



**MACROECONOMIC AND FISCAL FRAMEWORK
FOR THE WEST BANK AND GAZA:
THIRD REVIEW OF PROGRESS¹**

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EXECUTIVE SUMMARY

The economic and political situation in 2008 and early 2009 has been far bleaker than hoped for in the Palestinian Reform and Development Plan (PRDP). In the West Bank, Israeli restrictions on movement and access were tightened compared to 2007 based on security concerns, and settlements have expanded. Gaza's economic and humanitarian situation has deteriorated markedly due to the war and its increased isolation. The restrictions on cash entry into Gaza has reduced depositor confidence in Gaza banks, and further reduced people's ability to cover their basic needs. The surge in inflation, while subsiding later in 2008, further eroded household incomes and raised production costs. The adverse growth impact of these factors has to some extent been tempered by improved security conditions in West Bank cities, as well as higher-than-expected donor budgetary assistance.

Despite the difficult conditions on the ground, the Palestinian Authority (PA) has continued with institution-building and prudent fiscal policies and reforms. A strict government employment policy was followed, wage rates have been virtually frozen, and measures have been implemented to improve utility bills payment. The Public Finance Management System has been strengthened further, which is helping prioritize and raise the quality of spending. Expenditure increases have been below the inflation rate, implying a retrenchment in real terms. The draft 2009 budget envisages further reforms and deficit reduction, with a significant shift in the composition of spending away from wages and subsidies, and toward public investment. A supplementary budget is being prepared to include spending for Gaza's reconstruction and rehabilitation to address the war's impact.

There is a pressing need to secure adequate external assistance to finance the budget deficit for 2009. A lower budget deficit, combined with the front-loading of arrears repayment in 2008, will result in a substantial reduction in external recurrent financing requirements to \$1.2 billion in 2009, compared to \$1.8 billion in 2008. This will make it easier for donors to accommodate the increase in public investment, which is projected at \$0.5 billion in 2009, in addition to \$0.6 billion to address Gaza's war-related reconstruction. The latter is a preliminary estimate, and the actual expenditure required may be much higher.

Close cooperation among all three parties, the PA, the Government of Israel, and donors, remains critical for the success of reforms and the recovery of Palestinian living standards. A collaborative approach has become all the more important given the setback to the peace process, the major increase in Gaza's reconstruction needs, as well as the deepening global recession. Perseverance by the PA in the PRDP's implementation is essential to bolster business confidence and fiscal sustainability. However, there is a risk that its efforts will be hampered by social and political pressures, especially if Gaza's reconstruction is delayed, and incomes and employment opportunities remain constrained. These risks would be substantially reduced by a breakthrough in the peace process, easing of Israeli restrictions in the West Bank and of the blockade on Gaza, including on the entry of urgently needed reconstruction inputs and cash, as well as the timely disbursement of adequate donor assistance.

I. RECENT ECONOMIC DEVELOPMENTS

1. **Even before the onset of the war in Gaza in late December 2008, the macroeconomic environment in the West Bank and Gaza (WBG) had been more difficult than expected in the Palestinian Reform and Development Plan (PRDP).** Restrictions in the West Bank were tightened during 2008, while Gaza's isolation increased.² Moreover, inflation was much higher than anticipated, further eroding real wealth and incomes. Nevertheless, in the West Bank the adverse impact of the above factors on private sector confidence and growth has been tempered by the redeployment of security forces in several cities, as well as a prudent expenditure policy that minimized new arrears accumulation. Moreover, higher-than-envisaged donor budget support enabled the settlement of past wage and private sector arrears. Overall, real GDP growth in 2008 in the WBG is estimated at about 2 percent, or a decline of more than 1 percent in real per capita terms. The global financial crisis has thus far not had a significant impact on the Palestinian economy (Box 1).

2. **Unemployment and poverty has been high, with a marked deterioration in Gaza.** The 2008 unemployment rate is estimated at an average of about 40 percent in Gaza and 19 percent in the West Bank, up from an average of 30 percent and 18 percent (respectively) in 2007. The sharp rise in unemployment in Gaza reflects the tighter blockade compared to 2007. Poverty levels, based on data from a 2007 household survey, are estimated to be much higher in Gaza than in the West Bank, with 80 percent of households in Gaza living below the poverty line compared to 45 percent in the West Bank.³ While data on poverty levels in 2008 are not yet available, Gaza's humanitarian situation has worsened, especially during the last quarter of 2008 with more severe restrictions on the entry of essential items,

including cash. Cash shortages in Gaza have prevented banks from accommodating local customer cash demands, including to cover government wages and aid transfers (Box 2). The resulting cash shortage has made it even more difficult for poor households to cover their basic needs. Several economic indicators suggest that economic conditions have deteriorated markedly in Gaza, including in relation to the West Bank (Box 3).

3. **The impact of restrictions on real incomes was compounded by the rise in inflation to about 7 percent in the year to December 2008 (from around 1 percent in mid-2007),** despite a decline from the peak of about 12S percent in July. The rise was much more pronounced in Gaza (10 percent) than in the West Bank (4S percent) and East Jerusalem (6S percent), given the blockade on Gaza. Changes in inflation during the year reflected world prices of food and petroleum products. The impact of the rise in food prices on inflation was much higher than in Israel, reflecting its higher weight in the WBG's consumption basket. Given the importance of dollar-denominated sources of income such as part of remittances and donor assistance, the impact of inflation on real incomes was worsened by the appreciation of the average shekel exchange rate vis-a-vis the dollar by 15 percent in 2008.

4. **While domestic banks have not been significantly affected by the global financial crisis, the growth of deposits and private credit remains constrained by the subdued economic activity.** Private deposits contracted by about 6 percent in real terms in the year to September 2008. Reflecting banks' conservative lending practices and limited investment demand, most deposits continue to be placed abroad, with private sector credit (as a share of private sector deposits) falling to 25 percent by September 2008 (compared with 39 percent at end-2006 and 30 percent at end-2007).⁴ Risks to the balance sheets of some banks persist, due in particular to Gaza's isolation and the deterioration of security conditions there. These risks have increased in recent months following tight restrictions on the entry of cash into Gaza. Banks' profitability is also bound to be affected by the severance by Israeli banks of correspondent relations with Gaza banks in January 2009, and their threat to discontinue their relations with banks operating in the West Bank as well (Box 4).

5. **The Palestine Monetary Authority (PMA) has continued institutional reforms.** These reforms, which have been supported by IMF technical assistance, aim at transforming the PMA's organization and operations with the medium-term objective of becoming a full-fledged central bank.⁵ The PMA has made considerable progress during 2008 in internal reform and capacity building, including in strengthening the supervisory framework and governance. A macroprudential division was created, and progress was made in establishing an early warning system. A new credit registry is allowing banks to better evaluate risks, reduce collateral requirements, and improve credit flow. The financial legal framework has also been strengthened. An Anti Money Laundering Law has been in force since 2007, and a new Banking Law and a new Central Bank Law are expected to be enacted in 2009.

II. FISCAL DEVELOPMENTS IN 2008

6. **The Palestinian Authority (PA) continued with fiscal consolidation in 2008.** The recurrent fiscal deficit on a commitment basis is estimated to have declined to 19 percent of GDP in 2008 from 24 percent of GDP in 2007, reflecting largely expenditure restraint on the wage bill and reduced utility subsidies. The deficit has been lower than envisaged in the 2008 budget on a commitment basis, but somewhat higher on a cash basis due to the front-loading of arrears repayment. Developments in the main budgetary components can be summarized as follows:

- Total "regular" net revenues (excluding dividend payments and other one-off items) grew by about 6 percent in 2008, broadly in line with the budget. Nontax revenues in 2008 included several revenue items not foreseen in the budget, notably: (i) a license fee payment from Wataniah Telecommunications Company of \$80 million; and (ii) a cash dividend payment from the Palestinian Investment Fund (PIF) of \$25 million. A special dividend payment of \$197 million from the PIF was also recorded, which was entirely used to settle part of the PA's debt to the PIF.⁶ At the same time, the PA has repaid about \$30 million in net domestic bank financing, significantly less than budgeted.
- On a commitment basis, the 2008 wage bill decreased by 1 percent in nominal terms, or by 11 percent in real terms, given strict controls on the general wage rate and new employment. A total of about 3,000 new employees were recruited mainly in the health and education areas, and about 4,000 security personnel retired early as part of efforts to streamline the security forces. Cash wage expenditures were about 3 percent higher than in 2007 in real terms, reflecting the clearance of all wage arrears in 2008. While the PRDP envisaged the repayment of about NIS 1 billion in arrears owed to public sector employees in a phased manner during 2008–10, the PA fully repaid these arrears in 2008. This helped cushion the impact of the higher-than-expected inflation on the real incomes of PA employees.
- Nonwage expenditure commitments were only about 1 percent higher than budgeted, taking into account the higher cost of goods and services and unforeseen pension payments to security personnel. In addition, the PA repaid about NIS 250 million in arrears to the private sector.
- Net lending (including payments by the central government for utility bills due by consumers, and tax rebates or losses related to the marketing of petroleum products) was 17 percent higher than the budgeted amount, largely reflecting the higher-than-envisaged fuel prices. Nevertheless, it fell by 27 percent from its 2007 level, reflecting implementation of measures to raise utility bill collection rates, notably (i) the requirement of "certificates of utility bill payment" for users of government services; (ii) incentives for municipalities to ensure that consumers' utility payments are passed on to the electricity companies, in addition to a close monitoring of municipalities' bank accounts; and (iii) installation of prepaid meters in West Bank refugee camps.⁷

