INTERNATIONAL MONETARY FUND

WEST BANK AND GAZA

REPORT TO THE AD HOC LIAISON COMMITTEE[1]

April 10, 2017

KEY ISSUES

The peace process looks increasingly vulnerable. In January, the international community reaffirmed its support to the two-state solution at the Paris Conference, although the position of the new U.S. administration is perceived as less clear. While a United Nations Security Council resolution condemned settlement activity, Israel stepped up settlement approvals in early 2017. The domestic situation remains unsettled, with municipal elections planned for May in the West Bank.

Underlying trends point to a sobering outlook. While growth edged up to an estimated 4 percent in 2016, ongoing constraints and political uncertainty have eroded the economy's productive capacity. Absent a breakthrough on the peace process, growth is projected at around 3.3 percent in the medium run—insufficient to reduce unemployment and boost per capita incomes. The outlook is subject to significant and interconnected risks: (i) reduced donor support; (ii) escalating unrest; (iii) geographic fragmentation and erosion of economic control; and (iv) strained Israeli-Palestinian correspondent bank relations.

Persistent financing gaps require further fiscal adjustment balanced against the need to invest in the economy. The priority in 2017 is to reduce the nearly $800 million financing gap, by restraining non-priority current spending and looking for scope to raise revenue. Lackluster growth and persistent financing gaps over the medium term require further adjustment based on efforts to rebalance spending toward investment to help support growth, ensure fiscal sustainability and preserve financial stability. Strengthening public financial management is a priority reform that could generate significant payoffs by supporting fiscal adjustment, but requires support across government. Increasing the predictability of revenue transfers from Israel and reversing the decline in aid will reinforce domestic efforts to secure fiscal sustainability.

[1] The IMF provides technical services to the West Bank and Gaza, including policy advice in the macroeconomic, fiscal, and financial areas, as well as technical assistance, with a focus on tax administration, public expenditure management, banking supervision and regulation, and statistics. See www.imf.org/wbg for recent reports.

Approved By
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Discussions were held in East Jerusalem and Ramallah during January 31–February 9, 2017, and the report was updated with subsequent developments. The staff team comprised Karen Ongley (head), Priscilla Toffano, Anna Unigovskaya, Jean van Houtte (all MCD), Ragnar Gudmundsson (IMF Resident Representative), and Hania Qassis (IMF Resident Representative Office). The mission met Finance Minister Bishara, Palestine Monetary Authority Governor Shawwa, other senior officials, donors and private sector representatives. The mission prepared a concluding statement and issued a press release. Ramsey Andrawis, Greg Basile, Cecilia Pineda, and Hanan Altimimi Bane also contributed to producing this report.

CONTENTS

ANNEXES

CONTEXT

1. **Mounting political uncertainties and strains are testing the peace process**. Tensions linked to continued settlement expansion have risen, particularly since the December 2016 United Nations Security Council (UNSC) Resolution 2334 condemning settlement activity. In early 2017, Israeli approvals for new construction units increased sharply and, on February 6, the Knesset passed a law (currently under review by the High Court of Justice) retroactively legalizing settlements in the West Bank. Nevertheless, the international community reaffirmed its commitment to the two-state solution at the January 2017 Paris Conference, although the position of the new U.S. administration seems less clear.

2. **Despite yielding positive results, the economic dialogue between the Palestinian Authority (PA) and Government of Israel (GoI) has faltered in crucial areas**. Constructive discussions between the Palestine Monetary Authority (PMA) and Bank of Israel (BoI) have sought to mitigate risks regarding the potential termination of correspondent banking relations (CBRs). There has also been technical progress toward the electronic payment of wages of Palestinian workers in Israel, but implementation of the system was delayed. The GoI is also reviewing the work permit system to empower workers vis-à-vis employers and middlemen. Despite technical discussions on revenue transfers[2] and electricity debts yielding noteworthy results in 2016, dialogue at the highest level between the PA and GoI finance ministries has not resumed in 2017.

3. **The domestic situation remains unsettled, with persistent political and socio-economic divisions.** Notably, the recently announced Fatah-Hamas agreement to form a unity government has yet to bear fruit. Previously postponed municipal elections have been rescheduled for May 2017, but will only take place in the West Bank, as Hamas is opposed to holding elections in Gaza. Without a breakthrough on national reconciliation, prospects for parliamentary elections and a fully-functioning legislature remain a distant hope. Worsening humanitarian conditions in Gaza, exacerbated by chronic power and water shortages, and the increasingly precarious economic situation in the West Bank create fertile ground for social unrest.

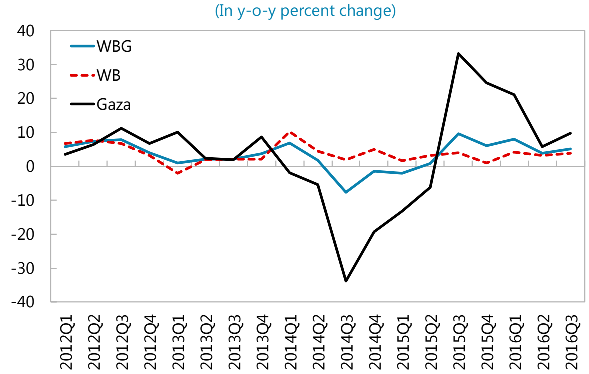
[2] Revenue transfers refer principally to clearance revenue (i.e., mainly indirect taxes) collected by Israel on behalf of, and later transferred to, the PA.

RECENT DEVELOPMENTS

4. **While growth edged up in 2016, underlying conditions remain stagnant in the West Bank and volatile in Gaza**. Based on third quarter data, overall growth is estimated to have increased to 4 percent in 2016 from 3½ percent in 2015. The composition of growth in the West Bank (3.9 percent year-on-year through 2016 Q3) remains of concern as it mainly reflects private consumption with low investment. While growth in Gaza accelerated (to 9.7 percent year-on-year through 2016Q3), it remains heavily dependent on post-war reconstruction and the ability to import construction materials.

Real GDP Growth, 2012–16

(In y-o-y percent change)



Sources: Palestinian Central Bureau of Statistics; and IMF staff estimates.

5. **Conditions in the labor market are discouraging, especially in Gaza.** In the West Bank, the unemployment rate decreased by 2 percentage points to 16.9 percent by end-2016, buoyed by an increase in Palestinians working in Israel. The unemployment rate in Gaza stood at 40.6 percent, up by about 2 percentage points compared to end-2015, with almost two-thirds of young people remaining out of work. Moreover, the overall participation rate has been decreasing steadily since its 2014 peak and reached 45 percent at end-2016, with a remarkable gender gap (71 percent for males and 19 percent for females).

West Bankers Employed in Israel and Settlements

(In percent of total people employed in the West Bank)

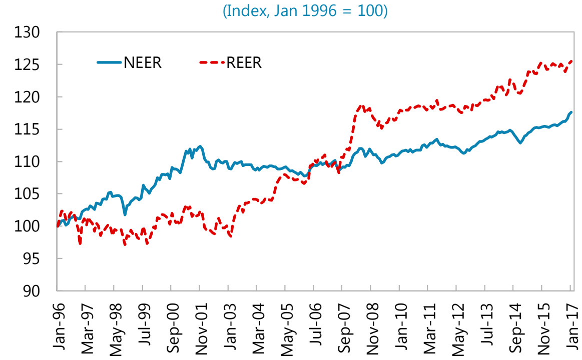
	2014	2015	2016
With permit	9.3	9.9	9.5
Without permit	4.1	4.9	6.6
With Israeli ID	2.2	2.0	2.1
Total	15.6	16.8	18.2

Source: Palestinian Central Bureau of Statistics.

6. **In 2016, West Bank and Gaza (WBG) experienced deflation for the first time.** Overall prices declined by 0.22 percent (year average), reflecting low food and housing services' prices as well as deflation in Israel. Nevertheless, competitiveness did not improve, as the real effective exchange rate continued the upward trend of the past decade and non-price factors (especially restrictions on movement and access) remain the dominant consideration.

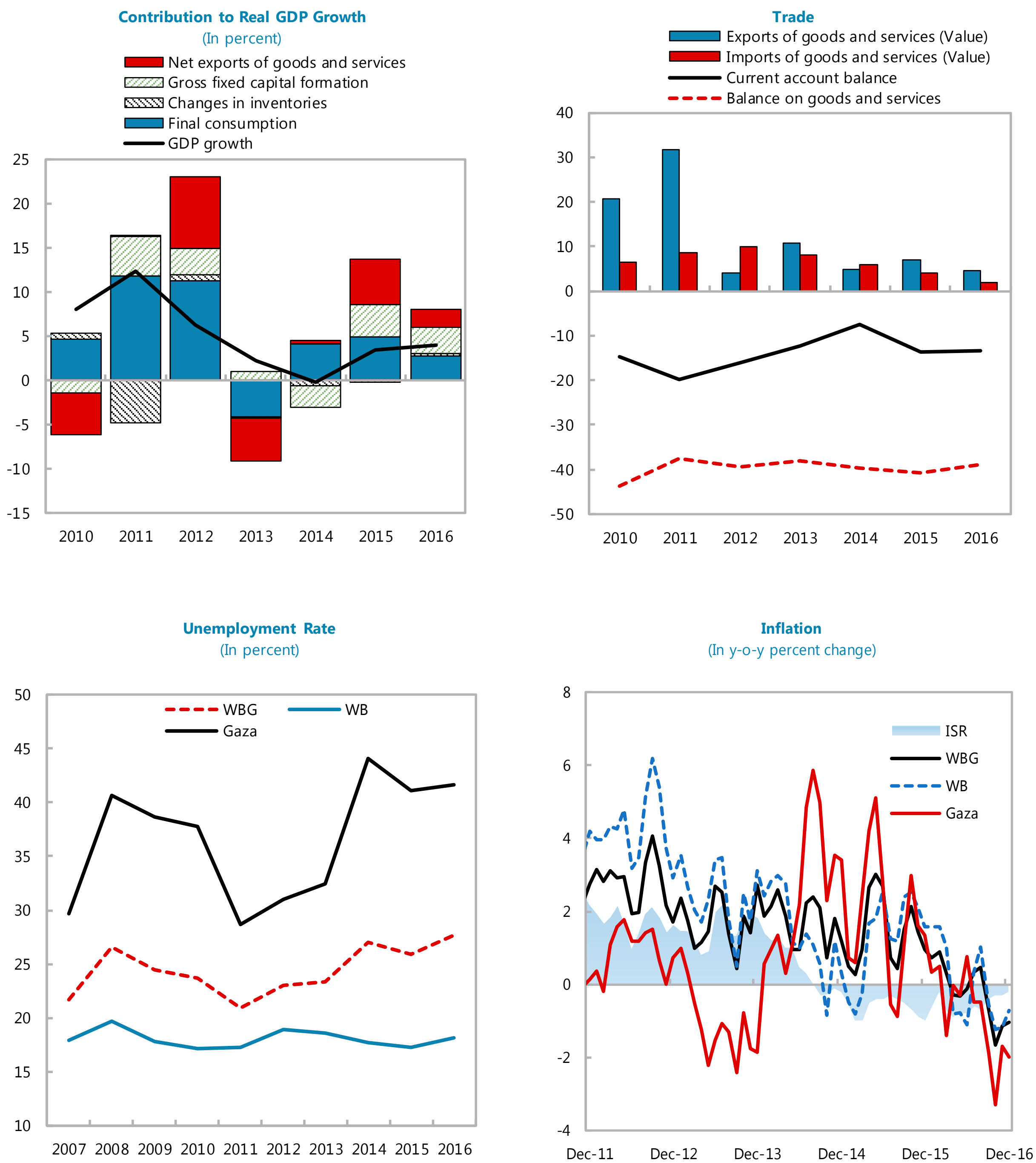
Effective Exchange Rate

(Index, Jan 1996 = 100)



Note: An increase indicates appreciation.
Sources: Haver Analytics, Information Notice System; and IMF staff calculations.

Figure 1. West Bank and Gaza: Recent Economic Developments, 2010–16



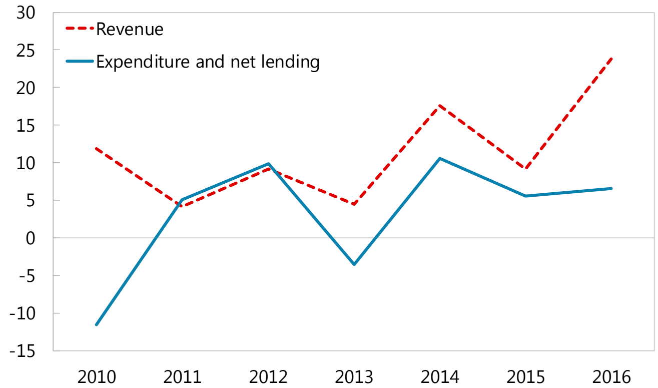
Sources: Palestinian Central Bureau of Statistics; and IMF staff estimates.

7. The fiscal deficit decreased markedly in 2016 due to strong exceptional revenues.

- Technical discussions with Israel led to additional payments toward the partial settlement of clearance revenues (CRs) and border crossing fees (about NIS 570 million[3]) in March–April, and as part of an electricity debt restructuring agreement (NIS 572 million) in September (discussed in paragraph 21). Also, the successful negotiation of a new telecom license resulted in the disbursement of the first installment (NIS 558 million).[4] This led to a 12 percent increase in CRs and a 147 percent increase in non-tax receipts—equivalent to about 2½ percentage points of GDP.

Revenue and Expenditure Growth

(In y-o-y percent change)



Source: Ministry of Finance and Planning.

- However, domestic tax revenue increased by only 1.6 percent in 2016, below nominal GDP growth, as efforts to register new taxpayers and good customs performance did not fully offset lower corporate income tax and domestic VAT.

