Economic Update and Potential Outlook
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West Bank and Gaza
Economic Update and Potential Outlook

1. This note previews the findings of the Bank's Economic Monitoring Report #2, requested by the Ad Hoc Liaison Committee in December 2005 and due next month. It reports on developments in 2005 on the basis of recent data, and reviews the potential economic impact of various policy measures currently under consideration.

Developments in 2005

2. In 2005, real Gross Domestic Product (GDP) grew by an estimated 6.3 percent. As explained in the Bank's December 2005 Economic Monitoring Report #1[1], a confluence of factors explains this level of growth, including an expansionary (but unsustainable) fiscal policy by the Palestinian Authority (PA), increased banking credit to the private sector, a relaxation of closures (permitting a higher number of Palestinian workers to find jobs in Israel), and increased Israeli demand for Palestinian exports[2]. Despite positive growth rates during 2003-5, Palestinian incomes remain considerably lower than their pre-intifada levels, with real GDP per capita in 2005 about 31 percent lower than in 1999.

Current Context

3. In recent weeks, both the Government of Israel (GOI) and donors have been considering a variety of economic responses to the outcome of the Palestinian Legislative Council (PLC) election of January 25, 2006, some of which are already under implementation. GOI has suspended the regular transfer of revenues which it collects on behalf of the PA; other forms of economic interaction at issue are Palestinian labor access to Israel and the Israeli settlements (ISI), and the flow of imports and exports across Palestinian borders with Israel. Donors are planning to reduce various categories of foreign assistance.

4. By way of introduction, two points are worth noting. First, the Palestinian economy is highly sensitive to external stimuli, due to its degree of dependence on Israel and on foreign assistance; consistent with this, the Ad Hoc Liaison Committee (AHLC) in December 2005 agreed that achieving desirable rates of Palestinian GDP growth would depend on Israel continuing to transfer revenues, rolling back the system of movement restrictions in force and maintaining or increasing labor access to Israel—and on sustained high rates of donor and private investment as well as Palestinian governance reform. It follows that suspending revenue transfers, constraining Palestinian movement and access and reducing aid flows would cause severe economic damage if the available tools were employed with sufficient vigor. Second, the impact of the suspension of clearance revenue transfers and restrictions on movement and access would be much greater than the impact of reduced aid flows. The relative impact of GOI and donor actions is borne out by the economics of the second intifada—a period in which the various restrictions placed on the movement of people, labor and goods, and on the transfer of revenues collected by GOI on the PA's behalf, led to a contraction in real personal incomes of almost 40 percent between the third quarter of 2000 (Q3/2000) and Q3/2002—despite a doubling of annual donor disbursements in the same period.

Potential Measures and their Impact

5. **Possible economic measures**. Those with the greatest immediate impact are of three main types.

- *Suspending the transfer of tax revenues collected on the PA's behalf*. As agreed under the Paris Protocol of 1994, and consistent with the operation of the quasi-customs Union between Israel and the PA, GOI remits to the PA through a regular 'clearance' mechanism taxes and VAT levied in Israel on merchandise destined for Gaza and the West Bank. These revenues have in the past represented up to two-thirds of total Palestinian revenue—a sum amounting to some US$740 million in 2005, or approximately 13 percent of Gross Disposable Income (GDI[3]). Last month GOI announced it would suspend these transfers and deposit the proceeds due to the PA in an escrow account.

- *Restricting trade across borders*. Border trade has been significantly constrained since the beginning of the intifada (at present, all merchandise trade flows either to or through Israel). In 2005, imports and exports totaled nearly US$3.4 billion—an amount equivalent to 83 percent of Palestinian GDP, illustrating the openness of the Palestinian economy (and its consequent vulnerability to trade restrictions)[4]. A recognition of the importance of normalizing Palestinian trade flows led to a trilateral dialogue in 2004-5, culminating in the Agreement on Movement and Access (AMA) concluded between the parties on November 15, 2005. GOI and the PA have not yet fulfilled various obligations under the AMA[5]. Furthermore, GOI has recently announced that it will tighten security checks on its borders with West Bank and Gaza.

- *Restricting or terminating Palestinian labor flows to Israel*. In 2005, a daily average of approximately 44,800 Palestinians worked in Israel[6]. These workers were paid approximately US$405 million in the course of the year (amounting to 7 percent of GDI). Even before the PLC election GOI policy was to reduce to zero the number of permit-holding workers by the end of 2007. Since the election, labor flows have averaged 25-

30,000 per day.

