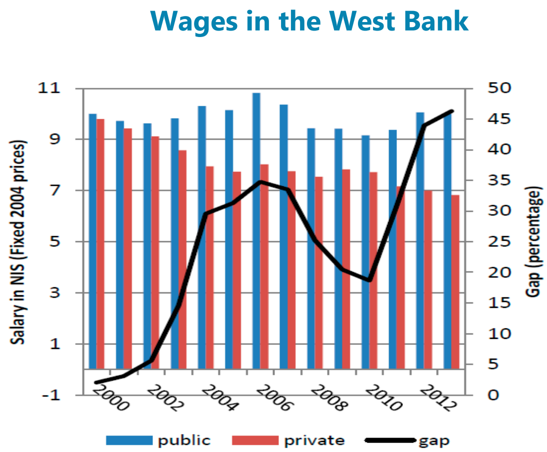
Furthermore, a recent study by the World Bank found that public sector wages in the WBG are significantly higher than private sector wages, and that the gap between public and private sector wages has been increasing over time, hurting competitiveness.[8]

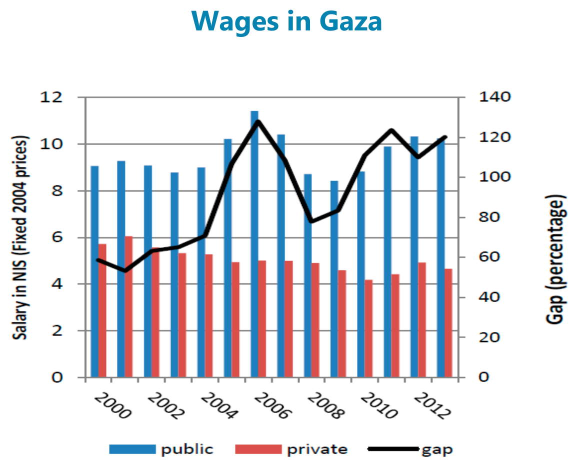
[5] See, for example, IMF (2015) and Kumar and others (2007).

[6] Staff finds that fiscal multipliers for public investment spending are higher than those for wages and transfers (see Cerisola and others, 2015).

[7] Examples of lower-quality measures include deferral of payments, savings on essential operations such as maintenance, sudden cuts in public investment, etc. These measures would ultimately lead to arrears, stalled projects, or lower long-term investment and growth.

[8] See "Causes behind the Palestinian Authority's Large Wage Bill and the Road to Its Sustainability" (forthcoming, World Bank).





Source: World Bank estimates.

There is also room to reduce untargeted subsidies on fuel which amounted to about 1 percent of GDP in 2014, and to limit increases in age-related spending (for instance, by raising the retirement age).[9]

Fiscal reforms should be accompanied by wider structural reforms. To ensure sustainability, wage restraint should be accompanied by broader civil service reforms that raise productivity and link remuneration to performance. In Nigeria, wage increases without supporting civil service reform led to a reversal of fiscal consolidation achieved over 1990–2000 in follow-up years. Little progress on civil service reform was also among reasons for a similar reversal of reforms from 1989–94 in Zambia. As noted above, it is also important to prompt a strong, positive private sector response to fiscal consolidation in order to ensure success. This could be achieved not only by improving the fairness of the tax system and investing in infrastructure, but also by enhancing the business climate through improvements to the regulatory and institutional infrastructure. Promoting a business-friendly environment should be part of a complementary structural reform strategy. Countries, that underwent large fiscal adjustments, had to tackle labor (Canada, Finland, New Zealand, South Africa) and product (New Zealand, Zambia) market rigidities, trade restrictions (Brazil, Zambia), distortions in the energy sector (Russia), privatization of state-own enterprises (Russia, Brazil), inefficient tax system (Brazil, Cote d'Ivoire).

Successful implementation of a fiscal consolidation strategy is associated with sound PFM. Strong budget institutions are needed to understand the scale and scope of fiscal issues. This entails efforts to improve the quality of fiscal reporting, to build capacity for medium-term projections, and to deepen the analysis of long-term issues (such as an aging population). Fiscal consolidation requires the development of a medium-term fiscal framework that can provide guidance for annual budget allocations based on transparent fiscal objectives such as the reduction of the deficit or ensuring debt sustainability. Improvements in budget planning and execution, combined with

[9] See *Public Expenditure Review for the West Bank and Gaza* (forthcoming, World Bank).

transparency in the use of public resources, can boost trust in the government and make reform—especially if it involves an increase in effective tax levels—more acceptable to the public. Experience from other countries shows that the establishment of a strong macro-fiscal unit embedded in the ministry of finance can be an effective way of tackling the aforementioned challenges. In Tsibouris and others, in six out of 13 study cases large fiscal consolidations were accompanied by a transition to medium-term budget frameworks supplemented in some cases by strengthened legal frameworks for developing, implementing and monitoring annual budgets, and improved expenditure planning, accounting and reporting, and oversight.

