MACROECONOMIC DEVELOPMENTS AND OUTLOOK IN THE WEST BANK AND GAZA

AD HOC LIAISON COMMITTEE MEETING

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INTERNATIONAL MONETARY FUND

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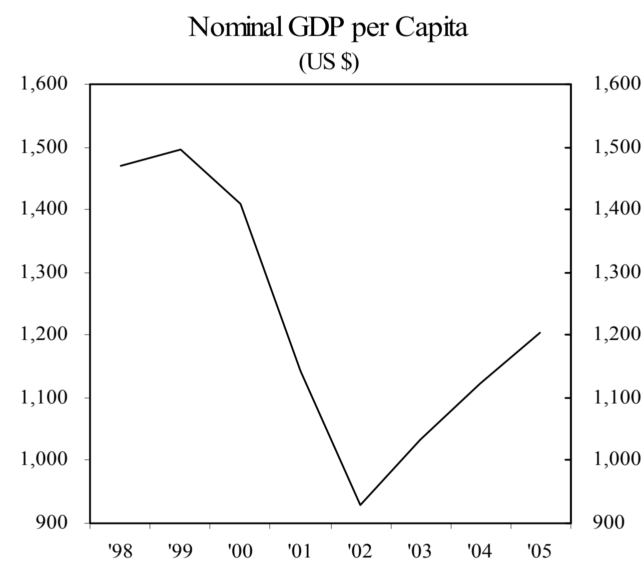
I. RECENT ECONOMIC DEVELOPMENTS

1. **Economic activity in the West Bank and Gaza (WBG) continues to recover but remains highly dependent on political and security developments**. Real GDP continued to rebound in 2004 from the effects of the Intifada, with growth estimated at 6 percent, driven by increases in manufacturing, trade, and transportation. In addition, speculative real estate activities boosted construction in some parts of the West Bank. Growth continued at a similar pace in the first half of 2005, supported by a substantial increase in public spending, with notable increases in activity in trade, transportation, services, and agriculture, which together constitute nearly half of GDP. In addition, the Israeli disengagement from Gaza fuelled activity in construction and real estate. Consequently, GDP growth is projected to remain at around 6 percent in 2005. Nonetheless, economic activity remains well below its potential, constrained by the volatile security situation, continued Israeli restrictions on passage, and further extensions of the separation wall—all of which continue to severely limit the movement of Palestinian goods and people. The recent agreement on movement and access is a very welcome step that should help to ease some of these constraints.

2. **Despite the recovery, economic and social indicators in WBG remain severely affected by years of conflict.** Notwithstanding robust growth since 2002, nominal income per capita (at about $1,100 in 2004) remains around 25 percent lower than in 1999, prior to the Intifada. About half the population in WBG lives in poverty.



3. **Unemployment remains very high.** Despite rising employment (mainly in services), the overall rate of unemployment in the West Bank is over 20 percent, with Gaza unemployment at 30 percent. While structural unemployment has generally been higher in Gaza, the situation has been exacerbated by restrictions on the movement of

Palestinians in Gaza, which have prevented them taking up employment opportunities in Israel and the West Bank.

Regional Social Indicators, 2004

	Unemployment Rate	Nominal per Capita GDP (US$)
WBG	26.8	1,122
Jordan	14.3	2,043
Egypt	9.6	1,111
Morocco	12.0	1,677
Tunisia	14.2	2,848
Israel	9.1	17,781

4. **Inflation remains relatively low, at 5 percent in October 2005.** Price increases in WBG largely mirror inflation developments in Israel, although the cost of living in WBG continues to be adversely affected by the high costs of transportation, mainly reflecting restrictions on the movement of goods. A small spike in inflation in October 2005 was largely due to increased food prices.

5. **Despite the volatile economic and political situation, the financial sector is sound.** Private sector deposit growth has slowed, but the level of deposits remains high, at 74 percent of GDP. Credit to the private sector has expanded rapidly, by about 30 percent over the past year, with the increase benefiting various sectors, including real estate projects in Gaza following the Israeli disengagement. As a result, credit to the private sector has risen to 28 percent of GDP but remains very low relative to other countries in the region. Moreover, liquidity in the banking sector remains high, with a liquidity ratio of about 72 percent. Although the financial situation of commercial banks continues to strengthen, with increased profitability and a lower rate of non-performing loans,[1] the Palestine Monetary Authority (PMA) has yet to resolve the situation of a few undercapitalized, non-systemic banks.

Regional Financial Indicators, June 2005

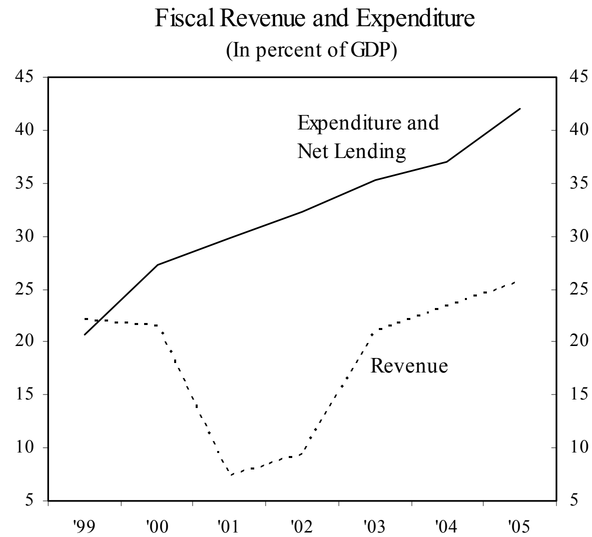
	Credit to the Private Sector	Private Sector Deposit s
	(In percent of GDP)	
WBG	28.4	74.3
Jordan	70.4	47.0
Egypt	43.5	76.7
Morocco	63.3	78.3
Tunisia	59.3	25.0
Israel	94.6	93.3

