MACROECONOMIC AND FISCAL FRAMEWORK FOR THE WEST BANK AND GAZA: SEVENTH REVIEW OF PROGRESS[1]

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

Brussels, April 13, 2011

EXECUTIVE SUMMARY

The economic recovery continued in the West Bank and Gaza (WBG) in 2010, with real GDP growth estimated at 9 percent in 2010. However, the recovery cannot be sustained without a further easing of Gaza's blockade and of restrictions on movement and access in the West Bank. Gaza's recovery represents mostly a "catch up" from a very low base following the tightening of restrictions in 2006. Despite the surge in Gaza's output by 15 percent in 2010, driven by the easing of import controls, its level is lower today than in 2005 by about 20 percent, and the unemployment rate remains high at about 38 percent. The West Bank's strong performance since 2008 has been enabled by PM Fayyad government's sound economic management and reforms supported by donor aid, as well as some easing of Israeli internal barriers. Nevertheless, the West Bank's growth, which is estimated at 8 percent in 2010, is also bound to wane, especially with the Palestinian Authority (PA)'s continued fiscal retrenchment and declining aid, without a strong stimulus from a further easing of Israeli restrictions.

The PA has pursued a tight fiscal stance in 2010, and continued to undertake structural reforms in line with the vision toward statehood presented in the Program of the Thirteenth Government. The PA's fiscal performance has been broadly as envisaged in the 2010 budget, with a marked reduction in the recurrent deficit from 26 to 16 percent of GDP. Lower-than-expected donor aid for both recurrent spending and development projects has led to a buildup of expenditure arrears and borrowing from commercial banks. Progress in structural reforms in 2010 included applying the social safety net to target social assistance to the truly needy; the transfer of electricity distribution from several West Bank municipalities to commercial companies to reduce implicit electricity subsidies; and steps toward comprehensive pension reform.

IMF staff considers that the PA is now able to conduct the sound economic policies expected of a future well-functioning Palestinian state, given its solid track record in reforms and institution-building in the public finance and financial areas. Steady reforms in the public finance management system have enabled the PA to tightly control expenditures, apply rigorous budget preparation and execution practices, and establish fiscal transparency and accountability in line with international standards. These reforms, along with a prudent fiscal policy, have contributed to a rise in the quality of spending and a sharp reduction in donor aid for recurrent spending, from $1.8 billion in 2008 to $1.2 billion in 2010, with a view to a further reduction to less than $1 billion in 2011. The Palestine Monetary Authority (PMA)'s institutional reforms have enabled it to fulfill core functions of a central bank. These functions include the application of a rigorous banking supervision and regulatory framework, providing a strong credit and payment infrastructure, and monitoring compliance with a governance code and an anti-money laundering law.

The PA has made major strides since 2008 in raising the quality, transparency and timeliness of the WBG's economic and financial statistics. The Palestinian Central Bureau of Statistics (PCBS) is expected to meet all the requirements of the IMF's Special Data Dissemination Standard (SDDS) in 2011, reflecting the best practices applied by the PCBS as well as by the ministries and agencies that provide the source data. The quality, transparency and timeliness of the data produced today by the PCBS, Ministry of Finance, and the PMA compare favorably with those of IMF member countries that maintain high data management and dissemination standards.

The draft Palestinian National Plan (PNP) for 2011–13 envisages a steady reduction in the recurrent budget deficit to about 4 percent of GDP by 2013. The draft PNP is ambitious but achievable given the PA's strong track record in implementing the equally challenging Palestinian Reform and Development Plan for 2008–10 presented at the Paris Donors' Conference in December 2007. To further raise public sector efficiency, phase out reliance on aid for the recurrent budget, and sustain private sector confidence, it is essential for the PA to step up the implementation of structural reforms, including electricity sector, pension, and civil service reforms. For 2011, it is particularly important for the PA to abide by the expenditure ceilings set in the 2011 budget to achieve the targeted reduction in the recurrent deficit from 16 to 13 percent of GDP, especially given the highly uncertain global environment and prospects for donor aid. While expenditure arrears and domestic bank borrowing cannot be fully prevented in case of continued shortfalls in donor aid, the PA should do its utmost to minimize these by continuing with cost-saving measures, prioritization of operational expenditures, postponement of lower priority projects, and by making effective use of the Financial Management Information

System to better match expenditure commitments with cash availability.

To sustain the solid economic growth and reduce unemployment, prompt action needs to be taken by the Government of Israel (GoI) to ease restrictions on economic activity. The measures envisaged in the agreement between the Quartet Representative and the GoI in February 2011 are prime examples of initial practical steps that could be implemented despite political challenges. To ensure sustained and broad-based growth, it is important to implement these measures as scheduled and build on them by phasing out remaining restrictions on economic activity, in particular the restrictions on trade between the WBG and Israel, on internal barriers on movement in the West Bank, and on access by the private sector to about 60 percent of the West Bank's territory (Area C).

A key component of the agreement between the Quartet Representative and the GoI is the decision by the GoI to engage in discussions with the PA to agree on new measures to enhance the collection of clearance revenue. These discussions have started in March 2011, with the aim of settling outstanding issues by June 2011. One key objective should be to agree on practical steps to minimize clearance revenue leakages, including through: (i) enhanced monitoring by the PA officials of imports at border crossings to raise the collection of invoices for VAT and other taxes and fees; and (ii) an assessment of potential revenue on the basis of comprehensive data compiled by the GoI on imports from Israel into the WBG.

It is essential that adequate aid to support the PA's reforms be pledged as soon as possible and disbursed in a timely manner. For 2011, there is an urgent need to secure donor assistance to cover the recurrent financing requirements of $967 million. About $0.7 billion was disbursed or indicated by donors during the first quarter of 2011, leaving a financing gap of about $0.3 billion in the remainder of the year.

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