7. **The Palestine Authority (PA) continues to strengthen the Public Finance Management System.** A General Accounting Department (GAD) was established at the Ministry of Finance (MoF), and a new Computerized Accounting System (CAS) has been developed to link the MoF to line ministries, with better integration of the recurrent and development budgets. That system has significantly improved the quality of budget execution and reporting by the MoF. The MoF's action plan for 2009 includes (i) ensuring that all line ministries are linked to the CAS, (ii) setting up a cash and debt management unit in the GAD with a view to further prioritizing spending and minimizing arrears accumulation, and (iii) presenting the 2010 budget with a revised economic classification in line with international standards.

III. MACROECONOMIC AND FISCAL OUTLOOK

8. **Notwithstanding the war and crisis in Gaza, the world community's hope is that all three parties (the PA, the Government of Israel, and donors) will do their utmost to fulfill their commitment to sustainable growth and development in the Palestinian territories** as envisaged at the 2007 Annapolis and Paris Conferences. Progress hitherto made by each side can be summarized as follows:

Fiscal Indicators for 2007-08
(In millions of NIS, unless otherwise indicated)

| | 2007 | 2008 | |
|---|--------|--------|--------|
| | | Budget | Est. |
| Total net revenues 1/ | 5,214 | 5,277 | 5,624 |
| Gross domestic revenues | 1,646 | 1,507 | 2,016 |
| Gross clearance revenues | 3,673 | 3,842 | 4,025 |
| Tax refunds | 105 | 72 | 417 |
| Total recurrent expenditures (commitment) | 10,302 | 9,995 | 10,138 |
| Total recurrent expenditures (cash) | 10,398 | 10,776 | 11,526 |
| Of which: repayment of wage and nonwage arrears | 96 | 781 | 1,388 |
| Recurrent balance (commitment basis, before external budgetary support) | -5,088 | -4,718 | -4,514 |
| Recurrent balance (cash basis, before external budgetary support) | -3,454 | -5,499 | -5,850 |
| Development projects | 537 | 1,949 | 900 |
| Overall balance (cash basis, including capital expenditures) | -3,991 | -7,447 | -6,749 |
| Financing | 3,991 | 7,447 | 6,749 |
| External budgetary support required | 4,687 | 7,652 | 6,880 |
| Domestic financing | -223 | -180 | -106 |
| Net external debt | -473 | -25 | -25 |
| Memorandum items: | | | |
| GDP | 21,387 | 21,918 | 23,260 |
| External budgetary support required (in millions of U.S. dollars) | 1,140 | 2,126 | 1,917 |
| Recurrent balance (commitment basis), percent of GDP | -23.8 | -21.5 | -19.4 |
| Recurrent balance (cash basis), percent of GDP | -16.1 | -25.1 | -25.1 |

Sources: Ministry of Finance, and IMF staff estimates.

1/ To facilitate comparison between years, nontax revenues in 2008 do not include NIS 653 million received as dividends from the Palestinian Investment Fund (PIF), which was then fully used to settle part of the Palestinian Authority's debt to the PIF.

- During 2008, the PA made substantial progress in establishing security in several Palestinian cities in the West Bank by deploying police and security forces. This brought about a large measure of stability and business confidence. As noted above, the PA continued with fiscal consolidation, underpinned mainly by a strict government employment policy and a virtual wage rate freeze, as well as measures to reestablish payment discipline for utilities. The sharp rise in inflation, not envisaged in the 2008 budget, contributed to higher-than-expected net lending and a faster pace of arrears repayment. Nevertheless, the PA's adherence to the budget's ceiling for expenditure commitments led to a significant retrenchment in real terms.
- The PRDP envisaged a gradual relaxation of the Government of Israel (GoI) 's restrictions on movement and access during 2008, to enable a recovery of trade and private investment, and an acceleration in public investment. The restrictions in the West Bank have overall been tightened compared to 2007, despite some relaxation in late 2008, while Gaza's isolation has increased markedly since November 2008. Even after the cessation of hostilities in mid-January 2009, restrictions on the passage of goods and people across Gaza's primary crossings remain tight.
- Donors disbursed about \$1.8 billion in 2008 to finance the recurrent budget, compared to \$1 billion in 2007, and well above the amount pledged at the December 2007 donors' conference in Paris.⁸ Out of the \$1.8 billion, about \$0.4 billion was used by the PA for arrears repayment, as opposed to creating new spending commitments, thus reducing the external financing requirements for 2009–10. On the other hand, the implementation of donor-financed development projects has been much slower than expected due to the Israeli restrictions.

9. **The revised macroeconomic framework is predicated on all parties (PA, the GoI, and donors) pro-actively pushing the peace process forward and supporting growth-enhancing reforms and institution-building.** In particular, it assumes that:

- Notwithstanding the global slowdown, the trade environment should improve (both with the rest of the world and within the WBG) if there is an easing of the blockade on Gaza and of restrictions on movement and access in the West Bank. This would lead to a recovery of exports and private investment, enable an acceleration of the public investment program, and allow Gaza's reconstruction and rehabilitation.
- The PA would continue its prudent fiscal policy based on a tight expenditure stance. The expansion of private sector activity would enable a sustained reduction in the budget deficit based on a strict government employment policy and wage restraint, as well as a phasing out of implicit subsidies to cover municipalities' utility payments. The composition of spending would continue to shift from wages and subsidies, and toward public investment and reconstruction.
- Donors would provide adequate and timely financial assistance to cover both the narrowing recurrent budget deficit and expanded public investment and reconstruction needs.

10. **Under the baseline scenario with the above assumptions and policy expectations, real GDP growth would increase from about 2 percent in 2008 to 5 percent in 2009, 6S percent in 2010, and 7S percent in 2011** (Table 1). Although trade with Israel could be affected by the global slowdown (other things being equal), WBG growth prospects would be much more strongly influenced by the easing of restrictions. The rise in donor-funded and private sector investments should offset the impact of fiscal consolidation as well as lay the foundations for sustainable growth in the long run. The share of public consumption in GDP would decline by over 7S percentage points over 2009–11, making room for a high rate of public investment averaging about 13 percent of GDP during 2009–11, while at the same time reducing reliance on external financing. Reflecting the relaxation of border restrictions, expansion of exports from repressed levels, and strong demand for raw materials and capital, real export and import growth would average 9–10 percent per year during 2009–11.

11. **While the projected recovery may appear impressive, it would still leave living standards below pre-closures levels in 2000.** Real GDP is estimated to have declined by a cumulative 13 percent since the imposition of Israeli restrictions on movement and access in 2000 up to 2008 (or a cumulative 34 percent in real per capita terms), suggesting an income level for the Palestinian economy well below its potential (Box 5). Even with the assumed relaxation of Israeli restrictions starting in 2009, real income per capita in 2011 would still be about 27 percent below its level in 2000. The rate of unemployment would remain high at 23 percent in 2011, compared to 11 percent in 2000.

12. **The above projections are subject to the risk that the peace process will remain stalled, with persistence of Gaza's blockade and Israeli restrictions in the West Bank.** Given that risk, a "pessimistic" scenario was developed on the premise that Gaza's blockade and Israeli restrictions would remain unchanged, inhibiting trade and private investment, and hindering the implementation of the donor-financed public investment program and reconstruction, with the following implications:

- Slower revenue growth, combined with rising social and emergency spending, would substantially reduce the pace of fiscal consolidation, even with a continued strict policy on government wages and employment. The recurrent budget deficit, on a commitment basis, would decline slightly from 19 percent in 2008 to 16 percent by 2011. Assuming the same level of external support for the recurrent budget as in the baseline scenario, at an average of around \$1 billion per year, cash spending would need to be curtailed, and significant expenditure arrears would accumulate.
- Continued restrictions on imports of capital goods and raw materials and passage of project personnel would reduce the pace of implementation of public investment and Gaza's reconstruction. This would have an adverse impact on longer-term growth, in addition to its immediate impact on private sector activity.
- With private activity repressed by the trade restrictions and with public consumption and investment restrained, real GDP per capita would likely remain on a declining trend, possibly contracting by an average of 1.2 percent per year during 2009–11. Unemployment would rise from 24 percent in 2008 to over 30 percent by 2011. The risk of social upheaval would rise, which would by itself put further pressure on private sector growth, and make it increasingly difficult to restrain public sector wages and employment.

