PALESTINIAN TERRITORIES

Recovering slowly from the 2014 recession, the Palestinian economy is estimated to have expanded by 8 percent in Q12016 due to transitory factors, mainly an uptick in Gaza reconstruction. At 27 percent, unemployment continues to be stubbornly high. Given the ongoing constraints to economic competitiveness, medium-term growth is projected at 3.5 percent. Lower than expected aid and the possibility of further conflict pose downside risks to growth and employment.

Recent developments

After a recession in 2014 following the Gaza war, economic activity has picked up in the Palestinian territories. Real GDP growth for West Bank and Gaza as a whole reached 3.5 percent in 2015 and 8 percent in the first quarter of 2016. Growth was mainly driven by a rebound in Gaza where the economy is estimated to have expanded by 21 percent in the first quarter of 2016 due to an upsurge in reconstruction activity. The West Bank economy expanded by 4.2 percent in the first quarter of 2016, and growth was concentrated in services and household consumption financed by bank loans.

At 27 percent, the unemployment rate in the Palestinian territories remains stubbornly high. The overall figure masks wide regional differences with unemployment in Gaza, at 42 percent, more than twice as high as that in the West Bank at 18 percent. Youth unemployment continues to be a major concern in the Palestinian territories, particularly in Gaza where more than half of those aged between 15 and 29 are out of work.

The inflation rate remains very low averaging 0.2 percent in the period between January and June 2016. The Israeli Sheqel is the main currency in circulation in the Palestinian territories, and hence inflation has been kept low by deflation in Israel and a fall in global fuel and food prices.

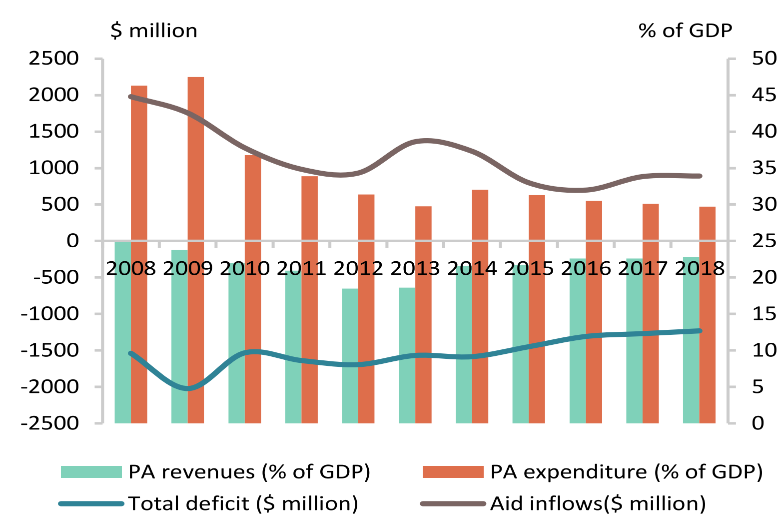
The Palestinian Authority's (PA) fiscal situation remains difficult despite an impressive revenue performance so far in 2016. Public revenues grew by 24 percent in the first half of 2016 on account of frontloaded domestic taxes and one-off revenue transfers by the Government of Israel (GoI). This offset the higher than budgeted growth in expenditures, driven by unexpected wage increases for teachers and engineers, and led to a 23 percent drop in the deficit in the first half of 2016 (year-on-year). In parallel, aid to the PA treasury declined by 28 percent, resulting in a US$205 million financing gap and further arrears accumulation.

The external current account deficit (excluding official transfers) is estimated to have widened by 4 percentage points in 2015 to reach 22 percent of GDP. This is due to an increase in the trade deficit to 41 percent of GDP, as a result of a rise in non-Israeli imports. On the other hand, imports from Israel, the Palestinian territories' main trading partner, saw a decline in 2015 due to lower fuel prices and a growing trend among Palestinian consumers to substitute products imported from Israel by those from other countries. Exports remained low and stagnant at around 18 percent of GDP in 2015.