Timing of reform matters. A supportive external environment often presents a good opportunity to launch reforms. For example, in Russia in the late 1990s, favorable oil price developments contributed to better revenue reform outcomes and mitigated negative effects of expenditure consolidation on growth. In the WBG now, strong export demand from trading partners (Israel and the EU for the WBG) and declining oil prices should help mitigate the negative effects on output of fiscal contraction; low fuel prices should also help oil-importers, such as the WBG, to lower fuel subsidies with minimal impact on consumers. At the same time, a challenging domestic environment should, in and of itself, push reforms forward. In the WBG, the detrimental effect of public sector arrears on the economy, and the impact of the ongoing fiscal crisis on the quality of public infrastructure and services, should be sufficient to motivate fiscal reforms.

A fiscal consolidation strategy needs to include a public communication strategy. Successful implementation of fiscal reforms requires public support. Governments successful at implementing fiscal consolidation design and implement a public communication strategy to educate the broader public about the conduct of the reforms and their goals. Messages emphasize how reforms are advancing equity by creating fiscal space for well-targeted social spending and growth-enhancing infrastructure, and leveling the playing field for businesses. Adequate attention is also given to safeguarding social safety nets and improving their targeting. A review of subsidy reform experiences by the Fund, for example, found that the likelihood of success almost tripled with strong public support and proactive public communications.[10]

External partners can play a key role in bringing about fiscal reform. Bilateral donors and international organizations—including the IMF—can serve as advisors and honest brokers to explain the pros and cons of reforms to the public, add credibility, and provide technical assistance to facilitate design and implementation. Notably, in nine out of 13 cases of large fiscal consolidation in Tsibouris and others, the countries have active programs with the IMF.

[10] See IMF (2011).

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Annex V. West Bank and Gaza—Technical Assistance by the IMF to the Palestinian Authority, 2011–15

The TA support has been in the areas of public financial management, revenue administration, banking supervision, and national accounts. There was also support to the recently established macro-fiscal unit within the MoF. The priorities over the medium term remain on public financial management, revenue administration, and banking supervision. There is need for intermittent review and assistance to enhance the statistical capacity especially in GFSM 2001, external sector, and national accounts expenditures side. It is expected that FAD and MCM will continue in providing TA, dependent on the authorities' commitment and progress, supported by METAC.[1]

Mission Date	**Mission**	**Date of TA Report**
Fiscal Sector: Since 2007, numerous reform components of a modern public financial management system have been put in place and steadily upgraded. Significant progress in PFM was made in drafting legal frameworks, adopting Single Treasury Account (STA), establishing debt management and cash planning units, modernization of budget classification and Chart of Accounts, developing computerized financial management information system (FMIS), strengthening accounting and reporting, activating internal audit departments in ministries, establishing an independent external audit agency, and establishing a macro-fiscal unit. A medium-term plan of reforms had been agreed upon in 2011 and further updated in 2012. Currently, the key objective is to consolidate the institutionalization of progress already made. Further to consolidation, approval of legislative and regulatory frameworks, review of implementation of commitment control and STA, cash planning, arrears recording and formulation of strategies for minimizing arrears, and compliance with GFSM 2001 standards need to be addressed. Since 2010, the TA efforts expanded into mobilizing revenue compliance by modernizing tax administration. A medium-term work program, recommended by FAD, will strengthen particularly the administration of income tax and VAT for the large and medium taxpayer segments and reform the income tax and reduce tax incentives and exemptions. So far, a computerized revenue management system has been launched, a tax procedures code was approved by the Cabinet but not enacted, and the LTU, under a newly appointed director, has begun more effective work. In the medium term, FAD TA priorities will remain the improvement of public financial management and modernization of revenue administration.		
Mar. 19–30, 2011	Palestinian Authority Integrated Tax Administration System	Mar. 2011
Jul. 3–7, 2011	Self-Assessment Preparations and Progress with its Introduction in LTU	n.a.
Sep. 14–27, 2011	Tax Audits Procedures	Oct. 2011
Sep. 28–Oct. 30, 2011	Improving Compliance with Income Tax	Dec. 2011
Dec. 1–12, 2011	Public Financial Management Progress Review	Jan. 2012
Feb. 1–14, 2012	Tax Administration	n.a.
Apr. 15–22, 2012	Tax Revenues Clearance Procedures	May 2012