West Bank and Gaza - Comparison with Pessimistic Scenario

| | 2008 Est. | 2009 Baseline Scenario | 2010 | 2011 | 2009 Pessimistic Scenario | 2010 | 2011 |
|--|--------------|---------------------------|-------|-------|------------------------------|-------|---------------------|
| Output and Investment | | | | | | | |
| Real GDP (percentage change) | 2.0 | 5.0 | 6.5 | 7.5 | 0.0 | 2.5 | 3.0 |
| Real GDP per capita (percentage change) | -1.2 | 1.8 | 3.3 | 4.3 | -3.1 | -0.6 | -0.1 |
| Gross capital formation (in percent of GDP) | 19.1 | 32.8 | 24.8 | 25.6 | 20.8 | 22.2 | 23.5 |
| o/w: public investment (in percent of GDP) | 4.2 | 17.8 | 9.8 | 10.3 | 6.1 | 7.6 | 9.0 |
| | | | | | | | (In percent of GDP) |
| Public finances 1/ | | | | | | | |
| Revenues 2/ | 24.2 | 25.8 | 26.1 | 26.3 | 24.5 | 24.5 | 24.8 |
| Recurrent expenditures and net lending | 43.6 | 44.0 | 39.4 | 38.3 | 45.9 | 43.0 | 41.2 |
| Recurrent balance (before external support) 2/ | -19.4 | -18.2 | -13.3 | -10.0 | -21.4 | -18.4 | -16.4 |
| Recurrent balance, cash basis (before external support) 2/ | -25.1 | -18.2 | -13.3 | -10.0 | -18.7 | -14.3 | -11.2 |
| Expenditure arrears accumulation | -8.0 | 0.0 | 0.0 | 0.0 | 2.7 | 4.1 | 5.2 |
| Capital expenditures | 3.9 | 17.5 | 9.5 | 10.0 | 5.7 | 7.2 | 8.7 |
| (In millions of U.S. dollars) | 251 | 1,103 | 663 | 763 | 350 | 470 | 590 |
| External recurrent budgetary support (in billions of U.S. dollars) | 1.8 | 1.2 | 0.9 | 0.8 | 1.2 | 0.9 | 0.8 |
| Total external support, including for capital expenditures | 29.6 | 35.7 | 22.8 | 20.0 | 24.5 | 21.6 | 20.0 |
| (In billions of U.S. dollars) | 1.9 | 2.3 | 1.6 | 1.5 | 1.5 | 1.4 | 1.4 |
| | | | | | | | (In percent of GDP) |
| External sector | | | | | | | |
| Exports of goods and nonfactor services | 13.1 | 13.2 | 13.7 | 14.0 | 12.7 | 12.3 | 12.0 |
| Imports of goods and nonfactor services | 71.6 | 86.3 | 76.0 | 75.8 | 77.9 | 77.5 | 75.5 |
| Current account balance (excluding official transfers) | -27.2 | -39.7 | -29.3 | -28.0 | -28.3 | -27.1 | -26.4 |
| Current account balance (including official transfers) | 2.4 | -4.0 | -6.5 | -8.0 | -3.8 | -5.5 | -6.5 |
| Memorandum items: | | | | | | | |
| Unemployment rate (average in percent of labor force) | 23.9 | 23.6 | 23.3 | 22.7 | 25.3 | 27.6 | 30.6 |

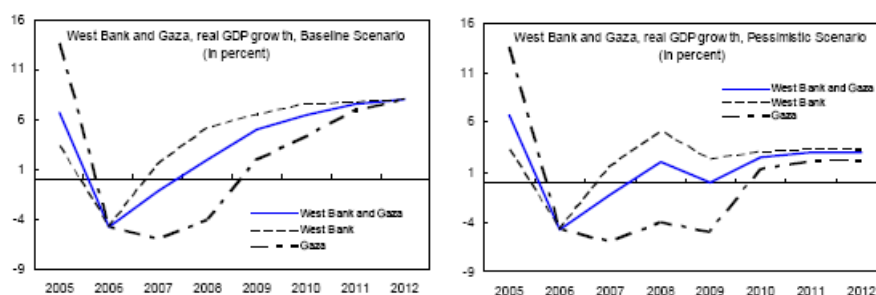
Sources: Palestinian authorities and IMF staff estimates.

1/ Commitment basis.

2/ For 2008, revenues exclude the special dividend from the Palestinian Investment Fund (PIF) of \$197 million.

West Bank and Gaza: Path of real GDP growth, 2005-2012

Persistence of the blockade and restrictions on movement and access will markedly slow economic growth, especially in Gaza.



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

13. The draft 2009 budget, expected to be signed by the President by end-March 2009, is characterized by continued reduction in the recurrent deficit and a shift in the composition of expenditure away from wages and subsidies, and toward nonwage and capital spending. The draft budget was completed and sent to the Cabinet before the outbreak of the war in Gaza. Preliminary estimates are being prepared by the PA, in cooperation with United Nations agencies, of Gaza's war-related reconstruction and rehabilitation needs. These needs will be taken into account in a supplementary budget, also expected to be sent to the President. The key features of the draft 2009 budget are as follows:

- Containment of the wage bill on the basis of (i) a maximum increase in the wage rate of 4 percent (the first general wage rate increase since 2005); and (ii) an employment freeze except for net new hires of up to 3,000, mainly health and education personnel.⁹
- Measures to phase out utility subsidies will continue to be strictly applied, resulting in a decline in net lending by 0.9 percent of GDP. Utility bill collection rates would rise due to continued enforcement of measures to improve compliance, installation of pre-paid meters, as well as the transfer of electricity distribution in the West Bank from local governments to utility companies that operate on a commercial basis.¹⁰
- Nonwage expenditures are projected to increase by 1.4 percent of GDP, reflecting mainly (i) higher projected spending by the ministry of health on emergency care, in particular for Gaza; and (ii) higher recurrent costs associated with the expansion of development, reconstruction and rehabilitation projects.
- The share of development projects in total spending is targeted to rise significantly, from 8 percent to 13 percent, as part of the PA's strategy of assuming increased "ownership" of the WBG's public investments. The PA plans to devote an increasing share of its public investment to community projects which are much less susceptible to implementation delays due to restrictions on movement and access.¹¹
- Preliminary assessments of Gaza's war-related reconstruction and rehabilitation needs suggest that a minimum of \$0.6 billion in PA spending in this area will be required in 2009. The actual figure may be much higher.
- The revenue-to-GDP ratio is projected to recover toward more typical past levels,¹² reflecting (i) a significant recovery in real income; (ii) improved compliance due to reestablishment of law and order in West Bank cities; and (iii) higher nontax revenues from PIF dividends and receipt of license fees.
- The deficit reduction from the above policies, combined with the front-loading of arrears repayment in 2008, will result in a substantial reduction in external financing requirements for the recurrent budget in 2009 by about \$610 million.¹³

IV. ASSESSMENT

14. IMF staff considers that public finance reforms undertaken so far by the PA, and envisaged to continue in the draft 2009 budget, are broadly in line with the PRDP and represent a significant move toward fiscal sustainability. The PA has maintained strict controls on government employment and wages, and substantially reduced utility subsidies. The Public Finance Management System has been strengthened, which has helped tighten control on nonwage expenditure and raise its quality. The fiscal retrenchment has been implemented in the context of a much more difficult environment than envisaged in the PRDP. In particular,

living standards continued to erode due to the blockade on Gaza and tightened restrictions on movement and access. The impact of these factors on confidence and growth has to some extent been tempered by the redeployment of PA's security forces in the West Bank as well as the higher-than-anticipated external budgetary assistance. Also noteworthy is the fact that the higher aid was used to repay arrears, rather than create new spending commitments, thus reducing future financing needs while cushioning real incomes.