6 . **Reducing aid flows**. Foreign assistance to the Palestinians is conventionally classified under three broad headings—budget support, emergency/humanitarian, and development aid. In 2005, donors contributed a total of approximately US$1.3 billion[7] to the Palestinian economy, or some 22 percent of GDI. Of the US$1.3 billion, it is estimated that some US$350 million (27 percent) was provided in the form of budget support, US$500 million (38 percent) as humanitarian/emergency assistance, and US$450 million (35 percent) as developmental aid (either in the form of capital assistance or for technical assistance/capacity building).

7. Donors have by and large stressed that emergency/humanitarian assistance is not at issue in the current debate, and might even be increased to mitigate any hardships for the neediest in Palestinian society accruing from a reduction in other forms of foreign assistance. In addition, in contrast to the other forms of aid, almost all of this assistance is routed through the UN or through NGOs rather than through the PA. Potential aid reductions, therefore, would come from the c. US$800 million provided in 2005 for budget support and developmental aid.

8. Regarding the provision of aid exclusively through UN and NGO channels, the following points should be borne in mind. First, the PA delivers the vast bulk of public services[8]. Second, it would be difficult to ramp up emergency/humanitarian assistance levels quickly if humanitarian flows required new verification procedures; humanitarian delivery potential would also be impeded by the movement restrictions in place today at the borders and inside the West Bank (including those being experienced by donor Palestinian staff)[9]. Third, welfare levels cannot be divorced from PA salary payments; the case for sustaining these during the intifada was in part premised on the welfare benefits associated with such transfers[10].

Assumptions Made

9. Bank staff have modeled four scenarios for the period 2006-8. They do not cover all eventualities, and are thus illustrative in nature.

- For baseline comparative purposes, we have developed Scenario 1: No Abrupt Change. This assumes the resumption of the transfer of revenues, the continuation of the border trade management practices of 2005, and a daily average of 32,800 Palestinian workers in 2006, 20,100 in 2007 and 7,400 in 2008[11]. Aid disbursements are assumed to remain at 2005 levels in 2006, after which they decline gradually.

- Scenario 2: Suspension of Clearance Revenue Transfers, Trade and Labor Restrictions. This assumes that revenue transfers to the PA continue to be withheld, that border trade is further restricted[12], and that permits for Palestinian laborers are reduced considerably faster than under Scenario 1[13]. Aid flows, however, continue as under Scenario 1.

- Scenario 3: Reduced Aid Flows. This assumes that economic policies consistent with Scenario 1, but that donor assistance is reduced. *Budget support* in 2006 is assumed to decrease from US$350 million to US$300 million (OECD contributions decline to US$120 million[14], while overall Gulf/Middle Eastern flows remain almost unchanged). In 2007 and 2008 budget support is assumed to total only US$200 million as OECD support is withheld. *Emergency/humanitarian assistance* is assumed to increase by 20 percent in 2006, to US$600 million, and to peak at US$650 million in 2007. Disbursements of *developmental aid* are assumed to decline from US$450 million in 2005 to US$200 million in 2006 in the face of cut-backs, and to taper off to US$100 million in 2008 as ongoing programs gradually close.

- Scenario 4: Suspension of Clearance Revenue Transfers, Trade and Labor Restrictions, and Reduced Aid Flows. This assumes that all measures described in Scenarios 2 and 3 are applied.

Potential Outcomes

10. The projections show the following (see the *Attachment*):

- Even under Scenario 1: No Abrupt Change Palestinian economic prospects are not good. Readers of the Bank's Economic Monitoring R*eport #1* may recall that donors targeted a real GDP growth rate of 10 percent per annum in order to rapidly reduce unemployment to acceptable levels[15]. Under this Scenario, however, real GDP per capita growth declines from 6.3 percent in 2005 to 4.9 percent in 2006, and turns negative thereafter. By 2008, real incomes as measured by GDI per capita are 19 percent lower than in 2005, unemployment has grown to 34 percent of the workforce and poverty increases to 51 percent of the population.

- Scenario 2: Suspension of Clearance Revenue Transfers, Trade and Labor Restrictions results in a dramatic contraction in 2006 of real GDP per capita (minus 21 percent), which is comparable to the rate of decline associated with the early intifada period (minus 18 percent in 2001 and minus 13 percent in 2002—albeit from much higher base). Under this scenario, unemployment jumps to 35 percent in 2006 and to 45 percent by 2008, with poverty levels reaching 70 percent by the end of the period.

