RECENT EXPERIENCE AND PROSPECTS OF THE ECONOMY OF THE WEST BANK AND GAZA[1]

STAFF REPORT PREPARED FOR THE MEETING OF THE AD HOC LIAISON COMMITTEE

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I. EXECUTIVE SUMMARY

The Palestinian economy is facing serious risks, with a slowdown in growth and rise in unemployment in both Gaza and the West Bank. During 2008–10, the West Bank's real GDP grew by an annual average rate of 9 percent, reflecting sound economic management and reforms supported by donor aid, and an easing of Israeli internal barriers. However, growth declined to 5 percent in 2011 and the first quarter of 2012, while unemployment rose to 19 percent in the first half of 2012 from 16 percent in the same period last year. The economic slowdown reflects continued fiscal retrenchment combined with severe financing difficulties, declining donor aid especially from regional donors, and slower easing of restrictions on movement and access. In Gaza, after a rebound in its real output by over 20 percent on average in 2010–11 following the easing of tight restrictions, growth has declined to 6 percent in the first quarter of 2012, and unemployment has risen to 30 percent from 28 percent in the same period last year. Looking ahead, with persisting restrictions, financing difficulties with aid shortfalls, and stalemate in the peace process, there is a high risk of a continued economic slowdown, a rise in unemployment, and social upheaval.

The Palestinian Authority (PA)'s severe financing difficulties in 2011 and so far in 2012 have led to a substantial rise in domestic payment arrears and debt to commercial banks. Steady institution-building and prudent fiscal management by the PA during 2008–10 enabled a significant improvement in the quality of spending and a sharp reduction in recurrent budgetary aid from $1.8 billion to $1.1 billion. However, in 2011 and so far in 2012, donor aid for recurrent spending and development projects has been lower than needed to finance the already tight budgets. The consequent liquidity difficulties have been compounded by shortfalls in revenue in the context of a decline in economic growth and slower-than-expected implementation of clearance and domestic tax administration measures, as well as higher pension payments. Domestic payment arrears, including to the private sector and public pension fund, are estimated to have risen by about $0.3 billion in the first half of 2012. The stock of government debt to domestic banks has increased to $1.2 billion (12 percent of GDP) at end-June 2012 from $1.0 billion at end-2010.

Given the high risk of continued aid shortfalls, it is important for the PA to promptly implement a contingency plan to cover the financing gap, which as of mid-September is projected at $0.4 billion for 2012. The PA already announced in mid-August a freeze in new public sector employment and promotions for the remainder of the year. The contingency plan should complement these measures by a reduction in the cost of living adjustment for public sector employees. Non-wage expenditures should be carefully prioritized, making full use of the cash management system, to ensure that in case of continued aid shortfalls non-essential expenditures take the brunt of the cuts. Any measures to alleviate the impact of the September fuel price increases should be offset by cuts in other non-essential spending, given the severe financing constraint. Development projects should only be implemented if there are matching funds from donors, to prevent the diversion of aid away from essential recurrent spending. While domestic revenue measures are unlikely to start bearing fruit before the end of the year, nevertheless it is important to press ahead with the prompt implementation of the IMF technical assistance recommendations to improve tax administration, notably through enhancing compliance and widening the tax base.

Joint PA-Government of Israel (GoI) measures to raise clearance revenue should be implemented promptly to support the fiscal adjustment efforts. Given that clearance revenue, which is collected by the GoI on the PA's behalf, represents 70 percent of the PA's total tax revenue, the PA-GoI understanding reached in July 2012 to enhance the efficiency of the clearance revenue mechanism through joint PA-GoI measures has the potential to raise budgetary revenue and reduce the PA's reliance on aid over time. To ensure a sustainable rise in the Palestinian economic and revenue base, economic cooperation should be broadened to include an easing of restrictions on movement and access.

Along with its efforts to address the immediate financing difficulties, it is important for the PA to employ its enhanced institutional capacity to press ahead with measures to further raise public sector efficiency and phase out reliance on recurrent aid. As set out in the IMF staff reports for the Ad Hoc Liaison Committee meetings in 2011, IMF staff considers that the PA is able to conduct the sound economic policies expected of a future Palestinian state, given its solid track record of reforms and institution building. A milestone reached in April 2012 was the WBG's subscription to the IMF's Special Dissemination Standards (SDDS). This is the outcome of the PA's efforts to enhance the quality and transparency of economic and financial statistics, which compare favorably with those of IMF member countries that maintain high data management and dissemination standards. It is essential that the PA continues to build on its track record by taking measures toward comprehensive pension and civil service reforms, further strengthening the social safety net, completing the commercialization of electricity distribution, and enhancing the legal and regulatory framework facing businesses.

Additional aid is essential to sustain orderly reforms and fiscal adjustment. The delays in wage payments have already raised social tensions, and there is an increased public anxiety that, even with additional austerity measures by the PA, much needed social spending would be cut and wage payments delayed. It is thus critical that the PA's efforts be complemented by the prompt disbursement of additional aid to help cover the 2012 financing gap. It is also important for the PA and donors to work closely to develop a donor coordination framework to enhance the predictability of aid, especially from regional donors.

To stem the risks of a continued economic slowdown, a rise in unemployment, and a deepening fiscal crisis—which are bound to fuel social upheaval—urgent and concerted actions are needed by the PA, the GoI, and the international community. The PA should do its utmost to prudently manage the current fiscal crisis and continue to lay the foundation for sustainable growth and financial self-reliance. However, the economic and financial base that allows the PA to operate in a sustainable manner and build institutions, and its ability to ensure broad-based public support for its reforms, would be seriously eroded without sustained donor aid, including for public investment, and without an easing of Israeli controls on the WBG's external trade and access to the West Bank's Area C. The easing of these controls would relax a key constraint on private sector growth and employment, raise the WBG's economic and budgetary revenue potential, and help ensure a sustained rise in Palestinians' living standards.

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