15. In order to ensure that fiscal adjustment is sustained, structural reforms set out in the PRDP will need to be stepped up in 2009:

- It will become increasingly difficult to lower the wage bill by relying only on restraining new employment and wage rates. A relaxation of Israeli restrictions would raise private sector growth, which would facilitate a comprehensive civil service reform, combining adjustments of salary scales and restructuring. This will be important to achieve the medium-term objectives for the wage bill. Public sector efficiency is already being enhanced by the ongoing reform of the security forces. While the staff understands the difficulty of further retrenchment given the current unfavorable macroeconomic conditions, especially in Gaza, further personnel reductions would be desirable as the private sector expands.
- Measures to improve the collection of utility bills should be complemented by a broader reform of the electricity sector. The passage of the new Electricity Law has paved the way for a World Bank-supported project to fully transfer, by end-2010, electricity distribution from municipal control to utility companies that operate on a commercial basis.
- The impact of fiscal austerity on the poor needs to be eased by streamlined and better targeted social transfers using reliable household data. This should be facilitated by the implementation of the social safety net strategy, currently being developed with World Bank assistance, including an appropriate electricity tariff policy. The latter would help protect the poor from the impact of price increases from the commercialization of electricity distribution.¹⁴
- A comprehensive reform of the public pension system is needed to restore its viability. An action plan for such a reform is expected to be finalized in 2009, in cooperation with the World Bank, aimed at reducing pension liabilities to a sustainable level.

16. Close cooperation among all three parties (the PA, GoI, and donors) is essential to contain significant risks to the macroeconomic and fiscal outlook for 2009 and beyond:

- Slow progress in the peace process combined with continued restrictions on movement and access would further delay private sector recovery and impede public investment and reconstruction. This would limit income growth and employment opportunities, and would make it more difficult for the PA to continue with fiscal retrenchment. In particular, it would become more difficult to restrain real wages, raise collection rates for utilities, and reduce social spending. Furthermore, continuation of Gaza's blockade, by worsening its humanitarian crisis, would raise emergency spending and divert resources from growth-enhancing areas.
- Additional donor assistance needs to be secured immediately to cover external recurrent financing needs for 2009 of \$1.15 billion, in addition to \$0.50 billion for development projects, and at least \$0.6 billion for Gaza's war-related reconstruction and rehabilitation needs. If adequate funds cannot be secured, the PA would need to cut its cash expenditures and likely accumulate arrears, including on wages. Close coordination among donors, and between donors and the PA, will be essential to ensure adequate and timely disbursements for the recurrent budget.
- The drive to raise donor support for Gaza's reconstruction should not divert attention from the pressing need to finance the recurrent budget. It has already been difficult for the PA, since December 2008, to raise enough donor funds to cover the wage bill and basic recurrent spending. About half of the PA's recurrent spending has in recent years been deployed in Gaza, including through the wage bill and social assistance. Payment of these obligations, most of which are paid directly into the bank accounts of the designated beneficiaries, constitutes the most effective social safety net now in place in Gaza. Gaza's PA wage bill by itself covers 65,700 employees, which, with a dependency ratio of about 7, directly covers about one third of Gaza's population.
- The shortage of cash has made it even more difficult for people in Gaza to cover their basic needs. Failure to fully finance the recurrent budget, and to ensure that this financing is translated into cash received by employees and beneficiaries, poses a risk that an even larger proportion of Gaza's population will fall below the poverty line.

Box 1. West Bank and Gaza—Impact of the Global Economic Crisis

The economy of the West Bank and Gaza has so far not been significantly affected by the global economic crisis. This is due mainly to the lack of strong banking and trade links with the rest of the world, and the isolation resulting from Israeli restrictions on movement and access in the West Bank and from the blockade on Gaza. Indeed, in recent years economic growth in WB/G has been mostly a function of the varying severity of these restrictions. Nevertheless, looking forward, there are two potential areas of vulnerability for the Palestinian economy:

- The global recession could reduce growth in Israel, which in turn would adversely affect Palestinian exports. The impact on the Palestinian economy is however likely to be limited by the small share of exports in its GDP, currently around 15 percent, reflecting the tight Israeli restrictions on exports from the West Bank and the blockade on Gaza.

- The Palestinian economy is highly dependent on donor assistance for its budget financing, including public investment. Such assistance amounted to about \$2 billion in 2008, or about 30 percent of GDP. The economy is also dependent on remittances from Palestinians working abroad, estimated at about 8 percent of GDP. The global recession could adversely affect the willingness and ability of donors to provide financial assistance. However, so far donors have generally indicated that domestic and political factors, including the pace of reforms by the Palestinian Authority, would continue to dominate their disbursement decisions. Also, so far there are no indications of a significant decline in Palestinian workers' remittances due to the fall in oil prices or slower growth in the Arab Gulf countries.

Domestic commercial banks have been largely insulated from the global financial crisis. The banking sector is overall well-capitalized, with limited exposure to global financial markets, reflecting tight prudential regulations and conservative lending practices. About 95 percent of the foreign assets of banks operating in West Bank and Gaza are placed in overseas government-guaranteed bank deposits. The remainder is invested in securities, shares and foreign loans, with a broad diversification across both financial institutions and countries. The safety of the latter investments has been enhanced by implementation by the PMA in late 2007 of Circular No. 170/2007. This directive required banks to abide by ceilings on the placement of their deposits in nonfinancial institutions that are not highly rated by the major credit-rating agencies, and preventing asset concentration. The Circular also limits the ratio of real estate loans in banks' portfolios, and restricts trading in derivatives.

The surge in world fuel and food prices in the first half of 2008 fed directly into domestic inflation, which rose from around 1 percent in mid-2007 to a peak of 12.8 percent in

July 2008. This sharp rise in inflation in the first half of 2008 eroded real incomes, wealth and domestic demand. The recent fall in world food and fuel prices has reversed this erosion in real incomes. Thus one significant beneficial impact of the

global recession on the Palestinian economy might well turn out to be its indirect positive impact on production costs and real household incomes as commodity prices continue to fall in world markets. Nevertheless, the latter effect might be tempered should there be a continuation of the trend depreciation of the shekel vis-a-vis the dollar, which resumed in late 2008.

Box2. The Implications of Restrictions on Entry of Cash into Gaza

Over the past year, the Government of Israel has imposed tight restrictions on the entry of cash from West Bank banks to their branches in Gaza. As a result, cash available to banks has been well below what is needed to accommodate local customer cash demand, including for Palestinian Authority (PA) employee salaries and humanitarian assistance. The cash shortages have had serious repercussions in several respects:

- The living standards of Gaza's population had already been severely eroded by the impact of entry restrictions on other essential items such as food and fuel. Gaza's poverty rate, estimated by UNRWA at 80 percent in 2007, is likely have risen further following the tightening of the blockade in late 2008. The additional cash constraint on households' liquidity has further reduced their capacity to cover basic needs, especially given the large pent-up demand for basic necessities following the period of lost income and destruction of assets during the incursion. The inability of about 65,700 PA employees to draw their salaries from banks is estimated to have directly affected the livelihood of about half a million Gazans, given Gaza's average household size of about 7 people. This is in addition to the indirect repercussions on other households as a result of the shortage of cash for programs targeting Gaza's most vulnerable groups which are administered by the World Bank, European Union, and UNRWA.

- The steady fall in bank cash reserves has induced the hoarding of cash, and is bound to reduce the public's longer term confidence in its ability to draw cash from banks. Banks' profitability is bound to steadily decline, and—unless restrictions are lifted—this could ultimately lead to their closure.

- By reducing the role of Gaza's banking system and undermining its viability, the cash restrictions have resulted in the diversion of scarce resources from banks toward unregulated informal channels. This has reduced the relevance and effectiveness of the Palestinian Monetary Authority's prudential framework and its regulations against money-laundering and terrorist activities. Those groups with access to cash from unregulated sources outside Gaza's primary crossing points, and with control over informal nonbank channels, stand to gain most from the cash restrictions.

To prevent a further deterioration of living standards, safeguard banks' viability, and prevent continued diversion of resources toward unregulated activities, it will be essential for an agreement to be reached as soon as possible between the Government of Israel and the Palestinian Authority to allow the unhindered transfer of cash destined to banks in Gaza.

Box 1. West Bank and Gaza—Impact of the Global Economic Crisis

The economy of the West Bank and Gaza has so far not been significantly affected by the global economic crisis. This is due mainly to the lack of strong banking and trade links with the rest of the world, and the isolation resulting from Israeli restrictions on movement and access in the West Bank and from the blockade on Gaza. Indeed, in recent years economic growth in WBG has been mostly a function of the varying severity of these restrictions. Nevertheless, looking forward, there are two potential areas of vulnerability for the Palestinian economy:

- The global recession could reduce growth in Israel, which in turn would adversely affect Palestinian exports. The impact on the Palestinian economy is however likely to be limited by the small share of exports in its GDP, currently around 15 percent, reflecting the tight Israeli restrictions on exports from the West Bank and the blockade on Gaza.