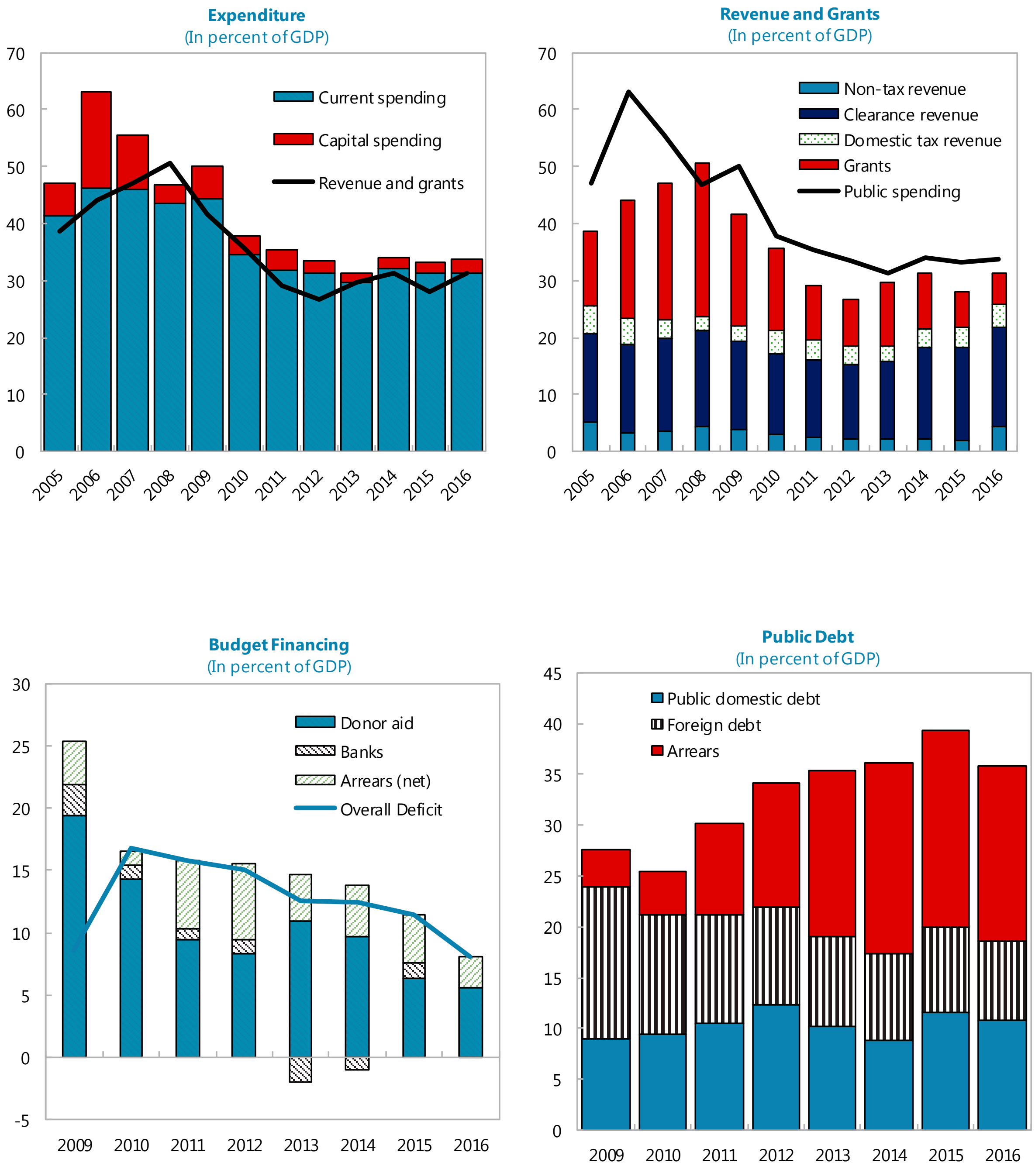
- Recurrent expenditure remained unchanged as a share of GDP, reflecting higher-than-budgeted spending on wages (salary increases to teachers and engineers) and goods and services (mainly health related). Development spending increased from 1.8 percent of GDP in 2015 to 2.5 percent in 2016, as donors redirected some financing from general budget support.

- On balance, this resulted in a substantial decline in the overall deficit from 11.4 percent of GDP in 2015 to 8.1 percent of GDP in 2016.

[3] NIS 500 million for Gaza and NIS 70 million for border crossing fees.

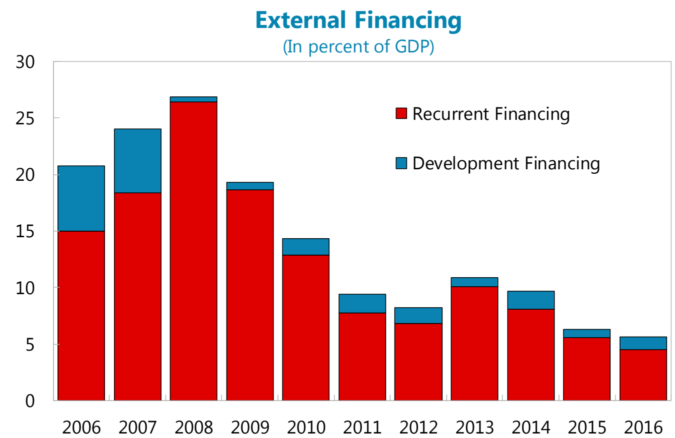
[4] The license agreement with Palestinian Telecommunication Company (PalTel), concluded in late 2016, involves the payment of $290 million in five installments, with the first installment of $145 million paid upon signature, and the remainder paid in four equal installments over 2017-18. The authorities' reported to staff the first installment on a commitment basis, but later recorded it on cash basis in 2017.

Figure 2. West Bank and Gaza: Fiscal Sector Indicators, 2005–16



Source: Ministry of Finance and Planning.

8. **Despite the lower deficit, arrears continued to accumulate as donor support faced further cuts.** While overall donor support declined from 6.3 to 5.6 percent of GDP, this mostly affected general budget support which was 15 percent less than in 2015. This contributed to a further accumulation of arrears to the pension fund, municipalities, and private suppliers. The authorities undertook negligible net new borrowing from banks despite banks' exposure to the PA falling below the regulatory limit toward the end of the year. However, the authorities stepped up issuance of promissory notes to repay arrears to private suppliers. The stock of promissory notes reached NIS 240 million (around 0.5 percent of GDP) at end-2016, with private suppliers selling around 50 percent to banks at a discount, raising banks' exposure to the PA.



Source: Ministry of Finance and Planning.

9. **The financial sector is generally sound, but pressures are growing.** While credit to the private sector continues to grow rapidly (25 percent year-on-year through December), prudential ratios are comfortable by international standards. Nonperforming loans remain low on average (around 2 percent) and stable in sectors where credit is concentrated—consumption, construction, and trade finance. However, banks have significant direct and indirect exposures to the PA.

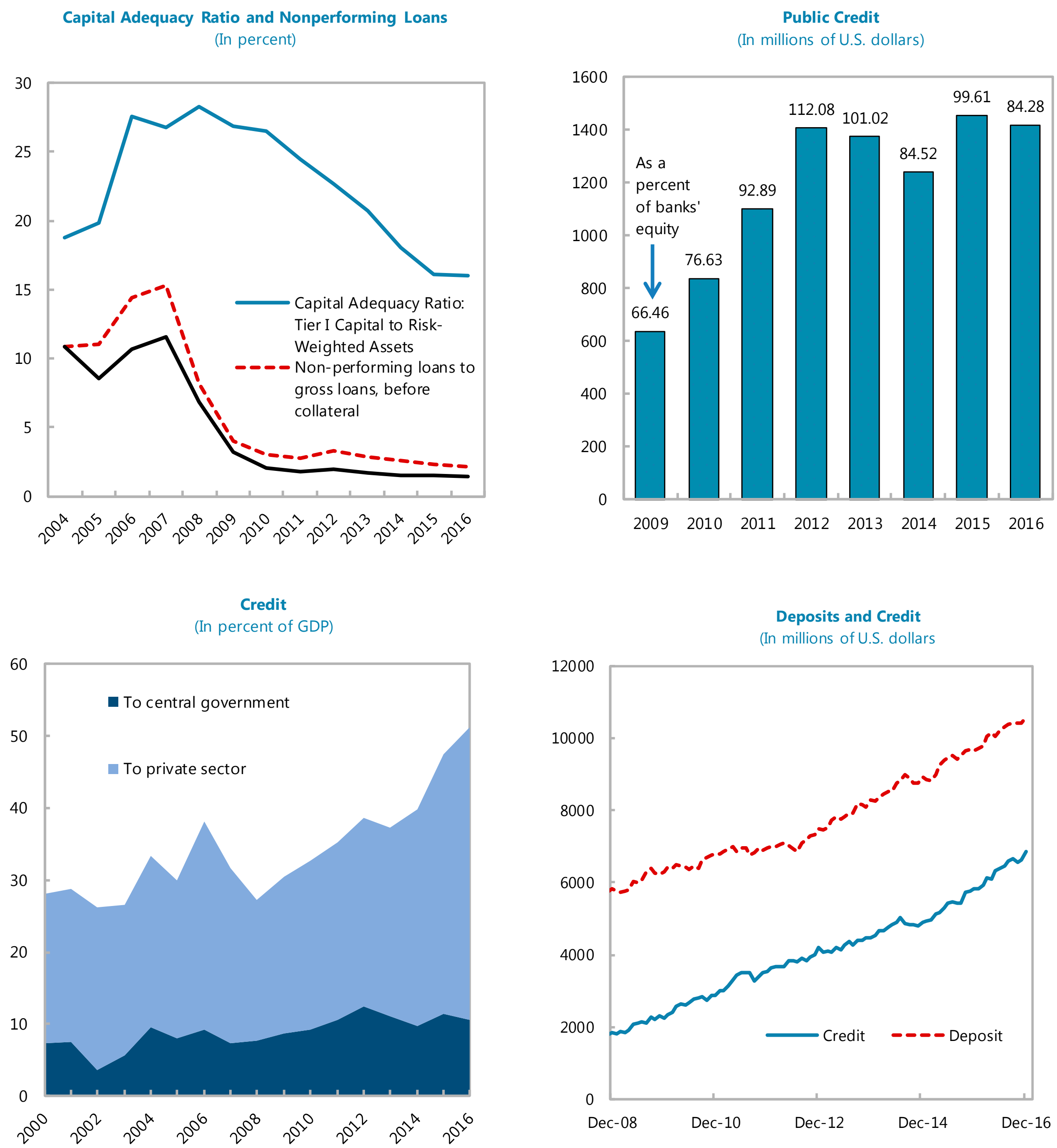
Banks' Exposure to the PA
(In percent of banks' capital)

	2015 Q4	2016 Q3	2016 Q4
Loans to the PA	99.4	90.7	84.1
Loans to the PA's employees	70.0	76.8	77.2
Promissory notes	n.a.	2.6	2.4
Total exposure	169.4	170.1	163.7

Source: Palestine Monetary Authority.

10. **The authorities continued efforts to address recurring CBR strains**. In early 2017, the two main Israeli correspondent banks renewed their warning of plans to terminate CBRs. At the same time, cash-related tensions resurfaced when one of these banks announced that, from April, it plans to stop accepting shekel banknotes from some banks operating in the West Bank. The WBG authorities continued, with IMF technical assistance, to prepare amendments of the anti-money laundering and combating the financing of terrorism (AML/CFT) law and implementing regulations, including the regulation to implement UNSC resolutions related to terrorist financing. They also successfully requested the evaluation of WBG's AML/CFT regime by the MENAFATF, which is currently scheduled for 2020. The authorities will conduct a National Risk Assessment (NRA) this year, with support from the World Bank, and have established the relevant sectoral committees. In January, the Israeli authorities also took exceptional steps, agreeing to put in place temporary financial and judicial assurances to help preserve Israeli-Palestinian CBRs, the details of which are still being developed.

Figure 3. West Bank and Gaza: Financial Sector Data, 2000–16

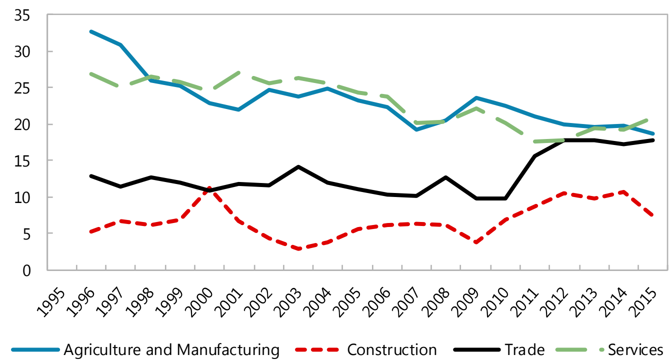


Sources: Palestine Monetary Authority; and IMF staff estimates.

OUTLOOK AND RISKS

11. Ongoing constraints and political uncertainty have eroded the productive capacity of the economy, stunting WBG's growth potential.[5] For example, agriculture and manufacturing together accounted for almost 33 percent of GDP in 1995, but their share had almost halved to 17 percent in 2015. At the same time, other sectors that might compensate as an economy develops (e.g., services) did not gain ground. While trade is one exception, the large structural trade deficit weighs negatively on the capacity of industry to create jobs.

Contribution of Key Sectors to GDP
(In percent of GDP)



Sources: Palestinian Central Bureau of Statistics; IMF staff calculations.

12. These underlying trends point to a sobering economic outlook. Assuming no breakthrough in the peace process, and that political and security strains persist but do not escalate, growth is projected to hover around 3.3–3.4 percent over the medium term (comprising 2.7 percent in the West Bank and 5–5.5 percent in Gaza). This would result in stagnant per capita incomes and rising unemployment. Staff's previous analysis showed that annual real growth would need to consistently exceed 4 percent to simply absorb new labor market entrants, and remains valid on current demographic trends.[6]

13. Risks to this already difficult outlook are mounting (Annex I). With mounting geopolitical uncertainty and donors continuing to face fiscal strains and competing demands, the risk of further declines in donor support or increased unrest pose the biggest threats to the outlook. Although the channels and effects would vary, if these risks were to materialize they would amplify existing fiscal strains, growth constraints, and social tensions (Box 1). Moreover, economic fragmentation among different regions of WBG could further erode productive capacity and exacerbate socio-economic disparities, undermining the long run economic viability of a future Palestinian state. Finally, the risk of severing of Israeli-Palestinian CBRs could undermine the functioning of the payment system and growth. Each of these risks can also trigger or reinforce one another.

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[5] See Box 2 of IMF staff's August 2016 *Report to the Ad Hoc Liaison Committee (AHLC)*.

[6] See Kock, Sumlinski, and Qassis, *West Bank and Gaza: Labor Market Trends, Growth and Unemployment*, 2012.

Box 1. Illustrative Scenarios on the Potential Impact of Key Risks

Two risks that could adversely impact the economy are the possibility of reduced donor support or an escalation in unrest. While staff's baseline projection does not reflect the realization of either risk, these scenarios illustrate their potential economic impact.

