INTERNATIONAL MONETARY FUND

WEST BANK AND GAZA

December 17, 2006

1. A staff team visited Ramallah during December 11–17, 2006 to discuss fiscal developments and prospects with the Office of the President and financial sector developments with the Palestine Monetary Authority (PMA). The mission also met with representatives of the business community, commercial banks, and international aid organizations to assess the extent of the decline in economic activity this year. The mission expresses its gratitude for the open and frank discussions and the hospitality offered during the mission's stay.

2. Resources to fund recurrent government expenditures have remained severely constrained in the last quarter of 2006.[1] External support remained relatively strong, with about $136 million disbursed this quarter, by mid-December—–of which some $104 million was channeled through the Temporary International Mechanism (TIM) and $32 million received from Arab donors via the accounts of the Presidency—bringing the total amount of external support received so far this year to over $700 million. All three windows of the TIM are now fully operational. The scope of its allowances has been expanded and now reaches over 140,000 beneficiaries. Together with the Arab donors, the TIM has been instrumental in cushioning the adverse impact of the diplomatic and financial isolation of the government on the Palestinian population.

3. The limited financial resources available have been used largely for payments to government employees and social hardship cases, and, to a lesser extent, to ensure the continued supply of fuel and utilities. By mid-December, an additional $110 million in payments to government employees have been made this quarter, which means that, since the Hamas-led government took office at end-March, they received on average some 40 percent of their normal incomes, but with considerable differences in this ratio between various categories of employees. Consideration is apparently being given to the possible use of the clearance revenues withheld by the Israeli government to settle arrears to Palestinian private suppliers and hospitals. Although intuitively attractive, the mission cautions that arrears should be carefully inventoried, verified, and prioritized before any are settled. Also, use of withheld clearance revenues in the suggested manner means that the amounts will no longer be available to clear wage arrears in the future.[2]

[1] Total resources available to finance recurrent government expenditures in the last quarter of 2005, including tax revenues, external support, and domestic financing, amounted to almost $525 million.

[2] The clearance revenues include customs duties, VAT on imports, and excises on petroleum products. Parts of these revenues continue to be used to pay for utilities supplied by Israeli suppliers or have otherwise claims against them.

4. The disintegration of the public financial management system is continuing. Sizable amounts of cash are reportedly being brought in from abroad, without adequate recording of the amounts or their uses. More generally, reporting on fiscal operations has weakened further. In this context, the mission welcomes the Presidency's intention to report regularly on its financial operations and to issue audited financial statements on the amounts received in its accounts and their use.

5. The fiscal outlook obviously depends heavily on the political situation. The political outlook has become more uncertain, as discussions on a new national unity government have stalled and the President has called for new elections to be held. This has increased the prospect that the political impasse witnessed during 2006 will continue, both domestically and internationally, for at least several more months. Consequently, financial resources—and thus spending—can be expected to remain severely constrained. Even assuming continued strong Arab support of $40–50 million per month, sizable TIM disbursements of some $30–40 million per month now that it is fully operational, and $15 million per month in domestic revenues, this would still cover only about half to at most two-thirds of monthly recurrent expenditures, and less if banks continue to reduce their exposure to the government. In this case, fiscal policy will remain limited to carefully selecting which payments to make using available funds.

6. If and when a new government that would allow for a normalization of international relations is formed, it will be imperative to address the underlying unsustainable fiscal position. Otherwise, based on passive projections, a new government would face a budget deficit of more than $110 million per month or about $1.3 billion (roughly 30 percent of GDP) on an annual basis—an amount that would be unlikely to be fully covered by external support and domestic financing. Any new government will therefore need to take strong and politically very difficult measures to address the underlying problems and reduce the fiscal gap. The government will urgently need to reduce its wage bill, improve the collection of utility bills, eliminate the subsidization of petroleum products, and streamline social transfers.