- The impact of a 15 percent contraction in aid flows in 2006 and the decline modeled thereafter under Scenario 3: Reduced Aid Flows is less alarming. Although real GDP growth turns negative in 2006 and real GDI per capita declines by 7 percent more than under Scenario 1, most other aggregates are only marginally worse than under No Abrupt Change.

- Scenario 4: Suspension of Clearance Revenue Transfers, Trade and Labor Restrictions, and Reduced Aid Flows is the most deleterious. Real GDP per capita declines by 27 percent in 2006, and personal incomes (real GDI per capita) by 30 percent—a one-year contraction of economic activity equivalent to a deep depression. Under this scenario, unemployment hits 47 percent and poverty 74 percent by 2008. By 2008, the cumulative loss in real GDP per capita since 1999 has reached 55 percent.

11. It is also worth noting that continued withholding by GOI of Palestinian revenues under the assumptions in this model would reduce available total budget resources to between US$700-750 million in 2006. This should be compared with the PA's 2006 draft Budget of US$1.9 billion (incorporating a salary bill of US$1.2 billion)[16]. A fiscal outlook of this nature is incompatible with continuity in essential government operations.

Notes

1 The Palestinian Economy and the Prospects for its Recovery—Economic Monitoring Report to the Ad Hoc Liaison Committee Number 1, December 2005.

2 In Economic Monitoring Report #1 (op. cit.), we estimated that real GDP growth might reach 8.7 percent in 2005. The economic data released since then, notably labor market data for the third and fourth quarters of 2005, show that economic developments in the second half of 2005 were less positive than anticipated.

3 Gross Disposable Income measures all resources available to the economy, including aid transfers and remittances.

4 In 2005, imports amounted to nearly US$2.8 billion (68 percent of GDP) while Palestinian exports contributed US$600 million in value added (15 percent of GDP).

5 See www.worldbank.org/ps: An Interim Assessment of Passages and Trade Facilitation, February 2006.

6 The labor flows used in this note exclude East Jerusalem ID holders. Of the 44,800, some 18,800 held valid permits, about 18,600 were clandestine/illegal entrants from the West Bank and another 7,400 were Israeli ID or foreign passport holders.

7 In the Bank's Economic Monitoring Report #1 (op. cit.), a total of US$1.1 billion was used. This excluded approximately US$200 million contributed to UNRWA's 'regular' budget (a convention generally observed since the beginning of the Oslo process in order to distinguish additional assistance accruing as a result of the Peace Process).

8 In primary and secondary education, the PA employs almost 30,000 staff (64 percent of all education personnel), runs 76 percent of all schools (1,660 of 2,190) and educates 67 percent of all schoolchildren. In health, 11,000 staff are employed to run 62 percent of all health facilities (800 of 1,290). These proportions are significantly more pronounced if refugee camps (in which UNRWA delivers such services) are excluded.

9 For these reasons, we assume that 2006 emergency/humanitarian aid flow increases are limited to 20 percent as compared with 2005.

10 See, for example, Twenty-Seven Months: Intifada, Closures and Palestinian Economic Crisis, Annex 1, World Bank, May 2003. In 2005, an average of c. 135,000 staff were employed by the PA; using a dependency ratio of 6.0 (the ratio of population to persons employed), this suggests that about 810,000 people, or 23 percent of the population, were directly supported by PA salary payments.

11 This presumes the termination of all Palestinian labor permits at the end of 2007, but with continued access by West Bank foreign passport holders. The labor figures in this scenario are composed of three elements: a) permit holders (a daily average of c. 18,800 in 2005, which we assume declines gradually in 2006 and 2007 in accordance with stated intentions, to c. 16,100 in 2006 and 12,700 in 2007); b) clandestine/illegal West Bank laborers (a daily average of c. 18,600 in 2005, reduced by half to c. 9,300 in 2006 as the separation barrier is completed, and disappearing thereafter); and c) West Bank foreign passport holders (c. 7,400 throughout).

12 In Gaza we assume that the management of Karni and Erez will remain significantly more constrained than in 2005 insofar as exports are concerned, though less so in relation to imports. In the West Bank, we assume both a tightening of border terminal management and (complementing this) that the separation barrier is completed in 2006.