Aid Shock

The aid shock assumes a permanent aid decline of $100 million starting in 2017. This would be additional to the reduction included in the 2017 budget, representing a cumulative decline of around $200 million relative to 2016. This is broadly consistent with the downward trend in aid over the past 5 years. The authorities would initially attempt to 'absorb' the shock, possibly running more arrears. However, as treasury management becomes arduous and suppliers refrain from contracting with the PA, this would force public spending to contract faster than the baseline toward the second half of the projection period.

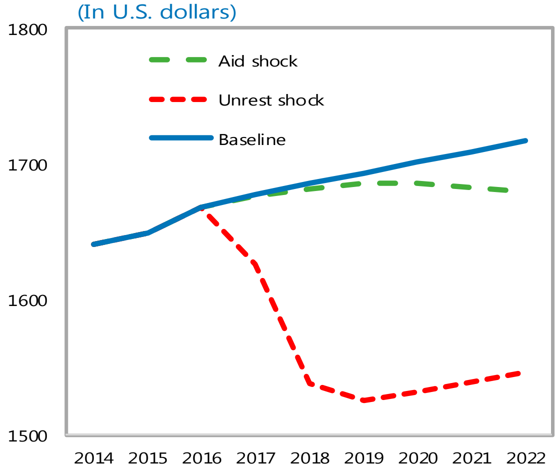
The consequences of an aid shock are significant. Growth is estimated to fall marginally at first, but contracts more in the outer years as suppliers cannot handle excess arrears and run out of working capital. The more rapid decline in public expenditure in the outer years, including investment spending, would also undermine activity. Lower GDP would cause public debt ratios to deteriorate and per capita incomes to stagnate.

Unrest Shock

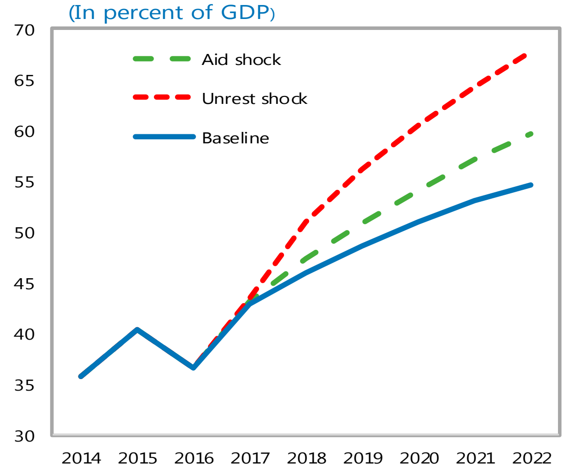
This scenario assumes an escalation of violence during 2017 in WBG as a result of economic hardship and/or political discontent. Economic activity would be eroded through (i) the destruction of physical capital, (ii) fewer Palestinians working in Israel, (iii) declining remittances and, thus, consumption, and (iv) a drop in trade after additional security measures compound the destruction of equipment.[1]

Even an episode of unrest confined to 2017 could have lasting effects on development prospects. As productive capacity is lost, and trade and consumption decrease, growth falls significantly in 2017 and 2018, before reverting to previous projection levels by the end of the forecast horizon. Real per capita income in 2022 remains well below its 2017 level, while the lower tax base expands the deficit and public debt. The composition of GDP would be further skewed toward consumption, as the unrest reduces both private and public savings. An Intifada-like shock would provoke a more severe economic disruption.

Real per Capita Income
(In U.S. dollars)



Public Debt
(In percent of GDP)



Source: IMF staff projections.

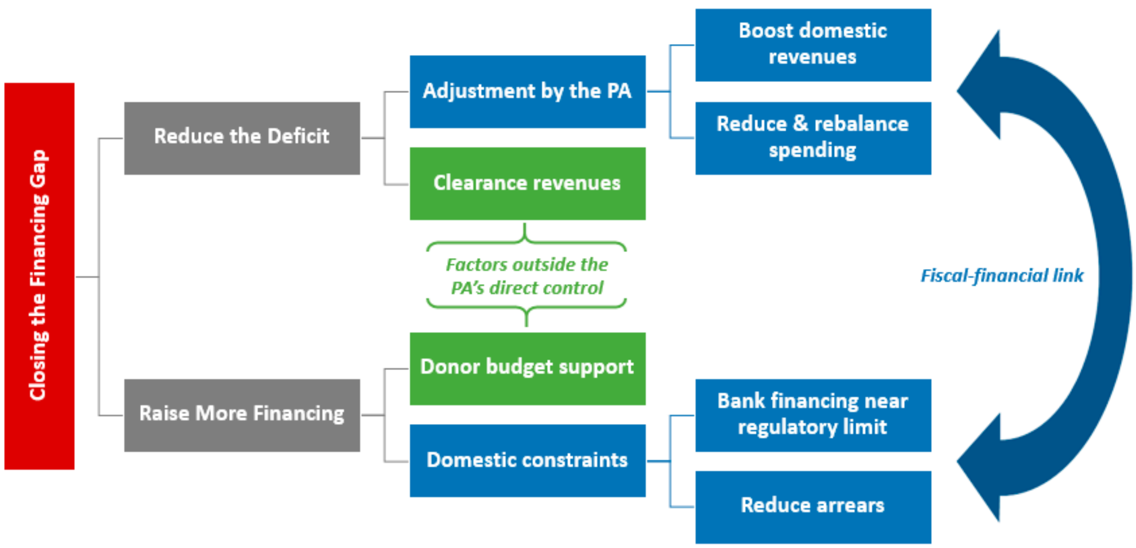
Prepared by Priscilla Toffano and Jean van Houtte.

[1] Productive infrastructure declines by 10 percent compared to the baseline in the year of the unrest. Palestinian labor to Israel also stops completely before gradually resuming from 2018 onwards (10 percent a year). As remittances decline, consumption declines by 10 percent in 2017.

POLICYMAKING WITH PERSISTENT FINANCING GAPS

The stagnating economy, geographic fragmentation, and steady decline in donor aid severely limit the authorities' policy options. Despite progress in reducing the fiscal deficit, these dynamics point to persistent financing gaps requiring further adjustment, particularly given the need to create space to invest in the economy. The materialization of key risks would introduce additional fiscal strains, complicate policymaking and increase the chances of social unrest. In this context, policy discussions centered on measures the PA can independently adopt to address fiscal strains, preserve financial stability, and support growth. The authorities and staff also discussed the need for Israel and donors to support these goals and help close the financing gap by, respectively, increasing the predictability of revenue transfers and reversing the decline in aid.

The Mix of Measures to Close the Financing Gap in the Medium Term



A. Addressing the 2017 Fiscal Financing Gap

14. Staff welcomed the policy measures and prudent external financing assumptions in the 2017 budget. The budget assumptions for growth and inflation are broadly in line with those of staff. Notwithstanding the authorities' desire to advance their discussions with the GoI on "fiscal leakages",[7] the budget does not rely on further exceptional revenue transfers from Israel. To compensate, the budget includes a sizable increase in domestic revenue based on a new government fee schedule and a new domestic tobacco marketing scheme, along with the next installments of the telecom license fee (text table). Recurrent expenditure and net lending are budgeted to decline as a share of GDP, reflecting moderate growth in the wage bill, lower spending on goods and services, and a drop in net lending with the implementation of the electricity sector

[7] See Box 1 of IMF staff's April 2016 *Report to the AHLC*.

agreement. After accounting for the exceptional payments from Israel in 2016, this would imply a reduction in the overall deficit of over 3½ percentage points of GDP.

15. **Staff expressed reservations about the feasibility of the budgeted decline in the deficit.** They pointed to risks associated with the launch of the complex tobacco marketing scheme, and observed that the budgeted cuts in non-wage expenditure could be difficult to achieve given unresolved commitment control issues, particularly in the health sector. Since the electricity agreement is not yet final, it is difficult to project lower net lending with any certainty. Staff is also more cautious about the ability to effectively and consistently scale up development spending. On balance, staff projects a widening of the overall deficit to around 10 percent of GDP in 2017. This is still lower than the 2016 overall deficit, excluding one-off transfers from Israel. With the budgeted decline in donor support to $500 million, the financing gap would widen to nearly $800 million (or 5.7 percent of GDP).

2017 Budget

(In NIS million, unless otherwise indicated)

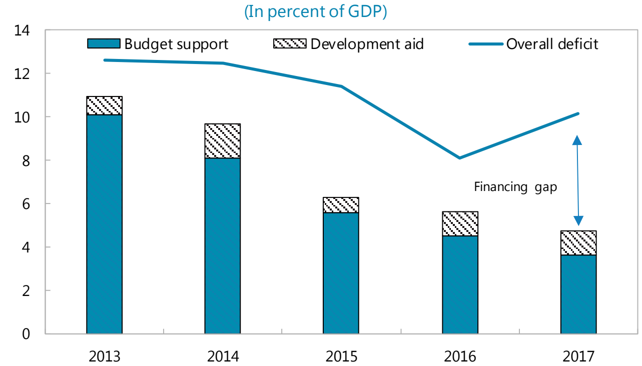
	2015	2016	2017	
			Budget	Proj.
Net revenues	10,712	13,258	13,350	12,519
In percent of GDP	*21.7*	*25.8*	*25.1*	*23.5*
Recurrent expenditures and net lending[1]	15,453	16,137	16,105	16,696
In percent of GDP	*31.4*	*31.4*	*30.3*	*31.4*
Wage expenditures	7,439	7,837	8,087	8,087
Nonwage expenditures	6,844	7,270	7,068	7,580
Net lending	1,169	1,029	950	1,029
Development expenditures[1]	893	1,287	1,365	1,224
In percent of GDP	*1.8*	*2.5*	*2.6*	*2.3*
Overall balance[1]	-5,635	-4,165	-4,120	-5,402
In percent of GDP	*-11.4*	*-8.1*	*-7.7*	*-10.1*
Total financing	5,635	4,165	-4,120	-5,402
External financing for recurrent expenditures	2,757	2,318	1,950	1,922
External financing for development expenditures	347	588	358	612
External debt repayment	-43	-71	0	-165
Domestic financing	2,572	1,330	1,812	3,033
Net domestic bank financing	677	53	0	384
Arrears (net)	1,876	1,256	-1,170	-384
Residual/financing gap	20	22	2,982	3,033
In percent of GDP	…	…	*5.6*	*5.7*

Sources: Ministry of Finance and Planning; and IMF staff projections.

[1] Commitment basis.

Deficit and Aid

(In percent of GDP)



Sources: Ministry of Finance and Planning; and IMF staff calculations.

16. **Staff and authorities agreed on the need for urgent action to address the challenging fiscal situation.** While recognizing the importance of continued donor funding, discussions centered on policy options to help narrow the financing gap.

- Staff discussed several measures, including restoring the top income tax bracket of 20 percent, introducing a 10 percent dividend withholding tax, limiting the wage bill to inflation, and further reducing fuel subsidies, while global oil prices are still low. Collectively, these measures could

Fiscal Measures Proposed by Staff

Measures	NIS million	$ million	% GDP
Identified financing gap in 2017	**3,033**	**789**	**5.7**
Total proposed measures	**793**	**206**	**1.5**
Return to 20 percent income tax rate	200	52	0.4
Introduce a 10 percent withholding tax on dividends	194	50	0.4
Limit wage bill to inflation	148	38	0.3
Eliminate fuel tax subsidy	251	65	0.5
Other unidentified measures/new financing	**2,240**	**583**	**4.2**

Source: IMF staff calculations.

reduce the financing gap by an estimated 1.5 percent of GDP. Additional measures could be considered to rationalize transfers by improving their targeting and further reduce tax exemptions in line with past staff recommendations.

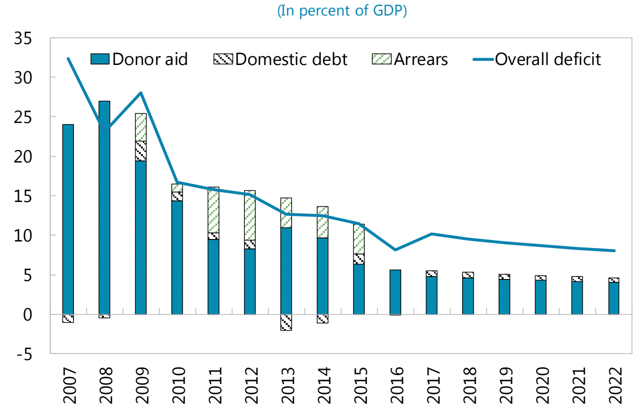
- The authorities generally agreed with staff's suggestions, but noted political sensitivities in some areas, including private sector opposition to a dividend withholding tax. Moreover, they reasoned that lowering the top income tax bracket had helped reduce tax avoidance and undervaluation of clearance revenue. Yet, recognizing the large financing gap, the authorities indicated a desire to explore other measures. They saw significant potential to increase revenue from real estate by reforming tenancy laws and rent controls, although staff noted that further work is needed to assess the impacts of this reform.

- The authorities and staff agreed on the importance of mobilizing revenues through dialogue with Israel, including by reducing administrative fees on imports and enhanced information sharing to minimize losses from the undervaluation of goods. The authorities also emphasized the importance of effectively transferring all fees collected on Palestinian workers in Israel and sharing equitably border crossing fees. As progress on these fiscal files was instrumental in managing fiscal pressures in 2016, staff expressed concern that discussions at the highest level had effectively stalled in recent months and encouraged their urgent resumption.

B. Managing Medium-Term Fiscal Risks

17. Fiscal strains are set to become more pronounced, and the PA will face even large financing gaps over the medium term. Somewhat lower growth under staff's baseline scenario will make fiscal adjustment more difficult, particularly as pressures on the wage bill are unlikely to abate. Together, the slower pace of fiscal consolidation and lower projected donor support (in line with the 2017 budget), imply persistent financing gaps in the order of 4½ percent of GDP in the medium term and increased risks to debt sustainability (Annex II).

Deficit and Financing
(In percent of GDP)



Sources: Ministry of Finance and Planning; and IMF staff calculations.

18. Developing a medium-term fiscal strategy would be essential to narrow financing gaps and preserve fiscal sustainability. The discussion focused on measures the authorities can independently implement.