II. Budgetary Operations in 2005

A. Overview

6. **The budget deficit has widened sharply in 2005, with increases in expenditure and net lending that more than offset continued strong revenue performance, while donor support has fallen short of the Palestinian National Authority's (PNA) expectations even before recent policy slippages.** In the first three quarters of 2005, compared with the same period in 2004, revenues increased by 26 percent in nominal terms

[1] The share of NPLs decreased from 10.4 percent at end-2004 to 8.3 percent at end-June 2005, mostly due to restructuring and rescheduling of loans, with enhanced monitoring and management of loan portfolios by banks.



while expenditures[2] increased by over 30 percent.[3] The expenditure increases were mainly accounted for by a higher wage bill, particularly since mid-year, a substantial increase in net lending to the Gaza Electricity Distribution Company (GEDC) and municipalities for the payment of utility bills, and higher transfers. The fiscal deficit for the first three quarters of 2005 was US$536 million, compared with a deficit of US$400 million for the same period in 2004 and US$574 million for 2004 as a whole. Only US$301 million in external budget support was disbursed by end-September, less than half of the US$654 million foreseen in the budget for the year as a whole. The resulting fiscal gap was financed mainly by unplanned borrowing from domestic banks and advances from the Palestine Investment Fund (PIF).

B. Revenue

7. **Budgetary revenues continued to outperform budget projections in 2005.** Gross revenues in the first three quarters of 2005 exceeded budget projections by 12 percent and are projected to reach over 25½ percent of GDP in 2005, above the regional average of 23½ percent of GDP for lower and middle-income countries. Administrative measures, as well as the pick up in economic growth and higher international petroleum prices, contributed to a 26 percent increase in domestic taxes during the first three quarters of 2005 from the same period last year, and a 20 percent increase in clearance revenue transferred by the Government of Israel (GOI) over the same period.[4] In particular, enhanced monitoring and cross-checking of taxes due by some large tax payers resulted in improved compliance.

C. Wage Bill and PNA Employment

8. **The wage bill was broadly in line with the Wage Bill Containment Plan (WBCP, Box 1) during the first half of 2005.** Overall, the total wage bill for the period amounted to 50 percent of the annual budget allocation. The civil service wage bill was around 13 percent

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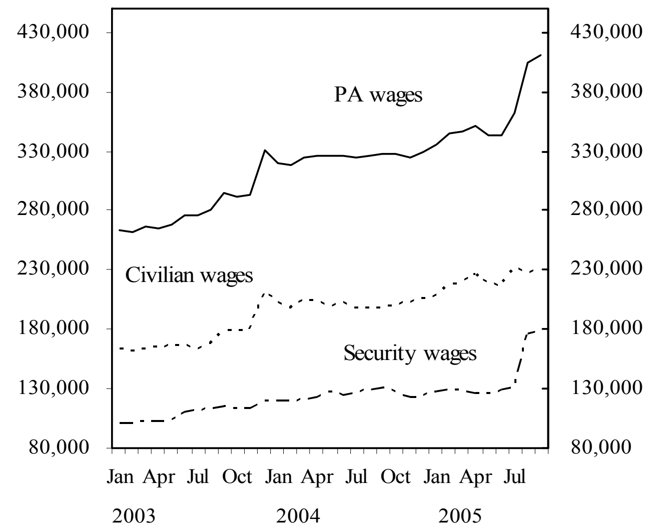
[2] Includes wages, nonwage current expenditure, PNA-financed capital expenditure, net lending, and VAT refunds.

[3] Throughout the text, percentage changes in revenue or expenditure refer to revenue and expenditure in New Israeli Shekels (NIS).

[4] Clearance revenues are indirect taxes collected by the Government of Israel on behalf of the PNA, and represent about two-thirds of total revenue.

of GDP, similar to the level in 2004. Net recruitment—at 2,660 new civil servants through end-June 2005—was higher than indicated under the WBCP, but the recruitment was mostly in the health and education sectors, and there was apparently no net recruitment of security forces, in line with the plan. As a result, with revenues performing strongly, the ratio of the wage bill to gross revenue declined significantly, from 91 percent in 2004 to 79 percent during the first half of 2005, representing a more rapid decline than envisaged under the WBCP.

Monthly Wage Bill of Public Employees
(In thousand NIS)



Box 1. The Wage Bill Containment Plan

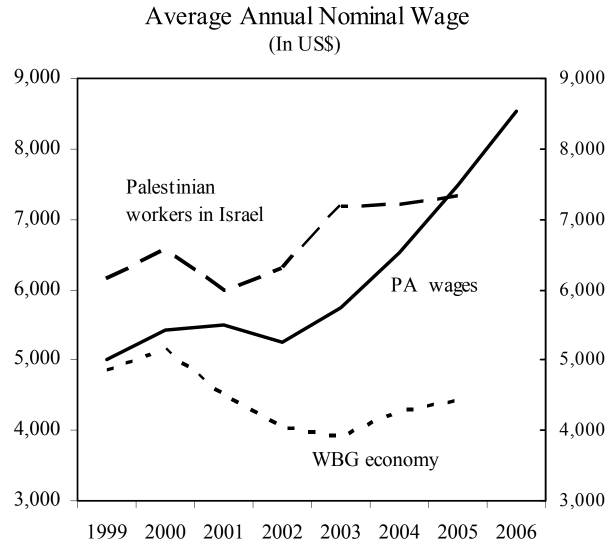
Following wage increases in 2003, and in light of the large share of the wage bill in budgetary expenditures and the need to reduce the deficit to more sustainable levels over the medium term, the authorities agreed during 2004 to a Wage Bill Containment Plan (WBCP) spanning the years 2004-2006.