13 We assume that a daily average of c. 6,000 permits is issued in 2006 and 2007, and that clandestine West Bank labor flows average 9,300 per day in 2006 and cease thereafter. West Bank foreign passport holders continue to have access to work in Israel.

14 Of this, c. US$60 million has been disbursed to date by Norway and the EC (in the latter's case to help the PA pay utility bills owed to Israeli companies), and US$42 million has been disbursed from the Bank-administered Reform Fund.

15 In the Bank's December 2005 projections, strong rates of economic growth were premised on a number of requirements that now appear unrealistic: a major reduction in Israeli closure measures (restrictions on border trade, movement inside the West Bank, movement and trade between Gaza and the West Bank), a maintenance of the relatively high labor flows of 2005 (averaging 45,000 per day), and a significant increase in aid levels (a further US$500 million per annum on average in 2006-8).

16 Macroeconomic Developments and Outlook in the West Bank and Gaza, prepared by the IMF for the AHLC Meeting, London, December 14, 2005.

Attachment
Illustrative Projections
March 2006 (US$ million)

	2005	Scenario 1			Scenario 2			Scenario 3			Scenario 4		
Assumptions	**(est.)**	**2006**	**2007**	**2008**	**2006**	**2007**	**2008**	**2006**	**2007**	**2008**	**2006**	**2007**	**2008**
Revenues transferred	740	790	783	778	100	0	0	704	696	689	100	0	0
Revenues withheld	0	0	0	0	489	568	573	0	0	0	422	503	507
Palestinian workers in ISI	44,800	32,800	20,100	7,400	22,700	13,400	7,400	32,800	20,100	7,400	22,700	13,400	7,400
Foreign assistance	1,300	1,300	1,200	1,100	1,300	1,200	1,100	1,100	1,000	900	1,100	1,000	900
Public consumption	1,514	1,551	1,567	1,583	1,243	1,243	1,243	1,514	1,514	1,514	1,071	1,071	1,071
Exports	590	647	681	723	500	540	576	655	690	732	506	547	585
Population (million)	3.51	3.63	3.76	3.88	3.63	3.76	3.88	3.63	3.76	3.88	3.63	3.76	3.88
Inflation (cpi, %)	3.5	2	2	2	2	2	2	2	2	2	2	2	2
Outcomes													
GDP	4,044	4,296	4,272	4,264	3,192	3,110	3,132	4,038	4,006	3,983	2,910	2,835	2,851
GDI	5,815	5,983	5,766	5,560	4,799	4,549	4,429	5,550	5,316	5,085	4,353	4,096	3,959
Private consumption	3,652	3,829	3,837	3,856	3,044	2,947	2,950	3,708	3,721	3,754	2,953	2,792	2,777
Investment	1,022	1,161	1,044	927	588	480	467	861	742	604	405	369	362
Imports	2,734	2,892	2,857	2,824	2,183	2,100	2,104	2,700	2,660	2,622	2,026	1,945	1,944
GDP per capita	1,152	1,183	1,136	1,099	879	827	807	1112	1066	1026	802	754	735
GDI per capita	1,657	1,648	1,533	1,433	1,322	1,210	1,141	1,529	1,414	1,310	1,199	1,089	1,020
Real GDP growth	6.3	4.9	-2.3	-1.7	-18.5	-4.3	-0.8	-0.2	-2.6	-2.1	-24.5	-4.3	-1.0
Real GDP p.c. growth (%)	2.7	1.3	-5.5	-4.9	-21.3	-7.4	-4.0	-3.6	-5.8	-5.3	-27.1	-7.4	-4.2
Real GDI p.c. growth (%)	4.3	-2.6	-8.6	-8.5	-21.9	-10.1	-7.7	-10.2	-9.2	-9.3	-30.0	-10.8	-8.3
Cumulative real GDP p.c. change since 1999	-30.6	-29.7	-33.6	-36.8	-45.4	-49.5	-51.5	-33.1	-37.0	-40.3	-49.4	-53.2	-55.1
Unemployment (%)	23.4	22.4	28.7	34.1	35.5	41.4	44.9	24.2	29.7	34.8	39.6	44.3	47.0
Poverty (%)	44	43	48	51	62	67	70	47	51	55	67	72	74

Scenario 1: No Abrupt Change
Scenario 2: Suspension of Clearance Revenue Transfers, Trade and Labor Restrictions
Scenario 3: Reduced Aid Flows
Scenario 4: Suspension of Clearance Revenue Transfers, Trade and Labor Restrictions, and Reduced Aid Flows