- **Boosting revenue**. The authorities feel they are approaching the limit to expanding the tax base (with the number of registered taxpayers reaching around 200,000, up by 20,000 from a year ago) under the available capacity of the tax administration. Staff suggested that further limiting tax exemptions, strengthening enforcement and audit techniques, and reviewing the tax code in line with IMF technical assistance could help expand the tax base. Moreover, strengthening the large taxpayer unit to combat tax evasion could also yield results. The authorities noted discussions with the GoI on establishing bonded warehouses, with a view to minimizing undervaluation losses and enhancing the autonomy of PA customs. Staff agreed that this would be a long-term effort requiring significant capacity building efforts and a phased approach to ensure any agreement could be implemented effectively.

- **Creating space for investment and priority spending**. The authorities highlighted that WBG has among the highest and lowest shares of current and capital expenditures, respectively, relative to comparator countries. Staff agreed that there is scope to better target and control current spending, including wages and social benefits, to create space for productive public investment and priority spending.[8] The authorities noted that the 2017 budget moves in that direction, by including allocations for educational investments in East Jerusalem and poverty alleviation projects in Area C. Staff welcomed this, but reiterated the need for comprehensive civil service and pension reform in line with the World Bank's recent Public Expenditure Review. The authorities indicated they were open to considering early retirement schemes and reviewing allowances.

19. However, successful fiscal adjustment would depend on implementing ambitious structural reforms.

- Staff welcomed progress on the new Public Financial Management (PFM) strategy (Box 2), which will help promote durable fiscal adjustment and help ensure that scarce public resources are spent effectively. Clear prioritization and a strategic action plan will support its implementation, and provide a basis for technical and financial support from donors. In this regard, staff recognizes ongoing progress with recording commitments in priority ministries and encourage further efforts to reduce the backlog in audited financial statements.

- The likely persistence of financing gaps requires a strategic approach to financing and debt sustainability. Given plans to expand the issuance of promissory notes in 2017, it will be even more important to ensure these are transparently recorded in the fiscal accounts. More broadly, developing a comprehensive arrears resolution plan and debt management strategy would help reduce financial sector risks, together with efforts to create space for priority spending.

C. Balancing Fiscal Sustainability and Growth

20. Israel and donors have a vital role to play in helping strike a balance between fiscal sustainability and growth. Even with the PA undertaking moderate fiscal adjustment, the persistent financing gaps and associated arrears could harm growth. With CRs from Israel representing two-thirds of WBG revenues, it is vital to continue discussions with Israel to improve revenue sharing

[8] Staff analysis suggests that the wage bill mainly reflects wages and allowances rather than oversized public sector employment. Also, more than 40 percent of social benefits are not targeted. See Annex III of IMF staff's *August 2016 Report to the AHLC*.

in the context of the customs union,[9] including more predictable clearance transfers from Israel. Staff noted potential for improved taxation of Palestinians employed in Israel, particularly with plans to implement direct deposits of salaries in Palestinians banks. The authorities and staff shared concern over the large and persistent declines in aid. Given the desire to enhance the quality of public services and maintain social cohesion, staff encouraged the authorities to demonstrate strong commitment to reforms, in particular on PFM, to catalyze donor support.

Box 2. The New Public Financial Management Strategy

While the authorities have continued to improve some key aspects of public financial management (PFM), there is still significant scope for further reform.[1] Efforts to bring PFM systems more closely in line with international best practice will be critical to improve the allocation, control, and monitoring of resources, the efficiency of public spending, and to enhance transparency and accountability—and ultimately to deliver enhanced public services.

The new PFM strategy represents a key component of the authorities' efforts to improve fiscal balances and the delivery of public services. The Ministry of Finance and Planning (MoFP) is close to finalizing the new PFM strategy, which was developed in the context of the National Policy Agenda (NPA). Importantly, the strategy identifies clearly existing gaps and how to address them, including through elaborating an Organic Budget Law, strengthening commitment controls, enhancing accounting systems, and regular and timely auditing of revenues and expenditures. The strategy and plans for its implementation are being developed in consultation with development partners, including the IMF.

Looking ahead, the strategy's success hinges on strong implementation. Key in this will be: (i) focus on building effective and efficient PFM systems rather than fiscal outcomes; (ii) narrowing the scope to cover all aspects of PFM from budget preparation to execution and reporting, but not procurement, divestiture, and tax administration; (iii) emphasis on building resilient systems, given the difficult operating environment and capacity constraints; (iv) a realistic implementation timeline, with clear milestones and expected outcomes; and (v) strong ownership through high-level MoFP involvement and active participation of line ministries.

Prepared by Ragnar Gudmundsson and Jean van Houtte.
[1] See Box 1 of IMF staff's August 2016 *Report to the AHLC*.

21. The authorities and staff also discussed how to boost the economy's productive capacity without compromising fiscal sustainability.

- Staff welcomed the launch of the NPA for 2017–22, which aims to promote sustainable development through sectoral investments, policies to promote job creation and poverty reduction, and stronger social protection. Staff supported the development of program budgeting to facilitate the envisaged re-orientation of public spending. However, it also reiterated the need to anchor the NPA in a realistic budget and a medium-term fiscal strategy. The authorities agreed and outlined plans to ensure integration with the 2018 budget.

- The authorities noted the importance of the electricity agreement with Israel. Staff agreed that this could provide important fiscal and economic benefits (Box 3), particularly as electricity

[9] See Box 1 of IMF staff's April 2016 *Report to the AHLC*.

supply is among the main obstacles for private sector development.[10] However, improved energy provision and fiscal savings on electricity bills depend on the yet-to-be specified details of the agreement. In this regard, staff underscored the need for progress toward a fair and transparent deal, that accounts for all costs associated with electricity infrastructure investment and maintenance.

Box 3. Potential Impact of the Electricity Sector Agreement

In September 2016, the PA and GoI reached an in principle agreement to resolve disputed claims on the Israel Electricity Company (IEC), and reform the electricity sector in the West Bank, with a view to transferring distribution and payment responsibilities to the PA.

The agreement reduced outstanding claims to NIS 636.5 million (around 1.2 percent of GDP) from an estimated NIS 2.030 billion. The reduction reflected a debt write-off and applying half of NIS 1.144 billion in previously withheld fees collected on Palestinian workers employed in Israel. The PA's remaining liabilities to the IEC are expected to be repaid over a 48-month period, starting once a new power purchase agreement is signed.

The agreement could improve the PA's fiscal position to the extent that it provides for reducing and eventually eliminating electricity-related deductions from monthly CR transfers. In 2016, these deductions amounted to NIS 864 million, representing about 10 percent of CRs, which in turn accounted for two-thirds of government revenue. Moreover, transferring responsibility for managing the electricity sector to the PA could allow for better control of payments by municipalities and more efficient electricity consumption. Lastly, preliminary discussions on a new power purchase agreement point to a possible 15 percent reduction in electricity tariffs.

While it is too soon to assess the longer-term economic gains of the agreement, improvements in energy infrastructure and provision in the West Bank could facilitate private sector development. However, fully realizing these benefits would depend on a broader relaxation of existing restrictions on economic activity.

The costs of implementing the agreement also require close attention, including those related to capacity building, as well as acquiring, operating, and maintaining new infrastructure. Implementation-related financing needs for 2017-18 are estimated at $35 million. In light of the PA's fiscal strains, financial support from development partners will be crucial, and should not substitute for existing budget support.

Finally, until the interim period ends, there are risks associated with new debt accumulating to the IEC. As of March 2017, the Jerusalem District Electricity Company accumulated estimated new debts of NIS 135 million. This underscores the need to enhance significantly the ability to collect payments and secure revenue streams in the run-up to the final agreement.

Prepared by Ragnar Gudmundsson.

22. **Staff also supported the authorities' efforts to enhance the business environment.** The new Companies law and Competition law (both expected in 2017), and planned Industrial Property Rights law aim to incentivize formalization of small businesses, protect minority rights, and attract foreign investments. With only around 30 percent of land registered in the West Bank, staff and the authorities agreed that improving clarity around land ownership could help reduce one obstacle to investment. The Financial Leasing and Secured Transaction laws aim to improve access to credit for

[10] "What is Holding back the Private Sector in MENA? Lessons from the Enterprise Survey"; EBRD, EIB and World Bank; 2016.

SMEs. However, staff and the authorities recognized that the full benefits of these reforms are contingent on access to resources and free movement of goods across WBG.

D. Balancing Fiscal Sustainability and Financial Stability

23. Staff encouraged the authorities to proactively monitor financial risks emanating from fiscal financing pressures. With bank borrowing the main source of domestic financing for the budget and banks' large exposure to the PA, risks in either sector are inextricably linked. The authorities shared staff's views about the importance of maintaining and enforcing regulatory limits on banks' exposure to the PA. Staff welcomed the PMA's efforts to adapt the regulatory regime, with the introduction of the limit on bank holdings of promissory notes. Given the large and persistent financing gaps, it will be important to resist pressure for banks to take on exposures beyond the regulatory limit, which would impinge on their ability to support private sector activity and amplify fiscal-financial risks (see Annex II).

Limits on Banks' Exposure to the PA

Banks' loans to the PA	100 percent of banks' total capital
Bank holding of promissory notes	$100 mn for all banking sector + bank specific limits
Risk weight on exposure to the PA	Rising from 0 to 20 percent over 4 years (5 percent per year from 2017)

Source: Palestine Monetary Authority.

24. The authorities highlighted their financial inclusion strategy and the need to preserve financial stability to support growth. They aim to diversify the financial sector to include SMEs and improve access in rural sectors, noting that credit to SMEs reached around $1.2 billion at end-December, with default rates below 6 percent. Staff commended the PMA on these achievements, while cautioning that strong and concentrated credit growth warrant close attention. Moreover, the authorities and staff agreed that efforts to promote inclusion should not come at the expense of supervisory standards. The authorities appreciated the dialogue with staff in developing the soon-to-be-completed new Central Bank Law.

25. Keeping CBRs intact will be crucial to avoid disrupting transactions with Israel and ensure economic stability in WBG. Transactions settled via correspondent services with an Israeli counterpart were valued at almost 90 percent of GDP in 2016.[11] Consequently, the termination of Israeli-Palestinian CBRs could have a significant economic impact, by cancelling transactions or driving them into cash.[12] Staff therefore strongly supported the authorities' ongoing efforts to upgrade their AML/CFT regime. While actions by the Israeli authorities to preserve CBRs may provide "breathing space", the authorities did not see this as a reason to delay their preparations for the MENAFATF evaluation. Staff agreed, noting the IMF technical assistance project to support reform of the legal AML/CFT framework, as well as the planned NRA. At the same time, the PMA has requested to make an exceptional cash shipment of NIS 1.5 billion to the BoI to address liquidity

[11] Transactions include checks and money transfers issued by Palestinians to Israeli beneficiaries or vice versa.

[12] See Annex V of IMF staff's August 2016 *Report to the AHLC*.

pressures from Israeli banks ceasing to accept cash from banks in the West Bank.[13] Efforts to promote cashless transactions should help alleviate these pressures in the long run.

STAFF APPRAISAL

26. The uptick in growth in 2016 masks the steady deterioration of the Palestinian economy's productive capacity. Sectors like agriculture, manufacturing, and services are either not developing or shrinking, and unemployment is high. Palestinians remain dependent on Israel for jobs (compensating for the lack of opportunities at home) and trade, while donor aid remains essential to finance Gaza reconstruction and contain broader fiscal strains. With bleak prospects for the peace process, growth is likely to stagnate over the medium term and remain insufficient to generate job opportunities, especially with looming demographic pressures. The ensuing frustration could exacerbate social tensions and increase the risk of social unrest, resulting in a vicious cycle of political and fiscal risks.

27. Increasing socio-economic fragmentation among different geographic regions in WBG further complicates the outlook. Together with existing restrictions on movement and access, the recent acceleration of settlement activity heightens political risks, further reduces access to productive resources, and limits the ability to exploit economic synergies between geographic regions. The resulting fragmentation acts as a drag on growth that can add to domestic political strains and jeopardize longer run economic viability.

28. While 2016 witnessed a welcome but unexpected fiscal windfall, the fiscal position is projected to weaken substantially in 2017. Technical dialogue with Israel on the fiscal files and negotiation of a new telecom license resulted in a large exceptional revenue increase in 2016. As a result, the overall deficit declined by over 3 percentage points of GDP in 2016 compared to 2015. However, in the absence of further exceptional transfers from Israel, the fiscal position is projected to worsen in 2017, notwithstanding the authorities' intention to increase government fees and change the basis for taxing tobacco products. With the budgeted decline in donor support, the financing gap is projected to approach $800 million (or around 5¾ percent of GDP).

29. This highlights the need for the authorities to adopt additional measures to narrow the gap, by restraining non-priority current spending and looking for scope to raise revenue. After a decade or more of fiscal adjustment, measures allowing "quick wins" have been almost exhausted and continued fiscal consolidation faces increasing resistance. Near-term efforts to contain spending could focus on tighter control of the wage bill and the cost of domestic health referrals. This could be complemented by eliminating fuel tax subsidies, and further strengthening revenues, including by restoring the top income tax bracket and further reducing tax exemptions. Given the political sensitivity of some measures, it is important that the authorities are beginning to explore other options to increase revenues (e.g., repealing rent controls).

[13] The BoI sets a limit of NIS 300 million per month on the amount of NIS cash transfers it accepts from Palestinian banks. However, the BoI occasionally accepts cash deposits in excess of this limit in response to requests by the PMA.

30. Lackluster growth and persistent large financing gaps over the medium term will require further fiscal adjustment that should not compromise financial stability and growth.

- **Fiscal sustainability and growth.** Investing in the Palestinian economy is necessary to generate growth but resources are scarce and financing gaps are projected at around 4.5 percent of GDP throughout the forecasting horizon. Without a breakthrough in the peace process, the PA will likely not be in a position to spend more on productivity-enhancing investments. In this context, the only credible option to create space for investment is by either boosting revenue or reducing the amount of current spending. The electricity agreement with Israel could also improve the supply of energy and yield fiscal savings, but it will be important to account for all implementation costs associated with the reform. Efforts to improve the business environment are important to stimulate the private sector, though their success is ultimately contingent on access to resources and free movement of goods across the West Bank, Gaza, and Jerusalem.