Outlook

The recent pickup in growth was driven by Gaza reconstruction and is not sustainable without efforts to improve economic competitiveness. Therefore, the economic outlook for the Palestinian territories remains worrying. Assuming that the current restrictions remain in place and that the security situation stays relatively calm, the real GDP growth rate

FIGURE 1 Palestinian territories / Estimates and outlook: Public finances



Sources: Palestinian MoF and staff estimates.

of the Palestinian economy in 2016 is projected at 3.3 percent: 2.7 percent in the West Bank and 5.5 percent in Gaza. In the medium term, real GDP growth could hover around 3.5 percent. This sluggish growth implies a stagnation in real per capita income and an increase in unemployment.

The fiscal deficit (before grants) is projected to decline to 10 percent of GDP (US$1.3 billion) in 2016. At the same time, foreign aid in 2016 could fall to under US$700 million, leaving a financing gap in excess of US$600 million (4.7 percent of GDP). The PA plans to implement measures to reduce this gap, but those will not be enough to fully close it. Unless donor aid is significantly stepped up, the gap will be mostly financed through arrears to the private sector and the pension fund since borrowing from local banks is very close to the maximum limit set by the Palestinian Monetary Authority. On the external side, the current account deficit (excluding official transfers) is expected to slightly decline to 21 percent of GDP in 2016 due to a decline in imports.

Risks and challenges

Lack of progress in the Israeli-Palestinian peace process and the ongoing constraints to economic competitiveness continue to stand in the way of a sustainable economic recovery in the Palestinian territories and downside risks to growth and employment remain significant. First, despite some progress in recent months, setbacks to the reconstruction process in Gaza are possible. The resumption of armed conflict cannot be ruled out and if this happens, the Gaza economy is expected to slip back into recession. Second, the outcome in the West Bank may be worse than expected if the decline in donor support exceeds current projections. Also, if tensions erupt again throughout the West Bank, they will result in elevated security risks that may negatively impact economic activity and poverty.

TABLE 1 Palestinian territories / Macro outlook indicators (annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	2.2	-0.2	3.5	3.3	3.5	3.5
Private Consumption	-4.0	3.5	4.6	4.0	5.0	5.0
Government Consumption	-1.6	3.7	2.9	4.0	4.0	4.0
Gross Fixed Capital Investment	17.7	-4.4	9.9	-6.1	-13.9	-8.4
Exports, Goods and Services	3.3	1.2	11.1	-5.3	5.6	4.0
Imports, Goods and Services	-1.7	3.5	9.0	-2.1	-0.6	2.1
Real GDP growth, at constant factor prices	2.4	-2.3	3.1	3.3	3.5	3.5
Agriculture	-8.6	-7.6	-11.4	0.5	1.4	1.0
Industry	6.1	-13.8	1.4	1.4	4.0	4.0
Services	1.7	3.1	4.7	4.1	3.4	3.5
Inflation (Consumer Price Index)	1.7	1.7	1.6	1.3	1.3	1.9
Current Account Balance (% of GDP)	-14.4	-9.6	-16.0	-15.6	-13.2	-12.6
Financial and Capital Account (% of GDP)	12.5	6.6	14.8	15.5	13.1	12.4
Net Foreign Direct Investment (% of GDP)	1.8	-0.2	-0.5	1.2	0.1	0.1
Fiscal Balance (% of GDP)	-1.7	-2.8	-5.1	-4.7	-3.0	-2.6
Poverty rate ($3.1/day PPP terms)[a,b,c]	0.6	0.7	0.6	0.6	0.6	0.6
Poverty rate ($5.5/day PPP terms)[a,b,c]	7.0	7.8	7.6	7.4	7.3	7.2

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: e = estimate, f = forecast.
(a) Calculations based on 2009-PECS.
(b) Projection using neutral distribution (2009) with pass-through = 0.7 based on GDP per capita constant in constant LCU.