The WBCP aims at: (a) maintaining a stable security forces wage bill in nominal terms, with any salary increase to be fully offset by a decline in employment (except for some drift reflecting promotions); (b) limiting net recruitment to 2,000 persons in 2005, mostly in the areas of health and education; (c) restraining salaries to a 2 percent wage drift by, in particular, not raising professional allowances for teachers nor implementing the second phase of the 1998 Civil Service Law; and (d) reducing the wage bill to 80 percent of budgetary revenue by 2006.

Adherence to the WBCP has been established as a benchmark for disbursements from the World Bank administered Public Finance Reform Trust Fund.

9. **However, since July, salary increases have been very large, leading to a substantial breach of the WBCP.** Notwithstanding the understandings under the WBCP, the authorities went ahead with implementation of the second phase of the civil service law in July 2005, beginning in the ministry of education with a 13 percent increase in its payroll between June and July. The new salary scale for the civil service was extended to all ministries in October, with an effective date of July 2005, and is expected to result in an average salary increase for the civil service of 15-20 percent. In addition, the adoption by the cabinet of the security service law in February 2005 intensified pressures to increase the salaries of PNA security personnel. Consequently, active security personnel were granted salary increases of 30-40 percent under a new salary scale implemented in August 2005. As a result of these changes, the average wage of PNA employees is now estimated to exceed the

average wage of Palestinian workers employed in Israel, and its divergence from the average wage in West Bank and Gaza continues to grow rapidly.



10. **Moreover, PNA employment has continued to rise, with some recruitment of security personnel since mid-year.** About 4,000 militants started to be integrated into the security forces over the summer, and will undergo training for several months.[5] At the request of the ministry of finance (MOF), security organizations have provided lists of performing personnel in order to facilitate the identification of non-performers. Eight to ten thousand personnel were identified as non-performing in September 2005.

11. **As there has been no significant employee retrenchment to offset the July-August wage increases—and none is likely before the January 2006 parliamentary elections—there will be a substantial breach of the WBCP for 2005 as a whole.** Net recruitment seems certain to exceed the WBCP indicative limit. The wage bill for security forces is set to rise by nearly 20 percent between 2004 and 2005, while the civil service wage bill is likely to increase by around 15 percent. As a result, the ratio of the wage bill to gross revenues is projected to increase from 79 to 95 percent between the first and the second halves of 2005. In sum, net recruitment, average wage increases, and consequently the wage bill growth are all expected to substantially exceed the objectives stated in the WBCP.

D. Net Lending

12. **Net lending has increased sharply relative to 2004 and has already substantially exceeded the 2005 budget allocation (Box 2).** Total PNA net lending averaged US$25 million per month during the first three quarters of 2005, more than double the budget allocation of about US$11 million per month. This is partly due to higher fuel costs and increases in electricity fees by Israeli providers. The council of ministers issued a circular to the municipalities in July giving them full responsibility for the payment of their bills, even if it means cutting off service to non-paying households, but this has not yet resulted in higher collections and lower deductions by the GOI from PNA revenues.

[5] PNA employment numbers shown in Tables 1-3 do not include these militants, as their status remains unclear.

Box 2. Net Lending

Net lending reported monthly by the ministry of finance includes:

1. Fuel oil expenses paid by the PNA to the Gaza Power Generation Company on behalf of the GEDC, which amounted to US$99 million in 2004 and US$99 million in January-September 2005. In addition, Israeli electricity companies send monthly reports on amounts owed for electricity provided to the GEDC. The amounts are then deducted by the GOI from the clearance revenue transferred from the GOI to the PNA.

2. The General Petroleum Corporation must meet monthly payments for petroleum purchased from an Israeli petroleum company. Gaps in payments, which amounted to US$40 million in January-September 2005, are met by the PNA.

3. Loans to municipalities for the delivery of water services, from US$2 to 3 million per month. Mekorot, the Israeli water company, sends monthly reports on amounts owed for water distribution. The amounts are then deducted by the GOI from the clearance revenue transferred from the GOI to the PNA.

4. Electricity bills and water bills unpaid by households: over 40 percent of unpaid electricity bills to Israeli companies are due by households to municipalities. Amounts owed are deducted by the GOI from clearance revenue transferred from the GOI to the PNA.

5. Additional financing to municipalities, other local governments, public agencies and for some personal loans.

In 2005, up to end-September, total deductions from clearance revenue by the Government of Israel represented about 40 percent of total net lending expenditures.

Net Lending by the PNA in January-September 2005
(In million of US$)

Total	227
Gaza Electricity Distribution Company	144
Financed directly by the PNA	99
Financed through clearance revenue deductions	45
General Petroleum Corporation	40
Financed directly by the PNA	40
West Bank municipalities	36
Financed directly by the PNA	-2
Financed through clearance revenue deductions	38
Other 1/	7

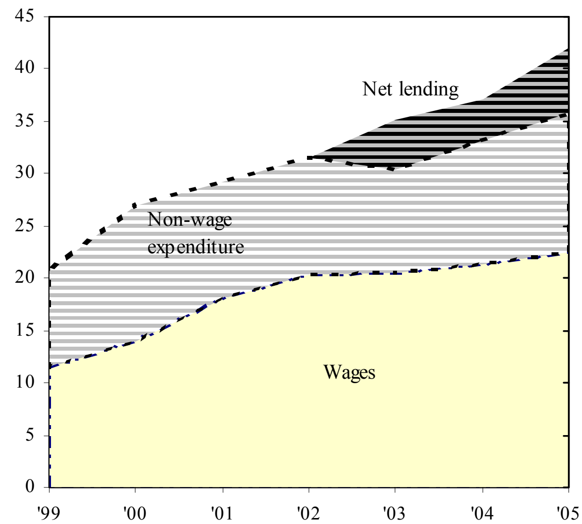
Source: Palestinian authorities.
1/ Includes payments to Israeli utility companies on behalf of other entities, personal loans, and loans to enterprises and to NGOs.