- **Financial stability and growth.** While the banking sector remains healthy overall, close and continuous monitoring can help manage risks related to banks' high exposure to the PA as well as the rapid growth and concentration of credit to the private sector. The continuation of correspondent relationships between Palestinian and Israeli banks is essential to preserve transactions between the two economies, and the PMA is working to step up its AML/CFT regime ahead of the comprehensive evaluation by MENAFATF planned for 2020. Continued dialogue with the BoI, together with efforts to promote cashless transactions, will be crucial to ease correspondent strains and devise a solution that can ensure CBRs in the long run.

31. Strengthening PFM systems remains a priority reform that requires support across government. A serious reform effort could generate significant payoffs, supporting fiscal adjustment by strengthening the ability to monitor and contain non-priority spending and re-orienting public spending towards productive investments. By enhancing transparency and accountability, PFM reforms could also help catalyze donor budget support. While the new PFM strategy is expected to provide a roadmap for structural fiscal reforms, significant gaps remain to be addressed, particularly in the auditing of public financial statements, and the commitment control and cash management functions.

32. Finally, Israel and donors also have a critical role to play to help ensure fiscal sustainability and preserve financial stability. A fundamental improvement in movement and geographic access is vital to preserving the viability of a Palestinian state in the long run. Reinvigorating technical discussions between the PA and GoI—ideally in the context of a revitalized Joint Economic Committee—can be instrumental to enhancing revenue and improving its predictability. Progress on allowing the direct deposit of salaries of Palestinians employed in Israel in Palestinian banks, together with efforts to promote more electronic transactions and maintain Israeli-Palestinian CBRs, could help expand the tax base and protect transactions. Moreover, reversing the declining trend in donor aid is crucial to help the PA avoid disorderly budget cuts motivated by urgency at the expense of growth-friendly investment.

Table 1. West Bank and Gaza: Selected Economic Indicators, 2014–22

(Population: 4.7 million; 2015 est.)
(Per capita GDP: $2,708; 2015)
(Poverty rate: 16 percent in the West Bank and 39 percent in Gaza Strip; 2014 est.)

			Est.	Projections					
	2014	2015	2016	2017	2018	2019	2020	2021	2022
Output and prices				(Annual percentage change)					
Real GDP (2004 market prices)	-0.2	3.5	4.0	3.4	3.4	3.3	3.3	3.3	3.3
West Bank	5.3	2.5	3.0	2.7	2.7	2.7	2.7	2.7	2.7
Gaza	-15.1	6.8	7.5	5.5	5.5	5.0	5.0	5.0	5.0
CPI inflation rate (end-of-period)	1.2	1.0	-1.0	1.5	2.0	2.1	2.1	2.1	2.1
CPI inflation rate (period average)	1.7	1.4	-0.2	0.7	1.8	2.1	2.1	2.1	2.1
Investment and saving				(In percent of GDP)					
Gross capital formation, *of which:*	19.0	21.2	21.0	20.3	19.8	19.8	19.7	19.8	19.8
Public	3.6	4.7	5.2	4.6	4.7	4.6	4.7	4.7	4.7
Private	15.4	16.5	15.8	15.7	15.1	15.1	15.0	15.1	15.0
Gross national savings, *of which:*	11.6	7.7	9.4	7.0	7.0	7.2	7.2	7.4	7.5
Public	-2.3	-4.0	-1.1	-4.2	-3.7	-3.5	-3.3	-3.1	-2.9
Private	14.0	11.7	10.5	11.2	10.7	10.7	10.5	10.5	10.3
Saving-investment balance	-7.4	-13.5	-11.6	-13.4	-12.8	-12.6	-12.5	-12.4	-12.3
Public finances 1/				(In percent of GDP)					
Revenues	21.6	21.7	25.8	23.5	23.6	23.6	23.7	23.7	23.8
Recurrent expenditures and net lending	32.0	31.4	31.4	31.4	30.8	30.4	30.1	29.8	29.5
Wage expenditures	16.1	15.1	15.2	15.2	14.9	14.7	14.6	14.4	14.3
Nonwage expenditures	13.6	13.9	14.1	14.2	14.1	14.1	14.1	14.1	14.1
Net lending	2.3	2.4	2.0	1.9	1.7	1.6	1.4	1.2	1.1
Recurrent balance (commitment, before external support)	-10.4	-9.6	-5.6	-7.8	-7.2	-6.8	-6.4	-6.1	-5.7
Recurrent balance (cash, before external support)	-5.1	-4.6	-2.2	-8.6	-7.9	-7.4	-7.0	-6.7	-6.3
Development expenditures	2.1	1.8	2.5	2.3	2.3	2.3	2.3	2.3	2.3
(In millions of U.S. dollars)	262	230	335	319	334	351	368	386	404
Overall balance (commitment, before external support)	-12.5	-11.4	-8.1	-10.1	-9.5	-9.1	-8.7	-8.4	-8.0
Total external support, including for development expenditures	9.7	6.3	5.6	4.8	4.6	4.4	4.3	4.1	4.0
(In millions of U.S. dollars)	1,230	799	757	659	667	676	686	696	706
External support for recurrent expenditure (in millions of U.S. dollars)	1,027	709	603	500	500	500	500	500	500
Financing gap (in millions of U.S. dollars)	...	...	...	789	753	752	751	751	749
In percent of GDP	...	...	5.9	5.7	5.2	4.9	4.7	4.5	4.3
Monetary sector 2/				(Annual percentage change)					
Credit to the private sector	17.3	19.2	20.0	15.0	14.0	13.0	13.0	12.0	12.0
Private sector deposits	7.2	7.3	6.8	8.1	8.3	7.8	8.6	8.1	8.1
External sector				(In percent of GDP)					
Current account balance (excluding official transfers)	-15.5	-19.1	-17.9	-17.0	-16.1	-15.9	-15.6	-15.3	-15.2
Current account balance (including official transfers)	-7.4	-13.5	-11.6	-13.4	-12.8	-12.6	-12.5	-12.4	-12.3
Exports of goods and nonfactor services	17.1	18.3	18.2	18.3	18.3	18.3	18.3	18.3	18.2
Import of goods and nonfactor services	56.8	59.2	57.0	56.5	55.6	55.1	54.9	54.5	54.1
Net factor income	10.9	10.9	10.9	11.0	11.0	10.9	10.8	10.7	10.6
Net current transfers	21.4	16.4	16.4	13.9	13.5	13.4	13.3	13.1	12.9
Private transfers	13.3	10.8	10.1	10.2	10.2	10.1	10.2	10.1	10.1
Official transfers	8.1	5.6	6.3	3.6	3.2	3.3	3.1	3.0	2.8
Memorandum items:									
Nominal GDP (in millions of U.S. dollars)	12,697	12,681	13,396	13,847	14,516	15,251	15,996	16,774	17,573
Per capita nominal GDP (U.S. dollars)	2,790	2,708	2,781	2,795	2,849	2,911	2,969	3,029	3,087
Unemployment rate	27	26	26	28	29	30	30	30	31
Al Quds stock market index (annual percentage change)	-7.1	6.0	...	...	...	...	...	...	...

Sources: West Bank and Gaza authorities; and IMF staff estimates and projections.

1/ Commitment basis.

2/ End-of-period; in U.S. dollar terms.

Table 2. West Bank and Gaza: Central Government Fiscal Operations, 2014–20

				Budget	Projections			
	2014	2015	2016	2017	2017	2018	2019	2020
	(In millions of shekels, unless otherwise stated)							
Net revenues	9,817	10,712	13,258	13,350	12,519	13,258	14,062	14,910
Gross domestic revenues	3,114	3,323	4,683	4,945	4,194	4,426	4,683	4,954
Tax revenues	2,149	2,354	2,392	3,134	2,673	2,822	2,988	3,164
Nontax revenues	966	969	2,292	1,811	1,521	1,604	1,695	1,790
Clearance revenues (accrued)	7,331	7,988	8,930	8,770	8,690	9,148	9,644	10,171
Of which: arrears	13	35	58	...	...	...	...	...
Less tax refunds 1/	628	599	355	365	365	315	265	215
Of which: arrears	147	335	-17	...	...	...	...	...
Recurrent expenditures and net lending (commitment)	14,556	15,453	16,137	16,105	16,696	17,291	18,095	18,937
Of which: arrears	2,281	2,194	2,366	-1,170	-384	-387	-390	-393
Wage expenditures (commitment)	7,336	7,439	7,837	8,087	8,087	8,362	8,756	9,171
Of which : arrears	570	603	505	...	...	...	...	...
Nonwage expenditures (commitment)	6,198	6,844	7,270	7,068	7,580	7,950	8,410	8,887
Of which: arrears	1,712	1,592	1,860	-1,170	-384	-387	-390	-393
Net lending	1,022	1,169	1,029	950	1,029	979	929	879
Development expenditures (commitment)	938	893	1,287	1,365	1,224	1,293	1,369	1,447
Of which: on Gaza reconstruction	89	132	...	...	...	...	...	...
Development expenditures (cash)	586	687	824	1,365	1,224	1,293	1,369	1,447
Of which: arrears	351	206	463	...	...	...	...	...
Recurrent balance (commitment, excl. development expenditure)	-4,739	-4,741	-2,878	-2,755	-4,177	-4,033	-4,033	-4,027
Overall balance (commitment)	-5,676	-5,635	-4,165	-4,120	-5,402	-5,326	-5,402	-5,474
Total financing	5,676	5,635	4,165	4,120	5,402	5,326	5,402	5,474
Net domestic bank financing	-469	677	53	...	384	387	390	393
External debt repayment	-38	-43	-71	...	-165	-173	-170	-176
External financing for recurrent expenditures	3,676	2,757	2,318	1,950	1,922	1,936	1,950	1,966
External financing for development expenditures	726	347	588	358	612	647	688	731
Arrears accumulation (net)	1,762	1,876	1,256	-1,170	-384	-387	-390	-393
Of which: repayment	-1,004	-917	-1,098	-1,170	-384	-387	-390	-393
Residual/financing gap	18	20	22	2,982	3,033	2,917	2,934	2,954
	(In millions of U.S. dollars, unless otherwise stated)							
Net revenues	2,744	2,756	3,452	3,473	3,257	3,424	3,605	3,792
Gross domestic revenues	870	855	1,219	1,287	1,091	1,143	1,201	1,260
Tax revenues	601	606	623	815	695	729	766	805
Nontax revenues	270	249	597	471	396	414	435	455
Clearance revenues (accrued)	2,049	2,055	2,325	2,282	2,261	2,363	2,472	2,587
Less tax refunds	176	154	92	95	95	81	68	55
Recurrent expenditures and net lending (commitment)	4,068	3,976	4,202	4,190	4,344	4,466	4,639	4,816
Wage expenditures (commitment)	2,050	1,914	2,041	2,104	2,104	2,160	2,245	2,332
Nonwage expenditures (commitment)	1,732	1,761	1,893	1,839	1,972	2,053	2,156	2,260
Net lending (commitment)	286	301	268	247	268	253	238	224
Development expenditures (commitment)	262	230	335	355	319	334	351	368
Recurrent balance (commitment, excl. development expenditure)	-1,324	-1,220	-749	-717	-1,087	-1,042	-1,034	-1,024
Overall balance (commitment)	-1,586	-1,450	-1,084	-1,072	-1,405	-1,376	-1,385	-1,392
Total financing	1,586	1,450	1,084	1,072	1,405	1,376	1,385	1,392
Net domestic bank financing	-131	174	14	...	100	100	100	100
External debt repayment	-10	-11	-18	...	-43	-45	-44	-45
External financing for recurrent expenditures	1,027	709	603	507	500	500	500	500
External financing for development expenditures	203	89	153	93	159	167	176	186
Arrears (net)	493	483	327	-304	-100	-100	-100	-100
Of which: repayment	-281	-236	-286	-304	-100	-100	-100	-100
Residual/Financing gap	5	5	6	776	789	753	752	751
Memorandum items:								
Revenues	21.6	21.7	25.8	25.1	23.5	23.6	23.6	23.7
Recurrent expenditures and net lending	32.0	31.4	31.4	30.3	31.4	30.8	30.4	30.1
Wage expenditures	16.1	15.1	15.2	15.2	15.2	14.9	14.7	14.6
Nonwage expenditures	13.6	13.9	14.1	13.3	14.2	14.1	14.1	14.1
Net lending	2.3	2.4	2.0	1.8	1.9	1.7	1.6	1.4
Recurrent balance (commitment) before external support	-10.4	-9.6	-5.6	-5.2	-7.8	-7.2	-6.8	-6.4
External financing for recurrent expenditures	8.1	5.6	4.5	3.7	3.6	3.4	3.3	3.1
Development expenditures (cash)	1.3	1.4	1.6	2.6	2.3	2.3	2.3	2.3
Overall balance (commitment)	-12.5	-11.4	-8.1	-7.7	-10.1	-9.5	-9.1	-8.7
Overall balance (cash)	-6.4	-6.0	-3.8	-11.0	-10.9	-10.2	-9.7	-9.3
Residual/financing gap	0.0	0.0	0.0	5.6	5.7	5.2	4.9	4.7
Nominal exchange rate (NIS per U.S. dollar)	3.58	3.89	3.84	...	...	...	...	...
Nominal GDP (in millions of shekels)	45,429	49,290	51,449	53,223	53,223	56,203	59,491	62,899

Sources: Ministry of Finance and Planning; and IMF staff projections.
1/ Includes fuel subsidies.