- The Palestinian economy is highly dependent on donor assistance for its budget financing, including public investment. Such assistance amounted to about \$2 billion in 2008, or about 30 percent of GDP. The economy is also dependent on remittances from Palestinians working abroad, estimated at about 8 percent of GDP. The global recession could adversely affect the willingness and ability of donors to provide financial assistance. However, so far donors have generally indicated that domestic and political factors, including the pace of reforms by the Palestinian Authority, would continue to dominate their disbursement decisions. Also, so far there are no indications of a significant decline in Palestinian workers' remittances due to the fall in oil prices or slower growth in the Arab Gulf countries.

Domestic commercial banks have been largely insulated from the global financial crisis. The banking sector is overall well-capitalized, with limited exposure to global financial markets, reflecting tight prudential regulations and conservative lending practices. About 95 percent of the foreign assets of banks operating in West Bank and Gaza are placed in overseas government-guaranteed bank deposits. The remainder is invested in securities, shares and foreign loans, with a broad diversification across both financial institutions and countries. The safety of the latter investments has been enhanced by implementation by the PMA in late 2007 of Circular No. 170/2007. This directive required banks to abide by ceilings on the placement of their deposits in nonfinancial institutions that are not highly rated by the major credit-rating agencies, and preventing asset concentration. The Circular also limits the ratio of real estate loans in banks' portfolios, and restricts trading in derivatives.

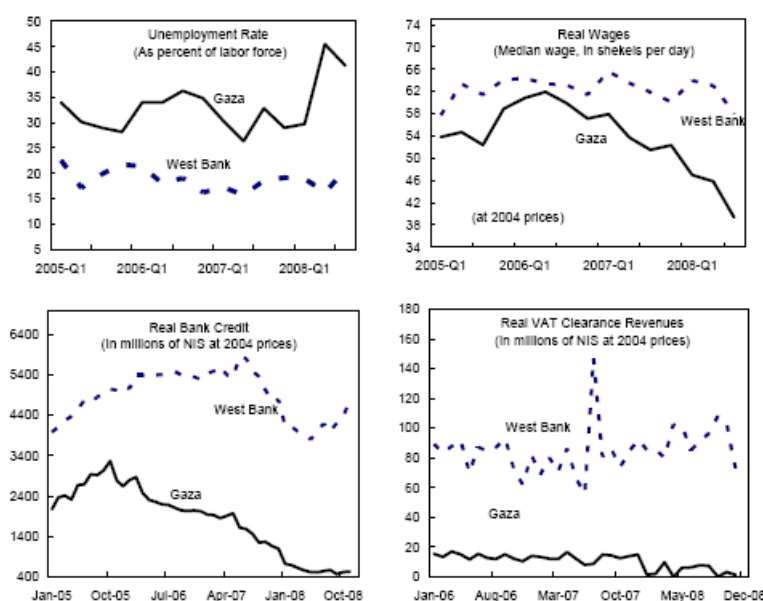
The surge in world fuel and food prices in the first half of 2008 fed directly into domestic inflation, which rose from around 1 percent in mid-2007 to a peak of 12.8 percent in

July 2008. This sharp rise in inflation in the first half of 2008 eroded real incomes, wealth and domestic demand. The recent fall in world food and fuel prices has reversed this erosion in real incomes. Thus one significant beneficial impact of the global recession on the Palestinian economy might well turn out to be its indirect positive impact on production costs and real household incomes as commodity prices continue to fall in world markets. Nevertheless, the latter effect might be tempered should there be a continuation of the trend depreciation of the shekel vis-a-vis the dollar, which resumed in late 2008.

Box 3. Diverging Economic Indicators: West Bank versus Gaza

There are limited survey data available that would allow a precise estimation of economic growth separately in Gaza and the West Bank. However, several indicators suggest that, in 2008, there was a marked deterioration in Gaza, including in relation to the West Bank:

- The average **unemployment rate** remained broadly stable in the West Bank during 2006–08 in the range of 18–19 percent of the labor force. On the other hand, it rose sharply in Gaza from 30 percent in 2007 to about 42 percent in the third quarter of 2008.
- The average nominal private sector daily **wage rate** in the West Bank rose from about NIS 75 in 2007 to about NIS 81 in the first three quarters of 2008, representing a rise in real terms of about 2 percent. By contrast, in Gaza it declined from about NIS 53 to NIS 41 over the same period, or by around 30 percent in real terms.
- While in the West Bank **bank credit** fell by 13 percent in the year ending in September 2008, it fell by 57 percent in Gaza over the same period.
- The tightening of the blockade on Gaza in 2008 led to a sharp fall in imports, and consequently in clearance revenues collected by Israel on the **Value Added Tax (VAT)** on imports. While revenue from VAT on imports rose by 20 percent in the West Bank, it fell by 65 percent in Gaza in 2008.



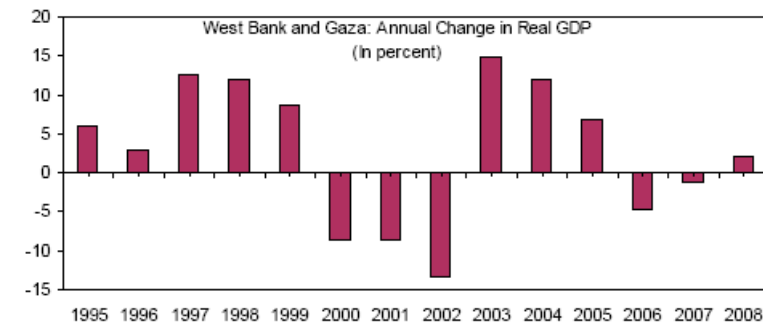
Box 4. Correspondent and Clearance Services by Israeli Commercial Banks to Banks in West Bank and Gaza

Two Israeli commercial banks (Bank Hapoalim and Discount Bank) have been threatening since mid-2007 to sever all correspondent and clearance services with banks operating in the West Bank and Gaza for NIS-denominated transactions. On January 1, 2009 the two banks' correspondent relationships with Gaza banks were ended, and there is now a risk of severance of relations with West Bank banks as well. The latter action would severely disrupt the operation of the Palestinian banking system and would significantly reduce banks' profitability. As Israel is the WBG's largest trading partner, inhibiting Palestinian-Israeli trade would have a significant adverse impact on the Palestinian economy. This action would also divert resources away from the banking system toward unregulated informal channels. The cost of bank transactions would rise markedly as these would need to be denominated in currencies other than the shekel and be cleared through offshore banks. This would expand the use of cash and informal international transfers (including through the "Hawala system"), which are much more difficult to monitor than bank transactions.

To ensure smooth economic relations between the Palestinian and Israeli sides and prevent disruptions in financial ties, it is important that the two sides continue to work closely together to reach agreement on an arrangement that would ensure unhindered access by Palestinian banks to Israeli banks' correspondent services.

Box 5. Shedding Light on the Palestinian Economy's Potential Using Electricity Consumption Data

The economic performance of the Palestinian economy has weakened markedly since the Intifada and the imposition of the restrictions on movement and access in 2000. While real GDP growth averaged 8.5 percent during 1995–99, it fell to virtually zero over the period 2000–08. Indeed, real GDP growth has been very low or negative for most years since 2000, with the exception of a brief recovery during 2003–05. Similarly, the average unemployment rate rose from 17 percent in 1995–99 to 23.5 percent in 2000–08. These trends indicate that, since 2000, the Israeli restrictions have constrained real GDP to a level well below its potential.