E. Nonwage Expenditures

13. **Nonwage spending is rising rapidly, although shortfalls in external budget support and large increases in the wage bill and net lending have squeezed it relative to budget provisions.** Through end-September, non-wage expenditures were running about 1 percent of GDP below the budgeted amount. Nonetheless, non-wage expenditure increased by 34 percent in the first three quarters of 2005 (on a year earlier), driven principally by an increase in transfers and, to a lesser extent, increases in operating expenses and PNA-financed capital spending.

14. **Spending on transfers increased by about 47 percent in the first three quarters of 2005, reflecting the introduction of the temporary unemployment insurance scheme, as well as higher pension and poverty-related spending.** The temporary unemployment compensation scheme is funded from the financial reserve[6] of the ministry of finance and targets the unemployed previously working in Israel or in industrial zones. There were increases in pension allowances due to additional retirements, and higher transfers paid by the ministry of labor and social affairs (MLSA) reflecting its appropriation for consolidated hardship and poverty alleviation programs.[7]

Composition of Expenditure and Net Lending
(In percent of GDP)



15. **Operating expenses increased by a relatively modest 15 percent in the first three quarters of 2005, with most of the increase accounted for by the ministry of interior and internal security, and debt service.** Compared to budgetary allocations, however, operating expenses were squeezed, as budgetary pressures forced cutbacks, especially on maintenance expenses.

[6] The rationale provided by MOF for keeping this appropriation in the Financial Reserve, instead of allocating it to MLSA, is to maintain its temporary characteristic.

[7] Excluding the special unemployment transfer program contingent on US$240 million in donor financing, which failed to materialize.

F. Deficit and Financing

16. **As external budget support has fallen short of budget projections, the increasing deficit has been financed by higher than anticipated borrowing from domestic banks and the transfer of exceptional profits and advances from the PIF.** Only just over half of the deficit for the first three quarters of 2005 was covered by external grants. As a result of the breach of the WBCP, further donor support under the Reform Trust Fund—beyond the US$53 million disbursed in September—is likely to be suspended. After budget support, the remaining deficit of nearly US$240 million was financed by borrowing from domestic banks,[8] exceptional profits and advances from the PIF, and receipt of tax revenues previously withheld by the GOI. While data are still incomplete, it appears that during the first half of the year, when budgetary pressures were less acute, the authorities were able to repay substantial arrears, in particular VAT refund arrears to international organizations, as well as arrears to private suppliers.[9]

West Bank and Gaza: External Budget Support, 2004-2005
(In millions of U.S. dollars)

	2004	2005		
		Prel.	Proj.	
		Jan.-Sep.	Oct.-Dec.	Jan.-Dec.
Total budget support	353	301	61	362
Arab countries	98	147	57	204
Of which:				
Saudi Arabia	77	15	31	46
Kuwait	0	40	0	40
Oman	0	1	0	1
Qatar	0	11	0	11
Libya	14	0	0	0
Egypt	3	1	0	1
Algeria	0	78	26	104
Tunisia	2	0	0	0
Other Arab	2	2	0	2
European Union	50	0	0	0
World Bank (ESSP)	67	22	4	26
Bank Trust Fund	118	132	0	132
EU	56	78	0	78
WB	20	0	0	0
Norway	12	21	0	21
Canada	7	0	0	0
UK	12	0	0	0
Japan	10	30	0	30
Australia and Korea	1	0	0	0
France	0	3	0	3
Other assistance	20	0	0	0

Source: IMF staff and Ministry of Finance

[8] Outstanding PNA debt to commercial banks reached a record US$583 million at end-September.

[9] Both UNRWA and UNDP are now on a "current" status with respect to VAT.

G. Projections for 2005

17. **With the budget deficit overshooting and external financing falling short, the PNA is facing a liquidity crisis.** Based on current trends in revenue, and even assuming sharp expenditure restraint in the last two months of the year in response to liquidity pressures, the deficit is projected at about US$70 million per month during the last quarter of the year. This would take the projected deficit for 2005 as a whole to about US$760 million, or nearly 17 percent of GDP compared with 14 percent of GDP in 2004. Furthermore, the PNA is not expected to be able to meet its wage bill with its own revenue during the last quarter of 2005. External budget support for the year as a whole is projected at US$362 million, well short of the US$654 million envisaged in budget projections. Financing from the release of previously withheld clearance revenue by the GOI has been largely exhausted. In the absence of increased external support, likely sources of financing are continued borrowing from domestic banks, additional advances from the PIF and, probably, accumulation of arrears, particularly toward the pension fund and private suppliers.

H. Public Finance Reforms in 2005

18. **The PNA continues to make progress on public finance reforms, including in areas monitored by the Reform Trust Fund administered by the World Bank.**

- First, in areas pertaining to the rules governing PNA employment: the unified pension law (UPL) was approved in June and its by-laws approved in October; an audit of the PNA's payroll for civil servants was completed by end-June, and an audit of security personnel was completed in September.

- Second, regarding reforms to improve expenditure management and control: the MOF supplies catalogue bidding document was revised according to the recommendations of the country procurement assessment report; and new financial regulations for ministries and public establishments were approved in August.

III. Outlook For 2006

A. The Fiscal Outlook Under Current Policies

19. **With unchanged policies, the fiscal deficit for 2006 is projected at about US$940 million or nearly 19 percent of GDP, about 2 percentage points of GDP higher than the expected outcome in 2005.** Projected gains in revenue would be more than offset by expenditure increases due to the full year effect of the mid-2005 wage increases for civil

servants and security employees,[10] and the impact of integrating security forces under the UPL.[11]

- The revenue-to-GDP ratio is projected to remain around 25½ percent in 2006. Clearance revenue is projected to increase by 12 percent, reflecting sustained improvements in revenue administration, while domestic tax revenues are also projected to increase by 12 percent as a result of administrative improvements and the wage increases for PNA employees, which will contribute to enhancing income tax collections.