Table 3. West Bank and Gaza; Central Government Fiscal Operations, 2013–20 (GFSM 2001)

					Projections			
	2013	2014	2015	2016	2017	2018	2019	2020
	(In millions of shekels)							
Revenue	13,263	14,220	13,816	16,164	15,053	15,841	16,700	17,607
Taxes	7,426	8,852	9,743	10,967	10,998	11,655	12,367	13,120
Domestic taxes	2,157	2,149	2,354	2,392	2,673	2,822	2,988	3,164
Clearance taxes	6,103	7,331	7,988	8,930	8,690	9,148	9,644	10,171
Tax refund	-834	-628	-599	-355	-365	-315	-265	-215
Grants	4,915	4,402	3,105	2,906	2,534	2,582	2,638	2,697
External budget support	4,532	3,676	2,757	2,318	1,922	1,936	1,950	1,966
External development support	383	726	347	588	612	647	688	731
Other revenue	921	966	969	2,292	1,521	1,604	1,695	1,790
Of which: dividends	116	121	122	288	191	201	213	225
Expenditures	14,009	15,494	16,346	17,423	17,921	18,584	19,464	20,384
Expense	13,336	14,556	15,453	16,137	16,696	17,291	18,095	18,937
Compensation of employees 1/	6,928	7,336	7,439	7,837	8,087	8,362	8,756	9,171
Use of goods and services	1,816	2,333	2,530	2,547	2,547	2,690	2,847	3,010
Grants 2/	760	1,022	1,169	1,029	1,029	979	929	879
Other expense 3/	3,832	3,864	4,314	4,723	5,033	5,260	5,563	5,877
Net acquisition of nonfinancial assets	674	938	893	1,287	1,224	1,293	1,369	1,447
Gross operating balance	-73	-336	-1,637	27	-1,643	-1,451	-1,395	-1,330
Net lending / borrowing (overall balance)	-746	-1,274	-2,530	-1,259	-2,868	-2,744	-2,764	-2,777
Net financial transactions	-746	-1,371	-2,487	-1,188	-2,483	-2,744	-2,764	-2,776
Net acquisition of financial assets	…	…	…	…	…	…	…	…
Domestic								
Currency and deposits	…	…	…	…	…	…	…	…
Net incurrence of liabilities	785	1,353	2,468	1,167	-550	-173	-170	-176
Domestic	785	1,391	2,510	1,238	-384	0	0	0
Loans	-895	-469	634	-18	384	387	390	393
Net domestic bank financing	-895	-469	634	-18	384	387	390	393
Other accounts payable	1,680	1,860	1,876	1,256	-769	-387	-390	-393
Arrears (recurrent)	1,628	1,424	1,612	693	-769	-387	-390	-393
Arrears (capital)	66	351	206	463	…	…	…	…
Arrears (clearance)	14	13	35	58	…	…	…	…
Arrears (earmarked revenue)		98	93	158				
Foreign	…	-38	-43	-71	-165	-173	-170	-176
Loans	…	-38	-43	-71	-165	-173	-170	-176
Statistical discrepancy/financing gap	-38	18	20	22	3,033	2,917	2,934	2,954
Memorandum items:								
Gross operating balance excl. grants (commitment)	-4,988	-4,739	-4,741	-2,878	-4,177	-4,033	-4,033	-4,027
Gross operating balance excl. grants (cash)	-3,374	-3,328	-3,164	-2,243	-4,946	-4,420	-4,423	-4,420
Overall balance (NLB) excl. grants (commitment)	-5,662	-5,676	-5,635	-4,165	-5,402	-5,326	-5,402	-5,474
Overall balance (NLB) excl. grants (cash)	-3,982	-3,914	-3,851	-3,067	-6,171	-5,713	-5,792	-5,868
Revenue (percent of GDP)	29.6	31.3	28.0	31.4	28.3	28.2	28.1	28.0
Expenditure (percent of GDP)	31.2	34.1	33.2	33.9	33.7	33.1	32.7	32.4
Expense (percent of GDP)	29.7	32.0	31.4	31.4	31.4	30.8	30.4	30.1
Wage expenditure (percent of GDP)	15.4	16.1	15.1	15.2	15.2	14.9	14.7	14.6
Nonwage expenditures (percent of GDP)	4.1	5.1	5.1	5.0	4.8	4.8	4.8	4.8
GOB (commitment) excluding grants (percent of GDP)	-11.1	-10.4	-9.6	-5.6	-7.8	-7.2	-6.8	-6.4
GOB (cash) excluding grants (percent of GDP)	-7.5	-7.3	-6.4	-4.4	-9.3	-7.9	-7.4	-7.0
External support (recurrent)	10.1	8.1	5.6	4.5	3.6	3.4	3.3	3.1
in millions of NIS	4,532	3,676	2,757	2,318	1,922	1,936	1,950	1,966
NLB (commitment) excluding grants (percent of GDP)	-12.6	-12.5	-11.4	-8.1	-10.1	-9.5	-9.1	-8.7
NLB (cash) excluding grants (percent of GDP)	-8.9	-8.6	-7.8	-6.0	-11.6	-10.2	-9.7	-9.3
Total external support (in millions of shekels)	4,915	4,402	3,105	2,906	2,534	2,582	2,638	2,697
Nominal GDP (in millions of shekels)	44,843	45,429	49,290	51,449	53,223	56,203	59,491	62,899
Exchange rate	3.6	3.6	3.9	…	…	…	…	…

Sources: Ministry of Finance and Planning; and IMF staff projections.

1/ Wage expenditures.

2/ Grants to local governments related to purchase of water and electricity.

3/ Includes transfers (social benefits) and minor capital.

Table 4. West Bank and Gaza: Financial Soundness Indicators, 2011–16

	Dec-11	Dec-12	Dec-13	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16
Capital adequacy (for all banks)												
Tier I capital to risk-weighted assets	22.9	22.2	21.5	20.0	18.8	18.2	17.9	18.1	17.0	16.4	17.1	17.2
Regulatory capital to risk-weighted assets	21.1	20.3	20.0	18.9	17.8	17.2	17.8	18.0	17.4	16.7	17.4	18.0
Capital adequacy (for local banks)												
Tier I capital to risk-weighted assets	24.5	22.7	20.7	18.0	17.4	16.9	16.2	16.1	15.1	14.2	15.7	16.0
Regulatory capital to risk-weighted assets	20.3	18.8	17.8	16.3	15.7	15.3	15.4	15.4	15.2	14.1	15.6	16.5
Asset quality 1/												
Nonperforming loans (percent of total loans)	2.7	3.1	2.9	2.5	2.7	2.5	2.5	2.1	2.0	2.0	2.2	2.2
Nonperforming loans net of provisions to capital	3.8	4.9	4.7	4.0	4.9	4.2	4.2	3.4	3.3	3.1	3.7	3.7
Coverage ratio (provisions as percent of nonperforming loans)	60.9	60.1	59.1	61.4	58.6	63.3	63.6	67.3	68.8	70.4	66.4	65.8
Earnings and profitability												
Return on assets (ROA)	1.9	1.8	1.9	1.7	1.6	1.6	1.6	1.5	1.7	1.6	1.5	1.5
Return on equity (ROE) 2/	17.0	16.2	18.7	17.1	15.7	15.5	15.7	15.0	17.4	16.9	16.0	15.6
Interest income to gross income	71.7	72.4	74.0	72.4	71.5	70.6	71.7	72.2	70.4	70.9	71.9	71.4
Non-interest expenses to gross income	57.2	55.4	54.8	60.1	60.2	61.0	62.0	63.0	61.3	61.7	61.9	62.6
Personnel cost to non-interest expenses	55.5	53.8	53.9	51.5	53.0	52.8	51.8	51.3	52.0	52.0	51.3	50.4
Liquidity												
Liquid assets to total assets	38.2	37.5	39.5	35.4	34.1	33.4	35.9	34.2	33.9	33.1	32.7	33.0
Liquid assets to demand and savings deposits	74.4	71.6	74.7	65.9	62.9	60.0	65.3	62.3	61.8	61.7	61.7	61.2
Liquid assets to total deposits	46.9	45.8	48.1	43.2	41.8	40.0	42.9	41.0	40.6	39.9	39.7	39.9

Source: Palestine Monetary Authority.

1/ Nonperforming loans includes loans more than 90 day overdue.

2/ Return on equity (ROE) is a ratio of income before extraordinary items and taxes to average Tier 1 capital.

Annex I. West Bank and Gaza—Risk Assessment Matrix[1]

Nature/Sources of Risk	Relative Likelihood	Expected Impact If Realized	Policies to Mitigate Risks
Domestic Risks			
Reduced and/or volatile donor support due to competing demands on donor resources, falling oil prices for Arab donors and/or shifts in donor sentiment	***High***	***High*** A larger than projected decline in donor budget support—particularly if sustained as donors reconsider their long-term support for the PA—could jeopardize fiscal sustainability. Larger financing gaps would make fiscal management even more difficult, leading to additional arrears or deeper spending cuts that could be detrimental to economic growth and social cohesion.	(1) Instill confidence through strong domestic policies, anchored in gradual medium-term fiscal adjustment and reforms to strengthen government institutions. (2) Implement pro-growth policies, including the composition of budget spending and ensuring resilience of the financial sector, could over time reduce aid dependency and support fiscal sustainability.
Economic fragmentation in the West Bank and Gaza due to pressures from settlement expansion or the persistent divergence of the two economies	***High***	***High*** Further erosion of geographic control or increased restrictions on access and movement would shrink the productive resources available to the Palestinian economy, including by limiting the ability to exploit the complementary aspects of the West Bank and Gazan economies. The permanent negative impact on growth would jeopardize the longer run economic viability of a Palestinian state. Growing socio-economic disparities could fuel unrest and further harm growth.	Maintaining strong domestic policies could help instill confidence. However, economic policies can do little to mitigate geo-political risks.
Escalation of violence due to widespread discontent with the peace process and lack of a political horizon, or a resumption of hostilities in Gaza	***High***	***High*** A significant or widespread increase in unrest in the West Bank and Gaza could undermine growth and lead to tightening of Israeli restrictions. Resumption of the conflict in Gaza would exacerbate the humanitarian and economic situation. This could add to uncertainty about the willingness or ability of donors to provide budget support.	In the short run, economic policies can do little to mitigate geo-political risks. However, maintaining strong domestic policies could help instill confidence.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Nature/Sources of Risk	Relative Likelihood	Expected Impact If Realized	Policies to Mitigate Risks
		GLOBAL RISKS	
Reduced financial services by correspondent banks	***High***	***Medium/High*** Restrictions on cash transfers to Israel by banks operating in WBG already pose a liquidity risk. Terminating correspondent bank relationships—namely Israeli-Palestinian bank relations—would lead to some trade and financial transactions being canceled, and others pushed into informality. This could undermine the functioning of WBG's payment system and financial stability, with repercussions for growth.	(1) Effectively implement the new "Anti Money Laundering and Terrorism Financing" law and related regulations to promote confidence. (2) Continue to build implementation capacity, including with technical assistance, ahead of the evaluation of WBG's AML/CFT regime by the MENA Financial Action Task Force scheduled for 2020.
Intensification of the risks of fragmentation/ security dislocation in part of the Middle East	***High***	***Medium/High*** Social and political unrest in the region could divert donor aid away from the WBG with associated fiscal pressures. Any direct spillover of regional instability and dislocation would exacerbate security and economic uncertainty in WBG.	Maintaining strong domestic policies could help instill confidence. However, economic policies can do little to mitigate external geo-political risks.
Structurally weak growth in key advanced and emerging economies	***High/ Medium***	***Medium*** The WBG is sensitive to a slowdown in Israel, including as a result of developments in Europe for example. Fiscal strains in donor countries could affect availability of aid for the PA. This could further weaken growth, increase unemployment, and worsen the fiscal position.	(1) Instill confidence through strong domestic policies, anchored in medium-term fiscal adjustment. (2) Improve competitiveness of the economy via scaled-up investment in infrastructure, and education to support human capital development.

Annex II. Public Debt Developments and Sustainability[1]

This annex assesses debt developments since IMF staff's report to the September 2016 Ad Hoc Liaison Committee. The narrowing of the deficit, together with downward revisions in arrears, resulted in a moderate reduction in the overall gross public debt in 2016. However, the increasingly challenging fiscal outlook, including lower aid projections, suggest that the PA's indebtedness has become increasingly unsustainable. While the debt stock steadily increases under the base case scenario, adverse shocks to growth or aid could add a further 20 percent to the debt stock within 5 years.

Recent Debt Developments

At end 2016, the stock of public debt[2] stood at $4,903 million (equivalent to 36.6 percent of GDP). Domestic debt[3] accounted for around three-quarters of the total, including arrears to the pension fund (12.1 percent of GDP), regular loans and overdrafts (11.4 percent of GDP) and obligations to private suppliers (4.5 percent of GDP) (Text Table II.1). External debt (8.5 percent of GDP) comprised largely of long-term development finance from multilateral or bilateral lenders.

While the PA's gross debt liabilities at end-2016 declined compared to end-2015 (40.4 percent of GDP), this mainly reflected adjustments in recorded debt during 2016 rather than more favorable fiscal financing. In particular:

- Liabilities owed to the pension fund were restated downward in data reported for June 2016 by an amount equivalent to almost 4½ percent of GDP after an audit by PricewaterhouseCoopers. However, fiscal financing strains led to a further accumulation of arrears to the pension fund in the second half of 2016.

- Domestic debt, excluding liabilities to the pension fund, remained largely unchanged as a share of GDP.[4] On one hand, domestic loans declined as percent of GDP as the PA undertook no net new borrowing from banks, with banks' exposure to the PA already close to the regulatory limit. However, liabilities stemming from obligations to suppliers—most of which are in arrears or refinanced with short-term promissory notes—increased by more than 40 percent in nominal terms and now account for 4.5 percent of GDP, up by 1.1 percentage point over a year ago.[5]

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[1] Prepared by Jean van Houtte.

[2] Debt coverage includes accounts payable and pension liabilities in line with the IMF's *Public Sector Debt Statistics: Guide for Compilers and Users* (2013).

[3] Domestic debt is defined on the basis of the residency of the creditor.

[4] Domestic liabilities do not include the overdraft balance accrued by the public petroleum authority with its suppliers, and which were last reported to be close to $200 million at end-2015.

[5] Arrears to suppliers cover payables owed by the central government and other entities such as municipalities and some parastatals. The stock of liabilities accrued by municipalities have been inferred from 2016 flow figures.

- External debt[6] decreased both in nominal terms and as a fraction of GDP, as amortization outstripped limited disbursements of long-term external financing. Prospects for additional external financing are poor, since no new agreements were signed in the second half of 2016.

Text Table II.1. West Bank and Gaza: Total Debt Liabilities of the PA
(In percent of GDP)

	2015	June 2016	Dec. 2016
Gross debt liabilities	40.4	34.9	36.6
Domestic debt	30.9	26.5	28.1
Private suppliers, municipalities (incl. arrears)	3.4	3.3	4.5
Bank loans and overdrafts	11.6	10.5	10.7
Other domestic loans	0.8	1.8	0.7
Pension fund	15.2	10.9	12.1
External Debt	9.5	8.4	8.5
Memorandum item:			
Domestic debt (excl. pension fund)	15.7	15.6	16.0

Sources: Ministry of Finance and Planning; and IMF staff estimates.