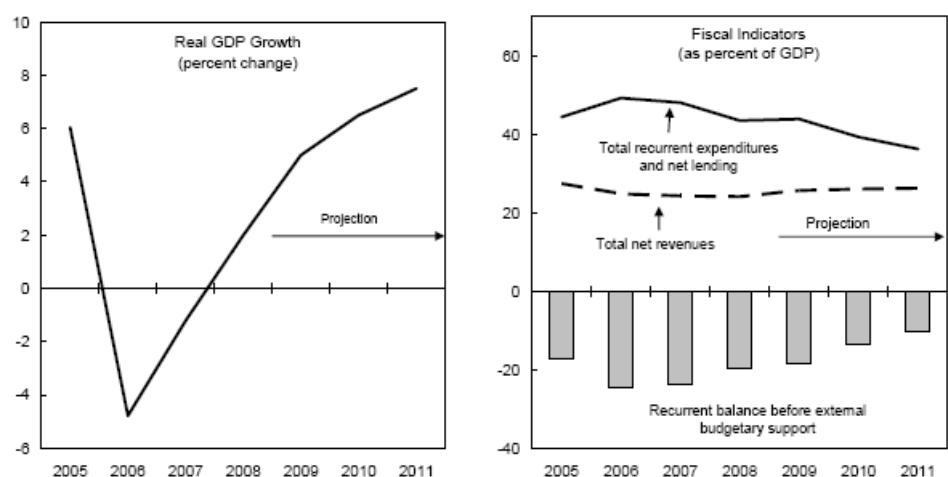


The data on long-term trends in electricity consumption in the West Bank and Gaza (WBG) provide a useful indication of the “output gap” that is likely to have emerged starting in 2000. Electricity exports from Israel to the WBG grew at an average compounded rate of about 13 percent during 1980–2000. Following the imposition of restrictions on movement and access in 2000, that rate fell to about 5 percent per year during 2001–08. To get an indication of the “electricity consumption gap” as a result of the slowdown, we compare in the graph below the actual path that electricity consumption took since 2000, with the one that it would have taken had it continued along the pre-2000 trend of about 10 percent per year. According to the latter simulation, electricity consumption would have been 56 percent higher in 2008 than what is actually estimated for that year. The large electricity consumption gap suggests that the WBG’s real GDP is well below its potential, and could thus grow rapidly for several years once the restrictions on movement and access are eased toward their pre-2000 levels.

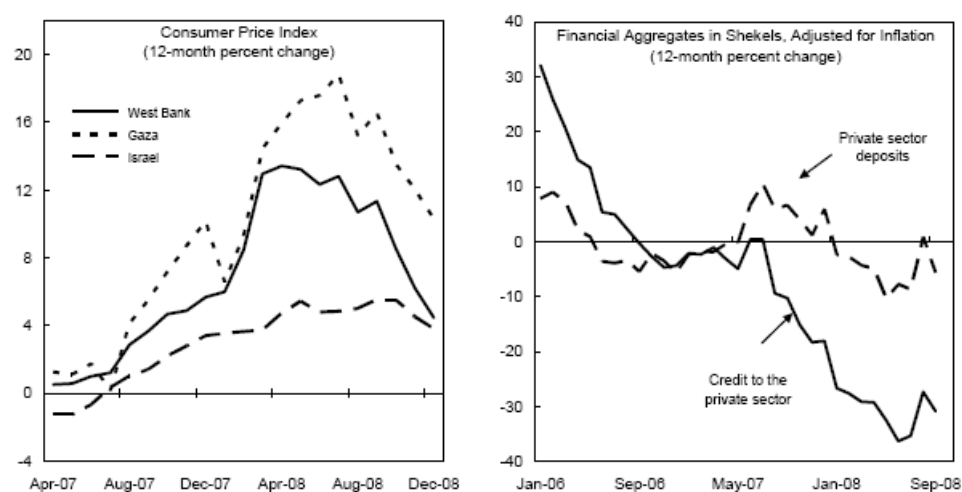


Figure 1. West Bank and Gaza: Macroeconomic and Fiscal Developments

A relaxation of restrictions on movement and access would enable a substantial recovery and fiscal adjustment over the medium term.



Inflation has risen significantly up to mid-2006, before easing in line with world food and fuel prices. Real bank credit and deposits have been on a declining trend.



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

Table 1. West Bank and Gaza: Selected Economic Indicators, 2006–11

(Population: 4 million; 2007 est.)
 (Per capita GDP: \$1,298; 2007 est.)
 (Poverty rate: 58 percent; 2006 est.)

| | 2006 | 2007 | 2008 Est. | 2009 Projections | 2010 Projections | 2011 Projections |
|--|-------|-------|----------------------------|---------------------|---------------------|---------------------|
| Output and prices | | | (Annual percentage change) | | | |
| Real GDP (1997 market prices) | -4.8 | -1.2 | 2.0 | 5.0 | 6.5 | 7.5 |
| CPI inflation rate (end of period) | 3.3 | 6.9 | 7.0 | 4.0 | 3.0 | 2.0 |
| CPI inflation rate (period average) | 3.8 | 2.7 | 9.9 | 4.0 | 3.0 | 2.0 |
| Investment and saving | | | (In percent of GDP) | | | |
| Gross capital formation, of which: | 20.7 | 17.8 | 19.1 | 32.8 | 24.8 | 25.6 |
| Public | 6.3 | 3.0 | 4.2 | 17.8 | 9.8 | 10.3 |
| Private | 14.4 | 14.8 | 14.9 | 14.9 | 15.0 | 15.3 |
| Gross national savings, of which: | 12.7 | 17.9 | 21.5 | 28.7 | 19.3 | 17.6 |
| Public 1/ | -2.8 | -1.9 | 10.2 | 17.5 | 9.5 | 10.0 |
| Private | 15.5 | 19.8 | 11.3 | 11.2 | 8.7 | 7.6 |
| Saving-investment balance | -8.0 | 0.1 | 2.4 | -4.0 | -6.5 | -8.0 |
| Public finances 2/ | | | (In percent of GDP) | | | |
| Revenues 3/ | 24.9 | 24.4 | 24.2 | 25.8 | 26.1 | 26.3 |
| Recurrent expenditures and net lending | 49.3 | 48.2 | 43.6 | 44.0 | 39.4 | 36.3 |
| Wage expenditures | 25.9 | 24.6 | 22.4 | 22.3 | 20.9 | 19.7 |
| Nonwage expenditures | 16.2 | 13.3 | 14.3 | 15.7 | 14.6 | 13.6 |
| Net lending | 7.3 | 10.3 | 6.9 | 6.0 | 3.9 | 2.9 |
| Recurrent balance (before external support) 3/ | -24.4 | -23.8 | -19.4 | -18.2 | -13.3 | -10.0 |
| Recurrent balance, cash basis (before external support) 3/ | -15.5 | -16.1 | -25.1 | -18.2 | -13.3 | -10.0 |
| Capital expenditures | 6.1 | 2.5 | 3.9 | 17.5 | 9.5 | 10.0 |
| (In millions of US dollars) | 281 | 131 | 251 | 1,103 | 663 | 763 |
| Overall balance (before external support) | -30.5 | -26.3 | -23.3 | -35.7 | -22.7 | -20.0 |
| External recurrent budgetary support (in billions of US dollars) | 0.7 | 1.0 | 1.8 | 1.2 | 0.9 | 0.8 |
| Total external support, including for capital expenditures | 21.7 | 21.9 | 29.6 | 35.7 | 22.8 | 20.0 |
| (In billions of US dollars) | 1.0 | 1.1 | 1.9 | 2.3 | 1.6 | 1.5 |
| Monetary sector 4/ | | | (Annual percentage change) | | | |
| Credit to the private sector | 7.6 | -5.7 | -2.3 | 12.4 | 18.4 | 19.2 |
| Private sector deposits | 6.2 | 21.9 | 22.7 | 7.4 | 12.7 | 13.7 |
| External sector | | | (In percent of GDP) | | | |
| Exports of goods and nonfactor services | 11.6 | 10.3 | 13.1 | 13.2 | 13.7 | 14.0 |
| Import of goods and nonfactor services | 75.3 | 68.0 | 71.6 | 86.3 | 76.0 | 75.8 |
| Net factor income | 11.6 | 14.6 | 12.3 | 11.7 | 11.3 | 11.8 |
| Net current transfers | 44.2 | 43.3 | 48.6 | 57.4 | 44.4 | 42.0 |
| Official transfers | 21.7 | 21.9 | 29.6 | 35.7 | 22.8 | 20.0 |
| Current account balance (excluding official transfers) | -29.6 | -21.8 | -27.2 | -39.7 | -29.3 | -28.0 |
| Current account balance (including official transfers) | -8.0 | 0.1 | 2.4 | -4.0 | -6.5 | -8.0 |
| Memorandum items: | | | | | | |
| Nominal GDP (millions of US dollars) | 4,615 | 5,204 | 6,496 | 6,318 | 6,904 | 7,635 |
| Per capita nominal GDP (US dollars) | 1,187 | 1,298 | 1,584 | 1,477 | 1,586 | 1,680 |
| Unemployment rate (average in percent of labor force) | 23.6 | 22.0 | 23.9 | 23.6 | 23.3 | 22.7 |
| AI Quds stock market index (annual percentage change) | -46.4 | -12.8 | -16.2 | ... | ... | ... |

Sources: Palestinian authorities and IMF staff estimates.

1/ The sharp increase in gross public savings during 2008-10 is due mainly to the substantial inflows of donor financing for the recurrent budget and development expenditures.