- In the absence of measures, expenditure and net lending would increase from 42 percent of GDP in 2005 to 44 percent of GDP in 2006, reflecting increases in the wage bill of 14 percent for civil servants and 18 percent for security personnel. No significant reduction in net lending, as a share of GDP, is projected under this scenario, reflecting the political constraints on decisions to cut the supply of utilities to non-paying households.

20. **In the absence of large expenditure cuts and revenue measures, the fiscal deficit would likely remain in the range of US$900-950 million in 2007-2008, declining only gradually as a percentage of GDP.** This is clearly unsustainable, as it is two to three times the amount secured in external budget support in 2004 and projected for 2005. On the assumption that external support continues at a level similar to the actual disbursements over the past two years, this would leave a very large gap to be covered from alternative sources. Moreover, the alternative sources that have been used so far are likely to become increasingly problematic: domestic bank borrowing has risen very rapidly and is becoming a costly additional burden on the budget; the transfer of clearance revenue previously withheld by the GOI is dwindling; and PIF assets should be assigned to more productive uses, in order to support medium-term growth and development.

B. An Adjustment Scenario

21. **There is therefore an urgent need to restore a sustainable fiscal position.** Convergence of expenditures toward revenues over the medium term is essential to ensure fiscal sustainability and continued donor support. In the 2006 budget circular issued in July 2005, the ministry of finance clearly stated its commitment to reduce the fiscal deficit to a level that can realistically be fully financed on a sustained basis. While the medium-term objectives set out in the circular remain broadly unchanged, recent decisions and developments have made it virtually impossible to achieve the objectives for the next couple of years. In particular, reducing the deficit in 2006 to US$480 million, as envisaged in the

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[10] Estimated at about US$225 million on a full year basis.

[11] The PNA will have to pay employer contributions to the pension fund for all security personnel aged less than 45.

circular, would require a fiscal contraction of over 9 percent of GDP, compared with the expected outturn in 2006 under unchanged policies. Adjustment will therefore likely have to be phased over about three years, but it is essential to take corrective measures as quickly as possible in order to begin the adjustment process.

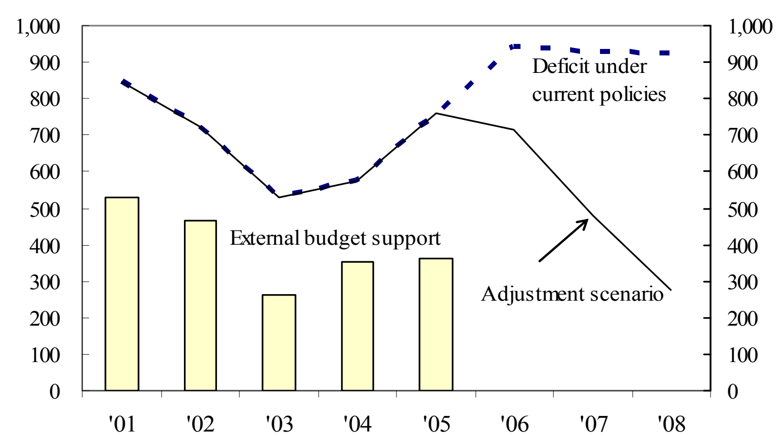
Fiscal outlook

22. **In light of recent developments, the authorities have asked the IMF and the World Bank to develop an updated medium-term scenario, underpinned by fiscal measures, to reduce the fiscal gap over 2006-2008 and achieve fiscal sustainability.** This is still work in progress and will need to be refined and supported by the specification of concrete measures, in coordination with the PNA. However, preliminary projections indicate that an illustrative package of significant measures (Box 3) could limit the deficit to around US$715 million in 2006, and reduce it substantially to US$480 million in 2007 and US$280 million in 2008—a fiscal contraction of around 12 percent of GDP phased over three years. The package would include revenue measures, as well as expenditure measures aimed at reducing the wage bill and net lending, and at merging existing social programs into a consolidated and affordable social safety net that could be sustained over time. This scenario would entail a substantial financing gap in 2006 and 2007, which would likely require continued recourse to bank borrowing and use of PIF resources. Moreover, the projections do not include certain temporary costs—nor the financing—associated with public expenditure restructuring, including the costs of a retrenchment fund, a possible recapitalization of the pension

Fiscal Adjustment 2005-08
(Percent of GDP)

	Contribution to Three-Year Adjustment
Revenue measures	1.8
Expenditures	5.2
Of which:	
Civilian wages	1.1
Security wages	1.8
Transfers	0.8
Net lending	4.9
Total	11.9

Fiscal Impact of the Adjustment Scenario
(In million of US$)



fund, and increased social safety net costs needed to facilitate enforcement of utility bill payments. It will be necessary to work on detailed cost estimates over the next few months, in close consultation with the PNA and the World Bank.[12]

Box 3. Possible Measures to Reduce the Fiscal Gap

- Unifying the direct and indirect tax administrations and improving cross-checking of direct declarations and VAT invoices. This requires accelerating the implementation of a large taxpayer office and further progress in revenue administration computerization project. This is projected to bring income tax revenue progressively to a level comparable to other countries in the region.
- Retrenching 10,000 inactive security employees in 2006. Retrenchment of additional civil servants and security employees would be desirable but would be contingent on financing of a retrenchment fund.
- A net hiring freeze on civil servants.
- No further wage increases, other than due to wage drift (about 2 percent a year).
- Strengthen payroll management procedures.
- Very sharp reduction in net lending.
- Merging and consolidating existing social programs, based on the outcome of the upcoming Public Expenditure Review (PER) of the World Bank.