Jun. 13–26, 2012	Improving Income Tax and Tax Incentives Proposed Tax Policy TTF	Jul. 2012
Jan. 22–31, 2013	Public Financial Management Progress Review	Jan. 2013
Jun. 25–Jul. 8, 2013	Supplementary Technical Review: Investment Tax Incentives and Tax Expenditure Costs	Jul. 2013
Nov. 24–Dec. 5, 2013	Strengthening LTO Operations	Dec. 2013
Jan. 8–21, 2014	Public Financial Management Reform Agenda 2014–16	Mar. 2014
Nov. 9–20, 2014	Strengthening Large Taxpayer Unit	Nov. 2014
Nov. 23–Dec. 1, 2014	Public Financial Management Progress Review	Dec 2014
Mar. 8–19, 2015	Compliance Modeling in LTU and Tax Departments	Mar. 2015
Aug. 16–27, 2015	Revenue Administration	n.a.
Aug. 23–28, 2015	Work Program for Macro-Fiscal Advisor	n.a.
Monetary and Financial Systems: The TA efforts have been to support the Palestine Monetary Authority (PMA) in becoming a competent monetary authority to operate a high-quality reserves management system, to supervise and regulate banks, to gain capacity in introducing government securities, and to prepare for eventual introduction of an independent currency for the WBGWBG economy when conditions are right. The PMA established a credit registry, instituted periodic stress testing of banks, introduced a deposit insurance scheme, and prepared plans for contingency crises management. The PMA has developed substantial capacity as a central bank toward the possibility of issuance of a national currency.		
Dec. 3–8, 2011	Support to the Palestine Monetary Authority Credit Registry	Dec. 2011
Dec. 8–15, 2011	Enhancing the Capacities of the Palestine Monetary Authority and Options for the Issuance of New Currency and the Monetary Policy Regime *	Mar. 2012
Jan. 15–26, 2012	Developing a Government Securities Market	n.a.
Feb. 5–9, 2012	Reserve Management Policy and Investment Guidelines *	Apr. 2012
Mar. 25–Apr. 3, 2012	Risk-Based Banking Supervision *	Apr. 2012
Oct. 9–18, 2012	Implementing Risk-Based Supervision	Oct. 2012
Oct. 31–Nov. 15, 2012	Strengthening the Stress Testing Framework, Consolidated and Cross Border Supervision and Contingency Crisis Management Framework	Nov. 2012
Dec. 8–12, 2012	Developing the Government Securities Market	Dec. 2012
Jan. 13–17, 2013	Reserve Management Policy and Investment Guidelines	Jan. 2013

Mar. 31–Apr. 11, 2013	Follow up on Risk Based Supervision Manual	n.a.
Jun. 30–Jul. 10, 2013	Follow up on Risk-Based Supervision	July 2013
Nov. 3–14, 2013	Implementing Risk Based Supervision*	Nov. 2013
Nov. 16–26, 2013	Credit Registry	Nov. 2013
May 25–29, 2014	Follow up on Risk Based Supervision Manual	June 2014
Oct. 26–Nov. 6, 2014	Follow up on Risk Based Supervision Manual	n.a.
Jan. 18–29, 2015	Follow up on Risk Based Supervision Manual	n.a.
Mar. 8–19, 2015	Contingency Planning and Crises Preparedness*	May 2015
April 5–16, 2015	Follow up on Risk Based Supervision Manual*	April 2015
April 13–17,2015	Risk Assessment and Stress Testing*	May 2015
Statistics: The TA efforts have been to implement and align existing statistical compilation and dissemination systems with the latest international statistical standards across three major datasets [government finance statistics (GFS), national accounts (NA), and external sector statistics (ESS)] for economic policy analysis. These efforts culminated with WBG joining the IMF's Special Data Dissemination Standard (SDDS) as a subscriber in April 2012. Further work is needed in improving data consistency in ESS, developing an inter-institutional strategic plan for GFSM2001 implementation, and developing of a set of high-frequency indicators to detect economic trends and risks. In general, the transparency and timeliness of the data produced by the Palestinian Central Bureau of Statistics, Ministry of Finance, and the PMA compare favorably with countries that maintain good data management and dissemination standards.		
Oct. 16–27, 2011	Report on the SDDS Assessment Mission	Oct. 2011
Nov. 27–Dec. 1, 2011	Balance of Payments Statistics – IIP	n.a.
Jan. 27–31, 2013	Balance of Payments Statistics – IIP	n.a.
May 18–29, 2014	National Accounts	June 2014
May 21–June 3, 2014	Monetary and Financial Statistics	n.a.
Dec. 7–18, 2014	Price Index	Dec. 2014
Feb. 1–12, 2015	External Sector Statistics	April 2015
Feb. 22–26, 2015	National Accounts	Mar. 2015

[1] METAC – Middle East Regional Technical Assistance Center.
n.a. – not applicable.
* The reports are classified confidential.