Debt Sustainability Analysis

The prospect of increased fiscal pressures raises questions about the sustainability of the PA's debt burden. The projected moderate pace of fiscal adjustment under staff's baseline scenario reflects, in part, uncertainty about CR transfers and progress on fiscal files. Moreover, sustained fiscal consolidation will likely become increasingly difficult in the context of persistently weak growth (3.3 percent over the medium term), particularly in the absence of a more favorable political horizon. This is compounded by the decline in donor budget support, resulting in larger than previously projected fiscal financing gaps.

Under this baseline scenario, the PA's debt increases steadily from 36.6 percent of GDP to 54.1 percent of GDP by 2022. While the pace of debt accumulation eases somewhat over time, debt does not stabilize during the projection period given the sizable fiscal financing needs.

Shocks to the macroeconomic or financial environment could see the PA's debt trajectory become increasingly unsustainable. Debt is most vulnerable to the growth shock, under which growth is 1.8 percentage points lower (i.e., a permanent ¼ standard deviation) and debt would increase to 66.4 percent of GDP by 2022 (more than 12 percentage points of GDP higher than under the baseline). Shocks to the primary balance or donor aid[7] would also trigger a significant upward

[6] External debt is defined as the sum of foreign loans as well as clearance revenue advances from Israel.

[7] These shocks correspond, respectively, to a permanent ½ standard deviation shock applied to the primary balance, and a permanent decrease of aid by 1.5 percentage points of GDP for each projection year.

adjustment, adding around 20 percent to the stock of debt within 5 years. In each case, the resulting debt level in 2022 would be significantly higher than in staff's previous DSA.[8]

Another key vulnerability for the PA is that the baseline scenario assumes, in line with past practice, that some of the financing gap will be covered by non-interest bearing arrears. This tends to understate the pressures on debt sustainability.

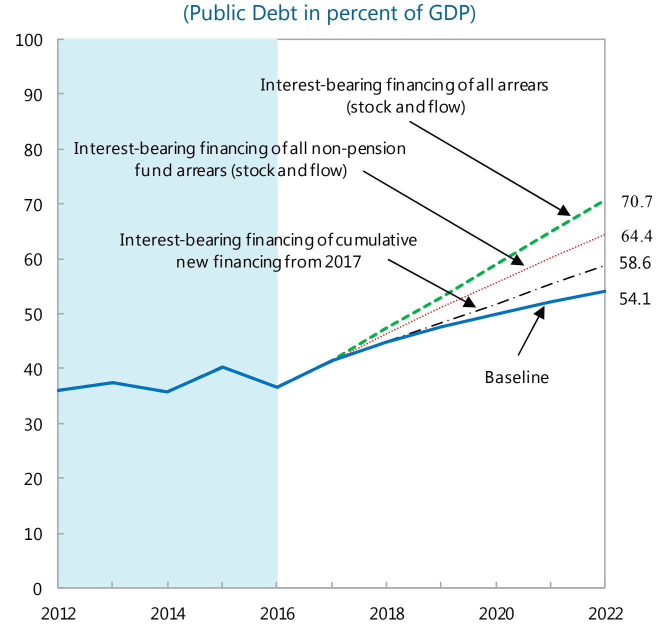
- If, instead, the PA were to seek to cover the cumulative financing gaps by interest-bearing loans or government securities, this would add to the debt burden. Assuming an average annual interest rate of 10 percent,[9] the debt stock would increase by 4½ percentage points of GDP by 2022 (text figure).

- If, in addition to the projected financing gaps, the PA sought to securitize the existing stock of non-pension fund arrears, the interest dynamics alone would add 10 percentage points of GDP to the debt stock by 2022.

- Moreover, if existing and projected pension fund arrears were also securitized, the interest dynamics would push debt above 70 percent of GDP by 2022. In this scenario, debt sustainability becomes even more sensitive to the interest rate—for instance, a doubling of the interest rate would have a snowball effect, with debt approaching 100 percent of GDP in five years.

Customized Scenario: Financing Gap and Arrears Financed by Interest-bearing Loans or Securities

(Public Debt in percent of GDP)



Sources: West Bank and Gaza authorities; and IMF staff estimates and projections.

Importantly, these scenarios do not speak to the demand for such instruments or the ability of banks—the main buyers of domestic debt—to take on more debt (both in terms of the regulatory exposure limit, and broader financial development and stability concerns).

[8] See Annex II of IMF staff's August 2016 *Report to the AHLC*.

[9] By comparison, interest rates in recent bond issuances with maturities greater than 5 years by Egypt have varied between 4.6 and 8.5 percent; by Jordan between 5.75 and 6.25 percent; and by Israel between 3 and 7 percent.

While these vulnerabilities underscore the importance of continued donor support, they also call for caution in taking on other forms of debt. For instance, government securities market could, in time, be an important source of fiscal financing, but a gradual approach is needed to avoid further compromising fiscal sustainability or financial stability (text box). Despite recent progress,[10] debt management capacity remains weak, and the high amounts of arrears (with undetermined maturities) undermines the ability to adopt and implement transparent debt management practices. The recent issuance of 6-month promissory notes has provided some structure to the debt profile, but they are more a tool for liquidity management than an instrument for development finance.

Prerequisites for Developing a Government Securities Market

The authorities have contemplated the possibility of issuing government bonds for at least 10 years. In 2010, IMF technical assistance provided guidance on the prerequisites for successfully developing and launching a government securities market, including: (i) macroeconomic conditions, (ii) legal framework, (iii) technical infrastructure, (iv) institutional capacity, and (v) the existence of market demand.

While some aspects might be manageable in the near term (e.g., the second category), the others point to specific issues that will be more difficult to address, namely (a) clearing arrears, (b) achieving a sustainable fiscal outlook, (c) filling gaps in macroeconomic forecasting and risk analysis, and (d) developing a comprehensive debt strategy and debt management capacity.

[10] The debt management unit has made significant progress in reducing overdrafts in one of the two commercial banks providing financial services to the PA (Arab Bank); thus limiting idle money balances in these accounts.

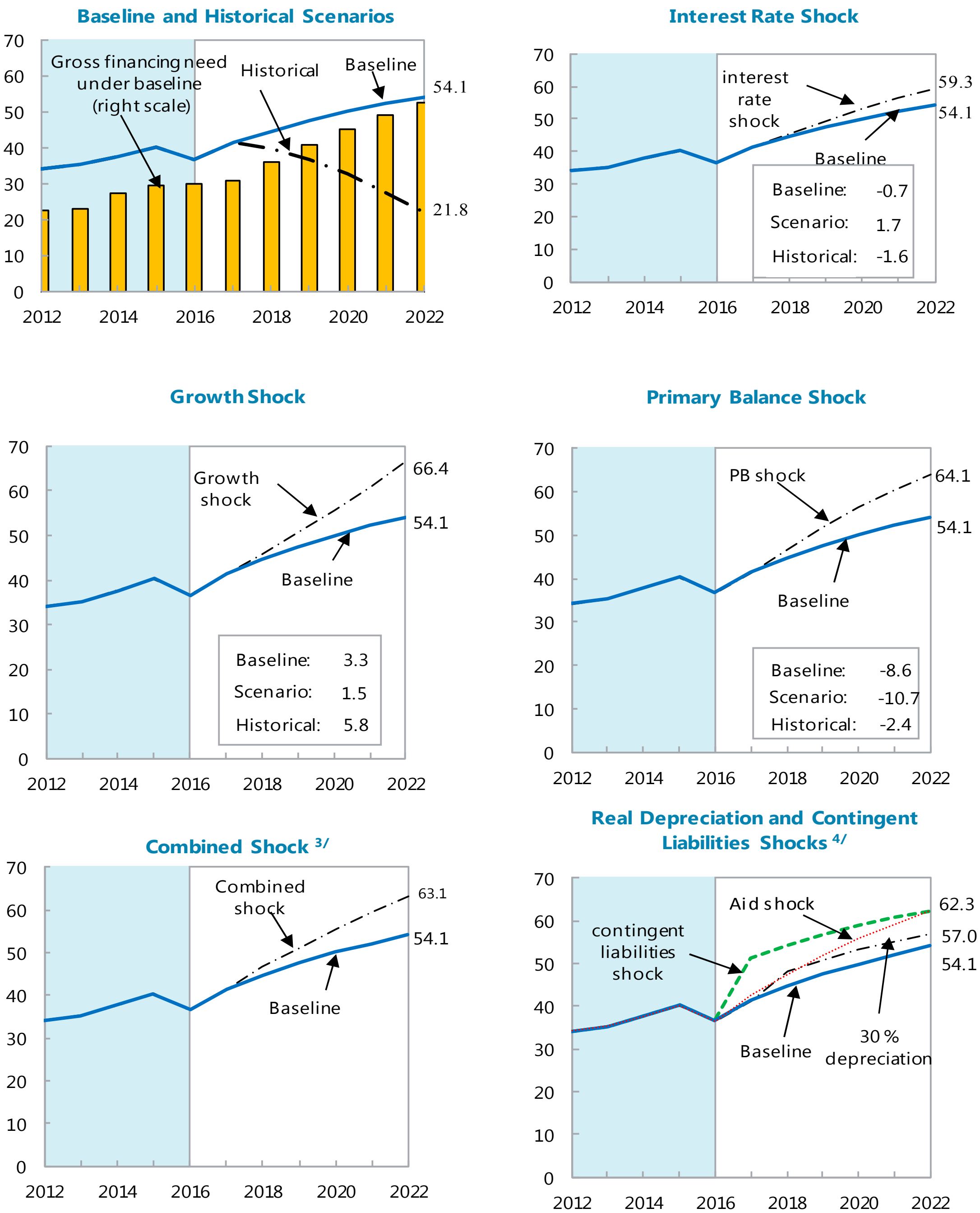
Table II.1. West Bank and Gaza: Total Debt Liabilities of the PA
(In millions of U.S. dollars)

	2012	2013	2014	2015	2016 June	2016 Dec.
Gross debt liabilities	4,051	4,628	4,550	5,117	4,679	4,903
In percent of GDP	36.1	37.3	35.8	40.4	34.9	36.6
Domestic debt 1/	1,385	1,268	1,128	1,467	1,457	1,440
Bank loans	719	661	631	799	785	817
Overdraft	480	366	303	433	436	383
Petroleum Authority loans	178	225	181	221	222	227
Other public institutions loans	8	15	13	13	14	14
Other domestic accounts payable, incl. arrears, and debt securities 2/	1,409	2,101	2,190	2,450	2,060	2,328
Pension fund 3/	1,058	1,465	1,619	1,923	1,508	1,627
Private suppliers, municipalities and ministries 4/	269	555	473	428	460	608
o/w promissory notes to private suppliers	…	…	…	…	91	62
Palestinian Investment Fund (PIF) 5/	79	79	95	96	89	89
PMA	3	3	3	3	3	3
External debt, incl. clearance advances	1,258	1,259	1,231	1,201	1,162	1,136
Arab Financial Institutions	629	630	621	618	618	606
Al Aqsa Fund	522	524	517	518	517	512
Arab Fund for Economic & Social Development	57	58	57	56	56	56
Islamic Development Bank	50	48	47	44	45	37
International and Regional Institutions	339	343	348	337	335	330
World Bank	290	284	277	269	266	266
European Investment Bank	26	36	48	45	46	41
IFAD	3	3	3	2	2	2
OPEC	19	20	20	20	20	20
Bilateral loans	130	136	120	101	103	93
Spain	92	96	84	76	77	73
Italy	33	35	31	20	20	20
China	5	5	5	5	5	-
Clearance advances from Israel (from 2012)	160	150	142	144	106	107
Memo: Debt of Palestinian entities to Israeli Electricity Company 6/		375	463	438	444	157
Gross debt liabilities, excl. Pension Fund	2,994	3,163	2,931	3,194	3,171	3,276
In percent of GDP	26.6	25.5	23.1	25.2	23.7	24.5

Source: Ministry of Finance and Planning; and IMF staff estimates.
1/ As reported by the MOFP in monthly reports (http://www.pmof.ps/en/41).
2/ Included in line with recommendations from "Public Sector Debt Statistics: Guide for Compilers and Users", IMF, 2013.
3/ As of June 2016, data reflect revised information on outstanding stock of liabilities following PriceWaterhouseCoopers audit of the pension fund. The MOFP has yet to advise of the impact on historic data for 2012-15.
4/ Includes debt to municipalities, which is under negotiation, with the MOFP seeking audit and reconciliation.
5/ The MOFP is currently negotiating a settlement to offset debt against PIF dividends to the budget.
6/ Of total debt, about $90 million is debt of the PA.