2/ Commitment basis.

3/ For 2008, revenues exclude the special dividend from the Palestinian Investment Fund (PIF) of \$197 million.

4/ End of period; in US dollar terms.

Table 2a. West Bank and Gaza: Central Government Fiscal Operations, 2007–11

| | 2007 | 2008 | | 2009 | 2010 | 2011 |
|--|--|---------------|---------------|---------------|---------------|---------------|
| | | Budget | Est. | Projection | | |
| | (In millions of US dollars, unless otherwise stated) | | | | | |
| Total net revenues | 1,269 | 1,466 | 1,568 | 1,630 | 1,828 | 2,011 |
| Gross domestic revenues | 400 | 419 | 562 | 625 | 704 | 771 |
| Tax revenues | 201 | 253 | 273 | 273 | 304 | 335 |
| Nontax revenues 1/ | 199 | 166 | 289 | 353 | 400 | 436 |
| Clearance revenues (accrued) | 894 | 1,067 | 1,122 | 1,123 | 1,254 | 1,382 |
| Clearance revenues (cash) | 1,315 | 1,067 | 1,137 | 1,123 | 1,254 | 1,382 |
| Clearance revenues (net arrears accumulation) | -421 | 0 | -15 | 0 | 0 | 0 |
| Tax refunds | 25 | 20 | 116 | 118 | 131 | 143 |
| Total recurrent expenditures and net lending (commitment basis) | 2,507 | 2,776 | 2,827 | 2,780 | 2,755 | 2,773 |
| Wage expenditures (commitment) | 1,280 | 1,481 | 1,453 | 1,410 | 1,460 | 1,507 |
| Wage expenditures (cash) | 1,366 | ... | 1,771 | 1,410 | 1,460 | 1,507 |
| Wage expenditures (net arrears accumulation) | -86 | ... | -317 | 0 | 0 | 0 |
| Nonwage expenditures (commitment) | 663 | 915 | 927 | 990 | 1,020 | 1,041 |
| Nonwage expenditures (cash) | 630 | ... | 996 | 990 | 1,020 | 1,041 |
| Nonwage expenditures (net arrears accumulation) | 62 | ... | -70 | 0 | 0 | 0 |
| Net lending | 534 | 380 | 447 | 380 | 275 | 225 |
| Recurrent balance (commitment basis, before external budgetary support) | -1,238 | -1,310 | -1,259 | -1,150 | -927 | -762 |
| add: expenditure arrears (net accumulation) | -23 | -217 | -387 | 0 | 0 | 0 |
| subtract: net clearance withheld (+) or transferred from past collections (-) | -421 | 0 | -15 | 0 | 0 | 0 |
| Recurrent balance (cash basis, before external budgetary support) | -840 | -1,527 | -1,631 | -1,150 | -927 | -762 |
| Capital expenditures | 131 | 541 | 250 | 1,103 | 663 | 763 |
| Development projects | 131 | 541 | 250 | 503 | 663 | 763 |
| Gaza reconstruction related to war | 0 | 0 | 0 | 600 | 0 | 0 |
| Overall balance (cash basis, including capital expenditures) | -971 | -2,069 | -1,881 | -2,253 | -1,589 | -1,525 |
| Total financing | 971 | 2,069 | 1,881 | 2,253 | 1,589 | 1,525 |
| Net domestic bank financing | -132 | -50 | -29 | 0 | 0 | 0 |
| Other domestic financing | 78 | 0 | 0 | 0 | 0 | 0 |
| External financing for recurrent expenditures (secured) | 1,010 | 1,584 | 1,764 | 0 | 0 | 0 |
| External financing for capital expenditures (secured) | 131 | 541 | 200 | 0 | 0 | 0 |
| Net external debt | 0 | -7 | -7 | -4 | -4 | -4 |
| External financing yet to be secured | 0 | 0 | 0 | 2,257 | 1,593 | 1,529 |
| Of which to cover: | | | | | | |
| budgetary recurrent expenditure | ... | ... | ... | 1,154 | 931 | 766 |
| community projects financed directly by donors | ... | ... | ... | 303 | 460 | 525 |
| large projects financed directly by donors | ... | ... | ... | 200 | 213 | 238 |
| Gaza reconstruction related to war | 0 | 0 | 0 | 600 | 0 | 0 |
| Residual | -115 | 0 | -46 | 0 | 0 | 0 |
| Memorandum items: | (In percent of GDP, unless otherwise stated) | | | | | |
| Revenues 1/ | 24.4 | 24.1 | 24.2 | 25.8 | 26.1 | 26.3 |
| Recurrent expenditures and net lending | 48.2 | 45.6 | 43.6 | 44.0 | 39.4 | 36.3 |
| Wage expenditures | 24.6 | 24.3 | 22.4 | 22.3 | 20.9 | 19.7 |
| Nonwage expenditures | 13.3 | 15.0 | 14.3 | 15.7 | 14.6 | 13.6 |
| Net lending | 10.3 | 6.2 | 6.9 | 6.0 | 3.9 | 2.9 |
| Recurrent balance (commitment basis) before external budgetary support | -23.8 | -21.5 | -19.4 | -18.2 | -13.3 | -10.0 |
| Recurrent balance (cash basis) before external budgetary support | -18.1 | -25.1 | -25.1 | -18.2 | -13.3 | -10.0 |
| External budgetary support (recurrent) | 19.4 | 26.0 | 26.5 | 18.3 | 13.3 | 10.0 |
| Capital expenditures | 2.5 | 8.9 | 3.9 | 17.5 | 9.5 | 10.0 |
| Overall balance (cash basis) | -18.7 | -34.0 | -29.0 | -35.7 | -22.7 | -20.0 |
| Total external support (millions of US dollars) | 1,140 | 2,126 | 1,917 | 2,257 | 1,593 | 1,529 |
| Nominal GDP (millions of US dollars) | 5,204 | 6,088 | 6,486 | 6,318 | 6,994 | 7,635 |

Sources: Ministry of Finance, and IMF staff estimates.

1/ To facilitate comparison between years, nontax revenues in 2008 do not include US\$197 million received as dividends from the Palestinian Investment Fund (PIF), which was then fully used to settle part of the Palestinian Authority's debt to the PIF.