23. **Given the very large share of the wage bill in the budget, retrenching PNA personnel is a key component of the fiscal package.** Under the envisaged package, 10,000 inactive security employees would be retrenched in 2006, which would generate savings of about 1½ percent of GDP that year. Furthermore, there would be no net hiring of civil servants through the medium term, implying that additional labor demands of priority sectors such as health and education would be met through offsetting retirements and shedding of redundant employment in other areas. Retrenchment of civil servants would be greatly facilitated by the establishment of a retrenchment fund, for which additional financing would need to be found.[13] Finally, there would be no wage increases over the planning horizon other than on account of wage drift (about 2 percent per year). As a result, the ratio of the wage bill to revenue would decline significantly from about 87 percent in 2005 to 71 percent in 2008, a level better aligned with regional comparators.

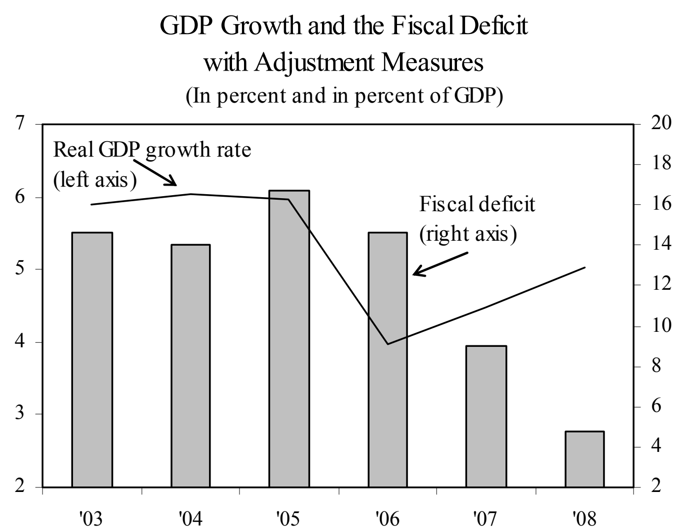
[12] In the meantime, the scenario presented here does not include any net reduction in PNA employment beyond the 10,000 security personnel identified as inactive.

[13] To the extent that external financing for severance payments is available, retrenchment of an additional 10,000 employees (both civil servants and security) would save another $85 million per year.

24. **The fiscal package also relies heavily on a sharp reduction in net lending.** Net lending would need to fall progressively from a projected US$280 million (6¼ percent of GDP) in 2005 to under US$100 million (1¼ percent of GDP) in 2008. This would require bold reforms in the management of the utility companies aimed at raising compliance rates in payments of bills and solving technical issues in the electricity sector (such as expanding the distribution network in Gaza and substituting gas for fuel oil in electricity generation). It will also require municipalities in the West Bank to cut utility supplies to non-paying customers.

Macroeconomic outlook

25. **Implementation of the fiscal stabilization measures outlined above will likely cause growth to slow in the short term, even in a generally favorable scenario of improving security and business conditions.** Recent economic growth, particularly in 2005, has been sustained in part by a sizeable fiscal stimulus. As this stimulus is withdrawn, growth is likely to slow initially, before recovering to recent rates over the medium term, as the beneficial effects of fiscal consolidation on the PNA's credibility help to boost private sector confidence and revive investment. The projections assume that a steady improvement in the political and security situation will also provide a positive boost to growth and help to limit any temporary slowdown.



C. Risks to the Outlook

26. **The macroeconomic and fiscal outlook described here is subject to a variety of risks.**

- Most critically, it depends upon a steady improvement in the political and security situation. The real growth rates underpinning medium-term projections assume that private sector investment and spending, rather than the government, will become the engine of growth. This would require a major relaxation of Israeli closures and checkpoints over the next three years, allowing much freer movement of people and goods in the West Bank and Gaza. In the absence of this, growth is likely to slow much more sharply than envisaged here, which would severely undermine the fiscal stabilization plan.

- Second, the feasibility of the required reduction in PNA personnel in both security and the civil service is questionable in the absence of the establishment of a public service retrenchment fund, and if there is no improvement in job opportunities in the private sector. A major concern is that a large and quick retrenchment of security personnel may result in increased criminality and a deterioration of the security situation if these people are left without alternative sources of income. In addition, the unified pension fund will likely need to be recapitalized, in order to accommodate the increase in retirements expected under the implementation of the UPL. The associated one-off costs of these important structural reforms have not yet been fully worked out, nor is it yet clear how they would be financed.

- Third, restoring fiscal sustainability hinges on reducing net lending by improving managerial practices at the GEDC and the compliance rate in the collection of utility bills. In an environment where non-payment has become deeply embedded, and given the serious political constraints on cutting supplies to non-payers, making progress in this area will be a major challenge. The PNA will need to formulate a concerted and convincing action plan to deal with this problem effectively.