Figure II.1. West Bank and Gaza: Public Debt Sustainability: Bound Tests 1/2/

(Public debt in percent of GDP)



Sources: Palestinian authorities; and IMF staff estimates and projections.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table II.2. West Bank and Gaza: Public Sector Debt Sustainability Framework, 2012–22

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Debt-stabilizing primary balance 9/
Baseline: Public sector debt 1/	36.1	37.3	35.8	40.4	36.6	**41.4**	**44.7**	**47.5**	**50.0**	**52.2**	**54.1**	**-2.1**
Of which: foreign-currency denominated	9.5	8.6	9.3	8.3	7.8	7.6	7.2	6.9	6.6	6.2	6.0	
Change in public sector debt	4.3	1.4	-1.5	4.5	-3.7	4.8	3.3	2.8	2.5	2.2	1.9	
Identified debt-creating flows (4+7+12)	2.2	-0.2	3.4	2.3	0.6	11.7	3.5	4.6	5.8	6.9	7.9	
Primary deficit	6.5	1.0	2.6	4.9	1.9	4.5	4.9	6.4	7.7	8.9	10.0	
Revenue and grants	26.7	29.6	31.3	28.0	31.4	28.3	28.2	28.1	28.0	27.9	27.8	
Primary (noninterest) expenditure	33.2	30.6	33.9	33.0	33.3	32.8	33.1	34.4	35.6	36.8	37.8	
Automatic debt dynamics 2/	-4.2	-1.2	0.8	-2.6	-1.2	-0.4	-1.4	-1.7	-1.8	-2.0	-2.1	
Contribution from interest rate/growth differential 3/	-4.0	-0.6	-0.3	-2.6	-1.1	-0.4	-1.4	-1.7	-1.8	-2.0	-2.1	
Of which: contribution from real interest rate	-2.3	0.2	-0.3	-1.5	0.5	0.8	-0.1	-0.3	-0.3	-0.4	-0.5	
Of which: contribution from real GDP growth	-1.7	-0.8	0.1	-1.1	-1.6	-1.2	-1.3	-1.4	-1.5	-1.6	-1.6	
Contribution from exchange rate depreciation 4/	-0.2	-0.7	1.1	0.0	-0.1	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	7.6	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	7.6	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	2.1	1.6	-4.9	2.2	-4.3	-7.0	-0.2	-1.8	-3.3	-4.7	-6.0	
Public sector debt-to-revenue ratio 1/	134.6	126.3	114.5	143.8	116.5	146.2	158.4	169.1	178.6	187.0	194.3	
Gross financing need 6/	22.4	22.6	26.6	29.5	29.8	30.7	35.2	39.9	44.2	48.1	51.6	
In billions of U.S. dollars	2.5	2.8	3.4	3.7	4.0	4.3	5.1	6.1	7.1	8.1	9.1	
Scenario with key variables at their historical averages 7/						**41.5**	**40.8**	**38.7**	**35.3**	**31.0**	**26.0**	**-1.8**
Scenario with no policy change (constant primary balance) in 2017-2022						**41.4**	**44.4**	**45.3**	**44.8**	**42.9**	**39.7**	**-1.5**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	6.3	2.2	-0.2	3.5	4.0	3.4	3.4	3.3	3.3	3.3	3.3	
Average nominal interest rate on public debt (in percent) 8/	1.3	1.9	0.6	0.6	1.5	2.4	1.9	1.8	1.7	1.6	1.5	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-7.8	0.6	-0.9	-4.3	1.2	2.3	-0.2	-0.7	-0.7	-0.9	-0.9	
Nominal appreciation (increase in US dollar value of local currency, in percent)	2.4	7.5	-10.7	0.2	1.4	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	9.2	1.3	1.5	4.9	0.3	0.1	2.1	2.5	2.3	2.4	2.3	
Growth of real primary spending (deflated by GDP deflator, in percent)	0.6	-5.7	10.6	0.6	5.1	1.9	4.4	7.4	7.0	6.5	6.2	
Primary deficit	6.5	1.0	2.6	4.9	1.9	4.5	4.9	6.4	7.7	8.9	10.0	

Sources: West Bank and Gaza authorities; and IMF staff estimates and projections

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Annex III. West Bank and Gaza: Technical Assistance by the IMF to the Palestinian Authority, 2012–17

Technical assistance (TA) provided by the IMF has focused on public financial management, revenue administration, financial sector supervision, and national accounts. Recent TA has also included macro-fiscal forecasting. Looking ahead, priority areas for support continue to be public financial management, revenue administration, and banking supervision. There is need for intermittent review and assistance to enhance statistical capacity especially in GFSM 2001, external sector, and national accounts. The Fund plans to continue providing TA, dependent on the authorities' commitment and progress.		
Mission Date	**Mission**	**Date of TA Report**
Fiscal Sector: Since 2007, components of a modern public financial management system have been put in place and steadily upgraded. Progress in PFM was made in drafting legal frameworks, adopting Treasury Single Account (TSA), establishing debt management and cash planning units, modernization of budget classification and Chart of Accounts, developing computerized financial management information system (FMIS), strengthening accounting and reporting, activating internal audit departments in ministries, establishing an independent external audit agency, and establishing a macro-fiscal unit. A medium-term plan of reforms had been agreed upon in 2011 and further updated in 2012. Currently, the key objective is to consolidate the institutionalization of progress already made. Further to consolidation, approval of legislative and regulatory frameworks, review of implementation of commitment control and TSA, cash planning, arrears recording and formulation of strategies for minimizing arrears, and compliance with GFSM 2001 standards need to be addressed. Since 2010, the TA efforts expanded into mobilizing revenue compliance by modernizing tax administration. A medium-term work program, recommended by the FAD, will strengthen particularly the administration of income tax and VAT for the large and medium taxpayer segments and reform the income tax and reduce tax incentives and exemptions. So far, a computerized revenue management system has been launched, a tax procedures code was approved by the Cabinet but not enacted, and the LTU, under a newly appointed director, has begun more effective work. In the medium term, the FAD TA priorities will remain the improvement of public financial management and modernization of revenue administration.		
Feb. 1–14, 2012	Tax Administration	n.a.
Apr. 15–22, 2012	Tax Revenues Clearance Procedures	May 2012
Jun. 13–26, 2012	Improving Income Tax and Tax Incentives Proposed Tax Policy TTF	Jul. 2012
Jan. 22–31, 2013	Public Financial Management Progress Review	Jan. 2013
Jun. 25–Jul. 8, 2013	Supplementary Technical Review: Investment Tax Incentives and Tax Expenditure Costs	Jul. 2013
Nov. 24–Dec. 5, 2013	Strengthening LTO Operations	Dec. 2013
Jan. 8–21, 2014	Public Financial Management Reform Agenda 2014–16	Mar. 2014
Nov. 9–20, 2014	Strengthening Large Taxpayer Unit	Nov. 2014
Nov. 23–Dec. 1, 2014	Public Financial Management Progress Review	Dec 2014

Mar. 8–19, 2015	Compliance Modeling in LTU and Tax Departments	Mar. 2015
Aug. 16–27, 2015	Revenue Management System	Aug. 2015
Aug. 23–28, 2015	Work Program for Macro-Fiscal Advisor	n.a.
Oct. 13–25, 2015	Improving Taxation of SMEs: Design and Compliance Issues	Dec. 2015
Jan. 10–21, 2016	Preparation of Files for Prosecution	Jan. 2016
June 12–24, 2016	Budget Preparation and Macro-Fiscal Forecasting	June 2016
July 10–22, 2016	Budget Preparation and Macro-Fiscal Forecasting	Aug. 2016
July 31–Aug. 18, 2016	Training on Investigative Technique and Preparation of Customs for Prosecution	Aug. 2016
Monetary and Financial System: The TA efforts have been to support the Palestine Monetary Authority (PMA) in becoming a competent monetary authority to operate a high-quality reserves management system, to supervise and regulate banks, to gain capacity in introducing government securities, and to prepare for eventual introduction of an independent currency for the Palestinian economy when conditions are right. The PMA established a credit registry, instituted periodic stress testing of banks, introduced a deposit insurance scheme, and prepared plans for contingency crises management. The PMA has developed substantial capacity as a central bank toward the possibility of issuance of a national currency.		
Jan. 15–26, 2012	Developing a Government Securities Market	n.a.
Feb. 5–9, 2012	Reserve Management Policy and Investment Guidelines *	Apr. 2012
Mar. 25–Apr. 3, 2012	Risk-Based Banking Supervision *	Apr. 2012
Oct. 9–18, 2012	Implementing Risk-Based Supervision	Oct. 2012
Oct. 31–Nov. 15, 2012	Strengthening the Frameworks for Contingency Crisis Management, Consolidated and Cross Border Supervision and Stress Testing	June 2013
Dec. 8–12, 2012	Developing the Government Securities Market	Dec. 2012
Jan. 13–17, 2013	Reserve Management Policy and Investment Guidelines	Jan. 2013
Mar. 31–Apr. 11, 2013	Follow up on Risk-Based Supervision Manual	n.a.
Jun. 30–Jul. 10, 2013	Follow up on Risk-Based Supervision	July 2013
Nov. 3–14, 2013	Implementing Risk-Based Supervision*	Nov. 2013
Nov. 16–26, 2013	Credit Registry	Nov. 2013
May 25–29, 2014	Follow up on Risk Based Supervision Manual	June 2014

Oct. 26–Nov. 6, 2014	Follow up on Risk Based Supervision Manual	n.a.
Jan. 18–29, 2015	Follow up on Risk Based Supervision Manual	n.a.
Mar. 8–19, 2015	Review of Crises Preparedness and Management Framework*	May 2015
April 5–16, 2015	Implementing Risk- Based Supervision *	April 2015
April 13–17, 2015	Risk Assessment and Stress Testing*	May 2015
Feb 14–25, 2016	Follow up on Risk Based Supervision Manual	n.a.
April 3–14, 2016	Implementing Risk Based Supervision	April 2016
Mid-2016–ongoing	Desk review of the Anti-Money Laundering and Countering the Financing of Terrorism legislation and regulations	n.a.
Statistics: The TA efforts have been to implement and align existing statistical compilation and dissemination systems with the latest international statistical standards across three major datasets [government finance statistics (GFS), national accounts (NA), and external sector statistics (ESS)] for economic policy analysis. These efforts culminated with WBG joining the IMF's Special Data Dissemination Standard (SDDS) as a subscriber in April 2012. Further work is needed in improving data consistency in ESS, developing an inter-institutional strategic plan for GFSM2001 implementation, and developing of a set of high-frequency indicators to detect economic trends and risks. In general, the transparency and timeliness of the data produced by the Palestinian Central Bureau of Statistics, Ministry of Finance, and the PMA compare favorably with countries that maintain good data management and dissemination standards.		
Jan. 27–31, 2013	Balance of Payments Statistics – IIP	n.a.
May 18–29, 2014	National Accounts	June 2014
May 21–June 3, 2014	Monetary and Financial Statistics	n.a.
Dec. 7–18, 2014	Price Index	Dec. 2014
Feb. 1–12, 2015	External Sector Statistics	April 2015
Feb. 22–26, 2015	National Accounts	Mar. 2015
April 17–24, 2016	National Accounts	n.a.
Aug. 28–Sept. 1, 2016	National Accounts	Mar. 2017
Mar. 26- April 6, 2017	National Accounts	n.a.
Notes: n.a. – not applicable. * Reports classified as confidential or strictly confidential.		

Annex IV. West Bank and Gaza—Statistical Issues[1]

(As of March 16, 2017)

I. Assessment of Data Adequacy
While data provision in the West Bank and Gaza has some shortcomings, it is broadly adequate for economic analysis and policymaking. Statistics on government finance statistics and the external sector are priority areas for improvement—for the former, the comprehensive and timely reporting of liabilities is an important issue; for the latter, the main issues are inconsistencies between BOP and IIP data, and timeliness of data dissemination.
National Accounts: The Palestinian Central Bureau of Statistics (PCBS) compiles and disseminates annual and quarterly national accounts estimates. The annual estimates were recently rebased to 2010 and there is need to begin work for the next rebase. The authorities have committed to improving both source data and compilation methods. The quarterly GDP estimates need improvement. GDP by production are available only at constant prices (2004). Since 2011, the expenditure components have been calculated at the current and constant prices. The 2013 supply and use tables will be finalized in the near term, providing well organized source data at a more detailed level which can be used to further enhance national accounts estimates.
Price Statistics: The PCBS has compiled and disseminated a consumer price index (CPI) for WBG since January 1996. In January 2014, the weights and index reference period was updated to 2010 using expenditure weights compiled from the 2010 Palestinian Expenditure and Consumption Survey (PECS). In October 2016, the PCBS started its field work on the next PECS, with the support of the World Bank. It is expected to take around one year, with the results becoming available in early 2018. The PCBS has disseminated a producer price index (PPI) since 1997. Current weights are based on data collected in 2013. An updated PPI was released in January 2016. There is need to improve CPI and PPI compilation methods.
Government Finance Statistics: The Ministry of Finance and Planning's (MoFP) Financial Reporting Department compiles data that are broadly aligned with the recommendations of the GFSM 2001. The general government sector is comprised of the budgetary central government, the social security fund and a variety of local government units. The latest annual data reported to the IMF Statistics Department (STA), with reference to 2015, excluded the social security subsector, reducing the usefulness of the data for fiscal analysis. The reported data also lack information on stock positions in financial assets and liabilities. Particular attention is needed to reconcile the stocks and flows of arrears, and to develop an accurate record of public debt on a gross and net basis. The Audit Report on the 2011 consolidated financial statements (published in May 2016) also points to fiscal accounting weaknesses, including the need for more frequent bank reconciliations and establishing a quality control function in the MoFP's Accounting Department. Quarterly and monthly series are disseminated by the authorities (http://www.pmof.ps/en/web/guest/43). The provision of institutional, transaction and balance sheet information needs to be enhanced to fully meet the reporting requirements outlined in *Government Finance Statistics to Strengthen Fiscal Analysis* (February 2010) and the related Board decision on the use of the GFS analytical framework for fiscal analysis.

[1] Prepared by STA and MCD.

Monetary and Financial Statistics: The Palestinian Monetary Authority (PMA) compiles and reports to STA monthly monetary data for the central bank and other depository corporations (ODCs) using the standardized report forms (SRFs). The PMA also compiles SRF-based monetary data for other financial corporations (OFCs) on a quarterly basis, comprising insurance companies only. In general, monetary data for the West Bank and Gaza based on the SRFs are in broad conformity with the recommendations of the *Monetary and Financial Statistics Compilation Guide* (*MFSMCG*), except that the source data for ODCs do not provide complete breakdowns by counterpart sector, i.e. no breakdown for OFCs and extra-budgetary central government units. For this reason, claims on public nonfinancial corporations include some claims on OFCs and extra-budgetary central government units, claims on private sector include some claims on OFCs, and deposits included in broad money also include some deposits of extra-budgetary central government units. These departures from the *MFSMCG* are well noted in the metadata (country notes).
Financial sector surveillance: Following assistance from STA, the PMA reports quarterly FSIs to the Fund, which are published on the IMF's FSI website. The reported FSIs comprise 12 core FSIs, 7 encouraged FSIs for deposit takers, 1 encouraged FSI for other financial corporations (OFCs), and 2 encouraged FSIs for non-financial corporations (NFCs).
External sector statistics: WBG reports quarterly balance of payments (BOP) and international investment position (IIP) in the format of the sixth edition of the *Balance of Payments and International Investment Position Manual* (*BPM6*). However, timeliness needs to be improved (as of March 2017, the latest IIP and BOP data submitted to STA correspond to Q2 2016). There are numerous inconsistencies between the IIP and BOP due to gaps in coverage, misclassifications in both datasets, and inconsistencies in the methodologies employed by the two agencies (PMA and PCBS) for recording related activities. The last BOP statistics mission was conducted in February 2015. WBG also provides monthly International Reserves and Foreign Currency Liquidity data to STA as prescribed by the SDDS and participates in the Coordinated Direct Investment Survey (CDIS) with annual data for the period 2010-2015.

II. Data Standards and Quality	
West Bank and Gaza has been an SDDS subscriber since April 2012.	No data ROSC has taken place in West Bank and Gaza.