Table 2b. West Bank and Gaza: Central Government Fiscal Operations, 2007–11

| | 2007 | 2008 | | 2009 | 2010 | 2011 |
|--|---|---------------|---------------|---------------|---------------|---------------|
| | | Budget | Est. | Projection | | |
| | (In millions of shekels, unless otherwise stated) | | | | | |
| Total net revenues | 5,214 | 5,277 | 5,624 | 6,520 | 7,311 | 8,043 |
| Gross domestic revenues | 1,648 | 1,507 | 2,016 | 2,500 | 2,816 | 3,085 |
| Tax revenues | 827 | 910 | 978 | 1,090 | 1,218 | 1,341 |
| Nontax revenues 1/ | 819 | 597 | 1,037 | 1,410 | 1,598 | 1,744 |
| Clearance revenues (accrued) | 3,673 | 3,842 | 4,025 | 4,492 | 5,018 | 5,528 |
| Clearance revenues (cash) | 5,403 | 3,842 | 4,078 | 4,492 | 5,018 | 5,528 |
| Clearance revenues (net arrears accumulation) | -1,730 | 0 | -52 | 0 | 0 | 0 |
| Tax refunds | 105 | 72 | 417 | 472 | 523 | 570 |
| Total recurrent expenditures and net lending (commitment basis) | 10,302 | 9,995 | 10,138 | 11,120 | 11,018 | 11,092 |
| Wage expenditures (commitment) | 5,262 | 5,333 | 5,212 | 5,640 | 5,839 | 6,028 |
| Wage expenditures (cash) | 5,614 | --- | 6,351 | 5,640 | 5,839 | 6,028 |
| Wage expenditures (net arrears accumulation) | -352 | --- | -1,139 | 0 | 0 | 0 |
| Nonwage expenditures (commitment) | 2,847 | 3,294 | 3,323 | 3,960 | 4,080 | 4,163 |
| Nonwage expenditures (cash) | 2,591 | --- | 3,573 | 3,960 | 4,080 | 4,163 |
| Nonwage expenditures (net arrears accumulation) | 256 | --- | -250 | 0 | 0 | 0 |
| Net lending | 2,193 | 1,368 | 1,603 | 1,520 | 1,100 | 900 |
| Recurrent balance (commitment basis, before external budgetary support) | -5,088 | -4,718 | -4,514 | -4,600 | -3,707 | -3,049 |
| Add: expenditure arrears (net accumulation) | -98 | -781 | -1,388 | 0 | 0 | 0 |
| Subtract: net clearance withheld (+) or transferred from past collections (-) | -1,730 | 0 | -52 | 0 | 0 | 0 |
| Recurrent balance (cash basis, before external budgetary support) | -3,454 | -5,499 | -5,850 | -4,600 | -3,707 | -3,049 |
| Capital expenditures | 537 | 1,949 | 900 | 4,412 | 2,650 | 3,050 |
| Development projects | 537 | 1,949 | 900 | 2,012 | 2,650 | 3,050 |
| Gaza reconstruction related to war | 0 | 0 | 0 | 2,400 | 0 | 0 |
| Overall balance (cash basis, including capital expenditures) | -3,991 | -7,447 | -6,749 | -9,012 | -6,358 | -6,099 |
| Total financing | 3,991 | 7,447 | 6,749 | 9,012 | 6,358 | 6,099 |
| Net domestic bank financing | -542 | -180 | -106 | 0 | 0 | 0 |
| Other domestic financing | 320 | 0 | 0 | 0 | 0 | 0 |
| External financing for recurrent expenditures (secured) | 4,149 | 5,704 | 6,253 | 0 | 0 | 0 |
| External financing for capital expenditures (secured) | 537 | 1,949 | 720 | 0 | 0 | 0 |
| Net external debt | 0 | -25 | -25 | -16 | -16 | -16 |
| External financing yet to be secured | 0 | 0 | 0 | 9,028 | 6,374 | 6,115 |
| Of which to cover: | | | | | | |
| budgetary recurrent expenditure | --- | --- | --- | 4,616 | 3,723 | 3,065 |
| community projects financed directly by donors | --- | --- | --- | 1,212 | 1,800 | 2,100 |
| large projects financed directly by donors | --- | --- | --- | 800 | 850 | 950 |
| Gaza reconstruction related to war | 0 | 0 | 0 | 2,400 | 0 | 0 |
| Residual | -473 | 0 | -93 | 0 | 0 | 0 |
| Memorandum items: | (In percent of GDP, unless otherwise stated) | | | | | |
| Revenues 1/ | 24.4 | 24.1 | 24.2 | 25.8 | 26.1 | 26.3 |
| Recurrent expenditures and net lending | 48.2 | 45.6 | 43.6 | 44.0 | 39.4 | 36.3 |
| Wage expenditures | 24.6 | 24.3 | 22.4 | 22.3 | 20.9 | 19.7 |
| Nonwage expenditures | 13.3 | 15.0 | 14.3 | 15.7 | 14.6 | 13.6 |
| Net lending | 10.3 | 6.2 | 6.9 | 6.0 | 3.9 | 2.9 |
| Recurrent balance (commitment basis) before external budgetary support | -23.8 | -21.5 | -19.4 | -18.2 | -13.3 | -10.0 |
| Recurrent balance (cash basis) before external budgetary support | -16.1 | -25.1 | -25.1 | -18.2 | -13.3 | -10.0 |
| External budgetary support (recurrent) | 19.4 | 26.0 | 26.5 | 18.3 | 13.3 | 10.0 |
| Capital expenditures | 2.5 | 8.9 | 3.9 | 17.5 | 8.5 | 10.0 |
| Overall balance (cash basis) | -18.7 | -34.0 | -29.0 | -35.7 | -22.7 | -20.0 |
| Total external support (millions of shekels) | 4,687 | 7,652 | 6,880 | 9,028 | 6,374 | 6,115 |
| Nominal GDP (millions of shekels) | 21,387 | 21,918 | 23,260 | 25,271 | 27,976 | 30,542 |

Sources: Ministry of Finance, and IMF staff estimates.

1/ To facilitate comparison between years, nontax revenues in 2008 do not include NIS 653 million received as dividends from the Palestinian Investment Fund (PIF), which was then fully used to settle part of the Palestinian Authority's debt to the PIF.

Notes

¹ This report was prepared by a team composed of Oussama Kanaan (Chief of Mission), Rina Bhattacharya, and Roman Zyttek. The macroeconomic and fiscal framework set out in the Palestinian Reform and Development Plan (PRDP) was assessed by IMF staff in "Medium-Term Macroeconomic and Fiscal Framework for the West Bank and Gaza," which was issued on December 5, 2007 (SM/07/384). The second review of progress in implementing the framework was issued on September 22, 2008 (FO/Dis/08/91). Staff reports are published on the IMF website (www.imf.org/wbg).

² In addition to Gaza's growing isolation during 2008, the UN Office for the Coordination of Humanitarian Affairs (OCHA) reports that restrictions on movement and access in the West Bank have been tightened. As of September 2008 there were 630 identified obstacles blocking internal Palestinian movement, up from 611 in April and 580 in February 2008. In late 2008, movement of people across some checkpoints in the West Bank were reported by the GoI to have been facilitated, such as during religious holidays in November and December. For updates, see www.ochaopt.org.

³ The poverty line for a six-person household (two adults and four children) in the household survey was established at NIS 2,362 (equivalent to \$572) in monthly expenditures. See the report by UNWRA, "Prolonged Crisis in the Occupied Palestinian Territory: Socio-Economic Developments in 2007," July 2008. See www.un.org/unwra/publications/pubs07.html.

⁴ Nevertheless, the clearance of government arrears to employees and private suppliers contributed to a fall in the share of nonperforming loans to total loans from 18.5 percent at end-2007 to 12 percent by end-September 2008.

⁵ The plan to modernize the PMA, set out in 2005, aims principally at: (i) streamlining the organization and management systems, which were heavy on administration and procedures; (ii) enhancing the safety, soundness, and efficiency of the procedures for the payments system to meet international standards; and (iii) developing banking supervision, including through a move to a risk-based approach, adequate staffing and training, and passage of supporting legislation. For more details on progress, see the IMF staff report on the West Bank and Gaza dated September 22, 2008 (www.imf.org/wbg).

⁶ This transaction was in effect a bookkeeping operation to reduce debt owed to the PIF, with no cash paid. To facilitate assessment of revenue performance, the dividend is excluded from the figures in this report's discussion and tables.

⁷ For example, the average collection rate from consumers by the electricity distribution utility in the municipality of Nablus (one of the largest in the West Bank) rose from 66 percent in 2007 to 80 percent in January to August 2008. As a further indication of progress, in 2008 municipalities repaid the Treasury about \$20 million in past loans to cover municipalities' utility bills.

⁸ At the Paris Conference, \$1 billion was pledged for recurrent budget support for 2008, in addition to \$0.7 billion for development projects.

⁹ The strict employment policy is part of the longer run PA strategy to gradually reduce the size of the wage bill from the current high level of 22 percent of GDP toward less than 10 percent of GDP as in most developing countries. The average public sector wage is also significantly higher than in the private sector. Restraint on the public wage rate, along with a sustained pick up in private sector activity, would help reduce the private-public wage wedge.

¹⁰ A new Electricity Law, designed in cooperation with the World Bank to facilitate such a transfer, is expected to be passed by end-March 2009.

¹¹ In 2008, only about half of the amount budgeted for “development projects” was realized due to the high susceptibility of the planned projects (mostly large infrastructure projects directly managed by aid agencies) to restrictions on movement and access. The 2009 budget envisages a rise in the implementation rate through a focus on community-based projects. Expenditure on development projects for 2009 is budgeted at \$503 million, consisting of \$200 million in large infrastructure projects and \$303 million in community-based projects. This compares with an estimated total public investment of \$250 million in 2008, about \$60 million of which was on community-based projects.

¹² The revenue-to-GDP ratio in 2009, at 26 percent, would still be lower than the outturn for 2005 (28 percent), due to the loss of Gaza’s tax revenue since mid-2007.

¹³ Reflecting the rise in public investment and Gaza’s war-related reconstruction, total external financing requirements (to cover both recurrent and capital spending) are projected to increase from \$1.9 billion in 2008 to \$2.3 billion in 2009. The \$2.3 billion consists of: (i) \$1.2 billion in recurrent budget support (compared to \$1.8 billion in 2008); (ii) \$0.30 billion for community projects; (iii) \$0.20 billion for large infrastructure projects; and (iv) \$0.6 billion for Gaza’s war-related reconstruction and rehabilitation. In comparison, the PRDP’s 2009 external financing requirements, as presented at the 2007 Donors’ Conference in Paris, consisted of \$1.3 billion for recurrent budget support, and \$0.6 billion for development projects.

¹⁴ The social safety net strategy under preparation includes the creation of a database on poor households, along with a reduction in the degree of overlap and leakage to the nonpoor of social transfers. A better targeted social safety net would make it easier for the PA to gradually reduce the size of the public sector.