Table 1. West Bank and Gaza: Macroeconomic Framework, 2001–2008

				Est.	Projections			
	2001	2002	2003	2004	2005	2006	2007	2008
	(In millions of U.S. dollars, unless indicated otherwise)							
Output, employment, and prices								
Real GDP growth (in percent)	-15.4	-9.4	5.9	6.0	6.0	4.0	4.5	5.0
Nominal GDP	3,742	3,153	3,628	4,083	4,531	4,886	5,316	5,784
Nominal GNI	4,187	3,555	4,127	4,533	5,063	5,429	5,835	6,316
Per capita nominal GDP (U.S. dollars)	1,142	929	1,032	1,122	1,204	1,257	1,324	1,395
Nominal gross domestic investment (percent of GDP)	19.7	24.1	26.8	25.1	23.8	25.1	25.6	26.1
Government	5.7	7.1	8.1	7.6	7.2	9.0	9.3	8.5
Private and other	14.0	17.0	18.7	17.5	16.5	16.1	16.3	17.5
Unemployment (percent of total labor force)	25.5	31.3	25.6	26.8	23.8	25.9	26.5	24.7
Employment (in thousands), *of which:*	508	486	590	617	651	655	674	715
In Israel, *of which:*	54	51	57	50	60	60	55	55
Work permit holders	26	19	21	19	23	...	...	...
Without work permit	44	32	36	31	37	...	...	...
In West Bank and Gaza, *of which:*	438	435	533	564	591	595	619	660
PNA 1/	122	125	129	133	136	126	126	126
Private sector 2/	316	310	404	431	455	469	493	534
Poverty rate (in percent of total population)	31	51	47	...	...	...	...	...
CPI inflation rate (period average)	1.2	5.7	4.4	3.0	3.5	3.0	3.0	3.0
	(In percent of GDP)							
Fiscal operations								
Revenue 3/	7.3	9.4	21.0	23.4	25.7	26.4	27.3	27.5
Expenditure and net lending, *of which:*	29.9	32.4	35.6	37.4	42.4	41.0	36.3	32.3
Current	29.3	31.5	29.4	32.3	34.9	34.9	32.2	29.8
Capital 4/	0.6	0.7	1.0	0.9	0.9	0.8	0.8	0.8
Net lending and VAT refunds	0.1	0.2	5.2	4.2	6.7	5.3	3.4	1.7
Balance before budget support	-22.6	-23.0	-14.6	-14.1	-16.7	-14.6	-9.0	-4.8
Budget support	14.2	14.8	7.2	8.7	8.0	...	...	...
Balance after budget support	-8.4	-8.2	-7.4	-5.4	-8.8	...	...	...
Domestic financing	8.4	4.6	-2.3	3.3	5.8	...	...	...
Transfers of withheld clearance revenues	...	2.6	8.3	2.4	1.4	...	...	...
External financing (for projects) and residual 5/	...	1.0	1.4	-0.2	1.5	...	...	...
	(In millions of U.S. dollars)							
Current account (including transfers)								
Exports of goods and non factor services	560	465	465	535	615	707	848	1035
Imports of goods and non factor services	2,701	2,530	2,846	3,266	3,613	3,868	4,119	4,422
Net factor income	445	402	498	450	533	543	519	532
Net transfers	1,365	1,426	1,276	1,403	1,468	1,740	1,784	1,779
Current account balance	-331	-238	-606	-879	-998	-877	-967	-1,076
(In percent of GDP)	-8.9	-7.5	-16.7	-21.5	-22.0	-18.0	-18.2	-18.6
	(In millions of U.S. dollars, end of period)							
Money and banking								
Private sector deposits	3,150	2,974	3,208	3,361	...	...	...	...
Growth rate (percent)	-3.4	-5.6	7.9	4.8	...	...	...	...
Demand deposits	746	746	1,006	1,159	...	...	...	...
Time deposits	2,404	2,229	2,202	2,202	...	...	...	...
Credit to the private sector	860	859	861	1,064	...	...	...	...
Growth rate (percent)	-7.2	-0.1	0.2	23.6	...	...	...	...
Memorandum items:								
Population growth (percent)	4.0	3.6	3.6	3.5	3.4	3.4	3.3	3.2
Average NIS/US$	4.21	4.74	4.55	4.48	...	...	...	...

Sources: Palestinian Authority; and Fund staff estimates.
1/ End of period.
2/ Includes local governments and public enterprises.
3/ Excludes accrued clearance revenue not transferred by Israel in 2001 and 2002 and transfers from accumulated stock in 2003 and 2004.
4/ Excludes foreign financed capital spending.
5/ In 2005, includes exceptional profits from the Palestinian Investment Fund.

Table 2. West Bank and Gaza: Fiscal Stabilization Plan, 2004–2008

Impact of new fiscal measures

	Prel.	Budget 1/	Proj.	Scenario I (Current policies)			Scenario II (New measures)		
	2004	2005	2005	2006	2007	2008	2006	2007	2008
				(In millions of US$)					
Gross revenue	954	1,078	1,164	1,299	1,450	1,609	1,289	1,452	1,593
Expenditure, *of which:*	1,355	1,582	1,620	1,905	2,047	2,201	1,747	1,753	1,769
Gross wages, *of which:*	870	936	1,017	1,174	1,285	1,407	1,078	1,102	1,126
Civilian	538	566	617	703	779	862	689	705	722
Security	333	371	400	471	507	545	389	397	404
Net lending and VAT refunds	173	150	302	335	331	329	258	178	100
Balance 2/	-574	-654	-758	-941	-928	-921	-715	-479	-276
				(In percent of GDP)					
Gross revenue	23.4	23.8	25.7	25.7	25.7	25.7	26.4	27.3	27.5
Expenditure, *of which:*	33.2	34.9	35.8	37.7	36.3	35.2	35.7	33.0	30.6
Gross wages, *of which:*	21.3	20.7	22.4	23.2	22.8	22.5	22.1	20.7	19.5
Civilian	13.2	...	13.6	13.9	13.8	13.8	14.1	13.3	12.5
Security	8.1	...	8.8	9.3	9.0	8.7	8.0	7.5	7.0
Net lending and VAT refunds	4.2	3.3	6.7	6.6	5.9	5.3	5.3	3.4	1.7
Balance 2/	-14.1	-14.4	-16.7	-18.6	-16.5	-14.7	-14.6	-9.0	-4.8
				(In percent of budget revenue)					
Gross wages, *of which:*	91.2	86.8	87.3	90.4	88.7	87.5	83.6	75.9	70.7
Civilian	56.4	52.5	53.0	54.1	53.7	53.6	53.5	48.6	45.3
Security	34.9	34.4	34.3	36.3	34.9	33.9	30.2	27.3	25.4
				(Annual growth rates in percent, unless otherwise indicated)					
Assumptions									
1. Net change in PA employment (level)	3,924	...	2,875	1,500	2,500	2,500	-10,000	0	0
2. Revenue (in NIS)	23.6	9.7	21.1	12.2	11.6	11.0	12.1	12.6	9.7
3. Wage bill (in NIS)	15.6	4.4	14.3	16.5	9.5	9.5	6.7	2.2	2.2
4. Wage increases (in NIS)									
Civil employees	11.3	...	10.9	11.9	7.5	7.5	11.9	2.3	2.3
Security employees	13.5	...	19.1	19.5	7.5	7.5	19.5	2.0	2.0
5. Real GDP	6.0	...	6.0	6.0	6.0	6.0	4.0	4.5	5.0
6. Imports	14.8	...	10.6	9.9	8.7	9.1	7.0	6.5	7.4

Sources: Ministry of Finance; and Fund staff estimates.

