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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

Relative to the already difficult situation when the AHLC met in September 2012, the economy and public finances of West Bank and Gaza (WBG) have deteriorated further. The economy is hobbled by persistent restrictions and increasing political uncertainty. The liquidity crisis has deepened, with large increases in arrears and domestic debt, affecting core government operations. Urgent actions are needed—by the Palestinian Authority (PA), by the Government of Israel, and by donors—to stabilize the fiscal position and rekindle economic growth over time.

The WBG finds itself in a far more precarious situation than six months ago:

- Economic activity has slowed and unemployment has increased to almost a quarter of the labor force at end-2012, with youth unemployment particularly high.
- The liquidity crisis has deepened and the public finances are on an unsustainable path. Domestic sources of financing are drying up, with both the bank and non-bank private sector increasingly reluctant to finance the government. With transfer of clearance revenues held up repeatedly and donor aid insufficient to cover the fiscal deficits, wage payments have been repeatedly delayed and arrears continue to increase, with adverse effects on institution building and social stability. If left unchecked, these trends will ultimately lead some to question the legitimacy of the PA and undermine its ability to govern effectively.
- Israeli restrictions on movement and access are virtually unchanged and continue to hamper growth prospects in the WBG.
- Political uncertainty has increased. The military confrontation between Hamas and Israel last November, continued settlement expansion, and recent outbreaks of unrest in the West Bank underline the common view that prospects for peace remain dim. In addition, unrest in the region deepens the sense of gloom.

The WBG economy weakened in 2012, with a slowdown in growth and a rise in unemployment. Real GDP growth has declined from an annual average of about 11 percent in 2010–11 to 6 percent in 2012 (January–September) reflecting shortfalls in aid, lack of easing of restrictions on movement and access, and increased political uncertainty. Moreover, the fragile regional economic and political environment continued to further dampen the WBG's export and foreign investment prospects.

The economic outlook is for a further weakening of growth and risks are tilted to the downside. Real GDP growth in the WBG is projected to decline to 5 percent in 2013, far below recent growth rates, with a continuing downward trend in subsequent years. Underlying this outlook is the economic impact of virtually unchanged controls on internal movement in the West Bank, the persistence of obstacles to export and import in the West Bank and the virtual closure of Gaza, and, to a lesser extent, fiscal retrenchment. While the WBG's global economic linkages are limited by the Israeli trade restrictions, the regional downturn and rise in political turmoil further dampens the economic outlook. Absent a revival of the peace process, risks are mostly on the downside, given that persistent restrictions in the WBG and shortfalls in aid could lead to a faster deterioration in the macroeconomic environment, resulting in wider fiscal deficits and arrears accumulation. The withholding of Israeli revenue transfers and lower-than-expected donor aid are additional risks, with similar consequences for growth and the fiscal position.

The PA's fiscal situation is increasingly precarious, with mounting domestic payment arrears, including on public sector wages, and rising domestic bank debt. In

2012, substantial aid shortfalls and worse-than expected revenue and expenditure outturns led to large arrears accumulation (nearly 6 percent of GDP) to the private sector, the public pension fund, and wages, with bank loans to the PA rising to $1.4 billion. The liquidity crisis has started to affect government operations, threatening some of the institutional improvements made in recent years (especially in the area of public financial management) and eroding public confidence in the PA. For 2013, the draft budget (which will be finalized by end-March) targets a recurrent deficit of $1.3 billion (on commitment basis), which, combined with expected donor financing of $1 billion and payment of wage arrears, implies a financing gap of $0.4 billion. The financing gap could be even higher if aid falls short or if Israel requires repayment of clearance revenue advances provided in 2012.

Efforts by the PA to rein in the deficit should be accompanied by increased donor assistance and enhanced economic cooperation with Israel. With WBG's private sector weak, a sharp public sector retrenchment to cover the financing gap would further weaken the economy and raise already-high social tensions. That said, domestic financing constraints are becoming binding and there is a high risk that the hoped for additional donor assistance will not materialize, given fiscal problems in the donor countries and competing demands for aid. As a result, additional fiscal adjustment (over and above the draft budget) by the PA is necessary.

With revenues largely outside the PA's direct control, the fiscal adjustment should focus on the expenditure side, with additional contingency measures in case fiscal risks materialize. Staff recommends a cap on expenditure commitments to accommodate the tighter financing constraint, including in the 2013 budget through freezes in wages and promotions, compression of operational spending, rationalization of allowances, postponement of non-essential development projects, while making room for expanding coverage of the cash transfer program to protect poor and vulnerable households. On the revenue side, the budget should increase selected fees to strengthen cost recovery. The financing gap would be commensurately higher (and perhaps reach $0.7 billion) if certain risks were to materialize, including a shortfall in donor support for projects—as has happened in past years—or if the Government of Israel requires repayment of revenue advances and electricity debts that it claims are outstanding. These risks should be mitigated by devising a contingency plan containing further measures to avoid across-the-board expenditure compression. Separately, the Palestine Monetary Authority (PMA) needs to carefully monitor and guard against financial stability risks that could arise from the banks' increasing exposure to the PA at a time of weakening public finances.

Concerted actions by the PA, Israel, and the international community are urgently needed to address WBG's daunting challenges. First, it is important to promptly implement the understandings reached in mid-2012 between Israel and the PA on measures to enhance the collection of clearance revenue and ensure its timely transfer to the PA, given that such revenue represents the bulk of the PA's revenue. Second, a broadening of cooperation to include an easing of Israeli restrictions on external trade and movement of goods and people in the WBG is essential to expand private sector growth and employment, and substantially reduce reliance on aid. Third, it is critical for the international community to re-engage more fully in supporting the WBG's development, in particular by providing a framework for economic cooperation between Palestinians and Israelis. In the short run, it is especially important that the PA's efforts at containing fiscal spending be complemented by the prompt disbursement of additional donor aid to avoid an excessive fiscal tightening, a further buildup of arrears and debt to commercial banks, and spending cuts that would trigger more social unrest.

Beyond immediate crisis management, structural reforms are vital to put the WBG on a higher and sustainable growth path. This will require an easing of the Israeli restrictions, improvements in the business climate, and reform of the PA's civil service, pension systems, and healthcare system.

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