7. In the short term, one measure that would be hard to escape would be a (partial) reversal of the 2005 wage increase. A reduction, in one way or another, of "take-home pay" could in principle be temporary, to be phased out gradually as additional resources become available when the economy recovers. The government payroll would need to be reviewed, with a view to an early retrenchment of inactive employees. At the same time, a schedule to settle wage arrears would need to be established—depending on financing prospects—although the release of clearance revenues withheld by Israel could cover part—but not all—of these. Again, nonwage arrears will need to be inventoried and audited, before any are settled. Other measures to improve the government's finances—such as further retrenchment of employees, improving utility bill collection, and social safety net and pension reforms—would take longer to implement. Reducing public employment, for example, will be difficult to achieve without an adequate social safety net and a strong revival of the overall economy. The latter will require a major easing of restrictions on movement and access, starting with the implementation of the November 2005 Agreement on Movement and Access. Security sector reform, while focusing primarily on stability and security, will also increasingly need to take into account affordability, in light of the need to contain spending. For the

government to be able to take such difficult measures, it will be critical that it can provide adequate assurances to the population that it can meet its recurrent obligations, requiring in turn that it can rely on sufficient and predictable financial resources—including foreign assistance and clearance revenues—to do so.

8. Following the formation of a new government, the authorities, as well as the international community, will also need to quickly endeavor to repair the damage done to the public financial management system. In particular, government finances should again be centralized in the Ministry of Finance, with the re-establishment of the Single Treasury Account (STA); the accounts of the Office of the President should be brought under the STA. Efforts that had been underway to strengthen internal and external audit functions will need to be revived, and commitment control will need to be strengthened.

9. Meanwhile, the PMA has been actively addressing the fall-out of this year's political difficulties on the financial sector. So far, the situation has been manageable and banks in West Bank and Gaza (WBG) remain liquid. Deposits have continued to grow, apparently reflecting strong inflows from abroad. Banks have also continued to extend credit to the private sector, although this has slowed considerably in recent months. Banks do have a sizable exposure to the Palestinian Authority (PA) and to PA employees. They have been able to significantly reduce their exposure to the PA, while a large part of the remaining loans to the PA are collateralized by the assets of the Palestine Investment Fund. Debt service obligations due by PA employees have been relatively small, in part because loans were rescheduled. Banks have also started to deduct small amounts from allowances and partial wage payments paid to government employees to help cover interest due. But as loans to PA employees have little or no collateral, other than wages and personal guarantees, these loans will become a concern if normal payments of PA salaries do not resume in the near future. In this case, banks will need to start provisioning for these loans. Loans to PA employees are spread across several banks, but the risks are mainly concentrated in a few domestic banks that have a narrower capital base. The PMA is working with these banks to develop remedial plans aimed at reducing the size of loans to PA employees relative to their capital, including by retaining all profits.

10. Also, the PMA has been working closely with the Bank of Israel (BoI) to ensure continued relations between Israeli banks and those in WBG. Measures agreed with the BoI focus mostly on improved disclosure by both sides on bank transactions, in line with international practice, and prohibiting check endorsements. The new Anti-Money Laundering/Combating Financing of Terrorism (AML/CFT) implementing regulations adopted recently in Israel—which include tougher identification and reporting requirements for transactions with banks in WBG and which are to be implemented within one year—together with similar regulations issued in October by the PMA to banks in WBG—which are to be implemented within six months—should enable banks on both sides to continue doing business with each other.

11. The economy has suffered from the deteriorating security situation, intensified closures, and the fiscal crisis. Much stronger-than-expected official and private inflows, including increased humanitarian assistance, however, appear to have helped avoid a major decline in gross national income and consumption levels. Gross domestic production is still

believed to have fallen, although considerably less than initially expected, reflecting these sizable inflows. The Palestinian Central Bureau of Statistics estimates the decline in output in the third quarter of 2006, compared to the same period in the previous year, at about 8 percent (at factor cost). The decline has been most pronounced in Gaza, which has been subject to major closures, but appears to have been much more limited in the West Bank. Thus, the disparities between Gaza and the West Bank have increased substantially, as well as those between the higher income groups and the poorest segments of the population, with the sharpest increases in poverty being witnessed in Gaza.