

Economic Monitoring Report to the Ad Hoc Liaison Committee

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The World Bank

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I. Executive Summary

1. The Palestinian economic outlook is worrying: recovering slowly from the recession of 2014, the per capita income growth has almost stagnated and projected growth levels will not support an improvement in living standards. The growth rate of the Palestinian economy is projected to hover around 3.5 percent in the medium term. Given the high population growth in the Palestinian territories, this implies a near stagnation in per capita incomes. The economy has also not been able to create enough jobs, resulting in stubborn unemployment rates reaching 27 percent in 2016 (18 percent in the West Bank and 42 percent in Gaza), despite recent steps by Israel to increase the number of work permits for West Bank Palestinians. The productive capacity of the Palestinian economy has been eroded over the years with a significant decline in the size of manufacturing and agriculture in the economy.

2. Despite impressive fiscal consolidation efforts over the years, the Palestinian Authority's (PA) fiscal situation remains fragile with a US\$600 million financing gap projected for 2016. The PA has managed to reduce the relative size of the fiscal deficit by 15 percentage points of GDP over the last decade, a highly impressive achievement rarely experienced in other places around the world. The improvement in the deficit has been achieved through a general containment in the wage bill and efforts to curtail net lending. The total deficit is projected to further decline to US\$1.3 billion in 2016, 10 percent of GDP. Yet, recent trends in foreign aid have projected the full 2016 donor support at under US\$700 million (down from about US\$2 billion in 2008) -- resulting in a financing gap in excess of US\$600 million.

3. The current critical situation requires renewed efforts by the donors, the PA and the Government of Israel (GoI). Until there is a permanent peace agreement, the Palestinian economy will continue to perform below its potential and this will impact the economic and fiscal performance. However, even without a final peace deal there is more that can be done to enhance the performance of the Palestinian economy and improve the fiscal situation.

- **In the short term, donor support, and in particular budget support, is vital to address the financing gap and avoid a fiscal crisis leading to wider economic problems -- as alternative options are limited.** While the PA needs to continue to stop non-priority spending, accelerate reform efforts, and optimize any one-off revenues (such as licensing fees), the potential contribution from these actions will not be enough to cover the full financing gap. The PA's borrowing from local banks is very close to the limit set by the Palestinian Monetary Authority. With the local borrowing opportunity now largely exhausted, the gap will translate into additional arrears. Although a financing gap and arrears have been experienced in recent years, their size is growing and the options for addressing them are now extremely limited. With the performance in 2016 helped by one-off receipts, future prospects indicate an even larger gap unless current trends can be adjusted. In the short term, there is no feasible alternative to budget support as a key source of deficit financing. A higher level of donor support -- beyond the current -- is essential to avoid a fiscal crisis leading to wider economic problems. The GoI could make a valuable contribution by building further on the positive steps it has taken to redress some of the areas of fiscal loss described in the World Bank's April 2016 report to the Ad Hoc Liaison Committee (AHLIC).

- **In parallel to the increased donor support, sustained reform actions by the PA are needed now to ensure improved competitiveness and fiscal sustainability of the Palestinian economy over time.** More sustained and fundamental reforms are needed to improve the quality of expenditures and revenue collection and many of the fiscal reform options earlier reported by the Bank to the AHLIC -- and summarized in Chapter III -- remain unaddressed. Particular attention should be given to making the pay and pension systems for government employees sustainable and fair to the rest of society, as further gains are limited without these far reaching and politically difficult reforms. As identified in Chapter III, further efforts by the PA to improve the business climate are also important. Despite progress in recent years, the Palestinian territories still rank 129th out of 189 countries in the World Bank's 2016 Doing Business.

- **GoI actions to help Palestinian private sector activity and raise employment levels could significantly mitigate the stress of economic stagnation.** Restrictions have been the main constraint to Palestinian economic competitiveness and have pushed private investment levels to amongst the lowest in the world. Restrictions on Area C are amongst the most detrimental to economic growth and World Bank analysis has reported that access to Area C could increase Palestinian GDP by 35 percent and would be expected to lead to a 35 percent increase in employment. The World Bank estimates that GDP losses in Gaza, since the blockade of 2007, are above 50 percent -- in addition to large welfare losses.

- **To advance Gaza reconstruction, donor disbursements also need to accelerate and as larger recovery projects start progressing, the current import mechanism will need to be adjusted.** Starting March 2015, the World Bank was asked to update each AHLIC on the progress of Gaza reconstruction and recovery. Out of the US\$3.5 billion pledged at the Cairo conference for Gaza reconstruction, 46 percent has so far been disbursed. Since the last AHLIC meeting, amounts disbursed have increased by US\$188 million, but are still US\$1.3 billion behind the planned disbursement. While donors need to accelerate disbursement, material entry also needs to be accelerated, particularly as efforts shift towards long term recovery projects. The Gaza Reconstruction Mechanism (GRM) has been fairly effective at facilitating material for minor home repairs and at increasing the transparency of the review and approval process. However, more complex infrastructure projects are facing long delays depending on the type of material and equipment needed. There is a need for a longer-term solution that builds on the transparency achieved by the GRM while streamlining the administrative processes (including within the PA and establishing direct coordination between the Israeli administration and the PA line agencies in Gaza).

4. The main body of the report is organized in two chapters. Chapter II focuses on recent developments in the real, fiscal and banking sectors while providing a near term outlook that highlights critical challenges facing the Palestinian economy. In view of the need for far-reaching reform, Chapter III presents a stock take of World Bank recommendations to the AHLIC meeting over the years, discusses the state of the issues, and suggests a way forward. It is hoped that it will galvanize the efforts of all parties to address the immediate crisis while setting in place actions for long term sustainability of the Palestinian economy and public finances.

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