1/ Excludes contingent social safety net grant of US$240, which was in the 2005 budget but did not materialise.

2/ Gross revenue net of expenditure, net lending and VAT refunds.

Table 3. West Bank and Gaza: Central Government Current Fiscal Operations, 2001–2008

	2001	2002	2003	2004	2005 *				2006	2007	2008
				Prel.	Budget 1/	Jan.–Sep.	Oct.-Dec.	Year	Projections 8/		
				(In millions of U.S. dollars, unless otherwise stated)							
Gross revenue	275	296	762	954	1,078	885	285	1,164	1,289	1,452	1,593
Gross domestic	275	224	291	337	396	332	84	411	449	499	563
Tax revenues	183	141	167	191	230	185	60	245	282	326	376
Nontax revenues	92	82	124	146	166	147	24	166	167	174	187
Gross monthly clearance	0	72	472	617	682	553	201	753	841	953	1,029
Expenditure 1/ 2/ 3/	1,117	1,017	1,104	1,355	1,582	1,176	448	1,620	1,747	1,753	1,769
Gross wages	678	642	743	870	936	735	287	1,017	1,078	1,102	1,126
Civilian	426	404	456	538	566	449	168	617	689	705	722
Security 4/	252	239	288	333	371	285	119	400	389	397	404
Nonwage expenditure 5/	417	352	324	449	623	406	157	563	628	609	599
Of which:											
Operating	...	...	124	193	263	164	59	223	215	212	210
Transfers, *of which:*	...	...	201	257	360	241	97	340	413	396	389
Pensions	0	43	46	73	119	...	...	95	160	166	172
Social programs	0	57	64	75	123	...	...	163	136	112	97
Other	0	88	91	109	118	...	...	82	117	118	120
PA financed capital spending 2/	22	23	36	36	23	36	5	41	41	42	44
Net lending 6/	0	0	173	157	130	227	56	282	238	158	77
VAT refunds	2	5	16	16	20	18	1	20	19	20	22
Balance	-845	-726	-531	-574	-654	-536	-221	-758	-715	-479	-276
External budget support	530	467	261	353	654	301	61	362	...	...	...
Balance after budget support	-315	-259	-270	-221	0	-236	-160	-397	...	...	...
Total other financing	315	259	270	221	0	236	...	397	...	...	...
Exceptional PIF profits and advances	...	...	...	...	0	109	...	109	...	...	...
Gross withheld clearance revenues	0	82	300	97	92	64	...	64	...	...	...
Net domestic bank financing	83	115	85	134	-69	263	...	263	...	...	...
Net change in arrears (- = repayment) and residual	232	65	-115	-9	-23	-200	...	-39	...	...	...
					(In percent of GDP)						
Gross revenue	7.3	9.4	21.0	23.4	23.8	...	...	25.7	26.4	27.3	27.5
Expenditure	29.9	32.3	30.4	33.2	34.9	...	...	35.8	35.7	33.0	30.6
Wages	18.1	20.4	20.5	21.3	20.7	...	...	22.4	22.1	20.7	19.5
Nonwages	11.1	11.2	8.9	11.0	13.8	...	...	12.4	12.8	11.4	10.4
Net lending and VAT refunds	0.1	0.2	5.2	4.2	3.3	...	...	6.7	5.3	3.4	1.7
Budget balance before budget support	-22.6	-23.0	-14.6	-14.1	-14.4	...	...	-16.7	-14.6	-9.0	-4.8
Budget balance after budget support	-8.4	-8.2	-7.4	-5.4	0.0	...	...	8.0	...	...	...
Memorandum items:											
Nominal GDP in U.S. dollar	3,742	3,153	3,628	4,083	4,531	...	...	4,531	4,886	5,316	5,784
Exchange rate NIS/$ (period average)	4.21	4.74	4.54	4.48	4.35	4.42	...	...	...	...	...
Government employment (end of period) 7/	123,450	122,329	129,182	133,106	...	135,564	...	135,981	125,981	125,981	125,981
Of which:											
Civilian	70,034	70,157	72,542	76,039	...	78,497	...	78,914	78,914	78,914	78,914
Security	53,416	52,172	56,640	57,067	...	57,067	...	57,067	47,067	47,067	47,067

Sources: Ministry of Finance and Fund staff estimates.

* Fiscal data for January to September 2005, October to December 2005, and 2005 as a whole are converted from New Israeli Shekels to US dollars using average exchange rates for each period. As a result, the figures in US dollars for the year as a whole may differ slightly from the sum of the figures for the two sub-periods.

1/ Excludes contingent social safety net grant of US$240, which was in the 2005 budget but did not materialize.

2/ Excludes foreign financed capital spending.

3/ Excludes net lending.

4/ In the 2005 budget, includes all employees of the Ministry of the Interior and Internal security services.

5/ Includes one-off expenditures in 2005 tied to elections and security operations related to the Israeli disengagement from Gaza.

6/ Payments deducted at source by GOI from disbursements of withheld clearance revenue for bills owed by Palestinian municipalities.

7/ There is a break in the series between 2002 and 2003 owing to computerization of the payroll and elimination of double counting.

8/ Projections assume the implementation of the medium-term fiscal stabilization plan.